Rahmaniah Occasional Paper 06

# Back to the 70s:

# Saudi Arabia's Political Economy after the Arab Uprisings

Steffen Hertog

AL-RAHMANIAH CULTURAL CENTER
ABDUL RAHMAN AL-SUDAIRY FOUNDATION

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A Paper Presented at

**The Rahmaniah Annual Seminar**

January 2013

Al-Ghat

AL-RAHMANIAH CULTURAL CENTER

ABDUL RAHMAN AL-SUDAIRY FOUNDATION

***The Rahmaniah Occasional Paper Series** is a select presentation of papers offered at the Rahmaniah Annual Seminar, a forum on current, socio-economic and international affairs as they pertain to Saudi Arabia. The Seminar is organized by the Rahmaniah Cultural Centre and its participants include more than forty scholars, lawyers and businessmen from Saudi Arabia, the Arab countries, the U.S. and Europe. The Rahmaniah Cultural Centre is sponsored by the Abdulrahman Al-Sudairy Foundation. The Seminar is held annually in Al-Ghat.*

## Steffen Hertog

*Steffen Hertog is a senior lecturer in comparative politics at the London School of Economics and Political Science. He holds a PhD from the University of Oxford and was previously Kuwait Professor at the Chaire Moyen Orient at Sciences Po/ Paris, lecturer at the University of Durham and post-doctoral researcher at Princeton University. His main research interest lies in Gulf and Middle East political economy, with special focus on public sector reform, labour markets and state-business relations.*

*He has a subsidiary interest in micro-dynamics of political violence and has published in journals such as World Politics, Review of International Political Economy, Comparative Studies in Society and History, Business History, Archives Européennes de Sociologie, and International Journal of Middle East Studies. His book about Saudi state-building, "Princes, Brokers and Bureaucrats: Oil and the State in Saudi Arabia" was published by Cornell University Press in 2010, and a book about Islamic radicalism and higher education, co-authored with Diego Gambetta, is forthcoming with Princeton University Press.*

# Back to the 70s: Saudi Arabia's Political Economy after the Arab Uprisings

That the Saudi government would instinctivelyreact to the regional unrest in 2011 with domestic distribution policies was not surprising, but the scale was unexpected: The employment, housing and welfare decrees of February and March 2011 alone reached a total volume of about 130 billion USD, more than the country's total annual budget as recently as 2007.In September 2012, the Saudi Council of Ministers announced that 299,000 Saudi men and women had been hired by government in that year alone[(1)] –about as much as the total (official) addition to public employment in the whole previous decade, and corresponding to almost half of the total Saudi employment in the private sector in 2010.

The governmentseems determined to mollify popular socio-economic grievances – which arguably were the factor that converted elite protests into mass movements in the poorer Arab countries. Distributional policiesseems to have done the trick. The kingdom has gotten through the Arab uprisings without major domestic unrest, at least outside of Shiite towns in the Eastern Province; attempts to organize broader-based protest fizzled out in 2011.

Perhaps even more impressively, while young Arabs continued to demonstrate and fight in the streets of Cairo,

(1) Arab News, 18 September 2012;
http://www.arabnews.com/saudi-arabia/299000-saudis-join-civil-service

Damascus, Sana'a and Tunis, the 2012 "Arab Youth Survey" indicates that young Saudis' approval of their own governmenthas increased significantly from 2011 to 2012.(1) While 60% of Saudis between 18 and 25 years of age agreed in 2011 that the country is "going into the right direction", the figure increased to 76% in 2012, a result above both the GCC and non-GCC averages.(2)84% endorsed the statement "Your government has become more trustworthy and transparent since the Arab Spring", the second highest score after Libya(3).

If this paper was about explaining the socio-economic stability of Saudi Arabia up to 2012, it could perhaps end here. The effects of distributiongo beyond immediate pacification of the national population however, and the picture becomes more complex and problematic if we consider the ramifications of recent policies on economic development and the long-term sustainability of the Saudi political economy.

The welfaredecrees indicate a return to the fiscal and political practices of the 1970s oil boom period – but on a much larger and less sustainable scale, catering to much more complex demands – and a roll-back of long-term trends towards socio-economic autonomy of Saudi businesses and citizens, as the state dependence of both has grown significantly and the economy has moved away from an autonomous growth path.Thepolicies have put a much

(1) The survey involved 2,500 face-to-face interviews among respondents aged 18-24 from December 2011 to January 2012; in Saudi Arabia, 250 individual were interviewed, of whom 40% were from Riyadh, 40% from Jeddah, and 20% from Dammam. http://www.arabyouthsurvey.com/english/pdf/presentation_ays2012_01052012_English.pdf
(2) Arab Youth Survey, slide 19.
(3) Ibid, slide 26.

larger onus on the state, which is now on a trajectory that is fiscally unsustainable in the long run, all the while their pacifying effect will be temporary, as new distributional measures inevitably come to be seen as entitlements, and expectations continue to rise.

The rest of the paper will flesh out the arguments of the above paragraph. It will first provide an overview of the Saudi distributional system, describing the evolution of various (formal) channels through which the state has been distributing material resources in society, how this system has marginalized private economic activity, and how young Saudis have generally gotten the short end of the stick in this set-up. The next section will discuss the impact of the 2011 and 2012 distributional measures on the Saudi system in economic and political terms.After a discussion of the economic sustainability of the current distributionalsystem, the paper concludes with a summary of its main arguments and a discussion of economic policy alternatives.

The paper is based on quantitative data from official Saudi sources and the IMF, a survey of the Saudi press since early 2011 and various polls that have been conducted in Saudi Arabia since 2003.

## The Saudi Distributional System

Saudi Arabia's political economy is characterized by an unusually dominant role of the state, as all oil rents accrue to government and rent distribution continues to be the core driver of economic growth and, in many ways, the formation of social groups. The central role of the distributional state has led not only to the relative marginalization of private production, but also of autonomous social organization, as most social formations – kinship networks, urban elites, social classes etc. – have come to be concentrically organized around the state, which in itself has grown internally fragmented in the process (Hertog 2010a).

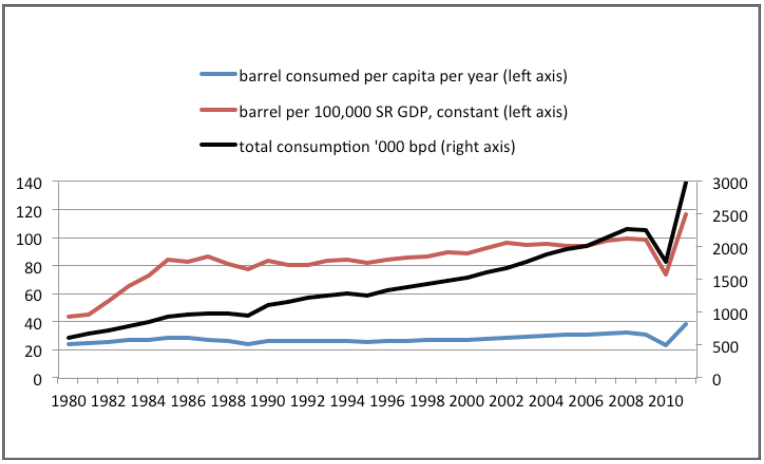
The Saudi distributional system was first created in the 1950s, drastically accelerated its growth in the 1970s, and has remained basically unchanged since. State resources continue to play a deep role in most Saudis' everyday lives, even if in some regards socio-economic autonomy has gently increased from the mid-1980s to the 2000s. The following section provides an overview of the distributionalstructures that Saudi society and economy are enmeshed in. The focus is mostly on institutionalized mass distribution rather than discretionary, elite patronage, which is important in its own right but less relevant for the macro-structure of Saudi state-society relations that is our primary interest here.

## Subsidized Goods and Services

Saudis enjoy a wide range of free or heavily subsidized services, including education and health provided by state agencies free of charge and water, electricity and transport fuels provided below production cost and far below opportunity costs (on energy see Stevens & Lahn 2011). As a result, over-consumption is rampant and,against all global trends,the energy efficiency of the Saudi economy has been declining. The opportunity costs of energy subsidies alone have been estimated at 10% of Saudi GDP (Hodson, Nathan

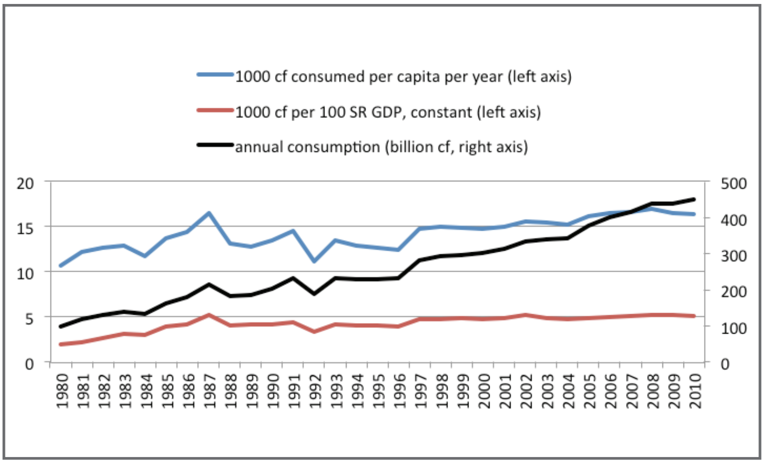
2011); the government's education budget constitutes another 8% or so of GDP.

**Figure 1: Domestic petroleum consumption since 1980**




Sources: EIA, SAMA

**Figure 2: Dry natural gasconsumption since 1980**




Sources: EIA, SAMA

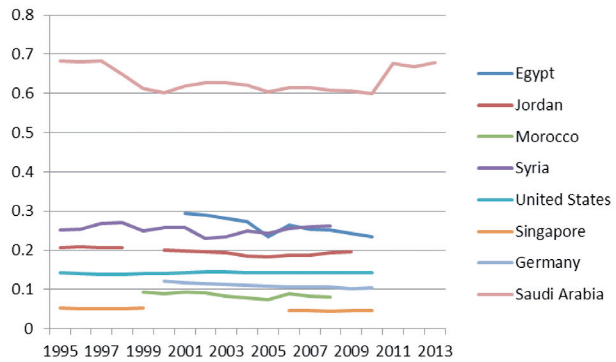
In the face of a rich, omnipresent but administratively rather inaccessible state, many Saudis also derive income from "brokering" access to state services and administrative decision-making to less well-connected compatriots and foreign residents. The goods involved in such interactions include visas for foreign workers, commercial registrations of companies registered in a national's name but in fact run by foreigners, access to health and other public services, land, various types of licenses and, on more senior levels, government contracts (Hertog 2010b).Such practices increase individuals' dependence on the state, but also come at a great cost in terms of equity and efficiency. While there are serious attempts to reduce some of these brokerage activities, it remains to be seen how sustainable the impact of recent campaigns against trade in visas and "cover-up" businesses will be.

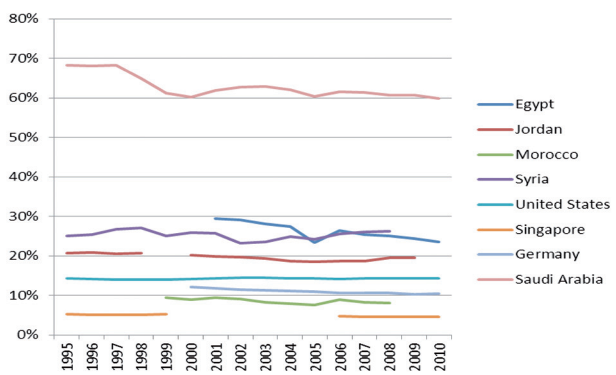
## Public Employment

The politically most important component of the Saudi distributionalsystem however is public employment – which sometimes is mediated through informal brokerage, but quite frequently is also allotted just on the basis of formal educational criteria and one's position on a waiting list. It is hence as institutionalized as free or subsidized public services.

The ratio of public to private employment among Saudis is drastically higher than among non-GCC states and has stabilized above 60% after some decline in the austere second half of the 1990s. Even the modest number of Saudis in the private sector is to some extent an outcome of state interventions forcing companies to employ Saudis – including the post-2011 upward tick in Saudi private employment in figure 4, which results from the government's "Nitaqat" policiesthat progressively restrict companies' ability to hire new workers if they fall below certain Saudization thresholds.

**Figure 3: Share of government employees in the economically active population of select countries**(1)

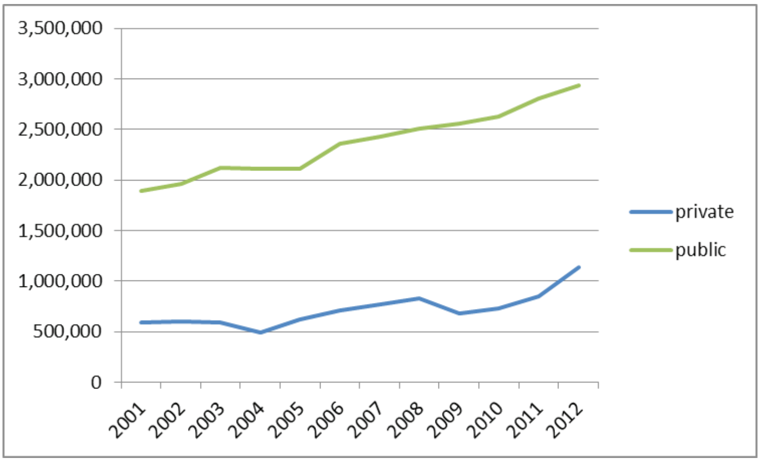


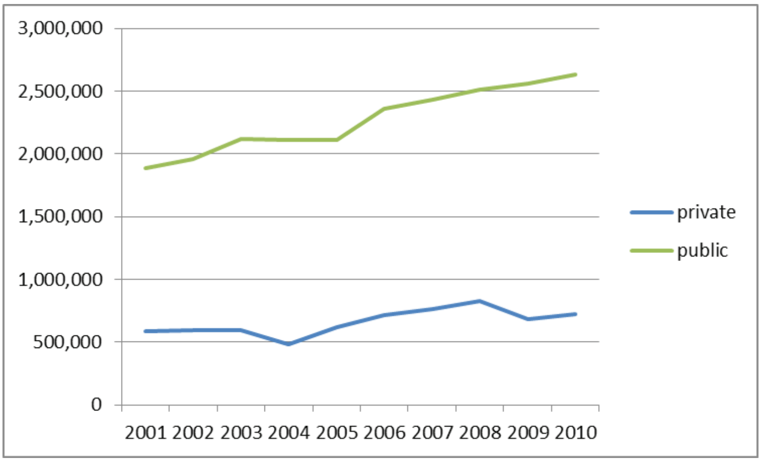




Source: World Bank, ILO, Saudi Labor Force Survey, and SAMA

(1) The Saudi shares are calculated as (government employed)/(all employed + 10 percent unemployed), with all figures taken from labor force surveys. The data for the other cases are from ILO (public employment) and World Bank (economically active population). Public enterprises are not included for any of the cases, hence all figures are likely to be somewhat underestimated (possibly more so for Saudi Arabia, where important sectors such as mining, hydrocarbons, inter-city transport and aviation, utilities, and heavy industry are still largely in state hands). Non-Saudi cases include non-citizen employment, which could not be separated out but is unlikely to bias results strongly.

**Figure 4: Number of Saudi public and private employees, 2001-2012**



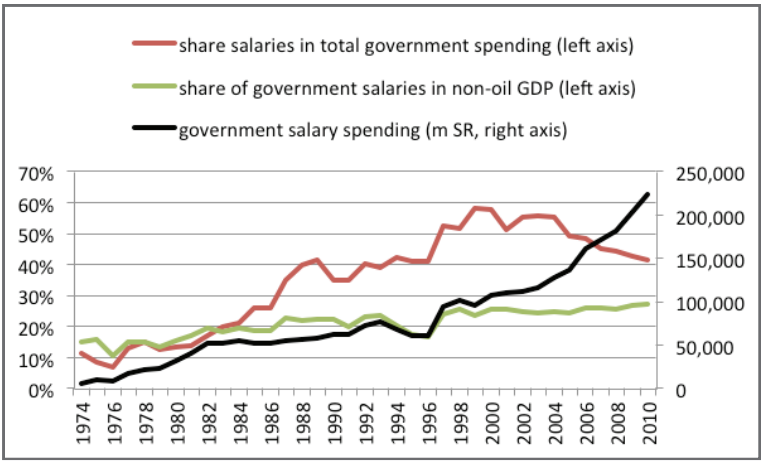




Source: Ministry of Labor, Saudi Labor Force Surveys

Administrative data from the Ministry of Labor indicate that in 2011 only 6.5% of the Saudi working age population held a private sector job, which contrasts with more than 50% in non-oil developed countries.

Figure 4 below indicates that spending on public sector salaries and benefits has been increasing dramatically, and the share of such spending in non-oil GDP has now reached more than a quarter. Although its share in total government spending has somewhat declined recently due to very larger expenditure on infrastructure projects, it still remains around 40%, which is much higher than in OECD countries, where it typically lies between 15 and 30%.

**Figure 5: Budgeted spending on public sector salaries and benefits since 1974**[1]




Source: based on various statistical yearbooks, SAMA yearbooks

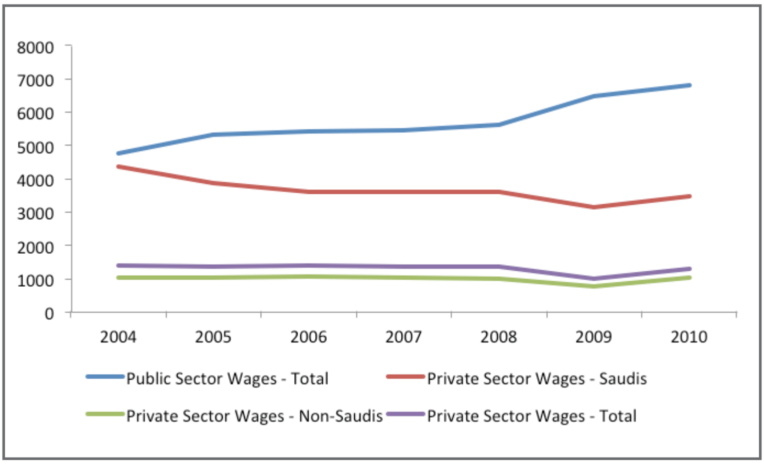
Based on non-oil benchmark countries, we can estimate that perhaps half of public sector wage spending is a result of over-employment and hence constitutes rent distribution.[2]

In addition to employing more Saudis than the private sector, the government also pays considerably more and typically offers much easier working conditions – although Saudis in the private sector in turn are stillmuch better paid than foreigners (a recent estimate of the wage premium paid

(1) Figures for 1986 are identical to those for 1985 and refer to the same Islamic budget year (the budget cycle was subsequently adjusted to the Gregorian calendar).
(2) If the share of government wage spending in non-oil GDP is taken as a benchmark, the estimate of patronage is somewhat higher than if we use the share of wage spending in total government spending (as total government spending is quite high to start with in the kingdom).

Saudis receive compared to otherwise equivalent foreigners reached 215%). Understandably, private employment is generally considered second choice by all but the most talented nationals, and Saudi polling data from the World Value Survey indicates lower levels of initiative, a stronger preference for convenient working hours and long holidays, and stronger rejection of performance pay among Saudis than among citizens of other countries.

**Figure 6: Average wages in the public and private sectors, 2004-2010**




Source: National accountsdata, Ministry of Labor, and author's calculations

Despite the attempt to share the oil riches through large-scale over-employment in the public sector, Saudi society suffers from considerable inequality. The range of public sector salaries is wide (regular payscales range from 3000 SR to 42,000 SR a month);more important, due to continuing population growth, many Saudis remain excluded from government employment. And many remain altogether out of the labor force – the labor force participation ratio is estimated at only 36% – or join a private sector with generally lower incomes.

Large-scale importation of foreign labor helped Saudi Arabia develop rapidly in the 1970s and 1980s, but it has marginalized nationals in the local labor market. Private employment remains dominated by cheap Asian workers who pull down wages particularly in the low- to mid-skilled market segments, leading to an unequal wage distribution also for Saudis.Based on published salary data, the Ginicoefficient for private wages of Saudis registered with the national social insurance organization in 2011 was 0.51, a very high value in international comparison.[1]

The ready availability of cheap foreign labor has led the Saudi private sector to invest in low-productivity, low-technology businesses that produce little innovation or research, which in turn means that few jobs with higher value-added are created (Hertog 2011a). Labor productivity has declined since 1980, and according to the IMF, the Saudi economy's total factor productivity declined by an average of one percentage point from 2000 to 2007, which were boom years in macro-economic terms(International Monetary Fund 2011).The main drivers of growth have been increasesin the amount of capital and (foreign) labor employed, not increases in efficiency and technology upgrades.

(1) The Gini coefficient is a measure of the inequality among levels of income. Zero expresses perfect equality and 1 maximal inequality. To give a comparative sense of where Saudi Arabia stands, the Gini coefficient for gross wages in 12 OECD countries documented in a recent study averaged 0.36, while the coefficient for net wages in 11 further OECD countries averaged 0.32. Saudi numbers are even more dramatic if foreigners are included in the estimate: The Gini coefficient for foreign workers alone is 0.58; the total Gini for all GOSI-registered private employees reaches 0.64, an extremely high value.

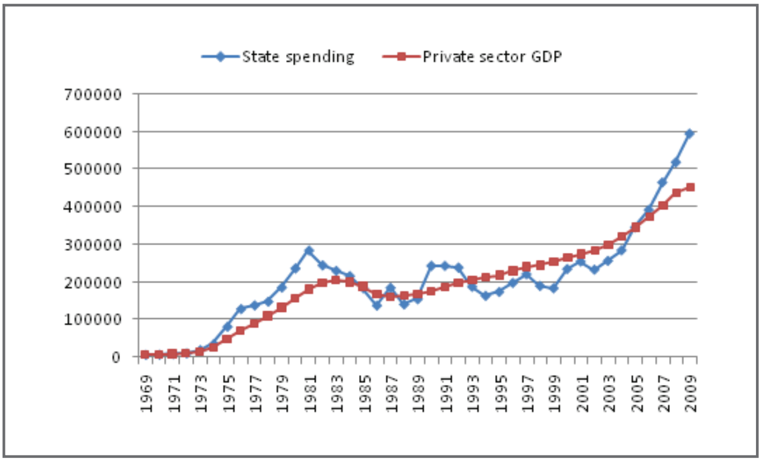
## Business and the State: Demand Generation

Saudi business, just like the population at large, remains fundamentally state-dependent.

Support can take the shape of government lands and contracts or subsidized inputs like cheap electricity, gas and state credit.Even if in some important regards the allocation is done without favoritism,[1] state resources are central to the business sector's thriving. Business continues to rely on subsidized inputs, notably cheap energy, and cheap foreign labor for its profits; its production structures are factor-intensive.Different from conventional developed economies, business in turn contributes practically nothing to state resources, as there are practically no taxesin Saudi Arabia. There is no "Keynesian multiplier" under which higher state spending can at least be partially recouped through higher tax revenue. Growth instead relies on ever higher levels of state expenditure financed from a finite resource. In years of stagnating or declining state spending, the private sector never managed to grow significantly of its own accord, and econometric tests show a tight long-term correlation of state spending and the size of the private sector.

(1) While access to large infrastructure contracts and non-industrial lands for example is in many cases de facto limited to a small number of well-established players (even if they are held to certain performance standards), access to cheap electricity and transport fuel is universal.

**Figure 7: Private sector contribution to Saudi GDP vs. total government expenditure (million SR)**




Source: Based on SAMA data

Saudi merchants have been accumulating and reinvesting capital for decades, increasing their day-to-day autonomy from the state, and their dependence on state contracts is relatively smaller than it was during the 1970s boom. Private capital on average caters to a larger private consumer demand than it used to. It is less sensitive to short-term fiscal shocks than it was before the mid-1980sand has become managerially more sophisticated (Hertog 2011b; Luciani 2006).

Even the "private" Saudi consumer demand however is for the most part state-generated and in the mid-term almost completely dependent on state spending.The main reason for this is the very low share of private remuneration in total Saudi GDP, which in turn resultsfrom low wages and the marginal role of Saudis on the private labor market. GOSI data indicate that Saudi employees in the private sector in 2010 had total annual earnings of about 50 billion

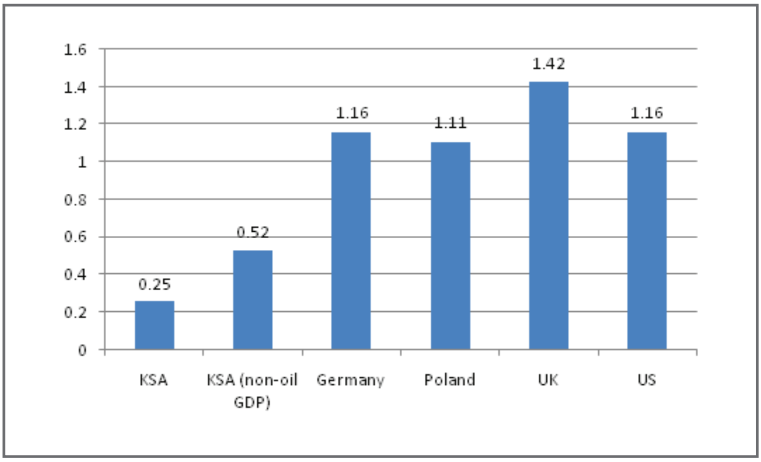
SR, while expatriates earned a total of about 75 billion SR, the vast majority of which was remitted abroad.[1] Both together account for only about 7 percent of Saudi Arabia's GDP. Saudi Arabia's private wage share is very low in international comparison. In developed OECD economies it lies around 40-50 percent of GDP.[2]

This means that most demand in the Saudi economy is still state-generated, and public sector wages – which accounted for 15 percent of GDP in 2010 – play a more important role than private sector wages in stimulating consumption. Even if one uses only the non-oil private sector as a denominator (which constituted 29% of total GDP in 2010), the private wage share for 2010 only reached about 25%, probably reflecting a strong element of rent extraction from cheap foreign labor. The wage share of the government sector by contrast was almost 80%. Figure 8 below shows that the ratio of private wages to GDP per capita in Saudi Arabia also reaches only 25%, much lower than in benchmark countries, reflecting the small contribution to the Saudi macro economy of privately generated consumer demand.

(1) SAMA estimates total remittances for 2010 to have reached 98 billion SR, which in fact exceeds the total size of GOSI-registered wages. This indicates that some wages must be unreported or under-reported. According to the national accounts for 2010, non-government salaries constitute about 8.8% of GDP, possibly reflecting some labor that is not GOSI-registered.

(2) Glyn (2007) reports total OECD wage shares around 65% (although these are corrected upward for self-employment). With government employment typically accounting for about 20% of total employment, private wage shares generated through salaried work typically account for about half or a bit less of GDP.

**Figure 8: Ratio of average private sector wages to GDP per capita[1]**

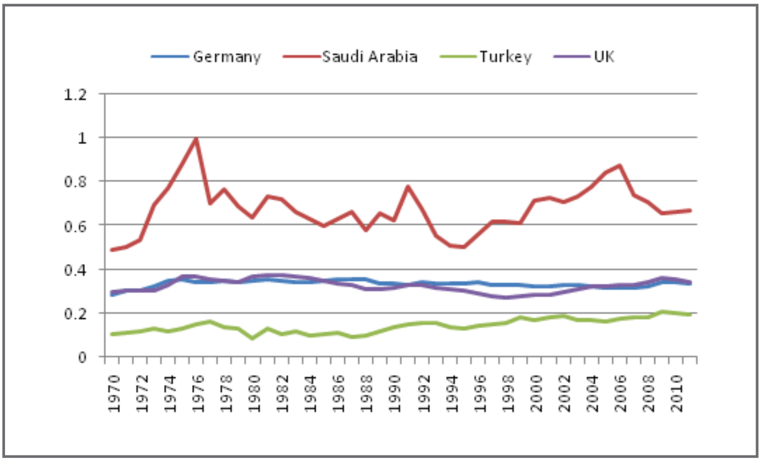



Sources: OECD, World Bank, SAMA, MoL

Saudi businesses' reliance on cheap foreign labor drives citizens into state employment and state-dependence more broadly, while the marginality of Saudi citizens in the private labor market in turn makes business more dependent on state spending for economic stimulus. The ratio of public to private consumption in Saudi Arabia is very high in international comparison, reflecting an outsize role of the state in the economy – and this ratio does not even account for the fact that most private consumption is indirectly state-generated.

(1) The estimates here use the (lower) average wages reported by the MoL and labor force surveys. Average wages derived by dividing the aggregate private wages reported in the national accounts by the number of private sector workers reported by MoL results in higher ratios of 0.42 (total GDP) and 0.86 (non-oil GDP). GOSI data indicate even higher average private sector wages in Saudi Arabia, resulting in ratios of 0.47 (total GDP) and 0.97 (non-oil GDP). Even the highest estimate however still lies below the benchmarks.

**Figure 9: Ratio of government to private consumption in Saudi Arabia and select comparative cases, 1971 to 2011**




Source: UNSTATS

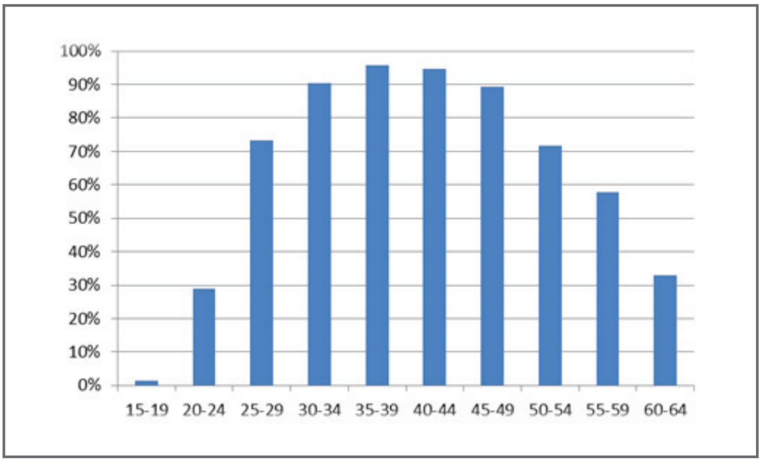
The Saudi economy is characterized by high levels of state dependence of both the national population at large and Saudi business – a dependence that in some regards has become more rather than less entrenched since the 1970s. Despite the size and reach of the distributionalsystem, its discretionary and "lumpy" nature has combined with an open labor migration regime to produce high levels of inequality among Saudis.The deep reach of distribution allows the state to guarantee basic livelihood and economic security for most citizens, thereby guaranteeing the socio-economic stability that has eluded poorer Arab countries. The distributional system however is also less sustainable in the long run than the poorer economies of the region, as it entrenches ever higher levels of entitlement over time with no corresponding increase in the productive capacity of Saudi society.

Saudi youth on the margins of the distributional system

Inequality in Saudi Arabia has a particularly sharp generational dimension that deepens its political potency. Despite a demographic transition, the Saudi population continues to grow above 2% per year, while the labor force has been growing even faster, at above 4% per year in the decade from 2000 to 2009(IMF 2012b: 22).An important driver of this growth has been the increasing labor market participation of young Saudi women, who have increasingly fewer and later children, have ever less traditional lifestyle expectations, and are on average better-educated than men.

More than 400,000 young Saudi males and females reach working age every year, while less than 70,000 Saudis reach retirement age. Accounting for deaths in working age, the net addition to the working age population is currently about 300,000 per year. This puts an enormous strain on the Saudi labor market, which is unable to accommodate such volumes of first-time job seekers. 80% of Saudi unemployed registered with the Ministry of Labor in 2010 were between 20 and 34 years of age; many Saudis obtain full employment only in their 30s.

**Figure 10: Employment ratios of Saudi males by age group**



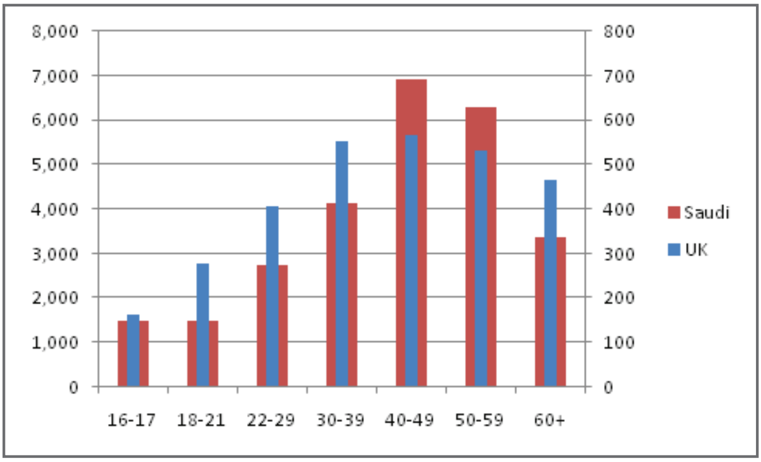

Source: Labor force surveys and SAMA

The limits of the distributional state are hence most acutely felt among young Saudis who are unable to find an adequate job in the private sector and have to spend many years on waiting lists for public sector jobs. The tensions are particularly severe for young Saudi women.The official female unemployment rate is approaching 30%. According to administrative data still only 350,000 Saudi women of 5.6 million in working age were in employment in 2010, mostly in the public education and health sectors. This indicates a huge gap that will be difficult to fill in a system where most jobs are state-provided and financed through finite rents that men and women are de facto rivals for. This rivalry might explain why 68.7% of Saudis in a 2003 World Value Survey poll agreed that job provision for men should have priority over that for women, compared to 47.1% in the 40other countries in the sample[(1)].

Even if young Saudis manage to find a private sector job, they are penalized particularly harshly for their age in wage terms. Figure10 below shows that the age premium in private sector wages is very high in Saudi Arabia compared to the UK (where a progressive tax system further reduces inequalities in net incomes). It is unlikely that all of this can be explained with the better quality and experience of older Saudi workers; age discrimination seems to be at work[(2)].

(1) This contrasts with other gender-related attitudes which are surprisingly liberal: Compared to non-Saudi respondents across the world, more Saudis agreed that marriage is an outdated institution and that a woman does not need children to have a fulfilled life.
(2) Paradoxically however, young Saudis appear to care least about a fair wage compared to their Arab peers; Arab Youth Survey 2012, slide 8.

**Figure 11: Weekly gross wages in the UK (GBP, right axis) vs.monthly earnings in the private sector in Saudi Arabia (SR, left axis)**




Sources: General Organization for Social Insurance, UK Office for National Statistics

Young Saudis also profit less from prevailing subsidy regimes. They are de facto excluded from state support for housing due to long waiting lists, which in turn means they also make less use of cheap utility services than their older compatriots. The subsidy they profit most from is arguably cheap petrol, which in the absence of employment is of little use for anything but idle cruising.

As the poll numbers cited in the introduction indicate, generational inequality might not be a sufficient cause of political disquiet if otherwise the times are good. It should be noted however that the only serious phase of oppositional mobilization in modern Saudi history – the wave of Islamist protests in the early 1990s – had a strong generational component. More than that, it was rooted in material inequalities between generations that came to the fore in the age of austerity and economic stagnation in the

1980s and 1990s. Many young Islamists were latecomers to the Saudi system stuck in unemployment or on low levels of the bureaucracy, lorded over by a "liberal" generation that had made rapid careers in the boom days of the 1970s (Lacroix 2011a).

Opportunities are better now, as growth rates of state spending have been in the double digits for most of the 2000s. Times are probably too good for dissatisfaction to become acute and widespread – but the position of Saudi youth on the margins of the distributional system is nonetheless precarious. The numbers of young Saudis are now so large that the government's distribution policies, however vast, reaches only a fraction of them. As in the 1990s, there continues to be a structural tension between a governmentthat is led by a small and aging generation of technocrats on the one hand and much larger young, educated and restless demographic cohorts on the other – and some of this tension has recently been expressed in a new, albeit smaller wave of youth activism inspired by the Arab uprisings.

## The Effects of the Distributional Measures Since 2011

The welfaredecrees of spring 2011 arguably reflected, among other things, an attempt to extend the state's distributional networks to politically sensitive youth cohorts. In addition to the 300,000 new public sector hires, and a public sector minimum wage of 3000 SR that mostly affected low-level employees with limited seniority, the government created an unemployment assistance scheme paying 2000 SR per month to all national job seekers for a maximum period of 12 months. The planned provision of 500,000 new houses by the government also targeted younger Saudis, although those in their late 20s and 30s rather than younger students or first-time job-seekers.

The new measures have helped to spread the kingdom's wealth somewhat more broadly. They are also pushing a new generation of Saudis as well as the Saudi private sector back into an earlier age of state dependence, however, with potentially debilitating long-term consequences for the kingdom's economic development path and fiscal sustainability. The measures have also created new, often unequal rent-seeking opportunities. And once more, the measures reach the intended beneficiaries, especially among the youth, only unequally.

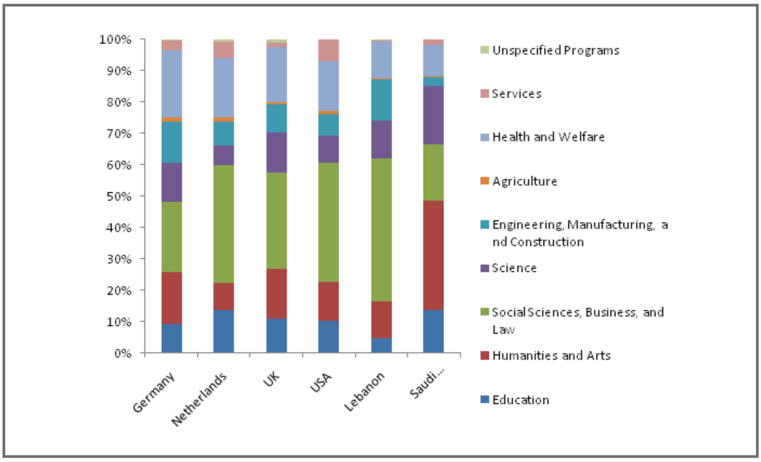
## The Effects on Citizens

One-off bonuses, new hires and public sector minimum wage together have contributed to 16% growth in the government's salary expenditure from 2010 to 2011 alone (IMF 2012a); it is likely that the larger wave of hiring in 2012 will lead to further significant growth of this budget item. Welfare spending has also increased by 20% in 2011, and the full roll-out of the "Hafiz" unemployment assistance scheme – providing 2000 SR per month for up to a year to Saudi job seekers below 35 – means that total social spending was expected to more than double in 2012 (IMF 2012a).At the same time, the government has strongly stepped up its efforts to force private employers to take on Saudi workers through the new "Nitaqat" quota system,which important parts of the business class perceive as a quasi-tax.

Apart from Nitaqat, most employment-related policies reduce the prospect of Saudi nationals' sustainable integration into the private labor force. The Hafiz benefit, even if modest by Saudi standards of living, lies about 50% above the average wage in the private sector,(1) thereby giving nationals incentives to drop out of low-wage private employment or at least not join the private sector before the expiry of the benefit. More problematic, the new minimum wage in the public sector is more than twice the average wage for all private sector employees and only 15% less than the average private sector wage for Saudis. Together with the new government hiring wave, it gives young Saudis strong incentives to join the waiting queue for a public sector job and pushes them to make educational choices that are not relevant for the private sector – notably in favor of degrees in "soft" humanities subjects, which are generally less demanding in the Saudi context, but yield similar returns in the public sector job market as most "hard" degrees. Soft degrees are already strongly over-represented in Saudi universities. Pro-Saudization policies like Nitaqat, however forcefully pursued, are up against strong incentives that pull Saudis into the public sector and away from the acquisition of relevant skills.

(1) The average private sector wage according to 2010 Ministry of Labor data lay at about 1300 SR; the average for Saudis was about 3500 SR, the average for expatriates around 1000 SR.

**Figure 12: Graduates according to field of study (2010)**




Source: UNESCO

The prospect of generous public employment has likely increased the reservation wages of young Saudis, further pricing them out of the private labor market and inflating their expectations of easy and convenient working conditions. At the same time, the government has continued its open migration policy, sustaining rock-bottom wages in the private sector; the recent introduction of a 2400 SR annual fee on foreign workers dents their cost advantage, but only at the margin.The employability gap between nationals and expatriates in the private sector has seldom been larger.

Recent distributionalmeasures tend to marginalize Saudis on the private labor market, further removing them and,as we will see, the Saudi private sector from an ideal of economic self-sufficiency that is not dependent on state largess. At the same time, the new policies have been insufficient to accommodate all job seekers. Public employment, however generous, remains selective even after 2012, covering less than a third of working-age Saudis. Like access to state housing it privileges older over younger Saudis both in terms of salaries and in terms of the waiting queue for recruitment, even if the latter have been shortened recently by a year or two.

There are also indications that new schemes like Hafiz and Nitaqat have created new, unintended opportunities for illicit rent-seeking. Some 700,000 Hafiz recipients have been removed from the program after it turned out that they did not fulfill its requirements,(1)for example, because they already held public sector jobs, held company registrations in their name or – in the case of at least 3000 individuals – were actually dead(2).

The Nitaqatsystem does not provide direct state resources, but also potentially invites manipulation. The number of female employees in the private sector, for example, has exploded from 77,000 in 2011 to 202,000in 2012 with the introduction of the scheme, and the number of student workers suddenly grew from 26,000 to 97,000. In both cases, a good deal of the increase might be explained bythe "phantom employment" of nationals who donot actually show up at the workplace (but might receive a small stipend in return for letting themselves be listed on a company payroll).(3) The Saudi press has reported numerous anecdotes of phantom jobs involving female homemakers

(1) Arab News, 27 August 2012; http://www.arabnews.com/saudi-arabia/labor-ministry-plans-crack-down-work-visa-sellers.
(2) Arab News, 30 November 2011; http://www.arabnews.com/node/399677.
(3) For the numbers see Saudi Gazette, 28 November 2012; http://www.saudigazette.com.sa/index.cfm?method=home.regcon&contentid=20121128144254.

on minimal salaries or even incumbent civil servants who were not aware of their position on the payroll of private companies.

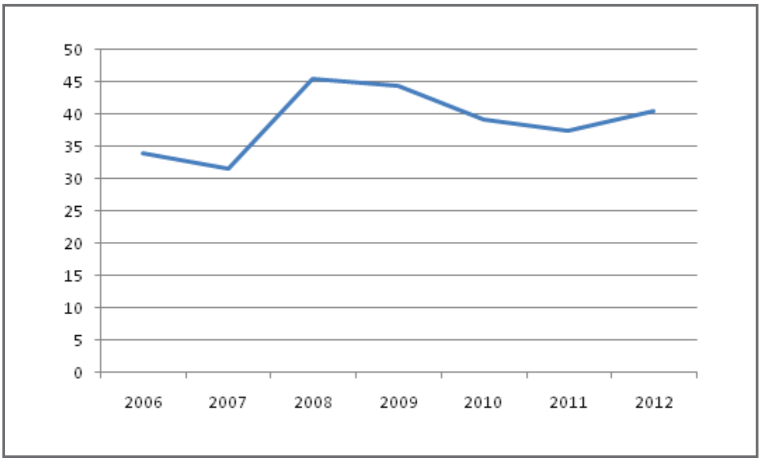
Needless to say, such rent-seeking opportunities undermine incentives to seek productive employment, and create further inequality in favor of those willing to break the rules. The government is working on enhancing its inspection capacity, but the new policies are complex and the labor market has a long history of lightsupervision and regulatory evasion by employers. Monitoring challenges are large. As long as broader incentives are stacked against private employment of Saudis, businesses and nationals will try to find loopholes and, if possible, try to derive rents in the process. Recent policies appear to have generated some genuine jobs for Saudis – but the extent is unclear, and it is in doubt whether these steps are sufficient to put the kingdom on a self-sustaining Saudization trajectory as long as the broader distributional system works against them.

## The Effects on Business

On the face of it, it appears harder to argue that recent distributional policies have been bad for the private sector. Saudi Arabia's non-oil GDP has witnessed real growth rates consistently above 6% from 2009 to 2011, and growth for 2012 is expected at 5.6% (IMF 2012a) – while the poorer states of the Arab world have been in crisis with much lower or negative growth rates for 2011 and 2012.

Growth driven by state spending has led to a lower share of the private sector in GDP however, as figure 10 shows. The current share of government in the economy is considerably above the 35.5% average recorded in 2000-2006 (IMF 2012a), although these already were years of rapidly growing state expenditure.

**Figure 13: General Government Total ExpenditureandNetLending (Percent of GDP)**




Source: IMF

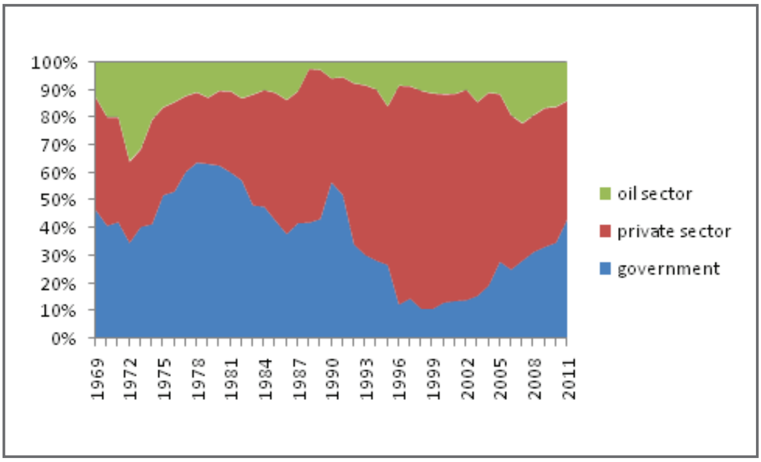
Most worryingly, state spending corresponded to about 90% of non-oil GDP in 2011, compared to around 80% in 2010(IMF 2012a; Saudi Arabian Monetary Agency (SAMA) 2012). Most private activity hence happened in reaction to state-generated demand. The retail boom since 2011 is almost exclusively a result of higher state salaries and employment.(1) Compared to the lean 1980s and 1990s, the private contribution to consumption has shrunk (see figure 8 above).

The government has also ramped up its share in capital formation; in 2011, for the first time since the 1990/91 Gulf

(1) Bloomberg, 8 October 2012; http://www.businessweek.com/news/2012-10-08/saudis-buy-burgers-with-royal-handouts-in-boom.

war, its contribution was larger than that of the private sector, even if the state-owned oil sector is excluded from the calculation. In the 1990s and early 2000s, private capital formation had been 5 times as high as that of government.

**Figure 14: Sectoral contributions to gross fix capital formation**




Source: SAMA

Private sector growth in recent years has been impressive; the price however has been a level of state dependence last witnessed in the early 1980s.Saudi consumption levels have been immune to the vagaries of the global financial crisis as well as the Arab spring, as most demand has been a function of state spending on salaries and contracts. While this provides a highly secure environment for the private sector in the short run, it also means that the kingdom is the furthest from self-sustaining growth it has been in decades.

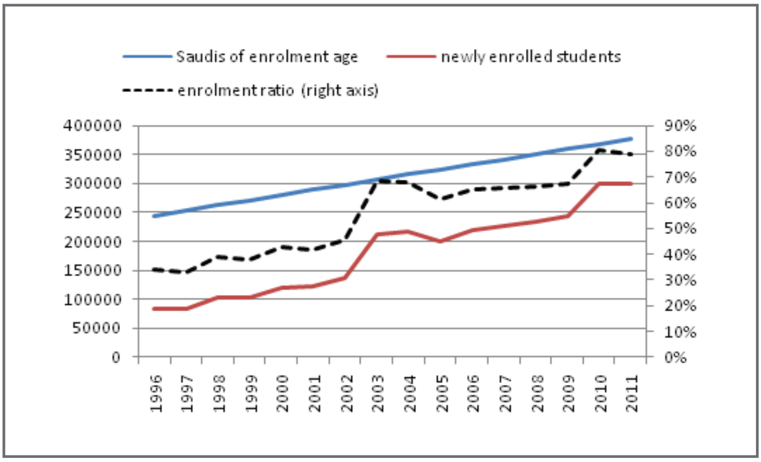
In addition to state-generated demand, Saudi business also continues to depend on the state-organized provision of cheap inputs, be it energy or low-cost foreign laborfrom Asia. The reform debate about domestic subsidies on energy and gas was put on halt in the wake of the Arab uprisings and has been rekindled only very carefully in 2012 – another setback on the way to putting the kingdom on a sustainable growth path built on technological and industrial? diversification rather than low-tech factor price arbitrage and ever-growing government spending.

The youth employment outlook after the distributional decrees

While there are few signs of self-sustaining private growth, an employment crisis ispotentially brewing.Young Saudis' elevated job market expectations resulting from the decrees of 2011 are unlikely to be accommodated in the private sector; at the same time, the public sector alone is unable to absorb the large new cohorts of job-seekers even if over-employment further escalates. A mid-term crisis of socio-economic demands looks more likely now than it did in 2010.

One major factor that would contribute to such a crisis is the much increased level of formal education among young Saudis. The Saudi government has rapidly expanded its higher education system throughout the 2000s, in partthrough the expansion of existing universities, but also through the rapid build-up of numerous new provincial universities the quality of which is often put in question.

**Figure 15: Number of enrolled students in Saudi Arabia (male and female)**




Source: SAMA/Ministry of Higher Education

While the population cohorts of university age have grown about 60% over the last 15 years, total enrolment has grown about 300%. About 300,000 new students are now entering the Saudi university system annually, corresponding to about ¾ of their age cohort. A further 120,000 are currently enrolled in universities abroad. While university students were a small minority among their age groups during the last phase of political unrest in the early to mid-1990s, they now constitute the crushing majority.

The expansion of higher education has allowed the temporary parking of young Saudis, many of whom would otherwise be unemployed, in local universities;the monthly allowance to which Saudi students are entitled is in some ways equivalent to an unemployment benefit. But kicking the employment problem down the road through over-expansion of the university system has arguably made it worse. While the quality of higher education and prospects of gainful private employment remainin doubt, material expectations almost certainly have increased among young graduates, many of whom will not be willing to work as drivers, shop clerks or security guards – the only types of positions of which there are enough to accommodate future numbers of job seekers.(1)

The vast majority of Saudi students are in bachelor's programs, which means that the huge freshmen cohort of 2010 will hitthe job market in 2013 and 2014. The quickly growing bars on figure 12could be the harbinger of an employment crisis that is closer than the government has realized.The 2012 Arab Youth Survey indicates that young Saudis are more worried about the economy and unemployment than average Arab youngsters.(2)

Further absorption of these young cohorts in the bloated civil service is possible and can, for the time being, be financed comfortably thanks to a fiscal reserve cushion that is still growing. Distributional obligations are very hard to reverse however, and any additional measureswould further distort labor markets, increase state dependence and shorten the life expectancy of the Saudi economic model as we know it. Further distributional spending along established lines would only bring the eventual day of reckoning closer; its precise date is simply a function of oil price and future levels of spending.

(1) Among the more than 5 million expatriate-held private sector jobs in 2010, only 380,000 paid a salary of more than 3000 SR/month. Unless levels of productivity increase drastically, the private sector will not be able to pay living wages to the millions of Saudis in need of employment in future years.

(2) 54% of young Saudis are "very concerned" about the economy and 51% about unemployment; the average regional figures in the survey are 48% and 44% respectively; Arab Youth Survey, slide 11.

Much ink has been spilled in discussions of Saudi breakeven oil prices, a discussion that does not need to be rehashed here. Point predictions of when the government will start incurring deficits are impossible, but the following is clear: Spending will continue to trend upwards, while oil revenues will fluctuate. At some point the two curves will intersect and the kingdom will have to draw on its overseas reserves. While there are some components of spending that can be cut – capital spending on projects in particular, as has happened in the austere 1980s and 1990s – current spending on salaries, subsidies and transfers has proven politically immune to cuts in the past. Such spending will continue to grow due to population growth and gradually increasing social expectations.Economic growth is part of the problem rather the solution in the Saudi context, as the nature of growth in the kingdom is fundamentally different from tax-based states. Private sector growth continues to be driven by increases instate spending, as there is little autonomous demand created by the private sector, the private wealth of which is often kept abroad and the (typically meager) salaries paid by which tend to leak abroad in the form of remittances. Reliance on low-cost labor also means no or negative productivity growth, pushing away business from an technological growth path that could make it internationally competitive. As there is little taxation, business also makes no significant contribution to state income, which means that Saudi Arabia has no "Keynesian multiplier".Different from tax-based states, economic growth does not help the fiscal situation through higher taxes (in fact it undermines it to the extent that it is based on state spending).

With a much larger population and much increased needs "ratcheted in" on a high level, current distributionformulas could prove economically and politically unsustainable within years rather than decades. At a stretch, the government will be able to provide surplus employment to young cohorts of job seekers for another decade or so, but thereby make eventual reform of the distributional model all the more difficult and painful.

The dominant role of the Saudi state in the economy and labor market has been the system's strength in recent times of political and economic crisis. It could be its weakness further down the road when government resources get scarce and there is little autonomous economic activity in society to build on. The crash could be all the more severe after both population and businesshave reached a new level of state dependence that was last witnessed during the 1970s/80s oil boom.

There is clearly a sense of foreboding among parts of the Saudi technocracy and an awareness of long-term labor market and fiscal challenges – as is reflected in the much slowed rate of fiscal expansion in 2013 and the stepped-up Nitaqat efforts, which constitute a significant conceptual and practical improvement over past Saudization efforts and are pursued with a vigor that was unimaginable just three or four years ago. To some extent, stronger Saudi employment through Nitaqat will improve local demand (thereby functioning even more as a quasi-tax and substitute for state spending) and give Saudis the hands-on job skills that the education system often cannot impart.

The fundamental features of the distributional status quo however limit the efficacy of both fiscal consolidation and Nitaqat. Public sector over-employment continues to skew labor market incentives and locks in current spending on an increasingly unsustainable level. The domestic energy pricing regime structurally underminesthe fiscal basis of the state, while being a singularly ineffective way of sharing the wealth as it incentivizes over-consumption and benefits richer households disproportionately. Both will need to be tackled to move Saudi Arabia onto an autonomous growth path in which a majority of nationals play a productive role in their own economy.

## Conclusion and Policy Outlook

The Saudi government's fiscal reaction to the Arab spring has considerably deepened the role of the state in Saudi society and economy. New distributionalpolicies have created a number of perverse economic incentives, increasing state dependence of business andexcluding nationals from productive participation their own economy. Although the Saudi system is more institutionalized than in the 1970s, it has returned to the same logic of distribution and state-driven growth.

Many young Saudis continue to be play a marginal role in the political economy of state support, but are more politically aware and have higher material expectations – partially as a result of the very distributionalpolicies specifically aimed at them, notably the expansion of the higher education system. Not all their demands can be satisfied through state spending in the long run.

It is clear that some distribution of rent income to the Saudi population is hard to avoid and can indeed be argued to be a political and moral imperative. There are howevermuch less distortionary and sustainable alternatives to conventional distributionthrough government over-employment and subsidized utility services. Rents could for examplebe shared in a more incentive-neutral way through direct and unconditional cash grants, which could politically justify a smaller intake into the public sector while allowing more nationals to achieve an acceptable total income despite low private sector wages.

Such a citizens' income would provide basic income security in case of unemployment, but would also decrease Saudi reservation wages on the private labor market, as national employees could top up their private sector wages with the cash grants, which would not be means-tested. It would therefore boost private sector Saudization outcomes without having to force employers to recruit nationals they are not interested in employing.

A citizens' income of 1500 SR per month could make other, more restrictive policies, such as a reduction in public sector recruitment, a tightening of civil service standards and energy pricing reform, more politically acceptable. Simulations show that in the long run, such a scheme would be less expensive than the current practice of public sector over-employment. A 1500 SR grant for all adults who are not state-employed could in fact be perpetually financed by an assumed 5% return on Saudi Arabia's current overseas assets.

Such a quid pro quo of cash grants against more selective government recruitment would contribute to a leaner and better-functioning bureaucracy, give stronger work incentives to nationals in both civil service and private sector, and would be transparent, fair, and easier to predict and plan than the current ad hoc regime of rent circulation. It would also make for a powerful political gesture of benevolence and inclusion towards Saudi Arabia's citizens.

In the mid-term, the kingdom also needs a meaningful taxation system that gives business, government and citizens a shared interest in a prosperous private sector, and which could be used to disincentivize excessive imports of low-skill foreign labor – the other main factor keeping Saudi nationals away from the private labor market. All this could increase the long-term economic autonomy of both Saudi citizens and of Saudi business, which could thrive on the back of a more substantial demand derived from private wages. Some steps of this kind are deliberated in parts of Saudi government; it looks unlikely however that they will be undertaken when they are most needed, namely in times of crisis[1].

(1) A paper on unconditional cash grants for GCC citizens is currently under preparation by the author.

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