Strength in unity
Making the GCC the sixth largest economy in the world
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We would like to thank Khalid Shahin for the artwork featured throughout this report.
Growth Drivers

In today's challenging market conditions, both governments and businesses know they have to change the way they run their operations - looking for opportunities to cut costs and enhance revenues. The real difficulty is to find the optimal balance between these two options that positions them not just to survive, but to compete for growth now and in the longer term. **One of the key opportunities that the GCC has both to attract new revenue sources and to optimize costs is integration.** That may seem both unrealistic and irrelevant as governments rush to tackle the fallout from low oil price, but we are not talking about coordinating monetary or fiscal policy. In this Growth Drivers report, we argue that **removing the remaining barriers to intra-regional trade and investment could boost efficiency and promote growth and diversification.**

In the 1990s, low oil price led GCC governments to recognize there was strength in unity. That push produced the customs union and common market that citizens and businesses take for granted today. These achievements deserve to be recognized, but they remain unfinished. **Lengthy border checks and lack of regulatory alignment mean that journeys that should take just a few hours require three to four working days, making the GCC a weak link in global supply chains.**

**Foreign investors are still unable to treat the GCC as one large market.** Existing regulations mean that companies still need multiple strategies for the six GCC markets – and foreign investment flows to the GCC as a whole have halved since 2010, despite the advances in integration. With Iran fast emerging as an investment target for the region, it is crucial that the GCC moves quickly to close loopholes, streamline regulations and align them across the region.

EY has developed an integration model to measure the economic impact of removing the remaining non-tariff barriers (NTB) that hold back trade, investment and productivity. **Our analysis shows that removing obstacles to trade and investment could boost the GCC economy by US$36 billion** – with 96% of the gain coming from the removal of bureaucratic barriers to efficiency. The benefits would be spread across all six economies, with the strongest gains in Bahrain, Oman, Saudi Arabia and the United Arab Emirates (UAE). The most significant impact comes not from boosting intra-GCC trade, but from making the region's trade and investment relations with the rest of the world easier.

Our research suggests that, if the GCC continues to grow at an average of just over 3% for the next 15 years and overcomes its fragmentation, **it could become the sixth largest market in the world by 2030.** A single market without the bottlenecks and red tape that currently fragment the region would be a significant lever to help sustain growth at this level.
GCC economies are facing a decisive moment. With oil price falling, they have to accelerate the creation of growth drivers that do not rely on oil revenues. To do that, they need to make multiple changes simultaneously – overhauling laws and regulations, shifting incentives and removing bottlenecks – while developing new revenue sources for the long term.

Governments are already responding to the challenge, introducing measures that would have been unthinkable just a few years ago. But the GCC is missing one lever that could help boost the private sector, create jobs and attract serious levels of foreign investment – creating an open and competitive GCC single market.

It was in the depths of the oil price crisis of the 1990s that GCC governments first decided it was vital to strengthen their economies by integrating them economically. Within less than a decade, they had launched both a customs union and a common market, introducing a solid framework for the free movement of goods, and of labor and capital for GCC nationals.

Implementing the details of that framework dragged out, as a steady boom in oil price reduced the sense of urgency for economic integration. The urgency is back – but GCC governments are still focusing on how best to use their reserves to diversify their own economies. To date, that has meant competing with each other on downstream industrial projects and, in sectors such as aviation and finance, nurturing national companies. It is time to take a fresh look at the power of GCC integration to strengthen the region’s economies.

In this report, we argue that forging ahead with a less idealistic and more pragmatic version of economic integration could bring three big benefits as governments respond to the oil price crisis. Firstly, removing the many bottlenecks to intra-regional trade and investment, while cooperating on joint infrastructure projects, would make it easier for GCC companies to become globally competitive and bring the benefits of scale and efficiency to the diversification drive.

Secondly, creating a single market with foreign investment regulations that are both streamlined and aligned would make it more attractive for global companies to invest heavily in the GCC market as a whole. That move would not only bolster investors’ confidence by increasing transparency and predictability, but could provide more fluid investment into the GCC. For the GCC, it would create jobs and provide a new source of revenue through fees, or potentially even taxes in the future.

Thirdly, the process of gradually developing stronger and more autonomous GCC institutions to implement and monitor the single market could improve policy effectiveness, execution and predictability across the board. It could also create a firmer basis for implementing joint infrastructure projects and pushing through difficult policy initiatives, such as the introduction of taxes. Finally, we highlight the key steps for governments and business to consider to drive forward GCC integration.

There would be sacrifices. National governments would need to give up some sovereignty to create effective GCC institutions that can help drive change. Local monopolies would fade as countries open up to competitive markets and foreign investment. Creating common projects and platforms would require a shift in mindset. But we argue that the benefits of introducing a modern and dynamic GCC single market would outweigh the costs – and facilitate the wider transformation that is already underway.
Where efficiency meets integration
The low oil price has transformed the GCC policy and business agenda. The focus has shifted, in just a few months, from long-term strategies and visions to better budget allocation, sustainable cost reductions, new revenue streams and efficiency. The tools to optimize costs and enhance revenues have been honed since the crisis in mature markets, where austerity-thinking has shaped both public and private sectors. The need now, in the GCC, is to ensure that the lessons are learnt from this experience, in particular finding strategic solutions that tackle urgent pressures, while providing the means to finance growth and greater productivity.

The sweet spot of cost optimization is to be found between maximizing market opportunities, cutting costs, improving operational agility and building confidence with stakeholders. For GCC businesses and governments, one key lever to cut costs, improve efficiency, build new markets and introduce new revenue streams is to build on the success of integration. Red tape and costly border controls, for example, raise prices for citizens, raise the cost of doing business and reduce its efficiency and attractiveness within global supply chains, while raising government costs. Eliminating border controls and border delays would take investment in security technology, a dialogue between business and government to identify bottlenecks and the streamlining of regulations – but could optimise costs and enhance efficiency.

Distinguishing between what is urgent and what is important – and finding the right balance – is a tough task. By focusing on cost optimization, GCC organizations can ensure they take a strategic approach to transformation and not a tactical one.

Enhanced revenues and improved productivity

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The plummeting oil price has reminded GCC governments of the short window of opportunity they have to create economies that are not dependent on oil revenues. The past five years have seen some progress, especially in building infrastructure, but long-term progress in diversification was, at times, sacrificed to achieve short-term goals, such as maintaining social peace and protecting vested interests.

The next five years must focus on investing for long-term stability and prosperity by generating new sources of income and optimizing costs. Again it will be important not to sacrifice the progress that has been made to achieve quick cost-savings that ultimately damage the potential for sustainable long-term growth. This is particularly essential with GCC integration, which has taken a back seat as countries focus on their own urgent domestic agendas. It is clearly not essential right now to push on with large joint infrastructure projects or pursue goals, such as monetary integration, for which there is no consensus. What is essential is to leverage the potential the GCC has to boost trade, attract new revenues and work together to cut unnecessary costs.

Three main areas of action are needed. The first is to make it easier for foreign companies to invest serious amounts of money in the region. Allowing them to treat the GCC as a single market would be an important step in that direction, but it is also crucial to create a stable, transparent and predictable regulatory environment for investors. That means introducing laws that welcome and protect foreign investment, minimizing the need for free zones and reduce the potential for institutions to block licenses without adequate reason. With Iran now open for business, the GCC must act quickly to encourage and facilitate investor interest.

Secondly, governments need to look more seriously at introducing taxation to gradually replace oil income as the main source of government revenue. Value-added tax (VAT) is already under discussion and most of the GCC countries will be working to implement by 1 January 2018 to avoid distortions arising from intra-GCC trade. But for the long term, governments will also need to look at increasing tax revenue in other ways too. Oman is already planning to bring all companies into its tax regime, but other governments will also need to consider taxing businesses and employees.

Thirdly, governments and businesses alike need to focus on driving more efficiency through sustained cost and revenue optimization programs. It will be vital to keep cutting government subsidies for energy and water. The UAE, Qatar and Saudi Arabia have already pioneered the first cuts, but these remain limited, and governments are still very wary of raising prices. Despite their many differences, GCC countries face many of the same challenges and can achieve more when they work together to tackle them.
Integration and growth: becoming the world's sixth-largest economy

If you raise the topic of GCC integration in the region today, you will typically get three types of response. Yes, it would be a good thing, say some, but not a priority in the light of the urgent need for GCC countries to transform their oil-dependent economies. Yes, it would make fragmented markets more attractive to investors, say others, but it’s naïve to expect that GCC countries will take the bold steps needed. Many agree that GCC integration is a unique achievement in the Middle East and North Africa (MENA) region, but also argue that it is of only limited value — integrating the Arab region, they say, would be the far more important prize.

All three responses are right, up to a point. Governments in the GCC are now focused on how they will raise fiscal revenues, create jobs and shift momentum to the private sector without destabilizing their countries, rather than on how to work more closely together. Investors would like a unified GCC market, but have found ways to work around the obstacles. There are certainly limits to the synergies that can come from markets that are similar to each other both in what they export (hydrocarbons) and what they import (food, vehicles, consumer products and machinery). Integrating the Arab world’s big labor resources with its oil wealth would be the far more powerful step.

The reality, however, is that moving beyond today’s limited level of economic integration to create a truly integrated single market could facilitate the kind of urgent change that is needed in many different areas. It could help turn the private sector into a growth driver, attract the heavyweight foreign direct investment that could boost employment and provide a firm basis for cooperation across the wider MENA region over the long term.

So far, the achievements of GCC integration have largely come from steps that have had tangible gains for everyone — removing tariffs, waiving visas and creating common infrastructure. Many of the changes needed to achieve a fully functioning single market are less simple, and they would weaken the protection from competitive forces that many citizens, companies and public officials have come to enjoy in GCC markets. Taking these steps could, however, bring significant future gains in terms of higher productivity, faster diversification, better institutions and a stronger global presence for the GCC — topics we have explored in earlier reports in our Growth Drivers series.

The environment is ripe. GCC governments are now exploring options and taking decisions that have been avoided over the past decade — ending subsidies, opening up to foreign investors, introducing taxation and cutting jobs in the public sector. There are signs that serious change has begun. The UAE, Qatar and Saudi Arabia have reduced fuel subsidies; the latter has removed ownership thresholds in some sectors and revamped budget allocations. GCC-wide discussions on introducing VAT are more advanced than ever before.

These reforms could be less disruptive and more effective as part of a wider push toward rekindling and modernizing the drive toward a single GCC market. That could bring the benefits of scale and efficiency to the diversification drive, and strengthen the most productive parts of the private sector by introducing more competition and more jobs. It would also provide a framework of stability and cooperation to help balance the uncertainties of change.
**Economic boost**

The economic impact could be substantial too. If the GCC were to become one single market instead of six separate ones, it would be the ninth-largest economy in the world today – similar in size to Canada and Russia, and not far from India. If it is able to keep growing at an annual average of 3.2% for the next 15 years, it could become the sixth-largest economy in the world by 2030, hovering just below Japan.

**Figure 1: Gross domestic product (GDP) projection to 2030**

The GCC is currently the ninth-largest economy. Sustaining growth is essential – 2020 is the inflection point. An annual growth of 3.2% would make the GCC sixth-largest economy.

Over the past decade, GCC economies have grown rapidly, but labor productivity has stagnated or fallen. In the UAE, where the statistics are most complete, value added per worker fell by almost 4% during the boom years from 2002 to 2011. Over the 10 years to 2013, Saudi Arabia’s productivity declined a further 4.3% points behind that of the USA. Economic growth, in other words, has been a result of the expanding population and labor force, not improved productivity.

EY has developed a model to explore the impact on GDP of removing the many non-tariff barriers that hold back intra-GCC trade and investment. Our analysis shows that a fully functioning single market could reduce overall trade costs in the GCC, boost productivity and attract higher levels of foreign direct investment. Together, these growth drivers could boost GDP by 3.4% or US$36 billion, with increases of between 3.5% and 4.1% in the UAE, Saudi Arabia, Oman and Bahrain (see Methodology on page 22).

**Figure 2: Impact of reduction in non-tariff barriers on US$m GDP**

But with oil revenues declining, growth will not reach this level unless governments can harness the potential of their growing populations. Moving decisively to the next stage of GCC integration could bring some benefits in the form of lower trade costs and a higher level of intra-regional trade. The far greater effect, however, would be to boost long-term productivity levels by increasing competition in the private sector, attracting significantly higher levels of foreign investment and creating more streamlined and effective institutions to enable world-class business.
The most significant impact comes not from boosting intra-GCC trade, but from removing efficiency barriers that would make GCC companies more productive and trade and investment relations with the rest of the world easier and less costly.

Figure 3: Impact of removing non-tariff barriers on GDP

Immediate impact on intra-GCC trade

Rent-creating barriers

Efficiency barriers

Trickle down to trade with non-GCC trade partners

US$0.1b

US$1.3b

US$12.4b

US$21.7b

Removing non-tariff barriers – understanding the impact

We have used a trade policy model to understand the economic impact on GCC countries of reducing non-tariff barriers (for full details, please refer to the Methodology on page 22). We classify these into two categories:

- Rent-creating barriers (demand side), such as commercial licensing regulations that protect domestic interests in the form of increased profits.
- Efficiency barriers (supply side) that act as “sand in the wheels” of global trade as they raise production costs; for instance, through specifying technology or standards that must be used in production. In the context of the GCC, non-automated customs controls, non-harmonized standards, multiple permits, weak personnel and so on reduce the efficiency of trade.

We estimate that regional integration will result in a reduction in trade costs among GCC countries of approximately 12%, split equally across the two types of barriers. This reduction in costs will also lower trade costs between the GCC and the rest of the world, which would also benefit from initiatives such as streamlined intra-GCC customs processes. We model the impact of this trickle-down effect as a reduction in costs of 4%, again, equally split among the two types of barrier.

Although the cost reduction in trade costs with the rest of the world is smaller, the impact on GDP is substantially higher due to the low share of intra-GCC trade. The trickle-down effect accounts for 96% of the total GDP gain. Similarly, the impact of removing efficiency barriers is significantly higher than that of removing protective rent-creating barriers, yielding 65% of the overall GDP gain. That’s good news for the GCC, since it suggests that the more urgent changes are the easiest to implement. It also suggests that the similarity of trading profiles within the GCC does not prevent integration from bringing sizeable economic benefits.

“It is difficult to explain to your business community why it makes sense to open up to competition.”

Tarek Sultan, CEO, Agility
GCC integration so far – achievements and impact

European Coal and Steel Community formed
1951

Agreement to form single market and aim for monetary union
1970

Intra-GCC tariffs abolished
1983

Customs Union launched
1958

Common market implementation begins
1981

Single market launched
1992

Gulf Monetary Council established
2003

Customs Union launched
2001

European Central Bank set up
2015

Year 1

Year 64
1951 - European Coal and Steel Community formed
1958 - Agreement to form single market and aim for monetary union
1970 - GCC formed
1983 - Intra-GCC tariffs abolished
2003 - Custom union implementation starts
2008 - Customs Union completed
2001 - Decision to form customs union and common market
2002 - Euro is used as currency
2003 - Common market implementation starts
2008 - Customs Union established
2010 - Gulf Monetary Council established
2015 - Year 34
2022 - Year 64
It’s important to recognize what the GCC has achieved since it was set up in 1981 – particularly over the last 15 years, during which its six members systematically built the elements of an economic community. The GCC is a globally recognized grouping and the only Arab integration initiative to have transformed rhetoric into concrete results.

Following the completion of the customs union in 2015, the GCC has a common external tariff collected at the point of entry and has made real progress in tackling non-tariff barriers within the region, especially in harmonizing standards. It has free movement of labor for citizens, and expatriate residents of one GCC country can visit others without a visa, except for Saudi Arabia. Goods produced in one country are granted equal treatment to national products, and Gulf nationals can invest freely in equity and real estate across the GCC.

These regulatory frameworks have encouraged cross-border economic activity. Intra-GCC trade has grown 15% per year over the past decade, slightly higher than the rise in total GCC exports. The composition of intra-GCC trade is significantly more diversified than with the rest of the world. While hydrocarbons make up 80% of non-GCC exports, within the GCC, they account for just 25%, made up of mostly of Qatari gas piped to the UAE and Saudi oil to Bahrain. Intra-GCC trade is also less volatile: in 2013 and 2014, when total GCC exports shrank, the level of intra-GCC trade – machinery, food and building materials – continued to grow.

Figure 4: The makeup of GCC trade

Gulf trade with rest of the world

![Bar chart showing the percentage of trade with rest of the world by commodity category from 2000 to 2014.](image)

Intra-GCC trade

![Bar chart showing the percentage of intra-GCC trade by commodity category from 2000 to 2014.](image)

Reflecting the new era, several companies — such as Saudi Arabian dairy producer Almarai and the UAE’s EKME Group, which runs the Lulu supermarket chain — have transformed themselves into sizeable pan-GCC companies and are now using that larger home base to expand globally. There have been significant cross-border GCC investments, especially in the telecommunications, real estate, retail and banking sectors. Intra-GCC investment flows are now at around US$80 billion, accounting for around one-fifth of the total. Qatar is the largest foreign investor in Kuwait, for example — largely through Ooredoo’s acquisition of Wataniya Telecom. Kuwait is the largest foreign investor in Bahrain and the second largest in Saudi Arabia.

**Figure 5: Intra-GCC foreign direct investment by target country (latest available data)**

At an intergovernmental level, there have also been important cross-border infrastructure developments that have seen the GCC become significantly more integrated in practice. Joining up GCC electrical grids between 2005 and 2011 has helped to smooth out supplies during peak demand in summer (June to August), especially in Kuwait. Gas shortages in the UAE, Oman and Kuwait are partly addressed through gas supplied by Qatar through the Dolphin pipeline and liquefied natural gas. Shipments by land from Saudi Arabia and the UAE have ameliorated a shortage of port capacity in Qatar.

A number of internet trunk routes have been set up such as the subsea network operated by Gulf Bridge International feeding all Gulf countries with internet and cloud services across a 40,000 km from Singapore all the way to major European cities. The growth of the major Gulf airlines has increased the frequency and decreased the cost of intra-GCC travel, with good links between all major GCC cities. Despite delays, a 2,200km rail network, linking the major coast cities from Kuwait to Muscat could be operational in the early 2020s, boosting both freight and passenger transport.

Over the past 35 years, in sum, the GCC has transformed itself into a grouping that is far more than a collection of separate states. The pace of development has been broadly in line with the time it took for the European Union (EU) to form its common market and customs union, before moving on to create a single market and common currency. Now is the time to shift to the next phase of integration in order to sustain economic expansion and facilitate diversification.
Strength in unity

The potential of integration

A closer look at the statistics highlights the remaining opportunities. Intra-GCC trade has grown, but it remains small at less than 6% of the GCC’s total trade in 2014. While that is almost double the share in 1981, it is also down from a peak of 10% in 1989 – and it remains tiny compared with over 20% for the Association of South-East Asian Nations (ASEAN), 40% for the North American Free Trade Association (NAFTA) and over 60% for the EU. A large part of intra-GCC trade is accounted for by re-exports from outside the region, particularly those arriving at Dubai’s ports, which account for over one-quarter of intra-GCC trade.

The free movement of labor, in effect since 2008, has also had little concrete impact on mobility within the region. Data from the GCC Secretariat shows that 36,000 Gulf nationals work in other GCC states, equivalent to about 1% of the workforce of nationals. But this low figure is misleadingly high, since nearly two-thirds are Saudis working with oil firms on the Kuwaiti side of their shared oilfields. Excluding these, no more than 0.2% of GCC nationals are migrant workers within the region, compared with an average level of 3% in the EU. There is an increasing number of Omanis in the UAE and of Bahrainis in Saudi Arabia, reflecting the move from smaller to larger job markets, but employing GCC labor is not incentivized. GCC citizens do not count as nationals for job quotas, so they compete with expatriates, who are often cheaper and better-skilled.

The potential is there. BNP Paribas, a French bank that operates across the region, has created a talent pool of young GCC citizens who are highly trained in finance, well suited to working with GCC clients and willing to move for their career. But this remains an unusual arrangement, and there are still only a few ambitious young Saudis or Kuwaitis taking up opportunities in Dubai, for example – in the way young Europeans might move to London for a job in finance or to Berlin to launch a start-up.

As a result, GCC countries are still importing expatriates even though there is a surplus of labor and growing unemployment in the region. But companies are hampered in the way they deploy that expatriate talent. “We want people with specific competences to be able to move to different offices as needed,” says Waleed Al-Osaimi, Market Segment Leader for the EY member firm in Kuwait. “Recruiters always have to bear restrictions and rulings around expatriates in mind.”

Even the free movement of capital, which has been one of the most successful aspects of GCC integration, shows a lack of momentum, while monetary union has disappeared from the agenda for now. The flow of foreign direct investment between Gulf states has slowed after an initial boom in 2004–08. Many of the large deals – for example, in telecommunications – have been completed and privatization has slowed. Sovereign wealth funds have remained more interested in investing outside the GCC than within, and smaller GCC companies, without connections to government agencies, still struggle to do business across the region.

Banks have been slow to expand regionally, with just 27 branches of GCC banks in other Gulf countries in 2014, up from 15 in 2005. The region’s largest bank, the Qatar National Bank, is the most widespread, with an associate company, CBI, in the UAE, branches in Oman and Kuwait and a license, approved in 2015, to open a branch in Saudi Arabia.
The real estate sector has seen a boom in cross-GCC investment. Companies such as Dubai’s Majid Al Futtaim Properties and Damac have been active across the region, and there has been a tenfold increase in the numbers of GCC citizens owning property outside their own country. The scale of investment, however, has been no greater than that of other international investors. In Dubai, for example, non-UAE GCC nationals — mainly Saudis and Qatars — spent US$7.5 billion in 2014-15. But that was only 14% of the total value of foreign real estate investments in those two years, with Indians and Britons outspending other GCC nationals.

“*The kinds of transformation taking place now ... will help to make it easier to move quickly on integration.*”

Fahad Altoaimi, EY member firm in Riyadh

The GCC has embarked on integration, but it needs to move much further if it is to reap the full benefits. “The idea of integration is there and all countries accept it – but really applying it and putting it into practice is not an easy step,” says Fahad Altoaimi, Market Segment Leader for the EY member firm in Riyadh. “The kinds of transformation taking place now in Saudi Arabia and other countries have maybe deferred integration as a concept, but the transformation will help to make it easier to move quickly on integration.”
Big challenges and next steps

The next phase of GCC integration needs to address and facilitate change in three key areas:

**Trade**
Transform the customs union into a modern, technology-enabled single market that addresses the bottlenecks to cross-border business

**Foreign investment**
Streamline and align approaches to foreign investment and company ownership regulations to increase the size and competitiveness of the entire private sector

**Institutions**
Build GCC institutions that have the capacity to sustain momentum and push against vested interests

**Trade: beyond the customs union**

In 2015, the GCC put the finishing touches to the customs union that was launched in 2003 and initially scheduled for completion in 2005. Reaching a consensus on difficult details was certainly a victory for integration despite the delay, but the regulations and processes that were agreed are insufficient to meet the needs of modern business.

Despite the customs union, there are lengthy border delays. Better cross-border infrastructure would certainly help, but it’s not the main issue. Journeys that should take just a few hours require three to four working days due to lengthy border checks and unpredictable outcomes. National laws and processes are not aligned across member countries – or even at different border crossings within the same country. Tariff barriers have gone, but multiple approvals are still needed from ministries and municipalities. New areas such as e-commerce have not been taken into account. Small express packages, for example, are not allowed to cross land borders, but have to be sent by air.
“Laws on e-commerce and transportation have to be enhanced and updated to ensure the free flow of goods. It’s good for the industry and the economy,” says Hussein Hachem, CEO of Aramex, who is optimistic that planned legislation will come into effect. “Customs and regulatory issues raise the costs of shipments and slow down supply chains.”

Two major elements need to be tackled urgently. Firstly, the GCC needs to create a trading environment that is consistent and predictable by addressing the national rules, regulations and processes that are not aligned and cause bottlenecks or unpleasant surprises for business. Identifying exactly where the problems are would require an in-depth dialogue with the private sector, which, in itself, would be a valuable exercise to ensure that government and economic players are working together to solve problems. That dialogue would need to be followed up with a clear plan, a timeline and a budget to make necessary changes.

Secondly, the GCC needs to replace the current system of checking all goods at the border with a modern electronic customs superhighway. This would create a regional customs operation where a container that is checked on entry into the GCC, for example, in Dubai, would not need to be checked again on entry into Saudi Arabia. Screening and tracking technology would monitor cross-border trade, while random physical checks are conducted inside borders, acting as a further control. Security concerns keep the current system going, but the technology is tried and tested elsewhere.

“Trade and competitiveness are intimately connected,” says Ahmed Amor Al-Esry, EY’s Market Segment Leader for the EY member firm in Oman. “No country has developed successfully in modern times without opening its economy.”

“Customs and regulatory issues raise costs and slow down supply chains ...”

Hussein Hachem, CEO, Aramex

Foreign investment: aligning fragmented markets

Viewed from a global perspective, the GCC is an attractive market due to high personal incomes, strong government spending and a fast-growing population of over 50 million. The free zones that have sprung up in places such as Dubai and Abu Dhabi have also made it easy to set up a business. And yet, investing to do business across the GCC is difficult. There are strict foreign ownership thresholds in most countries, and these vary from one GCC market to the next. Companies registered in the free zones in Dubai and Abu Dhabi are recognized in some GCC countries, but not all.
Momentum to liberalize foreign investment laws is hampered by short-term vested interests and a desire to protect the national private sector. As a result, large-scale investments outside of the oil and gas sector are rare. In 2015, for example, Jaguar Rover’s plans to build the region’s first car assembly plant in Saudi Arabia, close to aluminum smelters and strong markets, was taken off the table due to a series of heavy requirements and restrictions. The plant is now being built in Slovakia.

The statistics show the problem clearly. Foreign investment flows to the GCC as a whole have halved since 2010 and are just over one-third of the 2008 level. “Each of the GCC states has its own requirements when it comes to foreign ownership – there is not a single approach,” says Benjamin Smith, Senior Associate at Clyde & Co. “While it is an attractive idea, it is not currently possible to operate in all GCC states under a single registration.”

In the GCC, as in the EU, the political will is not currently there – but neither are the common institutions and policy-makers whose role it is to define and promote that sweet spot of common advantage. As a result, it’s far easier to see the differences between countries and their interests than the commonalities.

There are, however, immediate steps that the GCC could take that would optimize the existing levels of cooperation, bringing significant economic gains to each of the member countries, while allowing them to focus separately on creating the incentives that will make them most attractive as investment locations. A first step would be to work with the private sector to identify the top 10 barriers to business across the GCC. These would include specific obstacles at borders that slow the free movement of goods, outdated laws that don’t reflect the realities of the digital world and the multiplicity of regulations relating to business in each country that make compliance so hard for cross-border investors. Pinpointing and resolving these barriers might not sound like integration, but it would be a major step forward to leveraging the GCC’s common strengths to the benefits of each country.

“Each of the GCC states has its own requirements when it comes to foreign ownership”

Benjamin Smith, Senior Associate, Clyde & Co
To ensure that the GCC is perceived as a great place to invest—especially as Iran returns to investors’ radar screens—governments need to consider two aspects. Firstly, they must streamline and align regulations in the key areas of interest to business—free zones, commercial agencies, foreign investment and employment laws—so investors can treat the GCC market as one from a compliance perspective. Here, it might be helpful to look at state-of-the-art trade agreements, such as the Transpacific Partnership among 12 Pacific-rim countries, which incorporatess foreign investment rules and intellectual property rights into the overall trade agreement.

Secondly, governments need to focus on providing a supportive but competitive environment for the increasing number of GCC companies that no longer rely on outdated national protection regimes that were introduced to foster a private sector. For competitive companies, foreign investors provide access to global value chains and expand the private sector—something to be embraced, not limited.

**Institutions: moving beyond national sovereignty**

One of the main advantages the EU has over the GCC is its powerful and well-resourced institutions—in particular, the European Commission, which is able to sustain integration when political will flags and is able to push back against national authorities in the name of a broader common interest. “In the GCC, decision-making is intergovernmental,” says Simon Williams, Chief Economist for EMEA at HSBC. “The lack of permanent institutions means there isn’t the necessary backdrop to drive change.”

To move ahead with the integration agenda, the GCC needs to strengthen the organizational structure of the Secretariat and boost its autonomy and resources, so that it can become an independent source of dynamism and decision-making support within the GCC and a partner for international institutions.

Other institutions are also key. The Monetary Council became more powerful when a joint currency was on the cards, launching 12 committees to drive integration in areas from payments systems to banking supervision. The demise of monetary union sidelined the council, but there is significant scope for rapid progress in the area of finance and investment. GCC-Stat could have a key role to play in filling in the gaps in national statistics that hamper a clear understanding of developments and make comparative analysis between the GCC markets difficult.

Bringing government officials together to share best practice would not only help individual countries to implement transformation plans and develop a pan-GCC viewpoint, but also encourage them to dismantle the internal silos that slow progress. Moving from a competitive to a collaborative approach—whether nationally or across the GCC—will be crucial to future-focused decision-making in a world where areas such as transport infrastructure, health care and digitalization are increasingly connected.
GCC integration is a key piece of the puzzle for ensuring that the region can achieve cost optimization and sustain economic growth and prosperity in the new low-oil-price world. It is an enabler for global competitiveness, diversification, jobs and stability at a time when the global economy is undergoing a dramatic transformation, driven by rapid technological change, a fast-growing population and the reshuffling of power structures. Regardless of oil price, the GCC has to invest in creating an open economy, led by a globally competitive private sector and supported by world-class physical, digital and educational infrastructure.

Reducing the remaining non-tariff barriers could help the private sector to cut costs and boost productivity. Making the region more attractive to foreign investors could provide a new source of revenue, while introducing a more competitive environment and helping embed local companies within global value chains. Encouraging ministries and government entities across countries to work more closely together would make it easier to introduce reforms and develop joint infrastructure initiatives — boosting cooperation in the public sector while encouraging competition in the private sector.

The customs union and common market were launched as GCC governments searched for ways to strengthen their economies after a decade of low oil price. With oil price falling again, it would be a mistake to wait another decade before taking joint action. It's the right time to take a fresh look at the power of integration to tackle the new set of challenges the region faces. Far from being a distraction, pushing ahead with integration could facilitate and accelerate the GCC's ascent to become the world's sixth-largest economy.
Key considerations

For governments:

- Identify and remove bottlenecks at the borders
- Streamline and align legislation on foreign investment
- Leverage digital technologies to facilitate trade flows

For the private sector:

- Actively voice business support for further GCC integration
- Seek a dialogue with the public sector on removing obstacles to investment and competitiveness
- Embrace foreign investment and an open economy
Strength in unity

Objective and rationale of EY integration model

The objective of this study is to understand the economic impact on GCC countries of reducing non-tariff barriers. The EY analysis is based on a Global Trade Analysis and Policy (GTAP) model (version 9) divided into seven regions (Saudi Arabia, the UAE, Qatar, Kuwait, Oman, Bahrain and rest of the world), three sectors (agriculture, manufacturing and services) and five factors of production (skilled labor, unskilled labor, land, capital and natural resources) to estimate the impact of a reduction in non-tariff barriers in the GCC.

We classify non-tariff barriers into two categories:

- Rent-creating barriers, such as commercial licensing regulations, that protect domestic interests in the form of increased profits. These rents can be conceptualized as an ad valorem equivalent (AVE) tax equivalent to the difference between domestic and global prices, except that they accrue to producers rather than governments. In the GTAP, these rents accrue to the regional household account and therefore flow directly into GDP calculations.

- Efficiency barriers act as sand in the wheels of global trade as they raise production costs; for instance, through specifying technology or standards that must be used in production. In the context of the GCC, nonautomated customs controls, nonharmonized standards, multiple permits, limited mobility of expatriate workers and so on reduce the efficiency of trade.

Both kinds of non-tariff barriers are important for the GCC, so we have modelled the impact of a reduction in both, assuming each is responsible for half of the overall effect.

The updated GTAP model is based on understanding non-tariff barriers as tariff or tax equivalents, based on estimates in the UNESCAP and World Bank International Trade Costs database. We used sector-specific estimates for agriculture and manufacturing and took the overall equivalent for each country for services, since the UNESCAP and World Bank Database does not provide sector-specific estimates.

We modelled four complementary scenarios based on the assumption that the cost of intra-GCC trade would decrease in line with that witnessed in the EU since 2008 (11.9%). This estimate was obtained through EY’s econometric analysis using difference-in-differences methodology, and the UNESCAP and World Bank International Trade Cost Database (see below).

We shocked the model in four steps:

- First, we decreased the rent-creating barriers by applying a negative shock of 5.95% (half of the reduction) to the “tms” variable in the CGE model for trade flows between GCC countries only. This variable measures the tax on imports of tradable commodities. Because we modeled NTBs as AVE taxes, the ‘tms’ variable can be used as a proxy for the embedded cost of trading across countries due to rent-creating barriers.

- Second, we increased the intra-GCC efficiency of trade through a positive shock of 5.95% to the “ams” variable for intra-GCC trade only. This variable measures import-augmenting technological change in the GTAP model, and therefore captures supply-side efficiency and productivity changes that impact the cost of trading.

- Third, we decreased the rent-creating non-tariff barriers with a reduction of 2% to reflect the positive trickle-down effect on trade with the rest of the world.

- Fourth, we assumed that improving the efficiency of trade within the GCC also brings trade and investment gains with the rest of the world, and modeled this through a 2% positive shock to the ams variable.

For the sake of this exercise and in order to provide clearer policy recommendations, we assumed that 50% of the reduction in costs comes from rent and efficiency NTBs so as to be able to compare the relative magnitude of gains from each scenario.

Finally, we assumed that investment flows will shift to take advantage of better returns in the GCC after the change in trade costs. While the GTAP model does not explicitly model financial flows, we follow the approach detailed in Malcom (1998) and set the RORDELTA parameter to one that allows for equalizing risk-adjusted rates of return across regions after the shocks, so that investors (“the global bank” in the CGE model) reallocate investment where returns are higher.
Estimating the reduction in trade costs because of trade integration

It is inherently difficult to measure the incremental impact of changes in the levels of integration on trade costs in the GCC. In our analysis, we ran two models: one to estimate the changes in trade costs in the EU pre- and post-2004 enlargement and one for the GCC after 2008 (i.e., after the common market takes effect). The EU case is one of deep integration and the creation of a fully fledged single market. The case of the GCC is one of partial integration in terms of elimination of intra-regional customs tariffs and the creation of a common external tariff, but without the gains of a fully integrated single market.

We used a regression analysis technique called difference-in-differences to isolate the incremental impact of these two rounds of trade integration on the intra-regional trade cost in the EU and the GCC, using the UNESCAP and World Bank trade cost database for the period 2000–12.

For the EU, we specified a model that includes a dummy variable for the period after 2004 (“Post2004”), a dummy for EU (“EU”), a dummy for EU after 2004 (“EU Post2004”) and control variables such as GDP, USD – EUR exchange rate (“Exchange”) and price of oil (“Oil”) to decrease the size of the standard errors.

\[
\text{Costsi}_t = \alpha_i + \beta_1 \text{Post2004}_t + \beta_2 \text{EU}_t + \beta_3 \text{EU} \text{ Post2004}_t + \beta_4 \text{Exchange}_t + \beta_5 \text{GDP}_t + \beta_6 \text{Oil}_t
\]

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Coefficient</th>
<th>Standard Error</th>
</tr>
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<tbody>
<tr>
<td>Post2004</td>
<td>11.53</td>
<td>(2.80)</td>
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<td>EU</td>
<td>29.89</td>
<td>(1.60)</td>
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<tr>
<td>EU Post2004</td>
<td>-14.04</td>
<td>(2.21)</td>
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<tr>
<td>Exchange</td>
<td>21.25</td>
<td>(6.63)</td>
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<tr>
<td>GDP</td>
<td>0.00</td>
<td>(0.00)</td>
</tr>
<tr>
<td>Oil</td>
<td>0.15</td>
<td>(0.07)</td>
</tr>
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</table>

All coefficients are statistically significant (standard errors in brackets). The negative coefficient on the EU post2004 variable shows a decrease of 14.04 in trade costs (measured in AVE) due to changes that affected intra-EU trade after 2004 (i.e., it did not affect trade between EU and non-EU countries, and it did not happen before 2004). The 2004 enlargement and the deepening of the single market are the two main policy changes that have impacted intra-EU trade, but not EU trade with the rest of the world. The UNESCAP database shows that the average intra-EU trade cost in the period before 2004 is 117.4; therefore, a decline of 14.04 represents an 11.9% decrease in trade costs, measured as AVE. The 11.9% estimate is what we used for our GTAP modeling exercise detailed above. For robustness, we ran the same analysis without control variables for exchange rate, GDP and oil price, and we obtained a coefficient of -15.69 (standard error 2.70).

We conducted a similar analysis for intra-GCC trade, using 2008 as the reference period (the year in which the common market came into effect). The GCC Post2008 variable is not statistically significant, implying that, after the common market came into effect there were no significant changes in trade costs between the GCC countries.

\[
\text{Costsi}_t = \alpha_i + \beta_1 \text{Post2008}_t + \beta_2 \text{GCC}_t + \beta_3 \text{GCC} \text{ Post2008}_t + \beta_4 \text{Exchange}_t + \beta_5 \text{GDP}_t + \beta_6 \text{Oil}_t
\]

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Coefficient</th>
<th>Standard Error</th>
</tr>
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<tbody>
<tr>
<td>Post2008</td>
<td>8.40</td>
<td>(6.36)</td>
</tr>
<tr>
<td>GCC</td>
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<td>(10.40)</td>
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<td>GCC Post2008</td>
<td>6.19</td>
<td>(22.94)</td>
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<td>Exchange</td>
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<tr>
<td>GDP</td>
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<td>(0.00)</td>
</tr>
<tr>
<td>Oil</td>
<td>-0.01</td>
<td>(0.28)</td>
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</tbody>
</table>

We would like to acknowledge the Economic Advisory Team; Sera Balu Mani, Maxime Clémenceau, Tamer Al Ghussein and Yiannis Zahariadis for their contribution to the analysis.

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3. Fugazza and Maur (2008), Non-Tariff Barriers in Computable General Equilibrium Modelling, in UNCTAD – Policy issues in international trade and commodities study series No. 38.
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