The prolonged slump in oil prices continues to disrupt the economic development model of the Arab Gulf states.

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The prolonged slump in oil prices continues to disrupt the economic development model of the Arab Gulf states. Bahrain is especially under pressure, as its credit rating has deteriorated to "junk" status, or below investment grade, as Standard and Poor's agency lowered its rating of Bahrain to BB/B on February 17. That the ratings downgrade occurred in the midst of Bahrain's efforts to raise a $750 million bond offering underlines the time sensitivity governments in the Gulf (and indeed in most emerging markets globally) now face to raise capital. Amid fiscal deficits, bloated public sectors, and accelerated efforts to create jobs (especially for young people) and diversify economies, there is a perfect storm on the horizon.

Since the 1960s, the Arab Gulf states' economic model has relied on foreign labor to build infrastructure, create and staff public institutions from schools to hospitals to police forces, and create a service sector that underpins much of social and cultural life in the region. Fifty years later, this system, in which the state has played the leading role in directing economic growth, faces a rocky transition.

In order to continue to provide the social welfare that citizens have grown to expect, governments have two stark choices. They must find a new source, besides oil, to generate funds for outlays in subsidies, public sector wages, and continued expansion in real estate and infrastructure. Or, they must reduce spending and radically change the way that labor markets function across the Gulf Cooperation Council.

The abundance of cheap labor from sending countries (since the 1980s, mostly men from poorer countries in South Asia) has subsidized the construction of roads, homes, and entire cities in the Gulf. Labor without a path to citizenship, in which workers are tied to specific employers, is the hallmark of the *kafala* system, meant to help nationals gain a foothold in developing businesses, and attract both human capital and manpower.

In its inception, kafala was a program that tried to avoid the pitfalls of foreign direct investment in developing countries that only benefitted the sending, richer country and its corporates. Instead, the kafala system and laws forbidding foreign ownership of land and businesses protected ownership for nationals, and preserved citizenship rights, mostly envisioned as a proportion of oil wealth, rather than participatory governance. For all of its flaws, the kafala system was successful in creating commodity-exporting economies, which maintained national ownership and national economic dominance. Postcolonial politics in the Gulf are decidedly different than those in Latin America, Africa, or Asia, and this is one reason why.

The problem with labor markets now, and the highly restrictive system of migrant labor tied to employers, is that it impedes competition in the private sector and creates disincentives for nationals to enter the labor force. It is also incredibly inefficient, and prone to abuse. This system cannot be sustained. Gulf states are no longer growing at the pace they had in the last decade. In a slow down, labor markets will need to adjust.

It is easy to lay off workers. It is more difficult to change the way people think about work. “Thobe syndrome,” the notion that Gulf nationals should always have managerial positions rather than entry-level or service sector roles, will have to change. There may also be a reconsideration of appropriate market size. Population growth, largely driven by foreign laborers, may be unsustainable at current levels of private sector growth.

These are changes that no government would want to take on quickly. Nor are these surprises that have arisen only from the decline in oil prices. Diversification of the economy, increased trade inside the GCC and the region in non-oil products, nationalization of workforces to become less dependent on foreign labor, and the production of knowledge economies all have been government priorities in the Gulf for many years.

The last year has just accelerated the discourse of reform, and animated a prescription for reform that is more in line with free market thinking in which the state takes a back seat to the private sector in driving growth. This shift in thinking, evidenced by the national transformation agenda in Saudi Arabia, the recent world governance forum in the UAE, and new efforts in Bahrain to reform the kafala system (through amnesty programs and the ability to transfer visas between employers), points to a market-driven approach to governance that is a major shift from previous decades. Fiscal necessity will accelerate these reforms, and trends in global capital markets will scrutinize government balance sheets. More importantly, a liberalizing shift in the way Gulf governments question their responsibility to create jobs for nationals, and their preference to drive expansionary growth through imported low wage labor in construction and infrastructure projects, will have a broader societal impact than what is measured by credit ratings.

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