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# Challenges to the Saudi distributional state in the age of austerity

## Workshop Item (Paper)

# Challenges to the Saudi distributional state in the age of austerity

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## Introduction

With oil prices dropping to below half their 2014 levels, Saudi Arabia faces an unprecedented challenge of economic adjustment. In 2015, the government's reported salary and allowance spending alone exceeded its total oil income. Its current distributional obligations in terms of state employment, provision of free public services, and energy subsidies are unsustainable. The Saudi wealth distribution regime has contributed to the kingdom's political stability for more than half a century. It does now however pose unique challenges to the economic modernization of Saudi Arabia. These challenges, and the state's attempts to overcome them, are the main focus of the present paper.

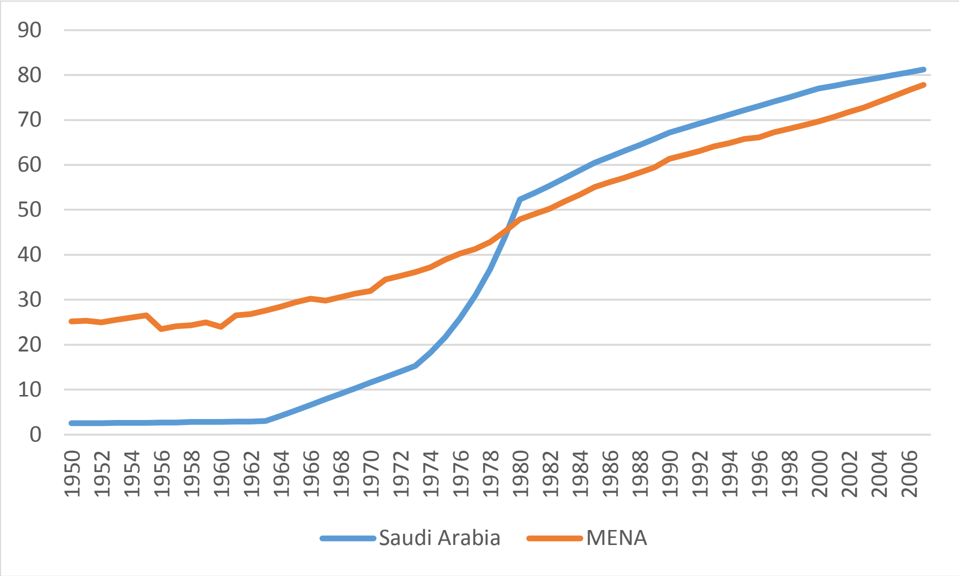
The paper will start with a brief exploration of the historical origins of the Saudi rent distribution regime, which goes back to the era of Arab nationalism in the 1950s and 1960s and was, as I will argue, to an important extent a reaction to political challenges emerging from nationalist movements. It will outline how Saudi elites quickly built a distributive state that, while itself fragmented into different fiefdoms, rapidly expanded its intervention in society and created many layers of material dependency. The paper will illustrate how distribution of state resources has been the key factor to shape (and distort) economy and labor markets. After a quick overview of the government's post-2014 adjustment policies, I will analyse the rather unique of economic and institutional constraints that the distributive state has created for economic diversification and fiscal sustainability – which in some cases seem to be underappreciated by decision-makers. Just like the building of the distributive state, economic adjustment in Saudi Arabia will constitute a unique historical experiment. But it is not clear that the ruling elite will enjoy the same degree of autonomy and eventual success in the process, even if the first steps of adjustment have come faster and met less resistance than many observers expected.

The paper's main conclusions are forward-looking, but will also discuss key aspects of change and continuity since the publication of "Princes, Brokers and Bureaucrats", my 2010 book-length account of the Saudi political economy and its historical roots (Hertog 2010). While it is clear that we are in a new era of policy-making and that elite-level politics have changed drastically, I will argue that many of the structural factors characterizing and constraining the Saudi state have remained exactly the same.

## Wealth sharing in Saudi Arabia

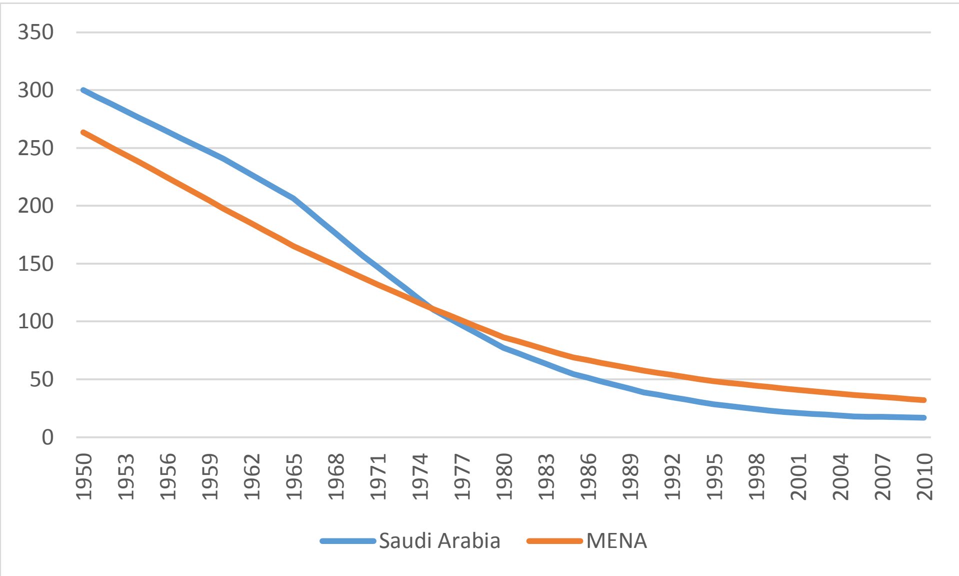
Like most of its peers in the Gulf Cooperation Council, the state of Saudi Arabia is deeply authoritarian but – by the standards of a mid-income country – exceptionally generous with its population. Two thirds of all Saudi workers are employed by government, energy and fuels for households as well as inter-city transport remain subsidized, while healthcare and education are free. While the quality of education and health services is generally considered as not on a par with those in most advanced countries, the improvement in the provision of basic public goods in Saudi Arabia since the 1960s has been remarkable. The graphs below show that Saudi Arabia has been much faster than its MENA peers in increasing literacy levels and reducing child mortality. This is although the MENA region, perhaps surprisingly, is already among the fastest-improving regions in the developing world on these two indicators.

**Figure 1: Literacy ratio of population (per cent)**




Source: Barro & Lee dataset

**Figure 2: Infant mortality (per 1000 births)**




Source: UNDP

It seems obvious that an oil-rich state would share some of its wealth with the population, but Saudi Arabia – and the Gulf monarchies more broadly – stand out even among oil rich countries in their material generosity. Other oil-rich states in the developing world do no better on the provision of basic welfare than their neighbours and some, notably in sub-Saharan Africa, do markedly worse (Eibl and Hertog 2016b).

## Historical background

The reasons for the Saudi state's broad-based welfare regime are historical and, as I will argue, have to do with largely forgotten ideological challenges that the Al Saud family faced in the 1950s and 1960s – challenges that I underestimated in Princes, Brokers and Bureaucrats, which focused on elite competition as key cause of state expansion. The following section will outline how this elite competition in fact interacted with what key princes perceived as substantial subversive threats, leading them to prioritize mass welfare policies in the process of Saudi state-building. I draw on both secondary historical literature and primary sources from diplomatic archives; the latter in particular illustrate key motivations of the ruling elite in building a distributive state.

The modern Saudi state had little modern administration before the onset of oil exports in 1947 (Al-Rasheed 2002; Hertog 2010; Vasil'ev 1997). The Al Saud ruling elite faced an institutional *tabula rasa* when they started to build the country's modern bureaucracy. They were also unconstrained by constitutional processes or modern interest group politics in their decision-making. Elite whims and conflicts hence played a particularly large role in shaping the institutional landscape (Hertog 2010).

### Early ideological challenges and patronage

At the same time, however, at key junctures of state-building in the 1950s and 1960s, Saudi rulers felt threatened by the nationalist and leftist ideologies coursing through the Arab world. These never gave birth to a mass movement in the kingdom (Hertog 2010, 81). Yet repeat threats of assassinations and military coups, combined with a febrile regional environment in which several Arab monarchies had already fallen, pushed key Al Saud players to start sharing wealth with the population – a process that also allowed them to build their own institutional fiefdoms.

After the takeover of the republican Free Officers in Egypt in 1952 and the death of Saudi founder king Abdulaziz in 1953, Arab nationalism found adherents among Saudi army officers, the nation's small intelligentsia and its student population. The spread of socialist-tinged nationalist ideology across the Arab world happened at a time when rapidly rising oil income made the creation of modern welfare state institutions possible at least in principle. In this context, a nationalist "Front of National Reforms" formed in 1953; it called for a constitution and an elected parliament as well as the abolition of illiteracy, schools for girls, and the expansion of higher and technical education (Vasil'ev 1997, 339) – all demands that would have been unthinkable without the new oil income. Nasser's republican Egypt started an active campaign of subversion in Saudi Arabia in the mid-1950s. As a result, the largely illiterate bulk of the population was increasingly exposed to radio propaganda from Cairo (Vasil'ev 1997, 340).

1955 saw an aborted military coup by nationalist officers (Al-Rasheed 2002, 112; Lacey 1981, 312; Samore 1983, 94f.), and in July 1956 Abdulaziz' successor King Saud was met by anti-Western mass demonstrations on a visit to the oil-rich Eastern Province (Vasil'ev 1997, 337). The same year, tens of thousands of Saudis cheered Nasser during a visit to Riyadh in the hitherto largest non-religious public display in the kingdom (Lacey 1981, 314). In May 1957, evidence emerged that the Egyptian military attaché in Jeddah had been working on a plot to assassinate Saud (Holden 1982, 195; Lacey 1981, 317).

Saud's personal profligacy was well known. He brought the kingdom to the brink of fiscal crisis in 1958, all the while Egyptian attacks and nationalist subversion were continuing. Fearing the end of the dynasty, the Al Saud family installed King Saud's brother Faisal as head of government (Vasil'ev 1997, 355; Yizraeli 1997). Faisal was unable to publicly distance himself from Nasser, instead professing his nationalist and reformist convictions to placate republican tendencies (Samore 1983, 104, 124f.). In practice, Faisal stalled on political reforms, but increased the kingdom's education and communication budgets in 1958-59 while decreasing the king's privy purse (Samore 1983, 125).

King Saud managed to wrest government power back from Faisal in 1960 and styled himself even more of a Nasserist, recruiting nationalist technocrats and a number of radical princes as ministers and making even more extensive promises of development, especially in education. (Vasil'ev 1997, 359; Vitalis 2007). Saud's policies were seen as a direct reaction to nationalist threats. According to a 1962 UK diplomatic report, Saudis outside of the royal circle reportedly liked Nasser's "Voice of Arab" radio attacks on Saud as they heard that these made the king contemplate the economic development of the country more.[1]

In 1962, the country once again reached a crisis as Egyptian military supported a nationalist revolution in neighbouring Yemen, a small number of Saudi troops defected, and Egyptian subversion in Saudi Arabia picked up. Faisal again took over from Saud with the support of a number of powerful half-brothers (Lacey 1981, 341). At the time both Financial Times and Guardian expected the Saudi monarchy to follow the fate of its peers in Egypt and Iraq and be overthrown (Lacey 1981, 342). Other Gulf rulers were similarly concerned about a Nasserist revolution in the kingdom.[2]

Faisal once more reacted to the subversive threats with material welfare. The "ten point program" he announced in 1962 promised education, health and social welfare improvements; the program's political components included a constitution, a consultative assembly, local government and the creation of an independent judiciary. While Faisal implemented the welfare promises (Samore 1983,

[1] British Embassy, Amman, to FO, 17 Aug 62, outlining Saudi press conference criticism of Nasser [FO 371/165355]
[2] Secret memorandum of 15 Nov 1962: "Effects in the Persian Gulf of Developments in Yemen and Saudi Arabia", PM office to FO, 10 Dec 62 [FO371/162781]

164; Vasil'ev 1997, 434), and once again cut royal allowances,[3] he largely did not deliver on the political reforms (Yizraeli 2012).

The political motivation behind the regime's generosity was obvious to contemporary observers. A 1963 British assessment was that "Faisal knows that he must bring about reforms quickly if the regime is to survive."[4] Faisal had personally told his fellow ruler Rashid of Dubai that revolution came from poverty and that development was needed to forestall it.[5]

Like in the rest of the region, subversion did not disappear overnight. Revolutionary networks remained in the armed forces.[6] A coup attempt was reported in 1965,[7] followed by a more serious plot among nationalist army officers in 1969 (Lacey 1981, 381). The 1969 crisis seems to have pushed Faisal, who had become king in 1964, to pursue further social reforms and initiate the kingdom's first five-year development plan in 1970 (Samore 1983, 177, 246; Hertog 2010, 98f.)

Gradually, material welfare seemed to defang the militant opposition: A member of the Saudi Communist party complained of sagging revolutionary spirits after the 1960s as a broad-based consumer society emerged in the kingdom (Vasil'ev 1997, 464). In the 1970s, the Saudi regime proved particularly adept at co-opting dissidents, often into lucrative bureaucratic positions (Matthiesen 2014, 502). At the same time, the distributive state managed to gradually envelop all of Saudi society through provision of infrastructure, public services and employment. The dependence of both Saudi households and businesses on state resources reached unprecedented levels (Hertog

[3] Summary of 1963 budget, no provenance; Jedda to DS, 16 April 63 [FO 371/168880]
[4] Assessment of local governance, Jeddah to FS, 18 April 63 [FO371/168868]
[5] Telegram from Dubai to Foreign Office, 16 January 1967; telegram from Kuwait to Foreign Office, 28 March 1967; telegram from Dubai to Foreign Office, 9 October 1967; Political Agency, Dubai to Political Residency, Bahrain, 14 December 1967; record of conversation between the Political Resident and the Ruler of Dubai, 11 December 1967; conversation between Political Agent and Shaikh Rashid, 2 November 1967 [FCO 8/830] [find right doc]
[6] Possible Change of Regime in SA (top secret), c. 30 Sep 1964 [FO371/174671]
[7] FO minute reporting attempted coup, 27 April 65 [FO371/179878]

2009). As local business expanded rapidly, it did so almost exclusively on the back of state-provided privileges and demand, and largely based on low-cost expatriate labor that substituted for a local working class (Hertog 2010, 84–135).

Organized opposition virtually disappeared during the 1970s and only returned in Islamist garb in the early 1990s (when it again was undercut by a mixture of repression and co-optation; (Lacroix 2011). The deep patronage of the Saudi state seems to have bought "peace" for a very long time, both among the ruling elite and the population. Politics has not stopped of course, but it tends to happen within the state. To the extent that there is ideological contestation, this is usually with Islamist forces, and often over social issues and the control of state resources in education and judiciary rather than control of the political system per se (Hertog 2009; Lacroix 2011).

Different from what rentier state theory makes us expect, oil wealth did not automatically create political quiescence in the kingdom. Instead, if anything, it initially augmented political challenges from society as the potential material rewards from political contestation suddenly increased drastically. The regime's reaction to these challenges – large-scale patronage – did then however produce the political quiescence and fragmentation that rentier theories predict. The fact that very similar patterns of contestation and co-optation unfolded in other GCC countries from the 1950s to the 1970s suggests that there is a shared causal pattern (Eibl and Hertog 2016a).

## State fragmentation and fiefdoms

Broad-based distribution was a key motivation driving the expansion of the Saudi state apparatus. Yet the sudden availability of huge fiscal resources and the absence of formal political constraints also left much space for elite agency in shaping individual institutions. As a result of the princely rivalries and bargains of the 1960s, a number of parallel fiefdoms emerged that continue to dominate the Saudi state today. The Al Saud-controlled Ministry of Defense, National Guard and

Ministry of Interior developed into full-fledged states within a state, each with hundreds of thousands of employees (the Ministry of Interior recently seems to have reached 1 million), their own health and education systems, residential cities and large land banks. As oil income grew and senior princes competed for patronage and generosity, their institutions sprawled. At the same time, oil surpluses allowed Al Saud elites to build a number of smaller, insulated elite institutions headed by commoner technocrats and to co-opt traditional social forces like the religious establishment into new educational and judicial bureaucracies (Hertog 2010).

This fragmented process of state growth has made it hard to coordinate policy-making, while the use of state employment as distributive tool has made it difficult to hold bureaucrats accountable on a day-to-day level. As the state has become weighed down by its various distributional obligations, its autonomy to create or change institutions or economic policies has declined, as shown by the state's paralysis during the more austere 1980s and 1990s (Hertog 2010, 118–31).

When oil prices picked up again in the 2000s, the kingdom in many ways went back to the 1970s: new institutions and fiefdoms were built, state employment growth accelerated and subsidy and social transfer regimes were expanded. At no point in history has the Saudi state penetrated people's lives as deeply as it did at the peak of the boom in the early 2010s – a factor that likely has contributed to the muted local reaction to the Arab uprisings in 2011. At the same time, the dependence of Saudi business on state protection and support arguably increased again during the recent boom, after it had gained a modicum of autonomy in the 1980s and 1990s.

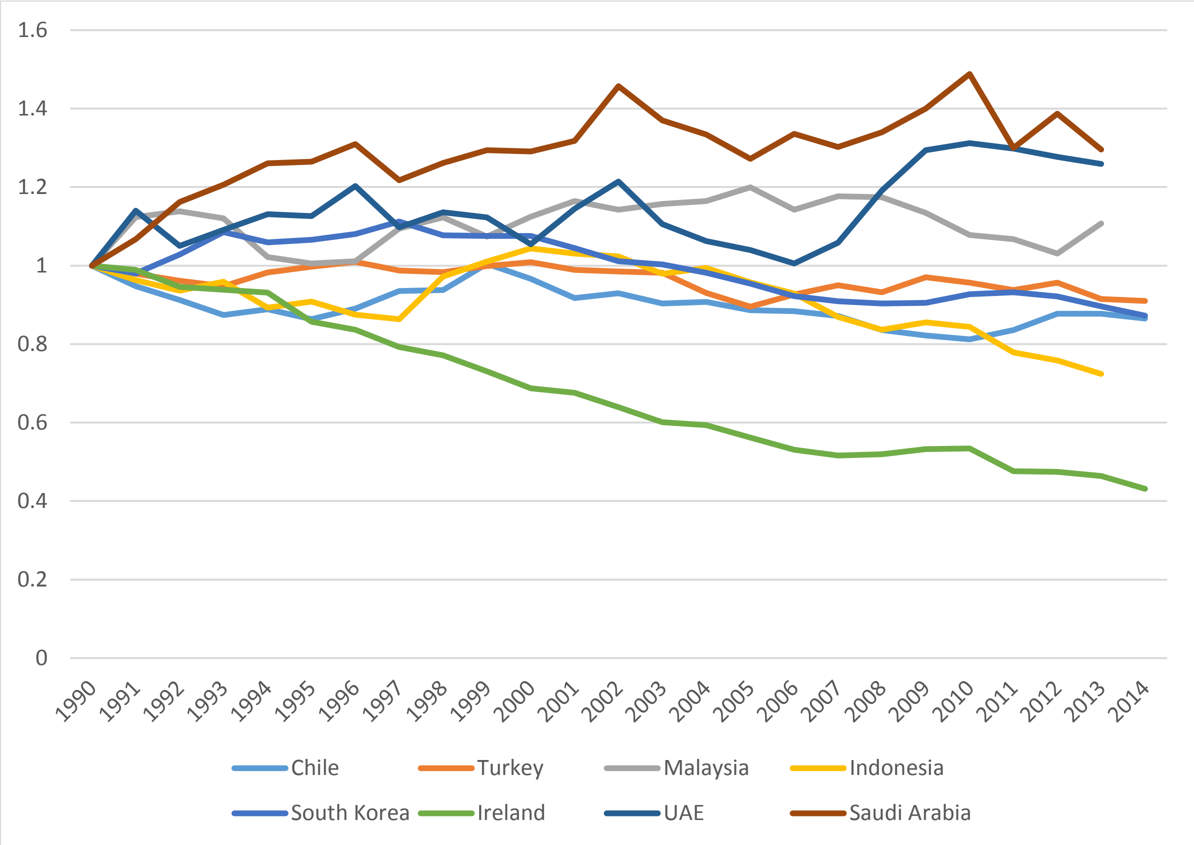
## Long-term consequences of wealth sharing

The Saudi brand of wealth-sharing is not egalitarian: State salary scales are less equal than in most Arab republics; women are excluded from large parts of state employment, and even young men often have to wait for many years until a government job becomes available. Energy subsidies are regressive as they disproportionately benefit larger and richer households. Saudi business remains dominated by a limited number of families with close government connections. Yet the breadth of wealth sharing is impressive and unlike anything seen in rich oil states outside of the Middle East (with the one exception of Brunei, which has a population of only 400,000).

The extent of wealth distribution also means that its distortionary effects on the Saudi economy are particularly wide and deep. These effects make the Saudi system costly and unsustainable in the long run. They are increasingly well known yet difficult to tackle without a wholesale re-engineering of the Saudi political economy, key features of which have become deeply ensconced since at least the 1970s oil boom.

The IMF estimates Saudi Arabia to have the highest energy subsidies in the GCC, reaching almost 10 per cent of GDP in 2011 (International Monetary Fund 2013). This has led to significant distortions in the Saudi economy which, different from most other countries in the world, has witnessed declining energy efficiency over the last decades (see figure 3). This falling efficiency has increasing economic opportunity costs, as growing domestic energy consumption has started to eat into the kingdom's energy export capacity. Very low energy prices have also spawned state-dependent industries and consumption habits that might not be economically sustainable when energy prices are brought closer to opportunity costs.

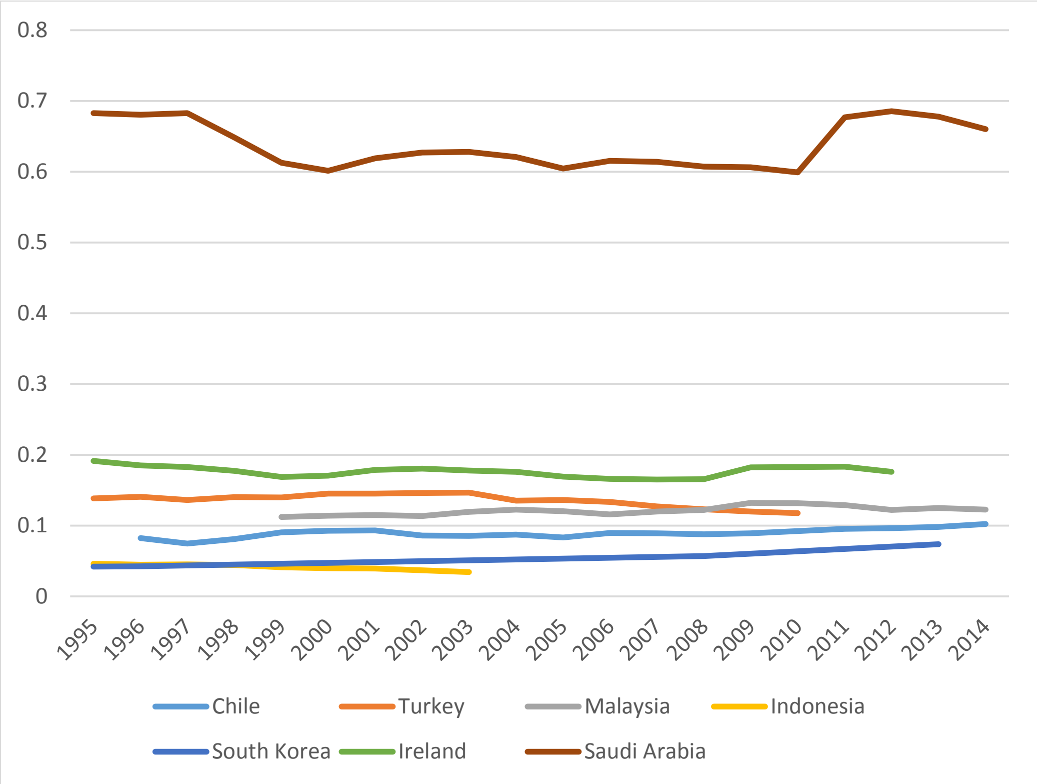
**Figure 3. Energy use (kg of oil equivalent) per $1,000 GDP (constant 2005 PPP)**




Source: World Bank

The Saudi patronage system gives even more problematic incentives in the local labor market, where two thirds of the national labor force remains employed in government (see Figure 4).

**Figure 4: Share of government employees in the economically active citizenry of select countries**[8]

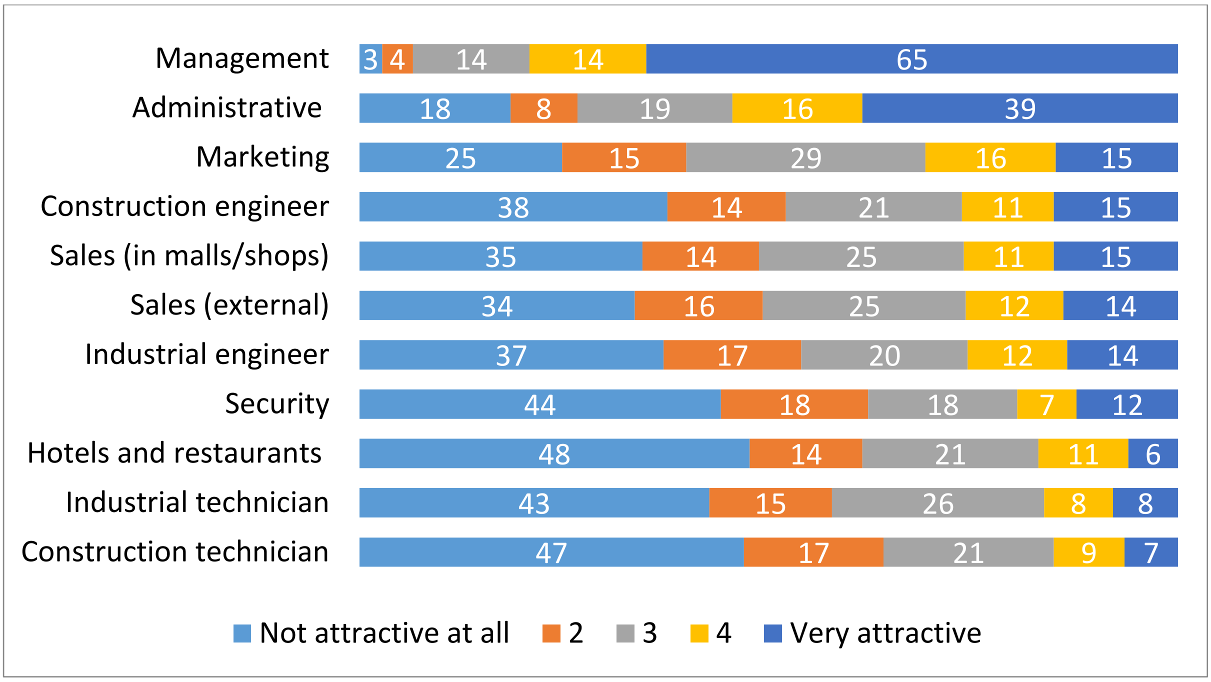



Source: World Bank, ILO, Saudi Labour Force Survey, and SAMA

This open-handed provision of government jobs has created labor market attitudes that in turn reinforce dependency on and expectation of state employment. Figure 5 below, based on a 2014 survey, shows that most Saudi job-seekers rank most of the jobs available in the local private sector as unattractive. The following figure 6 shows that even Saudis currently employed in the private sector would largely prefer government employment.

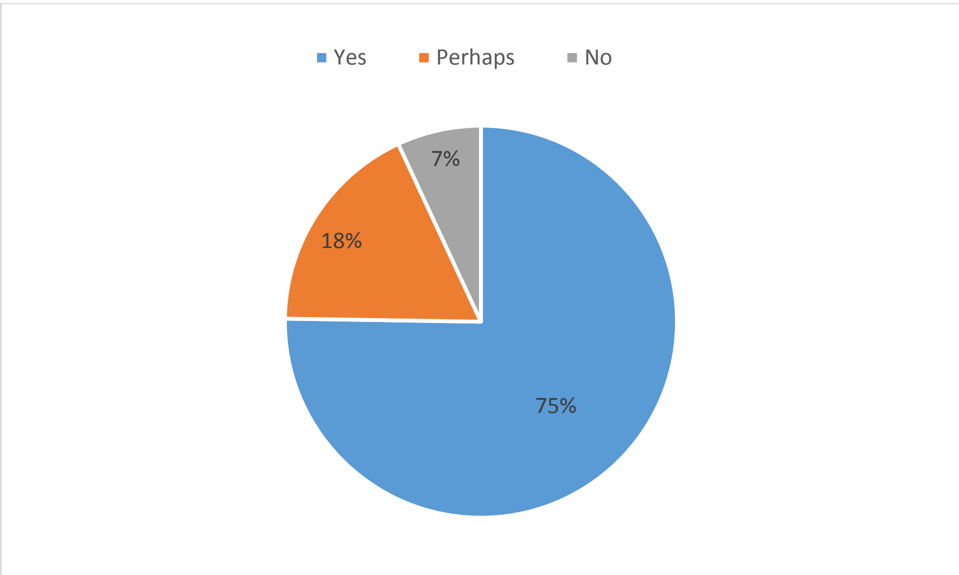
[8] The Saudi shares are calculated as (government employed)/(all employed + 10 percent unemployed), with all figures taken from labour force surveys. The data for the other cases are from ILO (public employment) and World Bank (economically active population). Public enterprises are not included for any of the cases, hence all figures are likely to be somewhat underestimated (possibly more so for Saudi Arabia, where important sectors such as mining, hydrocarbons, inter-city transport and aviation, utilities, and heavy industry are still largely in state hands). Non-Saudi cases include non-citizen employment, which could not be separated out but is unlikely to bias results strongly.

**Figure 5: Saudi job-seekers' ranking of occupations by attractiveness**




Source: 2014 Accenture/Yougov Saudization survey

**Figure 6: Would you accept a government job with similar salary, higher job security and working hours from 7:30 to 2:30 over your current job?**



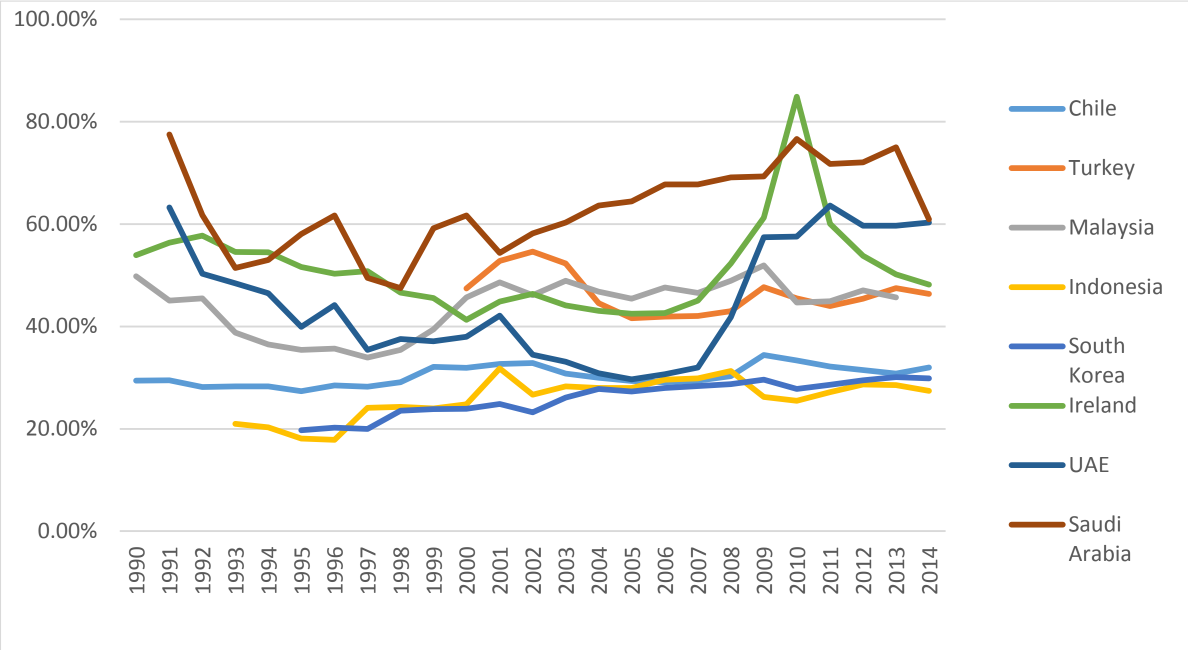

Source: 2014 Accenture/Yougov Saudization survey

Saudi expectations have been further raised by a higher education system that by now enrols almost three quarters of recent secondary school graduates, hence creating widespread expectations of white-collar employment despite the often questionable quality of tertiary degrees. Saudis are disproportionately enrolled for humanities degrees that are not in demand in the private sector, but which have historically provided the formal credentials needed to apply for government positions. Again, patronage has been reinforcing itself, creating dependencies and expectations that lead to demands for further patronage. The very welfare demanded by the nationalist opposition in the 1950s and 1960s has made Saudi society deeply dependent on the paternal, authoritarian state controlled by the Al Saud.

While the Saudi private sector has matured since the 1970s (Luciani 2006), it also remains directly or indirectly dependent on the state for most of its activities. Both subsidies and state-generated demand have created easy opportunities for profit that have undercut incentives to seek independent markets and sources of demand.

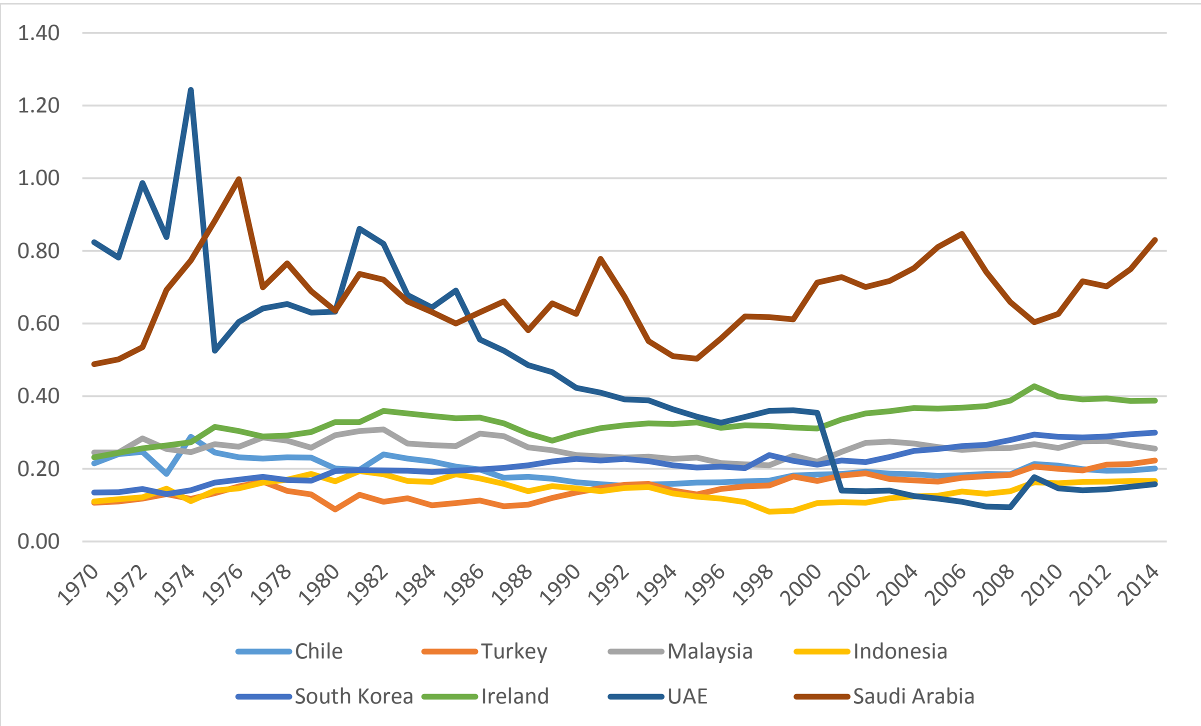
Figure 7 shows that the ratio of government spending to non-oil GDP in the kingdom is uniquely high, while figure 8 documents a very high ratio of public to private consumption. Both measures have, if anything, trended up during the last decade. They suggest that a) much of domestic demand is directly government-created and b) the fiscal multiplier through which government spending stimulates private economic activities is quite low. One reason for this is that much of the government-created demand "leaks" abroad as the private economic activity it stimulates leads to subsequent imports of foreign goods and services that are not part of local GDP, rather than creating knock-on demand for local goods and services.

**Figure 7: Share of government spending in non-oil GDP**




Source: calculated from UNSTATS and IMF data

**Figure 8: Ratio of government to private consumption in Saudi Arabia and select comparative cases, 1971 to 2014**

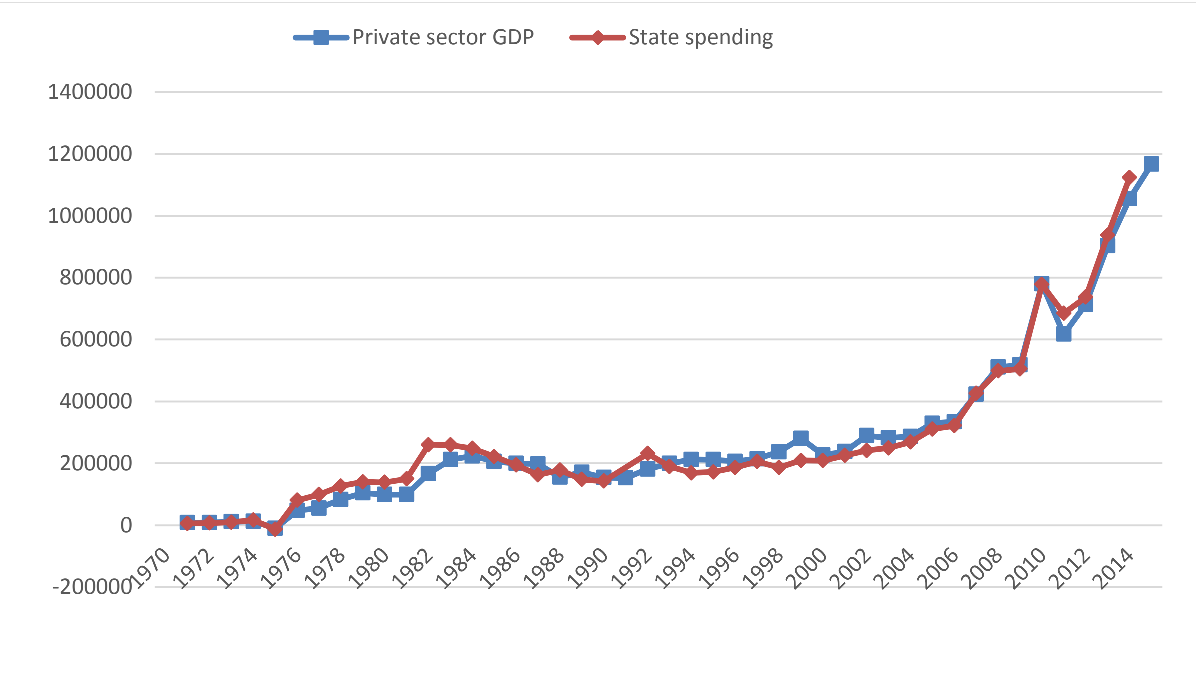



Source: calculated from UNSTATS data

Much of demand that is technically private is in fact also government created: Government salaries and allowances constituted more than 18 per cent of GDP in 2015, while private salaries to Saudis accounted for only about 4 per cent of GDP (a further 5 per cent is accounted for by salaries to expats, which are largely remitted abroad hence do not create much local demand).[9]

Unsurprisingly, the size of total private sector GDP in the kingdom remains closely linked to the total volume of state expenditure (see Figure 9). As there are few domestic taxes to finance government spending, it is clear that causality runs from (oil-financed) spending to private economic activity rather than the other way around.[10]

**Figure 9: Private sector contribution to Saudi GDP vs. total government expenditure (million SR)**




Source: Based on SAMA data

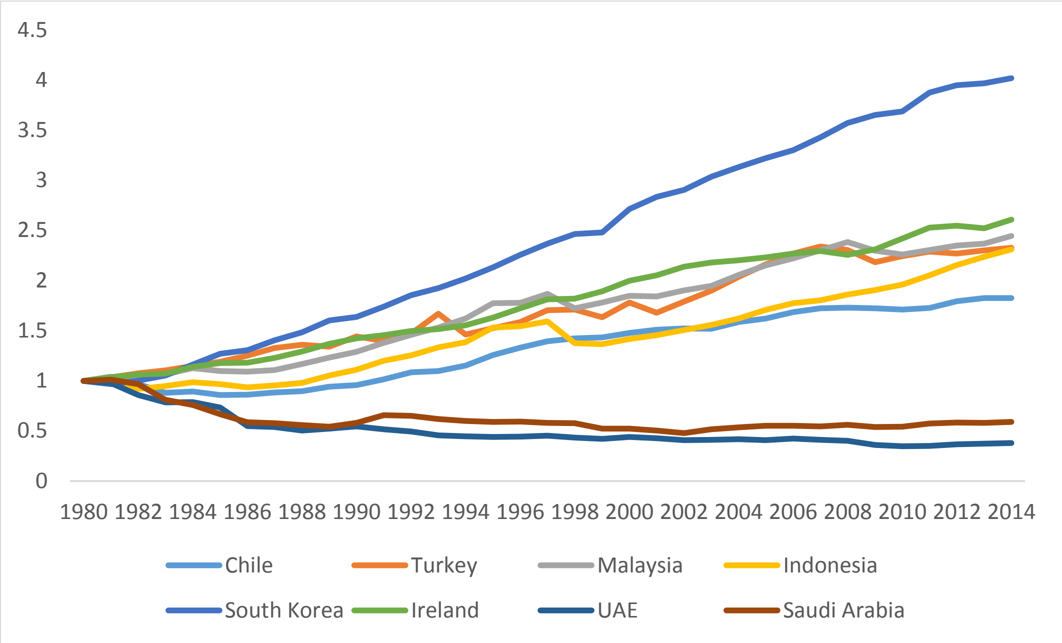
[9] Estimates based on data from Ministry of Finance budget statements, SAMA yearbooks and Ministry of Labour yearbooks.

[10] This direction of causality is also confirmed by recent IMF research (International Monetary Fund 2016, 56–60)

Private employment remains dominated by foreign workers, who outnumber Saudis in private jobs by about five to one. This is part of the distributive bargain for both businesses and households: Businesses obviously profit from cheap and easily controlled foreign labor, especially at times of rent-financed economic expansion. Saudi households too benefit from cheap services provided by foreigners. As important, the presence of a large foreign work force has historically obviated the structural need for citizens to participate in the more demanding private labor market; a majority of national households can instead draw on more convenient government salaries and transfers.

Reliance on low-cost foreign workers does not only limit privately financed household demand in the Saudi economy. The predominant focus on low-skilled workers also has led to low and stagnant productivity levels (see Figure 10). As private Saudi employers effectively face a flat international labor supply curve, they can always expand production by just adding more cheap foreign labor instead of investing in skills or upgrading their production structures. The labor scarcity that has pushed other Western or Asian countries into industrial deepening does not apply in the Saudi distributive state.

**Figure 10: Relative labor productivity growth in comparison (1980=1)**




Source: Conference Board

While Saudi business can pay low wages to its expatriate labor, non-wage costs of migrant labor recruitment are significant and foreign workers' reservation wages for work in Saudi Arabia significantly higher than what they expect to be paid in their home countries. This means that labor cost in Saudi Arabia, while lower than in advanced countries, is still high compared to low-wage developing countries – and this is even more so where Saudis are privately employed. This means that the labor-intensive strategy of industrialization with which most successful emerging economies have started their industrial upgrading process is not feasible.

The Saudi combination of low and stagnating productivity with relatively high operating costs creates a rather unique development trap that is hard to escape. Saudi businesses – incentivized to cater to a captive local market – have found it difficult to break into the production of exportable goods outside of energy-intensive industries that rely on state-provided cheap energy. The kingdom's exports outside of oil and heavy industry are miniscule and mostly low-tech; according to the World Bank, less than 1 per cent of Saudi manufacturing exports are classified as hi-tech.

The Saudi wealth sharing regime has bolstered political stability since the 1970s, but has created deep dependencies and distortions that have become a threat to the kingdom's economic sustainability. Even incomes and activities that are formally private – and which are supposed to drive the kingdom's future non-oil diversification – are often predicated on continued state patronage. While there would be ways to re-engineer rent distribution to make it less distortionary and to incentivize more genuinely private activities, creative thinking about such alternatives remains in short supply (Hertog 2014).

## New fiscal challenges

Three years after the 2014 collapse of the oil price, public employment and cheap energy remain the main channels of broad-based rent distribution and economic stimulus in the kingdom. That being said, a sense of crisis has set in much faster in Riyadh than was the case during the austere years of the 1980s and 1990s under King Fahd. The policy reactions to growing deficits, while partial, have been much quicker – and they have been accompanied by changes to the ruling elite that are comparable in depth only to the royal reshuffle the kingdom saw in the troubled 1950s and 1960s.

### Adjustment steps

Key components of the kingdom's post-2014 economic policies are the "Vision 2030" and the 2016-2020 "National Transformation Program" that were published in the first half of 2016 and hold out the promise of a private-driven, post-oil economy. At the same time, and more concretely, the government has undertaken several significant steps of fiscal adjustment in 2016.

The accelerated decision-making is the result of a fundamental shift in the kingdom's elite politics. The key economic policy maker behind recent measures has been Deputy Crown Prince Mohammad bin Salman. His father King Salman succeeded King Abdullah in January 2015 and has since given his favourite son wide latitude to shape the kingdom's economic and military strategy.

Salman is the last surviving player of a core group of brothers and half-brothers that used to rule Saudi Arabia collectively since they wrested power from King Saud in 1962, resulting in the above-mentioned institutional fragmentation and elite-level checks and balances (Al-Rasheed 2006; Herb 1999; Hertog 2010). Now that all of the old veto players are gone, Salman has enjoyed unprecedented autonomy in reordering the ruling family. To be sure, two brothers of Salman have been able to bequeath core state institutions to their sons: Mohammad bin Naif remains in charge of his father's Ministry of Interior, while Mit'eb bin Abdullah now controls the National Guard, which his father had previously controlled for more than 50 years (for a variety of reasons, sons of Salman's senior brothers Fahd and Sultan and Fahd were less lucky).

Both institutions remain large and important, providing employment and patronage for hundreds of thousands of Saudi households. Yet they do not convey as much power on the top level as they did under the previous generation. Personality and relationship to the current king matter much more: Mit'eb is of far lesser stature than his father for example, and Mohammad bin Naif, although Crown Prince and an experienced policy-maker, was side-lined during much of 2015 and 2016 in favour of Mohammad bin Salman in all policy areas bar internal security. Similarly, the Riyadh governorate, once Salman's key fiefdom, now is of much less importance under his successor as governor Khalid bin Bandar.

All this indicates that power structures at the top level are determined by informal family politics at least as much as princes' formal position or the sheer weight of the institutions they control – as important as the latter remain in structuring quotidian wealth distribution and bureaucracy in the kingdom. As the transition to the next generation of Al Saud was delayed until almost all members of the old ruling generation had died, no-one in the new generation, with the partial exception of Mohammad bin Naif, has been able to establish anything like the autonomous political stature that members of the old guard enjoyed.

The more centralized new generation leadership has fewer political sensitivities about established family hierarchies and a much larger appetite for risk than the consensus-oriented previous leadership had. That said, the top-level reshuffle has also produced some familiar patterns of bureaucratic politics: Similar to the growth of new institutions around the new leadership in the 1960s and 1970s, new institutions have come into being or been empowered as personal tools of the Deputy Crown Prince, notably the new Council of Economic and Development Affairs (which different from its predecessor, the Supreme Economic Council, excludes the Crown Prince), the Public Investment Fund, various new economic commissions, and a re-engineered and expanded royal court – all while most of the existing institutions remained untouched. Like in the transition to the de facto rue of Mohammad bin Zayed in Abu Dhabi after his father Zayed's death in 2004, international consultants have also suddenly started to play a key role in policy-making at the very top level of government, adding another layer of complexity and parallel structures to government.

The main sign of the new centralization of power and risk appetite on the domestic front has been the unexpectedly strong fiscal adjustment the kingdom has gone through since late 2015, involving energy price increases, hikes in various administrative fees, the announcement of (still to be implemented) land taxes and a VAT, a freeze in public sector hiring and, most notably, substantial cuts to the allowances of public sector employees in September 2016, which according to some estimates amount to close to 20 billion USD. In December 2016, the government announced a four-year "fiscal balance program" that will lead to further taxes on soft drinks and cigarettes as well as, more substantially, gradually increasing fees on foreign workers and further hikes in energy prices – albeit partially cushioned through a new, means-tested household cash grant.

This fairly rapid adjustment differs drastically from King Fahd’s days of cautious austerity in the 1980s and 1990s, when the regime went to great lengths to spare the population from any broad-based cuts, and when government employment continued to grow every single year (Hertog 2010, 118–31). The only salient commonality between Fahd’s austerity and the current fiscal policies are freezes in government payments to private contractors and drastic cuts in capital expenditure – generally seen as politically less sensitive as they do not directly affect most of the citizen population.

The “National Transformation Program” (NTP) published in early June 2016 aims to increase the government’s non-oil revenue from 165 billion SR in 2015 to 530 billion by 2020 with a view to re-balancing the Saudi budget by then. 530 billion SR are equivalent to 44 per cent of the Saudi private sector’s contribution to GDP in 2015 which – assuming that most non-oil revenue has to be generated locally – would potentially entail going from practically no local taxes to OECD-style taxation levels within four years. While this objective is unlikely to be accomplished in such a short timeframe, it gives a sense of the new leadership’s ambitions.

## Reactions to fiscal adjustment

The most immediate impact of the austerity has been a sizeable dent in the growth and confidence of the local private sector, which is expected to expand by only 0.7 per cent in real terms in 2016, which given the kingdom’s continued population growth implies shrinkage per capita. This contrasts sharply with real growth levels between 5 and 10 per cent p.a. during the boom years from 2009 to 2014. The construction sector has been hit particularly hard by non-payment of government contracts and reduction of capital expenditure. But consumer-focused sectors that were relatively protected during the 1980s and 1990s austerity such as retail have also contracted from mid-2015 to mid-2016. Manufacturing has similarly shrunk due to partial increases in energy prices.

Total private sector growth during Q3 of 2016 was negative. The overall mood among both population and businesspeople in Riyadh has shifted discernibly from the first half of 2016, when Vision and NTP were announced, to the second half, when deeper austerity kicked in. Available statistics on foreign exchange transactions indicate significant private capital flight from the kingdom, different from the 1990s when Saudi banks and large families repatriated capital to purchase government bonds.

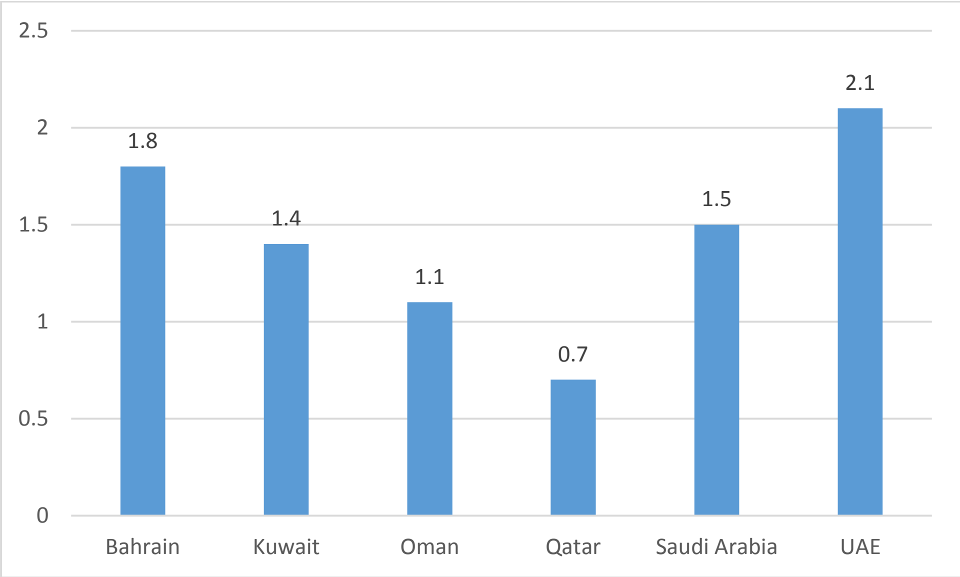
The negative impact of austerity seems to have been stronger than the government expected, yet should have been predictable given the private sector's deep dependence on state spending outlined above. The allowance cuts alone seem to have cut average incomes of Saudi state employees by up to 20 per cent. To get a sense of the magnitude of these cuts relative to private sector activities, consider that their aggregate volume is equivalent to two thirds of the aggregate of *all private sector salaries* paid to Saudis – creating a potentially substantial gap in consumer demand. Based on 2016 IMF estimates of fiscal multipliers (International Monetary Fund 2016, 57), the allowance cuts alone could shave about 2 percentage points off non-oil GDP over a period of two years, assuming they are fully implemented. Further cuts through the fiscal balance program would further eat into domestic demand generation.

While the generation of non-oil revenue is a worthwhile target, the centrality of state spending in the economy means that the kingdom's domestic tax base itself is dependent on state spending. High levels of taxation would reduce the state's effective demand stimulus, depress business activity and potentially lead to further capital flight at a time when local business is already skeptical of investing in the Saudi economy because of plateauing or declining state spending. The higher domestic price levels resulting from taxation would also exert upward pressure on government expenditure that relies on local suppliers – the financing of which in turn could require even higher taxation levels. Tax-induced inflation would also lead to real appreciation of the (pegged) Saudi Riyal, reducing the competitiveness of future non-oil exports and potentially diverting more domestic spending towards imports.

In tax-based economies, fiscal stimulus can potentially enlarge the tax base, allowing governments to recoup some or all of the extra spending through taxes. But Saudi Arabia is still far away from such a "Keynesian multiplier" mechanism: For the foreseeable future, leakage of state-generated demand towards imported goods and services will remain large, thereby blunting the growth spill-overs of fiscal policy, while taxes as share of the private economy will remain too low for the state to be able to recoup much of whatever local stimulus it generates.

Generating non-oil revenue is important and the government's efforts appear serious, but there are strict short-term structural limits to increasing such revenue without shrinking the local economy. Available estimates of the revenue potential of most new fees and taxes are modest: A recent discussion of Saudi VAT plans by JP Morgan indicates that the kingdom will raise 22 billion SR of revenue through this tax, which is a mere 0.8 per cent of GDP (the IMF estimates a more optimistic 1.5 per cent). The new foreign worker levy alone is likely to raise more substantial revenue, reaching an estimated 65 billion SR per year by 2020 – but probably with significant knock-on effects for inflation and business profits.

**Figure 11: Estimated revenue from a 5 per cent VAT as share of GDP (IMF)**




Source: IMF

Most private business activities in the kingdom are predicated on direct or indirect state support. For the same reason, the diversification promised by Vision 2030 and NTP remains a long-term ambition. While the Saudi private sector has built real capacities since the 1970s, it mostly caters to a domestic market that relies on state-generated demand, and has developed production models that rely on state protection and state-provided subsidies. Some private sector leaders privately admit their confusion over which concrete policy measures the Vision entails and ask why the government has not systematically consulted them in the process of drafting it. The contrast between the concrete fiscal cuts that have hit the profits of Saudi business and the lofty but long-term ambitions of the Vision has created some frustration among Saudi merchants.

As discussed above, the Saudi distributive state has also created deep institutional legacies, which include an overstaffed, slow-moving and fragmented bureaucracy as well as the historical co-optation of religious forces with little understanding of modern commercial law into the judiciary. These create a difficult regulatory and bureaucratic environment that has changed little since 2014 according to local lawyers and businessmen as well as international rankings of institutional performance. While civil service reforms are an important component of the NTP, changing the behaviours and incentives of about 3.5 million state employees after decades of patronage employment is a secular and politically difficult task – as was reflected in the public backlash after the current Minister of Civil Service stated on TV in October 2016 that Saudi bureaucrats only work an average of one hour per day. The kingdom's challenging institutional environment is a further factor that disincentivizes the taking of entrepreneurial risks and investment in new sectors.

While the Saudi regime enjoys an increased level of political autonomy at the top level, the structural legacy of the distributive state below the top is deep: Low productivity and dependence on cheap but low-productivity foreign labor which substitutes for a local working class, dependence of business and Saudi households on state support, a relatively high domestic cost base, and a sprawling bureaucracy that serves as employment machine for citizens are deep-seated and in many ways interdependent. They all will make competitive, export-oriented economic development difficult.

Saudi Arabia would be the first high-rent oil country to achieve genuine private-driven diversification. While the task is not impossible, it is not clear that NTP and Vision address the key structural constraints, price distortions and institutional bottlenecks resulting from the distributive legacy of the Saudi state. Specifically, without a move from state employment and subsidies towards more incentive-neutral ways of sharing the kingdom's wealth with business and citizenry, incentives will remain stacked against autonomous private growth.

## Households in the era of austerity

Real incomes and employment for Saudi households have been affected surprisingly quickly by the new austerity policies. As the private economy remains strongly state-dependent, private job creation has stalled at exactly the time when the Saudi government has stopped hiring, leading to flat employment growth in 2016 despite a rapidly growing working-age population.

Austerity has led to fairly open expressions of discontent on Saudi social media and even some local newspapers. That being said, to the surprise of many observers (including local ones), the scaling down of decade-old distributional commitments has not given rise to any open unrest or oppositional mobilization. There are diffuse complaints about the fact that royal family allowances seem to be almost the only budget item untouched by austerity, and the deep involvement of many royals in local land markets at a time when the national housing shortage has become acute. Some intellectuals also mention the link between taxation and political representation. Yet none of this amounts to an organized political reaction to the regime's partial reneging on its patronage commitments. Instead, there seems to be a widespread sense of fatalism among Saudis, who compare the stability of their own country to the chaos in many neighboring countries and see no realistic alternative to the present regime.

The ability of the leadership to impose austerity suggests that much of the previous elite commitment to stable mass patronage in the 1980s and 1990s might have been self-imposed: the result of elite bargaining and princely risk aversion – potentially rooted in royal memories of the tumultuous 1960s – rather than genuine pressures from below. It is clear that recent austerity steps violate established clientelist expectations. Yet decades of patronage have also made Saudi society so state-dependent, and have undermined the formation of independent social groups to such an extent (Hertog 2009), that society has been unable to mobilize against austerity. Should fiscal cuts be slowed down or reversed in the future, this is likely to be the outcome of elite conflict rather than anything else.

The swift, unchallenged imposition of austerity after the oil price collapse presents a striking contrast to the politics of patronage in the 1950s and 1960s, the last time the royal leadership was fundamentally reshaped and the future of rent distribution was at stake: Back then, the Al Saud faced and feared open ideological challenges, and reacted with increased generosity. Nowadays, decades of patronage seem to have removed ideological alternatives to the Al Saud, whose rule over the kingdom is not even challenged by most political dissidents. The rentier state, whose growth was once triggered by subversive challenges, seems to have done its work of undercutting independent opposition most thoroughly. The "Islamic State" alone poses an ideological challenge of sorts to the Al Saud, but it so far has directed most of its energies towards the Syrian and Iraqi theatres – and it certainly does not make any concrete programmatic demands on public goods provision like the nationalists and leftists did two generations ago.

None of this is to say that more contentious politics might not return, possibly if harsher steps like a reduction in the number of civil service workers are taken or if continued current account deficits and capital flight lead to a devaluation of the Saudi Riyal and hence an imported inflationary shock. For time being, however, it seems that the depoliticizing effects of patronage that set in from the 1960s on are long-lasting, even at a time when patronage is reduced. The Al Saud family is sits at the centre of the omnipresent Saudi distributional state and thereby has become an indelible fact of Saudi life.

The most likely future scenario right now seems to be survival of the Saudi system, but with diminished patronage powers. A less distorted labor market might gradually emerge as new public jobs remain scarce and Saudis reorient themselves towards less lucrative private employment – although a truly integrated labor market would require substantial reforms to the migrant labor regime that both businesses and household might resist. The least optimistic economic scenario would be a gradual "Egyptianization" of Saudi Arabia, under which real incomes decline and public service provision is stretched thin but households and businesses continue to be oriented towards government patronage, all the while a bloated bureaucracy makes life difficult for citizens and businesses alike.

## Conclusion

Saudi Arabia has entered another era of fundamental political, social and economic change, similar to the one it witnessed in the late 1950s and early 1960s. The full consequences are not yet clear – arguably not even to the kingdom's current leaders. What is clear is that the legacies of the distributive state that was created half a century ago will continue to strongly constrain the policy options of even the most ambitious leadership. The level of patronage entitlements in the Saudi economy are unique for a mid-income country. The experiment to try to move this system from a state-driven onto a private growth path is similarly unprecedented.

The two years of elite change and reform since 2014 do allow us a few comparative remarks against the background of earlier periods of state building: First, while the large institutional fiefdoms of the Saudi state have not disappeared, they now convey less power at the top level, indicating that the influence of senior regime players has at least as much to do with their history and position in the family as with the institutional resources they control. Politics at the top remains informal. Secondly, it is now clear that some of the past patronage obligations of the regime have been voluntary and potentially reversible, possibly created and maintained through a contingent power balance among ruling elites. Again, personality and elite politics continue to matter more in the mature Saudi state than I anticipated in Princes, Brokers and Bureaucrats. Third, and in line with past patterns, political change is once more accompanied by the creation of new, often parallel institutions, potentially deepening institutional fragmentation below the top leadership – despite the centralization of the latter. Oil rents and political autonomy of the leadership still allow institutional experiments. Fourth, structural change below the top level of the state apparatus remains very slow, often disconnecting the bulk of the state apparatus from the current leadership's ambitious top-down reform projects.

The Saudi oil state provides much better infrastructure and public goods than its more kleptocratic peers in other world regions. Yet, in pursuing economic adjustment, it now is probably more hampered by its distributive legacies than klepto-states like Angola, Gabon or Equatorial-Guinea. While these legacies will continue to guarantee comparatively high (if potentially declining) levels of citizen welfare, they will also reproduce structures of state dependence for households and businesses. These would appear to be good ingredients for political survival but also for gradual economic diminishment.

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