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Saudi Arabia: Ambitious reform processes initiated

Martin Hvidt

News

This paper takes a closer look at the very ambitious reform programs underway in Saudi Arabia. Spurred by massive budget deficits since the collapse of the oil prices in 2014, and an economy in which reforms have long been overdue, King Salman and his just 31 year old son have initiated reforms that were unthinkable just a few years ago.

Summary

In April 2016 Saudi Arabia took the world by surprise with the launch of its Vision 2030 plan. The surprise was not the plan in itself, as the kingdom has since 1970 guided its development through a series of 5-year plans, but rather the radical approach to development contained in the plan. Private sector focus, privatization of state owned entities and salary cuts in the public sector were proposed. But the item that drew most attention was the plan to sell a 5 per cent stake in the oil company Saudi Aramco, the national pride of the Kingdom, which was seen by many as selling the family silver.

Later in 2016 the Vision 2030 plan was followed by the National Transformation Plan 2020 which is a far more detailed plan or operational plan, posting specific benchmarks and targets for the economy in order to fulfill the aims of the Vision 2030.

Key Words

Saudi Arabia, economic reforms, King Salman, Muhammad bin Salman, Vision 2030

About the Author

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Analysis:

Vision 2030 and the National Transformation Plan 2020 have the overall aims of diversifying the Saudi economy away from a near total dependence on incomes from oil and gas. The key element of the plans is to encourage the private sector to play a much more prominent role in the economy and not least in job creation, thus relieving the state from financing such activities. The overall vision is to double the kingdom's economy and create 6 million jobs by 2030. Higher growth, government efficiency and non-oil income is thought to eliminate budget deficits as spelled out in a report by the consultant to the government by McKinsey & Company.

The government is to undertake the twin tasks of reducing the governmental spending to align with the current deficit on the state finances and at the same time to invest in forward looking activities such as education, reconfiguring the energy sector, and undertaking strategic investments in order to increase income for non-oil sources over time. The National Transformation Plan aims to add 450,000 jobs in the private sector already by 2020. All in all, the plans propose massive and rapid transformations in the Saudi society based on a strong neo-liberal belief/sentiment.

While the proposed reforms might not seem specifically radical to hard-taxed Europeans, they are indeed radical in a Saudi context where they represent a break with old time soft-handed policies by the Saudi government which were based on the fear of upsetting the 'social contract' between the ruling elite and the citizens. In the plans, the population is being asked to carry far greater financial burdens related to their upkeep and the all-encompassing welfare system.

The Saudi government has acted fast by introducing costs reductions. In September 2016 the government announced that wages in the public sector would be cut and that some of the benefits normally enjoyed by the more than 1 million Saudi nationals employed by the government, such as long paid holidays, would be curtailed by 1 October. The pay cuts are around 20 per cent across all types of employment, even Ministers. Subsidy cuts on fuel, electricity and water have been implemented too. A Saudi citizen now pays $0.24 a liter for 95 octane gasoline up from $0.16. This is an increase of approximately 50 per cent. Prices for diesel, electricity, water, sewage and garbage collection are scheduled to be increased by the same rates. 146 state-owned entities have been identified as candidates for either privatization or public sale.

As mentioned, the item in the Vision 2030 plan that caught most of the headlines is the proposed sale of a 5 per cent stake in Saudi Aramco. The total value of Saudi Aramco is estimated to be around 2 trillion dollars (i.e. $2,000 billion). The company currently produces 10 million barrels of oil a day for export and another 3.5 for domestic consumption. The sale is scheduled to take place in 2018 with an estimated income of $1.5 to $2 billion.

Saudi Aramco (officially Saudi Arabian oil Company), which until 1988 went under the name Arabian American Oil Co., struck oil in 1938 and production commenced in the latter part of the 1940s. The company was brought under full Saudi ownership in the 1970s, and during the 1980s full management and operational control was placed in Saudi hands. The company has since then grown to be the most valuable company in the World with more than 260 billion barrels of oil in reserves. The company is thus a nationalistic project and represents an immense amount of national pride.

And here is the trick; the proceeds from the sale will be deposited in a government controlled wealth fund, the Public Investment Fund (PIF), which then is charged with making strategic investments which will benefit the country in the long run. Or as pointed out by Simon Kerr in the Financial Times:

> 'Creating new industries rooted in technology that can attract young Saudis into the private sector is a critical plank of the prince's reform. PIF is also expected to be involved in plans to build theme parks with US operator Six Flags, as well as the development of a domestic defence industry.'

It is believed that Saudi Arabia will follow the strategy employed in Abu Dhabi, implying that it will use its sovereign wealth fund to appropriate stakes in a variety of international firms and have them set up projects or production in the Kingdom. In this way, investments overseas can lead to highly skilled jobs at home.

Why the reforms?

The recent impetus for the reforms has been the drastic fall in oil prices commencing in 2014. Saudi Arabia experienced a deficit of nearly $100 billion in 2015 on their state budgets and, even after significant budgetary cuts were introduced, a deficit of $79 billion in 2016. In 2015 the IMF raised concerns when it estimated that the kingdom most likely would deplete all of its monetary reserves within 5 years if such deficits continued.

However, the need for reforms is not only caused by the current fall in oil prices. The distribution state model employed by Saudi Arabia builds on a 'social contract' in which the Royal family distributes large parts of the oil and gas revenues to citizens in the form of infrastructure, free education and not least a broad range of welfare benefits, e.g. subsidies and well paid jobs in the government sector in trade for political acquiescence.

The distributional model worked well in the 1960s and 1970s but as both the population grew and the benefits to each citizen became more and more costly, this model has become more and more unsustainable. However, the high oil income regime between

1999 and 2014 kept the pressure for serious reforms at bay. But with the drastic drop in oil prices commencing in 2014 not only the oil dependence of the society, but also the unsustainability of the Saudi economy, has been exposed.

The recent shift in leadership in the Kingdom too is a factor that has facilitated the reforms. In 2015 King Salman came to the throne and immediately appointed his son, at the time 30 years old, Mohammad Bin Salman (MbS) to several important posts, among them Deputy Crown Prince, Minister of Defense, chief of the House of Saud royal court and Chairman of the council for Economic and Development Affairs. Both Vision 2030 and the National Transformation Plan are his brain children (with a little help from the international consultancy firm McKinsey & Company and others which are estimated to have billed the Kingdom $1.25 billion for their work on the plans) and under his direct supervision and auspice. He is the one that has introduced and defended the plan both for the Saudi citizens and the international community.

This has without doubt been a deliberate move. Nearly half of Saudi Arabia’s 22 million citizens, that is, Saudi nationals, are below the age of 25 - in other words, young. As such it is believed that he can better spearhead a reform agenda which needs to involve the young generations if it is to succeed, than can the older generation.

Discussion

For those who have observed politics in the Arab Gulf countries, the most pressing question to ask is whether the reform will actually be implemented? Over time many reforms have been announced but few have been seen through to implementation.

So far, the reforms seem to hold ground. The implemented cuts in salaries and subsidies have not been eased or abandoned. While both King Salman and Prince Muhammad bin Salman exude the political will to carry through the reforms, they are helped along by the gradual rise in oil prices witnessed lately. The average oil price for 2016 was $43 a barrel and has for the first month in 2017 been approximately $10 higher. This has eased the pressure for further cuts and helped the government to finance their delivery of services.

More reforms are in the pipeline, however minor. In April 2017 a ‘vice’ tax on sugary drinks and tobacco will be implemented which might affect the poorest segments of the population and in early 2018 a value added tax of 5 per cent will be implemented in Saudi Arabia as well as in the other Gulf countries. Even though poorer segments of the Saudi population might be compensated for the effects of the tax, all observers agree that the tax will translate into higher consumer prices and thus affect the economy of the individual household negatively. And this will come on top of the already implemented reforms the households have witnessed encompassing lower salaries, if they have persons working in the public sector, increased prices of fuel, water and electricity and on garbage collection. All reducing the disposable household income.

So far there has been fear among decision makers in the region, materialized as we saw in governments' willingness to hand out cash- and other benefits under the Arab Spring, that a break in the social contract would lead the population to take to the streets and maybe topple the incumbent King or Emir. During the past years we have seen a range of reforms within the Arab Gulf states making it more expensive to be a citizen. But so far, no upheaval has taken place. Saudi Arabia has by far implemented the toughest reforms, actually slashing the salaries in the public sector, a move which just a few years ago was thought an impossible thing to do. And so far they have survived. This is indeed good news for the long-term reform effort the region is facing.

The two planning documents call for a revolution in the way the kingdom is governed. Transforming a tribal society where faith and family comes first to a market economy where merit matters most. As O'Sullivan, a senior writer for MEED points out: "Only a management consultant could think it possible. And only the son of a king could attempt it."

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