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UPDATE: SAUDI ARABIA'S ECONOMIC REFORMS

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SUMMARY

- Saudi leaders have been forceful, and largely successful, in pushing through economic reforms since unveiling their ambitious agenda in April 2016.

- However, for the foreseeable future, the government will remain the main engine of the Saudi economy, and institutional constraints will limit the options of even the most determined and capable leadership.

- The Saudi government promises increased private sector participation in the economy, but the austerity measures required for achieving long-term goals entail short-term disruption.

- Privatization initiatives will create opportunities for foreign companies and investors, and the Kingdom's increased transparency and reform efforts will enhance the long-term position of the private sector.

- But companies must keep a close eye on Saudi Arabia's underlying structural issues while also finding ways to engage the government and to work with Saudi officials to implement their promised reforms.

FISCAL REFORMS GUIDED THE KINGDOM'S ECONOMIC TRANSFORMATION IN 2016

A central pillar of the government's reform agenda in 2016 was getting its fiscal house in order. The government cut public salaries and allowances, introduced administrative fees, and reduced subsidies. It also embarked on a systematic review of capital expenditures to reduce waste and trim spending. The first phase of this review examined five ministries and cut unfinished projects worth SAR 100 billion ($27 billion). The next phase will involve a review of projects worth an additional SAR 1.18 trillion riyals ($315 billion), although it is not yet known what portion of these will be scrapped. After a 46% year-on-year reduction in capital spending in 2016, the government is expected to increase it in 2017 to nearly 2015 levels (approximately 30% of total spending), in large part to support private sector growth.

Concerted government efforts—and a welcome rebound in oil prices—reduced the budget deficit from 11.7% of GDP in 2015 to 7.7% in 2016. This involved some economic disruption, and at the end of the year, King Salman publicly acknowledged the "painful" realities of the transition. Nonetheless, Saudi leaders are pushing ahead with reform.

Over the course of 2017-18, the government will roll out excise taxes, a value-added tax (VAT), and tax on unused land. The government is also considering plans to raise fuel prices again and will start a cash-transfer program to compensate all but the wealthiest for cuts in universal subsidies. However, without an unexpected external source of income (e.g., in the form of high oil prices), it is unclear how quickly the government can reduce its deficit without triggering a recession. Notwithstanding these challenges, the IMF has been cautiously supportive of the Kingdom's reform efforts and has applauded the Fiscal Balance Program released in December.

There are several reasons to be optimistic:

- **Saudi Arabia has demonstrated a degree of openness that stands in marked contrast to years past.** One example is the prospectus for Saudi Arabia's $17.5 billion sovereign international bond issue, which included a comprehensive description of the Kingdom's reform plans and potential risks, including the admission that unforeseen circumstances might lead the government to reconsider its exchange rate policy. In anticipation of Saudi Aramco's partial IPO, external auditors have examined the company's crude reserves and are expected to review its books, which would be an unprecedented exercise in transparency. Moreover, Saudi Arabia's 2017 budget was the most detailed yet and included expected oil revenues for the first time. The Kingdom is far from a paragon of transparency, but it is moving in the right direction, which is necessary to attract foreign investors.

THERE CAN BE LITTLE DOUBT THAT SAUDI LEADERS ARE SERIOUS ABOUT ECONOMIC REFORM, AND THEY HAVE ALREADY MADE REAL PROGRESS.

- **Deputy Crown Prince Mohammed bin Salman, the mastermind behind Vision 2030 and the National Transformation Program (NTP), has surrounded himself with talented and hard-working advisors and ministers.** These officials are being held to account, and Minister of Economy and Planning Adel Fakieh is tasked with corralling government bodies to implement the NTP. Thus far, the Deputy Crown Prince has been able to achieve a high degree of policy coordination. However, this has been done largely by establishing an elite bureaucracy sitting on top of and in parallel to the existing one, which could result in fragmentation and which raises questions about the ability of the civil service to execute the government's priorities. This structure has also given rise to questions about which new policy measures the government has in store. Some private sector players have complained that policies are announced suddenly and without broad discussion or consultation.

There can be little doubt that Saudi leaders are serious about economic reform, and they have already made real progress. But both resource scarcity and a general reluctance to set priorities impede the implementation of the latest reform efforts. Ultimately, how much the government can achieve in the short-term depends on how much low-hanging fruit there is in the system and how much strain the population can tolerate to achieve long-term economic sustainability.

MANY CHALLENGES REMAIN

While there are reasons for optimism, there are also reasons to be concerned about the potential for short-term and even long-term change. Saudi Arabia has deep structural challenges, and its institutional legacies are not so easily reversed.

- **Saudi Arabia faces several entrenched labor issues.** First, the Saudi government is plagued by an overstaffed, slow-moving, and fragmented bureaucracy. Civil service reforms are an important part of the reform agenda, but changing the behavior of millions of state employees after decades of patronage employment will not be easy. Second, dependence on cheap but low-productivity foreign labor has deterred the emergence of an indigenous working class. Third, economic activity must greatly expand in order to accommodate the swell of Saudi youth moving into the labor force. The labor market might slowly reorient itself as new public jobs remain limited and the private sector expands, but even the most optimistic observers think it will be another five or ten years before quality talent has rooted itself in government and industry.

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- **Given the government's outsized role in the economy, austerity policies will suppress private demand.** Real non-oil private sector growth expanded by only 0.1% in 2016. By comparison, non-oil private sector growth had hovered between 4% and 7% during the expansionary years from 2009 to 2014. However, the IMF does expect the non-oil sector to rebound slightly in 2017, due to a boost in consumer confidence and clear government fiscal plans. But high levels of taxation could depress business activity and lead to capital flight. Companies that once relied mostly on Saudi government contracts may now have to look for other markets.

- **Doing business in Saudi Arabia remains a challenge, particularly in the areas of contract enforcement, starting a business, trading across borders, and resolving insolvency.** The good news is that Saudi officials recognize these shortcomings and are working to correct them. A new companies law is already in place, and changes are expected in the laws affecting bankruptcy, enforcement, mortgages, and mining. However, a judicial system that does not fully incorporate modern commercial law means that foreign companies—multinationals and SMEs alike—still face difficulties doing business with their local partners and distributors.

The government's ability to achieve progress also depends on factors that are not strictly economic. Even setting aside its many domestic political and security challenges, the Kingdom operates in a tumultuous regional environment and a tenuous global economic system. Competition with Iran is an ongoing geopolitical risk subject to unforeseen escalation. And while Saudi leaders are cautiously optimistic about the new U.S. Administration, President Trump's unpredictability could have wide-ranging repercussions on U.S.-Saudi relations, oil prices, interest rates, and the purchasing power of the Saudi riyal.

SAUDIS WILL PUSH FOR PRIVATIZATION AND LOCALIZATION IN 2017

The planned economic transformation will take decades, but 2017 will be marked by continued improvements in the government's fiscal position and a push for privatization and localization. In late 2016, authorities established the National Center for Privatization, which has been tasked with setting policy and programs for privatization and public-private partnerships (PPPs). In 2017, the Center will consider privatization initiatives in a number of sectors, including public utilities, healthcare, education, transportation, and municipal services.

The most high-profile and significant privatization effort is the partial IPO of Saudi Aramco, slated for 2018. But while Aramco is by far the biggest, more than 100 state enterprises will be privatized through IPOs, trade sales, or PPPs. In January, an executive from the Saudi Electricity Company said that all future power plants in Saudi Arabia will be developed as PPPs. The Ministry of Health is pursuing the privatization of hospitals and the establishment of a domestic pharmaceutical industry. The Saudi Stock Exchange (Tadawul) and the Saudi Grains Organization are also expected to be privatized in the next several years.

All of these initiatives create much opportunity for foreign companies and investors. However, the government remains squarely focused on localization, which could raise costs for companies doing business in the Kingdom because it will require that they hire and source more products locally rather than rely on inexpensive imported labor and goods.

To encourage firms to hire locally—and, of course, to boost revenues—the government has raised fees for expatriate workers and their dependents. Saudi Arabia has set a target of increasing the percentage of employment localization in the private sector from 19% to 24% by 2020. The government is also encouraging an expansion of local content (inputs produced in Saudi Arabia rather than imported). The NTP calls for increasing the percentage of local content in total public and private sector spending from 36% to 50% in the next four years.

Implications for Business

Foreign companies must continue to be mindful of the risks of doing business in Saudi Arabia. The structural challenges are real, and many institutions have not yet caught up to the bold reform efforts advanced by senior Saudi officials. To the extent that government spending continues to contract in the near future, economic growth is likely to remain depressed. 2016 was also a difficult year for companies which do business with the government. Many faced a cash crunch, as the government delayed payments for months while it reexamined past projects. This impacted many multinationals as well as local companies.

However, there are very real opportunities as Saudi Arabia moves ahead with its privatization and infrastructure expansion, especially in renewables, utilities, healthcare, education, manufacturing, and petrochemicals. Saudi Arabia is still the largest market in the Middle East and an economic anchor in the GCC. Saudi authorities are determined to expand the role of the private sector in the Saudi economy, which undoubtedly creates opportunities for business.

Thanks to the Kingdom's increased transparency, businesses now have a slightly better sense of where the government is going. As Saudi officials now say often, they seek partners and not just vendors. And ministers in many areas have been much more receptive to hearing from companies about where the government could do better. This openness and self-reflection is something on which businesses can capitalize. Firms willing to align their plans to advance Saudi reform initiatives will be in a much better position to protect their existing business, win new contracts, and find ways to benefit from the many opportunities in Saudi Arabia.

ASG's Middle East & North Africa Practice has extensive experience helping multinationals and investors understand and navigate the political, commercial, and regulatory landscape in Saudi Arabia and markets across the Middle East. Our robust network of working relationships includes senior government officials, business executives, civil society directors, and thought leaders. For questions or to arrange a follow-up conversation please contact Nate Hodson.
