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The Political Realities of Economic Reform in the Gulf Monarchies

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In a nutshell

- *Economic diversification in the Gulf Cooperation Council monarchies requires labor market reforms.*
- *The current conventional wisdom, from international institutions at least, requires recommends reducing citizen employment in the public sector, cutting wage differentials between the public and private sectors, and improving citizen education.*
- *In this Policy Brief I argue that these steps will fail in the absence of serious steps to address prevailing low wages for less-skilled labor in the Gulf economies. It is not politically feasible to push low or modestly skilled citizens onto the low-wage private sector job market. Given the overwhelming preference of employers for foreign labor the only real alternative for most Gulf regimes is to bifurcate the job market, creating enclaves where citizen labor can be used productively. This requires, first and foremost, strong state institutions capable of fairly and consistently imposing labor market regulations on businesses.*
- *The creation of these institutions is the central challenge facing GCC states in their efforts to make productive use of citizen labor.*

About the author

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1. Introduction

There is no doubt that Gulf labor markets pose an obstacle to economic reform in the Gulf. The reforms proposed by institutional institutions, however, often do not adequately take into account the political realities that led to the creation of the Gulf's labor markets.[1] It is not politically feasible for the Gulf regimes to cut public sector jobs, and public sector pay, while preserving a private sector job market in which the private sector has little incentive to hire citizens instead of abundant and very low-wage foreign labor.

The political realities facing reform efforts are shaped by the three primary economic constituencies in the Gulf monarchies: the citizen middle class, businesses, and expatriates. The fortunes of all three depend, in the end, on the distribution of oil wealth by the regimes. Like regimes leaders everywhere, the rulers of the Gulf monarchies want to avoid serious domestic and international challenges to their rule, and target budget cuts accordingly. Of the three main economic constituencies, the citizen middle class poses the greatest threat to the regimes because a wholesale alienation of citizens invites a replay of the Arab Spring. Expatriates pose the least threat. Business owners are important to regime leaders because they are often members of the ruling families or otherwise closely linked to the regimes. The political influence of business, however, is less than it otherwise might be because businesses employ few citizens and pay few taxes. This makes for a potentially sharp conflict of interests between business owners and the citizen middle class.[2]

Options

The regimes have five main options to avoid budget deficits in the face of lower oil prices:

- Spend down reserves / borrow money
- Reduce spending
- Redistribute rent income via taxation
- Use existing rent income more efficiently through reforms to the non-tradable part of the economy
- Nurture economic sectors not dependent on oil, and then extract revenues from these sectors via taxation

I begin by addressing the distributional consequences, and efficacy, of the first three options; I then examine in more detail the labor market implications of reforms for the tradable and nontradable sectors.

Borrowing and spending reserves: Prudence suggests that a fall in the price of oil that is persistent over time be dealt with by measures other than spending reserves and borrowing. Saudi Arabia's substantial foreign assets give the regime some time — though a finite amount of time — to adjust to lower oil prices.

Taxation: In some contexts it makes sense for the Gulf states to recapture oil rents from the economy via taxation. A tax on undeveloped land encourages the building of houses while affecting mostly the better-off; a VAT taxes foreigners and wealthy citizens in addition to the citizen middle class; and a tax on foreign labor raises revenue and makes citizen labor at least marginally more competitive with foreign labor. But an income tax on citizens who work for the public sector, as the vast majority do, is an accounting gimmick, a wage cut by a different name.

Budget cuts: Because public sector employment is the lifeblood of the citizen middle class, we can expect that the regimes will cut salaries and employment only as a last resort. Foreign labor in the public sector, however, is a prime target for budget cuts, as can be seen with the recent layoff of 5000 workers by the (state-owned) Abu Dhabi oil company.[3] The Gulf states have taken serious recent steps to reduce subsidies.[4] Many of these cuts are designed to cushion the impact on citizens: it is now common in the Gulf for there to be two separate electricity tariffs, one for citizens and one for foreigners.

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[1] Reda Cherif and Fuad Hasanov, "Soaring of the Gulf Falcons: Diversification in the GCC Oil Exporters in Seven Propositions," in Breaking the Oil Spell: Gulf Falcon's Path to Diversification (Washington, DC: International Monetary Fund, 2016); Staff of the IMF, "Economic Diversification in Oil-Exporting Arab Countries," April 2016, http://www.imf.org/external/pp/longres.aspx?id=5038; Tim Callen et al., "Economic Diversification in the GCC: Past, Present, and Future," IMF Staff Discussion Note, December 2014, http://www.imf.org/external/pubs/cat/longres.aspx?sk=42531.0.

[2] Michael Herb, The Wages of Oil: Parliaments and Economic Development in Kuwait and the UAE (Ithaca, NY: Cornell University Press, 2014).

[3] For coverage of steps taken by the Gulf states to deal with budget issues, see "Gulf Economic Barometer," Arab Gulf States Institute in Washington, n.d., http://www.agsiw.org/gulf-economic-barometer/.

[4] International Monetary Fund, "Energy Price Reforms in the GCC — What Can Be Learned From International Experiences?," Gulf Cooperation Council: Annual Meeting of Ministers of Finance and Central Bank Governors, November 11 ,2015 ,10.

The Gulf monarchies spend a great deal on capital infrastructure (or "projects"). While the end result mostly benefits citizens, the immediate beneficiaries are contractors and foreign labor. In Saudi Arabia especially, spending on projects has fallen sharply — and rather than canceling projects in an orderly manner the government has simply stopped payment to contractors, who then do not pay their foreign labor. And thus foreigners bear the brunt of falling oil prices.

Increase non-tradable efficiency

While the Gulf economies ultimately depend on oil, increasing the efficiency of the non-tradable sector — that is, the production of goods and services that cannot affordably be imported — offers a strategy for making the most of finite hydrocarbon revenues. One easy target is the removal of monopolies that allow privileged businesses to reap substantial rents from consumers. This is hard to do, of course, because those who benefit tend to be well-off and well-connected, but Qatar recently lifted monopolies on the import of a wide range of consumer goods.

The most important area of potential increased efficiency lies in the use of citizen labor. One way to accomplish this is to replace foreign labor with citizen labor in the public sector. Beyond this, however, the current structure of labor markets in the Gulf states does not encourage the productive use of citizen labor in any sector of the economy. In the public sector, citizens are hired as a method of distributing oil revenues. The relatively high wages paid to most Gulf citizens — especially in the richer rentiers — have little relationship to labor productivity. Private sector employers typically hire citizens only when obliged to by government policy, and even then often do not make much effort to put citizen labor to productive use. There are thus high obstacles, imposed by the market and by political reality, to increasing the productivity of citizen labor.

Labor costs in the private sector are already very, very low, due to the presence of millions of foreign workers whose reservation wage rates are set by their home economies. In some respects reliance on foreign labor is expensive. Much of the wage bill for foreign labor immediately leaves the economy in the form of remittances, and is gone for good. And each foreigner imposes costs on the state in the form of infrastructure, subsidized services, and the like. The upside of foreign labor is clear: cheaper goods and services. Replacing foreign labor with citizen labor in the private sector is not an easy path toward increasing efficiency in the non-tradable sector of the economy or addressing budgetary shortfalls.

Diversification with whose labor?

The Gulf monarchies can address their budget problems by encouraging productive economic activity beyond the export of crude hydrocarbons, then taxing that activity. In the long run this is necessary to sustain living standards. The central question of Gulf diversification, though, is whether it will be citizens, or foreigners, who provide the labor in the diversified sectors of the economy. There are roughly four option in this regard.

One approach, which we can call the Dubai strategy, is to fully embrace the use of low cost foreign labor to build a diversified economy. This economy is then taxed, producing revenue that can be distributed to citizens via public sector jobs (though citizens today primarily rely on the state's oil income). The Dubai strategy, not surprisingly, requires plentiful foreign labor: in the UAE today the ratio of non-citizens to citizens is in the neighborhood of 8 to 1. The diversified economy is low-wage, making any future transition to the use of citizen labor unlikely. The long term problem with this strategy is political: it makes citizens a small but very privileged minority in their own country, living on the tax revenues generated by millions of resident non-citizens.

A second strategy is to reduce the number of citizens employed in the public sector and cut the wages of those who remain. The hope is that citizens, in need of income, will enter the private sector job market.

This strategy is a favorite of international institutions.[5] But the strategy is very unlikely to work, except for the most educated citizens, if cheap foreign labor remains abundant: instead, citizens will simply leave the labor market, sit at home, and reflect on how they are not receiving their fair share of their country's oil wealth. Education is not the solution, except at the margins: there needs to be a place in the labor market for less well educated Gulf citizens. In countries that still enjoy substantial oil wealth, reducing the standard of living of unskilled citizen workers to that of laborers from some of the world's poorest countries is simply not a politically sustainable option.

A third strategy is to rely only on citizen labor. This is no more likely to be adopted than the second strategy. Nonetheless it is worthwhile, as a thought experiment, to consider the consequences this strategy as a way of illustrating the complex interactions between labor markets, diversification, budgets, and political constraints:

- Foreign workers lose their jobs and labor exporting countries lose remittance income.
- Local economies retain money that would have left as remittances.
- The state saves money that is currently spent on foreigners in the form of infrastructure, health care, policing, subsidies, and the like.
- The economy contracts sharply.
- Businesses, by necessity, raise wages enough to attract citizen labor.
- The cost of non-tradable goods and services increases sharply.
- Citizen labor is used productively in the private sector.
- Businesses seeking to produce tradable goods have a citizen labor force available that is expensive, but also productive.

The upside of this strategy is that the private sector would have no choice but to put citizen labor to productive use in the nontradable sector of the economy. And citizen labor that is productive in the private sector might also develop the skills necessary to produce non-energy exports as well. Moreover, the positive effect on the budget would lengthen the time that the Gulf regimes would be able to live off existing oil wealth. The negative effects fall on foreigners and businesses; the citizen middle class also would see a very sharp increase in the price of services.
The fourth strategy, and the one most likely to be pursued by the Gulf regimes (apart from the UAE and maybe Qatar) is a variant on the third. Instead of relying only on citizen labor, the regimes segment the private sector labor market, reserving some areas (usually sectors, or professions) for high-cost citizen labor, and other sectors for low-cost foreign labor. This achieves some of the positive aspects of the third strategy while avoiding the cataclysmic negative effects.

The strategy requires a very strong administrative apparatus that rigidly maintains the boundaries between sectors reserved for citizens and those open to expatriates. In the absence of strong institutions, politically connected businesses circumvent the rules and hire foreign labor wherever and whenever possible. This results in further distortions to the labor market and the creation of even more rents for the politically connected: it also does little to address budgetary problems, or to use citizen labor productively. Seriously pursued, however, this is the most politically feasible solution to the labor market problems faced by the Gulf monarchies.

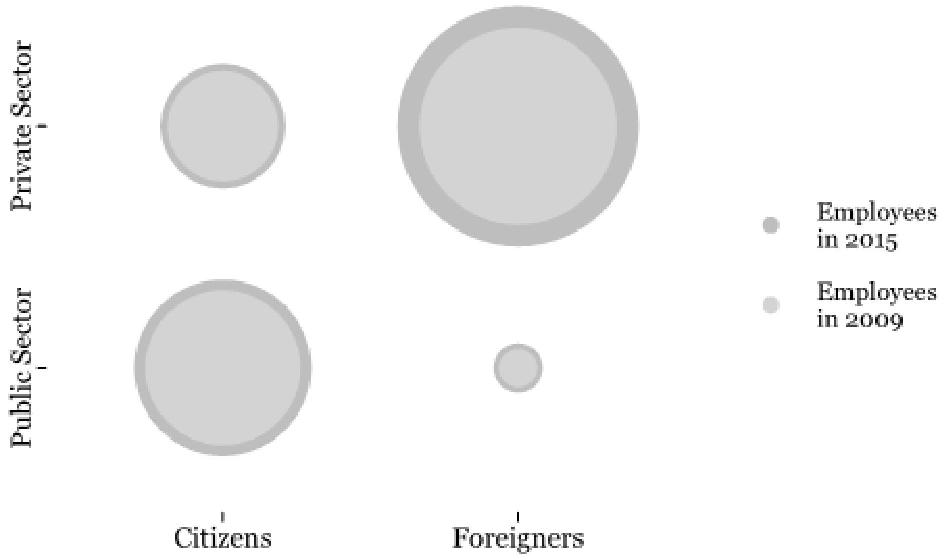
The key measure of the success of this strategy is the ratio of citizens to foreigners in the labor force. In recent years, however, across the Gulf monarchies the number of foreigners in the private sector has continued to rise, as has the foreign share of the workforce.

Conclusion

In the long term the only permanent solution to lower oil prices is the production of non-hydrocarbon tradable goods and services in the Gulf economies.

[6] For example, IMF Country Report 251/15, Saudi Arabia 2015 Article IV Consultation page 19.

Figure 1: Saudi employment by sector and citizenship, 2009 and 2015.



Notes: Circle sizes are proportional to the number of workers.
Source: Jadwa Investments, February 2016, Labor Market Update, p7.

This can be done with citizen labor, or without. The Gulf economies need to either adopt the Dubai model, with its political risks, or find ways to put citizen labor to work in productive ways in both the non-tradable and tradable sectors.

The UAE will follow the Dubai model: it has successfully created a diversified non-hydrocarbon economy centered in Dubai, using low cost foreign labor, and it is hard to see how it can easily change course. The rest of the Gulf monarchies are attempting to move citizens into the private sector labor market, mostly by forcing businesses to hire citizens in contexts in which businesses would prefer to hire foreigners. These efforts are undermined by the fact that the Gulf monarchies have had only very limited success in reversing the long-term trend toward the domination of their labor markets by foreign labor.

Policy recommendations

1. Labor market issues must be put at the center of efforts to deal with lower oil prices in the Gulf monarchies.
2. As Gulf states move to reduce spending, they must respect the contractual rights and humanitarian needs of foreign labor.
3. The Gulf states — the UAE and Qatar in particular — should seriously consider the political dilemmas created by diversifying their economies using large amounts of low-cost foreign labor.
4. The Gulf monarchies with relatively less oil wealth per capita — Oman, Bahrain and Saudi Arabia — are not likely to be able to follow the Dubai model, and thus in the long run will need to restructure their economies to rely on citizen labor in the private sector. The key measure of their success is the ratio of citizens to foreigners in the private sector job market.
5. Forcing the private sector to use citizen labor requires a highly developed administrative apparatus that prevents politically linked businesses from substituting foreign labor for citizen labor. The most important step that the Gulf monarchies can take to address their labor market problems, in the long run, is to develop this administrative capacity.

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