The Economic Architecture of Hydrocarbon Exporting Countries: Implications for Economic Development and Reforms

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2:00 Pm – 3:00 Pm

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The Agenda

- Background
- The Characteristics of the Economic Architecture
  - Multidimensionality
  - Historical Determinants
- Implications for Reforms
- Why are Reforms Difficult to Initiate – The Ignored Reason
- Discussion

Multidimensionality

- Dimensions of the economic architecture
  - Resource allocation: Market vs. Central Planning
  - Capital (incl. human) income distribution: Capitalism vs. Socialism
  - Enforcement: fiat/sanction vs. parametric
  - Value: Hydrocarbon rent-distributing vs. value creating
  - Supply-driven vs. Demand driven
  - Social welfare protection: Redistributive vs. Asset-based ‘welfare’ state
- Unappreciated/Underappreciated micro-institutions
  - Learning by doing in self-started & managed clubs, associations, societies, businesses …

Historical Determinants

- Economic architecture rooted in national history, culture, institutions, ...
- Shaped by wars (WW1 and WW2), economic crises (Great Depression), demographic shocks, level of economic development
- Result of political settlements. Compromises among stakeholders reflect relative power
  - Labour market arrangements
  - Rules and regulations in the goods and services markets
  - Tax policies and expenditure priorities
- **Compromises routinely produce sub-optimal outcomes from the economy-wide point of view**

The Two Historical Dimensions of the Economic Architecture
Capitalism vs. Socialism
Free Market vs. Central Planning

Allocation Mechanism Returns to Capital	**Free market** allocation – prices set by supply and demand conditions, determine composition of national output, consumption and saving	**Central planner** determines the composition of production. Prices meaningless under direct central planning; may be used under “parametric” planning
Returns to ‘capital’ fully private – endogenous to personal investment in human capital and personal saving & investment	Free market and capitalism – efficient, maximizing social welfare and dynamically stable in its unrestricted form	War-time capitalism
Returns to ‘capital’ appropriated and distributed by the State – exogenous to personal investment in human capital and personal saving & investment	Market ‘socialism’ – stable but inefficient due to the missing link between personal saving and capital income, missing incentives for effort and saving	Centrally planned communist/socialist economies. Inefficient and unstable if central planners try to ensure social welfare maximization

Increasingly Important Dimensions

Rent Distributing vs. Value Creating

Supply-Driven/Government-Centred

Vs.

Demand-Driven/Household Centred

Allocation Mechanism **Sources of Value and Objectives of Economic Effort**	**Supply Driven** Mostly Government-centred	**Demand Driven** Mostly household-centred
Hydrocarbon rent distributing	Large, government funded and supplied in-kind benefits (large role of GLCs/SOEs and public organizations) For example, developing O&G Exporters, but also many developed and some developing countries with large share of public consumption	Cash/deferred cash benefit (could be targeted to finance specific expenditure) Competitive supply of services by GLCs competing with private parties (The idea behind the Iranian December 18, 2010 reform)
Value creating		Labour and capital income earned in value creating activities topped up with cash/deferred cash benefit from hydrocarbon rents ("Singapore on steroids")

A Few Highlights

Rent Distributive

Focus on limiting rent leakage

- Income distribution: primary: oil and gas contractors, government
- Secondary: public sector employees and contractors
- Tertiary (goods & services)
- Selective concern about import leakage
- Lots of affinity-based relations
- Labour markets distribute rents
- Efficiency, competitiveness & productivity are of secondary concern

Value Creating

Focus on value creation

- Value creation everywhere
- Domestic specialization
- Exports oriented
- Import leakage not a concern
- Most relations based on merit, genuine business demand
- Labour markets create value
    - Efficiency, competitiveness & productivity of primary concern

A Few Highlights

GOVERNMENT-CENTRED

Rents captured by the budget

Spent on government priorities

Government assistance to “most vulnerable”

Supply driven economic model

- Increase in social spending
- Increase in subsidies to firms
- Selective private capture likely
- Weakens domestic competition & slows adjustment and growth
- Benefits from reforms unravel

HOUSEHOLD-CENTRED

Rents go directly to all households (O&G dividend)

Households decide how to spend

All nationals benefit

Demand driven economic model

- Increase in personal choice
- Increase in demand-driven expenditure on education, health care, housing, other
- Supply response to genuine demand
- Competitive economic model
- Promotes domestic & international competition, cost reductions, competitiveness, jobs and growth

Marrying the Two Models
Singapore on Steroids?

- Transition to a financial & human capital/asset-based "welfare state"
- A share of hydrocarbon dividends goes to households … but use of the money is restricted
- Rents fund individually owned, portable, inheritable savings accounts at a National (Sovereign) Provident Fund (NPF). Used to pre-finance:
  - Old-age pensions and disability insurance
  - Routine health care expenditure, help finance catastrophic insurance
  - Career-long education
  - Short-term unemployment benefits (to limit moral hazard), help finance long-term unemployment insurance
  - Limited housing equity, other major routine life-cycle expenditure

Marrying the Two Models
Singapore on Steroids?

- The reforms that set up the NPF:
  - Strengthen long-term fiscal sustainability
  - Create a nation of shareholders, spread the long-term benefits of efficient investing in low-cost, globally diversified indices to the poorest segments of the society, offer a genuine opportunity for inclusive growth
  - Significantly reduce the demand for fiscal expenditure, therefore, …
  - Significantly reduce the need for payroll and other distortive taxes in the long term
- Create demand for private sector-provided services
- Fiscal reserve in the Sovereign Wealth Fund is the insurance of last resort
- **Strong professionalism, governance and transparency necessary for success.**

Some Thoughts for Aspiring Reformers

- Policy advice can be biased by providers' past experience, natural home-bias
  - European advice rooted in the experience of Europe's redistributive, government-centred welfare state, however ...
    - Scandinavian advice may dramatically differ from Italian or Spanish
  - U.S. advice rooted in the specific U.S. arrangements in different sectors, but attitudes can vary ...
    - Northern vs. Southern States; East Coast vs. West Coast
  - Singaporean advice rooted in business-friendly, asset-based welfare & individual responsibility
- Reformers must understand the available options, design the most efficient architecture, not blindly copy existing but mostly suboptimal "solutions."

Why are Reforms so Difficult to Start?

Inconsistent Time Preferences, Risks & Uncertainty

Standard approach

- Typically economists use exponential discounting to estimate today's value of future consumption

More realistic approach

- Policymakers, like all humans, use hyperbolic discounting to estimate today's value of future consumption
- They look at short horizons
- Discount positive developments differently than negative
- Are more concerned about possible immediate losses than future gains

Moreover

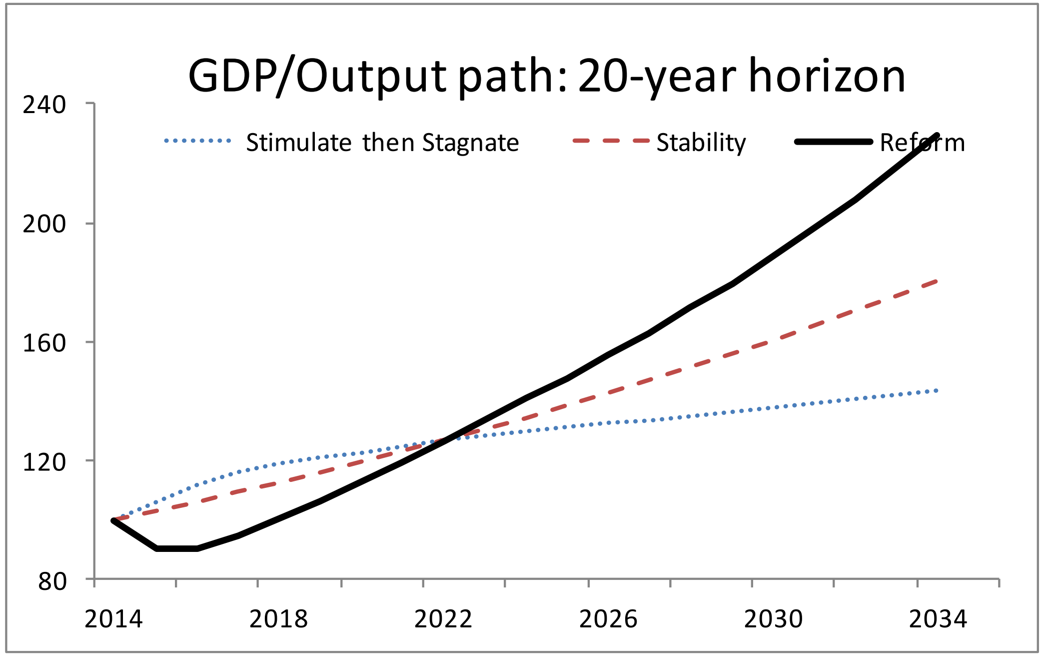
- Known risks and uncertainty about the adjustment costs may further reduce the expected present value of future benefits

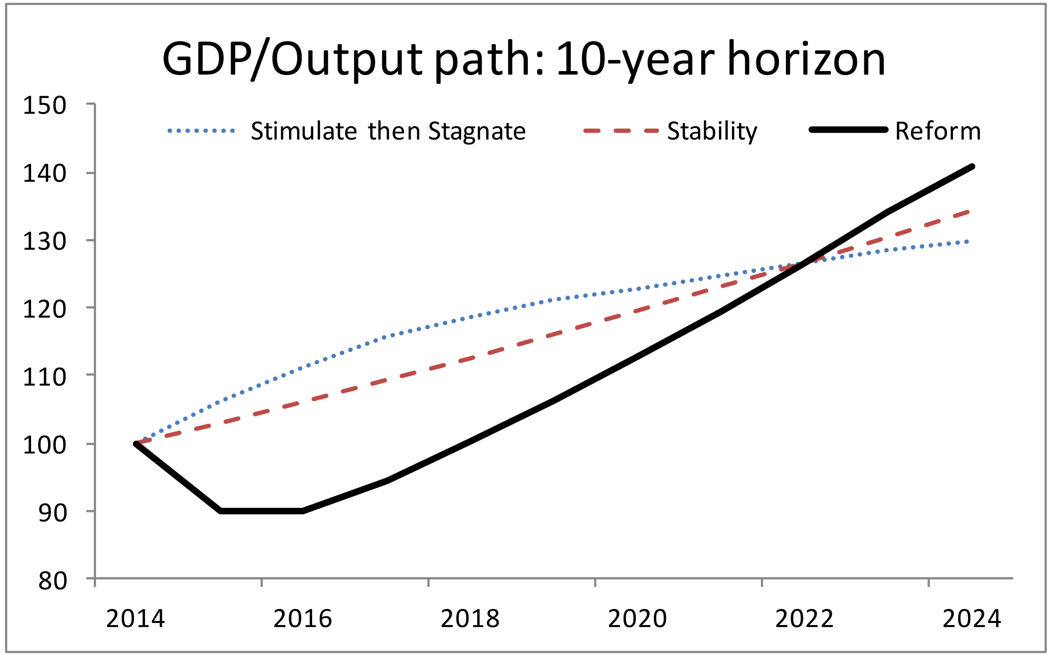
Why are Reforms Difficult to Initiate

Horizon and Business/Policy Discount Rate

Hyperbolic Discounting Adds to the Challenge

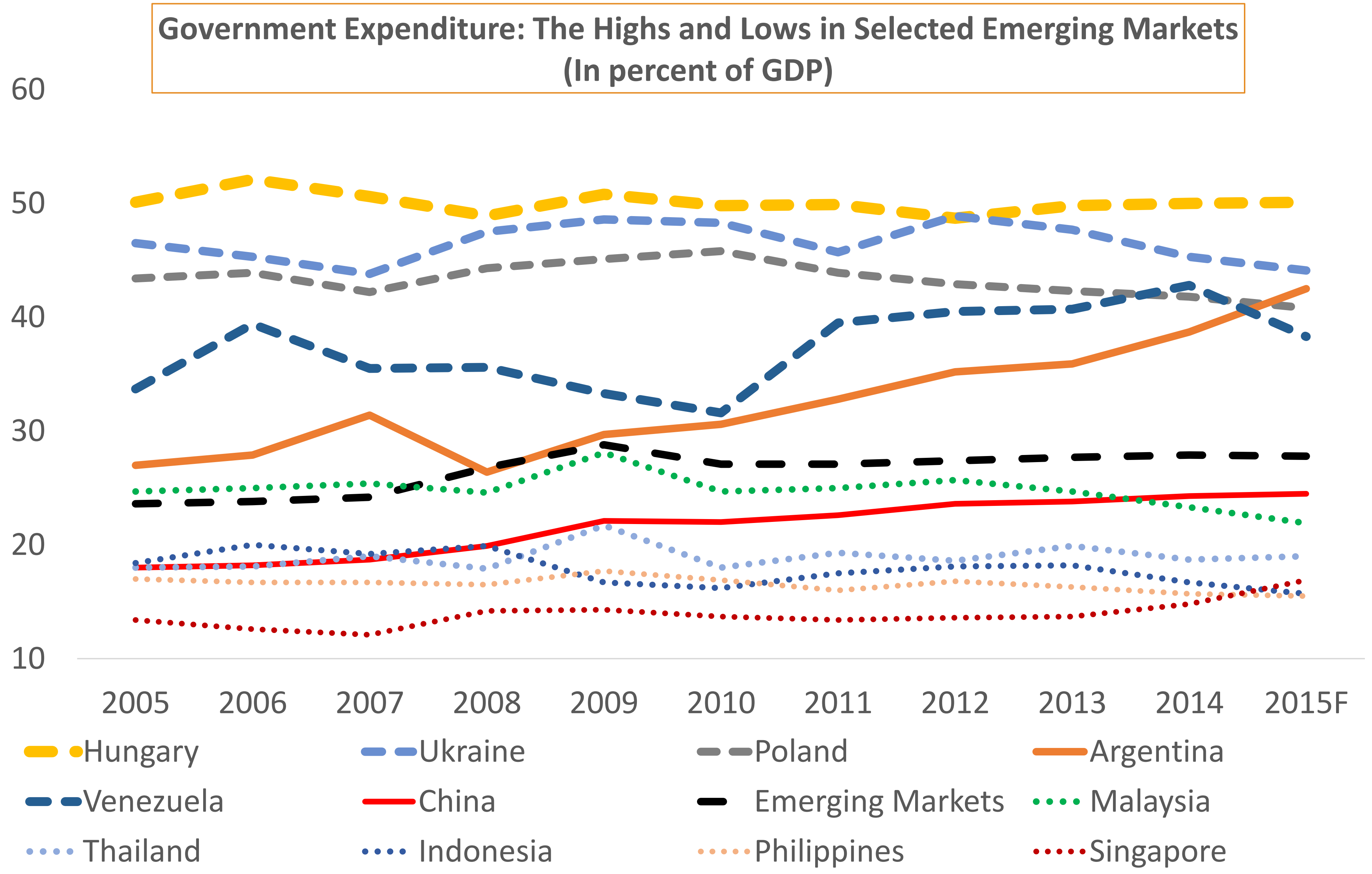
GDP or corporate profits





Reference

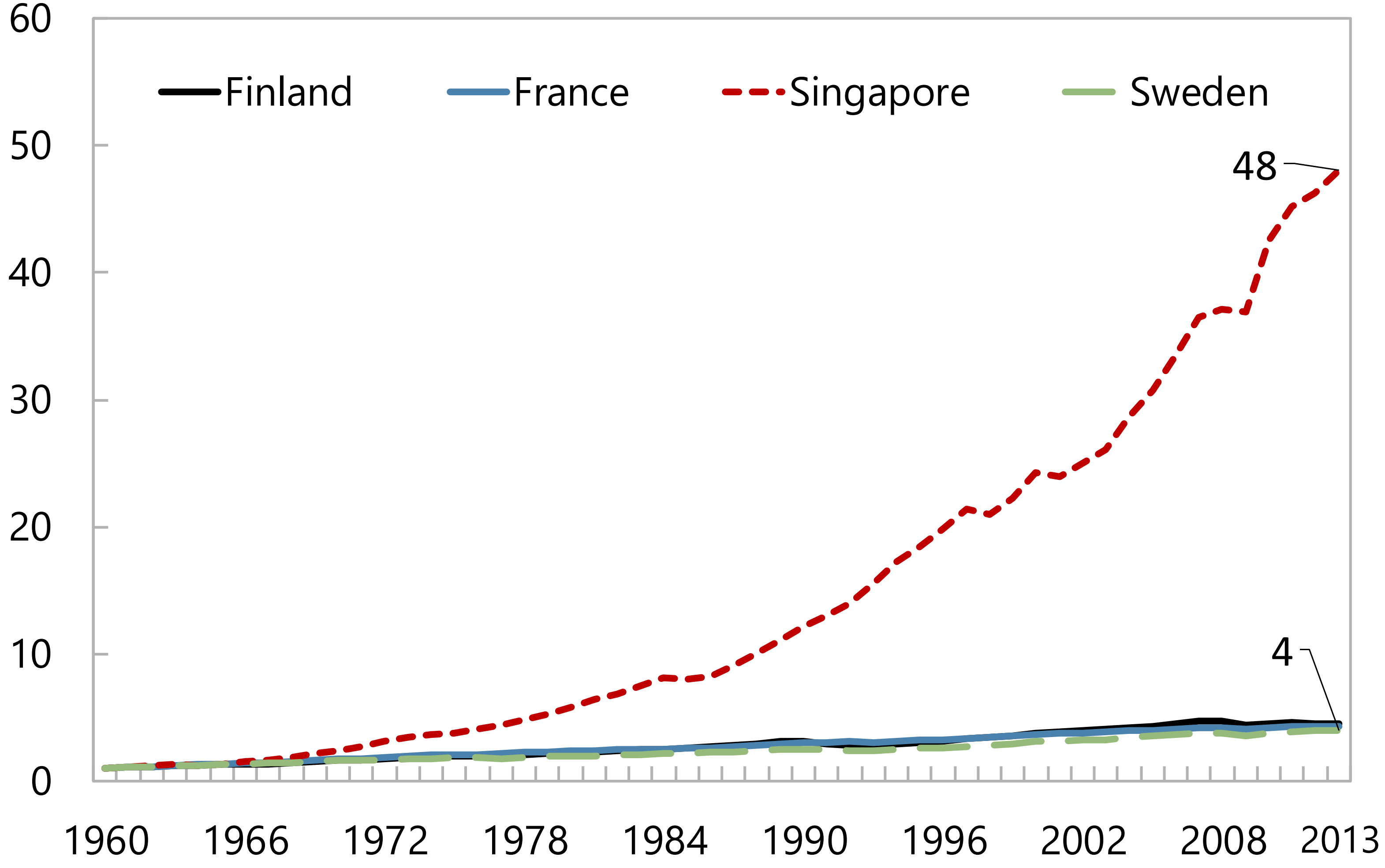
Zytek, Roman, 1991, "Capital Income, Incentives and Macroeconomic Equilibriums," in *Essays on East European Economies.* Ph.D. Dissertation, Virginia Tech. https://vtechworks.lib.vt.edu/bitstream/handle/10919/39872/LD5655.V856_1991.Z998.pdf?sequence=1&isAllowed=y



Government Expenditure: The Highs and Lows in Selected Emerging Markets
(In percent of GDP)
60
50
40
30
20
10
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015F
Hungary
Ukraine
Poland
Argentina
Venezuela
China
Emerging Markets
Malaysia
Thailand
Indonesia
Philippines
Singapore

Real GDP

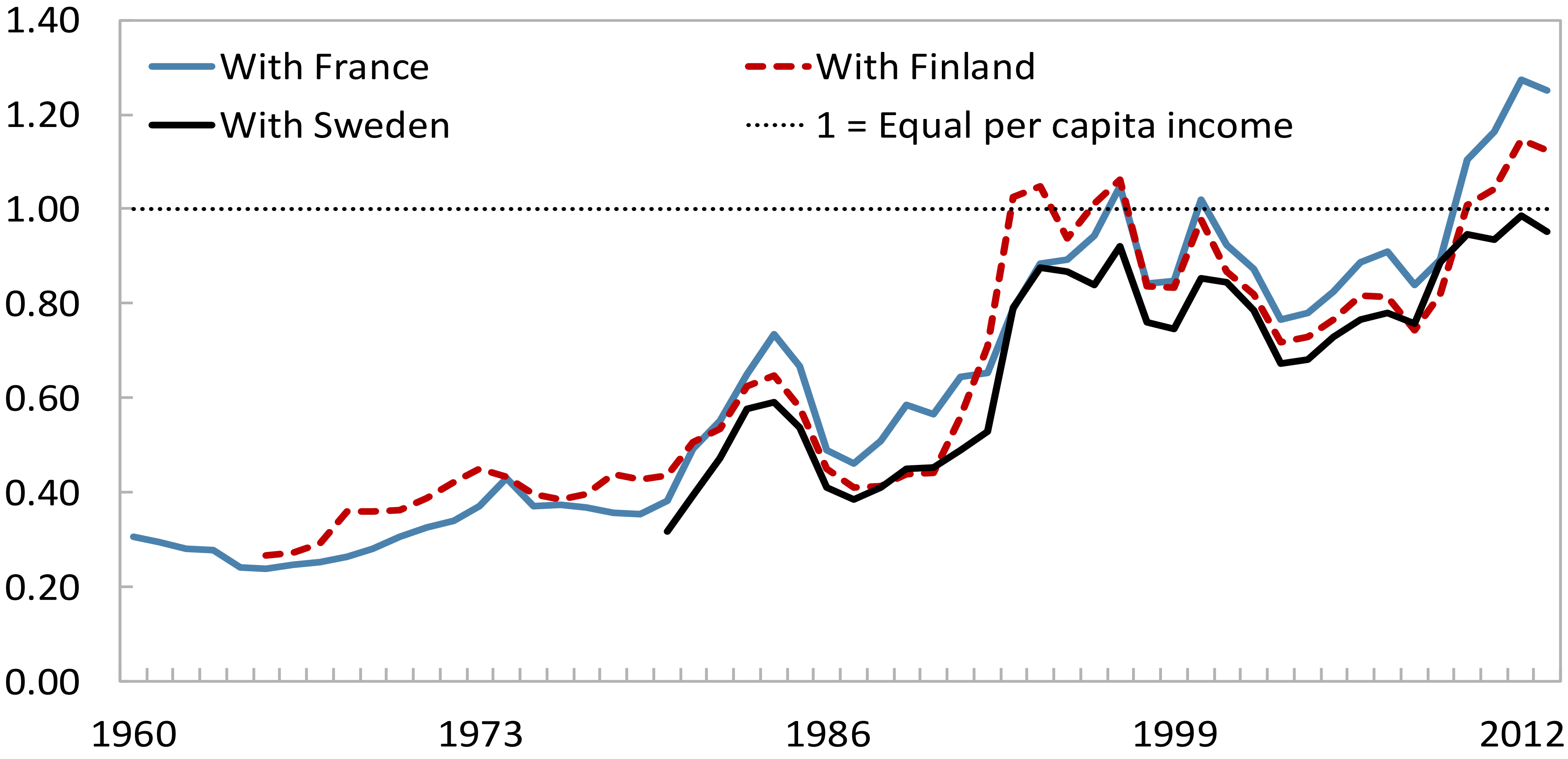
(Index, 1960=1)



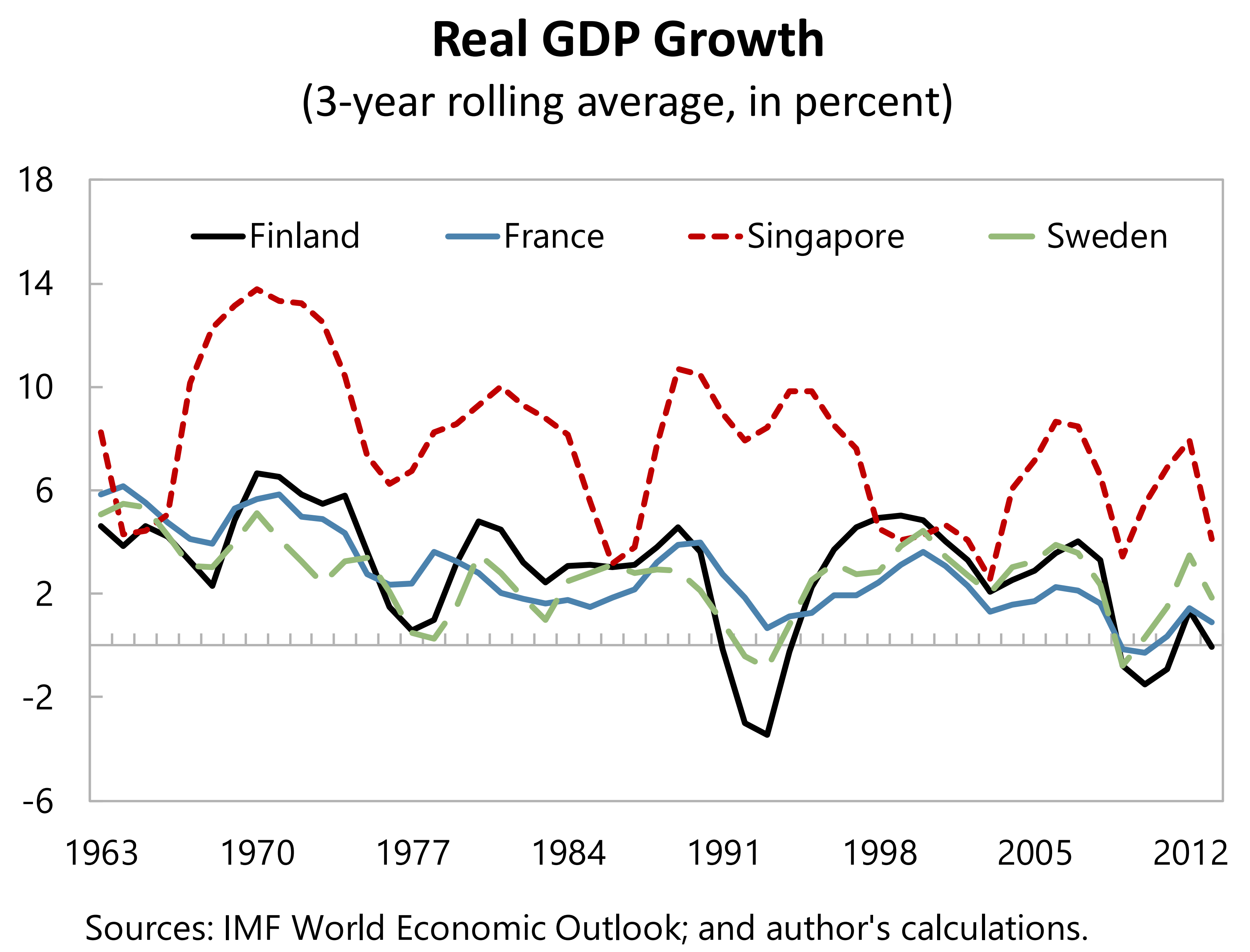
Sources: IMF World Economic Outlook; and author's calculations.

Singapore Per Capita GDP Catch Up

(Ratio of Singapore's per capita U.S. dollar income to the other countries' per capita U.S. dollar income; at current exchange rates)



Sources: IMF World Economic Outlook; Haver Analytics; and author's calculations.


Real GDP Growth
(3-year rolling average, in percent)
18
14
10
6
2
-2
-6
Finland
France
Singapore
Sweden
1963
1970
1977
1984
1991
1998
2005
2012
Sources: IMF World Economic Outlook; and author's calculations.