Economic Challenges and Prospects
for Gulf Economies

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Introduction

The Gulf states - consisting of Iran, Iraq, Bahrain, Qatar, Saudi Arabia, the United Arab Emirates (UAE), Kuwait and Oman - have historically played an important role in international trade and commerce. The coastal area surrounding the Gulf region is one of the oldest continuously inhabited places in the world and the center of flourishing civilizations. The importance of the Gulf states has always depended on their strategic location and recently on basic resources, particularly oil, essential to the entire world economy. In earlier times as well as now, the Gulf has been one of the main maritime trade routes between the area surrounding the Indian Ocean and the Mediterranean basin. In recent times, it is the principal region which provides more than half the oil needs of the world economy, and is a rich market for exports from the rest of the world.¹

Because of their strategic location and their principal resource, oil, the Gulf states lie at the heart of a sensitive global web of intertwined economic and strategic interests. Their prosperity and that of the rest of the world are closely interconnected. Consider two examples of this interdependence: the emergence of OPEC and the spectacular increase in oil prices in the 1970s and early 1980s were clearly responsible for the unprecedented economic prosperity of the Gulf states and substantial retardation of economic growth in OECD and developing countries. The events in the war between Iraq and Iran and the forceful military intervention of the US against Iraq clearly demonstrate that the economic and political stability of the Gulf is of paramount interest to the rest of the world. Both domestic and external economic interests and political considerations lie at the heart of the military upheavals in the region and political stability in the region in turn is crucial for an orderly working of the world economy.

The linkage between economic growth and political stability is highly complex. Though the issue has been discussed intensively by political scientists and some economists, the evidence is inconclusive. Some argue that political stability is a prerequisite for economic growth, while others claim that economic growth may lead to political change which if not accommodated may lead to political instability at least in the short run. Some of the conflicts in the Gulf region are deeply embedded in the class, religious, and institutional structures of the countries of the region. They are often intensified by outside interventions. We cannot address this tangled web of relationships here. We simply adopt the reasonable working hypothesis that given the past and present political and economic turmoil in the Gulf, future economic difficulties will substantially narrow the options of the existing governments and could lead to domestic political challenges which could be destabilizing.  

In this paper we shall address the two most important forces that are likely to threaten peace and prosperity in the Gulf. First, the structural economic imbalances and policy impediments that inhibit effective economic performance; second, the actual and projected rapid growth of population in this region, when combined with slow economic growth, can have strong political and social consequences. Indeed, the Gulf states are inadequately prepared to meet the cumulative impact of the rising tide of population growth. We shall also outline a number of suggestions for domestic and international policy actions which would relieve the internal pressures and may allow the Gulf states to play an expanding role in the new emerging world economy.

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I. The Gulf States in the World Economy

The Gulf states play a central role in the international economy. The Gulf region is the premier crude oil and refined oil products producer for the entire world economy. The collective importance of oil rich Gulf states to the international financial system cannot be denied. It was their cumulative bank deposits in the 1970s and 1980s that made transfer of credit by Western European and US banks to fast industrializing and oil importing developing countries like Brazil, Korea, Turkey and others possible. Any major withdrawal of funds from the Western financial institutions now or in the future certainly will be destabilizing to the entire world financial structure. The Gulf states have provided major markets not only for industrialized OECD countries but also for newly industrialized countries (NICS) such as Korea, Brazil, India, Pakistan, Singapore and others. In fact, the growth of NIC economies would have been less impressive if the rich Gulf markets for their civilian and military products were not available. The Gulf states increasingly set up banking and financial relationships with the NICS as well as developing refining capacity in the NICS. With the likely rise in oil demand in the 1990s, the Gulf states will once again be the likely providers of "excess" capital to both industrialized OECD countries and the emerging NICs, as well as being rich markets for their exports. Also, these countries have provided sizeable employment opportunities for both skilled and unskilled workers, mainly from Arab and Asian countries.

The Gulf states, in the face of considerable political and military difficulties, have made spectacular strides in the past two decades. As a whole they have broken away from their status as low income economies to achieve the rank of middle and even upper income societies.
According to a recent UN Human Development Report\(^3\), the Gulf states have made substantial progress in the social and economic conditions of their population. In the past two or three decades, enormous strides have been made in life expectancy, adult literacy and education, student enrollment, quantity and quality of food consumption, availability of good quality health services, access to safe water and sanitation, etc. The Human Development Index (HDI) compiled by UNDP ranks the western Gulf states very high, about 76% to 82%, except for Oman where it is 60%. Iran and Iraq's HDI score reaches about 60%, which is much higher than many other developing countries.

The problem facing the Gulf states is how to successfully meet the challenges of the future. Can they sustain their role in the international economy and generate high growth rates in their domestic economies? These states have rather weak agricultural foundations, not very high rates of savings and investment, an inadequate supply of human capital, high income inequality, low productivity, and low growth of manufactured goods. The size of their domestic markets, except for Iran, is rather small. Sustained economic growth in the Gulf states is likely to be dependent on conditions prevailing in the world economy. Their reliance on sustained and stable oil revenues is quite clear. Diversifying their economies and pursuing a high rate of investment and saving now to soften adverse economic effects when oil revenues are no longer available, at least to some of the Gulf States, depends on developments in world demand for oil.

However all this happening depends upon the twin tasks of successfully transforming their domestic economies to generate high and sustained economic growth and avoiding the pattern of political upheavals that generates uncertainty about the security of oil supplies from the Gulf.

For these economies to prosper they must integrate more closely into the world economy through trade, transfer of capital and labor and interdependent production structure.

II. Growth Stagnation and the Pressure of Rising Population

a. The Growth Rate of GDP and Per Capita Income

The Gulf States can be divided into the eastern Gulf states and the western Gulf states: The eastern Gulf states, Iran and Iraq, are large in terms of both geographical size and size of the economy; the structure of their economy is more diverse and they import a very small number of expatriate workers. They tend to have high rates of inflation, and as shown in Table 1 have lower per capita income than the western Gulf states. They are also regional political and military powers in the Gulf. The western Gulf states consist of a number of small economies - Bahrain, Qatar, Oman and United Arab Emirates, and a major regional economic and military power, Saudi Arabia. The countries of the region also vary considerably in size and distribution of population. Populations range from less than half a million in Qatar to over 61 million in Iran. Iraq and Saudi Arabia have populations of 19.5 and 17.4 million, respectively. The populations of Kuwait, Oman and UAE range between 1.5 to 2 million, while Bahrain and Qatar have extremely small populations of about half a million. As indicated in Table 1, the largest economies in the region in terms of size of GNP are Iran and Saudi Arabia, while Iraq and Kuwait are middle sized economies and the remaining Gulf states, both in terms of geography and size of GNP, are very small. However, because of the small size of their populations, the western Gulf states have much higher per capita income than the eastern Gulf states. The small states of UAE, Qatar and Kuwait have some of the highest per capita incomes in the world.
Table 1

Levels of National and Per Capita Income Size and Growth Rate of Population,

<table>
<thead>
<tr>
<th>Country</th>
<th>Area Square Miles</th>
<th>Gross National Product (GNP)</th>
<th>Population</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Nominal 1991 (Million US$)</td>
<td>per Capita 1991(US $)</td>
</tr>
<tr>
<td>Bahrain</td>
<td>268</td>
<td>3,679</td>
<td>7,130</td>
</tr>
<tr>
<td>Iran</td>
<td>632,457</td>
<td>127,366</td>
<td>2,170</td>
</tr>
<tr>
<td>Iraq</td>
<td>167,975</td>
<td>35,000</td>
<td>1,940</td>
</tr>
<tr>
<td>Kuwait</td>
<td>6,880</td>
<td>33,089</td>
<td>16,210[*]</td>
</tr>
<tr>
<td>Oman</td>
<td>118,150</td>
<td>9,688</td>
<td>6,120</td>
</tr>
<tr>
<td>Qatar</td>
<td>4,412</td>
<td>6,968</td>
<td>15,870</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>865,000</td>
<td>120,279</td>
<td>7,820</td>
</tr>
<tr>
<td>UAE</td>
<td>30,000</td>
<td>32,813</td>
<td>20,140</td>
</tr>
</tbody>
</table>

[*] 1989

Sources:
Table 2  
The Growth Rate of Real GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain⁶</td>
<td>N/A</td>
<td>10.40</td>
<td>1.64</td>
</tr>
<tr>
<td>Iran⁷</td>
<td>12.15</td>
<td>0.23</td>
<td>1.41</td>
</tr>
<tr>
<td>Iraq⁸</td>
<td>5.5</td>
<td>11.2</td>
<td>-10.59</td>
</tr>
<tr>
<td>Kuwait⁹</td>
<td>3.55</td>
<td>-2.12</td>
<td>1.68</td>
</tr>
<tr>
<td>Oman⁶</td>
<td>17.92</td>
<td>13.02</td>
<td>8.72</td>
</tr>
<tr>
<td>Qatar⁹</td>
<td>N/A</td>
<td>N/A</td>
<td>2.77</td>
</tr>
<tr>
<td>Saudi Arabia⁶</td>
<td>18.08</td>
<td>8.72</td>
<td>2.20</td>
</tr>
<tr>
<td>UAE⁸</td>
<td>N/A</td>
<td>14.61</td>
<td>1.54</td>
</tr>
</tbody>
</table>

*Sources International Monetary Fund (IMF) for 1976-1990 and Economist Intelligence Unit (EIU) for 1991-1993


The growth rates of GDP of Gulf economies have varied considerably over time and among the countries. As shown in Table 2, all member states in the Gulf region experienced very high growth rates in the 1960-1980 period. In the 1973-1980 period the Iranian economy suffered a severe setback because of the political revolution in Iran, while Iraq experienced a very high rate of growth, 11%. Other countries in the region (except for Kuwait) had very high growth rates, especially Oman and UAE. However, the growth rates started to stagnate after 1980; the growth rates in every country became very volatile because of changes in oil revenues and the two Gulf Wars. Lower growth rates were experienced by almost all of these economies in 1980-1993. The Gulf War made the growth rates of the Gulf states extremely volatile. The war had a devastating effect on the economies of Kuwait and Iraq. For example, Kuwait experienced negative growth rates of 35% and 40% in 1990 and 1991, while in 1992 it experienced a positive growth rate of almost 90%. Iraq experienced the same type of volatility in its growth rate in 1989-1993. Iran also experienced significant volatile growth rates before and after the first Gulf War. Similarly, the average growth rates shown in Table 2 do not show the degree of volatility of the growth rates, but what it shows is that the average growth rates of GDP for the periods 1973-1980 and 1980-1993 are dramatically different. All of the countries experienced substantial retardation in their growth rates; some experienced even negative growth rates in the period 1980-1993. To be sure, the underlying data is rather weak, and for some countries such as Iraq and Kuwait the data after the Gulf War is either not available or unreliable. However, it is reasonable to assume that these two economies have yet to recover and the general picture of substantial slowdown of economic growth in all the Gulf economies remains valid.
The most telling sign of economic stagnation however can be seen from the data on per capita GDP in the countries of the region since the early 1980s. The stagnation in the standard of living was partly the result of the slow and uneven growth of the economies and partly due to the spectacular rise in growth of population in the Gulf states. The growth rate of real GDP for the period 1970-1980 and 1980-1993 is shown in Table 3. The growth rate of population was very high in each of the countries of the region during the whole period 1973-1993, but the growth rate of income or GDP in the period 1980-1993 fell much below the growth of population. In two countries, Iraq and Kuwait, the size of the population shrank considerably because of the second Gulf War. Many expatriate laborers either left or were forced to leave. Also, war casualties reduced the potential growth of population. In Kuwait the size of population shrank from 2.1 million in 1990-1991 to 1.3 million in 1992, and has risen since to 1.33 million in 1993. Such a contraction in the size of population leads to the perverse result of a rising standard of living. This is hardly an acceptable outcome considering that the economies of Kuwait and Iraq were damaged severely during the Gulf War.

b. **Population Pressure and Economic Growth Prospects**

The most dramatic structural problem facing the economies of the Gulf is the effects of the excessive population growth projected for the next two to three decades. The population of the region, as shown in Table 4, was about 96 million in 1990. The projected population increases for the years 2000 and 2010 are respectively 125 and 162 million, an increase of approximately 70% in just the next sixteen years. The two main reasons for this rapid population increase are the drop in the infant mortality rate and the death rate, and the tendency
Table 3

The Growth Rate of Real GDP Per Capita

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain*</td>
<td>N/A</td>
<td>4.15</td>
<td>-1.81</td>
</tr>
<tr>
<td>Iranb</td>
<td>9.19</td>
<td>-2.70</td>
<td>-2.05</td>
</tr>
<tr>
<td>Iraqc</td>
<td>2.20</td>
<td>7.70</td>
<td>-14.61</td>
</tr>
<tr>
<td>Kuwaitd</td>
<td>-2.80</td>
<td>-8.42</td>
<td>0.67</td>
</tr>
<tr>
<td>Omanc</td>
<td>15.00</td>
<td>8.75</td>
<td>3.67</td>
</tr>
<tr>
<td>Qatarf</td>
<td>N/A</td>
<td>N/A</td>
<td>-2.55</td>
</tr>
<tr>
<td>Saudi Arabiag</td>
<td>15.18</td>
<td>4.18</td>
<td>-2.86</td>
</tr>
<tr>
<td>UAEh</td>
<td>N/A</td>
<td>1.16</td>
<td>-4.59</td>
</tr>
</tbody>
</table>

*Sources International Monetary Fund (IMF) for 1976-1990 and Economist Intelligence Unit (EIU) for 1991-1993


to have large families. In the past two decades increased health standards and literacy, especially in women, have reduced the infant mortality rate. This process has some distance to go because compared to western economies the infant mortality rate is still very high. In addition, the fertility rate in the countries of the region is very high, twice the world average. However, the increases in female literacy and increased female labor participation are likely to be accompanied by declining fertility rates in the long term.

Even more alarming are the projections for the "stationary population," i.e., the level where the population achieves a zero growth rate, for each of the countries and the region as a whole. As shown in table 4, the stationary population of the area will be nearly half a billion people by approximately the middle of the twenty first century. The distribution of the increased population will vary greatly among the countries. By the first quarter of the next century the populations of small countries such as Bahrain, Kuwait and UAE will more than double, while those for Iran, Iraq, Oman, Qatar, and Saudi Arabia are likely to increase by more than 400% over the population level in 1990. The growth rate of population may slow down in the next few decades and the stationary population may turn out to be smaller than the estimates suggest. Even if the actual numbers are about 75% of what is reported in Table 4, the pressure of the population on the resources of the region will be very heavy. To mitigate the situation requires stable and high growth of the economies in the region and a substantial decline in the population growth rate.

Another feature of increased population, particularly in the western Gulf states, is the ever increasing size of the non-national or expatriate population. In some small states like Qatar and United Arab Emirates, the expatriate population is twice or three times larger than the nationals
Table 4  
Actual and Projected Size of Population in Gulf Countries*  

<table>
<thead>
<tr>
<th>Country</th>
<th>Population by Decade '000s</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th>Stationary Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>127</td>
<td>162</td>
<td>215</td>
<td>342</td>
<td>484</td>
<td>582</td>
</tr>
<tr>
<td>Iran</td>
<td>16,913</td>
<td>21,554</td>
<td>28,359</td>
<td>38,783</td>
<td>55,928</td>
<td>71,253</td>
</tr>
<tr>
<td>Iraq</td>
<td>5,180</td>
<td>6,847</td>
<td>9,356</td>
<td>13,043</td>
<td>17,751</td>
<td>23,947</td>
</tr>
<tr>
<td>Kuwait</td>
<td>145</td>
<td>292</td>
<td>748</td>
<td>1,358</td>
<td>2,125</td>
<td>1,702</td>
</tr>
<tr>
<td>Oman</td>
<td>413</td>
<td>505</td>
<td>654</td>
<td>984</td>
<td>1,530</td>
<td>2,165</td>
</tr>
<tr>
<td>Qatar</td>
<td>47</td>
<td>59</td>
<td>151</td>
<td>229</td>
<td>484</td>
<td>659</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>3,201</td>
<td>4,075</td>
<td>5,745</td>
<td>10,399</td>
<td>15,557</td>
<td>22,621</td>
</tr>
<tr>
<td>UAE</td>
<td>70</td>
<td>90</td>
<td>223</td>
<td>1,015</td>
<td>1,844</td>
<td>2,281</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>26,096</strong></td>
<td><strong>33,584</strong></td>
<td><strong>45,451</strong></td>
<td><strong>661,153</strong></td>
<td><strong>95,703</strong></td>
<td><strong>125,210</strong></td>
</tr>
</tbody>
</table>

Table 5
Population of Nationals and Non-Nationals in 1992
Percentage of 0-19 Years in Each Population Category

<table>
<thead>
<tr>
<th>Country</th>
<th>Nationals</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total Population</td>
<td>Age 0 - 19 (%)</td>
<td>Total Population</td>
<td>Age 0-19 (%)</td>
<td>Total Population</td>
<td>Age 0-19 (%)</td>
</tr>
<tr>
<td>Bahrain</td>
<td>330,162</td>
<td>51.1</td>
<td>185,836</td>
<td>19.4</td>
<td>515,999</td>
<td>39.7</td>
</tr>
<tr>
<td>Iraq</td>
<td>18,373,810</td>
<td>44.6</td>
<td>158,895</td>
<td>2.9</td>
<td>18,532,706</td>
<td>44.3</td>
</tr>
<tr>
<td>Kuwait</td>
<td>896,038</td>
<td>57.9</td>
<td>231,738</td>
<td>35.2</td>
<td>1,127,776</td>
<td>53.3</td>
</tr>
<tr>
<td>Oman</td>
<td>1,380,312</td>
<td>51.4</td>
<td>362,236</td>
<td>18.5</td>
<td>1,742,548</td>
<td>44.5</td>
</tr>
<tr>
<td>Qatar</td>
<td>122,772</td>
<td>54.3</td>
<td>417,810</td>
<td>20.3</td>
<td>540,582</td>
<td>28.0</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>12,195,930</td>
<td>59.3</td>
<td>4,516,690</td>
<td>28.2</td>
<td>16,712,620</td>
<td>50.8</td>
</tr>
<tr>
<td>UAE</td>
<td>492,772</td>
<td>59.6</td>
<td>1,012,535</td>
<td>28.4</td>
<td>1,505,307</td>
<td>38.7</td>
</tr>
</tbody>
</table>

(see Table 5). The size of the non-national population is also increasing in Saudi Arabia, Kuwait and others. There is a question of whether the expatriate population should be considered part of the population of these countries. All the evidence points to the fact that the expatriate populations are an integral part of the functioning of western Gulf economies and are likely to remain so for some years to come.

The age structure of the population in the Gulf states is even more alarming. In Table 5 we provide the totals and the percentage of population between the ages of 0 - 19 years for both nationals and non-nationals in each of the Gulf states. Though the percentage of this age group in the population varies somewhat among the countries, what is noticeable is that generally over 50% of the native population is below 20 years old. This dependency ratio is much higher (with some exceptions) than many other countries and contrasts sharply with those in the EC (34%) and the US (36%). This type of population growth requires that substantial resources be devoted to health, education, and related services.

Another indicator of the pressure of population growth on the economy is the percentage of economically active individuals in the population. Except for some of the small Gulf states, this ratio is low in comparison to developed countries. This is partly a reflection of the low participation rate of the female population in the labor markets and the large number of young people in the population. If we add to the picture the high rate of unemployment (mostly in Iran and Iraq) and even excessive underemployment that exists in most of the Gulf states, the economic burden of excessive dependency of young and old non-working population becomes quite evident.

A related issue is the rapid shift of the population from rural to urban areas. Between
1960 and 1988 the urban population increased very rapidly because of internal migration from the rural areas. There are only a few urban centers in this region which absorb the internal migration. Except for Iran and Oman, about 70% to 98% of the population of the Gulf states are already living in urban areas. The rate of urban population increase is also higher than in rural areas. To the credit of the governments in the region, the population, especially women and the young, has benefited from growing literacy and expanding educational programs. In fact, the educational institutions are under pressure because of the great demand for education. It is reasonable to assume that the educational system in these countries will turn out increasing numbers of students for the labor market, especially in the urban centers. However, the poor quality and inappropriate nature of education in some of these countries is a major problem. More and more of the population of these countries will become concentrated in urban centers and they will mostly be young.

Will these increased numbers of young find appropriate work? That depends on whether the economies of the region can keep pace with the rate of population increase and have the potential to create desirable jobs. As was noted earlier, the Gulf states did well in terms of growth rates in 1960-1973 and 1973-1980. This was partly the result of increased growth of output and the fact that population growth had not picked up speed. Between 1980 and 1993, the picture changed dramatically. The likelihood that these economies will once again experience the growth rates of the years before 1980 is not very high. There are several reasons for this. First, the growth rate of population is, as noted earlier, likely to be very high, diverting larger percentages of output to subsidies and to private and public consumption. Second, current

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forecasts suggest that the growth of the world economy will be sluggish for some time to come, which means that oil prices are likely to remain low.

The Gulf countries will face some difficulties even if the demand for oil increases. The governments are committed to fairly generous subsidies for their populations. Unless substantial economic growth is generated, the rising population will mean lowered subsidies per person. If the governments are forced to adopt austerity programs, the possibility of disaffection and unrest may increase. Several economies of the region, Kuwait, Iraq and Iran, are still suffering from the ravages of the recent wars. Some countries like Iraq, Kuwait and Saudi Arabia have lost most of their surplus foreign reserves and the level of external indebtedness has increased in all the countries of the region. Thus Saudi Arabia and Kuwait, which were major financial donors to other Arab and Muslim countries, are no longer in a position to play a similar role in the region in the near future.

Because of the twin pressures of a rapidly rising population and the likelihood of insufficient economic growth, it is essential that significant structural reforms be undertaken in each country, and a new international framework for economic cooperation be found. Otherwise, should the standard of living in the region deteriorate, the likelihood of domestic turbulence and instability will increase. The major responsibility of meeting the challenges of the future will fall mainly on the countries of the region, but the industrialized countries, and the US in particular, have a major stake in resolving some of the major economic challenges that confront the Gulf states.

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III. Major Impediments

There are a variety of specific obstacles to economic growth in each of the economies of the region. The governments in the region are in the process of addressing some of these impediments. Instead of listing the specific problems and the suggested solutions, we shall consider very briefly only the three most important issues facing the Gulf economies. These are: the domination of the state in the economy; the extraordinary expenditure on defense and arms and the significant distortion and peculiarities of the labor markets in most of the Gulf states.

a. The Dominance of the Public Sector

Forms of government and political and economic orientation vary greatly in the Middle East. However, one common feature of all the Gulf states and the Middle East in general is the dominance of the state in society and the economy. Except for a few countries, the state employs large numbers of people, ranging from 25% to over 40% of the entire labor force. In some countries, state-owned public enterprises exclusive of financial institutions account for about 9% of GDP, employ 47% of the manufacturing labor force, use 27% of all manufacturing investment, and on average run sizeable deficits. The state controls large investment budgets and owns the basic infrastructure in transportation and communication and all mineral rights and oil deposits; the state regulates prices and wages in the private sector extensively. It subsidizes many economic activities in the economy through price regulations or direct transfers. The private sector is either not encouraged or has remained dependent on government direction.

The government-led growth achieved a great deal in the 1960s and 1970s. Investments

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in health, education, infrastructure, and communication systems have been quite impressive in almost all the countries of the region.\(^7\) In most of the Gulf States, the basic infrastructural capital and basis for industrialization and economic growth are in place. But these achievements have also led to inefficient and noncompetitive industrial structures with high cost and inefficient technologies. In some countries like Iran and Iraq, the overvalued exchange rates and domestic price distortion have led to misallocation of resources in agriculture and industry. Because of these factors the gap between domestic saving and domestic investment has grown very large and had to be filled by external borrowing.

Another aspect of the role of the state in the economy is the sizable and chronic budget deficit that exists in several countries. Consumption expenditure, both public and private, is growing at the expense of investment. In most of the countries, the government's budget suffers from a structural deficit which is met either by running down the foreign reserves accumulated during the oil price rises or by borrowing from abroad.\(^8\) Expenditures on defense, welfare and subsidies, and interest payments on foreign debt are big items in the public sector budgets of most countries in the region.

b. **Arms and Defense Expenditure**

Aside from the pervasive dominance of the state in controlling economic activity, the governments in the Gulf region spend a large portion of their budget on sophisticated arms and

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defense-related activities. The Gulf, like the Middle East as a whole, has had more than its share of wars since World War II and have therefore devoted a considerable amount of their income and human resources to defense related efforts. The defense expenditure in 1987 by the Gulf states amounted to $50.5 billion, though substantially less than almost $70 billion spent in 1985, is very large. Between 1978 and 1987 the sum spent on defense by all the states totaled a spectacular sum of over a half a trillion dollars. Iran, Iraq and Saudi Arabia were the countries with substantial defense budgets. As a percentage of GNP, all the Gulf states devote a large portion of their resources to defense, which exceeds world and U.S. averages by a substantial margin. As an example, the average defense expenditure per soldier in the Gulf comes to $80,000, in Saudi Arabia more than $200,000, and in the US to about $50,000.

As a consequence, the expenditure on arms and defense in most of these countries significantly exceeds expenditure on health and education. At one extreme, Iraq's military expenditure before the Gulf war was seven times greater than its expenditure on health and education. This ratio is between one and three times in other countries of the region, except for Kuwait. In contrast, in industrialized countries military expenditure adds up to about half of the combined expenditure on health and education. A considerable part of the defense budget is used to import weapons and equipment and for installation and improvement of military infrastructure. Impressive as the quantitative arms build up in the Gulf may be, it is surpassed by the speed of qualitative changes. The Gulf states have some of the most sophisticated ballistic missiles, state

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10 Cordesman, ibid.
of the art aircraft, chemical weapons, etc.

The reasons for the massive military build up in the Gulf are not difficult to find. The Gulf states are going through rapid modernization of the economy with consequent changes in attitudes, beliefs and social adjustments that generate anxiety. They are situated in a region of the world that has experienced several wars in recent times and the feeling of insecurity is very high. Also deep-seated mistrusts inherited from past history often lead to armed conflict inside the states and among the Gulf states. The policy of the industrial powers in the last two decades has stimulated rather than dampened the internal militarization already existing in the Gulf. Finally, arms sales are very profitable for the industrialized countries and for the defense establishment inside the countries. The high defense expenditures of the Gulf states have attracted huge sales of sophisticated weapons. The major arms exporting countries are the U.S., USSR, France, and China; North Korea and Brazil are also important participants in the Gulf in this market. What is to be noted is the large size of this market and the increasing sophistication and deadliness of the types of weaponry.

Aside from the diversion of significant amounts of resources from economic activities, defense expenditures have had a major impact on the structure of the economies of the region. In a number of these countries, particularly Iran and Iraq, the emphasis on military expenditure has led to an absorption of highly skilled labor and technology for military and quasi-military purposes, which are thus denied to the rest of the economy. Further, it has strengthened the public sector hold on the economy and handicapped the private sector. Also there is a danger that continued expenditure on military and sophisticated arms may lead to the enhancement of the military's power in politics; in some cases the military may be tempted to seize power.
Clearly, there are good reasons for defense expenditure, particularly by small countries that may feel more vulnerable. However, compared to other regions of the world with similar political and economic problems, the defense expenditure in the Gulf states is entirely out of proportion.

c. Labor Markets and Subsidies in the Gulf Economies

The labor markets in the region, particularly in the western Gulf states, have special features. As can be seen in Table 5, a large proportion of the labor force consists of expatriates. This is especially true in the small states of Bahrain, Qatar and UAE. In Qatar and UAE the nonnationals exceed the nationals two to three times. In Kuwait, Oman and Saudi Arabia, the number of expatriate workers is rising and now exceeds a quarter or third of the labor force. The number of expatriates in the two comparatively diversified economies of Iran and Iraq is quite small. Also, the demand for expatriate labor often increases when oil revenues are high and the economy is expanding. Most of the expatriate labor in GCC countries comes from South and East Asia and the main reason for the surge in Asian workers is their low cost. Expatriate workers from Arab countries often cost more in wages and may entail security risks in some cases.

Desire for rapid growth and conversion of the GCC economies to become more diversified were the basic motivations for the importation of expatriate labor. The preference of the native population for jobs with social status and government employment policies have increased demand for migrant workers. The private sector in GCC is essentially non-Arab,
mainly South and East Asian working environment.\textsuperscript{11} One study indicates that over the period 1985-95 total employment in GCC will grow from 6.8 million in 1985 to 7.7 million in 1995; non-nationals' employment from 5.1 million to 5.4 million, while the nationals' employment will grow from 1.7 to 2.3 million during the same period. The nationals' unemployment rate will increase from 2.6% in 1985 to almost 6.0% in 1995.\textsuperscript{12} These figures suggest that there is little substitution of nationals for non-nationals in the work place and an increasing percentage of nationals will be unemployed.

Another feature of the labor market in the Gulf is the extreme distortion in the wage structure. The public sector wages exceed private sector wages by a substantial margin and the productivity or efficiency of labor is much lower in the public sector than in the private sector. The governments often guarantee high wage employment in the public sector for their own nationals. Also the degree of underemployment in the public sector of these economies is estimated to be too high. Another fiscal policy that further distorts the labor market is that the state pays for the cost of electricity, gasoline, housing expenses, and in some cases food of the expatriate workers either directly or indirectly through the employers. This in effect lowers the wage of the expatriate labor substantially and encourages demand for this type of labor. These types of fiscal and employment policies have encouraged production to be more labor intensive and thus increase the need to import more expatriate labor. These government policies, instead of increasing efficiency and employment of the national workers, have led to non-optimal use of


\textsuperscript{12} Birks and Sinclair, ibid.
resources, using too many workers in the labor constrained economies of the western Gulf.

Two other features of the labor market in the Gulf should be mentioned. First, the existing pattern of education and training in the Gulf states is not geared to enhance labor productivity and efficiency in production. At present not enough emphasis is given to primary education, vocational training at the secondary level, and science and technology at the higher education level. These countries have spent large sums on education and the degree of literacy has increased substantially. However, the skill level and performance capacity of the labor force still remains low. Second, the labor market in the Gulf, as in the rest of the Middle East, is dominated by males in the work place. The female labor participation rate is over very small, ranging from about 4% in Saudi Arabia to a high of 17% in Bahrain. There is a large reservoir of potential labor that is not yet employed. With rising numbers of educated females currently coming out of educational institutions, the issue of female labor participation will likely become an important concern for policy. Should the role of female labor participation increase substantially it is likely to reduce the pressure of labor shortage and may in the long run be a major force for decline in the growth rate of population in this region. However, there are strong social and cultural forces that work against substantial female participation in the labor market.

IV. Gulf Oil Industry in the 1990s

Finally, the most important stimulus for economic growth will be a substantial increase in the oil revenue for the Gulf states. Predicting the course of oil prices and demand has never been easy. However, new forces are likely to affect the oil industry in the 1990s and once again
result in a different balance between internal and external forces in the region. Also, the balance among the oil producers in the Gulf states is also likely to change, perhaps somewhat dramatically.

The high oil prices in the early 1980s led to a decline in demand for oil and rising non-OPEC production. Non-OPEC production rose from 16.3 million bpd in 1975 to 25.3 bpd in 1988. Overall demand for oil declined from 50 bpd in 1979 to 43 bpd in 1983. As a consequence, excess production capacity within OPEC rose to 17 million bpd in 1985; 85% of this excess capacity was in the Gulf states. Investment in crude production in the Gulf virtually ceased during the 1980s. Substantial oil tanker surpluses and refinery capacity increased in response to the decline in demand. Slowly this excess capacity diminished in the decade of the 1980s. In 1990 the excess capacity in various parts of production, delivery and refining of OPEC oil has virtually ceased to exist as a consequence of rising demand and stagnation of production in non-OPEC production. It is likely that the 1990s will be a period of heavy investment in all sectors of the oil industry. However, not all producers can afford the investment needed very easily. Therefore, the Gulf states, especially Saudi Arabia and Kuwait, are likely to expand production capacity much more easily than Iran or Iraq and the small oil producers in the Gulf.13

There are some uncertainties that could affect oil production and consumption of Gulf oil in the 1990s. One powerful force is concern over the environment, particularly in the West, which would limit the growth of demand for oil. But if the non-OPEC producers remain

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capacity constrained, it is unlikely that demand for Gulf oil will decline in absolute terms unless the oil prices once again surge. The environmental concern however may lead to demand for sweet crude which is in limited supply in the Gulf but may generate demand for new LNG projects and possibly for gas pipelines from the Gulf to consumer markets. Also it is unknown what will happen to the oil prices when Iraqi oil eventually comes to the market. On the other hand, the likely increased dependency of the US\textsuperscript{14} and European economies on Gulf oil and the rising demand for oil from China if it continues to grow at a 10 to 12\% growth, suggest rising demand for Gulf oil in the 1990s. Two factors however will likely trigger substantial substitution of Gulf oil - one, if oil prices are allowed to surge and demand consequently declines, and two, if political instability arises in the Gulf, leading the consuming nations to consider Gulf supplies not secure.

V. An Agenda for Action

The strategic question facing the Gulf states and the world community is whether the twin issues of stagnating standards of living and political instability in the Gulf region can be successfully addressed in the near future. Can the world economy afford the repeat of conflicts like the Iran-Iraq War and the Gulf War, wasting enormous resources that could be best used to finance growth in the region, and finance investments in the rest of the world? We have identified three sets of issues that require policy action by both the governments in the Gulf and the international community.

\textsuperscript{14} US oil imports have increased from 34\% of its total demand to 50\% in 1990 and US oil production is likely to continue to decline in the 1990s. See Davies and Stevens, ibid.
a. Economic Reforms within the Countries

A great deal was accomplished in 1960-80 and the early 1980s in the Gulf States. Most of the countries experienced high growth rates and per capita income rose substantially (see table 2). Infrastructure investment in most of these countries rose dramatically. Education and health expenditures rose sharply between 1960 and 1986; life expectancy has increased substantially since the 1960s. Enrollments in primary, secondary, and higher education, both of males and females, rose by leaps and bounds everywhere. Adult and female literacy rates also rose rapidly. The number of radios and television sets per 1000 people rose dramatically. The substantial growth of infrastructure, education, health, and national organizations has laid the foundation for the next phase of development of these countries.

However, without a basic reform of the internal structure of these economies, the impediments to sustainable growth mentioned earlier may force a decline in the standard of living of the residents of the region. The stunning achievement of the New Industrialized Countries (NIC) in Asia (South Korea, Singapore, Taiwan, Hong Kong, Thailand and recently China) and the dramatic failure of the east European economies both show that those countries that reformed their economies succeeded and those which did not failed. The state-led economies of the Gulf have clearly run into diminishing returns in promoting investment, saving and productivity, avoiding large foreign indebtedness, and in narrowing the income distribution among the classes of the population. To achieve structural transformation of these economies governments must help to manage the economy efficiently. They should develop a framework of policies to remove as many of the obstacles discussed earlier in Section III as possible. There are some specific steps

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that can be taken in this direction.

The role of the state in the economy must be reduced. Macro economic stabilization programs to reduce chronic budget deficits and balance of payments is required; liberalization of prices and regulations that encourage investment and efficiency at enterprise level is another step; tax and financial market reforms are also needed. A comprehensive strategy to increase the share and vigor of the private sector though a variety of means needs to be developed. A comprehensive privatization plan of the public sector enterprises must be undertaken as soon as possible. The main principles that should guide the process of privatization should be to increase economic efficiency and overall productivity of the economy, to maximize state revenues and if possible achieve a fair distribution of wealth, and to increase the financial stake of the citizens in the economy and encouraging them to invest in the domestic economy rather than sending their capital abroad. Privatization could encourage development of capital and financial markets, reduce fiscal costs and attract foreign capital and technology. By expanding opportunities for the private sector and assisting its growth, the government can help create employment opportunities for the expanding population.

Public sector management reform is badly needed to reduce the inefficiencies of public enterprises and to enable the state to support rather than to substitute for private economic activity. Public sector employment must be reduced significantly in most countries, and employees must be trained for private sector work. The web of regulations, subsidies, price guarantees and tariff fees, regulations on investment allocations and the various impediments to the privatization of public sector enterprises need to be examined and relaxed as soon as possible.

An important area of reform is subsidies and welfare. Many subsidy programs for
industries and labor markets, as noted earlier, are not tied to increased efficiency. They encourage and sustain inefficient use of both native and expatriate labor. The welfare policies often unduly encourage consumption, thus discouraging a rise in the saving ratio, a key parameter for long-term growth. The subsidizations often discourage provision of the subsidized goods by the private sector by keeping prices artificially low, thus perpetuating the dominance of public enterprises in the economy. Also the generous welfare policies discourage incentives to work. Finally, since most of the consumer subsidies are not based on the level of income, they tend to be regressive, especially in quasi-absence of income and sales tax in the Gulf states.

Finally, the governments must take the lead in educating and assisting their populations in efforts to reduce the rate of population growth. The high growth rates of the recent past are not sustainable. A comprehensive program is needed to address all aspects of the rising growth in population and its relationship to employment and productivity. Education of females and their participation in the labor market is an important restraining force against further growth of population and would increase growth and productivity of the economies in the region.

b. Reduction in Defense Expenditure

An assessment of the events of the past two decades would indicate that the increased expenditure on defense and arms has not solved any of the existing problems of the Gulf states; rather it has aggravated them and created new problems. As noted earlier, large amounts of resources are divested to unproductive use; the resources can be used for economic development, environment protection and social improvement within the Gulf states and neighboring countries. Economic disorder, social eruptions and environmental pollution in neighboring countries would
affect the Gulf and military power will not provide any appropriate means against that kind of threat. It is also remarkable that no one has actively pursued a course of détente in the arms race in the Gulf region. The two superpowers, the USSR and the US, called for détente in the arms race between themselves in the early 1970s but assisted in the arms race in the Gulf. The question facing the Gulf states is how much defense expenditure is enough, how long this arms race can go on, and whether the large expenditure of the past decades have lead to any sense of security in any state in the region.

Governments must attempt to reduce their expenditure on defense; this process can be gradual and will probably require bilateral and multilateral negotiations between Iraq, Iran and GCC countries. Substantial resources can be saved through such a process and invested to promote economic growth. Governments can also reduce their purchases of new arms. The size and quality of arms now at the disposal of Gulf states, except for the very small Gulf states, are such that they could inflict serious damage to other countries. If cross border invasions are not very likely (as a result of the second Gulf War and the US military presence) in the next decade or so, then a diversion of resources from military use to an expansion of the domestic economy should be possible. Freezing the arms race in the region could be the first step in this direction. Another major step would be for the US and other major arms suppliers to restrict arms sales to the Middle East and particularly the Gulf states. This will not be easy when the share of defense expenditure is falling in the US and Europe and the Gulf market for weapons remains so profitable. The Gulf countries cannot continue their arms race forever. The collapse of Soviet economic and political power under the pressure of continued military expenditure when its economy was basically weak can yet repeat itself in the Gulf. The USSR was, at least,
fortunate enough not to be facing a population explosion.

c. **International Support and Closer Ties to the World Economy**

The advanced countries, particularly the EC and Japan, could help the process of domestic economic reform mentioned earlier. One possibility is to encourage Japan to take a significant lead in the economic revitalization of the Gulf states. Japan is highly dependent on Gulf states oil and has significant investment interests in the region. In addition, it is not considered a colonial power in the region and can therefore easily broker the economic interests of the advanced countries and the Middle East. The EC also has an important role to play. The European countries will need oil from the Gulf States even if the Russian oil sector resumes its previous production levels. Also they have significant commercial and economic interests in these states. It is often suggested that Japan and the EC (and particularly the former) have become economic superstars but have not accepted the leadership commensurate with their economic prowess. Now that the Israeli/PLO dialogue has made substantial progress, perhaps the time has come for a joint effort by Japan and the EC to assist in further economic transformation of the Middle Eastern economies in general and Gulf states in particular.

International organizations such as the World Bank and IMF could provide encouragement for privatization of some of the state enterprises and they could initiate a comprehensive program to encourage a shift in resources from defense toward non-defense activities in these economies. Further, they should undertake studies to explore potential economic co-operation on a specific project basis between the GCC countries and the Eastern Gulf States, Iran and Iraq.

Finally, it is important to remove, as much as possible, the instability that pervades
the world oil market. Excessive fluctuations in oil prices must be avoided for they inflict substantial economic costs on the world economy and subject the Gulf economies to a highly unstable growth pattern. Attempts should be made to establish a continual consultative channel between the oil consuming and oil producing countries. Reasonable structures exist for dealing with other commodities such as coffee, tin, etc. Similar systematic ways need to be found to handle potential crises in the oil market. A steady and reasonably priced oil supply will benefit both oil producing and consuming countries and will facilitate the economic reform and restructuring of a number of economies in the Middle East. Another possibility is further integration in the oil production sector. That is, a selective re-entry upstream on risk basis in some capital constrained Gulf states and further moves by countries like Saudi Arabia into downstream production.\textsuperscript{16}

A number of new steps are required to further incorporate the Gulf economies into the world economies. During the past decade a triangular relationship has been developing between Asia and the Gulf states. The pattern is that the GCC countries are importing more and more expatriate labor from South and East Asia. The Gulf states, including Iran and Iraq (before the war) are increasingly importing Japanese and East Asian products and an increasing volume of Gulf oil exports is destined for Asia. Some new steps are in order. The Gulf states, particularly Saudi Arabia, could extend their energy based drive for low cost petrochemicals by establishing new refineries or purchasing existing ones in various markets. This would be particularly appropriate for countries such as India, Pakistan and China. Another avenue is to establish international banking and investment services in the Gulf to serve world trade needs. Certain

\textsuperscript{16} P.A. Davies and P.J. Stevens, ibid.
areas of the Gulf such as Dubai can utilize the experience of Hong Kong and Singapore to service the trade between the Mediterranean and Asia. Also the Gulf states could follow the Kuwaiti example of overseas financial and direct investment in both emerging Asian countries and the well established markets of the OECD countries. The strategy of direct investment will likely be most fruitful if it is tied to establishing downstream petrochemicals in the consuming countries.

Another important role that the Gulf states need to consider is their relationship with their neighbors. A prosperous Gulf cannot easily escape its neighborhood. They must contribute to the economic development of the Arab Middle East; Iranian contribution to strengthening the embryonic economic union of Central Asian countries (ECO) will be necessary. Finally, the conflicts between Iran and Iraq and Iraq and Kuwait need to be addressed. If these admittedly difficult problems are not actively pursued, the very strategy of domestic industrialization and expansion of domestic service industries as well as the relationship of the Gulf states to the world economy will be severely tested. In order to achieve economic prosperity, peace is an absolutely necessary precondition and the resolution of outstanding economic and political problems in the neighborhood of the Gulf states is of ultimate importance.

VI. Summary and Conclusion

The fate of the Gulf economies is intertwined with that of the world economy. They are the major suppliers of oil to the world and rich markets for the exports of other countries. Any upheavals in the Gulf impose a large cost on the world economy, as was witnessed in the oil price shocks during the 1970s and in the recent Gulf wars. Prosperity in the Gulf states is in
turn critical for an orderly political and economic development of the region and the rest of the world.

Two major important developments documented in this paper that may threaten political and economic stability in the Gulf are the uneven and slow economic growth of the Gulf States since 1980 and the excessive rate of growth of their population. As a consequence the levels of real income per capita in these economies have grown very little and the growth rates of per capita income have either stagnated or declined. Most of the population growth in the region is in the age group below 20 years which requires a considerable amount of resources for health and education and other services.

The challenges facing these economies are to achieve sustained, stable and high growth rates and decrease the phenomenal growth rate of the population. To achieve these goals substantial reforms are needed. They may include privatization of industries and state enterprises, changing the pattern and size of subsidies and welfare programs, and reducing regulation of the private sector. A number of specific steps to achieve these goals are outlined in this paper. Two of these steps are particularly important. One is the reduction in defense expenditures which are very high in the Gulf compared to any other country or region in the world; they are a heavy burden on the economies of the region. The other is the reform of the labor market to enhance productivity, encourage substitution of expatriate workers by nationals, and increase the participation of females in the labor force. Another major policy concern which requires urgent and comprehensive attention is to address the causes and consequences of the rise in population growth in the region.

The Gulf states and the international community need to address two sets of issues critical
to domestic reform and world economic growth. One is to achieve stability in the oil markets by increased co-operation between the consumer and producer countries and avoiding political and military instability in the region. The other is a set of economic policy actions outlined in this paper that would integrate the Gulf economies further in the world economic system and enhance their chances to prosper.

To achieve these goals and to reform the domestic economies in the region and to decrease the burden of the continuous arms race in the Gulf would certainly test the will of the Gulf societies and the international community. But the rewards are also extremely high for all concerned.
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