THE NEW GEOPOLITICS
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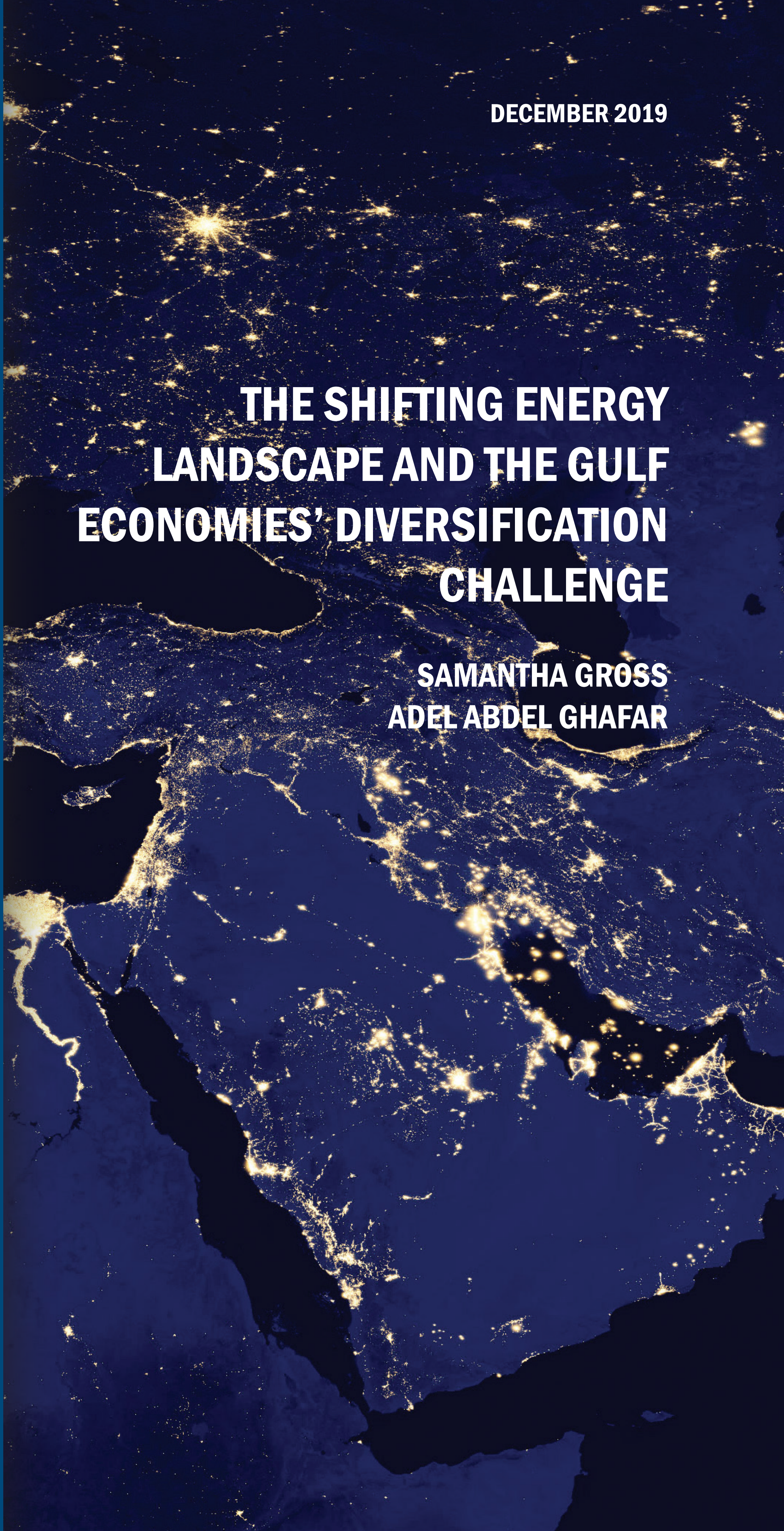

THE SHIFTING ENERGY LANDSCAPE AND THE GULF ECONOMIES' DIVERSIFICATION CHALLENGE

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B | Foreign Policy
at BROOKINGS

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EXECUTIVE SUMMARY

The hydrocarbon-dependent countries of the Gulf Cooperation Council (GCC) face challenges in adjusting to the new reality in energy markets. Increased oil and gas production in the United States and growing concern about climate change mean that their hydrocarbon revenues are likely to decline over the long run. At the same time, growing populations and a rentier social contract make declining revenues a challenge for governance and stability. Governments in the region share oil wealth with their citizens through a large and well-paid public sector and through very low prices for energy.

Each of the GCC countries is working to diversify its economy away from oil dependence and to increase the private sector's share of the economy. However, the high capital productivity of the energy sector makes diversification difficult and government investments often crowd out the private sector investment they are trying to encourage.

The urgency of reform is not consistent across the GCC. Kuwait, Qatar, and the United Arab Emirates have the strongest economies in the region. They have large resources and small populations, leading to very high levels of hydrocarbon exports and reserves per capita. With less of an existential threat, reform is focused on continuing growth and providing a diverse and vibrant economy for their citizens. Saudi Arabia, Bahrain, and Oman face deeper challenges. Saudi Arabia has vast petroleum reserves, but its large and diverse population means that its reserves and revenues are relatively small on a per capita basis. Saudi Arabia also faces the challenge of providing meaningful employment for a significant youth bulge – 40% of its population is under 25. Bahrain and Oman have much smaller reserves and revenues and face declining production. They also both face political challenges in enacting reform, although of a different nature in the two countries.

Across the GCC, continuing investments in education and human capital, and increasing the role of women in the economy, could pay dividends. Additionally, increasing the role of the private sector in these public-sector dominated economies is crucial. Establishing public private partnerships and privatizing some public assets are good places to begin.

INTRODUCTION

The global market for oil and gas is changing. Only a few years ago, the notion of peak oil and gas supply and the inevitability of skyrocketing oil prices was popular in certain circles. Today, there is a general recognition that the oil age will not end because the world runs out of oil, or even out of inexpensive oil. Instead, the concern today is about peak oil demand, with many forecasts placing the peak sometime in the 2030s. Greater end-use efficiency and the world's response to the dangers of climate change are likely to reduce demand for oil and gas over time, with a greater impact on the consumption of oil. Demand is likely to reach a plateau and decline slowly after that time, rather than declining quickly, but the change still has important implications for the hydrocarbon-reliant economies of the Gulf Cooperation Council (GCC).

In addition to the coming decline in demand, GCC countries are facing more competition than in the past. Oil and gas production in the United States skyrocketed over the last decade. The United States is now a net exporter of natural gas[1] and recently became the world's largest oil producer.[2] The technology that produced the U.S. boom — horizontal drilling combined with hydraulic fracturing — has the potential to be applied in other areas as well. Recent events in oil markets demonstrate the new reality. Disruptions to supply from Iran, Libya, and Venezuela have had little upward effect on oil prices, as short-cycle oil from the United States has filled the supply gap and concerns about economic growth have kept a lid on prices.

Given that the production costs of GCC oil producers are among the world's lowest, oil markets are likely to become more dependent on them in a world of declining oil demand, as higher-cost producers are pushed out of the market. [3] This is cold comfort for the GCC, however, as this lower-demand, low-price world means lower resource rents to fund GCC governments. Furthermore, even steady resource rents would not be enough, as population growth and greater government largesse require ever-growing revenues. Regardless of short- and mid-term fluctuations in energy prices, in the long term GCC countries will need to fundamentally reform their economies. Such reforms are likely to have a significant impact on state-society relations and overall governance in the GCC.

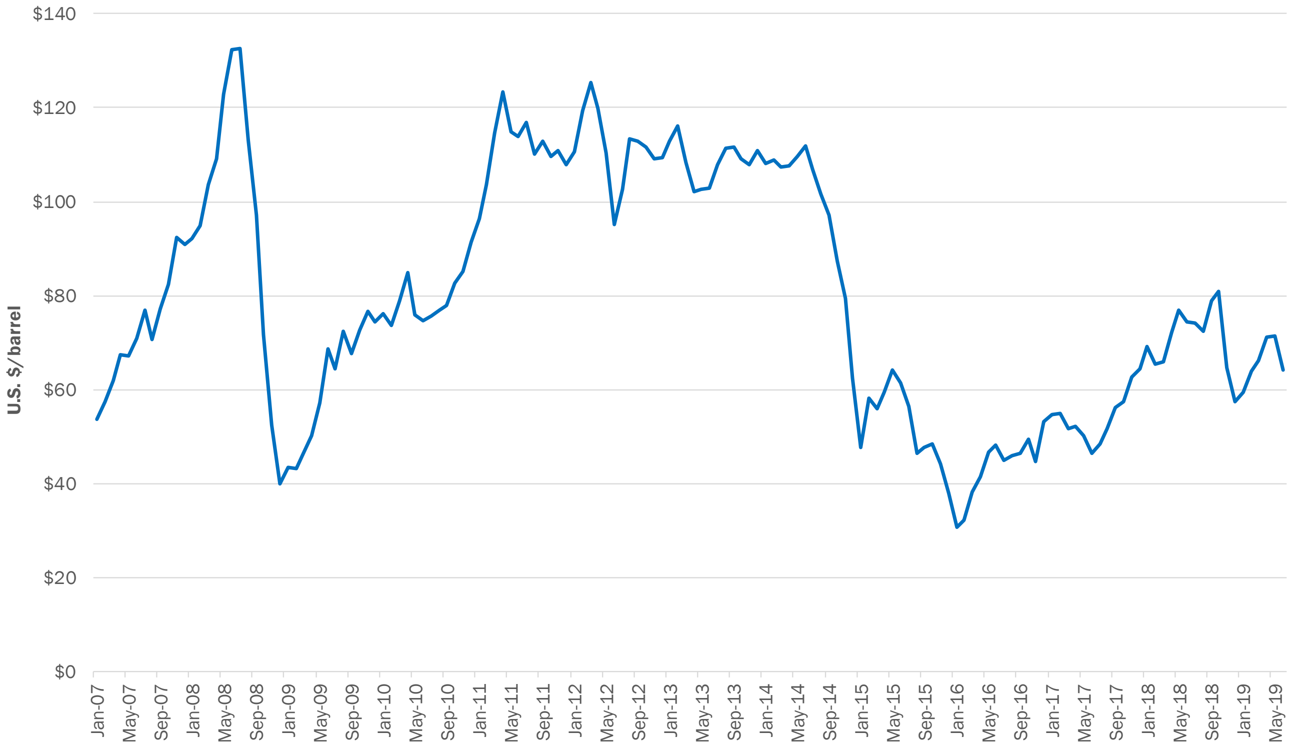
COMMON CHALLENGES AND STRATEGIES AMONG GCC COUNTRIES

In preparing their economies for a world with lower oil rents, the six countries of the GCC — Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE) — face several common challenges. They have long had a rentier social contract with their citizens, with the implicit bargain that citizens exchange some political rights for a share of energy wealth. However, economic diversification requires governments to act as economic enablers, rather than providers, to avoid crowding out private investment and set up a structure where private industry can succeed.

Over the past decades, economic downturns and collapses in oil prices have put pressure on GCC economies. Continued demographic pressures, geostrategic uncertainty, and the most recent downturn in oil prices have made the need for diversification even more clear. Earlier this decade, oil prices rose sharply to recover from the drop that occurred amidst the 2008 financial crisis, reaching well over $100 per barrel at times in 2011 through 2014.[4]

Oil revenues for GCC countries expanded exponentially and governments increased their expenditures year after year, investing in large-scale infrastructure projects, enhancing the welfare system, and raising public sector employment. This trend continued until the end of 2014 when oil prices and GCC government revenues collapsed.[5] Budget deficits and foreign exchange reserves suffered. However, since prices rose again in 2016, governments are tempted to sideline diversification efforts, particularly if they are unpopular.

FIGURE 1: BRENT CRUDE OIL PRICES



Source: U.S. Energy Information Administration.[6]

One way that GCC countries distribute oil rents to their people is through large and well-paid public sectors, both government and government-owned enterprises. The most important business sectors — oil and gas production, electricity, transportation — are dominated by government-owned enterprises. More than half of employed GCC citizens work in the public sector, up to 84% in Qatar and 78% in Kuwait.[7] Jobs in the public sector are generally more attractive than those in the private sector, with higher pay, shorter hours, and better job security. With growing populations in need of employment and the potential for reductions in resource rents over time, maintaining this level of public employment will be unsustainable. However, making cuts in public employment is much more difficult than cutting budgets through delaying or cancelling capital spending.

Subsidies are another way that the GCC countries distribute oil rents. Prices for fuel and electricity in the GCC are among the lowest in the world. Additionally, much of the water supply in the GCC is desalinated seawater. The oil-powered desalinization process means that these countries are, in a sense, turning oil into water. This is costly, especially considering the opportunity cost of selling the fuel onto the global market, but consumers do not pay the full costs.

The GCC countries have also undertaken some common strategies to diversify government revenue. Each has adopted five- or 10-year national plans focusing on economic liberalization, establishing a knowledge-based economy, and limiting oil and gas dependency.[8] Fiscal reforms have included cuts in subsidies, raising water and electricity tariffs, and increasing excise taxes on certain products.[9] All six GCC countries have agreed to implement a 5% value-added tax (VAT). However, only Bahrain, Saudi Arabia, and the UAE have implemented a VAT to date. Kuwait, Oman, and Qatar have delayed implementation.[10]

This austerity-driven reform agenda has had a negative impact on many GCC citizens, who are accustomed to state largesse in return for political acquiescence. In a survey of young Arabs in the GCC, 90% of respondents in Qatar, Oman, and Bahrain, and 86% in Saudi Arabia, wanted subsidy programs to continue.[11] Consequently, to mitigate some of the reforms' effects, several countries initiated cash transfer schemes targeting those most in need. For instance, at the end of 2017, Saudi Arabia established the Citizen's Account Program, and, in 2018, Oman started a fuel support scheme based on income levels. However, such programs faced challenges in identifying and helping those most in need since the governments did not have good information on income levels due to the absence of effective income and asset tax collection systems.[12]

With the exception of Kuwait, the GCC countries have pegged their currencies to the U.S. dollar to improve macroeconomic stability in a world where oil is priced in dollars (the Kuwaiti dinar is pegged to a basket of currencies heavily weighting the U.S. dollar). However, this leaves GCC economies tethered to U.S. macroeconomic and interest rate policy, and has at times required GCC governments to raise interest rates when their own economies could have benefitted from stimulus.

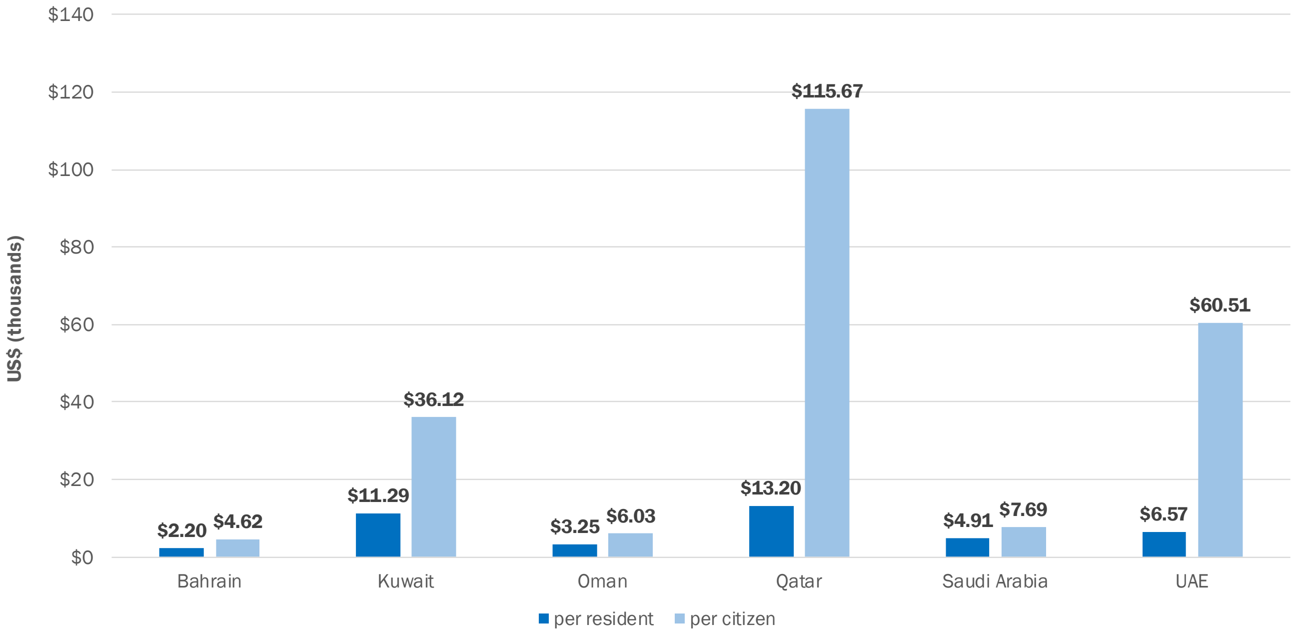
DRIVERS FOR REFORM DIFFER ACROSS GCC COUNTRIES

Clearly, flattening oil demand and lower resource rents pose an existential challenge for GCC countries and provide a strong incentive for economic diversification. However, the urgency of the push for reform differs across countries. Important indicators for reform include resource reserves, such as oil and gas resources and sovereign wealth, and population statistics, including demographics and unemployment rates.

Figures 2 through 4 depict key financial indicators for the six GCC countries. Tables 1 and 2 contain employment and demographic data, respectively. Countries with lower levels of resource reserves face a greater need for diversification, while those with a significant youth bulge must supply meaningful employment for these citizens as they mature. The remainder of this paper draws upon these data to describe the unique situation of each country, and the specific challenges each faces in its journey toward economic diversification.

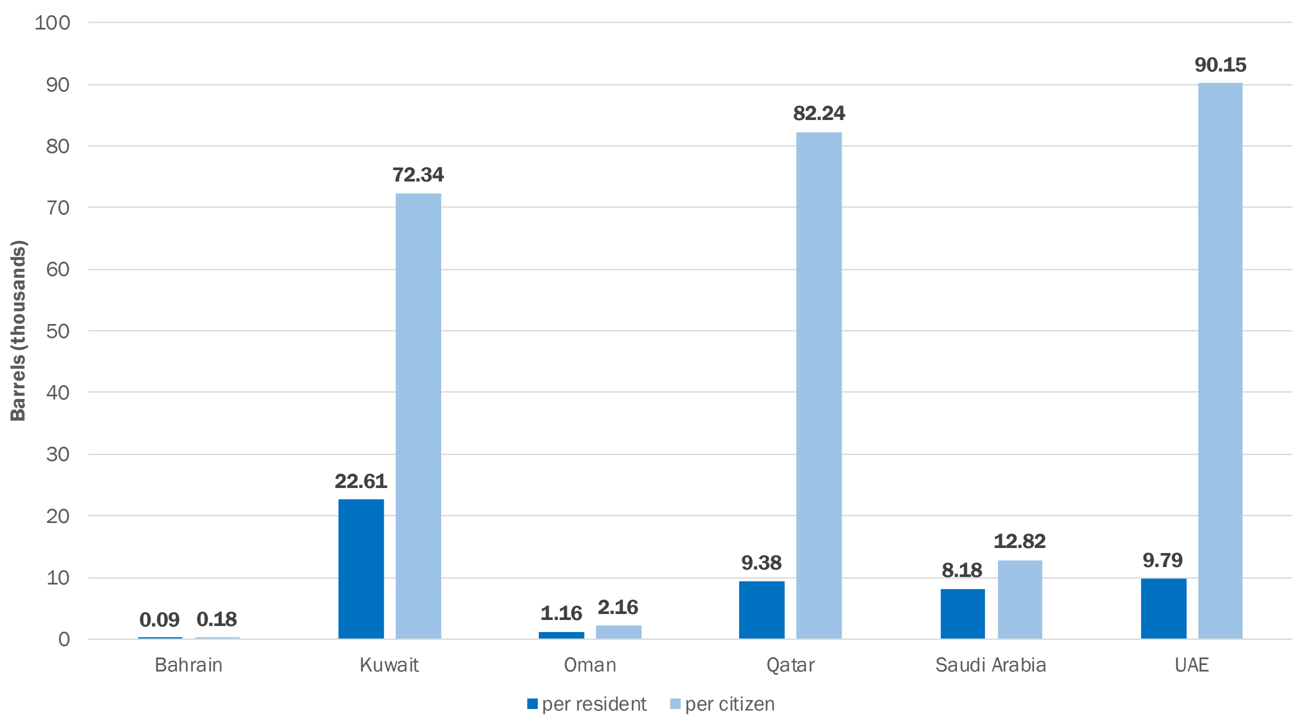
FIGURE 2: 2017 PETROLEUM EXPORT VALUE PER CAPITA

Source: Calculated using data from 2018 OPEC Annual Statistical Bulletin,[13] 2018 BP Statistical



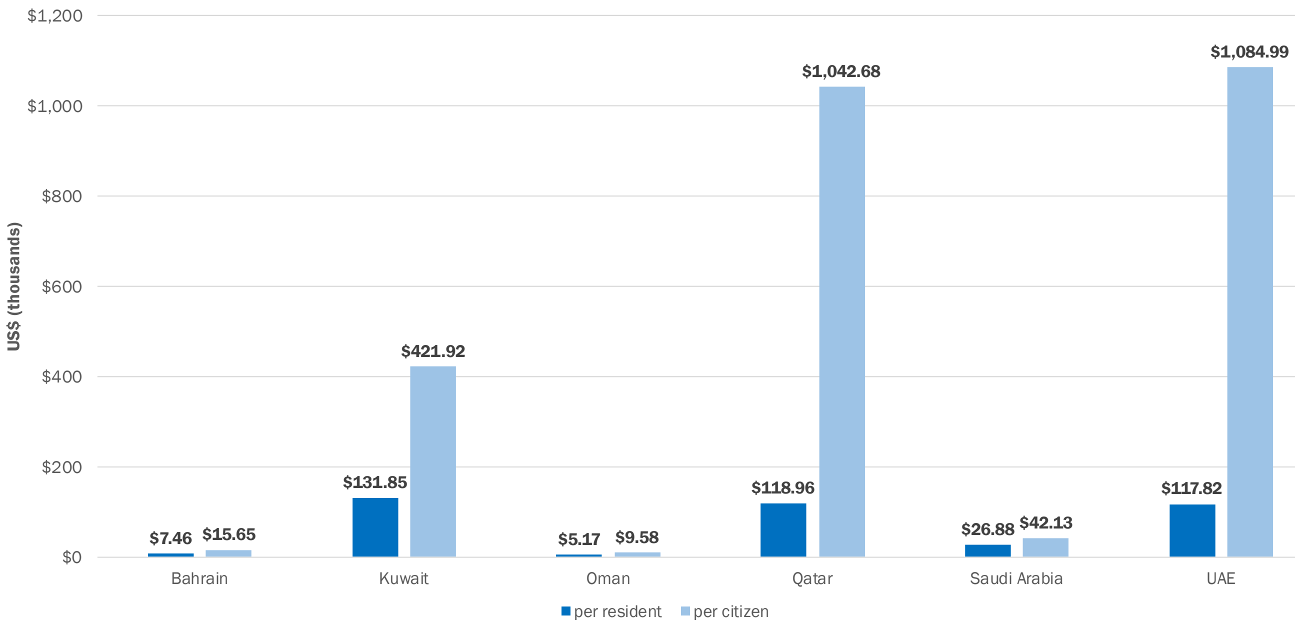
Review of World Energy,[14] Bahrain Open Data Portal,[15] Oman National Centre for Statistics and Information,[16] and Gulf Labor Markets and Migration.[17]

FIGURE 3: 2017 OIL RESERVES PER CAPITA



Source: Calculated using data from 2018 OPEC Annual Statistical Bulletin,[18] 2018 BP Statistical Review of World Energy,[19] Bahrain Open Data Portal,[20] Oman National Centre for Statistics and Information,[21] and Gulf Labor Markets and Migration.[22]

FIGURE 4: 2017 SOVEREIGN WEALTH PER CAPITA



Source: Calculated using data from 2018 OPEC Annual Statistical Bulletin,[23] 2018 BP Statistical Review of World Energy,[24] Bahrain Open Data Portal,[25] Oman National Centre for Statistics and Information,[26] the Sovereign Wealth Fund Institute,[27] and Gulf Labor Markets and Migration.[28]

TABLE 1: UNEMPLOYMENT RATES FOR GCC COUNTRIES, TOTAL POPULATION

	Total	Youth
Bahrain	1.2%	5.3%
Kuwait	2.1%	15%
Oman	3.3%	14%
Qatar	0.1%	0.5%
Saudi Arabia	5.5%	24%
UAE	1.7%	7.7%

Source: World Bank Open Data.[29]

Note: Data are the most recent available for each country – 2018 for Qatar, Saudi Arabia, and the UAE; 2016 for Kuwait and Oman; 2011 for Bahrain.

TABLE 2: 2017 DEMOGRAPHIC DATA FOR GCC COUNTRIES (POP. IN THOUSANDS)

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
0-14	294.4	872.5	1,011.3	366.3	8,288.8	1,306.2
	20%	21%	22%	14%	25%	14%
15-24	200.3	506.3	681.5	392.4	4,886.4	1,069.3
	13%	12%	15%	15%	15%	11%
25-54	872.2	2,391.1	2,642.8	1,731.1	16,750.7	6,512.5
	58%	58%	57%	66%	51%	69%
55-64	90.3	269.8	191.5	115	1,926.9	404.6
	6%	7%	4%	4%	6%	4%
65+	35.4	97	109.2	34.5	1,085.5	107.5
	2%	2%	2%	1%	3%	1%
Total	1,492.6	4,136.7	4,636.3	2,639.3	32,938.3	9,400.1
Citizens	677.5	1,403.1	2,505.4	306.9	20,768.6	1,084.8
	45%	34%	54%	12%	63%	12%

Source: United Nations,[30] Gulf Labor Markets and Migration[31]

LESS PRESSURE FOR REFORM: KUWAIT, QATAR, AND THE UNITED ARAB EMIRATES

Kuwait, Qatar, and the UAE are in the best financial condition of the GCC countries. They are the highest in terms of hydrocarbon export value per capita and reserves per capita. Their strength is particularly apparent in terms of sovereign wealth, where each has more than $100,000 per resident in sovereign wealth funds. In part, their wealth is due to very large resource endowments and relatively small populations.

The resource endowments are even larger when one excludes expatriate workers and only considers citizens. In Qatar and the UAE, expatriates make up approximately 88% of the population and in Kuwait they constitute 66%.

Although these countries have relatively fewer drivers for economic reform, their strong economic position makes reform easier to undertake. With less of an existential threat, reform is focused on continuing growth and providing a diverse and vibrant economy for their citizens.

Kuwait

Oil makes up half of Gross Domestic Product (GDP) in Kuwait and 90% of government revenue and exports.[32] Kuwait's National Assembly is the strongest legislature in the GCC, allowed to draft and approve bills and even override the Emir's veto.[33] The constitution does not allow political parties, and thus individual members of parliament must appeal directly to voters, often through populist messages to improve wages or benefits. Elected representation in government makes economic reform in Kuwait more responsive to popular will and reforms have stalled due to popular and parliamentary opposition.[34]

Kuwait made progress in subsidy reform after the 2014 oil price crash, including reductions in diesel and kerosene subsidies, and increases in prices for gasoline, electricity, and water. In January 2015, fuel prices were linked to international values with periodic revisions. Subsidies declined by nearly half between 2013 and 2016, to $5.3 billion U.S. dollars (USD), representing a decline from 15% of government spending in 2013 to 9% in 2016.[35]

However, since that time the government has attempted to slow down or reverse the reforms and manage their consequences. The government has become more cautious about introducing major reforms that might anger the people, especially since the National Assembly includes popular groups that have been critical of the proposed transformations.[36] Reforms are now mostly targeting benefits to expatriates, rather than Kuwaiti citizens.

When water and electricity tariffs were increased in 2016, Kuwaiti citizens were not affected by the change. Lawmakers amended their original proposal, which would have included nationals, to avoid sparking protests. Instead, the reform targeted businesses and residents of apartments, who were mostly foreigners. In addition, the state reassured the people that it did not plan to introduce individual taxes.[37] The government delayed VAT implementation until 2021.

The government increased fuel and utility subsidies 12.4% for fiscal year 2018-19. Additionally, the Ministry of Finance announced that it will not consider further change in fuel subsidies in the near future without an analytical study of its effects.[38]

In 2017, the government adopted a strategy to increase the percentage of Kuwaitis in both public and private sectors. During the first year, 3,000 expatriates working in the public sector were let go, leaving room for locals. The strategy of terminating foreigners continued over the following years, since the government was not able to create new jobs to increase the share of Kuwaitis. They also adopted stricter restrictions on hiring foreigners. Since these reforms favored Kuwaiti nationals, Kuwaitis welcomed and encouraged them.[39] The government has also made progress on asset privatization efforts, reducing public opposition by allocating a portion of offerings to Kuwaiti nationals. However, the parliament has often moved against efforts to bring in foreign direct investment.

Qatar

Unlike the other GCC countries, Qatar's wealth is primarily in natural gas rather than oil. Qatar has the third largest reserves of natural gas in the world and is the world's leading exporter of liquefied natural gas (LNG).[40] Nonetheless, the prolonged decrease in oil prices since 2014 diminished state revenues. Along with large-scale infrastructure projects in preparation for the 2022 FIFA World Cup, this created a significant budget deficit. Thus, Qatar is under pressure to cut government expenses like the other GCC countries, despite having the second-largest sovereign wealth reserves per capita in the GCC, after Kuwait.

Saudi Arabia, UAE, Bahrain, and Egypt began an economic blockade of Qatar in June 2017.[41] The blockade was ostensibly in protest of Qatar's independent foreign policy, support of Islamist activists around the region, and closeness with Iran, with whom Qatar shares the world's largest natural gas field. To date, Qatar has largely been able to deal with the consequences of the boycott. It dipped into its vast financial reserves to stabilize banks, began producing more goods domestically, and rerouted banking ties and shipping routes. Qatar withdrew from the Organization of Petroleum Exporting Countries (OPEC) at the beginning of 2019, stating that it intended to focus on natural gas, but certainly to distance itself from its Gulf rivals as well.[42] The government has presented the blockade as an attack on sovereignty and the Qatari people, and thus the blockade has rallied the people behind the political leadership.[43]

To deal with its structural challenges, the Qatari government accelerated its plan to hire more Qatari nationals, rather than expatriate workers, and slowed down public sector hiring. For instance, in 2015, around 3,000 foreign workers were dismissed from Qatar Petroleum, the county's energy giant.[44] In the health sector, approximately 1,000 people were let go in 2016.[45] These cuts also affected other major industries like media and telecommunication, damaging the morale of the remaining expatriate community and pushing a number of them to seek employment opportunities outside the country.[46]

Qatar also made efforts to diversify its economy away from oil and gas dependency, encouraging entrepreneurship and private sector expansion, especially after the blockade. The Qatar Development Bank boosted its support to small- and medium-enterprises, providing advisory, training, and financing services. More than 96 percent of the private sector businesses in Qatar are classified as small- and medium-sized enterprises.[47] In addition, some creative microenterprise initiatives arose, including public space commerce, despite the decrease in consumer demand following the economic slowdown. For instance, both nationals and foreigners have appropriated several parks and public spaces as open food halls and flea markets.[48]

The government also adopted a subsidy reform plan to cut government spending. The Minister of Energy and Deputy Prime Minister announced the reform plan in 2015. The government increased water and electricity tariffs and linked them to consumption, increased gasoline prices and established a committee to consider further price adjustments, established a 10-year spending cap, and created a department to manage public investment.[49]

However, while the Qatari economy has been able to weather the crisis in the short term, it remains to be seen how it will fare in the long term if the ongoing crisis continues. Although diversification efforts continue, the economy remains heavily reliant on LNG. As World Cup construction projects are completed, the Qatari economy has begun to slow down. According to Qatar's Planning and Statistics Authority, output excluding oil and gas extraction shrank for the first time since records began in 2012, dropping an annual 1.1% in the second quarter.[50]

While the Qatari government has taken measures to address the economic impact of the crisis, the aviation sector, in particular the national carrier Qatar Airways, has suffered. Recently, the airline reported a loss of $639 million as it grapples with the ongoing embargo which has restricted its air routes and driven up costs.[51] As a national carrier and a symbol for the country, the state will likely continue to heavily subsidize Qatar Airways, but the perpetuation of the crisis will continue to be a drain on the state budget.

United Arab Emirates

The UAE has the most diversified economy in the GCC, but the overall statistics hide differences among the seven emirates. The three largest emirates, Abu Dhabi, Dubai, and Sharjah, have 85% of the nation's population[52] and generate the overwhelming majority of GDP.[53] Abu Dhabi has the majority of oil wealth in the country and Dubai is the country's commercial and tourist capital. Sharjah is an important manufacturing center. Petroleum is the largest sector, making up 22% of GDP in 2017, the lowest share among GCC countries.[54] Strong economic growth in Dubai is leading the diversification, with focus on the construction, manufacturing, transshipment, and financial services industries.[55] The government is also investing heavily in transportation infrastructure and education.

Economic reforms in the UAE started before the 2014 oil crisis, differing across the emirates. In 2011, Dubai increased electricity and water tariffs by 15 to 20% for government, industry, and expat residences. Emiratis there experienced a modest increase in electricity tariffs and a minimal rise in water prices on consumption exceeding 20,000 gallons per month. In Abu Dhabi, water and electricity tariffs also increased, and, most recently, the municipality fees on residential villas were also increased for expat tenants.[56] In response, some citizens turned to social media to express concerns over fundamental changes in their relationship with the state. Dubai began monitoring social media for signs of unrest.[57] However, these concerns did not evolve into something bigger. In July 2015, fuel prices were also restructured by cutting state subsidies, and linking them to international prices with monthly revisions.[58] The authorities introduced excise taxes on certain products like tobacco and soft drinks and the UAE adopted VAT on all consumed products in January 2018.[59]

Economic reforms enacted in 2018 allow foreigners to own 100% of businesses without a local partner. Previously, foreigners could only own a minority share, except in special economic zones where government fees are higher.[60] The UAE ranks 11th in the world in the World Bank's ease of doing business index, the highest rank by far among the GCC countries.[61]

THE CHALLENGE OF A LARGE AND DIVERSE POPULATION: SAUDI ARABIA

Saudi Arabia has the largest oil reserves in the GCC, and the second largest reserves in the world.[62] However, its population of 32.9 million[63] is more than three times the size of any other GCC country, and its per capita oil reserves and sovereign wealth are lower than those of the three countries above.

Unlike Kuwait, Qatar, and the UAE, Saudi Arabia has citizens who are socio-economically disadvantaged. In the last Household Expenditure and Income Survey in 2013, median household income for Saudi citizens was $34,300, and $5,700 U.S. dollars on a per capita basis.[64] The country must also deal with a significant youth bulge — 25% of the population is under 15 years of age and 40% is under 25. Providing meaningful employment for this rising generation will be a difficult task. The youth unemployment rate (among those 15 to 24 years of age) is 25%.

Despite the urgency of economic reform in Saudi Arabia, public opposition has made cost-cutting measures challenging. After the oil price crash in 2014, Saudi Arabia adopted several reforms to cut public spending and limit the budget deficit. The government hired 10,000 fewer public employees in 2015 than in 2014. However, private sector employment suffered even more; companies hired 43,000 fewer Saudis in 2015 compared to 2014.[65] In September 2016, authorities cut financial allowances for civil servants and military personnel, but this angered the public and brought calls for protests. In April 2017, the government backed down and restored the allowances.[66]

Saudi Arabia also adopted subsidy reform similar to other GCC countries, raising gasoline prices and electricity tariffs for commercial and industrial use.[67] Water prices increased by an estimated 500%, according to the Gulf Research Center.[68] In response, Saudis expressed their opposition on social media, and demanded that the government reconsider the change. Following the public complaints, the water and electricity minister was fired, and a cash compensation scheme was developed to support low- and middle-income Saudis.[69]

Saudi Arabia also raised some taxes and duties. *Zakat* is a 2.5% levy on each bank's net worth, collected under Islamic law to be used for charitable and religious purposes. In 2018, the authorities increased *zakat* liabilities, demanding retroactive payments from major banks going back to 2002.[70] The move created major concerns among local banks regarding the damage to their earnings, given that the requested payments exceeded 50% of annual net profits for some banks. Several banks challenged and appealed the government's General Authority of Zakat and Tax assessment and worried that these demands might be a "money grab" to cover the budget deficit.[71]

Apart from cost-cutting efforts, Riyadh in 2016 announced Vision 2030, a sweeping plan to remake the Saudi economy by boosting investment and private industry and increasing innovation.[72] An initial public offering (IPO) of 5% of the state oil company, Saudi Aramco, was a crucial part of the plan, with the proceeds to be deposited in the Public Investment Fund for investment in non-oil industries. Saudi Aramco is the world's most profitable company and even a 5% offering promised to be the largest IPO ever. However, the plan changed from an international offering of 5% to an offering of 1.5% on the local Saudi stock exchange, the Tadawul, which was finalized on December 5, 2019.[73] The IPO has been challenging for the Kingdom, requiring a greater degree of transparency about Aramco operations and revenues than the Saudi government is accustomed to providing. The Kingdom also struggled to reach the valuation they envisioned, given concerns about the security of its facilities after the attack on the Abqaiq and Khurais facilities in September 2019 and the potential for declining oil demand in a world concerned about climate change.

The plan also calls for increased private investment and a larger role for the private sector in the economy. However, a number of recent events may undermine that push. In November 2017, Crown Prince Mohammad bin Salman ordered a roundup of wealthy individuals accused of corruption, including some in the royal family. This anti-corruption purge was intended to consolidate the Crown Prince's power and show the Saudi population that he is willing to hold elites accountable.[74] However, some viewed the action as a shakedown for cash. The murder of journalist Jamal Khashoggi in October 2018 in the Saudi consulate in Istanbul also had the potential to slow down foreign investment in the Kingdom. Additionally, government investments in strategic industries may capture the best opportunities and crowd out private funds.

The reform agenda has been volatile and confusing to Saudis who are witnessing a major recalibration of their relationship with the state. The people were expected to back the government and sustain the newly planned growth away from oil dependency. However, they lacked institutional support, including entrepreneurship training, access to finance, and bankruptcy protection, which prevented many of them from taking the risk of starting businesses.[75] The Saudi government has allowed somewhat more social freedom to encourage the Saudi acceptance of the economic reforms. For example, restrictions have been imposed on the religious police, cinemas were opened, and women are now allowed to drive. Despite these reforms, activists are still jailed for their views, including several women who have been long-term supporters of the right to drive.

THE MOST URGENT CASES: BAHRAIN AND OMAN

Bahrain and Oman have much lower per capita oil reserves and sovereign wealth than the other GCC countries. Nonetheless, the oil and gas sector made up about 75% of 2016 government revenues in both countries. Diversification is already a crucial priority in these nations, as oil production is in decline. Bahrain recently made a huge discovery in the offshore Khalij al-Bahrain field, but this will take years to come online and deliver revenue. Oman is the largest non-OPEC oil producer in the region and is applying advanced recovery techniques and increasing natural gas production to keep hydrocarbons flowing.

In addition to their fiscal challenges, both countries face political challenges as well, although of a very different nature.

Bahrain

The 2014 oil price crash was brutal for Bahrain, crippling the government budget and inducing significant deficit. The political situation in Bahrain has made responding to the crisis particularly difficult. The Sunni Al Khalifa family rules Bahrain, even though the majority of the population is Shia. Saudi Arabia and the UAE deployed troops to respond to mass protests against the ruling family in 2011 during the Arab Spring. Under Saudi Arabia's continuing influence, the government has hardened its stance against the Shia opposition, painting the Shia population as aligned with Iran.[76] Bahrain also depends on Saudi Arabia through Saudi operation of the shared Abu Saafa oil field, a crucial source of government revenue. The ongoing conflict between Bahrain's government and its Shia majority makes austerity measures difficult, lest they add fuel to the fire.

In response to its fiscal challenges, the Bahraini government cut subsidies and increased water and energy tariffs.[77] In 2015, the government removed meat price subsidies and increased industrial gas prices.[78] In addition, taxes were increased to generate larger non-oil revenues.

These austerity measures angered the public and caused a backlash in parliament, which demanded a compensation system for low- and middle-income Bahrainis. As a result, the government could not fully implement other reforms, like introducing VAT, until parliament reached an agreement. The government was stuck between paying allowances to affected Bahrainis, which would further increase the budget deficit, or facing public anger, since the main opposition groups were not part of parliament and were looking for an opportunity to attack the government's decisions.[79]

Other Gulf countries have offered aid packages to bail out Bahrain from its crippling deficit, if the government implements sensitive austerity measures. Kuwait, Saudi Arabia, and the UAE pledged $10 billion in October 2018 to help Bahrain get its fiscal balances in order.[80] The parliament adopted a multi-stage approach to apply such fiscal reforms, so the opposition does not use the austerity program to challenge the government's legitimacy.[81] The bailout has allowed Bahrain to carry out delayed reforms, and it implemented VAT beginning in January 2019.

In terms of economic diversification, infrastructure projects are the focus of reform in Bahrain to stimulate growth in the transportation, real estate, and energy sectors. The GCC Development Fund is focusing its investments on housing, electricity and water projects, roads, and airport modernization. An additional causeway connecting Bahrain with Saudi Arabia is also under consideration, to include vehicle lanes and a railway.[82] Bahrain allows 100% foreign ownership in in some industries and ranks second in the GCC in the World Bank index for ease of doing business.[83]

Oman

Sultan Qaboos has absolute power in Oman, along with an elected Consultative Assembly that has some legislative power. The Sultan is 79 years old and has been in power since 1970, ruling the country since it had only three schools and a few miles of paved roads.[84] He does not have an heir, raising questions about succession. When the Sultan dies, a council of his relatives will meet to choose a successor and the Sultan reportedly has left names in a sealed envelope if his relatives cannot decide. However, many groups will likely try to sway the decision and the new ruler may face challenges in establishing legitimacy.[85]

The government started gradually reducing fuel subsidies following the 2014 oil price crash, and also increased water tariffs.[86] As in other countries, citizens were unhappy with the rise in prices, and on February 2, 2017, hundreds of Omanis took to the streets in the first demonstration since 2011, demanding a stop to fuel price increases.[87] Around 500 people protested in front of the Ministry of Oil and Gas in Muscat, carrying slogans expressing the need to stop petrol price increases and increase salaries. A few days after the protests started, the authorities caved in and capped fuel prices, committing to refrain from further increases. However, they did not promise to return to pre-2014 prices.[88]

The government also slowed public sector hiring to reduce spending. In return, young Omanis queued for the few public employment openings available. In January 2018, hundreds of Omani youth protested unemployment outside the Ministry of Manpower in Muscat.[89]

Overall, the government has kept austerity measures limited to avoid backlash. [90] The country has witnessed several protests against rising living costs, high unemployment, and corruption, which present a significant risk to a government facing an upcoming leadership transition.

Owing to its low level of oil reserves, Oman has prioritized economic diversification since the 1990s. The non-hydrocarbon share of the economy is now around 60%.[91] Oman has focused on requiring companies to hire more Omani workers, rather than expatriates. With 55% of Oman's native population under 25 years of age, finding meaningful jobs, especially in the private sector, for the growing youth population is crucial. In 2016, only 15% of private sector employees were Omani, while about 45% of Omanis worked in the public sector.[92] Oman has a freeze on the hiring of foreign workers in 87 private sector job categories, although there are several loopholes, including for small- and medium-enterprises, and for replacing existing foreign employees.[93]

DIFFERENT SITUATIONS, SAME UNDERLYING CHALLENGE

Reforming and diversifying their economies presents a challenge to all six GCC countries, as it requires a fundamental change in the relationship between governments and their citizens. Citizens have come to expect the government to take care of their needs in many ways, providing well-paying jobs, and low-cost utilities and fuels. In exchange, many citizens have accepted their lack of meaningful representation in government. Can this arrangement hold as governments are forced to reduce their largesse? Already, protests and acts of government oppression show that the relationship is fraying.

All the GCC countries face a challenge in finding meaningful employment for their youth as they enter the job market. In four of the six countries, 20% or more of the population is under the age of 15. These young people are becoming more educated but are not necessarily reaping the employment benefits of that education. For example, the unemployment rate in Saudi Arabia is higher for those with a college education than for those without and is especially high among young college graduates.[94] These young educated people could be drivers of economic change, or drivers of instability.

Economic diversification must focus on investment in areas that provide high productivity and preferably high levels of employment, such as software and technology. However, such investments have a difficult time competing with the energy sector, where capital productivity is very high. The GCC has a competitive advantage in industries, like petrochemicals, refined hydrocarbons, and aluminum, that take advantage of the region's abundant and inexpensive hydrocarbons. However, these industries are more capital intensive than labor intensive, and thus don't ameliorate the employment challenge. The International Monetary Fund found that the knowledge intensity of GCC exports is quite low, while knowledge-intensive industries are associated with higher income levels.[95]

Thus far, the backlash toward economic reform has been smallest in Qatar. However, Qatar is unique for two reasons. Qatar has the second highest per capita income in the world, trailing only Liechtenstein, and the push for reform is less urgent owing to its large gas reserves and small population, meaning that the steps it is taking have less bite. Additionally, the blockade has increased Qatari nationalism and united the population against external enemies, real or imagined.

The Saudis are also making interesting moves to sweeten the deal of economic reform. Saudi Arabia had the most social constraints of any of the GCC countries, with the religious police harassing people deemed to be breaking the country's strict codes of dress, gender mixing, and acceptable conduct. Crown Prince Mohammad bin Salman has loosened these strictures somewhat, allowing more personal freedom and more public entertainment, such as concerts, festivals, and movie theatres. These moves have two motives — to increase public acceptance of the less palatable reforms, and to help keep Saudis within the country during their leisure time, creating jobs. Time will tell how well these trade-offs work, since the country still has a long way to go on its reform path.

RECOMMENDATIONS

Continue Investing in Human Capital

A key pillar of the success of any diversification strategy is continued investment in human capital. Despite massive investments in education, GCC countries, to varying degrees, have not been able to fully reap the benefits of these investments. According to a recent World Bank report, there is a need to accelerate human capital formation in the GCC through the adoption of holistic government strategies to improve educational outcomes.[96]

Expand the Role of the Private Sector

Despite efforts to boost the private sector, economic activity, to a large extent, continues to be dominated by GCC state governments. In the region, the lines between the public and private sectors are blurred, in part because ownership structures overlap. Public sector officials and members of ruling families complicate the entrepreneurial landscape.[97] Because a sizable part of private sector demand is driven by the state, and by the public sector in general, state-driven austerity cutbacks, similar to those Saudi Arabia enacted in 2014, have caused the private sector to contract. The establishment of more public private partnerships and the privatization of some public assets would work towards creating a more robust private sector. If GCC states actively seek to bolster the involvement of the private sector, they could avoid $164 billion in capital expenditures by 2021 in various sectors including utilities, airports, healthcare, and education.[98]

Strength in Unity

Before the blockade of Qatar, the GCC stood as the best example of inter-Arab regional cooperation. In contrast to the defunct Arab Maghreb Union and the ineffective Arab League, GCC member states were able to effectively collaborate on economic and security issues. The GCC customs union and the plan to introduce VAT, in particular, were examples of successful collaboration. The perpetuation of the GCC rift will negatively affect the organization's ability to collectively deal with socio-economic issues. At a geostrategic level, political shifts in the West, China's increased engagement with the Middle East through its Belt and Road Initiative, the ongoing conflicts in Syria and Yemen, and the potential breakdown of the Iran nuclear deal provide increased impetus for intra-GCC dialogue, as well as for coordination with international partners like the United States and the European Union.

Increased Role of Women in the Economy

Marked increases in women's educational attainment in the GCC have not yet translated to higher employment rates.[99] The GCC's female labor force participation continues to be low by global standards, ranging from 22% in Saudi Arabia to 46% in Kuwait and around 46% in the UAE.[100] Affirmative action policies, opportunities for training and apprenticeships, and more flexible working arrangements can encourage further participation of women in GCC economies.

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