Rahmaniah Occasional Paper 01

Beyond Sovereign Funds: Transforming a Rentier Economy and Improving Governance through the Creation of Autonomous Endownments

Giacomo Luciani

Al-Rahmaniah Cultural Center
Abdulrahman Al-Sudairy Foundation

Beyond Sovereign Funds: Transforming a Rentier Economy and Improving Governance through the Creation of Autonomous Endownments

Giacomo Luciani

A Paper Presented at
the Rahmaniah Annual Seminar

January 2009
Al-Ghat

Al-Rahmaniah Cultural Center
Abdulrahman Al-Sudairy Foundation

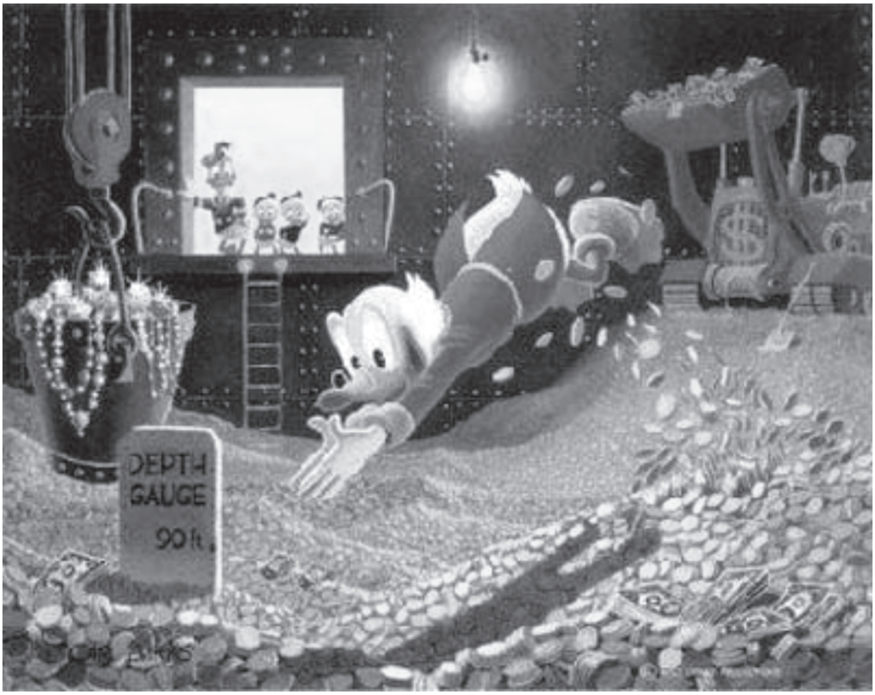
__The Rahmaniah Occasional Paper Series__ is a select presentation of papers offered at the Rahmaniah Annual Seminar, a forum on current, socio-economic and international affairs as they pertain to Saudi Arabia. The Seminar is organized by the Rahmaniah Cultural Centre and its participants include more than forty scholars, lawyers and businessmen from Saudi Arabia, the Arab countries, the U. S. and Europe. The Rahmaniah Cultural Centre is sponsored by the Abdulrahman Al-Sudairy Foundation. The Seminar is held annually in Al-Ghat.

ISBN: 4 - 6 - 90028 - 603 - 978

First Edition
Riyadh, Saudi Arabia 1431H/ 2010
All Rights Reserved

Giacomo Luciani

Director, Gulf Research Center Foundation (Geneva); Professorial Lecturer of Middle Eastern Studies at the SAIS Johns Hopkins University Bologna Centre: and Visiting Professor, Graduate Institute of International and Development Studies (Geneva) and Institut d'Etudes Politiques de Paris (Menton Campus). Prof. Luciani's career has been marked by repeated "trespassing" between academia, industry and government. He has been economist at the Bank of Italy (1972-74), founded and directed the Institute for Research on International Economics (IRECI), and worked for the Italian Institute of International Affairs (1977-86). From 1990 to 2000 he worked for ENI, the Italian Oil Company. He has taught at UCLA (1986-88), the Institut d'Etudes Politiques in Paris (1994-97), the Robert Schuman Centre of Advanced Studies at the European University Institute in Florence (2000-6), and the College of Europe (2007-8). He has consulted for various international organizations, companies and Gulf governments. His research interests include Political economy of the Middle East and North Africa and Geopolitics of energy.


DEPTH
GAUGE
90 ft.

Beyond Sovereign Funds:

Transforming a Rentier Economy and Improving Governance through the Creation of Autonomous Endownments

Much of academic literature on resource-rich countries is influenced by the "resource curse" paradigm, which asserts that resource-poor countries stand a better chance to develop than their resource-rich counterparts. A key theoretical element in support of the resource curse is the so-called Dutch disease, according to which the increase in spending (whether government or private) which normally follows a resource bonanza undermines the competitiveness of the "modern" or "emerging" economic activities exposed to international trade, and attracts resources to activities that are not exposed to international trade, the so-called non-tradables sector. Considering that, sooner or later, any resource boom is bound to be followed by a bust, the country is left unable to fend for itself.

The Washington consensus has therefore tended to encourage governments of resource rich countries not to spend any additional income that they might receive when the price of their exports increase, but set the money aside in specially created funds, variously called stabilization funds or funds for future generations. More recently, as the size of these pools of money increased, the term "sovereign funds" has become popular, to underline the pretended danger that these funds might be used for political, rather than purely economic purposes.

Already in the 1970s, at the time of the first "oil crisis", it was common to predict that the Gulf countries' attempt to industrialize, transform their economies and develop would be doomed to fail. Thirty plus years later we know that this has not been the case: the Gulf countries have made enormous progress in transforming their economies, and clear signs of diversification are visible. In this, their experience contrasts with that of the majority of resource-rich countries, whose record, because of mismanagement and/or conflicts, has been distinctly poor.

The literature has accordingly taken a more nuanced attitude. It is now acknowledged that the resource curse may be avoided, and transformation of economies originally based on natural resources into diversified and viable modern economies is possible.(1)

The dilemma, however, has not faded away. Rentier states need to spend, because it is through government expenditure that the national economy benefits from increased oil revenue. In the process, the continuation of economic diversification is endangered by the Dutch disease, and the key to avoiding the latter is in carefully selecting how to spend, and specifically how to invest.

At times of rapidly rising oil revenue, it is not advisable to let expenditure grow in line with revenue. The resulting surplus must be employed somehow: hence originates the expectation that sovereign funds will grow tremendously in the coming years.

In contrast, I argue in this paper that Gulf governments, and in particular Saudi Arabia, should adopt a strategy based on channelling increased revenue into corporate equity and endowments for service-delivering agencies,

(1) See for example M. Humphreys, J.D. Sachs and J.E.Stiglitz eds. “Escaping the Resource Curse”, New York, Columbia University Press 2007.

progressively restricting the role of the Government. The two aspects – strengthening national corporations by providing them with larger equity bases and establishing endowments for service-delivering agencies – are closely related, because agencies' endowments would be invested in corporate equity instruments. In the end, the system would generate a multiplicity of endowments, rather than one or few large funds; and endowments would invest primarily in national financial assets, facilitating the growth and internationalization of national corporations.

(1)

Let me begin by stating my assumptions.

First, I assume that the current decline in the price of oil is temporary. The potential for aggregate expansion of non-Opec oil production is limited or non-existent; the major industrial countries will slowly reduce their dependence on oil, but this will take time. In the meantime, demand from the emerging countries will continue to rise fast. Oil will grow relatively scarcer, and prices will be sustained. How much, nobody can tell: but surely well above the so-called "budget requirements" of the GCC countries. I join in this conviction the mainstream of opinion as represented by the International Energy Agency, which predicted prices back at $100 and rising within the end of the decade.

The GCC governments will therefore enjoy surplus funds that they will need to use somehow. The question is: what might be the best use?

The answer, of course, depends on the nature of the objective that these governments might be pursuing. Here my second assumption is that the fundamental inclination in favour of pursuing national development will be maintained. This means, first and foremost, pursuing economic growth and diversification, and extending the benefits of the same to all nationals, by providing them with education and jobs (other things as well, but less essential). In other words, we assume that Gulf States (the States - not necessarily the individuals in power) will not behave like Uncle Scrooges, whose goal is pure financial wealth accumulation.

The third assumption is that the GCC countries are not going to evolve towards totalitarian regimes, in politics as well as in economics. This means that the fundamental inclination in favour of the private sector will remain: the state will not push out the private entrepreneurs by investing in areas in which they may invest; it will rather progressively open new spaces to private investors in areas which, so far, have been dominated by state agencies.

Under these assumptions, Gulf governments face some real dilemmas concerning the use of surplus funds from oil revenue (i.e. funds in excess of what is required to balance the budget with a conservative approach to expenditure). It looks like whatever they do with these funds, they run into trouble.

(2)

Consider for example the policies of Saudi Arabia since 2003. When it became clear that oil revenue would surpass expenditure requirements, the government opted for not increasing expenditure in line with revenue. Instead, it used the excess revenue to pay back debt – a very conservative move by common standards. However, as debt was held by domestic financial intermediaries and investors (including state entities such as General Organization for Social Insurance (GOSI) and the Public Pension Fund), paying it back injected liquidity into the economy, at a time when this was already receiving liquidity from abroad (repatriated private funds attracted by the improved growth prospects, foreign direct investment).

The stock market bubble of 2003-2006 was fuelled by this inflow of liquidity, and the government was largely powerless to calm down the frenzy. To counter excessive stock valuations, the government should have borrowed from the market and mopped up liquidity. It should have either issued bonds or offered some of the shares it owns for sale on the market. But had it done so, it would have further added to its own excess funds: how to employ such funds?

The government could have injected more equity into companies that it owns or controls, or even established new companies. This, however, would have been a step in the wrong direction, further increasing the role of the state in the economy, and pushing out the private sector. We have assumed that this is not what the government wants.

Private sector companies would indeed need access to additional risk capital, to expand both domestically and internationally - and in some sectors also to facilitate mergers and acquisitions - substituting a few capable national champions to a large number of small and weak players. However, if the government provides the equity, this is nationalization, and eventually companies cease to be private.

(3)

Enter the sovereign funds. Excess liquidity can be kept as reserves of the central bank, which are meant to compensate for short-term balance of payments deficits, and should be kept in liquid assets. However, considering that no balance of payments deficit is foreseeable, piling up central bank reserves is a bit like creating a huge stock of umbrellas in Riyadh, in case the monsoon comes.

Instead, one can invest in assets that are less liquid and more risky, but presumably allow for more interesting returns: international stocks and other forms of sophisticated financial placements. It is the promise of better reward in exchange for taking risks -- which obviously many have tended to underestimate -- that has motivated the establishment of investment vehicles separate from the Central Bank – the sovereign funds.

For a time, international attention has focused on the issue of transparency: sovereign funds are not transparent, they are not accounting publicly for their holdings and investment policies. But, with all that has happened on international markets in the last few months, lack of transparency will probably be excused. Everybody will understand the embarrassment of fund managers that might have to admit to huge losses!

Somehow, proponents of establishing reserve or stabilization funds have assumed that returns on international investment would always be positive. The possibility of disastrous losses has never been considered in the literature -- but it is now a reality in front of our eyes. Sovereign funds are not obliged of marking their investment to market, and as a consequence we do not know exactly how much they lost since the onset of the global financial crisis in the summer of 2008 – but estimates indicate that losses have been substantial[1]. Indeed, it would be difficult for major investors to do much better than the market on average. It is of course possible that the market will to some extent recover, hence "in the long run" losses might be offset and sovereign fund investment might move back to positive ground. Nevertheless, the long run is made of a sequence of short runs, and for the time being the oil producing countries may be viewed as having traded their good oil for paper that has lost much of its value.

As a consequence of this traumatic experience, I expect that enthusiasm for "sterilizing" oil revenues by putting them into some sort of fund – which has been the long-standing doctrine of the Washington consensus – will be greatly diminished in the future. Oil in the ground is an asset, and should be exchanged for other valuable assets: preference will go to assets that are more tangible and under closer control of the investing country – and if not enough of these are available, the temptation may arise to take a little less of the oil out of the ground.

(4)

To find a palatable alternative to simply accumulating financial assets in sovereign funds -- which has proven to be

(1) A recent working paper of the Center for Geoeconomic Studies of the Council on Foreign Relations in New York estimates that the sovereign funds of Abu Dhabi, Kuwait and Qatar have recorded losses of 40%, 36% and 41% respectively between December 2007 and December 2008. Saudi Arabia is estimated to have lost only 12%, because of its more conservative investment posture. B. Setser and R. Ziemba "GCC Sovereign Funds: Reversal of Fortune", New York, Council on Foreign Relations, January 2009.

too risky and, in addition, is not looked at kindly by the rest of the world -- we need to set off from a consideration of the current status of the process of economic development in the region.

After some 35 years of intensive development efforts, at times supported by abundant oil revenue, the region has achieved remarkable progress in creating modern infrastructure. It has also established a certain number of enterprises that are well positioned in the global pecking order and recognized as highly competent in their respective fields: Saudi Aramco, Sabic, Dubai Ports World, Agility, Zain and more. These enterprises are mostly state-owned, either in full or in part, and controlled.

In parallel, companies owned by private interests have also grown and strengthened, but few of these have yet managed the crucial transition from being family businesses, privately held, to being proper public corporations, whose shares are significantly traded on the stock exchange. In turn, the slow pace of this necessary transformation has hindered the process of mergers and acquisitions, whereby corporations normally focus on their area of greatest expertise and potential, and divest side activities. Through this process, national or regional champions may emerge which, in turn, are capable of entering the global mergers and acquisition scene and expand internationally.

We have to this date very few examples of Gulf companies investing internationally and pursuing a strategy of global expansion; those that have done so have the State as important or sole shareholder. In contrast, corporations from Russia, India and China have been much more active in the global mergers and acquisition scene, and have been much more aggressive in expanding internationally.

Because of the open nature of the Gulf economies, economic development and diversification can only further progress if the Gulf enterprises are capable of engaging in international competition and acquire a global dimension. The alternative to this is being perennially confined to the role of local joint venture partners of major global corporations – a subordinate role, which will never allow for satisfactory development of the national economy. The challenge to nurture regional corporate champions capable of standing up in the global arena is the key feature of the next phase of Gulf economic development.

(5)

The slow pace of corporate transformation into publicly traded and professionally managed entities may at least in part be attributed to the conservative mentality of many business families, who are afraid of losing control and prefer to keep their affairs outside of public scrutiny. Indeed, it may very well be that in certain circumstances it is better for the implementation of the desirable business strategy that a company be privately, rather than publicly held, and in the advanced economies private equity funds have specialized in the acquisition of public companies that are then turned private. But generally speaking it remains the case that publicly held companies are able to grow more easily through acquisitions, and become true global corporations.

Hence, the slow pace must also be related to insufficient incentives. It has not been attractive enough to take companies public and float their shares through IPOs for more than very marginal fractions of their respective equity capital.

Equity markets in the region have not provided the kind of stability and rewards that would convince a larger number of family businesses to be transformed and floated. To be sure, we do have a continuing flow of IPOs, so the process I am envisaging is to some extent already unfolding – but one would expect it to gather pace and become much more significant.

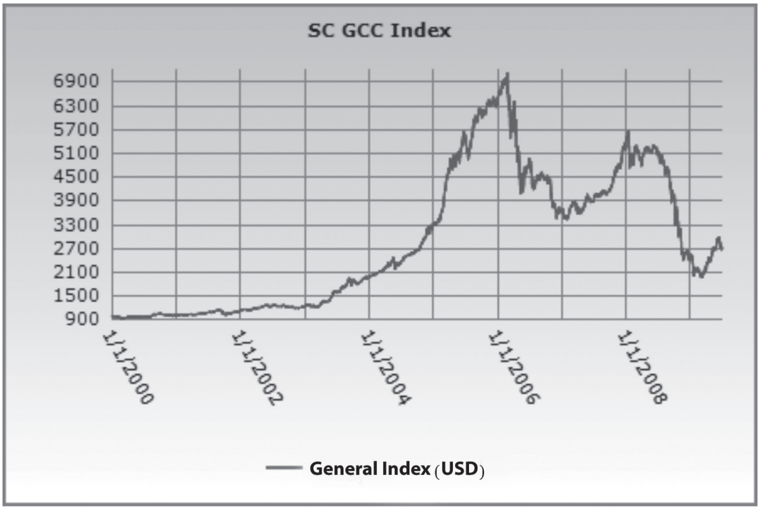
In turn, the equity markets in the region have manifested excessive volatility. The first reason for the excessive volatility has been that too few companies are traded and too little of their equity is actually available for trading. Movements of funds in and out of the equity market generate large excursions in prices, increasing risk and facilitating the formation of bubbles. Stability requires significantly increasing the supply of quality assets which may attract new investors and provide confidence in the valuation of the stock. In this respect, a major opportunity was lost at the time of the stock exchange boom in 2003-6: if more of the government-held stocks had been offered to the market, we would have today a much broader base and healthier markets.

The second critical reason why Gulf equity markets are so volatile is the absence of important institutional investors. The latter are key players in many industrial countries' equity markets, and are normally believed to play a stabilizing role. I write "normally" because several institutional investors in recent years have fallen prey to the universal delusion of seeking large returns at reputedly low risk, whose consequences the whole global economy is suffering at the moment. Institutional investors, just as sovereign funds, have been forced to book some very large losses, in some cases because they trusted the wrong professional administrators, in some other cases because they took excessive risks – or simply because the financial maelstrom has left no one unscathed, not even the most prudent investor. But, assuming appropriate regulations are imposed and order is re-established, it remains true that institutional investors play a fundamentally important role in the proper functioning of equity markets.

The Gulf economies therefore are in need of policy solutions that will create or facilitate the emergence of strong and well managed institutional investors, which may contribute to channelling savings towards the equity market, and create a stable environment, attracting companies to become public and be traded.

The need for a proactive role of the government in "managing" the domestic equity markets to deliver orderly and solid growth is, I believe, more evident today than ever. The failure to contain the bubble of 2005-6 has had disastrous consequences on many small investors, and has destroyed – temporarily at least – the prospect of giving birth to popular capitalism in the Gulf. This has deprived the regimes of an essential tool to spread more widely the benefits of the oil economy, and left them with the traditional tools of government employment and procurement – both of which have well known limitations.

Since the bursting of the bubble, confidence in the equity markets has not really been restored. A recovery has taken place in the first semester of 2009, but needs to be sustained by improved regulation and corporate governance, to support the confidence of investors in the potential for earnings and growth.



The weakness of equity markets is a source of worry for the regimes in power and a threat to the support they enjoy in public opinion. It is certain that most Gulf investors, who had their wealth in real estate or financial assets in the OECD countries, have suffered badly when markets collapsed. Adding weakness in the domestic equity markets points to a substantial downsizing of private sector financial capabilities, at a time when governments have been able to accumulate substantial excess funds. A mechanism for redistribution must be found, and re-establishing confidence in a prosperous equity market is a necessary ingredient of the policy package.

In order to put the equity markets back on a solid and sensible growth path, financial authorities must have tools to control both supply and demand of equities. They can control supply of equities through policies of encouraging private companies to go public and/or through gradual divestment of government equity holdings. At the same time, they can control demand through setting up a class of institutional investors that will invest in the market for the long term, and channelling oil revenue into the market through them. Careful management of these policy tools should give the government the possibility of influencing and stabilizing equity markets, avoiding the formation of bubbles but also sudden losses in asset valuations.

It should be noted that some institutional investors do exist, such as the Public Pension Fund and GOSI in Saudi Arabia. However, they have not been directed to play an active role in the stock market, but are rather investing in areas, such as real estate, in which they compete with private entrepreneurs. To my knowledge, a breakdown of assets held by these institutions is not publicly available,[(1)] preventing a discussion of the appropriateness of their posture for fostering economic development – but the impression is that their portfolio is very traditional and not dynamically managed.

Legislation and appropriate regulation concerning investment from institutional investors and private bankers (professional administrators of institutional

(1) According to information made available by the Saudi Press Agency, GOSI has invested in 60 companies, including stakes in banks, cement and healthcare companies. Among its publicly known positions are a 13% stake in the Southern Province Cement Company and a 9.9% stake in al Raji Bank. In March 2009 GOSI launched the Hassana Investment Company, to invest in local, regional and international stock markets. Bloomberg, July 1, 2009.

endowments) should be put in place to pave the way to filling this important gap in the region's financial architecture.

(6)

What policies can governments put in place to foster the transition sketched above?

The State cannot directly invest in domestic companies because this would be tantamount to nationalization – outright, creeping, or disguised: call it what you want, it would still be nationalization. Doing the same through the screen or intermediary of a sovereign fund does not really make much of a difference. To the contrary, the State should be actively selling some of the holdings it owns at present in order to increase the supply of assets that are actually available for trading.

The search for a solution might begin with establishing a national development bank whose mission would be to extend long term credit in various forms, including buying bonds or equity, to corporations wishing to go public. The difference between this and a sovereign wealth fund would be not only that the bank would not normally interfere with corporate governance, but also that any participation in the equity of corporations would be understood as being temporary and for successive liquidation.

One prominent example of this kind of institution is Brazil's National Development Bank (BNDES) whose mission includes also supporting Brazilian exports through the provision of export credit (see text box)

The Brazilian Development Bank (BNDES) is a federal public company associated with the Ministry of Development, Industry and Foreign Trade. Its goal is to provide long-term financing for endeavors that contribute to the country's development.

The results of the endeavors financed by BNDES can be seen in the improved competitiveness of the Brazilian economy as well is in the higher quality of life of its population.

BNDES also seeks to strengthen the capital structure of private companies, the development of capital markets, the trading of machines and equipment and the financing of exports.

Since its establishment, on June 20th, 1952, BNDES has financed large-scale industrial and infrastructure endeavors, and has played a significant role in the support of investments in agriculture, commerce and the service industry, as well as in small and medium-sized private businesses.

Source: BNDES web site: http://inter.bndes.gov.br/english/

BNDES also has a clear mission to contribute to the development of the Brazilian capital market, by encouraging companies to go public and improve their governance, through a variety of tools (see next page text box)(1).

(1) BNDES is certainly not the only institution of its kind, but, to my knowledge, it is the largest in the world. At the end of 2008, it had $120bn in assets. The IFC, a subsidiary of the World Bank, performs a somewhat similar role inasmuch it takes (small) equity participations in newly established companies. But in the last budget year BNDES had total disbursements of US$ 30.8 bn, while the World Bank and its concessional arm IDA had total disbursements of US$ 20 bn, and IFC had total disbursements in loans, equity and investment in debt securities for US$ 7.6 bn. Considering that BNDES serves a single country, albeit a large one, and the World Bank group has a global remit, the difference is quite remarkable. By this metric, Saudi Arabia's SIDF fares rather well, as in 2008 it had disbursements of the order of US$ 12.6 bn, which is considerable when related to the size of the Saudi economy. However, SIDF only lends to new industrial projects, and does not engage in the broader range of activities that we advocate.

Capital Market

The growth of companies is given by the capital investments from shareholders, reinvestment of profits and credit operations. In the current stage of the Brazilian economy it is fundamental to strengthen and increase the number of companies with papers traded in the capital market, an important canalization instrument for internal and external savings.

BNDES operates several financing modes to companies, and can also participate as a subscriber of securities in open companies or in companies that, in the medium run, can enter the capital market, including the operations for internationalization, restructuring of competitive companies, merges and incorporations.

Small and medium innovative companies, which are prioritized in the capitalization action of BNDES, can receive direct participation and/or participation through closed investment funds. Depending on their regional/ sectorial actuation, these offer a greater operability range, thus also allowing the leveraging of private resources for the capital of these companies.

The operations of BNDES in the capital market aim at:

- Strengthening the capital market through new market operations;
- spreading the concept and encouraging the use of corporative governance by companies;
- expanding the demand and liquidity of securities;
- contributing to the democratization and strengthening of the capital structure of companies;

- developing products that make the capital market more attractive and safer to small investors;
- developing the closed funds industry; and
- supporting small and medium innovative companies.

To achieve these objectives, BNDES permanently operates:

- in the development of technical tools, utilizing innovative investment analysis techniques, specific mechanisms for each security value, specific legal models and varied divestiture mechanisms;
- in the elaboration of indirect programs through a minority participation in closed funds administrated by third parties - emerging companies, private equity, of governance/liquidity - that perform the important task of expanding and giving wider range to the operations; and
- in the diffusion of corporative governance practices in the companies tin which it participates so to provide greater transparency and respect to minority shareholders, together with the Securities Commission [CVM] and the Stock Market of São Paulo [Bovespa].

Source: BNDES web site: http://inter.bndes.gov.br/english/

The difference between a development bank and a sovereign fund should be clear. A sovereign fund may to some extent invest domestically rather than internationally, but its mission is normally to maximize the value of its holdings or at least protect the real value of the capital that is entrusted to it. A development bank has a much more complex and ambitious goal of promoting development in its multiple dimensions, and will generally invest only in domestic enterprises.

A development bank may be viewed as an evolution of the special funds that have played such an important role in Saudi economic development, especially the Saudi Industrial Development Fund (SIDF). However, the latter only extends subsidized loans, while the proposed development bank would do more than that[1].

(7)

The establishment of a development bank, albeit richly endowed, would still not be sufficient to solve the "embarrassment of riches" that the Gulf countries are suffering from. Nor does it offer a solution for the need for institutional investors to provide a stable investment base for the regional equity markets.

The other component of the solution to our policy dilemma might come from a new approach to the provision of social services in the Gulf countries which may lead to substantial restructuring of the state and contribute to a much narrower definition of the "government" strictly identified.

Today, social services are extended by government agencies, which in certain cases enjoy some autonomy in governance but mostly are little more than ministerial departments. Their degree of financial autonomy is strictly limited, and their budget is part and parcel of the annual budget of the State.

This rigidly centralizing approach is not the best-suited

(1) In a recent article which barely hid the magazine's lack of sympathy for BNDES, The Economist wrote: "The government still has a thing about helping to create big companies that can conquer rivals abroad—BNDES is now helping to finance projects carried out by Brazilian firms elsewhere in South America." This is exactly the reason why I believe BNDES is an example worth looking at. See "Brazil›s development bank: Central planning", The Economist, April 16, 2009.

to achieve efficiency and responsiveness; furthermore, it concentrates all spending in the hands of the government, reinforcing the built-in tendency to grow a bloated bureaucracy.

The alternative that I would propose is one whereby agencies delivering various social services would be granted financial and governance autonomy, and progressively receive endowments from the State. Once they have received an endowment, agencies would be partially or totally taken off the annual budget of the State. They would thus have to support themselves through other sources of income, including fees paid by their customers, private donations, or funds that may be made available to them out of other endowed agencies on a competitive basis(1).

The precursor to this scheme may be identified in the King Abdullah University of Science and Technology, which has received an endowment of US$ 20 billion. The idea of establishing a new university, which will have special characteristics of autonomy and governance, through the establishment of an endowment, points exactly in the direction that I am interested in exploring(2).

Progressively, not only all universities, but also secondary and even primary educational establishments (federated in districts) could be turned into self-governing non-profit institutions, each living off an endowment, plus other funds

(1) For example, universities may be endowed and a separate Foundation for Scientific Research may be set up to allocate research funds competitively to projects submitted by the universities. This is a fairly standard and frequently adopted institutional structure.

(2) In fact, KAUST is not the only example. The newly established King Abdullah Petroleum Studies and Research Center (KAPSARC) that is to be based in Riyadh has also received a US$ 3 billion endowment, while the status of other major programs initiated by King Abdullah is less clear (they look more like large multi-year expense budgets rather than proper endowments).

made available to them in a variety of ways, separate from and independent of the annual government budget.

Students would be required to pay tuition, but they might receive scholarships from a national education foundation or multiple other foundations, including some that might be established by private or corporate donors. Tuition fees should be high enough that each education delivery establishment will be encouraged to increase enrolment and compete for new students. Scholarships should be made widely available, and for the lower levels of education be universal, but the student and his/her family should be able to choose where to enrol.

Educational establishments would also be able to tap other funds made available on a competitive basis for various purposes (e.g. to encourage research, promote IT or language skills, encourage reading skills, encourage sports etc.) and from multiple agencies with well-defined missions, each operating on the basis of its own endowment.

The role of the government in this context would shift from the actual delivery of services to the formulation of policies, setting of standards and curricula, and the monitoring of the functioning of individual educational establishments.

It is clear how this architecture may contribute to greater efficiency – through the use of systematic comparative evaluation and benchmarking – and flexibility. The government can, and should, dictate a core curriculum common to all, but individual establishments would be free and indeed encouraged to introduce variations and experimentations to differentiate themselves from the rest of the offering.

We may repeat pretty much the same reasoning for the provision of health services – another major item in the Saudi budget – and other social services, in particular those rendered to the poor and needy. What has been an obvious trend in recent years -- with the establishment of numerous private foundations which have engaged progressively in more important work in education and other forms of philanthropy -- would be reinforced by the state itself engaging in setting up endowed delivery institutions.

The use of accumulated oil revenue for establishing a constellation of autonomous, non- profit institutions, endowed and independent of the annual government budget would thus progressively serve the purpose of slimming down the latter's size and the requirements placed on it. Considering the size of expenditure on social services in the Saudi budget, we are speaking of the possibility of reducing the size of the government budget by 30-40%, which would be quite substantial.

(8)

Traditional public finance doctrine is opposed to separate funding arrangements for different categories of expenditure: all revenue should accrue to the central budget, and all expenditure should be paid out of the same. The main rationale for this approach is to prevent the emergence of separate accounts that are not equally transparent and monitored, and may end up serving special interests rather than the general interest.

While there is good reason for being prudent with policies of segmenting the government budget, it is a fact that the practice of connecting specific sources of revenue to specific expenditures is frequently used in international experience. Similarly, we assist in a growing trend towards granting governance and financial autonomy to public agencies, and monitoring their performance on the basis of contractual relations with the relevant ministry, or of domestic/international benchmarking. In the context of being financially autonomous, public agencies are allowed to raise funds in a variety of ways, including imposing fees on the relevant client group in ways that are not very different from taxation[1].

Furthermore, it is not clear that the argument in favour of a single, all-encompassing government budget should logically be extended to government savings and to the revenue derived from the same. There is an intrinsic ambiguity of oil revenue, which may be viewed as current revenue or as a form of asset liquidation. The common practice is to view it as current revenue, and in this case the creation of endowments should be considered part of the government's single budget current expenditure, even if it serves the purpose of weaning service delivery agencies from dependence on the annual budget itself.

The proposed way of managing public finances may be uncommon, simply because most governments have limited or negative savings, and are hard pressed to engage in infrastructure and other investment. It is rare for governments to be in a position of establishing endowments, although it does happen, e.g. under the form of the granting of land or other state property.

(1) For example, regulatory agencies are normally funded through a levy on the turnover of the companies which they regulate.

For oil producers with substantial government savings, the proposed approach makes good sense because it avoids stirring the kind of resistance that accumulating a single, large, centralized sovereign wealth fund inevitably would evoke. The multiple endowments of service-providing institutions would be able to invest nationally or internationally, may be managed independently by their own managers or rely on professional outside management, and would have a clear mandate to generate long term revenue for the concerned institution.

Domestic as well as foreign enterprises would not be confronted by a small number of directly government-controlled funds, which may be problematic because of size and the possible interference of political considerations in their investment decisions. Instead, they would be confronted by a large number of relatively small investors that may very well remain invisible to the public and politicians, and would in any case not have a direct impact on the fortunes and valuation of the company. They would be perceived as just regular institutional investors wishing to maximize the value of their assets.

The controversy surrounding SWFs would thus disappear: even if SWFs are not entirely superseded by the proposed policy, they will not grow as large as it is sometimes predicted, and therefore appear much less threatening.

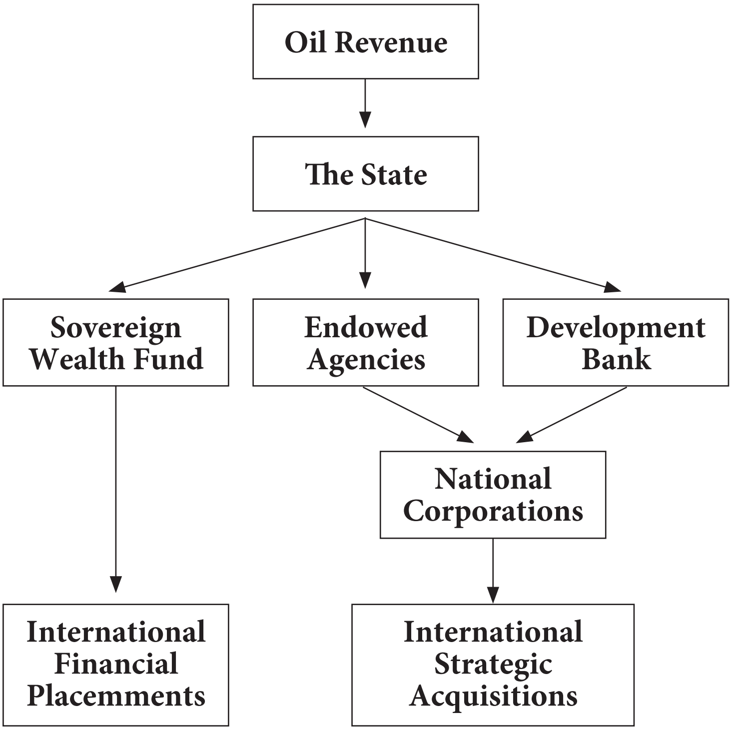
Of course, one needs a very good policy in place to monitor and limit the risk that the constellation of endowments will be allowed to take: rules of prudence and good governance must apply to them and a supervisory authority must be empowered to monitor their investment decisions and benchmark their financial results. This, however, should fall well short of establishing common governance for all funds.

(9)

Establishing a plurality of service agency endowments would set the stage for revitalizing and stabilizing the region's equity markets.

The progressive destination of oil revenue to the establishment of funds would generate a stream of resources which may be invested with priority in domestic bonds and equity. Although parameters to steer the investment of endowments towards various asset classes may vary over time, it would be appropriate to encourage them to engage in investment strategies different from those of a majority of private investors. If endowments simply "follow the herd" their potential benefit for national economic development will be more limited. This may mean discouraging them from investing in real estate (a sector that has attracted excessive investment in the region) and limiting international investment, while favouring the purchase of instruments which would channel finance towards publicly traded national corporations. The putting in place of such a policy, with the clear promise of a stream of revenue being channelled towards equity and long-term debt, would constitute a powerful incentive for companies to go public. The government might carefully monitor the behaviour of the market, and avoid instigating a new bubble by being ready to sell equities, at least those that it does not need to own for strategic reasons.

The key to the success of the policy would be the combination of the action of the proposed development bank, of various other domestic and international development banks, and of the inflow of investment funds generated by the transformation of oil revenue into endowments. If the policy succeeds in increasing the transformation of family businesses into public companies, and these have access to additional capital resources allowing them to expand domestically and internationally through mergers and acquisitions, then the net outcome will be the transformation of oil revenue into strategic, rather than purely financial, international investment.



Establishing national corporations that have the financial clout to engage in major international acquisitions is what is required to guarantee the future of economic development and diversification in Saudi Arabia and the rest of the

GCC. If the region is to play a key role globally in major industries such as petroleum, petrochemicals, aluminium and more, it must be able to take over some of the existing major players in the field, and absorb their technology and marketing networks.

Thus a strategy to create national corporations of global significance is superior to simply investing internationally through sovereign wealth funds, because the latter are expected to engage in purely financial placements, which do not offer any benefit with respect to industrial capabilities. Sovereign funds are purely a tool for “parking” excess balances, while international strategic investment is a tool for development and increasing competitiveness.

It should also be noted that so far fewer objections have been raised on the part of the major industrial countries to international strategic investment than to financial placements on the part of sovereign wealth funds. While this might to some extent be paradoxical, it is a fact that suspicion towards SWFs is mainly rooted in the pretended danger that they might be politically motivated in their investment decisions. Financial placements are volatile and easily reversed; hence some governments are afraid that SWFs might influence the stability of their equity markets through sudden withdrawal of large funds. No such threat may exist in the case of strategic investment.

There will be resistance to strategic investment as well -- just as periodically we see utterances against foreign direct investment in general and resurgence of economic nationalism. We have the negative precedents of KIO’s investment in BP; of the Chinese attempt to buy UNOCAL and, just recently, Rio Tinto; of Dubai World Ports in the US. In all cases, the fact that the companies involved were state-owned was part of the problem. But we also have many positive cases: for example SABIC's acquisitions, notwithstanding their large size and strategic importance, have stirred no political controversy at all.

There are lessons to be learned from past experience, and I believe some of the lessons are:

- That acquisitions made by private or publicly traded companies in which the State is not the dominant shareholder are less controversial than those made by wholly state-owned entities
- That acquisitions of companies that are in financial difficulty and whose share value has declined will be less controversial (existing shareholders will be happy, the bailout will be viewed with relief)
- That acquisition of individual divisions or businesses of larger companies will not be controversial (all of SABIC's acquisitions have been of this type)

Strategic investment is an art which must be progressively perfected and is best implemented by industrial rather than financial players. Hence it is supremely important that oil revenue be transformed from financial into industrial capital. The role of endowed institutional investors would be exactly that of transforming accumulated oil revenue into equity capital of industrial enterprises, which can then engage in strategic international investment.

(10)

The process envisaged would have profound economic and political consequences on the oil producing countries.

The reader may visualize the process as unfolding in steps over an extended period of years or even decades. The first step is likely to be the transformation of one or more of the existing special credit institutions – such as the SIDF – into the proposed National Development Bank. The Bank would provide institutional and financial support to a process of corporate restructuring, further empowering the array of investment banks that have proliferated in the region, in the expectation that such a process will start in earnest.

At the same time, key institutions may be selected to receive initial endowments. The major universities are probably among the early candidates to receive endowments: as these are progressively built up, their financial autonomy from the government should be increased, and they should be told that sums that they receive out of the government's annual budget will be progressively reduced.

In parallel, other initiatives, which resemble endowed institutions but properly speaking are not, should be more clearly organized as endowed institutions. For example, the King Abdullah Scholarship Program should be transformed into a Foundation for Supporting International Education and made independent of the Ministry of Higher Education. The King Abdullah Project for Developing Public Education (Tatweer) should similarly be transformed into an independent foundation.

Other independent foundations might be set up for the promotion of specific priority targets, such as fostering the study of mathematics and science, or improving the quality of school buildings, or supporting extracurricular activities in schools – all on the basis of competitive allocation of funds.

Presumably, at the beginning the preferred area for the creation of endowments would be higher education, but there is no need to rigidly limit the scope. Foundations for purposes related to public health or medical objectives are an obvious possibility, as are endowed agencies to pursue priority social goals, such as providing for housing for the poor.

Some of the endowments may be large, other will be rather small. "Sizing" of endowments will be a crucially important task, as endowments that are too large or too small relative to the task which the endowed agency is expected to fulfil would create misallocation of resources. Benchmarking of international experience and a policy of progressively building up endowments from a deliberately insufficient starting base may help in avoiding gross misallocations.

Some of the endowed institutions may manage their own endowment; others will rely on professional outside advice. Plurality and diversity of experience should be encouraged, because it is the best way to compare outcomes and progressively improve on governance and delivery.

From the point of view of the economy, after a certain time one would register:

- A much reduced role of the government from all points of view: smaller government budget, smaller government employment, reduced revenue requirements…

- A much stronger private sector, composed of more numerous, larger corporations, in which the government may in most cases keep a participation, but whose equity would be primarily owned by a large number of foundations (originally established by the government, but legally and institutionally separate)
- An economy which is more diversified and better integrated in the global context
- A broader, stronger and more stable financial market
- A much richer potential fiscal base, opening the door to progressively financing the government budget by way of taxation, and devoting a growing share of the oil revenue to establishing new, or adding to existing endowments

In terms of GDP statistics, it is likely that the role of the “oil sector” would be significantly reduced (the net outcome very much depends on oil prices). The perception of economic dependency on oil would certainly be reduced. Injecting capital into a totally new class of institutional investors would facilitate the task of mobilizing the private sector in the implementation of some of the key development projects, such as Saudi Arabia’s new economic cities. These are expected to be entirely financed by the private sector, but this is turning out to be more difficult than was originally envisaged. Endowed agencies (or targeted investment companies, originally fully owned by the state, but destined to be privatised as soon as possible) may be established to take up some of the tasks related to the creation of the economic cities.

The political implications might be even more interesting. Of course, much will depend on the exact structure of governance of the autonomous endowed entities that I propose to establish. If they are subjected to strict governmental control, then they will be viewed as simply appendices of the government and part of the public sector even if they legally are not. But is this a necessary outcome? After all, Islam has a rich tradition of relying on endowed institutions – waqf – for the pursuit of specific priority objectives: in many countries, the state has tended to tighten the control on waqfs; here we advocate the opposite: that the state should rely on waqfs to decentralize decision making and implementation on the basis of a clear mandate, preferably consisting of a single, well-defined and measurable objective – which would facilitate monitoring and assessment of performance.

My assumption is that the autonomously endowed entities would be governed by boards appointed by the King rather than by Ministers; and will be responsible to the King rather than to the government. This is the prevailing practice already today in Saudi Arabia.

The rules governing the composition of the board of each endowed institution may vary for each individual case, and room might be created for partial representation of specific categories of stakeholders (e.g. in universities a certain number of seats may be reserved to members elected by alumni, by the faculty, or appointed by the local municipal or regional administrative authorities – as is common practice even in the US). However, the leadership should be chosen or ultimately confirmed by the King, whose diwan will be able to monitor performance through systematic benchmarking and measurement, establishing a practice of pruning out all non performers. The King may opt for establishing a formal or informal consultation mechanism to receive advice on appointments, but the whole concept rests on the ability of the final arbiter to promote competent management, and get rid of non performers. This is not an easy task in any society and requires an authority which is genuinely above the fray, and capable of making difficult or potentially embarrassing decisions.

At the same time, individuals appointed to govern the endowed institutions must be given sufficient stability to encourage strategic vision and planning. This is not a problem in Saudi Arabia, where rotation in ministerial and other executive positions is normally very slow; but it is one of the recognised merits of autonomous quasi-state entities in Western democracies, where frequent government change generates excessive instability in the management of a wide array of agencies.

(11)

If then oil revenue comes to be used increasingly for the purpose of establishing or adding to endowments rather than paying for the annual budget of the government, and this becomes the main tool in the hands of the King to pursue his strategic vision of the development of the nation, coupled with the supervisory role on the governance of endowed institutions, we would then be looking at a novel and very interesting division of institutional roles between the monarch and the government.

The monarch would concentrate on the long-term vision and strategy for the nation, and pursue the same not through day-to-day intervention in administrative decisions, but through the allocation of oil revenue to different autonomous entities, each with a clear mandate, and through the ultimate supervision of the same[1].

The government, whose budget might increasingly be funded through taxation rather than oil revenue, would focus on administrative tasks, in line with a rather narrow definition of its role, focusing on international representation, defence, law and order, the administration of justice and the setting of broad policies.

In complex contemporary societies, the traditional distinction between the three powers – legislative, executive and judicial – must be revised and further distinctions introduced. In particular, there is a crucial distinction between strategy and tactics, long-term vision and short-term implementation, that acquires increasing importance, especially in countries undergoing profound economic and social transformation. This distinction is well recognised in the corporate world, where the strategic and tactical roles are frequently separated (the CEO vs. the COO). It is also recognised in some constitutions, such as the French, where the role of the President is separate from that of the Prime Minister (the latter being responsible to Parliament and possibly hailing from a different political party or coalition

(1) It is interesting to note that the KAUST endowment was established overseas and in such a way as to be buffered from any future meddling.

than the President)[1].

It is commonly recognised that democracies are not very good at strategic thinking and policy making. Although surely democracies are sometimes capable of making policy decisions whose effects and benefits will be seen years into the future – while costs may be seen immediately. Nevertheless, it is well understood that the natural tendency is towards prioritizing short-run benefits. The electoral cycle in fiscal behaviour and policy-making – engaging in liberal deficit spending, or refraining from imposing new taxes in the months preceding an election, so as to create consensus or avoid alienating voters who are not fully conscious of the long-term implications -- is all too well known.

It is for this reason that democracies have increasingly opted for establishing autonomous agencies, which are, in a sense, deliberate exceptions to democratic accountability. Autonomous central banks with governors that cannot be removed from their post for the duration of their mandate are a case in point. Another is the example of the US Supreme Court where the judges are appointed for life terms.

It is only too easy to expect that a country enjoying a stream of oil revenue if ruled by democratic institutions may fall into the trap of populist policies (see for example Venezuela today). We must assume the prior existence of a mature democracy with strongly rooted civic values, such

(1) It has been pointed to me that the proposed division of roles resembles that between the historical Caliph and the Sultan, with the former focused on the overall and long-term welfare of the umma and the latter responsible for its quotidian affairs. Some may point to the constitution of the Islamic Republic of Iran and the division between the Supreme Leader and the President of the Republic. I would rather stress that there is no necessary religious justification for the separation I propose, just one based on good governance and the need to separate strategic vision from day-to-day implementation.

as in Norway, to expect the kind of restraint which may be needed to resist populist temptations in the presence of an oil bonanza.

In this respect, the political dynamic in Kuwait is quite telling: as the government is appointed independently of the Parliament, the latter indulges in populist initiatives which are expected to increase the popularity of elected MPs, but are quite irresponsible and create a permanent conflict and total stalemate with the government. It is possible that if Parliament had a greater say in the composition of the government it might then behave more responsibly, but this might very well not be the case, and the populist spirit may still prevail.

But should we conclude that government in an oil producing country needs to be authoritarian? I believe not: rather one should move in the direction of deconstructing "government" and "State" and look for a novel allocation of tasks and powers that will clearly separate the strategic from the administrative function.

Control of the allocation of oil revenue is the key in this respect. The government should not have control of the oil revenue: it should receive an allocation from the King and finance any excess expenditure through taxation. This would open the door to a different relationship between the government and the legislative branch (whether the latter is appointed or elected is a different issue), progressively making government accountable to the legislative power. Taxation may be introduced progressively, beginning with indirect taxation in the form of Value Added Tax (VAT), then taxation on corporate entities which would encourage greater discipline and transparency in corporate management. Taxation is important as a source of revenue but also as a basis for regulation of the economy. Direct personal income taxes are especially difficult to administer and should be introduced only at a later stage.

So the government would receive an allocation from oil revenue but would not be the only beneficiary. A growing share of the oil revenue would be used to establish endowments, each with specific purposes and rules of governance. There might be room for further forms of representation within the governance of some of these autonomous agencies, while the ultimate supervisory power would pertain to the monarch.

In other words, I can see a path for progress towards not only greater political participation – which is happening already – but also representation – a path which will not necessarily lead the King of Saudi Arabia to playing the same role as the Queen of England. It is a path that can be advocated on the basis of sensible arguments of prudent investment, economic diversification, good governance and best practice. It does not need to be proposed in ideological terms that smack of outside interference. It can be original and quite interesting, even rooted in Islamic norms of governance and supervision.

(12)

In informal discussions of these ideas I have been asked: has this that you suggest been done or attempted in any other country? Do we have precedent?

The answer is no, if we think of the grand scheme in its entirety. Governments have not resorted to the systematic establishment of endowed institutions for service delivery with a macro vision for national development. And the reason for this is quite simply that the normal condition of the vast majority of governments is to be strapped for cash rather than flush with it. That said, we have precedents of governments setting up autonomous agencies and guaranteeing their independence, including separate funding. We have the experience of endowed service delivery institutions whose endowments have been built progressively over decades and centuries, including some through the generosity of governments.

We also have the precedent of setting up endowments for the purpose of facilitating industry restructuring. The Italian banking system is a case in point: Italy had a large number of relatively small banks, many which were not set up as corporations – rather as charitable institutions whose profits were expected to be devoted to projects of public interest in their respective communities. Mostly, these were local banks with a strong link to a particular territory or community.

The problem with this set up was that banks, not having a clear ownership structure (they had, strictly speaking, no owner) could not be sold, preventing a process of merging many small local banks into a smaller number of banks of international significance. In order to address this issue, the government decided in 1990 to restructure the banks, and transform them into foundations: the foundation would own the bank, which would be organised as a separate corporate entity. In this way, the foundations became the owners, and the banks became proper commercial corporations.

This then opened the door to the rapid process of mergers, out of which two major Italian banks have risen. The foundations have administered their endowments, which initially consisted entirely of the shares of “their” banks, and now increasingly consist of a diversified portfolio of financial assets. Because of this for the first time powerful and wealthy foundations have emerged in Italy – a country where private foundations were not very well developed at all.

Of course this is not an exact precedent for what we have presented above. There are a number of important differences: the banking foundations are not service providing institutions, and they were not created through grants originating from the state. But the Italian state could have approached the issue by asserting ownership over the banks and then divesting the same, rather than establishing foundations.

In conclusion, while we may find discrete precedents for elements of the proposed strategy, the combination of the same in the way I tried to sketch in this paper would be new and unprecedented. But is that so surprising? After all, the Kingdom of Saudi Arabia is a sui generis economy and polity, and must look for and develop its own original solutions.