CHAPTER - III
3.1 An Analysis Of Government Policy

The Kuwaiti economy is of an unusual type because of two basic factors; one, huge income on account of heavy crude oil export and two, small size of area and population. Thus, the rate of economic growth was at a faster pace in the beginning coexisted with the imbalances in the economy. The serious imbalances were experienced by the Kuwaiti economy in its factors of production, different sectors and the investment mix as an outcome of an inadequate resource base. This situation occurred due to the disparities in the distribution of oil revenues among all the sectors of the economy and their low absorptive capacities which happened to be the result of constrained utilization of the indigenous resources. Prior to the independence of the country and the establishment of the constituted parliament in 1961 and elected parliament in 1963,

Kuwait had no sound budgetary system and a well-established and organized administration. Lack of expertise in modern public administration, planning and budgeting and other tools vital for effective management were the factors responsible for duplication of work in many spheres, less coordinated various government departments and high costs. All the sectors of the economy could not be flourished equally due to the predominance of oil sector, undeveloped primary sector (agriculture) and the lack of human capital formation. But with the increase in oil revenues as a result of a continuous increase in oil production, the formation of OPEC which helped in stagnation and later pushing up oil prices, and the independence of the country which enabled the government of Kuwait to increase its participation in oil operating activities induced the planners and policy makers to make optimum use of their depleting asset for future generations through a sound planning and management. The Kuwaiti

economic policy can be well assessed by having a closer look at its plans and policies of which initiation streamlined a diversified and swift development of the economy.

3.2 Planning and Economic Policies

The Kuwaiti economy experienced rapid diversification as a consequence of upstream of oil at commercial scale in 1946 but the establishment of Development Board in 1952 gave an impetus to the overall progress. The Board was set up with the motives of planning and coordinating construction activities particularly with regard to public utilities. The progress was, therefore, observed in the form of water disinfection plant at Shwaikh which streamlined the development of small scale industrial activities in the 1950s in Kuwait. The independence of the country brought about many structural changes in the economy but the major efforts of the Kuwaiti government, in

order to promote industrialization in the country, were proved successful with the establishment of Shuaiba Industrial Zone. In response to the speedy economic development, the government posed a sense of priority of having a clear picture of various sectors of the economy since an accurate national income account was needed for the sound economic planning and fruitful policies. Therefore, to achieve these goals, the Development Board in 1961, which was entrusted with the responsibilities of planning and advising the government on economic policy related to the identification of new development projects. But, having found the purpose unfulfilled, the government of Kuwait had to extend an invitation to the International Bank for Reconstruction and Development (IBRD) in order to achieve the task of focusing a brighter view of the economy and proper planning. The ruler of Kuwait H.H. Sheikh Jabir Al-Ahmad Al-Sabah was the principal architect of Kuwait's policy and planning as he,

being the President of the Department of Finance and Economy in 1961, had extended his noble advice and generous support to the Bank mission.

The IBRD had sent two missions; first in 1961 and the second in 1962. The first mission could not bring much positive results on account of scanty informations available on various aspects of the economy but the second mission brought forth many things which were mentioned in its report. The outlines of the previous five year plan were drawn on the basis of the final report of IBRD.

The resource potential, capital surplus and the imbalances in the economy induced the architects of the plans in Kuwait to design a policy in such a way that the socio-economic development of the country could be made possible by making optimum use of the indigenous resources. The initial plan which released in April 1967 spanning the period from 1967-68 to 1971-72 had the more conservative and realistic approach of evaluating revenues as to lower the growth rate target
with the rationale that such increments can be realized and surpassed under favourable conditions\(^5\). In this plan, tentative estimates were made on the basis of historical background due to the unavailability of sufficient and reliable current statistical data regarding many aspects of the economy. The Industrial Development Committee, which was set up in 1965, recommended the two sets of objectives of planning which were as follows\(^6\):

### 3.3 Long Term Objectives

These objectives dealt with the basic structure of the society to actuate socio-economic principles, were:

1. Building diversified self sustaining economy with emphasis on non-oil sector.
2. Developing infrastructural facilities, i.e; transportation, roads, communications, hospitals etc.
3. Ensuring a high rate of economic growth.

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6. Ibid., pp.124-127.
Increasing Kuwaiti population to achieve majority.

Raising the standard of education and training.

Creating employment opportunities.

Ensuring a rise in Kuwaiti labour force.

-Limiting the non-indigenous manpower except in highly technical areas.

Realizing a greater degree of social justice.

Inviolable propriety rights to the citizens and;

Working towards Arab economic complementarity.

**Short Term Objectives**

The objectives more immediate in nature were:

Increasing the Gross Domestic Product by 37 per cent averaging 6.5 per cent during the first five year plan which in turn would increase the upstream of oil by 6 per cent annually.

ii - Economic diversification through two ranges:

(a) **Short run** - directed towards the reduction in the high degree of dependence of the economy on housing, construction and trade sectors.
(b) Long run - the aim of alleviating the predominance of oil sector in the construction of the economy. Thus, widespread industrialization would diminish the dominant position of oil sector.

iii- Providing socio-economic opportunities to the population by reducing the number of expatriates by 2000 every year.

iv - Developing the human resources through education, training and raising health standards.

v - Improving the standard of living by upgrading the quality as well as the quality of public services.

vi - Improving infrastructure in order to reduce the social overhead capital.

vii- Redistributing the income and wealth by increasing wages.

viii-Creating geographical balance between cities and towns.

Thus, the plan seems to be the cornerstone of the later plans and the precedence in order to achieve the institutional and organizational setup to sustain
future planning. In its first development plan, government's policy aimed at investing for such projects which might deem to be the greatest contributors to the development of socio-economic infrastructure. The emphasis was given to the actual development and its consistent flexible approach. The main thrust of the plan was towards diversification of the economy from single source reliance to the multidirectional approach.

The policy, thus, aimed at the priority of making up the investments so that the absorptive capacity of the economy could be enhanced. Curtailing from the keynesian theory, the investment is the transaction of ownership of existing capital goods, or in other words, it is the purchase of new factories, plants and machines etcetra in order to steal the opportunity cost. The investment is made expecting for a yield of return in future. It depends upon the marginal efficiency of capital or level of consumption which

consists of demand for investment goods, i.e; derived demand which ultimately depends upon the current expenditure on consumption. Its variations are responded by the rate of investment. Investment may be autonomous or of government such as on the development of infrastructural facilities, and induced such as on fixed and capital stocks which depends more upon income and marginal efficiency of capital than the rate of interest. The Kuwaiti economy could gain by enhancing its capacity to absorb the revenue surpluses. In other words, the current investment would increase the future consumption and the returns, thus, opening more avenues for future investments. Since the domestic absorptive capacity of the Kuwaiti economy was too limited to absorb the increments in revenues and savings, the government infused the policy, in the first five year plan, of making up more investments abroad. The effectiveness of the policy is discernible from the table-3.1:

Table - 3.1

Savings and Investments in Base Year and Final Year of Plan (At Base Year Price)

(In Million U.S. Dollars)

<table>
<thead>
<tr>
<th></th>
<th>1966-67</th>
<th>1971-72</th>
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</thead>
<tbody>
<tr>
<td>Savings and Investments</td>
<td>1966-67</td>
<td>1971-72</td>
</tr>
<tr>
<td>Total Savings</td>
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<td>876.4</td>
</tr>
<tr>
<td>Domestic Investment</td>
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<td>582.4</td>
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<tr>
<td>Foreign Investment</td>
<td>190.4</td>
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</tr>
<tr>
<td>Total Investment</td>
<td>610.4</td>
<td>876.4</td>
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</table>

The main policy of the plan revolves around the oil sector which was considered the central pole of the Kuwaiti economy. Since oil sector accounted for more than 90 per cent to GDP and was expected to sustain its dominant position for a long Kuwaiti government planned to invest a substantial amount on the development of pre-established downstream industries and the installation of more oil-based industries. The general policy aimed at the diversification and mobilization of the resources in order to attain a
sustainable rate of economic growth. To establish an industrial base and materialize this policy, the government of Kuwait allocated $280 million in its previous budget with a projected increase of about 4.1 per cent to GDP by the fiscal year 1971-72. But the policy seemed to be getting away ineffective in the wake of high rate of depletion of oil owing to which the level of oil reserves were sinking. Thus, this situation not only snatched the attention of the government and the public but also induced the Kuwait's planners to adopt an oil conservation policy which in detail is as follows:

3.5 Oil Conservation Policy

A Flash Back:

Prior to the Tehran Agreement in 1971, the revenues to the government, despite an increase in oil production, were not increasing with the same pace. The oil industry was considered to be the buyers' market.

There was no control of the producer government over the operating practices of the oil companies which drilled where they liked and produced as much oil as they wished. Since the demand for oil and its products was increasing sharply owing to the speedy recovery of war ravaged economies of the industrial nations after the termination of World War II, the operating majors began to exploit the oil fields particularly in the West Asian region. It is also substantiated from the fact that between 1950 and 1970, massive discoveries of oil took place primarily in this region. These discoveries involved low marginal costs that created the impression of huge oil reserves and resources available to the world. The increasing demand for oil products in industrial countries led to a row of swift industrialization. As a result of it, new refineries and petrochemical industries were constructed and the old units were expanded and


11. El-Mallakh, Ragaei,(ed); OPEC: Twenty Years and Beyond, Westview, Colorado (USA), 1982, p.78.
modernized which ultimately put a strain on the oil fields particularly of the Gulf states since they were entirely being operated by the majors. Production of crude oil in Kuwait continued in a rising trend throughout the fifties and sixties until the supply of oil declined as a result of technical and political problems. The majors used to take up Kuwait's only natural resource as an alternative of the scarcity of oil in the world market. This situation emerged on account of the stoppage of supply and deceleration in oil production in other Gulf countries. It appears that the stoppage of oil supplies in 1951 and 1961 was the aftermath of nationalization of Iranian oil industry by Dr. Musaddegh and the conflict between General Qassim of Iraq and the operating majors respectively. The other things which induced the majors to exploit and produce oil in this region were: the low cost of extraction and the technical capabilities of the oil facilities in the Gulf states particularly Kuwait.

Thus, the high rates of oil production caused a decline in actual reserve-production ratio. As the production approached the reserve-production ratio declined further which consequently lessened the lifespan of the reserves of crude oil and natural gas in Kuwait. The unscrupulous exploitation of hydrocarbon resources at a faster pace on one hand and undercutting of oil prices in 1959 and 1960, though stagnated after the formation of OPEC and the independence of the country on the other caused a deep concern on the part of Kuwaiti government. The huge production of natural gas and its wasteful flaring in abundance, since it is found associated with crude oil in Kuwait so as in the entire region, turned to be a major issue which was discussed in the parliament during 1969 and 1970. The operating companies had flared several million cubic feet of gas every day which had infuriated the Kuwaiti public in general and intelligentsia in particular since they considered it as sheer wastage of their valuable natural resource. On 28 October 1970 when the
session of parliament was convened, the gas industry was 'de-facto' nationalized\(^\text{13}\). When the production of crude oil began to increase at a faster pace and the reserves dwindled, the OPEC member countries felt an urgent need of conserving their valuable non-renewable natural resource so that the supply of oil would be a determining factor in realizing higher prices. The governments of OPEC member nations had already been urged and recommended through the OPEC Policy Statement of 1968 to issue the written instructions and regulations to the operating companies to conserve their oils. These recommendations were initially implemented in certain countries but later in the rests as well\(^\text{14}\).

3.6 Adoption of Oil Conservation Policy

After the Teheran Agreement in February 1971, the oil industry transformed itself from buyers' market to

\[^\text{13}\text{ Ibid, p.34.}\]
\[^\text{14}\text{ Al-Otaiba, Mana Saeed: OPEC and the Petroleum Industry, Croom Helm, London, 1975, p.157.}\]
sellers' market. The first price rise in 1971 to some extent had stabilized the position of oil producing countries. The year 1972 was the turning point in the history of Kuwaiti oil industry when the government of Kuwait deliberately adopted the strict conservationist policy. The production of crude oil had reached its all time peak of 3.28 million barrels per day in March of the same year. Thus, in the following month, the pressure of domestic public opinion demanding a policy of oil and gas conservation ultimately culminated in a parliamentary legislation, when the government set the first limit on the annual average crude oil production at 3 million barrels per day\textsuperscript{15}. The eruption of Arab-Israel war in 1973 gave way to Kuwait to further reduce oil production as a result of its boycotting policy\textsuperscript{16}. The conservation laws were enacted to put an


end to the wasteful production techniques practised by the operating companies and to make some use of conservation and rationing experiences of the United State of America since it was the first country to adopt such policy with a view to make, economically and technically, optimum use of depletable vital natural resource 17.

Though the production of oil continued to decline as a result of the adoption of conservation policy but the revenues even then increased tremendously. The upsurge in oil revenues attributed to the sky rocketing of oil prices which was observed mainly during the years 1971-72, 1973-74, 1979-80, and 1980-81 respectively. The prices of the Kuwaiti crude of 31° API increased by about 1598 per cent between February 1971 and January 1981. Hence, the increasing oil prices despite a substantial deceleration in oil production put a problem before Kuwaiti government to absorb its

incomes, it led the government to set another limit of merely 2 million barrels per day of oil in 1975\(^\text{18}\). Above all, the "Supreme Petroleum Council" was set up on 26 August, 1974 which was entrusted with drawing up the general policy in regard with the preservation and utilization of oil resources and the development of industries related thereto within the context of the country's overall policy and socio-economic development\(^\text{19}\). In order to execute these policies, the "Committee for Supervision and Coordination of Oil Industries" was established on 27 July, 1975\(^\text{20}\). The main task to be achieved by this committee was to coordinate and follow up of the activities of the operating majors in order to enhance the degree of integration. This was followed by the establishment of "The Council of Preservation of Oil Wealth" in December.

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1975 which encompasses the execution of the above mentioned policy through many ways, mainly the specification of the appropriate rate of crude oil production.21.

3.7 Implications of the Oil Conservation Policy

Many implications may be derived from the policy discussed above but Kuwait's case seems to be based on exogenous and endogenous variables which might be effective for its economy. Exogenous variables are broadbased and matching with the OPEC's policy regarding production and prices of oil. This way Kuwait shared, with other members of OPEC, the responsibility of maintaining equilibrium between the world demand for and supply of crude oil which resulted in an upsurge in oil prices. Endogenous variables might induce Kuwaiti government to manipulate the extent of deviation of its domestic policies since OPEC has no control over the

activities of individual member countries. In this way Kuwait might take advantage of positively affecting its economy from within and outside the country. The policy implies several other interpretations which are discernible from the following points:

I - This policy was adopted hoping that oil reserves could last for about a century or so due to the limited production, thus, it would result in a longest lifespan.

II - The policy would go along with demand for higher prices of oil.

III - The production should not have exceeded the potential production capacity of Kuwait which was estimated at 5 million barrels per day at that time.

IV - The motivation behind this policy seems to have been the domestic economy's low capacity to absorb


the increasing oil revenues, first due to oil price hike and second on account of rising rates of production. It is substantiated from the fact that Kuwait needed only 17.3 per cent of the quantity of crude oil produced in 1972 to cover development expenditure and domestic consumption.

V - Demand for higher prices for its oil and the country's urge for securing higher participation in operations of oil industry made it essential to curtail the production level of 1972.

VI - Wasteful flaring of associated natural gas could be prevented by conserving oil and gas and asserting policies of expanding the absorption of domestic economy.

VII- The heavy crude of Kuwait of 31^o API could be sold easily in the western markets only by regulating its production.

VIII-Uncertainties in the world political economies and the potential for future increase in oil prices would have been the factors behind the adoption of this policy.
The realization of the significance of conservation by the Kuwaiti government is manifested in the later plans. As soon as the conservation law was passed, the regulations were imposed on all consumers to abide by them. This led to immediate savings through minimized flaring of associated gas and implementation of projects such as the LPG Recovery plants. The consumers were stressed upon to curtail their current fuel and gas consumption in Kuwait. Special auditing teams were appointed to carry out surveys leading to analyse the energy consumption and the pattern of losses in various projects. Thus, the savings in the fuel and gas consumption not only made it advantageous to the country to save the costs spent on it but also stretched the lifespan of the reserves of these natural resources longer. Hence, the conservation policy implies that its direction was paralleled to the policies of OPEC which, through its Policy Statement of 1968, urged the member countries to

make the future of their non-renewable depleting resource by adopting conservationist policies. From this policy, the applicability of theory of the mine can, thus be discerned. The theory encompasses the key economic decisions of when to extract and use the limited stock of resources that the mine contains. This decision involves a strict trade-off between the present and the future, i.e.; what is used today can not be used tomorrow and what is conserved can not be used today. This is concerned with the allocation over time of non-renewable natural resources. It can be inferred from the theory that both immediate use and delayed use have advantages. On the one side, the immediate or present consumption gratifies the consumer demand without delay or permits the use of the resource for investment purposes thereby increasing future supply of productive capital. But on the other side, the non-renewable resource can be conserved in its original form beneath the earth, thus, what is not being used today will be scarce tomorrow and more valuable.
When the resource, 'here in this case is oil', exists in known and fixed quantity and the cost of extraction is low, the trade-off between current and future consumption depends on the structure of the market. Under the perfect idealized conditions or in a competitive market a producer can sell his oil on a benchmark. The only decision left in such a condition is whether to extract their oil or gas and sell it now or to conserve all or a portion for future. In the 1970s the world oil market had been thirsty which made it an ideal condition for the oil producers, particularly whose economies were wary of surpluses, and led them to make choice of conserving most of their oil beneath the ground for future. By keeping the reserves in the form of energy Kuwait, therefore, increased the value of its resource in future. Only that quantity of oil and gas was produced which was essential to meet the requirements of consumption in its original form and in the form of revenues to cope with the needs for development expenditure. This refers to the attitude of the producers of oil and gas who
took conservation of their oil resources necessary because of the following reasons:

I - Oil is an exhaustible national capital, its utilization can optimize the rate of development which refers to a long-term structural transformation that cannot be attained by one generation. In other words, future welfare cannot certainly be achieved by maximizing current welfare which means the conservation is essential for future and long-term development.

II - Since Kuwait had lesser potential for structural diversification owing to the scarcity of natural resources other than oil and manpower; oil represented the only viable option of long-term technological changes, hence to sustain future growth through hydrocarbon-based industrialization which met public expenditure to maintain levels of employment and to balance external payments. Oil is, for these reasons, continually needed as long as new sources of income are not created. An
immediate conversion of oil depletion into new sources of income generation is not permissible by such conditions. For a long term socio-economic development, oil reserves must have a proportionately longer life span\textsuperscript{25}.

III- The need for conservation in the Gulf region is essential the fact that the rate of depletion were highest in the world. As the reserve to output ratio declined continuously and dramatically which could have been catastrophic for the economic development, the concept of conservation reached a consensus among the producers\textsuperscript{26}.

IV- The approach to the conservation of oil was morally and politically justified. The pressure on depletion were rational to check the over consumption and over spending and to create viable socio-political conditions for future generations on the one hand, and to fulfill the financial

\textsuperscript{25} Op.Cit., Al-Chalabi, p.17.

\textsuperscript{26} Ibid, pp. 18-19.
needs, as a moral as well as political obligation of the less developed countries through aids on the other.  

V - The low absorptive capacity due to the scarcity of natural and human resources motivated for the foreign investment of surplus of oil revenues in order to generate a new source of income.  

Thus, the motivation behind the oil conservation policy was to make optimum use of oil revenues by avoiding over-consumption, over-spending or wasteful use of the resource, in order to create a hydrocarbon industrial base so as the present and future generations might enjoy this natural gift bestowed on them. It stressed upon the investments on developmental projects and to keep reserves for future generation as well.  

The continuous upswing in oil revenues between 1972 and 1981, as a result of increase in oil prices  

27. Ibid, pp. 21-22.  
induced the Kuwaiti government to further drop its crude oil production. The conservationist policy was more forcefully executed in 1981. As it is true to the view of Oil Minister, H.E. Sheikh Ali Khalifa Al-Sabah*

"The country's oil policy requires the optimum exploitation of oil reserves and their conservation for as long as possible in their natural reservoires, and consequently the limitation on production"\textsuperscript{29}.

The rate of production was, therefore, kept low until the revenues declined on account of a decrease in oil prices in 1981. The reasons behind the upsurge in oil revenues were the oil price-rocketing and mobilization of the revenues, in the establishment of an industrial base mainly of derivative industries could, therefore, be achieved only after the full take over of oil industry by the government which brought about a change in the pattern of export from mere crude oil to its products.

\textsuperscript{*}Sheikh Ali Al-Khalifa Al-Sabah has later advocated the scrapping of oil production-quota as to enhance the sustainable capacity since the demand for oil started rising.

Although, the planners had chalked out an economic structure and set up certain goals in the first plan but the development projects were ignored in the beginning. The first two plans were drawn but not strictly pursued. The second phase of development planning (1971-76) beginning with the upswing in oil prices seems to have been more emphatic as stressed on the following objectives 30:

i Diversification of the sources of national income.

ii Development of human resource in the technical and administrative fields.

iii Absorption of concealed employment in commerce and civil services, and

iv More than 80 per cent of the total investment envisaged under the industrial plan was earmarked for export-oriented industries.

Besides, many more incentives were thereafter promised to give to the private investor in order to

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encourage their participation in the industrial development programme. The industrial development Bank was, thus established to expand industrial investment. The planning and the government policies regarding socio-economic development of the country have ever been based on the volume of oil receipts which were diverted into other channels. But a large part of the GDP was invested on development projects. Through the Law-106 of 1976 the government has therefore been prompt in allocating 10 per cent of its annual revenues to constitute the Reserve Fund for Future Generations (RFFG).\textsuperscript{31}

In the third five year plan (1976/77-1980/81), the government geared its policy towards the broadening and diversification of the productive base of the economy and raising the welfare of the population. This plan placed a strong emphasis on industerlization in order to diversify the economy\textsuperscript{32}. Higher priority in

\textsuperscript{31} Ibid, p.35.

\textsuperscript{32} Central Bank of Kuwait; Economic Report: 1976, p.16.
this regard has, however, been given to the capital-intensive and export-oriented industries directed at expanding the country's petroleum refining capacity and petrochemical industries, and increasing considerable amount of production of natural and liquified gas. The private investment was also encouraged. In this regard, an estimated KD 145 million were invested by the private sector intending to produce manufacturing goods for domestic as well as neighbouring countries' markets. Industrial Bank of Kuwait has also been proved of immense help as it provided a loan of KD 100 million to finance the industrial projects at concessionary terms in order to speed up industrialization. The plan gave the high priority to the infrastructural projects particularly to enhance the production capacity of the country. It includes water and power plants and the modes of transportation. The development of human resources through education and training was also put on priority in the same plan.

33. Ibid, p.17.
The priority accorded to growth in the non-oil sector in all the plans through the development of oil-derivative industries. The reason behind the diversification of resources was one and only that oil being non-renewable and depleting source could no longer remain as the base of the Kuwaiti economy and it had to be replaced by some non-oil economic base. The upsurge in oil revenues ensued from price-rocketing in the 1970s resulted in huge surpluses of government revenues which could only be absorbed by the capital intensive industries and other development projects. Keeping in view the future of the economy, the Kuwaiti government left no stone unturned in making its efforts in building up enormous development projects which absorbed a substantial part of surplus funds. Kuwait had no formal economic development plan, though, the economic guidelines were set for the periods-1967/68-1971/72 and 1976/77-1980/81\(^\text{34}\). Planning strategies, however, exist in specific economic sectors particularly

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in oil and gas, industrial development, infrastructural development, electricity and water, and public health services. The intention of the planners is, therefore, discernible from the following strategies.

i Development of downstream oil industries through expansion of refining capacity and transportation; and acquisition of retail outlets overseas.

ii Diversification of resources (public revenues) through industrialization and expansion; and promotion of financial sector in order to generate revenues from non-oil sectors.

iii Improving and maintaining nation's infrastructural facilities such as transportation and communication etc.

iv Increasing generation of power and disalinated water to cope with the expanding demands.

v Improving public services and providing them to

35. Middle East Research Institute; MERI Report: Kuwait, 1985, Pennsylvania (USA), p.66.
the Kuwaiti public at minimal cost.

vi Providing adequate housing facilities to the public.

vii Promoting the participation of private investment in the domestic production.

The economic planning, thus, focusses strongly on the rationalization of public expenditure, giving priority to the productive investment and the projects of social significance. It is substantiated from the fact that the planning goals emphasize on public expenditure rather than revenues. There are indications of increasing essentially needed schemes and reducing unnecessary spending as well.\(^{36}\)

The key economic indicators shown in the Table 3.2 clearly reveal to what extent Kuwaiti government has been able in materializing its planning and policies. It is essential here to explain that the public revenues in Kuwait originates from three main sources. The most important single source is receipts

Table - 3.2

KEY ECONOMIC INDICATORS
(In Million Kuwaiti Dinars)

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from oil. The remaining two sources are income from investments and other tax and non-tax receipts. The oil revenues comprise exports of crude oil, refined products and LPG. The government revenues are distributed among three heads of public expenditure, i.e., current, development and land purchase. Since public expenditure is one of the principal instruments whereby the government is enabled to realize its varied national aspirations, it similarly acquires special importance in Kuwait as well. Under the prevailing circumstances, public expenditure is a dominant force in the Kuwaiti economy setting the pace of economic activity and the trend of the country's balance of payments. It is considered to be the main stimulus of the economic activity in view of the large amounts of funds injected by the government into the economy. This characteristic has acquired more weight since oil revenues started increasing substantially, a major portion of which is used to finance the bulk of public expenditure. The role of public expenditure in the Kuwaiti economy is not limited but also to steering
country's overall long-term development.

The development expenditure is of paramount significance as it contributes to enhance the productive capacity of the country. It is evident from the table that the expenditure on development projects increased from KD 51 million in 1972 to KD 756 million in 1985 registering a 15-fold increase. This has been in a continuous rising trend throughout the period from 1972 to 1985 except for the year 1980-81 when it slightly slipped downward. Development expenditure up to 1978 had been increasing at much higher rates than GDP and the aggregate public expenditure. It had, however, declined during the 1980s except for the year 1981-82. Development expenditure, increased as the ratio of total expenditure, had continuously increased during 1972-78 except for the year 1974-75. Its size had reduced to some extent during 1980s as a consequence of diminishing oil revenues. The average rate of growth of development expenditure was 24.1 per cent during the period under review mainly due to its exceptional
growth up to mid seventies.

This is also clear from the table that the oil sector's contribution, measured as the ratio of GDP, had been in an upward trend up to the year 1974 but declined thereafter. The position of public expenditure in Kuwait is evident from the fact that the total expenditure, during the period under review, increased 9 folds and the development expenditure 14 folds whereas the GDP expanded only 4 folds and the oil revenues 3 folds. This indicates to what extent the Kuwaiti government has been able to expand the absorptive capacity of the economy and mindful to the socio-economic development of the country. The surpluses also give as an illuminating picture as they increased from KD 77 million in 1972 to KD 4776 million in 1980 but this occurred through a variational trend. The position of surplus funds during 1980s, as they decline to only KD 729 million in 1985, remained favourable. The revenues remained in surplus during seventies as a result of upsurge in oil prices and low absorptive capacity of the country. But the situation
Figure - 3.1
Ratio of Oil Revenues and Public Expenditure in GDP

Figure - 3.2
Oil Revenues, Development Expenditure And Surpluses
changed during eighties on account of declining oil prices and the oil conservation policy adopted by the government; and more significantly government's strict policy aiming at huge investment for future generations. The emphasis was laid on the diversification of resources that a strong non-oil industrial base may be built up for future. A clear picture can be viewed in the table 3.2 and the figures 3.1 and 3.2 which illustrate the real economic indicators and their inter-relationships.

The efforts made by the Kuwaiti government have always been in the direction of downstream operation by mobilizing domestic resources. It has, therefore, been emphasised that the available surplus funds be diversified into various channels so as to make a viable economic base. The present level of the economy in general and the oil industry in particular could be achieved only by adopting certain policies through various plans. Kuwait's policy of entering downstream is mirrored by the flourishing stage of oil derivative
industries and the related services which attained an accelerated pace since prices of oil began to move upward.

3.8 Downstream Operations

The increasing awareness in oil producing countries particularly of the West Asian region after the first price adjustment of oil in 1971, and subsequent skyrocketing of oil prices made them realized that their oil reserves are finite and non-renewable, and their supply would no longer be unlimited. The rising prices brought about huge revenues to these nations, but induced the consumers to conserve oil and substitute it by a few other sources of energy and investing more in energy-efficient building and industrial machinery\textsuperscript{37}. The paramount significance of oil was reflected from the deteriorating condition of world energy market. The

growing concern about the future of the Kuwaiti economy, mainly due to the insufficient human and physical resources other than oil, has put a strain on its hydrocarbon resources to bridge up the gap between the stages of under development and the development. Thus the role of 'development bridge' was left to be played by vast oil reserves of this valuable depleting source of energy. The Kuwaiti government, at this juncture, had the only choice to reduce its entire dependence on the export of crude oil and prepare its economy for the post oil era by skimming through this bridge. Thus, the economic policy revolved around the choice of trade-offs between present and future. The higher rate of growth to increase the country's productive capacity was thought to be the prerequisite of higher standard of living. But it left the choice open between capital formation, consumption of sectoral outputs, profit locations and the portfolios proportions of investments. All these trade-offs

38. Attiga, Ali Ahmad; Interdependence on the Oil Bridge: Risks and Opportunities, Oxford, 1988, p.44.
(policy choices) were relevant to planning for industrial development and were needed to be faced more seriously and urgently in the initial stage throughout the process of development.

The domestic policy of the Kuwait government aimed at the optimum utilization of its hydrocarbon resources through plans to shift from entire dependence on crude oil sales to industrialization and the export of refined products, liquified petroleum gas, chemical fertilizers and other petrochemical products\textsuperscript{39}. This way, the policy affected not merely production and prices but also the utilization of both crude oil and natural gas in the domestic economy. The volume of export of these products depends not merely on the levels of their production but the consumption as well. Hence, the utilization of these raw materials in the production of final products (consumer goods) is described as "Downstream Operations" in the

\textsuperscript{39} Central Bank of Kuwait; \textit{Economic Report}: 1977, p.18.
literature\textsuperscript{40}. Besides the processing of crude oil and associated natural gas, these operations include other related activities, i.e; transportation of oil, products and gas through tankers and pipelines which provide the opportunity of expansion of oil industry as a whole.

3.9 Rationale For Downstream Activities

The industrialization has been the perception of OPEC members as the key to modernization, higher economic growth and greater economic independence. Although, these oil producing developing countries have basic characteristics common to all as richly endowed with indigenous natural resources and surplus revenues to take-off for the economic and industrial development but their low absorptive capacities, lacking in technological know-how and human and physical resources except oil, impeded their progress. Despite all these impediments their policy choice for downstream proved to be rational on the following

\textsuperscript{40} El-Mallakh, Ragai, and Atta, Jacob K; \textit{The Absorptive Capacity of Kuwait}, Lexington, Massachusetts (USA), 1981, p.23.
arguments:

i. Capital Surplus:

The increasing oil revenues in the oil producing states heavily surpassed their expenditures on the import needs. In the wake of vulnerability of the international monetary system mainly caused by the present level of world tension, it would not be favourable keeping its reserves in the shape of foreign exchange in the banks abroad. Since downstream oil industries are highly capital intensive, the surpluses could, in this way, be absorbed in the domestic economy. Investing on downstream operations is not only safe but advantageous as well. It serves the country's planning in a right way.

ii. Value Added:

The concept of value added is valid since it, in

manufacturing stage, not only would expand the low capacity of the economy to absorb the surpluses but also would increase the value of the products when exported. This is true to the fact that in the case of mining, the primary production has an exceedingly high natural resource content, and because of being extractive, it is adding very little to the original value of the raw materials. The economy of such production exhibits a lopsided structure and weak linkages that tend to impede the process of economic development. Thus, optimum utilization of indigenous natural resources could be made possible only by going downstream exclusively.

iii. Cost Advantage:

The availability of cheap and abundant indigenous raw materials, i.e., crude oil and natural gas, brought about a comparative cost advantage from the use of feedstock in refining and petrochemical processes thereby the cheap bunker fuel could also be

42. Ibid, p.100.
available\textsuperscript{43}.

iv. Employment Opportunities:

By going downstream an oil producing country has the greater, stable and productive employment opportunities for its living and future generations since oil industry provides a smooth way, for the other sectors too, of the economy to come-up which in turn create exclusive employment opportunities on account of being highly labour intensive\textsuperscript{44}.

v. Domestic Viable Alternatives:

The expansion of downstream facilities encouraged the development of the related activities mainly transportation, construction, manufacturing and derivative industries. This way, a viable domestic alternative could be established to absorb the indigenous and expatriate manpower and further revenues

\textsuperscript{43} Ibid, p.101.

\textsuperscript{44} Kubursi, Atif A; Oil, Industrialization and Development in the Arab Gulf States, Croom Helm, London, 1984, p.104.
vi. Economies of Scale:

The utilization of a considerable amount of crude oil and associated natural gas was characterized by the economies of scale since a substantial gain could be achieved by saving the costs of raw materials and their transportation which other non-oil producing countries have to pay for the same.

The Kuwaiti oil industry's case is almost of the same characteristic as of other OPEC nations. Kuwait, in the beginning, had neither possessed the technological know-how and other necessary prerequisites for economic and industrial take-off nor a viable alternative and comprehensive structure for sustainable growth. Though, the low capacity of the economy and the small size of population, to absorb its surplus revenues accrued from the sales of crude oil, impeded the establishment of viable industrial atmosphere and the pace of the

development but could no longer deter Kuwait from investing for a widespread downstream industrialization.

The Kuwaiti economic policy, in this direction, could be described as rational one as it is substantiated from the fact based on its ability to:

......utilize indigenous raw material and recuperate value added; create new employment opportunities; help in learning process and new technologies; substitute for imports from abroad; encourage development of new regions and induce further related industrial activities, and foreign supplies and create self reliance 47.

Hence, the policy aims at attaining the reasonable standard of living of future generations. The government's endeavour to scintillate Kuwaiti public's tomorrow based on the experiences of industrialized nations mainly of Europe and North

America where the existence of indigenous natural resource deposits gave momentum to the Industrial Revolution. In this way, today's industrially developed countries had established their infrastructure around such deposits which resulted into a massive concentration of resource-oriented industries. Petroleum, therefore, provides domestic opportunities for the development of downstream oil operations and avenues for the people of the nation. Kuwait set out in the same direction so as to catch up the industrialized countries since abundant and cheap raw materials available at their doorstep offered a logical starting point. It was thenceforth proved to be a launching pad for the development of derivative industries and related new business activities.

3.10 Development Impetus

Though the downstream oil operations in Kuwait were set-out by KOC with the inception of upstream of oil at commercial scale and the shipment for export

which was first sailed on in 1946, but the actual development took place only after the nationalization of oil industry in 1975. Initially the operating companies gained substantial profits on the upstream and downstream investments but during 1950's and 1960s their property rights were jeopardised by an apparent wave of nationalization and participation in most of the oil producing countries. The increasing fear for their property rights made them react by raising their discount rates. Production, thus, shifted from future to present. Their fear resulted in rapid increments in oil production thenceforth. Reflecting these output increases, crude oil prices declined by 6 per cent between 1950 to 1970. By the end of 1973, the host governments of oil rich nations had acquired complete control over the output of their valuable natural resources and they unilaterally determined the prices of oil. Therefore, the property rights shifted from operating countries to the producing countries and the security of these rights was reestablished. The
discount rates thereafter became the affair of the producers rather than the operators. In the case of Kuwait, the nationalization of oil industry in 1975 made the country's property rights more secure since it entered the downstream oil business with exclusive shares. Kuwait had realized the value of its natural resource which gave an impetus to the development of pre-established downstream oil industries.

This is an undeniable fact that oil revenues accruing to the country in terms of foreign exchange are of transitory nature since they are influenced by the variations in demands for oil and its products in the domestic as well as external markets and, thus, must not last soon. To cope with the existing and predictable situations, the Kuwaiti government has endeavoured to promote the absorptive capacity of the domestic economy. This is substantiated from the fact that the emphasis was placed primarily on the elimination of the surpluses and not on the rational

management of scarce resources in pursuit of socio-economic development. Therefore, even the availability of the funds could not work favourably owing to the lack of complementary resources, indigenous unskilled and skilled manpower, technical know-how, entrepreneurship, work ethics and the domestic market. These factors in the domestic economy could, in this way, depress the returns to the investments and inhibit capital formation. Hence, the policy of the Kuwaiti government regarding oil operations focusses on the expansion and modernization of pre-established downstream facilities in accordance with the feasibility of economy and the world market conditions. Kuwait’s efforts in this direction coincided with the favourable demands for and prices of oil and its products in the international market. It has synchronized the downstream activities of Kuwait.

within a short span of time. This way, value added in manufacturing stage not only expanded the absorptive capacity of the country but enhanced the export value of the products as well. By increasing utilization of crude oil and associated natural gas in the domestic economy Kuwait has made a thoroughfare in the international market. The increase in oil receipts clearly reflects the advantage of diversification from mere sales of crude oil to products' exports. A substantial gain derived from selling petroleum products or value added is obvious.

The efforts made by the Kuwaiti government in the direction of downstream may be classified into three following categories:
1. Refinery
2. Petrochemical industry
3. Transportation of oil, products and gas through pipelines and marine transport.

The unscrupulous exploitation of oil and associated natural gas by the operating companies in Kuwait caused a decline in their reserve to production
ratios and consequently indicated at the shrinkage of life span of the reserves of the hydrocarbon resources. At this juncture, the government of Kuwait had the only option of strict conservation of its vast oil and gas reserves whereby their prices could be pushed up. It made the government realise the value of its natural resources. But the growing concern about the future of the economy on account of its entire dependence on single source, i.e., oil, left the government with the choice of trade-offs between present and future, or in other words, consumption or capital formation. This choice was relevant to the planning and policy making for industrial development and was needed to be taken more seriously in the initial stage.

The Kuwaiti government, therefore, adopted a moderate policy aimed at the optimum utilization of its vast hydrocarbon resources through proper planning to shift the economy from total dependence on oil and its sales to industrialization and the exports of refined products, LPG and petrochemicals and simultaneously
limiting the oil production. This way, the policy positively affected the production, prices and utilization of oil and gas. The utilization of these raw materials in the making of final products, thus, referred to as 'Downstream Oil Operations' which provided the Kuwaiti oil industry a wider scope of development. The expansion of pre-established downstream industries through refining and processing of crude oil and natural gas offered opportunities for the development of related services such as transportation of oil, gas and products through pipelines and ships.

The government policy related to the downstream operations seems to be a rational choice as it has opened up tremendous avenues to the Kuwaiti economy. The downstream activities are not only capital intensive that absorb the huge surpluses but are also cost advantageous as add the value of hydrocarbon resources. They also accelerate the pace of economic activities in other sectors which open up employment opportunities to the indigenous workforce. The
expansion of these activities brings about economies of scale too. Though, the expansion and modernization of pre-established downstream oil industries had already set out but the upsurge in oil prices and the nationalization of oil industry in 1975 gave an impetus to further development. The shift of the property rights of oil industry from operators to the producers as a result of its complete take over by the government made them more secure and thereafter the Kuwaiti government entered the downstream business within and outside the country with exclusive shares. Since the surplus funds were needed to be absorbed within the domestic economy which could be made possible only by enlarging the infrastructural facilities, the government placed special emphasis on the elimination of the surpluses through the development of downstream facilities. It was favourably coincided with the upswing in demand for oil and products in the international market which further synchronized the expansion, modernization and development process. The government
policy option has, thus, materialized in a peculiar fashion that the downstream oil industries have developed simultaneously with the expansion of absorptive capacity of the domestic economy. The increased utilization of crude oil and natural gas in the downstream activities clearly reflects Kuwait's endeavour to diversify its reliance from its oil sector to the other sectors of the economy. Kuwait has, therefore, not only gained substantially from these activities but has also been succeeded in establishing an alternative economic base.