Economic Diversification in the GCC: Past, Present, and Future

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ECONOMIC DIVERSIFICATION IN THE GCC

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Economic Diversification in the GCC: The Past, the Present, and the Future

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EXECUTIVE SUMMARY

The Gulf Cooperation Council (GCC) growth model has delivered strong economic and social outcomes over several decades. GCC economies rely on oil as the main source of export and fiscal revenues. Over the years, GCC governments have increased public sector employment and spending on infrastructure, health, and education. This has helped raise standards of living and support private sector activity, particularly in the nontradables sector.

The current growth model has weaknesses, however, and increasing economic diversification is paramount. Greater diversification would reduce exposure to volatility and uncertainty in the global oil market, help create private sector jobs, increase productivity and sustainable growth, and establish the non-oil economy that will be needed in the future when oil revenues start to dwindle.

A number of policies have been adopted to diversify the GCC economies and reduce their reliance on oil. A stable, low-inflation economic environment has been achieved, the business climate has been strengthened, education has been expanded, trade and foreign direct investment (FDI) has been liberalized, and the financial sector deepened. National development plans are being implemented with a view toward boosting the human capital of nationals, and developing new industries and services that can employ high-skilled labor. Nevertheless, to date these diversification strategies have yielded mix results. The share of non-hydrocarbons output in GDP has increased steadily but is highly correlated with oil prices, and progress with export diversification, a key ingredient to sustainable growth, has been more limited.

International experience shows that diversifying away from oil is very difficult. Success or failure appears to depend on the implementation of appropriate policies ahead of the decline in oil revenues. Malaysia, Indonesia, and Mexico perhaps offer the best examples of countries that have been able to diversify away from oil, while Chile has had some success in diversification away from copper. In addition to creating a favorable economic and business environment, these countries focused on export diversification and quality upgrading by encouraging firms to develop export markets and by supporting workers in acquiring the relevant skills and education to boost productivity.

Going forward, diversification in the GCC will require realigning incentives for firms and workers. At present, the distribution of oil revenues within the economy crowds out non-oil tradables production. Producing nontradables is less risky and more profitable for firms because they can benefit from the rapid growth in government spending, while the easy availability of low-skilled, low-wage foreign labor has helped extract larger rents. The continued availability of public sector jobs discourages nationals from pursuing entrepreneurship and private sector employment. In addition to measures that improve the business environment, there is a need to fundamentally alter these incentives—to fill a “missing link” in current policies. Measures could include reorienting public spending, strengthening the role of private sector competition, developing backward and forward linkages across sectors with a comparative advantage, and implementing labor market reforms to incentivize private sector employment of nationals and improvements in productivity.
INTRODUCTION

The Gulf Cooperation Council (GCC) economies have evolved significantly over the past decade, but further diversification is important. The GCC countries have been implementing many policies to support economic diversification, including reforms to strengthen the business environment, develop infrastructure, increase financing for companies (particularly small and medium-sized enterprises (SMEs)), and improve educational outcomes. While the share of non-hydrocarbons output in GDP has increased steadily, export diversification has been more limited. Further diversification would make these economies less reliant on volatile hydrocarbon revenues, would create high-value-added private sector jobs for nationals, and would establish the non-oil economy that will be needed when oil reserves are eventually exhausted.

International experience, however, shows that diversifying away from oil is very difficult. A number of key obstacles often hinder diversification, including the economic volatility that is induced by reliance on oil revenues, the corroding effect that oil revenues have on governance and institutions, and the risks that oil revenues lead to overvalued real exchange rates (traditional Dutch-disease issues). Success or failure appears to depend on implementing appropriate policies well ahead of the decline in oil revenues. There are few relatively successful diversification cases (Indonesia, Malaysia, Mexico), but many examples of failure.

While the GCC does not appear to suffer from traditional Dutch-disease problems that afflict many commodity-producing countries via an overvalued real exchange rate, the distribution of oil revenues within the economy may crowd out non-oil tradables production in other ways. The ready availability of low-wage expatriate labor in the region has meant that high oil revenues and oil wealth have not pushed up wages in the private sector; consequently, conventional Dutch-disease effects have not been evident. However, the distribution of oil revenues does have important effects on the incentive structure in the economy that crowds out non-oil tradables production. The relatively higher wages and benefits available for nationals in the public sector often make it a more attractive employment choice, particularly for lower-skilled workers, compared with the private sector. At the same time, for firms, producing goods and services to meet the consumption and investment needs of the domestic market while relying on low-wage foreign labor is a more reliable income source than attempting to enter riskier export markets. The risk-return trade-off favors the nontradables sector. Improving the business environment, investing in infrastructure, and reducing regulations are very important to spur tradables production, but will not be sufficient unless the incentive structure within the economy, for both workers and firms, is changed.

Reforms are therefore needed to change the existing incentive structure. Nationals need to be encouraged to seek private sector employment and firms to develop business models that have an increased focus on the tradables sector. In this context, this paper sets out the case for export diversification in the GCC, assesses progress to date, and considers the policies that are needed to spur further diversification. It particularly highlights a “missing link” in current policies—the need to fundamentally change the incentive structure of firms and workers.
THE CASE FOR ECONOMIC DIVERSIFICATION IN THE GCC

The GCC economic model relies on oil as the main source of export and fiscal revenues (Figure 1). The government is the dominant force in the economy, receiving oil export revenues and in turn distributing them to citizens. A portion of these revenues is spent directly by the government and provided to citizens through transfers and public sector jobs; another portion is invested in infrastructure and real estate, education, and health; while the rest is saved, including in sovereign wealth funds (SWFs). Most GCC countries have long oil and/or gas production horizons and, consequently, have significant wealth underground as well as saved in SWFs or at the central bank.

This growth model has helped achieve rapid economic development and a significant improvement in social indicators. Over the past decade, the GCC has been one of the fastest-growing regions in the world because it has benefited from rising oil prices; sound macroeconomic policies; investments in health, education, and infrastructure; and reforms to the business environment. Human development index scores have improved substantially, infant mortality has decreased, expected years of schooling have increased; and life expectancy has risen (Figure 2).

Yet, the growth model has weaknesses. Over the past decade, strong GDP growth was supported by rising government spending, financed by rapidly increasing oil revenues. However, with oil prices unlikely to show significant increases going forward, this growth strategy may no longer be viable (Gruss 2014; IMF 2014a). Moreover, even with strong growth, average labor productivity growth has been weak or negative and total factor productivity growth for the overall economy and for the non-oil economy has been negative, with only Saudi Arabia experiencing slightly positive Total factor productivity (TFP) growth in the non-oil sector (IMF 2013).² Indeed, a sectoral decomposition of employment and average labor productivity in Saudi Arabia over the past decade (Fayad and Rasmussen 2012) has found that employment is increasingly shifting toward sectors with relatively low productivity (for example, construction and nongovernment services). Private sector activity has remained concentrated in low-skilled nontradables sectors. These trends contrast with the international growth experience (Box 1).

² The concept of economic productivity refers to how many goods and services workers can produce using available machinery and other capital. For purposes of this analysis, it is used synonymously with the term total factor productivity.
Box 1. The Role of Economic Diversification and Export Quality Upgrading in Sustaining Economic Growth

Empirical studies have documented a strong association between economic diversification and sustained growth for low- and middle-income economies. Higher GDP per capita and lower volatility are strongly positively associated with diversification of output and exports in low- and middle-income countries (Papageorgiou and Spatafora 2012). Diversification in output and exports are closely linked to one another and are considered to be the outcome of structural transformation—the dynamic reallocation of resources from less productive to more productive sectors and activities (IMF 2014b; Lin 2012; McMillan and Rodrik 2011). This transformation involves a reallocation away from agriculture and natural resources and toward manufacturing, as the latter has greater potential for improvements in productivity and upgrading quality. However, as countries become wealthier and reach advanced-economy status, their diversification declines. The decline in diversification at high income levels involves specialization in high-value-added products (Cadot, Carrere, and Strauss-Kahn 2011; Imbs and Wacziarg 2003).

Higher income levels are also strongly associated with export quality upgrading and greater exports sophistication. Exports can provide an important channel for utilizing economies of scale and a path to new technologies and knowledge spillovers (Lall 2000; Santos-Paulino 2002). Lucas (1993) argues that constantly introducing new goods rather than learning only with a fixed set of goods is needed to generate productivity gains and move up the quality ladder. Aghion and Howitt (1992) emphasize the importance of innovation and moving up the quality ladder. To accumulate human capital, boost productivity, and move up the quality ladder on a large scale, the country must be a large exporter. Evidence shows that export quality upgrading is strongly associated with higher per capita income (Henn, Papageorgiou, and Spatafora 2013). Some studies have also found that export sophistication is a major predictor of subsequent growth, even after controlling for initial conditions, institutions, financial development, and other growth factors (Cherif and Hasanov forthcoming; Hausmann, Hwang, and Rodrik 2007).¹

¹ Export sophistication is measured as in Hausmann, Hwang, and Rodrik 2007. The quality of exports is measured as in Papageorgiou and Spatafora 2012.
Figure 1. GCC: Economic Structure

Export Composition of GCC, 2010
- Minerals, crude materials, etc.
- Chemicals
- Manufactured goods
- Food/live animals, beverages, tobacco, animal & veg. oils
- Machinery and transport equip.
- Misc. manufactured articles
- Others

Composition of Real GDP by Sector
- Mining and utilities
- Agriculture, hunting, forestry, fishing
- Manufacturing
- Construction
- Wholesale, retail trade, restaurants and hotels
- Transport, storage and communication
- Other activities

Composition of GCC Labor Market, 2012
- Nationals: Public
- Nationals: Private
- Expats: Public
- Expats: Private

Sources: United Nations Statistics Division; and country authorities.
1 U.A.E. exports excludes re-exports.
2 Kuwait data are 2011; U.A.E data are unavailable for publication.
It is also becoming increasingly expensive for the public sector to employ nationals. The private sector produces to meet the consumption and investment needs of the domestic market, but it employs few nationals. Instead, it depends on low-wage foreign labor. Nationals are employed mostly in the public sector and typically seek an education that prepares them for these jobs. As a consequence, the government wage bill has become large (in percent of GDP). However, with the GCC labor force projected to increase by some 1.2–1.6 million nationals by 2018, it will be difficult for the government to continue to absorb new labor market entrants, and unless the employment of nationals in the private sector increases, unemployment will likely rise (IMF 2013).

The reliance on oil revenues means the GCC economies are exposed to developments in the global oil market. Hydrocarbon prices are volatile and a key source of macroeconomic volatility. With the decline in oil prices in the early 1980s, the GCC countries experienced a long decline in consumption per capita that on average fell by more than 30 percent from the early 1980s peak and returned to the early 1980s level only in the late 2000s as oil prices recovered (Figure 3). This decline and the poor productivity performance caused a substantial decline in relative income—from 4 to 1.5 times the U.S. income per capita in 1980 for most countries to the U.S. levels or below, except Qatar, which fell from 3.5 to about twice the U.S. level, in 2010. During the 1980s, fiscal spending fell in the region and public debt levels increased. With limited alternative sources of revenue, GCC countries are exposed to similar risks as in the early 1980s in the event of a decline in oil prices.

Last, while oil production horizons are long in many GCC countries, oil is an exhaustible resource. Over time, as oil revenues decline, governments will have less ability to provide services to support the economy. Rising employment for nationals in the public sector will consume an increasing portion of the oil revenues, leaving less space for public investment or savings for intergenerational equity. Meanwhile, unless oil exports are replaced by non-oil exports, accumulated international reserves will be depleted owing to large and growing non-oil external current account deficits.

Economic diversification is therefore very important for the GCC countries and this has been recognized in the economic and social strategies in the region (Box 2). First, diversification would reduce exposure of the economies to volatility and uncertainties in the global oil market. Second, it would help create jobs in the private sector that are needed to absorb young and growing working-age populations in the region into the workforce. Given that GCC countries are high-income countries, the private sector will need to create high paying high-productivity jobs in high-value-added sectors to attract nationals. Third, it would help increase productivity and sustainable growth. Fourth, it would help put in place the non-oil economy that will be needed many years down the road when oil revenues start to dwindle.
Box 2. Economic Diversification in National Development Plans in the GCC

Long-range economic and social development strategies in the Gulf Cooperation Council (GCC) countries emphasize the importance of economic diversification. These strategies aim to promote sustainable development, reduce dependence on oil revenues, and increase private sector job creation for nationals (for example, Saudi Arabia's long-term strategy 2025, Vision 2020 in Oman, Vision 2021 in the United Arab Emirates, Vision 2030 in Bahrain, and Qatar National Vision 2030). Economic diversification is considered to be an important stepping stone to achieving all three objectives. In formulating these economic strategies, there is implicit recognition among policymakers that GCC economies are high-income countries already and are unlikely to follow the development trajectory of emerging markets that have diversified their economies by developing low-cost manufacturing sectors. Therefore, sustainable development in the GCC will require economic diversification to create high-paying private sector jobs for nationals in high-value-added sectors.

While some variation exists across countries, economic diversification and development efforts are geared toward boosting the human capital of nationals and developing high-productivity industries and services that require high-skilled labor. Although there is no clear recipe for success, policies being implemented draw on international experience and include the following:

- Stepped-up investments in education, including in science and technology and technical and vocational education
- Development of specific sectors and industries (for example, the financial sector in Bahrain, airlines and logistics in Qatar and the United Arab Emirates, downstream petrochemicals and mining in Saudi Arabia, and the SME sector in Oman and other countries)
- Investments in physical infrastructure, and strengthening of the legal and regulatory environment to reduce the cost of doing business (including through free trade zones)
- Encouragement of entrepreneurship and innovation through improved access to information, communication technology, and finance, and greater spending on research and development-

Export diversification and quality upgrading could be better emphasized in GCC economic strategies. There is limited discussion of diversifying exports per se, and of utilizing export quality upgrading and increasing export sophistication as channels for building relevant human capital and accessing new technologies to increase productivity. Similar to countries that have diversified successfully, this area is especially important to create a growth-enhancing structural transformation and reverse the weak trends in productivity growth.

DIVERSIFICATION IN THE GCC: PROGRESS SO FAR

Non-oil output has increased considerably in the GCC economies since 2000, but progress toward genuine output diversification has been modest. Growth in GCC non-oil output averaged 6.8 percent during 2000–13, and the share of the non-oil sector in total real GDP rose by 12 percentage points to 70 percent, driven mainly by Saudi Arabia and the United Arab Emirates (Figure 4). However, high rates of non-oil GDP growth were primarily driven by concurrent growth in oil prices (Gruss 2014, IMF 2014a). Rising oil prices since 2000 have helped governments finance rapid increases in spending, which has led to strong growth in consumption demand and in the low-
productivity domestic nontradables sector. In fact, regression estimates indicate that the relationship of non-oil GDP growth to oil price growth is five times stronger than it is to oil price levels, implying that progress toward genuine output diversification has been modest.

Despite strong growth in non-oil output, the private sector generated only a limited number of attractive job opportunities for nationals. Between 2000 and 2010, about 7 million jobs were created in the GCC (excluding the United Arab Emirates, for which data are unavailable), of which 5.4 million were in the private sector. Although some variation exists across countries, on aggregate, nearly 88 percent of these private sector jobs were filled by foreign workers (with about 85 percent of them being low skilled), while nationals filled over 70 percent of public sector jobs. Nationals in the private sector are employed in high-paying jobs (for example, financial services) or in supervisory positions in low-productivity sectors (for example, construction, trade, and transportation).

In terms of export diversification, while non-oil goods exports have risen over time, export quality has remained low. Diversification in non-oil exports has progressed; from 2000 to 2013, total non-oil exports (goods and services) rose from 13 to 30 percent of non-oil GDP (Figure 5). This increase largely reflects trends in non-oil exports of goods, which increased from 8 to 23 percent of non-oil GDP over the same period. Within non-oil exports of goods, manufacturing exports (in percent of non-oil GDP) have risen the most in the United Arab Emirates and Saudi Arabia, followed by Oman, and less so in other countries (see Box 3 for a discussion of Dubai’s diversification experience). Except for Bahrain and the United Arab Emirates, manufacturing exports are concentrated in chemicals. This is a concern because the chemicals sector is likely to be oil-related and may not help reduce economic volatility. Along these lines, a measure of export diversification, the Theil index, shows limited progress toward export diversification since 1990; according to this index, export product diversification has increased in the United Arab Emirates and Oman, but Saudi Arabia and Kuwait have witnessed greater export concentration, and Bahrain and Qatar have experienced little change (Figure 6). This is unsurprising, given that oil products continued to dominate the export basket (constituting over 80 percent of total goods exports) and the GCC exports few new non-oil products, making GCC exports considerably less diversified than many other countries.3 Additionally, the increase in manufacturing exports in some countries has not led to

3 The Theil index as applied here is a measure of concentration in a country’s export structure. A higher value represents a more concentrated export structure. According to Papageorgiou and Spatafora (2014), aggregate export diversification can be disaggregated into two distinct dimensions: the extensive margin, which “measures the number of different export sectors,” and the intensive margin, which “represents the diversification of export volumes across active sectors.” For most countries in the GCC, the Theil index appears to reflect the lack of diversification at the extensive margin, given that not many new non-oil export products have been created over the years.
quality upgrading—indicators of export quality have shown only slight improvements in the GCC since the early 2000s, and remain low compared with other regions (Figure 7).

Box 3. Dubai’s Road to Growth and Diversification

Starting with few natural resources, a small population, and limited infrastructure, the Emirate of Dubai has seen remarkable growth and transformation of its economy over the past couple of decades. Dubai’s favorable location in the oil-rich Gulf region, its tradition of openness to trade, and capital and labor inflows—both skilled and unskilled—have served the economy well. Dubai has built a modern infrastructure and instituted a business-friendly environment and regulations to promote the city as a trade and finance hub in the region. It launched projects in aluminum (DUBAL, now part of Emirates Global Aluminum), transportation (Emirates Airlines and two large airports), trade (Jebel Ali Port), finance (Dubai International Financial Center), and tourism (more than 500 hotels). During 2000–13 real GDP grew on average by about 9 percent per year, compared with a GCC average of 5.6 percent. In the early to mid-2000s trade, construction and real estate, transportation and logistics, and finance were fast-growing sectors, while manufacturing, transportation and logistics, and tourism led growth during and after the financial crisis of 2008. Exports (including re-exports) grew very strongly, by an average of 30 percent from 2000 to 2011, as the economy developed.

While Dubai has successfully transformed itself into a modern economy, challenges remain. Despite high growth rates in the 2000s, productivity has not grown and labor productivity declined during the real estate boom. The major explanation of low productivity gains is the concentration of economic activity in sectors with limited productivity growth, such as tourism, retail trade, and construction. Further, despite diversifying more successfully than many other oil exporters, exports are concentrated in gold and jewelry as well as tourism and transportation services, and despite strong growth are insufficient to cover imports. Exports of services in the United Arab Emirates (data are not available for Dubai) have been rising due to tourism and transportation and logistics, but the net services balance has been in deficit since 1990.

What lessons can be learned from the experience of Dubai for the rest of the United Arab Emirates and the GCC at large? Its business-friendly environment, light regulations, modern infrastructure, and efficiency in project implementation showcase Dubai as a model for the region. However, replicating the same model to create financial, trade, tourism, transportation, and logistics hubs in a limited geographic region may be difficult for the whole country and its Gulf neighbors.
Services exports have also stagnated. An alternative to developing high-value-added manufacturing exports may be to develop high-value-added services exports. However, overall services exports for the GCC have stagnated as a share of total non-oil output, despite some growth in services exports for Oman, Qatar, and the United Arab Emirates from a very low base. In the other countries, the ratio of services exports to non-oil GDP increased initially, but then declined after 2006. These trends in services exports reflect limited services trade, where the GCC is ranked as having the highest Trade in Services Restrictions Index in the world.4

Diversification in other areas has been mixed. Financial diversification has increased, but progress on the fiscal side has been less evident (see Box 4).

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4 See the World Bank, Services Trade Restrictions Database.
**Figure 6. GCC Exports: Share of Manufactures and Trends in Export Product Diversification and Export Quality**

**Breakdown of Merchandise Trade: Manufactures**
(Share in Total Exports, 2012 or latest year available)

**Export Diversification: 1962 versus 2010**
(Index; a decline over time denotes diversification)

**Export Quality: 1986 versus 2010**
(Index; a decline over time denotes deteriorating export quality)

Sources: Export Diversification and Quality Dataset (IMF Data Mapper); and World Trade Organization, Country Trade Profiles database.

1/ Manufactures refer to iron and steel, chemicals, other semi-manufactures, machinery and transport equipment, textiles, clothing and other consumer goods (according to the WTO’s International Trade Statistics definitions).
Figure 7. Export Quality Ladders across the GCC

Sources: IMF, Export Diversification and Quality Dataset.
Box 4. Financial and Fiscal Diversification in the GCC

The main text focuses on output and export diversification. This box briefly considers financial diversification and diversification of government revenues. Financial diversification—the investment of government savings in a diversified portfolio of assets to finance future government consumption—can help generate income flows that can help mitigate the economic volatility associated with government reliance on volatile commodity revenues. Fiscal diversification involves increasing taxes and fees on the non-oil sector to reduce the reliance on oil revenues for financing spending.

**Financial diversification in the region has increased as governments have saved part of their rising oil revenues overseas.** Total gross international reserves topped $906 billion by end-June 2014, about 55 percent of the region’s GDP (up from $75 billion or 20 percent of GDP in 2000). Further, the combined assets of the GCC’s Sovereign Wealth Funds stood at an estimated $2.4 trillion (as of July 2014, according to the Sovereign Wealth Fund Institute). These accumulated foreign financial assets provide important diversification to the asset portfolio of the region and provide income flows denominated in foreign currency. Little information is available on the asset or currency composition of these assets.

**Diversification on the fiscal front has been less evident.** While GCC countries have run large budget surpluses and accumulated sizable fiscal buffers, the dependence on oil receipts as the prime source of revenue remains. Oil-related receipts continue to dominate budget revenues in the GCC (almost 80 percent of total revenue in 2013). Although non-oil revenue remained largely unchanged as a share of non-oil GDP at about 20 percent, its share in total revenue fell from nearly 30 percent in 2000 to 22 percent in 2013. This has occurred despite flourishing non-oil sector growth, due to the existing tax structures across the GCC, which do not tax much of these activities.
POLICIES TO SUPPORT DIVERSIFICATION IN THE GCC

The GCC countries have been implementing policies to support economic diversification for many years. These policies have focused on providing a stable macroeconomic environment; strengthening the business environment; investing in infrastructure, education, and skills; targeting the development of specific sectors; and promoting entrepreneurship through SMEs. Yet the experiences of other oil-exporting countries show that it is very difficult to diversify economies that rely on oil, particularly if the oil production horizon is long (Box 5).

Macroeconomic Stability

GCC countries have achieved strong growth combined with relatively low inflation. Although the volatility of inflation has been low, the volatility of growth has been more elevated (Figure 8). This is partly explained by the volatility of government spending, which is quite high. Comparing fiscal outcomes in the GCC and emerging and developing Asia, the latter has seen higher real growth in fiscal spending with lower volatility. Espinoza and Senhadji (2011) estimate long-run fiscal multipliers for non-oil GDP in the GCC in the 0.3–0.7 range for current expenditure and 0.6–1.1 for capital spending, suggesting a significant growth impact from fiscal expenditure volatility.

Business Environment

A number of policies and initiatives have been implemented in recent years to improve the business climate across the GCC. Wide-ranging reforms have streamlined the legal and regulatory environment in a number of areas, including start-up and licensing procedures for businesses, competition policies, investor and consumer rights, and bankruptcy and company laws. Financial market infrastructure has been enhanced to improve credit information and transparency in financial markets. A number of policies geared toward the support, development, and promotion of SMEs have been enacted (for example, through extending affordable bank sector loans, loan guarantees, feasibility studies, and establishment of a national fund for SME development in Kuwait).
Box 5. Experiences with Diversification in Oil-Exporting Countries

Achieving economic diversification in oil-exporting countries is a difficult task. Diversification strategies implemented in many countries have not been successful, and historical experience offers few examples of countries that have been able to successfully diversify away from oil, particularly when their oil production horizon is still long. A number of key obstacles often hinder diversification, including the economic volatility that is induced by the reliance on oil revenues, the corroding effect that oil revenues have on governance and institutions, and the risks that oil revenues lead to overvalued real exchange rates (traditional Dutch-disease issues). Success or failure appears to depend on the implementation of appropriate policies ahead of the decline in oil revenues. Many oil-exporting countries (for example, Algeria, Congo, Ecuador, Gabon, the GCC countries, Nigeria, Venezuela) have had limited success in diversification. On the other hand, Malaysia, Indonesia, and Mexico perhaps offer the best examples of countries that have been able to diversify away from oil, while Chile has had some success in diversification away from copper. These successful commodity-exporting countries are similar to successful non-commodity-exporting countries in that they followed export-oriented development strategies (in the case of Mexico, helped by its close proximity and relationship to the United States).

While each country followed its own path, a number of common themes are evident in diversification successes. First, diversification took a long time and took off only when oil revenues began to dwindle. For example, Malaysia started its export-oriented strategy in the early 1970s and experienced rapid growth in export sophistication in the 1980s–90s. It took more than 20 years to reach a level of sophistication comparable to some advanced economies. Second, successful countries focused on creating incentives to encourage firms to develop export markets and to support workers in acquiring the skills and education to get jobs in these new expanding areas. In addition to focusing on creating a stable economic environment and a favorable climate for doing business, the incentives entailed the following:

- Making investments in high-productivity industrial clusters, even when no prior comparative advantage existed. The early experience of Malaysia, Mexico, and Indonesia showed that import substitution or reliance on labor-intensive manufacturing led to inefficient firms with limited scope for income and productivity gains. These countries changed their approach and, despite starting from a low technology base, increased their export sophistication (Figure) by focusing on specific manufacturing clusters that led to an upgrading of technology. Chile used export subsidies and public-private partnerships to establish new firms and upgrade technical skills in specific sectors.

Box 5. (concluded)

- **Developing horizontal and vertical linkages from industrial clusters.** Creating networks of local suppliers around existing export industries can expand the employment potential of a given sector, although care should be taken that the local source sectors are efficient and do not lead to a loss in competitiveness. Malaysia entered downstream and upstream activities based on rubber and palm oil to build linkages with the rest of the economy and upgrade research capabilities and technology. Mexico developed linkages around the automobile sector.

- **Using foreign capital to promote technological transfer.** In the 1980s Indonesia attracted foreign capital through the creation of free trade zones, the provision of tax incentives, and the easing of tariff restrictions and nontariff barriers. Similar policies were implemented in Malaysia and Mexico. In Mexico, accession to NAFTA played an important role in attracting foreign direct investment that facilitated the development of the automobile sector.

- **Using export subsidies, tax incentives, and access to finance to facilitate risk taking by entrepreneurs, especially SMEs.** The bigger the technological push in entering a new sector, the bigger the risk for private sector firms (Rodrik 2005; Lin and Chang 2009). To some extent, export subsidies and tax incentives can help reduce the risk for entrepreneurs in infant industries. In addition, financing and support provided by development banks, venture capital funds, and export promotion agencies can also reduce risk. Chile provided financial assistance to SMEs and monitored their performance through a specialized development agency. Malaysia also focused on SME development. In these countries, export subsidies and tax incentives were paired with measures to hold firms accountable for their export performance.

- **Making investments in training to ensure the availability of high-skilled workers.** Creating industry clusters necessitates human capital and skills relevant to the sector, along with required infrastructure and industrial facilities. For instance, Malaysia and Mexico focused on training workers and upgrading their skills, and sponsoring workers for foreign training. Over time, these training investments paid off in terms of building a high-skilled workforce.

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1 See Cherif and Hasanov (2014).
The business climate in the GCC is relatively favorable, yet challenges remain. In the Global Competitiveness Report 2014–15, the United Arab Emirates is ranked as the 12th most competitive economy out of 144 countries, followed by Qatar (16th) and Saudi Arabia (24th), with Bahrain, Kuwait, and Oman also ranking among the top 46 countries. Similarly, rankings by the World Bank’s Doing Business Indicators are also strong. Nevertheless, some common challenges remain across the GCC including contract enforcement and the resolution of company insolvency, especially in Saudi Arabia and the United Arab Emirates (efforts to address these issues are under way in Saudi Arabia). More generally, businesses across the GCC report restrictive labor regulations, an inadequately educated workforce, inefficient government bureaucracy, and, to some extent, lack of access to finance as key factors inhibiting private sector activity.

Trade and Foreign Direct Investment

GCC economies have taken a number of measures to promote trade and liberalize foreign direct investment. Efforts have included the creation of free trade zones in the United Arab Emirates, and the establishment of the GCC Free Trade Area with a common external customs tariff in 2003. A GCC Customs Union is envisioned to enter into force beginning January 2015. Prior to that, the GCC also participated in the Pan-Arab Free Trade Area. Beyond the Middle East region, the GCC has been discussing free trade agreements with the European Union and India, although an exact timeline for their implementation is not clear. GCC countries are also expanding transportation networks, unifying technical standards, and harmonizing and reducing custom administration procedures and clearance requirements. Dedicated export promotion entities have been established to help companies export their products (for example, the Export Development Authority in Saudi Arabia and an Export Development Center in Bahrain). The Saudi program provides insurance and credit facilities to exporters.

The environment for exporters has improved in the GCC, yet intraregional trade within the GCC remains limited. In comparison with dynamic emerging market and developing countries EMDCs, the number of documents required to export is relatively lower in Qatar, Saudi Arabia, and the United Arab Emirates, but is higher in Bahrain, Kuwait, and Oman. Exporting costs have risen at a slower pace than in other countries. The GCC boasts a strong network of trade and transport-related infrastructure, but similar export structures and a lack of product complementarity have held back intraregional trade. Within the broader Middle East and North Africa (MENA) region, shortcomings in trade-related infrastructure and access to finance are also likely to hamper intraregional trade.

A sizable share of FDI inflows into the GCC has not been associated with improvements in export quality and sophistication. Based on available sectoral FDI data, some 20 percent of FDI inflows to Saudi Arabia (in 2010) were concentrated in the chemicals and refined petroleum products activities, and another fifth went to construction. In the United Arab Emirates (2011) one-fifth of FDI inflows targeted the construction sector, another one-fifth targeted the finance sector, and 10 percent targeted wholesale and retail trade (and in Qatar only 4 percent went to trade-related activity in 2011). FDI in these sectors, while welcome, has not led to technology transfers that could support increased export quality or sophistication.
Education

GCC countries have made significant advances in education in recent years, but more needs to be done. School enrollment and literacy rates have increased and are now at high levels. Average adult and youth literacy rates are over 90 percent and 97 percent, respectively, comparable to some European economies. A number of countries have established universities, colleges, and academic and technical institutes (some with a focus on scientific and technological research areas), while some governments have expanded the size of overseas scholarship programs. However, public spending on education in the GCC as a share of national income (2004–13) averaged 3.9 percent, relative to an average global spending ratio of 4.6 percent. Further, aggregate years of schooling and enrollment rates in early childhood education are still low in relative terms, while standardized test scores (Trends in International Mathematics and Science, TIMSS) reveal a comparatively low level of academic achievement. While it will take time for investments in education and skills to yield dividends, the effectiveness of increased expenditures in these areas needs to be carefully monitored. To the extent that industrial clusters are being developed, targeted investments to address skills shortages among the nationals may also be useful.

Industrial Policies and Clusters

GCC countries have sought to diversify their industrial base and service sectors. The GCC countries have developed oil-related industries, tourism, logistics, transportation, business, and financial services. For example, Bahrain has invested in an offshore financial sector, while the United Arab Emirates and Qatar have developed airlines and logistics with the former developing into a major trade and services hub in the Middle East. Saudi Arabia is developing industrial and economic cities to promote technology and industrial and service clusters around oil and mining. Kuwait is developing downstream oil industries and Qatar has established industrial cities to house a mix of energy-related industries to help integrate upstream and downstream hydrocarbon activity. Hvidt (2013), however, suggests that while the investments in chemicals and energy-intensive sectors like aluminum have helped diversify production and exports, industries have few links to the rest of the economy. Local sourcing of tradables has not been developed, and most of the complex technology is still imported because investment in research and development is low (Figure 9). As a result, the productivity gains and spillovers have been limited and the employment impact of these capital-intensive industries is small.
A MISSING LINK—CHANGING THE INCENTIVES OF FIRMS AND WORKERS

As discussed in the previous section, governments in the GCC have followed most of the policies that are commonly thought to be needed to support strong, sustained, and diversified economic growth. A stable, low-inflation economic environment has been achieved, the business climate has been strengthened, trade and FDI have been liberalized, the financial sector deepened, and the importance of education emphasized. Yet these policies have not been sufficient to create a dynamic tradables sector and spur diversification in the presence of high and long-lasting oil revenues. In addition to addressing remaining weaknesses in the business environment, more needs to be done to create the incentives for firms and workers to invest and work in the higher-value-added areas of the tradables sector.

The presence of oil revenues may crowd out the production of non-oil tradables goods and services. This crowding out is important because the non-oil tradables sector will not develop to eventually replace oil when oil resources deplete in the future. The GCC countries do not appear to suffer from traditional Dutch-disease problems that hold back the development of the non-oil tradables sector because the ready availability of low-wage expatriate labor in the region has meant that high oil revenues and oil wealth have not pushed up wages in the private sector and, consequently, conventional Dutch-disease effects have not been evident. However, the distribution of oil revenues does have important effects on the incentive structure in the economy, which crowds out non-oil tradables production. First, for domestic firms, the availability of government contracts in the non-traded sector provides a means of realizing healthy profits at relatively low risk compared with gearing business plans toward export-oriented activities. Second, for national workers, the relatively higher wages available in the public sector are a more attractive employment choice, particularly for the lower skilled, than private sector options. Indeed, these two effects on the incentive structure have historically been self-reinforcing. The lack of high-paying jobs in the private sector means that young people have an incentive to get an education that is suited to employment in the public sector, while the lack of nationals with the skills needed for the private sector combined with an immigration system that may discourage high-skilled expatriate labor has left firms unable to produce the higher-value-added tradables goods that can compete internationally.

The GCC economic model rewards firms that produce in the nontradables sector. Producing in the tradables sector is typically more challenging and riskier because firms have to continually invest in new technologies to be internationally competitive; albeit, it can enable them to grow faster if the domestic market size is small. In the GCC, producing nontradables is less risky and more profitable for the following reasons:

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5 Dutch disease, that is, the crowding out of the nonresource tradables sector, represents a suboptimal equilibrium in the presence of such externalities as learning-by-doing in the tradables sector, even in the absence of uncertainty (see Krugman 1987).
Rapid growth in government spending on infrastructure and wages has contributed to strong growth in low-value-added sectors such as construction, trade and retail, transport, and restaurants. Producing goods and services to meet the consumption and investment needs of the domestic market has so far been a reliable income source, made possible by recycled oil revenues. This has provided incentives for economic activity to shift into mostly low-skilled sectors, contributing to declining labor and total factor productivity. In fact, large infrastructure projects may exacerbate the crowding out of the tradables sector as they increase risk-adjusted returns in the nontradables sector.

The availability of low-wage, low-skilled foreign workers has helped firms to extract large rents. Reservation wages of low-skilled foreign workers are often set in their home countries because they have limited bargaining power and mobility in the GCC labor market. The coexistence of large increases in their employment with declining average labor productivity over time suggests that wages for this group of workers may lie below their marginal product, leading to large rents for firms. In equilibrium, this is also consistent with the existence of entry barriers in product and labor markets.

The GCC immigration system does little to attract high-skilled, high-productivity workers. In today’s global economy, high-skilled workers are internationally mobile and countries compete to attract them. The GCC framework of employer sponsorship does little to distinguish between high- and low-skilled workers and provides employers with limited flexibility to attract top talent.

National accounts data support the view that the current GCC growth model results in a highly profitable corporate sector (Figure 10). For five of the GCC countries where data are available, a high proportion of national income, about 75 percent, goes to capital (gross operating surplus) and only a small portion goes to labor (about 25 percent). While oil-exporting countries do typically have a higher share of national income going to capital than other countries given the nature of the oil sector, the GCC countries are still at the high end of this spectrum. Indeed for Saudi Arabia, the share of income going to capital in the non-oil private sector is estimated at 75 percent.

![Figure 10. Nominal GDP, by Income Approach](source)

(Latest available data, Percent of GDP)

Sources: U.N. Statistics, and country authorities.
For workers, the availability of high-paying public sector jobs creates a strong disincentive for nationals to seek private sector employment or become entrepreneurs. High pay and benefits for public sector workers have led to high reservation wages for nationals: average wages in the public sector are often several times those of the private sector, particularly for low-skilled workers (IMF 2013). Nonwage benefits, working hours, and job security are also more attractive in the public sector. An overwhelming majority of nationals work in the public sector in all GCC countries, and public sector hiring has continued at high levels in recent years. The availability of these jobs discourages labor market entrants from pursuing a more risky path of entrepreneurship or employment in the tradables sector, and creates a disincentive for nationals to invest in human capital.

Weaknesses in the quality of education and training systems adversely affect the risk-return trade-off for nationals in seeking private sector jobs. Over the past decade, GCC countries have invested in raising enrollments in primary through tertiary education. However, the quality of educational outcomes has lagged behind other countries (Figure 11). These weaknesses pose an obstacle to workers as they consider making skills investments and to firms as they consider hiring nationals.

CONCLUSIONS AND POLICY RECOMMENDATIONS

Policies to support economic diversification in the GCC have been implemented over many years, and important progress has been made. Efforts to improve productivity, strengthen non-oil private sector growth, and increase diversification should continue with the current priorities focused on the following:
The macroeconomic policy framework—While growth has been strong and inflation low, further refinements to the fiscal and macroprudential policy frameworks could help further reduce macroeconomic volatility (Arvai, Prasad, and Katayama 2014).

The business climate—Remaining areas of weakness, including strengthened abilities to enforce contracts and resolve insolvencies, should be addressed.

Infrastructure investment—Large public investments are being made to develop infrastructure. Care is needed to ensure that this spending is efficient, and that it will help develop and support the tradables sector (Albino-War and others 2014).

Development of SMEs—The continued facilitation of SMEs’ access to finance and other forms of support, especially in tradables and high-value-added industries, are important for further developing this sector.

Trade and foreign investment—The implementation of the Gulf Common Market launched in 2008 (with the objectives of the free movement of factors and production and goods and services), stronger Arab-Arab integration, and further free trade agreements would help strengthen trade. Encouraging FDI to strengthen the manufacturing and technology base is another important element.

Yet, the GCC countries already score quite well on many of these measures on a cross-country basis, and indeed often better than other countries that have been able to achieve a greater degree of economic diversification. The question, therefore, is to what extent will further improvements in the macroeconomic and business environments, and the further development of infrastructure, encourage diversification without a change in the underlying incentive structures of the GCC economies. At present, workers and firms do not have strong incentives to work and produce in the tradables sector. Addressing these incentives is a crucial step—“a missing link”—in encouraging further diversification.

A number of measures could help to strengthen the incentives for, and abilities of, nationals to work in the private sector. These include the following:

Limiting government employment—Firm limits need to be placed on public sector jobs and wages, and it should be clearly communicated to people that they should not expect to obtain a public sector job. Transitioning to a model with smaller public sector employment could be accomplished in the context of a civil service review to ensure that nonessential positions are eliminated as they become vacant.

Strengthening social safety nets—Rather than using public sector employment as a safety net, unemployment insurance and job search support needs to be in place to ensure that those without a job have a minimum income level and the incentives to search for employment. As in Belgium and Germany, vouchers could be used for various training programs,
apprenticeships, and vocational education to support retraining and skills acquisition where needed.

- **Ensuring that the education and training systems provide workers with the skills needed for private sector employment**—Oil revenues can be used to increase investment in education and skills development. Further, improving the quality of schools and universities and creating apprenticeship and vocational programs could provide the relevant skill sets.\(^6\) Improvements to teacher quality and early childhood education can help boost student achievement and change societal attitudes (Dolton and Marcenaro-Gutierrez 2011; Heckman 2008).

**On the corporate side, the experiences of other oil-exporting countries in diversifying their economies point to the usefulness of enacting specific measures to encourage firms to export.** These measures include the provision of export insurance guarantees and financing for those engaged in export activities, as well as other business support services. The development of a venture capital industry has also been successful in some countries. Incubators with university links, coupled with research and development funds, would support the promotion of technology transfer and commercialization. More generally, the government can help foster linkages between state-owned enterprises, multinational companies, and SMEs to promote the development of tradables and exports.

**More important, other factors that may inhibit firms’ incentives to move into tradables production should be identified.** These may include the following:

- **The ability to extract monopoly rents in nontradables sectors.** Indicators suggest that the degree of local competition intensity varies across the GCC, with Qatar, Saudi Arabia, and the United Arab Emirates scoring well, but Bahrain, Oman, and particularly Kuwait doing less so (Figure 12). A review of competition policy law and its implementation, efforts to reduce barriers to trade, and a review of whether government procurement procedures are ensuring an adequate range of companies bidding for government contracts could all help

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\(^6\) More than two-thirds of 15- to 16-year-olds in Switzerland enter apprenticeship programs, while more than half of students in Germany are apprentices (Nash 2012).
increase competition in GCC markets. Interconnectedness of firms may mean that profits derived from government spending are concentrated, creating high barriers to entry for new firms and discouraging these firms from entering risky export markets.

- **The presence of large state-owned enterprises (SoEs) and their wide-ranging mandates.** Many SoEs have been established with the objective of developing particular sectors of the economy and they dominate non-oil exports. With large SoEs dominating entire sectors, barriers to entry may prevent private firms from competing on a level playing field. Diversification could benefit from reducing barriers to competition (Figure 13) and integrating the private sector, particularly through backward and forward linkages in upstream and downstream input industries. In addition, limiting the current reach of SoE activities and enforcing competition policies can further incentivize the private sector and attract FDI and technology into the expansion of the non-oil tradables sectors.

- **The ability to pay less than domestic market wages to expatriate workers under the sponsorship system.** Allowing greater mobility of foreign workers, which is under way in some countries, will ultimately result in their wages increasing and the wage differential with nationals narrowing. This result will reduce incentives for low-productivity production and increase incentives for hiring more-skilled workers and investing in technology to help boost productivity.
## Annex I

**Country Groupings Used in Figure 13**

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<th>GCC</th>
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ECONOMIC DIVERSIFICATION IN THE GCC

