



SAUDI ARABIA

SELECTED ISSUES

September 2019

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SAUDI ARABIA

SELECTED ISSUES

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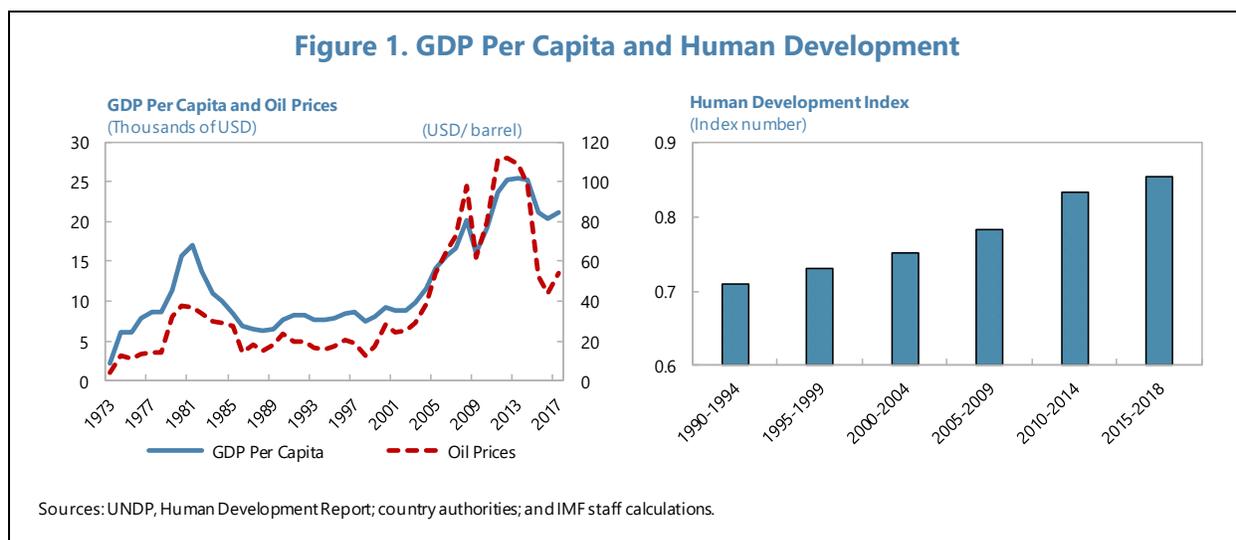
POLICIES TO DRIVE DIVERSIFICATION FOR SAUDI ARABIA¹

Diversification is needed to create jobs for Saudis and to mitigate the impact of uncertainty in oil markets. While the business climate should be improved, and remaining infrastructure gaps addressed, reforms need to go beyond these areas. Diversification in Saudi Arabia that creates jobs for nationals could be held back by the effects of relatively high wages and their impact on cost competitiveness. Creative solutions are needed to address the impact of high government wages and employment on competitiveness. Industrial policy could help overcome the incentives that encourage companies to focus on the non-tradable sector, but should be handled carefully, keeping lessons from other countries' experiences in mind. Export orientation and competition are crucial mechanisms to ensure discipline. Strengthening human capital to raise productivity and provide workers with the skills needed in the private sector will be essential to success.

A. Introduction

1. Living standards in Saudi Arabia have improved substantially over the decades.

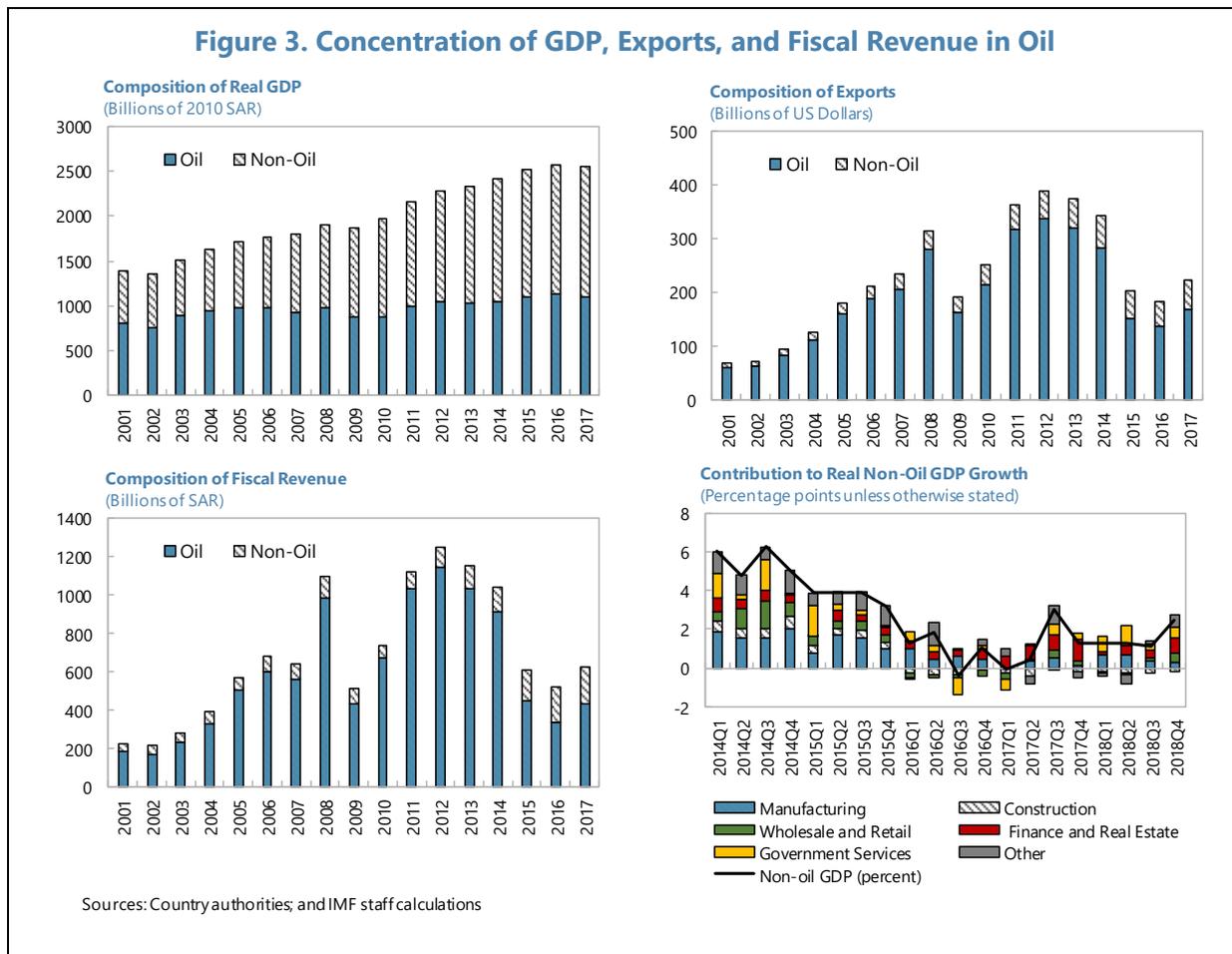
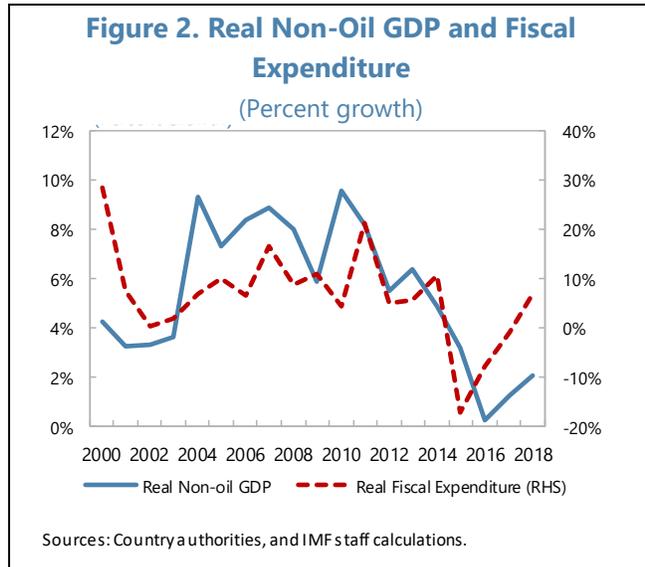
Revenue from oil exports has strongly supported growth in income per capita (while also introducing volatility) (Figure 1). Development, however, consists of more than just greater income (Sen 2000), and Saudi Arabia has also improved on the Human Development Index, reflecting higher life expectancy and wide access to education. With substantial reserves remaining, oil will remain important for the foreseeable future.



¹ Prepared by Divya Kirti, with input from Nahla Samargandi (Ministry of Finance). Tian Zhang and Diana Kargbo-Sical respectively provided research and editorial assistance. The authors are grateful to seminar participants at the IMF and Ministry of Finance for helpful comments.

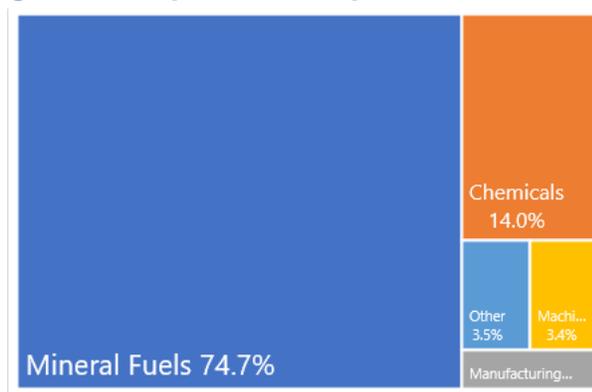
2. Nevertheless, greater economic diversification is needed to create jobs for Saudis, to increase the resilience of the economy, and to help prepare it for the coming decades.

Oil represents a large share of economic activity, exports, and fiscal revenues, but provides little direct employment. Oil directly accounts for more than 40 percent of GDP, nearly 70 percent of fiscal revenues, and close to 80 percent of exports. Non-oil activity is highly dependent on government outlays financed by oil revenues (Figures 2 and 3). Accommodating the large number of young Saudis entering the labor market will require strong non-oil growth. The uncertain outlook for oil prices, both at short and long horizons, also calls for diversification.



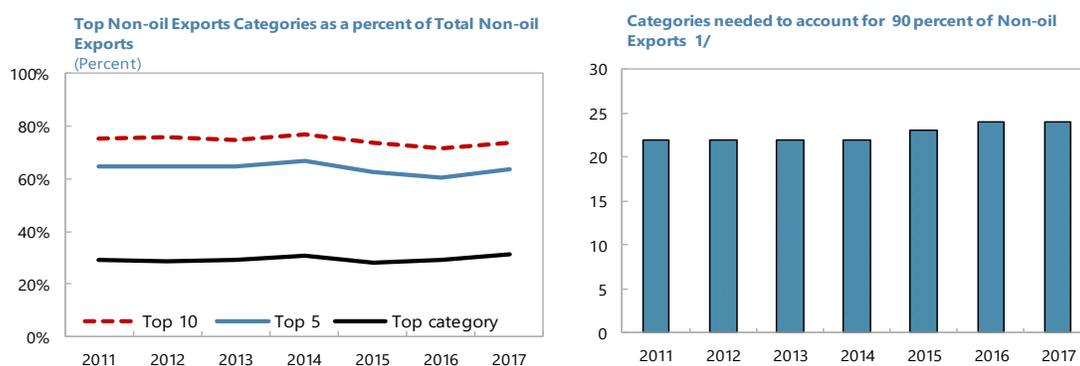
3. Efforts to diversify exports so far have focused on petrochemicals and plastics. In 2017, oil exports were \$170 billion (75 percent of total; Figure 4). Petrochemical exports were \$31 billion, while other non-oil exports were only \$21 billion (less than the \$22 billion recorded in 2011). While Saudi Arabia does export a number of non-oil categories, non-oil exports remain concentrated (Figure 5). The petrochemical and plastics sectors are supported by low cost energy inputs. This advantage may diminish over time given the government's energy reform plans, requiring additional efforts to boost competitiveness.

Figure 4. Composition of Exports of Goods, 2017



Sources: Country authorities; and IMF staff

Figure 5. Concentration of Non-Oil Exports



Sources: Country authorities; and IMF staff calculations.
1/ There are 61 non-oil and gas export categories in total.

4. Saudi Arabia's Vision 2030 aims to create a diversified, self-sustaining economy that provides jobs for Saudis. This plan is based on two broad and linked components:

- A large expansion of the external investments of the Public Investment Fund (PIF), the country's sovereign wealth fund (SWF), to provide both an external investment income stream and to gain access to advanced technologies to support growth in Saudi Arabia.
- Wide-ranging plans to increase investment in the domestic economy to support the development of the non-oil sector, including a significant industrial policy component. Several of the Vision Realization Programs (VRPs), including the Public Investment Fund (PIF) Program, the National Transformation Program, and the National Industrial Development and Logistics Program (NIDL) directly aim to promote diversification. The latter emphasizes domestic industrial policy, focusing on industry, mining, energy, and logistics. Box 1 summarizes the authorities' plans to advance diversification.

Box 1. Saudi Arabia's Plans to Grow and Diversify the Economy¹

Saudi Arabia's dependence on oil presents a major challenge to sustainable economic development.

The Saudi Arabian economy is endowed with large oil reserves as well as significant mineral deposits. However, its dependence on oil presents challenges due to the volatility of oil prices and the emergence of increasingly competitive renewable energy sources and technologies. Moreover, the oil sector is capital rather than labor intensive and hence is unable to absorb the large numbers of young Saudis joining the workforce every year. To address these challenges Saudi Arabia is advancing policies on several fronts to encourage diversification.

The government aims to encourage private sector growth in several priority sectors. Under Vision 2030, specific targets include increasing the private sector's contribution to GDP from 40 percent in 2018 to 65 percent by 2030, enabling SME development, and growing the economy from the 19th largest to among the 15th largest economy in the world. Vision 2030 and the Vision Realization Programs (VRPs), including most recently the NIDLP, identify several priority sectors, including:

- **Retail:** The retail sector employed 1.5 million workers in 2018, of whom only 0.3 million were Saudis. The authorities aim to provide jobs for Saudis by attracting leading brands and increasing the use of technology and e-commerce.
- **Manufacturing:** Targets are to develop petrochemicals and plastics further, encourage localization in the oil and gas industry, and encourage automotive, defense, and pharmaceutical manufacturing.
- **Mining:** The country has significant mineral resources, including aluminum, phosphate, gold, copper, and uranium. Output and exports are already growing quickly and by 2020, the government sees a potential contribution to GDP of nearly SAR 100 billion (up from SAR 12.5 billion in 2018), as well as 90,000 jobs in the mining sector.
- **Logistics:** Significant investments have already been made in ports, railways, roads, and airports. Through additional investments and new partnerships, the country aims to develop into a logistics gateway between Asia, Africa, and Europe.
- **Renewable energy:** Saudi Arabia aims to generate nearly 60 gigawatts of renewable energy to meet increasing energy demand. In doing so, it aims to localize the industry and produce the necessary skill-sets and encourage public-private partnerships.
- **Tourism and entertainment:** The government plans to develop tourist sites, invest in supporting infrastructure and facilities, and improve visa issuance procedures. Saudi Arabia already attracts many visitors for religious purposes. Following renovations at Mecca and Medina that reduced visitors from 2013–16, visitor arrivals rebounded in 2017. The country aspires to double domestic household spending on entertainment and develop a SAR 30 billion recreational services market.

Structural reforms are being pursued to support growth in the non-oil sector:

- **Competitiveness:** In 2018, Saudi Arabia rose two places in the Global Competitiveness Index, to 39th. It aims to be among the top ten.
- **Special Economic Zones (SEZs):** The government is establishing SEZs focused on logistics, tourism, industry, and finance, with special regulatory regimes on offer. NEOM, a planned city on the Red Sea coast with separate tax, labor, and judicial frameworks, is a prominent example.

¹This box was prepared by Nahla Samargandi.

Box 1. Saudi Arabia's Plans to Grow and Diversify the Economy (concluded)

- **Foreign Direct Investment (FDI):** The authorities aim to increase FDI from under 1 percent to 6 percent of GDP by 2030. The PIF is tasked with forming partnerships with global leading companies to bring new FDI into the country and develop domestic production capacity, including for military products.
- **Education:** Recognizing that equipping Saudis with the skills to work in the targeted industries is essential, the 2019 budget allocated SAR 1 billion to support universities in enhancing skills to allow Saudis to participate in a diversified and knowledge-based economy. Broader reforms to the education system are also being considered.
- **Mining:** Saudi Arabia is conducting centralized surveys to catalogue potential mineral resources with public access and is developing a licensing regime for private companies for both exploration and mining.
- **Tourism and entertainment:** Qiddiya, a planned collection of amusement and theme parks, outdoor activity spaces and sports facilities located near Riyadh, aims to serve the domestic market. The Red Sea project aims to attract international tourists with planned luxury hotel developments by the coastline and coral reefs.
- **Subsidy reform:** Criteria for energy subsidies are being reassessed based on the maturity of the sector and ability to compete both locally and internationally. The aim of this reform is to maximize government income and eliminate market distortions.
- **Privatization:** Privatization of state-owned assets, including leading national companies, is being discussed to enhance efficiency.
- **Local content requirements:** The government and state-owned companies are actively focusing on increasing the share of domestic procurement, to encourage local supply chains.
- **Cooperation with GCC:** The government aims to implement a GCC common market, unifying customs, economic, and legal policies, and constructing shared infrastructure. This will allow the region to become an international leader in logistics.

The PIF is playing a central role in catalyzing and supporting the government's reform agenda. The PIF's assets have already increased from SAR 570 billion to SAR 840 billion. The government aims to increase its assets to over SAR 7 trillion by 2030, with an annual return target of 4–5 percent. The PIF is supporting mega projects including NEOM, Red Sea, and Qiddiya. In addition, it is seeking to support the localization of technology and know-how by launching new sectors, as well as through strategic partnerships with global partners. It expects to invest SAR 210 billion (7 percent of GDP) over the coming three years in advanced technology and research and development, locally and internationally.

If successful, these plans will transform the Saudi economy. To succeed, they will need to attract significant investment: close to \$1 trillion, with the NEOM project and NIDLP expecting to attract investments of \$500 billion and \$426 billion respectively. To achieve these objectives, significant private sector involvement will be needed. Training and equipping Saudi nationals with the skills and wage expectations that will make these new sectors internationally competitive will be an essential element if the ambitious programs are to be successful.

5. As these plans are pursued, it is important that structural reforms address constraints to diversification in the Saudi economy and industrial policy is handled with care. This paper is structured as follows. Section B examines why progress with diversification is crucial for Saudi Arabia to create jobs and to reduce dependence on oil. Section C observes that vast financial accumulation would be needed to provide a meaningful stream of alternative revenues. Section D turns to policies

to drive diversification of the Saudi economy. Section D highlights key lessons from other countries' experiences to keep in mind as Saudi Arabia implements industrial policy. Section E concludes with a summary of key policy recommendations.

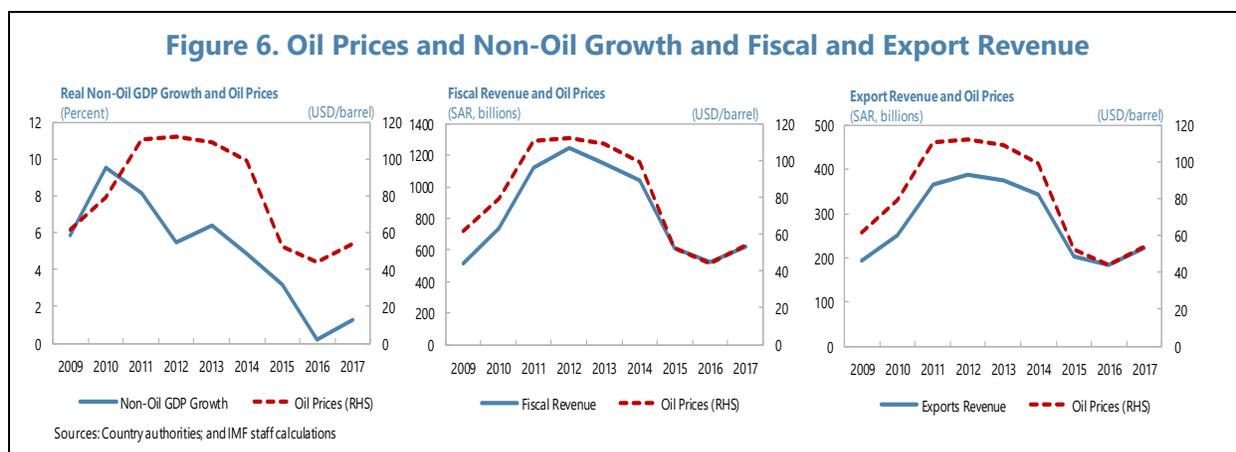
B. Why is Diversification Important?

6. Jobs need to be created for the many young Saudis entering the labor market. With a young population and rising labor force participation, up to 1 million jobs could be needed over the next five years. Accommodating these young Saudis in the government is not feasible: adding 1 million government jobs at the current average government pay for Saudis (about SAR 11,000 per month) would increase the wage bill by 4.5 percent of GDP. Beyond fiscal considerations, the development of a self-sustaining and dynamic non-oil economy must ultimately be the source of job creation.

7. Diversification will also help Saudi Arabia manage the challenges that could arise from both temporary and permanent shifts in oil markets. When activity, exports, and revenues are highly reliant on oil, shocks to oil markets can have a large impact on the economy. Two types of shocks are important to consider. First, oil prices can exhibit substantial temporary variation. For instance, while Brent prices doubled to well above \$100 a barrel from 2009 to 2011, in 2016 they dipped back below \$50 a barrel. Second, the global economic environment may shift in more permanent ways: demand for oil may decline before Saudi Arabia's large reserves are exhausted. While diversification is a long-term process, it can help address the effects of these shocks by reducing Saudi Arabia's exposure to oil. Strengthening fiscal frameworks to delink government expenditures from oil prices would also minimize the extent to which oil price volatility flows through to the Saudi economy.

8. Diversification reduces exposure to, and facilitates management of, temporary shocks to oil prices. A high reliance on oil leads to heightened macroeconomic volatility (Figure 6): per capita consumption in Saudi Arabia, as in other Gulf Cooperation Council (GCC) countries, is strongly linked to oil prices (IMF 2016a). The outlook for oil prices remains uncertain with shifting supply dynamics and an evolving global economic and geopolitical environment. An economic structure less reliant on oil would reduce exposure to this uncertainty.

9. Diversification can help sustain comparable living standards for future generations, even if oil reserves diminish in value or after they are exhausted. Although large, Saudi Arabia's oil reserves will eventually run out. Moreover, the value of these reserves may decline before they are exhausted. Alternate energy sources may become feasible earlier than expected. As a prospectus recently issued by Aramco highlights, efforts to address climate change could reduce the demand for oil. Sustaining living standards for future generations in a post-oil world will require financial accumulation or economic activity and exports outside of oil.



C. Financial Diversification

10. Financial diversification—through accumulation of financial assets—can significantly contribute to external and fiscal revenue diversification. Returns on financial investments can provide a component of revenues that does not directly rely on oil. These returns can help diversify revenues, even if economic activity and exports remain concentrated in oil (i.e., even if limited progress is made with ‘real’ sector diversification). It is important to consider the role financial diversification can play for Saudi Arabia: Vision 2030 places significant emphasis on expanding the Public Investment Fund (PIF) well beyond its existing \$300 billion in assets.

11. Vast accumulation of financial assets would be needed to provide Saudi Arabia with a meaningful alternative stream of external and fiscal revenues. Appropriately allocated financial assets can help diversify revenues, but with the world’s largest sovereign wealth funds (SWFs) today holding roughly \$1 trillion in assets, even if Saudi Arabia were to grow its PIF from its current \$300 billion to this scale, financial returns alone would not constitute adequate income replacement in a post-oil world. Oil production of 10 million barrels per day, valued at \$65 per barrel, translates to annual oil revenues of about \$11,000 per Saudi at present. Assuming the Saudi population increases to about 26 million by 2030, accumulated assets of \$5–7 trillion would be needed to generate the same level of per capita revenues from financial assets.²

D. Policies to Drive Real Sector Diversification

12. Real sector economic diversification will be needed to develop a stronger non-oil economy and export base to create jobs and provide external and fiscal revenues in the future. Experience shows that diversifying away from oil is extremely difficult when, as in Saudi Arabia, oil resources remain plentiful. As this section discusses, a comprehensive package of complementary policies will be needed to support diversification. This includes both structural reforms that encourage private sector activity and investment and support to encourage entry and

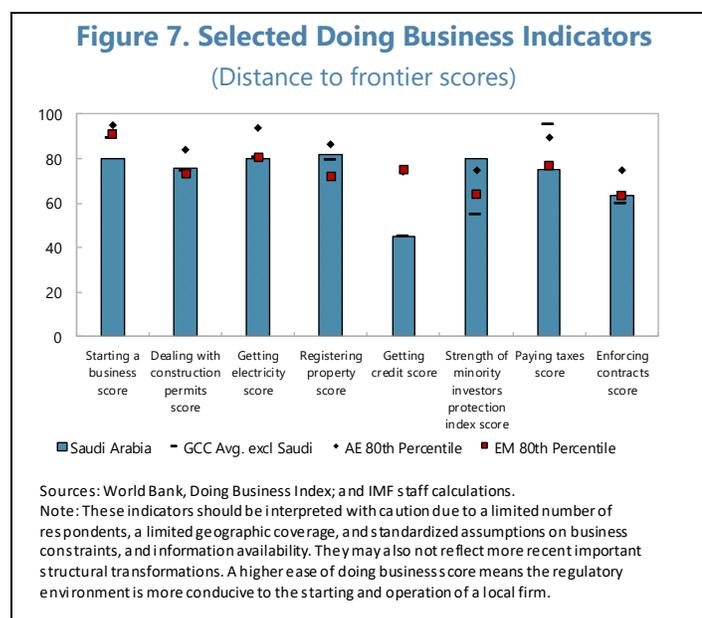
² Per data from the General Authority of Statistics (GASTAT), the Saudi population in 2018 was 20.1 million. At an annual growth of 2 percent, the population by 2030 would be 26.3 million. The main text reports the asset base required to provide a per capita annuity of \$11,000 per person for real returns ranging from 4–6 percent.

development in specific sectors with clear and transparent criteria. For these policies to succeed, it will be important to improve cost competitiveness and human capital. As these efforts may be fiscally costly, domestic investments to support real sector diversification should be evaluated with care. Although Saudi Arabia has significant accumulated and accruing income, foregone financial diversification constitutes an important opportunity cost of increased real investment.

Structural Reforms

13. Structural reforms should aim to create an environment that enables non-oil growth outside the government sector. Widely acknowledged pre-conditions for growth include a stable macroeconomic environment, a predictable and simple legal framework, robust institutions, a favorable business climate, appropriate incentives, low corruption, and a strong education system (Rodrik 2005, Acemoglu and Robinson 2013, Callen and others 2014, IMF 2016a, IMF 2018a). In their absence, private activity can be paralyzed: businesses are wary of committing to investments, contracts cannot be enforced, and resource allocation can be highly inefficient.

14. Reforms have begun to improve the business environment, although weaknesses remain (Figure 7). The bankruptcy and commercial pledge laws fill important gaps in the legal infrastructure, while efforts to streamline procedures for starting a business and clearing containers through ports should support business formation and trade. While infrastructure has improved over time, the authorities are working to close remaining gaps with significant investments in transportation. GCC countries face high tariffs in their export markets, and GCC-level trade negotiations and agreements to reduce tariffs could support exports (IMF 2018a). The quality of education needs to be substantially improved, to equip workers with the skills demanded in the private sector.³



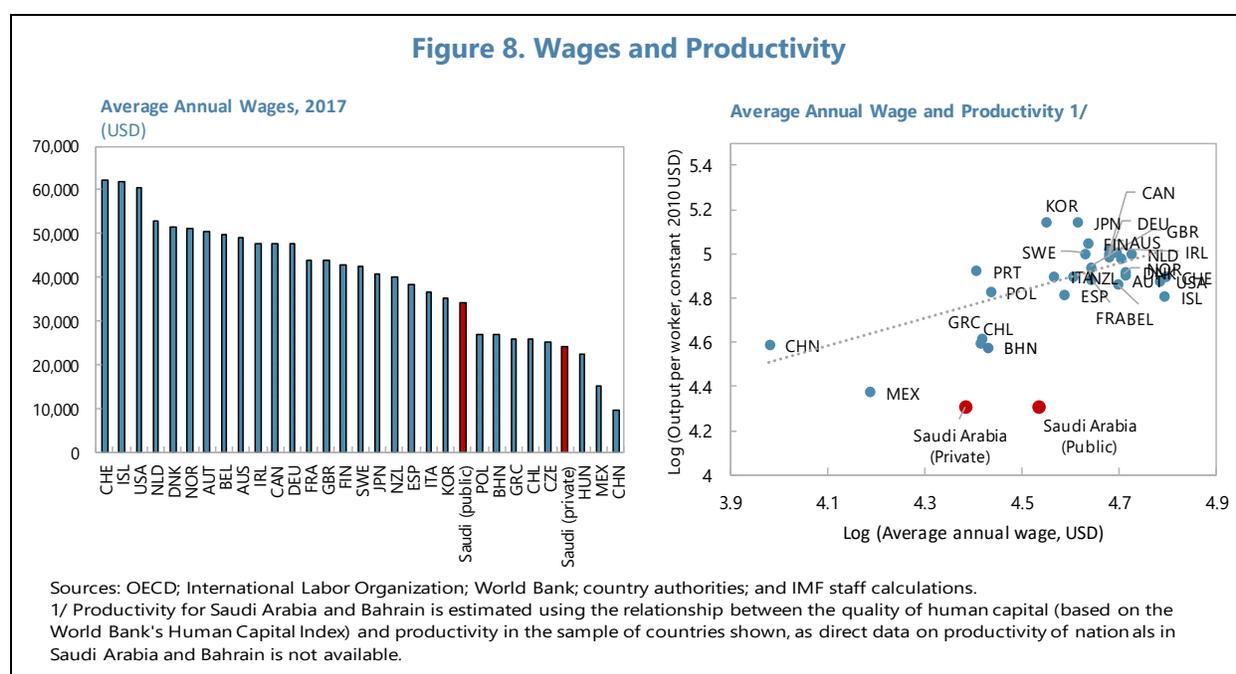
15. Special Economic Zones (SEZs) should be viewed as a temporary solution to issues with the business environment while broader structural reforms are pursued. Although they can support private activity and diversification, SEZs should be viewed as temporary solutions to frictions in the business environment until a well-structured regulatory framework and environment can be extended throughout the country (IMF 2018a). For example, many SEZs offer access to special legal regimes. These should not be treated as a substitute for improvements to contract enforcement and

³ Several researchers link human capital accumulation directly to diversification. For a recent example, see Giri and others (forthcoming).

dispute resolution mechanisms that apply across the country: after all most Saudi businesses cannot be housed in SEZs.

Cost Competitiveness and Incentives

16. Improvements to cost competitiveness may be required before a diversified private sector that employs Saudis can develop (Figure 8). Saudis employed in the private sector earn close to \$25,000 a year on average (converting to U.S. dollars at the current exchange rate). This is well above wages in countries like Mexico, and comparable to wages in Portugal, Chile, and Poland. At about \$35,000, wages for Saudis in the government sector are not much lower than economy-wide average wages in Korea, Italy, or Spain. It is not clear that productivity justifies wages at this level: productivity in Saudi Arabia seems to be below levels in countries with comparable wages.⁴ While the mismatch between wages and productivity is smaller in the private sector, it is still substantial. A private sector that primarily employs Saudis may therefore find it difficult to be internationally competitive with current cost structures and wage expectations. Although input costs are currently low in some sectors, going forward low input costs will offset high labor costs to a lesser degree as energy and water prices are reformed to incentivize lower usage.



17. Several levers could facilitate improved cost competitiveness over time. Efforts to improve productivity of Saudi workers through improved education and training will help, but will take time—where successful, such efforts in other countries have been pursued over decades.

⁴ Direct data on productivity of Saudi nationals are not available. Productivity for Saudis is estimated based on the relationship seen between human capital (based on the World Bank's Human Capital Index) and labor productivity seen in the sample of countries shown in the text figure. Regression coefficients connecting human capital to log output per worker are used to estimate labor productivity of Saudi nationals based on the level of human capital in Saudi Arabia.

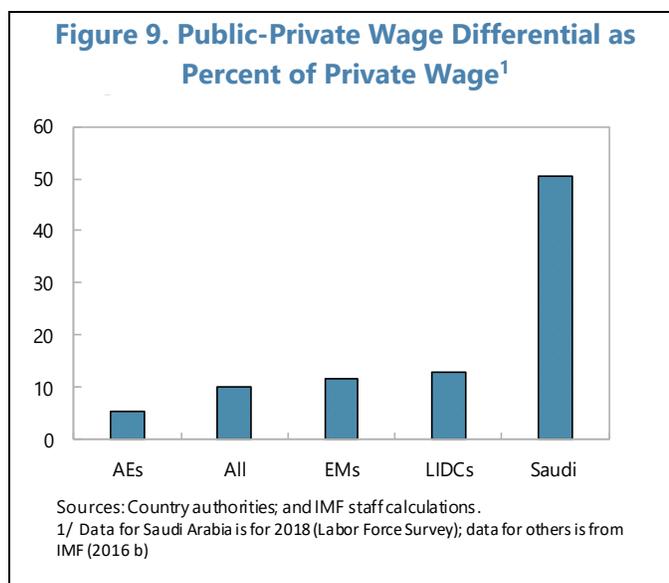
Clearly communicating that government employment will not grow would lower reservation wages in the private sector. Wage subsidies for Saudis could reduce the wages that private sector firms need to offer, and might fit within a sustainable fiscal envelope if combined with other fiscal reforms. Finally, slow nominal growth could allow real wages to adjust over time: for instance, even nominal growth at 1 percent below inflation would reduce real wages by 10 percent in a decade. In principle, the level of the exchange rate could also be reassessed to bring cost structures in line with competitor countries, but this would involve a significant reduction in real incomes and entail other costs as discussed in the staff report.

18. Labor market incentives for Saudis present a crucial structural barrier to economic diversification.

Most Saudis are employed in the government sector, where wages are roughly 50 percent higher than for Saudis working in the private sector: well above the 12 percent average public-private wage premium in emerging markets (Figure 9) (IMF 2016b).

Consequently, incentives for Saudis to work in the private sector are limited (IMF 2018b). Working outside the government may seem to involve challenges beyond lower pay, including uncertainty and perhaps the need to acquire new skills.

Diversifying the Saudi economy while creating jobs for Saudis outside the government sector will require addressing this incentive misalignment.



19. The international experience suggests there is significant scope to creatively resolve fundamental incentive problems without undermining fiscal priorities. Rodrik (2005) argues that there is “substantial room for creatively packaging ... principles into institutional designs that are sensitive to local constraints and take advantage of local opportunities.” For example, China’s dual-track reforms to agriculture retained quotas while allowing farmers to sell production above quotas at market prices. This preserved an implicit source of government revenue (quota production received low prices, whereas if the government paid market prices alternative sources of revenue would be needed) while providing the same marginal incentives as full market pricing (productive farmers were rewarded). This approach was later applied to industrial goods too.

20. Careful evaluation of how government spending affects human capital and employment incentives and meets social and economic objectives is needed. The government employs a large share of working Saudis at relatively high wages, and provides free healthcare and education, housing assistance, and transfers through various programs. This spending should be evaluated to ensure it provides the right incentives for Saudis to pursue education and training in areas that are in demand in the private sector and for Saudis to see the private sector as the

employer of choice rather than the government. Given fiscal constraints, any changes should be instituted in a fiscally neutral way.

21. Creative mechanisms may allow the government to meet its social spending objectives while improving incentives for private sector employment. For example, if government wages were in line with those earned by Saudis of similar skill levels in the private sector, one could consider other mechanisms to help ensure that take-home income remained unchanged. Options could also be looked at to positively incentivize entry into the private sector such as negative taxes on private sector wages, with a cap to address distributional concerns (Hoynes and Rothstein 2019). Such an approach could improve incentives for Saudis to enter the private sector and help with cost competitiveness, although fiscal costs would have to be carefully managed. While the specifics of such options would need careful study in the context of Saudi Arabia, the broader point is that creative solutions to seemingly difficult incentive problems have been found in other countries.

Industrial Policies

22. Meaningful progress with diversification may require support for specific sectors in addition to structural reforms. Both general and more GCC-specific arguments can be advanced in favor of sector-specific industrial policy that goes beyond broad structural reforms. The ‘big-push’ theory makes the case that genuine progress in modern sectors may require coordinated, simultaneous investments without which individual entrepreneurs would be unwilling to enter (Murphy and others 1989, Rodrik 1995). New types of activity may involve a level of risk that entrepreneurs are not willing to tolerate (Mazzucato 2013). These constraints may be exacerbated by the structure of the economy in Saudi Arabia. The strong presence of oil can itself discourage entry into innovative tradable sectors. Such new sectors can seem significantly riskier than activity driven by government contracts (Cherif and Hasanov 2018). Well-structured industrial policies designed with recognition of the opportunity cost of domestic investments may therefore have a role in aiding diversification.

23. Sectors that link with existing economic strengths, with potential to expand exports and innovate, can help drive diversification. The literature links growth and diversification of exports to stronger economic growth (Frankel and Romer 1999, Hausmann and others 2007, IMF 2018a). Existing export industries can be expanded both vertically and horizontally (Callen and others 2014, IMF 2016a). Malaysia presents an example of vertical expansion: it entered upstream and downstream activities related to rubber and palm oil. Mexico, which built links around its existing automotive sector, illustrates the potential for horizontal diversification. IMF (2018a) finds that Saudi Arabia’s non-oil exports are smaller, less diversified, and less sophisticated than in countries with similar fundamentals. Lin (2014) stresses the importance of prioritizing sectors with significant room for continued innovation, to leave scope for dynamism.

24. The NIDLP lays out an industrial policy strategy to promote development in industry, mining, energy, and logistics and create jobs for Saudis. This plan begins by identifying Saudi Arabia’s strengths, including a cost advantage in inputs for petrochemicals and energy, potential mineral resources, and a large domestic market. High-level priorities range from pharmaceuticals,

automotive and military production to innovative sectors such as renewable energy and desalination. In some instances, very specific investment opportunities are presented, including plants to manufacture shock absorbers and wiper blades. The NIDLP emphasizes the role that new technologies such as 3D printing, automation, and big data techniques can play. It is important to be realistic and account for existing capacity (the region already has strong logistics sectors in some countries) and plans to pursue similar sectors in other GCC countries.

Building Expertise

25. Investments in specific clusters of activity can initiate self-reinforcing, virtuous cycles of knowledge acquisition and innovation. Clusters of related activity can allow stronger improvements and growth than the pursuit of narrow opportunities in isolation. Such ‘agglomeration effects’ can operate across three important dimensions (Tirole 2017). First, firms working in related areas can provide each other sufficient demand for growth in scale, impetus for innovation, and together develop expertise. Second, similar positive dynamics are possible within the pool of people working in related areas. Third, firms that link with each other can benefit from shared, cost-effective access to specific investments, common infrastructure, and to each other. Many of the best-known clusters have developed naturally around existing universities: the quintessential example is Silicon Valley. There are, however, examples of more active policy approaches to clusters. Singapore brought together international leaders in petrochemicals, and located them together on an artificially constructed island, allowing them to collectively benefit from specialization, low-cost transportation links in vertical production chains, and joint innovation (Lin 2014).

26. Targeted subsidies, incentives, and access to finance can enable entrepreneurial risk taking. The elevated risk and daunting time horizons associated with entering new sectors can be overwhelming for any private enterprise. Development banks and venture capital funds focused on small, innovative firms can facilitate the significant leap needed in infant industries. Programs supporting innovation through early stage financing for small firms are a fixture of many advanced economies. Singapore has used venture capital support linked to private financing decisions (for example, matching investments for companies able to attract private funding) to shape innovate ecosystems. More broadly, export subsidies and tax incentives have been used to encourage innovation and entry into tradable sectors even in advanced economies.⁵

27. Foreign partners can play a key role in supporting entry into new sectors. Countries looking to adopt technological and methodological advances in sectors new to them have a significant advantage: they can learn from others. At various points in their histories, the United States, Germany, Japan, Korea, and China have all learned from other countries (Studwell 2013). Working with foreign partners, by inviting foreign investment and entering into joint ventures with leading foreign companies, can be crucial for entering new sectors and improving domestic

⁵ For example, Boeing, Alcoa, Intel, Dow Chemicals, Airbus, and more recently Tesla have benefited from subsidies amounting to billions of dollars (Cherif and Hasanov 2016, Mazzucato 2013).

technological capacity (Lin 2014). When large investments are required, the public sector may need to enter joint ventures.

28. Deliberate investments in human capital, targeted at priority sectors, are essential for developing expertise. Development of human capital is an essential component of building valuable know-how in advanced sectors. To succeed, plans to prioritize specific sectors must be accompanied by targeted investments in human capital linked to the same sectors (Callen and others 2014). Technical training can be more valuable in some cases than other types of higher education: in Switzerland and Germany, apprenticeship programs are a more common path after high school than university (Cherif and Hasanov 2016). Singapore initially focused on training technicians, engineers, and local managers, although it increasingly placed emphasis on scholarships extending to the doctoral level at both local and foreign universities (Yeo 2016).

29. The examples of Singapore and China show the importance of well-sequenced plans with ambition over the long term. In the early decades of its development path, Singapore had little human capital, a shallow labor pool, and few natural resources. It was ambitious, but with well sequenced, focused plans. Beyond drawing on its historical strength as a trading hub to encourage trade and financial flows, Singapore followed a structured path, choosing precision engineering, chemicals, and most recently biomedical sciences as priorities (Yeo 2016). This meant eschewing more advanced sectors until the human capital, infrastructure, and technological foundations were ready. One of Singapore's SWFs, Temasek, played an active domestic role in key sectors such as ship building, shipping, airlines, telecommunications, and finance, with portfolio companies managed at arms length. China experimented with a variety of special economic arrangements and zones to identify successful innovations, and then applied the lessons learned to the wider economy. Over time, this approach allowed market forces including private entry, product market competition, and price-based incentives to play a major role (McMillan and Naughton 1992).

Ensuring Discipline

30. If not handled carefully, industrial policy risks supporting inefficiency, with widespread economic and financial costs. In the absence of clear benchmarks, industrial policy in some countries has resulted in small groups of business owners and 'national champions' claiming significant rents with little impact on the wider economy beyond inefficient import substitution (Callen and others 2014, Studwell 2013). If this situation arises, beneficiaries of government support have strong incentives to stall reform and protect their rents. Avoiding this outcome is difficult even for policymakers with the best intentions: implementation takes time, and distinguishing success from inefficiency in previously unknown sectors is challenging. The international experience suggests that two key mechanisms can help enforce discipline: export markets and competition. As Saudi Arabia has introduced a comprehensive set of incentives for investors in priority sectors, ensuring accountability will be crucial.

31. Export markets can provide an objective benchmark to assess progress in new sectors. Some countries have effectively used export markets as a yardstick against which to measure progress. The ability to export to consumers that can choose from other established options

provides an external benchmark to gauge the extent to which emerging activity can be sustainable without ongoing support. Crucially, support can be discontinued where sustainability seems unachievable. Beyond this role as a device to distinguish success and failure, export markets of course also constitute a source of demand at scale.

32. Korea’s experience illustrates how export markets can serve to enforce discipline.

Export markets featured prominently in Korea’s implementation of its Heavy and Chemical Industrialization Plan in the 1970s. To access bank credit or policy loans at favorable terms, industrialists had to produce letters of credit from foreign buyers and meet stringent criteria that included export volumes, minimum requirements for the number of export items, destinations, and overseas branches (Woo 2016). Importantly, industrial groups unable to meet these conditions did not receive continued support (Studwell 2013). Export markets were therefore essential for holding recipients of industrial policy support accountable, ensuring that Korea’s industrialization plan did not simply lead to import substitution. The lesson here is that the inability to consistently export can signal inefficiency and poor quality.

33. Supporting sectors, but not individual firms, allows dynamism to flourish. Domestic competition provides an internal way to ensure discipline. If sector-specific policies ultimately provide support to a single firm, it can be difficult to remove this support even if inefficiency is widely observed. The international experience highlights the value of encouraging and retaining competition even in priority sectors. Japan and Korea both supported a multitude of industrial groups that competed against each other (Studwell 2013). State subsidies in China targeting more competitive sectors have generated stronger positive effects on productivity and innovation (Aghion 2016). Decentralized implementation of industrial policy has been vital for the development of general-purpose technologies in the United States. Best practices include calling on independent experts to help identify narrow objectives, supporting many different attempts to achieve these objectives, and again, withdrawing support in the absence of sufficient progress (Mazzucato 2013).

Implications for Saudi Arabia

34. Encouraging clusters and working with foreign partners will help build expertise. Saudi Arabia does plan to co-locate industrial cities and logistics hubs with access to ports or airports, supplemented by research centers. Nevertheless, while the number of new FDI licenses has increased, FDI remains low and creating an attractive environment for FDI is an important policy goal. Licensing requirements for foreign investors may be an important roadblock to FDI in Saudi Arabia, even though foreign investment is formally permitted in most sectors. Once foreign investment is attracted, it is important to integrate the resulting enterprises into the Saudi economy to facilitate improvements in technological capacity throughout the economy.

35. While incentives may support entrepreneurial initiative, domestic and export market competition is crucial to enforcing discipline. The NIDL outlines a comprehensive set of incentives, including loans for up to 75 percent of invested capital, equity investments, tax incentives, export financing through an Exim bank, low prices for energy and other inputs, as well as

subsidies as large as 15 percent of value added for car manufacturers.⁶ While these incentives may encourage entry into priority sectors, export markets and domestic competition should be used to enforce accountability and avoid inefficiency. For example, when Aramco offers access to finance to encourage the development of domestic suppliers, it requires these suppliers to export at least 30 percent of their production without subsidies. This ensures domestic suppliers are globally competitive. Where the PIF plays a role, arms-length management on a commercial basis, with room for competition whenever possible, will also support efficiency. Having a range of financing options available that meet the needs of both new and established companies will be important. Significant efforts are under way to develop the venture capital ecosystem in Saudi Arabia with several venture capital firms recently obtaining licenses to operate.

36. Ensuring the availability of skilled labor at competitive wages is essential.

Improvements in human capital targeting the specific skills needed in priority sectors are essential. This approach has precedent in Saudi Arabia: The Royal Commission in Jubail operates colleges and vocational training with curricula designed to meet the labor needs of specific industrial entrants focused in the petrochemicals sector. Considering how to address high government wages will improve incentives for Saudis to work in the private sector and avail themselves of training opportunities such as vocational colleges to improve skills. Without addressing the productivity-wage gap among nationals, barriers to diversification will be difficult to overcome. Indeed, government interventions through infrastructure development and support to industry will be less effective unless education and training are improved and wages paid to nationals by the private sector are in line with productivity.

E. Conclusion

37. Further diversification is important for Saudi Arabia. Many young Saudis will enter the labor market in coming years and will need jobs outside the government sector. Moreover, oil prices are highly volatile with an uncertain long-term outlook. Vast financial resource accumulation would be needed to sustain current Saudi incomes in the absence of diversification of economic activity and exports.

38. Policies to spur diversification will need to range from reforms that continue to improve the business environment to those that more narrowly support specific sectors. These policies need to complement each other and move in tandem to maximize the chances of success. It is certainly important that remaining infrastructure gaps are addressed and the business climate improved. SEZs can temporarily address key constraints with the business climate while broader reforms are pursued. The effectiveness of SEZs will not be maximized unless the lessons learned from the effects of changes in the regulatory environment in these zones are then applied in the broader economy.

⁶ As Saudi Arabia is a WTO member, policies should be carefully designed in view of rules that prohibit subsidies with direct export conditionality and domestic content requirements.

39. Well-targeted, structured, and sequenced policies to encourage specific sectors can also play a role in diversifying Saudi Arabia's economy. Vision 2030 and the VRPs stake out a wide-ranging agenda to diversify the economy, including a significant industrial policy component focused on industry, mining, energy, and logistics. Two main lessons from the international experience with industrial policy should be kept in mind:

- ***Policies should aim to build expertise in specific clusters of innovative activity.*** Strengthening human capital to provide workers with the skills needed in export-oriented, competitive industries is essential. It is important for Saudi Arabia to account for existing capacity in the region and overlap with other GCC countries' development plans. Once innovative foreign ventures are attracted, they should be integrated into the economy.
- ***Export markets and competition should be used to hold recipients of support accountable.*** Investors in priority sectors in Saudi Arabia are eligible for a comprehensive package of incentives. This support should come with clear conditions and should be withdrawn in the absence of progress. In sectors that are new to Saudi Arabia but not to global markets, success in export markets should be used as an external benchmark to measure progress. Policies should aim to encourage sectors, not specific firms, to ensure that competition is preserved even in new sectors.

40. These policies are unlikely to succeed unless Saudis are equipped with the right skills and have the incentive to offer them at competitive wages. Creative solutions will be needed to ensure government spending achieves its social and economic objectives while not creating impediments to private sector employment.

41. Lastly, efforts to drive economic diversification can be fiscally costly. Even for countries that do not need to borrow, foregone financial diversification is an important opportunity cost of domestic investments. These investments need to be evaluated with care.

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NON-OIL REVENUES REFORMS—AN INITIAL ASSESSMENT OF THE FISCAL AND ECONOMIC IMPACT¹

The government is introducing reforms to raise non-oil revenues as part of its broader strategy to reduce the fiscal deficit and diversify its revenue sources away from oil. The successful introduction of the value added tax (VAT) at the beginning of 2018 was a landmark achievement. The tax authorities now need to focus on solidifying the operation of the VAT, while considering options for raising additional non-oil revenues. These options could include raising the VAT rate from its current low level, in consultation with the GCC. Consideration could be given to implementing the increase in expatriate labor fees more gradually than planned to help mitigate the impact on businesses and the economy, while smaller fees and taxes on tourism and entertainment may adversely affect development in these sectors with little revenue gain and could be reconsidered.

A. Introduction

1. The Saudi Arabian government has relied on oil revenues to finance its expenditures. Oil revenues accounted for an average of 86 percent of government revenues during 2012–15. Non-oil revenues averaged less than 5 percent of GDP during the same period.

2. As part of the Fiscal Balance Program (FBP) introduced in 2016, the government has begun to diversify its budgetary revenues by introducing new non-oil sources of revenue. As a result, non-oil revenues were above 8 percent of GDP in 2018. This paper reviews the non-oil revenues reforms, with a focus on the VAT, and discusses next steps. It does not cover the possibility of broadening the non-oil revenue reforms to personal income or corporate taxes, which have been ruled out at this time by the government, nor does it discuss the domestic energy price reforms which have also provided additional revenue to the government budget since 2016.²

B. Non-Oil Revenue Reforms—A Close Look

3. Before the recent reforms, non-oil revenues came mainly from Zakat, customs duties, a profits tax on foreign companies, and an assortment of fees and fines:

- **There are limited personal income taxes.** There are no taxes on wage income for either nationals or non-nationals. National companies are subject to Zakat, which is levied at 2.5 percent of net worth.³

¹ Prepared by Abdulelah Alrashidi (Saudi Arabian Monetary Authority), Tim Callen (MCD) and Charles Jenkins (FAD), with research assistance from Kanar Ahmed (FAD) and Tian Zhang (MCD). Diana Kargbo-Sical provided editorial assistance. The authors are grateful to seminar participants at the IMF and Ministry of Finance for helpful comments.

² See International Monetary Fund, 2015, “Tax Policy Reforms in the GCC Countries: Now and How?” for a discussion of broader tax reforms in the GCC and Appendix IV of the 2018 Staff Report for a discussion of energy price reforms in Saudi Arabia.

³ Zakat is an obligatory contribution of a certain portion of one's wealth in support of the poor or needy or other charitable purposes.

- **Income taxes apply to foreign companies and to companies in the oil and gas sectors.** Saudi Arabia imposes a corporate income tax of 20 percent on a non-Saudi's share in a resident corporation. Tax relief for losses and tax incentives are provided which lowers the effective tax rate. A 20 percent capital gains tax is imposed on the disposal of shares in a resident company by a nonresident shareholder. Companies in the oil and gas sectors are subject to different tax rates.
- **Customs duties are unified across the GCC.** After implementation of the Common External Tariff (CET) on January 1, 2003, the standard customs duty rate on non-GCC products is 5 percent. Products of GCC countries enter into each other's markets free of customs duties. There are many items such as medicines, food products, and capital goods and raw materials for industries which are exempt from duty while some other products are subject to higher duty rates.
- **Dividends from the central bank/public entities.** The government does not receive investment income directly, but rather through dividends from the central bank and on occasion in the past from the Public Investment Fund (PIF).

4. A series of non-oil revenue reforms have been implemented as part of the recent fiscal consolidation efforts. A value-added tax was introduced in January 2018; excise taxes on tobacco and tobacco products and carbonated and energy drinks were introduced in July 2017, and it has recently been announced that they will be expanded to sugar-sweetened beverages (SSBs) and e-cigarettes in December 2019; fees on expatriate workers were raised starting in January 2018 and introduced on dependents starting in July 2017; and various fees/taxes have been introduced on hotel stays, visas, cinemas, and vacant land.

VAT

5. The GCC countries agreed in June 2016 to introduce a common value-added tax. The GCC VAT agreement sets a single tax rate of 5 percent and harmonizes the main features of the VAT. It prescribes a common legal framework which is binding on all countries and calls for some harmonization of the tax base but leaves countries to decide the tax treatment of six sectors: education, health, real estate, domestic transportation, financial services, and oil and gas. The Agreement also allows member countries to zero rate certain domestic food items from a common list of about 100 items drawn up using customs Harmonized System (HS) codes as well as medicines and medical equipment. Exports are zero rated. The treaty sets a compulsory registration threshold of \$100,000 (businesses with revenues above \$50,000 can register voluntarily). The GCC VAT agreement became effective when it was ratified by two members (which were Saudi Arabia and UAE).

6. Saudi Arabia introduced the VAT on January 1, 2018, along with the UAE. Bahrain followed at the beginning of 2019, while the other three GCC countries have yet to implement the VAT. To transpose the GCC agreement into domestic legislation, Saudi Arabia approved and published its VAT law in July 2017 and the implementing regulations were published in September 2017. Exemptions/zero-rated items have been kept limited with only medicines and medical equipment, exports, and international transportation zero rated and residential rents and some financial services exempted. Public services are not considered a form of economic activity and any

goods and services provided by the government are not subject to VAT. The mandatory registration threshold for businesses was set at a higher level of SAR 1 million (\$267,000) in the first year to ease the administrative burden, and the threshold was reduced to the level in the GCC agreement of SAR 375,000 (\$100,000) on January 1, 2019. For large taxpayers (those with taxable supplies above SAR 40 million), VAT is paid monthly and for other taxpayers quarterly.

7. A comprehensive registration exercise was carried out by the General Authority of Zakat and Taxes (GAZT), the tax authority. This resulted in a large number of taxpayers being registered prior to the implementation date of January 1, 2018. As a result, the collection base, which is highly concentrated in the large taxpayer segment, was secure from the outset. On January 1, 2018, there were 92,535 businesses registered, and this had risen to 158,194 at end-December 2018 and to 173,208 at end-March 2019 (Table 1). Most of the growth has occurred in the small and medium taxpayer segment (those below SAR 40 million). On-time filings of large taxpayers averaged over 99 percent in 2018, while on-time filings for small and medium taxpayers were around 84 percent.

Active Businesses ¹	January 1, 2018	October 31, 2018	December 31, 2018	March 31, 2019
VLTP (≥ SAR 200 million)	1,235	1,262	1,791	1,882
LTP (≥ 40 million, < 200 million)	7,941	8,442	8,588	8,898
SMTP (< 40 million)	83,359	127,435	147,815	162,428
TOTAL	92,535	137,139	158,194	173,208

Source: General Authority of Zakat and Tax

¹ Active businesses are divided into taxpayer segments made up of: Very Large Taxpayers (VLTP); Large Taxpayers (LTP); and Small/Medium Taxpayers (SMTP). For the purposes of this report, reference to "Large" taxpayers should be taken as encompassing VLTP and LTP, and reference to small taxpayers should be taken to be SMTP, unless specifically stated otherwise.

8. Challenges relating to public understanding of the VAT and administrative capacity were tackled through active communications and capacity building and recruitment. The VAT is the first broad-based tax implemented in Saudi Arabia for many years and needed to be explained both to consumers and businesses. This was done through active media campaigns, the design of a comprehensive website, and substantial outreach to the business community and the accountant/tax advisory profession. GAZT itself was reorganized and a dedicated department established to handle the VAT. At end-2018, the VAT department had around 800 staff (of which nearly one half were female), with substantial investments being made in hiring, training, and IT systems. A further reorganization of GAZT is now underway to integrate VAT functions more closely with Zakat and corporate income tax functions to improve overall tax administration.

9. The complications of administering the VAT within the GCC customs union have so far been avoided. It is intended that VAT on intra-GCC transactions will ultimately be processed through a centralized, automated clearing facility. However, not all GCC member states have yet introduced the VAT, and the clearing system has yet to be designed. In the interim, the VAT treatment of intra-bloc transfers is the same as for non-GCC members—with exports being zero rated and import VAT being levied at the point of entry.

10. Revenue collections from the VAT were 1.6 percent of GDP (2.4 percent of non-oil GDP) in 2018. Gross collections totaled SAR 60 billion, with net collections after refunds of SAR 46.7 billion. Two-thirds of the revenue was collected from domestic transactions and one-third from imports (Table 2). The c-efficiency ratio, a measure of how effectively the VAT taxes the consumption base, was 0.53.

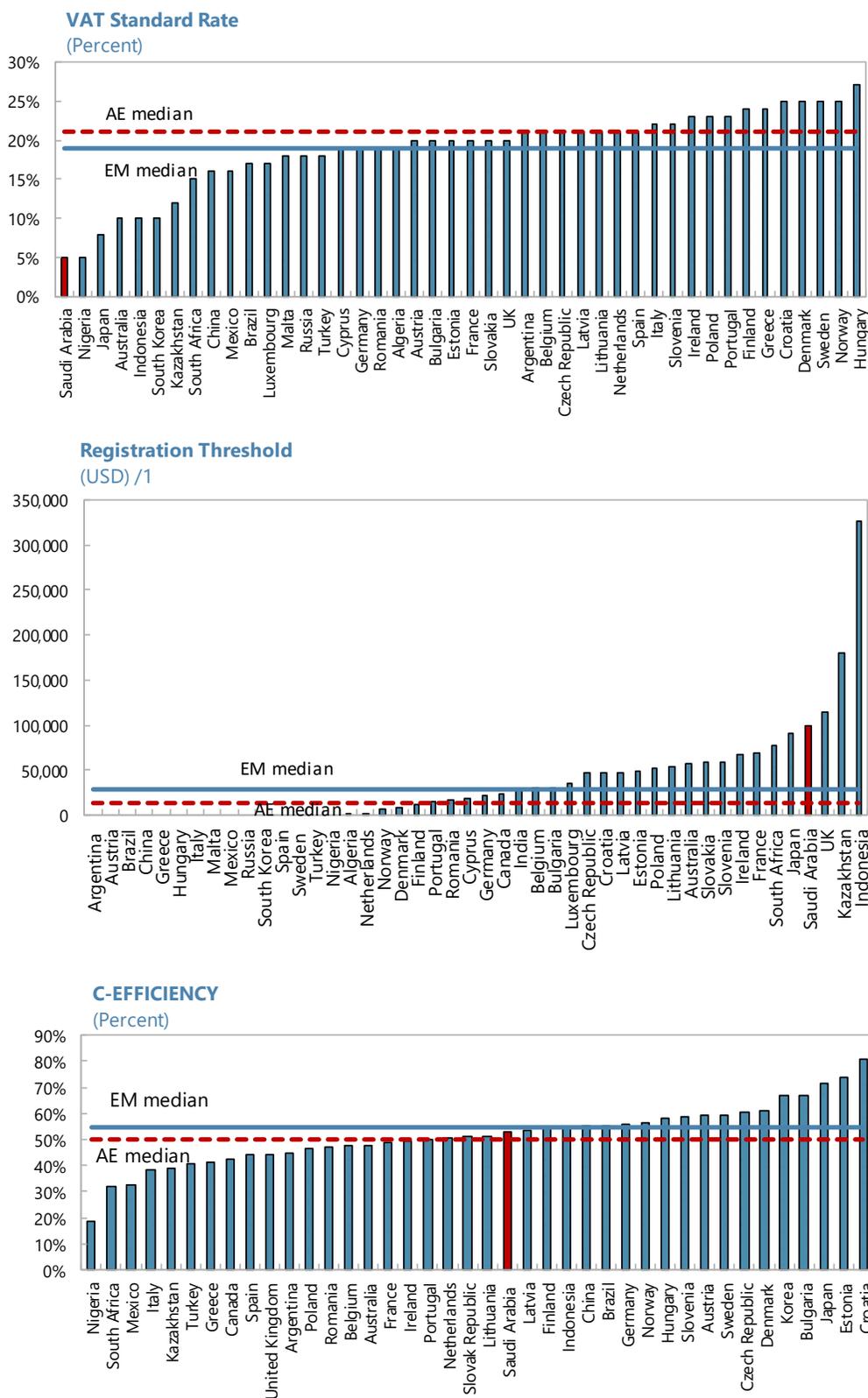
Month	Import	Domestic	Total
January	1,537	0	1,537
February	1,644	4,395	6,039
March	1,857	3,153	5,010
April	1,981	4,746	6,727
May	2,114	2,925	5,039
June	1,571	2,764	4,335
July	2,066	4,740	6,806
August	1,199	2,674	3,873
September	1,620	3,564	5,184
October	1,360	4,348	5,708
November	1,917	2,924	4,841
December	2,350	2,025	4,375
TOTAL	21,852	38,311	60,163

Source: General Authority of Zakat and Tax

11. Three features of the Saudi VAT stand out from an international perspective. Compared to a sample of 40 advanced, emerging market, and oil exporting countries with a VAT, Saudi Arabia has (Figure 1):

- *At 5 percent, a very low standard VAT rate.* Standard VAT rates in other countries range from 8 percent (Japan) to 27 percent (Hungary), although in the later some products are subject to reduced rates.
- *A high registration threshold.* Only three countries in the sample (Indonesia, Kazakhstan, and UK) have a higher registration threshold than Saudi Arabia.
- *VAT efficiency already in line with many other countries.* The C-efficiency ratio in Saudi Arabia in the first year of operation was already at the median level of advanced and emerging market countries.

Figure 1. Key Features of the VAT



Sources: Country authorities; and IMF staff calculations.
1/ Converted to dollars at 2018 average exchange rates.

12. The introduction of the VAT has had broader benefits for tax administration. GAZT now has much better information on the corporate sector and has been using this to strengthen tax administration in other areas. For example, Zakat collections increased by 31 percent in 2018.

Excise Taxes

13. The GCC countries adopted an Agreement for Excise Taxes in May 2017 which forms the common framework for the introduction of excise taxes in the region. Excise taxes are to be applied to goods that are deemed harmful to human health and the environment, as well as to luxury goods. Saudi Arabia was the first GCC country to affect its own excise tax law in June 2017 and implemented the taxes in July 2017 on tobacco and tobacco products and energy drinks (100 percent rate) and carbonated drinks (50 percent rate).

14. Revenues from excise taxes totaled SAR 12.4 billion in 2018 (0.4 percent of GDP). Most of these revenues (70 percent) came from tobacco products (Table 3). The application of the excise tax to carbonated and energy drinks leaves a gap in coverage if the primary purpose of the excise tax is to address health concerns. Other sugar-sweetened beverages escape the tax net, and substitution possibilities exist with adverse health and revenue implications. To address this, it has been announced that the excise tax will be broadened to cover all SSBs (and e-cigarettes) in December 2019. This broadening is in line with previous IMF recommendations. Thow et. al, 2018, list 17 countries that have taxes on sugar-sweetened beverages and they suggest that implemented taxes are on average around 10 percent by value. The excise tax rate in Saudi Arabia is therefore much higher. Smuggling and bootlegging in the case of tobacco may also be an issue given that not all GCC countries have introduced excises, but this is not specific to the GCC. This reinforces the view that high tax rates on tobacco must be accompanied by effective enforcement and control of illegal activities to be successful in their revenue and health impacts.

Table 3. Revenues from Excise Taxes, 2018
(SAR, billions)

Tobacco and related products	8.5
Carbonated drinks	3.4
Energy drinks	0.5
Total	12.4
Source: General Authority of Zakat and Taxes	

Levy on Expatriate Workers and their Dependents

15. Fees have been increased on expatriate workers and introduced on their dependents. Fees on expatriate workers were first introduced in 2011 at the rate of SAR 200 a month per expatriate employee in companies where expatriate employees outnumbered Saudi employees. The revenues were used to cover the cost of various labor market and training programs implemented by the Human Resources Development Fund (HRDF). In January 2018, the fee was increased to SAR 400 a month (SAR 300 per person in an enterprise in which the number of expatriates is equal or less than the number of Saudis) and further to SAR 600 a month (SAR 500 a month) in January 2019. These fees are scheduled to increase to SAR 800 a month (SAR 700 a month) in January 2020. A fee was also imposed on dependents starting from July 2017 at SAR 100 a month per person, increased to SAR 200 a month in July 2018, and will increase to SAR 400 a month by July 2020. The fees are paid for the

full year ahead at the time of the renewal of the visa and therefore can have a substantial impact on the liquidity of households and/or companies.

16. Given the size of the expatriate population in Saudi Arabia, the expatriate fees raise considerable revenues. Data from the General Organization for Social Insurance (GOSI) indicates that an average of 7.2 million expatriates were employed in the private sector in 2018 and there were around 3 million dependents (General Authority of Statistics data). In 2018, revenues from the increased/new fees totaled SAR 29 billion (1 percent of GDP). The revenues are budgeted to rise further in the coming years if the announced schedule of fee increases is maintained, although the size of increase will depend on whether expatriates continue to depart the country.

Other Non-Oil Revenue Measures

17. A range of smaller fees and taxes have been introduced which raised about SAR 15 billion (0.5 percent of GDP) in revenues in 2018.⁴

- *Visa fees* have been increased, although they vary depending on the nationality of the passport holder. For some nationalities, a 3-month multiple entry business visa costs over \$500. These higher visa fees generated SAR 3.2 billion in 2018.
- An additional sales tax of 25 percent on *cinema tickets* was introduced in May 2018. It raised negligible revenue in 2018.
- A fee on *vacant (white) lands* was announced in 2016 and implemented from March 2017. The fee is designed to encourage investors to develop rather than hold vacant land given the need to boost housing availability in the country. The 2.5 percent fee is applied to undeveloped land in urban areas. Land owners had 12 months from the date of receiving the invoice to pay the tax or develop the plot of land. The fees generated revenue of around SAR 1 billion in 2018.
- A *tax on hotel rooms and serviced apartments* was introduced at the beginning of 2018. It is applied at 5 percent (on 4- and 5-star hotels) and 2.5 percent (on other hotels). It raised about SAR 0.5 billion in 2018.

18. These fees and taxes appear to have different purposes and could in some cases run counter to economic development objectives. For example, while the vacant land fees have been introduced as an incentive to landowners to develop their land (and if successful the government would collect no fees), visa fees and cinema and hotel taxes have no economic rationale and provide little fiscal gain.

⁴ The SAR 15 billion includes SAR 10.1 billion of revenues from higher electricity tariffs.

C. Impact of the Reforms on Non-Oil Revenues

19. Non-oil revenue collections have increased due to the reforms

(Tables 4 and 5). Non-oil revenue was 4.8 percent of GDP (8.2 percent of non-oil GDP) during 2012–15 with tax revenues being less than 3 percent of GDP. The new non-oil revenue measures raised 3.5 percent of GDP in 2018 and total non-oil revenues increased to 8.2 percent of GDP and 12.4 percent of non-oil GDP (both excluding revenues from the anti-corruption settlements) in 2018, with non-oil tax revenues increasing to

4.8 percent of GDP. VAT revenues in 2018 were 1.6 percent of GDP, very similar to the 1.7 percent of GDP collected in UAE. Staff estimates that if the non-oil revenue reforms announced by the government are implemented in full, non-oil revenues will be 10 percent of GDP in 2024.

20. Non-oil tax revenue collections in Saudi Arabia are now higher than in other GCC countries, but lower than in some other oil exporting countries

(Table 6; Figures 2–3). With the introduction of the VAT and excises, Saudi Arabia is now collecting considerably more non-oil tax revenues, particularly from taxes on goods and services, than other GCC countries, but still less than oil exporters in the comparator group. Non-oil non-tax revenues in Saudi Arabia (excluding the revenues from the anti-corruption campaign) are lower than the average in the GCC and similar to the comparator group.

Table 4. New Non-Oil Revenue Measures, 2018

	SAR (billions)	Percent of GDP
VAT	46.7	1.6
Excises	12.4	0.4
Expat levy	28.9	1.0
Other revenues 1/	14.7	0.5
Total	102.7	3.5
<i>Memo item:</i>		
Revenues from energy price reforms	41.3	1.4

Sources: General Authority of Zakat and Taxes and Ministry of Finance.
1/ Includes revenues from higher electricity tariffs

Table 5. Revenue Structure

	2012-2015	2016	2017	2018
(Percent of GDP)				
Total Revenue	37.0	21.5	24.1	29.0
Non-oil Revenue	4.8	7.7	7.2	8.2
o/w Tax revenue	2.8	3.4	3.4	4.8
Oil Revenue	32.2	13.8	16.9	20.8
(Percent of Non-GDP)				
Total Revenue	67.0	28.9	34.1	44.1
Non-oil Revenue	8.2	10.3	10.2	12.4
o/w Tax revenue	4.9	4.6	4.8	7.2
Oil Revenue	58.9	18.6	23.9	31.6
(Percent of Total Revenue)				
Non-oil Revenue	14.4	35.8	29.9	28.2
o/w Tax revenue	8.3	15.8	14.0	16.4
Oil Revenue	85.6	64.2	70.1	71.8

Sources: IMF WEO; and staff estimates.

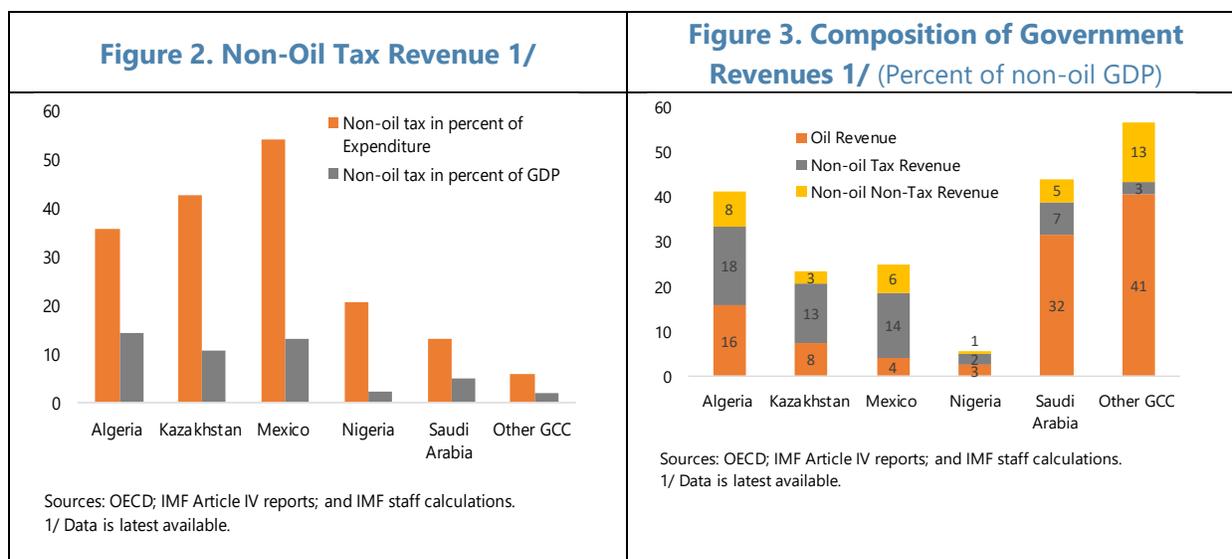


Table 6. GCC: Composition of Non-Oil Tax Revenues, 2018
(Percent of non-oil GDP)

	Total	Personal Income	Corporate Income	Goods & Services	Trade	Property	Other
Saudi Arabia	7.2	...	0.9	4.5	0.8	...	1.1
Bahrain	0.1	...	...	...	0.1	...	0.0
Kuwait	2.6	...	0.8	...	1.6	...	0.2
Oman	5.4	...	2.5	...	1.5	...	1.3
Qatar	3.9	...	...	...	...	...	...
UAE	4.3	...	0.5	3.0	0.7	...	0.0

Sources: IMF WEO; and staff estimates.

D. Macroeconomic Effects of the Non-Oil Revenue Reforms

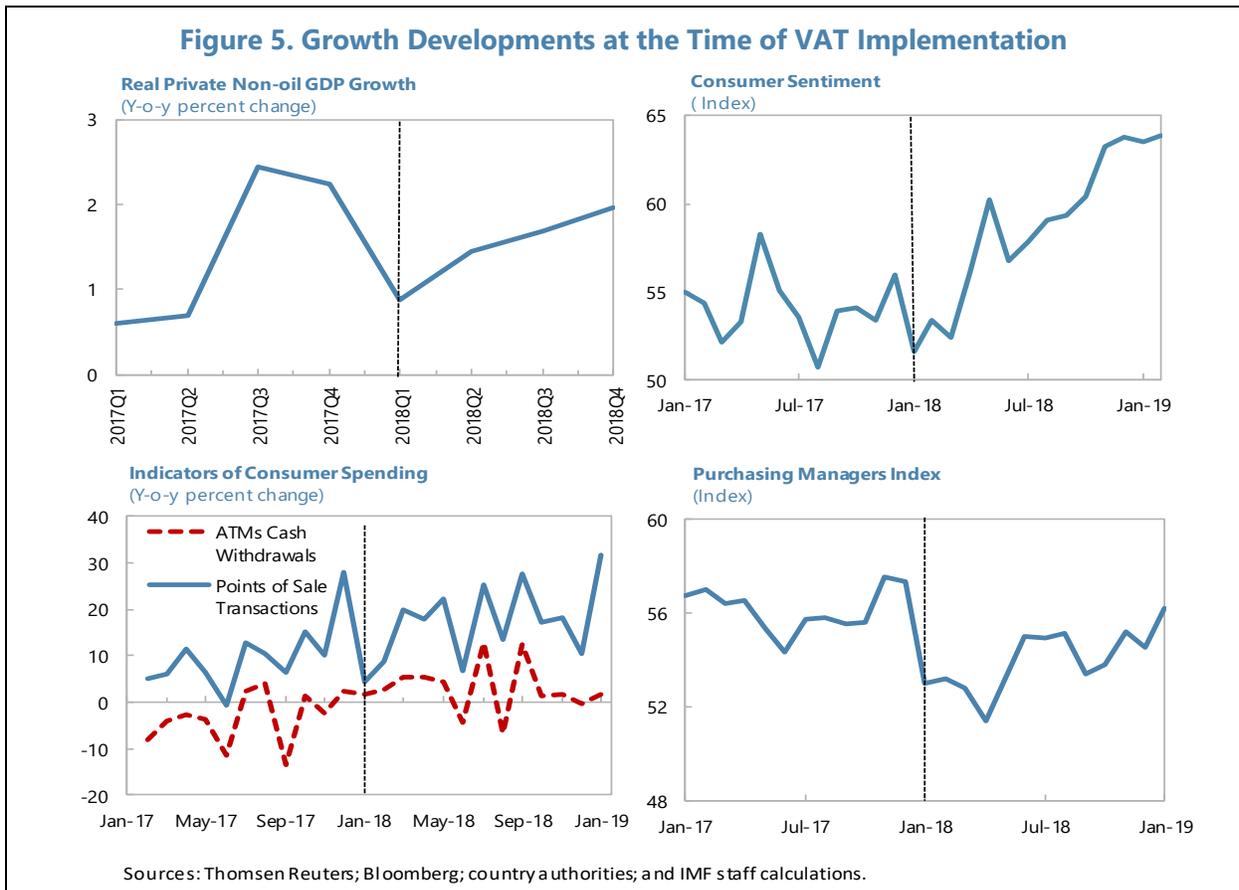
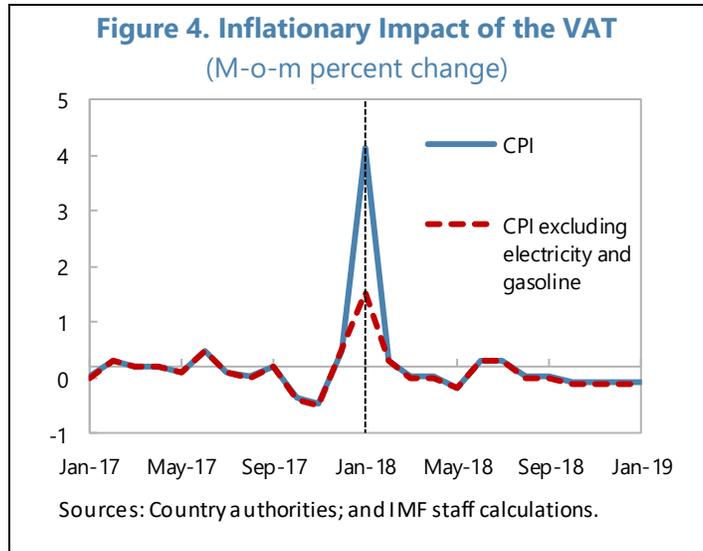
21. The macroeconomic effects of the non-oil revenue reforms are difficult to disentangle because several of the measures were introduced at the same time. The VAT and the increase in the fees on expatriate workers were both implemented at the beginning of January 2018 (as were increases in gasoline and electricity prices), although with the expatriate fees being paid at the time of the renewal of a workers' visa, the effects will be staggered through the year. The paragraphs below assess the impact on inflation and growth through simple calculations and simulations of SAMA's DSGE model of the Saudi economy.

22. The inflationary impact of the non-oil revenue reforms was contained (Figure 4). The CPI increased by 4 percent (m/m) in January 2018, although this was mostly due to the energy price increases. Stripping out the effects of the gasoline and electricity price increases, the CPI rose by 1.6 percent (m/m). Second-round effects were minimal, likely because of the credibility of monetary

policy and the relatively weak domestic demand environment. By comparison, the CPI in the UAE increased by 2.7 percent in January 2018 and the CPI in Bahrain by 1 percent in January 2019 (with no changes in energy prices or other fees introduced).

23. There appears to have been a modest impact of the reforms on economic activity, but again it is difficult to disentangle the effects

(Figure 5). While monthly economic indicators generally strengthened in November and December, possibly as people brought forward purchases ahead of the VAT introduction, they turned down in January 2018, with the PMI falling particularly sharply. Private non-oil GDP growth showed a similar pattern, strengthening in 2017H2 and slowing in 2018Q1. Indicators rebounded quite quickly, although the PMI remained below its level in late 2017 throughout 2018.



24. The expatriate fees are likely to have dampened non-oil growth, although data do not allow a clear analysis of the impact. Data from the General Organization for Social Insurance (GOSI) suggest that expatriate employment in the private sector declined by nearly 1 million during 2018. This would have had a substantial drag on private consumption. Consumption by non-Saudis accounts for close to 30 percent of total private consumption, so the exit of this number of expatriates could have reduced real private consumption growth by 2¼ percentage points and real GDP growth by around ½-¾ percentage points (after accounting for the impact of lower consumption on imports) in 2018. Their exit has also had an impact on the housing market with the rent component of the CPI having fallen by 11 percent since end-2017 and on remittance outflows which declined by 7.5 percent in 2018. While ultimately the impact of the expatriate labor fee will depend on where the incidence falls (worker or employer), it will reduce growth, at least in the short term, with an unclear impact on the employment of nationals.⁵

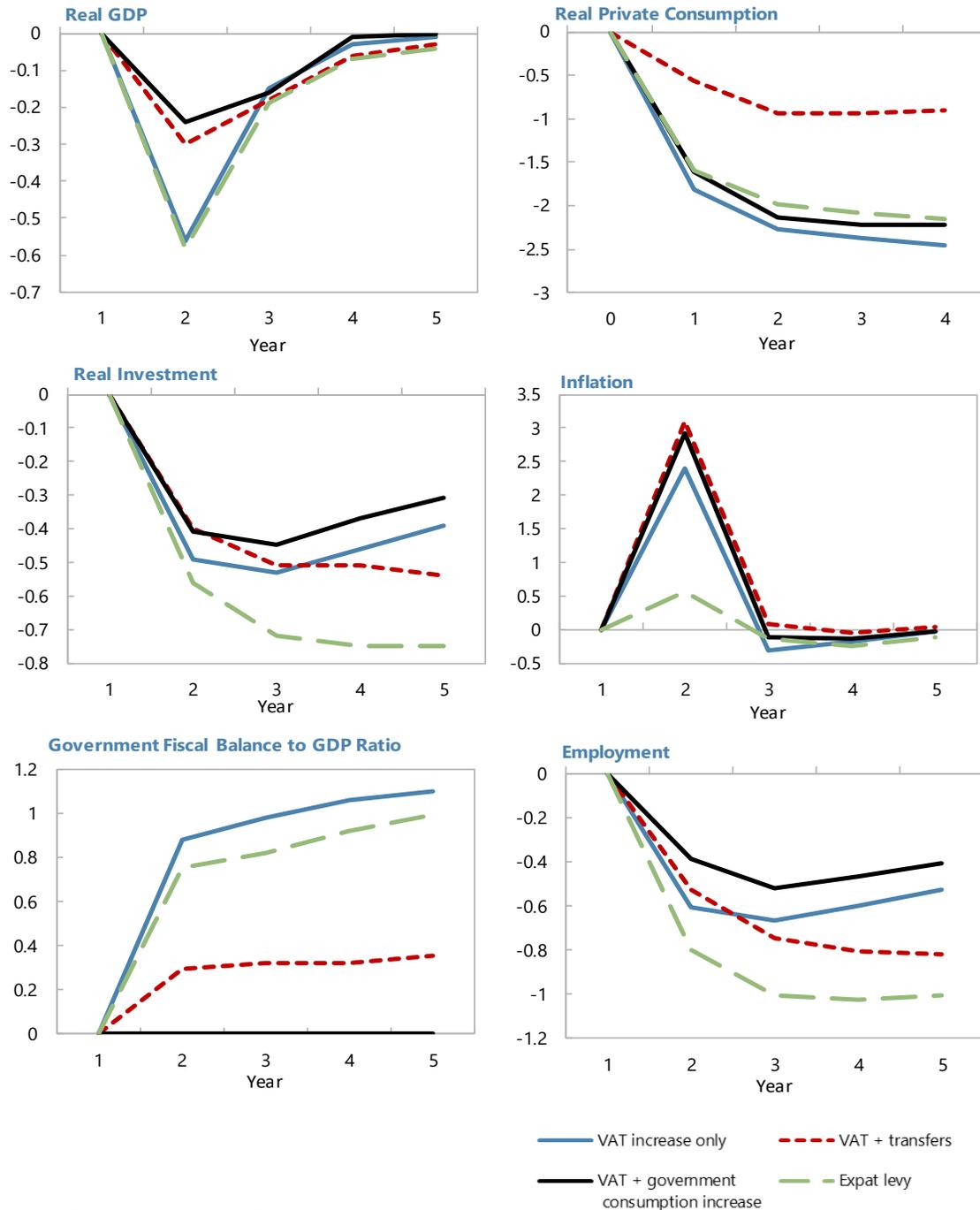
25. The impact of the VAT (and other reforms) on households has been mitigated by payments through the Citizens' Accounts and the cost of living allowances decreed by King Salman in January 2018. The authorities decided to limit exemptions and zero ratings for the VAT and to use cash payments to Saudi nationals through the Citizens Accounts introduced in December 2017 to mitigate the impact of the reforms on low- and middle-income households. In January 2018, King Salman also announced additional cost-of-living allowances for government workers, military personnel, students, pensioners, and those on social security. These were originally introduced for one year but have subsequently been extended to end-2019. Fiscal spending on the citizens accounts and the cost-of-living allowances totaled SAR 70 billion in 2018, while revenues raised from the non-oil revenue and energy price reforms (including electricity tariff reform) were SAR 144 billion without accounting for the improved administration of other taxes that has accompanied the VAT implementation. The net fiscal impact was therefore around 2.5 percent of GDP in 2018.

26. To provide further analysis on the economic effects of the VAT and expatriate levies, simulations were run using SAMA's DSGE model of the Saudi economy. The model captures key characteristics of the Saudi Arabian economy including its reliance on oil exports (see Appendix for more details). Four simulations are presented in Figure 6 (all relative to a baseline of no change in policies): (i) the introduction of a 5 percent VAT; (ii) the VAT with transfers from governments to households; (iii) the VAT and an increase in government consumption so the net fiscal impact is zero; and (iv) an expatriate levy modelled through increases in labor taxes equivalent to 1 percent of GDP. As expected, real private consumption and real investment are negatively affected by the introduction of the VAT and the expat levy, with consumption more affected by the VAT and investment more affected by the expatriate levy (given it raises costs of production). Imports decline relative to baseline given both consumption and investment are import-intensive, thus limiting the negative effects on real GDP growth (which declines by around 0.5-0.6 percentage points (pp) in the first year). Employment declines, particularly with the expatriate levy. Inflation jumps with the introduction of the VAT, but this increase is temporary; the inflation impact of the expat levy is much more limited. As the

⁵ See "The Economic Impact of Policies to Boost the Employment of Saudi Nationals" in Saudi Arabia Selected Issues, 2018.

government introduces compensation measures through transfers and increases its own consumption, the growth impact is lessened (to about 0.2 pp), but the fiscal benefits also decline.

Figure 6. Macroeconomic Impact of the VAT and Expat Levy
(Percentage point deviation from baseline unless otherwise stated)



E. Policy Recommendations

27. The economic impact of the introduction of the VAT was quite limited, although the increase in expatriate fees may have had a larger (although difficult to quantify) impact. The inflationary impact of the VAT was modest and quickly dissipated, while any growth impact appears to have been transitory. The expatriate levy likely had a bigger impact on consumption and the housing market.

28. Looking forward, efforts should focus on further embedding the recent reforms and considering how additional non-oil revenues can best be raised in the coming years.

- **Build on the successful implementation of the VAT.** GAZT should continue to build its own and taxpayers' capacities and ensure that compliance remains high as the tax is expanded to more companies. A robust revenue forecasting mechanism is needed as a basis for target setting in GAZT, and the compliance strategy should increasingly become risk-based and ensure it is not overly burdensome to companies or GAZT. Consideration should be given to raising the VAT rate which is very low by international standards, in consultation with other GCC countries.
- **Continue to monitor the impact of the excise taxes.** This will help ensure that the government achieves the balance it is seeking between the health and revenue benefits of the excises.
- **The planned increase in the levy on expatriate workers could be implemented more gradually.** The levy raises the employment cost of expatriate workers and thus plays a role in reducing the wage gap between expatriates and nationals, supporting both labor market and fiscal objectives. The planned increases should continue, but their pace and timing could be reconsidered to help mitigate the impact on businesses and the economy.
- **Smaller fees and taxes should be assessed to ensure they are consistent with other policy objectives.** High visa fees and taxes on hotels and the cinema tax do not raise significant revenues but may deter development in the tourism and entertainment sectors of the economy.
- **Ensure the social safety net is well targeted.** The cost of non-oil revenues (and energy price) reforms to low-income households should continue to be mitigated through effective compensation mechanisms. It is important, however, that this compensation is well targeted to ensure the net fiscal benefits of the reforms are maximized.

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Appendix I. DSGE Model of the Saudi Arabian Economy

1. **All fiscal scenarios were generated from the Saudi Arabian Monetary Authority's (SAMA) DSGE policy analysis model.** The model is designed to support simulation analysis of longer-run macro developments and their interactions with fiscal and monetary policies.
2. **While built with parsimony in mind, the model integrates real economic activity and financial transactions of a relatively large number of agents within a stock-flow consistent framework.** The main sectors include two types of households (intertemporally optimizing households and hand-to-mouth households), three types of producers (producers of local intermediate goods, producers of consumption goods, and producers of investment goods), primary exporters of oil, the government, and the central bank.
3. **Both types of households, optimizers and hand-to-mouthers, purchase consumption goods, supply labor to local producers, and receive net transfers from, or pay net taxes to, the government.** Moreover, the optimizing households also have access to several types of financial and nonfinancial assets or can issue financial liabilities. They purchase investment goods to accumulate physical capital (which is then rented out to local producers) and purchase local-currency government or foreign-issued foreign-currency bonds; alternatively, they may issue foreign-currency bonds to the rest of the world. Their access to the assets and ability to issue liabilities enables these households to optimize intertemporally, smoothing their consumption-leisure choice across time.
4. **The local production sector is organized as a two-stage supply chain.** The local producers of intermediate goods first combine imported inputs with two local inputs, labor and capital supplied by households, and supply the resulting goods to the producers-distributors of final consumption goods and those of final investment goods. These final goods then sell locally to households and government.
5. **The exporting industry comprises oil extraction. It is an endowment industry, with a maintenance and service cost paid to the rest of the world.** The sales revenue net of costs is transferred to the government budget.
6. **All the production sectors are delegated sectors.** This means they do not have their own net worth, do not issue debt, or hold assets. All their revenues or losses are transferred immediately to the budget of their respective principal: households (in the case of local producers) or the government (in the case of primary exporters).
7. **The public institutions include the government and the central bank.** The government purchases consumption and investment goods and finances these purchases by levying taxes and issuing debt. The taxes include a value added tax, input (excise) tax, labor tax, a windfall tax and profit revenues from primary exports; furthermore, the government makes net transfers to, or collects net taxes from, households. To manage its finances, the government

maintains a cash reserve at the central bank. The central bank builds official reserves investing in foreign-issued foreign-currency debt.

8. Three flowcharts visualize the real and financial interactions within the economy.

Figure A1 depicts the flows of goods, services and input factors. In this figure, an arrow pointing towards an agent means the agent purchases the goods or services downstream and makes payment to the other agent upstream. Figure A2 shows the government's current receipts and outlays, except the interest paid on debt. Here, the monetary flows (sources of funds) go downstream. Finally, Figure A3 summarizes the financial positions between individual agents or them and the rest of the world. Here, arrow points from a liability issuer towards an asset holder.

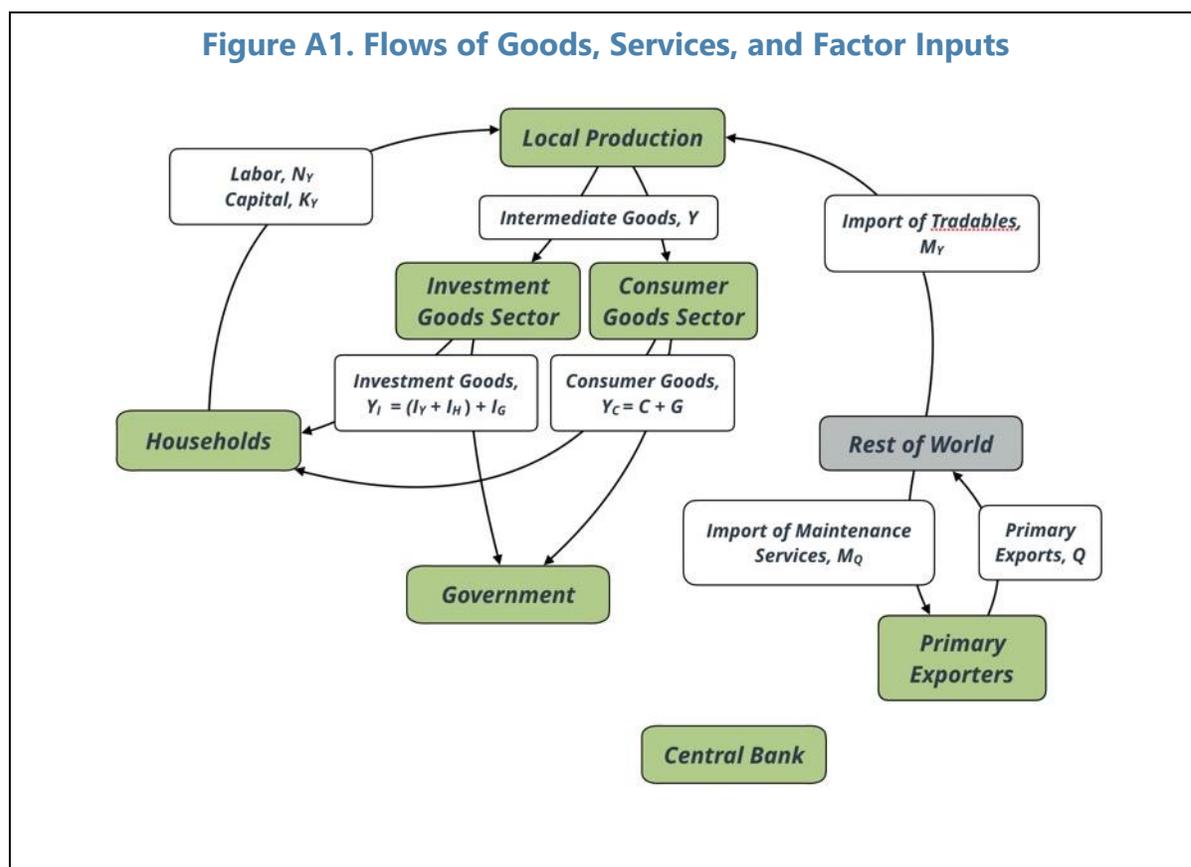


Figure A2. Government Receipts and Outlays

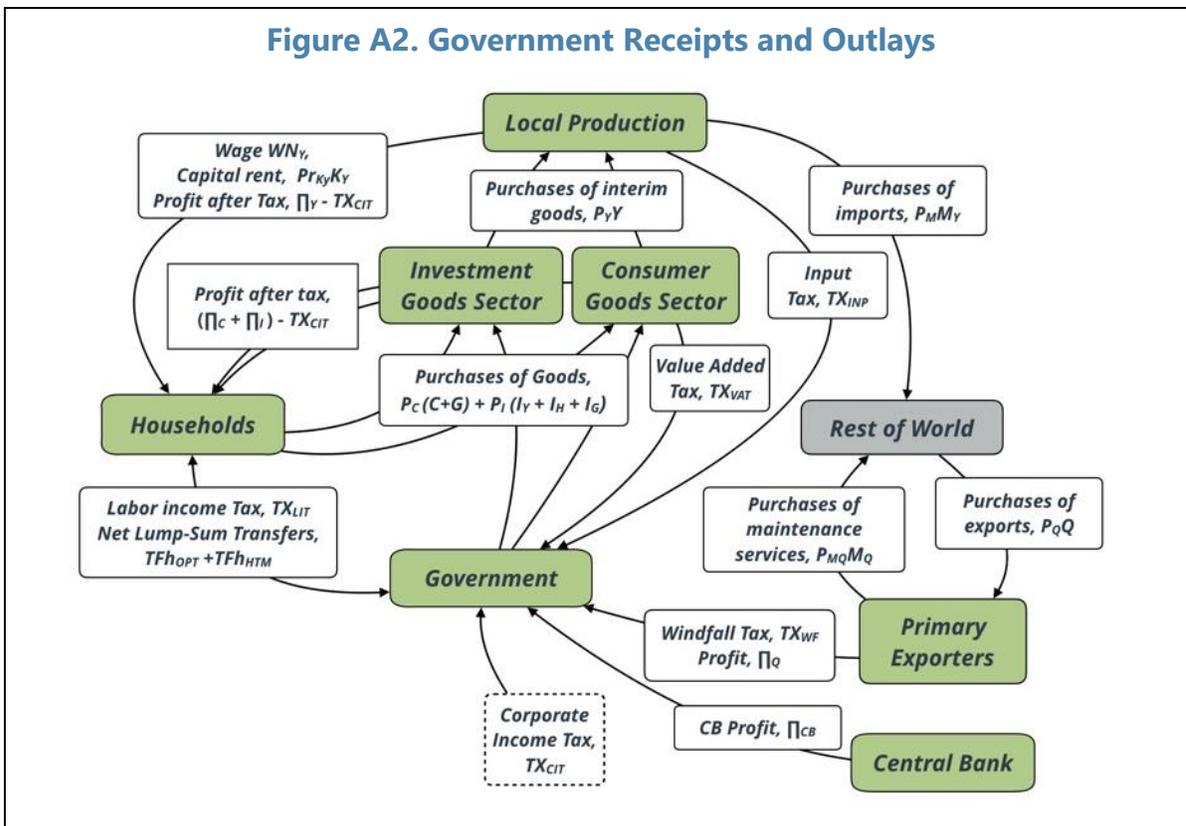


Figure A3. Financial Positions

