

Kuwait Programme on Development, Governance
and Globalisation in the Gulf States

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January 2011

Number 13

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The Programme is funded by the Kuwait Foundation for the Advancement of Sciences.

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Research Paper, Kuwait Programme on Development, Governance and Globalisation in the Gulf States

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Published in 2011.

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Anatomy of an Oil-Based Welfare State: Rent Distribution in Kuwait

LAURA EL-KATIRI, BASSAM FATTOUH AND PAUL SEGAL

Abstract

Oil wealth has transformed Kuwait within decades from a modest, trade-based desert emirate into a modern city-state. It has also created a relatively egalitarian economy based on an extensive distributive system that provides Kuwaiti citizens with essential services including free healthcare, education and social security. Therefore, the most important fact about Kuwait's oil wealth is that it has been successfully used to benefit its citizens. This feat has been achieved through a broad distributive welfare state. Nevertheless, Kuwait's policies of rent distribution have developed in an ad hoc manner into an uncoordinated system. Some of Kuwait's policies of rent distribution, such as subsidizing utilities and providing public employment, have resulted in substantial distortions, inefficiencies and institutional deficiencies, and thus there remains substantial scope for improvement.

1. INTRODUCTION

Oil has made Kuwait rich. Oil is Kuwait's largest productive sector by a long way, and oil rents are the foundation of even the non-oil economy. But wealth does not lead automatically to economic and social development. Kuwait's achievement is that it has, for the most part, used its oil income to provide a high standard of living for full Kuwaiti citizens, while to a much lesser extent also benefiting non-Kuwaitis. Oil wealth has transformed the country within decades from a modest, trade-based desert emirate into a modern city-state. It has also created a relatively egalitarian economy based on an extensive distributive system that provides Kuwaiti citizens with essential services including free healthcare, education and social security. Therefore, the most important fact about Kuwait's oil wealth is that it has been successfully used to benefit its citizens. This feat has been achieved through a broad distributive welfare state, developed over the decades since oil was discovered.

Nonetheless, Kuwait's policies of rent distribution have developed in an ad hoc manner into an uncoordinated system with substantial distortions, inefficiencies and institutional deficiencies. These include the long-term use of subsidies to energy and other utilities that lead to inefficient use and misallocation of resources; a highly segmented labour market whose ability to absorb large numbers of young Kuwaitis outside the public sector remains in doubt; and an uncompetitive and deteriorating business environment that stifles private and foreign investment.

In our analysis we also note, however, that given Kuwait's extensive wealth, the structure of the economy and productive relations will necessarily look different from those in most countries. One therefore has to be careful to distinguish between policies and behaviours that are genuinely inefficient or distorting and those – such as low labour force participation – that may be a rational response to unearned wealth.

The main purposes of this paper are to examine the effects of Kuwait's extensive welfare system and identify the various channels of rent distribution that underlie it.

2. OIL RENT AND THE TRANSFORMATION OF KUWAIT

In an economy dominated by natural resources the management of the *rents* becomes one of the most important roles of the government. Here we take the standard economists' definition of rents as *payments to a factor of production over and above that required to induce it to do its work* (Wessel 1967). This definition implies that resource rents are any payments to the owner of a natural resource that remain once labour (including highly skilled labour), capital (including technology) and any other inputs to the extraction of the resource have been paid.¹ In most resource-rich countries these rents accrue to the government. In countries like Kuwait in which the modern state apparatus developed after or during the development of the resource sector, countries often referred to as rentier economies or rentier states, the development of the institutions and policies of the government are heavily influenced by its role as the manager and distributor of rents (Mahdavy 1970; Beblawi 1987; Karl 1997).

2.1. Kuwait's pre-oil economy

Kuwait's pre-oil economy was marked by three main features: first, the accumulation of early wealth in Kuwait during the eighteenth and nineteenth centuries through trade and trade-based activities, largely in the hands of the merchant families; secondly, the political stabilization of the emirate of Kuwait under the family of the Al-Sabah, which provided the stability needed for successful trade; thirdly, the virtual absence in any form of the welfare state known in Kuwait today.

Kuwait was founded in the early eighteenth century by a group of tribal clans that had migrated from the Najd in Saudi Arabia. Owing to its rich coastal waters, its suitability at the upper edge of the Western side of the Gulf as a natural harbour, and its strategic location

¹ This follows from the definition because there is no opportunity cost to extracting natural resources: since they are worth nothing in the ground, any payment left over after extraction counts as rent.

between the mainland trade routes between Baghdad and Aleppo, Kuwait soon flourished as a trading hub between the East and the West. The economy's main businesses sectors – land trade, seafaring and a lucrative pearl industry – laid the foundations for early wealth creation in Kuwait, primarily in the hands of the merchants and trading families of Kuwait (Al-Sabah 1980: 23; Crystal 1995: 19). Soon known throughout the Gulf region as Kuwait's powerful elite, the merchant families not only dominated economic life, but also constituted an important element in the political balance between the amir, the ruler of Kuwait, on the one hand, and the ruled on the other (Crystal 1995: 19).

Prior to the discovery of oil, the amir remained financially dependent on taxes and customs duties collected from the population. In the nineteenth century the merchants, as the main providers of these funds, exercised a strong influence on policy making under the amir. In the early twentieth century as the amir began to benefit from strategic rent paid by the British and from the first payments for oil concessions, the merchants sought to reassert their influence through a political movement that led to a short period of political confrontation and, briefly, to the creation of an elected assembly, the majlis, during the 1930s (Crystal 1995: 47).²

This period overlapped with a period of economic decline caused by developments partly outside Kuwait's control: the 1920s began with a conflict over trade routes with Saudi Arabia, leading to many routes being blocked for much of the decade. The dependence of Kuwait's economy on international trade meant that the emirate was severely hit by the global financial crisis of the 1930s. The collapse of the pearl industry in the Persian Gulf during this period, a result of a flooding of international markets with cheap mass products from East Asia, further compromised the economy. While most of Kuwait's merchant community proved to be resilient to the crisis, those working further down the hierarchy, such as pearl divers, boat builders and Bedouin tribes, faced increasing impoverishment (Al-Sabah 1980: 16–24; Khalaf and Hammoud 1988).

2.2. Kuwait's oil economy

Oil was first discovered in Kuwait in 1938, following a concession agreement between the state of Kuwait and Britain that allowed the British to explore and produce from Kuwaiti oil

² A majlis is a traditional form of assembly usually comprising tribal elders, but in this format also includes representatives of leading families, gathering with the amir and discussing policy issues.

fields, with production starting in 1948. Kuwait's oil revenues grew substantially in the decades after oil was discovered, rising from US\$760 thousand in 1946 to US\$567.5 million by 1965 and, following the oil price bonanza of the mid-1970s, US\$9.8 billion in 1976, the equivalent of 2.3 times non-oil GDP, or 70 per cent of total GDP (Khouja and Sadler 1984: 39; Ismael 1993: 135; authors' own calculations).³

Kuwait's oil revenues have always accrued directly to the state.⁴ Until 1975, the mechanism was royalties and taxes on profits paid by foreign oil companies. In 1975, Kuwait nationalized the country's oil industry, and in 1980 placed both the upstream and downstream sectors under the control of its national oil company, the Kuwait Petroleum Company. With such vast rent income, the state not only became extraordinarily wealthy, but also found itself in control of the majority of the economy's overall output. The removal of most taxes levied on the domestic economy since the early 1950s clearly signalled that the basic relation between the state and its citizens was no longer one of mutual financial dependence, but one defined by the purely distributive role played by the state.

It became clear soon after the discovery of oil that the state, as the owner and distributor of such substantial parts of the economy's wealth, needed to modify its approach to the economy as a whole. In the absence of a central planning department during the 1950s and early 1960s, the government began to spend increasing sums on the country's social and economic infrastructure. Kuwait's first five-year plan, adopted in 1967, defined the state's long-term objectives: first, the diversification of Kuwait's economy towards a self-sustaining growth independent of oil revenues; secondly, ensuring an equitable distribution of income among Kuwaitis; and thirdly, the training of Kuwait's human resource base and the development of specialized skills (Ismael 1993: 135).⁵

As a result of its need to channel rent into the economy following these objectives, the role of the state in the economy grew. The mining and quarrying sector, since 1975 entirely state-owned, has accounted for more than half of the Kuwaiti economy's output continuously

³ GDP shares are at domestic prices.

⁴ Until the 1962 constitution, the recipient of oil royalties was the amir of Kuwait. This changed with the introduction of a written constitution which made Kuwait one of the first countries in the Gulf to declare formally that all of the country's natural resource revenues belonged to the state, rather than the ruler (Kuwaiti Constitution, Part 2 Art.21, available at www.kt.com.kw/ba/dostour.htm).

⁵ These aims have been reiterated throughout Kuwait's development plans, the most recent of which was adopted in early 2010 (Government of Kuwait 2009).

since the 1950s (KASA 2008: 220, Table 139).⁶ Various industries, such as the refining, petrochemicals and fertilizer industries, as well as other economic sectors such as transport and logistics, have been highly dependent on the country's oil sector. In addition, sectors such as banking and finance and real estate have benefited from the availability of large sums of capital in Kuwait due to oil rents. In this way much of Kuwait's economy outside the oil sector proper is dependent on oil. The private sector, alongside many public business sectors, benefits not only from direct transfers and subsidies, but also from the overall high living standards of Kuwaitis and high public investment in infrastructure. For these reasons the state in Kuwait has been described as the prime mover of the economy (Al-Sabah 1980: 72; Ismael 1993: 95, 105; NBK 2001–9 (2003): 19).

Kuwait's total population by the mid-1950s reached barely 200,000 individuals and grew at a rapid pace to 2.2 million by 2005. While some of this population expansion was due to natural growth, a large part of it was due to migration of expatriate labour to Kuwait, most immigrants coming on temporary work permits and visas. The percentage of Kuwaiti nationals both in Kuwait's total population and in Kuwait's workforce has declined substantially since the 1950s. Today 1.3 million people living in Kuwait, or more than 60 per cent of the population, are expatriates, primarily from Asia and other Arab countries, while non-Kuwaitis comprise 81 per cent of Kuwait's workforce (see Table 1). Kuwaiti nationals thus constitute a minority in their own country, and their participation rate in the national labour force is extremely small by international standards, with only 42 per cent of the working age (15–64) population employed (KASA 2008: 25, Table 24).⁷ An important consequence of the dichotomy within Kuwait's overall population is that one would expect the distribution of rent by the government to be aimed primarily at Kuwaiti nationals, as opposed to expatriates who have few legal rights and no legal claim on the country's oil wealth.

⁶ With a brief exception during the Iraqi invasion in 1990/1 as a result of the stopping of all industrial activity in the country.

⁷ The figure of 42 per cent does not take into account those in full-time education, for which we do not have data. Approximately one quarter of 25–9-year-olds and 30–4-year-olds have university or postgraduate education. Assuming that a quarter of 15–24-year-olds are in education and removing them from the total population implies a participation rate of 46 per cent, still a low figure.

Table 1. *Kuwait's population and labour force according to nationality, 1957–2005*

Year	Nationality	Population	% of total	Labour force	% of total
1957	Kuwaiti	113,622	55	24,602	30.6
	Non-Kuwaiti	92,851	45	55,686	69.4
	Total	206,473	100	80,288	100
1965	Kuwaiti	168,793	36.1	43,018	23.3
	Non-Kuwaiti	298,546	63.9	141,279	76.7
	Total	467,339	100	184,297	100
1975	Kuwaiti	307,755	30.9	91,844	30.2
	Non-Kuwaiti	687,082	69.1	212,738	69.8
	Total	994,837	100	304,582	100
1985	Kuwaiti	470,473	27.7	95,812	14.3
	Non-Kuwaiti	1,226,828	72.3	574,573	85.7
	Total	1,697,301	100	670,385	100
1995	Kuwaiti	653,616	41.5	105,189	18.4
	Non-Kuwaiti	921,954	58.5	466,836	81.6
	Total	1,575,570	100	572,025	100
2005	Kuwaiti	860,324	39.2	217,131	18.9
	Non-Kuwaiti	1,333,324	60.8	929,245	81.1
	Total	2,193,651	100	1,146,376	100

Source: KASA (1977, 1994, 2000, 2008).

3. CHANNELS OF RENT DISTRIBUTION

The primary economic question facing the Kuwaiti government is how to spend its oil revenues. The challenge in distributing government oil rents derives from the fact that there is no final consumer to whom they ‘naturally’ accrue (Segal forthcoming). In most economic activities the majority of value added gets distributed as wages and profits, most of which is then spent by the recipients in the private sector. In contrast, oil revenues flow directly into the treasury, and their distribution is decided by political means. When resource rents substitute for taxation of the private sector, as in the case of Kuwait, then individuals also

benefit according to how their actual tax bill compares with the counterfactual situation of the absence of the resource. Thus, the elimination of taxation of the private sector is not a distribution-neutral tax policy: if taxation in the absence of the rents would be progressive, then the elimination of taxes is regressive. While we cannot identify the counterfactual of what the economy or fiscal policy would look like without rents, we can identify the policies and channels used by the government to distribute oil rents.

These channels comprise fiscal policies that determine the distribution of the current benefits of oil rents. But Kuwait, like a number of resource-rich countries, also saves a share of oil receipts in the form of a sovereign wealth fund, named the Reserve Fund for Future Generations (RFFG). Sovereign wealth funds are at heart also a component of distributional policy in that they distribute the benefits of today's oil revenues to future generations. We discuss sovereign wealth funds in general and the RFFG in particular in more detail below.

In this section we identify eight main channels through which the Kuwaiti government distributes rents into the wider economy. These are domestic public investment, land purchases, public transfer payments, subsidies, public employment, intervention in the private sector, the regulation of Kuwait's FDI environment and, finally, investment abroad. It is important to note that some of these channels do not involve direct distribution of resources, but rather involve the creation of regulatory rents which benefit certain sections of the society.

3.1. Domestic public investment

Since the beginning of the 1950s, the government has invested substantially in infrastructure, the country's economic diversification programme, and social services including health and education – which can also be seen as benefits in kind received by the population. These investments serve multiple purposes, all of which relate to the government's three central objectives of helping diversify the economy, developing the country's skills base and channelling oil revenues to the population (Ismael 1993: 135). Although the efficiency of and returns on some of these investment projects have been quite low, and achieving the objective of diversifying the economy remains elusive, public investment has been successfully used to benefit Kuwaiti citizens. Kuwait can look back at some important achievements in key areas such as literacy, education and health. This contrasts with some of the discourse in the 'oil-curse' literature where it is argued that weak institutional features, such as poor governance

structure, a lack of accountability in government spending decisions, corruption and a lack of long-term planning, prevent citizens from benefiting from their oil wealth at all.

Fighting illiteracy and building a comprehensive education system accessible to all Kuwaitis were among the earliest priorities for the government's social programmes. The government invested heavily in the construction of schools, the hiring of rapidly increasing numbers of teachers – most of them from other Arab countries such as Egypt and the Palestinian territories, owing to a lack of Kuwaiti teachers – and literacy programmes aimed at the then largely illiterate population. In 1966 Kuwait University opened its doors to both Kuwaitis and children of expatriates living in Kuwait (Al-Sabah 1980: 57–8). Kuwait's education system is still free to both Kuwaiti nationals and non-Kuwaitis, and includes free books, school uniforms, meals, transportation and, for low-income families, a parental allowance. University education includes free dormitories, meals, sportswear, transportation and field trips. Kuwait awards some of the Gulf's most generous state funding to provide high-achieving students with scholarships to study abroad (Crystal 1995: 57).

Expenditure on education in Kuwait has accordingly been one of the largest items on the government's budget, typically representing some 5 per cent of GDP and 13 per cent of total government expenditure, comparable to, if not higher than, spending in high-income OECD countries (MBRF and UNDP/RBAS 2009: 298, Table 29; World Bank 2009). Kuwait has one of highest literacy rates in the MENA region – more than 94 per cent – including the MENA's highest rate of literacy for women of 91 per cent, and among the region's highest rates of gross school enrolment of 75 per cent (UNDP 2009: 253, Table 25; World Bank 2009). The style and content of Kuwait's education system have, however, been criticized along with those of other Arab states.⁸

The 1950s also marked the beginning of a comprehensive approach towards improving Kuwait's formerly non-existent medical infrastructure, with medical treatment now being free to both nationals and expatriates. Despite criticism, particularly with regard to its cost, Kuwait's health system is seen today as one of the best in the region. Where Kuwait does not possess the necessary medical expertise, medical treatment for Kuwaitis is paid for

⁸ Criticism mainly concerns the mismatch between the skills of Kuwaiti graduates and the needs of the economy (Al-Sabah 1980: 58; Crystal 1992: 62). While much has been done by the government to encourage more students to study science subjects and to undertake vocational training, a report produced by MBRF and UNDP/RBAS (2009: 105–31) argued that many problems remain (see also the section on the labour market below).

abroad in specialist clinics, with transportation as well as accommodation costs for patients and their relatives paid for by the state (Crystal 1992: 62).

Beyond these social programmes, the state also initially invested heavily in public infrastructure and the development of an industrial base in a state-led drive for economic diversification. Infrastructure in the form of roads, harbours and an airport was key to any future growth of economic activity outside the all-dominating oil sector. While such infrastructure projects were initially essential to Kuwait's progress, the limited returns on government investment in the industry soon became evident. A lack of planning behind parts of the infrastructure development projects during the 1950s and 1960s in particular have been criticized (Al-Sabah 1980: 110–11). Unsuccessful cases of national companies include Kuwait Airways, which has been making losses for several decades, since its establishment in 1954 (Al-Sabah 1980: 63).

3.2. Land purchases

A second channel for the distribution of Kuwait's oil wealth, particularly during the 1950s and 1960s, was Kuwait's land purchase programme. Despite its name, the programme was essentially designed as a form of transfer system with the aim of channelling the state's rapidly growing rent income to the population, while also redistributing land ownership on a large scale (Al-Sabah 1980: 57; Khouja and Sadler 1979: 44). Under the land purchase programme during the 1950s and up to the 1980s, the central government bought land that was not in use from Kuwaiti nationals at highly inflated prices, retained some for public buildings, and sold the remainder back to the public at low prices. These transactions implied transfers of wealth to both sellers and purchasers of land. In the early 1960s, one quarter of total government expenditure went into the land purchase programme (Al-Sabah 1980: 57).

The programme, however, lost its momentum during the 1980s and 1990s. Today, less than 3 per cent of total government expenditure is on land purchases (KASA 2008: 229, Table 145). The decline of the programme may have been partly due to the decline in land available for purchase, but it may also have been a response to severe criticism aimed at the programme throughout the 1960s and 1970s. Some observers objected that it was a highly inequitable redistribution of wealth and a major distortion of the real estate market (IBRD 1965: 45; Al-Sabah 1980: 57; Crystal 1992: 62). A World Bank report from 1965 describes the land purchase programme as 'a rather indiscriminate and inequitable way of distributing

the oil revenues. In addition, probably the largest share of these funds are invested abroad, so that the land purchase program fails to accomplish its main objective of invigorating the Kuwaiti economy' (IBRD 1965: 4). Crystal argued that the main beneficiaries of the programme have been Kuwait's wealthy seafaring and pearl-trading families, who historically owned most of the land bought by the government. In many cases, the land was later bought back by the same families who had sold it, resulting in large net profits for those families, leading essentially to 'a transfer of wealth from the state to the rich' (Crystal 1992: 62). In addition, Ismael found that the programme profoundly distorted land and property prices, and invited large-scale property speculation (Ismael 1993: 102–4). Inflated property prices as well as access to land for building have remained a problem in Kuwait to this day, for both residents and the business sector (personal interviews, March 2010).

3.3. Public transfer payments and pensions

The 1950s also witnessed the beginnings of a rapidly expanding social security system based on transfers paid directly to Kuwaiti nationals or businesses. Initially these transfers were aimed primarily at poverty reduction, and were thus conditional on grounds such as low income, illness and disability, widowhood, divorce and unemployment. In subsequent decades Kuwait's transfer system became broader, and developed into the single largest item on the government budget, surpassing general development expenditure and land purchase allocations. As can be seen from Table 2, the item 'miscellaneous expenditure and transfers' constituted 43 per cent and 59 per cent of total government expenditure in 2007/8 and 2008/9 respectively. This category can be further broken down into miscellaneous expenditure, domestic transfers and external transfers. In 2008/9, domestic transfers constituted the bulk of this expenditure item, accounting for close to 50 per cent of total government expenditure. The 2008/9 figures have been inflated by the dramatic increase in transfers made to the pension fund in that year (discussed below). However, the 2007/8 figures still reveal the importance of such transfers in the Kuwaiti welfare system. In 2007/8, domestic transfers accounted for 25 per cent of total government expenditure, similar to the expenditure on wages and salaries in that year.

Domestic transfers have evolved into a complex system of different forms of government support which include transfers to individuals, civil institutions and public institutions (which include the Public Institute for Social Security (PIFSS), the body

Table 2. *Government expenditure (KD million), 2007/8–2008/9*

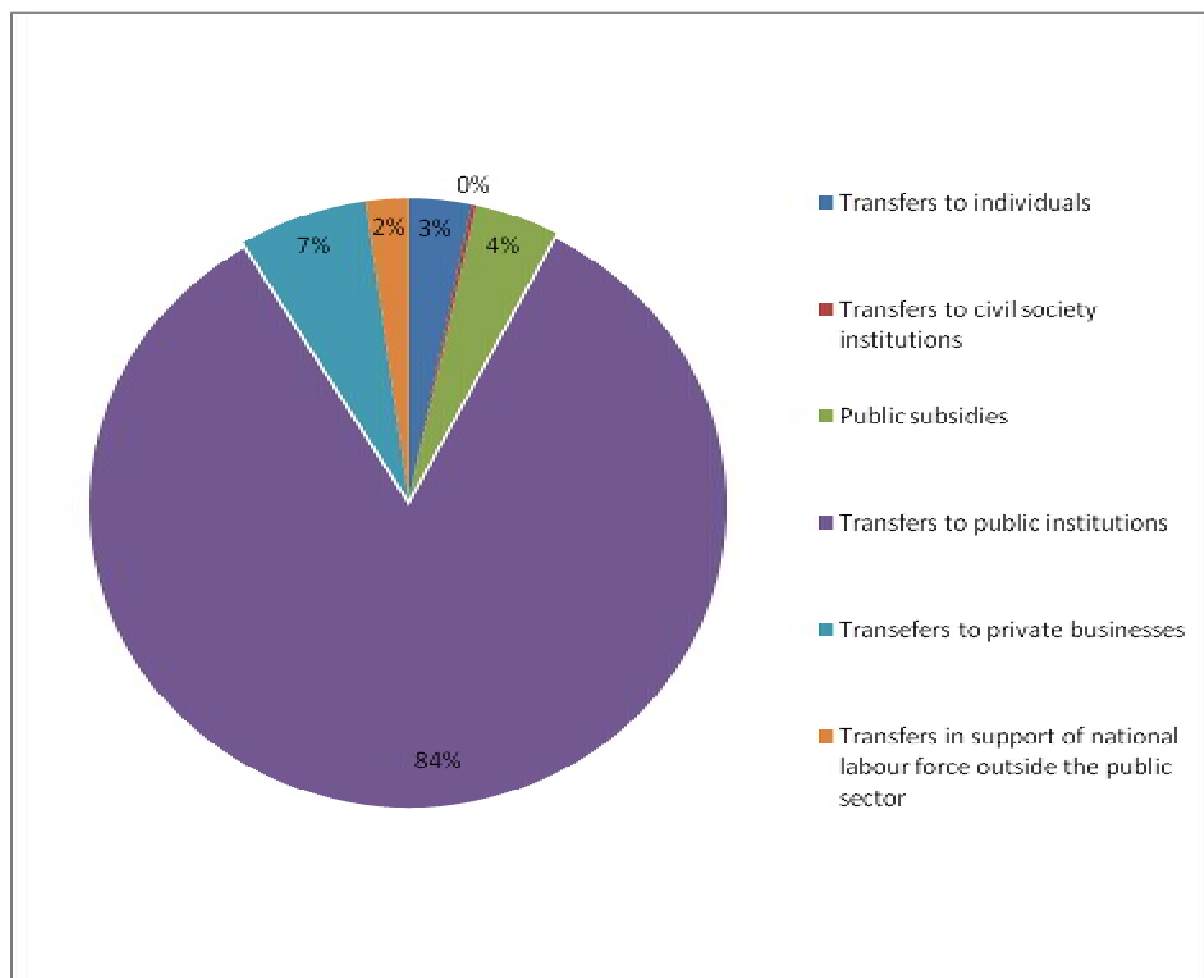
Type of expenditure	2007/8	% of total	2008/9	% of total
Wages and salaries	2,477	25.5	3,039	16.6
Goods and services	1,768	18.2	3,002	16.4
Vehicles and equipment	90	0.9	122	0.7
Projects, maintenance and land purchase	1,206	12.4	1,358	7.4
Miscellaneous expenditure and transfers	4,157	42.9	10,741	58.8
<i>Miscellaneous expenditure</i>	1,283		1,286	
<i>Transfers (domestic)</i>	2,509		8,920	
<i>Transfers (external)</i>	365		535	
Total expenditure	9,698	100	18,262	100

Source: Ministry of Finance of Kuwait (2008/9).

responsible for administering and paying out public pensions), general subsidies, support for private sector activity and businesses and support for the national labour force outside the public sector (see Figure 1). In 2008/9, by far the most important component of domestic transfers was pensions, which cost more than double the government expenditure on wages and salaries. In 2008/9, out of the KD10,741 million spent on miscellaneous expenditure and transfers, social security payments cost KD6,877 million, an enormous 38 per cent of total government expenditure (Ministry of Finance of Kuwait 2008/9; see Appendix B below). This spending is the result of many decades during which a large share of the Kuwaiti national workforce has been in public employment. The extent of the cost of Kuwait's pensions programme prompted the unusual move by the government of levying a type of social insurance contribution on each national's wage, paid by employers of Kuwaiti nationals (10 per cent of the wage rate with a cap at KD2,250) as well as by national employees (5 per cent of the monthly salary; Government of Kuwait 2010). However, pension payments far surpass government social insurance receipts, implying that pensions are not just a form of saving for individuals, deferring expenditure when young in order to have an income when retired, but another means for the government to transfer oil rents to individuals. Indeed, they clearly comprise the largest channel of rent distribution in Kuwait.

Other transfers to individuals comprise around 7 per cent of domestic transfers. They are very diverse and include annual housing loan forgiveness on the grounds of poverty or death, a marriage fund that enables young Kuwaiti men from low income families to pay the

Figure 1. *Distribution of domestic transfers by various categories, 2008/9*



Source: Ministry of Finance of Kuwait (2008/9).

obligatory marriage dowry, and irregular untargeted transfers. Examples include Amiri grants that are paid irregularly to each national at a fixed rate per head, as a kind of bonus at times of high oil revenues,⁹ and general loan forgiveness to Kuwaiti nationals, often used to write off capital or interest on the financing of home maintenance, holidays abroad or cars. Transfers to civil institutions include financial support to private education institutions, newspapers, clubs and unions. Though they fall into the category of general subsidies, payments under this heading refer to transfers made to individuals and include items such as extra allowances to protect households against the rising cost of living. These general

⁹ The last time an Amiri grant was paid out to all nationals was in the fiscal year 2006/7. The grant was worth KD 200 per citizen, or US\$690 (NBK 2006: 25; IMF 2009: 20).

subsidies do not include other types of subsidy such as production subsidies to the electricity and water sectors. These are discussed in detail in the next section.

In the external transfers category, health services constitute the largest share, accounting in 2009 for 65 per cent of external transfers (Ministry of Finance of Kuwait 2008/9: 34, Table 8). These transfers are provided for Kuwaiti nationals in need of medical care in foreign countries and students studying abroad. As seen in Table 2, however, external transfers constitute a small share of total transfers and general government expenditure.

Figure 2 shows the share of transfers out of total household expenditure by fifteen income groups for Kuwaitis and non-Kuwaitis. As seen from this graph, for Kuwaitis the share of transfers in total households' expenditure does not follow a uniform pattern. It varies between 8 per cent and 13 per cent while the poorest group receives 15 per cent of its income in transfers.¹⁰ For non-Kuwaitis the picture is different. As we move up the income ladder, the share of transfer in total household consumption expenditure increases unevenly up to the eleventh expenditure group, then declines slightly for the top four groups. Thus for non-Kuwaitis, transfers appear somewhat regressive in nature. The share of transfers out of total expenditure in the lowest income groups is greater for Kuwaitis, while in the higher income groups it is greater for non-Kuwaitis.

It may seem surprising that the Kuwaiti government would give transfers to non-Kuwaitis. Does it imply a 'pure' transfer of rent to non-Kuwaitis alone? While non-Kuwaitis seem to benefit from transfers, these also benefit Kuwaitis indirectly by allowing businesses to pay immigrant workers a lower nominal wage. The same point applies to price subsidies, which are also enjoyed by non-Kuwaiti residents.

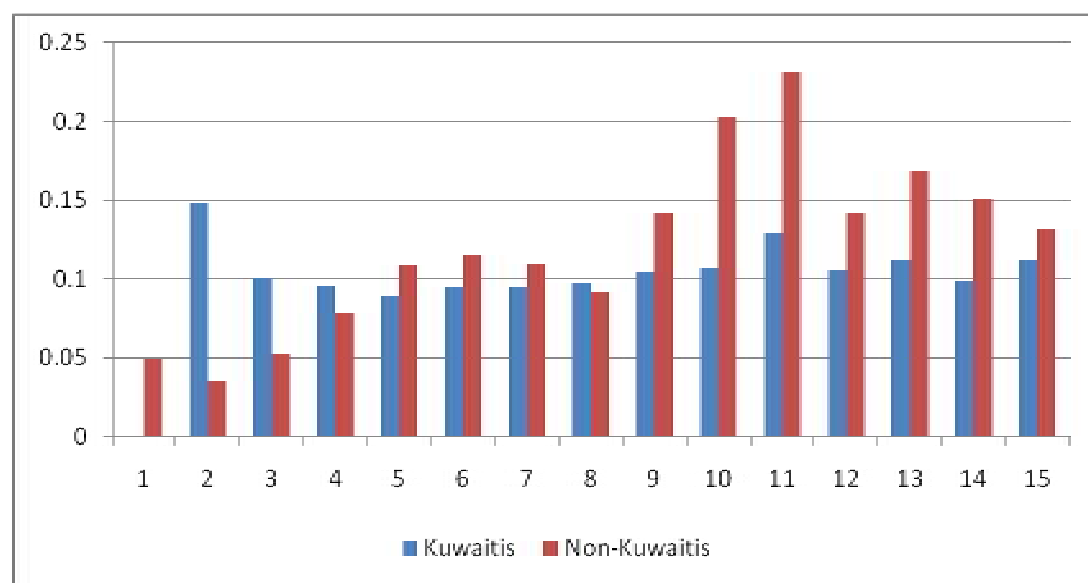
3.4. Subsidies

The Kuwaiti government subsidizes a number of goods and services, including electricity, water, food and housing. The measurement of subsidies is often a contentious issue, as one needs to compare the price charged to domestic consumers with some measure of cost. This, however, is not straightforward, as there is more than one concept of cost (the average cost, the marginal cost and the opportunity cost) and it is not always clear which measure is used in the different studies.¹¹ This can, in part, explain the large divergence in estimates of

¹⁰ No Kuwaitis fall into the first income group.

¹¹ From an economic point of view the correct cost to use is the opportunity cost, but this is not always followed.

Figure 2. *Share of transfers out of total expenditure by income group*



Source: Government of Kuwait (2008); authors' own calculation.

subsidies between different organizations. Furthermore, some studies tend to treat transfers and subsidies in the same manner, which makes comparisons across studies meaningless. Nevertheless, regardless of the concept of cost used, subsidies are widespread in Kuwait, with those for electricity being the most important followed by those for education, health and water. According to a World Bank study, in 2003, subsidies accounted for 20 per cent of GDP, though this figure includes some of the transfer payments discussed in the previous section (see Table 3).

Though provision of subsidies can be seen as an additional means to distribute the oil rent, subsidies are highly inefficient, leading to over-use of the subsidized good or service. Subsidies distort the allocation of resources by diverting part of the oil total from exports (sold at international prices, i.e. the opportunity cost of oil) towards domestic use in power generation or water desalination (sold at a fraction of international prices). Subsidies can also be regressive, in that in many instances richer households tend to capture the bulk of them. Finally, subsidies are entrenched in institutional barriers and lock-in mechanisms that make it difficult to abolish them. This is especially true in oil-rich countries where the local population considers access to cheap energy as their birthright.

Due to data limitations, this section will focus only on a few sectors where subsidies are highly prevalent, mainly electricity and water. According to Table 3, electricity

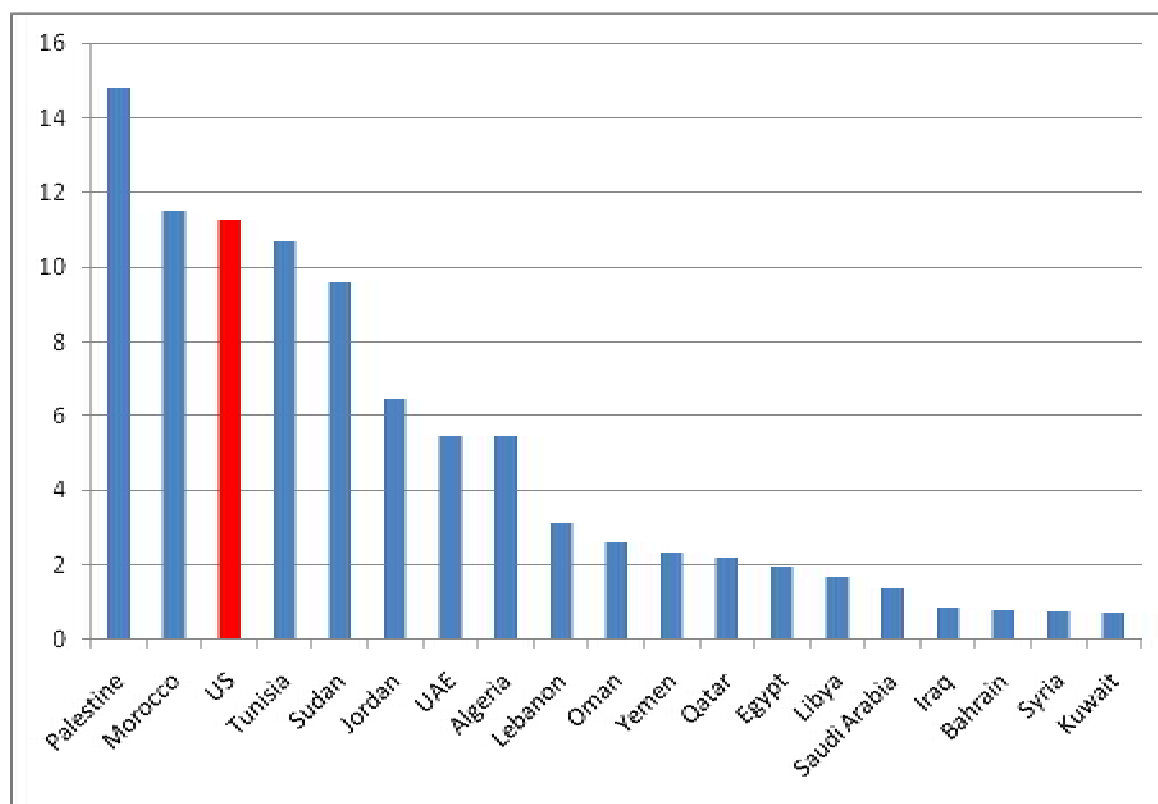
Table 3. *Estimated subsidies in Kuwait (KD million), 2003*

Subsidy	Consumption subsidies			Production subsidies	Total subsidies	% of grand total
	Kuwaitis	Expatriates	Total			
Electricity	157.6	127.8	285.4	139.6	425	23.8
Water	71.7	48.5	120.2	39.4	159.6	8.9
Fuel	0.3	0.2	0.5	4.4	4.9	0.3
Housing loans	126.9	–	126.9	–	126.9	7.1
Renovation loans	7.4	–	7.4	–	7.4	0.4
Marriage loans	8.7	–	8.7	–	8.7	0.5
Industrial loans	–	–	–	4.1	4.1	0.2
Government housing	67.5	–	67.5	0	67.5	3.8
Government plots	49.7	–	49.7	271.2	320.9	18
Healthcare	70.2	91.8	162	–	162	9.1
Education	246.2	70.5	316.7	–	316.7	17.7
Transportation	0.4	6.7	7	–	7	0.4
Communications	8.6	4.6	13.2	4.4	17.6	1
Direct government aid	34.5	–	34.5	–	34.5	1.9
Basic food items	5.2	–	5.25	–	2	0.3
Cleaning and maintenance	54.7	35.9	90.6	26.2	116.8	6.5
Grand total	909.6	386	1295.6	489.3	1784.9	100
Ratio of subsidy to %:						
Government revenues	17.4	7.4	24.7	9.3	34.1	–
Government expenditure	22.7	9.6	32.3	12.2	44.5	–
GDP	10.2	4.3	14.6	5.5	20.1	–

Source: World Bank (2005: 59, Table 2.5).

consumption and production subsidies amounted to KD425 million in 2003, around 6per cent of total government revenues during that year. All residents, both nationals and expatriates, enjoy subsidized electricity prices. Electricity prices for the residential sector in Kuwait are the cheapest in the Middle East, standing at around US 0.7 cents per kWh (see Figure 3). Subsidized prices are among the many factors – perhaps the most important one – that can

Figure 3. Residential electricity prices in selected Arab countries and the US (US¢ per kWh), 2008



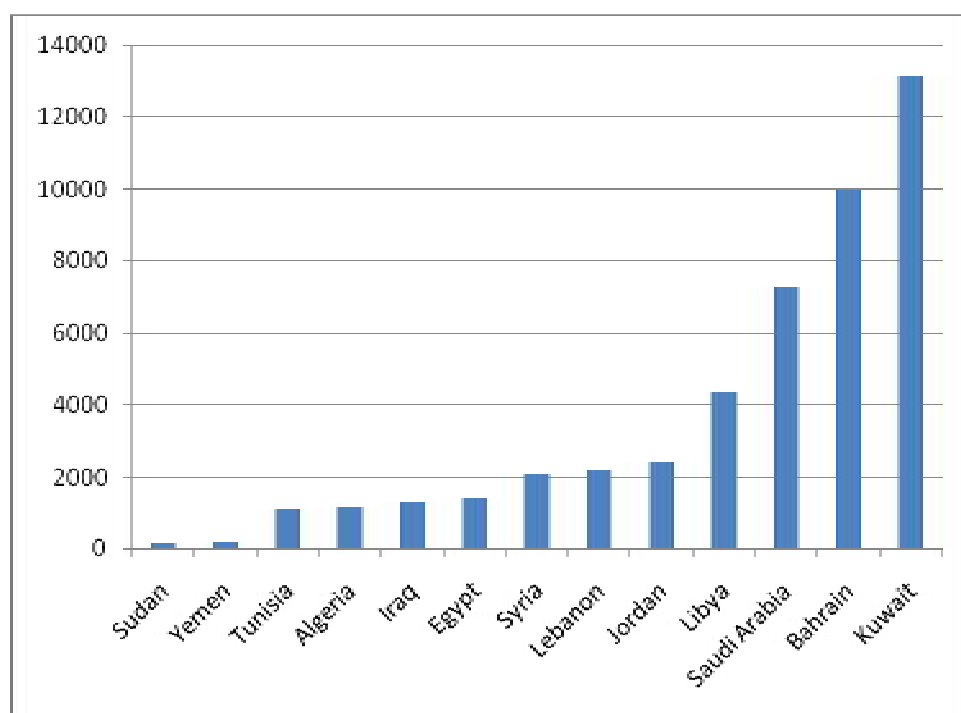
Source: Arab Union of Producers, Transporters and Distributors of Electricity (2008); data for Kuwait from Eltony and Al-Awadhi (2007).

explain why Kuwait has the highest electricity consumption per capita in the region (Figure 4).

As in the case of electricity, water tariffs are very low and do not come close to covering the cost of production. In 2002 the water tariff ranged between US\$0.18/m³ and US\$0.57/m³, depending on the end user, while the cost stood at around US\$1.98. The resulting subsidy therefore amounted to about US\$830 million in 2000, about 2.4 per cent of GDP and 5.9 per cent of oil export revenue (World Bank 2005). As seen in Table 3, both Kuwaitis and non-Kuwaitis benefit from water subsidies directly through consumption subsidies and indirectly through production subsidies.

While the underlying method used to calculate water and electricity subsidies is not clear in Table 3 and hence one may doubt the reliability of the figures, the data on government revenues and expenditure can shed some light on the extent of the problem. In 2009, the revenues from the water and electricity sectors constituted only 3.2 per cent of

Figure 4. *Electricity consumption per capita in selected Arab countries (kWh), 2008*



Source: Arab Union of Producers, Transporters and Distributors of Electricity (2008: Table 17).

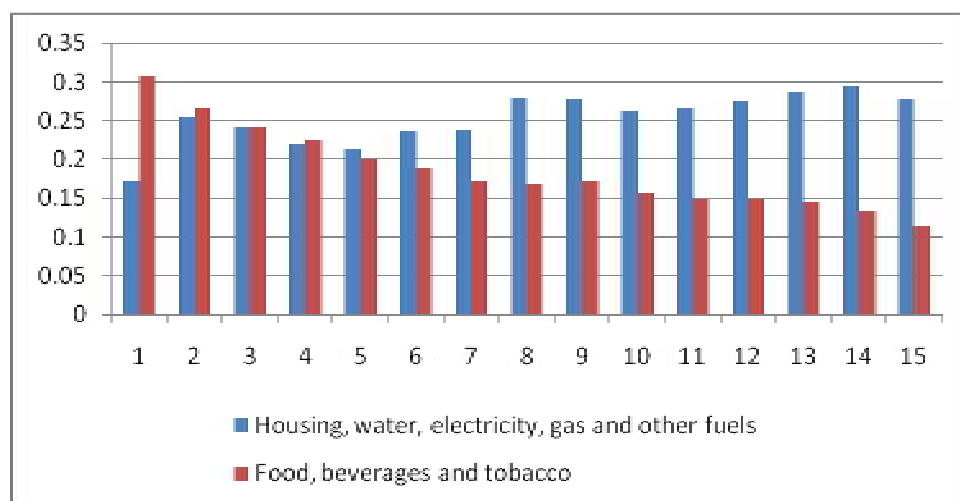
government spending on these sectors. Such a large gap imposes a heavy financial cost on the government budget.

In addition to electricity and water subsidies, the government provides food subsidies on certain basic items, such as rice, sugar and cooking oil, through the use of ration cards. Judging from Table 3, these subsidies are relatively small, and benefit Kuwaitis only.

Married Kuwaitis who meet certain criteria are also entitled to housing subsidies. These can be used to purchase plots or houses from the National Housing Authority at prices well below cost, though the scheme has a long waiting list. While waiting, eligible Kuwaitis are entitled to rent smaller houses from the housing authority at a fraction of the market rent. The government also subsidizes construction material for houses built on lands purchased from the National Housing Authority.

Figure 5 shows the share of housing, water, electricity, gas and other fuels out of total households' budget by fifteen income groups of nationals. As seen from this figure, the share for this category out of total expenditure does not show any significant pattern. Apart from the lowest income group, the shares are quite similar across the various income groups. This suggests that universal subsidies on electricity, water, housing and fuel will not have any

Figure 5. *Expenditure on category out of total expenditure by income group, 2007/8*



Source: KASA; authors' own calculations.

strong distributional impact. In contrast, the share of food, beverages and tobacco in total expenditures declines as income rises, following Engel's Law, with the poorest group spending nearly three times as much as the richest group in proportional terms. This implies that food subsidies are likely to be progressive.

There are two arguments that can, in the right circumstances, be used in favour of subsidies. First, if the social cost of a good is lower than the private cost – for instance, if a positive externality implies that there is some social benefit to consuming the good that is not reflected in its price – then it will be efficient to provide a subsidy that brings its private cost or price down to the level of its social cost. In this case the subsidy will increase efficiency, not reduce it. Secondly, even if the subsidy is inefficient, it may be a 'second best' way to distribute income to certain groups, if direct distribution of cash is not feasible. Thus subsidizing low-quality foodstuffs consumed predominantly by the poor can be a way of reducing poverty if targeting direct transfers at the poor is difficult, as it may be since the poor are typically hard to identify (Cornia and Stewart 1993).

We have just seen that food subsidies are progressive in that they benefit the poor proportionately more than the rich, which may justify their use. In the case of housing, water, electricity and other fuels, however, it appears that the subsidies have no clear distributional impact and tend to benefit more those households in the high income group, and hence are regressive. It also seems clear that there are no positive externalities associated with the

consumption of these goods. On the contrary, environmental considerations would suggest that there are *negative* externalities associated with the consumption of fuel and power. These subsidies are therefore wholly inefficient.¹²

3.5. Public employment

A job in the public sector is guaranteed to Kuwaiti nationals and comes with attractive salaries and benefit packages. In consequence, 91 per cent of the Kuwaiti national labour force works in the public sector, while 98 per cent of private sector jobs are occupied by non-Kuwaitis (calculated from numbers from KASA 2008: 113, Table 71). Government expenditure on wages and salaries is typically about 20 per cent of total expenditure, the second largest budget item after transfers (KASA 2008: 224, Table 142).¹³ Wage discrimination between Kuwaiti nationals and expatriates further adds to the perception by many Kuwaitis that their job is a form of entitlement based on nationality (Al-Sabah 1980: 116; personal interviews, March 2010).

There is a widespread perception that Gulf Cooperation Council (GCC) governments' policy of distributing rents through provision of employment in the public sector has led to 'overstaffed bureaucracies' and 'overgrown public sectors whose omnipresence in the economy stifles the private sector, distorted work incentives, and extreme dependence on governments to provide jobs [*sic*]' (Eifert et al. 2003). Given that most public sector output does not have an observable market value and hence cannot be measured in an uncontroversial way, there is no straightforward way to test such claims. Nevertheless, evidence suggests the existence of a highly segmented Kuwaiti labour market induced by an implicit guarantee of employment in the government sector. Due to the substantial size of oil rents, the Kuwaiti government has been able to afford relatively high wages, job security, social allowances and generous benefits for public employees. As a result, the gap between

¹² One further argument for subsidies sometimes given by policy makers is that they reduce inflation. This argument is not, however, valid in general. A distinction has to be made between the price level and the rate of inflation. A subsidy lowers a given price and thereby probably lowers the overall price level, so removing a subsidy will result in a one-off rise in the price level. However, in the absence of other pressures, this implies only a one-off rise in inflation: once the subsidy has gone and the average price has risen there will be no continuing inflation. But though the price level has risen, the country has saved the money it was spending on the subsidy, and overall the country is better off. So if the price level has risen by 1 per cent then nominal income will have risen by more than 1 per cent. Thus this inflation-based argument for subsidies is spurious.

¹³ In the fiscal year 2008/9, wages and salaries rose in absolute terms but were down to 16.6 per cent of total expenditure. This is due to an extraordinary increase in the government's spending on miscellaneous expenditure and transfers. See also Table 2 above.

the private and public sector wage remains wide (especially if one takes into account the non-wage benefits), leading to high reservation wages for Kuwaitis. Thus, there is little incentive for nationals to take on employment in the private sector. Unlike other countries in the GCC where the private sector accounts for the bulk of employment growth, the Kuwaiti public sector continues to be the major source of employment generation for nationals, accounting for more than three-fourths of employment growth in Kuwait during the period 1996–2000 (Fasano and Rishi 2004).

If it is true, as most observers appear to believe, that a significant share of Kuwaiti public sector employment is not productive, then the drawback of public employment as a form of rent distribution is that it prevents public sector employees from doing productive work in the private sector. It presents the employee with the following choice: be unproductive in the public sector and be rewarded with oil rents, or be productive in the private sector and do not be rewarded with oil rents. Moreover, beyond the immediate problem of currently unproductive workers, over-employment in the public sector can cause a failure to develop skills that would lead to growth and higher productivity. In this way, public employment as a form of rent distribution distorts incentives to produce, creating an inefficient and segmented labour market.

The Kuwaiti government has, however, partly responded to this problem by subsidizing Kuwaiti labour in the private sector: KD200 million are annually channelled to private sector employers who employ nationals, in addition to government campaigns promoting the Kuwaitization of the private sector. In 2008 another KD138 million went to the National Labour Support programme, which subsidizes Kuwaiti nationals' wages in the private sector with an average of KD180 per month, plus additional payments for spouses and children, adding up to the same benefits paid by the state to public sector employees (NBK 2001–9 (2001): 9; Ministry of Finance of Kuwait 2010: Table 15; personal interviews, March 2010). While subsidizing Kuwaitis to work in the private sector helps to reduce the distortion that draws them into the public sector, such subsidies may create the additional distortion of encouraging private sector employers to employ Kuwaitis over better-qualified non-Kuwaitis.¹⁴

¹⁴ This distortion would occur if employers found it cheaper to employ Kuwaitis, which would be the case if the wage gap between Kuwaitis and non-Kuwaitis were smaller than the total subsidy for employing Kuwaitis.

3.6. Transfers to the business sector

While employing less than 10 per cent of the Kuwaiti national labour force, Kuwait's private sector employs more than 75 per cent of the country's total labour force, including expatriates (KASA 2008: 113, Table 71). The private sector dominates not only services, manufacturing, catering, transportation and logistics, and community and social work, but also the quickly evolving banking and finance sectors, real estate and trade (KASA 2008: 112–13, Table 71). If Kuwait is to avoid having to create more unproductive public employment the private sector will be necessary to absorb the next generation of Kuwaitis entering the job market – more than half of Kuwait's national population is below the age of 20 and will flood the job market in coming decades (KASA 2008: 48, Table 21). At the same time, the development of Kuwait's private sector is key to Kuwait's economic diversification strategy.¹⁵ The state has thus channelled large funds into the private sector in an effort to safeguard the latter's growth.

The government's provision of the public infrastructure and services that business requires, while not charging personal or corporate income tax, is one of the principal channels of indirect rent distribution to the private sector.¹⁶ All sectors of the economy have benefited from large government expenditure on infrastructure projects including roads, electricity, water projects and other public works, particularly in recent years of high oil prices (NBK 2001–9 (2007): 25). Other measures used throughout the past fifty years include technical aid and preferential government purchases. Low-interest or interest-free loans provided by institutions created by the government, such as the Industrial Bank of Kuwait, were designed to fund the expansion of the private sector (Crystal 1992: 52). Transfers also include bail-outs to private investors and institutions, the most controversial of which was during the Suq Al-Manakh crisis of 1982.

3.7. Foreign investment

Foreign investment in Kuwait is highly regulated, with the aims of protecting jobs for Kuwaiti nationals, ensuring Kuwaiti control over natural resources, and generating additional rents to Kuwaiti nationals. It is important to note that FDI regulation does not involve direct

¹⁵ Reiterated throughout Kuwait's development plans, e.g. Government of Kuwait (2009: 5).

¹⁶ Only foreign companies owned more than 50 per cent by non-nationals pay a corporate income tax, which is in any case negligible and is discussed below; GCC nationals are treated as Kuwaiti nationals, following GCC agreements.

distribution of resources, but rather the creation of regulatory rents which benefit certain sections of the society.

Several sectors remain closed to FDI, including the emirate's all-important hydrocarbon sector. Foreign ownership of companies is restricted to 40 per cent in most sectors, though a recent change in the law has introduced 100 per cent foreign ownership in some sectors (*Arab Times Kuwait*, 7 February 2008; NBK 2010: 28). Foreign companies opening business branches or wishing to import into Kuwait also need a Kuwaiti agent (NBK 2010: 30, 35). This legal framework assures the involvement of Kuwaiti nationals as sponsors, agents and business partners in every business deal involving foreign investors, generating additional rents for Kuwaiti nationals.

This creation of artificial barriers is inefficient and one would expect it to deter investment. Unsurprisingly, therefore, Kuwait's share of FDI into the GCC has historically been low, and is today the lowest in the region by far. In 2008, Kuwait was able to attract only US\$56 million, a tiny amount if compared with the GCC average of above US\$10 billion; Bahrain, the second smallest market for FDI in the GCC, by comparison attracted nearly US\$1.8 billion (UNCTAD 2009: 249). In 2010, Kuwait ranked at number 61 out of 183 economies in the 'Ease of Doing Business' index compiled by the World Bank/IFC, placing Kuwait far behind other GCC members such as Saudi Arabia (ranked at 13), Bahrain (ranked at 20) and Qatar (ranked at 39; World Bank/IFC 2010). The amended corporate tax law of 2008, which reduced foreign corporate tax from a 5–50 per cent range to a flat rate of 15 per cent tax (NBK 2001–9 (2008): 34), seems to have failed in improving the foreign investment climate.

More worrying for Kuwait is investors' perception of widespread corruption in private and public institutions. In 2009, Kuwait dropped for a second consecutive year in the global corruption index produced by Transparency International, placing Kuwait at number 66 out of 180 countries. Kuwait is currently perceived by investors to be the most corrupt country in the GCC. The seriousness of the problem has prompted the creation of non-governmental organizations such as the Kuwait Transparency Society aimed at supporting 'the adoption and enforcement of anti-corruption legislative reforms with a view to eradicating all causes and manifestations of corruption'.¹⁷

¹⁷ Kuwait News Agency, 'Kuwait Transparency Society celebrates its fifth anniversary', 14 March 2010.

While oil rents are not directly responsible for the general deterioration in the business environment, they may create the impression that Kuwait does not need, or does not feel the urgency, to improve its business and regulatory environment in order to attract foreign investment.

3.8. Kuwaiti investment abroad

While most of its distributive policies aim at channelling oil rent to various target groups, Kuwait was also one of the first oil-rich countries to start investing oil revenues abroad rather than channelling them immediately into its domestic economy. The limited absorptive capacity of Kuwait's economy, due in part to the lack of potential for industrial development, and the prospects of higher returns for the resulting capital surplus through investment abroad, led the state to embark on a gradual increase of its foreign investments (Crystal 1992: 52). At the same time, the idea of keeping money safely abroad for bad times in the future began to gain ground.

The establishment of the General Reserve Fund (GRF) in 1960 was a first step that marked the beginnings of Kuwait's foreign investment programme. Following the 1973 oil price hike and the resulting dramatic increase in revenues, Kuwait decided to lock away part of its annual oil revenues in the form of a Reserve Fund for Future Generations (RFFG), thereby ensuring the distribution of the country's current wealth to future, potentially post-oil generations. In 2005, the RFFG was estimated at KD35 billion or US\$114 billion (NBK 2001–9 (2005): 34).¹⁸ In 1982, the government established the Kuwait Investment Authority (KIA), which holds stakes in big corporations such as DaimlerChrysler and BP, Citigroup (sold December 2009) and Merrill Lynch (sold September 2008; *Financial Times*, 19 November 2009, 7 December 2009).

Sovereign wealth funds such as the RFFG have two different fundamental purposes. The first, as the name suggests, is to save wealth for future generations, in anticipation of the exhaustion of oil reserves. A resource-rich but capital-poor, low productivity and low income country such as Nigeria or Bolivia might find that the best way to serve future generations is to invest most of their savings in human and physical capital at home, if they are able to do so effectively. For high income countries, however, where the capital–labour ratio is high, and where there is already sufficient investment in education, further domestic investment is

¹⁸ Kuwait's foreign investment programme is kept off-budget and its total value is thus unknown.

likely to yield very low returns. In these cases, there is a strong incentive to seek higher-yielding investments abroad.

The second purpose of a sovereign wealth fund is to act as a ‘stabilization fund’ to smooth incomes to oil producers in the face of highly volatile prices. Typical commodity stabilization funds smooth government expenditures by taking a view on the long-run price of the commodity, with government expenditures kept at the sustainable level, estimated on the basis of predicted long-run average income. Such funds have a poor track record globally, however, because it is very difficult to estimate the long-run price correctly. In addition to this technical challenge, governments in need of finance have an incentive to over-estimate the long-run price in order to justify extracting funds in the short run, leading to unsustainable expenditures and long-run indebtedness. In the case of Kuwait, however, the fact that the country is saving so much wealth, in addition to attempting to smooth its income, implies that it is very unlikely to suffer from this problem.

4. ASSESSMENT

4.1. Oil rents and living standards

What is the net effect of the complex system of transfers described above? We find no explicit targeting, and in particular there appears to be no effort to direct social benefits specifically at the poor. Unlike in countries that do not have large resource incomes, in Kuwait social benefits and other transfers distribute income, but they do not *redistribute* it: they are financed from oil rather than by taxing individuals or businesses. The role of the fiscal system is thus not to adjust an existing distribution of income but, rather, to ensure that all Kuwaitis gain from oil rents.

The net effect appears to be a very egalitarian distribution in the economy, as indicated in household expenditure survey data presented in the government’s Annual Statistical Abstract. On the basis of these data we estimate a Gini coefficient of 21.8 for the Kuwaiti national population alone. This is an exceptionally low level of inequality, lower, indeed, than any recently recorded Gini coefficient for any whole country.¹⁹ For the whole population we estimate a Gini coefficient of 28.0, also a very low level of inequality and similar to that of the egalitarian northern European countries such as Germany. However, the

¹⁹ Going back to 2000, no national Gini coefficient this low is reported in the United Nations University’s World Income Inequality Database (WIID, available at www.wider.unu.edu/wiid).

household survey data are problematic: they imply a level of aggregate household consumption that is only 42 per cent of that reported in national accounts data, and in our view the above are likely to be under-estimates of the true level of inequality (Anand and Segal 2008). We discuss this issue further in Appendix A.

The shortcomings of the data make it difficult to estimate the level of poverty in Kuwait. Since Kuwait does not report an official poverty line, we employ a US-based poverty line as used by the OECD (2008b: 152), which is US\$8,087 per capita. If we take the household survey data at face value, then, we find that 27 per cent of Kuwaitis and 58 per cent of non-Kuwaitis live below this poverty line. If we scale up the survey-reported expenditures so that household consumption equals that reported in the national accounts, then no Kuwaitis, and only 6 per cent of non-Kuwaitis, live below this poverty line. The widths of these ranges reflect the inconsistencies in the data (see Appendix A).

Beyond the share living below a poverty line, we can also use household survey data to investigate how well household expenditures reflect the magnitude of oil rents. We estimate adjusted per capita oil rents for consumption of KD9,634, while mean per capita expenditure in the household survey is KD2,856. According to the data, it appears that most, if not all, Kuwaitis are consuming much less than per capita oil rents. Where is the money going? Households save some share of their incomes, and if this share is large then their expenditures would be substantially lower than their incomes. It is highly unlikely, however, that they would save more than two-thirds of their incomes on average. It is also possible that the survey data are broadly correct except for the very top of the distribution, in which case there may be a very small share of Kuwaitis, who do not take part in the survey, who receive the lion's share of the oil rents. If this is the case then Kuwait is far more unequal than the data suggest and we cannot rule out the possibility that the majority of Kuwaitis are not benefiting from their oil to the extent that they should.

There is a further puzzle in the Kuwaiti data. While the economy has grown in recent years, household expenditure has not. Household final consumption expenditure (HFCE) has fallen from a range of 40–50 per cent over 2000–3 to around 30 per cent over 2005–7 – compared to about 70 per cent in the US, and between 40 and 46 per cent in Norway. In fact, while per capita GDP in Kuwait rose by 38 per cent over 2002–6, HFCE *fell* absolutely by 21

per cent.²⁰ The extra income appears to have been saved abroad through the large current account surplus discussed above. But while the precautionary saving of windfall income due to high oil prices is sensible, we can find no reason to save so much that current consumption actually declines as oil prices rise. We are inclined, therefore, to be sceptical of these national accounts data, but we have no satisfactory explanation for this finding.

4.2. Distortions and inefficiencies

An advantage of taxing oil rather than the population is that it is not economically distortionary. However, we have seen that Kuwait's government expenditures typically are distortionary. Subsidies to utilities are highly inefficient, leading to over-use of the subsidized good or service. Kuwait's system of general loan forgiveness has been criticized for rewarding risky expenditure on unnecessary goods (e.g. *Wall Street Journal*, 4 November 2005). We have also seen that public employment as a means of rent distribution distorts the labour market, discouraging Kuwaitis from taking up potentially more productive jobs in the private sector. All of these inefficiencies derive from the basic fact that, when the goal is the distribution of rents to citizens, any attempt to achieve it through indirect distribution policies will end up distorting people's incentives in one way or another. In addition to these inefficient expenditures the government also creates artificial barriers to foreign investment into Kuwait, deterring such investment and potentially reducing longer-run growth.

While there are numerous sources of inefficiency in official policies, we have not found evidence of 'rent-seeking behaviour' as discussed in the development economics literature.²¹ According to this literature such behaviour involves individuals devoting their energies to extracting as large a share of pre-existing rents as possible, instead of engaging in productive activities. In Kuwait the diversion of otherwise productive individuals into unproductive activities would seem to be caused primarily by official policies and distorted incentives, including public over-employment, rather than efforts by individuals. While distorted incentives and inefficient policies are shaped in part by oil rents, they seem to reflect broader social, political and institutional factors.

²⁰ World Development Indicators online, <http://data.worldbank.org/data-catalog/world-development-indicators>, accessed April 2010.

²¹ See Krueger (1974), Baumol (1990) and Murphy et al. (1993).

5. CONCLUSIONS

Since the middle of the twentieth century Kuwait has successfully used its oil revenues to improve the living standards of its people. While data problems preclude firm conclusions, it seems reasonably clear that all Kuwaitis enjoy substantial benefits from their oil. They receive generous public services, in addition to a variety of mechanisms that distribute oil income among the population. While many benefits are aimed at Kuwaitis alone, Kuwait's oil wealth has attracted large numbers of immigrants who enjoy, at least, the employment opportunities it creates.

The role of the distributive system is not to adjust an existing distribution of income but, rather, to ensure that all Kuwaitis gain from oil rents. Hence, some of the distribution channels such as subsidizing utilities are regressive in nature in the sense that rich households tend to benefit relatively more than poor households from these subsidies. There is no taxation system to reverse some of these effects. Yet our very tentative findings suggest a relatively egalitarian economic structure in Kuwait. Such findings may be the result of errors in national accounts data. Alternatively, it is possible that other channels of rent distribution (such as private transfers) offset some of the regressive elements associated with subsidies.

One of the largest mechanisms for distributing oil income is public employment, and this also implies perhaps the largest distortion of the economy. Since Kuwaitis have the right to public employment, it appears that some jobs are created simply to fulfil this right, rather than to provide any useful service. From the point of view of economic efficiency, it would be preferable to give all Kuwaitis a direct payment from oil revenues independently of where they work. Without the disincentive to work in the private sector, Kuwait might be more likely to achieve the economic diversification that it desires. Another clear source of economic inefficiency is the provision of subsidies to utilities, especially electricity and water. These subsidies not only make Kuwaitis worse off in aggregate, but, by increasing Kuwaiti consumption of energy, also contribute to the country's huge and rapidly rising energy consumption, and resulting carbon emissions.

Kuwait should therefore be considered broadly a success story. It has certainly avoided the perils that some resource-rich countries have faced, and oil has unquestionably improved the lives of Kuwaitis. Nevertheless, some of Kuwait's policies of rent distribution, such as subsidizing utilities and providing public employment, have resulted in substantial distortions, inefficiencies and institutional deficiencies, and thus there remains considerable

scope for improvement. One area of improvement could be the abolition of subsidies. Individuals would be better off if the government raised the price of utilities to their marginal cost and the revenues resulting from eliminating the subsidy were directly given to consumers through cash transfers. Given Kuwait's extensive distributive system and the fact that the bulk of Kuwaitis are employed in the public sector, this policy could be implemented at a low cost.

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APPENDIX A: ESTIMATING THE DISTRIBUTION OF INCOME AND OIL RENTS IN KUWAIT

Estimating the distribution of income

Household survey data for Kuwait present the population broken down into fifteen expenditure groups (KASA: 272–3, Table 164), within which the population is further divided into Kuwaitis and non-Kuwaitis. We use the program Povcal²² to fit a Lorenz curve to the data and to estimate inequality. Povcal estimates Lorenz curves using the Generalized Quadratic (GQ) method and the Beta method (Datt 1998); when both estimates are valid, it chooses the curve with the better fit.

There are, however, several problems with the survey data. First, the populations within the fifteen groups are very unbalanced: there are no Kuwaitis in the poorest group, while the top group contains 22 per cent of the Kuwaiti population (8 per cent of the total population). Non-Kuwaitis are represented in all fifteen groups, but the top eight groups combined contain only 6 per cent of the non-Kuwaiti population, while the third from bottom contains 28 per cent and the second from bottom 22 per cent.

Secondly, the entries given for the ‘total’ population are problematic. They simply add together the number of Kuwaiti and non-Kuwaiti households and individuals in each expenditure group, so that, for instance, the top expenditure group contains 2,928 Kuwaiti individuals and 58 non-Kuwaiti individuals, with the ‘total’ entry reporting 2,986 individuals. Thus each Kuwaiti in the survey is given the same weight as each non-Kuwaiti. This gives incorrect aggregates because the ratio of Kuwaiti individuals to non-Kuwaiti individuals in the survey is $13,612/11,303 = 1.20$, while the ratio in the actual population is 0.65. In our calculations we multiply the share of Kuwaitis in a given expenditure group by the share of Kuwaitis in the population, and similarly for non-Kuwaitis, in order to achieve the correct aggregates.

Thirdly, the data are ordered by total household income, not per capita household income. We simply assume that this provides the same ordering, implicitly assuming that household size does not correlate with expenditure. We attempted to get hold of the original data but received no reply from the Kuwaiti Central Statistical Office.

Fourthly, as reported in the text, probably the most important problem is that total household expenditure implied by the household survey data is only 42 per cent of the level reported in the national accounts. In most countries household consumption is lower when measured in household surveys than in national accounts, but Deaton (2005) finds that the average ratio is 86 per cent – more than double that in Kuwait. In Kuwait’s survey data total household expenditure is KD4.6 billion for the year October 2007 to September 2008, while the national accounts estimate of Private Consumption Expenditure, which is very close in concept (and which we take to mean the same thing as HFCE),²³ is KD11.0 billion for 2008.

One likely part of the explanation is that the rich tend to be under-sampled: data collectors for household surveys are unlikely to make it past the mansion gates. If this is the reason why the survey fails to capture more than half of private expenditure, and the

²² Povcal was written by Shaohua Chen, Gaurav Datt and Martin Ravallion and can be downloaded from <http://go.worldbank.org/YMRH2NT5V0>.

²³ See Anand and Segal (2008) for discussion of the relationship between national accounts and survey estimates of consumption.

expenditures of the rest of the population are not under-estimated by any large amount, then it implies that inequality will also be greatly under-estimated. For this reason we suspect that the estimated Gini of 28.0 is lower than the true value.

On the other hand it is possible that all expenditures, including those lower down the distribution, are under-estimated. If they are uniformly under-estimated then inequality will not be affected but poverty levels will be. As explained in the text, since Kuwait does not report an official poverty line we employ a US-based poverty line as used by the OECD (2008b: 152), of US\$8,087 per capita,²⁴ which we convert into Kuwaiti dinars using the PPP exchange rate. If we take data straight from the survey, 26.6 per cent of Kuwaitis and 58.4 per cent of non-Kuwaitis live below this poverty line. If we scale all expenditures up to the level estimate in national accounts, multiplying them all by $1/0.42 = 2.38$, then less than 1 per cent of Kuwaitis and 6.1 per cent of non-Kuwaitis live below the poverty line.

Estimating per capita oil rents

In estimating the extent to which household expenditure reflects the magnitude of oil rents, there are two reasons why we cannot simply compare household expenditure with per capita oil revenues to the government. First, as we have seen, the government saves a large share of its revenues in the form of the RFFG. These savings are intended to benefit Kuwaitis in the future rather than today. To account for this we can take government expenditure, as opposed to government income due to oil rent, as our measure of the quantity of oil rents that we should expect Kuwaitis to be currently benefiting from. This makes a very big difference: in 2007/8 government income from oil was KD17.7 billion while government expenditure was KD9.7 billion.

Secondly, some government expenditures are in kind, including subsidies and health and education services, which benefit households without appearing in survey data as household expenditures. We therefore exclude government expenditures on subsidies and services from the amount of rent that should appear as household private expenditures. We identify four categories as those that we expect to provide in-kind benefits to households: transfers to civil institutions, general subsidies, education and research, and health services. These comprised 7.2 per cent of government expenditures in 2008/9. Subtracting this share from government expenditure in 2007/8 gives KD9.0 billion, or KD9,634 per Kuwaiti, which we refer to as 'adjusted per capita oil rents'.

²⁴This line is defined as 60 per cent of median US household consumption for a four-person household, which is US\$32,388. The OECD poverty lines are based on equivalence scales, so the per capita income poverty line depends on the number of individuals in the household. We use the four-person household poverty line because it is the largest household size whose poverty line is reported, while in the survey data Kuwaiti households have on average 8.6 individuals and non-Kuwaiti households have 5.2. The Kuwaiti data do not, as far as we know, use any equivalence scales. The application of this poverty line is therefore imprecise.

APPENDIX B: MISCELLANEOUS EXPENDITURE AND TRANSFERS (KD MILLION), 2008/9

	2008/9	As a %
Public services	851.06	7.9
<i>Services to organizations</i>	521.26	4.9
<i>Financial services</i>	43.76	0.4
<i>Security and justice</i>	119.67	1.1
<i>Foreign expenditure</i>	166.37	1.5
Defence	953.03	8.9
Social services	7,755.44	72.2
<i>Education</i>	530.38	4.9
<i>Health</i>	347.79	3.2
<i>Social security payments</i>	6,877.27	64.0
Public services	370.64	3.5
<i>Information</i>	32.95	0.3
<i>Religion</i>	7.83	0.1
<i>Residential</i>	201.80	1.9
<i>Public facilities</i>	128.07	1.2
Economic services	344.14	3.2
<i>Mining and quarrying</i>	254.26	2.4
<i>Transport</i>	0.37	
<i>Communication</i>	0.74	
<i>Electricity and water</i>	1.21	
<i>Trade and industry</i>	2.90	
<i>Agriculture and fishery</i>	84.66	0.8
Other	467.09	4.3
Total	10,741.39	100.0

Source: Ministry of Finance of Kuwait (2008/9: 40).

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This research paper was written under the auspices of the Kuwait Programme on Development, Governance and Globalisation in the Gulf States at the London School of Economics and Political Science with the support of the Kuwait Foundation for the Advancement of Sciences.



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