A Prudent Man's Curse

Without the right public institutions, the temptation of power politics can imperil longer-term development goals

Vitor Gaspar

IN 1596, Philip II of Spain defaulted on debt for the fourth time. An experienced and systematic administrator with an eye for the tiniest detail, he requested and pondered arguments from his trusted advisors, approaching difficult political decisions from every angle. He organized the complete administrative records of his government's workings. He even ordered architect Juan de Herrera to redesign a castle into the first-ever government archive, which strictly adhered to archival rules and served as the repository of documents produced by the Crown until the 19th century. His wise and considered approach to the conduct of political matters, and his many innovations to public administration, earned him the moniker Philip the Prudent.

Despite his administrative brilliance, Philip was forced into default early in his reign, in 1557 and 1560—for two reasons. First, Philip inherited personal debts belonging to his father, Charles V—at a time when the distinction between private and state debts was not well defined—with limited resources to service them. Second, and perhaps more important, the Spanish coffers were exhausted after war with Henry II of France.

When urged to default for a third time, in 1574, Philip postponed the decision for over a year. This time, default would affect debt that he himself had contracted with his Genovese bankers and jeopardize his personal reputation. But in 1575 he finally agreed to sign a decree (*Decreto*) suspending debt payments on *asientos*—the Crown's short-term, high-cost debt instruments typically serviced with silver from the Americas.

The Decreto explained that the king was disappointed so few creditors were willing to advance funds to the Crown, that he was shocked by the high interest rates, and that the use of credit, in general, was a dubious activity on both moral and legal grounds. Hence, no payments would be made until a thorough review of all terms, conditions, and past payments could be scrutinized. These were the grounds for the suspension of debt payments.

For the fourth default, in 1596, there is no record of hesitation, and the 1596 Decreto was expeditiously signed.

Why did Philip the Prudent resort to expensive asientos and then to default? The reasons were political. By doing so, the king remained in sole control of his resources. He did not have to make political concessions to the Assembly, whose approval was required to issue longer-term debt backed by regular revenues. He could afford not to compromise because, as had happened with his father, Charles V, financial probity was occasionally rescued by the timely arrival of American silver. Indeed, one can argue that these events delayed political, institutional, and financial development in 16th century Spain.

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This story is not unusual. It illustrates the complex interaction between politics, institutional development, and governance that is the very essence of public policy. This interplay is manifest in all policy decisions on taxation, spending, and financing.

The story of Philip II parallels the modern experience of many countries rich in natural resources (such as oil, gas, or minerals) that fall prey to the "natural resource curse"—which often leads to unstable economic growth, weak financial development, and political disruption.

Intuitively, it seems natural resources would be a blessing for a country. Resource wealth should make it easier to finance investment for sustainable growth while allowing the government to provide fundamental social goods like education, health, and collective insurance against individual contingencies. But quite a number of resource-wealthy countries have failed to achieve sustained high growth. Conversely, in recent decades, many high-growth developing economies have not been rich in natural resources.

The main challenge is that abundant natural resource wealth can distort political and economic incentives. If left unchecked, natural resource wealth diverts political efforts from the core functions of government to the appropriation

of resource wealth. In other words, the incentives for self-serving behavior may come to dominate political activities. Physical and institutional structures that support sustainable long-term growth are neglected in favor of activities that provide high payoffs to individuals. In the extreme, competition for natural resource wealth can even lead to civil strife. Furthermore, opportunities for personal enrichment and position through political lobbying can lead to the diversion of entrepreneurial talents away from productive activities.

In any case, the management of revenues from natural resources puts governance to the test. Weak institutions misallocate and mismanage natural resources, to the detriment of social peace, efficiency, sustainable economic growth, and the environment. Boom-bust cycles—the ramping up of inefficient public spending in the "good times" of high income from natural resources, followed by an abrupt fall in expenditure during "bad times" when resource revenues collapse—are commonplace. Governments rely excessively on revenues derived from commodities and export earnings, and are subject to the unpredictable ebb and flow of commodity prices.

In the past few years we have witnessed significant drops in commodity prices. For example, metal prices have fallen dramatically since their peak in 2011. Oil prices plunged in the second half of 2014, with the decline persisting into early 2015. As of January 2015, most oil-exporting countries were facing oil prices well below their notional fiscal breakeven levels—the average oil price needed for the country to balance its budget. The unpredictability of commodity prices, so vivid in recent developments, underlines the importance of public financial management in natural resource–rich countries.

Another challenge comes from so-called Dutch disease. Real exchange rate appreciation, associated with the spending of natural resource revenues on nontradable goods and services diverts resources from competitive tradable goods sectors, undermining openness and growth.

For natural resource–rich countries, the increased opportunities for governments come, therefore, with many responsibilities. The task in the near term is to break the boom-bust cycle by decoupling current government spending from volatile resource revenues.

Fiscal institutions have proven a powerful tool in helping to achieve such decoupling.

Chile has pursued a policy of prudent fiscal management of its copper revenues through adoption of a fiscal rule that targets a structural budget balance. The fact that the values for long-term copper prices and potential GDP are set by an independent panel of experts enhances the transparency of the rule.

In Norway, expenditure can be financed only by the income generated by the assets accumulated from past resource extraction. Furthermore, Norway has vested the management of its oil wealth in its independent central bank rather than in its Ministry of Finance for the explicit purpose of increasing the distance between the management of the oil fund and the political process.

Botswana has also earned a reputation for good governance, prudent macroeconomic policies, and sound management of mineral resources. Botswana's mineral wealth has been managed based on a rule to ensure that current spending is financed only with non–resource revenues. Resource revenues are either used to finance investment or saved in the Pula Fund (a sovereign wealth fund) to transfer wealth to future generations.

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Australia and Canada provide further examples of good management of natural resource wealth.

Governments also face the responsibility of building public institutions to guard against behavior that favors personal gains over longer-term development. Fiscal transparency and good governance play a central role, a theme that is actively promoted by the IMF.

To ensure more effective checks and balances and greater transparency, management of natural resource revenues should follow these four principles:

• comprehensive legal framework and fiscal regime, with open and transparent procedures for granting natural resource extraction rights and clear rules governing resource revenue generation and collection;

• comprehensive, timely, and reliable reports by governments and resource companies on holdings of natural resource rights, extraction and trading activities, and payments and collections of resource revenue;

• budget documentation with a clear statement of the government's resource management objectives and reporting on the allocation of resource revenues for public spending and saving; and

• disclosure, analysis, and management of the social, environmental, and operational risks associated with natural resource exploitation.

Ideally, greater transparency and accountability would go hand in hand with more inclusive political institutions. Sustainable growth and prosperity are built on the accumulation of human capital and knowledge. Stable and inclusive political institutions are central to guaranteeing an environment that fosters the accumulation of physical and human capital. Being blessed with an abundance of natural resources is clearly not enough. Without the right incentive structure, political gains can override longer-term development goals.

Remember that even Philip the Prudent was seduced by power politics over financial institutional building. Good governance and strong institutions are necessary conditions for sustainable growth. We can reasonably hope that the difficulties associated with the volatility of oil and other commodity prices will lead many countries to adopt robust public financial management practices fostering long-term prosperity and stability. ■