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# Earnings Differentials and Nationalisation Policies in GCC's Private Sector Labour Market

Usamah F. Alfarhan

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edited by Philippe Fargues and Nasra M. Shah

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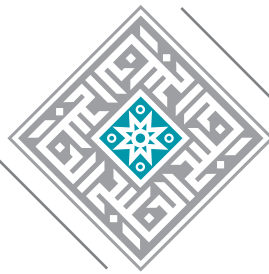


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## About the Gulf Research Center

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# About the Gulf Labour Markets, Migration, and Population (GLMM) Programme

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## XII

### Earnings Differentials and Nationalisation Policies in GCC's Private Sector Labour Market

*Usamah F. Alfarhan\**

**Abstract:** Unjustified earnings differentials between locals and migrants are considered a major impediment to successful nationalisation policies in the GCC under current quota systems. This chapter provides empirical estimates of the earnings differentials between local and migrant labour from the Indian sub-continent and the Arab region, who constitute the majority of migrant labour in the GCC. It states that the higher earnings of locals over both groups are fully explained by distorted earnings structures. The chapter also provides a theoretical explanation for the failure of current nationalisation policies GCC-wide and presents a market-based alternative that depends on a tax/subsidy scheme where relative prices of local and migrant labour are altered in accordance with preset policy employment targets. The success of such policies is contingent on the relative elasticities of labour supply as well as the elasticity of demand for a firm's final output under noncompetitive input and output markets.

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## **Introduction**

The structure and development of labour markets in the GCC is inextricably linked to the growth in oil wealth that these countries witnessed in the 1970s. Although some of the GCC countries, such as Saudi Arabia, began exporting oil in the 1950s and 1960s, oil wealth became more apparent after the Saudi oil embargo of 1973.

For the first time in history, oil prices increased above \$5 per barrel and continued to climb to \$40 at the end of the 1970s when the Shah of Iran fell from power. Subsequently, there was a progressive departure from the traditionally nomadic and tribal governing systems to a more unified state building arrangement among local populations. The combination of these events resulted in the sudden and significant transformation of the GCC countries into wealthy modern economies. Oil wealth presented the young GCC nations with an opportunity to develop their infrastructure rapidly. Since their populations at the time were very small and relatively uneducated, development required a large influx of labour. According to Fasano and Goyal (2004), “To satisfy this demand, and in light of the relatively small size of local populations, the GCC countries adopted an open door policy to foreign workers.”

An adverse consequence of the GCC’s oil surpluses, and governments’ unofficial policy of distributing oil income to nationals by employing them in the public sector with high wages and ample benefits, was that nationals preferred public employment. Foreign workers were concentrated in the private sector, which pays lower wages and offers employment benefits that are inferior to those in the public sector. With falling oil prices and a fiscally distressed public sector, increased competitiveness of GCC’s private sector has become more relevant than ever. In fact, the GCC governments believe that their private sector, unlike in the previous decades, will be the main driver of their countries’ future economic growth.

In this chapter, we provide estimates of the local-migrant earnings differentials using a data set that enables us to observe the productivity-related characteristics of workers at the individual level and introduce a market-based alternative to the currently implemented quota systems, where a tax/subsidy scheme is proposed to change the relative costs of hiring local and migrant labour. The introduced theoretical framework takes into account the noncompetitive nature of GCC’s output markets, as well as the monopsonistic nature of the local labour market.



## **Regional Literature**

Wage differentials among various social and demographic groups of workers, including local and migrant labour, have been widely documented in international literature. However, the local-migrant earnings differentials in the GCC has received much less attention.

This lack of documentation is partly due to the scarcity in relevant micro-level data on productivity-related characteristics of workers in the region, which form the main construct of the analysis of such differentials. Existing literature has confirmed that the persistence of wage differentials in the GCC private sector is a major impediment to effective nationalisation policies. Hertog (2012) reports that wage differentials between locals and migrant labour are too large, given that the majority of migrants originate from low-wage countries with relatively low reservation wages. Based on official aggregated statistics from the Saudi Ministry of Labour, Hertog shows that, in 2007, migrants earned on average 2.6 times lower wages than Saudi nationals. Even after controlling for education levels and productivity as per the distribution of workers across various occupations, migrants are generally still the lower earners with the exception of those employed in managerial positions. He also argues that despite a general trend of declining wages for Saudis over time, it is unlikely to indicate declining pay for the same type of job. Rather, it may be because Saudis have become more willing to accept jobs that were previously unacceptable due to increasing socio-economic pressures.

Ramady (2013) argues that the prevalent wage gap between locals and migrant workers in Saudi Arabia is a fact and remains a potential problem to nationalisation and the participation of locals in private employment. As per official statistics, he cites that Saudi males earned on average about 4.6 times higher than migrant males. This gap, however, does not only reflect the direct wage differential between locals and migrants, but also the pay gap between public and private sector jobs. Sadi (2015) cites the particularly low wages in the Saudi hospitality and tourism sector, which is dominated by migrant workers. Despite the measures taken by the government to increase employment of locals, such as a minimum monthly wage of \$800, many organisations have been paying migrants wages that are appreciably below that minimum rate.

Similar trends are also found in other GCC countries. In Oman, as reported by Hertog (2014) there was an attempt to reduce the wage differential between locals and migrants by a 7 per cent levy on migrant labour whose proceeds were to be used in the training of locals, as well as the introduction of regulations that

increase migrant labour mobility, where they no longer need the consent of their current employer to switch to a new one. Such policies potentially increase the attractiveness of the private sector for nationals, as available figures show that private employment of Omanis increased by 138 per cent between 2003 and 2010. Nevertheless, the subsequent increases in minimum wages for Omanis in 2011 and 2012, the introduction of an unemployment benefit for Omanis in 2011, and the creation of thousands of government jobs have imposed serious challenges for Oman's nationalisation progress. According to Hertog, average monthly real salaries of Omanis in the private sector rose by about 45 per cent between 2006 and 2012. Since neither of the aforementioned measures would have affected migrant wages, it is more probable that the wage differential between Omanis and migrants ever came to a decline.

In Bahrain, Randeree (2012) reports that the government implemented labour market reforms in 2007 that aimed at deregulating the labour market and eliminating the cost differential between local and migrant workers, among other targets. Measures included taxation of migrant labour and increasing their mobility, similar to that in the Omani labour market. Bahrainis are also entitled to an unemployment benefit after contributing at least 12 months' pay to a 1% income tax geared towards an unemployment and insurance scheme. Despite all the measures taken, the wage differential between locals and migrant workers remained at between \$520 and \$1,040 per month.

Randeree also reports on the GCC-wide phenomenon that migrant labour, on average, is willing to work for longer hours and accept lower wages compared with locals. As part of the nationalisation policies in the UAE, wage subsidies for locals as well as wage restraints for government employees were put in place in the late 1990s. Also, Fasano and Goyal (2004) argue that the wage differentials between the GCC public sector that is dominated by local workers and the private sector that is dominated by migrant labour constitutes a strain in the region's labour markets. They report that during 1997-2001, private sector wages in the UAE declined by 8 per cent, whereas public sector wages increased by 11 per cent. Consequently, the authors propose lowering the wage differential between the public and private sector as an effective strategy to increase the employment of locals in private jobs. Furthermore, Forstenlechner et. al (2012) argue that that in the case of the UAE, a cheap pool of migrant labour exerts downward pressure on migrant wages. According to the authors, locals earned on average 2.9 times as much as migrants in 2008, and similar patterns were documented in all GCC countries.

Shaham (2008) also reports the wage gap between local and migrant labour as a challenge to nationalisation in the GCC. The significantly lower migrant wages, while competitive with the levels in their home countries, are hardly sufficient by GCC standards. This creates a gap in the local-migrant reservation wage and forms the basis for a persistent wage gap in GCC's labour markets. Kapiszewski (2006) also recognises policies adopted by the GCC member states to increase nationalisation rates. Such policies are wage subsidies for locals, and fees and charges on the employment of migrants, to make the latter less attractive to hire.

Previous literature on the issue of relative local-migrant earnings has consistently observed an aggregate differential in favour of locals, but failed to provide detailed analyses of the sources of such differentials at the micro-level and to decompose the differentials into the portion that is justified by workers' differentials in job-related attributes, as compared to the portion that is potentially due to price distortions. Also, most previous studies lumped local and migrant workers into two pools that included both skilled and unskilled labour, thereby not recognising the effect of the skill composition of both types of workers on relative earnings.

## **Data**

In this section, we discuss the source of our data set and compare it with the available official aggregates, upon which previous studies were based. Further, we provide a description of the main variables underlying the empirical analysis in this chapter.

### ***Data Source and Validity***

The dearth of official individual-level data on earnings and productivity-related characteristics of workers in the GCC explains why the topic of earnings differentials has this far not been properly addressed. We extract our data from a publicly available source, Salary Explorer. Despite the several sources of bias associated with this type of online survey, this data set is capable of reproducing aggregates that are highly comparable to available official employment figures, as well as producing econometric results that are reflective of observed trends and are theoretically consistent.

The data set comprises cross sections 2012-2016 including 7,262 skilled workers in the GCC private sector, and reports on workers' earnings, productivity-related characteristics and employment terms, as well as their distribution across industries, occupations, and GCC member states.

For instance, Table 12.1 shows that in GLMM's<sup>1</sup> consolidated official data, the percentages of all migrants in the private sector of Bahrain (2013), Saudi Arabia (2013), Kuwait (2013), Oman (2012) and Qatar (2012) are 80.7 per cent, 86.6 per cent, 93.2 per cent, 87.4 per cent and 98.7 per cent, respectively. Years between parentheses are those for which the latest data are available. Our dataset's equivalents are 81.3 per cent, 88.6 per cent, 97.5 per cent, 93.8 per cent and 99.4 per cent, corresponding to the same years and following the same order. Official data on the UAE are unavailable.

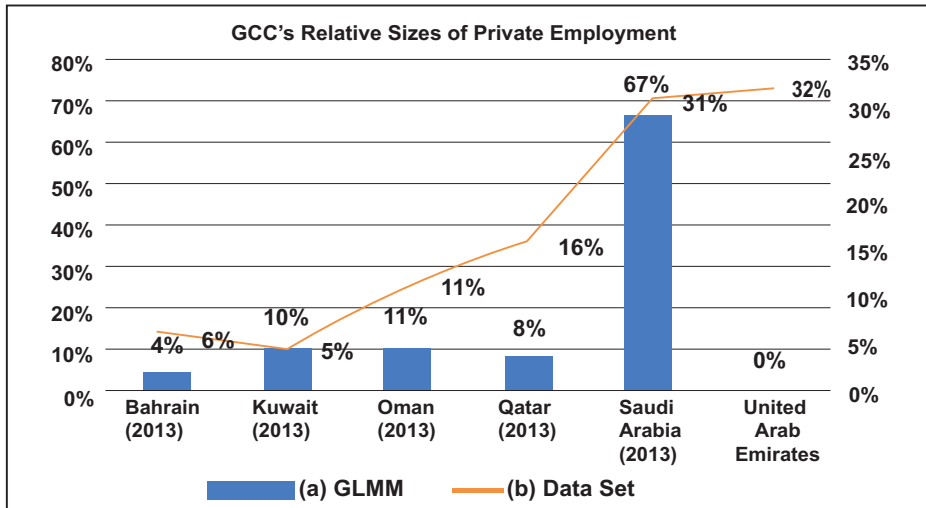
**Table 12.1: Percentage of migrants employed in GCC's private sectors**

| <b>State</b>         | <b>GLMM <sup>a</sup><br/>(%)</b> | <b>Data Set <sup>b</sup><br/>(%)</b> |
|----------------------|----------------------------------|--------------------------------------|
| Bahrain (2013)       | 80.7                             | 81.3                                 |
| Saudi Arabia (2013)  | 86.6                             | 88.6                                 |
| Kuwait (2013)        | 93.2                             | 97.5                                 |
| Oman (2013)          | 87.4                             | 93.8                                 |
| Qatar (2012)         | 98.7                             | 99.4                                 |
| United Arab Emirates | NA                               | 98.8                                 |

Furthermore, Figure 12.1 shows the relative size of employment in the GCC private sectors. The reported percentages are the number of employees in each country's private sector labour force divided by GCC's total private sector labour force, comparing GLMM's consolidated official data with our data set. With the exception of Saudi Arabia, whose share is underrepresented in our data, the reported shares follow a similar structure in both data sets. Official data on the number of workers in the private sector of the UAE are unavailable.

1. <http://gulfmigration.eu/percentage-of-non-nationals-in-government-sector-and-in-private-and-other-sectors-in-gcc-countries-national-statistics-latest-year-or-period-available/>.

**Figure 12.1: The relative sizes of private employment in the GCC by member state**



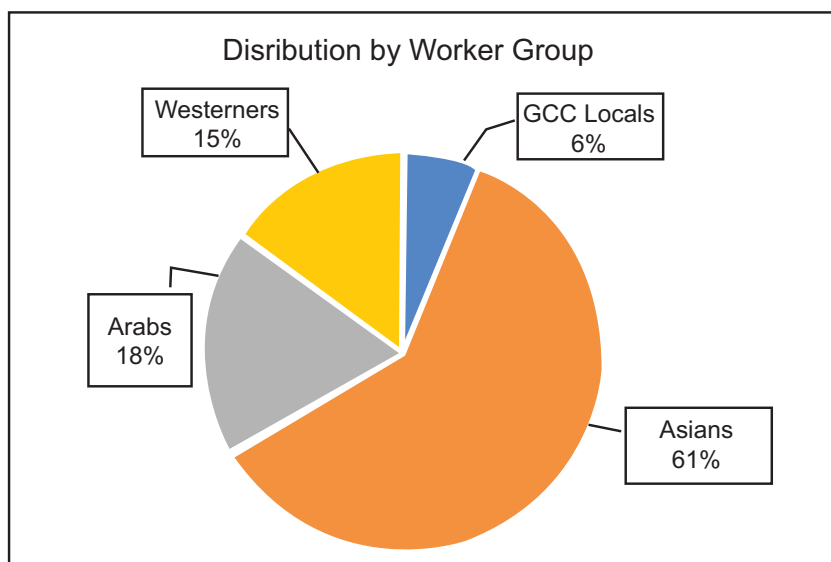
Source: (a) Consolidated GLMM data, table GCC EMP 3, by state and year for which the latest data are available. (b) Salary Explorer survey 2012–2016 data for the corresponding official state GLMM Figures.

The previous exposition briefly demonstrated that this data set is representative of general trends in the GCC's labour markets, confirmed by official statistics.

### *Selected Descriptive Statistics*

Figure 12.2 reveals that Asians constitute the majority of the 61 per cent of workers employed in the GCC countries' private sector, followed by Arabs who constitute 18 per cent and Westerners who form 15 per cent of the total private sector workforce. It is noteworthy that migrant groups are based on workers' nationalities, as opposed to their actual ethnic backgrounds. Locals, on the other hand, constitute about 6 per cent of the private labour force in the GCC.

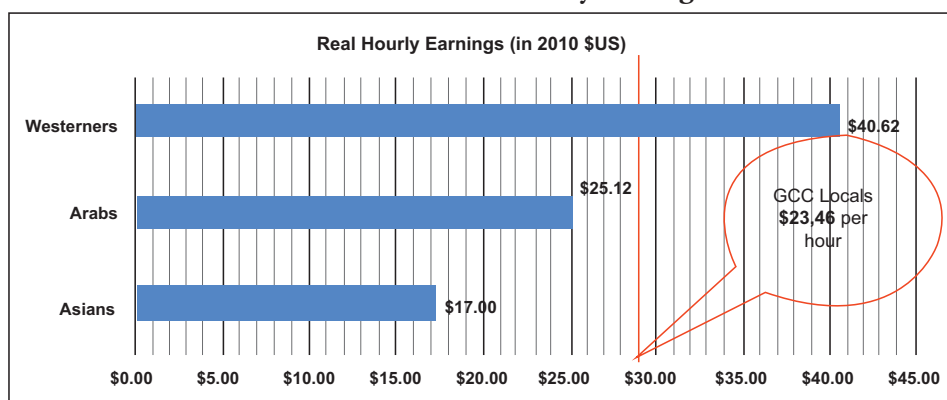
**Figure 12.2: Distribution by worker group**



Source: Authors' calculations.

As shown in Figure 12.3, skilled locals earn on average 63.8 per cent more than Asians, 13.3 per cent more than Arabs and 42.7 per cent less than Westerners. These differentials are significantly less than those reported by Hertog (2102), Ramady (2013) and Forstenlechner et al. (2012) because of their inclusion of both skilled and unskilled workers in their statistics.

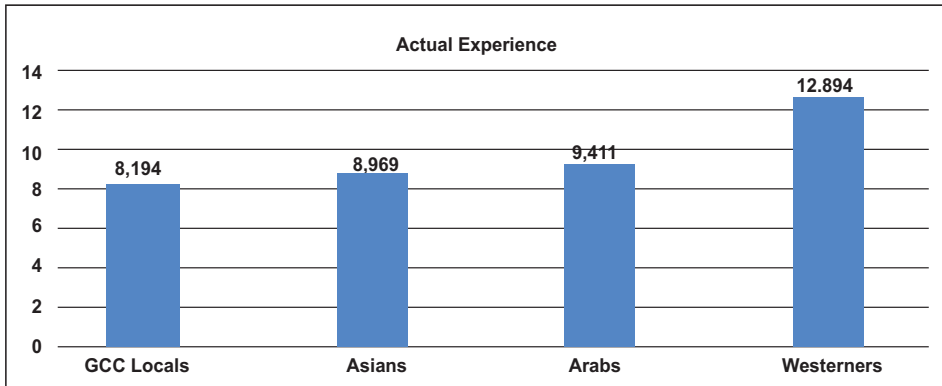
**Figure 12.3: Local-migrant group composition of GCC's private labour force and real hourly earnings**



Source: Authors' calculations.

Figure 12.4 shows workers' distribution in terms of actual job market experience. Westerners possess a clear advantage in experience over the other groups of workers, with about five more years as compared with locals, four more years as compared with Asians, and 3.5 more years as compared with Arabs.

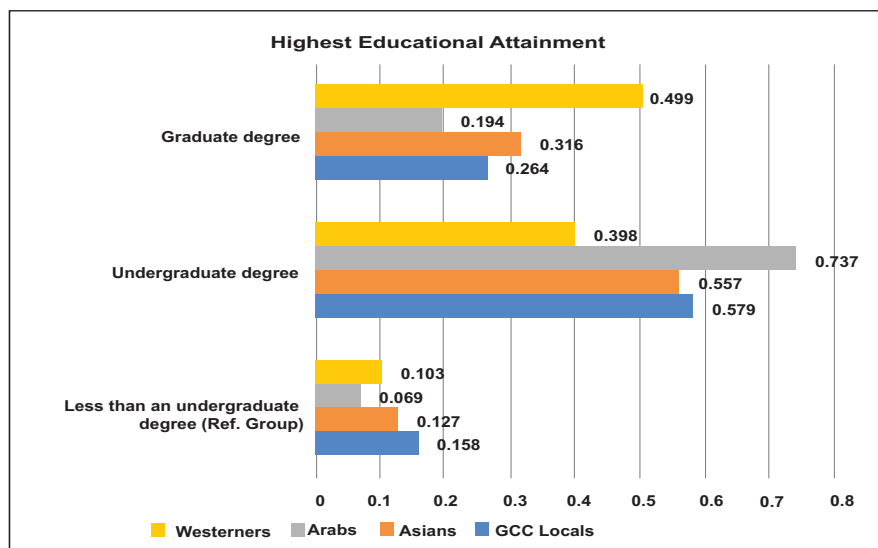
**Figure 12.4: Actual experience**



Source: Authors' calculations.

With respect to educational attainment, Figure 12.5 confirms the notion that, if education reflects skill, our sample is representative of skilled workers, as the vast majority of workers possesses at least an undergraduate degree. Data show that about 50 per cent of Western migrants possess a graduate degree and another 40 per cent possess an undergraduate degree. For Arabs, 19 per cent possess a graduate degree and as many as 74 per cent possess an undergraduate degree. The corresponding percentages for Asians are 32 per cent and 56 per cent, respectively.

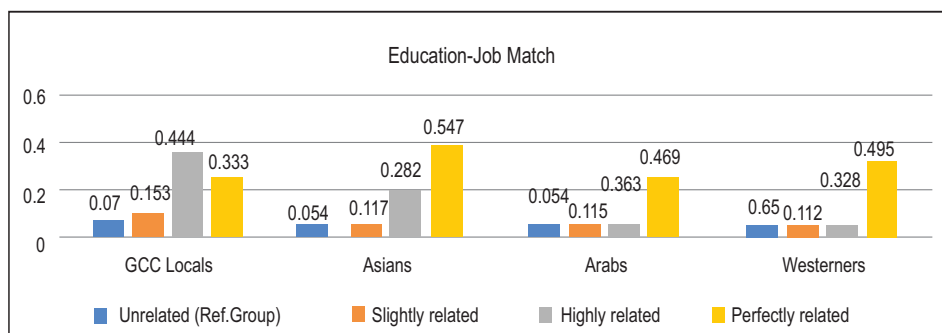
**Figure 12.5: Actual job market experience and highest educational attainment**



Source: Author's calculations.

Figure 12.6 represents the quality of the match between workers' educational attainment and their job characteristics. The premise is that the better the education-job match the higher will be a worker's productivity, hence earnings. Data show that for all migrant groups, the education-job match is better than for locals. About 50 per cent of Westerners, 47 per cent of Arabs, and as high as 55 per cent of Asians work in jobs that perfectly match their educational attainment. This compares with only 33 per cent of locals whose jobs perfectly match their educational attainment.

**Figure 12.6: Education-Job match**



Source: Author's calculations.



With respect to the size of the employer, a positive association with workers' earnings is well-established in labour economics literature [see Brown and Medoff (1989), Reilly (1995), Green et al. (1996) and Troske (1999)]. Figure 12.7 shows that about 40 per cent of Westerners work for employers with more than 1,000 employees. The corresponding shares of Arabs, Asians and locals are 32 per cent, 29 per cent and 37 per cent, respectively. These employer size percentages are consistent with the differentials in workers' earnings, where locals earn more than Arabs and Asians but less than Westerners.

The descriptive statistics of our data set show that migrants generally are better endowed with the typical productivity-related characteristics, as they surpass the endowment levels of locals in actual job market experience, highest educational attainment, and the quality of the match between a worker's education and his or her job requirements. These, in turn, would suggest that migrants should earn higher than locals. Therefore, the higher earnings of locals over Asian and Arab migrants, as shown in Figure 12.3 could partially be explained by the presence of price distortions, which would dominate the expected influence of migrants' better productivity-related attributes.

**Figure 12.7: Employer size**



Source: Author's calculations.

## Methodology

In the empirical section of this chapter, we follow the well-established Oaxaca (1973) and Blinder (1973) decomposition of the persistent earnings differentials between skilled GCC locals and each of Asian and Arab migrants who together constitute an overwhelming majority of about 80 per cent of the GCC's skilled labour force; they are better endowed in terms of productivity-related characteristics, yet paid significantly less than their local co-workers.

First, we estimate the semi-log, Mincer-type earnings regressions;

$$W_i^g = X_i^g \beta^g + \varepsilon_i^g \quad \dots (1), \text{ where } g = [L, M] \text{ and } i = [1, \dots, n^g]$$

via ordinary least squares.  $W_i^g$  is the natural logarithm of real hourly earnings from employment in 2010 prices.  $X_i^g$  is the  $(1 \times k)$  vector of explanatory variables that include age, gender, highest educational attainment (three categories), actual job market experience and its square, the education-job match (four categories), size of employer (four categories), occupation (12 categories), industry (12 categories), a dummy variable for each cross-section and a dummy variable for each of the six GCC member states that captures the cross-country differences in their private sector earnings structures. Our reference worker is a woman with less than an undergraduate degree whose education does not match her job, works for an employer with less than 100 workers, in a sales occupation within the wholesale or retail trade industry. The year of reference is 2016 and the reference state is Kuwait.  $\beta_i^g$  is the  $(k \times 1)$  vector of estimated coefficients and  $\varepsilon_i^g$  is the respective regression's residual term, such that  $\varepsilon_i^g \sim n(0, \sigma^2)$ . Also,  $g = (L, A, R)$  refers to each of the workers' groups, where  $L$  stands for GCC locals,  $A$  for Asians, and  $R$  for Arabs. Finally, the subscript  $i$  represents an individual worker belonging to group  $g$ .

Using the estimated coefficients  $\beta_i^g$  and  $\beta_w$ , we can now construct the weighted average  $\beta^1$  that serves as a vector of reference coefficients for our OB decompositions, such that

$$\beta^1 = \alpha \beta_L + (1 - \alpha) \beta_w \dots (2), \text{ where } 0 \leq \alpha \leq 1$$

The case  $\alpha = 0$  produces the case of nepotism, thereby using the parameter estimates from the earnings regression of the respective migrant group as references. Analogously, the case  $\alpha = 1$ , produces the case of discrimination, thereby using the parameter estimates from the earnings regression of GCC locals as references. In our empirical section, we report the decompositions for each of the values  $\alpha = 1$ ,  $\alpha = 0.75$ ,  $\alpha = 0.50$ ,  $\alpha = 0.25$ , and  $\alpha = 0$ , sequentially.

By adding and subtracting the terms  $\beta^1 X_L$  and  $\beta^1 X_M$  to and from the right-hand-side of equation (3), we derive the two-fold OB decomposition, such that

$$\Delta W_K = [\beta^1 (X_L - X_W)] + [(\beta_L - \beta^1) X_L + (\beta_L - \beta_M) X_M] \dots (3),$$

where  $k = [1, 2, 3]$ .

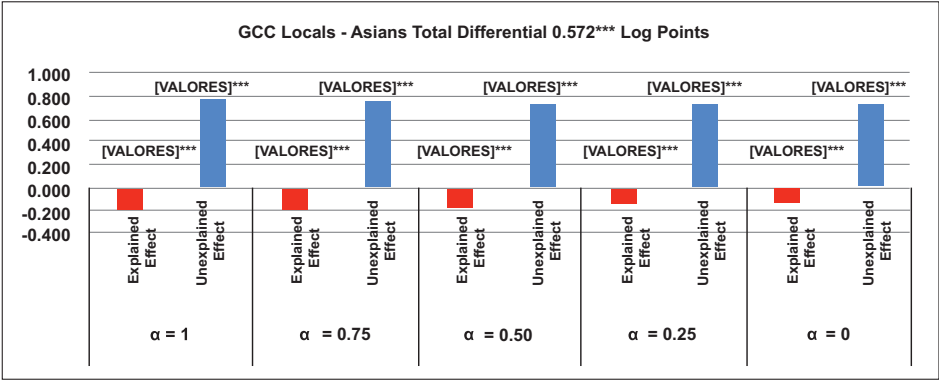
The first term in equation (3) represents the explained effect, i.e., the difference in average productivity-related characteristics between locals and migrants, and the second term represents the unexplained effect, i.e., the difference in the estimated returns to workers' productivity-related characteristics.

### ***Empirical Results***

As shown in Figure 12.8 and Figure 12.9, both decompositions follow a similar trend, where the majority of the earnings differentials is due to OB's unexplained effect. This effect gradually declines as the value of  $\alpha$  decreases from 1 to 0. That is, the weight given to the coefficient estimates from the earnings regressions of locals declines from 100 per cent, indicating the underpayment of migrants, to 0 per cent that indicates the overpayment of locals. Despite that decline, the general structure remains virtually the same.

Figure 12.8 shows that the explained effect causes the earnings differential between GCC locals and Asian migrants to fall by 35 per cent to 24.3 per cent (the ratio of the explained effect to the total differential) as we move from the assumption of discrimination to nepotism. This comes as a result of Asians possessing relatively higher productivity-related characteristics. The explained effect is, however, overturned by locals' higher returns, the unexplained effect. The relative size of the unexplained effect ranges between 135 per cent under the assumption of discrimination to 124.3 per cent under the assumption of nepotism.

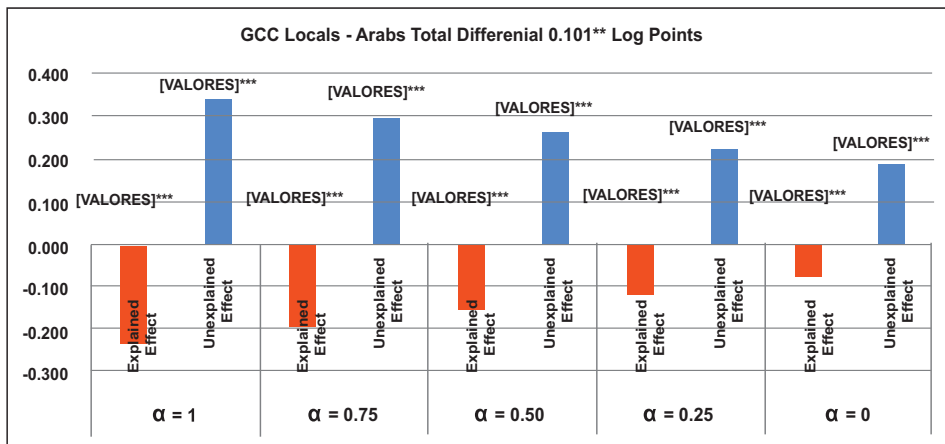
Figure 12.8: GCC Local-Asians total differential



Source: Author's calculations.

\*, \*\*, \*\*\* indicate the statistical significance at levels 10%, 5% and 1%, respectively.

Figure 12.9 shows the decompositions between GCC locals and Arab migrants and follows a similar pattern as the previous decomposition. The main difference lies in the relative weight of the explained effect, which is larger in the latter. The differences between locals and Arab migrants in terms of productivity-related characteristics cause the earnings differential to fall by 233.7 per cent under the assumption of discrimination to 84.2 per cent under the assumption of nepotism. In particular, Arabs compared with locals possess higher levels of job market experience, are relatively more educated, and surpass locals in terms of the quality of the match between their educational attainment and their jobs. When it comes to the returns to workers' characteristics, we can see that the unexplained effect overturns the impact of Arabs' better endowment levels. The size of the unexplained effect ranges between 333.7 per cent under the assumption of discrimination to 184.2 per cent under the assumption of nepotism.

**Figure 12.9: GCC Local-Asians total differential**

Source: Author's calculations.

\*, \*\*, \*\*\* indicate the statistical significance at levels 10%, 5% and 1%, respectively.

The previous exposition reveals that the earnings differentials between GCC locals and Asian and Arab migrants are mainly due to price distortions, where locals are significantly overpaid (nepotism) or migrants are underpaid (discrimination) or a combination of the two. This ambiguous result with respect to the nature of existing price distortions originates from the choice of reference estimates as the nondiscriminatory vector of returns. Yet, regardless of the choice of reference, the previous analysis shows that the earnings differentials between locals and Asian and Arab migrants is mainly due to the unexplained effect.

## Nationalisation Policies between Fiat and a Market-based Alternative

This section provides a theoretical explanation to the failure of current nationalisation policies, as manifested in the quota system. Further, it suggests a market-based alternative, which considering the price distortions estimated in the previous section, can alter the relative costs of employment of locals and migrants, leading to higher employment levels of the former in the GCC private sector.

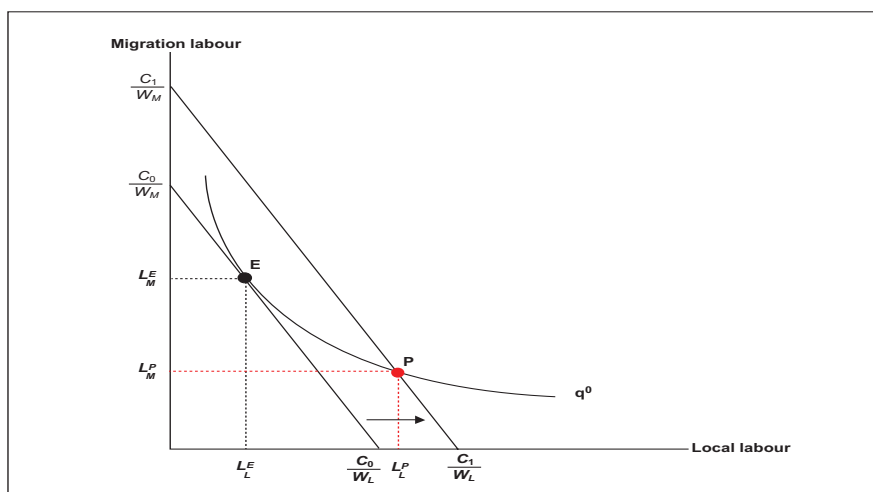
### *Failure of the Quota System*

Within the framework of competitive producers' cost minimisation in terms of two-dimensional isocosts and isoquants, Borjas and Van Ours (2000) show that affirmative action policies, intended to alter the racial, ethnical or gender composition of its workforce would lead discriminatory employers to move back to optimality,

where the input mix is consistent with market returns and workers productivities. In the case of GCC employment quotas, the situation is reversed, such that firms are pushed away from their respective optimal input mixes, which ultimately leads to a significant deal of resistance even with the presence of sanctions for noncompliance.

Figure 12.10 shows the introduction of a quota system that forces firms to increase the relative employment of locals. There, the firm would be pushed away from point E down the isoquant to point P, the input mix targeted by the quota policy, where  $L^y_u$  of migrants and  $L^y_L$  of locals are hired. With wages and output levels unchanged, this increase in the local-migrant employment ratio can only be achieved by incurring higher costs,  $C_1$  as represented by a shift in the firm's isocost to the right from  $C_0$ .

**Figure 12.10: The impact of a quota on the costs of a competitive employer**



Given these circumstances, the quota system will result in a drop in the firm's competitive profits and create sufficient motive for noncompliance, especially because with competitive markets, firms could already be operating at long-run normal economic profits.

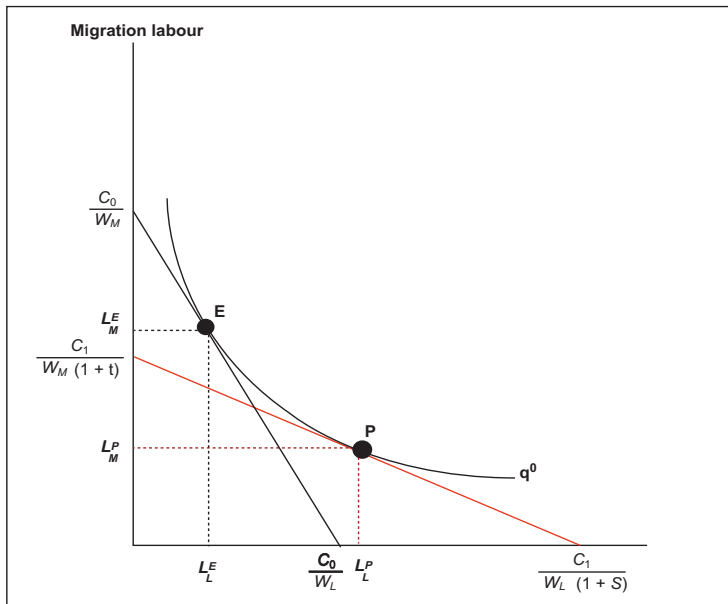
### ***A Market-based Alternative***

It is rather obvious from the previous exposition that despite the restrictive assumptions of competitive markets, particularly in the context of the GCC, any potentially successful nationalisation policy ought to operate through market forces. Such policy should preferably leave the firm's profitability untouched, to

bypass noncompliance. One way of addressing this challenging task is through the implementation of parallel payroll taxes and subsidies in the virtually segmented labour markets of migrants and locals. These taxes and subsidies must, however, be synchronised with reasonably targeted employment levels of each type of labour and be designed in accordance with realistically estimated elasticities of the supply and demand for labour in each market.

Figure 12.11 shows the effect of a payroll tax on migrant labour, while simultaneously subsidising employment of locals. Retaining, for the moment, the assumptions of competitive input and output markets, the analysis implies that taxes and subsidies are completely borne by or due to employers, given that any given employer can hire any desired amount of labour at a given market wage.

**Figure 12.11: The effect of a market-based nationalisation policy, assuming competition in both markets**



The imposition of a payroll tax on migrant labour will raise the cost of hiring an additional worker from  $W_K$  to  $W_K (1+t)$ . Also, subsidising the employment of locals will reduce the cost of hiring one more worker from  $W_K$  to  $W_K (1+S)$ . This change in the relative prices of inputs would result in a counter-clockwise rotation in the firm's isocost, without necessarily altering the firm's costs of production, as there is no theoretical restriction on the firm's costs before and after the change in relative input prices, according to Borjas and Van Ours (2000). In that case, the

firm's optimal levels of employment and output would move down from point E to point P along the isoquant  $q_0$ , where the policy levels of employment  $L_u^i$  of  $L_u^u$  of migrants and of locals are achieved.

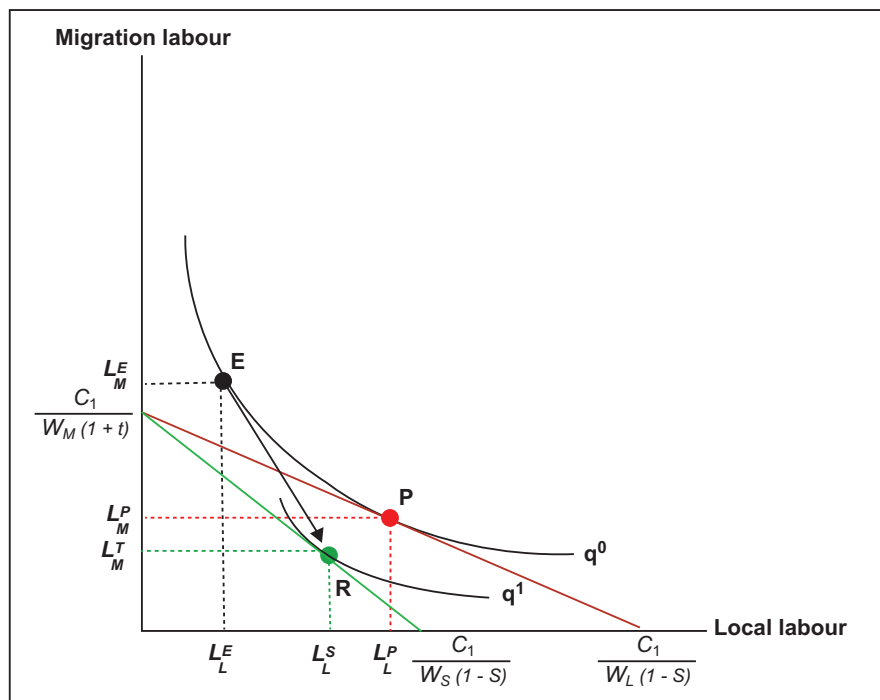
The previous discussion is based on the assumption that firms are perfectly competitive in both labour markets and the output market. In the GCC, it is relatively safe to retain the assumption of competition in the migrant labour market, if migration policies and regulations governing the recruitment of migrant workers were properly altered to mobilise labour internally and across borders, such that the supply of migrant labour facing any particular employer becomes perfectly elastic. In the market for local labour and the output market, on the other hand, it is best to assume that firms are monopsonistic in the market of local labour, facing an upward sloping supply, and noncompetitive in the output market, where they face a downward sloping demand curve for their final product.

Noncompetition in the output market implies that firms' labour demands are driven by their respective marginal revenue products of labour, as opposed to the values of their marginal products under the assumption of competitive output markets. This implies a lower demand for labour, given that the competitive price is higher than a noncompetitive firm's marginal revenue. The assumption of a monopsonistic labour market for locals carries an important implication that firms face less-than-perfectly elastic labour supplies. This, in turn, influences the impact of payroll taxes and subsidies on employment and wages. Hamermesh (1979) shows that the extent to which a payroll tax or subsidy is shifted to workers depends on the labour demand and labour supply functions underlying the state of equilibrium. The effects of a tax or subsidy on employment would be less, the lower the relative elasticity of the supply of labour.

First, we discuss the effect of a payroll tax imposed on a noncompetitive producer in the output market, who happens to be competitive in the market for migrant labour, which is consistent with our assumption about a typical GCC private employer. As in Figure 12.11, the firm would initially hire migrants at the competitive wage rate of  $wM$ , and locals at a wage rate of  $wL$ , point E. If a payroll tax were to be imposed on the firm, its marginal revenue product of labour will shift to the left, reaching a new post-tax equilibrium, hiring less migrant labour. Note that this point does not correspond to point P, where the after-tax level of employment of migrants is higher for competitive producers. As shown, the after-tax level of employment will drop somewhere to as indicated in Figure 12.12, such that the wage will remain unchanged, implying that the firm will bear the entire tax burden.



**Figure 12.12: The effect of a market-based nationalisation policy, assuming competition in market for local labour and the output markets**



Furthermore, the effect of a simultaneous payroll subsidy for the employment of locals granted to the firm will increase its demand for local workers. Since the firm is assumed to be a monopsonist in the market of local labour and noncompetitive in the output market, instead of reaching the competitive post-subsidy level of employment of  $L_L^u$ , the subsidy will shift the firm's marginal revenue product of labour to the right along an upward-sloping supply of local labour, reaching a new equilibrium where  $L_L^S$ ; locals are employed at a higher wage rate of  $wS$ , as shown in Figure 12.12. Given that the two markets are segmented, it is reasonable to assume that there will be no cross effects between the act of taxing and subsidising.

Comparing the scenario of perfectly competitive markets with the case where firms are noncompetitive in the output market and monopsonists in the market of local labour reveals that post-policy levels of employment of both types of labour will be less in the latter, as shown by comparing point  $R(L_L^S, L_M^T, q^1)$  with point  $P(L_L^u, L_M^Y, q^0)$ . Under the traditional assumptions of well-behaved isoquants, this will inevitably lead to a lower profit-maximising output of  $q^1$ , instead of  $q^0$ . Since firms are assumed to be noncompetitive in the output market, these lower post-

policy levels of employment and output will trigger an increase in the output price. Therefore, the extent to which a simultaneous tax/subsidy policy will influence a firm's profits is contingent on the elasticities of the supply of labour as well as the degree of competition in the output market, which would be reflected in the level and the elasticity of demand for a firm's final product. As the compliance of firms with the proposed policies is fundamentally motivated by their pre- and post-policy profits, the tax and subsidy schemes ought to be designed by taking into account the degrees of competitiveness in both input and output markets, in addition to reasonable local-migrant employment ratios targeted by such policies.

## **Conclusion**

Differentials in earnings between locals and migrant labour in the GCC have been identified in previous literature as a major cause of failing nationalisation policies in the region. The emergence of young mineral-based economies that are highly dependent on cheap migrant labour and the early economic development paths followed by regional governments, where public sectors became the primary employer of local labour with lucrative earnings and benefits, have contributed significantly to the creation of segmented labour markets in terms of public-private, local-migrant earnings structures, and the distribution of local and migrant workers across economic sectors.

This chapter addresses the persistent earnings differentials between skilled local and migrant labour and provides estimates of the relative shares of the differentials that are due to market forces and workers' productivity-related characteristics, and those due to the presence of price distortions. We find that Asians and Arabs are better endowed than locals in terms of productivity-related characteristics, which cause the local-migrant earnings gap to narrow. This effect is, nonetheless, overturned completely by firms' likely unimpeded discrimination against migrant labour, given the significant power of firms over migrants' hiring terms, mobility, and low costs of firing. Firms are therefore unwilling to hire locals, which leads to the inevitable failure of government quotas intended to increase the share of locals in the GCC's private sector workforce.

From a policy perspective, this chapter provides a theoretical explanation with for the failure of nationalisation initiatives across the GCC and introduces an alternative policy approach, which is market based. This could be aimed at skilled workers, where locals and migrants are imperfect substitutes, given their actual skill heterogeneity. The alternative policy approach seeks to reduce prevalent

price distortions by proposing a tax/subsidy scheme on private employers, who are assumed to be noncompetitive in the output market, competitive in the market for migrant labour, and monoposonists in the labour market for locals.

The policy suggests increasing the cost of employing migrants via a payroll tax that, due to competition, will be completely borne by employers. The policy must also be augmented by proper wage protection systems in all GCC countries to ensure that wages are paid duly and in full, and that firms do not shift the tax onto employees. Simultaneously, a payroll subsidy may be granted in the monopsonistic market for locals, where the generated savings will compensate private employers for the tax costs incurred in the market for migrants. The proposed policy is also expected to lead to higher output prices, which further offset the impact of taxing migrant labour. The final impact of the policy on firms' profits, the principal motive for compliance, ultimately depends on the relative elasticities of the supplies of local and migrant labour, as well as the elasticity of the demand for the firms' final outputs. These elements, in turn, should be taken into account while designing the proposed tax/subsidy schemes.

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## **Migration to the Gulf: Policies in Sending and Receiving Countries**

International migration is a ubiquitous reality in the Gulf states where foreign citizens are a majority in the workforce as well as in the total population of several states. Migration is instrumental in the Gulf nations' prosperity and at the same time regarded as a challenge to their identity. For many countries of origin in Asia, the Arab world and East Africa, migration to the Gulf is an integral part of the daily lives of tens of millions and a constitutive element of economies and societies.

On the sending side, there is a widespread view that emigrants serve the prosperity of their nation, through financial remittances, enhanced skills, and enlarged business networks, and that they must be protected in the countries where they live. State institutions have been created to look for migration opportunities and to defend the rights of their expatriate nationals in terms of living and working conditions. Fair recruitment and decent work have become an integral part of their agenda. Emigration is now regarded as a resource for national economies in the same way as trade, and a matter for external policies and politics.

On the receiving side, Gulf policies must address the challenge of admitting contract workers needed by ambitious development programmes and welfare goals, while tackling a number of migration-related imbalances: too much dependency on foreign labour; too few women in the labour force; too much unused education and wasted skills among nationals; too much money flooding out of the country in the form of workers' remittances; and too rigid regulations ending up in high levels of irregularity.

This book is about policies designed to regulate migration and protect the migrants and enable them to contribute to the prosperity of the Gulf and the development of their home countries. It brings unique knowledge to all those striving to improve current systems, from a state's as well as a migrant's perspective.

