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Will oil continue to be an umbilical cord for the two Sudans?

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Abstract

In this paper we will try to provide an analysis of the interlocking relationships created by the oil sector between South Sudan and Sudan: inherent characteristics of two countries heavily dependent on oil revenues and continue to display symptoms of the "Dutch disease."

South Sudan today, just like united Sudan of before independence, is among the resource-rich developing countries that is still struggling with 'teething problems' associated with the protracted liberation struggle and building strong institutions to ensure equitable distribution and efficient management of the proceeds of oil earnings. Those oil revenues have been almost entirely allocated to recurrent expenditures at the expense of capital expenditures as well as the share of future generations in this natural resource, which is subject to depletion.

The turbulence CPA-era and outbreak of conflict in December 2013 and July 2016 didn't enable South Sudan to delink itself from Sudan. Despite its independence in July 2011, South Sudan remains a hostage to Sudan; given the unfair 'fixed' agreement for transporting its crude oil through Sudan's port. To buffer itself against volatility of oil revenues, South Sudan should adopt more strict fiscal rules and find a last solution to the issue of transporting its crude oil via Sudan.

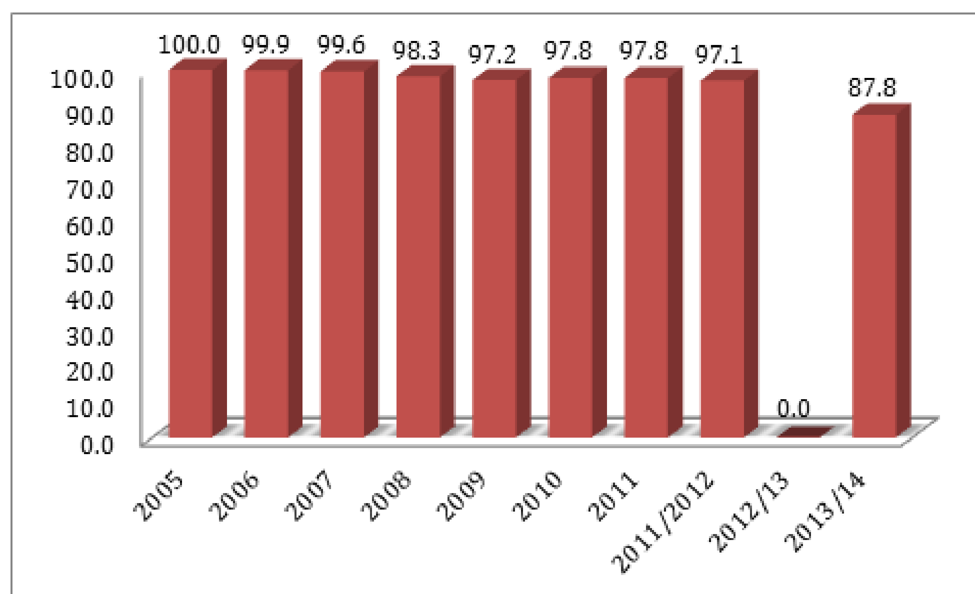
Oil Curse Syndrome in South Sudan and Sudan

Sudan has been heavily dependent on the oil sector since the start of commercial production of oil in the 1990s and South Sudan followed suite after its independence in July 2011. Although oil exploration in Sudan dates back to the 1970s, serious production started around the late 1990s.

The National Congress Party (NCP) came to power through a military coup on 30th June 1989. Despite the raging war in the Southern part of the country, the NCP regime was determined to pursue oil exploration and production as a viable source of funding for government operations, including hefty war expenditure. The United Sudan started actual oil production in 1999. With oil exports and associated revenues, Sudan was able to triple its per capita income in a span of one decade.

The oil sector constitutes an umbilical cord for the two Sudans as it continues to play a crucial role regarding the viability of their economies. At independence in July 2011, South Sudan walked away with almost 75% of oil production fields, which caused Sudan to lose 50% and 60% of its revenues and foreign exchange earnings, respectively . South Sudan emerged not only as the world's newest nation, but the most oil-dependent country where about 98 of government revenues- excluding development aid- were extracted from oil revenues (See Figure 1)[2]. Despite claims that Khartoum was distorting oil revenues during the Comprehensive Peace Agreement (CPA) era, the oil revenues that accrued to the Government of Southern Sudan (GoSS) during the same period amounted to US$13 billion, which translated to US$192 per capita per annum .

Figure 1: Share of Oil Revenues in Total Revenues Outturns (%)



Source: Various Budget Reports, Ministry of Finance and Planning and Author's computation

Although South Sudan has a substantial amount of the oil-producing fields that fall within its territory, and hence under its control, it is dependent on Sudan for transporting oil through its pipelines for processing and export. In turn, the transit and processing fees paid by South Sudan to transport its crude oil constitute a major source of income for Sudan's economy. South Sudan has been going through a steep fiscal cliff since the shutdown of oil production in January 2012 over a dispute with Sudan regarding transit and transport fees. Many observers maintained that the Cooperation Agreement reached between the two Sudans in September 2012 has been favouring Sudan, especially the so-called Transitional Financial Arrangement (TFA). Under the TFA clause, South Sudan is obliged to pay Sudan US$3.028 billion over a three-year (at the rate of US$15 per barrel) as a compensation for Sudan's fiscal stress, which is partly attributed to South Sudan's cessation in July 2011. However, payments to Sudan has been disrupted by two shocks: (i) reduction of oil production that was caused by the violent conflict in South Sudan and (ii) sharp decline in global oil prices. According to the Budget Speech Fiscal Year 2018/19 payments to Sudan

are estimated at SSP88, 900 billion (or US$644.2 million, using an official exchange rate of SSP138/US$)[3].

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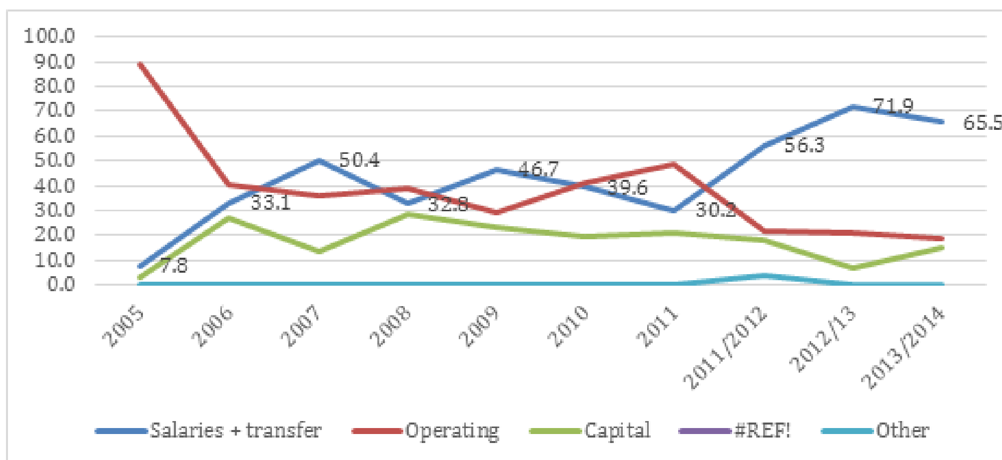
Moreover, South Sudan and Sudan are almost entirely dependent on oil sector at the expense of other non-oil sectors. For instance, prior to shifting its focus to the oil sector during the 1990s, Sudan's economy was classified as an agriculture-based. Commodities such as cotton and Gum Arabic were leading in terms of contribution to foreign exchange earnings and funding the government's budget in Sudan. However, by the late 1990s, the agricultural sector and other non-oil sectors were crowded out by the oil sector. Sudan's heavy dependence on the oil sector as the only source of export earnings, and hence the major source of foreign exchange earning, drastically exposed its economy to the 2007/8 global financial crisis and what's largely referred to as the 'Dutch disease.'

It's unfortunate that South Sudan didn't learn from the fiscal difficulties Sudan's economy went through because of its heavy dependence on oil revenues. Since its independence in July 2011, oil revenues have been the major source of funding public expenditure in South Sudan. Review of successive national budgets indicates that oil revenues' contribution to the resource envelope has been exceeding 90%. For example, budget for FY 2018/19 indicates that net oil revenues represent 128% and 408% of resources available and non-oil revenues, respectively. This largely depicts the exposure of South Sudan's economy to any schlock, be it internal or external. Seasoned South Sudanese economists have been emphasizing that the Government should set aside (or deposit) any windfall accruing to the Government, in excess of the established budget benchmark of US$55 per barrel, into the Fiscal Stabilization Fund and Future Generation Fund in accordance with provisions of the Petroleum Management Act.

Infact it appears that South Sudan and Sudan had the illusion that oil revenues will always be there and hence allocated largely for recurrent expenditure (i.e. salaries and operating) at the expense of capital expenditure. Figure 1 below highlights the pattern of budget outturns during the period 2005-2013/14. Salaries have been taking the lion's share of public expenditure. It can be observed that salaries expenditures were 50% of public expenditure in FY 2007 and reached their record-high of over 70% in FY 2012/13. This pattern of spending generally indicates that South Sudan inherited the symptoms of and suffers from the "Dutch disease" from Sudan.

Figure 2: Patterns of Budget Outturns, South Sudan (2005-2013/14)



Source: Various Budget Reports and Author's computation

How to escape the natural resource curse?

The challenge that has been facing Sudan, and now facing South Sudan, is how to escape the natural resource curse. Unfortunately, the stories of South Sudan and Sudan are not unique. Many resource-rich developing countries have almost failed to optimally utilize the wealth accumulated from oil resources. This assertion is commensurate with the argument made by Meijia and Castel (2012) that: " Excessive oil resources had allowed the political elite to hallow out governmental institutions- allowing those in power to operate without oversight."[4]

Nonetheless, South Sudan stands a chance to escape the natural resource curse. South Sudan doesn't have to reinvent the wheel. Instead, South Sudan could borrow from the few success stories even among developing countries. Botswana has been always cited as the leading success story in Africa regarding optimal allocation of the wealth emanating from its major natural resource: Diamonds. Broadly speaking, resource-rich countries have to deal with certain challenges, which are centered around: 1) creating buffers that shield their economies against short-term revenue volatility; 2) avoiding contraction of other non-oil sectors (e.g. manufacturing and agriculture) and hence their protection against the "Dutch disease"; 3) establishing a strong socio-economic institutions for economic and revenue based diversification; 4) insulating their economies against decline of revenue since most of the natural resources are subject to depletion in the long-term; and 5) setting side funds for the benefit of future generations[5].

With increased prospects for peace in the country, South Sudan should strive to follow the successful of Botswana by establishing string institutions and policies that would allow it leapfrog and escape the natural resource curse. However, for South Sudan to escape the natural resource curse requires creation of strong institutions and commitment on the part of the leadership in order to take the required tough decisions. Such tough decisions include: 1) establishment of sustainable fiscal rules for the treatment of natural resource revenues[6]; 2) ensuring good governance because its promotion is a pre-condition for the Government to adhere to and apply its strategy responsibly; 3) promotion of economic diversification; and 4) promoting efficient investment policies and ensuring natural resource wealth benefits future generations as well.

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South Sudan remains an economic hostage to Sudan

Despite its political independence in July 2011, South Sudan remains economically hostage to Sudan and oil appears to be the umbilical cord for the two countries. The major positive aspect of the Cooperation Agreement, which the two countries signed in September 2012, is that it facilitated resumption of oil production[8], albeit temporarily due to the outbreak of violent conflict in December 2013 and July 2016. The terms of the Economic Cooperation Agreement have been contested on the ground that they're favoring Sudan more than South Sudan. For instance, the transit fees are pegged very high to ensure that Sudan recovers what was lost as a result of independence of South Sudan. In addition, best practice indicates that transit fees are charged as a percentage of the price of the oil barrel rather than a 'fixed cost', as is the case between the two countries. Consequently, South Sudan's earnings from oil has been affected by the oil transit agreement, which is a 'fixed' cost instead of a 'sliding' cost. In accordance with the 'fixed' cost agreement, South

Sudan has to pay Sudan the agreed upon fees even if the oil prices drop on the international market, which has been the case since June 2014, contrary to the 'sliding' cost agreement, which would have enabled South Sudan to pay Sudan in accordance with prevailing global oil prices. The Government in South Sudan has been experiencing unnecessary fiscal pressure partly as a result of the 'fixed' cost agreement. For example, the budget for FY2014/15 was planned for SSP11.7 billion, assuming that global oil prices will remain at US$101 per barrel. However, global oil prices dropped by almost half of the projected prices. As a result, the Government had a budget reduction of 46%, which translated to a fiscal deficit of SSP5 billion. Since FY 2014/15 the Government has been operating under budget deficits. The 'fixed' agreement is partly responsible for these fiscal deficits.

In conclusion South Sudan must graduate from this unfavorable agreement in order to gain its economic independence from Sudan. A number of options could be explored in this regard and the Government should opt for whichever is more feasible: renegotiate the transit fees with view of adopting the 'sliding' rather than the 'fixed' cost approach to the transit fees; cancelation of the TFA given the deteriorating economic conditions in South Sudan because of the decline in global oil prices and outbreak of violent conflict; and investing on building alternative transit route(s) for South Sudan's crude oil (e.g. Djibouti and Lamu in Kenya).

Reference

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[4] Meijia, P. X. and Castel, V. (2012). Could Oil Shine like Diamonds? How Botswana Avoided the Resource Curse and its Implications for a New Libya. African Development Bank. www.afdb.org accessed on 16 August 2018.
[5] Asfaha, S. (2007). National Revenue Funds: Their Efficiency for Fiscal Stability and Intergenerational Equity. International Institute for Sustainable Development.
[6] Separating public expenditure from oil revenue and linking them to non-oil revenues as well as adherence to strict National Development Plans, which are approved by the parliament, can facilitate this. The current three-year National Development Strategy *2018-2021) can be used as an example.
[7] This notion implies: citizens could raise their voice and hold the Government accountable, Government becomes more effective by introducing and enforcing credible regulations for managing natural resource revenues, creation of conducive business environment and enforcement of anti-corruption policies.
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