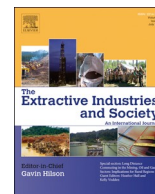




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Original article

## Extractive industry revenues and the subnational resource curse: The case of the Peruvian Andes

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## ABSTRACT

This paper explores how the allocation of revenues from extractive industries has contributed to a subnational resource curse in Peru, drawing on findings from a qualitative-based comparative analysis of conditions in two of the country's provinces, Espinar and Huari. The findings suggest that large quantities of revenue are being transferred to municipalities, despite local institutions' limited capacity to manage public investment. This, it is argued here, is fuelling a subnational resource curse in provinces such as Espinar and Huari.

### 1. Introduction

Over the past three decades, several theoretical and empirical works have emerged as explanations for economic performance of resource-rich countries. In the 1990s, a global debate began to take shape focusing on what is now referred to as the “resource curse” (Sachs and Warner, 1995, 1997, 1999), underpinned by evidence which challenges the view that resource abundance is a blessing for developing countries (Blanco and Grier, 2012; Brunnschweiler and Bulte, 2008; Dubé and Polèse, 2015; Beine et al., 2012). Since this time, a rather broad literature has emerged containing diverse findings, which both support and challenge the resource curse. The broad conclusion that can be drawn from this literature is that this phenomenon exists but cannot be generalized to all resource-rich countries (Kim and Lin, 2017; Dubé and Polèse, 2015).

Indeed, scholars recognize that natural resources can be both a blessing and a curse for developing countries (Van der Ploeg, 2011). How well a resource-rich country performs economically and socially, it is now widely believed, is dependent on a number of factors, including the quality of its legal structures, robustness of its institutions and political stability (Kim and Lin, 2017; Suutarinen, 2015; Wright and Czelusta, 2004; Rosser, 2006; Ahrend, 2008:3, 7–8). Even within a single country, it may be possible to obtain variable evidence of the positive and negative impacts linked to resource extraction (Lederman and Maloney, 2007).

For this reason, studying the resource curse at the local level, or what is often referred to as the “subnational resource curse”, is imperative (Borge et al., 2015; Ponce and McClintock, 2014; Tynkkynen, 2007). Emerging literature on the symptoms of the subnational resource curse has been closely connected with the capacity of

institutions to translate benefits from extractive activities into local sustainable development (Brown, 2014). This paper contributes to this body of literature by illustrating how, in Peru, fiscal decentralization mechanisms implemented specifically to distribute revenues are failing to catalyze public investment in areas where resource extraction takes place. The case of Peru illustrates how the transfer of finances into systems ill-equipped to manage them, and into environments devoid of strategic planning and citizen accountability, may, in fact, incentivize corruption and constrain opportunities for local development.

This paper critically examines the extent to which the allocation of revenues from the extractive industries have created conditions conducive for a subnational resource curse in Peru. The country is an intriguing case for investigating this phenomenon, being one of the world's leading producers of silver, copper, gold, tin, zinc and lead (U.S. Geological Survey, 2018). Its economic growth is, therefore, dictated heavily by mineral extraction but the revenue accrued from this activity, which has been distributed across the country, has presented more challenges than benefits (Arellano-Yanguas, 2016). Added to this is the local opposition toward extractive industries across the country, even when companies have increased committed to, and intensified investment in the area of, corporate social responsibility (Haslam and Tanimoune, 2016).

This research reports findings from a comparative qualitative-based analysis of the subnational resource curse in two provinces in Peru, the link between revenues from extractive industries and public investment in each, and the factors which determine the allocation of funds in both. Espinar and Huari were the two provinces selected here because they are among the 10 provinces in the country that receive the highest concentration of revenues from extractive industries but which at the same time, exhibit disappointingly low levels of economic development

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and poverty alleviation. The comparative analysis undertaken allowed for the identification of common drivers of funding allocation which cannot be explained by quantitative methods alone.

## 2. The subnational resource curse: a review

The subnational resource curse is defined as the “set of unintended consequences that originate from resource extraction activity and trade that can end up negatively affecting the development of regions hosting the resources extraction industry” (Cust and Viale, 2016: 5). Such “unintended consequences”, such as conflict, poverty, unemployment and environmental degradation, may constrain opportunities for a local population to take advantage of the benefits associated with natural resource extraction.

The subnational resource curse seems to be a common phenomenon in developing countries but has also been observed in developed countries such as Norway (Borge et al., 2015), Canada (Coulombe, 2011) and the United States (Freeman, 2009), although the results from these analyses are wide-ranging (Dubé and Polèse, 2015). For instance, using panel data for the period 1970–2001, Boyce and Emery (2011) showed that resource abundance in states in the U.S. was negatively correlated with growth rates but positively correlated with income levels. Conversely, in some Canadian provinces, the “technologies of resource exploitation [have] induced innovation, investments in human capital and productivity” (Coulombe, 2011: 17) due to royalties and other revenues being invested in public infrastructure and education. Similar observations were made by Fleming et al. (2015), who modelled economic growth across nonmetropolitan regions of Australia during a period of resource windfalls, finding that in most cases, resources have proved to be a blessing for local economies.

On balance, although the subnational resource curse is not generalizable, this paper agrees with the argument that the monitoring of its “symptoms” may be advisable for enhancing institutional governance mechanisms and strategies for sustainable long-term socioeconomic development, as well as for avoiding the negative consequences of resource-based development (Manzano and Gutiérrez, 2019). These include capacity building programs, strategic planning for public investment projects, transparency in the use of funds, and accountability to build trust with citizens. The following phenomena are identified in the literature as “symptoms” of the subnational resource curse: local dependency on extractive revenues under rentier regimes (Bradshaw, 2006: 725; Thorp et al., 2013; Schmallegger and Carson, 2010: 204); inefficient use of revenues (Karl, 1997; Ponce and McClintock, 2014); unproductive diversification (Auty, 2002; Carson and Carson, 2011: 373); environmental degradation linked to extensive resource extraction (Tietenberg and Lewis, 2016; Suutarinen, 2015); paternalistic attitudes towards, and expectations of, resource industries (Schmallegger and Carson, 2010: 205); and conflicts between stakeholders (Paredes, 2016; Stammler and Peskov, 2008; Rodríguez, 2019).

The relationship between government spending of funds derived from natural resource extraction and political risks, investment efficiency and volatility is at the core of many of these problems (Hassler et al., 2017). Certainly, many resource-rich countries have failed to invest resource revenues and address the impacts of Dutch disease effectively. While experiences are mixed, three concerns linked to institutional capacity have been identified: technical difficulties in handling volatile and time-limited revenues; management skills to resist short-run spending pressures; and a lack of commitment to long-run investment strategies (Venables, 2016: 18).

The literature suggests that resource-dependent countries with low-quality institutions are likely to be susceptible to the resource curse, while resource-dependent countries with high-quality institutions are not (Wiens, 2014). Certainly, the empirical evidence suggests that when institutions are weak at the national and subnational level, ‘easy’ revenues can easily corrupt and trigger conflicts (Ross, 2004, 2006; Ponce and McClintock, 2014), and lead to the financing of economically

inefficient—but politically-significant—projects (Robinson and Torvik, 2005). Institutional capacity within local governments, therefore, can be a decisive factor in determining whether natural resources will be a blessing or a curse (Cabrales and Hauk, 2011; Arezki and van der Ploeg, 2007; Ponce and McClintock, 2014; Poncian, 2019).

Fiscal decentralization, or the shifting of certain responsibilities for the management of expenditures and/or revenues to lower levels of government, has been prescribed as strategy for improving public investment in resource-rich countries. However, the literature has shown that countries with a higher level of fiscal decentralization are certainly more vulnerable to the resource curse. This is why the case of Nigeria has been studied in-depth: the mechanism to distribute royalties has not yielded any improvement in the quality of life of individuals in local communities (Idemudia, 2012). Obstacles inhibiting effective allocation of revenues from extractive industries may also persist in developed countries. For example, Borge et al. (2015) found evidence of the resource curse in Norwegian municipalities endowed with revenue from hydropower production. Here, the authors observed, higher revenues may retard efficiency of public goods, even though Norwegian municipalities are already robust in comparison with those found in other countries.

Peru’s regulation has been studied in the context of decentralization of revenues through subnational governments under the Canon mechanism, which was implemented in 2004.<sup>1</sup> The Canon mechanism promotes the concentration of revenue transfers at the locality, province and region where natural resources are extracted. This mechanism was approved in a bid to alleviate social discontent in communities based around extractive industries (Zavalla, 2004).

The sharp increase in world prices of minerals was unanticipated. This generated substantial royalties for Peru, the Canon transfers multiplying 13 times in just three years (Arellano-Yanguas, 2011).<sup>2</sup> But while this mechanism seems to be advantageous, economically, for the locality and province where natural resources are being extracted, it has yielded disappointing results, developmentally, due to the lack of planning at the national and subnational levels, the absence of articulation between institutions and the labour turnover in subnational governments (Arellano-Yanguas, 2008, 2011, 2012). Researchers have shown that transferring financial resources to local governments is not necessarily a decisive factor for subnational development. In effect, other factors influence how politicians elect to invest public resources. These include citizen participation, management capacity for planning and spending at the municipalities, the poor articulation between institutions and public programmes, and ethics in the decision and execution of funds (Díaz (2016); Pebe et al., 2017).

In the case of Peru, research has shown that regions of the country which receive the highest transfers of revenues from extractive industries have been less efficient in facilitating economic and social development (Díaz (2016)). Here, it has been observed that a lack of investment capacity (project management, accounting and finances, planning and co-ordination with other public entities) can adversely impact local governments’ ability to increase public investment, despite having abundant financial resources (Aragón and Casas, 2009), as well as incentivizes corruption (Pebe et al., 2017). This lack of management capacity is likely to be an obstacle for long-term economic prosperity (Wiens, 2014). Conversely, “where institutional capacities have been

<sup>1</sup> The introduction of the Canon as compensation for the extraction of natural resources dates back to 1976, following the introduction of the oil Canon. In 1992, the government introduced the mining Canon that distributed 20% of the income tax paid by the mining companies to the territory where the revenues had been generated. In 2001, parliament approved the Canon Law, Ley No. 27506, which extended this mechanism to other extractive industries and, in the case of mining, increased the Canon from 20% to 50% of taxes paid by the companies (Arellano-Yanguas, 2011).

<sup>2</sup> At the time it was launched, mining Canon transfers and royalties amounted to 90 million US dollars.

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