Chapter 5

Property Rights Can Solve the "Resource Curse"

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There is a long, paradoxical, and tragic tradition of resource-rich developing countries suffering from prolonged economic stagnation. This "resource curse," so costly in terms of both economic and human development, has its roots in the failed statist economic policies of the past.

Victims of this curse can be found all over the world, from oil- and gas-rich Russia to soybean- and beef-laden Argentina, not to mention most of the Middle East and many countries in Africa. Nigeria, for instance, has received about $600 billion in oil revenue since gaining independence in 1960, yet its economy has shrunk (in terms of purchasing power parity), and its poverty rate has increased from 36 percent to nearly 70 percent. Since Hugo Chávez took power in Venezuela in 1999, close to $100 billion in oil export revenues has flowed into the government's coffers *every* year,[1] yet inflation in Venezuela has never been higher, there are shortages of basic staples, and the murder rate in Caracas is one of the highest in the world.

Other resource-rich nations, such as Canada, Chile, and Norway, have avoided this fate. How? They did it by adopting a strong system of private-property protections within a market-based democracy, protected by government institutions dedicated to transparent rule of law. The key is to create a government large enough to guarantee property rights but small enough not to threaten them.

The "resource curse" results when massive streams of revenues from resources are forced through the economic choke point of a statist government with its multiple opportunities for corruption by government officials, heavy and job-killing taxation, and overall excessive interference in the economy by those who consistently favor big-government solutions to every problem. Recent efforts by development assistance experts to promote "conditional cash transfers"[2] as a solution are merely attempts to push another statist approach in disguise.

The cure for this economic and political disease is the adoption of the core principles of economic freedom: limited government, decentralization of power, privatization of ownership of mineral resources, and protection of all privately held property. The 17th-century English philosopher and Father of the Enlightenment John Locke famously observed that the most basic form of property, after one's own body, is the fruit of one's labor.[3] Locke's breakthrough revelation in 1690 in his *Second Treatise* was that those fruits themselves are the property of each person. The exchange of goods and services throughout communities benefits all parties to a transaction if all of the participants in the market are, in Milton Friedman's words, "free to choose."

PRIVATE PROPERTY: ENGINE OF GROWTH IN THREE STEPS

Economists from Adam Smith to Milton Friedman have noted the crucial role played by property rights as the engine of economic growth, upon which the equally important development of a middle class depends.[4] Establishing those property rights is step one.

Step two is creating and maintaining rule of law. Transparent judicial systems are vital for the protection of property rights—not just for the wealthy and powerful, but also for average citizens. Their incentive to work hard and save for the future depends on whether they have confidence in the political and economic system and believe that it will protect their earnings and possessions. The rights to acquire, keep, and dispose of property must be protected so that it is available to provide a better life for their families.

However, defenders of private property rights within a system of "ordered liberty," from Edmund Burke[5] to the American Founders[6] and many others, knew that humans and the markets they create, though inherently imperfect, are vital for the efficient functioning of an economy. Step three, therefore, is the ongoing requirement that all citizens and market participants be informed by a moral code, exercise self-restraint, and be governed by laws that are derived from that moral code. In other words, they must avoid corruption.

The American Founders generally believed that a strong system based on values that enshrined and protected the right to acquire, hold, and dispose of private property would create diffuse sources of wealth and political/economic checks and balances. This system was, and remains, the best antidote not only to the tyranny that lies at the heart of statist and totalitarian worldviews, but also to the vicissitudes, moral hazard, and even good intentions of politicians and bureaucrats in regulated market-based systems. It is also the best system by which to counter the negative effects of the resource curse.

THE RESOURCE CURSE: ITS HISTORY AND RELEVANCE TODAY

Although early literature on the resource curse led to the counterintuitive conclusion that an abundance of natural resources leads to economic stagnation, later work has shown that, like other inputs for growth, institutional strength plays a large (almost completely dominant) role in how natural resource abundance affects growth.

Early work by economists on the resource curse noted that countries like Nigeria, Zambia, Sierra Leone, Angola, Saudi Arabia, and Venezuela all possessed vast quantities of natural resources yet suffered from severe stagnation. On the other hand, the "Asian tigers" possessed few natural resources and experienced powerful growth. Since, intuitively, the opposite should have been true, the resource curse became a popular topic of research and discussion among growth economists. A number of explanations were offered as to how and why resource abundance seemed to be such a curse.

Development economists Jeffrey Sachs and Andrew Warner provided the most comprehensive look at the resource curse in 1997 and came to the gloomy conclusion that natural resource abundance inevitably led to stagnation.[7] Their study of 97 countries over a 19-year period suggested that resource-rich countries grew slower on average than resource-poor countries even after controlling for a wide variety of other factors commonly thought to influence development.

Sachs and Warner leaned toward the "Dutch Disease" explanation of the economic stagnation. Dutch Disease refers to two effects that the discovery of natural resources is thought to have: an appreciation of the nation's exchange rate, which results from increased exports, and the tendency for labor and other resources to be drawn away from other sectors of the economy and toward the industry surrounding the new resource.[8]

However, later research challenged the notion that the causal chain was so simple. Norwegian economists Halvor Mehlum, Karl Moene, and Ragnor Torvik, for instance, argued that institutional strength plays the true defining role in how countries grow.[9] Their resistance to the simple resource curse thesis results from a number of striking exceptions: countries that, with great amounts of natural resources, also experience stronger than average growth. Analysis of data and studies about Botswana, Norway, Chile, and Canada indicate that other factors beyond mere possession of resources determine the prospects for countries that find themselves blessed (or cursed) with oil or mineral riches.

Mehlum and his colleagues approach the resource curse as a problem of rent-seeking. According to their research, the institutions dictate how resources within a country are spent. Their model breaks down the entrepreneurs in an economy into two groups: "grabbers," who spend their resources trying to skim off as much monopoly rent from the natural resources as possible, and "producers," who spend their time and effort using the resources to create and produce additional wealth. It is a country's institutions that determine whether an economy will be "grabber" heavy or "producer" heavy, and the fate of an economy therefore depends upon the types of incentives those institutions create.

INSTITUTIONS MATTER

Natural-resource abundance, its discovery and profitable exploitation, is neither an automatic blessing nor an inescapable death sentence for a nation's economy. Institutions matter. Yet developing countries need more than a simple reminder to improve property rights, reduce corruption, and minimize political rent-seeking. They must recognize the unique potential for nations to shape their future when abundant natural resources become available. Natural-resource abundance has the effect of reinforcing both good and bad institutions and can truly change the economic fortunes of a nation for better or worse.

In a country with weak institutions, potential payoffs for rent-seeking behavior are increased, allowing rulers to pay off rivals, increase income inequality, and discourage productive entrepreneurship. For countries with strong institutions, incentives are put into place that increase global competitiveness, encourage foreign investment, and raise the standard of living, all of which contribute to more economic and political freedom. Good governance and a healthy, well-functioning market-based economy can be mutually reinforcing.

The impact of free markets and the institutions (both public and private) that accompany them have an unambiguously positive impact on growth, as well as on other measures of well-being that are of concern to the international community.[10] Institutions, then, play the determinant role in the causation of wealth or poverty. Recent research has shown that once institutional measurements are included and countries are separated roughly into those with weak and strong institutions, the correlation between large endowments of natural resources and growth rates becomes markedly different.

Countries with large endowments of natural resources and bad institutions almost universally have poor growth rates. Good institutions, on the other hand, make the negative impact of natural resources almost nonexistent. Some countries, like those discussed below, clearly demonstrate that, when paired with the right institutions, natural-resource abundance can change a country's fortunes for the better. The lesson to be learned is that in many cases, institutions that promote private property and that favor producers over grabbers can trump other factors that might otherwise hinder growth.

THE RESOURCE CURSE: CASE STUDIES IN FAILURE

The following four countries score poorly both in the protection of property rights and in freedom from corruption.

Nigeria. According to a 2010 study by Nigerian political scientist Segun Oshewolo, the

The Connection Between Commodity Exports, Property Rights, and Corruption

The table at right lists 51 developing countries. Generally speaking, nations with high levels of resource exports tend to have worse scores in property rights and corruption.

Country	Combined Resource Exports as Percentage of Merchandise Exports	*2013 Index of Economic Freedom* Property Rights Score	Transparency International Corruption Perceptions Index 2011
Algeria	97.79	30	2.9
Angola	99.69	15	2.0
Australia	47.17	90	8.8
Azerbaijan	78.16	25	2.4
Bahrain	92.76	55	5.1
Barbados	32.0	80	7.8
Belarus	35.16	20	2.4
Bhutan	45.05	60	5.7
Bolivia	66.07	10	2.8
Cameroon	55.18	30	2.5
Cape Verde	48.61	70	5.5
Chile	58.03	90	7.2
Colombia	41.82	50	3.4
Cuba	40.59	10	4.2
Dem. Rep Congo	53.11	10	2.0
Ecuador	58.84	20	2.7
Egypt	46.8	35	2.9
Gabon	81.69	40	3.0
Guinea	71.7	20	2.1
Indonesia	36.0	30	3.0
Iran	83.77	10	2.7
Iraq	35.27	n/a	1.8
Kazakhstan	79.39	35	2.7
Kuwait	92.58	50	4.6
Laos	75.96	15	2.2
Liberia	64.88	30	3.2
Libya	92.63	10	2.0
Mauritania	45.96	25	2.4
Mongolia	63.36	30	2.7
Mozambique	73.16	30	2.7
Niger	56.53	30	2.5
Nigeria	97.93	30	2.4
Norway	73.87	90	9.0
Oman	86.63	50	4.8
Papua New Guinea	71.1	20	2.2
Peru	60.08	40	3.4
Qatar	83.82	70	7.2
Rep. Congo	87.97	10	2.2
Russia	55.8	25	2.4
Rwanda	30.06	30	5.0
Saudi Arabia	89.57	40	4.4
Seychelles	36.42	50	4.8
South Africa	32.79	50	4.1
Sudan	87.72	n/a	1.6
Syria	68.69	20	2.6
Tajikistan	69.67	20	2.3
Trinidad and Tobago	70.62	50	3.2
United Arab Emirates	71.88	55	6.8
Venezuela	90.79	5	1.9
Yemen	91.67	30	2.1
Zambia	72.62	30	3.2

Sources: Resource exports: NationMaster.com, http://www.nationmaster.com/index.php (accessed July 12, 2012); Terry Miller, Kim R. Holmes, and Edwin J. Feulner, *2013 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2013), http://www.heritage.org/index; Transparency International, *Corruption Perceptions Index*, 2011, http://www.transparency.org/cpi2011/results (accessed November 16, 2012).

Table 1 heritage.org

poverty rate in Nigeria has risen from about 15 percent of the population at the time of its independence in 1960 to more than 30 percent (as measured by the United Nations Human Development Index) in 2010.[11] Yet Michael Watts of the University of California, Berkeley, estimates that in roughly the same time period, Nigeria earned more than $600 billion in oil revenue.[12] Much of the increase in poverty occurred after the first of the oil booms in the 1970s and provided one of the most striking indicators that natural-resource abundance does not, on its own, lead to growth.

Zimbabwe. Zimbabwe is probably the most compelling recent example of the impact of instability on growth potential. Under the long misrule of Robert Mugabe, corrupt government institutions have allowed Zimbabwe's considerable natural and human resources to be squandered. Property rights that protect economic investment are nearly nonexistent, and corruption runs rampant. The result has been high unemployment and years of hyperinflation. Despite having one of Africa's best-educated populations and large shares of natural resources, Zimbabwe remains one of the world's poorest countries. The ability of the government to arbitrarily seize foreign and private assets has caused investment in Zimbabwe's potentially lucrative natural resources to diminish significantly.

Bolivia. Bolivia is a classic example of the resource curse. Throughout its history, its economy has been characterized by dependence on exports of just a few commodities. Bolivia currently is a large producer of hydrocarbons (especially natural gas). Political instability and changes in national policy regarding property rights and privatization have harmed Bolivian growth over the past 20 years. Most recently, under President Evo Morales, state ownership of economic resources has increased significantly, and foreign investment has been explicitly rejected.

It is estimated that Bolivia possesses 5.4 million tons of lithium—the largest amount of any country in the world. Yet it continues to have poorly protected property rights and high levels of corruption, and economic growth remains slow. It has been observed that the lack of diversification in Bolivia has long been an impediment to growth.

That lack of diversification is a direct function of a lack of property rights. Entrepreneurs have no guarantee that they will benefit from innovation, so incentives for creating new products or even industries are low. Property rights thus play a central role in motivating growth and promoting the realization of new business opportunities. With poor protection of property rights, significant impediments to entrepreneurship, restrictions on investment, and extensive and increasing corruption, Bolivia's economy remains at the mercy of fluctuations in the demand for a few goods.

Venezuela. The case of Venezuela since 1999, when Hugo Chávez was elected president, offers one more poignant example of the damage that results from institutions and regimes that are hostile to private property and the rule of law. Despite large increases in oil prices since Chávez took power, the Venezuelan economy has experienced a decline in sustainable development. The economy is especially susceptible to movements in world oil prices, and as prices have recently dropped, Venezuela's economy has likewise shrunk.

Oil is the primary good of the Venezuelan economy, making up about 30 percent of GDP, over half of government revenues, and about 95 percent of exports. Venezuelan crude is highly sulphuric and costs more to refine, which translates into lower prices per barrel than for "lighter, cleaner" crudes. Nevertheless, between the early 2000s and 2008, the world price for crude oil roughly tripled, and Venezuela experienced strong economic growth. The economy has been hit especially hard over the years since then, and the price per barrel of oil has dropped. While other countries have begun to recover, Venezuela's economy remains sluggish.

Lack of incentives to innovate, based on low rankings for private property, the influence of redistribution, and rampant corruption, have prevented Venezuela from diversifying its output even as oil revenues have performed poorly.

AVOIDING THE RESOURCE CURSE

The following three countries have scores on property rights and freedom from corruption that are significantly above average.

Chile. Chile is a powerful example of a country that has entirely avoided the resource curse; it is blessed with substantial natural resources and has the highest GDP per capita in the region. Copper has long been an important source of income and Chile's primary export, and although its share of GDP has declined steadily since the 1980s, it still accounts for a large proportion of exports and government income. Reliance on mining and other natural resources, however, has not proven to be an impediment to growth.

In fact, Chile stands out among South American countries not for any substantial differences in resource availability, but rather because of its commitment to private property rights and economic freedoms. Businesses have incentives to grow and diversify because entrepreneurs and investors know that they will reap the benefits of their risks.

Coupled with a strong commitment to trade liberalization, Chile's pro–free market policies have spurred the rapid expansion of international trade, especially in agriculture. Wine, salmon, and fruit are particularly strong exports, despite the fact that a relatively small percentage of the population is devoted to these industries. The result of pro-investment and pro-business policy in Chile has been a robust economy that grew roughly 5 percent in 2010 despite suffering a debilitating earthquake in February of that year.

Botswana. Botswana is possibly the most striking counter-example to the resource curse thesis. With almost 40 percent of GDP coming from gem mining (mainly diamonds), a proportion which actually increased during a period of strong economic growth, Botswana would seem to be especially vulnerable to the curse of abundant natural resources. The phenomenon of increased reliance on a single natural resource during periods of growth, as witnessed in Venezuela, can easily lead a country to dependence on that product. Without proper political restraint and the rule of law, a single-good economy can lose its flexibility and become tied to the fate of that one good. Botswana, however, has not gone the way of Venezuela and has grown steadily at an average rate of around 10 percent for decades since its independence in 1966.

Botswana maintains constitutional protections against the nationalization of property. This, combined with policies friendly to entrepreneurship and light regulation of the labor market, has allowed the business sector to flourish. Botswana has one of the lowest unemployment rates in the region and ranks second in the region for business freedom.

As more private citizens become participants in the formal market, Botswana's economic growth has a positive impact for the entire country. With revenues from diamonds expected to level off in coming decades and the country in need of growth beyond commodity-based growth, business freedoms have led to a growing tourism sector (now roughly 12 percent of GDP).

Norway. For many decades, oil, gas, and other natural resources have played a key role in Norway's economy. Yet rather than seeing their resource wealth squandered by a corrupt ruling elite, Norwegians live in one of the wealthiest countries in the world, with an economy protected by a strong rule of law. Norway also displays a high protection of property rights, similar to other countries in the developed world, and is a good example of how natural-resource abundance can be a blessing when accompanied by strong public and private institutions.

Despite being widely considered a welfare state, with low rankings in the *Index of Economic Freedom* for both government spending and labor freedom, Norway ranks high on protection of private property rights. It has sound and stable institutions and scores well above the global average in the *Index* as a whole. As a result, Norway has the fourth-highest GDP per capita in the world—far from a curse!

CONCLUSION

Natural resources are not the ultimate determinant of growth, but they do play an important role in moving a country more quickly in the direction in which their institutions are guiding them. Bad institutions can lead a country into turmoil, and when abundant resources are made available to a corrupt regime, the situation can become worse. Likewise, good institutions can help a nation make the most of its natural endowments.

The institutions put in place by the leaders of any country shape the incentives for their citizens and determine whether they end up looking like Chile and Botswana or Bolivia and Nigeria. Private property rights encourage investment, entrepreneurship, and innovation; protection against corruption discourages rent-seeking and helps to guide resources to productive use. The resource curse is the unfortunate result of bad institutions making the worst of great potential, and the only way to cure it is to focus on improving policy at the top of the institutional structure.

Endnotes

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