UNITED NATIONS UNIVERSITY

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World Institute for Development Economics Research

Research Paper No. 2009/38

The Omani and Bahraini Paths to Development

Rare and Contrasting Oil-based Economic Success Stories

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June 2009

Abstract

Oman and Bahrain are Middle Eastern success stories. There are some key similarities. Both have followed pragmatic development strategies built on a stable foundation of strengthened governance structures and enhanced economic liberalization. These improvements occurred in somewhat different settings, with Oman developing in a more authoritarian environment, whereas Bahrain enjoyed greater democracy but somewhat less stability. While both countries have relied on oil revenues to support their development efforts, it appears that, in contrast to their less successful oil producing neighbours, each country had just enough oil to do some good, but not enough to do serious damage.

Keywords: Oman, Bahrain, Middle East, GCC, economic development, economic growth, development strategies

JEL: O53

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This study has been prepared within the UNU-WIDER project on Country Role Models for Development Success, directed by Augustin Kwasi Fosu.

UNU-WIDER gratefully acknowledges the financial contributions to the project by the Finnish Ministry for Foreign Affairs, and the financial contributions to the research programme by the governments of Denmark (Royal Ministry of Foreign Affairs), Finland (Finnish Ministry for Foreign Affairs), Sweden (Swedish International Development Cooperation Agency—Sida) and the United Kingdom (Department for International Development).

ISSN 1810-2611 ISBN 978-92-9230-209-2

Acronyms

FDI	foreign direct investment
GCC	Gulf Cooperation Council
MENA	Middle East/North Africa region
OR	Omani Rial
SOEs	state-owned enterprises
UAE	United Arab Emirates

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Typescript prepared by Liisa Roponen at UNU-WIDER

1 Introduction

One of the more perplexing patterns of growth found in developing countries in recent decades is that, except for short periods of resource boom, resource-based economies generally experienced significantly slower rates of growth than resource-poor countries.[1] This finding is robust in light of both sensitivity tests and differences in how the natural resource endowment is classified (Auty 2000: 347).

Economic theory provides no convincing explanation as to why resource abundance should be inherently disadvantageous. Developing oil states have a tendency to be rich but weak and unstable. Oil wealth comes and goes as oil prices rise and fall, and its sheer volume combines with its lack of predictability to make true economic development extraordinarily difficult. Still, the additional rents and foreign exchange obtained from commodity exports should permit higher levels of investment and greater capacity to import capital goods to accelerate economic growth (Auty and Mikesell 1999).

Part of the explanation may lie in the fact that oil states fall into two groups. The first includes states that developed economically before discovering oil, such as Canada, Norway and Australia. For these states, oil is merely a supplementary source of income with little impact on the broader economy. In contrast, for the second group, which includes countries like Nigeria, Angola and Iran, oil is a primary economic activity. The easy money that comes from oil distorts such countries' economies, diverting income to corruption and to reinforcing the oil industry while other economic sectors languish. After all, why take the decades necessary to develop an efficient automotive industry when one can just buy cars?

The distinction between the two country groupings is not absolute. Notably, Oman and the much smaller Bahrain have been doing their best to develop economically despite being relatively resource-rich, while Russia seems to be slipping from an industrial economy to a resource-based one. This situation can perhaps be explained by the fact that countries like Oman and Bahrain have limited reserves and are thus under severe pressure to diversify and to create a viable non-oil economy, while Russia's abundance of oil makes diversification far less urgent. The paucity of Oman and Bahrain's oil reserves has been painfully illustrated by the recent oil boom, during which both countries faced falling production and export volumes at a time of record-high oil prices (Appendix Figure 1).

The post-Second World War pattern of poor growth associated with developing country raw material producers contrasts sharply with earlier periods. From 1870 to 1913, resource-abundant countries experienced rapid growth and in many cases outperformed resource-poor countries. While Prebisch and the Structural School[2] suggest declining terms of trade as a possible explanation for the sub-par performance of resource-rich countries during certain time periods, policy differences—perhaps inspired by the size of countries' oil reserves—also certainly play a role.

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1 See, for example, Lal and Myint (1996); Sachs and Warner (1995: 1-118), Ross (1999: 297-322) and Sachs (2000: 579-600).

2 An excellent discussion of the Prebisch Theory and the Structural School can be found in Kay (2001).

Table 1
Success stories of sustained high growth

	Period of high growth	Per capita income (constant US$):	
		At the beginning	In 2005
Botswana	1960-2005	210	3,800
Brazil	1950-80	960	4,000
China	1961-2005	105	1,400
Hong Kong	1960-97	3,100	29,900
Indonesia	1966-97	200	900
Japan	1950-83	3,500	39,600
Korea, Republic of	1960-2001	1,100	13,200
Malaysia	1967-97	790	4,400
Malta	1963-94	1,100	9,600
Oman	**1960-99**	**950**	**9,000**
Singapore	1967-2002	2,200	25,400
Taiwan	1965-2002	1,500	16,400
Thailand	1960-97	330	2,400

Source: Commission on Growth and Development (2008: 20).

The impact of policy choices is demonstrated by the performance records of Oman and Bahrain, which have sustained rates of growth notably above their oil producing counterparts in the Gulf. Oman has been classified as the only Arab ‘success story’ by the prestigious Commission on Growth and Development (2008) and was one of only 13 countries worldwide (Table 1) that grew at an average rate of 7 per cent or more for 25 years or longer. Similarly, an article in *World Economic Forum* cites Bahrain as having successfully moved through the first two stages of development, in the process creating a diversified and efficient economy poised for innovation (Lawson 1989: 35). Together, the two countries lead the oil-producing nations of the Gulf Cooperation Council (GCC) in economic performance, progress in reforms, and institutional development. With regard to economic growth (Table 2):

– Of the GCC countries, Oman has the highest and Bahrain the second highest overall rate of growth for the 1980-2007 period;
– Oman and Bahrain are the only GCC countries that have not experienced a sub-period of negative growth;
– Oman and Bahrain alone have maintained high steady rates of growth, with Bahrain’s growth rate accelerating over time.

What factors have been responsible for Oman and Bahrain’s relative success when compared with other oil exporters? As a starting point, the Commission on Growth and Development (2008: 21) finds five striking commonalities in its 13 ‘success stories’.

– All 13 countries fully exploited the world economy;
– They maintained macroeconomic stability;
– They mustered high rates of savings and investment;
– The 13 countries allowed markets to allocate resources; and
– All had committed, credible, and capable governments.

Table 2
Comparative rates of GDP growth in the GCC

		Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
1980		7.49	-20.36	6.08	-1.02	6.52	-1.78
1981		2.78	-18.92	17.10	-3.89	4.69	8.02
1982		6.41	-9.50	11.50	-8.21	-11.10	-7.19
1983		6.99	5.25	15.95	-5.33	-8.22	-5.25
1984		4.19	5.24	13.90	15.99	-3.09	4.45
1985		-0.93	-4.26	14.52	-13.03	-4.32	-2.52
1986		0.48	8.57	2.15	3.71	5.09	-19.27
1987		-1.22	8.14	-3.99	0.90	-3.98	5.30
1988		5.95	-10.05	5.25	4.70	8.22	-2.62
1989		4.41	25.90	2.98	5.30	0.06	15.73
1990		7.28	-26.23	8.38	-14.64	8.33	23.56
1991		1.73	-41.01	6.04	-2.55	9.10	1.89
1992		6.70	50.69	8.49	8.16	4.63	2.74
1993		12.87	33.76	6.14	-0.46	0.03	-2.21
1994		-0.25	8.63	3.85	1.96	0.67	6.74
1995		3.93	1.38	4.83	3.63	0.20	6.21
1996		4.10	0.60	2.89	7.60	3.38	5.38
1997		3.14	2.48	6.18	28.45	2.59	7.93
1998		4.81	3.66	2.71	9.03	2.84	0.12
1999		4.32	-1.78	-0.24	5.50	-0.75	3.14
2000		5.24	4.69	5.49	10.94	4.87	12.38
2001		15.14	0.22	7.51	6.32	0.55	1.70
2002		5.19	3.01	2.57	3.20	0.13	2.65
2003		7.25	17.33	2.01	6.32	7.66	11.89
2004		5.64	10.68	5.33	17.72	5.27	9.69
2005		7.85	11.40	6.02	9.24	6.06	8.19
2006		6.55	6.28	6.79	10.34	4.30	9.39
2007		6.63	4.58	6.38	14.23	4.10	7.38
Avg. growth	1980-89	3.66	-1.00	**8.54**	-0.09	-0.61	-0.51
	1990-99	4.86	3.22	4.93	4.67	3.10	5.55
	2000-07	7.44	7.27	5.26	**9.79**	4.12	7.91
Avg. growth	1980-95	4.30	1.08	**7.70**	-0.30	1.05	2.11
	1995-2007	6.14	4.96	4.50	**10.19**	3.17	6.62
Avg. growth	1980-2007	5.17	2.87	**6.31**	4.43	2.06	4.06

Source: IMF (2008).

The report concludes that while it may be possible to prescribe "ingredients" for sustained long-term growth in developing countries, each country will require a different combination of those ingredients. Although this conclusion is disappointing to those expecting specific, country-by-country policy answers from such a large-scale endeavour, the reasoning is sound: in developing countries, policy impacts may be unpredictable if institutions differ from those common to mature economies.

Clearly, many different factors must be considered when trying to explain Oman and Bahrain's recent economic success, both relative to each other and to the other countries of the region. A useful way of analysing their performance is to look at impacts and interactions of what recent economic literature calls the 'deep determinants' of economic development: natural endowments, integration (trade and other policy reforms), and institutions.

With these factors in mind, the sections that follow examine Omani and Bahraini social factors and development strategies in an attempt to determine why each country has been so successful. This analysis will examine (i) the initial conditions that each country faced; (ii) their development policies and the factors that influence them; (iii) the quality of governance and degree of economic freedom, and (iv) the extent to which each country's development strategy remains viable for the future.

2 Oman

The development of an oil economy such as Oman's, which is dominated by a non-renewable resource that can be sold at a price considerably above its production cost, is generally characterized by several unique elements (World Bank 1994). First, the public sector typically dominates the development process as a consequence of public ownership of the resource. Second, pervasive economic dependence on public spending of resource revenues tends to foster a private economy dominated by rent-seeking behaviour. Finally, governments are inevitably forced to confront the problem of economic slowdown or decline as the resource becomes exhausted. From the beginning, Oman's carefully planned development strategy has demonstrated an awareness of these factors and focused on their avoidance.

2.1 Initial conditions

Oman, a country with a population of more than 2.5 million, has a history that dates back to almost the 3rd millennium BC. It is the only country in the Islamic world with a majority Ibadhi population, a form of Islam distinct from Shiaism and orthodox Sunnism, that is known for its 'moderate conservatism'. One distinguishing feature of Ibadhism is the choice of ruler by communal consensus and consent (*Oman* 2008: 20).

Historically, Oman was the most diversified and developed economy on the Arab side of the Gulf, with a broad-based agricultural sector and a thriving fishing industry. Even so, its progress towards a modern economy is a very recent phenomenon (Looney 1990: 65). Oman's economic development began later and progressed more slowly than that of its oil exporting neighbours because of the country's minimal financial resources and its various political problems. The treasury was entirely dependent on customs revenues, the *zakat* (religious tax) collected on agricultural produce and loans and subsidies from the British government (Allen 1987: 89).

Under Sultan Said bin Taimur who reigned from 1932 to 1970, Oman remained largely cut off from the rest of the world. The majority of the population lived in a society akin to that of the Middle Ages with no general education, no health services, poor internal communications and repressive petty restrictions on personal freedom (Al-Yousef 1995: 21). Although the discovery of oil and the beginning of exports in 1967 provided the necessary financial resources, the reluctance of Sultan Sa'id to spend on development further delayed the country's progress.

In 1970 the Sultan was deposed by his son, Qaboos bin Said. The new sultan was confronted with insurgency in a country plagued by endemic disease, illiteracy and poverty. Qaboos inherited a large underdeveloped country with a population of about

666,000, three schools, 12 hospital beds, 10 kms of paved roads, 557 telephone lines and a per capita income of less than US$400 (Al-Yousef 1995: 22-3).

One of the new sultan's first measures was to abolish many of his father's harsh restrictions and offer amnesty to the thousands of Omanis who had fled the country during his father's regime. Qaboos established the first structures of a modern government. He also initiated a major development programme to upgrade the nation's educational and health facilities, build a modern infrastructure, and develop the country's natural resources.

Oman's development strategy under Qaboos has gone through several phases, each characterized by a distinct policy focus. The early period, 1970-95, saw expanded government involvement in and expenditure on the economy. A period of initial diversification efforts occurred from 1995-2000, followed by further diversification and integration into the world economy after Oman was accepted into the WTO in November of 2000.

2.2 The early development period: 1970-95

After assuming power, Qaboos concentrated on restoring control over southern Dhofar—a vast region that had rebelled against his father's oppressive rule. He used both economic and military means, believing that poor economic conditions had helped motivate the Dhofar rebellion. By 1975, he succeeded in suppressing the rebellion and turned his attentions to development issues and the establishment of modern governmental and administrative institutions.

Development strategy

At this time, an attempt was made to define the country's development strategy. This strategy included both shorter-term objectives and long-term targets that might take a generation or more to achieve. From the start, there was recognition that diversification away from oil was imperative, given Oman's relatively meagre petroleum reserves and production capacity, as well as the unlikehood of major new discoveries. With this in mind, the goals of the initial development plan were (Al Yousef 1999: 55-6).

- To develop new sources of national income to augment and eventually replace oil revenues;
- To increase the ratio of national investments directed to income-generating projects, particularly in manufacturing, mining, agriculture and fisheries;
- To distribute national investments among geographical regions with a view to spreading prosperity and progress to all regions of the Sultanate, reducing differentials in the standard of living between the regions, and assigning a special priority to the least developed areas;
- To support the maintenance of existing population centres and communities, to safeguard those communities from potential emigration to densely populated urban centres, and to protect the environment;
- To develop natural water resources as a vital prerequisite for continued economic activity and growth;

- To develop local human resources and to improve their capacity to contribute to the national economy;
- To meet infrastructure requirements;
- To support commercial activities by removing market deficiencies, particularly those in the areas of transport, communications, storage and other obstacles to trade, with a view to enhancing the emergence of a competitive market and maintaining a reasonable level of prices;
- To provide for the creation of a national economy based on private enterprise and free from monopolistic practices by extending to the private sector, to the degree permitted by the availability of resources, various incentives, tax exemptions, concessional loans, and the right to participate in the equity of vita projects, and
- To improve the efficiency of the government administration.

Oman launched its development efforts with the enlightened belief that the circumstances—economic, political and social—of each underdeveloped country vary, so that the appropriate path of economic and political development cannot be determined a priori but only in the context of specific conditions. This philosophy allowed government the freedom to pursue pragmatic strategies and policies in its initial economic development programmes.

Central to Oman's development strategy was the paradoxical role of oil. Petroleum was to be invested wisely for the benefit of future generations. This meant that, on the one hand, the strategy attempted to maximize the impact of oil revenues through effective resource development and allocation policies. On the other, the first objective was to reduce the dependence of the economy on oil by developing new sources of national income to augment and eventually replace petroleum revenues (Al-Yousef 1995: 56.).

Rather than nationalizing the oil sector as was done in the other Gulf countries, Oman retained its links with multinational petroleum firms. In turn, these firms provided approximately 50 per cent of the capital required for the sector's expansion.

While the government's development strategy has undergone modifications over time, its basic objectives have remained unchanged.

Questions of sustainability

By 1995, as evidenced by the falling share of construction in GDP, Oman had completed its infrastructure and service base, with roads, schools, port facilities, airports, and such in place. However, a number of difficulties were starting to develop in the early 1990s. Most obvious was the significant impact on government operations of the fall in oil revenues that began in the 1980s. In addition, major studies conducted by the IMF and World Bank suggested more subtle factors were at play and questioned the sustainability of the country's initial development strategy.

The IMF's analysis of the Omani economy found that the patterns of non-oil growth were, as expected, strongly correlated with government expenditures (Mansur and Treichel 1999: 26-7.) However, this linkage had begun to weaken in the mid-1980s, suggesting diminishing returns were associated with a continuance of the original development strategy, which focused largely on the government's investment and infrastructure programmes.

The World Bank report (1994) was prepared at the request of the Omani government. Asked to examine the country's long term economic prospects and provide a frank assessment of the government's economic policies, the Bank identified a number of problems and again questioned the sustainability of the country's development strategy. In particular, the Bank noted that the role of the Omani government went well beyond the traditional functions of providing public goods, developing public institutions, promoting efficient resource allocation, stabilizing the economy and promoting an equitable distribution of national income. At the same time, the government's discharge of its traditional functions had been mixed. Furthermore, the Bank found serious deficiencies in a number of key areas:

- There were serious deficiencies in the quality of basic health and educational services, and the legal framework governing private investment and business activity was inadequate.
- Efficient resource allocation had been promoted by low tariffs and the absence of foreign exchange controls but hampered by public monopolies, legally sanctioned monopolistic private trading and production arrangements, poor internal locative efficiency in the public sector, and distortion-creating subsidies.
- The stabilization of the economy was judged only partly effective and this at the expense of a rundown in savings for the future.
- The promotion of a more equitable regional distribution of income had been attempted via an expansion of state investment in regional infrastructure but thwarted by limited productivity growth in agriculture and fishing.
- The promotion of a more equitable interpersonal distribution of income had been fostered by the provision of free access to education but counteracted by the emergence of a privileged class of highly paid pubic employees, private entrepreneurs and upper-level private sector employees.

The World Bank's report noted that the Omani government's extensive involvement in the economy included: direct provision of a range of commercial goods and services; guidance and subsidies to aid private sector activity; controls over the labourmarket and investment; targeted and subsidized Omanization; the provision of medium-term financing to the private sector; overinvestment (by normal developing-country standards) in urban infrastructure and public buildings; and the supply of expensive municipal services. In the World Bank's judgment, most of this involvement appeared unnecessary and counterproductive. The cost of government could be considerably reduced and economic efficiency increased by concentrating the government's efforts on the effective fulfilment of the traditional public functions.

The Bank concluded that the public sector deficit should be reduced mainly by cutting spending, which at the time was exceptionally high by international standards. Public consumption accounted for half of total consumption, and public investment accounted for over three-fifths of total investment. The large element of rent in public sector wages, salaries and allowances could not be sustained indefinitely, and the Bank felt it imperative that public sector remuneration be brought into line with remuneration levels in the private sector. In addition to the concerns raised by the World Bank, it was also becoming apparent that the government would have to scale back its involvement in the economy in the face of declining and uncertain oil revenues.

The Omani government took the IMF and World Bank assessments seriously and, in June 1995, convened a development conference: *Visions for Oman's Economy—Oman 2020* (Allen and Rigsbee 2000). Although the final conference report included the long-standing goals of diversification, regional equity and improved standards of living, three new goals stood out. The first called for opening the economy, with a much greater emphasis on private sector development. To accomplish this, greater internationalization of the economy would be sought, with a lifting of controls on foreign investment and expanded contacts with international organizations as the World Trade Organization and regional economic blocks. Finally, Omanization would now focus on encouraging Omanis away from the public sector and into the manual labourforce by shifting the focus of education toward technical and vocational skills.

The importance of *Vision 2020* lay in its recognition of the inevitable changes that must occur in the role of government in Oman's economy. Before the mid-1990s the government had to assume most of the burden for transforming the country's economy from a traditional to a modern economy. This involved the production of necessary goods and services, as well as government participation in several production companies. In addition, generous subsidies had to be provided in order to enable the private sector to take initiatives and become self-sufficient (*Oman* 2008). Now, however, it was time for the government to shift away from a role of economic dominance in favour of more limited and strategic guidance if it hoped to create an economy based on a dynamic private sector.

With the Fifth Five-Year Plan, the country began a new phase in development planning—one that took a longer-term view of the economy and envisaged Oman participating much more fully in the international economy. While previous development could be characterized as resource-based and investment driven, this new phase placed much more emphasis on raising efficiency through economic reforms and improved governance.

2.3 Growth and development since 1995

Guided by the general guidelines of *Vision 2020*, in 1995, Oman began implementing a development strategy centred on a liberal trade regime and aimed at reducing its high dependence on crude oil and natural gas, which then accounted for almost 50 per cent of its GDP, 65 per cent of government income, and 90 per cent of merchandise exports. To this end, the country has promoted downstream industries and tourism; improving education and health services; modernizing infrastructure, and addressing some structural problems, including the privatization of state-owned enterprises (SOEs). It has also established a reserve fund for the use of oil revenues to insure inter-generational economic equity in the exploitation of its non-renewable natural wealth. Underlying these initiatives is a firm commitment to on-going improvements in governance and economic liberalization.

Economic progress since 1995

This new development strategy resulted in real average annual GDP growth of 5.3 per cent from 2000 to 2007, with an inflation rate considerably below that of other GCC countries (Appendix Figure 2). In recent years, Omani inflation has remained largely under control, despite increased pressures on the demand side from increased oil revenue expenditures and cost increases on the supply side stemming from rising import prices. These costs have been associated with rising world commodity prices and the pegging of the Omani riyal to a weakening dollar. Oman has also registered surpluses in both its overall fiscal position (an annual average of 8.4 per cent of GDP over 2001-06) and external current account (an annual average of 8.6 per cent of GDP over 2001-07). The net result has been a rise in the country's per capita income to around US$14,500 as of 2007.

Progress has been particularly noteworthy in the important non-oil sector of the economy. While Oman's non-oil economy did not expand as rapidly as that of Bahrain and the other GCC countries in the early stages of the current oil boom, it has maintained a momentum that these other countries lack (Appendix Figure 3). This achievement is all the more impressive given that the country's relatively meagre oil revenues (Appendix Figure 4) and debt levels have remained consistently below those of the other GCC countries (Appendix Figure 5). Consistent with the Oman's attempts at diversification into industry and other sources of potential exports, the country was able to avoid a marked appreciation of its currency during the early phases of the oil boom (Appendix Figure 6).

Oman's average annual inflow of foreign direct investment (FDI) increased from OR 208.9 million in 2003 to an estimated OR 637.7 million in 2006, partly as a result of steps taken to improve Oman's investment climate, including the 1997 establishment of the Oman Centre for Investment Promotion and Export Development. Recent government initiatives to bolster foreign investment include:

- 100 per cent foreign ownership for entities who are 'engaged in a national economic development project that is approved by the National Development Council, and that has a minimum capital investment of Omani Rial (OR) 500,000' (Article 2 of Decree 102/94);
- Exemption from the licensing requirement for foreign companies that have special contracts with the government, or provide services that are needed in Oman (Article 3 of Decree 102/94). Otherwise a local partner is needed.
- A five-year tax exemption for corporations whose main objective is '…manufacturing, agriculture, fishery, tourism, exportation of local products, public utility projects and infrastructure projects, as well as companies whose activities are deemed essential for economic development' (Royal Decrees 125/94; 102/94; and 75;21). These corporations may carry forward losses incurred during the five-year exemption period for as many years as needed until the losses are offset against taxable income.

Nonetheless, FDI inflows have been inhibited by slow progress in parts of the privatization programme, prohibition of land ownership for foreigners, except in the new tourist areas, and prohibition of foreign investment in activities such as tourist guides, internal waterway transportation, and taxi transportation.

In accordance with Oman's long-term development strategy, as detailed in *Vision 1996-2020*, the contributions of agriculture and manufacturing to GDP are expected to increase, respectively, from 2.8 per cent and 7 per cent in 1996 to 5 per cent and 29 per cent. In contrast, the shares of services and oil and natural gas are to fall, respectively, from 52.3 per cent and 40 per cent in 1996 to 47 per cent and 19 per cent. Oman is pursuing an intensive exploration drive to enlarge its known hydrocarbons reserves so as to expand the duration of their export, as well as to broaden its production capacity. Oman is also increasing its electricity network in order to meet growing demand.

Services constitute a crucial component in Oman's overall policy of economic diversification. Obstacles to foreign investment are being removed to encourage private sector participation. Several SOEs in the sector operate as monopolies, or hold exclusive rights in some branches (e.g. Oman Telecommunications Company, Oman Postal Company, and Oman Air). Under the General Agreement on Trade in Services, Oman made commitments in all services categories and has tabled its initial conditional offer in the ongoing services negotiations.

Oman's manufacturing sector benefits from its relatively large endowment of hydrocarbons, which are used as inputs by industries producing chemicals and liquefied natural gas. The government continues to hold a 100 per cent stake or is an important shareholder in some manufacturing companies (e.g. Salalah Methanol Company, Oman Polypropylene Company, and Oman Cement Company). Tariffs on manufactured goods average 5.6 per cent, with rates ranging up to 100 per cent on alcoholic beverages, tobacco and tobacco products.

Despite its small and decreasing share of total GDP, agriculture is an important sector in the economy because of Oman's desire for food security. The government assists agricultural producers by offering basic infrastructure, such as drainage and irrigation facilities, free inputs, such as new seed varieties, fertilizers, and chemicals, and soft loans. Nonetheless, while Oman is a net exporter of fishery products, it remains a net importer of agricultural products, and food security is expected to be achieved mainly through relatively low customs tariffs.

Progress in economic freedom

Oman's high rates of growth suggest that the country has successfully undertaken a programme of economic reforms, particularly those associated with increased economic freedom. There is a vast literature linking economic freedom to growth and measures of well being. Studies by Scully (1988, 1992); Barro (1991); Barro and Sala-i-Martin (1995); Knack and Keefer (1995), Knack (1996), Keefer and Knack (1997) all show that measures of well-defined property rights, public policies that do not attenuate property rights and the rule of law tend to generate economic growth. Using the Fraser and Heritage indexes of economic freedom, Norton (2002) finds that strong property rights tend to reduce deprivation of the world's poorest people while weak property rights tend to amplify it. Grubel (1998) also finds that economic freedom is associated with superior performance in income levels, income growth, unemployment rates, and human development.

Significant progress in economic reforms is rare for oil-producing developing countries. Specifically, an examination of the rankings of oil-rich countries in the Index of Economic Freedom published by the Heritage Foundation and the *Wall Street Journal* reveals that most citizens of oil-producing countries are stuck in poverty and live under brutal and dictatorial regimes (Roberts and Leahy 2008). These factors combine to create what economists term the 'curse of oil'.

Oman and Bahrain (which is discussed in detail in a following section) are notable exceptions to this rule. In the 2008 Index of Economic Freedom (with data referring to 2007), Oman ranked as the world's 42nd freest economy. Its overall score rose by 1.4

percentage points over 2006, reflecting improved scores in three of the ten economic freedoms. Oman is ranked the third freest of 17 countries in the Middle East/North Africa region, and its overall score is higher than the regional average. While Oman's economic freedom ranks somewhat below that of Bahrain (Appendix Figure 7), in recent years it has been slightly higher than that for the other GCC countries.

Oman's scores are higher than the world average in eight of the ten economic freedoms and especially high in fiscal freedom, trade freedom, labour freedom, and freedom from corruption. The country imposes no taxes on private income, and its highest corporate tax rate is 12 per cent. Corruption is low, particularly for a nation that is not a democracy. The labourmarket is flexible, although foreign enterprises are forced to hire Omanis.

With regard to the all-important trade freedom, there are significant non-tariff barriers to trade, but a free trade agreement signed with the United States in 2006 should lead to the easing of some restrictions. The sharp improvement in trade freedom (Appendix Figure 8) starting in 2005 is, no doubt, linked with the preparations for the Free Trade Association with the United States.

3 Bahrain

Like Oman, Bahrain has unique social, political and economic structures that combine to set it apart from other Arab oil-producing Gulf States. However, while both Bahrain and Oman have limited oil reserves, there are sharp differences between the two countries and their approaches to economic development. Bahrain is a much smaller country, with a population of just over 700,000 as compared to Oman's 2.5 million, and began its economic development considerably earlier. In contrast to Oman's relatively tranquil society, Bahrain's indigenous population is sharply divided along class and religious lines, and its native industrial workforce has a history of political activism that is unmatched in neighbouring states. Finally, in contrast to Oman's cohesive, long-term development planning, Bahrain's development strategies have repeatedly shifted over time. Nonetheless, Bahrain has achieved a level of economic diversification into non-petroleum related activities that is the envy of its region's planners.

3.1 Initial conditions

Bahrain began its economic development process in the 1920s, when it first discovered oil. Since then, its economic growth has revolved around the petroleum sector. However, in part as a result of the country's trading and pearling traditions, its more developed educational system and its small size and extremely limited oil reserves, Bahrain also became one of the first Gulf countries to begin diversifying its economy. It was among the first countries in the region to industrialize and has been by far the most innovative in attracting foreign participation, including regional participation in its industrial development (Looney 1989: 5).

The country's population is divided largely along sectarian lines. About a third of the population follows the tenets of the majority Sunni branch of Islam, whereas the remaining two-thirds belong to the largest of the religion's Shi'a offshoots. Despite their numerical disadvantage, Sunnis dominate the country's politics and economy. The ruling Al Khaliftah family, a majority of the prominent merchant clans, and the powerful Arab tribes aligned with the Al Khaliftah are all Sunni. The increasingly rancorous Shia claim that Sunni dominance is buttressed by nepotism and point to the security services, in which Shia make up less than 3 per cent of the army and police forces (Oxford Analytica 2008: 2).

Bahraini society is divided into distinct classes: the dominant class of retainers made up of the Arab tribes allied to the Al Khaliftah; the staff of the country's central administration; the smaller traders and shopkeepers in the larger cities and towns, and a subordinate class composed of urban and rural workers, artisans and craftspeople, fisherman and subsistence farmers. Conflicts of interest among Bahrain's classes and religious groups have led to the formation of coalitions as well as to sometimes violent demonstrations of political discontent. In addition, Bahrain's rulers confront problems associated with rapid urbanization, increasing numbers of immigrant labourers, dramatic fluctuations in the price of petroleum on international markets and growing regional instability.

As a result, the country's development problems are far different from those faced by the more homogenous and socially tranquil Oman. Unfortunately, because Bahrain's oil reserves are even smaller than those of Oman and are being rapidly depleted, the regime has limited resources for meeting these challenges (Lawson 1989: ix). With a much larger indigenous industrial workforce than found in other Gulf countries, unemployment is a constant concern. Some 100,000 Bahrainis will enter the job market over the next decade, requiring the economy to provide three times more jobs than in the past ten years (Oxford Analytica 2006: 2).

3.2 Development strategy

From the beginning, the impending exhaustion of the island's relatively limited petroleum reserves and the regime's persistent efforts to supplement oil operations with other forms of economic activity have been persistent themes in Bahraini development planning. As the oldest oil-producing country on the Arabian Peninsula, Bahrain's national treasury relied upon revenues generated by petroleum production and refining for the greatest part of its income from the early 1930s to the mid-1960s. However, as early as the mid-1940s, substantial quantities of crude oil had to be imported from the eastern province of Saudi Arabia to keep the Bahrain's main refinery operating profitably (Lawson 1989: x).

While the country's strategy has focused on creating an economy independent of oil revenues, the strategy has not cantered on a single, over-riding theme, such as that contained in Oman's Vision 2020. Instead, Bahrain has emphasized the development of different parts of the non-oil economy at different points in time. During the 1960s, the government encouraged the creation of an indigenous heavy industrial sector, which initially focused on industries linked to oil but soon grew to encompass other forms of manufacturing. Around 1975, the government turned its attention towards inducing financial and service institutions to set up regional offices in the country, as a result of which Bahrain became the primary centre for banking, transportation and communication in the Gulf. In the 1980s, 1990s and beyond, emphasis shifted towards communications and transport to enhance the country's potential for tourism and retail trade (Lawson 1989: 35). As a result of its communications and transportation infrastructure, regulatory structure, and cosmopolitan outlook, Bahrain became home to many multinational firms that do business in the region and, in 2005, entered into a free trade agreement with the United States.

Although Bahrain's development strategy differed in many ways from that of Oman, both countries benefitted from the existence of a strong, traditional mercantile class. As the World Trade Organization (2007: 5) notes:

> Bahrain's private sector has historically been one of the most active sectors in the region, moving from a mercantile focus to develop sizeable industries and services, such as light manufacturing, retail, tourism, telecommunications and financial services. Small and medium-sized enterprises (SMEs) make up around 99 per cent of all businesses in Bahrain.

In addition, like Oman, Bahrain appears to have placed a high value on creating an educated, indigenous workforce. However, while Bahrain has focused on educating a high number of students in the relevant age groups, Oman appears to have concentrated on providing a higher quality of education to a smaller proportion of the school-age population.

Specifically, using the World Economic Forum's 2008 dataset (Table 3—figures are for 2006), Bahrain has managed to enrol 96.8 per cent of primary age students, as opposed to 77.9 per cent in Oman. In terms of percentage of primary age students enrolled, Bahrain ranks 33rd out of 128 total countries and Oman 107th. Bahrain ranks even higher at 27th for secondary education, but falls to 56th for tertiary education. The corresponding figures for Oman are 62nd and 91st.

On the other hand, Bahrain scores consistently lower across all measures of the quality of education, ranking 80th as compared to Oman's 38th place. Particularly important for providing immediate inputs to the economy, Bahrain is only in the 60th place in staff training, where Oman ranks 32nd. Finally, Bahrain falls to 90th place in terms of the local availability of specialized research and training, while Oman ranks 43rd.

The two countries' different approaches to education have several implications for the future. By focusing on broad-based participation, Bahrain appears well placed to continue its heavy industrialization, as well as standard banking and financial services. However, the country does not appear to be anticipating the labour needs required to move to a higher level of sophistication. Oman on the other hand, appears to be creating more of an elite workforce capable of sustaining its current growth profile into the next stage of development. Presumably the country is satisfied that those with less education will still be able to find meaningful work in the more traditional sectors of agriculture and handicrafts.

3.3 Growth and development

As in Oman, Bahrain's diversification and supporting economic reforms have created an environment conducive to growth. While the country's rate of growth has not been as high as Oman's, its progress has been steadier and is accelerating. For the periods 1980-89, 1990-99, and 2000-07, Bahrain's GDP grew at rates of 3.66 per cent, 4.86 per cent and 7.44 per cent (Table 2). Its average rate of growth for the period 1980-2000 was 5.17, compared with Oman's 6.31.

Table 3
Patterns of education: Oman and Bahrain

Education measure		Oman Rank	Oman Value	Bahrain Rank	Bahrain Value
Enrolment (% students enrolled)	- Primary	107	77.9%	33	96.8%
	- Secondary	62	86.4%	27	98.8%
	- Tertiary	91	13.0%	56	34.0%
Quality of the educational system (1 = does not meet needs of a competitive economy) (7 = does meet needs of a competitive economy)		38	4.2	80	3.2
Quality of math and science education (1 = lags far behind most other countries) (7 = are the best in the world)		59	4.3	89	3.4
Quality of management schools (1 = limited or poor quality) (7 = among the best in the world)		63	4.2	78	3.7
Local availability of specialized research/training services (1 = not available) (7 = available from world-class local institutions)		43	4.3	97	3.1
Extent of staff training (1 = to invest little in training & employee development) (7 = to invest heavily to attract, train and retain employees)		32	4.5	60	3.7

Source: World Economic Forum Data Tables 2008.

Over the last several decades, Bahrain's economy has undergone significant structural change, which in some ways parallels Oman's. However, due to its lower hydrocarbon reserves and production, Bahrain's primary sector has historically accounted for a significantly lower share of GDP (Appendix Figure 9), with this differential remaining fairly constant over time. Due to the country's early start at diversification, Bahrain historically had a significantly larger share of manufacturing in GDP, although this gap has narrowed over time, with Oman's share of manufacturing increasing just about every year since 1974 and Bahrain's declining after 1995.

Beginning in the late 1980s, the Bahraini economy began a fundamental shift, marked by a significant decline in the share of government services in GDP. Government services declined from approximately 23 per cent of GDP in the late 1980s, to 15 per cent by 2004 (Appendix Figure 10). The corresponding decline in terms of non-oil GDP was 27 per cent in the late 1980s to a little over 20 per cent by 2004 (Appendix Figure 11). To some extent this decline reflects the expansion of Bahrain's finance sector in recent years (Appendix Figure 10). Interestingly, Oman has experienced a similar decline in government services. However, Oman's decline has been somewhat greater in recent years, leaving government services with a 10 per cent share (as opposed to 18 per cent in the late 1980s). Shares of government services in GDP and non-oil GDP may be partially responsible for Bahrain's slightly lower growth rate.

Despite Bahrain's emphasis on commerce and transport in recent years, the country's pattern of growth has been erratic in these sectors (Appendix Figure 12), with commerce suffering a sharp decline from the mid-1970s to the mid-1980s, only to stabilize at a share considerably below its 1975 level. After steady growth through most of the 1970s and into the 1980s, Bahraini transport began a similar decline, stabilizing at a level slightly under 10 per cent of non-oil GDP. In contrast, Oman's commerce has stabilized at around 25 per cent of non-oil GDP, while transport's share of non-oil GDP has increased steadily (Appendix Figure 12).

The generally volatile movements of sector shares of output in Bahrain no doubt reflect in part the country's shifting sectoral priorities within a general strategy of diversification. Oman, in contrast, has pursued a more consistent set of economic priorities over time.

3.4 Progress in economic liberalization

Because Bahrain is a small country, any diversification efforts require increased reliance on external markets—both as an outlet for production and as a source of productive inputs. In turn, survival in this environment requires a high degree of economic liberalization to bolster the country's competitiveness. In this regard, the country has made considerable progress in liberalizing its economy, surpassing even Oman.

According to Heritage House's 2008 Index of Economic Freedom (Heritage Foundation 2008) (data for 2007), Bahrain was the world's 19th freest economy, ranking 1st out of 17 countries in the Middle East/North Africa region. In addition, Bahrain had a perfect score for two critical areas of the economy—taxes and banking—and scored higher than the world average in eight of the ten factors of economic freedom. In terms of the key areas of liberalization:

Business freedom

Bahrain's commercial law system is relatively straightforward, but starting, operating, and closing a business can be slowed by an uncoordinated regulatory environment. Despite steps to streamline licensing and approval procedures, complicated bureaucratic procedures make obtaining a business license difficult.

Trade freedom

Bahrain's average tariff rate was quite low at 4.6 per cent in 2005. There were few non-tariff barriers, but a limited number of products are subject to import and export prohibitions and licenses, enforcement of intellectual property rights remains a concern, and the government uses price controls and subsidies to manage inflation and promote domestic supplies.

Fiscal freedom

Historically, Bahrain has imposed no taxes on personal income. However, in 2006, the government announced that it would levy a 1 per cent tax on Bahraini nationals' salaries to fund an unemployment scheme. Most companies are not subject to corporate tax, but a 46 per cent corporate tax rate is levied on oil companies. In the most recent year, overall tax revenue as a percentage of GDP was only 5.5 per cent.

Government size

Total government expenditures, including consumption and transfer payments, are moderate. In the most recent year, government spending equalled 25.6 per cent of GDP.

The government is also trying to reform itself by restructuring official bodies and privatizing a variety of state services, including power provision and port management.

Monetary freedom

Historically, inflation has been relatively low, averaging 2.8 per cent between 2004 and 2006. Relatively stable prices explain most of the monetary freedom score. However, the country still retains extensive price controls and subsidies that distort domestic prices for many food products, electricity, water, and petroleum.

Investment freedom

The government welcomes foreign investment, except in cases involving competition with established local enterprises or existing government-owned or parastatal companies. Bahrain has a comparatively advanced commercial code and is open to outside contract adjudication. GCC nationals may own 100 per cent of the shares of firms listed on the stock exchange, but non-GCC nationals are limited to 49 per cent. Foreign-owned companies may now operate in some cases without a Bahraini partner. There are no restrictions on the repatriation of profits or capital, no exchange controls, and no restrictions on converting or transferring funds, whether associated with an investment or not.

Financial freedom

Bahrain has become a regional financial hub, and both foreign and local individuals and companies have access to credit on market terms. In August 2006, there were 25 commercial banks, but the financial sector is dominated by some 50 offshore banking units that use Bahrain as a base from which to conduct operations in other countries. Overall, there were 368 financial institutions in 2006. The central bank introduced new business classification rules in 2006, aiming to make the financial framework more flexible. The IMF has praised Bahrain's financial supervision as effective and its regulation as modern and comprehensive. As of 2006, the stock exchange listed 52 companies, with GCC nationals allowed to invest freely and foreigners allowed to own up to 49 per cent, and the growing insurance sector had 12 national and eight foreign insurance companies engaged in direct business.

Property rights

Property is secure, and expropriation is unlikely. The judiciary is not fully independent because the king has the right to appoint judges and amend the constitution. Nevertheless, the legal system is well regarded, and foreign firms can resolve disputes satisfactorily through the local courts. There are no prohibitions on the use of international arbitration to safeguard contracts.

Corruption

Corruption is present but relatively low, with Bahrain ranking 36th of 163 countries in Transparency International's Corruption Perceptions Index for 2006.

Labour freedom

The labourmarket is still too inflexible to create overall productivity growth. Businesses are required by law to employ Bahrainis, and this hinders job creation as the government tries to micromanage decisions by private businesses. Rigid regulations about dismissing a worker still create a risk aversion for companies that would otherwise hire more people and grow.

4 Improved governance: a comparison of Oman and Bahrain

As noted above, Oman and Bahrain have achieved significant levels of economic freedom, with Bahrain's progress in this area clearly superior to that of Oman and the GCC countries as a whole. Oman started out in 1996 with a level of economic freedom somewhat below that of the other GCC countries but improved over time. By 2007, its average was somewhat above that of the GCC group, albeit still below that of Bahrain. While higher economic freedom is associated with superior rates of growth, another complementary factor, governance, also plays a significant role in this regard. In this area, both countries have also made considerable strides, again outpacing the other GCC countries. This pattern is consistent with the increasing importance given to institutions by development theorists who see them as a critical factor in accounting for divergent growth patterns across countries.

At the broadest level, institutions can be defined as the structure of incentives that promote or impede entrepreneurial services and productive investment. In many empirical studies, institutions are often measured by the extent to which governments are effective in promoting respect for the rule of law, contract enforcement, and the protection of property rights.

A number of organizations, such as the Political Risk Services Group, the World Bank and the World Economic Forum, have developed surveys to measure over time the effectiveness of government institutions across a range of emerging market and industrial countries. These surveys typically score countries on an annual basis according to a variety of indicators, such as control of corruption, government effectiveness or bureaucratic quality, regulatory quality, political stability and democratic accountability.

These measures of government institutional capacity show clear weaknesses for the Middle East/North Africa (MENA) region as a whole, and in some cases for the other GCC member countries when compared to Oman. Several elements of government institutions that stand out in Oman and Bahrain are captured in the World Bank dataset, which presents a set of estimates of six dimensions of governance covering 199 countries and territories for 1996, 1998, 2000, 2002, 2003, 2004, 2005 and 2006. In looking at the two countries' performance on these dimensions, it is useful to compare them to MENA and the GCC. The World Bank dataset's six dimensions of governance are:

Voice and accountability

This variable measures various aspects of the political process, civil liberties and political rights. These indicators demonstrate 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.

While Oman lies below the norm (negative values in Appendix Figure 13) for the total sample of countries, it still has one of the best regional scores, considerably above the

MENA norm, on this measure of governance. Until the last several years, the country's score on this measure of development has been even higher than that of the GCC countries as a whole. In contrast, Bahrain, which started out with a much lower score, has made considerably more progress in recent years. However, lack of progress in this area may not necessarily have had a detrimental impact on the Omani economy, since it allowed the government to consistently pursue a set of business-friendly policies. As Business Monitor International (2008) noted:

> Unlike Kuwait or Bahrain there is no noisy parliament or opposition to stand in the way of legislation and public protest is virtually unheard of. This is positive for the business environment as long as the government's chosen policy direction is market friendly.

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.

Oman has consistently been the highest rated country in the MENA region (Appendix Figure 14), although progress seems to have slowed in the early 2000's with some backsliding in recent years. Still, the country remains considerably above the MENA norm and slightly above the GCC countries.

In contrast, Bahrain's attainment of political stability and the absence of violence has lagged considerably below that of Oman and the other GCC countries. Improvements occurred in the late 1990s following Shia protests and a period of violence. However, since 2002, the country has declined in this area. With increased sectarian tensions, demonstrations against the government are again taking place.

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.

Again, both Oman and Bahrain (Appendix Figure 15) are considerably above the norm for the region as a whole and, to a lesser extent, the GCC and the total sample of countries. On the other hand, there is scope for improvement as both countries have had a slight deterioration in their ranking in recent years.

Regulatory quality

This aspect of governance focuses on the economic 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.

Oman and Bahrain (Appendix Figure 16) clearly outpace the other MENA countries on this important dimension of governance. Both countries made considerable progress in the mid to late 1990s in strengthening regulation, although the gap with the other GCC countries has closed somewhat in recent years.

Rule of law

Included in this dimension of governance are several indicators that 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.

Again Oman and Bahrain (Appendix Figure 17) greatly out-distance the other MENA countries, with Bahrain making significant improvements in the late 1990s and early 2000s. However, their progress has been minimal since 2002 and their lead over the GCC has narrowed in recent years.

Control of corruption

This dimension of governance measures perceptions of corruption, with corruption 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.

In this important dimension of governance, both Oman and Bahrain (Appendix Figure 18) greatly outshine the MENA region as a whole. However, their scores on this dimension of governance are nearly identical to those of the other GCC countries.

In sum, a good case can be made that the economic success of Oman and Bahrain over the last several decades can be attributed in part to superior governance structures. However, these governance reforms seem to have stalled, with little relative progress made so far in the 2000s. Clearly, both Oman and Bahrain still have some distance to go in the reform process before they can approximate the governance structures of the advanced industrial countries. Given both countries' significant democracy gap (voice and accountability), it will be interesting to see if they will be able to approximate the wave of successful growth reported by other authoritarian states (cf. Dimitrov 2008: 24-9). The extent to which future growth will require additional reforms is unclear at this time.

4.1 Assessment

While both Oman and Bahrain have impressive development records, the sustainability of their growth has been questioned in light of the instability found in many rentier economies. A close examination of the Oman's institutional underpinnings reveals a number of reasons for optimism. While oil has played a dominant role in the economy, Oman has avoided many of the socioeconomic patterns often associated with rentier states. Land-wise it is much larger and more diverse than the Gulf city states, which provides it with more economic options. Unlike Saudi Arabia, it has neither a large royal family nor large oil reserves.

The homogeneity of its population, the personality of its sultan, and the continued strength of its traditional private sector bode well for the country's future. The one element of uncertainty is the identity if the next sultan, since Qaboos does not have a direct heir. But, given the careful attention to detail seen in Oman thus far, it is likely that this eventuality has also been thought through and planned for.

There is also considerable optimism for Bahrain's future. The transition to a constitutional monarchy in 2002 based on a national referendum has resulted in political liberalization and strong backing for further economic reform programmes. In addition, Bahrain has achieved great regional and international success as a result of the sophistication and openness of its financial markets. Furthermore, recent efforts to attract FDI into more technology intensive sectors appear promising.

There are, however, two lingering areas of concern: namely the country's societal volatility and the quality of its educational system. Clearly, the on-going sectarian friction will continue to be a major issue for foreign investors. However, the Sunni-dominated Bahraini government is responding to the country's internal frictions by actively engaging the Shia leadership. While the educational situation does not get as much attention, in the longer term it may prove to be a bigger obstacle to the country's continued progress. Despite a remarkable expansion of the system to encompass most of the school-age population, there are some serious questions as to whether it is adequately preparing the new generation of graduates for the increasing technological demands of a sophisticated service economy—an area where Bahrain conceivably might be able to develop a real comparative advantage. Unless the country undertakes serious educational reforms, Oman, Qatar and the UAE may be in a much better position to capture these industries due to their lead in educational quality.

5 Conclusion

Oman's accomplishments border on the spectacular. The country has essentially developed from a medieval state into a nation poised to assume a regional and global role. Economic growth has in many ways been spectacular. Yet, while the changes in some cases have been exponential, the notion of rushing things with imported ideas and off-the-shelf solutions has never been considered. Oman has successfully resisted the

Table 4
Classification of Arab world countries into stages of development

Stage of development	Arab world countries	Other countries at this stage	Important areas for competitiveness
Stage 1 (factor-driven)	Egypt Mauritania Syria Morocco	India China	Basic requirements (critical) and efficiency enhancers (very important)
Transition from 1 to 2	Algeria Libya Oman Tunisia Jordan	Colombia Thailand Venezuela	Basic requirements (critical) and efficiency enhancers (increasingly important)
Stage 2 (efficiency-driven)		Turkey Russia	Basic requirements (very important) and efficiency enhancers (critical)
Transition from 2 to 3	Bahrain	Barbados Czech Republic Korea	Same as above, but innovation factors become increasingly important
Stage 3 (innovation-driven)	Qatar UAE Kuwait	United States United Kingdom Japan	All three areas important: basic requirement efficiency enhancers and innovation factors

Source: Hanouz and Yousef (2007).

temptation to copy some of its neighbours, and its growth has been sure and steady. It development strategy is an unorthodox but successful mixture of the conservative and the ambitious—a mixture that is distinctly Omani (Oxford Business Group 2005).As a result of its efforts at reform and diversification, Oman has grown beyond the early stages of development. It has moved beyond its initial reliance on oil revenues towards a diversified economy and is entering a development stage where efficiency will become an increasingly important factor in determining economic success.

Bahrain's record, if a bit more erratic, is no less impressive. Despite the country's shifting economic policies over time, its broad focus on diversification has produced significant results in a social environment more hostile to cooperation and policy experimentation. Because Bahrain had an earlier start in concerted development planning, its economy is more advanced—moving beyond the World Economic Forum's efficiency-driven stage into an environment where innovative activity will play an increasingly important role (Table 4) (Hanouz and Yousef 2007). In this regard, the country is well positioned, with stable and efficient public institutions and advanced infrastructure.

Both Oman and Bahrain have enjoyed economic success because their governments made pragmatic choices at each phase of development, which allowed the countries to progress to higher levels of economic sophistication and welfare. Policies favouring improvements in economic freedom and governance clearly set these countries apart from their neighbours and go a long way in accounting for their superior growth records. These improvements occurred in somewhat different settings, with Oman developing in a more authoritarian environment, whereas Bahrain enjoyed greater democracy but somewhat less stability. However, the two countries also had one very important factor in common: each had just enough oil to do some good, but not enough to do serious damage. Still, both countries have relied on oil revenues to support their development efforts. The true test of the success of their development strategies may well be revealed by how well they fare if the oil price declines of late 2008 continue for a prolong period.

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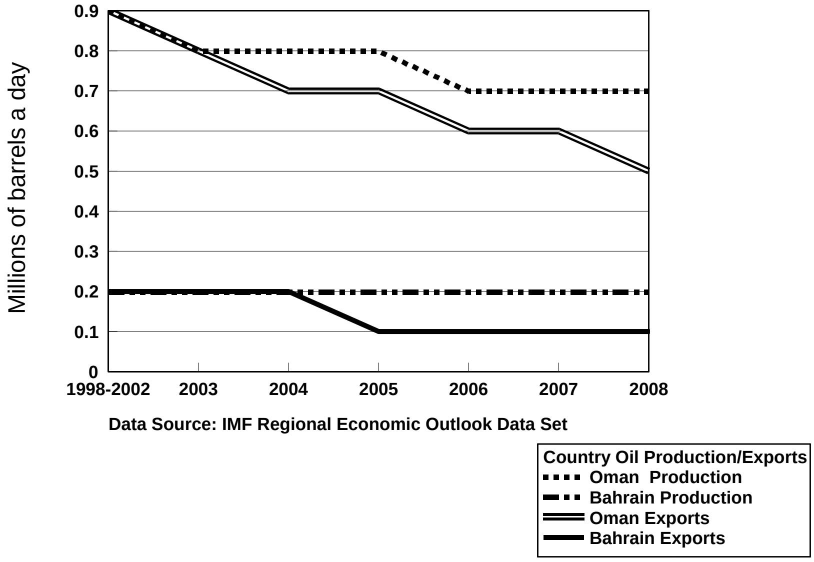
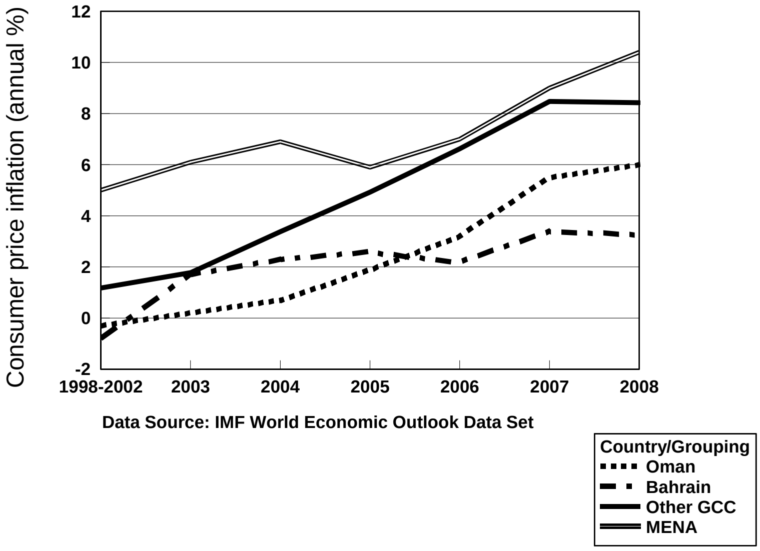
Appendix Figures

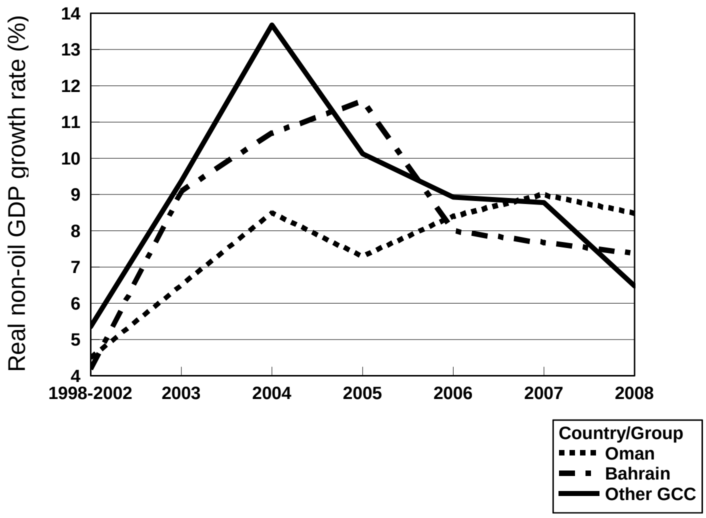
Appendix Figure 1
Recent patterns of decline in crude oil production and exports: Oman and Bahrain



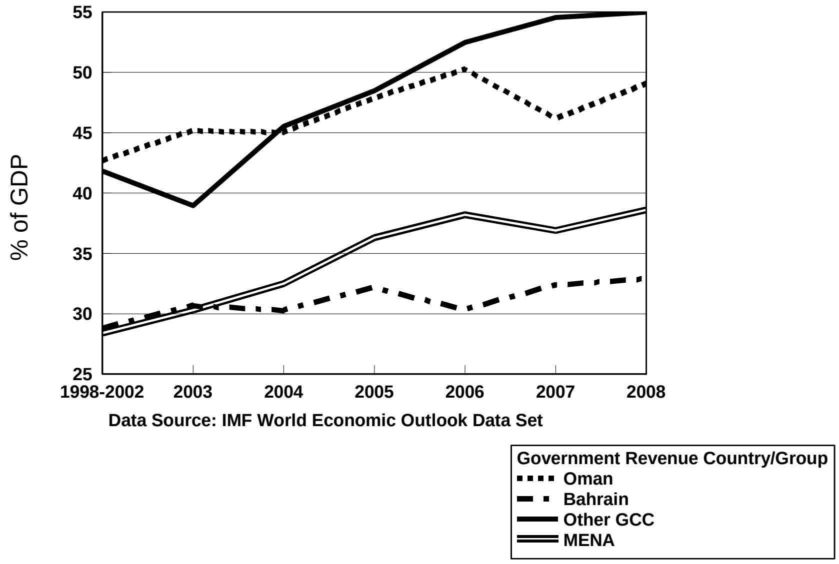
Appendix Figure 2
Recent patterns of inflation: Oman, Bahrain and the region



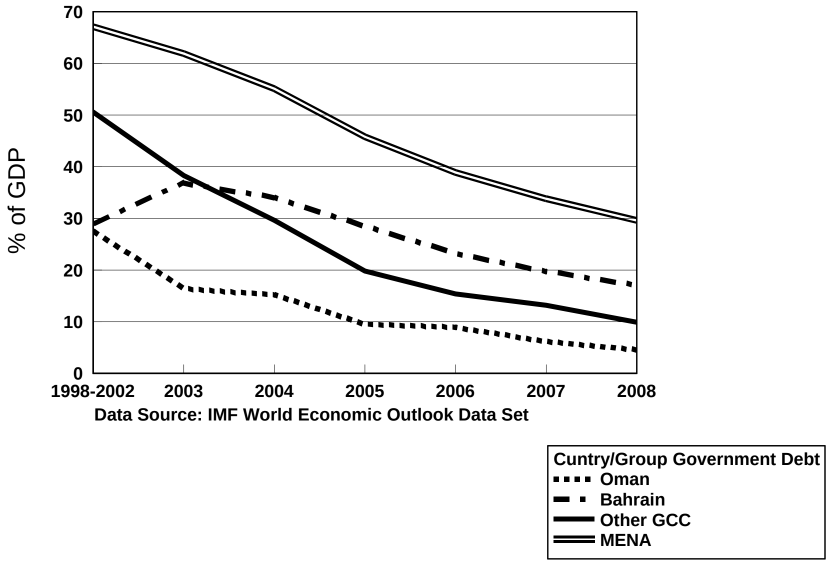
Appendix Figure 3
Recent patterns of non-oil GDP growth: Oman, Bahrain and the region



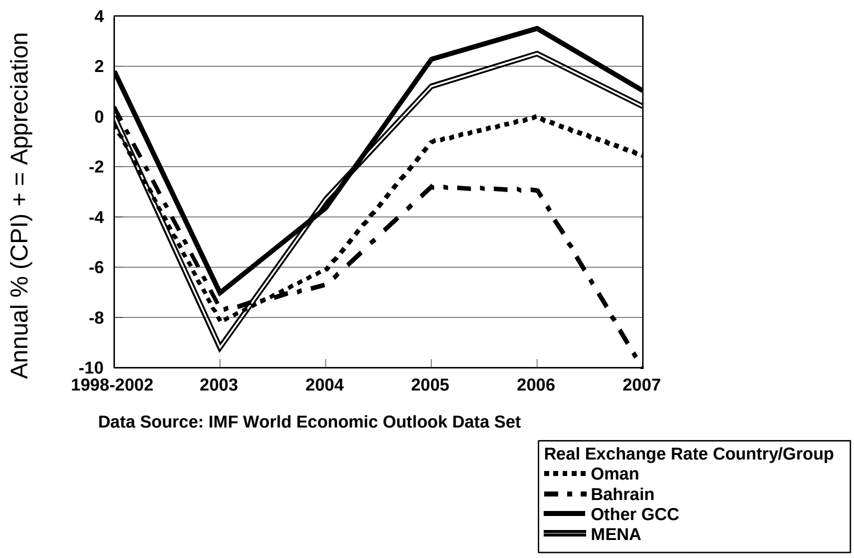
Appendix Figure 4
The share of government revenues in GDP: Oman, Bahrain and the region



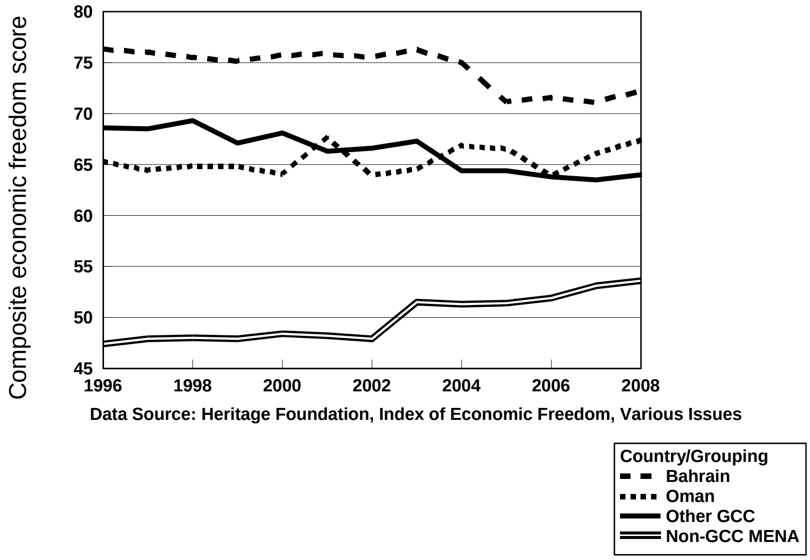
Appendix Figure 5
Recent patterns of central government debt: Oman, Bahrain and the region



Appendix Figure 6
Recent movements in the real exchange rate: Oman, Bahrain and the region

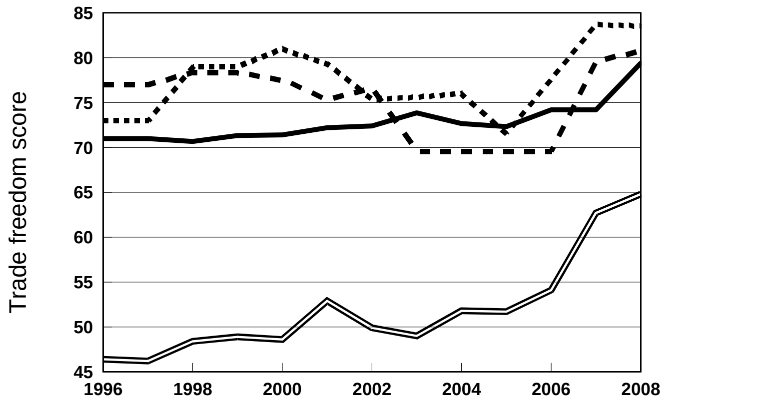


Appendix Figure7
Progress in economic freedom, COMPOSITE SCORE: Oman, Bahrain and the region



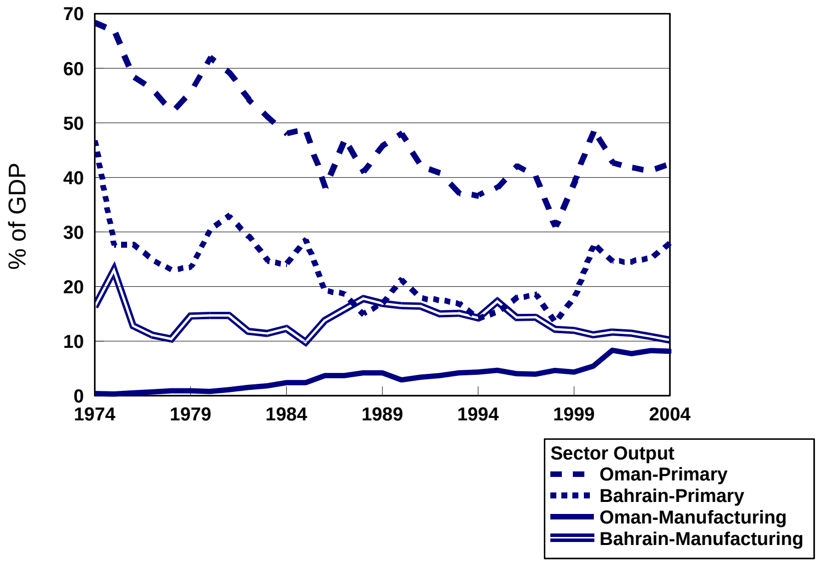
Data Source: Heritage Foundation, Index of Economic Freedom, Various Issues

Appendix Figure 8
Progress in economic freedom, TRADE DIMENSION: Oman, Bahrain and the region

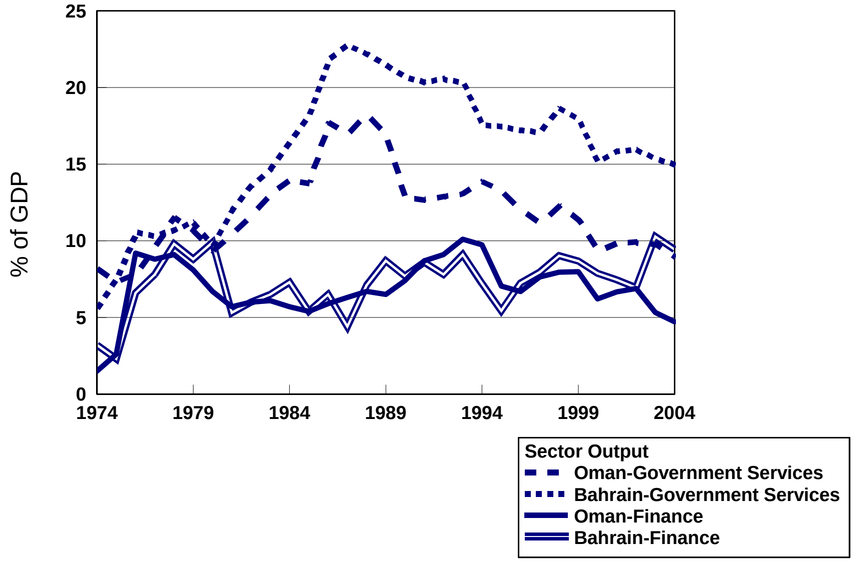


Data Source: Heritage Fundation Index of Economic Freedom, Various Issues

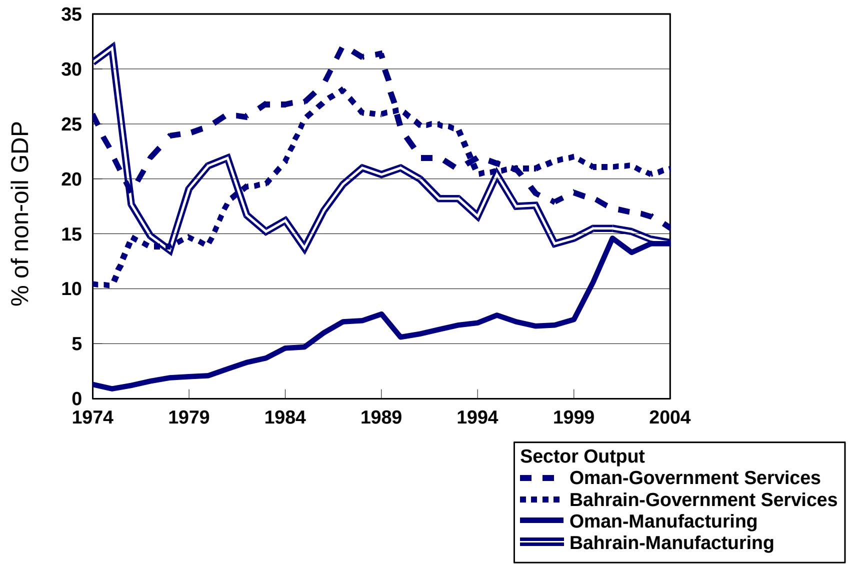
Appendix Figure 9
Broad sectoral shifts (1974-2004) in GDP shares: Bahrain and Oman



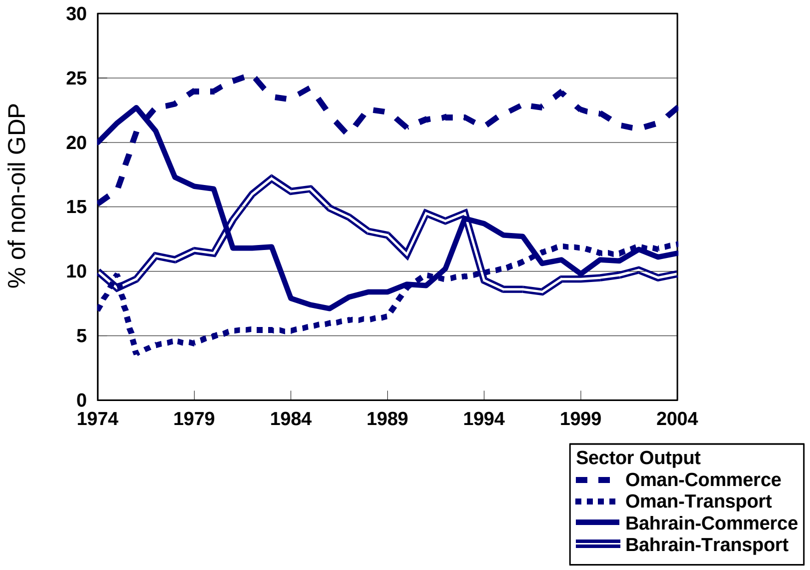
Appendix Figure 10
Sectoral GDP shifts (1974-2004) in government services, finance: Bahrain and Oman



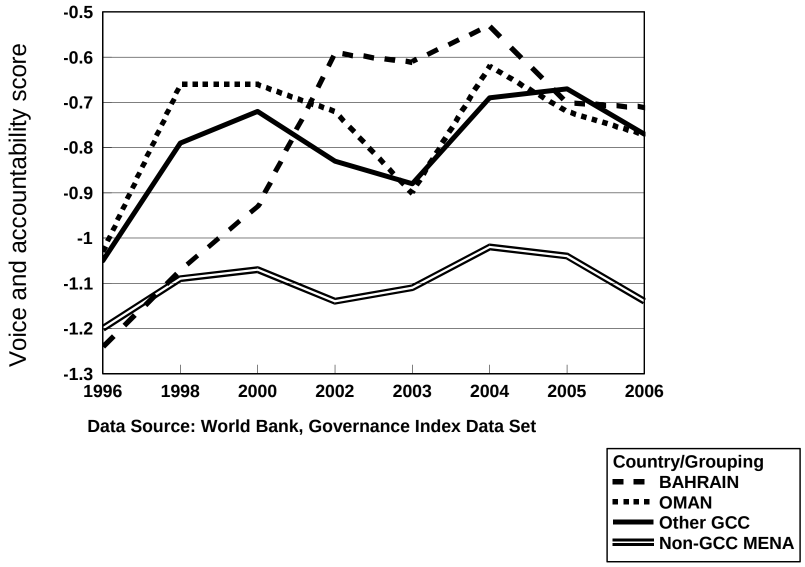
Appendix Figure 11
Broad sectoral shifts (1974-2004) in non-oil GDP shares: Bahrain and Oman



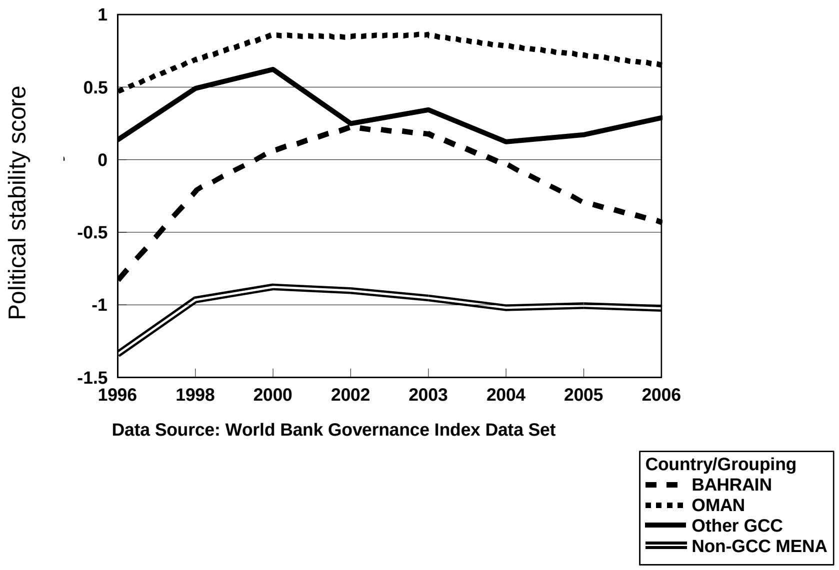
Appendix Figure12
Sectoral non-oil GDP shifts (1974-2004) in commerce/transport: Oman and Bahrain



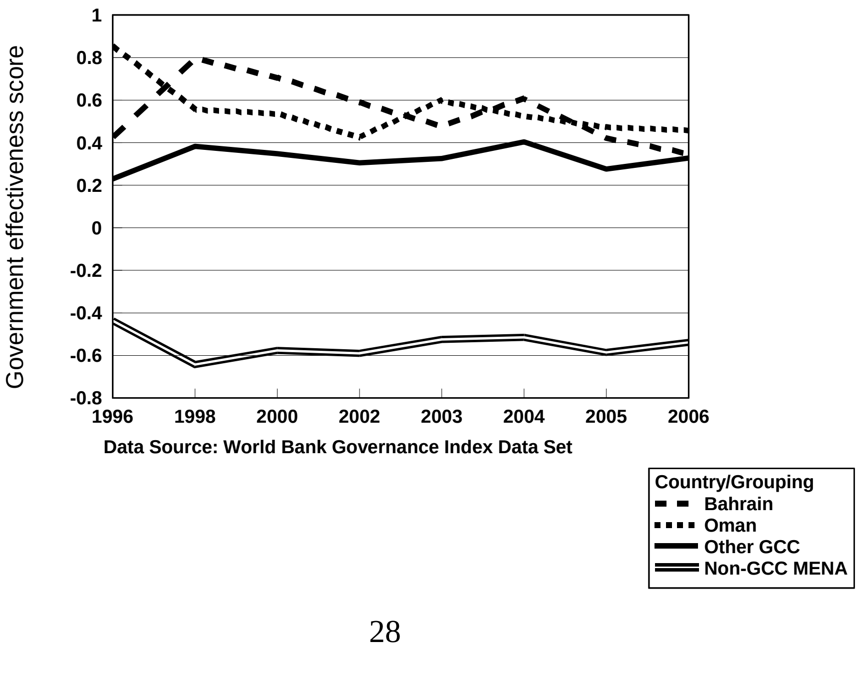
Appendix Figure13
Progress in governance, VOICE AND ACCOUNTABILITY: Oman, Bahrain and the region



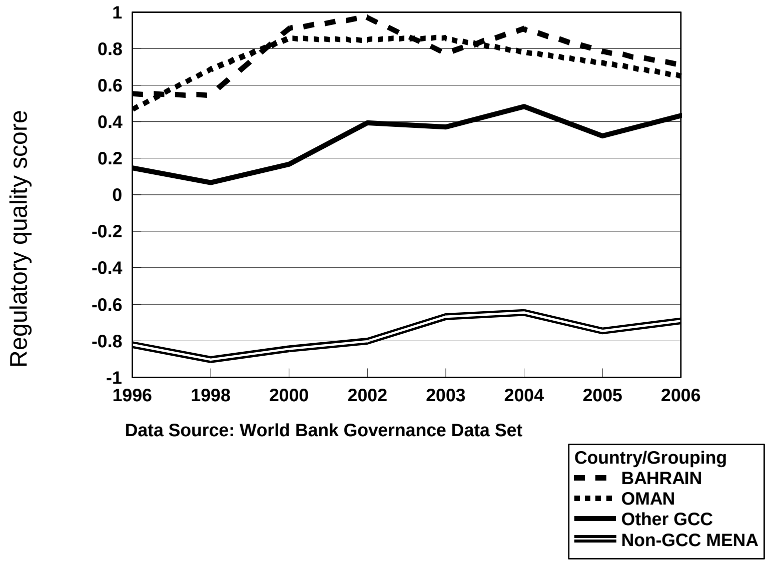
Appendix Figure14
Progress in governance, POLITICAL STABILITY: Oman, Bahrain and the region



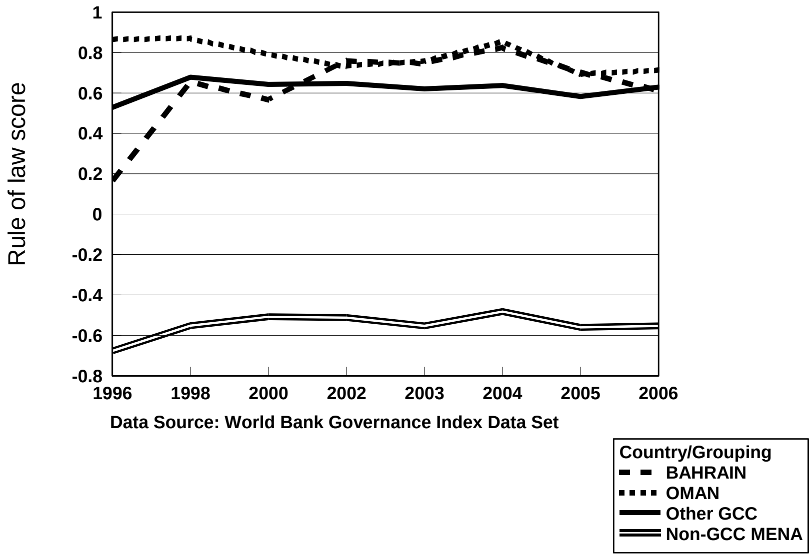
Appendix Figure15
Progress in governance, GOVERNMENT EFFECTIVENESS: Oman, Bahrain and the region



Appendix Figure16
Progress in governance, REGULATORY QUALITY: Oman, Bahrain and the region



Appendix Figure17
Progress in governance, RULE OF LAW: Oman, Bahrain and the region



Appendix Figure18
Progress in governnance, CONTROL OF CORRUPTION: Oman, Bahrain and the region