
Executive Summary and Recommendations

Yemen

Corruption, Capital Flight and Global Drivers of Conflict

A Chatham House Report

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Executive Summary and Recommendations

Yemen, the poorest country in the Middle East, is a case study of critical importance to anyone trying to understand the complex political transitions set in motion by the ‘Arab Spring’ as well as international policies on ‘fragile states’ and the ‘war on terror’. The negotiated handover in November 2011 from President Ali Abdullah Saleh to his deputy, Abd Rabbu Mansour Hadi, after three decades at the helm of a military republic averted the immediate risk of a civil war while establishing a framework for longer-term reform. This has led some observers to cite Yemen’s transition as a regional success story, and even to suggest that it could offer a model for conflict-affected states including Syria.

Yet the outcome of the transition remains uncertain. Far from being on a guaranteed path towards a secure, prosperous future, Yemen confronts serious risks of political instability and a looming resource crisis, forced by the rapid depletion of the oil reserves that underpin the state budget. Despite concerted efforts by donors to boost development assistance and promote governance reform during the past decade, incredibly high rates of poverty and hunger in Yemen persist. The World Food Programme estimates that over 10 million Yemenis – 46 per cent of the population – do not have enough to eat. The situation is exacerbated by the self-enriching behaviour of the country’s elites, who are depleting Yemen’s resources, sending illicitly earned and untaxed profits abroad, and often actively resisting much-needed structural reforms.

Yemen’s internationally brokered transition roadmap is made up of an ambitious National Dialogue Conference, military restructuring and constitutional reform. This

process, which is scheduled to end in fresh elections in 2014, represents a historic opportunity to rethink the structure of the state. The prominence of women and youth activists alongside traditional social and political forces in the Dialogue has established an important precedent for broader political inclusion. However, fostering legitimacy is complex, long-term work, and achieving a stable new political settlement is by no means guaranteed.

Like many transitional leaderships, the interim government of Yemen has committed itself to political and economic reforms, but may struggle to push them through in face of the resistance of incumbent elite interests. Many Yemenis in fact question whether the transition agreement marks the start of a historic negotiation of political access, or whether it is designed to mask the preservation of power and wealth by members of the existing elite. This situation is not unique to Yemen, as debates continue over whether former President Mohammed Morsi’s administration in Egypt was itself blocking reforms, or was blocked by opposing political interests from fulfilling its mandate.

Having backed and brokered the transfer of power from Saleh to Hadi in an effort to ensure a controlled transition, foreign actors, especially the UN, the United States, the United Kingdom and Saudi Arabia, are heavily involved in day-to-day implementation of the transition agreement, providing valuable diplomatic momentum and technical support. Yemen’s transition does indeed have the potential to lay the groundwork for a more inclusive and accountable political configuration that would, over time, initiate a parallel transformation in the political economy. But bringing this promise to fruition will require sustained high-level international engagement that goes beyond traditional diplomacy.

However, external actors also operate both as a force for stability and as a risk factor when their interventions – often driven by short-term counter-terrorism priorities – are inconsistent with Yemeni perceptions of local legitimacy, and sometimes, as in the case of the US drone strategy, directly undermine them. Aid spending has traditionally been far less of a priority for international donors than military assistance, which in itself sends messages to Yemen’s leaders about the priorities their international partners expect them to pursue.

Yemen key facts

Republic of Yemen

- Formed: 1990 (previously the Yemen Arab Republic ('North Yemen'); People's Democratic Republic of Yemen (PDRY) ('South Yemen'))
- Head of State: President Abd Rabbu Mansour Hadi
- Head of Government: Prime Minister Mohammed Salem Basindwah

Economy

- Annual average GDP growth rate 2000–10: 4.5 per cent
- GDP per capita: \$1,361.20 (2011) (World Bank)
- MENA GDP per capita: \$7,400 (2010) (World Bank)
- Oil production: 180,000 barrels a day (b/d) (2012) (*BP Statistical Review of World Energy 2013*)
- Peak production: 457,000 b/d (2002) (*BP Statistical Review of World Energy 2013*)

Demographics

- Population: 24.8 million (World Bank)
- Population growth rate: 3.1 per cent (2011) (World Bank)
- MENA average population growth rate: 2 per cent (2011) (World Bank)

Humanitarian snapshot

- People without access to safe water, sanitation: 13.1 million
- Food-insecure people: 10.5 million
- People without access to healthcare: 6.4 million
- Acutely malnourished children: 1 million
- Internally displaced people: 306,087
- Refugees: 237,717 (officially registered); 1.2 million (government estimate)

Sources: UNHCR, WFP, OCHA, WHO, UNICEF, Government of Yemen, July 2013.

Yemen's dependence on external assistance should provide at least some prospect that external donors can act as a lever for change: external grants to Yemen increased from around 1% of GDP in previous years to about 6% of GDP in 2012, according to the IMF. However, overall levels of foreign aid have been overshadowed by high volumes of capital flight: Yemen ranked fifth among Least Developed Countries surveyed for capital flight between 1990 and 2008. Illicit financial flows on this scale are incentivized by the global issue of international tax havens, which include Western entities and dependencies, and capital flight damages the domestic tax revenues and local investment needed to fund Yemen's development.

In this respect, there is some dissonance between Western donors' aid policies and their policies towards international tax evasion, yet this is an area in which the concerted action of international donors can, and should, have more impact. In an increasingly globalized world, international support for reform programmes in developing states cannot be isolated from removing the

international incentives that allow for personal enrichment at the cost of good governance. Facing the alternative scenario of an increasingly impoverished and aid-dependent Yemen, the recent G8 focus on international tax transparency and the future of global poverty reduction, highlighted by Prime Minister David Cameron during the UK's 2013 G8 presidency, represents an important and welcome opportunity for more joined-up policy in this area.

This report is the culmination of a major, multi-year research project led by the Chatham House Yemen Forum, involving intensive fieldwork in Yemen, expert-level workshops and detailed consultation with donors, diplomats, defence ministries and civil society organizations. It places Yemen's transition in the context of longer-term state formation, exploring regional and international changes since the end of the Cold War, examining the complex interplay between domestic politics and international drivers of corruption and conflict, and highlighting systemic failures in global governance that are visibly manifest in 'fragile states' such as Yemen.

Main findings and recommendations

I. The importance of political legitimacy

The 2011 popular uprising in Yemen brought the state's crisis of political legitimacy to a head as well as accelerating overt conflict between elite regime factions. Young Yemenis frustrated with political and economic exclusion began mass nationwide protests in January 2011. They saw the uprising as a chance to create a modern civil state and replace a corrupt elite that was barely delivering any public goods or services. The protests amplified existing tensions between rival elite factions, leading to an open split within the regime. Fear of civil war between military rivals encouraged the US, UK and Saudi Arabia to push for a negotiated transition that led to President Ali Abdullah Saleh leaving office but left the elites in place, while creating space for future mediation and peace-building.

The youth-led uprising followed a fundamental crisis of legitimacy in Yemen's political institutions, including the country's major political parties. During the final years of Saleh's rule, the shift to violence by the Houthi rebels in Sa'dah province, the evolution of the secessionist southern movement and the continued prominence of Al-Qaeda in the Arabian Peninsula signalled a loss of faith in the existing parliamentary system – and in some cases the nation-state framework – as a legitimate means of resolving grievances. The *de facto* fragmentation of state power in Sa'dah and the south accelerated during 2011 and 2012, as non-state armed groups expanded their control, increased their provision of security and services and exploited long-standing regional grievances. There is no 'quick fix' for these problems, which, if left unaddressed and isolated from newly opened channels of political participation, can only become more difficult to solve.

The National Dialogue provides a historic opportunity for groups that were politically and socially marginalized under Saleh to press for new terms of inclusion, under international supervision. The transition agreement brokered by the Gulf states with international backing provided for a six-month series of inclusive talks, the National Dialogue Conference. The recommendations

produced by delegates during the talks will influence the new constitution and inform the future shape of the state. To achieve a stable and enduring agreement, the transition process must also successfully defuse the grievances of the southern separatists and armed groups such as the Houthis.

Yemen's transition must be seen in the long term, beyond the two-year framework of the Gulf Cooperation Council (GCC) agreement. The National Dialogue talks are just one of several ways in which politics and power structures are being renegotiated and Yemen's future is being decided. Given the historical weakness of the country's formal institutions and the strength of its networks of power and patronage, the inclusive platform offered by the Dialogue to marginalized groups needs to be matched by changes to the underlying, informal power structures that currently make up the regime.

Recommendations

1. **Yemen's transition should be seen in the context of a prolonged process of state formation.** The process of building a stable new political settlement is likely to extend far beyond the framework of the current two-year transition arrangement, requiring sustained and high-level international engagement, including ongoing oversight by the United Nations.
2. **Western governments and the United Nations need to maintain their commitment to previously marginalized social and political actors, beyond the expiry of the transition timeframe.** The presence of women and youth activists alongside traditional social and political forces in the National Dialogue has established an important precedent for broader political inclusion, including elsewhere in the Middle East and North Africa region. Women and youth include a diverse range of political actors, who are nevertheless likely to share a general disadvantage when seeking to compete with established interests in future parliamentary elections. Support for their attempts to create new political organizations or advance their role in existing ones should thus extend over decades, not just the coming years.

3. **Successful elections – if elections are held at all – will not necessarily translate into an immediate sense of improved legitimacy, and policy-makers therefore need to prepare for future political unrest.** The powerful interest groups that were central to Saleh’s regime are likely to do well in future elections, and their subsequent disposition to embrace – or block – change will be just as important as during the transition.
4. **Western governments, Gulf donors and international aid agencies need to focus their planning on scenarios in which Yemen becomes significantly poorer and hungrier.** Food security should remain a high policy priority. The most likely outlook is that the hoped-for structural reforms will not take place and that non-state actors will continue to broker power at a local level. International governments and organizations should build contingency planning into their long-term operational and country strategies, with the aim of mitigating worsening humanitarian conditions in the future.

II. Understanding Yemen’s political economy

Yemen’s political economy is built around a small elite drawn from the military, tribes, political class and private sector. Saleh’s patronage system was built on rents from oil exports and access to the newly liberalized economy. Around 10 key families and business groups with close ties to the president control more than 80 per cent of imports, manufacturing, processing, banking, telecommunications and the transport of goods.

During the 2000s, a new generation of ‘inheritors’ began to emerge within the elite, and competition for inward investment began to intensify as oil production fell. Saleh’s son, Ahmed Ali, offered nominal support to a group of young technocrats who advocated modest reforms – such as civil service job cuts, reducing diesel subsidies and a general sales tax – that might ease the transition to a post-oil economy, but they encountered repeated resistance to implementing these reforms from vested interests, including Ahmed Ali’s rivals.

The substructure of Saleh’s political economy has remained largely intact throughout the transition, with all evidence pointing to internal ‘rebalancing’ between elite beneficiaries as opposed to radical change. Elite rivals drew on their respective patronage networks and personal resources to confront one another during the 2011 uprising. In accepting the terms of the transition deal at the end of that year, they demonstrated a collective interest in protecting their personal wealth and coming to an agreement that was – initially, at least – likely to preserve their common advantage.

Yemen’s future depends on whether its elite remains more concerned by the threats posed by rival factions within the elite, or prioritizes its response to popular anger arising from the failure to allocate resources more widely. The National Dialogue contains the potential to lay the groundwork for a more inclusive and accountable political configuration that initiates a parallel transformation in the political economy over time. However, the extent to which the Dialogue’s recommendations will be implemented is still uncertain, while established political parties look set to dominate the next parliament, thus making it harder for new ‘outsider’ factions to enter the established parliamentary game.

Recommendations

1. **The Friends of Yemen and the ‘G10’ – a diplomatic group based in the capital Sana’a, comprising France, the United Kingdom, the United States, Russia, China, the UN, the EU and the Gulf states – need to mainstream political economy analysis as a tool for maximizing their collective leverage for structural change.** They can do so in part by improving their understanding of elite incentives and exploring new ways of promoting change. Understanding the informal networks and family and business interests that link key elite players is vital to assessing the likelihood of success of formal institutional and constitutional reforms such as federalism, or a stronger parliamentary system, that have the potential to widen the distribution of power and the basis of future political mobilization.

2. **Further research is needed to understand the impact of the transition process on the political economy.**

Western donors and the World Bank should commission a dynamic, interactive study capable of tracking changes to the substructure of the regime during the course of the transition period and beyond. This study should also consider the impact of longer-term social and economic trends.

3. **Yemen's emerging political leaders and youth activists need to be better enabled to contribute to the international policy debate about their country, given the importance of international actors there and the impact of international shifts in the global political and economic scene.** They already hold detailed mind-maps of the informal relationships that underpin elite networks and structure the political economy, and have important critiques to make of enduring elite patronage networks. These tend to be expressed in different frameworks and terms from those used by international institutions and Western governments, which now need to capture and incorporate them in their own planning to assist Yemen.

III. International factors and strategic implications

Security interests have shaped the strategy of Western and Gulf governments in Yemen over the last decade, including the effort to support a controlled transition in 2011. The threat of Al-Qaeda has led the British, US and Saudi governments to prioritize counter-terrorism operations, despite their distorting effects on Yemen's political dynamics. While military assistance has historically grown far more rapidly than development aid, Al-Qaeda is not the greatest threat to the country's stability, and the support of local elites – including President Hadi – for US drone strikes on alleged Al-Qaeda targets risks further undermining the government's legitimacy.

International actors' capacity for collective bargaining is weakened by their tendency, at times, to pull in different directions, because of the differing priorities that exist at a country level, and different agendas within individual countries' agencies. Yemen's status as a 'frontline state'

in the war on terror and categorization as a 'fragile state' have pushed it up the international agenda and led to an increase in aid flows. However, prioritization of short-term security goals, failures in development approaches that have discounted the domestic political context, and global systemic factors such as the liberalization of international capital movements have undermined efforts to reform the country's political, as well as economic, system.

Despite significant international aid pledges made to Yemen during the transition, low state capacity, elite resistance and factional rivalries are hindering the disbursement process. The Friends of Yemen – a group of more than 20 countries, comprising Western and Gulf donors – have pledged \$8.1 billion in development and humanitarian aid since President Hadi's appointment, of which \$1.8 billion has been disbursed. Saudi Arabia is the largest bilateral donor, followed by the United States, but disagreements continue between Yemenis and donors over distribution procedures and related governance reforms.

Elite competition in Yemen is incentivized by capital flight. The country was the world's fifth largest source of illicit capital outflows among Least Developed Countries between 1990 and 2008, with \$12 billion leaving the country. A growing literature examines the negative effects of illicit capital flows, which facilitate corruption while diminishing incentives to build strong institutions and invest equivalent sums in the domestic economy. The perception that stolen sovereign wealth often ends up in foreign bank accounts or in property located in tax havens that are influenced by or associated with Western governments is a source of some anger in the Arab world, and has been articulated in Egypt and Libya as well as in Yemen.

International aid flows to Yemen are dwarfed by outward capital flows, with tax havens facilitating capital flight.

For every dollar spent on aid in Yemen between 1990 and 2008, another \$2.70 left the country. Successful efforts to curb illicit financial flows from fragile states depend on a wider reform of the international tax system and international monitoring of capital movements. However, donors'

deliberations on reform in fragile and conflict-affected states have often remained isolated from discussions of the impact of these international systemic issues on the objectives promoted in individual states.

Failure to achieve significant reform in the oil-based patronage system represents the greatest risk to a successful outcome for the transition and has set Yemen on the path to economic collapse. In December 2012, President Hadi's government agreed a greatly enlarged state budget, despite facing a rising balance-of-payments deficit resulting from falling oil production. If successive governments continue postponing essential economic reforms, Yemen is likely to become increasingly dependent on foreign aid, in particular on direct budgetary support from Saudi Arabia.

Across the Middle East and North Africa, contested and sometimes violent processes of negotiating new bases for political legitimacy, economic policy and greater equality will form the dominant story of the coming decade. Yemen's transition takes place at a time of broad uncertainty over long-term Western strategy and engagement across the region, as well as growing pressure on the levels of Western aid spending in so-called fragile states. Political and economic grievances articulated by protesters remain unresolved, and while policy-makers struggle to interact with such fluid and diverse movements, new approaches to diplomacy will make them more alert to the potential for change that such movements can provide.

Recommendations

1. **Western and Gulf donors need more effective strategic planning to reconcile the differences and trade-offs between short-term security and counter-terrorism priorities and longer-term political and economic development objectives.** The impact on local political legitimacy and consent needs to be understood as central to a successful security strategy for Yemen. This includes assessing the efficacy of security measures – including drone strikes – in terms of their overall impact on the local legitimacy of Yemen's government.
2. **Western donors need to widen the scope of their political economy analysis to address the interaction between domestic and international factors that facilitate and incentivize corruption and governance weaknesses in Yemen, in line with the latest OECD recommendations.** This includes examining the role of global tax havens as a 'pull' factor for capital flight. Despite the obvious challenges involved in tracking illicit financial flows, further research is also needed to identify specific patterns of capital flight from Yemen.
3. **Prime Minister David Cameron should continue to highlight tax compliance during the United Kingdom's final months as G8 president, and ensure that all British dependencies keep pace with UK reforms.** Tackling illicit financial flows from fragile states to tax havens depends, in part, on new global standards of information-sharing, in which fragile states can participate. The revised global development framework to replace the Millennium Development Goals (MDGs) from 2015 onwards should also highlight the need for international tax reform and combating illicit capital flight.
4. **A public advocacy campaign is needed to help emerging political leaders and youth activists in Yemen participate in the global debate about corruption, capital flight and international tax reform.** Western civil society organizations supporting political inclusion in Yemen should broaden their agenda to facilitate policy dialogue on questions of tax transparency, and should help campaigners to develop their own policy messaging targeted at Yemeni elites and the government, as well as international actors.

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The Chatham House Yemen Forum is a global policy consortium which brings together a dynamic group of stakeholders, including politicians, aid practitioners, academics and diplomats. The collective knowledge and influence of Yemen Forum members raise awareness, share expertise and support the formation of policies that address the causes of conflict, poverty and poor governance in Yemen. The Yemen Forum also builds strategic relationships to sustain support for change, working closely with international governmental and non-governmental organizations, governments and Yemeni civil society activists.

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