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Economic Diversification in the Gulf: Time to Redouble Efforts

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Gulf Arab economies have remained stubbornly dependent on revenues from oil and natural gas despite decades of policy efforts to diversify them. One reason is that past policy efforts have not adequately taken into account the governing social contract. Gulf states pass along natural resource rents to their citizens through three main channels: access to generous public benefits and services; access to high-paying public sector jobs; and access to exclusive government contracts and licenses. Passing along economic rents through these channels has created market distortions that have weakened efforts to develop a competitive private sector capable of generating sustainable economic growth in a post-hydrocarbon future. However, these channels serve a purpose: they allow citizens to access their legitimate share of their country's hydrocarbon wealth and will not be easy to renegotiate even as oil revenues decline. Still, reforms are needed. Future policy efforts should restructure these wealth-sharing channels to make them more transparent, economically efficient, socially equitable, and considerate of the financial constraints that Gulf states are facing.

Key Recommendations

- **Improve the sustainability of public services:** Gulf states should grant purveyors of public services greater financial autonomy and ensure their sustainability. They should encourage citizens to fund social services through private non-profit initiatives and endowments (awkaf).

- **Better regulate public enterprises:** Gulf states should limit the operation of public enterprises to specific sectors. They should establish a firewall between public enterprises and regulatory agencies. State support to public enterprises should be transparent and clear.

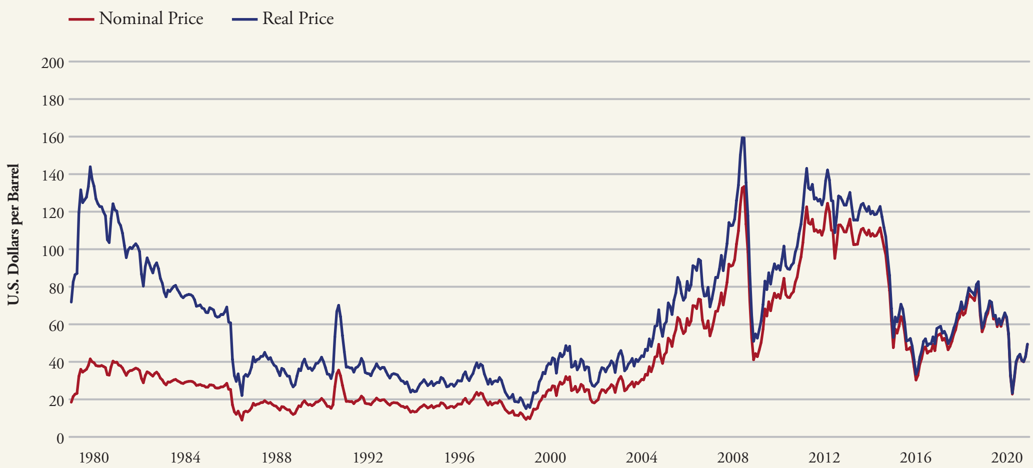
- **Support real private sector development:** Gulf states should keep growth-oriented, export-driven sectors that are not dependent on revenues from oil and gas free from insider meddling. They should expand free zones, reduce onerous regulations, and improve regional integration.

- **Address employment challenges:** Gulf states should engage in a dialogue with their citizens regarding the fiscal constraints they face. High public sector wages can be replaced with more transparent supplemental "social wages" that could be adjusted to reflect fiscal circumstances.

Introduction

The issue of economic diversification has gained a renewed sense of urgency in Gulf Arab countries. A global economic slowdown induced by the coronavirus pandemic pushed Brent crude prices down from $64 per barrel at the start of 2020 to a low of $23 in April 2020 (see Figure 1).[2] Oil prices are expected to remain below $50 per barrel through 2022.[3] This has placed substantial pressure on the fiscal positions of Gulf Cooperation Council (GCC) countries,[4] which are expected to run budget deficits averaging 9.2 percent in 2020 and 5.7 percent 2021.[5]

Figure 1: Monthly Average Brent Crude Prices

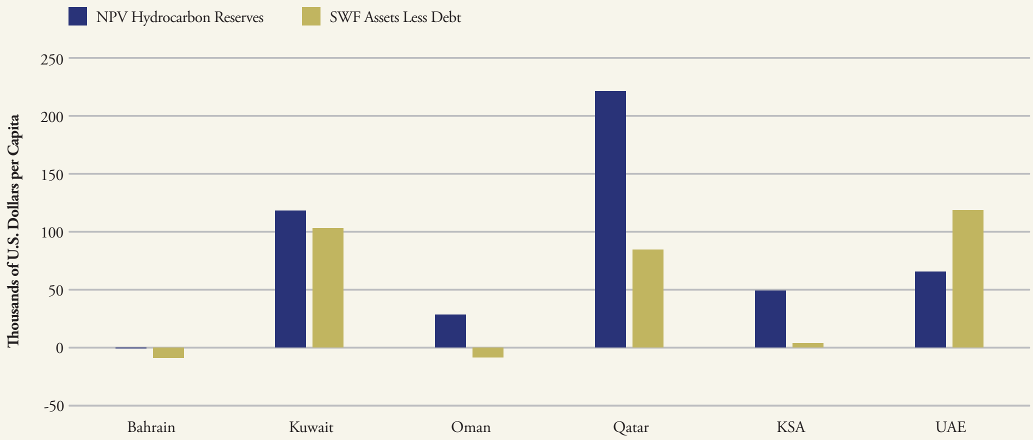


Source: Calculated by the authors based on World Bank Commodity Price Data (The Pink Sheet), "Monthly Brent Prices in Nominal US dollars, 1979 to Present," accessed January 14, 2021, https://bit.ly/3il5p2i; "Short-Term Energy Outlook: Real Prices Viewer," U.S. Energy Information Administration (EIA), accessed November 14, 2020, www.eia.gov/outlooks/steo/realprices/.

GCC countries have been concerned about the sustainability of their hydrocarbon revenues for decades. In the long term, oil and gas reserves will eventually run out. Bahrain and Oman are in the most precarious position, with reserves expected to run out within the next decade for Bahrain and within 25 years for Oman.[6] In the medium term, revenues from oil are expected to decline in the face of reductions in global demand starting around 2040, if not sooner.[7] This will be driven by higher demand for renewable energy and improvements in energy efficiency and storage. In the short term, GCC countries are already tapping into $2 trillion in financial assets accumulated over decades and invested in sovereign wealth funds (SWF) for future generations (see Figure 2).[8] Before the pandemic, the International Monetary Fund (IMF) estimated that, unless GCC countries undertake substantial fiscal and economic reforms, they will deplete their conserved wealth by 2034.[9] The pandemic has likely shortened this timeline.

The expected fall in hydrocarbon reserves and revenues has long motivated GCC countries to diversify their economies by developing productive sectors outside oil and gas. Unfortunately, private sector activity in the GCC continues to rely heavily on government-funded projects and consumption that are ultimately supported by oil

Figure 2: Per-Capita Net Present Value (NPV) of Hydrocarbon Reserves and Net Sovereign Wealth (SWF Assets Less Debt) (2019)



Source: Authors' calculations using British Petroleum (BP), "Statistical Review of World Energy 2020, 69th Edition," June 2020, 14–19, 32, 42, https://www.bp.com/content/dam/bp/business-sites/en/global/corporate/pdfs/energy-economics/statistical-review/bp-stats-review-2020-full-report.pdf; World Bank Group, "Economic Diversification for a Sustainable and Resilient GCC," Gulf Economic Update Issue 5, December 2019, 24, http://documents1.worldbank.org/curated/en/886531574883246643/pdf/Economic-Diversification-for-a-Sustainable-and-Resilient-GCC.pdf; "List of 25 Sovereign Wealth Fund Profiles in Middle East," Sovereign Wealth Fund Institute, accessed October 15, 2020, https://www.swfinstitute.org/profiles/sovereign-wealth-fund/middle-east; Gulf Labour Markets, Migration, and Population (GLMM) Programme Demographic and Economic Database, "GCC: Total population and percentage of nationals and non-nationals in GCC countries (national statistics, 2017–2018) (with numbers)," accessed October 15, 2020, https://gulfmigration.org/gcc-total-population-and-percentage-of-nationals-and-non-nationals-in-gcc-countries-national-statistics-2017-2018-with-numbers/.

and gas revenues. GCC policymakers must overcome the shortcomings of previous diversification efforts and create incentives for real economic development that is not reliant, directly or indirectly, on the oil and gas sector. GCC countries must also diversify their revenue streams by building up sovereign wealth funds and avoiding projects that require ongoing government support or subsidies. Many government-funded mega projects are white elephants that fall into this category. Finally, GCC countries must involve their citizens more closely in wealth and economic diversification efforts. This should include encouraging savings and investment at an individual level.

There has been no shortage of policy advice from think tanks, international organizations, and consultants on what GCC governments can do to diversify their economies and prepare for a post-hydrocarbon future. However, this policy advice has often failed to address the political-economic realities of the governing social contract, in which GCC governments rely on specific economic channels to transfer hydrocarbon wealth to their citizens. These channels often stand in the way of necessary reforms. This policy brief aims to outline the economic reforms that GCC countries must take in order to diversify their economies and promote sustainable growth, taking into consideration the constraints imposed by the governing social contract.

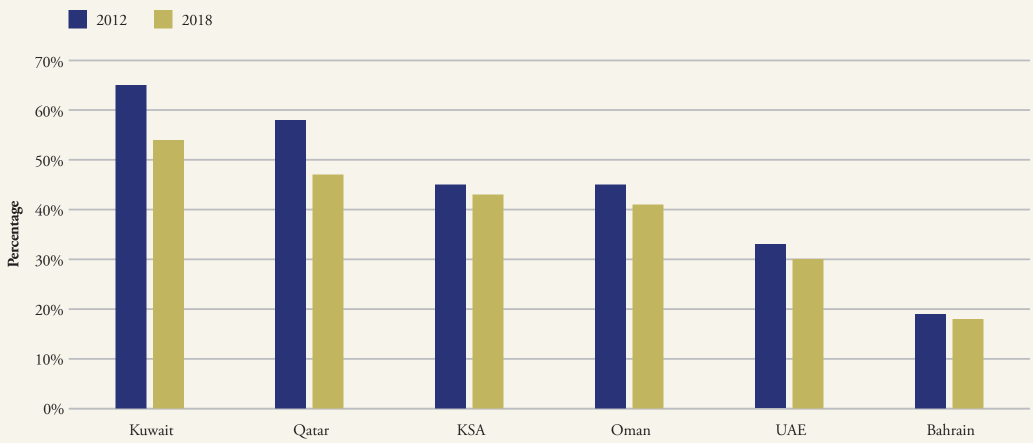
Resource Rents: A Blessing and a Challenge

GCC countries have been blessed with an abundance of natural resources. They have invested this wealth in improving the lives of their citizens, developing their infrastructure, and preparing for a future without oil. GCC countries have made substantial progress toward the first two goals.[10] They have built modern cities and the infrastructure to service them, providing a solid foundation for future economic development. All have Human Development Index scores above 0.8, placing them collectively ahead of all other Middle East and North African (MENA) countries and on par with some countries of the European Union (EU).[11]

However, GCC countries have struggled to achieve progress on the third goal: diversifying their economies. Despite good intentions, reflected in their national visions and economic development plans,[12] GCC economies remain stubbornly dependent on hydrocarbons.[13] Reducing this dependence has several dimensions. First and foremost, it involves replacing oil and gas production with the production of goods and services that are not dependent, directly or indirectly, on the oil and gas sector. It also involves replacing government revenues derived from oil and gas with revenues from other sources, such as taxes on consumption and non-oil sectors, but not to the extent that these emerging sectors become hampered and uncompetitive. Thus, to succeed, economic diversification requires other key ingredients, including moderating government spending, increasing non-oil exports, and increasing foreign direct investment (FDI).

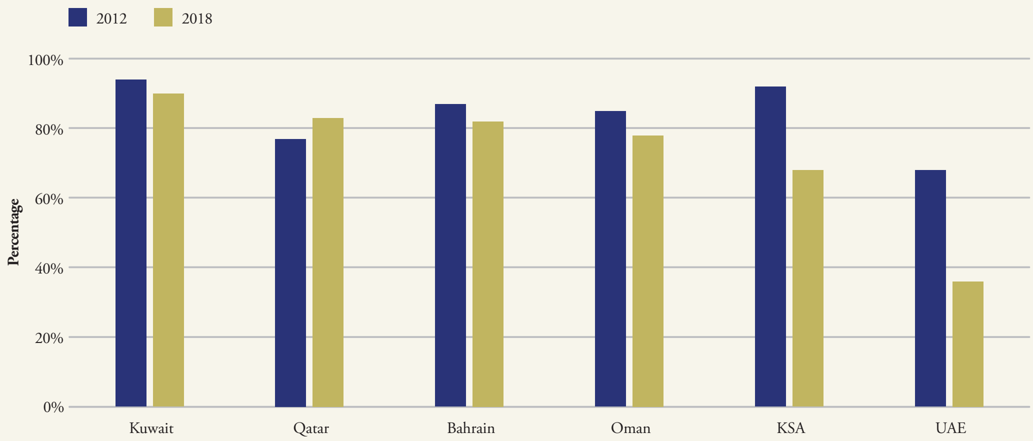
While GCC states have made some progress over the past decade (see Figure 3), oil and gas production continues to represent over 40 percent of gross domestic product (GDP) in most countries, except for the United Arab Emirates (UAE) (30 percent) and Bahrain (18 percent).[14] Even so, much of the region's other economic activities, such as construction and infrastructure development, are directly supported by revenues from oil and gas. In Bahrain's case, oil accounts for a small share of GDP because it has largely depleted its oil reserves;[15] however, oil continues to support economic activity indirectly through transfers and spending from neighboring countries. Similarly, while improvements have been made in diversifying government revenues, hydrocarbons account for 70 percent or more of total revenue (see Figure 4), except for Saudi Arabia (68 percent) and the UAE (36 percent). Even so, again, many of the diverse revenue streams in those two countries derive from economic activities supported by oil and gas.[16]

Figure 3: Hydrocarbon Sector (Share of GDP)



Source: World Bank Group, "Economic Diversification for a Sustainable and Resilient GCC," Gulf Economic Update Issue 5, December 2019, 54–59, http://documents1.worldbank.org/curated/en/886531574883246643/pdf/Economic-Diversification-for-a-Sustainable-and-Resilient-GCC.pdf.

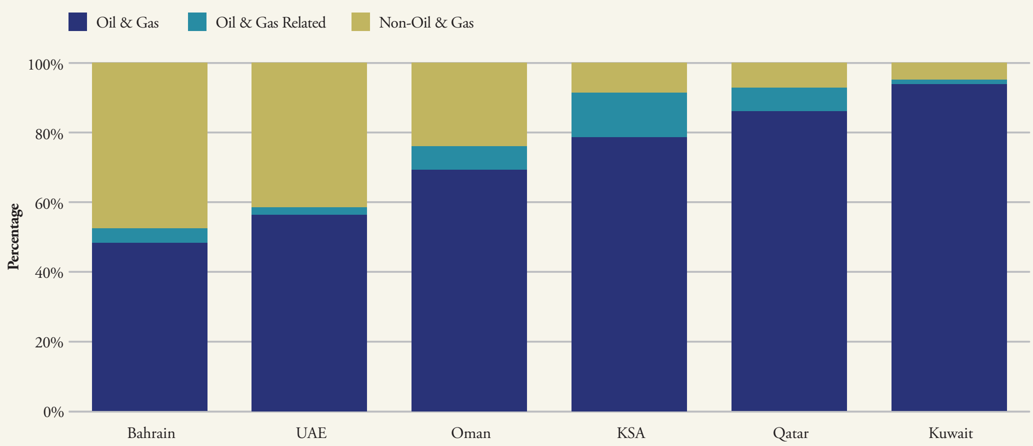
Figure 4: Hydrocarbon Revenues (Share of Total Revenues)



Source: World Bank Group, "Economic Diversification for a Sustainable and Resilient GCC," 54–59.

Gulf countries do produce goods and services within their borders, mainly for domestic consumption. These include agricultural products, manufactured goods, and business services. However, domestically produced goods and services will not soon replace the vast quantities of imported goods and services that are needed to support the 27 million citizens and 29 million expatriates living in the region.[17] Furthermore, real economic diversification requires producing goods and services, other than hydrocarbons and their derivatives, that can be traded with the rest of the world. Here, Gulf countries still have a long way to go. In 2018, hydrocarbons and related products represented over 90 percent of total exports in Kuwait and Qatar, over 80 percent of total exports in Saudi Arabia and Oman, and over 50 percent of total exports in the UAE and Bahrain (see Figure 5).[18]

Figure 5: Hydrocarbon and Related Exports (Share of Total Exports, 2018)

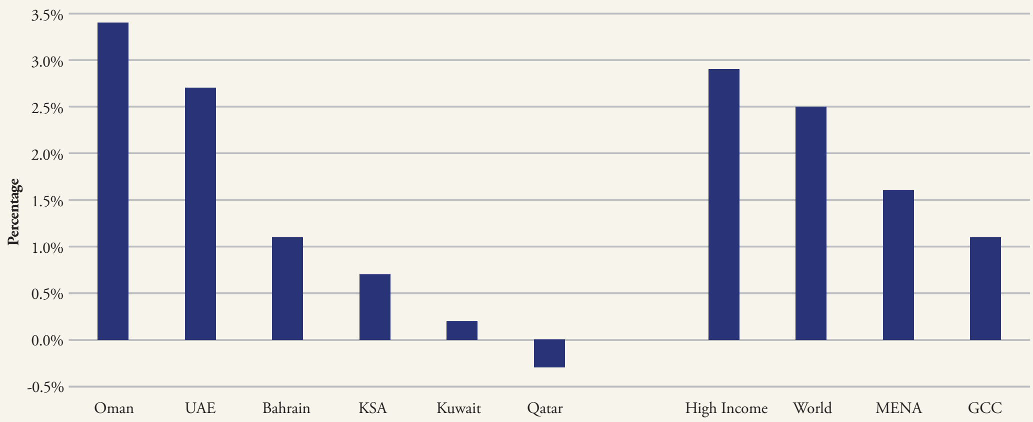


Source: Calculated by authors using United Nations (U.N.) Comtrade Database, "Exports Value 2018," accessed November 1, 2020, https://comtrade.un.org/data/.

Another indicator of an economy's potential competitiveness is FDI, which reflects the willingness of foreign entities to invest in a country. FDI too is lagging in the GCC. Between 2015 and 2019, only Oman and the UAE had FDI inflows (as a share of GDP) that were higher than the world average of 2.5 percent.[19] Net inflows of FDI into the GCC as a whole were only 1.1 percent of GDP; this represents less than half the global average and almost three times less than FDI inflows into high-income economies (see Figure 6).[20] The weak business environment in most GCC states is part of the reason behind such low FDI inflows. It is difficult for firms that are not connected to insiders to enter and compete in the market.[21] Furthermore, policy changes often occur on an ad hoc basis with little warning or recourse. These might include limiting work permits from specific countries, limiting the transfer of funds overseas, and cutting off economic ties with neighbors. Such policy uncertainties increase the risk to international, and even local, businesses wishing to invest in the region. When they were flush with revenue from oil and gas, GCC states had the luxury of making arbitrary policy decisions and even costly policy mistakes. However, the tighter fiscal realities of today require them to be more responsive to the needs and concerns of investors.

The key to economic diversification remains developing non-hydrocarbon sectors in which GCC economies can compete. While it is not clear what these sectors might be, this is a difficult question to answer without trial and error. While the GCC is unlikely to become competitive in agriculture, this can be a source of import substitution. Manufacturing has promise, but GCC economies must build infrastructure and create free zones to compete against low-cost manufacturers in Asia. Dubai has positioned itself as a financial, business, and logistics hub for the region, something that might have been difficult to imagine fifty years ago. Can the region accommodate other such hubs? Most GCC countries want to create high-tech knowledge economies, but this requires a level of skills and research facilities that remain in short supply. The GCC might be able to build a competitive technology ecosystem by importing talent from other Arab and Asian

Figure 6: Foreign Direct Investment, Net Inflows (Average Share of GDP for 2015–2019)



Source: World Bank Development Indicators DataBank, "Foreign direct investment, net inflows (% of GDP)," accessed November 12, 2020, https://databank.worldbank.org/source/world-development-indicators.

countries. Tourism has shown promise in Oman, Saudi Arabia, and the UAE, while Qatar is trying to position itself as a hub for cultural and sports tourism. Islamic banking could be an area where the GCC might develop a competitive advantage.[22]

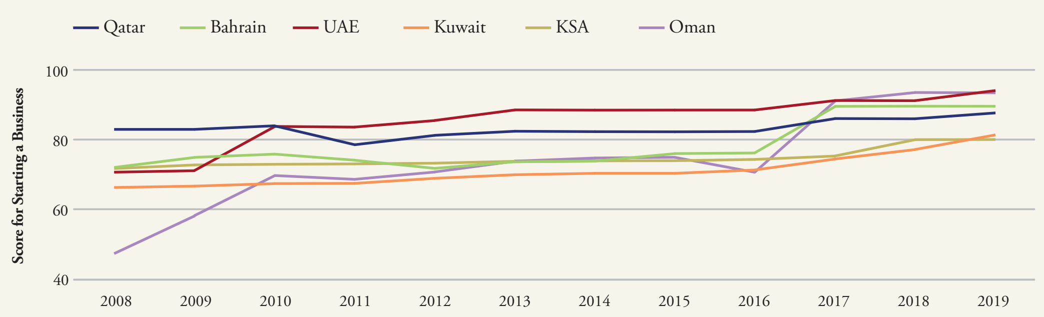
Successful economic diversification and sustainable economic growth require building sectors that are truly independent of oil and gas. Over time, as oil and gas revenues fall, these independent sectors can expand as economic activity shifts away from hydrocarbon-supported sectors. The ability to create independent sectors rests on three pillars: (1) introducing a fiscal framework that allocates oil and gas revenues into either short-term rents or long-term investments with minimum economic distortions; (2) enabling an export-oriented private sector that is not dependent on oil and gas to grow and thrive; and (3) building a capable and motivated workforce outside the public sector, including entrepreneurs.[23] Gulf countries have made some progress on all three fronts. However, they have been more apt to pursue partial reforms that provide the illusion of economic diversification but, in reality, continue to rely to a large extent on revenues from oil and gas.

Diversification Efforts Gain Traction

GCC governments have sought to diversify their economies by supporting sectors that often reflect the preferences of policymakers more than the competitive strengths of their economies. However, most GCC states have come to realize that these diversification models are themselves unsustainable and have begun creating space for real private sector development. These efforts were initially led by Bahrain, which had the most limited oil reserves in the GCC. However, Bahrain has since been eclipsed by the emirate of Dubai, which also has limited oil reserves, and which has set the pace for the rest of the UAE.[24] The UAE has been leading the other GCC countries in terms of providing an enabling environment for business and entrepreneurship. For example, over the past decade, all GCC countries have made significant progress in terms of ease of starting a business based on the World Bank Ease of Doing Business Index (see Figure 7).[25]

Gulf countries have also developed more holistic approaches to their diversification efforts in recent years. They have embedded economic di-

Figure 7: World Bank Scores for Starting a Business (0–100)



Source: World Bank Doing Business Database, “Ease of doing business score global (DB17–19 methodology),” accessed November 10, 2020, https://www.doingbusiness.org/en/custom-query.

versification into their national visions and established commissions to better integrate the private sector into ongoing economic activities.[26] They have also established agencies to support small and medium enterprise (SME) development and financing, such as Saudi Arabia's Small and Medium Enterprise Authority,[27] Qatar Development Bank,[28] and Oman's Riyada.[29] SMEs are the cornerstone of diversification efforts, as their growth creates real economic value and jobs.

These policy actions have been supplemented by free trade zones and special economic zones that operate to various degrees outside the regulatory distortions of the private sector. These zones help attract FDI and serve as hubs for innovation that could be absorbed over time into the national economy. The UAE has 45 free zones that allow 100 percent foreign ownership.[30] Bahrain has gone a step further and allows 100 percent foreign ownership in several sectors including real estate, communication, and administrative services.[31] Gulf states also introduced hubs for innovation within their ecosystems, such as Bahrain's International Investment Park,[32] Qatar's Science and Technology Park,[33] and Saudi Arabia's Prince Abdullah Science Park.[34]

Gulf states have also introduced educational reforms aimed at better aligning graduates' skills with market needs.[35] In countries where a vast majority of young people typically indicate a preference for public sector jobs, interest in entrepreneurship and private sector employment has risen. Initiatives supporting young entrepreneurs and providing them with training and counseling have spread across the Gulf. In Oman, vocational training centers and technical colleges have introduced the Know About Business (KAB) program, developed by the International Labour Organization (ILO) to support knowledge on the private sector.[36] INJAZ Al-Arab, a regional non-governmental organization (NGO), targets aspiring young entrepreneurs in all six GCC countries and provides them with needed support and training.[37]

Yet, even though business regulations have improved and the startup ecosystem has developed significantly over the past two decades, GCC countries continue to lag in providing an enabling business environment and continue to suffer from weak capacity among their nationals.[38] The private sector in the GCC, as in much of the MENA region, is overregulated and governed by an entrenched system of clientelism and connections. This is further exacerbated by the fact that much private sector activity is run through public or quasi-public enterprises, relies on government contracts, is financed through public financial institutions, and is supported through government subsidies or handouts. In such an environment, it is difficult for the private sector to grow organically or for someone who is not politically connected to establish and grow a successful business. These factors have their origins in the political economy and the governing social contract of the GCC states.

The Political Economy of Gulf Rentier States

Gulf states began exporting oil in the 1940s and 1950s, leading to substantial increases in their incomes and wealth. GCC governments have been passing on this wealth to their citizens through three main channels. First, they have expanded and improved public benefits and services, including education, health care, and access to finance. Second, they have provided their citizens with access to public sector employment opportunities at substantially higher wages and benefits than those offered by the private sector.[39] Citizens flocked into government jobs and public sector employment rates among citizens reached 90 percent in some states.[40] Third, Gulf states have provided business owners with access to economic rents through government contracts and exclusive licenses, allowing them to generate excess income and profits from their businesses.

Understanding the nature of this social contract is important and has implications for the kinds of policy reforms that are both needed and might succeed. The key point is that these channels exist for a reason: they allow citizens to access their legitimate share of their country's hydrocarbon wealth. The channels operationalize the social contract and will not be easy to renegotiate even as oil revenues decline. Aligning public sector salaries with those in the private sector means that citizens will receive fair compensation for their efforts, but citizens will cease to access their share of the wealth through public sector wage premiums. Limiting the access of citizen-owned businesses to exclusive contracts means that they will earn profits dictated by the market but, again, citizens will cease to access their share of the wealth through exclusive business contracts. Instituting such reforms, without first identifying and putting in place alternative channels for sharing natural resource rents, is both unfair and doomed to failure.

That said, reforms are needed. Channeling economic rents through expanded public services, government employment, and exclusive business contracts has weakened efforts to develop a competitive, dynamic private sector that is capable of generating sustainable economic growth in a post-hydrocarbon future. Yet, any policy effort to reduce rent-seeking behavior requires addressing the constraints of the governing social contract or introducing new channels. Once natural resource rents run out, Gulf countries will be in a precarious position of having to maintain the deadweight of channels that no longer serve a purpose. What can a country do when it can no longer afford to cover the costs of a large public sector workforce that has long-term contracts and does not have the skills to transition to jobs in the private sector?

Reexamining policy reforms through the lens of the social contract can present novel policy insights. Each of these requires policy changes that increase private sector and private citizen activity. This will not be easy in countries that subscribe to a state-led development paradigm.

Addressing the Sustainability of Public Services and Encouraging Citizen Participation

As GCC countries began accumulating wealth, they initially focused on improving public goods and services. This started with education, health, and utilities, but quickly expanded to other sectors, including banking, finance, telecommunications, and transportation. In terms of basic public services, GCC governments have done a remarkable job of improving access for all their citizens. For example, educational attainment has improved considerably in the region. However, quality remains a concern. GCC students are among the lowest-scoring students on standardized international tests. While reform efforts have improved outcomes, they have not resulted in major shifts.[41] In the long run, GCC governments should consider granting hospitals, schools, universities, and other purveyors of public services greater financial autonomy and establishing endowments to ensure their long-term sustainability. States can also encourage wealthy citizens to fund social services through private non-profit initiatives. Privately established endowments (known as "awkaf") have a long and rich history in the Gulf region but were largely displaced by government initiatives after the discovery of oil. Bringing them back would allow private citizens to contribute to their country's future and support a deeper change in the social contract.

Improving the Regulation of Public Sector Enterprises

Many industries across the Gulf have come to be dominated by large state-owned or state-run enterprises, even in industries that are normally the purview of the private sector, such as banking, construction, fuel distribution, and insurance. These state-owned enterprises played an important role in stimulating modernization, innovation, and economic growth. However, over time, they came to dominate their respective sectors. They erected bureaucratic barriers to entry, preventing smaller enterprises from growing and competing in their space.[42] Indeed, many public enterprises effectively serve as the main regulators of their industries. Furthermore, while some state-owned enterprises have extended their operations internationally, a closer examination suggests that they were able to do so because of public subsidies and support, such as paying no taxes or paying below market price for inputs such as energy, land, and capital. There is little evidence to suggest that these state-owned enterprises can compete in a global economy without continued support. Rather than serving as a source of new revenue, they draw resources away from more promising economic sectors.

Still, state-owned enterprises remain a valuable source of public services, innovation, and employment. GCC governments are not likely to consider privatization unless they have to. However, reforms can be introduced to create a more competitive environment around them. GCC states need to develop a clear strategy for delineating the sectors and industries where public enterprises will operate and leave other sectors free from their interference. They also need to be transparent about recordkeeping and ensure that all subsidies and support are clear and limited. Finally, GCC governments must build a firewall between public enterprises and their regulatory agencies. This would not only be a form of good governance, but would also improve competition and help to spur innovation and economic growth in the long run.

Encouraging Real Private Sector Development

Much private sector activity in GCC countries continues to be linked directly or indirectly to government contracts and spending that, in turn, are funded through revenues from oil and gas. This tends to benefit public enterprises and private companies that are connected to ruling elites, at the expense of more competitive SMEs and startups, which should form the foundation upon which future growth and prosperity are built. In addition, members of the ruling elite may simultaneously hold government positions and head their own companies, gaining an ability to tilt the playing field to their advantage.[43] Such constraints to private sector activity and competition reduce the incentive for entrepreneurs to introduce the kind of disruptive innovation that can create globally competitive industries that drive true economic diversification. Consequently, the private sector's contribution to GDP remains low. While official estimates are difficult to come by, in Saudi Arabia, for example, it was below 40 percent in 2018.[44]

This kind of rent-seeking is part of the governing social contract and will likely continue, but it can be moderated and limited to specific economic sectors and activities. For example, holding a government job while owning a business that benefits from government contracts represents double-dipping and has the potential to be mitigated. GCC states should also keep growth-oriented, export-driven sectors that are not dependent on revenues from oil and gas free from insider meddling. Also, they should continue to expand their free zones and economic zones, especially those that are developed around influence-free sectors. GCC states must also continue their efforts to reduce burdensome laws and regulations. These include introducing bankruptcy laws, removing the need for virtual companies to have a physical address, reducing the time and number of steps it takes to register a business, allocating a minimum share of government contracts to SMEs, ensuring that government payments are made on time, and improving access to finance for SMEs.

Finally, GCC governments should strive to disentangle politics and business. Too often, private economic activity is subordinated to impulsive political considerations. This increases risk and uncertainty and dampens international interest in investing in the region. The blockade of the UAE, Saudi Arabia, and Bahrain against Qatar is a case in point. The blockade disrupted supply chains, investment flows, business contracts, and even employee living arrangements.[45] It came at a high cost to all countries involved with little political gain to show for it. GCC countries should remain mindful of the benefits of maintaining a stable and predictable investment climate and aim to keep politics away from the more crucial long-term objective of achieving sustainable economic growth and ensuring the prosperity of future generations. Equally important, GCC governments should establish formal mechanisms for regulatory notification and public comment. This would improve the quality and effectiveness of regulations as well as increase the transparency of the regulatory process, which would go a long way toward assuaging the concerns of potential investors.

Addressing Employment Challenges

GCC governments provide their nationals with access to public sector jobs at high wages and benefits as a means of accessing their share of the economic rents.[46] The system affects the education and career choices of nationals, who typically seek the minimum credentials needed to access public sector jobs, with less concern for developing the skills needed to contribute to productive jobs in the private sector.[47] The result is a segmented labor market, with citizens dominating the public sector and expatriates prevailing in the private sector.[48] Furthermore, because public salaries include a share of economic rents, the civil service salary structure for nationals is both augmented and compressed. Those at the lower end of the salary scale with the least marketable skills are paid higher premiums over private sector alternatives compared to those with higher skills. This creates perverse incentives in terms of sector preference, with lower-skilled workers more resistant to accepting private sector work. Also, whenever GCC states wish to increase the share of oil rents distributed through the wage structure, in response to political conditions or increases in the price of oil, it results in an appreciation of the wage bill that is not easily reversed when circumstances change.

With the decline in oil revenues, public sector jobs have become scarce and GCC governments have transferred the responsibility for employing nationals to the private sector. However, people's sense of entitlement has transferred with them.[49] This is manifested in expectations of higher wages and benefits and weak motivation to work.[50] In return, private sector employers typically avoid hiring citizens unless obliged to do so by the state. In such cases, they often treat this as a cost of doing business and do not develop the hired citizens' productive capacities.[51] This breaks the link between performance and reward and creates an entitlement mentality,[52] which may persist after oil rents have been depleted. It has also resulted in high unemployment rates among young nationals, who queue for scarce public sector jobs despite the large supply of jobs in the private sector that are filled by expatriate workers. Youth unemployment rates among young nationals in most GCC countries with available data are high, reaching, for example, 40 percent in Saudi Arabia.[53]

GCC states have been reluctant to tackle this system of entrenched interests in employment. Attempts to bring public sector wages and benefits into alignment with those in the private sector have not been successful.[54] For instance, Saudi Arabia was forced to reverse a decision to cut public sector benefits in 2017 after "widespread grumbling."[55] Some GCC governments have sought to maintain the wage gap between citizens and expatriates by increasing the latter's work permit fees. However, this increases business costs and reduces their ability to compete globally, hampering long-run diversification efforts. A more effective strategy would be to make this channel for accessing economic rents more explicit. This could be done by introducing a scheme similar to an income tax credit. Employers would pay citizens a fair market wage, while the state would supplement this with a basic social wage or bonus that reflects their share of economic rents. This kind of transparency would better link wages for nationals to productivity and performance. It would also make it easier for GCC states to adjust the social element of the wages in response to changing economic circumstances, and can more easily be communicated to their citizens.

The Road Ahead

Policy efforts aimed at economic diversification must take legitimate rent-seeking behavior into account. GCC governments will have to engage in an honest conversation with their citizens regarding the financial constraints they face and the options going forward and then redraw the parameters of the governing social contract in a way that is perceived as equitable and fair. This renegotiation must involve both political elites and ordinary citizens giving up some of their benefits and privileges in light of reduced hydrocarbon reserves and lower prices that are expected to persist and decline further in the long run. Asking ordinary citizens to give up access to government jobs or reduce their salaries and benefits without business owners giving up excess profits from exclusive contracts will sow public resentment and social unrest. Over the past two decades, GCC countries have created free zones, innovation parks, and entrepreneurship hubs outside the frameworks of their rentier-based private sectors. Yet, these policies remain rudimentary. In preparing for a post-oil future, GCC states will have to further reduce public services, benefits, and jobs and limit opportunities for rent-seeking in the private sector.

The coronavirus pandemic and lower global oil prices have increased the pressure on Gulf states to push ahead with economic diversification efforts. GCC policymakers must look beyond the immediate impetus to cut budgets and focus instead on developing the necessary building blocks for a dynamic and sustainable post-hydrocarbon economy. The economic and political pressures facing Gulf states have already induced Saudi Arabia, the UAE, and Bahrain to end their three-and-a-half-year blockade of Qatar, opening the door to greater regional economic integration. Likewise, economic pressures have created space for a more open and honest dialogue between citizens and their states regarding financial constraints, economic rents, and channels for their distribution. Providing clarity on which parts of the economy will be allowed to grow unimpeded is central to creating incentives for young nationals to engage in these sectors. Market-based mechanisms can then be allowed to function in these sectors, disentangled from rent-seeking behavior. Together, more competitive economic sectors and greater regional integration can increase the global competitiveness of GCC economies and support their economic diversification efforts.

Endnotes

1 Nader Kabbani is director of research at the Brookings Doha Center (BDC) and senior fellow with the Brookings Global Economy and Development Program. Nejla Ben Mimoune is a research assistant at the BDC. The authors would like to thank the Brookings Doha Center (BDC) research and communications teams for their valuable feedback and helpful support, as well as the two anonymous reviewers for their insightful comments and suggestions.

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4 Formally called the Cooperation Council for the Arab States of the Gulf, the GCC is a regional intergovernmental political and economic union consisting of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

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