

Public Policy Resources

IP3's Public-Policy Information Series – April 2006

Avoiding the Curse of Oil: Strategies to Improve Governance and Finance Social Investment in Sub-Saharan Africa

Matthew Hensley

About the Author...

Matthew Hensley is the President and co-Founder of the Institute for Public-Private Partnerships (IP3), and an economist specializing in private sector participation in public service provision. In addition to his PSP work, Mr. Hensley is the architect of several landmark environmental infrastructure financial innovations, designed to promote and guarantee investment in infrastructure.

Abstract

Oil revenues do not necessarily equal national wealth, as corruption and poor governance have caused many oil rich countries (emerging market and developed countries alike), to squander their economic potential. This article is drawn from an IP3 working paper slated for publication in late 2006 that will propose innovative governance tools to assist oil rich countries to leverage oil revenues more efficiently and effectively. Author **Matthew Hensley** examines the root causes of the 'oil curse' and highlights examples of African and European countries that have taken steps to avoid it.

Introduction

Oil is currently \$65 a barrel. Many analysts, this author included, expect the spot and forward price of oil to soar to as high as \$150 or more in the not so distant future. While high and higher oil prices have a significant impact on the global economy in general, and high net importing countries and oil dependent users in particular, higher prices should translate into a windfall for oil producing economies including several in emerging markets including sub-Saharan Africa. However, the benefits of oil revenues have not, and may not in the future, be captured and utilized to the fullest potential for several of these countries. In emerging market countries and developed countries alike, a common lack of capacity and governance represents a tragic missed opportunity for equity and development that has to be addressed.

For many oil-producing countries in emerging markets, petroleum revenues make up a significant percentage of economic output, GDP, national and local budgets and foreign exchange earnings and reserves. However, due to a number of "governance" issues, the management and stewardship of petroleum revenues and wealth has been woefully inadequate. In fact, some experts estimate that in certain countries, between 30-50% of oil revenues have been diverted into other hands, "siphoned" off by corrupt individuals, corporations or bureaucracies, or simply squandered on inefficient and inappropriate spending or financing of projects. This situation is even more egregious when one considers the recent windfalls of oil revenues based on higher world prices and the urgent need for oil revenues to finance social and economic development in once very poor countries.

As Table 1 indicates, the fact that per capita income is barely increasing in most oil producing sub-Saharan countries while oil revenues and earnings are soaring at a dramatic pace, tells us that

something is desperately wrong. However, many sub-Saharan African countries have a chance, and some are beginning to examine strategies aimed at managing petroleum revenues more transparently and effectively in order to capture the benefits of petroleum wealth for current and future generations. Some such as Sao Tome, Angola, Gabon, and Guinea are trying to establish mechanisms that not only manage petroleum wealth as a means of economic governance and stewardship, efforts that can not only lead to greater management and efficiency, but also are looking at means to directly or indirectly finance essential social and economic infrastructure.

Table 1 – African Oil Reserves and Production

Country	Proved	Production	GNI Per
	Reserves		Capita
	End 2004	2004	Income
	Thousand Million Barrels	Thousand Barrels Daily	2004
			US Dollars
Algeria	9.2	1,563	\$2,280
Angola	5.4	731	\$1,030
Cameroon	0.4	80	\$800
Rep. Of Congo (Brazzaville)	1.5	271	\$770
Egypt	2.9	758	\$1,310
Equatorial Guinea	*	181	\$700
Gabon	2.5	301	\$3,940
Libya	29.5	1,425	N/A
Nigeria	24.0	2,184	\$390
Tunisia	0.3	73	\$2,630
Other Africa	0.9	284	
Total Africa	76.7	7,814	
Percent of World Total	7.3%	10.3%	
* Included in "Other Africa"			
Source: <i>Statistical Review of World Energy 2002</i> (BP plc, 2002), <i>World Bank Data & Statistics 2005</i>			

Some are initiating concepts that feature public-private partnerships (PPP's); approaches whereby "Petroleum Revenue Funds" are established to ring fence and professionally manage petroleum revenues, professionally account for and invest funds in earmarked projects or sectors of priority, and to reduce corruption and waste so that national revenue from petroleum is contributing to national savings, income growth, and overall economic development. These efforts should be accelerated throughout Africa and donors, oil corporations, and civil society should all work together to design and implement such arrangements for mutual beneficial reasons. Oil is a finite resource. But the returns from prudent investment today can be long lasting.

Can Sub-Saharan Africa Avoid the Curse of Oil?

Over the last decade, offshore discoveries of oil off the west and southern coast of Africa has yielded one of the most promising oil finds in the world. 6-10 countries are by now established oil producers and some are already producing at record levels. With output of more than 4M barrels per day, Sub Saharan Africa already produces as much oil as Iran, Venezuela, and Mexico combined. Output has increased by 40% in last the last 8 years compared with 15% for the rest of the world. Africa is emerging as a potential huge source of oil while the rest of the world's more

mature fields in the US, Mid-East, and Asia are in decline. Sudan, which only started exporting five years ago now, produces more than some OPEC states. Nigeria is producing over 3M barrels per day, and Angola may eclipse all producers in the region and become one of the most prolific oil economies in the world. More importantly, several small states in the Gulf of Guinea, sit on reserves estimated at over 25 Billion Barrels. Equatorial Guinea, for example, is poised to become Africa's third largest producer with close to 1 Million barrels per day. With a population of just over 500,000 citizens, it could be one of the richest countries of the world, but without governance of petroleum revenue, it will not.

The Oil Curse, just like the Dutch Disease¹, stems from the historic record of countries with prolific extractive industries unable or willing to take advantage of those resources in a sustainable manner. The experience of most countries that have received large, unexpected income from natural resources is not positive. As Sachs and Warren state in "The Curse of Natural Resources", "countries with large income from natural resources have generally recorded weaker economic growth from comparable countries due to mismanagement, corruption, capacity, and a lack of vision for governing sustainably. Table 1 above already indicates there is a mismatch between barrels produced and exported, and reflows into the economy as illustrated by low GDP and per capital income. Even with a preliminary assessment, one can see that windfall gains in oil revenue are not translating into neither per capital income or in social investment.

However, there are models to change that. There can be a way to manage petroleum revenue, re-invest in the sector, finance social investment, manage the sector sustainably and maintain sovereignty. The experience of Norway provides a useful lesson.

Petroleum Revenue Funds: From Norway to Sub-Saharan Africa

Social Needs or Investment Funds have been in operation in many countries since the early 1980's. Initially conceived by Norway, Mexico, and other petroleum exporting countries, the concept of "ring-fencing" revenues and setting up a dedicated fund to nurture investments and technical assistance in high priority sectors is still being fine tuned. There are various models of Social Needs Funds ranging from the "Petroleum Revenue Management Fund" where revenues are professionally managed for capital appreciation and a percentage is dedicated to social investments (such as in Azerbaijan, Mexico, and Kazakhstan, to "Social Funds" where revenues are ring fenced and channeled directly to social needs projects in the form of grants and technical assistance (as in Egypt, Bolivia, etc.) In all cases, the benefits of such funds can only be realized if at the design stage; some critical approaches are followed including:

- Governance systems need to be in place that separate conflicts of interest between fund management and beneficiaries
- Fund Management should be representative and include private sector and stakeholder participation if possible
- Clear rules and regulations on fund operations should be in place prior to disbursements
- Independent auditing of activities should be required and procurement practices should reflect international standards

¹ The term "Dutch Disease" refers to the deindustrialization of a nation's economy that occurs when the discovery of a natural resource raises the value of that nation's currency, making manufactured goods less competitive with other nations, increasing imports and decreasing exports. The term originated in Holland after the discovery of North Sea gas. Source: www.investorwords.com

- Guidelines on eligibility of project should be established to ensure funds are allocated to priority projects and pass a certain screening criteria
- Conditions should be built into the design to achieve certain social objectives such as capacity building programs, development of local consultants, diversification of resource allocations, and financial sustainability
- Lastly, “sunset provisions” should be in place but options for a transition strategy should be in place early.

The Lessons of Norway: Governance and Petroleum

The oil age in Norway began in the 1970’s and will likely last many years in the future. A key part of its success was in establishing the Petroleum Fund once it was recognized that oil was part of national wealth and could not afford to be squandered by the state or by individuals. In 1990, Norway established a transparent system for managing petroleum revenues. All the revenues are transferred directly into a foreign currency fund that is professionally managed. The Norwegian parliament must adopt a resolution on any use of the fund beyond asset management. The Fund is strictly off limits to special interests or spending. After years of accumulating surpluses through prudent management and investment, the Petroleum Fund is now one of the world’s largest institutional investors. Norges Bank has managed the fund on behalf of the Ministry of Finance and results are published openly. The Fund invests not only in Norway, but internationally as well. This allows for diversity and greater risk management.

Now that the Fund has accumulated surpluses, and can be used as a hedge for fiscal management in the event of downward oil prices, it is essentially a long-term savings tool for all Norwegian citizens. The Fund is now aimed at covering, if needed, the financing gaps in the pension system. The success of the fund allows Norway to cover the increases in pension benefits as well as continue to invest in long-term assets, even if oil supplies dwindle over time.

Based on the success of Norway and others, some African countries have sought to design Petroleum Revenue Funds based on their own economic and social characteristics. Some of these funds focus on accountability, some on social investments, others on transparently segregating revenues so that efficiency gains can be realized. One of the latest efforts to establish a system that had multiple objectives was in Chad. With the assistance of the World Bank, the Chadian government agreed to a format where a fund would be created and managed to benefit the poor. Once cited as a model, the progressive fund design was recently undermined by the Government thus resulting in a cancellation of the World Bank financing for the sector. While this is a setback in promoting good governance, the design components of the Fund are useful to examine.

Elements of the Proposed Chad Fund: A Missed Opportunity?

Chad’s proposed petroleum revenue management system established a legal and institutional framework for managing revenues from Chad’s three Doba fields. Some of the features of the system included:

- All direct revenues, royalties and dividend, are paid by the ExxonMobil consortium into a Chadian government controlled escrow account at Citibank in London
- Indirect revenues, income taxes on the oil companies, and customs duties, are paid directly into Chad’s Treasury

- After debt payment to the World Bank and other debtors are withdrawn from the Citibank account, the remaining direct revenues are allocated as follows:
 - 10% into a Future Generations Fund to save for the post-oil era in Chad
 - 72% to finance capital investments in priority sectors to fight poverty including health, education, social services, rural development and sanitation,
 - 4.5% to the oil-producing region in Southern Chad as earmarked funding
 - 13.5% to Chad's treasury for discretionary spending until 2007, afterwards will be divided into priority sectors
- A joint government civil society Petroleum Oversight Committee will be established to approve or reject specific projects financed by direct oil revenues.

While innovative, this proposed system did not address the issue of financing the sustainability of the sector nor having applications to the entire oil sector as a whole not just limited to the three large fields. Since the government attempted to revise the draft law establishing the system, the World Bank has postponed the financing of the proposed Chad-Cameroon pipeline project highlighting the sensitivity of this issue in general, and establishing accountability while maintaining sovereignty in particular. Nevertheless, this and other examples do point out the importance of "ring-fencing" revenues so that governance can be improved and the financing of social investment and professional management of oil wealth can be realized.

In addition to their accountability and investment functions, the design of such funds can also include components that improve the environment for financing social investments in low-income countries. If funds also included mechanisms to promote public-private partnerships, these Funds could be used to co-finance or co-guaranty private finance for public purpose projects.

Public-Private Partnerships as a Credit Enhancement Tool: Leveraging the Private Sector into Social Investment

In addition to the accountability and governance features of such funds, one could see how these funds could be structured to also feature a financing tool. By establishing a percentage of such funds, say 10-20% to not only be dedicated to financing social investments, but to be utilized as a credit enhancement tool, tremendous leverage could be gained. For example, if such funds earmarked say 10% of their reserves to be used as a subordinated debt or guaranty facility for private financed projects, both local and foreign investors could be attracted to finance investments in sectors that heretofore would not have been financially viable. The use of such PPP or credit enhancement strategies could extend the long term availability of finance, both debt and equity, and make the Petroleum Revenue Management concept not just a financier and trustee of oil wealth and assets, but could be a catalyst for greater efficiency of capital, private sector development, and socially responsible investment in countries desperate for governance, capital, and social equity. Hopefully, in the future, new Petroleum Revenue Management Funds will look to the leveraging power and efficiency dimensions of Public-Private Partnerships (PPP) as a governance tool.

Copyright ©2006 Institute for Public-Private Partnerships, Inc. All rights reserved