Economic failure in the Middle East *

HOSSEIN ASKARI and ROSHANAK TAGHAVI

1. Introduction

Despite having earned more than three trillion dollars in oil revenues during the last thirty years, economic despair and dissatisfaction remain widespread throughout the Middle East. Economic growth has not been sustainable but has fluctuated with the level of oil revenues and, as a result, has engendered substandard long-term economic development in the more populated countries.[1] Their respective private sectors remain underdeveloped and are not viable competitors in the global marketplace. Massive unemployment exists throughout the region, and the quality of education and healthcare has generally remained low. Effective institutions have not been nurtured to develop and implement economic policies, and have thus allowed the general course of national policy to be determined by political expediencies. Economic equity and social justice, the core elements of Islamic teachings, have remained a mirage on the Middle Eastern landscape (Figure 1).

To our mind, it is almost impossible to explain the economic failure, slow social development and pervasive conflicts of the oil export-

☐ George Washington University, Washington (USA); e-mail: hgaskari@aol.com;
Columbia University, New York (USA); e-mail: rt2198@columbia.edu.

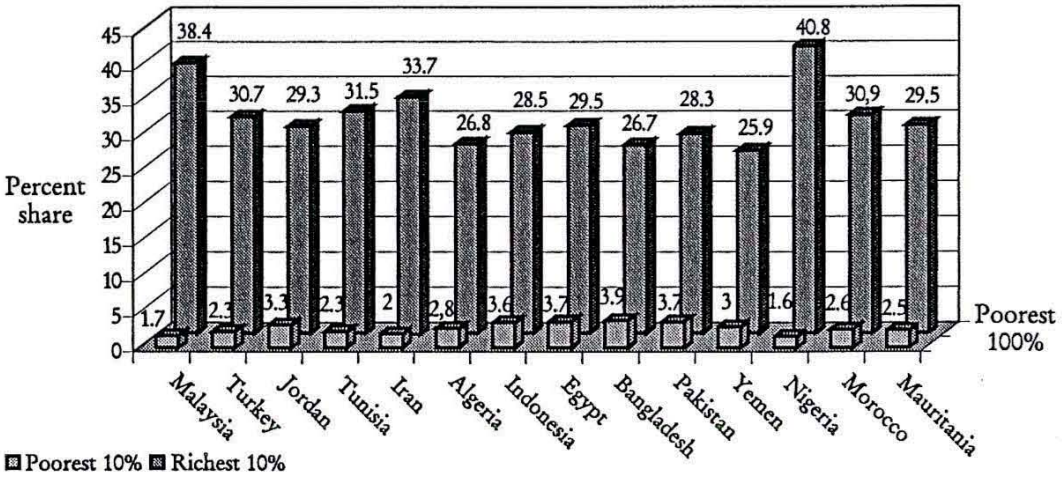
* The authors are grateful to two anonymous referees for their helpful suggestions.

[1] See Askari, Nowshirvani and Jaber (1997).

BNL Quarterly Review, vol. LIX, no. 236, March 2006, pp. 81-111.

FIGURE 1

SHARE OF INCOME OR CONSUMPTION (%) IN MUSLIM COUNTRIES



Source UNDP (2004). A country was not included in an average calculation if the UNDP *Report* did not provide data for that country in that specific computation.

ing countries of the Persian Gulf in an elaborate econometric model, and even less so in a few simple equations. How does one account for the intra-regional wars and conflicts? How can the economic, social and political effects of oil be explained? Can simple indices plugged into an equation sufficiently gauge the degree to which ineffective institutions have stifled development and growth? It would be tempting and even a relief to be able to attribute failure to a single factor for individual countries. We could, for example, blame religion, oil, economic policy shortfalls, institutions, wars, instability, or the role played by foreign powers, depending on the country of focus. Such a course of action would be too simplistic and not helpful in developing a comprehensive approach for an economic renaissance in the region. We avoid this temptation and attempt to provide the more intertwined, and thus less clear-cut, reasoning for Middle-Eastern failure.

This paper is divided into seven sections. We first show how human and economic development has generally remained low among Middle Eastern oil-exporters (section 2). We then afford an explanation of how Islam and religion have not contributed to the region's failure (section 3). In section 4, we explain the extensive mismanagement of oil wealth and discuss how it has decelerated economic growth and reduced economic freedom in oil-producing countries. Furthermore, we explain how governmental inefficiency and barriers to trade

discourage foreign investment and undermine growth (section 5). We follow with an explanation of the relative economic costs and impact of conflicts in the region (section 6), and conclude with a brief assessment of each oil exporter's current economic state and potential for future growth (section 7).

2. Development failure in oil-producing countries [2]

Since 1975, per capita GDP growth in the Middle East has been worse than that of any other region in the world. Excepting Bahrain, most oil exporters of the Persian Gulf have experienced negative per capita annual growth despite having earned more than three trillion dollars in petroleum revenues throughout the last thirty years (Figure 2).

From 1975 to 2002, these oil exporters have, along with Egypt, experienced per capita annual growth that was either negative or extremely low (Figure 3):[3] Iran (-0.4%), Kuwait (-1.2%), Saudi Arabia (-2.5%), the United Arab Emirates (-2.8%), Bahrain (1.1%) and Egypt (2.8%). Only sub-Saharan Africa experienced lower growth than the Middle East during this period. The low level of GDP per capita for Egypt, Iran and Saudi Arabia is of particular concern: their combined average of $ 7,717 (PPP in 2002 US$) is a little over 25% of that of high income countries ($ 28,741) and only 41% of the average ($ 18,919) for the smaller Persian Gulf countries (Figure 4).

While the considerable rise in oil prices throughout 2004 to 2006 has undoubtedly generated economic growth and increased GDP and GDP per capita since the period discussed above, the direct connection of this growth to oil revenues clearly underscores the continuous dependence of these countries on oil for their economic welfare. This will be discussed further in section 4.

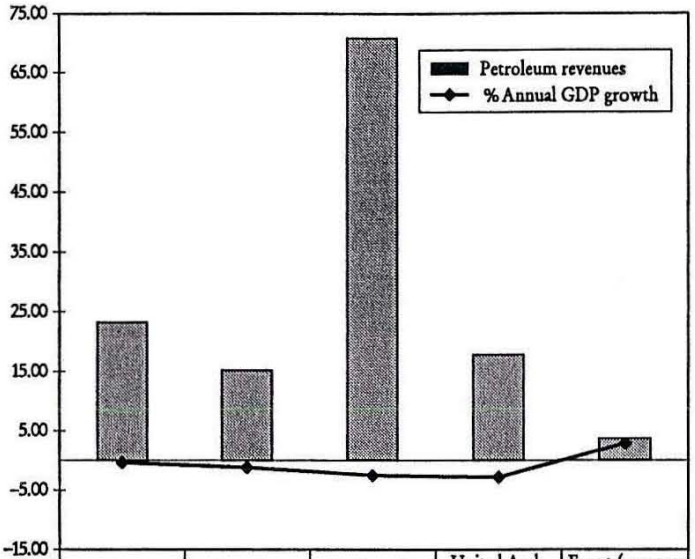
---

[2] The data used in this section and in the corresponding figures was obtained from the UNDP (2004), as well as the data depicted in figures 1-4, 6-10 and given in Tables 1 and 2. A country was not included in an average calculation if the UNDP *Report* did not provide data for that country in that specific computation.

[3] We have included Egypt in some of the discussion because of its large population in the context of the Middle East region.

FIGURE 2

AVERAGE PETROLEUM REVENUES (1975-2000)
VS GDP PER CAPITA ANNUAL GROWTH (% 1975-2000)

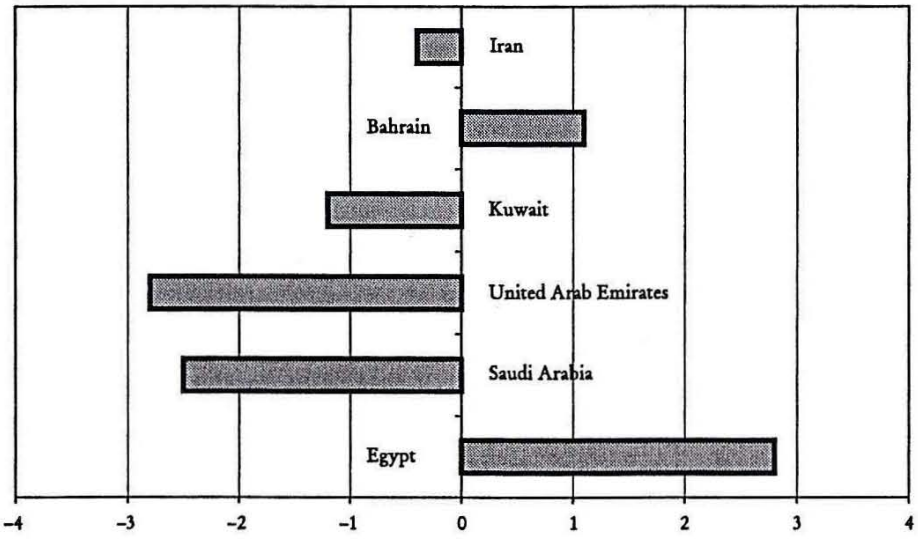


	Iran	Kuwait	Saudi Arabia	United Arab Emirates	Egypt (revenues 1980-2002)
Petroleum revenues	23.22	15.28	70.80	17.86	3.68
% Annual GDP growth	-0.4	-1.2	-2.5	-2.8	2.8

Petroleum Revenues in US$ 2000 billions.
Source of petroleum revenues: Feld (2005).

FIGURE 3

GDP PER CAPITA ANNUAL GROWTH RATE (% 1975-2002)

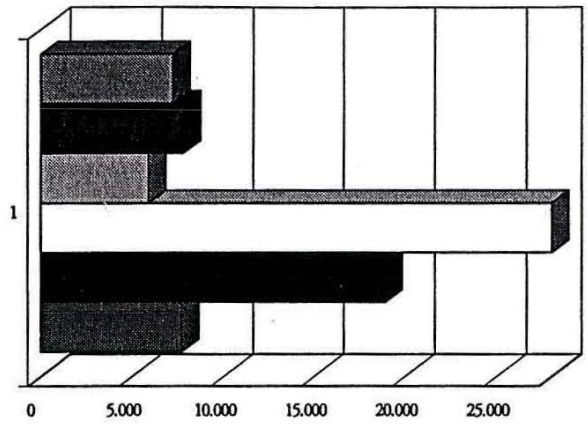


Egypt	Saudi Arabia	United Arab Emirates	Kuwait	Bahrain	Iran
2.8	-2.5	-2.8	-1.2	1.1	-0.4

Source: UNDP (2004). A country was not included in an average calculation if the UNDP *Report* did not provide data for that country in that specific computation.

FIGURE 4

GDP PER CAPITA (PPP US$2002)



Latin America/Caribbean	7,223
World	7,804
Middle Income	5,908
High Income	28,741
Average small Gulf countries	18,919
Avg. Egypt, Iran, Saudi Arabia	7,717

Source: UNDP (2004). A country was not included in an average calculation if the UNDP *Report* did not provide data for that country in that specific computation.

TABLE 1

GDP PER CAPITA (PPS US$ 2002)

Egypt	3,810
Iran	6,690
Saudi Arabia	12,650
Bahrain	17,170
Kuwait	16,240
Qatar	19,844
United Arab Emirates	22,420
High income	28,741
Middle income	5,908
World	7,804
Latin America/Caribbean	7,223
Average Egypt, Iran, Saudi Arabia	7,717
Average Small Gulf countries	18,919
High income	28,741
Middle income	5,908
World	7,804
Latin America/Caribbean	7,223

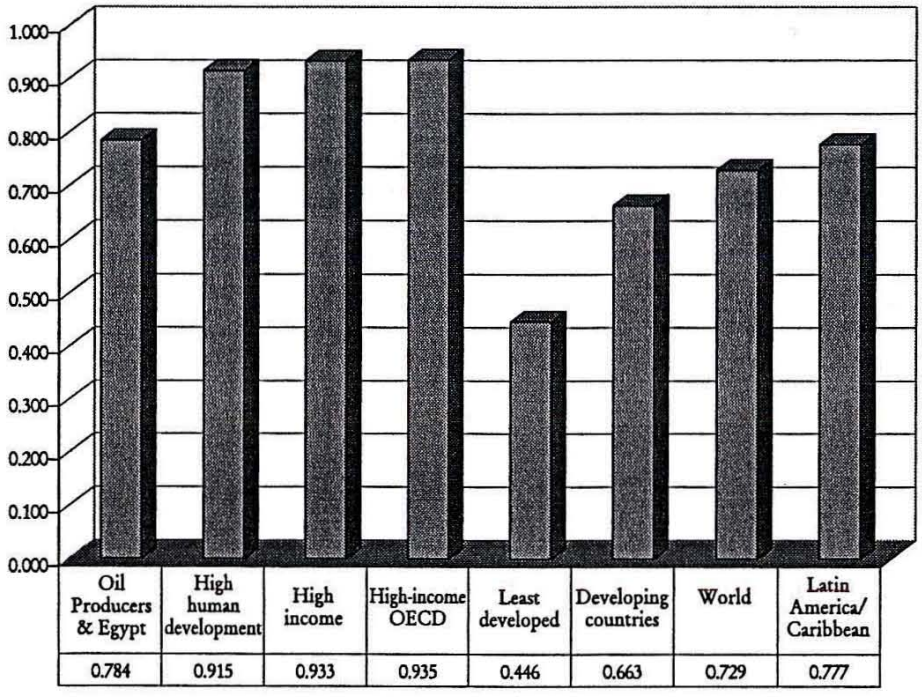
Source: UNDP (2004).

In a recent study on economic development indicators, Enrico Casadio Tarabusi and Paolo Palazzi use a theoretically appealing approach based on a number of variables to rank the development levels for 126 countries. Due to data limitations, only three of the countries in our study (Iran, Egypt and Saudi Arabia) were ranked. Saudi Arabia, whose UN Development Programme GDP and human development indices placed above Iran and Egypt's, also ranked above these countries in Casadio Tarabusi and Palazzi's study; Saudi Arabia was ranked 29, followed by Iran (55) and Egypt (77).[4]

The average Human Development in these countries is above the world average, but remains 16% less than the corresponding value for high-income countries (Figure 5). Bahrain, Kuwait, Qatar and the United Arab Emirates (UAE) have been judged by the UNDP to have high rates of human development. With an average Human Development Index (HDI)[5] of 0.835, however, these wealthy oil-producing countries are still

FIGURE 5

AVERAGE HUMAN DEVELOPMENT INDEX



[4] See Casadio Tarabusi and Palazzi (2004).

[5] The UNDP Human Development Index is a measure of human development that gauges a country's average achievements by evaluating its life expectancy at birth, level of knowledge (as measured by the Education Development Index, which is based on the rate of adult literacy and the total primary, secondary and tertiary gross enrollment ratio) and standard of living (measured by GDP per capita).

among the lower echelons of the world's top fifty most developed countries, and have significant room for improvement given their considerable oil/gas wealth.

Political power in the majority of these countries is generally converged into the hands of an executive authority that is fortified and sustained by a powerful military and state security apparatus. All major Middle Eastern oil producers maintain internal power by continually investing in their respective military and security establishments at the expense of state education and healthcare. Out of the nine countries examined here, Bahrain and Iran are the only two that, as of 2004, spend a higher percentage on education than they do on military. Healthcare has received the least investment in all of the countries except the UAE, which spend more on healthcare than on education (Figure 6).

While average educational development in the Persian Gulf oil-producing countries and Egypt is comparable to that of Latin America, the Caribbean and the world at large, it is still 20% less than what it must be to attain high educational development (Figure 7). Egypt's rate of adult literacy as of 2002 is of particular concern: only 55.6% of Egyptians ages 15 and above are literate; the adult literacy rate for all nine countries as of the same year averaged only 77.6% (Figure 8/Table 2). Female life expectancy at birth, female adult literacy and female estimated earned income are generally unequally distributed in each country, and must undergo significant growth.[6] The Gender Development Index (GDI) for Bahrain, Egypt, Iran, Kuwait and Saudi Arabia ranges from 0.634 to 0.832, while the world's five most developed countries have GDIs ranging from 0.938 to 0.955 (Figure 9).

3. The role of Islam in economic failure[7]

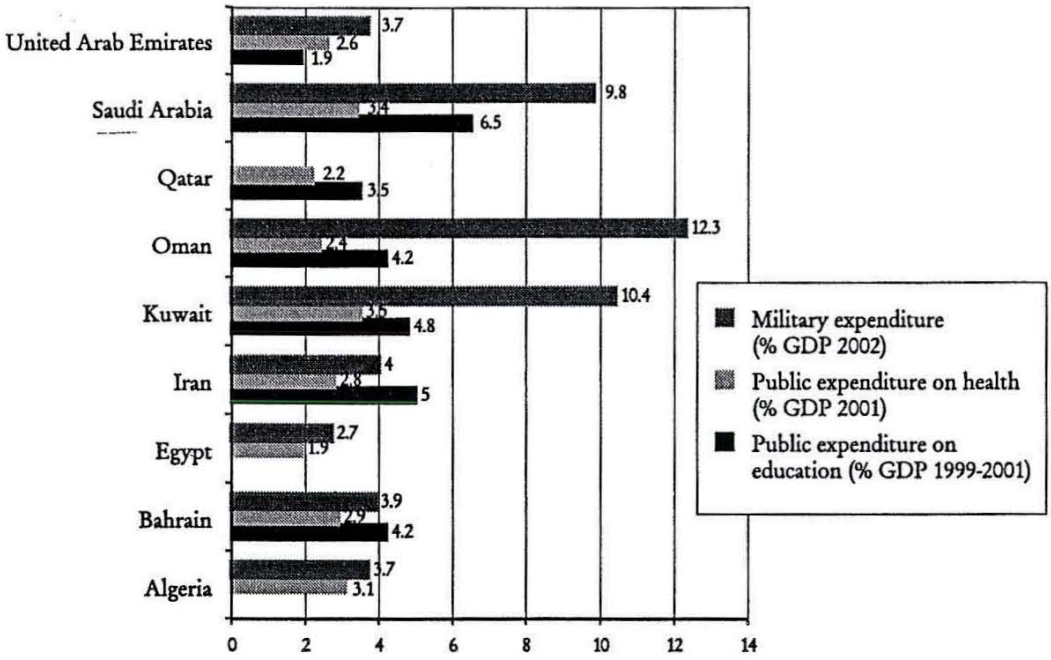
Three points should be emphasized when examining the policies of these oil-producers. The issue of equity is a critical consideration, espe-

[6] The UNDP averages an equally distributed (between male and female) life expectancy index, an equally distributed education index and an equally distributed income index to calculate the Gender Development Index.

[7] For an in-depth explanation of Islamic economic principles, refer to Askari and Taghavi (2005a).

FIGURE 6

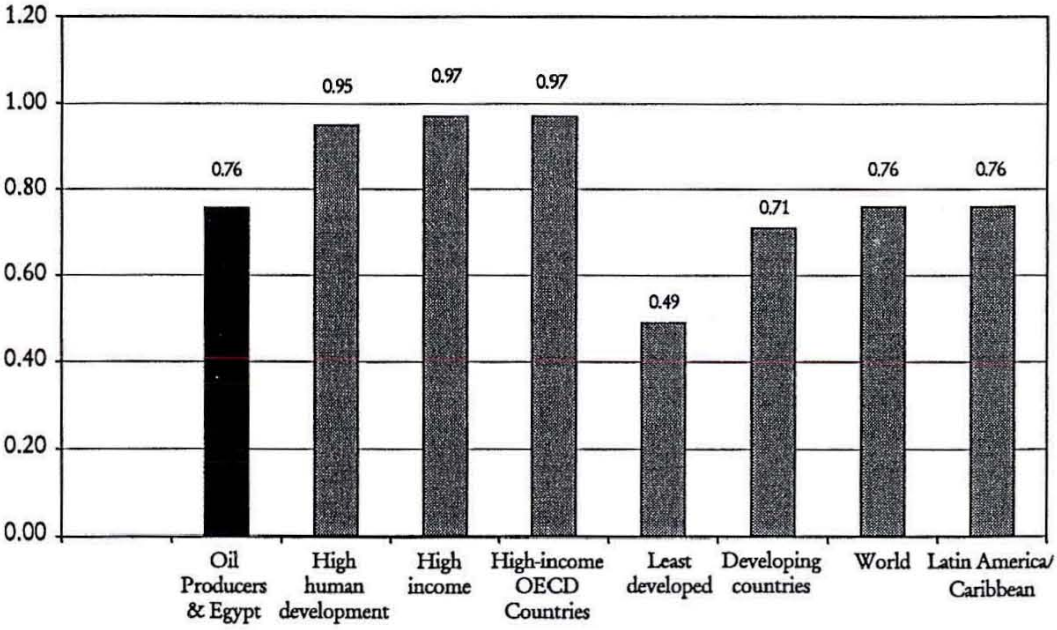
PUBLIC EXPENDITURE ON EDUCATION, HEALTH & MILITARY
(% GDP)



Source: UNDP (2004). A country was not included in an average calculation if the UNDP *Report* did not provide data for that country in that specific computation.

FIGURE 7

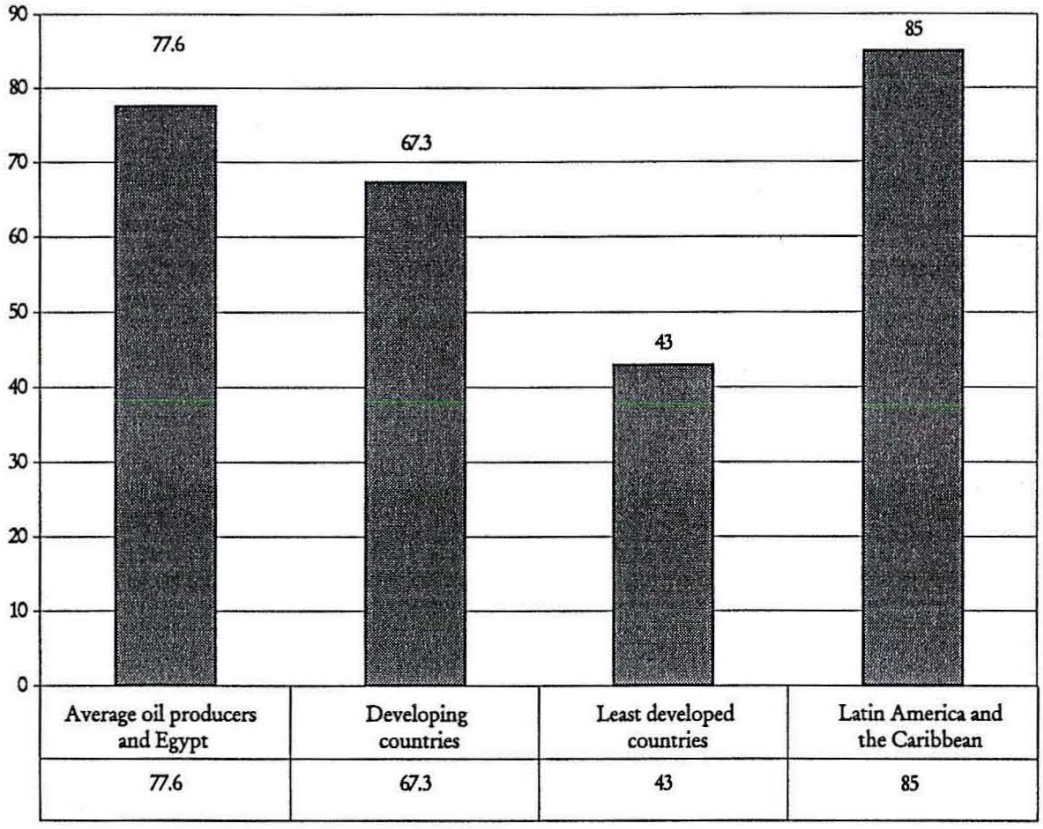
AVERAGE EDUCATION DEVELOPMENT INDEX



Source: UNDP (2004). A country was not included in an average calculation if the UNDP *Report* did not provide data for that country in that specific computation.

FIGURE 8

ADULT LITERACY RATE
(% ages 15 and above as of 2002)



Source: UNDP (2004). A country was not included in an average calculation if the UNDP *Report* did not provide data for that country in that specific computation.

TABLE 2

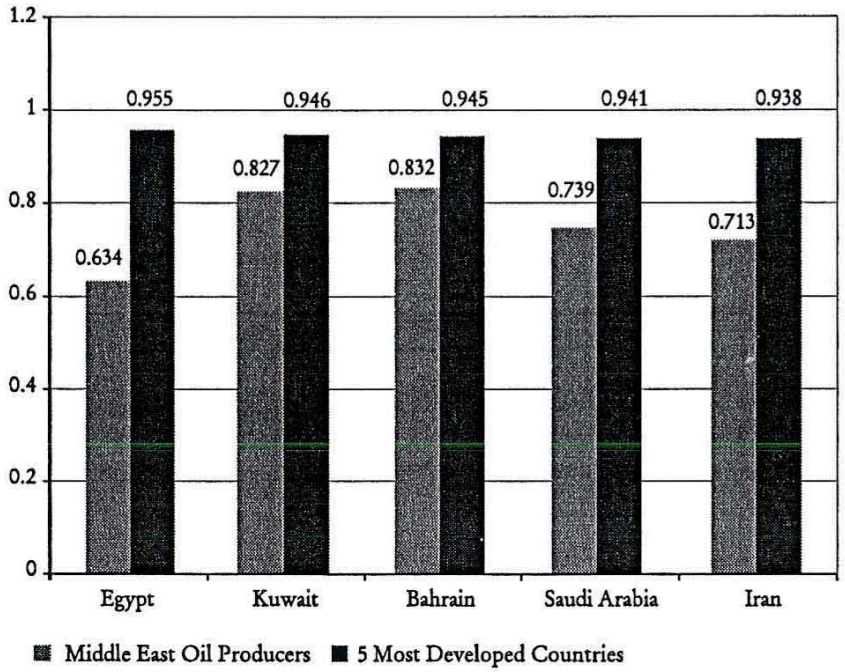
ADULT LITERACY RATE
(% ages 15 and above as of 2002)

Bahrain	88.5
Kuwait	82.9
Qatar	84.2
United Arab Emirates	77.3
Saudi Arabia	77.9
Iran	77.1
Egypt	55.6

Source: UNDP (2004).

FIGURE 9

GENDER-RELATED DEVELOPMENT INDEX



Source: UNDP (2004). A country was not included in an average calculation if the UNDP *Report* did not provide data for that country in that specific computation.

cially for countries with large oil and gas resources. Islamic tenets on land and the depletion of minerals are clear: because God created the earth, land in its natural form (i.e. with no improvements or development by humans) belongs to society at large; thus if a piece of land is still in its original natural state, its price must be zero when it is sold.[8] Ownership in Islam is *not* absolute, and humans may only charge a price for land that is equivalent to improvements made on that land since its creation by God. Most schools of Islamic thought support a variant of the above when it comes to land.

Islamic stipulations regarding resources below the ground are equally unambiguous. Anything under ground belongs to society at large; that is, all citizens – including both current and future generations – should have an equal share in the fruit of what is under the land. A 'Muslim' government's task is very difficult but clear. It must firstly take control of all minerals and then make sure that depleting mineral resources – which are the birthright of all citizens and must be used productively – are not wasted. Then, as minerals are depleted, the

[8] For a detailed discussion, see Mustafa and Askari (1983).

government must ensure that its revenues are used in such a way – through consumption and investment – that all citizens today and for all future time receive *similar* benefits.

It is virtually impossible to reconcile the inequalities that exist today between average citizens and the governing elite in the oil-exporting countries with anything that remotely resembles Islamic teachings. To be fair, one must acknowledge that the practical application of Islamic principles on equity is no easy task but these countries have not even tried to apply Islamic principles (Figure 4). Ironically, there would undoubtedly be a high correlation between countries whose religion is nominally Islam and slow per capita GDP growth. But that would prove nothing. Middle East oil-producers have never practiced what they preach. Thus a hypothetical economic model correlating the false Islamic economics practiced in these countries with economic stagnation is of diminutive aid. The management of oil resources in Norway and in the US state of Alaska is more in accord with Quranic principles and Islamic teachings than is the case in most oil-exporting countries that are nominally Muslim. Interestingly, the popular press *wrongly* attributes the treatment of women in Islamic countries to the teachings embodied by the Quran, yet does not *correctly* point out that economic mismanagement, especially regarding the use of oil, is in actual defiance and contradiction of Islamic tenets.

While any thoughtful explanation of the failure in the region is helpful, one should interpret econometric results explaining failure in the Middle East with a great deal of caution and a heavy dose of skepticism.[9] Religion cannot be blamed for the region's decelerated economic and social development because public policies based on actual Islamic principles have never really been practiced.[10] Thus the question must be asked: if the use or misuse of religious policies did not engender the region's economic failures and decelerated social development, what did?

---

[9] See Hakura (2004).

[10] For a good analysis of factors that have allowed authoritarianism to remain so strong in Middle Eastern countries, see Bellin (2004).

4. The curse of oil and economic policy failures

The economic performance of major oil exporters has been largely determined by conditions in the international oil market. Major oil exporters were adversely affected by oil market developments from the mid-1980s to 1999. International oil price developments have had a considerable impact on export earnings, the availability of foreign exchange and the balance of payments. In economies that do not rely heavily on a depletable resource such as oil, economic output (more correctly Net National Product or NNP) does not diminish with time but is normally expected to increase. In an oil-based economy, if the income from oil is consumed (and if oil output is counted as a part of NNP), NNP declines as oil reserves are depleted. So at least a part of current oil revenues must be saved and invested, domestically or abroad, to even out NNP and thus avoid a decline in national output in the future.[11]

The indicated savings rate (to compensate for oil depletion) is negatively related to the expected life of energy reserves (i.e. the longer oil reserves last, the lower the savings rate). In an extreme scenario, no savings from oil revenues would be needed if oil revenues were expected to last forever. As the rate of return on investments rises, the required savings rate is lower; if the rate of return were infinite, a diminutive amount of savings would compensate for oil depletion. If the current generation does not care if future generations have no resources and go hungry, then there would be little need for savings today. In other words, if a country has many years of oil output, it has less to worry about in comparison to a country whose oil will soon run out. But if society cares for future generations, it is important to save and make investments with a high rate of return in order to afford future generations the same benefits that current generations derive from oil.

---

[11] The conceptual interpretation of NNP in an economy is that it represents the highest level of sustainable consumption. In the development of the conceptual framework of national income accounting, extractive industries were treated as any other source of national product. As a result, the value of the extracted resource was added to national product at the point of extraction. This method of valuing the contribution of extractive industries, as is now widely recognized, is ill conceived and results in significant distortions. For the derivation of the required rate of savings see Askari (1990) and for a calculation of the savings rate for individual oil exporting countries see Askari, Nowshirvani and Jaber (1997).

This scenario may be represented by a basic equation for an economy that is based 100% on depletable resources, with the required savings rate to compensate for resource depletion set at:[12]

$$S = 1 - RT(1 - S')$$

where S' = required savings rate; S' = desired post-resource (when the resource is depleted) savings rate; R = real rate of return on investment; T = life of oil reserves in years.

Thus if R = 1%, T = 40 years, S' (the eventual savings rate when oil runs out) = 20%, then the conventionally measured needed savings rate is 68%.[13] This result is for an economy that derives 100% of its NNP from oil. For such an economy it is conceivable that today's indicated savings rate could be even negative. The reason for this seemingly perverse result is essentially this. Imagine a country that has many years of oil reserves (such as Abu Dhabi, a part of the federation that is the UAE) at current depletion rates and wants a modest savings rate when oil is projected to run out, then today it can afford to even dissave. This result is clearly the exception and is not indicated when we account for the fact that in reality for most countries there is a significant percentage of non-oil NNP (see the adjusted equation below) and that countries want to be in a position to have a high savings rate when oil runs out.

For an economy that is not 100% resource-based, the equation is:

$$S = PS' + (1 - P)[1 - RT(1 - S')]$$

where: P = proportion of national output that is not depletable-resource-based.

Countries with very high levels of oil and gas reserves *per capita* (such as Abu Dhabi, Kuwait and Qatar) have more time and leeway to develop the needed economic policies than do countries that are less endowed on a per capita basis, such as Iraq and Iran. Abu Dhabi is so rich in oil and has such a small indigenous population that its oil per capita is simply staggering; Kuwait's oil wealth is akin to that of Abu Dhabi and Qatar is similarly rich, but in gas. These small countries are an anomaly in that they can just pump their oil, invest *some* of the revenues abroad wisely and live off of the income. But the countries with larger populations do not have the same luxury.

---

[12] See Askari, Nowshirvani and Jaber (1997, pp. 12-15).

[13] $S = 1 - (0.01)(40)(1\ q - 0.2) = 0.68$

Whether a country is saving or not depends upon all of the variables in the above equation. The importance of the rate of return on investment should not be undervalued, however.[14] Even Abu Dhabi must earn a return on a share of the oil it produces in order to have some sort of income once the oil is depleted. If a country earns a high rate of return, it may survive with a lower savings rate. This lesson is even more important for countries that are not as rich in oil. Iran, for example, must exploit its oil (and gas) even more wisely than the UAE because it has less oil on a per capita basis, and will therefore deplete it faster.

Major oil exporters in the Middle East are, along with minor exporters such as Bahrain, Egypt and Syria, heavily reliant upon petroleum revenues for fiscal revenues and foreign exchange earnings. Oil revenues also bolster the transfer of funds to non-oil countries in the region, including Jordan and Lebanon. The legitimacy of Persian Gulf governments such as Saudi Arabia, Kuwait, the UAE and Qatar, who earn the bulk of their revenues through energy exports, has historically been based on cultural traditions and religious authority. With the more recent phenomenon of 'oil-driven modernization', however, their lawfulness has increasingly become a function of their capacity to use oil wealth as a way to maintain an adequate national standard of living and thus 'buy' domestic support. Rather than make direct payments to citizens in this pursuit, oil-exporting governments have chosen to focus primarily on public sector employment and the flow of oil revenues to the population through indiscriminate subsidies for fuel, electricity, food, health, education and much more.[15]

If oil revenues did not exist, these governments would need a thriving private sector to provide them with a tax base. In part because oil revenues accrue to the government, the relative share of the public sector in GDP in most of these economies is large and has suppressed development and growth of the private sector. The use of state expenditures to preserve political support has prompted oil states to finance indiscriminate subsidies, maintain excessively high levels of public employment and support uneconomical state enterprises. Thus state de-

[14] For a calculation of whether savings rates have been 'adequate' see Askari, Nowshirvani and Jaber (1997, p. 18).

[15] See Askari and Taghavi (2005b). For a detailed calculation of subsidies see Askari (1990) and Askari, Nowshirvani and Jaber (1997).

pendence on oil exports to finance openhanded welfare systems and garner political support has, given rapid population growth, resulted in increased unemployment, budgetary deficits and decelerating rates of per capita growth. Ineffective institutions, bad governance and regional conflicts have further undermined growth.[16]

The government's generous public sector employment compensation in the richer oil exporting countries (UAE, Kuwait, Qatar and Saudi Arabia) has also adversely affected private sector employment by increasing compensation in the private sector. As the population in each of these countries has grown, their respective public sectors have been unable to adequately expand and absorb the increasing number of newcomers in the labor market.[17] In the more heavily populated countries – namely, Iran and Iraq – a high level of protection has also restricted competition from abroad. In most if not all of these countries, sensible economic policies have been ignored. After two decades of rapid population growth, shortsighted policies – coupled with fluctuating oil revenues – have resulted in high unemployment and broad social dissatisfaction. Most of the governments in the region – excepting the small and very rich Persian Gulf countries – are now unable to continue the historic and destructive largesse that has thus far been facilitated by oil revenues.

Modern governments need an efficient tax system to serve as a source of relatively stable revenues, a mechanism for affecting income distribution and a tool for macroeconomic management. Yet while most oil exporters – Saudi Arabia in particular – have been compelled to cut their expenditures to a certain extent, most have resisted imposing taxes on their populations.[18] A system of income taxation – a vital key to raising government revenues and improving a heavily skewed income distribution – has not been established in most Middle Eastern oil-exporting countries.[19] Citizens have come to view 'handouts' of state oil-wealth and subsidies as their birthright because government revenues are largely derived from oil and oil is the dominant sector in most of these economies since economic performance in the non-oil

[16] See Askari and Taghavi (2005b).

[17] *Ibid.*

[18] *Ibid.*

[19] In cases where income taxation does exist, such as Iran, it is hardly respected or paid.

sector has been less than impressive. Convincing their citizenry of the need for an effective income tax system will be a monumental task because the average citizen does not believe that the government will set up a fair social safety net to take care of the less fortunate if indiscriminate subsidies were to be eliminated. Thus taxes, when implemented, are often avoided and left unpaid by the average citizen, and the implementation of an effective tax system will in all likelihood require a minimum of a decade.

5. Governance

It is now universally accepted that governance plays a vital role in attaining sustainable economic development and growth. Good governance entails respect for the rule of law, the protection of property rights, the control of corruption and constructive policy-making that serves a country's social and economic needs. A direct consequence of good governance is a favorable and productive investment climate, because an atmosphere that is conducive to investment instigates a positive cycle of growth. As the level of investment rises, firms are able to expand operations, create more jobs and increase their output. Thus a receptive and appealing investment climate promotes productivity, stimulates growth and reduces poverty.

Creating an economic environment that encourages private sector growth entails the creation of sensible macro-economic policies, the preservation of social stability and an effectual legal and regulatory framework. Business regulations that are not complicated and costly also play a key role in attaining investment and ensuring compliance. In nearly every country in the Middle East and North Africa (MENA) region, the primary barriers to conducting business include antiquated and bureaucratic regulatory environments and the presence of volatile and inadequate enforcement mechanisms. The primary constraints to development in the region include inconsistent business and tax administration policies, rigid regulations on entry into the country, property rights, land titling and lax enforcement of contracts and accounts receivable. While such bureaucratic constraints force companies to incur

costs merely for compliance, navigating through intricate and obscure laws also imposes an added cost of time. In countries where it takes excessive time and cost to complete regulatory procedures, potential investors anticipate diminished earnings and may choose to locate elsewhere or cancel investment projects.[20] These costs often have the greatest impact on small business development. Even more importantly, weak and unreliable judiciary systems, particularly with regard to property rights and contract enforcement, instill a sense of insecurity among investors that ultimately reduces inflows of capital and stagnates business development.

Middle Eastern regulatory reforms on business entry and exit, contract enforcement, access to credit and labor have lagged behind those in the rest of the world. In a global ordering of countries, MENA countries rank, on average, in the middle.[21] As a whole, the region has made very little progress in reducing procedural barriers and costs for private investment and has made the *least progress* when compared to any other region in the world. With an average Economic Freedom Index of 3.02, Middle Eastern oil producers and Egypt are currently regarded as *mostly unfree* economies in much need of economic liberalization, improved judiciaries, a loosening of non-tariff barriers to trade and considerable fiscal reform (Table 3). The median score of the entire

TABLE 3

HERITAGE FOUNDATION INDEX OF ECONOMIC FREEDOM, 2005
(1-5, 1 = most free, 5 = most repressed)

Country	Index
Bahrain	2.10
Iran	4.16
Iraq	-
Egypt	3.38
Kuwait	2.76
Qatar	3.10
Saudi Arabia	2.99
United Arab Emirates	2.68
Chile	1.81
Malaysia	2.96
South Korea	2.64
Singapore	1.60

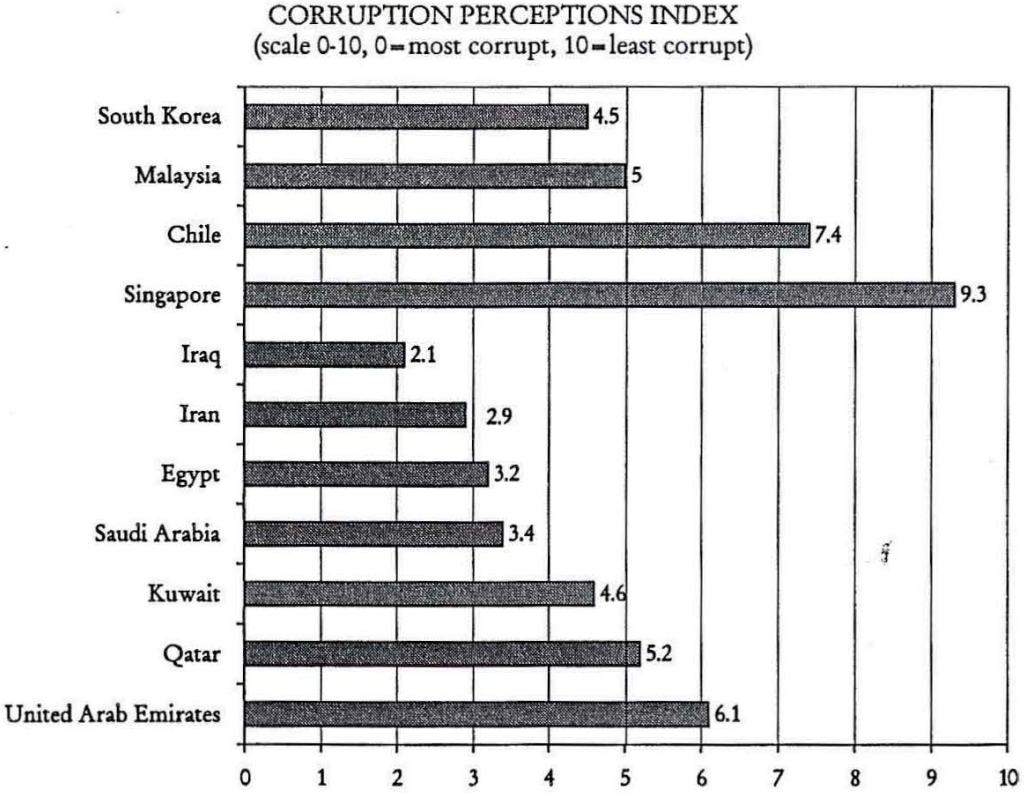
Source: The Heritage Foundation (2005).

[20] See Morisse (2002).
[21] See World Bank (2005).

MENA region has declined by 0.15 since 1997, and because of Bahrain's decrease in economic freedom, there is not even one free economy in the region. Iran's repressed economic state is of particular concern: with a score of 4.16, the country is the second most economically repressed and excessively regulated country (after Libya) in the Middle East and North Africa.[22]

Although Kuwait, Qatar and particularly the UAE are reportedly somewhat less corrupt than their regional counterparts, the Middle East in its entirety is also currently considered (along with South Asia) to be the most corrupt region in the world (Figure 10/Table 4). The

FIGURE 10



Source: Transparency International (2004).

Corruption Perceptions Index (CPI) for the region's major oil producers and Egypt averaged 3.9 in 2004 (Figure 11). Iraq, which scored a CPI of 2.1 in the same year, is currently considered the most corrupt oil exporter in the Middle East. Moreover, none of the nine countries is democratically free. Neither Egypt nor any oil producers in the re-

[22] See Miles, Feulner and O'Grady (2004).

TABLE 4

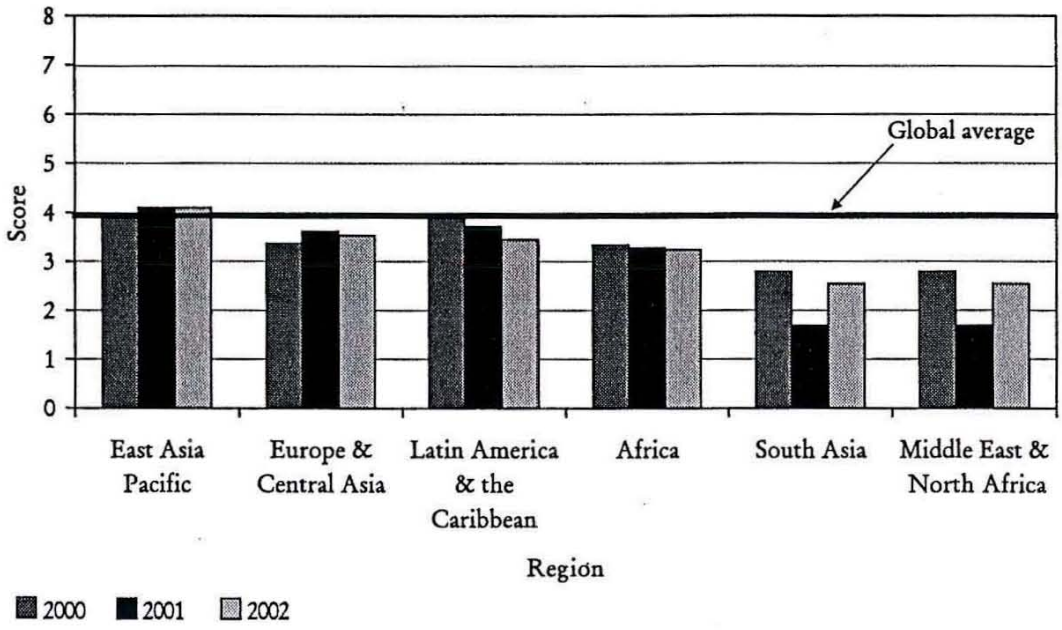
CORRUPTION PERCEPTIONS INDEX
(scale 0-10, 0=most corrupt, 10=least corrupt)

Country rank	Country	2004 CPI score
29	United Arab Emirates	6.1
38	Qatar	5.2
44	Kuwait	4.6
71	Saudi Arabia	3.4
77	Egypt	3.2
87	Iran	2.9
129	Iraq	2.1
5	Singapore	9.3
20	Chile	7.4
39	Malaysia	5.0
47	South Korea	4.5

Source: Transparency International (2004).

FIGURE 11

MIDDLE EAST AND NORTH AFRICA CPI VS. OTHER REGIONS



Source: Transparency International (2004).

gion allow free and full public political participation, and all lack a fair electoral system through which their constituents may balance state rule by forming independent legislatures and judiciaries. Excepting Bahrain and Kuwait, which are partly free, Egypt and its oil-producing counterparts have undemocratic governments that are currently rated not free (Table 5).[23]

TABLE 5

FREEDOM LEVELS

Not Free	
	Egypt
	Iran
	Qatar
	Saudi Arabia
	United Arab Emirates
Partly Free	
	Bahrain
	Kuwait

Countries may be rated as either: Free, Partly free or Not free. Ratings measure the depth of political freedom and degree of civil liberty.
Source: Freedom House (2004).

6. The economic impact of military expenditure and conflicts[24]

Public dissatisfaction with economic and social progress and the absence of elective legitimacy has made rulers and governments rely on force to maintain power. Between 1980 and 1995, the Arab Middle East and Iran spent an estimated $ 396.2 billion as military expenditures, *excluding* any 'collateral' damages inflicted by US-led operations during the second Persian Gulf war (1990-91). Military expenditures in the Middle East did, nevertheless, begin to decelerate after the post-Cold War cessation of Soviet and American arms transfer to the region, falling from 6.8% of world military expenditures in 1987 to 6.2% in 1997. Yet while world military expenditures as a whole began to de-

[23] See Freedom House (2004).

[24] All financial figures are given in US$ 2000, unless otherwise specified. See Table 6 for cost of conflicts.

cline after 1989, the Middle East continued to expend a considerable amount of economic resources on military activities, and underwent a 17% increase in military spending. In 1999, Middle Eastern military expenditures as a percent of government expenditures stood at 21.4% – the highest level in the world.[25] More ominous than the long-term economic effect of military expenditures is the fact that military equipment, if acquired, will in all likelihood eventually be used. The resulting destruction of war has been the staggering negative economic fallout of military expenditures.

Military spending in the Middle East – particularly in the Persian Gulf – surged with the onset of the Iran-Iraq war in 1980. The most notable jumps in spending occurred in Iraq, Saudi Arabia and the UAE, who respectively increased their expenditures by $ 5.4 billion, $ 2.9 billion and $ 0.8 billion. From 1980 to 1988, the UAE spent an average 42.8% of Central Government Expenditures (CGE) and 6.7% of Gross National Product per year on military expenditures. Between 1990 and 1992, the United States sold $ 35.5 billion in arms to the Middle East, $ 27.7 billion of which was sold to Saudi Arabia. By 1994, Saudi Arabia alone had spent a total of $ 33.2 billion on American weapons and $ 153.6 billion on military expenditures (between 1990 and 1994). Kuwait, which had spent an average of roughly $ 2.2 billion a year on its military burden from 1975 to 1985, spent $ 56.2 billion in military expenditures between 1990 and 1992. Egypt, which spent an average $ 2.2 billion per year on military expenditures from 1990 to 2000, has centered the country's air force modernization program on American fighter aircraft. Although public data from the Bureau of Verification and Compliance set Egyptian defense spending, which is never announced, at 8.4% of CGE, the country has reportedly allocated up to 20% of CGE (in 1994) on military expenditures. The UAE spent on average $ 2.5 billion – 47.8% of CGE and 16.6% of petroleum revenues (on average) – on annual defense spending from 1990 to 1999. While data from the US Bureau of Verification and Compliance for this time period sets the UAE's military expenditures on average at 5% of GNP per year, Arab League figures have in the past denoted periodic military spending on the part of the federation that has run in excess of 30% of Gross Domestic Product (from 1994-1995, for example). Arms sales to the UAE in 1990 alone comprised 14.3% of total imports, 40.8% of

[25] See Askari and Taghavi (2005b).

CGE, 4.4% of GNP and slightly more than one tenth of petroleum revenues. Qatar also undertook a drastic increase in military expenditures after 1990: defense spending increased by $ 0.58 billion to a total $ 1.1 billion between 1990 and 1991. In 1992, Qatar's arms imports alone accounted for 41% of CGE, 17.8% of GNP and almost half (47.4%) of petroleum revenues. From 1991 to 1999, the country expended an annual average 11.3% of GNP, 23.3% of CGE and 42.4% of petroleum revenues on military spending.[26]

While the economic burden of military expenditures has been highly significant, it is trumped by the economic cost of conflicts and wars. The combined cost of the Iran-Iraq war to Iran and Iraq is estimated to have been over $ 1.3 trillion – 182.1% of all combined Iranian and Iraqi petroleum revenues from 1975 through 2000, 2.6 times the amount of all oil revenues earned by both Iran and Iraq *from the beginning of the twentieth century until the end of the war*, and 1.8 times the amount of all petroleum revenues earned by both countries throughout the entire 20th century. The US-led aerial bombing campaign against Iraq soon after its invasion and occupation of Kuwait inflicted an additional $ 254.6 billion in economic damages, so that between 1980 and 1991 Iraq suffered a total cost of about $ 809 billion in economic damages, of which total infrastructural damage (resulting from both wars) accounted for $ 105.8 billion.[27] Since the onset of the Third Persian Gulf War in March 2003, Iraq's energy infrastructure (including the country's pipeline system) suffered an estimated 123 attacks from April 2003 through September 2004, so that as of June 2005 the country's reconstruction costs were set at a minimum of $ 100 billion (US$ current). The reconstruction of the country's power sector alone will cost an estimated $ 35 billion (US$ current). It has since been predicted that the war will generate a regional loss of wealth of approximately $ 1 trillion (US$ current) of (Middle Eastern) GDP.[28]

Although Saudi Arabia has not been directly involved in an external war or conflict, the country has not been immune to the economic ravages and fallouts of military expenditures: the country provided a considerable amount of financial support to warring parties in the region. Saudi Arabia's arms imports and military expenditures

---

[26] See Askari and Taghavi (2005b).

[27] *Ibid.*

[28] *Ibid.*

have also taken a heavy toll on the country's economy. Saudi Arabia loaned and later forgave $ 40 billion to the Iraqi war effort against Iran.[29] Some sources have placed the payment by Saudi Arabia, Kuwait and the UAE to coalition forces at $ 36 billion for the Gulf war to force the Iraqis out of Kuwait. The authors' sources put this figure at around $ 60 billion, with $ 30 billion from Kuwait, $ 20 billion from Saudi Arabia and $ 10 billion from the UAE. These payments of $ 60 billion for two conflicts are a significant sum even for oil-rich Saudi Arabia. But in the case of the war to force Iraq out of Kuwait, Saudi Arabia not only provided logistical support through its military bases (especially by allowing coalition forces to use Jubail as their major landing site), but also supplied free jet fuel and other fuels to the coalition. Our estimate for the cost of this support is a figure in the neighborhood of $ 10 billion. Saudi Arabia additionally sustained minor damage during the hostilities and suffered a great deal of environmental damage. Lastly, Saudi Arabia incurred some direct military expenses as a member of the coalition forces, which we estimate to be $ 5 billion. Thus Saudi Arabia, which was not a direct party to the Iran-Iraq war and was peripheral to the battle with Iraq in the second Persian Gulf war, incurred financial costs in the neighborhood of $ 75 billion. Foreign investors have furthermore been largely deterred from investing in Saudi Arabia (along with the rest of the region) because of the negative reputation of the Middle East as an unstable area (Table 6).

Although Saudi Arabia has been significantly affected by military expenditures and regional conflicts, the absolute and relative magnitude (in proportion to the size of its economy) of their economic im-

TABLE 6

COST OF CONFLICTS (US$ 2000)

Iran-Iraq war (Persian Gulf I)-Iran and Iraq	1.3 trillion
Persian Gulf II-Iraq	254.6 billion
Persian Gulf II-Kuwait (excluding heavy milex)	150.0 billion
Iran-Iraq war and Persian Gulf II-Saudi Arabia	75.0 billion
Iran-Iraq war and Persian Gulf II-Kuwait	175.0 billion
Persian Gulf III reconstruction costs-Iraq	100.0 billion (US$ current)
Projected cost of Persian Gulf III to the Middle East region	1.0 trillion (US$ current)

Source: See Askari and Taghavi (2005b)

[29] Authors' estimate.

pact has been far less than that on Iraq and Iran. The size of payments and Gulf war expenses amount to roughly one year of the country's GDP and one to three years of oil revenues (depending on the year taken for comparison purposes); but these comparisons to GDP and oil revenues do not include the cost of heavy military expenditures to the economy. In the case of Saudi Arabia, both because it was not directly involved in the conflicts and suffered less of an economic burden, and because of the country's high oil revenues, better economic policies could have made a major difference for economic development and growth.

Because Saudi Arabia has not been directly involved in any major conflicts or wars, and has considerably higher per capita oil revenues, the country remains in a much better economic situation than Iran. Saudi Arabia does nevertheless face the same general economic problems as Iran: high unemployment, a growing labor force, rigid factor markets, weak institutions, an uncompetitive private sector and the absence of resolve to adopt policies, such as the establishment of an income tax system (coupled with an appropriate social safety net) and currency devaluation, that may be generally unpopular in the short run.

The Second Persian Gulf war inflicted approximately $ 5.8 billion worth of damage on Kuwait's oil installations and cost the country $ 129.6 billion in public and private sector losses, excluding the cost of foregone oil revenues.[30] We estimate that Kuwait paid approximately $ 30 billion directly to the coalition effort. In addition to this sum, Kuwait incurred major damage to its infrastructure (including oil fields), large cash payments to Kuwaitis (both in and out of Kuwait during the conflict), vast military expenditures after the conflict (for US military pre-positioning in case of future conflicts and to support the coalition's military establishment)[31] and lost oil revenues and GDP. Our estimate of infrastructure damage to Kuwait ($ 20 billion) and cash payments to Kuwaitis ($ 5 billion) brings the aggregate Kuwaiti cost (excluding resulting heavy military expenditures) to more than $ 150 billion. While Iraq has paid Kuwait some reparations and is theoretically expected to do so in the future, the probability that reparations will significantly reduce the cost incurred by Kuwait is at best

[30] See Askari and Taghavi (2005b).

[31] See Askari, Nowshirvani and Jaber (1997) for military expenditure figures.

small. If Kuwait's loans to Iraq during the Iran-Iraq war were added to this figure, the sum would approach $ 175 billion.

7. Cumulative economic assessment

Broadly speaking, oil-exporters of the Middle East have not embraced the basic economic fundamentals and policies that have proven successful elsewhere around the world. Effective institutions have not been nurtured. The rule of law has been but a mirage. Corruption has been rampant. Consistent policies that would be needed for success, including macroeconomic policy stability, thoughtful encouragement of private sector development, economic diversification, flexible and competitive factor and product markets and much more, are hard to see in the region. The fundamental decision to use indiscriminate input subsidies to distribute oil wealth and to support private sector development was a significant policy mistake. Output subsidies coupled with an appropriate exchange rate policy and other supportive measures may have gone a long way towards developing an internationally competitive private sector. Output subsidies would have first reduced waste. They would have then mitigated the negative effects of "Dutch Disease",[32] and increased the international competitiveness of the private non-oil sector. While the fixed exchange rate policy has afforded consumers another subsidy, that subsidy is consumed at the expense of private sector production and the ability of the country to compete internationally.

In the case of Saudi Arabia, consumer and input subsidies have – along with military expenditures, payments to former and current allies and protectors and corrupt practices – strained government finances. In 1987, the Saudi government began to borrow both domesti-

[32] Dutch Disease = real currency appreciation as the price of non-tradables to tradables rises with the massive inflow of export revenues. Because non-tradable goods (such as housing, services, etc.) cannot be readily imported, an inflow of oil revenues tends to increase the price of non-tradables relative to the price of tradable goods. Thus individuals and companies are provided with an incentive to produce more non-tradables, and ultimately discourage the development of a diversified and competitive export base.

cally and externally so that by 1994 its domestic borrowing alone was $ 77 billion.[33] Oil revenues began to decline, expenditures could not be cut and the government did not and still does not have a comprehensive tax system. The government raises a small amount of income from corporate taxes, custom duties and other fees, but the sum of these averages less than 25% of total government revenues.[34]

Like Saudi Arabia, Iran could have created more effective institutions and adopted more flexible economic policies that would have helped the country attain longstanding growth in spite of the tremendous economic damage it has sustained since 1975. For Iran to increase per capita income and absorb its rapidly growing labor force, the country must achieve and sustain considerably higher GDP growth rates than it has ever achieved in recent memory. The necessary growth cannot be generated by the country's over-employed and inefficient public sector and numerous foundations, but must instead come from an animated and rapidly growing private sector. In order to avoid social upheaval, Iran must eliminate its subsidies, develop a just social safety net coupled with an equitable tax system, and maintain its credibility to the population. To sustain economic growth, Iran must also develop a business-friendly environment that embraces the rule of law, reduce corruption and expand the country's private sector.

In the case of Iraq, all that one can add is that it has Iran's problems but even more so. On top of Iran's general problems, Iraq's infrastructure is in much worse shape. Its institutions are even more corrupt and ineffective. Its unemployment rate is at least two times that of Iran. Domestic violence (between Shia, Sunni, Kurds) and instability are likely to continue for a number of years. The country's only two advantages over Iran are that it has more oil on a per capita basis and can make a fresh start in almost all areas.

Kuwait, Qatar and the UAE (Abu Dhabi in particular) are different from Saudi Arabia and especially from Iran and Iraq in one important respect: population size. The populations of Iran and Iraq together amount to roughly five times the total population of the other four Gulf oil exporters. Iran by itself is larger than all five remaining Gulf petroleum exporters combined. Kuwait and the UAE each have

---

[33] See Askari, Nowshirvani and Jaber (1997, p. 148).

[34] See Askari, Nowshirvani and Jaber (1997, p. 31) and IMF Statistics Department (2004).

around 75% of Iran's oil reserves, but with native populations that each comprise only 2% of Iran's. Qatar's natural gas reserves (an increasingly valuable export fuel) are worth roughly 40% of Iran's, yet Qatar's native population is less than 1% of the Iranian population. In other words, these small (in terms of population) countries are far more oil/gas rich on a per capita basis than the remaining three countries – most notably Iran. This has at least one important policy implication: these countries could theoretically invest a large portion of their oil/gas revenues each year abroad and live off of the income, or supplement that income when oil prices decline for all future generations as oil/gas is depleted.

Kuwait has, along with Iraq and Iran, incurred tremendous economic damages because of direct conflicts. While Kuwait's loss is smaller than that of Iraq or Iran in absolute size and relative to oil revenues, it is much higher on per capita terms. Nevertheless, we estimate that Kuwait's net foreign assets in 2005 approach $ 100 billion (US$ current). Thus the long-term impact on Kuwait is much less significant than for the other two countries because the country is so rich in oil per capita. Kuwait may therefore continue to pursue its previous implicit policy of becoming a welfare state supported by income from external assets when oil is depleted. On the other hand, if Kuwait chooses to become a more productive state, the country will have to change its economic policies. Effective institutions, flexible labor and product markets, an income tax system, the elimination of wasteful subsidies and the adoption of an efficient social safety net and suitable exchange rate policies will develop Kuwait into a productive state.

The UAE (Abu Dhabi) has steadily increased its foreign assets (currently estimated to exceed $ 150 billion by the authors) and is well on its way to achieving sufficient income from foreign investments for future generations. The federation has been only indirectly affected by regional conflicts – Abu Dhabi is the only emirate to have incurred any significant direct costs because it is so wealthy and was 'persuaded' to pay. By our estimate, the indirect cost to Abu Dhabi consisted of forgiven loans to Iraq worth approximately $ 10 billion, a payment of about $ 5 billion to coalition forces for the Gulf war, and much higher arms imports after the Gulf war (for pre-positioning and support for defense contractors in coalition countries, primarily in the United States). These costs are less than 10% of Abu Dhabi's net foreign assets and current oil revenues. If it has not done so already, Abu Dhabi will

soon attain sufficient income from foreign assets to support itself permanently.

Dubai, an emirate with little oil, has developed internally and is well on its way to becoming the major financial center of the Middle East, the hub for multinationals to establish their regional headquarters, a regional trans-shipment and re-export center, and the tourist destination capital of the region. Dubai has made these considerable achievements primarily by disassociating itself from the political turmoil in the region. It has also developed more transparent institutions (at least in comparison to other Persian Gulf countries), designed policies that attract foreign companies and respect personal freedoms, stipulated few burdensome regulations and built excellent infrastructure and communication systems. The emirate could, however, still improve its income distribution by establishing more liberalized social policies. The remaining emirates rely on financial transfers from Abu Dhabi, and are trying with difficulty to emulate Dubai.

While Qatar harbors some oil, its major source of wealth (per capita) lies in unassociated natural gas. Qatar has aggressively promoted the development of its gas industry, and has already attained a level of per capita GDP equal to that of Abu Dhabi. To encourage domestic development, the country has also adopted economic policies similar to those of Dubai.

8. Conclusion

The relatively large populations of Iran and Iraq allowed the economic effects of their conflict(s) to resonate throughout the region. The severity of their war(s) triggered a massive wave of militarization throughout the Persian Gulf during a period when petroleum revenues were declining. The mortgaging of future petroleum revenues made it possible for the region as a whole to undertake such massive military purchases. The sophisticated weaponry and weapons of mass destruction sold to both countries throughout the war ultimately made the destruction that ensued even more significant.[35] Conflicts and wars, par-

[35] See Askari and Taghavi (2005b).

ticularly those involving Iran and Iraq, have therefore been a major cause of the region's current economic retardation. Nevertheless, the massive economic damage suffered by the region as a whole because of conflicts could have been mitigated to a certain extent if these countries had managed the development and distribution of their natural resource wealth more industriously and had adopted more effective institutions and enlightened policies. Iraq, Iran and Saudi Arabia still have the requisite resource wealth and economic potential necessary to attain rapid growth and economic success akin to that of Chile.

Major Middle Eastern oil exporters must diversify their economies. Export diversification requires sound exchange rate policies, limited production subsidies, flexible factor and product markets and access to foreign markets. Although export diversification may present policy challenges, the benefits of energy revenues must not be forgotten. Oil revenues are akin to a foreign loan that carries zero interest and does not have to be paid back to foreigners, but must instead be paid in some fashion to future generations of citizens. Chile, a major copper (another depletable resource) exporter, has managed to benefit from its copper exports while diversifying its export base. Yet even a country as successful as Chile still relied on copper for nearly 40% of its export earnings in 2004.

While oil wealth cannot be the only cause of the Middle East's dismal economic state, it has certainly *enabled* it. Easy-come oil wealth has fueled government corruption, and rulers have not helped create the proper environment, infrastructure and foundation necessary for sustained growth of the private sector. Governments see little need to promote rapid growth in the private sector, and do not feel pressed to establish an effective tax system. Economic inequality has become widespread, and there is an inadequate social safety net. Oil has been an enabling factor in every one of these developments.

A broad indicator of a country's general economic performance is how the outside world gauges its economic conditions as indicated by the level of Foreign Direct Investment (FDI). Foreign investors will hesitate to invest their money and manpower in a country that they themselves are afraid to visit. It is therefore equally important for the West to appreciate the political as well as the economic changes that are called for; one without the other will do little to reverse the dangerous prognosis for the region. Simply said, our assessment of the reasons behind economic failure in the Middle East is that economic prosperity

requires stability, and stability requires economic prosperity. Not one conflict that has taken place in the Middle East throughout the last thirty years has been strenuously opposed by the developed world. To help usher a lengthy period of peace and tranquility into the region, the West should acknowledge its own past shortsightedness in its relations with the Middle East, and recognize that its steady transfer of armaments to so many Middle Eastern governments has made the destruction generated by the region's conflicts even more significant. Supporting indigenous efforts to develop these countries politically and economically will prove to be the means of attaining political stability, economic growth and social prosperity in the Middle East.

REFERENCES

ASKARI, H. (1990), *Saudi Arabia: Oil and the Search for Economic Development*, Preface by Robert Solow, JAI Press, Greenwich, Ct.

ASKARI, H., V. NOWSHIRVANI and M. JABER (1997), *Economic Development in the Countries of the GCC: The Curse and Blessing of Oil*, JAI Press, Greenwich, Ct.

ASKARI, H. and R. TAGHAVI (2005a), "The principle foundations of an Islamic economy", *Banca Nazionale del Lavoro Quarterly Review*, vol. LVIII, no. 235, pp. 187-205.

ASKARI, H. and R. TAGHAVI (2005b), "The economic impact of conflicts and military expenditures: a Middle Eastern tragedy", unpublished manuscript, Washington.

CASADIO TARABUSI, E. and P. PALAZZI (2004), "An index for sustainable development", *Banca Nazionale del Lavoro Quarterly Review*, vol. LVII, no. 229, pp. 185-206.

FELD, L. (2005), "OPEC and non-OPEC oil export revenue spreadsheet", *Energy Information Administration*, email to authors.

FUKUDA-PARR, S. (2004), *Human Development Report, United Nations Development Programme*, United Nations Development Programme, New York.

FREEDOM HOUSE (2004), *Freedom in the Middle East and North Africa: A Freedom in the World Special Edition*, The Rowman & Littlefield Publishing Group, Inc., Lanham.

HAKURA, D.S. (2004), "Growth in the Middle East and North Africa", *Working Paper*, no. WP/04/56, International Monetary Fund,Washington.

THE HERITAGE FOUNDATION (2005), *Index of Economic Freedom*, The Heritage Foundation, Washington.

IMF STATISTICS DEPARTMENT (2004), *International Financial Statistics*, International Monetary Fund, Washington.

MILES, M., A. EDWIN, J. FEULNER and M.A. O'GRADY (2005), "Executive Summary", *Index of Economic Freedom*, The Heritage Foundation, Washington, pp. 1-18.

MORISSE, J. (2002), "Administrative barriers to foreign investment in developing countries", May, mimeo.

MUSTAFA, A. and H. ASKARI (1986), "Economic implications of land ownership and land cultivation in Islam", *Proceedings of the Second International Conference on Islamic Economics*, Islamabad, 1983, published in I. Munawar ed., *Distributive Justice and Need Fulfillment in an Islamic Economy*, International Institute of Islamic Economics, Leicester.

PAGE, J. (2003), "Structural reforms in the Middle East and North Africa", in K. Schwab, *The Arab World Competitiveness Report 2002-2003*, ed. by P. Cornelius,World Economic Forum, Oxford University Press, Oxford and New York, 2003, pp. 62-79.

TRANSPARENCY INTERNATIONAL (2004), *Corruption Perceptions Index*, 20 October, London.

WORLD BANK (2005), *Middle East and North Africa Economic Developments and Prospects. Oil booms and revenue management*, Washington.

UNDP - UNITED NATIONS DEVELOPMENT PROGRAMME (2004), *Human Development Report 2004. Cultural liberty in today's diverse world*, New York.