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SMEs, TRADE AND DEVELOPMENT IN GCC COUNTRIES: A DEVELOPMENT PERSPECTIVE

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TRADE IMPACT FOR GOOD

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Abstract

Small and medium enterprises (SMEs) have by far the greatest potential to generate employment opportunities and assist in developing globally competitive economies. Therefore, almost all countries have specific policies and support mechanisms to assist in the development of a vibrant SME environment. This is more important for the hydrocarbon dependent Gulf Cooperation Countries (GCC) where the government has sought to ensure the growth of this sector perhaps at the expense of the private sector. This has led to a heavy reliance on the hydrocarbon sector with little in the way of economic diversification. Hydrocarbons contribute to an average of 78% of export earnings, 83% of state budget and 60% of GDP for the GCC countries. More importantly, the dominance of the hydrocarbon sector with its fluctuating price implies that all the GCC economies are prone to global events which impact their economic performance. With a growing population that is expected to increase by 50% between 2010 and 2050, a large public sector and falling hydrocarbon reserves the GCC countries need to diversify their economies through the development of the SME sector. Although, the GCC countries have initiated programmes to support the SME sector they have been transactional in nature through the provision of small loans, training and access to business accelerators and incubators. Evidence shows that these transactional support mechanisms have helped to increase the flow of new business start-ups and, to a certain extent, their survival beyond the initial stage of development. The main criticism of these transactional support mechanisms is that they have not helped to develop a globally competitive SME sector. With limited domestic markets SMEs in the GCC need to trade globally and be able to compete in the international marketplace. This article seeks to examine the competitiveness of the SME sector in the GCC countries through a multi-faceted approach that incorporates the importance of the hydrocarbon sector alongside the drivers of entrepreneurship and the government support mechanisms as well as policies that have been developed in each of the GCC countries.

JEL Classification: F14, L15

Keywords: trade, prices, SME

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Introduction

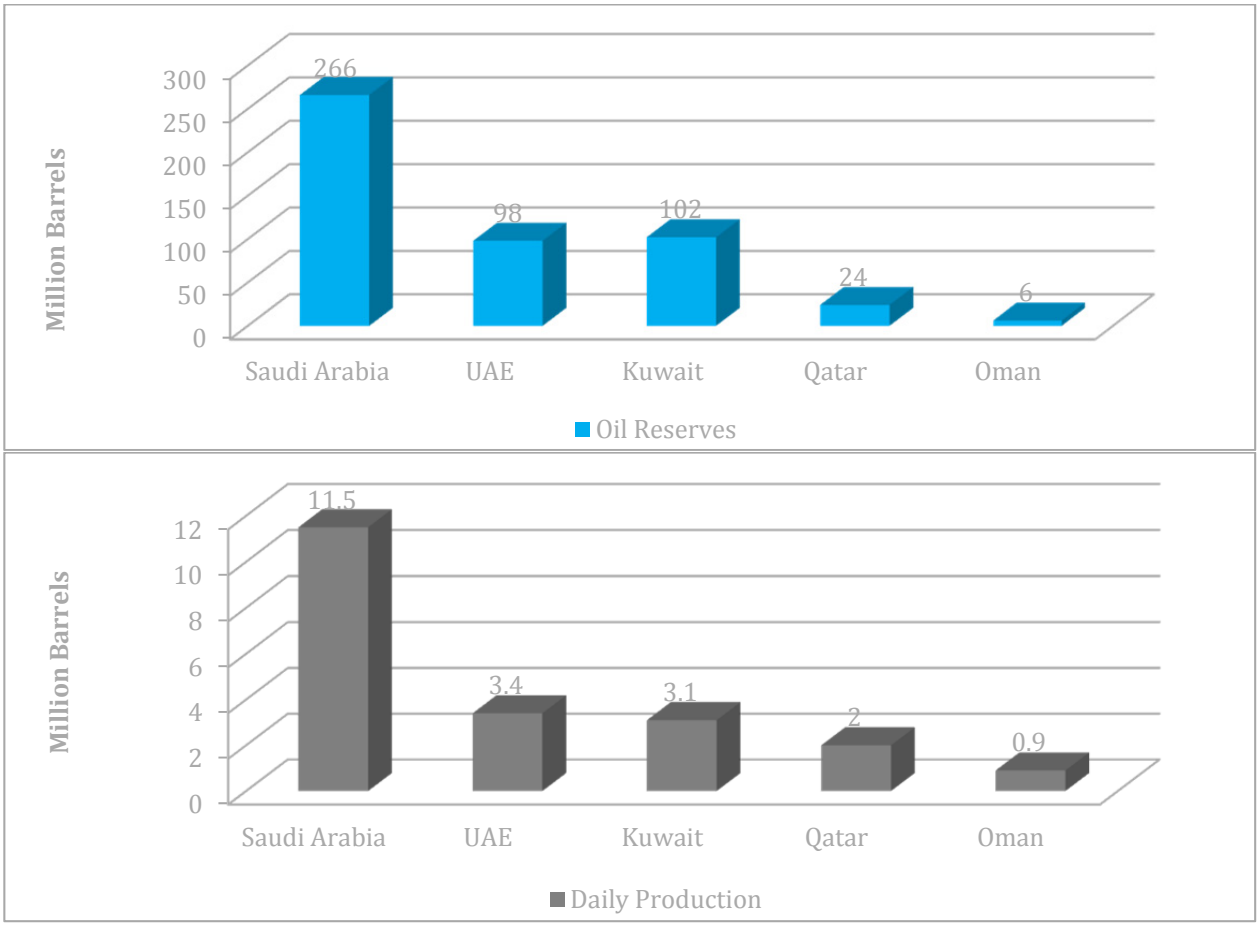
Small and medium enterprises (SMEs) in all countries form the largest proportion of businesses and contribute significantly to the economy in terms of creation of employment, increase in productivity, adoption of technology, spearheading innovation and accumulation of capital. Therefore, it is important that governments create an environment that allows for the development of a strong and vibrant SME sector that is globally competitive. This is an important policy issue for the resource rich Gulf Cooperation Countries (GCC) which, until the discovery of oil, had little in the way of a commercial sector. In the post-oil period the public sector has played an important role, supported by revenues from the hydrocarbon sector, however it is doubtful as to whether this model is sustainable in the long run. Therefore, in recent years all GCC nations have placed a much greater focus on supporting entrepreneurship, especially among their own nationals. Data produced by each of the GCC countries shows that the number of business start-ups has increased and policies have been developed to support SMEs. By and large, these policies and support programmes are transactional in nature through the provision of small loans, training and access to business accelerators and incubators. Evidence shows that these transactional support mechanisms have helped to increase the flow of new business start-ups and, to a certain extent, their survival beyond the initial stage of development. There is, however, little, if any, evidence to support their impact in increasing the competitiveness of the SME sector. This is an important policy issue for the GCC countries because of their need to diversify their economies away from the hydrocarbon sector through a strong and sustainable private sector. The small domestic market size and the openness of each individual country within the GCC imply that if SMEs are to be successful then they need to trade globally and be able to compete in the international marketplace. This article seeks to examine the competitiveness of the SME sector in the GCC countries through a multi-faceted approach that incorporates the importance of the hydrocarbon sector alongside the drivers of entrepreneurship and the government support mechanisms as well as policies that have been developed in each of the GCC countries.

1. Economic Dependence of GCC Countries to the Hydrocarbon Sector

The GCC countries have achieved considerable economic and social progress in a very short period of time, which has been made possible by the discovery of oil. Initially the oil discoveries were limited to Bahrain and Saudi Arabia. By the 1940s, Kuwait and Qatar began exporting oil and by the 1960s were joined by Oman and the UAE. With little in the way of a formal industry and with only one percent arable land, the hydrocarbon sector became the engine for the GCC's economic and social development. The hydrocarbon sector has been the backbone of the economy, and has allowed GCC governments to invest in building modern infrastructure. The hydrocarbon revenues also facilitated GCC governments to support their nationals through generous transfer payments as well as attracting foreign businesses and workforce with a tax-free environment. At the same time the surplus hydrocarbon revenues were used to build reserves and invested through national sovereign wealth funds or authorities to meet the future needs of the country and its people.

Although, there have been various recent oil discoveries across the world the GCC still accounts for almost 40% of the global proven reserves and produces a quarter of the daily output. Saudi Arabia is by far the largest producer of oil within the GCC at an estimated production level of 11.5 million barrels of oil per day and also holds the largest reserves at 266 billion barrels as shown in Figure 1.

Figure 1 GCC Proven Oil Reserves and Production (2012)



Source: BP (2013)

With a heavy reliance on the hydrocarbon industry, it is not surprising to find that state revenues and budgets are tied very closely to it. As Figure 2 shows, on average, hydrocarbons make up 83% of GCC budget revenues. Non-hydrocarbon state revenues are limited and the main sources are fees and charges for government services as well as customs tariffs. The GCC states have very little in the way of corporate taxation and no income or sales tax[1]. The limited form of taxation that does exist is imposed on foreign companies in Saudi Arabia at 20%, Qatar 10% and in the UAE to only foreign owned banks at 20%. Ever since the 1980s, the GCC countries have considered imposing corporate, income and sales taxation however, to date there are no formal plans to implement such measures. Therefore, the hydrocarbon sector represents the largest component of the economy, as measured by the Gross Domestic Product (GDP), for all the GCC countries. The hydrocarbon sector accounts for an average of 46% for the GCC countries, with the highest for Kuwait - at 64% - and the lowest for Bahrain - at 28% (IMF 2013). Figure 2 illustrates the importance of the hydrocarbon sector to each of the GCC economies in terms of export earnings, state budgets and percentage of GDP. The very close connection between the hydrocarbon sector and the economy implies that the GCC countries, in the first instance, become dependent on global events, which impact the price of oil and the corresponding revenues. Second, in all the GCC countries, the government tightly manages the hydrocarbon sector due to its importance, and therefore the economy becomes dominated by the public sector.

[1] The one exemption is Saudi Arabia where a payment of 2.5% of income has to be paid in the form of zakat i.e. alms to the poor, and is a requirement in Islam. However, the proceeds of these receipts are not used for government expenditure as there are very strict guidelines in Islam on the use of zakat funds.

Figure 2 Importance of Hydrocarbon Sector to GCC Governments Budgets

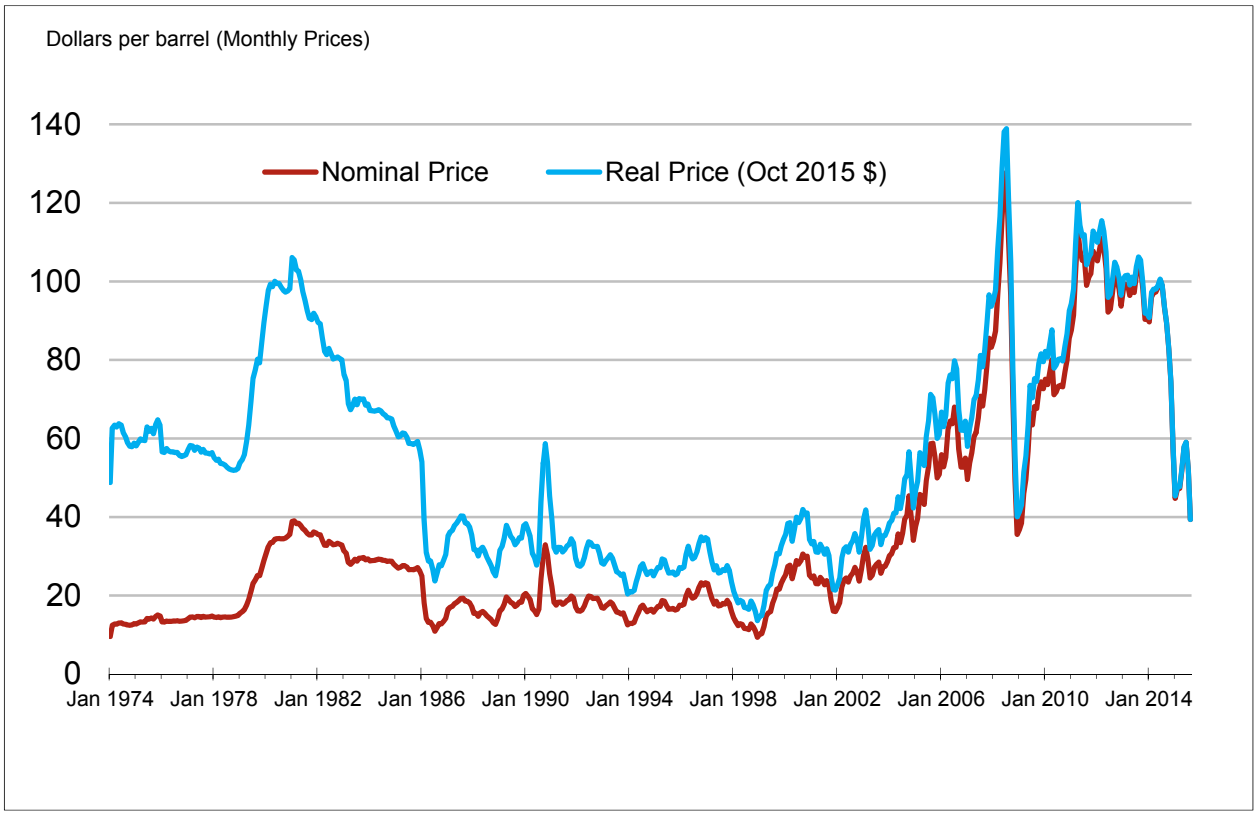
Country	% of export earnings	% of state budget	% of GDP
Bahrain	69	86	28
Kuwait	90	93	64
Oman	65	77	49
Qatar	91	80	54
Saudi Arabia	85	85	47
UAE	69	77	33
GCC Average	78	83	46

Source: Percentage of Export earnings and state budget from Statistical Appendix in Europa Publications (2011) and percentage of hydrocarbon GDP from IMF (2013).

1.1. The Impact of Oil Price on Government Revenues

Oil is an international commodity and its price has fluctuated considerably over the last half century. The international price of oil has a long- and short-term component. The former is determined by the underlying demand and supply conditions. The latter arises due to market sentiment as well as economic, political and social events that may have the potential to disrupt the supply of oil. The greater the variability in the expectation of these events the higher is the level of oil price fluctuations. The short-term volatility in oil prices is due to the inability of producers or consumers to change to alternatives or increase output. The low price elasticity of oil implies that price changes are needed to bring about equilibrium in the market. More than a half of the proven oil reserves are in regions that have a history of political and weather related events leading to a higher level of short-term variability in oil prices. Figure 3 shows how market uncertainty has greatly impacted the short-term price of oil which has fluctuated from US$12.45 per barrel just after the Arab oil embargo in 1973-74, to US$19 at the start of the Iranian revolution in 1979, to US$34.5at the outbreak of the Iran-Iraq war in 1980 and US$30 at the start of the first Gulf War in 1990. Thereafter, the oil price dropped to US$12 in 1999 and the price has reached as high as US$129 per barrel in 2008. Figure 3 also shows that there is a long-term trend in oil price, which has generally fallen from the mid-1970s to the turn of the millennium after which it has tended to rise until the middle of 2014. The long-term trend is determined by structural changes in the global economies and the ability of producers to change supply either through new discoveries or technologies.

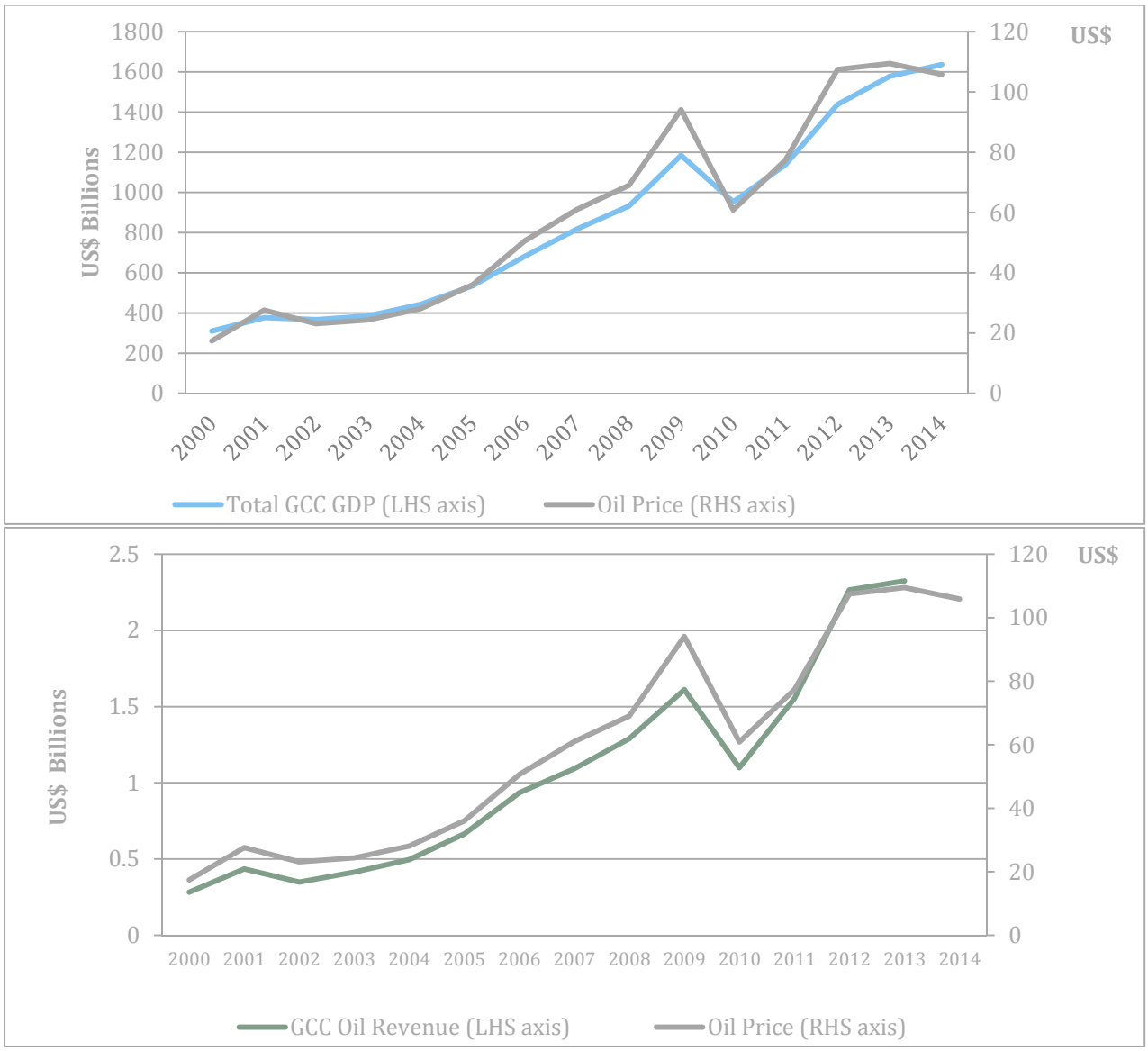
Figure 3 Real and Nominal Oil Price 1974 to 2015



Source US, EIA (October 2015)

The heavy reliance of oil within GCC economies substantially impacts their economic performance and certainly the government revenues as well as GDP. Figure 4 illustrates the oil price with the GCC government revenue and finds an almost identical movement. It is not surprising to see that government revenues are highly correlated to the oil price as the output, for each GCC country, is stipulated by the Organisation of Petroleum Exporting Countries (OPEC) and therefore a higher market price corresponds with a higher level of revenue and vice versa. More interesting is the very strong correlation between the oil price and the GDP in the GCC economies. The strong correlation is highlighted by the fact that at the time of the oil price lows in 1999, the GCC economies experienced a GDP growth of 0.9%. With the increase in oil price, the GCC GDP rate rose each year until 2009 when oil prices dropped to US$60 per barrel and the GCC GDP growth was 1.6% compared to 8.2% in the previous year. With a rebound in oil prices in 2010, the GDP in the GCC increased by 5.8% and 8.8% in 2011 when oil prices exceeded US$100 per barrel. The data in Figure 4 lends support to the argument that not only GCC economies are vulnerable to international oil prices but so is their GDP. Associated with this is the fact that GDP per capita is also related to the oil price. Data from the IMF (2013) shows that on average the GCC GDP per capita increased each year between 2000 and 2008 when it reached a high point of US$42,800 in 2008. Then, when oil prices fell in 2009, the GCC per capita GDP also dropped to US$32,000 and then increased the following year to US$46,700 with a corresponding increase in oil prices.

Figure 4 GCC GDP, Oil Revenue and the Oil Price



Sources: GCC GDP calculated from Trading Economics; Annual oil price from Statista; Annual oil production from BP Statistical Review of World Energy (2014)

Figure 2 shows that the hydrocarbon sector on average accounts for 83% of state budgets for GCC countries. Therefore, any change in hydrocarbon revenues will, in the medium- to long-term, impact government spending which itself is divided into two components, namely capital investment and current expenditure. The former relates to expenditure associated with infrastructure or social development projects and to a large extent it is discretionary in nature. The discretionary nature of this component of GCC government expenditure is highlighted by the fact that on average it was 16% during the low oil price period (i.e. 1996 to 2001). With the increase in oil prices during the period 2002 to 2008 the discretionary component of GCC government expenditure in the GCC was 23%. The second component of public expenditure relates to current expenditure such as salaries of staff and there is usually little room to manoeuvre in this area and is non-discretionary in nature.

The GCC governments fix their annual budgets on an arbitrary breakeven price level, which may be considerably lower than the expected or even the prevailing price. For instance, the average GCC budget breakeven price was about $82 per barrel in 2014 while the average market price for the year was US$96. Within the GCC there are wide variations, for the breakeven oil price, between the different countries. For example, in 2014 Bahrain is assumed to have had a breakeven price of US$135 while for the UAE it was

US$70. As a result of the higher market to breakeven price the GCC countries, in 2014, on average are estimated to have achieved a budget surplus of 7.9% of GDP. Countries such as Bahrain that used a high breakeven price are estimated to have a budget deficit of 5.7% while Kuwait is expected to have had a budget surplus of 17.9%, Oman 10.9%, the UAE 9%, Qatar 7.4% and Saudi Arabia 5.4% (Deutsche Bank,2014). Therefore, the GCC countries ability to avoid a budget deficit is dependent on the breakeven oil price used as well on the global oil price.

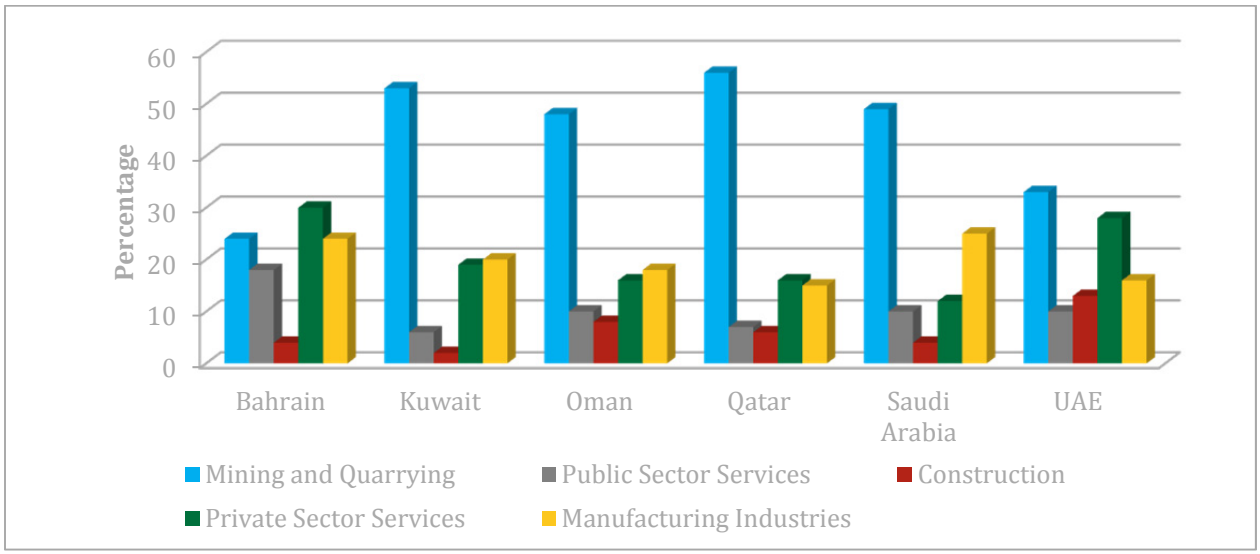
1.2. The Control of the Hydrocarbon Sector and its Impact on the Economy

The second impact of the dependence on the hydrocarbon sector to the economy is the control of the public sector. As discussed above, the government tightly controls the hydrocarbon sector in all the GCC countries. As a result, the government has the freedom to pursue policies, which favour the hydrocarbon sector even if they are detrimental to the private sector. It can be argued that the hydrocarbon sector renders the private sector to a subordinate status. Al Kuwari (2012) argues that the strong grip of the government in the economy through its spending makes the private sector dependent on its plans and budgets and thus restricting it's development. It is important to have a strong private sector because of the role it plays in being a provider of income, jobs, goods and services (IFC 2013). Also, the private sector is the most efficient allocator of scarce resources and an essential mechanism by which to achieve economic growth through higher levels of productivity and knowledge transfer (World Bank 2008). Despite the importance of the private sector, the GCC countries have not been successful in increasing its contribution in their economies.

The strongest sectors in the GCC economies are those related to the hydrocarbon sector. This is not unexpected as the region is the world's largest exporter of petrochemicals and owns 8.5% of the global refining capacity. Even where the GCC economies have ventured outside the wider hydrocarbon sector it has been in the energy intensive sectors, e.g. aluminium. More importantly, these industries tend to be state owned (or government related) and little in way of private sector investment has taken place. Therefore, it is not surprising to find that the government's spending in non-oil GDP and in consumption of total final expenditure is higher than in other countries (Hertog 2013). The revenue led government expenditure argument is well supported by econometric studies such as Espinoza and Senhadj (2011).

A decomposition of the GDP in the GCC countries is provided in Figure 5 which shows that manufacturing represents on average about 9% of GDP while private sector services are approximately 20% and construction a further 5%. This shows that on average, the private sector contributes to a third of the GCC GDP (mining tends to be government controlled and quarrying by and large is limited). The two most notable exceptions to the general GCC pattern are Bahrain and the UAE. In the case of the former, low hydrocarbon production and reserves imply that it had to develop other sectors. As a result Bahrain has built a strong financial services sector, which contributes to about 17% of the country's GDP along with manufacturing at 17%. The UAE has a much more diversified economy with trade, tourism, logistics and financial services being the key sectors each of which contributes 12%, 9%, 9% and 7% respectively to the country's GDP.

Figure 5 Decomposition of GCC GDP



Source: Arab Monetary Fund

2. The Nature of SMEs in GCC Countries

Due to the heterogeneity of businesses and commercial environments it is extremely difficult to have a single definition of an SME. Therefore, we have no globally agreed definition of SMEs. The basis of classifying them tend to be similar in that they use either the number of employees, the revenue and level of assets. Some countries use just a single base of classification while others use two or three because it is difficult to have a single measure that captures the true size of the firm. For instance, if a firm rents its capital equipment through a finance lease, then the total assets invested as per the balance sheet will be low but the sales can be very high. Similarly, the production function implies that a firm can choose between labour and capital and the preference to one as opposed, due to relative cost, to the other will alter its classification. The GCC SME classification is relatively recent and has been carried out by financial institutions based on their own needs to differentiate between personal and corporate clients. However, with the development of government support agencies a more concerted effort has been made to define SMEs. The SME definition in the GCC countries takes into account the fact that due to the abundance of low cost foreign labour even a micro firm can afford to hire a fairly large number of staff. Certain GCC countries such as the UAE have also taken into account that a large proportion of their SMEs are trading enterprises (i.e. focused on re-exporting) and hence they can generate vast revenues with two or three staff. Therefore, these governments have developed SME definitions that are dependent on the type of activity prevalent in their country. Figure 6 illustrates the definition of a micro, small and medium sized firm for the GCC countries along with comparisons with multinational organisations.

Figure 6 shows that there is no single GCC definition of a SME and hence it is difficult to make cross - country comparisons. More importantly, in some countries such as the UAE each emirate has a separate definition of a SME. What is clear from Figure 6 is that there is a strong emphasis to using the number of employees and turnover. This is somewhat different to the European Union and World Bank definitions that include the balance sheet value of assets. The average GCC values show that a firm with less than 9 employees is classified as micro, between 10 and 52 employees as small and up to 167 employees as medium. In two definitions, namely Bahrain and the UAE emirate of Dubai, there is a distinction based on the industry. Interestingly, only Oman and Bahrain have formal countrywide definitions of SMEs. The other four GCC countries have informal definitions, which are adopted by local or emirate based government agencies.

Figure 6 GCC Definitions of a Micro, Small and Medium Sized Firms

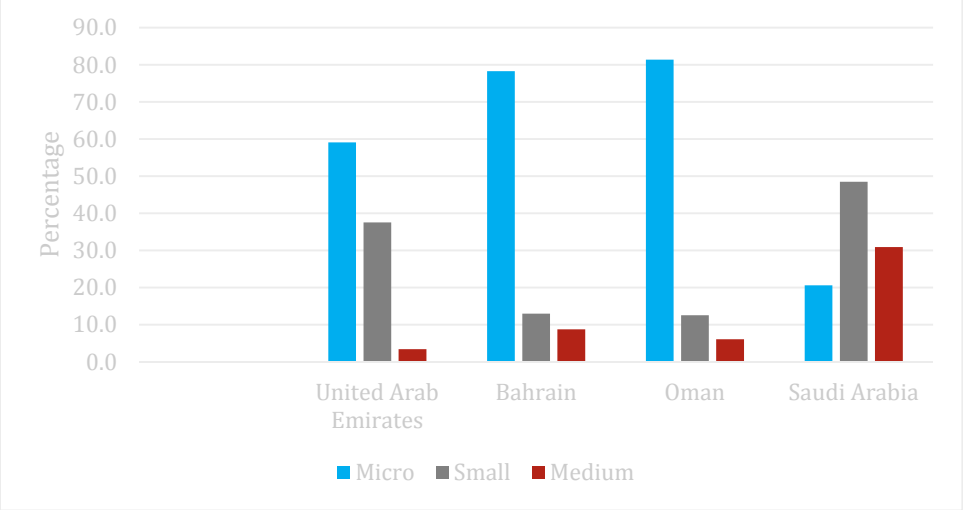
Country/ region/ Institution	Micro		Small		Medium	
	Number of Employees	Turnover	Number of Employees	Turnover	Number of Employees	Turnover
Bahrain	1-10	BD100k (US$ 265,421)	11-50 (up to 100 for construction sector)	BD 100k to BD1 m (US$ 265,421 to US$2,654,213)	51-250 (up to 400 for construction sector)	BD 1m – BD 5m (US$ 2,654,213 to 13,271,069
Kuwait	1-20		21-50		50+	
Oman	1-5	RO25k (US$ 64,935)	6-9	RO 25k to RO250k (US$ 64935 to US$649,351)	10-99	RO 250k to RO1.5m (US$ 649,351 to US$3,896,108)
Qatar	-	-	-	-	250 and 100 for creative industries	QR 100m (US$27,465,387
Saudi Arabia	1	SR 100k (US$26,662)	2 to 49	SR 100k to SR 5m (US$26,662 to US$1,333,137)	50 to 200	SR 5m to SR 50m (US$1,333,137 to 13,331,378)
UAE/Dubai (Trading)	1-9	AED 9m (US$2,450,346)	10 to 35	AED 9m to AED 35m (US$2,450,346 to US$9,529,125)	36 to 75	AED 35m to AED 75 (US$9,529,125 to US$20,419,555)
UAE/Dubai (Manufacturing)	1-20	AED 10m (US$2,722,607)	21 to 100	AED 10m to AED 100m (US$2,722,607 to US$27,226,074)	101 to 250	AED 100m to AED 250m (US$27,226,074 to US$ 68,065,185)
UAE/Dubai (Services)	1 to 20	AED 3m	21 to 100	AED 3m to 25m	101 to 250	AED 25m to AED 150m
UAE/Abu Dhabi	1 to 5	-	6 to 19	-	20 to 45	
GCC Average	10		52		167	
European Union	1-10	€2m (US$2.2m)	11-50	€ 10 m (US$11m)	51-250	€ 50 m (US$55m)
World Bank	1-10	US$100k	11-50	US$3m	51-100	US$15m

Source: WB, EU and national authorities in each country (Bahrain – Ministry of Industry and Commerce; Kuwait - Kuwait Chamber of Commerce and Industry; Oman- The Ministry of Commerce and Industry; Qatar – Enterprise Qatar; Saudi Arabia- Saudi Arabian Monetary Agency [speech delivered in 2010]; UAE/Dubai – Dubai SME; UAE/Abu Dhabi - Abu Dhabi Executive Council on June 30, 2013). **Notes:** In Bahrain manufacturing companies also need to comply with capital investment where investments (excluding value of land and building) less than BD 20,000 are micro, between BD20,000 and BD 500,000 are small and between BD 500 and BD 3 million are considered to be medium sized firms. In Kuwait the Chamber also has capital invested as up to KD 150,000 being micro, between BD 150,000 and KD200,000 as small and between KD 200 and KD 500,000 as medium sized firms. In Kuwait the Ministry of Commerce & Industry has issued a resolution No. 17/2000 which defines "An enterprise having an independent ownership and management that is working within a local market with limited productive capacity and with small capital ranging between KD50,000 and KD 250,000 and having a number of workers of not more than 40". Exchange rate conversations are approximations.

SMEs in all countries are considered to be the engine of economic growth and a major contributor to the GDP in terms of output and employment. In the GCC, SMEs account for over 90% of the registered firms. Figure 7 illustrates the distribution of SMEs across the GCC countries. Within the SME category about 60% are micro firms followed by 28% of small firms and only 12% are medium. This skewed distribution highlights the fact that GCC countries have a heavy reliance on very small-scale operations. Generally speaking, micro sized firms are limited as far as competitiveness and exporting is concerned. In the case

of the former they do not tend to have the financial resources to invest into the business for expansion. In the case of the latter the small scale of operations implies that they are generally not ready for export, as they do not have the necessary internal infrastructure to meet overseas demand such as processes, human resources, ability to raise finance, the need to meet import regulations etc. Various surveys have shown that SMEs in the GCC tend to be focused on low value-add manufacturing, retail, trading and contracting. Using Dubai as an example of, perhaps, the most diversified economy, 73% of SMEs are involved in retail or trading, 16% in the services sector and 11% in manufacturing.

Figure 7 The Distribution of Micro, Small and Medium Sized Firms



Source: IFC (2015) Note: There is no data for Kuwait and Qatar

The difference in definitions of SMEs implies that it is difficult to determine their contribution to the GDP. Nevertheless, estimates by AT Kearney (2014) show that the average contribution of GCC SMEs to the GDP is 22% compared to the European Union average of 55%. The GCC average does have a high level of variance with the UAE and Bahrain at 30% and 28% respectively, and on the other extreme Oman with 14%. The contribution of SMEs to GDP is well correlated to the level of diversification and the importance of hydrocarbons in the economy. As far as employment is concerned AT Kearney (2014) find that the GCC average to be considerably lower, at about 40% compared to the global figure of 62%, and the developed country value of 60%. Even in regions where SMEs play a larger role, such as Dubai, the employment levels are at 40%, which is still well below the global average.

3. Drivers of Entrepreneurism in the GCC

The discussion in section 2 argues that hydrocarbon revenues has driven the economic growth in the GCC countries over the last half-century. As the government controls this sector, it has become the main actor in the economy at the expense of the private sector. However, fluctuating oil prices with its corresponding impact on government revenue shows that the GCC model of economic development, as successful as it has been in leading to world standard infrastructure, social facilities (e.g. hospitals, schools, etc.), has its weaknesses. Economic growth in the GCC has been funded through government expenditure, however this may not be sustainable into the long run. A rapidly increasing population with rising costs of maintaining a large public sector imply that it is not possible to absorb the large number of nationals that will be active for employment. Even if the GCC countries could expand their public sector, it would be through relying on the revenues from the export of a single commodity, which for some GCC countries is now rapidly dwindling both in terms of reserves and production. With falling oil reserves and the development of substitutes to hydrocarbons the GCC countries have an urgent need to diversify their economies. Below we examine some of the motivations for GCC countries to build a culture of entrepreneurship as well as support mechanisms to ensure that SMEs become successful into the long run.

3.1. Economic Diversification Away from Hydrocarbons

A number of attempts have been made to diversify GCC economies away from oil and to capitalise on their existing strengths. The abundance of low cost power has meant that industries, which are energy intensive have been supported, such as petrochemicals and building materials where cement, steel rebar and aluminium have been the key products. Two problems are associated with such a diversification strategy. First, with the exception of aluminium sector, these sectors are linked to the oil price. For instance, petrochemicals are priced based on the underlying oil price. Building materials are linked to the construction sector which itself is tied to the oil price for its investment. The second problem is that these industries have been in many instances developed by the state and it has been the driver of diversification. As a result diversification is still hydrocarbon dependent.

In the services sector, some GCC countries such as the UAE have sought to become an international trading center similar to Hong Kong, Singapore or even Holland. Here the private sector has become important, supported by large-scale government infrastructure. This has allowed GCC countries such as the UAE to become the third largest re-export center globally. Tourism has also become an important sector that has allowed the private sector to flourish and countries such as the UAE are major tourist destinations in their own right. Linked to trade and tourism is the aviation sector and at least two of the six GCC countries have pursued strategies to develop this into a globally competitive and large-scale sector. Bahrain, Qatar, Saudi Arabia and the UAE have also developed the financial services sector. Despite these attempts at diversification, GCC countries have had a limited level of success and the hydrocarbon sector is still the main driving force in the economy. What the GCC experience of diversification shows is that if it is to be successful, it needs to incorporate entrepreneurship and private investors taking risk.

3.2. Dealing with the Unemployment Problem

The need for economic diversification in the GCC has been heightened by the need to create jobs for nationals. In some countries where the national population is very small, such as UAE and Qatar, unemployment of its citizens is not a so serious problem. However, in the relatively larger economies such as Saudi Arabia and to some extent Oman, unemployment poses both social and political challenges. According to the World Bank WDI, average unemployment in the GCC is 4.5%. However, there are wide variations between the countries with Oman, Bahrain and Saudi Arabia with the highest unemployment rates at 8.1%, 7.4% and 5.6% respectively. Moreover, the GCC countries have witnessed one of the highest rates of population growth in the world. In the last 65 years the GCC populations have increased more than tenfold from 4 million in 1950 to almost 50 million in 2015. At present about 54% of the population is under the age of 25 however by 2050 half the population will be under the age of 36 years. As a result of the young population and relatively high growth rates it is expected that by 2050 the population of the GCC will increase by 50%. Therefore, youth unemployment, which is already high, will continue to be a major concern for GCC countries. Current estimates show that youth unemployment is 28% in Saudi Arabia and Bahrain and slightly lower at 25% in Oman. Even in the smaller GCC countries such as the UAE, Kuwait and Qatar youth unemployment is 11%, 9% and 2% respectively.

The active population has been growing at about 4% per year implying that between now and 2020, on average, the GCC countries need to create 1.6 million jobs or 320,000 each year. The bulk of these jobs need to be created in Saudi Arabia at about 184,000 each year. Despite the strong presence of the hydrocarbon sector in the economy the capital-intensive nature of the industry implies that it cannot employ all the unemployed nationals. The GCC governments have tried to absorb nationals into the public sector, 90% of the jobs in the public sector are carried out by nationals. In the private sector the opposite is true, with 90% of jobs carried out by expatriates. Traditionally, few nationals have been employed in the private sector due to the relatively lower salaries and benefits. The rising cost of employing nationals in the public sector implies that it will not be possible to increase employment here to a large extent. Also, all the GCC governments have initiated some form of e-government programmes, which have sought to make the public sector more efficient and transacted electronically. As a result it is expected that the growth of the public sector will be much slower than in previous years.

Figure 8 shows that between 2000 and 2015 approximately 7 million jobs were created in the GCC countries. Of these, 89% were created in the private sector where 78% of the employment opportunities were taken up by non-nationals. To limit the employment opportunities of non-nationals in the private

sector, some GCC countries have imposed quotas or restrictions as well as introduced the concept of minimum wages for nationals. The GCC governments realize that if they will be able to achieve full employment for their people in the private sector then the job creation has to be beyond the levels that have taken place to date. At the same time, the incentives to nationals in the private sector have to be increased so more nationals are attracted to it. Entrepreneurship is considered to be one manner by which nationals can become part of the private sector.

Figure 8 Estimates of Job creation by sector and nationality 2000-2015

	Job Creation		Private Sector		Public Sector	
Country	**in thousands**	**% of total GCC Value**	**in thousands**	**%**	**in thousands**	**%**
Bahrain	297	4.2%	284	95.6%	14	4.7%
Bahraini	55	3.1%	42	76.4%	13	23.6%
Non Bahrainis	242	4.6%	242	100.0%	1	0.4%
Kuwait	986	13.9%	680	69.0%	306	31.0%
Kuwaiti	135	7.5%	65	48.1%	69	51.1%
Non Kuwaitis	851	16.1%	615	72.3%	237	27.8%
Oman	527	7.5%	481	91.3%	46	8.7%
Omani	157	8.7%	105	66.9%	52	33.1%
Non Omanis	370	7.0%	376	101.6%	-6	-1.6%
Qatar	1,118	15.8%	1,078	96.4%	40	3.6%
Qatari	40	2.2%	21	52.5%	19	47.5%
Non Qataris	1078	20.4%	1057	98.1%	21	1.9%
UAE	1,546	21.9%	1,391	90.0%	155	10.0%
Emirati	110	6.1%	99	90.0%	11	10.0%
Non Emiratis	1436	27.2%	1292	90.0%	144	10.0%
Saudi Arabia	2,598	36.7%	2,344	90.2%	254	9.8%
S. Arabian	1,302	72.4%	1,068	82.0%	234	18.0%
Non Saudis	1296	24.6%	1276	98.5%	20	1.5%
Total	7,072	100.0%	6,258	88.5%	814	11.5%
Nationals	1,799	100.0%	1,401	77.9%	398	22.1%
Non Nationals	5273	100.0%	4857	92.1%	416	7.9%

Source: IMF (2011) data for post 2010 is estimated

3.3. Reducing Export Concentration and Increasing Export Sophistication

The GCC region, as a whole, is very open, driven by the fact that the countries are highly dependent on exporting hydrocarbons and importing their food and consumer goods. The GCC as a total accounts for 2.6% and 4.6% of global imports and exports respectively. The most important as far as trade is concerned are the UAE and Saudi Arabia, which account over half of the combined GCC import and export values. In the case of imports, the UAE heads the GCC countries largely as it is the regional re-export centre. In the case of exports, Saudi Arabia is the most dominant, which is explained by its position as the largest exporter of oil within the region. In fact, these two countries account for approximately three quarters of the GCC. The Herfindahl index shows that the supplying and importing nations are not very concentrated[2]. However, when one examines the list of major trading partners one finds that seven countries account for

[2] A Herfindahl index measure between 0.1 and 0.18 is assumed to be moderately concentrated while any measure higher than 0.18 implies a high level of concentration

a little over half the total value of GCC trade. More significant is the fact that just two countries namely China and India account for a quarter of all GCC trade.

Figure 9 GCC Trade Performance and Supplying Nation Concentration

Importers	Value imported in 2013 (US$ millions)	Percentage of GCC Total	Annual growth in value between 2009-2014 (%)	Share in world imports (%)	Concentration of supplying countries
World	18,790,832		4	100	0.04
Gulf Cooperation Council (GCC) Aggregation	496,066	100		2.6	
United Arab Emirates	232,239	46.82%	10	1.2	0.07
Saudi Arabia	152,448	30.73%	13	0.8	0.06
Kuwait	31,489	6.35%	8	0.2	0.06
Qatar	30,509	6.15%	8	0.2	0.05
Oman	29,305	5.91%	12	0.2	0.13
Bahrain	20,076	4.05%	4	0.1	0.19
Exporters	**Value exported in 2013 (US$ millions)**	**Percentage of GCC Total**	**Annual growth in value between 2009-2014 (%)**	**Share in world exports (%)**	**Concentration of importing countries**
World	18,682,444		5	100	0.04
Gulf Cooperation Council (GCC) Aggregation	855,286	100		4.6	
Saudi Arabia	348,905	40.79%	8	1.9	0.08
United Arab Emirates	201,922	23.61%	10	1.1	0.09
Qatar	131,578	15.38%	14	0.7	0.13
Kuwait	101,132	11.82%	11	0.5	
Oman	53,705	6.28%	12	0.3	
Bahrain	18,044	2.11%	10	0.1	
Key Import Partner Countries			**Key Export Partner Countries**		
Exporter	**Value exported in 2014 (US$ millions)**	**Percentage of GCC Total**	**Importer**	**Value exported in 2014 (US$ millions)**	**Percentage of GCC Total**
China	70,320	14.18%	Japan	123,988	14.50%
India	50,231	10.13%	Korea, Republic of	81,494	9.53%
USA	49,566	9.99%	India	78,924	9.23%
Germany	32,597	6.57%	China	77,028	9.01%
Japan	25,855	5.21%	USA	53,636	6.27%
United Kingdom	20,745	4.18%	Singapore	38,437	4.49%
Korea, Republic of	19,153	3.86%	Thailand	24,155	2.82%
Top 7 Supplying Countries	268,468	54.12%	Top 7 Export Countries	477,662	55.85%
Other Countries	227,598	45.88%	Other, Countries	377,624	44.15%

Source: ITC Trademap

The GCC countries are not only highly concentrated as far as their geographical distribution of importing and exporting countries is concerned, but also in terms of products that they export. Figure 10 shows that 81% of exports from the GCC countries are hydrocarbon based. The most important non-oil export product categories are plastics, gold and jewellery, chemicals and aluminium at 19.4%, 15.3%, 14.6% and 8.4% respectively of non-oil exports. As such, 58% of GCC non-oil exports are made up of only four product categories. These product categories tend to be low technology areas. The World Bank Development Indicators for high technology manufactured exports show the value for the GCC to average at about 1%[3]. The highest value is for Oman at 3.4% and the lowest for Qatar at 0.01%. The World Bank definition of high technology exports are those products that have an element of research and development such as aerospace, computers, pharmaceuticals, scientific instruments, and electrical machinery. In comparison the average for the Middle East North African countries is 2.2% implying that the GCC countries are well below their regional neighbours. The trivial GCC value becomes more apparent when compared to the low and medium income countries whose average values are 5.5% and 18.8% respectively. The best-performing group are the East Asia and Pacific countries with an average value of 26.7. This shows that although the GCC countries have a high level of financial resources and modern infrastructure they have nevertheless not been successful at increasing the value of high value manufactured exports.

Figure 10 Composition of GCC Exports

HS Code	Product label	Exported value in 2013	Percentage Including oil	Non-Oil Percentage
TOTAL	All products	855,285,995	100%	
'27	Mineral fuels, oils, distillation products, etc.	693,341,920	81.07%	
	Non Oil Trade	161,944,075		100%
'39	Plastics and articles thereof	31,420,633	3.67%	19.40%
'71	Pearls, precious stones, metals, coins, etc.	24,841,848	2.90%	15.34%
'29	Organic chemicals	23,677,950	2.77%	14.62%
'76	Aluminium and articles thereof	13,638,806	1.59%	8.42%
'87	Vehicles other than railway, tramway	8,412,407	0.98%	5.19%
'31	Fertilizers	5,800,215	0.68%	3.58%
'84	Machinery, nuclear reactors, boilers, etc.	5,418,265	0.63%	3.35%
'72	Iron and steel	5,052,895	0.59%	3.12%
'85	Electrical, electronic equipment	4,727,286	0.55%	2.92%
	Others	38,953,770	4.55%	24.05%

Source: ITC Trademap

3.4. Increasing Productivity in the Economy

One of the main drivers of economic growth is the level of a country's efficiency. The Penn World Tables show that GCC labour productivity as measured by GDP per worker (in PPP US$) generally fell in the period from 1970 to 2010[4]. The data shows that the initial period (i.e. 1970 to 1980) labour productivity increased and this can be explained by the fact that almost all GCC countries started from a very low base. Then from 1980 onwards the labour productivity fell with the exception of Qatar and Oman. The experience of Qatar and Oman is largely due to the fact that gas reserves were discovered in these countries slightly later and hence their economic development was delayed. One very important source of low labour productivity in the GCC has been the unlimited and cheap supply of foreign labour largely from Asia. All GCC countries have until fairly recently had a very relaxed foreign labour policy in the private non-oil sector

[3] The WDI data code is TX.VAL.TECH.CD and refers to 2013.

[4] Table 7.1

which allowed a flow of inexpensive and flexible overseas workers. As a result all the GCC countries have very high levels of expatriate workers. In some countries such as the UAE expatriates make up 88% of the population. However, the availability of cheap foreign labour has meant that it has not always been well skilled or even educated. In fact, the preference for the cheapest class of labour has meant that it has tended to be unskilled. Also, in a model where output is dependent on capital and labour the lower relative cost of the latter has led to its greater use.

The main drivers of economic growth can be viewed as the improvements in labour through efficiency building initiatives such as education, training, etc. or increase in capital. In theory, these increases in inputs should result in an increase in total output. However, there occurs a change in output, which is not due to an increase in the inputs of labour and capital. This residual change is referred to as the total factor productivity (TFP) and is interpreted as the measure of an economy's long-term technological change. As Figure 11 shows that over the last two decades overall labour productivity in the GCC has increased. However, total factor productivity (TFP), which measures the rate in which capital and labour are converted into outputs, has actually fallen. During the 1990s, the TFP has on average been negative for the GCC countries but only slightly with exception of Oman, Qatar and Bahrain. In the period from 2000 to 2012, the TFP levels have deteriorated further and turned negative with the exception of Qatar and to some extent Saudi Arabia. It may be argued that the negative TFP may be due to the fact that increases in capital accumulation have not kept pace with increased population growth. Also, the increase in labour may have suffered from substantial diminishing returns to scale further supporting the need for increased capital accumulation.

Figure 11 Average Contribution to Non-Oil Sector Growth

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	U.A.E	GCC Average
	1990-9						
Growth	4.20	6.60	5.80	3.80	3.40	9.00	5.47
TFP	0.40	-3.10	1.80	0.20	-0.10	0.00	-0.13
Capital	1.80	3.60	2.50	2.50	2.00	3.00	2.57
Labor	2.00	6.10	1.60	1.10	1.50	6.00	3.05
	2000-12						
Growth	6.80	6.20	7.30	14.50	6.30	6.70	7.97
TFP	-2.40	-0.60	-2.30	-0.20	0.40	-1.00	-1.02
Capital	3.70	4.00	4.80	6.00	2.90	3.60	4.17
Labor	5.50	2.90	4.80	8.60	3.00	4.10	4.82

Source: IMF (2013b)

The results in Figure 11 may also be explained by a Caselli and Wilson (2004) type of effect where due to the heterogeneity of capital accumulation the GCC countries, as a result of employing lower skilled and cheaper foreign labour, were not able to adequately raise their output, being a lower level from any increase in the stock of capital. Espinoza (2012) finds support for such an argument but with a different explanation whereby there appears to have been a build-up of higher level capital accumulation but the human talent, which is largely unskilled, has not been able to harness its full potential. Artadi and Sala-i-Martin (2002) find that the lower TFP in GCC countries may be due to the incentives that the governments make available to the private sector. These incentives lead to capital accumulation in areas where the greatest level of transfer payments from the government can be obtained rather than where the productive potential is the highest.

3.5. Addressing the Incentive Structure for Nationals

Over 90% of the workforce in the private sector is represented by expatriates, highlighting the strong preference for foreign workers due to their lower wage cost and flexibility. Although it is difficult to measure relative wage costs they are not made public, various estimates show that the cost of employing nationals is 50% to 150% more than expatriates. As a result, the vast bulk of new job creation in the private sector is

geared towards expatriates. In order to limit the employment of expatriates and encourage private sector to employ nationals, the governments have initiated a programme of interventions with various degrees of seriousness and success. With limited opportunities for nationals in the private sector the public sector remains the mainstay of employment. Also, the public sector offers higher salaries and benefits than private sector with a few exceptions. The key exceptions to this are multi-national companies, financial services and state related enterprises. These sectors have done rather well in attracting and retaining nationals. In addition, to public sector led job creation for nationals, the GCC governments have initiated a very generous system of benefits for their people which when the population numbers were small were not a burden. However, with rising population the generous system of benefits may not be sustainable. More importantly, these generous benefits act as a disincentive towards risk taking and entrepreneurship. At the same time, the poor work ethics implies that nationals tend to have low productivity. Results from the World Economic Forum (2014) study shows that the GCC countries rank among the top ten nations with the worst work ethics. Attempts have been made to tackle the poor work ethics through a change in the education system and developing a more productive government sector. Another initiative is to encourage nationals to become entrepreneurs, and hence the self-motivated. This will reduce the poor work ethics as well as enhance productivity.

3.6. Developing A Knowledge Based Economy

All GCC governments have publicly declared their ambition to become knowledge-based economies. Although the GCC countries have invested in fixed infrastructure such as housing, roads, ports etc. they are yet to achieve the pillars of a knowledge-based economy. Using the World Bank Knowledge Assessment Methodology which is a measure of four pillars considered to be essential in any knowledge based economy namely economic incentives and institutional regime; innovation and technological adoption; education and training and finally information and communication infrastructure, the GCC achieves an average score of 6.19 which is higher than the world average but markedly lower than the North America or Europe which are the leading regions. The GCC score was higher than the global average value of 5.12. The main areas of strength for the GCC appear to be in ICT infrastructure and to some extent economic incentives. The relatively high score for ICT infrastructure supports the vast level of investment made in this area by all GCC governments. The areas of weaknesses were in innovation and technological adoption as well as education and training.

Figure 12 The Knowledge Economy Index for the GCC Countries (2012)

Rank	Country	KEI	Economic Incentives	Innovation and Technological Adoption	Education and Training	ICT Infrastructure
42	UAE	6.94	6.50	6.60	5.80	8.88
43	Bahrain	6.90	6.69	4.61	6.78	9.54
47	Oman	6.14	6.96	5.88	5.23	6.49
50	Saudi Arabia	5.96	5.68	4.14	5.65	8.37
54	Qatar	5.84	6.87	6.42	3.41	6.65
64	Kuwait	5.33	5.86	5.22	3.70	6.53
	GCC	6.19	6.43	5.48	5.10	7.74
	World Average	5.12	5.45	7.72	3.72	3.58
1	The Top ranking Country (Sweden)	9.43	9.58	9.74	8.92	9.49

Source: http://data.worldbank.org/data-catalog/KEI

Figure 12 highlights the fact that the GCC countries have a knowledge gap, which needs to be filled if they are to be a knowledge-based economy. Knowledge is increased through education and R&D, which can be measured by its share of public spending. The GCC countries on average spend 26.4% of their spending on education, however Figure 12 shows that it is not achieving the outcomes to make the GCC countries into knowledge based economies. One explanation for this may be the fact that the emphasis of GCC countries is on primary and secondary school rather than increasing the body of knowledge. It is that

latter that leads to innovation. Similarly, GCC countries spend little if any proportion of their government spending on research and development activities. This implies that invention, which can assist innovation to take place, does not tend to occur in the GCC countries. Entrepreneurship especially among the young population can be argued to encourage innovation and adaptation of technology to take place. More importantly, the younger population would have been expected to grow using modern technology and thus would be more likely to adopt it in their entrepreneurial activities.

Another more serious explanation is that despite the large level of spending on primary and secondary school, education is not matched with a corresponding level of quality of instruction or student performance leading to learning inefficiencies. Scores from the Trends in International Mathematics and Science Study, show that all GCC countries perform very poorly. In the case of the mathematics, score which is calculated on eight grade students all GCC countries obtain a score that is below the global average of 500. The scores for the GCC countries were Bahrain 409, Kuwait 342, Oman 366, Qatar 410, Saudi Arabia 394 and the UAE with 456. The average GCC score is more than 20% below the international average at 396, one of the lowest in the study. More worrying is the fact that between 2007 and 2011 all the GCC countries with the exception of Qatar have experienced deterioration in their mathematics scores. A similar pattern emerges with the science scores for eight grade students. The science scores were Bahrain 449, Kuwait 347, Oman 377, Qatar 394, Saudi Arabia 429 and the UAE with 428. The GCC average score again is about 20% lower than the global average at 404. A comparison with 2007 shows that again there was deterioration in performance for the countries that participated in the 2007. The high spending on primary and secondary education coupled with a low performance of students in mathematics and science indicates that the emphasis of the GCC governments has been on hardware (i.e. infrastructure and resources (i.e. buildings, computers etc.) rather than on the software (i.e. developing student centric learning systems, training teachers, improvement in curriculum, etc.)

4. The role of the SME government support policies

The nature of SMEs puts them at a disadvantage compared to their larger peers in terms of the inability to achieve economies of scale as a result of not being able to invest in fixed capital; disproportionally higher compliance costs, lack of funding etc. The disadvantages experienced by SMEs have raised the question of the role of government to support SMEs. The GCC countries have tended to adopt an approach that focuses on start-up programmes so as to grow the number of SMEs. As such the GCC approach has been very transactional in nature and cannot ensure success. As Annex I illustrates the GCC governments have largely sought to provide initial funding which has differed from country to country and a limited level of pre- and post-start up assistance. In the case of the latter the pre-start up assistance has tended to focus on helping entrepreneurs conduct a feasibility study and a business plan. As far as post start up assistance is concerned the SME support institutions have provided training courses in areas such as accounting, finance, marketing etc. Some SME support agencies have also developed government procurement programmes, which require either state or federal government to allocate a certain percentage of their purchases to be made with registered SMEs. As the discussion above has shown that the governments tend to be the largest force in the economy, such programmes have been successful in assisting SMEs to achieve business performance. In recent years countries such as the Oman, Qatar and the UAE have developed export promotion agencies that have sought to internationalise their SMEs.

Although, the SME support programmes have led to the creation of new SMEs it is unclear whether it has achieved its full potential. Little if any data is available on the survival rates of SMEs or the disproportionate regulatory and administrative burdens that they experience. More importantly, the lack of targeting of SME programmes towards high value added and technologically intensive areas of activities implies that the real beneficiaries will not necessarily be nationals but expatriates. With an abundance of cheap foreign labour the development of low technology activities will imply that entrepreneurs will recruit expatriates. Also, the uneven cost of labour versus capital promotes the use of the former rather than the latter through encouraging SMEs to invest in modern technology. As a result SMEs tend to be in low value added activities such as trading, contracting and retail. Also, the lack of sufficient finance implies that SMEs cannot really invest in operations that allow for economies of scale. Annex I shows that the SMES are limited to the extent to which they can obtain financial support from government agencies with limits of US$2 million. With little in the way of bank finance available for start-ups, entrepreneurs are not able to establish technologically intensive manufacturing operations.

The SME support agencies and policies have failed to adopt a more holistic approach that will help develop globally competitive SMEs. An important part of this approach is to have an effective government policy to support and encourage SMEs. Less than half of the GCC countries have any type of legislation to support and promote the development of their SME sector. Second, the regulatory framework and infrastructure needs to support SMEs. One of the issues that greatly impacts SMEs is the regulatory burden that they face. Alrabeei and Scott (2014) find that local regulations imposed by a government authority to be the second most important obstacle to the growth of SMEs. It can be argued that SMEs tend to favour low value added and less complex activities so as to avoid the administrative and regulatory difficulties that are argued to exist in many GCC countries. None of the GCC countries have any process to assess the impact of their administrative and regulatory processes on SMEs. Finance both in the form of formal and informal debt is important. The financial viability of a project depends on the weighted average cost of capital, which in turn depends on the cost of debt and equity. Government policy needs to develop both formal and informal sources of debt and equity for new and growing SMEs. Only one GCC country has a formal legislation that requires banks to lend 5% of their loans to SMEs.

The entrepreneurial culture within a country is very important, especially acceptance of risk taking and tolerance to failure. With a skewed level of benefits against risk taking especially for those employed in the public sector, entrepreneurs will choose either not to start their own business or to enter low risk activities such as food and beverage, retailing etc. These types of firms have limited growth potential and ability to be globally competitive. Very few of the SME support agencies in the GCC offer continuous support or mentoring beyond the initial start-up period. Linked to mentoring is the idea of connecting SMEs to the local universities and thereby allowing for a flow of knowledge and expertise from the latter to the former. Universities are centers of research and development, yet they tend to be weak at commercializing their discoveries or knowledge. Developing formal linkages between the two will allow SMEs to upgrade their working practices, and move up the technology ladder into producing more sophisticated goods and services.

One of the key limitations in the development of a private sector in the GCC has been the limited local demand for goods and services. The largest of the GCC economies namely Saudi Arabia has a population of 22 million while for the smallest is Bahrain at 1.4 million. The combined household final consumption expenditure for all GCC is only US$518 billion, which is lower than that of Turkey and comparable to Indonesia[5]. A decomposition of the GCC countries shows that just two of them namely Saudi Arabia and the UAE account for 81%. Saudi Arabia is the largest market with consumer expenditure of US$222 billion followed by the UAE at US$200 billion. The smallest is Bahrain at just US$6.7 billion, Qatar at US$17.7 billion, Oman at US$ US$21.2 billion and Kuwait at US$50.1 billion.

Such small populations make it difficult for SMEs to invest in large-scale operations unless established primarily for the purpose of export. Therefore, SME activities tend to be those that require lower investment levels and are focused towards the local market in areas such as construction, real estate, retail provision of required services such as education and medical treatment etc. By and large, these activities have no or very little in the way of value added with the exception of financial services. More importantly, they also tend to be low technology based and not very sophisticated in nature and as a result are not really exportable. The main exception here is the UAE, which has focused not on the domestic but the international market. As a result the domestic services such as hospitality and leisure are targeted to the tourist market. Similarly, the manufacturing and trading sectors are very export-oriented, and supported by modern infrastructure. The same is true of the logistics and financial services industry, which cater to a global audience.

There has long existed an understanding among the GCC countries that they need to coordinate their political and economic policies. In 1981, the GCC countries came together to form the Gulf Cooperation Council and the charter clearly emphasises the importance of “coordination, integration and inter-connection between member states in all fields.” Throughout the first twenty years of the GCC it was largely a political cooperation between the six countries in face of the first and second Gulf War. In 2001, the GCC countries through the Economic Agreement approved more ambitious goals, which sought to create a common market and a monetary union. In 2008, the GCC countries established the common market, which essentially created a single market with a uniform external tariff, removal of internal barriers

[5] United Nations Statistics Division - National Accounts Main Aggregates Database

to allow the free movement of goods, capital and labour. As a result of these changes intra GCC trade has been growing annually at about 20% and stands at approximately 10% of the GCC total trade value. This is substantially lower than the intra EU trade at 57% or even the intra-NAFTA value at 41%. Intra GCC trade is hindered by the fact that all the countries with perhaps the exception of Bahrain rely largely on the export of hydrocarbons. Also, the GCC countries have relatively small manufacturing sectors but a large appetite for consumer goods and hence rely on Europe and Asia for imports instead of their GCC partners.

Despite the fact that there is a very high correlation of export products between the GCC countries they have worked towards increasing the level of integration. On 1st January 2015, the GCC gave the nationals of member countries an equal right to work in government, provision of social insurance and retirement coverage, ability to own real estate and access to education, healthcare as well as other social services. Also, the GCC countries have established channels for the coordination of a forthcoming taxation system and accounting standards. To support the free movement of goods the GCC has established the GCC Standardization Organization (GSO) to ensure that product conformity is the same across all the countries. Prior to the GSO there were, in some cases, wide variations in product standards hindering the free move of goods. A further potential boost to intra GCC trade is the GCC rail system, which will connect all the countries and is expected by 2018. Although, developing an intra GCC trade is important to create a larger frictionless market the GCC governments also need to initiate policies and programmes that can assist their SMEs to access international markets. Export promotion agencies are one important channel to assist SMEs to access international markets. Equally important are the development of trade facilitation systems, negotiation of free trade agreements, provision of import and export banks and guarantees system, etc.

5. Role of Free zones and Clusters in SME development

A major feature of the development of the private sector in the GCC has been through the cluster approach. According to Porter's (1998) definition "A cluster is a geographical proximate group of interconnected companies and associated institutions in a particular field, linked by commonalities and externalities". One can have specialized clusters, as is the case in the GCC that focus on one or two areas of activity. Solvell et al (2003) claim that countries that have strong clusters are better able to create opportunities leading to more competitive firms. More importantly, the high level of interconnectedness that is argued to exist within a cluster is more likely to lead to innovation and the development of a knowledge-based economy. The argument is that the linkages between firms in a cluster allow for information to flow between them with ideas generated and developed in a manner that is not possible for a single company. Of course simply putting firms within a cluster will not generate innovation but the interactions that take place between firms and developing networks has shown to increase the level of innovation.

No region has applied the idea of clusters as extensively as the emirate of Dubai in the UAE. The rationale was to fast track the development of the country into a diversified economy, expanding beyond hydrocarbons into other sectors, particularly in services. The development of the logistics cluster in 1983 with the establishment of the Jebel Ali Free Zone proved to be highly successful in elevating Dubai to becoming the sixth largest port in the world, and the most important logistics center in the region. Dubai has adopted a strategic approach in using clusters to diversify its economy and to promote the growth of the service sector. The UAE has over 30 clusters, by far the highest within the GCC. Although all GCC countries have clusters, the focus has not been the same as illustrated in Figure 13.

Figure 13 Cluster Development in the GCC

Country	Cluster Focus Areas
Bahrain	Education, Financial Services
Kuwait	Downstream oil; energy related industries
Oman	Software; energy; processed food; knowledge industries
Qatar	Education, Financial Services
Saudi Arabia	Downstream oil; energy related industries; education
UAE	Logistics; technology; media; science and education; construction/design; light manufacturing; financial services; aviation; defence; clean technology and renewable energy

The value proposition for setting up a cluster in the GCC is that they tend to be free zone areas and therefore provide overseas investors the ability to have full ownership rights in a country which restricts foreign ownership to 49%. This was a key motivator for the vast pool of foreign talent in the country to establish his or her own business. Second, the clusters or free zones dramatically reduced costs in establishing and operating a business. In many cases the administrative burden of establishing a business was reduced through dealing with a single authority. Also, the rules and regulations of establishing and operating a business were more transparent than those outside the free zone or cluster and requiring far fewer days for approval. More important is that in some cases activities are permissible within the free zone or cluster that are difficult to undertake outside. For instance, the GCC countries tend to have restrictive regulations regarding media, however within the media free zones or clusters simpler rules exist. Similarly, it is very difficult to obtain banking licences in the GCC countries but within the financial services free zone or cluster it is possible. In order to encourage firms, the governments invested heavily in developing world-class infrastructure. The free zones or clusters also provide a whole host of business support and matchmaking activities. The latter are focused towards enhancing the companies' ability to acquire additional business.

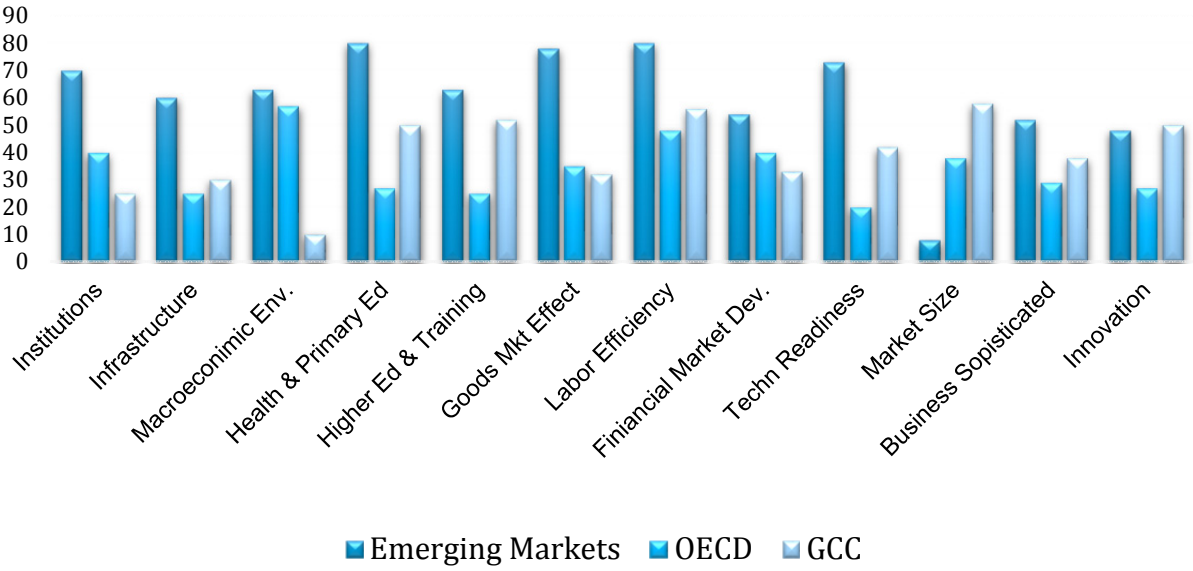
Our primary lesson from the development of clusters, in the GCC, is based on the experience of the emirate of Dubai, which was the regional pioneer and with the largest number. In Dubai the early clusters greatly benefitted from a focused approach with complementary supporting services and facilities developed around the core sector. For instance Jebel Ali Free Zone was greatly assisted by the development of the adjoining port, which allowed for mother and feeder vessels to use the facilities. Similarly, the growth of the tourism sector has assisted in developing a market for commercial buyers that visit Dubai on the back of Emirates Airlines. Each added service had very good synergy with the core service and they mutually supported and enhanced each other. Greater trade helped the logistics sector, which increased the number of visitors, which assisted the tourism industry and supported the trading activities of the emirate. However, with the new portfolio of cluster development has lacked the same level of synergy with each cluster tending to operate in isolation. With hindsight, one can argue that a more successful approach would have been to establish a few selected clusters and to develop them and their supporting services in a holistic manner. The achievement of efficiency and effectiveness benefits associated with the development of clusters are closely associated with synergies realised among supporting industries, suppliers and customers in the value chain. Networking among these stakeholders present in the cluster creates a dynamic and positive culture of continuous innovation thereby leveraging the benefits of geographical proximity, and the achievement of economies of scale. It is possible that the real estate focus of the clusters and the large profits that were earned at the time may have detracted the clusters from building their core activities. The key lesson learnt for the development of clusters, is to define key areas so as to chart out the activities of periphery industries. A mix of specific support services is required for synergy among cluster members and to develop vibrant, sustainable SMEs with good opportunities to offer products and services both locally and globally

6. SME Business Competitiveness

One of the key factors that determines the competitiveness of SMEs is the regulatory burden that they face from the initial point of establishing the business, to, in the worst case, having to close it. Typically, a SME faces four types of regulatory burden: the first in the start-up phase of obtaining licences and permits, recruiting staff, obtaining the necessary utilities and of course a premises. Second, in the operational phase of carrying out day-to-day businesses, paying government fees or taxes, trading across borders and submitting the necessary documentation to the relevant government authorities. Third, in the expansion phase when it's important to obtain finance, bring in new investors and hence offer them sufficient protection, provide exit routes for initial founders etc. Finally, when things go wrong regulation has to ensure the enforceability of contracts as well when the business becomes bankrupt there are processes to closing it. The World Economic Forum (WEF) conducts a global assessment of the regulatory impact on firms within an economy using twelve pillars. Using the overall global competitiveness ranking the GCC countries fare rather well. The average GCC ranking is 30 while countries such as the UAE, Qatar and Saudi Arabia are within the top 25 at 12th, 16th and 24th place respectively. This shows that at least half the GCC countries are comparable to the western countries that dominate this part of the ranking list. In fact, the UAE, which is best performing, has an overall score that is about 6.3% lower than the best performing country. Lower down the ranking list are Kuwait, Bahrain, and Oman at 40th, 44th and 46th place

respectively. The GCC countries compared to the OECD nations have a lower ranking labour efficiency which to a certain extent can be explained by corresponding lower values for health and primary education as well as higher education. It appears that competitiveness in the GCC is hindered by the technological readiness despite the very high levels of computers and telephones per capita. Similarly, the GCC countries perform poorly when it comes to innovation, and this can be explained by the very low level of patents filed or new discoveries made. The WEF (2014) confirms the discussion above that the GCC countries tend not to export sophisticated or high value added products. Finally, the small domestic size implies that firms in the GCC need to be international if they are to be competitive.

Figure 14 Breakdown of the Global Competitiveness Rankings for GCC Countries 2014/5



Source: WEF (2014)

The World Bank also conducts annual assessment of companies using a slightly different approach to the WEF in which the focus is largely on the three aspects of doing business, namely establishing it, the business friendly nature of regulations and the aspect of paying taxes or government fees. Under the World Bank (2014) "ease of doing business" rankings, the GCC countries performing less well, with an average ranking of 54. As Figure 15 shows the rankings tend to have a very high level of variance. The UAE is by far the best performing at 22nd place while Kuwait is at 86Th place. The difference between the WEF (2014) and the World Bank (2014) rankings can be explained by the difference in criteria and approach.

Figure 15 World Bank Ease of Doing Business Rankings for GCC Countries 2014

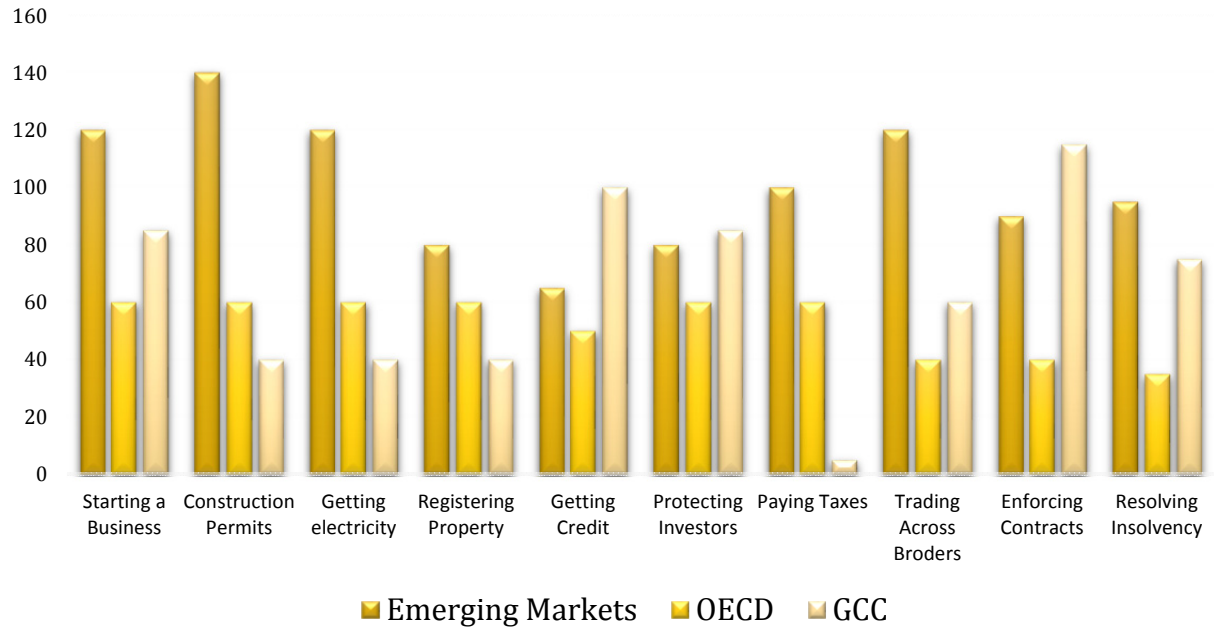
Economy	Ease of Doing Business Rank
United Arab Emirates	22
Saudi Arabia	49
Qatar	50
Bahrain	53
Oman	66
Kuwait	86

Source: World Bank (2014)

As far as the third aspect is concerned, namely paying taxes or government fees, the GCC with their low or in some cases non-existent taxes allowed them to be highly rated in this area. The high prevalence of free zones implies that the aspect of paying tax is even simpler. The World Bank (2014) study places the UAE

in the 1st place, followed by Qatar, Saudi Arabia, Bahrain, Oman and Kuwait at 2nd, 3rd, 7th, 9th, and 11th respectively. As far as SME competitiveness is concerned the ease of starting up a new business, securing construction permits, registering property, getting electricity connected, paying taxes and trading across borders are relevant factors. Figure 16 shows the comparison of GCC countries against emerging and developed (i.e. OECD) countries. The key areas where GCC countries tend to be uncompetitive compared to OECD countries are in terms of starting a business, obtaining finance, protecting investors, trading across borders, enforcing contracts and resolving insolvency.

Figure 16 Breakdown of Ease of Doing Business Ranking for GCC Countries



Source: World Bank (2014)

Summary and Conclusions

This article highlights the fact that the GCC countries are highly dependent on the hydrocarbon sector. As a result the government role has been to develop this sector and to ensure that their nationals (citizens) derive sufficient benefit from it through transfer payments, development of social facilities such as schools and hospitals and infrastructure development. Thus, the hydrocarbon sector has gained considerable importance in the economy and government policies have sought to ensure it growth at the expense of the private sector. This has led to a heavy reliance on the hydrocarbon sector with little in the way of economic diversification. Hydrocarbons contribute to an average of 78% of export earnings, 83% of state budget and 60% of GDP for the GCC countries. More importantly, the dominance of the hydrocarbon sector with its fluctuating price implies that all the GCC economies are prone to global events which impact their economic performance. With a growing population that is expected to increase by 50% between 2010 and 2050, a large public sector and falling hydrocarbon reserves is not sustainable. Therefore, the GCC countries have sought to diversify their economies through the development of the SME sector.

The GCC countries have initiated various programmes to support the SME sector but they have been transactional in nature, focusing on providing small levels of loans. The GCC countries have not developed a holistic approach that seeks to build a truly entrepreneurial environment. An essential aspect of the entrepreneurial environment is to have legislation that supports the SME sector as well as investors. The global competitiveness studies show that the GCC countries lack in their absence of appropriate insolvency laws, business friendly regulations and excessive bureaucracy. Also, the transactional nature of government support has meant that it has not supported the development of a manufacturing sector. By and large, the government SME support mechanisms have placed an undue importance on the growth in the number of start-ups rather than concentrating on type and quality of SMEs in terms of activity, competiveness, etc. As a result the SME sector tends to be focused on the small domestic markets, perhaps with the exception of the UAE, which has a strong trading sector. Companies that do export tend to do so in low technology sectors with little value added. Private investors favour these activities because of their lower risk as well as cost of entry. None of the government SME support agencies provide sufficient loans to establish a modern technologically sophisticated business. With little in the way of bank financing or method of obtaining equity finance for start-ups implies that SMEs have little choice but to enter the low level activities.

GCC countries have done little in the way of developing anchor industries. These industries are important because they source from the local market and hence encourage SMEs to raise their level of production and efficiency. Also, anchor industries are an effective channel by which technology transfer can take place into the SME sector. Knowledge or technology transfer has not been facilitated by linking SMEs with universities. Countries where these networks have been established tend to show that SMEs adopt technology at a faster pace and tend to be more competitive than companies without university linkages (Lam 2013). We also find that the low incentives for citizens need to be addressed, and private sector risk taking must be supported. Through greater risk taking the private sector can be encouraged to invest in new areas and activities leading to export sophistication as well greater value added. Our general view is that the importance of oil in the economy may have displaced the private sector leading to an “oil drag” which has had a negative impact on the competitiveness of the private sector and especially of the SME sector.

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Annex I

Figure 13 Government Support Agencies in GCC Countries

Country	Institution
Bahrain	Small and Medium Enterprises Unit (SMEU) The Ministry of Industry has established this entity with the aim of developing and supporting SMEs and assisting potential entrepreneurs and investors. The SMEU has three programmes which focus on sharing the cost of feasibility studies through the Industrial Investor Development Program (IIDP); support to conduct international marketing research through the Industrial Marketing Development Program (IMDP) and to encourage skill development through the Industrial Talents Development Programs (ITDP.
	Tamkeen and Bahrain Development Bank Tamkeen was established with the aim of developing the country's private sector. Bahrain Development Bank is a developmental financial institution. The two intuitions have jointly developed two programmes namely the Financial Assistance for Feasibility Studies of SME and the Pre-Seed Capital Support. These programmes assist SMEs to conduct feasibility studies and basic start up funds. In the case of the former the programme provides BD 5,000 (US$ 13,271) and the latter BD5,000 (US$ 13,271) for materials, rent and other related expenditure.
Kuwait	Injaz This is a non-profit and non-governmental organization initiated by Kuwait's private sector. Injaz is focused on conducting training programmes to assist entrepreneurs.
	Emir of Kuwait Fund This fund was established with a capital of US$2 billion to provide capital for new SMEs.
	Kuwait Small Projects Development Company The Kuwait Small Projects Development Company was established with funding from the country's sovereign wealth fund of KD 100 million (US$ 330 million). The company provides loans of up to KD 500,000 (US$ 1,649,081). The company also takes equity stakes between 20% to 80% again with a limit of KD 500,000 (US$ 1,649,081). The company exits from its investment within eight years. Investments are abandoned if losses exceed 50% of the paid-up capital.
Oman	The Public Authority for Investment Promotion & Export Development This entity was established to assist Omani firms to enter foreign markets through export promotional activities.
	The Sanad Program This programme seeks to assist young Omanis aged 18 – 40 years start their own business with loans of up to maximum of OR5,000 (US$12,987)
	Oman Development Bank The Ministry of Commerce and Industry established this entity to provide loans of up to OR1 million (US$2,597,405) at low interest rates. The entity also provides micro finance with interest free loans of up to OR 5,000 (US$12,987). The Bank also provides training courses to existing and potential SMEs.
	Fund for Development of Youth Projects (Sharakah) This entity provides start-ups with loans and equity participation of up to OR

	200,000 (US$519,481) as well as training.
Qatar	Qatar Development Bank This entity provides funding at low interest rates of up to 5% for periods of up to 8 years in the case of new projects. The bank has also established two specialized units namely Enterprise Qatar and Tasdeer. The first seeks to assist SMEs terms of providing training courses, support and advice. The latter is an export promotion agency which hopes to internationalise its SMEs.
	The Qatar Industrial Manufacturing Company (QIMC) This entity was established to promote larger scale firms in downstream activities. To date the projects have been either wholly owned or through government entities.
	The Social Development Center This entity was established under the Qatar Foundation largely to provide training to young entrepreneurs.
Saudi Arabia	Saudi Arabian General Investment Authority The entity was established to develop a business friendly environment part of which includes supporting the SME sector.
	Saudi Industrial Development Fund (SIDF) Under the Ministry of Finance this fund provides bank guarantees to SMEs so that they can obtain loans from private banks.
	Saudi Credit Bank This entity focuses on providing social loans to low-income of a maximum of SR 200,000 Riyals (US$53,325)
	Centennial Fund This fund was established by the late King Abdallah to support young entrepreneurs aged between 25 and 35 years. The fund offers loans of up to SR 200,000 (US$53,325) for a period of five years. All borrowers receive mentoring as well as training and administrative support.
	Namaa Al Munawara Fund This fund was launched by His Royal Highness Prince Faisal Bin Salman providing finance to start ups in the Medina region of Saudi Arabia.
	Saudi Export Development Authority This is an export promotion agency assisting Saudi SMEs to become international through export promotion and support activities.
UAE	Dubai Department of Economic Development The UAE emirate of Dubai through the Department of economic Development has two specialised entities that assist and support SMEs namely Dubai SME and Dubai Exports. The first is a SME support agency that assists start-ups with advisory and training. The latter is an export promotion agency and one of the first in the GCC which assists SMEs in the UAE to export globally through export promotion and support activities.
	The Khalifa Fund The fund, which was established with a capital of AED 1 billion (US$ 272,260,740) to provide interest free loans of up to AED 3 million (US$ 816,782) for start-ups and AED 5 million (US$ 1,361,303) for existing businesses with flexible repayment periods. The fund also provides micro-financing of up to AED 250,000 (US$ 68,065) which are administered by certain local banks.

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