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The resource curse hypothesis and its implications on the Nigerian tax system

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Abstract
The study entitled the resource curse hypothesis and its implications on the Nigerian tax system provides a conceptual insight and an in-depth analysis of the dynamics of the resource curse on the political economy of Nigeria. The objective of this paper is to examine the implications of the resource curse hypothesis on the Nigeria tax system. Using extensive literature review the researcher explored the resource curse hypothesis and its implications on the Nigerian tax system. The study highlighted the perverse connections between oil dependence and weak institutional framework as well as low human development and its concomitant effect on conflict and political instability in Nigeria. Nigeria's performance in terms of development indicators such as gross fixed capital formation; quality of governance and institutional capacity; level of inclusive human development; infrastructure performance and spread of the tax base is far below average. We conclude in line with extant literature that to some degree the low development performance of Nigeria is symptomatic of the oil resource curse and common to many other mineral exporting countries in many developing regions of the world. The policy implications of this paper implies an urgent need for structural transformation of the economy from sectors with low productivity and net employment such as mineral exploration to sectors with high productivity and employment such as agriculture and manufacturing in order to stimulate the creation of better and productive jobs for the bulging population. The study also recommends an urgent need for institutional reforms that will strengthen the governance and administrative capacity of the country in order to foster a paradigm shift from a rentier economy to more inclusive and sustainable economy.

Keywords: oil, natural resource, curse, structural, transformation, taxation

Introduction

Despite the potentially beneficial impact of natural resource wealth on economic prosperity, natural-resource abundant economies tend to grow at a slower pace (Sachs and Warner, 1995, 1997 and 1999a, Rodriquez and Sachs, 1999, Leite and Weidmann, 1999, and Gylfason, 2000 and 2001a) [33, 34, 36]. Over the last two centuries, countries rich in natural resources, e.g. Russia, Nigeria and Venezuela, experienced growth of comparatively low or mediocre magnitude. Sachs and Warner (1995) [33] claim that this is a historically common pattern. Countries that base their economies on natural resources tend to be examples of development failures. In contrast, countries that had only limited access to natural resources, such as Japan, Hong-Kong, Korea, Singapore and Switzerland, experienced remarkably high economic growth rates. Many development economists, e.g., Nurkse (1953) [29] and Rostow (1960), [32] accentuate the positive role of natural resources in economic development. To many economists the tendency of natural resource-rich countries to experience low economic growth is a conceptual puzzle. Economists consider natural resources to be a potential source of income, some of which is saved and converted into capital to support increases in future output levels. For example, resource rents may be used for the construction of roads, modernization of telecommunication systems, health and educational programs. Several countries did benefit from their natural wealth; the nineteenth century resource booms in Latin America stimulated economic progress. For example, Ecuador experienced a significantly higher income per capita level after its boom (Sachs and Warner, 1999a) [35]. Similarly, the industrial revolution in Great Britain and Germany was possible only because of the vast deposits of ore and coal (Sachs and Warner, 1995) [33]. As a more recent example, Norway manages its natural resource abundance well and converts it into economic prosperity. Although Norway did experience a recession for several years, the way in which its present and future natural wealth is exploited provides an example of carefully planned development. Almost 80 percent of the oil rents are collected through taxes and fees and then invested in foreign securities to protect the economy from abrupt and large income increases so that a fair division of oil rents between generations is achieved (Gylfason, 2001a) [14].

Given the relatively few successful examples, this paper investigates the causes for underperformance by most resource-rich countries. In the literature, several negative transmission channels have been investigated. At a natural resource discovery, the resulting sudden increase in income may lead to sloth and less need for sound economic management and for institutional quality (Sachs and Warner, 1995, Gylfason, 2000 and 2001a) [33]. The boom may also create a false sense of security and weaken the perceived need for investment and growth-promoting strategies. Natural resource abundant economies benefit less from the technology spillovers that are typical in manufacturing industries because the exports of these industries are harmed by an appreciation of the local currency, e.g. through the inflationary pressure

resulting from increased domestic demand (Sachs *et al.*, 1995 and 1999a, Gillis *et al.*, 1996, and Gylfason, 2000 and 2001b) [33, 10]. Finally, as the natural resource sector expands relative to other sectors, the returns to human capital decrease and investments in education decline (Gylfason, 2001a) [14].

Meaning of the resource curse theory

The resource curse hypothesis is also known as the paradox of plenty, refers *to the paradox that countries with an abundance of natural resources tend to have less economic growth, less democracy, and worse development outcomes than countries with fewer natural resources* (Wikipedia, 2019). There are many theories and much academic debate about the reasons for, and exceptions to, these adverse outcomes. Most experts believe the resource curse is not universal or inevitable, but affects certain types of countries or regions under certain conditions. The *resource curse* or *the paradox of plenty* also involves *to the failure of many resource-rich countries to benefit fully from their natural resource wealth, and for governments in these countries to respond effectively to public welfare needs* (Natural resource governance institute, 2015). While one might expect to see better development outcomes after countries discover natural resources, resource-rich countries tend to have higher rates of *conflict* and *authoritarianism*, and *lower rates of economic stability and economic growth*, compared to their non-resource-rich neighbors. This paper describes political and economy theories about why some resource rich countries do not do as well as expected.

Fundamental messages of the resource curse theory

The following are the main lines of the resource curse theory. They include

1. The term resource curse encompasses the significant social, economic and political challenges that are unique to countries rich in oil, gas and minerals.
2. Many oil-gas-and mineral-rich countries have failed to reach their full potential as a result of their natural resource wealth. In general, they are also more authoritarian, more prone to conflict, and less economically stable than countries without these resources.
3. While there are many challenges unique to oil, mining and gas extraction, governments can make policy decisions that help avoid some of the negative consequences of extraction and maximize the benefits.

Historical developments and improvements to the resource curse theory

The idea that resources might be more of an economic curse than a blessing began to emerge in debates in the 1950s and 1960s about the economic problems of low and middle-income countries. However, in 1711 the spectator wrote "it is generally observed, that in countries of the greatest plenty there is the poorest living", so this was not a completely new observation. The term resource curse was first used by Richard Auty in 1993 to describe how countries rich in mineral resources were unable to use that wealth to boost their economies and how, counter- intuitively, these countries had lower economic growth than countries without an abundance of natural resources. An influential study by Jeffrey Sachs and Andrew Warner (1995) [33] found a strong correlation between natural resource abundance and poor economic growth. Hundreds of studies have now evaluated the effects of resource wealth on a wide range of economic outcomes, and offered many explanations for how, why, and when a resource curse is likely to occur. While the lottery analogy has value but also has short comings, many observers have likened the resource curse to the difficulties that befall lottery winners who struggle to manage the complex side- effects of new found wealth. Scholarship on the resource curse has increasingly shifted towards explaining why some resource – rich countries succeed and why others do not, as opposed to just investigating the average economic effects of resources. Research suggests that the manner in which resource income is spent, system of government, institutional quality, type of resources, and early vs. late industrialization all have been used to explain successes and failures.

Variant to the Resource curse hypothesis

A 2008 study argues that the curse vanishes when looking not at the relative importance of resource exports in the economy but rather at a different measure: the relative abundance of natural resources in the ground. Using that variable to compare countries, it reports that resource wealth in the correlates with slightly higher economic growth and slightly fewer armed conflicts. That a high dependency on resource exports correlates with bad policies and effects are not caused by the large degree of resource exportation. The causation goes in the opposite direction: conflicts and bad policies created the heavy dependence on exports of natural resources. When a country's chaos and economic policies scare off foreign investors and send local entrepreneurs abroad to look for better opportunities, the economy becomes skewed. Factories may close and businesses may flee, but petroleum and precious metals remain for the taking. Resource extraction becomes the default sector that still functions after other industries have come to a halt. A 2011 article that examines the long term relationship between natural resource reliance and regime type across the world from 1800 to 2006 reports that increases in natural resource reliance does not induce authoritarianism. With a focus on alleviating the methodological biases of earlier studies, the authors find evidence which suggests that increasing reliance on natural resources promotes democratization, the opposite of what the resource curse theory suggests. The researchers provide qualitative evidence for this fact across several countries both here, and in another article; as well as evidence that there is no relationship between resource reliance and authoritarianism in latin America. The main methodological bias of earlier studies, the authors claim, is the assumption of random effects: Numerous sources of bias may be driving the results of earlier studies on the resource curse, the most serious of which is omitted variable bias induced by unobserved country- specific and time –invariant heterogeneity. In other words, this means that countries might have specific, enduring traits that get left out of the model, which could increase the explanation power of the argument. The authors claim that the chances of this happening is larger when assuming random effects, an assumption that does not allow for what the authors

call unobserved country- specific heterogeneity.

The Dutch Disease

The concept of Dutch disease says *that a large increase in natural resource revenues can hurt other sectors of the economy, particularly export-based manufacturing, by causing inflation or exchange rate appreciation and shifting labor and capital from the non-resource sector to the resource sector*. It first became apparent after the Dutch discovered a huge natural gas field in Groningen in 1959. The Netherlands sought to tap this resource in an attempt to export the gas for profit. However, when the gas began to flow out of the country, so too did its ability to compete against other countries' exports. With the Netherlands' focus primarily on the new gas exports, the Dutch currency began to appreciate, which harmed the country's ability to export other products. With the growing gas market and the shrinking export economy, the Netherlands began to experience a recession. This process has been witnessed in multiple countries around the world including but not limited to Venezuela Oil, Angola (diamonds, oil), the Democratic Republic of the Congo (diamonds), Nigeria (oil and gas) and various other nations. All of these countries are considered resource- cursed. Dutch disease makes tradable goods less competitive in world markets. Absent currency manipulation or a currency peg, appreciation of the currency can damage other sectors, leading to a compensating un favorable *balance of trade.* As imports become cheaper in all sectors, internal employment suffers and with the skill infrastructure and manufacturing capabilities of the nation. This problem has historically influenced the domestic economics of large empires including Rome during its transition from a Republic in 509 BC, and the United Kingdom during the height of its colonial empire. To compensate for the loss of local employment opportunities, government resources are used to artificially create employment. The increasing national revenue will often also result in higher government spending on health, welfare, military, and public infrastructure, and if this is done corruptly or inefficiently it can be a burden on the economy. While the decrease in the sectors exposed to international competition and consequently even greater dependence on natural resource revenue leaves the economy vulnerable to price changes in the natural resource, this can be managed by an active and effective use of hedge instruments such as forwards, futures, options and swaps, however if it is managed inefficiently or corruptly this can lead to disastrous results. Also, since productivity generally increases faster in the manufacturing sector than in the government, so the economy will have lower productivity gains than before.

Causes and Effects of the Resource Curse hypothesis

Countries with nonrenewable resource wealth face both an opportunity and a challenge. When used well, these resources can create greater prosperity for current and future generations; used poorly or squandered they can cause economic instability, social conflict and lasting environmental damage.

Political scientists and economists argue that oil, mineral and gas wealth is distinct from other types of wealth because of its large upfront costs, long production timeline, site-specific nature, scale (sometimes referred to as large *rents*), price and production volatility, non-renewable nature, and the secrecy of the industry. Below are some of the leading observations and theories about how these special characteristics of natural resource revenues create additional challenges for countries:

a. Democracy and the Resource curse hypothesis

Natural resource wealth, particularly oil wealth, has made it more likely for governments to become or remain authoritarian over the past 30 years. The explanation for this lies in *taxation*. In general, political scientists find that governments are more responsive to their citizens and are more likely to transition to democracy when government spending is reliant on citizen taxation. When countries collect large revenues from natural resources, they are less dependent on levying taxes on citizens, and thus citizens feel less invested in the national budget. Politicians and government officials are also less directly tied to citizen requests or demands. Further, when resource revenues are secret, citizens do not have a clear sense of whether the resource revenues are being spent well or not. Those who outline this theory suggest that the tendency toward authoritarianism can be mitigated by increasing transparency of revenues and strengthening the links between government and citizens through citizen participation in budgeting or direct distribution of wealth (e.g., cash transfers).

b. Conflict and the Resource hypothesis

Natural resources can, and often do, provoke and sustain internal conflicts as different groups fight for control of the resources or use natural resources to finance their fighting. Since 1990, oil-producing countries have been twice as likely to have a civil war compared with non-oil-producing countries. Political scientists point to examples of the Democratic Republic of the Congo, the Niger Delta, Iraq, Libya and Angola to illustrate this tendency. *Petro-aggression*, the tendency of oil rich states to instigate or be targets of international conflict, has been observed in some cases, such as with Iraq's invasion of Iran and Kuwait, but researchers debate whether the data supports the conclusion that resource-rich countries do this at a greater rate than non-resource-rich countries.

c. Inefficient spending and borrowing and the Resource hypothesis

The amount that governments collect in resource revenues can change drastically from year to year because of changes in commodities prices and production. Several studies have shown that it is very difficult to effectively spend fluctuating and unpredictable revenues. Governments often get trapped in boom-bust cycles where they spend on legacy projects, such as airports and monuments, when revenues are rising and then must make painful cuts when revenues decline. Resource-rich governments have a tendency to over-spend on government salaries, inefficient fuel subsidies and large monuments and to under spend on health, education and other social services. In addition, governments often over-borrow because they have improved credit-worthiness when revenues are high. This type of behavior led to debt crises when revenues declined in Mexico, Nigeria and Venezuela in the 1980s. The private

sector can be similarly impacted, as it can over-invest in boom times and then experience widespread bankruptcy during busts.

d. Declining manufacturing sector and The Resource curse hypothesis

A large increase in natural resource revenues can hurt other sectors of the economy; particularly export-based manufacturing, by causing inflation or exchange rate appreciation and shifting labor and capital from the non-resource sector to the resource sector (see revenue management reader). This is known as "Dutch disease." While inflation and exchange rate appreciation can harm large swathes of the economy over within a few years, their impacts can be felt for decades. The detrimental effect of natural resources on other industries has been well documented in Iran, Russia, Trinidad and Tobago, and Venezuela, all of which have either stunted manufacturing sectors or saw a precipitous decline in manufacturing. These impacts can be minimized if the country has the *absorptive capacity* to transform resource revenue inflows into tangible investments, such as roads and electricity; the government uses resource revenues to make investments in the economy that generate non-resource sector growth; or the government places a portion of its resource revenues in foreign assets. Over the last 25 years, Chile,

Indonesia, Norway and the UAE have largely managed to overcome Dutch disease.

e. Patriarchy and gender-based challenges and the resource curse hypothesis

Natural resource wealth seems to disproportionately impact women. Recent research indicates that oil-rich countries tend to have fewer women in the workforce and a smaller representation of women in government. One explanation for this is that industries that are usually easier for women to enter, such as export-oriented manufacturing, are less likely to succeed in resource-rich countries because of Dutch disease. In addition, studies have shown that women in resource-rich regions often have higher rates of HIV/AIDS and other life-threatening diseases. The large influx of men to communities surrounding a mine has also been associated with an increase in rates of gender-based violence. This trend is particularly concerning as study after study shows that gender reforms are key to lasting poverty reduction. To address this, researchers suggest countries take steps to protect manufacturing through avoiding Dutch disease and that governments surrounding resource-rich areas include gender perspectives in their development plans.

f. Limited government capture of benefits and the Resource curse hypothesis

In some cases, only a small share of the production value of the resource stays in the country. One explanation is that many *fiscal regimes*, rules about how to split the profits between companies and governments, fail to compensate the state and communities for depleting their resources and related environmental damage or loss of livelihood. These bad deals can happen when countries are so eager to encourage resource extraction that they lower the rates for taxes and royalties without understanding the true value of their resources. In Argentina, Canada, the United States and South Africa, the average effective tax rate (AETR) on many oil projects is less than 50 percent, and in Cameroon, DRC, Peru and the Philippines, the AETR on many mining project is less than 40 percent. In comparison, the AETR on many oil projects in Angola, Libya, Norway and Timor-Leste is more than 70 percent. Also, in capital-intensive (rather than labor-intensive) extractive industries, few *non-tax benefits*, such as jobs, accrue to locals. While expectations for *local content*, that is employment, local business development and improved workforce skills, are often very high, the actual number of opportunities may be few. The industry has a very low employment rate relative to the size of investments and those jobs, and the machinery required to implement them, mostly imported from abroad, tends to be extremely specialized.

g. Weaker institutional development and the Resource curse hypothesis

Some researchers *argue that institutions are weaker in resource-rich countries because it is easy for elites to capture or take large sums of cash.* The theory suggests that large single-point sources of revenue, such as an oil project, can be managed outside the normal budget process and are relatively easily captured by powerful elites. Examples of tools used to capture revenues include sovereign wealth funds, national oil companies and contractors for extractive operations. As such, elites in natural resource-rich countries are less likely to invest in productive enterprises, such as job-creating manufacturing industries, and instead pursue *rent-seeking*, that is, fight for control of these resources. In some cases, politicians or government officials have also purposefully dismantled societal checks or created new regulations to get access to these resources or to provide access to friends or family, a process nicknamed *rent-seizing*.

Some argue that elite focus on rent-seeking and rent-seizing promotes corruption and is damaging to institutional development. In turn, the theory suggests that countries with elite rent seekers and rent-seizers tend to have weaker institutions and lower levels of public service delivery. The data behind this theory is hotly debated, but there are well-documented examples in Afghanistan, Sierra Leone and Tunisia.

h. Social and environmental problems and the Resource curse hypothesis

The point-source nature of extractive industries often creates challenges when trying to balance the needs of the people and environments that surround the mining area. Sharing and compensating for resources such as land, water and the minerals can create conflict between the extraction companies and the communities. In addition, extraction projects often attract large influxes of people, whether or not additional employment is actually available. This can cause stress on economic, social and cultural relations. Environmental issues include a host of problems, such as dust from mining, scarring of the landscape, noise from process operation, contamination of hydric sources (from waste rock and tailing disposal), massive use of water in the extractive process, gas flaring (causing health problems and wasteful CO2 emissions) and

seismic disturbances. In addition, many of the political and economic problems outlined above constitute or can result in the violation of human rights. The contract between the government and the extraction company could address these issues and clarify whose responsibility it is to manage these impacts.

The resource curse is not inevitable, and several countries that have natural resource wealth do not exhibit many of these tendencies. Because of the theoretical connotation of the term, NRGI, (2015) refers to the many challenges described above as "challenges associated with natural resource extraction" rather than the resource curse. That said, some studies have shown that low-income countries are more vulnerable to resource curse challenges. As there are an increasing number of new discoveries in low-income countries, it is useful for policymakers to be aware of these trends so that they can respond appropriately. The Natural Resource Charter is one tool developed in response to this research to help countries understand the risks and opportunities at various decision points in natural resource governance.

Implications of the Resource curse hypothesis on the Nigerian tax system

With large a *informal sector and low tax base*, Nigeria has one of the lowest tax revenue to GDP ratios in sub-Saharan Africa accounting to a meager 1.5% in 2012 compared that with Botswana's 27.1%, South Africa's 25.5% and the regional average of 13.83% (World Development indicators, 2015). A number of factors have been advanced as being responsible for this sorry state. The sudden inflow of dollar- denominated revenues from oil exports gave the Nigerian government little incentive to develop any non-oil sources of wealth or even to raise revenues through taxation. This consequently creates a situation of mutual dependence where the citizens being largely *untaxed* develop little or no incentive to hold government accountable (Sala-i-Martin and Subramanian, 2003; karl, 2004) [39, 21]. Another possible explanation will be that because Nigeria operates a dual economy with *small modern sector* and a *relatively larger informal sector* of the economy. Such a dualistic economy will have huge tax implication for the economy in a sense that a large part of the population is engaged in shadow economy and thus denying government vital revenues. A third argument which also seems plausible is that due the weak and corrupt bureaucratic institutional framework, public officials often collude with private businesses and divert tax revenues for their own private gains thus depriving the country of stable fiscal revenue. The plethoral of tax incentives and wavers often granted by government to businesses in order to attract investment is also another reason for the low tax base in the economy. Considering the large number of tax incentives and exemptions generously on offer in order to attract foreign direct investment in spite of ample empirical evidence suggesting that tax incentives are a necessary but not sufficient a condition in attracting foreign investments but rather stable economic and political environment, a highly-skilled human capital, good infrastructure and dependable rule of law. This ill- advised tax breaks are eroding the tax base and thus depriving the government precious little tax revenue. According to Action- aid Nigeria country Director Dr. Hossain Abdul, it is estimated that between 1999- 2012, Nigeria lost almost $6.3 billion (averaging $448million annually) on import and export duty waivers.

Conclusion and Recommendation

During the past decades, the paradox of a negative impact of natural resource abundance on economic growth and taxation has been widely observed. Many countries rich in oil reserves, gas, or tropical forests used for timber production experienced disappointing growth levels. In contrast, many resource-poor countries experienced strong growth. However, exceptions to this phenomenon can be found. This study conceptually explored the resource curse hypothesis, its oeldhistory, development, variants, causes and effects on the social, political and economic wellbeing of nations and finally its on implications the Nigerian tax system. In suggesting what to be done to come out of the resource curse debacle, Falana (2016) [9] reasoned that the first thing is to demystify oil in the political economy of Nigeria. We must return to development planning. *Government revenues should be derived primarily from taxes to be collected from economic players in agriculture, industries and technological advancement and the public sector*. Jeyifo (2016) noted that before Nigeria became one of the largest oil producing countries, we were well on our way to using surplus accumulation from export or so- called 'cash crops' to transform our economy into a modern capitalism with an industrial base for light consumer goods for a very large home market that embraced virtually all of West Africa. The richest Nigerians then did not depend, as they do now, on patronage from the government, federal or regional." We must move away from a cargo economy to *the knowledge economy*. You cannot develop a knowledge economy without huge and deliberate investments in human capital in the areas of education and health. The development of Nigeria depends on its greatest assets- The human beings especially the youth. The future of Nigeria is not oil. It is even more so with the focus on greener sources of energy by the major oil consumers. The global agreement signed in December (2015) on climate change is a loud signal to the nations such as Nigeria where oil is all. Implicit in the agreement is that the world economy should consume less oil; it is a pact against the central role of hydrocarbons in economic management. The agreement is to limit carbon emissions. As soon as alternative sources of energy are discovered the economic importance of hydrocarbons will eventually reduce. That is an unmistakable signal of peril, (not promise) for a nation whose economy depends mainly on the sale of oil. The economy should be *weaned* from oil. It has depended on *petrodollars* for too long, and the consequence has been poverty, misery on the streets and underdevelopment. The environment of the Niger Delta should be reclaimed and injustice done to the region should be redressed.

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