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Mohammed Nasser Al-Hejry

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OMANI GENERAL BUDGET DEFICIT
DURING THE THIRD FIVE-YEAR PLAN
PERIOD 1986-1990: CAUSES,
MACROECONOMIC EFFECTS AND POLICY
EVALUATION

Ph.D. Thesis submitted to:

The Faculty of Social Sciences

Centre for Middle-Eastern and Islamic Studies

by Mohammed Nasser Al-Hejry

1997

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Abstract

This thesis is concerned with the causes and macroeconomic effects of the budget deficit in Oman during the period 1986-1990. From 1986 onwards the budget deficit became very high, and national saving, national investment, economic growth were declining. The Omani economy is an oil based, small, open economy. Oil exports constitute 87% of total exports. Oil income predominates GDP (60%) and government revenue (88%). Despite these facts, the oil sector is an enclave sector exerting its effects on the economy financially through the government budget but not physically through real economic interactions.

Examining the impact of budget deficit requires that it is carefully measured. The commonly used measurement methods are the conventional (or the public debt) concept of deficit and many special-purpose concepts, e.g. the budget balance reflecting the impact on aggregate demand. Although the conventional concept has some drawbacks such as the inclusion of the inflation effect and the effect of the previous year's deficit, i.e. interest payments on previous debt, it was found that these effects in the case of Oman are minimal and do not make a great difference.

The causes found to be responsible for the deficit are divided into two categories: those relating to the expenditure side of the budget and those relating to the revenue scale. In the first category, two kinds of causes can be distinguished: general causes which affect whole public spending such as administrative setbacks and population growth, and particular causes relating to each type of public spending such as increasing wages and salaries and increasing defence expenditure. On the revenue side, declining oil prices, higher cost of oil production, small proportion of non-oil revenues and the depreciation of the dollar are the main causes of the deficit. The fluctuation of oil prices was found to be responsible for 40-60% of the actual government budget imbalances.

Regarding the macroeconomic effects of deficit, the overall evidence pointed to a negative impact on national saving, national investment, private consumption, and the balance of payments. The decline of oil revenue, cutting public investment expenditure and increasing public consumption are the adverse economic consequences of the deficit that led to the negative macroeconomic effects.

The suggested approach to coping with the deficit is based on three pillars: rationalising public spending, improving the sources of financing and the diversification of the economy.

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List of Abbreviations

b/d:	Barrel per day
bb:	Billion barrels
bbI:	Barrel(s)
CBO:	Central Bank of Oman
CPI:	Consumer Price Index
DBO:	Development Bank of Oman
DC:	Development Council
EEC:	European Economic Community
FIDP:	First Development Plan (1976-1980)
FODP:	Fourth Development Plan (1991-1995)
FT:	Financial Times
GCC:	Gulf Co-operation Council
GDP:	Gross Domestic Product
IMF:	International Monetary Fund
LNG:	Liquefied Natural Gas
MOD:	Ministry of Development
MOFE:	Ministry of Finance and Economy
OBAF:	Oman Bank for Agriculture and Fisheries
OHB:	Oman Housing Bank
OPEC:	Organisation of Petroleum Exporting Countries
PDO:	Petroleum Development Oman (Company)
PSBR:	Public Sector Borrowing Requirement
RO:	Rial Omani (the Omani Currency)
SDP:	Second Development Plan (1981-1985)
SGRF:	State General Reserve Fund
SOEs:	State-Owned Enterprises
SYB:	Statistical Year Book
ThDP:	Third Development Plan (1986-1990)
UAE:	United Arab Emirates
UK:	United Kingdom
UNDP:	United Nations Development Programme

Introduction

Oman started its development programmes in the early 1970s with its economy almost at a subsistence level. A modern government did not exist. Public services such as education, health, communications, etc., were almost at zero level. Agriculture, fisheries, trading, handicrafts were the main sources of income for the population.

Oil production began in the early 1960s and regular commercial crude oil exports began on 1 August 1967 at 64 thousand barrels. In 1968 it rose to 244 thousand barrels. The oil price was extremely low at \$1.82/b. In 1971 it increased to \$2.22/b.

The period 1970-1975 was the period of the institutional foundation of the government. The government structure had been formulated and the basic political, social and economic directions had been shaped. In 1975 the government began to fulfil systematic development plans to modernise the economy and to transfer it from a subsistence economy to a modern one in which the private sector played the leading role.

With the rise of oil price in 1973 and 1974 to \$3.13/b and \$11.4/b respectively, the oil sector began to fuel the economic development. Oil production constituted 69% of total GDP in 1970. Oil exports were increasingly dominating total exports. In 1975 it formed almost 100%.

The government raised its share in the ownership of the oil producing company PDO. By 1975 the government share was 60% of the company's capital. Oil surpluses from exports accrued to the government. Oil revenues increased from RO 45m in 1970 to RO 373m in 1975 and RO 1109.5m in 1980. Government

expenditure increased from RO 20.6m in 1970 to RO 495.0m in 1975 and RO 949.8m in 1980. The government expenditure was channeled into building public administration, defence and national security, and to provide social infrastructure and services such as education, health and structural infrastructure, roads, airports, sea ports and water resources.

From 1975 to 1995 the government executed four development plans. As will be shown, remarkable performance has been achieved in public services. The standard of living of the population has improved tremendously.

During this time the economy became more dependent on oil. The sector of agriculture and fisheries, which had been the main source of gross domestic product, had lost its importance. Its participation in total GDP fell from 37% in 1967 to 2.5% in 1985. The economy, on the other hand, became more dependent on government revenues. The state has been providing all public services. Its total expenditure recorded 68% of GDP in 1975, 46% in 1980, and 55% in 1985. The state became the main source of investment. Public investment recorded 77% of total investment in 1975, 70% in 1980 and 1985. In 1990 and 1995 it was 68.5% and 60% respectively.

Therefore, the private sector has not been developing properly despite the government's strategy adopted to create a private sector led economy. Within the private sector, the reliance on the expatriate labour force was increasing. The expatriates increased from 74,000 in 1975 to 154,000 in 1980, 313,000 in 1985 and 430,000 in 1993. Their number has been increasing by 10% per annum. The Omani labour force increased from 135,000 in 1975 to 152,000 in 1980, 192,000 in 1985 and 240,000 in 1993. Their proportion in total labour force has been falling from 64% to 50%, 38% and 35.8% during these years respectively. Their number has been rising by only 5.6% per annum. Despite the noticeable quantitative

development of the Omani labour force due to education and vocational training programmes, this development was not in balance with the needs of the private sector both quantitatively and qualitatively.

The Omani economy, in short, became increasingly strained by two problems: heavy reliance on the government and high dependence on the oil sector. In other words, the development strategy did not succeed to put the country in a private-sector led economy and self-sustained development. Accordingly, the government budget has been suffering from semi-chronic deficit. During the period 1972-1995 the government budget has been in deficit except for a few years, namely 1979, 1980 and 1981. The deficit recorded 13% of GDP in 1972, 16% in 1973, 10% in 1974 and 14% in 1975. Not very long after enjoying a surplus of 2.5%, 11.5%, 1.5% of GDP during 1979-81, the deficit occurred again recording 9%, 11%, 10% in 1982, 1984 and 1985 respectively. However, when the oil price declined to \$13/b in 1986 (compared to \$36/b in 1980), the budget deficit went up to 25% of GDP.

The government applied particular measures to cope with the problem, the first of which was a tangible cut of its expenditure, especially development expenditure. Thanks to the measures adopted and the rise of oil prices in 1990 because of the Gulf Crisis, the government managed to reduce the deficit to 0.3% of GDP. In 1991 the government started to execute the fourth plan. One of the main objectives of the plan was to achieve a balanced budget by the end of the plan in 1995. In reality, however, the government expenditure resumed its momentum and a deficit of 13% of GDP was recorded in 1992. In 1993 and 1994, it was 11% and 10% respectively. By the end of 1995, the deficit was still at 9% of GDP.

The aim of this thesis is to study the causes of the budget deficit in Oman, and to analyse its macroeconomic effects on the Omani economy. The objective of this

thesis is also to examine the policy that was adopted to reduce and to finance the deficit.

The budget deficit was chosen to be the subject of this thesis for three reasons:

1. To investigate the internal economic and social reasons that lie behind the intensive intervention of the government in the economic activities and accordingly its rising expenditure which was increasing during 1970-1995 by 28% per annum on average.
2. To explain the external effects of the world oil market that induced fluctuating trends on the public finance and the private sector due to the heavy reliance on one single commodity, the price of which is completely out of government control. When oil prices jumped to \$36/b in 1980, the government budget gained the highest surplus during the oil boom of 11.5% of GDP, but when oil prices sank to \$13/b in 1986 the government revenue declined by 31% and the budget recorded the biggest deficit so far of RO 700 million, i.e. 25% of GDP.
3. To assess the deficit reducing and financing policies which have deep and long-term macroeconomic effects on the Omani economy. Cutting investment expenditure has negative effects on social and structural infrastructure. External borrowing and the withdrawals from the state's General Reserve Fund to finance the deficit have been using up the oil resources and accelerating the depletion of the oil wealth.

More attention will be paid to the period 1986-1990 for two reasons: First, this period has witnessed the worst fiscal situation of the government and accordingly very difficult conditions for the Omani economy. Oil prices plummeted to \$13/b on average and to \$8/b in August 1986. The average price during this period was \$16.3/b whereas the average price during 1981-1985 was \$31/b. Oil revenues declined by 31% in 1986 and were not restored to their 1985 level until 1990.

During this period the budget deficit recorded its highest levels. It peaked in 1986 at 25% of GDP, with a 97% rise on the 1985 deficit. The public debt figure jumped from RO 648.1 million at the end of 1985 to RO 1027.3 million in December 1990, i.e. it rose by 58.5%. Accordingly, all economic indicators were repressed. In 1986 the GDP went down by 26%. It was restored to its 1985 level only in 1990. National saving declined by 48% in the same year and national investment went down by 5.7% and by 37% in 1987.

Second, to examine the economic development strategy of the state that was formed in 1975. The main objectives and policies of this strategy were to invest the oil resources in diversified income-generating projects in order to augment, and finally replace, the ample and depleting oil income, taking into account the unpredictable changes of the oil world market. The means with which oil resources were sought to be invested were intended to safeguard the best use of these resources, to give strength to, and to secure the future progress of, the Omani economy. The strategy also aimed to balance regional distribution of the fruits of development in order to maintain the existing geographical balance of the population. It was intended that the Omani economy would be led by an efficient private sector free from monopolistic practices. After forming the strategy, a series of development plans have been implemented in an attempt to achieve the broad outline of these long-term targets and policies.

The period under study was one link in this series of development plans. Therefore, it is important to see to what extent these targets have been achieved, to what extent the above difficult conditions have interrupted the development efforts, and what are the lessons that can be learnt to reform new development strategies.

Primary sources and problems of data

Three main sources of data have been used: primary sources, books and articles. These are all mentioned in the bibliography list. I would like here to focus on the primary sources and problems thereof.

The primary sources are government documents of previous development plans, official annual reports, statistical year books, and other government publications. I have visited several ministries and other government units. From the Ministry of Finance and Economy I collected the documents of the state general budget of the previous years, particularly of the period under study. I also collected the financial accounts of those years. They benefitted the present study a great deal, because they provided the raw material about the government's finance, i.e. the official figures about government expenditure and revenue, both projected and actual.

From the Ministry of Development (previously the Development Council), I collected the documents of development plans and the statistical year books. These documents contain very important information about the Omani economy both public and private sectors. They provide statistics about sources and uses of the gross domestic product, investment expenditure, employment, the population and the labour force. The Ministry also provided me with some studies and reports issued by international institutions such as the IMF and the WBDC.

Several visits were made to the Central Bank of Oman. Its annual reports were of considerable benefit to my work. They cover many topics related to the issues investigated through different chapters of the thesis such as GDP growth, oil sector development, money and banking, consumer price index, and international trade.

The Ministry of Commerce and Industry and the Oman Chamber of Commerce and Industry have published some studies and reports about commerce and

manufacturing sectors. I have used these resources in my analysis of related subjects.

The problems I have faced are related to the delay in publication of statistics and information about the economy when a particular year has finished. Data and statistics were issued a long time after the end of the period concerned.

Some statistics are contradicted by the statistics of other government publications. For example, the Ministry of Agriculture and Fisheries has conducted an agricultural survey and found that the number of employees in the sector of agriculture and fisheries in 1993 was 163,000. The number of Omani employees was 123.9 thousand, i.e. 67% of total agricultural employment. The Ministry of Development, in contrast, has found, through the general census of the same year, that the agricultural employment was 62.8 thousand and the Omani employees were 21.4 thousand, i.e. 35% of agricultural employment. These two contradictory figures about agricultural employment give very discrepant implications regarding the population reliance on agriculture and fisheries. Bearing in mind the average family size of 7.4 (according to the census), 58.5% of the population relies on 3.6% of GDP if we take the figures of the Ministry of Agriculture and Fisheries into consideration. However, if we consider the figures announced by the Ministry of Development, 9.6% of the population relies on 3.6% of GDP. Although this problem does not fall within the bounds of my thesis, it faced me in the discussion of the main characteristics of the Omani economy and I have tried to explain it (see chapter one).

Another problem related to my study is the lack of previous studies about the Omani economy in general and in fiscal and monetary policy in particular. For example, no studies have been done on inflation or consumption or government expenditure and economic growth.

Literature Survey

While there is substantial literature on budget deficits for developed countries, particularly for the USA, the material is quite sparse for the developing countries. In spite of the urgency and the importance that is being attached to this issue, it is surprising that there has been no systematic study of this area for many of the developing countries. The investigation of this problem in the oil producing countries in particular has not received any attention. I have found only a few articles about budget deficit in the Gulf States, two of which are the most important: one is about the case of Kuwait and the other is about the United Arab Emirates (I will comment on them later). The lack of literature about the issue in these countries can be explained by the fact that the issue is quite recent in these economies.

The literature on the subject consists mostly of discussions of different aspects of the problem that had been experienced in different countries such as budget deficit and inflation, budget deficit and national saving, budget deficit and interest rate, etc. The best examples of this type are two books: *Essays in Contemporary Economic Problems* edited by Philip Cagan (1981) and *Debt, Deficit and Economic Performance*, edited by Mario Baldassari and others (1993).

The second type of literature is written on one single country's experience during a particular period of time. The best two examples of this type are *Deficit Spending and the National Income*, by Henry H. Vilard (1941) and *Deficit Financing and Economic Development* by R.G. Kulkarni. The first book consists of four parts: the problem of business cycle, the theoretical effects of deficit spending (e.g. the concept of multiplier), analysis of the public expenditure in the US during the period 1923-1938, and the conclusion. The second book is divided into two parts: theoretical foundation and analysis of the Indian finances during 1792-1945 and 1946-1951. The definition foundation includes a definition of deficit financing, and

the economic significance of balanced and unbalanced budgets. The analysis of the Indian finances is a discussion of deficit financing in India during the process of economic development.

The third type of literature are articles and essays published in a wide range of economic and management periodicals. A variety of topics revolving around the budget deficit have been addressed. IMF staff papers assumed the lion's share in this type of literature due to the availability of data on the one hand, and as a part of the IMF function to investigate the financial problems of developing countries and advising them to follow its prescriptions on the other.

The other observation is that most of the literature concentrates on the implications and effects of budget deficit. There has been little attention given to the causes of the problems. The phenomenon of increasing public spending as a main cause of the problem has been mostly emphasised. This phenomenon, which started after the second world war in the industrial countries, and after the movements of independence in developing countries, has attracted most of the attention of public finance economists. The backwardness of the taxation system in developing countries, which is the other main cause of the problem, has received less consideration in the literature and consequently in practical reforms.

After these general comments, let us now make some critical points on the literature with special reference to developing countries in general and oil producing countries in particular.

Since alternative formulations of budget balance can give significantly different indications, careful discussion on the appropriateness of the use of various concepts for specified purposes and of the relative merits of different approaches is an

essential prerequisite for careful investigation of the causes of the budget deficit and clear analysis of its impacts on the economy.

Bleyer and Cheasty (1991), and Chelliah (1973) have made valuable contributions to this discussion. Bleyer and Cheasty distinguished between several concepts of budget deficits. Firstly, they draw a general framework within which the budget deficit is defined. The comparison between so many concepts of budget balance made their work quantitative but not qualitative. They did not elaborate sufficiently on each of those concepts. They did not point out the difficulties and shortcomings of the application of such concepts in the real world.

Chelliah's work in contrast is more concentrated. He studied three concepts of the budget balance: the public debt concept, the budget balance reflecting change in net worth and the budget balance reflecting impact on aggregate demand. He elaborated more on the latter. He discussed the practical issues encountered in applying this concept such as the treatment of government lending and government borrowing regarding their impacts on aggregate demand.

From the point of view of developing countries, most of these concepts of the budget balance are far from reality because they need an advanced database which these countries are lacking. On the other hand, the structure of public finance of oil producing countries is quite different from that of industrialised countries in which these concepts are more easily applicable. For example, the treatment of oil revenue as internal revenue is questionable since these revenues are not derived from an economic activity integrated with the local economy. The extraction of oil revenues does not affect local economy activities. In my study, oil revenue will be treated as external revenue. Therefore, the concepts of budget deficit need some modification to measure government transactions of oil countries properly. That is to say, special work is needed to fill this gap.

As for empirical studies on budget deficit in developing countries, William Easterly and Klaus Schmidt-Hebbel (1992) and Gupta (1992) conducted complementary works. They tried to study the problem comprehensively. In other words, these two works attempted to cover all dimensions – causes, effects and remedies – and not only confined to one aspect. The first one is a paper of 70 pages summarising the results of ten case studies of developing countries: Argentina, Chile, Colombia, Cote d'Ivoire, Ghana, Mexico, Morocco, Pakistan, Thailand and Zimbabwe. The merit of the study is its comprehensiveness. It controlled the different aspects of the problem. It investigated the causes of the budget deficit on each country through analysing the sensitivity of deficits to foreign variables such as export prices and foreign interest rates, and to domestic macroeconomic variables such as inflation, real interest rate and real exchange rate. The study also covered the most important implications of the deficit: inflation, money supply and the private sector response to public deficit via private consumption and private investment. However, there are some serious imperfections in this study. It is based on different measures of budget deficits. For example, in comparing the significance of deficit of the countries under study it depended on primary deficits which range, due to varying degrees to data, from the central government to the total consolidated public sector. In analysing the causes of deficits it adopted the consolidated non-financial public sector deficit, whereas it examines the consequences of deficit in the light of the consolidated total (non-financial) plus quasi-fiscal public sector deficits. In addition, some data of the countries examined covered different years. Thus, the results of the study cannot be accepted with sufficient confidence.

Gupta's work is a small-sized book of 190 pages. It is a comparative study of 10 Asian countries: India, Indonesia, South Korea, Malaysia, Pakistan, the Philippines, Singapore, Sri Lanka, Taiwan and Thailand. It focuses on the following aspects of the budget deficits in these countries: their sustainability; their effects on aggregate demand; the channels through which budget deficits engender these effects; the

irrelevance of the mode of financing a given budget deficit; and effects on monetisation, money growth and inflation. The period covered is unified. It extends from 1961 to 1985. The concept of budget deficit used in this study is also unified.

The difference between Gupta's study and Easterly/Schmidt-Hebbel's study is that Gupta has applied the same analytical tools on the data of all the countries covered, whereas Easterly/Schmidt-Hebbel's study is a comparison between the results of separate studies that might have applied different techniques. Despite these facts, Gupta has come to many inconclusive results regarding the impact of budget deficits on aggregate demand, money growth and inflation in his sample of countries.

From the point of view of oil producing countries, Al-Ibrahim (1989) and Al-Yousef (1993) have contributed with two papers.

Al-Ibrahim focused on the budget deficit in Kuwait during the period 1981-1989. He suggested the comprehensive balance in which the return of general reserve fund and the next generation fund should be added to the list of revenues. In this case the budget would record a surplus but the lack of availability of data makes the adoption of this concept difficult.

In analysing the causes of the deficit, he attributed the deficit to the increase in public expenditure and the decline of oil revenues between 1981-1989 by 50%. The causes of increasing government expenditure are similar to that of Oman because the structure of both governments and societies are similar. There were two sources of deficit financing: withdrawal from the general reserve fund and selling treasury bills (internal borrowing). The same sources are used in Oman. The government in Kuwait started to use the second option in November 1987 while in Oman it was first used in January 1990. He criticised the adoption of the first source since it leads to the erosion of the government assets. The second source was expected to

attract the Kuwaiti resources invested abroad but it did not succeed. In confronting the deficit, the writer suggested introducing new taxes and rationalising public expenditure. In the long-term, however, this solution is not adequate in his opinion because the problem originally refers to disequilibrium between the structure of government assets and revenues on the one hand, and the government's long-term social and political commitments on the other hand.

Al-Yousef studied the budget deficit of the UAE in the decade 1980-1990. The deficit was caused – as in Kuwait – by the decline of oil revenues and continuous increase in public expenditure. The writer pointed out that the United Arab Emirates has financed its deficit by drawing from its general reserves and borrowing domestically.

For long-term confrontation of the deficit he suggested the devaluation of the local currency (Dirham) and the diversification of the economy. Through diversified economy, he suggested imposing some taxes. Taxes would rationalise consumption, increase the responsibilities of the tax payer, and would provide the government with financial resources. He predicted that oil prices will not exceed \$20/b during 1991-2005 so he placed more importance on rationalising public expenditure.

Neither paper has discussed the effects of budget deficit on the local economies of Kuwait or United Arab Emirates.

From an Islamic economic perspective, three papers on the subject were submitted to the Higher Advisory Council for Implementation of the Islamic Shari'ah in Kuwait, in January 1993.

The first was written by Mohamed Anas Al-Zarqua, the second by M. Mundher Quhf, and the third by Refaat Al-Awadhi. They all stressed three points: the importance of the rationalisation of government expenditure, applying the Islamic techniques of financing and the prohibition of borrowing with interest. I will comment on the first paper as an example.

Al-Zarqua first stressed the importance of the Islamic prioritisation of government expenditure. He then argued that the deficit can be reduced by cutting expenditure and cancelling some other items of expenditure and by increasing fees on government services and taxes. He has not said which part of expenditure can be reduced or abolished. He also did not say how the policy of increasing fees and taxes can be accepted by the public, and how such a policy can be justified according to the Islamic law. Al-Zarqua suggested some financing methods through which the Islamic government can run its projects and public utility units such as *mudarabah*, *ijarah*, *musharakah*, and *murabahah*. Such methods are applied nowadays by Islamic banks with individuals and companies in the private sector, but their applicability has not been tried in public finance.

Three concluding remarks can be made from the literature survey.

First, budget deficit (particularly its causes) needs more and improved investigation in developing countries. This observation is more applicable to the case of oil exporting countries, in which this thesis tried to take a small part.

Second, the availability and quality of data are both crucial factors for a good diagnosis of the problem of budget deficit on the one hand. On the other hand, homogenous data and unified measures of the budget deficit are essential for useful comparative studies. The main source of discrepancies has been the different coverage of the public sector in the countries compared.

Third, most of the results of econometric models, due partially to data problems, are by no means definitive. Thus, where the data may be a source of problems, diagrammatic and tabular data representations are more useful to draw good inferences about the causality of the budget deficit, the technique that will be adopted in this thesis.

The Plan of the Study

An adequate treatment of the subject under study necessitates addressing many major issues relating to the budgetary policy and its impact on the Omani economy. The general objectives and policies of budgeting must be distinguished. The organisation of the budget and the budgeting techniques have to be explained. A conceptualisation process of the budget deficit is essential to make the discussion logical and the arguments clear. The core of the subject consists of three major topics: the causes of the budget deficit, the macroeconomic effects of the deficit and the evaluation of the policy adopted by the government to tackle the problem. Three chapters have to be assigned to cover these three topics. A prerequisite of all these is a comprehensive review of the Omani economy to understand its structure and its main characteristics.

To control the discussion of all these aspects and issues the thesis will be organised in six chapters.

Chapter one is appropriated to review the Omani economy. The Omani economy can be divided into three main sectors: the oil sector, the non-oil commodity sector and the service sector. They will be discussed in three sections. Three other topics will be addressed: the role of the government in the Omani economy, the demographic characteristics and the foreign trade. The three main sectors of the economy will be assessed through their contributions in the main macroeconomic

variables, i.e. gross national product, exports, and employment. Special attention will be given to the oil sector due to its leading role.

Chapter two discusses the government's budgeting in Oman: objectives, policies and mechanism. It is divided into three sections. In section one the government as a link between the oil sector and other sectors is explained. It explains how the rent received from exports is concentrated in the hands of the state which establishes the links between the oil sector and the rest of the economy. In section two, the objectives and policies of budgeting in Oman are distinguished. It is explained in this section how the objectives and policies of budgeting are deductive from the main aims of the five-year plan and how these are derived from the long-term objectives of the development strategy. This step is necessary to understand the environment in which the budget is working. In section three the organisation of budgeting is detailed. This section shows the cycle through which the budgeting process is fulfilled. It also explains the classification of the budget items and explains the advantages and disadvantages of each type of classification and the economic and administrative purposes of classifying expenditure and revenue items. This step is important in recognising the structure of the budget and the main sectors of expenditure and revenue.

Chapter three examines the techniques of measuring budget deficit. The correct measurement of the budget deficit is vital for correct diagnosis of economic problems and accordingly appropriate fiscal policies. This chapter presents the different definitions of budget deficit and their analytical purposes, and the most appropriate one for the case of Oman. Therefore, this chapter represents the conceptualisation section of the study.

Chapter four is devoted to analysing the causes of the budget deficit. It is divided into two sections. Section one presents a review of the evolution of the budget

deficit in Oman, from 1970 to 1995. This will be conducted through tracing the gap between the government revenue and expenditure. This section will make a comparison between the budget deficit in Oman and other GCC countries, and the group of developing countries in which Oman falls. Such a comparison is significant in judging the magnitude of the budget deficit in Oman. After distinguishing the significance of the budget deficit, section two will analyse the causes that lie behind the occurrence and contentions of the deficit. This will be conducted through studying the behaviour of government expenditure and government revenue. The first subsection diagnoses the causes of the increase of government expenditure. Two types of causes will be distinguished: general causes and particular causes related to each type of government expenditure. The second subsection analyses the factors that govern the government revenue. They are the structure of government revenue, oil prices, oil production, and the depreciation of the dollar.

In chapter five, the macroeconomic effects of the budget deficit on the Omani economy will be examined. The impact of the deficit depends on how they are financed. The impacts include the impact of deficit on monetary and financial markets, aggregate demand and the balance of payment. Thus, this chapter will be divided into four sections. Section one presents a general insight into the mode of deficit financing. It examines the structure of deficit financing during the past development plans. It also analyses the direct effects of such financing on the position of public debt and the balance of foreign assets. Section two analyses the effects of the budget deficit on money supply and inflation. Section three examines the consequences of the deficit on aggregate demand. This will be done through the analysis of the effect of the deficit on private investment, private consumption and output growth. Section four discusses the impact of the budget deficit on the balance of payments. Two kinds of impact will be distinguished: the direct effect of the

budget on the balance of payments and the indirect effect through the exchange rate mechanism.

After investigating the causes of budget deficit and examining its macroeconomic consequences on the whole economy, the question that emerges is how has the government tackled this problem? This will be addressed in chapter six that will assess the policy by which the financial authority tackled the problem. This assessment will be organised in three sections. Section one will define a “standard” by using a set of criteria that make the budget decision prudent. Accordingly Oman’s budget deficit will be examined as to what extent it approached this standard. Section two will evaluate the fiscal policy in controlling the problem and how this policy has worked. The fiscal policy adopted two measures: cutting public expenditure and devaluating the Omani Rial. The first measure will be assessed in light of its advantages and disadvantages. The second will be evaluated as to what extent this policy has achieved its goals. Having assessed the official policy against the problem, section three will present our suggested approach. It consists of three main elements discussed in three subsections: rationalising public expenditure, improving the sources and techniques of financing, and diversification of the economy.

Finally, the concluding remarks provides a summary of the main results found and main points developed through the discussion of the several aspects of the subject.

The concluding remarks are of three main types: those drawn from the first chapter which presents the main characteristics of the Omani economy; those deducted from the core of the thesis (chapters 3, 4 and 5), which address the financial imbalances and their macroeconomic consequences on the economy; and third, the main points suggested to tackle the problem.

The first type of remarks shed light on the main structural difficulties of the Omani economy and give signals for the strategic reforms required to put the economy in the correct way ahead.

The second type of conclusions point at the financial difficulties of the government and focus on the main points of weakness in the financial structure of the government.

Finally, the main suggested points represent the practical actions that can be taken to correct the wrong trends within the public finance. They also suggest linking the financial remedy with the structural reforms represented in the diversification policy.

CHAPTER I

STRUCTURE AND CHARACTERISTICS OF THE OMANI ECONOMY

Introduction

The aim of this chapter is to present an overview of the structure of the Omani economy. Despite the fact that this thesis is concerned mainly with public finance, the correlation between this sector and the other sectors in the economy is so strong in Oman that it cannot be ignored. For example, government expenditure is the major motive for the growth in output of the other sectors.

The distinctive characteristic of the Omani economy will be presented in six sections:

1. The Oil sector
2. The commodity sector
3. The service sector.
4. The role of the government in the Omani economy
5. Demographic characteristics and the labour force
6. Foreign trade

However as an introduction to the discussion of these six sections, it is important to present a historical background of the institutional and basic infrastructural foundation, the growth and the sectoral formation of the Omani economy.

I. Historical Background of the Omani Economy

The official name of the state is the Sultanate of Oman. It occupies most of the south-eastern corner of the Arabian Peninsula and has a coast-line that extends more than 1700 km from the Straits of Hormuz in the north to the frontier with the Yemeni

Republic. It is located between latitudes 16 40°N and 26 20°N and longitudes 50°E and 59 40'E.

The recorded history of Oman began with the appearance of the Arabs in the second century BC when Arab tribes from Yemen and from the north entered Oman. These tribes were the origins of the present Omani tribes.

The most important phase in the history of Oman has been the Islamic era. Under Islam the country has been unified and a new political, legislative and social system based on Islamic principles has emerged in Oman.

After the discovery of the Cape of Good Hope, Oman started to play an important role in international trade and witnessed an important phase of development during the 17th Century. In 1649 the Omanis succeeded in eliminating the Portuguese presence in Oman and East Africa and a new era in the history of Oman and its role in the African continent began. Oman was able to maintain a strong fleet and emerged as the most important naval power in the Indian Ocean. It witnessed a long era of boom in trade, construction and development, and territorial extension. A vast empire was formed extending from Baluchistan Province (on the south-eastern border of Pakistan), to East Africa. The empire continued to develop its naval power and in 1749 Ahmed Bin Sa'id came to power and laid the foundation for the rule of Al Bu Sa'id family.

In the 19th century, the international situation changed and the great powers began to reinforce their presence in the area, supported by a strong naval presence, consisting of steam-driven ships. At the same time, the international trade route was changed to the Suez Canal. A long period of stagnation followed, until 1970 when His Majesty Sultan Qaboos Bin Sa'id came to power.

In fact the development of modern Oman only started in this year. Before 1970 Oman completely lacked the basic requirements of a modern state. There were no government agencies or ministries in the modern sense. Oman was completely isolated and hardly affected by the developments that were taking place in other parts of the world.

II. The Institutional and Basic Infrastructural Foundation of the Omani Economy: 1970-1975

Before July 1970 there were only three state schools in Oman, employing 30 teachers who were educating 900 boys at primary level. By the 1973/74 academic year the number of schools had increased to 110, including six preparatory schools and one secondary school. There were 1225 teachers and the number of pupils had reached 34,830. Between 1970 and the end of 1973 the number of hospitals in Oman had increased from 5 to 15, the number of beds provided increased from 276 to 825; the number of doctors rose from 33 to 122 and the number of nurses and ancillary personnel from 132 to 375. Public health compounds were being established to deal with preventative medicine. Low-cost housing was on the government's list of priorities.

New ports were constructed at Mutrah and at Raysut in Dhofar. The international airport was completed in September 1972. At the end of 1970 there existed only 10 km of asphalt-surfaced road and 1,800 km of graded roads with maintained natural surface. By the middle of 1974 these extended from the capital area to the borders with the United Arab Emirates, a network of roads had been built around Salalah in the Dhofar region and other asphalt roads had been built. These transport facilities reduced the cost of Oman's imports.

It is worth noting that about 93% of government investment expenditure in the period 1970-1974 was directed towards projects for the development of economic and social

infrastructure. Consequently, one may say that the period up to 1975 represents a stage of building up economic and social infrastructure without which no economic growth could be achieved.

On 17 November, 1973, the General Development Organisation became the Ministry of Development. In common with previous planning and development units this ministry continued to exercise both planning and executive functions. Under its executive jurisdiction it continued to carry out the activities relating to the economic sectors for which no separate ministries existed. These were: the Sectors of Agriculture, Irrigation and Fisheries; Mining and Petroleum; Commerce and Manufacturing.

At the same time the administrative organisation of the Omani economy was taking place. The administrative process of the economy has undergone several organisational changes since 1970.

On November 17, 1974, the Council of Ministries was reshuffled and executive functions were separated from planning functions as a result of which the Ministry of Development was dissolved and its executive functions were distributed amongst other ministries, including two new ministries: the Ministry of Agriculture, Fisheries, Petroleum and Minerals, and the Ministry of Commerce and Industry. The Development Council (DC) was created on November 17, 1974, to exercise planning functions. The following are some of the functions specified by this Council:

- To set objectives and a strategy for economic development.
- To discuss and establish an annual development budget.
- To set and approve priorities for development projects (DC, FIDP, pp.9-11)

On 9 February, 1975, the Development Council passed a resolution regarding the aims and objectives of the Economic Development Policy in Oman which, in fact,

represented the development strategy of the government. Among these aims and objectives were the following:

1. Oil reserves are apt to be a privilege of the present Omani generation, but the wealth derived from it should be invested for the benefit and welfare of both present and future generations. Therefore, it is important to make the best use of these limited resources by utilising them in development projects which give strength to the Omani economy.
2. The basis of the Omani development policy should be to achieve the basic requirements of a free economy in which an efficient and capable private sector plays a leading role. The opportunity to participate in the building of this economy should be open to all nationals of the country on the basis of free participation in a market without monopolistic practices.
3. It is necessary to effect a wider geographical distribution of investment in order that the benefits may be shared by different regions to narrow the gap in the standard of living in different regions.
4. Care should be taken to develop local human resources in order that they might be able to play a more active role in the national economy. In this respect it is necessary to extend and develop educational and training programmes.
5. The main objective of economic development is to implement income-generating projects which add to the national income until additional sources of income have been tapped to supplement oil revenues and to secure suitable economic prospects for the future. In this respect agriculture and fisheries were greatly stressed.
6. It is important to encourage domestic trade activities by finding suitable solutions to the problems of transportation and storage and other obstacles which block the way to establishing the perfect market. The solutions should aim at increasing competition and maintaining reasonable prices, particularly with regard to food items and their availability in all regions.

7. The resolution also placed great emphasis on other strategic aspects such as: water resources, the efficiency of government administration, and surveying the country's natural resources (Ibid, pp.106-109).

Broadly speaking, this resolution laid down the principles of the socio-economic philosophy. Points 2 and 6 defined the identity of Oman's economic system that should be applied in the country. It is a free economy in which the private sector plays a leading role. Policies will be addressed to obtain free market, free competition, without monopolistic practices.

On 28 June, 1975, the Law of Administrative Organisation of the Government was issued in the Sultan Decree No. 26/1975. This law was one of the major laws that built the structure of the government and the characteristic of the administration system in the country. This law defined the means of organising government administration and the functions of the different government units. The law also defined the powers and functions invested in the heads of the administrative units.

To sum up, the period 1970-1975 was a preliminary phase of development which witnessed intensive efforts to prepare and to develop the country and accelerate it into the twentieth century.

III. The Growth and Sectoral Formation of the Omani Economy

It could be said that the period from 1970-1975 saw the birth of Omani economy. From 1976 up to the present day Oman's economy has been systematically developed. Four development plans have been executed by the government, the fifth is being implemented. Therefore, it is this period within which Omani economy has been characterised, and its own identity has been practically created.

The First Five Year Development Plan (FIDP), 1976-1980, was a preliminary step towards the Sultanate's entry into a new phase of development within the framework of integrated plans for economic and social development. The main development effort in this plan was directed primarily at completing the infrastructure, increasing the absorptive capacity of the Omani economy and initiating policies of support and encouragement to the private sector with a view to increasing competition and completing the components of a free market economy.

The Second Five-Year Development Plan (SDP) (1981-1985) also contributed to the acceleration of economic development and the stimulation of the private sector to increase its participation in economic and social activities through direct and indirect sets of policies.

The inception of the Third Five-Year Development Plan (ThDP) (1986-1990) coincided with a steep fall in oil prices - which has continued on a downward trend since the early 'Eighties.

The basic objectives of the fourth plan were to achieve a high rate of growth, to pursue the policy of diversification of national income, to ensure regional development and to achieve a balance between total public expenditure and the growth revenue.

The specific peculiarities of the Omani economy, the interaction and the behaviour of its major sectors was characterised during these four plans.

The Omani economy consists of three major sectors, the oil sector, the service sector and the non-oil commodity sector. The oil sector includes crude oil and natural gas. On average it accounted for 55.5% of total GDP during the period 1970-1990. The commodity sector includes: agriculture, fisheries, industry, electricity and water, construction, and mining. On average it accounted for 14.5% of total GDP. The

service sector can be divided into two parts, government services and other services. It averaged 27.3% of total GDP during the same period. It is the second sector after the Oil sector and exceeded it in 1986 and 1988, for its contribution in total GDP was 39.7% and 46.1% in these two years respectively whereas the oil sector's contribution was 37.9% and 40.6% respectively.

Table (1-1) shows the relative importance of these three main sectors during the previous development plans.

Let us now explain the significance of these three sectors in the economy as a whole starting with the oil sector.

1.1 The Oil Sector

The oil sector includes crude oil and natural gas. the significance of the oil sector in the Omani economy can be examined through its share in the main macro-economic variables, i.e. total GDP, total exports, and employment. It can also be assessed through its contribution in government revenues. However, it is worth starting with a presentation of historical and general information about the oil sector.

The exploration for crude oil started in Oman in 1924 and commercial quantities were discovered in 1964. The actual export of crude oil started in August 1967, when exported quantities reached 20.9m barrels per year; three years later this increased to 121.3m barrels per year.

Until 1973, Petroleum Development Oman (PDO) was owned by Shell (85%), Compagnie Francaise des Petroles (10%) and Partex (5%). In December 1973 the Government agreed with the three companies to acquire 25% of PDO's capital. Government participation in the capital of PDO was further increased to 60% in July

1974. The three companies continue to own, at present, a total of 40% of PDO, of which 34% is owned by Shell, 4% by the French Company (CFP) and 2% by Partex.

On May 31, 1980, the PDO was finally registered as an Omani company in the Commercial Register of Oman, with shares of participation in its capital as mentioned above. It is the country's main producer of oil, accounting for 97% of total oil output in 1986. The government policies which were applied during the years of the First Five-Year Development Plan (FIDP) revived the interest of international oil companies in obtaining concessions and exploring for oil in Oman. During those years several new concession agreements were concluded with international oil companies.

Due to the continued efforts of new oil field discoveries (17 fields in 1992), Oman's proven reserves moved up from 2.5 billion barrels in 1982 to 4.74 billion barrels in 1992 then to 5.2 billion barrels in 1995. At the current rate of output, Oman's proven reserves represent about 17 years (Central Bank of Oman (CBO), Annual Report 1992, 1995).

The production of crude oil rose progressively from 332 thousand barrels per day in 1970 with continuing and intensifying exploration efforts, to 884 thousand barrels per day in 1995 (see Table 1-4).

With regard to natural gas, all its reserves discovered in Oman were discovered as a by-product of the exploration for oil. There have been no programmes for the exploration for gas as a separate activity. It started during the FIDP (1976-1980). All existing oil concessions granted by the government of Oman to international oil companies stipulated that any natural gas discovered remains government property and is not subject to concession agreement.

Table (1-1): The Relative Importance of the Main Sectors During the Previous

Development Plans (%)

Main Sectors	1st Plan 1976-80	2nd Plan 1981-85	3rd Plan 1986-90	4th Plan 1991-95
Oil Sector	61.0	52.0	46.0	38.9
Non-Oil Sectors	39.0	48.0	54.0	61.1
– Commodity sectors	14.8	13.1	14.8	11.5
– Agriculture and fisheries	2.7	2.7	3.6	2.5
– Manufacturing	0.9	2.3	3.9	4.0
– Construction	9.0	7.0	5.0	3.0
– Others	2.2	1.1	2.3	2.0
– Services sectors	24.2	34.9	39.2	49.6
– Government services	12.2	14.9	19.2	25.7
– Other services	12.0	20.0	20.0	23.9
Total GDP	100.0	100.0	100.0	100.0

Source:

1. DC, SDP, Table (5), p.12.
2. DC, ThDP, Table (7), p.14.
3. DC, The Assessment of ThDP, Table (2-8), p.49.
4. CBO, 1995, Table (1), p.127.

Table (1-2): Distribution of Labour Force Between the Major Sectors

Sectors	Number of workers			% of Total Labour Force
	Omani	Non-Omani	Total	
Oil Sector	3276 (64.6%)	1795 (35.4%)	5071 (100.0%)	0.8
Commodity sector	37780 (18.5%)	204101 (81.5%)	241881 (100.0%)	36.1
Service Sector	64210 (24.4%)	198789 (75.6%)	262999 (100.0%)	39.2
Public Administration and Defence	134714 (84.0%)	25610 (16.0%)	160324 (100.0%)	23.9
Total	239980	430295	670275	100.0%

Source: DC, SYB, 1994, p.145 and 1995, p.57

Table (1-3): The Average Growth Rate of the Main Sectors During the Last Four Development Plans (%)

Sectors	1st Plan 1976-80	2nd Plan 1981-85	3rd Plan 1986-90	4th Plan 1991-95
Oil Sector	14.0	5.5	7.8	-2.5
Non-Oil Sector	19.6	17.6	2.2	7.7
– Commodity Sectors	16.4	17.9	0.3	9.2
– Agriculture & Fisheries	13.4	12.3	5.6	2.5
– Manufacturing	66.6	38.6	13.2	10.8
– Construction	9.8	15.4	-10.6	2.5
– Services Sector	33.1	17.5	2.8	7.4
– Wholesale & Retail Trade	23.7	15.0	2.6	10.4
– Financial Institutions	25.0	38.0	7.9	4.3
– Transport & Communications	17.6	21.7	6.7	7.7
– Public Administration	24.3	16.7	4.8	4.3
Total GDP	16.3	10.8	4.6	3.4

Sources:

1. DC, SDP, Table (4), p.11.
2. DC, ThDP, Table (6), p.13.
3. DC, FODP, Tables (1.6), (1.4), (1.5), pp.16-23.
4. CBO, 1995, Table (3), p.131.
5. CBO, 1995, Table (1), p.127.
6. MOD, The Main Components of the Fifth Development Plan, Table (3.4), p.29.

Table 1-4
Production of Crude Oil
1970-1995

YEAR	PRODUCTION	
	Daily Average (Th. BBL)	Annual Average (Mn. BBL)
1970	332	121
1971	294	107
1972	282	103
1973	293	107
1974	290	106
1975	341	125
1976	367	134
1977	340	124
1978	314	115
1979	295	108
1980	283	104
1981	328	120
1982	336	123
1983	389	142
1984	416	152
1985	498	182
1986	560	204
1987	582	212
1988	619	227
1989	641	234
1990	685	250
1991	708	259
1992	742	271
1993	790	284.6
1994	820	295.4
1995	864	311.3

Source:

1. DC, Statistical Year Book (SYB), 1992, Table 1-8, p.198
2. CBO, 1995, Table 3.1, p.29.

Economic utilisation of natural gas also started during the First Plan, and a number of plants were constructed for extracting petroleum liquids from associated gas before it is flared. It is largely utilised by being re-injected into the oil reservoirs to maintain pressure and sustain oil production. It is also used as fuel to generate power in electric power stations, desalination plants, the cement factories, Cooper Smelter and other industrial projects as well as for domestic use. Liquefied natural gas (LNG) exports are expected to begin in the year 2000.

The production of natural gas rose from 93 million cubic feet in 1980 to 187 million in 1990. Oman's proven gas reserves are estimated at 27.5 trillion cubic feet (3 trillion cubic feet of associated gas and 24.5 trillion cubic feet of non-associated gas) (CBO, 1995, p.30).

Natural gas in Oman whether associated or non-associated, is considered as the principle source of energy until other alternative sources of energy, such as solar energy, become economical. Therefore, sufficient quantities of natural gas reserves should be earmarked for the purpose of meeting the country's energy requirements for a minimum period of 40 years.

The oil sector is still the single largest segment of the economy. Economic growth in Oman is strongly influenced, both directly and indirectly, by developments in the petroleum sector.

During the ThDP the Omani economy came under severe stresses and strains largely triggered by the collapse of the international oil price, especially during the first three years. Total GDP declined steeply from RO 3454 million in 1985, to RO 2800 million in 1986, namely by 18.9%. It exceeded its 1985 level only in the final year of the plan. The oil sector proportion in total GDP averaged 44.1% with a fall of 7.5 per cent points from that of the previous plan period.

In general, despite the continued increase in the absolute value of the oil sector in the total GDP from RO 72 million in 1970 to RO 2021 million in 1995, the relative importance of the Oil Sector in total GDP fell from 67% in 1970 to 38.2% in 1995.

It is worth noting that, the oil sector contribution in total GDP is totally in the form of extracting raw material and exporting it as it is without any manufacturing process. In other words, there is no industrial integration between the oil sector and other sectors. The sole exception is the natural gas and the refining process of Oman Refinery Company. Natural gas has already been mentioned. Oman refinery daily capacity is limited at 80,000 barrels, to meet the local market demand for petroleum products. Up to 1995, it refined on average only 7.3% of crude oil produced annually.

The nature of such production means the oil economy is described as a rentier economy, for rent is “any income not originating from the productive activity of the unit concerned, the flows and dimensions of which are not directly linked to the beneficiary’s activity, i.e. any income the amount of which is determined for the most part by decisions the unit concerned cannot control” (Chatelus and Schmotl, 1984, p.255).

Chart 1-1 illustrates the following peculiarities of the Omani economy that can be derived from the role of the oil sector.

1. Oil income fluctuates in response to the world market oil price.
2. Total GDP has been influenced by the oil sector. There is almost complete correlation between them.

3. In the long term, the non-oil sector is still dependent on the oil sector. It can be seen from the chart that the progress in the oil sector which started in 1973 and continued up to 1981 made corresponding progress in the non-oil sector which continued up to 1985. Similarly, the decline in the oil sector which started from 1981 and deteriorated rapidly between 1985 and 1986, caused an accompanied recession in the non-oil sector, starting from 1985 and continuing up to 1988.

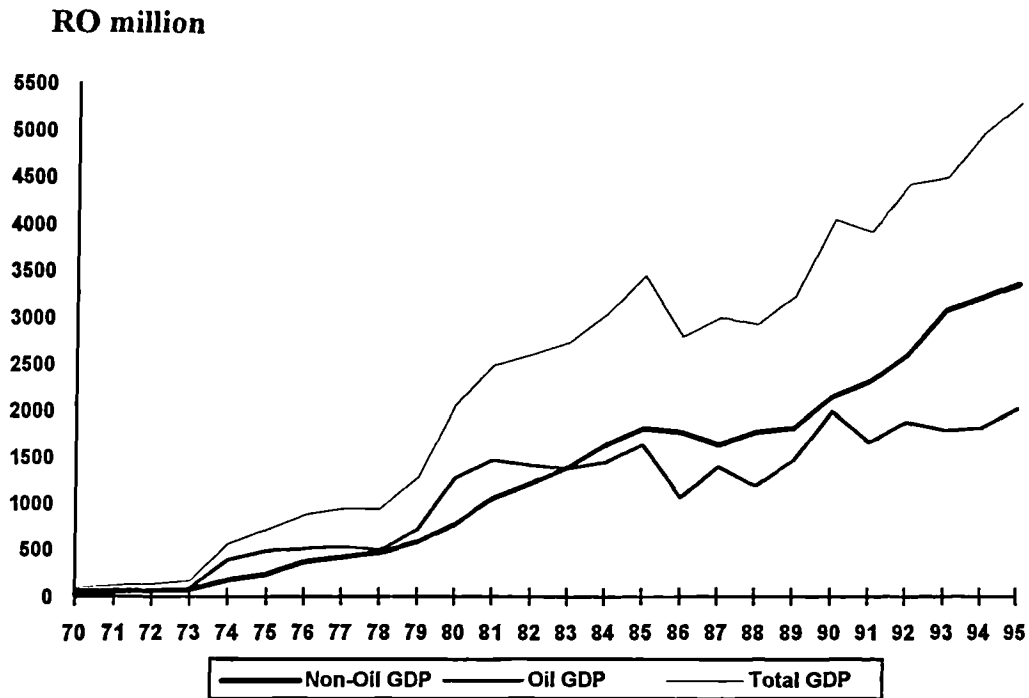
The next indicator through which the significance of the oil sector in the Omani economy can be examined is the relationship between oil revenue to total government revenue.

During the period 1970-1995, oil revenue registered an average of 87.6% of total government revenue. The highest ratio was in 1970 at 97.8% because oil receipts were more or less the sole source of government receipts. The lowest ratio was in 1986 at 63.5% because of the sharp decline in the world market prices of oil, which sank to an average price of \$13.5 per barrel that year.

Chart 1-2 illustrates the relationship between the oil revenue and total government revenue. It can be seen that oil revenue has become the dominant source of government revenue.

The third ratio that may indicate the importance of the oil sector is the ratio of oil exports to total exports.

Chart 1-1
The Relationship between Oil GDP and Non-oil GDP
1970-1995

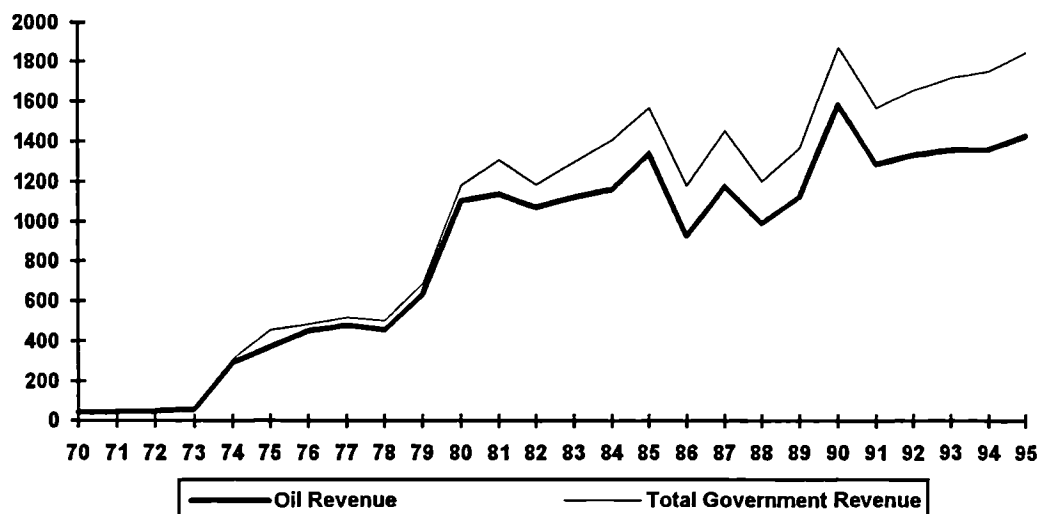


Source:

1. DC, SYB, 1992, Table 1-14, p.379
2. DC, FoDP: Table 1.3, p.16; Table 1.4, p.19; Table 1.5, p.23
3. CBO, 1995, Table (1), p.127

Chart 1-2
The Relationship Between Oil Revenue and Total Government Revenue
1970-1995

RO million



Source:

1. DC, FIDP, Table 3, p.7
2. DC, SDP, Table 15, p.21
3. DC, The Assessment of the Economic Performance of the ThDP, Table 2-54, p.136
4. CBO, 1995, Table (4.1), p.38.

Throughout the period 1970-1992, oil exports averaged 89.8% of total exports (Table 1-5). The highest ratio registered was 99.8% in 1975 because crude oil was almost the sole exported product. The lowest ratio was 83.6% in 1992. It can be seen from the same table that oil exports consist entirely of crude oil. With effect from 1985, small quantities of refined oil produced by the Oman Refinery Company, started to be exported, however, it only accounted for 3 percent of total oil exports on average. The Omani policy regarding oil exports is derived from the classical and new classical theory of foreign trade and development. According to this theory, foreign trade can be a stimulus of development. The excess resources are used to produce a surplus of goods for export, and trade thereby “vents” a surplus productive capacity.

The strategy adopted for development from 1976 onwards by the government ... was in fact very much in line with the new classical theory of trade and development. By using oil as a leading sector, the government used all its exports to optimise oil production and reserves and maximise exports of oil by minimising domestic consumption (Al-Yousef, 1995, p.32).

It is also worth noting that total exports include re-exports. This will be clarified in more detail later in the analysis of foreign trade. It is obvious that oil exports are the dominant factor in obtaining the foreign exchange (chart 1-3) and this domination fluctuates according to oil market conditions. Therefore, it has been seen that the diversification of the local economy was one of the strategic policies of the government taken into consideration throughout the Development Council Resolution on Aims and Objectives of Economic Development.

Table 1-5
Oil Exports and Total Exports
1970-1992 (RO Million)

Year	Oil Exports (RO Million)			Total Exports (RO Million)	O.E/T.E%
	Crude	Refined	Total		
1970	44.4		44.4	44.8	99.1
1971	47.7		47.7	48.1	99.2
1972	49.6		49.6	50.0	99.2
1973	61.3		61.3	61.9	99
1974	—		—	—	—
1975	488.1		488.1	489.2	99.8
1976	543.8		543.8	551.2	98.7
1977	545.9		545.9	559.4	97.6
1978	521.8		521.8	552.0	94.5
1979	745.7		745.7	787.4	94.7
1980	1244.6		1244.6	1294.5	96.1
1981	1526.4		1526.4	1621.8	94.1
1982	1409.6		1409.6	1526.8	92.3
1983	1346.6		1346.6	1467.2	91.8
1984	1401.5		1401.5	1527.5	91.7
1985	1597	60.8	1657.8	1778.1	93.2
1986	981	29.8	1010.8	1122.5	90.0
1987	1928	33.0	1361	1484.9	91.7
1988	1101.7	34.7	1136.4	1291.4	88.0
1989	1346.4	48.8	1395.2	1562.9	89.3
1990	1885.9	54.3	1940.2	2116.4	91.7
1991	1575.1	54.6	1629.7	1873.9	87.0
1992	1745.8	39.3	1785.1	2135.3	83.6

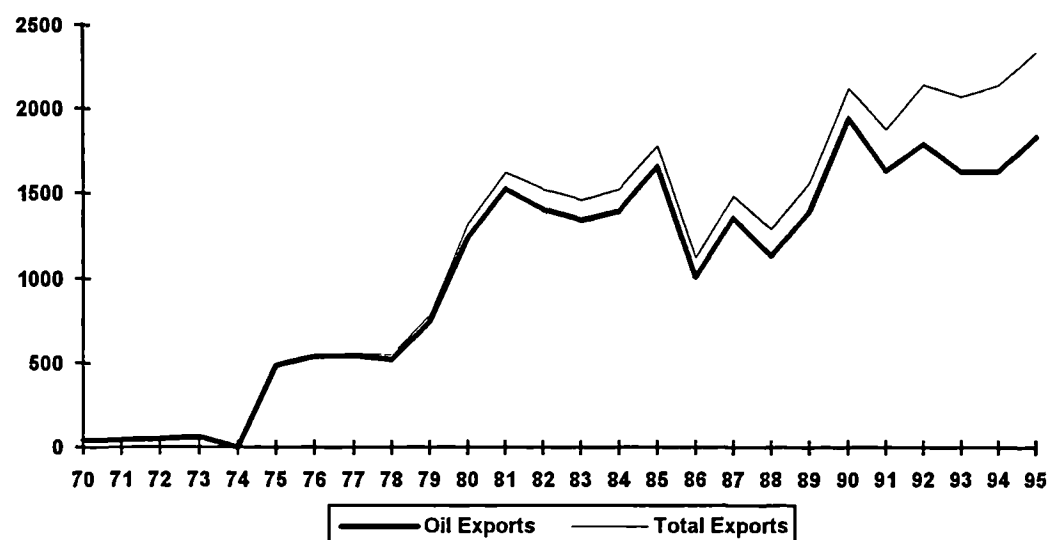
Source:

1. DC, SDP, Table 18 p.24
2. DC, SYB, 1992, Table 1-11, p.280

Notes: O.E = Oil exports
T.E = Total exports

Chart 1-3
The Relationship Between Oil Exports and Total Exports
1970-1995

RO million



Source:

1. DC, SDP, Table 18, p.24
2. DC, SYB, 1992, Table 1-11, p.280
3. CBO, 1995, Table (6.1), p.91

The last indicator that may measure the relative importance of the oil sector in the Omani economy, is its contribution to total employment. Government documents classify oil sector employment as private sector employment. The number of total employees in oil companies reached 5071 employees in 1993 (Table 1-2). The number of expatriate employees in the private sector reached 404685 in 1993. By adding the number of Omani employees in main private sectors, the total number of employees in the Private Sector is 509951. Hence, the relative contribution of the oil sector in private sector employment is 1.2%. If it is to be calculated from total employment: private and government employment (including quasi-government bodies), then the oil sector contribution will only be 0.8%. Apart from the fact that 37.7% of oil sector employees are non-Omanis, this result reflects the low degree of oil sector integration into the whole economy.

Oman is not an exception to other oil states of the region where

the oil sector exists in an enclave of its own, with few productive linkages to the rest of the economy. It is of course a source of revenue for the government, and through government spending the major stimulus of economic activity. The links with other sectors are at the macro rather than micro level, financial rather than involving the real economy (Wilson, 1995, p.47).

In other words, the direct integration of the oil industry – the vertical and horizontal linkages – with the other sectors of the economy is minimal. The limited number of people employed by the oil industry in Oman makes the creation of wealth centralised around a small fraction of the society. On the other hand, the large extent of centralisation of the oil industry on foreign technological experience has triggered its remoteness.

1.2 The Commodity Sector

This sector consists of agriculture and fisheries, industry, construction and electricity and water, although the inclusion of the last three sub-sections as commodities is questionable. Its share in the total output decreased from 14.8% in the FIDP to 11.5% in the FODP. This decline can be explained by the declining ratio of private investment to non-oil GDP on the one hand (Chart 1-5). On the other hand it can be attributed to the increasing participation of services sectors.

In 1993, it employed 36.1% of total labour force (Table 1-2). 44.5% of them were in the construction sector. Omani employees formed 18.5%.

From Table (1-3), it can be seen that it achieved a high average growth rate during the FIDP and SDP, but almost stagnated during the ThDP and started to recover during the FODP.

1.2.1 Agriculture and Fisheries

The significance of the agriculture and fisheries sector has always been emphasised in the development and diversification of the Omani economy. Agriculture, fisheries and trade were the back-bone of the Omani economy before the discovery of oil.

The number of holdings is 95100 which constitute a total area of 106200 hectares. Only 67% of the total area of holdings is utilised. The number of agriculture holdings is distributed between the country's regions as follows. Al-Batinah 33%, A'Sharqiya 18%, Al-Janubiya 17%, A'Dakhilya 13%, A'Dahire 9%, Muscat 5%, Al-Wasta 3% and Musandam 2% (Ministry of Agriculture and Fisheries). Batinah, which contains 33% of total holdings, is a coastal plain and is the most fertile and inhabited area in the country. It contains 28% of the total population with a density of 41.8/km² (See table 1-11)

Chart 1-4
The Relationship Between Non-Oil GDP and Government Expenditure
1970-1995

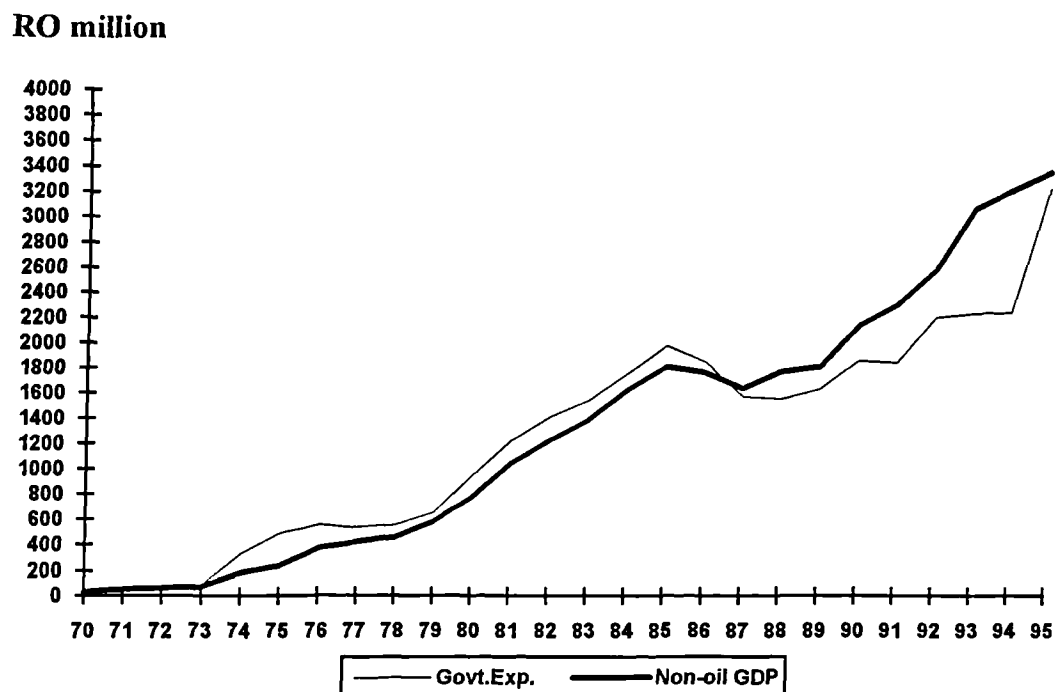


Chart 1-5
The Ratio of Private Sector Investment to Non-Oil GDP
1970-1995



Source:

1. DC, SDP and ThDP
2. DC, The Assessment of Economic Performance of the Third Plan
3. DC, SYB, 1993
4. CBO, 1994, Table (3), p.127.
5. DC, The main components of the Fifth Development Plan, Table (3-5), p.30)

Table 1-6 shows the distribution of cultivated area and output between three major products, i.e. vegetables, field crops and fruits in 1993.

As can be seen from this table, about 64% of cultivated area is allocated for fruits which account for about one fourth of total output of these three crops. Field crops constitute around one fifth of total cultivated area. Alfalfa occupies 88.6% of the area cultivated with field crops and accounts for 97.4% of total output of this category. The area planted with palm trees accounts for 70.5% of total area planted with fruits, and dates account for 58.8% of total fruit output. These two products together with lemons are three of the most traditional agricultural products in Oman.

The size of animal wealth in the country in number reached 1405990 in 1993, 60.7% of which are goats, 17.1% are sheep, 15.2% are cows, 7.0% are camels (Ministry of Agriculture and Fisheries).

Regarding fisheries, the country has a great potential for substantial growth as Oman enjoys 1700 km of ocean coast-line rich with different varieties of fish. Fishing activity in the country is undertaken by traditional fishermen and one fishing company: Oman National Fishing Company. The annual local production of fish exceeds local demand and the surplus is exported to several countries.

Table 1-6

The Distribution of Cultivated Area and Output Between Three Major Products,

1993

Product	Cultivated Area		Output	
	Hectares	%	Tons (000)	%
Vegetables	10459	17.4	183.3	23.4
Field Crops	11460	19%	385.1	49.1
Fruits	37921	63.6	215.9	27.5
Total	60200	100	784.3	100

Source: Ministry of Agriculture and Fisheries

Concerning agriculture and fisheries' contribution to total GDP, oil has changed the traditional situation of this sector and its total output to national income has diminished. Throughout the period 1967-1973, the sector contribution to total GDP averaged 17%. The higher ratio was at 34.6% in 1967. However during the period of the FIDP (1976-1980) its contribution declined to 2.7%. During the Second, Third and Fourth Plans, it recorded an average of 2.7%, 3.6% and 2.5% of total GDP respectively. It is clear that its relative importance has not recorded any progress although, in absolute value, it was developing within this period but at a diminishing rate. During the First, Second and Third Plans, it grew by 13.4%, 12.3% and 5.5% respectively. During the Fourth Plan it grew by 2.5%. In fact, this sector is suffering from particular problems which will be discussed later.

With regards to its relative importance in total exports, in 1971 and 1972 agricultural and fisheries products accounted for 99.8% and 99.7% of non-oil exports and 0.7% and 0.4% of total exports respectively (Department of Information, Oman, 1972).

During the period 1980-1992 its proportion in non-oil exports and total exports averaged 56% and 2.7% respectively. Its relative contribution in non-oil exports started to decrease from 1983 after its peak at 86.5% in 1982. On the other hand its relative contribution in total exports is obviously marginal. 44% of the sector's exports is fish.

With respect to employment, this sector employed 163,000 employees in 1993, 76% of whom were Omanis (Ministry of Agriculture). The sector employment accounted for 23% of total employment. Omani nationals accounted for 45% of total Omani employment.

The average family size is 7.4 (Oman newspaper, 28 December, 1993). By multiplying this number with the number of Omani agricultural labour force and adding the non-

Omani labour force in the sector, the agricultural reliance will be 1030 thousand. This number accounts for 51% of total population. This means that 51% of the population relies on 3.6% total GDP. These figures are worse if we only consider Omani labourers and their families and only calculate Omani population. In this case, the sector reliance will be 58.5% of the population viz. a viz. less than 3.6% of total GDP. According to the Ministry of Development (MOD), the sector of agriculture and fisheries employs 62,792 workers, 35% of which are Omanis (MOD, SYB, 1995, p.57). The sector reliance would be 9.6% of total population against 3.6 of total GDP. In fact the Omani agricultural labour force does not rely entirely on agricultural income. Some agricultural labourers practise trading activities, some work in government departments and others have other sources of income. Therefore, the actual figures may fall between the two ministries' statistics.

This sector encounters some severe problems related to water availability, production techniques, marketing, and rural/urban migration.

With regards to water availability, the Omani irrigation system depends entirely on underground water and about 50-60% of cultivated area is irrigated by the Aflaj¹ system. Oman receives a very low average annual rainfall. It is only 100 mm, 80% of which evaporates, 5% falls in the sea and only 15% seeps underground (Oman Newspaper, 28 March, 1994). Rapid expansion in the use of water from underground water sources for several purposes together with drought has led to a shortage of water supply in many areas, and to salinity problems near the coast. In the Al-Batinah area, for instance, the annual rate of underground water charge is 442 cubic metres, and the annual rate of water consumption for all purposes is 688 cubic metres. Therefore there is a deficit of 246 cubic metres per annum (Ibid.). As a result of extravagant use of water on the one hand, and drought on the other, many Falajes have dried up. Historically, Oman enjoyed the existence of 11,000 Falajes, however, only 3075 Falajes are now in existence (Ministry of Water Resources).

To overcome this problem, the government has employed three measures. A restraint on excessive well drilling was enforced. The government, starting from the SDP, has been executing a maintenance programme for Falajes. To overcome the salinity problem and conserve or even increase the underground water resources, the government has been constructing water dams that will stop rain water wastefully flowing into the sea.

The Ministry of Agriculture and Fisheries encourages farmers to use modern irrigation techniques that economise the use of water.

Regarding production techniques, because agriculture in Oman relies on underground water, many cultivated lands are scattered in numerous small plots over many areas of the country, and some of them in rugged locations, depending on the availability of water. Consequently, the size of farms tends to be small and the potentiality of applying large scale mechanization is, therefore, limited. Moreover, about 50% of the cultivated area is under palm trees which is difficult to mechanize.

Equally important, the money available in Oman as a result of oil exports has created the possibility of importing almost anything from abroad. It has also brought people, including the rural population, into close contact with a level and sophistication of material goods which were previously quite unattainable and which were certainly not achieved locally. The speed of change from poor to rich has given no time to adapt local produce and local manufacturing techniques to the new demands (Pridham, 1987)

The government is conducting extensive research to improve the agriculture sector. There are also many extension centres and nurseries for garden and fruit trees run by the government.

With respect to marketing, many farmers have little experience in approaching the consumption centres properly. Quantities produced of some kinds such as dates, tomatoes and cucumbers, exceed demand in peak season thus prices decline sharply. Whereas demand exceeds supply elsewhere. Some agricultural products encounter fierce competition from imported products such as dates prepared for animal feed competing with imported barley.

The marketing problem led to the establishment of the Public Authority for Marketing Agricultural Produce which commenced operation with six distribution centres and twelve collection centres throughout the country.

This problem still needs to be worked on, e.g. the private sector efforts in setting up agricultural industry to dispose of the surplus of agricultural products through food industries.

Many farms are not run economically. They are mainly used for personal enjoyment by their owners at the weekend, although they consume large quantities of water and other inputs. Efficient, economic administration for such farms is to be adopted and cost/benefit analysis is to be applied to run them effectively.

Rural-urban migration is another problem facing the agricultural sector. The sustained efforts made to modernise and diversify the economy have, over the years, led to the opening up of several jobs as well as investment opportunities. In response to these changes, while some have ventured into new fields of business, there have been others who left the countryside leaving their farms to their families in search of higher paid jobs in the urban areas.

The government has been seeking to solve this problem through its investment programme and the provision of basic services, i.e. electricity, communication, health

services education, etc. One of the strategic objectives in the regional distribution of the government investment expenditure is to support the existing populated areas and protect them from mass migration to heavily populated centres. According to the last agricultural census carried out by the Ministry of Agriculture and Fisheries in 1993, about half of the population is still engaged in agriculture and fisheries. The census established that the total suitable land for cultivation is two million hectares, only 5.3% of which is the total area of existing holdings, and then only 67% of the latter is utilised.

To sum up, there is considerable potential for growth in the agriculture and fisheries sector and the Sultanate is forecast to be the food basket of the Gulf states, but because of existing problems, actual growth remains far below its potential. For instance, land reclamation projects cannot be carried out before ensuring the availability of a sufficient water supply. Even so, vertical expansion can be achieved through increased productivity. Some studies indicate that productivity of agricultural land in the country could be doubled (DC, SDP, p.75).

1.2.2 Industry

The industrial process in the Sultanate was initiated on import substitution basis. Lately, however, export promotion has gained much prominence. One of the targets and policies of the government in this sector is to give higher priority to the industrial projects which employ one or more of the following factors: the use of local raw materials, the production or processing of food stuffs, the benefit of a relative advantage in export markets, or the use of a high percentage of local manpower. (ibid, p.85). Manufacturing in Oman consists of medium and small scale industries, such as oil refinery, cement factories, edible oil blending plants, detergent manufacturing unit, certain processing units for food stuffs and plastic products, petroleum gas bottling plants, paint manufacturing plants, building materials, toiletries, light bulbs, car

batteries, electric wire and cables, and other light to medium size industries which mainly cater for the local market.

The Oman Refinery Project started to operate in November 1982, with a daily production of 50,000 barrels. Its capacity was enlarged to 80,000 barrels in 1987.

The interest in this sector was initially limited because market conditions favoured trading and real-estate activities with a much higher margin of profit. However, with the trading sector nearly reaching saturation point, local entrepreneurs have increasingly invested in industries for long-term returns on capital and resources employed.

Between 1975 and 1990, the end of the ThDP, the number of registered industries reached 3484 establishments. Their entire invested cost reached RO 381.8 million, and total production reached RO 401 million. Table 1-7 shows the distribution of establishments, the total investment cost, and the total production according to industrial activities.

The average annual industrial output during 1978-1990 was about RO 27 million. Its relative contribution to total GDP averaged 1.0%, 2.3%, 3.9% and 4.0% during the previous development plans respectively (Table 1-1).

A report issued by the World Bank attributed the low proportion of industrial output to total GDP in Oman to many reasons some of which are as follows:

- Current public expenditure/saving policies discriminate against goods production, while other policies inhibit non-rent seeking investment.
- Sanction monopolistic practices.
- The role of public enterprises limits the investment opportunities open to the private sector.
- The dominance of small-scale enterprises (The World Bank, 1994, p.79).

Table 1-7
Registered Industries
Number of Establishments, Total Investment Cost and Total Production Value
1975-1990

Industrial Activity	Number of Establishment		Total Investment		Production Value	
	Number	%	RO (000)	%	RO (000)	%
Manufacture of food and beverages	143	4.1	34331.7	9	26942.9	6.7
Textiles (clothing) and leather	21	0.6	13935.2	3.7	23448.6	5.8
Wood & wooden products including furniture	761	21.8	10247.8	2.7	23627.7	5.9
Paper & paper products, Printing and Publishing	35	1.0	8231.8	2.2	9428.5	2.4
Chemicals & chemical products	47	1.3	74203	19.4	171110.9	42.7
Non-metallic mineral products	1867	53.6	131177.3	33.4	107669.7	26.8
Basic Metal Industries	2	.06	89200	23.4	8795	2.2
Fabricated metal products	602	17.3	20034.3	5.2	29597.9	7.4
Other Manufacturing Industry	6	0.2	398.8	0.1	772.5	0.2
Total	3484	100	381759.9	100	401194	100

Source:

CBO, 1990, Tables:15, 17, 19, pp.170, 172, 174

With respect to exports, petroleum refined products were the first industrial components in Omani exports. They started to be exported in 1985 forming a proportion of 3.8% of Omani origin exports (excluding re-exports). From 1988, other industrial products were exported such as products of chemical and allied industries, plastics, rubber articles thereof, processed food, textile wearing, non-metallic mineral products, etc. In general, industrial products contribution to total exports registered an average of 4.9% between 1988 and 1991.

Finally, the ratio of industrial employment in total employment in 1993 was 8.9%, only 7% of which were Omanis (MOD, SYB, 1995, p.57)

1.2.3 Construction

Construction activity comprises public infrastructure projects and residential and non residential buildings in the private sector. The main stimulus of the construction sector in the country is government capital expenditure which is tied to development projects. Private sector activity in this sector is merely financed by the banking system: commercial banks and Oman Housing Bank. This sector witnessed a boom during the Second plan (1981-1985) as its annual growth rate reached 15.4%. During the Third Plan (1986-1990) it showed a very sharp decline at -10.6% per year on average.

Cuts in government civil expenditure which generally has a high construction component (e.g. schools, hospitals, roads, etc.) and the high supply of residents and the decline in rents from the end of 1989 had a direct impact on the level of activity in the sector.

The sector's significance through its contribution in total GDP was very high during the period 1970-1975. It came directly after the oil sector at an average 12.6% of GDP. The highest ratio at 16.5% was in 1971. Its relative contribution during the last

four plans were 9%, 7%, 5% and 3% respectively. The reasons for this decline during this period have been mentioned above.

Regarding employment, the construction sector percentage in total employment reached 16%, 4% of which were Omanis (Ibid). The main characteristic of the commodity sector is the limited domestic productive capacity of all areas of this sector compared to the rent producing industry, i.e. oil sector.

1.3 Services Sector

This sector can be divided into many subsections. Some of them are purely Government Services such as Public Administration, Education, Health Service, Social Services, Religious, Information and Cultural Services etc., and others are private services such as the Wholesale and Retail Trade, Business Services, Restaurants and Hotels, and Real Estate. Transport and Communications, and Financial Services are “Mixed Services” because the government and the private sector share some of these activities, e.g. in Financial Services the government shares in the specialised banks, in Transport and Communications it shares in the capital of the General Telecommunication Organisation and the Omani Aviation Company.

From Table (1-1), it can be seen that its relative importance exceeds the commodity sector, it has been growing rapidly and during the FODP overweighted the oil sector. During the second and third plans, it formed more than one third of total output. During the FODP it participated by almost one half of total output.

In 1993, the service sector employed 39.2% of total labour force, one fourth of which are Omanis (Table 1-2).

The phenomenon of a large and expanding service sector at the expense of commodity sector is a general observation of oil rentier economies.

These economies are characterised by so-called 'Dutch Disease'. It occurs when a major increase in domestic spending takes place as a consequence of the large-scale development of natural resources and an associated large-scale increase in public services and expenditure. This phenomenon drives up the prices of domestic services relative to those of domestic tradable goods. The increase of the ratio of the prices of non-tradable to tradable goods increases the return to capital in the non-tradable sector, thus inducing an increase in the rate of investment in this sector at the expense of the traded sector. The exportable part of the agriculture sector is likely to be hurt most by the oil boom. On the other hand, large foreign exchange receipts from the oil industry resulted in an overvalued exchange rate that this discourages industrial exports while encouraging import commodities and local produced services.

In addition "there may also exist a considerable monopoly element in the valuation of services in rentier countries ... since the external rent is paid to the government, it is tempting for the government to reward its employees and supporters with regular salary increases, fringe benefits or lucrative contracts etc" (Mahdavy, 1970, p.447).

1.3.1 The Wholesale and Retail Trade

Trade has been a principal economic activity for Oman throughout its history. After 1970, trading activities flourished beyond any level recorded at any time in the past. Among the targets and policies of the government regarding commerce has been to set up a free economic system based on market economy with free competition and free foreign trade policy, and to encourage foreign investment.

The total number of companies registered with the Commercial Register of Oman increased from 239 companies in 1974 to 28616 companies in 1990. These companies were characterised by their small size. There were about 11165 companies, i.e. 39% of the total with a registered capital of less than RO 10,000.

Individually-owned economic establishments in Oman in 1990, represented a majority of 87.7% of total establishments. General partnership companies were 7%, limited partnerships only 2%, limited liability companies 3.1% and joint stock 0.4%.

The number of companies fully owned by Omani nationals reached 42892 at the end of 1990, representing 96.5% of total companies.

The contribution of this sector in total GDP reached an average of 7.5% during the FIDP, then increased to 11%, 11.7% and 12.4% throughout the last three plans.

Expatriate employment in this sector reached 77.6 thousand employees in 1993, i.e. 18% of total expatriates. The proportion of Omanis was 12.7%. Due to the high number of expatriate labour force in general and in this sector in particular, Oman's economy is exposed to a high rate of financial outflow.

According to a paper submitted to the Consultant Council for the State in 1988, covering the period 1980-1986, (Al-Hinai, Financial Remittances of Expatriate Labourers and Their Effects on the Omani Economy, 1988), it was found that the average annual rate of increase of expatriate labour force was 10.2%. The paper also found that net remittances to outside the country was increasing annually, averaging RO 267 million within the period covered, at 10.7% of GDP. The ratio of net remittances to domestic saving was increasing. It averaged 24.7% and its highest level was in 1986 at 39%. This means that 24.7% of domestic saving was leaking out of the country in addition to the outflow of foreign companies' profits.

Therefore, the ratio of national saving to total GDP was decreasing annually. It fell from 37.6% in 1980 to 18.9% in 1986.

Despite the fact that employment wages were increasing annually during the period under study, their contribution in generating GDP, i.e. the labour cost/output ratio fell from 3.84 in 1980 to 1.77 in 1986. The paper stated that this result might indicate that the productivity of the labour force was going down. Furthermore, the sector of commerce is subjected to a structural problem known as “veiled trading”. This means that, in many cases of business activity, the Omani sponsor has only the name, but capital of the firm and its profits belong to the expatriate. The expatriate pays his sponsor a small portion of his return as a rent or a commission then he transfers all his profits out of the country. This arrangement is existent in other sectors as well but to a lesser extent.

Consequently, economic surplus in general and in this sector in particular, is not re-invested or circulated in the economy, the capacities of enterprise have not been enlarged, and the entrepreneurial experience of Omani sponsors has not been developed.

1.3.2 Financial Institution, Insurance, Real Estate and Business Services

The Oman Banking System comprises the Central Bank of Oman (CBO), 18 commercial banks, three specialised credit institutions, money exchange companies, insurance companies, pension funds, hire purchase and leasing companies, investment banking institutions and the security market. Among the commercial banks, 7 are locally incorporated while the other 11 are branches of foreign banks. The domestic network of commercial bank branches which was 175 at the end of 1985 increased to 275 at the end of 1995 scattered all over the country.

Each of the three specialised credit institutions has an independent legal entity, partially or wholly-owned by the government, and specialises in extending medium and long-term loans to development projects. Those institutions are: The Development Bank of

Oman (DBO), The Oman Housing Bank (OHB), and the Oman Bank for Agriculture and Fisheries (OBAF).

It can be seen from table 1-8 that the bulk of commercial banks' credit (76%) goes to personal loans, import financing, construction and trade. The nominal maximum loan term is 3 years and the maximum on mortgage loans 10 years. Reflecting the small size of manufacturing and the short-term character of commercial bank lending, credit to the sector is very limited (only 3.6%).

Most commercial banks were established during the 1970s oil boom. Since 1981, there has been a moratorium on the establishment of new banks. After the collapse of oil prices in 1986, some commercial banks encountered difficulties and the authorities concluded that there were too many small under-capitalised banks. Regarding long-term credit provided by the specialised banks and Ministry of Commerce and Industry in 1991, about 50% was directed to the housing sector by the Oman Housing Bank.

The sector's contribution to GDP recorded an average of 8.8%, 9.8% and 2.7% during the Second, Third and Fourth Plans. Its growth rate fluctuated during these periods. The highest rate was in 1980 at 62.9%. It averaged 25%, 38%, 7.9% and 4.3% during the previous development plans.

The ratio of employment in this sector to total employment, Omani and non-Omani, averaged 3% during the Third Plan period (1986-1990). The average portion of Omani employees in commercial banks reached 61.4% during the same period.

To sum up, it is obvious that the structure of banking in Oman reflects the basic peculiarities of the economy as it has developed under the dominant influence of oil exports and government spending.

Table 1-8
Bank Credit by Sectors in December 1993

Sector	Amount RO (000)	%
Import Trade	213389	18.81
Export Trade	7106	0.63
Wholesale and retail trade	96301	8.49
Mining and quarrying	15681	1.38
Construction	113913	10.04
Manufacture	40242	3.55
Electricity, gas, water	8663	0.76
Transport. & communications	9403	0.83
Financial institutions	18918	1.67
Services	43706	3.85
Government	40843	3.60
Personal loans	440593	38.83
Agriculture & allied activities	5143	0.45
All others	80788	7.12
Total	1134689	100

Source:

CBO, Quarterly Bulletin, March 1994, Table 10, p.14

1.4: The Role of the Government in the Omani Economy

The government plays a significant role in the Omani economy. It owns and operates the bulk of the country's economic and energy resources. It has 60% of the Oil Sector and all natural gas earnings, all public electricity generating stations (25), 100% of the General Telecommunications Organisation, 32% of the Omani Aviation Company, 35% of Port Services Corporation, 99% of the Oman Mining Company, 99% of the Oman Refinery Company, 100% of Al-Bustan Hotel, and 100% of Oman National Transport Company.

Moreover, it has established many other financing and production projects either financed by it completely or in association with the private sector such as cement factories, Oman Flour Mills, the DBO, the OHB and the OBAF.

It is obvious that the government takes the leading role in utilities, communications, transportation, financing, energy and tourism, through the establishment of these public authorities and wholly or partially-owned companies.

The government became so rich because of the fact that oil wealth flows its rents into the hands of the government, therefore the government is wealthy, not the society, and because the economy depends approximately on one source of income, namely, oil.

It has also attempted to define and influence the direction and character of private sector development. The government development plans have had legal force with respect to activities of the public sector. As was mentioned previously, the government has been seeking to achieve two long-term major objectives: to lessen the economy's dependence on oil through the diversification of the economic base and the development of a strong private sector, and to promote social and regional balance.

The government's approach to achieve these objectives followed four identifiable policy tracks:

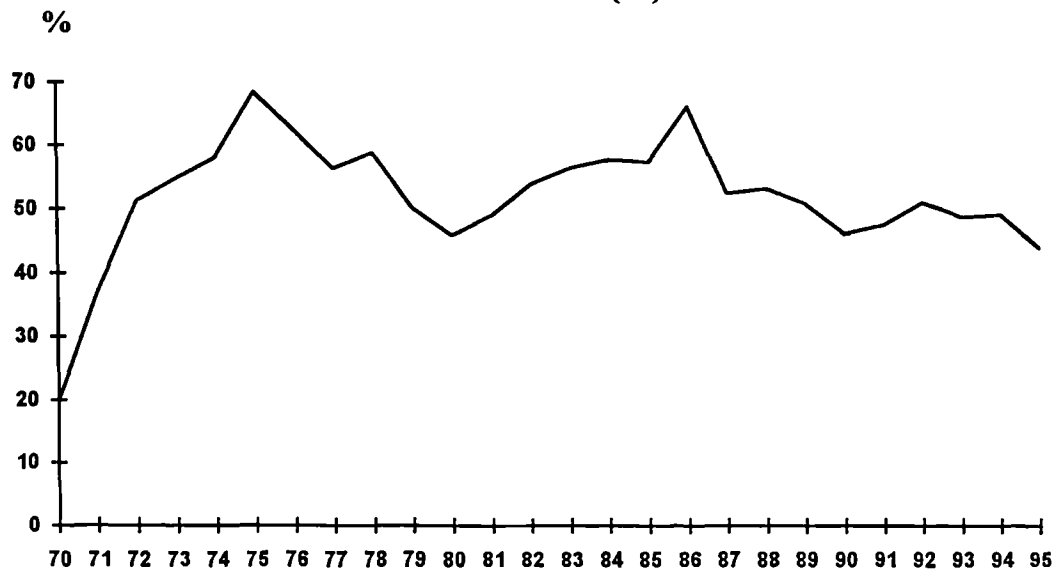
1. Continued efforts to build institutions and infrastructure.
2. Investment in large-scale projects the capital requirements of which far exceeded the capacity of the private sector, e.g. telecommunications, desalination plants, the oil refinery and cement.
3. The development of a system of incentives under which the private sector receives a variety of input and output subsidies.
4. The adoption of a social policy based on the principal that every citizen has the right to free education and health services regardless of his income.

However, the size of the government and its economic and social role in the economy can be measured through its total expenditure. In other words the government expenditure can be considered as a parameter for the government importance in the economy. During the past stages of development, government expenditure represented 53% of GDP on average (see Chart 1-6). It consists of current expenditure (32.3%), development expenditure (25.6%), defence and national security expenditure (40%) and contributions and support for the private sector (2.3%).

As can be seen from Table 1-9, the contribution of the government in total capital formation was on average 71.1% during the previous development stages, compared to 28.9% for the private sector. On average it accounted for 17.5% of the total GDP. It comprises the following:

- Capital expenditure on projects for civil ministries and other public organisations.
- Capital expenditure associated with natural gas expenditure.
- Government share in PDO capital formation.

Chart 1-6
The Ratio of Government Expenditure to Total GDP
1970-1995 (%)



Source:

1. DC, SYB, 1992, Table 1-15 p.435, Table 1-14 p.379
2. DC, The Development Plans
3. CBO, Annual Reports

Table 1-9
The Uses of GDP between the Government and Private Sector During the Previous Plans

	Government						Private Sector					
	Capital Formation			Consumption			Capital Formation			Consumption		
	RO(m)	% of total	% of GDP	RO(m)	% of total	% of GDP	RO(m)	% of total	% of GDP	RO(m)	% of total	% of GDP
70-75	430.6	77.7	23.6	373.4	61.6	29.5	123.5	22.3	6.8	232.8	38.4	3.0
1st Plan	1186.3	70.6	19.3	1409.6	53.6	25.2	494.9	29.4	8.1	12.18	46.4	21.8
2nd Plan	2755.9	70.8	19.2	3853.5	47.3	26.9	1137.5	29.2	7.9	4237.7	52.7	30
3rd Plan	2005.2	68.5	12.5	5319.2	49.3	33.2	920.1	31.5	5.8	5479.6	50.7	34.2
4th Plan	2330	60.0	13.0	6676.2	36.2	26.1	1556	40.0	6.2	11764.3	63.8	40.5
Average		71.1	17.5		49.6	28.2		28.9	7		47.1	25.8

Source:

1. DC, FIDP, Table 2, p.6
2. DC, SDP, Table 31, p.49; Table 6, p.14
3. DC, ThDP, Table 10, p.19; Table 5, p.13
4. DC, FODP, Table 7-1, p.178; Table 1-2, p.24
5. MOD, The Main Components of the Fifth Development Plan, Table (1-4), p.35

The regional distribution of public capital formation is one of the mainstays of the development process in Oman. The aims and policies of economic and social development emphasise the importance of distributing investment among the various geographic regions of the country. They also stressed the necessity to “support and develop existing population areas and protect them from mass migration to heavily populated centres”.

This high level of the government expenditure resulted from the vast and rapid expansion role of the government in operating and managing a wide range of goods and services units. Purely government services contribution in the total GDP accounted for 12.2%, 15%, 19% and 25.7% during the previous four development plans respectively.

This high level of public expenditure makes the State the biggest consumer compared to the private sector. During the 5 previous stages public consumption accounted for almost 50% of total consumption (Table 1-9). The State consumed 28.2% of total GDP, whereas the private sector, on averaged, consumed 25.8%.

The rise in government expenditure during the previous development stages was a result of the incremental expansion of the range of government services and a result of increasing public investment as a social and political commitment for the people.

Gradually, total government expenditure became rigidly responsive to changes in the GDP. Because of the deterioration in oil prices, GDP declined steeply from RO 3453.8 million in 1985 to RO 2800 million in 1986, i.e. by 18.9%, whereas government expenditure declined by only 3.2%.

Due to the high level of public expenditure, little importance was given to the generation of adequate levels of public saving. As a consequence, planned public

saving and investment have been low and public capital flowed primarily into domestic infrastructure in health, education, communications, electricity and water, with little left for other investment that would possibly yield future public income. Domestic investment has been occasionally employed for socio-political reasons as a primary instrument of job creation and regional development than as a complement to private sector economic activity. The intensive role of the government in the economy, through its high capital and current expenditure and through its large public administration, had precluded the achievement of the objective of free economy with an efficient and able private sector playing a leading role. It resulted in a decline in participation of the private sector in some aspects of economic activity, limiting its interest to certain areas like trade and banking. In its turn, this led to the neglect of other important primary areas of investment such as manufacturing, agriculture, fisheries, petroleum, and mining, leaving the financing of these sectors to the government which contradicts the establishment of a private sector-led economy.

As can be seen from Table 1-10 the biggest portion of private sector investment spending during the Second and Third Plans went into housing (22%), followed by trade and contracts (13.7%). Manufacturing received 8.8%, while agriculture and fisheries received only 2.2% and 0.4% of investment respectively. This picture did not change throughout the Fourth Plan. The low rate of private investment in goods-producing activities is not due to the investors so much as to the lack of profitable investment opportunities.

This trend can be partially explained by the argument that “expected oil wealth tends to have an adverse impact on private investment; this may reflect the competing nature of private and government investment expenditures as perceived by private entrepreneurs. The availability of petroleum resources reduces the private sectors’ propensity to save and its demand for investment” (Vaez-Zadeh, 1989, p.364).

Table 1-10
Non-oil Private Sector Investments During the Second, Third and Fourth Plans
(Relative Importance)

Sector	The Second Plan (1981-1985)	The Third Plan (1986-1990)	The Fourth Plan (1991-1995)
Agriculture	2.2%	2.2%	0.7%
Fisheries	0.4%	0.7%	0.4%
Industry	8.8%	9.5%	4.6%
Trade and Contract	13.7%	7.6%	-
Finance and Banking	2.2%	2.6%	-
Transport	1.2%	2.0%	-
Tourism	-	0.9%	-
Housing	21.7%	21.6%	5.6%
Others	-	-	3.4%

Source;

1. DC, ThDP, Table 11, p.23; Table 12, p.20-23
2. DC, The Assessment of the Economic Performance of the ThDP, Table 2-49, p.108
3. DC, FODP, Table 3-10, p.69

Another relevant explanation of low rate of private investment and heavy intervention of the government in Oman, particularly in the first stage of development, is the market failure to achieve social optimum allocation of resources. “The level of investment may fall below the social optimum, firstly because private investors ignore external economics and the supplementary benefits of projects when calculating prospective returns, and secondly because the element of risk will be higher for a series of uncoordinated individual projects than for co-ordinated investment programmes systematically undertaken with some central direction” (Thirlwell, 1990, quoted in Al-Yousef, 1995, p.53).

At the same time, the increasing role of the government, the speed with which government units and organisations were established, and the need to employ qualified personnel, necessitated regulating an incentive system to increase national participation in the work force in the government sector. This system has attracted workers to employment in government departments. Conversely, the system has become an obstacle in the development of the private sector, because it became unable to provide corresponding incentives. This has affected the sectoral and occupational distribution of the labour force. Hence, more basic measures are needed to address the large public/private sector salary differentials.

To sum up, the government’s role needs to be reprioritised and the role of the Private Sector needs to be expanded. The public infrastructure can appropriately support, but not supplement private development as an engine of economic growth. The assumption of a more appropriate role by Oman’s public sector would necessitate withdrawing from ineffective, unnecessary or undesirable activities and confining the government role to necessary limits. In this direction, the World Bank report suggests the following actions in setting national priorities:

- More reliance on economic criteria when setting national priorities in the selection of public investment programmes.

- Substantially reducing or eliminating government involvement in commercial activities.
- Reviewing current policies and instruments for promoting industrial diversification with an aim to using more efficient means.
- Scaling down public expenditures on buildings and other low-return infrastructure (The World Bank, 1994, p.63).

In fact, the government has started to implement a programme of transferring certain public operations to the private sector such as billing and collecting for water and electricity maintenance and cleaning contracts, and operating contracts for water and power stations and hotels. Further privatisation of infrastructure projects are one of the features of the new Five-Year Development Plan which came into effect in January 1996. The private sector is invited to invest in 10 new projects, the estimated cost of which is RO 1008m. They include sewage, electricity, water desalination and power, roads and Polyolefin projects (Ministry of National Economy, 1996).

In reality, however, the liberalisation process in Oman, like in other Arab Gulf States, encounters three difficulties:

First, there is the problem of finding enough genuine entrepreneurs (rather than just merchants or speculators) to take up the developmental challenge after the completion by the state of the basic infrastructure. Second, the network of subsidies and protection to an extent undermines the building of an efficient free enterprise system. Third, it is frequently the case that much of the equity in privatised companies is taken up by the same families and groups (Nonneman, 1995, pp. 258-289).

1.5 Demographic Characteristics and the Labour Force

The results of the population census that was carried out by the government in December 1993 (DC, SYB, 1993) established that Oman's population had reached 2,018,074 inhabitants, of which 1,483,226, i.e. 73% are Omanis. Sex distribution differs between Omanis and non-Omanis. Amongst Omanis, 50.9% are male and 49.1% female, whereas non-Omanis are 79.1% male and 20.9% female. This means that the total population, Omani and non-Omani, comprises 58.2% male and 41.8% female, and this is due to the composition of the non-Omani population.

The age distribution of the Omani population is consistent with that of developing countries. It is characterised by a population pyramid with a wide base which decreases gradually. This means a high fertility and birth rate, which results in a rise in the number of young people among the population. 51.6% of Oman's total population is under 15 years old. This has led to an increasing dependency on foreign labour in the last phase of economic development.

This population structure resulted in a decline in the number of people of working age and proportion of the labour force to the total population. It also meant a rise in the level of economic dependency (proportion of non-working to employed population) to 3.2 for Omanis which means that each worker supports between three and four dependents. It is worth noting that the level of economic dependency for the entire population is 1.3. This is because the level of economic dependency of expatriate labour is very low.

Regarding the distribution of population among the areas of the country and the density in each of them, it can be seen from Table 1-11 that the highest density is in Muscat, at 152.5 per km², whereas the lowest is in Al-Janubiya at 1.6 per km². The highest portion of the population is in Al-Batinah at 28%, whereas the lowest portion is in Al-Wusta at 0.8%.

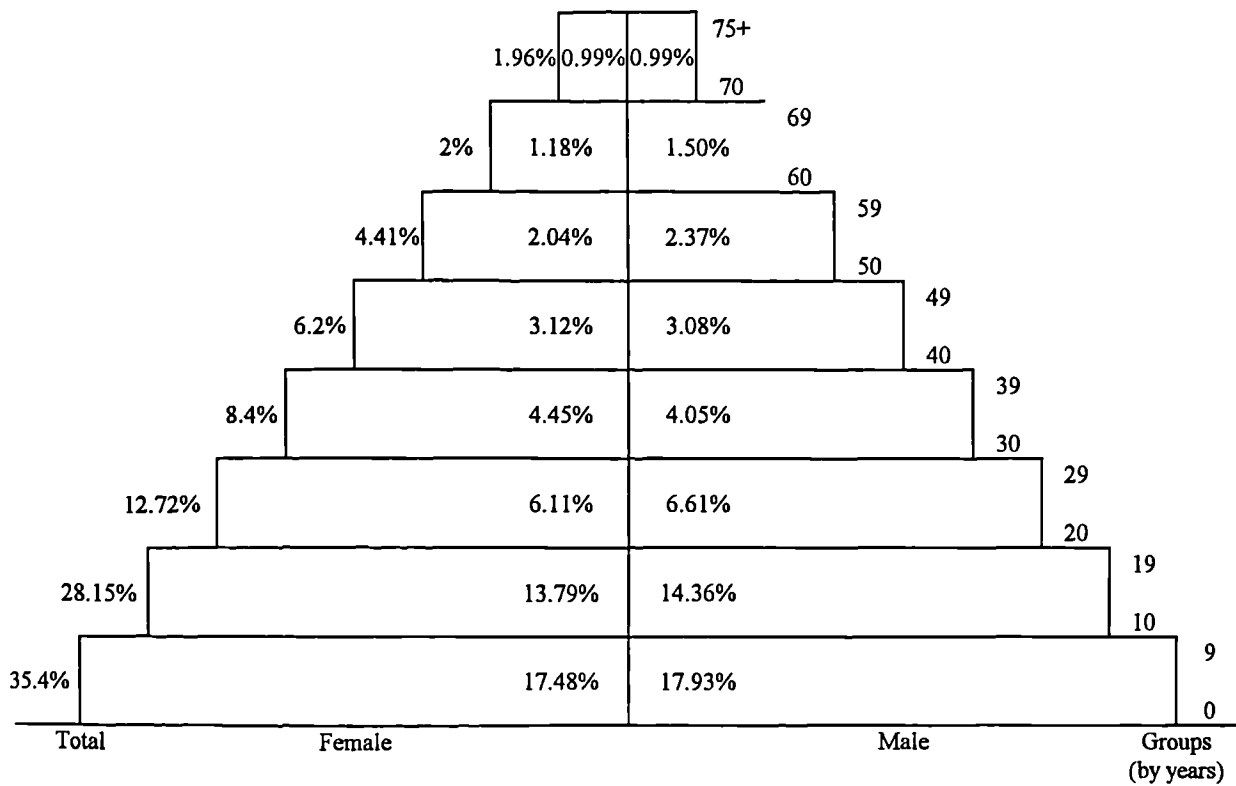
Table 1-11
Regional Distribution and Density of Population in 1993

Region	Area %	Population %	Density (personper 1km ²)
Muscat	1.2	27.2	152.5
Al-Janubiya	38.4	9.4	1.6
A'Dakhliliya	25.2	11.4	3.0
Al-Batinah	4.5	28.0	41.8
A'Sharqiya	13.7	12.8	6.3
A'Dahira	16.5	9.0	3.7
Al-Wusta	-	0.8	-
Musandam	0.5	1.4	19.2
The Sultanate	100	100	6.7

Source:

DC, SYB, 1993, Table 1-2, p.46

Chart (1-7): The Population Pyramid



Source: DC, SYB, 1994, Table (3-2), p.55.

1.5.1 Labour Market Characteristics

Firstly, there are three terms that must be distinguished: human resources, manpower, and labour force. Human resources means total population in the country. Manpower means the number of people of working age, regardless of aptitude, willingness, or ability to work. Labour force consists of people economically active and according to international definition “those able, willing and looking for work”. Here, labour force does not include housewives, students and disabled people. It includes those actually working, as well as those unemployed and looking for work (DC, FODP, pp.135-136).

According to the census results, Omani manpower, which comprises the number of people between the ages of 15 and 65, accounted for 45.4% of total population in 1993. This percentage is expected to rise mainly by virtue of changes in the age structure of the population: the widening base of the population pyramid due to an increase in the number of young. The labour force represented 40.7% of the manpower in 1993.

Nevertheless, the rate of crude economic participation which is the ratio of the labour force to the total population is 18.5% and about 22.5% in 1995. The fact that this portion is so low is due, on the one hand, to decreased participation of women in the labour force, and on the other hand, because of the decrease in average age of the population, to a large proportion of manpower being in the various stages of education, and therefore outside the labour force.

There are many peculiarities marking the Omani labour force. The most prominent one has been the increasing labour force in the public as well as in the private sector. This has been to fulfill the demands of developments and the need to implement its programmes at a time when the number of Omanis entering the labour market has been limited because of the age structure of the population, the rise in the number of young people, and those in various stages of education. Due to the lengthy period of preparation and qualification, there has been a need to fill the gap by using foreign

labour, the amount of which has increased both in the public and private sectors (this will be discussed later).

The peculiarities of the Omani labour market can be summarised as follows:

1. The average annual growth rate of foreign labourers exceeded the average annual growth rate of GDP (at 1980 prices) during the First, as well as the Second Five-Year Plans. The former was 15.8%, 15.2%, whereas the latter was 9.7%, 14.8% during the two periods respectively. However, when the level of GDP fell in the first years of the Third Plan the growth rate of number of expatriate decreased faster (2.9% and 0.6% respectively).
2. The ratio of expatriate to total labour force highly exceeded the ratio of the Omani labour force. The increased rate of economic growth led up to 1985 to a widening of the labour market and accordingly a greater demand for labour in the country. However, the local supply of labour was unable to meet this increase because of the wide base of the population pyramid, which implies a large number of young people outside the labour force. Therefore, the rate of Omanisation (the rate of Omani labour force to total labour force) fell from 65% in 1975 to 50% in 1980 and 38% in 1985 and 35.8% in 1993 (The Fourth Plan and the Census result). The entire labour force grew between 1975 and 1993 by 238%, equivalent to an annual growth rate of 10%, whereas Omani labour force increased during the same period by only 103% at annual rate of growth of 5.6%. This disparity in the rates of growth of the total labour force and the Omani labour force resulted in an increase in the level of foreign labour at 10.3% per annum and a decline in the rate of Omanisation.
3. The Omani labour force is concentrated in technicians and skilled occupations. It can be seen from Table 1-12, which shows the occupational distribution of the labour force, that 48.5% of total Omani workers, who account for 35.8% of the total labour force, were concentrated in technicians and 70.3% in skilled occupations in 1993.

Table (1-12)

Distribution of Labour Force per Vocational and Educational Status

Nationality	Total Labour Force		Omani Labour Force		
	Number (000)	%	Number (000)	Omanisation in Each Group (% of Groups)	Distribution of Omani Labour Force among Groups (% of Total Omanis)
Vocational and Educational Status					
Specialists (Graduates and above)	63	9.4	20	31.7	8.3
Technicians (Diploma after general education)	33	4.9	16	48.5	6.7
Skilled (general education and training)	158	23.6	111	70.3	46.3
Semi-skilled (drop-outs from different education systems)	112	16.7	9	8.0	3.8
Other semi-skilled and unskilled	304	45.4	84	27.6	35.0
Total	670	100	240	35.8	100

Source: MOD, SYB, 1995, Table (4-2), p.58.

4. Government jobs have special attributes which attract Omani workers to the public sector, including wages, work conditions, services regulations, retirement benefits, etc. The absence of similar attributes and conditions in the private sector resulted in a work performance for the government sector and created tremendous pressure on government organisations to employ an incremental number of workers even who are qualified for work in industrial services units in the private sector. On the other hand, wage scales and conditions in the private sector vary between Omani and expatriate labour. In general, expatriates accept situations and conditions unacceptable to Omanis, including low wages and long working hours. The availability of such cheap alternative labour has led to sluggishness in Omanisation, especially in some private sector activities.
5. The contribution made by women (Omani and expatriate) in the labour force was 9.7% in 1993. The total number of females in the labour force was around 68,000, of which 23,500 were Omani. In other words, Omani women accounted for 3.5% of the total labour force and about 9.8% of the Omani labour force. This can be attributed to a number of economic and social factors, such as female education and qualification, and the type and nature of occupations which the labour market provides and the unsuitability of these occupations for religious reasons. By virtue of the increase in the education of girls and the expectation that thousands of girls will complete various stages of education in the next few years, the role of women in the labour market will continue to increase.

1.6 Foreign Trade

Oman follows a free foreign trade policy in accordance with existing laws. It continues to maintain a liberal exchange system and there are no restrictions on payments or transfers for current or capital transactions. There are virtually no trade restrictions. Only about a half of imports are taxable. The general tariff applicable to duty goods was raised from 4 % to 5% in the 1986 budget. Under the broad Unified Economic Agreement among the Arab Gulf Cooperation Council countries, it was agreed that the

members would seek to establish a common tariff policy. With this objective in mind, imports from other GCC countries were not subjected to tariffs.

Oman's economy is an export-oriented economy where foreign trade plays a leading role and is a driving force for all activities of the community. I mentioned earlier that oil exports accounted for 88.4% of total exports during the period 1970-1995.

Total exports increased from RO 44.8 million in 1970 to RO 2332 million in 1995 (Table 1-13). It multiplied 52 times during this period. Its average annual growth rate was 12%. The highest growth rate was in 1980 at 64.4% compared to the 1979 level because of the increase in oil prices. In 1986 (the first year of the Third Plan) it decreased by 36% compared to 1985 level because of the sudden drop in oil prices.

Total imports increased from RO 12 million in 1970 to RO 1684 million. It multiplied 140 times throughout this period. The average annual growth rate of imports was approximately the same as exports at 11.8%. The highest growth rate was 39% also in 1980, whereas, the steepest decline was at 23.6% in 1987 one year after the steepest decline in exports.

Non-oil exports of Omani origin consist of: fish, dates, limes, livestock, foodstuffs, beverages, mineral products, plastics and articles thereof, textiles and textile articles, and base metals. Its average annual growth rate within the Second Plan period (1981-1985), was 35.7%. Throughout the Third Plan, 1986-1990, it grew at an average annual rate of 30%. During the Fourth Plan it grew at 21.5% per year on average. The growth was most pronounced in the export of frozen fish and wheat flour. Moderate increases were also achieved in the export of traditional items such as dates and dried limes. However, as can be seen from Table 1-13, it still has a marginal importance in total exports because its highest proportion to total exports was 7.8% in 1995.

Table 1-13
Summary of Foreign Trade
1970-1995

	Non-oil Exports		Omani Origin Exports to Total Exports (%)	Total Exports RO mn	Total Imports RO mn	Trade Balance RO mn
Year	Re-exports	Omani Origin Exports				
1970		0.4	0.9	44.8	12	32.8
1971		0.4	0.8	48.1	40.2	7.9
1972		0.4	0.8	50.0	61.6	-11.6
1973		0.6	1.0	61.9	85.8	-23.9
1974	-	-	-	-	-	-
1975		1.1	0.2	489.2	264.3	224.9
1976	6.0	1.4	0.3	551.2	250.5	300.7
1977	12.0	1.5	0.3	559.4	302.1	257.3
1978	26.9	3.3	0.6	552.0	327.1	224.8
1979	37	4.7	0.6	787.4	430.5	356.9
1980	45.3	4.6	0.4	1294.5	598.3	696.2
1981	88.9	6.5	0.4	1621.8	790.4	831.4
1982	109.5	7.7	0.5	1526.8	926.6	600.2
1983	110.0	10.6	0.7	1467.2	860.8	606.4
1984	109.3	17.2	1.1	1527.5	949.2	578.3
1985	97.4	22.9	1.3	1778.1	1088.9	689.2
1986	85.1	26.6	2.4	1122.5	916.7	205.8
1987	84.9	39	2.6	1484.9	700.7	784.2
1988	92.1	62	4.8	1291.4	846.4	445.0
1989	101.2	66.5	4.3	1562.9	867.9	695.0
1990	107.4	68.7	3.3	2116.4	1030.9	1085.5
1991	165.1	79.1	4.2	1873.9	1228.1	648.8
1992	253.5	96.7	4.5	2135.3	1449.2	686.1
1993	320	122	5.9	2063	1652	411
1994	359	145	6.8	2131	1543	588
1995	322	182	7.8	2332	1684	648

Source:

1. DC, Development in Oman 1970-1974
2. DC, SDP, Table 17, 18, p. 24
3. DC, SYB, 1992, Table 1-11, p.280
4. CBO, 1995, Table 6.1, p.91

Japan continued to be the largest buyer of Oman's oil, importing more than 66% in 1985, while West Europe's share declined significantly. On the other hand, South Korea, India, Singapore, Taiwan and China continued to increase their share of Omani crude oil. South Korea became the next largest importer at 31% in 1989.

Total Omani exports and re-exports to the UAE fall short of covering the Omani imports from it. They covered 55.2%, 64.8%, 73.8%, 44%, 48% and 56% of Omani imports in 1990, 1991, 1992, 1993, 1994 and 1995 respectively and this ratio was increasing in general. This situation is inconsistent with the Sultanates comparative geographically advantageous location. The Sultanate overlooks the Arabian Sea and the Oman Gulf with a coastline of 1700 km all of which is outside the Hormuz Strait.

Government spending and total imports have a strong correlation because government spending is the prime mover in the Omani economy, especially in the demand for goods and services.

Machinery and transport equipment, manufactured goods and food and livestock, constitute the main items of recorded imports. These three groups together constitute more or less 75% of total imports in 1991. According to Standard International Trade Classification (SITC), consumer goods accounted for the major portion at 42.5%. Intermediate goods, viz. goods that require further processing constitute 27.5% whereas capital goods accounted for 28.5% (CBO, 1991, p.99).

The UAE, Japan and the UK have been the three most important sources of imports. In 1990, the participations of these three countries in Oman's imports were 23.2%, 17% and 11.5% respectively. The bulk of imports from the UAE were in the form of re-exports and consisted of building materials, clothing, fruit and vegetables, electronics, etc. Those from Japan were mainly made up of machinery and transport equipment. Imports from the UK covered a wide range of goods.

With respect to major regions, Oman's imports in 1990 came from: Western Europe 31.7%, Asia 27.5%, Arab countries 27.3% (of which 99% was from GCC countries), America 10%, Oceania 2.7%, Eastern Europe 0.5% and Africa 0.4% (DC, SYB, 1992).

Oman's balance of trade has always been in surplus since the development of the oil sector (except in 1972 and 1973). This surplus had been growing since 1979, reflecting the trends in oil prices. It reached a peak of RO 788.9 million in 1981, then leveled at an average of RO 542.5 million. In 1986 it dropped sharply to RO 113 million. Imports compression, together with a recovering in oil earnings, brought a strong improvement in 1987 at RO 707 million, while the 1990 trade surplus was high because oil prices and production was prompted by the Gulf crisis.

In spite of the trade surplus, there is a remarkable net outflow on the invisible transactions which has left the country with a much-reduced current account surplus since 1982 and a deficit of RO 383 million in 1986 and 129 million in 1988. The large number of foreign workers in the country has contributed to this phenomenon through workers' remittances. These remittances alone cut the trade balance surplus by an average annual rate of 61% during the period 1980-1986 (Al-Hinai, 1988).

Free trade policy, unrestrained transfers, and oil exports have widened the openness of the Omani economy. One simple measure of openness is to add the value of exports and imports, then divide the total by the GDP. The economy of increasing ratio could be described as opening up, and that of decreasing ratio is anti-trade. Chart (1-8) depicts the openness of the Omani economy. It is obvious that the openness of the economy has been affected positively with oil production and oil prices.

Chart 1-8
The Openness of the Omani Economy

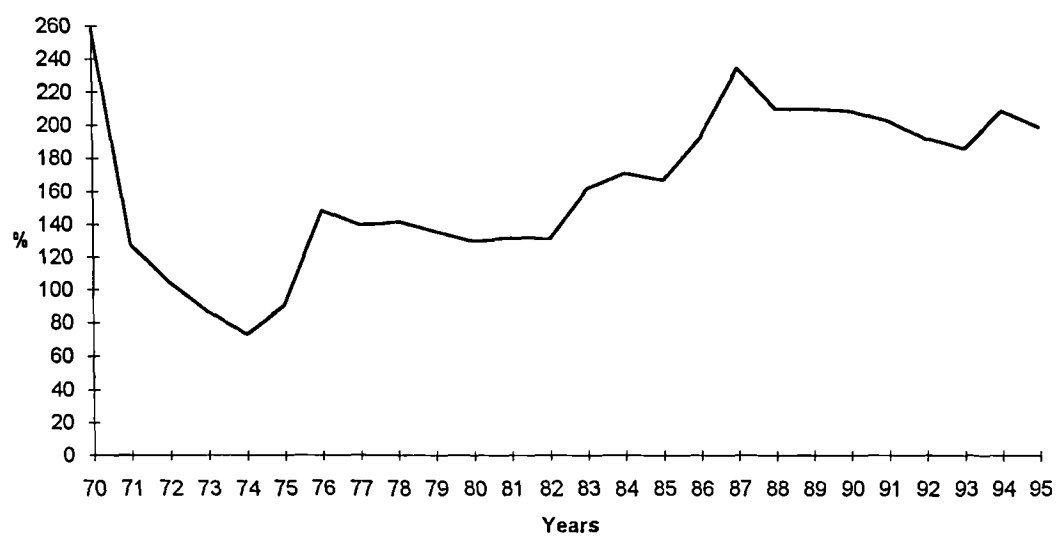


Source:

1. CBO, 1985, 1990, 1995
2. DC, FIDP, SDP

Trade balance surplus means that total exports exceed the country's needs of all goods, but would this be the case without oil exports? Non-oil exports could not satisfy the country's needs. As has already been pointed out, it comprises a maximum of only 7.8% of total exports. It accounts for a maximum of 10% of imports. Non-oil exports means that non-oil output exceeds local consumption in some items. Therefore, non-oil GDP compared to total imports could be used as an indicator of the self-sufficiency of the country. Chart 1-9 represents the ratio of non-oil GDP to total imports during the period 1970-1995. On average, non-oil GDP accounted for 163.9% of total imports. In other words, non-oil output is enough to meet the country's needs of all commodities by 1.63 times. This indicator, nevertheless, may be criticised by the fact that the imports of an oil-producing country is effected by the Oil Sector. Namely, total imports includes equipment, machines, tools and materials related to the oil industry. On the other hand, the needs of other producing sectors for some capital and intermediate goods, and the household sector needs for consumer goods, is motivated by oil receipts. As a result, without oil GDP, the structure and magnitude of imports would have changed. However, non-oil GDP itself, as has been indicated earlier, is affected by oil GDP. Thus, the effects of the Oil Sector on both sides, imports and non-oil GDP, would counteract each other. Accordingly, the ratio of non-oil GDP/imports could work as an approximate indicator for Oman self-sufficiency.

Chart 1-19
The Ratio of Non-oil GDP/Total Imports 1970-1995



Source: previous tables

Conclusion

The Omani economy is a small economy based on oil production. It consists of three major sectors: the oil sector, the non-oil commodity sector and the service sector. Although the relative importance of the oil sector in total GDP has fallen from 67% in 1970 to 38% in 1995, oil production is still dominating the other sectors of the economy because of its far-reaching effects through government expenditure.

The development strategy is based on oil exports. Oil revenues that accrued to the government have been channelled to establish the infrastructure projects and to provide a wide range of public services.

Several development plans that have been executed have transformed the country from subsistence economy to a modern one.

Despite the leading role of the oil sector, it is described as an enclave sector employing a low proportion of total labour force (0.8%). The economic effects of the oil sector on other sectors are financial and macro-level effects through government spending. There is a weak integration between the oil sector and other sectors.

The non-oil commodity sector has achieved a remarkable growth rate during the last development plan after a stagnation period during the previous plan.

This sector has been suffering from narrow-base investment, especially in agriculture and fisheries. It also lacks adequate entrepreneurial skills. Manufacturing is dominated by small projects of light and medium industries. The small local market and imports competition are critical difficulties facing industry.

The oil-based economy has adversely affected the agriculture sector. Although in absolute value agriculture and fishing produce has been increasing enormously, the

relative importance of the sector declined from 34.6% in 1967 to 2.5% during the last development plan. Lack of water resources, marketing skills, external competition, rural-urban migration and slow adaptation of modern production technology are the main serious problems challenging the sector. The commodity sector is also characterised by the dominant role of expatriate workers who contribute 81.5% of the labour force working in the sector compared to 18.5% for Omanis. This means the nationalisation of production techniques is growing slowly.

Large-scale development of natural resources through high government spending has created the so-called “Dutch Disease”. The result of this phenomenon was a rise in the prices of domestic services and relative decrease in the process of the tradable goods. This has encouraged the investment in service activities at the expense of tradable goods, opening the way to increasing importance of the service sector.

The service sector consists mainly of government services such as education, health services, communications, and of other service activities practised by the private sector such as wholesale and financial and business services. Its relative importance as a source of gross domestic product has been increasing rapidly. Presently it generates almost one half of the GDP, exceeding the participation of the oil sector. Private activities within this sector are dominated by expatriate labour force (75%), especially in the trading sector.

The other main peculiarity of the Omani economy is the major role of the government, with its total expenditure forming 52% of GDP on average, and its development expenditure contributing by 71% to total investment spending of the economy. The positive result of this heavy intervention of the government is the quick and remarkable modernisation of the country. However, the intensive role of the government has hindered the progress of the private sector, leaving it with narrow options.

The next characteristic of the Omani economy is that the population enjoy high fertility and high birth rate, which makes 51% of the population under 15 years of age. This has resulted in an increasing need for foreign labour. The ratio of expatriate to total labour force is 65%. The expatriate labour force has been increasing by 10% whereas the Omani labour force constitutes 35% and has been increasing by 5.6%.

Finally, the openness of the Omani economy is high since Oman believes in free trade without restriction on imports and financial transfers. Oil exports form 88% of total exports. Commodity exports of Omani origins form only 7.8%. While imports provide Omani consumers with a large variety of consumer goods, they harms the Omani producers through the competition of equivalent products.

Due to the large number of expatriate workers, the current account balance records a small surplus and sometimes a large deficit. Its position has been reducing the trade balance surplus and the gross domestic saving.

¹ "Aflaj" is the plural of "falaj" which is a method of obtaining water for irrigation by locating a water source under the earth in the flank of a mountain and making a path from this spring to the area to be watered. Vertical shafts at intervals of about twenty to fifty yards are sunk along this path, and the bottoms of the shafts then connected by a tunnel along which the water flows down a gentle gradient to reach the surface at or near the area to be watered.

CHAPTER II

GOVERNMENT BUDGETING IN OMAN : OBJECTIVES, POLICIES, AND MECHANISM

In the context of analysing the cost and effects of the budget deficit in Oman, it is important to know the main objectives which the government budget is required to achieve. It is also necessary to understand how the mechanism of the budget is prepared, organised and executed. Moreover, the importance of government finance in Oman as a rentier state and its role in transforming the oil wealth from the oil sectors to other sectors of the economy is important to examine. Therefore, this chapter will be divided into three sections as follows:

Section I: The Government in Oman as a Link between the Oil Sector and Other Sectors.

Section II: The Objectives and Policies of Budgeting in Oman.

Section III: The Organisation of Budgeting in Oman

2.1 The Government as a Link Between Oil Sector and Other Sectors in the Omani Economy:

From the overview that has been made on the Omani economy in chapter one, as an oil rentier economy, certain main characteristics have been distinguished which can be summarised as follows:

First, the limited domestic productive capacity in areas other than the rent producing industry.

Second, weak relationship between oil revenues received by the government and the productive efforts exerted by members of the society. In other words, oil prices are almost disconnected with the local production cost of oil.

Third, the enclave nature of the oil industry, where its direct integration - the vertical and the horizontal linkages with other sectors of the economy is minimal. The oil industry has little direct impact on the course of development in the country since it engages only a small portion of domestic labour and capital.

Fourth, the above characteristic leads to the conclusion that the creation of wealth is centred around a small fraction of the society; the rest of the society is only engaged in the distribution and utilisation of this wealth.

Fifth, the oil industry's major contribution is that it enables the government to embark on large public expenditure programmes without resorting to taxation. The government becoming the dominant factor in the economy.

Sixth, expected oil wealth have an adverse impact on private investment, the availability of petroleum resources reduced the private sectors propensity to save and

to invest. This indirect influence can be interpreted as the confidence effect of the oil wealth.

Seventh, high wages in the oil industry and its related services sector increased the wages in industries competing for labour and thereby raised their costs. High industrial and service sectors wages also increased the degree of income inequality and widened the gap between the modern sectors and the low productivity agricultural sector.

Eighth, continued high public spending on services meant that the demand for, and the prices of factors of production, including urban labour, remained high, reducing the incentive for those factors to seek employment in goods production.

The government as the recipient of oil rents and the purposes and tools of its role as a link between the oil sector and other sectors are shaped by these peculiarities of rentier economy.

In Oman, as in other oil-based economies, the large size of export earnings accruing to the government relative to the size of the economy give more importance to the operations of the government than is the case in other developing countries. Because the oil sector is typically characterised as an enclave sector, the government's operation serve as the main link between that sector and the rest of the economy. In other words, in the rentier state, the rent received from the exports is concentrated in the hands of the state which establishes the links between the rent generating sector and the rest of the economy through expenditure side of the budget. This enables the state to play a crucial role in both the diffusion of oil rent among the population and in determining the economic and social fabric of the society.

Hence, the state is at the centre of the analysis of rentier economies. As one author has argued: "The oil-exporting rentier economy is seen as a hierarchy of layers of

rentiers, with the state or the government at the top of the pyramid, acting as the ultimate support of all other rentiers in the economy” (Beblawi 1987, p.33).

This role of the government as a link - between oil sector and the rest of the economy is governed by three factors:

- 1-The weak influence of taxpayers.
- 2-The weak forward-backward linkages of the oil sector.
- 3-The strong fiscal linkage through the budget.

2.1.1 The Weak Influence of Taxpayers

The rapid increase in oil rents during the 1970s and early 1980s generated strong domestic pressure to increase the scope of government services. These offered or provided attractive channels through which governments could distribute oil income and raise living standards. On the other hand, the availability of large oil revenues has meant that there has been little need for regular taxation in Oman like other oil exporting countries in the region. However, partially because of this limited financial involvement and support, the population as a whole has little say or representation in the government. In other words, because taxpayers, as a body are not very important, they have very little political weight or influence in the conduct of the countries affairs. (Bideleux 1990, p.10). Rentier states are more concerned with spending revenue than collecting taxes, and they are relatively free from social and political pressures to spend money carefully. (Ibid. p12).

2.1.2 The Weak Forward Backward Linkages of Oil Sector

The availability of petroleum resources reduced the private sector's propensity to save and its demand for investment. As a result, Vaez-Zadeh stated that “the growth prospects of the economy would depend to a large extent than in other countries, on the activities of the government” (Vaez-Zadeh 1989, p.347). This finding highlights the importance of the composition of government expenditure for the growth

prospects of oil-based economies. Vaez-Zadeh argued “ whether oil wealth will act as a stimulate or a barrier to economic growth in the long run depends on the government's ability to take a leading role in expanding the productive capacity of the economy through appropriate incentive schemes for the private sector to help mitigate the adverse influence of oil wealth on private investment” (Ibid.).

In the same way, to understand the economic implications of the government intermediary in an oil rentier state, like Oman, an appraisal of the existence, strength, and reliability of various linkages effects of the petroleum sector is important and conclusions drawn from studies of other oil exporting developing countries are of interest.

The first conclusion suggests that the petroleum industry has tended to be relatively deficient in spread effects associated with production and consumption linkages. Obviously, the failure of petroleum to create production linkages was a direct result of the technology used in it, which is high capital and skill intensive (Pearson and Scott, 1970, p.173). Hence, in a developing country like Oman, petroleum industry input requirements were highly divergent from domestic factor supply. On the other hand, the failure of the oil industry to raise or generate consumption linkage could be due to its low labour demand as a result of its technology.

The second conclusion is that fiscal linkage in an export oriented economy are by far the most important means through which developments in the petroleum sector are transmitted to the rest of the economy. As Amuzegar has put it, “most studies suggest that, due to its high capital intensive and enclave nature, the oil industry in almost all developing countries generates few significant forward or backward linkages. The most effective means of transmitting the oil sector's growth to the rest of the economy is through the budget” (Amuzegar 1983, p.20).

The third conclusion is that the difference between production and consumption linkages on the one hand and fiscal linkages on the other is vital to the understanding of the unique problem the sector has in transmitting its growth to the rest of the economy. Production as well as consumption linkages' success or failure is worked out through the market mechanism while the success of fiscal linkages depends primarily on the government's ability and willingness to participate in the income originated in the petroleum industry (Pearson and Scott 1970, p.173). An assessment of export-led growth in petroleum economies suggests that Oman was obliged to rely primarily on fiscal linkage. This means that government finance has to play the leading role in initiating development.

2.1.3 The Strong Fiscal Linkage Through the Budget

Fiscal linkage was defined as “inter-sectoral effect associated with government expenditures of incremental revenues collected from expansion of given industries” (Ibid.).

The Omani government's financial performance has major ramifications for the entire economy. The financial flow is represented in four different types of expenditures: Current, defence, development expenditures, and contribution and support to private sector.

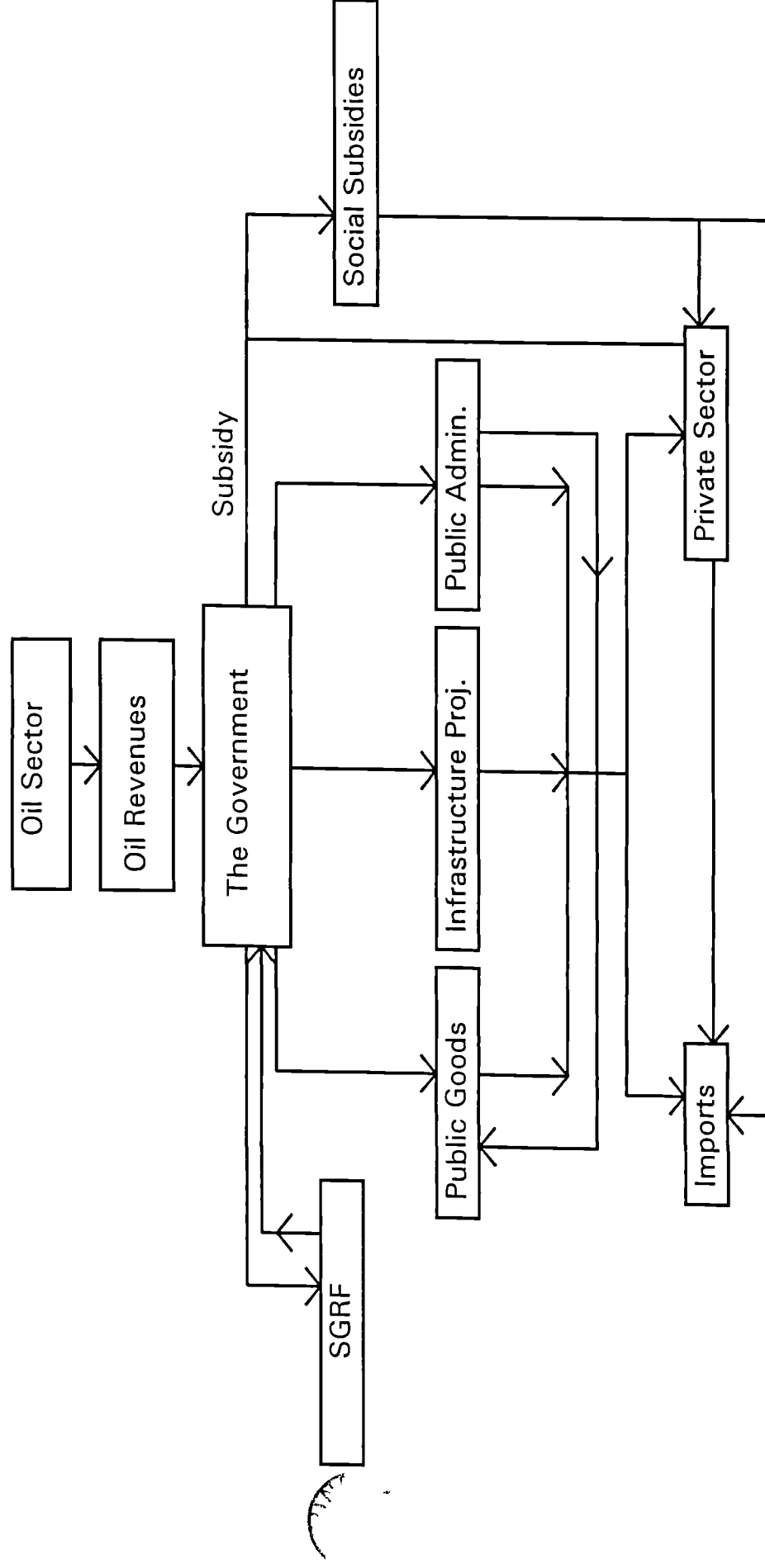
A major financial flow of dispersing oil revenues through expenditure is government employment. Citizens assumed recruitment in the state apparatus as a legitimate aspiration. Assuming social obligation to ensure the employment of its citizens, the government found that the easiest way is to create large bureaucracy to fulfil such an aspiration. Defence expenditures is directed to strengthen the army and security departments. With the development expenditure the provision of public goods and services represent an important tool of redistributing oil rent among the population. The development and expansion of the infrastructure absorbed a large share of the

government expenditure of this channel. A sizeable proportion of government revenues is spent on roads, schools and hospitals. The largest portion of the fourth channel of government expenditure goes to support private sector through soft loans and subsidies of rate of interest.

Chart 2-1 shows the main lines of financial linkages between oil sector and other sectors through government expenditures. From this chart it can be seen that the government uses oil revenues in five ways:

1. It provides public goods and services; education, health services, defence and security services, electricity, water and communications etc.
2. It establishes infrastructure projects such as roads, schools, hospitals, airports, seaports, dams etc.
For executing infrastructure projects and operating public units and enterprises that supply public goods and services, the government buys goods and services from the private sector and the external sector (through imports).
3. The government buys services from the public administration officials. They use the money to buy goods and services from the government (electricity, water, fuels, etc.) and from the private sector and the external sector.
4. The government pays subsidies for social, political and economic purposes. The individuals and the establishments use the money to buy goods and services from the private sector and the external sector.
5. The government appropriates 15% of its total oil revenues to build general reserves for future needs. It has been resorting to these reserves to finance its budget deficit.

Chart (2-1):
The Government Intermediary Between the Oil Sector and the Rest of the Economy
 (Government Non-Oil Revenues Excluded)



However, to examine the influence of government spending on the economy, the analysis of government expenditures in national income accounts is of great importance. The Gross Domestic Product may be looked upon as the aggregate of expenditures on currently produced output. Government contributes to these expenditures through its purchases of goods and services. As shown in (Table 2-1) government purchase of goods and services is a major component of GDP. 56.5% of total output was purchased by the government in 1986. Looked at from other end, 56.5% of goods and services when received by users are provided almost free of charge and paid for indirectly through the government budget. Thus, it can be recorded that over one half of total output is based on budgetary provisions.

In examining how budgetary provision fits into the economic structure, Musgrave distinguished between three types of government purchases:

- 1-Purchases of factors and purchases of products.
- 2-Provision for consumption and provision for investment.
- 3-Provision to consumers and provision to firms.(Musgrave, 1980, p.161).

The first and second distinctions are related here and can be applied to the Omani economy national account as follows:

1-Purchase of factors versus purchase of products:

Governmental factor purchase are represented in government wage payments. Government wage payments amounted to 60.2% of total government consumption purchase in 1986. The remainder is the purchase of consumption goods and services from local private firms and from abroad. The government wage bill can be assessed through its importance in total GDP and through the total wages bill of the economy. GDP reflects the total of production factor earnings. It may be broken down into income derived from, or “originated in” the government and the private sector. The

bulk of income originating in government is in the form of wages and salaries paid by government, i.e. it is equal to the share of government purchases which are used for factor rather than product purchases. Table (2-2) shows the volume and relative importance of government wages and salaries to total wage bill of the economy and total GDP in three years: 1985, 1986 and 1990. It can be seen that the government pays about 50% of total wages bill of the economy, and this constitutes about 14.5% of total GDP.

2-Provision for consumption versus investment:

The second distinction is between consumption and capital formation. Both private and government component of GDP can be broken down by consumption and gross capital formation. If structure only are included, the share of government purchases going to capital formation was about 41.2% of total purchases in 1986 (Table 2-1). But if the concept of capital formation should be defined broadly so as to include investment in human resource such as Education and Health, capital expenditure of the government comes to comprise a much larger share of public purchases. According to this approach, about 50.2% of total government purchases in 1986, and 38.8 in average during 1986-1990, was of capital formation type. Capital formation, it appears, is an important function of the government, a fact to be kept in mind in our later discussion of fiscal (or budgetary) policy objectives and effects on development and stabilisation.

2.2. The Objectives, and Policies of Budgeting in Oman

The word “budget” originally meant the “Money Bag” or the “Public Purse”; which served as a receptacle for revenue and expenditure of the state. In Britain, the term was used to describe the leather bag in which the Chancellor of the Exchequer carried to parliament the statement of the government needs and resources (Muller, 1979, p.97).

Table (2-1):

The Structure of Government Purchases
and Their Relative Importance

Particulars	1986 %	1987 %	1988 %	1989 %	1990 %
1.Gov. Purchases of Total Output	56.5	43.7	44.8	39.2	36.1
2.Gov. Wage Payments to Total Gov. Consumption Purchases.	60.2	60.5	58.6	60.3	60.2
3.Gov. Purchases of Goods and Services to Consumption Purchases	39.8	39.5	41.4	39.7	39.8
4.Gov. Capital formation of Total Gov. Purchases	41.2	30.4	27.0	23.0	20.9
5.Gov. Capital Formation of Broader sense to total Gov. Purchases.	50.2	41.2	37.8	34.2	30.6

Sources

1. DC, The assessment of the economic performance of the ThDP, Table 2-11,
2. MOFE, Final Accounts 1990, Table 9/1 p54, Table 9/2 p.57

Table (2-2)

The Volumes and Relative Importance of Government Wage Bill

Particular	1985	1986	1987	1988	1989	1990	1991
Government Wages (R.O. million)	477.9	495.8	509.9	535.2	548.7	658.6	669.5
Gov. Wages to Total Wages of the Economy %	49.7	48.1	54.1	53.3	53.2	54.3	51.8
Gov. Wages to Total GDP %	11.5	14.8	17.1	18.5	17.0	16.3	17.3

Sources:

1. DC, SYB, 1988, Table 236, p.465.
2. DC, SYB, 1994, Table (10-14), p.430.

Many definitions of the concept of the budget exist because of different financial, political, economic and administrative dimensions of the budget. All definitions of the budget concept revolves around three main elements:

1. The budget is a financial statement showing the statistics of the estimated figures of government receipts and expenditures.
2. It reflects the one-year programme of the economic and social development plan which may be extended to five years or less. Hence it is a one-year time-unit of this plan.
3. There is a strong connection and interrelated flow of data between the planning department and the budgeting department.

The financial law in Oman has defined the budget as “the financial programme of the plan for the coming financial year to achieve certain objectives in the framework of the general economic and social development plan according to the general policy of the state and which is approved annually according to the law” (Royal Decree No. 56/82). According to this definition the budget has two main uses: a) it forms the basis of the government’s longer-term financial planning of its own economic and social commitments; b) it is an instrument of the fiscal policy in regulating the level of aggregate demand and aggregate supply in the economy.

Before clarifying how the budget works in these two uses, the scope of this budget, i.e. the area which is covered by the government budget, must be defined.

The government administration consists of a number of ministries and government units, public non-financial authorities, public financial authorities, other state owned enterprises, and the Central Bank of Oman.

The financial law in Oman indicates that there is one public budget which covers central government administrative apparatus, the municipality units and the administrative departments of all the provinces of the country. At the end of 1991, there were some 25 domestic public authorities and public companies owned entirely by the government or jointly with the private sector (Table 2-3).

In 17 of these bodies, government participation is 51% or higher; of these majority-owned bodies, 14 are owned almost entirely by the government. In six cases, the government is a minority shareholder. Wholly or partly state owned enterprises are involved in a wide range of business activities such as banking, refining, mining, cement, transportation, telecommunications, agriculture, fisheries, hotels, insurances, etc.

The financial system of these public bodies is regulated by a financial circular issued in 1985. Each is required to keep its own special annual budget, which is annexed to the general budget.

The link between the general budget and the public bodies budget is represented in the financial flow that the circular has regulated. If the public body makes a surplus, it must pay dividends to the state general budget through the Ministry of Finance. If it shows a deficit it can receive a subsidy or loan from the state general budget. (Financial Circular No 6/1985). In addition, the public body can use its internal resources or borrow from domestic or foreign sources to finance its capital expansion (Ibid.). In other words, the state's general budget includes any capital subscriptions, loans, and subsidies from the treasury to state enterprises and any dividends, interests and loan repayments from them to the government, but not their commercial transactions. Government supervision of public authorities and companies is carried out through representation on their boards (as members or chairperson) of the officials from the ministry involved and the Ministry of Finance and Economy.

Table 2-3

Public Authorities and State Owned Enterprises at the End of 1991

Authorities and enterprises	Date of establishment	Subscribed capital (R.O.'000)	% of share owned by government
Central Bank	1975	175000	100
Telecom	1975	50000	100
Golf Hotel	1974	2000	32.1
Oman Aviation	1981	7000	35
Bank of Agriculture and Fisheries	1981	19000	99
Oman Cement	1977	41429	99.9
Oman Development Bank	1977	1000	54.1
Oman Fisheries	1989	12500	24
Oman Flour Mills	1975	10500	60
Housing Bank	1976	30000	61
Oman Mining	1978	25000	99
Oman National Insurance	1977	5000	15
Oman National Transport	1975	6000	99.9
Oman Refinery	1983	30000	99
Port Services	1975	4800	35.6
Raysut Cement	1981	8000	20
Marketing Agricultural Production	1985	9807	100
Salalah Hotel	1978	2500	99.9
Al Bustan Hotel	1985	N.A.	100
Inshirah Restaurant	1987	N.A.	100
Muscat Intercon Hotel	1987	N.A.	100
Storage and Food RSV	1980	N.A.	100
Rusail Indus. Estate	1983	N.A.	100
Seeb Novotel	1982	N.A.	100
PDO	1980	N.A.	N.A.

In addition to the ordinary ministries and public authorities that seek for profit, there is another kind of public authority which is administratively independent and does not seek for profit, such as Majlis Al-Shura and Sultan Qaboos University. They are included in the state's general budget.

In short, the Omani government has one general budget called the state general budget. Profit-seeking public authorities and enterprises have their own balance sheets which must be annexed to the general budget. Non-profit-seeking authorities which are not financially independent are included in the state general budget.

After defining the budget, the objective, policies and the organisation of the budget must be discussed.

From the above definition of the budget as the “financial programme of the plan for the coming financial year to achieve certain objectives in the framework of the development plan and according to the general policy of the state”, three main elements can be abstracted:

- 1-The budget is the annual financial programme of the plan.
- 2-The budget seeks to achieve certain objectives.
- 3-These objectives are deduced from the economic and social development plan, according to the general policy of the state.

The development plan referred to shall be regarded as a reference guide for the planning and implementing of government financial and economic policies, without prejudice to the rules and procedures for approving and issuing government budgets and procedures followed in the approval of projects in accordance with the Economic Development Law, 1975. (Royal decree No. 32/1976, concerning the sanctioning of the Five-Year Plan 1976-1980).

Therefore, to see how the main objectives of the development plans are reflected in the budget, the objectives of the development plans must be examined.

The objectives rest on the socio-economic strategy of the state which was declared by the Development Council in February 1975 (see Chapter I p.5). This strategy consists of the following main targets:

1. To develop new sources of national income to augment and eventually to replace oil revenues.
2. To increase the ratio of national investments directed to income generating projects, particularly in manufacturing, mining, agriculture and fisheries.
3. 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 assuming a special priority to the least developed areas.
4. 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.
5. To attach high priority to the development of local human resources.
6. To support commercial activities by removing market deficiencies, particularly in the areas of transport, communications, storage, and other obstacles to competitive trading, with a view to enhancing the emergence of competitive market and to maintaining a reasonable level of prices.
7. To provide for the creation of a national economy based on private-enterprise and free from monopolistic practices.

The long-term strategy does not change from one five-year plan to the other. Naturally, the emphasis and priorities attached to each of these targets do change from one-five year plan to the other in accordance with the achieved stage of development.

This strategy put an emphasis on achieving the basic requirements of a free economy led by an efficient and capable private sector. It stressed the diversification of the economy by developing the income generating projects specially in the fields of agriculture, fisheries, industry and mining. It highlighted the importance of human resources and the effectiveness of the government administration. It paid attention to the significance of the wider geographical distribution of investment between regions in order to narrow the gap in the living standards between these regions.

Since 1975, four development plans have been executed. The main aims of these plans were deduced from the strategy above. Since the focus of this thesis is on the third plan, the main short-term targets of this plan are highlighted as follows:

1-To achieve an average growth rate of 4% in national income in expected prices.

Economic growth should exceed the population growth rate.

2-To achieve equilibrium between the resources of the state and their uses by applying suitable and necessary steps which will reduce government expenditure and redistribute the available resources accordingly.

3- To give priority to the development of natural water resources and to the income generating projects in such sectors as those of agriculture, fisheries, manufacturing, mining, and natural gas.

4- To increase the daily crude oil production to 550,000 barrels in 1986 and 1987, and to 575,000 barrels per day during the next three years (1988-1990).

5- To expand regional development in the field of social services, such as education, health, vocational training and housing.

6- To fix an amount of RO 1483 million as the total development expenditure for the civil ministries, of which RO 753 million would be for the on-going projects and 730 for new projects.

7- The plan has allocated RO 120 million to encourage the private sector and to create a suitable atmosphere for contribution to the development of the country's economic activities.

- 8- To set RO 299m as the ceiling for government borrowing.
- 9- To give due attention to the completion of the public infrastructure within the available resources and to attach high priority to sanitary drainage projects, drinking water services, electricity, means of communication and the establishment of local markets. (DC, ThDP, pp 48-49).

Subsequent to the issuance of the plan in January 1986 the oil prices started to decline and during the six months that followed there was an oil price crisis. The price of Omani oil declined till it reached US \$8/barrel in July 1986, whereas the average price during 1985 was US \$27/barrel. Consequently, a decision was taken to devalue the Omani Rial against the Dollar by 10.2% on 25 January 1986, and to reduce government expenditure in the plan by 10%, except for those sectors which rendered services to the public, such as education, health and social affairs.

As a result of these variables, the targets of the short term policies of the plan were reformulated and they are summarised as follows:

1. To stand against the decline of oil prices.
2. To stabilise the economy and assist the private and government sectors to cope with the new environment.
3. To limit reduction in the national income in 1986 and to sustain it thereafter, while attaining modest development in the following years of the plan.
4. To tackle the deficit in the budget of the country which was caused by the decline in oil prices.
5. To concentrate on increasing value added in the non-oil producing sectors so as to compensate for the reduction in revenues caused by the fall in oil prices.

The figure-targeted by the plan were broken down into the annual programme (the budget). Plans provide a conceptual framework and represent a thinking process, but budgets are operational documents. "It is generally agreed that planning is of two

types: substantive planning or development planning, and fiscal planning. Development planning is concerned with the planning of social goals and objectives and the mobilisation of natural, human and financial resources needed for their achievement. Fiscal planning, which is one of the tools of substantive planning, consists of planning the future budget, current and future budget decisions, the implications for financing and the methods of obtaining the necessary resources and allocating them in accordance with overall national goals” (Premchand, 1983, p.176).

The previous goals of budgeting fall in those categories – Musgrave has called them the budget functions – allocation, distribution and stabilisation.

- 1 Allocation function, i.e. the provision for social goods, or the process by which total use of resources is divided between private and social goods and by which the mix of social goods is chosen.
- 2 Distribution function, that is the adjustment of the distribution of income and wealth to assure conformance with what society considers a “fair” or “just” state of distribution.
- 3 Stabilisation function which means the use of budget policy as means of maintaining high employment, a reasonable degree of price level stability and an appropriate rate of economic growth, with allowance for effects on trade and on the balance of payments. (Musgrave, 1989, p.6-7).

The question may be raised here: on what budgetary theory the budget policy in Oman is based? Is it based on Keynesian theory or on the monetarists’ theory?

Keynes believed that the government is the only mechanism with the ability to play the role of stabilisation factor for aggregate demand. If the economy is in recession and suffers from lack of aggregate demand, the government must apply a certain package of fiscal and monetary policies and inject the economy with motivating doses so as to increase the effective aggregate demand. For this purpose, he called for interest rate

reduction in order to absorb the unemployed workers and to raise the volume of demand on consumption and investment goods. This policy may lead to a budget deficit, but according to Keynes, it is not important. In the case of full employment when the economy is threatened by inflation, the government must apply a certain package of fiscal and monetary policies in order to absorb the excess demand. He called for high interest rate, tax increase and government expenditure cuts which would create a surplus in government budget. In this way Keynes explained that the point is not to stress the principle of annual balance of the budget, but the long term balance of the budget which could last the whole business cycle of about ten years.

Keynes provided the theoretical justification for government intervention in economic activities thus he gave the government budget and public finance as well as the monetary policy a critical importance on the management of the economy.

Opinion prior to this was that the government should operate a balanced budget policy, allowing the economy to respond in its own way without government intervention. This opinion was continued by the New Classical School, who expressed its rejection of Keynesianism since the beginning of its emergence in 1936. This school believed in a strict version of economic liberalism.

The “Chicago School”, also known as monetarism, which was one of the salient stream of the New Classical School, had led the attack against Keynesianism and the principle of government intervention in economic activities. It blamed all the problems (Crisis) facing the economic system on Keynesianism and its economic policies.

The most important feature of this school which is represented in Milton Friedman’s view is its strong emphasis on money and monetary policy.

Milton Friedman's and his supporters attributed all economic problems of the system, such as inflation, unemployment and stagflation, merely to faults in monetary policy which was aggravated by Keynesian policies of economic intervention. Thus the central aim of economic policy is to struggle against inflation i.e. to achieve monetary stability not full employment which was a top priority of Keynesian economic policy. Monetary stability can only be achieved through a strict monetary policy and the control of the growth rate of the quantity of money relative to the growth of real national product. In order to achieve this goal the main sources of excess money supply has to be checked first. According to Friedman and his supporters, the most important source is the increase of budget deficit (Ibid.). Therefore the economic policy should aim for decreasing the ratio of budget deficit to GDP gradually. This will only be possible through tangible cut in government spending.

Budgetary (fiscal) policy in Oman as a developing country and oil exporting country is not normally based on Keynesian theory. This theory was designed to address problems originated in Western industrial countries. Those problems were represented in a shortage of aggregate demand against aggregate supply, unemployment and recession.

Monetarism, on the other side, is based on the confining of government intervention in the economic activity and the reduction of tax and interest rate and focuses on monetary stabilisation.

However, the problems and characteristics of Oman are different. On the one hand Oman started its development plans with its economy suffering from lack of basic economic and social infrastructure, lack of skilled labour and technology, lack of adequate education and high rate of illiteracy. On the other hand, as has been mentioned earlier, a large fraction of the value of oil exports consists of state revenue.

The state revenue is initially sterilised in the form of state owned foreign assets, that are not matched by income and asset accumulation in non-government sector.

Under these conditions, the collection of oil revenues has no direct effect on the income of residents. The excess of local expenditures will add to domestic income, while the growth of money will expand liquidity. The demand for imports will be stimulated, and the inflationary impact will be partly offset by reduction in the balance of payments surplus. "Because imports and home goods are not a perfect substitute, as some economists argue, spending on home goods also will be stimulated and prices will tend to rise. However, a country with a strong export position resulting from enclave production suffers less from inflation than other countries do" (Goode, 1984, pp.278-279).

Oman budgetary policy is aimed to affect both sides of the economy: supply and demand.

1-Supply Side:

Policies to augment aggregate supply have played a considerable role in the recent growth performance. Through the budget the government tried to raise the country's growth potential by channelling growth investment in the proper direction considered necessary by the government and to direct and encourage private investment. Through the budget the government tried to make the proper utilisation of economic resources because the problem of economic growth requires proper participation between the private sector and the public sector. In the total available productive resources government was using the budget to support the private sector to play its role in the economy.

Its development expenditures in the plan mentioned above represented 23.5% of total government uses, while the government's share in PDO development expenditures

represented 28.2% of total development expenditures (DC, ThDP, p.62). The plan has allocated an amount of R.O. 88m to support the private sector and financial institutions (specialised banks) (Ibid. p80). The government continued developing the educational and vocational training centres to meet the country's economic need for human resources. It stressed the importance of secondary and high level technical education.

2-Demand side:

The government development plan tried to regulate purchasing power in accordance with the over-all pattern specified in the plan. Government expenditures both current and development, aimed to modify the inequality of income distribution. According to the plan one of the objectives was to expand the scope of regional development in the under-developed Wilayats to reduce the gap in the standard of living and to upgrade the social services, specially in the health and social housing sectors (Ibid. p72). The government subsidises through the pricing policies some of the public utilities such as electricity and water. On the other hand, there are no indirect taxes such as sales taxes or direct taxes on individual income. There are no user charges on health services or education.

However, on the demand side, the fiscal policy is not directed to increase aggregate demand and employment. The priority or more stress is on the supply side to encourage the production of goods and services. Oman, on the one hand is still characterised by many features of underdeveloped countries: insufficient infrastructure, limited endowment of skilled labour and a large proportion of the population in economic sectors where productivity remains low. On the other hand, new problems have emerged such as budget deficit, balance of payment deficit, wages that rose beyond labour productivity, inefficient industries, decline of traditional exports, waste, stagnation in non-oil exports, increasing dependence on imports, and rural migration to towns and cities.

Oil revenues help to some extent to remove one constraint on development, the financial one, but this does not, of itself, remove others, such as lack of managerial, administrative, and entrepreneurial talent, and of infrastructure. Investment drives on the ports, for example, did not remove the bottleneck of congestion completely.

In brief, measures to augment aggregate supply involving the easing of key bottlenecks have a critical but limited role to play in restoring efficiency and effectiveness of the private sector.

On the demand side, there are still discrepancies in income distribution. The civil service system is biased towards upper administration officials and against the low-salary officials. The regional distribution of investment, specially private investment, is still unfair.

However, the objectives and policies of the budget do not give a broad enough picture of the importance of the government budget within the area of public finance in Oman. The organisation of the budget process, i.e. the budget cycle, its classification or techniques, and its structure demonstrate the significance of the budget in Oman. These topics will be discussed below starting with the budget cycle.

2.3 The Organisation of Government Budgeting in Oman

In 1970, the government started regulating its financial system in the framework of a comprehensive organisation encompassing all sectors.

Regarding the financial system of the government, a rough assessment of revenues and outlays was prepared according to which the first budget was issued. In 1971 a more accurate assessment of resources, and current and capital spending was prepared. In 1973, in the framework of the process of adapting modern systems for the sake of

building a modern state, the first financial government account of the 1972 budget was issued. After a long process of adjustment, the first budget had a scientific basis, prepared according to modern technical methods of categorisation and classification. It was issued in 1976.

Three related topics will be discussed here. They are:

- The budget cycle.
- The classification of the budget: the budget techniques.
- The budget structure.

We will now examine these topics in turn:

2.3.1 The Budget Cycle

It is necessary that budgeting is processed through a cycle to enable the government to secure accountability for its actions. The budget cycle in any government should be marked by a flow-up and flow-back of decisions with a view to creating a two-way communication. The budget cycle usually consists of four phases: preparation, approval, execution and audit. Let us look at these phases in the Oman budgetary process.

A-Preparation

The financial year of the government in Oman starts on the first of January and finishes at the end of December. According to the financial system law of the Omani government, the preparation of the budget takes four steps:

- 1 A financial circular is issued by the Deputy Prime Minister of Finance and Economic Affairs in July of each year. This includes the regulations that must be followed by all the ministries and government departments regarding the preparation of their budget. It is called The Budget Circular No 1/19.
- 2 In each ministry or department, a special committee is formed to prepare its draft budget.

- 3 The Ministry of Financial and Economic Affairs has the task of preparing the draft of the general budget of the sultanate after examining the draft of all ministries and government units.
- 4 The Council of Financial Affairs takes charge of the financial discussion of the draft budget. (Royal Decree No 56/82, articles 10, 12, 13, 15).

It is essential to co-ordinate the efforts of all participants in the budgeting process. Therefore each unit must know its role and the role of others. This requires a means of communication before and during the budget process. According to Premchand, “the budget circular should convey the national goals, state the economic prospect of the country and reflect the policies proposed”. (Premchand, 1983, p.143). It seems that the financial circular in Oman provides the medium of communication and co-ordination between several government units, because it “includes the regulations that must be followed by these units”. It states that these units should prepare their draft budget in the “light of planned targets that they are required to achieve according to the public policy of the state” (Royal Decree No 56/82). In other words the budget circular consists of directions that define the budget policy which reflects the interests that the government assigns to different economic sectors (Abdul-Ghafour 1992, p72).

However, the quality of this co-ordination depends, on one hand, on the extent to which these regulations are sufficient and clear. On the other hand, it depends on the ability of the administrative unit to transmit the planned targets to accurate annual transactions. Furthermore, in the process of budget formulation, spending agencies work according to the direction of the control agencies, while the control agencies are responsible for economic and financial policies and the management of the economy. The acceptance of this relationship has provided the finance authorities with great power as well as planning influence. The Ministry of Finance and Economic Affairs depends on the participation of other agencies to achieve co-operation and success in its own operations. Thus the preparation of the general budget draft in the Ministry of

Finance in Oman involves the “examining of the draft budget of several ministries and government units and co-ordination must be considered” (Ibid.). Yet, as Premchand has stated, “different perceptions of how much expenditures can and should be reduced will lead to the emergence of competitive interests among the central and spending agencies. Spending agencies believe in the importance of their own programmes, which may, nevertheless, not be important on a national scale. Thus there is a possibility of conflict” (Premchand, 1983 p150).

The Omani financial system law has stressed that the draft budget must remain within the financial bounds of the development projects approved by the plan (Royal Decree No 56/83).

Revenue estimates are considered here in relation to the formulation of the following years' estimates. These estimates must be made before passing the expenditures' ceiling to the spending agencies. Revenues and the level of deficit constitute the policy variables which define the broad level of expenditures. Special attention should be paid to the formulation of revenue estimates because they facilitate the consideration of the expenditures' policy options. This point is of great interest to an oil producing country. During the second half of the seventies the oil prices were going up. Oil producing countries found it easy to estimate their revenues. Consequently these countries did not put strict ceilings on their expenditures. However, in the early eighties when oil prices started to decline, it was difficult to make an accurate formulation of their revenues. When oil revenues started to go down, the oil producing countries found it hard to adjust their expenditures. Moreover, the implementation of the development plans became uncertain. Oman had designed its third development plan (1986-1990) according to 1985 oil prices, the average of which was \$27 per barrel. However, in 1986 the oil prices sank to \$13 /barrel, thus the government was obliged to introduce significant changes in its plans. Public expenditures were brought down by 10%.

From the above considerations, it is obvious that the objectives of the government should be the starting point for the formulation of programmes, policy guidance, resources constraint and good judgement regarding expenditure programmes.

B-Approval

This phase depends to a large extent on the political system. Under some political systems the budget is essentially approved by a legislative body. However, the executive sometimes play a prominent part in the authorisation of the budget. The authority of the executives in this phase of the budgetary process varies from country to country. "These may be full authorisation of the budget by the executives with formal legislative sanctions, or a limited determination of the budget by the executives with legislative scrutiny and approval, or there may be advisory budgetary proposals by the executives subject to legislative initiative and action" (Buck, 1934, p. 87).

In Oman the Deputy Prime Minister for Financial and Economic Affairs submits the draft budget, for approval by His Majesty the Sultan after the final discussion by the Council of Financial Affairs. This happens in December each year. His Majesty the Sultan approves the budget in a royal decree which makes a public financial order to all public finance officers in the country on how to conduct their spending (Royal Decree No 56/82).

Although there is a consultative council (Majlis A-Shura) which has the right to discuss social and economic affairs, it still not authorised to discuss and approve the state general budget.

C-Execution

Execution of the budget in the government is ideally seen as a co-operative effort between the participants of several levels of government and the agencies at each level.

“The initial aim during the implementation of the budget is to guarantee the fulfilment of the financial and economic aspects of the expenditures” (Premchand, 1983, p.351)

The budgetary and economic tasks are achieved through four major steps:

- a) An allocation system under which expenditures are controlled by the release of funds.
- b) Supervision of acquisition of goods and services to ensure value for the money spent.
- c) An accounting system that records government transactions and provides a framework for the analysis of their implications.
- d) A reporting system that permits a periodic appraisal of the actual implementation of the policies (Ibid, 1983, p.358).

For the estimation of revenues and expenditures in the Oman budgeting process, there is a set of forms used by all government administrative units covered by the regulation of the financial law. There are eight forms, four of which are for the estimation of the four type of revenues, while the other four are for the estimation of the main types of expenditures.

The financial circulars No. 9/83 and 3/84 concerning the control on government receipts and expenditures have organised complementary regulations and a set of documents for recording and accounting, and therefore controlling the government transactions. However, the problem in such a case is that the routine usually attracts more attention than the real objectives.

The administrative and budgetary tasks must be integrated; they must be performed together with a view to securing legal accountability, and the efficient and flexible use of resources. The agencies are responsible for compiling a review of their own performance of the budgetary and economic tasks they need to achieve. The purpose

of the spending agencies' review is to examine the financial trends and assess the effectiveness of their own administrative policies. The Ministry of Finance and Economic Affairs submits to the Council of Financial Affairs a monthly report showing the state's actual spending on each budget item, the balance of the government's account in local and foreign banks, the balance of receipts and repaid loans and grants, the balance of standing commitments and others which are necessary to show the fiscal position of the state (Royal Decree No 56/82). Neither the financial system law nor the financial circular of expenditures audit has obliged the other government units to make similar performance reports.

For the implementation of the budget programmes, funds may be made available by various central agencies for different periods. Some constraints may be placed on the use of the funds in certain projects, which may entail a prior approval by the central agencies for the release of funds.

With respect to current expenditure, according to the financial system law, no government unit may exceed its allocations. Transferring from one item to another is also not allowed, except for very limited cases.

Regarding development expenditures, exceeding the allocations for a development project is approved up to a limit of 10% more than the cost projected in the development plan. Conditions for approval are set out in a contract approved by the Adjudication Council (Ibid.).

Finally, if the royal decree concerning the approval of the budget has not been issued before the beginning of the financial year, the financial law permits spending within the limit of the previous year's appropriations.

D-Audit

Financial control and audit have been given a large legislative effort in Oman. In 1982, the financial system law was issued. It assigned to the Deputy Prime Minister the following responsibilities:

- 1- The approval of the accounting system to be applied by all public finance officials in the Sultanate.
- 2- Devising the most suitable financial records and forms, and generalising and unifying their application.
- 3- To ascertain that all public finance officials keep records and forms and that they register all official transactions at the proper times according to the budget classification, in order to facilitate the examination and auditing of any of them at any time. They must also apply the laws, orders and regulations related to the financial affairs in a correct manner.
- 4- To verify that taxes and fees are imposed and collected according to orders, laws and statements.
- 5- To verify that complete precautionary procedures are undertaken to keep the state assets, properties and records in safe conditions so as to prevent any fraud, forgery or embezzlement from financial officials.
- 6- To verify that all records, tables, and data are provided to the ministry at the proper time and in a correct form. (Royal Decree No 56/82).

In 1983, the Deputy Prime Minister of Financial and Economic Affairs issued the financial circular No 9/83 concerning the control on government revenues: oil revenues, taxes, fees, etc. It emphasised that any receipt must be made according to legislation. It focused on the co-ordination between the Ministry of Finance and other government units concerning the definition of fees and the prices of goods and services provided by these units. It obliged all government units to send their receipts to the Ministry of Finance each day or at agreed times unless the unit was permitted to open its own bank account. It prevented all units from spending their receipts on any kind

of expenditure. According to the circular the Ministry of Finance had to keep complete records of the projected and actual receipts of all government units and these had to be classified according to the budget order. (The Financial Circular No 9/83).

In 1984, the Deputy Prime Minister of Financial and Economic Affairs issued the Financial Circular No. 3/84 concerning the controls on the government's expenditures. It defined government expenditures as the current, capital, and development expenditures. It requested the chiefs of other government units to inform the Deputy Prime Minister and the Diwan of Royal Court about the names of officials authorised with spending and about the limits of their jurisdiction. Spending commitments had to be in accordance with the relevant laws and regulations, specially the Contract System law. These commitments had to be within the limits of the approved appropriations of the annual budget with respect to current and capital expenditures. Regarding development expenditure, the commitment had to be within the limit of approved costs. Government units were obliged to send any payment deed, supporting evidence and documents showing all details in a manner that facilitated the auditing process. The Ministry of Finance and Economy audited all deeds before paying to be sure that all the prevailing laws, regulations, and systems in the sultanate were applied.

After issuing these financial circulars, the Directorate General of Expenditures was established in the Ministry of Finance and Economy to fulfil the spending control function of the ministry. The two above mentioned circulars provided a documentary and logical organised system for after-spending control in government finance.

If this system is to be viewed from the Ministry of Finance's side, it is an external audit. In other words, other government units consider the Ministry of Finance and Economy as an external auditor. However, if the Ministry of Finance and all government units are to be viewed as one body (as they are in reality), that is the executive authority, then the above auditing system is an internal ante-spending audit system.

In 1991, the Law of State Financial Audit was issued by the Royal Decree No. 129/91. It defined the aims of the Secretariat General, which was created by this law, as follows:

- 1- Co-operation with the financial departments covered by this law to protect public properties of the state. The secretariat provides financial audit after spending to ascertain the soundness of financial transactions and accounting records and the following of financial laws and systems.
- 2- The discovery of financial deviations in units covered by this law.
- 3- Drawing attention to inefficiencies and shortcomings in the applied laws and financial systems and suggesting of required reforms.
- 4- The evaluation of the development projects performance, and the confirmation of efficient utilisation of resources.

The Secretary General is appointed by royal decree. The Secretariat General has its own budget, included as one item in the budget of Diwan of Royal Court. The Minister of Diwan of Royal Court oversees the Secretariat General. The law defines the covered units as follows:

- All units comprising the administration system of the state, independent government units and departments whose budgets are included in the general state budget excluding that which has been exempted by royal decrees.
- Public authorities and companies and all units that are wholly owned by the government or it shares in their capital.
- Private authorities and units in the Sultanate which are subsidised by the government or public authorities.

According to this law the jurisdiction of the secretariat includes: reviewing both receipts and spending; reviewing the decisions related to appointing and promoting government officials and remuneration; following up the implementation of development plan projects according to their projected costs in relation to the time

agenda; examining and evaluating the results of the achievements of these projects-ascertaining that resources have been used effectively; examining the government final accounts; examining what might be ordered by His Majesty the Sultan to be reviewed.

The Minister of Diwan of the Royal Court, who oversees this secretariat, submits the special issues from the units concerned to his Majesty the Sultan.

The secretariat must prepare an annual report comprising the following issues:

- The discovery of any contraventions in the units subject to this law and also opinions concerning the procedures and penalties that have been carried out.
 - The secretariat's observation on the government's final accounts.
 - The overall evaluation of the development projects.
 - All observations related to the question of the efficiency of the financial laws and systems and of the public finance officials.
 - Any other issues emerging through the reviewing process of the past financial year.
- (Royal Decree No 91/29).

This law, then, provides the post control which usually aims to promote the effectiveness of future administrative and financial performance. It includes all the necessary aims. It covers current, capital and development expenditures and seeks to evaluate the implementation of development plans and the efficient use of resources. However there are two points of which hinder the effective financial control of the Secretariat General of State.

First, in the light of the wide range of its duties, its administration capacity has to be supported by a number of efficient qualified staff.

Second, taking account of the size of the task that it is required to carry out, according to its law, it needs more authoritative power as an external auditor. Accordingly, its

independence needs to be strengthened, that it needs to be connected directly to the highest political power. Once these two points of reform have been carried out, the outcome will be one of a valuable feedback on the performance of the public financial system.

2.3.2 The Classification of the Budget; the Budget Techniques:

The budget has several functions: allocation, distribution and stabilisation. It is also a tool of management, a tool of accountability and an instrument of economic policy. Hence, it must be organised in a manner in which these functions can be secured.

Broadly speaking

growing state intervention in economic and social fields has been the underlying cause of increasing public budgetary responsibilities. The diversification of government units, activities and functions in response to more and more specific purposes has made the classification of the public budget a matter of increasing importance. This has meant that the public budget necessarily had to be formulated as a unified and comprehensive statement comprising public expenditure and public revenue. Particular attention had to be paid to the method of presenting the budget in a clear form so as to be intelligible and easy to analyse, especially as economic planning has come to be involved. This has imposed on the public budget a mode of formal economic incorporation (Al Sayyid, 1964, p.487).

Budget data and transactions can be divided according to several scientific classifications, each of which can serve a single purpose or a variety of purposes. Given the diversity of purposes however, no single classification could have served all purposes. So as to examine the different types of the classifications of the budget, the purposes of classifications and scientific classification will be discussed first:

A-The purposes of budget classification

There are four main purposes of the scientific classification:

- I Facilitating programme formulation. The budget account should be arranged in a manner as to show obviously the programme decisions that have been made.
- II Achieving efficiency in the budget execution. A budget classification is required which provides a means of measuring the degree of efficiency of the execution of the budget and a comparison of the efficiency of that same programme with previous one.
- III Serving the purposes of accountability. Public activity is undertaken by certain organisational units. Collecting and spending government revenue is done by specific officers. Thus it is necessary to classify the budget in a manner that define these responsibilities accurately.
- IV Studying and analysing the economic effects of the many activities undertaken by the public economy units. (Arabic Organisation for Administrative Studies 1970, p.20).

B-Scientific classification of the budget

Government intervention in the economic field and its involvement in planning brought about the development of what is known as budget economic classifications. Budget statements can be organised by putting all financial transactions which serve a particular purpose in one group. Therefore, classifying the budget is done according to its purposes, and its type of services and functions. There are other bases for the classification of the budget. These consist of a group of practical considerations: political, administrative, and organisational. According to these bases, classifications are known as procedural, administrative or institutional, and for particular purposes there are sectoral and regional classifications of the budget.

Before presenting how these different types of classifications are applied to the state's general budget, it is necessary to show the summarised statement of this budget which is known as schedule No 1 (see table No 2-4).

This table summarises the budget in three main sections:

- 1 Revenue, which consist of five items: net oil revenues, gas revenues, other current revenues, capital revenues and capital repayments.
- 2- Current and capital expenditures, loans and participations.
- 3- The means of financing, i.e. the way in which the government finances its deficit - such as through borrowing, withdrawal from SGRF and grants or, as is less likely, utilises the surplus.

Loans, some participations and borrowing are not included in the budget tables, and, therefore, they do not appear in budget classifications. They belong to Fiscal Stance Accounts. (Al-Sayegh, p14).

2.3.2.1 Traditional classification

This classification is called traditional because it belongs to the state's structural configuration. The first forms of the budget were classified in this way. Some states call such a budget 'the administrative budget' or 'the line-item budget'. It can be defined as “a form of budgeting in which there is a high level of legislative or executive control over individual objects of expenditures in large organisations” (Lewis 1988, p.7). Yet objects of expenditure are fundamental elements in formulating and executing a budget at the lower level of organisations. Administrative classification, or classification by organisational units, produces state accounts on the basis of these units. This classification aims to aggregate expenditures according to their types internally in every administrative units.

Table No.(2-4). Schedule No. (1)
State's General Budget For the Financial Year 1988
(Amount In Million of Rial Omani)

Particulars	Budget	Estimates
First: Revenue:		
1)Net Oil Revenue		1065.3
2)Natural Gas Revenue		43.0
4)Other Current Revenue (Schedule No.2)		202.7
3) Capital Revenue (Schedule No.3)		3.9
4)Capital Repayments(Schedule No.3)		35.4
6) Total Revenue (1+2+3+4+5)		1350.3
Second: Expenditure and Lending & Participation:		
Current Expenditures:		
7) Defence & National Security	532.6	
8) Civil Ministries (Schedule No.4)	533.0	
9) Interest on Loans	84.0	
10) Government Share in PDO's Current Expenditure	70.0	
11) Total Current Expenditures (7+8+9+10)		1219.6
Capital Expenditures:		
12) Project Expenditure for Civil Ministries (Schedule No.4)		
13) Exploration of Natural Gas	245.0	
14) Government Share in PDO's Capital Expenditure	6.3	
15) Non Project Capital Expenditure for Civil Ministries. (Schedule No. 4)	74.0	
	12.0	
16) Total Capital Expenditure (12+13+14+15)		337.3
Lending & Participation:		
17) Industrial Sector	8.0	
18) Oman Housing Bank	7.0	
19) Oman Development Bank	2.0	
20) Oman Bank for Agriculture & Fisheries	5.0	
21) International Regional and Domestic Establishments	23.4	
22) Total Lending and Participation (17+18+19+20+21)		45.4
23) Total Expenditures, and Lending & Participation (11+16+22)		1602.3
24) Net Surplus (deficit) (6-23)		(252.0)
Third: Financing:		
25) Net Borrowing		
Loans Receivable	178.0	
Loans Repayable	<u>123.0</u>	55.0
26) Net Grants		3.0
Total Financing (25+26)		58.0
Balance Deficit(24-27)		(194.0)

Source: Ministry of Finance, The State's General Budget 1988. Page 5

Incrementation is the main characteristic of this system. The concept of incremental budgeting is defined by Charles L. Schultze as “The system whereby budget reviews examine only those items for which increases over the prior year are requested. Unless a new programme is proposed, there is no examination of basic programme structure or performance. It does not bring up alternatives. It does not lend itself to the periodic examination of the objectives of other programmes”. (Schultze, 1966, p.79).

From the above account we infer that line-item budgeting focuses on accountability, control and items of expenditures, not on the quantity of required services. The current conceptions of accountability are those of political accountability, managerial accountability and legal accountability. With the adoption of “the executive budget system” the legislative authorities were compelled to concentrate on funds as a means of control over state activities.

Line items or administrative or organisational classification has a number of advantages:

- I- It is necessary for the ministries preparing the budget to undertake their tasks through their internally organised services. It is also a requisite for the budget approval of the legislative authority and for the determination of the budget. This classification is characterised by simplicity. It involves preparing estimates for every organisational unit, determining unit execution responsibilities and following the changes faced by every organisation unit from year to year.
- II- This classification concentrates on the accounting aspects of governmental transactions. Governmental services need and purchase similar articles, such as personal services, clothing, publications, repairs and furniture, etc. This classification helps lay down a unified system of accounts for all state activities.
- III- The classification of expenses, on the basis of what the subject necessitates, creates a unified system of accounts.

IV- This classification helps to restrict spending in order to control the activities of the executives and facilitates personal management. In addition, this system is marked by flexibility since it facilitates the transfer of allocations from the items of one activity or enterprise to other activities listed in the same programme. (Abdullah, 1991, pp. 103-104).

The budgeting techniques in Oman adopted this system. In October 1987 the financial circular No. 8/87 was issued concerning the classification of the budget of the sultanate. According to this circular, the budget was divided into two chapters: the first, for revenues, and the second for expenditures. Each chapter was divided into sections, items and subjects in a version compatible with the Government Finance Statistics (GFS) which was designed by the International Monetary Fund (IMF). Current non-oil revenues are classified in this way. According to this classification the volume of non-oil revenues is broken down between ministries and public authorities according to their annual contributions (see appendix 1).

Current, capital and development expenditures are broken down according to all several government units (see appendix 2). It is helpful to make a comparison between the allocations made to these different units. From this system, the financial legislator has aimed to obtain the following objectives:

- 1- The achievement of the comprehensiveness principle of the budget, i.e. the budget includes all government revenues and expenditures, and not to earmark special revenue for special outlay; unless a special royal decree is issued for certain cases.
- 2- The distinction between current and development expenditures.
- 3- Assigning separated items for salaries and wages (Royal Decree No.56/82 article 19).

The Ministry of Defence, the Royal Oman police and other security units, according to the same decree (article 23) are not included in any type of classification because of

their special status. The allocations of all security units are presented as one item without further details.

This kind of classification has some disadvantages:

- I- Attention centres on expenses within the limits of specific allocations, while the link between the expenditure, performance and the real result of this material process is ignored. There is a high level of legislative control over individual objects of expenditure in large organisations, hence control is too highly centralised. In short, the focus in this system is on control and the legality of expenditures.
- II- It does not facilitate the economic analysis of individual transactions within the government's financial activities. While this classification aids the enforcement of legal accountability, it does not provide useful information for the purpose of planning or managing the programmes.
- III- Fragmented expenditure in many items makes it impossible to assist the achieved result.
- IV- There is almost no relationship between the expenditure made and the results obtained.

Furthermore, outputs obtained are nearly nil. Consequently this system does not assist in linking the budget with the development plan.

2.3.2.2 Functional Classification

Functional classification is the classification of all public expenditures, for example, according to the public services achieved by the government department. The criterion here is the type of service (or function) on which the finances are spent. The focus is basically on the service the government department is to provide. In other words functional classification comprises all expenses included in the general budget for a particular purpose without confining them to a particular administration unit. For example spending on education is considered as one programme regardless of the unit

that undertakes it. The ministry of health and the ministry of agriculture, for instance, may provide education in addition to the ministry of education.

The UN Social and Economic Affairs Agency in 1956 and 1961 laid down a model for functional classification. It divided state functions into four groups as follows:

- 1- The first group; public services, includes public administration, defence, justice and security, etc.
- 2- The second group; collective services, comprises routes, maritime lines, water provision, public health, etc.
- 3- The third group; social services, consists of education, health, social security, housing, etc.
- 4- The fourth group; economic services, includes agriculture, industries, lending, transport, communication, etc.

Functional classification has many advantages such as:

- 1- It permits trends in government expenditures on a special function to be examined over time and thus helps forecast future expenditures. It also clarifies the functions and the programmes of the administrations.
- 2- It involves preparing estimates, following changes up and tightening control which is simple since items and sub-items are given unified numbers in all ministries, and establishments.
- 3- It can be used as a summary as it is effectively an outline of the budget statement. It thereby facilitates the process of following up spending on various activities or governmental functions, and of controlling and checking the purpose for which funds are spent.
- 4- Thanks to this classification state fiscal activity can be analysed. Changes and developments can be followed up and changes in the nature of government programmes can be measured. A study and comparison can then be made of the areas of public expenditure and the development of its distribution among different functions and purposes. (Al-Shaihk, 1969, pp. 237-45).

This classification in Oman is applied to both revenues and expenditure. According to this classification, government units are divided into twelve functional sectors, each of which includes a number of ministries and departments. (See appendix.3).

The first sector is that of the General Public Services. It comprises twelve units such as the Diwan of Royal Court, Cabinet Secretariat, the Ministry of Foreign Affairs, the Ministry of Finance and Economic Affairs, etc. The second one consists of six units such as the Ministry of Interior, Border Centres, the Magistrate Court, the Authority for Settlement of Commercial Disputes, etc.

The third sector is the Health Sector. It has only one unit i.e. the Ministry of Health. The fourth sector is the Social Security and Welfare Sector. It comprises three units: the Ministry of Social Affairs and Labour, the Civil Service Council, and subsidies to house holds and other organisations and establishments.

As regards the development expenditures it is useful to indicate the relative importance of the above sectors concerning the allocation of resources to social, economic and public services and to other sectors.

The application of the functional classification for both sides of the budget i.e. expenditures and revenues, facilitates the comparison between the receipts and expenditures of each sector and gives the government an indication of the cost and benefit to each sector.

Unfortunately, this classification has some shortcomings and it seems that some government units are difficult to classify into a particular group because their spending programmes serve many purposes. For example the Diwan of Royal Court is included in three sectors.

In contrast, there are some activities served by several units and yet they are not collected into one sector. The prime example is education as there are many kinds of education agricultural, industrial, commercial, health, science, etc., all of which are practised by different ministries. However, functional classification in Oman does not include these several types in the Education Sector. Some units' activities have no clear criterion by which to put them into any one of the twelve sectors defined, thus they are grouped under an additional category named the Other Economic Affairs Sector. These units include the Ministry of Commerce and Industry, the Technical Secretariat for the Development Council, Muscat Securities Market, etc.

Furthermore, the justification for classifying some units is not obvious. For example, the Council for Civil Service and the Ministry of Civil Service are classified under the Social Security and Welfare Sector, whereas, logically they should be put under General Public Services. Another example is the Ministry of Water Resources, which is classified under the Housing Sector, while the more relevant sector would be the Agriculture and Fishing Sector. The third example, is the subsidy to the Rusayle Industrial Estate Authority which has formed its own sector called the Mining, Manufacturing and Construction Sector. Alternatively, this unit should be joined to the Other Economic Affairs Sector which includes the Ministry of Commerce and Industry. Finally, the Ministry of Defence and the Royal Police are not mentioned, whereas they can be classified under the Public Order and Safety Sector.

Consequently, this type of classification cannot be of benefit in the case of the Oman budget. For example, the trends in government expenditure are difficult to examine functionally, because the functions of the government programmes are not properly classified: An examination of the change and development in government fiscal activities would not be meaningful. Moreover, a comparison of public expenditures and their distribution among different functions and purposes would be misleading.

This classification requires that the sections of the government or public administration be as small as possible. This in turn entails the distribution of various items of overheads among the diversity of functions or purposes into which the budget is divided.

2.3.2.3 Classification by Objects of Expenditures

In this type, the budget is divided into items, each of which is assigned for certain expenses. It concentrates much interest on government purchases of commodities and services, which include two main kinds: current expenditure and transferable expenditure. According to this classification, the public expenditure of every public economic unit is classified in accordance with the object or services against which finance will be spent. Hence, public expenditure is firstly classified administratively, then qualitatively according to the object of expenditure. Different units have outlays for similar goods and services (wages, costs of energy, etc.). This helps to produce a unified quantitative classification for all units. Therefore, the idea originated of a unified accounting system in the diverse units of the public services and sectors. Accordingly, control over transactions and the detection of errors was made easier.

Thus, the use of the qualitative classification is considered by some economists as notable progress in the field of public finance. This classification has some merits. Its simplicity facilitates for the planners their estimation of the needs of spending from allocations, the auditing of these estimates, and the controlling of expenditure. It makes possible a unified accounting system, because of the similarities in spending by government units on similar objects, such as salaries, wages, repairs and consumption of water and electricity, etc. Finally, it provides the means to make simple comparisons when all government units at the central and local level agree to follow this classification. Hence, a comparison can be made between items at the level of several administrative units (Burkhead, 1967, p128).

The classification of the state budget in Oman combines classification by object of expenditures and economic classification as will be explained below.

2.3.2.4 Economic Classification

As the operations of the government increased, both in terms of aggregate spending and in assuming responsibility for economic development and stability, attention had to focus on measuring the impact of the government expenditures. An economic classification of governmental activities has become a very important part of the materials of fiscal planning in the countries where national governments have much responsibility for growth and stabilisation of the economy.

Budget economic classifications are diverse and the two most relevant here are:

- * The distinction between unilateral and bilateral transactions
- * The distinction between Current and capital transactions.

I- The distinction between unilateral and bilateral transactions

The distinction between unilateral and bilateral transactions rests on an analysis of the nature of government expenditure.

- Sometimes government expenditure is used to purchase commodities and services. In this case there is a transaction, money passes from the government to other economic units, and commodities and services pass from these units to the government. These are called real expenditures and represent real incomes received by citizens against commodities and services they provide to the government.
- In contrast, there are some unilateral transactions such as transfer of resources from individuals to the government through all kind of taxes, and the transfer of resources to individuals in the form of direct transfer (pensions, national debt interest and payment for social security) or indirect transfer, such as aid for the peasants.

According to the distinction between unilateral and bilateral transactions, government expenditure is divided into two main sections:

The first includes spending on commodities and services, while the second are transfers. Therefore, economists distinguish between real expenditures and transfers. These real resources of commodities and services form part of the national output. Real expenditure means the use of these resources directly by the government. By contrast, transfers can be distinguished as follows:

- They do not provide proceeds in return for offering current commodities and services.
- They do not represent a part of the final demand, national expenditure and national output.

Real expenditure, real income and transfers in the sultanate budget can be distinguished as follows:

1. Real expenditure and real income of the government.
 - a Real expenditures are represented in expenditures on goods and services such as:
 - 1- Salaries, wages, allowances, and other remuneration.
 - 2- Purchase of goods for resale at subsidised prices.
 - 3- Services such as maintenance for building, machinery, etc., Rents for real estate, and insurance of vehicles.
 - 4- Government services expenses e.g. posts, electricity, water, etc.
 - b- Real income of the government: is represented in sales of oil, gas, copper, cement, electricity, water, food stuffs, fisheries, etc., and in returns from ports and airports services, etc.
2. Transfers: they can be divided into two kinds, transfers from the government and transfers to the government.
 - a- Transfers from the government: they can be classified according to many criteria such as:

- i- Transfers to institutions and transfers to individuals.
- ii- Transfers for economic purposes (e.g. Subsidies) and transfers for social purposes (e.g. Social Securities).
- iii- Direct and indirect transfers.
- iv- Domestic transfers and external transfers.

In the state's general budget in Oman, transfers from the government are classified into five categories:

- 1- Subsidies of financial and non-financial authorities.
 - 2- Transfers to non-profit-seeking authorities and establishment such as clubs.
 - 3- Grants to citizens such as allotment to *sheikhs* and tribes and grants to students.
 - 4- Compensations, and
 - 5- External grants.
- b- Transfers to the government: These include income tax on companies, municipality fees on rent, custom duties, interest on bank deposits and lending.

The importance of this kind of economic classification may be summarised in the following points:

- 1 Identifying the influence of public expenditure on the national income, and on the level of consumption, since the rise in real public expenditure affects the increase in the national income. By contrast, transfers assist the increase in consumption without increasing the national income except in narrow limits.
By this classification, the effect of public expenditure on the price level can also be identified.
- 2- This classification supports the prevailing trend towards several budgets instead of a unified budget which comprises costs of different natures.
- 3- The economic planner is assisted in identifying the weakness of public expenditure. It guide him towards achieving social and economic goals.
- 4- It facilitates analysis, the study of the budget and identifying its economic and social effects.

II- Distinction between current and capital transactions:

The distinction between current and capital transactions is considered most important in the budget structure as well as being generally useful for economic classification. Burkhead states that “ its significance is most apparent in an underdeveloped country, where the government is continually seeking ways and means to increase the volume of domestic capital formation” (Burkhead, 1956, p229). In this case, the measurement of government capital expenditure will constitute an indication of past fulfilment and provide a basis for planning the government's role in capital formation. There are economic considerations that favour the budget structure, showing clearly the current and capital outlays. Borrowing and its utilisation are clearly identified and information on actual capital formation is precisely described.

The classification of current and capital transactions (as an economic classification) for both sides of the state budget in Oman (revenues and expenditures) is combined with a classification by objects (see Appendix 4). For the development expenditures it is organised with a sectoral classification which will be discussed later.

1-Current transactions

Current revenues consists of: 1-Revenues of natural resources, 2-Tax and fees revenues, 3- Non-tax revenues (see appendix 5).

Revenues of natural resources are divided into further sub-sections, i.e. oil revenues and gas revenues, while tax and fees revenues are further divided into many subsections, such as income tax, payroll tax (company participation in technical training project), and municipality fees on rents custom duties, etc. Non- tax revenues comprise several objects e.g. revenue from sale of electricity, airport revenue, ports revenue, surplus from public authorities, etc.

Current expenditures are divided into six categories: wages and salaries, expenditures on goods and services, transfers to non-financial authorities and establishments, grants

and compensation to national households, subsidies to national households, foreign grants, and contributions to non-financial organisations. Each of these categories is divided into many objects. (see Appendix 5).

2-Capital transactions

We now come to the capital budget, which has several meanings that vary from country to country. Generally it indicates, on the revenues side, returns from the sale of government property, or taxes paid from private capital, as different from income such as capital levies.

There are two approaches which dominate the capital expenditure budget: a capital expenditures budget comprising outlays on the acquisition of newly produced assets that are a part of the nation's gross investment for the period and a finance budget comprising depreciation allowances and acquisition of previously produced assets that do not affect the volume of production but that involve a periodic valuation of government assets which may be real or financial (Premchand, 1983, p.293).

Financial assets reflect government lending appreciation as well as other financial assets acquired.

A capital budget, on the expenditure side, may be used to indicate programmes and projects that are financed by foreign aid. In some developing countries, the capital budget is employed to denote the plan programmes and investments. Premchand maintains that “the principal accepted feature of a capital budget is that it primarily consists of the proceeds of borrowing, which are then used for the acquisition of assets, leaving the net worth of government unaltered” (Ibid.).

In the field of the capital account, there is a distinction between direct investment which includes the outlays made by the government for the purchase of new assets,

while indirect investment which comprises government grants or loans to encourage private capital formation (Burkhead 1956, p.231). Operationally, the difference between the two is obvious, since indirect investment puts the control of the new asset into private hands, while direct investments add control over resources to the government. (Ibid.).

On the revenue side, the budget system differentiates between capital revenues and capital repayments; capital revenues are divided into three categories: revenue from sales and rents from government fixed assets, capital transfers, and grants. Each category is subdivided into many objects.

Capital repayments are classified into three sections each of which is subdivided into many items. The three sections are: repayment of loan instalments, sale of investments, and profits.

On the expenditures side, under capital expenditures the budget system differentiates between non-project capital expenditures, project expenditures for civil ministries, exploration of natural gas and the government's share in PDO's capital expenditure. The last three sections form the development expenditures.

Non-project capital expenditures are classified into many objects such as furniture and equipment, cars and transport equipment, machines, etc. (see appendix 6).

Development expenditures are classified into sectors, beneficiary units, and projects.

Capital revenues and capital repayments are not matched by capital expenditure in one budget because they are very little. On the other hand, according to Oman's state's general budget system "there are no particular resources earmarked for capital expenditures, i.e. all revenues are unified and allocated to the total expenditure: current and capital" (Assaigh, p.4).

However, since oil and gas revenues, and non-oil revenues almost cover current expenditures of civil ministries and defence expenditures only, development projects are financed either by loans or by withdrawal from SGRF. Thus government documents mention sometimes that there is a surplus in current account of the government and it directed to the development expenditures. For example, in 1990 there was a surplus of R.O. 283m, and it was almost enough to finance development expenditure of that year (CBO, 1990, p.59).

Economic classification has advantages and disadvantages: On the positive side, the separation of capital from current transactions, makes the government able to determine the size of the surplus on the current account, thus national savings are available for investment. This classification should be able to specify the extent of the government's capability of developing this surplus. It provides information about the extent of the government's contribution to the development of the national income and is a useful tool for economic analysis.

Budget economic classification divides transactions into current and capital accounts. It thereby makes it possible to differentiate between sources of revenue and expenditure, such as collected funds and interest on national debts, wages and salaries of officials, goods and services, and paid transfers. Thus an economic classification is a useful instrument for identifying direct and indirect effects on financial policy. It is worth noting that the economic classification is not an alternative to a budget; it represents an addition to it since it encourages the use of a national budget which shows the economic results of policies.

The separation of current expenditures' estimates makes it possible to finance each one in a non-inflationary manner. This separation enables executives to control the magnitude of current expenditure. Furthermore, the economic classification of the budget makes it possible to estimate the total extent of the government's transactions,

or to define the importance of its establishments specified for a certain purpose by estimating their expenditure and income.

On the negative side, however, if capital spending is defined as spending on tangible assets with a life span of more than one year, the distinction can introduce a bias towards investment in physical capital at the expense of current operations and maintenance. (The World Bank, 1988, p. 108). Such a bias can, in turn, lead to a bias toward “hard” sectors for which physical capital investment is a small share of the total spending.

In addition to the problem of bias, an emphasis on the current balance alone may be misplaced. For macroeconomics' stabilisation the important variables are the overall budget balance and its means of financing. Furthermore, borrowing may need to be limited not only for stabilisation but also because public investment may not always yield long term returns as high as the cost of debt service. Finally, the existence of two budgets is often institutionalised in two budget-making bodies. For example, in developing countries ministries of finance often have responsibility for the current budget, while ministries of planning are in charge of the capital budget. Lack of co-ordination between the two can lead to serious inefficiencies and biases in the allocation of overall spending.

2.3.2.5 Sectoral and Regional Classification

The development budget is the tool by which the five-year social and economic development plan in Oman is carried out. It represents the detailed annual investment programme of the financial year. In this sense it is considered the tool used for planning the annual expenditures on development projects.

Financial allocations of the development budget are classified according to several criteria, some of which have been studied earlier. Sectoral and regional criteria will be studied here.

1-Sectoral classification

According to the nature of the product or service provided by the government units, they are classified according to different sectors: the Commodity Production Sector, the Service Production Sector, the Social Service Sector and the Infrastructure Sector. Each of these sectors consists of many ministries and government units.

Development allocations are classified according to these four sectors. The financial allocation of each sector is broken down according to either organisational (institutional) criteria or objective (objects of purchase) criteria. (See appendix 7).

According to the former, there is a sectoral-organisational classification, and, according to the latter, there is a sectoral-objective classification.

Let us take the Social Service Sector as an example. Financial resources allocated to this sector - according to the sectoral-organisational classification - are divided between the following: the Ministry of Health, the Ministry of Information, the Ministry of Justice, Awqaf and Islamic Affairs, the Ministry of Education, the General Organisation for Youth Sports and Cultural Activities, the Ministry of Social Affairs and Labours, the Ministry of National Heritage and Culture and the Institute of Public Administration.

According to the sectoral-objective classification the allocations are divided as follows: Education, Vocational training, Health, Information, Culture and Islamic Affairs, Community centres and youth centres.

In this type of classification, the projects, their costs and their execution stages are defined. This classification helps in estimating the total cost of each sector, then, of the whole plan. It allows the planning authorities to know the required financing for sectoral investment, thereby enabling the decision makers to take an account of sectoral balance. Sectoral classification in the framework of financial control over

investment expenditure helps to achieve efficiency in the allocation of the state's financial resources.

2- Regional classification

In this case development allocations are classified according to regional criteria. The sultanate is divided administratively into eight regions. Financial allocations for development are divided between these eight regions according to demographic, social, political and economic considerations. It has been mentioned earlier that one of the strategic objectives of the development plan is to achieve a balance in the growth of different regions of the country in order to maintain a stabilised distribution of population.

The regional classification helps the government in designing its regional planning. It enables the decision makers to estimate the required allocations for the different sectors and to monitor the development of each of them.

The above discussion was concentrated on Line Item Budgeting, according to which the state's general budget in Oman is prepared and classified. The advantages and disadvantages of this technique have been examined. The discussion now will be addressed to the advanced techniques of budgeting to see their possibilities and limitations.

2.3.3 The Structure of the Budget in Oman

The anatomy of the budget is displayed here. In other words, the importance of each component of revenues and expenditures is considered separately.

2.3.3.1 The Structure of Revenues

In examining the relative importance of revenues, three types of government revenues can be distinguished: oil and gas revenues, tax and fees revenues, and non-tax revenues. Oil and gas revenues consist of receipts from PDO in the form of royalties

and income tax, sale of the government oil shares in PDO and other operating oil companies, and gas revenues. Tax and fees revenues comprise custom duties, corporate income tax, training tax (payroll tax) and fees on licences, etc. Non-tax revenues are represented in electricity and water revenues, postal revenues, airport and ports revenues, surplus from public authorities, income from government investments, interest on bank deposits and lending, capital revenues, and miscellaneous. (Table 2-5) shows the relative importance of these three types of revenues at the end of each of the four development plans that have been carried out so far. It is obvious that oil revenue still dominates the government revenues, and its contribution to the total government revenues ranked between 93.4% in 1980 and 77% in 1995. Both tax and non-tax revenues have marginal importance. Non-tax revenues are more significant than tax revenues. They were evaluated at 5% in 1980 rising to 9% in 1985, and 15% in 1995. 50% of non tax revenues, on average, is attributed to the user charge for electricity and water, airport and ports facilities. Tax revenues have minimal importance. These constituted 1.3% in 1980, 5% in 1985 then declined to 3.7% in 1990 because of the weak performance of the economy during the third development plan.

About 40% of tax revenues on average comes from custom duties, while 37% comes from corporate tax.

Due to high oil revenues, government finance, and the whole economy in general, became more vulnerable to changes in world oil market prices. In addition, oil revenue is temporary because oil resources are exhaustible, therefore, the government must plan to increase the internal, non-oil revenues. Further discussion of this point will be in chapter six.

2.3.3.2 The Structure of Expenditures

Regarding the government expenditures, four main types of expenditures can be distinguished: current expenditure of civil ministries, current expenditures of defence

and national securities, development expenditures, and contributions loans and support to the private sector.

Current expenditures of civil ministries include those of the government's share of PDO's current expenditures, interest paid on loans, and capital expenditures of civil ministries on such items as equipment, furniture, etc. Current expenditures of defence and national security includes development expenditures of a civil nature. Development expenditures includes the development expenditure of civil ministries, the government's share in development expenditures of PDO and gas exploration expenditures. Contributions, loans and support to the private sector consist of: 1) direct loans and contributions to financial investment organisations or loans to national, regional and international organisations. 2) support to the private sector. Table (2-6) shows the relative importance of these four types in 1980, 1985, 1990 and in 1995. It is clear that current expenditures of civil ministries formed around one third of the government's expenditure between 1980 and 1985. It rose to 45% in 1990, then 47% in 1995. National Security expenditures constituted about 43% in 1980 and declined to about 39% between 1985 and 1990 then it continued falling, forming 33% in 1995. Development expenditures constituted 26% in 1980, 27.9% in 1985, but fell to 14.2% in 1990 because of the decline of oil revenues during the third development plan due to the collapse of oil prices, then it rose again to about 19% in 1995. Contributions, loans and support to the private sector tapered off gradually from 2.6% in 1980 to 1.6% in 1985 to 0.7% in 1990.

Table (2-5)

The Structure of Government Revenues (%)

Particulars	1980 %	1985 %	1990 %	1995 %	Av. %
Oil and Gas	<u>93%</u>	<u>85.8%</u>	<u>85.7%</u>	<u>77.4%</u>	<u>85.5%</u>
Tax and fees Rev	<u>1.3</u>	<u>5.1</u>	<u>3.7</u>	<u>6.6</u>	<u>4.2</u>
Custom duties	57%	53.4	21.0	37	42.1
Corporate tax	43%	34.3	48	24.6	37.5
Non tax Rev.	<u>5.3</u>	<u>9.1</u>	<u>10.6</u>	<u>14.9</u>	<u>10</u>
Income from Public					
Service & Utilities	68.7	42.6	46.1	43.3	50.2
Investments	31	14	13.4	15	18.4
Miscellaneous	0	43.3	40.5	41.3	31.3
	100	100	100		100

- Sources:**
1. CBO, 1986 Table (4.2) p43.
 2. CBO, 1991 Table (4.2) p41.

Table (2-6)
The Structure of Government Expenditures

Particulars	1980	1985	1990	1995	Av.
	%	%	%	%	%
Current expenditures of civil ministries	30.7	31.6	45.3	47.3	38.7
Defence and national securities	42.8	38.9	39.7	33.3	38.7
Development expenditures	26.0	27.9	14.2	18.8	21.7
Constitutions, loans and subsidies	2.6	1.6	0.7	0.6	1.4
	100		100		100

Source: 1) DC, SYB, 1988. Table (222) p.429.

2) CBO, 1990, Table (1-4) p.60.

3) CBO, 1991, Table (4-1) p.40.

Conclusion:

This chapter has been assigned for the discussion of government budgeting in Oman: objectives, policies and mechanism. The discussion has been organised into three sections. Section one: focused on the government as a link between the oil sector and other sectors. This section has also been devoted to explaining the importance of government finance in Oman as a rentier state. Since the oil sector is characterised by weak backward and forward economic effects on the other sectors of the economy. The government, as the owner of the oil wealth, has established the links between the oil sector and other sectors. these links are represented in government expenditure which have far reaching effects on the economy as a whole.

The second section defined the budget and its scope and discussed its objectives and policies in Oman. The definition of the budget was a pre-requisite step for further discussion of related topics. After defining the budget, the objective and the fiscal (or budgetary) policy was examined. this policy was not based on the principles of Keynesian theory or the monetarists' perception. The economic structure, and consequently, the economic and social problems originating in Oman as an oil exporting country are completely different from those of industrial countries. Fiscal policy was not directed to raise the aggregate demand or to curb inflation. The budgetary policy goals were to develop the economic and social infrastructures of the economy and to improve the standard of living of the people as fundamental goals towards the achievement of comprehensive development.

The third section illustrated the organisation of budgeting in Oman. The budgeting process in Oman is similar to other countries and works through four phases: preparation, legislation, execution, and auditing. All these phases of the Omani budgeting process fall within the responsibility of the executive authorities. Majlis Ashura, which is allowed to discuss some economic and social issues is not authorised to discuss and approve the state's general budget. The external and post-spending audit

is still inefficient. The budget is classified according to the Line-Item techniques. While this classification facilitates the enforcement of legal accountability, it does not provide useful information for planning and programmes management. In this context, other additional classifications of the budget in Oman were evaluated. some of them have some advantages for making comparison and economic and political assessment, but others are ambiguous and misleading such as functional classification.

Finally, the structure of the government budget was analysed, regarding revenues, oil and gas revenues are still dominating the government's receipts constituting 85.5% of total revenues. This peculiarity makes the government's financial position very sensitive to changes in the world oil market. On the expenditure side, current expenditure of civil ministries and defence expenditure absorb the largest proportion of government resources.

CHAPTER III

HOW TO MEASURE THE BUDGET DEFICIT

Introduction

The measurement of the fiscal deficit is supposed to provide policy makers with an indication of the net effects of government budgetary activity on aggregate demand and on financial markets. It is intended to indicate the magnitude of additional resources over the ordinary revenue that the government must extract from the private sector, or from external sources, in order to finance its own operations. In order to diagnose economic problems and find appropriate fiscal policies with which to address them, the correct measurement of the public sector's net requirements is vital.

Several concepts of budget deficit are currently in use, and the definition of deficit as used in a particular context is often not made clear. It is obvious that alternative formulations of budget balances can give significantly different indications, and there has been considerable discussion in the literature on the suitability of the use of various concepts for specified purposes, and on the relative merits of different approaches. Once the definition of budget deficit has been agreed on, the question which then arises is this: are there data bases available which can be used in the context of our definition of budget deficit? When measurement problems have been resolved, the next question that arises is this: how important are the macro-economic causes of fiscal deficits, and what role do domestic and foreign shocks play in relation to fiscal policy changes in the evolution of deficits?

The main objectives of this chapter are to analyse the major alternative concepts of budget deficit and to indicate the considerations necessary to select the most appropriate one for the case of Oman.

3.1 The General Framework of Measurement Techniques

In one sense, the budget is always in balance: revenues equal expenditures. A deficit or surplus in the budget is arrived at only by designating some items as balancing items, that is, by excluding them from the side of revenues or expenditures so that an inequality is created between expenditure and receipts. The size and sign of the budget balance, therefore, depend on (a) what items are included to make up the budget and, hence, the expenditure total and (b) what items are excluded from revenues to calculate the difference between expenditure and included receipts. The variety in deficit measures is due to different answers to these two questions.

Fiscal deficit measures have to be specified over three dimensions:

1. The deficit has to be defined for a public sector of given coverage.
2. The coverage or size of the public sector and its composition must be delineated.
3. The time-horizon needed to assess the magnitude of the deficit must be identified (Blejer and Cheasty, 1991, pp. 1644-45).

Issues falling into these three measurement categories have generated a substantial literature, thus producing a methodology for assessing the true scope of budgetary policy. The literature distinguishes between the conventional deficit and many different measures that been considered operationally applicable as policy tools in various circumstances. They are special purpose measures that attempt to isolate in

the annual deficit the magnitudes needed to assess the effects of the deficit on specific indigenous macro-variables such as domestic demand, inflation, or the balance of payments.

3.1.1 The Conventional Deficit

The conventional deficit is one of the commonly used concepts of the budget deficit:

"It measures the difference between total government cash outlays, including interest outlays but excluding amortisation payments on the outstanding stock of public debt, and total cash receipts, including tax and non-tax revenue and grants but excluding borrowing proceeds." (Vito Tanzi and others, 1987, p. 714).

Expenditure also includes wages of public employees, spending on goods and fixed capital formation, transfers and subsidies. Revenue includes user charges, interest on public assets, transfers, operating surpluses of public companies and sales of public assets. Expenditure does not include accumulation of financial assets, while revenue does not include the draw down of cash reserves (The World Bank, 1988, p. 56).

Thus, fiscal deficits reflect the gap to be covered by net government borrowing. Most countries record some variant of this deficit. Arguably the variant most widely used is the Public Sector Borrowing Requirement (PSBR), which measures the government's use of new financial resources and the net repayments of previously incurred debt.

In the absence of government rules for standardised accounting, the conventional deficit is not well defined and the deficits of different countries are not directly comparable. Two main areas of variance are:

1. The distinction between the items that determine the deficit - income and outlays, and the items that finance it (drawing "the line").
2. Specification of the time at which the resource use is measured (the cash versus the accrual deficit) (Blejer and Cheasty, 1991, p. 1646).

3.1.1.1 The Criteria for Drawing the Line

One criterion for distinguishing between revenue/expenditure and financing is the "government debt criterion" where transactions are thought to affect the deficit and are therefore classified above the line (i.e. as revenue or expenditure) . This is the case only if there is no government liability; if there is then these transactions are considered as positive or negative financing (Ibid). For instance, interest payments on government debt are part of government expenditure while the repayment of principal is recorded below the line. The economic underpinning of this distinction is that while a shift in the level of net public expenditure affects aggregate demand, the repayment of outstanding debt does not represent new income to asset-holders, and therefore leaves demand pressures unchanged.

This measure of deficit is also known as the public debt concept of deficit (Chelliah, 1973, p.743). This concept is in accord with the dictionary meaning of deficit spending, i.e. the spending of funds raised by borrowing. In other words, this deficit measures total net borrowing by the government sector, adjusted for changes in cash holdings (Ibid). Since changes in cash holdings as a rule are fairly small, the budget may be said to be balanced, in terms of this concept, if net borrowing is equal to zero, or, in other words, if public debt remains unchanged. This measure is therefore referred to as the public debt concept of deficit (Ibid p. 744). The deficit so defined

is also often referred to as the overall deficit, while the items on the receipt side that are excluded when this deficit is computed are called the financing items (Ibid)..

Thus, initial debt + the deficit = end of period debt.

As Chelliah remarks,

Since changes in cash balances are usually of minor significance, the overall deficit for any past year indicates the total of government borrowing; likewise the overall deficit in the budget estimates may be said to give the total borrowing needs of the government for the coming year. As such a measure of the overall deficit is useful for treasury management and is in fact necessary for proper budget planning. Also, it is of interest to know the extent of the increase in public debt or in gross liabilities of the government, because any such increase has complications for debt servicing in the future (Chelliah, 1973, p. 745).

The conventional definition is designed to act as a measure of government contribution to aggregate demand and, through this, to the external current account disequilibrium. Under this definition, amortisation payments are not added to other government outlays in the computation of the deficit because of the implicit assumption that such payments will not be regarded as income by those in receipt of them. Therefore one basic assumption is that the behaviour of the bond holders as consumers will not be changed by amortisation payments (Vito Tanzi, 1987, p. 719).

Prior to 1983, the financial authorities in Oman applied the government debt criterion to foreign grants, i.e. they classified grants above the line. Since 1983, however, government documents have put such grants below the line, i.e. the government considers foreign grants to be a sort of financing (See: CBO, 1987, p. 48).

Foreign grants place no financial commitment on the shoulders of the government; according to the government debt criterion, they should be put above the line, i.e. considered as revenue. By considering them a sort of financing, the budget department is able to rely on them with greater confidence; this in turn may lead to a loosening up of the deficit. In the case of Oman, the reason for not considering grants as revenue may be uncertainty on the part of the budget department: such grants are, after all, marginal, and the government does not accord them much importance when estimating its revenue. Therefore I have applied this point of view and unified the calculation process of deriving the deficit figures for the period prior to 1983. However, in countries which depend significantly on foreign grants, the classification of grants below the line can widen the deficit by more than 5 percentage points of GDP (See Blejer and Cheasty, 1991, p. 1648).

With regard to the treatment of repayment loans, government documents show that in 1974 and 1975 the repayment of loans was included in government expenditure, but excluded in following years (See: DC, FIDP, 1975, p. 7). Responding to the economic rationale of excluding loan repayments from government expenditure, and in order to calculate the deficit homogeneously, I have omitted the debt repayment figures for those two years from the calculations of government expenditure. The inclusion of amortisation above the line results in a deficit which corresponds to the government's gross borrowing requirements rather than to the net increase in its liabilities.

3.1.1.2 The Cash and Accrual Deficits

The other main conceptual variation among conventional deficit measures is the choice between cash and accrued accounting:

At one end of the spectrum is the completely cash deficit, where only government outlays for which cash has been disbursed during the 365-day period, and only actual cash revenues received, are included in the budget balance. At the other end is the completely accrual deficit, which attempts to capture the actual net resource pre-emption of government - the consequences of its policy decisions - during the fiscal year, regardless of whether or not transactions have actually been paid for (Blejer & Cheasty, 1991, p. 1649).

An important example is the depreciation of fixed capital, which is included as an outlay in the accrual deficit, but which does not show up in the cash deficit.

A deficit calculated on the basis of the 'System of National Accounts' (SNA) would be an accrual measure, while the public sector borrowing requirement (PSBR) is measured on a cash basis.

In practice, different countries' deficit measures lie somewhere in between the complete cash and the complete accrual models. Even in countries which use a PSBR (cash) deficit concept, interest payments are usually measured as they accrue rather than when they are actually paid. Revenues, however, are almost always measured on a cash or quasi-cash basis, the reason being that tax liabilities may be disputed and, as a result, a certain percentage never collected.

This means of measuring deficit does have its drawbacks. For example, it does not take into account the effects of inflation on the budget items. It would seem realistic to assume that different parts of the budget would respond differently to inflationary pressures. These reactions, however, often depend on political considerations, union power, indexation rules for wages and pensions, and so on. For nominal interest payments as a category of public expenditure, it is now generally recognised that an

increase in expected inflation almost always brings about a fairly automatic increase in nominal interest payments.

The growth of interest payments in an inflationary situation is often explained by the nominal rate of interest, which tends to approximate to the real rate that would have prevailed in the absence of inflation, plus the expected rate of inflation (Vito Tanzi, 1987, p. 712). Assume, for example, that the debt in question is US\$1 million. With expected price stability and a nominal interest rate of 5%, the income of the individual (the debtor) and the interest expenditure of the government would be \$50,000. With an expected inflation rate of 10%, the nominal rate of interest would rise to 15%. Therefore the nominal interest income received by the debtor would increase to \$150,000, with the government's interest expenditure increasing by the same amount. Thus an increase in the rate of inflation from zero to 10 per cent has the effect of increasing the government's interest expenditure by 200%. If the debtor is perfectly rational, he will realise that although his nominal interest income has gone up by 200%, his real income has not changed at all, for the simple reason that two-thirds of the \$150,000 nominal interest income is compensation for the erosion of the real value of his financial capital. This compensation may be called the 'monetary correction'. The individual in question will treat this \$100,000 in exactly the same way as he would have treated an amortisation payment of the same amount, since in a real economic sense - though not in an accounting or legal sense - it is, in fact, amortisation. His behaviour as a consumer will continue to be determined by the real value of his permanent income, which presumably has not changed. Thus one should treat this monetary correction exactly as one would a normal amortisation payment:

Because amortisation payments are not part of the fiscal deficit, the monetary correction should also not be part of the deficit (Ibid., p. 713).

The second alternative assumes that the individual does not distinguish at all between real interest payments and monetary corrections, regardless of how high the expected rate of inflation may be. He would behave as though his real income had, in fact, increased from \$50,000 to \$150,000.

Under this assumption, which is implicit in the conventional way in which the fiscal deficit is measured, whereas amortisation payments are not considered income for those who receive them or ordinary expenditure by the government and are thus not assumed to increase the deficit and to affect aggregate demand, monetary corrections are treated as income. The conventional measure of the deficit is thus highly sensitive to the rate of inflation whenever the size of the domestic debt is significant (Ibid).

In short, as far as inflation is concerned, the conventional deficit treats all nominal interest as part of the deficit. In other words, it overestimates real public dissaving because it disregards the inflation erosion of the public debt.

Therefore in the presence of inflation, and provided that the domestic debt is in short-term instruments, the share of the conventional fiscal deficit relative to GDP becomes a function of: (i) the rate of inflation; (ii) the size of the domestic public debt; and (iii) the composition, domestic versus external, of total public debt. For countries with all their public debt in foreign currencies, their fiscal deficit as a share of GDP will not be affected by their inflation rate, irrespective of the magnitude of such debt. However, those countries whose debt is held in the form of floating-interest domestic debt will carry a fiscal deficit that depends on the rate of inflation and the magnitude of their public debt.

In the case of Oman, the debt is relatively small, and denominated in foreign currency. Also the interest rate at which Oman borrows is not indexed to the rate of inflation;

nor is it particularly high, averaging 7.7 between 1981 and 1991. Therefore interest payments are not high as an absolute value or as a percentage of GDP (See Table 3-1). Thus conventional deficit in the case of Oman is not a distorted measure.

Another shortcoming of the conventional deficit is that it does not allow for the Central Bank deficit (or surplus), or the public financial and non-financial deficit. Thus it fails to measure the public sector saving (or dissaving) and is therefore less likely to account for its ensuing financial and real implications.

Another shortcoming in the conventional measure of the public deficit stems from the inter temporal dimension of government transactions:

Deficiencies include the omission of valuation adjustment, the treatment of asset sales, and of the financial implications of entitlement programmes and government guarantees (Blejer & Cheasty, 1991, p. 1665).

For example, the conventional deficit includes no provision for valuation changes in government assets or liabilities, though these could conceivably change the sign of the budget balance in any fiscal year. Government ability to pay can be affected - in real terms - by inflation, devaluation, changes in the terms of trade or in relative prices, and capital gains or losses on the purchasing power implicit in government assets and liabilities, although none of these effects is captured by a summary of government transactions during a given fiscal period.

Financial economists have developed some special purpose measures of deficit in order to get rid of such shortcomings in the conventional concept of defeat.

**Table (3-1) Conventional Primary and
Current Account Deficits (or Surplus)**

YEAR	CONV.DEFICIT		PRIMARY DEFICIT		CURRENT AC. DEFICIT	
	RO.M	%GDP	RO.M	%GDP	RO.M	%GDP
1970	24.8	23.9	—	—	31.9	30.8%
1971	4.1	3.3%	—	—	30.0	24.2%
1972	-18.6	-13.4%	—	—	17.3	12.4%
1973	-26.7	-15.9	—	—	9.8	5.8%
1974	-58.8	-10.4	—	—	127.9	22.6%
1975	101.5	-14.1	—	—	89.7	12.4%
1976	-94	-10.6	-87.0	-9.9%	193.1	21.8%
1977	-37	-3.9	-27.0	-2.9%	192.0	19.2%
1978	-83	-8.8	-67.0	-7.1%	103.4	10.9%
1979	30	2.3	50.0	3.91%	246.6	19.1%
1980	238.1	11.5	259.2	12.6%	552.6	26.8%
1981	38.4	1.5	53.9	2.2%	433.3	17.4%
1982	-236.5	-9.0	-219.0	-8.4%	265.2	10.1%
1983	-242.3	-8.8	-222.8	-8.1%	247.2	9.9%
1984	-346.8	-11.4	307.5	-10.1%	164.1	5.4%
1985	-355.4	-10.3	-308.3	-8.9%	308.2	8.9%
1986	-699.9	-25.0	-624.0	-22.3%	-78.2	-2.8%
1987	-148.9	-5.0	-76	-2.5%	241.3	8.0%
1988	-362.4	-12.4	-278.4	-9.5%	-49.1	-1.7%
1989	-304.6	-9.4	-210.1	-6.5%	-17.8	-0.6%
1990	-11.1	-0.27	81.3	-2.0%	274.9	6.8%
1991	-283	-7.2	-213.6	-5.5%	105.5	2.7%
1992	-578.5	-13.1	-480.0	-10.9%	-114.1	-2.6%
1993	-480.7	-10.7	-386.8	-8.6%	0.4	0.01%
1994	-495.5	-10.0	-394.8	-7.9	-271.4	-5.5%
1995	-479.4	-9.1	363.7	-6.9	-127.9	-2.4%

Sources:

1. DC, FIDP, Table (3), p.7.
2. DC, SDP, Table (15), p.21.
3. DC, ThDP, Table (18), p.32.
4. CBO, 1985, Table (4.1), p.38.
5. CBO, 1990, Table (4-1), p.60.
6. CBO, 1995, Table (4.1), p.38.

3.2 Special-Purpose Deficit Measures

Although the conventional deficit measures exist in competing versions, all versions have at least one characteristic in common: in calculating the budget balance, they include, with the same weight, all government transactions. However, policy makers have, from time to time, calculated alternative measures of the deficit, with the aim of highlighting the different impacts of various budgetary transactions (investment, import purchases or debt service) on important macroeconomic variables such as savings, the balance of payments, and inflation. The main types of special-purpose deficit that have been fairly widely calculated are:

1. The primary deficit
2. The operational deficit
3. The current account deficit
4. The deficit measuring the contribution of different transactions to aggregate demand.
5. The domestic deficit
6. The cyclically adjusted deficit
7. The consolidated comprehensive deficit

3.2.1 The Primary Deficit

The primary or non-interest deficit attempts to measure the discretionary budgetary stance by excluding net interest payments from the budget. In other words, it tries to remove the effects of previous deficits on the budget.

The interest paid on debt is a result of past deficits rather than current behaviour. A measure of the current policy stance may therefore exclude all interest payments, yielding the primary deficit.

The primary deficit measures how current actions improve or worsen the public sector's net indebtedness, and it is important for evaluating the sustainability of government deficit (The World Bank, 1988, p. 56).

Table (3-1) shows the primary deficit in Oman as an absolute value and as a percentage of GDP. because interest payments of the government are not too high, there is no significant difference between conventional (or PSBR) deficit and primary deficit. However, the difference has started to increase since 1986. See also (Chart 3-1)

3.2.2. The Operational Deficit

The operational deficit is defined as the conventional deficit minus the part of the debt service that compensates debt holders for actual inflation; alternatively, it is equal to the primary deficit plus the real component of interest payments (Vito Tanzi, 1987, p. 728). Only real interest payments, i.e. that which exceeds the product of the outstanding debt and the actual inflation rate, are included in the government expenditures that determine the operational deficit.

The economic rationale of this definition is the assumption that inflation-induced interest payments are similar in their effects to amortisation payments. Conventional deficits exclude amortisation payments from deficit calculation independently of the way in which those payments are financed. The operational deficit concept excludes only the portion of the debt service that

compensates for inflation. In other words, sometimes the debt principal is explicitly indexed to inflation, in which case the indexation inflates the PSBR. The operational deficit is defined as the PSBR minus the inflation correction part of interest payments; it is sometimes called the 'inflation corrected deficit' (The World Bank, 1988, p. 56).

It measures the real government dissaving. If D_0 is the conventional deficit, D_1 is the primary deficit, D_2 is the operational (or inflation adjusted or corrected deficit), then:

$$D_0 = D_1 + \text{real public debt service} + \text{inflation correction}$$

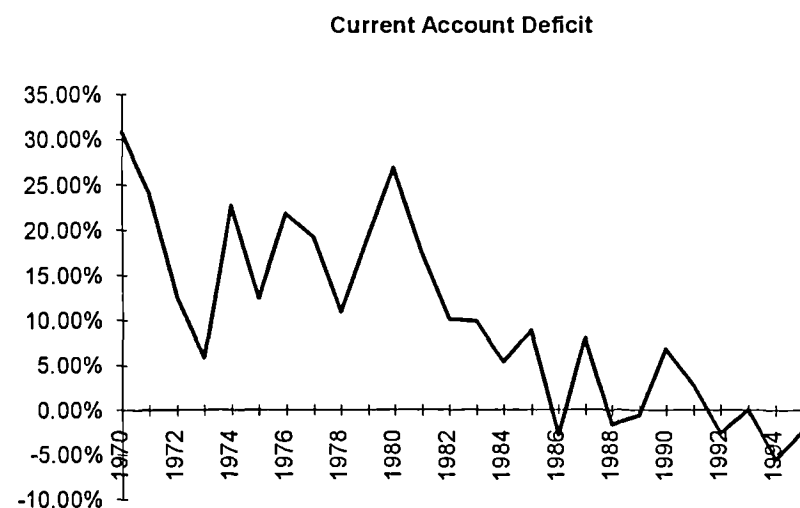
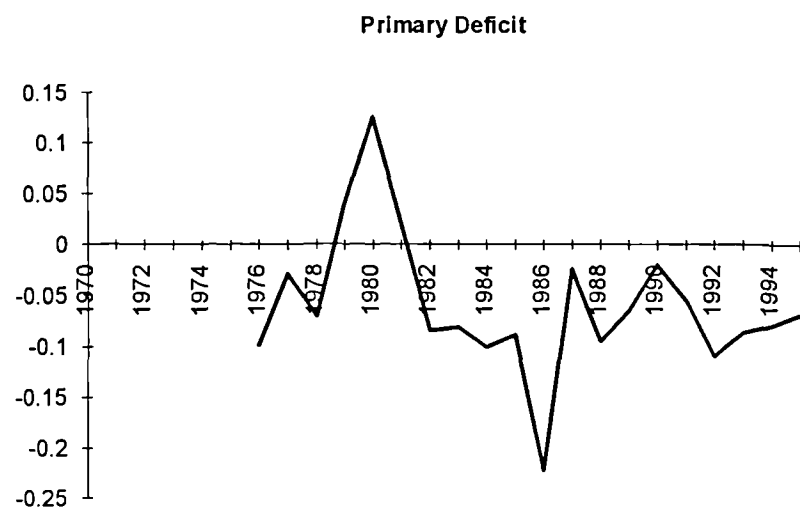
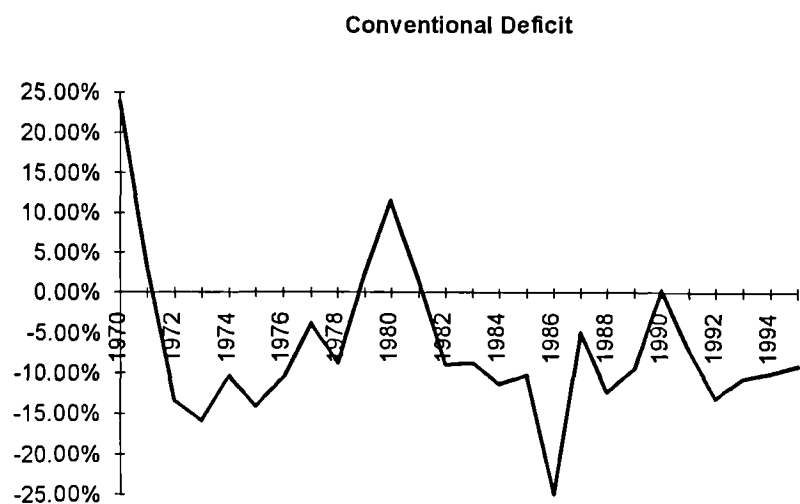
$$D_2 = D_0 - \text{inflation correction}$$

$$D_2 = D_1 + \text{real public debt service}$$

The difference can be significant. In 1985 in Brazil the inflation correction component of the indexed domestic debt was so large that the PSBR was 27.1 per cent of GDP, while the operational deficit was only 3.5 per cent of GDP (Ibid).

As indicated earlier, in the case of Oman the government debt is not domestic; rather it is denominated in foreign currencies and as such is not indexed to inflation. Furthermore, the public debt is not big; consequently the inflation erosion of the public debt is very small. Therefore there are no good reasons to calculate the operational deficit in the case of Oman.

Chart (3-1) Conventional, Primary and Current Account
Deficits (or Surplus) As % of GDP



Source: Table (3-1)

3.2.3 The Net Worth Concept of Deficit (or the Current Account Deficit)

The net worth concept of deficit or, as it is sometimes called, the balance on current account of the budget, is used to indicate the magnitude of savings generated in the government sector. The concept of current account balance is also widely used, but it is not always measured or interpreted correctly. The derivation of the overall deficit necessitates the division of government receipts into current and capital items; the derivation of the balance indicating change in net worth requires, in addition, a similar division on the expenditure side (Chelliah, 1973, p. 746).

The balance on current account or the net worth concept of budget balance is derived by 'subtracting current expenditure, that is, expenditure not leading to capital formation or to an increase in financial assets, from current revenues.' (Ibid, p. 775)

In other words, the current deficit is the difference between non-capital revenues and expenditures. It indicates simply the saving generated in the government sector. This concept is not so relevant for demand analysis, but it is useful for a long-term appraisal and for economic planning in developing countries.

It is commonly held that current expenditures should be fully financed by taxes, whereas, like a private firm, the government could legitimately finance its socially profitable investment by debt.

According to this view, the deficit on current account provides a measure of the extent the government strayed from (prudent management) (Ibid).

Musgrave has proposed - with special reference to developing countries - a somewhat different type of balance on current account which could be said to reflect the contribution of budget policy to capital formation in the economy. The current

balance, in this sense, must be defined not to show the actual savings in the government sector but to reflect the increase in capital formation in the economy brought about by budget policy (Musgrave, 1980, p. 570). For this purpose, current expenditure would include all public expenditure that provides for current services in the nature of consumption. This would be equivalent to the current expenditure minus recurring expenditure representing capital formation not resulting in the acquisition of physical assets - such as investment in human capital - minus the portion of government transfer payments saved by the recipients. Current revenue would include shares of different taxes and other receipts that could be said to be drawn from private consumption. In other words, current revenue would represent the fall in private consumption brought about through the revenue side of the budget, and current expenditure would represent public consumption (narrowly defined as above) plus the rise in private consumption arising from government transfer payments.

The difference between the two is to be a measure of the contribution of the budget to total capital formation in the economy (Ibid).

This measure of deficit is of great importance to the Omani government because it measures the government current saving that should be allocated to finance, at least, part of development expenditure.

Current revenue in the Omani government budget is defined by the government documents as total revenues minus loans and grants (DC, FIDP, p. 17). Current expenditure includes current expenditure of civil ministries, the government share in PDO current expenditure, interest payments, and current expenditure of defence and national security. Defence and national security expenditure usually includes the development expenditure of civil nature; it should be excluded in order to calculate the defence current expenditure.

Table (3-1) shows the current account deficit during the period 1970 - 1995. The government had been achieving current surplus (or saving) until 1986. From 1986 onwards it has been showing deficit except for 1987, 1990 and 1991. The table gives the financial authorities an indication of how they must endeavour to control current expenditures in order to develop a saving that can participate in financing the development expenditure (or capital formation).

To apply Musgrave's version of current account deficit in the case of Oman, education and health current expenditure must be omitted from current expenditure, since they represent capital formation in human resources. However, there are some statistical difficulties encountered when the Musgrave version is applied. For example, the portion of government transfer payments saved by the recipients must be deducted from current expenditure, but there is no way of knowing their magnitudes. Nevertheless in the case of Oman, it may be supposed that all transfer payment included in current expenditure will be totally consumed by the recipient, for the simple reason that they are given to poor individuals or social institutions which do not seek profit. Another statistical problem is that some educational activities are carried out not by the Ministry of Education but by other government units such as the Ministry of Social Affairs and Labour. There are no data available at present on expenditures devoted to these activities.

3.2.4 Budget Balance Reflecting Impact on Aggregate Demand (or Expansionary Deficit)

Since different elements of government expenditure and revenue generate different net increases to, and withdrawals from, demand, policy makers have sometimes attempted to create a deficit measure that assesses the government's contribution to aggregate demand. For instance, tax-financed transfers such as pensions and unemployment

benefits merely redistribute purchasing power from one part of the private sector to another. In terms of their impact on aggregate demand they are similar to negative taxes rather than to government expenditure on goods and services. Policy makers have also recognised that the inclusion of transfers in government spending may overestimate the government's contribution to aggregate demand because there are lags in how quickly transfers can be spent.

More details about how this measure is calculated and how it can be used to assess the effects of budget deficit on aggregate demand in the case of Oman will be addressed in chapter five.

3.2.5 The Domestic Deficit

Since trade and capital flows between the public sector and the external sector vary enormously from country to country, a given conventional deficit can encompass a large spectrum of contribution to the domestic economy. For instance, expenditure on domestic goods that is fully financed by foreign grants increases aggregate demand with no offsetting withdrawal. Government imports financed by domestic taxes reduce aggregate demand by the full extent of the import bill - a case where government expenditure may have contractionary rather than expansionary effects. Blejer and Cheasty state that "the overall deficit could well be zero in each of the two examples, though they each imply an opposite domestic impact" (Blejer and Cheasty, 1991, p. 1653). To isolate the effect of government on aggregate demand in an open economy, 'domestic' and 'foreign' deficits have, in many cases, been calculated separately.

The domestic deficit is measured by including in the calculation only those budgetary elements that directly affect the domestic economy. The foreign

deficit - the impact of the budget on the balance of payments - can be measured by including only budget transactions directly connected to the external sector (Ibid).

Transactions affecting the balance of payments include:

- i) expenditure on goods, services and transfers abroad
- ii) net lending abroad
- iii) increases in government balances abroad
- iv) current receipts from abroad
- v) net borrowing from abroad
- vi) sales of physical assets abroad
- vii) decreases in government balances abroad.

The subtraction of the last four items from the first total gives the foreign deficit or the net impacts of the budget on the balance of payments (Chelliah, 1973, p. 770). Most governments do not present - and probably do not maintain - separate accounts of domestic and foreign expenditure. Thus a fiscal analyst can at best make only rough estimates of direct expenditure abroad. This measure will also be used in detail in the next chapter, where the effect of the budget deficit on domestic demand and on the balance of payments will be examined.

3.2.6 The Cyclical Adjusted Deficit: Removing the Effects of Fluctuations in Economic Activity on the Budget

One of the most important distinctions in modern public finance is that between structural and cyclical deficits. The idea is simple. The structural part of the budget is active determined by discretionary policies such as setting tax rates, social security

benefits or the size of defence spending. In contrast, the cyclical part of the budget is determined passively by the state of the business cycle, that is, by the extent to which national income and output are high or low. In an oil exporting country this refers to the changes in GDP owing to changes in oil prices.

Economists define structural and cyclical budgets quantitatively as follows:

The actual budget records the actual dollar expenditure, revenues, and deficits in a given period. The structural budget calculates what government revenues, expenditures, and deficits would be if the economy were operating at potential output. The cyclical budget calculates the effect of the business cycle on the budget - measuring the changes in revenues, expenditures and deficits that arise because the economy is not operating at potential output but in boom or recession. The cyclical budget is the difference between the actual budget and the structural budget (Samuelson and Nordhaus, 1992, p.625).

The cyclical adjusted deficit is obtained by removing from the actual deficit the cyclical and inflation components of public receipts and non-financial public expenditure. The use of the term 'discretionary' to distinguish the underlying component of the deficit from the cyclical component implies that the former is within the government's control, while the latter is not (Bredenkamp, 1988, p. 7).

To construct a cyclically adjusted budget, the essential steps are:

- 1.- Choosing a reference trend for GNP free from short-run fluctuations.
- 2.- Determining the responsiveness of each category of receipts and expenditures to short-run movements in GNP (e.g. cyclical tax elasticities).
- 3.- Applying these responses to gaps between trend GNP and actual GNP.

- 4.- Adding the expenditures and receipts 'gross-ups' from step 3 to the actual budget to obtain a cyclically adjusted budget. In other words, in this process the analysis is directed to diverting public receipts and expenditures from their cyclical and inflation effects.

The first step is the most important and controversial. All other things being equal, the higher the level of the reference trend, the smaller the cyclically adjusted deficit.

In the case of Oman – as an oil exporting country – revenues and expenditures are not determined by changes in GNP. Instead, they are governed by changes in oil prices. In fact, the opposite is correct, i.e. GNP is governed by oil revenues which, in turn, is affected by changes in oil prices.

Taking the above caveat into consideration, we can give two examples of how actual, structural and cyclical budget balances can be distinguished. Oil prices went up from \$20/b in 1979 to \$36.8/b in 1980. If the average growth rate of the previous three years, i.e. 1977, 1978 and 1979, of both government expenditure and revenues have been used to calculate them, they would have been RO 694.2m and RO 788.6m respectively in 1980. The budget balance, therefore, would have been RO 94.4m. The actual figures of these three variables, in contrast, were RO 949.8m, RO 1181.9m and RO 238.1m respectively (see the table below). Consequently, the cyclical effect on the budget balance was RO 143.7m. The other extreme example is what happened in 1986 when oil prices dropped from \$27/b to \$13/b. Potential government expenditure and revenues would have been RO 2120.2m and RO 1715.8m respectively. The potential deficit would have been RO 404.4m, whereas the actual deficit was RO 669.9m. The cyclical effect on the budget was RO 265.5m.

In the first example, 60.4% of the actual budget balance was cyclical, i.e. caused by changes in oil prices, whereas 40% of the budget balance was potential, i.e. due to

“normal” developments in government finance. In the second example, about 40% of the deficit was cyclically induced. Accordingly, it can be said that approximately 50% of the financial disequilibrium is caused by external factors, i.e. oil prices.

However, this cyclical effect has been mitigated by the change in the volume of oil production. On the other hand, it ought to add up to zero in the long term.

<u>Years</u>	<u>Variables</u>	<u>Potential B</u>	<u>Actual B</u>	<u>Cyclical B</u>	<u>Cyc/Act %</u>
1980	Expen	694.2	949.8	+255.6	26.9%
	Rev	788.6	1181.9	+393.3	33.3%
	B. Balance	94.4	+238.1	+143.7	60.4%
1986	Expen	2120.2	1854.0	-266.2	14.4%
	Rev	1715.8	1186.9	-528.9	44.6%
	B. Balance	-404.4	-669.9	-265.5	39.6%

Note: B = Budget

3.2.7 Comprehensive or Consolidated Deficit

Alternative measures for public sector composition stretch from the central government deficit to consolidated non-financial public sector deficit. The latter includes, in addition to the central government, local government, social security, and non-financial public enterprises. Alternative measures even stretch to the consolidated total public sector deficit, which includes the public sector non-financial deficit, the Central Bank and, possibly, the public commercial banks deficit (or surplus).

While deficit measures based on the widest public sector coverage are the most accurate measure of fiscal stance and public sector resource transfers, they are often not readily available or free from controversy. In other words, the public sector should include the central government, provincial and municipal governments, decentralized agencies, and state-owned enterprises. Conventional deficit measures often include only the central government. "This can give a very misleading picture when other public entities are running large deficits or surpluses." (The World Bank, 1988, p. 56) Even in comprehensive measures the public financial intermediaries are often excluded because of their special role as financing agents. On occasions these intermediaries, especially the central bank, have run up large losses. "They usually arise because the central bank assumes the exchange rate or portfolio losses of private banks, or because the central bank directly engages in subsidised lending" (Ibid).

The deficit of public financial intermediaries has macroeconomic effects similar to the deficits of other public entities; therefore they should be included in the overall PSBR (Ibid).

The above discussion raises the issue of government composition and the coverage of deficit, both of which concern us here. It has already been mentioned in the previous chapter (p.26) that the definition of government in this study, according to its general scope, is what may be called the 'general government', which includes public administration (civil and military), and non-profit agencies, which have no independent financial identity. In other words, the state general budget does not include financial and non-financial public entities and the central bank. There are also no local governments and decentralized agencies in Oman. However, there are particular financial relationships between the state general budget and the financial and non-financial entities. These relationships must be distinguished in order to decide whether the budget deficit here is consolidated or conventional.

Firstly it should be stated that the budget deficit (or the government budget balance) is considered to be consolidated if it represents, or shows, the net worth of all public sector (financial and non-financial) units in addition to the central government. The net worth is defined as any long-term funds employed in a firm. It takes the form of shareholders' capital – employed plus long-term loans.

In 1991 there were some 25 financial and non-financial authorities (See Table 2-3), their total net worth amounted to RO 712.6m (World Bank, 1994, p.99). However, this figure was not included in the State General Budget of 1991.

On the revenue side of the state general budget there is an item known as the estimate of public authorities surplus. It includes, inter alia, the central bank. On the expenditure side there is an item known as the estimate of public authorities subsidy. The match between the two items does not indicate the net worth of the public authorities.

Thus the net worth of the public sector is not presented in the state general budget. Accordingly, the budget deficit discussed in this study is not the consolidated or the comprehensive deficit. It is a conventional deficit since it does not cover the public sector as a whole.

Conclusion

Different measures of the budget deficit provide policy makers with indications of net effect the budgetary transactions have on the economy. To function properly they require the availability of developed databases.

The conventional deficit is one of these measures. It is the definition applied to the budget deficit in Oman, and accordingly, the measure which is adopted in this study. The criterion used to calculate this measure in Oman is, with the exception of foreign grants, is the government debt criterion. According to this criterion, if transactions caused no liability to the government they are classified above the line, if they do not then they are considered positive or negative financing and classified below the line. The conventional deficit measures the total net borrowed by the government, therefore referred to as the public debt concept of deficit. It has some drawbacks that motivate financial economists to discover alternative methods or techniques to measure the budget deficit. They serve different purposes for financial analysis.

One disadvantage of the conventional measure is that it does not take into account the effects of inflation on the budget items. It also includes the effect of previous years' deficits through including interest rate in the expenditure. Two alternatives are provided to solve these shortcomings: the primary deficit and the operational deficit. The former excludes net interest payments from the budget. The latter removes only the part of debt service that compensates debt holders for actual inflation. Because interest payments of the government are not too high, there is no significant difference between the conventional and the primary deficit.

The public debt is not domestic and it is not indexed to inflation. Furthermore, the public debt is not large, therefore, the inflation erosion of the public debt is very small. In short, there is no justification to calculate the operational deficit in the case of Oman.

The third alternative measure is the current account deficit. It is derived by subtracting current expenditure from current revenues. It is an important indicator for the financial analysis because it measures the government current savings that should be allocated to finance capital (development) expenditure.

The fourth and fifth techniques are the budget balance reflecting the impact on aggregate demand, and the domestic deficit. The former is used to assess the government's contribution to aggregate demand. The latter is used to distinguish the effect of the budget on domestic demand from that on the balance of payments. They will be practically employed in our analysis in the next chapter. However, the problem facing the benefit from these two techniques in particular is that the government does not maintain separate accounts of domestic and foreign expenditure.

The sixth one is the cyclical adjusted deficit. Its function is to remove the effects of fluctuation in economic activity on the budget. Because of the swinging behaviour of oil prices and its fluctuation effects on government finance, this measure is of great importance for Oman and other oil countries. My estimation of the cyclical effects on the actual (conventional) deficit is that it varies between 60% and 40%.

Another shortcoming of the conventional deficit is that it does not allow for the public financial and non-financial deficit. This can give a misleading picture when other public entities are running large deficits or surpluses. The alternative measure is the comprehensive or the consolidated deficit. It includes, besides the central government deficit, local government, social security and financial and non-financial enterprises' deficits or surpluses. While this measure is the most accurate one of the public fiscal stance, its calculation and controversial problems are beyond the scope of this study. It has already been mentioned in the previous chapter that the definition of government in this study is what may be called the "general government", which includes public administration (civil and military) and non-profit agencies that have no independent financial identity.

CHAPTER IV

THE CAUSES OF THE BUDGET DEFICIT

In this chapter, the causes of the budget deficit in Oman will be analysed. Before doing that, it is important to trace the evolution of deficit and to compare its magnitude with that of other countries regionally and internationally. Therefore, this chapter will be divided into two sections: the evolution of the budget deficit and regional and international comparison as section 4.1 and the causes of budget deficit as section 4.2.

4.1 The Evolution of the Budget Deficit and Regional and International Comparison

4.1.1 The Evolution of the Budget Deficit

The government budget started to show a deficit in 1972 (Table 3-1) and steadily grew worse over the next four years. There were two main reasons for this: the quick development of the basic infrastructure, which had been at almost zero level, and a steady decline in oil production (Table 4-1) due to the fact that oil exploration was not intensive. Furthermore, oil prices were almost stagnant (Table 4-2) and the government's financial system and control over expenditure were far from sound.

Table (4-1)**The Annual Growth of Government Expenditures and Revenues**

Year	Government Expenditure ROM	Annual Growth %	Government Revenue ROM	Annual Growth %	Deficit / Surplus ROM
1970	20.6	---	45.4	---	24.8
1971	46.0	123.3	50.0	10.1	4.1
1972	71.6	55.7	53.0	6.0	-18.6
1973	91.7	28.7	65.0	22.6	-26.7
1974	362.0	294.8	303.2	366.5	-58.8
1975	489.2	35.1	387.7	27.9	-101.5
1976	581.0	18.8	487.0	25.6	-94
1977	557.0	-4.1	520.0	6.8	-37
1978	586.0	5.2	503.0	-3.3	-83
1979	663.0	13.1	693.0	37.8	30
1980	949.8	43.3	1181.9	71.4	238.1
1981	1223.8	28.9	1262.2	6.3	38.4
1982	1411.9	15.4	1175.4	-6.9	-236.5
1983	1546.9	9.6	1253.9	6.7	-242.3
1984	1760.3	13.8	1340.7	6.9	-346.8
1985	1915.3	8.8	1559.8	16.3	-355.4
1986	1854.0	-3.2	1186.9	-23.9	-699.9
1987	1576.4	-15.0	1460.2	23.0	-148.9
1988	1567.2	-0.6	1204.8	-17.5	-362.4
1989	1665.8	6.3	1370.1	13.7	-304.6
1990	1887.4	13.3	1876.3	37.0	-11.1
1991	1868.1	-1.0	1585.1	-16.3	-283
1992	2258.7	20.9	1680.7	-5.8	-578.5
1993	2197.7	-2.7	1717.0	3.4	-480.4
1994	2252.9	2.5	1757.4	2.4	-495.5
1995	2331.0	3.5	1851.6	5.4	-479.4
Average 1986-90	1710.2	0.2	1419.7	6.5	-305.4
Average 1970-95	1220.6	28.6	1022.0	24.9	-108.4

Source:

1. DC, FIDP, Table (3), p.7.
2. DC, SDP, Table (15), p.21.
3. DC, ThDP, Table (18), p.32.
4. CBO, 1985, Table (4.1), p.38.
5. CBO, 1990, Table (4-1), p.60.
6. CBO, 1995, Table (4.1), p.38

Table (4-2)
Oman's Oil Production and Prices

OIL PRODUCTION

Year	Annual (M.B)	Daily Th.Barrel	Prices \$/b
1970	121.3	332	1.82
1971	107.4	293	2.22
1972	102.8	282	2.52
1973	107.0	293	3.13
1974	105.8	290	11.43
1975	124.6	342	11.48
1976	133.8	366	11.66
1977	124.2	340	12.9
1978	114.7	314	13.0
1979	107.7	295	20.05
1980	103.7	283	36.83
1981	119.8	328	36.88
1982	122.6	336	34.3
1983	141.9	389	29.17
1984	152.4	416	27.85
1985	181.9	498	27.07
1986	204.3	560	13.46
1987	212.5	582	17.3
1988	226.6	619	13.52
1989	233.8	640	16.25
1990	250.1	685	20.73
1991	258.5	708	17.44
1992	270.8	740	18.0
1993	284.6	780	15.0
1994	295.4	809	14.80
1995	311.3	865	17.80

Source:

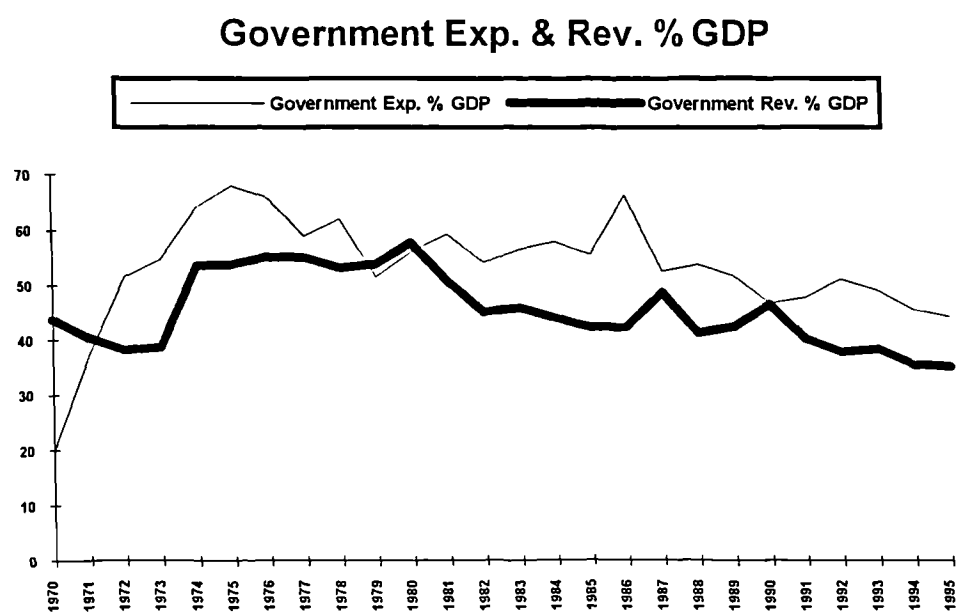
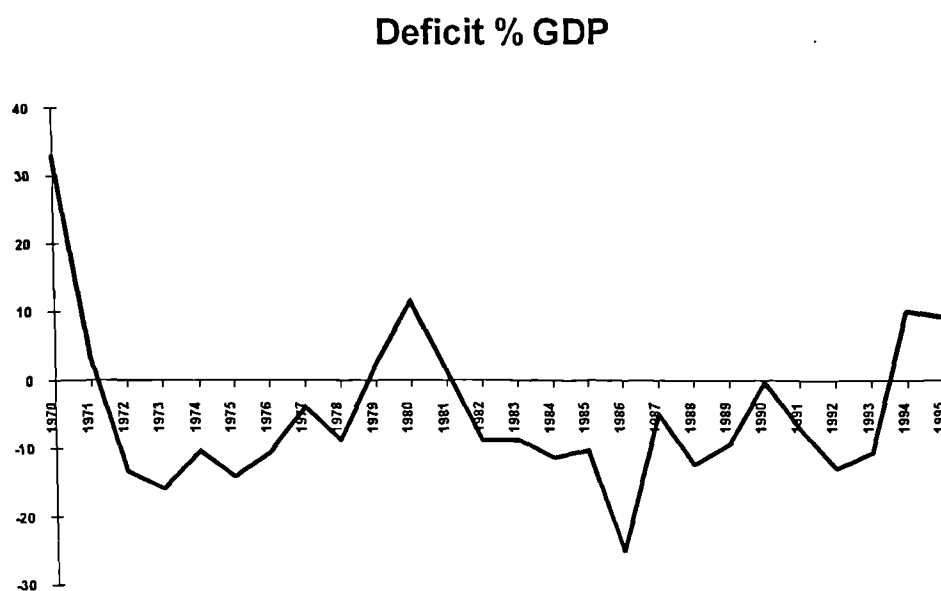
1. Ministry of Petroleum and Mineral, Sultanate of Oman. The assesment of Petroleum Sector performace. p.10
2. BP Statistical Review of World Energy, June 1995, p.12.
3. CBO, 1995, Table (3.1), p.29.

In 1979, 1980 and 1981, the government's budget went into surplus: 1980s surplus saw a 693.7% increase on the 1979 level. Although the volume of oil production was still declining, and government expenditure increasing, the sharp rise in oil prices was more than enough to offset the two negative changes. Unfortunately the government was unable to increase oil production in order to take advantage of the higher price of oil. Had oil extraction operations been more intensive, the budget surplus during this period would have been considerably greater.

From 1982 onwards, the budget balance has turned back to deficit. During the period 1982-1985, the deficit was bigger in absolute values than that of the period 1972-1978. However, as a percentage of GDP it was smaller. Throughout the period 1986-1990 (The Third Development Plan) the world oil market price had been declining sharply. It fell from its highest level of \$41/b in 1980 to \$13/b in 1986. In this year, oil revenue decreased considerably by 31.5% compared to 1985's level. On the other hand, government expenditure has been increasing on average by 12.5% annually, i.e. the government agencies have been accustomed to experiencing increases in spending during the second five-year development plan (1981-1985). Hence, as it can be seen from chart (4-1), the budget deficit had been fluctuating, reflecting the oscillation in oil revenues and the excessive increase in total government expenditures. It reached its peak in 1986 recording 25 percent of GDP.

The deficit minimisation policy which was adopted by the government (to be discussed in chapter six) has succeeded to bring the deficit down to about 0.3% of GDP in 1990. This success can be partially attributed to the sudden increase of oil prices during the time of the Gulf crisis.

Chart (4-1) Oman's Budget Balance
as a percentage of GDP



Source: Table (3-1) and Table (4-1).

However, in 1991, the beginning of the fourth development plan, the government expenditure resumed its high momentum and oil price returned to its falling trend. Thus the budget deficit started to rise and recorded 13% of GDP in 1992.

Table (4-3) sums up the significance of the accumulating deficit as a percentage of GDP and total government revenue throughout the previous development plans.

4.1.2 The Regional and International Comparison

A - Regional Comparison

To assess the extent of the budget deficit in Oman, a comparative regional and international study would be useful. To begin with the regional comparison, the budget deficit of Oman must be compared to that of the other GCC countries. The GCC countries are similar in economic, social and political characteristics; they are all oil producing countries. The oil sector is the leading sector of their economies, oil exports constitute around 85% of total exports and oil revenues form about 90% of total government revenues. Accordingly GCC countries are rentier states with export-oriented economies. They also have a small population with 50% under the age of 15 years. With the lack of adequate quality and quantity of skilled labour their economies rely heavily on expatriate labourers who constitute about 75% of the total population, (e.g. Kuwait and UAE). All of these countries are monarchies experiencing the very early stages of parliamentary practice, with the exception, to some extent, of Kuwait.

Table (4-3)

Oman's Budget Deficit during the previous Development Plans

	1970-1975	The First Plan 1976-1980	The Second Plan 1981-1985	The Third Plan 1986- 1990	The Fourth Plan 1991-1995
The Deficit (absolute value) RO.M	-176.7	+148.1	-1266.6	-1452.5	-2316.8
% of T.R.	19.6 %	5.1 %	19.2 %	20.5 %	28%
% of GDP	9.7 %	2.4 %	8.8 %	9.1 %	10%

Note: T.R. = Total Revenue

Source: Table (4-1)

Oman differs slightly with regard to certain features. Economically its oil production is much less than Saudi Arabia, Kuwait and UAE. For example, the amount of oil produced in one month in Oman, is produced in 3 days in Saudi Arabia, in ten days in UAE, and between 10-16 days in Kuwait. Regarding proved oil reserves in 1994, Oman's oil reserve amounted to 2.0% of that of Saudi Arabia, 5.2% of UAE, 5.3% of Kuwait, but 138% of Qatar. Concerning natural gas proved reserve in 1994, Oman's reserve equalled 10% of that of Qatar, 12% of UAE, 14% of Saudi Arabia, and 49% of Kuwait.

Gross domestic product of Oman in 1991 represented 47% of Saudi Arabia's, 22% of UAE's, 29% of Kuwait's, 83% of Qatar's, and 208% of Bahrain's. If per capita income in the same year is to be considered, the per capita income of Oman represented 23% of that of UAE, 19% of Qatar, 40% of Kuwait, 45% of Saudi Arabia and 71% of Bahrain.

With respect to public finance, total government revenue of Oman in 1981 represented 35% of that of Saudi Arabia, 29% of UAE, 72% of Qatar, 16.5% of Kuwait, and 264% of Bahrain. Total government expenditure of Oman in the same year formed 4% of that of Saudi Arabia, 27% of Kuwait, 27% of UAE, 61% of Qatar, and 356% of Bahrain. However, the Agriculture and Fisheries Sector in Oman has more potential capability than the other countries to participate in the total GDP, with the probable exception of Saudi Arabia.

Regarding demographic trends, Omani nationals form 75% of the total population which is larger than the case of other countries, except Saudi Arabia. Nevertheless, the proceeding comparison must take into account that Oman had started its modernisation process relatively later than all the other GCC countries. Table (4-4) displays some economic and social indicators of comparison between Oman and the GCC countries.

Table (4-4)
GCC countries, some economic and social indicators

		UAE	Bahrain	Saudi	Oman	Qatar	Kuwait
Population ¹	1981	1.10	0.35	9.81	1.03	0.24	1.43
	1985	1.35	0.42	11.60	1.24	0.30	1.71
	1991	1.91	0.52	15.31	1.55	0.50	1.10
Pop. growth	1982	6.36	5.71	4.49	5.83	8.33	4.9
	1985	4.65	2.44	4.22	4.2	7.14	4.24
	1991	3.8	4.0	4.15	1.97	4.17	-48.6
Oil Production ²	1984	1280	-	4585	420	355	1230
	1990	2280	-	7300	695	435	1265
	1994	2490	-	8965	815	450	2085
Oil Res. ³	1994	98.1	-	261.2	5.3 ⁴	3.7	96.5
Gas Res. ⁵	1994	204.6	5.3	185.9	25.13 ⁶	250	52.9
GDP ⁷	1981	32988.3	3467.6	153902	7210.5	8661.3	25246.8
	1985	27081.4	3704.3	86673.8	9999.4	6153.3	21456.8
	1991	33621.4	3984.0	112275.8	10236.2	6672.8	14526.9
GDP Growth	1982	-7.2	5.1	-21.3	4.9	-12.1	-14.5
	1986	-20.0	-14.0	-15.5	-26.7	-17.9	-17.6
	1991	-0.1	2.1	7.3	-2.8	-9.3	7.8
Per Capita income ⁷	1981	29989	9907	15688	7000	36089	17655
	1985	20060	8820	7472	8064	20511	12548
	1991	17603	7662	7333	6604	13346	13206
Gov.R. ⁷	1981	13289.2	1437.8	10879.7	3799.1	5286.5	22975.2
	1985	7094.4	1413.3	36304.9	5117	3739	7019
	1991	11693.5	1361.2	38655	4838	3298.9	2754.1
Gov.Ex ⁷	1981	11927.9	915.2	83756.4	3256.5	5322.8	12120.2
	1985	8620.4	1323.1	50109.1	5582.8	3420.6	10328.9
	1991	13177.9	1421.0	72543.0	4859.0	3128.6	21874.8

Source:

1. Arab Monetary Fund, November 9, 1992. Table 1,2,3,6-7
2. BP Statistical Review of World Energy, June 1995, p. 2-18

Notes:

1. In millions
2. Daily Thousands Barrel
3. Billion Barrels
4. In 1995 (Ministry of Petroleum - Oman)
5. Trillion cubic feet
6. Oman newspaper, February 6, 1995
7. In millions of U.S. Dollars, at current price.

Table (4-5)
The Budget stance of GCC Countries

Million of US Dollars

YEAR	UAE	BAHRAIN	SAUDI	OMAN	QATAR	KUWAIT
1981	1361.3	522.6	25040.6	111.1	-36.3	10855.0
1982	-872.6	224.2	370.5	-684.1	348.1	1966.6
1983	-1448.8	-124.7	-6888.9	-700.1	161.8	2453.1
1984	-810.3	-47.3	-12827.0	-1003.2	90.9	-2482.4
1985	-1526.0	90.2	-13804.2	-1028.1	318.4	-3309.9
1986	-3412.4	-137.0	-16247.0	-1818.4	-83.7	-4461.2
1987	-2740.6	-73.7	-18167.2	-368.9	-1249.7	-2797.9
1988	-2677.3	-215.1	-14300.0	-941.5	-902.2	-3109.7
1989	-1794.0	-154.2	-8929.7	-791.4	-1839.0	-628.3
1990	-2155.8	-276.3	-8829.0	-28.8	-403.0	-5048.1
1991	-1484.4	-59.8	-33888.0	-735.3	+170.3	-19120.7

Source: Arab Monetary Fund, November 9, 1992. Table 8

If this general comparison has been made, it would have thrown more light on the comparison between Oman's budget deficit and the budget deficit of these countries. According to the availability of data, Table (4-5) shows the budget stance of the GCC countries over the period of 1981-1991. It can be seen that all these countries because of high oil prices have achieved surpluses in their budgets in 1981 except for Qatar. Oman and UAE budgets started to witness deficits in 1982. In 1983, Bahrain and Saudi Arabia started to incur a deficit. Kuwait began to show a deficit in 1984, whereas Qatar started in 1986. In absolute values, the largest deficit was that of Saudi Arabia, the second was that of Kuwait, the third was that of UAE. Oman's budget deficit was the fourth.

However the comparison in absolute values may be misleading. Therefore macroeconomic criteria, such as total GDP, total government revenues, the volume of oil production, oil reserves, financial reserves, foreign assets, etc., should be taken into account. Table (4-6) shows a comparison of the budget stance of these countries as a percentage of GDP. The last column represents the ratio resulting from the total yearly budget balances of these countries, except Oman, divided by the sum of their corresponding total GDP.

First of all, these countries' budgets have witnessed surpluses in 1981 (except Qatar), because of the oil boom. The largest surplus was that of Kuwait (43% of GDP). The second was that of Saudi Arabia (18.3% of GDP). In 1984, all these countries witnessed large deficits with the exception of Qatar which continued to achieve a surplus from 1982. The deficits continued to increase, reaching their peaks in 1986, with the exception of Saudi Arabia, whose deficit reached its peak in 1987 at 24.7%, and Qatar in 1989 at 28%. The highest deficit during the mid eighties was that of Kuwait and Oman at 25%. The deficits of Kuwait and Saudi Arabia in 1990 and 1991 were due to exceptional circumstances, i.e. the Gulf crisis. Kuwait incurred a deficit at 73.5% of GDP in 1990, and it increased to 131.6% in 1991. As an average, excluding the exceptional cases of 1990 and 1991 because of the Gulf crisis, the highest deficit was that of Oman and Saudi Arabia at 10% and 10.6% respectively. If the special circumstances are to be included, the highest average was that of Kuwait at 17%, then that of Saudi Arabia at 12.2%.

Table (4-6)
The Government Budget Stance in GCC countries
as a percentage of GDP

YEAR	UAE	BAHRAIN	SAUDI ARABIA	OMAN	QATAR	KUWAIT	GCC
1981	4.1	14.3	16.3	1.5	-0.4	43.0	16.8
1982	-2.9	6.2	0.3	-9.0	4.6	9.1	1.1
1983	-5.2	-3.3	-6.4	-8.8	2.5	11.8	-3.5
1984	-2.9	-1.2	-12.9	-11.4	1.3	-11.4	-10.1
1985	-5.6	-2.4	-15.9	-10.3	5.2	-15.4	-12.8
1986	-15.7	-4.3	-22.19	-25.0	-1.7	-25.2	-20.2
1987	-11.5	-2.3	-24.7	-5.0	-23.0	-12.7	-19.6
1988	-11.3	-6.4	-18.8	-12.4	-14.9	-15.5	-16.4
1989	-10.2	-4.3	-10.8	-9.4	-28.4	-2.7	-10.0
1990	-6.4	-7.1	-8.4	-0.3	-5.5	-37.5	-10.3
1991	-4.4	-1.5	-30.2	-7.2	2.6	-131.6	-31.8
Average before 1990	-6.8	-0.4	-10.6	-10	-6.1	-2.1	-8.3
Average after 1991	-6.5	-1.1	-12.2	-8.8	-8.4	-17.1	-10.6

If the case of Oman in 1986 is to be compared to that of the GCC countries as one unit (the last column), it can be seen that the deficit of Oman was larger, (25% versus 20%). The average of Oman's deficit excluding the special circumstances, was also larger than the average of GCC countries under the same conditions (10% versus 8%).

B - The International Comparison

Oman, along with countries such as Iraq, Iran, Mexico, Nigeria and Venezuela, is classified by the World Bank as a middle income country (The World Bank, 1988, p. xi). Therefore in international terms, Oman's international budget stance will be compared with that of the middle income countries. Table (4-7) shows the budget deficit of Oman compared to that of some middle income groups according to the availability of data, and as percentage of GDP. This group includes Malaysia, Poland, Thailand and Turkey (Ibid, p.44). It can be seen that the budget deficit of Oman was larger than that of its group countries, except for 1979, 1981 and 1990.

4.2 The Causes of the Budget Deficit

Growing deficit can simply be attributed to the gap between expenditure growth and revenue growth. This fact, despite its simplicity, needs an understanding of the rapid increase of government expenditure and the nature of government revenue. The behaviour of public spending and revenue before and after the oil booms in Oman has changed. Public revenue accelerated dramatically during the boom; public spending also increased. Even as the boom was ending, spending was maintained or increased (See Chart 4-1). This led to a jump in public deficit. The behaviour of government expenditure and revenues will be examined here, starting with expenditure.

Table (4-7)
The Budget Stance in Oman and Some Middle Income Countries
as a Percentage of GDP

YEAR	OMAN	MIDDLE INCOME COUNTRIES
1979	2.3%	-3.0%
1980	11.5	-6.5%
1981	1.5%	-8/0%
1982	-9.0	-7.5%
1983	-8.8	-5.8%
1984	-11.4%	-5.0%
1985	-10.3%	-4.5%
1986	-25.0%	-3.3%
1987	-5.0%	-2.8%
1988	-12.4%	-3.0%
1989	-9.4%	-3.4%
1990	-0.3%	-3.9%
1991	-7.2%	-4.9%
1992	-13.1%	-3.1%
1993	-10.7%	-6.4%

Source: 1) The World Bank, World Development Report, 1988. Figure 2.1 p.44.
2) IMF, International Financial Statistics, 1996.

4.2.1 The Behaviour of Government Expenditure

With the emergence of the Omani economy from a long period of stagnation, government recurrent and investment expenditure has inevitably increased at a high and rapid rate.

The variation of government expenditure in general is explained by the variation in the number of employees, the number of pupils, the number of patients, the quantity of electricity produced, the amount of military equipment purchased, and the growth in population. These factors refer to different types of government expenditure which will be discussed later. However there are common factors which affect government expenditure; these will be discussed first.

It can be seen from Table (4-8) and Table (4-9) that, on average, government expenditure accounted for 52.3% of GDP, growing by 28.6% over the period 1970-1995. During 1986-90 it grew by 0.8% due to a reduction in development expenditure. Chart (4-2) compares the government expenditures (as per centages of GDP) of Oman, the GCC and the developing countries. The higher rate of government expenditure to GDP in Oman can be attributed to the general and special causes affecting the different expenditure components.

Table (4-8)**The Components of Total Expenditure (% of GDP)**

YEAR	TOTAL	CURRENT	DEVE.	DEFENCE	SUBS	EDUC.	HEALTH
1970	19.9	5.8	2.0	12.0	-	-	-
1971	37.1	8.0	16.1	13.0	-	1.0	-
1972	51.4	9.9	21.5	20.0	-	1.9	-
1973	54.7	12.0	17.6	25.0	-	1.6	-
1974	63.9	11.6	31.6	20.8	-	1.0	2.2
1975	67.8	9.0	21.7	33.4	-	1.3	2.0
1976	65.7	12.9	22.1	30.8	-	1.4	2.0
1977	58.8	16.1	15.4	25.0	2.3	2.1	1.4
1978	61.9	18.3	13.0	28.0	2.6	2.7	1.7
1979	51.4	14.6	15.0	20.9	0.9	2.1	1.4
1980	46.0	13.1	12.0	19.7	1.2	1.8	1.1
1981	49.1	13.4	12.7	20.9	2.0	2.2	1.6
1982	54.0	17.0	15.1	19.9	1.8	2.9	1.4
1983	56.5	16.1	13.8	24.5	2.1	3.2	1.5
1984	57.8	16.7	15.3	25.7	2.0	3.2	1.8
1985	55.5	17.5	15.5	21.7	0.9	2.9	2.6
1986	66.2	23.1	19.0	23.8	0.3	4.1	2.8
1987	52.5	21.6	10.9	19.4	0.5	3.9	2.1
1988	53.6	23.8	9.1	20.1	0.5	4.0	2.2
1989	51.6	23.9	8.0	18.9	1.1	3.5	2.3
1990	46.6	20.9	6.6	18.3	0.8	3.3	1.8
1991	47.7	21.4	7.0	16.4	0.3	3.5	2.2
1992	51.1	22.4	10.0	17.6	1.1	3.7	2.5
1993	48.9	21.7	10.0	16.4	0.7	3.8	2.6
1994	45.4	20.4	8.9	15.7	0.3	-	-
1995	44.1	20.8	8.3	14.7	0.3	-	-
1986-90	54.1 ²	22.7	10.7	20.1	0.6	3.8	2.2
1970-95	52.3	16.6	13.8	20.8	1.2	2.7	1.9

Source:

1. DC, SYB, 1988, 1993, 1994.
2. CBO, 1985, 1990, 1995.

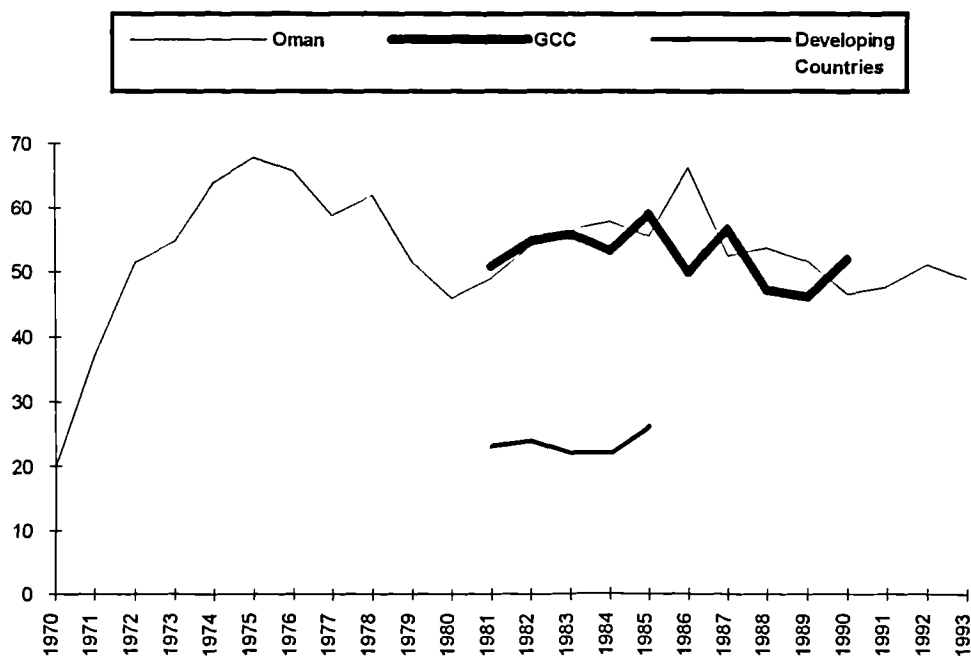
Table (4-9)
The Growth Rate of Major and Important Types
of Government Expenditure

Year	T. Ex.	Current	Dev.	Def.	Sub	Edu.	Health
1970							
1971	123.3	62.3	852.4	29.8	-	-	-
1972	55.7	39.4	49.5	73.3	-	-	-
1973	28.1	46.4	-1.34	50.5	-	-	-
1974	294.8	224.8	505.8	180.2	-	115.4	-
1975	35.1	-0.9	-12.3	104.8	-	67.9	20.5
1976	18.8	75.5	24.4	12.9	-	35.1	19.7
1977	-4.1	33.2	-25.1	-12.9	-	57.5	-25.0
1978	5.2	13.8	-15.8	11.8	13.6	29.5	20.5
1979	13.1	8.7	57.7	1.5	-52.0	6.2	11.3
1980	43.3	44.3	27.2	51.2	109.2	37.8	31.1
1981	28.9	23.5	28.7	28.3	97.2	43.3	34.9
1982	15.4	32.4	24.5	-0.1	-4.0	40.2	17.6
1983	9.6	-0.7	-4.6	28.7	23.4	15.2	24.5
1984	13.8	15.1	23.3	16.6	2.7	10.2	36.0
1985	8.8	19.5	14.9	-4.8	-49.0	2.8	17.5
1986	-3.2	7.0	-0.2	-10.7	-73.9	16.0	9.0
1987	-15.0	0.1	-38.2	-12.3	93.8	1.2	-19.8
1988	-0.6	7.3	-19.1	1.0	2.6	-0.1	1.9
1989	6.3	11.0	-2.9	1.9	116.4	-1.9	11.5
1990	13.3	9.8	2.8	23.6	-8.4	18.6	2.3
1991	-1.0	-1.0	2.5	-13.3	-57.5	2.3	14.6
1992	20.9	17.9	31.0	20.9	267.9	9.5	27.2
1993	-2.7	-1.31	2.2	-5.3	-31.9	13.4	9.5
1994	2.5	0.1	-2.3	5.6	-55.0	-	-
1995	3.5	8.4	-0.7	-0.4	-12.6	-	-
1986-90	0.2	7.0	-11.5	0.7	26.1	6.8	1.0
1970-95	28.6	27.8	58.4	23.3	21.2	26.0	13.9

Source: Table (4-8)

Chart (4-2)

**Government Expenditure as Percentage of GDP, A Comparison Between
Oman, GCC, and Developing Countries**



Source: 1. Arab Monetary Fund, 9 November 1992, Table 7, p.11; Table 1, p.2..

2. The World Bank, World Development Report, 1988, Table 2.2, p.46; Figure 5.1, p.106.

4.2.1.1 General causes

1. Population growth

This is reflected in the increasing numbers in need of education, health care, transportation, electricity and water, etc. Changes in the rate of population growth generate changes in age distribution, and this trend is reflected in expenditures for education as well as care for the aged. The baby boom has resulted in a vastly higher school and college enrolment, thus placing a higher burden on the state. If the more recent population trends continue, education needs will give way to demands for housing facilities; as the population moves further up the age scale, the major fiscal problem forty or fifty years hence will be that of support for the aged (Musgrave, 1980, p. 154). In addition to these conditions, the need for public services is influenced by factors such as population mobility, leading to the growth of new cities and resulting in demands for additional municipal facilities.

Oman began to experience high birth rates and declining infant and child mortality rates in the mid-1970s. Population growth rate between 1980 and 1989 has been estimated at 4.7% per year, and between 1989 and 2000 at 3.9% per year (World Bank, World Development Report (19), p. 189). By 1989 Oman had reached a crude birth rate of 44 per 1000, a crude death rate of 6 per 1000, and a total fertility rate of 7.1 (Ibid).

2. Administrative setbacks

The dominant role and pervasive influence of the government not only inhibit the dynamics of the private sector but place heavy demands on the government's administrative apparatus that it is not capable of meeting (World Bank, 1994, p.

60) There are evident weaknesses in the public sector's analytical, administrative and supervisory capacities that are exacerbated by the extended reach of government activities. At the same time that the government is attempting to improve the performance of the entire economy, serious deficiencies hamper its provision of traditional basic services - notably in health and education - and its overall financial and economic management (Ibid). In the health sector, for example, the cost of drugs could be cut by about 20% through improvements in the procurement system. The cost of medical supplies could be reduced in the same way. Hospital construction costs are high on a per-bed basis and hospital over-capacity is estimated at 15 - 20% (World Bank, 1994, p. 68).

The government's monopoly over the supply of electricity, gas, gasoline and water, together with the lack of competition in the sphere of petroleum exploration and development, mean that inefficient activities survive without check. The absence of competition, overstaffing, inefficiency and lack of unit cost controls in health and education imply poor resources allocation in these areas of traditional government involvement, as well as the diversion of resources from more productive activities within the private sector (Ibid., p. 61)

3. Monetary variables

Monetary variables such as inflation and the exchange rate affect public expenditure to different extents and in different directions.

Inflation exerts a direct effect on government expenditure, forcing increases by pushing up the cost of goods and services needed by the government. The more rapid the rate of inflation in the price of inputs or goods purchased by the public sector, the higher the increase in nominal expenditure.

Inflation affects different types of government expenditure at different rates. Current expenditure represented by wages and salaries is not affected by inflation directly; it increases according to a particular system.

On the other hand, local inflation which is likely to affect wages and salaries is relatively low, hovering around 3.2% between 1976 and 1985. In 1986 it increased to 7.1%. Between 1987 and 1989 it did not exceed 2.5%, while in 1990 and 1991 the rate of inflation was recorded at 9% and 5.8% respectively (IMF, 1994, p. 134).

Current expenditure (represented by equipment, furniture, drugs and the like), defence expenditure (represented by military equipment) and development expenditure are the main types of expenditure subject to imported inflation.

The rate of inflation is taken into account in estimating the government expenditure at the beginning of each year.

However, there is a dialectical relationship between the budget deficit and inflation. The former may lead to the latter if the government has financed the deficit by printing banknotes. Conversely, inflation results in deficit by driving up the prices of government-purchased goods. Thus a vicious circle of deficit-inflation ensues. In the case of Oman, however, the vicious circle of deficit-inflation does not exist because the government has not yet resorted to this means of financing.

The appreciation or devaluation of any currency against other currencies, the countries of which the particular country has an exchange trade, affect the prices of goods imported from, or exported to those countries.

The depreciation of the currency increases public expenditure - in local money - by increasing foreign interest payments, and the cost of capital and intermediate goods demanded by the public sector. The Omani Rial was pegged to the US Dollar from 1973 to 1986 at a rate of 1 RO to 2.8 Dollars. In 1986 the Omani Rial was devalued to 2.6, as just one of the monetary measures designed to cope with the collapse of oil prices.

The USA is the fourth exporter to Oman: many capital, intermediate and consumer goods are imported from the USA. After the devaluation of the Omani Rial, the prices of these goods - in Omani Rials - have increased. Certain amounts of these goods are acquired by the public sector; therefore the increases have been embodied through the direct government purchase or through the contractors' bids offered to execute the public works.

In addition to the official devaluation of the Omani Rial in dollar terms in 1986, the real effective exchange rate has been influenced by the decline in the value of the US dollar in relation to other currencies in recent years. The Central Bank of Oman (CBO) reports show that the effective exchange rate index of Omani Rials was 77.6 in 1984 (as a weighted average). In 1993 it was 127.8. A rise in the index indicates the increase in the number of units of Omani Rials exchanged for a composite unit of foreign currencies, thus indicating the extent of depreciation (CBO, 1986, p. 103; 1993, p. 101). The above two indices indicate that the real effective exchange rate depreciated by 64.7% between 1984 and 1993. The effect of the devaluation of the rial on Oman has been mainly to raise the cost of Oman's imports substantially in terms of the domestic currency, both as a consequence of the decline in the rial vis-a-vis the dollar, and as a consequence of the decline in the value of the dollar vis-a-vis other currencies.

4. Psychological causes

The climate of confidence, prosperity and well-being engendered by oil-wealth has led to an injudicious use of oil resources. Rising government expenditure in different groups of countries would not be possible without raising tax rates or imposing new taxes. These countries have faced difficult options when balancing their budgets; as a result, more attention has been paid to thrift in spending. In oil-producing countries, however, government revenues are not based on taxation, the corollary being that since no hard options are faced when budgets are balanced, the cautious use of public resources has not been given adequate attention.

4.2.1.2 The Components of Government Expenditures

As mentioned elsewhere there are four types of government expenditure: current expenditure; development expenditure; defence and national security expenditure; and participation, loans and support to the private sector. Each of these types has its own peculiarities and special evolutionary causes.

4.2.1.2.1 Current Expenditure

Current expenditure is what the government spends on operating the various government bodies which provide economic and social services in addition to government expenditure to cover its share in current expenditure of PDO. It also includes interest payments on government loans and the purchase of cars and equipment. Table (4-8) shows that on average it formed 16.6% of GDP up to 1995. Table (4-10) shows that it accounted for 32.3% of total government expenditure, and 42.4% during the period of study. From Table (4-9) it is clear

that it has been growing by 27.8% annually; during the period 1986-90 it grew by 7% on average. Table (4-11) displays the significance of current expenditure in terms of GDP, total expenditure, and oil revenue during the previous development plans. It consumed over a quarter of oil revenue in the first plan and over one half in the third. Its annual growth rate exceeded the growth rate of GDP and the growth rate of government revenue. Its high proportion and growth constitute one of the main causes of growth in government spending and, therefore, government budget deficit.

In order to discover the main factors which push up this type of expenditure, it has to be broken down into its main component parts. Table (4-12) explains the structure of recurrent expenditure. As the table shows, there are three elements: civil recurrent expenditure; the governmental share in PDO recurrent expenditure; and interest payments. On average the first element formed 85.7% up to 1995. The main cause of rising current expenditure is government employment, which increased by almost a fifth over the five years from 1986 to 1990. This high level of current expenditure resulted from the vast and very rapid expansion of public administration, which in turn was due to the incremental role of the government in operating and managing goods and services units. The administrative system of state presently consists of about 26 ministries, in addition to a number of general authorities and the *majlis al-shura*. As the Sultanate covers a large land area, with scattered population centres, it is divided into eight provinces, each of which is sub-divided into a number of *walayats* (provincial governments). Many ministries have opened directorates and other law departments in each *walayat*.

Table (4-10)**The Structure of Government Expenditure (% of total expenditure)**

Year	Current	Dev.	Def.	Sub.	Edu.	Health
1970	29.6	10.2	60.2	–	–	–
1971	21.5	43.5	35.0	–	–	–
1972	19.3	41.8	39.0	–	–	–
1973	22.0	32.2	45.8	–	2.8	–
1974	18.1	49.4	32.5	–	1.5	3.4
1975	13.3	32.1	49.3	–	1.9	3.0
1976	19.6	33.6	46.8	–	2.2	3.0
1977	27.3	26.2	42.6	4.0	3.6	2.4
1978	29.5	21.0	45.2	4.3	4.4	2.7
1979	28.4	29.3	40.6	1.8	4.1	2.7
1980	28.6	26.0	42.8	2.6	4.0	2.4
1981	27.4	25.9	42.7	4.0	4.4	2.6
1982	31.4	28.0	36.9	3.4	5.3	2.6
1983	28.5	24.4	43.4	3.8	5.7	3.0
1984	28.8	26.4	44.4	3.4	5.4	3.5
1985	31.6	27.9	38.9	1.6	5.1	3.8
1986	35.0	28.7	35.9	0.4	6.1	4.2
1987	41.1	20.9	37.0	1.0	7.2	4.0
1988	44.4	17.0	37.6	2.1	7.4	4.0
1989	46.4	15.5	36.1	1.7	6.9	4.4
1990	44.9	14.1	39.3	0.7	7.2	3.9
1991	44.9	14.6	34.4	2.2	7.5	4.6
1992	43.8	19.5	34.4	1.5	6.7	4.9
1993	44.4	20.5	33.5	1.5	7.7	5.2
1994	45.0	19.6	34.5	0.7	–	–
1995	47.2	18.8	33.3	0.6	–	–
1986-90	42.4	19.2	37.2	1.2	7.0	4.1
1970-95	32.3	25.7	40.1	2.3	4.9	3.5

Source: Table (4-8)

Table (4-11)

**The Significance and Growth Rate of Current, Development and Defence
Expenditure During the Previous Development Plans (%)**

	The First Plan 1976-1980	The Second Plan 1981-1985	The Third Plan 1986-1990	The Fourth Plan 1991-1995
<u>% of GDP</u>				
- current exp.	14.7	14.9	17.9	21.3
- devel. exp.	16.2	14.6	11.9	8.8
- defence exp.	25.9	22.6	16.5	16.2
<u>% of Total</u>				
- current	26.9	28.9	40.7	45.1
- devel.	27.1	26.5	23.5	18.6
- defence	43.4	41.2	41.0	34
<u>% of Oil R.</u>				
- current	28.8	37.3	56.4	73.0
- devel.	31.6	36.4	37.4	31.6
- defence	50.7	56.7	51.8	54.7
<u>Growth Rate</u>				
- current	35.1	18.0	7.0	4.8
- devel.	13.7	17.4	-11.5	6.5
- defence	12.9	13.7	0.7	1.5
<u>Total Rev. Growth Rate</u>	27.7	5.9	6.5	-2.2
<u>GDP Growth Rate</u>	25.2	11.0	2.6	3.4

Source: Previous Tables.

Table (4-12)
The Structure of Current Expenditure

<u>YEAR</u>	<u>CIVIL RECURRENT</u>		<u>PDO</u>		<u>INTEREST</u>	
	RO m	%	RO m	%	RO m	%
1970	6.1	100	–	–	–	–
1971	9.9	100	–	–	–	–
1972	13.8	100	–	–	–	–
1973	20.2	100	–	–	–	–
1974	59.9	91	5.7	9	–	–
1975	54.8	84	10.2	12	–	–
1976	95.0	83.4	12	10.5	7	6.1
1977	127	83.6	15	9.9	10	6.3
1978	138	79.8	19	8.7	16	9.2
1979	144	76.6	24	12.8	20	10.6
1980	214.8	79.2	35.3	13	21.1	7.8
1981	272.5	81.3	47	14	15.5	4.6
1982	315.7	71.2	55.7	12.6	17.5	3.9
1983	362.7	71.5	58.7	11.6	19.2	3.8
1984	448.7	74	58.5	9.6	39.2	7.7
1985	478.7	79	63	10.4	47.1	7.8
1986	488.2	75.3	72.3	11.2	75.9	11.7
1987	499.5	77	66.5	10.3	72.9	11.2
1988	535.2	76.9	62.7	9.5	84	12.1
1989	600	77.7	66	8.5	94.5	12.2
1990	660	77.8	75.4	8.9	92.4	10.9
1991	674.1	80.3	76.2	9.1	69.4	8.3
1992	779.8	78.8	82.2	8.3	98.5	10
1993	796.7	81.6	92.4	9.5	100.3	10.3
1994	825.6	81.4	87.7	8.5	100.7	9.9
1995	896.7	81.4	89.6	8.1	115.7	10.5
1986-90		76.9		9.7		11.6
1970-95		85.7		10.3		8.8

Source:

1. DC, FiDP, Table (3), p.7.
2. DC, SDP, Table (15), p.21.
3. DC, ThDp, Table (18), p.32.
4. CBO, 1985, Table (4.1), p.38.
5. CBO, 1990, Table (4-1), p.60.
6. CBO, 1995, Table (4.1), p.38.

Public service wages and salaries averaged 56.8% of the recurrent budget during the period 1986 - 1990; the overall wage and salary bill rose at an average rate of 10% a year over the same period. Government civil employment has grown in recent years at a rate substantially in excess of that of population growth. Employees of government civil service excluding the quasi-governmental bodies rose in number from 1750 employees in 1970 to 98,342 employees in 1993 - an average annual increase of 15%. This number forms 39% of the Omani labour force and 14% of the total labour force.

Government employment has been viewed by the government partially as a policy of income distribution. The local labour force, in turn, has been motivated to seek employment in the government administration by salaries and wages that are higher than those in the private sector. Employment in government administration is seen as a secure option for those seeking work; other incentives include social care, transport, good catering facilities etc. Furthermore, because of the limited capacity of the private sector to absorb the increasingly large numbers of school, college and university leavers each year, the government has come under social and political pressure to employ the newly graduated students.

During the period under study, government employment grew at a rate of 3.9% annually.

This policy was deemed justified as income distribution policy during the oil boom, however it has long-term negative effects which were not borne in mind. Such effects are increasing government expenditure, bureaucratic inertia, and continuous dependence on the government for employment, consequently creating a weak private sector.

Interest payments have been increasing during the period under study. Its proportion in total current expenditure jumped from 7.8% in 1985 to 11.7% in 1986. It grew by 61% due to the increase of accumulated debt. Interest payments represent vicious circle of deficit in which the deficit of the previous year increases the deficit of the next year. During the period under study 28.5% of the deficit on average is caused by interest payments. In other words, the primary deficit (interest payments are excluded from expenditure) averaged 71.5% of the conventional deficit (see Table 3.1).

Part of the high growth of current expenditure has been induced by extravagance in some items such as furniture and equipment. High prices by which the government has been purchasing such items was another cause behind the momentum of this type of expenditure. Private interest and personal relations are blamed for excessive purchase and higher prices.

4.2.1.2.2 Development expenditure

Development or investment expenditure, or capital formation, is the investment allocated by the government to establish and equip capital assets in order to fulfil the requirements of increasing government services and increasing production of goods. It comprises the following:

- Capital expenditure on projects for civil ministries and other public organisations.
- Capital expenditure associated with natural gas expenditure.
- Government share in PDO capital formation.

From Tables (4-8) and (4-10) it can be seen that in the early seventies it constituted high proportions of both total public expenditure and total GDP. This was expected because of the country's urgent need for basic infrastructure. It formed about 13.8% of GDP and 25.7% of total government expenditure on average. It declined from a high of 49.4% of total government expenditure in 1974 to 14% in 1990. As a percentage of GDP, it dropped from an average of 15% over the period 1976-1985 to 10.7% over the period 1986-1990 (the period under study). Between 1970 and 1995 its annual growth has been approximately 58.4%, however, it was diminishing by 11.5% during the period under study. Its proportion of total government expenditure has fallen to 19% owing to cuts after the collapse of the oil revenue.

Although the development expenditure has been regarded as investment in the promotion of private sector production to replace oil and gas production, it has declined markedly over the previous development plans as a percentage of both total public expenditure and total GDP (See Table 4-11).

There are two important forms of distribution for development expenditure or capital formation: sectorial distribution and regional distribution, each of which is directed to specific aims. Both will be dealt with here.

According to government planning documents, development expenditure is classified into four sectors: the goods production sector; the service sector; the social structure sector; and the infrastructure sector. There are five factors governing sectoral distribution:

1. Working towards developing new sources of national income alongside oil revenues, so as to replace them in the future;

2. Increasing the proportion of investment allocated to income-generating projects, particularly in manufacturing, mining, agriculture and fisheries;
3. Paying attention to the development of national human resources so that they may fulfil their role in the Omani economy;
4. Completing the infrastructure;
5. Establishing the components of a free national economy based on the activities of the private sector and free competition.

(DC, FODP, p.173)

Government development programmes in the infrastructure sector covers roads, airports, ports, irrigation and water resources, town planning, municipality services, and government administration. The goods production sector consists of crude oil, natural gas, mining and quarries, agriculture, fisheries, and manufacturing. The services sector comprises housing, commerce and tourism, electricity and water, post and telecommunications, financial and banking institutions, and transport. The social structure sector consists of education, vocational training, health, information, culture and religious services, and social centres.

Table (4-13) shows the sectoral distribution of development expenditure during the previous development stages. It is clear from the statistics that the lion's share of government attention has been paid to the infrastructure sector, followed by the goods production sector and the services sector. The social structure sector, which includes education and health, comes fourth in the list of government priorities.

With regard to regional distribution, the regional dimension of development is one of the mainstays of the development process in Oman. The aims and policies of economic and social development emphasise the importance of distributing investment among the various geographic regions of the country, so that economic prosperity may spread to all citizens on the largest possible scale, thus diminishing disparity in the standard of living between the regions, while at the same time giving priority to less developed areas. Economic and social development policies also stress the need “to support and develop existing population areas and protect them from mass migration to heavily populated centres.” (Ibid., p. 223). Table (4-14) shows the regional distribution of development expenditure. Unfortunately, like sectoral distribution, where social structure was ranked fourth in the list of priorities, the actual regional distribution of investment has not met the policy objectives properly.

Other regions which are inhabited by 60% of total population have got only 33.8% of total investment of the previous development plans on average. This type of government expenditure represents capitalist accumulation. It aims at the structural transformation of the economy. “It is a process whereby the state nurtures or strengthens the private sector” (Alan Richards and John Waterbury, 1990, p. 214). It does so in several ways. It provides roads, railways, ports and electrical power in order to stimulate economic activity in general. Through its basic industries and mines, it provides raw materials (natural gas, oil) and semi-manufactured goods (iron, copper, chemicals, synthetic fibres), which feed directly into private production. However, in the field of manufacturing, the scenario of an early rentier state like Iran has been repeated in Oman. Government investment in many industrial fields was competing with or even replacing private enterprise.

Table (4-13)
Sectoral Distribution of Government Capital Formation
During the Previous Development Stages
Relative Importance

	1970-1975	First Plan (1976-1980)	Second Plan (1981-1985)	Third Plan (1986-1990)	Fourth Plan (1991-1995)	Average
Good producing sector	14.2	22.6	23.9	32.6	44	27.5
Services sector	22.8	16.6	19.5	17.0	20	19.2
Social structure sector	10.8	6.2	12.2	12.6	12	10.8
Infrastructure sector	42.6	54.2	43.2	36.0	24	40
Other develop. expenditure	9.6	0.4	1.2	1.9	-	3.3
Total	100	100	100	100	100	100

Source:

1. DC, SDP, Table 32, p.51.
2. DC, TDP, Table 42, p.68.
3. DC, The Assessment of the Third Plan, Table 2.49, p.108.
4. MOD, The Main Components of the Fifth Development Plan, Table (4-2), p.38.

Table (4-14)**Geographical Distribution of the Government Capital Formation****During the Previous Plans***

Region			The First Plan (1976-1980)		The Second Plan (1981-1985)		The Third Plan (1986-1990)		The Fourth Plan (1991-1995)	
	% of total area	% of total pop.	RO (m)	%	RO (m)	%	RO (m)	%	RO (m)	%
Muscat	1.2	30.8	284.5	42.4	956.8	56.1	580.3	48.9	322	13.8
Al-Janubia	38.4	8.7	119.8	17.8	164.7	9.7	113.2	9.5	139	6.0
Other Regions	59.9	59.1	267	39.8	541.8	31.8	483.4	40.7	530	22.8
Musandam	0.5	1.4			35	2.0	7.7	0.7	29	1.2
Abroad					7.1	0.4	2.4	0.2	1310	56.2
Total			671	100%	1705.4	100%	1187	100%	2330	100%

Source:

1. DC, FODP, Table 8.1, p.225; Table 8.4, p.237; Table 8.9, p.240.

2. MOD, The Main Components of the Fifth Development Plan, Table (4-3), p.3.

* Excluding Government share in PDO's development expenditure and natural gas exploration and capital expenditure of defence and national security.

In fact the sluggish growth of the private sector with regard to industrial activity in general is due to the so-called 'confidence effect' of oil wealth. As Vaez-Zadeh has stated, "The confidence effect...adversely influences private saving and investment, and it imparts more significance to the pattern of government expenditure...in the oil-producing countries compared with other developing countries" (Vaez-Zadeh, 1989, p. 378). He argues that "the growth prospects of the economy would depend on the ability of the government, which is the recipient of oil revenues, to embark on adequately productive projects that compensate for the adverse effect of expected oil wealth" (Ibid).

Under this effect, Oman, like other rentier states, has launched, in addition to infrastructure and social structure programmes, mining and manufacture projects (copper, cement) and even insurance and hotels, etc. Some of the latter projects have been economically unsuccessful, representing a leakage of scarce resources without good return.

During the last three years of the period under study the transfers to financial SOE have contributed by 23.4% of the budget deficit on average. The transfers take the form of subsidised interests not lending and equity injections. The first part is acceptable because it protects low-income borrowers from higher interest rates, however the other part must be reduced.

In addition, public works in Oman are executed at high costs. A study prepared by the Secretariat General of GCC countries in the mid-Eighties reveals that electricity prices in Oman, for example, are much higher than in other countries, despite the fact that they are subsidised. Strict application of adjudication law and administrative reform are required to bring investment costs down.

In this context it is important to evaluate expenditure on education and health as one of the main components of government expenditure to examine its performance and effects on the government budget.

Expenditure on education and health:

Oman has put a great emphasis on education and health. Expenditure on education represented 2.8% of GDP between 1970 and 1993. As a percentage of total government expenditure it reached about 5% and 7% during the period under study (Table 4-10). It had an annual growth rate of 26% (Table 4-9). Because of the high population growth and the scattered distribution of population, the need for education has been increasing. Education in Oman is free of charge; furthermore, the government encourages students financially in certain types of education. The government's emphasis on education has meant that education achieved high levels in quantity terms during the previous development plans. It has been widely diversified. There are general education schools and technical and training institutes. With regard to technical education, there are commercial, industrial and agricultural schools; a number of intermediate vocational training colleges; health, banking and public administration institutes; the Industrial Technical College of Oman; and, at the top of the educational hierarchy, the Sultan Qaboos University. There is also an increasing number of scholarships for higher education abroad.

Government capital expenditure is employed in this field in constructing and equipping general education schools at several levels, the intermediate specialized colleges and institutes, in the establishment of administrative buildings for regional departments, and in the construction of Sultan Qaboos University, at a total cost of RO 55 million. The number of public general education schools increased from 3 in 1970 to 779 in 1990. The number of pupils in state schools increased from 909 to 355, 986.

Regarding health expenditure, Tables (4-8) and (4-10) show that it represents about 2% of GDP and 3.5% of total government spending (and 4% throughout the period under study). It has been growing by about 14% annually on average. These figures represent the expenditure of the Ministry of Health alone; there are other ministries or agencies which offer health services.

Remarkable progress was achieved during the implementation of the previous plans. All government health services are free of charge. Government investment in this field has been directed to the construction of new hospitals, health units, clinics and maternity centres in various regions. The number of government hospitals increased from 1 in 1970 to 47 in 1990; the number of clinics from 9 to 90; the number of beds from 12 to 3421.

In 1990, Oman had 1,060 persons per doctor and 2,810 persons per nurse compared with the average of 3,410 persons per doctor and 3,940 persons per nurse for countries ranked in the medium human development countries – into which Oman falls (UNDP, 1994, p.152, quoted in Al-Yousef, 1995, p.93).

At the top of the medical services are the Royal Hospital, the Hospital of the Sultan's Royal Forces, and the Sultan Qaboos University Hospital, which alone was built at a cost of RO 50 million. Accordingly health conditions have improved significantly in some health indicators. For example, UNICEF's 1994 report stated that "Oman had achieved 97 per cent rate of immunization against measles – against a goal of 90 per cent to be achieved by the year 2000" (Ibid) (see also Section 4.2.1.1 – Population growth). Table (4-15) compares Oman with other Middle Eastern and developing countries; Oman's advanced position in terms of expenditure figures is clear.

Table (4-15)

Government Expenditure on Education and Health (As Percentage of GDP)

A Comparison Between Oman and Middle East and Developing Countries

	OMAN	MIDDLE EAST	DEVELOPING COUNTRIES
Education: 1985-87	3.6	3.7	3.6
1988-90	3.6	3.2	3.3
Health: 1985-87	2.5	1.9	1.7
1988-90	2.1	1.6	1.6

Source: 1. World Economic Outlook, World Bank, May 1992, p. 76.

2. The previous tables (for Oman).

Educational expenditure at the general government level typically represents 4.5% to 7% of GDP in industrial countries. In developing countries, education expenditure ranges from 2.5% to 7.5% of GDP (Ke-Young Chu and Richard Hemming, 1991, p. 107).

Expenditure on education may have a large element of consumption, but its character as an investment in human capital is especially important. One special feature of an educational investment is its long gestation period. The expansion of the primary school system does not yield its returns until after 6 to 8 years; a graduate of medicine represents an investment of perhaps 20 or more years of formal education. The long gestation period required for education to pay off and the limited opportunities to borrow against prospective human capital imply that education costs are usually entirely or substantially subsidized (Ibid).

Education also offers wide-ranging external benefits to society. By improving the quality of the work force, education increases the rate of return on other investments and promotes growth; education provides the scope for greater specialization of labour and can facilitate more outward looking economic development; and education is viewed by many governments as a means of promoting national identity, loyalty, and generally more social patterns of behaviour (Ibid., pp. 107-108).

From an economic standpoint, adequate health care improves human capital by strengthening an individual's capacity. Unfortunately, expenditure figures do not necessarily measure the standard of education or health service. Basic education in Oman, i.e. elementary, primary and secondary, has been declining in quality. Because of the increasing numbers of pupils, schools have been operated in two shifts. This means that the length of lessons has been shortened. The number of students per teacher has increased, resulting in bigger classes. Despite this,

however, the growth of education expenditure during the period under study has been reduced. Table (4-9) shows that education expenditure grew by only 6.8% on average during the period under study compared with 26% during the period up to 1993. Health spending grew by only 1% compared with 14%. The rationalization of health spending may be required because hospitals have been run at high costs.

4.2.1.2.3 Defence and National Security Expenditure

Oman's defence and national security expenditures have been among the highest in the world, representing 22% of GDP on average. It constituted 40% of total government spending. It was 60% and 50% in 1970 and 1975 respectively. Since then it has grown at a rate of 23.3% a year on average up to 1995. However, during the period under study this rate of growth had slowed to 0.7% a year. Its significance in total government expenditure has declined slightly to 37.2%; as a percentage of GDP it decreased to 20% (Tables (4-8), (4-9) and (4.10)).

Table (4-11) shows the evolution of this type of government expenditure throughout the previous development plans. It has been absorbing more than 50% of oil revenues. Table (4-16) shows a comparison between Oman and some other Middle Eastern countries regarding the per capita spending on military purposes.

Defence and national security expenditure consumes the equivalent of 78% of all civilian recurrent expenditure combined; more than three times the expenditure on education; and seven times the expenditure on health (The World Bank, 1994, p. 66). This report has pointed out that "the sheer scale of such spending means that any economies that might be achieved could have a far greater impact on the government's financial position than those achievable anywhere else" (Ibid).

Military spending as a share of GNP is highest in the Middle East and North Africa, where it accounted for 11 to 14% between 1974 and 1985:

Table (4-16)**Per Capita Military Expenditures (US \$)****A Comparison Between Oman and Some Middle Eastern Countries**

	EGYPT	IRAN	IRAQ	KUWAIT	OMAN	S.ARABIA	SYRIA
1975	163	268	107	n.a.	n.a.	1,153	96
1978	40	280	159	848	852	1,259	125
1979	42	270	213	769	906	1,796	244
1980	53	117	227	769	1,245	2,525	254
1981	49	113	n.a.	936	1,785	3,014	268
1982	56	329	568	n.a.	1,808	2,780	286
1985	85	297	858	1,051	1,739	1,527	339
1987	67	70	592	683	1,270	1,375	339
1988	61	52	433	703	1,073	1,103	133
1989	59	83	n.a.	673	926	995	183
1990	47	73	251	5,816	885	2,386	183
1991	63	77	n.a.	3,907	744	3,343	235
1992	60	n.a.	n.a.	5,000	943	1,371	n.a.

Source: Military Balance, 1982/1983, p.124

1983/1984, p.126

1984/1985, p.141

1985/1986, p.171

1987/1988, p.218

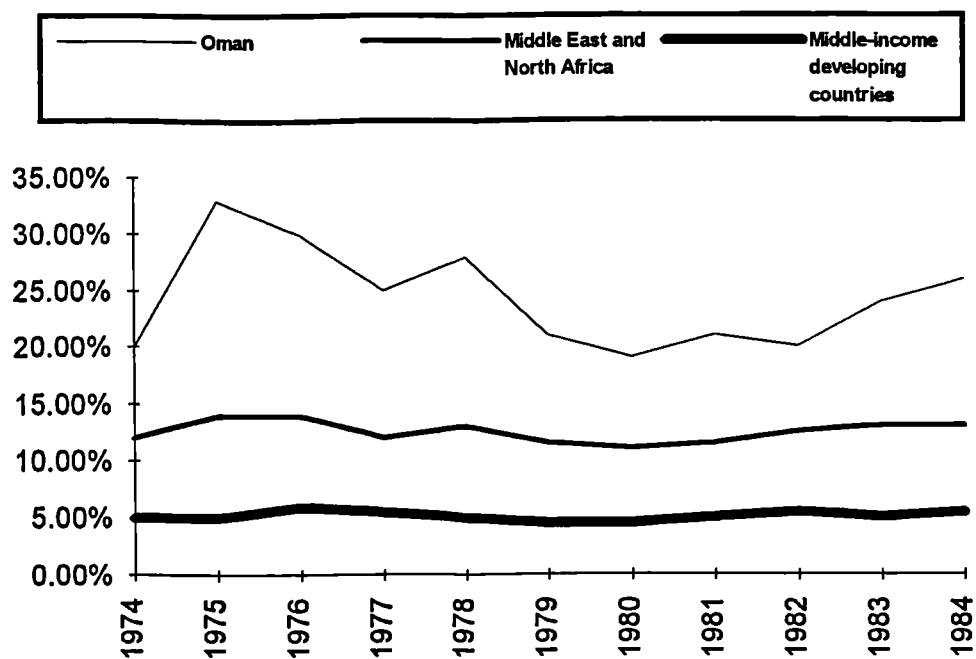
1989/1990, p.209

1991/1992, p.213

1992/1993, p.219

Chart (4-3)

**Military Spending in Oman, Middle East and North Africa,
and Middle-Income Developing Countries (% of GDP)**



Source:

1. The World Bank, World Development Report 1988, p.107
2. Previous Tables (For Oman).

The goals of military spending are non-economic ones - primarily defence against external threats and internal instability. However, some have also justified military spending by claiming it can contribute to economic development. A controversial 1973 study...found that higher spending was positively associated with economic growth (The World Bank, 1988, p. 107).

It is argued that military spending can have positive spin-off effects such as fostering technological innovation, training personnel who later move into civilian jobs, providing employment opportunities, building domestic institutions, stimulating a country's tax effort, and promoting more intensive use of existing resources.

Military industries can be a focus of industrialization activity. In recent years, several developing countries have developed arms export industries of their own.

These positive effects appear to be more than offset by the long-term negative impact of military spending, however. Research in the past decade, although not conclusive, points to a negative relation between military expenditure and economic growth...The most basic criterion is the high opportunity cost of military spending, that is, the diversion of scarce resources from more productive civilian uses...A 1982 study of sixty-nine developing countries indicated that growth of military spending during the 1950s and 1960s significantly reduced overall investment, agriculture production, and economic growth. Other studies have found negative relations between military spending and spending on social development (including education and health) and between military spending and savings (Ibid).

Nowadays, defence spending often has a high import content. In developing countries as a whole, arms imports represent about 5% of the total imports. Payment for such imports can add considerably to the balance of payments problems and to the debt burden (Ibid). Arms imports of Oman averaged 4.4% of total imports between 1987 and 1990 (UNDP, 1993, quoted in Wilson, 1995, p.190).

Chart (4-3) makes a comparison between military spending in Oman, the Middle East, North Africa and middle-income countries during the period 1974-1984.

4.2.1.2.4 Participation, Loans and Support to the Private Sector

This consists of two components: (i) direct loans and contributions to financial investment organisations or loans to national, regional and international organisations and authorities; and (ii) support to the private sector. The latter combines various types: direct support through soft loans to the industrial sector and indirect support for productive sectors through subsidised rates of interest on loans granted by specialized banks. Direct government support is channelled through several ministries. Traditional fishermen, for instance, are given support through the Ministry of Agriculture and Fisheries in the form of modern boats, motors, nets and other equipment. The government usually bears part of the cost of this equipment, while the remaining part would be in the form of an interest-free loan.

This new type of direct government support was introduced for the first time in the Sultanate by the Second Plan. The total sum allocated for this type of support was RO 135 million, of which RO 16 million was in the form of grants and 119 million in the form of interest-free loans repayable over 20 years, including a five-year period of grace. The grant portion of the programme is allocated for the

support of small enterprises whose capital assets do not exceed RO 100,000. It is limited to enterprises which are located outside the area of the capital so as to encourage regional development.

Indirect support is represented in allocations for the creation and financing of the three specialised banks mentioned above. It is represented in allocations used for increasing the capital of these banks; in providing government loans to them; or for subsidising the interest rate charged by their clients. These banks are authorized to borrow from the government and/or other sources, and the government is authorized to guarantee this borrowing up to four times the bank's paid-up capital and general reserves. The government also guarantees the DBO paid-up capital and a minimum return of 5% on its equity.

The need to finance persistent gaps between the state owned enterprises (SOE) saving and investment has added greatly to the public deficits and public indebtedness in developing countries. Direct budgetary subsidies to SOEs have substantially increased central government deficits (World Bank, 1988, p.10).

During the last three years of the period under study, the transfers to the financial SOE have contributed by 23.4% of the budget deficit on average. Subsidising the interest rate is acceptable because it protects low-income borrowers from higher interest rates, however, the other parts must be reduced.

Total amounts allocated for this type of government expenditure during the previous Plans were RO 89 million, 266.7 million, 170.8 million, and 129 million respectively. This type of government spending averaged 1.2% of GDP, 2.3% of the total government spending, with a growth rate of 21.2%. During the period

under study it averaged 0.6% of GDP, 1.2% of total government spending, and exhibited a growth rate of 26%.

Some writers have argued that when administrative prices are held below costs or enterprises are unable to compete in contested markets, the ready availability of budgetary resources prevents them from going bankrupt. While budget support can be justified by reference to those compelling non-economical objectives that prevent otherwise efficient enterprises from making a profit, it often compensates for inefficiency (Hemming, 1991, p. 78).

The above mentioned report on the Sultanate prepared by the World Bank has valued the cost of the financial subsidies at approximately 11% of industrial value added (The World Bank, 1994, pp. 80-81). In the 1980s, the GCC Secretariat commissioned a study of industrial incentives in the GCC member states. This study pointed out that the Sultanate has the lowest level of subsidisation among the GCC countries (GCC Secretariat General, 1983, p.63). Successive IMF missions have reached similar conclusions. Inclusion of the full costs of those elements of incentive system, i.e. economic input and output support, in the 11% above, would undoubtedly raise the real cost of private sector support substantially.

In fact pressures are mounting for higher subsidies to counter the effects of heavy subsidisation by neighbouring states and to minimise its impacts on the competitiveness of Omani products in these markets as well as in Oman itself. However, the World Bank has inferred that, while contributing to some extent to the growth of manufacturing, subsidisation in Oman has not been successful in achieving substantial economic diversification. The hidden fact, however, is that this type of government expenditure has been driven by the pressure of interest groups.

4.2.2 The Behaviour of Government Revenue

Along with government expenditure, budget deficit is affected by the evolution of government revenue. In the previous chapter it was found that changes in government revenues were responsible for 60% of the budget balance in some years and for 40% in others. Thus the analysis of the structure and movements of government revenue and the internal and external factors that influence them are of great importance. Government revenue constituted 46% of GDP up to 1993 compared with 55.2% for total expenditure. Throughout the period under study it formed 44.2% compared to 54% for expenditure. It had been growing at a rate of 27.2% on average compared with 31% for expenditure. During the period under study it grew at a rate of 6.5% on average compared with 0.8% for expenditure (Table 4-1).

Total expenditure has been greater than total revenues for most of the time, i.e. there has been a gap between the two sides since 1972. This gap has been seen to widen at times and to narrow at others. Whenever the gap was widening, the reason was either that expenditure was rising more quickly than total revenue, or that revenue was declining faster (for example, the period 1982 - 1986), see Table (4-1).

Government revenues are governed by three factors: oil prices; the volume of oil production; and non-oil revenues, a factor which refers to the structure of the government's total revenues. The depreciation of the dollar has a negative effect on government revenues.

In this section I intend to discuss these three factors, beginning with the structure of government revenues.

4.2.2.1 The Structure of Government Revenue

As can be seen from Tables (4-17), (4-18), (4-19), oil revenue dominates the government receipts. It constitutes 88% of total government revenues on average. It forms 45% of total GDP and has been growing by 25% on average. However, during the period under study its proportion of total revenues decreased to 82%, representing 44% of total GDP and exhibiting a growth rate of 6.5%. Non-oil revenues account for no more than 12% of total revenues. Tax revenue is quite small, comprising 4% of total receipts; it covers custom duty and corporate income tax. The latter component represents less than 50% of tax revenue. Although it has been growing faster than oil revenue (Table 4-18), it has been fluctuating, thus mirroring the case of oil revenue, which in turn reflects the instability of oil prices. Non-tax revenue is greater than tax revenue, representing 8% of total receipts. It consists of user charges on electricity and water, other government services, and interests. It has been growing faster than tax revenue. Because the economic performance of the country depends, to a large extent, on government expenditure, which in turn depends on oil revenue, it can be seen that the trends of all types of non-oil revenue reflect the trend of oil revenue (Table 4-18).

The marginal importance of tax revenue has resulted in the weak role of fiscal policy, which has concentrated on the expenditure side of the budget as an adjustment tool. In other words the income redistribution power of fiscal policy is weak. On the other hand, the marginal role of taxes has abolished the tax payer as a controller of public spending policy.

In normal economies, public revenues are derived from local economic activities through the procedures of fiscal policies. In other words, economic activities such as manufacturing, trading services, tourism etc. are normally the sources of public revenue. However, in the case of Oman as an oil-rentier state, 88% of public revenues are independent of the economic activities outside the oil sector.

Table (4-17)**The Structure of Government Revenues (% of Total Revenues)**

Year	Oil Revenue	Non-oil revenue	Tax, fees	Non-tax
1970	97.8	2.2		
1971	95.8	4.2	2.8	1.6
1972	93.6	6.4	4.0	5.3
1973	94.3	5.7	3.8	1.8
1974	96.1	3.9	0.9	2.9
1975	96.2	6.6	0.7	3.1
1976	93.4	7.3	1.9	4.7
1977	92.7	8.9	2.0	5.3
1978	91.1	8.4	2.1	6.8
1979	91.6	6.6	1.8	6.6
1980	93.4	6.6	1.3	5.3
1981	90.6	9.4	2.0	7.4
1982	91.6	8.4	2.6	5.8
1983	86.5	10.0	3.6	6.4
1984	82.5	13.0	5.9	7.1
1985	85.4	13.9	5.7	8.1
1986	78.6	21.4	7.1	14.3
1987	81.0	19.0	4.7	14.3
1988	82.6	17.4	5.9	10.7
1989	82.4	17.6	4.7	11.0
1990	84.7	15.3	3.7	10.5
1991	82.1	17.9	5.2	12.3
1992	80.6	19.4	5.6	13.4
1993	79.0	24.1	5.6	14.2
1994	77.6	22.4	6.1	14.8
1995	77.4	22.6	6.6	14.9
1986-90	81.9	18.1	5.2	12.2
1970-95	87.6	12.3	3.9	8.3

Source: Table (4-18)

Table (4-18)**The Components of Government Revenues (as % of GDP)**

	Total Revenue	Oil Revenue	Non-oil	Tax	Non-tax
1970	43.8	42.9	1.0		
1971	40.3	38.6	1.8	1.1	0.6
1972	38.1	35.6	3.5	1.5	2.0
1973	38.8	36.6	2.2	1.5	0.7
1974	53.5	51.5	2.1	0.5	1.8
1975	53.7	51.7	2.0	0.4	1.7
1976	55.1	51.5	3.6	1.0	2.6
1977	54.9	50.9	4.0	1.1	2.9
1978	53/1	48.4	4.8	1.1	3.6
1979	53.7	49.2	4.5	1.0	3.5
1980	57.6	53.8	3.8	0.7	3.1
1981	50.7	45.7	4.7	1.0	3.7
1982	45.0	41.2	3.8	1.7	2.6
1983	45.8	41.2	4.6	1.7	2.9
1984	44.0	38.3	5.7	2.6	3.1
1985	45.2	38.9	6.3	2.6	3.7
1986	42.4	33.3	9.1	3.0	6.1
1987	48.6	39.4	9.3	2.3	7.0
1988	41.2	34.0	7.2	2.4	4.4
1989	42.4	35.0	7.4	2.0	4.7
1990	46.3	39.2	7.1	1.7	4.8
1991	40.1	32.9	7.5	2.1	4.9
1992	37.6	30.3	7.7	2.1	5.0
1993	38.2	30.2	9.2	2.2	5.4
1994	35.4	27.5	7.9	2.2	5.2
1995	35.0	28.9	7.9	2.3	5.2
1986-90	44.2	36.2	8.0	2.3	5.4
1970-95	45.4	40.2	5.3	1.7	3.6

Source:

1. DC, FIDP, Table (3), p.7.
2. DC, SDP, Table (15), p.21.
3. DC, ThDP, Table (18), p.32.
4. CBO, 1985, Table (4.1), p.38.
5. CBO, 1990, Table (4-1), p.60.
6. CBO, 1995, Table (4.1), p.38.

Table (4-19)
Annual Growth of Different Types of Government Revenues

Year	Total Rev.	Oil Rev.	Non-oil	Tax, fees	Non-tax
1970					
1971	10.1	7.9	120.0		
1972	6.0	3.6	122.7	50.0	250.0
1973	22.6	-16.7	-24.5	19.1	-57.1
1974	366.5	605.8	216.2	12.0	641.7
1975	27.9	28.0	24.8	-7.1	34.8
1976	25.6	22.0	119.2	250.0	90.8
1977	6.8	6.0	18.8	15.4	20.1
1978	-3.3	-5.0	-7.9	1.0	25.1
1979	37.8	38.7	65.7	18.9	32.0
1980	71.4	74.7	35.2	19.8	39.4
1981	6.3	3.1	50.8	64.9	47.4
1982	-6.9	-5.9	-16.6	22.5	-27.0
1983	6.7	4.8	27.2	49.5	17.2
1984	6.9	3.4	38.9	72.8	19.6
1985	16.3	15.2	24.1	13.7	32.6
1986	-23.9	-30.6	17.5	-5.8	34.1
1987	23.0	26.7	9.5	-18.3	23.3
1988	-17.5	-15.8	-24.6	2.6	-38.2
1989	13.7	13.5	14.7	-9.0	16.4
1990	37.0	40.6	19.7	6.4	30.4
1991	-16.3	-18.8	-2.5	18.3	-1.2
1992	5.8	3.8	14.7	14.9	14.8
1993	3.4	-2.7	28.6	3.9	9.4
1994	1.9	0.2	8.3	11.4	5.4
1995	5.4	5.1	6.3	14.0	6.5
1986-90	6.5	6.9	12.2	-4.8	13.2
1970-95	25.4	32.4	36.4	26.8	53.2

Source: Previous tables.

This situation, namely one in which public revenues are easy to extract and are not dependent on the growth of non-oil activities or on changes in tax rates, has made the expansion process of public expenditure an easy one. On the one hand, this ease has increased the Omani society's demand for public services; on the other hand, the dependence of public expenditure on oil revenue as a source of financing has made the fiscal position of the government extremely vulnerable to changes in the world oil markets, which, of course, are out of control. This leads us to the question of oil prices.

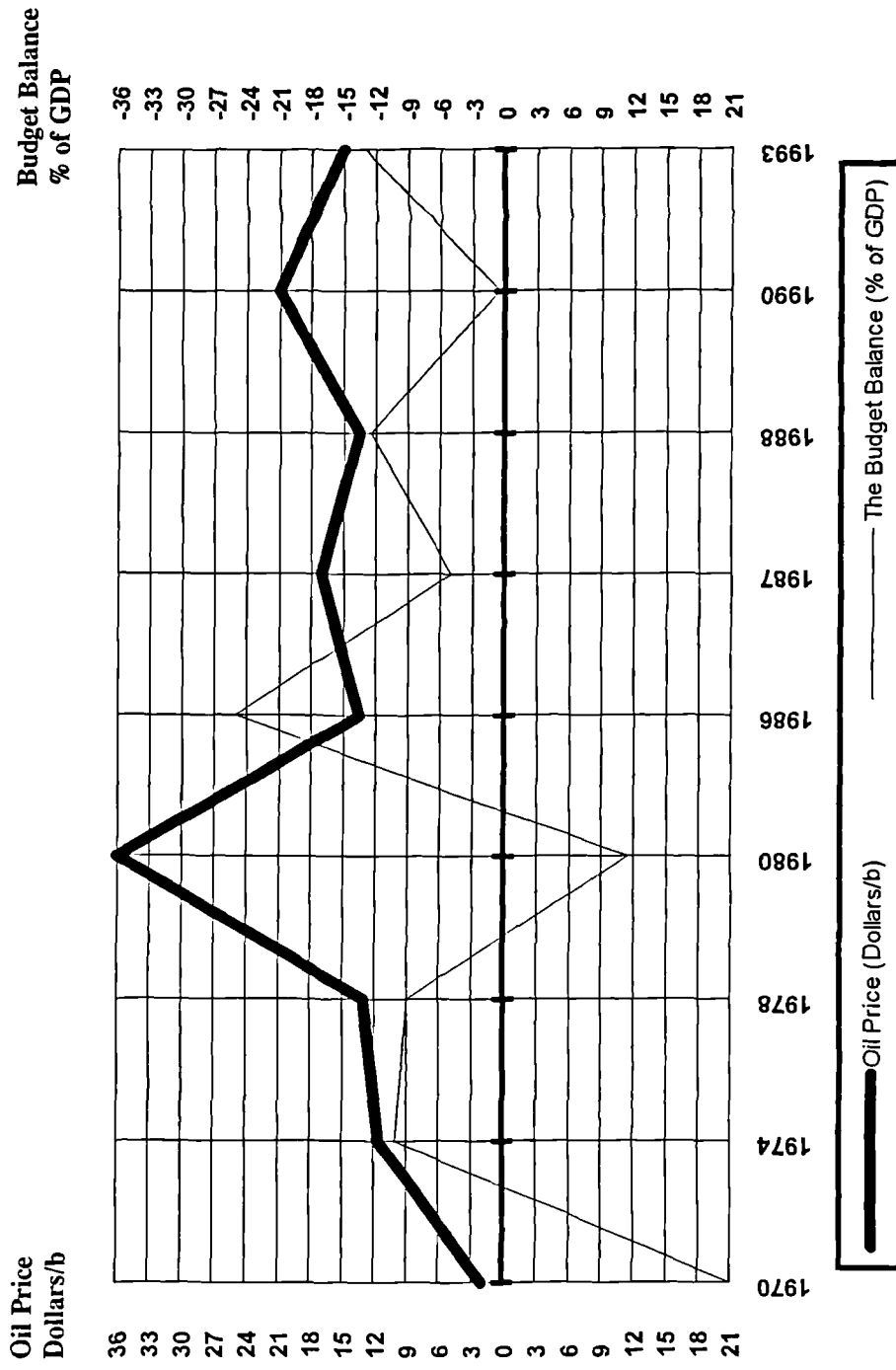
4.2.2.2 Oil Prices

Foreign shocks are a source of fiscal instability in developing countries such as Oman. Commodity exporters face an inherent instability from fluctuating export prices. Oman, as a developing country, relies on one commodity export as its major source of foreign exchange, i.e. oil. Cyclical swings in oil prices have had a great effect on both external and fiscal accounts. There is almost a negative relationship between oil price and the budget balance. When the oil price goes up the budget shows a surplus or the deficit goes down and when the oil price goes down the opposite happens to the budget balance. Chart 4.4 depicts this relationship. The price increases of the late seventies and the later unexpected collapse created fiscal crises in many countries.

With hindsight it is clear that resources generated by the 'booms'...were managed in a way that left countries vulnerable to the coming collapse (World Bank, 1988, p. 71).

Chart (4-4)

The Relationship Between Oil Price and the Budget Balance -- Selected Years



The price at which Oman's oil output could be sold rose precipitously in 1973. It jumped again in the late 1970s, almost tripling between 1978 and 1981, when it reached US\$ 36.88 a barrel.

In 1982 the international oil prices started to decline. Hence, the total oil revenues fell by 9.4% in comparison with 1981 revenues, despite a 2.3% increase in oil production. Oil prices continued to fall during the last three years of the SDP (1981-85). The Sultanate tried to stabilise oil revenues by increasing oil production to compensate for the fall in prices. Despite this measure, oil revenues in the Sultanate did not reach the 1981 level until 1985, when it exceeded the 1981 level by 12.6%, despite the fact that oil production in 1985 exceeded the 1981 level by 51.8%.

To assess the effect of oil prices on oil revenues, three elements must be discussed: Oman's oil pricing policy; the general factors affecting the world oil market prices during the 1980s; and the direct causes of the 1986-89 oil crises.

A. Oman's oil pricing policy

From the time of the first commercial oil exports made by Oman in 1967 until the end of 1970, oil prices had been stable at a level of \$1.82 a barrel. Oman has never been a member of OPEC or OAPEC, although it has benefitted from the existence of OPEC price markets in setting its own oil prices. From the beginning, Sultan Qaboos never considered joining OPEC; he wished to keep Omani oil policy under his own control, thus avoiding any unnecessary risks (Skeet, 1988, p. 102).

As a smaller oil producer, Oman needed to preserve greater freedom of manoeuvre. Oman benefitted - albeit passively - from OPEC's role in the international oil market during the 1970s. During the 1980s, however, Oman changed its oil policy and became the main mediator between OPEC and non-

OPEC oil producers, particularly from 1986 onwards. There were two reasons for this change: Oman's membership of the GCC, established in 1981; and the persistent decline in international oil prices from 1982 onwards. Since Oman's economy was heavily dependent on oil, the Omani government's initial priority was to obtain the highest possible price for its oil. In practice, however, Omani oil prices were fairly comparable with OPEC oil prices during the 1960s and 1970s, and Oman had little control over oil prices. Oman was a 'price-taker' rather than a 'price-setter'.

Oman's oil sector in the early 1970s was still under the control of the foreign oil companies, as were the oil sectors of most oil-exporting countries at that time. However, Oman was putting relatively little pressure on the oil companies for 'national' control of the oil sector (Al-Ghilani, 1994, p. 96).

During the early 1970s the most difficult problems for the government were the decline of Oman's oil production and the rebellion of the Popular Front for the Liberation of Oman and the Arab Gulf in Dhofar. Only later was it able to turn its attention to other matters, including economic and social development.

The Shell Oil Company, which dominated PDO, found itself in a very favourable position in Oman at that time. It was able to pursue its own interests and maximise the level of oil production at a fair price of \$1.82 a barrel during the 1960s (Ibid., p.97).

It only gradually increased that price as growing pressure for higher oil prices and greater 'national' control of oil sectors emerged in other oil-exporting countries.

From 1975 onwards, Oman began to give a higher priority to improving the performance of the oil sector by employing new secondary and enhanced recovery

techniques and promoting more extensive exploration for oil (Hughes, 1987, p. 169).

The international oil market was relatively stable from 1975 to 1978. During these years the price of Omani oil increased by only 4 per cent, from \$12.55 to \$13.07 per barrel. In this period of relative calm on the oil market, Oman inaugurated its first five-year development plan (1976-1980):

The plan increased government involvement in the oil sector and in the economy as a whole (Ibid., p. 101).

Oman became increasingly dependent on oil as its main resource, with oil revenues representing about 90% of the government total revenues. Political events in Iran at the end of 1978 and the Iran-Iraq war, which began in September 1980, led to a second 'oil shock', causing spot market oil prices to increase rapidly to almost \$40 per barrel in 1980. Oman, as a non-OPEC oil-producer, sold most of its oil on the spot market. The average Omani oil prices increased by 192% between 1976 and 1980. The highest ever price for Omani oil was obtained in January 1980, when it fetched \$41.33 a barrel (Ministry of Petroleum and Minerals).

Omani crude oil pricing underwent major changes during the 1980s. From 1982 'contract' prices replaced official prices until the end of 1984. In January 1985 Omani oil pricing shifted from the 'contract' to the 'spot price' system. The price paid by Oman's customers was to be adjusted at the end of each month to the average level of spot market prices during the month. On 1 February 1987, the spot price was replaced by an official contract price. The price (determined in relation to the OPEC reference-price of \$18 per barrel) was set at \$17.63. However, this contract price system had to be abandoned in December 1987; since

then, oil export prices have been based on monthly spot market-related assessments (Al-Ghailani, 1994, p. 140).

From 1981 onwards, Oman decided actively to support the OPEC oil policy of stabilising oil prices on the market. Omani membership of the GCC increased GCC OPEC members' confidence and strength, owing to Omani influence on non-OPEC oil-producers. The first GCC oil ministers' meeting was held on 14 October 1982 (Skeet, 1988, p. 189). From then onwards, Oman encouraged non-OPEC oil producers to stand shoulder to shoulder with OPEC on oil matters and in 1988 it took the initiative in organising a meeting of non-OPEC oil producers in support of OPEC (Skeet, 1992, p. 103).

B. General factors affecting the world oil market during the 1980s

The role of OPEC in the international oil market had been gradually declining since the beginning of 1980. The price increase in December 1980 marked the end of a golden era for OPEC. Members agreed to increase their official oil price to \$36 per barrel for reference marker crude, and they also decided to set the maximum price for OPEC crudes at a level of US\$41 per barrel (OPEC, 1990, p. 192). Demand for OPEC oil began to decline from 64.5 mb/d in 1979 to 60.3 mb/d in 1981, which amounted to a 6.5% decrease in world consumption in 1981 (Table 4-20). Oil consumption in the USA continued to decline from 17.9 mb/d in 1979 to 14.8 mb/d in 1982. It fell by 17.3% in 1982 alone. This decline of demand on oil was a long-term responsiveness to changes in oil prices.

Table (4-20)
World Oil Production and Consumption 1970-1990 (mb/d)

Year	Consumption	Opec Production	Non-Opec Production*
1970	79	23.4	16.7
1971	96.3	25.3	16.8
1972	---	27.1	18.9
1973	96.3	31.0	18.7
1974	93.8	30.7	18.7
1975	91.8	27.2	19.2
1976	97.7	30.7	19.9
1977	100.6	31.3	20.8
1978	103.2	29.8	---
1979	64.5	---	---
1980	62.1	26.88	18.36
1981	60.3	22.60	18.84
1982	58.4	18.99	20.09
1983	58.1	16.99	20.88
1984	59.1	16.35	22.20
1985	59.1	15.45	23.05
1986	60.8	18.33	22.63
1987	61.8	17.32	22.56
1988	63.6	19.68	22.75
1989	64.7	21.34	22.29
1990	65.2	23.26	22.55

* Excluding the former Soviet Union, Eastern Europe and China

Source: 1. BP Statistical Review of World Energy, June 1990, p.8. Autumn 1990, 311.
2. Opec Annual Statistical Bulletin, 1990, Table 13, p. 15. 1980, p. xxvii and 1992, p. 15.
3. BP Statistical Review of the World Oil Industry, 1980, p. 21.

In the short run the demand for oil is inelastic with respect to price, with little response even to the large price rises. In the long term, if the price rises are maintained the demand response will be much more elastic, partly as a result of fuel and energy consumption savings but also as a consequence of the substitution of other sources of energy for oil (Wilson, 1995, p.124).

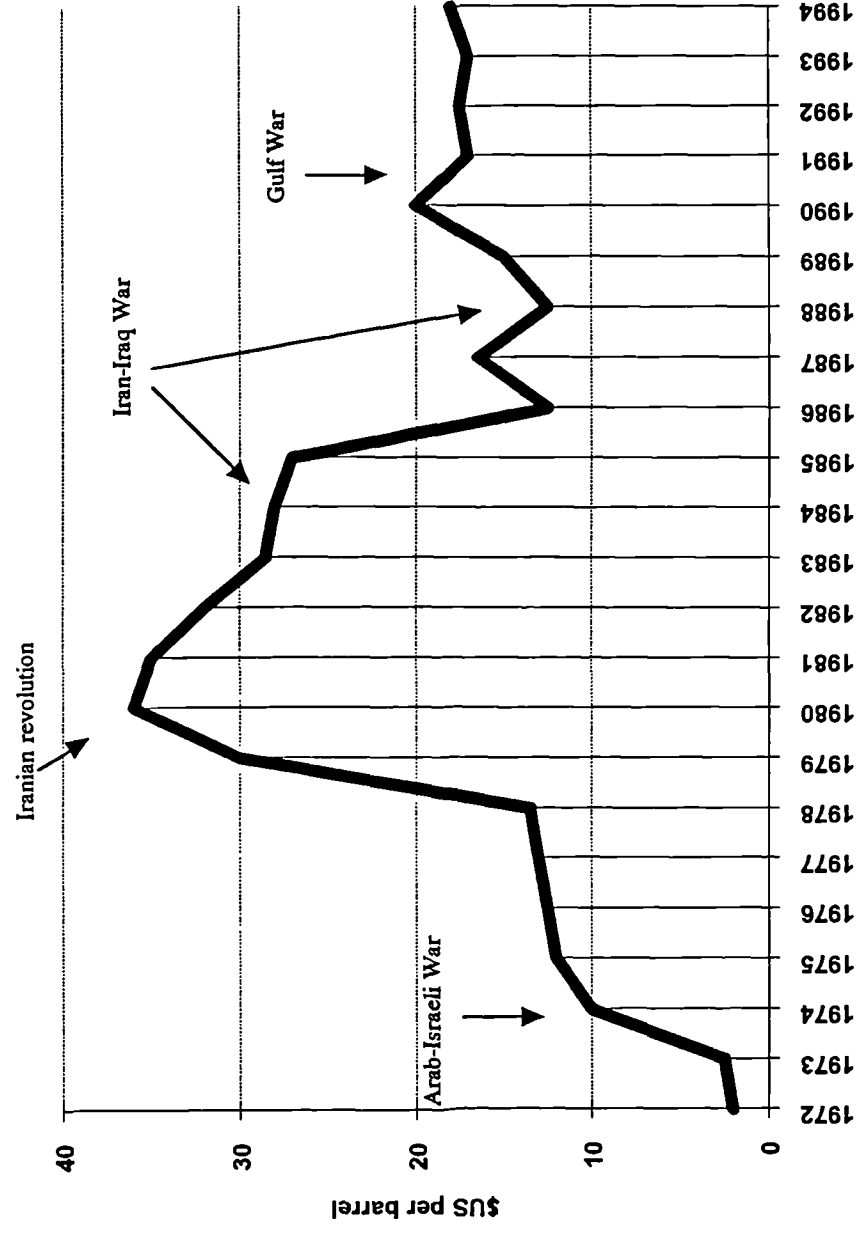
Moreover, non-OPEC oil production increased from 17.7 mb/d in 1979 to 20.09 mb/d in 1982 (OPEC Review, Spring 1988, p. 14).

The period from 1981 to 1984 was of the greatest importance in the history of OPEC. All the OPEC members needed to increase their oil prices in order to finance their development programmes - conceived during the period of high oil prices - as their expenditures had sharply increased. Moreover, Iraq and Iran were at war, and so they particularly needed to increase their oil production prices and revenues. The weakening of the OPEC countries' position on the international oil market between 1980 and 1984 can be seen clearly in the gradual decrease in their share of world oil output (Table 4-20). Overall, the OPEC share of world oil production fell from 55.7% in 1974 to 30.3 % in 1984 (OPEC, ASB 1992, p. 15).

During this period there was a lack of cooperation and coordination among the OPEC members (Mohd, 1990, p. 18). A price war began both within OPEC and between OPEC and non-OPEC oil producers. This stimulated the sale of oil through the offering of discounts and long-term supply contracts which 'improperly' allowed consumers extra time to pay (Ghanem, 1988, p. 170). During this period, OPEC members should have displayed stronger solidarity in order to stabilize oil prices, but trust among OPEC members was lacking because political pressures and the various disputes among OPEC members were stronger than the desire to reach agreement on prices (Skeet, 1988, p. 183).

Chart (4-5)

Spot oil prices (Arabian light ex Dubai)



Source: British Petroleum, *Statistical Review of World Energy*, quoted in Rodney Wilson, 1995, p.135.

Chart (4-5) demonstrates how oil prices have been influenced by the wars of the Middle East as one of the general factors affecting the world oil market.

C. Direct Causes of the 1986-8 Oil Crises

The new OPEC quota system imposed in 1984, with an overall ceiling of 16 mb/d, put Saudi Arabia under great pressure in its role as the main price defender within OPEC. By the middle of 1985 it was clear that demand for OPEC oil was declining relentlessly (OPEC Review, Spring 1988, p. 9) and that the Saudi position as the swing producer on the oil market was no longer tenable. By August 1985, Saudi oil production had fallen to 2.3 mb/d, compared with around 10 mb/d in 1981. In November 1985, Saudi Arabia suddenly decided to boost its production to a maximum of nearly 6 mb/d by the summer of 1986 (FT, Feb 3, 1987, p.15). Like other OPEC members, Saudi Arabia had embarked on ambitious expenditure and development programmes which it had been forced to trim significantly in 1984 (Saudi Arabia Ministry of Planning, 1987, pp. 2-4). It decided to abandon the position of swing supplier. The spot price for Brent Crude declined from \$26.5 per barrel in January 1986 to \$16.70 in March and \$10.30 in April. In May it recovered slightly to \$13.65, but by August the price had collapsed to around \$8 per barrel (Skeet, 1988, p. 218).

The world economy recovered significantly between 1986 and 1989, causing world oil consumption to increase by 1.6% per annum, from 60.8 mb/d in 1986 to 64.7 mb/d in 1989 (Table 4-20), whereas it had fallen from 1980 to 1985. Falling oil prices and a plentiful supply of oil from both OPEC and non-OPEC oil-producers encouraged the oil-importing countries to use more oil. OPEC production increased from 19.6 mb/d in 1986 to 23.2 mb/d in 1989, while the non-OPEC share of world oil production declined slightly. By 1989, international oil prices had recovered slightly. In 1989 the main OPEC target was to gain \$18 per barrel

for its oil (reference crude), with an output ceiling of 17.3 mb/d. However, the price remained within the range of \$15 - 18 per barrel until the beginning of 1989, when it temporarily exceeded \$20 (Petroleum Economist, April 1991, pp. 9-10). The Iranian economy had been very adversely affected by the oil price collapse of 1986. Thus in July 1988 Iran informed the UN of its acceptance of a ceasefire; by 20 August the war was over. After the war, the significant recovery of Iraqi and Iranian oil exports temporarily depressed international oil prices. On the spot market, oil prices fell from an average of \$17.10 per barrel in 1987 to \$14.99 per barrel in 1988. In 1989, nevertheless, the continuing world economic upswing increased world oil consumption and lifted international oil prices to about \$20 per barrel. The \$15-18 per barrel price range was enough to encourage some OPEC and non-OPEC oil producers to increase their oil output and by late 1989 OPEC production had reached 24 mb/d, causing an oil glut in the winter of 1989/90 (Ibid). The incipient oil glut became apparent on the oil market from the end of 1989 and it forced oil prices down to about \$16 per barrel in the winter of 1989/90.

4.2.2.3 Oil Production

The other factor affecting government oil revenue is the volume of oil production. When oil prices go down, making oil revenue far less than what is needed to meet spending programmes, the government increases the volume of oil production, and vice-versa.

The volume of oil production is governed by the quantity of oil, i.e. proven reserves and production cost and the earnings needed to cover government needs, government partners repayments, and partners' profit. The initial discoveries in the late 60s established proven oil reserves of about 1.8 billion barrels. These were

maintained until 1972 and then began to decline as extraction rose to exceed 100 million barrels a year. Reserves expanded rapidly to the 4 billion barrel level as new discoveries were made over the period 1979 to 1984. Since then they have grown more slowly than the annual rate of extraction, which rose very sharply over the period 1983-86.

The proven reserve at the end of 1995 stood at 5.2 billion barrels. Table (4-21) shows the development of oil reserves and production. Oman's oil production is ample compared with that of OPEC or non-OPEC countries. Up to 1976 it fluctuated; throughout the 1976-80 period, oil production was on the decline. After that the production rate was positive but in a fluctuating mood owing to available quantity and world oil market prices.

Because of the geophysical nature of the oil fields and the long transportation distances involved, the cost of oil production in Oman is relatively high. The costs of supply and service contracts form the greatest portion of capital and operating costs (Ministry of Petroleum, 1995, p. 16). It can be inferred from the Ministry's report that these costs are very high (See pp. 15, 16, 28 and 32). The Ministry of Petroleum is trying to slow down the production cost for all working companies so that it compares with regional and international standards (Ibid., p. 32). Production unit costs in PDO are equal to operating costs + 60% of capital costs + 40% of total capital repayed instalments spent by foreign partners during the last five years (depreciation) + 40% of the costs of dry holes provision dug during the same year + 40% of the costs of gas holes works + net recompense, all divided by total quantity produced.

Table (4-21)
Development of Oman's Oil Production:
Prices and Proved Reserves

	Oil Price		Production (Daily)				Oman	
Year	\$	Growth	Opec	Non-Opec	Oman	Growth	An. Pr.	Prov. Res
1970	1.82		23.4 ⁽¹⁾	16.7 ⁽²⁾	332 ⁽³⁾	-	121.3 ⁽⁴⁾	1.741 ⁽⁵⁾
1971	2.22	22.0	25.3	16.8	293	-11.7	107.4	1.670
1972	2.52	13.5	27.1	18.9	282	-3.8	102.8	1.810
1973	3.13	24.2	31.0	18.7	293	3.9	107.0	1.698
1974	11.43	265.2	30.7	18.7	290	-1.0	105.8	1.489
1975	11.48	0.4	27.2	19.2	342	17.9	124.6	1.329
1976	11.66	1.6	30.7	19.9	366	7.0	133.8	1.278
1977	12.9	10.6	31.3	20.8	340	-7.1	124.2	1.414
1978	13.0	0.8	29.8	—	314	-7.6	114.7	1.535
1979	20.05	54.2	—	—	295	-6.0	107.7	2.480
1980	36.83	83.7	26.88	18.36	283	-4.1	103.7	2.493
1981	36.88	0.1	22.60	18.84	328	15.9	119.8	2.908
1982	34.3	-7.0	18.99	20.09	336	2.4	122.6	2.991
1983	29.17	-15.0	16.99	20.88	389	15.7	141.9	3.500
1984	27.85	-4.5	16.35	22.20	416	6.9	152.4	3.852
1985	27.07	-2.8	15.45	23.05	498	19.7	181.9	4.026
1986	13.46	-50.3	18.33	22.63	560	12.5	204.3	3.972
1987	17.3	28.5	17.32	22.56	582	3.9	212.0	4.088
1988	13.52	-21.8	19.68	22.75	619	6.3	226.6	4.119
1989	16.25	20.2	21.34	22.29	640	3.4	233.8	4.269
1990	20.73	27.6	23.26	22.55	685	7.0	250.1	4.361
1991	17.44	-15.9	23.0	42.1	708	3.4	258.5	4.471
1992	18.0	3.2	24.1	41.5	740	4.5	270.8	4.748
1993	15.0	-16.7	24.7	41.1	780	5.4	284.6	4.970
1994	14.8	-1.3	24.9	41.6	809	4.7	295.4	5.138
1995	17.8	20.2	25.3	42.9	864	6.8	311.3	5.2

1 & 2) m.b. 3) thousand b. 4) annual m.b. 5) billion b.

Source: For Oman - The Ministry of Petroleum and Minerals and CBO, 1995, Table (3.1), p.29.
For Opec and non-Opec - Table (4-20) and *OPEC Bulletin*, January 1996, p.38.

Total expenditure of PDO has been increasing by 14% from 1980 to 1985 (CBO, 1985, p. 31). In 1986 total expenditure rose by 45.4% from RO 279.1 m to RO 405.8 m. The increase was due mostly to the construction and acquisition of assest in respect of the pipeline project completed in that year, and to a lesser extent by an escalation in operating expenses (CBO, 1986, p. 37). Rising expenditures, coupled with the larger depreciation which enabled a complete write-off of capital outlays in five years, have pushed unit production costs to high levels (Ibid). The cost reached US\$5.73 /bbl in 1982.

The increasing expenditure of PDO's operations resulted in a rising level of government participation in this expenditure. As can be seen from Table (4-22), government participation in PDO expenditure has been rising at 21% on average against 10% increase in government shares in oil revenues produced by PDO (Columns 2 and 3). If government participation in PDO expenditures has to be abstracted from government shares in revenue, Column 4 will result, representing net government revenue from PDO production. The last column represents the net government revenue as a percentage of total PDO revenue. It ranged from 55% in 1974 to 25.5% in 1993. It averaged 37.7% and 31.6% in the period under study. The result is that the 60% of PDO revenues which go to the government has diminished to about 38% because of the expenditures paid by the government.

The final result is that although Oman's oil production is ample, it has been adversely affected by high production costs, leaving the net government revenue very low.

Table (4-22)**The Government Receipts and Expenditure in PDO's Production.**

	PDO Production		Government Receipts (60%)		Govt. Exp. in PDO \$m		Net Govt. Receipts	% of PDO Produc.
	m/b	\$m	Growth		Growth			
1970	121.3	220.8	132.5		-		-	-
1971	107.4	238.4	143.04	-	-	-	-	-
1972	103.1	259.8	155.9	-	-	-	-	-
1973	107.0	334.9	200.9	-	-	-	-	-
1974	105.9	1210.4	726.2	-	59.7	-	666.5	55.1
1975	124.6	1430.4	858.2	18	76.6	28	781.6	54.6
1976	133.8	1560.1	954.1	11	75.4	-2	878.7	56.3
1977	124.1	1600.9	960.5	1	178.8	137	781.7	48.8
1978	114.7	1613.3	968.0	1	260.4	46	707.6	43.9
1979	107.7	2159.4	1295.6	34	377.0	45	918.6	42.5
1980	103.3	3804.5	2282.7	76	495.5	31	1787.2	47.0
1981	-	-	-	-	-	-	-	-
1982	118.4	4061.1	2436.7	7	670.9		1756.8	43.3
1983	137.4	4008.0	2404.8	-1	706.5	3.9	1698.3	42.4
1984	149.1	4152.4	2491.4	4	707.8	0.2	1783.6	43.0
1985	178.5	4832.0	2899.2	16	728.5	2.9	2170.7	44.9
1986	201.2	2708.2	1624.9	-44	1146.7	57	477.5	17.6
1987	208.4	3605.3	2163.2	33	929.3	-19	1233.9	34.2
1988	220.0	2974.4	1784.6	-18	803.5	-13	981.1	33.2
1989	224.9	3575.0	2145.0	20	886.0	-10	1259.0	35.2
1990	238.1	4935.8	2961.5	38	1112.2	25.5	1849.3	37.5
1991	242.6	4230.9	2538.5	-14	1208.2	8.6	1330.3	31.4
1992	253.4	4561.2	2736.7	8	1286.3	6.5	1450.4	31.8
1993	267.5	4012.5	2407.5	-12	1385.7	7.7	1021.8	25.5
1970-93				9.8		20.9		40.4
1986-90				5.8		8		31.5

Source: Column 3 - Ministry of Petroleum and Minerals, 1995, p. 24.
Column 1 - DC, SYB, 1993, p. 202.
CBO, 1986, p. 27.

4.2.2.4 The Depreciation of the Dollar

The Omani Rial is pegged to the dollar. The dollar has been depreciating against major currencies which dominate the Oman imports. The effect of depreciation of the dollar has weakened Oman's terms of trade by reducing export price index and raising import price index. Its overall terms of trade index declined from 134.6 in 1974 (1987 = 100) to 86.8 in 1992 (World Bank, World Tables, 1989, p.510).

Thus, the purchasing power of oil has been declining with the exception of the first half of 1980s. According to the World Bank, the purchasing power of Oman's oil rose from 50.6 during the late 1970s to 91 during the first half of the 1980s then declined again to 60.5 during the second half. This figure represents the oil price index divided by import price index (World Bank, 1994, p.53).

By the 1990s the oil-exporting countries of the Middle East were more or less back where they were before the oil price shocks of 1973-4. The dollar in which oil prices are denominated, had itself depreciated against the German Deutchesmark and Japanese Yen, the currencies in which a substantial part of the civilian imports into the Middle East are denominated. In terms of purchasing power ... the economies of the Middle East which are oil-dependent appear to have experienced a continuous deterioration, with the two brief exceptions of the oil price shocks (Wilson, 1995, p.136).

Conclusion

Careful diagnosis of the causes of the budget deficit is of great importance because it provides policy makers with clear information that helps them to form the financial policy properly.

The government budget started to show a deficit in 1972. There are two reasons for the budget deficit during the early 1970s: an urgent building of basic infrastructure and the steady decline of oil production. Although the volume of oil production was still declining and government expenditure was rising in 1979 and 1980, the budget achieved a surplus in these two years, and in 1981, because the sharp increase in oil price was more than enough to offset the two negative changes. From 1982 onwards, the budget has been in deficit. It peaked in 1986 at 25% of GDP because of the 31.5% decline in oil revenues due to the collapse of oil prices, despite the harsh measures taken by the government to reduce the deficit. The oil surpluses of 1979, 1980 and 1981 caused the government agencies to become accustomed to experiencing successive increases in their spending.

Thanks to the increase of oil price in 1990 because of the Gulf crisis, in addition to the deficit minimisation policy, the deficit declined to 0.3% of GDP in this year. However, in 1991, the government expenditure resumed its high momentum and the oil price returned to its falling trend. Thus the budget deficit started to rise and it went up to 13% of GDP in 1992.

In comparison with other GCC countries, the budget deficit of Oman and Kuwait were the highest in 1986 (25% vis-à-vis – 22.2% in Saudi Arabia, 15.7% in UAE, 4.3% in Bahrain and 1.7% in Qatar). However, Oman's budget deficit in this year compared to the GCC as one unit was larger (25% against 20%). On average, excluding the exceptional cases of the Gulf crisis in 1990 and 1991, the highest

deficit was that of Oman and Saudi Arabia at 10% and 10.6% of GDP respectively.

In comparison with other middle income developing countries, the category in which Oman falls and during the period 1979-1993, Oman's deficit was larger except for 1979, 1980 and 1981.

The growing deficit is simply explained by the gap between expenditure growth and revenue growth. Total expenditure has been greater than that of revenues for most of this time. This gap has been seen to widen at times and be narrow at others. Therefore the causes underlying the deficit are the factors affecting the behaviour of public expenditure and revenues. Public expenditure growth rate averaged 28.6% during the period 1970-1995, against 24.9% for total revenues.

Total public expenditure has been rising because of general causes that exert their influences on all types of expenditure. On the other hand, each type of public expenditure has been induced by particular factors. The general causes that pushed up successive increases in expenditure are population growth, administration setbacks, inflation, exchange rate depreciation, and psychological causes represented in the climate of confidence and prosperity engendered by oil-wealth, which led to an injudicious use of oil resources.

Different types of public expenditure have different circumstances.

Current expenditure, which accounted for 32.3% of total expenditure up to 1995 and 42.4% during the period under study, has been growing by 27.8% and 7% during those two periods. The main causes of rising current expenditure are government employment, interest payments and intensive purchase of equipment, cars and furniture at higher prices. Wages and salaries averaged 56.8% of recurrent

expenditure during the period under study and were rising by 10% per annum. The interest payments jumped from 7.8% of current expenditure in 1985 to 11.7% in 1986. During the period under study it grew by 61% per annum.

Development expenditure formed one fourth of that of spending up to 1995 and 19% during the focused period. It was growing by 58% on average. It is the most important type of public spending. It plays a short-term and long-term economic and social role in the economy. It provides the social and structural infrastructure, i.e. education, health, communication, and agricultural and industrial income generating projects. It also represents a tool of the sectoral and regional distribution of the oil wealth.

The increasing needs of the country for schools, hospitals, roads, electricity, telephones, dams, etc. is the main cause of the increase of this spending. However, there is an avoidable increase which is represented in the high costs at which public works have been executed. During the period under study, development expenditure was the sacrifice of fiscal adjustment. It was slashed by 11.5% per annum.

Defence and national security expenditure in Oman is one of the highest in the world. It formed 60% of total government spending in 1970 and 50% in 1975. Up to 1995 it constituted 40% on average. It has been absorbing more than 50% of oil revenues. 41% of military spending during the period under study on average is on military salaries.

Changes in public revenues are the other factors affecting the budget deficit. Changes in public revenues are caused by their structure, oil prices, oil production, and the depreciation of the dollar.

Oil revenues dominate the government receipts. It constitutes 88% of total public revenues on average. It has been growing by 25% per annum on average. During the period under study it declined to 82% of total revenues and grew by 6.5%. Accordingly, total revenues have been very vulnerable to changes in oil prices. It was found in the previous chapter that changes in total revenues, due to swinging trends of oil prices, are responsible for 40% to 60% of the actual deficit. The structure of public revenues implies that 88% of government revenue is not derived from local economic activities. This situation has made the expansion process of public expenditure an easy one. On the other hand, this ease has increased the Omani society's demand for public services.

The volume of oil production has been playing a stabilising role. When oil prices go down, making oil revenue far less than is needed to meet spending programmes, the government increases the volume of oil production, and vice versa.

Finally, the effect of the depreciation of the dollar has weakened Oman's terms of trade by reducing the export price index and raising the import price index. Thus, the purchasing power of oil has been declining except for the first half of the 1980s. The purchasing power of Oman's oil rose from 50.6 during the late 1970s to 91 during the first half of the 1980s, then declining again to 60.5 during the second half.

CHAPTER V

THE MACROECONOMIC EFFECTS OF THE BUDGET DEFICIT

Introduction

The budget balance has generally been used as an important summary measure of the impact of the budget on the economy. However, no macro-economic issue has generated more controversy in economic literature than the impact of government deficit and debt upon the economy. The consequence of deficits depends on how they are financed. The macro-economic implications of deficits includes their impact on monetary and financial markets, aggregate demand, and external disequilibrium. Accordingly this chapter will consist of five sections and will be organised as follows:

In the first section, a general analysis of the means of deficit financing in Oman will be conducted, and their direct effects and consequences on the economy will be examined.

In the second section, the effects of the deficit on money supply will be analysed.

In the third section, the discussion will be addressed to assess the effects of the deficits on aggregate demand, i.e. investments and consumption.

Finally, in section four, the study will focus on the consequences of the deficit on the balance of payments.

5.1 The Means of Deficit Financing in Oman and Their Direct Consequences

The consequences of deficits depends on how they are financed. To a first approximation, each major type of financing corresponds to macro-economic implications, if used excessively. Domestic borrowing from the Central Bank to finance the deficit often leads to inflation; domestic borrowing from commercial banks leads to credit squeeze and crowding out of private investment and consumption; external borrowing leads to a current account deficit and real exchange rate appreciation.

Casual observation of the ways in which recent deficits have been financed in a sample of 64 developing countries indicates that the first source used was often external debt. The sample includes countries from Latin America such as Bolivia and the Dominican Republic, and from Asia such as Indonesia and Malaysia, and from the Arab world such as Jordan and Tunisia (see Vito Tanzi, 1985, pp.69-71).

Resorting firstly to external debt because:

This was readily available to countries with a small total foreign debt that were just entering a process of fiscal deterioration. And at least at the beginning, this source had low political and economic costs (Ibid.)

This observation is applied to Oman because it could easily obtain additional resources through external borrowing. Partially, Oman financed the deficit via the withdrawal from its reserves funds, and therefore, external borrowing did not cause political problems.

Governments started to depend on other sources of financing only after they had exhausted foreign sources of financing that ranged from grants to commercial credits. Foreign reserves seem to have been the next financing source used. In fact countries often borrowed to maintain or even to increase their levels of resources. The next sources turned to were domestic non-bank credit, domestic arrears and inflationary finance.

First, we will take a bird's eye view of the general features of the means of deficit financing in Oman. Then we will turn to a worm's eye view of different types of deficit financing to see their economic and political implications. Table (5-1) shows the means of deficit financing that has been implemented.

To start with inflationary finance, it has not been used in order to avoid the harmful effects on the economy. Commercial credits have not been resorted to, and the government has been a net creditor to the commercial banks. Domestic arrears may have been used, but only in very limited cases and for a short time. Regarding foreign arrears, the government has a very good reputation in financial circles because it refunds its matured debt in time. Its financial record as a borrowing country is clean.

Two main sources of financing have been implemented: foreign borrowing and withdrawal from the State General Reserve Fund (SGRF). Foreign grants have been occasionally used especially during the early years. Development bonds have been introduced very recently. From Table (5-1) it can be seen that foreign borrowing was excessively used to finance the deficit at the early development stages (1970-1985).

Table (5-1)
Means of Deficit financing During the Previous Development Plans
(ROm) and Percentage of Total

Period	Deficit	Financing							Debt B.	SGRF B.
		Total	Net Borrowing		Draw. SGRF		Net Grants			
1970-75	222	229 ⁽²⁾	149	65%	-	-	80	35%	-	-
1976-80	215	241	26	10.8%	-	-	215	89.2%	70.0	250
1981-85	1266	1284	478	37. 2%	628	48.8%	179	13.9%	648.1	1181
1986-90	1526.9	1539.9	123	8.9%	1414	90.9%	2.6	0.2%	1027.3	1230.2
1991-95	2354.9	2354.9	-44	0.0%	823.2	35.3%	21	0.9% ³	1501	-

Notes:

1. B = Balance (at the end of the period)
2. The total means of financing is slightly higher than total deficit and the difference forms the change in Government Accounts.
3. 16% of the deficit was financed by development bonds, 47.8% was financed by change in Government Accounts.

Source:

1. MOFE Internal Report (unpublished) p.11
2. DC, The Assessment of the Third Plan Economic Performance, 1992 p16-17
3. The World Bank, Sultanate of Oman, Report No. 12199-OM, 1994 p.18.
4. CBO, 1995, Table (4.1), p.38.
5. MOD, The Main Components of the Fifth Development Plan, Table (2-1), p.18.

Higher proportions of borrowing and grants in the structure of deficit financing in the first stage were attributed to the absence of other sources and to the strong and friendly relationships with other countries.

During the first plan the highest participation of grants relates to the military aid that was given to the government during the war in the south of the country. At any rate, the total deficit during this plan was relatively low at RO 215m which explains the higher oil return achieved by the government in the last two years due to rising oil prices.

The structure of deficit financing during the second plan reflects the relatively high deficit recorded by the budget. Despite significant participation by newly-created SGRF - by almost half the magnitude of total financing - the government had to rely heavily on borrowing (37%) and to a lesser extent on grants (14%).

With the deficit climbing to almost RO 1527m, and in spite of the total foreign borrowing receipts standing at RO 929m (Table 5-2), the contribution of net borrowing in deficit financing stood at only about 9%. The interpretation is this: receipts from new borrowing have been allocated to repay the previous borrowing. The total borrowing receipts was RO 929m, but the total amortisation was RO 1225m. The difference came from SGRF which bore the heaviest burden of the deficit financing, i.e. 91%. The foreign grants contribution in the deficit financing almost vanished (0.2%) because total grants paid by Oman nearly approached total grants received.

Table (5-2)
Indebtedness and SGRF Balances (ROm)

Year	Indebtedness			SGRF		
	Receipt	Amortisation ⁽¹⁾	Balance ⁽²⁾	Drawing	Net Addition	Balance
1980	66	65	70	-	-	250
1981	89	54	120	-	380	700
1982	70	47	180	40	250	830
1983	192	50	320	80	100	950
1984	195	81	470	145	50	1000
1985	125	99	648.1	300	190	1181
1986	298	158	940	526.3	100	1283.9
1987	123	248	887.8	198.4	-	1285.1
1988	219	231	959.9	274.6	100	1193.1
1989	232	292	994.5	254.9	-	1192.0
1990	57	296	1027.3	160	50	1230.2
1991	227	142	973	50	n.a.	n.a.
1992	106	129	1088	149.2	n.a.	n.a.
1993	137	163	1165	292.0	n.a.	n.a.
1994	254	144	1311	221.0	n.a.	n.a.
1995	118	110	1501	111.0	n.a.	n.a.
1986-90 ⁽³⁾	929	1225	1027.3	1414.2		1230.2
1980-95	2508	2309	1501.0	2802.4	-	-

Notes

1. Including interest payments
2. The Debt balance is not exactly the difference between receipt and the amortisation because the loan prescribed is not totally drawn and the outstanding debt is not totally amortised.
3. Total/Balance.
n.a.: not available

Sources

1. CBO, 1985, Table 6.9, p.100.
2. CBO, 1990, Table 5.6, p.127.
3. CBO, 1994, Table 6.8, p. 95.
4. DC, The Assessment of the Third Plan Economic Performance, 1992, Table 1.4, p.16.
5. The World Bank, sultanate of Oman, Report no. 12199, p.19.
6. MOD, The Main Structure of the Fifth Plan, 1996, Table 2.1, p.18.

From 1991 the government began to borrow from domestic sources using treasury bills and development bonds. These were seen as a means of both contending with the financing of the deficit and of absorbing excess domestic liquidity. They contributed by 16% in the deficit financing.

The main two sources of deficit financing, namely foreign borrowing and withdrawal from SGRF have direct and indirect effects on the economy. The direct effect is represented in the increase in the country's indebtedness and exhaustion of its foreign assets. The indirect effects work through money supply, aggregate demand, and balance of payments, which will be discussed later. Only the direct effects will be addressed here.

5.1.1 Indebtedness

Oman, like many middle income countries, developed debt problems because of excessive fiscal expansion and overvalued currencies, which made the economy vulnerable to the rise in global interest rates and the falling export prices after 1981.

The continuation of borrowing as illustrated in Table (5-1) has led to increasing debt. During the period under study the indebtedness rose from RO 648m in 1985 to RO 1027m in 1990. In 1995, it reached RO 1500m. The debt balance as a percentage of GDP has been increasing (Chart 5-1).

5.1.2 The Exhaustion of Foreign Assets

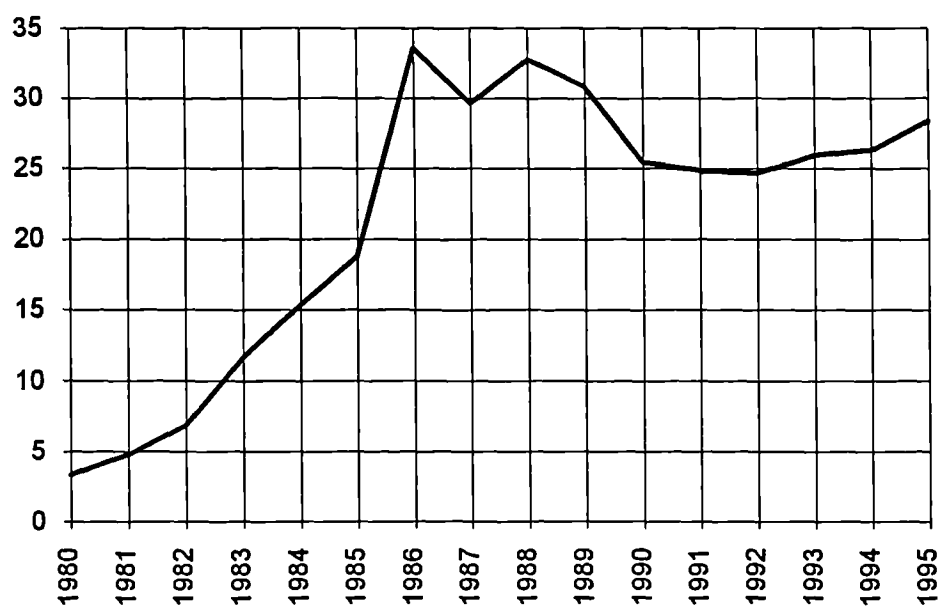
The approach of financing budget deficit by drawing down the foreign assets has been taken by some oil exporting countries that accumulated large foreign assets when the price of oil rose sharply in the 1970s. Oman accumulated publicly-owned foreign assets. They are in the form of foreign exchange owned by the central bank; foreign deposits owned by the State General Reserve Fund and foreign assets belonging to the Ministry of Finance including shares in foreign companies. The foreign assets accumulated when export earnings were high allowed Oman to maintain a higher deficit (and a higher level of consumption) when economic conditions were not so good. This option obviously reduced the need for forms of financing that lead to inflation, directly increase foreign debt, or that crowd out the private sector.

The SGRF was established in 1980, the income of which has been specified on the basis of 15% of each net payment of revenue from oil. The establishment of this fund has been regarded as a prudent policy. Because of the emergence of the series of budgetary deficit after 1981, the government allocation of gross oil revenues has been shrinking rapidly (Table 5-2). The withdrawal was increasing substantially throughout the period under study, forming a total of RO 1414m. Thanks to strong earning on the fund assets over this period its final balance has not been falling quickly.

Whether on economic ground a country should meet its financial needs by using its foreign assets or borrowing abroad is an open question. If the country can use real foreign assets (if it can liquidate, say, foreign property holdings) then the question is whether the marginal cost of foreign borrowing is less than the earning foregone if the assets are liquidated. In each situation the answer will be different and will need to be assessed on its merits (Vito Tanzi, 1989, p. 77).

Chart (5-1)

Public Debt as a Percentage of GDP



Source: Table (5-2).

5.2 The Effect of the Budget Balance on Money Supply

In the oil exporting countries, fiscal policy is the primary determinant of domestic liquidity and aggregate domestic demand. “It must be the primary instrument of demand management for oil exporting countries ... there exists a close relationship between domestic budget deficits, domestic liquidity expansion and inflation” (Morgan 1979, p.57). Budget Deficits are expansionary because they are often financed in a way that adds to the stock of money.

So as to analyse the effect of the budget balance on the money supply in Oman which has witnessed, as have other oil exporting countries, a noticeable volume of external receipts and payments through the government’s budget, the domestic budget balance provides a better measure than the overall budget balance.

The domestic budget balance has been defined in Chapter Three as “government domestic revenue – government domestic expenditure”.

Concentrating on the domestic, rather than overall budget balance is due to its direct implications for the analysis of monetary policy. More precisely:

the concept of domestic budget balance highlights the role of the budget in the determination of domestic liquidity more accurately. Ordinarily, an overall budget surplus implies a contractionary effect on domestic liquidity. This result does not necessarily hold in the case of oil exporting countries. In these countries a government may incur large budget surpluses and yet have an expansionary impact on domestic liquidity. This follows from the fact that the government relies predominantly on oil exports to meet its expenditures rather than through taxing the private sector. It is the domestic budget balance that

determines whether the government plays an expansionary or contractionary role in domestic liquidity creation (Kalmoor 1988, p.59).

Money supply may be defined for our purposes as consisting of: a) Currency notes and coins with the public and b) Demand deposits held by the public. This is because a narrow definition of money supply is more suitable in the case of developing countries.

It is obvious that the direct (positive) impact of the budget on the money supply will be equal to the excess of government payments to the non-bank private sector over the receipts from that sector. That is, it is equal to:

(domestic expenditure on goods and services + transfers to the domestic non-bank private sector + domestic net lending) - domestic tax and non-tax revenues including depreciation but excluding profits from the central bank + sale of physical assets within the country + net domestic borrowing from the non-bank private sector (Chelliah 1973, p.774).

Alternatively, domestic expenditure can be calculated by subtracting the external expenditure from total expenditure. Domestic revenue is total revenue minus oil revenue, i.e. oil revenue is to be considered external revenue because, as has been mentioned in chapters one and two, oil revenues are generated outside the domestic economic activities. The excess of domestic expenditure over domestic revenues has to be financed through:

- borrowing from the banking system;
- drawing down of the domestic cash balance;
- profits received from the central bank net of interest payments to the banking system;
- the sale of foreign exchange by the government to the banking system = (the excess of foreign receipts including drawing down of the government to foreign assets over foreign expenditure) (Ibid.)

Put another way, Overall deficit (OD) can be financed by:

- net foreign borrowing.
- net credit from domestic banking systems.

Then, $OD = \text{net foreign borrowing} + \text{net credit from domestic banking system}$.

However, overall deficit is equal to domestic deficit (DD) plus foreign deficit (FD) $OD = DD + FD$, i.e. $OD = DD + FS$

Then, $DD + FS = \text{Net foreign borrowing} + \text{Net credit from domestic banking system}$.

Then, $DD = \text{Net foreign borrowing} - FS + \text{Net Credit from domestic banking system}$

In other words, domestic deficit = Net foreign borrowing - foreign deficit + net credit from domestic system.

However, Net foreign borrowing - foreign deficit = change in foreign government assets.

In the case of Oman, foreign deficit is a surplus and it is larger than the foreign borrowing.

Then, change in foreign government assets = foreign surplus - net foreign borrowing.

Then, domestic deficit = foreign surplus - net foreign borrowing + net credit from domestic banking.

Oman does not borrow from the domestic banking. Instead, it depends on drawing from SGRF and grants.

Then, domestic deficit = Foreign surplus - net foreign borrowing + drawing from SGRF + net grants.

These three sources all represent three channels through which foreign assets flow to the country and are then transferred to local currency partially or totally then affecting the supply of money. The impact of the budget balance on money supply, therefore, must be judged in light of the domestic not the overall deficit.

Table (5-4) shows that increasing overall deficit particularly since 1982, indicates that external balance (surplus) was not enough to cover the domestic deficit leading the government to restore to external financing represented in *borrowing and drawing* from SGRF. Domestic financing has been short term and temporary and represented in borrowing from the banking system.

With respect to the relationship between budget deficit and domestic liquidity or money supply, government borrowing from the banking system has a positive relationship with liquidity. However, this effect is countered by a negative relationship between money supply and government deposits. Domestic liquidity is positively affected by the increase of government foreign assets as a consequence of inflow of foreign exchange from foreign borrowing and external budget surplus. The supply of money, M , can be multiplicatively related through the money multiplier, m , to the stock of monetary base, H .

$$M_t = m_t H_t$$

An increase in the fiscal deficit is thus assumed to result in an increase in the money supply through the monetary base. In other words, the effect of budget deficits on the growth of money supply is a two-step sequential process, namely from deficit to the monetary base and from the monetary base to the money supply. This would be true to the extent that government deficits were financed by borrowing from the central bank

or using cash balances held with the central bank, by borrowing abroad, or by borrowing from commercial banks with the banks immediately replenishing reserves by recourse to the central bank. The money supply equation can be written as:

$$M_t = m_t (G - R_t + E_t)$$

where m_t is money multiplier

$(G - R_t)$ is budget deficit

$$E_t = \Delta O A_t + H_t - 1$$

$\Delta O A$ is changes in international reserves and changes in claims on private sector.

Table (5-3) depicts the change in money supply owing to changes in budget operations. From this table it can be seen that the domestic deficit growth rate and the growth rate of money supply (M_1) have a positive relationship but sometimes with a one year lag, i.e. M_1 has been increasing one year later. This can be economically justified by the fact that government expenditure does not ensue its monetary effect in the same year of spending. For example, the high rate of increase (or decline) in the domestic deficit in 1980, 1984, 1987, 1988 has been associated by corresponding increase (or decline) in M_1 one year later. However, this correlation has been disturbed in some years. For example, in 1982 domestic deficit increased by 31% whereas M_1 did not increase in 1983. In 1993 domestic deficit declined by 10% (from an increase of 22% in the previous year), whereas M_1 did not decline in 1994.

Table 5-3**Budget Deficit and Inflation**

Date	Domestic Deficit			Government Borrowing ⁽¹⁾ and Deposits		Inflation	
	ROm	Growth	% GDP	ROm net	Growth	m ₁ Growth	CPI Growth
1976	-285.7	-	32.2	+68.5	-	42.4	-
1977	-292.0	2.2	30.8	-7.1	-89.6	10.3	-
1978	-316.6	8.3	33.4	+27.3	+284.5	4.2	-
1979	-336.6	6.4	26.1	-63.9	+134.1	5.5	-
1980	-482.2	43.4	23.4	-147.1	+130.2	28.5	51.3
1981	-584.3	21.0	23.5	-194.9	+32.5	36.2	3.2
1982	-763.8	30.7	29.2	-189.6	-2.7	11.5	-15.9
1983	-789.0	3.3	28.8	-279.3	+47.3	11.9	-9.6
1984	-885.3	12.2	29.1	-347.2	+24.3	7.1	-4.7
1985	-961.1	8.6	27.8	-259.1	-25.4	12.3	-0.3
1986	-930.5	-3.2	33.2	-60.0	-76.8	-5.2	-21.7
1987	-785.5	-15.6	26.2	-114.9	+91.5	7.8	11.4
1988	-855.1	8.9	29.2	-52.9	-54.0	-6.7	-7.9
1989	-910.9	6.5	28.2	-149.0	+181.7	10.3	-23.3
1990	-997.7	9.5	24.6	-268.9	+80.5	13.4	10.1
1991	-999.5	0.2	25.5	-326.4	+21.4	3.4	-0.6
1992	-1212.1	21.8	28.8	-164.0	-49.8	7.0	-1.5
1993	-1091.7	-10.3	24.3	-12.4	-92.4	4.3	5.9
1994	-1052.9	-3.6	21.2	+31.2	+151.6	4.6	7.9
1995	-1097.3	4.2	20.7	-0.4	-101.3	-0.4	-1.3
Average 1986-1990		1.2	28.0	-129.1	44.6	3.9	-6.3
Average 1976-1995		8.1	27.2	-125.5	36.2	10.4	0.2

Note:⁽¹⁾From Domestic Banking System**Source:**

- Money Growth: CBO Reports, Development Plans.
- Inflation: CBO Reports and IMF, Government Finance Statistic Year Book, Vol. XIII, 1989, p.449
- The World Bank, Sultanate of Oman, Report no. 12199-OM, 1994, p.48.
- Other sources such as World Development Report 1990 and World Economic and Financial Surveys give different figures for inflation.

This disturbance can be attributed to the effect of net claims on government to the banking system on domestic liquidity (columns 4 and 5). M_1 did not increase in 1983 because the net negative balance of borrowing and depositing increased sharply by 47%. In other words, the government's high deposits in the banking system in 1983 has mitigated the growth of money supply. In 1994, M_1 did not decline because the negative balance has converted to positive, i.e. government borrowing exceeded its deposits.

Generally speaking, expanding domestic budget deficit has been associated with monetary expansion. During the period 1980-1985 the domestic deficit growth rate averaged almost 20% and M_1 growth rate averaged 18%. During the period under study (1986-1990), the domestic deficit grew by 1.2% against 2.9% for M_1 . During the whole period, i.e. 1976-1995, the former averaged 8% and the latter averaged 10%. The monetary expenditure has been induced by external borrowing and by the drawing of the cash balances of the government to finance the deficit.

5.2.1 Budget Deficit and Inflation

Some economic perceptions hold that government budget deficits are inflationary because they stimulate aggregate demand (the Keynesian view), or because they lead to higher money growth rates (the monetarist view) either as a result of direct monetisation or following the attempts of the central bank to prevent increases in interest rate. Inflation can be measured either by money growth rate or CPI (consumption price index) growth rate. The budget deficit in Oman has not been inflationary through the demand-pull channel as will be explained in the next section.

The CPI measure of inflation as shown in Table (5-3) has been -6.3 during the period under review.

With respect to the monetarist view - that budget deficit induces high money growth - the analysis rests on the way in which the deficit is financed and the level of interest rate. Inflation is caused by governments with no alternative source of deficit financing resorting to money creation at a higher rate than the growth in money demand. Excessive reliance on money creation is particularly risky if the inflation itself worsens the deficits, because expenditure keeps pace with rising prices while revenues do not. This means that still more money creation becomes necessary - further worsening the inflationary spiral. In such circumstances, money growth becomes much higher than the rate of real output growth. Consequently, the share of one unit of output from the quantity of money increases. Fortunately, Oman has not resorted to this type of deficit financing.

Monetisation or financing the budget deficit through sales of short-term government debt, namely treasury bills, to the banking system lead to monetary expansion and raises interest rate. The purchase of treasury bills by banks adds to their reserves and thus to their capacity to create money. Oman has not been using this source of financing during the period under study (1986-1990) and never before. It started using it in 1991. Consequently, the interest rate has not risen in accordance with rising deficit. The Central Bank of Oman defined a ceiling on Omani Rial deposits and lending in 1982. It was 9.5% and 11.5% respectively. In February, 1986 the Central Bank lowered these two ceilings from 9.5% to 8.5% on non-government deposits, and from 11.5% to 10.5% for loans. This action was taken in accordance with falling

international rates of interest coupled with the need to encourage the private sector in particular against the expected decline in government expenditure. Stable interest rates in Oman are also due to integration of world capital markets through which Oman partially finances its budget deficit at current world long-term interest rates. As some economists put it:

The size of the domestic economy is a determining factor: in a small country with open capital markets, an increase in the public borrowing requirements should not affect national interest rates as far as this is financed by net capital inflow from abroad (Nunes-Correla and Stemitsiotis 1993, p.7).

In spite of all these positive consequences, Table (5-3) gives us two contradictory results. As far as money growth is concerned, it is obvious that the budget deficit has led to inflation. However, CPI indicates that there has been no inflation because the growth rate of CPI was 4% throughout the period 1980-1985, and -6.3% during the period under study (1986-1990), and only 0.2% during the whole period (1976-1995). In fact, the relationship between budget deficits and money growth represent indirect effects of budget deficit on inflation (Gupta, 1992, p.111). It is, therefore, inadequate to explain inflationary behaviour (Ibid., p.137).

CPI on the other hand, may give a misleading picture about inflation because “the coverage of price indices in the Middle East countries is often restricted, making their usefulness open to question” (Wilson, 1995, p.31).

There are also distribution issues that arise when deflating GNP.

Price indices in the Middle East are based on urban rather than rural prices. As a result the impact of inflation on agriculture and the countryside may be over or under estimated (Ibid).

The last observation of the price index is applied totally to Oman because it is calculated about the capital area only i.e. Muscat.

At any rate, inflation in Oman is mostly imported inflation, and therefore the budget deficit has been causing inflation through the real and effective exchange rate mechanism.

5.3 Budget Deficit and Aggregate Demand

Chapter III presented a brief summary of several definitions of budget balance, one of which was the budget balance reflecting the impact on aggregate demand. We will now elaborate more on this sort of budget balance and then look at how the aggregate demand has been affected by the budget deficit.

5.3.1 The Budget Balance Reflecting the Impact on Aggregate Demand

A stimulus to aggregate demand generally leads to an increase in the demand both for domestically produced goods and services and for imports. That is, an impact on aggregate demand is reducible to an impact on gross national product (GNP) and on the balance of payments.

Theoretically, a budget balance that reflect the impact on aggregate demand may be computed by subtracting the sum of receipts that either reduce purchasing power or add to real resources available for spending from total expenditure (all of which would lead to an increase in either GNP or the demand for imports) (Chelliah 1973, p.751).

A positive budget balance would denote net expansionary stimulus. In reality, however, it is not easy to make strict statements about the impact of certain types of receipts and expenditure on private demand, because the results depend, inter alia, on institutional arrangements and monetary policy.

The influences of budgetary transactions involving foreign receipts or expenditure differ according to the types of receipts and expenditure that are combined in given transactions:

Four different combinations can be envisaged (assuming that the receipt and expenditure are equal in each case):

1. Foreign receipts, such as grants from abroad - combined with foreign expenditure - net impact is neutral with respect to both GNP and the balance of payments.
2. Foreign receipts combined with domestic expenditure - an expansionary impact on GNP but a countervailing favourable impact on the balance of payments.
3. Domestic receipts other than borrowing combined with foreign expenditure - a contractionary impact on GNP but an adverse impact on the balance of payments.

4. Domestic borrowing combined with foreign expenditure - a nil impact on GNP but an adverse impact on the balance of payments (Ibid.:752).

In the context of the use of this definition of budget balance, an expansionary impact is defined in terms of an increase in the demand for domestic goods and of the impact on the balance of payments. Given this definition, the net impact of budgetary transactions can only be obtained by combining the effects on GNP and on the balance of payments. Thus, not only (a) but also (b) combined with (c) are examples of neutral impact, while (d) is a case of expansionary impact. Since expenditure abroad is added to domestic expenditure in computing this definition of budget balance, foreign receipts, all of which have a favourable impact on the balance of payments, need to be placed “above the line” in the derivation of the expansionary deficit.

In calculating the expansionary deficit in this way, two items of government transactions must be examined: domestic lending and domestic borrowing.

a) Domestic Lending

Domestic lending has been included in expenditure (placed above the line). This procedure implies the assumption that government lending, or net acquisition of financial assets by the government, increases aggregate demand in the same way as any other expenditure.

Two different questions seem to be at issue here. First, does financial investment create less demand than an equivalent amount of direct investment by the government?

Second, do not the effects of borrowing neutralise the effects of lending, i.e. is there any justification for treating lending to and borrowing from the same sector asymmetrically? The answer of these two questions will take us out of the scope of this study, and the domestic lending item in Oman's budget is small, forming only 0.35% of total expenditure during the period 1986-1990 on average.

b) Domestic Borrowing

In our definition of expansionary deficit (given earlier) all domestic borrowing has been included in the deficit with the implicit assumption that there is no act of borrowing which has a negative impact on demand. It is, of course, granted that such an assumption is not exactly equally valid for all types of borrowing. The distinction should be made between borrowing that reduces purchasing power in the hands of the public and that which does not. There are three major types of borrowing: borrowing from the central bank, borrowing from commercial banks, and borrowing from the non-bank private sector. The first and the last two types are not existent in the Omani government budget.

Government borrowing from the commercial banks will have no impact on aggregate demand if the banks have excess reserves, and so domestic expenditure financed by such borrowing will have a direct expansionary effect. In other words, since the commercial banks have excess reserves, their lending to the government will not necessitate them to reduce their credit to the private sector. Therefore, government domestic spending will have an expansionary effect on aggregate demand. If the commercial banks do not have excess reserves when the government offers them its

bonds, they can lend to the government only by curtailing credit to the private sector. This would exert a contemporary pressure off-setting the expansionary effect of the additional government expenditure. Commercial banks in Oman do not lack enough reserves. Therefore, their credit to the private sector has not been curtailed by making credit available to the government. This point will be elaborated upon later.

The use of the previous simple budget balance as a measure of the impact of budget policy on demand is based on a number of simplifying assumptions. Some of the limitations of the use of this measure arise from those assumptions.

First, there is the implicit assumption either that foreign transactions are not significant or that it is not necessary to distinguish between the impact of the budget on GNP and on the balance of payments. Second, it is obvious that the simple budget balance approach is based on an implicit model in which all items of expenditure and receipts that are included to compute the balance have equal (and one-to-one) impact on aggregate demand, negative and positive, respectively, and that those items included in the deficit have no direct impact on demand (Ibid. p.767-768).

Different types of lending and borrowing tend to have an unequal impact on demand. This is also true of various forms of taxation and different kinds of expenditure. For example, the impact of expenditure on goods and services on GNP plus imports is equal to the amount of expenditure itself, whereas the impact of transfer payments is reduced by the savings leakage. On the revenue side, the negative influence of a dollar of a given tax on consumption demand depends on the marginal propensity to consume of the taxpayer; the influence will rarely be equal to the amount of the tax.

From all these circumstances it is obvious that a balanced budget may exert a positive or negative impact on domestic demand and accordingly an equal increase in revenues and expenditure generally cannot be considered to be “neutral” in its impact. In order to get a more satisfactory measure of the impact of the budget, the weighted budget balance is suggested.

This balance is derived by assigning a specific weight to each budgetary item and then summing up the items multiplied by their respective weights. The weight assigned to each item would be designed to reflect its impact on GNP or on demand for domestic goods and services, as to both magnitude and sign (Ibid).

For example, if expenditure on imports and saving are the only leakages to be taken into account for the personal income tax, the weight for this tax would be $-(1-m)c$, where m is the marginal propensity to import of the income-tax payers and c is their marginal propensity to consume. A budget item multiplied by its weight may also be called the first round effect of that item, since its total effect can be obtained by multiplying this product and the general multiplier. A relatively simple way of assigning weights to different budget items would be to use a basic analytical framework for deciding what leakages should be allowed for and then giving them numerical value derived from existing estimates of the relevant propensities.

Because of the lack of specific statistics in the case of Oman that can be utilised to derive such estimates and indicators, it is difficult to obtain available weighted budget balance. However, in the absence of a general weighting system it ‘may be desirable to

work out a limited “weighting” exercise designed to show separately the impact on GNP and on the balance of payments.’ According to Chelliah this can be worked out

by the separation of the total budget balance into domestic and foreign components in such a way that the former will reflect the direct impact on demand for domestic goods and the latter the direct impact on the balance of payments (Ibid., p.769).

5.3.1.1 Domestic Balance or the Budget Balance Reflecting the Impact on GNP

The government budget affects national economy through both revenues that are drawn from the private sector and the expenditure on the purchase of goods and services from the private sector. The domestic balance of the budget is the measure that is used to evaluate the effect of the government budget on the national economy (GNP).

The domestic balance is very important because it indicates to what extent the government transactions influence the national economic activities. In other words, is government expenditure completely directed to motivating the national economy or is it spent mostly on goods and services produced outside the country, consequently having no strong impact on GNP?

The domestic balance is measured by including in the calculation only those budgetary elements that directly affect the domestic economy. More precisely, this balance equals the total expenditure on domestic goods and services, minus the sum of domestic current revenues.

In the case of Oman:

$$\text{Domestic Budget Balance} = \text{Non-oil Revenue} - \text{Domestic Expenditure.}$$

Oil revenue is considered non-domestic because its collection does not affect the income of the private sector. In other words, it is a renter receipts obtained from an enclave sector (oil sector).

Regarding expenditure, the government accounts do not distinguish between domestic expenditure and foreign expenditure but this distinction can be roughly estimated. As analysed in chapter four, there are four types of government expenditure: current expenditure, development expenditure, defence expenditure, and lending, subsidy and participation.

From the current expenditure two items must be subtracted: the transfer of the expatriate civil workers of the government and the costs of Omani embassies abroad. With respect to the first item, the number of workers is given, and average salary is estimated for these workers and a proportion of the average salary that is transferred must also be estimated (e.g. 70%). Multiplying the three previous steps gives the total transfer made by the expatriate civil workers of the government. Regarding the costs of Omani embassies abroad, there are about 40 Omani embassies currently operating world-wide; an estimated average of 15 employees in each one. Government spending on embassies abroad includes:

1. salaries for Omanis that are spent abroad and the salaries of foreign officers
2. the rent of the embassy buildings
3. furniture, maintenance, fuel and communication
4. transport equipment

5. expenses for official ceremonies
6. building and purchasing embassies' buildings and ambassadors' residences
(this item is included in development expenditure)

This estimation makes for 65% of the expenditure of the Ministry of Foreign Affairs and it must be subtracted.

These two items, that is the transfer of salaries of the expatriate workers and the cost of Omani embassies, represent a high outflow of money.

The expatriate workers employed by the government averaged 24.8 thousand from 1980-1990, and 33 thousand during 1991-1995. They are high-wage employees such as experts, doctors, and teachers. The average monthly salary estimated is RO 800, 70% of which has been estimated to be transferred out of the country. This means that RO 560 per employee a month is transferred, in other words RO 67.2 thousand a year per employee has been transferred.

By multiplying this figure with the average number of employees from 1980-1990, the result would be that RO 1.7 million a year was transferred. During 1991-1995 the average transferred amount was RO 2.2 million a year.

The expenditure of the Ministry of Foreign Affairs averaged RO 11.6 million per year from 1981-1990, and RO 16.5 million throughout 1991-1995. With 65% of these figures being transferred outside the country, RO 7.5 million a year during 1981-1990 and RO 10.7 million during 1991-1995 on average has been transferred.

From development expenditure, the costs of imported capital and intermediate goods, foreign employees' and contractors' transfers must be subtracted. Large government contracts involved in building hospitals, schools, dams, airports, ports, roads, etc. are mainly fulfilled by foreign companies. These companies employ expatriate workers and import their needs of capital goods and equipment from abroad because they are not mainly available from domestic production. My estimation is that nearly 35% of development expenditure has been appropriated to imports, 15% to contractors' profits, and 10% to labour wages. Therefore, 50% of development expenditure has been leaking outside.

With respect to defence expenditure three items must be estimated: weapons and equipment, capital and intermediate goods for military engineering establishments (because defence expenditure includes development expenditure) and the transfers of senior military experts. My estimation is that about 25% of defence expenditure went to weapons and equipment, 20% to capital and intermediate goods, and 5% to senior military experts transfers. Thus, 50% of military expenditure has also been flowing outside.

Regarding lending, subsidy and participation, about 60% of it is spent abroad as participation in regional and international organisations (See Ministry of Finance, Final Accounts 1990, p.56). Thus this proportion must be deducted from this type of government expenditure.

After making these deductions and estimating foreign expenditures, the domestic budget balance can be computed according to the above equation. This balance is

displayed in table (5-4) compared to foreign and overall budget balance. It simply represents the net government expenditure that has been injected into the domestic economy, and it measures the impact of government budget on the domestic demands on domestically produced goods and services. This table illustrates that only 63% of government expenditure during 1976-1993 and 67% during the period under study has been received by the local economy. In other words, there has been a considerable leakage of government expenditure flowing abroad and it should be totally reflected in import and transfer statistics. Accordingly, if import and transfer figures are correct, i.e. all imports and transfers are completely recorded, then the gross national product (GNP) of the previous years was correct. However, if this is not the case - which is quite likely - then GNP has been overvalued.

5.3.1.2 Foreign Balance or the Budget Balance Measuring the Impact on the Balance of Payments

The equation which represents the domestic budget balance excludes the impact of the budget on the balance of payments.

An approximate measure of the direct (adverse) impact of budgetary operations on the balance of payments may be said to equal:

expenditure on goods, services, and transfers abroad
+ not lending abroad
+ increase in government balance abroad (if any)
- current receipts from abroad
- net borrowing from abroad
- sale of physical assets abroad
- decrease in government balance abroad (if any)
(Chelliah 1973, p.770)

In other words, whereas domestic deficit is measured by including in the calculation only those budgeting elements that directly affect the domestic economy, the foreign deficit - the impact of the budget on the balance of payments - can be measured by including only budget transactions that directly connect to the external sector.

As has already been mentioned the Omani government (and most governments) does not present separate accounts of domestic and foreign expenditure. Hence, a fiscal analyst can at best make only rough estimates of direct expenditure abroad. However, it is much easier to obtain a separation of the two components of receipts. In other words, it is arbitrary to exclude from the domestic component all expenditure directly incurred abroad, because there is an import content of domestic expenditure that should be added to expenditure abroad. This arbitrariness is one of the limitations to the measures of impact on GNP and the balance of payments. The second limitation is that these two measures give an indication of only the direct impact of the budget on GNP and the balance of payments (Ibid. p.770-771). However, Oman's foreign budget balance can be derived by subtracting domestic expenditure from total expenditure to get foreign expenditure. Foreign revenues are oil revenues.

$$\text{Foreign balance} = \text{foreign revenue} - \text{foreign expenditure.}$$

Since, overall budget balance = domestic balance + foreign balance

then, foreign balance = overall budget balance - domestic balance

As can be seen from table (5-4), whereas domestic balance is in minus foreign balance is in plus.

Table (5-4)
Domestic Expenditure, Domestic, Foreign and Overall Budget Balance (ROm)

Year	Domestic Expenditure		Domestic Balance	Foreign Balance	Overall Balance
	ROM	% of T.E.			
1976	317.7	54.7	-285.7	191.7	-94.0
1977	330.0	59.2	-292.0	255.0	-37.0
1978	351.3	59.9	-316.3	223.3	-93.0
1979	394.6	59.5	-336.6	366.6	+30.0
1980	531.1	59.1	-482.7	720.8	+238.1
1981	702.5	57.4	-584.3	622.7	+38.4
1982	862.4	61.1	-763.8	527.3	-236.5
1983	914.4	59.1	-789.0	496.0	-293.0
1984	1059.5	60.2	-885.3	465.9	-419.4
1985	1177.2	61.5	-961.1	605.6	-355.5
1986	1184.5	63.9	-930.5	263.4	-667.1
1987	1063.6	67.5	-785.5	669.3	-116.2
1988	1064.9	67.9	-855.1	492.7	-362.4
1989	1151.5	69.1	-910.9	615.2	-295.7
1990	1285.7	68.1	-997.7	986.6	-11.1
1991	1280.4	68.5	-999.5	701.8	-297.7
1992	1539.2	68.1	-1217.1	619.4	-597.7
1993	1505.8	68.5	-1091.7	611.0	-480.7
1994	1419.9	63.0	-1052.9	531.0	-521.9
1095	1496.2	64.2	-1097.3	598.5	-498.8

Source:

1. DC, FIDP, Table (15), p.21.
2. DC, ThDP, Table (18), p.33.
3. CBO, 1985, Table (4.1), p.38.
4. CBO, 1990, Table (4-1), p.60.
5. CBO, 1995, Table (4.1), p.38.

5.3.1.3 The Effect of Budget Deficit on Domestic Demand for Domestic Output

Domestic demand for domestically produced output is the private and public expenditure (consumption and investment) spent on domestically produced goods and services. However, in the absence of statistics which differentiate between what is spent domestically and abroad, the above four components of total domestic demand for domestic output cannot be computed separately. Instead, total domestic demand can be calculated aggregately. This can be done as follows:

Total domestic demand for domestic output =

- + Total consumption (private and public)
- + Total investment (private and public)
- imports
- factor income payments

Exports are not added because they represent external demand on domestically produced product. Table (5-5) expresses a comparison between domestic budget balance and domestic demand. The best criterion by which they can be assessed is the gross national product because it excludes imports and factor income transfers. It seems that there is a strong relationship between domestic budget balance and the domestic demand on domestic output. This relationship is understood because the latter is motivated by the former. This motivation is direct on public demand (investment and consumption), however, it is indirect on private demand.

The domestic balance affects public demand directly because, by definition, domestic expenditure of the government goes to purchase domestically produced investment and consumption goods and services. While the motivation of the domestic balance is indirect on private demand because domestic expenditure of the government either for

consumption or investment purposes goes into the hands of people: contractors, consumers etc., then they use the money in investment and consumption activities.

The last column of the table also demonstrates the weak sectoral integration within the national economy since only 42% of gross national product is purchased domestically. 58% represents the foreign trade component of the gross national product.

The macroeconomic effects of deficits are to a large extent determined by the direct response of private spending - consumption and investment - to changes in the deficit and in its components. Because we are dealing here with domestic demand then the private spending, both investment and consumption, must be confined to domestically produced products. However, due to the lack of statistics the examination will be on their existing figures which include spending on imported goods and services.

William Easterly and Glous Schmidt Hebbel found that fiscal adjustment during the 1980s was often done in a way that was costly for private sector investment. In their 10-country sample (all developing countries) private investment declined sharply from an average of 13% of GDP in 1981 to a trough of 9% of GDP in 1986 (Easterly and Schmidt-Hebleck 1992, p.49). Public investment declined also as it was the vehicle of choice for fiscal adjustment. In contrast, consumption, both public and private was relatively insulated from the adjustment. In particular, the sharp increase in public consumption in the 1970s - which has much to do with subsequent fiscal crises - was not reversed in the adjustment of the 1980s (Ibid.). We will now look at the case of Oman, starting with private investment.

Table (5-5)
Domestic Demand Compared with
Domestic Budget Balance

Year	GNP		Domestic Budget Balance			Domestic Demand		
	ROm	G.R.	ROm	G.R.	GNP %	ROm	G.R.	GNP %
1976	647.8	-	-285.7	-	44.1	148.7	-	23%
1977	745.3	15.1	-292.0	2.2	39.2	216.4	45.5	29
1978	766.8	2.9	-316.0	8.3	41.2	240.7	11.2	31.4
1979	1016.9	32.6	-336.6	6.4	33.1	275.9	14.6	27.1
1980	1740.5	71.2	-482.7	43.4	27.7	641.7	132.6	36.9
1981	2129.5	22.3	-584.3	21	27.4	717.5	11.8	33.7
1982	2239.6	5.2	-763.8	30.7	34.1	895.6	24.8	40.0
1983	2304.9	2.9	-789.0	3.3	34.2	1030.9	15.1	44.7
1984	2574.7	11.7	-885.3	12.2	34.4	1213.7	17.7	47.1
1985	3054.8	18.6	-961.1	8.6	31.5	1345.8	10.9	44.1
1986	2464.4	-19.3	-930.5	-3.2	37.8	1379.4	2.5	56.0
1987	2721.6	10.4	-785.5	-15.6	28.9	1247.6	-9.6	45.8
1988	2517.9	-7.5	-855.1	8.91	34.0	1323.9	6.1	52.6
1989	2826.6	12.3	-910.9	6.5	32.2	1361.6	2.8	48.2
1990	3633.7	28.6	-997.7	9.5	27.5	1696.7	24.6	46.7
1991	3494.4	-3.8	-999.5	0.2	28.6	1847.4	8.9	52.9
1992	3843.4	10.0	-1217.1	21.8	31.7	1922.8	4.1	50.0
1993	3877.2	0.9	-1091.7	-10.3	28.2	1839.5	-4.3	47.4
1994	4202.3	8.4	-1052.9	-3.6	25.1	2249.3	22.5	53.5
1995	4488.2	6.8	-1097.3	4.2	24.4	2346.2	4.3	52.3
Average 1986-90		4.9		1.2	32.1		5.3	49.9
Average 1976-95		12.1		8.1	32.3		18.2	43.3

- Source:**
1. DC. 4th DP. Table 1.3, p.16; Table 1.4, p.1; Table 1.5, p.23.
 2. CBO, 1994, Table 1, p.125.
 3. CBO, Quarterly Statistical Bulletin, June, 1996, Table (29) p.37, Table (30) p.38
 4. CBO, 1995, Table (6.1), p.91.

5.3.1.3.1 The Effect of Budget Deficit on Private Investment

The relative importance of private investment during the period 1976-1995 has been 32% compared to 68% for public investment. This low participation can be explained by the lack of experience of the private sector. It can also be explained by the lack of opportunities opened for the private sector. In other words the public sector has been a strong competitor with the private sector even in commercial fields like insurance and tourism. This experience of the private sector in Oman is almost in line with the cases of other developing countries. For example, William Easterly and Klaus Schmidt-Hebbel, who carried out a study on ten developing countries such as Chile, Morocco, Thailand, and Pakistan, stated that:

Public capital could be a close substitute for private capital and drive down the private rate of return. Public investment in steel plants is an obvious example. Governments also invest in activities where the private sector would not invest, like infrastructure, which has large fixed costs and for which it is sometimes difficult to charge user fees. The net effect on private investment will be more positive the lower the substitutability of public for private capital (Ibid. p53-54).

In addition, foreign competition and the limitation of local markets are also blamed for the weakness of the private sector. Table (5-6) shows that, during the focused period when the budget deficit reached its peak, private investment was declining. In 1987 it went down by 33.2%. Its growth rate averaged 1.2% during this period compared to 12% throughout the total period (1976-1995).

Public investment decreased even more sharply. It plummeted from RO 651.9 million in 1986 to RO 399.7 million in 1987, i.e. by 38.7%. Its annual growth during the examined period was negative at -13.8% on average. As has been mentioned earlier the government cut public investment in order to cope with the problem of climbing deficit.

Table (5-6)
Private and Public Investment:
Relative Importance and Annual Growth Rate

Year	Private Investment								Public Investment	
	Oil		Non-oil			Total				
	R.I	G.R.	GDP %	R.I	G.R.	R.I	G.R.	GDP %	G.R.	R.I
1976	26.7	-	5.0	73.3	-	18.8	-	6.8	-	81.2
1977	26.7	34.2	6.3	73.3	33.9	20.0	33.9	8.5	-11.8	80.0
1978	36.3	52.3	6.1	63.8	-2.2	32.3	12.4	9.6	-17.3	67.7
1979	53.2	63.2	3.7	46.8	-18.4	31.8	11.1	7.8	14.2	68.2
1980	45.7	35.9	2.9	54.3	27.7	34.3	58.3	7.7	40.9	65.7
1981	50.7	34.7	3.8	49.3	58.3	33.2	21.3	7.8	27.4	66.8
1982	56.1	28.1	3.8	43.9	3.1	31.8	15.8	8.6	23.8	68.2
1983	47.3	-22.2	4.0	52.7	10.5	28.1	-7.8	7.6	9.9	71.9
1984	50.6	34.5	4.2	49.4	18.3	28.5	25.9	8.6	23.1	71.5
1985	48.9	-6.7	3.7	51.1	-0.4	26.4	-3.6	7.3	7.5	73.6
1986	53.7	7.6	4.1	46.3	-11.1	27.4	-1.9	8.8	-7.1	72.6
1987	49.5	-38.4	2.6	50.5	-27.2	29.2	-33.8	5.5	-38.7	70.8
1988	53.6	3.7	2.5	46.4	-11.9	30.9	-4.2	5.4	-11.6	69.1
1989	51.9	-6.5	2.3	48.1	0.1	34.3	-3.4	4.7	-17.4	65.8
1990	53.2	48.7	2.6	46.8	41.1	41.7	45.0	5.5	5.6	58.3
1991	50.3	7.5	3.2	49.7	20.7	38.0	13.7	6.4	33.1	62.0
1992	47.1	-3.9	3.1	52.9	8.7	34.0	2.7	5.8	22.3	66.0
1993	47.7	21.2	3.6	52.3	18.9	38.4	19.6	6.9	-1.4	61.6
1994	-	-	-	-	-	34.7	-17.1		-2.8	65.3
1995	34.5	-	-	65.5	-	46.0	60.0	7.7	0.0	54.0
1986-90	52.4	3.0	2.9	47.6	-1.8	32.7	1.2	6.0	-13.8	67.3
1976-93	46.5	17.3	3.8	53.5	10.0	32.0	13.0	7.2	5.3	68

Notes: R.I. - Relative Importance, G.R. - Growth Rate

Source:

- . DC, ThDP, Table (6), p.13; Table (8), p.16
- . DC, The Assessment of the ThDP, Table (2-12), p.56
- . MOD, The Main Components of the Fifth Development Plan, Table (3-5), p.30.
- . DC, 1994, Table (3), p.127.

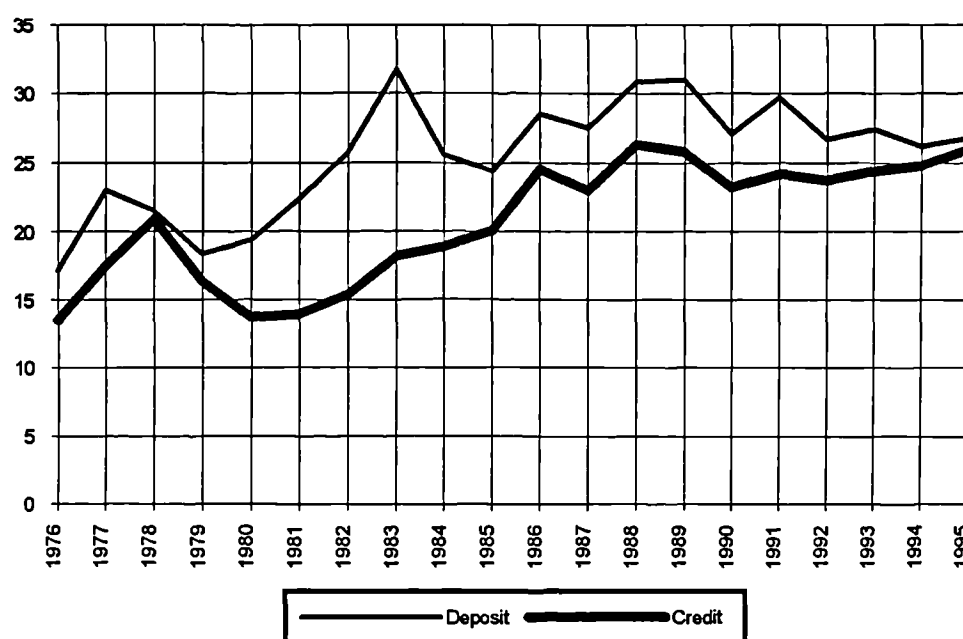
However, the decrease of private sector investment has to be examined more carefully. There must be a distinction between oil and non-oil private investment. Oil investment is done by foreign partners of oil companies whereas non-oil investment is executed by local companies in manufacturing, mining, commerce, agriculture, etc. The proportion of oil investment to total private investment averaged 47.3% during 1976-1993 and 52.4% during the period under study. The contribution of non-oil investment averaged 53.5% and 47.6% throughout the two periods respectively. Its relative importance in general, has been falling until 1990, while the oil investment has been rising. The growth rate of oil investment averaged 17.3% while the non-oil averaged 10%. The former, in general, was increasing, whereas the latter was decreasing. During the period under study, the average growth rate of the oil investment was 3% while that of the non-oil was -1.8%. The normal effect of crowding out, when the government resorts to financial system credit to finance its budget deficit, is that the interest rate increases and accordingly private investment declines. In other words, if there is domestic financial repression with preferential access at the public sector to domestic credit, the deficit would crowd out private investment through financial markets. A study which attempted to examine the role the real interest rate plays in private investment in Oman has found that

In no attempt was the interest rate or private credit significant. The conclusion emerging from this is that: the costs of funds in the private money market does not play much of a part in the private sector's decision to invest (Kalmoor 1987, p.47).

There is no lack of loanable funds that can be used by the private sector. Commercial banks have had surplus liquidity since the early years of the oil boom. It can be seen from Chart (5-2) that the commercial banks' total deposits has been higher than their credit to the private sector. Moreover there are three specialised banks which provide soft long-term credit to the private sector in the fields of agriculture, industry and housing. Then, the decline of private sector investment during the period of large budget deficit cannot be explained by a crowding out effect. The decline in total private investment during this period can be attributed mainly to the decline of non-oil investment, the causes of which have been indicated at the beginning of this subsection. The decline of oil investment can be interpreted by the falling of the rate of return of oil companies because of the collapse of oil prices.

The main cause behind the falling total investment (private and public) is diminishing national saving. National saving is equal to domestic saving minus net factor income. Domestic saving is computed by subtracting total final consumption (public and private) from gross domestic product (GDP). National saving can be considered as a measure for financial resources generated through national economic activity, that can be invested by residents. Due to higher total consumption caused mainly by high public consumption (and large deficit) the domestic saving is low. National saving has been worsening by large workers' and contractors' transfers out of the country. Table (5-7) shows domestic and national saving and total investment as a ratio of GDP and their growth rates. Chart (5-3) depicts the relationship between total investment and national saving.

Chart (5-2): Commercial Banks' Deposits and their credit for the private sector as a percentage of GDP



Source:

1. DC, SDP, Table (20), p.26.
2. CBO, 1985, Table 5-8, p.67.
3. CBO, 1990, Table 5-6, p.87.
4. CBO, 1994, Table 5-7, p.61.
5. CBO, 1995, Table (5-7), p.61.

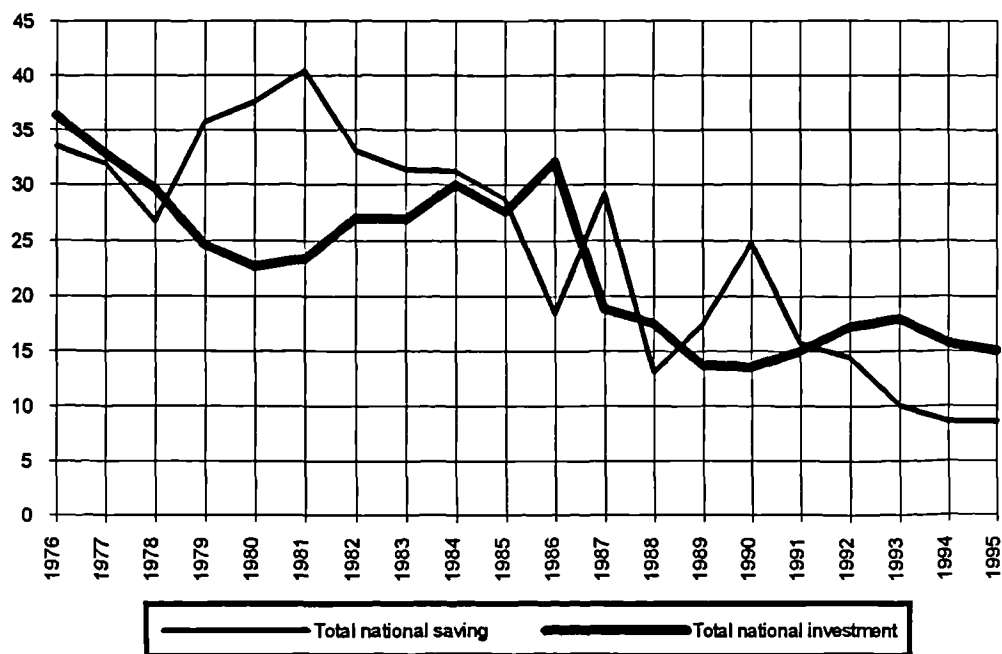
Table (5-7): Domestic and National Saving

	Domestic saving		National saving		Total National Investment	
	% of GDP	Growth Rate	% of GDP	Growth Rate	% of GDP	Growth Rate
1976	52.2	-	33.5	-	36.3	-
1977	45.6	-6.4	31.9	-3.8	32.8	-3.2
1978	38.5	-15.7	26.8	-16.2	29.7	-9.6
1979	46.3	+64.1	35.7	+82.1	24.7	13.2
1980	47.9	+69.4	37.6	+87.2	22.6	46.4
1981	49.9	+14.7	40.5	+13.9	23.4	25.3
1982	42.2	-12.1	33.1	-18.2	27.0	21.1
1983	42.3	+13.4	31.4	+7.2	26.9	4.3
1984	42.7	+12.3	31.2	+10.4	30.0	23.9
1985	40.2	+6.9	28.7	+4.3	27.6	4.4
1986	30.0	-38.8	18.4	-48.0	32.0	-5.7
1987	39.0	+36.2	29.2	+70.4	18.8	-37.2
1988	27.0	-31.8	13.1	-56.5	17.5	-9.4
1989	30.0	+22.8	17.5	+48.2	13.7	-13.1
1990	35.2	+46.9	24.8	+77.7	12.5	14.2
1991	26.5	-27.2	15.7	-38.9	16.7	29.1
1992	27.4	+16.8	14.4	+3.8	17.7	19.5
1993	24.2	-12.9	10.1	-31.0	18.7	7.6
1994	24.0	10.1	8.6	-4.8	15.7	-7.2
1995	23.7	5.1	8.6	6.1	15.0	1.7
Average 1986-1990	32.2	7.1	20.6	18.4	18.9	-10.2
Average 1976-1993	36.8	9.1	24.5	10.2	23.0	6.6

Source:

1. DC, *The Assessment of the Third Plan*, Table (2-13), p.75.
2. CBO, 1994, Table (4), p.128.
3. DC, *Statistical Yearbook, 1986*, Table 247, p.462.
4. CBO, Quarterly Statistical Bulletin, June 1996, Table (30), p.38, Table (29), p.37.

Chart (5-3):
Total national investment and total national saving as a percentage of GDP



Source: Table (5-7).

During the oil boom (1979-1985) domestic saving averaged 44.5% of GDP compared to 34% for national saving. The former was growing by 27.6% per annum on average, while the latter was growing by 26.7%. However, during the period of higher deficit (1986-1990) domestic saving proportion of GDP fell to 31.6% and national saving proportion declined to 20.6%. The former growth rate plummeted to 7% and the latter to 18%. It has been indicated in chapter one that the transfers of the expatriate workers were blamed for 60% of the difference between domestic saving and national saving.

With respect to total investment, it averaged 26% of GDP during the first period and grew by 20%. During the second period, it averaged 19% of GDP and declined by 10% on average. From table (5-7) and chart (5-3), it can be seen that total investment was rising or falling one year lag after national saving which means that national saving was the main factor affecting total investment.

5.3.1.3.2 The Effects of Budget Deficit on Private Consumption

The real interest rate determines how consumers schedule their consumption over time, assuming they have access to credit. The effect of the interest rate on today's consumption levels is theoretically ambiguous due to the offsetting, substitution, income and wealth effects. An increase in interest rates causes consumers to substitute consumption tomorrow for consumption today, but it also induces consumers to feel richer and thus to spend more both today and tomorrow. The effect of the real interest rate on consumption would also be low or zero when borrowing constraints are pervasive. Does public saving or the deficit affect private consumption directly? Table (5-8) shows the development and the relative importance of private consumption

compared to public consumption during the period 1976-1995. To know the behaviour of private consumption in relation of budgetary transactions, the factors that affect it must be identified and the budget policy during the period under study must be recalled.

Real consumption can be considered as a function of real income and prices. Public consumption consists of total civil recurrent expenditure and total general reserves allocated to meet the probable increase in government consumption plus expenditure on defence and national security (DC, FIDP, p.58). Consumption is affected positively by income and the excess demand for money, but negatively by prices. However, the relationship with real interest rate is somewhat different. Reflecting the fluctuation in oil income and accordingly non-oil income, both annual growth rate and the proportion to GDP were dwindling for both public and private consumption (Table (5-8)). During the period 1986-1990, private consumption fell sharply. Its average annual growth rate dropped from 20.2% during 1976-1995 to only 0.3%. This can be explained by the decline of non-oil income, which in turn reflects the decline in oil income on one hand. On the other hand it was adversely affected by the increase in import prices due to the devaluation of the local currency. However, the ratio of both private and public consumption to GDP during the period exceeded the general average. This is because GDP declined faster than the two types of consumption.

Table 5-8
Private and Public Consumption:
Relative Importance and Annual Growth Rate

Year	Total Consump tion	Private Consumption			Public Consumption		
		R.I.	G.R.	% GDP	R.I.	G.R.	% GDP
1976	361.1	32.6	-	14.3	67.4	-	29.5
1977	426.9	47.8	73.4	23.3	52.2	-8.4	25.3
1978	521.0	52.0	32.9	30.3	48.0	12.1	28.0
1979	592.1	52.1	13.9	26.3	47.9	13.4	24.2
1980	1078.0	39.5	86.9	28.0	60.5	76.1	24.2
1981	1247.0	47.4	2.4	23.7	52.6	31.5	26.4
1982	1509.9	52.6	34.6	30.4	47.4	9.0	27.4
1983	1582.0	50.7	0.9	29.6	49.3	9.0	28.5
1984	1746.5	53.7	17.0	31.4	46.3	3.6	26.5
1985	2063.7	54.5	19.9	32.6	45.5	16.1	27.2
1986	1949.0	52.3	-9.4	36.4	47.7	-1.0	33.2
1987	1843.3	50.4	-8.9	31.0	49.6	-1.7	30.4
1988	2135.8	55.2	26.9	40.3	44.8	4.6	32.7
1989	2260.4	56.8	8.9	39.8	43.2	2.1	24.6
1990	2625.5	41.2	-15.9	26.7	58.8	58.4	38.1
1991	2880.0	51.6	37.5	37.9	48.4	-9.7	35.6
1992	3210.2	46.0	-0.7	33.4	54.0	24.4	39.2
1993	3314.6	60.9	36.9	46.2	39.1	-25.4	29.6
1994	3775.3	62.2	16.2	47.2	37.8	10.4	28.8
1995	4035.2	63.8	9.7	48.7	36.2	2.3	27.6
	Average 1986-'90	51.2	0.3	34.8	48.8	12.5	31.8
	Average 1976-'95	51.2	20.2	32.9	48.8	12.0	29.5

Notes: R.I - relative importance of total

G.R. - annual growth rate

Source:

1. DC, SDP, Table (6), p.14; Table (7), p.15
2. DC, ThDP, Table (5), (6), p.13
3. DC, the Assessment of the ThDP, Table (2-12), p.56
4. CBO, 1985, Table (5), p.119
5. CBO, 1994, Table (3), p.127
6. CBO, Quarterly Statistical Bulletin, June 1996, Table (29), p.37.

5.3.1.4 The Impact of the Budget Deficit on Output Growth

I would like now to investigate whether an increase in the government's fiscal deficit stimulates economic activity. The presumption created by fifty years of Keynesian macroeconomics is that it does. However, a much older classical tradition suggests that it does not. According to this older view, any increase in the economic activity of the government sector will be offset by a reduction of private sector activity. The classical prediction is that in the long run overall economic activity will fall because public sector resource use is likely to be less efficient than in the private sector. It is important to distinguish between the impact of deficits on output of the government sector and the output of the rest of the economy. Output in the private sector can be measured by its market value. The output of the government sector is not typically marketed however, so its imputed value is taken to be the value of the resources it uses up. If the government hires another worker, the output of the government section is assumed to rise by the earnings of the extra worker, even if he does nothing.

This difference in the way output is measured in the public and private sectors is important because it biases tests in favour of the result that deficits increase output. The government has only to hire more people and its output goes up accordingly. The interesting question is, however, what happens to output in the rest of the economy? (Chrystal & Dowd, 1987, p.17).

Unfortunately, this distinction cannot be made directly in our case. The official statistics do not present separate output composition between the government and private sectors because both of them are mixed in many fields of production. Rather the distinction is made between the oil sector and the non-oil sector. Within the non-

oil sector one can distinguish between pure government sectors and mixed sectors, or between goods producing sectors and services producing sectors. Let us turn first to the non-oil sector.

5.3.1.4.1 The Impact of the Budget Deficit on the Non-oil Output Growth

In the non-oil sector there are pure government sub-sectors such as Public Administration and Defence, Transport and Communications, and Electricity and Water. They have the highest relative importance in the composition of the non-oil output. They accounted for 12%, 15%, 19% and 25.7% of non-oil output in previous development plans on average (Table 5-9). They make a direct and almost one to one relationship between government expenditure and output. The other sub-sectors are mixed sectors such as commerce, manufacturing, agriculture and fisheries which depend mainly on private sector investment. It can be seen that agriculture and fisheries and manufacturing, i.e. the non-oil goods produce have the lowest proportion in the non-oil output. They constituted 4%, 5%, 8% and 6.5% during the previous plans. Other services which include commerce, ownership of dwellings, financial and business services, make up 20% of non-oil output. If these service sectors are added to pure government services they will account for 26%, 36%, 41% and 49.7% of non-oil output during the four development plans respectively. Due to the highest relative importance of government services in non-oil output, the growth rate of this sector would relate mostly to the government expenditure growth.

Public expenditure is only the cost of providing these goods and services. Thus a 10% increase in nominal expenditure does not translate into a similar increase in the volume of goods and services provided by the public sector (Hemming 1991, p.36)

From table (5-10) it can be seen that non-oil output has been growing even faster than government nominal expenditure. The average growth rate of the former was 12% during 1976-1995 compared to 7.9% for the latter. In the period on which we are focusing these two rates were 3.8% and 0.8% respectively. This means that non-oil output is highly swollen. Expenditure has to be deflated by the relevant price index which should in turn reflect the price indices for the various components of expenditure.

Table 5-9
The Structure of Output (GDP)
During Previous Plans

Main Sectors	1 st Plan	2 nd Plan	3 rd Plan	4 th Plan
Oil	61%	52%	46%	38.9%
Non-oil:	39%	48%	54%	61.1%
of which				
- Govt. services ⁽¹⁾	12%	15%	19%	25.7%
- Agriculture and manufacturing	4%	5%	8%	6.5%
- Construction	9%	7%	5%	3.0%
- Other services ⁽²⁾	12%	20%	20%	24.0%
Total	100	100	100	100

Notes:

- . Includes Public Administration and Defence, Electricity and Water, and Transport and Communications
- . Includes trade, ownership of dwellings, banking and other services

Sources:

- . DC, SDP, p.12
- . DC, ThDP, p.15
- . DC, the Assessment of the ThDP, p.49
- . CBO, 1995, Table (1), p.127.

In general, these will differ from indices corresponding to private sector output. Richard Hemming states that “the usual argument being that the price of public sector output rises faster than that of private sector and output” (Ibid). While wage costs are higher, productivity growth is slower in the public sector, reflecting the low level of competition, the inefficiency of complex bureaucracies

After making this precaution, the discussion now will turn to the question of how non-oil output growth has been affected by the budget deficit.

The budget deficit has been influencing non-oil output growth indirectly through two tracks:

1. The ‘leakage’ represented in transfers and imports.
2. Lost opportunity cost related to rising debt service.

1. The Leakage Represented in Imports and Foreign Government Expenditure

It was found earlier in this section that the impact of budget deficit on domestic demand must be examined in the light of domestic budget balance not the overall budget balance. This is because of the large proportion of government spending that has been flowing out of the country through transfers and imports. This leakage was reflected in low domestic and national saving. It also resulted in low domestic demand for domestic output compared to total consumption and investment as a proportion of gross national product (see Table 5-5). In other words there has been a ‘leakage’ from total demand (or total purchasing power) to outside the economy, off-setting the effect of government expenditures multiplier. This depression in turn can stand as a reason to

the “deflation” that has been indicated by the negative change in the consumer price index starting from 1982 (see Table 5-3).

2. Lost Opportunity Cost Represented in Debt Service Spending

Debt service is a direct consequence of budget deficit. The increasing foreign public debt lead to increasing debt service expenditure. If those funds had not been spent in this way, they might have been invested in schools, roads, electricity, water, etc. Non-oil output might have increased, especially if we take into consideration the volume of the debt service compared to public investment. From 1976 to 1993 debt service represented 41% of public investment on average. It climbed to 69% during 1986-1990. In 1989 it peaked at 100%. Therefore, the following statement by Samuelson and Nordhaus can be applied completely to Oman’s case:

An increase in external debt lowers national income and raises the fraction of national output that has to be set aside for serving the external debt ... taking all the effects together, output and consumption will grow more slowly than they would had there been no large government debt and deficit (Samuelson and Nordhaus 1992, p.635).

So the two factors above have been slowing down the non-oil output growth. Table (5-10) shows that its annual growth rate has been falling since 1982 with the exception of a few years. In the first two years of the period under study its growth rate was negative. The average annual growth rate during that period was 3.8%. According to the official estimation, of course, this decline was mirroring the decline of oil revenue, yet this growth rate has been overestimated.

Table (5-10):
The Growth Rate of GDP, GNP, Oil and Non-oil GDP and Government
Expenditure

Year	GDP	GNP	T.G. Ex.	Oil output	Non-oil output
1976	-	-	-	-	-
1977	7.1	15.1	-4.1	2.9	13.4
1978	0.0	2.9	5.2	-7.5	10.0
1979	36.2	32.6	13.1	45.8	25.6
1980	60.0	71.2	43.3	78.0	33.0
1981	20.7	22.3	28.2	15.2	34.8
1982	4.9	5.2	15.4	-3.6	16.9
1983	4.8	2.9	9.6	-3.0	13.7
1984	11.2	11.7	13.8	4.6	17.4
1985	13.4	18.6	8.8	13.6	11.3
1986	-26.7	-19.3	-3.2	-35.1	-2.4
1987	6.5	10.4	-15.0	32.0	-7.3
1988	-2.6	-7.5	-0.6	-15.4	8.4
1989	10.4	12.3	0.3	23.1	2.3
1990	25.4	28.6	13.3	36.1	18.0
1991	-2.8	-3.8	-1.0	-16.7	7.6
1992	12.8	10.0	20.9	13.1	12.2
1993	1.7	0.9	-2.7	-10.7	6.1
1994	3.4	8.4	0.5	1.8	4.9
1995	6.5	6.8	3.5	11.4	4.1
Average 1986-1990	2.6	4.9	0.8	8.1	3.8
Average 1976-1993	10.2	12.1	7.9	9.7	12.1

Notes: T.G. Ex.: Total government expenditure

Source: Previous tables.

5.3.1.4.2 The Impact of the Budget Deficit on Oil Output Growth

Oil output is dominated by two factors: world oil market prices and the volume of production. The two factors go upwards together and sometimes they go downwards. Very often the government moves the volume of production upwards in order to offset the effect of falling prices. The rapid rise in Oman's oil output from 1978-81 reflected primarily the strong increase in prices over that period. From 1983, when the oil prices started to fall gradually, the government started to increase the volume of production so as to minimise the ensuing budget deficit. However, starting in 1986, when budget deficit was triggered by the sharp and sudden falling of oil prices, the magnitude of oil production was excessively increased. Notwithstanding this increase the value of output was depressed over 1986-89 as a consequence of the particularly low oil prices over the period. It is obvious then that the budget deficit has been forcing the government to raise the volume of oil production but the adverse effect of oil prices has been offsetting the growth of oil output. Sometimes oil prices increase unexpectedly making the deficit fluctuate. Table (5-10) shows the dwindling oil output growth. This makes the reliability of oil output growth as a measure of economic growth questionable. Rodney Wilson has made the case well, when he says that:

Oil production distorts gross national product figures and for the Arabian peninsula states in particular much of the change reflects oil price decreases on production swings. It is often asserted that for OPEC countries per capita income is a totally misleading indicator of the level of economic development as the high figures merely reflect oil productions not successful advance through economic diversification (Wilson 1995, p.28).

In this way, budget deficit has a negative long-term effect on proven oil reserves. Oil is an almost depleted energy resource. By the existent extracting rate, which is now at 800,000 b/d the total proven reserve (5bb) will be depleted in as little as 17 years.

5.4 The Effect of Budget Deficit on Balance of Payments

Changes in fiscal policy affect the balance of payments in various ways. At the aggregate level, changes in the size of the budget as well as the extent of the surplus or deficit will affect aggregate income and prices. These will lead to changes in imports and exports through income and price effects. At the micro level, the types of taxes and expenditure in the budget will have effects on imports, exports and capital flows.

In an oil exporting country with a limited home production base, there is likely to be a close relationship between foreign fiscal balance and balance of payments developments. Government oil revenues are the principle source of foreign exchange, and a large proportion of government expenditure consists of payments for imports and for other external transactions. Also, government injection of oil revenues into the domestic income stream via its domestic expenditure is reflected in private sector imports, given a limited home production base and a reasonably open economy.

An adequate analysis of exactly how budget deficit has been affecting the balance of payments requires an insight into the structure of the balance of payments. There are four main components of the balance of payments (Table 5-11). They are: trade balance, current account balance, capital account balance and overall balance. Trade balance is the merchandise account that shows the balance of exports and imports. It has always been in surplus and the oil exports is the major export item forming 85% of total exports. The current account balance represents the result of two accounts: trade account, and services and private transfers. The latter consists of the non-factor

Table (5-11)
Balance of Payments (in ROm)

	1985	1986	1987
1. Trade Balance	555	113	707
Exports and re-exports (f.o.b.)	1717	1093	1463
Oil Exports	1597	981	1339
Other exports	23	27	39
Re-exports	97	85	85
Imports (c.i.f.)	-1162	-980	-756
Recorded (custom)	-1089	-917	-701
Unrecorded	-73	-63	-55
2. Services and Private Transfers	-534	-513	-393
Travel	-18	-18	-18
Port Dues	5	5	5
Profit remittances	-184	-182	-138
PDO foreign partners	-35	-65	-65
Contractors, Commercial banks, Others	-149	-117	-73
Official interest (net)	69	145	119
Receipts	114	221	192
Payments	-45	-76	-73
Commercial banks' interest receipts (net)	11	7	8
Other services (net)	-104	-147	-99
Workers' Remittances (net)	-312	-323	-270
Inward Remittances	15	15	15
Outward Remittances	-327	-338	-285
Other Private Transfers (net)	-1	0	0
3. Current Account Balance	21	-400	314
4. Official Capital	110	211	-64
Grants	60	0	3
Loans (net)	73	216	-52
Receipts	125	298	123
Amortisation	-52	-82	-175
Other official capital (net) 1/	-23	-5	-15
5. Oil Sector Capital (net)	31	110	5
Direct Investment	52	51	12
PDO foreign partners	5	22	-18
Other companies	47	29	30
Oil exports credit (net)	-21	59	-7
6. Commercial banks' Capital (net)	3	2	1
7. Capital Account Balances (4+5+6)	144	323	-58
8. Total Current and Capital accounts (3+7)	165	-77	256
9. SDR ALLOCATION	0	0	0
10. Errors and Omission (2)	-166	-218	-184
11. Overall Balance	-1	-295	72
12. Change in reserves and net foreign assets	1	295	-72
Central Bank*	-35	136	-92
Government	-37	93	48
Changes in holdings 3/	-230	-157	-19
Valuation change 4/	193	250	67
Commercial banks	73	66*	-28

Source: Central Bank of Oman, Annual Report 1989, p.114

service e.g. shipment of merchandise, remittances of contractors, banks, and workers. Workers' remittances is the largest item affecting the current account after the trade balance. The current account balance showed a deficit in 1975, 1976, then a surplus from 1977 onwards up to 1985. In 1986 it witnessed a significant deficit and since then it has been swinging between deficit and surplus. The capital account balance consists of three main sections: official capital, oil sector capital and commercial banks' capital. The capital account is mainly affected by movements of official capital, i.e. government loans. The overall balance, which shows the final result of the balance of payments, concludes the net balance of the main three previous balances, i.e. trade balance, current account balance and capital account balance. Overall balance showed a deficit in 1975-1976. From 1977 onwards it showed a surplus. Since 1985 it has been fluctuating. At the end of the balance of payments there is a financing statement which is the exact opposite of the overall balance. It represents the means of financing the deficit or using the surplus of the balance of payments. When the balance of payments shows a deficit it means drawing down on foreign assets of the banking system and/or the government. Conversely, when the overall balance shows a surplus it means inflow of foreign assets has gone into the accounts of banking system and/or the government. The means of deficit financing consist of all or some or one of the following resources:

-

- transactions with IMF

- changes in reserves

- changes in net liabilities to other external banks.

Oman has not resorted to IMF transactions yet. It depends mainly on oil revenues to finance its expenditure. Non-oil revenues, which are considered domestic revenues fall short of fulfilling domestic expenditure, i.e. there is a domestic deficit represented in local currency.

This can be expressed by the following equation:

$$DE - T = DD \quad (1)$$

Where DE = domestic expenditure, T = non-oil revenue, DD = domestic deficit.

On the other hand oil revenues, which are considered foreign revenues, exceed foreign expenditure. Consequently, there is a foreign surplus represented in foreign currencies. This can be expressed by the following equation:

$$FE - OR = FS \quad (2)$$

Where FE = foreign expenditure, OR = oil revenue, FS = foreign surplus.

Foreign surplus is used to finance domestic deficit. This can be expressed as follows:

$$DE - T = FS + \quad \text{(see Table 5-4)}$$

FS is a function of oil exports and it changes positively with it.

Obviously, the government budget and the balance of payments affect each other through FS. FS is an outcome of FE - OR. Supposing OR is constant then the smaller FE the larger FS. Thus, what makes the foreign surplus bigger is lower foreign expenditure which affects the balance of payments through imports and transfers. It also becomes bigger when OR is bigger which influence the budget. (See Chart 5-4).

However, when the foreign surplus (FS) is not enough to finance the domestic deficit entirely, the government resorts to the foreign borrowing (BR), and grants (GR). Thus, the above equation can be rewritten like so:

$$DE - T = FS + BR + GR \quad (3)$$

The larger the difference between DE and T, i.e., domestic deficit - or the smaller the FS - the larger the component BR. In other words, the larger the domestic deficit the larger the borrowing from abroad.

Consequently, the bigger the deficit the bigger the borrowing, the heavier the effect on the balance of payments. Therefore, there is a direct effect between budget deficit and the balance of payments through foreign borrowing.

Again, when $FS + BR$ do not fill the gap $DE - T$, the government draws down its foreign reserves and assets (FA) to finance the gap. Accordingly, the balance of payments is affected by the budget deficit through the change in foreign assets and reserves. Then equation (3) becomes:

$$DE - T = FS + BR + GR + FA \quad (4)$$

The last equation means that domestic deficit (DD) is equal to foreign surplus plus the means of financing. Then:

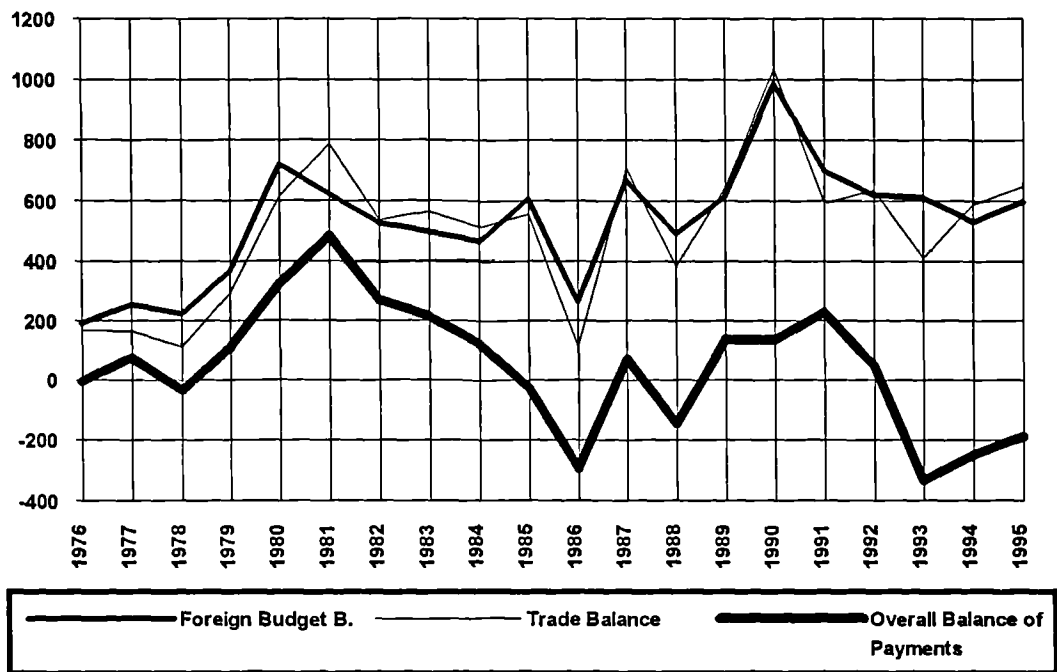
$$DD - FS = BR + GR + FA \quad (5)$$

Which means domestic deficit minus foreign surplus equal to the means of financing. Hence the left part of equation (5) is the overall deficit (OD) of the budget, then:

$$OD = BR + FA + GR \quad (6)$$

equation (6) simply means that the overall deficit is equal to its means of financing.

Chart (5-4)
The Relationship Between Foreign Budget Balance
and The Balance of Payments RO(m)



Source:

1. DC, SDP, Table (16), p.23.
2. DC, ThDP, Table (28), p.45.
3. CBO, 1990, Table (5-6), p.127.
4. CBO, 1994, Table (6-8), p.95.
5. CBO, 1995, Table (6-8), p.103.

Since deficit financing by drawing down the foreign government reserve makes no obligation on the government to repay the funds, this sort of financing does not occur in the balance of payments. However, when the overall balance shows a deficit, a drawing down of government reserves abroad would occur as a sort of financing beside negative or (positive) change in the central bank or commercial bank's foreign assets. When there is a surplus in overall balance, it means that there is an accumulation of foreign exchange on the government accounts.

All these reactions can be considered as direct effect on the balance of payments whereas the exchange rate mechanism (which is influenced by budgetary transactions) has an effect on import prices and thereafter on the volumes of imports. This will affect the foreign expenditure (FE) in equation (2) and thereby the foreign surplus (FS). It will also affect non-oil exports influencing the trade balance. These types of transactions form the indirect effect on the balance of payments.

5.4.1 The Direct Effect of the Budget on the Balance of Payments

The analysis will be stressed here on the public capital outflow as a budgetary transaction stemming from budget deficit. The analysis will interpret how the public outflow affects the trade balance and the overall balance of the balance of payments.

Table (5-12) illustrates how the surplus of the trade balance has been declining and becoming a small surplus (or even a deficit) in the overall balance. The table also shows the main causes of this decline which is the debt service. The trade balance fell by 105% in 1985 and the debt service contributed 17% of this decline. In 1986 it fell by 138.2% with the debt service contributing 43%. In 1991 it dropped by 61% and

the debt service contributed 58%. During the period under study the average contribution of debt service in trade balance cut was 42.3%.

Obviously the budget deficit - through the debt service - has adversely affected the balance of payments. The debt service has been cutting the foreign exchange earning of the country accomplished by the trade balance and even eroding the foreign reserves in overall-deficit-years.

As indicated earlier in this section, when the result of the overall balance is positive there will be an accumulation of foreign exchange i.e. an increase in foreign reserves from outside the country. In contrast, when the result is negative there will be a cut in previously accumulated reserves outside the country. In this case, the government finances the deficit in the overall balance by resorting to foreign reserves which are invested in foreign banks and establishments. From Table 5-12 it can be seen that average decline of the foreign reserves of the government and the Central Bank during 1986-1990 amounted to 83% of overall deficit. The remainder was the decline in commercial banks' foreign assets.

Table (5-12)
The Direct Effect of the Budget Deficit
on the Balance of Payments

Year	Trade Balance	Overall Balance	Decrease in Trade Balance		Debt Service		Drawing of Foreign Reserves	
	ROm	ROm	ROm	%	ROm	% of dec.	ROm	% of O.D.
1985	555	-29	-584	105.2	99.1	17	-44	151.7
1986	113	-295	-408	361.0	157.7	38.7	-199	66.6
1987	707	72	635	89.8	248.1	39.1	+44	61.0
1988	385	-147	-532	138.2	230.7	43.4	-180	122.4
1989	646	138	508	78.6	291.8	57.4	109	79.0
1990	1042	147	895	85.9	296.2	33.1	128	87.1
1991	594	230	364	61.3	211.6	58.1	209	90.9
1992	636	49	587	92.3	227.7	38.8	114	232.7
1993	411	-335	-746	181.5	262.3	35.2	-407	61.8
1994	588	-249	-837	142.3	244.7	29.2	-253	101.6
1995	648	-190	-838	129.3	225.7	26.9	-166	87.4
Average '86-'90	578.6	-17	219.6	150.7	244.9	42.3	-19.6	83.2
Average '85-'95	575	-55.4	-86.9	133.2	226.9	37.8	-55.9	103.8

Notes:

O.D. = Overall Deficit

Source:

- . CBO, 1990, Table (6-5), p.127
- . CBO, 1994, Table (6-8), p.95
- . CBO, 1995, Table (6.8) p.103, Table (4.1) p.38

5.4.2 Indirect Effect of the Budget Deficit on the Balance of Payments

This sort of effect works through the monetary policy tools such as the exchange rate and interest rate. The effect of the exchange rate on the balance of payments can be divided into two types: the effect of devaluation and the effect of the real exchange rate. The effect of devaluation was a discretionary policy taken by the government to cope with collapse of oil price and accordingly with the budget deficit. This effect will be discussed in the next chapter which will address the evaluation of the deficit - reducing policy. The effect of the real exchange rate is the appreciation or depreciation induced implicitly by the budget deficit. Hence the discussion here will be confined to this.

The Omani Rial was pegged to the U.S. dollar in fixed exchange rate at RO 0.345 = one dollar up to January 1986. It was then changed to RO 0.385 = one dollar. This is called the nominal or the official exchange rate. The real exchange rate is the:

exchange rate of a currency expressed in constant price terms to make allowances for the effects of inflation. For example, where a country experiences a higher rate of domestic inflation than its trade competitors, then its exports will become more expensive than those of competitors' exports and its imports cheaper than domestic product unless its exchange rate depreciates to offset fully the inflation differential (Pass & Lowes, p.461).

When a major increase in domestic spending takes place as a consequence of the large-scale development of a natural resource and an associated large-scale increase in public revenues and expenditure, this is known as the 'Dutch disease'. This drives up the prices of domestic services relative to those of domestic tradable goods, i.e. it produces an appreciation of the real exchange rate.

The result is that tradable goods production becomes less profitable than the production of domestic services. Rising domestic demand also raises the cost of domestic labour and capital. This further reduces the profitability of domestic production of tradables. Countries, such as Oman, experiencing a resource boom thus typically experience a gradual decline in tradable goods vis-à-vis services production as factors of production are re-deployed in response to the fundamental changes in relative prices and costs (The World Bank, 1994, p.iv).

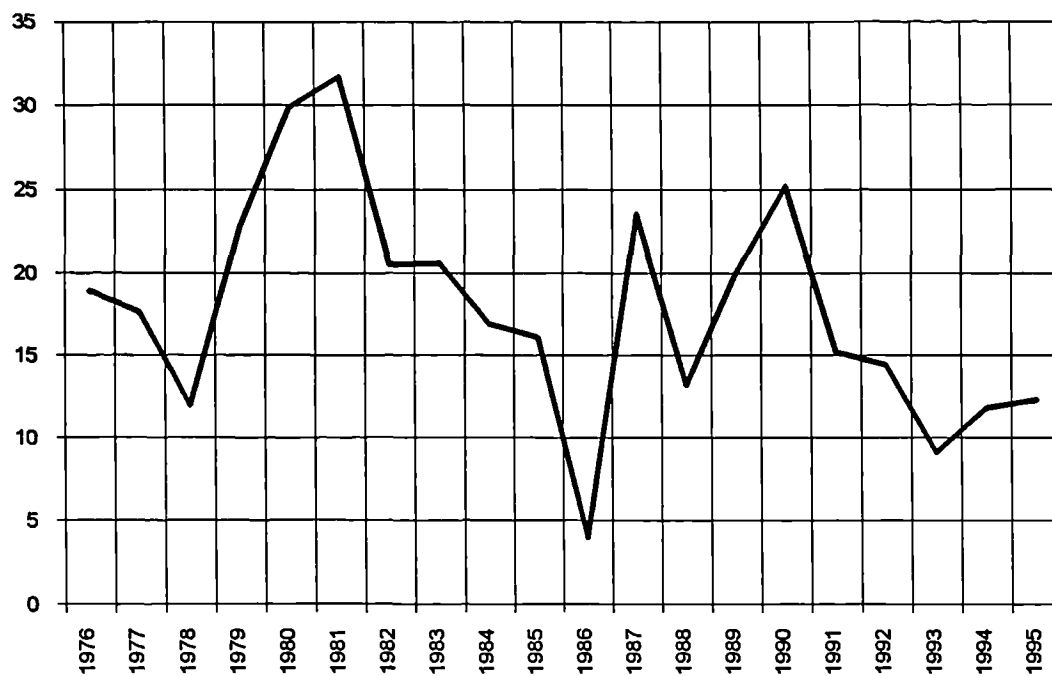
Oman witnessed three episodes of real exchange rate; depreciation in 1978-1979, appreciation during 1980-1985, then depreciation throughout the period 1986-1991 reflecting the oil cycle. The first two years (1987-1989) witnessed relatively poorer terms of trade and lower purchasing power for oil compared to the middle period (1980-1985), characterised by an improvement in both indicators. Real exchange rate appreciation inhibited the growth of the non-oil traded goods sectors. The share of agriculture and fisheries does seem to have responded to both real exchange rate depreciation and appreciation. The share of the sector in total GDP declined by 16% between the first and second periods as the real exchange rate appreciated by more than 60%. On the other hand, in response to real exchange rate depreciation in the last period its share grew by 35%. However, it remains rather small and despite the real depreciation in the last period, did not rise above the level reached in the first period (Ibid., p.5).

It can be inferred then, that the balance of payments was adversely influenced by the appreciation of the real exchange rate because the price of Omani non-oil exports could not compete with its trade partners. This also made it cheaper for the country to

import from abroad narrowing the trade balance surplus. This is also correct even during the period of real exchange rate depreciation (1989-1991) since the growth rate of the non-oil exports was 8.5% compared to 13.4% for imports. As a consequence, the share of net exports (the trade balance) to GDP dropped from 20.7% over 1976-1985 to 17% over 1986-1990 (Chart 5-5).

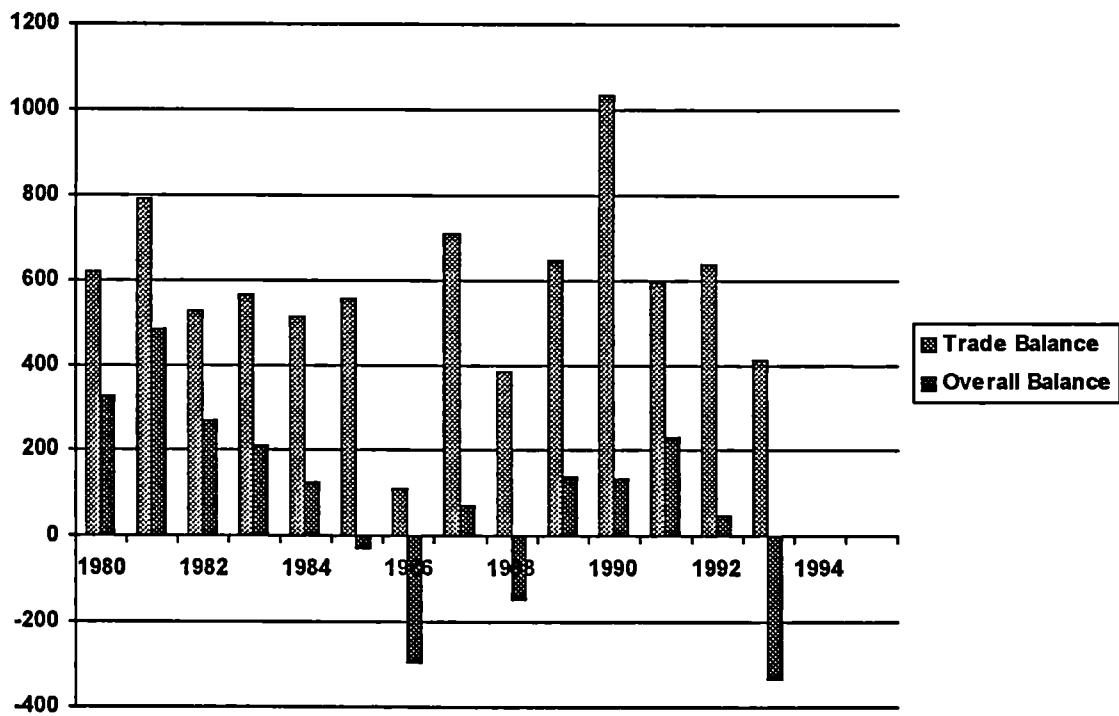
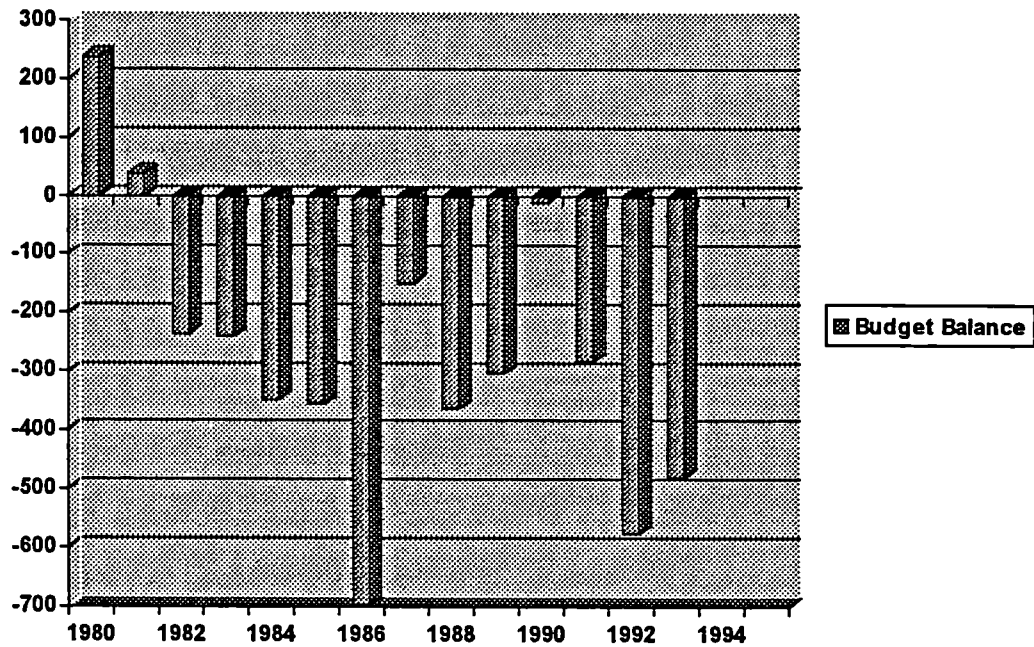
To sum up, the internal (or the fiscal) disequilibrium, i.e. the budget deficit has been shifted to an external disequilibrium, i.e. the deficit of the current account balance and the overall balance of the balance of payments. This shift was taking place through the outflow of the official capital as a direct effect of the deficit and through the real exchange rate mechanism as an indirect effect. Chart (5-6) depicts this relationship.

Chart (5-5)
Net Exports (Trade Balance)
as a Percentage of GDP



Source: Table (1-16).

Chart (5-6)
The Relationship Between the Budget Deficit and the Balance of Payments



Source: Previous tables.

Conclusion

This chapter addressed the examination of the macroeconomic effects of the budget deficit on the Omani economy. The consequences of deficits depend on how they are financed.

During the period 1981-1985, the deficit totalled RO 1266 million. 48.8% of the deficit was financed by withdrawals from the SGRF, 37.2% by external borrowing, and 14% by foreign grants. During the period under study, the total deficit was RO 1526.9 million. It was financed by withdrawal from SGRF (91%) and external borrowing (9%). The first direct effect of increasing deficit was the rise of accumulated debt. The indebtedness balance rose from RO648 million in 1985 to RO1027 million in 1990, then to RO1501 million in 1995. As a percentage of GDP it peaked in 1986 at 33%.

The other direct effect of the deficit was the exhaustion of the government foreign assets. The withdrawal from the SGRF totalled RO 1414 million during the period under study. During 1991-1995 the total withdrawal was RO 823 million.

The indirect macroeconomic impacts of the deficit were on money supply and inflation, the aggregate demand and the balance of payments. Regarding the analysis of the impacts on money supply, the concept of domestic deficit was adopted. It was defined as government domestic revenue - government domestic expenditure. The study has found that there is a positive relationship between the domestic deficit and money supply with one or two years lag, which means that the budget deficit has an expansionary effect on money supply. The monetary expansion has been induced by

the external borrowing and the drawing from the cash balances of the government. However, this monetary expansion was not an adequate evidence that the budget deficit has an inflationary effect, because the consumer price index (CPI) has not been indicating inflation in general. This result is supported by the fact that the government has not resorted to inflationary means of deficit financing such as the borrowing from the central bank or excessive reliance on selling treasury bills.

To examine the effect of the budget deficit on aggregate demand, the budget balance was separated into domestic and foreign components. The former reflects the direct impact on demand for domestic goods and the latter reflects the direct impact on the balance of payment. Domestic budget balance was calculated as non-oil revenues - domestic expenditure. Due to the absence of classifying statistics of government expenditure to domestic and foreign items, the study has resorted to rough estimation.

The consequence of the budget deficit on domestic demand for domestic goods was examined through the impact on private investment and private consumption. The growth rate of private investment declined during the examined period. It averaged only 1.2%. Private investment was not falling due to the so-called crowding out effect, because the government was not competing with the private sector for commercial bank's credit. The commercial banks have been in surplus financial resources. Non-oil private investment was declining because of structural setbacks such as lack of opportunities and lack of experience. Oil investment was falling because of falling oil prices. Other main reasons for falling total investment was falling national saving. The latter was falling because of large expatriates' and contractors' remittances and large

public consumption and higher deficit. The macroeconomic consequence of the budget deficit on investment, then, was through the lack of saving both public and private.

The fluctuating behaviour of both private and public consumption during the period under study was explained by the swinging trend of oil income and accordingly non-oil income.

The output growth was another aspect of the macroeconomic impacts of the budget deficit on aggregate demand. Due to higher relative importance of government services in the non-oil output its growth rate is explained mostly by the growth rate of government expenditure. The budget deficit has been adversely affecting non-oil output indirectly through two factors: first, through the leakage represented in transfers and imports and second, through the lost opportunity cost related to rising debt service. Oil output is governed by oil prices and the volume of production. The budget deficit has been forcing the government to raise the oil production to offset – at least partially – the adverse effect of oil prices.

Finally, the balance of payments has been affected by the budget deficit directly and indirectly. The direct effect has been represented in the decline of the foreign exchange earning of the country due to increasing debt service. The indirect effect worked through the exchange rate mechanism. The balance of payments was adversely influenced by the appreciation of the real exchange rate because the prices of Oman's non-oil exports could not compete with its trade partners. This also made it cheaper for the country to import from abroad, reducing the trade balance surplus.

CHAPTER VI

ASSESSMENT OF THE DEFICIT-REDUCING POLICY

Introduction

Having identified the causes of the budget deficit, and having investigated the macro-economic effects of the deficit, we will now evaluate the policy by which the financial authority has tackled the deficit. In order to do so we will address three topics in three sections, as follows:

- Section I: The criteria of prudent deficit and how close is Oman's actual deficit to it.
- Section II: The government's fiscal policy in confronting the problem and how this policy has worked.
- Section III: Suggested alternatives to this policy.

6.1 The Criteria of Prudent Deficit and Oman's Actual Deficit

One of the most important aspects of fiscal policy is the management of the public sector's deficit. Deficits in themselves may not automatically imply macro-economic problems. If the use of public resources is sufficiently productive, future income can be generated to cover the cost of any debts incurred. Deficits can be absorbed by countries with high rates of domestic private saving and well-developed capital markets. Thus a relatively high deficit need not cause problems in an efficient, high-saving economy, whereas in a low-saving, highly distorted one, even a small deficit might be destabilising.

A prudent fiscal policy can therefore be defined as one that maintains the public deficit at a level that is consistent with other macro-economic objectives: controlling inflation, promoting private investment and maintaining external creditworthiness (World Bank, 1988, p.55).

To do this, financing must be broken down into its components. A good starting place is the rule stating that the sum of all investment in the economy must be equal to the savings available both from Omani residents and other foreigners.

$$PI + PrI = PS + Prs + FS$$

where:

PI = Public Investment

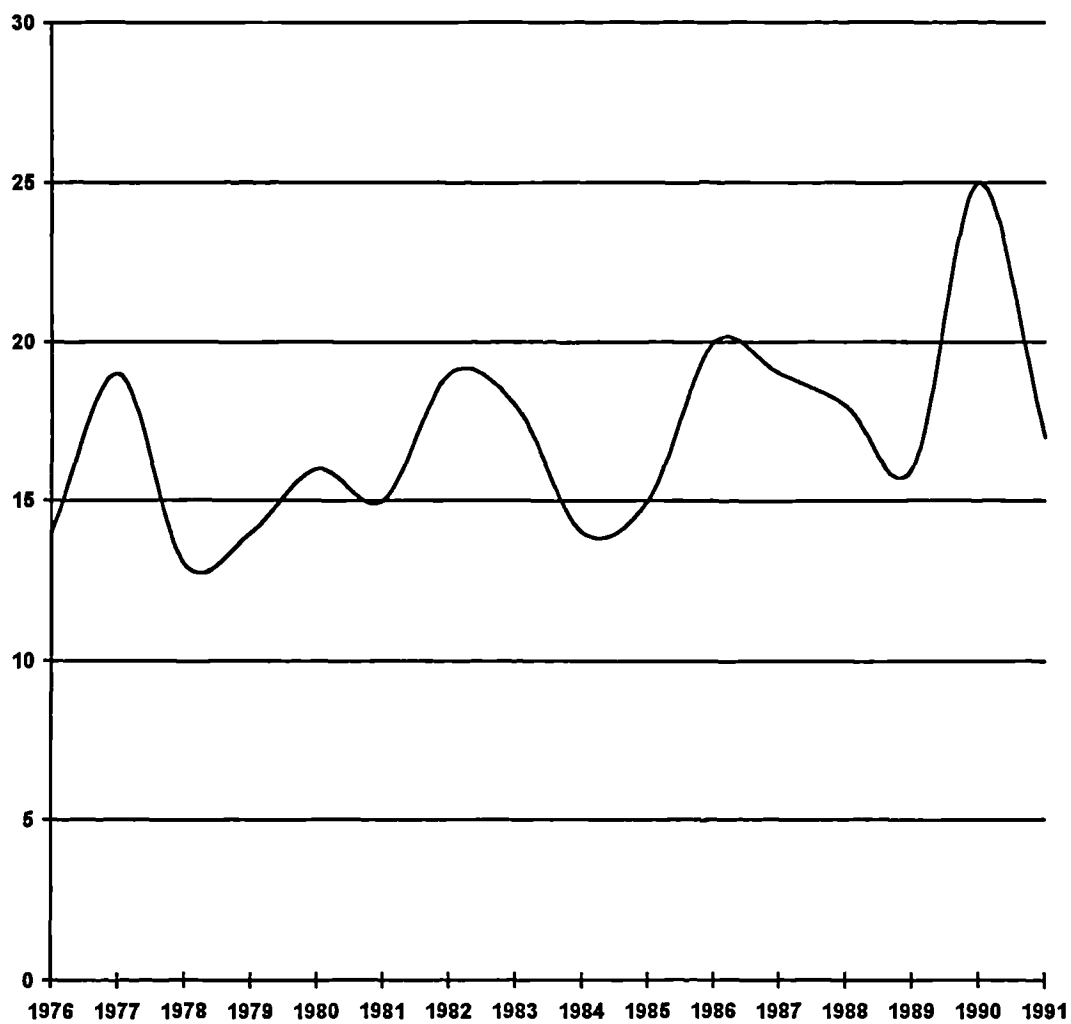
PrI = Private Investment

PS = Public Saving

PrS = Private Saving

FS = Foreign Saving

Chart (6-1)
Private Saving as a Percentage of GDP



Source:

The World Bank, 1994, Report No. 12199 -
OM Chart No. 2.15, p.27

Foreign saving is the excess of foreigners' income from the domestic economy over their spending in it. This is equal to the current account deficit in the balance of payments.

Public saving is the excess of public current revenues over current spending and the public deficit can therefore be defined as public investment minus public saving.

Public deficit must be balanced by a domestic private sector that saves more than it invests and/or by an external current account deficit.

$$PI - PS = PrS - PrI + FS$$

This can be changed to:

$$PD = PSR + CAD$$

where:

PD = Public Deficit

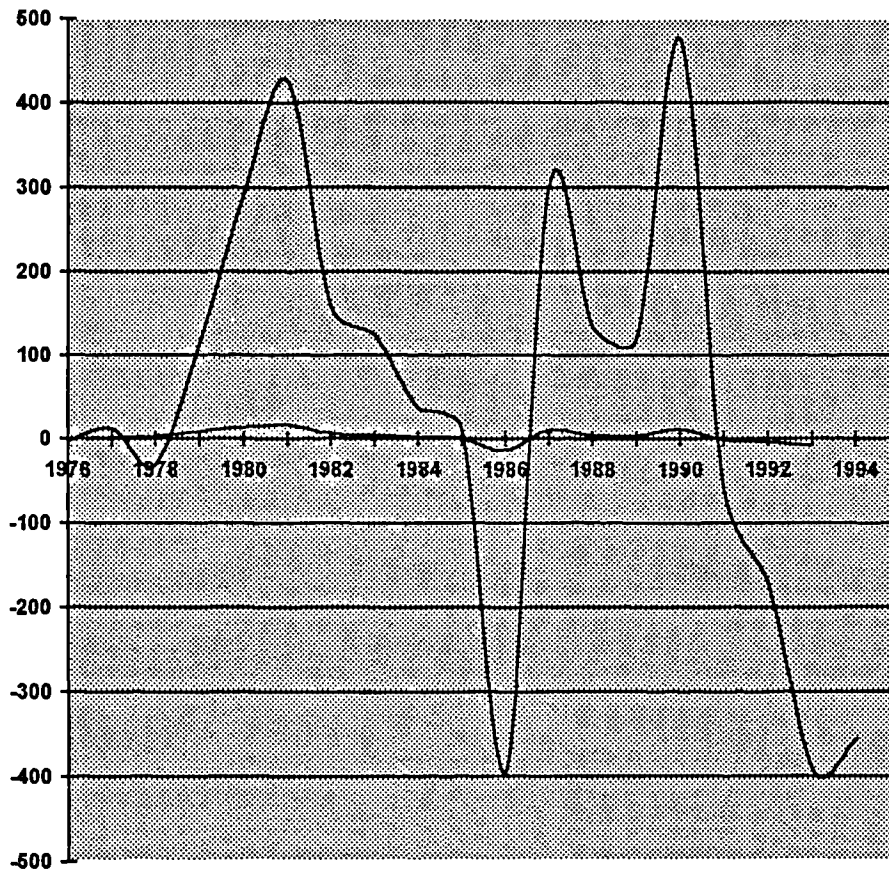
PSR = Private Surplus

CAD = Current Account Deficit

The prudence of the public deficit depends on the level of private saving, the desired level of private investment, and the desired current account deficit (World Bank 1988, p.58).

It was found in Chapter Five that private investment represents a small proportion of GDP and is continuing to fall (see Table 5-6). It can be seen from Chart (6-1) that private saving has been dwindling. Current account deficit of the Balance of Payment is assessed in Chart (6-2). It was improving until 1981 when it reached its peak at

Chart (6-2)
Current Account Balance/GDP



Source:

1. DC 2nd DP. Table (16) p.23
2. DC 3rd DP. Table (28) p.44
3. CBO, 1990, Table (6-5) p.127
4. CBO, 1994, Table (6-8) p.95

17% of GDP and then began to fall sharply due to foreign workers' transfers. In 1986 it saw a deficit at 14% of GDP. In 1987 and 1980 it recovered again, registering a surplus at 10% and 12% respectively, but since then it has been deteriorating. Thus, it's positive position is generally not sustained.

The amount of foreign lending determines whether or not public deficit is consistent with other macro-economic goals. The external creditworthiness is one criteria adopted in this issue:

External creditworthiness is sometimes defined as maintaining an acceptable ratio of gross external debt to exports. This is because exports determine the ability to serve debt, a permanently increased debt-export ratio could impair creditworthiness (Ibid.).

This suggests that public external debt should grow at the same rate as exports over the long run.

Table (6-1) and Chart (6-3) tell us that the debt/export ratio has risen quickly. It peaked in 1986 at almost 84% which meant that 84% of exports had to be appropriated to serve the indebtedness balance. During the period under study this ratio averaged 66%. Indebtedness has grown faster than exports. Throughout 1980-1995 its growth rate was more than five times that of exports. It is obvious then, according to the creditworthiness criteria, that the position is unacceptable.

Commodity booms during the early eighties caused excessive spending, which led to

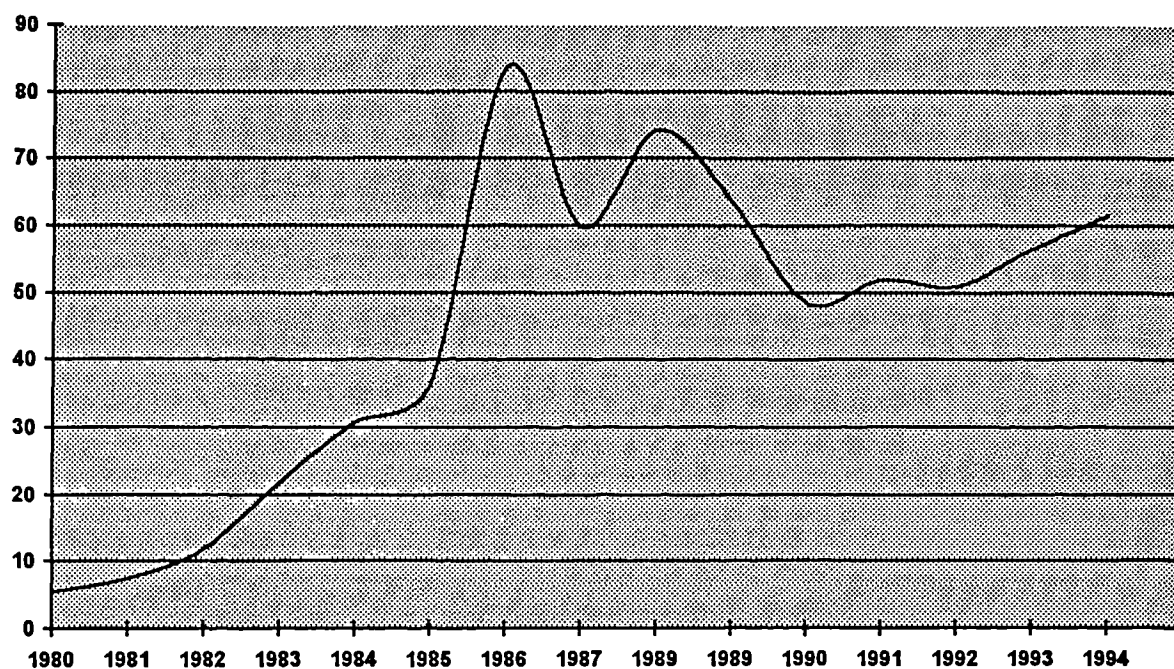
Table (6-1)
Creditworthiness Indicators

Year	Debt/Export %	Export Growth %	Debt Growth %	Foreign Reserve/ Imports %
1980	5.4	-	-	-
1981	7.4	25.3	71	33.6
1982	11.8	-5.9	50	33.6
1983	21.8	-3.9	77.8	31.6
1984	30.8	4.1	46.9	33.9
1985	36.4	16.4	37.9	34.8
1986	83.7	-36.9	45.0	40.6
1987	59.8	32.3	-5.6	77.0
1988	74.3	-13.0	8.1	47.9
1989	63.6	21.0	3.6	60.0
1990	48.5	35.4	3.3	62.4
1991	51.9	-11.5	-5.3	52.1
1992	50.9	13.9	11.8	42.9
1993	56.5	-3.4	7.1	-
1994	61.5	3.3	12.5	-
1995	64.4	9.4	14.5	-
1986-90	66.0	7.8	10.9	57.6
1980-95	45.3	5.7	27	45.9

Source:

1. Table (1-16).
2. Table (5-2).

Chart (6-3)
Debt/Export (%)



Source: Previous tables.

rapid borrowing and the accumulation of debts. Countries that depend on commodity exports face a particularly difficult fiscal environment. Their safest strategy is to treat commodity revenue as inherently volatile. Mistakenly treating a temporary boom in revenue as permanent is costly in the long-term because it can take years to cut spending and reverse the accumulation of debts incurred during the boom. By contrast, erring on the side of caution and treating a permanent boom as temporary can easily be put right later. Boom revenue can then be used to accumulate external assets or repay debt, thus avoiding the risk of inflation and an appreciating exchange rate. This policy, which has been firmly rooted in the Keynesian theory of substitutionary finance, has been misused by countries that depend on commodity exports such as Oman. Chapra pointed out this misuse when he stated that:

The Keynesian concept of compensatory financing has been unduly exploited and deficits incurred during recessions have not been offset by surpluses in boom periods (Chapra, 1985, p.136).

If access to voluntary foreign lending has already been interrupted because of excessive borrowing in the past, then it makes sense to aim for a lower debt/export ratio, implying that the growth of debt should be held below the growth of exports. The usual objective in managing foreign exchange reserves is to maintain an adequate ratio of reserves to imports of goods and services. Deficits can be prudently financed by running down reserves only to the extent that reserves remain above this target. Table (6-1) illustrates that foreign reserves have covered 45.9% of imports on average. During the examined period the reserves covered 57.6% of imports.

The above criteria are used to judge what level of fiscal deficit is prudent. Higher growth in exports, real demand for money, and overall financial savings means a higher deficit can be financed without violating the objectives of external creditworthiness, low inflation, or reasonable interest rates.

In general, faster economic growth brings bigger deficits within the bounds of prudence, because it usually implies faster growth of exports and demand for money. In a slowly growing economy with low financial savings and stagnant exports, the prudent fiscal deficit is likely to be low (World Bank, 1988, p.59).

The assessment of these elements in the previous chapter and in preceding pages indicates low prudent position.

Let us now examine which elements of fiscal and monetary policies have been applied to reduce the deficit.

6.2 Assessment of Deficit-Reducing Policy

The Third Development Plan which covers the period under study has been based on \$23.65/b for oil. At that time - December 1985 - the actual price in the world market was \$27.35/b. After the approval of the plan, oil prices started to fall dramatically. In July 1986 the price plummeted to \$8.20/b. It averaged about \$13/b in 1986, which was about half the 1985 price. Accordingly, the government adopted strong measures to cope with the new situation. For the purpose of our study the following two measures are most relevant:

1. Cutting public expenditure by 10%;
2. Devaluating the Omani Rial against the US dollar by 10.2% (See CBO, 1986, p.6).

In addition to the above two big decisions, the volume of oil production was raised by 12.4% in 1986. The growth rate averaged 6.6% during 1986-1990.

Despite the precautions being taken, the budget deficit amounted to RO 700 million at the end of 1986, i.e. 96.9% higher than 1985's level. The deficit was financed mainly by withdrawal from SGRF as was indicated earlier.

We will now take a closer look at the first two measures mentioned above and the far-reaching effects they had, i.e. cutting public expenditure and the devaluation of the Omani Rial.

6.2.1. Cutting Public Expenditure by 10%

While the reduction envisaged in total spending was in the region of 10%, actual expenditure figures for 1986 showed that a 3.2% reduction on 1985's level was actually achieved and in 1987 it dropped by 15%. The average reduction during the period 1985-1988 was 18.2%. The government was able to bring down the growth rate of total expenditure from 30% during 1970-1993 to less than 1% on average over the examined period. In 1991, total expenditure was still 2.5% less than in 1985. The rate of reduction has varied between different types of government expenditure. The sharpest cut was in development expenditure which was slashed by 11.5% annually. Next was that of defence and national security, the growth rate of which has been brought down from 25% to 0.7%. The third highest cut was in current expenditure the growth rate of which dropped from almost 30% to 7%. The cut in subsidies was minimal at only 2% from 28% to 26%. Other areas where there were reductions

included education where the expenditure growth rate was reduced from 26% to 6.8%, and the health service whose growth rate was reduced from 13% to 1%.

The alternative of reduction was not chosen on economic grounds. There should be a distinction between areas where there is waste, prodigality and unnecessary spending and areas where government spending is essential. The Omani economy still suffers from key bottlenecks such as port congestion, few roads (some with low capacity), limited skilled labour and lack of vocational training. Public spending plays a critical role in development. Through spending, governments presume and promote national identity, supply infrastructure for development, influence both the course of economic growth and the distribution of its benefits and provide social services to meet the basic needs of the population. It is useful here to quote Al-Yousef, from his book *Oil and the Transformation of Oman*, who was aware of the Omani economy:

The economic and cultural development of a country requires the efficient and steadily expanding provision of a whole host of non-revenue-yielding services - education, health communication systems, and so on (Al-Yousef, 1995, p.73).

It is unwise to stop development projects such as schools, hospitals, roads, and electricity, as they represent the future wealth of the economy. The country's network of highways, transit system, power plants and schools all represent enormous wealth-producing assets. Lessening capital formation had led to diminishing private investment, lower growth of non-oil output, and finally almost stagnation.

6.2.2 Devaluating the Omani Rial

Three objectives were targeted from devaluation:

- i. Raising government oil revenues in local currency.
- ii. Improving the position of the balance of payments by reducing imports.
- iii. Reducing the demand on foreign exchange especially by expatriates working inside the country.

The success of the devaluation policy depends on the extent to which the above three goals have been achieved. The following discussion will examine the costs and benefits corresponding to each of these three goals.

6.2.2.1 Raising Government Oil Revenue in Local Currency

Since the government sells its oil in dollars and the Omani Rial is pegged to the dollar, devaluation of the Omani Rial against the dollar would bring more money to the government in local currency, thus mitigating the adverse impact of falling oil prices.

The increase in oil revenue through devaluation in 1986 has been calculated at RO 109.7 million according to the volume of oil production (see chapter four). Nevertheless, the devaluation process has other adverse impacts on government finance through expenditure on imported goods and services, debt services and the balance of foreign debt evaluated in local currency. In that year (1986) the government's foreign expenditure was estimated at RO 669.5 million (see chapter five). With the increase in imports prices i.e. imported inflation by 18.1% (CBO, 1985, p.6) in addition to the increase due to devaluation by 10%, the total increase in imports in that year was RO 133.3 million. Table (6-2) gives the total increase in government foreign imports (approximated by its foreign expenditure) caused by devaluation.

From 1986 to 1990, the total increase in imports was RO 264.3 million. From 1986 - 1993 this item totalled RO 316.7 million.

Annual amortisation instalments increased by 10% every year when paid in Omani Rials. Supposing that annual amortisation of public debt has been paid in Omani Rials i.e. there was a conversion of currency from local to US dollars, then every instalment increased by 10% because of devaluation. Table (6-2) gives the total increase in amortisation instalments from 1986-1990 and from 1986 to 1993 caused by the devaluation. If this extra payment is added to the increase in government foreign spending the result will be that at the end of 1990 the government received RO 582.8 million through oil revenue but it paid out RO 344.8 million. At the end of the day the government had saved only RO 238 million.

6.2.2.2 Improving the Position of the Balance of Payments

The effect of devaluation on the balance of payments can be traced through the three main accounts: a) the trade balance, b) the current account balance, and c) the capital account balance.

a) The effect of devaluation on trade balance

The ordinary aim of devaluation is to increase exports (because the products of the country become cheaper for foreigners) and to reduce imports (because foreign products become expensive to the people whose currency is devaluated). Omani exports are of three types, oil exports, non- oil exports and re-exports.

Table (6-2)
The Effect of Devaluation on Government Finance

Year	Oil Revenue	Foreign Expenditure	Change in Import Prices %	Increase in Govt.Imports ROm	Amortisation ROm
1985	1343.7	738.1	-0.2	-147.6	
1986	932.9	669.5	18.1	121.2	82
1987	1182.1	512.8	11.5	59.0	175
1988	995.0	502.3	9.7	48.7	147
1989	1129.5	514.3	-0.7	-3.6	197
1990	1588.3	601.7	2.5	15.0	204
1991	1289.5	587.7	2.9	27.0	142
1992	1338.9	719.5	5.5	39.6	129
1993	1302.9	691.9	-1.3	-9.0	163
1994	1364	833	4.6	38.3	144
1995	1433.3	834.8	4.4	36.7	110
Total 1986-90	5827.8			240.3 ¹	805
DE	+582.8			-264.3	-80.5
Total 1986-95	125556.4			362.9	1493.9
DE	+1255.6			-399.2	-149.3

Notes:

DE - Devaluation Effect

⁽¹⁾ Increase in imports due to imported inflation only

Source:

1. Previous Table
2. CBO Annual Reports, Different Issues

Oil exports are sold in dollars so devaluation does not affect them. Devaluation raised the value of oil exports in terms of Omani Rials. As has been found above, the total increase during 1986-1990 was RO 582.8 million. Unfortunately, oil exports have been dwindling (see Table 6-3), due to the fluctuation of oil prices. The losses caused by the collapse of oil prices were too great to be offset by the devaluation gains.

Non-oil exports of Omani origin rose during the period at higher rate especially in 1987-1998. Their average annual growth rate from 1986 to 1990 was 26.3%. The increase was mainly in copper, fish, and live animals. Whether this rise was motivated by devaluation or not is a questionable because the growth rate declined sharply to 6% and 3% in 1989 and 1990 (see Table 6-3).

It is generally thought that the devaluation policy in the Middle East could not raise the volume of non-oil exports because the foreign demand for these exports is not sensitive to price change. Rodney Wilson explained this point when he said:

The responsiveness of foreign buyers to exchange rate falls has been disappointing. The price elasticity of demand for Middle Eastern non-oil exports appears to be rather low. Most Middle Eastern exports are dollar - denominated, so export prices do not fall with domestic currency depreciation (Wilson, 1995, pp 154-155)

By and large, non-oil exports are of marginal importance in total exports since they formed an average of only 3.5% of total exports during the period. Their total absolute value during the period was RO 263 million.

Re-exports declined in 1986 and 1987 by 12.6% and 0.2% respectively. After 1987 they started to recover gradually and recorded a sharp rise in 1991 at 53.7%. Movements of both non-oil exports and re-exports have been influenced by the disturbance taking place within the oil sector.

On the other side of the trade balance, the target was to raise the cost of imports in terms of local currency in order to improve the situation of this balance. From Table (6-3) it can be noted that imports declined in 1986, 1987 and 1988. However the decline should be explained carefully. First, they have been declining with a one year lag compared to oil exports which indicate the dependence of imports to oil revenues. For example, imports fell by 15.8% in 1986 following the decline of oil exports in 1985 and in 1986 by 13.6% and 38.5% respectively. In 1988 it rose by almost 21% as a reaction to the increase in oil exports in 1987 by 36.5%. This correlation can be explained through the effect of government spending which adversely affected the overall economic activity, particularly the construction and trade sections.

Second, because of the depreciation of the dollar against the other major currencies such as the Yen and the Deutschmark, import prices have been rising. According to CBO reports they rose by 18.1%, 14.4% and 6.2% in 1986, 1987 and 1988 respectively on a year by year basis (CBO, 1990, p.41). Therefore, another part of the decline can be attributed to the depreciation of the dollar.

Table (6-3)
The Effect of the Devaluation on Trade Balance

Year	Exports ROm						Imports ROm	
	Oil	GR.	Non-oil	GR	R. Ex.	GR.		
1985	1597	-13.6	22.9	33.1	97.4	-11.2	1088.9	14.7
1986	981	-38.5	26.6	17.0	85.1	-12.6	916.7	-15.8
1987	1339	36.5	39.0	44.0	84.9	-0.2	700.7	-23.6
1988	1130	-15.6	62.0	61.5	92.1	8.5	846.4	20.8
1989	1388	22.8	66.5	6.0	101.2	9.7	867.9	2.5
1990	1934	39.3	68.7	3.0	107.4	6.1	1030.9	18.8
1991	1629	-15.8	79.1	15.1	165.1	53.7	1228.1	19.1
1992	1786	9.6	96.7	22.3	253.5	53.5	1449.2	18.0
1993	1621	-9.2	122.0	26.2	320.0	26.2	1652.0	14.0
1994	1627	0.4	145.0	18.9	359.0	12.2	1543.0	-6.6
1995	1828	12.4	182.0	25.5	322.0	-10.3	1684.0	9.1
Average 1986-90		8.9		26.3		10.4		0.5
Average 1985-95		2.6		24.8		12.3		6.5

Notes:

GR: Growth Rate

R.Ex: Re-exports

Source:

1. CBO, 1988, Table (6.1) p.104
2. CBO, 1990, Table (6.1) p.104
3. CBO, 1990, Table (6.1) p. 85
4. CBO, 1995, Table (6.1) p.91

Third, the devaluation of the Omani Rial caused an additional increase in import prices. The above changes in import prices would be 31%, 19.5% and 10.6% respectively (CBO, 1986, p.6). The fall in imports caused by devaluation, therefore could have come through this increase. Consequently, the devaluation increased import prices but did not make a tangible reduction in the volume of imports.

To sum up, devaluation has not made noticeable positive change to the trade balance since the financial saving it has formed in oil exports has been cancelled out by price increases in imports.

b) The Effect of Devaluation on the Current Account Balance

The main items in this account are profit remittances of oil companies, contractors, foreign banks and others, official interests, workers remittances and other services. Profits remittances tapered off between 1986 and 1990. From 1991 they started to rise again (Table 6-4). Oil companies' profits have been adversely affected by the collapse of oil prices. Contractors' profits fell because of the cut in government expenditure. Foreign banks' profits declined due to a slump in banking activities mirroring the overall recession in the economy. Devaluation may have encouraged them to reinvest their profits in Oman in order to raise more profit so as to compensate their losses in dollars, or on the other hand it could have induced them to transfer their money to avoid the decline of its purchasing power. Registering profits in the balance of payments in Omani Rials makes them greater by 10% compared to 1985's level. Table (6-4) shows that they totalled RO 749 million at the end of the period under study, RO 74.9 million of which was the effect of devaluation.

A small item of inflow was the local commercial banks' income from outside (not mentioned in the table). This item amounted to RO 55 million and the positive devaluation effect was RO 5.5 million. Therefore, the net negative effect of devaluation on profit item was RO 69.4 million

The item of official interest consists of receipts as a return on government foreign assets on the one hand and payments on its foreign debt on the other. Both have increased by 10% because of devaluation but due to the greater weight of the receipt side, the current account balance has been gaining from devaluation. Unfortunately, the positive net official interest fell during the period because of increasing interest payments. At the end of the period the current account balance saved RO 31.2 million from this item.

Net workers' remittances increased by 3.5% in 1986 despite a 9.8% decrease in their numbers (CBO, 1990, p.127). In 1987, the remittances dropped by 16% which could be explained by the 12.8% fall in the number of workers in that year. After that this type of outflow witnessed a fluctuating growth. In 1991, it went up by 35.5% reflecting an increase in workers' numbers by 27% in the previous year. The increase in remittances in 1986 can be attributed to three factors:

Table (6-4)
The Effect of Devaluation on
Current Account Balance and Capital Account Balance

Year	Profit R. (net)	Official Interest (net)	Workers R. (net)	Other Services (net)	Official Capital (net) ROm	OSC. (net) ROm
1985	-184	67	-312	-112	73	31
1986	-174	145	-323	-147	216	110
1987	-159	119	-270	-91	-52	5
1988	-136	4	-293	-93	72	47
1989	-131	14	-304	-106	35	18
1990	-149	30	-325	-146	-147	-27
1991	-156	59	-335	-218	85	126
1992	-205	29	-454	-184	40	18
1993	-196	33	-532	-158	-81	66
1994	-195	16	-592	-165	162	0
1995	-171	9	-669	-177	-51	1
Total 1996-90	749	312	1515	583	124	153
DE	74.9	+31.2	-151.5	-58.3	+12.4	+15.3
Total 1986-95	1672	458	4097	1485	330	363
DE	167.2	45.8	-409.7	-148.5	33.0	36.3

Notes:

R: Remittances,
OSC: Oil Sector Capital
D.E.: Devaluation Effect

Sources:

1. CBO, 1990 Table (6.5) p.127
2. CBO, 1994 Table (6.8) p.95
3. CBO, 1995 Table (6.8) p.103

1. The number of workers increased in the two previous years by 14.5% and 3.8%.
2. Their consumption in Oman may have decreased so as to compensate the cut in their remittances in terms of foreign currency, bearing in mind that government departments and the media had been discussing the Omanisation policy which could motivate the workers to increase their savings quickly.
3. 10% of the increase - in terms of Omani Rials - is due to devaluation. In other words, if each worker tried to transfer the same amount of dollars after devaluation, the figure would be 10% higher in terms of local currency compared to 1985's level.

The total amount transferred by workers during the period under study was RO 1515 million, 10% of which, i.e. RO 151.5 million, was the devaluation effect.

Other services, such as insurance and freight are paid in foreign currency. They rose by 10% due to devaluation. They totalled RO 583 million in 1990 and the devaluation effect was RO 58.3 million. The collective result of the devaluation effect on the current account balance (the first four columns) was that: the positive effect totalled RO 31.2 million whereas the negative effect totalled RO 279.2 million. Thus the net effect was negative at RO 248.5 million. However it must be borne in mind that the negative effect through profits and workers' transfers is monetary, not real, since they are paid in local currency. If the real effect were to be taken into account, the final result would be negative at RO 96.5 million.

c) The Effect of Devaluation on Capital Balance

The main items in the capital balance are the official capital and oil sector capital. The official capital consists of loans and grants.

Starting with loans, the effect of devaluation depends on whether the new loan is converted to local currency, or is used to repay the old one directly. In this case devaluation has no real effect on the capital account. The effect would be only monetary, i.e. translating the figures of loans from dollar to Omani Rial. If there is a conversion, however, from foreign to local currency and vice versa, there will be a real effect of devaluation on the capital account, i.e. it would show real change in both directions. In this case the final effect of devaluation would depend on the net of receipts and amortisation of loans. Table (6-4) illustrates that the total net capital receipt was RO 124 million during the period under study. If government loans were fully converted to local currency, the devaluation effect on capital account would be RO 12.4 million. The gain has been diminishing since 1986 because amortisation has generally been higher than receipts i.e. the net receipt has been tapering off. Regarding grants, devaluation has had a positive effect because they have been advanced in foreign currency and then transferred to local currency. Unfortunately, total grants received during the period under study were too small at RO 3 million and the devaluation effect was RO 0.3 million (not shown in the table).

Oil sector capital transactions consist of direct investment by PDO and other oil companies and oil exports' credit. The final effect of devaluation rests on the balance or the net of these two elements. The question is raised here as to whether this type of

capital is received in the form of equipment or in cash. If it is in cash, then an increase of 10% has been gained thereby improving the capital account balance compared to 1985. Table (6-4) demonstrates that this sort of capital inflow, like official capital, has been diminishing except for 1986 and 1991. By the end of the period under study it totalled RO 153 million, the effect of the devaluation of which was RO 15.3 million.

The total effect of devaluation on the capital account balance was RO 27.7 million. However a precaution should be put in mind that devaluation might provoke capital flight because savers could have anticipated more devaluation. Capital flight is much easier under unlimited currency convertibility. If it is wanted to be hidden and not appear in the capital account, there are several tricks to transfer it indirectly in order for it to be hidden and not appear in the capital account, such as raising import prices by agreement between importers and exporters.

Taking all the above into consideration, devaluation did not improve the position of the balance of payment. The positive effect has been cancelled out by negative effects on the same account or on other accounts. The positive effect on the capital account of RO 27.7 million was offset by the negative effect on the current account of RO 96.5 million and the final result is negative at RO 68.8 million. The financial increase of oil exports on the trade balance was counteracted by increases in imports prices.

6.2.2.3 Reducing the demand on foreign exchange, especially by expatriate workers inside the country

Foreign exchange is demanded by importers, foreign contractors, foreign investors in oil companies, foreign bankers, foreign workers, travellers and the government to serve its debt. The behaviour of importers, as indicated by imports movements has been governed by government expenditure which is affected by oil exports. The

demand of the next three categories on foreign exchange, which is represented in profit remittances as has been indicated above, has declined for particular reasons (see p.19). Workers demand has been increasing except in 1987 which was explained by the decline in the number of workers themselves. Travellers have not changed their behaviour. As is shown in CBO reports, no change took place in spending on travel (CBO, 1990, p.127). The government demand for foreign exchange increased because of the rising debt services. Therefore, devaluation has not reduced the demand on foreign exchange.

However, within the domestic economy, the government has benefited from devaluation through using it as an inflation tax. As the wages of government officials were fixed and consumer prices were rising, purchasing power was falling. Devaluation played a role as a tool for redistributing resources.

It is a potent tool in countries where the government owns the primary export commodity and where wage earners are not in a position to adjust their non-oil income in line with the rate of inflation. For in such countries the government gain is two-fold. It gains from inflation tax and from the redistribution of resources away from wage-earners as a consequence of inflation (Kalmoor, 1987, p.170).

6.3 What Should be Done?

A more comprehensive approach is necessary in dealing with the problem of the budget deficit, with a thorough investigation of all causes lying behind the emergence and continuance of the problem. The cause of this problem, as has been revealed in Chapter Four, has two sources. The first is related to expenditure, each type of which has three parts, necessary, unnecessary (misallocation) and waste (inefficient

spending). The part of the deficit that is attributed to expenditure has emerged from unnecessary expenditure and waste. All types of expenditure need to be re-prioritised in order to eliminate all sorts of prodigality. Effectiveness and efficiency should be secured in the necessary types of spending so as to avoid all kinds of waste. The second part of the deficit relates to the revenue side of the budget. This can be broken down into two factors. One is external and is represented in oil prices, which are not controlled by the government. The volatility of oil prices exposes the fiscal position of the government and general situation of the economy to serious uncertainty and instability. The second factor is internal and is represented in non-oil revenues. The developing of permanent and stable income generating from the domestic economy will eliminate the second part of the deficit on the one hand and will improve the fiscal position of the government and immunise the overall economy against external shocks on the other. Accordingly, this section will address the following issues in three sub-sections.

1. Rationalising Public Expenditure
2. Improving the Sources and Techniques of Financing
3. Diversification of the Economy

6.3.1. Rationalising Public Expenditure

The government plays an essential role in allocating resources - in influencing what is produced, how it is produced, who receives the benefits and who pays. It does so both directly and indirectly. For instance, directly it provides defence and social infrastructures, supplies power and telephone services and produces industrial and agricultural goods. The government has created state-owned enterprises (SOEs) to

carry out some of these functions. Indirectly it influences the production and allocation of privately-produced goods through subsidies, taxes and a wide range of regulatory tools. Therefore, setting up a clear priority for public spending is a crucial pre-requisite for the government's economic policy. Improving public administration and financial control and the rational use of available resources are necessary for the government to perform its above functions efficiently:

6.3.1.1. Reprioritization of public spending

This process rests on some fundamental steps including

- considering both the benefits and costs of government involvement
- recognising the institutional and political constraints that are likely to be encountered in implementing a particular policy.
- searching for ways to ensure that the public sector operates efficiently within those constraints.

According to the World Bank a pragmatic approach to public policy analysis might begin by:

Ranking areas of economic activity according to the extent to which government intervention is desirable. Plausible criteria for ranking would be the scope for government to promote efficiency growth, poverty alleviation and stabilisation (World Bank, 1988, p.52).

Promoting efficiency, boosting growth, alleviating poverty and securing stabilisation are vital goals of the Omani economy and the government is responsible for their achievement. Economic, political and social activities through which the government can obtain such goals are of different levels.

First the government has certain core areas of responsibility. Public goods that only the public sector can effectively provide include defence, diplomacy, macro-economic management and a legal and institutional system that defines and enforces the roles of justice, property and commerce.

Second, the government needs to help provide social, physical, and information infrastructure: education, health, transport networks, public utilities, technological development and environmental protection. Market failures are common in these areas and many of the goods required to meet basic needs are found here. Elsewhere the case for the government involvement is weaker on economic grounds and the costs of intervention threatens to outweigh the benefits. For example, in agriculture, industry and mining, although some support may be needed, the government is not well enough equipped to play a major role.

Where exactly the line should be drawn between government involvement and the private sector responsibility depends in principle on careful evaluation of the costs and benefits of government intervention. Where the system for collecting revenue allows additional resources to be raised with little distortion of private sector activity, greater government involvement may be appropriate, e.g. gas producing, marketing, and

distributing. Shifting public resources from low to high-priority areas can significantly improve the effectiveness of the public sector.

6.3.1.2. Ensuring the Efficiency of Public Administration and Financial Control

The government faces the need to trim expenditure and to improve its allocation. The technical and institutional problems involved in planning, budgeting, implementing and monitoring expenditure are great.

Poor accountability of decentralised agencies and poor fiscal relations among the different parts of the government have often contributed to an ineffective mobilisation and use of public resources. The government's administrative capabilities are an important constraint on its ability to design and implement high-quality expenditure and revenue programs. Improving the quality of administration is an essential part of improving the quality of the government. Particular reforms should be taken covering the following three areas:

1. Reducing the Bureaucracy of Government Administration

The government apparatus has been expanding since 1970. The number of ministries has increased to 23, each of which has a number of directorate generals which are divided into directorates each of which is in turn sub-divided into a number of sections. Each section is recruited by several officials and clerks. There is also a number of independent institutions which are financially covered by the state general budget such as Sultan Qaboos University.

There are some unnecessary directorates and sub-directorates in some ministries. Procedures are numerous, complicated and time-consuming. In order to simplify these procedures and enable government administration to be carried out efficiently two steps need to be taken:

- I. The number of government administration units can be minimised. During the first half of the eighties there were some government units with a large number of experts taking high salaries. The financial burden of these units caused the government to reconsider and transfer their duties to other ministries. The same thing could be done now for similar cases.
- II. A comprehensive training program should be devised to promote the efficiency of middle and low level government administrators. The programme should consist of four steps. First, a full survey should be conducted of the qualifications, skills, training experiences and ages of all government officers. Second, job specification should be provided for all occupations of government units and the skills and qualifications required for each job should be defined. Third, government manpower should be redistributed among these occupations, according to their skills and experience. Fourth, training programmes should be implemented for those who need particular skills and certain knowledge.

2. Supporting the Confidence of the Financial Control System

Tremendous legislative effort has been made covering expenditure, revenues, internal and external control ante- and post- audit, but it's implementation has been executed in a routine and logical manner. The Secretary General, which was created in 1991 to be

responsible for the overall post audit over public finance, should be equipped with experts and well-trained staff. Its authoritative power should be strengthened through giving it independence from any ordinary government department and connecting it with the highest political power.

3. Reforming the Adjudication Law

Many times in the past, the government contracts have been taken through personal relations and at higher prices. This was one of the main causes of the increase in public expenditure. Therefore, the adjudication law should be reformed so as to safeguard the lowest and optimal bids for government contracts and secure the strict application of the law.

6.3.1.3. Rational Use of the Available Resources for Various Purposes

The emphasis has to be on the careful evaluation of government expenditure and the elimination of as much fat as possible. Every effort should be made to increase efficiency in government spending and reduce waste and extravagance. As the World Bank has correctly emphasised:

Over the longer term the challenge for developing countries is to use their limited resources efficiently and more equitably. Every government faces this challenge: whatever the political objectives, the goal is to find the most cost-effective means of achieving them. Evidence abounds of how much can be gained from greater efficiency... And in most countries, the consequences of these inefficiencies are felt most by those who have least - the poor (World Bank, 1983, p.126).

The proceeds from oil and gas should be regarded as capital rather than income. Resources should be allocated carefully between the main four use types, i.e. defence, recurrent expenditure, development expenditure, and subsidies. From a technical point of view the increase of the relative share of either category would reduce the resources available for the other purposes and thus their rates of growth and activity would be affected accordingly. Therefore a long-term and concrete decision should be taken in this regard to ensure reasonable allocation of government resources between the main four categories. Within each type of expenditure important changes should be made.

a) Current expenditure

Since 1986 its relative importance to total expenditure has outweighed that of defence expenditure. It began to be so with respect to development expenditure very early i.e. in 1980 (see Table 4-10). Its share stands now at 44.5% of total expenditure. It consumes about 56% of oil revenue. Its annual growth rate outweighs both total revenue and GDP i.e. 7% vis a vis 6.5% and 2.6% respectively (see Table 4-11). Reducing current spending is important for creating a surplus in the current account of the budget. The surplus should be transferred to the capital account of the budget. Tangible reductions should be made in the following areas.

- Cutting furniture appropriations, especially in high level offices of government administration. There has been a great deal of extravagance in this area.
- Cutting the rental of private buildings and abolishing some of them. In many cases government units have rented private buildings despite the fact that some of their public buildings are empty. This source of waste has been and still is brought about by interest groups.

- Rationalisation of the purchase of cars, equipment, tools, clothes, etc. The need of government units for such items has been overestimated. On top of that, they have been sold to the government at very high prices. Careful evaluation of the costs and benefits of such things should be implemented. For example many government units have been equipped with computer systems. Few of them have been used efficiently. In some cases there have been changes from one system to another with all previous machines being cancelled. Such expenditure has been induced by private interests.
- Savings in the health service could also be achieved through better use of hospitals, a reduction in the cost of hospital construction, the elimination of redundant staff and competitive procurement of drugs and medical supplies.

b) Development Expenditure

This type of expenditure has been drastically cut during the period under scrutiny. It was the sacrifice of fiscal reform. Its relative importance declined from 28.7% of total expenditure in 1986 to 14% in 1990. The average rate of cut was 11.5% per annum. The objective of long-term economic development strategies should be the increase of development expenditure directed at the productive and social structure sector (agriculture, fisheries, industry, health, education, vocational training). It is suggested that the following approach should be followed in the allocation of development expenditure.

- a concrete and stable concept should be developed of how to allocate the resources available for development expenditure between the various sectors over the coming years.

- Construction costs should be rationalised in order to ensure that the biggest percentage of resources is directed to the production activity of the project.
- In light of the general plan objectives, the projects should be prioritised on an economic basis. The selection of projects to be implemented and their implementation should be made on a scientific basis, such as the expected increase in income, the value of investments required, production efficiency, new employment opportunities, etc.
- Given the importance to building infrastructure (i.e. seaports, roads, schools, hospitals electricity) in initiating development, in previous plans some regions have received the majority of the development expenditure while others have received a relatively smaller share (see Table 4-14). Therefore, a redistribution of development expenditure between the less rich regions should be considered, to meet the key objectives of the development strategy. In urban services, public provision of roads, water and electricity is critical. In rural infrastructure, roads, schools, irrigation, and electricity are areas in which the public sector has been and should continue to be involved. Such reforms can expand the access of the poor to basic services, while increasing growth and development. The following are some areas where these are sources of waste and inefficiency.
- White-elephant projects which are a financial burden on government expenditure and whose public benefit is doubtful or insufficient to justify the expense. An obvious example of this is the copper project at Sohar.

- Luxurious buildings of some ministries and other government units. The building of government units of this standard should be stopped. Concern must only be for sound engineering and security.
- The bids in which government contracts have been executed were high. As was mentioned earlier in Chapter Four some studies revealed that public services prices in Oman are much higher than in other GCC countries, even though they are subsidised. Private interests and personal relations are blamed for this.

c) Defence Expenditure

It was found earlier that defence expenditure is one of the highest in the world. On average it has formed 40.6% of total expenditure. Between 1975 and 1980 it constituted about 45%. It has been consuming about 54% of oil revenue and on average has been growing by 25% per year (see Tables 4-10 and 4-11).

During the period under study it has been reduced, averaging 37% of total expenditure, and its growth has almost stopped. Defence expenditure is important and expresses a political decision in the first place. There are several advantages of defence expenditure. In addition to defending the country and securing its stability, defence expenditure contributes towards reducing unemployment. It also provides technical training, raises per capita income and boosts economic growth. The allocation of scarce resources inevitably puts the decision-makers in a dilemma regarding where to put the money, because each use implies costs and benefits. Due to lack of information regarding the structure of defence expenditure it is impossible to

put forth particular suggestions. Nevertheless, efficiency and effectiveness should be secured and any possible saving is essential.

d) Subsidies

This kind of expenditure has been directed to public entities and privat enterprises. It should be rationalised in both directions. Public entities are both financial and non-financial (see Chapter Two). They have been subsidised financially by sharing in their capitals or by lending and they should be reformed. Public finance analysts and policy makers have focused their attention on the central government budget as the main determinant of fiscal policy. Analysis of SOE finances has largely been left to sectoral experts, thus few systematic attempts have been made to monitor SOE financial performance on aggregate, or to compile fiscal data for all levels of the public sector. SOEs often do not follow uniform accounting standards, so their financial statistics are difficult to consolidate with other public sector statistics. However, the failure to view public finances comprehensively is not entirely caused by lack of data. SOEs were often set up or enlarged precisely because they were largely exempt from fiscal control. They have therefore, been both a cause and a symptom of weak fiscal discipline and lack of transparency. Transparency - the ability to assess the financial implications of public sector activity in advance, to evaluate them after the event, and to identify who bears the costs and who receives the benefits - is necessary if decision-makers are to be accountable for their actions. They often operate in areas of special concern to the government: financial services, communication, transport and their investments are seen as crucial for development. In allocating their resources, they are not subject to a direct market test. Moreover, in financing their expenditure, they often draw on

subsidies, loans, or guarantees from the government. Accordingly, their spending and especially their investment, should face an evaluation as rigorous as that applied to direct government transactions. Improving the transparency of SOE finances calls for up-to-date data. These should include data on actual and planned spending and revenues and on changes in assets and liabilities organised in a systematic accounting framework. Had these amendments been made, there would have been no need for direct government subsidies. Instead, there would have been a good source of income for the state general budget.

Financial subsidies given to the private sector took the form of interest-free and low-interest loans and grants. The assessment of this kind of subsidies revealed that it has not succeeded in achieving its objectives (see Chapter Four). The present fundamental, economy-wide structure of incentives is thus not adequately supportive of sectoral diversification into tradable goods production (World Bank, 1994, p.51). In many cases it has been given to big enterprises which have not been suffering from lack of financial resources. In other cases subsidies have been given to ambitious new projects that have been conducted by inexperienced individuals without sound appraisal studies. Thus, this sort of government spending should be revised and carefully controlled. Enterprises should not be subsidised unless they meet specific criteria that can secure the effective use of scarce resources. The priority should be give to small and medium firms that are in need of capital and conducted by skilled Omanis. Subsidies should also be directed towards supporting new graduates from technical colleges to encourage them to initiate their own projects.

On the expenditure side, in general, the emphasis has to be on the careful evaluation of government expenditure and the elimination of as much fat as possible. Every effort should be made to increase efficiency in government spending and reduce wastefulness and prodigality.

6.3.2. Improving the Sources and Techniques of Financing

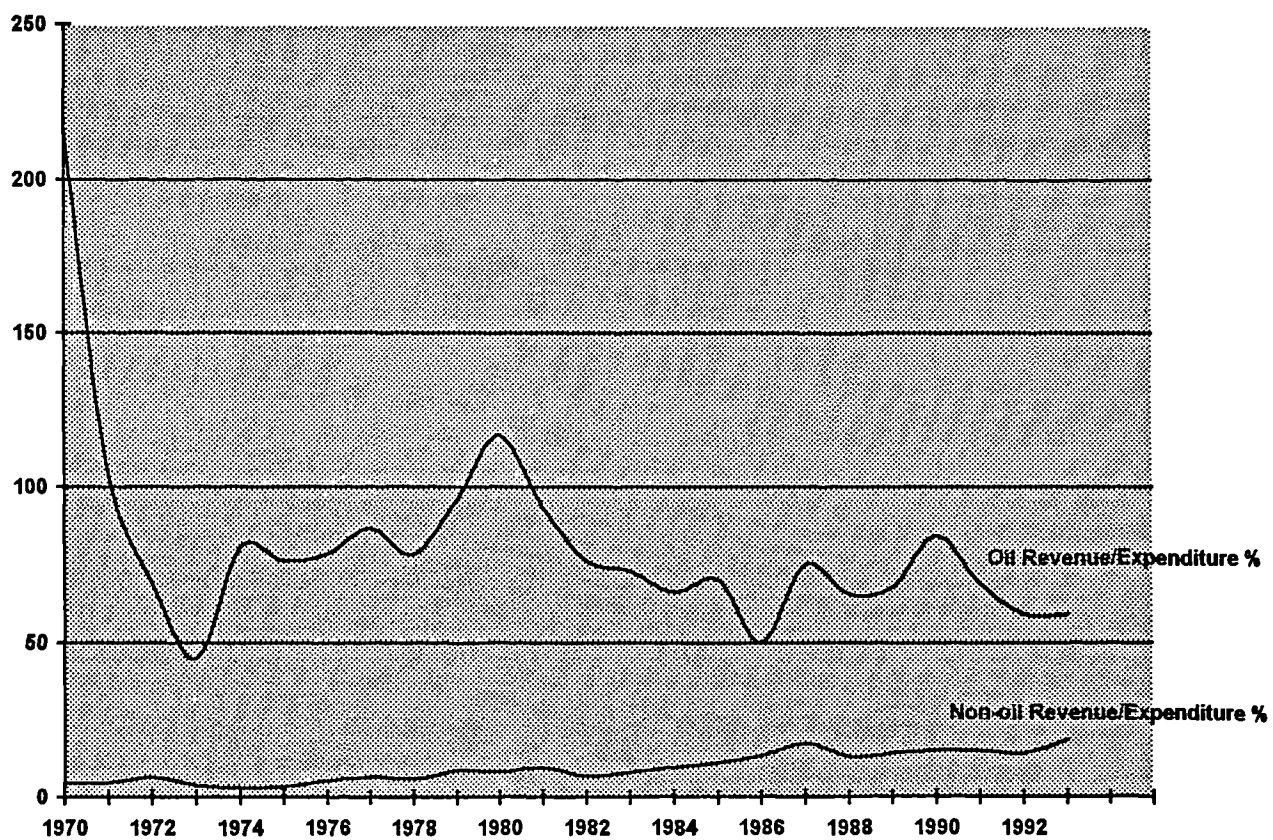
On average, 81% of government expenditure, has been financed by oil revenues (see Table 6-5 and Chart 6.4). Non-oil revenues have financed only 9.6%. During the focused period the average share of oil revenues fell to 68%. The participation of non-oil revenues began to increase in 1979. However, they have also fluctuated, following the trend of oil revenues. The overall rise of their participation from 1986 onwards was due to the fall in government spending.

Table (6-5)
The Ratio of Total Government Expenditure Financed by
Oil and Non-oil Revenues

Year	Expenditure	Oil Revenue	Non-oil Revenue	Oil Revenue/ Expenditure %	Non-oil Revenue/ Expenditure %
1970	20.6	44.4	1.0	215.5	4.9
1971	46.0	47.9	2.2	104.1	4.8
1972	71.6	49.6	4.9	69.2	6.8
1973	91.7	41.3	3.7	45.0	4.0
1974	362.0	291.5	11.7	80.5	3.2
1975	489.2	373.1	14.6	76.3	3.0
1976	581.0	455.0	32.0	78.3	5.5
1977	557.0	482.0	38.0	86.5	6.8
1978	586.0	458.0	35.0	78.2	6.0
1979	663.0	635.0	58.0	95.8	8.7
1980	949.8	1109.5	78.4	116.8	8.3
1981	1223.8	1144.0	118.2	93.5	9.7
1982	1411.9	1076.8	98.6	76.3	7.0
1983	1546.9	1128.5	125.4	72.9	8.1
1984	1760.3	1166.5	174.2	66.3	9.9
1985	1915.3	1343.7	216.1	70.2	11.3
1986	1854.0	932.4	254.0	50.3	13.7
1987	1576.4	1182.1	278.1	75.0	17.6
1988	1567.2	995.0	209.8	63.5	13.4
1989	1665.8	1129.5	240.6	67.8	14.4
1990	1887.4	1588.3	288.0	84.2	15.3
1991	1868.1	1289.5	280.9	69.0	15.0
1992	2258.7	1338.9	322.1	59.3	14.3
1993	2197.9	1302.9	414.1	59.3	18.8
1994	2252.9	1363.7	393.7	60.5	17.5
1995	2331.0	1433.9	418.3	61.5	17.9
Average 1986-'90				68.2	14.9
Average 1970-'95				79.8	10.2

Source: Previous Tables

Chart (6-4)
The Ratio of Government Expenditure Financed by
Oil and Non-oil Revenue



Source: Table (6-5).

The above situation of government finance implies the following facts.

- i. Public expenditure is funded almost entirely by oil revenues. Oil is a depleted commodity and it will last for no more than 17 more years. Thus another source should be developed. Also oil prices are unpredictable, making the fiscal position of the government and the economic atmosphere of the country highly vulnerable to external shocks. Therefore, public finance needs a “shock absorber” to protect it and the overall economy from external shocks.
- ii. Non-oil sources of public finance, which are not external, and therefore should be stable, are marginal and unstable. They are influenced by changes in government expenditure which are in turn affected, by changes in oil revenues. Consequently, the internal source of public finance should be promoted.
- iii. The low level of financial resources from non-oil domestic economic activities for public purposes makes the fiscal policy one-sided, relying on expenditure policies. Accordingly, the diversification of sources and techniques of non-oil finance will equip the fiscal policy with various tools to achieve the goals of income redistribution, economic growth and stabilisation. The development of tax revenue will also enable the tax payer to play some role of accountability in public expenditure.

The application of these reforms can be fulfilled through two channels:

1. Maintenance of the current level of oil revenue and restoring the stability of the State General Reserve Fund (SGRF).

2. Developing stable sources of financing.

6.3.2.1 Maintenance of Current Level of Oil Revenue and Restoring the Firmness of the State General Reserve Fund (SGRF).

This can be achieved by certain measures:

- a) Continuing the current level of oil production namely 800,000 b/d,
- b) Reducing the cost of production as far as possible. See Chapter Four for an explanation of the high production cost.
- c) The Sultanate should continue to co-operate with OPEC and non-OPEC countries to preserve the stabilisation of the world oil market. Balancing the oil supply in accordance with world oil demand is essential for stable prices. The Sultanate should also maintain its co-operation inside and outside the GCC in order to convince the countries of the European Economic Community not to impose carbon tax on oil consumption. These countries have suggested that the tax should be three dollars per barrel increasing by one dollar a year to reach ten dollars per barrel. This would increase oil prices by 10% (Al Hassan et al, 1993, p.15). The purpose of this tax is to reduce the demand on oil through raising the final consumer price. The direct effect of this tax would be a fall in the demand of industrial countries on oil, leading to a decline in oil exports of producing countries. The indirect effect would be the increase of the prices of industrial products imported by oil countries. The carbon tax, however, would adversely affect the EEC countries in several ways.
 - It would raise inflation, reduce investment and increase unemployment.
 - It would weaken the competitiveness of their industries (Ibid., p. 16).

Carbon dioxide is not only caused by oil, but also by other fossil fuels such as coal and natural gas. Despite the fact that coal is a high pollutant emitting more carbon dioxide, it is subsidised in European countries, whereas it is suggested that petrol, which is less pollutant, be taxed.

d) The essential step to restoring the firmness of the State General Reserve Fund is a sound management for the commodity price movements.

One commonly stated principle for managing commodity price movements is that the revenue from temporary price increases should be saved, whereas income from permanent increases can be spent (World Bank, 1988, p.74).

However, classifying a particular shift as permanent or temporary in an environment of extremely volatile prices is uncertain. The policy makers therefore have to ask which sort of mistake is more costly. The cost of assuming a temporary price increase to be permanent is probably higher than that of assuming a permanent increase to be temporary.

Delays in adjustment to the fall in export prices lead to further debt accumulation. When the adjustment finally comes it is more difficult because countries have to cope not only with lower commodity revenue, but also with increased debt service and reduced flows of new lending (Ibid.).

Consequently, the prudent strategy is for the government to save a large portion of its commodity revenue. This would be a practical use of Keynes' Theory of substitutionary finance; the surplus of boom is for the deficit of recession. In this way the technique would serve as a "buffer or shock absorber" for the budget.

The government decision in 1980 to establish the State General Reserve Fund was prudent and it was used as a stabiliser of government expenditure and the total output against the collapse of oil prices. However, the successive and intensive withdrawal from the fund was at the cost of running down the government accumulated saving.

6.3.2.2. The Development of Stable Sources of Financing

A practical policy issue in stabilisation programmes is how to plan diverse and stable resources to mitigate the adverse affects of unstable revenues. As analysed in Chapter Four, the two main types of non-oil revenue are tax and non-tax. The former comprises only 3.7% of total receipt on average whereas the latter forms 7.8%. Custom duties make up 50% of taxes. The other 50% is made up of several fees and corporate income tax which is very tiny. Non-tax revenue consists of user charges, i.e. payments from beneficiaries in exchange for goods and services provided by the government. These have grown faster than taxes 57% as opposed to 28%. The growth of both of these has been affected by the fluctuation of oil revenues, especially tax revenue which has been retreating by 4.8% on average during the period under study (see Tables 4-17, 4-18, 4-19).

It is normally appropriate for recurrent expenditure to be financed by tax revenues. However, not only the tax revenues, in our case, but all non-oil revenues fall short of financing half the recurrent expenditure. As can be seen from Table (6-6) and Chart (6-5) non-oil revenues covered only 30% of current expenditure on average. Throughout the period under review this ratio has increased slightly to 34%. They

have not been sufficient to cover the wages bill of the government. Only 76% of the wages has been covered. During the period under scrutiny the ratio rose to 86.8%. It is obvious then, how small the non-oil revenue is in comparison with government expenditure.

The diversification of non-oil revenue could follow three routes:

- i. Improving existing taxes and introducing new ones
- ii. Using the current deposits of the commercial banks
- iii. Restoring traditional Islamic sources of revenue.

i. Improving Existing Taxes and Introducing New Ones

Imposing any sort of tax has costs and benefits. A dilemma, therefore, inevitably occurs as to whether the costs outweigh the benefits or the vice versa. The criteria that can help in suggesting the raising of the present taxes or inventing new ones relates to effects of taxing on saving, income redistribution, economic growth, productivity, the competitiveness of industries, prices and the budget needs of resources. Short term and long term effects, either positive or negative, should be taken into consideration. Due to the urgent budget needs for stable, sustainable sources of revenues, improving the existing taxes is necessary, and the imposing of new taxes is indispensable. The development of a fair and effective taxation system is also justified as far as the present wide disparities in income is considered. Improving the currently legislated taxes necessitates revising of widely granted exemption either from tariffs or from corporate income tax. Many companies have been exempted from

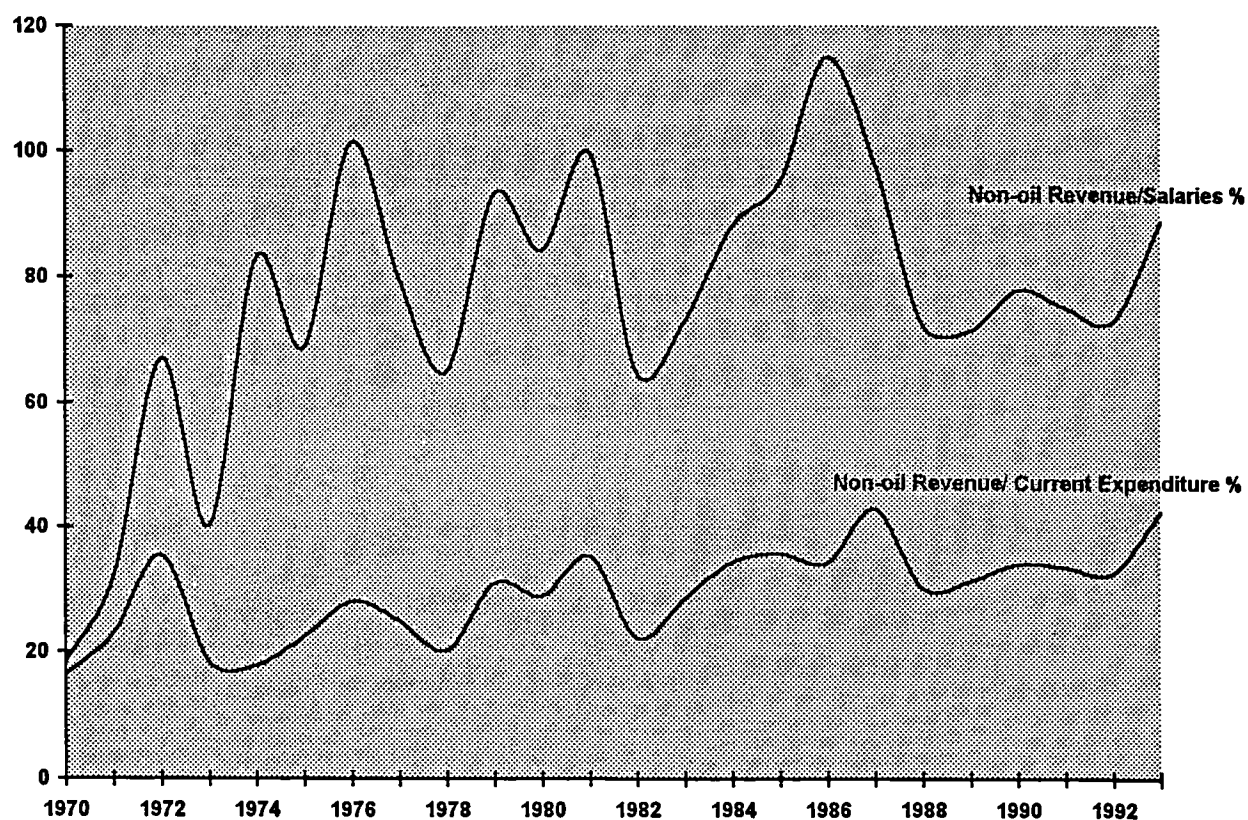
Table (6-6)
The Ratio of Current Expenditure and
Salaries Financed by Non-Oil Revenues

Year	Current Expend.	Non-oil Revenue	Salaries	Non-oil R/ Current Expend. %	Non-oil R/ Salaries %
1970	6.1	1.0	5.4	16.4	18.5
1971	9.9	2.2	6.9	22.9	31.9
1972	13.8	4.9	7.3	35.5	67.1
1973	20.2	3.7	9.2	18.3	40.2
1974	65.6	11.7	14.1	17.8	83.0
1975	65.0	14.6	21.2	22.5	68.9
1976	114.1	32.0	31.6	28.0	101.3
1977	152.0	38.0	47.6	25.0	79.8
1978	173.0	35.0	53.9	20.2	64.9
1979	188.0	58.0	62.3	30.9	93.1
1980	271.2	78.4	93.2	28.9	84.1
1981	335.0	118.2	118.9	35.3	99.6
1982	443.6	98.6	152.4	22.2	64.7
1983	440.6	125.4	171.7	28.5	73.0
1984	507.2	174.2	197.7	34.3	88.0
1985	606.0	216.1	227.4	35.7	95.0
1986	648.2	254.0	221.4	39.2	114.7
1987	648.5	278.1	284.6	42.9	97.7
1988	696.0	209.8	290.1	30.1	72.3
1989	772.3	240.6	337.0	31.2	71.4
1990	847.9	288.0	370.2	34.0	77.8
1991	839.1	280.9	374.8	33.5	74.9
1992	989.5	322.1	441.5	32.6	73.0
1993	976.5	414.1	467.1	42.4	88.7
1994	1014.0	393.4	480.1	38.8	81.9
1995	1102.0	418.3	523.9	38.0	79.8
Average 1986-'90				34.3	86.8
Average 1970-'95				30.2	76.4

Source:

1. DC.SDP & THDP
2. CBO. 1985, 1990, 1995
3. SYB. 1993, 1994

Chart (6-5)
The Ratio of Current Expenditure and Salaries
Financed by Non-oil Revenues



Source: Table (6-6).

custom duties on imported raw materials and equipment. The exemption given for five years has mostly been extended for another five years. New projects are also normally exempt from income tax for five years. In many cases companies continued enjoying these exemptions for extra periods. In some circumstances these exemptions have not been justified objectively or on a real economic basis. All these exemptions which were allowed of course by the law itself should be revised. The law of taxes should be amended in the light of the above criteria and any exemptions should be made after careful investigation. The next step towards improving the effectiveness of the current tax system is to establish a clear complementary accounting system to facilitate the taxing process. Finally, a well-trained taxing staff should be recruited which, bearing in mind the cost of tax administration, should not consume large proportion of the tax income.

As far as the goal of recruiting new resources for public services and the redistribution of income are concerned, new types of taxes are essential. Such taxes could include:

- a) Tax on luxury consumer goods, cars, expensive residential real estate, etc.
- b) Tax on real estate that exceed the owner's need for accommodation. There are many individuals and families who own buildings and other units for residential and commercial uses. Many of them have been blessed with large plots and financial grants therefore they have good reason to pay the tax.

Without these measures the need for borrowing would continue. Some economists have emphasised this fact, stating that:

there is no escape from sacrifice and austerity, particularly for the rich, if economic development and general well-being are to be pursued. The easy availability of interest-based borrowing tends only to weaken the urge for sacrifice. It only postpones the sacrifice. The procrastination continues and the debt keeps on accumulating until debt-servicing becomes unbearable (Chapra, 1986, p.138).

ii. Using the Current Deposits of the Commercial Banks

The commercial banks act as agents of the public for mobilising the society's idle resources. Also the banks do not pay any return on current deposits. In addition, there is no risk to the public from these deposits. Therefore, I agree with some economists who suggest that:

a certain proportion of commercial bank demand deposits up to maximum of say, 25%, should be diverted to the government to enable it to finance socially-beneficial projects in which profit-sharing is not feasible or desirable (Ibid., p.196-197).

iii. Restoring Traditional Islamic Techniques of Financing

Zakat was an important source of revenue for the government in the Islamic world. It has been also collected by the Omani governments in the past. It is imposed by Islamic law on money, primary agriculture crops (such as wheat, dates, corn and barley) and on animals classed as *Al-Anaam* (camels, cows, goats and sheep). The rate of *zakat* varies according to the type of wealth. On money it is levied at 2.5% on money capital if it is not invested. If it is invested *zakat* would be on the profit only after discounting the costs. On agriculture crops it is imposed at 10% of the yield if the crop is irrigated by rain or natural resources of water e.g. rivers, and at 5% if the crop is irrigated by

mechanical techniques. On *Al-Anaam* it is levied according to particular categories. It is paid annually on money and on the *Al-Anaam* whereas in crops it is paid at the end of every harvesting season. There is a minimum level of income and minimum quantity of crop and minimum number of each of the four kinds of animals stipulated for paying the *zakat* under which *zakat* is not paid. On money capital it is paid in money. On crops and animals it is paid in kind.

Zakat has many advantages that make it very useful financially, economically and socially. Firstly, it is imposed on the total money capital, i.e. not just on the profit like the tax unless the capital is invested. This peculiarity, on the one hand makes the financial proceeds very large bearing in mind that *zakat* is the second practical worshipping duty of Muslims after prayer thus every Muslim who meets *zakat* conditions should pay it. On the other hand, it motivates the rich to invest their capital funds so as to pay *zakat* only on the profit yielded from the investment, the characteristic which maximises investment, employment and income growth. Second, the first beneficiaries of *zakat*, according to Koran itself, are the needy and the poor. Consequently, it alleviates poverty, narrows the gap between the rich and the poor, and acts as an income re-distributor. In this way, *zakat* can meet all of the social security expenditure, lightening part of the burden from the government budget. Third, one group of beneficiaries, according to the Koran, are those employed to collect and distribute it between its expenses. In this way *zakat* contributes towards reducing unemployment directly.

Another important source of revenue from the Islamic perspective is endowment (*waqf*). Before they die, rich people can bestow some of their property, e.g. shops, farms, houses, etc., for particular social or educational uses, such as the needs of the poor, students relief, Islamic education, the upkeep of mosques, etc. Such properties can be developed into a modern framework by establishing special authorities equipped with Islamic and economics-educated staff to utilise these resources in well-organised methods. The income can be used to maintain mosques, provide Koranic education, and support for poor students, according to the will of the endower. The rich should be enlightened and encouraged to bequeath some of their possessions to future generations (for more detail see Quhf, 1993, p.8)

Other techniques that can be used are known as possession-based sources of financing. They are based on the idea that the government can recruit financial resources from the public not by taxes or borrowing but by selling them deeds or documents, called *sanadat* or *sokuqu* as shares of the capital that will be invested. The public buy these deeds because they will get dividends out of them and they can liquidate them if they need cash, in stock markets. Several versions of these documents can be selected, according to the nature of goods and services the government wants to produce. They are based on particular Islamic bases or *oquood* called *Mudarabah*, *Musharakah*, and *Ejarah*. For example, if the government wants to build an electricity-generating plant, it may issue *Mudarabah* or *Musharakah* deeds, or it may combine the two kinds. Those who buy *Mudarabah* deeds have no right to participation in the administration. They will get dividends according to the profitability of the project or they may lose if it loses. Their proportion of profits and losses is defined and agreed upon with the

government beforehand. Those who buy *Musharakah* deeds can participate in the administration. Their profits and losses are proportionate to their shares in the capital invested.

Regarding *Ejarah* (renting) if, for example, the government wants to establish a tourist project and it doesn't have the financial resources required it can sell the plot to the public and give them *Sokuqu*. These documents imply that the government will rent the project from them after completion. They buy these deeds because the project is promising so they will get return. Otherwise they can sell them on the stock market, i.e. they can liquidate them. Thanks to resources collected from the buyers of these deeds, the government will be able to build the project. After completion it will be opened to the people in exchange of fees. From the income generated by the project itself, the government will be able to pay the rent to the owners (shareholders). The more profitable the project, the more valuable the *Ejarah* deeds will be and the more acceptable on the stock market.

Such financing techniques have many economic advantages, including:

- a) *Sokuqu* are exchangeable on the stock market and their prices are defined by market forces, regardless of their nominal values. This will motivate the public to deal with these deeds. In addition to their liquidity, their market prices are linked to the expected return, their opportunity cost and the demand on their products.
- b) They do not create an indebtedness on the government. Thus, the government doesn't need to borrow or to impose taxes in order to amortise them. Consequently they do not issue the question of justice between present and future

generations, which inevitably occurs in the case of borrowing when the next generation becomes obliged to pay the debt of the present generation. In the case of *Ejarah* the government is obliged to pay a fixed rent, annually or quarterly, to the owners. It may be supposed that this rent is not higher than the interest rate paid to the creditor. In addition, there is no need to refund the *Ejarah* deeds. Therefore the arrangement of *Ejarah* provides better conditions than interest-based financing.

- c) These tools represent a type of privatisation. However, this is applicable to possession rights but not to administration, which remains under the control of the government with the exception of *Musharakah*, which enables shareholders to participate in the administration of the project. Nonetheless, the government can keep the fundamental decisions of the project in its hands via owning the majority of the project shares.
- d) Offering these *sokuqu* to the public represents a kind of democracy, since if a project is well-accepted by the public this shows that they value it highly. In other words, buying these deeds is a kind of vote of confidence for the government.
- e) In all these tools of financing, funds are linked with particular projects or assets. The government cannot transfer the funds to other uses. In other words, these techniques provide a complete association between the source of funding and the purposes for which the government will use the money. Accordingly, there is less probability of extravagance and waste (for more details see Quhf, 1993, p.25-28)

6.3.3 Diversification of the Economy

For the development of various sources of non-oil revenues for the government budget and reducing the exposure of the economy to external shocks, diversification of the sources of the gross domestic product is essential. Diversification will strengthen inter-sectoral relations and raise the domestically-generated value added. Hence, the urge for economic diversification implying the creation of a viable modern economy integrated with the oil sector that would sustain a relatively high income level after the end of the oil era. This requires maintaining extremely high levels of investment compared with production in the non-oil sector for extended periods, while at the same time sustaining large expenditure on training and education.

The diversification goal was not absent in the development strategies adopted by the policy makers through the DC in 1975 but the domestic economy in reality, has not been developing as the decision makers here had hoped.

Previous investigation, particularly in Chapters One and Five, pointed out some indicators that reveal weak inter-sectoral relations and a high degree of independence of the economy to the external world.

About 90% of exported oil is crude oil with the locally manufactured - which is the refinery industry- forming less than 10%. The total manpower employed in the oil sector comprises only 1.2% of private sector employment. The non-oil sector is dominated by the non-trade services. Agriculture and manufacturing together made up 8% of Gross Domestic Product in the ThDP. This proportion declined to 6.6% in the FODP. The Service sector contributed to 50.9% (see Table 5-9). Non-oil exports

form 7.8% of total exports (in 1995). Domestic uses of gross national product - which indicate sectoral integration in general is 45%, and the foreign trade component in GNP contributes to 55%, bearing in mind the domination of oil exports by almost 78% of total exports (in 1995).

Agriculture and fisheries, the sector which employs 23% of all employees and 45% of Omani employees, contributes to 3.6% of GDP, and makes up 2.7% of total exports. The ratios express severe disparity of income distribution and low productivity where the development strategy has attached great importance. Wholesale and retail trade sectors are dominated by small shops run by foreign nationals whose aim is not to recycle their profit and enlarge their projects, but to save and send their money to their home countries. Few Omani nationals have gained experience in this sector.

The non-oil sector output is, nonetheless, highly sensitive to changes in oil output. This is explained by the dependence of the former on government expenditure, which is governed by oil revenue.

The domination of service sectors coupled with high rate of government consumption fuelled by revenues derived from natural resources, and low productivity resulted in so called "Dutch Disease" in which the picture is: high prices of services, an appreciation of the real exchange rate, less profitability and less competitiveness of local tradable goods.

The general picture is what is perceived by economists regarding oil-producing countries in general, when they state that:

they have all been unable to find a development strategy capable of combining industrial growth with rural development, full employment and equitable income distribution (Amuzegar, 1983, p.20).

This picture can be changed by a package of reforming policies working simultaneously through the key sectors: the oil sector, agriculture and fisheries, commerce and industry.

6.3.1.1 The Oil Sector

The financial relationship between the oil sector and other sectors through the government budget should be developed to physical-economic integration. Although this linking began in the early eighties through the domestic utilisation of natural gas in industry, electricity generating and household uses, through the refinery plant and some contractual services between oil companies and the private sector, the physical-economic relations could be strengthened.

One way to do that is via the petro-chemical industry. The advantage of such industry is to:

move from being supplier of crude oil into high value-added petro-chemicals, and eventually further downstream into consumer goods inputs, if not the final products themselves (Wilson, 1995, p.143)

The output of such industry can be absorbed partially by the manufacturing sector, the agriculture sector and the surplus could be exported. This will increase local value added, bring technology transfer, create employment and raise export earnings.

6.3.3.2 Agriculture and Fisheries

- i. Support should be given to small producers of vegetables, livestock, eggs, etc., through the OBAF financially and physically. This could be done by providing physical capital such as stores, fields, vehicles, pumping machines, modern irrigation techniques etc. This sort of support should be given to new graduates of agricultural colleges.
- ii. Rural areas should be developed by retaining the traditional irrigation system, promoting handicrafts and organising local markets. The traditional irrigation system in Oman is called *Al-Falaj*. It can be described as

a unified irrigation system which distributes, by means of a network of canals, a source of water to those who have established rights in it (Wilkinson, 1980, p.124).

It is by far the cheapest and most mechanically efficient water supply system in Oman, old and new, but only so long as it is properly maintained (Ibid., p.132). Between 50% and 60% of cultivated land in Oman is irrigated by this system (*Oman Daily Newspaper*, 21 November, 1996). The existence of this system in Oman has created good distribution of the population of the country in thousands of villages, many of which have expanded and become towns and cities. If this system collapses a mass rural-urban migration will take place, exerting great pressure on the government to provide jobs, settlements and several other services for the people. According to Wilkinson:

Even more damaging to the country's development is the collapse of the social framework of village life through drawing off its population into non-productive occupations (Ibid, p. 135).

The agricultural and rural craft base in Oman has been profoundly disrupted by economic and social changes stemming from oil wealth. (Dutton, 1987, p.94) The decline of rural craft resulted in unemployment and under-employment and migration to urban areas, the phenomenon which has been expected by the policy makers and the development strategy was aiming to promote regional development to keep a proper distribution of population. The impact of oil wealth is felt throughout rural Oman by *badu*, farming and fishing communities in the interior and on the coast. The speed of change from poor to rich has given no time to adapt local produce and local manufacturing techniques to the new demands.

They need new ranges of skills to enable them to cope with new agricultural systems of husbandry, to produce the new foodstuffs which Oman's consumers now demand (ibid.).

A greatly stimulated local demand coupled with the ability to pay for cheap mass-produced imports, has tended to inhibit local production. Some of the traditional products such as wheat have been replaced by imported equivalents.

The rural economy should be integrated with the modern one, and negative influences of oil-based economy must be controlled. This policy can be applied in several procedures such as:

- 1) Intensifying agricultural training by increasing the number of agricultural institutes. This can be applied by reducing the general secondary education and converting secondary schools to agricultural ones. All aspects, concepts, and problems of rural economy should be introduced into the agricultural educational curriculum in particular and the general education curriculum in

general. The traditional irrigation system, *Al-Falaj*, how it works; it's importance; the problems facing it, is one of the most fundamental aspects of what should be taught in the agricultural colleges and institutes. Special Institutes for handicraft could be established, establishing higher authority for handicraft. These should study the problems of traditional industries and set out the appropriate policies.

2) Organising the traditional markets (*souk*).

Large cities and towns in Oman usually organise traditional markets or auctions known as *souk* or *halaquah*. Animals, agricultural products and traditional goods such as daggers, old weapons, etc., are sold at these auctions. Many other agricultural products are marketed in these occasional or weekly markets. These markets play a dynamic role in rural economy in Oman because they match suppliers and consumers around a wide variety of domestic products. The role of the government here is to encourage these traditional markets in several ways such as:

- i. Building the ancient market places which used to be the best area for *souk* or *halaquah*.
- ii. Providing infrastructural facilities like storage, electricity, water, car parks etc.
- iii. Extending these activities to other cities and choosing suitable times by co-ordinating them with other cities.
- iv. Revising the protection system through tariffs. Agricultural products face fierce competition from imported equivalents, and domestic producers have given up their traditional work because they became unprofitable. The

protection tariffs should be amended to provide an adequate competitive position for Omani agricultural products.

6.3.3.3 Commerce and Industry

Omani naval history was based on commercial activities, exchanging agricultural Omani products with spices, wood, textiles from India, and coffee, cloves and other products from Africa. From the seventh to the fifteenth centuries Oman's maritime trade flourished. Omani ships regularly called at ports in Persia, India, and south-east Asia. Oman has played an important mediation trading role because of its strategic location overlooking the Indian Ocean, Arabian Sea, and Arabian Gulf with a coast line of 1700 km. It is an important part of the Middle East which

has always been a cross-roads for commerce due to its geographical position between the more populated regions of Europe, South Asia and East Asia. Rather than being a barrier to trade, the deserts of the region have been like oceans, crossed by important trade routes (Wilson, 1995, p.148).

The following steps are suggested in order to enhance commercial activities:

- i. Big businessmen should be prevented from monopolising several activities. For example, some of them trade in cars, building materials, foodstuffs and electronics. Instead, each businessman should be involved in only one activity.
- ii. Trade should be confined to Omanis. This includes supermarkets, building material shops, clothes shops, cold stores, greengrocers and all distributors.
- iii. Government officials should be prevented from practising private business. To put this procedure into effect, all civil workers who registered commercially before 1980 should leave their work in government departments. The rationale behind

this arbitrary criterion stems from the fact that those who have been running their businesses since then, have already established a secure income and must administer their business themselves instead of foreigners. At the same time they would lighten the pressure on the government budget.

With respect to industry, the problems include foreign competition, a limited local market, lack of opportunities, and lack of entrepreneurial and marketing skills. All industrial firms in Oman are small and medium sized. This sector is given high priority from the government economic policy. Five industrial estates have been established in five regions, but the biggest and most important firms are centralised in the capital area. Omanisation and utilisation of local raw materials must be highly emphasised. All firms depend mostly on expatriate workers. This trend hinders the “nationalisation” of technology in the long term, because foreigners are going to leave the country soon or later. Industry on the other hand must benefit from cheap local agricultural, fish, and mineral raw material. This would lower costs on the one hand, create inter-sectoral linkage, and maximise the local value added. In this regard I suggest the following industries:

- Tomato and fish packaging
- Lemon-juice producing
- Mango acetifying
- Using dates in manufacturing biscuits
- Making fishing boats

Conclusion

The discussion in this chapter addressed the evaluation of the deficit-reducing policy adopted by the financial authority, following which the suggested alternatives were presented.

The prudence of public deficit depends on the level of private saving, the desired level of private investment and the desired current account deficit. The assessment of these three variables has found that they were not in a good position and were not sustainable. The other criterion was the external creditworthiness that is measured by the ratio of external debt to exports. The study has found that this ratio was rising quickly. It peaked in 1986 at almost 84% which meant that 84% of exports had to be assigned to serve the indebtedness balance. During the period under study this ratio averaged 66%. Indebtedness has been growing five times faster than that of exports. In a slowly growing economy with low financial savings and stagnant exports, the prudent fiscal deficit is likely to be low. The assessment of these elements in the previous chapter and in preceding pages indicated a low prudent position.

Secondly, the discussion focused on the fiscal and monetary measures taken to reduce the deficit. Two main measures were evaluated: cutting public spending and the devaluation of the Omani Rial against the US dollar by 10%.

Regarding the first measure, the financial authority was able to bring down the growth rate of total expenditure from 30% during 1970-1993, to less than 1% on average over the examined period. The sharpest cut was in development expenditure which was cut

by 11.5% annually. Other high cuts were in the areas of education and health services. Lessening capital formation had led to diminishing private investment, lower growth of non-oil output, and finally almost stagnation. Efforts should be made to increase efficiency in public spending and to reduce waste and extravagance.

The devaluation policy was directed to achieve three goals: raising government oil revenue, improving the position of the balance of payments and reducing the demand on foreign exchange.

The devaluation has increased oil revenues in terms of local currency by RO 582 million during the period under study, but it raised the value of the public imports – through prices – by RO 344 million, making the final gain ample at RO 238 million. With respect to the second aim, the devaluation did not improve the position of the balance of payment. The positive effect has been cancelled out by negative effects on the same account or on other accounts of the balance of payments. The third goal also has not been achieved according to our analysis.

Thirdly, the alternative policy was discussed and presented. This alternative rests on a more comprehensive approach to deal with the problem, taking into account all causes of the deficit on both sides' expenditure and revenues. The suggested approach consists of three elements: rationalising public expenditure, improving the sources and techniques of financing, and the diversification of the economy.

Rationalising public expenditure can be accomplished through three measures: reprioritisation of public spending, ensuring the efficiency of public administration and the financial control, and assuring national use of the available resources between types of public spending.

Improving the sources and techniques of financing can be assured through two channels: firstly by maintaining the current level of oil revenue and restoring the stability of the State General Reserve Fund and secondly by developing stable sources of financing through improving the existing taxes and introducing new ones, using the current deposits of the commercial banks and restoring traditional Islamic sources of revenues.

Finally, for the diversification of the economy a suggested strategy was discussed. It rests on combining oil income with industrial growth, rural development, and full employment. The oil sector should be economically, rather than financially integrated with the other sectors. This can be done through petrochemical industries. In agriculture and fisheries, support should be given to small producers, rural areas should be developed and the rural economy should be integrated with the modern one. With respect to commerce and industry, monopolistic behaviour should be eliminated, trade should be confined to Omanis, and manufacturing should use local agricultural and mineral raw materials and should depend on the Omani labour force.

CONCLUSION

This thesis has addressed the causes of the problem of the budget deficit in Oman and examined its economic repercussions on the economy. The last chapter was directed to evaluate the effectiveness of the economic policy adapted by the financial authorities to tackle the problem.

The overview on the Omani economy in chapter one recognised the main characteristics of the Omani economy. The Omani economy can be divided into three main sectors: the oil sector, the non-oil commodity sector and the services sector.

The oil sector has been playing a leading role in the economy. The production of crude oil dominated the structure of GDP. Up to 1980 it was forming 61% but since then its relative importance has diminished until it reached 39% in 1995. Crude oil still dominates total exports by 87%, and oil revenues still constitute the mass of government revenue at about 85%. Notwithstanding its predominant role in the economy, the oil sector is an enclave activity employing only 0.8% of total employment and its links with other sectors are macro-financial rather than micro-economic links. It exerts its total effects through government expenditure.

The non-oil commodity sector consists of three main subsectors: agriculture and fisheries, manufacturing, and construction. Agriculture and fisheries before 1970

was the main sector, generating the main source of income for the population and employing about 75% of the labour force. Although the agricultural produce had been increasing in absolute value, the relative importance of this sector in the economy has been diminishing. Oil-based economy has adversely influenced the rural life and the agricultural activities. With the easy access to financial resources derived from oil through working in the government and other linked activities, a massive rural-urban migration has been taking place leaving the farms for farmers' families. The availability of money has made it too easy to import items which previously were produced domestically. Imported agricultural products have also brought severe competition for local products, making the work in agriculture unprofitable. Rapid social and economic change made agriculture producers unable to adapt their production techniques to modern ones. Accordingly, the relative contribution of this sector as a source of income has not increased during the previous four development plans, forming about 2.7% of GDP. The growth rate of the sector has been falling, recording 13%, 12%, 5.6% and 2.5% during the previous development plans.

Manufacturing is a modern small sector based on light industries. It received great consideration from the government with the aim of creating structural change and to diversify the sources of national income. The sector consists of light industries based on import-substitution strategy and recently it started to be partially export oriented.

This sector, however, encounters structural impediments such as small local markets, lack of investment opportunities, lack of experience and entrepreneurial and administrative skills. Its contribution in the gross domestic product rose from 0.19% in the first development plan to 4% in the fourth plan. With comparison with other sectors, it recorded the highest growth rate of about 32% during the last four plans on average.

The construction sector flourished during the first and second plans due to the government public works and the increasing needs of the population for housing units and the rising rates of rents induced by the oil boom.

Due to the above structural problems, the non-oil commodity sector was unable to increase its participation in GDP, recording a proportion of 15%, 13%, 15% and 11.5% of GDP during the previous plans. Its growth rate averaged 16%, 18%, 0.3% and 9% respectively.

An increasing importance has been achieved by the third sector – the services sector. Its relative importance of GDP started to take the place of the oil sector since the end of the FODP (1991-1995). It consists of government services, wholesale and retail trade, and financial and business services.

The characteristic of the rising services sectors and falling significance of commodity sectors is one major structural change in Oman as a rentier state. This characteristic has been caused by the so called “Dutch Disease”. It takes place with a

high rate of increase of domestic spending as a consequence of the large-scale development of natural resources. Dutch Disease drives up the prices of domestic services relative to those of domestic tradable goods motivating the investors to spend their money in service activities at the expense of agricultural and industrial goods.

Large foreign exchange from oil channelled into successive public spending also resulted in an overvalued exchange rate which discouraged industrial exports and encouraged imports and locally produced services.

Consequently, the relative importance of the service sectors in total GDP has been rising frequently. It recorded 24%, 35%, 39% and 50% throughout the previous development plans respectively. The sector's growth rate averaged 33%, 17.5%, 2.8% and 7% during these development plans respectively. Its absorption of employment has been rising until it reached 39% of total employment in 1993.

The next salient characteristic of the Omani economy is that the state increasingly assumed a major role in the economy. Intensive and urgent intervention of the government in the economy was economically, socially and politically justified. The Omani economy in 1970 was stagnant and operating at subsistent levels, lacking the basic infrastructure and basic health, educational and communication services. The government role was essential to construct these basic pillars in order to put the economy on the starting point. The elementary status of the market forces and the

weakness of the private sector, the government has to assure an optimal social distribution of oil resources.

In order to take this huge task the government started to build up its administration apparatus and to set the organisational foundations. From 1976 onwards, four systematic development plans have been executed so as to create the required economic and social structural change. In 1975, a development strategy has been set up. The strategy aimed to achieve some fundamental long-term objectives. According to the strategy, the Omani economy must be based on economic freedom, the private sector assuming the leading role. All opportunities must be equally be open to all Omanis. The strategy places a high emphasis on the importance of the agriculture, fisheries, industry and commerce, as a diversification policy for the source of income. The strategy also concentrated on the importance of just regional distribution of the capital formation in order to maintain the existent distribution of the population.

Therefore, the government raised its share in the Petroleum Development Oman (PDO), which dominates oil production, producing almost 95% of the crude oil, to 60%. The government also gradually increased its ownership in several activities extending from complete control on electricity generating stations, oil refinery plants, the general telecommunications organisation, the financial institutions, to partial ownership of several projects scattered in transport, manufacturing, tourism and civil aviation.

The state control over the oil sector provided it with massive financial resources which enable it to pursue its social, economic and political objectives. Oil revenues have been channelled into four types of public expenditure: recurrent, development, defence and national security, and subsidies. Current expenditure has been directed to operate the public administration which has been stretching increasingly. Government civil employees rose to 94 thousand, forming 14% of total employment. Development expenditure was injected in the economy in building schools, hospitals, roads, dams, airports, in several regions. Defence and national security expenditure provided a well prepared and equipped army and police force which secured the country's social and political stability and profound security. Subsidies have been appropriated to support the private sector and it varied from pure grants to low interest loans and long-term interest free loans.

Consequently, public expenditure reached one of the highest levels in the world, forming 53% of GDP on average. Public capital formation constituted 70% of total capital formation, and public consumption formed 50% of total consumption.

Government-produced services contributed to 12% of GDP during the first development plan. By the end of the fourth development plan they were contributing by 26%. In 1993 total government employment, both civil and military, formed 24% of total employment.

Unfortunately, this intensive role of the government has inhibited the achievement of some of the long term objectives of the development strategy. The private sector

has failed to play the leading role. Private investment has been decreasing. Businessmen have been mainly interested in quick-return-yielding activities such as real estate, commerce, and contracting with the government.

The lack of profitable opportunities open to the private sector was one result of the government's dominating role. With the obstacles encountered in the development of the non-oil commodity sector in agriculture and industry, the objective of economic diversification has not been accomplished.

If oil provided the opportunity for growth and proved to be a blessing for the state and the economy, it was also a curse, because it imposed limits on the economy which revenue alone could not remove. The inability of the state to diversify the economy led to the increasing dependence on the government and the oil revenues.

Oman's population, due to remarkable progress in education and health services and good living standards, has been increasing at a high rate of growth (3.4%). One demographic peculiarity of Oman is the large proportion of teenagers. Those who are 15 years or less constitute 51% of the total population. This characteristic has led to shortage of labour force triggered by the inadequate vocational training programme – despite the quantitative performance – to meet the labour market needs for technicians, skilled and semi-skilled manpower. Accordingly, all private and economic activities both in the commodity sector and services sector are predominantly occupied by expatriate labourers. They occupy 82% of work opportunities in the commodity sector and 75% in the services sector.

The incremental reliance of the economy on the government and accordingly excessive public spending accompanied by intensive dependence on oil revenues which have been exposed to unpredictable trends of oil prices, has resulted in a semi-chronic budget deficit.

Chapters 3, 4 and 5 were devoted to measuring the deficit, to analysing its causes and examining its impacts on the economy. To facilitate the study of these three major aspects, chapter 2 focused on the government as a link between the oil sector and other sectors and examined the objectives of the fiscal policy.

Due to the high capital intensive and enclave nature of the oil sector, there are few significant forward or backward linkages. The most effective means of transmitting the oil sector's growth to the rest of the economy is through the budget. Therefore government purchases of total output averaged 50% and government wage bill averaged 52% of the total wage bill of the economy and 16% of GDP. The objectives of the fiscal policy are derived from the long-term objectives of the development strategies: improving the quality of human resources through education, health service and vocational training, the diversification of the economy by developing the income generating projects, and equitable distribution of income through sectoral and regional distribution of oil resources. Theoretically, these objectives fall in the three main functions of the budget defined by Musgrave: an allocation function, the distribution function, and the stabilisation function.

Oman budgetary policy is aimed at affecting both sides of the economy: supply and demand. On the supply side, the government tried to raise the country's growth potential by channelling growth investment in the proper direction. It was also using the budget to support the private sector to play its role in the economy. On the demand side, the government expenditure both current and development aimed to modify the inequality of income distribution. However, Oman is still characterised by many features of underdeveloped countries such as insufficient infrastructure, lopsided nature of economic growth, maldistribution of income, limited availability of skilled labour, wages that rose beyond labour productivity, and decline of traditional exports.

The financial control is still not efficient, lacking autonomy and skilled specialists and the availability of database.

The budget is classified according to the line-item technique. This has a number of advantages, but one disadvantage is that it does not facilitate the economic analysis of individual transactions within the government's financial activities. It does not provide useful information for the purposes of planning. The functional classification permits trends in government expenditure on a special function to be examined over time. Through this type of classification, the state fiscal activity can be analysed, changes and developments can be followed up. Unfortunately, this classification is not applied properly in Oman. Some government units are difficult to classify into a particular group because their spending programmes serve many purposes, e.g. the Diwan of Royal Court. In contrast, there are some activities

served by several units and yet they are not collected into one section, e.g. education. There are several kinds of education: agricultural, industrial, commercial etc., all of which are practised by different ministries. However, the functional classification does not include these several types in the education sector.

With respect to the measurement of the deficit which was discussed in chapter 3, the conclusion that can be drawn is that the measurement of the fiscal deficit provides the policy makers with analytical instruments to assess the net effects of government budgetary transactions on different aspects of the national economy such as the aggregate demand, the money supply, and the balance of payments. The deficit measure which is adopted by this study is the conventional concept of deficit, which is also known as the public debt concept of deficit because it measures the Public Sector Borrowing Requirements (PSBR). There are other special purposes measures of deficit, the most important of which for Oman are the current account concept of deficit and the cyclical adjusted deficit. The former indicates the saving capacity of the current budget to use it to finance the development budget. The latter is used to remove the business cycle effects on the budget. By using this concept we found that between 40%-60% of actual deficit in Oman is cyclical effect induced by swinging oil prices.

The investigation of the causes of the deficit was conducted in chapter 4. The deficit resulted from a gap between government expenditure and government revenues. Government expenditure has been mostly higher than government revenues and it was rising faster than government revenues. Accordingly the deficit consists of two

parts. One relates to the expenditure side of the budget and the other relates to the revenue side. There were two kinds of causes behind rising expenditure: general causes and special causes. The general causes are population growth, administration setbacks, monetary variables e.g. inflation and exchange rate depreciation, and psychological causes relating to climate of confidence during the oil boom with ease of access to financial resources.

The special causes refer to each one of the four types of government expenditure. For example, current expenditure has been increasing because of increasing wages and salaries as the main reason. Defence expenditure has been rising due to massive spending on military and security purposes. All of the four types implied unnecessary spending, i.e. misallocation of resources, and waste, i.e. inefficient spending. In current expenditure the misallocation is represented in excessive purchase of equipment, e.g. computer systems. Inefficient spending is represented in purchasing at higher prices because of private interests.

Government revenues were impeded by their structure, oil prices, the cost of oil production, and the depreciation of the dollar.

Regarding the structure of revenue, the small proportion of domestically collected revenues, i.e. taxes and fees, to total revenue (12%) and the large contribution of oil revenues (88%) made the public finance highly vulnerable to the external shocks of the unstable world market of oil. The negative movement of oil prices adversely

affected government revenues. For example, when oil prices declined to \$13/b in 1986, oil revenue declined by 31%.

The high cost of Oman's oil production increases the government participation in PDO capital expenditure and reduces the government's oil revenues. The depreciation of the dollar has weakened the purchasing power of Oman's oil through increasing import price index and reducing export price index.

The macroeconomic impacts of the budget deficit were traced first on the indebtedness balance and foreign reserves, then on three macroeconomic variables: money supply, aggregate demand and the balance of payments. The deficit effects on these variables have been working through the way in which the deficit was financed. One direct negative effect of the deficit has been the increasing public debt which rose, by 1995, to RO 1500m. Its percentage of GDP averaged 30% during the period under study which meant that one third of the country's income is engaged by foreign debt.

The second direct negative effect was the rapid exhaustion of the foreign reserves. Regarding money supply, the budget deficit has an expansionary influence on the financial markets. Money supply is measured by the currency with the public and demand deposits, and has had a positive responsiveness to the movements of domestic budget balance. The influence was working through the inflow of oil resources, and foreign borrowing. Therefore, commercial banks have been in surplus, i.e. their total deposits have been larger than their total credit.

Concerning the aggregate demand, total investment (private and public) was decreasing during the period of budget deficit. Private investment has been hindered by structural obstacles, as indicated earlier. It was not crowded out by public investment, because, as mentioned above, the banking system was not short of resources. In fact, the deficit has hindered both private and public investment through the erosion of public saving. Due to massive public consumption and deficit, the public saving was diminishing. Accordingly, the government reduced public investment at sharp rates. This reduction has adversely affected the private saving and investment because the private sector activity is almost contingent upon the continuation of a high level of public expenditure.

The slow-down of both private and public consumption during the period under study was caused by the decline of oil income and consequently non-oil income.

The balance of payments has been adversely affected, both directly and indirectly. The direct impact of deficit on the balance of payments happened through the debt service which has been reducing the foreign exchange gained by the trade balance. The deficit has also been eroding the government's foreign reserves when the overall balance of the balance of payments has been in deficit. The indirect impact of the deficit on the balance of payment was working through the exchange rate mechanism. The appreciation of the real exchange rate made the prices of the Omani non-oil exports uncompetitive. It also made import prices cheaper than local products, which has been minimising the trade balance surplus.

The final chapter (chapter 6) evaluated the fiscal policy directed to cope with the deficit problem. Finally it presented the alternative reforms.

The fiscal policy was evaluated through the assessment of the management of the deficit and through the examination of the measures adopted to reduce the deficit.

The extent to which the deficit was prudent was judged via criteria such as domestic private saving and investment, the creditworthiness concept, the current account balance and the ratio of foreign reserves to imports. The result found was that the level of the deficit was unacceptable because all these criteria were in unsatisfactory positions. Private investment was falling, private saving was unstable, the current account balance of the balance of payments has been falling since 1981. In 1986 it saw a deficit of 14% of GDP. It recovered in 1987 and 1990 and recorded surplus of 10% and 12% of GDP but since then it has been deteriorating. The creditworthiness is measured by the debt/export ratio. This ratio was rising. In 1986 it peaked at 84% which meant that 84% of exports were engrossed in debt. The usual objective in managing foreign reserves is to maintain an adequate ratio of reserves to imports of goods and services. Foreign reserves covered 46% of imports on average. However, this position has improved during the period under study to 57.6% due to the decline of imports.

Two main measures were adopted to reduce the deficit in addition to raising the volume of oil production. The first one was the reduction of public spending. Development expenditure was sacrificed. It was cut by 11.5% per annum during the

period under study. The growth rate of education expenditure was reduced from 26% to 6.8%, and that of health services from 13% to 1%. Other reductions may be acceptable such as that of military expenditure. However the sharp reduction of development expenditure was harmful to the economy. The country's network of highways, schools, hospitals, roads, etc. all represent the future wealth of the country. The emphasis has to be on careful assessment of public spending and to eliminate as much fat as possible. Every effort should be made to increase efficiency in public spending and stop waste and extravagance.

The second measure to minimise the deficit was devaluation of the Omani Rial by 10.2% against the US dollar. Three goals were intended to be achieved through this devaluation: raising government oil revenues in local currency, improving the position of the balance of payments, and reducing the demand on foreign exchange. In so far as these three goals has been achieved, the devaluation policy would be successful. However, with the exception of the first one to some extent, the collective result was not helpful.

Our suggested approach to deal with the problem, and even to avoid such problems, is a more comprehensive one. It takes into consideration all the causes of the deficit, as has been investigated above and articulated in chapter 4.

This approach has three main dimensions: rationalising public spending, improving the source and techniques of financing and the diversification of the economy.

The rationalisation of public spending requires a review of spending priorities, a reform of public administration, and a rational use of the available resources. Plausible criteria for ranking the areas of government involvement are promoting efficiency, boosting economic growth, alleviating poverty and securing social and macroeconomic stabilisation. These elements represent the country's national economic and social goals and the government is responsible for their achievement.

Social, physical and information infrastructure: education, health, transport network and public utilities are at the second level of government responsibility after defence, justice and macroeconomic management. They meet the basic needs of the population and the private sector is unqualified to produce them and distribute their benefits equitably.

The second requirement to rationalise public spending is efficient public administration and strict financial control. This can be achieved through reducing bureaucratic trends in the government sector, organising training programmes for civil officers, and strengthening the regulations and mechanisms of financial control.

The third requirement to rationalise public spending is ensuring efficient use of available resources. Resources should be allocated carefully between the main types of spending. Careful assessment of each type of public expenditure must be conducted to find the most cost-effective means to achieve the targeted objectives. Current expenditures can be trimmed in areas of inefficient spending such as

furniture, rents, cars and equipment. In development spending, white elephant projects and luxurious building should be avoided.

The second dimension of the suggested approach is improving the sources and techniques of financing. The financial situation of the government is characterised by its dependence on depleted sources of revenue and high vulnerability to external shocks. This is due to the fact that 80% of government expenditure is financed by oil revenue. To immunise public finance against this vulnerability and to protect the whole economy from external shocks, the internal source of financing (i.e. non-oil revenue) must be developed. This will equip the government with fiscal tools that can help obtain the goals of income redistribution, economic growth and macroeconomic stabilisation. Therefore, the current level of oil revenue must be maintained and stable sources of financing must be developed. The first goal can be achieved through the reduction of production costs, continuing the current scale of production, and effective co-ordination with other oil producing countries to maintain a stable demand for oil in the world oil market. This policy must be complemented by restoring the firmness of the SGRF.

To attain the second goal, the following measures are required: improving existing taxes and introducing new ones, using the current deposits of the commercial banks and restoring traditional Islamic sources of financing.

The third dimension of our approach is the diversification of the economy. The diversification policy is vital in seeking sustainable development as it would obtain the following four objectives:

1. It would increase employment and create various sources of GDP.
2. It would strengthen the inter-sectoral relations and raise the domestic value added.
3. It would immunise the economy against external shocks.

The diversification policy needs a development strategy that combines industrial growth with agricultural development, full employment and equitable distribution of national income. The oil sector needs to become more integrated with other sectors through backwards and forwards real economic linkages. The petrochemical industry is the most appropriate option for this. Financial resources generated in the oil sector and transferred through the government budget can be used wisely to develop the agricultural and rural economy. This can be achieved through agricultural training, irrigation projects, roads, providing physical capital such as stores, fields for the new graduates of agricultural colleges and developing the traditional markets. In this way, the agricultural economy will become more integrated within the modern economy based on oil income. Another requirement is the revision of the protection system through tariffs, since agricultural producers face strong competition from imports.

Commerce needs the elimination of monopolistic trends that prevail with some large businessmen, who control trading in several activities. The economic surplus of this

sector has not been recycled and projects have not been enlarged because the sector is dominated by foreign nationals who transfer most of their profit to their home countries. Therefore, commercial activities should be confined to Omanis.

The manufacturing sector should use local agricultural and mineral raw materials. It should also increase the employment of Omanis. By adopting such measures, the industrial sector would lower costs, create sectoral integration, increase local value added and nationalise technology.

To round up this thesis, a general conclusion that can be reached from this study is that drawing up theories and policies for development are one thing, but the right application of these theories and policies is quite another. Each society is a special case, and careful analysis of the real economic and social fabric of each society is necessary to formulate realistic targets and policies for the country's development. Clear vision for the future is required, in which sufficient and reliable databases, especially on demographic realities, are of prime importance. Decision-making, on the other hand, must take place through taking into consideration all the points of view of concerned enlightened members of the society and not just through closed meetings between one particular group of people all the time. A country may be blessed with sufficient resources but the question is how to use these resources carefully.

APPENDICES

1

Schedule No. (2/2)
Estimates of Other Current Revenues
Itemwise for the Financial Year 1995

(Thousands of Rial Omani)

Account Number			PARTICULARS	Revenue Estimates
Head	Class	Item		
			A) Taxes and Fees Revenue :	
1	101	21	Income Tax on Companies and Establishments	35,000
1	103	11	Pay Roll Tax (Company participation in Technical Training Project)	43,077
1	104	11	Municipality Fees on Rents	3,838
1	104	41	Fees on Real Estate Transactions	4,036
1	105	51	Business Licences	0,656
1	105	52	Transportation Licences	8,500
1	105	53	Fees from Hotels and Entertainments	2,011
1	105	54	Taxes on concessionary use	2,001
1	105	55	Domestic Miscellaneous Licences	2,938
1	106	11	Custom Duties	42,000
			Total of Taxes and Fees Revenue	144,057
			B) Non Tax Revenue :	
1	108	11	Revenue from Sale of Electricity	91,544
1	108	12	Other Electricity Revenue	2,420
1	108	13	Revenue from Sale of Water	21,377
1	108	14	Other Water Revenue	0,394
1	108	15	Postal Revenue	4,507
1	108	16	Airport Revenue	12,158
1	108	17	Ports Revenue	0,958
1	108	21	Surplus from Public Authorities	45,000
1	108	31	Rent from Government Real Estate	2,429
1	108	41	Income from Government Investments	33,054
1	108	42	Interest on Bank Deposits and Lending	4,402
1	109	11	Passport and Immigration Fees	4,100
1	109	12	Miscellaneous Administrative fees and Charges	10,028
1	110	11	Compensation Fines and Forfeits	5,392
1	112	11	Mining Revenue	0,898
1	112	21	Sale of Food Stuff	0,092
1	112	22	Miscellaneous Agricultural Revenue	0,190
1	112	23	Fisheries Revenue	1,007
1	112	24	Medical Revenue	4,524
1	112	25	Sale of Goods at reduced prices	1,144
1	112	26	Miscellaneous Revenue	8,855
1	100	12	Other Revenue	1,470
			Total of Non Tax Revenue	255,943
			Total Estimates of Other Current Revenue Itemwise (A + B)	400,000

Schedule No. (4)
Estimates of Current and Capital Expenditure
for Civil Ministries for the Financial Year 1995

2

(Thousands of Rial Omani)

Budget Number	MINISTRY / DEPARTMENT	Current Expenditure	Capital Expenditure	Total Expenditure
10100	Diwan of Royal Court	91,989	1,858	93,847
10200	General Secretariat of the Cabinet	0,619	0,030	0,649
10300	Office of HM's Personal Representative	0,512	0,009	0,521
15300	Cabinet to the Deputy Prime Minister for Council of Ministers	0,404	0,010	0,414
10400	Ministry of Legal Affairs	0,974	0,008	0,982
10500	Ministry of Finance & Economy	5,960	0,127	6,087
10600	Ministry of Foreign Affairs	18,212	0,090	18,302
10700	Ministry of Interior	13,496	0,165	13,661
10800	Ministry of Information	14,473	0,318	14,791
10900	Ministry of Commerce & Industry	5,437	0,031	5,468
11000	Ministry of Petroleum & Minerals	4,961	0,025	4,986
11100	Ministry of Agriculture & Fisheries	16,684	0,092	16,776
11200	Ministry of Justice Awqaf & Islamic Affairs	10,695	0,247	10,942
11300	Ministry of Health	102,574	4,526	107,100
11400	Ministry of Education	150,324	1,443	151,767
11500	Ministry of Social Affairs & Labour	30,022	0,219	30,241
11600	Ministry of National Heritage & Culture	2,950	0,037	2,987
11700	Ministry of Housing	7,777	0,133	7,910
11800	Ministry of Communication	21,068	0,282	21,350
11900	Ministry of Electricity & Water	123,079	0,544	123,623
12000	Ministry of Post, Telegraph & Telephones	4,755	0,019	4,774
12100	Ministry of Regional Municipalities & Environment	21,844	0,281	22,125
12200	High Committee for National Day	0,215	0,003	0,218
12300	Office of Minister of State & Governor Dhofar	22,293	0,553	22,846
12400	Governorate of Muscat	1,395	0,012	1,407
12500	Secretariat General of Development Council	0,125	0,006	0,131
12600	Office of Special Advisor to His Majesty the Sultan	0,200	0,003	0,203
12700	Office of Advisor to His Majesty the Sultan for Development Planning Affairs	0,701	0,008	0,709
12800	Office of Advisor to His Majesty the Sultan for Economic Planning Affairs	0,230	0,010	0,240
12900	Office of Advisor to His Majesty the Sultan for External Liaison	0,213	0,006	0,219
13000	Secretariat General of Consultative Council	1,775	0,105	1,880
13100	Ministry of Civil Service	19,236	0,023	19,259
13200	Secretariat General of Civil Service Council	0,244	0,004	0,248
13300	Secretariat of Supreme Committee for Town Planning	0,292	0,004	0,296

Schedule No. (2/1)
Estimates of Other Current Revenues Functionwise for Ministries and
Public Authorities for the Financial Year 1995

(Thousands of Rial Omani)

Budget Number	MINISTRY / DEPARTMENT	Revenue Estimates
	(1) General Public Services Sector :	
10400	Ministry of Legal Affairs	0,072
10500	Ministry of Finance and Economy	35,508
10600	Ministry of Foreign Affairs	1,986
12200	High Committee for National Day	0,014
12700	Office of the Advisor to H.M. the Sultan for Development Planning Affairs	0,201
12900	Office of Advisor to His Majesty the Sultan for External Liaison	0,003
13000	Secretariat General of Consultative Council	0,018
14000	Ministry of Finance and Economy (Ministers and Under Secretaries Appropriation)	0,008
	Total of General Public Services Sector	37,810
	(3) Public order and Safety Sector	
10700	Ministry of Interior	0,037
11201 & 11202	Ministry of Justice, Awqaf and Islamic Affairs (Justice Affairs)	0,048
12400	Governorate of Muscat	0,004
13600	Magistrate Court	0,011
13900	Authority for Settlement of Commercial Disputes	0,507
20400	Ministry of Defence	1,000
20600	Royal Oman Police	61,897
	Total of Public Order and Safety Sector	63,504
	(4) Education Sector :	
11400	Ministry of Education	0,620
13700	Sultan Qaboos University & Educational Hospital	0,163
15100	Vocational Training Authority	0,037
15200	Institute of Public Administration	0,040
11204	Ministry of Justice, Awqaf and Islamic Affairs (Institute of Juris prudence)	0,001
	Total of Education Sector	0,861
	(5) Health Sector :	
11300	Ministry of Health	4,881
	Total of Health Sector	4,881
	(6) Social Security and Welfare Sector :	
11500	Ministry of Social Affairs & Labour	46,599
	Total of Social Security and Welfare Sector	46,599
	(7) Housing Sector :	
10100	Diwan of Royal Court (Municipality of Muscat and Sohar Development Office)	8,550
11700	Ministry of Housing	4,796

3 A

Schedule No. (4/1)
Estimates of Current and Capital Expenditure Functionwise
for Civil Ministries for the Financial Year 1995

(Thousands of Rial Omani)

Budget Number	MINISTRY / DEPARTMENT	Current Expenditure	Capital Expenditure	Total Expenditure
	(1) General Public Services Sector			
10100	Diwan of Royal Court	76,764	1,607	78,371
10200	Cabinet Secretariat	0,619	0,030	0,649
10300	Office of HM's Personal Representative	0,512	0,009	0,521
15300	Cabinet to the Deputy Prime Minister for Council of Ministers	0,404	0,010	0,414
10400	Ministry of Legal Affairs	0,974	0,008	0,982
10500	Ministry of Finance & Economy	5,960	0,127	6,087
10600	Ministry of Foreign Affairs	18,212	0,090	18,302
12200	High Committee For National Day	0,215	0,003	0,218
12600	Office of Special Advisor to His Majesty the Sultan	0,200	0,003	0,203
12700	Office of Advisor to His Majesty the Sultan for Development Planning Affairs	0,701	0,008	0,709
12900	Office of Advisor to His Majesty the Sultan for External Liaison	0,213	0,006	0,219
13000	Secretariat General of Consultative Council	1,775	0,105	1,880
14000	Ministers & Under Secretaries Appropriation	4,776	0,183	4,959
14100	Secretariat General for Supreme Committee for Conferences	0,267	0,001	0,268
	Total of General Public Services Sector	111,592	2,190	113,782
	(3) Public Order and Safety Sector			
10109	Diwan of Royal Court (Appropriation for Ministers and Sheikhs)	1,506	—	1,506
10700	Ministry of Interior	13,496	0,165	13,661
11201 & 11202	Ministry of Justice Awqaf, and Islamic Affairs (Justice Affairs)	5,005	0,108	5,113
12400	Office of State Minister & Governorate of Muscat	1,395	0,012	1,407
13600	Magistrate Court	1,269	0,022	1,291
13900	Authority for the Settlement of Commercial Disputes	0,720	0,009	0,729
	Total of Public Order & Safety Sector	23,391	0,316	23,707
	(4) Education Sector			
11204	Ministry of Justice, Awqaf, and Islamic Affairs	0,871	0,009	0,880
11400	Ministry of Education	150,324	1,443	151,767
13700	Sultan Qaboos University	46,725	0,603	47,328
14600	Supreme Committee for Vocational Training & Labour	0,186	0,014	0,200
15100	Vocational Training Authority	10,528	0,285	10,813
15200	Institute of Public Administration	0,910	0,018	0,928
15500	Ministry of Higher Education	4,859	0,023	4,882
	Total of Education Sector	214,403	2,395	216,798

Schedule No. (3/1)
Estimates of Capital Revenues and
Repayments itemwise for the Financial Year 1995

(Thousands of Rial Omani)

Account Number			PARTICULARS	Estimates of Revenue and Repay-ments
Head	Class	Item		
			Capital Revenue :	
1	213	11	Revenue from Sales of Social Houses & Govt. Buildings	1,486
1	215	11	Revenue from Sale of Government Land	5,014
			Total Estimates of Capital Revenue	6,500
			Capital Repayments :	
			Repayment of Loan Installments :	
1	430	11	Repayment of Loans by Public Authorities Establishments and Others	13,138
			Sale of Investments :	
1	431	11	Sale of Investments in Public and Private Authorities and Establishments	10,000
			Total of Estimates of Capital Repayments (Itemwise)	23,138

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Schedule No. (4/1)
Estimates of Current and Capital Expenditure Functionwise
for Civil Ministries for the Financial Year 1995

(Thousands of Rial Omani)

Budget Number	MINISTRY / DEPARTMENT	Current Expenditure	Capital Expenditure	Total Expenditure
	(5) Health Sector			
11300	Ministry of Health	102,574	4,526	107,100
	Total of Health Sector	102,574	4,526	107,100
	(6) Social Security & Welfare Sector			
11500	Ministry of Social Affairs & Labour	30,022	0,219	30,241
13100	Council and Ministry of Civil Service	19,236	0,023	19,259
13200	Secretariat General of Civil Service Council	0,244	0,004	0,248
14214	Subsidies to Household and Other Establishments	1,045	—	1,045
	Total of Social Security and Welfare Sector	50,547	0,246	50,793
	(7) Housing Sector			
	Diwan of Royal Court Comprising of :			
10103	- Municipality of Muscat	11,603	0,236	11,839
10105	- Advisor for Environment	0,245	—	0,245
10107	- Sohar Development Office	1,684	0,015	1,699
10111	- Office of the Advisor to H.M. the Sultan for Environmental Affairs	0,187	—	0,187
11700	Ministry of Housing	7,777	0,133	7,910
11903 & 11908	Ministry of Electricity and Water (Water Sector)	9,207	0,094	9,301
12100	Ministry of Regional Municipalities & Environment	21,844	0,281	22,125
12300	Office of Minister of State & Governor of Dhofar	22,293	0,553	22,846
13300	Secretariat of Supreme Committee for Town Planning	0,292	0,004	0,296
14900	Ministry of Water Resources	10,470	0,666	11,136
	Total of Housing Sector	85,602	1,982	87,584

Schedule No. (4/1)
Estimates of current Expenditure for Civil Ministries
for the Financial Year 1988 (Item wise)

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(Amount in Thousands of Rial Omani)

Account Number				Particulars	Estimates of Expenditure
Head	Sub Head	Item	Sub Item		
2	101	00	00	Expenditure on Goods and Services	
2	101	10	00	Wages and Salaries	
2	101	11	00	Wages	
2	101	11	01	Basic Salary	191.652
2	101	11	02	Wages of Temporary Employees	0.353
				Total Salaries and Wages	192.005
2	101	12	00	Allowances	
2	101	12	01	Housing	20.426
2	101	12	02	Electricity	4.317
2	101	12	03	Water	1.635
2	101	12	04	Telephone	0.337
2	101	12	05	Nature of Work	2.669
2	101	12	06	Expatriation	0.370
2	101	12	07	Transport	2.299
2	101	12	08	Others	32.621
				Total Allowances	64.674
2	101	13	00	Other Remunerations	
2	101	13	01	Travel Tickets	10.648
2	101	13	02	Travel Expenses	1.084
2	101	13	03	Bonus	4.306
2	101	13	04	Leave Encashment	0.116
2	101	13	05	Overtime	2.661
2	101	13	06	End of Service Benefits	5.090
2	101	13	07	Rents for Staff Accommodation	10.580
2	101	13	08	Cost of Special Employment Contracts	22.434
				Total Other Remuneration	56.919
				Total Wages Salaries Allowances and Others	313.598
2	101	30	00	Other Purchase of Goods and Services	
2	101	31	00	1) Goods	
2	101	31	01	Medical Supplies	7.481
2	101	31	02	Agricultural Supplies	1.943
2	101	31	03	Chemical and Insecticides Supplies	0.021
2	101	31	04	Education Supplies	5.964
2	101	31	05	Food Supplies	6.165
2	101	31	06	Office Supplies and Printed Materials	2.622
2	101	31	07	Building and Roads Supplies	0.737
2	101	31	08	Broadcasting and TV Supplies	1.930
2	101	31	09	Computer Supplies	0.025
2	101	31	10	Machinery Fuel	0.955
2	101	31	12	Machinery Spare Parts	63.447
2	101	31	13	Fuel for Vehicle and other Transportation	2.329
2	101	31	14	Spare Parts of Vehicles and Other Transporations	0.611
2	101	31	15	Other Supplies of Goods	3.091
				Total Supplies of Goods	97.321

**Estimates of current Expenditure for Civil Ministries
for the Financial Year 1988 (Item wise)**

(Amount in Thousands of Rial Omani)

Account Number				Particulars	Estimates of Expenditure
Head	Sub Head	Item	Sub Item		
2	101	32	00	2) Purchase of Goods for Resale at Subsidised Prices	
2	101	32	01	Dates	0.165
2	101	32	02	Meat	0.891
				Total Purchase of Goods for Resale at Subsidised Prices	1.056
2	101	33	00	3) Services	
2	101	33	02	Cleaning Contracts	2.193
2	101	33	03	Building Maintenance	5.321
2	101	33	04	Office Furniture and Equipment Maintenance	0.714
2	101	33	05	House Furniture and Equipment Maintenance	0.071
2	101	33	06	Maintenance of Vehicles and Other Transport	4.181
2	101	33	07	Machinery Maintenance	0.085
2	101	33	08	Computer Machinery Maintenance	0.189
2	101	33	09	Other Maintenance	1.450
2	101	33	10	Rents of Real Estates	3.793
2	101	33	11	Insurance of Vehicles	1.298
2	101	33	12	Insurance of Govt. Properties & Treasuries	0.603
2	101	33	13	Travel on Duty Expenditure	2.216
2	101	33	14	Subscription for Newspaper & Periodicals	0.977
2	101	33	15	Advertisement and Exhibition	0.240
2	101	33	16	Training and Scholarship	13.804
2	101	33	17	Medical Treatment Abroad Expenditure	1.900
2	101	33	18	Cost of Other Services	3.893
2	101	33	19	National Day Celebration Cost	0.690
2	101	33	20	Hire & Vehicles	4.502
2	101	33	21	Cost of Electric Connection Outside Capital Area	0.439
2	101	33	23	Contracts of Consulting Services	1.474
2	101	33	24	Contracts of Operating Service	0.614
2	101	33	25	Contracts for Other Services	0.937
2	101	33	29	Unclassified Expenses	17.755
				Total Services Supplies	69.339
2	101	34	00	4) Government Services Expenses	
2	101	34	01	Posts, Telegraph and Telephones Services	3.362
2	101	34	02	Cost of Electricity Consumption	6.414
2	101	34	03	Cost of Water Consumption	0.841
				Total Government Services Expenses	10.617
				Total Expenditure on Goods & Services(1+2+3+4)	178.333
2	103	00	00	Subsidies and other Current Transfers	
2	103	10	00	1) Subsidies	
2	103	11	00	Subsidies for Non Financial Authorities and Establishments	
2	103	11	01	Subsidies for Public Authorities Schedule No. (4/3)	5.002
				Total Subsidies	5.002

Schedule No. (41)
**Estimates of current Expenditure for Civil Ministries
for the Financial Year 1988 (Item wise)**

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(Amt In Thousands of Rial Omani)

Account Number				Particulars	Estimates of Expenditure
Head	Sub Head	Item	Sub Item		
2	103	30	00	2) Transfers to Non Financial Authorities and Establishments	
2	103	31	01	Transfers to Clubs and Sports Unions	2.115
2	103	31	02	Transfers to other Authorities and Establishment	0.068
				Total Transfers to Non Financial Authorities and Establishments	2.183
2	103	40	00	3) Grants and Compensation to National Households	
2	103	41	00	Aids to National Household	
2	103	41	01	Grants for Social Purposes	11.711
2	103	41	02	Sheiks and Tribes Allotment	0.219
2	103	41	03	Emergency Grants	0.921
2	103	41	04	Students Cost of Living Allotment	1.549
2	103	41	05	Miscellaneous Aids	4.282
				Total Grants and Compensation to National Households	18.682
2	103	42	00	4) Subsidies to National Household	
2	103	42	04	Allocation for Rural Development	0.100
				Total Subsidies to National Household	0.100
2	103	61	00	5) Foreign Grants	
2	103	61	01	Foreign Grants	0.200
				Total Foreign Grants	0.200
2	103	62	00	6) Contribution to Non Financial Organisation	
2	103	62	01	Gulf Council Organisations	1.869
2	103	62	02	Arab Organisations	0.748
2	103	62	03	International Organisations	1.079
				Total Contribution to Non Financial Organisations	3.696
				Total Subsidies and Other Current Transfers (1+2+3+4+5+6)	29.863
				Current Budget Reserve	11.206
				Total Current Budget Reserve	11.206
				Total Estimates of Current Expenditures for Civil Ministries (Item wise)	533.000

**State's General Budget for the
Financial Year 1988**

6

(Amount in Million of Rial Omani)

PARTICULARS		BUDGET ESTIMATES	
First: Revenue:			
1) Net Oil Revenue			1065.3
2) Natural Gas Revenue			43.0
3) Other Current Revenue (Schedule No.2)			202.7
4) Capital Revenue (Schedule No. 3)			3.9
5) Capital Repayments (Schedule No. 3)			35.4
6) Total Revenue (1 + 2 + 3 + 4 + 5)			1350.3
Second: Expenditure, and Lending & Participation:			
Current Expenditures:			
7) Defence & National Security	532.6		
8) Civil Ministries (Schedule No. 4)	533.0		
9) Interest on Loans	84.0		
10) Government Share in PDO's Current Expenditure	70.0		
11) Total Current Expenditures (7 + 8 + 9 + 10)			1219.6
Capital Expenditures:			
12) Project Expenditure for Civil Ministries (Schedule No. 4)	245.0		
13) Exploration of Natural Gas	6.3		
14) Government Share in PDO's Capital Expenditure	74.0		
15) Non Project Capital Expenditure for Civil Ministries (Schedule No.4)	12.0		
16) Total Capital Expenditure (12 + 13 + 14 + 15)			337.3
Lending & Participation:			
17) Industrial Sector	8.0		
18) Oman Housing Bank	7.0		
19) Oman Development Bank	2.0		
20) Oman Bank for Agriculture & Fisheries	5.0		
21) International Regional and Domestic Establishments	23.4		
22) Total Lending and Participation (17 + 18 + 19 + 20 + 21)			45.4
23) Total Expenditures, and Lending & Participation (11 + 16 + 22)			1602.3
24) Net Surplus/(Deficit) (6-23)			(252.0)
Third: Financing:			
25) Net Borrowing			
Loans Receivable	178.0		
Loans Repayable	<u>123.0</u>	55.0	
26) Net Grants		3.0	
Total Financing (25 + 26)			58.0
Balance Deficit (24-27)			(194.0)

**Estimates of Non Project Capital Expenditure
for Civil Ministries for the Financial Year 1988
(Item wise)**

6A

(Amount in Thousands of Rial Omani)

Account Number				Particulars	Estimates of Expenditure
Head	Sub Head	Item	Sub Item		
2	204	00	00	Acquisition of Fixed Capital Assets	
2	204	30	00	Non Project Expenditures	
2	204	30	00	Furniture and Equipment	
2	204	31	01	Office Furniture and Equipment	1.198
2	204	31	02	House Furniture and Equipment	2.842
				Total Furniture and Equipment	4.040
2	204	32	00	Means of Transport	
2	204	32	01	Vehicles	5.151
				Total means of Transport	5.151
2	204	33	00	Machinery and Equipment	
2	204	33	01	Machinery	1.672
2	204	33	02	Equipment	0.319
				Total Machinery and Equipment	1.991
2	204	34	00	Miscellaneous Fixed Assets	
2	204	34	01	Other fixed Assets	0.806
				Total Miscellaneous fixed Assets	0.806
				Total Estimates of Non Project Capital Expenditure (Itemwise)	11.988

Sectoral Distribution of Development Budget for 1995

(Thousands of Rial Omani)

Sectors	Cost of on-going Projects from Third Five Year Plan	Cost of New Projects in the Fourth Five Year Plan	Total Allocations
A. Commodity Sector			
- Oil	0,014	0,167	0,181
- Natural Gas	8,374	29,992	38,366
- Minerals and Quarries	0,427	6,579	7,006
- Agriculture	0,443	12,212	12,655
- Fisheries	1,051	35,691	36,742
- Manufacture	0,070	35,017	35,087
Total Commodity Sector	10,379	119,658	130,037
B. Services Sector			
- Housing	0,416	29,161	29,577
- Trade	0,839	5,354	6,193
- Electricity	1,041	67,135	68,176
- Water	4,986	76,704	81,690
- Posts, Telegraph & Telephones	0,895	2,623	3,518
- Transport	—	0,118	0,118
- Tourism	0,757	7,125	7,882
Total Services Sector	8,934	188,220	197,154
C. Social Services Sector			
- Education	1,149	71,227	72,376
- Vocational Training	0,345	11,113	11,458
- Health	4,079	53,232	57,311
- Information, Culture & Islamic Affairs	0,209	18,788	18,997
- Community Centres	0,762	2,919	3,681
- Youth Centres	0,143	6,760	6,903
Total Social Structures Sector	6,687	164,039	170,726
D. Infrastructure Sector			
- Roads	2,603	47,010	49,613
- Airports	0,316	11,526	11,842
- Ports	0,015	4,526	4,541
- Irrigation & Water Resources	3,867	39,512	43,379
- Town Planning & Municipal Services	6,653	38,080	44,733
- Government Administration	6,087	59,607	65,694
- Environment & Pollution Control	0,021	4,605	4,626
Total Infrastructure Sector	19,562	204,866	224,428
Total (A+B+C+D)	45,562	676,783	722,345
Estimate of Actual Expenditure for 1995			250,000

7A

Schedule No. (5)
Total Development Budget Allocations
for the Financial year 1995

(Thousands of Rial Omani)

Sector / Ministry and Subsector	Balance on going Projects from third Five Year Plan	Cost of Projects included in the plan for years 1991 - 1995	Total Allocations
A) Commodity Production Sector			
Ministry of Petroleum & Minerals : Oil	0,024	1,713	1,737
Ministry of Petroleum & Minerals : Gas	8,374	34,732	43,106
Ministry of Petroleum & Minerals : Minerals	0,427	6,579	7,006
Ministry of Commerce & Industry : Industry	0,061	2,928	2,989
Public Establishment for Industrial Estates	0,009	17,093	17,102
Ministry of Agriculture & Fisheries : Agriculture	0,735	13,636	14,371
Ministry of Agriculture & Fisheries : Fisheries	1,051	35,691	36,742
Ministry of Agriculture & Fisheries Irrigation & Water resources	2,460	6,845	9,305
Support for Industrial Development Programme	—	15,500	15,500
Subtotal	13,141	134,717	147,858
B) Service Producing Sector			
Ministry of Commerce and Industry : Trade	0,508	6,263	6,771
Ministry of Commerce and Industry : Tourism	0,931	7,125	8,056
Ministry of Housing	1,898	23,321	25,219
Ministry of Electricity & Water : Electricity	0,975	67,297	68,272
Ministry of Electricity & Water : Water	3,215	70,907	74,122
Ministry of Posts, Telegraphs and Telephones	0,895	2,623	3,518
Authority for the Settlement of Commercial Disputes	—	0,054	0,054
Public Authority for Stores & Food Reserves	0,316	0,753	1,069
Public Authority for Marketing Agricultural Products	0,015	0,026	0,041
Muscat Securities Market	—	1,556	1,556
Subtotal	8,753	179,925	188,678
C) Social Service Sector			
Ministry of Information	0,187	11,035	11,222
Ministry of Justice, Awqaf & Islamic Affairs	0,164	2,607	2,771
Ministry of Health	3,653	53,506	57,159
Ministry of Education	0,522	37,256	37,778
General Organization for Youth Sports and Cultural Activities	0,143	6,788	6,931
Ministry of Social Affairs & Labour	0,975	3,847	4,822
Ministry of National Heritage & Culture	0,055	6,614	6,669
Ministry of Civil Service	0,001	17,239	17,240
Institute of Public Administration	—	0,340	0,340
Magistrate Court	—	0,448	0,448

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