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A comparative assessment of labor market nationalization policies in the GCC

Steffen Hertog, Sciences Po/LSE

1 Introduction and executive summary

For many years, GCC countries have been struggling to substitute national workers for foreigners on their domestic labour markets, with decidedly mixed results. The Gulf labour market has become the achilles heel of what in general has been a successful oil-driven development model. Despite rapid economic growth and diversification into a number of new sectors, the GCC faces significant national underemployment. In the face of considerable demographic momentum, increasing the participation of nationals on the private labour market will be the crucial socio-economic challenge for GCC regimes over the coming years and decades.

The objective of the present paper is to identify core obstacles to labour market nationalization in the Gulf. Saudi Arabia, the most important GCC country, will be the main case study, but its experience will be systematically compared with the labour market situation in the other GCC countries. Against this background, existing attempts to remedy the labour market situation will be analyzed and evaluated.

Through large-scale imports of cheap labour since the 1970s and especially the 1980s, large parts of Saudi and GCC business have been locked into a low-productivity pattern of growth: substituting cheap foreign labour for process and technology upgrades that would make employment for more expensive and better-trained national employees feasible. GCC labour productivity has fallen in the 1980s and stagnated since the 1990s.

Saudi Arabia is arguably the Gulf country facing the most formidable labour market challenge: Almost two million young Saudis are currently between 15 and 19 years of age, implying that about 400,000 Saudis are reaching working age every year. While the public sector has reached the limits of its absorptive capacity, just slightly more than 800,000 Saudis are currently formally employed in the private market. Policies of Saudization since 2004 have achieved some degree of success, but these fall far short of the magnitude of job creation required to accommodate the kingdom's future job seekers.

So far, labour market nationalization in Saudi Arabia and the GCC has mostly happened "by fiat", through quotas and prohibitions. This has led to rule avoidance and illegal practices rather than genuine national employment. The paper will show that the current segmentation of the Gulf labour market makes large-scale job creation for nationals unrealistic, as a) wage differentials between locals and expatriates are too large and b) higher job mobility and better labour rights for locals make them less attractive employees.

Only Bahrain and, to a lesser extent, Oman have tried to use market-based incentives to make national employment more attractive. Drawing on these cases, I will argue that increases in the price of foreign labour, together with the creation of an internally liberalized labour market, have produced the most convincing national employment results thus far. Unless labour market mechanisms in the GCC are further adjusted along these lines, nationalization will remain an unwinnable uphill battle.

The paper's first section will analyze the threefold segmentation of the Saudi labour market, while engaging with some data problems that reflect the low regulatory power of the institutions in charge of regulating the Saudi labour market. It then estimates productivity and employment rates in the kingdom, and provides a comparison of GCC labour market structures and developments. This is followed by an analysis of existing Saudization policies that is contrasted with other labour nationalization experiences in the GCC.

2 The Saudi labour market

Saudi Arabia has begun large-scale foreign labour imports in the 1970s. Whereas the public sector now is largely Saudiized, attempts to nationalize the private labour market, although official policy since at least the early 1980s, have made little headway. Throughout booms and busts, dependency on foreign labour has remained high.

The total Saudi population in 2007 was estimated at 17.7 million individuals. Population growth is estimated at around 2.4% and has been trending downwards. About 10.5 million Saudis were of working age, i.e. between 15 and 64 years, with the bulk of dependents (6.6 million) children between 0 and 14 years of age. Only about 600,000 Saudis were estimated to be older than 64 years.

According to SAMA and CDS, the total number of foreigners in Saudi Arabia in 2007 was estimated at about 6.5 million. This is probably an underestimate, for several reasons:

- Other official sources – such as the current Minister of Labour – have been speaking of 8 million and more foreigners.
- CDS estimates an increase in the number of foreigners in the last four years of only about 150,000 per year. This seems out of line with the large increase in the foreign labour force as reflected by a doubling of working visas given by the Ministry of Labour (reportedly up to 1.7 million a year).
- The numerical relationship of foreigners to locals according to CDS data has been practically constant since 1993. The only plausible explanation for this is that the data have been extrapolated rather than derived from survey results.

Whatever the precise number of foreigners, we know that they still dominate the private labour market, as the large majority of them are of working age and have come to Saudi Arabia as labour market participants. The fact that many of them are from low-wage countries, and have limited working skills, is the main factor explaining the segmentation of Saudi labour markets and the problems the Saudi government has had with Saudiizing private employment.

A note on aggregate labour market data

Before discussing the basic structure of the Saudi labour market, another note on available data is in order.

Labour market data in Saudi Arabia, as in several other Gulf states, differ significantly depending on the source. The CDS manpower survey for 2007 shows a total Saudi labour force of 4.03 million, of whom 3.58 million are recorded as employed (not broken down by public and private sectors). This is greatly at variance with some of the data emerging from the Ministry of Labour, the General Organization for Social Insurance (GOSI) and the Ministry of Civil Service, if the latter are combined:¹

- According to the Ministry of Labour (MoL), 770,000 Saudis were employed in the private sector in 2007.
- GOSI, which records every private employee subject to mandatory social insurance, has recorded 550,000 private Saudi employees for 2007.
- According to the Ministry of Civil Service (MoCS), a total of 760,000 Saudis were employed in government.

The MoL and MoCS figures amount to only 1.53 million employed Saudis. It is highly unlikely that the difference to the CDS aggregate number can be explained away with self-employment and informal employment. Given that Ministry of Labour data is based on actual (compulsory) registration of Saudi employees in the labour and social security systems, it is rather likely that the CDS estimate of Saudi employment is considerably too large, as it is based on smaller surveys and self-reporting.

This being said, the government employment figure of the Ministry of Civil Service probably is too small, possibly by a factor of two or more. Several forms of state employment – most prominently in the security and religious sectors – go largely unrecorded by the Ministry. A recent independent report has given a figure for actual Saudi government employment of 1.8 million individuals. The Ministry of Interior alone is reported to employ up to 500,000 individuals.²

Estimates of the number of foreign employees also differ depending on the source, but different from Saudi employees, the orders of magnitude do not vary. The Ministry of Labour estimate non-Saudi employees in the private sector at 5.06 million in 2007. The CDS estimate of total foreign labour (calculated as the difference between total labour and Saudi labour) is 4.18 million. According to the Ministry of Civil Service, 69,000 foreigners worked in the government in 2008.

Whatever data we base our analysis on, it is clear that foreigners still outnumber Saudis on the private labour market.

¹ The 2007 SAMA annual report in fact cites some of these inconsistent numbers within the same chapter (pp. 224-246).

² Giving a Boost, Saudi British Bank report, 7 February 2008; a news report from early 2008 mentions 1.2 million state employees; cf. Arab News 30 January 2008.

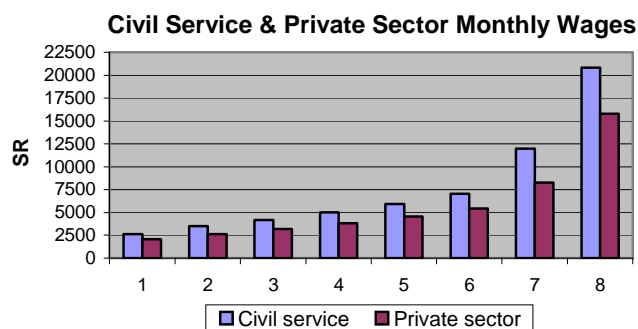
Structures of segmentation on the Saudi labour market

Different from some of the smaller Gulf states such as the UAE and Qatar, public sector Saudization has by and large been achieved, although – as will be shown below – the price of this might have been a decline in government productivity.

The Saudization of the public sector has however in many ways complicated the Saudiizing the private sector, as it has created a segmented labour market, to the more privileged section of which only nationals have access. As a result, many Saudi entrants to the job market still prefer public sector employment to the vagaries of the worse-paying private sector. Segmentation means that there is no integrated labour market, incentives are skewed, and resources are not allocated efficiently.

The public/private segmentation has several aspects:

- According to data from the late 1990s, average wages on all levels of education are higher in the civil service. As average private sector wages for Saudis have declined during the last four years, and the civil service has seen several salary increases (first by 15%, then by three annual increments of 5%), this gap probably has not narrowed.



Source: Diwan/Girgis, *Labor force and development in Saudi Arabia*, World Bank/Ministry of Planning 2002

- Fringe benefits (allowances, agency-specific social services etc.) in the civil service tends to be higher.
- Working hours generally are shorter in the civil service. Private sector working hours can amount to 50 and more per week.
- Job security in the civil service is very high, and salary increments tend to happen almost automatically. Private sector working legislation by contrast is rather liberal, allowing for “hire and fire” policies, although de facto the legislation is often interpreted in favour of Saudi employees.

There is a second, as important dimension of labour market segmentation: the differential wages and benefits available for foreigners vs. locals. Apart from the very highest levels of qualification, locals tend to be more expensive to employ than expatriates, as they have higher wage expectations (or “reservation wages”). This is reflected in average private sector salary levels:

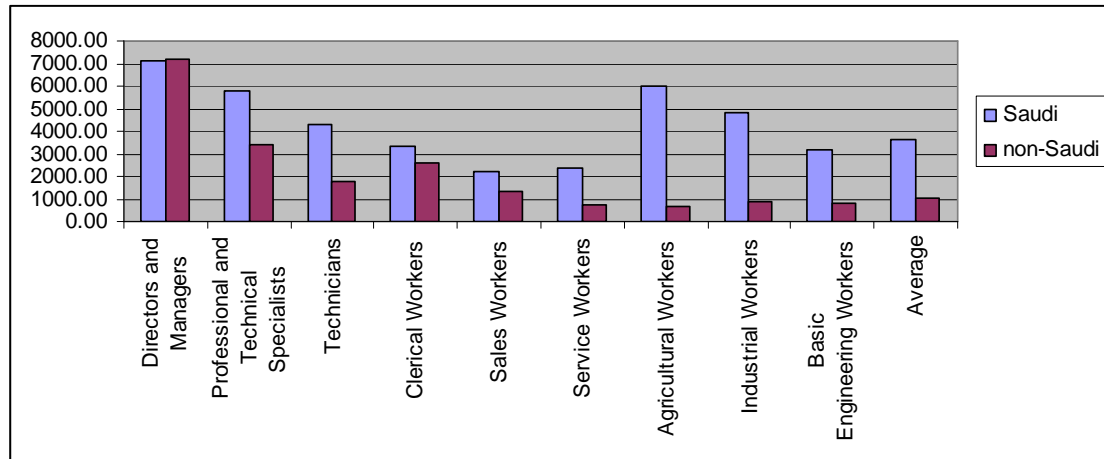
Average Monthly Wage in the Private Sector 2004-2007 (SR)

Years	2004	2005	2006	2007
Saudi	4367	3878	3596	3624
Non-Saudis	1037	1028	1060	1011
Total	1385	1360	1384	1354

Source: Ministry of Labour

Saudi wages are on average more than three times as high as those of expatriates. Of course, the share of expatriates with very little education is higher than that of uneducated Saudis, so that more highly paid Saudis might also be more valuable workers. But even if wage statistics are broken down by type of occupation – which controls for education levels and productivity – Saudis in all but the very highest categories are paid much better than foreigners.

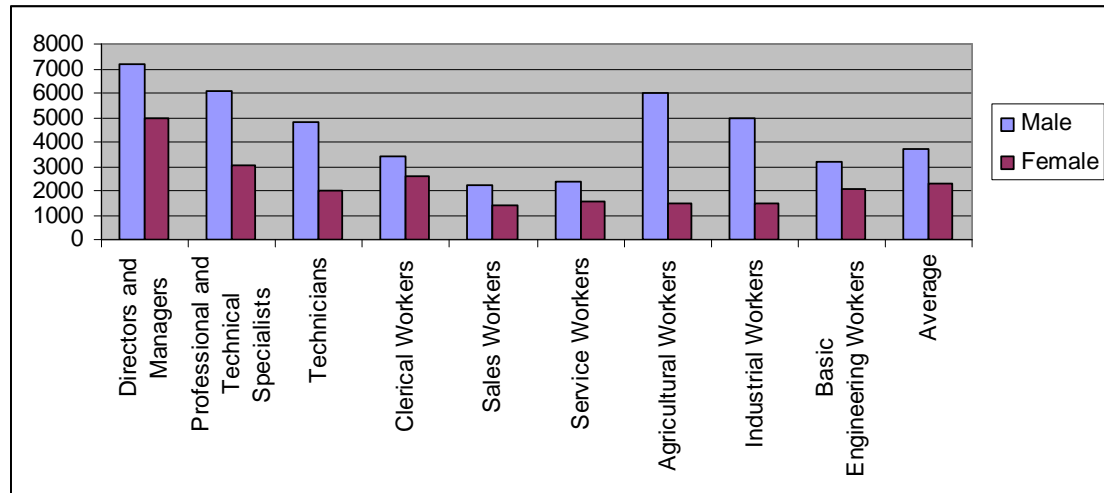
Saudis vs. expatriate monthly wages, 2007 (SR)



Source: Ministry of Labour

A third dimension of labour market segmentation should be mentioned briefly: that between Saudi men and women. Tackling this topic in depth would require a separate research paper, but in the context of Saudization, we should note that women seem to have considerably lower wage expectations in all sectors. Education cannot be the reason, as Saudi women on average perform better in school and university than Saudi men. Their lower wage demands mean that, all other things being equal, it would be easier to transfer foreign-held jobs to them.

Saudi male vs. female monthly wages, 2007 (SR)



Source: Ministry of Labour

Data on wage trends in recent years gives a mixed picture about the trends of labour market segmentation: On the one hand, average private sector wages for Saudis seem to have declined relative to expatriate wages, making it easier for employers to hire Saudis. The decline in average wages however is unlikely to indicate declining pay for the same type of jobs – it rather might be explained by the fact that more Saudis are willing to take worse-paid jobs that previously were off-limits to them, as socio-economic pressures to get employed have increased. This would mean that the Saudi-expatriate wage differential for individual jobs – at least on higher levels – has not been declining, and the number of Saudis in such jobs has not necessarily increased.

One cause for concern is that the gap between high-level and low-level wages seems to have increased: Despite considerable inflation, lower-skill jobs seem to have hardly seen raises, as we can deduce both on the basis of anecdotal data from the kingdom and by combining different statistical sources: Available international surveys such as the annual “GulfTalent” report indicate that wages for “professionals”, i.e. highly qualified workers, have been increasing considerably in Saudi Arabia (albeit at lower rates than in most other Gulf countries). Professional wages are estimated to have risen 7.4% in 2005, 6.5% in 2006, 7.7% in 2007, and 9.8% in 2008, making for compound growth of 35% over four years. The only way to explain stagnation of the overall wage averages cited above is with stagnation or decline of lower-level wages.

Given that for the time being, only a small proportion of Saudi nationals are equipped to work as professionals and managers on the private labour market, this development is disconcerting.³ There is evidence that the Saudi leadership has been very concerned about the widening gap between rich and poor, the potential erosion of the Saudi middle class, and the widespread feeling that the current boom is bypassing a large share of nationals. Raising wage levels for mid-skilled jobs on the private labour market has to be

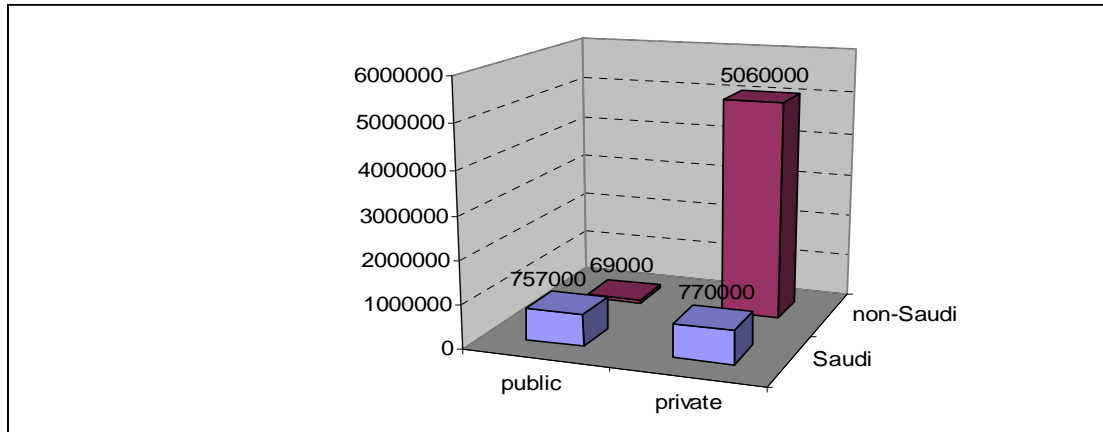
³ A CDS wage survey from 2000 gives an average wage for Saudi nationals of about 5700 SR, a slight increase over results from a similar survey in 1996. In combination with the above MoL data, this indicates either another instance of incompatible statistics or a large-scale entrance of lower earners into the labour market after 2000, or a mixture of the two. The latter seems the most likely.

an essential component of any strategy to stabilize the socio-economic structure of the kingdom.

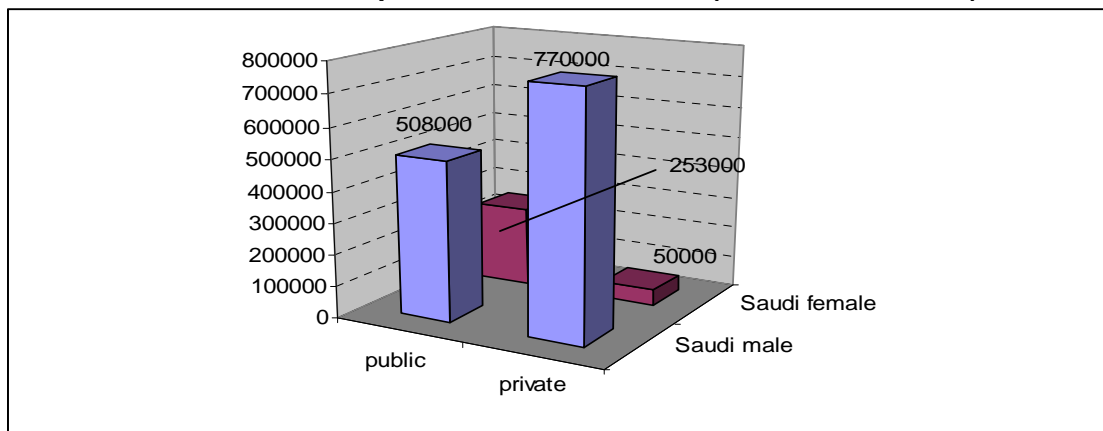
The threefold segmentation of the Saudi labour market

The three dimensions in which the Saudi labour market is segmented is reflected in the skewed distribution of Saudi men, Saudi women, and foreign workers in public and private labour markets.

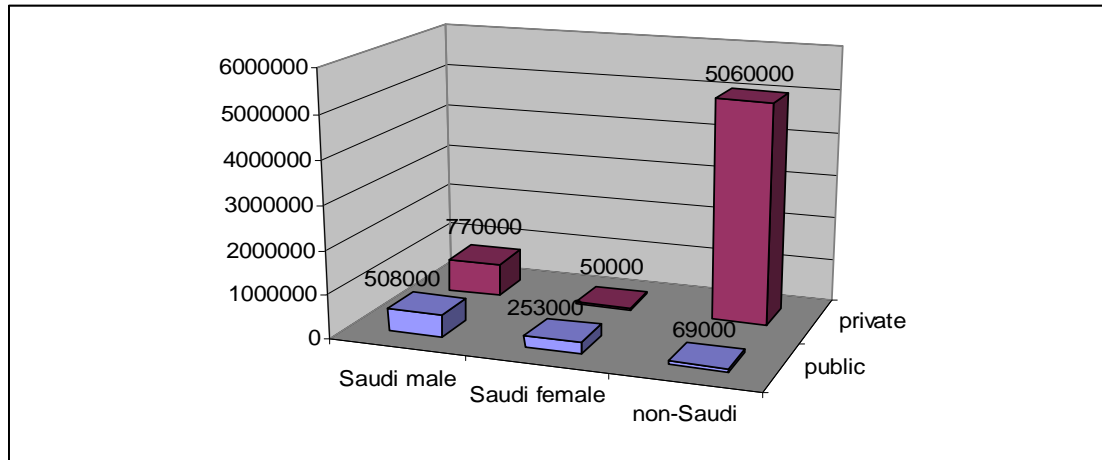
Dimensions 1 and 2: Saudi/expatriate and public/private (total labour force, 2007)



Dimensions 2 and 3: Public/private and male/female (Saudi labour force)



The three dimensions of segmentation together



Sources: Ministry of Civil Service, Ministry of Labour

We see first of all that while locals dominate the civil service, they are still outnumbered in the private labour market, where they are less competitive. We see secondly that this pattern is particularly pronounced for Saudi ladies, who have been by and large unsuccessful in finding private employment. Most of the rather small number of female Saudi workers are employed in government-run education and health institutions. This is paradoxical, as in fact their wage expectations and qualifications should make it easier for them to find private employment. The failure to employ Saudi women privately cannot be explained through pure market forces. The reasons rather must lie in the cultural, institutional and legal environment. Thirdly, we see that the ratio of Saudis in government employment to those in private employment is about 1:1,⁴ which is considerably higher than in both developed and developing countries, where state employment constitutes around 20% of the total among nationals.

Several reasons for the general preference of Saudi nationals to seek public employment have been rehearsed above. There are also supply side factors that tend to make employers averse to employing Saudis: Surveys have shown that they often expect Saudi nationals to be less experienced and, in many fields, lacking practical qualifications relative to their expatriate competitors. Moreover, as we will see below, the current labour sponsorship system makes it easier for employers to control their foreign workers, hence making them more attractive employees. All these factors are also amply documented for the labour markets of other Gulf countries and have been shown to inhibit the employment of nationals there.

Anecdotally, Saudi employers also frequently complain about the deficient work motivation of some Saudis employees. But as far as this is indeed a problem, it is probably an outcome of other underlying factors, such as the perceived availability of low-effort public sector jobs and the fact that current Saudization policy sometimes forces national employees on firms who would otherwise not intend to hire them.

⁴ Taking MoCS figures at face value. If we believe the estimate of 1.8 million Saudis in public employment, the ratio is dramatically higher, with more than two out of 3 Saudis working for the government.

Apart from some menial occupations, it is unlikely that there are immutable cultural factors that inhibit the employment of Saudis. Rather, the current labour market segmentation twists incentives and prices in a way that makes it less likely for Saudis to seek mid-level private sector jobs, and less likely for businesses to want to employ them.

Labour segmentation looks different on different levels of qualification, further underlining the fact that it is largely driven by prices and incentives. Among Saudi nationals, there is a bifurcation between highly qualified individuals and the rest: The former are competitive on the private market, where they receive similar high salaries to highly qualified expatriates, as evidenced in the above statistics on wages for directors and managers. Most of these Saudis now seek private sector rather than public sector employment, as they can draw better salaries in large corporations.

The relatively less qualified majority of nationals however still tends to prefer public sector jobs, in which salaries are higher for a given level of education (see above). Within that group, there is further difference between individuals with mid-level qualifications, many of whom could be competitive on the private labour market if the local-expatriate salary wedge was narrowed significantly, and Saudis with only basic qualification, who without skills upgrades would struggle to ever become competitive. This is because the salary gap for mid-level jobs like technical specialists or sales workers is much less dramatic than that on the level of unskilled labour (construction workers, agricultural workers etc.).

In areas demanding unskilled labour, wages for non-Saudis can be as small as 20% of that of Saudis, while wages for Saudis on mid-level jobs are only between 1.5 to 2 times higher than those for expatriates. Taking into account that non-wage costs of foreign labour are significantly higher, Saudis on the middling level of the labour market should be the main focus on labour policy in the coming years. Working towards a narrower wage gap is only one of several necessary steps to overcoming labour market segmentation, however.

Labour productivity issues

Labour market policy tends to have two major aims. The first one is to provide full employment for the national population. The second one is to regulate and support labour markets in a way that maximizes productivity and therefore economic growth. The two can be at variance. Indeed, the Saudi labour and employment policies that have created the segmentation of public and private labour market since the 1980s seem by the same token to have led to a decline in productivity in both private and public sectors.

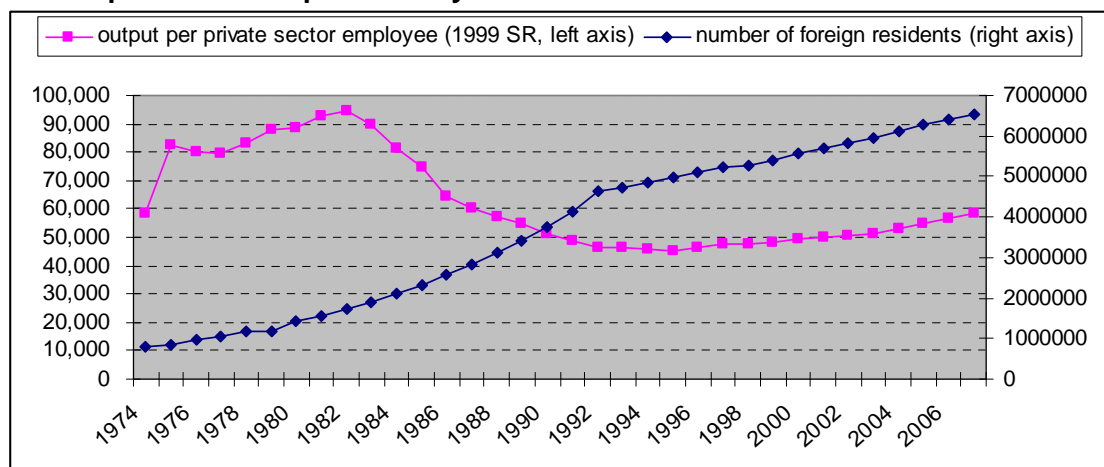
Labour productivity in the non-oil sector of the Saudi economy in 2007 can be estimated at around 71,000 SR per worker and year.⁵ The same figure for 2001 is 69,800 SR, indicating only a marginal improvement in output per worker. If we took into account capital as another factor of production, then probably total factor productivity – indicating the efficiency at which labour is used – would have gone down, as a significant amount of gross fixed capital accumulation has taken place since the early 2000s.

Productivity in the private sector, measured as non-oil private sector GDP divided by the number of private sector workers, has been even lower, as the chart below indicates.

⁵ Based on CDS figures for total labour in the kingdom and SAMA national accounts data. The figures are constant 2000 SR.

Although it might have somewhat recovered since the mid-1990s,⁶ it had seen a precipitous decline from 1982 on. The main reason for this is that the Saudi economy shrank significantly in this period, while the number of foreign workers continued to grow rapidly, reducing output per worker. Practically speaking, this entailed the large-scale substitution of mid-skilled Arab labour with low-skilled Asian labour, a process also witnessed in other GCC states. It is this substitution which has decreased private sector wages in many areas so much that Saudization under current market conditions is hardly feasible. The availability of cheap, unskilled labour has also undermined incentives for Saudi business to invest in technology and management structures with a view to enhancing productivity per labourer, creating a vicious cycle of low-margin production vs. low-margin workforce.

Non-oil private sector productivity rates since 1974⁷



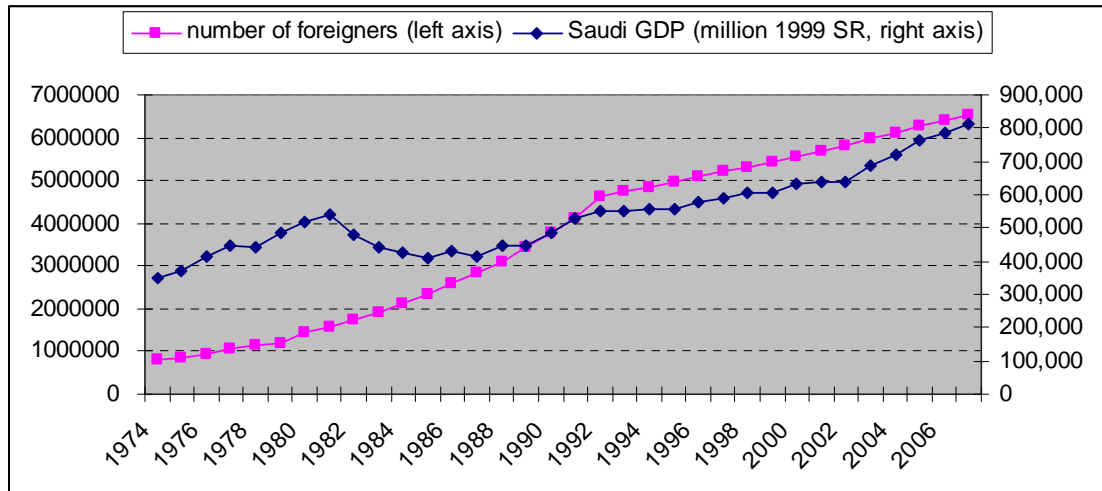
Sources: CDS, SAMA

The below graph illustrates that the 1980s were a decade of accelerated labour imports in the face of a stagnant economy. It is the structural legacy of this decade of cheap labour inflows which makes Saudization such a difficult problem today.

⁶ It is not sure this actually is the case, as in fact CDS demographic figures likely underestimate the influx of foreign labour since 2004, see above.

⁷ Private sector employment is estimated by assuming that average private sector employment rates of the total population of foreigners and Saudis (the only demographic figures available on a year-to-year basis back to the 1970s) have corresponded to those witnessed in the 2000s. While this necessary assumption introduces some degree of imprecision, it does not change the order of magnitude of the estimate.

Labour imports vs. GDP

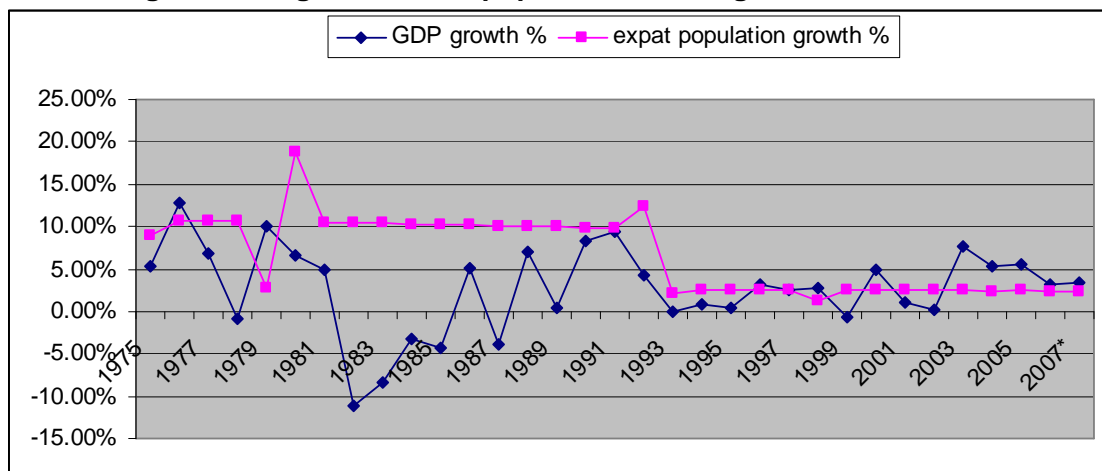


Sources: CDS, SAMA

Looking at growth rates instead of absolute numbers, we again see that the rate at which the population of foreigners increased seems to have had no relationship with GDP developments. OLS time series analysis does indeed show that changes in GDP growth do not explain changes in the growth rate growth of the expatriate population. Cheap labour imports in the 1980s might have been used to compensate to some extent for the losses Saudi business witnessed in the course of the oil price crash and the collapse of government contracting budgets.

The only statistically significant factor influencing the growth rate of the foreign population in a given year is the expatriate population growth rate of the previous year ($p < 0.01$, coefficient 0.625). This however is probably an outcome of imperfect statistics, which also casts some doubts on the above results: As the graph below shows, growth rates of the foreign population as recorded in the SAMA annual reports have been improbably stable both after the 1982 and the 1992 census, indicating interpolation of data rather than actual measurement. We hence have to treat aggregate data on foreign labour with caution.

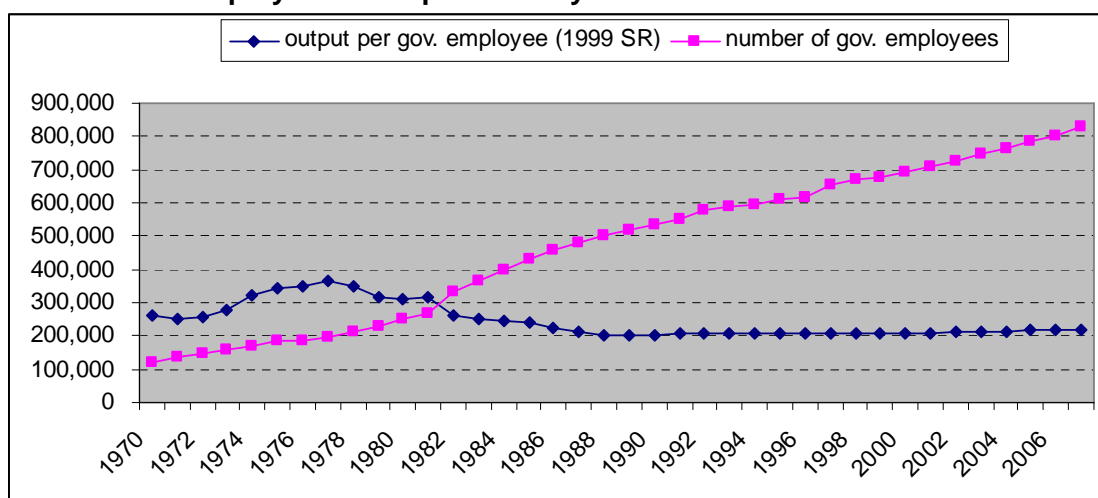
Economic growth vs. growth in the population of foreigners



Sources: CDS, SAMA

As mentioned above, it is also not quite clear how complete available statistics on government employment are. That being said, the figures issued by the Ministry of Civil Service probably reflect the overall trends in public employment fairly well. Using them in the denominator, we can estimate the productivity of government employment over time. The resulting pattern is strikingly similar to that of private sector productivity: Output per employee has shrunk significantly since the early 1980s and seems to have stabilized from the early 1990s on. Between 2001 and 2007, productivity per employee seems to have increased from 209,000 SR to 216,000 SR. This seems fairly high, but we need to keep in mind that the MoCS employment figures only include part of the total government payroll.

Public sector employment and productivity



Sources: CDS, SAMA

The declining productivity in both sectors is intimately tied up with the institutionalization of a segmented labour market in the 1980s: On the one hand, the public-private wage gap increased significantly through the large-scale import of cheap private sector labour. On the other hand, increasing numbers of Saudis were given guaranteed government employment, which a) undermined their incentive to seek private sector jobs and b) led to overstaffing in certain government agencies that reduced overall civil service productivity. Expatriate employment in the government reached its peak in 1992, when about 160,000 foreigners worked in the government, and has since declined to 69,000 in 2007.

Cheap labour imports and generous state employment might have helped to soften the impact of the 1980s economic crisis on Saudi businesses and citizens. They however also entailed a pincer movement through which both private and public productivity were squeezed and a labour market structure institutionalized that makes private employment unattractive for a large share of Saudi nationals. The situation has stabilized since the 1990s, but it has yet to improve significantly. As will be argued, only a strategic immigration policy, and a labour market strategy based on prices rather than on administrative intervention, can re-integrate public and private labour markets, and sustainably increase productivity in both.

Unemployment vs. underemployment

Labour market segmentation is the main explanation for the low labour market participation rate in Saudi Arabia. Low participation, rather than unemployment per se, indicates the scale of the employment challenge and the extent to which educational resources and potential manpower are left idle in the kingdom. It merits a quantitative discussion.

As mentioned above, the overall Saudi employment figure of 3.58 million from the 2007 labour force survey probably is an overestimate. But even if we take the figure to be true, only 34.1% of Saudis in working age are in employment, and only 38.2% of Saudis are labour market participants, i.e. active on the labour market as job holders or job seekers (with the difference between the two figures reflecting Saudi unemployment).⁸ These ratios are far below the rates of developed countries, and significantly below those of most developing countries. They reflect a large-scale under-utilization of Saudi Arabia's national labour potential, which is not sustainable in the long run.

Part of the explanation is the uniquely low rate of female employment in the kingdom, which is particularly striking given the high educational achievement, willingness to work for lower wages and, anecdotally, better work motivation of Saudi women. Different figures on female employment have been produced by different agencies. According to the CDS, 502,000 Saudi women were employed in 2007. This would make for a (very low) employment rate of about 10%. Summing up individual figures from MoCS and the Ministry of Labour, however, we arrive at an even lower employment rate: 253,000 women were employed by the state in 2007, while 51,000 held private employment. Although the latter reportedly reflected an increase of more than a quarter over 2006, the total of 304,000 female employees still makes for an employment ratio of only 5.8%. This not only indicates a large waste of educational resources, but arguably also worsens demographic pressures in Saudi Arabia, as lower employment ratios are globally correlated with higher birth rates.

Adding up official male employment in public and private sectors according to MoCS and MoL, we arrive at a total of 508,000 + 718,000 = 1,260,000 employees. This would mean an employment ratio of only 24% even for Saudi males, meaning that only one in four Saudi men of working age (15-64) actually held a job.⁹

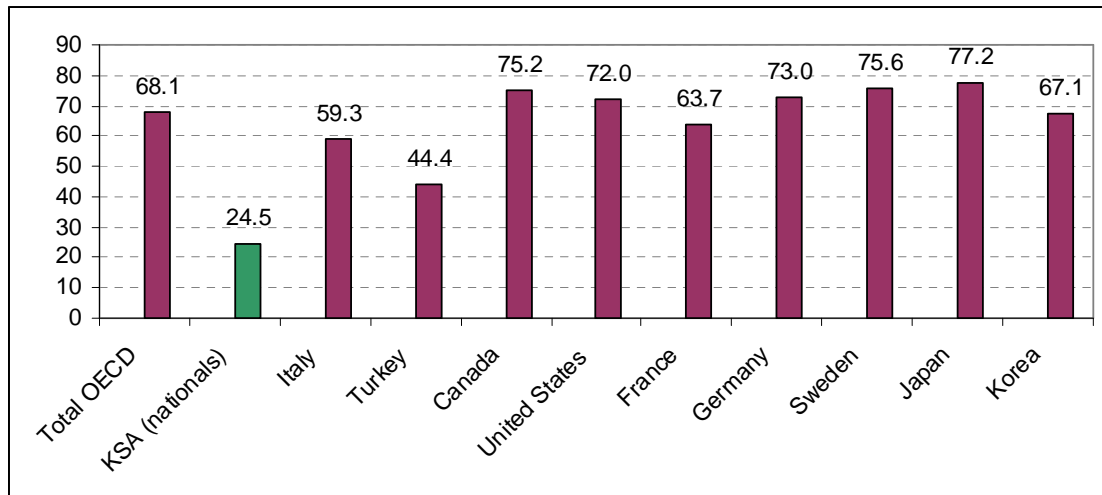
This seems improbably low, and much of the explanation probably lies in the fact that total government employment is not officially known. If we presume that the above-cited figure of 1.8 million government employees is true, and add this to the Ministry of Labour's number of total private sector employees, we arrive at a total of 2.57 million Saudi employees (the exact male-female breakdown of which is not known), which would imply a participation ratio of 24.5% of the total Saudi population of working age. If we presume that all of the unaccounted public employment goes to males – which is reasonable, given its likely focus in the religious and security sectors – we would arrive at a male employment ratio of 43.1%, while the female employment ratio would remain at 5.8%.

⁸ Based on CDS demographic data, we can calculate the total number of Saudis between 15 and 64 years of age, generally considered working age, as 10,484,000.

⁹ Figures would be even lower if we take the number of GOSI-registered employees (546,000) as estimate for the national private sector labour force.

Whatever the details, these figures mean that unemployment – officially estimated at 11.05% for 2007, though considerably higher for females – is a lesser challenge for Saudi Arabia than underemployment. The graph below shows the employment ratio for Saudi nationals is much lower than employment ratios in any OECD country. Whereas we estimate that one out of four Saudis in working age has a job, three out of four Canadians do.

Employment rates in %, 2007¹⁰



Sources: OECD, SAMA, SABB, CDS, Ministry of Labour

The low employment ratio in Saudi Arabia means that the “dependency ratio” in Saudi society is very high, i.e. many individuals depend on one salary. This anecdotally rings true, considering how many members of large families often rely on one earner in the kingdom. With each earner among Saudi nationals come about six dependents.

While the reasonably low cost of living in Saudi Arabia might have allowed many families to maintain high dependency ratios, this is not sustainable indefinitely. Indeed, the higher participation of Saudis on low-to-mid-wage private labour markets observed above seem to reflect the increasing socio-economic pressure to get employment even under less favourable conditions. The number of jobs currently available for wages that would guarantee equitable socio-economic development is limited, however. While pauperization of larger numbers of nationals probably would eventually induce them to take menial, badly paid jobs, this does not appear desirable and is unlikely to be acceptable to the Saudi leadership. Instead, the mid-wage labour market needs to be boosted. Saudis cannot be forced to compete with Indians working for 100\$/month – no Gulf citizen would be willing to work for this wage, just like no OECD citizen would.

The scope of the future employment challenge, and the danger of pauperization, becomes clearer if one looks at the age distribution of the Saudi population: Currently, almost two million young Saudis are between 15 and 19 years of age, implying that about 400,000 Saudis are reaching working age every year, with increasing tendency

¹⁰ The picture for participation ratios is essentially the same, just that figures are a few percentage points higher for both Saudi Arabia and the comparative cases.

over the coming years. If only half of the new cohorts are supposed to be employed, 200,000 jobs need to be created every year.

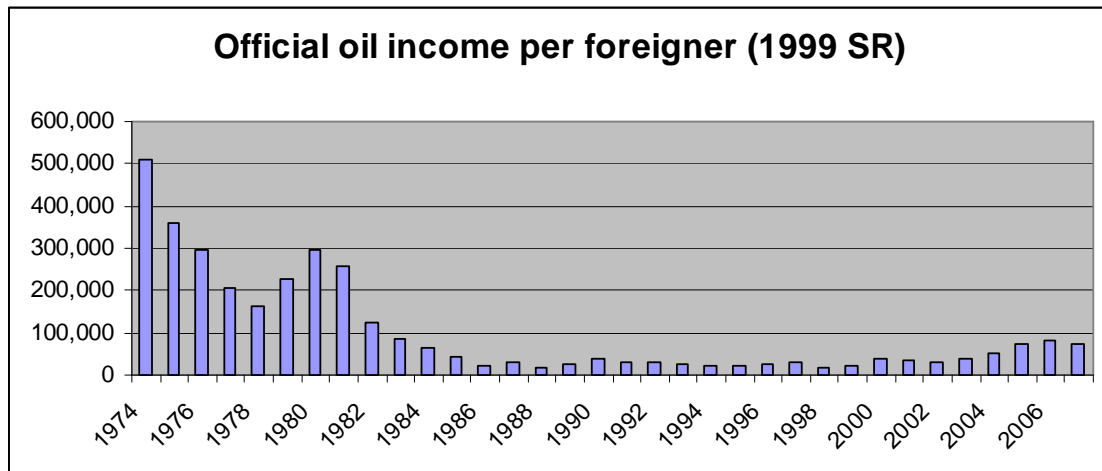
For comparison, the total 60-64 age cohort, from which many of the current generation of senior bureaucrats and managers of the kingdom are recruited, consists of only about 300,000 individuals in total – some 60,000 per cohort year. If everyone in that generation who holds a job currently would resign at the same time, this would still not be enough to employ only one of the new cohort years.

Age structure of Saudi Arabia (mid-2007 estimates)

Age Category	Males	Females	Total
0-4	1188.2	1141.8	2329.9
5-9	1095.8	1081.3	2177.0
10-14	1042.1	1048.0	2090.1
Subtotal (0-14)	3326.1	3271.0	6597.1
15-19	971.1	989.9	1961.0
20-24	869.5	888.5	1758.1
25-29	760.8	775.4	1536.2
30-34	651.3	657.4	1308.7
35-39	543.3	540.2	1083.5
Subtotal (15-39)	3796.1	3851.5	7647.6
40-44	448.7	437.2	885.9
45-49	360.2	342.4	702.6
50-54	278.8	263.8	542.6
55-59	205.9	195.7	401.5
60-64	153.9	150.3	304.2
65-69	110.5	112.6	223.1
70-74	78.6	80.2	158.8
75-79	52.3	52.2	104.5
80 & over	65.6	57.9	123.5
Subtotal (40 and over)	1754.5	1692.2	3446.7
Total	8876.7	8814.7	17691.3

Source: SAMA

At the same time, the presence of growing numbers of expatriates puts an increasing burden on the infrastructure and public services of Saudi Arabia. Taxing foreigners for their use seems out of the question, as many of them earn too little, and important parts of public services are public goods from which non-locals are difficult to exclude. The below graph shows that despite the recent oil boom, a large army of foreign labourers meets increasingly restricted fiscal resources:



Source: SAMA and CDS

McKinsey has estimated that expatriate workers create an average cost of 1300\$ per year for local governments in the GCC. In the Saudi case, this implies annual costs between 30 and 40 billion SR, depending on how many expatriates we presume to be in the kingdom.

Probably more important, expatriate workers continue to send significant shares of their income abroad, to the tune of 50-60 billion SR per year, which corresponds to about 15% of the total private sector contribution to GDP, or the total education and human resources budget of the Saudi government in 2004. If this income instead accrued to Saudis and was locally spent or reinvested, the multiplier effects for Saudi GDP would probably lie considerably above the 50-60 billion alone.

3 A GCC-wide comparison of labour markets and nationalization policies

The aim of this paper is not only to analyze the mechanisms of the Saudi labour market, but also to benchmark the Saudi experience against that of other Gulf countries. In the following, therefore, an overview of labour market structures in Saudi Arabia's GCC neighbours will be provided. This will be followed by an evaluation of labour market nationalization policies in Saudi Arabia, to be succeeded in turn by an analysis of policy experiences in other GCC countries.

Labour market data in other GCC countries is often unreliable and can differ according to source. Nonetheless, orders of magnitude are clear and reproduced in the below table for 2005, which collates the most recent available data for the other 5 Gulf states. In regional comparison Saudi Arabia has a relatively large share of locals in its total labour force (22%). More important, locals play a comparatively large role on the private labour market.

Table: Employed individuals in the GCC in 2005 ('000)

	Bahrain	Kuwait	Oman	Qatar*	Saudi Arabia	UAE**
Nationals	106	319	208	64	1336	262
% of total labour force	31%	18%	32%	8%	22%	9%
private sector	72	43	99	9	623	70
public sector	34	276	109	55	713	192
Expatriates	231	1495	446	768	4809	2738
% of total labour force	69%	82%	68%	92%	78%	91%
private sector	227	1401	423	601	4739	2538
public sector	3	94	23	167	70	200
Total labour force	337	1814	654	832	6145	3000
% of total population	47%	61%	26%	71%	27%	63%

Sources: Gulf Investment Corporation, MoCS, MoL, SAMA, Qatar Statistics Authority, press survey

* Data from 2007 labour force survey (the 2005 labour force survey severely underestimates the size of the private labour force)

** estimates combined from different sources, no precise data available

Based on the latter criterion, the GCC countries can be grouped into two categories: mid-income countries in whose private labour markets locals play a significant minority role, and high-income countries, whose private sectors are almost completely dominated by expatriates. Bahrain, Oman and Saudi Arabia belong to the former group, while Kuwait, UAE and Qatar are members of the latter. All of them have experimented with labour market nationalization policies and are therefore worth comparing to Saudi Arabia.

United Arab Emirates

The UAE labour market is heavily segmented, with even higher wage differentials than in Saudi Arabia: Average public sector wages were higher than 30,000 \$ per year already in the mid-1990s, and have since then seen several significant raises. In all segments of the private sector, the IMF estimates wages as lower than in government – including in the remunerative oil and financial services sectors. In agriculture and domestic services, wages are barely more than a tenth of what the average civil servant earns. In hotels and trade, individuals earn barely a quarter of the average civil servant. Clearly the

public-private wage gap is even wider than in the kingdom, making “Emiratization” of private labour even more elusive. There are different estimates for the share of nationals in the private sector workforce, varying between 1% and 3%.

Surveys have shown that the majority of UAE nationals do not want to work in the private sector and that nationals suffer from a lack of initiative on the private labour market. Although not very advanced in its nationalization policies, the UAE are a useful comparison case to demonstrate the same mechanisms which complicate “Saudization” in a more extreme and clear-cut fashion.

Kuwait

Kuwait is the one GCC country in which citizens’ entitlement to a public sector job is perhaps the most pronounced, not least due to an activist parliament which makes sure that oil income is widely distributed among nationals. Over-employment in the civil service is estimated at 50% and more, and 40% or more of Kuwaiti civil servants have not completed high school education. At the same time, wages for publicly employed Kuwaitis are very generous. The 36% of expatriates employed in the civil service in the late 1990s accounted for only 13% of the total salary bill.

The share of Kuwaitis in the private sector has been estimated at 2.3 % for 2005. Although this result is very low in absolute terms, the shares of Kuwaiti men and women were 1.3 % and 0.9 %, respectively, indicating much better access of female nationals to the private labour market than in Saudi Arabia.

Qatar

Qatar is the country with the biggest per capita GDP and the smallest national population, meaning that its current labour nationalization policies are still oriented towards the public rather than the private sector. It is the only state in which expatriates still dominate even in the civil service. This means that the politically salient line of segmentation in the labour market runs between foreigners and locals, less so between public and private. Labour force participation rates for Qatari nationals are estimated at 64.7% for males and 34.6% for females. While this is much higher than in Saudi Arabia, it is explained with the availability of free jobs for all nationals who are interested in state employment – a policy option that has long since ceased to be available in the Saudi case.

Oman

Omani labour markets are structurally much more similar to Saudi Arabia. While expatriates still dominate overall private employment, and nationals are reported to prefer public employment, the country has a significant track record in labour market nationalization. As in Saudi Arabia, a significant share of Omanis now rely on private sector incomes. In 2008, the number of privately employed Omanis¹¹ surpassed those employed by the government for the first time, reaching 132,000 nationals, up from 75,000 in 2004, reflecting a successful Omanization trend.¹² At the same time, however,

¹¹ The Central Bank of Oman estimates privately employed Omanis based on registrations with the social insurance agency – a very conservative way of calculating private employment, corresponding to GOSI figures in Saudi Arabia (see above).

¹² Other official sources estimate private Omani employment at 255,000 for 2008, based on compound annual growth rate of 12.7% since 2000; Khaleej Times 12 October 2008.

expatriates increased from 407,000 to 638,000, meaning that the proportion of Omanis in private employment increased only slightly. Moreover, more than 80% of Omanis in the private sector are reported to earn less than 200 Omani Riyals, a salary that is easily surpassed by most public sector jobs. This means that civil service employment is still more attractive than most private employment; labour markets remain segmented.

Rates of Omanization moreover differ strongly from one sector of the private economy to the other. Banking has achieved a high Omanization rate, surpassing 85% already in the 1990s and reaching 91% by the mid- 2000s. Omanization rates are also considerable in transport, storage, and communication. However, neither sector is a very large employer. Trade, manufacturing, and hotels provide considerably more jobs but have much lower Omanization rates. Private education, consulting and contracting have Omanization rates around only 20%. Similar to Saudi Arabia, the struggling sectors are the ones who either pay very badly or demand highly specialized education. The high banking Omanization might seem to contradict the latter assertion, but in fact Omanis tend to perform simpler jobs in this sector: one-third of nationals in banking have a tertiary level of education, compared with 85 percent of the expatriates active there.

Bahrain

Bahrain is the other GCC country with a similar labour market structure to Saudi Arabia, and it also has a considerable track record of labour nationalization policy. The number of Bahrainis in the private sector increased from 55,000 to 72,000 between 2001 and 2005, which is a considerable change compared with an almost stagnant share of Saudis in private employment during the same period. 78,000 Bahrainis were registered as privately employed in 2008, of whom 22,000 were women, a considerably higher proportion than in Saudi Arabia. 341,000 non-Bahrainis are active on the private labour market.

Bahrainization successes have again been most pronounced in better-paying sectors such as banking and oil. However, a large segment of the private sector still remains off-limits to nationals due to low wages: According to a recent Ernst & Young report, 70% of expatriates earn 99 Bahraini Dinar or less a month, while only 1% of the national workforce works for such low wages. Public sector salaries averaged 770 Bahraini Dinar, while the average private sector salary amounted to 248 BD. With public sector employment stagnating at less than 40,000 employees, however, increasing numbers of nationals are probably forced into menial jobs paying insufficient salaries, similar to what is happening in Oman. That being said, considering that the average private salary of *nationals* in 2008 was 527 BD (up from 372 in 2005), Bahrain seems to be the most advanced among all GCC countries in placing its nationals in the private sector on all levels of seniority – including those requiring higher education. Bahraini's experience should be closely analyzed.

Shared GCC labour market trends

All GCC countries share similar problems of labour market segmentation, and they are also subject to common trends in productivity and wages which need to be taken into account in long-term labour policy planning. Just like Saudi Arabia, other GCC countries saw a precipitous decline in labour productivity in the 1980s, reflecting similar liberal labour import policies and structural shifts in the economy.

Moreover, all GCC governments have engaged in large-scale labour imports in the course of the current boom – mostly to satisfy local contractors' demands for cheap construction workers, but also with spillover effects into other sectors. Omani and Saudi attempts to stanch the inflow of workers in the mid-2000s were quickly abandoned. The almost full international liberalization of labour markets has allowed the perpetuation of very low wages in significant areas of private employment despite an economic boom. Cheap labour imports have also led to a further decline in labour productivity in most GCC markets. A study by the Conference Board has shown that output per hours worked across the GCC fell slightly by 0.2% between 2000 and 2007 if the oil and gas sector is excluded.

The Gulf states seem to be collectively locked into a peculiar economic growth path that is built on low-skills, low-margin labour markets and thus is unsuitable for the nationalization of private employment. The unique situation of a national labour force being exposed to wide-ranging international competition – unequalled among rich countries in the world – will be hard to reverse completely. Yet it needs to be contained.

It is encouraging that there are two exceptions to the general decline or stagnation in productivity: Labour productivity in Bahrain has increased by 5.1% between 2000 and 2007, while Oman achieved 4.1% growth. While this is modest, it is significantly better than the results of other GCC countries. Oman and Bahrain are the only countries that have pursued a systematic, price- and market-based policy of labour market nationalization. The increase in productivity likely has to do with the entry of national labour on private job markets above the menial level. A partial substitution of highly and mid-skilled local labour for unskilled foreign labour seems the most plausible explanation for increased productivity – which is a sine qua non for successful employment of locals. The labour policies which have allowed this shift in these two cases will be subjected to closer scrutiny in this paper.

Another encouraging fact that is common to all GCC countries is that global wage levels of unskilled and semi-skilled labour have gone up significantly in recent years, at least until the recent global slump. This has somewhat narrowed the gap between the wages foreigners and locals are willing to work for. Although increased wage expectations might create short-term problems for low-margin local businesses, they are necessary part and parcel of labour market reform.

In India, the most important labour exporter to the Gulf globally, wages have increased by some 14-15% for four consecutive years until 2008, and Gulf currencies have lost value relative to many Asian currencies thanks to their peg to the dollar. The current economic crises has halted or partially reversed both developments, but if Asia reverts to its long-term growth trend – which is likely – this will bring along increased salary expectations of international workers. Not least due to the sponsorship system that ties workers to specific employers in the short and mid-term, wage increases of the recent Asian boom had not fully trickled through to Gulf labour markets. This is bound to happen over time, however. While most unskilled jobs will still not pay enough to sustain a family of nationals, a significant share of mid-skills jobs might start yielding salaries acceptable to nationals with secondary education. In any case, the wage chasm that active labour policy has to bridge will be not quite as wide as it was in recent years.

Summary

All GCC countries but Qatar are facing public sector absorption issues today, meaning that most employment growth for nationals has to come from the private sector in the long run. All of them have very high rates of civil service employment relative to the total national workforce, and the bureaucracy remains the preferred employer for most nationals apart from highly qualified individuals who can compete with expatriate professionals for well-paid managerial positions in business.

All labour markets are segmented in at least two important dimensions: between public and private employment and expatriate and local employment. The main factor of segmentation are wages, but working conditions and expectations as well as flexibility in hiring and firing also play an important role in preventing integrated national labour markets from emerging.¹³

The two countries that are under the strongest pressure to nationalize private sector labour markets are Bahrain and Oman. Their labour market structures and the available resources per citizen are also the most similar to the Saudi one. They are relatively more advanced in their nationalization and “de-segmentation” policies, however. As in Saudi Arabia, some of the nationalization has happened in the low-wage sector, but overall rates and levels of nationalization are more advanced all across the board.

The overview of GCC labour markets shows that all suffer from broadly similar long-term problems. The challenges are deep and structural in nature and hence can only be influenced by policies that change the basic market mechanisms underpinning employment in the Gulf – which puts a question mark over the utility of some of the short-term administrative measures of labour market nationalization the region has seen in the last decade.

¹³ Kuwait is the one country that seems to have overcome gender segmentation of the labour market to a significant degree. Other countries have been less successful at this, but nowhere is the problem as pronounced as in the Saudi case.

4 Saudi Arabian labour and Saudization policy

Against the above background of structural labour market forces, the following section will analyze existing labour market nationalization policies in the Saudi kingdom, explaining both their successes and failures.

Saudi Arabian labour legislation is fairly liberal, but often interpreted in a rather labour-friendly way, especially when Saudi employees are concerned – to the extent that labour courts force companies to re-employ individuals who feel that they have been wrongly dismissed. Expatriate employees can in general be fired rather easily, and working hour rules are flexible, earning Saudi Arabia high scores for Labor Freedom (80.6%) on the Heritage Foundation's Economic Freedom Index. With regards to the employment of expatriates, the new labour law of 2005 has included only rather minor changes to the existing legislation, leaving basic rules on sponsorship and restricted internal mobility for expatriate labour intact.

The system of sponsorship constitutes the main legal difference between Saudi and foreign employees, and usually puts foreigners in a position of relative dependence on their sponsor. They can leave for a new employer only if their current one writes them a "no objection letter", meaning that they usually are not internally mobile on the Saudi labour market and hence have a disadvantaged bargaining position vis-à-vis their employers, who in many cases also keep the passports of their expatriate workers. Sponsorship makes it hard for foreigners to effectively negotiate wages and working conditions, which in turn makes them attractive as relatively cheaper and more compliant employees. Saudis by contrast can leave their employers any time and hence have a much stronger bargaining position, which makes many employers reluctant to take them on. Many businessmen complain about the high turnover of local employees, making it unprofitable to recruit them even if issues such as higher salary expectations and lesser experience are discounted. Apart from wages, the sponsorship system is the main reason segmenting labour markets between foreigners and locals, undermining the competitiveness of nationals on the private labour market.

Saudization reforms

"Saudization" policies thus far have mostly been based on administrative intervention rather than on changing the prices and regulatory mechanisms that create segmented markets. Saudization by decree has had some degree of success, but has brought along significant costs and inefficiencies that a market-oriented policy could have minimized.

Saudization has been under way since the mid-1990s in earnest, and has been given a further boost by the consolidation of labour policy jurisdiction under the Ministry of Labour in 2004, which put an end to the issuing of work visas by numerous different government agencies – a crucial prerequisite for a nationally integrated labour policy.

The main instruments of Saudization have been:

- *National employment quotas* of both sectoral and global nature. Decree 50 of 1995 stipulated an annual 5% increase in the employment share of Saudis in all companies with more than 20 employees. As the quotas turned out to be unimplementable in most sectors, however, the decree has been interpreted in many different ways, and in recent years the Ministry of Labour has taken to imposing different quotas on different sectors (allowing for lower Saudization in the low-wage contracting sector e.g.). Even those quotas however have often

been honored in the breach, and in fact employment of Saudis is often negotiated on a discretionary basis between companies and labour offices. The new labour law restated a previously existing, global 75% Saudization quota, but without outlining an implementation mechanism. The first Saudization quotas were in fact codified as early as the late 1940s, but never consistently implemented.

- The *reservation of specific job categories for Saudis*. An increasing number of jobs – often of security, administrative/clerical and sales nature – have been reserved for Saudis. Visas are not given for these occupations anymore, but employers have found ways to move around these restrictions.
- The *subsidization of training and initial employment for Saudi workers* through the Human Resources Development Fund (HRDF). HRDF supports both on-the-job training and the initial phase of employment through subsidizing wages, with a view to making Saudi employees affordable to employers while guaranteeing a livable income to Saudis. While this appears a viable method of temporarily tackling the foreigner-Saudi wage gap, it is not clear whether Saudis will remain competitive employees after wage subsidies are phased out. Recent reports have shown that some 75% of HRDF beneficiaries do not stay on the job after the end of the subsidy period.

There are various sanctions for companies that fail to Saudiize, including exclusion from government tenders and loans, a ban on labour card renewals, and the stoppage of administrative transactions with the MoL in general. There is even a 1997 GCC-wide resolution stipulating a preference for nationalizing companies in their dealings with government. Sanctions have been implemented increasingly frequently in recent years, but the criteria for doing so are not always clear, given that a large majority of national companies are not fulfilling official Saudization quotas.

Implementation issues

The ambitious targets of quota-based Saudization have often led to situations of legal ambiguity in which decrees were clearly not adhered to by business, while the government remained unwilling to sanction non-implementation. In many cases, specific Saudization demands were withdrawn post hoc, followed by renegotiations of quotas and job bans between government and business. Repeated attempts to fully nationalize businesses such as the taxi sector, Saudi travel agents, vegetable markets and the gold retail trade have had to be abandoned or rescheduled. This has led to great insecurity among businesses, undermining their capacity for long-term resource planning, and doing significant damage to businesses in the short run in the cases where they were subject to sudden crackdowns and sanctions that were then rescinded again.

In fact, business-level Saudization is often negotiable between a company and the labour office in charge, and quid pro quos can be found in which e.g. training for Saudi employees is accepted as an alternative to an unrealistically high Saudization quota, resulting in the release of desired job visas. While such deals might make pragmatic and mutually beneficial solutions possible, bureaucratic discretion also reduces the legal security of business, and create opportunities for corruption. Labour offices moreover have limited information about the actual needs and structures of the hundreds of thousands of businesses operating in the kingdom, which can result in misallocation of visas and Saudization requirements.

The Ministry of Labour is in charge of inspections to follow up on Saudization commitments and to check whether companies have provided correct information about their payroll. While the Ministry's attempts to micro-manage individual companies' employment structures put a high regulatory onus on its bureaucracy, inspection capacities have been criticized as insufficient. It remains to be seen whether the recently established, MoL-controlled body for labour inspections will significantly increase monitoring capabilities.

A recent accord between MoL and the Jeddah Chamber of Commerce (JCCI) delegates the assessment of individual companies' visa and labour needs to a body within JCCI on a trial basis. While this body might develop a better "feel" for the employment needs of different sectors, it remains unclear whether any central organization is able to assess company-level labour needs as well as a price-based, internally liberalized labour market could. Even in the best of circumstances, a central clearing house for labour visas will be susceptible to manipulation, suffer from insufficient information, and create both redundancies and bottlenecks in different parts of the market.

Saudization successes in regional comparison

Despite administrative pressure and a plethora of Saudization rules, levels of Saudization on the private labour market stagnated for many years. It is only since 2006 that private employment of Saudis seems to have picked up at a measurable pace. Some of this is bound to be an outcome of regulatory pressure and sanctions from the government. Some of it however is also an outcome of population growth, increasing socio-economic pressures on non-employed nationals and increasing cost of living in the course of the new oil boom. The Saudization increase in the kingdom remains smaller than the increases witnessed in Bahrain and Oman.

Number of Saudi employees in the private sector

2001	2002	2003	2004	2005	2006	2007	2008
588,000	598,000	592,000	486,000	623,000	714,000	766,000	829,000

Source: MoL, SAMA

Although the absolute increase is sizeable, the increase in the rate of Saudization is relatively small, because significant numbers of expatriates were imported into the kingdom in the same years that more Saudis entered private employment.

Saudization rates in the private sector (2004-2007)

2004	2005	2006	2007	2008
10.1%	11.6%	12.8%	13.1%	13.3%

Source: MoL

The Saudi performance has been lagging relative to its mid-income neighbours Oman and Bahrain. While number of private Saudi employees between 2003 and 2008 increased by about 40%, the corresponding Omani figure is 97%. Despite heavy importation of foreign labour, the Omanization ratio remains higher than the Saudization ratio.

Number of Omani employees in the private sector

2003	2004	2005	2006	2007	2008
74,816	87,064	98,537	114,311	131,775	147,194

Source: Central Bank of Oman

Omanization rates (2003-2007)

2003	2004	2005	2006	2007	2008
15.5%	17.0%	18.8%	18.3%	17.1%	15.6%

Source: Central Bank of Oman

In Bahrain, the increase in Bahraini employees on the private sector between 2003 and 2008 only amounted to 32% (from 62,000 to 82,000). However, increases in previous years – stagnant in Saudi Arabia – were significant, and the overall Bahrainization ratio in 2008 reached almost 20%.

The price of informal labour markets

Saudization policies in their current shape have produced some successes, but they have arguably also come at a heavy cost. As they are based on company-level administrative intervention in the labour markets, they have created numerous labour market bottlenecks and incentives for “working around” the rules.

The current national-level regime regulating the Saudi labor market significantly impedes the efficient allocation of the foreign workforce, be it expatriates already present in the Kingdom or expatriates who are newly recruited from abroad. One can argue that the aggregate level of foreign labor in Saudi Arabia would be largely sufficient for the Saudi economy: the Ministry of Labor has recently reported that four million new work visas have been issued in the last two years alone. However, as long as the right workers are not matched with the right employers, the aggregate provision of expatriate labor will remain insufficient. The *internal mobility* of foreign labor in Saudi Arabia is strictly limited, which leads to misallocation and bottlenecks on the labor market and, in some cases, corruption.

The current sponsorship system ties foreign workers to their current employer and cannot change jobs without his/her consent. Workers, however, are not necessarily sponsored by the employer who needs them most. Indeed, while some companies have a surplus of laborers (and even “hoard” laborers to safeguard future expansion), others suffer from labor deficits. Moreover, the workers with the best qualifications for a specific job are not always employed by the company who needs this specific expertise the most. It is the job of the Ministry of Labor to apportion work visas according to the needs of private employers, but it is practically impossible even for the best-run bureaucratic body to effectively assess the shifting employment needs of hundreds of thousands of companies in an increasingly complex national economy. The result is a misallocation of resources and the appearance bottlenecks, which hurt promising companies that lack sufficient access to labor and incentivize companies with surplus labor to engage in extra-legal practices of reallocating their workforce to other employers (through the “free visa” system and other mechanisms of the informal labor market).

Quotas and occupational bans are policies of “micro-management” that demand a monitoring capability that is beyond even the most modern of bureaucracies. They create incentives for manipulation, “fake employment” and corruption. Rigid Saudization ratios moreover are insensitive to the cost caused to individual companies, which can

imply a very uneven burden on the private sector and can stymie the development of particular industries.

Saudi and foreign companies have been very creative at skirting Saudization rules: They create sub-companies registered in sectors which demand lower Saudization ratios, import workers under false job descriptions – senior Western managers have been brought into the country as “camel herders” – buy workers from other companies on an informal “free visa” market, put Saudis on the payroll who do not actually do any work etc. The uneven allocation of labour and visas through the sponsorship system has created a large-scale informal market in which privileged actors with better access to visas “resell” workers to employers who actually needs them – either informally or through officially transferring sponsorship to them.

All other GCC states have tried to nationalize private labour markets through similar mechanisms: global and sectoral quotas, bans on specific professions and temporary subsidization of national wages. In all cases, similar methods of shirking rules and informal markets for foreign labour have developed, and in all cases, patchy implementation, “grace periods” and constant revisions of quotas have created insecurity for business. Regulatory capacities and information available to national labour agencies have been limited and not up to the very ambitious task of controlling employment patterns in every single enterprise. That implementation problems have developed among strikingly similar lines in the other Gulf states shows that the underlying causes are shared. They are the nature of the sponsorship system and the interventionist character of national employment policies.

Kuwaiti as well as UAE companies are known to engage in “ghost employment”, to the extent that some Kuwaiti managers spend hours in front of ATMs withdrawing salaries of fake Kuwaiti employees, which were temporarily deposited to convince the Ministry of Labour of their existence. Qatar and Bahrain until recently have had flourishing “free visa” markets and numerous “letterbox companies” whose only purpose is to import workers who can then be resold into illegality. Needless to say, free visa employment further undermines expatriates’ labour rights, and therefore further tilts the playing field against national job-seekers.

The income from the free visa market in Kuwait alone has been estimated at 3 billion \$. The Saudi figure could be proportionally larger. The deadweight costs for business, the extent to which such operations distract from productive activity, and the opportunities for administrative corruption are enormous and a heavy burden on economic development. It is not clear whether the benefits of Saudization as it is practiced currently outweigh the costs. Probably they do not.

5 The GCC debate about the sponsorship system and labour pricing

The limited successes of conventional, top-down, interventionist methods of labour market nationalization have led to a lively debate about the nature of labour market regulation in general, and about alternative, market-based mechanisms for attaining higher national employment quotas. The next section will review these debates and the policy steps that have been taken on this basis. The basic idea, most clearly articulated by the Bahraini government, is that nationalization cannot be decreed, but it has to be induced through market mechanisms, most of all through narrowing the wage gap between locals and foreigners, and by allowing foreigners mobility on the local market. The idea that a government can let in almost unlimited numbers of low-wage foreign workers, but then can prevent them by fiat from competing with locals on the labour market, is fallacious – and attempts to prevent competition by enforcing national employment will lead most of all to rule avoidance and “fake jobs”, not productive employment.

Kuwait

An additional factor leading to a debate about the sponsorship system has been the increasing pressure that international human rights groups and some Western governments have put on Gulf countries due to reports of widespread labour abuse. This is perhaps the factor that has been most important in the case of Kuwait, where human rights groups are well organized and local civil society as well as the national parliament have played an important role in the debate.

Occurrences of labour unrest in summer 2008 galvanized the debate about the utility of the sponsorship system, and led to an emergency session of the parliament. The parliament has formed a “technical labour committee” to discuss the details of sponsorship reform. Kuwaiti Minister of Labour Bader Al-Duwaila himself has admitted that senior officials in his ministry are involved in the visa trade, and has explicitly spoken of “alternatives for the sponsorship system” to meet international rights standards.

One of the proposals under discussion is the creation of a private joint stock company that would handle the recruitment of foreign labourers. This would replace the current situation of individual companies importing labour directly from abroad or through a plethora of recruitment agencies. The specialized company would be in charge of monitoring the fate of foreign workers who would presumably be mobile between different employers, and who would be imported not on the basis of individual company requests, but based on a national human resources strategy that would assess the *aggregate* needs of the Kuwaiti economy.

The government is also considering a special state organization to be put in charge of labour imports, and is planning to directly import workers for its own contracting and construction projects in order to prevent free visa deals. It has already prohibited employers from keeping the passports of their employees.

For the time being, however, the debate on sponsorship in Kuwait seems to have moved to the backburner, as the new labour law issued in late 2009 did nothing to abolish the sponsorship system. Although it increased a number of other formal workers’ rights regarding holidays, working hours, severance pay etc., it has done little to close the fundamental legal chasm between nationals and expatriates.

Oman

Oman has been pursuing a dedicated Omanization policy since 1994 under the title of "Sanad" ("support"). It set rather high quotas for different sectors of business and reserved several job categories for nationals. The implementation of several of the steps had to be postponed, however, and during the first few years, Omanization was seen as a relative failure.

Omanization has always had a market-based component, however: A 7% levy on foreign workers has been used for the training of nationals, similar to the HRDF mechanism in Saudi Arabia. The training costs of nationals are subsidized by the government, but the subsidies are tied to the condition of subsequently employing the individual in question. In the 2008 budget, the training allocation for the private sector amounted to 714 million \$, a sum that is considerably larger than the budget of the Saudi HRDF, despite the much smaller size of the Omani market.

The increased cost of foreign labour due to the training levy has probably contributed to the relative successes of Omanization in recent years. While there have been attempts to increase the fees levied on foreign labour in Saudi Arabia, these have not been systematically implemented. Fees for foreign labour are still low: a work permit costs 100 SR per year, a residence permit 500 SR per year, to which the government adds a 150 SR "human resources" fee that accrues to the HRDF.

The most important measure taken by the Omani government in recent years, however, has been the relaxation of the "non objection certificate" requirement. Since late 2006, expatriates no longer need the permission of their current employer to switch to a new one, in effect abolishing the core component of the sponsorship system. This means that foreigners can now compete with locals on an even footing, making the latter relatively more attractive as employees. This regulatory shift towards a real, integrated labour market has also led to an increase in wage levels of expatriates (8.4% in 2008 in the case of professionals according to GulfTalent, higher than for any other GCC country), which has further decreased the segmentation of the labour market. These two factors probably explain a significant part of the impressive Omanization results of 2007 and 2008, when national employment on the private market increased by 15% and 12% respectively.

Case study: Bahrain

The country which has seen the most comprehensive debate about the sponsorship system and about labour market integration is Bahrain. It has also adopted the most coherent policy package, based on research by international consultancies.

Originally, "Bahrainization" was also based on quota rules, imposed in 1995: A company had to employ 20% nationals during its first year, and 5% during all following years until 50% were reached. Existing companies also had to follow 5%/year increments until they reached 50%. As in other cases, these quotas were usually not reached and created an atmosphere of insecurity and backhand dealings. 9000 unemployed Bahrainis were reported to make a living off registering fake companies for free visa deals.

With the creation of the Economic Development Board under the Crown Prince, a comprehensive policy review was initiated. The basic conclusion of the process was that labour market nationalization can only be reached through integrating the labour market,

i.e. by narrowing the wage gap between locals and foreigners and by giving foreigners the same internal mobility on the market.

The official aims of Bahrain's labour reform as initiated in 2007 are to:

- Deregulate the labour market
- Equalize the cost differential of foreign and local labour
- Give equal rights and choices to foreigners and locals
- Upgrade the working environment standards
- Eliminate Bahrainization policy in terms of quotas rules
- Deregulate 'hire-fire' procedures

A separate Labour Market Regulatory Authority (LMRA) was created and started its operations in 2008 by taking over visa matters and work regulation from the Ministry of Labour. All foreign employees had to be re-registered and companies had to "cleanse" the data the Ministry of Labour had collected on them. LMRA is building up a larger inspection capacity than the MoL had and offers e-government services for both employers and workers, who can check their status and data online. A "one-stop-shop" has been created to deal with all labour-related bureaucratic transactions. Employers are not allowed to hold employees' passports anymore.

The two core components of the reform however are

- a) that foreign labour is in effect taxed through a biannual and monthly fee, increasing its price relative to local labour, and
- b) that foreign employees enjoy increased mobility on the market, being able to move to new employers.

Under the new setup, the government charges firms a levy of 200 Bahraini Dinar for a two-year work visa, in addition to a 10 Dinar/month fee. Originally, the government had planned a much larger fee, but gave in to business protests against a sudden increase in labour costs. The idea now is to raise the fees gradually to narrow the wage gap while allowing businesses to adjust their organizational structures. Steps towards further increases have yet to be taken, however, making the fee's effect on employment choices marginal to date. Bahrainization quotas, which were supposed to be abolished instantly, were only reduced and will be maintained for the time being.

As 80% of Bahraini labour levies are used for training purposes, the fees are spent locally and their use is expected to contribute to increase the overall productivity of the national labour force. Training schemes for Bahrainis are administered through the Tamkeen fund (formerly the Labor Fund) and a joint public-private training institute.

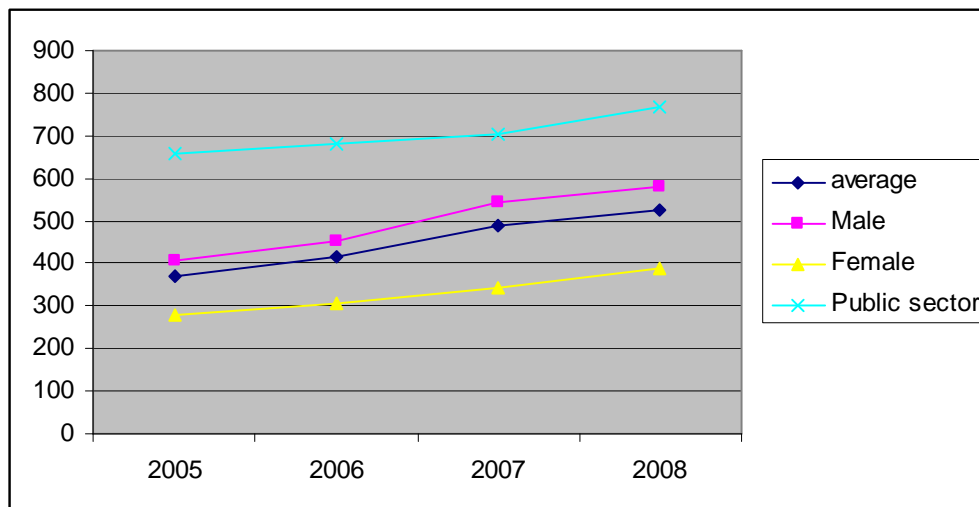
The second component of the labour reform is the abolition of the sponsorship system, effected through the abrogation of the requirement for a "no objection certificate" from employers that allows foreign workers internal mobility on the Bahraini job market. In force since summer 2008, its full effects cannot be evaluated yet. As in Oman, however,

it seems to already have led to wage rises for expatriates above the GCC average, increasing the relative competitiveness of national labour. Bahrain was the only GCC country in which professional wages rose above inflation in 2008.

The Bahraini reforms were preceded by wide-ranging public debate about the policy proposals; draft regulations are usually posted on the LMRA website for public comment. This way, the reform could be introduced in a reasonably smooth manner, and apart from the reduction of the planned labour fees, the Bahraini government avoided the sudden reversals and short-term modifications usually so typical of GCC labour policy.

The Bahraini government is also pursuing deliberate policies to prevent the emergence of a stratum of “working poor” among its nationals – a distinct danger in case nationalization policies are promoted without controlling the aggregate supply and increasing the price of foreign labour. The average income of Bahrainis in the private sector lies significantly above that of Omanis and has increased considerably in the last three years – narrowing the gap with public sector wages from 284 to 239 Dinar despite several raises in the civil service. Preliminary data for 2009 show that the gap has further narrowed below 200 Dinar. The Bahraini government is encouraging companies to guarantee a minimum wage for Bahraini nationals, in some cases subsidizing the increased salaries for up to six months.

Private sector wages of Bahrainis (BD per month)



Source: Central Bank of Bahrain

The Bahraini government has also introduced a 1% income tax for a national unemployment insurance, from which unemployed university graduates are paid a stipend between 120 and 150 BD in return for attending training courses. Nationals who lose their job after paying contributions for a minimum period of 12 months are eligible to receive 60% of their salary every month, with a maximum payment of 500 BD and a minimum of 150 BD.

The Bahraini government is clearly concerned not only with increasing the participation rate of nationals on the private job market, but also with creating jobs that pay them a living wage. The trends in Oman and Saudi Arabia, by contrast, seem to have been to increase national employment, but at the cost of decreased wages.

Bahrain seems to be the most successful case of combining acceptable incomes with acceptable employment levels in the Gulf. The current official unemployment rate in Bahrain is 4%. This only includes individuals officially registered as unemployed and hence might be of limited utility. What is more significant is that the employment rate of Bahrainis in working age is above 40%: below OECD averages, but significantly above the figures we estimated for Saudi Arabia above. Moreover, most of this employment is provided by the private sector, not the government.

The Saudi debate on sponsorship

Saudi Arabia has also seen a lively debate about the sponsorship system in 2007 and 2008, but is less advanced than Bahrain and Oman in reforming it. In early 2008, Mifleh Al-Qahtani, deputy president of the National Human Rights Society (NHRS), explained that he expected the current sponsorship system to be abolished within three years. Discussions between Ministry of Interior, Ministry of Labour, the state-run Human Rights Committee and the National Human Rights Society on the issue appear to be fairly advanced, but public participation in the debate has been limited.

Two major proposals have been floated about the issue: One is from the Ministry of Labour, which plans to license several private recruitment companies to take over the sponsorship of expatriate workers. The second one is from the Human Rights Society, which prefers the establishment of a dedicated state organization to be in charge of labour imports and to work as “state sponsor” of foreign labour. Both proposals seem to be based on the conclusion that a real, integrated labour market needs to be created.

Creating such a market would imply granting foreign workers full internal labor market mobility, allowing them to find the employers who need them most. Ideally, a simple price mechanism would determine labor allocation, and hence employment would be structured according to the actual demand (and the actual readiness to pay) of employers. Once a pool of specialized expatriate personnel is created in Saudi Arabia, the labor market, and not the bureaucracy, should allocate them. This will greatly help to accommodate sectoral change and the development of new industries in particular.

Current quota- and prohibition-based mechanisms of Saudization constitute attempts of “micro-management” that demand a monitoring capability that is beyond even the most modern of bureaucracies. They create incentives for manipulation, “fake employment” and corruption. Rigid Saudization ratios moreover are insensitive to the cost caused to individual companies, which can imply a very uneven burden on the private sector and can stymie the development of particular industries.

The only realistic way of accomplishing Saudization without choking business growth and imposing huge deadweight losses, is through a market mechanism of some kind that will allow companies to adjust to Saudization according to their individual needs and capabilities, while also allowing an increase of the aggregate Saudization level.

There would be two conceivable ways of achieving this:

- By limiting the *aggregate* supply of foreign labor, thereby gradually increasing its price, making Saudi employment more attractive
- By levying a fee on the employment of foreign labor, again shifting relative prices and leading to higher Saudi employment

One of the two will have to happen for Saudis to become more competitive employees. As long as there is an aggregate surplus expatriate labor, no amount of micro-intervention can prevent a de facto wage differential and a de facto preference for foreign workers. Regulations will be ignored or circumvented and informal labor markets be created, counteracting the intention of the sponsorship system that was supposed to increase control over foreign labor issues. No country, including the most developed OECD countries, could guarantee gainful employment for its national population as long as the gates of mass migration for cheap labour are open to the extent that they are in the GCC.

In principle, both of the tools proposed by MoL and NHRS could be used for such aggregate labour supply and pricing mechanisms, which require much less administrative intervention, put a lesser burden on the labour bureaucracy's monitoring capacities, create much smaller total cost for government and business, and much less opportunity for corruption than the current decree-based Saudization policies.

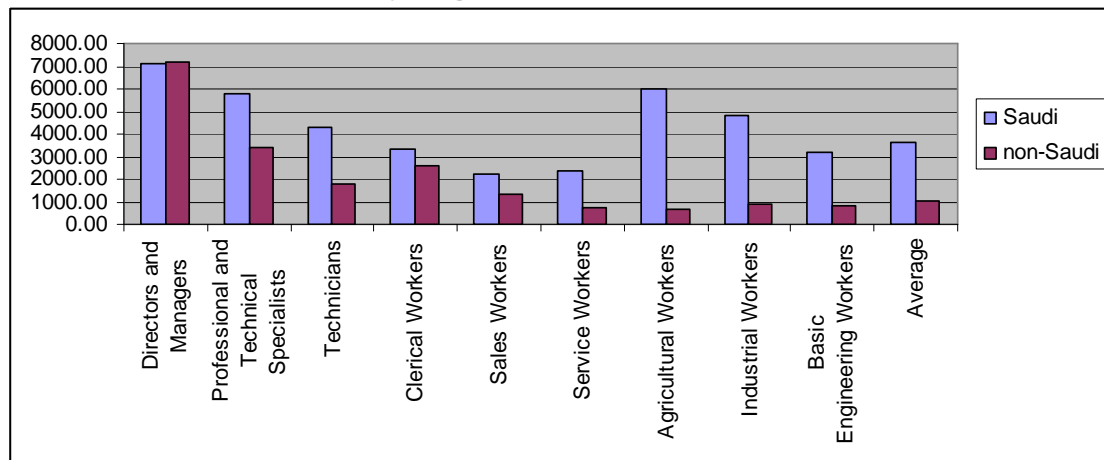
6 Outlook: sectoral and macro-economic dimensions of labour nationalization

In Saudi Arabia as elsewhere in the GCC, labour nationalization has its biggest potential in mid-skills, mid-wage sectors, where enough jobs can be generated to make a difference to aggregate national employment, nationals are most likely to be competitive on skills, and the expatriate-local wage gap is the narrowest. The nationalization of low-wage sectors at current salary rates is neither economically nor politically desirable, and not feasible with current national reservation wages. High-income sectors are attractive to nationals, but they will never produce a large amount of jobs, and the current supply of highly qualified nationals is limited. Moreover, in a globalized economy, countries' competitiveness increasingly depends on the import of small numbers of highly skilled international workers.

Mid-income occupations, including clerical/administrative workers, technical specialists, technicians, and sales workers, should hence also be the main target of national training efforts. In the Saudi case, national wages in such occupations are only 1.2 to 2 times as high as those of foreigners (compared to an almost tenfold gap in low-wage agriculture for example). Given the higher non-wage costs of foreigners, a labour policy that would increase foreign wages to the level of national wages here would impose only moderate costs on business, but could have significant local employment effects if combined with general labour market liberalization. Currently, mid-skills Saudi workers seem to be *particularly* underemployed (Girgis), indicating a particularly large potential for increasing national labour market participation.

At the same time, these sectors could provide wages above 3000 SR/month. Judging by informal interviews conducted for this study, this seems to be the average reservation wage of young Saudis with secondary education, and also seems to be the bare minimum that would be acceptable from a standpoint of social stability and equity. Note that expatriate wages in construction and other low-wage services are very significantly below this threshold.

Saudis vs. expatriate monthly wages, 2007 (SR)



Source: Ministry of Labour

The macro-economic impact of higher labour costs

A full estimate of the macro-economic impact of higher labour costs in the GCC is beyond the remit of this paper (see the JISR paper by Eberhard Fees on this topic). Yet, a few basic observations can be made.

First, it is clear that competitiveness of GCC companies would be affected by higher average wages, even if these are market-determined and phased in gradually. However, the impact on tradables sectors will be different from that on non-tradables. Non-tradables – service sectors such as commerce, finance, restaurants etc. – are less exposed to international competition and therefore could hand on somewhat higher production prices to the consumer. However, as higher prices would be caused by higher wage payments to nationals, which moreover would partially substitute for foreigners, the aggregate direct income effect for nationals would be positive. Moreover, past sectoral successes, such as the Saudization of supermarket cashiers, have had a negligible impact on price levels.

In tradable sectors, i.e. those producing exportable goods, the impact of higher wages on competitiveness would depend on the labour intensity of businesses. In heavier industries, higher wages will have a negligible impact. In more labour-intensive downstream manufacturing, higher wages need to be combined with a stronger focus on specialized technical training with a view to increasing labour productivity of national employees. In many sectors there is considerable scope for technological upgrading of production, and as above productivity statistics have shown, the availability of very cheap labour might in fact have stymied efforts at increasing productivity. To some extent, therefore, higher wage levels will by themselves induce a quest for higher productivity. Beyond this, a reform of technical training with heavier involvement of private sector players is probably needed, which however is beyond the scope of this paper.

Generally speaking, market-based nationalization will lead to fewer nationals replacing more expatriates. The assumption of one-to-one substitution on which some of the past labour market plans have been based are unrealistic, as they include numerous low-

wage jobs that will (and should) disappear in the course of nationalization. Expected national-expatriate substitution ratios for Gulf countries have been estimated at 30%.

This means that wages up to three times as high can be paid presuming that the labour of higher will be utilized more productively. This will be a challenge in many sectors, but is far from impossible, given the very low existing rates of labour productivity. The government and its sectoral agencies could play a role by promoting model projects together with chambers of commerce that demonstrate the use of higher value-added national labour.

Needless to say, a reduced number of expatriate workers would stanch the drain of remittances from GCC economies and reduce the infrastructure and public service costs created by foreigners outlined above. Moreover, locally spent wage income would have a significant multiplier effect in the national economy.

At this point, the economic and regulatory requirements of well-implemented labour nationalization are clear to many GCC technocrats, but the political will from the highest leadership in most case is still lacking. Moreover, even forward-looking Bahrain has failed to find a strategy to “package” internal labour market liberalization and increased foreign labour costs in a way to make it acceptable to business. Finding a political quid pro quo that will bring business on board for meaningful labour market reform is arguably the primary economic policy challenge that GCC regimes will face in the coming decades.