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REPORT

Future Challenges for the Arab World

The Implications of Demographic and Economic Trends

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Prepared for the United States Air Force

RAND PROJECT AIR FORCE

The research described in this report was sponsored by the United States Air Force under Contract FA7014-06-C-0001. Further information may be obtained from the Strategic Planning Division, Directorate of Plans, Hq USAF.

Library of Congress Control Number: 2011927725

ISBN: 978-0-8330-5100-4

Published 2011 by the RAND Corporation
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Summary

The purpose of this technical report is to help USAF and Department of Defense analysts assess likely demographic and economic challenges in the Arab world through 2020, a region of primary concern for U.S. security and foreign policies. The report is designed to provide a more-informed platform on which to build U.S. defense planning and policy. The report references conflicts in the region but focuses on longer-term, region-wide trends that are likely to affect U.S. interests no matter how events in Iraq or between Israel and Palestine unfold.

The Pressure of People

In terms of population, the Arab world remains the second-most rapidly growing region in the world after sub-Saharan Africa. But even though cultural factors have contributed to higher fertility rates than in countries with similar standards of living, population growth rates have fallen sharply everywhere but in the West Bank and Gaza. Population growth rates are projected to continue to decline as the region experiences the same downward pressures on fertility that have resulted in slower population growth in East and South Asia and Latin America.

Because of the large increases in population in the 1980s and 1990s, the numbers of young people entering the labor markets of these countries have been rising rapidly and will continue to do so for the next two decades, adding to the difficulties young people currently face in finding employment.

Due to variations in birth rates and migration, religious diversity in the Arab world is declining. The dwindling of non-Muslim religious communities reduces the number of citizens making the argument for a secular state. Secular influences in the form of more female participation in education and the labor force and through movies and television now have a greater impact on these societies than religious diversity.

Economic Performance of the Energy Rich

For the foreseeable future, the world will continue to depend on oil pumped from the Arab region, especially the Persian Gulf. The region will continue to account for a third of global production in 2020. Even if rates of depletion are higher than previously estimated and production costs in the Persian Gulf double or triple their current levels of just a few dollars per barrel, the Gulf states will remain the world's lowest-cost producers. They will hold more than half of global reserves.

Despite their oil riches, the "energy-rich" countries in the region fell on hard times after the oil boom of the 1970s ended. In most countries in the Gulf, per capita gross domestic product (GDP) in constant-dollar terms is still below previous peaks. The primary reason for the poor economic performance of these larger countries has been declines in factor productivity. These declines have been due to poor investment decisions and microeconomic policies, especially price subsidies and bureaucratic barriers to the entry of new firms into markets.

Economic output in the energy rich, especially for the smaller Gulf states, will continue to be closely linked to oil output and prices. However, oil and gas exports will serve more as a foundation than a driver of growth. Only in Iraq and Qatar are increases in oil production likely to exceed population growth through 2020. Although energy will continue to provide a ready source of revenues to governments, the key to increasing per capita incomes will be increasing factor productivity.

To increase factor productivity,[1] these countries need to reduce price distortions by cutting producer and, to the extent politically feasible, consumer price subsidies. Barriers to trade and foreign investment need to be reduced, especially in Algeria and Libya. Continued expansion and integration of the Gulf Cooperation Council (GCC) would do much to increase competition and improve factor productivity in those countries. Privatization of non–energy-sector assets has improved efficiency and generated more-rapid growth in revenues and output of formerly state-owned enterprises in those Arab countries that have braved this step. A more-aggressive approach to privatization would generate additional benefits in terms of accelerated growth in factor productivity.

How likely are the governments of the energy-rich countries to adopt policies that would foster more-efficient use of resources? Going forward, we expect the GCC countries to continue to push ahead with economic liberalization, regional integration, and privatization. If oil prices continue to stay substantially higher than their average levels of the 1990s, the citizens of the smaller countries should continue to enjoy high levels of income and continued growth. Algeria, Iraq, Libya, and, to a lesser extent, Saudi Arabia are poorer, have larger populations, and, as can be seen by recent events in Libya, are more vulnerable to political unrest.

None of the energy rich has successfully addressed the issue of state employment. These governments will need to devise incentives to encourage new entrants to the labor force to seek jobs outside of government. Modest shifts in expectations have taken place in some of these countries, as jobs in private finance and some service industries have become socially acceptable, but the government overwhelmingly remains the preferred employer. In light of the political difficulties, we do not expect these states to cut employment of nationals in overstaffed state bureaucracies or state-controlled companies.

Prospects for Growth in the Energy Poor

Improvements in economic policies from unifying exchange rates, reducing tariffs and other barriers to trade, and privatization have contributed to more-rapid growth in all but one of the "energy poor" over the past two decades than was the case in the 1980s. In most instances, higher oil prices have also helped the energy poor as demand for foreign labor has risen in the

[1] The amount of additional output that inputs of capital and labor are able to generate.

Gulf, leading to increased remittances and, in the case of Egypt and Syria, bumping up the value of their own modest exports of oil and natural gas.

Like most of the energy rich, the energy poor suffered from the global recession, but, for the most part, their economies are projected to continue to grow. Exports, remittances, and incomes from tourism are falling, but lower commodity prices, especially for food and petroleum products, have eased pressures on the poor. With some luck, these countries could soon see a return to growth rates of the recent past. If growth recovers to the rates of the recent past, the energy poor will enjoy appreciable increases in per capita incomes through 2020, with per capita GDP rising by 3.0 percent per annum in the case of Egypt and 4.5 percent in the case of Jordan, as solid growth in GDP is accompanied by slower rates of growth in population.

How likely is it that these rates of economic growth will resume? Egypt, Jordan, Morocco, and Tunisia have made significant moves toward liberalizing their economies, especially trade, over the past decade. Free-trade agreements with the European Union (EU) and the United States have helped spur this development. Some progress has been made on liberalizing controlled prices on refined oil products and food and better targeting food and other subsidies. A number of formerly state-owned companies have been privatized. The energy poor have also attempted to make their local business climates more hospitable for private entrepreneurs.

To make further progress in reducing barriers to entry for new businesses and to foster private-sector job creation, the governments will need to markedly improve the efficiency of their bureaucracies and social welfare systems. Making the bureaucracy more efficient will not only entail streamlining procedures but also involve cutting staffs and linking rewards to performance. Because of the entrenched opposition of the bureaucracy, implementing these changes will be difficult. In addition, despite some reforms, these governments preserve expensive, often dysfunctional systems of subsidies. Making further changes in these systems is likely to be politically difficult.

Under conditions of a return to the growth rates of the recent past, the outlook for growth in employment and wages is positive. Rates of unemployment have dropped sharply in Algeria, Morocco, and a few other Arab countries in recent years. Privatization of state-owned enterprises has increased labor productivity and, counterintuitively, employment by lowering the cost of business services and making the labor market more flexible. But governments in the region still impose strictures on firing, hiring, and minimum wages that have discouraged businesses from hiring and entrepreneurs from investing. Additional measures to improve labor market flexibility and a shift in social acceptance of female participation in the labor force are likely to increase employment and accelerate growth. In all but Yemen, growth rates should be rapid enough that real wages will rise along with employment.

Institutional reform will not be the sole factor determining economic growth. For most of the energy poor, security—internal and external—will remain a key determinant of growth. As shown by the recent events in the region, countries suffer economically from conflict, either domestic or from spillover effects from neighboring states. Countries suffer substantial economic losses from unrest and conflict, especially from falloffs in tourism revenues. If security remains a major problem, economic growth will suffer. For example, Egypt and Tunisia experienced falloffs in tourism revenues from their unrest.

Policy Implications

In the light of these trends and challenges, we make the following policy recommendations:

- Although fertility rates and population growth rates have been declining, the population of the Arab world is still growing more rapidly than in other parts of the world. Increasing populations are straining water resources, public services, and infrastructure. However, fertility rates are not uniform: Some Arab countries have much higher fertility rates than others. Slower rates of population growth would ease pressures on water supplies and on governments to provide more public services, especially in countries with rapid rates of population growth. Over time, slower rates of population growth would permit Arab governments to shift from focusing on quantity to improving quality. U.S. assistance programs can help ease these pressures by continuing to support family-planning initiatives across the region, especially in countries that have higher fertility rates. More U.S. funding to train local staff to conduct outreach and to make contraceptives more widely available would be valuable, as would more indirectly supporting female education.
- Policy toward Arab migrants resident—or attempting to reside—in the United States and Europe will be an increasingly important factor influencing their host-government policies toward the Arab and Muslim worlds. At a minimum, policymakers should recognize that Arab and Muslim communities abroad are now a critical part of the regional equation and will provide an increasingly important window into political futures in the region itself. They are a valuable point of engagement, from counterterrorism to political and economic reform. The special prominence of Muslim communities and political networks in Europe, and their close connection to developments in North Africa and elsewhere, also means that there is a strong argument to be made for transatlantic coordination in this as in many other facets of regional strategy.
- Procedures to provide tourist, student, and business visas to the United States can have major effects on U.S. influence in the region. The large numbers of Arabs who have studied, lived, and worked in the United States have been a major source of U.S. influence in the region. The sharp decline in the numbers of Arab students studying in the United States following September 11 because of more-stringent visa regulations is detrimental to U.S. interests. The U.S. government should carefully review current procedures to ensure both that they prevent the entry of individuals seeking to harm the United States but also that Arabs seeking to visit the United States to study, visit, or conduct business are able to visit this country and are treated with respect when doing so.
- U.S. development agencies should continue to support family-planning initiatives across the region. This can be accomplished by training local staff in outreach and making contraceptives more widely available and indirectly by supporting female education. Given the sensitivities of family planning among some religious conservatives in the region, the United States should take pains to build off of local initiatives and, to the extent possible, keep local organizations as the "face" of these programs and the primary interface with communities.
- Outside of discussions with governments of major oil exporters concerning broader roles for foreign, including U.S., companies in their energy industries, we believe that the U.S. government should relegate discussions about oil output and markets to low levels. In our view, high-level discussions about oil output and prices muddy other U.S. messages

concerning economic policies. These discussions might also give the governments of the energy rich an exaggerated sense of the importance of lower-cost oil for the long-term health of the U.S. economy. A focus on preventing increases in oil prices runs counter to the U.S. government's commitment to reduce U.S. emissions of carbon dioxide and other greenhouse gases, undercutting achievement of another major policy goal, the reduction in U.S. consumption of fossil fuels.

- In its role as a board member of both the World Bank and the International Monetary Fund, the United States should strongly support programs and loans that encourage economic liberalization in the region. The United States should work closely with these organizations and channel its economic assistance to encourage these countries to better target subsidies and reduce costs and hurdles facing the private sector. The United States should also negotiate and sign free-trade agreements with friendly countries in the region.