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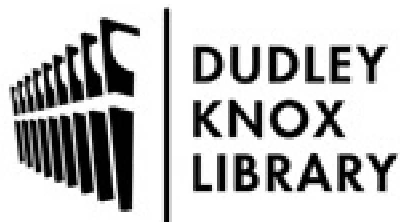

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Reforming the Rentier State: The Imperatives for Change in the Gulf

Robert Looney

> On a journey through the Kingdom, I heard the word reform everywhere I went, though no one seemed to agree on exactly what it meant.
>
> —Elizabeth Rubin[1]

Introduction

An economic irony that is gaining increasing attention is the "resource curse" effect, whereby many of the poorest and most troubled states in the developing world have paradoxically the highest levels of natural wealth.[2] In fact, a rapidly growing body of literature suggests that resource wealth itself, especially where it accounts for the bulk of government revenues, as in the case of the so-called rentier states,[3] may harm a country's prospects for development. Country growth data bear this out: rentier states, with greater natural resource wealth, tend to grow more slowly than their resource-poor counterparts.[4]

This "rentier state" effect is beginning to manifest itself in what are commonly thought of as some of the wealthiest regions of the world.[5] In the Persian Gulf, for example, relatively stable levels of oil production and flat oil revenues, combined with an unanticipated rapid increase in population, have resulted in declining per capita income in Saudi Arabia. At the height of the oil boom in the 1980s, Saudi Arabia's per capita income was around US$17,000. By 2003 this figure had declined to about US$8,200.

The Saudi Arabian example is not unique. The unfortunate fact is that most oil-rich developing countries are underperformers across a whole spectrum of economic, social, political, and governance standards. Large windfall gains associated with a rapid increase in oil prices have been a particular problem in that they appear to create severe distortions in the working of the economy and the political system with strongly negative sociopolitical

proved overwhelming, undermining even the best efforts to develop each country's non-oil economy, eradicate poverty, and improve living standards for broad-based segments of the population.

There is still great controversy over the best way to escape the rentier syndrome. For some analysts, a microeconomic approach stressing increased competition, privatization, and greater incentives for risktaking is key. For others, the establishment of supporting macroeconomic institutions, such as a sound financial system and efficient, equitable tax systems, play a central role. Others focus on the necessity of developing stable and effective macroeconomic policies—the efficient timing and focus of fiscal and monetary policies. In addition, a growing school of thought suggests that governance issues predominate. The failure of the rentier states to eliminate corruption while developing responsive government institutions is the main factor accounting for poor economic performance in the rentier states.

A related controversy surrounds the extent to which useful generalizations can be made about the rentier economies. Although all share a number of common structural conditions, are these similar enough to form an economic environment that responds predictably to a common set of policy initiatives? Or is each rentier economy likely to have unique features to the extent that require a tailor-made economic program for achieving, growth, diversification, and integration into the global economy?

This chapter examines these issues from the perspective of the two largest rentier states in the Gulf—Saudi Arabia and Iran. What do these economies share in common? What are their chief differences? Which has made the most progress to date in transitioning away from the rentier state syndrome? What tasks lay before them in their integration to the world economy? In particular, which area of reforms appear critical for successful transition to a more normal economy capable of generating self-sustained growth independent of conditions in the oil markets? Based on the answers to these questions, a final section examines the implications for Iraq.

Rentier Malaise

The recent oil price increases have given both Saudi Arabia and Iran a temporary reprieve from their longer-run economic dilemmas. Both countries are experiencing transitions that are complex and decisive for their futures. Both are facing a dual set of problems: on the one hand, those of a developing country and, on the other, those of a rentier economy. Both possess some of the main characteristics of a developing country: a predominantly young population and an economy mainly focused on the primary sector—oil for both, with Iran having, in addition, a large agricultural sector.

The rentier nature of both economies is no less evident: revenues derived from oil represent the bulk of public and external revenues. In essence, these revenues enable the governments in each country to dominate the private large. In short, the collection and subsequent redistribution of oil revenues takes on both an economic and political dimension. Both economies are faced with dual challenges: first, transforming the rentier economy into a diversified economy through encouraging expansion in the non-oil private sector areas of activity and, second, implementing the political reforms necessary for establishing institutions and governance structures capable of creating an environment conducive to enabling non-oil activities to operate on a sustained basis.

Saudi Arabia

Within this context, Saudi Arabia is currently facing a number of challenges. The first problem involves attaining and maintaining economic growth rates that are least sufficient to keep pace with the rise in population. For Saudi Arabia, low economic growth has become a chronic problem (see table 3.1). Gross domestic product (GDP) increased by only 1.6 percent between 1990 and 2000, whereas growth in the country's population grew at an annual rate of 2.7 percent during that period, thus producing a declining trend in per capita income.[6]

This low rate of growth cannot be attributed to a lack of capital formation. In fact, the rate of investment is relatively high in Saudi Arabia. The Sixth Development Plan (1995–2000), for instance, envisaged a total capital of around 472 billion riyals ($125.8 billion), including nearly 212.7 billion riyals ($56.7 billion) from the private sector. It had also targeted an economic growth rate of 3.8 percent over the plan period. By the end of the plan, actual investment increased by around 2 percent to 481 billion riyals ($128.2 billion) including nearly 292 billion riyals ($77.8 billion) from the private sector, an increase of around 37 percent over the projected level.[7]

Thus, even though the plan overachieved in terms of investment, it underachieved in terms of what really counts: real economic growth. The ineffectiveness of investment to sustain growth appears to be structural, stemming in part from a weakening of the linkage between public and private expenditures together with a decline in the ability of public expenditures to stimulate real output.[8] Given the inability of the public sector to directly stimulate real

Table 3.1 Saudi Arabia: GDP growth, 1960–2002 (average annual rate of growth)

GDP measure	1960–2002	1970–2002	1980–2002
Oil	3.8	2.3	−0.9
Private	8.8	8.9	2.0
Public	5.9	5.1	3.0
Total	5.7	4.7	1.0
Non-oil	7.4	7.1	2.3

non-oil output, all of the pressure to provide expanded employment opportunities, jobs, and output is now placed on the private sector.

Job creation is then the second major problem facing the region. Ironically, even though the Saudi economy is heavily dependent on foreign workers (4.6 million or 71 percent of the country's workforce), the unemployment rate among Saudis is 8.2 percent, reaching 32 percent among younger workers.

The third challenge relates to maintaining the pace of economic reforms. Here the Saudis have initiated a series of measures designed to attract foreign investment, deregulate many key industries, and liberalize the economy to qualify for membership in the World Trade Organization (WTO) as well as to facilitate further economic integration with the country's fellow GCC members.

If carried out successfully, economic reforms should remove many of the constraints currently impeding growth and job creation in the private sector. As discussed below, this is critical, given the current inability of public expenditures to perform this task. The country's three main challenges—restoring rates of growth above that of the population, expanding job creation, and implementing a comprehensive reform package—appear to be relatively compatible. Good progress in the reform area should assure higher rates of economic growth and, through that, more jobs. But will they be jobs for Saudis? Apparently, the government is not confident this will be the case because it is simultaneously broadening and expanding its Saudization program. The Saudi government appears to feel that if jobs cannot be created through high rates of investment, then they must be forced through quotas.

Iran

Iran faces a similar set of challenges. Although the country's growth has not decelerated (see table 3.2) to the extent found in Saudi Arabia, there are several troubling trends.[9] During 1960–76, Iran enjoyed one of the fastest growth rates in the world. The economy grew at an average rate of 9.8 percent in real terms and real per capita income growth averaged 7 percent.

This growth trend was reversed during 1977–88, reflecting the aftereffects of the 1979 revolution, the eight-year war with Iraq, sanctions and international isolation, the increased state dominance of the economy, and plummeting oil output and revenue. In 1988, oil production was only 36 percent of its

Table 3.2 Iran: Average sectoral growth, 1960–2002

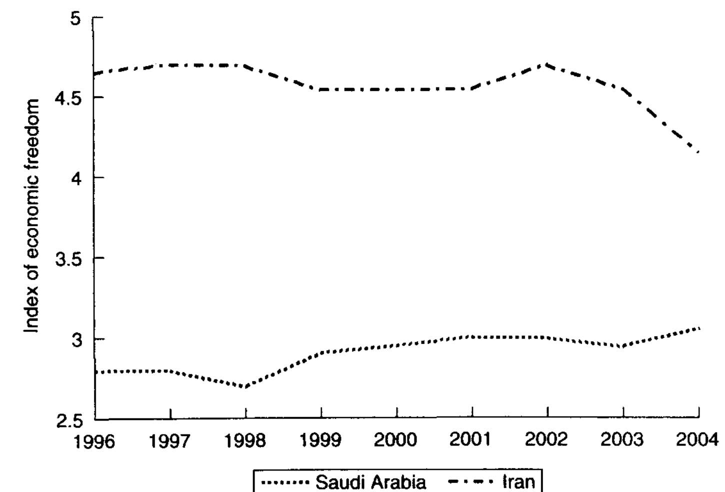
Period	1960–76	1977–88	1989–2002	1960–2002
Agriculture	4.6	3.9	4.1	4.2
Oil and Gas	10.0	−8.6	2.5	2.4
Industries and Mines	14.0	−1.3	7.3	7.6
Services	11.1	−1.9	4.8	5.4
Non-oil GDP growth	10.1	−0.5	5.0	5.5
GDP	9.8	−2.4	4.7	4.6

level in 1976 and oil prices were 40 percent lower in real terms. This resulted in a negative real GDP growth of 2.4 percent per annum. Excluding oil output, non-oil GDP also declined, averaging a fall of 0.5 percent per annum.

With the reconstruction effort and partial recovery in oil output, real economic growth recovered during 1989–2002, averaging 4.7 percent per annum. This period, however, was marked by sharp fluctuations in the growth pattern as the postwar economic boom (1989–2002) was followed by the stagnation of 1993–94 when the economy was hit by lower oil prices, lack of external financing, and economic sanctions. The ensuing severe debt crisis, together with inappropriate macroeconomic policies, had an adverse impact on growth, which hovered around 3.6 percent during 1995–2000.

In the more recent period (2000–03), real GDP growth has increased to 6 percent due to significance progress in economic reforms: exchange rate unification, trade liberalization, opening up to foreign direct investment (FDI), and financial sector liberalization. Higher oil prices and expansionary monetary and fiscal policies have also contributed to the country's recent economic recovery.

As is the case with Saudi Arabia, growing unemployment is becoming a major social and political problem. During the 1996–2000 period, 693,000 new workers entered the labor market whereas only 296,000 jobs were created. The result is a current rate of unemployment of over 20 percent of the active population. This unemployment mainly affects the young urban population. According to the World Bank, the creation of between 700,000 to 800,000 new jobs each year (thereby achieving unemployment rate stability) would require an annual growth of the economy of at least 6 percent per annum.



Iran is attempting to put more flexibility and job creating capacity into its economy through a series of reforms. Although some progress has occurred in the last several years, the country still lags considerably behind Saudi Arabia in many critical areas. Using the aggregate economic freedom index discussed below (where higher numbers signify lower levels of freedom), it is interesting to note a general backsliding in Saudi reform efforts, whereas those in Iran appear to be cautiously moving ahead (see figure 3.1).

Although notable differences exist, Saudi Arabia and Iran appear to share a number of common economic characteristics and face a set of similar challenges. In recent years many of these problems seem to have intensified, perhaps because the pace of population growth, globalization, and technological change are outpacing the ability of the rentier system to effectively resolve new challenges as they arise.

Commonalities Associated with Oil

In attempting to explain the inability of rentier economies to sustain steady expansions in their economies, most researchers have focused on their most apparent defining features: the manner in which oil revenues accrue to the government and the subsequent impacts the utilization of these revenues have on economic activity. In this regard, a large literature has spawned in recent years attempting to clarify some of the complex and negative transmission mechanisms associated with oil revenues, especially those that occur during periods of rapidly rising petroleum prices.[10] There are many competing explanations, but they are not necessarily mutually exclusive.[11] They may reinforce each other, resulting in a slowing of economic growth and productivity. In extreme cases, the non-oil sector of the economy even begins to contract.

One way to understand the uniqueness of the rentier state is to contrast its dynamics to that of a normal economy, known as the production state (see table 3.3). Because the rentier state is not based on broad-based production, its main dynamic stems from the forces set in motion by the distribution of revenues. Several mechanisms associated with this expenditure help define the rentier state's rather unique development pattern.

Table 3.3 Rentier or allocative versus non-rentier or production states

Production states	Rentier states
State based on extractive capability and economic growth	State based on rent
Representational pressures and political conflict over economic policy	Economic policies do not create same degrees of political conflict or representational pressures Spends without taxing
Unequal distribution of wealth leads to pressures for redistribution of change	Distribution of rent-generated wealth creates less pressure to change status quo

The Dutch Disease Effect

The mechanism that has probably gained the most attention in academic circles is the so-called Dutch Disease. This phenomenon has two effects both of which should concern postwar Iraq. The first focuses narrowly on the exchange rate. In technical terms, the Dutch Disease refers to the potentially adverse effects of a booming export sector on the performance of other exports and of industries competing against imports. These effects work through a strengthening (appreciation) of the exporting country's exchange rate. In the 1960s, the Netherlands experienced a vast increase in its wealth after discovering large natural gas deposits in the North Sea. Unexpectedly, this seemingly positive development had serious repercussions on important segments of the country's economy, as the Dutch guilder became stronger (a 30 percent appreciation), making Dutch non-oil exports less competitive. The exchange rate appreciation resulting from a ramp-up of oil exports is likely to reduce the profitability and competitiveness of traditional agricultural exports. It would also encourage imports of food and raw materials, which may compete with domestic production. It is also likely to discourage the emergence of new manufacturing exports, essential for the successful diversification of the economy. The expansion of Iranian oil export earnings in the 1970s provides a good example of these effects.[12]

The second effect of concern is that, during the modernization and expansion of the oil sector, the rest of the economy may be crowded out from access to key factor inputs. That is, the oil sector, with its financial resources, would preempt these resources, weakening the ability of the private sector to invest and diversify.

The Dutch Disease also tends to result in increased poverty, but here the links are more difficult to establish.[13] The price distortions created by the appreciating exchange rate can be seen as a tax on exports, and, if the country has a trade pattern based on comparative advantage, this would likely involve labor-intensive activities. Rates of economic growth in these areas would decline, inhibiting any tendency for benefits of oil-based expenditures to "trickle down." Under these circumstances, the economy would likely become more vulnerable to external shocks from which the poor cannot protect themselves. Finally, the inflation stemming from expanded oil-financed expenditures would, again, likely harm the poor disproportionately.

Although the disease is generally associated with a natural resource discovery, it can occur from any development that results in a large inflow of foreign currency, including a sharp surge in natural resource prices, foreign assistance, and FDI, all of which are distinct future possibilities for a country such as Iraq.

The Rentier Society/Authoritarian Effect

The second dimension of negative oil-related effects has to do with govern-

institutional and other policy changes. It also can lead to the development of a rentier society where there is often a disconnect between effort and reward. A common result is the creation of a dualistic economy where a vibrant oil and gas sector coexists with a weak, poorly performing non-oil economy.

Along these lines, Halliday has noted that

> the uniqueness of oil resides . . . in the peculiar form of payment resulting from it, a rent to producer states that does not entail the forward and backward linkages within the local economy that are characteristic of other primary production in the third world. The collection of this "rent" enables the producer state, and those controlling it, to amass enormous sums of money without engaging in any form of production; it is this which has generated such major social tensions within the producer states. These tensions include growing income inequality, rampant corruption in the state, grandiose development projects, and the neglect of productive activity and skills, especially in agriculture.[14]

Because oil infrastructure can be controlled easily by a few, it leads to a concentration of political power. Thus, rentier states tend to be authoritarian (as shown in table 3.4). There are several reasons for the political system to evolve in this direction.[15] First, an oil-rich government can provide vast social services without taxing the public. Because there's no taxation, there's less demand for representation. Rentier governments also tend to buy off the opposition and amass large internal security forces capable of crushing dissent. Second, the skewed development of oil-dependent states means that they lack the working- and middle-class citizens, who historically have been a force pushing for democracy. In short, whereas oil exporters fall into a number of political categories, lack of accountability and transparency is a common characteristic of the group. Again, these patterns are readily apparent when, as noted earlier, comparisons are made with so-called production economies (table 3.2). The net effect of these factors has led (to one degree or another) to corruption, mismanagement, and a colossal waste of resources.

Table 3.4 Political classification of oil exporters

Factional democracy
- Political features
  - Government and parties often unstable relative to interest groups
  - Political support gained through clientelistic ties and patronage
  - Wide social disparities, lack of consensus
  - Politicized bureaucracy and judicial system
- Institutional implications
  - Short policy horizon
  - Policy instability, nontransparency, high transaction costs
  - Strong state role in production
  - Strong interests attached directly to state expenditures
- Economic implications

Table 3.4 Continued

- Rents transferred to different interests and public through subsidies, policy distortions, and public employment
- Main Examples
  - Ecuador, Venezuela, Colombia

Paternalistic autocracy
- Political features
  - Stable government, legitimacy originally from traditional role, maintained through rent distribution
  - Strong cultural elements of consensus, clientelistic and nationalistic
  - Bureaucracy provides both services and public employment
- Institutional implications
  - Long horizon
  - Policy stability, nontransparency
  - Low Competitiveness, high transaction costs
  - Strong state role in reduction
  - Strong interests attached directly to state expenditures
  - Weak private sector
- Economic implications
  - Procyclical expenditure, mixed success with stabilization
  - Risk of unsustainable long-term spending trajectory leading to political crisis
  - Little economic diversification
- Main examples
  - Saudi Arabia, Kuwait, Qatar, UAE, Oman

Political classification of oil exporters
- Political features
  - Stable government, legitimized by development
  - Social range of consensus toward development
  - Constituency in non-oil traded sectors
  - Insulated technocracy
- Institutional Implications
  - Long horizon
  - Policy stability, nontransparency
  - Drive for competitiveness, low transaction costs
  - Strong constituency for stabilization and fiscal restraining
- Economic implications
  - Expenditure smoothing stabilization
  - State investment complementary to competitive private sector
  - Active exchange rate management to limit Dutch Disease
- Main examples
  - Nigeria (elected governments), Indonesia

Predatory autocracy
- Political features
  - Unstable government, legitimized by military force
  - Lack of consensus-building mechanisms
  - Bureaucracy exists as mechanism of rent capture and distribution
  - Corrupt judicial system
  - Little or no civic counterweight

Table 3.4 Continued

Policy instability, no transparency
Low competitiveness, high transaction costs
Spending interests strong vis-à-vis private interests or prostabilization interests
Economic implications
No saving
High procyclical expenditure
Very high government consumption, rate absorption by elites through petty corruption and patronage, capital flight
Main examples
Nigeria (military governments), Iraq

Source: Eifert, Gelb, and Tallroth, 2003.

Whereas Saudi Arabia's political system clearly falls in the "paternalistic autocracy" group, Iran's is rather unique and hence more difficult to characterize. The Iranian state appears to be guided by a "benevolent neutrality" in its relations with citizens where any modification (in the form of decreases in subsidies, for example) or reduction in living standards has a major political impact. These forces are offset to a certain degree by an additional element ensuring the cohesion of the system: a strong ideological system (Shi'ite Islam) encompassing all economic and political spheres, both at the public and private level.[16]

The Fiscal Uncertainty Effect

The final dimension of oil-related problems stems from the fiscal implications of fluctuating and uncertain revenues. Although one cannot say that oil revenues create a certain political system, it is a fact that, for the most part, the political systems adopted by most of the oil-exporting countries are short-sighted and pursue a pro-cyclical stabilization policy. The net effect is to intensify the detrimental impact that fluctuations in oil prices have on the domestic economy.

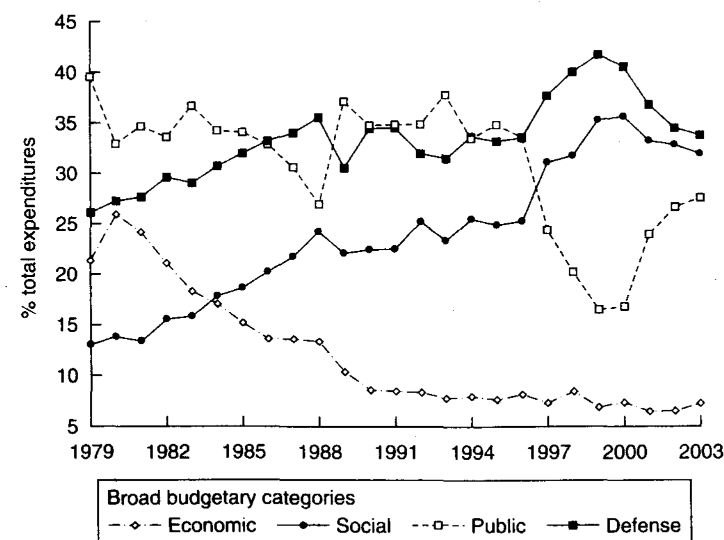
Oil-exporting countries' budgetary patterns tend to be an extreme version of the fiscal rules used in many developing countries facing fluctuating revenues. Many of these countries initiate expanded capital expenditures during periods of rising revenues on the assumption that these revenues are sustainable. When revenues decline, budgetary cuts occur, but in a fairly predictable manner.[17] In general, social sectors are less vulnerable to cuts than defense and administration, which, in turn, are considerably less vulnerable than production and infrastructure.[18] Of course, these patterns can be affected by the willingness of countries to assume increased governmental debt in an attempt to maintain programs during periods of declining revenues. Another complicating factor, especially for Middle Eastern oil exporters, is their large budgetary commitment to defense expenditures. These factors combine to

Budgetary Patterns in Saudi Arabia

As is well known, Saudi Arabia has experienced ongoing budget difficulties since the mid-1980s. Growing deficits have been the norm with non-oil revenues unable to pick up the slack during periods of falling oil revenues. What is less well known is that the composition of public expenditures has been undergoing some profound changes during this period. Of particular significance is the fact that economic expenditures (economic services, transport and communications, and infrastructure) have declined steadily since 1980, from around 25 percent of the budget at that time to a little over 7 percent by 2003.[19] Social expenditures (human resource development and health) have been the major beneficiaries of the decline in economic allocations more than doubling their share of the budget over the period 1979–2003 (from 13 percent to nearly 32 percent of total expenditures). As noted, defense remains the largest budgetary item, fluctuating in the 35–40 percent range in the period after 1988 (figure 3.2).

Public expenditures (administration, loans, and subsidies) have shown the most erratic pattern. After fluctuating at around 35 percent of the budget between 1979 and 1994, they fell sharply to less than 20 percent in 1999 only to increase to about 27 percent in 2003. The sharp decline in public expenditures in the early-to-mid-1990s stemmed, in part, from a sharp cutback in the government's loan programs.

The patterns described are suggestive of an environment in which the public sector is contracting in many areas. This is especially the case with regard to economic expenditures and other activities directly supportive of the private sector. Budgetary shifts away from economic categories are the



most obvious manifestation of this phenomenon. Falling shares of investment relative to non-oil output are also indicative of Saudi Arabia's capital stock and productive expenditures playing much less of a stimulating role as in the unbalanced growth strategy implicit in the early oil-boom years.[20]

More subtle shifts in policy or policy effectiveness can only be inferred from a more detailed analysis of budgetary patterns and their impacts. Of particular importance are the linkages between public and private sector expenditures (output) on non-oil production and investment. In this regard, a common theme in the development literature is that economic processes in oil-based countries become more complex as these economies mature and begin to diversify away from a complete reliance on oil revenues and associated public sector expenditures. There is clear evidence that this process is well advanced in Saudi Arabia.[21] With regard to the economy's leading productive sectors, several patterns stand out:[22]

(1) Growth in the agricultural and mining sectors became more dependent on private expenditures and less dependent on public expenditures, especially during the 1975–2001 period.
(2) The non-oil manufacturing sector has become almost completely dependent on private sector expenditures, with strong linkages to these expenditures in both the short and longer term. In contrast, public sector expenditures now have little stimulating effects on the sector.
(3) Traditionally the wholesale and retail trade sectors have been dependent on both public and private sector expenditures. Whereas this remains the case for private sector expenditures, public sector expenditures currently have only a short-run transitory effect on the sector's output.
(4) In a major change from earlier periods, output in the construction sector is no longer dependent on public expenditures. Instead, output in this sector now depends primarily on the long-term pattern of private sector expenditures.
(5) Private expenditures have strengthened their linkages to the housing sector as well as to transport, storage, and communications sectors. Although output in this sector is still responsive to public sector expenditures, this linkage has weakened over time.
(6) Other financial activities are dependent on private expenditures. However with regard to public expenditures, this effect is confined to the longer-term effects of governmental expenditures.
(7) Finally, linkages between private expenditures and the service sector (community, social, and personal services) have strengthened considerably in recent years. This sector's links to public sector expenditures have also weakened.

In sum, the pattern found here is one of strengthening linkages between private sector expenditures and sectoral output. At the same time, the ability of public sector expenditures to provide a positive stimulus to output has

manufacturing and construction, public sector expenditures no longer play a role in affecting output growth. In other areas, such as agriculture, mining, trade, and services, public expenditures may only play a minor role in the overall growth of these areas of activity.

The question that immediately arises concerns the factors responsible for the deterioration in links between government expenditures and, for all practical purposes, the rest of the economy. Given the fall in the relative share of government expenditures in such areas as non-oil GDP, diminishing returns can no doubt be ruled out. The major changes in the composition of the government's budget noted above would appear to be a more likely source of the decline in the strength of public sector linkages.

Again, in aggregating the various sections of the government's budget into four main categories (social expenditures, economic expenditures, public expenditures, and defense), several interesting statistical patterns emerge that may help to explain the effect of public expenditures on the non-oil private sector. First, looking at the links between government revenues and expenditures, economic expenditures, public expenditures, and defense spending reveals a similar pattern: each expands in the short run with increased government revenues (of course, they would also contract with falling revenues). This pattern carries over into the longer term with each category of expenditure maintaining a stable relationship with revenues.[23]

On the other hand, there do not appear to be any links, either short or long term, between revenues and social expenditures. As noted, this category has been the fastest growing category of expenditures. More importantly, it, along with defense, now dominates the government budget. The fact that the expansion in social expenditures appears to be independent of the government's revenue position suggests that either these allocations receive a much higher priority over other expenditures and/or that the government is willing to incur large deficits to fund these programs. No doubt their rather steady increase until the last several years means that they have played a rather limited role in fiscal macroeconomic stabilization.

A closer look at social expenditures reveals that their budgetary share has grown largely at the expense of several economic sections of the budget, namely transport, communications, and direct economic allocations. Short run increases in social expenditures had a negligible impact on their budgetary shares. However, the more fundamental long-term impact was clearly negative. The only economic category not adversely affected was infrastructure, where social expenditures did not appear to affect this categories' budgetary share in either the short or longer term. The dramatic decline in the budgetary share of subsidies may be attributed in part to the growth of social expenditures. Both the short- and long-term impacts of expanded social expenditures reduced the proportion of the budget allocated to subsidies.

Interestingly, defense allocations did not suffer at the hands of social expenditures.[24] Short-run increases in the budgetary share going to social categories actually increased the share of the budget controlled by defense

were the only budgetary subcategory unaffected by the expansion of social expenditures. The contraction of this category apparently was due, in part, to a shift in governmental priorities rather than a direct allocation conflict with social expenditures.

In short, the high priority given to social expenditures, followed by defense together with limited oil revenues during most of this period, resulted in a tremendous contraction in the public sector's allocation to economic services of various types.

Patterns of Productivity and Growth

The three dimensions of the "Paradox of Plenty"—Dutch Disease, rentier state, and fiscal uncertainty—have combined to produce, in part, the dismal performance of rentier states noted earlier. This pattern has been confirmed in a recent study examining the sources of economic growth in various parts of the world.[25] At issue is how much of the growth in output per worker is associated with growth in physical and human capital per worker and how it can be attributed to other factors, such as technological change. This latter category is often referred to in the literature as total factor productivity (TFP).[26]

The importance of TFP stems from the fact that, in its absence, economic growth eventually slows and stagnates due to diminishing returns to capital formation. Within this context, there are striking differences in the manner in which oil and non-oil economies grow (see table 3.5):

(1) Looking at the Middle East as a whole, oil exporters have sustained an average output growth of 0.83 percent. Associated with this expansion has been a growth in physical capital of 2.24 percent and in human capital of 1.96 percent.

(2) These growth rates occurred in an environment characterized by negative growth in total factor productivity per worker of 1.22 percent.

(3) The high negative rates of growth of TFP for the major oil exporters is particularly telling: Iraq (−1.92), Oman (−2.28), Saudi Arabia (−2.99), Iran (−0.95), and UAE (−2.89).

(4) In contrast, non-oil exporters in the Middle East grew about twice as fast (1.59 versus 0.83) and invested at a rate about twice that of the oil exporters (4.94 versus 2.24). And, if Yemen, an oil producer, is omitted, they had less of a decline in TFP (−0.47 versus −1.22). Noteworthy here are the positive TFPs achieved by the major economies: Egypt (0.19), Israel (0.10), Morocco (0.02), and Tunisia (0.15).

(5) Oil exporters allocated a proportionate amount of resources to human capital (1.96 percent versus 1.86 percent for the non-oil producers).

(6) Other oil exporters experienced similar patterns with stagnant growth (0.07 percent) and total factor productivity per worker declining by 1.74 percent per annum. This is in sharp contrast to an average growth in

Table 3.5 Average growth of output and input by country

		Growth rate per worker			
	First year	Output	Capital	Human capital	TFP
Middle East					
Oil exporters					
Algeria	1948	3.00	3.04	1.85	0.76
Iran	1956	1.56	3.02	2.26	−0.95
Iraq	1950	1.14	5.51	1.86	−1.92
Kuwait	1980	−0.35	−4.58	1.55	0.12
Libya	1960	3.68	4.99	2.47	0.38
Oman	1970	0.67	4.63	2.11	−2.28
Saudi Arabia	1960	0.70	7.73	1.70	−2.99
UAE	1980	−3.74	−6.42	1.89	−2.89
Average		0.83	2.24	1.96	−1.22
Non-oil exporters					
Egypt	1917	2.00	2.63	1.14	0.19
Israel	1948	3.10	4.64	2.20	0.10
Jordan	1960	1.36	4.16	1.61	−1.09
Morocco	1951	1.77	2.54	1.36	0.02
Syria	1953	0.76	4.37	2.25	−2.19
Tunisia	1956	2.61	2.99	2.20	0.15
Yemen	1970	−0.44	13.24	2.27	−6.33
Average		1.59	4.94	1.86	−1.31
Other oil exporters					
Norway	1855	2.05	2.68	0.89	0.57
Nigeria	1952	0.08	3.76	1.12	−1.91
Venezuela	1936	0.55	2.41	1.46	−1.22
Ecuador	1950	1.15	3.32	2.13	−1.36
Indonesia	1951	1.76	4.21	1.72	−0.78
Russia	1917	1.98	3.72	1.74	−0.41
Azerbaijan	1990	−6.40	−4.41	2.92	−6.90
Kazakhstan	1990	−0.65	−1.24	2.47	−1.89
Average		0.07	1.81	1.81	−1.74
Southern european					
Cyprus	1950	6.03	6.66	1.81	2.62
Greece	1910	2.85	3.41	1.24	0.89
Italy	1861	1.79	2.57	0.96	0.30
Portugal	1849	1.97	2.46	0.75	0.65
Spain	1857	1.34	1.77	0.82	0.21
Turkey	1935	1.99	2.12	1.36	0.38
Average		2.66	3.17	1.16	0.84

Source: Adapted from Scott L. Baier, Gerald Dwyer, and Robert Tamura, "How Important Are Capital and Total Factor Productivity for Growth, April 2002, at www.vanderbilt.edu/Econ/faculty/Crucini/tamura.pdf

Total Factor Productivity in Iran

A more detailed examination of TFP in Iran sheds further light on possible TFP patterns over time.[27] Also illustrated are several measurement problems

manner in which increased schooling is allocated, one gets two estimates of TFP in Iran, each with a particular bias. The noninclusion of the effect of increased schooling on the productivity of the labor force results (as shown in table 3.6) in appositive contribution of TFP to growth during the 1969–2002 period (because changes in the quality of the labor force are implicitly included in TFP). Using an alternative specification assuming human capital increases linearly with the average years of schooling, the contribution of TFP to growth becomes negative (−1.2 percent on average during the 1960–2002 period).

Under both accounting exercises, the contribution of TFP to growth is positive during the high growth subperiod of 1960–76 and becomes negative during the political turmoil and war period of 1977–78. This result points to the critical importance of political and external developments for Iran's economic growth. The results differ in the growth accounting for 1989–2002. Under the first specification, in which human capital equals raw labor, the contribution of TFP to growth is positive. On the other hand, if we assume a linear effect of education to human capital, the contribution of TFP becomes negative. As the IMF notes,[28] a more realistic TFP estimate may lie between these two extreme cases. In particular, it is likely there was a very small (or even negative) contribution of TFP to growth during the 1989–2002 subperiod due to slow progress in structural reforms and increased macroeconomic instability.

If Iran, Saudi Arabia, and the other rentier states want to achieve better economic performance, their governments will have to create an environment that encourages and forces sustained levels of positive TFP. Again, it is unlikely this has happened on a sustained basis in the oil economies outside of Norway.

Table 3.6 Iran: Sources of economic growth, 1960–2002

		Contribution of		
Period	Average growth rate	Capital	Raw labor	TFP
1960–76	9.8	3.9	1.2	4.7
1977–88	−2.4	1.7	1.4	−5.5
1989–2002	4.7	2.3	1.5	1.0
1960–2002	4.6	2.1	1.4	1.1
		Capital	Human capital	TFP
1960–76	9.8	3.9	2.7	3.2
1977–88	−2.4	1.7	5.5	−9.6
1989–2002	4.7	2.3	4.3	−1.8
1960–2002	4.6	2.1	3.7	−1.2

Source: Islamic Republic of Iran... [illegible]

COMMONALITY IN REFORM EFFORTS

There is still great controversy over the best way to stimulate TFP. For some analysts, increased competition, privatization, and greater incentives for risk-taking are key.[29] For others, the establishment of supporting institutions (i.e., an independent central bank, a sound financial system, and efficient, equitable tax systems) play a central role.[30] Both of these strategies are critically dependent on the progress made in economic reforms (economic freedom) and improved governance.

Economic Freedom

Both the Heritage Foundation/Wall Street Journal's *Index of Economic Freedom*,[31] and the Fraser Institute's *Economic Freedom of the World*[32] provide good measures of the relative progress made by countries in moving to a deregulated, limited government, free-market environment. Because the Heritage Foundation data set included more of the Middle Eastern countries, it was used for the analysis that follows. The Heritage Index reflects the absence of government constraint or coercion on the production, distribution, or consumption of goods and services. Stripped to its essentials, economic freedom is concerned with property rights and choice. To measure economic freedom the Heritage Foundation/Wall Street Journal index takes ten different factors into account:

- Trade policy
- Fiscal burden of government
- Government intervention in the economy
- Monetary policy
- Banking and finance
- Capital flows and foreign investment
- Wages and prices
- Property rights
- Regulation
- Informal market.

Implied in these measures is the notion that economic freedom also requires governments to refrain from many activities. They must refrain from actions that interfere with personal choice, voluntary exchange, and the freedom to enter and compete in labor and product markets. Economic freedom is reduced when taxes, government expenditures, and regulations are substituted for personal choice, voluntary exchange, and market coordination. Restrictions that limit entry into occupations and business activities also retard economic freedom.

The index provides a framework for assessing progress toward a modern market economy integrated into the global economy: how open countries are

through taxation, spending, or overregulation), and the strength and independence of a country's judiciary to enforce rules and protect private property. Some countries may have freedom in all factors; others may have freedom in just a few. One of the most important findings of research carried out using the index is that economic freedom is required in all aspects of economic life. Countries must score well in all ten of the factors in order to improve their economic efficiency and consequently the living standards of their people.[33]

As noted earlier, Saudi Arabia's progress in attaining economic freedom has been rather slow, suggesting that despite the fact that a number of reforms have been enacted in recent years, their impact has been somewhat limited. According to the Heritage/Wall Street Journal index, economic freedom by 2004 was a bit lower than in the mid-1990s (figure 5.1). In 1996, Saudi Arabia was classified as mostly free (index = 2.95). Starting in 1999, however, Saudi Arabia's economic freedom index moved into a range characterized as mostly un-free, reaching its lowest point in 2002.[34]

Saudi Arabia's relative lack of economic freedom is illustrated by particularly low scores (table 3.7) in several of the ten categories noted above: trade policy; government intervention; foreign investment; and banking and finance. In fact, the country consistently received a "free" score in only one area—monetary policy. Wages and prices and fiscal burden were the only areas consistently receiving a "mostly free" score, whereas trade policy, government intervention, foreign investment, and banking and finance consistently received scores of "repressed." Clearly, these are the areas that need the most immediate attention.

In contrast to Saudi Arabia, Iran's economy has been in the "repressed" range as defined by the economic freedom index. Hopes for broad-based economic reform were raised under President Mohammed Khatami, who was reelected in June 2001. But, Khatami's reform efforts were largely thwarted by opposition from entrenched interests, government bureaucrats who

Table 3.7 Saudi Arabia and Iran: Progress in economic freedom, 2004

	Saudi Arabia	Iran
Overall score	3.1	4.3
Trade policy	4.0	2.0
Fiscal burden	2.0	3.6
Government intervention in the economy	4.5	5.0
Monetary policy	1.0	4.0
Capital flows and foreign investment	4.0	4.0
Banking and finance	4.0	5.0
Wages and prices	2.0	4.0
Property rights	3.0	5.0
Regulation	3.0	5.0
Black market	3.0	5.0

manage many of the state enterprises, and Islamic hardliners in the judiciary and other state institutions who value ideological purity over economic progress. As a result, Khatami made little progress in reforming the economy.

Iran's economic freedom lags behind that of Saudi Arabia in all areas with the exception of trade policy. The country receives the lowest score possible (5.0) in a number of areas including, (a) government intervention, (b) banking and finance, (c) property rights, (d) regulation, and (e) informal (black) markets.

Looking at the specific areas of economic freedom, several distinctive patterns stand out between the two countries.

Trade Policy. Saudi Arabia receives consistently low scores in this area largely because of a wide range of nontariff barriers. Saudi Arabia also has a number of preferences for Gulf Cooperation Council (GCC) countries as well as a vast government program that favors domestic producers. Hopefully, the phasing out of these restrictions will also pave the way for Saudi Arabia's entry into the World Trade Organization.

Iran's trade policy score in the 2004 index was 2.0, signifying a relatively open economy. The country's weighted average tariff rate in the 2004 index was 3.1 percent, down from the 6.1 percent rate in the 2003 index. In contrast, Saudi Arabia's average tariff is approximately 10.0 percent. Traditionally the main instruments used by Iran to restrict trade were nontariff barriers and the system of multiple exchange rates. However, with the unification of the exchange rate, the country has taken a major stride toward freer trade.

Government Intervention. Saudi Arabia was considered to have a low degree of economic freedom in this area because of the high level of government consumption (27 percent of GDP in 2001). A gradual shift in budget priorities toward investment and away from government salaries/welfare state should assist Saudi Arabia's movement to a higher degree of economic freedom without disrupting the economy or risking higher levels of unemployment.

Iran received the lowest score possible (5.0) in this area, largely because of its inefficient state-owned enterprises (SOEs) and politically powerful individuals and institutions such as the *bonyad* (Islamic charities that control large business conglomerates). The *bonyad* have established a tight grip on much of the non-oil economy, utilizing their preferential access to domestic credit, foreign exchange, licenses, and public contracts to protect their positions. These advantages have made it difficult for the private sector to compete and, as a result, it remains small and incapable of playing a major role in creating new employment opportunities.

Capital Flows and Foreign Investment. Although Saudi Arabia receives a relatively low score in this area, the country appears to be actively working to eliminate many of the existing restrictions. However, much work remains to

actual practice.[35] Commonly noted problems for foreign investors include: the existence of many disincentives to invest (including the absence of accurate data); a government requirement that companies hire Saudi nationals; slow payment of government contracts; a restrictive visa policy for all workers; and enforced segregation of the sexes in most businesses.

Iran received a similar score for reforms in this area. However, in 2002 the government updated its foreign investment code for the first time in over 50 years with the enactment of the Law on the Attraction and Protection of Foreign Investment. Certain limitations on foreign investment were incorporated into this law including the prohibition of a market share of greater than 25 percent in one sector or 35 percent in individual industries. The statute also guaranteed market-rate compensation for assets that are nationalized. Most importantly, the country now allows for international arbitration in legal disputes, addressing a key concern of foreign investors. By late 2004, however, hard-liners were advancing a legislative agenda in the Iranian parliament that would effectively hamper foreign investment, make it more difficult for the government to negotiate deals with foreign companies, and roll back privatization plans.[36]

Banking and Finance. The Saudi Arabian Monetary Authority, the country's central bank, maintains tight control over the country's banking system. Saudi domestic commercial banks are heavily exposed to the government and to contractors dependent on government payments. As a result, the country receives a fairly low score in this area. A major complaint is that credit institutions such as the Saudi Industrial Development Fund (SIDF) allocate credit based largely on government-set criteria rather than on market conditions.

Iran's banking and finance system received the lowest score possible. A number of factors contributed to the sector's dismal state of affairs, including the fact that the ability of banks to charge interest is restricted under Iran's interpretation of Islamic law, and much of the country's commercial bank loan portfolio is tied up in low return loans to state-owned enterprises and politically connected individuals and businesses. However, in 2000 the government began permitting private banks for the first time since the revolution. Several private banks have opened, but they are not expected to have a major impact on the country's financial system because their operations are tightly regulated. Their ability to attract funds is also limited by the central bank's policy that limits the interest rate they set to within 2 percentage points of those offered by the state-owned commercial banks.

Wages and Prices. The Saudi Arabian domestic market for private goods and services is fairly free of wage and price controls. Religious leaders in the country consider market interferences as contrary to Islamic law. Hence, the country received a relatively high score in this area. However, in the past, public sector goods and services such as water and power have often been heavily

cut back many subsidies, some remain, especially for basic food commodities, utilities, medicines, and cement.

Iran has made some progress in this area in recent years with the deregulation and abolishment of the "price enforcement courts." Still, the country received a fairly low score largely because of massive subsidies and price controls on "essential" items such as fuel, power, and basic foodstuffs. The total cost of these subsidies is currently in the range of US$8–10 billion annually. In addition, the government sets minimum wages for each sector and region.

Property Rights. The Saudi judiciary is not perceived as independent, but as influenced by other branches of government. In addition, many businessmen complain that the enforcement of contracts is slow and often arbitrary. A recurring complaint is that the Saudi courts more often than not side with local partners when disputes involve foreign firms or individuals. This is especially true in the case of well-connected Saudis.

Property rights are even more tenuous in Iran. The country again received a 5.0 or the lowest score possible due to the widely held view that property rights are not protected. A common complaint is that the rule of law in Iran is inconsistent or unsatisfactory. The courts are unwieldy and rarely arrive at a swift resolution. Many firms will not deal with Iran because the court system is perceived to be under government or religious influence. At best the judicial system is opaque. At worst it is corrupt and arbitrary.

Regulation. There is considerable regulation in Saudi Arabia, but for the most part, it is not transparent or oriented toward serving the consumer. There are also many inconsistencies in the country's regulatory process. "Saudization" or the mandated quotas of Saudi nationals on payrolls, changes often and unexpectedly. The regulatory system also facilitates a high level of corruption. Bribes often disguised as "commissions" are common in many industries. This situation may change, however, as Crown Prince Abdullah has made anticorruption one of his major priorities.

Again, Iran comes in with the lowest score possible. Many firms find dealing with the government a long, tedious process. The government effectively discourages the establishment of new businesses. Contract negotiations are often lengthy, excessively detailed, and painfully slow to finalize. The whole process appears riddled with corruption. President Khatami's efforts at reform have been thwarted by the bureaucracy and various religious leaders.

In sum, there has been little movement toward increased economic freedom in Saudi Arabia during the last several years. In fact, during 1996–2004 there was a slight deterioration in the country's overall index. Future movements are difficult to predict simply because they appear to depend in large part on the state of the government's finances. When oil revenues are low and the government needs more employment generation in the private sector, there is usually increased resolve to undertake a new round of reforms. In 2004, with oil prices high and revenues abundant, official discussions of

To some extent, official resolve in Iran to push ahead with reforms may also be driven by public finances. However, the failure of the reformers to make significant changes in the last few years despite the seriousness of the country's unemployment suggests that the entrenched bureaucracy and Islamic hard-liners will remain a formidable obstacle to change in that country. Even more ominous, a new Iranian neoconservative movement hostile to reform of any sort and comprising mostly young and fervent advocates of Islamic republican ideals is making a bid to seize control of Iran's political agenda.[38]

Governance

In addition to economic freedom, democracy and governance are increasingly seen as essential for long-run economic growth and prosperity. In fact, some dimensions of governance now sit at the center of academic and policy discussions of economic development.[39] Although the ranking of countries on the basis of their relative progress in attaining improved governance is inherently subjective, a recent World Bank study provides a set of rankings incorporating the full extent of our knowledge about this phenomenon.[40] More precisely, the World Bank data set presents a set of estimates of six dimensions of governance covering 199 countries and territories for 1996, 1998, 2000, and 2002: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption.

Reform Gaps and Catching-Up

As expected, the overall quality of governance in Saudi Arabia and Iran lies below the norm (as shown in table 3.8). Of the two countries, Saudi Arabia has made considerably more progress in several areas, with governance levels actually above the norm in political stability, rule of law, and control of corruption. Saudi Arabia is also near the norm in the areas of government effectiveness and regulatory quality. The country's big governance deficit is in voice and accountability. There is considerable room for improving its governance structures, but Saudi Arabia appears to have a good initial start in laying a fairly solid foundation for sustained economic growth.

Iran's governance paints a stark contrast to that of Saudi Arabia, with the country consistently below the norm. Also, many of Iran's largest governance deficits fall in areas with direct economic ramifications: regulatory quality, control of corruption, and the rule of law. However, although the country did achieve some improvements over the 1996–2002 period in many of the governance subcategories, the country's overall average governance deteriorated due to a fairly sharp deterioration in political stability.

As a whole, both Middle East rentier and non-rentier economies have lagged considerably behind other major groupings of countries (see table 3.9).[41]

Table 3.8 Governance attainment in Iran and Saudi Arabia

Country	Iran	Saudi Arabia
Voice accountability		
1996–98	−0.962	−1.263
2000–02	−0.862	−1.333
Average	−0.912	−1.298
Political stability		
1996–98	−0.191	0.028
2000–02	−0.392	0.281
Average	−0.292	0.154
Government effectiveness		
1996–98	−0.314	−0.221
2000–02	−0.307	0.010
Average	−0.310	−0.106
Regulatory quality		
1996–98	−1.515	−0.068
2000–02	−1.273	−0.010
Average	−1.394	−0.039
Rule of law		
1996–98	−0.610	0.804
2000–02	−0.507	0.537
Average	−0.558	0.670
Control of corruption		
1996–98	−0.702	0.022
2000–02	−0.497	0.326
Average	−0.599	0.174
Overall governance		
1996–98	−0.640	−0.032
2000–02	−0.678	−0.074
Average	−0.716	−0.053

Thailand, Mexico, and so on—have made considerably more progress in nearly all of the major areas of reform. In turn, there is a comparable, but generally smaller, gap between the various reform measures of the catching-up and advanced, endogenous growth countries.[43]

The reform gap between the Middle East rentier and non-rentier economies varies considerably with the rentier states attaining lower levels in voice and accountability, but higher scores in the other major categories. In the economic area, the rentier states are much more interventionist than their non-rentier counterparts. Rentier states also lag in creating an environment conducive to foreign investors and in domestic price and wage reform. On the other hand, the rentier states lag considerably behind the more successful (catching-up) developing countries, especially in the area of governance. Monetary policy and the fiscal burden are the only areas where the rentier

ble 3.9 Middle East rentier/non-rentier advanced countries governance—economic freedom group comparisons

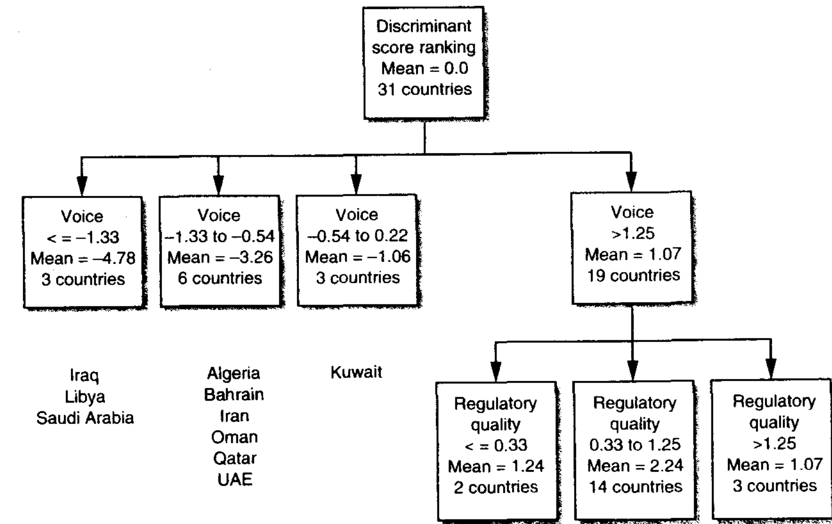
	Voice	Political stability	Government effectiveness	Regulatory quality	Rule of law	Control of corruption	Trade policy	Fiscal burden	Government intervention	Monetary policy	Foreign investment	Banking and finance	Wages and prices	Property rights	Regulation	Informal market
ddle East non-rentier ntries (11 countries)																
an	−0.93503	−0.72547	−0.31767	−0.43910	−0.38383	−0.43424	4.28000	3.82600	2.90000	2.28000	2.94000	3.30000	2.86000	3.44000	3.58000	3.95000
ddle East rentier 9 countries)																
an	−1.00535	−0.01978	−0.01233	−0.37366	0.19158	0.12086	3.50000	3.10200	3.93000	2.06000	3.62000	3.64000	3.40000	3.22000	3.43333	2.94000
ching-up countries 1 countries)																
an	0.87424	0.77986	0.66561	0.77078	0.63895	0.54852	2.70952	3.60595	2.36429	2.23810	2.35238	2.48571	2.39762	2.38571	2.83095	2.94048
ogenous growth ntries (23 countries)																
an	1.21215	1.09461	1.66271	1.41013	1.67973	1.75939	1.96522	3.90174	2.47391	1.14783	1.88696	1.93043	2.03478	1.20870	2.45217	1.44348

e: Average values for 2000–02. Values are derived from an index for each measure. The index has a mean of zero so negative values indicate inferior governance.
ce: Compiled from *Governance Matters III: Governance Indicators for 1996–2000* and *Index of Economic Freedom Rankings*.

Although it would not necessarily guarantee the economic successes enjoyed by the catching-up countries, progress in a number of areas of reform is no doubt a necessary first step in transitioning into an environment capable of encouraging those economic forces necessary for achieving self-sustained growth. Statistically, the Middle East rentier states and the catching-up countries fall into two unique groupings based on their progress in (1) voice and accountability, and (2) reducing corruption.[44] In other words, knowing the progress made in just these two areas would allow one to predict which grouping a country belonged with a 96.8 percent chance of success. In all of the areas needing increased reform efforts, these two, especially voice and accountability, should have the highest priority.

A further statistical[45] analysis (see figure 3.3) of the dimension[46] leading from rentier to catching-up status suggests the Middle East rentier states fall into three groupings of relative progress based on the level of voice and accountability reform: (1) a low group comprising of Iraq, Libya, and Saudi Arabia; (2) an intermediate group consisting of Algeria, Bahrain, Iran, Oman, Qatar, and the UAE; and (3) the top group consisting only of Kuwait. Once progress in voice and accountability enables the threshold to catching-up status to be reached, improvement in regulatory quality would become a top priority for further advancement.

As a basis of comparison, in their quest to become high performing developing countries, the non-rentier economies in the Middle East must first achieve significant progress in reforming three key areas (in declining order of importance): (1) voice and accountability; (2) foreign investment; and (3) fiscal burden. For this group, the dimension leading to catching-up status is dominated by voice and accountability (as shown in figure 3.4).



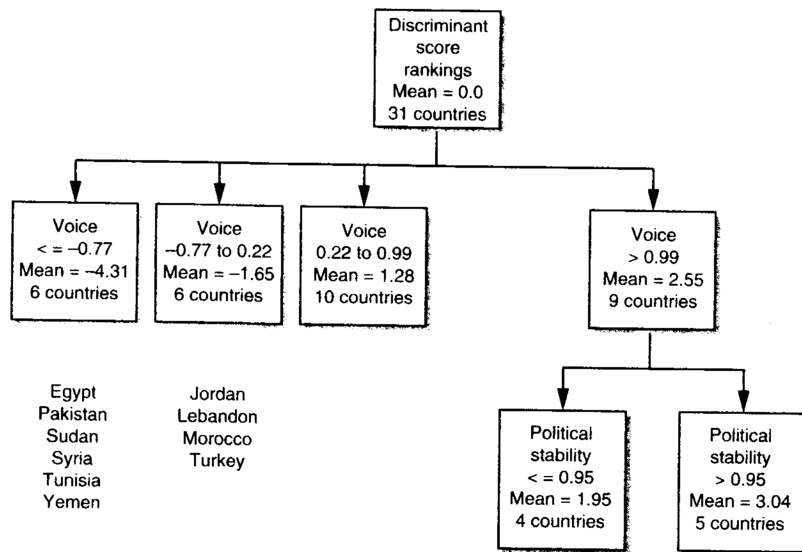


Figure 3.4 Steps in Middle East non-rentier, catching-up country progression.

Although Jordan, Lebanon, Morocco, and Turkey have made the most progress in moving toward an environment more conducive for economic success, it is clear that they have a considerable distance to go before reaching that goal. Of the three main clusters of pre–catching-up countries, none has reached the third stage.

Although these findings provide interesting insights as to the challenges confronting the Middle Eastern countries, the question remains as to whether this is the best perspective for examining the two key rentier states in the region, Saudi Arabia and Iran. Clearly these two countries are considerably larger, both economically and demographically, than the other Gulf rentier states. Does this size factor systematically define a reform strategy unique to their needs?

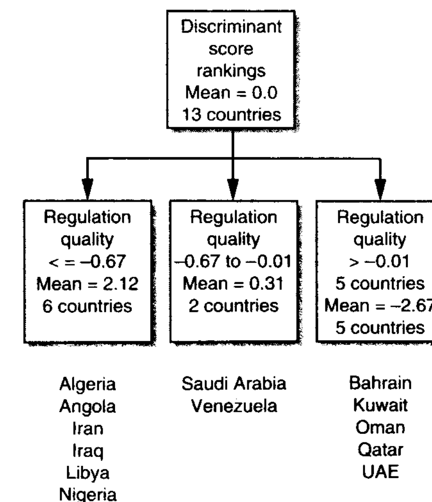
To test whether a meaningful delineation of rentier states exists, several larger non-Middle Eastern rentier economies—Angola, Nigeria, and Venezuela—were added to the analysis. As before, using the five governance and ten economic freedom variables as the basis of profiling unique policy environments shows (in table 3.10) considerable differences between them. The states fall into two groups: one with relatively large rentier states composed of Algeria, Angola, Iran, Iraq, Libya, Nigeria, Saudi Arabia, and Venezuela, and the other with smaller rentier states—Bahrain, Kuwait, Oman, Qatar, and the UAE.

In particular, the larger rentier states have lagged considerably behind the smaller states in all areas of governance. Although the gaps are not as large, the larger rentier economies have also not made nearly the same progress as

Somewhat surprisingly, the key reform area separating the two groups of countries is trade policy with the larger rentier countries lagging considerably behind their smaller counterparts. Just knowing the relative attainment of reforms in this area would have been sufficient to have correctly classified, with a high degree of probability, each country as a large or small retainer economy.

The progression from largest (Angola, Iraq, Libya, Nigeria) to smallest (UAE) rentier state is defined by the progress made in the governance area of regulatory quality (figure 3.5) with the smaller rentier states defined as a cluster of high regulatory quality environments. A middle cluster of countries consists of Saudi Arabia and Venezuela with moderate attainment in this area. The remaining large rentier economies, including Iran, are in a cluster of extremely low regulatory quality. These findings are consistent with the fact that the large rentier economies have pursued considerably different development strategies than their smaller counterparts. Because of their larger populations and domestic markets, industrialization made a certain amount of economic sense for this group. This industrialization has been achieved in large part through an inward-oriented import substitution strategy as evidenced, in part, by the group's lack of progress (openness) in trade policy.

The findings are also consistent with the patterns of declining effectiveness of government expenditures in Saudi Arabia and Iran, as well as the observed negative TFP in both countries. Lack of good regulation (together with other reform deficiencies) in both countries has limited the potentially positive economic role of governments in both countries. Negative TFP is also found in many developing countries attempting to industrialize through relatively inward-oriented import substitution development strategies.[47]



le 3.10 Large–small rentier governance—economic freedom group comparisons

	Voice	Political stability	Government effectiveness	Regulatory quality	Rule of law	Control of corruption	Trade policy	Fiscal burden	Government intervention	Monetary policy	Foreign investment	Banking and finance	Wages and prices	Property rights	Regulation	Informal market
rentiers (5 countries)																
	−0.59191	0.76373	0.68647	0.56745	1.01083	0.84929	2.48000	2.39600	3.62000	1.00000	3.16000	2.84000	2.88000	2.08000	2.84000	1.80000
eviation	0.248959	0.430938	0.279736	0.355327	0.121150	0.122204	0.363318	0.601232	0.383406	0.000000	0.753658	0.942338	0.178885	0.889944	0.753658	0.374166
rentiers (8 countries)																
	−1.19190	−1.04153	−0.87597	−1.19469	−0.84223	−0.78901	4.55000	3.62500	3.97500	3.65000	3.82500	4.17500	3.70000	4.20000	4.11667	4.23750
leviation	0.556134	0.808771	0.528483	0.887352	0.670689	0.539870	0.531843	0.761333	0.922342	1.488048	0.958794	0.736304	0.997139	0.732900	0.817856	1.019716

: Average values, 2000–02.

e: Compiled from *Governance Matters III: Governance Indicators for 1996–2002* and *Index of Economic Freedom Rankings*.

If higher oil revenues over the next few years are not sufficient to begin reducing both countries' unemployment problems, increased reforms will have to be given a much higher priority than at present. This is especially the case in many key governance areas such as voice and accountability and regulatory reform. Government expenditures will have to be refocused on activities that directly support private sector investment. In Saudi Arabia's case (and to a lesser extent Iran's), the welfare state will have to be scaled back and a higher priority given to economic allocations. More emphasis must be placed on efficiency and productivity in government activities. There is also tremendous waste in government ministries that will have to be dealt with. In short, an environment will have to be created that encourages investment and provides better incentives for risktaking and job creation. Without these efforts, growing unemployment, rising poverty, and unfulfilled expectations will produce a volatile situation, perhaps beyond the control of either government.

TRANSITION STRATEGIES

Interestingly, nearly all of the patterns of governance, economic reform, and transition out of the rentier state described here are consistent with the assumptions underlying a model of growth and terrorism developed by Bremer and Kasarda.[48] Bremer and Kasarda see countries moving through three distinct stages as their economies evolve and become more sophisticated and market driven. By their criterion, Saudi Arabia and Iran fall in the first stage (along with countries such as Egypt and Pakistan) (see figure 3.6). This group of economies has failed to move forward to the middle stage largely because of growth-limiting policies (captured by the various measures of economic freedom) and institutional rigidities (depicted by the various areas of governance).

To this basic economic/governance framework, Bremer and Kasarda add the dimensions of disillusionment and resentment. In effect, these countries have had a "failed take-off" in Rostow's terms.[49] Expectations of rapidly improved standards of living have been raised only to be left unfulfilled by the inability of the economy to sustain growth. Following Hirschman's observations on income disparity in developing countries, the tolerance of lower-income groups for large-income inequalities also wears thin as they see their dreams of a better life fade, especially if they perceive the country's elites are a source of the country's economic stagnation or decline.[50]

The key feature of Bremer and Kasarda's model is the historical record: "History suggests that failure to make steady progress through the New Second World transition's early phase to the middle period is extremely dangerous. If the transition stalls here—as it did in post–World War I Russia, and as it has now in much of the Middle East—failure can lead to revolution and al Qaeda–style international violence."[51] The one thing that the nations stuck in the early phase have in common is slowness in adopting choice-based systems. Bremer and Kasarda define "choice-based" systems as encompassing

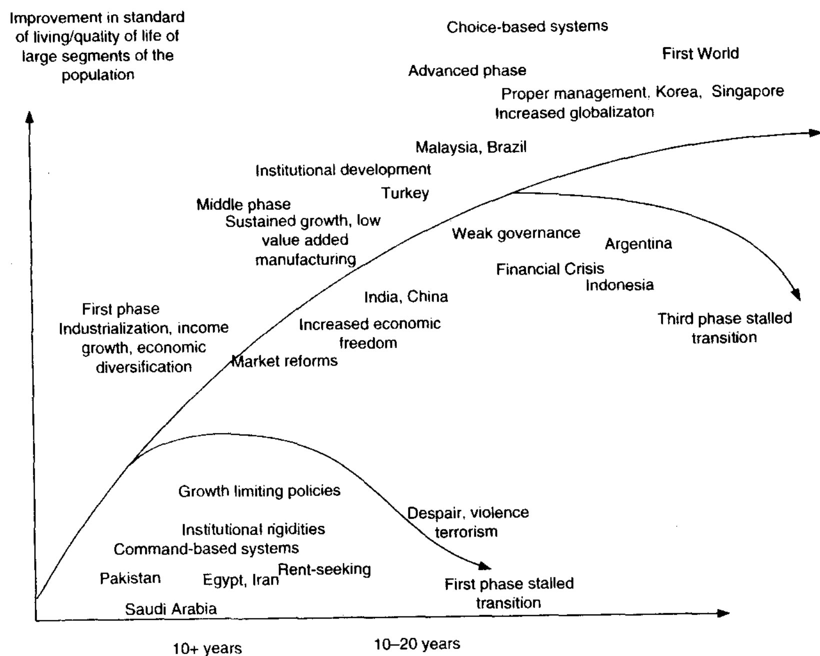


Figure 3.6 New Second World transitions.

Source: Based on the description of transition provided in Jennifer Bremer and John Kasarda, "The origins of Terror: Implications for U.S. Foreign Policy," *The Milken Institute Review* (Fourth Quarter, 2002).

organizations—basically the economic freedom and governance measures noted earlier.

The large rentier states appear particularly susceptible to the failed processes noted by Bremer and Kasarda. By any standard, the economic freedom and governance indicators of the first group (table 3.11) lie well below that of the second group. Deficiencies are seen nearly across the board, but are particularly evident in regulatory quality and government intervention, areas where Bremer and Kasarda stress lack of reforms are likely to retard progress to higher stages.

To further assess the relevance of the Bremer and Kasarda model for the large rentier economies, our set of six governance and ten economic freedom variables were examined statistically to see if they were capable of classifying groups of countries in a manner similar to those described by Bremer and Kasarda. The analysis was successful in identifying Stage 1 and Stage 3 as unique groupings based on their relative progress made in reforms. Significantly, all of the large rentier economies fell in the first stage with a high degree of correct placement in this category. In addition, a group of ... (Albania, Russia, Brazil, China, Egypt, Indonesia, Turkey,

ble 3.11 New Second World/advanced country governance—economic freedom group comparisons, 2000–02

	Voice	Political stability	Government effectiveness	Regulatory quality	Rule of law	Control of corruption	Trade policy	Fiscal burden	Government intervention	Monetary policy	Foreign investment	Banking and finance	Wages and prices	Property rights	Regulation	Informal market
Stage—failed take-ountries																
1	−.86315	−.71912	−.78036	−.85507	−.76866	−.79876	3.90000	3.46875	3.39375	3.26250	3.52500	3.76379	3.46766	3.77639	3.88740	4.34444
nd stage countries																
)	−.44289	−.47498	−.04219	−.09212	−.17796	−.43235	3.73333	3.70000	2.88333	2.96667	3.10000	3.33333	3.00000	3.11667	3.81667	3.92500
l stage countries																
1	.76082	.69934	.74122	.82972	.70999	.61611	2.58750	3.45021	2.46042	2.11667	2.24167	2.52800	2.41944	2.11833	2.54278	2.71800
nced countries																
1	1.40122	1.27231	1.75752	1.45466	1.77718	1.88875	2.00000	4.09455	2.37727	1.14545	1.91818	1.99545	2.08725	1.22778	2.55720	1.30505

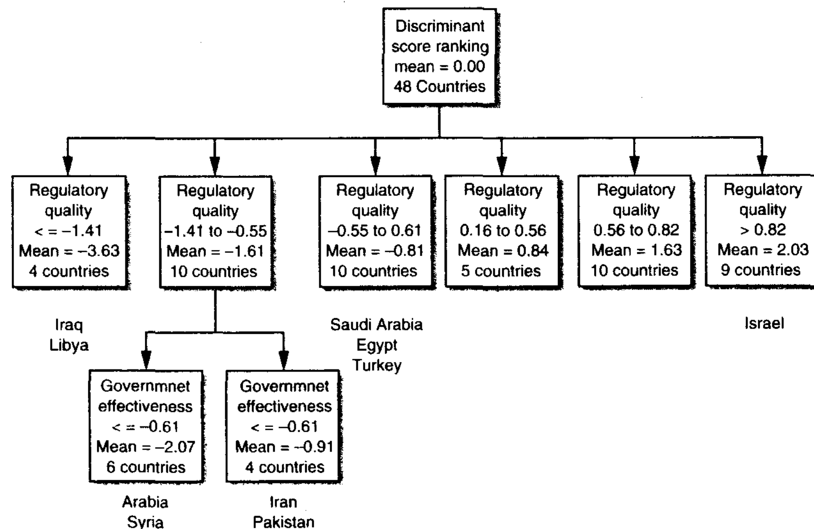
: Average values, 2000–02. Variables significant in the 4 group discriminant analysis in order of importance: government effectiveness, voice regulation, corruption. Correct placement: failed take-
37.5% (14 of 16), second stage countries, 100.0% (6 of 6), third stage countries, 87.5 (21 of 24), advanced countries, 90.9% (20 of 22).

ce: Compiled from *Governance Matters III: Governance Indicators for 1996–2002* and *Index of Economic Freedom Rankings*.

The variables critical for profiling the countries in these groups were (in declining order of importance): government efficiency, voice and accountability, and corruption. These are all areas consistent with the Bremer and Kasarda contention that deficiencies cause growth in the first stage to fall to levels incapable of creating adequate jobs and sustaining economic growth.

As noted earlier, another area stressed by Bremer and Kasarda, improved regulatory quality, seems to be critical in moving countries along the New Second World dimension to higher stages (figure 3.7). In the progression to the second stage, Iran is in a group of countries with very low regulatory quality. Through their modest efforts at improving government effectiveness, the Iranians have passed Libya and Algeria. The country clearly lags behind Saudi Arabia (and Egypt and Turkey) in moving up the ladder to the second stage of Bremer and Kasarda's New Second World of development. However, compared with the progress made by a country such as Israel, it is apparent the Saudis have a very long reform road ahead of them.

None of this bodes particularly well for the Saudis or the Iranians. Both countries appear to be going down the road to disaster projected for Bremer and Kasarda's stage one countries. In Saudi Arabia's case, it is clear that ten or fifteen years ago, when many of the economy's problems were becoming clearly apparent, the government had time on its side.[52] A well thought-out neoliberal reform program stressing free markets, access to capital, integration into the world economy, and major efforts in the various areas of governance, especially regulation and corruption, could have been undertaken at a safe pace, laying the foundation for the transition to a higher growth path and Bremer and Kasarda's middle stage of development.



Instead, the government postponed hard decisions, hoping that a new oil boom would solve all of its problems. None was forthcoming, nor will one likely appear in the foreseeable future after the current oil boom subsides. As a result, the Saudi authorities find an economy still mired in Bremer and Kasarda's first stage and facing an unemployment rate that is approaching 30 percent.[53] Poverty is definitely on the rise and, even more ominously, an increasing number of Saudis complain that their national wealth is being plundered by corrupt members of the royal family.[54] Increasingly, one hears:

> there's a lot of frustration and anxiety among young Saudi men. Almost half of them have lost hope for the future. And they are ripe for recruitment by Islamic extremists . . . Adding to the frustration are the lack of outlets for discussion and debate. Trade unions are barred as are all other professional associations . . . Saudi society has few political tools to counter the extremism that has taken root here and the results are actions like the recent bombings in Riyadh.[55]

Domestic terrorism does not plague Iran nearly to the extent found in Saudi Arabia, nevertheless the picture in many ways is gloomier because Iran lags considerably behind Saudi Arabia in nearly all areas of reform. Vested interests in the existing system have greatly limited reform. Because many opposed to reform have religious legitimacy, there are only modest prospects for dramatic reforms in the near future. In turn, the reform gap has limited the private sector's ability to create jobs. At the same time rapid demographics are overwhelming the public sector's ability to expand hiring. The result is a progressive breakdown of the link uniting the population to the state through the rentier distribution system. Given the government's low tolerance for direct protest, the population's growing dissatisfaction and frustration is likely to manifest itself in the form of increased political and economic instability.

IMPLICATIONS FOR IRAQ

Iraq certainly has a lot to learn from the experiences of Saudi Arabia and Iran. With the fall of Saddam, the country had the golden opportunity of starting with a clean slate. Perhaps because of the difficulties in moving ahead with reform, once entrenched interests were strengthened by the rentier state redistributive mechanisms. The Coalition Provisional Authority (CPA) was quick to install a package of reforms reminiscent of the shock therapy programs carried out in the early to mid-1990s in many of the Transition Economies of Central and Eastern Europe. Overnight, Iraq became the most open economy in the Arab world.[56]

The reforms clearly incorporated much of the agenda originally laid out in the now somewhat discredited Washington Consensus.[57] The main thrust of the Washington Consensus was a set of actions that, if taken at an early stage of transition, should have facilitated a smooth evolution into the world economy. It consisted of many elements of the economic freedom measures

(liberalization, stabilization, and fiscal austerity), stressing the importance of bringing down inflation and establishing economic growth. It also incorporated a number of elements of microeconomic reform (e.g., privatization, promoting FDI), as well as structural/administrative reforms (e.g., property rights, replacement of quantitative restrictions). Specifically, these included:

- Fiscal discipline: limits to budget deficits
- Public expenditure priorities: redirect expenditure toward building human capital and infrastructure
- Tax reform: broaden tax base and cut marginal tax rates
- Financial liberalization: abolish interest rate controls
- Exchange rates: introduce unified and competitive exchange rates
- Trade liberalization: replace quantitative restrictions by tariffs and then reduce the tariffs over time
- Foreign direct investment: encourage increased international capital inflows
- Privatization: privatize state enterprises
- Deregulation: regulate only safety, environment, and financial sectors (i.e., prudential supervision)
- Property rights: introduce secure enforcement at low cost

Progress of reform design and implementation varies considerably by categories; the September 2003 CPA reforms have little to say about fiscal discipline or public expenditure priorities, no doubt due to the great uncertainty surrounding oil revenues, the external debt situation, and foreign assistance. Surprisingly, however, property rights, a key element of the neoliberal reforms, has received less attention than one might have expected. It is also clear that, by any measure, Iraq world score very high on an economic freedom index. On the other hand, very little has been implemented or even discussed in the important areas of complementary governance: corporate governance, anticorruption, flexible labor markets, World Trade Organization agreements, financial codes and standards, prudent capital account opening, nonintermediate exchange rate regimes, independent central banks/inflation targeting, social safety nets, and targeted poverty reduction. Of these, only some initial, albeit limited, progress has occurred in the areas of financial standards and central banking.

Perhaps the intent of the CPA and the current provisional government is to simply defer many of the specifics in these areas to an elected Iraqi government. However, as the cases of Iran and Saudi Arabia illustrate, governance reform may be a more critical element in assuring Iraq is able to progress along the path to a stable modern economy. Without significant improvement in these areas in the near future, the country is likely to have only the disadvantages of the free market to show for its reform efforts. The

NOTES

1. Elizabeth Rubin, "The Opening of the Wahhabist Mind," *New York Times Magazine*, March 7, 2004, 38.
2. A more detailed account is given in Robert Looney, "Iraqi Oil: A Gift from God or the Devil's Excrement?" *Strategic Insights*, vol. 2, no. 7 (July 2003), at www.ccc.nps.navy.mil/si/july03/middleEast2.asp.
3. A loose definition of a rentier state is one where significant amounts of oil/mineral royalties (rents) accrue directly to the state and where only a few are engaged in the generation of this rent (wealth), the majority being only involved in the distribution or utilization of it. Cf. Michael Ross, "Does Oil Hinder Democracy," *World Politics*, vol. 53 (April 2001), 329.
4. Jeffrey Sachs, "Globalization and Patterns of Economic Development," *Weltwirtschaftliches Archiv*, vol. 136, no. 4 (2000), 584.
5. An assessment of the rentier state dynamics as they pertain to Saudi Arabia are given in Robert Looney, "Saudi Arabia: Measures of Transition from a Rentier State," in Joseph A. Kechichian, ed., *Iran, Iraq and the Arab Gulf States* (New York: Palgrave, 2001), 131–160.
6. Unless otherwise indicated, all economic data are from the Saudi Arabian Monetary Agency Annual Report, various issues.
7. Nadim Kawach, "Saudis Need to Adopt More Reforms to Spur Growth," *Gulf News*, August 17, 2003.
8. Robert Looney, "Can Saudi Arabia Reform Its Economy in Time to Head off Disaster?" *Strategic Insights*, vol. III, no. 1 (January 2004), at www.ccc.nps.navy.mil/si/2004/jan/looneyJan04.asp.
9. This description of Iran's recent growth patterns draws heavily on IMF information. Cf. *Islamic Republic of Iran*—Selected Issues (Washington: International Monetary Fund, September 2004), 7–9.
10. Alan Gelb, *Oil Windfalls: Blessing or Curse* (Washington: World Bank, 1988); see also Robert Looney, "Diminishing Returns and Policy Options in a Rentier State: Economic Reform and Regime Legitimacy in Saudi Arabia," *Political Crossroads*, vol. 5, nos. 1 and 2 (1997), 31–50.
11. Paul Stevens, "Resource Curse and Investment in Oil and Gas Projects: The New Challenge," *Internet Journal*, June 2002.
12. Robert Looney, *The Economic Origins of the Iranian Revolution* (New York: Pergamon Press, 1982).
13. Stevens, "Resource Curse."
14. Fred Halliday, *Islam and the Myth of Confrontation* (London: I.B. Tauris, 1995), 40.
15. Michael Ross, "Does Oil Hinder Democracy," *World Politics*, vol. 53, no. 3 (2001), 325–361.
16. "Iran: the Future of the Rentier System in Question," *Banque Paribas Conjoncture*, October 30, 2003, 12.
17. Norman Hicks and Ann Kubisch, "Cutting Government Expenditure in LDC's," *Finance & Development*, vol. 2, no. 3 (September 1984), 37–39.
18. Robert Looney, "The Budgetary Impact of Defense Expenditures in the Middle East," *The Middle East Business and Economic Review*, vol. 5, no. 2 (1993), 38–49.
19. Unless otherwise indicated, all data on Saudi Arabia is from the Saudi Arabian Monetary Agency (SAMA) Annual Report, various issues.
20. Robert Looney, "A Post-Keynesian Assessment of Alternative Austerity

21. Robert Looney, "Saudi Arabia: Measures of Transition from a Rentier State," Kechichian, *Iran, Iraq and the Arab Gulf States*, 131–160.
22. Robert Looney, The Saudi Arabian Quandary: The Economy's Inability to Sustain Growth," *METU Studies in Development*, vol. 31, no. 1 (June 2004), 71–92.
23. Ibid.
24. Using different statistical techniques, a similar result was previously found in Robert Looney, "Deducing Budgetary Priorities in Saudi Arabia: The Impact of Defense Expenditures on Allocations to Socio-Economic Programs," *Public Budgeting and Financial Management*, vol. 4, no. 2 (1992), 311–326; and Robert Looney, "Budgetary Priorities in Saudi Arabia: The Impact of Relative Austerity on Measures of Human Capital Formation," *OPEC Review*, vol. 25, no. 2 (Summer 1991), 133–152.
25. Scott Baier, Gerald Dwyer, and Robert Tamura, "How Important Are Capital and Total Factor Productivity for Growth?" 2002, at www.vanderbilt.edu/Econ/faculty/Crucini/tamura.pdf.
26. Blair et al. calculate TFP in the standard manner. Details can be found at www.vanderbilt. edn/Econ/faculty/crucini/tamura.pdf.
27. The following draws heavily on *Islamic Republic of Iran—Selected Issues* (Washington: International Monetary Fund, September 2004), 11–14.
28. Ibid.
29. Jeffrey Sachs, "Globalization and Patterns of Economic Development," *Weltwirtschaftliches Archiv*, vol. 136, no. 4 (2001), 579–600.
30. Dani Rodrik and Arvind Subramanian, "The Primacy of Institutions," *Finance & Development*, vol. 40, no. 2 (June 2002).
31. See, for example, Marc Miles, Edwin Feulner, Mary Anastasia O'Grady, and Ana Eiras, *2004 Index of Economic Freedom* (Washington: Heritage Foundation, 2004).
32. Available from Global Economic Software, Ltd, at www.globaleconomicsoftware.com. Robert Looney, "Iraq's Economic Transition: The Neoliberal Model and Its Role," *The Middle East Journal*, vol. 57, no. 4 (Autumn 2003), 568–587, for an application of this data set to the Middle East.
33. Ana Isabel Eiras, *Ethics, Corruption and Economic Freedom* (Washington: Heritage Foundation, December 9, 2003).
34. Miles et al., *2004 Index of Economic Freedom.*
35. Miles et al., *2004 Index of Economic Freedom.*
36. Kamal Yasin, "Iranian Neo-Cons Make Power Play in Tehran," *Iran Press Service.com*, October 6, 2004.
37. Mohamad Bazzi, "Fledgling Saudi Arabia Reforms Don't Fly," *San Francisco Chronicle*, October 31, 2004.
38. Yasin, "Iranian Neo-Cons."
39. Herbert Kitschelt, "A Review of the Political Economy of Governance," *World Bank Policy Research Working Paper 3315*, May 2004, 1.
40. Daniel Kaufman, Aart Kraay, and Massimo Mastruzzi, *Governance Matters III: Governance Indicators for 1996–2002* (Washington: World Bank, June 30, 2003).
41. Higher governance scores indicate greater progress in these areas whereas lower economic freedom scores signify greater progress in the economic area.
42. As defined in Sachs, "Globalization and Patterns of Economic Development," 581. Sachs considers these countries to be narrowing the income gap with the higher technology and richer countries through a process of technological diffu-

43. Defined by Sachs as countries that in residents in 1995 were able to register at least ten U.S. patients per million inhabitants of the country.
44. The procedure used was discriminant analysis. For a description of this technique see *SPSS Base 10.0 Guide* (Chicago: SPSS Inc., 1999), 243–292. A full set of results are available from the author upon request at relooney@nps.edu.
45. See *AnswerTree 3.0 User's Guide* (Chicago: SPSS Inc., 2001) for a description of the technique.
46. As depicted by the discriminant function (table 5.4) with rentier countries characterized by large negative scores and catching up countries, positive scores.
47. The classic study in this regard is Henry Bruton, "Productivity Growth in Latin America," *American Economic Review*, December 1967.
48. Jennifer Bremer and John Kasarda, "The Origins of Terror: Implications for U.S. Foreign Policy," *The Milken Institute Review*, Fourth Quarter 2002. For an application of this model to Pakistan, see Robert Looney "Failed Economic Take-Offs and Terrorism: Conceptualizing a Proper Role for U.S. Assistance to Pakistan," Center for Contemporary Conflict, February 1, 2003.
49. W.W. Rostow, *The Stages of Economic Growth* (Cambridge: Cambridge University Press, 1960).
50. Albert Hirschman, "The Changing Tolerance for Income Inequality," Quarterly Journal of Economics, vol. 87, no. 4 (November 1973), 544–566.
51. Bremer and Kasarda, "The Origins of Terror," 36.
52. Robert Looney, "Saudi Arabia's Development Strategy: Comparative Advantage vs. Sustainable Growth," *Orient*, vol. 30, no. 1 (1989), 75–96, at http://web.nps.navy.mil/~relooney/RelOrient_2.pdf.
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55. Ibid.
56. Samson Mulugeta, "Reform Concerns: Changes Have Iraqi Workers Nervous," *Newsday*, December 14, 2003.
57. Comprehensive surveys and critiques of the Washington Consensus can be found in: Kaushik Basu, "Globalization and the Politics of International Finance: The Stiglitz Verdict," *Journal of Economic Literature LLI* (September 2003), 885–899; and Dani Rodrik, "Understanding Policy Reform," *Journal of Economic Literature*, (March 1996).
58. Robert Looney, "A Return to Ba'thist Economics?" *Orient*, vol. 45, no. 3 (September 2004), 385–400.