Combating Terrorism Through Reforms: Implications of the Bremer- Kasarda Model for Saudi Arabia

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On a journey through the Kingdom, I heard the word reform everywhere I went, though no one seemed to agree on exactly what it meant.[1]

-Elizabeth Rubin

Saudi Arabia is currently implementing a broad set of economic, political and social reforms.[2] The progress made in implementing them will have a significant impact on the Kingdom's fight against domestic terrorism. The important question is not what kind of presence Al Qaeda has established in Saudi Arabia, but how some segments of society can be weaned away from the type of thinking represented by Al Qaeda. Unless that is done, Saudi Arabia will not be able to achieve either social or political stability.

Given the fact that significant progress cannot be made simultaneously in all the relevant areas of reform, the problem facing the Saudis is one of identifying those reforms (and their sequencing over time) that are most likely to be critical in combating the country's domestic terrorist threat. The sections below attempt to sketch out such a reform strategy from the perspective of a model developed by Jennifer Bremer and John D. Kasarda.[3] This new approach is very relevant for the Saudi case because their model suggests that that terrorism is likely to develop and thrive in certain specific environments defined in terms of the lack of progress made in broad based economic, social and political reforms. On this basis Bremer and Kasarda classify Saudi Arabia as a prime candidate for a high level of terrorist activity.

Terrorism and the Economy

Frustration stemming from the economy's inability to sustain growth and provide jobs for a growing segment of the population is widespread in Saudi Arabia. From time to time expectations have been raised with oil price booms, only to be dashed once prices crash. Increasingly one hears:

> ...there's a lot of frustration and anxiety among young Saudi men. Almost half of them have lost hope for the future. And they are ripe for recruitment by Islamic extremists…Adding to the frustration are the lack of outlets for discussion and debate. Trade unions are barred as are all other professional associations…Saudi society has few political tools to counter the extremism that has taken root here and the results are actions like the recent bombings in Riyadh.[4]

This environment is an integral component to Bremer and Kasarda's framework.[5] Their main conceptual construct is what they term "The New Second World". This is a group of countries that have reached middle-income status over the past two decades and that are now in the midst of the critical economic and political transitions from third world to the first.

The New Second World transition has three phases. The first, or early phase, typically begins when a low-income country starts to industrialize rapidly, unleashing the complex transformations—urbanization, income growth, economic diversification—that accompany it. Take-off occurs if growth continues for a decade or more. In the middle phase, industrial production per capita approaches three times what it was when the transition started, and growth in low-value-added manufacturing is rapid and sustained. Incomes rise and a middle class begins to emerge. Bremer and Kasarda note that if this middle phase continues for 10 to 20 years, the country would likely reach the advanced phase, often a time of recurring economic crisis and political turmoil. Countries currently in this advanced group include Brazil, Poland, Russia, and Turkey.

Saudi Arabia is in the first stage, along with countries such as Egypt, Iran, and Pakistan (Figure 1). This group has failed to move forward to the middle stage largely because of growth-limiting policies and institutional rigidities. As Bremer and Kasarda note:

> History suggests that failure to make steady progress through the New Second World transition's early phase to the middle period is extremely dangerous. If the transition stalls here—as it did in post-World War I Russia, and as it has now in much of the Middle East—failure can lead to revolution and Al Qaeda-style international violence.[6]

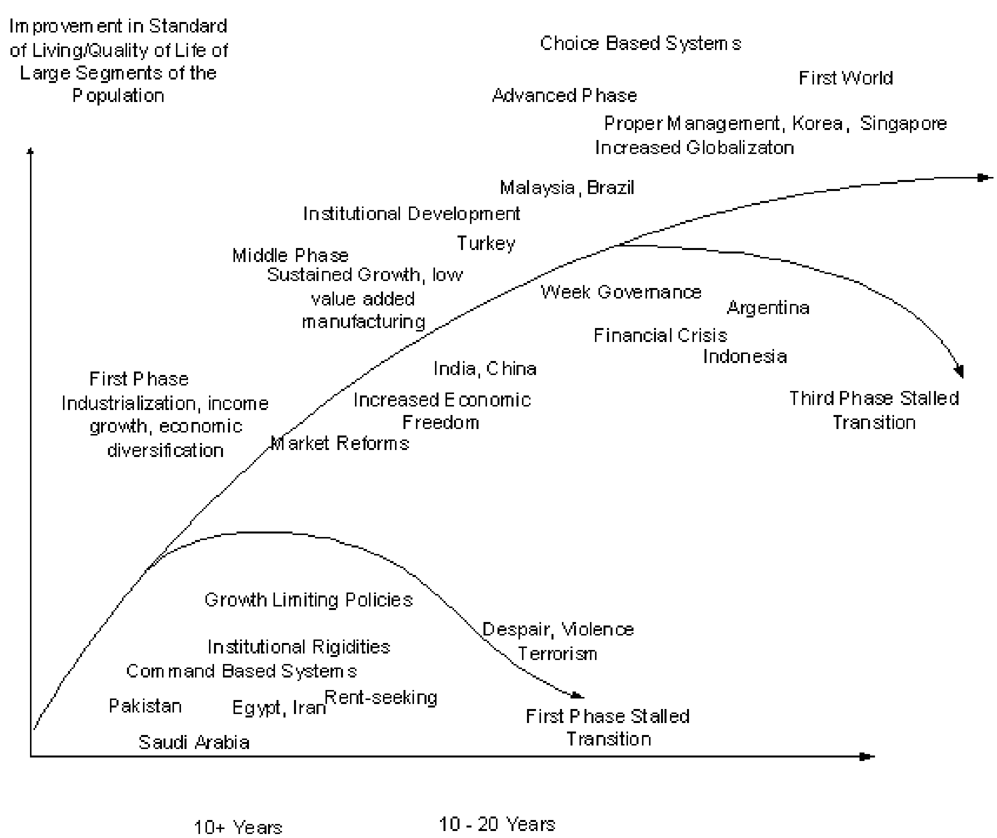

Figure 1: New Second World Transitions; Created, based on the description of transition provided in Bremer and Kasarada.

The one thing that the nations stuck in the early phase have in common is slowness in adopting market-based economies and democratic political institutions and organizations.

Measuring Economic Freedom

The Heritage Foundation/Wall Street Journal Index of Economic Freedom[7] reflects the absence of government constraint or coercion on the production, distribution or consumption of goods and services. Stripped to its essentials, economic freedom is concerned with property rights and choice. To measure economic freedom the Index takes ten different factors into account:

1. Trade policy;
2. Fiscal burden of government;
3. Government intervention in the economy;
4. Monetary policy;
5. Banking and finance;
6. Capital flows and foreign investment;
7. Wages and prices;
8. Property rights;
9. Regulation, and
10. Informal market.

The index provides a framework for understanding how open countries are to competition, the degree of state intervention in the economy, whether through taxation, spending or overregulation, and the strength and independence of a country's judiciary to enforce rules and protect private property. Some countries may have freedom in all factors; others may have freedom in just a few. One of the most important findings of research carried out using the index is that economic freedom is required in all aspects of economic life. That is, countries must score well in all ten of the factors in order to improve their economic efficiency and consequently the living standards of their people.[8]

Saudi Arabia's Progress

Unfortunately, the Kingdom's progress in attaining economic freedom been rather slow, suggesting that despite the fact that a number of reforms have been enacted in recent years, their impact has been somewhat limited. According to the Heritage/Wall Street Journal Index, economic freedom by 2004 is a bit lower than in the mid 1990s (Table 1). In 1996 the Kingdom was classified as mostly free (index =2.95). Starting in 1999, however, Saudi Arabia's economic freedom index moved into a range characterized as mostly un-free, reaching its lowest point in 2001. Since, that date, the Kingdom has improved its economic freedom slightly, but not enough to return to the "mostly free" category, the minimum value needed to escape Bremer and Kasarda's first phase.

The Kingdom's low economic freedom is illustrated by particularly low scores (Table 2) in several of the 10 categories noted above: trade policy; government intervention; foreign investment; and banking and finance. In fact, the country consistently received a "free" score in only one area—monetary policy. Wages and prices and fiscal burden were the only areas consistently receiving a "mostly free" score, while trade policy, government intervention, foreign investment, and banking and finance consistently received scores of "repressed." Clearly, these are the areas that need the most immediate attention.

Trade policy (4.0 in 2004; stable, high level of protectionism). The Kingdom receives consistently low scores in this area largely because of a wide range of non-tariff barriers. The Kingdom also has a number of preferences for Gulf Cooperation Council (GCC) countries as well as a vast government program that favors domestic producers. Hopefully, the phasing out of these restrictions will also pave the way for the Kingdom's entry into the WTO.

Government Intervention (4.5 in 2004; stable, very high level). The Kingdom was considered to have a low degree of economic freedom in this area because of the high level of government consumption (27 percent of GDP in 2001). A gradual shift in budget priorities towards investment and away from government salaries/welfare state should assist the Kingdom's movement to a higher degree of economic freedom without disrupting the economy or risking higher levels of unemployment.

Capital Flows and Foreign Investment (4.0 in 2004; worse, high barriers). As noted in the sections above, the Kingdom is actively working to eliminate many of the restrictions in this area. However, a lot of work remains to be done despite a flurry of new investment legislation. Outside observers are also skeptical. Miles et al. note that in the Saudi case there is a wide gap between reform rhetoric and actual practice.[9]

Banking and Finance (4.0 in 2004; stable, high level of restrictions). The domestic commercial banks are heavily exposed to the government and to contractors dependent on government payments. Another complaint is that credit institutions such as the Saudi Industrial Development Fund (SIDF) allocate credit based largely on government-set criteria rather than market conditions.

Property Rights. The Saudi judiciary is not perceived as independent, but as influenced by other branches of government. In addition many businessmen complain that the enforcement of contracts is slow and often arbitrary. A recurring complaint is that the courts more often than not side with Saudi partners in disputes with foreign firms or individuals.

In sum, there has been little movement toward increased economic freedom in Saudi Arabia during the last several years. In fact, for 1996-2004 period as a whole there was a slight deterioration in this indice. If the country is to escape from Bremer and Kasarda's initial stage of transition, it must attack corruption and bureaucratic inefficiencies, improve its regulatory environment, and strengthen its legal system. Historically, the unfortunate fact is that despite the high pay-off to economic liberalization, the process in Saudi Arabia has proceeded unevenly.

Links of Reforms to the Real Economy

One advantage of assigning numbers to the various dimensions of economic freedom is that it facilitates comparisons across countries. While this information is useful in and of itself, it also lends itself to the identification of empirical links with the real economy. Does increased economic freedom facilitate higher rates of economic growth? Lower inflation? If so, are certain components of economic freedom more important than other components?

Numerous empirical studies have tended to confirm the positive links between increased levels of economic freedom and economic growth and development.[10] Taking the Middle Eastern economies explicitly into account, several patterns are readily apparent:[11]

Saving and Investment. Key macroeconomic indicators such as capital formation, foreign investment, and national savings are all positively affected by increased economic freedom, especially the freedom to exchange with foreigners. Improved legal structure and property rights result in higher levels of national savings. On the other hand, reduced government size and improvements in the legal structure and property rights reduces consumption, presumably by opening up profitable outlets for increased savings.

International Trade. Increased freedom to exchange with foreigners increases both imports and exports. In addition, deregulation in credit, labor, and business assists in expanding exports.

Government Expenditures and Taxes. The percentage of the budget allocated to subsidies tends to decline with increased economic freedom in the public sector. Interestingly increased size of government is associated with lower tax revenues, no doubt leading to even greater deficits in many cases.

Financial Development. In the financial area, and after controlling for the level of development, market capitalization of listed companies as a share of GDP would increase with reductions in regulation of credit, labor and business. Financial intermediation, a key indicator of successful development, would also expand with deeper reforms in the area of legal structure and property rights.

Diffusion of Technology. The spread of technology or more technologically sophisticated products is greatly enhanced with progress in expanding economic freedom. In most cases, the key element is improvements in legal structure and property rights.

In sum the empirical literature confirms the positive linkages between increased economic freedom and a wide spectrum of economic indicators. Clearly progress in this area should assist in Saudi Arabia's quest to escape the terrorism-prone first phase (Figure 1) of Bremer and Kasarda's New Second World development. The real question however is, given the Kingdom's limited capacity for undertaking extensive reforms, should further attention be devoted to improved economic freedom, or should emphasis be shifted at this time to other areas noted by Bremer and Kasarda: governance, financial regulation and development, and globalization? Perhaps even some elements of each?

Governance

As noted above, improved governance is another area of reform suggested as critical for sustained growth and progression through Bremer and Kasarda's phases of Second World development. While the ranking of countries on the basis of their relative progress in attaining improved governance is inherently subjective, a recent World Bank study provides a set of rankings incorporating the full extent of our knowledge about this phenomenon.[12] More precisely, the World Bank data set presents a set of estimates of six dimensions of governance covering 199 countries and territories for 1996, 1998, 2000 and 2002.

Voice and Accountability. This variable measures various aspects of the political process, civil liberties and political rights. These indicators measure the extent to which the citizens of a country are able to participate in the selection of governments. Also included in this variable are indicators measuring the independence of the media.

Political Stability and Absence of Violence. This governance cluster combines several indicators that measure perceptions of the likelihood that the government in power will be destabilized or overthrown.

Government Effectiveness. This variable combines aspects of the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies.

Regulatory Quality. This aspect of governance is more focused on the policies themselves. It includes measures of the incidence of market-unfriendly policies such as price controls or inadequate bank supervision as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business development.

Rule of Law. Included in this dimension of governance are several indicators, which measure the extent to which the citizens of a country have confidence in and abide by the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts.

Control of Corruption. This dimension of governance measures perceptions of corruption. By this measure corruption is defined as the exercise of public power for private gain. It is often a manifestation of a lack of respect of both the corrupter and the corrupted for the rules that govern their interactions, and hence represents a failure of governance.

Assigning these measures of governance to the countries in different phases of New Second World development produces some interesting patterns (Table 3):

1. Each measure of governance attainment improves significantly as countries progress from phase 1 to phase 3. This result is consistent with the Bremer and Kasarda thesis concerning the relative progress in reforms as countries reach higher phases of Second World development.
2. For the phase 1 countries, there was a slight deterioration between 1996 and 2002 in Voice and Accountability, Political Stability, Government Effectiveness, Regulatory Quality and Rule of Law.
3. Over the same time interval, these same countries experienced a very slight improvement in their ability to control corruption.

In Saudi Arabia's case:

1. The Kingdom consistently scores the lowest in the area of Voice and Accountability. The country's scores for this dimension of governance were considerably below the norm for even phase 1 countries. Even worse, there was a significant deterioration in voice and accountability over the 1996-2002 period.
2. The country experienced a marked improvement in political stability between 1996 and 2002. In this area the Kingdom scores considerably above the norm for phase 1 countries.
3. Government effectiveness and Regulatory Quality are both considerably above the norm for phase 1 countries. Each dimensions of governance have experienced some improvement over the 1996-2002 interval.
4. In recent years the Kingdom's progress in the areas of Rule of Law and Corruption have also shown considerable gains. Progress in these areas has been significant to the extent that the Kingdom's scores in these two areas are comparable to those found in the phase one group of countries.

Access to Capital

Because of the Asian Financial Crisis in the late 1990s and the Argentine financial crisis of 2000, Bremer and Kasarda attach great significance to capital market development as a key to sustained growth and development. While the Heritage/Wall Street Journal index is suggestive of relative progress in this area, the level of detail required by Bremer and Kasarda's model requires the Milken Institute Capital Access Index (CAI). This index gauges the ability of entrepreneurs to gain access to financial capital. That is, it provides a relative score of the ability of innovators, managers and owners in need of capital to start a new enterprise, expand a promising line of business, finance ownership change, or restructure a large multi-industry firm. The CAI measures not only the breadth, depth and vitality of capital markets, but also the ability to gain access without discrimination. By this index Saudi Arabia ranks fairly low: 80th of 89 countries in 2003. In 2003, the kingdom was the lowest rated of the Middle Eastern countries included in this annual ranking of countries.[13]

An insight into the factors responsible for Saudi Arabia's low capital access ranking can be gained from examining the factors that comprise the index. The index is made up of five key aspects of the country's financial markets: (1) the general economic environment; (2) bank lending, (3) capital market development, (4) international environment and the country's sovereign ratings.

The General Economic Environment

The general economic environment creates the conditions for entrepreneurial activity. Here the macroeconomic measures used in the CAI reflect variables relating to inflation, interest rates and fiscal policy. Institutional measures reflect the fact that capital access is constrained when legal contracts are not enforced or private and/or government agents can expropriate assets or earnings with no recourse. Given the basic condition of a sound macroeconomic and institutional setting, the next important aspect of capital access is the ease of securing bank lending.

In creating a measure of the general economic environment, the CAI poses a number of questions to respondents. In what countries are banks free to lend to projects of their choice that are likely to yield high returns? What countries have competitive banking markets? Where are banks dominated by repressive policies or outright state ownership? Is the banking sector stunted or robust? Here, Saudi Arabia scores below the Middle East norm, itself already low by international standards, on the macroeconomic environment, institutional environment, banking depth, while scoring above the norm on banking governance and banking repression .

Capital Market Development

The next component of the CAI is capital market development. Equity and debt are vital sources of startup and later stage external finance, and can facilitate the restructuring of entire industries. Securitization and other more sophisticated instruments of finance are included in the measure of advanced capital market development. Here, the Kingdom again scored below the mean on equity and advanced aspects of capital markets. The bond market in the Kingdom, along with most other Middle East countries, did not get a rating on the Milken index, presumably because their capital markets have not reached the level of sophistication needed for meaningful comparisons.

The International Environment

The international environment gauges entrepreneurs' ability to access international capital, an additional source of funds for entrepreneurs and active capital market participants. Poor sovereign credit ratings are a significant barrier to capital access. While these rankings are based in large part on measures already included, the Milken Institute considers them on the premise that the various rating agencies bring additional expertise and knowledge of these markets in assessing country ratings. They use sovereign credit ratings by Moody's and Standard and Poor's. Here Saudi Arabia scored above the mean on its sovereign debt rating and international portfolio flows. It was below the mean on general international capital and foreign direct investment.

With regard to the Second World grouping patterns (Tables 4, 5), there is a sharp break between phase 1 and phase 2 countries, but not such a sharp break between phase 1 and phase 2 countries, suggesting that major strides in capital access may come in the latter stages of phase 2 and the first part of phase 3.

Globalization

Finally, Bremer and Kasarda's model assumes increased integration (globalization) into the world economy as a condition for successful progress through the phases of Second World development. Unfortunately, there are no direct measures of globalization.[14] It is a multidimensional phenomenon that defies precise measurement. However, the A.T. Kearney company has compiled a comprehensive data set including most of the facets commonly associated with the term.[15]

Kearney's sixty-two sample countries are ranked on their attainment of each aspect of globalization Saudi Arabia ranks 54 in Economic Integration, 48 in personal contacts, 50 in Technology, 35 in trade, 61 in FDI and 38 in portfolio flows.[16]

New Second World Dynamics [17]

All the areas of reform noted above: economic freedom, governance, capital access and globalization define the three phases of New Second World development. The major question at this point is whether or not Bremer and Kasarda's model is operational. That is, given the available data described above and the values for specific countries could we place, with a high degree of certainty, a country in a unique phase and specify the conditions (progress in reforms) required to advance to the next phase? Steps along these lines would enable us to: (1) identify those reforms critical for successful transition out of the first, terrorism prone phase, and (2) the proper time to implement key reforms. Should significant progress be made in governance before tackling globalization? If so, what areas of governance are critical? And is progress in certain areas of globalization much more productive than others in speeding up the transition to higher phases?

Since many of the reforms in discussed above reflect the same phenomenon, for example freer markets, a factor analysis was first undertaken to determine the dominant dimensions of reform—variables that are highly associated with each other thus forming an independent reform dimension.[18] Out of our data set only four independent reform dimensions were found to be present:

Dimension 1: Governance

1. CA - Environmental/Institutional
2. EF - Informal Market
3. GOV - Corruption
4. GOV - Government Effectiveness
5. EF - Average Level of Economic Freedom
6. GOV - Rule of Law
7. GOV - Regulatory Quality

Dimension 2: Capital Access

1. CA - Capital Markets, Equity
2. CA - Bank Depth
3. CA - Overall Average Score (2002)- Capital Access
4. CA - Average Value of Capital Access Scores for Financial Markets

Dimension 3 Mixed Reforms

1. CA - International, FDI Flows
2. EF - Banking and Finance
3. GOV - Political Stability
4. GLB - Economic Globalization

Dimension 4 Globalization

1. EF - Trade Policy
2. GOV - Voice/Accountability
3. GLB - Portfolio Flows

4. GLB - Technology

Where: CA = Capital Access reform category, EF = Economic Freedom reform category, GOV = Governance reform category, and GLB = Globalization reform category

A second step in the analysis, sought to determine if these dimensions could replicate the classification of countries provided by Bremer and Kasarda.[19] If the three phases of Second World development can not be defined precisely in terms of one or more of the four main reform dimensions noted above, then Bremer and Kasarda's framework would have little operational value in identifying those reforms most productive in advancing a country to a higher phase of Second World development.

The analysis suggests that of the four reform dimensions two, globalization, followed by capital access, are sufficient to clearly define a unique set of reform conditions in each of the three phases of second world development. Based on their relative level of progress in these two reform dimensions 92.9 percent of the countries were classified along the lines suggested by Bremer and Kasarda (Table 6) The only two countries classified differently than in the Bremer and Kasarda framework were Venezuela, classified as a phase one country and Thailand, classified as a phase two country. Clearly recent developments (Asia Crisis—Thailand, Stagnation, Venezuela) suggest that the revised classification of is more in line with reality than that assumed by Bremer and Kasarda. Saudi Arabia is firmly placed in phase one with a probability of 86 percent (Table 6), thus corresponding to Bremer's and Kasarada's evaluation of the existing state of reforms in the Kingdom.

To sum up, since Bremer and Kasarda's three phase framework can be replicated using a set of reforms for as the basis of country placement, the model can form the basis of identifying those areas of action are most productive in advancing countries to higher levels of development.

Assessment

The value of this analytical work is that it helps bring the challenges facing Saudi Arabia into clearer focus and enables one to prioritize reforms into an optimal sequence for action. In particular the this analysis of New Second World countries suggests that in the short run, Saudi Arabia needs to giver particular attention to trade issues and speeding up the globalization process. This dimension of reform was the most important in the country-grouping scheme. Joining the WTO is a good start as is further integration into the GCC regional group.

As noted, the four key elements of the globalization dimension are: (a) trade policy from the economic freedom dataset, (b) voice accountability in the area of governance, (c) portfolio flows and (d) technology aspects of globalization. While one characteristic of group one countries are a low level of voice and accountability, the Kingdom scores very low even by this group's standards. Clearly immediate action is needed in this area, especially in transparency of government operations, the accountability of public official interests and various aspects of government censorship.

In the medium term, the Kingdom will have to focus on improving the various components of capital access, especially deepening the banking system, and improved equity markets. While improved governance is always important, the analysis suggests that a higher priority needs to be given to capital access if the country is to progress through the Second World phases of development.

In sum, this strategy would appear to be the most productive in lifting the Kingdom out of its current terrorism prone phase one stage of Second World development. A second advantage of the reform strategy noted above is that it would most likely not have adverse side effects on the country's longer-term economic growth. In this sense there appear to be no apparent trade-offs between the reforms suggested here, growth, and the creation of an environment less supportive of terrorist causes and activities.

A final word of caution. The arguments above acknowledge that economic factors are not the sole contributor to Saudi Arabia's indigenous terrorist groups. Clearly, other factors, many specific to Saudi Arabia are no doubt important contributors. For that reason, a reform-led strategy to move into the higher phases of Second World development may be a necessary, but not sufficient condition, for significantly weakening the attraction posed by terrorism. Many of the real motivating grievances of terrorists in Saudi Arabia no doubt stem from local factors such as the influence of Wahhabism. Unfortunately there is little agreement on how to combat this source of discontent.

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