

Does diversification improve institutions in resource rich countries?



Angola's non-oil resources: Will its potential ever be exploited?

Angola is the world's second most concentrated country in terms of exports. Furthermore, concentration has increased during recent years. Angola also faces the challenge of a resource curse prevalent in resource rich countries with weak institutions.

This brief argues that diversification has to address the scope for patronage and rent seeking if it is to efficiently counteract the resource curse. We focus on how diversification affects the scope for patronage through its effect on institutions of democratic accountability. We find that it is the pattern of industrial activity rather than diversification per se which affects institutions like democracy.

HIGHLIGHTS

- Diversification into more mobile and human capital intensive sectors is more likely to promote democratization than diversification into less mobile sectors (for instance, sectors depending on land use).
- Diversification may be difficult to attain when it threatens the power basis of the ruling elite. New sectors can empower social groups that can threaten the power of the existing class, which in turn can impede diversification efforts of elites.
- Policies for diversification should therefore focus on international regulation affecting elite incentives, rather than domestic industrial policy.

INTRODUCTION

Diversification of the economy is believed by many to reduce problems created by dependence on natural resources, the so-called resource curse. In particular, diversification is thought to counteract Dutch disease effects of natural resources, where natural resources drives up the domestic price level, crowding out the tradable manufacturing sector, resulting in lower rates of productivity improvement and economic growth. While early studies referred to the Dutch disease as a main source of resource related problems, recent studies have come to emphasize political mechanisms as a key cause of the resource curse. To assess diversification as a means of addressing the resource curse, the relation between diversification and institutions is therefore important to consider.

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SOME DATA ON DIVERSIFICATION AND DEMOCRACY

The pattern of diversification in an economy can be analyzed at different levels of the value chain: diversification of imports, intermediary production, of factor endowments, of technology, of production and of exports of goods and services (or even destinations of exports). Moreover, one can measure diversification in terms of public revenue sources and how the income is allocated. At all levels diversification implies a lower level of concentration. Here, we focus on diversification in terms of exports.

An overview of diversification among some Sub-Saharan African (SSA) countries over the last 25 years reveals the following:

- The level of concentration has increased for SSA during the period from 1995 to 2009. SSA is less diversified than developing countries in general.
- Major petroleum exporters in Sub-Saharan Africa like Angola, Nigeria, Sudan and Gabon are the most concentrated

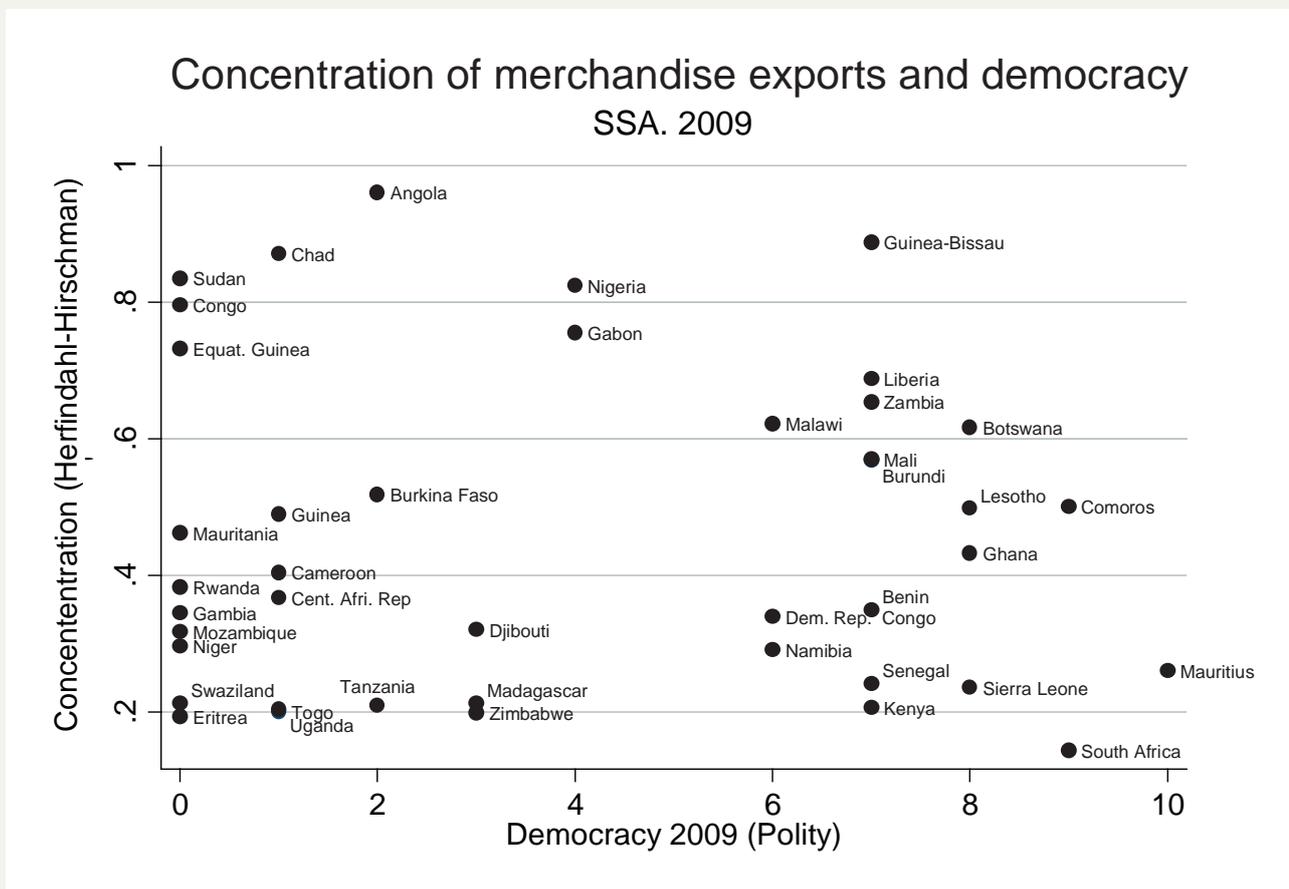
merchandise exporters, but also some mineral rich countries like Zambia exhibit a great concentration of exports.

- Large economies without access to large oil reserves such as South Africa, Kenya and Mozambique have a more diversified industrial structure than the other countries.

These patterns can be recognized in the following figure, where the concentration of exports is given in the vertical axis. As the figure reveals, Angola is the least diversified (most concentrated) country in the sample, followed closely by several other oil exporting countries.

The horizontal axis captures democracy levels for the countries, as measure by the Polity IV democracy scale, which runs from 0 to 10, with higher values representing more democracy. As we can see from the figure, there does not seem to be a clear pattern here for how diversification is related to democracy. The lack of a clear

Figure 1. Diversification in SSA countries



Source: Wiig and Kolstad (2012a)

relationship may of course be due to factors which the simple figure above does not account for, so more analysis of a possible relationship is in order.

DOES DIVERSIFICATION IMPROVE CHANCES OF DEMOCRACY?

Theoretical arguments imply that the diversification of an economy does not necessarily improve chances of democracy. The effect of diversification depends on which sectors the economy diversifies into. One important dimension is whether the industries a country diversifies into are characterized by intensity in mobile or immobile assets.

Where a country's elite has its main investment in assets characterized by mobility, these are more difficult to tax by a democratic government than more immobile assets. In such a setting, the elite has less to lose from democracy and is more likely to introduce democratic institutions.

For a country whose economic activities are concentrated in natural resources like oil, this has two sets of implications. Diversification into sectors whose production are based on more mobile factors (such as manufacturing or services) will induce less elite opposition to democratization, and improve chances of a viable democracy. Diversification into sectors based on immobile factors controlled by the elite (such as agriculture in societies where land ownership is heavily concentrated), may cement elite opposition to democratization, and not improve the chances of democratic transition.

In other words, it is the pattern of industrial activity that affects the probability of democracy, not diversification per se. A country whose economic activities are fully concentrated in one human capital intensive industry may have better prospects for democracy, than a country whose production or exports are equally divided between two industries intensive in oil and land, respectively. Reciprocal dependence is one of the characteristics of knowledge-based industries. The costs of conflict are high in human capital intensive sectors, too high for the ruling elite to risk discontent and upheaval.

This means that diversification away from natural resources may improve chances of a viable democracy if it entails diversification into industries intensive in factors that are relatively mobile, such as many forms of manufacturing or services. Diversification into industries based on immobile factors controlled by a small elite, for instance agriculture in a society where land ownership is heavily concentrated, is unlikely to promote democracy. In other words, though many Sub-Saharan African

countries may have a comparative advantage in agriculture, exploiting this advantage may not be the best way of promoting democratic rule, particularly the less capital intensive the agricultural sector is.

IMPLICATIONS: PROSPECTS FOR DIVERSIFICATION

Even if diversification into certain sectors may be beneficial for a country, this form of diversification may be difficult to attain. The elite of a country faces a clear trade-off when deciding whether or not to pursue a strategy to introduce new industries. On the one hand, this could help elites access new sources of income, for instance from manufacturing or services. On the other hand, the elite will likely foresee that these new areas of industries might make them more likely to lose political power and access to rents over which they previously had control.

If the income from existing immobile factors are sufficiently large compared to the expected income from new industries, this means that:

- Diversification into new areas is not necessarily in the interest of the ruling elite. To the extent that an elite will introduce industrial policies of diversification in this case, these will likely focus on diversification into industries that shore up their political power.
- In other words, if the elite in a resource-rich country also controls the immobile asset of land, diversification will likely focus on industries that make intensive use of that asset. This, however, is unlikely to promote democracy.

In resource-rich countries with weak institutions of democratic accountability, strategies of diversification may be implemented as an additional patronage tool, that is, another means of conferring advantages on supporters of the political elite.

- To attain an industrial structure more conducive to democratization, it may be necessary to instead focus on how external institutions (like the international trade regime or other types of international regulations) may change the incentives of political elites in undemocratic countries.
- Trading in products based on immobile factors should be made relatively more costly than trading in products based on mobile factors.
- Somewhat simplistically, international trade in oil should be taxed, while manufactured products should be given easier market access, in order to attain diversification and democratization.

A country whose economic activities are fully concentrated in one human capital intensive industry may have better prospects for democracy.

The Angola Brief series is an output of the CEIC-CMI Cooperation Programme for research in social and economic issues concerning Angola. The series aims to contribute research findings and policy recommendations to enhance public debate in and about Angola.

In sum, while some forms of diversification may improve democratic institutions in resource rich countries, diversification may be difficult to attain when it threatens the power base of the ruling elite. These arguments provide a clear warning to uncritically promoting diversification as a solution to

the resource curse. However, it should be noted that the above arguments are based on theory and need further empirical testing that are followed up in subsequent empirical analyses by the authors. In particular, it will be very interesting to discuss their particular implications in the case of Angola.

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