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A DUAL-TRACK DEVELOPMENT STRATEGY FOR SAUDI ARABIA

*Robert E. Looney**

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.[1] In fact, a growing body of literature that suggests resource wealth itself, especially where it accounts for the bulk of government revenues as in the case of the so-called "rentier states,"[2] may harm a country's prospects for development. National growth data bear this out: rentier states with greater natural resource wealth tend to grow more slowly than their resource-poor counterparts.[3]

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The "rentier state" syndrome[4] is most dramatic in the Arabian/Persian Gulf region where, beginning in the mid-1980s, relatively stable levels of oil production and flat oil revenues combined with rapid increases in population have resulted in declining per-capita income in Saudi Arabia and only modest gains elsewhere. At the height of the oil boom in 1980s, the Kingdom's per-capita income was around $17,000. By 2003 this figure had declined to about $8,200, lagging far behind most of the other Gulf oil producers.[5] This decline is even more pronounced if corrected for inflation and the decline in the dollar exchange rate.

Saudi Arabia's falling per-capita income has been made even more painful by increased unemployment, especially after 2000. Various surveys suggest the unemployment rate among young Saudis is estimated to be anywhere from 15 to 30 percent. Furthermore, the unemployment rate among new graduates (in the age group of 20 to 24 years) is upwards of 27 percent for Saudi men and 33 percent for Saudi women. It is hard to comprehend how this state of affairs arose in a country that is the world's largest oil producer with one-fourth of the world's proven oil reserves. In the volatile Middle East of the early 2000s, a youthful population with increasing numbers of job seekers facing growing rates of unemployment has the potential of becoming a full-fledged economic crisis, perhaps severe enough to destabilize the regime and bring a new era of uncertainty to the Kingdom.

No doubt the boom-and-bust cycle that has characterized Saudi Arabian economic growth since 1973/1974 has been an additional factor underlying the Kingdom's poor job-creation record. Oil revenues, representing 85 to 90 percent and 75 to 80 percent of total exports and budgetary receipts, respectively, are both volatile and insufficient for funding development projects needed to stimulate needed levels of private-sector investment. In retrospect, the establishment of an oil development fund might have buffered the economy from these shocks.

Unless the oil prices of 2003-2004 continue to hold for some time, government expenditures will be able to absorb only a small fraction of the new labor force entrants, thus leaving the private sector as the only significant source of new job creation. Based on the historical patterns of investment, growth, and new job creation, only robust investment-led growth in nonoil gross domestic product (GDP) in the range of 5 or 6 percent can absorb the yearly influx of job seekers. Since the mid-1990s, the private sector, while showing encouraging signs of vitality, has not been up to the task, growing at rates considerably below this 5 to 6 percent range:[6] 0.9 percent (1995), 4.9 percent (1996), 4.5 percent (1997), 2.6 percent (1998), 4.2 percent (1999), 4.3 percent (2000), 3.7 percent (2001), and 4.4 percent (2002).

Developing a dynamic private sector is critical. Much of the slowdown in employment and nonoil growth has stemmed from the decline, over time, in the government's ability, to stimulate private-sector output and expenditure simply through its own public expenditures. Also, the Kingdom's current approach to employment creation, the Saudization program, while well intended has a limited potential to make a significant contribution to the country's employment needs.[7]

The sections that follow examine ways to invigorate the private sector. Key to this objective will be significant progress in the areas of diversification, modernization, and increased competitiveness across the whole spectrum of private establishments.[8] To complement progress in these areas, development strategies are suggested that are likely to further enhance the Kingdom's employment creation potential through shifting resources toward those sectors with the highest job-creation potential.

Reoriented Development Strategies

The oil/gas sector and the petrochemical industry continue to dominate the economy in general and the manufacturing sector in particular. This phenomenon can be characterized as a single-track development strategy, with focus on the modern export-oriented segment of the economy.

Diversification in nonhydrocarbon industrial activities has started but is still relatively modest, with a strong concentration in food, textile, furniture, and household appliances. Since the oil/gas/hydrocarbon sectors are largely capital intensive, they are not a dynamic source of jobs, at least of the magnitudes currently needed. Clearly, Saudi Arabia needs to exploit its comparative advantage in the energy area, especially tapping into the rapidly growing natural gas industry. However, for significant employment creation more concerted efforts at diversification into more labor-intensive activities are needed and should proceed based on the exploitation of locational advantages within the Kingdom, such as access to markets, transport, or nonhydrocarbon resources. Here, small- and medium-sized firms, often neglected or overlooked in the past, can play a leading role in solving the nation's employment problems.

Programs for Small- and Medium-Sized Firms: In many countries, small- and medium-sized enterprises (SMEs) have played a crucial role in creating jobs and providing economic stability. In Thailand, for example, a whole new development model has centered on SMEs playing a leading role in advancing the economy. The results have been stunning,[9] with growth accelerating since 2002 and projected to reach 8 percent in 2004.

In Saudi Arabia's case, SMEs have the potential to play a variety of important roles: (a) selling their own products, usually finished goods and (b) acting as either subcontractors for or (c) suppliers of raw materials for larger multinational enterprises. There are several great success stories in creating a large number of jobs and relatively low costs. For example, the information technology (IT) job market is booming in Saudi Arabia, with many positions filled by Saudis working for SMEs.[10] By 2004, SMEs in Saudi Arabia represent almost 93 percent of total enterprises and account for about 24.7 percent of total employment.[11]

Problems Confronting Small- and Medium-Sized Enterprises: Unfortunately, the information-technology sector is the exception. In Saudi Arabia, small- (less than 59 employees) and medium-sized (60-99 employees) businesses to date have not lived up to their potential for a number of reasons.[12] Extensive surveys carried out by the Council of Saudi Chambers of Commerce and Industry (CSCCI) and the United Nations Industrial Development Organization document the main concerns of businessmen.[13]

Lack of Credit/Finance/Capital: The effective cost of capital is often quite high because regular lending institutions have a difficult time evaluating new businesses, especially those with unfamiliar production areas. As a result, lending institutions often require guarantees or collateral beyond the means of the borrower. Most SMEs in the Kingdom are not satisfied with the existing banks/financial institutions. They find loan procedures very complicated. Most of them are unable to meet the demands for personal guarantee and securities. Many small- and medium-sized enterprises also contend that, compared with the terms given the country's larger, more established firms, banks are generally too rigid with their terms, existing loan procedures are too cumbersome, and there is too much difficulty obtaining loans.[14]

Dependence on Foreign Resources: Ironically, given SMEs' ability in many developing countries to create local jobs, many of them in Saudi Arabia create very few employment opportunities. As part of the country's Saudization program, whereby the percentage of the jobs held by Saudi nationals was to reach 30 percent by the end of 2003,[15] many of these companies have managed only marginal progress—2 percent on average in the case of very small enterprises (1-9 workers).[16] As is often the case, imported capital and technology in effect have made many SMEs dependent on foreign technicians and manpower. Because of the pervasiveness of imported equipment across the Kingdom, many companies face tight labor markets for skilled workers.

Access to Technology: On the other hand, the digital divide is a significant problem for many SMEs in Saudi Arabia.[17] Improving access to technological networks of international standards can be very expensive and out of reach for many SMEs.

Limited Marketing Skills: Many SME managers in Saudi Arabia, even by developing-country standards, have little in the way of formal training in marketing and product distribution. As a result, their operations often cannot take advantage of economies of scale and are high cost. They are limited to local rather than export, or even national, markets. In a survey of 60 existing SMEs in 2000 in the Eastern Province of Saudi Arabia by the Small and Medium Enterprises Development Council of the Eastern Province Chamber of Commerce and Industry, over 75 percent of the enterprises reported problems in marketing.[18] While in the Kingdom many of these obstacles are more perceived[19] than actual, they have had the effect of stifling the growth of SMEs.

Bureaucratic Hindrances: While some progress has been made in cutting bureaucratic red tape, as late as 2001 the *Middle East Economic Digest* noted that

> Approvals can take a long time in Saudi Arabia, and tax the patience of even the hardiest entrepreneur. In the water sector, for example, there is currently no tariff, no regulator, no law and no credible counter-party, so private financing is impossible. Such legal complications may take years to clarify.[20]

The cost of complying with national and international standards also can be very expensive for SMEs. This will be the case particularly when Saudi Arabia joins the World Trade Organization (WTO), where compliance with government commitments (such as trade-related aspects of intellectual property, etc.) can be difficult for SMEs.

Limited Information on Possible Markets and Clients: Many Saudi SME owner/operators have little experience in exporting into foreign markets. Similarly, they have difficulty identifying and attracting foreign investors. As a result, their firms are often undersized and cannot expand in line with growing markets.

Compounding these problems is the fact that, because of their lack of access to credit, Saudi SMEs usually are the most vulnerable in times of economic recession. The resulting business failures often add to the severity of the recession. This problem only will be compounded as the economy moves to a freer price system[21] with the country's joining the WTO in 2004 or 2005.

Suggested Initiatives: Unfortunately, government policy toward SMEs has not been as extensive or as effective as it should and could be. A 2001 report noted that

> ...despite the importance of SMEs in the economy, these are unable to benefit from the incentives provided by the government and, due to their small or medium size, commercial banks view them as high risk borrowers and refrain from funding their needs.[22]

Given the great potential for job creation in SMEs, government policy initiatives clearly are warranted. Areas for special emphasis should include the following.

1. Training/Human Resource Development: This covers both on-the-job training and the broader education system. There is a strong need to improve skill bases in a range of areas.

2. Funding for Research and Development: SMEs lack assistance both for developing new ideas and turning these ideas into commercial products.

3. Addressing Weaknesses in Transportation and Infrastructure: This can affect access to markets and business revenue (telecommunications, ports, airports, road networks).

4. The Encouragement and Creation of Alternative Financial Sources: Islamic financial institutions, such as Modarabas in Pakistan, could play an important role in providing financial capital on equitable terms in accordance with Islamic codes.

5. Improving Knowledge of the Legal Environment for SMEs: The government has established a series of regulations and provides instruments to support domestic industry. Unfortunately, because they now are aware of their options, many Saudi SMEs work under restrictive licensing agreements with foreign partners. This often prohibits the SMEs from exporting and forces reliance on foreign managerial and technical skills. Thus, these firms rarely undertake product and process innovation. By subsidizing e-commerce legal services and related online information,[23] the government could enable more advantageous contracts for local firms.

6. Securing Property Rights: One area that the government seriously should consider examining in detail is the extent to which property rights can be more formalized and legalized. As noted above, one of the main constraints entrepreneurs face in Saudi Arabia is collateral for loans. To what extent is this problem due to the legal system's failure to provide secure titles? Once entrepreneurs have secure titles to assets, the world of credit opens up because assets can be used as collateral for lending. The amounts may be significant. H. de Soto and his colleagues estimated the amount of "dead capital" in untitled assets held by the world's poor as at least \$9.3 trillion.[24]

The Saudi authorities appear aware of many of the issues confronting SMEs and are beginning to respond with effective programs. In particular, the 2004 national budget allocates substantial funding for the newly established Loan Guarantee Fund (LGF), which is charged with granting credit to SMEs at the grass-root level.[25] If the LGF can demonstrate its effectiveness in this regard, it could become a prime tool in attaining the Kingdom's employment creation goals.

A major advantage of pursuing a strategy favoring SMEs is that their development most likely would provide much better regional balance in incomes. Currently, high incomes are relatively concentrated in the industrial cities of Jubail and Yanbu, the capital (Riyadh), and the financial and diplomatic center, Jeddah. SMEs would bring jobs and higher incomes to many of the towns and villages bypassed in the Kingdom's petroleum-based growth.

An SME regional-based strategy probably would not stop the agglomeration of the Kingdom's population, but it might slow the process.[26] In this regard, a Saudi SME-oriented regional development program could be modeled to incorporate elements of the more successful European Union (EU) regional programs, especially those cropping up throughout the transition economies.[27] In fact, there has been a growing emphasis in EU policy to foster SMEs in the less advanced and more peripheral regions of the Community and in regions most negatively affected by structural adjustment and thus less likely to attract foreign investment. As in EU programs, the goal of fostering job creation and growth in disadvantaged regions could be implemented through policies aimed at overcoming institutional constraints, such as obtaining finance and developing an adequate infrastructure. In Saudi Arabia these programs would have to be extended to address the need to develop business skills in areas such as marketing and accounting.

Return to Unbalanced Growth: Saudi Arabia's development strategy has changed considerably over the years. Initially after the 1973-1973 sudden increase in oil prices and vastly expanded revenues, the government pursued what is often referred to in the literature as unbalanced growth.[28] This particular strategy entails investment in social overhead (mainly infrastructure) investments. The projects were attractive to the authorities since they used imported labor, raw materials, and management. In addition, they were highly visible.

The theory underlying this strategy is that it would minimize the amount of decision making needed in the private sector.[29] By making profitable investment opportunities readily apparent, massive infrastructure investments would induce the private sector to greatly step up its investment. In short, the strategy took into account the vast financial resources of the government as well as the limited entrepreneurial skills of the private sector.

In retrospect, the strategy was well conceived and began paying fairly high dividends around 1979. This approach to the Kingdom's development allowed the nonoil economy to sustain fairly respectable growth rates, even during the period of relatively slack oil revenues in the mid-to-late 1980s. Its main flaw, however, was its underestimation of the extent to which Saudi Arabia would remain dependent on an expatriate work force.

Investment on social overhead capital on the scale seen in the late 1970s to early 1980s has not been replicated. Whereas public investment accounted for around two-thirds of the overall growth of fixed capital formation between 1970 and 1990, investment by the private sector constituted around 83 percent of the total investment between 1991 and 2003.[30] Since the mid-1980s, the government has been unable to fund another significant round of infrastructure expenditures as around 85 percent of public expenditure in the budget is allocated to the salaries of government employees and current pensions.

With time, the private sector has expanded to the point where diminishing returns to infrastructure no doubt have set in and, hence, the observed inability of government expenditures at this time to induce significant amounts of either private-sector output or expenditures.[31] In essence, the initial post-1973/1974 infrastructure imbalance has been neutralized by subsequent private-sector activity over the years to the point where an implicit cost subsidy to the private sector no longer exists.

Clearly, a return to the unbalanced growth development strategy of the 1970s and early 1980s would expand private-sector investment and growth to the point where significant improvements in job creation would be sustainable. It also would create, through increased investment profitability, opportunities to nurture and develop the Kingdom's stock of entrepreneurs.

However, the financial costs of this strategy are staggering. If the country's population continues to expand as projected, the Kingdom will be home to 38.5 million people by 2023. The government has concluded that to respond effectively to the country's infrastructure needs will necessitate the mobilization of investments worth Saudi riyals (SR) 1,000 billion in the coming 20 years, suggesting a yearly average of SR50 billion. This includes investments of around SR438 billion in the power sector, capital needs of SR340 billion for building water and sewage projects, around SR100 billion for the natural gas initiative, and the remaining funds of SR122 billion for projects in the areas of telecommunication, roads, airports, and related transportation systems.[32]

Financing this level of expenditures is possible, but it will require several initiatives.

1. While the lending capacity of Saudi domestic banks has remained around SR11 billion a year in the over the 1997-2001 period, thus greatly limiting the role of these banks in financing SMEs, it has increased somewhat in the last several years (2002-2004) because of the greater influx of oil revenues. Most of this increase will not flow into SME loans without some sort of government subsidy or guarantee.

2. Clearly, the government will have to redirect expenditures toward economic services, perhaps at the expense of salaries.[33]

3. Major efforts will have to be undertaken to improve the efficiency of government services and at least start work on seriously tapping nonoil related taxes.

4. Semi-privatization of infrastructure through financial arrangements along the lines of existing and successful build, operate, and transfer (BOT)[34] programs will have to become the norm in the Kingdom.

While these initiatives are a beginning, other areas of additional support will have to be tapped.[35]

So far, the lessons of international experience show that very few government and donor initiatives have succeeded in implementing sustainable strategies for SME development. To succeed, sustainable SME development will require concerted efforts among the various parties concerned, including commercial and rural banks, leasing companies, and equity providers and consulting and training firms, internet providers, and local business associations.

Adoption of a Dual-Track Development Strategy: The undertaking of a major new infrastructure expansion program, by reducing production costs, should provide a very significant stimulus to private-sector investment. To assure that this incentive is not neutralized by insufficient consumer demand, the Saudi authorities seriously should consider establishing a "dual-track" development model focused on achieving a more balanced economy.[36]

Problems Associated with the Existing Oil-Based Development Model (OBDM): Many of Saudi Arabia's employment problems stem from the normal difficulties associated with overreliance on oil exports. The mechanism that probably has gained the most attention in academic circles is the so-called Dutch Disease. This phenomena has two effects, both of which have impacted the Saudi economy at one time or another.[37]

The first focuses narrowly on the exchange rate. In technical terms, the "Dutch Disease," named after the experience of Holland—where increased natural gas revenues in the late 1950s resulted in the strengthening of its currency (the guilder) and the resulting loss of export markets and deindustrialization—refers to the potentially adverse effects of a booming export sector on the performance of other exports and of industries competing against imports. In the case of Saudi Arabia, the real exchange-rate appreciation resulting from a ramp up of oil exports is likely to reduce the profitability and competitiveness of some agricultural exports, such as dates, wheat, and dairy products. It also would encourage imports of food and raw materials, which may compete with domestic production, while discouraging the emergence of new manufacturing exports essential for the successful diversification of the economy and the creation of jobs.

A second, albeit more problematic, effect of concern for Saudi development is that, during periods of modernization and expansion of the oil or gas sectors, the rest of the economy may be "crowded out" in the sense of facing higher costs in competing for resources. A-M. Abdel-Rahaman found that domestic investment in Saudi Arabia may have "crowded out" a certain amount of foreign direct investment, presumably because of adverse cost developments.[38] This effect would not necessarily be a major inhibitor to private-sector expansion in many areas, however, since many inputs to hydrocarbon expansion would be fairly specific to that sector. On a more general level, D. S. Hakura has shown that in members of the Gulf Cooperation Council (GCC), where oil revenues are significant, large governments appear to have been a key factor stifling private-sector growth and impeding diversification.[39]

Another series of oil-related problems stems the fiscal implications of fluctuating and uncertain revenues. While one cannot say that oil revenues create a certain set of fiscal policy rules, it is a fact that, for the most part, Saudi Arabia and the other Gulf countries have used fiscal policy in a pro-cyclical stabilization pattern. The net effect has been to intensify the detrimental impact that fluctuations in oil prices have on the domestic economy.

In addition, oil exporters' budgetary patterns tend to be an extreme version of the fiscal rules used in a number of developing nations 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.[40] In general, social sectors are less vulnerable to cuts than defense and administration, which in turn are considerably less vulnerable than production and infrastructure.

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 produce a budgetary pattern typified by the Kingdom, which consistently allocates around 30 percent of its budget to defense. In Saudi Arabia the following five elements can be observed.[41] (1) Typically, increases in planned defense expenditures come largely at the expense of economic services. These reductions carry over to transportation/communications and infrastructure as well. (2) Economic services, transportation, telecommunications, and other infrastructure also are reduced when the government experiences unanticipated increases in the fiscal deficit. (3) On the other hand, the country's extensive subsidy program often is funded with unanticipated increases in the fiscal deficit. (4) Allocations to human resource development are increased along with expanded defense expenditures. (5) In addition to economic services, the government tends to reduce allocations to municipal services and public lending programs during periods of expanded defense expenditures.

As noted above, the net effect of these budgetary priorities has contributed to a decline in the overall strength of government expenditures in stimulating growth of the nonoil domestic economy. In part, this stems from the stop-and-start nature of many infrastructure projects and the generally low priority given economic expenditures during periods of austerity. In addition, increased levels of public indebtedness have come at the expense of increased private-sector investments.

The budgetary and exchange-rate patterns associated with the OBDM model have manifested themselves in a pattern of growth that has set the oil exporters apart from nonoil Middle Eastern countries.

First, looking at the Middle East as a whole, oil exporters have sustained an average output growth per capita of 0.83 percent (table 1). This has been the result of a growth in physical capital of 2.24 percent and in human capital of 1.96 percent. Second, these growth rates occurred in an environment characterized by a negative growth in total factor productivity of 1.22 percent. Third, in contrast, nonoil exporters in the Middle East grew about twice as fast (1.59 percent vs. 0.83 percent), invested at a rate about twice that of the oil exporters (4.94 percent vs. 2.24 percent), and had a positive ratio of total factor productivity per output (1.55 percent vs. -1.15 percent). Fourth, as in the Saudi Arabian case noted above, the oil exporters allocated a proportionate amount of resources to human capital (1.96 percent vs. 1.86 percent for the nonoil producers). Fifth and finally, 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.

While these results should be taken with caution, the dismal performance of oil exporters is undeniable. Their established pattern of total factor productivity (TFP) is especially troubling, with oil exporters averaging significantly lower rates of TFP than their nonoil counterparts (table 1). Basically, total factor productivity reflects technological change and the ability of economic agents to respond efficiently to price signals in a continuing search for lower costs and greater competitiveness. In this regard, Saudi Arabia has had one of the lowest rates of TFP, averaging negative values over much of the period since 1960. If Saudi Arabia

Table 1
AVERAGE GROWTH OF OUTPUT AND INPUTS BY SELECTED COUNTRY

				Growth Rate per Worker		
Middle East oil exporters	First Year	Output	Capital	Human Capital	Total Factor Productivity (TFP)	TFP/ Output
Algeria	1948	3.00	3.04	1.85	0.76	0.25
Iran	1956	1.56	3.02	2.26	-0.95	-0.61
Iraq	1950	1.14	5.51	1.86	-1.92	-1.68
Kuwait	1980	-0.35	-4.58	1.55	0.12	-0.33
Libya	1960	3.68	4.99	2.47	0.38	0.10
Oman	1970	0.67	4.63	2.11	-2.28	-3.42
Saudi Arabia	1960	0.70	7.73	1.70	-2.99	-4.24
United Arab Emirates	1980	-3.74	-6.42	1.89	-2.89	0.77
Average		0.83	2.24	1.96	-1.22	-1.15
Nonoil exporters						
Egypt	1917	2.00	2.63	1.14	0.19	0.09
Israel	1948	3.10	4.64	2.20	0.10	0.03
Jordan	1960	1.36	4.16	1.61	-1.09	-0.81
Morocco	1951	1.77	2.54	1.36	0.02	0.01
Syria	1953	0.76	4.37	2.25	-2.19	-2.90
Tunisia	1956	2.61	2.99	2.20	0.15	0.06
Yemen	1970	-0.44	13.24	2.27	-6.33	14.37
Average		1.59	4.94	1.86	-1.31	1.55
Other oil exporters						
Norway	1855	2.05	2.68	0.89	0.57	0.28
Nigeria	1952	0.08	3.76	1.12	-1.91	-22.43
Venezuela	1936	0.55	2.41	1.46	-1.22	-2.21
Ecuador	1950	1.15	3.32	2.13	-1.36	-1.18
Indonesia	1951	1.76	4.21	1.72	-0.78	-0.44
Russia	1917	1.98	3.72	1.74	-0.41	-0.21
Azerbaijan	1990	-6.40	-4.41	2.92	-6.90	1.08
Kazakhstan	1990	-0.65	-1.24	2.47	-1.89	2.91
Average		0.07	1.81	1.81	-1.74	-2.78
Southern European						
Cyprus	1950	6.03	6.66	1.81	2.62	0.43
Greece	1910	2.85	3.41	1.24	0.89	0.31
Italy	1861	1.79	2.57	0.96	0.30	0.17
Portugal	1849	1.97	2.46	0.75	0.65	0.33
Spain	1857	1.34	1.77	0.82	0.21	0.16
Turkey	1935	1.99	2.12	1.36	0.38	0.19
Average		2.66	3.17	1.16	0.84	0.27

Source: Adapted from: Scott L. Baier, Gerald Dwyer and Robert Tamura, “How Important are Capital and Total Factor Productivity for Growth,” Memo, April 2002, available at http://www.dwyerecon.com/pdf/tfp.pdf.

wants to achieve better economic performance than the oil-exporter norm, the authorities will have to create an environment that encourages and forces sustained levels of positive total factor productivity, which apparently is an extremely difficult, if not impossible, task if confined to the OBDM model.

Development of a Second Track: 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; for others, the establishment of supporting institutions—a sound financial system and efficient, equitable tax systems—play a central role. The sections above have noted Saudi Arabia's progress in several of these areas. Given the experiences of other oil-producing countries, however, it is not apparent that these measures, while desirable in and of themselves, are capable of restructuring the economy in a manner consistent with the employment demands currently facing the Kingdom. An alternative is to pursue simultaneously with the OBDM model a second track more focused directly on the domestic economy and small- and medium-sized enterprises.

The rationale for the two-track strategy is straightforward: most developed countries have a smaller proportion of exports to GDP than do Saudi Arabia and the other Gulf oil exporters. Therefore, the most developed nations are less vulnerable to external shocks like a slowdown in the U.S. or world economy or a collapse in oil prices due to surges in non-OPEC production.

Even nonoil developing countries are moving in the direction of a dual-track model. Malaysia, for example, having realized that its economic model before the Asia Crisis (1997) placed too much emphasis on foreign direct investment and mass manufactured exports, now is looking for more balanced growth. In particular, the government is focusing on a steady strengthening of domestic demand and diversifying the sources of growth. On May 21, 2003, a U.S. $1.9-billion economic package was announced with about half of the expenditure allocated to grass-roots initiatives to boost domestic demand. As in most developing countries, these expenditures tend to have strong multiplier effects on domestic income and jobs. The announced initiatives are to support small- and medium-sized enterprises, agriculture, rural development, and new housing for the masses.[42]

As with Malaysia and several other East Asian countries, this second track of the Kingdom's development efforts must focus on the job-creating potential of SMEs. Stress on SMEs would not come at the expense of the oil/gas industry; Saudi Arabia can pursue a dual-track development strategy with foreign investment flowing into larger, hydrocarbon-based enterprises and, to a lesser extent, into SMEs. This first track would continue as the prime foreign-exchange earner.

The second track would be the more locally based SMEs to utilize natural resources and skills to produce for an expanding domestic market. As noted above, an increase in Saudi employment, such as that produced by Saudization, would complement this strategy as the replacement of expatriates by Saudi workers also creates a much larger domestic demand multiplier.

The idea is to stimulate domestic demand[43] in the short run through increased government expenditures, while simultaneously searching for new local industries to develop as part of the diversification away from OBDM activities. At the same time, domestic-market-focused policies can achieve structural change by assisting business in moving up the value-added chain, thus keeping ahead of direct competition from the other GCC countries.

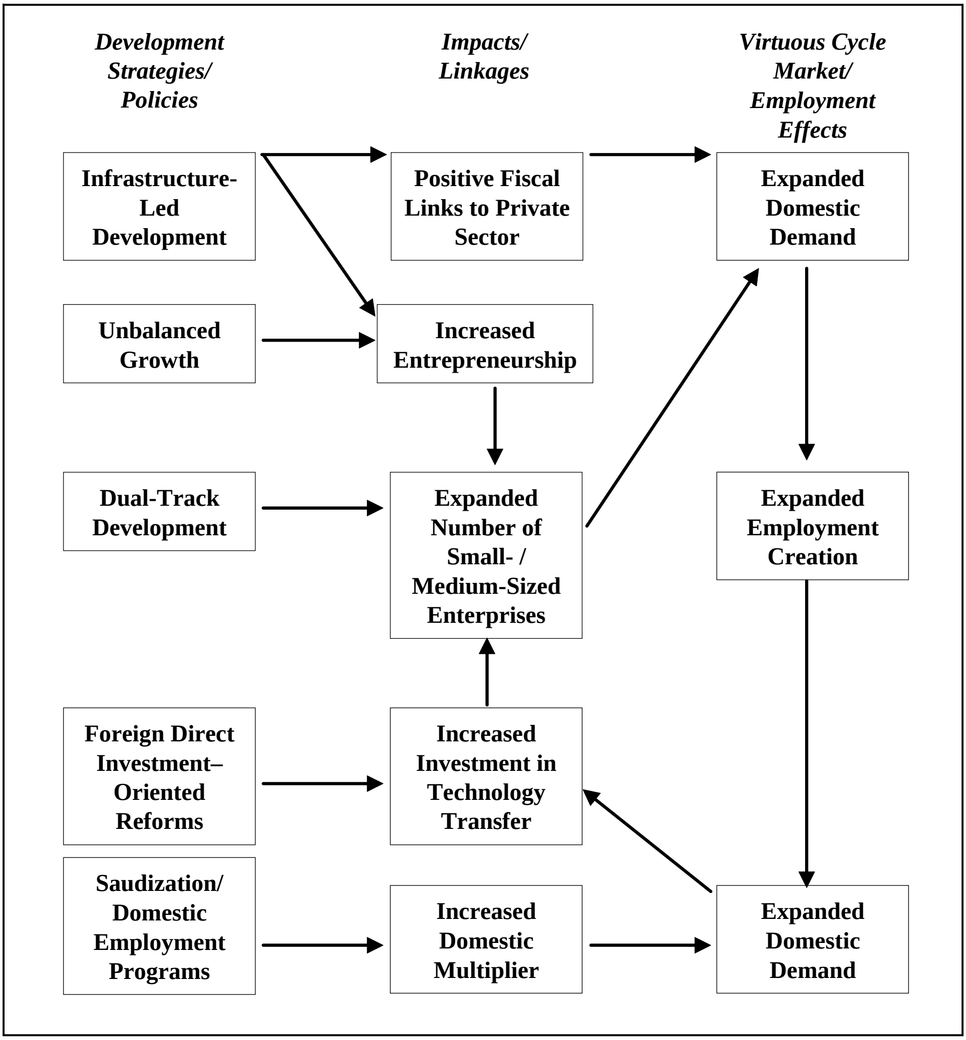
Assessment

Beginning in 2000, the most important among a number of positive elements in the government's approach toward the private sector seems to be the realization that a rapidly growing private sector is essential if any significant progress is to be made in attacking the unemployment problem and job-creation needs. The previous sections outlined several areas that require greater attention in the nation's reform program as well as strategies that might be considered to attain greater job-creation capacity. Taken as a whole, these policy initiatives have the potential of not only significantly expanding domestic employment opportunities, but also, perhaps more importantly, doing so through the creation of a virtuous cycle with feedbacks between the domestic market and the labor markets (figure 1).

As the previous sections suggest, a virtuous cycle of demand and investment-led job creation can be generated through the following process. (1) Shifting government expenditures back to an infrastructure-led investment strategy should restore the positive links between government expenditure and private-sector output and expenditure. (2) Infrastructure-led development can be expected to open up a number of profitable areas of investment, stimulating increased entrepreneurship. (3) Within this context, the shift to a dual-track development strategy with a focus on small- and medium-sized enterprises would assist the creation of new firms and associated employment. (4) Relaxing many of the disincentives to foreign direct investment would assist in providing these new enterprises with another source of capital, as well as special technologies, to take advantage of the new investment opportunities. (5) The Saudization process, by redirecting a higher percentage of wages and incomes to the internal market, would provide added demand for a wide range of domestic consumer goods. (6) Once the process is under way, several links between added employment and further demand creation would reinforce, in a virtuous cycle-type mechanism, the employment creation capability of the economy.

Still, many challenges and uncertainties remain. Globalization driven by liberalization and new technologies provides opportunities and challenges for the dynamics of private-sector activity in Saudi Arabia. On one hand, it creates greater access to markets, technology, and foreign partners but, on the other, stronger competition, now based not only on price but on quality, delivery, and innovation.

Figure 1
SAUDI ARABIA: VIRTUOUS CYCLES



NOTES

[1]A detailed account is given in R. Looney, "Iraqi Oil: A Gift from God or the Devil's Excrement?," Strategic Insights, July 2003, available at http://www.ccc.nps.navy.mil/si/july03/middleEast2.asp.

[2]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. See Michael Ross, "Does Oil Hinder Democracy?," *World Politics*, April 2001, p. 329.

[3]J. Sachs, "Globalization and Patterns of Economic Development," *Weltwirtschaftliches Archiv*, vol. 136, no. 4 (2000), p. 584. This pattern has been confirmed in recent studies including C. Leite and M. Weidmann, "Does Mother Nature Corrupt? Natural Resources, Corruption and Economic Growth,"

IMF Working paper WP99/85 (Washington, D.C.: International Monetary Fund, 1999) and C. Bravo-Ortega and J. De Gregorio, “The Relative Richness of the Poor? Natural Resources, Human Capital and Economic Growth,” University of California, Berkeley (2001). However, there is not unanimous agreement of the detrimental impact of resources on growth. O. Manzano and R. Rigobon, “Resource Curse or Debt Overhang?,” National Bureau of Economic Research (NBER) Working paper 8390 (Washington, D.C.: NBER, July 2001), make a good statistical argument that previous findings were flawed due to their failure to net out spurious correlations. They contend that much of the poor performance of the natural resource countries has not stemmed from resources per se, but from overborrowing by these nations in the 1970s when commodity prices were high. The subsequent debt burden following the fall in prices in the mid-1980s subsequently has suppressed growth in these states. Of course, one could contend that if these countries did not have natural resources, they could not have overborrowed in the first place.

[4]An assessment of the rentier state dynamics as they pertain to Saudi Arabia are given in R. Looney, “Saudi Arabia: Measures of Transition from a Rentier State,” in *Iran, Iraq and the Arab Gulf States,* ed. J. A. Kechichian (New York: Palgrave, 2001), pp. 131-60.

[5]Unless otherwise noted, economic figures are from the Saudi Arabian Monetary Agency (SAMA), *Annual Report* (Riyadh: SAMA, various issues).

[6]Computed from Saudi Arabian Monetary Agency, *National Account Statistics, Private Sector*, available at http://www.sama.gov.sa/reports/annual/default.htm.

[7]R. Looney, “Saudization and Sound Economic Reforms: Are the Two Compatible?,” Strategic Insights, February 2004, available at http://www.ccc.nps.navy.mil/si/2004/feb/looneyFeb04.asp.

[8]Since our focus here is employment creation, the country’s privatization program is not examined—it may actually result in less job creation, at least in the short run.

[9]R. Looney, “Thailand’s Thaksinomics: A New Asian Paradigm?,” Strategic Insights, December 2003.

[10]“Saudi Arabia’s IT Employment Sector Grows at Four Percent Per Annum,” *MENA Business Reports*, July 31, 2003.

[11]I. I. Sajini, “Effects of WTO on Small & Medium Enterprises,” *Arab News*, January 19, 2004.

[12]The literature has grouped many of the problems faced by small- and medium-sized enterprises under the category of “Organizational Dualism.” See H. Myint, *Organizational Dualism and Economic Development*, vol. 3, no. 1 (1985), pp. 24-42.

[13]See, for example, F. Richard, *Strategic Guidelines for Industrialization in Saudi Arabia in the New Global Setting* (Vienna: United Nations Industrial Development Organization (UNIDO), 2003) and *Integrated Program for Saudi Arabia* (Vienna, UNIDO, 2003).

[14]A. H. Kola, “Small Industries Need Better Financing,” *Saudi Gazette*, November 17, 2001.

[15]R. Looney, “Saudization and Sound Economic Reforms: Are the Two Compatible?”

[16]M. Otsuki, “SMEs Supporting Systems in Saudi Arabia,” Memo, October 15, 2002, available at http://216.239.57.104/custom?q=cache:YNL6tQAu7T8J:www.planning.gov.sa/PLANNING/ALL%2520PAPERS/DAY3/Small%2520and%2520Medium%2520Enterprises/SME%2520Development%2520in%2520Saudi%2520ArabiaSME%2520Development%2520 in%2520Saudi%2520Arabia.doc+Mitsuo+Otsuki+SMEs+Supporting+Systems&hl=en&ie= UTF-8.

[17]I. A. Bu-Hulaiga, “Challenges of e-Business in GCC: Digital Divide & Economic Reform,” available at http://www.itu.int/arabinternet2001/documents/ppt/315,3,Slide 3.

[18]“Indian Minister Highlights Key Role of Small Scale Enterprises,” *Riyadh Daily*, October 7, 2003.

[19]C. Crick, M. Al Qbaidi, and S. Chaudhry, “Perceived Obstacles of Saudi Arabian Exporters of Non-Oil Products,” *Journal of Marketing*, December 1998, p. 187.

[20]Quoted in P. J. Cooper, “Saudi Reforms Hold Key to Mid East Boom,” *AME Info*, May 13, 2001.

[21]I. Radwan, “Small and Medium Enterprise Development: A Vision for Action in Saudi Arabia,” Paper prepared for the Economic Vision Conference, Riyadh, Saudi Arabia, June 9, 2001, available at http://216.239.57.104/search?q=cache:QrnRZv49FhIJ:www.planning.gov.sa/PLANNING/ALL%2520PAPERS/DAY3/Small%2520and%2520Medium%2520Enterprises/4.%2520%

2520Small%2520and%2520Medium%2520Enterprise%2520Development/SME%2520Ismail%2520Radwan%2520and%2520Jamal%2520Alkibbi.doc+Ismail+Radwan+%22Small+and+Medium+Enterprise+Development%22&hl=en.

[22]A. H. Kola, "Small Industries Need Better Financing," *Saudi Gazette*, November 17, 2001.

[23]S. A. Khan, "Expert Calls for National Agenda on Internet," *Saudi Gazette*, October 23, 2002.

[24]H. de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000), p. 6.

[25]"Kingdom Budget: An Underlying Expansionary Stance," *Arab News*, December 29, 2003.

[26]I appreciate a reviewer pointing out the fact that regionally based SMEs never have greatly modified urbanization patterns in the developing world.

[27]See L. Konopielko and J. Bell, "Reinventing Aid for SMEs in Eastern Europe: Lessons from the Implementation of the STRUDER Program," *Regional Studies*, May 1998, pp. 290-94.

[28]R. Looney and P. C. Frederiksen, "The Evolution and Evaluation of Saudi Arabian Economic Planning," *Journal of South Asian and Middle Eastern Studies*, winter 1985, pp. 3-19.

[29]A. O. Hirschman, *The Strategy of Economic Development* (New Haven, Connecticut: Yale University Press, 1958).

[30]"Saudi Arabia Pumps $725 Billion into Infrastructure Projects over the Past 3 Decades," *Middle East North Africa Financial Network*, December 16, 2003.

[31]R. Looney, "Measures of Transition from a Rentier State," pp. 131-60.

[32]*Saudi Economic Survey*, available at http://www.saudieconomicsurvey.com/html/reports.html.

[33]"Complacent Budget Shuns Challenges," Oxford Analytica, December 4, 2002, accessed through ProQuest data base.

[34]Since the early 1980s, developing countries have used build/operate/transfer (BOT) contracts for infrastructure development. Basically a company will build, operate, and, after a profit is made, transfer the project to the government for possible privatization. The terms usually are laid out in specific formal contracts between the most-often foreign company and the host government.

[35]I. Rawwan and J. Al-Kibbi, "Small and Medium Enterprise Development: A Vision for Action in Saudi Arabia," Paper prepared for the Economic Vision Conference, Riyadh, Saudi Arabia, October 2001, p. 5, contains recommendations for encouraging and facilitating the expansion of SMEs.

[36]As a possible analogy, East Asian dual-track strategies are used to diversify away from the East Asian Development Model, which is skewed toward mass manufacturing for export. See, for example, Daniel Lian, "Malaysia: A Positive Dual-Track Economics Package," *Morgan Stanley Global Economic Forum*, May 23, 2003, and R. Looney, "Thailand's Thaksinomics: A New Asian Paradigm."

[37]R. Looney, "Real or Illusory Growth in an Oil Based Economy: Government Expenditures and Private Sector Investment in Saudi Arabia," *World Development*, September 1992, pp. 1367-376.

[38]A-M. M. Abdel-Rahman, "The Determinants of Foreign Direct Investment in the Kingdom of Saudi Arabia," Economic Research Forum Working paper 0238, Cairo, Egypt, 2002.

[39]D. S. Hakura, "Growth in the Middle East and North Africa," Working paper (Washington, D.C.: International Monetary Fund, April 2004). Members of the Gulf Cooperation Council include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

[40]R. Looney, "The Budgetary Impact of Defense Expenditures in the Middle East," *The Middle East Business and Economic Review*, July 1993, pp. 38-49.

[41]R. Looney, "Saudi Arabia's Economic Challenge," *Japanese Institute of Middle Eastern Economies Review*, autumn 1996, pp. 37-56.

[42]D. Lian, "Malaysia: The Laggard Could be Ready for a Spurt," *Morgan Stanley Global Economic Forum*, August 6, 2003.

[43]The domestic demand would be stimulated with deficit financing. However, this must be controlled closely to avoid inflationary pressures and associated Dutch Disease problems.