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Chapter 2

# PUBLIC FINANCE AND INDUSTRIALISATION IN THE ARAB COUNTRIES

By

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## Introduction

The main purpose of this paper, as has been assigned, is to discuss the influence of the public finance realities on the sectoral distribution of industrial investments and on industrial policies in the Arab countries. It is of interest to remark that the major two aspects of the ensuing discussion, which are the public sector and industrialisation, represented since mid-1950s basic shifts in Arab economic life and were highly interrelated.

As in most developing countries, Arab governments have increasingly involved themselves in mobilising and allocating economic resources. This was prompted by the need to accelerate economic growth and development, and by the emergence of social welfare and social justice as areas for government action. The extent of this involvement can be depicted clearly from the rising trend in both the share of the public sector in the economy, and in the public sector/GDP ratio. It is observed that the role the public sector is more prominent in the Arab countries whose socio-economic systems have undergone basic transformations. In Egypt, Syria, Iraq, Democratic Yemen and Algeria, the adoption of socialist-orientated policies following nationalisation measures have greatly enhanced the role of the public sector. In the oil-producing countries, which are by definition private enterprise economies, the fact that oil revenues accrue to the government has made it inevitable that the public sector take a leading role in the overall socio-economic transformation.

It must be highlighted, however, that the shift in economic power from the private to the public sector varies in scope and nature as between the above two groups of countries and among countries within each group. While the public sector in the socialist-orientated countries has a firm grip on the economy by controlling the rate and pattern of investment as well as the foreign trade sector, it is concerned in the oil countries mainly with the channelling of oil revenues, through specialised institutions and public organisations, into infrastructural and development projects.

At the same time, most of the Arab countries have accorded high priority for industrialisation in their development plans. The driving force behind this is the importance of industry not only in diversifying sources of income and increasing material production for local consumption and exportation, but also in internalising the dynamics of economic growth and building an indigenous technological base. With respect to the oil countries industrialisation provides the basic means for absorbing a large part of the oil revenues in productive investments, thus reducing their heavy dependence on the exportation of crude oil. Eventually this would transform the present oil economies into petro-industrial economies. Analogously, in the non-oil (agricultural) countries industrialisation provides a means for transforming domestic natural resources into useful products to meet basic needs of the population, and brings into productive employment factors of production which would otherwise have been idle or underemployed, or consumed (in the case of capital). Thus, it is apt to bring about a better allocation of resources and save and/or generate foreign exchange by replacing imports and increasing exports. This would eventually transform the agricultural economies into agro-industrial economies.

To provide a background for discussion, the first part of the paper will examine briefly the public finance realities in the Arab countries with a view to assess the place of industry in overall public investments. The second part will present an overview of industrial policies in the Arab countries in an attempt to analyse the impact of the public finance situation on these policies. The third part will focus on the emerging patterns of industrialisation and the extent to which these patterns have been shaped by the public finance situation. Finally, in the fourth part some concluding observations will be made.

Public Finance and Industry

Despite the growing importance of the fiscal system in influencing the level and direction of economic activity in most of the Arab countries, it is observed generally that this system is not yet developed. Much remains to be desired whether in terms of attaining a fuller mobilisation of financial resources through better tax administration and reform, or in terms of a more rational and effective use of these resources.

However, it is evident that government revenues and expenditures have undergone substantial changes since the early 1970s. Following the dramatic increases in oil prices in 1973 and after, government revenues in the Gulf oil countries recorded substantial annual average increases ranging between three and five fold. At present, no less than 85 per cent of total government revenues in these countries is generated by oil receipts and investment income. But with the appearance of oil glut in the early 1980s, government revenues in these countries dropped. As a matter of fact budgetary deficits were incurred in some countries after 1982, and had to be financed from surpluses of previous years. To mitigate the impact of lower government outlays on economic activity, as was the case in 1983 and 1984, efforts are being made to increase the involvement of the private sector in economic activities.1/ This could be taken to highlight the growing need in the oil countries to institute higher taxes and a more equitable income distribution, as well as to introduce tax reform that would subordinate the tax system to overall development efforts.

In the non-oil countries, where fiscal policy is more developed, government revenues recorded marked increases since the early 1970s, but had to be supplemented by internal loans and external aid to finance development expenditures and, in some countries, current expenditures. A striking feature of government revenues in the non-oil countries is the heavy reliance on indirect taxes (customs duties). Only in a few of these countries direct taxes have shown some increase.

What needs to be highlighted is that government expenditures in the oil as well as the non-oil countries increased markedly and in certain countries, such as Saudi Arabia, Bahrain, and United Arab Emirates, increased at faster rates than GDP. In the non-oil countries, government dissaving occured as expenditures increased faster than revenues. For instance, the budget deficit in Syria increased from LS 2096 million (or 7.5 per cent of GDP) in 1975 to LS 13161 million (18.4 per cent) in 1982, whereas in Jordan the deficit increased from JD 18.8 million (5.9 per cent) to JD 108.6 million (7.9 per cent), respectively.[2/]

Development expenditures have generally tended to increase at a higher rate than current expenditures, particularly in the oil countries. This should not overshadow the fact that current expenditures have increased notably in various directions, including education, health, housing and defense. It is observed that expenditure classification in use in most of the Arab countries does not provide sufficient guidelines for dividing government budgetary transactions into current, capital and financial categories.[3/] This obviously limits the use of available figures in analysing the economic and social impact of the budget.

Focussing on public investments in the industrial sector, one is apt to be encountered with lack of adequate data and detailed information. However, an attempt will be made below to assess the place of industry in overall public investments, using both regional and national data. Unless otherwise stated, the concern will be with manufacturing industry only. This excludes the mining and oil-exporting industries, but includes industries based on the processing of mining products and extracted oil such as fertilisers, refining and petrochemicals.

As alluded to earlier, manufacturing industry in most of the Arab countries recorded significant expansion over the last two decades. During 1970-81, the average annual rate of growth ranged between 11 and 14 per cent in Tunisia, Algeria, Libya and Yemen, compared with 8 per cent in Kuwait, Syria and Egypt, and 5 per cent in Saudi Arabia and Morocco. It is to be noticed, however, that the share of manufacturing industry in GDP remained relatively modest. In 1983, only 8.3 per cent of GDP of the Arab countries as a whole was contributed by manufacturing industry, though this contribution varied markedly between individual countries.4/

Table (I) presents a comprehensive picture of Arab investments in manufacturing industry during 1970-85. Although it is not possible to relegate public investments out of these figures, which include private investments, it is thought that as these figures represent investments made in the context of development plans implemented by the countries concerned they stand largely for public investments. This can be supported by the fact that in the oil countries most of the financing

TABLE (I)

Investments in Manufacturing Industry in Groupings of Arab Countries, 1970-85

(in current prices; value in $ million)

| Country Grouping | 1970-75[a] | | | 1975-80[a] | | | 1980-85[a] | | |
|---|---|---|---|---|---|---|---|---|---|
| | Value | % of all sectors | % of all countries | Value | % of all sectors | % of all countries | Value[b] | % of all sectors | % of all countries |
| A. Oil Countries | | | | | | | | | |
| GCC countries[c] | 599.9 | 5.1 | 5.3 | 19475.9 | 14.7 | 31.1 | 38569.0 | 12.9 | 32.5 |
| Others [d] | 3800.2 | 18.3 | 33.6 | 28611.0 | 30.2 | 45.7 | 54947.0 | 18.5 | 46.2 |
| Total | 4400.1 | 13.5 | 38.9 | 48086.9 | 21.4 | 76.8 | 93516.0 | 15.7 | 78.7 |
| B. Medium-Income Countries [e] | 6624.5 | 24.3 | 58.5 | 13744.9 | 22.8 | 21.9 | 23906.0 | 19.6 | 20.1 |
| C. Low-Income Countries [f] | 302.1 | 11.1 | 2.6 | 798.9 | 9.9 | 1.3 | 1375.0 | 10.0 | 1.2 |
| GRAND TOTAL | 11326.7 | 22.3 | 100.0 | 62630.7 | 21.3 | 100.0 | 118797.0 | 16.2 | 100.0 |

a/ Plan periods are not unified and range between 4 and 5 years.
b/ Planned investments.
c/ Gulf Cooperation Council (GCC) includes in its membership Saudi Arabia, Kuwait, Qatar, U.A.E., Bahrain and Oman.
d/ Algeria, Iraq and Libya. Investments of Iraq which are incorporated in total figures are estimates.
e/ Jordan, Tunisia, Syria, Lebanon, Egypt and Morocco.
f/ Mauritania, Djibouti, Democratic Yemen, Yemen and Somalia.

Source: Compiled from Arab League-AMF-AFESD-OAPEC, Unified Arab Economic Report, 1984, p.204.

of industrial projects, particularly basic industries, comes from public funds arising largely from oil revenues. Moreover, apart from Jordan, Lebanon, Morocco and Tunisia, the private sector plays a limited role in financing industrial investments.

It is revealed that during 1970-75 the Arab countries allocated 22.3 per cent of their total development expenditures to manufacturing industry, but this ratio declined slightly to 21.3 per cent during 1976-80. The planned investments for the period 1980-85 account for only 16.2 per cent of total planned development expenditures. More importantly, it is noticed that the share of manufacturing industry in total development expenditures increased in the oil countries from 13.5 per cent during 1970-75 to 21.4 per cent during 1976-80, whereas it declined slightly in the medium-income countries from 24.3 per cent to 22.8 per cent, and in the low-income countries from 11.1 per cent to 9.9 per cent, respectively. As a result, the share of the oil countries in total Arab investments in manufacturing industry increased substantially to 76.8 per cent during 1976-80, against 38.9 per cent during 1970-75, and is expected to account for 78.7 per cent of total planned investments during 1980-85.

On the basis of these figures, it is possible to visualise a direct relationship between public finance and industrialisation.

It is evident that there has been an upsurge in industrial investments with the increase in government revenues. This could be related to the public preference for industry, in view of the direct and indirect developmental effects. But it seems that in most countries, particularly those that are oil producing, public investments in manufacturing industry had little effect on the tax base, as can be discerned from the industrial policies pursued by the Arab countries and the emerging patterns of industrial growth.

## Industrial Policies

The path of industrial development followed by the Arab countries is similar generally to that pursued by most countries in the Third World. Yet, it is observed at a lower level of generality that there is some contrast in the industrial development orientation, objectives, investment priorities and policies of the Arab oil and non-oil countries.

With respect to the oil countries, there is a strong emphasis on outward-looking industrialisation. The basic concern of these countries is the maximisation of overall economic growth in terms of GDP, expanding and improving the physical infrastructure, and modernising the socio-economic set-up. This is conditioned mainly by the availability of investible funds that need to be transformed as quickly as possible into income-generating assets, as well as by the nature of national resources and the size of the market. In contrast, industrialisation in the non-oil countries is largely inward-looking, oriented to self-reliance for fulfilling basic needs and reducing external dependence. The main objective is to achieve a high rate of economic growth, higher than the rate of population increase, associated with a fair distribution of income and wealth, expanding the material production and related infrastructure, and creating employment.

The first wave of industrialisation in the Arab countries came in the early 1950s. It embraced most of the non-oil countries, particularly Egypt, Syria, Lebanon and Jordan, as well as Iraq which is a major oil producer. Industrialisation was largely induced by policy instruments favouring import-substitution, with a view to take advantage of existing local demand, to save foreign exchange by reducing imports, and to promote self-sustained growth. Tariff protection is the most widely used instrument for the promotion of industrial activity in these countries, and in some cases it is associated with quantitative restrictions in the form of import licensing and a quota system. It is of interest to note that in countries which experience a deficit in their current account, such as Egypt and Jordan, these measures have been utilised both defensively to deal with the payments situation and positively to attain the objective of greater industrialisation. The effect of these instruments on industrial development arises from their discriminatory impact on relative prices of inputs and outputs, and hence on the allocation of resources.

The direct participation of the public sector in industrialisation emerged in the early 1960s as a policy aspect in some of the non-oil countries, following nationalisation measures. Though this participation was meant to achieve industrial growth targets that cannot be attained by the private sector, either due to lack of resources or risks involved, it did discourage private investments. For instance, during 1969-74 the public sector in Egypt provided no less than 95 per cent of industrial investments,[5/] and by 1975 it accounted for about 76 per cent of gross fixed investments in industry.[6/] In Syria, cumulative industrial investments by the public sector accounted for about 80 per cent of total industrial investments by 1974.[7/]

Another wave of industrialisation in the Arab countries came in the early 1970s, following the increase in oil prices. It embraced the oil-producing countries, particularly Saudi

Arabia, Kuwait, United Arab Emirates, Qatar and Bahrain. This wave which is evolving mainly in an international context has been prompted by two concurrent forces. One is a push force arising from the need of the oil countries to invest a part of their oil revenues, and to increase the value-added of their oil exports by processing crude oil in one form or another. The other is a pull force arising from the desire of multinational companies to take advantage of cheap energy by establishing, in partnership with the oil governments, process industries that are highly integrated with the industrialised countries.

In analysing the impact of the public finance situation on industrial policies, one would notice that these policies have been shaped basically by the quest for industrialisation as a means for diversifying economic structure and income, for internalising the dynamics of economic growth, and for gaining prestige. It is not unrealistic to observe that in most Arab countries, governments have been more concerned with the size of the industrial sector than with the efficiency with which it performs. Excessive tariff protection and quantitative restrictions in some countries led to the creation of industrial plants with high cost structure. However, this protection helped to keep industrial returns at comparatively high levels, thus allowing for higher wages and subsequently for a broader scope for income taxation.

With respect to countries which experienced a rapid expansion of their public sectors, primarily through nationalisation measures, it can be discerned that the policy of establishing public industrial enterprises was motivated by the desire to enhance government revenues, apart from contralising ownership and management of the industrial sector. It is difficult to ascertain the profitability of public enterprises, as these do not issue regular profit-and-loss statements. But it is reckoned that governments generally intervened to cover losses of some of these enterprises.[8/] However, it is of interest to note that in the case of Syria transfers from the public sector enterprises accounted during the 1970s for much of the increase in total government receipts, since non-tax sources of revenues increased while tax revenues showed a steadily declining trend.[9/]

The impact of the public finance situation on industrial policies in the oil countries could be depicted from the sizeable investments made in large-scale industries. These industries are not expected to operate, at least in the early years, without the financial support of the government. In point of fact, the developing setting in the oil countries acts to increase the capital cost of industrial projects as well as the working capital and pre-operating expenses, thus threatening to erode whatever international competitiveness these countries may have due to the abundance of oil resources. Hence, it seems that without the varying forms of subsidy that the public finance situation allows, large-scale industries installed or entertained in the oil countries would not be conceivable.

## Industrial Patterns

There are marked differences in the emerging patterns of industrialisation between the oil and non-oil countries. Table (II) presents the structure of manufacturing industry in the Arab countries in 1980. It reveals that in the non-oil countries there is a marked bias for consumer industries, whereas in the oil countries the bias is for intermediate industries. In both groups of countries (with the exception of Libya) capital industries represent only a minor share.

Import-substitution industrialisation in the non-oil countries induced the establishment of consumer non-durable industries, especially those that are not demanding in terms of capital and technology and can be operated with relative efficiency within the confines of the domestic market.

TABLE (II)

Structure of Manufacturing Industry in Arab Countries, 1980

(in percentages)

| Country | Consumer Industries | Intermediate Industries | Capital Industries | Total |
|---|---|---|---|---|
| Non-Oil Economies | | | | |
| Jordan | 51.2 | 31.7 | 16.4 | 100.0 |
| Tunisia | 61.1 | 25.2 | 13.7 | 100.0 |
| Sudan | 57.0 | 29.0 | 14.0 | 100.0 |
| Syria | 74.1 | 13.2 | 12.7 | 100.0 |
| Somalia | 65.9 | 33.0 | 1.0 | 100.0 |
| Lebanon | 54.0 | 31.8 | 14.2 | 100.0 |
| Morocco | 45.9 | 35.0 | 19.1 | 100.0 |
| Mauritania | 93.0 | 3.5 | 3.5 | 100.0 |
| Yemen | 55.2 | 35.5 | 9.3 | 100.0 |
| Dem. Yemen | 30.7 | 64.9 | 4.4 | 100.0 |
| Oil Economies | | | | |
| U.A.E. | 15.7 | 74.0 | 10.3 | 100.0 |
| Iraq | 38.3 | 42.3 | 18.8 | 100.0 |
| Qatar | 21.5 | 68.4 | 10.6 | 100.0 |
| Kuwait | 12.4 | 78.4 | 6.1 | 100.0 |
| Libya | 18.2 | 40.1 | 42.2 | 100.0 |
| Arab World | 48.4 | 38.7 | 12.0 | 100.0 |

Source: Arab Industrial Development Organisation, Basic Paper on Arab Industrial Development, Document No. 1, presented to 6th Arab Industrial Development Conference, Damascus, 20-25 October 1984, p. 81.

Note: Figures for some countries do not add up to total, presumably due to rounding.

In a way, these countries are trying to make the process of industrial development more adapted to their national human and natural resources. Table (III) reveals the distribution of employment in manufacturing according to industrial branches in 1980. It is noticed that in the non-oil countries, particularly Syria, Egypt, Jordan and Sudan, consumer industries (food and textiles) provide employment for a ratio ranging between 40 and 60 per cent of total workers engaged in manufacturing.

However, it is generally observed that manufacturing industry in the Arab countries has not been absorbing labour at a satisfactory rate, at a time when employment creation is a major objective of industrial development. This phenomenon could be explained by the drift towards capital-intensive and labour-saving techniques of production, due to the importation of technologies that have been determined by the requirements and factor endowment of industrialised countries. In point of fact, the "capital deepening" in the industrial sector in some of the non-oil countries has been induced by the cascaded structure of tariff rates which favours the importation of capital goods and machinery.

What needs to be highlighted is that the bias for consumer industries did not help to develop in the non-oil countries

TABLE (III)

Employment in Manufacturing Industry in Arab Countries, 1980
(000 workers)

| Country | TOTAL EMPLOYMENT | Branches of Manufacturing Industry | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Food | Textiles | Wood & Furniture | Paper & Printing | Chemicals | Non-metallic mineral | Basic Metals | Machinery | Others |
| Algeria | 341.0 | 54.6 | 52.2 | 13.6 | 20.5 | 70.2 | 42.9 | 17.7 | 56.6 | 12.6 |
| Iraq | 229.3 | 51.3 | 57.5 | 5.3 | 9.0 | 22.3 | 41.4 | 0.8 | 40.9 | 0.6 |
| UAE | 39.2 | 5.5 | 0.7 | 3.4 | 0.7 | 5.5 | 8.4 | 5.9 | 9.1 | - |
| S. Arabia | 148.1 | 29.2 | 4.3 | 3.1 | 16.4 | 17.6 | 44.4 | 29.9 | - | 3.1 |
| Kuwait | 31.0 | 4.7 | 4.7 | 2.4 | 1.2 | 9.2 | 3.5 | 0.6 | 4.7 | - |
| Libya | 58.0 | 25.3 | 18.9 | 1.0 | 0.5 | 3.9 | 6.0 | - | 2.9 | - |
| Jordan | 73.6 | 17.5 | 13.1 | 5.3 | 2.6 | 13.3 | 7.7 | 12.4 | - | 1.5 |
| Tunisia | 399.7 | 60.8 | 114.7 | 7.2 | 9.2 | 13.6 | 74.3 | - | 66.0 | 53.6 |
| Syria | 230.4 | 51.5 | 97.4 | 16.8 | 2.7 | 15.9 | 19.1 | 1.4 | 22.7 | 2.9 |
| Egypt | 1532.0 | 278.8 | 706.3 | 32.2 | 42.6 | 235.0 | 9.2 | 189.6 | 38.3 | - |
| Sudan | 183.3 | 84.5 | 65.1 | 1.1 | 6.6 | 13.2 | 4.4 | - | 8.8 | - |
| Somalia | 95.3 | 41.7 | 25.4 | 2.8 | 7.2 | 3.6 | 7.2 | 1.0 | - | 6.4 |
| Yemen | 128.4 | 37.4 | 28.4 | 2.6 | 1.8 | 17.9 | 15.4 | 3.9 | 12.2 | 9.0 |
| Dem. Yemen | 36.4 | 9.5 | 16.0 | 1.3 | 3.0 | 2.2 | 0.4 | - | 3.9 | - |
| Total | 3527.0 | 752.2 | 1204.9 | 98.1 | 124.0 | 443.0 | 474.3 | 73.6 | 266.1 | 89.7 |

Source: As for Table (II), p. 87

Note: Figures may not add up to total due to rounding.

an integrated industrial sector, in terms of both its ability to meet increasingly the demand for manufactured goods by the other sectors of the economy and its reliance on locally produced rather than imported supplies of intermediate and capital goods. It is expected that inter-sectoral linkages would increase once the process of industrialisation proceeds through backward linkages to the production of intermediate and capital goods. But considering the smallness of the domestic market in most of the Arab countries, a more efficient import-substitution with a spillover to external markets ought to be conceived.

As to the oil countries the emerging industrial patterns are characterised by the heavy emphasis on hydrocarbon-based and energy-intensive industries. Already a wide array of oil refining capacities and petrochemicals plants have been set up in the Arab Gulf region, together with smelting operations for aluminium and iron and steel. These industries comply with the factor endowment of the oil countries, but their success depends to a large extent on the ability of the countries concerned to minimise production costs in order to compete in international markets. On the average the capital cost of a plant in the Arabian Gulf region is 50 per cent higher than that in Western Europe. Also operating costs tend to be high due to the smallness of the domestic and regional markets, to which these industries are oriented in the shorter-run.

As alluded to earlier, it seems that government financial support to these industries is essential at the present stage, and hence they cause a drain on public funds. However, it is possible to conceive the petrochemical industry as a center for smaller industrial units. The chain of production which could emerge from the petrochemical industry in various directions would definitely amplify the domestic effects and induse the generation of investments and employment.

## Concluding Observations

/Verbal Statement/

## FOOTNOTES

1/ Economic Commission for Western Asia, Mid-Term Review and Appraisal of Progress in the Implementation of the International Development Strategy for the Third United Nations Development Decade in the ECWA Region, E/ECWA/XI/6/Add. 1, 9 April 1984, p. 118.

2/ Arab Monetary Fund, Economic Statistics on Arab States, 1975-82, Abu Dhabi, April 1984, pp. 12 and 15 (in Arabic).

3/ Economic Commission for Western Asia, Survey of Economic and Social Development in the ECWA Region, 1970-78, E/ECWA/80, 29 April 1979, pp. 45-46.

4/ In individual countries, the share of manufacturing industry in GDP in 1983 was as follows (in per cent): Morocco (16.2), Jordan (15.4), Tunisia (14.6), Algeria, Egypt and Lebanon (13.0), Democratic Yemen and Bahrain (11.0), Syria (10.0), U.A.E. (9.0), Yemen (8.2), Iraq (7.0), Qatar, Kuwait and Saudi Arabia (6.0), Libya (3.5), and Oman (1.5). Arab League-AMF-AFESD-OAPEC, Unified Arab Economic Report, 1984, pp. 200-201 (in Arabic).

5/ World Bank, Arab Republic of Egypt: Economic Management in a Period of Transition, Vol. VI: Statistical Appendix, pp. 117-18.

6/ Arab Republic of Egypt, Ministry of Industry and Mineral Resources, Elements of the Industrial Development Strategy in Arab Republic of Egypt Until 2000, a study presented to the 4th Conference on Industrial Development for Arab States, Baghdad, December 1976, p. 3 (in Arabic).

7/ Syrian Arab Republic, Central Bureau of Statistics, Statistical Abstract of 1976, Vol. 29, December 1976, p. 301.

8/ Burhan Dajani, Patterns of Rapid Growth, an address at the 6th ICC Annual Conference, Seoul, 25-28 March 1985, p. 6

9/ Economic Commission for Western Asia, Survey of Economic and Social Development in the ECWA Region, op. cit., p. 41.