

**THE RELATIONSHIP BETWEEN GOVERNMENT
EXPENDITURE, OIL PRICE AND ECONOMIC GROWTH:
A CASE STUDY OF KUWAIT**

ALI EBAID

UNIVERSITI SAINS MALAYSIA

2016

**THE RELATIONSHIP BETWEEN GOVERNMENT
EXPENDITURE, OIL PRICE AND ECONOMIC
GROWTH: A CASE STUDY OF KUWAIT**

by

ALI EBAID

**Thesis submitted in fulfillment of the requirements
for the degree of
Master of Social Science**

November 2016

ACKNOWLEDGMENT

All praises are due to Allah, the all merciful and the all beneficent, for all his bounties and for giving me the endurance to accomplish this work. I am grateful to many people for the completion of this thesis. I would like to express my appreciations to my supervisor Associate Professor. Zakaria Bahari, for his unlimited guidance, encouragement, and support throughout my study at USM University. I would like to thank the staff of the school of social science Economics Department at USM University, for their valuable administrative assistance. I am grateful to many colleagues and friends from the Kuwait Ministry of Finance and my colleague Yasser Qattan for their help in data collections. Am indebted to my friends Ramez Badeeb, Behnaz Saboori for their considerations, comments, and technical support. I am thankful to my brother Mansour for his endless care and inspiration through God all these years. Finally, I would like to express my sincere gratefulness to my small family, my wife, Monifa, my daughter Jamayel total love and support, which created a perfect setting to complete this dissertation, my dearest sons Zeyad, Haneen, Joory, Meshal and small lovely daughter Joody for their love and mature behavior that enabled me to focus on my studies.

TABLE OF CONTENTS

ACKNOWLEDGMENT	ii
TABLE OF CONTENTS	iii
LIST OF TABLES	vi
LIST OF FIGURES	vii
LIST OF ABBREVIATIONS	viii
ABSTRAK	x
ABSTRACT	xi

CHAPTER ONE INTRODUCTION

Introduction	1
1.2. Background of study	2
1.2.1 An Overview of Kuwait Economy	3
1.2.2 Kuwait GDP growth	8
1.2.3 Kuwait government expenditure, revenue and economic growth	10
1.2.4 The oil price and Kuwait government expenditure in both Consumption and Investment	13
1.2.5 Kuwait's Primary Economic Reform	16
1.3 Problem Statement	22
1.4 Research Objective	24
1.5 Research Question	24
1.6 Significance of the study	25
1.7 Scope and limitation of the study	26
1.8 Contribution of the study	27

1.9 Organization of the study	28
-------------------------------	----

CHAPTER TWO LITERATURE REVIEW

2.1 Introduction	30
2.2. Theoretical framework	30
2.2.1 Keynesian Theory	34
2.3. Empirical Studies on the relationship between government expenditure into government consumption and government investment and economic growth	35
2.3.1 Related Empirical Studies of the Relationship between Government Expenditure and Economic Growth	39
2.3.2 Related Empirical Studies of the Relationship between Government Revenue and Government Expenditure	41
2.3.3 Related Empirical Studies of the Relationship between Oil Price and Government Expenditure	50
2.3.4 Related empirical studies to the effect of oil price on aggregate Government expenditure	54
2.3.5 Related Empirical Studies of the Effects of Oil Price on Disaggregate Government Expenditure	55
2.3.6 Related empirical studies to the effect of Oil Price on Economic Growth	58
2.4 Empirical Studies Focused on Kuwait	62
2.5 Literature Gap	64

CHAPTER THREE METHODOLOGY

3.1 Introduction	66
------------------	----

3.2 Model Specification	66
3.3. Estimation Techniques	70
3.3.1 Unit Root Test	70
3.3.2 Cointegration Test	73
3.3.3 Granger Causality	76
3.4 Data	80
3.5 Diagnostic tests	84
CHAPTER FOUR RESULTS	
4.1 Introduction	87
4.2 Unit root tests results	88
4.3 ARDL cointegration test results	90
Granger causality test results	101
4.5 Conclusion	104
CHAPTER FIVE CONCLUSION	
5.1 Introduction	107
5.2 Summary of the Results	110
5.3 Policy Recommendations	112
5.4 Limitation of the Study and Suggestions for Future Research	113
5.5 Concluding Remarks	114
REFERENCES	115

Appendix

Figure 4.1: CUSUM and CUSUMSQ plots of Model1.	139
Figure 4.2: CUSUM and CUSUMSQ plots of Model 1.	139
Figure 4.3: CUSUM plots of Model 2.	140
Figure 4.4: CUSUMSQ plots of Model 2.	140

LIST OF TABLES

	Page
Table 1.1: Oil revenues to total revenue in Kuwait from 1970 to 2014	7
Table 4.1: Unit root tests results (level)	89
Table 4.2: Unit root tests results (First difference)	90
Table 4.3: Results of the ARDL Cointegration (model 1).	91
Table 4.4: Results of the ARDL Cointegration (model 2).	91
Table 4.5: Diagnostic test results (model 1).	93
Table 4.6: Diagnostic test results (model 2).	93
Table 4.7: Long-run estimation results (model 1).	96
Table 4.8: Long-run estimation results (model 2).	98
Table 4.9: Short-run estimation results (model 1).	99
Table 4.10: Short-run estimation results (model 2).	101
Table 4.11: TYDL Granger causality test results (model 1).	102
Table 4.12: TYDL Granger causality test results (model 2).	102
Table 4.13: the results of the causality test between all variables in model 1.	103
Table 4.14: the results of the causality test between all variables in model 2.	103

LIST OF FIGURES

	Page
Figure 1.1: The Kuwait GDP historical growth from 1970 to 2012.	10
Figure 1.2: The Kuwaiti government revenue and government expenditure.	11
Figure 1.3: Comparison between oil price and Kuwait government Expenditure on investment and consumption (1970-2013).	13
Figure 1.4: The Kuwait budget from 1970 to 2012 compare with oil price.	19
Figure 4.1: the percentage change on the GOVINV to the one unit of independent	96
Figure 4.2: the percentage change on the GOVCON to the one unit of independent	98

LIST OF ABBREVIATIONS

IMF	International Monetary Fund
NBK	National Bank of Kuwait
FY	Fiscal Year
FDI	Foreign Direct Investment
CBK	Central Bank of Kuwait
KWD	Kuwaiti Dinar
GCC	Gulf Countries Council
(AD-AS)	Aggregate Demand and Aggregate Supply model
GDP	Gross Domestic Product
MENA	Middle East and North Africa
OECD	Organization for Economic Co-operation and Development
VECM	Vector Error Correction Model
VAR	Vector Autoregressive model
DF	Dickey-Fuller
AR	Autoregressive
MA	Moving Average
ARDL	Autoregressive Distributed Lag
OLS	Ordinary Least Square
LCB	Lower Critical Bound
UCB	Upper Critical Bound
SBC	Schwartz–Bayesian criteria
HQC	Hannan-Quinn Criterion
ECT	error correction terms
MWALD	modified Wald

AIC	Akaike Information Criterion
LM	Lagrange Multiplier
RESET	Regression Equation Specification Error Test
CUSUM	Cumulative Sum
CUSUMSQ	Cumulative Sum of Squares.
FMOLS	Fully Modified Ordinary Least Squares
ARDL	Autoregressive Distributed Lag
TYDL	Toda and Yamamoto test

HUBUNGAN DIANTARA PERBELANJAAN KERAJAAN, HARGA MINYAK DAN PERTUMBUHAN EKONOMI: KAJIAN KES DI KUWAIT

ABSTRAK

Kajian ini mengkaji hubungan antara dua jenis perbelanjaan pelaburan kerajaan, penggunaan dan pertumbuhan ekonomi dalam kes di Kuwait sebagai salah satu daripada negara-negara pengeksport minyak. Ia juga menyiasat punca antara mereka. Kaedah terkini iaitu siri masa digunakan seperti ARDL dan TYDL, data untuk tahun 1974-2014 dirujuk, kajian mendapati bahawa peningkatan kadar pertumbuhan ekonomi memberi kesan negatif dan signifikan jangka panjang keatas perbelanjaan pelaburan kerajaan sebagai pembolehubah bersandar, walaubagaimanapun hasilnya adalah bertentangan dengan model kedua iaitu perbelanjaan penggunaan kerajaan merupakan pembolehubah bersandar, manakala harga minyak mempunyai hubungan positif jangka panjang keatas GOVINV dan hubungan negatif keatas GOVCOS adalah pembolehubah bersandar, sebaliknya hasil kajian daripada TYDL menguji punca dimana ia menunjukkan satu arah Granger yang memberi punca dari KDNK ke GOVINV dan tiada punca diantara KDNK dan GOVCOS. Ini kerana kesan kepentingan pertumbuhan dalam kecekapan perbelanjaan penggunaan kerajaan di Kuwait dan memberikan beberapa cadangan terbaik berteraskan dasar perbelanjaan kerajaan. Bagi menyelesaikan masalah yang berkaitan dengan perbelanjaan pelaburan kerajaan, perbelanjaan penggunaan kerajaan terhadap pertumbuhan ekonomi. Kajian ini membincangkan punca berkemungkinan terhadap keputusan kajian keatas kes di Kuwait dan melakar beberapa implikasi dasar.

THE RELATIONSHIP BETWEEN GOVERNMENT EXPENDITURE, OIL PRICE AND ECONOMIC GROWTH: A CASE STUDY OF KUWAIT

ABSTRACT

This study examines the relationship between two types of government expenditure 'investment, consumption' and economic growth in the case of Kuwait as one of oil exporting countries. And also investigate the causality between them. Using recent time-series methods such as ARDL and TYDL, the data for 1974-2014, the study finds that increases of economic growth rate have a negative and significant long-run effect in investment government expenditure as dependent variables, but its result is opposite with second model that's the consumption government expenditure as dependent variable, also the oil price has positive long-run relationship with GOVINV and negative relationship with GOVCOS as dependent variable, on the other hand the result of TYDL to test causality shows unidirectional Granger causality running from GDP to GOVINV and no causality between GDP and GOVCOS. Because of the important growth effect of the efficient use of government expenditure in Kuwait and provides some recommendations based on what are considered to be best practices in government expenditure policy. To relieve the problems associated with government investment expenditure, consumption government expenditure on economic growth. The study discusses possible reasons for these findings in the Kuwaiti case and draws some policy implication.

CHAPTER ONE: INTRODUCTION

1.1 Introduction

Government expenditures plays an important role in an economic growth (Barro, 1990). The main focus of any government is to elevate the living standard of the people in its country by stimulating the economic growth, which is required to meet the economic well-being, i.e. providing the basic need for citizens like education, health care, subsidies and others. The relationship between government expenditures and economic growth is a critical factor in determining the impact of government expenditure policies on an economic growth in developing countries such as oil-exporting countries.

Due to the instability of global oil prices, those countries that depended heavily on oil-export will have to face fluctuation in revenue, especially in the event of an oil price decrease. It's also not able to benefit from high oil revenues over the years to ensure the high economic growth has derived during future periods, during which prices could fall and thus lose their current opportunities may not be repeated. Especially with the growth of population and their needs to spend, the biggest gradual fits with the requirements of the size of the population gradually rises and high growth rates.

Peacock and Wiseman (1961) the expenditures of government require an increasing yearly finance, but total revenue is not certain, as, it entirely depends on oil prices in

the global market. In most of the oil exporting countries, there is no certain knowledge regarding an impact of the government expenditures on the economic growth, especially, the fact that expenditures depend on the oil revenues. Kuwait is an example of such oil exporting countries that depends heavily on the oil revenues in order to have the required finance of its expenditure. This study investigates the relationship between the government expenditure in both consumption and investment, oil price and economic growth in Kuwait over the past four decades, during the period from 1970 to 2014.

This study will discuss the chapter introduction; a second section will outline the background of the study. After that, the problem statement will be discussed in part three. The fourth section will go over the aims of the study. Research questions will be divided into five categories. Afterwards, the significance of the subject will be explained, followed by the scope of the study and its limits, the contribution of the study, and finally, the organization of the study.

1.2. Background of study

A relationship between oil prices, government expenditure and economic growth have been investigated in this research study. This section presents a brief overview of the economy of the state of Kuwait, which is a case study of this research. The details regarding the GDP of Kuwait over the last four decades has been presented in this section, whereas, the performance of government expenditures, consumption and investment during the time scale of the study have also been addressed. Finally, a

review was presented to show the economic reforms that have been done in Kuwait over the past decade along with the current obstacles faced by the Kuwait's economy, such as the dependency on the extraction of oil revenues to fund government expenditure in both consumption and investment, the dominance of the public sector on the movement of domestic economic activity and excessive dependency on the outside world in closing the service and merchandise to local needs through imports and trade openness to the outside world.

1.2.1 An Overview of Kuwait Economy

The wealth of oil resources changed Kuwait from a poor desert country into a modern country. Oil revenues, create a strong Kuwaiti economy that provides Kuwaiti people with the essential services. Thus, the oil wealth of Kuwait has been positively exploited to the advantage of Kuwaiti nationals. Over the time span of four decades, oil prices in Kuwait went through several phases, which were encountered every time by carrying major disruptions in oil costs, causing political unrest in most instances.

The Kuwaiti government has made key decisions to support economic growth, but a rapid increase in population and inflation has resulted in a continuous increase in government expenditure on public investment and consumption. The state of Kuwait depends on one resource of revenue, which is oil. The price of oil is determined by the global market, which make it very difficult for the Kuwaiti government to continue supporting some commodities for its citizens. Therefore, it is crucial for

Kuwait to diversify its economy because the country has no control over oil prices. If, Kuwaiti government continues to concentrate only on one source of revenue, the possibility of facing real challenges would become high.

In the state of Kuwait, oil accounted between 80 to 96 percent during the period of study (Table 1.1), which financed nearly all the government expenditures. The same scenario exists in other oil-exporting countries, especially those who are the members of the Gulf Cooperation Council (GCC), which explains a fact that a real economic growth is not guaranteed in oil exporting countries, as in developed countries. Real economic growth is calculated by the amount of manufacturing goods and services during a specific period of constant time. Furthermore, fluctuation of oil prices during this period of time might be due to an economic growth. The cause of the Kuwaiti economy's dependency on oil in the emergence of consequential problems on the production and export of a single commodity in the formation of the national income, low GDP when the fall in world oil prices, which may adversely affect the financing of government expenditure, income individuals, development projects and other economic activities. Therefore the economy suffers National fluctuation of national income levels on a yearly basis as a result of this.

The annual budget of the state of Kuwait in the expenditure side includes five sections, which are categorized as salaries, supplies of goods and services, various expenditures and transfer payments, the means of transport, equipment, fixtures, projects, and maintenance and land purchases. According to the ministry of planning, these five sections are divided into two types, the first one is consumption, which

includes the first three sections and the second type is an investment, which is included in the remaining two sections.

Economic growth is a primary objective for any government expenditure in a short and long term. The Kuwaiti government intends to help their citizens in improving their standards of living and assists in providing a social welfare. According to Andrew Abel, Bernanke and Croushore (2011), a leader of economic growth is government expenditure. Here, expenditure has been referred in terms of consumption and investment – that exists in the developed countries. In some of the small countries, such as Kuwait, the economic restructuring differs rentier economic structuring. Case in point: there is a difference in the sources of revenue in a government's budget in developed countries, where it is produced through the four main sources: sales of goods and services, various taxation schemes, methods of borrowing and printing money. According to Barro (2013). In addition, there is also a difference in terms of private spending. Recently, developed countries have adopted robust educational and health care systems, while developing countries have remained content with calculative expenditure on Ministries of health, education, and transport, where the investment expenditures are considered such salaries are consumption expenditure.

According to the Kuwait Ministry Of Finance (MOF), three factors determine the size of government revenues of the State of Kuwait's annual revenue, the first factor is the price of a barrel of Kuwaiti oil and the exchange rate of the Kuwaiti dinar against the dollar or a basket of currencies, as well as the Kuwaiti oil production or the size of oil derivatives. Assumed the importance of the exchange rate in oil

revenues, as the oil sales are in dollars and thus will determine the size of the revenue through the exchange rate and the amount of production over a specified period of time and thus may will cause the exchange rate in the gross domestic product which is economic growth scale, and that the exchange rate of its task relocation of local funds and investment in the country without transferring to other areas, which will increase the size of government investment expenditure if it cannot resettled local funds, at least not to mention attracting foreign investment. Barro, Robert (1991).

All economic sectors linked directly or indirectly connected to the outside world, which, requires them to deal in foreign currencies to settle signed economic deals with foreign partners and inadvertently gain economic operator confidence in the direction of the local currency, besides make supporting the latter economic policies and to contribute to the direct macroeconomic indicators in the desired direction. Then, on her head ensure economic growth remains for the task of monetary authorities to rationalize the process of selecting the appropriate exchange rate regime for its currency, the real national and sustainable. Kuwait, like other developing countries adopted in the early the seventies incremental steps to re-examine.

Perhaps, the exchange rate and trade openness an important role in Kuwait government revenues, especially in single-country supplier such as oil exporting countries, where it sells a commodity in the global markets in US dollar, and thus will affect the currency exchange on the size of annual revenue, as well as the volume of trade openness between them and the countries of the world price as the exchange rate of the currency, so it became important global Add exchange rate and

trade openness as factors control in our Model government expenditure and economic growth.

Table 1.1: Percentage of the total oil revenues in the State of Kuwait during a period from 1970 to 2014. (The source of data: Ministry of finance- Kuwait (2015))

Year	Total revenue (million KWD)	Oil revenue (million KWD)	the oil revenue percentage in total revenue %
1970	344	298	86.6
1971	383	354	92.4
1972	548	506	92.2
1973	588	544	92.5
1974	2,121	2,057	96.9
1975	3,635	3,458	95.1
1976	2,706	2,598	96.0
1977	2,712	2,575	95.0
1978	3,285	3,036	92.4
1979	6,146	5,940	96.7
1980	4,676	4,434	94.8
1981	3,009	2,764	91.9
1982	2,602	2,335	89.7
1983	3,175	2,924	92.1
1984	2,745	2,494	90.9
1985	2,345	2,095	89.3
1986	1,731	1,484	85.7
1987	2,252	1,991	88.4
1988	2,368	2,035	86.0
1989	3,235	2,936	90.8
1990	273	246	90.1
1991	2,364	2,085	88.2
1992	2,363	2,085	88.3
1993	2,775	2,324	83.8
1994	3,101	2,785	89.8
1995	3,473	3,113	89.6
1996	4,391	3,936	89.6
1997	3,608	3,208	88.9
1998	2,798	2,254	80.6
1999	5,241	4,794	91.5
2000	4,965	4,528	91.2
2001	5,337	4,525	84.8
2002	6,219	5,498	88.4
2003	6,937	6,150	88.7
2004	8,962	8,171	91.2
2005	13,728	12,955	94.4
2006	15,509	14,511	93.6
2007	19,023	17,719	93.1

Year	Total revenue (million KWD)	Oil revenue (million KWD)	the oil revenue percentage in total revenue %
2008	21,006	19,711	93.8
2009	17,688	16,585	93.8
2010	21,502	19,947	92.8
2011	30,236	28,570	94.5
2012	32,009	29,970	93.6
2013	31,811	29,292	92.0
2014	24,926	18,805	75.4

1.2.2 Kuwaiti GDP growth

The economic growth in Kuwait almost depends on oil resources and its current production is about 2.5 million barrels daily which it sells according to the price prevailing in the international market. As evident from the Table 1.1 the economic growth, which was close to the level of one billion US dollars (USD) increased to about USD 20 billion by the end of the first decade of the study period i.e. 1980. This high growth was the direct result of hike in the price of oil because of the first Arab-Israeli war in 1973. Subsequently, there was an oil crisis due to the revolution in Iran in 1978, followed by the Iran-Iraq war in the beginning of the eighties.

The era of the eighties has seen years of decline until the year 1990, which was the year of the biggest action in the Kuwait history as the Iraqis invaded the state of Kuwait and kept it occupied for 7 months. From the year 1990, all things were affected in Kuwait right from GDP to population because many foreign residents left Kuwait and some of the citizens moved to other countries. Thereafter, the population declined from about 2 million to about 1.5 million only in 1992. The economic growth, which fell rapidly after the war took a lot of time and resources to liberate Kuwait and reinstate the infrastructure and oil refineries damaged by the Iraqis before leaving Kuwait in 1991. Thereafter, it gradually regained the economic

growth as well as re-entry of the foreigners for rebuilding of Kuwait until 1998. However, due to the Asian financial crisis, the oil prices fell as low as USD 8 per barrel and therefore GDP fell significantly, losing about half of the total.

During the years 2002 to 2008, the GDP increased from USD 40 billions to USD142 billions, until financial crisis in 2008 that drastically affected the oil prices that fell to USD 35 from USD 147 in the mid of 2008 and Kuwait's GDP was also dropped to USD100 in 2008. Later on, the GDP returned to the growth level of USD 180 billion in 2012.

Figure 1.1 shows the strong fluctuation in Kuwait GDP growth in four decades except in 1990. Figure 1.1 clarifies that Kuwait GDP has witnessed sharp fluctuations in some years by almost a quarter. Therefore, there is an urgent need to study the economic growth and the way of recovery like government expenditure, which are covered through oil revenues as the almost of oil-exporting countries, except in 1990, which happened during the Iraqi invasion. Therefore, it emerged the importance of studying government expenditure, oil prices and its relationship to economic growth in the state of Kuwait as one based on the export of oil to cover the increased government expenditure, according to configurable consumption and investment expenditure. In spite of the continuing growth, both consumer and investment spending, but its impact on economic growth was a mystery, and which is supposed to be the first goal of government spending is the sustainability of economic growth away from the affected by fluctuations in oil prices

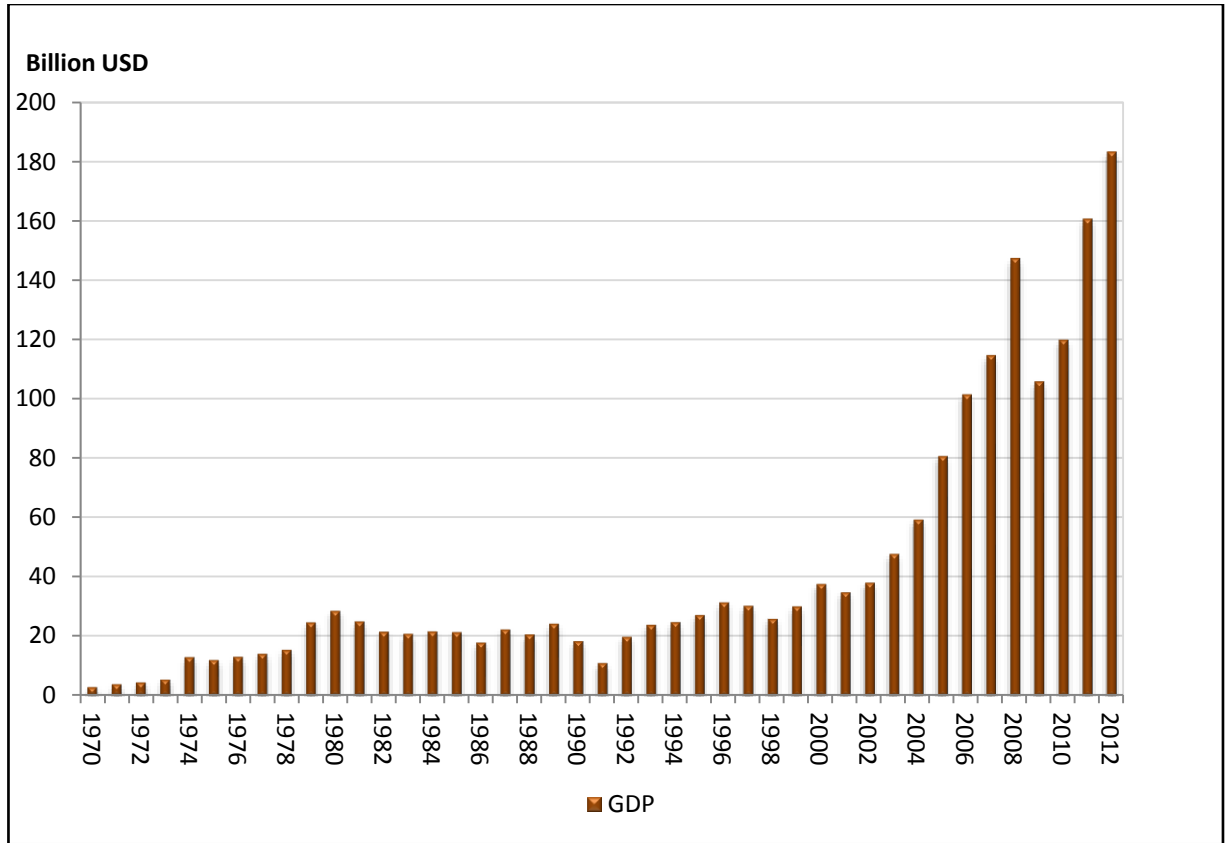


Figure 1.1: The Kuwaiti GDP from 1970 to 2012.

Data source: World Bank (2014).

1.2.3 Kuwaiti government expenditure, revenue and economic growth

Because of the oil revenues that represent the largest share of the total state revenues, the total revenues were doubled as well as the total expenditure, during the last decades compared with the first and second decades of the study as expressed in Table 1.1.

In the third decade of the study, revenues and expenditures were approximately stable, but after the year 2000, the revenue increased rapidly along with large

increases in the total expenditure. And that this consistent with the fluctuation of oil prices during that period where that oil is a major source of financing government expenditure, where it provide about 60 per cent of kuwait GDP and about 95 per cent of the revenues that come from export (OPEC 2014).

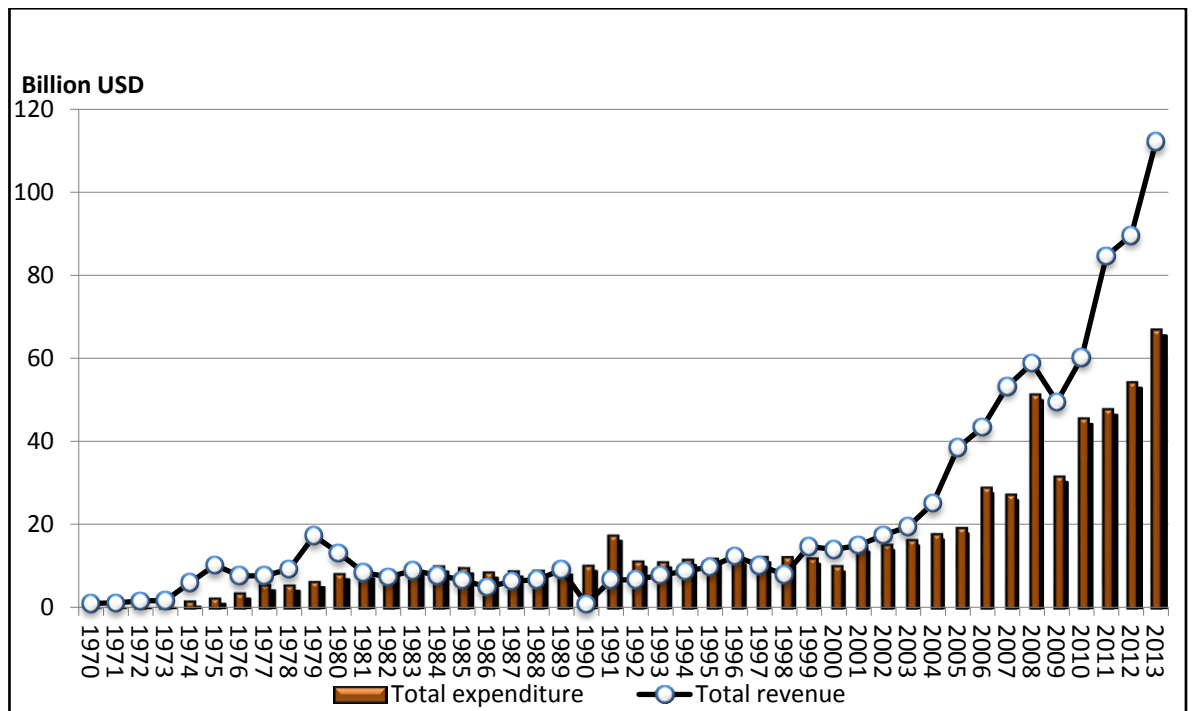


Figure 1.2: The Kuwaiti governmental revenue and expenditure of 1970 to 2013

Notes: Data Source, World Bank Database, and the Kuwaiti Ministry of Finance (annual budget 1970-2013).

As reviewed in the figure 1.2, Kuwait had strong macroeconomic outcomes in recent years, but it still faces challenges in improving its physical and social infrastructure as well as diversifying its economic infrastructure. Kuwait experienced fiscal and external surpluses through thirteen consecutive years, and it keeps up a largely steady macroeconomic situation. However, Kuwait is relatively low in international comparisons with regards to the quality of its infrastructure, health and education. This is particularly true when compared with countries with similar gross domestic

production (GDP) per capita level, such as Qatar and United Arab Emirates (UAE) (IMF report, 2008). IMF report mentioned the difference between Kuwait public sector and the Gulf Countries Council (GCC). In 2008, Kuwaiti government expenditure on education was about 3 percent of GDP. Compared to Saudi Arabia, Kuwait spends six percent of GDP; Qatar spends 2200 US dollars per capita percentage on health care. Nevertheless, Kuwait spends only 1000 US dollars per capita. Moreover, in 2008, Kuwait's expenditure was around 5800 US dollars per thousand capita on roads, which is not sufficient. However, there are efficient international standards, but the ratio of roads is equal to 4.5 percent per capita of GDP.

According to the IMF (2012) report, the oil sector has expanded, but non-oil sector recovery is still moderate. Government expenditure continued to increase in fiscal year (FY 2011/12) (8 percent), reflecting a significant increase in the wage bill and capital expenditure (about 20 percent). The budget expansion was more than offset by the increase in oil revenue (35 percent) emanating from higher oil prices and production levels. Overall, fiscal and external surpluses are estimated to have reached more than 30 percent and 41 percent of GDP in 2011, respectively.

The substantial financial support over the past few years and the rate of recovery of non-oil economic activity after the 2008 global financial crisis has been restrained. Non-oil growth, in 2011, is estimated to be 4.5 percent, which was still on the lower side. Nonetheless, there is improved growth of 2½ percent of banks' credit to the non-government sector. Corporate net income declined in all sectors except for inspection and repairs. The banking sector continued to generate profits, due to its

strong build-up in provisions, and the investment and real estate company sectors posted losses. Simultaneously, real estate trades were improved in the housing and investment sectors, but commercial real estate continued to suffer from low occupancy rates and declines in rental rates. Inflation remained moderate at 4.7 percent.

1.2.4 The oil price and Kuwait government expenditure in both consumption and investment

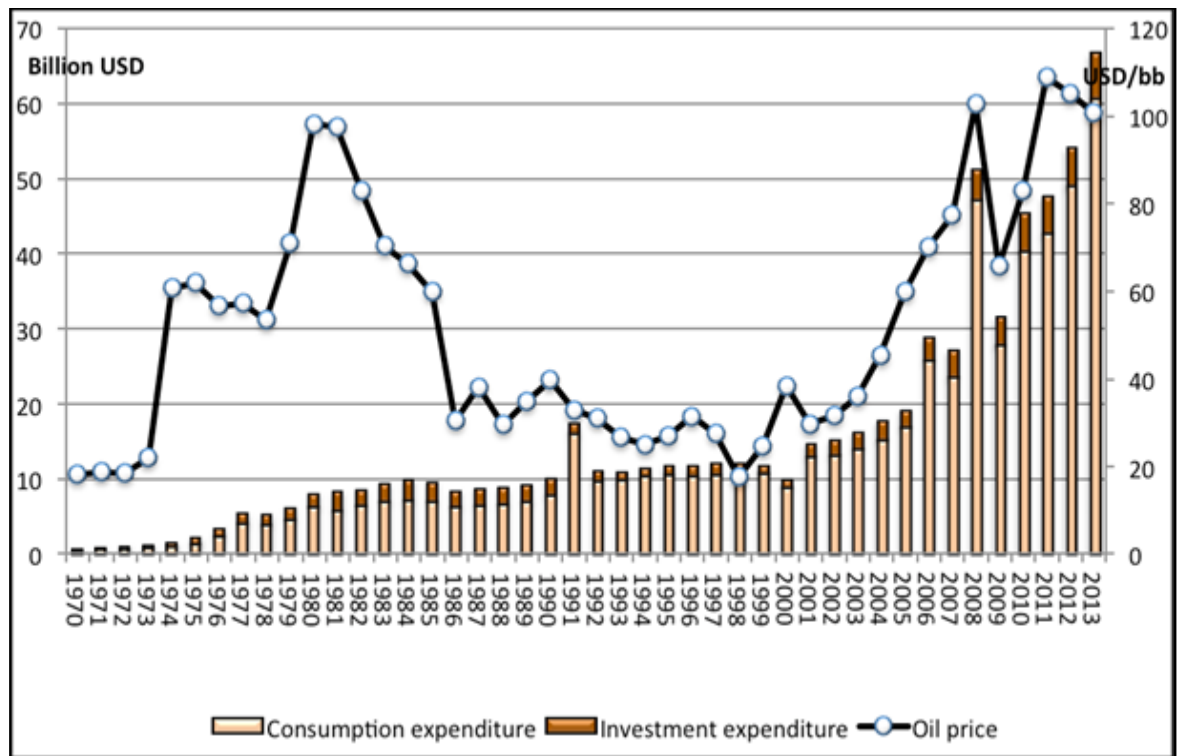


Figure 1.3: Comparison of oil price and Kuwait government expenditure on investment and consumption during the period (1970-2013)

Notes: the figure is based on the Ministry of Planning and the Ministry of Finance (1970-2013).

While a few of the decades were influenced by economic crises, and from a glance at the situation (Figure 1.3), which shows the case of oil prices and Kuwait government

expenditure on investment and consumption from 1970 until 2012. Since 1970, the price of Kuwaiti oil did not exceed three USD per barrel, however, a record upward oil price trend was seen until 1979 and the price reached to USD 90, which was about 30 times higher than the price of 1970. There were political factors, increasing successively in three scenes. Political influence, skewed oil prices, and then beginning of the year 1973, and the Arab-Israeli war in 1977, followed by the popular revolution in Iran that was led by Imam Khomeini, which brought the end of the decade-long Iran-Iraq war(Figure1.4). The first decade of finance has benefited from the rise of financial surpluses. There is a balance in investment and consumption expenditure, where it was the first experience of surprise and excessive increase in oil revenues in Kuwait as shown in Figure 1.2.

After that, the price of oil shot up to its highest level by the end of 1980, touching the level of 90 USD per barrel. Then, it fell sharply until it reached 21 USD per barrel during 1986 and then it settled at this rate till the end of 1989. Then, in this decade, the fiscal deficit in the budget of the state of Kuwait reflected during eight fiscal years. In this respect, the recorded surplus exchange during the first two years alone was the reason of the first financial crisis. Also, then it hit the global economy in the early 90s, which caused a corrective action towards the oil prices. Consequently, this resulted in pressure on prices until the end of the decade, as the Iran-Iraq war ended in 1988, and then the price was stabilized at the level of 27 USD approximately.

Kuwait witnessed, in 1990, the biggest event in its history. In August, Iraqi forces invaded Kuwait and continued its occupation for seven months. Consumption expenditure exceeded the investment expenditure by the end of the first decade of the

study period. The total expenditure was stable in the second decade with the decrease in oil prices in the mid 80's and the investment expenditure remained constant at twenty-five percent of consumption expenditure. In 1991, the consumption expenditure increased to cover the needs of the population after the Iraqi invasion finished. The consumption expenditure continued to be high even though the oil prices decreased in the late nineties. In 2000, oil prices began to rise and consumption expenditure improved, compared to the decrease in investment expenditure from total expenditure, as shown in the previous figure.

Kuwait oil production stopped during the occupation period and returned after the Iraqi military lost the war. The deficit, in 1991, was more than 15 billion USD including the cost of military to liberate Kuwait and the reconstruction efforts made after the war. After 1991, the deficit decreased to reach around 4.5 billion USD for eight years out of ten (from 1990 to 2000). In the third decade of the study period, continued budget deficit in the State of Kuwait was the primary cause of the low amounts of oil exports, because of what happened to the infrastructure – it was severely damaged and repairing of the damaged ports took a long time.

The financial performance improved as a result of increased export after nearly five years, but then appeared a financial crisis in Asia, which affected commodity prices. In this case, the oil price reaching its lowest level at a 6.5 USD per barrel, which only led to a re-deficit of the budget aggressively up to 6 billion USD in 1990. The oil prices reached 7 USD by the end of 1998 and then again in 2007, reached to its peak of 90 USD. Furthermore, the annual averages for this year in the State of Kuwait

resulted in large financial surpluses. Although, the consumption expenditure suffered, but the investment remained at a low level compared with consumption.

In the mid-2008, the financial crisis hit the financial markets and caused heavy losses in oil prices where they left off when the average oil price fell to 50 USD. Following this, the annual surplus decreased to 7.5 USD billion and then returned after the trip up and continued to be volatile. This limited the surpluses, which came down to 15 billion USD until 2010. Thereafter, the surpluses doubled because of the increase in the rate of oil prices. Due to the crisis of the Arab Spring, it reached 100 USD to achieve a budget surplus during 2011 and 2013. This was up to 38 billion USD, and then again, it jumped. Then the consumption expenditure was much larger than the investment expenditure as shown in the Figure 1.2. Such changes were offset by a significant change in oil prices that may be related to government expenditure, which is the source of change.

1.2.5 Kuwait's Primary Economic Reform

Almost all specialists call for economic reforms in Kuwait, starting from the government expenditure, then do the administrative, legislative reforms, I will mention them briefly, but a lot of obstacles are in front of them, for example, Strong growth in consumption and investment government expenditure, in particular, as well as the urgent need for funding from oil revenues unconfirmed in the coming years in an effort to reduce government expenditure and the restructuring of the economic structure of the government with some economic reforms, which have failed to curb spending growth or even contribute to reducing dependence on

financed by oil revenues, as well as its importance for economic growth over the past four decades, an unstable political environment, difficulties in changing social cultures, and limited natural resources except oil. (Kuwait news agency) (KUNA, 2007). Kuwait's government worked earlier to reform its economy in the last decade and initiated a structural reform, which started with encouraging private sector activities by many measures, like financial small project, promoting foreign direct investment and labor market restructuring. The first measures, at the beginning of the last decade in the health sector were introducing health care charges, and increasing the custom duties on tobacco which resulted in the advance diversifying of income base. This included elimination of exceptions from duties on imports, imposing duties on government services, rising payments on public utilities, and imposing taxes on luxury things (World Trade Organization, 2012).

On the other hand regarding expenditure, extra concern should be set toward government employment, cutting of subsidies and transfers, and more justifying of government expenditure. A committed application of the last measures can develop the construction budget and improve the physical condition against the oil price variations. The developed revenue forecasts may help to increase the capital spending, which may result in stimulating the economic action. By the way, the Kuwaiti government may feel that is good to establish official oil-revenue steadiness technique that touches the budget course and variations in oil prices strictly.

After that, the National Assembly accepted the Labour-Market Law (May 2000) and the Foreign Direct Investment (FDI) Law (April 2001). In October 2003, social allowance was given to Kuwaitis who work in the private sector. There was an

Implementation of the “Kuwaitization”. The Kuwaiti government performed major reforms in the financial sector. The first reform was militancy on the Kuwaiti banks to improve the process of managing and checking the operational risks by the Central Bank of Kuwait CBK (October 2003), issued instructions. Moreover, they established a framework of the Islamic banking law (September 2003) and a fully functioning credit bureau, named as Ci-Net, in April 2002, in addition to the development of regulation and supervision agenda for anti-money laundering actions (AML) that has been supported by the government in the last decades.

Measures included the performing of a law on forbidding money-laundering actions, combating the financing of terrorism (CFT) (March 2002), Releases of AML/CFT rules for banks and money exchange companies, and the creation of the Kuwait Financial Intelligence Unit at the CBK (July 2003) (IMF Country Report No. 04/186). For capital markets, Reforms included the expansion of the stock market by adding parallel market, besides establishing of a guaranteed fund to protection nonpayment by brokers (June 2002) (IMF, 2003). The National Assembly agreed in 2004 for the first time allow the opening of branches of foreign banks in Kuwait. Exciting of the implicit blanket guarantee on bank deposits was planned, the CBK abandoned the peg to the U.S. dollar and related to basket of currencies, and the Kuwait National Assembly voted for the amendment in the tax law for minor corporate income tax, which was applicable only to foreign companies, from the current rate of 55 percent to 15 percent (2008). A corrected labor law is under seeing while the Civil-service law is being revised to rationalize public sector employment.

For labor market, the administration is considering to announce on-the-job employment training; for capital markets, an additional increase of cross-listing agreements is planned. Moreover, under consideration edit rules that the participation of non-residents in the capital market and the development of the current electronic trading system for transactions in real time control. In the year of 2008, the Kuwaiti government amended tax regulations affecting foreign companies. Aside from this, the Kuwaiti government guaranteed the bank deposits in the same year, as the financial crisis that hit the Gulf Bank of Kuwait.

After the fall of the Kuwaiti stock exchange, the Kuwaiti government regulated a new law, the law on financial stability and the enhancement of bank conditions, after it was passed by the parliament of Kuwait in the year 2009. The Kuwaiti government had worked on two strategies to reform and recover weakening economy, by 2010, a breakthrough took place; the Kuwaiti parliament approved a number of reform strategies.

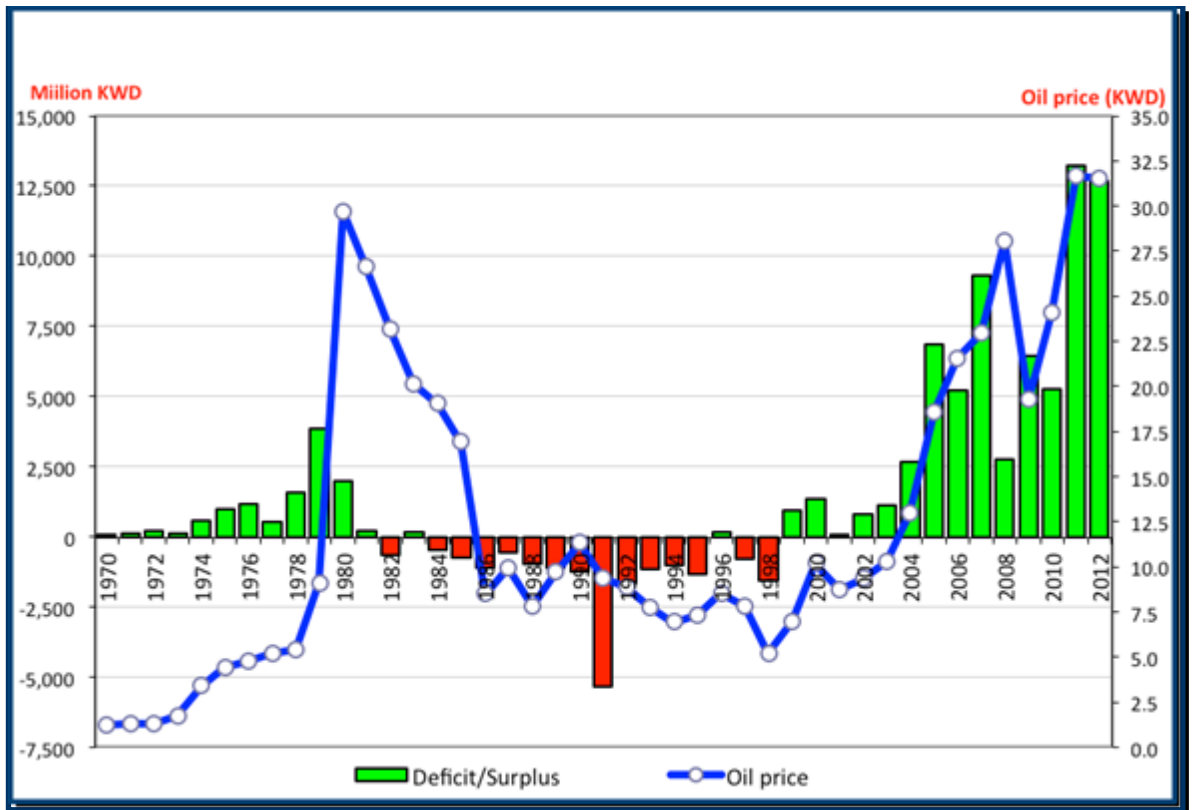


Figure 1.4: The Kuwait budget (surplus and deficit) from 1970 to 2012 compare with oil price.

Notes: The data source for Kuwait budget is Kuwaiti MOF, and the oil is USEIA in the same period (1970 to 2012)

Despite all the Kuwaiti economic reforms and huge expand on government expenditure, the oil revenues continued the massive funding of the government expenditure, and Figure 1.4 represents the large change on the deficit and surplus in the Kuwait financial annual budget through the 42 years from 1970 to 2012. While, the unknown effects of big government spending in partial investment and consumption to reduce dependence on oil, as a major supplier as well as its contribution to the economic growth in the State of Kuwait during four decades ago. Kuwait faced deficit 15 times to finance the government expenditure. Finally, it arrived on the mentioned reforms or attempts to reform the social organization of the

Kuwaiti economy and reduced dependence on oil to cover the expenditure plans of government. However, it continued dependency on oil at high rates that exceeded 90 percent in the fiscal year of 2012, as reflected in the budget of the Kuwaiti government, presented by the ministry of finance. For that, this research focuses on examining the relationship between economic growth and oil prices, government expenditure as a whole, where the state needs to advance the well-being of the citizens by improving the human needs of the human capital investment and the fiscal capital investment. In addition, the focus of the government expenditure was on consumption. The idea can be viewed from the foregoing continually high government expenditure on the demands of the citizen's life, year after year, and the rising population, which has repeated in every decade, relying mainly on government expenditures. This rose year after year on the export of petroleum prices in the global marketplace, which has proven record volatility in prices in 1998, equivalent to prices in 1973. After 25 years, prices had returned to their lowest levels, as well as the rise in government expenditure. This clearly indicates the seriousness of the dependence on oil prices to cover government expenditures on the main sectors in the economy. Hence, the data obtained from this study will be used to investigate the relationship of government expenditure of oil in Kuwait, which will reveal the challenges that would be faced by the Government of the State of Kuwait during the coming period. The increasing trend in population growth translates to increase in the government expenditure contrary to oil price fluctuations. These three main factors need to be studied carefully to help the government of Kuwait to develop a robust economic structure to manage its revenues more efficiently.

According to the previous figures related to the changes in Kuwait's total revenue for the past 43 years, starting from the year 1970 to 2013, compared with the above figures related to the changes in government expenditure, GDP as illustrated in Figure 1.1 In addition to the movement of government expenditure, both investment and consumption for the same period, compared with the price of oil in Figure 1.2. Figure 1.3 comparison between oil price and Kuwait government expenditure on investment and consumption, where the government expenditure had taken an upward direction. Nevertheless, there was an obvious fluctuation of oil price movement, as well as revenue, which is constituted mainly by oil, as well as the increasing growth in population which could affect the government expenditure and revenue. This requires an in-depth study of the relationship between government expenditure, which has a great economic importance to meet the requirements of the population and the historically volatile oil prices. Acknowledging the effects caused by the changes of oil prices, which may also affect the current government and development expenditures, therefore, the economic growth will be affected in both the short and long term.

1.3 Problem Statement

The Government of Kuwait has been an increase in government spending as a fiscal policy tools, that drive economic growth, and as a developing country with a rentier