



Labor markets and informality in GCC countries — Current Labor policy and future changes

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Motivation

- ✓ **Informality in Modern Labor Markets**
 - ✓ **Workers avoid contributions**
 - ✓ **Firms avoid payroll taxation**
 - ✓ **Firms avoid VAT on goods or CIT on profits**
- ✓ **GCC economies: no VAT (yet), limited income taxes**
- ✓ **Key problem is not informality but distorted incentives through a market of **economic rent seekers****
- ✓ **Still informality in the labor market exists**
 - ✓ **But differs from that in modern labor markets**



Plan

- **Characteristics of Labor Markets in the GCC**
- **Empirical evidence (UAE, Saudi Arabia)**
- **Distortions**
- **Implications for Informality in the GCC**
- **GCC in the context of the present model**
- **New forthcoming changes in GCC (UAE, KSA, Bahrain) and informality**



Characteristics of GCC Labor Markets

- Historical scarcity of local workers
- Massive import of (low cost) expatriate workers
 - **UAE (91% of about 8 million)**
 - **78.6%** Participate in the labor market
 - **KSA (26% of about 27 million)**
 - **80%** Participate in the labor market
- Characteristics (e.g., **UAE**):
 - Male (**87%**), unskilled (**70% < HS**) and relatively young (**50% below 30**)
- Dual labor market → **Nationals** and **Expatriates**



Continue, characteristics

- **Nationals (supply)**
 - **Expectation of public employment (94%)**
 - **Skills mismatch (71% humanities)**
 - **Low participation rate (45%) as result of voluntary unemployment (n.w.t.w)**
 - **Wage gap between public and private sector employment among locals**
 - **Arabization (Emiratization, Saudization,..)**
 - **Quotas (e.g., min. 5% if size>50)**
 - **Minimum wage for nationals**
 - **Nationalization, protectionism**

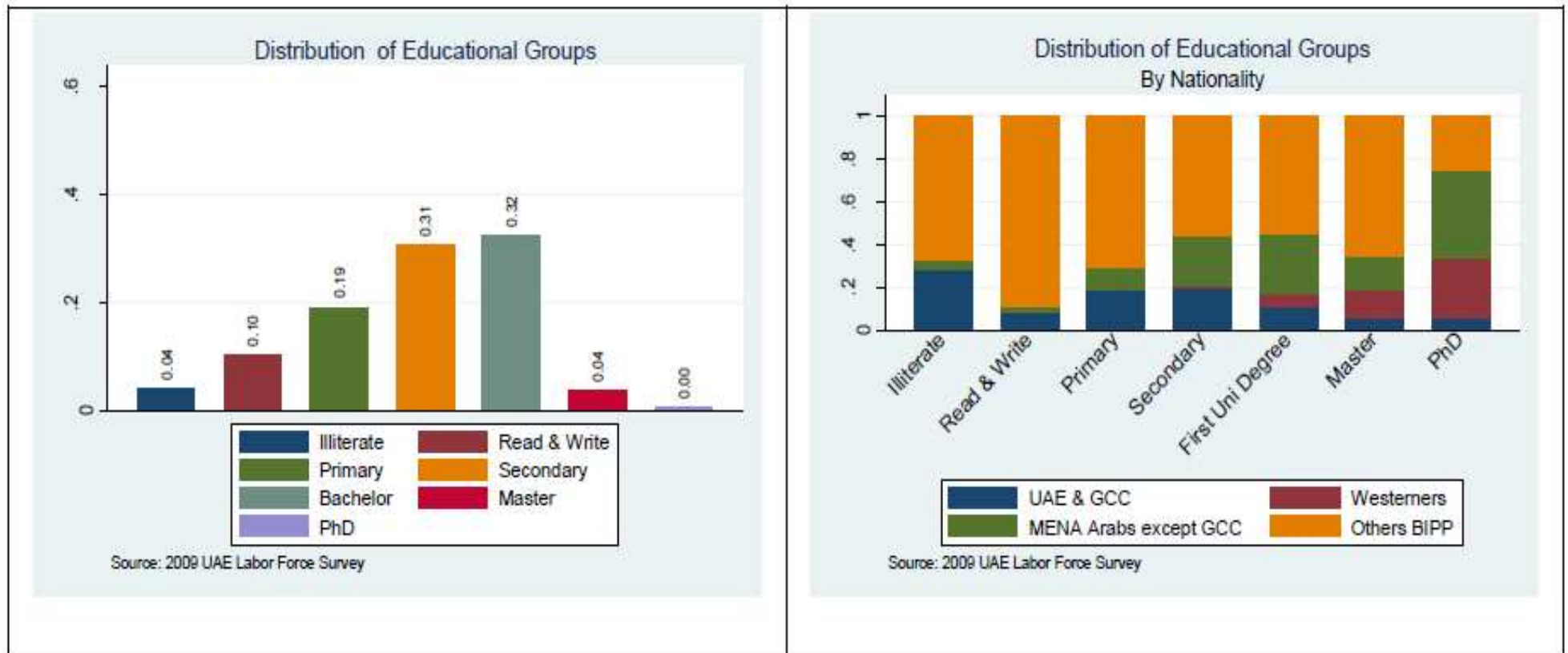


Continue, characteristics

- **Expatriate workers (supply)**
 - **Sponsorship system (migration law)**
 - **Lack of mobility (no unemployment)**
 - **Limited contracts, nominal wages**
 - **Assigned to low occupational categories**
 - **Migrants arrive mostly from labor abundant economies with low reservation wages (75% are from BIPP+)**
 - **Significant wage gap (locals, expatriates)**

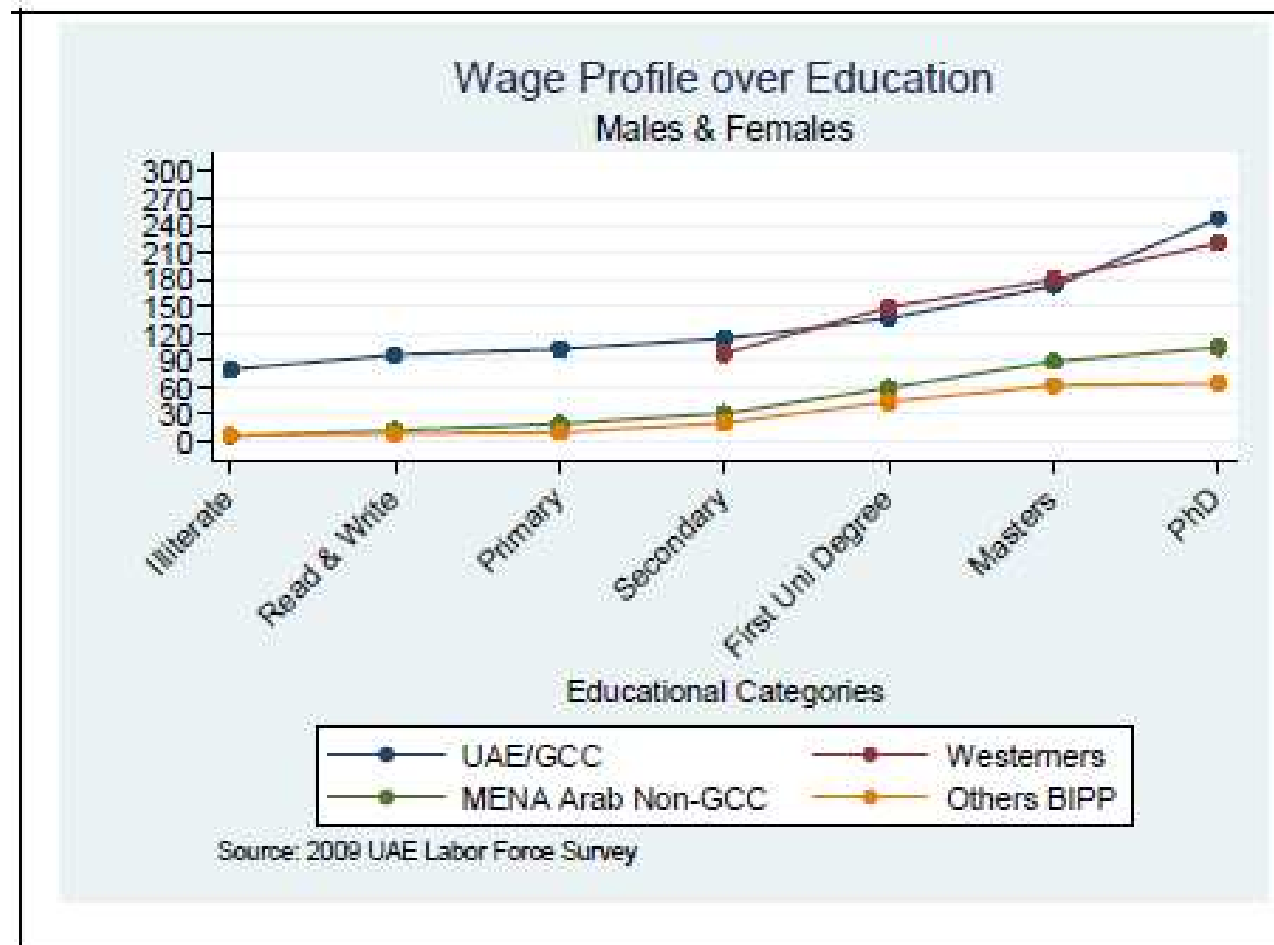


Evidence: Education in the UAE





Wage profile (UAE)





Wage profile, KSA

Economic Activity	SAUDI AVERAGE MONTHLY WAGE RATE	NON-SAUDI AVERAGE MONTHLY WAGE RATE
Agriculture , Hunting , Forester & Fishing	4,630	1,244
Construction	3,261	1,145
Electricity, Gas & Water	9,185	3,487
Banking, Finance, Insurance	6,963	2,880
Manufacturing	6,091	1,929
Mining & Quarrying	15,080	7,944
Other Activities, Private sector, non Social Services	23,587	18,353
Social Services Activities in the Private sector	5,075	2,331
Postal, Transport & Communication	8,417	2,518
Trade, Hotel, Catering	3,605	1,420
Average Of Total	8,589	4,325
SOURCE: Gov. Social Security Inst. (GOSSI), WB own estimates based on micro-data. All estimates are in SA-Monthly, 2011		



So, how do firms react? (KSA)

Economic Activity	ALLOW FOR PUBLIC ADMINISTRATION JOBS		DO NOT ALLOW FOR PUBLIC ADMINISTRATION JOBS		
	SAUDI EMPLOYEES	NON-SAUDI EMPLOYEES	SAUDI EMPLOYEES	NON-SAUDI EMPLOYEES	
Agriculture , Hunting , Forestry & Fishing	-1,090	28,509	-1,090	28,509	
Petroleum & Minerals	-15,714	1,510	-15,714	1,510	
Manufacturing	-5,802	8,722	-5,802	8,722	
Electricity, Gas & Water	2,336	5,370	2,336	5,370	
Construction	6,121	-66,810	6,121	-66,810	
Wholesale & Retail Trade	26,091	44,572	26,091	44,572	
Restaurants & Hotels	-674	19,115	-674	19,115	
Transportation , Storage & Communications	9,923	10,739	9,923	10,739	
Banking & Insurance	781	7,712	781	7,712	
Real Estate & Business Services	10,223	-644	10,223	-644	
General Administration	43,176	-591			
Education	2,830	2,217	2,830	2,217	
Health & Social Services	5,337	-23,180	5,337	-23,180	
Community & Social Services	-5,798	16,963	-5,798	16,963	
Private House Holds	4,088	-3,089	4,088	-3,089	
International Organizations	-529	-1,722	-529	-1,722	
Total	81,299	49,393	38,123	49,984	



So how are firms characterized?

- Firms (demand for labor)
 - Sponsors are monopsonists that extract **economic rents** from workers
 - Preference for low cost (low skilled) labor in labor intensive industries with low added value per worker
 - Low labor productivity
 - Low capital investment (lack of investment of new physical and human capital)

□ *Which policies drive Rents?*

- **SPONSORSHIP INCOMING IMMIGRANTS**
 - *Rents for Sponsoring Employer as result of Monopsony behaviour on immobile Low Cost Labor*
- **SPONSORSHIP of foreign ENTREPRENEURS**
 - *Rents from foreign entrepreneurs through the 51-49 share*
- **ARABIZATION for LOCALS willing to supply labor**
 - *Earning of Native above Marginal Cost of Immigrants*
- **GOVERNMENT SYSTEM OF FEES**
 - *Fees from sponsorship system & foreign entrepreneur*
 - *Empirical question mark in some cases (e.g., UAE)!!*

□ Who are WINNERS?

- *National Entrepreneurs (sponsors)*
 - *Rents from low cost workers as long as $W < MRP$*
 - *Rents if Social Cost not covered by labor fees*
 - *Rents from foreign entrepreneurs investing in the UAE*
- *Pure sponsors*
 - *Rents from ghost sponsored employment (visa handling) → INFORMALITY*
- *National Employees*
 - *Rents for Public Sector employees above rents obtained by Nationals in the private sector*
 - *Rents for private sector National employees because on average they receive earnings above that dictated by the MC*
- *Foreign and local entrepreneurs, and high skill foreign workers*
 - *Foreign entrepreneurs benefit from low cost foreign workers*
 - *High skilled foreign workers*
- *Government: Net Revenue gain ?? (differs in importance, e.g. UAE or Emirates)*

□ **Historical Justification (sponsorship)**

- **Positive at *take off stage* of economic development: low cost labor**
- *Low cost labor → Room for native human capital development*
- **Rents for high skilled foreign workers implies importing their knowledge, i.e., faster closure of human capital knowledge gap**
- *Low cost workers helps keep competitiveness in an oil producing economy (i.e., avoids wage productivity spiral)*
- **Cultural identity** maintained through clear cut differential between natives and immigrants
- **Fiscal Reason:** Government (especially UAE) justify sponsorship dynamics – rents from immigrants – as way to cover social costs of non-native labor.

❑ **But are there any costs?**

- **Sponsors exercise Monopsony Power**
 - **Limited mobility of immigrants → lower efforts, lower productivity growth, lower AVW**
 - **Less employment opportunity for Natives**
 - **Weak incentives for employers to drive high added value industries**
- **Local Employees lack market incentives**
 - **Human capital formation might suffer**
 - **Locals Self-select into government work**
 - **No entrepreneurial skills developed nationally**
 - **Perpetuate seeking government protection (low participation)**
- **Foreign Entrepreneurs invest conditional on sponsorship risk**
 - **Short run investment with high risk and volatility**
 - **Adverse effects for long run diversification towards a KBE**
- **Social Costs**
 - **Demographic imbalance**
 - **Perpetual reliance on high skilled foreign workers in key area**

❑ **Example, cost of Arabization (e.g., Emiratization):**

Emiratization: Since 1998 the QUOTA → 4% annual increase
 2010, Dubai: **39.4%** (Emirates Inst. Of Banking & Finance)
 That is, approximately 2.5% per year
 Well below the Quota!

But what has been the costs?

- **Free Zones open to make up for potential adverse effects of the Sponsorship system**
 - **Dubai International Financial Centre (DIFC)**
 - **‘Sophisticated Financial Services’**
 - **3.6% of Dubai’s GDP in 2010 and growing**
 - **12,000 Employees, 86% University**
 - **But only **2.2%** of the workforce are Emirati!**
- **Emiratis Excluded from sophisticated skill development sectors as result of the system based on rent-seeking behaviour**

□ *Two Questions:*

➤ *Is the current system of sponsorship sustainable?*

➤ *In the Short Run:*

- *Rents*
- *Protection for Emiratis*

➤ *In the Long-Run:*

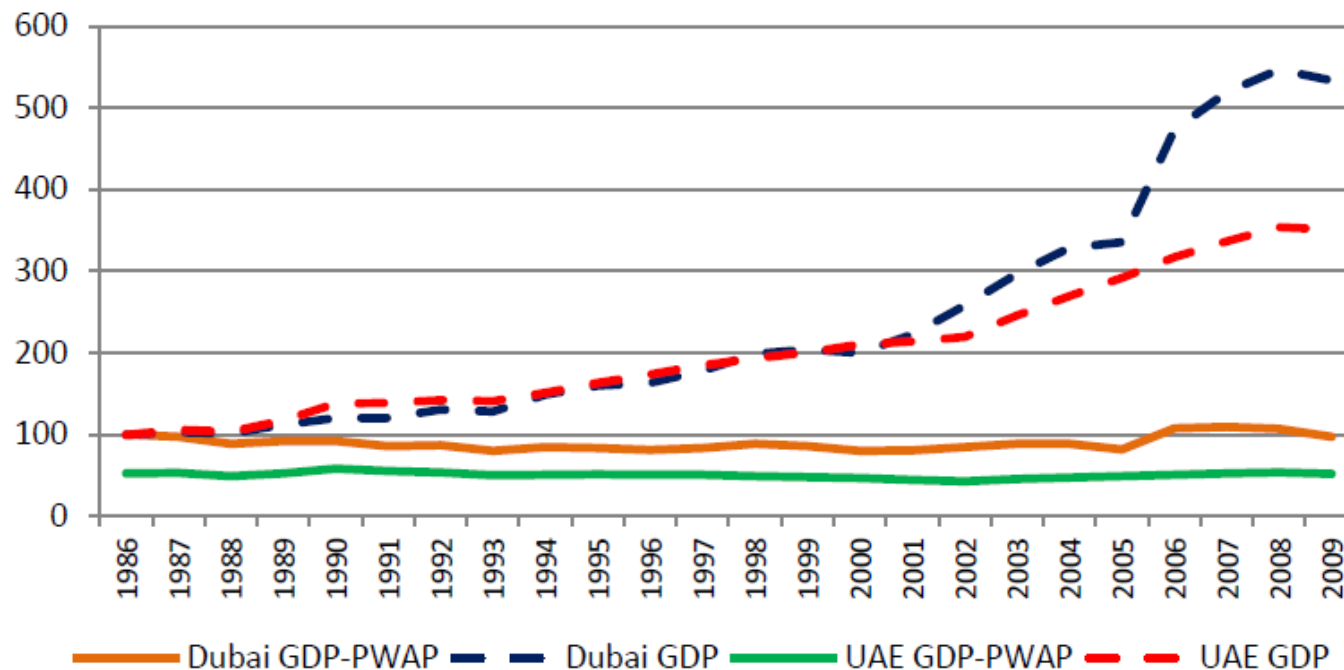
- *Reliance on low skilled labor intensive activities*
- *Slow movement to Knowledge economy (KBE)*
- *Slow national human capital growth*

➤ *Cost in the form of low labor productivity*



E.g., (Soto-Merino, 2011)

Figure 1
Real Gross Domestic Product and estimated Per Worker Average Productivity (PWAP)
(Dubai in 1986=100)⁴



Source: Own estimates, data from the Dubai Statistics Centre and UAE National Bureau of Statistics

□ **What is the way forward?**

- **Consider alternatives to SPONSORSHIP:**
 - **Increase internal mobility using market mechanisms to elicit such mobility (e.g., Price mechanism, Quota mechanism)**
 - **Lower Risk for foreign entrepreneurs and their investment behaviour (e.g., Investment laws & regulations reduce risk)**
 - **Promote competitive behaviour among Emirati and between Emirati and rest of the workforce (e.g., mechanisms to lower wage gap in the market , reduce Emirati Reservation Wage, reduce Emirati uncertainty in the private sector)**
 - **Reshape revenue sources for the government through alternative fee-scales in tune with a mobile labor market (e.g., promote Free Zones, pricing accessible land, immigrant's labor fees scaled to reflect cost of immigrants)**

□ **What would be the outcome of such alternatives?**

- **Positive Outcomes:**

- *A labor market is created*
- *Employers (sponsors) gain on AVW if movement toward KBE*
- *Foreign entrepreneurs engage in longer term investment (KBE)*
- *Develop entrepreneurial class of Locals (Human Capital)*
- *KBE → Diversification and greater participation given diversification*
- *Lower share of labor intensive industries → Higher share of knowledge based industries → Demographic Rebalancing*

- **Who are the Losers?**

- **Sponsors (Entrepreneurs):** *lose RENTIER status → AVW instead?*
- **Households:** *Employees lose rents from their employee's privileges → But they might gain from greater employment creation, greater participation & integration into the productive sector*
- **Government:** *lost revenue from fees but can gain from alternative fees in tune with technology based economies*



How about 'informal' labor?

Worker's behavior

Illegal market for visas (but legal workers)

Illegal workers who have lost rights legal status

Firms' behavior

Avoid social contributions

(social security payments)



Workers

Worker's preferences

- ✓ **Illegal market for visas where 'locals' obtain rent from workers willing to buy freedom from sponsor**
 - ✓ **E.g., UAE**
 - ✓ **10,000 paid for a visa that costs 3,000**
 - ✓ **Worker avoids rent subtraction from employee at a high risk**

Consequence?

- ✓ **'Legal firms' (similar services) face unfair competition**
- ✓ **No effective loss for government (visa payment)**
- ✓ **Deportation**



How do firms avoid contributions?

Example, high skill K –(local) or X –(migrant)

$U = \text{base wage} + \text{allowances} \rightarrow \text{firms decide!}$

Locals :
$$U_h^k = w_h^{ka} + w_h^{kb} + b(w_h^{ka}) + ss(w_h^{ka})$$

Expats :
$$U_h^x = w_h^{xa} + w_h^{xb} + b(w_h^{xa})$$

$$U_{LF}^x = w_{LF}^{xa} + w_{LF}^{xb} + b(w_{LF}^{xa})$$

$$U_{LI}^x = w_{LI}^{xa}$$

Firms combine workers :

$Y(K, X) = Y(K(X), X) \rightarrow \text{benefits from quotas!}$

e.g., in UAE, if $\text{size} \geq 50$, $\text{quota} = 5\% \Rightarrow K \geq X \times 0.05$

\Rightarrow Imposing QUOTAS leads to 'informal' hires

\Rightarrow Otherwise, social security contributions **distorts** 'information'



Evidence of cheating on SS-contributions

In Saudi Arabia, employers pay contributions to Saudi employee's pension funds proportional to their base salary at the rate of 9%

Saudis count towards the mandatory quotas for Saudization if these earn at least SR 1,500 per month

The following is from GOSI data, April 2011:



Evidence of cheating on SS-contributions

Distribution of sample by monthly wage category

	Full population	Saudi	Non-Saudi
Below SR1500	64.9%	0.7%	78.6%
Exactly SR1500	4.7%	19.7%	1.5%
Above SR1500	30.4%	79.6%	19.9%

Distribution of sample by region if earning SR1500 or below

	Full Population	Saudi	Non-Saudi
North West	8.2	6.4	8.6
North East	7.9	6.2	8.3
South West	26.3	26.6	26.2
South East	23.7	23.0	23.8
Riyadh	33.9	37.8	33.2



Movements towards modern labor markets

- ✓ **Abolishing sponsorship system**
- ✓ **Unemployment Insurance for Expats?**
- ✓ **Unemployment Assurance & Insurance + activation policies for natives (KSA mainly)**
- ✓ **But no income tax, limited CIT (more likely, VAT)**
- ✓ **Key question to be answered is what would the above changes imply for informality (besides the movement towards a modern labor market)?**
- ✓ **End!**