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November 19, 2024

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ADVANCING ECONOMIC DIVERSIFICATION IN KUWAIT: REFORM PRIORITIZATION AND SEQUENCING[1]

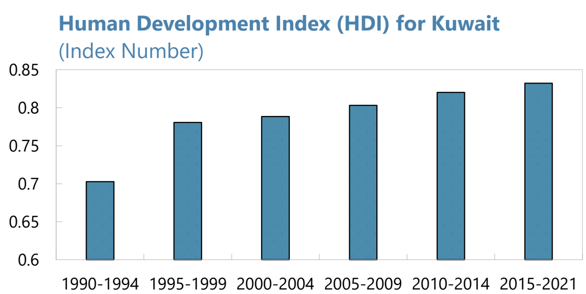
Kuwait has made progress in improving living standards over the past decades; however, sustaining these improvements has been challenging amid limited economic diversification. This paper emphasizes the need for accelerating reforms in governance, regulatory quality, external sector, labor market, and credit market to drive non-oil growth and bolster economic resilience. The findings suggest that adopting a strategic sequencing of reforms that prioritizes first-generation reforms, including improving governance and regulatory quality and enhance trade facilitation to open up the external sector, followed by labor and credit markets reforms, can amplify initial non-oil growth dividends.

A. Introduction

1. **Although Kuwait has made significant strides in improving living standards over the past decades, sustaining these improvements has been challenging amid limited economic diversification.** This progress is reflected in steady improvements in the Human Development Index (HDI), showcasing advancements in health, education, and income levels[2]. Nevertheless, Kuwait's transition toward sustaining these gains faces hurdles, primarily due to its limited economic diversification. Unlike regional peers such as Saudi Arabia and UAE, where diversification has helped support growth in real incomes, Kuwait has experienced a downward trend.

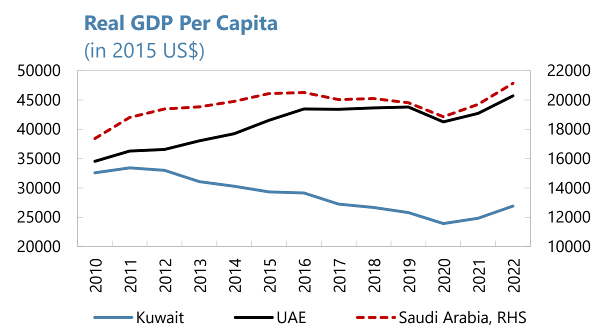
Figure 1. Key Macroeconomic and Development Indicators in Kuwait

Kuwait's living standards have seen notable improvements …



Sources: UNDP Human Development Report and IMF Staff Calculations.
Notes: The HDI is the geometric mean of normalized indices for life expectancy, education, and gross national income.

Nevertheless, Kuwait's real GDP per capita has been on a declining trajectory, contrasted with the rising real incomes of its regional peers.



Sources: World Bank Development Indicators and IMF staff calculations.

[1] Prepared by Muayad Ismail.

[2] HDI is a measure for assessing average performance in three basic dimensions of human development: (1) a long and healthy life, (2) access to knowledge, and (3) a decent standard of living. It is calculated as the geometric mean of normalized indices for life expectancy, education, and gross national income.

2. The progress toward economic diversification in Kuwait has been hindered by regulatory and governance challenges, labor market rigidities, and political gridlock. Addressing these challenges through targeted reforms would help to close structural gaps, foster diversification, and improve resilience to shocks. Drawing on the methodology of the IMF (2023a), this paper quantifies the potential impact of structural reforms on non-oil output and explores optimal prioritization, sequencing, and integration strategies necessary to maximize non-oil growth dividends.

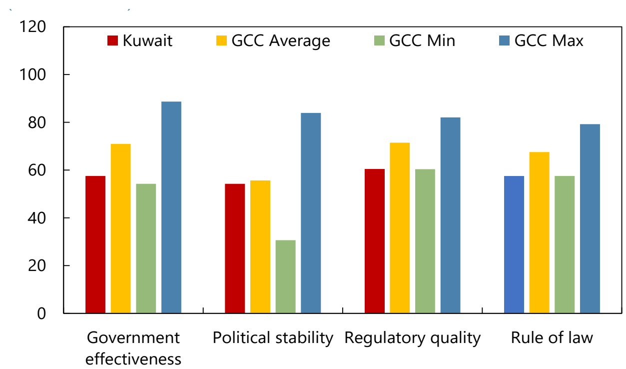
3. The rest of this paper is organized as follows. Section II delves into the progress and prevailing challenges of economic diversification in Kuwait. Section III quantifies the potential impact of structural reforms and identifies most effective sequencing and integration strategies of these reforms. Section IV highlights Kuwait-specific policy options to accelerate the diversification process. The paper concludes with Section V, synthesizing key conclusions.

B. Progress of Economic Diversification in Kuwait

4. Kuwait Vision 2035 and successive National Development Plans (NDPs) have helped partially reduce structural gaps. This strategy seeks to reposition Kuwait as a financial and commercial hub in the region, diminishing the country's reliance on oil revenues and to steer the Kuwaiti economy towards a more diversified, knowledge-based economy. In this context, the authorities implemented a series of structural reforms that have helped reduce structural gaps with leading economies in the areas of governance, business regulation, external sector, labor market, and credit market. Key structural reforms include:

- **Governance:** Kuwait embarked on governance reforms to improve the integrity and efficiency of its economic and legal systems, including several legislative packages to promote competitive markets, establish anti-corruption authorities, enhance judiciary effectiveness and transparency, modernize and prevent conflict of interest in government procurement and public tenders. However, Kuwait still faces significant governance challenges.

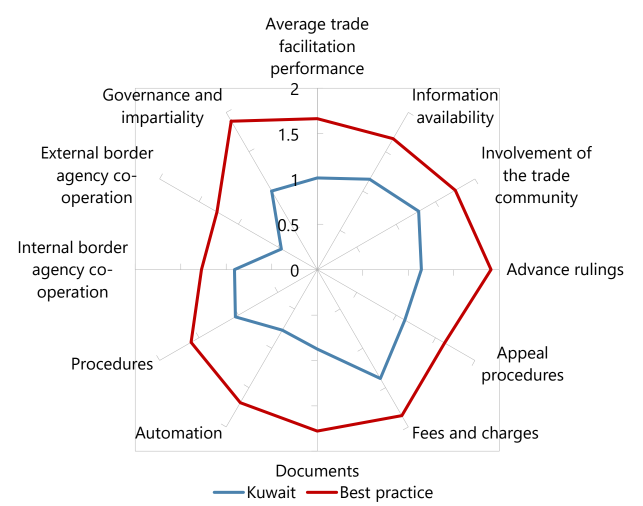
Figure 2. Governance Indicators, 2022
(Percentile Rank)



Sources: WBG Worldwide Governance Indicators.

- **External Sector:** Kuwait has implemented several key reforms aimed at improving international trade and bolstering its external sector. These included introducing a single customs window system, developing free trade zones, and signing bilateral trade agreements to encourage foreign investment. Nevertheless, there remain challenges facing trade facilitation such as cumbersome border procedures and limited automation relative to best international practices.

Figure 3. Trade Facilitation Performance in 2022

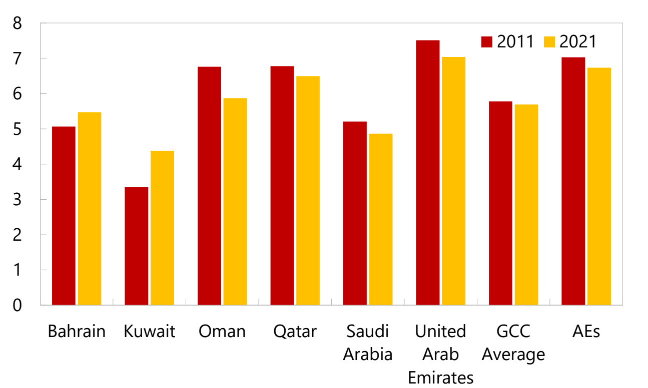


Source: OECD Trade Facilitation Indicators and IMF staff calculations.

- **Credit Market:** The financial sector in Kuwait is well-functioning and performs well relative to MENA peers. The authorities have attempted to bolster the small and medium enterprises (SME) sector by creating the National Fund for the Development of Small and Medium Enterprises. However, the National Fund paused its SME financing activities since the COVID-19 pandemic.

- **Business Regulation:** Reforms to promote FDI, foster digitalization, and improve the functioning of government commercial agencies helped reduce regulatory gaps but business and regulatory inefficiencies remain, such as high bureaucracy costs.

Figure 4. Overall Business Regulation
(Score: 0 to 10, highest)



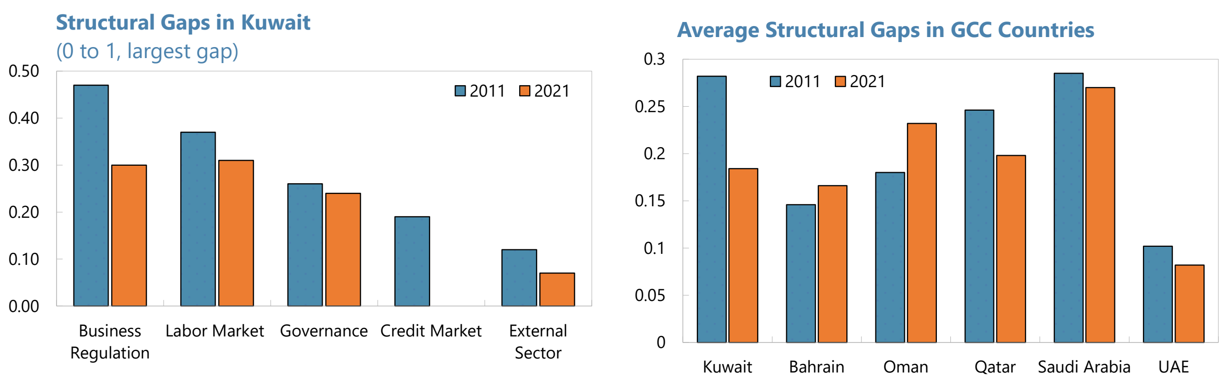
Sources: Fraser Institute Database and IMF staff calculations.
Note: Overall business regulations score is computed as a simple average of three sub-components: (1) regulatory burden; (2) bureaucracy costs; and (3) impartial public administration

- **Labor Market:** Key reform initiatives included the establishment of the Public Authority for Manpower in 2013 to oversee labor market regulations and protect workers' rights, the introduction of unemployment insurance for Kuwaiti nationals, and enhancements in accreditation of professional degrees. Notwithstanding these reforms, labor market segmentation, driven by the public sector's higher wages and benefits compared to the private sector, poses a significant barrier to economic diversification in Kuwait (IMF 2016).

- **The Government Work Program (2024-2027), proposed by the previous administration in Kuwait, outlines key legislative agenda aimed at fostering economic diversification and sustainable growth.** Key proposals include the Business Profits Tax Legislation and Excise Tax Law to bolster non-oil revenues, and the Liquidity Instruments Law to facilitate government borrowing and deepen financial markets. Other important proposed structural reforms include amendments to the PPP Law, the Draft E-Commerce Law, and amendments to the Public Tender Law.

5. **Despite structural reform initiatives and ambitious strategic objectives, Kuwait's progress in economic diversification remains limited.** A recent report issued by the General Secretariat of the Supreme Council for Planning and Development indicates that progress in achieving the goals of the Kuwait Vision 2035 has been limited (GSSCPD, 2024). In parallel, the strategic framework for reform prioritization proposed by Budina et al., 2023 allows for quantification of Kuwait's structural gaps relative to EMDES. This framework suggests that Kuwait should focus on governance and business regulation reforms, areas in which Kuwait faces the largest structural gaps. Kuwait faces smaller gaps relative to EMDEs in the external sector and credit market, while results for the labor market are not applicable to Kuwait given its market segmentation.

Figure 5. Structural Reform Gaps in Kuwait and GCC Countries



Source: Budina, et al., 2023, the RES Structural Reforms Dashboard, and IMF staff calculations.
Notes:
• Structural gaps are defined as the differences in performance indicators between Kuwait and the leading countries in each category (referred to as the 'frontier'), with larger values indicating more significant gaps. Gaps are set to zero when a country is above the selected comparator group frontier.
• The average structural gap for GCC countries is computed as the simple average of the structural gaps across governance, business regulation, external sector, labor market, and credit market.

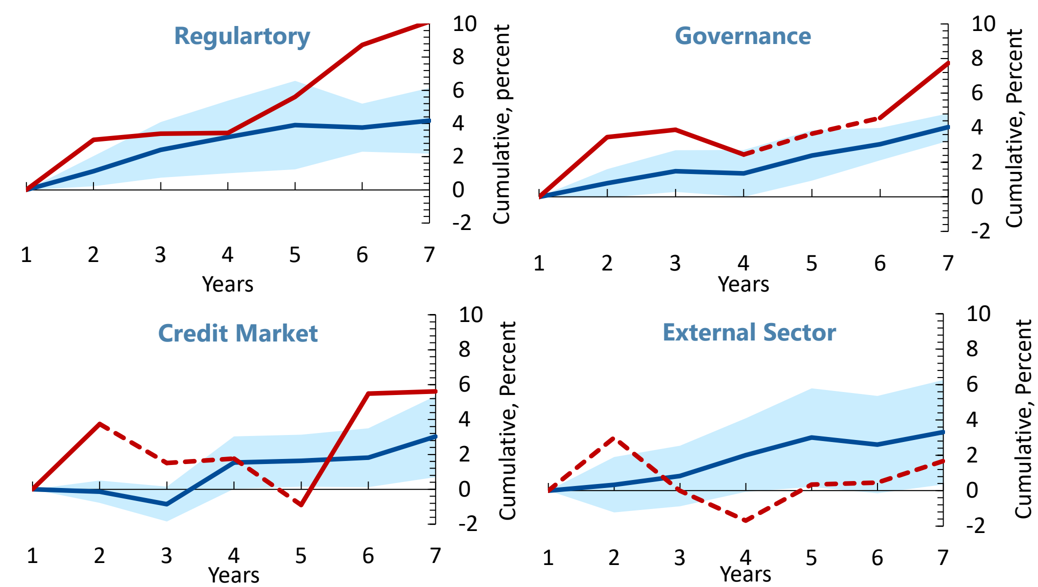
C. Quantifying the Impact of Key Structural Reforms

6. **This paper adopts the methodologies described by the IMF (2023a) and Budina et al., (2023) to quantify the impact of structural reforms on non-oil growth.** It estimates the effects of key structural reforms—specifically governance, regulatory quality, external sector, labor market, and credit market—using the local projections method by Jordà (2005). This method was applied to

a dataset comprising oil-exporting countries, including Kuwait, as detailed in Annex 1 and Annex 2. This approach allows for a nuanced analysis of the structural reforms' impacts across a diverse set of economies sharing similarities with Kuwait's economic structure. This paper also employs the new Structural Reforms toolkit developed by the IMF Research Department to estimate Kuwait-specific reform dividends.

7. The empirical results suggest reforms aimed at improving the regulatory quality and governance yield the highest non-oil output gains, with increasing magnitudes over the medium term. Specifically, non-oil growth can increase by about 4.2 percent and 4.0 percent five years after implementing regulatory quality and governance reforms, respectively. Meanwhile, external sector and credit market reforms can result in increases of about 3.3 percent and 3.0 percent, respectively, in non-oil output five years after their implementation.

Figure 6. Impact of Structural Reforms: The Baseline versus Low Growth Scenario



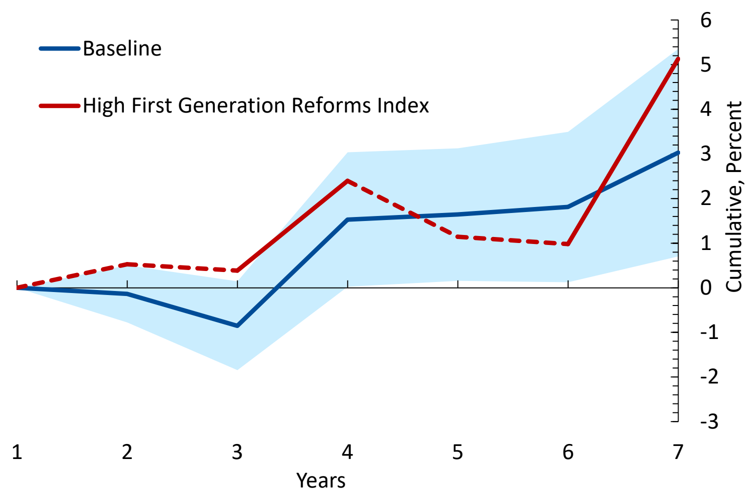
Note: The scale of the x-axis is years, where t = 0 is the first year of the reform is implemented. y-axis denotes the cumulative change in non-oil output. The blue lines denote the responses to structural reforms, defined as two standard deviations of the annual change in the respective structural index. The shaded areas denote 90 percent confidence bands. The red lines denote the responses when growth is low, where the solid (dashed) lines indicate statistically significant (insignificant) responses at the 90 percent level.

8. Some reforms could yield larger non-oil output gains during periods of low growth. Enhancements in regulatory quality and governance could yield non-oil growth dividends during economic downturns that are more than double the gains under the baseline[3]. Additionally, reforms in the credit market can lead to greater non-oil output gains relative to baseline growth conditions.

[3] To identify periods of economic downturn, a country is considered to have weak economic activity or low growth for a specific year when it experiences below-median growth during that period.

9. Strategic sequencing and packaging of structural reforms could amplify initial non-oil growth gains for oil exporting countries. A first-generation reform package encompassing governance, regulatory quality, and external sector reforms will help augment the non-oil growth dividends from subsequent reforms in the credit market. Medium-term non-oil output gains from credit market reforms could increase by about 2 percent over the baseline when preceded by first-generation reforms (Figure 7).

Figure 7. Impact of Credit Market Reforms: The Baseline versus High First-Generation Reform Index



Note: The scale of the x-axis is years, where t = 0 is the first year of the reform is implemented. y-axis denotes the cumulative change in non-oil output. The blue lines denote the responses to structural reforms, defined as two standard deviations of the annual change in the respective structural index. The shaded areas denote 90 percent confidence bands. The first-generation reforms index is defined as an average of governance, regulatory quality, and external sector indices. The red lines denote the responses when first-generation reforms index is above the sample median, where the solid (dashed) lines indicate statistically significant (insignificant) responses at the 90 percent confidence level.

10. Closing the gaps in first-generation reforms presents Kuwait with substantial low-hanging fruit, setting the groundwork for impactful labor market reforms. Kuwait's total output could increase by about 2.5 percent in the short-term by halving the first-generation reforms' gap with emerging market economies, which stood at 18 percent in 2020.[4] Additionally, implementing broad-based labor market reforms that align incentives between the public and private sectors could raise non-oil output by about 5.2 percent relative to the baseline (IMF, 2023b).[5]

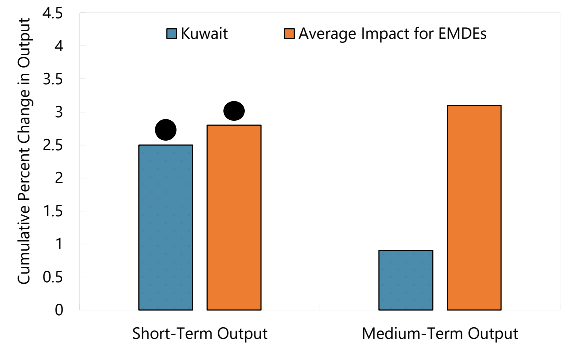
[4] Structural gaps range between 0 and 100, where larger values indicate larger gaps relative to the frontier and negative gaps are set to zero when a country is above the selected comparator group frontier.

[5] The Structural Reforms Dashboard toolkit currently lacks wage regulation indicators, which are crucial for assessing the potential impact of Kuwait's labor market reforms. This could lead to underestimating the non-oil growth dividends from such reforms.

D. Policy Considerations

11. While reforms under the previous national development plans have helped reduce structural gaps in Kuwait, addressing the remaining gaps is crucial to fully realize the country's economic diversification goals. This section provides an overview of reform recommendations presented in recent IMF reports to complement the sequencing proposed above.

Figure 8. Impact of Closing Half of the First-Generation Reform Gap on Output



Source: The estimated impacts of structural reforms are derived from the Structural Reforms Dashboard developed by IMF Research Department in 2024.
Notes: The y-axis is the cumulative percent changes in output and employment while the symbol "●" indicates that the impacts are statistically significant at the respective time horizon.

- **Governance:** The authorities need to enhance the rule of law, including by strengthening judicial independence, enhancing contract enforcement, and improving the protection of property rights. These efforts could also benefit from improving fiscal governance by enhancing the quality and coverage of fiscal reports and strengthening public procurement processes and fiscal risk assessments (IMF, 2021).

- **External Sector:** The authorities should address trade facilitation weaknesses, highlighted in the latest OECD Trade Facilitation Indicators report, including by streamlining customs and border procedures, enhancing automation, and improving the availability of trade information. Accelerating ongoing and planned infrastructure projects, including the expansion of Kuwait International Airport, Mubarak Al Kabeer Port, and rail networks, can also help facilitate international trade. Additionally, allowing full foreign ownership of businesses and relaxing land ownership restrictions will further attract FDI, providing essential capital for non-oil growth.

- **Credit Market:** Priority measures include phasing out interest rate ceilings on commercial loans and introducing risk-sharing mechanisms, such as credit guarantee schemes to facilitate more efficient risk pricing and expand credit supply to SMEs (IMF, 2019, 2023). Enacting the Liquidity Instruments Law can help develop domestic debt market as well as further deepening credit markets (IMF 2023).

- **Business Regulation:** Priority areas identified in previous IMF work include simplifying and digitizing business and regulatory procedures, introducing regulatory impact assessments, developing a formal framework for public consultations throughout the regulatory process and increasing public awareness and utilization of the Competition Protection Agency (IMF, 2023b). Allocating more land for commercial development purposes can help attract both domestic and foreign investments (IMF, 2023b). Additionally, boosting transparency through better data disclosure practices and adopting universal auditing standards for corporate financial statements will create a conducive business environment for domestic and foreign investment.

- **Labor Market:** Broad-based labor market reforms are needed to improve productivity and foster diversification. Recommendations from IMF (2023b) include implementing a labor market reform package focused on eliminating restrictions on hiring and firing workers, aligning incentives between public and private sector jobs, linking pay and promotion with performance, and adopting more flexible labor market policies for expatriates, and investing in education and vocational training that closely align with the evolving demands of the private sector and diversified economy. This involves identifying and focusing on high demand areas such as digital technology, entrepreneurship, and green energy (World Economic Forum, 2023; ILO, 2018).

E. Conclusions

12. Kuwait's national development efforts, driven by Kuwait Vision 2035 and successive plans from 2010 to 2020, have helped narrow structural gaps, setting a foundation for economic diversification and resilience. Notwithstanding these advancements, the transition toward a diversified economy encounters persistent barriers, including regulatory and governance hurdles, labor market segmentation, and a business environment that deter the shift away from oil dependency. This paper underscores the importance of accelerating structural reforms to foster economic diversification, sustain living standards, and bolster resilience against external shocks.

13. The empirical findings indicate that implementing structural reforms, informed by strategic sequencing and careful packaging of sectoral reforms, can substantially bolster non-oil growth. The results suggest that implementing structural reforms could yield larger economic gains during economic downturns, which is particularly relevant for Kuwait given the currently low growth environment. Furthermore, the findings indicate that adopting a strategic sequencing of reforms that prioritizes first-generation reforms, including improving governance and regulatory quality and opening up the external sector, followed by reforms in the labor and credit markets can amplify initial non-oil growth dividends. This strategic approach emphasizes the foundational role of governance, regulatory quality, and external sector reforms in setting the stage for broader economic diversification and resilience.

Annex I. Quantifying the Impact of Structural Reforms

1. **The impact of major structural reforms—namely labor market, regulatory quality, governance, external sector, and credit market reforms—on non-oil output was estimated using the local projections method developed by Jordà (2005).** The estimation sample consists of 22 oil exporting countries, including Kuwait, distributed across different regions and spans the period from 2000 to 2021 at annual frequency. This group of countries share similar economic structures with Kuwait. It is important to note that the exact impact of structural reforms is difficult to be estimated given that these reforms vary widely in their nature, scope, and implementation mechanisms across different countries and sectors. Therefore, the results are subject to uncertainty, but the analysis provides a broader assessment of the direction, relative size, and importance of reforms. Furthermore, the structural reforms and policies should be tailored to country economic, political, and social conditions to enhance their probability of success.

The baseline local projections model takes the form:

$$y_{i,t+k} - y_{i,t-1} = \beta_k S_{i,t} + \delta X_{i,t} + \alpha_i + \theta_t + \varepsilon_{i,t}$$

Where $y_{i,t}$ denotes the log of non-oil output; t and i are the time and country dimensions, respectively; and k=0,1, 2,…5. $S_{i,t}$ is the structural reform variable, defined as the change in the structural reform indicator; $X_{i,t}$ is a set a of control variables, including lags of the dependent variable and past reforms; α_i denotes country fixed effects, incorporated to control for unobserved cross-country heterogeneity; θ_t is the percentage change in oil prices.

2. **Each structural reform indicator is computed as a simple average of normalized index values of sub-indicators.** The labor market regulations indicator is a simple average of two components: hiring and firing regulations and centralized collective bargaining. The trade and external sector reforms index is computed as the simple average of four sub-indicators: (1) tariffs, which aim to measure to what extent tariffs can be a barrier to trade freely internationally; (2) nontariff trade barriers; (3) black market exchange rate, which aims to capture the disparity between the official and the parallel market exchange rate; and (4) control of the movement of capital and people, which encompasses a country’s degree of financial openness, restrictions to visitors, and whether capital controls are in place. The credit market indicator consists of ownership of banks, private sector credit, and interest rate controls. The governance indicator the simple average of voice and accountability, political stability and absence of violence and terrorism, government effectiveness, the rule of law, and control of corruption. The indicator for regulatory quality from the World Bank Governance Indicators is used as a proxy for business regulations.

Annex II. List of Oil Exporting Countries Included in the Sample

1	Algeria
2	Angola
3	Azerbaijan
4	Bahrain
5	Brunei Darussalam
6	Chad
7	Republic of Congo
8	Ecuador
9	Gabon
10	Iran
11	Iraq
12	Kazakhstan
13	Kuwait
14	Libya
15	Nigeria
16	Oman
17	Qatar
18	Saudi Arabia
19	Trinidad and Tobago
20	United Arab Emirates
21	Venezuela
22	Yemen

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