DIIS POLICY BRIEF
FRAGILE SITUATIONS

Fragility and natural resources

For donor countries, the challenge is to promote policies that enable fragile states to make the best of their resource endowments without falling prey to resource conflicts or authoritarianism.

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Poorly governed spaces in the developing world are increasingly attracting the attention of donor countries. Paradoxically many of the world's fragile states have become dysfunctional, despite vast resource endowments. It is important to rethink the governance of valuable resources, not only because this sometimes leads to state fragility, but also because improved resource management offers ways out of fragility and towards economic growth and development.

This brief argues that problems with natural resource governance are frequently associated with: 1) situations of extreme state fragility where groups clash in violent conflict over resources or in attempts to secede by a resource-rich part of a country; or 2) lack of economic development and the persistence of repressive regimes, with little ability or desire to promote growth and welfare for their citizens.

For donor countries, this amounts to a challenge when it comes to promoting policies that enable fragile states to make the best of their resource endowments without falling prey to resource conflicts or authoritarianism. A fine balance must be struck to ensure that state strength, resource extraction and economic growth positively reinforce each other, rather than resulting in the two undesirable outcomes noted above.

A first step in designing policies that mitigate these problems involves further scrutiny of the mechanisms that link natural resources with adverse outcomes for fragile states. Consequently, this brief first maps the challenges geographically before describing the paradox of how natural resources create dysfunctional states. Based on this analysis, a series of policy recommendations will be made.

POLICY RECOMMENDATIONS

Resource wealth has been a curse for many fragile states. To allow fragile states to make the best of their resource endowments, donors should work towards:

- Increased transparency in the oil, gas and mining sector
- Improved local capacity for contract negotiation and creation of natural resource taxation schemes
- Better opportunities for companies to make investments in risky environments
- Multilateral progress towards better market access for processed raw materials from fragile states.

MAPPING DEPENDENCE ON NATURAL RESOURCES

In several countries, including Angola, Chad, Nigeria and Sudan, wealth in the form of natural resources has spurred not economic growth, but corruption, repression and violent conflict. This so-called resource curse affects many but certainly not all fragile states. The risk of a state descending into resource-based conflict or authoritarianism is highly correlated with the degree of resource dependence. Table 1 offers an overview of the resource dependence of selected fragile states.

The table indicates that both fuel-producing and mineral-rich fragile states can be highly dependent on natural resource extraction. In some states half of all economic activity revolves around resource extraction. When it comes to exports, and hence the possibility

TABLE 1: RESOURCE DEPENDENCE IN SELECTED FRAGILE STATES

		Fuels (Oil, Coal and Gas)		Ores and Metals		
Country	Failed state ranking[1]	Export Dependence[2]	GDP Dependence[3]	Export Dependence	GDP Dependence	World Bank Data Year
Sudan	1	87	15	0	0	2005
Cote d'Ivoire	6	37	18	0	0	2006
Guinea	9	0	0	72	16	2002
Central African Rep.	10	0	0	17	2	2005
Nigeria	17	98	38	0	0	2003
Congo Rep.	26	88	49	0	0	1995
Cameroon	35	62	12	5	1	2006
Mauritania	45	0	0	69	21	2005
Papua New Guinea	52	22	14	49	31	2003
Angola	53	93	36	6	2	1990
Azerbaijan	62	85	27	1	0	2006
Algeria	89	98	47	1	0	2006
Gabon	99	86	50	3	2	2006
Libya	115	93	23	0	0	1998

Source: Calculations based on World Bank WDI data.

1) Ranking according to Fund for Peace failed-state index score 2007.
2) Export dependence is resource value as a percentage of merchandise export.
3) GDP dependence is resource value as a percentage of GDP.

for attracting foreign currency, the degree of reliance is often even higher.

In general, trade and economic data from fragile states should be treated with care. For instance, some fragile states fail to register as resource-dependent because of a lack not of resources, but of data and/or the absence of a functioning economy. Chad, Liberia and DRC are examples.

For donor countries, it is absolutely essential to consider the importance of natural resources in the economies of fragile states when creating policies to enhance further economic development. Natural resources are an important issue in connection with state fragility because they highlight some avenues *into fragility* and, equally importantly, a potential route *out of fragility,* provided the inflow of capital can be put to good use.

NATURAL RESOURCE CONFLICTS

Fragile states are characterized by defective economies, lack of social cohesion and the absence of effective and responsive state institutions in all or parts of their territory. When these characteristics are combined with the presence of valuable natural resources, the result often becomes natural resource conflicts or the persistence of authoritarian regimes.

Natural resources and state fragility combine to create violent uprisings in cases where states are unable to extend their own monopoly of violence to their entire territory. When authority is absent or weak and the potential financial gains from controlling resource-rich areas loom large, warlords or secessionist movements might feel tempted to challenge the state. Warlordism has affected West Africa, whereas secessionism has beleaguered resource-rich areas in Nigeria (Biafra), DRC (Katanga), Indonesia (Aceh) and Angola (Cabinda). Such uprisings have rarely succeeded in creating much political change, let alone new states, but they have caused tremendous humanitarian problems, while enriching only a few leaders. This is the resource curse in its purest form. When states fail to uphold their monopoly of violence, internal conflicts makes it impossible to ensure economic development and use resource revenue to improve the livelihood of citizens.

LACK OF ECONOMIC DEVELOPMENT AND THE PERSISTENCE OF REPRESSIVE REGIMES

It is counterintuitive to think that presence of valuable natural resources should lead to a lack of economic development. Yet such natural riches frequently result in poor economic performance and the persistence of authoritarian political regimes.

Resource-rich fragile states owe their economic difficulties to corruption, mismanagement and the downward spiral or so-called Dutch Disease. The latter entails appreciation of the resource-exporting country's currency and, in the case of fragile states, significant difficulties in establishing viable industries outside resource extraction. Failing to create economic diversification and to develop industries that involve the processing of natural resources, rather than merely their extraction, hinders economic growth.

There is also a political aspect to these problems. Resource-exporting states tend to become *rentier states,* i.e. states that survive on rents rather than traditional taxation of the population. Rents in this context are derived from the sale of concessions, royalties and corporate taxes, which create a political system void of incentives to provide the basic education and health care that allow citizens to add to the country's economic development. At the same time, citizens have little incentive to demand democratic representation in exchange for taxes. The result is a complete absence of mutually binding ties between political elites and the general population.

Without reciprocity between political elites and citizens, fragile rentier states become weak in terms of welfare provision. They are, however, frequently strong in terms of repressive power. This puzzling characteristic is caused by close and often opaque connections between political elites and the extractive industry. Political leaders rely on income from the extractive industry to maintain the patron-client relationships that allow them to stay in power. Hence authoritarian regimes use resource rents to increase their repressive power, thus prolonging their periods in office.

For donors, these linkages between natural resources and adverse political and economical outcomes constitute a major challenge. Policies must promote a balance in which fragile states become strong enough to control their territories and provide a reasonable level of services to their citizens without reaching the other extreme of state strength being used to suppress citizens and political opposition.

TARGETING POLICY INTERVENTIONS

Breaking the linkage between state fragility and natural resources is a challenging and risky undertaking. Policies aimed to create growth based on natural resource extraction run the risk of solidifying authoritarian regimes' grip on power. In order to achieve economic development while maintaining a balance between state strength and basic freedoms, policy interventions must be carefully targeted.

Given the likelihood that local political elites might resist change out of fear of losing their privileges, and that growing resource demand by high-growth economies in Asia diminishes action space for Western donors, policy interventions might need to circumvent local political elites. The focus will often need to be on the private sector and civil society. Given the absence of a commonly shared idea of community in many fragile states, engagement with local power structures and businesses might also offer donors broader impact than an explicit focus on governments. Therefore a two-pronged response that involves action both within and outside fragile states is required.

IN FRAGILE STATES: PROMOTE TRANSPARENCY, ECONOMIC DIVERSIFICATION AND CAPACITY-BUILDING

Donor policies towards fragile states can break the link between resource wealth, governance failure and lack of economic development by promoting transparency, economic diversification and local capacities.

Transparency relating to resource management and revenues can be increased by aiding the implementation of internationally recognized governance principles such as those set forth by Extractive Industries Transparency Initiative (EITI). The implementation of EITI principles follows the criteria listed below. Many of the resource-dependent fragile states mentioned in Table 1 are currently EITI candidate countries, and their process towards EITI compliance is supported by numerous donor countries, including Norway, the UK and the Netherlands.

To ensure that increased transparency translates into economic development, local capacity to manage resources must be improved. Ensuring that fragile states are able to negotiate reasonable contracts with extraction companies and to set up a comprehensive tax regime that channels resource rents towards development are two important places to start. Norway, for instance, is facilitating capacity-building in these fields through its Oil for Development initiative.

BOX 1: SELECTED EITI CRITERIA

- Regular publication of all material oil, gas and mining payments by companies to governments and all material revenues received by governments from oil, gas and mining companies to a wide audience in a publicly accessible, comprehensive and comprehensible manner.
- Where such audits do not already exist, payments and revenues are the subject of a credible, independent audit, applying international auditing standards.
- Civil society is actively engaged as a participant in the design, monitoring and evaluation of this process and contributes towards public debate.
- A public, financially sustainable work plan for all the above is developed by the host government, with assistance from the international financial institutions where required, including measurable targets, a timetable for implementation, and an assessment of potential capacity constraints.

Source: www.eitransparency.org

Finally, efforts to help fragile states diversify their economies would prevent the resource curse from gaining a foothold. Most fragile states rely economically on pure extraction, rather than processing, of natural resources. An increased focus on value-added processing would create more local jobs and generate higher export earnings. Moreover, such diversification would improve the political and financial stability of fragile states by shielding them from the price volatility of raw material markets.

IN DONOR COUNTRIES: PROMOTE INVESTMENT AND REMOVE OF TRADE BARRIERS

Efforts in donor countries, or by donor countries in multilateral settings, can go a long way towards helping fragile states making the best of their resource endowments. In particular, questions relating to investments made by multinational companies and international trade regulation are more easily addressed by donors than by fragile states.

Donors can help tighten control of illicit payments and help ensure that companies abstain from using bribery and other exploitive strategies. Moreover, donors could promote investment further in the risky environments in fragile states. Investment is needed by reputable companies that can be held accountable by well-developed legal frameworks in donor states, and perhaps by share-holder and CSR concerns too. This would help crowd out companies that fail to live up to reasonable standards of conduct and transparency. Public agencies that offer financing and political risk insurance for businesses that invest in developing countries could play a key role in this strategy.

Donor countries also need to do their part to ensure that the transparency standards mentioned above take hold. To put warring parties in fragile states out of business, certification of valuable natural resources should be implemented more broadly. The Kimberley process has already minimized trade in conflict diamonds, and similar schemes could be created for other valuable resources.

Finally, donors can push for international removal of the tariffs and nontariff trade barriers that make local processing of raw materials financially unviable.

Removing such trade barriers for processed raw materials would give fragile states incentives to build up their own industries and increase exports. Along with the other suggested policies, this would help minimize the risk of fragile states falling prey to the resource curse.

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BOX 2: EXAMPLES OF MEAN OECD TARIFFS ON RAW PROCESSED AND UNPROCESSED RAW MATERIALS

Copper

Ore and concentrates, OECD average tariff: 0

Copper-based heating and cooking apparatus, OECD mean tariff imposed on MFN: 3.7%

Oil

Crude, OECD average tariff: 0
Woven fabrics of (oil-based) nylon/polyester, OECD mean tariff imposed on MFN: 6.0%

Source: UNCTAD-TRAINS database.
MFN=Most Favored Nation

FURTHER READING:

Bannon, Ian, and Paul Collier, eds. 2003. *Natural Resources and Violent Conflict.* Washington D.C: World Bank.

More on fragile situations: www.diis.dk/fragile

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