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October 24, 2022

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CONTENTS

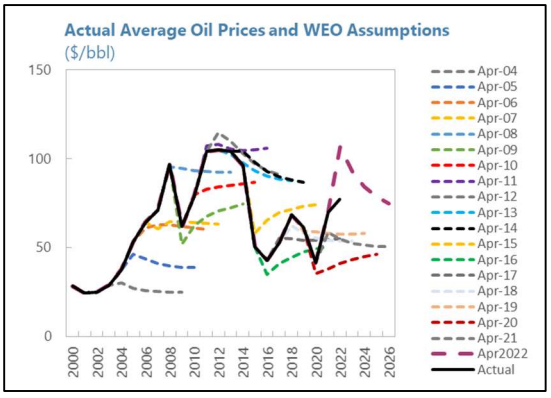
REINFORCING FISCAL SUSTAINABILITY IN OMAN: THE ROLE OF FISCAL FRAMEWORKS[1]

Fiscal policy in Oman is undergoing significant changes. The government has adopted the Medium-Term Fiscal Plan, introduced public-sector reforms, and made good progress in improving central government fiscal reporting. These reforms are important, and now there is need to strengthen fiscal frameworks—including clearly defining fiscal policy objectives and the long-term fiscal anchor—before introducing a formal fiscal rule. A fiscal rule is only as good as the institutions that support it.

A. Context

1. Fiscal policy plays a crucial role in Oman as the main vehicle for converting the oil and gas (hydrocarbon) wealth into economic outcomes for its population. Oil and gas are the major sources of export income and fiscal revenues, and this income impacts the rest of the economy through government spending. Over the past several decades, government spending on infrastructure, education, health, and social programs has transformed the Oman's economy and supported some of the highest living standards in the world.

2. Volatility and unpredictability of oil prices have increased in recent years, posing significant challenges to policymakers. Oil price shocks are often large and persistent, with booms and busts involving prices moving up by around 400 percent (2001-2008), increasing by 100 percent (2009-2013), before declining by 40 percent (2014-2019). Sharp drops in oil prices in 2009 and 2020 proved to be only temporary and oil prices rebounded quickly, while oil prices remained low for few years after the 2014 commodity price shock. Hence, forecasting commodity prices has proved exceptionally difficult. Given high uncertainty around commodity prices and dependency of government revenues on oil and gas, policymakers have faced two competing challenges: avoiding procyclical fiscal policy and supporting long-term growth (IMF 2015).



3. These developments highlight the benefits and risks associated with natural resource wealth. Although such wealth creates opportunity to accelerate economic development, it also comes with risks such as susceptibility to fluctuations in commodity prices which can be large and persistent, exhaustibility of natural resource deposits, a tendency to pro-cyclical fiscal policies that can amplify business cycles, and Dutch Disease (Kanda and Mansilla, 2014). Avoiding the impact of these risks on the fiscal position and macroeconomic stability requires strong institutions and often

[1] Abdullah AlHassan, Salim Al Jahwari, and Hatim Bukhari.

the establishment of a fiscal anchor or rule that enforces a sustainable fiscal position and countercyclical fiscal policy.

4. Against this backdrop, the paper looks at the potential role that fiscal frameworks and anchors could play in reinforcing fiscal sustainability in Oman. The authorities aim to further develop their fiscal frameworks to safeguard fiscal sustainability. They have already introduced policies to balance the budget by 2025 and contain central government debt below 60 percent of GDP over the medium term. These policies are important, and now there is need to deepen reforms by strengthening fiscal frameworks (including medium-term macroeconomic framework, fiscal strategy, fiscal governance, and medium-term budget framework, and expanding fiscal coverage beyond central government). A formal fiscal rule could then be considered. A fiscal rule is only as good as the institutions that support it.

5. The paper is structured as follows: section II provides a retrospective on fiscal policy in Oman since the early 2000s; section III provides some considerations to strengthen fiscal frameworks, including options and challenges for adopting a long-term fiscal anchor and designing a fiscal rule for Oman as well as summarizing simulation results on fiscal outcomes for a variety of fiscal rules; and section IV concludes.

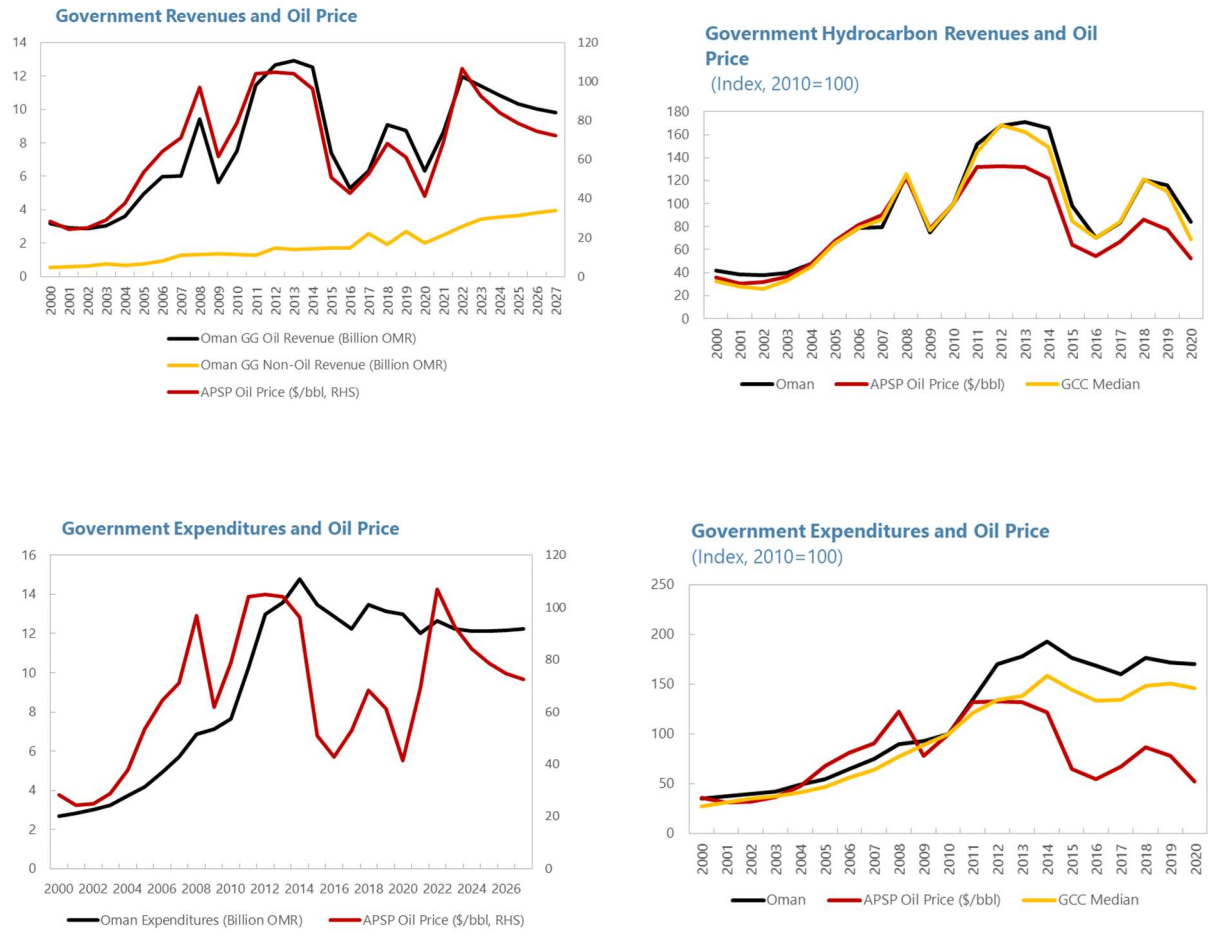
B. Retrospective of Fiscal Policy

6. Fiscal developments in Oman have been mostly driven by movements in oil and gas prices in recent decades (Figure 1). The prominent role of hydrocarbon production has in the past implied a pro-cyclical link between oil and gas prices, government spending, and economic outcomes.[2] Driving this relationship has been the large share of income from oil and gas in total government revenues.

- Government revenues are highly correlated with the oil price, with a correlation coefficient of 0.93 during 2000-2020. Hydrocarbon revenues averaged 83 percent of total budget revenues since 2000. Movements in hydrocarbon revenues in Oman have resembled its GCC peers. On the other hand, the non-hydrocarbon tax base is narrow representing on average about 7 percent of total budget revenues and the remaining from non-hydrocarbon non-tax revenues.
- The prominent role of hydrocarbon revenues in the budget has in the past implied a pro-cyclical link between oil prices and government spending, albeit to a lesser degree with a correlation coefficient of 0.53. The lower volatility of spending reflected in part constraints on reducing spending during periods of oil price slumps and increasing it during booms. However, during 2012-2019, Oman ramped up expenditures more than its GCC peers. Government spending has also reflected the tendency to set annual budgets on the basis of conservative oil prices during oil booms and then overspend when prices turned out to be higher than budgeted.

[2] Hydrocarbon includes oil and gas, and it is used interchangeably in this paper.

Figure 1. Revenues, Expenditures, and Oil Price



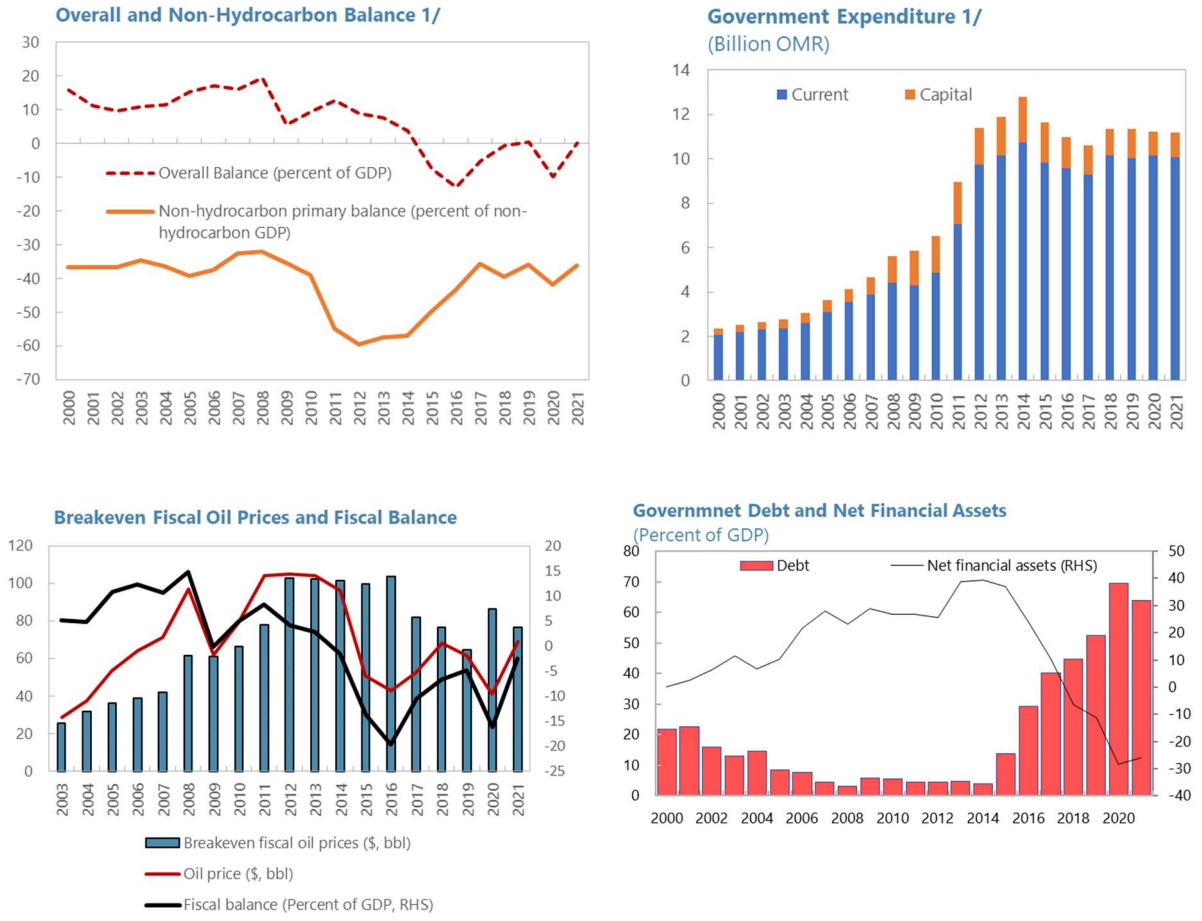
Sources: Country authorities; and IMF staff calculations. Calculations for GCC median include Oman.

7. Prior to 2020, policy frameworks were not sufficiently developed to deal with fiscal vulnerabilities. Fiscal policy was short-term oriented—largely conducted in the context of the annual budget—and reflected a policy preference to build fiscal buffers during booms that supported a gradual approach to any required adjustment when commodity prices fell. Revenue projections generally reflected the oil prices prevailing at the time of budget preparation, while expenditure allocations usually followed a bottom-up approach, with limited medium-term budget planning or consideration of fiscal sustainability.

8. The fiscal position generally deteriorated over 2014-2020. The decline in the overall fiscal balance was driven by movements in oil prices, reaching 14.6 percent in 2008 and -19.6 percent of GDP in 2016. The breakeven oil price—the price at which the fiscal balance would be

zero— increased sharply from early 2000s to 2016 and remained above actual oil prices, given limited progress in reducing government expenditures. Notably, there were large increases in wages and subsidies during 2010-2015. Efforts to contain expenditures intensified after 2016, as the government contained the wage bill and gradually removed fuel subsidies, while ensuring vulnerable groups were protected from the removal of subsidies. Nevertheless, central government debt rose from 29.3 percent of GDP in 2016 to 69.7 percent in 2020 (52.5 percent at end-2019), and net financial assets ratio—central government debt less deposits at depository corporations and OIA's liquid assets—declined from 24.2 percent of GDP to -28.5 percent during the same period.

Figure 2. Fiscal Balance, Expenditure, and Net Financial Assets



Sources: Country authorities; and IMF staff calculations.

1/ Taking out expenditures relating to investment in the oil and gas sector.

9. To address rising fiscal vulnerabilities, the authorities announced the Medium-Term Fiscal Plan (MTFP) and broad public-sector reforms in 2020 (Box 1). The MTFP targets the elimination of the fiscal deficit over the medium term by boosting non-hydrocarbon revenue while restraining fiscal expenditure by improving its efficiency and targeting. In line with the Gulf

Cooperation Council Value-Added Tax (VAT) Treaty, Oman introduced a VAT in April 2021. The government is also preparing to introduce a personal income tax, adopting measures to improve tax collection, and containing expenditures. Furthermore, the government established the OIA to assume ownership of all government companies and investments that were earlier overseen by the MoF. Energy Development Oman (EDO) was also created to manage government investments in oil, gas, and renewables. Revenue of EDO will be shared with the government through royalty taxation, and dividend, after deducting operational spending and debt service.

Box 1. Medium-Term Fiscal Plan (2020-2024) 1/

Oman's Medium-Term Fiscal Plan (MTFP) is a holistic framework designed to achieve fiscal balance over the medium term. The MTFP was published on November 2nd, 2020, to address growing fiscal vulnerabilities and assist the government's adjustment plans. It is shaped and considered as an enabler for "Oman Vision 2040". The implementation of the MTFP will be guided by several economic programs and measures aiming to improve the business environment and stimulate investments, in addition to the launch of a social safety net that will reduce the impacts of the fiscal measures on selected groups of society.

The MTFP is based on five pillars:

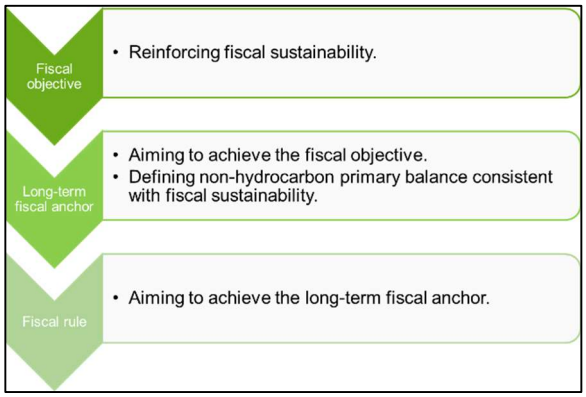
- *Supporting economic growth* through improving business environment and encourage domestic and foreign direct investment.
- *Diversifying and enhancing government revenues* through increasing non-hydrocarbon revenues as a share of GDP to protect against oil price volatility and mobilize domestic resource efficiently.
- *Rationalizing government expenditures* though prioritization, increased efficiency, and larger involvement of the private sector.
- *Enhancing the social safety net* through targeting government support for vulnerable groups, increasing social cohesion, and promoting intergenerational equity.
- *Strengthening public financial management* through fiscal structural reforms and enhanced capacity development.

1/ https://www.mof.gov.om/MediumTermFiscalPlan

10. Oman has made good progress in improving central government fiscal reporting and there is scope to expand data coverage beyond the central government. Since February 2021, the MoF has been publishing the monthly Fiscal Performance Bulletin, with high level aggregates on revenues, expenditures, financing, and economic developments. Some details on central government fiscal outturns are also published in the monthly statistical bulletin by the National Centre for Statistic and Information (NCSI). Nonetheless, there is a limited data collection and dissemination on fiscal operations beyond the central government. As part of the fiscal governance reforms, the MoF intends to regularly publish central government debt management operations.

C. Strengthening Fiscal Frameworks and Anchors

11. Fiscal frameworks enable country authorities to establish mechanisms to reliably ensure that the key objectives of fiscal policy are met. The objectives of fiscal policy differ according to the time horizon in question, ranging from long run fiscal sustainability to short-medium term macroeconomic stabilization (or, for example, economic development), and fiscal frameworks enable authorities to pursue both short and long run objectives in a coherent and consistent manner.

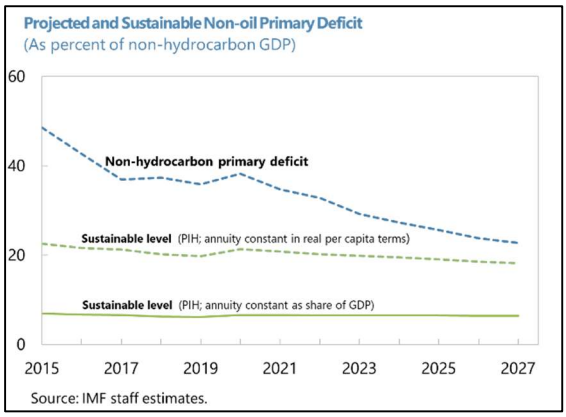


12. In the long run the key objective of fiscal policy is fiscal sustainability. The concept of fiscal sustainability is based on posing the following question: given the current fiscal stance, if the authorities decide to take no further fiscal measures from now onward, can they maintain that posture over the long run? If they can do so, the fiscal position is considered sustainable (and the fiscal sustainability gap is then zero). However, if the fiscal stance is not sustainable, lack of corrective fiscal measures eventually leads to a situation where fiscal assets are depleted and the debt-GDP ratio rises continuously without bound, with interest payments taking an ever-increasing share of government expenditure. This crowds out non-interest spending and increases fiscal financing difficulties until a point is reached where the government is forced to take drastic action to put the fiscal position on a path consistent with sustainability (Kanda 2011, Kanda and Mansilla 2014). Fiscal frameworks typically ensure consistency with fiscal sustainability by adopting a long-term fiscal anchor. The anchor defines a target (or ceiling or floor) for an important fiscal variable which, if met, would ensure that the overall fiscal path is consistent with sustainability.

- In many non-resource-rich countries this is done by adopting a ceiling for the debt-to-GDP ratio—limiting fiscal deficits to levels consistent with a constant or declining debt/GDP path over the long run—which in turn ensures that fiscal financing needs are contained to manageable levels. In line with this, IMF (2021) defines public debt as "...sustainable when the primary balance needed to at least stabilize debt under both the baseline and realistic shock scenarios is economically and politically feasible, such that the level of debt is consistent with an acceptably low rollover risk and with preserving potential growth at a satisfactory level".
- For resource rich countries, such as Oman, explicit account has to be taken of large financial assets and the time horizon of hydrocarbon resources in assessing fiscal sustainability.

13. The most common approach to defining a long-term fiscal anchor in resource-rich countries is based on the Permanent Income Hypothesis (PIH). Here, fiscal authorities estimate net wealth—measured as net financial wealth (financial assets minus debt) plus resource wealth (the present value of future hydrocarbon revenues)—and determine the "sustainable" flow of income from this wealth that can be spent each year while keeping wealth constant (either in nominal terms,

real terms, real terms capita, or as a share of GDP, depending on the authorities' views on intergenerational equity). The anchor is then defined as the non-hydrocarbon primary balance consistent with financing needs not exceeding the sustainable flow of income from net wealth. For Oman, this anchor is estimated to be a nonhydrocarbon primary deficit of 19 percent of nonhydrocarbon GDP (which would keep wealth constant in real per capita terms). Steadfast implementation of MTFP will cause the nonhydrocarbon primary deficit to decline to 24.7 percent of nonhydrocarbon GDP by 2027, significantly reducing the gap with the fiscal position consistent with intergenerational equity, but indicating also that additional consolidation would be needed beyond the medium term to achieve full fiscal sustainability. Once the anchor is achieved, total net wealth would be kept constant although its composition changes over time: the share of hydrocarbon resource wealth will decline over time as hydrocarbon reserves get depleted or as climate change reduces the value of those reserves, but this decline will be offset by an increase in net financial wealth as hydrocarbon revenues are saved and invested.



Box 2. An Overview of the Permanent Income Hypothesis

The permanent income hypothesis (PIH) is a consumption theory that has evolved into a benchmark for designing a long-term macro-fiscal policy to mitigate resource management challenges. The hypothesis aims to answer what is the appropriate savings (and sustainable spending) of resource revenue to maintain fiscal sustainability and intergenerational equity.

For resource-rich economies, the management and preservation of wealth over time is essential due to the exhaustibility of resource revenue, especially for countries with a relatively short reserve horizon.

The PIH provides the framework to addressing intertemporal choices. It designs a constant path of maintaining a net wealth position over time by determining the amount of consumption (saving) for current and future generations.

So how much consumption should be targeted? This depends on how the marginal utility of a unit of consumption out of the resource wealth is maximized across time. Two broad approaches exist for long-term management of natural resources (IMF 2015):

- The ***standard PIH approach*** focus on perfect consumption smoothing across generations. The consumption target is a constant share of the net wealth every year. Two variations of this approach are the Modified PIH and the Fiscal Sustainability Framework that allow for deviation from the standard PIH approach to meet large infrastructure needs for low-income countries. The drawdown under the modified PIH would be offset by fiscal adjustment in the future to rebuild financial assets to the same level as under the standard PIH, while takes into account the expected impact of higher investment on growth and non-resource revenues under the fiscal sustainability framework.
- Under the ***"bird-in-hand" approach***, countries would save all oil revenue as financial assets, with only the yield from the accumulated financial assets spent.

14. However, in the near to medium term, the focus of fiscal policy tends to be on macroeconomic stabilization, subject to the fiscal path not deviating substantially from fiscal sustainability. Notably, fiscal policy should be countercyclical to help stabilize the economy. In times of economic boom, tightening fiscal policy helps contain aggregate demand pressures, which in turn helps contain external imbalances and inflation. On the other hand, in times of economic slack, a looser fiscal policy helps support aggregate demand, jobs, and economic growth. The scale of tightening or loosening envisaged should reflect the size of the output gap as well as the need to pursue a medium-term fiscal path that on average does not deviate substantially from the long run fiscal anchor. Moreover, the volatility of hydrocarbon prices creates additional challenges for macroeconomic stability. Notably, sharp increases in hydrocarbon prices tend to stimulate pressures for additional fiscal spending out of these windfall revenues, which however lay the seeds of future fiscal crises when hydrocarbon prices experience sharp declines that lay bare the need for politically difficult expenditure measures to ensure sustainability. Other near to medium term objectives could include supporting growth, social safety net reforms to improve resource allocation, etc., but these are typically constrained by the macroeconomic stabilization and sustainability objectives.

15. A fiscal rule is often adopted to guide medium-term policy making consistent with the long-term fiscal anchor. Fiscal rules are defined as constraints on fiscal policy through a simple numerical target on fiscal aggregates such as expenditure, revenue, the budget balance, or cyclically adjusted balance. The primary function of fiscal rules is to constrain the government's use of fiscal discretion. Rules are often enshrined in legislation, signaling the importance attached by the government to reinforcing fiscal sustainability, and detail the circumstances under which the rules can be amended. In Oman, the government has an implicit fiscal deficit ceiling of 3 percent of GDP, but this is not legislated.

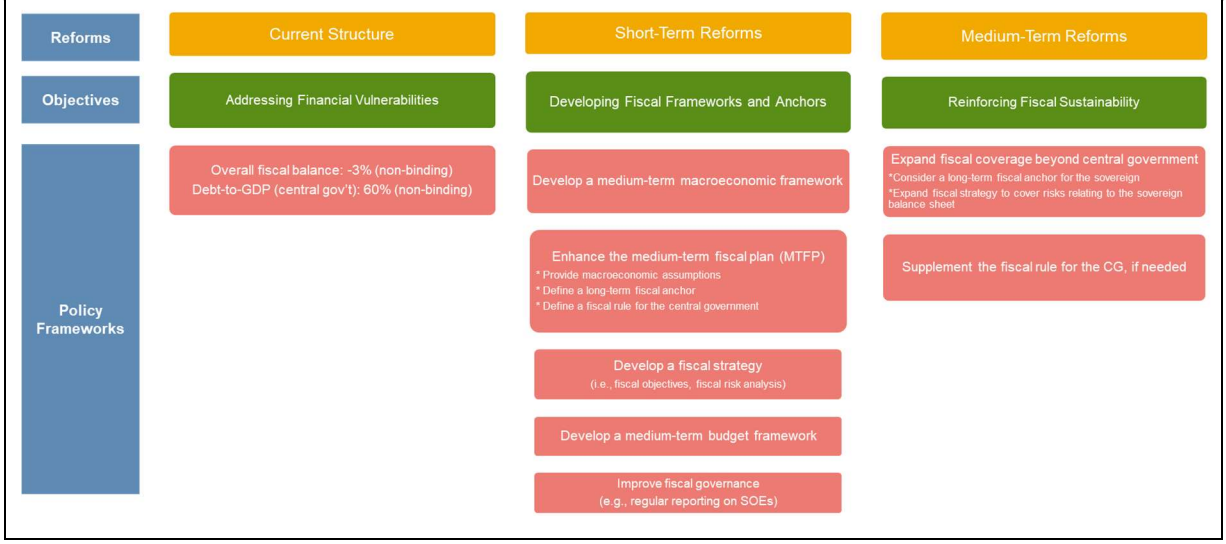
16. A number of desirable features should be considered in selecting an effective fiscal rule. The use of criteria, as highlighted by Kopits and Symansky (1998), ensures that the rules will be able to correct policy biases—by ensuring sustainability and economic stabilization—and perform efficiently—through simplicity, operational guidance, resilience, flexibility, and ease of monitoring and enforcement. In particular:

- *Sustainability*: compliance with the rule should ensure long-term debt sustainability.
- *Stabilization:* following the rule should not increase (and might even decrease) economic volatility. Economic stabilization requires that the rule lets automatic stabilizers operate and/or allows discretionary countercyclical changes in taxes or expenditures.
- *Simplicity*: the rule should be easily understood by decision makers and the public.
- *Operational* guidance: it should be possible to translate the rule into clear guidance in the annual budget process. Budget aggregates targeted by the rule should be largely under the control of the policymaker.
- *Resilience*: the rule should be in place for a sustained period to build credibility, and it should not be easily abandoned after a temporary shock.

- *Flexibility*: the rule should be flexible enough that it can be modified in case of permanent economic shocks. Escape clauses can provide adequate flexibility, but they should be introduced with pre-established rules to trigger them.
- *Ease of monitoring and* enforcement: compliance with the rule should be easy to verify, and policy makers should be held accountable for deviations from the rule.

17. Notwithstanding the significant progress made, fiscal reforms in Oman would best be situated within a broader framework for fiscal policy making (Figure 3). This would entail developing or strengthening: (i) a medium-term macroeconomic framework, which would provide multiyear projections of key economic variables; (ii) a medium-term fiscal framework (MTFF), which would provide multiyear targets or ceilings on aggregate fiscal variables given projected economic variables, subject to sustainability and macro stabilization constraints; (iii) a fiscal strategy document, which translates the MTFF into a statement on medium term fiscal policy priorities and contains fiscal risk analysis; (iv) a medium-term budget or expenditure framework (MTBF or MTEF), which would translate the overall budget envelope from the MTFF into a set of multiyear expenditure ceilings and policies; and (v) an annual budget, which remains the basis for legal appropriations of expenditure but should be consistent with all of the above. Each item, while crucial on its own merits, has interlinked and critical prerequisites for developing and successful implementation of fiscal rules (IMF 2009, 2015). The focus of this paper is on items (i) to (iii). Previous technical assistance from the IMF provided recommendations for introducing a MTBF and strengthening annual budget preparation.

Figure 3. Strengthening Fiscal Frameworks



18. There is a scope to provide greater depth underpinning Oman's MTFP. The document begins with a brief description of global and national economic developments. It also reports fiscal developments since 2014, albeit in a highly aggregated manner, showing total revenues,

expenditures, fiscal balance in nominal terms for the next five years, the share of non-hydrocarbon revenues on total revenues, and the fiscal balance and debt as a percentage of GDP. However, the MTFP does not describe the rationale for the proposed deficit path and the macroeconomic assumptions underlying the fiscal projections. Similarly, the MTFP sets out the five pillars underpinning the fiscal consolidation process—supporting economic growth, revenue enhancement and diversification, expenditure rationalization and efficiency, social safety net, and public financial management and governance—but does not provide details on their fiscal impact. In addition, the MTFP does not report fiscal scenarios, illustrating how fiscal outcomes would be affected by macroeconomic outlook, or provide sustainability analysis.

19. Fiscal risk analysis and management are a key component in strengthening the MTFP. Fiscal risks are factors that may cause fiscal outcomes to deviate from forecasts. The sources of fiscal risks can be exogenous and outside the government's direct control (e.g., oil price shocks) or endogenous and within the control of government (e.g., risks stemming from SOEs). Fiscal risks can be managed with a combination of mitigation, provisioning, and accommodation. While the MTFP should provide sufficient fiscal space to accommodate the realization of fiscal risks, improving oversight and management of SOEs could help to mitigate the related risks. Ongoing SOE reforms are welcome and would enhance competition and efficiently manage public resources. Oman Investment Authority and Capital Market Authority are working together to develop a Code of Governance for SOEs— based on the OECD guidelines on Corporate Governance of SOEs—to strengthen corporate governance.

20. Greater fiscal transparency can help strengthen the credibility of fiscal reforms. Communication on fiscal policy, underpinned by strong fiscal frameworks, contributes to improving fiscal credibility (End and Hong. 2022). Reporting of fiscal developments and outlook, including their underlying assumptions and deviations from them, in line with international standards such as the IMF Fiscal Transparency Code (IMF 2019) is critical for effective fiscal management and accountability. The monthly Financial Performance Bulletin could provide more detail on macroeconomic and fiscal performance, more narrative, and more analytical content. The annual fiscal accounts document could analyze compliance with fiscal targets. In case of non-compliance with the MTFP, the document should explain the causes and the short-term policy options to correct the fiscal path. In addition, a published fiscal risk statement would provide a vehicle for outlining the key risks to the fiscal outlook, describing how these risks affect the MTFP, and summarizing the government's policies for mitigating and managing the risks.

21. Expanding fiscal coverage beyond the budgetary central government will provide a more comprehensive picture on the sustainability of the broader public sector. The current coverage leaves out important spending units such as [139] SOEs that could have significant implications for the sovereign's balance sheet. The ownership of all government investments and public enterprises (excluding Petroleum Development Oman) previously overseen by the MoF transferred to OIA in 2020. These SOEs operate in 11 sectors and with 36,000 staff, accounting for approximately 28 percent of GDP (about US$18.2 billion) at end-March 2021. SOE debt (excluding Petroleum Development Oman) increased from 16 percent in 2015 to 42 percent of GDP in 2021,

with explicit government guarantees to SOEs amounting to about 10 percent of GDP. Furthermore, since September 2021, expenditures on gas and oil sectors were hived off the central government budget to EDO.

22. Commonly used fiscal rules have their strengths and weaknesses. Box 3 provides an overview of various rules. A number of commodity-exporting countries have adopted fiscal rules (Annex I).

Box 3. Overview and Assessment of Selected Fiscal Rules

Overall balance rule: it imposes a ceiling on the headline deficit in percent of GDP. It is simple and easy to communicate to the public. The overall budget balance is closely linked to debt dynamics, making the rule effective in supporting debt sustainability. The large impact of externally driven changes of the oil prices on the overall balance could give misleading signals about the underlying fiscal position and fiscal risks. The rule can also lead to a procyclical fiscal stance (e.g., consolidating to offset the cyclical decline in revenues in bad times and expanding spending in good times).

Golden rule: it imposes a ceiling on the overall deficit net of capital expenditures (also called current balance), aiming to protect capital expenditures which are key to long-term economic growth. This rule is consistent with intergenerational equity, shifting the burden of financing public investment projects from current to future generations that will be the main beneficiaries of such projects. However, it may favor creative accounting through reclassification of unproductive expenditures as investment to circumvent the rule. The rule can also allow excessive borrowing and weaken the link between the targeted deficit and debt dynamics, creating possible risks to debt sustainability.

Cyclically adjusted rule: it imposes limits on the overall balance, correcting for the effects of business cycle fluctuations on revenues and expenditures. By disconnecting spending from cyclical revenues and letting automatic stabilizers operate freely, such rule can be used to stabilize the path of expenditures. Changes in the cyclically adjusted balance are, in principle, closer to the discretionary fiscal efforts, whereas an equivalent decline in the nominal fiscal balance might simply reflect a deterioration in cyclical conditions. However, monitoring and enforcing cyclically adjusted balance rule is challenging, as it requires timely and reliable estimates of the output gap, which is often hard to estimate, particularly in countries that are undergoing structural changes and those with poor data quality. Cyclically adjusted balances are also prone to frequent ex-post revisions resulting from measurement errors of potential output.

Structural rule: it is an extension of cyclically adjusted rules (Bornhorst et al. 2011), as it adjusts the overall balance beyond the business cycle by correcting revenue and spending for one-off fiscal measures and other economic cycles, such as those related to asset or commodity prices. The structural budget balance allows for the smoothing of oil price volatility when setting spending decisions. Specifically, expenditure is set based on an estimate of the long-term oil price—say, a 5 or 10-year average—and a target for the structural balance.

Expenditure rule: it sets a target on total, primary, or current spending. The rule is typically set in absolute terms (levels) or growth rates and occasionally in percent of GDP (and non-resource GDP for commodity exporting countries), with a time horizon that typically ranges from three to five years (Lledó et al. 2017). Expenditure rules in levels and growth rates allow automatic stabilizers to operate on the revenue side in times of adverse shocks, while expenditure rules set as a ratio of GDP tend to be procyclical.

Revenue rule: it sets floors or impose ceilings on government's income proceeds. Neither revenues floors nor ceilings constrain spending, and therefore the rule does not ensure achieving fiscal sustainability. It can also complicate macroeconomic stabilization efforts by, for example, hiking taxes in bad times.

Non-resource primary balance rule: it excludes resource revenues and resource expenditures, which is more suitable for assessing long-term sustainability and fiscal risks in resource rich countries. The rule gives good signals about the underlying fiscal stance, with an increase in the non-resource primary deficit indicating a loosening of fiscal policy arising either from higher expenditure or a relaxation of non-resource revenue collection.

Box 3. Overview and Assessment of Selected Fiscal Rules (concluded)

A reduction in the non-resource primary deficit would signal fiscal consolidation. The short-run macroeconomic impact of a loosening/tightening the non-resource primary deficit is similar to increase/decrease in the overall deficit in a conventional economy (Medas and Zakharova. 2009). Non-resource primary balance is usually normalized by non-resource GDP to avoid the fluctuation caused by commodity prices and to better reflect the domestic economy.

Assessment of Fiscal Rules

Overall Balance	**Golden (overall deficit net of capital expenditure)**
+Easy to communicate and monitor	+Protect public investment
+Closely linked to debt sustainability	+Intergenerational equity
+Clear operational guidance	- Weak link to debt sustainability
-Could lead to procyclicality	- Creative accounting
-Could adversely affect quality of adjustment	
Expenditure	**Revenue**
+Easy to communicate and monitor	+Raise revenue or limit tax burden
+Allow macroeconomic stabilization	-Weak link to debt sustainability
+Clear operational guidance	-Could lead to procyclicality
+Could ensure debt sustainability if well-designed	
-Could adversely affect quality of adjustment	
-May reduce incentive to raise revenues	
Cyclically Adjusted and Structural	**Non-Resource Primary Balance**
+Foster economic stabilization	+Easy to monitor
+Good operational guidance	+Could encourage non-resource revenue generation
-Difficult to compute and monitor	-Difficult to communicate
	-Narrow coverage and weaker link to financing needs/debt

Source: IMF 2018a; and authors.

23. While all desirable features may not be simultaneously achievable with a single fiscal rule, the choice should reflect Oman's circumstances. The more flexible the rule to adapt to macroeconomic shocks, the more complex its design is likely to be (e.g., rules that correct for the impact of business cycles by targeting cyclically adjusted balances). Another trade-off could exist between resilience and operational guidance, where rules that include flexibility provisions (e.g., escape clauses) might complicate the budget process as fiscal targets can change with circumstances. Furthermore, using multiple rules has become a global trend that emerged after the financial crisis, as countries sought to address shortcomings and trade-offs involved in single rules (what is referred to as second generation rules, Eyraud et al. 2018). It has a drawback, however, of increasing the complexity of the framework and potential inconsistencies and overlap between the rules.

24. On balance, a rule based on the non-hydrocarbon structural primary balance could be appropriate for Oman.[3] Such rules have the benefit of disconnecting spending from the volatility of oil and gas prices and economic fluctuations. Delinking expenditure decisions from commodity price volatility requires saving some of the hydrocarbon revenue when prices are high and drawing on these savings to finance expenditure when prices fall. However, estimating cyclically adjusted balance or structural rules could be challenging because of the assumptions utilized to define the

[3] Annex II provides illustrative simulation of fiscal outcomes for selected fiscal rules.

targeted balance. In addition, monitoring compliance requires timely and reliable estimates of the output gap—as real-time assessment of the cyclical position of the economy is difficult especially given ongoing structural reforms under Vision 2040—and long-term commodity prices, which can be challenging to prepare regularly. Therefore, further developing institutional capacity within the MoF and enhancing data quality will be perquisites in developing these rules. In the meantime, complementing the implicit overall balance rule in the MTFP, a rule on the non-hydrocarbon primary balance can be explicitly linked to the long-term fiscal anchor.

D. Conclusion

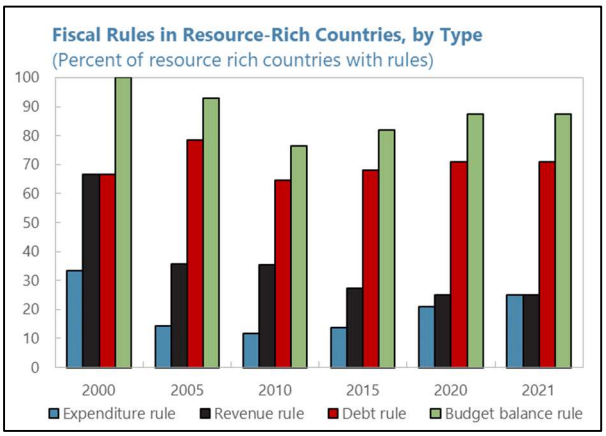
25. Strong fiscal frameworks are important for Oman because of its significant reliance on hydrocarbon resources. The high fiscal reliance on hydrocarbon revenues—which are non-renewable resources—combined with the volatility of oil and gas prices have resulted in large swings in public expenditures and consequently GDP growth. This increases the need for well-designed fiscal frameworks to reinforce fiscal sustainability while taking into account stabilization, development, and intergenerational equity in the use of hydrocarbon resources.

26. Once fiscal frameworks are well-developed, a formal fiscal rule could be considered as a way of reinforcing fiscal frameworks. Successful implementation of fiscal rules is generally preceded by a period of fiscal consolidation and strengthening fiscal frameworks. The eventual introduction of a fiscal rule could help the government achieve its long-term fiscal policy objective, but the focus should be first on further strengthening fiscal frameworks. One key question before the government is to define its long-term fiscal anchor, where it would provide a guide to formulate fiscal rule(s). In thinking about its long-term fiscal anchor and a possible fiscal rule, the authorities will have to balance short-term macro-management, medium-term development, and longer-term saving goals.

Annex I. Fiscal Rules in Commodity-Exporting Countries[1]

Countries' experiences show that fiscal rules have the potential to prevent excessive deficits, smooth shocks, and address intergenerational equity challenges, particularly when supported by strong institutions.

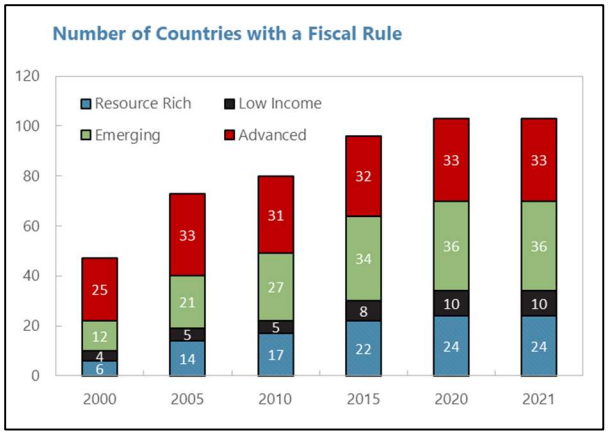
1. Fiscal rules have become common in resource-rich countries. The number of resource-rich countries with fiscal rules increased from 6 in 2000 to 24 by 2021, and such countries are increasingly using more than one fiscal rule. Rules targeting the budget balance are the most common, combined in many countries with a public debt rule. Expenditure rules are gaining popularity among resource-rich countries. In most resource-rich countries, standard fiscal rules are modified to take into account fiscal sustainability and commodity price volatility. While some such countries target traditional fiscal aggregates such as the overall balance and debt, non-resource balance and structural balance rules are more common among resource-rich countries.



2. Generally, rules for commodity exporters can be classified in two categories, depending on the rule's main objective (IMF 2018a):

- *Rules to cope with price volatility and achieve macroeconomic stability*: using fiscal rules for stabilization purposes is particularly relevant for countries with long commodity reserve horizons, where exhaustibility is not a primary concern. Within this category, potential rules include—but not limited to—revenue split, price smoothing, structural balance, and expenditure rules.
- *Rules to ensure fiscal sustainability and an equitable intergenerational allocation of resources*: while all commodity-exporting countries need to ensure the sustainability of public finances, this issue is particularly relevant in countries with a relatively short commodity reserve horizon. Given the prospect of resource depletion, the main purpose of fiscal rules is to determine the amount of savings (and sustainable spending) for current and future generations (IMF 2012).

[1] Based on Fiscal Rules and Fiscal Councils Database (2021) and authors.



3. Botswana (expenditure rule, since 2003): a ceiling on the expenditure-to-GDP ratio is set at 40 percent. Botswana also introduced a debt rule in 2005 that limits domestic and foreign debt each to 20 percent of GDP.

4. Chile (structural balance rule, since 2001): under the structural balance rule, government expenditures were budgeted in line with a structural balance target and structural revenue, that is, revenues that would be achieved if: (i) the economy were operating at full potential; and (ii) the prices of copper and molybdenum were at their long-term average (10-year). Starting from the 2015 budget, the government no longer adjusts revenues based on long-term prices of molybdenum. The expenditure is the residual, after subtracting the structural balance target from the estimated structural revenue. The implementation of the rule has changed over time: from 2001–07, a constant target for the structural balance (a surplus of 1 percent of GDP was defined to help eliminate debt and accumulate assets for the future); in 2008, the target was changed to 0.5 percent of GDP; and in 2009, the target was set at zero, and an escape clause was introduced to accommodate countercyclical measures—which helped Chile weather the global financial crisis. A fiscal council established in 2013 to oversee two existing independent committees—on potential GDP and long-run copper price—and ensure such parameters are correctly used in the computation of the structural balance. The council also advises the Minister of Finance on issues regarding the structural balance rule. The council, whose views are made public, but not binding, to help enhance the rigor and transparency of the rule.

5. Norway (non-oil primary balance rule, since 2001): the fiscal rule ties the non-oil primary deficit to the investment income of the sovereign wealth fund (SWF). Net cash flows from oil and gas are transferred to the SWF to accumulate financial assets and the government can use only the yield from these assets for spending. The rule sets a ceiling on the non-oil primary deficit not to exceed 3 percent of the accumulated financial wealth, which corresponds to the expected long-run real rate of return of its SWF. However, the transfer from the SWF could be higher during downturns for the purpose of countercyclical stabilization and expenditure smoothing.

6. Russia (evolving rules, since 2007): its first fiscal rule (2007-2009) targeted a long-term non-oil deficit of 4.7 percent of GDP to be achieved by 2011, was suspended in 2009 to allow for a fiscal package to stimulate the economy during the global financial crisis. The rule was abolished in 2012 and replaced with a redesigned fiscal rule beginning in 2013. The revised rule (2013-2017) set a ceiling on expenditures equivalent to the sum of oil revenue (measured at the benchmark oil price), plus non-oil revenues, plus a net borrowing limit of 1 percent of GDP. Benchmark oil revenues are calculated according to a 10-year backward looking oil price rule. Oil revenues above the "benchmark" oil price need to be saved in the Reserve Fund until it reaches 7 percent of GDP. Once the Reserve Fund reaches this threshold, at least half of excess oil revenues should go to the National Wealth Fund, while the remaining resources would be channeled to the budget to finance

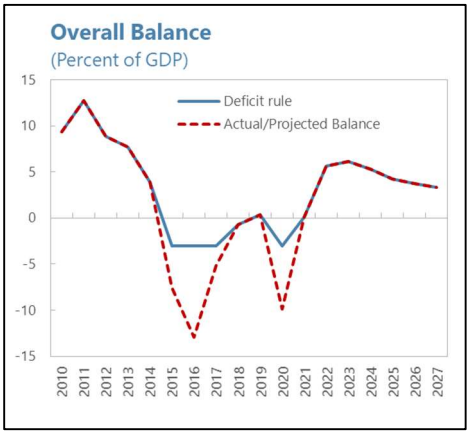
infrastructure and other priority projects. When oil prices are below the benchmark, the Reserve Fund could be tapped to maintain expenditures. In case of a prolonged decline in oil prices, the benchmark oil price formula is reset to equal the three-year backward average. However, after the 2014 oil shock, the rule did not allow a fast-enough adjustment of the benchmark oil price, which led to it suspension in 2015 (as its continued implementation would have led to unwarrantedly large non-oil fiscal). In 2018, the authorities started the implementation of a modified fiscal rule targeting a non-oil primary deficit of 1 percent of GDP in 2018 (and zero for 2019 and beyond)—at a fixed benchmark oil price per barrel of $40 (in real 2017-dollar terms) with a proposed annual adjustment by the US CPI inflation.

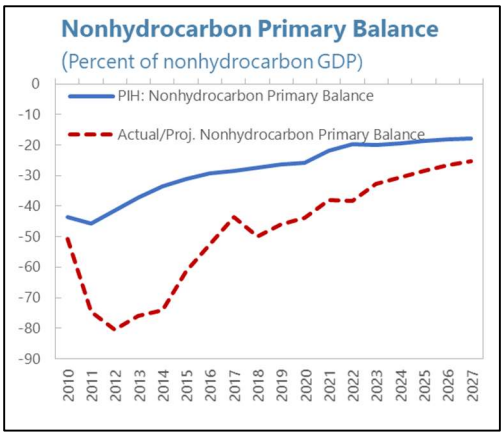
7. Timor-Leste (non-oil primary balance rule, since 2005): annual transfers from the Petroleum Fund to the budget are equal to the Estimated Sustainable Income (ESI), set at 3 percent of government wealth. The government wealth is estimated as the sum of financial assets in the Petroleum Fund and the net present value of expected future petroleum revenues. This formulation is in line with the permanent income hypothesis approach and the ESI is updated annually (i.e., the path of the non-oil primary fiscal deficit is calculated based on the PIH model), allowing for deviation from it to scale up public investment.

Annex II. Illustrative Simulation of Fiscal Outcomes Using Fiscal Rules

The simulations, which are for illustrative purposes only, are carried using historical data (2010-2020) and projections (2021-2027) to illustrate how Oman's budgets would have performed under the selected rules.[1] Designing fiscal rules that would yield the right mix of sustainability, simplicity, counter-cyclicality and policy guidance is a complex exercise that goes beyond the scope of this paper. For the simulations, the first step is to determine the fiscal balance in each fiscal year based on each rule. If the actual fiscal balance (depending on the rule) has a better outcome than the ceiling implied by the rule, then the rule will not be binding, and actual figures are used for that year.[2] Otherwise, the fiscal outcome will be bound by the rule-implied ceiling. While these simulations are illustrative and carried out only for selected rules, the results show a nonhydrocarbon primary balance rule, and an expenditure rule are more binding in ensuring long-term debt sustainability and economic stabilization compared to an overall balance rule. In particular:

- *Overall fiscal balance rule:* this rule tends to lead to a procyclical stance. During the boom in oil prices in 2010-2014, the rule would have permitted a ramping up of spending as higher oil revenues enabled the deficit rule to be met quite easily, with overall fiscal surpluses masking the expansionary fiscal policies where non-hydrocarbon balance deteriorated sharply (from -50 percent in 2010 to -80 percent of non-hydrocarbon GDP in 2012). Such a rule was also rarely binding except for 2015-2017 (after the 2014 oil shock) and 2020 (during the dual shock of the pandemic and a collapse in oil prices).
- *The non-hydrocarbon primary balance rule:* the rule excludes hydrocarbon revenues and expenditures and is therefore a better measure of the impact of fiscal policy on domestic demand. For the simulations: (i) for 2010-2020, the non-hydrocarbon primary deficit ceiling as a percent of non-oil GDP is set based on the average



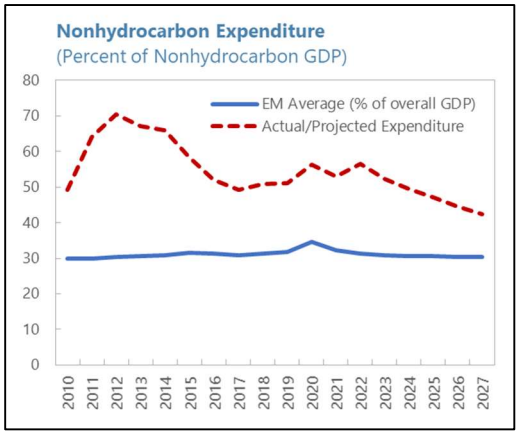


[1] Balances are adjusted to take out hydrocarbon capital and operation expenditures, which is consistent with internationally accepted practice.

[2] Taking out expenditures relating to investment in the oil and gas sector.

of PIH benchmark for a particular year[3]; and (ii) for 2021-2027, the ceiling corresponds to 2021 medium-term benchmark calculated using the PIH. The results indicate that the rule would have been binding during 2010-2020. The rule would also have been consistent with long-term fiscal sustainability and would have been more countercyclical compared to the overall balance rule. Nevertheless, setting a non-hydrocarbon primary balance rule can be challenging. The estimation and communication of the equilibrium level for fiscal sustainability can pose challenges. In addition, a suitable mechanism has to be designed to structure the adjustment in cases when there is a sizeable gap between the current non-oil primary deficit and the equilibrium level and to allow for periodic revisions of the medium-term benchmarks to reflect changing conditions (e.g., assumed long-term oil and gas prices, proven reserves and production levels, rate of return on financial assets).

- *The expenditure rule:* the rule imposes a ceiling on government spending in percent of nonhydrocarbon GDP, where the ceiling is estimated based on emerging economies average of expenditure to GDP. The simulation results show the rule would have been binding and steadfast implementation of the MTFP would significantly narrow the over the medium-term. An important drawback of this rule is that it leaves revenues outside the coverage of the rule. Hence, were revenues falling as a share of GDP, the rule could allow for widening deficits over time, since the expenditure-to-GDP ratio would remain broadly constant under the rule.



[3] As previously estimated by the IMF staff at that point of time.

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THE PATH TOWARD STRONGER GROWTH IN OMAN[1]

Oman's robust economic growth in past decades has generated substantial improvements in social welfare and financial wealth. Nevertheless, the growth momentum supported by the production of hydrocarbons has been showing limits, especially given the prospect of a permanent shift in global demand triggered by the transition to a low carbon economy. To navigate toward stronger, job-rich, and sustainable growth, well-crafted and carefully sequenced reforms would be needed. The authorities' reform agenda, under the strategic direction of Oman Vision 2040, is a big step in the right direction. Steadfast implementation of these reforms is critical to fully unlock the potentials of the well-educated national labor force and accelerate the non-hydrocarbon private sector-led growth.

A. Context

1. Oman has registered significant economic development in past decades, supported by large hydrocarbon production.[2] Oil and oil-related production, which accounted for about 36 percent of total real GDP in the period of 2016–2020, continues to be the key pillar of Oman's economy, sustaining the wellbeing of its nationals and contributing to the accumulation of sovereign wealth. Export diversification has improved with both volume and types of non-oil exports expanded, but exports of manufactured goods are generally of lower technology values.

2. Nonetheless, economic competitiveness has declined mostly owing to lower productivity and relatively high wages. The segmented labor market, as shown by the wage gap between the public and private sectors and the relatively large share of Omani citizens in the public sector, has hindered the growth of labor productivity. Public investment has resulted in high-quality and well-developed infrastructure, but private corporate investment has slowed down, associated with declining profitability.

3. Against this backdrop, this paper analyzes the characteristics of and challenges facing Oman's economy through the lens of a production function and provides policy and reform recommendations to lift growth potentials. The paper is structured as follows: section 2 analyzes characteristics of Omani economy; and section 3 discusses the policies and proposed reforms. The last section concludes.

B. Characteristics of Omani Economy

Economic Output and Export

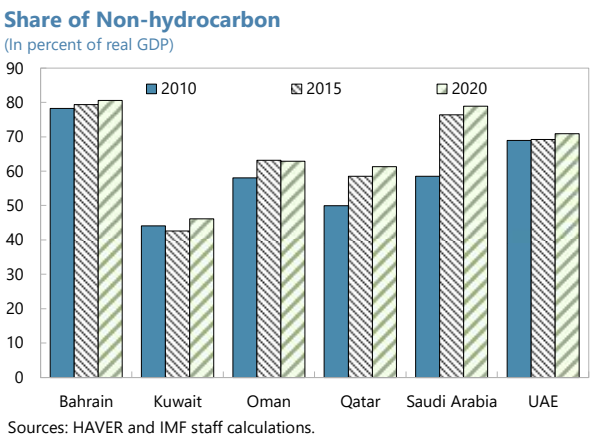
4. Large oil wealth has supported economic development and lifted living standards in Oman in the past several decades. In 2016–2020, crude oil and natural gas production accounted

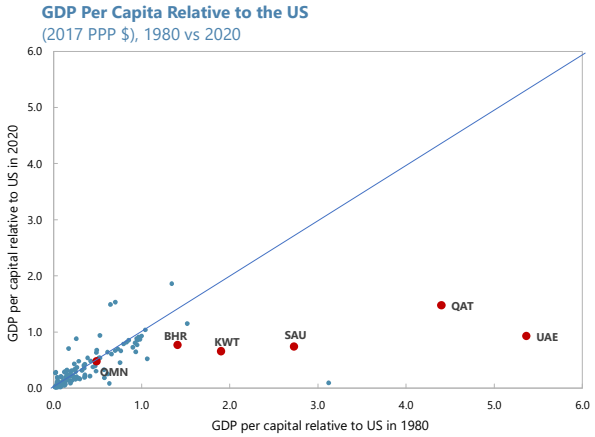
[1] Prepared by Fei Liu.

[2] Hydrocarbon sector includes oil and natural gas production, and downstream oil and gas activities such as refining and petrochemical manufacturing.

for about 32 percent of total real GDP, and downstream oil and gas activities such as refining and petrochemical manufacturing accounted for about 4 percent of total real GDP. Nonetheless, progress in raising the share of the non-oil sector in the economy in the past 10 years has been limited—from 58 to 63 percent of real GDP between 2010 and 2020. Living standards were broadly maintained at the same relative level in the past forty years—GDP per capita in Oman was about half of the U.S. level in 1980 and in 2020 (Figure 1).

Figure 1. Size of Non-hydrocarbon Sector and GDP Per Capita



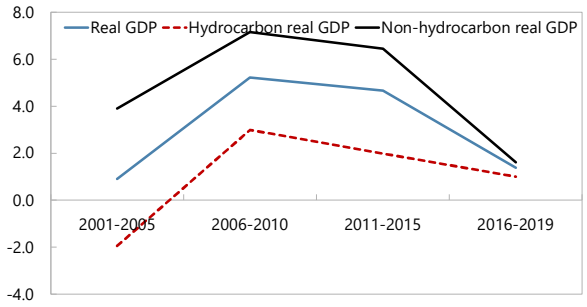


Sources: Haver, country authorities, and IMF staff calculations.

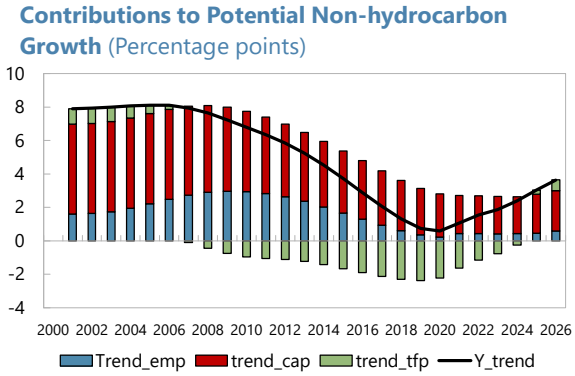
5. Real non-hydrocarbon GDP growth has slowed down since the global financial crisis. In the period 2001–05, real GDP growth averaged around 0.9 percent while non-oil growth averaged around 3.9 percent per year. Real GDP growth increased to about 5.2 percent per year between 2006 and 2010 with non-oil growth averaging around 7.2 percent. However, real GDP growth has slowed since the 2014 oil price slumps (Figure 2). Oman's potential growth has slowed down in recent years, driven by the declines in trend growth of capital investment growth, employment, and total factor productivity (TFP).[3] The global financial crisis and 2014 oil price plunge have weighed on confidence, investment, and growth in both the hydrocarbon and non-hydrocarbon sectors. The contribution of total factor productivity (TFP) has been relatively small, and its contribution turned negative since the global financial crisis. In 2020, the COVID-19 crisis and oil price shock caused a large recession notwithstanding a range of policy support measures, which could have caused damage to the economy, bringing to the forefront the urgent need for reforms.

[3] Non-oil capital stock is approximated by using overall capital stock (calculated by perpetual inventory approach) minus capital stock of the large oil and gas companies based on company-level financial data sourced through S&P Market Intelligence.

Figure 2. Average Growth and Contribution to Potential Non-hydrocarbon Growth



Sources: Country authorities and IMF staff estimates.



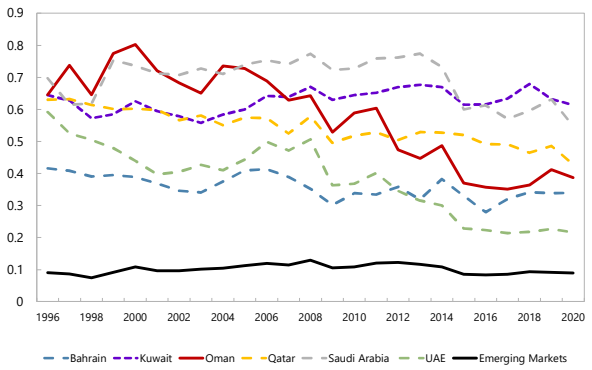
Sources: Country authorities and IMF staff estimates.

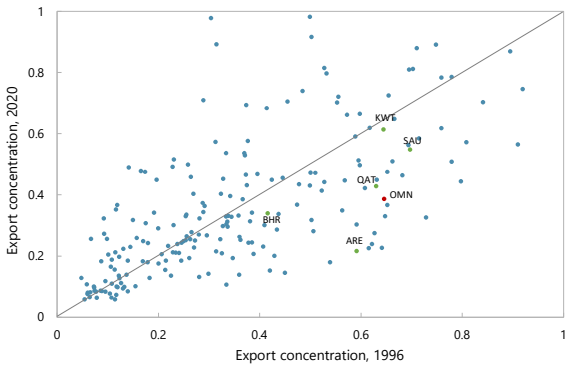
6. Export diversification has improved but there is still a large scope for improvement (Figure 3). Introducing new goods and tasks would allow active learning and progress up the quality ladder, which would make investment and labor more productive and increase overall productivity. Economic diversification is a stage that countries typically experience before they move into more advanced stages of development and become more specialized on products with high technology content (Lian and others, 2021). Hausmann, Hwang, and Rodrik (2007) show empirically that export sophistication is one of the major determinants of growth, accounting for initial conditions, institutions, financial development, and other growth factors. Over the years, Oman has progressed toward more export diversification, although GCC countries in general lag Emerging Market countries (EMs) in the overall degree of export diversification, due to the dominance of oil exports.

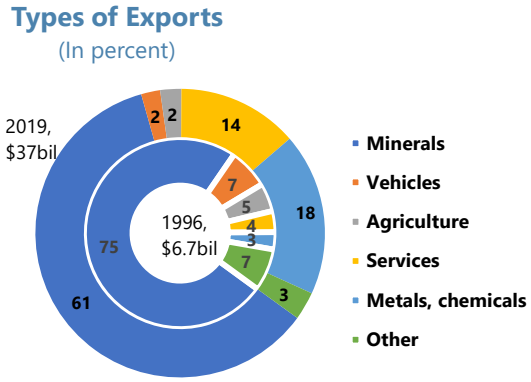
7. The volume and types of non-oil exports have expanded. Though total exports are still dominated by oil and minerals, the share of oil and minerals has decreased from 75 percent of all exports to about 61 percent between 1996 and 2019. In 2019, the non-oil export basket accounted for about 39 percent of the total export and included a range of goods and services such as chemicals, agricultural products, metal, vehicles, electronics, textile, and services.

8. Exports of manufactured goods are generally of lower technology values. Oman's export share of high-technology products is low, compared to high-income countries, but relatively high if compared to GCC countries who also rely on oil and oil-related exports. Goods with higher technology values generally are more knowledge-intensive, entail more transfer of technology and innovation and thus more spillover effects to other domestic sectors. The relatively small size of Oman's knowledge-intensive exports imply that the trading sectors still have room to deepen their participation in the global value chains and grow.

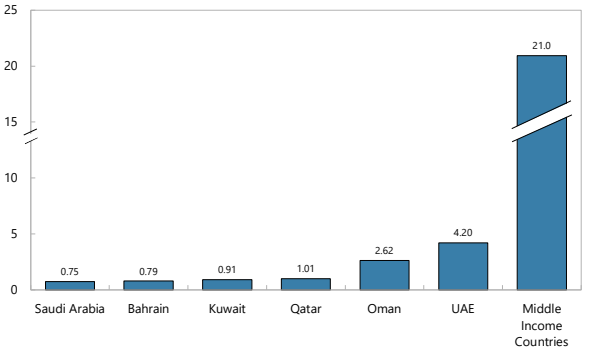
Figure 3. Export Diversification







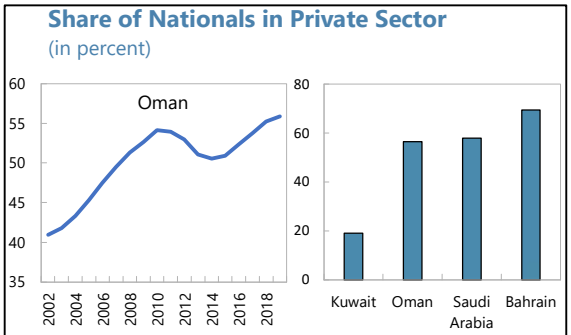
Sources: Atlas of Economic Complexity, IMF staff calculations.



Sources: United Nations, Comtrade database through the WITS platform.

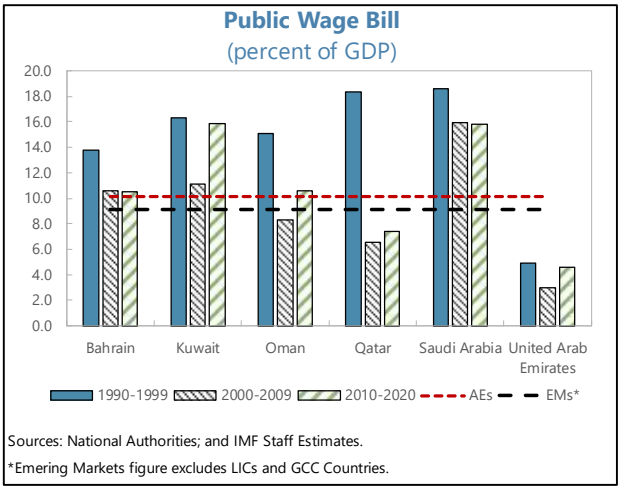
Labor Market

9. Public sector jobs, which generally pay higher wages and benefits and provide greater job security, remain attractive but the share of Omanis working in the private sector has been rising. Private sector employment relies more on expatriate workers (IMF, 2021). There were about 1.4 million expatriate workers in Oman by the end of 2021, accounting for 80 percent of total employment. The government of Oman has been implementing policies to promote employment of Omanis in the private sector, and the share of nationals in the private sector employment has been generally trending up in the past two decades.



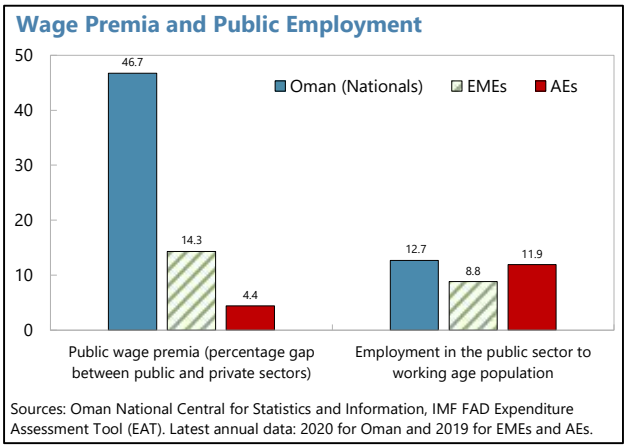
Source: Haver, Oman NCSI, and IMF staff calculations.

10. With a young population, large numbers of young Omanis are expected to enter the labor market over the medium term, while at the same time the room for the public sector to continue to absorb new labor has become increasingly limited. Based on the population structure, in a five-year horizon nearly 280,000 young Omanis would be added to the working-age population, and taking account of rates of labor participation and replacement of retirees, about 120,000 new jobs will need to be created. Consequently, based on the estimated employment-output short- and long- term elasticities between non-oil growth and employment of national and expatriate labor forces in the GCC (Behar, 2015), it is estimated that the non-oil sector would need an annual growth rate of about 6.8 percent to offer sufficient opportunities to job seekers. The relatively high government wage bill points to limited capacity to absorb additional employees without adding to fiscal vulnerabilities.



Sources: National Authorities; and IMF Staff Estimates.
*Emering Markets figure excludes LICs and GCC Countries.

11. A segmented labor market with wage gap between the public and private sectors and skills mismatch hinder employment of Omanis in the private sector. The sizeable wage gaps skew the supply of Omani labor toward the public sector and the demand for labor in the private sector toward expatriates.[4] Also, differences in labor policies between nationals and expatriates, pertaining to dismissal procedures, pensions, and other social security rules, also contributes to making nationals less attractive to businesses to the extent that these differences make employing nationals more costly.[5]



Sources: Oman National Central for Statistics and Information, IMF FAD Expenditure Assessment Tool (EAT). Latest annual data: 2020 for Oman and 2019 for EMEs and AEs.

12. The efficiency of public spending on education can be improved and labor skills can be diversified further.[6] Oman has made big strides in raising educational attainment, and Omani

[4] The wage premia are calculated for Omani workers only due to data availability. Average wage is calculated by the median of each wage range weighted by the number of employed, and the public sector wage premium is the difference between the public sector average wage and national average wage, and the private sector wage premium is the difference between the national average wage and the private sector average wage.

[5] See GLMM, 2014, Arab Gulf States: An Assessment of Nationalisation Policies. Also, according to the *2021 Investment Climate statements: Oman*, the top complaints of businesses often relate to requirements to hire and retain Omani national employees and a heavy-handed application of "Omanisation" quotas (for details, see https://www.state.gov/reports/2021-investment-climate-statements/oman/)

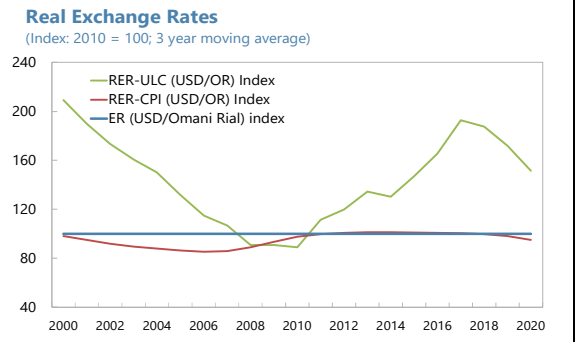
[6] For details, see Annex III in Oman 2021 Article IV Consultation Staff Report.

workers are better educated on average than expatriates. Nonetheless, while educational outcomes, as proxied by TIMSS scores, are similar to EM average, Oman's public spending on education is higher than averages in EMs, and skills mismatch remains a challenge as a large share of college graduates majored in business, administration and law (IMF, 2021).

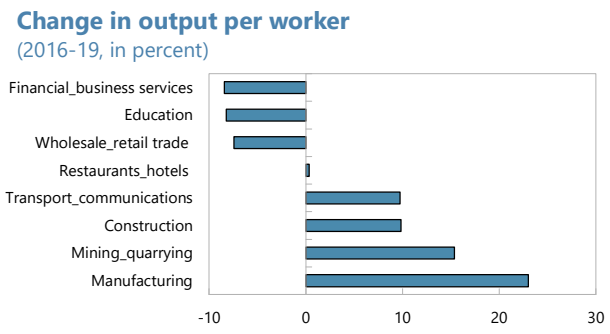
13. Expatriates have contributed to economic growth in the past decades and will likely continue to play a role in future development. The use of foreign labor has helped overcome periods of local labor shortages and contain overheating pressures during periods of high oil prices. It has also helped to reduce the pace at which price competitiveness declined by containing the increase of aggregate wage levels, given the lower wages of expatriates.

Productivity and Competitiveness

14. Competitiveness has declined mostly owing to lower productivity and relatively high wages. Rising oil prices since 2000 have helped finance rapid increases in public spending, which has led to strong growth in consumption demand and boosted the low-productivity domestic non-tradable sector (IMF, 2014). The unit labor cost (ULC)-based real exchange rate (RER) reveals a significant decline in Oman's competitiveness owing to the divergence between wage and price inflation rates (IMF, 2021). Although sectors including transport and communication, construction, and manufacturing have shown improvements in output per worker in recent years (2016-2019), some service sectors such as financial and business services, education, wholesale, and retail trade have shown lower output per worker.[7] Bolstering competitiveness would require lowering unit labor costs by increasing productivity and containing relatively high average wages.



Sources: UNIDO INSTAT database, FRED Economic Data, and IMF staff calculations.
UNIDO INSTAT data cover manufacturing industry only.

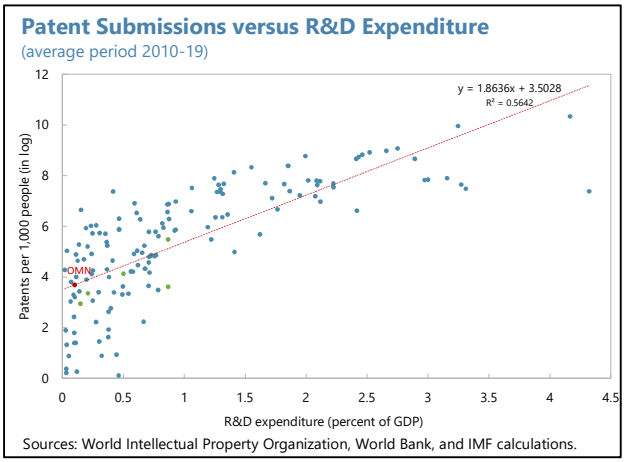


Source: Oman National Center for Statistics and Information; IMF staff calculations.

15. Expenditure on research and development (R&D), which is closely related to innovation, has been low in Oman. R&D expenditure as a share of GDP has averaged 0.1 percent during 2010-19, compared to 2.4 percent in AEs. A significant correlation between R&D and innovation has been intensively discussed in literature, and the figure illustrates this relationship, using the number of submitted patents per capita as a proxy for innovation. The COVID-19

[7] Due to data limits, the sectoral analysis starts from 2016. It ends in 2019 to avoid including the transitory impact from COVID-19 pandemic.

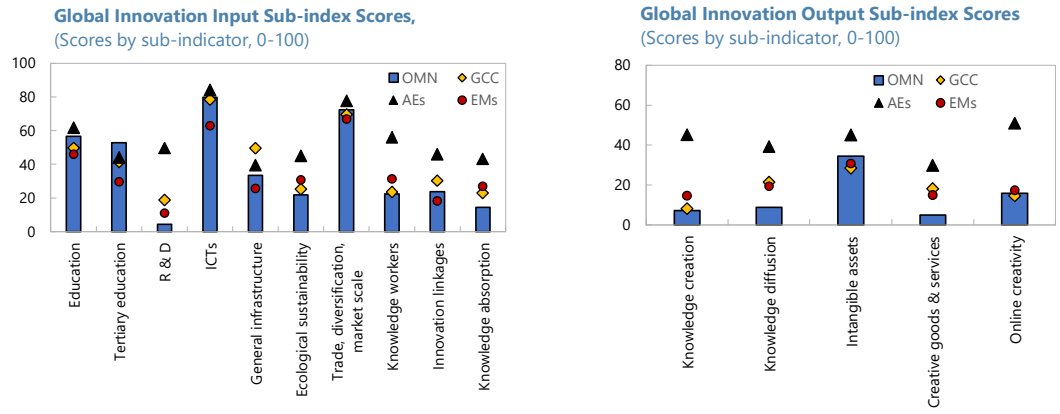
pandemic revealed the strong potential of digital technology in generating future growth opportunities, such as emerging clusters of opportunities related to the accelerated shift to e-commerce, increasing use of digitalization and modern communication technology in daily life (e.g., telehealth, online education, and working remotely).



Sources: World Intellectual Property Organization, World Bank, and IMF calculations.

16. Oman's innovation outputs have been limited relative to its level of innovation investments (Figure 4). A major benefit of innovation is its contribution to economic growth. Innovation can lead to higher productivity, expansion of new business and production opportunities, and greater global market share. As more goods and services are produced with higher productivity, the economy grows and standards of living increase. Measured by the Global Innovation Index (GII), Oman produces less innovation outputs relative to its level of innovation investments.[8] Oman does well in terms of education, information and communication technologies (ICTs), and infrastructure inputs. However, the high level and standard of education and good infrastructure haven't been fully utilized to generate innovative output—Oman lags in terms of the output indices, measured by knowledge creation, knowledge diffusion, and other creative goods and services. These output sub-indices are built on variables including patent applications filed by residents, scientific and technical articles published in peer-reviewed journals, the entry density of new firms, spending on computer software, the number of certificates of conformity with standard ISO 9001 on quality management systems issued, and high-tech exports (net of re-exports) as a percentage of total exports, etc.

Figure 4. Global Innovations Index



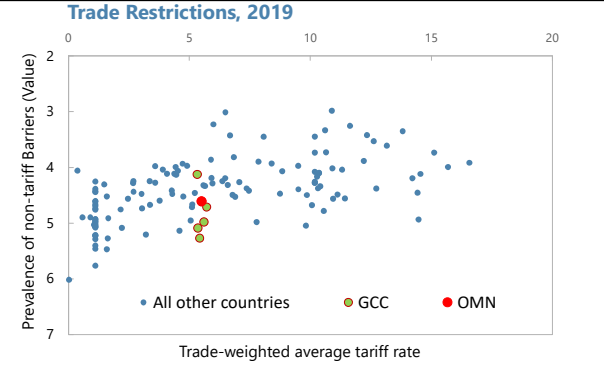
Sources: Global Innovation Index, and IMF staff calculations.

[8] See Global Innovation Index 2021, Oman. Consisting of roughly 80 indicators, the GII aims to capture the multi-dimensional facets of innovation. The charts used innovation input sub-indices, including human capital and research, infrastructure, market sophistication, and business sophistication; and output sub-indices include: knowledge and technology outputs, and creative outputs.

Business Environment and Governance

17. Oman has been making efforts to improve the business environment and governance, which have broadly contributed to attracting investment and enhancing efficiency. Oman's business environment has experienced steady improvements in recent years, with simplified procedures in starting a business and dealing with various permits. Since the launch of "Oman Vision 2040" under the leadership of Sultan Haitham, Oman has implemented a range of reforms to further improve the business environment and attract private investment. These efforts include:

- Updated Oman's Commercial Companies Law (CCL), Foreign Capital Investment Law (FCIL), Privatization Law, Public-Private Partnership Law, and Bankruptcy Law. Oman's Capital Market Authority (CMA) issued regulations on shareholders and boards of directors in 2019 for a more transparent and robust corporate governance system. In October 2021, the Executive Regulations of the CCL was issued to improve the regulatory framework of commercial companies. Under the new FCIL, 100 percent foreign-owned company is allowed, and single shareholder companies are also allowed. More clarity on the exact scope of business activities that would be allowed to be 100 percent foreign-owned is being developed.
- Created the Public Authority for Special Economic Zones and Free Zones (OPAZ) in August 2020 to facilitate investment in the Special Economic Zones.
- Restructured the Ministry of Commerce, Industry, and Investment Promotion (MOCIIP) to provide a comprehensive range of business formation and private-sector development support, including investment advice to foreign companies looking to invest in Oman, especially in key target sectors that the country's diversification program identifies.[9] On trade restrictions, though the trade-weighted average tariff rate is about the same as in other GCC countries, its prevalence of non-tariff barriers[10] is relatively high compared to other GCC countries.



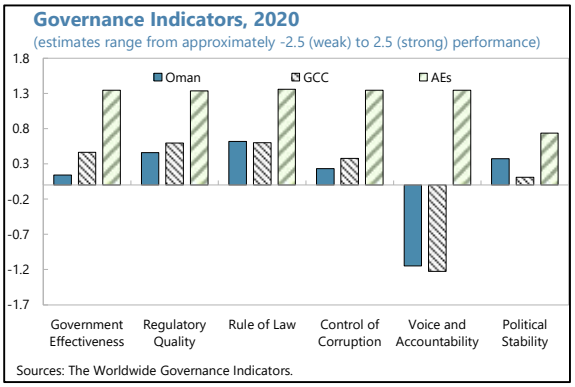
Sources: WEF, IMF staff calculations. Indices on the prevalence of trade barriers ranking and subcomponents are based on WEF's quantitative and qualitative assessment of the trade environment. These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints, and information availability. For "Prevelance of non-tariff barriers", 1 = strongly limit; 7 = do not limit at all.

- Undertook reforms for investment such as making its tender system transparent, modifying its labor laws to provide companies with workforce flexibility to address manpower redundancies, increasing access to credit, speeding up approvals for new businesses, and developing advantages for foreign investors, including permissions to invest in several new industries in the economy, and expanded land use.

[9] MOCIIP was restricted in August 2020 following Royal Decree 97/2020. It assumed the functions that the Public Authority for Investment Promotion and Export Development (ITHRAA) previously held.

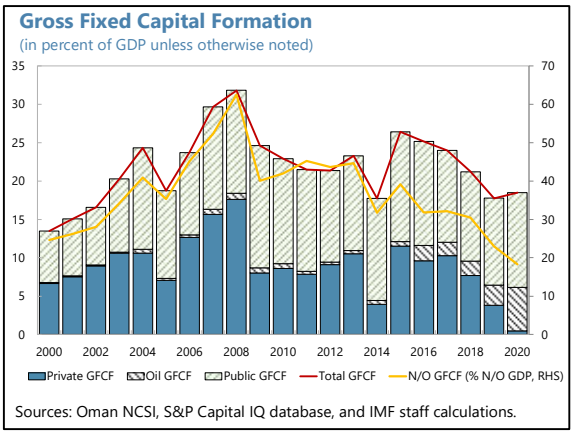
[10] Examples of non-tariff barriers include health and product standards, technical and labeling requirements, etc.

18. Improving economic governance would support higher investment. Good governance is often associated with stronger private investment, while weak governance coupled with a high perception of corruption may create uncertainty about the returns to investment due to factors including unpredictable policies and/or uneven enforcement of regulation.[11] Based on Mauro's (1995) empirical results, an improvement in the corruption index by one standard deviation is estimated to increase investment by as much as 3 percent of output. While Oman's rule of law, voice and accountability, and political stability indicators are above the GCC average, it lags the performance of AEs.



Capital Inputs

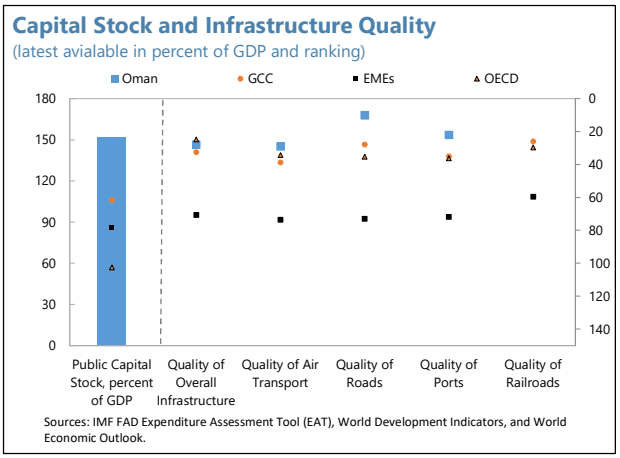
19. Private investment has been generally volatile and trending down since 2015. The rapid expansion of public investment reflected in part the expansionary fiscal position and investment in infrastructure as oil revenue expanded at the beginning of the century. The limited private investment likely reflects weak competitiveness that has also led to a concentration of the non-oil economy on non-tradable activities—notably construction and services—with a concentration of low-skilled and low-wage labor. The relatively labor-intensive non-oil sector generated less room for additional spending on physical capital, and the share of non-oil capital investment to non-oil GDP has been generally declining in recent years.

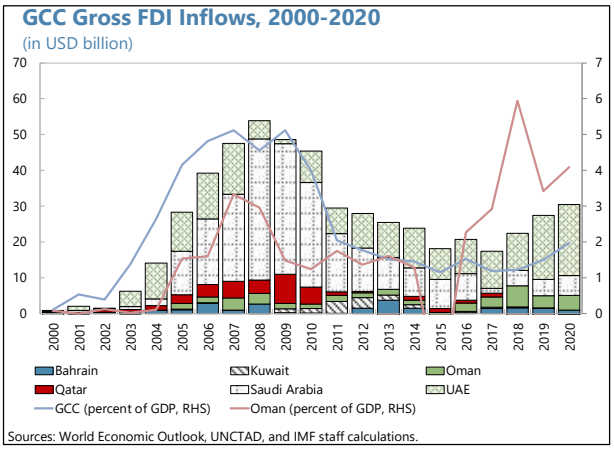


20. The public investment in infrastructure has resulted in high-quality and well-developed infrastructure. Oman's public capital stock/GDP ratio exceeds not only the GCC average but also AE and EME averages. The available quality indicators also show that the quality of Oman's infrastructure is above average. While these investments lay a solid foundation for sustained longer term growth, they also suggest room for better prioritization of projects going forward. Being more

[11] See for instance Busse and Hefeker (2007), IMF (2016a).

selective in the projects, and enhancing efficiency in implementing public projects would increase the "value for money" of public investment.



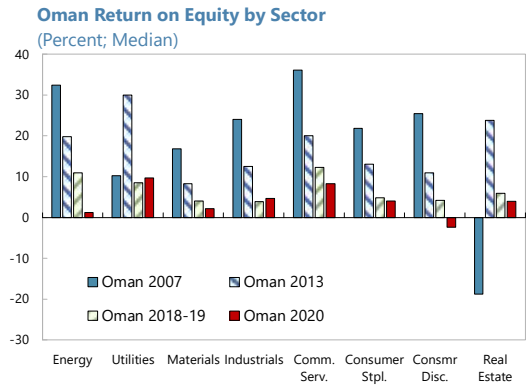


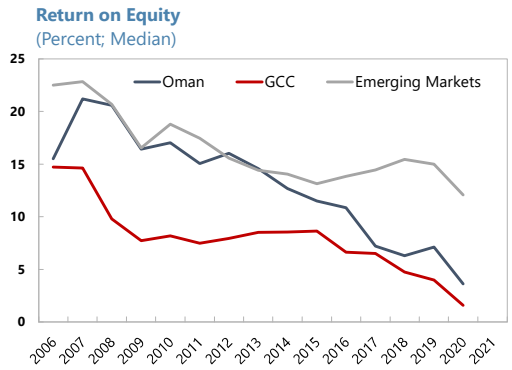
21. FDI inflows strengthened somewhat since 2018. Since Oman joined the WTO in 2000, FDI inflows have been relatively anemic until 2018 when a large hydrocarbon related FDI flowed into Oman. While the bulk of FDI inflows were directed toward the oil and gas sector in the past, ongoing economic reforms and policy initiatives to attract FDI could strengthen and diversify FDI inflows going forward.

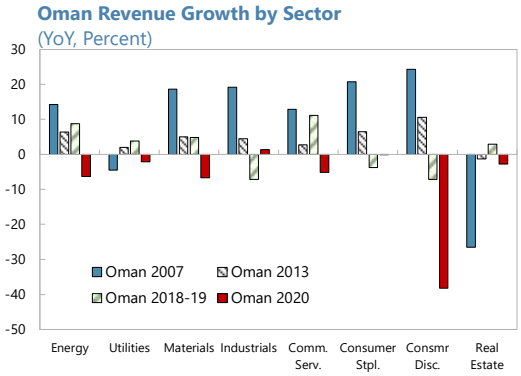
22. Lower corporate investment is associated with declining corporate profitability (Figure 5).[12] Corporates' Return on Equity (RoE) has been declining over the past decades. Though this trend has been a wider phenomenon in EMs in general, the decline in GCC countries has been more rapid in recent years than in EMs especially prior to the pandemic. The deteriorating performance of corporates is widely distributed across sectors, suggesting that the reasons for the decline are less likely to be sector specific. A broad decline of corporates' capacity to generate revenues appears to be the origin of RoE underperformance.

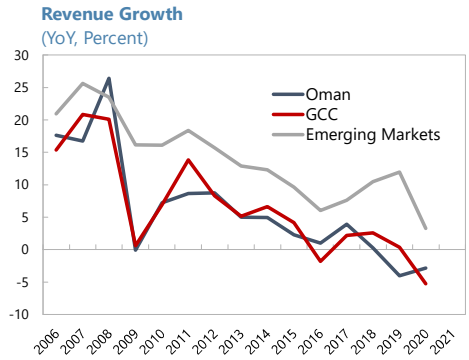
[12] The analysis is based on a firm-level data published in financial statements of over 400 GCC corpriates, and over 650 emerging market corporates over the 15-year period of 2006-2020. To approximate the profitability of the non-oil sector, firms in energy sector (8 Omani corporates and 28 other GCC corporates) have been excluded from the time series charts.

Figure 5. Corporates Performance



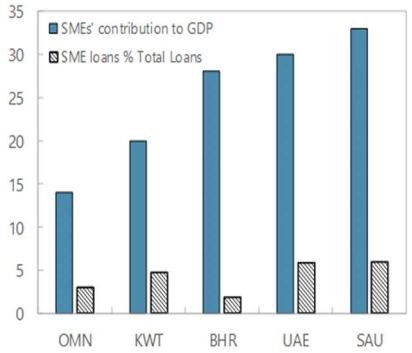






Sources: S&P Capital IQ database, and IMF staff calculations.

23. SMEs constitute a small part of Oman's economy and have large room for development. A vibrant SME sector has been demonstrated to play an important role in tackling diversification challenges while being a major source of new job creation. Small firms have the largest shares of job creation, and highest sales growth and employment growth, even after controlling for firm age. Conditional on size, young firms are the fastest growing. Large mature firms have the larger employment shares, but small young firms have higher job creation rates (Ayyagari and others, 2014). Large firms usually have higher productivity growth given their economy of scale and larger human capital and technology endowment, relative to smaller firms. However, it is expected that being a small firm is a natural part of development and having a base of dynamic SMEs is crucial for market development. SMEs' contribution to GDP is relatively limited in



Sources: IMF 'Enhancing the Role of SMEs in the Arab World—Some Key Considerations'; Financial Stability Report by Central Bank of Oman, UAE, Kuwait and Bahrain and IMF staff estimates.

Oman, and their share of total loans is also low.[13] The number of registered SMEs has continued to grow despite the economic constraints imposed by the pandemic: there were 62.3 thousand registered SMEs in November 2021, up from 47.8 thousand a year ago and 44.1 thousand in March 2020, according to the National Centre for Statistics and Information.[14]

24. Policies have been deployed to support the development of SMEs. To address SMEs' financing challenges, the Central Bank of Oman (CBO) has prescribed that at least 5 percent of total bank credit be disbursed to SMEs and the Oman Development Bank has worked to provide subsidized loans to SME subsectors. Oman created a SME Development Fund in 2014 to foster entrepreneurship and help finance SMEs. Meanwhile, the Public Authority for SME Development runs a technical support program, and entities such as Sharakah provide financial support and consultation to SMEs.

25. Investment in renewables. Oman is actively working to reduce its dependency on hydrocarbons and increase economic diversification. For example, Oman's National Energy Strategy aims to derive 30 percent of electricity from renewable sources by 2030.[15] Oman's Ministry of Energy and Minerals has been identifying areas for green hydrogen and renewable energy-related investments with other governments. Model simulation suggests that an initial green investment push combined with initially moderate and gradually rising carbon prices would deliver the needed emission reductions while supporting GDP and employment in the near term (IMF, 2020b). In the medium term, it can spur innovation, create new sources of growth, and reduce poverty and inequality while delivering cleaner air and water.

C. Reforms for Strong, Job-Rich, and Sustainable Growth

26. Strong, job-rich, and sustainable non-hydrocarbon private sector-led growth is needed to ensure higher living standards for future generations. The global trend toward transitioning to renewable energy would significantly affect oil exporting countries' fiscal revenues and economic activity, rendering the tasks of economic diversification and transformation more urgent, and Oman is no exception. For it, a more diversified and competitive tradable sector and a growth that generates sufficient high-quality jobs for the well-educated Omanis and future generations, are the key.

27. To achieve this objective, a comprehensive set of reforms supported by three overarching principles are needed. The reforms would range from labor market policies to social safety net reforms, from business environment and regulatory framework to educational reform. The reform actions would need to be fully implemented to ensure an efficient market-based resource

[13] Sources: IMF "Enhancing the Role of SMEs in the Arab World—Some Key Considerations" (IMF, 2019); Financial Stability Report by Central Bank of Oman, UAE, Kuwait and Bahrain and IMF staff estimates.

[14] See "Over 62K SMEs Registered in Oman till November 2021." http://omannews.gov.om/NewsDescription/ArtMID/392/ArticleID/45208/Over-62K-SMEs-Registered-in-Oman-till-November-2021

[15] See https://www.omanobserver.om/article/1113763/oman/environment/renewables-shine-bright

reallocation mechanism that would motivate the creative abilities of Omanis and attract private investment, and therefore being effective in supporting growth. The reforms should be sequenced properly—from the core issues to cross-cutting issues while taking into consideration the implementation capacity. The medium-term fiscal framework would help avoid procyclical fiscal policies and anchor needed spending rationalization.

Principle I. Broad-Based Reform	Principle II. Proper Sequencing	Principle III. Multi-Year Efforts
A broad-based reform that tackles challenges from multiple areas within a coherent framework would be more effective than a piecemeal approach. It would allow the various effects and spillovers from separate policy measures to be addressed and harmonized and help create positive tailwinds that increase the probability of success of the reforms.	Policies that foster conducive business environment and attract private investment need to be implemented in the near term. Harmonizing labor market policies would improve competitiveness and productivity, **which** should be accompanied by the social safety net reform to ensure adequate and equitable social protection. Other reforms on cross-cutting issues could proceed with a measured pace while taking into consideration the implementation capacity.	Persistent efforts are needed to fully implement comprehensive reforms. No reform design is perfect, and there will need to be a focus on resolving unexpected challenges as they **manifest** in a dynamic manner, reflective of the core principles and objectives of the reform agenda. Sustained broad consultation with private stakeholders and the public is crucial to secure broad social support for the multipronged reform agenda.

28. The implementation of the authorities' reform agenda under Vision 2040 is continuing. The near-term priorities include improving business environment for private investment; advancing national program for diversification to further develop renewable energy, manufacturing and tourism; promoting digital transformation and fintech; and continuing the implementation of the actions identified under the National Strategy for Adaptation and Mitigation to Climate Change. The Oman Vision 2040 Implementation Follow-up Unit is actively developing, updating, and following up with the implementation of the initiatives, in cooperation with relevant government agencies.

Near-term reforms: a three-pronged reform consisting of improving business environment, enhancing access to financing, and further liberalizing labor market policies and strengthening social safety nets, would be critical.

International experience shows that diversifying away from oil can be difficult. In the GCC region, diversification would require realigning incentives for firms and workers to encourage individuals to work in the private sector and for firms to look beyond the confines of domestic markets and seek new export opportunities (IMF, 2014). Supported by social safety net reforms, harmonizing labor market policies across all sectors in line with market conditions would be needed to enhance competitiveness, attract private investment, and promote strong, job-rich, non-hydrocarbon private sector-led growth. Enabling an export-oriented private sector that is not dependent on oil and gas to grow and thrive would also requires facilitating financing for corporates and SMEs, and building a capable and motivated work force outside the public sector, including entrepreneurs.

Pillar I. Reforming Labor Market Policies and Strengthening Social Safety Net

29. Omani authorities have been making efforts to improve labor market functioning. The 10th Five Year Development Plan endorses policies that contribute to modifying the structure of employment and introducing a new structure based on a wide base of skilled manpower through recruitment of skilled labor and offering it incentives. The plan also encourages new investments based on knowledge-economy, developing the education system and increasing the participation of women in the labor market. To this end, the authorities have simplified the system of multiple minimum wages linked to qualification levels and introduced a single minimum wage of OMR 325/month in 2020. The government has introduced a time-bound wage subsidy of OMR 200/month for first time Omani jobseekers to facilitate private sector employment of Omanis, relaxed restrictions on job transfers for expatriates, reduced hiring fees for expatriates, and launched government sponsored training and habilitation initiatives to facilitate job seeking in the public and private sectors. The Job Security Fund that was established in November 2020 has provided unemployment benefit to facilitate the reallocation of workers. Work on updating the labor law is ongoing.

30. Nonetheless, more needs to be done to improve the functionality and flexibility of the labor market. In particular, with the anticipated decline in oil revenues due to the climate change mitigation actions, public sector jobs will become even scarcer and the responsibility for employing nationals will have to be mainly shouldered by the private sector. Deeper reforms to support the transition to a harmonized market-based labor market would include:

- Gradually eliminate other factors that may hinder market efficiency and segment the private and public labor markets, including flexibility in hiring and firing workers, and other differential policies for nationals versus expatriates.[16] The current minimum wage of OR325 per month can be revisited to better reflect labor productivity and there is merit to extend minimum wage requirement to cover expatriates. Wage growth in the public sector should not outpace that of the private sector to help secure the gains from reforms and better align the incentives between public sector and private sector jobs.

- Strengthening transparent public sector performance metrics and linking them to pay scale and promotion can help foster creativity and better job performance Also, a clear accountability framework which lays out how individual work contributes to the whole entity's goal can also stimulate employee's performance.

- Build a social incentive structure that encourages entrepreneurship, employment in the private sector, and attaches high recognition to career achievements in the private sector. It is critical to clearly signal limited future jobs in the public sector.

[16] Private sector employers typically avoid hiring citizens unless obliged to do so by the state. In such cases, they often treat this as a cost of doing business and do not develop the hired citizens' productive capacities (Kabbani and others, 2021).

- Deploy as needed temporary policy measures to alleviate the pain from economic transition. Notably, reallocation of workers across jobs can entail costs for certain workers who require skills upgrading or retraining in order to be re-employed. Government support in enhancing job search and training is important. Unemployment benefits and the coverage periods can be adjusted to better tailor to the needs of the labor force.

- Further increase female employment to promote inclusive and sustainable growth. Measures can be deployed to further encourage women to participate in the workforce, including by improving the working environment for women, and providing flexibility in work schedules and locations. Promoting more women to senior positions and encouraging female entrepreneurs under SME initiatives could generate positive demonstration effects to encourage further female labor participation (Box 1).

- Going forward, the world is becoming more digital and greener, underlying the urgent need to diversify areas of specialization of college graduates—from business administration, law, and manufacturing to the areas that are in greater demand in future, such as information technology, data science, climate issues and renewable energy.

Box 1. Enhancing Female Labor Force Participation

Higher female labor force participation (FLFP) benefits growth and development through multiple channels including:

- A boost to growth and productivity. Greater participation of women in the labor force has direct impact on growth through higher domestic demand and the impact on productivity. Women bring new skills and ideas for production and management, boosting aggregate productivity (Ostry and others 2018; Christiansen and others 2016). Empirical analysis has also demonstrated this positive relationship. The entry of married women greatly expanded potential GDP in the United States in the 1970s and the 1980s (Juhn and Potter 2006). Ostry and others (2018) finds that male and female labor are complementary in production, which implies that standard models that do not differentiate between genders, i.e., assume perfect elasticity of substitution between men and women, understate the favorable impact of gender inclusion on growth, and likely misattribute a part of growth that is caused by women's participation to technology advancement.
- More inclusive growth. Service sector tends to be more gender equal in employment (Borghans and others, 2014). As countries develop, the service sector's share in the economy expands, employing more labor, while agriculture sector's shares in output and employment decline. Because services are more gender equal in employment than other sectors, reducing barriers to FLFP leads to a more efficient allocation of labor and to gains in both measured marketable output and welfare (Ostry and others, 2018), and contributes to a more inclusive growth.
- Possible higher wages for the male. Increasing FLFP can increase male wages because gender complementarity increases productivity, but also can dampen male wage as the capital/labor ratio is likely to be lower when total labor supply increases. Empirical analysis has found that the first effect dominates when the elasticity of substitution between capital and labor is below a certain threshold (Ostry and others, 2018).

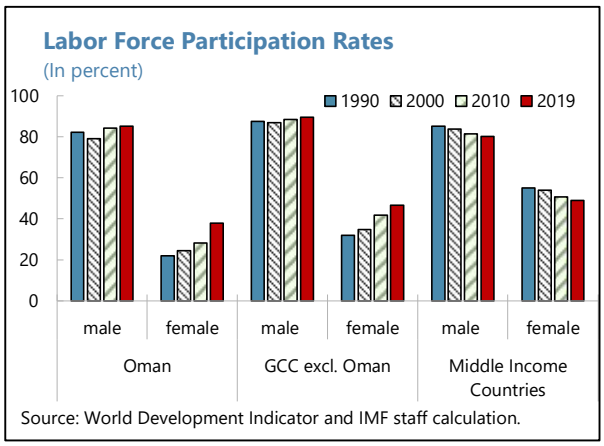
The Basic Law of the Sultanate of Oman confirms the equality between men and women in Oman, and there are no legal restrictions or limitations in the female's participation in labor force. The Oman government has taken initiatives to promote participation and involvement of women in economic and social development process, guided by the National Strategy for Advancement of Omani Women (2007-2020) and Oman Vision 2040 which aims to further promote socio-economic empowerment of women. The current female labor force participation rate is low, compared to other GCC countries and middle-income countries more broadly. Literature finds that in Oman, education level and proximity to urban areas are significantly positively associated with higher female labor

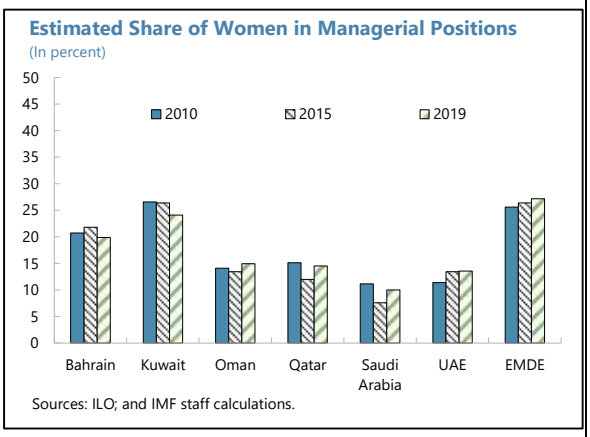
Box 1. Enhancing Female Labor Force Participation (concluded)

participation, while other factors including social norms and traditional customs continue to challenge female labor participation (Mansour and others, 2020).

Omani female forms a pool of skills, talents, and labor force that can be better utilized to support future growth and development, especially as women in Oman are well-educated—as shown by high net enrollment ratios for secondary education (comparable to male) and higher net enrollment ratios for tertiary education than male (IMF, 2021). Increasing FLFP would likely reduce the demand for expatriates, including high-skilled expatriates, and naturally contributes to higher Omanisation ratios across the economic sectors. The following considerations can be of help to enhance FLFP:

- Measures can be deployed to further improve working environment for women, including by providing flexibility in work schedules and locations, extending maternity benefits, improving the provision of childcare, and facilitating job searching.
- Promoting more women to senior positions and encouraging female entrepreneurs under SME initiatives could generate positive demonstration effects to encourage further female labor participation.
- Pressing ahead with the structural reform agenda to promote private sector development and economic diversification, which would help form a virtuous cycle between urbanization progress and greater economic empowerment of women.





31. Policies toward expatriates can be revised accordingly to address the remaining issues. Given the economic structure in Oman, it is anticipated that expatriate labor will continue to be needed in the foreseeable future, though the demand could decline as reforms incentivize Omanis to move from the public to private sector and productivity is gradually lifted. More flexible expatriate labor policies can help facilitate resource reallocation across industries and attract more high-skilled labor, thereby increasing productivity. In this regard, the recent reduction of fees for hiring expatriates is a welcome step. Moreover, significant potential for positive spillovers from expatriates to the wider economy—including transfer of skills in a range of sectors, and strengthening of consumption, savings, and investment—could be harnessed by improving the

policy framework for expatriates.[17] For example, restrictions on investing in real estate by expatriates has been gradually relaxed in other GCC countries over time. In Oman, the authorities launched the Investment Residency Program, which offered self-sponsored residence permits, which would help generate more job opportunities while attracting and retaining investment. Also, allowing expatriates to invest in residential and commercial real estates under the usufruct system would encourage consumption and investment of expatriates and thus support domestic demand.[18]

32. Reforms to social safety nets should accompany the labor market reforms to ensure adequate and efficient social protection. The ongoing social safety net reforms would simplify the various social assistance programs, tackle potential weaknesses in the existing social safety nets, improve efficiency and strengthen adequacy of the social safety nets. Potential future savings from improving the efficiency of the existing social programs can be reallocated to areas that need more resource. The establishment of the Job Security Fund and the extension of the coverage to first time job seekers are a welcome step.

Pillar II. Improving the Business Environment

33. Private investment, whether foreign or domestic, is largely driven by profitability, which is mostly determined by competitiveness and productivity. Freezones, tax incentives, or other forms of preferential treatment would only help private investment at the beginning of the business. Over time, higher competitiveness and productivity, supported by flexible and conducive labor market and business and regulatory enviroment, are the key to sustain a vibrant private sector investment and growth. This would require steps to further improve the business environment, including reinforcing the ease of entry of firms and exit of underperforming or zombie firms to release resources to more productive uses, and establishing a transparent and level playing field based on robust competition policy that strengthens competition among firms.

34. Better business environment would help improve investment including FDI. The Tenth Development Plan also targets setting up necessary infrastructure for the acceleration of private investment and the execution of major strategic projects and public-private sector partnership projects, as well the attraction of direct foreign investment. In this regard, the recent launch of the electronic licensing service via its Invest-Easy Portal, which is governed by the Foreign Capital

[17] Based on empirical analysis covering a set of AEs (see IMF 2016b), average per capita incomes of both the top 10 and of the bottom 90 percent of earners increase as a result of immigration, although high-skilled immigration benefits top incomes more strongly, possibly due to stronger synergies among high-skilled migrants and high-skilled natives.

[18] Expatriates who have reached the age of 23 can purchase housing units under the usufruct system in multi-story residential and commercial buildings for a period of 99 years, provided that he has a residence permit of no less than two years when submitting the application and satisfied other applicable requirements.

Investment Law, is a welcome step.[19] Specific consideration to improve the business environment can be given to:

- **Promoting market competition.** Market competition leads to lower prices, higher quality goods and services, greater variety, and more innovation. Competition is critical not only in product markets, but also in labor markets. When firms compete to attract workers, they must ensure a competitive wage and compensation scale and conducive working conditions. The Competition and Anti-Monopoly Law (Royal Decree No. 67/2014) aims to combat monopolistic practices by prohibiting anti-competitive agreements and price manipulation. It includes a reporting requirement for any activity, such as mergers and acquisitions, which results in a dominant market position for one firm. Competition Protection and Monopoly Prevention Center was established under Royal Decree 2/2018 to monitor the application and implementation of the Competition Law. Strengthening the role of the Center to investigate infringing parties, regulate market practices and promote competition is crucial.
- **Strengthening procurement policymaking and implementation.** The procurement framework and public-private partnerships (PPP) can be strengthened, such as strengthening capacity for project appraisal, conducting systemic audits of investment projects, and strengthening risk management for a fairer, more open and transparent process. The e-tendering system, which has been developed and used as part of the e-government initiates, would facilitate the strengthening of the procurement framework.
- **Establishing formal mechanisms for regulatory notification and public comment.** Ministries or regulatory agencies could benefit from soliciting comments on proposed regulations from the general public and conducting impact assessments of proposed regulations. It would be particularly helpful before important policy actions, to strengthen public support including from community organizations and private sector associations. This would also improve the quality and effectiveness of policy and regulations as well as increase the transparency of the regulatory process, which would go a long way toward assuaging the concerns of potential investors.
- **Providing more flexible policies toward FDI and addressing the challenges faced by foreign investors.** The structural and fiscal reforms would all help improve the business environment and strengthen investor confidence. Korea's experience showed that FDI liberalization is more effective when embedded in a broader reform agenda (OECD, 2013).[20] Additionally, a forum or venue for regular public dialogue is an essential component of reforms, helping to improve both the effectiveness of reforms and the buy-in from local stakeholders; and such dialogue should also

[19]The Ministry of Commerce, Industry and Investment Promotion has launched an electronic licensing service via its Invest-Easy Portal. The service targets companies governed by the Foreign Capital Investment Law. See http://omannews.gov.om/NewsDescription/ArtMID/392/ArticleID/44312/Commerce-Ministry-Launches-E-Licensing-Via-Invest-Easy-Portal

[20] In November 1998, the Korean government enacted the Foreign Investment Promotion Act, with a view to attracting FDI and regaining the confidence of foreign investors. The Act eased the regulations and restrictions on investment by foreign nationals while expanding the range of tax incentives intended to attract foreign investment into the country. Complicated administrative procedures were streamlined with the relaxation of more than half of existing restrictions.

include foreign investors as well as across ministries and different levels of government (Box 2). Following up with the foreign investors' feedbacks and addressing the practical challenges they face is a critical part of this dialogue.[21] Once the economy of scale is established—studies have found when a critical mass of FDI is attracted, it will become easier to attract more FDI as foreign investors perceive the presence of other foreign investors as a positive signal—a positive feedback loop can be formed and help attract more investment. Further reducing non-trade barriers would also help attract foreign investment and facilitate trade.

- **Enabling the business environment for green investment.[22]** Development in renewables and green projects is particularly important in the context of an accelerating global trend in developing environment-friendly industries. Such investment would help narrow the technological gap with respect to other countries and promote sustainable creation of high value-added jobs. However, starting business in renewables would require specific infrastructure and skilled labor, and whether these production inputs can be easily found in Oman plays an important role in attracting foreign investors.

Box 2. A New Approach to State Intervention in Economic Diversification

Industrial policy, defined as the promotion of new infant industries or protection of local traditional activities from competition by products from more advanced countries, have been facing opposing arguments, even in cases with known market failures or unfair competition from foreign governments. These arguments mainly include information asymmetry, i.e., government usually is not in the best position to identify correct industries, products and firms to support, since it requires deep knowledge of the markets and technological processes, and rent-seeking, i.e., government may be influenced by bribes and lobbying, which generate big distortions and lead to market inefficiencies. World Bank (1993) acknowledged that state intervention to spur specific industries was successful in some cases, but suggested that in general industrial policy did not work.

However, researchers, including Rodrik (2005), Ocampo, Taylor, and Rada (2009), Stiglitz and Greenwald (2014) also found that policies play an important role in the structural transformation and diversification of developing economies. Dani Rodrik (2004) proposed a new approach to industrial policy — a process of economic self-discovery where during an interactive process, strategic cooperation between the private and public sectors serves to elicit information on business opportunities and constraints and, on the other hand, generates policy initiatives in response. Governments will be constantly on the lookout for ways in which they can facilitate structural change and collaboration with the private sector. Much of the industrial policy is therefore concerned with the provision of public goods for the productive sector, including public R&D, health and infrastructural facilities, vocational and technical training.

Cherif and Hasanov (2014) noted that GCC countries have pursued some of the policies that promote diversification—such as the creation of special economic zones, links between universities and businesses, skills development, SME funds, developments banks, and export promotion agencies—but these policies are yet to deliver the desired results, and diversification policies on their own are unlikely to be enough to spur non-oil

[21] For example, while the Chinese authorities have adopted preferential policies to attract FDI, including tax concessions and special privileges for foreign investors, and establishment of Open Economic Zones, they have also relaxed certain governmental controls and provided practical assistance responding to the complaints of foreign investors (IMF, 2002). However, in general the empirical evidence on the impact of preferential policies on FDI flows has been mixed across countries (see Chalk 2001). The authors also noted that China's success, also came with some costs, such as an increasingly complex tax incentive system and growing regional income disparities.

[22] Green investment is generally defined as the investment necessary to reduce greenhouse gas and air pollutant emissions.

Box 2. A New Approach to State Intervention in Economic Diversification (concluded)

exports. They suggested three key principles to achieve high and sustained growth in their 2019 paper: (i) the support of domestic producers in sophisticated industries, beyond the initial comparative advantage; (ii) export orientation; and (iii) the pursuit of fierce competition with strict accountability. While they argue for some level of state intervention to pursue technology and innovation-oriented policies, they also emphasized that the role of state intervention is to correct market failures where exist and enforce a strict market discipline, rather than continued tolerance for under-performing, under-innovating and rent-seeking firms.

Pillar III. Enhancing Access to Financing

35. Progress has been made in facilitating access to financing. Oman Credit and Financial Information Centre (Mala'a), established by Royal Decree 38/2019 issued on 8th May 2019, is an independent organization under the supervision of the Central Bank of Oman, providing access to credit through information services, credit rating, creditworthiness and solvency insights for individuals and corporates. Mala'a includes members from banking, finance, small and medium enterprise funds, telecommunication, and insurance industries, and collaborates with several Government registries as Data Providers to establish a centralized database of credit and financial information. The Oman Development Bank (ODB) also administers loans with an OMR 1 million (USD 2.6 million) ceiling to support development of smaller industries in the agriculture, fisheries, petroleum, mining, and services sectors. ODB also offers an SME loan guarantee program in partnership with commercial banks, interest subsidies, and attractive export financing rates.[23] In 2013, the government launched the OMR 70 million Al Raffd fund to finance start-ups and entrepreneurial ventures.

36. For corporates, who generally have good financing channels, more flexible and efficient market resource reallocation is key. A market-driven restructuring mechanism can be strengthened to allow non-viable firms to exit in an efficient way to facilitate resource reallocation.

- Greater reliance on some form of out-of-court restructuring mechanisms offers a cost-effective and speedy alternative to address some corporates' financial difficulties. Out-of-court restructuring mechanisms may require government involvement through potential financial and regulatory incentives as well as through mediation and arbitration. Oman's Bankruptcy Law came into force and effect in July 2020, which would improve the business environment in Oman once the executive regulations and the law are enforced, contributing to attracting more foreign investment and growing the private sector.[24]

[23] See https://www.oman.om/wps/wcm/connect/en/site/home/gov/gov1/gov5governmentorganizations/odb/smallproject

[24] The Bankruptcy Law introduces, amongst other things, three key procedures for individuals and legal entities to help them handle financial difficulties and challenges in paying debts: Restructuring; Preventative Composition; and Bankruptcy. Restructuring is a process whereby a debtor and its creditors agree to a "Restructuring Plan" which sets out binding steps to help the debtor overcome financial and administrative hardship and avoid liquidation. The

(continued)

- To ensure the financial sector maintains adequate flow of credit to the economy, non-bank sources of financing for corporate restructuring—e.g., special investment vehicles—could also be promoted.[25] If public capital injection is needed, it should be subject to safeguards that address concerns of moral hazard and conflict of interest. Further development of the Oman stock market and local debt market would help diversify corporates' funding sources and support non-oil private sector development more broadly.

37. Specific considerations can be granted to SMEs, who naturally face different types of challenges. Existing SMEs could grow into bigger companies—such as by integrating into the industrial chains of bigger companies or proliferating by providing services to bigger companies—or remain to be SMEs or exit as market evolves. New SMEs could emerge, and a proliferation of such startups would be instrumental to promoting innovation and facilitating diversification and growth.

- Better business incubation support and improved access to credit would contribute to their development, especially when labor market reforms align wages in the public and private sectors with productivity and market conditions and individuals are incentivized to explore their creative abilities in the private sector. Startups would particularly benefit from enhanced access to credit; and business incubation support, including via facilitating sharing of information and providing training on business management and marketing.
- Investors can benefit from a well-designed SME Credit Guarantee Scheme (CGS) with the objective of providing third-party credit risk mitigation to lenders to stimulate debt financing to SMEs. A World Bank global survey identifies the following key principles for a successful design and implementation of the CGS: (i) clearly defined legal framework to strengthen the credibility of the scheme—namely, ownership of the policy, sources of funding, financial accounting standards, and independent oversight; (ii) sound corporate governance and risk management with clearly defined mandate of the CGS; (iii) regular monitoring and evaluation; (iv) quality and timely credit information for SME's access to bank financing, which could help relaxing collateral requirements.[26] Besides, some country evidence shows that the introduction of collateral registries for movable assets can increase the likelihood of firm access to bank financing.

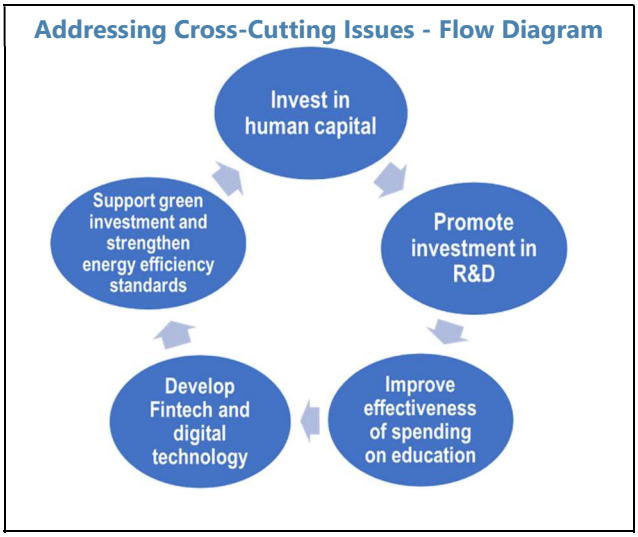
Bankruptcy Law further introduces the concept of "Preventative Composition", which is a method for a debtor to seek relief if the debtor is facing financial difficulties and it is likely the debtor will fail to pay off its debts. Under the Preventative Composition mechanism, the debtor must submit an application to the Court. In the event the application is approved, the Court shall assign a trustee to administer the Preventative Composition process, including meetings with creditors, preparing a list of debts owed by the debtor, and its opinion on how the debtor should settle the debts.

[25] Some countries, such as Korea, created special purpose vehicles to purchase corporate securities and loans to SMEs, with funding from the central bank and the government providing equity for loss absorption. The US also created a public capitalization vehicle through the Capital Purchase Program under the Troubled Asset Relief Program.

[26] See https://www.worldbank.org/en/topic/financialsector/publication/principles-for-public-credit-guarantee-schemes-cgss-for-smes

Medium-Term Reforms: Addressing the Cross-Cutting Issues

Research has found that investing in infrastructure, education, R&D, facilitating financing, and opening trade support growth and development. For Oman, addressing these cross-cutting issues, including expanding the usage of the digital technology and investing in renewable energy, are instrumental to promote export diversification and economic transformation.



38. Investing in human capital would help ensure sustained improvements to productivity. Human capital encompasses the knowledge, skills, education, and health of a country's working age population. Increasing human capital improves productivity and is key for sustained economic growth, particularly in the context of rapid technological change.[27]

39. The effectiveness of spending on education could be improved to achieve higher quality education. Reforms to increasing the quality of basic and higher education so that graduates are acquainted with competitive qualifications and employability skills to enter the local and international labor market are all welcome steps. There is scope to improve spending efficiency, enhance education outcome, and expand vocational training. Specifically, education reforms can be introduced aiming to diversify the areas of specificalities for college students and above, covering a range of subjects such as STEM,[28] information and digital technology, data science and engineering, and social science, which are the foundations for economic and social development, and to encourage citizens to pursue the highest educational outcome with best efforts, thus better preparing them for advanced positions in their career path. Vocational training can take more flexible modality, including via a combination of on-site job training and classroom learning, and responds to the evolving needs of the market. Additionally, if accompanied by improvements in education, stronger research institutions, and university–industry collaboration, R&D investment would likely generate higher returns.

40. Promoting investment in R&D can help improve the quality and sophistication of the products and competitiveness. To encourage spending on innovating technologies, government can invest directly in R&D (through subsidizing targeted scientific programs in universities and government research institutes) and design policies that encourage firms to undertake more private

[27] Improving the quality of education is important for all countries and this calls for education policy reforms to enhance service delivery and to reduce the skills mismatch in the labor market (OECD 2016; World Bank 2018).

[28] Science, technology, engineering, and mathematics.

R&D because it often involves a high level of risk, significant fixed costs, and returns that materialize only in the medium to long term.

41. Developing Fintech and digital technology would support development and facilitate economic diversification. New technology, such as artificial intelligence (AI) and machine learning (ML), is improving efficiency and reducing cost, enhancing forecasting accuracy, and improving risk management and compliance. It also enhances financial inclusion and boosts geographic competition among banks, which can service more distant customers. These new technologies also offer the potential to strengthen prudential oversight and to equip central banks with new tools to pursue their monetary and macroprudential mandates. For example, many country Financial Stability Board authorities are currently using ML and Natural Language Processing (NLP) tools in data analysis, processing, validation, and plausibility. AI can identify patterns that humans fail to spot and thereby enhance the quality of supervision. It can also make supervision more agile by flagging anomalies to supervisors in real time (ECB 2019). Given the rapid development of advanced technology, adopting digital technologies, as being implemented as part of Oman's e-government initiatives, and investing in relevant education are of even greater importance to support development and facilitate economic diversification (Box 3).

Box 3. Fintech in Oman

In recent years, the Oman government and the CBO have been building an ecosystem that is conducive to the success of the financial services sector. The CBO has taken steps to develop Fintech and the digital transformation journey in the financial and banking sector.

The CBO has been drafting an Open Banking API Strategy, as part of a broader push to stimulate innovation in the finance sector. The Open Banking API Strategy is part of the Oman Fintech strategy, which aims at establishing a comprehensive and nurturing fintech ecosystem in Oman.

In December 2020, the CBO launched the Financial Regulatory Sandbox, allowing participants to live-test their innovative fintech solutions in a safe environment under the supervision of the central bank. A Regulatory Sandbox allows the regulator, innovators, financial service providers and customers (as final users) to conduct field tests in an off-market development environment and collect evidence on the benefits and risks of new financial innovations, while carefully monitoring and containing their risks.

In November 2021, Oman and Saudi Arabia signed a memorandum of understanding (MoU) to strengthen cooperation in the fields of communications and information technology. The Saudi-Omani Digital Skills Initiative was launched at the same time. The initiative aims at exchanging best practices and expertise, participating in meetings and joint working sessions, and implementing joint programs and initiatives, to develop digital skills to meet the needs of the labor market.

A number of initiatives have been undertaken by banks to keep up with the fast-evolving landscape. In September 2020, Bank Muscat, one of the biggest financial institutions in the country, launched a US$100 million fintech investment vehicle called BM Innovate to create a strong network in the fintech ecosystem and invest in both local and international fintech companies. The Oman Banking Perspectives 2021 (KPMG report) notes that some banks are harnessing data and advanced analytics to get a real-time understanding of their customers. Others are engaging and partnering with third parties to increase speed to market, reduce costs and close capability gaps.

42. Supporting green investment and strengthening energy efficiency standards would help address climate change and has the potential to attract private investors and contribute

to growth and economic diversification. The long-term objectives would need to be linked to measurable short-term targets and policies to guide the reform process and facilitate an orderly transition. Supporting green investment under a sound medium-term fiscal framework, enhancing human capital and promoting clean and efficient energy technologies would support the energy transition, which should also take into consideration possible social and economic impacts. These structural shifts in the market could also cause some workers to exit the labor market due to lack of commensurate skills. This requires careful policy attention to tackle the potential hardships associated with these disruptions, including through strengthening the social protection system in the short term, and retraining workers over the medium-to-long term. Persistent efforts are of essence and sustained consultation and communication with relevant stakeholders and the public would help secure broad social support.

D. Conclusion

43. To promote stronger, job-rich, sustainable and inclusive, non-hydrocarbon private sector-led growth, a comprehensive reform that addresses the intrinsically linked economic challenges is the key. Stronger growth would broaden the revenue base that is critical for long term fiscal sustainability. Diversification would also lift growth and income levels by shifting resources from sectors where prices are highly volatile, such as mining and agriculture, to less volatile sectors, such as manufacturing, resulting in greater macroeconomic stability and lower vulnerability to adverse terms of trade shocks and more sustained growth over the longer term.

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