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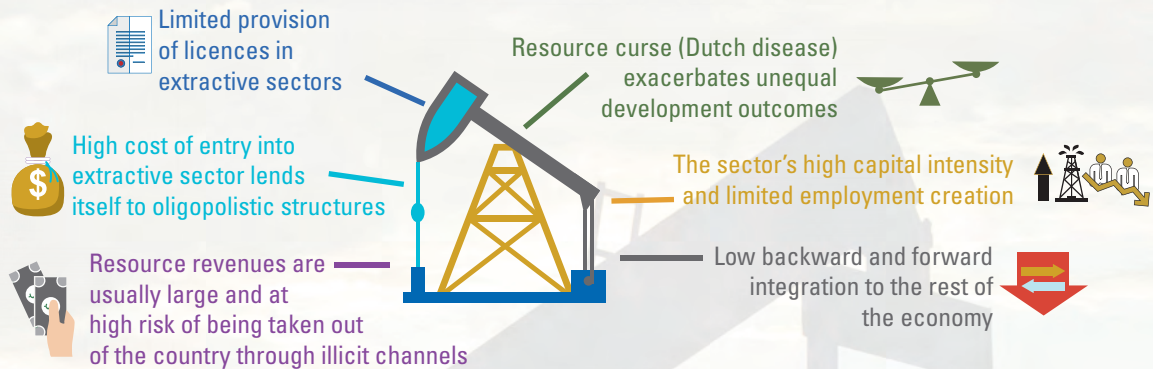
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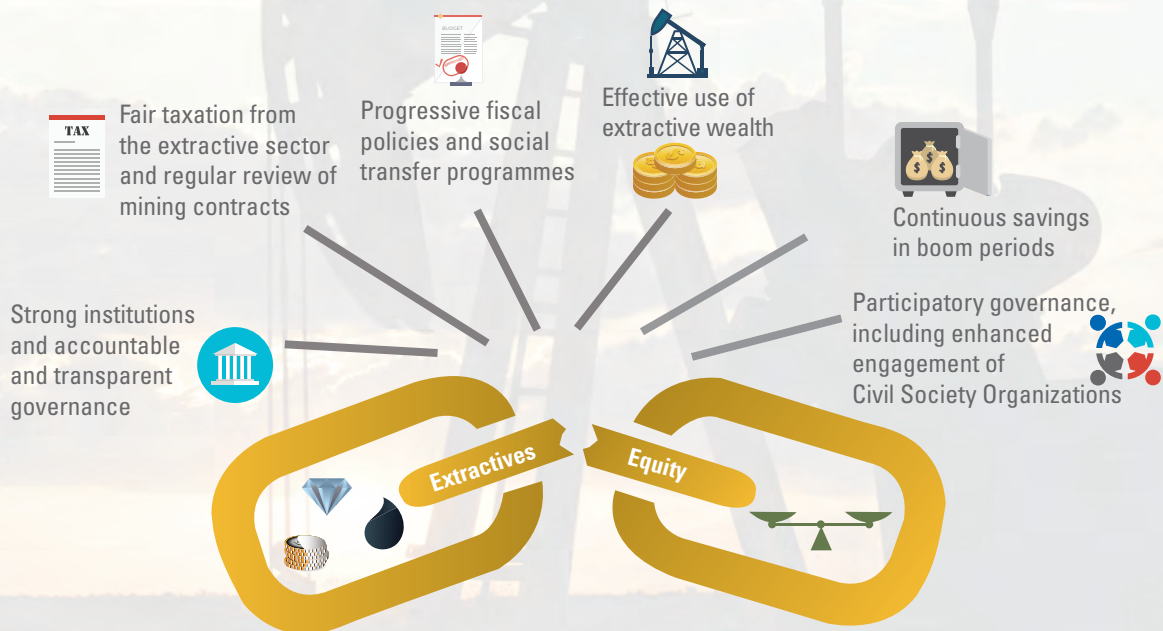
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Towards a pro-equity based extractive sector strategy

Inequality-induced resource-dependent channels



Cutting the extractives - inequality link



6 Resource Dependence and Inequality in Africa: Impacts, consequences and potential solutions

HAROON BHORAT, GRIEVE CHELWA, KARMEN NAIDOO AND BENJAMIN STANWIX

6.1 Introduction

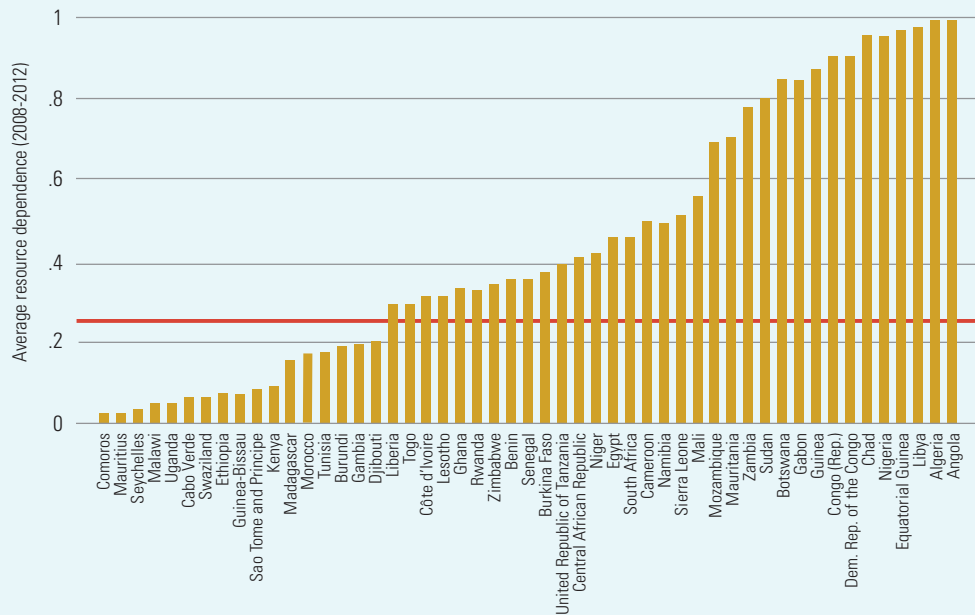
Over the last decade an increasing number of the world's fastest-growing countries have been in Africa. This recent progress created widespread optimism among many as economic development prospects across many parts of the continent improved. This optimism has, however, been accompanied by concerns regarding the inclusivity and longer-term sustainability of the current growth processes, which have been driven largely by extractive industries. Moreover, situating the observed growth in a broader historical context is important. Similar optimism accompanied the relatively short-lived growth boom in Africa following the Second World War (1950-1970), which provided limited long-run gains and should perhaps serve as a cautionary example in the current growth climate (Broadberry and Gardner, 2013). Going further back, Jerven (2010) suggests that periods of rapid growth, followed by reversals, have characterised economic performance in the region for several centuries, with commodity demand always the driving force behind these 'booms and busts'.

While natural resources can offer rapidly increasing wealth, an over-reliance on extractive industries may create attendant challenges captured under the well-known banner of the 'resource curse', especially when some of the requisite institutional and structural factors that can underpin a successful transition to sustained growth are not present. In this chapter, the recent economic progress taking place across much of the region is examined with a specific focus on extractive industries and inequality, relying on cross-country data and specific country examples. The chapter begins by reviewing the post-2000 growth record in Africa and noting the empirical relationship between growth and inequality in the context of high levels of resource dependence. The tangled relationship between resource dependence and growth is then discussed. Some of the potential drivers of inequality in resource-dependent countries are then explored, briefly detailing the ways in which extractive industry revenues are closely linked to illicit financial flows and how this drains wealth from the continent. Finally, broad policy avenues are suggested, which offer some basic solutions to the challenges that extractive industries in Africa present.

6.2 The extractives boom and inequality

The rate of GDP growth for SSA was almost 6 per cent in 2013, second only to the performance of East Asia. In the five years prior to 2013, as many as 32 countries in SSA consistently posted growth rates of over 3 per cent, while 17 grew exceptionally fast at over 5 per cent per annum over this period. Crucially, however, within this ‘group of 17’, 14 are classified as resource-dependent: a country is considered to be resource-dependent if, over a five-year period, 25 per cent or more of export revenue is derived from natural resources.¹ Figure 6.1 shows the level of resource dependence for 51 SSA countries, while figure 6.2 plots the relationship between GDP growth and resource dependence for the fast-growing group of 17 countries mentioned above.

FIGURE 6.1 Level of resource dependence, 2008-2012



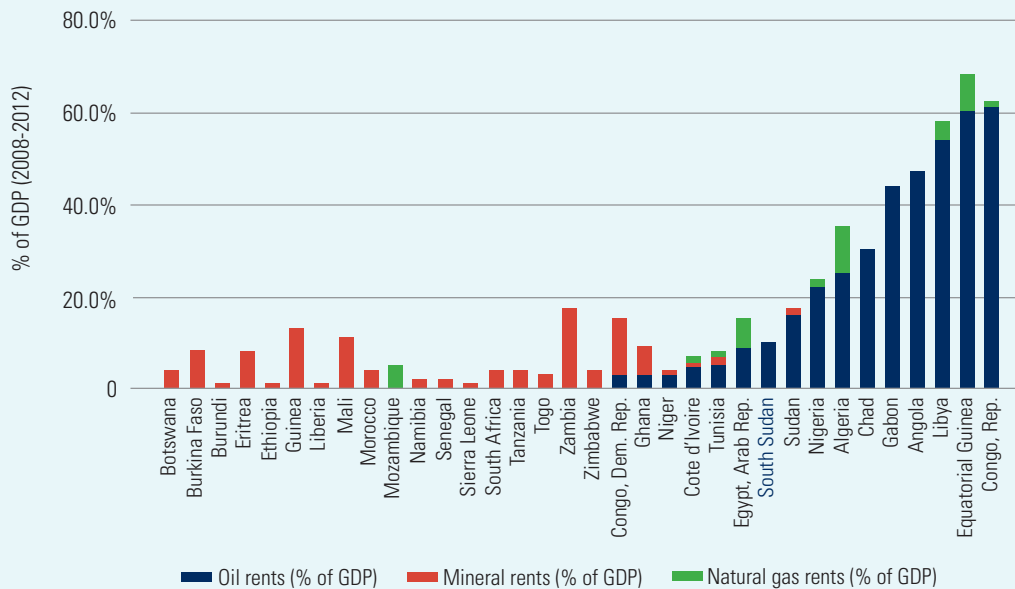
Source: Own calculations based on UNCTAD (2014).

Note: Horizontal red line at 0.25.

From figure 6.1 it is clear that for many countries in the region, resources are an important source of growth. Notably, 34 out of the 51 countries (67 per cent) shown here are considered resource-dependent according to the definition provided above, and a large group of these are almost exclusively dependent on extractive industries. For those countries classified as resource-dependent above, it is useful to understand which resources contribute to the overall level of dependence. Figure 6.2 breaks down resource dependence by rents accruing from oil, minerals and natural gas, showing the contribution of each to GDP over the same five-year period (2008-2012). While for several countries

¹ This is a generally accepted definition that is now widely used in the literature (see IMF, 2012), and ‘share of export revenue’ is used rather than ‘exports as a percentage of GDP’ following Sala-i-Martin and Subramanian (2003).

FIGURE 6.2 Oil, mineral and natural gas rents as a percentage of GDP, 2008-2012



Source: Own calculations using World Bank WDI (2014).

with lower levels of resource dependence, mineral rents are crucial, it is clear that for the majority of countries, oil is by far the largest contributor to resource rents.

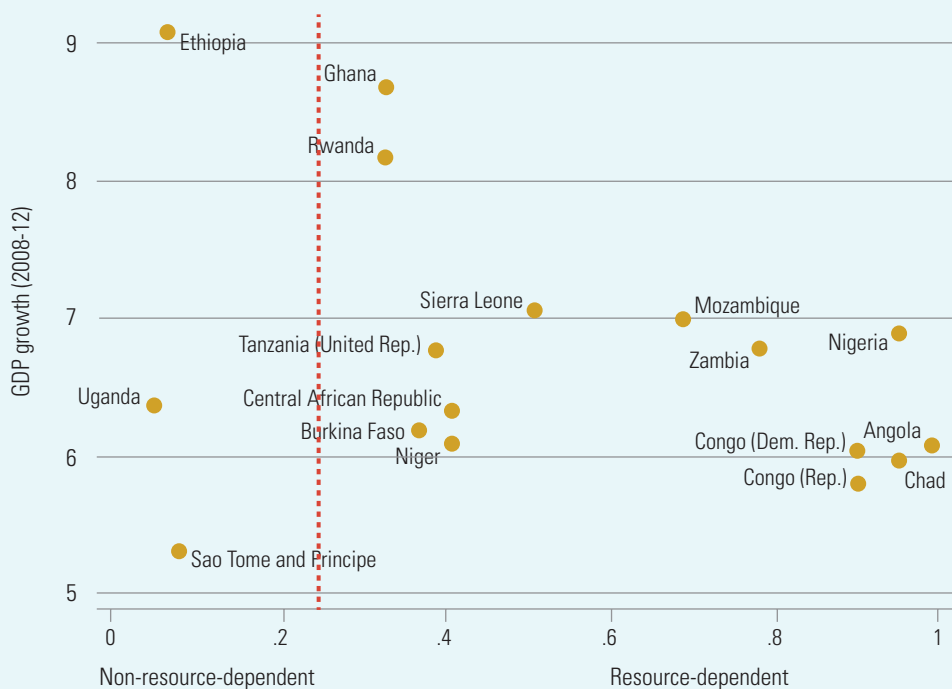
Figure 6.3 then relates overall resource dependence to growth and isolates the fastest-growing countries over a five-year period. It shows that while not all growth is resource-driven, it is certainly crucial for the vast majority of fast-growing economies on the continent, which have benefitted from high commodities demand and dramatically increasing prices since 2000. Some countries such as Mozambique, although classified as resource-dependent here, have had impressive growth, albeit from a low base, that preceded recent large-scale exploitation of natural resources.

The ideal outcome in this scenario is that these large and consistent growth gains translate into rapidly falling rates of poverty. The data suggest, however, that the growth-poverty elasticities for the region are appreciably lower than those found for most other developing countries. Otherwise stated, on average, African poverty levels have not reduced by as much as in other developing regions – for the same level of economic growth (Christiaensen, Chuhan-Pole and Sanoh, 2013).² One of the major reasons that positive and sustained economic growth does not always translate into rapid poverty reduction is that economic growth can have a negative effect on inequality.³ High and rising inequality hinders the effect of growth on poverty, and in many senses, is the thief of the potential

² Although it should be noted that SSA has made some progress in reducing poverty. Martin Ravallion and colleagues have estimated that the percentage of people living on \$1.25 or less reduced by 10 percentage points over the 1999 to 2008 period (see: <http://blogs.worldbank.org/african/node/2100>).

³ It is important to point out that there is a narrow focus on income poverty given that other aspects of deprivation are just as important to interrogate. However, other measures are not consistently available across countries and over time rendering them problematic to use in cross-country analyses.

FIGURE 6.3 GDP growth and level of resource dependence, 2008-2012



Source: Own calculations based on World Bank (2014) and UNCTAD (2014).

Note: Countries to the right of the dashed red line are classified as resource-dependent.

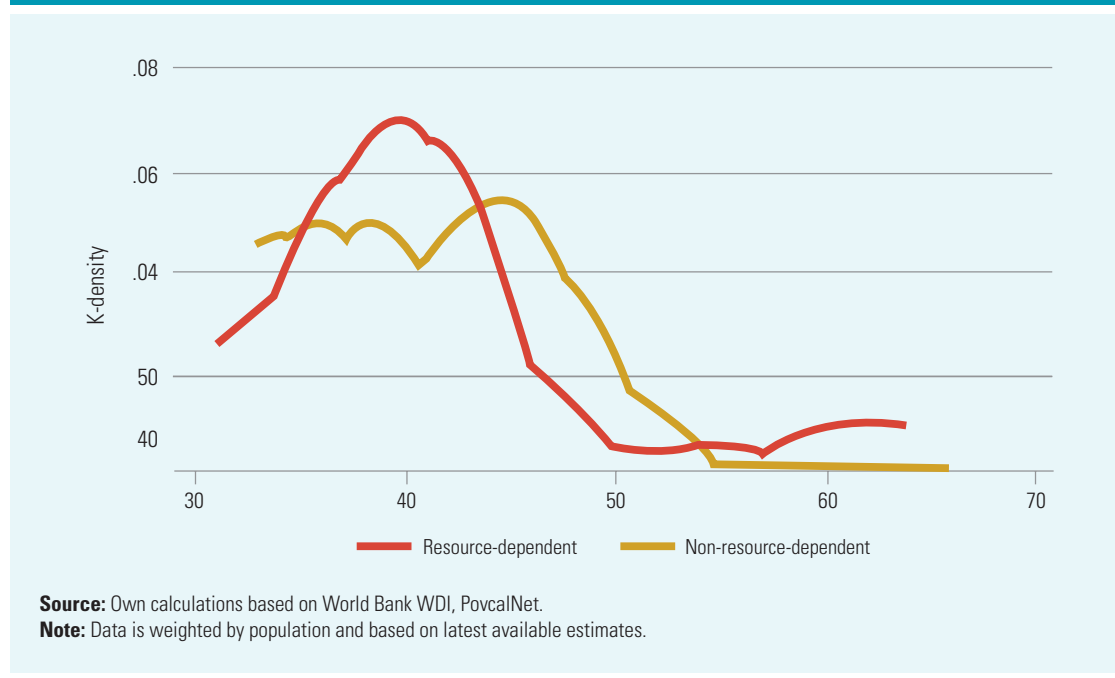
poverty reducing gains from growth (Ravallion, 1997; Fosu, 2009). Indeed, high inequality can itself impede and undermine growth (Ostry, Berg and Tsangarides, 2014). While rapid growth invariably lends itself to unequal outcomes given the initial conditions and endowments in many developing countries, particular forms of economic growth induce sharper rises in income inequality levels. For example, a growth path built on labour-intensive sectors (such as agriculture and light manufacturing) will generally be more poverty-reducing (and less inequality-inducing) than a capital-intensive trajectory, largely due to the much greater employment opportunities that the former provides (Ravallion and Datt, 1996; Khan, 1999; Ravallion and Chen, 2007; Loayza and Raddatz, 2010).

The natural resource boom over the last decade has helped to jump-start an infrastructure and construction boom, and in turn created many jobs that require low-level skills. Many countries have borrowed against future revenue streams from natural resources, and used proceeds to build roads and bridges, and upgrade power generation facilities. For example, since 2012, Zambia has issued a number of Eurobonds aimed at boosting infrastructure expenditure in the country. But there are concerns about the temporal nature of these types of jobs, and overall, given the relative capital-intensity of extractive industries, it is not surprising that in economies that are heavily dependent

on extractive industries, there is the potential for greater pressure on the distribution of income (Goldstein, Pinaud and Reisen, 2006).⁴

To examine the basic resource dependence and inequality relationship, figure 6.4 graphs inequality, as measured by the Gini index, for resource-dependent and non-resource-dependent countries in SSA. The figure shows that for the bulk of countries in Africa, inequality as measured by the Gini is between 0.30 and 0.50, and slightly lower Gini values are evident for resource-dependent countries, on average. However, there is a spike at the upper end of the inequality distribution, where a number of heavily resource-dependent countries (such as South Africa and Botswana) have very high levels of inequality – close to and above 0.60. This suggests that while there is no clear link between inequality and resource dependence overall, there may be a greater risk of extremely unequal outcomes in heavily resource-dependent economies, the possibility of which is explored in more detail below. It is also important to examine changes in income inequality over time. Figure 6.5 shows changes in income inequality over a 20-year period (1990-2010) for 34 African countries where data are available.⁵ The countries are again divided into resource-dependent and non-resource-dependent, and again, it is observed that there is no clear pattern emerging: 55 per cent of resource-dependent countries have experienced an increase in inequality, compared with 50 per cent of non-resource-dependent countries.

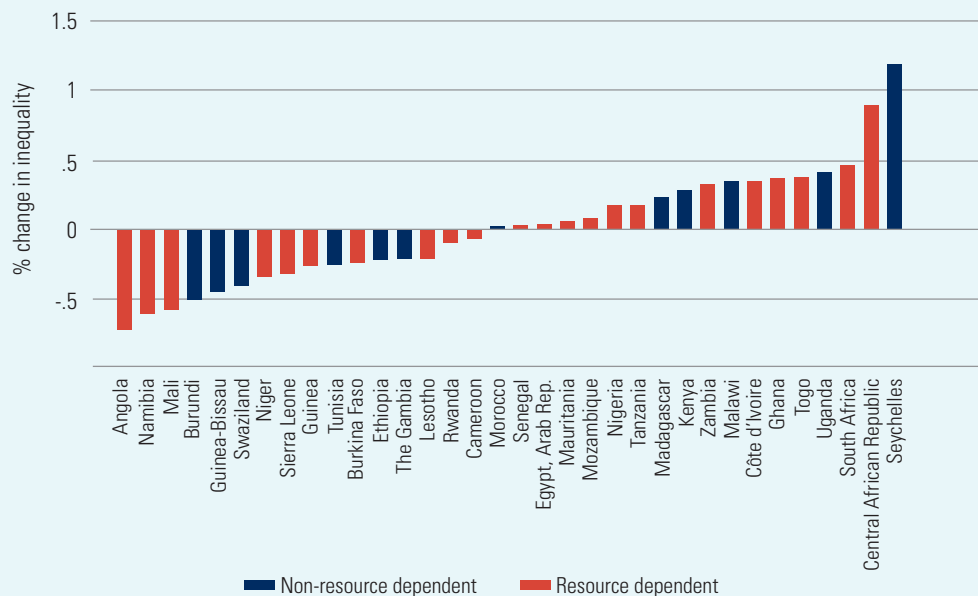
FIGURE 6.4 Resource dependence and inequality



⁴ As argued below, additional factors within a country such as ineffective taxation systems, poor governance and high levels of corruption may compound the inherent potential of a resource-dependent economy to generate unequal outcomes.

⁵ One observation each from the 1990s and one observation from the 2000s (the latest available data point) were selected.

FIGURE 6.5 Change in inequality (top 20%/bottom 20%), 1990s-2000s



Source: Own calculations based on WDI database (2014).

6.3 Drivers of inequality in resource-dependent countries

Despite no clear aggregate relationship emerging between resource wealth and inequality, it remains important to consider the inequality threat that an over-reliance on extractive industries poses in high-growth economies over the medium term. Here, the literature on resource dependence and growth will be discussed with a view to outlining some of the key channels through which reliance on extractive industries can drive within-country inequality.

The cross-country evidence on the effect that resource dependence has on growth and development is inconsistent and contested, but a growing body of literature in this field suggests that institutional quality in a country is critical in determining whether or not natural resources are a blessing or a curse (Robinson, Torvik and Verdier, 2006; Bulte, Damania and Deacon, 2005). Among the variety of institutions to which this literature refers, the state is arguably the most important. It can directly catalyse the redistribution of income through fiscal policies and regulate the structure of product and factor markets. While there is, again, no consensus on the specific channels through which resource dependence and institutions interact, there are explanations as well as country examples to guide understanding on this issue. Work by Mehlum, Moene and Torvik (2006), for example, provides evidence to support the simple argument that resource abundance is a blessing for countries with good institutions and a curse for those with bad institutions. A slightly more nuanced view suggests that the institutional setting of a country is in fact endogenous and can change with respect to resource endowments (Jensen and Wanchekon, 2004; Robinson, Torvik and Verdier, 2006). Here, Jensen and Wanchekon (2004) argue that natural resource dependence can have a serious negative

impact on both democratic transition and democratic consolidation. Finally, some cross-country evidence, not confined to Africa, suggests that the causality may in fact run from weak institutions to resource dependence, because countries with weak institutions are unlikely to develop non-primary production sectors (Brunnschweiler and Bulte, 2008).

Due to the complexity of the issue and the lack of robust empirical work on the subject, understanding of causality in the resource dependence and governance link is poor. One direction of causality may run from the discovery of natural resources leading to weakened institutions; this is independent of whether the country initially had strong or weak institutions. Over the last five years, there has been much optimism about natural resource discoveries in the East Africa Rift Valley (oil) as well as off the coasts of Kenya, United Republic of Tanzania and Mozambique (natural gas). While this represents a major opportunity for the sub-regions, there are concerns that may be in line with the above view.

The causality may run in the other direction, however. A country with weak institutions discovers natural resources, or becomes more dependent on natural resources, which decreases the state's ability to translate growth into welfare gains. While in a country with initially strong, transparent and accountable institutions, the ability to optimize the benefits of natural resource-driven growth is enhanced. An example of this is Ghana, a country with a history of both good institutions and resource dependence, where, since the discovery of offshore oil in 2007, the natural resource sector has become even more important as a driver of growth. In this case, socioeconomic indicators have largely continued to improve, supported by relatively strong, independent and democratic institutions (more nuanced details on this example are provided in box 6.1). Linked to the above hypotheses is the interaction between resource dependence and institutions over time. For some African countries, natural resources were discovered in the colonial era when exclusive and extractive institutions were the norm; in others, the discovery of natural resources coincided with the attainment of independence; and for yet others, resources were discovered only after independence. Even within successful democratic states that make good use of natural resource rents, however, there are specific features of any extractive industry that present problems for a state-led developmental agenda, and in particular make reducing inequality difficult. Some of these features are explored here.

First, a key but often overlooked channel is the limited provision of licences to allow for the extraction of natural resources. Opportunity for political capture of resource rents within the process of granting licences arises when the process relies on the discretion of public officials, where there is no transparency, and especially where the licence granting process is non-competitive. Even competitive bids can fall prey to the same factors if the process by which the bids are conducted is not transparent. Furthermore, the details of concluded contracts are rarely publicly available, and the same is true of revenues generated from most extractive sectors.

Second, the high cost of entry into natural resource markets lends itself to monopolistic or oligopolistic market structures. While this is not particular to the resource sector, it is a defining characteristic of the sector and can drive an unequal resource-driven growth path. In addition to higher pricing leading to a sub-optimal allocation of resources in the economy, two further problems are associated with markets controlled by a single or few firms. First, the resulting excess economic profit from higher prices (transferred from consumers to the monopolists) contributes directly to inequality. Second, the concentration of income by the monopolists provides them with greater political influence over policies that might alter the market structure, and creates an environment

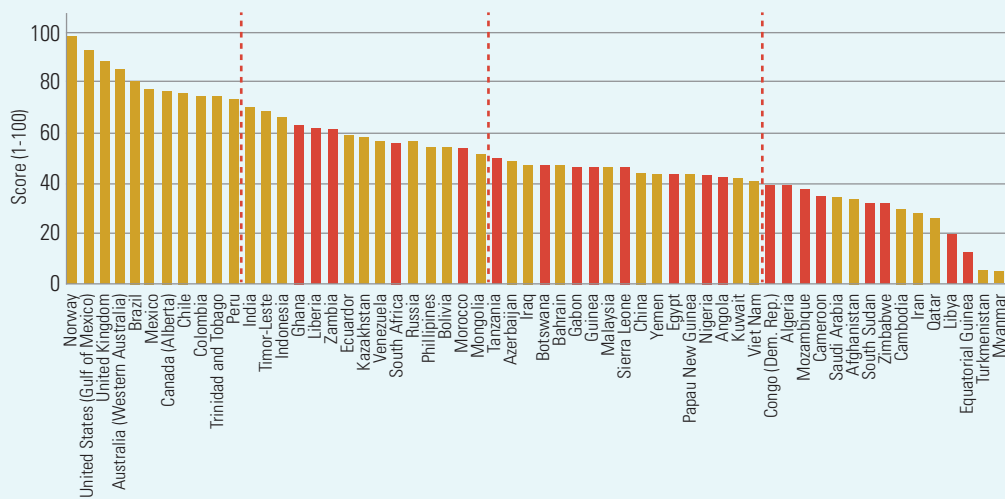
⁶ A well-cited example of these issues is the 2003 corruption trial of several former executives of Elf Aquitaine, a French State-owned firm, which paid off the Congolese political elite in return for access to oil.

more conducive to corruption.⁶ According to composite scores from the Resource Governance Index, shown in figure 6.6, which takes into account licensing and contracting procedures, 32 of the 58 countries in the sample of resource-dependent economies have weak or failing governance structures for natural resources. Half of these weak or failing states are African. Otherwise stated, over 75 per cent of the African countries included in the index had weak or failing resource governance bodies.

In addition, resource dependence may be associated with poor levels of social protection. Figure 6.7 graphs the WDI's Social Protection score for a range of African economies against their degree of resource dependence.⁷ It is clear that while all these African countries perform poorly on a scale of 1 to 6, highly resource-dependent countries perform the worst, further emphasising the potentially skewed distributional outcomes generated from resource revenues in these economies.

Third, unequal development outcomes can be exacerbated through the 'Dutch disease', where the natural resources sector thrives to the detriment of other sectors in the economy. For instance, the discovery of natural resources or a boom in commodity prices can lead to a significant appreciation of the local currency. An overvalued local currency can disadvantage employment-intensive and often export-reliant sectors such as agriculture and manufacturing. This can also be detrimental when a booming natural resource sector offers wages that attract the 'best and the brightest' from other sectors of the economy.

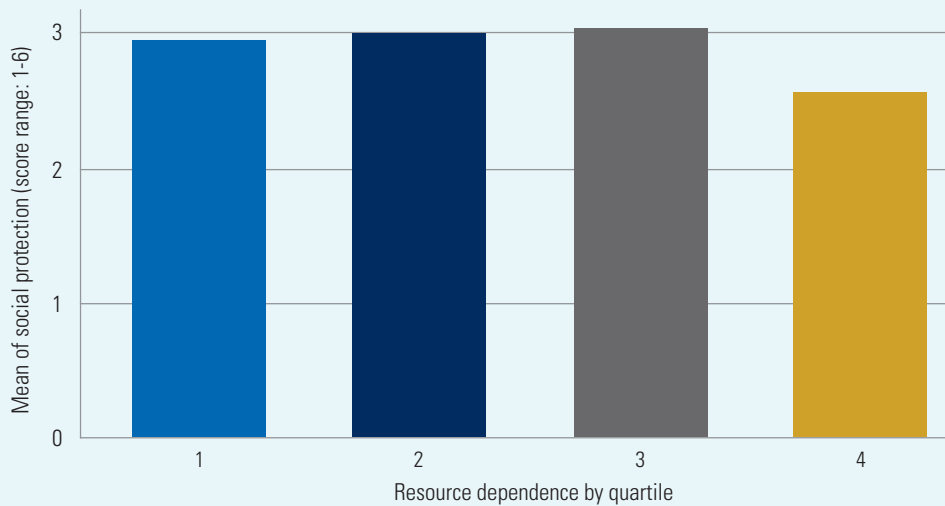
FIGURE 6.6 Resource Governance Index: Composite scores, 2013



Source: Own graph using data from Revenue Watch (2013).

⁷ The social protection index score is on a scale of 1-6 and was created by the International Development Association (IDA). The score takes into account "government policies in social protection and labour market regulations that reduce the risk of becoming poor, assist those who are poor to better manage further risks, and ensure a minimal level of welfare to all people" (see Metadata notes: <http://data.worldbank.org/indicator/IQ.CPA.PROT.XQ>).

FIGURE 6.7 Resource dependence and social protection, 2012



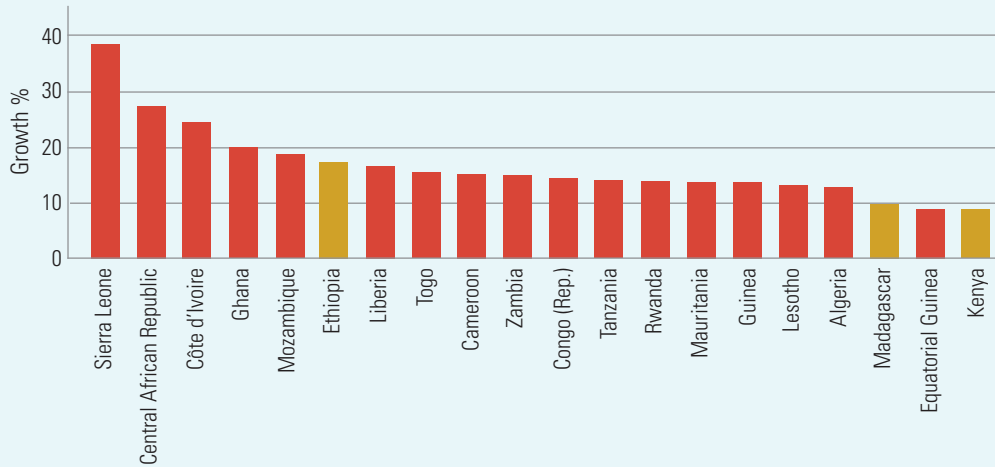
Source: Own calculations using World Development Indicators (2014).

As noted above, extractive industries are themselves often characterised by high capital intensity and limited employment creation. The relatively few jobs that are created within these extractive industries are often higher-skilled jobs, and given that a low-skills base is often characteristic of low-income African countries, high-skilled labour is often imported into these economies. These two factors of a low job creation quotient combined with a skills-biased pattern of labour demand contribute to maintaining or increasing high levels of inequality in many resource-dependent African economies. One of the ways in which extractive industries can create jobs is through local value addition; Zambia's copper mining sector during the period that it was state-run provides one example (see box 6.3). Without local value-addition, the extractive sector will continue to employ very few highly skilled individuals and be largely disconnected from broader development objectives.

Fourth, and related to the issue above, levels of beneficiation and secondary industry creation in extractive sectors are relatively low, which again hinders wide-scale job creation, in particular, the creation of better quality jobs. Resource-dependent economies show high growth in capital formation. Figure 6.8 shows the growth in gross capital formation for the 20 fastest-growing economies between 2008 and 2012. Moreover, many of these countries have also seen manufactured goods as a percentage of GDP decline. This phenomenon can be partially explained as a symptom of Dutch disease, the crowding out of non-resource investment (Papyrakis and Gerlagh, 2004), or hampered financial sector growth (Beck, 2011). In addition, an emerging political economy literature suggests that where elites are in control of resource revenues, they may be able to resist industrialisation, which has the potential of diluting their political and economic power base (Isham et al., 2003).

Fifth, resource revenues are usually large and at high risk of being taken out of the country through various illicit channels, which reduces the ability of the state to spend on public goods. Illicit financial flows occur through a number of channels, including: tax incentives offered by developing countries; aggressive tax planning by multinational companies; trade mispricing through intra-company trade;

FIGURE 6.8 Gross capital formation (annual (%) growth), 2008-2012



Source: Own calculations using World Development Indicators (2014).

and simple, illegal tax evasion (Zucman, 2014). At the top of the investment chain in Africa's extractive industries are companies such as Glencore, Rio Tinto and Anglo American. Glencore, for example, reports annual earnings that are 11 times the GDP of Zambia and 14 times that of Democratic Republic of the Congo. The presence of offshore registered companies within these ownership structures limits public disclosure requirements, and the use of subsidiaries and affiliates as conduits for intra-company trade creates opportunities for trade mispricing and tax avoidance since they can maximize the profit reported in low-tax jurisdictions. These issues are discussed in more detail below.

Ultimately, then, the above has suggested that there are a number of potential channels through which natural resource-dependent economies may lead to rising inequality. The problems that result are all inextricably linked to poor governance, and a lack of transparency in government expenditure collection and allocative fiscal decisions. Furthermore, deleterious outcomes on growth and development are perpetuated in an environment where civil society groups are often not free to actively engage in the governing process through the use of open media, legal protests or community awareness initiatives. The issue of illicit financial flows is discussed in more detail.

6.4 Illicit financial flows as a threat to development in Africa

While it is difficult to accurately estimate the magnitude of illicit financial flows out of Africa, current estimates place this annual figure in billions of US dollars. Over the 30-year period 1980–2009, it has been estimated conservatively that Africa has lost between US\$1.2 and 1.4 trillion through illicit financial flows; in real terms, peaking at US\$103.7 billion in 2007 (AfDB and GFI, 2013). Over the 30-year period, illicit outflows from SSA outstripped those from North Africa and have been driven by West and Central Africa (Nigeria, Republic of the Congo and Côte d'Ivoire) and Southern Africa (South Africa, Angola and Zimbabwe) – all resource-dependent economies (AfDB and GFI, 2013).

BOX 6.1 Ghana: Natural resource-driven growth can be more broadly inclusive

Ghana's extractives industry dominated its economy for centuries, and with the 2007 discovery of offshore oil and subsequent production of oil in 2010, Ghana's growth rates increased markedly. Over the last five years (2011-2014), it has been one of the fastest growing economies on the continent and in the world with an average annual growth rate of 7.7 per cent. With the World Bank's revised GDP per capita figures around 2010, the country was re-categorized as a lower-middle income country. However, it is important to point out that the country is currently facing economic headwinds that are related to the poor performance of commodity markets and fiscal mismanagement.

Ghana's history of strong and democratic institutions is often cited as one of the important reasons for the country's improved socioeconomic status over the last two-decades. Ghana's democratic institutions were recently tested with the successful transition after the death of President Atta Mills in 2012. Ghana has achieved significant improvements in poverty reduction – from an average poverty ratio of nearly 50 per cent in the early 1990s to about 25 per cent in 2005. In addition, the country outperformed the SSA average in terms of under-5 mortality; maternal mortality during childbirth; improved water sources; and youth literacy rates (IMF, 2013). There are, however, some areas of women's equality that lag behind the continental average. Ghana's Gini coefficient has risen slightly, from 40.75 in 1998 to 42.76 in 2005, but remains below the SSA average and below comparator countries such as Kenya and Nigeria.

Selected MDG indicators

	Earliest observation	Latest observation
Poverty headcount ratio (\$1.25 PPP per day, % of population)	1991: 47.38%	2005: 25.19%
Under-5 mortality rate (per 1,000 live births)	1990: 128.1	2012: 72
Maternal mortality ratio (per 100,000 live births)	1990: 580	2010: 350
Improved sanitation facilities (% of population with access)	1990: 6.5%	2011: 13.5
Youth literacy rate (% of population aged 15-24)	2000: 70.7%	2010: 85.7
Ratio of female to male tertiary enrolment (%)	1991: 30.6%	2012: 61.1%

Source: World Development Indicators (2014).

As of October 2010, Ghana was fully Extractive Industries Transparency Initiative (EITI)-compliant for both the mining and oil sectors, and EITI audit reports have shown very little discrepancy between company payments and government receipts. Furthermore, while there were concerns over the transparency of sub-national transfers in 2004, more recent reports have shown significant improvements. In the last few years, Ghana has made efforts to introduce measures to improve transparency, accountability and efficiency in public resource management through initiatives such as the Public Expenditure Tracking Surveys for education and health. Importantly, in 2011, several companies' oil contracts were published on the US Securities and Exchange Commission website, and soon after, the Ghanaian Minister of Energy ordered the publication of these contracts on the Ministry's website.

Importantly, Ghana's success in improving the well-being of many of its citizens has been underpinned by a history of high-quality governance. Ghana has long been highly rated by the World Governance Indicators and the Ease of Doing Business indicators, and continues to improve. The three World Bank Country Policy and Institutional Assessment (CPIA) indicators highlighted in the table above all place Ghana above the

75th percentile of African countries. Furthermore, the Resource Governance Index ranks Ghana 15th out of 58 countries in its composite score; its scores on institutional and legal setting, safeguards and quality controls compare favourably with countries such as Norway, the United States and Australia.

In the initial stages of a growth boom, it is not unlikely to see inequality increasing slightly, while having significant reductions in poverty. This is the experience of Ghana over the last five to ten years, where a history of strong institutions and governance has been able to translate significant economic growth into poverty reduction and development. The rising inequality over time should not be overlooked and should this persist, it will become a drag on the poverty reducing effects of future growth. Therefore, the Ghanaian Government needs to reassess its development objectives and uncover ways in which growth can become more inclusive – a focus on fundamental elements of the economy will be key: understanding the skills needed to promote fast-growing sectors outside of the natural resource sector; investing in basic infrastructure; and maintaining good governance standards and management of public funds. A key solution to dissipating the inequality-inducing outcomes from growth is to increase the supply of semi-skilled and skilled workers, so as to reduce the high wage premia which often drives inequality in many developing countries such as Ghana. Furthermore, a targeted and appropriate social transfer mechanism to improve the incomes of those at the lowest end of the income distribution has been shown to be effective in other countries, and is a policy that may prove to be applicable in the Ghanaian context.

Sources: Revenue Watch Institute (2010) www.revenuewatch.org/countries/africa/ghana/transparency-snapshot; IMF Ghana 2013 Article IV Consultation; World Bank's WDI 2013.

This further emphasises the risk that resource-dependent countries face in terms of losing revenue through illicit flows.

Figure 6.9 shows that over the 2000–2009 period, the estimated cumulative illicit outflows from the Republic of Congo at US\$28.9 billion was equivalent to almost half of its GDP for the period. For Chad, the estimated cumulative illicit outflows exceed one-quarter of its GDP; for Gabon, these outflows are equivalent to just under one-quarter of its GDP. As shown in figure 6.9, the countries with the highest ratios of illicit flows to GDP are resource-dependent countries. Furthermore, illicit flows as a percentage of health and education expenditure illustrate the cost of these flows to the economy and to social development. In Republic of the Congo, for example, average annual illicit flows are valued at 35 per cent of average annual public health expenditure, and 18 per cent of the public education expenditure.

There are several contributing factors that have allowed the problem of illicit financial flows to progress so rapidly, and central to this is the process of globalisation, which has changed the way companies operate. The tension is between global companies that operate across many different countries, on the one hand, and tax systems which remain under national government jurisdictions, on the other hand (Oxfam, 2014a). Different countries may even have competing or contradicting legislative structures and policy objectives that allow multinational companies to leverage these differences. Furthermore, due to the associated process of financial market liberalisation and financial market sophistication, it has become easier to make cross-border transfers of money, and the ability to track them has become more difficult.

The illicit outflow of resource revenues from Africa occurs through several channels, as noted above, but perhaps most significantly is through trade mispricing. Trade mispricing occurs when large

companies trade within their own group structures such that they can overstate the prices they pay for imported inputs and understate the price of goods sold to companies connected through overlapping ownership in order to minimize their tax payments. These transfer pricing arrangements are illegal and do not comply with the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Africa Progress Panel, 2013). This activity is very challenging to investigate, given the difficulty in establishing final sales prices of minerals and resources, and benchmark prices, as well as in obtaining information on intra-company transactions. An example of trade mispricing by a mining company that has an overly complex ownership structure is that of Glencore International (figure 6.10), which holds a controlling stake in Zambia's Mopani Copper Mine (MCM) through a chain of connected companies.

Economic theory has long emphasised the importance of investment in sustaining long-term economic growth, which is a necessary condition for poverty alleviation and development more broadly. As discussed in Ndikumana (2013), empirical evidence has linked a country's ability to sustain high growth rates with some sufficiently high level of domestic investment (De Long and Summers, 1993), as was particularly evident in the newly industrialised East Asian countries (Rodrik, 1995; Young, 1995). Therefore, capital flight and illicit financial flows have a direct role in limiting economic growth through reducing the pool of resources available for investment (reduces domestic savings) in infrastructure, capital formation, as well as other social services such as education and health care. Africa has a history of chronically low domestic investment, which has made it difficult to finance many of the developmental objectives as laid out, for example, in the United Nations' Millennium Development Goals and the more recent Sustainable Development Goals. For Africa,

FIGURE 6.9 Illicit flows in selected African countries, 2000-2009

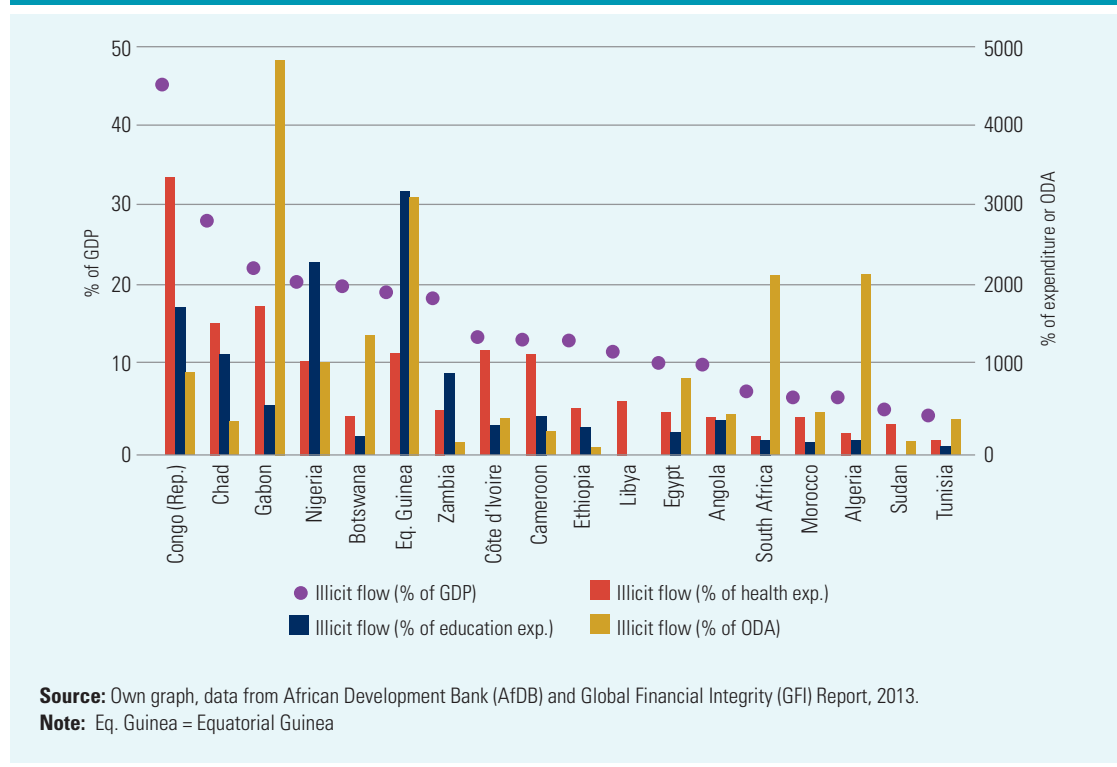
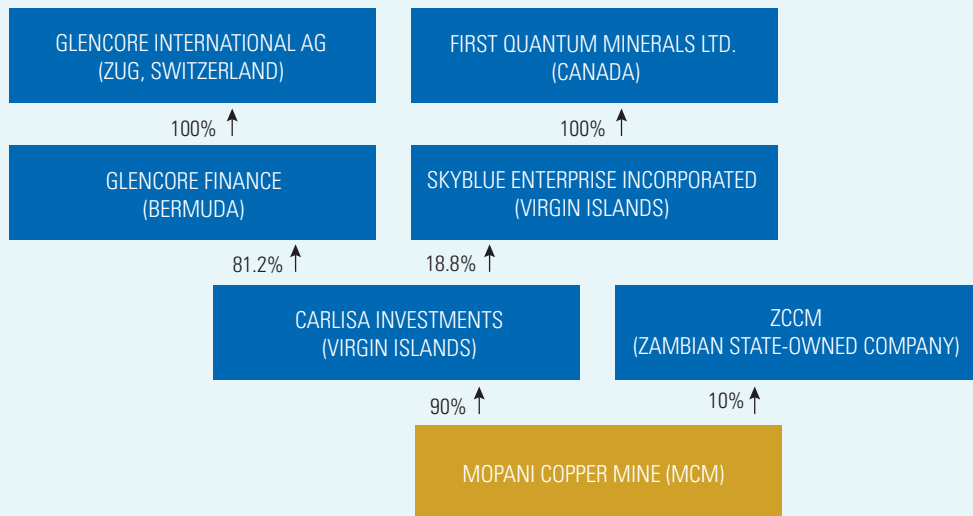


FIGURE 6.10 The structure of Mopani Copper Mine, Zambia



Source: Africa Progress Panel (2013).

Ndikumana (2013) has econometrically estimated a negative and significant impact of capital flight (of which illicit financial flows is a part) on domestic investment.

In 2008, the Zambian tax authority, together with an international audit team, audited selected mining companies including MCM. The findings noted that MCM was selling copper to Glencore (Switzerland) at prices far below the international price for copper – evidence of transfer pricing.⁸ The report states that during 2003–2008, there were progressively greater problems with reported copper revenues at MCM, and that the cumulative difference in copper revenues was approximately US\$700 million over that period.

Large multinational companies also have the bargaining power to secure tax incentives from governments who compete to attract foreign investment. Companies then abuse this to minimize their tax liabilities. Analysis by Abbas et al. (2012) suggests that developing countries, most notably in Africa, are locked into a partial race to the bottom. In particular, there has been a proliferation of tax incentives in Africa since 1980, with the majority of countries offering tax holidays to investors. In turn, free trade and industrial zones are now used to attract foreign investors. An example is the work by ActionAid and the Malawian Economic Justice Network, which estimated the losses from tax incentives in Malawi over 2008–2012 at US\$3.3 billion, almost equivalent to the value of corporate income tax raised during that period. More specifically, the large majority of forgone revenue was lost through the mining sector (ActionAid, 2013). Another recent example of the difficulties that poorer countries have in negotiating fair tax deals is the case of France’s Areva uranium company and the

⁸ The audit report on MCM by Grant Thornton is available at: www.scribd.com/doc/48560813/Mopani-Pilot-Audit-Report

Government of Niger: it is estimated that Areva's tax breaks cost Niger EUR23 million to 30 million a year in potential revenue, and efforts by the government to get Areva to adhere to a new mining tax law that removes these tax breaks have been met with strong opposition (see box 6.2) (Reuters, 2014).

Related to this point is a third channel – the use of aggressive tax planning strategies by multinational businesses, which often means shifting profits from high to low tax jurisdictions, or structuring cross-border transactions so as to avoid their tax liabilities. Companies can do this through registering 'shell companies' in tax haven countries, which often operate anonymous accounts (UN, 2013). A major challenge is that both the second and third channels mentioned here remain within legal boundaries, but are no less damaging to efforts to reduce inequality. Fourth, there is the illegal evasion of tax by multinationals, which is difficult to uncover because of complex multi-layered ownership structures and the lack of transparency in financial reporting. Initiatives to redefine international tax rules⁹ are critical to uncovering how the process of tax evasion is carried out globally, and designing effective policies to combat it. Finally, domestic corruption remains an important manner in which African economies are drained of resource revenues, albeit not of the same magnitude as through corporate tax avoidance and evasion (Nkurunziza, 2012).

It is clear then that illicit financial outflows from Africa's resource-dependent economies, particularly through the channels of trade mispricing and profit shifting, are a major factor in maintaining high levels of inequality in some of these countries. Essentially, the erosion of these economies' tax base means that there are fewer funds to put toward inequality reducing measures and development projects.

6.5 Cutting the extractives-inequality link

The challenge for resource-dependent countries is to transform the substantial wealth earned through extractive industries into shared and well-managed prosperity that produces shared benefits and not just wealth for an elite and well-connected few. While it is not the case that resource wealth results in inequality in every country, there are cases in which a resource boom can be a powerful driver of inequality. In this regard, ensuring that resource wealth is a blessing rather than a curse highly depends on country-specific factors (see the examples of Chile and Zambia discussed in box 6.3). Nevertheless, three important factors can work to inspire a more inclusive, resource-based growth path: strong institutions and good governance; progressive fiscal policies; and a more engaged civil society.

It is well-established that good governance and strong institutions are critical for inclusive growth. An economy heavily reliant on extractive industries that has fragile governance institutions is at risk of weakening these structures even further and suffering from a classic case of the resource curse, where corruption flourishes and the government and business elite capture extremely large rents. But the opposite is also true: where there are stable governance structures, resource wealth can be used productively to strengthen existing institutions that are able to enforce the rule of law, ensure fair taxation and engage in redistributive spending. It is crucial, therefore, that regardless of a country's particular growth path, the building of stable institutions and greater transparency should be viewed as necessary conditions for a more inclusive growth path. International initiatives such as the Extractive Industries Transparency Initiative (EITI) that encourage reporting and open dealings are valuable in

⁹ Examples are OECD's Action Plan on Base Erosion and Profit Shifting as well as the Extractive Industries Transparency Initiative (EITI).

BOX 6.2 Fair taxation: The case of Niger and Areva

Niger is in the unenviable position of being ranked lowest on the United Nations Human Development Index (HDI), with 60 per cent of its population living on less than US\$1 a day. Yet, Niger is also the world's fourth largest uranium producer. The country has received very little in return for the exploitation of its valuable natural resource. Uranium still represents over 70 per cent of Niger's exports, but only accounts for around 5 per cent of the country's budget.

Areva, a French company (in which the French Government controls the majority) and a leader in global nuclear energy, has been mining uranium in Niger for more than 40 years. During this time, it has negotiated a number of tax privileges such as exemptions from duties, VAT, fuel taxes, and a deal to exclude a portion of their profits from taxation. While Niger is one of the world's poorest nations, with 75 per cent of the population living below US\$2 (PPP) a day, Areva is one of the world's largest companies, with global revenues of \$12.56 billion in 2013, which is almost twice as large as the Niger economy (Reuters, 2014).

At the end of 2013, Areva's latest ten-year deal with the Nigerien Government expired, so the two parties have been negotiating a new contract. The Government wants to apply a new law that would remove exemptions on duties and VAT, and change the royalty rate (to rise progressively from 5.5 to 12 per cent, depending on the company's performance). As a point of comparison, the royalty rate in Canada's uranium producing province of Saskatchewan is almost 13 per cent.

Areva heavily resisted these changes and, at the time of the contract expiration on 31 December 2013, negotiations had stalled. The company claimed that paying these taxes would make its business unprofitable. Yet, Areva is actively exploring new deposits and intends to continue mining. However, since Areva does not disclose the profits generated from mining in Niger, its claims are difficult to contest. In what is believed to be a negotiating tactic, Areva suspended production at two sites in mid-December, which were reopened in February 2014. After 18 months of negotiation, Areva and the Government of Niger signed a new contract at the end of May 2014, to which Areva agreed to operate within the framework of Niger's 2006 mining code. The exact details of the contract were not public at the time.

Since Niger's national budget is only around \$2.7 billion, it desperately needs additional revenue to sustain and improve basic services such as education and free access to health care, which is under threat, and to invest in agriculture to address the threat to lives and livelihoods caused by recurring food crises. Official aid currently accounts for 40 per cent of Niger's budget. Simply by removing Areva's exemption on VAT, the country could earn as much as \$20 million a year. In 2013, \$20 million represented 5.6 per cent of Niger's education budget (Government of Niger, 2013), which could pay for more than 200,000 primary school children to go to school (UNESCO, 2011).

This example highlights the delicate political economy of natural resources in which sovereign nations can be undermined by large multinational corporations given the uneven balance of power. Given its development context, Niger could benefit from additional revenue. This context makes the Government more vulnerable to agree to suboptimal contracts. In addition, France is the major provider of aid to Niger, which complicates the relationship with France's State-owned Areva.

Source: Reuters (2014); Government of Niger (2013); Institute for Statistics (2011).

Note: This box has been updated from Oxfam (2014a).

this regard, but the fact that country and company reporting is voluntary is a major drawback. There is a crucial gap in the current global governance system that allows for international monetary flows to go unmonitored. This is a symptom of inadequate national tax systems in developing countries that allow companies to shift money offshore and avoid payment. There is a need for the rationalization of tax incentives across developing countries, ensuring that extractive industries are taxed fairly, as well as guaranteeing that tax systems are transparent. It is also absolutely critical to the success of domestic resource mobilisation that countries where the major global corporations are based are willing to share tax information. An institution that could work at a global level in this regard, monitoring international monetary flows and taxation would help to curb illicit flows and prevent tax leakages. As a recent Oxfam report suggests, such an institution:

...could independently follow global tax developments and gather statistics; be a forum for discussion on international issues related to tax policy; tackle tax competition by setting common minimum tax rates to prevent a 'race to the bottom' on corporate taxation; exert peer pressure on countries/jurisdictions that enable companies to be free riders; and develop best practices and codes of conduct on tax-related issues (Oxfam, 2014a).

The Bank of International Settlements, for example, might be ideally placed to add this focus to its mandate. (See Chapter 7 for a comprehensive analysis of the role of fiscal policies in promoting income distribution and reducing income inequality).

Looking beyond transparency, the role of fiscal policy (including efficient and progressive taxation, as well as fiscal transfers) offers some hope for poverty and inequality reduction while also promoting inclusive growth. Tax revenues play a key role in reducing income inequality if fiscal systems are progressive, fair and efficient. Ensuring that extractive companies pay their legally required tax bills is one essential component of a fair fiscal system; in turn, this will ensure that the burden of taxation does not fall disproportionately on individuals or on regressive taxation (such as VAT) that affect the poorest the most. Moreover, investing these tax revenues in public services like health and education is another strong tool for reducing inequality. A recent IMF report suggests that progressive taxation is underutilised in developing countries as a redistributive tool, with income tax in particular having the potential to significantly reduce inequality, as occurs in many more developed economies (IMF, 2014).

Income transfers to the poor is a strategy that has received increasing attention and has been suggested by several influential analyses and case studies in recent years (Gelb and Majerowicz, 2011; Moss and Young, 2009; Devarajan et al., 2013). Based on country case studies in Africa and Latin America, evidence suggests that the cost of social security programmes in many African countries is not prohibitive. Table 6.1 shows that the fiscal incidence of selected effective social programmes in Africa ranges from 1.2 per cent of GDP to 6 per cent of GDP per year. At the upper bound of this range is South Africa with Africa's most comprehensive social security programme, where grant coverage extends to 30 per cent of the population and provides an average annual household benefit of between US\$450 and \$2,000. At the lower bound of the range is Ethiopia's Productive Safety Net Programme, the third largest on the continent, which is acknowledged to have been effective in improving household food security as well as ensuring household asset protection (World Bank, 2010). In essence, then, a 'starter pack' in social protection, which can have significant poverty reduction effects, does not necessarily constitute a very high share of GDP, and is thus particularly affordable for all of Africa's resource-dependent economies.

Transferring a percentage of resource rents directly to the poor in the form of a cash grant has a number of direct and indirect benefits. Targeted income transfers have been shown in cross-country evidence to have strong and significant impacts on poverty, as well as on schooling enrolment, even when they are unconditional. For instance, a new evaluation of an unconditional child grant programme in Zambia significantly raised school enrolment and was key in the transition of older pupils to secondary school (Handa et al., 2015). A review of 19 social cash transfers across SSA by the Transfer Project found large positive effects on schooling outcomes with minimal to no adverse effects (Davis and Handa, 2014). In addition, raising the incomes of those at the lower end of the distribution decreases inequality. Beyond these direct effects, cash transfers could contribute towards altering government incentives and render taxation systems more effective, as more people start paying tax and as the State begins to increasingly rely on tax revenues and not only on resource rents as a main source of income. This also creates a new system of accountability in which the State has an incentive to track payments made to citizens, and citizens have a real incentive to hold the State accountable for the use of revenues earned from extractives. This system of transferring wealth from resource rents directly to citizens has been adopted by several countries or states, including Bolivia, Mongolia and the U.S. state of Alaska. Many more resource-dependent countries already operate a social grant system in some form, which could be linked to revenues from extractive industries. The case of Alaska is instructive, where a stabilisation fund was set up in order to limit government waste and create incentives for citizen accountability.

TABLE 6.1 Fiscal incidence of scaled-up social protection programmes in Africa

Social Protection Programme	Number of beneficiaries (million)	Coverage (% of the national population)	Average annual benefit level/ household (US\$)	Fiscal incidence (% of GDP)
South Africa: All Social Security Grants	15	30	450-2,000 ^a	6.0
Ethiopia: Productive Safety Net Programme	5	10	137 ^b	1.2
Rwanda: <i>Mutuelles des Santé</i>	10	91	235 ^c	1.2 ^d
Lesotho's Old Age Grants	0.07	3 ^e	350	3
International comparison				
Brazil: <i>Bolsa Família</i>	44	25	84-540	0.5
Mexico: <i>Oportunidades</i>	28	25	Range ^f	0.3
India: NREGA*	235 ^g	20	192 ^h	0.004 ⁱ

Source: The World Bank's Africa Social Protection Strategy 2012-2022 report.

Notes:

* National Rural Employment Guarantee Act

a Value of the transfers depends on eligibility.

b Equivalent to 40 per cent of the household food basket.

c Calculated using US\$47 per capita with an assumed household size of 5. Equivalent to total health expenditures.

d Government/donor contributions to *Mutuelles*. Total health expenditure of 10.7 per cent of GDP.

e 100% of the population over 70 years.

f Depending on multiple grants; equivalent to 8 per cent of expenditure of beneficiary families.

g Based on 47 million households participating in the programme and an assumed household size of five.

h Assuming 100 days of work per household at an average of US\$1.92 per day.

i Calculated by dividing annual expenditure on the programme by the country's GDP in 2010.

BOX 6.3 Ownership structures and inclusive growth: The cases of Chile and Zambia

Resource-rich countries manage and exploit their natural resources in different ways: in some countries, they are exploited and managed by state-run entities; in others, by the private sector; and still in others, through joint ventures between the state and the private sector. This box highlights the examples of Chile and Zambia: two countries that nationalised their copper mines at about the same time, but whose ownership structures have evolved differently over time. The examples of Chile and Zambia also show that ownership structures do have an impact on the attainment of broader development goals.

Chile

Large copper deposits were discovered in Chile in the early 1900s. Owing to a lack of Chilean firms with the necessary technical know-how and financial strength, the exploration and exploitation of Chilean copper was dominated by US firms over much of the first-half of the 20th century. In 1964, Eduardo Frei Montalva of the Christian Democratic Party became president and immediately began a programme of partially nationalizing Chile's most important copper mines. Consequently, the Chilean State took up a 51 per cent shareholding in El Teniente, Chuquibambilla and El Salvador mines. The overarching objective of the partial nationalization programme was to ensure that the country's copper wealth benefitted all Chileans. In 1971, the new government of Salvador Allende went further and completely nationalised Chile's copper industry. In 1976, the military government of Augusto Pinochet created the National Copper Corporation of Chile (CODELCO) to manage and exploit the copper mines that were nationalised under the government of Salvador Allende. CODELCO has since continued to wholly own and manage, on behalf of the Chilean State, the mines at El Teniente, Chuquibambilla and El Salvador. CODELCO's board also includes workers' representatives. Foreign direct investment (FDI) into Chile's copper industry is only encouraged under joint ventures with CODELCO, and even then only into new mining projects.

Since 1971, CODELCO has delivered US\$100 billion (in 2012 dollars) in dividends to the Chilean State. Some of this money has been used to fund Chile's relatively generous social spending regime. For instance, social spending tripled in real terms between 1990 and 2006. During this period, the poverty headcount ratio more than halved from 40 per cent in 1990 to 18 per cent in 2003. Further, some proceeds from CODELCO's mining profits have accrued to a copper stabilisation fund that seeks to insulate the Chilean economy from the negative effects of commodity price swings.

Zambia

The British South Africa Company (BSAC) obtained, through its Royal Charter of 1889, the rights to mine in what was later known as Northern Rhodesia. Mining operations took off in the early 20th Century, with Anglo American Corporation (AAC) and the Rhodesian Selection Trust (RST) running all of the country's mining operations. In 1964, Northern Rhodesia obtained independence from Britain and became Zambia. The strategic focus of AAC and RST post-independence was, however, largely disconnected from the broader societal goals of the new country. Therefore, in 1969, the Zambian Government took the step of partially nationalizing the mines owned by AAC and RST by taking a 51 per cent stake. The Zambia Consolidated Copper Mines (ZCCM) was later formed in 1982 to manage the country's copper interests. Unlike Chile, Zambia did not fully nationalize its mines. Soon after nationalization, the price of copper declined precipitously such that between 1970 and 1999, the real price declined by 70 per cent. In spite of

the challenges in the market for copper, ZCCM played a cardinal role in the provision of social services in the Copperbelt province. Schools, hospitals and housing were built and provided largely free of charge to most residents of the province, which is and was the most heavily populated province in Zambia.

In the late 1990s, the Zambian Government, during a wave of privatization, sold their equity stake in the mines. The different divisions of ZCCM were unbundled and sold to separate private interests. Privatization thus marked an end to the company's wide-ranging provision of basic social services in the Copperbelt province.

Due to the privatization of the mines, Zambia, unlike Chile, did not fully benefit from the boom in copper prices that began around 2000. Between 2000 and 2010, real copper prices rose by 230 per cent. The country has been engaged in a protracted process of trying to capture for itself much of this copper price windfall.

Source: Leniz (n.d.); Larranaga (2009).

For African countries, Devarajan et al. (2013) examine the costs and projected poverty impacts of a cash transfer system for eight resource-dependent countries. They show that in Equatorial Guinea, the allocation of 10 per cent of natural resource revenue for redistribution would result in a transfer of over US\$600 per person. In more populous countries such as Angola and Gabon, a similar allocation would effectively close the poverty gap in these economies.

Finally, giving voice to civil society groups and to the communities that are directly affected by resource extraction is vital for inclusive, sustainable development. It enables them to take part in public debate and influence the management of natural resources (Easterly, 2014). This includes acknowledging the rights of communities and the poor to shape a natural resource-based policy agenda based on prior and informed consent. The role of a free and critical national press should also not be overlooked as a partner in transparency. Such a democratic approach places important responsibilities on both the state and civil society, where the former is driven to make consultations, contracts and budgets open for public scrutiny, and the latter is needed to organize and work together with international bodies to monitor state and company behaviour to ensure that funds are well-managed. The examples of Ghana and Botswana offer some early positive lessons for Africa in this regard, although in each case, concerns remain. Chapter 8 explores the interaction between social protection and inequality in Africa – using both quantitative and qualitative analyses.

6.6 Conclusions

The post-2000 growth boom in Africa has led to rapid and positive change taking place across the continent. Yet, it is fair to argue that much of the recent economic growth gains in Africa can be attributed to high global commodity prices providing significant returns to resource-rich African economies. High levels of resource dependence, however, can also engender a specific growth trajectory in which income inequality rises and stifles poverty reduction. In addition, cross-country evidence alludes to the fact that many resource-dependent countries face a series of institutional and governance failures, which can potentially reinforce an unequal growth path. In addition, many African economies face the challenge of losing substantial revenues through illicit financial

BOX 6.4 Botswana: Effective use of its extractive wealth

Botswana is the world's largest source of diamonds and often ranked as Africa's least corrupt country, making it an outlier in terms of the 'resource curse' predictions. For the last 20 years, Botswana has grown at over 5 per cent per year. Although inequality remains an issue, poverty and inequality rates have decreased; education expenditure is now close to 8 per cent of GDP; and health expenditure has almost quadrupled since 1994, to over 5 per cent of GDP. According to the World Bank's World Governance Indicators (WGI), shown in the table below, Botswana scores well on government effectiveness, regulatory quality and control of corruption.ⁱ

World Governance Indicators

Governance indicator	Botswana	African Average
Control of corruption (-2.5 → 2.5)	0.94	-0.72
Government effectiveness (-2.5 → 2.5)	0.44	-0.72
Regulatory quality (-2.5 → 2.5)	0.69	-0.71

Source: Own calculations using World Governance Indicators (2014) from the World Bank.

The country's overall success has been attributed to several key factors: a history of sound pre-colonial political institutions; limited British colonial exploitation; stable leadership since independence; and strong motivation among elites to support good institutions (Acemoglu, Johnson and Robinson, 2002). Limi (2007) identifies four aspects of resource governance that have helped Botswana:

- Despite a lack of government and donor funding in recent years, there are systems in place for civil society to hold large companies and government to account.
- Botswana has been disciplined in its use of resource revenue combining investment in health, education and infrastructure, with longer-term savings through an asset fund.
- There are rules in place that govern access to leases for mining, which are transparent and not short-term. Diamond mining leases, for example, usually extend for 25 years.
- Corruption levels are low. There is a Directorate on Corruption and Economic Crime, which is independent and has the authority to report cases of corruption directly to the President, and the Attorney General is constitutionally independent from political and governance issues.ⁱⁱ

There is an additional factor that appears to have aided Botswana's development success, namely, an apparently healthy public-private relationship between the Government and the largest mining company operating in the country – De Beers. While these public-private partnerships are not always successful and indeed, can be disastrous (see Oxfam 2014b), in Botswana there appear to have been some positive results. The company operates as a 50-50 joint venture with the Government, and half of its executives are Botswana. In 2013, rough-diamond sales were moved from the United Kingdom to Gaborone. Unlike elsewhere in Africa, and in stark contrast to competing mining houses, De Beers have also invested in education, health care (e.g. funding the fight against HIV/AIDS) and basic infrastructure. It should, however, be noted that although corporate social responsibility can result in marginal gains for African countries, the importance of fair taxation for multinationals cannot be overstated. Nevertheless, the view from the company appears to be that committed investment beyond mining is also beneficial for them in

the long term, which may be a key point. Extractive industries need to work together with governments to plan for the future and avoid the temptation to cash in on short-term profits. The challenge is for private companies, governments and civil society, together with international bodies, to encourage this approach.

Notes:

- i See <http://info.worldbank.org/governance/wgi/index.aspx#doc> for full details of the WGI indicators used here.
- ii. The effectiveness of these functions needs attention from the Executive, the Parliament and the general public. Tangible results should be reported on an annual or *ad hoc* basis to the Parliament and the public at large to ensure that Botswana's institutions are functional and effective in practice.

flows – money that could be spent on poverty reduction. These failures can interact with extractive industries in various ways. In some cases, the discovery of natural resource wealth can weaken existing institutions and exacerbate corruption and other practices that impact negatively on development. In other cases, an over-reliance on natural resource wealth can itself be a result of weak institutions that fail to promote diversification.

While there are no clear success stories, countries such as Botswana and Ghana do provide some positive lessons to guide institutional arrangements that govern resource wealth. Yet, greater efforts could be made. Working with international initiatives for transparency and accountability can strengthen governance at the country level. Taxation systems that are progressive can help to alleviate poverty, but crucially, governments must ensure that multinationals in the extractives sector pay the required amount of tax. Using tax revenues to fund social transfers systems for the poor are also feasible interventions for many countries in Africa and can significantly reduce poverty and inequality. Finally, ensuring democratic rights such as a free and critical press, and the ability of civil society movements to have a public voice at the local and national level can contribute to better management of the gains from natural resources.

This current period of high growth in Africa is not new; there have been previous periods of rapid growth across Africa, but notably they were followed by phases of economic decline that eroded many of the gains yielded through growth. Ultimately, however, in order to avoid the boom-and-bust patterns that have characterised Africa's economic fortunes for much of the 20th century, a much more careful use of resources and the revenues they generate for an economy remains one critical ingredient in a bid to foster a more equal, inclusive economic growth trajectory for the continent.

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