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Private Sector Development in Kuwait: A Product Space Approach

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Abstract

The advent of oil in the GCC countries has led their governments to assume an ever-increasing role in the economy and to build comprehensive welfare states, based largely on the provision of employment in the public sector and the generous supply of social services and heavily subsidized utilities, to their citizens. Moreover, an intricate web of regulatory and restrictive rules and regulations has come into existence over time, resulting in a private sector that is not competitive, is not outward-looking and is generally rent-seeking. The aim of this paper is to investigate the challenges that are preventing Kuwait from succeeding in diversifying its economy and developing a competitive private sector and the pre-requisite enabling environment, thereby reducing its dependence on the oil sector. Results of the analysis carried out in this study reveal that developing the role of private sector in the economic transformation of Kuwait could be achieved through a three interconnected strategies: improving the enabling environment for business to free private sector investors from existing regulations and red tape, developing new markets and opportunities through the creation of new investment opportunities, and ensuring competitiveness and integration with the regional and world economies.

Keywords

qualitative, estimations, product space maps, FDI, public sector, regulatory

1. Introduction

The advent of oil in Kuwait led its government to assume an ever-increasing role in the economy and to build comprehensive welfare state, based largely on the provision of employment in the public sector and the generous supply of social services and subsidized utilities either at very low prices or free of charge. Today, despite it is a relatively open economy, the public sector continue to account for a large

share in the country's GDP. In fact, the dominance of the public sector is overwhelming, even if the oil sector, which accounts for an important share of GDP, is excluded. Moreover, an intricate web of regulatory and restrictive rules and regulations has come into existence over time. Notwithstanding the fact that government policies intended principally to increase the overall welfare of its citizens, these policies have simultaneously and inadvertently resulted in a private sector that is not competitive, is not outward-looking and is generally rent-seeking.

The discussion on diversification though dated, has re-emerged and has not been absent from the strategic plans of key players at the policy making level in Kuwait. In fact, there is a common position among policy makers that Kuwait requires more flexibility and discretion in the use of public policies to enhance its prospects for industrialization, diversification of production and exports, and overall development. Economic transformation and diversification are fundamentals for growth sustainability and job creation. Moreover, a diversified economy is less sensitive to fluctuations associated with any particular industry, due to the fact that risk is spread across a number of industries. The presence of different industries would be expected to offer opportunities for employment in growing sectors to compensate for employment losses in declining sectors. Diversification is in fact viewed by most economists as a form of employment insurance, especially during cyclical downturns. It is also argued that the more diversified the economy becomes, the more resilient it becomes to external events, shocks and developments (Sherma, 2008). Although, indiscriminate diversification (i.e., diversity for the sake of diversity) will not necessarily induce economic growth and stability (Smith & Gibson, 1995) given the current international economic environment which is characterised by liberalisation and globalisation, the effective implementation of any economic diversification program requires the establishment of an orchestrated, holistic and comprehensive policy framework, that is coherent, flexible and sufficiently linked to all facets of the economic structure.

To investigate the reasons behind the poor diversification of the Kuwaiti economy, three important questions immediately arise. Firstly, why after 50 years of sovereign policymaking had Kuwait been unable to diversify its economy when compared to other countries that had similar initial positions and prevailing conditions? Two, could it be that diversification in Kuwait context is not adequately understood, making diversification strategies in the country ill conceived, inevitably leading to failure? Third, what are the preconditions necessary for economic diversification?

Economic historians have deduced sufficient evidence that there is a tendency to have high variability of output in the early stages of development, with clear inverse relationships between variability of output and the growth rates of per capita incomes. This high variability is then indicated to be symptomatic of undiversified economies. In trying to explain the decreasing variability with the level of development, analysts have pointed the role of technological advances and scarcity of capital and limited savings as important. This raises the question whether there could be a link between economic policies in force in a particular country and the ability of the economy to diversify.

In Kuwait, and after many years of being a target of industrial policy benefits and receiving preferential

prerogatives, the private sector at large, continues to rely on government expenditures for its survival. Realizing that is has outgrown this stage of infant protectionism, the Kuwaiti government now recognize the need for change in order to establish a sustainable and competitive economic structure that will be help the country in minimizing the disruptive impact of fluctuations in the price of oil on the economy, creating significant employment opportunities for the large pool of young people entering the labor market, and increasing the rate of growth of the economy through its ability to attract FDI and technical know-how. Previous countries' experiences has shown that energizing the private sector has the potential to address these problems if carried out in a meaningful way, and if efforts are focused on intrinsically competitive growth in high value added sectors (World Bank, 2001).

The aim of this paper is to investigate the reasons and factors that are preventing Kuwait from succeeding in diversifying its economy and reducing its dependence on the oil sector and related activities. The analysis is based on the use of a mixed quantitative and qualitative analysis of economic transformation largely based on the implementation of a novel tool for the case of Kuwait, namely product space map. The results of this approach have been then used to identify the strategic choices for economic transformation and the required accompanying policies.

2. The Features of the Economy

Kuwait's GDP scarcely grew during the 1980s, dipped briefly around the time of the Iraqi invasion; recovered quickly, and by the mid-1990s was growing more rapidly. Over the whole period from 1990 to 2015, real GDP grew by approximately 7.7% p.a at current prices (World Bank, 2016). Despite the significant increase in oil-related GDP over the period 2000-2014, passing from 52.2% in 2000 to 62.4% in 2014, its share is falling since 2015 as a direct result of the drop in world oil prices.

The state of the manufacturing sector is very particular in Kuwait. In fact, and over the period 1990-2015, while total GDP maintained a slightly high rate of growth, GDP of manufacturing sector grew by a mere 2.9%. Its contribution to the country's GDP passed from 8.7% in 1990 to only 6.7% in 2010 and 5.3 in 2014. Productivity changes have been advanced as one of the main reasons behind the poor development of the manufacturing sector. In fact, productivity in most sectors has been at best static, and in many instances notably declining, for over two decades (Estrin et al., 2005).

The private sector in Kuwait currently accounts for a remarkably small share of GDP, accounting for only about 25% in recent years. Private operators are mostly present in agriculture and fishing as well as in many service sectors mainly construction, trade, hotels and restaurants. In the manufacturing sector, private operators generate only around 23.5% of GDP. These shares have not shown any marked tendency to increase. Aside from the small share of the private sector in the country's GDP, Kuwait has a number of other special features that need to be taken into account in any strategy of economic transformation and diversification. Being an economy essentially built around the oil sector, it is not surprising that Kuwait should experience the so called "Dutch disease", whereby burgeoning oil exports push up the exchange rate, with the result that most other manufacturing output is rendered

uncompetitive in the world market. An observation supported by the fact that in 2014, non-oil exports only accounted for around 6% of Kuwait's total exports of goods compared to 8.4% in 2002. Hence, the high dominance of the oil sector in the Kuwaiti economy make the development of transformation strategy based on the expansion of manufactured exports extremely challenging, unless productivity in select and targeted manufacturing sectors could be raised rapidly.

More surprisingly, Kuwait has attracted very small sums of FDI in recent years (both in absolute terms and in relation to GDP). Over the period 20003-2015, Kuwait attracted only around 11 USD billion of FDI, according Financial Times, the lowest of all MENA countries except for the Palestinian territories. Even Yemen attracted around 14 USD billion despite its successive internal conflicts. The UAE, the most popular destination for foreign capital in the six states of the petroleum-rich Gulf Co-operation Council, received 12 times more FDI than Kuwait. This is partially because Kuwait's own wealth—derived from its production of 2.6 million barrels of oil per day making foreign capital less necessary for development. Nevertheless, another prevalent and convincing reason is that Kuwait still has an inhospitable and unattractive business environment, particularly for international companies. This low performance has been the case for at least the past two decades, suggesting that structural and institutional conditions in the economy may be linked to poor economic performance.

Nevertheless, it is worth noting that Kuwait has achieved a high, and in recent years fluctuating savings ratio; presumably mostly attributable to variations in the price of oil. Thus in 2007, total savings accounted for 55% of GDP as a result of high world oil prices. However, when world oil prices declined, savings also declined substantially. In 2014, the rate of gross national saving dropped to only 38% (IMF, 2016). Despite the high level of national saving in 2007, gross domestic investment has been limited to only 19.7% of GDP. This rate has been decreasing in the recent years to reach only 16% in 2014. The low level of investment compared to saving is mainly due to the fact that most of the savings are public, whereas an important share is increasingly invested abroad. Undoubtedly, such overseas investment does generate (future) flows of income for Kuwait, but adds nothing to economic transformation and diversification of the country itself; which being the key determinants for job creation for nationals, outside of the public sector, which employs about 90% of the Kuwaiti labor force. In this context, it is not unreasonable to ask why Kuwait should even be especially concerned to attract FDI in a context where an important portion of national savings is invested abroad. However, the answer to this puzzle can be found in the very poor productivity trends already alluded to above, which imply that Kuwait is in pressing need of improved human capital, technological absorption, and the development of an appropriate business climate that is critical for increasing productive investments, both domestic and foreign, and diversifying the economy.

3. Methodology

The methodology adopted in this paper is based on three pillars. The first assessed the progress made so far in economic diversification using key indicators of economic diversification for Kuwait and a

panel of comparator countries. Second, the approach of *product space* has been applied to show the evolution of the Kuwaiti specialization patterns and its placement on the world trade map. Moreover, strategic options for economic transformation have been identified from the product space maps. Third, a special focus has been given to the identify the challenges faced by the private sector to increase its role in the Kuwaiti economy and enhance its transformation. Accordingly, an analysis of the current macroeconomic and sectoral policies and their impacts on the development of private sector has been carried out with the objective to suggest alternatives and appropriate policies to energize the contribution of the private sector to economic development of Kuwait.

3.1 Diversification Indices

Two main approaches are typically used to assess economic diversification. The first simplest approach is to look at changes in the sectoral composition of GDP among the main productive sectors; mainly agriculture, mining and quarrying, manufacturing and services. Alternatively, the second approach is often undertaken through the assessment of export diversification, which evaluates the level of changes in the composition of a country's export mix (Ali, Alwang, & Siegel, 1991). By changing the shares of commodities in the existing export mix, or by including new commodities in the export portfolio, a country achieves export diversification. A more general definition of diversification is the spread of production to a growing number of different outputs, which do not necessarily imply different productivity levels (Berthelemy & Chauvin, 2000). However, other economists focused mostly on the existing correlation between exports diversification and exports instability of different countries (Massel, 1970; and MacBean & Nguyen, 1980). Accordingly, diversification of exports appears among the key explanatory variables of economic growth in a large panel of economies (Al-Marhubi, 2000; and Berthelemy & Soderling, 2001). Meanwhile, other recent studies have employed "non-traditional" measures of export diversification that involve time series data to determine and compare the export experiences of different commodities (Gutierrez de Pineres & Ferrantino, 1997; and ESCAP, 2004).

Diversification indices fall into two main categories: concentration and commodity-specific indices. Concentration ratios are two-dimensional functions that determine one measure per country and per year. However, these indices do not reflect the same level of diversification for the same intervals of values. In fact, some of them show a well-diversified economy when the number estimated approaches zero, while others show an opposite scenario. On the other hand, commodity specific ratios are three-dimensional functions that determine one measure per country, per year and per product. Hence, for a given country and a given year, a commodity specific index shows values that correspond to HS codes (or commodities) that have been exported. For that, general cross-country comparisons can only be useful in determining concentration ratios, while for commodity-specific indices, comparisons are limited to a commodity by commodity basis. Table 1 below presents the mathematical specifications related to the estimation of the various concentration indices as well as their significance in terms of export diversification.

Table 1. Diversification Indicators

Indicator	Equation	
Ogive Index	$OGV = N.\sum_{i=1}^{N}(P_i - 1/N)^2$	A value of the index close to zero implies a well-diversified economy while a high value implies a poorly diversified economy.
The Entropy Index	$ENT = -\sum_{i=1}^{N} P_i \log_2 P_i$	A value reproaching to 0 implies an extreme diversification while a high value implies higher diversification as all commodities in the export portfolio have identical share.
Hirschman Index	$H_1 = \sqrt{\sum_{i=1}^{N}\left(\frac{x_i}{X}\right)^2}$	A high value of this ratio indicates large concentration of exports on few commodities while a low value, approaching to zero, indicates a large diversification.
Normalized-Hirschmann Index	$NH_1 = \frac{\sqrt{\sum_{i}^{N} P_i^2} - \sqrt{\frac{1}{N}}}{1 - \sqrt{\frac{1}{N}}}$	A value close to 1 represents the most extreme concentration. Likewise, a low value of this index indicates lower exports concentration or a relatively diversified economy.
Aggregate Specialization Index	$ASI = \sum_{i=1}^{N}\left(\frac{x_i}{X}\right)^2$	A numerical value of ASI approaching 1 implies reliance on a single export commodity (a high degree of concentration and specialization) while a numerical value of SPE approaching 0 implies a high degree of export diversification.
Inverse of aggregate specialization index	$IASI = \frac{1}{\sum_{i=1}^{N}\left(\frac{x_i}{X}\right)^2}$	The value of this particular index increases with the degree of diversification (which is from 1 to N). A value of 1 indicates extreme concentration and largely exceeding 1 exhibits perfect diversification.

The most utilized diversification ratio is the Ogive index developed by Attaran and Zwick (1987) which was originally developed to measure the deviation from an equal distribution of employment in all sectors, indicating the mean of the distribution. This index has been further updated to measure export diversification or concentration (Ali et al., 1991; and ESCAP, 2004). The minimum value of OGV, that is zero, is attained when the share of export is distributed equally among commodities indicating a highly diversified economy. On the other hand, a larger value of OGV indicates a relatively poor diversified economy, which means that there are only a few commodities in its export portfolio. Contrary to the Ogive index, the entropy index has been applied to many areas including natural sciences, communication theory, business and finance, and economics (Attaran & Zwick, 1987). Its

application was initiated during the late 60s and the 70s (Frenken, 2003) as a measure of diversity based on the assessment of the spread of the distribution. If the ith commodity is the only contributor to the country's total exports, the entropy index equals 0 which shows extreme specialization or concentration of exports in one commodity.

The next measure of diversification/concentration is the Hirschman Index (Note 1) (Hirschman, 1964), which has been widely used to measure trade and commodity concentration (Massell, 1970; Kingston, 1976; MacBean & Nguyen, 1980; Svedberg, 1991; and Stanley & Bunnag, 2001), specifically when concentration is a function of both unequal distribution and fewness (Hirschman, 1964). The Hirschman index is a function of the mean and variance of the value of exports' share in different commodity groups. Specifically, it is the index that would result if a country's export receipts were divided evenly among different commodities (Adelman, 1969; and Massell, 1970). This means that when the share of exports is identical or equally distributed amongst all commodity groups, the variance is equal to zero. The Hirschman index has been frequently used to investigate the relationship between export instability and export diversification (Massell, 1970; Kingston, 1976; MacBean & Nguyen, 1980; and Stanley & Bunnag, 2001) (Note 2). The normalized-Hirschmann (N-H_1) index has been directly derived from the original Hirschmann by Al-Marhubi (2000) to differentiate between countries that are relatively highly concentrated in terms of the structure of their exports. A value closer to 1 represents the most extreme concentration. Likewise, a low value of this index indicates lower exports' concentration or a relatively diversified economy.

The following indicator is the aggregate specialization index that measures export diversification based on the concentration of the distribution of exports among products. This index is quite similar to the Hirschmann index. A numerical value of ASI approaching 1 implies reliance on a single export (a high degree of specialization) while a numerical value of ASI approaching 0 implies a high degree of export diversification. When the share of exports is equally distributed among different commodities, then the value of ASI is 1/N, which is also the minimum value. Finally, the inverse of aggregate specialization index (IASI) that has been developed by Berthelemy and Sorderling (2001) varies between 1 to N. A value of 1 indicates extreme concentration and N exhibits perfect diversification. It has been observed that the Ogive, Entropy and Hirschman (below) indices can provide quite similar rankings of export concentration and thus, by and large, may be used interchangeably (Attaran & Zwick, 1987; and Ali et al., 1991). These measures are conceptually similar, as their approaches compare actual distribution to a hypothetical uniform distribution. For this reason, the analysis of the results of the calculations in this study will be limited to the Ogive index, the Normalized-Hirschman index, and the aggregate specialization index despite that calculations have been made for all indexes listed in the Table 2. Their calculations have been made using data extracted from the World Integrated Trade Solution (WITS); a software developed by the World Bank, in collaboration with various International Organizations including United Nations Conference on Trade and Development (UNCTAD), International Trade Center (ITC), United Nations Statistical Division (UNSD) and World Trade Organization (WTO).

WITS gives access to major international trade, tariffs and non-tariff data compilations for all WTO member countries. For the specific purpose of the estimation of diversification indicators, WITS provides the required data for all the comparator countries and for the whole period of analysis. However, for Kuwait required data is not available for the two years 2005 and 2010. In order to highlight the robustness of the results with respect to the level of disaggregation of products (the level of HS codes), the estimation has been carried out at both heading (4 digit HS codes) and subheading levels (6 digit HS codes).

3.2 Product Space

The sequential evolution of the developed economies from the production of less sophisticated to more sophisticated activities shows that economic development is not only a process of continuously improving the production of the same goods, but also one that requires structural transformation; that is, the accumulation of the capabilities needed to upgrade production toward activities associated with higher levels of productivity. This shift is in effect what leads to fast and sustained growth. This also implies that development is a path-dependent process and the only way to traverse it is through significant structural transformation. The recent works of Hausmann et al. (2007), Hidalgo et al. (2007), Hidalgo (2009), and Hidalgo and Hausmann (2009), among others, give emphasis to the role of structural transformation in inducing growth and development. Specifically they show that different products have different consequences for development. Hausmann et al. (2007) shows that the specific set of products that a country exports has important consequences for its pattern of development. Empirically, they show that, after controlling for factors such as initial income per capita, the sophistication of a country's export basket is a good predictor of future growth. This implies that development has to be understood as a process that involves not only the production of more of the same set of products, but also the introduction of new ones; in that, sustained growth involves the accumulation of more complex sets of capabilities. To analyze development and structural transformation from this perspective, Hidalgo et al. (2007) have developed the analytical tool called the "product space".

The product space is a network representation of all the products exported in the world. Central to the construction of the product space are two ideas: (i) that the ability of a country to export a new product is dependent on its ability to export similar products; and (ii) that commodities requiring similar capabilities are more likely to be exported together. Hidalgo et al. (2007) capture this notion of similarity between two products by observing trade outcomes rather than by looking at physical similarities between products or their inputs. They argue that the production (and export) of different products requires different and very specific capabilities, such as human or physical capital, knowledge of markets, legal systems, institutions, etc. What differentiates these capabilities is that some of them can be easily redeployed into the production and export of many other products; that is, there are some goods that are "closer" to other goods. Likewise, there are many other products that are "far away" from other products. One example is the case of natural resources such as oil, which requires very

specific capabilities that cannot be easily redeployed.

To assess changes in terms of export specialization or diversification, product space maps have been built for three specific years covering a period of 20 years (1990, 2000 and 2010) for Kuwait and a comparator country. The criteria, used to select comparator countries were; the structure of the GDP and the dominance of natural resources in the country's GDP, excluding larger countries like Canada and New Zealand and others, where in addition to immense natural resource endowments, industries and agriculture play a significant role in the generation of GDP. The other group of countries to which GCC could be compared includes countries that are relatively small in terms of GDP and population when compared to the first panel. This is the case of Venezuala, Uganda and Chile, for example. Chile's economy is based on the export of minerals, which accounts for about half of the total value of exports. Copper is the nation's most valuable resource, and Chile is the world's largest producer. Agriculture is the main occupation of about 15% of the population; it accounts for about 6% of the national wealth. The major products are copper and other minerals, processed food, fish meal, iron and steel, wood and wood products, transportation equipment, and textiles. However, and similarly to the economies of the GCC, the dependence of the Chilean economy on copper prices and the production of an adequate food supply, are the two main economic drivers and consequently, the major sources of economic vulnerability in Chile. Thus, in order to follow the transformation of Kuwaiti and Chilean economies and their respective positions in the world export maps, the product space maps have been built for both economies for the years 1990, 2000 and 2010. According to Hidalgo, the objective is not to consider marginal exports, but rather to confirm that a country exports a product whenever it has an established Relative Comparative Advantage (RCA) in it. This approach is based on the Balassa definition of RCA (see equation 1). It is defined as the ratio of two shares. The numerator is the share of a country's total exports of the commodity of interest in its total exports. The denominator is the share of world exports of the same commodity in total world exports. It takes a value between 0 and $+\infty$.

Equation 1

$$RCA(c,i) = \frac{\frac{x(c,i)}{\sum_{i} x(c,i)}}{\frac{\sum_{c} x(c,i)}{\sum_{i,c} x(c,i)}}$$

where x(c,i) is the value of the exports of country c in the i^{th} good. Basically, RCA is larger than 1 when the share of exports of a country of a given product is larger than the share of that product on global trade. For Hidalgo (2007), this definition of RCA allows setting a hard threshold for countries exports. When RCA(c,i) is greater or equal to 1, a country c exports product i. However, when RCA(c,i)<1 the corresponding country is not a competitive exporter of that product despite that a country with RCA lower than 1 could be an exporter for some goods. Many reasons could explain such situation. The most important factors are trade diversion from the most competitive exporters in favor of less or

non-competitive exporters as a result of preferential trade agreements. The second factor could be lower transaction costs that may compensate for the competitiveness gaps with competitors. The third reason may be related to the existence of informal and border trade.

For both Kuwait and Chile, the product space maps have been built at the level of SITC-4 disaggregation of exported commodities and for three years: 1990, 2000 and 2010. Figure 1 shows the visual presentation of the product space map.

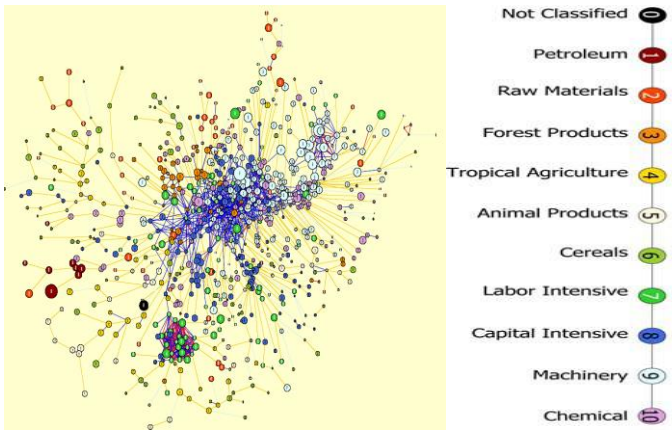


Figure 1. A Visual Representation of the Product Space

Source: Haussmann and Klinger (2007).

It is apparent from the figure above that the product space is highly heterogeneous. There are peripheral products that are only weakly connected to other products. There are some groupings among these peripheral goods, such as petroleum products (the large red nodes on the left side of the network), seafood products (below petroleum products), garments (the very dense cluster at the bottom of the network), and raw materials (the upper left to upper periphery). Furthermore, there is a core of closely connected products in the center of the network, mainly of machinery and other capital intensive goods. This heterogeneous structure of the product space has important implications for structural transformation, in that, if a country is producing goods in a dense part of the product space, then the process of structural transformation is much easier because the set of acquired capabilities can be easily re-deployed to other nearby products. However, if a country is specialized in peripheral products, then this redeployment is more challenging as there is no set of products that requires similar capabilities. The process of structural transformation can be impeded due to a country's orientation in this space (Hausmann & Klinger, 2007).

3.3 Public Policies and Private Sector Development

The third pillar of the methodological framework is directly linked to understanding the barriers and economic inefficiencies behind the small contribution of the private sector to economic diversification and transformation in Kuwait. International experience and empirical evidence suggests that private sector development can contribute to economic transformation of any economy through the

diversification of its productive structure and exports. Energizing the private sector has the potential to address the challenges of export concentration on a few products and low capacities in terms of job creation. This section provides a detailed review of the obstacles that hinder the development of the private sector in Kuwait. It is followed by a concluding section which lays out a strategy consisting of a package of reforms with specific interventions and implementation arrangements.

4. Diversification Performance

As pointed out in the methodological section, most of the diversification indices provide similar ranking of export diversification. Thus, the analysis is limited to two indicators; the Hirschman Index and the Aggregate Specialization index. Both of these indices have been estimated for Kuwait and a panel of comparator countries. The selection of the comparator countries have been made in order to cover two categories. The first panel of comparator countries includes countries that present a relative similar economic structure as that of Kuwait in terms of the dependence of their GDPs on natural resources; Norway and Chile. However, and despite the importance of the oil sector in the Norway's economy, this country is a prominent case of success in economic diversification. Besides Norway and Chile, the rest of the comparator countries cover economies that were categorically relatively, "low income" in the past and poorly endowed with natural resources. However, despite their poor endowment in natural resources, these countries became amongst the rapidly growing economies in the world over the past two decades. These countries are namely, China, Turkey and Brazil. The main motivation behind the inclusion of these three countries in the list of comparators is to understand how relatively countries with poor natural resource endowments succeeded in diversifying their economies, increasing their wealth, and reducing vulnerabilities to external shocks. Moreover, and despite that these three countries are hardly comparable to Kuwait in terms of population size and structure of GDP, the goal here is to investigate how macroeconomic and sector based policies could play a significant role in economic transformation and how Kuwait could be inspired to achieve economic diversification.

Figures 2 to 5 display the changes in the Hirschman and the aggregate specialization indices for Kuwait and the comparator countries over the period 2001-2011. Rows reflect years from 2001 to 2011 while columns represent the values of the indices. The main finding of this analysis is that Kuwait's pattern of specialization implies very little opportunity for flexible movement to new activities. Kuwait's exports are concentrated on producing a limited number of undiversified products, largely dominated by oil and oil related products, profiling a poor export package. Previous growth has been surprisingly strong given this pattern of concentration, explained by increasing revenues from the oil sector, and it is evident that ample room for growth expansion is prevalent through the increase of oil extraction and the development of refining capacities. However, Kuwait has little room to diversify its production, and its current export package does not offer a path to future structural transformation and growth. Furthermore, this isn't due to Kuwait's status as a natural resource-based economy, as the country lags

in these dimensions even when compared to countries like Norway and Chile. Movements to new sectors are necessary, but will be difficult given this pattern of specialization that creates multiple barriers and obstacles towards the development of the private sector, the channel through which diversification could be enhanced. These barriers and obstacles faced by the private sector are discussed in detail in a later section in this paper where options to energize the private sector are discussed. However, a slight improvement in the level of diversification is observed since 2009 despite the fact that the country is still lagging compared to the panel of comparator countries.

The figures show that Kuwait is the less diversified economy compared to the panel of comparator economies. Turkey has been the most diversified economy since both indices show the lowest values over the whole period of the analysis. Moreover, its diversification has been reinforced since the global economic recession that started in mid 2008. The impacts of the global economic crisis have been heterogeneous among the comparator countries. Accordingly, both Brazil and Chile experienced a decline in the levels of their export diversification. The figures show that while Malaysia experienced modest diversification, Norway has improved its profile by investing its oil revenues into implementing an ambitious stimulus program.

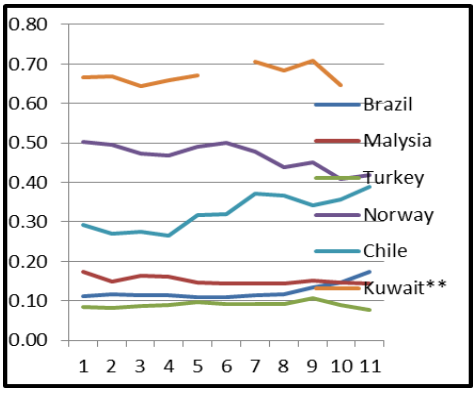


Figure 2. Hirschman Index at HS6

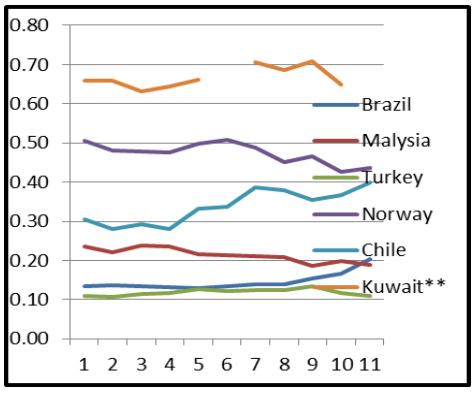


Figure 3. Hirschman Index at HS 4

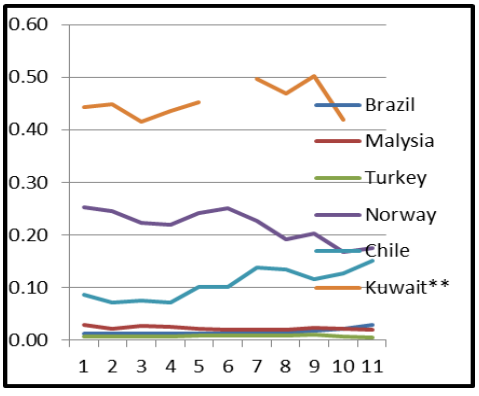


Figure 4. Aggregate Specialization Index at HS 6

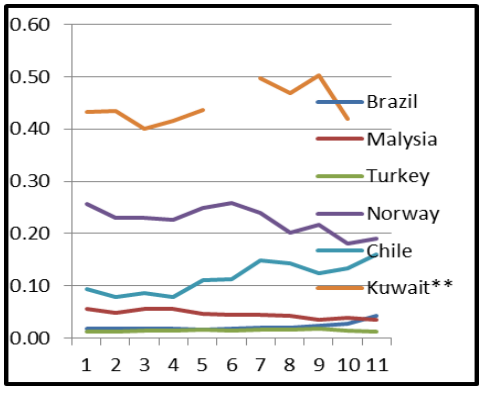
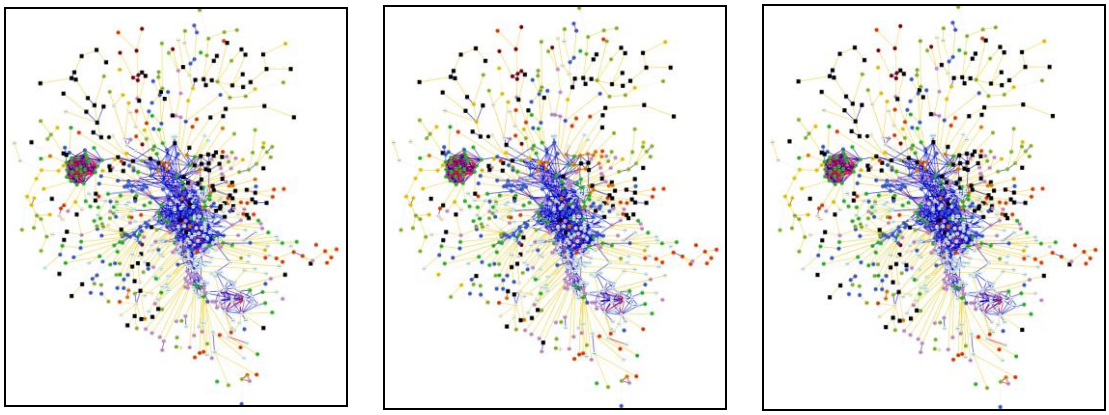


Figure 5. Aggregate Specialization Index at HS 4

The product space maps for Kuwait have been compared to Chile. In fact, Chile has been selected as a

comparator country for one main reason; namely the important role played by natural resources in its economic and social development over the past five decades. In the 1960s, the Chilean economy has been dominated by the extraction and exports of mining products mainly cooper. Five decades later, the Chilean economy have succeeded in reducing its dependence on the extraction and export of copper through the development of the agriculture sector, food processing, manufacturing of copper and services. Despite that among the top 20 Chilean exported goods there are no high value added manufactured goods (Table 2). The manufactured productive capacities are still limited in Chile and are mostly inward-oriented toward supplying the domestic market (Huasmann & Klinger, 2007). For both countries, Kuwait and Chile, an RCA view on the products that are exported with an RCA≥1 is provided. Figure 6 below shows Chile's evolution in the world product space map over the period 1990 to 2010, where a black square on top of a product indicates exports with a comparative advantage.



1990 **2000** **2010**

Figure 6. Product Space Maps for Chile 1990-2000-2010

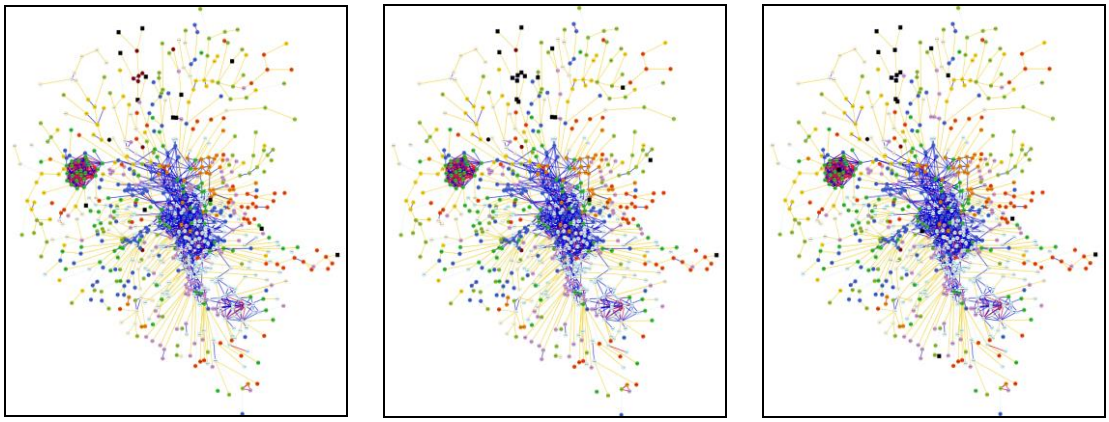
These figures show that Chile occupied a loose cluster of seafood products (lower-left) and wood products (upper middle) during this period. These clusters are now nearly fully occupied. But beyond these movements, there has been little change in Chile's orientation in the product space. It is specialized in mining and agricultural goods that are highly peripheral, with few nearby opportunities for future structural transformation. Table 2 shows that in 1990, Chile was highly specialized (i.e., it recorded a RCA>1) in 91 products. These products are dispersed within the map but none of them are located inside the core which is the densest location, where products are very well linked and connected to each other (Figure 6). The majority of these products exported with an RCA >1 for Chile include mineral, chemical, food and animal products. Copper is by far the prime export of this although its RCA has suffered from a striking decrease in 2010. In 2000, Chile had improved its export basket and showed an RCA in 123 products. This gain was lost after 10 years as Chile regressed to almost initial position with only 90 products exported, with an RCA of greater than 1. Nevertheless, it is worthy to note that Chile has maintained almost the same products on the list of the 20 first products

exported with an RCA greater than 1 apart from some exceptions.

Table 2. Chile's Top 20 Exports Sorted in Decreasing Order of RCA

SITC 4	Designations	RCA 1990	R	RCA 2000 F	R	RCA 2000	R	RCA 2010	R
2712	SODIUM NITRATE, NATURAL, CONTAIN <16.3% OF NITROGEN	221.85	**1**	221.87	**1**	214.81	**1**	82.11	**1**
6821	COPPER AND COPPER ALLOYS, REFINED OR NOT, UNWROUGHT	96.37	**2**	117.16	**4**	107.70	**3**	67.97	**2**
2871	COPPER ORES & CONCENTRATES, COPPER MATTE	54.00	**7**	124.58	**2**	114.73	**2**	54.72	**3**
575	GRAPES, FRESH OR DRIED	93.69	**3**	89.95	**5**	83.67	**4**	44.49	**4**
2714	POTASSIUM SALTS, NATURAL, CRUD	-	**-**	-	**-**	-	**-**	28.31	**5**
574	APPLES, FRESH	39.09	**9**	31.74	**9**	31.34	**6**	24.10	**6**
343	FISH FILLETS, FRESH OR CHILLED	5.89	**35**	74.98	**6**	71.80	**5**	20.92	**7**
814	FLOURS	86.21	**4**	33.83	**8**	29.04	**7**	18.76	**8**
2879	ORES & CONCENTRATE OF OTHER NON-FERROUS BASE METAL	11.13	**17**	18.91	**15**	20.74	**10**	18.14	**9**
2460	PULPWOOD (INCLUDING CHIPS AND WOOD WASTE)	35.12	**11**	23.96	**10**	24.87	**8**	15.71	**10**
2517	CHEMICAL WOOD PULP, SODA OR SULPHATE	8.72	**25**	19.50	**13**	18.54	**12**	15.19	**11**
586	FRUIT, TEMPORARILY PRESERVED	7.36	**27**	15.32	**17**	14.26	**15**	14.84	**12**
2783	COMMON SALT, ROCK SAT, SEA SALT; PUR. SODIUM CHLORIDE	7.29	**28**	12.14	**19**	12.57	**17**	13.97	**13**
579	FRUIT, FRESH OR DRIED, N.E.S.	19.44	**13**	19.95	**11**	18.71	**11**	12.66	**14**
344	FISH FILLETS, FROZEN	6.57	**31**	19.28	**14**	20.95	**9**	11.25	**15**
1121	WINE OF FRESH GRAPES (INCLUDING GRAPE MUST)	2.40	**61**	15.87	**16**	14.92	**14**	11.11	**16**
342	FISH, FROZEN (EXCLUDING FILLETS)	10.29	**21**	19.73	**12**	16.99	**13**	10.68	**17**
583	JAMS, FRUIT JELLIES, MARMALADES, FRUIT PUREE, COOKED	1.55	**79**	9.89	**22**	8.37	**28**	8.34	**18**
2479	PIT PROPS, POLES, PILING, POSTS & OTHER WOOD IN ROUGH	-	**-**	-	**-**	11.08	**18**	7.75	**19**
2881	ASH & RESIDUES CONTAIN. METALS/METALLIC COMPOUNDS	0.48	**133**	0.97	**114**	12.71	**16**	7.58	**20**

Figure 7 shows the position of Kuwait's exports on the world export maps for the three selected years: 1990, 2000 and 2010.



1990 **2000** **2010**

Figure 7. Product Space Maps for Kuwait 1990-2000-2010

These figures show that Kuwait occupied a very particular place in the maps that is limited to upper and the lower-right shares (raw minerals) for the whole period. Contrary to Chile, these shares in the map are not fully occupied which is the case of most raw materials in general and more particularly those exported by oil-based economies. But beyond this stagnation, there has been little change in Kuwait's orientation in the product space. It succeeded slightly in diversifying its economy through a limited number of new products that appear in the center of the map in 2010, dominated by chemical and intensive capital goods. These products represent the available opportunities for future transformation. However, the products concentrated in peripheral sides do not represent effective opportunities for future structural transformation. Tables 3 and 4 provide additional evidence on the small structural transformation experienced by the Kuwaiti economy. In fact, when oil and other related activities are considered; the number of products exported by Kuwait with an RCA greater than 1 range between 14 and 18 products for the entire period (Table 4). However, high fluctuations were noted for the RCA's rank among the products over time as shown in the three maps. It is noteworthy to indicate that the adopted measure of the RCA as mentioned in the previous section could not reflect the importance of products in terms of export value accurately. Tables 3 (with oil and related activities) and 4 (without oil and related activities) show that the product *"picture, postcards, greeting cards"* is ranked the first in 2010 for both cases (with and without oil and related activities). However the export value of this product is about USD130 million which represents only 0.3% of the value of oil exports (SITC 4 3330) that amounts to USD41,346 million. The same products prevailing in Table 3 are dominant in Table 4 apart from oil products.

When oil and related products are excluded, in 1990 Kuwait is specialized in only 43 products (Table 4). These products are very dispersed within the map and a few of them are located inside the core. There is no clear vision about the specialization of Kuwait in exporting particular products if we do not account for petroleum products. Table 4 clearly shows a high volatility in products exported with an RCA greater than 1 over years. There is no fixed basket which is maintained. As an example, the

product which was ranked the first in terms of RCA in 2010 was ranked 315 in 2000 and not exported at all in 1990. Another remarkable feature is the volatility of Kuwaiti exports over time. In 2000, Kuwait showed an RCA greater than 1 in exporting 71 products. However, in 2010, the number of exported products dropped to 59 products. Table 3 lists Kuwait's top exports indicating the predominance of the following products: chemical and related products, crude materials and iron and steel. The main conclusion that can be drawn is that Kuwaiti exports express high volatility over time, which can be explained by one main factor. In fact, Kuwaiti exports of non-oil and related products are mostly absorbed by the Iraqi market which itself is highly driven by public spending. Moreover, Kuwait has been able to take advantage of the international armed forces based in Iraq since 2003 where a large number of Kuwaiti firms have been in charge of their procurement in terms of foods, construction products, and other finished goods. The progressive reduction in the number of troops stationed in Iraq has been largely responsible for the declining trends of Kuwaiti exports of these goods.

Table 3. Kuwait's Top 20 Exports Sorted in Decreasing Order of RCA (with Oil and Related Activities)

SITC 4	Designations	RCA 1990	R	RCA 2000F	R	RCA 2000	R	RCA 2010	R
8924	PICTURE POSTCARDS, GREETING CARDS	-	**-**	-	**-**	0.00	**319**	14.57	**1**
3330	PETROL.OILS & CRUDE OILS OBT.FROM BITUMIN.MINERALS	10.36	**5**	8.77	**4**	11.82	**4**	9.68	**2**
5112	CYCLIC HYDROCARBONS	0.02	**195**	0.03	**98**	0.00	**496**	8.02	**3**
2741	SULPHUR OF ALL KINDS	4.56	**7**	5.86	**6**	9.69	**7**	6.57	**4**
5121	ACYCLIC ALCOHOLS & THEIR HALOGENATED,DERIVATIVES	-	**-**	4.68	**8**	5.89	**9**	6.24	**5**
5621	MINERAL OR CHEMICAL FERTILIZERS,NITROGENOUS	3.60	**10**	1.23	**13**	3.68	**11**	4.82	**6**
3413	PETROLEUM GASES AND OTHER GASEOUS HYDROCARBONS	3.32	**12**	6.90	**5**	8.05	**8**	4.23	**7**
5831	POLYETHYLENE	0.04	**140**	4.82	**7**	10.70	**6**	3.35	**8**
3354	PETROLEUM BITUMEN, PETROL.COKE & BITUMIN.MIXTUR.NES	2.34	**13**	4.39	**10**	4.26	**10**	2.50	**9**
6649	GLASS,NE.ES.	0.62	**24**	0.67	**19**	1.40	**17**	2.45	**10**
5161	ETHERS,ALCOHOL PEROXIDES, ETHER PEROX.,EPOXIDES ETC	-	**-**	0.68	**18**	0.82	**20**	1.58	**11**
5832	POLYPROPYLENE	0.08	**107**	1.06	**15**	1.43	**15**	1.47	**12**
460	MEAL AND FLOUR OF WHEAT AND FLOUR OF MESLIN	-	**-**	-	**-**	0.81	**23**	1.43	**13**
8973	JEWELLERY OF GOLD, SILVER OR	0.06	**122**	0.03	**91**	0.15	**75**	1.18	**14**

	PLATINUM								
6724	PUDDLED BARS AND PILINGS; INGOTS, BLOCKS, LUMPS ETC.	0.00	**280**	-	**-**	0.01	**240**	0.85	**15**
6782	SEAMLESSTUBES AND PIPES; BLANKS FOR TUBES & PIPES	0.00	**283**	-	**-**	0.01	**230**	0.76	**16**
483	MACARONI, SPAGHETTI AND SIMILAR PRODUCTS	0.16	**65**	0.34	**22**	0.72	**25**	0.71	**17**
2742	IRON PYRITES,UNROASTED	-	**-**	-	**-**	-	**550**	0.68	**18**
2820	WASTE AND SCRAP METAL OF IRON OR STEEL	0.54	**25**	0.10	**59**	0.59	**28**	0.65	**19**
5839	OTHER POLYMERIZATION AND COPOLIMERIZATION PRODUCTS	0.03	**167**	0.07	**66**	0.26	**45**	0.61	**20**

Table 4. Kuwait's Top 20 Exports Sorted in Decreasing Order of RCA (without Oil and Related Activities)

SITC 4	Designations	RCA 1990	R	RCA 2000F	R	RCA 2000	R	RCA 2010	R
8924	PICTURE POSTCARDS, GREETING CARDS	-	**-**	-	**-**	0.03	**315**	119.63	**1**
5112	CYCLIC HYDROCARBONS	0.09	**191**	0.12	**94**	0.00	**492**	65.84	**2**
2741	SULPHUR OF ALL KINDS	20.85	**5**	27.46	**3**	66.98	**4**	53.95	**3**
5121	ACYCLIC ALCOHOLS & THEIR HALOGENATED, DERIVATIVES	-	**-**	21.90	**5**	40.73	**5**	51.21	**4**
5621	MINERAL OR CHEMICAL FERTILIZERS,NITROGENOUS	16.43	**8**	5.78	**9**	25.42	**7**	39.56	**5**
5831	POLYETHYLENE	0.20	**136**	22.55	**4**	73.97	**3**	27.47	**6**
3354	PETROLEUM BITUMEN, PETROL.COKE & BITUMIN.MIXTUR.NES	10.68	**9**	20.54	**6**	29.47	**6**	20.54	**7**
6649	GLASS,NE.ES.	2.85	**20**	3.14	**15**	9.68	**13**	20.12	**8**
5161	ETHERS,ALCOHOL PEROXIDES,ETHER PEROX.,EPOXIDES ETC	-	**-**	3.19	**14**	5.69	**16**	12.95	**9**
5832	POLYPROPYLENE	0.37	**103**	4.98	**11**	9.90	**11**	12.05	**10**
460	MEAL AND FLOUR OF WHEAT AND FLOUR OF MESLIN	-	**-**	-	**-**	5.57	**19**	11.74	**11**
8973	JEWELLERY OF GOLD,SILVER OR PLATINUM	0.27	**118**	0.16	**87**	1.01	**71**	9.71	**12**
6724	PUDDLED BARS AND PILINGS; INGOTS,BLOCKS, LUMPS ETC.	0.01	**276**	-	**-**	0.06	**236**	6.98	**13**
6782	SEAMLESSTUBES AND PIPES; BLANKS FOR TUBES & PIPES	0.01	**279**	-	**-**	0.07	**226**	6.28	**14**
483	MACARONI,SPAGHETTI AND SIMILAR	0.74	**61**	1.60	**18**	4.95	**21**	5.85	**15**

	PRODUCTS								
2742	IRON PYRITES, UNROASTED	-	-	-	-	-	**546**	5.55	**16**
2820	WASTE AND SCRAP METAL OF IRON OR STEEL	2.47	**21**	0.45	**55**	4.07	**24**	5.36	**17**
5839	OTHER POLYMERIZATION AND COPOLIMERIZATION PRODUCTS	0.13	**163**	0.33	**62**	1.79	**41**	4.99	**18**
9410	ANIMALS,LIVE,N.E.S.,INCL. ZOO-ANIMALS	-	-	-	-	2.65	**31**	4.79	**19**
6651	CONTAINERS, OF GLASS, USED FOR CONVEYANCE OR PACKING	3.27	**18**	1.24	**23**	5.22	**20**	4.69	**20**

5. Understanding the Lagging Performance of the Private Sector

The unintended consequence of the governments' benevolent and protective philosophy is a marginalized private sector that is not competitive because: i) the enabling environment is over-regulated, ii) the public sector has crowded out the private sector in productive activities, especially those where there are clear comparative cost advantages (e.g., downstream oil activities), and iii) the overall regime of subsidies has created pervasive price distortions (World Bank, 2001). As a consequence, the private sector in Kuwait is very small. In many of the crucial activities for the Kuwaiti economy, including the oil sector, electricity, gas and water, transport and telecommunications, the share of the private sector is miniscule if not non-existent, with huge implications on employment shares and innovation potential.

A large number of economic problems can arise as a consequence of a small private sector. At the macro-economic level, the government may be unable to finance its expenditure on the long term when oil revenues drop, or if revenue is primarily generated through the profits of publicly owned companies, it may do so by distorting relative prices and exploiting monopoly power. The enterprise sector may be inefficient and not internationally competitive because of inadequate managerial incentives and a poor corporate governance structure. An insufficiently competitive market environment may also encourage inefficiency, and a stifling bureaucracy may act to limit the formation of new firms, especially small and medium-sized firms (SMEs).

Based on international experience, the development of the private sector has been achieved through three general channels: (i) boosting private and foreign direct investment (FDI), (ii) accelerating privatization of public enterprises and structural reform policies, and (iii) developing domestic small and medium sized enterprise (SME). However, the ability of a country to make progress in implementing the above three strategies is conditioned by the features of the economy itself. In particular, government policies and instruments that can represent a strong obstacle towards the development of the private sector in general and to the inflows of FDI should be identified and removed.

The following sub-sections tackle these three dimensions of the Kuwaiti economy that are categorically

reviewed in order to formulate strategies for private sector development based on the above assessment.

5.1 Attracting FDI

Kuwait has attracted very little FDI despite embedding a supportive legal framework for foreign investment, and one that is assessed by international surveys as being broadly supportive. In fact, in 2008, the UNCTAD survey ranked Kuwait 35th out of 141 surveyed countries in terms of its potential in terms of attracting FDI, thereby citing it as having a relatively good investment climate. However, the same survey ranks Kuwait 137th out of 141 surveyed countries in terms of its performance index, indicating the existence of barriers to FDI that prevent foreign investors from operating effectively. Hence, despite the fact that the investment climate in Kuwait is assessed as being hospitable to FDI, it is the performance that is not satisfactory, suggesting that the obstacles are not domestic barriers but rather that the country *per se* in terms of being a destination for FDI, is not found to be attractive by investors. The World Investment Report (UNCTAD, 2011), indicates that FDI inflows to Kuwait have only reached USD 81 million in 2010 in contrast to USD 1,114 million in 2009. On average, Kuwait has attracted only USD 278 million of FDI over the period 2005-2010. This low performance in terms of FDI did not improve with the new positive advances introduced in passing the 2001 FDI law, which was implemented in 2003 and offers better conditions for foreign investors; whereas the previous law specified 11 sectors open for FDI, the new law allows investors to become licensed to operate in Kuwait as completely foreign-owned entities in more sectors spanning across numerous and diversified economic activities, as follows: industries except for those related to oil or gas exploration or production; construction, operation and management of infrastructure enterprises in the field of water, power, drainage and communication; banks, investment corporations and foreign exchange companies which the Central Bank of Kuwait agrees to consider incorporating; insurance companies which the Ministry of Commerce and Industry agree to incorporate; information Technology and software development; hospitals and the pharmaceutical industry; land, sea and air transport; tourism, hotels, and entertainment; culture, information and marketing except for issuance of newspapers and magazines and opening of publishing houses; integrated housing projects and zone developments except for real estate speculation; and real estate investment through foreign investor subscription to the Kuwaiti shareholding companies as per the provision of Law No. 20/2002.

Prior to the 2001 FDI law, the government passed the Indirect Foreign Investment Law in May 2000, allowing the purchase of up to 100% of the stock of companies listed on the Kuwait Stock Exchange except for banks. Previously, foreign investment was not permitted in certain sectors such as banking and insurance, and was restricted to less than 49% of ownership shares in permitted areas. Foreign investors are no longer required to have a Kuwaiti sponsor, but are subject to a 55% corporate tax that Kuwaiti companies are exempt from.

However, and even with these improvements, FDI inflows did not increase. In fact, many other major barriers still persist and offset the positive reforms implemented with the 2001 FDI law. In this respect,

foreign investors coming to Kuwait find obtaining necessary licenses a very difficult and prolonged process and face obstacles in many other facets of business. To improve the attractiveness of the Kuwaiti economy, Kuwait's parliament passed a law in 2007 to reduce the tax burden on international companies for the first time in more than half a century, with corporate tax on foreign firms reduced to 15 percent from as much as 55 percent. Some of the reasons behind the low performance in attracting FDI in Kuwait are found in the 2001 FDI law itself. In fact, and based on international experiences, the publication of positive lists—sectors where FDI will be permitted—rather than negative lists, lists of sectors where FDI will not be permitted is not appropriate to attract FDI. Moreover, in setting conditions for firms to operate, no distinction should be made between nationally owned and foreign owned firms, especially in terms of taxation. Unfortunately, even in some of the "permitted activities" such as in infrastructure sectors, which are still wholly or partly state-owned, discrimination is experienced, which generates bias in the competition conditions between foreign and public investors, in favor of the latter.

Moreover, other macro factors that still characterize the business climate in Kuwait, such as, inefficient public administration and the relatively low productivity of local workers as a result of high public wages and poor education outcomes, detract from the attractiveness of Kuwait as a preferred destination for FDI.

5.2 Weight of the Public Sector in the Economy

The analysis presented in this study indicates that the small contribution of the private sector to Kuwait's GDP is attributed to two main factors. The first factor is directly linked to the various economic inefficiencies that reduce the attractiveness of the Kuwaiti economy to the private sector, including foreign investors. The second reason is attributed to the hefty weight of the public sector in the economy even in the non-oil sectors. As far as the second factor is concerned, the Kuwaiti economy is still characterized by the absence of private operators in many key sectors, such as the production and distribution of water and electricity, extraction and refining of oil, international transport and infrastructure, among others. Moreover, public enterprises are intensively active in many other sectors including banking, insurance, trade, real estate, among others. International experiences have shown that countries that experienced a significant economic transformation are those that succeeded in reducing the weight of the public sector in their economies. Estrin (2007) argues that the role of state owned enterprises in the economies of high income countries has declined from around 8.5% of GDP on average in 1984, to around 6% in 1991 and probably below 5% in 2007. Moreover, the reduction in state ownership has been even more dramatic in less developed countries, falling from around 16% of GDP in 1981 to around 5% in 2004.

5.3 Privatization

Privatization is the process whereby state owned enterprises, are sold under some sort of framework to the private sector and hence transferred to private hands. Privatization is intended to improve efficiency and innovative processes. For Dusan (1992), "privatization is not just one of the many items on the

economic program. It is the transformation itself". There is a large body of literature on the economic benefits of privatization. Vickers and Yarrow (1985) argue that transforming state owned assets into private hands can improve corporate efficiency and, particularly with the privatization of infrastructure, the benefits can spill over to the rest of the economy. Corporate governance under state and private ownership is motivated by different objectives; the former focus primarily on profit, which implies cost driven management processes that are efficiency prone, in addition to market and customer orientation. Public owned firms, on the other hand, may be interested in profits too, but this is most certainly tempered and compromised by other non-economic and politically driven motivations and targets, such as creating or maintaining employment in economically depressed regions or holding prices below average costs for redistributive purposes. The business model is different in both cases. In this situation, profits become a secondary criterion, or indeed are irrelevant, and business decisions become politicized and inefficiencies can thrive (Shleifer & Vishny, 1994). Few academic works explored the impact of privatization on economic growth. Among them, Plane (1997) looks at the effects of divestiture on growth in a sample of thirty-five developing countries. The problem of reverse causality is controlled by separately identifying the factors that determine a successful privatization program. It was found that the impact of privatization on economic growth is indeed positive, and is strengthened when privatization occurs in infrastructure or in industrial sectors. Sachs, Zinnes and Eilat (2000) use a fairly short sample period to undertake an aggregate growth study for the transition economies. It is concluded that, while privatization does not actually increase growth, there is a positive impact when the privatization process is accompanied by institutional reforms, especially in the midst of a functionally effective institutional and business environment where a competitive market is prevalent and property rights are secured..

In Kuwait, and in tandem with initiatives for privatization, the government has revamped the commercial laws, while establishing a dedicated agency for this purpose; the Kuwait Investment Authority (KIA), which oversees the players in the market. In 1992, the KIA implemented a three-phase privatization program that aims to reconstruct the economy and reduce the dependence on oil income. However progress has been extremely slow. In fact, and even before Iraq's invasion of Kuwait in 1990, there were draft plans to privatize some public holdings, though these were put on the backburner after the war as the state struggled to put the country and its economy, especially the crucial energy sector, back in working order. This was followed by initial moves in the mid-1990s to launch a privatization program. In 2004, the government approved a privatization program, based on previous plans, that took in major sell offs in the telecommunications, energy, postal, shipping interests, ports and utilities sectors. However, few of these ambitious proposals have translated into results.

Given that a number of Kuwait's state-owned enterprises operate at a loss or provide their services at a subsidized rate, as is the case with the electricity sector, these caveats would prove to be something of a disincentive to new owners seeking to restructure and indeed earn a profit. There has been some progress however. The state has privatized the majority of the 120 gas/petrol stations it owned, along

with the state-owned lubrication oil plant and the coke smelter operations in 2004. Prior to this, the state managed to sell most of the shares it had in 62 companies it acquired to assist creditors following the collapse of the unofficial stock market in 1982. One firm that has long been touted for full or at least partial privatization is the country's national carrier, the Kuwait Airlines Company (KAC), the first airline established by an Arab state. For many years a money-loser, the state-owned airline has suffered from underinvestment and growing competition, both from international carriers and more recently from local outfit Jazeera Airways. However, while all but stalled, there is a renewed push to give the privatization program new life. However, the Kuwaiti privatization program has been hindered on many fronts, not least of which has been opposition within the country's parliament. Though the legislature has passed laws to facilitate the sale of state assets, there has been no sense of urgency in pushing the program ahead. Furthermore, successive parliaments have shown a willingness to bind any privatization with the requirement that guarantees be included to ensure that there will be no job losses suffered by Kuwaiti nationals after the transfer into private hands and that the public be protected from any significant price rises. The significant budget surpluses that Kuwait experienced since 2003 have made the process of privatization more difficult with the multiple increments in public wages that have been implemented by the government since 2002, including those working in public firms.

In Kuwait, and despite some actions toward privatizing public enterprises, the weight of the public sector in the non-oil GDP is still high by international standards. In fact, privatization has been a key element of the government's economic reform program pursued since 2000. Its aims are multiple and consist of: (i) increasing economic efficiency and productivity of the economy; (2) maximizing government revenue; (3) ensuring a fair and equitable distribution of wealth; (4) attracting FDI, and (5) increasing the role of the private sector in economic activities by attracting private capital, including that which has been invested abroad. However, privatization involves many challenges as explained previously. In the context of these difficulties, privatization needs to be accompanied with policies that ensure: (1) establishment and maintenance of an appropriate enabling environment; (2) availability of required human resources; (3) availability of support infrastructure offering reasonable prospects for cost recovery; (4) domestic private sector participation in potentially profitable public enterprises; (5) overall transparency of the process and payment of fair prices for privatized assets; and (6) private ownership does not result in less transparency and accountability than the public sector ownership.

5.4 Small and Medium Sized Enterprises

Small and Medium Enterprises (SMEs) constitute the very basis of any economy and provide the effective means of stimulating indigenous entrepreneurship. SMEs demonstrate a higher degree of efficiency in using capital. SMEs also ensure structural balance in terms of small and large units and stimulate technological development and innovation. The case of Germany is illustrative of the role of SMEs in terms of technological development. They account for over a quarter of all R&D expenditures and almost half of all R&D expenditures in knowledge-intensive business services (Zimmermann, 2008). In the EU zone, 37% of small enterprises and 65% of medium enterprises have innovation

activities in 2006. Both small and medium enterprises contribute to more than half of the EU's GDP. They represent 99% of all companies in the EU. Due to their small size and lean structures, SME are potentially more dynamic than big enterprises, which makes them particularly important for job creation. But they are also more vulnerable, lacking often access to capital and to funding sources which require specific actions from policy makers, in terms of increasing their access to finances (EUROSTAT, 2008).

There is a need for a fully functional SME promotional policy, which not only stimulates the development of SMEs but also creates space for them in the export market. Before taking advantage of the changing global industrial environment based on specialization and subcontracting, the appropriate human resource and infrastructure must be in place. Kuwait is characterized by very limited entrepreneurial activity and a relative paucity of small and medium sized firms. Among the main factors behind the low development of SMEs is the high costs of entry in Kuwait compared to other countries in the GCC and the world (Figure 13).

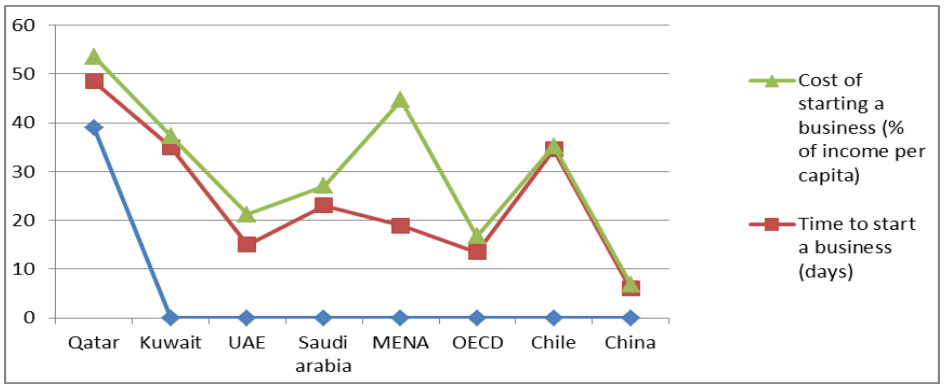


Figure 8. Costs of Entry in Kuwait and Other Selected Countries and Regions in 2015

Source: World Bank (2016): Doing Business Report.

The World Bank's "Doing Business Report" (2016) report suggests that there are significant barriers to entry in Kuwait both in terms of bureaucracy and financial costs. These barriers are in line with an economy where government expenditure represents about 70% of GDP. Kuwait is considered to be quite flexible in terms of private sector employment, which is largely dominated by foreign workers. However, labor market flexibility is much lower in the public sector, which is the predominant employer of Kuwaitis in Kuwait. Flexibility in the public sector is almost limited to foreign workers. Even in the private sector, with the quota of nationals, flexibility is also limited to foreigners. In general, Kuwait provides a poor private business environment relative to most of the countries in the GCC in particular, and in the MENA region as a whole. These deficiencies will be relevant for firms considering foreign direct investment in the country, as well as in terms of barriers to the entry of new domestic firms. The issue of bureaucracy in procedures will hamper entry processes. Thus, formal legal rights for borrowers and creditors in Kuwait are well above the regional average, and almost

comparable to the average of OECD countries. However, in terms of procedures or time taken to register property or required for contract enforcement or time required to go through an insolvency process, Kuwait is far worse than the MENA region as a whole, as well as the OECD countries. Corporate disclosure standards are also far below OECD norms, as is true for the rest of the region. The high level of bureaucratic intervention in bankruptcy and the relatively low level of recovery by OECD standards is also a particular worry when one is considering new firm entry, because exit barriers are also entry barriers, and are likely to hinder prospective new entrants.

Table 5. Regulatory Costs of Doing Business in Kuwait and Other Countries and Regions

Index	Qatar	UAE	Kuwait	Norway	Chile	OECD Countries
Ease of doing business index	5	22	86	6	41	……
Proceedures required to register	7	2	8	1	6	4.7
Time required to register property	13	2	49	3	28.5	21.8
Strength of legal rights	1	2	2	5	4	6
Proceedures required to enforce a contract	43	49	50	34	36	……
Time required to enforce contract	570	495	566	280	480	538.3
Time to resolve insolvency (yrs)	2.8	3.2	4.2	0.9	3.2	1.7
Resolving insolvency: recovery rate	56.2	29	32	92.5	31	72.3
Starting a business rank	103	58	150	22	59	……

Source: World Bank (2016). Doing Business Report.

Altogether, the evidence in figure 13 and table 6 supports the general observation that Kuwait does not provide a particularly conducive environment for private sector development, either through foreign direct investment or the creation of new firms. Unlike in the developing and transition economies analysed by the World Bank's 'Doing Business Report' (2016) in terms of cross-industry, cross-country studies, the principal entry barriers are in bureaucratic procedures and delays rather than in formal regulatory costs. Barriers in Kuwait are typically high for the region and very high by OECD standards, are critical in explaining why the private sector is so small and sluggish, and why it has failed to expand greatly even in sectors where private sector development has been rapid in other economies.

6. Conclusions and Recommendations for Strategic Reforms

Based on the analysis presented in this study that has shed light on barriers that disadvantage the development of the private sector in Kuwait and consequently its ability to diversify the economy, and based on success stories exemplified in other economies (Estrin, 2005) and (World Bank, 2002), a number of key recommendations may be proposed to address these challenges. Ideally, a strategy to enhance private sector participation in economic development should proceed along three tracks, simultaneously: Improving the enabling environment for business, to free private sector investors from

existing regulations and red tape; developing new markets and opportunities: create new investment opportunities that have comparative cost advantages, and ensuring competitiveness, sustainability and integration with the regional and world economy.

The main gaps in terms of the present agenda categorically relate to addressing financial sector reforms, opening up the downstream oil sector to the private sector and revamping the general regulatory framework to play a more supportive role. Moreover, energizing the private sector should typically cover a package of policy actions that include the following key factors:

- *Induce sound reforms of the labor market*. According WB surveys in Kuwait (World Bank, 2002), most enterprises expressed their concern regarding low labor productivity of nationals workers in contrast to foreigners which has been intensified through the programs of labor quotas implemented since mid-2000 and the successive increments in public wages.
- *Liberalize the financial sector to facilitate access to finances both for large firms and SMEs*.
- *Encourage transparency*. There is a clear positive correlation between corruption and the rigidities of economic regulations which contribute to a sense of unfairness in the business community where nepotism and favoritism plays a disruptive role.
- *Build stronger private sector collaboration with government*. In many of the "Asian miracle" countries, the key to energizing the private sector has been building strong collaborative bridges that improve the flow of information and develop trust between government and business, which encompasses; consulting with and partnering with the private sector to participate in policy development, developing a formal complaint and appeal mechanism, and incorporating "sunshine provisions" that allow for public disclosure and consultation on regulations prior to implementation. The program of Build-Operate-Transfer (BOT) is an important instrument to increase the contribution of the private sector mainly in the development of infrastructure. The private sector is believed to be the only way to improve efficiency, increase supply, and reduce costs. Privatization policies should move in parallel with other initiatives to improve interests of private investors to operate in the Kuwaiti economy.
- *Build a competitive private sector*. A package of policies would allow the private sector to become competitive, but it will not create markets—the lack of which stands as a major disadvantage for the development and growth of the private sector. In this respect, reinforcing regional integration with neighboring countries and free trade agreements with others may create new markets for existing produced products and new goods.
- *Improving business competitiveness (labor market rigidities)*. Expatriate workers, mostly in the private sector, lack mobility within the sector and nationals are not widely employed in the private sector. Reducing the costs of hiring expatriates through the reform of the "Kafil System" which prohibits expatriate workers to change jobs, is imperative and a critical pre-requisite to reinforce the productivity of labor and reduce costs for firms. Control of incentives for national workers and linking wage increments to labor productivity or inflation is also required, to reduce their feedback effects on

expatriate workers, especially those that are highly skilled. Improving business competitiveness through easing industrial licensing procedures should also be streamlined. Land regulations are linked to industrial licenses and major reforms should be implemented through better access of private operators to land at acceptable or more moderate costs.

In aggregate these measures emanate from sound policy reforms that collectively contribute to Kuwait's long term economic competitiveness.

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Notes

Note 1. This index is also commonly known as the Hirschman-Gini index (Massel, 1970; and Svedberg, 1991), or Gini-Hirschman Index (ESCAP, 2004), and also commonly refers to as the Herfindahl-Hirschman index or the "H" index (Adelman, 1969).

Note 2. See UNCTAD, 2004, p. 405, p. 414.