

# The political economy of transition in resource-based economies

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## **Abstract**

The 15 newly independent states that emerged from the breakdown of the Soviet Union are now celebrating their 10th anniversary of independence. This paper looks back over the first decade and draws some lessons from the experience made to date. It focuses on the energy-rich states of the Commonwealth of Independent States (CIS), namely Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan (AKTU for short) and contrasts their development to that in the resource-poor countries at the CIS periphery. The main argument of the paper is that far from being a blessing that would have allowed resource-rich countries to cushion the impact of reforms and thus make faster progress, resource rents have often been wasted or appropriated by the ruling elites. Progress in key structural reforms has in some cases lagged even behind other CIS countries and significant policy challenges need to be addressed if natural resource wealth is not to turn into a curse for the region.

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## INTRODUCTION

The 15 independent states that emerged from the breakdown of the Soviet Union are now celebrating their 10th anniversary of independence. This paper looks back over the first decade and draws some lessons from the experience made to date. It focuses on the energy-rich CIS states, namely Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan (AKTU for short)<sup>1</sup> and contrasts their development to that in the resource-poor countries at the CIS periphery. While agricultural land, minerals and hydrocarbon reserves are all part of a country's resource endowment, we focus on the availability of energy resources as the key differentiating factor in explaining transition paths in the CIS. This is because energy resources have tended to generate far larger resource rents than minerals or agriculture. Resource rents are here understood to be pure profits generated by the extraction of natural resources, once all factors of production have been remunerated and the costs of transport to market has been subtracted.

The main argument of the paper is that far from being a blessing that would have allowed resource-rich countries to cushion the impact of reforms and thus make faster progress, resource rents have often been wasted or appropriated by the ruling elites. Progress in key structural reforms has in some cases lagged behind even that in other CIS countries and significant policy challenges need to be addressed if natural resource wealth is not to turn into a lasting curse for the region.

The attempt to find a common explanation for the transition patterns observed across the resource-rich countries immediately faces the problem that along certain dimensions these patterns have differed quite dramatically between say Kazakhstan on the one hand and Turkmenistan on the other (Gürgen et al., 1999; Kalyuzhnova et al., 2001). However, we propose a political economy explanation that can account for these differences, while at the same time pointing towards key common challenges for all resource-rich transition economies.

At the centre of our argument is the idea that the presence of natural resource wealth reduced the incentives to reform, as reforms would have limited the opportunities for direct rent appropriation. Moreover, it allowed incumbent elites to remain in power and shut out reformers. This was the case in Turkmenistan and Uzbekistan. Where natural resources were not yet sufficiently developed – as in Azerbaijan and Kazakhstan – and the country depended on outside investment, an initial phase of liberalisation was succeeded by a phase of increasing national assertiveness. What all four countries have in common today are political structures centred on an authoritarian presidential administration and economic structures making entry and entrepreneurship very difficult. Resource rents provide the backbone of this reform-hostile political-economic “oligopoly”.

This paper does not consider Russia and the other CIS countries. Yet, the argument is easily extended to a characterisation of these countries' transition patterns as well. In Russia, the control over the country's natural resource wealth has been a key aspect of the political struggle between reformers and the old guard. In the early 1990s reformers believed that by transferring resource wealth into the hands of the oligarchs (in the loans-for-shares scheme) they could salvage Yeltsin's “reformist” presidency. They soon found, however, that reforms were blocked by these same oligarchs' efforts to safeguard their resource rents. In the resource-poor CIS countries, the absence of resource rents meant that incumbent elites were

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<sup>1</sup> We choose the slightly awkward acronym AKTU rather than the geographical label “Caspian”, since Uzbekistan does not actually lie on the Caspian Sea.

more likely to be replaced at the start of transition. The new governments typically had only two ready sources of potential revenues: IFI transfers or the continuation of implicit transfers from Russia. IFI transfers were conditional on adopting reform; transfers from Russia were not. Most of the CIS periphery adopted IFI-supported reform programmes. Belarus and to a lesser extent Ukraine, however, obtained energy transfers from Russia and consequently reformed less.

The arguments in this paper are related to the large literature investigating the impact of natural resources on economic performance (Sachs and Warner, 1995; Tornell and Lane, 1999; Gylfason, 2001; Auty and Mikesell, 1998). This literature generally finds that countries rich in natural resources have tended to grow less rapidly and experience higher macroeconomic instability than resource-poor countries. Most relevant to the present paper, Dalmazzo and de Blasio (2001) develop a model in which reform leads simultaneously to a reduction in rent appropriation by the elites and an expansion of private business opportunities. The results are that natural resource abundance reduces the incentives to reform and hurts growth. The combination of self-interested autocratic rule and access to resource rents is what drives the political economy of reform in this model, in line with the argument we outlined above. Political competition leading to more “voice” in decision making by interest groups not associated with the elites can help to bring about liberalisation.

The structure of the paper is as follows. Section 1 provides an overview of reform progress in the resource-rich countries to date and compares it with the rest of the CIS. It shows that resource rents have typically been large in the AKTU countries but much of it has been dissipated in energy subsidies, rather than used to accelerate reform through taxation and redistribution to potential losers. As a result, the resource-rich CIS countries have actually lagged behind the rest of the CIS in some dimensions of reform. Section 2 tries to explain the patterns observed with reference to the disincentives to reform faced by elites as they continued to enjoy access to resource rents. It also shows that – as expected – political turnover in the resource-rich countries has been low. Section 3 examines possible pathways out of excessive resource dependence by surveying the experience of two successful resource-rich economies and lists a few policy priorities for governments in the years ahead.

## 1. REFORM AND STRUCTURAL CHANGE – THE ROLE OF RESOURCE RENTS<sup>2</sup>

We begin this section by justifying the focus on the energy-rich CIS countries. Since most CIS countries are highly resource-dependent such a justification is in order. But as Auty and Mikesell (1998) show, among the resource-rich countries in the world, it is the small energy-dependent ones that have established the worst economic track record. This may be due to the fact that energy rents accrue primarily to the government in most instances and thus can be used to support subsidies to special interest groups favoured by the incumbent government.<sup>3</sup> Of course, by the same token, energy rents could also be used to cushion the social impact of reforms and make them more acceptable to the population. Other resources (land and hard minerals, and *a fortiori* human resources) typically do not generate similar government rents, although – as argued below – cotton served a similar function in Turkmenistan and Uzbekistan.

Moreover, the degree of energy dependence was particularly high in the former communist countries and hence availability of energy resources was a particularly important source of potential subsidies. The beneficiaries of such subsidies were principally the inefficient old industrial dinosaurs. In the transition, there seems to be a close correlation between price reform in the energy sector, enterprise restructuring and energy efficiency (*Transition Report* 2001, Chapter 5). We will show that energy rents in the energy-rich transition economies have indeed been largely consumed by implicit subsidies, rather than being used to support social safety nets and investment in public infrastructure and human capital to ease the process of adjustment.

### ENERGY RENTS AND REFORM

Table 1 shows that by the end of the 1990s, the AKTU countries had a dependence on oil and gas revenues in exports and government budgets similar to Iran or Norway and considerably higher than, for instance, Mexico. For Azerbaijan and Kazakhstan, resource dependence has increased considerably since the start of reforms. The Caspian oil fields were left under-exploited in Soviet times, both for strategic and technological reasons, as Russia felt safer and technologically better-equipped developing its own vast west Siberian reserves. Gas from Turkmenistan and Uzbekistan was, however, extracted at high rates during Soviet times and Turkmenistan was for a brief period in 1992-93 granted access to non-CIS markets for its gas exports, generating around US\$ 2-3 billion in early resource rents. This difference has had a bearing on reform patterns as we will show below.

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<sup>2</sup> This section draws on work from Chapter 4 of the *Transition Report* 2001.

<sup>3</sup> In Dalmazzo and de Blasio (2001) the availability of resource rents to the government is the key factor influencing the government's propensity to liberalise. In contrast to Auty and Mikesell (1998), however, Leite and Weidmann (1999) present a theoretical model in which corruption associated with resource dependence is particularly harmful to growth in economies with low capital intensity and support this with evidence that dependence on food production has a more negative impact on growth than energy dependence. Since we are interested mainly in the impact of resource dependence on progress in reform, the focus on energy resources seems justified.

**Table 1: Indicators of resource dependence, selected transition economies and other oil producing countries**

In per cent unless otherwise indicated

|   | Azerbaijan <sup>1</sup> | Kazakhstan <sup>2</sup> | Russia <sup>3</sup> | Turkmenistan <sup>4</sup> | Uzbekistan <sup>5</sup> | Venezuela <sup>6</sup> | Mexico <sup>7</sup> | Iran <sup>8</sup> | Norway <sup>9</sup> |
|---|-------------------------|-------------------------|---------------------|---------------------------|-------------------------|------------------------|---------------------|-------------------|---------------------|
| Oil and gas export in per cent of total exports               | 85.2 (78.2)             | 46.8 (34.1)             | 50.4 (60.2)         | 81 (62.6)                 | 12.3 (13.3)             | 69.8                   | 9.8 (7.3)           | 69.4              | 0.35                |
| Oil and gas export in per cent of GDP                         | 30.5 (17.6)             | 24.7 (12.1)             | 21.5 (16.3)         | 68.7 (31.6)               | 4.3 (3.6)               | 25.4                   | 0.7 (0.5)           | 14.7              | 0.14                |
| Oil and gas revenues in per cent of total government revenues | 36.2 (22.1)             | 27.5 (5.0)              | 30.1 (24.2)         | 42.0                      | 14.8 (15.4)             | 42.5                   | 24.1 (29.8)         | 45.9              | 0.16                |
| FDI in oil and gas sector in per cent of total FDI            | 80.5 (71.0)             | 69.7 (83.3)             | 10.7                | na                        | na                      | na                     | na                  | na                | na                  |
| <i>Memo:</i>  |                         |                         |                     |                           |                         |                        |                     |                   |                     |
| Oil production (mt, 2000)                                     | 14.02                   | 35.00                   | 312.70              | 7.25                      | 7.60                    | 153.88                 | 168.78              | 188.63            | 148.92              |
| Gas production (bcm) 2000                                     | 6.00                    | 11.50                   | 551.00              | 46.00                     | 54.88                   | 28.00                  | 36.40               | 53.20             | 20.00               |

For all transition economies oil and gas production is for 2001 and from *BP Energy Outlook*, 2000. For other countries energy production is for 1999 and from the EIA.

1/ Figures for Azerbaijan are all from the IMF *Staff Report*, June 2001. Figures are for 2000 and those in brackets for 1999. Figures for the share of the oil and gas sector in FDI were calculated from gross inflow data. Net FDI into the oil sector was negative in 2000, due to repayments on inter-company loans under the PSAs.

2/ Figures are for 2000, in brackets for 1999. Figures for oil and gas exports and government revenues are from IMF. Exports are not corrected for under-invoicing.

3/ Figures are for 2000, in brackets for 1999, except for the share of oil and gas in FDI, which is from UNCTAD *World Investment Report* 2000 and refers to 1999. For oil and gas exports revenues are for the first quarter only.

4/ Figures refer to 2000, in brackets to 1999. Figures for oil and gas exports are from Interfax. Turkmenistan's US dollar GDP is an EBRD staff estimate based on a weighted exchange rate taking into the existence of a large parallel market premium. Data for the share of oil and gas in government revenues are based on oral communications from the Ministry of Finance. Data for FDI into the energy sector is unavailable, but may amount to anything between half and two-thirds of FDI inflows in recent years.

6/ Data are for 1998 and from the IMF.

7/ Data are for 2000, in brackets for 1999. All data are from the Mexican statistical office.

8/ Data are for 1999 and all from the IMF.

9/ Data for exports are for 1999 and from the Norwegian statistical office. The share of oil and gas in government revenues is for 1998 and from the EU ([www.eubusiness.com](http://www.eubusiness.com)).

**Table 2 - Energy rents in AKTU and Russia, 1992-2000, in per cent of GDP**

|              | <b>Average 1992-2000</b> |                        |            |                             |
|--------------|--------------------------|------------------------|------------|-----------------------------|
|              | Export rent              | Domestic producer rent | Total rent | Domestic consumer subsidies |
| Azerbaijan   | 7.4                      | 27                     | 50.2       | 15.8                        |
| Kazakhstan   | 10.1                     | 5.7                    | 20.9       | 5.1                         |
| Turkmenistan | 25.7                     | -5.7                   | 44.4       | 24.4                        |
| Uzbekistan   | 5.7                      | 5.6                    | 39.5       | 28.2                        |
| Russia       | 9.4                      | -0.6                   | 26         | 17.2                        |
|              | <b>2000</b>              |                        |            |                             |
|              | Export rent              | Domestic producer rent | Total rent | Domestic consumer subsidies |
| Azerbaijan   | 31.2                     | 16.8                   | 61.4       | 13.4                        |
| Kazakhstan   | 20.2                     | 9.8                    | 33.6       | 3.6                         |
| Russia       | 15.2                     | 14.8                   | 39.9       | 9.9                         |
| Turkmenistan | 43                       | -5.2                   | 65.3       | 27.5                        |
| Uzbekistan   | 6.3                      | 26.2                   | 36.4       | 3.9                         |

Notes: Export rents are calculated as actual export revenues minus transportation costs, minus production costs.

Total rents are calculated as total production times export price minus production and transportation costs.

Domestic consumer subsidies are domestic consumption times the difference between domestic prices and import prices.

Domestic producer rent is total rent minus export rent, minus domestic consumer subsidies, minus producer rents.

Sources: National statistical offices, International Energy Agency, Interfax Petroleum Report, PlanEcon.

Commensurate with the high degree of dependence on energy resources as a source of foreign exchange and government revenues, oil and gas production in AKTU generates very significant rents. Rents in principle accrue on both exports and domestic sales, and are shared between producers, the owners of transport infrastructure, governments and domestic energy consumers. Table 2 shows the ratio of total energy rents to GDP and how this is distributed among exporters, domestic producers and domestic energy consumers. Transport rents accruing to domestic transport operators are not considered in this analysis, as this would considerably complicate the picture.<sup>4</sup> Total rents are calculated by multiplying total production (TV) with the export price (EP) net of lifting (PC) and transportation costs (TC) per unit of output:

$$TR = TV*(EP - PC - TC).$$

Of course, these total rents are only potential rents. Actual export rents are calculated analogously but using only actual export volumes (EV):

$$ER = EV*(EP - PC - TC).$$

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<sup>4</sup> Some transit countries, such as Belarus and Ukraine, have actually leveraged their control over export routes to extract very significant transit rents, which could explain their reform hesitation. To the extent that transit rents accrue to domestic pipeline operators, they can be treated analytically the same way as producer rents or export rents – namely as a source of tax revenue for the government.

Because of transport bottlenecks (particularly for gas) the domestic opportunity cost of energy is not the same as the net export price. Domestic subsidies (DS) are calculated using import prices (IP) as the opportunity cost of energy and taking the difference to domestic prices (DP) multiplied by domestic consumption (DV). Consumer subsidies do not include collection arrears, assumed to be zero in these calculations.

$$DS = DV*(IP - DP), \text{ where } DV + EV = TV$$

Domestic producer rents (DR) are simply the residual of total rents minus export rents and domestic consumer subsidies:

$$DR = TR - ER - DS = DV*(EP - PC - TC - IP + DP)$$

Assuming export prices minus transportation costs are always higher or equal to import prices, domestic producer rents will be positive whenever domestic prices are above production costs. The difference between net export prices and import prices contributes to domestic producer rents by construction, although it does not generate an actual resource flow as exports are constrained by the availability of transport.

Table 2 reveals that total energy rents during 1992-2000 have been in the order of 20-50 per cent of GDP in the four AKTU countries, which is high by any standards. Export rents have typically been less than half of the total, although they have increased over time as new transport capacity from the Caspian has come on stream. Domestic rents have been shared out among producers and consumers in different ways across the four countries. In Turkmenistan and until 1995 in Uzbekistan, domestic rents have gone almost entirely to domestic consumers in the form of untargeted price subsidies. In Azerbaijan and Kazakhstan, consumers have benefited less, although part of the producer rents have been lost due to huge energy arrears by power generators and local distribution companies (Walters, 2000).

In principle, governments can tax both export and domestic producer rents. Since consumer subsidies directly diminish domestic producer rents, their prevalence has contributed to the low tax take of AKTU governments from the energy sector when compared with other energy producers in the world (see also Gray, 1999). Thus rather than taxing available resources to cushion the costs of adjustment, governments have to various degrees chosen to maintain implicit transfers to special interest groups. In addition, in several instances, the leaders of the AKTU countries have appropriated export rents outside the state budget for the benefit of their closest entourage. This is most evident in Turkmenistan, where the US\$ 1.5 billion foreign exchange reserves, largely earned from gas sales in 1992-93, remain under the direct control of President Niyazov.

Table 3 turns to the expenditure side of the budget and examines whether the stronger potential tax base of the AKTU countries has allowed them to spend more on investment in health and education. This might be an indication of attempts to ease the social costs of structural adjustment and make reforms politically more acceptable. The evidence in Table 3 reveals that this is not the case: Kyrgyzstan spends as much as Kazakhstan, Moldova as much as Turkmenistan, Armenia almost as much as Azerbaijan, Ukraine as much as Russia and only Uzbekistan stands out as spending notably more than the average CIS country on health and education. These figures should not be over-interpreted, however, as the efficiency of expenditures and the quality of the services delivered in the social sector may vary.

**Table 3 - Average expenditures on health and education**

|               | Health<br>% GDP      |      | Education<br>% GDP   |      |
|---------------|----------------------|------|----------------------|------|
|               | Average<br>1991-2000 | 2000 | Average<br>1991-2000 | 2000 |
| <b>AKTU</b>   |                      |      |                      |      |
| Azerbaijan    | 1.5                  | 0.9  | 4.2                  | 3.8  |
| Kazakhstan    | 2.4                  | 2.2  | 4.1                  | 3.9  |
| Turkmenistan  | 2.6                  | 3.6  | 4.6                  | 2.8  |
| Uzbekistan    | 3.6                  | 3.0  | 8.2                  | 7.3  |
| Russia        | 3.3                  | 3.1  | 3.7                  | 2.8  |
| <b>CEE</b>    |                      |      |                      |      |
| Albania       | 2.5                  | 2.7  | 3.2                  | 3.4  |
| Bulgaria      | 4.1                  | 3.6  | 4.5                  | 3.8  |
| Croatia       | 9.2                  | 9.4  | 4.3                  | 4.2  |
| Czech Rep     | 6.2                  | 6.7  | 4.4                  | 4.2  |
| Estonia       | 5.5                  | 5.4  | 6.6                  | 6.6  |
| Hungary       | 6.5                  | 6.5  | 5.3                  | 4.7  |
| Latvia        | 3.5                  | 3.9  | 5.7                  | 6.5  |
| Lithuania     | 4.0                  | 4.6  | 6.0                  | 6.5  |
| FYR Macedonia | 7.9                  | 5.5  | 5.5                  | 5.6  |
| Poland        | 4.6                  | 4.3  | 5.5                  | 5.6  |
| Romania       | 2.8                  | 2.6  | 3.4                  | 3.3  |
| Slovak Rep    | 5.6                  | 5.5  | 4.1                  | 4.2  |
| Slovenia      | 6.6                  | 6.4  | 5.5                  | 5.8  |
| FR Yugoslavia | 6.8                  | 6.8  | 2.9                  | 2.7  |
| Montenegro    | 6.8                  | 6.8  | 2.9                  | 2.7  |
| <b>CIS</b>    |                      |      |                      |      |
| Armenia       | 2.0                  | 0.9  | 3.5                  | 2.8  |
| Belarus       | 5.1                  | 4.9  | 7.4                  | 6.4  |
| Georgia       | 2.7                  | 1.7  | 2.4                  | 1.7  |
| Kyrgyzstan    | 2.3                  | 2.1  | 4.0                  | 3.7  |
| Moldova       | 4.2                  | 2.5  | 6.8                  | 4.2  |
| Tajikistan    | 1.9                  | 0.9  | 5.2                  | 2.3  |
| Ukraine       | 3.8                  | 2.9  | 4.7                  | 4.1  |

Note: Where data for 2000 were not available the number refers to the last available year. The average is computed using all available data during 1991-2000.

Source: National authorities, IMF.



**Table 4 – Reform progress in energy-rich countries, compared to eastern Europe and non-oil CIS average 1/**

| Country                  | Year 2/ | LSP | SSP | G&ER | PL  | T&FES       | CP  | BR&IRL | SM&NB | ref1 | ref2 |
|--------------------------|---------|-----|-----|------|-----|-------------|-----|--------|-------|------|------|
| Azerbaijan               | t1      | 1.0 | 1.0 | 1.0  | 2.0 | 1.0         | 1.0 | 1.0    | 1.0   | 1.3  | 1.0  |
| Kazakhstan               | t1      | 1.0 | 2.0 | 1.0  | 2.0 | 1.0         | 1.0 | 1.0    | 1.0   | 1.5  | 1.0  |
| Turkmenistan             | t1      | 1.0 | 1.0 | 1.0  | 1.0 | 1.0         | 1.0 | 1.0    | 1.0   | 1.0  | 1.0  |
| Uzbekistan               | t1      | 1.0 | 1.0 | 1.0  | 2.0 | 1.0         | 1.0 | 1.0    | 1.0   | 1.3  | 1.0  |
| Russia                   | t1      | 2.0 | 2.0 | 1.0  | 3.0 | 3.0         | 2.0 | 1.0    | 1.0   | 2.5  | 1.3  |
| <b>CEE</b>               | t1      | 1.0 | 1.8 | 1.0  | 2.0 | 1.5         | 1.0 | 1.0    | 1.1   | 1.6  | 1.0  |
| <b>CIS non-oil</b>       | t1      | 1.1 | 1.4 | 1.0  | 2.1 | 1.4         | 1.2 | 1.0    | 1.2   | 1.5  | 1.1  |
| <b>AKTU (w/o Russia)</b> | t1      | 1.0 | 1.3 | 1.0  | 1.8 | 1.0         | 1.0 | 1.0    | 1.0   | 1.3  | 1.0  |
| Azerbaijan               | t5      | 1.0 | 2.0 | 1.7  | 3.0 | 2.0         | 2.0 | 2.0    | 1.0   | 2.0  | 1.7  |
| Kazakhstan               | t5      | 3.0 | 3.3 | 2.0  | 3.0 | 4.0         | 2.0 | 2.0    | 1.7   | 3.3  | 1.9  |
| Turkmenistan             | t5      | 1.0 | 1.7 | 1.0  | 2.0 | 1.0         | 1.0 | 1.0    | 1.0   | 1.4  | 1.0  |
| Uzbekistan               | t5      | 2.7 | 3.0 | 2.0  | 3.0 | 2.0         | 2.0 | 1.7    | 2.0   | 2.7  | 1.9  |
| Russia                   | t5      | 3.0 | 4.0 | 2.0  | 3.0 | 4.0         | 2.0 | 2.0    | 3.0   | 3.5  | 2.3  |
| <b>CEE</b>               | t5      | 2.3 | 3.5 | 2.2  | 2.8 | 3.6         | 1.8 | 2.4    | 1.8   | 3.1  | 2.1  |
| <b>CIS non-oil</b>       | t5      | 2.4 | 3.0 | 1.8  | 3.0 | 3.1         | 1.9 | 1.7    | 1.6   | 2.9  | 1.7  |
| <b>AKTU (w/o Russia)</b> | t5      | 1.9 | 2.5 | 1.7  | 2.8 | 2.3         | 1.8 | 1.7    | 1.4   | 2.4  | 1.6  |
| Azerbaijan               | T10     | 2.0 | 3.3 | 2.0  | 3.0 | 3.3         | 2.0 | 2.3    | 1.7   | 2.9  | 2.0  |
| Kazakhstan               | T10     | 3.0 | 4.0 | 2.0  | 3.0 | 3.3         | 2.0 | 2.7    | 2.3   | 3.3  | 2.3  |
| Turkmenistan             | T10     | 1.0 | 2.0 | 1.0  | 2.0 | 1.0         | 1.0 | 1.0    | 1.0   | 1.5  | 1.0  |
| Uzbekistan               | T10     | 2.7 | 3.0 | 1.7  | 2.0 | 1.7         | 2.0 | 1.7    | 2.0   | 2.3  | 1.8  |
| Russia                   | T10     | 3.3 | 4.0 | 2.3  | 3.0 | 2.7         | 2.3 | 1.7    | 1.7   | 3.3  | 2.0  |
| <b>CEE</b>               | T10     | 3.0 | 3.9 | 2.5  | 3.0 | 3.9         | 2.2 | 2.9    | 2.3   | 3.5  | 2.5  |
| <b>CIS non-oil</b>       | T10     | 2.7 | 3.4 | 1.8  | 3.0 | 3.6         | 1.9 | 1.9    | 1.8   | 3.2  | 1.8  |
| <b>AKTU (w/o Russia)</b> | T10     | 2.2 | 3.1 | 1.7  | 2.5 | <b>2.3*</b> | 1.8 | 1.9    | 1.8   | 2.5  | 1.8  |

Notes:

1/ \* indicates statistically significant difference in means of CIS oil and CIS non-oil at 10% level using a standard one-sided t-test.

2/ The start of transition varies across countries: t1= 1989 for Hungary and Poland, 1990 for Bulgaria, Czechoslovakia, Romania and former Yugoslavia 1991 for Albania and the Baltic states and 1992 for the CIS. t5 = t1 + 4 years; t10 = t1 + 9 years Results are not significantly changed if Russia is excluded from the group of CIS oil-rich economies.

What has been the effect of resource rents on economic reform? Table 4 shows the transition indicators for the eight dimensions scored by the EBRD in the first year of transition, in year 5 and in year 10, for AKTU and Russia, as well as averages for central and eastern Europe and the rest of the CIS. Compared with central and eastern Europe, the AKTU economies lag behind in most dimensions in year 5 and year 10. Compared with the rest of the CIS, this is the case only for foreign exchange liberalisation in year 10, where the difference is statistically significant using a standard one-tailed t-test.<sup>5</sup> The AKTU countries do not significantly exceed the average for the rest of the CIS in any reform dimension. This is a remarkable result, if we remember the size of the rents available to these economies to cushion adjustment costs and thus the potentially much weaker feasibility constraint on implementing reform. However, it squares well with the political economy story sketched in the introduction: countries with significant resource wealth have an incentive to limit (or restrict) reform and are less subject to a political challenge by reformers. The fact that it is the comparatively “easy” liberalisation dimension, where the energy-rich countries are significantly behind, strengthens this interpretation.

Table 4 also reveals, however, that the above result is driven by Turkmenistan and Uzbekistan. Azerbaijan and Kazakhstan record reform progress similar to or even slightly above the CIS average in most dimensions. As mentioned above, Turkmenistan had early access to gas export rents in 1992-93. Moreover, Turkmenistan and Uzbekistan are important cotton producers. Cotton rents in both countries have accrued mainly to the government as a result of state trading in cotton exports and the persistence of the state order system in agriculture, whereby farmers receive only a fraction of the world market price for their produce. Some estimates indicate that agricultural sector rents were as high as 15 per cent of GDP in Turkmenistan in 1998 (Pastor and van Rooden, 2000). The early and easy availability of resource rents was arguably a key factor in allowing both countries to pursue much less reform-oriented policies than in the rest of the CIS.

By contrast, energy resources in Azerbaijan and Kazakhstan were not immediately available for exploitation and had to be developed first. This was done through a policy of opening up to foreign investment, exemplified by contracts with Chevron and Mobil for the Tengiz oil field in Kazakhstan (signed in 1993) and with a consortium led by BP for the Azeri-Chirag-Guneshli concession areas in Azerbaijan (signed in 1994). These international investors had to be convinced of the business-friendly intentions of the government – a key aspect of their risk calculations. Thus both countries were comparatively reform-minded during much of the 1990s. The presence of important foreign investment and the initial reliance on IFI funding has provided a certain boost to economic reform policies, but how long this can last once major investments have been sunk and oil revenues increase substantially, is an open question.

## **RESOURCE DEPENDENCE AND STRUCTURAL CHANGE**

One consequence of a lack of market reform in energy-rich transition economies could be that key structural adjustment is delayed. All transition economies inherited an economic structure excessively geared towards heavy industry and with underdeveloped service sectors. Yet, to some extent this legacy was least heavy in the AKTU countries (and in other peripheral republics in Central Asia). The Soviets invested fewer resources to build up an industrial base in these regions, preferring instead to use them as a source of cheap raw materials (Orlowski,

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<sup>5</sup> The difference between AKTU and CIS non-oil economies for price liberalisation is marginally significant at the 12% significance level.

1993). This implies that the need for adjustment was consequently less drastic.<sup>6</sup> Table 5 shows the difference between the actual share of employment in industry and the level that would be predicted by the level of income.<sup>7</sup> It shows that the degree of excessive industrial employment was initially far higher in the non-energy-rich CIS countries, but declined very dramatically since the start of transition. By 1998, there was no difference between the AKTU countries and the rest of the CIS in this regard.

Thus while energy rents might have allowed over-employment in industry to be maintained longer, the initial problem was less in AKTU. The Russian case provides an interesting contrast, however, as by 1998 industrial employment was still 7 per cent higher than predicted and in 1996 even 11 per cent “too” high. Table 5 also examines employment in non-market services (largely government) relative to the per-capita income benchmark as another indication of the impact that resource rents may have had on structural adjustment. Thus, energy rents might be used to prop up public employment as one way to build domestic support. The evidence surprisingly suggests that this is a phenomenon which is common across the CIS, where public services seem to have become a kind of safety valve for the unemployed – that is, an arrangement for containing the appearance of open unemployment. Since the mid-1990s, over-employment in public services has decreased in the non-energy-rich CIS countries, whereas it has remained constant in AKTU. However, the difference is not statistically significant.

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<sup>6</sup> Zettelmeyer (1998) argues that the lack of over-industrialisation was a key advantage of Uzbekistan, which allowed this country to avoid the deep output fall characteristic of other CIS countries, despite much less reform commitment.

<sup>7</sup> There is a close link between employment allocation across broad sectors and GDP per capita both across countries and over time. See Syrquin and Chenery (1989) and Raiser, Schuchhardt and Schaffer (2001).

**Table 5 - Structural change in resource-rich and other transition economies, 1990-98**

*Difference between the actual and predicted employment shares*

| Country                        | Year                                    | 1990  | 1991  | 1992  | 1993  | 1994  | 1995  | 1996  | 1997  | 1998  |
|--------------------------------|---|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| <b>Azerbaijan</b>              | Employment share in industry            | 0.00  | -0.01 | -0.02 | 0.00  | 0.01  | 0.02  | 0.02  | 0.01  | 0.00  |
|                                | Employment share in non-market services | 0.10  | 0.09  | 0.10  | 0.11  | 0.10  | 0.10  | 0.11  | 0.11  | 0.11  |
| <b>Kazakhstan</b>              | Employment share in industry            | 0.07  | 0.07  | 0.06  | 0.04  | 0.02  | -0.01 | -0.02 | -0.05 | -0.05 |
|                                | Employment share in non-market services | 0.08  | 0.07  | 0.07  | 0.11  | 0.10  | 0.09  | 0.05  | 0.04  | 0.02  |
| <b>Turkmenistan</b>            | Employment share in industry            | -0.04 | -0.04 | -0.04 | -0.03 | -0.02 | -0.03 | -0.03 | -0.02 | -0.02 |
|                                | Employment share in non-market services | 0.03  | 0.03  | 0.03  | 0.03  | 0.04  | 0.05  | 0.05  | 0.05  | 0.04  |
| <b>Uzbekistan</b>              | Employment share in industry            | 0.02  | 0.01  | 0.00  | 0.00  | -0.02 | -0.02 | -0.02 | -0.02 | -0.03 |
|                                | Employment share in non-market services | 0.06  | 0.04  | 0.05  | 0.05  | 0.08  | 0.08  | 0.08  | 0.09  | 0.10  |
| <b>Russia</b>                  | Employment share in industry            | 0.17  | 0.16  | 0.16  | 0.15  | 0.13  | 0.11  | 0.10  | 0.07  | 0.05  |
|                                | Employment share in non-market services | 0.08  | 0.08  | 0.09  | 0.08  | 0.10  | 0.11  | 0.13  | 0.12  | 0.13  |
| <b>Average CEE</b>             | Employment share in industry            | 0.17  | 0.16  | 0.14  | 0.12  | 0.11  | 0.10  | 0.08  | 0.07  | 0.07  |
|                                | Employment share in non-market services | -0.04 | -0.03 | -0.02 | 0.00  | 0.00  | 0.00  | -0.01 | -0.01 | -0.01 |
| <b>Average CIS non-oil</b>     | Employment share in industry            | 0.09  | 0.08  | 0.07  | 0.06  | 0.05  | 0.01  | -0.01 | -0.02 | -0.03 |
|                                | Employment share in non-market services | 0.04  | 0.05  | 0.06  | 0.07  | 0.08  | 0.07  | 0.06  | 0.06  | 0.05  |
| <b>Average AKTU and Russia</b> | Employment share in industry            | 0.04  | 0.04  | 0.03  | 0.03  | 0.02  | 0.02  | 0.01  | 0.00  | -0.01 |
|                                | Employment share in non-market services | 0.07  | 0.06  | 0.06  | 0.07  | 0.08  | 0.09  | 0.08  | 0.08  | 0.08  |
| <b>Average AKTU w/o Russia</b> | Employment share in industry            | 0.01  | 0.01  | 0.00  | 0.00  | 0.00  | -0.01 | -0.01 | -0.02 | -0.02 |
|                                | Employment share in non-market services | 0.07  | 0.06  | 0.06  | 0.07  | 0.08  | 0.08  | 0.07  | 0.07  | 0.07  |

Source: ILO Handbook of Labour Statistics; Raiser, Schaffer and Schuchhardt (2001)

## 2. THE POLITICAL ECONOMY OF RESOURCE DEPENDENCE

Having established the importance of resource rents for the AKTU countries and highlighted the way in which these have been allocated, we now turn to a political economy interpretation of the observed patterns. First we show that already during Soviet times, AKTU served as a source of raw materials for the more industrialised western CIS. In return for selling their resources at prices far below world market values, these countries received considerable direct fiscal transfers from the Soviet centre. We then provide a conceptual framework that analyses the consequences of the elimination of these implicit and explicit transfers with the break-up of the Soviet Union.

### FROM SOVIET TRANSFERS TO DOMESTIC RENT APPROPRIATION

Under the Soviet system, the AKTU countries as well as other republics in the CIS periphery specialised in the extraction of natural resources and the production of cash crops, while receiving manufactured goods from the western CIS. Because of the Soviet Union's biased pricing policy towards industry, the relative prices of raw materials and industrial goods were highly distorted. Producers of primary goods received lower prices compared with producers of industrial goods than they would have received had both traded at world prices. To compensate for these imposed unfavourable terms of trade the CIS periphery received large transfers from the Federation.

A number of papers have attempted to calculate the terms of trade shifts that resulted from the dissolution of the CMEA and the move to market prices in intra-republican trade (Tarr, 1993; Orłowski, 1993). Orłowski's calculations of implicit transfers in Soviet trade as of 1989 are shown in Table 6. It appears that Turkmenistan and Russia were net donors to all other republics, and that the biggest recipients of implicit transfers were the western CIS and the Caucasus, while the AKTU countries with the exception of Azerbaijan neither benefited nor lost much from this system of transfers. This is in part due to the relative small net energy balances of AKTU, as their energy resources remained under-developed, and in part due to the significant production of final goods in countries such as Kazakhstan and Uzbekistan. The dead-weight loss associated with this distortionary system of taxes and subsidies did of course represent an unavoidable cost for all involved.

Yet, these numbers may be deceiving in two important respects. First, for many manufactured goods traded within the Soviet Union, a market reference price may not have existed. Orłowski's calculations are based on Goskomstat data, using their information of "world market" prices rather than a true market benchmark.<sup>8</sup> Primary goods exporters are thus likely to have paid larger effective subsidies than would appear from Table 6. Second, with the exception of Turkmenistan, all AKTU countries were also importers of energy during Soviet times, reflecting the existing cross-border transport infrastructure. Some of this cross-border trade may not have taken place under market conditions, and the AKTU countries may have borne an opportunity cost as a result.

The counterpart of being taxed through the system of distorted prices for traded goods was that the AKTU countries received among the largest subsidies from Federal transfers of any region in the former Soviet Union. Table 6 also shows the share of net fiscal transfers in GDP in 1989 based on Orłowski (1995). Armenia is an exception, driven by special support following the 1989 earthquake. Again with the exception of Azerbaijan, the AKTU countries

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<sup>8</sup> The author notes these shortcomings himself and says his calculations are a "plausibility test" (p.1002).

received around 8 per cent of GDP in central transfers, with Kazakhstan and Uzbekistan benefiting the most. The western CIS and the Baltic states, by contrast, made moderate positive contributions into the Federal budget.

With the breakdown of the Soviet Union, both implicit and explicit transfers largely disappeared. Ruling elites in the CIS countries were thus faced with a serious challenge: how to replace implicit and explicit transfers in order to maintain their support base. It is in this respect that access to resource rents becomes crucial.

**Table 6: Direct and indirect transfers in the Soviet Union**

| <b>AKTU</b>                    | <b>Indirect transfers</b> | <b>Direct transfers</b> |
|--------------------------------|---------------------------|-------------------------|
| Azerbaijan                     | 10.09                     | 0.8                     |
| Kazakhstan                     | 0.5                       | 8.1                     |
| Turkmenistan                   | -10.81                    | 8.1                     |
| Uzbekistan                     | 1.26                      | 9.6                     |
| <b>Other CIS periphery</b>     | <b>Indirect transfers</b> | <b>Direct transfers</b> |
| Armenia                        | 9.16                      | 22.7                    |
| Georgia                        | 16.02                     | 2.0                     |
| Kyrgyzstan                     | 2.72                      | 6.9                     |
| Tajikistan                     | 6.08                      | 7.1                     |
| <b>Western CIS and Baltics</b> | <b>Indirect transfers</b> | <b>Direct transfers</b> |
| Belarus                        | 8.91                      | -0.1                    |
| Estonia                        | 12.08                     | -0.2                    |
| Latvia                         | 10.43                     | 0.5                     |
| Lithuania                      | 17.09                     | -0.1                    |
| Moldova                        | 24.05                     | 0.6                     |
| Ukraine                        | 3.61                      | 0.3                     |
| <b>Russia</b>                  | <b>Indirect transfers</b> | <b>Direct transfers</b> |
| Russia                         | -3.67                     | -0.4                    |

Notes: Transfers are defined as positive for net recipients and negative for net donors.

Sources: Orlowski (1993); (1995).

## **RESOURCE RENTS AND ECONOMIC POLICY DURING TRANSITION**

Our basic framework follows Dalmazzo and de Blasio (2001). In their model, an autocratic government maximises its revenue through rent appropriation by extracting resource wealth directly and by taxing business activity. Economic reform reduces the ability of the government to appropriate rents through both mechanisms, while increasing production of non-resource output. In this set up, the presence of natural resources reduces reform incentives, because the direct effect on rent appropriation outweighs the indirect effect of increased business activity.<sup>9</sup> Dalmazzo and de Blasio also extend the model to the case of foreign aid and show how conditionality can lead to the adoption of reform policies, while non-conditional aid is equivalent to resource wealth in its negative effect on reform.

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<sup>9</sup> It is of course possible to imagine that reforms would increase effective tax revenues from the business sector and still encourage its growth. In this case, the effect of resources on reform might be immaterial, depending on the weight of the respective revenue sources.

We extend this basic framework with an argument about government turnover at the start of transition. The incumbent government is closely associated with those interest groups that benefited most from the system of explicit and implicit transfers during Soviet times. As these transfers disappear with the break-up of the Soviet Union, incumbent elites will only remain in power if they can find a source of revenues to maintain transfers to their supporters. Natural resources are obviously a key potential source of revenues in this regard and we therefore would expect government turnover to be lower in resource-rich economies. Indeed, for the Caspian countries, transition simply eliminated the “Moscow loop” in the flow of resources, but did not have more fundamental distributional consequences. We might expect this to be reflected in a higher degree of political cohesion and continuity with less of a challenge to the ruling elite than in resource-poor countries.

Looking at political turnover during the early transition period corroborates our general argument. Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan all have heads of state who were high communist officials during Soviet times. In the latter three countries these heads of state already stood at the helm of their country at the time of independence (Table 7). In all countries, moreover, the president has direct control over key natural resources. In contrast, the western CIS (and eastern Europe) were by and large characterised by a much higher degree of government turnover during the initial years of transition. Moreover, Table 7 reveals that the extent of political cohesion was also much higher in the AKTU countries, indicating the extent to which political preferences were fully aligned with the interests of the incumbent elites.

While this paper is not trying to offer a unified explanation for transition patterns in the whole of the CIS, it is worthwhile exploring the implications of the above arguments for the resource-poor CIS countries. There, implicit and explicit transfers were greatly reduced with no compensating gains from increased rent appropriation from the natural resources sector. This is reflected in higher turnover and less political cohesion. The only compensation for the loss of transfers was international support from IFIs and Western donors. Since this support was conditional on implementing reform, we expect a higher degree of reform in resource-poor countries, even if their governments were not *per se* interested in economic reform. Indeed, the most rapid reform progress during the first four years of transition among the former Soviet countries was made by the Baltic states, Kyrgyzstan and Moldova, while Armenia and Georgia made rapid headway once the regional instability in the Caucasus subsided. As mentioned, Belarus and to a lesser extent Ukraine are exceptions, as they continued to draw on implicit energy transfers from Russia partially as a result of their control over key energy transit routes. Economic reform could have reduced the ability of the ruling elite to appropriate these transfers and hence reform progress was less in both countries.

One could ask, of course, why resource-rich countries would not chose reform as well in order to access Western assistance and FDI. To the extent that this assistance outweighed the immediate loss to rent appropriation from reform, this would indeed be expected and we find that Azerbaijan and Kazakhstan chose this route during the early 1990s. As energy resources become more developed, however, we would expect reform incentives to weaken and IFI support to tail off, leading to less progress or even reversal in key reform dimensions. This phase is only beginning now but it points to the challenges ahead.

**Table 7 - Government turnover and social cohesion in transition economies**

|                  | <b>Government turnover</b><br>(average tenure of<br>governments in months<br>1990-1998) | <b>Social cohesion</b><br>(proportion of seats held<br>by ex-communists in<br>first parliament) | (proportion of seats<br>held by largest non-<br>communist party) |
|------------------|---|---|--|
| <b>CEE</b>       |   |   |  |
| Czech Republic   | 25.5  | 16  | 55   |
| Estonia          | 15  | 0   | 47   |
| Hungary          | 20.8  | 9   | 43   |
| Latvia           | 15  | 14  | 60   |
| Lithuania        | 13.25   | 26  | 31   |
| Poland           | 14.25   | 35  | 38   |
| Slovak Republic  | 25.5  | 16  | 39   |
| Slovenia         | 52  | 14  | 17   |
| <b>Other CIS</b> |   |   |  |
| Armenia          | 52.5  | 2   | 87   |
| Belarus          | 52.5  | 79  | 21   |
| Georgia          | 49  | 26  | 63   |
| Kyrgyzstan       | 53  | 100   | 0  |
| Moldova          | 26.5  | 38  | 35   |
| Tajikistan       | 106   | 99  | 1  |
| Ukraine          | 52.5  | 72  | 28   |
| <b>Russia</b>    | 105   | 40  | 40   |
| <b>AKTU</b>      |   |   |  |
| Azerbaijan       | 33  | 78  | 13   |
| Kazakhstan       | 105   | 94  | 6  |
| Turkmenistan     | 108   | 100   | 0  |
| Uzbekistan       | 106   | 100   | 0  |

Source: EBRD (1999), Chapter 5.

Finally, it is important to see this interpretation of the political economy of reforms in resource-rich transition economies not as a deterministic model of policy formation. A basic assumption of the model that underlies these stark conclusions is that governments in CIS countries are only interested in their revenues and do not care about society more generally. This assumption may be too strong, although it fits the main reform patterns in the region remarkably well. However, once we allow for a government that cares for society as much as it cares for its own welfare, economic reforms become more likely even in resource-rich economies. Indeed, when the government is only concerned with social welfare it will always reform as long as reforms increase aggregate resources and welfare.

Governments thus always have real policy choices. With this in mind, the final section of the paper looks at the experience of successful resource-rich economies around the world and draws some lessons for longer-term policy.



### 3. PATHWAYS OUT OF RESOURCE DEPENDENCE

International evidence suggests that the AKTU countries will have to make special efforts to avoid the “resource curse” of low growth and high volatility characteristic of many other resource-based economies (Sachs and Warner, 1995; Auty and Mikesell, 1998; Leite and Weidmann, 1999; Dalvazzo and de Blasio, 2001; Gylfasson, 2001). Four channels through which resource abundance may slow economic growth are typically highlighted in the literature: a) the Dutch disease; b) neglect of education; c) rent seeking; and d) poor economic policies or overconfidence.

These problems seldom occur in isolation. A typical sequence in a country failing to capitalise on its resource endowments could run as follows (see Auty and Mikesell, 1998). High capital inflows during resource booms have a tendency to push up real wages and erode the competitiveness of the non-resource-based tradable goods sector. Because labour demand in the resource sector is limited, more and more labour moves to an increasingly bloated public sector (or to subsidised import-substituting industries), attracted by generous conditions offered to state employees in return for political loyalty. High wage differentials, a segmentation of labour markets, low productivity growth and limited incentives to invest in skills upgrading result. The growing share of the public sector in resource allocation during times of increasing resource rents cannot be easily reduced once commodity prices fall or an important natural resource deposit becomes exhausted. The resulting fiscal and external deficits and growing debt burden make for macroeconomic volatility and further depress economic growth.

The evidence presented in Section 1 highlights the risks in the energy-rich transition economies that may result from over-dependence on natural resources, the dissipation of resource rents and the lack of investment in human capital. While there is no evidence so far of exchange rate overvaluation, it could be argued that the resource inflows still lie largely in the future. This throws up major policy challenges in the years ahead. AKTU need not fall into the resource trap, however. The policy choices that must be made in order to turn natural resources into a blessing rather than a curse are not intellectually demanding. A small number of countries have actually made these choices, despite starting out as resource-dependent economies, and as a result have successfully developed. These countries are Botswana, Chile, Malaysia and Thailand.<sup>10</sup> The experience of the successful resource-rich countries shows that management of resource windfalls and economic diversification are central to sustained economic growth. Indeed, in order to shelter itself from possible price swings and make best use of its resources, an economy can either diversify its asset portfolio or its economic production base, or both.

For an economy with exceptionally rich resource endowments, significant diversification of the production structure may not be a realistic aim. If returns to resource exploitation are very high, a high degree of specialisation may be a natural outcome, in line with both short-run and long-run or dynamic comparative advantage. However, in such a case, portfolio diversification becomes of fundamental importance. Strong budgetary institutions and responsible fiscal policy are important prerequisites for successful portfolio diversification. Governments should only spend the share of resource revenues considered part of permanent income. Resource windfalls should be used to buy foreign assets or to repay external debt. For this a modern, well-regulated financial sector is needed that can effectively intermediate between domestic savings and international capital markets. In some cases, the creation of a

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<sup>10</sup> Note, of course, that none of these countries is an important oil producer.

government-owned but independently managed national savings fund can also provide an effective tool for portfolio diversification.<sup>11</sup>

For economies with a variety of production factors, economic diversification is feasible and resource rents could be partially used to lay the foundations to further the growth of the non-resource sector. It would appear that most AKTU countries, with the possible exception of Turkmenistan (which is very highly specialised in natural gas) fall into the latter category. Economic diversification can be aided by complementary investments in physical infrastructure and human capital but is probably most directly linked to the investment climate for private business. Predictable government policies, low levels of red tape, stable tax rates and a level playing field for all businesses are the key ingredients of such a positive investment climate.

The remainder of this section considers in more detail the experiences of Botswana and Chile.<sup>12</sup> Botswana's success story is largely based on portfolio diversification, whereas Chile's rapid economic growth was driven by economic diversification and the inflow of investment into sectors outside traditional copper mining.

### **THE CASE OF BOTSWANA**

During the period of 1965-98 Botswana recorded average growth per annum of 7.7 per cent per capita, higher than the growth rates of the Asian tigers for the same period. This makes Botswana one of the few resource-rich countries that successfully sustained rapid economic growth over a long period of time.

The most important element in Botswana's success has been sound fiscal management. Having few other resources to offer, a small domestic market and being located far away from the most lucrative markets (except South Africa) Botswana never had much scope for economic diversification. The mineral sector continues to generate more than one third of GDP and 70 per cent of export earnings while manufacturing never contributed more than 5 per cent of GDP (Table 8). These economic limitations forced the government to focus attention on prudent fiscal policy to manage the revenues generated by diamond exports.

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<sup>11</sup> On the risks of political influence over national stabilisation funds, see IMF (2000).

<sup>12</sup> For references on both cases see Auty and Mikesell (1998). Useful overviews over Botswana's economic development and policy are given in Colclough and McCarthy (1980) and Harvey and Lewis (1989). Holzmann (1996) reviews financial market development in Chile, while Alesina et al. (1996) provides a review of fiscal policy. The sections below are not meant to be exhaustive but rather illustrative of the kinds of arguments made in the literature on these two success stories.

**Table 8. Botswana: sectoral real GDP, 1979-98 <sup>1</sup>**

|                    | 1979-84             | 1984-89 | 1989-94 | 1994-95 | 1995-96 | 1996-97 | 1997-98 |
|--------------------|---------------------|---------|---------|---------|---------|---------|---------|
|                    | (In percent of GDP) |         |         |         |         |         |         |
| Agriculture        | 10.9                | 5.8     | 4.6     | 4.1     | 3.9     | 3.4     | 3.1     |
| Mining             | 29.3                | 45.5    | 38.2    | 33.3    | 34.1    | 37      | 37.6    |
| Manufacturing      | 5.9                 | 5.2     | 4.9     | 4.9     | 5       | 4.9     | 4.8     |
| General government | 15.7                | 13.7    | 15.3    | 15.3    | 14.9    | 14.2    | 14.5    |

Source: Central Statistical Office of Botswana

1/ National accounts year beginning July1

A key instrument in this respect was the system of multi-year planning of government expenditures under the National Development Plan (NDP). A system of financial control and accountability was introduced to reinforce the discipline of the NDP. Without formal approval neither supplementary budget expenditures nor additional capital projects were allowed. Moreover, the government accumulated large foreign reserves during export booms and used these as a cushion against external commodity price and demand shocks. It is important to note that Botswana did not create a special stabilisation fund for this purpose. The framework provided by the National Development Plan was sufficient to prevent public over-consumption and allow the central bank to use its reserves to stabilise the economy.<sup>13</sup> One necessary ingredient of this system was the existence of reliable resource accounts, allowing the government to stabilise the national savings rate over time as it could predict fairly accurately how much rents would be generated in the future.

On the expenditure side, the government emphasised investment in physical and human capital rather than public consumption. A major portion of GDP was invested in infrastructure building and the average investment rate was 27 per cent of GDP during the period of 1965-98. Still with total factor productivity around 2 per cent over the past two decades, Botswana's growth was not just extensive but also intensive.

Botswana's human development record is as impressive as its physical capital formation. The main objective of human capital development has been the provision of free basic education and primary health care throughout the country. Botswana's secondary school enrolment rate increased from 20 to 50 per cent between 1980 and 1993, while infant mortality was halved from 63 to 34 deaths per 1,000 live births. On both counts Botswana stands out by regional standards. It is a tragedy in this respect that much of this accumulated human capital is presently being wiped out by the HIV/Aids epidemic.

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<sup>13</sup> The second and third fully funded "pillars" of a pension system such as in Kazakhstan, with a prudent, globally diversified portfolio of financial assets, could play a similar role.

## THE EXPERIENCE OF CHILE

Over the period of 1985-99 the Chilean economy markedly outperformed the rest of Latin America and the Caribbean (LAC) in many respects (Table 9). During this period Chile recorded an annual average growth rate of 7.7 per cent, twice as large as any other country's growth rate in the region. Chile consistently outperformed its neighbours on a number of macroeconomic and financial indicators such as saving and investment rates, consolidated fiscal balances, real exchange rate stability, degree of openness, financial depth and development of capital markets. Simultaneously, Chile demonstrated substantial improvements in poverty levels, achieved the best indicators in education and health, and ranked at the top on indicators of the quality of institutions, rule of law and governance.

**Table 9. Macroeconomic performance in Chile in regional comparison 1990-99**

(Averages for the period)

|              | GDP growth | Inflation<br>% | Public sector<br>balance<br>% of GDP | Current<br>account<br>% of GDP | Savings<br>% of GDP | Investment<br>% of GDP |
|--------------|------------|----------------|--------------------------------------|--------------------------------|---------------------|------------------------|
| Argentina    | 4.6        | 252.9          | -0.8                                 | -2.5                           | 15.2                | 17.7                   |
| Bolivia      | 3.9        | 10.5           | -2.3                                 | -6                             | 10.8                | 16.3                   |
| Brazil       | 1.8        | 843.6          | -5.2                                 | -1.8                           | 18.8                | 20.8                   |
| <b>Chile</b> | <b>6.5</b> | <b>11.7</b>    | <b>1.4</b>                           | <b>-3.1</b>                    | <b>21.4</b>         | <b>25.3</b>            |
| Colombia     | 2.8        | 22.3           | -1.7                                 | -2.3                           | 23.3                | 21.6                   |
| Mexico       | 3.4        | 20             | 0.1                                  | -3.7                           | 19.1                | 22.9                   |
| Peru         | 3.8        | 807.9          | -1.4                                 | -5.3                           | 16                  | 21.3                   |
| Venezuela    | 2.2        | 47.1           | -1.3                                 | 3.5                            | 21.2                | 17.4                   |

Source: IMF International Financial Statistics; World Development Indicators

The Chilean success was based on three main pillars. First, tight fiscal policies and prudent use of resource windfalls when copper prices were high prevented excessive real appreciation. One aspect of prudent fiscal management was the creation of the Copper Stabilisation Fund, which accumulated foreign assets when copper prices were high. Its independent management avoided the problem of political capture – a key lesson for Azerbaijan and Kazakhstan, which have both recently created similar National Stabilisation Funds.

Second, reforms to social security (such as the introduction of a fully funded two-tier pension system) and to the tax system led to significant increases in private savings, which helped to mitigate problems with the absorption of capital inflows. Chile's national investment rate doubled to over 20 per cent of GDP between 1961-74 (pre-reform) and 1990-97, largely on account of the surge in private voluntary savings from 7.7 to 14.4 per cent. This was combined with policies to strengthen the domestic financial sector following the banking crisis of the early 1980s and allow domestic savings to be invested abroad. There is an important lesson for Kazakhstan here, too, which has introduced a funded pension system but where assets so far remain badly diversified, and the banking system is not totally free from political interference.

Third, public sector reforms led to the depoliticisation of economic policy-making and significant improvements in governance and allowed spending priorities to be shifted towards investment in human capital without jeopardising fiscal prudence. Government employment remained relatively limited despite increased resource mobilisation and the creation of an independent audit office greatly improved budget execution. The build-up of a competent bureaucracy is arguably one of the most important long-term challenges in AKTU as in the whole CIS.

## 4. CONCLUSIONS

This paper has drawn a link between the rather disappointing reform performance of the energy-rich transition countries and their natural resource wealth. We have argued that the incentives of governments to implement reforms in resource-rich economies are reduced, as this would lead to a reduction in their ability to appropriate resource rents. The larger the rents, the less likely are reforms. We find some evidence for this pattern in the experience of the AKTU economies compared with the remainder of the CIS to date.

However, it would be an exaggeration to see resource wealth, even during the past decade, purely as a curse for the AKTU countries. Their energy wealth has allowed them to attract far greater inflows of FDI than other CIS economies, with the corresponding positive impact on domestic suppliers, and technological and business standards. In Azerbaijan and Kazakhstan in particular, this together with the assistance of IFIs has provided an anchor to economic policy that has allowed reform progress to be made during the first decade of independence. Still, judged against its potential, the region's performance has been disappointing. More reform will be needed if the present economic upswing in the region is not to remain just a flicker.

Looking ahead into the second decade of transition and independence, a crucial challenge remains to improve the business climate for private enterprises in order to provide the basis for economic diversification. This issue has dominated during the first ten years and remains possibly the most prominent concern. All four AKTU economies could do more to liberalise foreign trade, simplify domestic licensing and business registration, strengthen financial institutions and improve tax collection practices to make it easier to set up new businesses. Kazakhstan is most advanced in this regard, while in Turkmenistan reforms have hardly begun.

Yet, as the development of AKTU's substantial energy resources progresses, two further challenges will become ever more important. The first is to reform the domestic energy sector itself. Domestic energy producers will hardly be able to raise the external financing required, as long as they remain burdened with providing subsidies to domestic consumers through selling at below world market prices. These subsidies can be maintained because the government largely controls the transport infrastructure needed to access external markets. Yet, precisely this control also reduces the attraction of the AKTU countries to foreign investors. A policy to liberalise access to transportation while embarking on serious domestic price reform is thus needed. Again, Kazakhstan has moved furthest in this regard and with the Caspian Pipeline Consortium now has the first non-state-owned pipeline from the Caspian to world markets in operation.

The second challenge will be to create the basis for prudent fiscal management into the future. Both Azerbaijan and Kazakhstan have established national stabilisation funds to manage expected resource windfalls. Their independence from political interference remains yet to be tested. Kazakhstan has also introduced a funded pension system, which is expected to boost domestic savings over the medium term. However, its financial system, as that in the other AKTU countries, is ill equipped to handle the required international portfolio diversification. In the long run it is likely that fiscal prudence will only be achieved if the government itself becomes more accountable to the population at large. This suggests that in addition to issues of economic management, the question of political reform is likely to force itself onto the agenda sooner or later.

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