The political economy of reforms under Vision 2030

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Introduction

Although Saudi plans for economic diversification are almost as old as the Saudi oil age itself, the economic reform agenda that has been started with Vision 2030 in 2016 is unprecedented in reach and ambition. Within just a few years, key taboos have been broken regarding taxation, subsidy reform, high-profile deployment of sovereign wealth, and opening of new sectors like tourism and entertainment. At the same time, the new reform drive has not yet tackled many of the basic structural constraints that have held back non-oil growth in past decades, most notably dependence on low-cost foreign labor and, closely related, a wealth distribution system that disincentivizes skills acquisition and entrepreneurial efforts among citizens while increasing their reservation wages.

This chapter analyses the structure of Saudi social contract and how it relates to the kingdom's traditional "growth model", focusing specifically on how wealth distribution has been used to grow consumer markets. It examines attempts to adjust the social contract since 2015, how they have affected growth, and how the persistence of the old social contract holds back the economic diversification process under the Vision.

The Saudi social contract

The Saudi social contract, like that of other GCC countries, relies on broad-based wealth distribution through several channels. These include energy subsidies, housing aid, free education and healthcare and, most importantly, an implicit government employment guarantee for (at least male) citizens. The only other country in the world that shares its wealth similarly generously with its citizens as the GCC countries is tiny oil-rich Brunei. Decades of rent sharing have led to the emergence of a broad, state-dependent middle class with its own material expectations and vested interests across the GCC (Herb 2014).

It is worth remembering that the origins of the Saudi social contract are political, if only to underline that any adjustment to it is an essentially political process facing potential political constraints. The emergence of large-scale oil rents after WWII did not automatically lead to wealth distribution (Okruhlik 1999). Instead, the Saudi leadership pursued the rapid expansion of public employment and public goods provision to an important extent as a counter-revolutionary measure at a time when Arab nationalism and other leftist ideologies appeared to threaten the Saudi monarchy in the late 50s and 60s. Then Prime Minister Prince Faisal's 10-point program in 1962 took up many of the economic demands of the nationalist opposition and the archival record shows that Faisal saw economic development and wealth distribution as tools to counteract republican opposition (Hertog 2018).

To understand the political economy of this mass co-optation process, it is important to emphasize that has not primarily happened through conventional "welfare state" mechanisms; calling Saudi Arabia a welfare state is a misnomer. While social safety and security mechanisms like publicly supported pensions, unemployment benefits or income supplements for poor families and widows exist in the kingdom, they constitute only a small share of the overall patronage system. Instead, wealth sharing relies on an essentially Nasserist model of state employment. Social benefits amounted to only 77b SAR of 1048b SAR of total state spending in 2019, compared to 504b SAR of expenditure on public sector employee compensation (the official subsidy tally reached 22b SAR, which however undercounts implicit energy subsidies of perhaps 100b SAR or more).[1]

The share of public sector salaries in the national budget in Saudi Arabia is about twice as high as the typical share for advanced countries. It has been the budget item that has grown the most consistently over the years, even during episodes of relative austerity like the years of low oil prices from the mid-80s to the late 1990s and the post-2014 period until 2020. In short, the Saudi social contract revolves primarily around public employment.

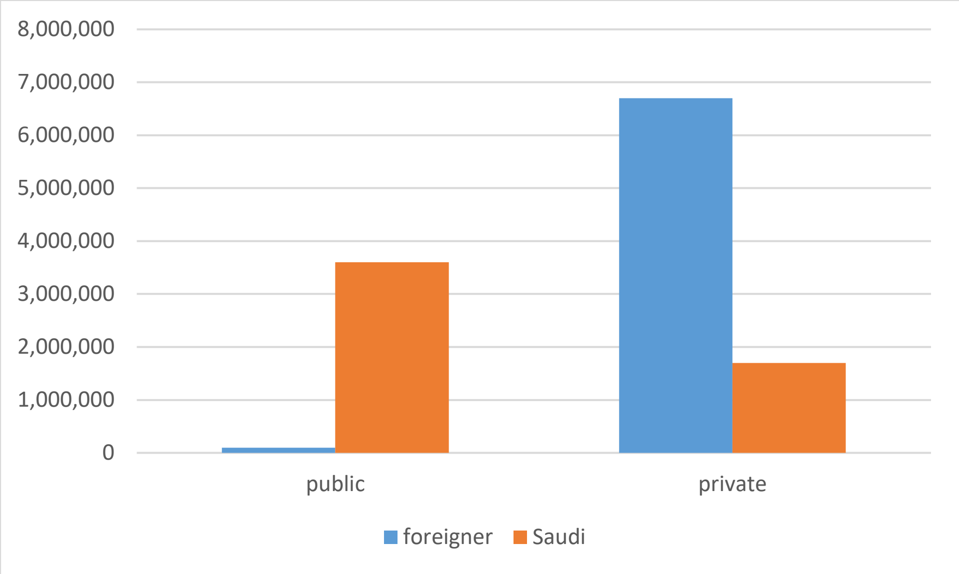
The majority of Saudis in dependent employment continue to work for government. The exact figure of public employees is not known as many of them work in the security sector and other areas that do not fall under published civil service statistics, which only indicate 1.48m Saudi government employees. We know from official labor force survey data, however, that average public sector salaries reached 11,6000 SAR/month in early 2020, while total official wage spending in 2019 reached 504b SAR. Combining the two figures results in an estimated number of 3.6 million citizens holding public jobs. This also roughly aligns with Crown Prince Mohammad bin Salman's own public statements, in which he has mentioned about 3 million government employees.[2]

The total number of Saudi private sector employees, by contrast, was only 1.7 million in early 2020, with their total wage income only reaching 150b SAR due to lower average wages of 7,300 SAR/month.[3] The public sector is not only a lot larger than the private labor market for Saudis, it also pays considerably better on average. This contrasts with the situation in non-rentier countries – both rich and poor – where public employees seldom exceed a third of the total labor force and the vast majority of wages are generated in the private economy.

Figure 1 below shows that Saudi labor markets continue to be deeply segmented, with private employment dominated by foreign workers and sheltered government employment largely reserved for Saudis.

Figure 1: Segmentation of labor markets in Saudi Arabia (Q1/2020)

[1] Ministry of Finance, 2020 budget statement.
[2] https://www.pbs.org/wgbh/frontline/article/mohammed-bin-salman-speaks-about-role-khashoggis-murder-first-time/
[3] GASTAT Labor Force Survey bulletin, Q1/2020.



Source: GASTAT, Ministry of Finance, own calculations

This structure has remained largely unchanged since 2015. While the expansion of public employment has slowed down due to fiscal constraints, private sector employment of Saudis has barely budged since 2015. Saudis' labor market participation continues to be very low, moreover, with only 46.7% of working age Saudis active as (employed or unemployed) participants on the labor market.

In many ways, the Saudi labor market as well as the country's wider benefits systems are an extreme version of a general Arab social contract that also exists in less affluent countries in the MENA region and which relies excessively on public employment and subsidies as quasi-welfare tools. This type of wealth distribution system disproportionately benefits relatively privileged "insiders" who have access to government employment or who derive larger benefits from subsidy systems due to their higher income and therefore consumption levels (Yousef 2004; Assaad 2014; Hertog, Steffen forthcoming; World Bank 2014). Sharing wealth through public employment rather than other welfare mechanisms gives the government stronger discretion in choosing whom to share rents with, but it also divorces recipients from the market in a particularly profound way.

What makes Saudi Arabia and GCC political economies different from other Arab countries is, first, that the insider group is relatively larger (albeit gradually shrinking due to fiscal constraints). Perhaps more important from an economic development perspective, in the GCC there is an additional, large group of outsiders in the shape of non-nationals who hold the majority of private sector jobs, often at very low wages. This extra labor segment makes cheap and convenient services available to state-supported nationals. The practically unlimited supply of foreign labor has allowed GCC economies to rapidly expand without facing the acute labor bottlenecks that tend to lead to inflationary shocks in oil-rich countries with limited labor migration, sometimes called the "Dutch Disease" (Razgallah 2008; Beine, Coulombe, and Vermeulen 2015). The availability of a large foreign workforce has also, however, further contributed to the distancing of nationals from the private labor market.

While public employment has been the main channel of wealth sharing with the broader citizenry, since the onset of the oil age the Saudi state has also developed a well-documented partnership with the local merchant class, which in return has abjured its political ambitions

(Hertog 2010) – a co-optation process that has also happened in other GCC countries (Crystal 1995; Moore 2009; Gause 1994; Hertog 2016). Merchants have benefited handsomely from state contracts, even if they have on occasion been expected to cut members of the royal family into their transactions (Field 1986). Other traditional elites like tribal leaders, ulama and urban notables have been similarly co-opted or side-lined by the Saudi rentier state through targeted patronage (Al-Rasheed and Al-Rasheed 1996; Gause 1994).

While there is some rivalry between spending on citizen benefits and spending on economic development that directly benefits the merchant class (Herb 2014), mass patronage for citizens also has benefits for the merchants: Salary income and other transfers from government are the main source of consumer demand in Saudi Arabia, which in turn benefits private investors operating in real estate, retail and other consumer services. Due to the central role of government in recycling oil rents and generating demand, the size of total state spending is closely correlated with that of the private sector (Hertog 2011b). This remains the case also in the era of Vision 2030.

The Saudi social contract and the Saudi growth model

Comparative political economists have come to realize that different capitalist systems can generate growth in very different ways, be it through export competitiveness or stimulating domestic consumption, laissez-faire approaches or deep state intervention and coordination (Hollingsworth and Boyer 1997; Hall and Soskice 2001; Lundvall et al. 2002).

More recently, comparative political economy has particularly focused on different "growth models", analysing the varied ways in which demand is generated in different types of capitalist economies and probing the different political coalitions that underlie these demand generation processes (Baccaro and Pontusson 2016).

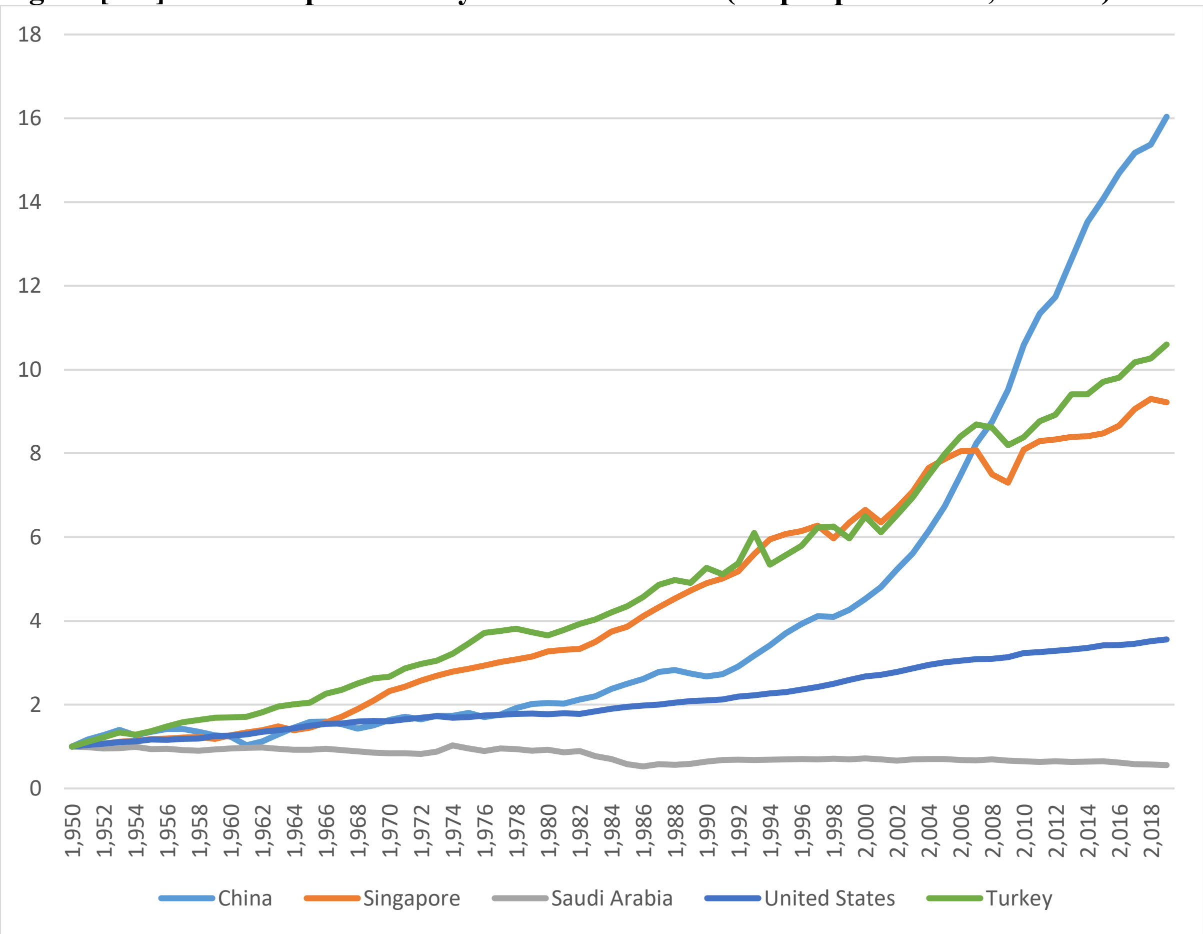
Saudi Arabia and the GCC arguably have developed their own, unique growth model in the post-WWII period; economic expansion is generated through very different mechanisms than in tax-based "production states". As Giacomo Luciani argued more than 3 decades ago, the size of the economy in rentier states is mostly a function of state spending rather than the other way around (Luciani 1987). More specifically, in GCC countries, consumer markets primarily depend on government employment and transfers rather than privately generated income derived from the market. Government spending in turn is independent of the local business cycle as none or only a small share of it is financed through local taxes (Mahdavy 1970). Different from "production states" with mature tax systems, the causal link between state spending and the private economy runs in only one direction (Hertog 2011b).

Rapid growth has been further facilitated by the availability of low-cost foreign workers, the numbers of whom can be quickly increased when the government stimulates the local economy through spending growth. Facing a flat international labor supply curve, there are no conventional supply constraints on GCC labor markets, as a result of which a large increase in demand does not necessarily trigger an inflationary spiral. The absence of collective wage bargaining mechanisms and the fragmentation of the labor force through the labor sponsorship system leads to further wage suppression in the foreign workforce (Baldwin-Edwards 2011; Hertog 2011a). This setup has allowed rapid growth with limited inflation during oil boom periods – an attractive model for GCC governments as long as national populations remain small and can be sheltered through public employment while reaping the benefits of infrastructural modernization and cheap markets for private services.

State dependence of most economic activity lies at the core of this model, however. Privately generated consumer demand is limited: As mentioned above, Saudi private sector wages of 150b SAR per year are less than a third of public sector wages. The total wage income of foreign workers in 2019 was higher at 350b SAR, but more than a third of this was remitted out of the country, contributing nothing to local consumption.[4] Moreover, even wage income and capital returns from the private economy often are generated through activities that themselves depend on state spending.

Dependence on foreign labor has also depressed productivity, as employers tend to rely on low-skilled expatriate workers, who are easier to control and for whom labor cost arbitrage is most attractive, given the large wage differentials in low-skilled labor across international labor markets. As foreign workers can often be imported with at least some on-the-job experience, local investment in skills formation has traditionally been limited. Figure [XX] below reflects how the low-skill bias of the Saudi economy has led to stagnating productivity over the decades.[5]

Figure [XX]: Relative productivity trends since 1950 (output per worker, 1950=1)



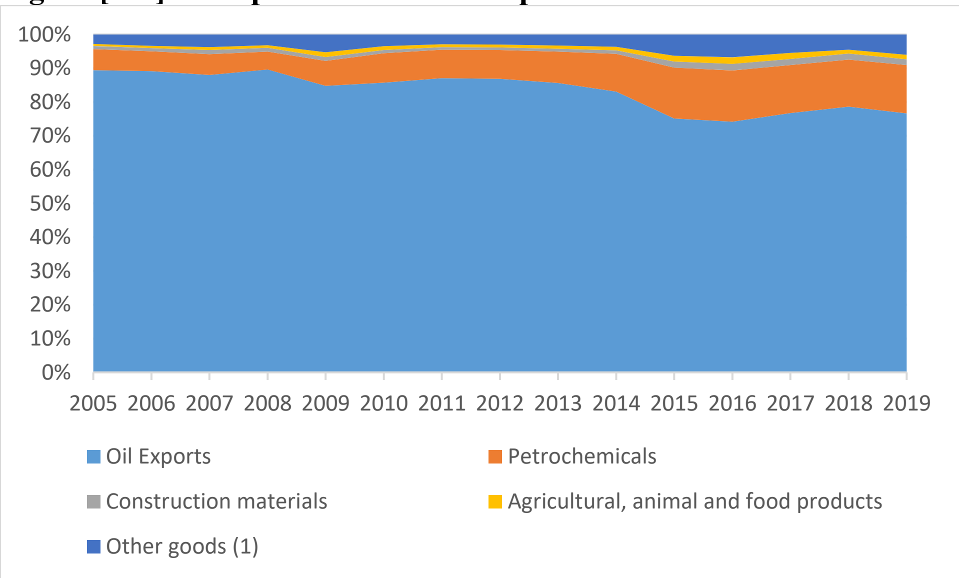
Source: Conference Board

[4] Data from SAMA and GASTAT.

[5] Some of the stagnant aggregate productivity is due to compositional effects: The oil sector in GCC countries is particularly productive, so relative growth in non-oil activities tends to pull down average productivity numbers. Within-sector productivity trends in recent decades have also been stagnant, however.

Low productivity has limited economic diversification. While non-oil GDP has grown considerably since the 1970s, it is deeply affected by state spending, so is not a very useful as measure of sustainable diversification. A more meaningful indicator that is relatively independent of state stimulus is the scale of non-oil exports, which have to compete on international markets. On this account, the Saudi economy – like all other GCC economies bar Dubai – remains quite undiversified. Despite some non-oil export growth in the early 2010s, the vast majority of goods sold internationally remain oil and refined products. Exports of petrochemicals, the kingdom's biggest export success which is at least one step removed from the oil and gas sector, have stagnated after the 2014 oil price collapse, indicating their relative dependence on global oil markets (see figure [YY]).

Figure [YY]: Composition of Saudi exports since 2005



Source: SAMA annual report

In sum, the Saudi/GCC growth model represents a crude kind of Keynesianism without either significant taxes or a conventional macro-economic cycle. It relies on an oversized state that generates consumer demand through (over-)employment in the public sector and uses a flexible, low-skilled foreign labor force in the private sector to cater to this demand. Despite growing sophistication of the Saudi private sector over time (Luciani 2006), private economic activity remains largely state-dependent.

As the size of the domestic economy largely remains a function of state spending, and because much state spending goes towards broad wealth sharing, the Saudi growth model itself is based on the social contract. Changing the growth model ipso facto implies changing the social contract.

Attempts to adjust the social contract

While the broad foundations of the social contract remain the same in 2021, since 2016 Saudi Arabia has witnessed measures to curtail wealth sharing that have cut deeper than any previous fiscal adjustments, even during the fiscal crises of the late 1980s and late 1990s. The economic driver has been the decline in oil prices since 2014, which has led to double-digit deficits in several years. The surprising outcome is not austerity per se, however, but the fact that since 2020 more of it has been borne by regular households than ever before. This stands in contrast to previous lean periods, when fiscal adjustment happened almost exclusively through cuts of capital expenditure and state contract spending, which primarily affected large local construction and service companies rather than average citizens (Hertog 2010).

Fiscal adjustment since 2015 has followed a meandering learning curve. The first iteration of the kingdom's "Fiscal Balance Program" issued in 2016 aimed to reduce the government's net spending – total expenditure minus fees and taxes – from 921b SAR in 2015 to 634b SAR by 2020, a shrinkage of 35%. The aim was a balanced budget by 2020, which however would have meant taking away about a third of the primary source of economic demand in Saudi Arabia within 5 years. The leadership quickly abandoned the plans when the formal abolition of a number of (mostly smaller) public sector allowances in autumn 2016 led to social backlash as well as a consumer recession. The allowances were reinstated in spring 2017.

The government instead took a more cautious approach to fiscal reform in which subsidy cuts and new taxes were at least partially compensated with other forms of welfare spending. As a result, while some spending has been rationalized and the revenue apparatus modernized, net fiscal savings have been limited.

Most notably, since 2016 the Saudi leadership has made significant adjustments to state-controlled domestic gas, electricity and fuel prices that have affected both industry and household consumers. Energy subsidies have historically been seen as a key plank of the GCC social contract (Fattouh and El-Katiri 2015; Krane 2013) and while prices remain below international benchmarks, the increases have had a significant effect on Saudi citizens' purchasing power.

In January 2018, the government also introduced a 5% VAT, following a GCC agreement on the matter which however only Saudi Arabia and the UAE acted on at the time. Again, the absence of taxation was generally seen as a key plank of the rentier social contract in the GCC (Luciani 1987), giving even a modest tax an outsize symbolic importance for local citizens and Gulf experts alike.

Energy price increases and VAT were partially compensated through the introduction of a "citizens account" in December 2017. This program provides means-tested cash payments to Saudi households below specific income thresholds; these were reported to average 930 SAR (about 250 US$) per month in July 2020.[6] Despite some targeting issues and carping on social media, the program appears to have been a success: While continuing to provide income supplements to deserving households, its cost is below the opportunity cost of previous energy subsidies and different from the latter, it does not distort consumption decisions or disproportionately benefit richer households. It represents an attempt to maintain the social contract while modernizing it and trimming it around the edges – and it broadly follows the reform prescriptions of international organizations like World Bank and IMF (World Bank 2014).

As a result of the leadership's relative caution until 2020, government net spending has remained roughly constant since 2016 as tax and subsidy reforms have gone hand in hand with higher spending. Net spending in 2020 reached 868b, only 6% less than in 2015. Fiscal deficit have therefore continued until 2021, although declining over time.

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[6] Two Million Saudis Lose Cash Aid When They Can Least Afford It[] https://www.bloomberg.com/news/articles/2020-07-15/two-million-saudis-lose-cash-aid-when-they-can-least-afford-it

A more disruptive, historically unprecedented adjustment to the social contract happened in summer 2020, after the collapse of oil prices that was induced by the Saudi-Russian war for market share in March of the same year. Starting 1 July, the VAT rate was tripled to 15%, while a 1000 SAR/month "cost of living allowance" for public sector employees – created as recently as January 2018 in the wake of the introduction of the 5% VAT – was abolished from 1 June.

Critically, this time the government made no attempt to compensate for these more significant cuts. Instead of modernizing the social contract, it opted to simply shrink its material basis. As the VAT increase hit private sector employees as much as public sector ones – and arguably hit lower-income households harder – it has done little to address the existing distortions of the Saudi wealth sharing system: Wage gaps between public and private employment persist and many higher-income "insiders" were less hit by the adjustment than lower-income households.

The abolition of the cost of living allowance, by contrast, has contributed somewhat to narrowing the public-private wage gap, but only on the margin (recall that the average wage differential between the two sectors is more than 4000 SAR/month). Its suppression has moreover affected lower-income public employees disproportionately, as it constituted a proportionately larger share of their take-home pay.

The abolition of the allowance is particularly politically significant in light of the failed previous attempt to suppress a range of (mostly smaller) public sector allowances in 2016-17. The leadership clearly was more willing to inflict pain this time around.

The total annualized reduction in the fiscal deficit resulting from the two measures of summer 2020 could amount to 150b SAR or more than 5% of GDP. Assuming that expatriate households and private businesses will absorb some of the hit, the resulting reduction of Saudi households' purchasing power could reach 100-120b SAR. In light of total Saudi wage income of less than 700b SAR per year, this is a significant blow to household finances.

The uncompensated fiscal cuts directly affect a key source of economic growth in the kingdom: state-supported household consumption. While the effect of the global COVID crisis on the Saudi economy has somewhat masked the specific impact of the cuts, their effect will become clearer once COVID restrictions are fully lifted and is likely be reflected in sluggish growth of key consumer markets. While the large deficit that the kingdom was facing in 2020 arguably required fiscal action, the targets – primarily households rather than large-scale capital expenditure – and the lack of accompanying compensation measures reflect a structural break in the leadership's approach to the social contract.

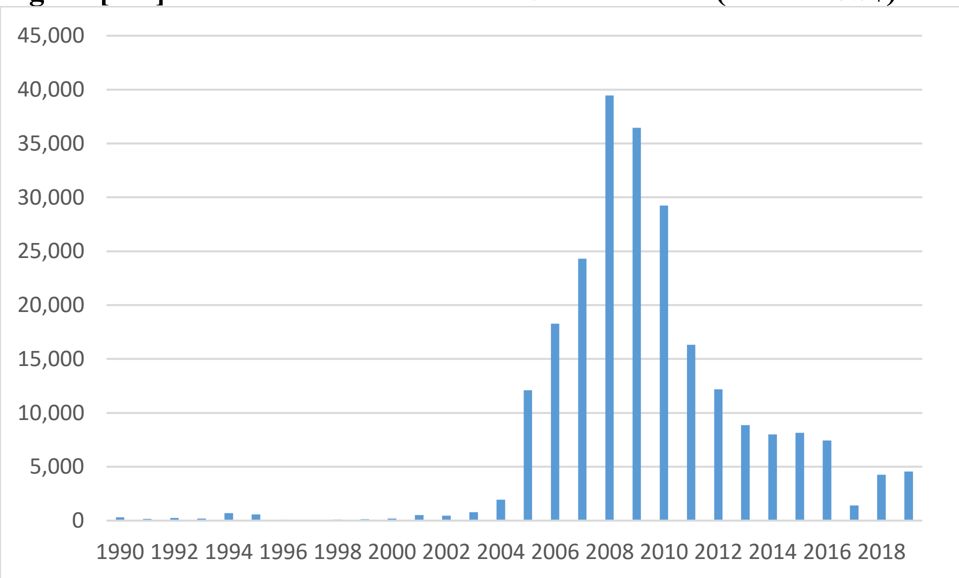
The measures reflect a level of political confidence vis-à-vis Saudi citizens that was lacking in the earlier phase of Prince Mohammad bin Salman's economic reign. While the government intends to increasingly stimulate the local economy through off balance sheet project expenditure by the Public Investment Fund, such spending does less to maintain consumer demand and the traditional social contract undergirding it. Remarkably, even after the substantial recovery of oil prices from late 2021 on, the kingdom has seen barely any fiscal loosening in the central government budget.

An arguably even more drastic adjustment to the social contract on the elite level happened with the anti-corruption crackdown in November 2017, during which hundreds of members of the Saudi merchant, technocratic and princely elite were detained at the Ritz-Carlton hotel in Riyadh. While the growth impact of the crackdown was less immediate, the elite disenfranchisement that it symbolized was more profound: It signalled to leading merchant families that their cozy relationship with government was essentially over. Internally, some advisors to the Crown Prince even spoke of the need to create a "new private sector" that would replace the old rentier class.

Emblematic of the new order were the bankruptcy and partial nationalization respectively of what were arguably the kingdom's two largest contracting firms, Saudi Oger and Saudi Binladin Group. Other members of the business elite survived but lost assets and much of their privileged access to government and their roles as intermediaries with international business. More openly than before, moreover, private firms are now expected to adjust their investment decisions to government priorities. At the same time, the leadership signalled a preference for foreign investors through the organization of high-profile investor events (one held in the same Ritz-Carton just 10 days before the crackdown) and the construction of new mega-projects that explicitly target FDI, foreign technology and foreign residents.

The new private sector that Vision 2030 implicitly is built on has been slow in emerging, however, given the private economy's historical dependence on state spending and relatively low productivity rates. FDI similarly has plummeted due to lower growth, policy uncertainty and the fact that "quick wins" in the fields of heavy industry and telecoms had mostly been reaped by the early 2010s (see Figure XX). A recent peak of FDI inflows in 2021 at an estimated $19.3b was mostly due to one-off proceeds from the partial sale of Saudi Aramco's oil pipeline network.

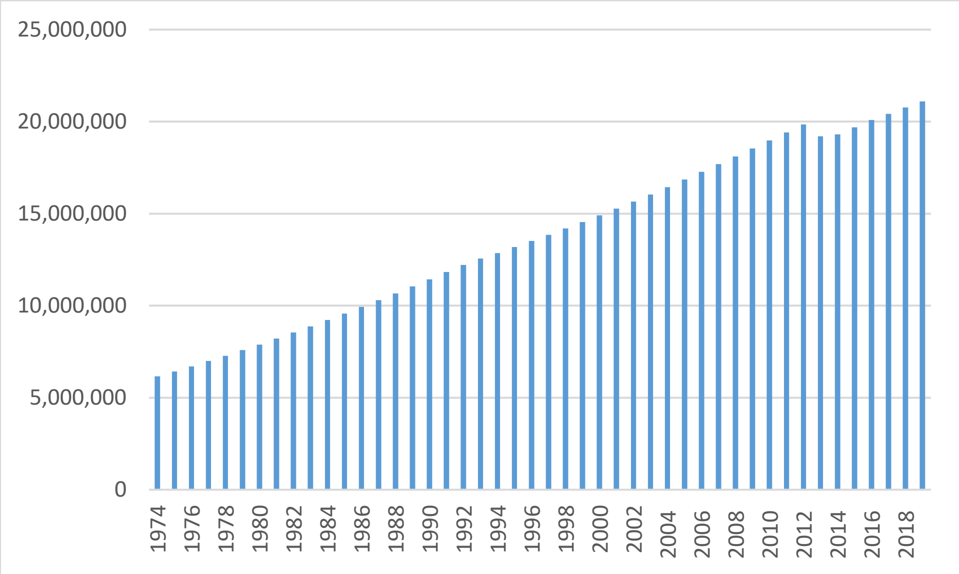
Figure [XX]: Annual FDI inflows into Saudi Arabia (million US$)



Source: UNCTAD

Closely related, no new sources of private household income have emerged yet to replace state-orchestrated mass wealth sharing. Saudi employment in the private sector remains stagnant [see chapter by TZ?]: In Q1/2020, 1.87 million Saudis held jobs under private social security regulations. With 1.86 million, the number was almost the same in Q1/2017, despite continuing growth of the Saudi population and of working age individuals in particular, which would require the creation of perhaps 200,000 new jobs annually.[7]

Figure [XX]: Estimated number of Saudi citizens in mid-year



Source: SAMA

The number of actual Saudi private sector workers has probably improved somewhat in recent years due to the decline of "phantom employees" who are only put on companies' payroll to fulfil Saudization quote requirements.[8] Yet the aggregate size of the private Saudi wage bill – whether resulting from real or phantom employment – has barely budged and continues to be less than a third of aggregate public sector wage payments. The stagnation of private employment is unsurprising, given that most private production directly or indirectly caters to state-generated demand, which has not grown substantially since 2015. Public and private employment in Saudi Arabia tend to be complements, not substitutes.

In principle, the Saudi state retains enough fiscal and administrative resources for a more fundamental revision, rather than just curtailment, of the social contract: It could gradually replace excess public sector employment with mechanisms to support private employment of Saudis at socially acceptable income levels, for example through a universal basic income (Hertog 2017) or a negative income tax that would make lower- to mid-skilled nationals more competitive with low-income foreigners.[9]

There has, however, not been any clear sign that such more fundamental revisions are being considered. "Saudization" of labor markets continues to rely on prescriptive quota rules which are costly for business and encourage evasion without addressing the large labor cost gap between nationals and foreigners. While the quotas of the *Nitaqat* Saudization system have been periodically adjusted, the system remains essentially the same as it was before 2015. Government employment, while much less easily available, remains more attractive for

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[7] Employees under social security also include workers in quasi-public entities that do not fall under civil service regulations. Unfortunately, the number of individuals employed in truly private establishments (1.7 million in Q1/2020) is only reported in the most recent labor force bulletins.

[8] This is not least suggested by the clearly increased visibility of Saudis rather than foreigners in customer service jobs in recent years.

[9] [N Dunais paper]

most Saudis (Hertog, Steffen 2020) and foreigners by and large more competitive on the private labor market (Baldwin-Edwards 2011).

Change in the social contract has therefore mostly happened through erosion, accelerated by continued population growth and a period of depressed oil prices. While prices have recovered at the time of writing, the erosion is likely to continue in the long run given that average per capita oil rents in the kingdom are likely to drop further as the working age citizen population continues to grow.

The one adjustment to the wealth sharing regime that pointed in the direction of a proactive reform were the 2017-18 energy subsidy reforms and the introduction of the citizens' account. These were significant steps forward but they pale in terms of scale and complexity compared to the challenge of reforming public employment. Moving from a growth model based on surplus public job creation to one that is at least in parts driven by private demand generation is not impossible. It is, however, both technocratically and politically more challenging and cannot easily draw on existing prescriptions from international organizations and consultants like the subsidy reform process could.

Vision 2030 and the social contract

Political and economic constraints created by the Saudi social contract are key to understanding both the potential and limits of Vision 2030. This is even though the wealth sharing and welfare regimes underlying the Saudi growth model are not a core concern of the Vision document and its attendant "Vision Realization Programs". The Vision focuses more on top-down diversification through state-owned enterprises and related megaprojects, accompanied by broader support for entrepreneurship and opening new sectors and, perhaps most dramatically, a set of fundamental lifestyle changes and a broad social opening of the kingdom. The basic incentive environment for citizens and in the labor market are not in the focus of the Vision process.

To the extent that the Vision proposes a new social contract, it is based around new social freedoms for a younger generation of Saudis who are meant to seize new, private economic opportunities. What these opportunities will be has not become clear yet, however. Tourism and entertainment alone, while important new fields of investment, will not provide sufficient jobs for young Saudis and under current labor market structures run the danger of once more providing more opportunities for foreigners than for locals.

To be fair, the social liberalization component of the Vision seems to have paid off considerable political dividends. While independent polls are not available, anecdotal evidence suggests that the process has been popular especially among young Saudis. This is true even though much of the investment into entertainment has consisted of government-organized "loss leaders" in the shape of high-profile sports events, concerts and city festivals, the logistical and security costs of which have been very high.[10]

The economic diversification component of the Vision process has been slower moving than the social one. Due to the post-2014 fiscal slowdown, GDP growth in recent years has barely exceeded the growth rate of the citizen population of close to 2%, including in the non-oil sector.

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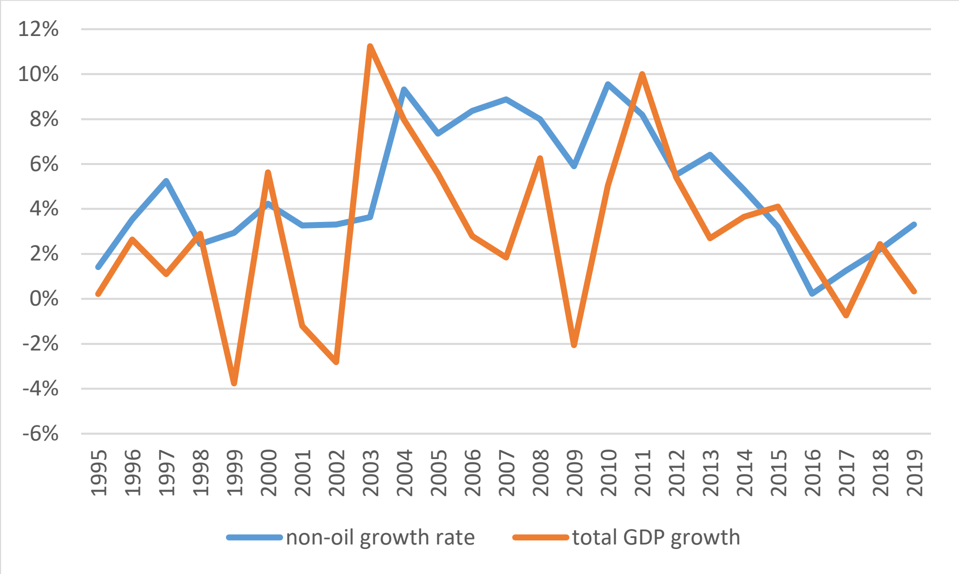
[10] Interviews in Riyadh, 2018 and 2019.

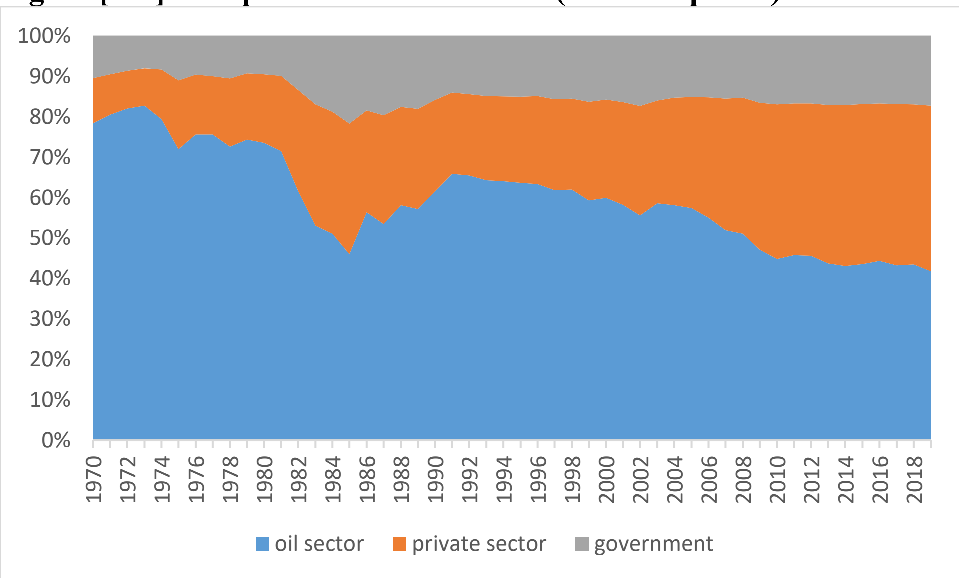
Figure [XX]: Annual real GDP growth rates



Source: SAMA

As figure [XX] below shows, the share of the private sector in GDP – which had been expanding significantly in the 2000s – has stagnated since the early 2010s, mostly due to the slowdown in state spending growth from 2014. While it can be argued that much of the previous expansion was not really autonomous diversification, it is clear that the private sector has not found an autonomous growth path after 2014 either.

Figure [XX]: composition of Saudi GDP (constant prices)



Source: SAMA

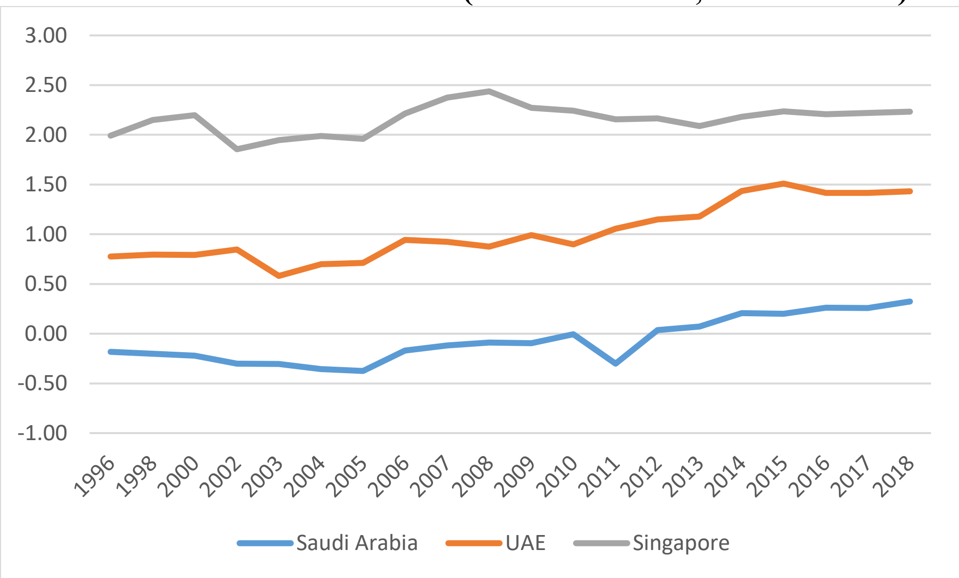
For the time being, due to the post-2014 fiscal slowdown, Saudi citizens face narrower opportunities in the public sector that are at best partially compensated through private opportunities. Many of the new Vision-related projects have remained enclave investments that exist in parallel to the rest of the economy. They have not yet involved the wider Saudi population – few of whom are employed in structures like NEOM or the Red Sea Tourism Project – or the local merchant class, which has yet to invest significantly in the new projects.

Some local observers expect the latter to change as the government uses its post-Ritz Carlton powers of political suasion to extract commitments of private capital to its flagship projects.

Implementation of the Vision has often moved slowly because of inherited institutional constraints that are in turn rooted in the kingdom's social contract. While some public job benefits have been cut, the government employment structures that the Saudi social contract is based on have remained largely the same. This has made improving accountability and performance of the bureaucracy below the top level difficult, explaining the relative stagnation in Saudi Arabia's scores on the World Bank's "government effectiveness" indicator (see figure [XX]).

Lingering bureaucratic ineffectiveness in turn affects the speed at which reforms are implemented and the general administrative environment for investors – even if there have been significant improvements in individual areas like bankruptcy legislation or the introduction of e-government in the slow-moving judicial system. Many processes still rely on the discretion of flesh-and-blood bureaucrats; investors report that just opening a bank account in the country can still take 9 months even with government support.[11]

Figure [XX]: Scores on the World Bank's "government effectiveness indicator of Saudi Arabia and benchmark countries (minimum is -2.5, maximum 2.5)



Source: World Bank World Governance Indicators

One arena in which the constraints that the social contract imposes on reform are particularly visible is that of privatization. In 2017, the government announced that it would raise about $200 billion (or 750b SAR) through privatization in the coming years as part of the Vision 2030 reforms. It has since turned out, however, that many of the entities slated for sale or private participation were in no state to generate commercial returns. Many of them did not have separate balance sheets or corporate structures and, most importantly in the context of the social contract, even potentially profitable entities are weighed down by their

[11] https://www.reuters.com/article/us-saudi-reforms/factbox-saudi-arabias-main-economic-and-social-reforms-investor-concerns-idUSKBN2AG1V5

employment obligations. The new National Center for Privatization often had insufficient control over the government entities historically in charge of specific assets.[12]

Already in 2018, drastically reduced targets were announced, with the government aiming for 35-40b SAR of proceeds by 2020. Even this target has not been achieved, as by 2020 the government's main asset sale were two flour mills formerly operated by the General Silos and Flour Mills Organization (privatization of desalination assets was ongoing at the time of writing). Little has been heard of the ambitious initial plans to privatize health and education assets, which are particularly deeply tied up with the social contract through the mass employment – and often over-employment – of nationals. This might change in the future, but for now the government has been reluctant to risk mass redundancies in the public sector. It has instead in many cases grown the public sector through the creation of new state-owned companies under the Public Investment Fund.

The struggle to reform existing government structures is also reflected in the Vision planning process itself, which has been relatively insular, relying heavily on foreign consultants and rapidly growing new bodies around the royal court, while both the wider ruling family and local merchant elites only have had a limited say in it. Vision Realization Programs have been bolted on top of existing administrative structures, sometimes adding to the complexity of an already fragmented and multi-layered government apparatus (Hertog 2010; 2018).

As a sign of the new attitude to the old social contract, investment in key mega-projects like NEOM, entertainment city Qiddiyah and the Red Sea Tourism project continued apace in 2020 at the same time that the VAT rate was tripled and the public sector cost of living allowance suppressed. This has led to some guarded criticism on social media. Some locals have taken to privately calling the increased VAT the "NEOM tax" – but there has been no sign of organized political resistance within government or outside, reflecting the newly centralized power of the leadership.

Some top-down force and risk-taking is clearly needed to modernize the Saudi economic system. There is, however, a danger that change is planned without taking relevant social constituencies on board, both reducing their "buy-in" into the process and insufficiently taking their needs and capabilities into account. In some cases, this marginalization has improved policy outcomes: The post-2015 diminution of the status of traditional religious forces, including in the judicial system, has removed a veto player that previously undermined legal modernization and social opening.

The much more centralized decision-making in the Vision era does, however, also reduce the political integration of local capitalist interests. While many of them are indeed rentiers who have lived off the state's generosity for decades, they still control local private capital and need to be brought on board if new diversification initiatives are to result in private investment. While there are occasional consultations, these appear mostly ad hoc and are a far cry from the close state-business coordination known from successful East Asian industrializers (Evans 1995; Wade 2003; Rodrik 2008). There is considerable potential in new service sectors like entertainment or tourism, especially for Muslim visitors, but many local stakeholders would want to see a more decentralized development model with more input from the private sector.

[12] The only large asset sale that has happened since was the partial IPO of Saudi Aramco in 2019, which struggled to attract international investors and which was conducted separately from the main privatization process.

[top-down approach most recently seen in HQ policy – international businesses operating in SA now also feeling a relatively heavy hand after years of frustration over low FDI flows]

The new era in Saudi Arabia has brought with it a centralization and personalization of power that is much closer to the typical pattern across the Arab world than the kingdom's previous collective, consensus-oriented governance. After decades of rent distribution and coalition-building had reduced the Saudi leadership's independent room of manoeuvre, the Vision-era Saudi state is characterized by a fairly high level of independence from social interests – bringing it back, forcefully, to the position of political autonomy predicted by classical rentier state theory (Luciani 1987; Mahdavy 1970).

Yet many of the Vision's components are deployed only slowly, not only because of limited buy-in from stakeholders but also because they are in tension with the structural foundations of the established social contract and growth model. []The privatization program has struggled to get off the ground not least because many of the entities slated for sell-off serve a job creation function for Saudi citizens. The ambitions of the cross-sectoral National Transformation Program had to be revised downwards because the overstaffed bureaucracy has often failed to deliver change on lower levels. The National Companies Promotion Program has had trouble finding top performing private companies to support given the orientation of local firms towards government and the protected local market (as well as distrust of new government initiatives on the part of some company owners).

The Fiscal Balance Program needed to be slowed down as the government realized how heavy the contractionary impact of spending cuts and new revenue measures was in the state-dependent Saudi economy; the specific aim to shrink the public payroll was postponed several times. The National Industrial Development and Logistics Program has struggled finding sectors to support that are not dependent on state-provided subsidized energy. Finally, the Human Capital Development Program that will focus on Saudi skill formation is yet to be issued; it will face a difficult battle reforming the teaching profession, which historically has been used as a job creation tool and has often attracted lower-calibre candidates.

These tensions are inevitable and not the fault of the new programs. Yet they have not been addressed in a systematic manner through a fundamental reform of the existing wealth distribution system that underlies many of the performance issues in the Saudi economy. While government programs have undergone numerous internal revisions, an overarching analytical framework that would address the binding constraints to Saudi growth is yet to emerge.

Conclusion and outlook

This chapter has shown that the old Saudi social contract is eroding, and with it the old growth model based on state spending and in particular state employment. Some of the components of Vision 2030 have politically compensated for this, especially the social opening of the kingdom. Yet the new era has not yet brought about new sources of private demand generation, as most economic activity continues to rely on fiscal stimulus from the state. The government is currently working on the introduction means-tested welfare tools. Yet a comprehensive reform of the social contract towards a less distortive and more market-conforming welfare system – one that would scale down government employment and help bridge the labour cost gap with foreigners in the private sector – is not yet in sight.

The re-established political autonomy of government under Vision 2030 has allowed the government to marginalize veto players that undermined previous reform efforts – yet increased autonomy also means that constituencies that need to contribute to Vision 2030, notably the local private sector, have not been fully integrated into the project, which does not always take their interests and capacities into account.

Economic diversification is hard and takes a long time under the best of circumstances. Saudi Arabia has not yet moved to a new growth model. It has few non-oil goods to export as Saudi labor by and large remains far from cost competitive and no significant non-government sources of demand are in sight for now.

That said, the relative austerity of recent years has led to some necessary adjustment: As government has stopped hiring freely, labor market attitudes have gradually been changing and reservation wages have fallen, with Saudis taking on more service sector jobs that they would have shunned just a few years ago. Gradual erosion of Saudi wages could lead to better competitiveness – not unlike what happened in Egypt after the forced devaluation of the Egyptian Pound in 2016 – but the road to such competitiveness is long. The adjustment process will not be finished by 2030 and much pain could be inflicted along the way, with living standards dropping for a younger generation of labor market entrants.

The transition could be smoothed through more proactive reforms of current wealth distribution structures, reorienting some of the rent sharing towards market-conforming welfare mechanisms rather than simply dismantling the old social contract through a reactive policy of austerity. For the time being, the Vision has focused more on large projects than on addressing structural constraints to economic development – although in the end, it will very likely be these constraints which determine the kingdom's growth and diversification trajectory.

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