IGC
International Growth Centre

Authors

Paul Collier
Professor of Economics
University of Oxford

Published on: 10 Dec 2013

Countries: Ghana, Tanzania, Uganda

Research themes: State

One budget number every African citizen will need to know

The past decade of high resource prices triggered discoveries in most African countries, including Uganda. As these newly discovered resources are extracted, governments that are accustomed to managing acute revenue scarcity are finding themselves with large but unsustainable revenues.

The revenues are unsustainable partly because the existing discoveries will be exhausted. While there is always a chance that more will keep being discovered right through the century, there are strong reasons to be cautious. For example, the world has already discovered far more carbon fuel than it can possibly burn without catastrophically overheating the planet, so it is likely that within a generation there will be strict controls on extraction, making many of these carbon assets worthless. Further, technical progress makes some natural resources obsolete: the big resource of the 19th century was nitrates, but technical progress has slashed their value.

Large, but unsustainable resource revenues constitute the most important opportunity to finance transformation that Africa has experienced. In new research, Tony Venables and I analyse how these revenues should be managed for the future (Collier and Venables 2013). While this question is of fundamental importance, it has not been politically salient. It is raised by neither resource extraction companies, nor impatient electorates. Nor, until very recently, have the available policy models been appropriate for poor countries. The IMF long advocated a ‘bird-in-hand’ rule, in which all resource revenues should be saved abroad with the only extra spending being the interest earned on the accumulated money. This rule might appear to be prudent, but it was not. While it wildly exaggerated the riskiness of future resource revenues, it ignored the much more evident risks that are the consequences of under-investment in the domestic economy. Similarly, the influential Norwegian model of an overseas sovereign wealth fund for future generations, while sensible for a capital-rich country like Norway, would be seriously inappropriate for the capital-scarce economies of Africa.

Venables and I focus on the broad aggregates of public investment and consumption. Our key results are as follows.

- First, savings out of revenues from depleting natural resources should be substantially higher than out of sustainable tax revenues. This follows straightforwardly from the brute fact that revenues from depleting a non-renewable natural asset are unsustainable. Between independence and the turn of the

millennium, known copper resources in Zambia were exhausted, but the revenues were used for consumption not assets. As a Zambian official said to me at the time, 'what will our children say about us?' Zambia has been fortunate: the boom in copper prices stimulated new discoveries and investment, and so the society has a second chance.

- Our second result is that in poor but rapidly growing economies, such as Uganda, while the appropriate savings rate out of resource revenues is high, it is much lower than 100%. This is important because the simple former IMF policy rule, which recommended a 100% savings rate, was derived from the permanent income hypothesis (PIH) which abstracts from growth. In a poor country it is sensible to use some of the revenues to meet consumption needs now; after all, the future will be better off than the present. Whereas in the stationary economy posited by the PIH all resource revenues are permanently added to assets, in a rapidly growing economy the role of unsustainable revenues is to speed the journey to prosperity. Hence, in the PIH model consumption is permanently higher – even in the 22nd century – whereas in a country such as Uganda, oil revenues should be invested to raise incomes in the coming decades, leaving 22nd century consumption unaltered. So, a savings rate of around 50% may be more appropriate than one of 100%.
- Our third result is that over a very wide class of circumstances, the savings rate should rise over the course of depletion. For example, it might start at a relatively modest rate such as 30%, but approach 100% by the time of exhaustion. Ghana has recently legislated a 30% savings rate out of oil and this is a sensible place to start, but it is a base for gradual increases in the savings rate rather than a rule for the entire future course of oil extraction. The rising savings rate rule is a rare case of economically appropriate also being politically easiest, so it is unfortunate that it has not yet been adequately incorporated into international policy advice.
- Our fourth result is that the thrust of asset accumulation should be domestic investment rather than foreign financial assets. A corollary is that there is an urgent need to build the capacity to manage domestic investment well. The IMF has a useful new index, the Public Investment Management Index, which enables governments to benchmark their initial capacity. Foreign assets do have a role to play, but for temporary savings: during years of peak prices, some savings should be parked abroad so as to smooth expenditures between peaks and troughs, and in the first few years following a discovery some revenues should be parked abroad until domestic investment capacity has been built.
- Our final result concerns rules and institutions. Whereas the new importance of natural resources has lengthened the horizon appropriate for economic policy, the spread of electoral democracy has shortened the horizon that governments find pertinent. The long horizons required for savings and investment can only be reconciled with electoral democracy through distinctive policy rules and implementing institutions. In turn, these must rest on public support.

The vital economic choice for resource-rich African countries is the proportion of resource revenues they devote to asset accumulation. This number, which should be public knowledge in all resource-rich societies, it is not even generated by conventional budget accounting. Recasting budgets so as to make this critical choice politically salient is an urgent matter.

Further reading

Collier, P and A Venables (2013), "Resource Revenue Management in Developing Countries: Economic Principles and Policy Rules", forthcoming IMF Working Paper.

The image used on the homepage for this column is © Kigali Wire, reproduced under the creative commons licence.