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BALANCING THE BOOKS: A DEEP DIVE INTO FISCAL POLICY AND DIVERSIFICATION IN OMAN

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February 2022

Oman's recent economic woes serve as a potent motivator for other petrostates currently undergoing diversification. Debt ballooned from 1.5 billion Omani rials (RO) ($3.89 billion) in 2014, equal to around 5% of GDP, to roughly 81% of GDP in 2020. Due to regular downgrading of the country's credit rating, interest rates rose, resulting in the stratospheric growth of interest payments from RO35 million to RO1 billion in the same period. As a result, more money was spent on interest payments (the third-largest governmental expense in 2021) than on domestic subsidies twice over. Since the decline in oil prices in 2014, Oman has run current and fiscal account deficits, the latter reaching 19% in 2020. These twin deficits were described by the Central Bank of Oman (CBO) as "a major source of macroeconomic vulnerabilities" and "the most critical challenge to macroeconomic stability in Oman." Growth in the country has been so anemic — 0.3% in 2017, 1.8% in 2018, and 0.5% in 2019 — that in real terms the economy has shrunk. COVID-19 worsened an already dire situation. It was a major factor in 2020's gaping budget deficit and has wreaked havoc on the domestic economy. In characteristically dry terms, the International Monetary Fund (IMF) stated "the financial performance of non-financial corporates has deteriorated." This slumping performance has the National Bank of Oman reporting that almost one in seven loans to the retail sector is non-performing, as are a fifth of loans to the service sector and a staggering third of loans to the construction sector.

Despite this rather grim backdrop, Oman's economy is rebounding. With the caveat that "there are substantial uncertainties around the outlook, with downside risks dominating," the IMF predicted in 2021 that there would be a fiscal surplus in 2022 thanks to the implementation of the medium-term fiscal plan (MTFP). What follows is a deep dive into the far-reaching and interrelated policies imposed by the government to reduce the country's deficits, debts, and reliance on hydrocarbons. Oman must drastically cut spending without causing more instability, which would curb much-needed foreign investment.

Attaining fiscal sustainability

During Oman's debt-buying spree, there were concerns that domestic government lending would crowd out the private sector and thus slow the pace of diversification and private sector growth. Banks' claims on the government grew from 10% to 19% between 2014 and 2020, with Omani banks buying government bonds to the tune of hundreds of millions of OR per quarter, starting in early 2016. At the same time, the government began issuing bonds for the first time since 1997, with 2018 witnessing the country's largest-ever bond issue ($6.5 billion) in an effort to reduce strain on the domestic banking sector. After a slowdown in 2018, domestic banks again started buying a large amount of bonds in 2020 due to the COVID-19 pandemic. About one-third of the 2021 deficit was financed by domestic borrowing. The mutually reinforcing dangers of the crowding-out of the private sector by the state on the one hand, and weak diversification on the other, have led to deep and wide-ranging spending cuts.

The MTFP was developed in 2020 to counter the unsustainable growth of Omani debts and deficits over the preceding half decade. It has become a race against the clock, as servicing ever-growing external debts is untenable, and growing domestic debts undermine economic development. Minimizing fiscal needs rapidly was, therefore, essential. The MTFP not only promises to reduce the country's debt burden, but also to strengthen Oman's appeal as an investment destination and contribute to Vision 2040, the country's long-term diversification plan. To achieve fiscal balance, the MTFP has two primary approaches: reducing spending and raising revenue, primarily through taxes.

Fuel subsidies have decreased, resulting in almost 50% lower total expenditures on subsidies since 2015, despite slight increases in electricity subsidies since 2014. New tariffs that help low-income households but increase the prices for higher earners were implemented in January 2021. Subsidies for non-vulnerable groups are expected to be removed entirely by 2025. To cut costs in government and state-owned enterprises (SOEs), Oman announced several measures: 1) suspending all bonuses, non-essential training programs, and events; 2) cutting compensation for board members by at least 50%; 3) retiring Omani employees older than 60 in all SOEs and retiring a minimum of 70% of Omanis who served for 30 years or more in all government entities; and 4) not renewing at least 70% of contracts of expatriate advisors.

A bundle of new taxes was also introduced. With more than half of Oman's population being overweight or obese, certain taxes aim to promote healthier lifestyles — a goal made more urgent by COVID-19. Tobacco, tobacco derivatives, energy drinks, and alcohol were slapped with excise taxes of 100%, while carbonated and sweetened drinks faced a 50% tax. A value-added tax (VAT) of 5% was introduced in April 2021, the same level as the United Arab Emirates but below Saudi Arabia's 15%.

The lack of greater tax reform likely stems from the government's desire to avoid "undertaking measures that could have more severe socioeconomic implications," a euphemistic phrasing of their desire to avoid reigniting protests. As a result, there is no VAT on basic goods, such as certain food items and medical supplies.

The total impact of the MTFP in 2021 is estimated to be RO3.5 billion ($9.09 billion). This includes a revenue increase of RO565 million, with VAT generating RO300 million, government investments RO195 million, and the excise tax and other taxes RO70 million. The remaining RO2.9 billion is the result of cost savings, mostly through cuts in government units (RO1.1 billion), subsidy reforms (RO215 million), and a reduction in oil and gas investments (RO1.3 billion). The final result is a budget deficit of only 3.8% of GDP in 2021, down from 19.3% in 2020, and a reduction in public spending of almost RO2 billion between 2020 and 2021.

Facilitating investment and economic diversification

Economic diversification in Oman takes two forms: investment diversification by reducing the role of the state while creating more room for the private sector, and sectoral diversification whereby tourism, logistics, and manufacturing surpass oil and gas as key productive sectors.

Fundamental to both these goals is improving Oman's investment environment. While the country's foreign direct investment (FDI) numbers rank quite high on a per-capita basis, a closer look unsurprisingly shows that the overwhelming majority of FDI is concentrated in oil and gas exploration, with all other sectors comprising barely a third of the total. The MTFP has highlighted that one of its core objectives "is to improve the business environment and stimulate investments." The centerpiece of these initiatives is the Foreign Capital Investment Law, effective since January 2020. It drastically eases registration and licensing procedures for foreign investors — for example, eliminating the requirement for a formal presence in Oman, either through a branch office or local agent.

The most interesting and important parts of the law are articles 18, 20, and 27. The latter allows 100% foreign ownership in most sectors, though the Ministry of Commerce and Industry has a list of exceptions for which foreign investment is completely prohibited. None of these sectors are of interest to the country's diversification drive, and are generally associated with the government's

Photo above: An aerial view shows a section of the Corniche Muttrah in the Omani capital of Muscat on April 9, 2021. Photo by HAITHAM AL-SHUKAIRI/AFP via Getty Images.

control over fuel prices (e.g., liquefied petroleum gas filling stations) or maintaining Omani traditions (e.g., the making of Omani sweets). Article 20 states that a project may be exempt from taxes, customs duties, and non-customs duties for an agreed-upon period. It also states that there are "other benefits that may be granted to the investment projects" based on the approval of the Council of Ministers. In practice, this means that companies can be temporarily exempted from (land) rental fees, Omanization requirements, and a variety of other obligations. Judging by Article 18 of the law (the Council of Ministers can grant additional "benefits to foreign investment projects … in the least developed areas in the Sultanate"), it is likely that these exemptions will be most prevalent in areas away from the highly populated Muscat and al-Batinah governorates. This would complement steps taken by the Oman Housing Bank to increase its lending activities in areas outside of Muscat, as well as the Implementation Support and Follow-Up Unit, a government entity with numerous projects to improve electricity access in rural areas.

Next to these broad changes, several smaller-scale inducements have stimulated private-sector growth. Companies beginning operations between January 2021 and December 2022 in sectors that are targets for diversification receive a five-year exemption from income and dividend taxes as part of the Economic Stimulus Plan. This comes on top of a reduction in license fees and land rents in industrial areas. Small and medium-sized enterprises (SMEs) — the holy grail for Gulf diversification plans — enjoyed a two-year reduction in income taxes and an equally long loan deferment program. With SMEs comprising less than 5% of bank loan portfolios (Bank Muscat's SME lending peaked in 2018), more work is needed to make them serious actors in diversification initiatives. Finally, real estate investment trusts (REITs) were introduced in 2018 with the goal of keeping more capital in the country. REITs allow both foreign investors and Oman-based expats to invest in housing, once only possible for Omanis. The second-order benefit of a subset of REITs is that at least 40% of their equity must be available to the public, which leads to their listing on the stock exchange and boosts overall stock market activity.

Photo above: A man walking past the walls of the Nizwa Fort, a 17th-century fortification in the city of the same name, about 160 km southwest of the capital, Muscat. Photo by GIUSEPPE CACACE/AFP via Getty Images.

Facilitating investment is one half of the Omani economic approach. The other half is diversification. While the hydrocarbon sector comprises 35-40% of GDP, it plays a 4.5 times larger role in GDP growth than the non-hydrocarbon sector. Meanwhile, GDP growth numbers for the non-petroleum sector do not experience the extreme fluctuations of the petroleum sector, and are therefore exponentially more predictable. An economy that rises and falls based on the vagaries of the international market is detrimental to consistent growth. Thus, diversification is crucial to Oman's long-term stability.

One key program aimed at achieving this is Tanfeedh, a government initiative to diversify targeted sectors, including manufacturing, tourism, transport and logistics, mining, and fisheries. Finance is considered an "enabling sector" in this endeavor. What is interesting about Tanfeedh is that it incorporates the opinions of sector stakeholders to ensure that reforms target needs, rather than being steered by edicts handed down from on high.

Oman hopes to modernize its manufacturing sector so that it can absorb young Omanis entering the job market and diversify the economy away from hydrocarbons. A notable initiative is Mazoon Dairy. The company will increase the size of its cattle herd from the current ~4,000 to 25,000 by 2026, aims to make Oman a net milk exporter by 2040, and employ a substantial number of workers. In line with a desire to make Oman a green investment destination, the Sebacic Oman Refinery is the world's largest refinery producing chemicals and polymers from green (castor) oil. The growth of castor removes carbon from the atmosphere, making Sebacic a carbon-negative company. In Salalah (southwestern Oman), an ammonia plant is under construction that will be fueled by solar energy, going hand in hand with Oman's budding green energy sector. Growing the renewable energy sector should be a high priority, as 97% of Oman's electricity currently comes from gas-fired power plants. Since gas production will not meet growing domestic demand for household consumption, feedstock, or industrial energy, taking advantage of the country's renewable energy potential is essential. Failing to do so would undermine the growth potential of Oman's more energy-intensive diversification sectors.

Next to manufacturing, Oman hopes to leverage its geographical location to become a logistics hub. Duqm refinery, a joint venture between the Omani OQ group and Kuwait Petroleum International, states that "one of the refinery's key competitive advantages is its location outside the Strait of Hormuz" — far from potential instability — and its strategic position on international shipping lanes in the Indian Ocean. Further south, the Port of Salalah has undergone an expansion to double its cargo capacity, in addition to modernization to facilitate the aforementioned ammonia plant. Between 2012 and 2018, cargo volume more than doubled. The Oman National Railway Project plans to construct a 2,100-km network that will eventually extend into the UAE and Yemen, building upon existing international transport networks. Further, the Air Cargo Village in Muscat aims to make Oman a regional hub for air logistics. How it will compete, however, with Dubai's Emirates SkyCargo and Qatar Airways Cargo, both among the largest cargo carriers in the world, remains unclear.

A consistent theme in Oman's self-advertising campaigns is the positive focus on the country's stability and rule of law. The royal family has not been embroiled in controversy — as is the case in Saudi Arabia and Jordan — nor has there been widespread social unrest like in Lebanon and Iraq. This relative calm spurred steady growth in tourism (from 2.6 million visitors in 2015 to 3.5 million in 2019) until the pandemic. Unlike the UAE and Qatar, Oman has a local population that comfortably outnumbers the expats, ensuring the visible presence of Omani culture. Nor does it suffer the negative connotations associated with Saudi Arabia. A possible reason for that is Oman's relative obscurity. A major challenge for its tourism industry is encapsulated by article titles such as, "Oman: The Paradise You Never Knew Existed."

To ameliorate that problem, Royal Decree 91/2020 changed the name of Oman's Ministry of Heritage and Culture to the Ministry of Heritage and Tourism, highlighting the country's desire to leverage its rich and well-preserved heritage to bolster tourism. Since 2013, Oman has proposed six sites for the World Heritage List, with several other locations under restoration as well. Tourism was expected to grow by 5% annually, and while the pandemic has undermined this goal, pre-pandemic numbers were highly encouraging.

Recommendations

Despite Oman's serious financial issues, the country has managed to make important changes to its economy at a time of global upheaval. Outlooks that have been overwhelmingly negative for the last six years are now stable, though Omicron-induced unpredictability might still erode some of the country's hard-won progress. I opened by saying that Oman's economic problems are a warning for other GCC states (and rentier states more broadly) not to postpone their diversification efforts. Yet Oman is also an example of how aggressive cost cutting, whether by forcing resignations or reducing subsidies, combined with a notable increase in taxes, can achieve fiscal balance in the medium term without posing existential threats to the ruling elite. While high oil prices play an undeniable role in achieving fiscal balance, the MTFP predicted a budget surplus by 2024, with a pre-cited oil price of $45/barrel; at the time of writing it is more than twice that. There are, however, some areas that require extra attention.

I) Activating the commercial banking sector

SME lending in Oman is woeful at only 5% of bank lending portfolios. This is because only 56% of Omanis used banks as of 2016, compared to 72% of Saudis. Many cite religious reasons for not having a bank account, a core reason why Islamic banks' market share is set to reach 20% by 2025 after assets have grown by almost 30% annually since the country's first Islamic bank was founded in 2012. Still, the growth in Islamic banking and financial technologies' potential to reach the unbanked is insufficient to increase SME lending to acceptable levels. Oman should revitalize and increase the capital of its Public Authority for SME Development (PASD). The Authority currently has capital of just RO7 million — inadequate to achieve the desired growth in the SME sector. A clearer division of labor between or, more reasonably, a merger of the similarly named but separate PASD, SME development fund, and the Oman Development Bank should be a short-term goal. All three have the aim of financing SMEs, though PASD has specialized programs to provide services and loans for rural women. Beyond that, differences between them are hard to identify and justifying the continued existence of all three is difficult. Then, moving forward, ensuring these funding bodies cooperate rather than compete with commercial banks is essential.

II) Keeping an eye on the real estate market

Around half a million expatriates have left Oman since the start of 2020. This could lead to a housing glut and subsequent market contraction, especially with rising unemployment and suppressed buying power due to inflation. The growing trend of Omanis buying apartments rather than villas will create less demand for housing, and both the IMF and the CBO have expressed worries about banks' large exposure to real-estate lending. Nonetheless, because most mortgages in Oman are recourse loans — with debt repayments deducted directly from wages — the ripple effects of slow or negative growth in the real-estate market will not create systemic risks for the financial sector. Both the health of the real-estate market and the construction sector, however, will be good indicators for the continued success of the diversification program.

III) Reassessing military expenditures

The elephant in the room when discussing Omani spending and cost saving is the defense budget. Oman is the world's largest spender on its military as a percentage of GDP, spending as much on its military as the total budget of the Oman Investment Authority. Defense spending in 2021 (RO2.9 billion) has already fallen drastically from 2020 (RO3.5 billion). That trend has not been carried over into 2022, when defense spending remained at the 2021 level. While the underlying political economy of this spending cannot be ignored (it is, in effect, another massive social program), the opportunity cost of a third of the state's budget being spent on ~200,000 active and reserve personnel is enormous. Reinvesting just 10% of the annual defense budget into renewable energy projects would free up enough cash to fund Oman's biggest solar photovoltaic project twice over.

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