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POLICY OUTLOOK

Regional Arrangements in the Arabian Gulf

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Summary

- To facilitate greater trade in goods, the Gulf Cooperation Council (GCC) must work to improve logistics and reduce non-tariff barriers to trade.
- The remaining big gains to be had from Gulf regional integration are likely to stem not from trade in goods, but from increased integration of the service sector.
- Measures for better integration of services are largely embedded in the 2001 Economic Agreement, but they must be better executed.
- The weak administrative capacities of the GCC countries—as well as the political obstacles facing the GCC as an institution—add further complexity to an already extensive and ambitious agenda of economic reform. Improving administrative capacity is key.

The Gulf Cooperation Council represents one of the oldest and most ambitious regional trading agreements (RTAs). It comprises six countries: Saudi Arabia—which accounts for more than 60 percent of the GCC's gross domestic product (GDP) and 70 percent of its population[1]—Bahrain, Kuwait, Oman, Qatar, and the United Arab Emirates. These countries share the Arabian Peninsula and account for some 40 percent of world oil reserves. They have security interests, language, and culture in common—which ground the GCC politically and help explain both its success and its staying power.

Merchandise trade among GCC countries represents only about seven percent of their total, a figure that compares unfavorably with other RTAs, such as the North American Free Trade Agreement (NAFTA), at 52 percent, and the EU, at 68 percent.[2] The low total is often ascribed to the GCC countries' similarity of factor endowments, given that all of them are oil exporters with relatively small populations, and the region's small market, which represents less than 3 percent of the world total trade.[3] However, when adjusting for their market size, trade among GCC countries is comparable to that among NAFTA member states and is, in fact, higher than trade among EU member states, indicating relatively high trade intensity despite similar factor endowments.[4]

To facilitate greater trade in goods, the GCC must work to reduce non-tariff barriers to trade. However, the big gains still to be had from regional integration in the Gulf are likely to stem not from trade in goods, but from increased integration of the service sector, which is also the region's most promising avenue of economic diversification and job creation. This integration requires regulatory cooperation, removal of "behind-the-border" barriers in services trade, and liberalization of foreign investment. Collaboration in trade facilitation and logistics can both enhance trade in goods and promote the GCC as a home for international transportation hubs. Such measures are largely already embedded in the 2001 Economic Agreement,[5] but they must be better executed. Successful implementation of the agreements will also enhance the region's competitiveness and integration into the global economy.

Increasing Trade in Goods in the GCC

With regard to trade in goods, the possibilities for the GCC contributing to future integration and growth by lowering tariffs are already being exploited. The GCC's tariffs are among the lowest in the world outside the high-income countries of the Organisation for Co-operation and Development (OECD); its average applied external tariff has been progressively brought down to under five percent,[6] except for a small number of tariff lines representing a small share of total trade. Thus, limited room remains for further gains from tariff liberalization.

The scope for increased gains from trade in goods is also limited by the region's similar export composition (dominated by oil), which hinders the development of distinct comparative advantages within the region. The small size of the Gulf economies further limits opportunities for intra-GCC trade, particularly compared to intra-EU or NAFTA trade, each of which represent about one-third of total world trade.[7]

Many of the GCC's efforts have thus far been targeted at lowering tariffs between member states. However, tariffs are only one factor affecting trade flows. Trade costs, including freight, insurance, and time lost at customs, comprise the other—and increasingly important—part. These costs, combined with tariff barriers, determine a given country's total trade costs, as measured by the "Overall Trade Restrictiveness Index" (OTRI).

Table 1: Overall and Tariff-only Trade Restrictiveness Indices (2007, percent)

Region	Total Trade Restrictiveness	Tariff-Only Trade Restrictiveness
MENA Countries		
GCC*	12.2	6.0
Egypt, Jordan, Lebanon	22.3	6.7
Maghreb	34.1	18.2
Richest Non-Gulf Countries**		
European Union	6.6	1.4
Japan	11.4	4.5
United States	6.4	1.6

Source: Kee, et al. (2006); Overall Trade Restrictiveness Index (i.e., including non-tariff measures) in bold; Tariff-Only Trade Restrictiveness Index in italics. *Only nontariff data are available for Oman and Saudi Arabia. **Year 2006 for richest non-gulf countries.

Comparisons between the OTRIs of GCC member states and those of high-income countries suggest that there remains a significant gap in containing trade costs within the GCC. Out of 178 countries in the World Bank's "Ease of Trading Across Borders" measure, GCC countries average a rank of 52 (with great internal variation); on the "Ease of Doing Business" rankings the GCC countries average a rank of 38. The number of documents per import/export transaction and the time required for import/export clearing remain significantly higher than the OECD average. On logistics performance, both the UAE and Saudi Arabia receive a score of 3 out of 5 by freight forwarders, whereas Singapore, the Netherlands, and Germany, the three highest-ranked countries, receive a score in the 4.1–4.2 range.[8]

Table 2: Ease of Doing Business (2008)

Countries	Ease of Doing Business Rank	Trading Across Borders Rank
Bahrain	18	21
Kuwait	52	104
Oman	57	119
Qatar	37	36
Saudi Arabia	16	16
United Arab Emirates	46	14

Source: World Bank (2009a).

Further reducing these costs would not only help facilitate trade among the Gulf countries, but it would also facilitate trade with the rest of the world, positioning Gulf transport hubs to compete in global markets and thereby providing a significant opportunity for economic diversification.

Services as the Main Avenue of Economic Diversification

Even a GCC completely open to trade in goods and with world class logistics would have limited potential for generating further growth, as the benefits from integration in trade in goods generally pale in comparison to the benefits from removing barriers to trade in services. For example, Konan et al. (2004) estimate that in the case of Egypt and Tunisia, comprehensive service reforms would yield gains 2–3 times those achieved from tariff removal (even though tariffs in these countries are relatively high).[9]

Opening the services market to regional competition will likely result in lower prices, improved quality, and an increased variety of services. Exposure to larger markets will allow service providers to take advantage of economies of scale. Increased competition will promote greater efficiency and spur innovation, often through technology transfers. Services liberalization—if it is accompanied by adequate regulation that ensures competition—can also be a powerful growth lever.[10]

This opening is particularly important in "backbone service" sectors—telecommunications, transport, finance, and business services—as their provision can hugely improve productivity and raise the economy's growth rate as a whole. Mattoo and Sauve (2004) estimate that countries with fully liberalized financial and telecommunications sectors may grow 1.5 percent faster than others, provided they have adequate regulation and a supportive business climate.[11]

Furthermore, services liberalization, which typically involves dismantling restrictive regulations, is less costly (at least with regard to lost tariff revenue) than liberalization in goods. The risk of job loss may also be smaller, since the bulk of services provision takes the form of commercial presence in the local market, essentially through foreign direct investment (FDI).

FDI may be the most important vehicle for providing services across borders. Beyond its role in cross-border services provision, FDI can provide a valuable form of stable and long-term capital. It can also transmit technology and management practices affecting all sectors of the economy. Regional trade agreements can increase foreign investment through the reduction of administrative barriers and can, in turn, raise the rate of return on all investments, regardless of their origin, as investors benefit from a larger pool of potential buyers, reduced transaction costs, and more efficient financial, telecommunications, and other services. Regional trade agreements may also incentivize potential investors by including explicit investor protection measures, such as guarantees of national treatment, nondiscrimination, and property rights, reducing the risks associated with investment.[12]

The Service Sector in the Gulf

Service liberalization is crucial in the oil-rich Gulf, where economic diversification and the creation of high-wage jobs comprise the region's major development challenges. In 2005, with the oil price at $55 a barrel, four of the six GCC countries—Qatar, Oman, Kuwait, and the UAE—were ranked among the world's 20 richest countries, and all six GCC countries had incomes per capita at least double those required to attain the World Bank's "high income" status. However, although the oil sector accounts for the largest share of exports and GDP in the region, it provides few jobs directly. Instead, the bulk of employment in the GCC originates in the service sector, which has accounted for all the job growth and a large share of the value-added growth in recent decades.[13]

Yet productivity in the sector is significantly lower in the GCC than it is in other high-income countries. While its share of employment is comparable to that in the rich countries, its share of GDP is about 10–20 percent lower, and is 30–40 percent lower than the most efficient service sectors in Hong Kong, Luxembourg, and France.[14] This gap in services productivity results in part from an overreliance on a relatively cheap and abundant stock of unskilled expatriate labor, on which the Gulf countries depend much more than other rich countries, due to their large resource endowment relative to their supply of native labor. Adopting a more efficient ratio of unskilled labor to other inputs in the service sectors that currently employ a high proportion of unskilled workers—for example, construction—would decrease reliance on imported unskilled labor. Furthermore, the development of a world class service sector in areas such as finance, telecommunications, health, and international transportation could potentially generate a large number of skilled jobs—complementing the Gulf countries' objective of dealing with the unemployment/underemployment problem among their nationals

Because the cost of many types of labor and labor-intensive services in the Gulf are lower than in the 20 richest countries,[15] the GCC may be able to compete in labor- and service-intensive merchandise export sectors that are currently of comparative advantage in the richest countries, if it can achieve comparable levels of productivity. Refined petroleum products and petrochemicals are clear examples, but other sectors may qualify, for example aluminum production.

A more efficient domestic service sector would also facilitate the development of service exports, including tourism, financial services, and transportation. Given the need to strengthen the Gulf countries' human capital, the development of a stronger education sector in collaboration with overseas institutions appears especially opportune. Over time, these investments may create a capacity to compete in the MENA region and internationally in health and other high growth sectors, as well as in education itself.

Table 3: Service Sector (2005)

Countries	Percent of employment in services [a]	Services value added [b]
GCC		
Bahrain	67.9	59.19
Kuwait	81.7	48.48
Oman	82.1	43.21
Qatar	56.0	..
Saudi Arabia	71.9	33.53
United Arab Emirates	58.6	42.03
Richest Non-Gulf Countries		
Euro Zone	67.5	71.8
Japan	66.4	68.61
United States	77.8	75.97
Emerging Economies		
China	16.1	39.94
India	20.3	54.06

Source: World Bank (2008)

Notes: [a] year 2004 for Qatar, year 2003 for Kuwait, year 2002 for China, year 2001 for Bahrain, year 2000 for Oman and UAE, year 1995 for India; [b] value added as a percentage of GDP, year 2004 for Oman, year 2003 for Kuwait, year 1995 for Bahrain, data missing for Qatar.

How the GCC Can Promote Trade in Services

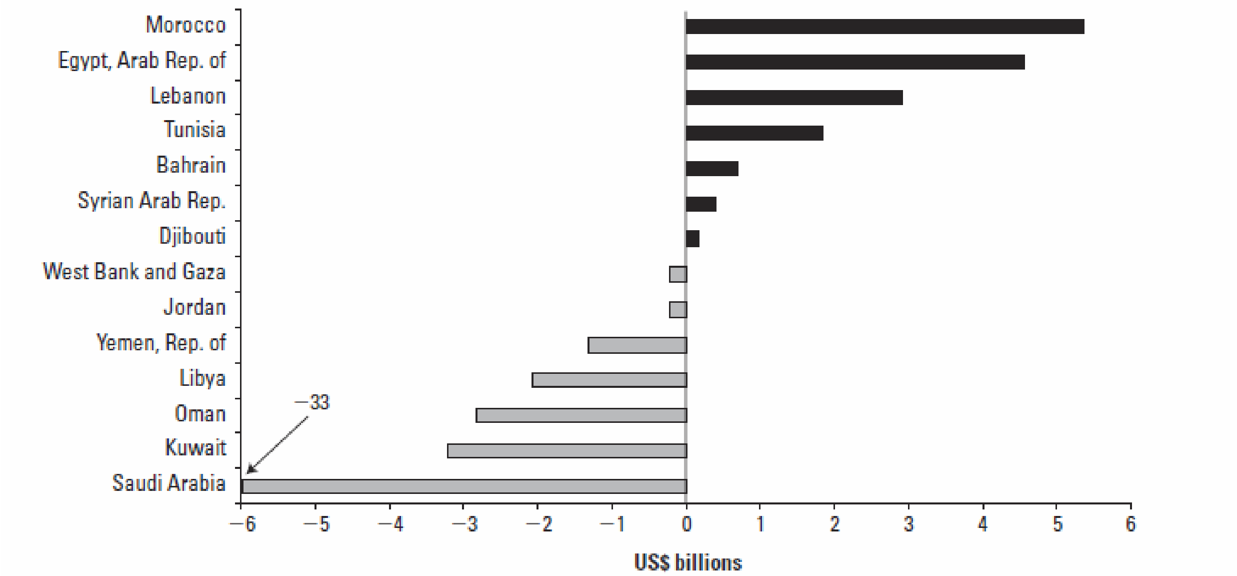
On paper, at least, GCC agreements have already gone a long way in opening up trade in services among the member countries. They provide for full national treatment of GCC firms and individuals, including the right to foreign establishment, as well as for unrestricted movement of GCC nationals and their freedom to invest anywhere in the GCC.[16]

The Gulf countries have also moved away from their restrictive FDI regime of the 1960s, when discriminatory taxes, requirements mandating the use of local commercial inputs, and licensing schemes requiring working with local partners limited FDI. Since the late 1990s, members of the GCC have sought to improve their technology and managerial skills to promote diversification in their capital-rich but expertise-deficient local economies. The increased mobility of local capital resulting from economic liberalization has also driven governments to reform their investment environments, as they must compete with each other to retain local capital. FDI flows have grown considerably over the period 1996–2006 in all of the GCC states except Kuwait.[17]

Finally, the multilateral services liberalization commitments of GCC members are also significant, although the picture is diverse across the GCC countries.

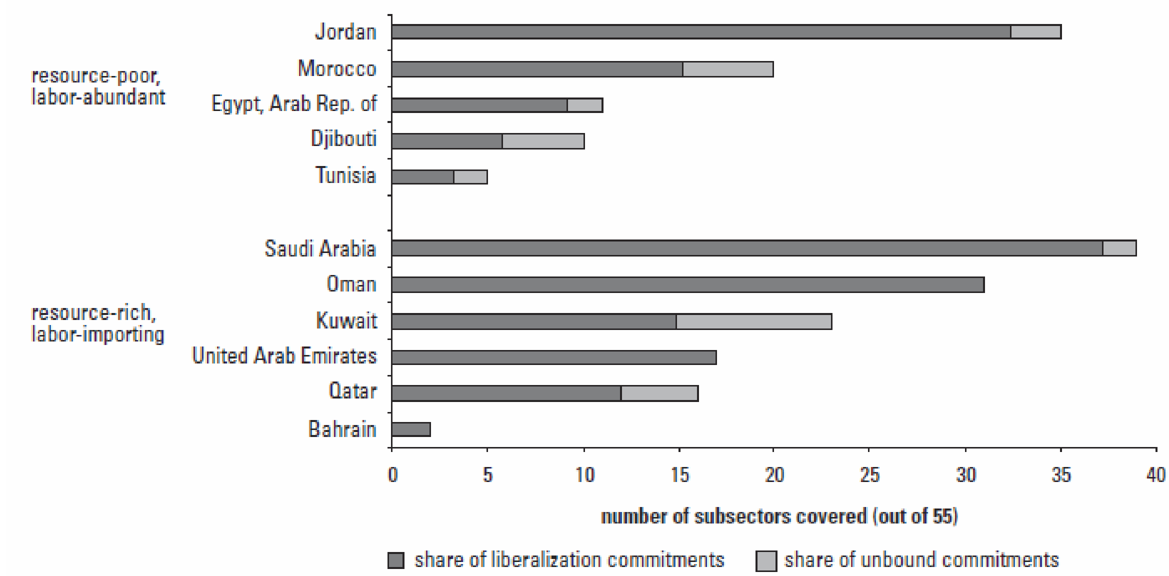
Saudi Arabia and Oman, both large net importers of services, have undertaken the most far-reaching GATS commitments, covering 37 and 31 out of 55 sectors, respectively, with only Jordan comparing in the MENA region (Figures 1 and 2). On the other hand, Bahrain is a net service exporter and has undertaken modest GATS commitments.

Figure 1: MENA countries' net services trade position, 2006



Source: World Bank (2009b).

Figure 2: MENA countries' attitude toward reform, as illustrated by GATS commitments



Source: World Bank (2009b).

Although the benefits are significant, enacting regulatory changes—such as privatization, safeguards against monopolization, and assurances for equitable service access—is a lengthy and complicated process. Privatization is frequently stalled by concerns about rigid hiring and firing rules, possible reductions in government subsidies, and unclear regulations for newly privatized entities. As a result, much of the privatization in the Gulf has been limited; for example, Saudi Arabia's decision to sell only 30 percent of its shares in Saudi Telecom Company and Saudi Basic Industries Corporation to the public allowed the government to retain a majority stake in the companies and control over management decisions.[18]

Attempts to rein in monopolies in the Gulf also have been pursued in a halfhearted manner. Rather than opening its telecommunications market to big foreign operators, the UAE decided in 2005 to curb the 30-year monopoly of the Emirates Telecommunications Corporation by establishing the Emirates Company for Integrated Telecommunications, effectively creating a duopoly structure.[19]

Nor have the Gulf's attempts at FDI liberalization been without challenges. Although each GCC state has pursued its own brand of FDI liberalization, two broad strategies have emerged: the enactment of broad reforms of national rules and bureaucracies, and the creation of discrete enclaves with independent, liberalized regulations and a well-established infrastructure.[20] The top-down commitments of the first strategy have proven difficult to translate into change on the ground, as exemplified by Saudi Arabia's and Kuwait's stilted experiences. Zones and enclaves, as used in the UAE, may be more appropriate for cases of rapid and efficient liberalization; rules within a small area are often easier to change than those of an entire national bureaucracy, especially in an environment where protectionist interests have weight and voice. Still, the creation of special zones and enclaves can enable leaders to defer badly needed reforms at the national level, and can also create internal distortions and inequities with unintended complications.

It is clear that numerous barriers remain to full integration of services markets both within the GCC and between the GCC and the rest of the world, indicating that, in practice, service liberalization in the Gulf falls short of the ambition presented in the agreements.

A Disconnect Between Ambition and Capacity

The disconnect between ambition and capacity is not specific to services or to trade more broadly. In myriad areas, the GCC has demonstrated a desire to achieve deep integration among its economies, which, despite their high-income status, are relatively undiversified. Some even exhibit characteristics normally associated with developing countries, such as weak governance indicators and administrative capacities (Table 4).

Table 4: Public Administration, Accountability, and Reform (Percentile Rank, 2007)

	Quality of public administration and reform process	Public sector accountability and reform process
Algeria	32	27
Bahrain	75	25
Egypt	42	23
Iran	30	22
Jordan	54	34
Kuwait	55	32
Libya	4	0
Morocco	75	32
Oman	56	17
Qatar	61	14
Saudi Arabia	71	5
Syria	13	8
Tunisia	73	20
UAE	44	20
Yemen	23	19
GCC	53	16
World	50	50

Source: World Bank (2009b).

In addition to the domestic administrative weaknesses of its members, the GCC also faces the political hurdles of coordination and cooperation. While similarities in culture and security interests ease these obstacles, convincing countries to relinquish any measure of sovereignty is never an easy task. The stagnation of the proposed GCC monetary union is a clear example of this challenge. The formation of a monetary union, prominently touted as the centerpiece of the GCC's future economic might, was initially scheduled to take effect in 2010. However, its progression has been severely handicapped, first by Oman's refusal to join, due to slow progress on implementing customs union regulations, and now by the UAE's refusal following a dispute about the location of the GCC Central Bank.[21]

The weak administrative capacities of the GCC member countries—and the political obstacles facing the GCC as an institution—further complicate an already complex and ambitious agenda of economic reform in the region.

Is the GCC Better Positioned to Enact These Reforms Than Unilateral or Multilateral Forums?

Does the GCC serve a unique purpose? Could countries do just as well by limiting themselves to autonomous and/or multilateral reforms? Compared to unilateral action, GCC agreements face the challenge of coordinating phasing and configuration among member states and are also limited by the similar export structures of the Gulf countries. Multilateral agreements offer much wider and more diverse market access.[22]

So, what does the GCC offer that multilateral and unilateral liberalization do not? Compared to unilateral liberalization, the GCC provides reciprocal market access, drawing on the political support of exporters to overcome resistance from import-competing sectors. Compared to a multilateral approach, the GCC can often negotiate agreements that are more extensive, deeper, and faster, as they involve fewer competing interests. Strong complementarities and common borders may also help facilitate the adoption of domestic regulatory reforms important in promoting trade, such as the harmonization of customs procedures, sanitary and technical standards, and investment rules. Finally, by deepening regional cooperation across a broad spectrum of issues, the GCC can help cement crucial political and security alliances, which can, in turn, strengthen the incentives to progress on liberalization.

Conclusion

Given its inherent restrictions due to its small market size and limited diversity, the GCC has been relatively successful in promoting trade in goods and eliminating or reducing both internal and external tariffs. Though further reductions in non-tariff barriers would be beneficial to trade in goods, the real opportunities for further growth lie in the liberalization of services, particularly for FDI.

Such reforms would not be novel; they are in fact encoded in many of the GCC's existing agreements. However, the GCC has at best a weak ability to implement these agreements, while many of its member states are plagued by poor governance and limited administrative capabilities.

These limitations highlight the interconnectedness of economic and administrative reforms. For the GCC to best fulfill its role as a driver of growth in the Gulf—a role that could potentially be significant—the GCC and its member governments must strive to develop stronger institutions to continue to progress on the broader economic front.

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A longer version of this paper was prepared for the "Human Resources and Development in the Arabian Gulf" conference, held by the Emirates Center for Strategic Studies and Research on February 2–4, 2009. The longer version will be published in a forthcoming conference volume.

Notes

[1] World Bank (2008).
[2] IMF (2009).
[3] IMF (2009).
[4] Trade Intensity Index (T) is defined as: Tcr = (xcr / Xct) / (xwr/Xwt), where xcr and xwr are the value of country's (c) exports and world's exports to the region (r), Xct is the country's total exports and Xwt is total world exports. An index of more (or less) than unity indicates that trade flows are larger (or smaller) than expected, given the partner region's importance in world trade. The Trade Intensity Index for the GCC is 2.7, 1.7 for the EU, and 2.8for NAFTA. Calculations are based on IMF (2009).
[5] GCC (2001).
[6] The World Trade Organization (2008).
[7] IMF (2009).
[8] World Bank (2009a).
[9] Konan at al. (2004).
[10] World Bank (2005).
[11] Mattoo and Sauve (2004).
[12] World Bank (2005).
[13] World Bank (2008).
[14] World Bank (2008).
[15] As measured crudely by the GDP Purchasing Power Parity (PPP) premium: the ratio of the PPP exchange rate to the market exchange rate.

[16] GCC (2001).
[17] UNCTAD (2009).
[18] Zawya (2009).
[19] Zawya (2009).
[20] Oxford Analytica (2008).
[21] El Siad and Ziemba (2009).
[22] While the GCC locks in, at most, access to three percent of the world market, the WTO can lock in 70 percent or more.

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