“Petroleum revenues, which theoretically should have supported economic prosperity, have in practice fueled regional conflicts, supported corruption, [and] created economic injustice. . . .”

Fixing the Mideast’s Economies

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Governments & Markets

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The literature on economic development is long and rich, but until the late 1970s no one challenged the standard conception of development, a model focused on raising per capita incomes and the simple transformation of economies from an agrarian to an industrial base. In recent decades, inspired by the pioneering work of Mahbub ul Haq and Amartya Sen, economists increasingly have argued that development involves much more.

Education, health care, equitable income distribution, environmental quality, freedom—all of these elements of human development have come to be seen as integral components of the economic development process. And all of these aspects of development in turn depend on effective institutions.

The Middle East, unfortunately, broadly lacks an adequate institutional infrastructure. A cursory glance across the region confirms this. Corrupt families and governments rule with little or no legitimacy. Rulers—preferring to maintain personal control of economic opportunities—eschew effective institutions that would promote the rule of law, produce a more stable social order, and lower transaction costs. As a result, the Middle East suffers from as much corruption, and the economic and financial uncertainty that goes with it, as any region in the world. Widespread underdevelopment is the continuing consequence.

This is not to say that the region is economically monolithic. Contrary to many people’s belief, the countries of the Middle East are not homogeneous—the region may be the most diverse in the world. Small nations with small populations, such as Qatar and the United Arab Emirates (UAE), sit side by side with countries such as Egypt and Iran, whose populations rank among the 20 largest in the world. Some nations, like Kuwait, Qatar, and the UAE, are richer than any country in the West, according to standard measures of prosperity, while Egyptians and Syrians earn annual per capita incomes of less than $2,000. (In the case of Yemenis, the figure is less than $1,000.) Yet we tend to look at these nations as a group, as if their mere location afforded them a large measure of sameness.

The factor that unites a number of these countries is their large deposits of oil and natural gas. But paradoxically—at least in terms of per capita endowment—this is also the factor that most divides them. That is, some Middle Eastern countries are very rich in oil and gas and others are poor in energy resources. Other factors that unite them, of course, are a common religion and, with the exception of Iran, a common Arab heritage. But here again, it should be recalled that a common religion has not precluded horrific discrimination along the Sunni-Shiite divide, nor has Arabism prevented violent conflicts.

DISMAL PERFORMANCE

Over the 30 years between 1975 and 2005, per capita real growth was anemic in Middle Eastern and North African economies. This was because economic output grew modestly while population grew rapidly. For the non–oil-exporting countries of the region, the growth trend was positive, but it was lower than for many other country groups outside the region. And in the oil-exporting countries, growth rates were slightly *negative*, which pulled down overall growth for the region.

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It is striking that performance in per capita GDP for the oil exporters of the region, despite their vast petroleum revenues, was comparable to that in sub-Saharan Africa. The Middle East's poor performance over the 30-year period becomes even more apparent when it is compared with the consistently high growth in East Asia.

And during this time, the Middle East largely missed the opportunity to be further integrated into the global economy, insofar as it failed to increase its non-oil exports and failed, outside of the oil and gas sector, to attract significant foreign direct investment (FDI)—a gauge of overall economic vitality.

To be sure, the global economic crisis that began in 2007 has not had as significant an impact in the Middle East as in most other areas of the world. For major oil exporters, the key to short-term prosperity is the price of oil, and the years before the crisis saw high petroleum prices. The United States adopted a highly expansionary monetary policy beginning in 2001. This fueled economic growth in the United States, providing a positive growth impetus for the rest of the world and contributing to increased demand for oil. Oil prices rose from $24 per barrel in 2001 to $64 in 2006 and $72 in 2007. The peak, in July 2008, was $147.

The most important shortcoming from which countries in the region continue to suffer is a lack of effective institutions.

So, while the financial crisis has been detrimental to global economic performance, the buildup that led to it increased oil prices, which still have not retreated to 2001 levels. (In August 2009, oil was going for about $70 a barrel.) As a result, oil-exporting nations in the region have been somewhat cushioned from the crisis; so too have non–oil exporters, because of the capital, aid, and remittances that flow from oil exporters to non–oil exporters. Moreover, Middle Eastern financial institutions, limited by Islamic law in their dealings with interest-bearing instruments, did not have a significant exposure to the West's toxic assets.

None of this changes the fact that the region's economic performance, including that of the oil exporters, has been dismal over the past several decades. And its human development progress, as calculated by the United Nations Development Program, has not been much better.

Social indicators have generally improved for average people in the oil-exporting countries. These advances have been more significant in the nations—Kuwait, the UAE, and Qatar—that are less populated and richer in oil and natural gas, because they can finance human development expenditures from their vast per capita export revenues. The more populated oil exporters, Iran and Iraq, have registered more or less average improvements that have not differed significantly from the human development performance of the region's countries that do not have big oil and gas deposits.

But income distribution across the region, though hard data are not available, appears to be heavily skewed—perhaps more so than anywhere else in the world. Medical care throughout the Middle East, though it has improved over the past 30 years, needs more attention, especially outside the major cities. And educational achievements are at best mediocre, with the education of women in some countries a second-tier priority, and the quality and availability of university education severely limited. This is important because education is increasingly recognized as a critical input for economic growth and a major requirement if countries are to realize the benefits of globalization.

As to freedom and political participation, the region has shown no appreciable progress, and the rights of women and minorities are routinely ignored. Family rulers and illegitimate governments continue to be the order of the day.

THREE TRIES

The Middle East's poor economic performance is manifested in high levels of unemployment, especially in the more populous countries. Both the oil exporters and the non–oil exporters have realized that they need to achieve faster growth if they are to avoid levels of joblessness that could threaten the stability of their societies. Three examples—Egypt, Saudi Arabia, and Dubai—afford a flavor of the region's different approaches to economic reform.

Egypt in 1991, as part of an effort to encourage job creation and growth in the private sector, adopted a privatization program (though the initiative did not actually get under way until 1994). In 1994, state enterprises numbered 314. Today, the state is still the sole or majority owner of 153 of these concerns, and it holds minority stakes in others. This amounts to slow progress, so the government in 2009 adopted a new approach. Instead of selling off businesses to the public, it has decided to give the firms to the public for free, or for a nominal fee.

Even so, the mere transfer of ownership in a moribund economy cannot by itself create a vibrant private sector. Egypt in general lacks effective institutions (especially an adequate legal and regulatory framework and an equitable, effective tax system). It also needs to achieve macroeconomic stability and consistency, and to eliminate subsidies.

Saudi Arabia in 2000 formed the Saudi Arabia General Investment Authority to help attract foreign investors. Later it adopted a so-called "10x10" initiative, which was intended to help the country join the world's top 10 investment destinations by 2010. In pursuit of these objectives, the government created a National Competitiveness Center.

The Saudis have also undertaken a number of megaprojects, such as developing "cities of the future" designed to offer investors a business-friendly environment. These cities are to feature a globally competitive regulatory framework and incentives for creating public-private ventures. The government's investment authority projects that six such cities will by 2020 add around $150 billion to the country's GDP and generate more than 1.3 million jobs. The goal, in addition to creating jobs, is to promote balanced growth and development and diversify away from oil.

Some early successes have been registered. In the World Bank's ranking of the easiest places to do business, Saudi Arabia rose from 67th in 2000 to 16th in 2008. The flow of FDI into Saudi Arabia has increased significantly, with the country now ranking 20th in the world and 1st in the Middle East. While this progress is commendable, sustaining such gains will depend on the institutional scaffolding that Saudi Arabia adopts, and on its progress with regard to issues such as the rule of law, economic justice, and the open political participation of all citizens, including women.

Dubai, with its very limited oil reserves, has used its strategic location to become a financial, business, and tourist hub for the Persian Gulf, and indeed for the Middle East. With its business-friendly environment, relatively relaxed social code, and proximity to economically sanctioned Iran and socially restricted Saudi Arabia, Dubai has become the preferred location for financial firms looking to establish a regional beachhead and for Middle Easterners who want a second home.

For a time during the past decade, Dubai's real estate sector boomed amid cheap credit and speculation, but the global financial crisis has hit the country, partly because of its exposure to international business, harder than any other state in the region. The government has had to ask Abu Dhabi, the leading member of the UAE, for a bailout to help it weather the storm. Dubai's future, it seems, will depend both on events in Iran (Dubai's trade with Iran, for instance, would decline if sanctions against the regime in Tehran were lifted) and on the prosperity of Dubai's neighbors—prosperity that still depends on oil prices.

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As these examples help to demonstrate, policy in the region always seems to favor the quick fix over long-term reform. Quick fixes afford support to regimes and deflect failures. In the face of massive joblessness, for instance, governments increase subsidies. This approach accords with the region's political structure, but it carries disastrous long-term economic consequences.

THE INSTITUTIONAL DEFICIT

The reasons that Middle Eastern countries have not performed better are many—but they are little different, except in the case of the oil exporters, from the issues that hold back other developing countries around the world. Indeed, to embark on a path of sustained growth, nearly every country in the region must embrace all-encompassing reforms that fundamentally change the relationship between governments and markets. The problem is that reforms such as these are initially unpopular, and it is difficult for governments that lack legitimacy and a popular mandate to enact them.

The more populous countries in the region need to relax economic controls, reduce the role of government, and create an environment in which the private sector can thrive. This would entail eliminating (or at least dramatically reducing) explicit and implicit subsidies; effectively privatizing state enterprises (including, in the case of Iran, commercial banks and foundations); doing away with remaining price and financial controls; creating an effective, equitable tax system; reducing tariff and nontariff barriers to trade in order to promote domestic competition; and liberalizing labor laws and markets.

It would also entail improving education policies to promote quality education and the development of technical and managerial skills; carrying out a real crackdown on corruption; developing a more favorable attitude toward FDI (which would include providing more personal freedoms to foreigners, as well as to citizens); and above all committing totally to upholding the rule of law and developing the institutional infrastructure that supports it. Small, rich, oil-exporting countries, on the other hand, need to focus on managing their wealth better and more equitably.

As noted above, the most important shortcoming from which countries in the region have suffered, and continue to suffer, is a lack of adequate and effective institutions. The term "institutions" essentially refers to formal and informal rules and their enforcement characteristics. With effective institutions, uncertainties and ambiguities, which are natural elements of human interaction, are reduced; thus interactions become more predictable. Indeed, it is the ability of rules to reduce ambiguity concerning the behavior of others that allows coordination in interaction and the emergence of collective action.

More specifically, societies' institutional structures are composed of constitutions, laws, and rules (which govern the society as well as its government, finances, economy, and politics); written rules, codes, and agreements (which govern contractual relations and exchange and trade relationships); and commonly shared beliefs, social norms, and codes governing human behavior.

The degree to which members of a society comply with rules, social norms, and enforcement characteristics depends to a large extent on their clarity. The higher the degree of compliance, the more stable the social order and the lower the transaction costs in the society. For example, social norms that prescribe trust, trustworthiness, and cooperation—because they induce people to do things they would not do without these relevant norms—have a significant impact on encouraging collective action and coordination.

Economists are coming around to the view that poor economic performance is due in significant measure to a country's institutional structure. However, these structures reflect belief systems that are difficult to change—either because changes that might improve economic performance run counter to the belief system itself, or because such changes pose a threat to existing political or business elites.

Also, while formal rules can be changed by fiat, social norms may be less flexible. The enforcement characteristics associated with social norms often respond slowly to attempts at change. A major conclusion of economic research has been that, without an adequate institutional structure, policies meant to improve economic performance—such as creating an incentive structure for the private sector—do not lead to rapid, sustainable economic growth.

We must also note that the region has borne a massive burden because of wars and instability. The Iran-Iraq War, the two Gulf wars, the civil war in Lebanon, and the continuing Palestinian-Israeli conflict have exacted a heavy price. By some estimates the two Gulf wars cost Iraq all it had earned in oil revenues during its entire existence. Without peace and stability in the Middle East, there can be no sustained economic growth, development, and prosperity. But without economic prosperity, there can be no stability.

THE OIL BURDEN

A country sitting on an ocean of oil has advantages and disadvantages. The advantages, for poor countries, are obvious. Poor countries, given their low levels of income, find it difficult to save enough to make initial capital investments that could lead to greater prosperity. Foreign aid is often too meager for these countries to make such investments, or it is in some way onerous. Wealth gained from exportable oil and gas, however, can pay for a country's start-up investments, if it is productively used. Unfortunately, history clearly shows that Middle Eastern oil revenues have not been used productively.

This does not explain why exploiting oil should actually create new problems. But indeed it can. Three important factors explain why, in the Middle East, it has. First, the interference of foreign powers—or imperialism—is imprinted on the history of the region. It has been the norm for outside powers to support malleable rulers and to overthrow "unfriendly" governments. Outside interference has contributed to the poor governance that creates problems from oil wealth.

The second factor, corruption, follows directly from the first. Corruption is closely tied to natural resource wealth, since activities related to its exploitation are rent-seeking in nature. In economics, the term "rent-seeking behavior" is applied to instances in which an individual, organization, or firm makes money not in a transparent way through the market but relies on nonmarket, political means to gain abnormal returns. Often such behavior is supported by bloated government bureaucracies that institutionalize systemic corruption and disincentivize individual drive and ambition. For major oil-exporting countries, the misallocation of talent from productive sectors of the economy to rent-seeking activities has had a significant negative impact on economic growth.

The third factor is usually referred to as Dutch disease. A country that exports a scarce natural resource for which demand is strong and increasing is likely to see its currency appreciate as foreigners bid for the resource. This is nice in one sense, since imports become cheaper. But at the same time the country's domestic industries become less competitive in world markets. Thus, producers of non-oil tradable goods, such as manufactured items, have a hard time getting established, producing, and growing.

The Middle East largely missed the opportunity to be further integrated into the global economy.

Is the exploitation of exhaustible natural resources like oil necessarily a curse? If one looked only at the countries of the Middle East, one would be inclined to say yes. But the experiences of Great Britain and Norway contradict this conclusion. Why? The reason seems to be that Great Britain and Norway, when they first discovered and exploited their oil, were already developed countries with effective institutions in place. In the Middle East, on the other hand, effective institutions did not exist—and now the country's rulers and interest groups find that developing such institutions would run counter to their personal and familial interests.

REVERSE THE CURSE

To use oil revenues to finance an opulent life for the few is to rob present generations of their fair share of income. But to subsidize consumption for all in society is to cheat future generations of their share of the country's natural inheritance. Given this, an appropriate share of current revenues should be invested in earning assets. These investments would gradually replace oil as a country's source of revenue as the oil ran out, became prohibitively expensive to extract, or faced increased competition from alternative fuels. Thus, future generations would share in the country's oil inheritance.

Exhaustible resources are part of a society's stock of capital. Their exploitation should not be used to finance consumption. Instead, their depletion should be balanced by amassing commensurate capital of another form, in order to benefit current and future generations; this is known as maintaining a constant capital stock. This must be done in such a way that all citizens benefit equally, rulers and ruled alike. Just as we must take care of air and water resources, both for ourselves and for those who follow us, we must take care of our exhaustible resources.

In the Middle Eastern countries most heavily endowed with oil and gas, the depletion of resources has not been accompanied by capital replacement, equal treatment of citizens, and progress toward human development. Some countries—most notably Kuwait, Qatar, and the UAE—have established significant sovereign wealth funds (SWFs), but the operation of these funds is not transparent, nor is their ownership.

Yet transparent, well-managed SWFs may provide the *only* vehicle through which resource-rich Middle Eastern countries can address resource mismanagement, reduce the interference of foreign powers, cut corruption, and put themselves on a path toward economic and human development that is just and sustained. Historically, SWFs have been designed to provide a source of income when oil and gas booms taper off. I suggest that SWFs should be used as a vehicle to manage the depletion of oil reserves in order to benefit all generations.

How would this translate into policy? The best way to extend real benefits to all generations of citizens, and to steer a country toward sustained, equitable development, is to provide each citizen, those alive today and those to come, with a payout from a well-managed SWF (with the payouts equal in terms of purchasing power).

This may sound like a difficult task from a technical perspective, but it is not. All oil revenues would flow into a national SWF. The real payout could then readily be calculated, and updated to reflect changes in the oil and gas markets and in the country's population. Governments would wean themselves from oil revenues over a period of, say, 10 years. Thereafter, all state expenditures would be financed by taxes.

Such an approach would bypass governments' tendency to spend money wastefully, whether on subsidies or on militaries. Individuals would be able to spend their money as they wished. This would be the most efficient way to transfer the benefits of oil to the citizenry. And governments would have to become more efficient and accountable because, like most countries in the world, they would rely on taxes for revenue.

The delinking of oil revenues from government budgets would help countries steer clear of spending too much on their militaries, which can be associated with civil war and conflict. (Conflict in turn leads to yet higher military expenditures, capital flight, loss of social capital, slower economic growth, and more poverty and refugeeism, all of which amounts to an almost unbreakable vicious circle.) Delinking oil revenues from state spending would also reduce corruption and produce more equitable societies.

Sovereign wealth funds that gradually take all oil revenues away from the government should be a primary, integral component of any plan to manage natural resource depletion. The management of such funds must be transparent and outside the personal control of rulers. Each system must be carefully designed to suit the country in which it operates, and to provide individuals with appropriate incentives to ensure that they live productive lives and contribute to the nation's economic and social prosperity.

TIME RUNNING OUT

It is not easy to see how Middle Eastern countries will move from their current condition—one of turmoil, economic and social injustice, discrimination, high unemployment, slow development and growth, and interference from foreign powers—and toward a rational strategy that is socially, politically, and economically inclusive.

If governments could successfully adopt the economic reforms outlined here, no easy task, they would create a favorable business climate in which investment (financed both domestically and from abroad) would increase significantly and help create the economic growth that is desperately needed. This would also encourage Middle Easterners living elsewhere—people from Iran, Iraq, Egypt, Syria, Lebanon, and Jordan (including Jordanians of Palestinian origin)—to return home, bringing their much needed skills and capital.

All of these economies, if they are to reduce unemployment over the next five to seven years—a period when the labor force is expected to grow rapidly in most of the region's countries—must create rewarding jobs in excess of the number of people who will newly enter the labor market. Although it must be acknowledged that some countries have made progress recently in regard to privatization and job creation, these advances will not be sustained unless governments adopt bolder policies, focusing especially on the establishment of efficient institutions, and stick with them.

If governments in the region, and Western powers, hope to see a prosperous, peaceful Middle East and better relations between the Muslim world and the West, time is running out. Oil alone cannot solve the region's deep-rooted economic, social, and political problems, though high oil prices may provide a short-term boon to major oil exporters. Petroleum revenues, which theoretically should have supported economic prosperity, have in practice fueled regional conflicts, supported corruption, created economic injustice, and enabled policies detrimental to economic, social, and political progress. Islam, which could have provided a foundation for economic, social, and political modernization, has been hijacked and distorted by tyrannical rulers supported by accommodating Western powers.

The only viable solution for the region is to use its oil revenues to afford all citizens equal benefit and then, as if oil did not exist, adopt fundamental policies of reform. Meanwhile, if the world does not come to terms with the global importance of Middle Eastern peace and prosperity, the global economy will suffer because increased energy supplies will not be brought on line in a timely fashion and major powers will find themselves embroiled in conflicts over restricted energy supplies. ■