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GCC Economic Integration: Opportunities and Challenges

Background Paper for Bahrain 2018 National Human Development Report

BAHRAIN HUMAN DEVELOPMENT REPORT 2018

Pathways to Sustainable Economic Growth in Bahrain

UNDP
Empowered lives. Resilient nations.

Omar Al-Ubaydli, Derasat

Erik Jones, Johns Hopkins University

Abstract

Economic integration between Bahrain and the remaining Gulf countries has played an important role in the growth of the Bahraini economy since the start of the new millennium. This paper presents and analyze data on the effects of economic integration. The paper also examines some of the problems that have emerged, as well as proposing solutions, with reference to the successful economic integration efforts of the European Union.

Background

17 PARTNERSHIPS FOR THE GOALS

The report is an initiative that promotes the implementation of the 2030 Agenda for Sustainable Development and the 17 Sustainable Development Goals (SDGs). For more information on the SDGs, see http://sustainabledevelopment.un.org/. While this paper addresses a variety of SDGs, it directly addresses issues related to Goal 17, "Partnership for the Goals."

UN in Bahrain SUSTAINABLE DEVELOPMENT GOALS

Disclaimer

1. Introduction

The remarkable improvements in living standards experienced across the globe over the last 300 years can be attributed to a combination of technological progress and global trade (Acemoglu, 2008), which is a form of economic integration. Economists have been espousing the benefits of economic integration since Adam Smith's Wealth of Nations, and an appreciation of these benefits has underlain policymakers' appetite for opening up their economies to those of neighboring countries (Rivera-Batiz and Romer, 1991). Moreover, as in the case of the European Union (EU), popular support for economic integration has been boosted by the perception that it can limit the possibility of international wars breaking out (Nugent, 2017).

As part of the Gulf Cooperation Council (GCC), Bahrain has integrated its economy substantially with that of its five neighbors, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE, with the pinnacle being the GCC single market, launched in 2008, and modeled upon the EU single market (Alasfoor, 2007). While data limitations prevent scholars from definitively demonstrating the benefits reaped by Bahrain from GCC economic integration, a variety of indirect indicators suggest that the gains have been large, which we demonstrate in this paper. This should come as no surprise, since the government's economic strategy has been predicated upon exploiting economic integration as a way to attract foreign direct investment (FDI), and with it jobs and innovative capacity (Looney, 2013).

Despite the positive impact of GCC economic integration upon Bahrain's economy, there remain significant challenges. In the case of the GCC, the most notable is incomplete adherence to the single market's principle of treating all GCC citizens equally in all member states (Abdulghaffar et al., 2013). Bahrain stands to gain significantly if mechanisms for full adherence can be adopted. Beyond this, a key obstacle to GCC economic integration is economic illiteracy among the general public and--on occasion--policymakers, too (Caplan, 2011). National communities have a history of responding to economic downturns--such as the one in the GCC caused by the 2014 decline in oil prices--by being suspicious of foreigners, including accusing migrants of "stealing jobs" or "undermining local industries" (James and James, 2009). Donald Trump has managed to resurrect the philosophy of economic nationalism, despite the massive evidence in favor of the benefits of economic integration.

This paper describes the GCC's economic integration project, with an emphasis on Bahrain. It then analyzes the consequences (including challenges and opportunities), and makes recommendations, with a special emphasis on what lessons can be learned from the EU--a logical source of insights in light of the EU being a de facto template for GCC economic integration.

Our main recommendation is that Bahrain should take steps to increase GCC economic integration, including the steps necessary to ensure stricter compliance with the GCC single market. We explore a variety of options available to Bahrain, including those inspired by the EU's hugely successful single market.

We conclude by noting that the evaluation of the effects of GCC economic integration is hampered by the lack of high quality data, especially in the microeconomic domain. Ideally, scholars would be able to compare product prices and profit margins in a variety of sectors across the GCC. Therefore, a key recommendation is the establishment of processes that result in scholars having access to good quality data, similar to that produced in the EU.

2. Economic Integration: Theory

2.1. Forms of Economic Integration

At the country level, there are several steps in the process of economic integration. We focus on regional economic integration, which is a special class of international economic integration. It applies to the case of Bahrain and the GCC.

When discussing regional integration, the departure point is restricted trade, which means that goods and services are mobile within the region, but subject to barriers such as tariffs and quotas. The trade barriers within the region are the same as those imposed upon trade with extra-regional countries. This is the default state for most countries. Usually, the barriers are subject to globally agreed-upon rules and regulations that are managed by the World Trade Organization.

The second stage is a regional free trade agreement (FTA), whereby goods and services can cross intraregional borders without restrictions, but where each country retains autonomous control over the restrictions that it imposes upon extra-regional countries. Moreover, physical and human capital continue to face restrictions in crossing intraregional borders.

The third stage is a regional customs union, which is equivalent to a regional FTA combined with a harmonized set of trade barriers imposed upon extra-regional goods and services, with the most prominent being a common external tariff (CET). Physical and human capital continue to face restrictions in crossing intraregional borders.

The fourth stage is a single market, which represents a significant advancement in economic integration over a customs union. A single market is equivalent to a customs union, but where the barriers to the movement of human and physical capital are also removed, thereby nominally creating a singular, integrated economy. Citizens of one country are free to relocate to another country within the region, purchase property, send their children to local schools, and start businesses, receiving the same treatment within the economic domain as citizens of that country. While not necessarily a defining characteristic, a single market also involves harmonized laws and regulations in the economic domain, such as commercial law, labor laws, investment laws, and so on. However, each country retains its own currency and fiscal policy.

The fifth stage is monetary union, which is equivalent to a single market but with a unified currency, and a common central bank that sets a centralized monetary policy. This is close to the arrangement between different states in the USA.

The final stage of economic integration is a fiscal union, whereby a supranational government implements a harmonized fiscal policy. This is the arrangement that most provinces have within a country, such as the different counties in the UK. Due to the importance of fiscal policy to government activity in general, fiscal unions de facto imply political union, too.

2.2. The Effects of Economic Integration

The case for economic integration is essentially as old as the discipline itself, dating back to Adam Smith. For a rigorous and thorough treatment, see Baldwin and Venables (1995). What follows is based on the lighter discussions in Allen et al. (1998) and Sauner-Leroy (2003), as well as the European Commission's own report (1996).

When economies integrate, the removal of barriers to trade implies that each firm faces two primary changes: first, an increase in the size of the available market, and second, an increase in the competition within and for that market. Economists predict that taken together, these two changes will lead to the following outcomes, all of which are considered to be desirable:

First, profit margins will decrease as the gap between prices and costs shrinks. Foreign competitors will present a novel set of challenges to each firm's existing profits, and the increased market size will attract previously uninterested entrants. Greater competition means lower profits per unit.

As an example, if GCC banks are allowed to only operate in their home country, then the level of competition is limited, meaning that the interest rates offered on loans will be moderate. However, if competition is opened up to all GCC banks, then this creates downward pressure on interest rates, lowering the per unit return that banks earn on their loans.

Second, costs will fall as firms consolidate and take advantage of economies of scale. In many industries, it becomes cheaper to produce each unit as the scale of production increases. Segmented domestic markets may be too small to permit the exploitation of all economies of scale. The market enlargement brought about by economic integration may allow existing firms to access these unexploited economies of scale. This process may be accentuated by firms merging to further enhance their scale.

As an example, a GCC architect can produce architectural drawings a lot more quickly if she uses professional software. However, the professional software is typically very expensive, and so she may need to sell at least 10 drawings per week for the software purchase to be profitable. In a segmented, local market, the demand for her drawings may only be 5 per week. After the launch of the GCC single market, demand expands beyond the confines of the local market, say to 20 per week, allowing her to purchase the software and reduce production costs.

The tendency for costs to fall as economies of scale are exploited is reinforced by the emergence of higher levels of specialization in production--the original Ricardian trade argument presented in introductory economics courses. When barriers to trade are significant, countries are forced to produce a wide array of goods and services; liberalization allows countries to focus their efforts on commodities where they possess a comparative advantage. For example, the USA imports approximately 300 million barrels of oil a month, and around 40% comes from regional trading partner Canada as part of the North American FTA. While the USA could conceivably produce this oil domestically, it would be relatively inefficient; instead, by importing this oil, capital and labor are freed up for the sectors where Americans have a comparative advantage, such as software or defense.

The Ricardian trade model is based on the assumption that production factors are internationally immobile. However, most economies are open to inward foreign direct investment (FDI), with the degree of openness being absolute in the case of a single market. FDI delivers economic gains in an analogous manner to trade in goods and services: allowing capital to flow to where it is most productive benefits the source country via higher returns, and the receiving country via higher employment for locals (Balasubramanyam et al., 1996). Moreover, since the capital exporting country often possesses superior technology, FDI will usually imply higher productivity--and hence wages--for local workers compared to depending on local capital. This static benefit is reinforced by the potentially far more important dynamic benefit embodied in technology transfer: knowledge of advanced production processes migrates from the capital exporter to the capital importer, helping reverse long-term sources of global economic inequality (Borensztein et al., 1998). NAFTA-facilitated FDI has been critical to the economic development of Mexico (Waldkirch, 2010): American car manufacturers have relocated some of their production facilities to Mexico, re-exporting the output to the USA, thereby delivering lower car prices to U.S. consumers.

The third outcome associated with economic integration is that firms will become more innovative. This is a byproduct of increased competition. The benefits of increased innovation are increased revenues from novel products and decreased costs from more efficient production techniques. Firms balance these benefits with the costs of innovating, such as research and development costs. When economies integrate, the benefits to innovation usually increase since there is a larger market in which to deploy the innovations. When competition intensifies, the costs of failing to innovate are usually greater since there are more varied and innovative adversaries to compete with.

As an example, the UAE has developed a robust defense manufacturing sector, which includes the production of advanced drones based on the latest technology. It chose to innovate its drones partially because it can sell them internationally rather than just the UAE, and partially because its own market share (in the UAE and internationally) is under threat by numerous international defense manufacturers.

While these advantages and examples are framed in terms of the commercial sector, they apply equally to the workers in the event that the economic integration permits human capital mobility. Thus, economic integration raises the returns to investment in education and skills, and it lowers the cost of acquiring such human capital.

Economists also expect economic integration to result in increased market concentration, i.e., a smaller number of firms servicing the combined market. This happens because the competitive pressure motivates firms to merge to increase production and exploit economies of scale; the smaller producers either get forced out of business or are acquired by larger competitors. Unlike the three consequences described above, the increased market concentration is not always considered to be desirable. On the positive side, it can encourage greater use of economies of scale. On the negative side, an oligopolistic market structure can lead to collusion and other forms of anti-competitive behavior, all of which constitute threats to innovation and efficiency.

Despite the uncertainty over the effects of increased market concentration, economists are essentially unanimously in favor of economic integration. This is because increased competition is almost always a good thing. A very influential paper by Nickell (1996) confirmed this widely held belief: in a study of 670 UK companies, he found clear evidence of increased competition leading to higher levels of productivity growth. Sometimes this is due to firms modifying their behavior in the manner laid out by the predictions above: adapt or fail. Yet Nickell also suggested a complementary mechanism that mimics biological evolutionary processes. Increased competition means that more firms try their hand in the market and only the best persevere, as compared to non-competitive markets, where a small number of firms (possibly one) are active. Thus, rather than forcing firms to adapt and improve, increasing competition benefits consumers by creating a larger pool of entrants from which to pick the winner.

Regardless of the precise mechanism, the fruits of competition usually require some disruption, namely the bankruptcy of inefficient producers. While society as a whole gains, there will be some individual losers. The small number who anticipate being losers from the introduction of a single market can often lobby far more effectively than the diffuse and numerous expected winners. For this reason, politics can often derail what economists unanimously regard as a highly desirable policy. Fortunately for GCC residents, policymakers were able to secure the political will to introduce a single market.

3. GCC Economic Integration: Descriptive Statistics

3.1. Formal Steps

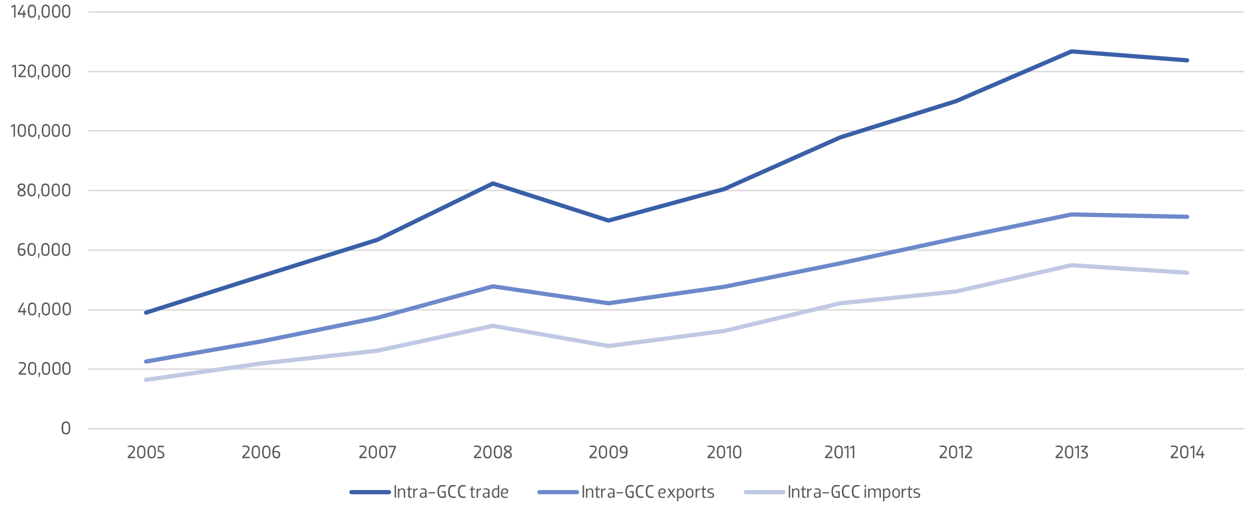
The GCC was established in 1981, and shortly thereafter, in 1982, a free trade area was established. Explicit plans for a single market appeared in 2001, and came into effect from the start of 2008. These included an agreement to establish a customs union in 2003. The 2010 establishment of a Gulf Monetary Council confirmed the desire to work toward a monetary union, but these plans were recently put on hold in the wake of the economic crises associated with the eurozone. In 2011, Saudi Arabia's King Abdulla floated the idea of a political union, implying fiscal union, but the idea is yet to gain traction.

At present, under the GCC single market, each of the six member states is required to treat all GCC citizens equally in the following domains (Al-Kila'i et al. 2009).

1. Travel and residency.
2. Employment in government and private sectors.
3. Pensions and social insurance.
4. The pursuit of professions and trades.
5. Engagement in all economic activities, investments and services.
6. Real estate ownership.
7. Movement of capital.
8. Taxation.
9. Trading shares and establishing companies.
10. Education, health and social services.

As we will discuss below, in practice, adherence to these requirements has not been absolute. Nevertheless, there has been significant progress in terms of integrating the economies, as reflected in the GCC integration data.

Figure 3.2.1.1a: Intra-GCC trade: All GCC ($ millions)
Source: GCC Secretariat General



3.2. Statistical Indicators

3.2.1. Trade and Commercial Activity

According to GCC regulations, goods and services should be free to cross GCC borders, and, after the establishment of the single market, GCC citizens should be free to operate commercial activities in other GCC member states. **Figure 3.2.1.1a** and **Figure 3.2..1.2a** show intra-GCC trade, the most commonly cited metric of economic integration.

Intra-GCC exports reached a peak of $72 billion during 2013, corresponding to 4.4% of GCC GDP. Both figures are significantly larger than at the start of the sample period: in 2005, intra-GCC exports were $23 billion, corresponding to 3.6% of GCC GDP. By way of comparison, intra-EU exports equaled 20% of EU GDP during 2013. These figures suggest that while intra-GCC trade is growing robustly, it is still significantly below the levels associated with an advanced regional single market such as the EU.

Figure 3.2.1.2a: Intra-GCC trade: All GCC (% of GDP)
Source: GCC Secretariat General

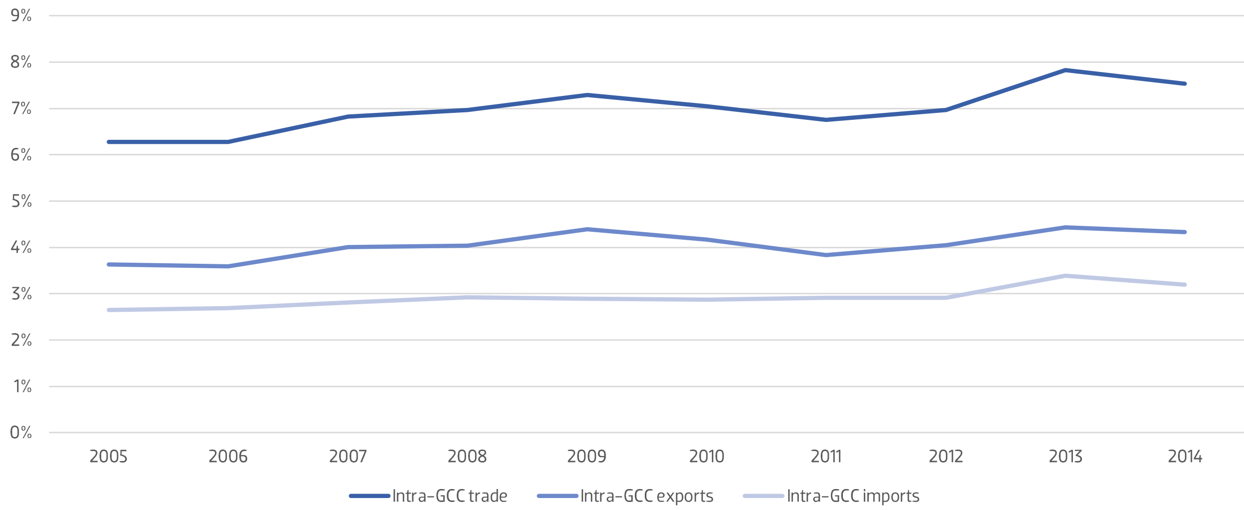
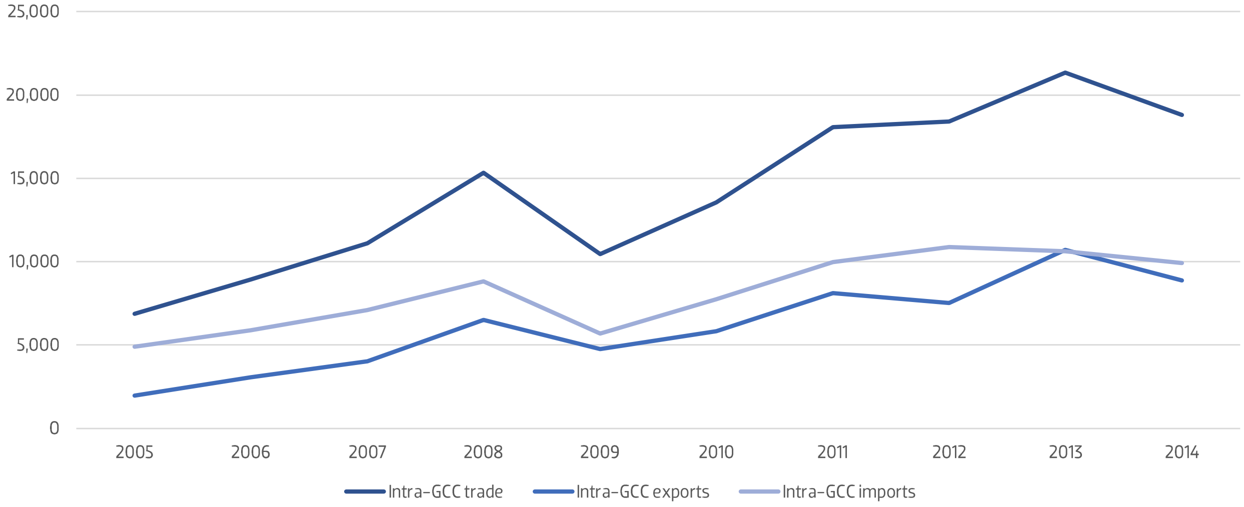


Figure 3.2.1.1b: Intra-GCC trade: Bahrain (% of GDP)
Source: GCC Secretariat General



In the interests of parsimony, we restrict our exposition of the breakdown of the trade to the case of Bahrain.

Figure 3.2.1.1b and Figure **3.2.1.2b** show the extent of Bahrain's trade engagement with the GCC.

In 2014, the sum of exports and imports with the GCC equalled $19 billion, corresponding to 56% of Bahrain's GDP. This latter figure is very large. The two figures in 2005 were $6.9 billion and 43%, confirming the rising importance of GCC trade to Bahrain's economy.

Figure 3.2.1.3 shows the contribution of each GCC country to Bahrain's product exports and imports versus the contribution of the rest of the world in 2014.

Within the GCC, Bahrain's key product trading partners are Saudi Arabia (23% of exports, 40% of imports) and the UAE (11% of exports, 5.3% of imports), with the remaining GCC member states making small contributions to Bahrain's trade balance in goods. Collectively, the GCC is very important to Bahrain, accounting for 42% of its product exports, and 48% of its product imports.

Figure 3.2.1.2b: Intra-GCC trade: Bahrain (% of GDP)
Source: GCC Secretariat General

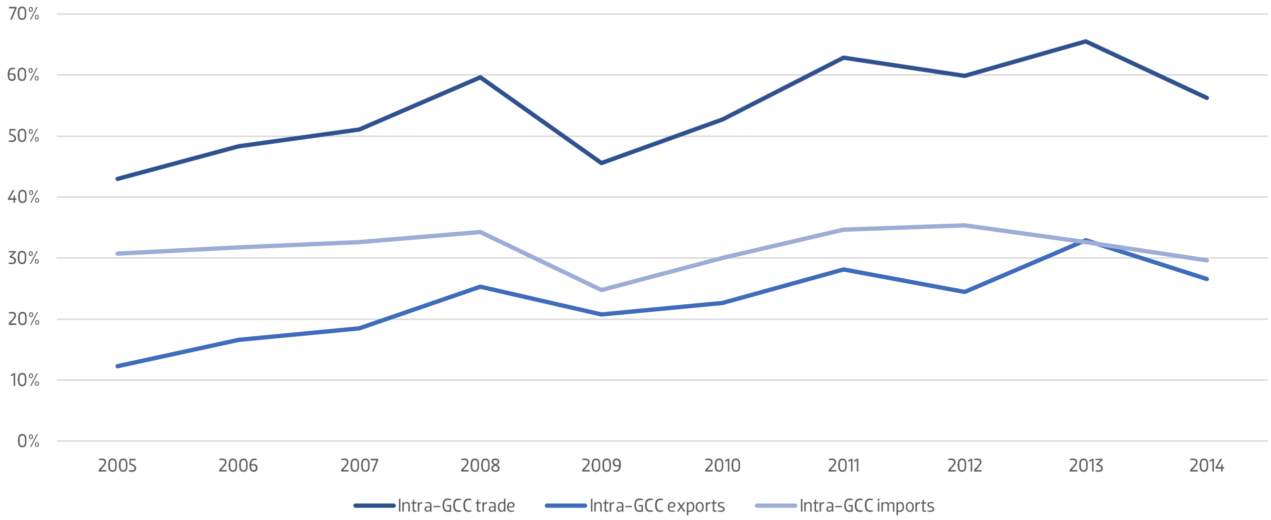


Figure 3.2.1.3: GCC Member Contributions to Bahrain Product Exports and Imports, 2014
Source: UNSTAT

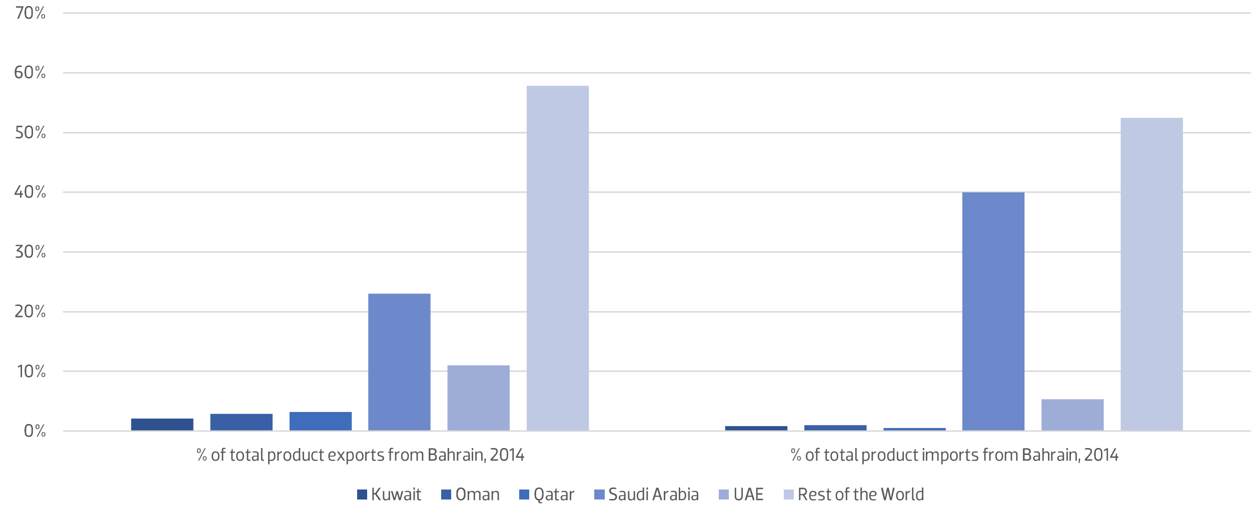


Figure 3.2.1.4 provides a breakdown of the products imported and exported by Bahrain from its two biggest trading partners in the GCC, Saudi Arabia and the UAE. In the interests of parsimony, we only report data for some of the major classes of goods according to SITC2 definitions.

Starting with Saudi Arabia, Bahrain's imports are dominated by crude oil, which arrives via pipeline, and is subsequently refined and re-exported. Bahrain's primary exports to Saudi Arabia are processed aluminum, cars, and electronic goods. The large boiler exports are primarily metal cable exports.

In the case of the UAE, Bahrain primarily imports gold and precious jewels, presumably for retail resale, and cement for construction. It also imports a variety of other inputs into constructions, such as iron bars and electrical wires. Bahrain's primary exports to the UAE include semi-processed and processed aluminum, cars, and a variety of electronics. Since these latter goods are not produced in Bahrain, they may well represent re-exports that take advantage of Bahrain's FTA with the USA.

Figure 3.2.1.4: Bahrain Product Exports and Imports with Saudi Arabia and UAE, 2014
Source: UNSTAT

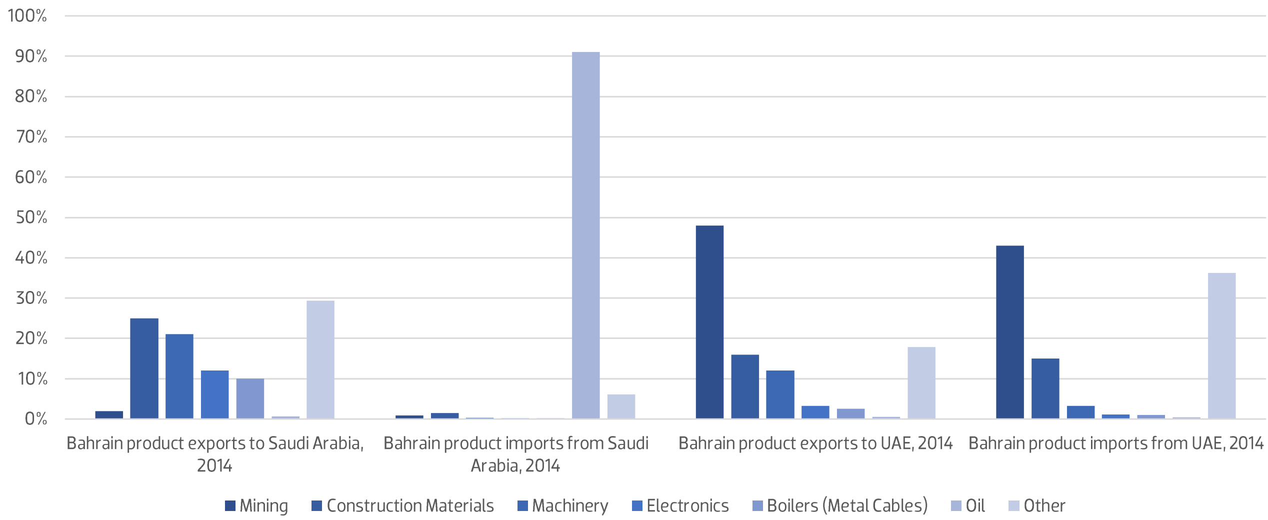
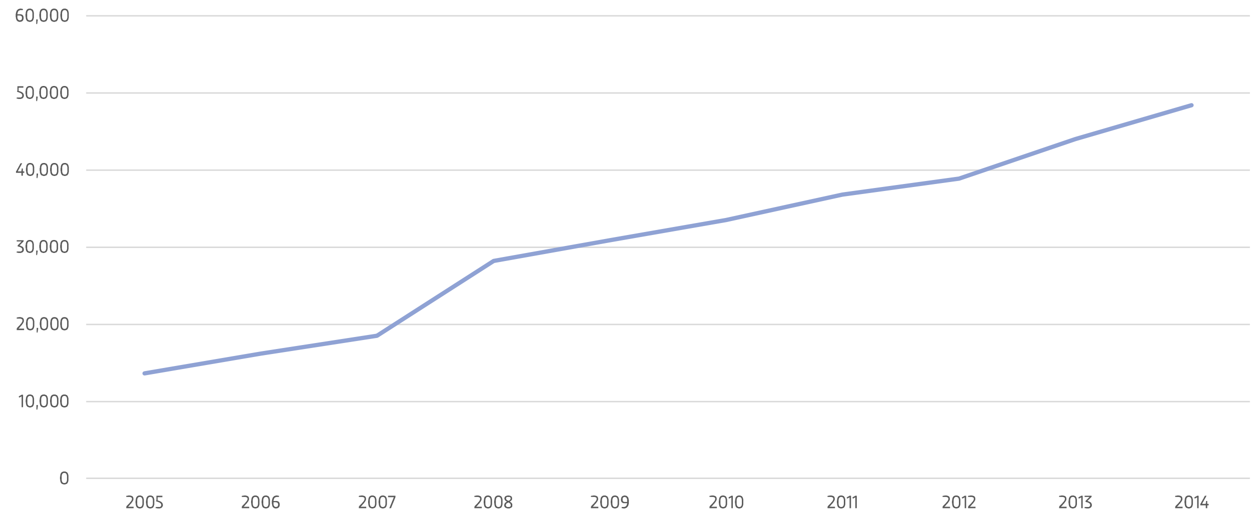


Figure 3.2.1.5a: Cumulative commercial licenses given to other GCC members: GCC
Source: GCC Secretariat General



Unfortunately, we do not have data on services. Such data would be especially useful in the case of Bahrain given the importance of tourism and financial services to the economy.

Turning our attention to commercial activity, **Figure 3.2.1.5a** shows the cumulative number of commercial licenses given to citizens of other GCC member states for the GCC, and Figure **3.2.1.5b** shows the cumulative number for the case of Bahrain--that is, the number of commercial licenses the Bahrain government has given non-Bahraini GCC citizens.

At the level of the GCC, in 2014, the cumulative number of licenses was 49,000, compared to 14,000 in 2005, implying an annual growth rate of 15%--a very large figure, confirming the growing integration of economic activity between the GCC states.

In separate data, the GCC figure is driven by the UAE, which accounts for around 80% of the cumulative licenses each year. This is the result of the UAE's aggressive strategy for attracting inward FDI via the streamlining of commercial registration procedures and the creation of a well-regulated, liberalized commercial environment (Mina, 2014).

Figure 3.2.1.5b: Cumulative commercial licenses given to other GCC members: Bahrain
Source: GCC Secretariat General

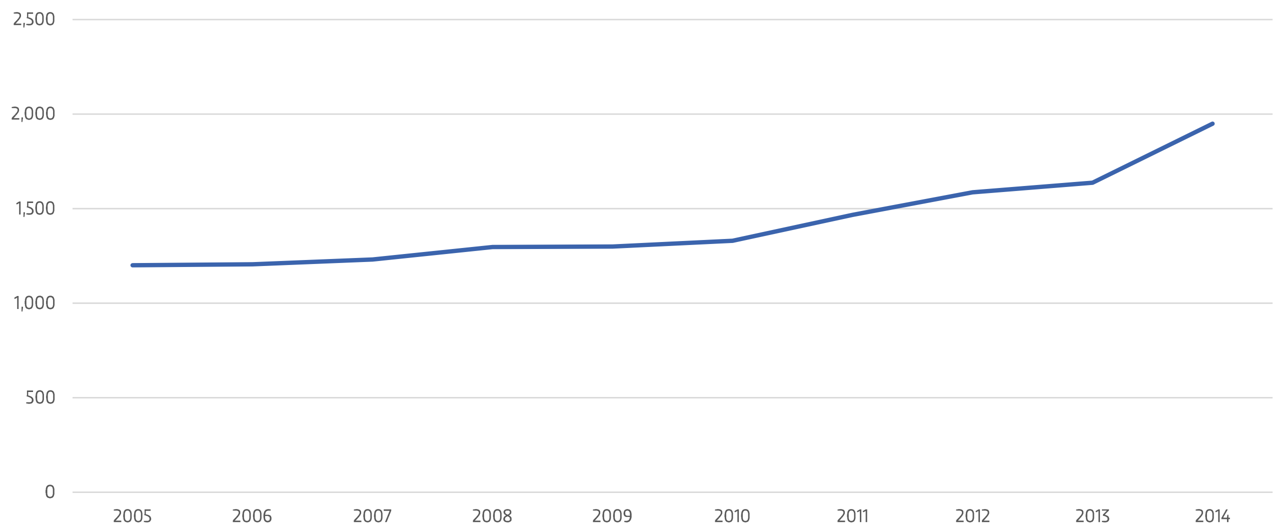
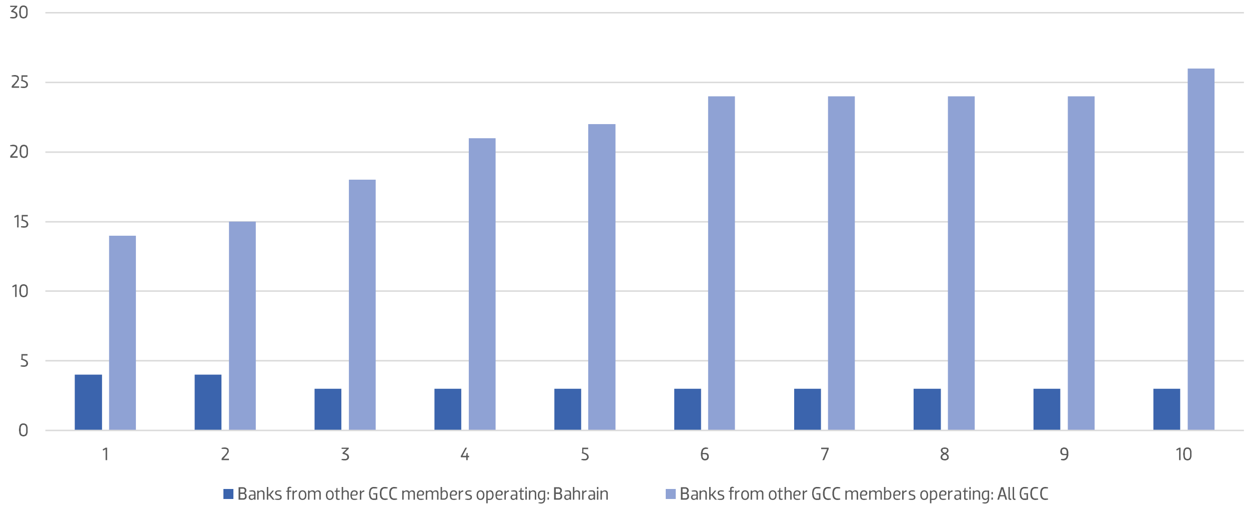


Figure 3.2.1.6: Banks from other GCC members operating: All GCC and Bahrain
Source: GCC Secretariat General



In the Bahrain case, the 2014 figure was 2,000, compared to 1,200 in 2005, implying an annual growth rate of 5.5%. This figure is still large, though not as large as that of the GCC as a whole, or the UAE in particular. It reflects Bahrain's parallel efforts at attracting inward FDI, which we discuss in greater detail below. Unfortunately, no data on the number of licenses granted Bahrainis in other GCC member states are available.

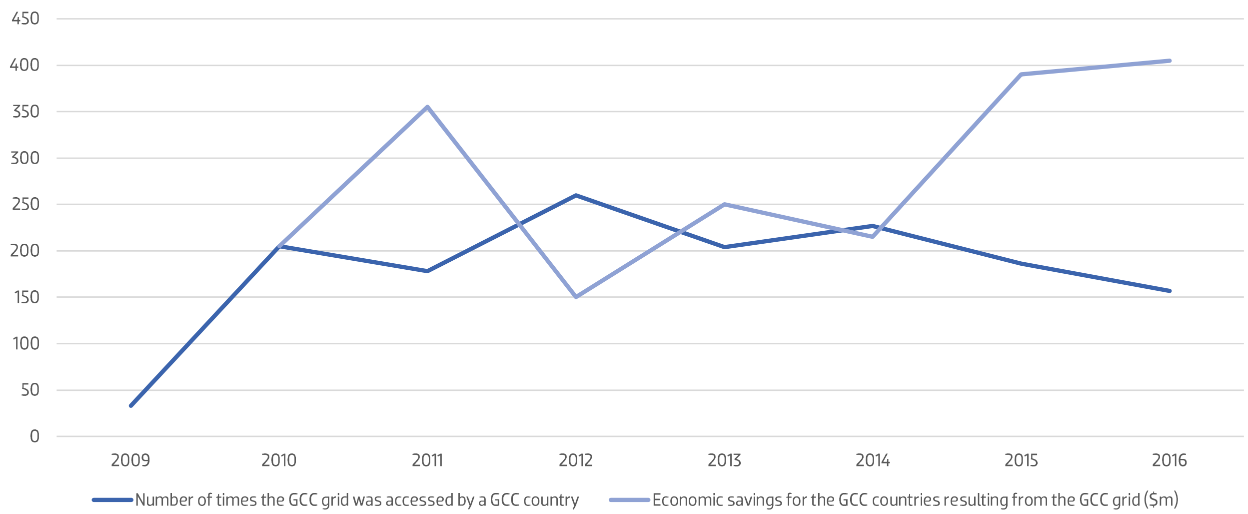
In both the GCC and Bahrain cases, though the single market was established formally in 2008, the data do not suggest any particular acceleration in commercial licensing after the announcement. This is partially due to the time taken for the bureaucracies to implement the decisions, and partially due to the existence of certain barriers to implementation, which we discuss in section 4 below.

A detailed sectoral breakdown of the commercial licenses is not available either at the level of the GCC or Bahrain. However, one exception is the banking sector. **Figure 3.2.1.6** shows the number of GCC banks from another GCC member state operating in the GCC, and in Bahrain.

At the GCC level, this figure has grown from 14 in 2005 to 26 in 2014, both of which are relatively small figures. In the case of Bahrain, it fell from 4 in 2005 to 3 in 2014. While this figure is small, too, it is large at the GCC level given Bahrain's modest contribution to GCC GDP (2%). It is unclear whether the small number of licenses given to banks from other GCC member states reflects restrictions in the banking sectors, or simply a reluctance by banks to explore the available commercial opportunities in other GCC states.

One sector that stands out in terms of GCC economic integration is electricity. In 2001, the six member states jointly created a GCC Interconnection Authority tasked with creating a GCC electricity grid (Al-Asaad, 2009). The project proceeded in three phases which were completed in 2012. **Figure 3.2.1.7** describes the usage of the grid by the member states in terms of the number of times it was accessed and the implied value of savings.

Figure 3.2.1.7: GCC Electricity Grid Usage 2009–2016
Source: GCC Interconnection Authority Annual Report, 2017



At present, the grid functions only to prevent emergency outages; the data in **Figure 3.2.1.7** indicate that it has performed this function successfully, consistent with significant levels of economic integration. For example, in 2016, the grid was accessed over 150 times, and this generated savings with a value of over $400m. At present, the member states are expanding the grid to allow for electricity trading. In fact, according to the GCCIA 2017 annual report, 2016 saw 734.4 GWh of traded electricity within the GCC.

3.2.2. Human Capital

According to the GCC single market, GCC citizens should be free to travel across GCC borders, to access the educational systems, to work, and to receive social insurance and retirement benefits. We examine each in turn.

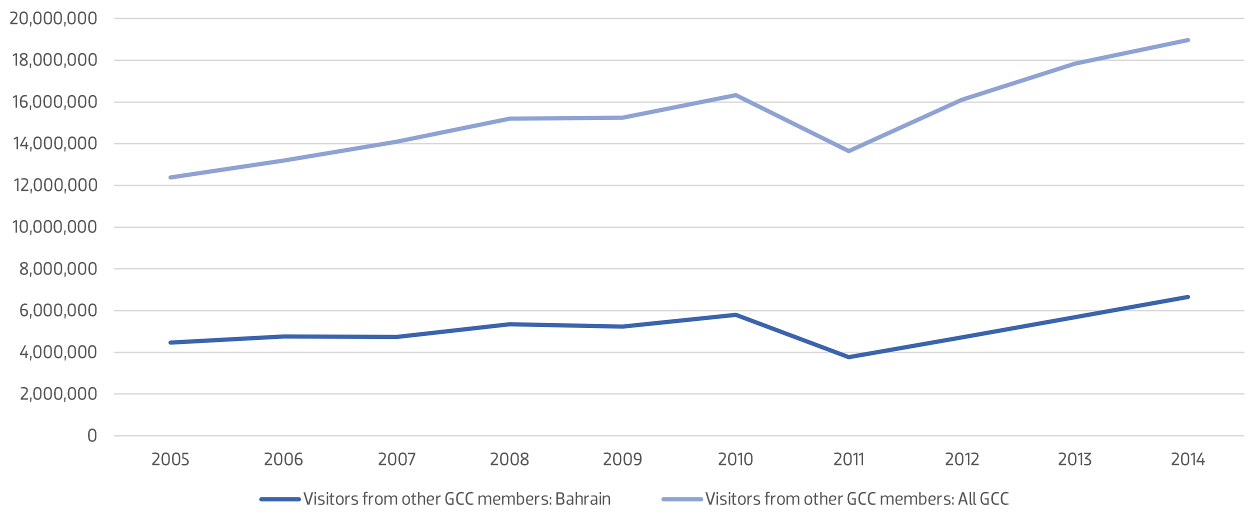
One of the most dramatic indicators of GCC integration is the large level of movement between the member states. **Figure 3.2.2.1** shows the total number of visitors from other GCC member states.

In 2014, the total number of visitors within the GCC was 19 million, compared to a population of approximately 50 million. In 2005, the total number of visitors was 12 million, compared to a population of 34 million, meaning that there has been a modest proportionate increase. Note that the fact that migrant workers represent a majority of the GCC population, and the absence of official figures on the number of citizens, means that caution should be exercised when interpreting the data.

In the case of Bahrain, the number of visitors rose from 4.4 million in 2005 to 6.6 million in 2014. Given that Bahrain represents around 3.5% of the GCC population, these data confirm the popularity of travel to and from Bahrain. In fact, much of the travel is conventional tourism, as the GCC is the biggest source of tourists to Bahrain (we expand upon this below). More generally, this pattern of Bahrain's attractiveness actually dates back to antiquity when Bahrain's natural water springs made it a key resting point on the East-West trade routes (Larsen, 1983). We do not have data on the number of visits by Bahrainis to other GCC member states.

The large movement with the GCC can be attributed to two factors. First, there are very strong cross-border tribal links, with many GCC citizens having first- and second-degree family members who reside in--or are citizens of--another GCC member state (Crystal, 2001). This creates a strong demand for travel, in light of the importance of family to the local culture. Second, throughout the sample period, GCC citizens have been able to travel between GCC member states using only their personal ID card, without the need to carry a passport, decreasing the cost of travel (Al-Kila' et al., 2009).

Figure 3.2.2.1: Number of Visitors from Other GCC Members
Source: GCC Secretariat General



Turning our attention to education, **Figure 3.2.2.2a** (GCC) and **Figure 3.2.2.2b** (Bahrain) show the numbers of GCC citizens studying in the primary/secondary/tertiary educational system of another GCC member state.

In the case of the GCC, in 2014, the numbers in primary/secondary education are 43,000, with 5,100 in tertiary education; the corresponding figures in 2005 are 37,000 and 4,100, respectively, indicating modest growth. The time profile is also somewhat undulating for reasons that we are unable to ascertain.

In the case of Bahrain, both variables produce a "U-shaped" time profile: primary/secondary enrollments in Bahrain from 1,100 in 2005 to 1,000 in 2014; tertiary enrollments go from 300 in 2005 to 410 in 2014. The rising higher education enrollments can be attributed to the development of private sector universities that seek to serve the entire GCC. In both cases, data on Bahraini enrollments on other GCC member states are not available.

Figure 3.2.2.2a: Students in Other GCC Member States: All GCC
Source: GCC Secretariat General

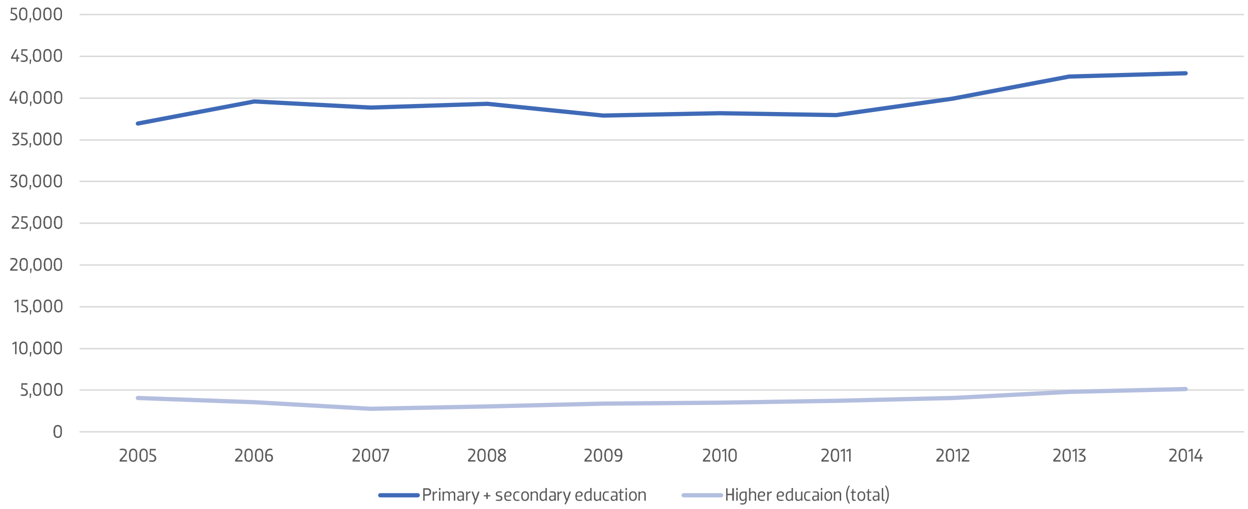


Figure 3.2.2.2b: Students in Other GCC Member States: Bahrain
Source: GCC Secretariat General

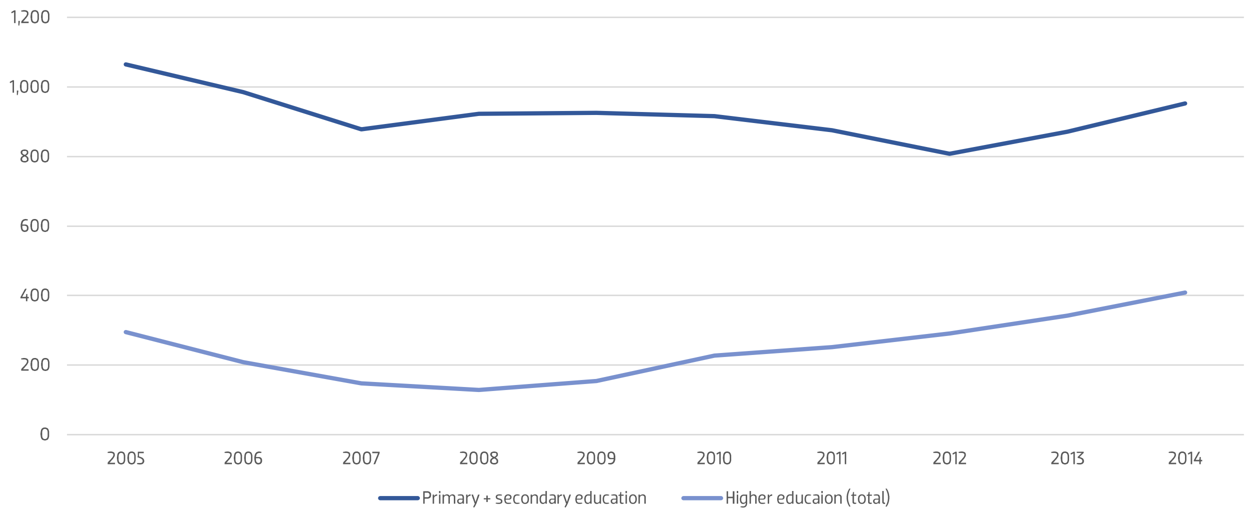


Figure 3.2.2.3a (GCC) and **Figure 3.2.2.3b** (Bahrain) show the number of GCC citizens working in other GCC member states, by sector (private versus public).

In 2014, 31,000 GCC citizens were employed in a different GCC member state (16,000 public sector, 15,000 private sector), compared to 25,000 in 2005 (9,800 public sector, 15,000 private sector). These are small figures compared to the total employment of GCC nationals (Hertog, 2012). This is presumably the result of GCC citizens' emphasis on physical proximity to family in their life decisions, which translates to very low levels of geographic mobility, even within the homogenous GCC.

Also notable is that the private sector series is more volatile than the public sector, which is to be expected since public sector positions are protected, whereas private sector workers can be dismissed in response to weakening economic conditions.

In the case of Bahrain, both series are approximately flat, with 2014 private sector employment being 600, and public sector employment being 210. We do not have data on the employment of Bahrainis in other GCC countries.

Figure 3.2.2.3a: Employment in Other GCC Member States: All GCC
Source: GCC Secretariat General

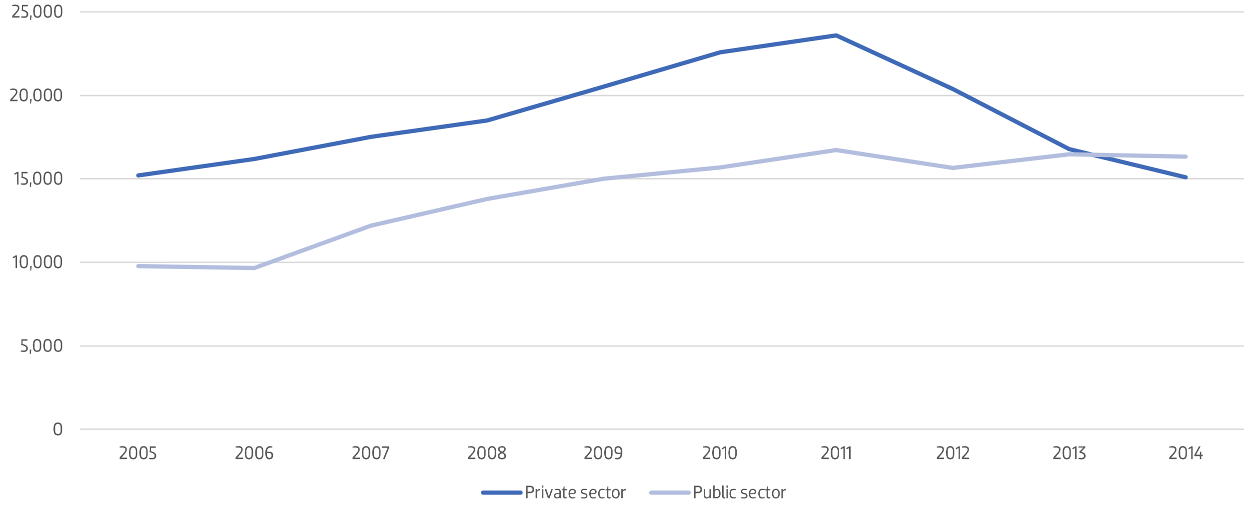
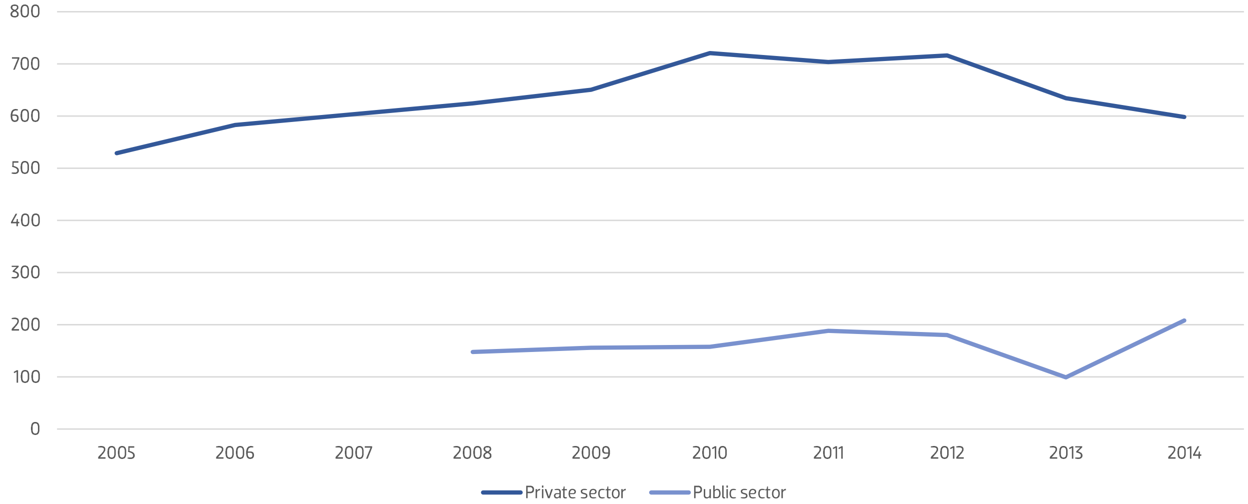


Figure 3.2.2.3b: Employment in Other GCC Member States Bahrain
Source: GCC Secretariat General



Finally, **Figure 3.2.2.4a** (GCC) and **Figure 3.2.2.4b** (Bahrain) show the number of GCC citizens working registered in the social insurance and retirement systems of other GCC member states.

In the GCC, in 2014, 13,000 citizens were registered in the retirement scheme of another GCC member state, and 7,300 were registered for social insurance (2013 figure). The corresponding figures for 2005 were 900 and 1,400, respectively, representing dramatic growth, no doubt enabled by the launch of the single market.

In Bahrain, both series are quite flat. In 2014, the number of people registered for retirement was 64, and for social insurance 440 (2013 figure). We do not have data on the number of Bahrainis registered in the schemes of other GCC member states.

Figure 3.2.2.4a: Number Registered for Social Insurance and Retirement in Other GCC Member States: All GCC
Source: GCC Secretariat General

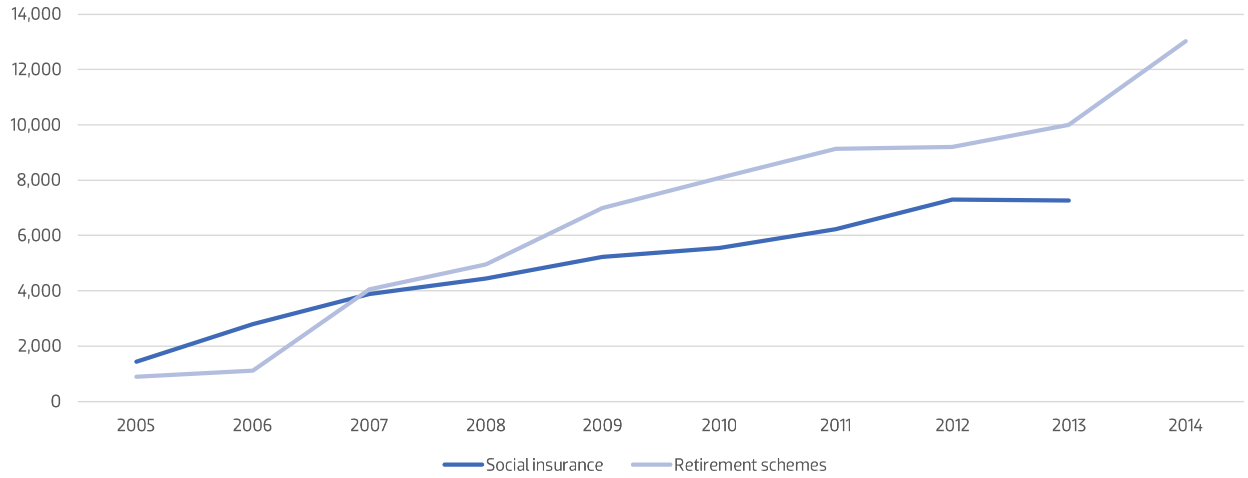
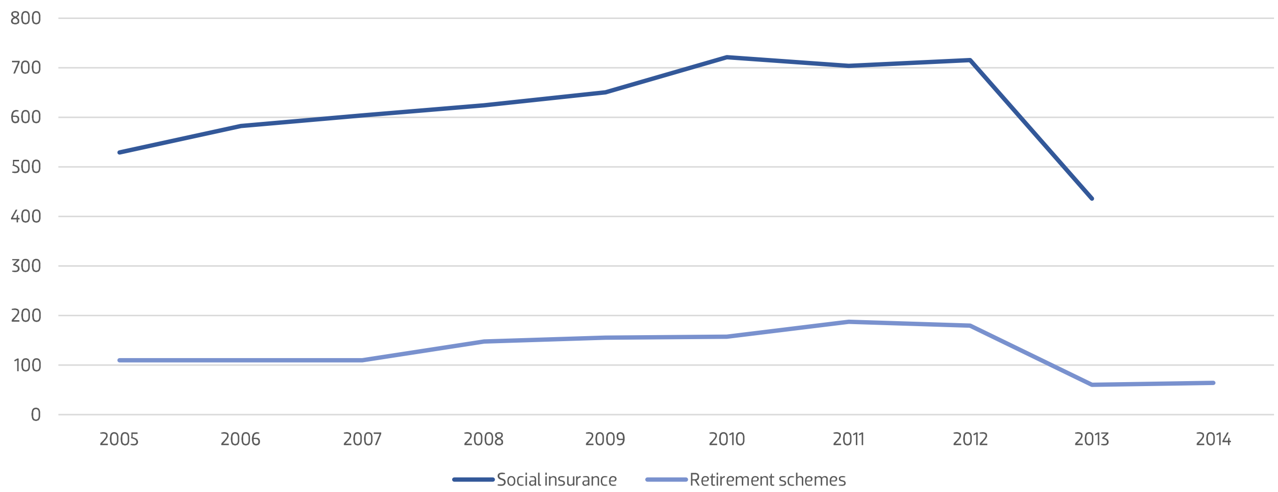


Figure 3.2.2.4b: Number Registered for Social Insurance and Retirement in Other GCC Member States: Bahrain
Source: GCC Secretariat General



3.2.3. Physical Capital

According to the GCC single market, GCC citizens should be unrestricted in their purchases of financial assets (including shares) and real estate in other GCC countries. **Figure 3.2.3.1** shows the access that GCC citizens have to shares in companies listed in other GCC member states, measured as the percentage of market capitalization that they can purchase, and the percentage of listed firms.

By 2014, access is high, both in terms of market capitalization (96%) and listed firms (95%). The corresponding figures in 2005 were 81% and 85%, respectively, suggesting that the single market had a substantial effect on eliminating barriers. In the case of Bahrain, access was 100% according to both definitions throughout the sample period.

Figure 3.2.3.2 shows the numbers of GCC citizens owning shares in another GCC member state, though the data are only available until 2011.

By 2011, nearly half a million GCC citizens owned shares in another GCC member state, compared to 270,000 in 2005, suggesting that increased access that the single market provided translated to actual purchases. In the case of Bahraini companies, by 2011, 27,000 citizens of other GCC member states owned shares in 2011, compared to a modest 3,600 in 2005. While the Bahraini figure rises consistently throughout the sample period, the GCC figure declines sharply in 2007 and stabilizes thereafter, presumably as a result of the global financial crisis that started in 2007.

Figure 3.2.3.1: Access to Shares within the GCC: All GCC
Source: GCC Secretariat General

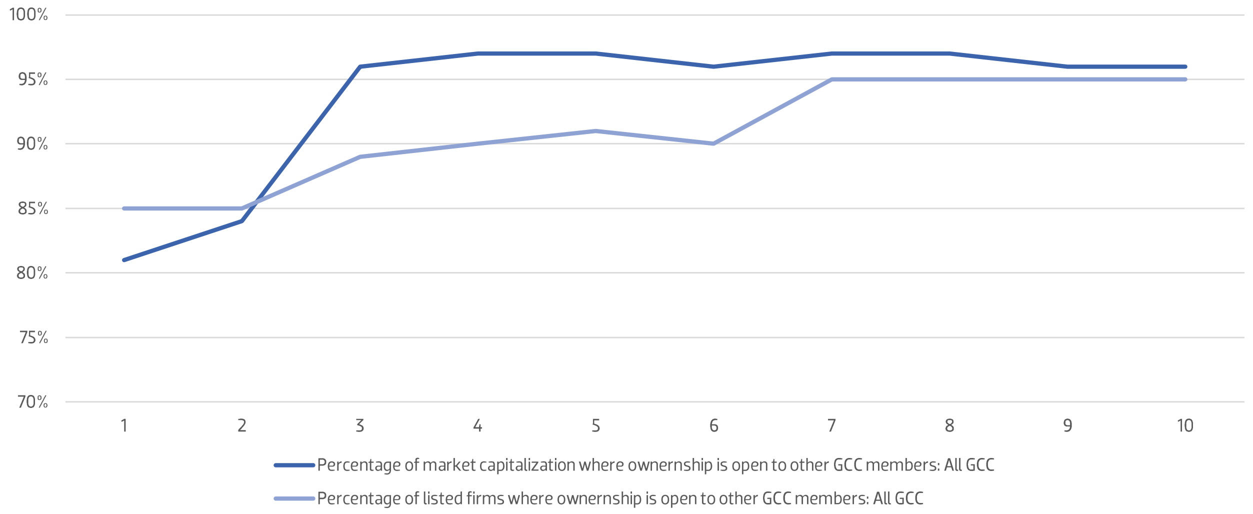


Figure 3.2.3.2: Shareholders from Other GCC Member States
Source: GCC Secretariat General

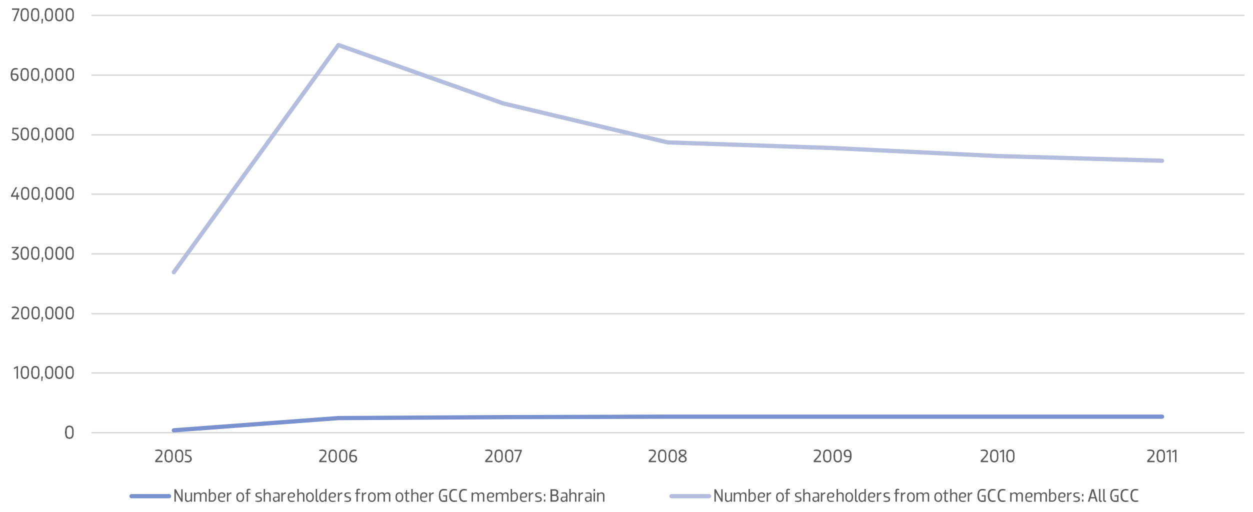


Figure 3.2.3.3: Real Estate Owners from Other GCC Member States
Source: GCC Secretariat General

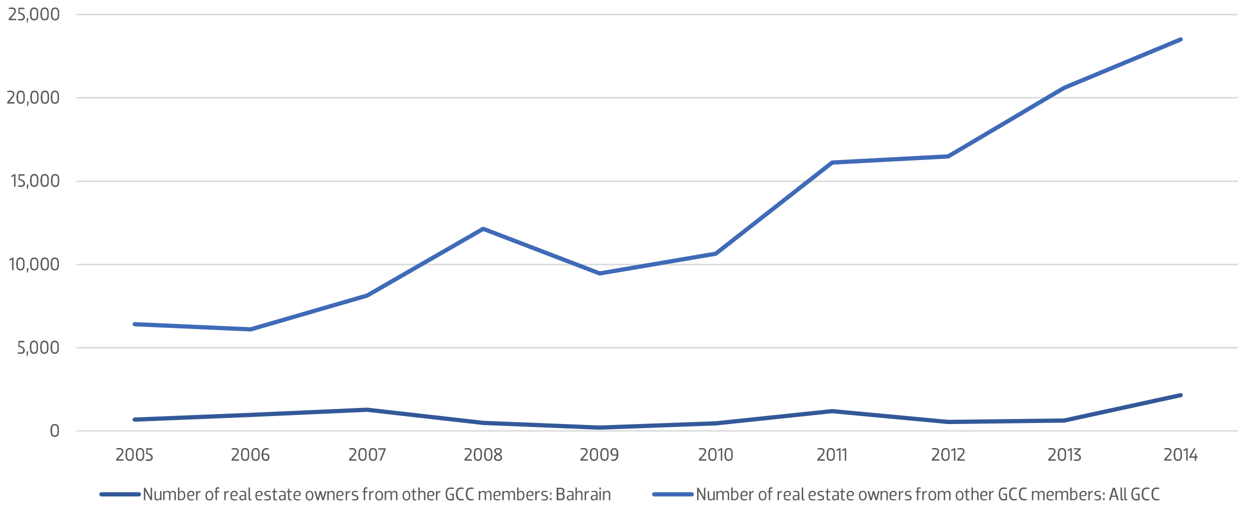


Figure 3.2.3.3 shows GCC ownership of real estate. At the GCC level, the figure in 2014 was 24,000 compared to 6,400 in 2005, implying rapid annual growth, no doubt spurred by the popularity of real estate projects and mega-projects within the GCC, and the importance of real estate projects to the portfolio of Islamic banks. Bahrain also witnesses robust growth, with ownership of Bahraini real estate by citizens of other GCC member states going from 700 in 2005 to 2,100 in 2015.

In the cases of both shares and real estate, we do not have access to data on ownership by Bahrainis in other GCC member states.

Foreign direct investment (FDI) has played an important role in Bahrain's economic strategy since the turn of the millennium, with an emphasis on GCC FDI. **Figure 3.2.3.4a** is a time series of FDI stocks in Bahrain (GCC versus non-GCC), while **Figure 3.2.3.4b** shows the GCC breakdown (we only have data on inward flows for Bahrain).

These data exhibit several notable features. First, the total value of FDI in Bahrain is very large by international standards, when deflated by GDP. Throughout most of the sample period, FDI stocks exceed 80% of GDP. By comparison, using OECD data (https://data.oecd.org/fdi/fdi-stocks.htm), the corresponding figure for the EU as a whole is around 50%, though smaller economies such as Luxembourg (351%) and Estonia (83%) occupy some of the higher rankings. This confirms the importance of FDI

Figure 3.2.3.4a: FDI Stocks in Bahrain (BD million): GCC/Non-GCC
Source: Bahrain IGA

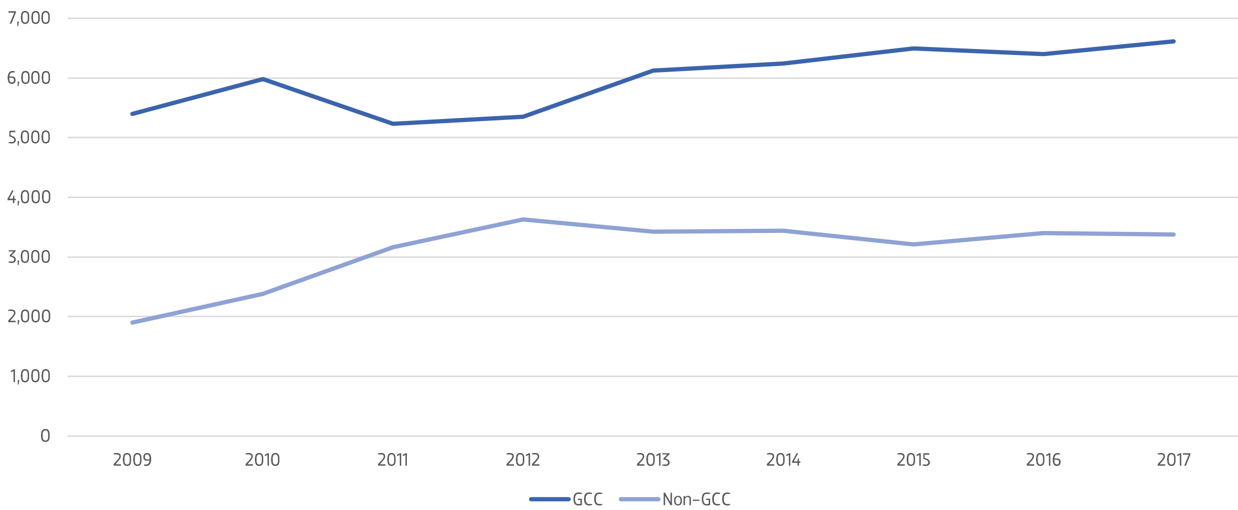
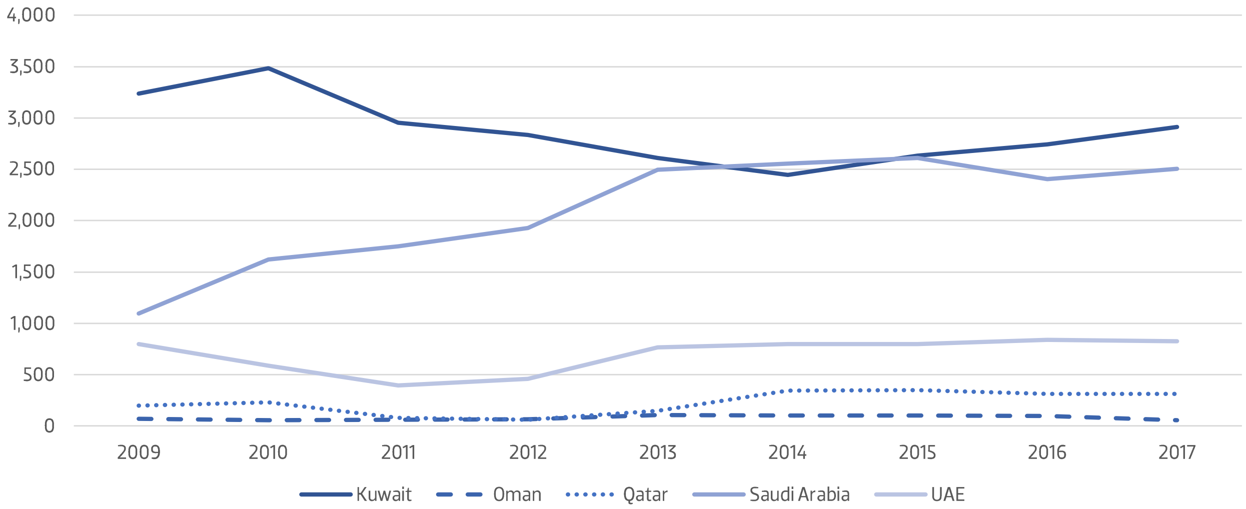


Figure 3.2.3.4b: FDI Stocks in Bahrain (BD million): GCC Breakdown
Source: Bahrain IGA



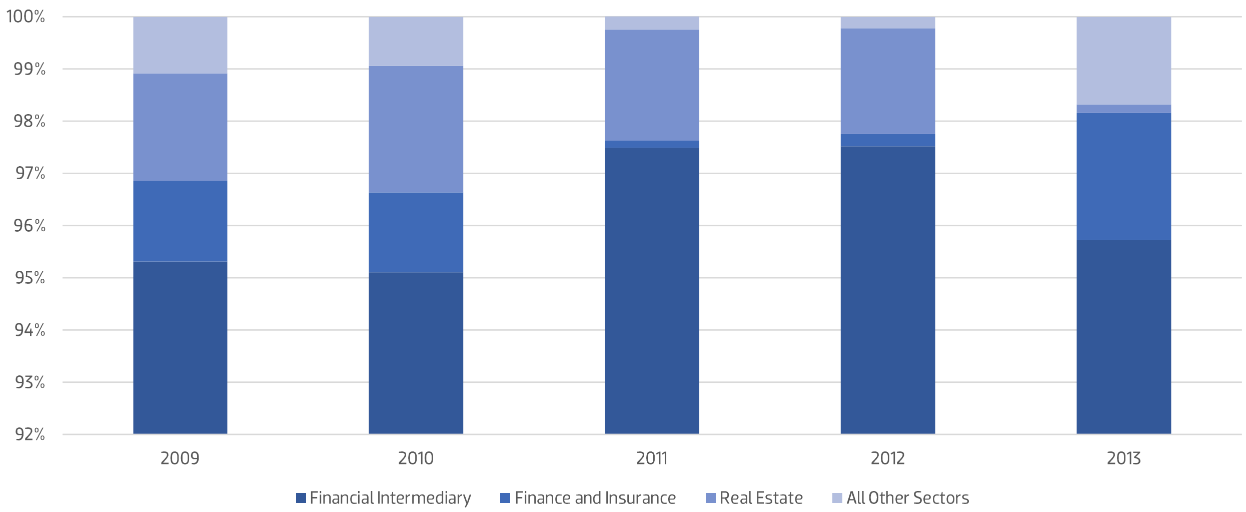
to Bahrain's economy, and the success of the government's FDI strategy.

Second, FDI stocks are dominated by the GCC, with the GCC accounting for 66% of stocks on average. When this is further broken down by country, Kuwait and Saudi Arabia are the dominant contributors, with a significant contribution from the UAE, too, versus modest contributions from Oman and Qatar. With the exception of a blip in 2011 due to the political crisis in Bahrain, GCC FDI stocks are increasing secularly both in absolute terms and as a proportion of the total FDI.

Figure 3.2.3.5 shows the sectoral breakdown of FDI stocks for the period 2009-2013, the latest period for which data are available.

These data confirm that the financial sector dominates FDI in Bahrain (an entirely analogous picture emerges if we were to restrict the exposition to GCC-origin FDI stocks): over 95% of FDI stocks are in financial intermediation, and finance and insurance, with the real estate sector being the only alternative that accounts for a significant percentage.

Figure 3.2.3.5: FDI Stock by Sector, 2009–2013
Source: Bahrain IGA



3.3. Evidence of Incomplete Integration

The preceding data paint a picture of strong economic integration within the GCC. However, in practice, GCC citizens seeking to take advantage of the single market have complained of impediments to its proper functioning. Some of these are reflected in official GCC data, such as the following examples taken from Abdulghaffar et al. (2013), which are based on 2011 data:

- 23 non-Saudi GCC citizens worked in the Saudi government.
- 32 non-Omani GCC citizens worked in the Omani private sector.
- 18 non-Saudi GCC citizens were enrolled in Saudi retirement plans.
- Two Omani citizens owned real estate in Qatar, compared to 966 in the UAE.
- One non-Qatari GCC bank operated in Qatar.

Note that these are arbitrary selections that are illustrative and are not designed to single out any particular offenders. A report by Federation of GCC Chambers (2012) systematically describes the various malfunctions of the GCC single market, and it is summarized in Abdulghaffar et al. (2013).

Merchants complain of barriers to the transportation of goods across intra-GCC borders. For example, trucks that have entered the GCC sometimes face strict inspections when crossing borders within the GCC, including the imposition of fees that function as pseudo-tariffs. Moreover, health and safety inspections are sometimes applied in a discriminatory manner, whereby citizens and goods transportation vehicles of the receiving country receive favorable treatment compared to those originating in other GCC states.

Humans crossing borders also face impediments. The aforementioned travel statistics confirm that GCC citizens are free to move around the GCC, but businesses complain that the movement of non-GCC citizens is restricted by the absence of a pan-GCC visa, or an analogue to the Schengen visa. Given the importance of foreign workers to the Gulf economy, these kinds of barriers can limit the ability of the GCC countries to realize the benefits associated with economic integration.

Factors of production relocating across borders also face restrictions that nominally violate the principles of a single market. In the labor market, it is not uncommon to see job postings expressing a preference for--or even stipulating--workers who have the same nationality as the employer, which violates the rule that GCC citizens enjoy the same labor market rights as nationals in all GCC countries. Similar forms of discrimination sometimes appear when GCC citizens seek licenses for various trades and professions in GCC member states outside their home country, or when they try to access social security and pensions.

Entrepreneurs can also face hurdles, as GCC governments are yet to fully eliminate barriers such as requiring a local partner with at least 51% ownership. Cross-border investment in shares and in real estate also fails to comply with single market guidelines, with GCC citizens sometimes being denied the same ownership rights as nationals when making purchases in another GCC state. And once a GCC citizen successfully launches a commercial enterprise in another GCC state, they may find the activity taxed similar to those operated by non-GCC citizens, rather than the zero taxes that local citizens typically face.

The qualitative evidence that the Federation of GCC Chambers of Commerce is based on discussions and complaints made by GCC merchants, but it is not the result of systematic surveying of the barriers to trade. The GCC Secretariat General does collect precise data on violations of single market rules, but these data are not released to the public (including researchers). The most likely reason is that the culture of conflict resolution in the GCC emphasizes discreet, behind-the-scenes negotiations, rather than open discourse. Al-Ubaydli and Abdulla (2015) argue that making such data public could yield a better-functioning single market.

3.4. Summary

Following in the footsteps of the EU, the GCC member states have taken tangible legislative steps toward creating an integrated GCC economy, most notably the single market established in 2008. These enabling steps have translated to tangible actual economic integration: goods, services, human capital, and physical capital have crossed GCC borders in substantial volume, though one glaring area of weakness is the limited amount of employment in other GCC member states. However, despite the considerable levels of economic integration achieved since the bloc's inception in 1981, the single market functions imperfectly, with various impediments to the flow of commodities and factors of production across GCC borders.

Bahrain is especially integrated into the GCC economy. Saudi Arabia and the UAE dominate its list of trading partners. Moreover, in most metrics of GCC integration, it accounts for a disproportionate share of realized integration when one accounts for Bahrain's small population and economy relative to the other member states. This can be attributed to two primary reasons.

First, Bahrain has historically (since antiquity) been inhabited by people keen to engage foreigners, and trade has played an important role in the economy (Fuccaro, 2009). The local culture is very hospitable to foreigners seeking to live and work in Bahrain, including those from the other GCC states, whereas the relative conservatism of some of the other GCC member states diminishes their receptiveness to foreign cultures (Crystal, 2001).

Second, the government has actively pursued an economic growth strategy based on attracting foreign economic activity, including FDI, with the GCC being a point of emphasis (Gilmore et al., 2003).

Despite Bahrain and the GCC's successes in exploiting the gains from regional economic integration, data limitations impair our ability to definitely ascertain the extent of the gains. At the GCC level, we would ideally have access to data on the prices of goods and services, as that would allow us to analyze the role of increased competitiveness. In the case of Bahrain, we have data on activity within Bahrain by other GCC member states, but we lack data on the activity of Bahraini citizens in other GCC member states.

4. GCC Economic Integration: Analysis

4.1. Benefits Accruing to Bahrain

Figure 4.1.1 shows the path of Bahrain's GDP during the period. In general, the growth rate is high, never dipping below 2%; in fact the arithmetic mean of the percentage growth rate is 4.5%, which is remarkably high for an economy with a GDP per capita of close to $30,000.

In principle, one could use GDP growth as a primary outcome variable of interest when assessing the impact of economic integration on the Bahrain economy. However, measuring the extent to which a country has benefited from economic integration using such methods is a very difficult task for two reasons.

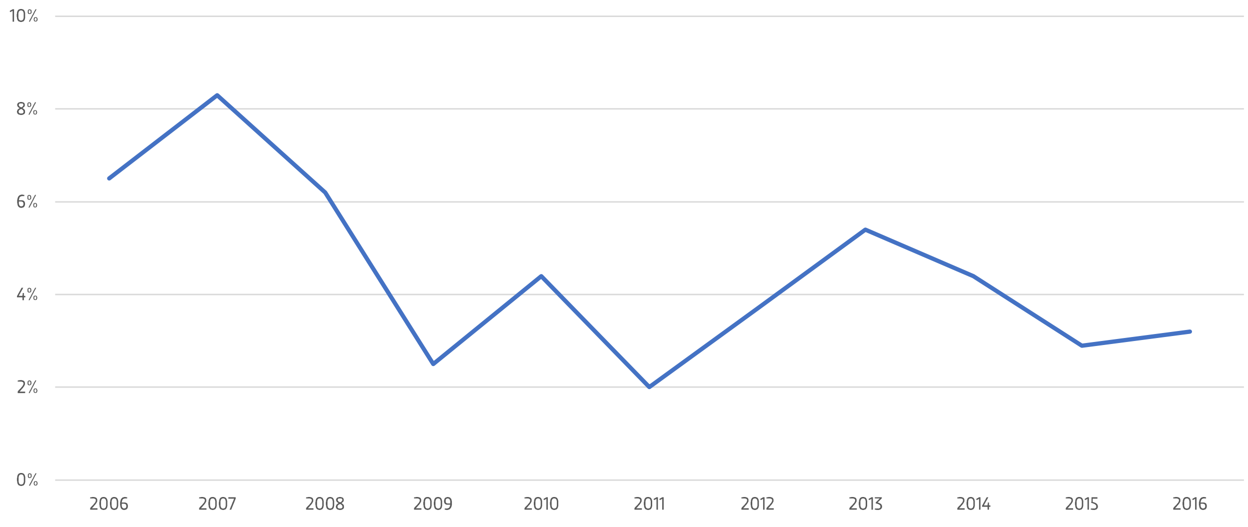
First, when using data on actual economic activity pre- and post-economic integration, it is impossible to construct a counterfactual of what the economy would look like in the absence of economic integration unless the researcher resorts to a highly restrictive array of simplifying assumptions (Sims, 1992).

For example, comparing Bahrain's economic performance following the launch of the single market in 2008 to its performance prior to the launch is instructive. However for this to result in an accurate estimate of the effect of the single market on the economy, the researcher must assume that the only economy-relevant difference between the pre- and post-2008 economy is the single market. This kind of assumption is an incredibly poor approximation of reality, and it is likely to yield highly misleading results due to the presence of a plethora of economy-relevant changes that happened after 2008 that are unrelated to the single market, such as the global financial crisis in 2008, or the subsequent decline in oil prices.

Researchers have the option of constructing econometric models of outcome variables such as GDP growth, where they control for as many alternative explanatory variables as possible. But in Bahrain, this technique is thwarted by the paucity of good-quality macroeconomic data. For example, quarterly economic data is only available for a small number of years, implying significant constraints on the number of explanatory variables that can be used as controls.

The second challenge facing researchers is the dimensionality of the effects of economic integration. Almost all markets for goods, services, and factors of production exhibit deep interlinkages, making it impossible for researchers to identify an exhaustive

Figure 4.1.1: Bahrain Real GDP Growth 2006–2016
Source: Bahrain IGA



set of outcome variables to analyze. Aggregate indicators, such as GDP or GDP growth, are reasonable summary variables, but they remain extremely crude ways of measuring the effects of an incredibly complex process such as economic integration.

As a result of these challenges, studies that seek to gauge the effects of economic integration typically focus on a narrow avenue that is econometrically tractable. For example: Akkoyunlu-Wigley and Mihci (2006) estimate the effect of Turkey's entry into the EU customs union on the price-cost markup in various Turkish industries; Bottasso and Sembenelli (2001) estimate the effect of the EU single market on market power and total factor productivity in a sample of Italian firms; and Griffith et al. (2010) estimate the effect of the EU single market on profitability, innovation intensity, and productivity growth in a selection of manufacturing sectors. Despite deploying sophisticated econometric tools, none of these studies claim to deliver a holistic assessment of the impact of economic integration, instead focusing on a limited microeconomic locus. In the case of Bahrain and the GCC, the kind of multi-sector, microeconomic data required to produce estimates of the effect of economic integration are unavailable to the best of our knowledge.

An alternative approach, popular with the policy and executive bodies charged with promoting economic integration, such as the European Commission or the consulting companies that support the process, is to construct complex mathematical models of the entire economy (sometimes referred to as dynamic stochastic general equilibrium [DSGE] models) which allow for explicit counterfactual analysis, and hence estimates of the aggregate, holistic impact of economic integration upon the economy (Colander et al., 2010). There exists significant debate in the economics profession about the extent to which such models provide insight, due to the highly restrictive assumptions necessary for analyzing the models (Pesaran and Smith, 2011). However, in the case of the GCC generally--and Bahrain specifically--we are not aware of any such models having been developed to evaluate the impact of economic integration. This is at least partially driven by the fact that DSGE models require significant volumes of detailed data that are usually not available in the GCC and Bahrain.

As a result of these methodological and data limitations, for the most part, the best available option in the case of Bahrain is reporting data on the extent of integration as a proxy for the effects of the integration. As noted above, even this process is impeded by the fact that we only have data about the non-Bahraini GCC activity in Bahrain, but not the activity of Bahrainis in the rest of the GCC.

Starting with the trade in goods and services, it is evident that Bahrain is heavily integrated with the GCC economy, with intra-GCC trade exceeding 50% of Bahrain's GDP. This includes crude oil imports from Saudi Arabia, which are a critical input to one of Bahrain's most important re-exports, refined petroleum.

Electricity via the GCC grid is also an important benefit reaped by the Bahrain economy. At present, the grid is primarily for emergency usage; but its role as a means of procuring energy is expanding. This can assist Bahrain in achieving its renewable energy targets: lack of space is one of the barriers to the deployment of large scale solar projects--a constraint that Saudi Arabia does not face; therefore, Bahrain can potentially use the grid in future to procure renewable energy.

The Bahrain economy also benefits heavily from intra-GCC tourism. For example, <u>over 70%</u> of its tourists are Saudis, and they spend significant sums during their visits.

As explained above, international trade permits specialization and the exploitation of economies of scale. Given the magnitude of Bahrain's intra-GCC trade, and the critical nature of the goods and services traded, Bahrain clearly reaps significant benefits from GCC economic integration, though a monetary figure remains elusive for the methodological reasons outlined above.

The same principles apply to factors of production. Bahrain also benefits from the job opportunities available for its citizens in other GCC countries, as well as the GCC expertise it can tap to fill gaps in its own labor market. Unfortunately, we do not have data on the former, while the number of non-Bahraini GCC citizens working in Bahrain is too small to imply a tangible impact upon the economy.

Despite the potentially low effect of intra-GCC labor exchange, the same cannot be said of FDI. The figures cited above suggest that GCC FDI has made a substantial contribution to the Bahrain economy. This is primarily the result of the efforts of the Economic Development Board, which is an entity dedicated to attracting foreign capital to Bahrain, and it reflects the important position that FDI has in Bahrain's economic strategy. While various figures are often proposed regarding the numbers of jobs created by the FDI, these are based on basic models of the economy that do not take into account the downstream or intersectoral impact of the FDI; it is therefore preferable to focus on the magnitude of the FDI itself as an indicator of its impact upon the economy. Similarly, we are not aware of any data that demonstrates the technology transfer that Bahrain has benefited from due to FDI, though the effect surely exists. In the reverse direction, outward bound GCC-FDI by Bahrain helps diminish the risks faced by the Bahrain economy.

Beyond the intra-GCC movement of goods, services, and factors of production, Bahrain has also benefited hugely from the GCC financial aid package that was announced in 2011 . So far, Kuwait, Saudi Arabia, and the UAE have begun disbursing up to $2.5 billion on infrastructure projects designed to elevate the fundamental pillars of the Bahrain economy. The money has been spent on the transport network, hospitals, educational projects, and housing. While the benefits accruing are not technically the result of economic integration--countries are free to provide financial aid to those outside their economic circle--there is no doubt that the interlinkages between the GCC economies played a role in securing the development assistance. For example, some of the aid is conditional on the projects being executed by contractors from the donor country, which is a stipulation that is made possible by the fact that GCC companies can freely engage in commerce across the entire GCC. Moreover, an indirect effect of the economic integration is creating an environment of cooperation which contributes to the desire to assist other member states.

4.2. Challenges

As described in section 3.3, the biggest challenge to extracting the full benefits associated with GCC economic integration is the asymmetric and incomplete adherence to the single market's rules, i.e., the existence of a gap between planned and actual economic integration. Ensuring symmetric and comprehensive adherence is equivalent to increasing the level of economic integration, which should result in a reinforcement of the benefits reaped thus far from the partial economic integration.

As discussed in Abdulghaffar at el. (2013), there are two broad reasons for lack of adherence. The first is institutional inertia: it can take governmental organizations years to autonomously take the measures necessary to comply with single market directives, as the process is both costly and time-consuming. For example, updating card readers to accept GCC personal identification cards belonging to citizens of other GCC states can require a significant investment, which may be delayed as other issues are prioritized.

The second is willful non-compliance stemming from a country's desire to protect what it regards as an economic advantage that it believes is threatened by the single market. This is entirely analogous to the protectionism encountered daily by the World Trade Organization. For example, banks in one GCC country may fear that their market share will be undermined by entrants from other GCC member states, leading them to lobby for an exemption from the GCC single market.

In both cases, the ultimate reason is the absence of a formal accountability mechanism that features tangible punishments. The GCC organization itself operates much more like an intergovernmental forum than an integrated political entity, and the key central institutions lack executive authority (Abdulghaffar et al., 2013). For example, the GCC SG, which is the organization most similar to the European Commission in terms of mandate, operates much more like a coordinating body than an executive one. On the other hand, the most powerful body, the Supreme Council, which wields significant power, meets annually and is not designed to enforce agreements that member states are failing to adhere to. Thus, while the European Commission has the power to impose fines upon EU countries that violate European laws (Grohs, 2005), no GCC organization possesses that ability, meaning that if a member state decides against complying with an agreement, it will face no formal punishment.

The second key challenge associated with GCC economic integration is the homogeneity of the domestic economic strategies, and the lack of effort at coordinating them. This phenomenon undermines the benefits associated with economic integration, which are usually larger when the integrating economies are more heterogeneous (Ottaviano, 2010).

Bahrain has traditionally exploited its cultural and economic complementarity with Saudi Arabia as drivers of the Bahrain economy. For example, one of the key reasons why Saudi tourists enjoy coming to Bahrain is that they can go to cinemas and women face fewer restrictions on their attire. This makes Bahrain distinctive, and therefore attractive, to Saudi Arabians and to those who do business there. Now that Saudi Arabia has eliminated such restrictions, Bahrain may need to restructure its economy to ensure that it continues to offer something sufficiently different--and therefore attractive--to prospective tourists from Saudi Arabia.

More generally, as discussed in Al-Ubaydli and Abdulla (2014), the homogeneity in the economic visions of the GCC states leads to some mutually inconsistent plans which threaten economic integration. All six countries seek to be the regional hub in a variety of sectors, such as finance or entertainment--a goal that it is impossible for all to attain. For the GCC countries to maximize the benefits that they reap from their economic visions alongside their plans for economic integration, they need to elevate the levels of coordination in the formulation of those plans.

A final challenge on the economic integration front is shared with all countries that are considering how much to integrate economically with their neighbors: economic illiteracy among policymakers and citizens (Caplan, 2011). As we explained above, a fundamental tenet of the economics profession is that economic openness is beneficial, and there is a large and conclusive empirical literature in support of that tenet (Baldwin and Venables, 1995). Despite this, non-economists continue to express suspicion toward international economic openness and specific forms of integration in particular (Caplan, 2011). This dynamic is evident in the second year of Donald Trump's first presidential term, where he has imposed significant tariffs against Chinese and other global producers, and found strong popular support, in spite of the manifest economic damage his policy will have upon the American people (Eichengreen, 2016).

In the case of the GCC, so far, we are unaware of the emergence of anti-integration rhetoric among policymakers or citizens. However there are two reasons for concern. The first is that the non-adherence to single market directives described above reflects--to some degree--misguided attempts by policymakers to benefit their own economies. The second is that national populations are notoriously prone to supporting xenophobic policies in the wake of economic downturns (James and James, 2009), meaning that the 2014 oil-price collapse is a potential source of anti-GCC sentiment. This has already led to the emergence of xenophobic attitude toward non-GCC migrant workers.

4.3. Recommendations Based on the EU Integration Experience and Elsewhere

In light of the preceding analysis, we have several recommendations for Bahrain and the GCC regarding maximizing the benefits associated with economic integration.

We begin with a simple, technical issue.

Recommendation 1: There needs to be better data made available to the public and to specialist researchers.

We perceive three areas for improvement:

First, complete bilateral GCC integration data. Thus, public datasets should go beyond reporting the number of non-Bahrainis working in Bahrain; they should differentiate between non-GCC and intra-GCC non-Bahraini workers and report the number from each GCC member for every single GCC member country economy.

Second, much more extensive microeconomic data needs to be collected so that researchers can conduct studies that resemble those conducted by scholars of European integration. This includes data on profit margins, production costs, and price dispersion, all which are critical to evaluating the extent to which an economy benefits from integrating with other economies.

Third, data on violations of GCC rules, including the single market. We expand upon this point below.

Our second recommendation is based on maintaining the decentralized model of economic integration that the GCC has adopted so far, in contrast to the more centralized approach of the EU.

Recommendation 2: Bahrain and the GCC countries should leverage reputational concerns to improve compliance with GCC rules.

As argued in Al-Ubaydli and Abdulla (2016), the GCC countries can achieve high levels of accountability and enforcement without having to create powerful supranational bodies simply by publicly reporting adherence metrics. The mechanism is driven by the desire for countries to cultivate reputations for adhering to international accords.

The World Trade Organization (WTO) offers a good illustration of this mechanism. Unlike the European Commission, the WTO does not wield significant executive power: it cannot punish violators. Even if it did impose a fine on a violating member, the member could simply decide to ignore the fine without suffering the sort of sanctions a citizen would face from their government should they decide to ignore an official fine. However, the WTO's rulings still carry clout due to the transparency of the proceedings. If, for example, France was interested in a FTA with Brazil, it could look up Brazil's file on the WTO website and see a history of alleged violations by Brazil, with full documentation of the details. This publicly available "CV" acts as a powerful incentive for Brazil and all WTO members to maintain good standing, as a history of non-adherence might result in Brazil forgoing opportunities for mutually advantageous trade relationships. Critically, this system requires no loss of sovereignty by WTO member states; it only requires their commitment to transparency.

In the case of the GCC, Bahrain should spearhead efforts at creating a transparent system of reporting on adherence to GCC economic integration directives. The benefits would go beyond the GCC: each member state could use a positive CV for its GCC dealings to leverage better international deals with non-GCC members, as a reputation for adhering to regional accords reflects positively on a country.

If, alternatively, the GCC wishes to pursue the more centralized form of integration favored by the EU, the following recommendations emerge.

Recommendation 3: Bahrain and the GCC should rely on a mixture of sanctions and conditional access.

The European Union has tended to rely heavily on sanctions to enforce rule compliance within its internal market. This policy has had only mixed success. Private economic actors are easily sanctioned in the context of competition policy, for example. They can also be regulated directly at the mergers-and-acquisitions phase. Levying sanctions directly on governments for infringements of state aid or public procurement procedures has been less successful. Member state governments tend to absorb or even ignore state aid rulings; public procurement proceedings often stretch out too long to have the desired effect. Levying sanctions on governments for failing to provide timing statistical information or for failing to meet agreed macroeconomic policy or institutional reform targets has been least successful of all.

By contrast creating conditional access incentives has proven very successful. The European Union's accession process for new member states is a good illustration. National governments provided huge amounts of information, undertook substantial institutional reforms, and engineered significant policy convergence in order to gain access to the European Union's internal market.

A successful framework of incentives for the GCC would involve participating countries in an ongoing recertification for continued market access. Much like firms that choose to list on an exchange must provide standardized reporting on their accounts, GCC governments could be required to provide high quality market data as a condition for continuous access to the GCC internal market. They could also be required to respond in a timely manner to complaints about market discrimination and segmentation. Failure to comply would be met with proportionate (commensurate) market exclusion by other GCC member states. This would place the emphasis on collective enforcement rather than centralized enforcement and so retain respect for national sovereignty (rather than emphasizing suprantional authority).

Recommendation 4: Bahrain and the GCC should be attentive to the possibility that firms will outgrow national regulatory competence.

The success of market integration in the GCC will strengthen both competitive forces and scale economies. This creates the very real prospect that firms will grow to match the size of the integrated market rather than remaining restricted by the size of the national (home) economy. Such disproportionate growth creates significant regulatory problems for home country governments. National regulators often do not have the human capital or the financial resources to maintain adequate oversight. This is true particularly in the financial services industries, where access to surplus savings generated by extractive industries could provide leverage for GCC financial firms to grow their asset portfolios to many times the size of the domestic economy.

The European Union has had unfortunate experience with such developments, as have smaller economies (like Iceland) which maintain access to Europe's internal market. The challenge in such situations is to develop cooperative regulatory capacity across GCC governments rather than necessarily developing a single, large regulatory agency for the GCC marketplace as a whole. Again, the goal is to balance respect for national sovereignty with the need for regulatory authorities to make the firms they oversee in terms of human capital and financial resources. GCC governments should begin developing those cooperative practices now rather than in reaction to the emergence of firms that are too big to rescue and yet also too big to fail.

Recommendation 5: Bahrain and the GCC should be attentive to the need to explain the benefits of GCC integration to their domestic populations.

The economic advantages of integration among the GCC countries are well-established. Who wins and who loses from integration among the GCC countries is often harder to anticipate in advance. This is true particularly as the effects of greater market competition, innovation, and scale economies accumulate over time. One of the most important lessons derived from the experience of the European Union is that it is important to maintain a constant dialog between national governments and their populations about the justification for specific forms of economic integration. Such dialog is important not simply to explain government policy but also to provide early identification of those groups who are becoming or are likely to become disaffected. Where governments provide the right mix of reassurance and redress, they are better able to maintain support for integration. They are also able to avoid the emergence of political alternatives (like UKIP in the United Kingdom, the National Front in France, the Alternative for Germany, or the Lega in Italy) that seek to exploit the popular sense of vulnerability in order to mobilize against the integration project.

Part of the long-term remedy to this state of affairs is to improve education and public awareness about the benefits of economic integration. Protectionism should be handled similar to a public health risk that needs to be eliminated by educational campaigns, such as smoking.

What happened in the interwar era serves as a sobering reminder of what can occur when parochial and uninformed attitudes toward economic integration are allowed to dominate public thinking: the post-Great Depression spiral of protectionism and xenophobia contributed to the breakout of the worst war in human history. While the GCC countries are fortunately far from dealing each other the death and destruction witnessed by Europe during the 1940s, they are failing to reap the benefits of economic integration. Moreover, many philosophers have argued that commerce is a force for peace and tolerance (Al-Ubaydli et al., 2013).

5. Conclusion

Bahrain is a small economy with very limited natural resources that are almost exclusively concentrated in the oil and gas sector. These are the ideal criteria for regional economic integration to result in significant improvements in living standards: it needs to import the vast array of goods and services that it cannot produce efficiently at home, and it needs the large regional market to export the narrow range of goods and services where it has a comparative advantage.

As a member of the GCC, Bahrain has experienced significant regional economic integration, culminating in the establishment of a single market in 2008. The economy has responded in the expected manner: it relies on the regional market for its most important imports, including crude oil which it refines and re-exports, and capital for its financial sector; and it relies on the regional market for some of its most important exports, including aluminium, tourism, and financial services. FDI inflows--a critical component of Bahrain's economy strategy--are dominated by the GCC.

The GCC single market is not functioning properly, however, with businesspeople complaining of bureaucratic sclerosis and strategic non-compliance by member states. This means that Bahrain can gain even more by taking steps to ensure full implementation of the single market, and further economic integration.

There are two broad techniques for achieving this goal. The milder approach is to maintain the GCC's current decentralized format, and to emphasize greater transparency in the recording of violations as a way of improving compliance. This is the more realistic option for Bahrain since it does not involve undermining the sovereignty of any of the member states.

The alternative approach is based on the European model, which involves greater centralization. Such an approach should combine sanctions with conditional access to the integrated marketplace in order to provide incentives not only for firms but also for national governments. A successful arrangement of this sort will be challenging to engineer, because it must strike an appropriate balance between respect for national sovereignty and the need for collective enforcement.

Finally, under all circumstances, Bahrain stands to benefit from making more data that needs to be of a higher quality than currently the case, available to policymakers, researchers, and the general public. The current lack of data contributes to the non-compliance with GCC directives, and plays an important role in the chronic lack of awareness about the benefits of economic integration--a condition that afflicts most of the world's citizens at present.

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