KUWAIT INVESTMENT AUTHORITY,
KUWAIT FUND FOR ARAB ECONOMIC DEVELOPMENT &
OLIVER WYMAN JOINT COMPANY

BUDGET RATIONALIZATION IN THE TIME OF A SHIFTING OIL PARADIGM
IMPLICATIONS FOR GOVERNMENT EXPENDITURE IN KUWAIT

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1. EXECUTIVE SUMMARY

With oil prices currently hovering in the range of $40–45 per barrel, many oil-rich nations are facing significant revenue shortages, while expenditures have been trending strongly upwards. Energy markets have reached a turning point, and analysts expect low oil prices to be the norm in the short- to medium-term. Because new revenue streams such as taxes require many years to be developed, governments will need to focus on an underutilized tool in the short- to mid-term: strategic budget rationalization.

Approaches to rationalization vary widely by region, country, and social condition. Many measures taken globally, such as salary reductions, would be extremely difficult to implement in the Gulf Cooperation Council (GCC). Innovative solutions are needed, devised with a nuanced understanding of the GCC, and in particular, Kuwait's political economy and the government's inherent social contract with its people.

In the GCC, nations on average spend more than 50% of their budgets on salaries and subsidies. In Kuwait, the pattern is particularly pronounced. Government budgets have grown significantly during the post-2003 oil boom, and wages and subsidies have followed suit. The magnitude of growth is alarming – budgets have grown at a much faster rate than inflation.

To correct their course, Kuwait and other GCC states should adopt subtle measures to improve financial conditions by reforming the public salary system, reducing certain subsidies, controlling growth of specific budget items, and introducing taxation. At the same time, governments should introduce compensation measures that maintain citizens' welfare levels while reducing the economic distortions and inequities in the current wealth distribution system, which mostly benefits "insiders" and rich households.

Many institutional, infrastructural, social, and political risks loom, and a clear-eyed understanding of these challenges is necessary if they are to be resolved. If implementation risks are mitigated, substantial savings and revenues could result. Rationalization measures are useful in the short- to mid-term, and give governments breathing space to re-direct their economies. They are necessary for sustainable economic development. Conservative TICG estimates show that fiscal reforms in Kuwait can result in close to $20 billion per year in savings and additional revenue – of which expenditure-side rationalization constitutes almost two-thirds. However, budget rationalization must be complemented by longer term policy reforms that will enable Kuwait to realize its strategic ambitions and help its economy diversify away from oil.

This paper focuses primarily on budget rationalization in expenditures, and particularly on wages and subsidies because of their large size and worrisome growth trajectories. Special emphasis is also placed on complementary wealth distribution policies that can make reforms politically possible. The paper explores the impact of the change in energy dynamics and the urgent need for action in Kuwait and the wider region. It then identifies relevant rationalization initiatives in the state of Kuwait. Finally, it outlines the importance of fiscal reforms for Kuwait's larger ambitions to become a diversified knowledge economy.

2. SHIFTING OIL PARADIGMS AND URGENT NEED FOR ACTION

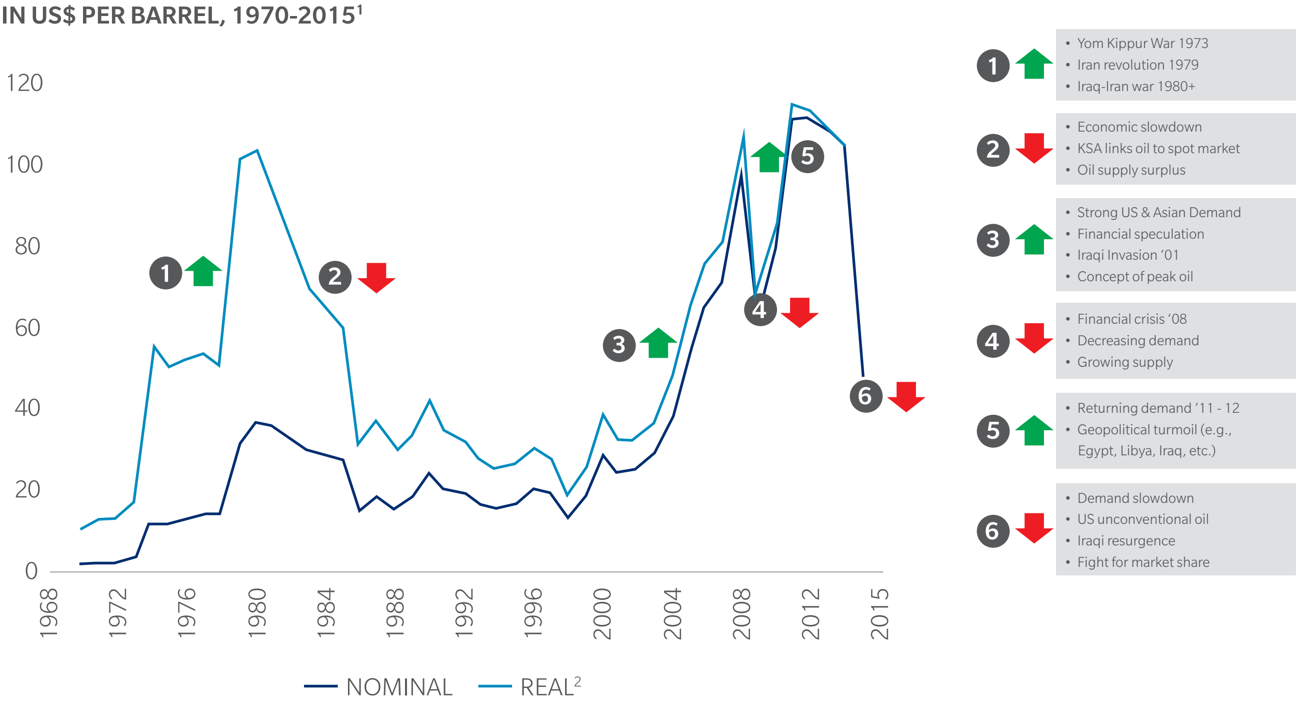
2.1. CHANGING GLOBAL ENERGY DYNAMICS

The continuing downward pressure on the price of oil marks an inflection point for global energy markets. Oil prices will be determined by a model in which market forces are the primary driver; political forces will be less influential than in past decades (see Figure 1).[1]

EXHIBIT 1: OIL PRICE DISRUPTION – DRIVERS AND IMPLICATIONS

OIL PRICE EVOLUTION IN US$ PER BARREL, 1970-2015[1]

DRIVERS



1. 1970-1983 Arabian Light in Ras Tanura; 1984-2015 Brent

2. Based on 2014 US$

Source: BP, Bloomberg, US Energy Market Emergency Act of 2008, Oliver Wyman analysis

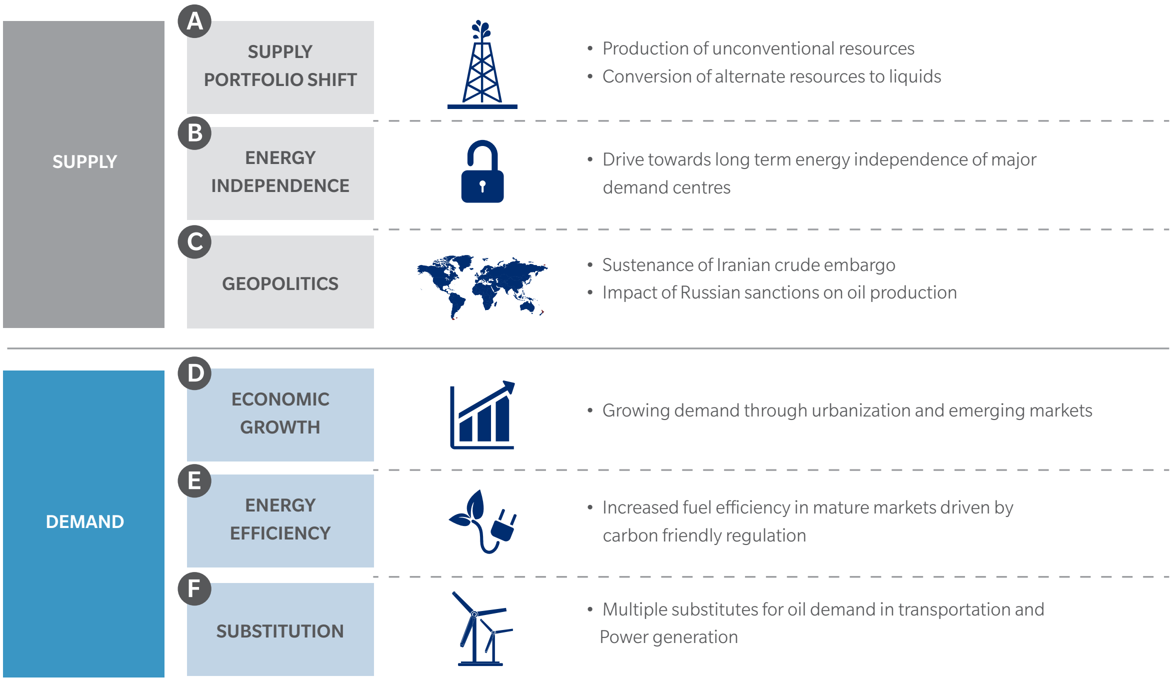
1. Oliver Wyman, "Oil: Implications of a Shifting Paradigm," 2015

Oil prices are expected to remain under $60 per barrel for the near future, impacting GCC fiscal and economic growth trajectories.

Many factors are influencing the trajectory of oil (see Figure 2). Demand for conventional is slowing, in part as a result of the economic slowdown in China. Even more significant are the supply side factors. Global reserves have seen unprecedented growth with new oil field discoveries and increasing recovery rates. Organization of Oil Exporting Countries (OPEC) countries have continued, and in some cases further increased, high levels of production in an effort to maintain their global market share and to fend off non-conventional oil and the Iranian oil that is expected to return to global markets. At the same time, US nonconventional oil output has expanded with more efficient production methods and is increasingly playing the role of a swing producer.

Under these new energy market dynamics, a new low-price era is likely to stay.

EXHIBIT 2: MAJOR DRIVERS IMPACTING OIL INDUSTRY



Source: Oliver Wyman analysis

2.2. IMPLICATIONS OF THE SHIFT ON GCC STATES

In the short term, nations that rely heavily on revenue from oil, such as those in the GCC, face an enormous fiscal challenge, given that they can derive up to 92% of their government revenues from oil[2] . In Kuwait, the figure is approximately 90 percent in 2014.[3] .

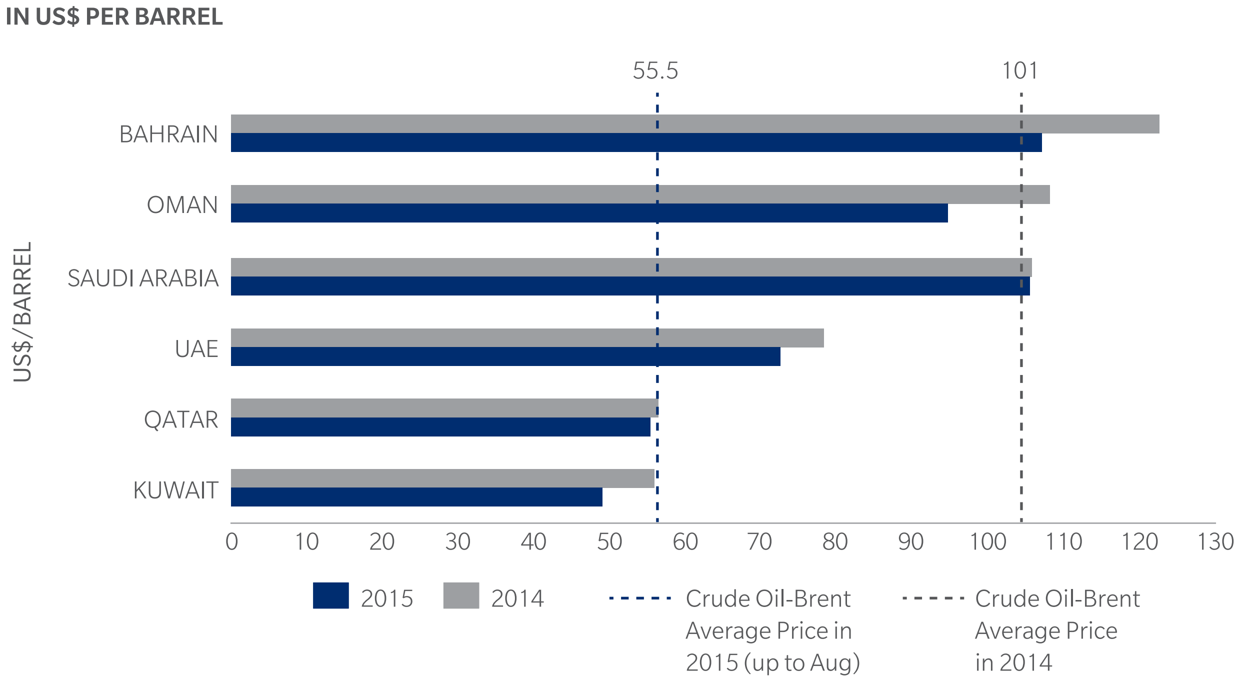
2. Al Khabeer Capital, "GCC Budget Analysis", August 2014

3. National Bank of Kuwait, "Kuwait: FY14/15 fiscal surplus narrows to 7.5% of GDP on lower oil prices", 8th September 2015, after deductions for the Reserve Fund for Future Generations

Over the past several years, increased government spending has pushed up fiscal break-even prices. A drop in crude oil prices now could expose the region to severe fiscal challenges (see Figure 3).

As spending continues to grow at a high pace on both operational and infrastructure development budgets, GCC states are likely to tap their fiscal reserves (worth an approximate $2.7 trillion[4]), including international assets held through large sovereign wealth funds (see Figure 4). Some of them will also tap debt markets to manage their cash flow. In Saudi Arabia, the government started issuing bonds worth $5.3 billion in August 2015, and plans to raise as much as $27 billion more in 2015 to maintain its spending[5]. Additionally, it tapped its foreign reserves: At the end of October, the central bank's foreign assets stood at approximately $655 billion, down more than 10% from the prior year. Although deficits will be relatively smaller for the high-income GCC countries Kuwait, Qatar, and the United Arab Emirates (UAE), under a "business as usual" scenario of continued spending, fiscal shortfalls are likely to become progressively larger.

EXHIBIT 3: GOVERNMENT BUDGET BREAK-EVEN OIL PRICES



Note – The oil price at which the fiscal balance is zero

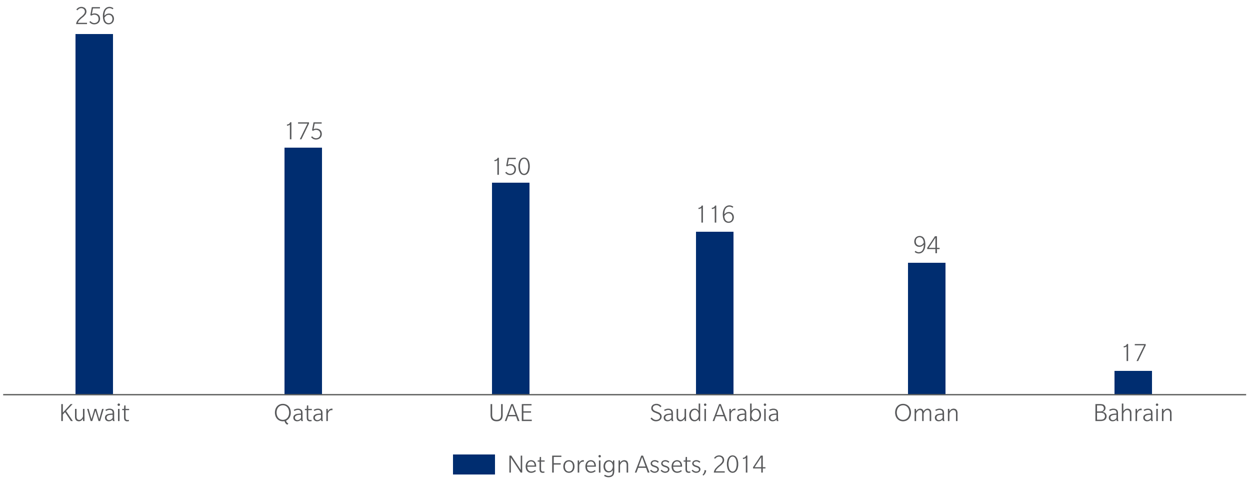
Source: IMF "Regional Economic Outlook: Middle East and Central Asia" , Oct2015

4. Kuwait Times, "Oil Drop to Fuel Fiscal Reforms in GCC", 2015, at http://news.kuwaittimes.net/website/oil-drop-to-fuel-fiscal-reforms-in-gcc-moodys-cooperation-with-opec-no-thank-you-say-ex-soviet-producers/For exampl footnote 2

5. Wall Street Journal, Saudi Arabia Issues Bonds Worth 5 Billion to Plug Budget Shortfall", 2015, at http://www.wsj.com/articles/saudi-arabia-issues-bonds-worth-5-billion-to-plug-budget-shortfall-1439305126

EXHIBIT 4: GCC EXTERNAL CREDITOR POSITION ANALYSIS

AS A % OF GDP



Calculation is = official reserves + SWF – Public External Debt

Source: Institute of International Finance (IIF)

Current trends are unsustainable in the long term even for the richest of GCC countries. Debt markets will reach a saturation point, especially when investors perceive the general fiscal outlook as unfavorable. Overseas assets, albeit large, are not infinite and could be depleted within as little as two decades.

Overseas reserves moreover should not be thought of as a short-term fiscal cushion, but rather as a source of a permanent, non-oil revenue stream benefiting current and future generations. A significant reduction or depletion of these assets could endanger the small GCC countries' economic security. To avoid this scenario, GCC states will need to balance their budgets by enacting rationalization measures that maximize revenues, minimize costs, and increase efficiency.

The benefits associated with rationalization extend beyond a well-balanced budget. It can result in greater overall effectiveness in policy planning and execution, allowing functions to be performed with greater transparency and efficiency. In fact, effective government is a core determinant of successful economic development and private sector empowerment – especially in the GCC, where government plays a central role in the economy.[6]

This is not the first time the GCC faces the specter of austerity: Low oil prices from the mid-1980s to the late 1990s forced governments to define spending priorities. In several instances, especially with measures involving subsidy cuts, Gulf governments faced a public backlash and resistance from the business community. A number of measures were either withdrawn or watered down, resulting in reduced savings and a loss of credibility. For rationalization to be successful, smart timing, comprehensive public communication, and politically astute packaging of reforms are essential. Fortunately, GCC states will be able to draw on many more regional and international "lessons learned" now than they could two decades ago.

6. Steffen Hertog "Public Sector Governance in Kuwait: Towards a Technical and Social Reform Package", 2013

2.3. IMPLICATIONS OF THE SHIFT FOR KUWAIT

The implications of the oil price trend for Kuwait are no different than for its GCC neighbors. For the first time this decade, Kuwait is expected to have a budget deficit of KD4.1 billion for 2015 fiscal year.[7] The situation will have drastic consequences should the current patterns of oil prices and government expenditures persist.

Currently, Kuwait's public expenditure, growing at a rate of 7 percent annually, is primarily driven by public sector wages and subsidies. The allocation of funds to investment activities, which have the potential to generate revenue, is limited, and the government has struggled to actually deploy these funds. These alarming trends have prompted greater discussion among government officials to re-allocate revenues into high value-add activities (such as industrial cluster development), which are expected to be explored with the next oil price cycle.[8]

As with other GCC states, Kuwait can in the short term cope with the bearish oil market by drawing on its overseas financial buffers and issuing debt. If expenditure continues to expand in line with growth in population and public sector employment and salaries, however, then Kuwait's general reserves will be depleted by end of fiscal year 2022/23[9].

As fluctuations in the price of oil are difficult to control, the government of Kuwait needs to explore new systematic measures to adjust revenue and expenditure.

7. Ministry of Finance - "Analysis and expenditure of financial performance during second quarter 2015/16"

8. Ministry of Finance – Kuwait Central Statistics Bureau, 2014

9. Calculation assumes no withdrawals from Future Generations Fund; oil price of $45/barrel; government expenditure growth of 4%; non-oil revenue growth of 5.5%, and oil production of 2.7 million barrels/day, growing at 2% and production cost reductions of 5% annually; includes payments to Future Generations Fund of 10% of total revenue; TICG analysis, 2015

3. BUDGET RATIONALIZATION IN GOVERNMENT EXPENDITURE

3.1. THE NEED FOR BUDGET RATIONALIZATION IN THE GCC AND KUWAIT

The GCC is not the only region facing budgetary pressures: In the wake of the international financial crisis, most advanced economies have had to freeze or cut public salaries and positions, raise taxes, cut non-essential spending, and improve the efficiency of existing government programs. The experience with such policies in the GCC is limited, for several reasons. Most obviously, GCC countries have not in recent history faced budgetary pressures that would warrant such action. GCC states moreover have developed a social contract with their citizens in exchange for benefits and entitlements that provide them with a high standard of living. Such elaborate entitlements can include the creation of non-value add or redundant, and relatively high paying, employment opportunities in the public sector, consistent wage increases, and large subsidies on essential consumables such as water, electricity, and food.

This approach has contributed to political stability and social cohesion in a volatile regional environment. However, not only is it fiscally unsustainable but it also has a number of hidden social and economic costs. Subsidies disproportionately benefit richer households and distort consumption and investment decisions. Employment in the public sector tends to benefit some at the exclusion of others, particularly young workers and women. Excessive public employment weakens the effectiveness of government – which in turn can affect citizens' quality of life.

That being said, current expenditure structures cannot be reformed through simple across-the board cuts. While improving equity and efficiency of spending is important, consideration must be given to the social and wealth-sharing purpose of expenditure, and the political interests served by the GCC social contract. This is particularly true in Kuwait, where the state-employed middle class citizenry is well organized through parliament, media, and public sector unions.

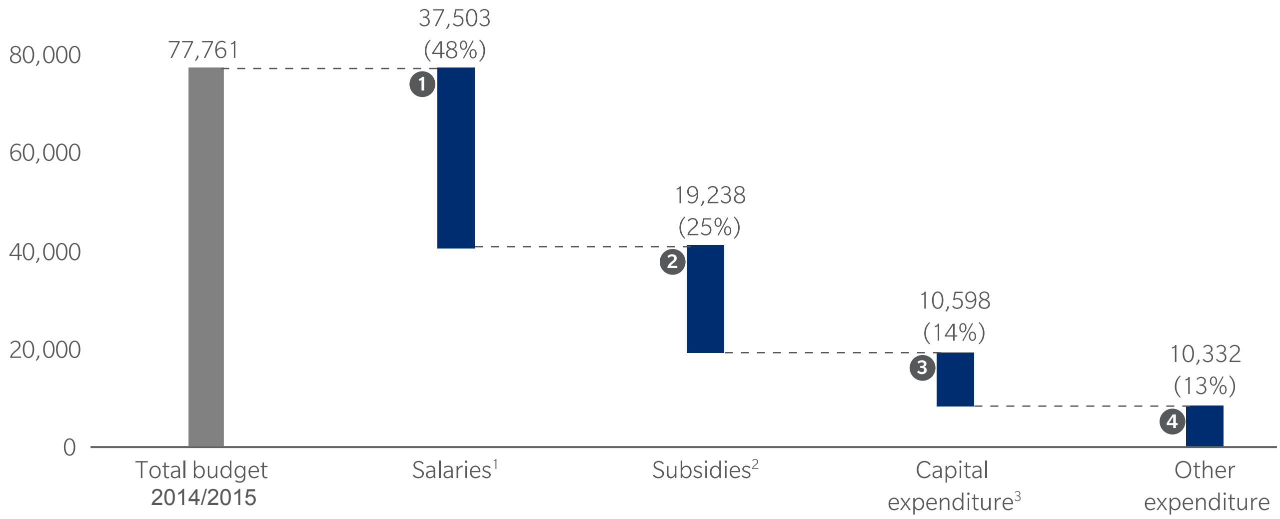
For reforms to work, there must be "buy in" from critical constituencies. In many cases, that entails compensatory policies that maintain the purpose of wealth sharing, but do so in a less distortionary and more efficient way than the current system.

3.2. UNPACKING THE BUDGET

Figure 5 shows that substantial fiscal reforms cannot avoid the items of salaries and subsidies, which together constitute three-quarters of state spending in Kuwait –to our knowledge, the highest proportion in the MENA region.

EXHIBIT 5: KUWAIT BUDGET FOR FISCAL YEAR 2014/2015

IN MILLION US$



Assumed $3.35/KD exchange rate

1. includes First Chapter Ministries and Governments, Attached, Independent, Ministry of Defense, Judiciary Affairs, Contribution of the treasury to social deposits, cost for raising salary ceiling , Da'am Al Amala subsidies, social assurances (ministry of social affairs, council of ministers)

2. include education, reduced cost of living, cost of fuel, local activities, etc.

3. Cap. Expenditure from a subset of Ministries, attached and independent

Source: Ministry of Finance Kuwait (Macroeconomics & fiscal policy unit) 2014/2015

1. Wages and benefits. Most nationals are employed in the public sector, which creates enormous pressure on the state budget and crowds out potential capital investment. The average wage bill in the GCC is more than double the amount found in the rest of the world – and at almost 50%, Kuwait has the highest share in the region[10].

The public sector salary bill has been growing at an average pace of 12 percent annually from 1990 to 2014[11]. The growth is driven by increases in employee base pay and allowances (6 percent), promotions and bonuses (4 percent), and new hires (2 percent). The government has applied light measures to control growth of this budget item that do not cause an immediate decline in salaries. Such steps include harmonizing wage grids, exercising early retirement programs, reducing job allowances, limiting promotions, and controlling the number of new entrants. Yet these actions will at best slow the upward trend.

Approximately 80 percent of Kuwaitis are employed in the public sector. Unlike Organization for Economic Co-operation and Development (OECD) countries, governments in the GCC have prioritized job creation for their citizens over recruiting on the basis of needs and specific qualifications. As a result, over-staffing is ubiquitous, causing many process inefficiencies and reducing the overall quality of service provision. Additionally, the lack of a standardized salary grid for different jobs within government has caused significant discrepancies in pay. The state's allowance system is a particularly unwieldy aspect of government

10. Ministry of Finance Kuwait (Macroeconomics & fiscal policy unit) 2014/2015

11. TICG Analysis

employment; on average allowances account for more than half of total pay. To date the government has a listing of approximately 200 allowance categories, which no doubt contributes to high pay[12].

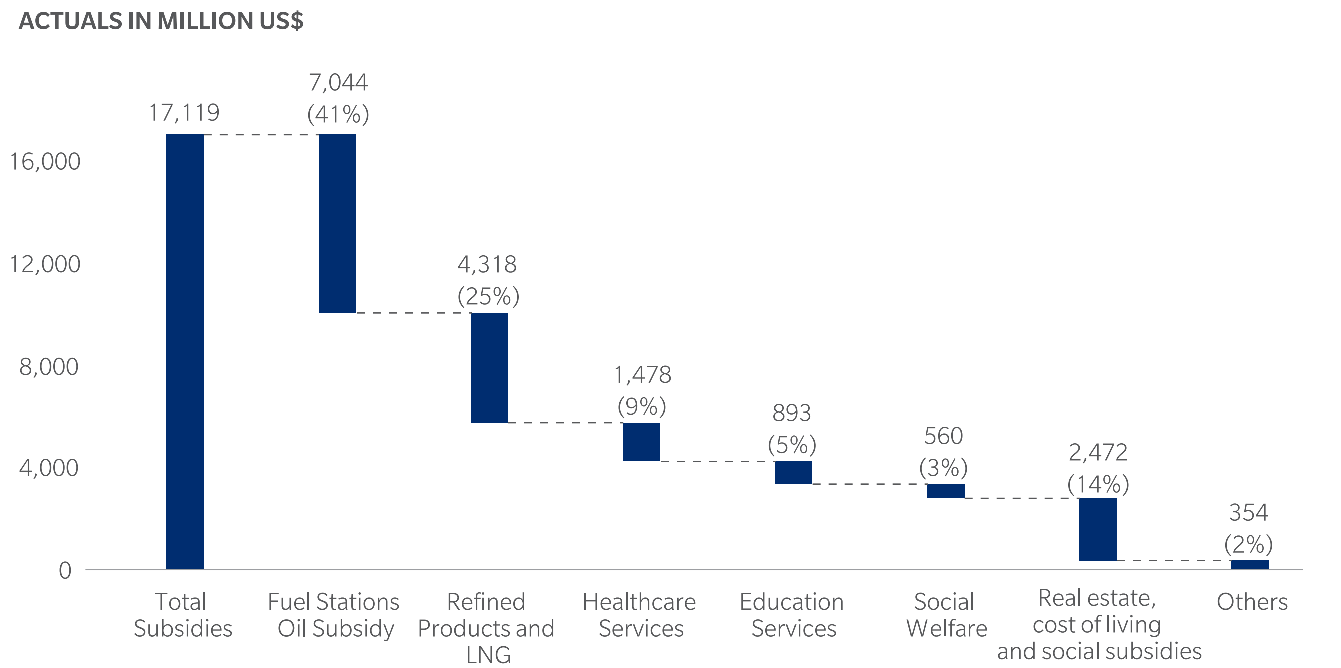
Governments have been slow to match demand and supply for workforce skills. Labor management challenges include the lack of a qualifications framework used during hiring and a below average skill level of the public workforce. Rewards such as bonuses are often handed out indiscriminately. Promotion procedures typically allow employees to advance based on the number of years spent in a role rather than on performance. Moreover, performance evaluations are rarely stringent; most employees receive an "excellent" rating from supervisors[13].

The Kuwaiti government is not investing sufficiently in employee training. Foreign employment in the sector has increased in step with local employment in recent years, indicating that skills gaps persist[14]. Moreover, employability and promotions in many cases are marred by influence peddling and patronage. Disempowering these factions will prove difficult.

The Kuwaiti social contract has created an expectation that wages will continue to rise. Disrupting this tradition without an appropriate sequencing and political communication strategy may cause a loss of confidence in government. In fact, such a disruption occurred in 2011, when professionals organized protests to demand salary increases. The state heeded their call, as the government was ill prepared to drive a harder bargain with organized labor.

2. Generalized subsidies. In the GCC, generalized price subsidies are a key component of the social contract. Subsidies on food, fuel, and shelter continue to grow significantly. Middle East & GCC countries spend much more on subsidies relative to their size

EXHIBIT 6: TOTAL KUWAIT SUBSIDIES FOR 2014/15



Assumed $3.35/KD exchange rate

Note that total subsidies herein account for actuals (which defers from the budget value depicted in Fig. 5)

Source: Ministry of Finance Kuwait 2014/2015

12. ibid
13. Ibid
14. Ibid

than other regions. Their total pre-tax energy subsidies in 2014 cost $237 billion, equivalent to 48 percent of world subsidies, 8.6 percent of regional GDP, and 22 percent of government budgets[15]. Despite these huge costs, generalized price subsidies are not well-designed to target the desired end user, namely, low-income and vulnerable households. Instead, subsidies disproportionately benefit larger and richer households. According to International Monetary Fund (IMF) estimates, the richest quintile of households in developing countries captures six times more in fuel subsidies (43 percent) than the poorest quintile. Subsidies also result in increased consumption of subsidized goods – particularly energy – wastage and inefficient distribution. This pattern has increased the pressure on governments to identify alternative measures to better target low-income households. Subsidies can also have negative consequences for economic diversification and upgrading: Countries with high hydrocarbon rents per capita that provide cheap domestic energy have witnessed a decline in energy efficiency over recent decades[16].

The current system in Kuwait provides blanket general subsidies to all consumers. A relevant share of the subsidy budget, is allocated to direct subsidies on fuel and other products (see Figure 6). Kuwait has seen rapid growth in subsidy spending on fuel, water, electricity, education, and healthcare services.

Policymakers recognize that the general welfare system in Kuwait has become unsustainable. Fuel prices have not changed in the past 15 years, and power subsidies are offered indiscriminately to citizens and residents at less than 5 percent of the cost.

However, removing generalized price subsidies will pose challenges to the Gulf States. Eliminating subsidies can, in the short term, adversely affect the competitiveness of industries that rely on them. Moreover, Kuwaitis would most likely take issue with price increases that are not accompanied by compensatory measures to soften the impact on low- and mid-income households.

3. Capital Expenditure. This category includes items like infrastructure maintenance, equipment, and supplies. In Kuwait, goods and service requirements, primarily expenditures on health goods and services, make up the largest share.

Items in this category are not optimized along cost-benefit lines. Funds could be allocated more efficiently, such as on projects that yield higher reward to risk ratios and are necessary for Kuwait's economic development, including critical logistics infrastructure. Additionally, with little transparency and monitoring, funds can be mismanaged or lost. A lack of budget ceiling enforcement further exacerbates issues.

As these expenditures are handled by many stakeholders, they are more difficult to impact and modify. Any reforms here are likely to be smaller-scale and require close individual evaluation.

Ultimately, an over-staffed, overburdened government creates inefficiencies and undermines governing capacity. Most important, the existing budgetary imbalance must be rectified.

15. IMF, "Energy Subsidies for the Middle East and North Africa", March 2014

16. Steffen Hertog "Rent Distribution, Labor Markets and Development in High-rent Countries", 2013

4. THE KUWAIT APPROACH TO BUDGET RATIONALIZATION

Fortunately, GCC governments have many tools at their disposal to mitigate budgetary pressures and shift to a course of sustainable prosperity. Over the past 24 months, GCC governments have begun exploring rationalization measures. The UAE has been perhaps the most daring, having quickly implemented the complete removal of fuel subsidies in the summer of 2015. Several countries have increased electricity or transport fuel prices in a more measured fashion. Saudi Arabia has drawn on international best practices to improve their budget classification and improve expenditure control. Qatar, UAE, and Oman have launched internal review programs to streamline spending in as infrastructure investments, maintenance, equipment, supplies, and to ensure timely and effective implementation.

TABLE 1. SUBSIDY-RELATED REFORM MEASURES IN MENAP OIL EXPORTERS

GCC	
Bahrain	Authorities announced increase in natural gas prices for industrial users (+11%) and employee medical insurance fees (paid by employers) in early 2015.
Kuwait	In Jan-15, government raised diesel and kerosene prices (+50%) and instituted monthly price review mechanism.
Oman	No reform measures recently announced.
Qatar	Diesel prices up in May-14 by 50%. Starting to improve desalination technologies and awareness of sustainable energy use.
Saudi Arabia	No reform measures recently announced.
UAE	Gasoline price highest in GCC (still below int'l levels). Abu Dhabi increased water (+170%) and electricity (+40%) tariffs in Jan-15.
Non-GCC	
Algeria	Authorities published cost of implicit subsidies in budget for first time in 2014.
Iran	Fuel prices were increased i n Mar/Apr-14 by about 30 percent. Similar increase is possible in 2015.
Iraq	No reform measures recently announced.
Libya	Two initiatives being piloted: (i) use of national ID to eliminate duplication, (ii) reduce number of subsidized food items.
Yemen	Increase in gasoline, diesel, and kerosene prices in 2014 by 20%, 50%, and 100%, respectively. Automatic fuel price adjustment mechanism planned for first half of 2015.

Source: National authorities and IMF staff.

4.1. WHAT HAS BEEN ACCOMPLISHED

In the last quarter of 2014, Kuwait cut subsidies on kerosene and diesel. The diesel price reform alone, it is estimated, will save the country nearly $1 billion a year, though the policy has since been amended to exclude some stakeholder groups.

The government of Kuwait has also taken steps to improve oversight and discipline in budget planning and execution[17]. It announced plans to transition to top-down budgeting starting in Fiscal Year (FY) 2016/17, and to a medium-term budgeting framework in FY 2017/18. Additionally, the government established a Public Financial Management Committee to guide and supervise public financial management reforms. Finally, it agreed to a full implementation of the Government Financial Management Information System starting in FY 2016/17.

These moves will no doubt help Kuwait strengthen its capital investment planning and prioritization towards high-growth sectors. But they do not yet amount to the comprehensive fiscal reform plan required to deal with the new oil price situation.

4.2. RECOMMENDED REFORMS

We recommend four target areas for reform. First, on the expenditure side, Kuwait should adopt the new strategic system that standardizes government wages, rewards high performers, and optimizes the size and service

EXHIBIT 7: BUDGET RATIONALIZATION MEASURES

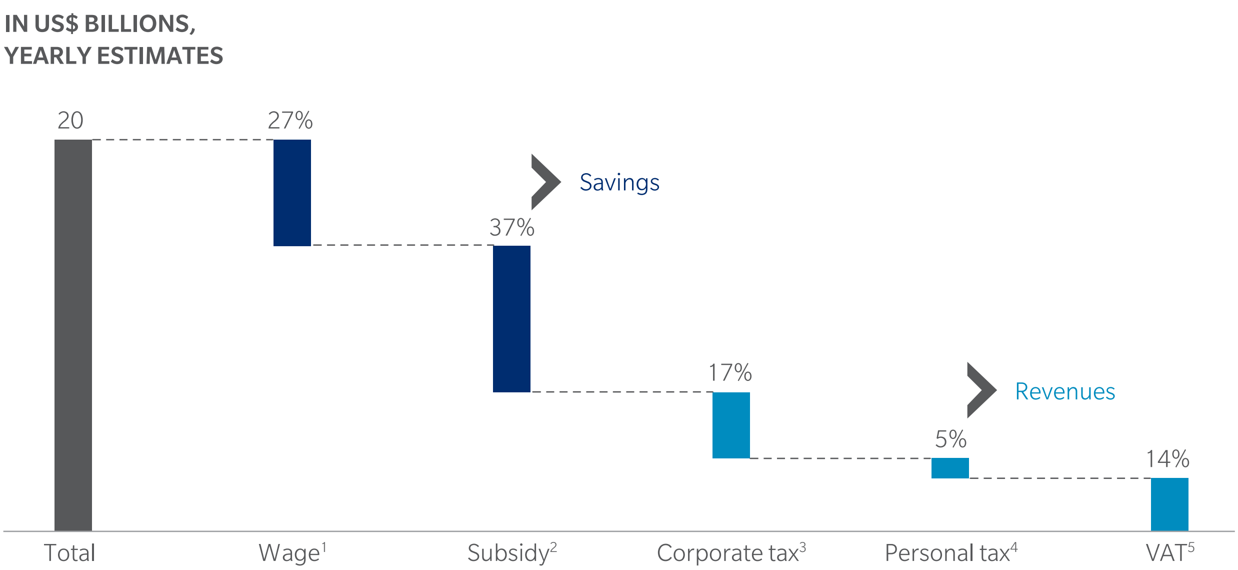
1	WAGE REFORM	• Revamp the current salary grid and review wages • Address redundancies and link reward to performance • Set thresholds on the number and type of new hires • Promote and personalize career development and training
2	SUBSIDY REVIEW AND CONTROL	• Replace indirect subsidy system with cash payments • Reduce subsidies for heavy industry users and for private consumers • Revise cost of services to reflect actual cost or part of the cost
3	BUDGETARY CONTROL	• Improve efficient resource allocation • Streamline national budgeting procedures • Utilize sovereign wealth funds • Implement anti-corruption framework
4	CORPORATE, PERSONAL AND VAT TAXATION	• Implement corporate tax • Introduce a VAT program on certain goods • Launch taxes on foreign labor for certain sectors

17. IMF Kuwait, Article IV Consultation Concluding Statement, 2015

provision of the government. Second, subsidies should be reviewed with a view to cutting waste while guaranteeing sustainable and politically important benefits for the more vulnerable members of society. Third, Kuwait should explore mechanisms to control budget spending and ensure efficient resource use, especially in unproductive sectors such as education, healthcare, utilities, and other services. Fourth, on the revenue side, the country should implement fiscal reform by preparing for the creation of personal, corporate, and value-added taxes (see Figure 8). The list is not exhaustive; rather it provides priority recommendations, especially on expenditure, that will make an impact and that are necessary for Kuwait's development. Therefore, this should be viewed as the start of a journey to improving the efficiency (and effectiveness) of public sector expenditure.

Implementing these recommendations will lead to savings of about $20 billion per year (see Figure 8).

EXHIBIT 8: POTENTIAL SAVINGS AND REVENUES FROM BUDGET RATIONALIZATION



Proportion of 2014/2015 Fiscal Budget

25%	7%	9%	4%	1%	4%

1. TICG estimate, yearly average savings for the period between 2015-2024, assuming the wage reform implementation vs current as is scenario

2. MoF document "The Effect of Amending Oil, Electricity and Water Tariffs and Subsides"

3. Ministry of Finance estimate

4. TICG analysis, (calculation assumes 5% tax rate for foreign resident earners of 800 KD or more employed in the private sector only)

5. International Monetary Fund estimate

- **Wage reform**. Stopping runaway growth in salary-related budget items is arguably the most important challenge. Without this reform, the Kuwaiti fiscal situation will be unsustainable in the long run. In addition to keeping salaries under control and in line with local cost of living, the overall size of government needs to be managed by setting hiring caps and encouraging greater private sector employment. If implemented, this program could generate savings above $50 billion in ten years. These reforms can be achieved in the following ways:
  - Revamp the current salary grid and organize allowances – create salary grids for each profession to ensure a fair and equitable system, and standardize allowances to avoid system abuse. Streamline allowances into eight key categories (late shift, shift, remote area, overtime, extended hours, managerial, committee, and working group allowances) for better planning and monitoring. Ensure salaries are competitive and reflect market trends.
  - Establish a wage-review system– introduce salary reviews for each professional category, allowing regular reviews of salaries and recommendations of adjustment based on market benchmarks. Salary reviews should be re-evaluated every three years to account for market changes and to adjust for inflation.
  - Address redundancies – revise existing organizational structures of government entities and identify job redundancies. Develop consolidated job repository or database to identify requirements and existing openings in the government. Re-allocate staff to existing job openings that complement their qualifications or re-train employees for other professions. Promote private sector job placements for departing staff and offer cash grant schemes for those who leave in order to gradually streamline public employment.
  - Link reward to performance – set up a new performance management system to track individual performance objectively, and establish policies for promotions and bonus policies that reward, financially and through increased responsibility, high performers. Make sure performance review board enforces fair and transparent evaluation standards across government.
  - Set maximum thresholds on the number and type of new hires – develop candidate assessment frameworks that systematize and mitigate the risk of personal bias from the hiring process and prioritize an individual's qualifications for the role. These frameworks will include a grading system for each candidate and will require the involvement of a panel of interviewers, in some cases from different departments. Additionally, the government can freeze recruitment in areas where it is not required, utilize short-term contracts, and encourage earlier retirement for senior employees.
  - Collaborate with universities – develop a robust assessment of government skills needs, identify subject-matter gaps at education institutions, and jointly promote student enrollment in those programs.
  - Promote and personalize early career development and training programs – develop training schemes that help employees grow vertically into more senior roles and laterally into adjacent roles that account for changing organizational needs. Training should address technical skills that improve and expedite output generation and include modules that address soft skills such as leadership, problem solving, and communication. Training should be supplemented by formal mentorship pairings that can increase the motivation, transparency of performance, and visibility of employees to their managers.
  - Implement a new performance management system – re-structure the bonus distribution curve based on a new performance management scheme across all civil sector employees. This will create transparency and equity in the bonus distribution process across all ministries and government entities.

The reform of wage bill growth will require a significant political communications effort. Improved fiscal sustainability – which will benefit Kuwaiti citizens in the long run – should be highlighted. Other advantages, such as greater transparency and fairness, are worth touting, as is the positive impact the reform will make on government accountability, performance, and customer orientation. Tying wage bill reforms to the introduction of alternative means of wealth sharing could help reduce political pressures to over-recruit in the public sector (see below for more detail).

- **Subsidy review and control**. Subsidy reforms require savvy political packaging and sequencing. Measures should minimize government revenue loss and maximize satisfaction among the largest number of Kuwaitis. Estimates indicate that a reduction of subsidies, primarily on fuel, gas, and health services, could lead to savings of as much as $7.3 billion per year[18].
  - Replace the indirect subsidy system with cash payments – this single-payer system will provide the same level of support to all eligible citizens instead of giving preferential support to high-income consumers.
  - Reduce subsidies for heavy industry users – target industry for subsidy cuts in accordance with a pre-announced schedule that allows production and cost structures to adjust. All across the GCC, industrial subsidies have proved easier to reform than broad-based subsidies benefiting the population at large. Subsidy cuts could hence be introduced in this sector first to avoid a joint backlash from business and citizens. Limited compensation should be offered.
  - Reduce subsidies for private consumers – introduce price changes for private consumers gradually, ensuring a rollout with an extended timeline of three to five years. In the case of electricity, redirect subsidies to eligible citizens only by offering "lifeline" tariffs that provide low prices for small levels of consumption.
  - Revise cost of services to reflect actual cost or part of the cost – follow a "pay-as-you-go" government approach, where prices are hiked on services to ensure cost is covered and a modest margin is achieved to support other non-revenue generating operations. This model will cut system abuse by reducing "free-usage" and will help to conserve energy input for the future. Such services can include small co-payments for insurance coverage and higher costs for access to services.
  - Offer an appropriate compensation scheme – offer a cash grant scheme that can reduce the newly introduced cost burden on vulnerable consumers. IMF research shows that the vast majority of successful energy subsidy reforms around the world have been accompanied by compensatory measures protecting the most affected households. Kuwait is in the fortunate position of being able to afford a relatively generous compensation policy. The simplest and politically most attractive option would be an unconditional, monthly cash grant to all adult Kuwaitis that could be financed out of subsidy

CASE STUDY – ENSURING LIMITED BACKLASH WHEN IMPLEMENTING SUBSIDY CUTS

- **Context** – a recent wave of reforms in the GCC and wider MENA region provides insights on how Kuwait can incorporate subsidy cuts with limited backlash[19].
- **Triggers of reform** – similar to the situation in Kuwait, countries sought to cut subsidies to mitigate large external and fiscal deficits and limit the growth of public debt. In the UAE, government also sought to take advantage of low oil prices to fix domestic prices.
- **Focus** – reform has focused on fuel products and electricity tariffs. Food subsidy reforms, by contrast, have been less prevalent as they are a lower cost burden for the government and are more difficult to impose on the public.
- **Mitigating measures** – countries mitigated the public backlash of the increase in fuel prices mainly through introducing or scaling-up cash transfer programs.
- **Communication strategies** – reform was generally accompanied by public communication campaigns, including media coverage showcasing the government's commitment to reform and highlighting the cost and unsustainability of existing subsidy programs.

18. Ministry of Finance, "The Effect of Amending Oil, Electricity and Water Tariffs and Subsidies," 2015
19. IMF, "Subsidy Reform in the Middle East and North Africa: Recent Progress and Challenges," 2014

savings (making grants conditional on household income would require the build-up of a complex income monitoring system that would slow the reform and reduce its political attractiveness).

The IMF estimates total energy subsidies in Kuwait at 7.2% of GDP in 2015. If all these subsidies were converted into cash grants to adult nationals of age 20 and older, each citizen would be granted more than $12,000. Even a grant considerably lower than that would more than compensate the majority of Kuwaiti consumers for higher energy prices. Similar oil-financed “resource dividends” for citizens have been successful in countries as diverse as Bolivia, Iran, and the United States (in Alaska).

- Pursue an adequate political communication strategy – deploy a multi-channel media strategy that highlights four things: a) the relative cost of subsidies to the government as well as per household, both currently and in the long run; b) the benefits of the alternative compensation scheme, illustrated by comparisons of how much the new cash grants can buy; c) a clear message that the reforms as well as the compensation mechanism are permanent; and d) ways in which households can save energy without compromising their quality of life.

In summary, the government will need to cut certain subsidies through the initial targeting of national industry players as well as sequenced price increases for other user groups. Policy reforms will need to ensure that subsidy mechanisms benefit low-income households.

The generosity of the compensation scheme could vary. An extreme version, where all savings are passed to citizen consumers, would offer no immediate fiscal benefit, but it could confer important long-term benefits, as higher prices would reduce energy consumption growth and hence prevent escalating subsidy costs in a business as usual scenario. Perhaps more important, converting cheap energy to a “citizens’ income” would be an important first step towards a fairer, more sustainable wealth-sharing system that would not distort consumption and investment patterns. It could make it politically easier to reduce government hiring in the future. The more government is able to share wealth directly and guarantee a minimal quality of life to its citizens, the less it will need to rely on over-employment and subsidies to fulfill its role in the social contract. Less public sector hiring of course also liberates resources for such wealth sharing.

- **Financial budgetary control**. Resource allocation and utilization should be improved and returns should be maximized by re-directing funds to key investment areas[20].
  - Improve efficient resource allocation – identify the optimal allocation of public spending through a robust output-driven budgeting process drawing on a long-term fiscal planning framework that takes into account revenue fluctuation. Capital expenditure should be prioritized based on an analytical assessment of expected output as well as centralized, transparent procurement mechanisms. Public investment, especially in infrastructure that can raise the economy’s productive capacity and alleviate bottlenecks, should be accorded special importance.
  - Streamline national budgeting procedures – introduce measurable, real-time indicators, such as budget ceilings, that allow government officials to quickly monitor and address budget overspending through a dashboard system.
  - Introduce performance-based budgeting – build procedures and capacity to link budget allocation to concrete, measurable objectives as well as policies and activities, and build capacity to undertake “performance audits” that go beyond the purely financial audits undertaken by the State Audit Bureau. These structures can be used for regular spending reviews that will require budget items to be justified for renewal.
  - Reduce corruption in spending – design and implement an anti-corruption framework that promotes transparency of budget flow and reduces misallocations and mismanagement. Disclosing easily accessible budget data to the public, along the lines of what OECD and Open Budget Initiative recommend, will help in this process.

In summary, the government should work to improve the efficiency of spending and to improve accountability and measurability of performance. Doing so will reduce unnecessary expenditures and help allocate government staff more rationally.

20. IMF, Article IV Consultation Concluding Statement, 2015

- **Corporate, personal and Value-Added Tax (VAT) taxation**. As recommended by the IMF, Kuwait should introduce a tax system that targets corporate, personal income, and value-added taxes.
  - Tax for large national enterprises – the Ministry of Finance estimates that Kuwait could generate up to $3.3 billion with this project, funding more than 90 percent of the deficit of the first 5 months of this year[21]. A corporate tax should be introduced gradually to avoid a recessionary impact on business at a time when economic activity is already slowing.
  - Personal income taxation – taxes on foreign labor could generate significant revenue from Kuwait's population of 1.8 million foreign residents and help facilitate private sector Kuwaitization, which is necessary to reduce pressure on the over-staffed public sector. This would be particularly true if the revenue was used to further support the employment of Kuwaitis in the private sector (e.g., through an improved and better monitored "da'm al-'amala" wage subsidy system). However, it is important that such policies be gradually introduced so as to not damage cash-sensitive Small and Medium Sized Enterprises (SMEs) or significantly impair the income of the existing population of low-wage foreigners. Conservative estimates of personal income taxes of private sector expat employees can generate nearly $1 billion[22].
  - Value-Added Tax – the government can reap additional revenues from taxing luxurious goods with VAT program. Such taxes have been successful around the world, including in parts of the UAE where a 5% tax is applied in hotel services and entertainment. The implementation of VAT should occur over the medium term. It is expected that VAT can generate between $1.7 billion and $2.7 billion[23].

Taxes remain politically sensitive in the region – but they are in the long-term self-interest of Kuwaiti business. The Kuwaiti private sector currently is under much political pressure from parliament and the broader Kuwaiti middle class constituency, which prefers government spending on Kuwaiti households over development spending that would benefit the private sector. To the extent that business will provide more taxes to finance public services, and will employ more Kuwaitis as a result of higher taxes on foreign labor, the outlook of the Kuwaiti public is likely to shift in a pro-business direction. It will become clear that a thriving private economy is in the best interest of citizens.

In utilizing both cost- and revenue-side levers of budget control, the government has considerable potential to manage deficits as well as improve incentives for efficiency improvements in both the public and private sector. Implementing these recommendations will require strong political commitment as well as collaboration from stakeholders.

21. Arabian Business, "Kuwait to Raise 3.3 Billion Annually from New Companies," 2015, at http://www.arabianbusiness.com/kuwait-raise-up--3-3bn-annually-from-new-companies-tax-minister-608236.html

22. TICG Analysis

23. IMF Kuwait, Article IV Consultation Concluding Statement, 2015

CONCLUSION

Increased oil price volatility has generated economic uncertainty and created strain on government budgets in the short term. Yet it has also unveiled many of the inefficiencies in budget allocation and spending that characterize the GCC fiscal process.

The measures that GCC nations take today to manage their fiscal budgets will have to be all encompassing and coordinated. If properly designed, these measures will have a profound effect—not just in helping to balance the budget in the short term but also in developing an effective, efficient government and providing incentives for more rational behavior among industry and consumers.

Applying controls on expenditures is not sufficient to secure a stable fiscal position for Kuwait. As noted, even in implementing the new wage system, unsustainable expenditure growth is likely. Therefore, the government must also expand and diversify revenue sources. The introduction of various taxes is a good first step, but it will only work in the long run if the private sector grows far beyond its current size. That means that Kuwait needs to facilitate a shift towards higher value-added economic activities.

Similarly, it should continue with other initiatives to increase the efficiency of the public sector such as centralized procurement, digitization, and development of new business models within entities.

Kuwait should also continue its drive to implement its national vision to diversify into new economic and trade opportunities. Investment in competitive clusters will generate high-quality jobs, attract foreign and local companies to invest in non-oil industries, and support sustainable, diversified, revenue generation based on a stronger and more resilient private sector.

Achieving those objectives will require a strengthening of government capacity, in terms of top-level, cross-agency strategic planning, coordination, and performance measurement, and in terms of lower-level implementation capacity. While those details fall beyond the scope of this paper, the salary and civil service reforms outlined above constitute critical steps not only towards budgetary consolidation but towards broad government reform.

Together, the suite of initiatives outlined here will empower Kuwait to realize its economic ambitions while ensuring a healthy and balanced budget, and affording better opportunities for the country, today and in the future.

ABOUT TICG

Tri International Consulting Group (TICG) is a world-class management consultancy that combines extensive industry knowledge and deep Kuwaiti market understanding with specialised expertise in strategy, operations, risk management, and organisation transformation. Our professionals help clients optimise their businesses, improve their operations and risk profile, and accelerate their organisational performance to seize the most attractive opportunities.

TICG was founded as a joint venture between the Kuwait Investment Authority (KIA), the first sovereign wealth fund in the world, the Kuwait Fund for Arab Economic Development (KFAED), the first Arab international development institution, and Oliver Wyman, a leading global management consulting firm.

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