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State-Business Relations in the Reform Era: **Growing Pressures and Diverging Economic Policy Agendas**

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Special Report

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Large fiscal deficits brought about by the precipitous decline in oil prices in late 2014 and long-standing challenges concerning youth unemployment have been two of the dominant underlying themes driving economic policy in Saudi Arabia in recent years. These challenges, though not unique in the region, loom particularly large when compared to those of some of the Kingdom's "super-rentier" neighbors,[1] and they have engendered a sense of urgency at the policy-making level.

These trends have also formed the backdrop against which significant domestic political change has taken place, with new leadership that is attempting to undertake a series of transformational economic reform programs, most notably the Vision 2030 plan and the more detailed National Transformation Program.

These changes taken together, however, have precipitated the early stages of transformation in the social contracts between the state and the various constituencies in the Kingdom. Perhaps most interesting for scholars of oil-rich states in particular, however, have been attempts to transform the relationship between the state and public sector employees, as well as the relationship between the state and the business sector.

This paper focuses on the changing dynamics of state-business relations in particular as it attempts to analyze the challenges this might pose to the broader reform agenda. By exploring the dual pressures being exerted on the state by high levels of unemployment on the one hand and large fiscal deficits on the other, the resulting, seemingly contradictory, policy outcomes can be identified, examined, and contextualized.

Pressures from Within and Without

The wide range of economic policy proposals that have emerged as part of the Vision initiative, as well as from other initiatives that predate it,[2] can be divided along a host of different lines.

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(1) The term "super-rentier" refers to the three wealthiest GCC states in GDP per capita terms, Qatar, the UAE, and Kuwait. See Courtney Freer, "Rentier Islamism: The Role of the Muslim Brotherhood in the Gulf," LSE Middle East Centre Paper Series 9, London School of Economics, 2015.

(2) Earlier initiatives included the five-year development plans, of which the ninth and tenth were the most recent.

One fruitful way to deconstruct the policy landscape is to start with the underlying pressures confronting the state and then explore their connection with the policy initiatives that have come about as a result. Two pressures quickly become evident as the dominant forces shaping economic policy since 2014.

The first, which is global in scope and is the more recent, is the decline in oil prices that took place in 2014, which brought about fiscal deficits on a larger and more troubling scale than those seen in the past. As an indication, the rate of savings-fueled deficit growth in 2015 would have led to the depletion of Saudi fiscal buffers within five years had it persisted, as the International Monetary Fund (IMF) indicated at the time; the trend has since improved, however.[3] There are, of course, varying levels of urgency felt among the Gulf Cooperation Council (GCC) states. Saudi Arabia sits somewhere in the middle, with the super-rentier states (Kuwait, the United Arab Emirates, and Qatar) on the less urgent side and Bahrain and Oman on the more urgent side. In the years immediately following the sharp decline in oil prices, the more short-term alarmist viewpoints—warning of impending fiscal insolvency—have largely been dismissed, but there is little doubt that the long-term fiscal prospects for business as usual are challenging.

The second pressure, which separates the Kingdom from its GCC peers, emerges as a result of the demographic trends that are bringing large numbers of young people into the labor market. This kind of demographic pressure is quantitatively different in the case of the Kingdom, as the sheer number of young people seeking to enter the labor market every year, combined with the state's shrinking resources, set Saudi Arabia apart from its neighbors. The statistic that 58% of the population is under the age of thirty is often cited,[4] and a very large percentage of youth, 40.5% (ages 15-24), are unemployed.[5]

It is the confluence of these two pressures that is alarming. Individually, such pressures are not uncommon, and the size of the current public sector wage bill (around 13% of

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(3) Ahmed Feteha, "Saudis Risk Draining Financial Assets in 5 Years, IMF Says." Bloomberg.com, October 21, 2015, www.bloomberg.com/news/articles/2015-10-21/saudis-risk-draining-financial-assets-in-five-years-imf-says.

(4) Saudi Arabia, General Authority for Statistics, "Population by Single Age, Nationality (Saudi/Non-Saudi) and Gender, Mid-Year 2018."

(5) International Monetary Fund, IMF Country Report No. 17/316, 2017, p.7.

GDP in 2016)[6] is a testament to how issues of bulging demography and unemployment were addressed in years and decades past—by distributing patronage through public sector employment.

In the current climate, however, these two pressures have brought about the rise of two seemingly incompatible economic agendas, with the fiscal situation prompting a neoliberal economic response from the state, whereas the unemployment pressures and recessionary climate have prompted a more statist and nationalist economic policy response. This will certainly not be considered an unusual trade-off by policy makers and scholars of other regions who have confronted similar challenges in the last few years.

Elements of the Liberal Economic Agenda

As a response to large fiscal deficits and unsustainable spending, the state has undertaken a host of new economic liberalization policies intended to promote private sector growth and foreign direct investment (FDI), and in doing so, alleviate the pressure on the Saudi state resulting from its role as the economy's main source of employment. This kind of reform is not new in principle. For several years, the World Bank's Ease of Doing Business Index was an important key performance indicator (KPI) for Saudi policy makers aiming to attract foreign investors to the Kingdom. Led by the Saudi General Investment Authority (SAGIA), the entity tasked with attracting FDI into the Kingdom, the state made strides in improving its performance on many of these indicators, leading to a rise to 12th place in the global index by 2011 (before the World Bank changed its metrics, as a result of which the country has ranked in the 90s in recent years).[7] In many ways this reflects broader concerns about the Saudi economy on the part of investors, often relating to issues such as deeper structural challenges in the judicial system. And while many of these structural issues remain, the new set of liberalization policies being implemented is clearly more ambitious and aims to cut deeper than attempts in years past.

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(6) Natalia T. Tamirisa and Christoph Duenwald, "Public Wage Bills in the Middle East and Central Asia," International Monetary Fund, Departmental Papers/Policy Papers, 2018, p. 7.

(7) World Bank, "Doing Business Project: Measuring Business Regulations," doingbusiness.org.

This part of the reform package has been met with a largely positive response from the global investment community, which is eager to gain greater access to what is seen as a largely untapped emerging market economy.[8] The privatization element of the agenda in particular, which is, perhaps, the most recognizable of the Vision 2030 economic initiatives, has attracted wide interest from investors but has also raised questions about the role and responsibilities of the state toward public sector employees, among other issues.

More broadly, the following set of policies that either have been implemented or will be implemented in the future emerges from this economic agenda:

- The liberalization of equity markets to promote investment and the opening of a wider range of industries to greater foreign ownership, including reforms such as the new bankruptcy law[9]
- The privatization agenda, which outlines plans to offload a range of valuable state assets (to include elements of health care and education, airports, and potentially 5% of the state owned oil company, Aramco)
- Energy subsidy reform, which has seen fuel and electricity prices rise in recent months (most recently in January 2018) as part of a medium-term plan to reach the level of global market prices for utilities[10]
- The roll-out of a variety of excise or sin taxes in 2017 and a value-added tax (VAT) in January 2018
- The consolidation of state assets under the Public Investment Fund (PIF) and the pursuit of a more aggressive investment strategy and dynamic asset allocation, as typified by the SoftBank Vision Fund[11]

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(8) F. Brinley Bruton, "'Davos in the Desert' Offers Glimpse of Changing Saudi Arabia," NBCUniversal News Group, October 24, 2017, www.nbcnews.com/news/world/davos-desert-offers-glimpse-changing-saudi-arabia-n813636.

(9) Baker McKenzie, "Saudi Arabia Issues Its First Developed Bankruptcy Law," March 5, 2018, www.bakermckenzie.com/en/insight/publications/2018/03/saudi-arabia-first-developed-bankruptcy-law.

(10) Fiscal Balance Program, 2018 Update, Ministry of Finance.

(11) "Public Investment Fund, SoftBank Vision Fund Sign Partnership to Establish 'Solar Energy Plan 2030,'" Saudi Press Agency," الجنادرية / زوار الجنادرية في ختام فعالياتها : ننتظر المهرجان بشغف كل عام وكالة الأنباء السعودية, October 25, 2017, www.spa.gov.sa/viewfullstory.php?lang=en&newsid=1681121.

- Cuts in capital expenditure by the state, particularly in education, health care, and infrastructure, as well as some early attempts at reductions in current expenditures through public sector benefits and pay freezes

- The issuance of local and international bonds totaling more than $40 billion in the 18 months through the end of the second quarter of 2018[12]

However, although these reforms have been well received by international investors, the response from the local private sector has been lukewarm.[13] That sector too is undoubtedly interested in the privatization opportunities, but energy subsidy reform, along with a host of new taxes and levies, has significantly increased the price of doing business in the Kingdom, particularly for energy-intensive industries (albeit from a low initial starting point).[14] Moreover, this has come at a time when the state has curtailed capital expenditures, which in years past has been the single most important factor underlying private sector growth, while also opening the door to greater foreign competition. More generally, these reforms have translated into a concerted effort by the government to rewrite the structural elements of the social contract between the local private sector and the state, upending the status quo and disrupting the way the local private sector had conducted business in the Kingdom in decades past. And though newer investors are not as accustomed or attached to the old contract (which, at its core, consists of cheap labor and energy and government capital expenditures), concerns will likely remain about how and when these contracts or bargains are renegotiated and what kind of clarity and foresight they will prove to have in years to come.

Key Elements of the Statist Agenda

Emerging as a result of the strong demographic pressures in the labor market, the state has also simultaneously continued to maintain a series of policies that have been grouped here under the umbrella of the statist agenda. These policies have a common statist and often nationalist

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(12) "Saudi Arabia: Bonds," Cbonds.Info, cbonds.com/countries/Saudi-Arabia-bond.

(13) Jane Kinninmont, "Vision 2030 and Saudi Arabia's Social Contract: Austerity and Transformation," Chatham House Report, July 20, 2017, p. 27.

(14) Vivian Nereim, "Anger At Rising Prices Hits a New Target in Saudi Arabia: Milk," July 3, 2018,ttps://www.bloomberg.com/news/articles/2018-07-03/in-saudi-arabia-anger-at-rising-prices-hits-a-new-target-milk.

theme, and in contrast to the liberalization agenda, these policies have often been viewed with skepticism by the private sector.

The centerpiece of this agenda is the ongoing effort of the Ministry of Labor and Social Development (MLSD) to increase the number of Saudis working in the private sector, predominantly through the Nitaqat and Taqat Programs.[15] As the centerpiece of the state's labor nationalization agenda since 2011, the Nitaqat Program is a quota system designed to push private firms to increase the number of nationals they employ through an incentive and penalty structure; and as Jennifer R. Peck (2017) argues[16], it has "succeeded in increasing Saudi employment, but . . . at significant cost to firm growth and survival." Taqat, the National Labor Gateway, is an additional program that was rolled out in 2015 by a number of government agencies including the Human Resources Development Fund (HRDF). Its goal was to facilitate the matching of job seekers' skills with opportunities for firms looking to hire, and in 2017 it began to mandate that firms engage and interview qualified candidates from the program for a certain period of time before being allowed to apply for visas for foreign workers.

More broadly, however, this statist agenda encompasses a host of policies, including:

- Levies on foreign labor and their dependents, which, against the backdrop of a broader recessionary climate, have led to a large exodus of migrant workers (likely exceeding 800,000 departures in the eighteen months leading up to April 2018)[17]
- An increase in the scope and pace of Saudization efforts through implementation of the Taqat Program by HRDF and the continued expansion of the Nitaqat Program
- A decrease in the ease of access to visas for skilled and semiskilled foreign labor

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(15) Nitaqat and Taqat are programs that require and also incentivize the private sector to recruit their labor forces locally according to a complex set of rules and regulations. See Steffen Hertog, "State and Private Sector in the GCC after the Arab Uprisings," *Journal of Arabian Studies*, 3:2 (2014): 174–195.

(16) Jennifer R. Peck, "Can Hiring Quotas Work?: The Effect of the Nitaqat Program on the Saudi Private Sector," *American Economic Journal: Economic Policy*, Vol. 9, No. 2, 2017, pp. 316-47.

(17) "1,500 Expats Leaving Saudi Arabia on a Daily Basis," *Saudi Gazette*, April 11, 2018, http://saudigazette.com.sa/article/532546/SAUDI-ARABIA/1500-expats-leaving-Saudi-Arabia-on-a-daily-basis.

- Growth in the scope and scale of state-owned enterprises (SOEs) and state-led initiatives, most prominently through the PIF and its "Saudi Sector Development" pool in, among other sectors, agriculture (the Saudi Fisheries project), energy (SoftBank Solar), and entertainment (AMC).[18]

It is clear that this set of policies, unlike those that are part of the liberal agenda, do not share as clear a link to an ideological paradigm, much in the same way that the historical growth of the welfare state in the Kingdom was not directly ideological, but rather constituted a type of rentier statecraft aimed at distributing patronage and wealth according to the cultural and social context of the time, and in response to the rise of socialist republics in the Arab world, as argued by Hertog.[19]

Areas Where the Agendas Collide

These two sets of policy agendas, which arose in response to different pressures, conflict in certain areas, which often results in a confusing policy landscape for multinational investors as well as for local businesses of all sizes.

A typical example of this conflict was the announcement by the government, in January 2018—five days after increases in utility prices and the introduction of a VAT—of a series of cash bonuses to government employees and members of the armed services.[20] The selective mitigation of these new economic conditions for public sector employees reinforced their split with private sector employees. In a deeper sense, however, the government's move revealed that even in an era of rapid change and economic liberalization, the reflexive reaction of the state is to revert to entrenched modes of patronage.

The following section highlights three typical ways in which, in a broad sense, these agendas may clash; of course, a more exhaustive analysis could be the focus of further research.

Skills Lagging behind Labor Market Needs

An often cited example of this kind of conflict involves the skills gap of young Saudis

(18) Saudi Arabia, Public Investment Fund (PIF), "Portfolio," 2017–2018, www.pif.gov.sa/en/Pages/Portfolio.aspx.

(19) Steffen Hertog, *Princes, Brokers, and Bureaucrats: Oil and the State in Saudi Arabia* (Ithaca, NY: Cornell University Press, 2011), 61–65.

(20) Alaa Shahine and Vivian Nereim, "Royal Handouts Cheer Saudis But Show Struggle to Revamp Economy," Bloomberg.com, Bloomberg, January 7, 2018, www.bloomberg.com/news/articles/2018-01-06/saudis-get-extra-pay-after-price-surge-sparked-public-complaints.

entering the labor market after graduating from the public education system.[21] Though the education budget in the Kingdom continues to be one of the world's largest in terms of GDP, even compared to the nations of the Organisation for Economic Co-operation and Development (OECD),[22] recent years have seen the budget shrink, even while other types of spending recovered in 2017–2018 following the mild austerity of the previous two years.[23] Additionally, educational outcomes, in STEM-related subjects in particular, are still lackluster (scores declined between the last two global studies of adolescent math and science skills), and there continues to be a pronounced mismatch of skills among university graduates entering the labor market.[24] These challenges have formed the backdrop against which additional pressure has been placed on the private sector to replace skilled foreign workers with Saudi counterparts. The complexity of new regulatory regimes, from the financial sector to energy and consulting, have also increased licensing requirements on companies operating in these spaces, often specifically calling for a certain number of employees with a particular set of qualifications. A case in point involves the new regulations in the Kingdom that govern small and medium-sized solar systems feeding into the electric grid. These regulations compel consultants and installers to comply with a set of requirements that include specific manpower requirements, detailing everything from the types of degrees engineers need to have to the numbers of projects they must have undertaken and years of experience they must have accrued. In a country with a nascent industry, this forces businesses to look abroad for qualified solar engineers and creates a tension with the Saudization demands of MLSD, which continue to push businesses in the opposite direction. Efforts have been made to address the mismatch of skills. The HRDF's Tamheer Program, which subsidizes job training for Saudi employees for up to six months, stands out as a promising initiative, though as of yet it remains unclear how broad its impact has been.

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(21) Steffen Hertog, *The Political Economy of Labour Markets and Migration in the Gulf, Workshop Proceedings,* 2016, eprints.lse.ac.uk/67919/1/Labour and Migration Report.pdf.

(22) OECD, "Education GPS—Saudi Arabia—Overview of the Education System (EAG 2018)," gpseducation.oecd.org/CountryProfile?primaryCountry=SAU&treshold=10&topic=EO.

(23) Saudi Arabia, "Saudi Fiscal Budget 2018" (English translation), Jadwa Investment, December 17, 2017, www.jadwa.com/en/download/2018-saudi-fiscal-budget/saudi-arabias-2018-budget-1-1-1.

(24) Ina V. S. Mullis et al., "Third International Mathematics and Science Study (TIMSS)," *Encyclopedia of Science Education*, ed. Richard Gunstone (Dordrecht: Springer Netherlands, 2015), p. 15.

The Crowding-out Effect

Another kind of clash, which has manifested in a variety of industries and on a number of scales, emerges from the growth of SOEs and state-run initiatives and the perception that they are having a "crowding-out" effect on investment from the local private sector, and from small and medium-sized enterprises (SMEs) in particular. An eagerness by the state to spur rapid growth in certain strategic industries that have been neglected in the past has led to SOEs directly tackling these opportunities, often by partnering with foreign joint ventures (JVs). In many instances this type of SOE growth seems to stem from challenges in implementing structural changes to create healthy and more organic investment ecosystems in the past, but also from an eagerness within the state to create "national champions" capable of using the Saudi market as a launchpad from which to compete globally. The description of the PIF's goals for its domestic portfolio, for example, states that "the Fund is working to unlock value within the domestic portfolio and create globally competitive national champions across multiple sectors." The examples of the PIF-AMC partnership and the PIF-SoftBank partnership to develop utility-scale solar plants in the Kingdom both fit neatly into this category.

Public Sector Employment Remains a More Attractive Prospect

The final, and perhaps most serious, clash resulted from the state's attempt to encourage the growth of private sector employment while maintaining high levels of public sector pay, benefits, and bonuses (as the public sector salary bonuses dispensed with the VAT rollout demonstrate), which continue to have a distorting effect on the labor market. This feature of public sector employment (which is often described in the literature as endemic to the structure of the state), along with the private sector's long-held reliance on cheap foreign labor, form arguably the most significant challenges to the agenda of economic reform.

The state's continued efforts to curtail the private sector's reliance on cheaper foreign labor (through fees and other means), while maintaining most elements of public sector compensation, is a symptom of the rigidity of the state's social contract with public sector employees, and simultaneously, the malleability and weakness of the social contract with the local private

sector and business elite (an obvious feature of the state's relationship to these constituencies, but worth mentioning nonetheless).

Foreign labor fees, which were first applied in 2013 at a rate of SAR 200 per foreign employee per month, have begun to increase as of January 1, 2018, and are set to reach SAR 800 per foreign employee per month by 2020.[25] This will go some way toward narrowing the wage gap between Saudi and non-Saudi labor in the private sector, but it only attempts to address one of the two variables. Given the rigidity and political sensitivity of the social contract between the state and the public sector, and more broadly, the sticky nature of wages (which are slow to adjust to changes in labor market conditions), it is clear that a direct attempt to curtail Saudi public sector wages as a means of further narrowing the gap does not seem possible or even desirable.

But as Hertog and others have suggested,[26] in order to make further serious progress in narrowing the wage gap, the fees collected from the private sector through the levies on foreign laborers and their dependents could be redirected and used to directly support private sector Saudi employment, in a system similar to Kuwait's private sector wage support program (*Da'm 'Amala)*. More broadly, this would be an example of how the two sets of policy approaches—the foreign labor levy and a potential wage support program—could be calibrated to balance each other in a way that both contributes to Saudization goals and supports what is currently an anemic local private sector.

Conclusion

The pressures that produce these two different economic agendas are not unique to Saudi Arabia. However, in the absence of strong institutions capable of balancing competing interests in a clear and predictable way and communicating the reasoning behind policy and agenda choices, the local private sector may find the policy mix that emerges from this melting pot

(25) Sara Khoja and Ahmed Almazed, "KSA: New Fees Applicable for Foreign Employees & Dependants," Clyde & Co., January 9, 2018, www.clydeco.com/insight/article/ksa-fees-applicable-for-foreign-employees-a-new-development-and-a-recap.

(26) Steffen Hertog, "Mohammed Bin Salman Isn't Wonky Enough," *Foreign Policy*, March 14, 2018, foreignpolicy.com/2018/03/14/mohammad-bin-salman-isnt-wonky-enough/.

difficult to digest. Looking at the economic landscape as a whole, further research is needed on the nature of these clashes, the common features between them, and the impact on policy effectiveness.

The challenges facing the economic reform agenda are complex and evolving. However, precisely because they are so complex, a wider-ranging and more thorough policy debate is needed to develop clear and coherent solutions to address them. To drive this debate in the future and cut across different ministry portfolios, a focal point for economic policy research could be chosen and given a strong mandate to produce objective, independent analysis and policy recommendations. Modeled after similar research institutions in other countries, this entity could work closely with the Saudi Arabian Monetary Authority (SAMA), the chambers of commerce, and the ministries responsible for developing economic policy and draw on resources from local and international academics and think tanks, as well as global institutions like the World Bank. Most important, they could also be tasked with engaging directly with the public to increase economic literacy among the citizenry and act as the main point of contact for economic policy outreach.

King Faisal Center for Research and Islamic Studies (KFCRIS)

The KFCRIS is an independent non-governmental institution based in Riyadh, the Kingdom of Saudi Arabia. The Center was founded in 1403/1983 by the King Faisal Foundation (KFF) to preserve the legacy of the late King Faisal and to continue his mission of transmitting knowledge between the Kingdom and the world. The Center serves as a platform for research and Islamic Studies, bringing together researchers and research institutions from the Kingdom and across the world through conferences, workshops, and lectures, and through the production and publication of scholarly works, as well as the preservation of Islamic manuscripts.

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