

Impact of trade policies on the economic growth and diversification of an oil surplus economy: The case of Kuwait

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Abstract. Real economic growth in Kuwait has averaged 4 percent over the past three decades. Coupled with the growing importance of non-oil economic activities, trade policies and regional trade agreements are viewed as critical tools of economic growth and competitiveness particularly for the upcoming era. With the proliferation of regional trading arrangements (RTAs) over the past years, an economic assessment of their accrued benefits becomes a point of empirical interest. The trend has been towards a deeper form of regional integration arrangements that involves liberalization of goods and services, harmonization of standards, rules governing investment, competition policy and labor movement. This paper provides quantitative estimations of the impacts of the implementation of free trade agreements (FTAs) between Kuwait and other GCC states and their main trade partners (EU and USA). A computational general equilibrium (CGE) model is built to investigate the economic impact and efficacy of various trade arrangements. A review of CGE modeling results confirm that shallow integration may in some instances give rise to trade diversion at least in the short run, and significant welfare gains accrue in the long run only to the extent that deeper forms of regional integration are envisaged. These include commitments to liberalize the services market, improvements in trade facilitation and the investment climate, financial and labor market reforms, the harmonization of standards and other export-related dynamic productivity effects. Moreover, findings confirm that when trade-related activities and strategies are integral to holistic reform, welfare gains become substantial.

Keywords: Regional trade agreements, Gulf Cooperation Council countries, customs union, regression, computational general equilibrium.

INTRODUCTION

Over the past three decades, Kuwait and the GCC at large have witnessed an unprecedented economic and social transformation. Oil proceeds have been used to modernize infrastructure, create employment and improve social indicators. Kuwait is a member of the GCC which has become an important centre for regional economic growth. Per capita income in Kuwait was close to \$15,000 in 2002 as compared to an average of \$12,000 in the GCC countries. With very low inflation,

overall real economic growth has averaged 4 percent a year during the past three decades, while the importance of non-oil economic activities has grown steadily, reflecting Kuwait's efforts at economic diversification. This progress has been achieved with an open exchange and trade system and liberal capital flows, as well as open borders for foreign labor.

The implementation of the GCC Customs Union and the internal free-trade agreement, are seen as a way to

boost trade, liberalize mutual investment funds and realize greater economic integration within the bloc (Gulf Common Market), and so meet the challenge of increasing globalization. In fact, the GCC is still negotiating a major free trade agreement (FTA) with the EU. At the same time, many other FTAs are planned to be signed shortly with other major trade partners, such as USA, China and India. These potential trade agreements will dramatically increase business opportunities for GCC member states.

Applications, findings and conclusions derived from this study may be generalized and applicable to other GCC states due to the numerous factorial, structural and situational commonalities that exist in the region. Reciprocal and preferential agreements are collectively known as regional trade arrangements (RTAs), and are distinguished from other non-reciprocal arrangements such as the Generalized System of Preferences and other comparable, regional programs.

RTAs are a perennial source of controversy. The principal economic question is whether, on net, RTAs create more trade than they divert. Some political economists conclude that they do, and that discriminatory agreements are therefore beneficial. Others argue that discrimination can serve to advance issues that might otherwise stagnate, and to make agreements more enforceable. Critics nevertheless charge that the economic benefits of discriminatory liberalization run a distant second to multilateralism, and some contend that the potential for abuse makes the very term "bilateralism" a virtual synonym for "protectionism." Some detractors associate discriminatory forms of trade policy with exploitation of the small and poor by the large and wealthy, the deepening of dependency, and even economic warfare.

The objective of this paper is to identify and analyse, both qualitatively and quantitatively, the potential impact of trade liberalization scenarios on the Kuwaiti economy. Next, it examines the expected effects of regional integration agreements with a special focus on their nature, coverage, and period of implantation. Thereafter, it presents a first attempt at quantifying the impact of trade reform scenarios on the Kuwaiti economy. It further provides a preliminary proposal for a coherent trade policy able to improve economic growth and diversification; followed by the conclusion.

REGIONAL TRADE AGREEMENTS: CATEGORIES, PROVISIONS AND MAIN EFFECTS

Regional Trade Agreements (RTAs) have grown dramatically in number and importance since the early-1990. In the last ten years, almost 200 RTAs have been notified to the WTO. This steady growth of regional trade agreements is not expected to slow down in the near future: taking into account RTAs currently under negotiation or not yet ratified, the number of notified

RTAs into force is expected to grow from 139 (July 2005) to 300 in 2008.¹

A recent World Bank report² estimates that over 40% of world trade now utilizes preferential trading arrangements of some sort. As the Consultative Board to the WTO Director-General points out in a report on the Future of the WTO, MFN is no longer the rule but almost an exception.³ Recent "regional" trade agreements are no longer necessarily geographically contiguous. Many are bilateral; many are cross-regional. They can be between individual countries, one country and a group of countries or between blocs of countries.⁴

Free trade agreements, customs unions and common markets

RTAs take three principal forms: free trade agreements (FTAs), customs unions (CUs), and common markets. For our present purposes, the distinction between CUs and common markets are less significant than the distinction between an FTA and a CU. Most of the observations made in this paper regarding CUs can be understood to apply to common markets as well.

It must be stressed from the beginning that the differences between FTAs and CUs go well beyond the tariffs that they impose on third parties. At first glance, a CU appears to be just an FTA that has taken the additional step of establishing a common external tariff (CET) among its members. From that one point, however, spring more and greater differences. Establishing a CET (a la GCC for example) is a first step towards closer integration of the members' trade policies, which may lead to operating as a bloc in negotiations with third parties (such as the current GCC-EU negotiations). The CET may also generate a common source of revenue (depending on whether the tariffs that it collects are centralized), which in turn may be used to fund common projects and establish common administrative structures. The public procurement market of the European Union, for example, has grown to be an economic factor of considerable proportions. Establishing

¹ J. A. Crawford and R. Fiorentino (2005), "The Changing Landscape of Regional Trade Agreements", WTO Discussion Paper, No. 8, WTO, Geneva, p. 3. The figure of 139 agreements is obtained by eliminating double counting of notifications of Economic Integration Agreements under GATS Article V.

² World Bank (2005), *Global Economic Prospects 2005*, World Bank, Washington DC, p. 27.

³ Consultative Board to the Director-General Supachai Panitchpakdi (2004), *The Future of the WTO: Addressing Institutional Challenges in the New Millennium* ("Sutherland Report"), WTO, Geneva, p. 19.

⁴ Because these agreements have outgrown the "regional" definition, some prefer to use the term preferential trade agreements. However, this paper continues to use the term regional trade agreements to avoid confusion with other trade preference schemes or arrangements.

a CU is a necessary step towards the creation of a true common market, in which integration moves beyond trade into other, more politically sensitive areas of economic and social policy. It might further be argued that a CU or common market, once it is established, has an even greater tendency than an FTA to attract new applicants. This may be attributed to some countries' fear of being left behind as a train leaves the station. All RTAs have the potential of imposing exclusion costs on third parties, but these may be even greater in the case of deeper integration schemes.⁵ FTAs can be relatively easy to negotiate, even for countries that are separated by vast distances, but CUs tend to be negotiated only by countries that are either contiguous or at least in the same vicinity. FTAs may therefore proliferate in absolute numbers, but CUs grow by accretion. In some cases, a CU may even move the members towards true political union; this was the case for the trade agreements that the United States negotiated with Texas and Hawaii.

RTAs are an increasingly significant element in the global trading system. A recent analysis by the World Trade Organization (WTO) identified 172 such arrangements that were in force as of mid-2000. Another 68 RTAs were still under negotiation. Given the observation above regarding the relative levels of integration required in these agreements, it should come as no surprise that FTAs are much more common than CUs. FTAs account for 148 of the RTAs that are in force (86.0%), and 67 of the RTAs still under negotiation (98.5%). Preferential agreements are geographically concentrated. Interestingly, close to half of the world's RTAs are in the Euro-Mediterranean region, while the smallest numbers are in the Asia-Pacific region and sub-Saharan Africa.⁶

RTAs and trade: Creation, diversion, deflection and regression

Understanding the consequences of reciprocal discrimination requires that one go beyond the familiar models based on two-country, two-product trade. This subject requires that one take into account the interests of third countries, as well as the complexities that result from multistage processing of industrial goods. RTAs entail both trade creation and trade diversion, they need to deal with the problems of trade deflection, and can the approaches that they take to this problem can even lead to trade regression. All four of these terms need to be defined.

Liberal economic orthodoxy holds that bilateral accords

⁵ Most of the countries that acceded to the EU in 1973 and 1995, for example, appear to have been motivated more by economic concerns over exclusion from a process of deeper integration than they were by enthusiasm over the political implications of that process for their sovereignty.

⁶ WTO (2000), pages 3-5.

are a second-best substitute for multilateral trade liberalization, as RTAs have the twin effects of creating efficient trade while also encouraging the diversion of trade from more to less efficient partners. In his seminal review of CUs, Jacob Viner noted that *trade creation* occurs for a commodity when "one of the members of the customs union will now newly import [the item] from the other but which it formerly did not import at all because the price of the protected domestic product was lower than the price at any foreign source plus the duty."⁷ In other words, the country switches from the inefficient production of protected domestic industries to the more efficient production of the trading partner. Conversely, commodities are subject to *trade diversion* when "one of the members of the customs union will now newly import [the items] from the other whereas before the customs union it imported them from a third country, because that was the cheapest possible source of supply even after payment of duty." In this case, the two-tiered tariff structure encourages importers to switch from the more efficient producers in some third country to the less efficient (but now cheaper) producers in the CU partner country. From an economic standpoint, the key consideration is whether the trade created outweighs the trade diverted. Viner argued that "whether a particular customs union is a move in the right or in the wrong direction depends ... on which of the two types of consequences ensue" from the arrangement:

Where the trade-creating force is predominant, one of the members at least must benefit, both may benefit, the two combined must have a net benefit, and the world at large benefits; but the outside world loses, in the short-run at least, and can gain in the long-run only as a result of the general diffusion of the increased prosperity of the customs union area. Where the trade-diverting effect is predominant, one at least of the member countries is bound to be injured, both may be injured, the two combined will suffer a net injury, and there will be injury to the outside world and to the world at large (Viner, 1950).

Viner's analysis, which established the framework in which most subsequent study of RTAs has been conducted, focused on CUs rather than FTAs. Had he turned his analytical skills to the newer RTA variant he may have uncovered a problem that is unique to this arrangement. *Trade deflection* is defined as the "redirection of trade for the purpose of exploiting the

⁷ Viner (1950), page 43. Note that where Viner referred specifically to customs unions one may substitute a generic reference to RTAs. He acknowledged FTAs as well, which were then a very new concept.

difference in trade restrictions among members.”⁸ It is one form of transshipment, although that term is used in other contexts as well (e.g., in efforts to evade the restrictions of country-specific import quotas). Deflection will be attractive to an exporter whenever:

- (a) The tariff rate in one FTA member country is lower than it is in another FTA member country,
- (b) The difference between these two rates is greater than the additional shipping costs and other inconveniences that may be incurred by routing the goods in a roundabout fashion, and
- (c) There are no legal barriers to such a transaction.

The CU’s answer to trade deflection is quite simple: The problem never arises because the CET ensures that point (a) is never true. In an FTA, however, point (a) will often be true and one must assume that point (b) will not always render the issue moot. It is therefore necessary under point (c) to establish ROOs in order to ensure that the FTA does not become a *de facto* CU in which the CET is set for each product at the lowest rate among the member countries.⁹ The challenge lies in devising ROOs that are strict enough to achieve the intended purpose of limiting the benefits of the FTA to the *bona fide* products of its member countries without being so strict that they either discourage compliance or provide incentives for trade and investment that would not otherwise be rational and efficient.

According to one analysis, an FTA may go a step farther and contribute to *trade regression*. This is the inefficient relocation of production among the members of an RTA, and not merely between the members and the outside world. The problem can arise “when ROOs are applied to intermediate goods trade directly between FTA members and occurs simultaneously with trade diversion from the non-member.”¹⁰

The Vinerian framework provides a standard by which we might examine the provisions of RTAs, by asking whether their rules and disciplines tend to increase or decrease their potential trade-diverting consequences. It must nevertheless be recognized that efficiency and trade creation are not the only reasons for which countries negotiate RTAs; if they were, discriminatory approaches would be replaced altogether by non-

⁸ Lloyd (1993), page 700.

⁹ It might be speculated that such an approach would be net welfare-enhancing for the members of the FTA, and perhaps for the outside world as well, insofar as it would be an indirect means of lowering the overall external tariff level for the FTA members. This rather sly approach to tariff liberalization would be politically unacceptable to most countries, however, insofar as it would mean losing control over at least a portion of their national tariff schedule. Furthermore, some of the apparent benefits of a more open market would be eaten away by increased shipping costs. The net effect in some cases may simply be a transfer of revenue from customs authorities to shipping firms.

¹⁰ Rodriguez (2001), page 219.

discriminatory negotiations based solely on the universal MFN principle.

MATERIALS AND METHODS: IMPACT ANALYSIS OF RTAS ON THE KUWAITI ECONOMY

As said previously, considerable interest has been generated in recent years by the dynamism driving regional trading arrangements and the challenges and opportunities these pose for participating countries. Both North–South potential trade arrangements (such as the United States–Kuwait and the EU–GCC FTAs) and the South–South multilateral arrangements (such as GAFTA) all provide evidence that the fever of regional trading arrangements has taken hold in the GCC region.

The expansion of regional trading arrangements has generated its own competitive momentum. In a world in which national barriers are becoming so many self-inflicted wounds - a sure way of being isolated from increasingly global investment and production decisions - all countries are facing irresistible pressures to keep pace with market liberalization. Countries enter into free trade relations only to find others joining the race for fear of losing out on investment, technology and market access. The result is a kind of a global chess match; one in which bilateral and regional trade initiatives become part of an overall drive to liberalize further and faster, yet the cumulative effect is to advance worldwide free trade.

Many countries have been attracted to strengthen regional trading arrangements for reasons of politics as well as economics. The political reasons often relate to the search for a stable international political order. The promotion of regional cohesion and security and various foreign policy considerations have also provided additional impetus for going regional. The economic reasons are related to the fact that in many industries market opening and the internationalization of production have been easiest to achieve on a continental basis. Other economic motivations also include:

- i) the prospect of enhanced economic growth originating from the opportunity to exploit scale economies, regional specialization and learning by doing and attracting foreign investment;
- ii) locking in domestic policy reforms at a regional level, and thus enhancing the credibility and sustainability of economic reforms including trade liberalization;
- iii) the “domino effect” which stipulates that the opportunity cost of remaining outside a regional arrangement rises as new ones are formed or as existing ones are expanded or deepened;
- iv) the “infant industry” argument that has promoted the pursuit of regionalism under the premise that it would broaden and deepen domestic regional market as a precursor to exposing regional industries to the full rigors of extra-regional competition;
- v) the prolonged process of multilateral negotiations as

witnessed during the Uruguay Round and now in the context of the Doha development Agenda; and vi) Attempts by governments to come to grips with the realities of deeper economic interdependence through a drive for greater and more quickly realizable liberalization.

The formation of a regional trading arrangement alters tariffs and creates trade preferences, thereby changing relative prices and patterns of production and consumption. There are two main "static" effects of such an arrangement. Trade creation comes from a shift away from high-cost domestically produced goods to lower-cost imports from regional partner countries. Other things being equal, the trade creation effect, combined with greater opportunities to exploit economies of scale, implies a regional expansion in real income. Analogously, trade diversion arises from the substitution of inefficient regional suppliers at the expense of efficient suppliers in third countries on account of the tariff preference; as such, it tends to reduce regional national income. Therefore, the real income of the regional grouping rises when trade creation dominates trade diversion.

Regional trading arrangements may also give rise to other dynamic effects. These effects arise from increased competition, enhanced by economies of scale, a stimulus to investment and more efficient use of productive resources. The dynamic gains from these factors, which can have an exponential effect on income growth, are usually thought to be much larger than the static gains from net trade creation.

Against these benchmarks of success, the final judgment as to whether a regional trading arrangement is welfare enhancing or reducing is an empirical question.

As part of this study, an unprecedented effort has been made to assess quantitatively the likely impact on the Kuwaiti economy of a trade reform strategy. The only work available and recently conducted by KISR (2005) as part of the project on developing quantitative tools looks only at the simple removal of import duties applied on the Kuwaiti imports of goods from selected trade partners without looking to the other components of a trade policy in a given country.

In order to assess quantitatively the impact of various reforms, we developed a simulation model tailored to the Kuwaiti context. Details of the model are presented in the appendix. We just discuss in the following paragraphs why we consider this tool particularly adapted to the analysis of trade reform in Kuwait. Trade reform is complex to analyze, as it combines a variety of economic mechanisms at the same time: macro-economic effects, sectoral effects, in the short and long run. Besides, the impact of the reform depends crucially on the initial situation: tax levels, distortions between sectors of activity, production and consumption patterns. A reform aimed at eliminating already low and uniform tariffs will not produce the same results than one aimed at correcting large distortion. The initial position of the country vis-à-vis other countries (their own degree of

protection) is equally important in the case of a negotiated agreement. In such a real world, theory cannot suffice to identify optimal policies; in depth empirical analysis based on a consistent and detailed picture of the Kuwaiti economy is essential.

CGE models have become a standard tool for integrated assessment of trade policies for developing countries¹¹. Its main advantage lies in the possibility of combining detailed and consistent databases with a theoretically sound framework, able to capture feedback effects and market interdependencies that may either mute or accentuate first-order effects. The equilibrium is general in the sense that it concerns all the markets simultaneously. For instance, a decrease in tariffs will affect the demand for imports of both final and intermediate goods. This will in turn affect the supply of domestic goods and the demand of factors in each activity. This will equally affect the price of goods and the disposable income of households, which will in turn affect their demand, etc.

As mostly interested in the impact of trade reform on trade activity and sectors, the Kuwaiti economy is disaggregated into 32 sectors of economic activity and 33 products. Each product can be produced by one or more sector, and each sector can produce more than one product. The model also distinguishes 3 different trading partners, mostly for assessing the impact of a single FTA with particular trade partner. On the other hand, as less interested by the distributional impact of trade reform, we only consider two representative average households (Kuwaiti and non-Kuwaiti), who receive their incomes from wages, rents and different subsidies and transfers, consume, save and transfer to the rest of the world.

The model used here is not designed to forecast the future, but rather to look at the impact of any reform on the structure of the Kuwaiti economy. In this regard, the fact that we use data from 2001 to describe the Kuwaiti economy should not be seen as a major shortcoming. Using such data permits to build a model particularly rich in terms of tax structure (tariff and non tariff barriers by product and origin, technical barriers on trade by product and origin, subsidies and taxation by sector, etc). In our view, the richness of information used here largely offsets the limitation of replying on six-year old data, a fortiori since Kuwait did not witness major structural changes since 2001, except on public budget and income from oil sector.

The model is intended to capture long term effects of various policies. Short term transition costs are ignored. Capital on the other hand, is not supposed to be fully flexible, the result of an inefficient financial system, currently unable to allocate savings to the most profitable sectors. But this constraint is relaxed in a specific simulation, in order to assess the impact of the

¹¹ See for instance Dessus and Suwa- Eisenman (2000) for Egypt and Tunisia or Chemingui and Dessus (2008), for Syria

liberalization of the financial sector.

Obviously, some important factors will impact the Kuwaiti economy over the next ten years, population growth and technological progress in particular. But as population growth is not directly impacted by trade and trade-related policies, we ignore it, as they do not affect the comparison (in relative terms) between the different impact simulations. As for technological progress, there is overwhelming evidence that it would be accelerated by trade openness, and the model results might therefore underestimate the positive effects of trade integration.

RESULTS: ALTERNATIVE SCENARIOS OF TRADE-RELATED POLICY REFORMS

This report analyses two broad kinds of scenarios: (i) pure trade liberalization scenarios; and (ii) liberalization scenario with additional supporting policies. Under the pure trade policy simulations, the following scenarios are calculated:

1. EU-Kuwait Association Agreement: cutting tariffs on imports from Europe gradually over the period 2010-2015 (scenario A)
2. USA-Kuwait Association Agreement: cutting tariffs on imports from USA over the period 2010 to 2015 (scenario B)
3. The combination of scenario 1 and 2 (scenario C)
4. Full trade liberalization scenario: remove tariff on all imports from all origins (scenario D)

We limited our analysis of FTAs to the most important among them: with the EU and with the USA. The conclusions of any other FTA with any third party, will not impact the local economy by the same level of magnitude given that USA and EU represents the most important trade partners of Kuwait. The last scenario on unilateral full trade liberalization with all partners has the advantage of removing the trade diversion effects and than maximize the expected benefits that Kuwait may expect from trade liberalization

Under the combined trade and domestic policy simulations, the following scenarios are tested:

1. Trade liberalization combined with financial liberalization and other service sectors (scenario E)

Subsequently, we simulate the impact of these various policies, with a view to measure and characterize their respective impacts. In turn, the comparison of the different simulations, in terms of welfare, on the one hand, and adjustment costs, on the other, helps us to identify the potential areas of reforms for Kuwait.

Policy impacts are compared to the situation that would prevail during the year 2015 in the baseline scenario, at

the time where all the potential reforms will have been fully implemented. Policy impacts are measured in terms of macro-economic aggregates, trade volumes, sectoral outputs, reallocation movements and households' welfares.

We assume in the baseline scenario that the dynamic growth path of the economy over the modeling horizon is determined by exogenous and endogenous growth of productive factors, as well as change in factor productivity. The rate of capital depreciation is determined exogenously, while the net increase in capital stock is determined endogenously, according to (savings-driven) new investments and the depreciation of the capital stock in the previous year.

The total factor productivity growth rate for all productive sectors is set at 0.1% annually to reflect a slight technological progress in the Kuwaiti economy. The rate of depreciation of the capital stock is set at 10% annually. This rate yields a gradual replacement of productive capital within 10 years. The capital output ratio, which determines the extent of capital accumulation, is set exogenously at 1.0. The Kuwaiti population growth rate is set at 2.7% annually for the period 2009 to 2015 and at 3.4% for the period 2002 to 2008 following the long term average expected for the Kuwaiti population until 2015. The non-Kuwaiti population growth rate is set at 6% annually for the simulation period reflecting the continuously large influx of foreign workers into the Kuwaiti economy.

Total real government consumption in the baseline scenario increases at 2.8% annually following the relative increase in the Kuwaiti labor force and the general growth path of the economy. In other words, the expansion of real government consumption translates into a balanced growth of public administration and other government services in accordance with the growing economy.

The implementation of the four initial scenarios are carried out through the complete removal of tariffs on imports of merchandises from the European Union (scenario A), from the USA (scenario B), from both partners (scenario C) and from all origins (scenario D).

While all FTA agreements both incorporate clauses for the dismantling of Non-Tariff barriers, the nature of the latter (licenses, lists, generally not specific to the origin of imports - but more often designed as a means to protect public enterprises), their relative importance compared to tariffs (between two and three times higher, excluding the impact of financing restrictions), their underlying political economy dimension (rents) and the international experience all concur to suggest that these two single agreements will not suffice to eliminate such barriers to trade. For these reasons, it is useful to distinguish the impact of non-tariff barriers dismantling from that of tariff removal linked to the two regional preferential agreements evoked in the above paragraphs.

We thereafter simulate the complete elimination of non-tariff barriers imposed on imports of goods stemming

from non-tariff trade regulations described earlier. Other barriers to trade, stemming from the use of multiple exchange rates and financing schemes for imports, or from inefficiencies in the transport and import sectors will be dealt with separately subsequently.

As the magnitude of non-tariff barriers far exceeds that of tariffs, it is not surprising to observe a larger impact of the former than the latter (a fortiori since NTBs are removed on imports from all origins) on the Syrian economy. Among the most important effects is the impact on investment, which becomes much cheaper, as imported equipments becomes available for all sectors. The same applies to some key intermediate inputs, plastics and fibers notably, which become also much cheaper after the reform.

This larger access to imported inputs permits to modernize the Syrian industry, which can now use more adapted technologies. Investment opportunities grow, and the capital stock accordingly. This in turn impacts positively labor productivity – real wages (+12.0 percent), and then labor participation rates. Consequently, economic activity is higher and the real annual GDP growth rate augments by 1.1 percentage points (or a real GDP 11.7 percent higher after the reform in 2015). Higher factor incomes (wages in particular, +5.1 percent), lower consumer prices and lower direct taxes (see below), more than offset the loss of rents stemming from NTBs and generate a welfare gain for households equivalent to 10.0 percent of GDP.

Trade activity significantly increases with the reform. Imports grow up by 21.5 percent, with comparable growth for imports from all origins (ranging between +25.5 and +22.0 percent), but from the Former Soviet Union (+14.3 percent only), which hence sees its market shares diminishing in Syria. Exports grow as well, +18.3 percent overall, in particular vis-à-vis the FSU (+38.2 percent – although from a modest base), GAFTA members (+31.5 percent) and the rest of the World (+26.0 percent). In contrast, export growth to the European Union and Turkey remains relatively modest (+13.1 and 13.3 percent respectively).

The overall impact of NTBs removal on factors allocation is modest, with 0.3 percent of the labor force leaving its initial sector of activity (against 1.1 percent with GAFTA). This principally because of the induced scale-effect of the reform, which permit most of sectors to benefit from cheaper inputs and greater demand for their products. The second important factor is the relative immobility of the capital, which limits both factors movements and specialization gains. Still, some sectors suffer from greater external competition. This is particularly the case for furniture and wood products sectors, public and private, which both contract (-16.2 and -9.1 percent respectively). The sector of textiles is also an interesting case, as the private sector develops here (+38.0 percent) at the expense of the public sector (-6.9 percent). All other sectors see their activity (as

measured with real output) growing.

Finally, from a fiscal perspective, the removal of NTBs is positive, as the rents stemming from it used to accrue to private entities. In contrast to tariffs, eliminating these barriers does not therefore mechanically affect fiscal accounts. On the contrary, induced greater economic activity and trade actually increase government revenues, whose surplus is redistributed to households (12.2 percent of government revenue).

The fifth and last scenario combines to tariff removal, reforms in service sectors and on all other barriers to trade both in the form of Non-Tariff Barriers (NTBs) and technical barriers to trade (TBEs). For any country embarked in trade integration, the agenda for behind-the-border trade reforms is generally large. Beyond the elimination of tariff and non-tariff barriers, it also encompasses financial liberalization, the streamlining of customs procedures and regulations and other trade-related services reform.

First, we model the impact of financial liberalization, which would be implemented in parallel to the comprehensive trade strategy evoked above. The financial liberalization is simulated by imposing perfect capital mobility, insuring the equalization of sectoral rental rates. It is worth noticing that, in reality, the impact of financial liberalization could even be higher than that simulated here, since we do not consider here the current level of financial repression (which typically favors public enterprises at the expense of private ones). We just consider the existing situation as an equilibrium situation, and the financial liberalization as a means to better allocate resources in the event of a change in comparative advantages.

This simulation also envisaged the streamlining of customs procedures and regulations, accompanied with a more modest improvement of the productivity (through the involvement of foreign companies) in the trade and transport sector. Trade in services is also encouraged by the partial removal of NTBs on services from all origin, as well as on tariffs imposed on imported services from all trade partners.

Results of trade reform scenarios

The results of these five scenarios are shown in [Tables 1 to 4](#). They indicate deviations from base value in 2015.

The results of the three first simulations show that the implementation of the two FTAs individually or jointly on their own is expected to have a relatively small impact on economic performance in Kuwait:

1. With the implantation of the FTA with the European Union, total absorption, a measure of economy-wide welfare, would experience 2.3 percent acceleration as compared to base in 2015. However, the implementation of the FTA with the USA, will improves the level of

Table 1. Macro results.

Scenarios	A (%)	B (%)	C (%)	D (%)	E (%)
Absorption	2.3	0.5	2.3	3.4	4.5
Private consumption	2.1	0.5	2.2	3.5	6.0
Total investment	0.4	0.1	1.1	2.4	5.9
Government consumption	0.0	0.0	0.0	0.0	0.2
Exports	1.0	0.2	1.1	2.0	4.1
Imports	1.0	0.3	1.1	3.0	4.9

Source: Authors' calculations

Table 2. Effects on sectoral production.

Scenarios	A (%)	B (%)	C (%)	D (%)	E (%)
Agriculture	0.8	0.9	0.9	1.4	7.4
Fishing	0.5	0.5	0.5	0.8	-3.1
Crude Oil	0.3	0.0	0.5	0.7	-0.3
Other mining	0.0	-1.2	0.6	0.7	4.2
Refined oil	0.0	0.0	0.0	0.0	0.0
Processed food	-0.2	-0.5	-0.3	-0.4	2.9
Textiles and clothing	0.1	0.1	0.2	0.3	2.7
Wood manufacture	0.3	0.0	0.6	1.0	1.6
Paper and publishing	0.4	0.2	0.5	0.8	2.7
Other chemical	-0.6	-0.9	-0.3	-0.5	1.6
Non-metallic products	0.8	0.5	0.8	1.4	7.6
Metallic products	0.4	2.7	0.6	0.8	2.8
Ferrous metal	0.9	-2.1	1.1	1.3	2.4
Other manufacture	0.7	-5.3	0.6	0.8	1.5

Source: Authors' calculations

absorption by only 0.3 percent, which indicates that the relative importance of the European Union in the total imports of Kuwait is higher than the USA. The implementation simultaneously of the two FTAs will improve the absorption level only by 2.3 percent compared to the base in 2015, which confirms the predominance of trade with the European Union.

2. The same is true for private demand which is anticipated to experience 2.1 percent acceleration in 2015 with the implementation of the FTA with the European Union as compared with base compared to only 0.5 increases with the creation of the FTA with USA.

3. Interestingly, investment experiences a very small increase (0.4 percent with the FTA with the European Union and only 0.1 percent with the FTA with the USA). It is only when Kuwait widens its FTAs to open-up trade with all partners that the investment nudges up by 1.1 percent.

4. An FTA with the EU is more welfare enhancing than one with the US, but only marginally.

5. Adding the US as an FTA in addition to the EU improves the prospects for investment, but also only marginally.

6. Opening trade with all partners improve the

macroeconomic performance of Kuwait as result of absence of trade diversion effect. In fact, the FTAs with Europe and USA will improve the competitiveness of European and American products on the Kuwaiti market. Some of this improvement is explained by the lower protection faced by the products originated from EU and USA and does not reflect a better competitiveness compared to imports from other regions.

7. The most important gains to Kuwait appear to originate from efforts to improve domestic trade-related services (scenario 5). Indeed, under such a scenario, total welfare would be expected to experience a much higher improvement supported by an anticipated surge in private demand and investment.

Notwithstanding the results of the three first scenarios, the anticipated effects of engaging in FTAs with large markets appear to be very low given the low diversification of the Kuwaiti economy and the dominance of oil and related activities in GDP, exports, and public finances. Furthermore, the low impact of trade liberalization with the two major partners of Kuwait is explained by the already low level of import duties applied by Kuwait on imports from all origin under the

Table 3. Effects on sectoral imports.

Scenarios	A	B	C	D	E
Agriculture	-1.3	-2.1	-1.0	-1.5	2.2
Fishing	-1.1	-1.8	-1.0	-1.7	2.9
Crude Oil	0.7	0.3	0.8	1.0	1.3
Other mining	11.4	9.0	12.7	14.0	4.2
Refined oil	1.9	1.6	2.9	4.0	2.9
Processed food	0.4	-0.4	0.6	1.0	2.9
Textiles and clothing	0.4	-0.5	0.8	1.2	2.3
Wood manufacture	0.3	-0.4	0.5	0.8	1.6
Paper and publishing	1.0	0.1	1.3	2.2	2.7
Other chemical	0.2	-0.7	0.7	1.1	1.6
Non-metallic products	1.4	-1.4	1.6	3.0	7.6
Metallic products	0.3	-0.3	0.7	0.9	2.8
Ferrous metal	0.0	-0.7	0.4	0.4	2.4
Other manufacture	0.3	0.0	0.4	0.5	1.5

Source: Authors' calculations

Table 4. Effects on sectoral exports.

Scenarios	A	B	C	D	E
Agriculture	0.5	0.6	0.7	1.1	3.1
Fishing	0.2	0.2	0.3	0.6	1.4
Crude Oil	0.4	-0.1	0.7	0.8	-2.2
Other mining	0.0	-1.5	0.8	0.8	4.2
Refined oil	0.0	0.1	-0.1	-0.1	-3.9
Processed food	-0.2	-0.6	-0.1	-0.1	2.9
Textiles and clothing	0.0	-0.1	0.1	0.2	1.3
Wood manufacture	0.3	-0.5	0.8	1.2	1.6
Paper and publishing	0.5	0.0	0.7	1.1	2.7
Other chemical	0.2	-0.8	0.8	1.2	1.6
Non-metallic products	1.1	0.6	1.3	2.4	7.6
Metallic products	1.0	-2.9	1.3	1.6	2.8
Ferrous metal	0.7	-7.1	0.7	0.8	2.4
Other manufacture	0.0	-0.1	0.0	0.0	1.5

Source: Authors' calculations.

custom union with the five other countries of the Gulf Cooperation Council (around 5% with many exemptions on a large list of products). Only when Kuwait tackles the bottlenecks in trade-related services such as finances, transport, insurance and custom clearance, significant welfare gains are expected to accrue.

In addition to the modeling of the financial sector described in the previous section, the liberalization of the other trade related services activities is modeled here by improvements in their efficiency leading to reductions in transactions cost, mainly in the form of technical barriers to trade (custom procedures and transports) and services related to economic activities (insurance, telecommunication, etc). This improvement is manifested by a reduction in the cost of intermediate consumption of

the economic activities on these services by 5%. This scenario (scenario 5) produces a healthy 4.5 percentage point increase in the overall economic absorption of the Kuwait economy in 2015 compared to the baseline scenario. While this is largely due to a decline in the cost of imported raw materials and equipment, it nevertheless spurs improvement in exports in the competitive sectors, such as petrochemicals and some other industrial activities. We should point out that the liberalization of services may induce an upward adjustment in wages for Kuwaiti workers as the skills required for an efficient service sectors are limited in the country and hiring expatriates seems to be the only option at least in the short and medium runs.

Indeed, numerous studies acknowledge the key role of

services in economic development and the growing importance of services trade in international economic relations. International experience suggests that better quality of services and lower costs of backbone services (such as telecommunication, transport, financial, ITC services) and important production inputs (such as electricity) play an important role in reducing the costs of exporting and strengthening linkages with global production networks. Regulatory reforms are instrumental in improving the efficiency of economic operators. In addition to substantial welfare gains, services liberalization can create more investment opportunities for the domestic private sector and help create more job-creating foreign investments as well.

A firm's ability to compete in the world economy depends in part on supporting services, such as transport, communications, and finance. The results of our simulations suggest that these costs in Kuwait are a higher trade barrier than tariffs. High costs of services add to the cost of supplying the world economy, and other things being equal, lower the profitability of exporting.

As shown above, trade liberalization has the potential to deliver substantial benefits, in part by increased efficiency through a better allocation of resources. Increased international competition can help drive this process. Trade liberalization also impacts on the country's terms of trade through changes in prices. However, through the combined effects of this reallocation of resources, including labor resources and price changes there will be some clear winners and losers in the short-run. At the macro level, for example, losers might arise in the case of a net food importing country negatively affected by price changes following the removal of subsidies as part of any trade agreement for a fair trade. At the micro level losers might arise, for example, among workers dislocated from a non-competitive sector.

The IMF and WB (2002) highlight the importance of early identification of adjustment needs followed by an appropriate policy response. Action might be taken on a variety of levels. It may take the form of a trade policy response that avoids or reduces the adjustment shock or that compensates in some way.

Matusz and Tarr (1999) review more than 50 studies on adjustment costs and trade liberalization. They note that virtually all of the studies find adjustment costs to be very small relative to the benefits of trade liberalization. This is because adjustment costs are typically short-term and welfare gains from liberalization permanent. Moreover, the employment opportunities flowing from trade liberalization help to reduce spells of unemployment that dislocated workers might face. Matusz and Tarr note the importance of complementary domestic policies to ensure macroeconomic stability and promote sustained private investment in response to the opportunities arising from trade liberalization. Complementary policies also include

appropriate social and labor market policies to facilitate adjustment. In terms of trade policy, they note that a uniform tariff policy can help to minimize incentives to special interest groups to seek protection which can impede adjustment.

Where matters concern Kuwait, adjustments costs will be lower than other countries in the region given the low level of tariffs already prevalent in the country. The two main negative effects observed by most developing countries that have undertaken trade reforms are linked to labor market adjustment and public finances. In these two areas, special attention is required in order to show that, contrary to other developing countries, Kuwait should go ahead with trade liberalization and market deregulation, given that adjustment costs are expected to be very low and could be very easily compensated. Contrary to past experiences, Kuwait could expect even gains on both fronts (labor market and public finances).

While, the model used in this report is not tailored to look at the impact of trade reforms on the labor market, nevertheless some conclusions can be drawn given the structure of the Kuwaiti economy. Although trade reforms in the form of FTAs with the main trade partners could entail significant sectoral restructuring, the scale-effect induced by additional reforms, mainly the reduction in inefficiencies in services would permit most economic activities to expand, thereby reducing the need for workers to move from one sector to another. Furthermore, the most sensitive sectors to tariffs liberalization are agriculture and food processing given the high competitiveness of European and American products as results of their policies of supporting farmers and subsidizing exports, which are not labor-intensive. Moreover, most of workers in these two activities are not Kuwaiti. On the other hand, the additional demand for labor that will be generated by the expanding sectors will more than compensate the loss in jobs in the declining sectors. The reforms could then lead to important opportunities for job creation, which will be an important benefit for a country that is already suffering from high concentration of national workers in the public sector (around 95% of Kuwaitis are working in the public sector) and a high growth rate of populations and new job seekers.

The case of Kuwait is very specific in the area of public finance. Contrary to most developing countries, custom duties represent less than 2% of total government revenue. Removing all tariffs on all imports will not affect the government finances in a dramatic way, especially since Kuwait benefited from high oil prices, which makes the contribution of import duties to government revenue almost absent. However, the risk of "Dutch disease" effect on the Kuwaiti economy seems to happen in Kuwait in the coming years as direct result of the recent rapid decline in oil prices as result of the financial crises, which will harm global economic growth and global demand of oil.

Finally, our simulation results, combined with lessons of experience in trade reform can be summarized as follows:

- i) While the Kuwaiti economy is very dependent on oil and related sectors, it reacts quite sensitively to changes in the policy environment given the importance of distortions and inefficiencies present in the economy.
- ii) Policy measures have to address specific sectors and aim at specific objectives.
- iii) Different policies and/or policy packages have to be well coordinated with each other, and
- iv) Opportunities for negative (or positive) externalities among policy measures need to be studied carefully with the view of minimizing (maximizing) their impact.
- vi) While adjustment costs associated with trade liberalization in Kuwait are expected to be lower than those experienced by other countries in the region, the evidence indicates that these costs tend to be short-term and outweighed on average by the welfare gains from the trade liberalization. Complementary policies (e.g. macroeconomic, social or labor market policies) can facilitate adjustment and boost the effectiveness of trade liberalization in promoting growth.

DISCUSSION: TOWARDS A COMPREHENSIVE TRADE REFORM STRATEGY

Principles of a good trade regime

The quantitative analysis developed in the previous section suggests that long term rewards from FTAs are relatively too small for Kuwait. However, opening up borders to imports from all origin combined with a sound reform in service sectors, mainly those dealing with international trade, are very substantive. In fact, opening border to imports from all origins have the advantage to avoid trade diversion, which is seen as very costly for any economy, and to improve trade creation. However, trade can not be improved though only a tariff reform, a multitude of other actions should be taken and other reforms should be implemented to give to Kuwait all the expected potential of gains from trade liberalization. In what follows, a detailed comprehensive trade reform strategy is designed and suggested to be implemented in conjunction with trade reforms.

International experiences show that introducing non-tariff reforms prior to any trade commitment with the rest of the world is always preferred than waiting the implementation of trade agreements to start other measures.

General principles

Based on international experiences, the following describe in a nutshell what constitutes a good trade policy regime:

- i) No licensing, or other approvals, except for health, safety and environmental reasons, and automatic licensing used for statistical purposes; no other quantitative restrictions should be applied.
- ii) While Kuwait already apply a uniform external tariff under the GCC's custom union (5%), it is still required to avoid the existence of a form of monopoly of trade in manufacturing products, which is very present in Kuwait and represent a high non-tariff barrier. This is the cases of almost transportation, communication, and household goods sold on the Kuwaiti market.
- iii) Insofar as tariffs are not an important source of fiscal revenue in Kuwait, there is a need for a sound fiscal reform in the country to give to the government an alternative ways to deal with fluctuations in world oil prices and to diversify its source of income. Such fiscal policy reform could include the introduction of a VAT system. This policy will give to the government a tool to avoid a "Dutch disease" effect mainly when government revenue fell as result of lower oil income. The introduction of a VAT system could be complemented by high excise duties on certain types of goods to raise revenue, as long as these are also imposed on domestic production. With such reform, the government could continue playing its major role in the economy in providing social services to its populations and improving public investments in infrastructure required to expand trade and make the economy more competitive at the international level.
- iv) An efficient customs clearance process with little red tape that ensures tariff-free access to imports of intermediate inputs for exporters. In fact, Kuwait is still among countries where custom clearance takes a lot of time, which represents a handicap for its economy. Autoimmunization of the custom procedures show its relevance in many countries around the world by reducing time of delay of containers as well by reducing cost of trade and improving efficiency of trade operations.
- v) No more than one instrument of contingent protection — a safeguard provision. Kuwait is a rich developing country, and it is believed that she should continue supporting some industries and agricultural productions from external competitions until these activities will be able to compete. The best option is to take advantages from the possibility of including special and sensitive products in each trade agreement. Such measures will give to investors and traders a clear and transparent picture on the Kuwaiti trade policy
- vi) Contestable service markets—measures to ensure competition prevails, including entry by foreign suppliers, and appropriate regulation to address market failures and achieve social or equity-related objectives.
- vii) An open and transparent regime towards foreign direct investment for both goods and services.

In terms of the process of trade reform, it is important to remove tariffs and non-tariff barriers across the board during each stage of a gradual reform. If instead a target is set based on the tariff average at the aggregate

imports, Kuwait must cut tariffs only where they cause no immediate difficulty and leave all the adjustment to last. However, when adjustment costs may occur, two options are available to the government. Either to remove some products from the liberalization process through their inclusion in a list of sensitive and special products to not be covered by the agreement or to keep their liberalization at the end of the reform period.

Broad trade reforms also tend to meet with much less political resistance than cuts in protection to individual sectors—they are seen as more equitable in terms of burden sharing, help the winners from reform recognize their potential gains, and tend to reduce the costs even for industries that lose protection on their output as their input costs fall. Services reforms play an important role here, especially for industries that already have duty-free access to imported inputs. In what follows a liberalization strategy is sketched out, starting with trade in goods, and then turning to services and investment-related reforms. The end of this section will discuss issues related to sequencing of these various elements.

Tariff adjustment

To reduce adjustment costs and give firms time to increase their efficiency, tariff and non-tariff reforms should be gradual. How might the government proceed in reducing tariff and non-tariff barriers? It is important to start with a clear view on the end point to be achieved and then establish a transition path to achieve the desired end point. In doing this, account should be taken of the transition path negotiated or under negotiation with the main trade partners involved in the FTAs. As Kuwait already member in GAFTA and is most likely to sign a FTA with Europe before any other partner, thus a significant proportion of imports will be free before concluding other FTAs with other partners, such as USA. A consequence of this will be that Kuwait may incur trade diversion costs insofar as preferred suppliers are not the globally least-cost producers. Lowering external trade barriers with other trade partners will help lower such costs. The current GCC custom Union signed with the other GCC countries was clearly at the benefit of the Saudi Arabia, which is selling its agricultural and manufacturing products in the Kuwaiti market at higher cost than what Kuwait can find on international market. This amount of trade diversion is a net reduction in the Kuwaiti welfare and a subsidization of Saudi welfare through Kuwaiti consumers.

Given that the Custom Union with GCC and the GAFTA agreements are already implemented, it does not make much sense to maintain a differentiated tariff structure for protective purposes. This suggests an additional reason to gradually move towards uniformity in the external tariff and non-tariff barriers. Uniform protection has many benefits. The differentiated tariff distorts investment incentives as well as consumption – it inherently taxes

some industries much more relative to others, and it is unclear that the right industries are supported. A major advantage of tariff and non-tariff uniformity is that if industries desire protection any increase must apply to all industries. This makes the gains to the industry much smaller as it would have to bear the costs of raising the tariff for all the other products. These costs would include the higher cost of imported intermediate inputs. Uniform tariffs also eliminate incentives to misclassify goods and will reduce customs clearance transactions costs, and provide less incentive to smuggle products that are subject to higher protection either in the forms of tariff or non-tariff.

To reduce the anti-export bias that tariffs and non-tariffs on intermediate and capital goods imposes; duty drawback and/or temporary admission procedures are needed. A problem with duty drawback schemes is that the administration of the schemes can be very costly, and lead to cumbersome procedures and delays. It is therefore preferable to adopt a system of temporary admission that allows free access to imported intermediates to establish exporters that use the inputs for export production.

Sequencing trade policy reforms

Trade policy involves a long and daunting set of actions. What comes first? What can be left for later? What should be done in parallel? There is no generally valid answer to these questions. Some general points are worth noting about sequencing:

- i) Pursuing the reforms over several years allows normal market adjustment and attrition to reduce adjustment costs. However, any gradual reform confronts a credibility challenge—reforms may be reversed if entrenched interests have time to mobilize a reversal. Spelling out the overall thrust and elements of the reform through a public announcement and committing to a staged reform that is scheduled to be implemented as part of, and in parallel to, trade agreements.
- ii) NTBs should be removed and TBTs should be improved for more efficiency in trade operations.
- iii) It is important to reduce tariffs across the board during each stage of the reform. If instead a target is set based on the tariff averages, the tendency will be to cut tariffs only where they cause no difficulty and leave all the adjustment to last.
- iv) Broad trade reforms that span services as well as border protection frequently meet with much less political resistance than cuts in protection to individual sectors. Broad reforms help the winners from reform recognize their potential gains, and tend to reduce the costs even for industries that lose protection on their output.

Given the macro preconditions are in place, the sequencing of trade reforms should proceed as outlined

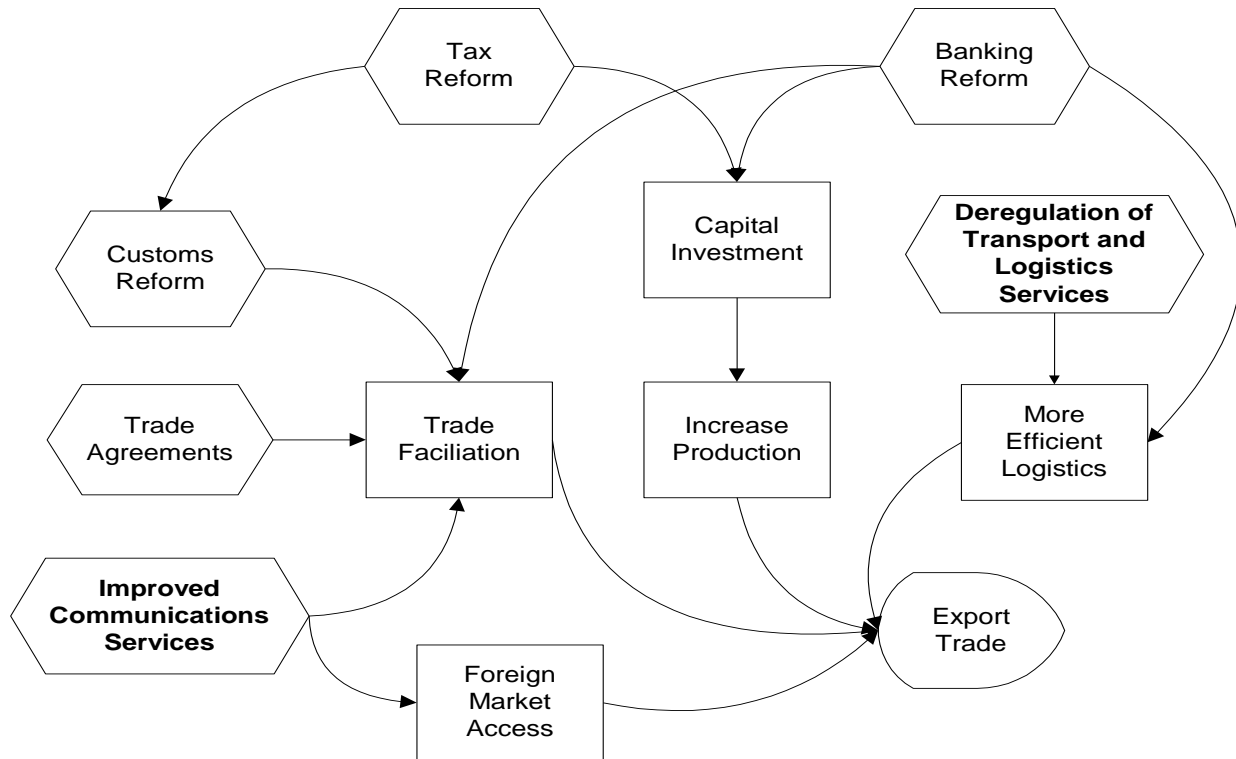


Figure 1. Flow chart.

above:

1. Identify a list of sensitive and special products to exclude from the FTAs agreements. These products will form the so-called "Negative List".
2. Decide on tariff reduction schedule under each trade agreement in consultation with local business community.
3. Extend tariff reduction to all the other trade partners if possibly to reduce at maximum the trade diversion effect.
4. Abolition of NTBs immediately as they represent the main obstacle to investment and consumption.
5. A safeguard mechanism should be initiated at the beginning of the process as well—over time, once liberalization begins to take effect, this will ensure that there is a safety valve that local firms can petition for.
6. Most of the service related actions should be taken in parallel with the elimination of tariffs—with trade facilitation and logistics initiatives given priority.
7. Identify adjustment costs and implement compensation mechanisms to reduce costs and improve gains

Proactive policies to support trade

At present, a number of factors limit the growth in Kuwait's trade. The quality of logistics and the scope of trade promotion activities are two such factors, but they are not the most important. There are several ways in which these two can be improved, but they are

functioning reasonably well at this time. More problematic is the lack of finance for capital investment in export production and for facilitating trade. In order to develop a balanced program for export growth, it will be necessary to consider all of these factors and to set priorities based on the complete set of factors. Many of the more important factors were not examined in great detail for this study, but should be the subject of government policy reviews. They are briefly discussed below to provide an understanding of their potential contribution to export growth. A flow chart showing the interaction of these various factors is presented in Figure 1.

Adding to this is the fact that the private sector is hesitant to give up the accommodation it has reached with the state bureaucracy and to risk mobilizing its resources to take advantage of the potentially liberalized environment.

In Kuwait, there are two main areas where policy changes can improve the nation's capacity and competitiveness in trade. These are:

- i) Trade facilitation
- ii) Communications services, mainly on the rules of origins

Improving trade facilitation

International trade is built on confidence between the

buyer and seller in which the fulfillment of the contract is key. Proper execution of the contract of sale after it has been concluded assures the buyer that the shipment will be received in good condition and that the seller will be paid on time, a factor that is critical in sustaining a trading relationship. To meet this requirement, good control of the international trade transaction process is paramount as it is a task that relies on the efficient performance of the international supply chain that begins from the time an international order is placed to the time the shipment is delivered. The task entails managing the functions related to purchasing of materials, transportation from foreign and/or domestic sources to the plant, processing materials in the plant, and delivering the finished products to buyers located abroad and/or at home, a process that covers the spectrum of international trade logistics.

Some countries perform better than others in managing the trade logistics system because of advantageous conditions related to infrastructure and equipment, information and communications technology, institutional framework, procedures for regulatory compliance, and practices in handling information flows as well as the physical movement of the goods, to name a few. Countries that have well-performing international trade logistics systems incur minimal friction in trade and thus are assured of low transaction costs that advance the cause of exporters. Where, in particular, does Kuwait's trade logistics performance stand in this context? And is the trade logistics system efficient or inefficient?

Customs procedures and regulations constrain trade through a complex tariff structure, lack of consistency, a manual system for processing customs data and inadequate dissemination of information on procedures and requirements. Increasing the efficiency, effectiveness and transparency of customs by simplifying the customs tariffs, documents and procedures is key in supporting a better trade policy. High transaction costs, of which customs clearance costs are often an important element, may heavily reduce the positive impact of trade liberalization. Cost reduction to the trader, derived from easier customs procedures, stem largely from the possibility of reducing inventories, and the amount of operations capital as well as the possibility for traders to satisfy increasingly stringent "just in time" requirements. In all countries, customs services as particularly prone to harboring corrupt practices that also substantially inflates the cost of business.

For Kuwait, efficiency and transparency in customs operations remain a formidable challenge, as it increasingly opens its border to world trade. Each of a shipment passed through customs controls at least twice – at entry and exit. Customs services have often had to cope with the growing trade volumes without any commensurate change in their clearance procedures and increase in resources. In addition, customs continue to face changes to their operating environment, which further the need to adjust and modernize their processes.

These include:

- i) More sophisticated and demanding clients, e.g., the traders, who have invested significantly in modern logistics, inventory control, manufacturing, and information systems;
- ii) Greater policy and procedural requirements associated with international commitment (as a member of WTO).
- iii) Regional trade agreements, which significantly increase the complexity of administering border formalities and controls.
- iv) Increased demand for good governance and integrity;
- v) Heightened security concerns and widespread revenue fraud.

Faced with challenges, the Kuwaiti customs administration is anxious to meet all the demands and priorities placed on it. More often than not, it still focuses on technical control. While the customs administrations express its clear desire to minimize administration barriers coming from inefficient and outdated customs procedures, participation barriers coming from inefficient and outdated customs procedures, participation in the regional trade group GAFTA and the GCC-Custom Union, both the structure of its customs tariffs and its procedures for collecting duties are complex enough to be counterproductive.

In recent years, customs has reduced the time required for cargo clearance and introduced a relatively consistent set of procedures. However, there are no formal requirements for clearing cargo within a certain period, and the shippers are still subject to arbitrary actions by officials. Because of this and the large number of forms requiring signatures, significant payments change hands when clearing cargo. Fortunately, these payments are relatively predictable.

The inefficient operations in the public ports, however, stand in the way of major improvement. Inefficient customs procedures, coupled with the multiplicity of documents needed to conduct a trade transaction can effectively negate improvements in other areas affecting trade, such as already a lower tariff barriers, and investments in transport and communication networks. The procedures for external trade in Kuwait require the processing of documents by multiple agencies – the Ministry of Trade, the Ministry of Finances, the port authority, and customs, as well as the usual professional organizations such as customs brokers, shipping agents, and freight forwarders.

In addition to these problems, inspection certificates, mostly at imports, represent another major handicap for trade in Kuwait. The non-existence of specialized laboratories for a specific control operation make the operation very long given that customs always rely on laboratories in other administrations which requires additional time for request of inspection, approval, doing the inspection, and provide a certificate.

Reductions in clearance time can be achieved only through a dramatic change in procedures and clearance processes. Without computerization, for instance, it is not possible to introduce a one-stop-shop. Customs has established a single warehouse in which the various participants involved in shipping and clearance are gathered. While this system is a significant improvement compared to the past, substantial improvements can still be expected from automation.

The Kuwaiti customs today faces the greater business expectations and continuing pressures to meet often-conflicting government revenue, trade facilitation, social protection, and national security objectives. Moreover, the customs administration is increasingly required to integrate its procedures with the sophisticated global logistics networks employed by international trade and transport operators. To cope with these challenges, the application of information technology seems indispensable as a key catalyst for improving organizational and operational efficiency and effectiveness.

An example of computerization that Kuwait might choose to adapt to its needs is the creation in Tunisia in recent years of an effective information network that significantly reduces the cost and time of a trade transaction. The key component is the so-called "TunisieTradeNet (TTN)" providing electronic data interchange (EDI) for that speeds the flow and processing of trade documents. In Tunisia the system interfaces with all agencies involved in international trade. Key trade documents, including customs declarations and technical control documents, are processed through this network. A single connection to the central server enables participants to exchange documents and messages with one another, thereby reducing the average time of processing trade document from 8 days to 3 days.

Tunisia's experience points to the dramatic improvements that can be made in trade clearing process when administration and political commitment joins forces with advances in information technology. But there is much more involved than simply applying information technology to trade documents. Perhaps the most important prerequisite is the commitment at the highest level of government. This was made possible in Tunisia by close involvement of the Minister of Commerce, who was also a chairman of the Superior Export and Investment Council, a cross ministerial committee reporting directly to the President of Tunisia. The second success factor was the cooperation among private sector operators and various government stakeholders at all committee composed of key stakeholders at the early stages of the process. Not only were these committees instrumental for the design of the initiatives, but also in their implementation. The third was the adoption of a regulatory framework that allowed for electronic processing and signature. Amendments to the legal framework were made to accommodate the following

changes: (a) layout of the simplified Liasse Unique documents, (b) the supply of value added network services through telecommunications and the internet, (c) new streamlined customs declaration procedure through TTN, (d) new procedures for submission and processing of documents for external trade through the TTN system, and (e) the recognition of legal validity of electronic documents and electronic signature.

Other success factors included: (a) the simplification of customs documentation, (b) the extension of electronic processing to all import and export administration and other agencies involved in trade transactions, and developing their "back-offices" to handle electronic processing of trade documents; (c) the adoption of internationally recognized standards and codes in order to ensure a common language among different users and in different countries, and (d) aligning the relative costs of processing paper documentation and on-line processing. Adopting such changes can reduce the time, cost and uncertainty in delivering exports of finished products and goods imported for production of exports as well as the transit of goods through foreign ports and airports facilities. Consequent gains in efficiency and consistency would improve Kuwait's competitive position.

Kuwait's logistics services for international trade vary in quality and coverage. Very few importers and exporters provide their own transport. Most arrange for transport from private companies through the services of forwarders who arrange shipments from the factory to the gateway or the overseas destination. They also arrange for the delivery of imported raw materials used to produce exports and act as customs clearance agents. Some forwarders provide their own trucks, but most contract for trucking services. Some provide warehousing and consolidation services, but most limits their services to transport and clearance. Forwarders prepare the shipping documents for the shipper. The forwarders vary from local specialists serving specific geographic areas and commodities to international forwarders able to serve all cargoes and countries. Most are able to issue house bills of lading for door-to-door movements. There are combined bills of lading, in which a correspondent forwarder provides the clearance and land transport in the foreign country. The fees charged for forwarding are not unreasonable but can account for as much as 20% of total door-to-door costs. Cargo clearance requires only a few days, while improvements in customs procedures would offer some savings in delivered cost and time, the major challenge would be increased reliability and therefore predictability of delivery times. Those improvements would enable producers and importers to reduce the slack time added to their order cycles in order to insure that they will meet delivery schedules even in the worst-case situation.

Overall, the logistics industry is limited in terms of range of services offered and level of technology employed. The supply chains are simple, with relatively

few parties involved. The demand for inventory management services is limited because of the relatively short transport times to the major markets in the Gulf and South Asia. The demand for management of inbound materials is also limited because of the long order cycle times. This situation is expected to change, as competition increases with global trade liberalization and flexibility in production, smaller order sizes and shorter order cycles become major sources of comparative advantage. Technology is limited by available communications services, which prevent the introduction of real-time cargo tracking and Electronic Data Interchange (EDI) for transactions involving cargo and transport services

A number of policy reforms can be introduced to reduce the cost and time and increase reliability for the delivery of trades and to increase the range of value-added services available to exporters and importers, but most of these are covered through the proposed improvements for customs and communications. Since there is already considerable competition among third-party logistic service providers, improvements in the range and quality of services offered is expected to occur in response to market demand. Knowledge about the logistics of alternative routes is expected to increase as more forwarders form alliances with international logistics companies and as the government simplifies border-crossing procedures and makes its procedures known to importers, exporters, and forwarders.

An efficient system of information on rules of origin in the various trade agreements

Given Kuwait's membership in GAFTA and the WTO, the magnitude of the benefits associated with these agreements will in part be determined by the rules of origin that are applied. GAFTA requires a minimum of 40% of value added of the final product in order for it to be considered as "originating" and receive GAFTA preferences. The percentage is reduced to 20% for assembly industries. The potential agreement with Europe will have more complex ROO that vary by product and comprise a mix of value added, change in tariff heading and technical processing requirements. These varying ROO raise the compliance cost for exporters and reduces the actual extent of preferential access to partner markets. It can be noted that value added criteria in particular give great scope for discretion on the part of customs authorities and are quite cumbersome, giving rise to a substantial administrative burden and related red tape. While rules of origin are not under the control of Kuwait, focusing on making the rules more liberal, simpler and transparent will enhance the gains from all the potential RTAs to be signed by Kuwait.

More generally, a major source of risk for the private sector in general and exporters in particular is the rapidly

evolving legal and regulatory framework. Inadequate dissemination of information on changes in law and regulations and insufficient legal support create an environment in which exporters limit their activities for fear that new rules and changed bureaucratic interpretation of existing ones will result in significant financial problems. As a first step, all laws and regulations (including those related to trade and transport) could be published on a government website together with appropriate indexing and summaries. This could then evolve into a system of e-governance.

Policies for trade promotion

At present, a number of factors limit the growth in Kuwait's export trade. As the preceding section detailed, the quality of logistics is a major factor. The others are the inappropriate environment for private sector, a low attractiveness of FDI, promotion of competitiveness of the Kuwaiti economy, and the need of reform in financial sector.

Creating a fair environment for the domestic private sector

Abolition of NTBs and tariff will increase the competitive pressure on local firms, both public and private. Both kind of firms are likely to need to improve efficiency and require investment for training, upgrading of equipment, etc. In a market economy, the financial sector then has the task of determining whether firms have compelling business plans and are credit worthy.

It is critical that the trade reform program be accompanied by credible measures to ensure SOEs are subject to hard budget constraints. This is much easier said than done, as SOEs will in principle have a valid case for new investment following trade liberalization. Thus, there must be a mechanism, ideally the financial system that determines whether and on what conditions firms are given access to credit. By far the most efficient and simple way to do this is by rapidly privatizing enterprises that operate in competitive markets (that is, Air transport for example). However, a process of privatization, even if politically acceptable and implemented on an accelerated basis, will inherently take time. Whatever the ultimate decision that is taken on this front, recognizing the need to establish a level playing field for finance must be a central part of the trade reform program to ensure that the desired adjustment process actually occurs.

Attracting and benefiting from FDI

FDI will be an important determinant of the success of the

trade reform strategy. Multinational enterprises bring with them know how and technology, demand for skilled workers and the ability to train employees, linkages to foreign markets and distribution channels, and generate demand for locally produced intermediate inputs and a variety of services. Entry by foreign investors will also put competitive pressures on local producers. However, the mere presence of FDI does not necessarily increase competition. Because they often possess significant intangible assets (brand names, technology, managerial skills etc.) that can give them market power, openness to trade and low barriers to new entry are needed both to maximize the return on FDI and help limit the capacity to abuse their market power in the domestic market.

If relatively high trade restrictions prevail, inward FDI will be less beneficial to the Kuwaiti economy. It will result in inward-looking investment, aimed at exploiting domestic consumers, and is likely to generate lobbying for exemptions on tariffs on imported inputs so as to increase the competitiveness of these firms of export markets. International experiences suggest that tariff-jumping FDI can be detrimental to national welfare.

Thus, openness to foreign investment must be accompanied with low trade barriers so as to prevent foreign investors from exerting market power domestically, and to discourage them from joining domestic vested interests lobbying for policies that perpetuate costly rent-seeking activities. This conclusion again points to the importance of launching trade reforms at the same time as efforts to further open access to foreign investors (World Bank, 2004).

International experience reveals that many factors play a role in the decision of foreign investors to locate facilities in a specific country. In the absence of a large domestic market, as in the case of countries such as China, the major determinant of FDI is the domestic investment climate. It concerns the approach to take in addressing key aspects of the investment climate, telecommunication, finance, transport, etc. Some of these could be addressed through zones as a first step to an economy-wide approach; others need immediate attention, starting with the trade logistics related actions outlined above, as these are major determinants of the trade costs that will confront foreign investors considering establishing work in Kuwait.

Trade promotion and competitiveness of Kuwaiti firms

The ongoing changes in the global market place require ever greater flexibility at the production end of the value chain so as to be able to satisfy and react to demands by retailers on a timely and cost-competitive basis. The type of equipment, management skills and labor required to be competitive on world markets will have to adjust in many firms, requiring up front and ongoing investments by both

the private sector and the government. A first need for firms is to better understand their strengths and weaknesses. Standard techniques of industrial organization and value-chain analysis have been developed to help firms identify changes that need to be made to their production process so as to enhance their competitiveness. A program that is based on a cost sharing formula between the government and the firms, on a demand-driven basis, could help provide access and increase awareness of need for retooling and adoption of new management and production techniques. Initially, technical assistance can be sought to provide these skills from abroad, including a focus on training to develop local consulting capacity for these services.

The risks of expanding into new markets, establishing new trading relationships and selling new products are considerable. Where these are foreign markets, the risks are much greater. Given the limited access of firms to credit from the financial system, the government could consider establishing an export credit program that would provide loans and guarantees for exporters entering into new markets. Smaller firms in particular are often constrained in their access to bank credit, especially long-term loans. These firms generally rely on own assets and retained earnings for working capital and on trade credit as a source of funds. Given that start-ups or new product line ventures may not have access to trade credit, this constraint will reduce the potential benefits from liberalization. One policy option therefore is to provide access to long-term credit, which can be done directly by the government or through financial intermediaries by giving them incentives to do so. Numerous countries have pursued such policies; often through credit lines or matching grant schemes, frequently at rates of interest that are below market rates. A general lesson from experience is that access to credit should not be at subsidized rates, to ensure both financial viability and efficient resource allocation, interest rate subsidies should be avoided (Batra and Mahmood, 2013).

Reforming the service sector

A comprehensive "behind-the-border" policy reform agenda focusing on services can help attract much-needed investment, both domestic and foreign, as well as enhance the overall economy wide benefits and reduce costs of merchandise trade liberalization.

An expanding and more efficient service sector that supplies an increased set of differentiated and customized products to consumers can enhance general industrial competitiveness, which in turn should facilitate merchandise trade liberalization (Hoekman and Djankov, 1997). Inefficient public sector services, the limited access to credit and the high cost of key intermediate services such as transport, are key factors impeding

trade expansion and investment. Services such as finance, telecommunications and transport are major inputs into the production of goods and services. The costs of these inputs can account for a major share of the total cost of production, and are thus an important determinant of the competitiveness of firms.

Services are also important determinants of the productivity of workers; education, training, and health services are key “inputs” into the formation and maintenance of human capital. Service sector reform and development can also help reduce the costs of trade liberalization by assisting domestic firms in confronting competition from imports through lower input costs and higher quality inputs.

Services reforms can play an important role in creating the employment opportunities that are required to allow adjustment to occur (and absorb new entrants into the labor force). One important benefit of services liberalization is that in contrast to what happens with merchandise liberalization the related sectors may or may not employ domestic labor. Foreign telecommunications or electricity operators, foreign banks or retailers, all need local labor. Thus, while allowing private entry inevitably will result in pressure on the domestic public sector firms industry and the private firms will absorb additional labor. While these employees may not be identical, the aggregate impact on employment of services reform will likely be less in the short run than merchandise trade liberalization. This is perhaps best documented by the experience in Central and Eastern Europe during the 1990s, where economic reforms generated a large increase in service sector employment, much of it in small and medium sized establishments.

Consumers are the primary beneficiaries of service reforms. As firms in agriculture and manufacturing are large consumers of services, they will be large beneficiaries of reforms in services. In other words, reforms in services have a magnifying effect, improving first the prices and quality of the services involved, then the production conditions of the service users; that is, manufacturing and agricultural producers, among others. There is no good measure available of this “multiplier” effect for past reforms of services industries and markets. However, economic analyses for Tunisia and Egypt support the existence of such an effect (Hoekman and Konan, 2000; Konan, 2003; Konan and Maskus, 2004).

Many of the proposed complementary actions centering on services will take time, and should therefore be pursued in parallel with the trade liberalization. Given that services reform and expansion can help to reduce the political and social costs of further trade liberalization, both agendas should be pursued in tandem. Opening the economy to the outside world through greater trade will allow the “behind-the-border” agenda to be pursued at lower cost by attracting FDI in infrastructure and services, and make available new, modern technologies and cheaper foreign goods and services that can boost the

skills and productivity of Kuwaiti workers. In short, the “behind-the-border” agenda and trade liberalization are mutually reinforcing.

CONCLUSIONS

With the proliferation of regional trading arrangements that has occurred over the past several years, questions naturally arise as to the motivations that countries may have in joining such arrangements and what economic benefits they may gain. This paper presents some answers to these questions by providing quantitative estimations of the impacts of the implementation of FTAs between Kuwait and other GCC states and their main trade partners (UE and USA).

As the most important objective behind the proliferation of these provisions is the fact that the “new” wave of RTAs that has gripped the world involves much more than reducing tariffs; the trend has been towards a deeper form of regional integration arrangements that involves liberalization of goods and services, harmonization of standards, rules governing investment, competition policy and labor movement. A simple review of CGE modeling results confirm that shallow integration may in some instances give rise to trade diversion at least in the short run, and significant welfare gains accrue in the long run only to the extent that deeper forms of regional integration are envisaged. These include commitments to liberalize the services market, improvements in trade facilitation and the investment climate, financial and labor market reforms, the harmonization of standards and other export-related dynamic productivity effects.

Using a dynamic CGE model built for Kuwait, this paper investigates the economic impact of the various initiatives of regional integration planned by Kuwait through the implementation of FTAs with the European Union on one side and with the USA on the other. Our findings are in line with experiences elsewhere: only when ancillary trade-related services activities are included do potential welfare gains to the Kuwaiti economy become substantial. Without this dimension, our modeling exercise points to the possibilities of trade diversion originating from overlapping RTAs which reduces the potential benefits to Kuwait.

Another critical result of the quantitative analysis is the contribution of investment across the different trade scenarios: we find that changes in investment from base to be marginal with the exception of scenario 4 where we introduce improvements in trade-related services. Investment is critical since as Winters (1997:14) notes: “Many economists see inflows of FDI, first as harbingers of confidence in the economy and, second, as the route through which an economy can modernize – for example through access to modern technology, modern management, marketing networks and sources of inputs.”

Spillover effects from FDI may take the form of improving productivity in domestic firms through a kind of demonstration effect or because of increased competitive pressures. Workers and managers may also become better trained and more efficient in working in multinationals and possibly moving on elsewhere in the country. The extent to which an FTA may help to attract FDI will depend importantly on sound economic policies in the host country. This will include stable macroeconomic conditions and policies, absence of labor strife, and a high degree of openness such that trade and financial flows can move efficiently across borders.

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APPENDIX

The dynamic general equilibrium model for RTAs assessment on the Kuwaiti economy

The model is a standard neoclassical dynamic model with imperfect substitution between domestic and foreign goods. Prices are endogenous on each market (goods and factors) and equalize supplies and demands (final demand from households, the government, investors and the trade partners; intermediate demand from producers; factors demand), so as to obtain the equilibrium. The equilibrium is general in the sense that it concerns all the markets simultaneously. For instance, a decrease in tariffs will affect the demand for imports of both final and intermediate goods. This will in turn affect the supply of domestic goods, and the demand of factors in each activity. This will equally affect the price of goods and the disposable income of households, which will in turn affect their demand, etc. The model uses the information contained in the Social Accounting Matrix for the year 2001. It considers two representative households (Kuwait and non-Kuwaiti), 32 economic sectors and 33 corresponding commodities, 3 trade partners (EU, USA and the Rest of the World). The model is calibrated on data for the year 2001 – the last year for which needed data were all available, but this should not be seen as a major shortcoming, as the intention of the exercise is primarily to capture the structural impact of trade reform.

Supply is modeled using nested constant elasticity of substitution (CES) functions, which describe the substitution and complement relations among the various inputs. Producers are cost-minimizers and constant return to scale is assumed. Output results from two composite goods: intermediate consumption and value added, combined in fixed proportions. The intermediate aggregate is obtained by combining all products in fixed proportions. The value-added is then decomposed in two substitutable parts: labor and capital, which are both fully employed.

Income from labor is allocated between the various households using a standardized fixed-coefficient distribution matrix. Income from physical capital and Oil are allocated in the same way between households, companies and foreign investors. Household demand is derived from maximizing the utility function (following the ELES system, Lluch, 1973), specific to each household, subject to the constraints of available income and consumer price vector. Household utility is a positive function of consumption of the various products and savings. Income elasticities are differentiated by product and by household, and vary from 0.75 for staple products for richest households to 1.20 for services. The calibration of the model determines a per capita subsistence minimum for each product, whose aggregate consumption grows with population, while the remaining demand is derived through an optimization process. Government and investment demands are disaggregated

in sectoral demands once their total value is determined according to fixed coefficient functions.

The model assumes imperfect substitution among goods originating from different geographical areas. Import demand results from a CES aggregation function of domestic and imported goods. Export supply is symmetrically modeled as a constant elasticity of transformation function. Producers decide to allocate their output to domestic or foreign markets responding to relative prices. At the second stage, importers (exporters) choose the optimal choice of demand (supply) across regions, again as a function of the relative imports (exports) prices and the degree of substitution across regions. Substitution elasticity between domestic and imported products is set at 2.2, and at 5.0 between imported products according to origin. The elasticity of transformation between products intended for the domestic market and products for export is 5.0 and 8.0 between the different destinations for export products.¹²

The equilibrium condition on the balance of payments is combined with other closure rules so that the model can be solved for each period. First consider the government budget. Its surplus / deficit is exogenous and the government transfers to Kuwaiti household schedule shifts in order to achieve the predetermined net government position¹³. Second, investment is savings-driven, the latter originating from households, enterprises, government and abroad. The sequential dynamic path of the model results from this closure rule. A change in savings influences capital accumulation in the following period. Finally, exogenously determined growth rates are assumed for other factors that affect the growth path of the economy, such as population, labor supply, extraction of oil, and total factor productivity (TFP). Agents are assumed to be myopic and to base their decisions on static expectations.

The model belongs to the recursive strand of the dynamic CGE literature, which is used more extensively in policy analysis than alternative intertemporal optimization models. A recursive model may be solved one period at time. The equations may be divided into a within-period module, which defines the decisions in each time period (this is the same structure as for the static model), and a between-period module, which provides a

¹² Trade elasticities come from the empirical literature devoted to CGE models. They are not specific to Kuwait. See for instance Burniaux, Nicoletti and Oliveira-Martins (1992), Konan and Maskus (1997) or more recently Gallaway, McDaniel and Rivera (2000). These elasticities are not distinguished by product, which explain to a large extent their low levels. They are not either statistically significant.

¹³ This closure policy can be understood as a net transfer from households to government (or the reverse). With one Kuwaiti representative household, it is considered the most neutral way to assess trade reform. Other closures could be tested (e.g. introducing new indirect taxes as Value Added Taxes) but would bear the risk to introduce new distortions, thereby making more difficult to conceptually isolate the impact of the trade policy.

link between different periods. All agents (private and public) are myopic, making their decisions on the basis of past and current conditions with no explicit role for the future. Our preference for assuming myopic agent behavior stems from the fact that we find little empirical support for the notion that, as a general rule, agents act on the basis of perfect foresight. We do not explicitly specify the factors that prevent agents from realizing patterns of savings and investment that, according to some criterion, are intertemporally optimal. However, they may include credit constraints and/or the belief that any knowledge about the future is too uncertain to act on.

Several assumptions have been made in order to define what seems to be the plausible development of the Kuwaiti economy up to 2015. This exercise in simulation must not however be seen as an exercise in forecasting, for which general equilibrium models are not the best tools. The definition of a benchmark using major exogenous hypotheses is intended merely to define a baseline scenario to which alternative policy scenarios can then be compared in order to isolate the specific impact of the latter. The fact that the value of the exogenous variables are set on *a priori* basis, within a realistic confidence interval, does not however have any major consequences. When the impact of alternative trade policies is assessed, it can be seen that these choices affect very little either amplitude or sign of the variations in the different aggregates relative to the baseline scenario.