MINISTRY
FOR NATIONAL ECONOMY

The „resource curse” and EU funding

The “resource curse” theory has been an exciting topic of modern economics. This theory examines the distortive effect of natural resources and the revenues they generate. This concept states that countries rich in certain resources tend to regard these revenues as the only means of development and the rigid focus on the exploitation of these resources as well as the lack of diversification lead to self-exploitation and this rather suppresses than assists the long-term social progress and material enrichment of the country’s citizens.

Norway, Russia, Venezuela – different locations and cultures, but even more importantly, different economic structures and standards of living. They share one common characteristic feature though: the awe-aspiring abundance of natural resources. But does it improve the financial situation of a country if natural gas is discovered beneath its seas or crude oil beneath its deserts? **And above all, can a parallel be drawn between EU funds and the revenues generated by raw materials?**

The theory emerged in the 1950s-1960s, as an element of the middle income trap debate, as a potential explanation to that phenomenon. The term, however, was first used by Richard Auty in a study published in 1993. But it only gained widespread recognition through a paper two years later by Jeffrey Sachs and Andrew Warner. In this work, the two economists evaluated the negative effect of the abundance of resources on economic growth, and they also presented this phenomenon by the help of historic examples, such as 17th century Spain and the Low Countries. The contribution of Nobel Prize-winning economist Joseph Stiglitz to the evolution of this topic must also be noted, as along with the aforementioned Jeffrey Sachs and Macartan Humphreys he was co-author of a landmark book published in 1997, titled *Escaping the Resource Curse*. One of the cases they examine in it is the so-called “Dutch disease” which they demonstrate through the example of the Netherlands in the 1950s-60s when the national currency of the country rich in natural resources appreciated due to the extraction and sales of these raw materials and this subsequently crippled the competitiveness of the manufacturing and agricultural sectors, and the quantity of exported goods slumped.

In addition, the extreme homogeneity of a country's revenues makes state budgets vulnerable to potential price shocks on world markets. The change of crude oil prices seems to have turned Russia and Venezuela victims of this pattern, too. The following data aptly demonstrate the vulnerability of these countries: crude gas sales account for 60 percent of Russia's total export volume and generate 30 percent of GDP. **The market price of crude oil of some USD 110 at the beginning of 2014 declined by more than 50 percent by the end of the year, and in the same period the RUB/USD exchange rate fell by almost 59 percent.** In Venezuela, the country with the world's second largest estimated crude oil reserves of 300 billion barrels, black gold accounts for 95 percent of the country's exports and 25 percent of GDP. **Slumping oil prices pushed the value of Bolivar down by 60 percent, while – following more than 5 percent GDP growth in 2012 – in 2014 the economy posted negative growth of 4 percent.**

The distortive effect also typically afflicts the labour market: it misshapes labour market demand, as besides a few specialist engineers the oil industry requires masses of low-skilled workers and it also tends to drain labour force from other industries. This is the so-called "rent seeking": it makes the majority of a country's population, which constitutes the prime labour force, seek direct or indirect gains from revenues generated by raw materials, instead of making their living in other economic sectors. Furthermore, extracting minerals may cost a country more dearly than expected. The topic's two prominent researchers, Daron Acemoglu és James Robinson, show in their book *Why nations fail* **what risks it may pose if direct control over resources becomes the sole ambition of leaders of a country, and removing potential obstacles to this objective ends with the annihilation of democratic institutions and forcibly keeping a tiny group of insiders in power.** This may lead not only to constitutional crises and corruption but even to the risk of armed conflicts between opposing groups and ultimately to civil war. In their opinion, the United States have been lucky to have scarce reserves of raw materials and this has facilitated innovation and driven the quest for efficient production methods.

Stiglitz points out that these states, instead of investing in the economy's diversification, education, research and development, regard the more and more intensive exploration of resources as the only guarantee of economic growth. This attitude, however, is contra-productive in the long term, and results in growth instability, unemployment and disfigured, uncompetitive

production models. Potential outcomes include uncontrolled and anarchic public administration and bloodshed, so it is justified to call the end result *self-exploitation*.

What can a state do?

Although the resource curse-theory is exciting and has been confirmed by various historic and recent examples, the Russian economist and ex-Kremlin advisor Peter Kaznacev is convinced that nobody and nothing have been cursed. **States in question must be capable of preventing the distortion of the economy through a potent institutional background, transparent and responsible governance as well as adequate private property regulations.** In accordance with the reasoning of Stiglitz and Sachs one may add that it is also crucial to keep a lid on the exchange rate of the national currency as it helps maintain competitiveness, and in order to build buffers for shocks the state must establish emergency funds from incoming revenues.

Norway is a good example for the latter measure. The Scandinavian oil exporter has channelled a large share of oil revenues into a welfare fund which aims to offset the effect of a potential recession stemming from diminishing reserves in the future. The Norway Government Pension Fund is the largest of its kind, and the value of its assets totalled USD 850bn at the beginning of 2015. It has stakes in some 9000 companies in 75 countries.

A similar fund also exists in Russia: the Stability Fund, established in 2004, aims to limit inflation and adjust the federal budget provided the crude oil price falls below the mark of USD 27 per barrel. In 2008, the Fund was split in two: **the National Welfare Fund and the Reserve Fund, with current investments of USD 137bn and USD 88bn, respectively.**

The case of Venezuela, on the other hand, is a telling example of self-exploitation. Although the government which was in office prior to the emergence of Hugo Chávez in 1998 had made an attempt to set up a Macro-economic Stability Fund, this had proven to be a futile bid as the Bolivar Republic was characterized until 2013, the death of President Chávez, by reckless spending. It is true that social inequality has significantly moderated and the country's GDP doubled between 2006 and 2010, but the country has wasted the opportunity of setting up a sizable fund and securing the financial stability of future generations.

	Norway			Russia			Venezuela		
	1995	2005	2014	1995	2005	2014	1995	2005	2014
GDP growth	3.6%	1.9%	1.1%	-4.2%	6.8%	-1.1%	1.8%	8.4%	-5.3%
Unemployment	4.9%	4.6%	3.4%	9.4%	7.1%	5.1%	10.2%	11.4%	8.6%
Inflation	2.5%	1.5%	2.2%	197%	13%	11 %	59%	16%	62.2%
Est. reserves, rank, 2014	6.9 million barrels, 21.			80 million barrels, 8.			297 million barrels, 1.		
Share, 2014	GDP	Export		GDP	Export		GDP	Export	
	22%	67%		30%	60%		25%	95%	

Source: World Bank, OECD, OPEC

The resource curse and EU funding

In their study, *Resource or not?,* Stockholm University professors Anne Boschini és Jan Petterson come to the conclusion that **it does not make any difference if extra resources stem from financial aid or the extraction of raw materials.** Nonetheless, EU support funds cannot simply be labelled as aid: it is in the best economic and political interest of contributing countries to assist the convergence of Central and Eastern European states.

Sluggish convergence, the sometimes unreasonable utilization of cohesion funds and the ensuing political-social fragmentation are nothing new. In the periods 2007-2013 and 2014-2020 these funds total EUR 336bn and EUR 351bn, respectively. Of the latter, EUR 182bn are to be disbursed in our region, the population of which constitutes 27 percent of the EU's total. The massive amount of funding signals that Europe has had a historic opportunity, but **several studies question the efficiency of the programme and they often voice similar misgivings.**

Pointless prestige projects and state-managed tendering turn some companies uncompetitive and alienate them from market conditions. EU transfers dwarf private investment. **EU funding average 2-3 percent in the Visegrad Four, but Hungary receives the largest share of EU funds in percentage of GDP, with some 3.2 percent or HUF 8000bn**. In absolute terms,

Poland is the top beneficiary (with EUR 77bn). Inefficient institutional systems and excessive bureaucracy limit the absorption capacity of countries: while the absorption rate is more than 90 percent in case of Lithuania, Romania and Croatia are hardly capable of utilizing 60 percent of funding. Certainly, Lithuania has had a head start of at least four years in setting up an adequate institutional system compared to its eastern and southern neighbours. Another factor that has been hampering the optimal utilization of these funds is widespread corruption and the power struggle of elites over financial resources. According to a study made within the framework of the ANTICORRP project, **one-third of projects financed by the EU have been tainted by corruption in Hungary, the Czech Republic and Slovakia.** These countries receive 3 percent, 8 percent and 13 percent, respectively, of total EU funding, which amounts account for 0.94 percent, 1.15 percent and 1.61 percent, respectively, of the countries' GDP. It can also be noted that that Hungary had a score of 54 points on Transparency International's Corruption Perception Index in 2014, which puts us ahead of the Czech Republic (51 points) and Slovakia (50 points), but perceptions of us are better than those on Poland (61 points) and Slovenia (58 points).

Certainly we cannot state that the situation in the two groups of countries (Norway, Russia and Venezuela vs. CEE countries) is the same. EU funding must not be seen as free handout. This form of support aims to help close the gap with richer countries and create competitive production models, which can secure the material well-being of citizens after the gradual but inevitable withdrawal of EU funding.

The utilization of funds is attached to concrete goals, which are formulated as a result of negotiations with representatives of the EU and an extensive process of programming and strategic planning. The role of various indicators and monitoring institutions is also crucial, as they are designed to guarantee the efficient utilization of funding and the realization of the ultimate goal – convergence – and the long-term economic and political equilibrium of the European Union. The above examples also serve as reminders for the Hungarian Government to use every possible instrument in the period 2014-2020 and allocate as much of EU funds as possible for economic development, thus laying the foundation of lasting convergence and steady growth that can help the country avoid the aforementioned pitfalls in the future.