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The Challenge of "Normalizing" the Saudi Economy

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ABDULRAHMAN AL-SUDAIRY CULTURAL CENTRE

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11), as the World Bank's Country Director for Ethiopia and Sudan, and then for Ghana, Liberia, Sierra Leone, Burkina Faso, and Guinea. In these capacities, he led several ambitious initiatives, such as Ethiopia's Productive Safety Net, Ethiopia's Protection of Basic Services Program, and in West Africa, initiatives to improve the governance of natural resources, among others. He has worked extensively on conflict prevention and on state building in Palestine, Sudan, Liberia, Sierra Leone, Yemen, Guinea.

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1. Introduction

Like many countries before it, Saudi Arabia now faces the twin challenge of having to stabilize its internal and external balances in the face of a large macro shock, and to reform its economic structure in order to fire up new sources of growth to replace a weakening but still overly dominant oil sector. The publication in 2016 of its Vision 2030 has injected a dose of optimism and unleashed a new momentum of change in a society known in the past for its conservatism and slow decision-making. Yet, the Vision also obfuscates three central issues, which are at the heart of the country's specificity, and which will make the challenges ahead particularly trying: the very large size of the required macro-economic adjustment, which threaten both the financial and social stability of the kingdom; the extraordinary dependence of its economy on migrant labor, which makes the challenge of creating jobs for young Saudis more difficult; and deeper down, its unusual political economy, which creates difficulties in balancing the interests of businesses and workers.

This paper explores each of these issues in turn. Its value added is not so much with highlighting these issues, which have been explored in the past, as much as it is with its claim that addressing them amounts to "normalizing" the Saudi economy. The discussion highlights the main areas of economic and social behavior that require a much better understanding for effective policies to be devised in the years ahead. Section 2 analyses the challenge of adjusting the macro-economy to the current oil price shock. Section 3 explores how to improve the employability of Saudi nationals in the labor market. Section 4 discusses the

structural change needed to do so. Section 5 broadens the discussion to the development models that the Kingdom could follow. Section 6 concludes with a discussion of the political economy challenges facing reform.

2. Adjusting to the macro shock

The first specificity of Saudi Arabia (KSA thereafter) today is the extraordinary size of the macro shock that has hit its economy. According to the most recent IMF article IV, oil exports revenue dropped by half, from around $300 billion/year during 2012-2014, to $140-160 billion/year during 2015-2018. Oil revenues that accrued to the state budget represented close to 90% of government revenues in 2014, and they have dropped from SAR 913 billion in 2014, to an estimated SAR 454 billion in 2017-18.

By most accounts, the current depressed level of oil prices, which dropped from about $100/barrel during the decade that ended in 2010, to about $50 afterwards, are unlikely to recover in the medium term, given demand and supply projections. This means that there is a good chance that the new level of prices would be permanent rather than transitory. Although this assertion can be debated, the paper will consider this hypothesis as its starting point. The implication is that the fiscal deficit resulting from this massive negative shock cannot be financed forever, and that there is therefore a need, sooner or later, to adjust the budget to the new level of oil prices.

The burden of the adjustment is made harder by the fact that by 2014, a year with record oil revenues, the budget was

already running a (small) deficit. This is unlike the situation of the previous oil shock of the 1990s, when the kingdom was running a large surplus, and the needed expenditure cutback was therefore more limited. It is also unlike the situations of most other GCC countries today (expect Bahrain and Oman), which were running large surpluses in 2014, and where the negative shock only reduced this surplus, or turned it into a small deficit.

Table 1. Central Government Budget 2014-22 (SAR, billions)

	Prelim.				Projected				
	2014	2015	2016	***2017***	2018	2019	2020	2021	2022
Revenue	1044	612	519	***649***	757	851	982	1019	1053
Oil	913	446	309	***455***	454	463	479	500	519
Non oil	131	166	210	***194***	303	388	503	519	534
o/w taxes	38	41	54	***63***	116	155	187	194	199
o/w energy/ water			20	***35***	81	119	198	203	210
Expenditures	1141	999	936	***890***	936	982	1023	1056	1077
Wages	335	394	439	***412***	422	433	444	455	466
Goods and services	286	229	229	***234***	236	239	244	250	252
Interest	4	3	5	***11***	17	26	32	35	36
Subsidies	45	42	54	***60***	75	81	86	89	91
Investments	471	331	209	***173***	186	203	217	227	232
Budget Deficit	-97	-387	-417	***-241***	-179	-131	-41	-37	-24
GDP	2836	2454	2424	***2596***	2713	2795	2896	3018	3095
o/w non oil GDP	1615	1768	1797	***1859***	1966	2047	2136	2239	2308
Prices - % Change	2.7	2.2	3.5	***1.7***	5	2	2.2	2.1	2

Source: IMF article IV, 2017.

The size of the shock can be appreciated in several ways. In 2015-16, the fiscal deficit was about SAR 400 billion/ year (or 16% GDP), in spite of the initiation of some budget cutting measures. By 2017, the deficit was cut by nearly half, to about SAR 240 billion (9.3% GDP), largely through deep cuts in public investment, which were running at a record high level to start with. In addition, a long-standing taboo was broken with the introduction of several new taxes (excise, VAT), and the initiation of increases in the domestic prices of energy and water, sectors that have been heavily subsidized to date. By 2017, public investment has fallen to a third of its 2014 level, to 7% of GDP, and non-oil revenues rose from 4.6 to 7.5% of GDP (see Table 1). So by the end of 2017, what has been achieved is already a large fiscal adjustment by global standards. But additional adjustments will be more challenging, as there is no more room left for reductions in the investment budget.

In spite of these considerable efforts, the fiscal deficit remained sizable at the end of 2017, as there was still about SAR 241 billion of excess of expenditure over revenues (9.3% GDP). Since the deficit has to be financed from the non-oil part of the economy, one gets a better sense of its magnitude by expressing it as a share of non-oil GDP. By this measure, it stood at 13% of non-oil GDP at the end of 2017, a large figure (down from 22% of non-oil GDP in 2015 and 2016). At the same time, the need to finance the deficit during the past 4 years has led public debt to rise from 1.6 to 13% GDP already, and external reserves to be reduced from $724 to $473 billion between 2014 and 2017.

The challenge ahead will be more difficult, as the types of expenditure left on the budget are more difficult to compress.(1) Wages and compensation of public servants now approach 50% of expenditure, and interest payments have started to rise. Moreover, as new taxes and new tariffs start hurting poorer households, the need for some compensation will rise. The government is finalizing a cash transfer program (called the citizen account), which should start disbursing during 2018.(2)

The government is thus left with only two choices: to increase revenues, and to finance (the remaining) deficit. So far, the government has taken an aggressive stance at deficit reduction and it has signaled that it intends to increase taxes and cost-recovery rapidly. Whether this will happen however remains to be seen. To get a sense of the magnitude of the needed adjustment, government plans foresee to eliminate the deficit by 2020. To achieve this ambitious goal, tax revenues are projected to rise to SAR 200 billion by 2022 (VAT initially at 5% and rising afterwards, excise on tobacco and high-sugar drinks, and higher expat fees), from a base of SAR 38 billion in 2014, and water and energy cost recovery are projected to rise by SAR 210 billion. In addition, non-tax revenues are expected to also rise due to an ambitious program of privatizations.

This financing effort represents therefore about SAR 400

(1) We have no particular information on military expenditures, besides that they are currently large.

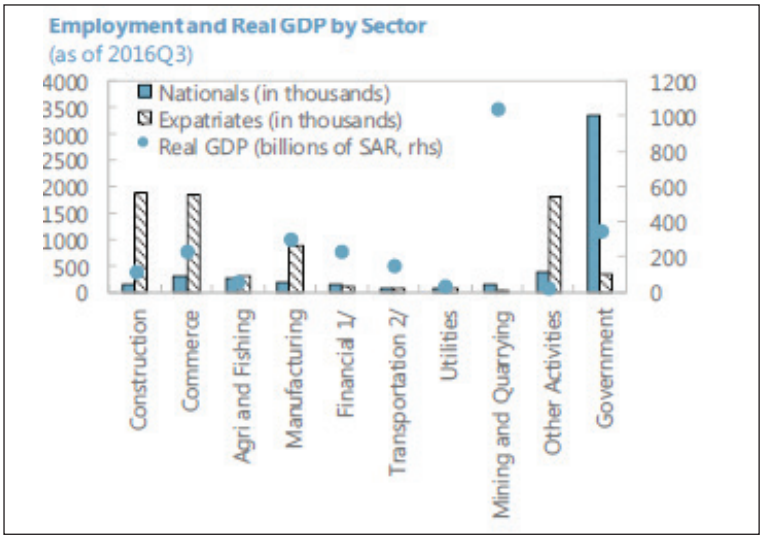
(2) The monthly transfer is expected to be about SAR 800 per household/month, and is expected to cost about 2.2 % of GDP when fully operational. It may target up to 80% of the population. It is not clear at this stage whether the program will be permanent, or temporary.

billion of additional revenues that will have to be paid by national households, corporations, and expatriate workers. To gauge the realism of these objectives, it is important (but difficult) to get a sense of the incidence of the planned fiscal effort on the various parts of the population.

Expats do create a buffer for the economy, but are unlikely to be part of the tax base. The predominance of expats in the construction sector (Figure 1) meant that, unlike other countries, the recent and ongoing closing-down of major infrastructure projects has not created large unemployment among nationals, as it has been absorbed instead by a shrinking of the expat labor force (Mahroum 2017). One presumes however that expats are being paid their reservation wage, and while they can be fired at will, it is not possible to compress their net incomes by much and keep them employed. Thus, while several fees are levied on them already (work permit, residence permit, training charges), and while these fees are expected to rise more in the future (by a total 2.2% of GDP by 2022, according to IMF projections), one expects that such additional costs will have to be borne by their employers rather than through a compression of their net income. Some more research on this issue, taking advantage of recent increases in these fees, will be useful to understand this central set of issues better.

The burden of taxation and cost recovery will therefore have to fall on Saudi households and firms. Concerning firms, there is little understanding of how large their profits are - there is actually no such data since corporate revenues are not taxed. Thus, it is not clear to what extent they would

Figure 1. Employment and Real GDP by sector (2016)



Source: IMF Article IV, 2017.

be willing to absorb the new taxes through reductions in their profits, as opposed to choosing to either close down their operations (especially for those in the traded sector), or to pass on the increased burden to consumers (especially for those in non-tradables). There are indications that in the aggregate, profitability is on the high side: the non-oil corporate sector has been growing fast in the past decade, and its investment rates can be estimated roughly from the national account to be about 25% of non-oil GDP, a pretty high figure which suggests overall high levels of profitability. Large firms traded on the stock exchange, and listed in the Orbis database, tend to report large profits. Excluding the petrochemical companies and energy utilities, their profit rates (relative to revenues) were of the order of 17% in 2014, falling to 15% in 2016 (IMF 2017). This can be considered high by international standards. Moreover, the private sector

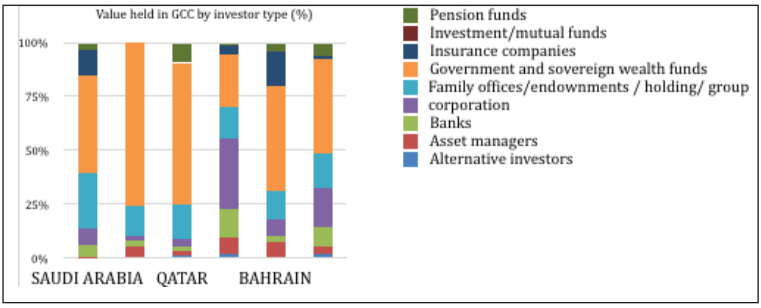
as a whole has relatively high access to credit, as total credit to the private sector is reportedly at about 90% of non-oil GDP, again, a large figure by international standards.

But it seems plausible to think that the corporate sector is highly dualistic, with large corporations benefitting from a privileged access to the credit market, and facing less competitive pressures than smaller firms (Hanieh 2016). This would imply that large firms are able to absorb more losses than SMEs. It should be noted however that state ownership in the largest firms is quite sizable - directly at about 45%, and overall even more, given state stakes in banks and insurance companies that own another 15% of these firms (Coksum et al, 20180 - see figure 2). This limits the net financial gains of passing the burden of adjustment on such firms. At the same time, there are indications that smaller firms operate in a highly competitive environment, and that they are already hurting from the deteriorating market conditions.(1) More research is needed to understand in more detail the performance of the corporate sector and its ability to sustain more taxation, as this will help devise better policies in the years ahead.

Finally, there is a possibility of taxing wealth, such as bank accounts, and other forms of assets. There has been to date no indication that this may take place formally, although the episode of the Ritz-Carleton hotel suggests that this may take place informally, at least at the top of the corporate pyramid. There have been reports of large

(1) It also appears that their access to finance is quite limited (SME survey, 2017, General Authority of Statistics).

Figure 2. Ownership of traded companies in the GCC



Source: Coskun, Cevikel, and Akgiray, 2018.

amounts of capital flight in recent years, which suggests that capital-holders are trying to shield their assets from potential taxation and state predation.

To get a sense of magnitude of the burden on households and corporations implied by the IMF projections, I will try below to estimate a lower and upper bound aggregate tax rate. As described above, the new taxes announced are essentially a VAT and excise taxes, which will fall directly on households, but that can indirectly influence prices, output, and profits; higher expat fees, which affect profits directly, and consumer prices indirectly; and increased utilities prices, which fall directly on consumers and firms, but that may end up falling more on consumers via their indirect influence on output prices.(1)

One extreme assumption one can make is that all of the burden will fall on Saudi households. If that were the case, the burden would be unbearable. To get a feel of magnitudes,

(1) Since Saudi household derive most of their income from public sector employment, an alternative (or complementary) way of taxing them is through a devaluation that reduces the real value of their wages.

70% of working Saudis work for government, and their total compensation in 2017 was SAR 412 billion (Table 1). Even if one accounts generously for income earned by Saudis in the private sector (which is unlikely to be more than a third of this amount), and from non-labor sources (such as return on savings and other assets), it is apparent that the burden of the extra taxes and utility costs will be a large proportion of their income – possibly more than half! (1)

A lower bound would consider a larger tax base that includes corporate profits and self-employment earnings. Non-oil GDP stood at SAR 1.8 trillion in 2017. One can estimate based on ministry of labor data that total expats income is about SAR 600 billion. Taking this out leaves about SAR 1.2 trillion of non-oil national income, which together with the public sector wage bill, adds to a total tax base of about SAR 1.6 trillion. With this larger tax base, a lower bound estimate of the average tax burden would stand at about 25%, a lower, but still quite a large burden.(2)

We can conclude that the only way for the burden of adjustment to become bearable is for non-oil GDP to rise in ways that boosts the tax base. However, growth – and thus stabilization - will be made harder by the headwinds created by fiscal stabilization itself. In the short term, cuts in government expenditure create a drag on non-oil

(1) An alternative way to compute a higher bound would be to start from the national consumption figure given by the National Accounts (about SAR 1 billion in 2016), and to deduct the estimated consumption of expats. Results would be in the same ballpark.

(2) The actual tax base is likely to be smaller, and the implied overall tax rate higher, since some of the profits are earned by foreign corporations and will be repatriated rather than end up as local consumption.

GDP growth whose size depends of the size of the "fiscal multiplier". The multiplier depends on how much of government spending ends up as imports and remittances - the larger these are, the smaller the "multiplier". It has been estimated, based on historical data, that the short-term multiplier is quite low at about 0.5 (Espinoza et al, 2010).(1) This means that large leakages reduce the growth impact of government expenditures – but by the same token non-oil GDP would not be too depressed by a fall in public spending. Still, one would expect a cumulative fall in the growth of non-oil GDP on account of stabilization by about 11% points once the fiscal deficit is eliminated. Already, non-oil GDP growth, which was fast before the 2014 shock, has halted to about zero. The stabilization this drag is expected to continue to operate for a while as firms adjust their level of operation to lower levels of government spending.

The government has announced ambitious plans to boost private sector growth, including improvements in the business climate, in trade logistics, and in the application of the rule of law. In the IMF scenario - which is reportedly more conservative than government expectations - these reforms are expected to increase non-oil GDP growth by 3 points by 2020, for a total of 3.5% growth per year. This seems quite optimistic given the large weight of government spending in fostering growth in the past. But more importantly, GDP growth per se does not tell us much about the economy's ability to absorb increased revenue collection, which

(1) The multiplier for both capital and recurrent expenditures are found to be similar.

depends not just on growth rates, but on the type of growth. A path of labor intensive growth leveraged on expat labor can allow for larger taxation of corporate profits, but if it does not manage to increased employment among Saudis, it would require social spending to preserve social peace, and thus, would not be conducive to correcting the macro-imbalances. On the other hand, a path of lower non-oil growth that manages to replace expat by Saudi labor would lead to a broader tax base over time.

Realistically then, a strategy to eliminate fiscal deficits that can work would be more gradual, and it would rely centrally on reforms that increase the size of the tax base over time. There are however financial limits to the extent of gradualism, since both slow fiscal adjustment, and reform require financing. There is thus a central trade-off, to which we will return in the last part of the paper: if adjustment is too slow, it would consume much of the fiscal space, leaving little financing resources available to invest sufficiently in new sources of growth.

3. The central challenge: Saudis employability

If the issue of fiscal stabilization illustrates well the size of the challenge facing the country in the short term, the long-term challenge of finding new sources of growth to replace oil has only been made starker by the recent drop in oil prices. With rising population and incomes, the "rentier" mode of development was unsustainable to start with.

It is only a bit of a caricature to state that the current growth model rests on a two separate deals: one deal with

businesses for a free hand at importing labor from abroad, and one with citizens for guaranteed public sector jobs and life-long support. With its current population of 23 million, and oil revenues of only $6,000/capita at present (compared to about four times as much in 1990, on the eve of the previous oil crisis) – KSA has clearly outgrown the current arrangement. The government is no longer hiring all Saudis that are willing to work. Already, unemployment is officially at 11.6%, 32.8% for women, and 29.4% for youth, and rising. The oil rent is not sufficient to finance anything close to current consumption levels of its population, and this can only get worse over time in the absence of a new source of economic growth.

In the current economic environment however, nationals are simply not employable in large numbers in the private sector. One can envision a worse case scenario – call it the status quo scenario - where dwindling oil revenues continue to be shared among the nationals, cheap labor continues to be freely imported, and Saudi reservation wages only fall slowly over time as oil rents per capita decline. In such a scenario, the kingdom will turn into an increasingly impoverished welfare state, with rising unemployment (or low labor force participation). Moreover, income inequality would rise fast, as business-owners continue to enrich themselves by exploiting cheap labor, while the rest of the population gets poorer over time. This is of course a farfetched scenario, and KSA can no doubt do better. But the point of the argument is that this will require policy reforms to create incentives for Saudis to join the labor force well before their incomes decline to expat wage levels – which

tend to be the lowest global wages for any level of skills.

While the stated strategy of the Vision 2030 document is to fuel growth by reducing inefficiencies, there is however far too little discussion in the document about the central challenge of employing Saudi men and women productively. Yet, the low labor force participation among Saudis is by far the largest inefficiency in the domestic economy. It is as if the Vision is implicitly counting on Saudis to lower their reservation wages rapidly so that their non-employability painlessly goes away. This is unlikely to be the case however, given the scale of labor market segmentation and of the perverse incentives faced by firms.

The current labor arrangements place a heavy disincentive on nationals from joining the labor force. Yet, huge gains could be made if they were instead encouraged to do so, both because national labor is grossly under-employed, but also because it is increasingly well educated, thus increasing the opportunity cost of low participation. Currently, only 40% of the working age is in the labor force, and only 35% population works (the rest is unemployed). This compares to employment rates of about 60% in the OECD. Low national participation rates are largely due to very low participation by women (19%), but men's participation is not high by international standards either (at 55%). To give a sense of magnitudes of the potential gains if national labor was employed more effectively, a simple projection model suggests that with participation rates growing from 40% to 60% of the working age population, and unemployment dropping to its natural rate, non-oil

national income would more than double if the additional workers join the non-oil sector at current productivity levels. This would provide a potential boost of about 2% of growth a year for the next 20 years. Improvements in labor productivity would add to this growth rate further. All together, such an addition to national wealth is comparable in magnitude to the kingdom's oil wealth!

At the same time, the extent of economic gains that can be obtained by fixing other inefficiencies, or by removing other constraints to growth, pale in comparison. The total cost of energy subsidies is about 7% GDP – there is certainly much over-consumption given low prices, but the extent by which the economic pie can actually be increased on this front is limited. Importing technology to increase productivity, the classical catch-up development policy, is desirable, but the reason for the relatively low labor productivity in the past has not been the lack of openness of the Saudi market to outside influences, but rather, the incentive of firms to use labor-intensive technologies, which is itself connected to the widespread availability of cheap (imported) labor.

The key challenge then is to provide incentives for Saudi women and men to join the labor market in larger numbers, and for Saudi firms to hire them. As a background for this discussion, lets us summarize the well-known duality of the Saudi labor market. About 70% of nationals work for the public sector, while expatriates fill 80% of private sector jobs. About 4 million Saudis work for the public sector, and 1 million in the private sector. According to data from the Central Authority for Statistics, the wage ratio between

Saudi men that work in the public sector over that of those that work in the private sector is about 2 (Figure 3). This means that Saudi current reservation wage is at around half the public sector wage.(1) Unemployment benefits, close family ties and support, and the hope to get a wasta (i.e., connection) to join some part of the public sector will keep reservation wages from falling rapidly, even as the prospect of getting a public sector job fades away.

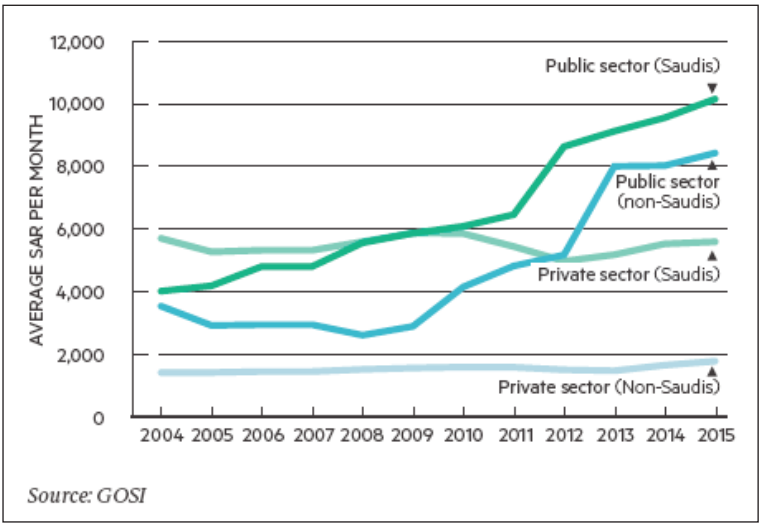
At the same time, a small proportion of Saudis already work in the private sector, where the men among them earn on average twice more than expats (and higher multiples for those with lower levels of education).(2) Firms are thus willing to hire Saudis at wages above those of expats. This may reflect in part constraints on firms imposed by the Saudization program, and in parts, the comparative advantages of nationals in some sectors. But clearly, the demand by firms for national labor must be also constrained by the size of the wage differentials.

Unemployment in such circumstances probably reflects both demand and supply constraints – Saudis with reservation wages too high given private sector wages for nationals, and firms finding it more profitable to hire cheaper expats. To improve the national labor force participation, expat wages need to go up in order to improve the attractivity of national

(1) The difference between the work conditions in the public and private sector also reduce the appeal of working for the private sector, meaning that on net terms, the reservation wage is already even lower than one half of the public sector wage.

(2) The ratios vary between 3.7 for illiterates, and 1.2 for master degree and above. On the other hand, Saudi women earnings in the private sector are equal to those of women expats.

Figure 3. Average month wages, 2004-15



Source: Ministry of Labor Report (2017)

workers to firms, and/or national reservation wages need to go down to expand labor supply. The more movement in these prices, the faster Saudi employment would expand. The balance in the use of the two approaches determines the terms of the burden sharing of reforming the labor market, i.e, the welfare loss of workers versus that of firms.

So far, the Saudization effort has largely focused on a system of quotas for Saudi nationals in various sectors imposed at the firm level. But it has become clear over time that a system of growing quotas cannot work effectively unless the cost of employing expats rises at the same time, so that the (rising) quotas remain close to the quantity of national labor effectively demanded by the market. As long as it is cheaper to employ expats at the firm level, rent seeking by firms would ensure that the current quota system

will leak.[1] A better system would therefore be to impose quotas at the national level, and to allow expats to move between firms, thereby allowing the price mechanism to work - the reduced supply of expat labor would lead to a rise in their wages.

The current policy stance does include efforts to shrink the Saudi-expat wage gap.[2] The government's stated goal is to reduce it by 20% by 2022. This goal seems however too modest given the need to create at least 1 million jobs for Saudis over the next 5 years. The main reason for the modest approach is that Saudization policies are naturally resisted by the corporate sector since they lower profitability in the short term. Moreover, as expat wages rise, some firms, especially those producing tradables, become globally uncompetitive and have to close down (especially that other input costs are also rising).

The alternative of squeezing the population into accepting lower reservation wages generates social discontent and resistance leading to delays and to policy reversals – so far, the government has backed down on several reforms that hurt the population (including wage cuts). Given the scale of the challenge, there is therefore a need to broaden the policy toolkit. There are three other ways to improve the labor force participation of Saudis in

(1) For example, through the rise in the number of ghost Saudi workers; the trading in expat permits; the proliferation of small contractor companies below the quota system radar.

(2) In particular, the cost of visa fees and residence permits has been rising, and is expected to reach about 2% of GDP by 2020. These fees however will still represent less that 20% of the total expat earnings, while the ultimate goal should be to increase expats labor costs by a magnitude of about two.

the non-oil sector, besides taxing the expats, and pushing Saudis to accept lower reservation wages: (i); to subsidize the private sector wages of Saudis with a negative income tax; (iii) to subsidize their in-firm training so as to improve their productivity; (iii) to influence social norms and work conditions in ways that encourage Saudi women to work more in the private sector. More likely, a successful strategy would use all these instruments.

4. Structural change

The discussion above assumes that the challenge of creating jobs for Saudis is a problem of riches, and that all that KSA needs to do is to substitute Saudi for foreign workers in existing positions. But simple substitution will not do. As stressed by various analysts, the 6 million jobs currently occupied by expats in the non-oil sector are either overly low skill, or high skill intensive (for example, Hertog 2014, Kabli 2014). This dualistic production structure has been molded by economic incentives – whenever possible, firms have tended to use production methods that take advantage of the low cost of unskilled labor, which saves on the necessity to invest in machinery and other productive assets. This is reflected in a decline in aggregate labor productivity over the past decade, even as non-oil GDP rose fast. At the same time, the generous energy subsidies, and the large supply of loanable funds have also advantaged capital intensity among large firms, resulting overall in a two-peak aggregate production function, focused around the employment of low and high skills workers, to the detriment of technologies using middle levels of skills more

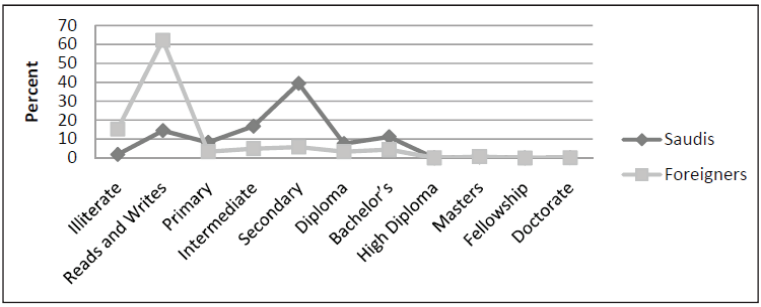
intensely.

The problem with this two-peaks dual production structure however is that it does not corresponds to the relative scarcity of national factors, as the Saudi labor force is now predominantly of a medium skill level (see Figure 4). Thus, the type of needed structural change is one that upgrades labor-intensive sectors, by adding capital, skills, and technology.(1) The new Middle-skill jobs would be at higher productivity, allowing paying higher wages, and attracting national labor. But such job upgrading will eliminate much of the menial positions occupied presently by expats. And in the tradable sector, many firms may not be able to survive this costlier production cost structure.

The recent work of Jennifer Peck (2017) on the effects of the Nitakat program between 2011 and 2012 illustrate well these difficulties. Using a detailed dataset at the firm level, she finds that the new quotas imposed by the program managed over a period of 16 months to increase the number of Saudi jobs by 93,000. But at the same time, the destructive effect of the program was considerable: 11,000 firms (mostly small ones) preferred to exit rather than have to respect the new quotas (or pay the fine); and 934,000 expat jobs were eliminated. These stark results owe much to

(1) Such job upgrading will eliminate much of the menial positions occupied by expat labor. This can even take place in the "domestic" sector. There is an estimated additional 2.4 million expat working in domestic occupations - maids, cooks, and drivers. While one is tempted to think that domestic positions are not substitutable by Saudis, here too, higher expat wages can incentivize the use of more technology intensive approaches that can appeal to Saudi entrepreneurs and workers, for example in agro-business and food industries, public transport, dry-cleaning businesses, or childcare centers.

Figure 4. Nationals and Expats employment in the non-oil sectors in relation to educational levels, 2010



Source: Kabli 2014, using Ministry of Labor statistics, 2012.

the precipitous nature of the program – if firms were given more time, they may have adjusted their capital investments in ways that rescued more jobs. Nevertheless, these figures give a sense of the potential implications involved in a labor replacement policy. At the end of the day, the 6 millions expats working in private sector firms may be replaced by less than 1 million Saudi workers, and the private sector could shrink considerably – even as the tax base grows.

At the same time, overly capital-intensive firms and sectors, which rest on massive energy and capital subsidies, may need to be scaled down or eliminated, as financial capital becomes more scarce, and in higher demand in medium-skill intensive sectors. Indeed, the new SMEs will need to not only pay sufficiently to attract Saudis workers, but they also will need to invest in more capital and skill intensive production methods, and to start training their workers so they can improve their productivity. These new financing needs are likely to be large. At the aggregate level, to create about one million jobs every 5 years, they can be

of the order of $250 billion over 5 years, and 0.5 trillion over ten years.(1) These funds will have to come from the national banking and financial sectors, FDI, or from public funds.

While improving the business climate, and access to credit, would help SMEs adjust to the new input price structure, more targeted policies can help speed up the adjustment. It has been noted that Saudization is more achievable in industries where the wage gap is smaller (Hertog 2014). In sectors with large gaps, a decision needs to be made about whether to sacrifice or rescue the sector. Construction and commerce are two sectors that would almost certainly need to be rescued given their important size (see figure 4). These sectors attract at present nearly 4 million uneducated expats and use labor-intensive methods to produce about 20% of non-oil GDP (see figure 1). They need to be incentivized to increase their labor productivity by investing in machinery and technology. More generally, a proper industrial policy needs to be put in place to support the transformation of whole economic sectors in ways that support increased Saudi labor participation. As for industrial policies more generally, the question is not as much why such policies are needed, but rather how to implement them in ways that work. Success here would be judged by their ability to elicit the cooperation of the private sector in finding effective solutions, while avoiding rent-seeking (on this, see Rodrik 2009).

(1) This assumes that each job requires on average an investment in machinery of $250,000, which is 20 times an average wage.

The Vision 2030 document puts a lot of emphasis on the development of new SMEs. This will however only help if at the same time, the less efficient firms face higher labor costs and are pushed to close down. According to national statistics, there are more than 1.1 million firms with less than 50 employees, which can be compared to 1.5 million such firms in Turkey, a country with a population four times that of KSA. A recent survey of SMEs by the General authority on Statistics reveals that an important constraint facing SMEs in KSA was competition and profitability. New SMEs that disrupt the labor-intensive way of doing business could play an important role in the transformation of various industries toward more productive structures, but this should then go hand in hand with the (creative) destruction of the old inefficient firms, so that the new firms can increase their market shares. Thus, policies that help firms survive the coming hard times – such as support to compensate for higher energy costs – should carefully discriminate between firms that should, and those that should not survive.

5. Towards a new development model

The discussion above presupposes that Saudis workers will replace expats over time, and that they will end up largely in jobs that service a domestic aggregate demand fueled by oil. This presupposes a particular economic model, which we can call the "normal oil economy model", which is not that of a diversified economy described in the Vision 2030 document. Instead, this is a model that resembles the path followed by Norway, whose economy

is centered around a publicly dominated large oil sector (which includes backward and forward linked sub-sectors), employing specialized workers (for example, about 50,000 oil engineers), working alongside high-productivity workers in privately driven service sectors, and only a few tradable sectors. Even less ambitiously, in a normalized Saudi economy, one can envisage that in the next phase (say next 10 years), a large share of the Saudi labor force (say half) will remain employed in government.

In such an economy, it is not clear that many firms producing tradables now will be able to survive, given that unskilled wages will rise, subsidies will fall, taxes will be introduced - except in a few areas of comparative advantages, such as religious tourism. But after the initial decline in the existing tradable sector, one can imagine that over time, creative young Saudis will find ways to export services to the rich GCC market, and Khaleeji capital will find countless growth opportunities in manufacturing and agriculture in the Middle East and elsewhere.

At the end of this transition, millions of expats would have returned to their home countries, having provided a central contribution to the task of building up a modern country at a record speed. The Saudi economy will then become possibly smaller than it is today, but it will be employing a large share of its own population productively, and it will end up landing into a more sustainable "normal" economy. Oil will remain central, but it will have a much larger multiplier effect in terms of the domestic employment of nationals.

This is not exactly the vision of a post-oil, diversified, knowledge based economy that is developed in the Vision 2030 document. But it is a more realistic goal for the next 10 years. It is also more realistic than an alternative model, which has not been clearly articulated, but seems to be guiding much of the economic intuition of decision-makers, which is one of a mega-Emirati economy. The idea there is to make middle skill Saudi workers complementary to expat workers (as opposed to substitute, as in our normalized model above). The problem with that vision, for a country the size of KSA, is that while one can think of particular sectors where such a production strategy can make sense, it seems too ambitious at the macro level. At the same time, insulating sectors with cheap foreign labor from others that employ higher skilled workers runs again into the same problem as with the current quantitative restrictions on labor use – the existence of cheap unskilled expats will reduce the incentives of firms to increase capital investment and improve efficiency and wages in the sectors selected for upgrades.

In spite of the complexity of the task of structural transformation of the non-oil sector, one should keep in mind that the overall challenge remains modest – to find productive jobs for about 1 million Saudis over the next five years, in an economy whose GDP is close to $1 trillion. Tweaking the time-tested Saudisation strategy further, moving faster and more ambitiously on increasing the cost of expat labor, and supplementing these labor policies with a well-targeted and dynamic industrial policy that helps domestic firms adapt faster to a new set of input prices, will

do the job. But there is no need for mega-projects to achieve these objectives. Instead, the risk of dissipating energy and finance on white elephants should be carefully managed by resorting to realistic project evaluation and cost/benefit analysis.

6. The Political economy challenge

While it is easy to recommend policies that are technically feasible, and argue that they are superior to other alternatives from an economic efficiency point of view, political constraints tend to push decision-makers to prefer to select a course of action that may be sub-optimal from a pure economic efficiency perspective, but that is perceived to fit better with the interests of regime durability. Thus, in order to discuss the political economy challenges, one needs to enlarge the frame of the discussion to the likely impact of the proposed reforms on the existing political settlement in the Kingdom. Such an investigation naturally leads to more political questions, such as: How will the proposed reforms balance the interests of the corporate sector versus those of households? Will the reforms evolve as planned, or would the plans likely change in order to accommodate rising opposition from firms or from the population? And more ambitiously, if the reforms do take place, are they not likely to lead over time to changes in governance?

To address such questions, it is useful to look at the proposed policy reforms from three angles: burden-sharing, speed, and sequencing.

A burden-sharing perspective must start by characterizing

the current ways in which resources are divided, since a changed economic structure will affect the distribution of resources among important social actors. More than the much-heralded political deal of the ruling family with the clergy, it is its parallel alliances with the business sector for a free hand at importing labor from abroad, and with citizens for guaranteed public sector jobs, that is at the heart of the modern political settlement, and which will be affected if important changes are made in the economic model followed by Saudi Arabia.

With lower oil rents to share, the domestic settlement comes under strain. The GCC is now the most open region of the world to global labor, ensuring that its businesses get the cheapest wage to skill ratio in the world. As a result, the reliance of the KSA on foreigners has no parallel in modern economic history. In no other country would nationals accept such open competition by foreign labor – they would want to be entitled to benefit from national growth through a rising labor market. Saudi nationals have accepted this policy only because they have been employed by the state at above market wage rates.

Cutting support for businessmen, the population, or both, will undermine the current national pact. Compared to the current situation, reducing the budget deficit and moving towards the "normal economy" situation will likely end up hurting both national labor and entrepreneurs. Firms will oppose policies that lead to more restrictions on their ability to hire expats at low cost. Labor will oppose measures to lower their reservation wage. On the positive

side, compared to the alternative Egyptianization scenario with no reforms, all actors could gain from reforms that enlarge the size of the economic pie. Thus, under favorable circumstances, all actors can be made to accept some short-term losses, if they are convinced that they will end up with long-term gains.

Early and credible signaling by government that helps key actors believe that the economic pie would rise over time would therefore reduce opposition to reforms. But more important, early signals that the burden of adjustment will be shared fairly across society will be crucial in reducing opposition to change. Often, reforms that have significant distributional implications end up pitting different groups against each other, with each trying to shift the burden of adjustment by engaging in a "war of attrition" in an attempt to wait the other group out (Alesina and Drazen 1989). This can happen more when those that stand to lose from reforms (e.g., old style labor intensive businesses) are different from those that stand to ultimately gain (such as more capital and skill intensive new businesses). Problems of this sort can be technically reduced with the use of well-targeted compensation programs, such as those currently being devised. Thus, an important ingredient of a successful reform program is an early and credible commitment to share the burdens and gains equitably among key parts of society, since this type of signal reveals that the political preferences of decision-makers are impartial, and that they will not be pushed by one side against the benefits of the other. So far, some of the big moves of Muhammad Bin Salman, the crown prince, fit the needs to reduce opposition

to reform. The Ritz Carlton episode seems to have been interpreted by the population as an attempt to make the first circle of the royal family and the corporate elite pay their fair share of the burden of adjustment. There are reports that this move has eased popular acceptance of the VAT introduction.

Going beyond the first circle, the corporate sector is being squeezed by the Nitaqat program, and needs to pay higher utility prices. One can argue that this is still an unfairly small share of the overall burden – as there are no talks of corporate income tax, and the Saudization plans remain modest. Perhaps this is perceived as a safer approach early on, given that firms are expected to be the main generators of jobs, but it is important to realize also that the political balance on the issue of burden-sharing is fairly tight. Clearly, a populist reform program that advantages labor over firms will have a hard time generating a supply response from the private sector, and it risks weakening elite cohesion.

But equally, a pro-business approach that pushes most of the burden of adjustment on the population (in higher effective taxes and lower reservation wages) would be met with opposition sooner or later. One can expect some trade-off between less income and more social rights, but can the terms of the trade-off be so steep as to induce young households to accept paying for increased social freedom with a 50% reduction in their consumption levels, relative to the situation of their parents? Thus, from a political point of view, going with the entrepreneurs may require a rise in repression. Another risk is that a program that puts firms

ahead of labor is unlikely to change the current incentive system of firms fundamentally, and may thus continue to attract more migrants rather than employ more Saudis. The need for balance is thus paramount.

The second policy design issue with important political economy implications is that of speed. To be sure, KSA can afford to implement its reforms at a slow pace, and to smooth the cost of adjustment over time. During the last large oil shock of the 1990s, the fiscal adjustment was largely confined to public investment, and KSA ran 16 years of deficit in a row, accumulating in the process a large public debt (which was repaid during the subsequent boom). Financing the deficit, rather than adjusting to it, would be much more expensive during this oil shock round, not so much because the drop in oil prices is larger, but rather, because a larger share of oil revenue was consumed to start with. But still, KSA has a relatively large fiscal space (i.e., its ability to borrow). With a current debt to GDP of 16%, an increase to say 75% would allow for loans of about $500 billion. Add to this proceeds from privatization, including of Aramco, would possibly triple the total.(1) Thus, at least theoretically, KSA could finance up to ten to fifteen years of deficit, at the current 2018 level, before risking bankruptcy. The government could therefore respond to popular opposition by kicking the can down the road and slowing-down the fiscal adjustment to a halt.

The main cost of going slow is financial. Large amounts

(1) By some estimates, the value of domestic public assets is about $1.5 trillion. Moreover, reserves are about $450 billion.

of public financing of deficits will crowd out funds going to the private sector. Given that the private investment required for a successful structural reform strategy is large, there is therefore a global finance trade-off. On our back of the envelop calculations, it would not be possible to wait ten years to adjust, while at the same time create one million new good jobs – i.e., endowed with a large capital per worker. To the extent there is no or little additionality (such as FDI), it is thus apparent that slowing adjustment too much will constrain how much can be invested to upgrade jobs and productivity.

While a myopic government may borrow to delay adjustment, a reformist government with foresight and a long horizon would reform more energetically when it is able smooth consumption, in order to avoid an initial consumption drop that may destabilize the reform effort. Thus, we need to make a distinction between borrowing to avoid reform, and borrowing to support reform. In this respect, the relation between speed and opposition to change comes to the fore. Will reforms have a greater chance of being implemented if they are imposed quickly, or if they are eased over time, with more effort to smooth the burden of adjustment – at the limit, waiting for non-oil growth to pick up before increasing taxation?

Two types of arguments can be made. First, the relative success of the big bang reforms of Eastern Europe, where countries that most successfully transitioned to a market economy made wholesale reforms very quickly, when the political window of opportunity created by the fall of the

Berlin wall was still wide-open (see for example Djankov et al, 2003, on this). The risk that quick reforms neutralize is that of giving time to the opposition to regroup, and ending up stuck in a situation of "smoothing to nowhere". But second, the cost of big bang reforms is the immediate heavy social toll they impose on society. In Eastern Europe, this was seen as the price to pay to move towards a democratic system supported by a market economy. The calculus is however likely to be quite different in the Kingdom. What has been special about Saudi Arabia in the past year is the refreshing voluntarism in policy-making. But can this survive the first wave of serious opposition that will no doubt arise once the costs of adjustment and reforms start becoming clearer? Once opposition sets in, reform tends to slow down, and its speed tends to become driven by a political rather than a technocratic logic.

Thus, the considerations above, both financial, and political, suggest that the reform program would ideally advance at a deliberate but gradual pace, taking advantage of the existence of a sizable fiscal space to smooth the cost of reforms over time, but at the same time, moving deliberately along a pre-set multi-year agenda. Now that a credible signal of change has been sent, credibility can only be enhanced with more realistic long-term plans going forward. It is true that cases where ambitious reforms were carried-out gradually have been historically rare. Indeed, the challenge of foresight and restraint is contrary to the rentier tendency for expenditures to rise to the level of revenues, "kicking the can" as long as possible (Karl 1990). But countries with significant fiscal space and a clear understanding of their

need to change their growth path in fundamental ways are also rare. And it is precisely this coincidence that sets KSA apart.

The last type of policy design issue with important political economy implications is that of sequencing. The potential social benefit of a gradual adjustment program, that of smoothing the pain, is only valuable if the program ultimately delivers an economic gain. Moreover, the earlier efficiency gains emerge, the cheaper is smoothing. At the extreme, if the economic pie grows fast enough, the necessity for a sharp adjustment to lower oil prices disappears altogether. These arguments therefore imply that the earliest structural reforms can start, the better.

There can be however various constraints to quick action on structural reforms. As argued earlier, fiscal adjustment depresses growth by itself, and thus makes firms less willing to contemplate quick changes in their business plans in response to structural reforms. In particular, the Ritz incident has also been interpreted by the business community as an expropriation that weakens their property rights, and more generally, the rule of law. Unless this is followed rapidly by measures that strengthen the rule of law, the Ritz incident may end up being seriously counterproductive.

An important risk that sequencing should guard against is that of reforms proceeding on the destructive side – i.e., making business more costly to firms by pushing expats out, increasing cost recovery, or raising taxes – way ahead of generating a supply response from the private sector. The main risk is pushing expats out, but not managing to

convince Saudis to get employed in greater numbers. This can happen in particular if firms are not incentivized to invest in the upgrading of jobs, which would allow them to pay higher wages for nationals working at higher levels of productivity. In order to guard against this type of risk, there is a need to develop rapidly the type of industrial policy discussed above.

Finally, beyond economic plans that manage to reduce opposition to stabilization and reform by sharing the burden of reforms more fairly across groups and time, one cannot avoid wondering how politics will adjust over time to the demands of a more autonomous population and private sector. How the current political regime will choose to adjust the ways the country is governed once circumstances change remains highly uncertain. In the long term, rent distribution will become less dominant and it will become unable to neutralize political voices as much as it did in the past. KSA's truest exceptionalism – the richest non democratic large country in the world - will surely come under stress as incomes start shifting from a rentier logic, to one based on private initiative.

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