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# “The Path to Economic Growth in Kuwait”

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# **The Path to Economic Growth in Kuwait**

**Policy Paper**

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## INTRODUCTION

The State Vision Kuwait 2035, the country's long-term economic development strategy, aims at Kuwait's development into a regional trade and financial hub through the fulfillment of six strategic goals: increasing its GDP, fostering private sector growth, supporting human and social development, stimulating demographic policies, improving administrative efficiency, and preserving Kuwait's Islamic identity (Hvidt 2013: 20-21; WTO 2012: 7-8). So far, only limited success can be seen in achieving those goals. The policy paper at hand therefore analyses remaining obstacles towards economic growth and proposes reform measures to be carried out by the government of Kuwait in order to overcome those hindrances.

As major obstacles to economic growth, the paper identifies Kuwait's lack of economic diversification away from hydrocarbon dependence, its segmented labor market, its inadequate educational system, and its unfavorable business environment. The proposed reform tackles these obstacles through the following measures: A downsizing of the public sector is envisaged in order to promote private sector employment of nationals, thereby complementing immigration policy reforms aiming at narrowing the gap between private and public sector employment. Furthermore, the education system is to be reformed in accordance with demands of the labor market. To this end, stronger links between education and the market and the promotion of relevant fields of study and vocational training are stipulated. Improvements in the business environment are expected to foster private sector growth and FDI flows. Lastly, the reform entails measures to enhance economic diversification, in particular through the promotion of export-oriented industries.

## OBSTACLES TO ECONOMIC GROWTH

Occupying 9% of worldwide oil reserves and at the same time inhabiting only about 1.2 million citizens, Kuwait finds itself in a comparably comfortable situation with a high rent-to-citizen ratio and high balance of payment surpluses (Hodgson & Hanson 2014: 18; Hvidt 2013: 21). Nevertheless, Kuwait's economic growth is limited due to several obstacles:

Endowed with vast hydrocarbon resources, economic diversification in Kuwait has been slow. Even in regional comparison to other GCC states, Kuwait sticks out as overwhelmingly hydrocarbon-dependent, with oil accounting for nearly half of the country's GDP, and oil and gas accounting for about 86% of total exports and 85% of government revenues (Hvidt 2013: 21; IMF 2013: 13). This dependency on hydrocarbons makes Kuwait's economy vulnerable to international price volatilities. While the country's Sovereign Wealth Fund, the Kuwait Investment Authority (KIA), diverts 10% of the yearly hydrocarbon revenues to the fund in order to create a "stable financial stream of wealth" (Hvidt 2013: 9) which protects against those price changes and provides funds for future generations (Bahgat 2012: 368), the country needs to diversify its economy away from hydrocarbon dependence in order to create a sustainable economic basis and employment opportunities for its citizens.

The need for the creation of employment opportunities arises in particular due to the country's demographic structure, with a share 65% of the population being under 25 years (Brinkley et al. 2012: 28). The large numbers pushing into the labor market every year cannot be fully accommodated by the current strategy of public sector employment anymore (El-Katiri, Fattouh & Segal 2011: 21). Not only increases this practice the wage bill and therefore government spending every year, but it also distorts the labor market creating a segmentation between the overstaffed, inefficient public sector – providing high salaries and social benefits to Kuwaiti nationals – and the private sector, based on mechanisms of international competition and employing almost exclusively expatriate workers with predominantly low salaries (Shediak & Samman 2010: 7; Al-Enezi 2002: 889). Nationalization policies – with the subsidization of wages of nationals working in the private sector under the National Labor support program as one main element – aim at the reduction of the number of expatriate workers and their substitution with Kuwaiti citizens (Hertog 2014: 19; Baldwin-Edwards 2011: 43-45). Those efforts, however, have shown limited success so far. The sense of entitlement to well-paid and comfortable public sector employment among Kuwaiti nationals disincentives them to look for jobs in the private sector, perceived to be inadequate (El-Katiri, Fattouh & Segal 2011: 19; Al-Enezi 2002: 889). Furthermore, open immigration regimes provide private sector employers with abundant resources of cheap expatriate labor for low-skill jobs and highly-skilled expatriate workers for more demanding positions (Randeree 2012: 3).

This in turn disincentives private firms to undertake human resource development and therefore leads a decline in total factor productivity (Hertog 2014: 6; Hertog 2013: 19; IMF 2013: 14). This issue is also closely linked to the low quality of education in Kuwait, which is contributing to a substantial mismatch between the acquired education and the required skills for private sector employment (Shediak & Samman 2010: 7; Al-Enezi 2002: 893).

Another obstacle to economic growth is the insufficient development of Kuwait's private sector. While the private sector has expanded into formerly state-controlled sectors and has experienced substantial growth, it is still heavily dependent on government spending (Hertog 2013: 175). Furthermore, hopes for the private sector to develop into the main driver of economic diversification have not been fulfilled, since the entry barriers remain high, access to credit remains limited and necessary knowledge expansion is marginal in scope (Hertog 2013: 182, 192). Kuwait's unfavorable business environment furthermore causes low levels of FDI and thereby hampers the creation of employment and technology transfer (Brinkley et al. 2012: 32; El-Katiri, Fattouh & Segal 2011: 22). The predominance of low-technology and factor-based production is one indicator of this lacking development (Hertog 2013: 182). Related to the issue of private sector growth is also the underlying opposition between society and private sector and their competition over government resources. The minimal contribution of the private sector to employment of nationals fails to create common interests between the two groups, which in turn results in lack of popular support for the private sector (Hertog 2013: 175, 187-188).

## **REFORM MEASURES**

In order to overcome those obstacles to economic growth in Kuwait, the policy paper proposes reform measures in four broad and interrelated areas: labor and immigration policies, education, promotion of the private sector, and economic diversification.

### *Labor and Immigration Policy*

Within the field of labor and immigration policies, the proposed reform touches the practice of public sector employment of nationals linked to nationalization policies and the latest reforms of Kuwait's immigration regime.

Despite efforts to shift Kuwaiti citizens into private sector employment, the government is still acting as “employer of last resort” (Brinkley et al. 2012: 28), for nationals. The emerging labor market distortions and budgetary burden point to the unsustainability of this practice. The proposed reform thus stipulates a downsizing of public sector employment as necessary step towards the normalization of Kuwait’s labor market and an increase in efficiency (Hertog 2014: 24-25). To balance negative effects, in particular a rise in national unemployment, employment opportunities in the private sector have to be created and negative perceptions of Kuwaitis towards private sector employment have to be challenged. As direct mitigating measure the reform includes cash grants to citizens, who are not employed by the public sector (Hertog 2014: 25). While also exhibiting high financial costs, cash grants do not incur labor market distortions. Furthermore, the reform allows for the more efficient use of human capital through private sector employment (Shediac & Samman 2010: 6).

Nationalization policies for a long time concentrated on quotas and prohibitions in order to reduce the number of foreign workers and increase nationals’ participation in the labor force. This has, however, shown limited success. Thus, recent reforms have shifted into a stronger market-based direction, trying to narrow the wage gap between domestic and foreign employees and to reduce differences between the two groups by granting foreigners labor market mobility (Hertog 2014: 4, 7; Shediac & Samman 2010: 6). The already-mentioned wage subsidy is the most prominent example of this approach. Furthermore, the announced plan to abolish the sponsorship system for foreign workers and the setting of a minimum wage for the private sector are seen as steps in the right direction (Baldwin-Edwards 2011: 24, 42; Shah 2011: 353-354). The announced reform also includes the formation of a central agency coordinating all foreign workers, which is seen to provide an effective tool for the regulation of labor migration in line with a comprehensive national human resources strategy (Shah 2011: 354). The policy paper at hand builds on those reform measures and further stresses the following points: The creation of a national human resources strategy is key to the effectiveness of the new agency. Relevant stakeholders from the executive and legislative branch and the private sector have to be incorporated into this process. Concerning the effective implementation of the reforms, it is necessary to make the content of the new regulations public and easily accessible through an information

campaign. This is to ensure that all foreign workers can act on their right to mobility on the labor market.

### *Education*

The field of education is an incremental part of a sustainable economic reform in Kuwait. While the segmentation of the labor market is partly caused by the already-mentioned sense of entitlement of citizens to public sector employment and the higher wages and better working conditions, another important reason of small numbers of nationals in the private sector is the lack of necessary skills. Despite comparatively high investments into education, amounting to about 5% of GDP, the quality of education in Kuwait remains low and exhibits a grave skills mismatch with the demands of the private sector (El-Katiri, Fattouh & Segal 2011: 8). Two main problems in this context are the predominant choice of humanities and social sciences over science and engineering as fields of study and the negative perception of vocational training (Shediac & Samman 2010: 7, 15; Al-Enezi 2002: 893). Aiming to tackle those issues, the government has to reprioritize its spending on education.

To provide incentives for students to choose science and engineering as fields of study, the government needs to work on attracting qualified teachers and creating links with scientific centers and institutions locally and internationally, in addition to improving the curricula (Shediac & Samman 2010: 22). In the case of vocational training, the strategy is twofold: One component is an awareness campaign, to be carried out in schools, targeting students as well as their parents to promote the value of vocational training. Additionally, some elements of vocational training are to be made compulsory within secondary education, to provide a basic level of skills for the labor market to all students and raise awareness about vocational training (Shediac & Samman 2010: 15). The third priority, creating a link between the education system and the private sector, can be seen as overarching element, relevant for both university education and vocational training. By working with the private sector, the education can be tailored towards private sector demand and thus minimize the skills mismatch (Shediac & Samman 2010: 2). This is in turn expected to increase private sector employment of nationals. Furthermore, the contribution of the private sector to the education of Kuwaiti citizens can offer a point of contact between the otherwise mostly unconnected groups, serving to dismantle negative attitudes towards each

other. This in turn might help to create a stronger popular support for private sector interests, thereby enhancing support for pro-business policies.

### *Private Sector*

The private sector is seen as most able to become the main driver of economic diversification and employment growth in Kuwait – provided it is enabled through a favorable business environment. To this end, the remaining high entry barriers into the market for new firms have to be reduced (WB 2009: 16). This includes the reduction of “red tape” by streamlining bureaucratic processes and unifying administrative requirements following a one-stop shop approach (IMF 2013: 17; Brinkley et al. 2012: 32). Furthermore, the access to credit has to be facilitated, especially for small and medium-sized enterprises (SMEs), which currently finance their activities mainly through retained profits (Hertog 2013: 182-183). This constitutes a substantial hindrance for market entry and points to necessary reforms of the financial sector, which is still largely dominated by the state and has to be opened further to competition (WB 2009: 17). By enabling new firms, in particular SMEs, to obtain credit and enter the market more easily, the reforms are expected to create a more diverse and less state-dependent economy.

Furthermore, investment conditions have to be enhanced in order to increase the current low levels of FDI. This entails the already-mentioned one-stop shop approach for business creation, as well as the expansion of the lifespan of the Build-Operate-Transfer scheme (BOT) and the acceptance of international arbitration (Brinkley et al. 2012: 32). Improving contract enforcement – which currently receives a low score in the Doing Business Index (WB 2014: 69-75) – is seen to provide legal security for foreign investors and create a more attractive business environment for FDI.

Higher levels of FDI bring capital, but even more importantly in Kuwait’s case, employment opportunities and technology (Hvidt 2013: 8). This enables the upgrading of the current factor-intensive production into a more knowledge- and technology-based production and the creation of high-skill private sector jobs, perceived as adequate activity by nationals (Hvidt 2013: 8). This is again linked to necessary education reforms. To ensure that private sector companies do not predominantly rely on expatriate labor to fill these positions and thereby prevent



employment of nationals and the development of domestic human resources, private sector companies are to be offered incentives such as reductions in administrative fees or taxes for foreign companies (IMF 2013: 11).

In line with Kuwait's stated goal of preserving its Islamic and Arab culture, the proposed measures for private sector growth are best carried out in special economic zones (IMF 2013: 16; WTO 2012: 8; Herb 2009: 391-392).

### *Economic Diversification*

The last area of reform concerns Kuwait's economic diversification away from its hydrocarbon dependence. Currently, oil revenues account for about 50% of GDP, while trade and logistics only reach a share of 12% GDP (Ramadhan, Hussain, Al-Hajji 2013: 412). Diversification efforts include vertical diversification within the hydrocarbon sector through increased downstream activities but more importantly – and less successfully – horizontal diversification into other sectors (Hvidt 2013: 35). Further diversification should therefore concentrate on already successful sectors, such as trade, in order to expand current operations, increase productivity and achieve competitive advantage (Hvidt 2013: 35).

Focusing on export-oriented sectors has proven a successful strategy for Asian developmental states and presents a promising option for Kuwait's economic development (IMF 2013: 11; Shediak & Samman 2010: 18). Energy subsidies, despite their distortionary effects on the overall economy, are seen as necessary in the medium-term in order to increase the competitive capabilities of export-oriented sectors. However, state-provided subsidized input should be made conditional upon technological upgrades within the companies, in order to minimize distortionary effects on energy use and efficiency (Hertog 2013: 182).

A further increase in export-related economic activities also depends on efficient regulations and the removal of trade barriers. Current low scores for “Trading Across Borders” in the Doing Business Index, indicating protracted and costly procedures, point to the need of streamlining bureaucratic procedures in order to foster export-oriented sectors and their role in Kuwait's economic growth (WB 2014: 64-68).

Also closely linked to the enhancement of trade is the fostering of closer GCC integration. While positive steps have been taken towards regional economic integration, such as the creation of a common market in 2008, results have fallen short of expectations so far due to a lack of coordination (Shediac et al. 2011: 1). Currently, overlapping production structures and duplication of activities impede the growth of intra-regional trade (Hvidt 2013: 41). Thus, those obstacles to increased trade have to be minimized through stronger coordination of national policies of GCC states.

The proposed reform measures, while emphasizing the role of market actors and market-based mechanisms, overall still assign a big role in Kuwait's economic development to the state. In particular, this includes the creation of adequate regulations for a favorable business environment and optimizing distributional spending to foster human capital formation, the development of a competitive private sector and the creation of employment opportunities for its citizens. At the same time, the reform aims to minimize distortionary effects of state involvement.

### **POLITICAL RISKS**

Potential political risks of the proposed reforms fall into two categories: the threat of popular resistance against public sector downsizing and a potential blockade of necessary legislation by the parliament.

As already mentioned, public sector employment is seen as entitlement by many citizens. The effects of downsizing the number of jobs in the public sector and thereby dissolving the promise of a guaranteed job in this sector should thus not be underestimated. However, the reform accounts for this risk of popular resistance through two mechanisms: Firstly, nationals who do not work in the public sector but instead take up a job in the private sector are provided with a cash grant in order to cover any losses and compensate for perceived strain. This cash grant will be installed in addition to the already existing system of wage subsidies. Therefore, no welfare losses are incurred. Secondly, the downsizing of the public sector is to be phased in at a later stage of the implementation of reform measures. Like this, positive effects of the reform, such as improved perception of the private sector and increased private sector growth with the respective creation of employment opportunities, are already

visible and are expected to moderate negative reactions. As mentioned, the reform is aiming to remove distortionary effects on Kuwait's economy and to create more space for economic growth and development without however attacking the distributional bargain fundamental to its political economy.

The second political risk associated with the proposed reform lays in the political impasse between the executive branch and the parliament. While business representatives historically had a strong position in Kuwaiti politics, they have been marginalized in the parliament over the last decades (Hertog 2013: 185-187). The parliament therefore predominantly represents the interests of the wider population, which are, as already mentioned, oftentimes opposed to private sector interests due to the underlying distributional conflict over government resources (Hertog 2013: 187-188). However, as the reform entails the creation of a stronger link between society and private sector – both through employment creation and cooperation in the education system – common interests are expected to arise and to lower the opposition of the parliament to pro-business legislation.

Accounting for potential political risks, the proposed reform is seen to support Kuwait's existing efforts to enhance economic growth.

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