ECONOMICS IN FOCUS

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Saudi Arabia: Saudization and the private sector employment challenge

Employment for Saudi nationals (Saudization) and the issue of labor market reform in Saudi Arabia, as in the rest of the GCC, has rapidly moved up the policymaking agenda in recent years as the kingdom adjusts to an era of lower oil prices, extended budget deficits and slower growth. The need for the private sector to pick up the mantle for Saudi nationals' employment has taken on added urgency. Under the revamped 'Nitaqat' program of 2011, it has accelerated but produced mixed results: the labor force has substantially expanded, but the number of Saudis in private sector jobs remains low amid still sizeable wage and other non-pecuniary benefits differentials compared with public sector jobs. Reforms have commenced, but progress has been uneven.

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Reconfiguring Saudi political economy to reap employment dividends

Saudi Arabia's Vision 2030 strategy and the various delivery plans introduced by the government, such as the National Transformation Program (NTP), envisage a fundamental reshaping of the productive and employment base of the kingdom in order to accelerate economic diversification and expand labor force participation and employment. Where once the government drove the economic model, as steward of hydrocarbon resource extraction and employer of first resort for nationals, now private enterprise is expected to be the engine of economic growth and provide the bulk of employment. This is the case in most advanced, free-market economies.

Over the past four decades or so, the proceeds from oil have facilitated rapid economic growth and supported strong job creation. Thanks to expansive government spending, employment has grown at faster rates than in other emerging economies, with the result that wealth and standards of living in Saudi Arabia and the GCC are among the highest in the world. Saudi GNI per capita has increased more than twenty-fold since 1970, from $930 to $21,540 2018.[1]

But due to sizeable demographic increases, stubbornly high unemployment, including youth unemployment, and a dwindling public sector capacity to absorb labor force entrants in the context of fiscal pressures, the socio-economic model of old is proving unsustainable. That model is characterized by the dominance of the public sector over the private sector, by the crowding out of non-extractive industries, by the extensive welfare system and by the preference of local firms for foreign over domestic labor. Reconfiguring the existing economic and social paradigm, where citizens are provided with jobs for life and cradle-to-grave welfare and where businesses are given free rein to import cheaper foreign labor, has proven especially challenging. For the private sector, the imposition of Saudization targets and foreign labor fees have raised the cost of doing business and impacted profits, adversely affecting growth of the non-oil sector.

[1] Gross national income (GNI) per capita, World Bank, https://data.worldbank.org/country/saudi-arabia

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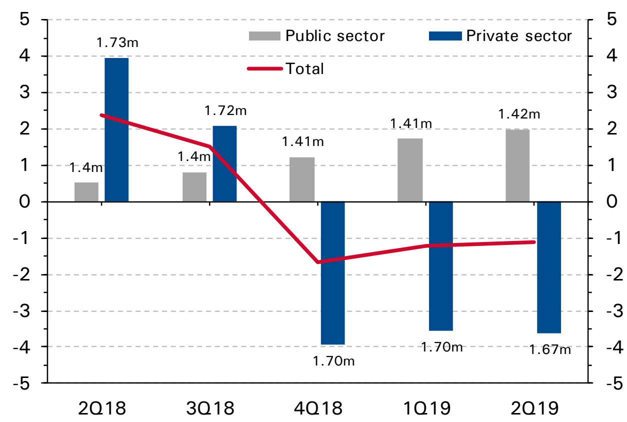
The nationalization of the labor force, which is a commendable objective, appears irreversible, notwithstanding calls to phase in the new policies and austerity measures more gradually. Under the present economic and political circumstances, the risks of reform rollback may be significantly less, although some changes along the way could still be introduced to mitigate the negative impact of specific reforms.

Recent trends in Saudi private sector employment

As of the second quarter (2Q) of 2019, there were 1.67 million Saudis working in the private sector, based on the administrative records of the Saudi General Organization for Social Insurance (GOSI).[2] This figure represents 54% of the total number of employed Saudis.

Of concern, however, is the fact that private sector employment growth over the twelve months to June 2019 has been negative, with a net loss of 62,660 (-3.6% y/y). (Chart 1.) It is not clear if the loss is due to Saudis leaving the private sector voluntarily to join the government or that firms have shed rather than created jobs for Saudis.

Chart 1: Employment growth (private and public sector)

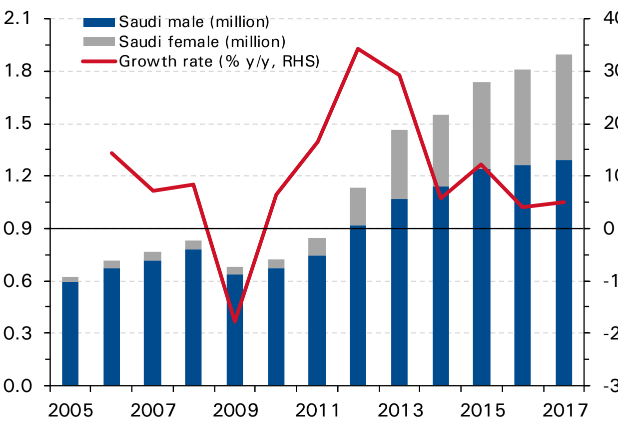


Source: GaStat

Admittedly, a year is not a sufficient amount of time from which to observe trends and draw meaningful conclusions. However, using annual Saudi labor force in the private sector data (to 2017) shows that the growth rate has been generally slowing since 2013/14, reaching just 5% in 2017. (Chart 2.)

In contrast, the public sector created 27,565 jobs (+2% y/y) for Saudis in the 12 months to June 2019, or about 6,891 jobs on average per quarter. The total number of public sector employees reached 1.42 million in 2Q19, the majority of whom are civil servants registered on the books of the Civil Service Ministry (MCS). This is a record high.[3] At first blush, the number of employed Saudis, at 3.09 million, would appear to be at its lowest level in more than two and a half years, but these figures discount military/security personnel and employees unregistered with the official administration agencies, and this could explain the drop in the unemployment rate to a three-year low of 12.3%.[4]

Chart 2: Saudi labor force in the private sector



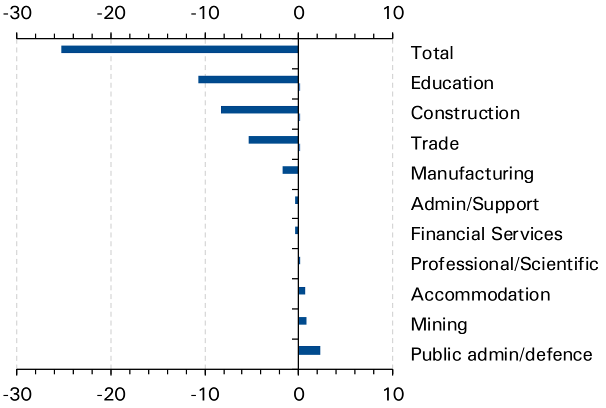
2 Private sector classified as establishments of fixed location that produce goods or services and owned by one or a group of private individuals. Excludes self-employed individuals.
3 As published in GaStat's quarterly labor market bulletin, which is based on administrative records that do not take into account military/security and unregistered personnel.
4 Important to note that GaStat labor market data is run off two data sets. Private and public sector employment figures are based on the administrative records of the Ministry of Civil Service (MCS) and General Organization for Social Insurance (GOSI) while the labor force, unemployment and participation rates etc. are estimated from GaStat's quarterly Labor Force Survey (LFS).

The recent trends in both Saudi private and public sector employment growth suggest that Saudi employment is moving in the opposite direction to government targets. Almost all the Saudi private sector departees originated from three sectors: education, construction and wholesale & retail trade. Manufacturing also recorded net outflows of Saudis. (Chart 3.)

Source: SAMA from Saudi Ministry of Labor & Social Development (SMLD)

Chart 3: Saudi employment growth (by sector) in 2Q19

(quarterly change q/q, thousands)



Source: GaStat

Losses in the trade, construction and manufacturing sectors is very much in keeping with the pattern observed since early 2018 and across both Saudi and expatriate demographics. This should concern the authorities as these economic clusters are important drivers of GDP growth (accounting for 27% of GDP in 2Q19) and key pillars of the Saudi Vision 2030 strategy. The drop in manufacturing sector Saudi employment is a particular source of concern given the importance attached to it in initiatives such as the National Industrial Development & Logistics Program (NIDLP). This program was launched in 2019 and aims to stimulate the development of Saudi industry—manufacturing, energy, mining & logistics—through investments of SR1.6 trillion ($427 billion) and the creation of an estimated 1.6 million jobs by 2030.

Employment gains were visible, however, in the mining, public administration, defense, and accommodation & food services sectors. The government introduced several measures to unwind rigidities in the system and liberalize these sectors. A law was recently passed to allow retail shops and businesses to operate 24/7. And the kingdom recently opened up its tourism sector to non-religious international visitors, including by making visas easier to obtain. According to the Vision 2030, the government aims to create 1.2 million jobs in the tourism sector by 2030.

So where did these 62,660 ex-private sector employees go? The net gain in public sector employment of 27,565 Saudis (including non-civil service public sector workers) in the 12 months to 2Q19 cannot entirely explain it although Saudis still prefer government jobs. They could have moved into jobs not covered by or registered under the administrative records, such as the self-employed and the military/security services; some of them could simply have retired. It is unlikely that they left their private sector jobs to become unemployed, though.

The private sector: a job less enticing for Saudis

Attracting Saudis to the private sector has been a historically difficult challenge. Under 30% of working Saudis are employed in the private sector.[5] This is one of the lowest ratios in the world when you consider that in advanced and emerging economies the private sector usually accounts for around four fifths of total employment.[6]

As with the rest of the GCC, the government sector in Saudi Arabia is the destination of choice and the employer of first resort. In contrast, the private sector is dominated by expatriate workers, accounting for 80% of total employment in this sector. Indeed, almost all of the expatriates in the kingdom (99%) work in the private sector (excluding domestic workers), of whom the vast majority are low-skilled construction workers and low-paid retail and services employees.

The differences are stark, as is the difference in growth rates between Saudi public and private sector employment growth, which were 2% y/y and -3.6% y/y in 2Q19, respectively. At the heart of the issue is the disparity in Saudi wages and working conditions between the private sector and the government sector that tend to favor the public sector. Similarly, differences in wages and employment rights between Saudis and expatriates in the private sector make hiring foreigners

[5] Estimated using a combination of administrative records and the LFS.

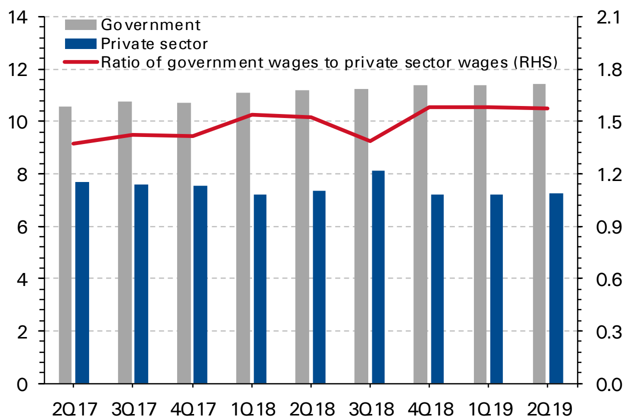
[6] Hertog, Steffen, Can we Saudize the Labor Market Without Damaging the Private Sector? King Faisal Center for Research and Islamic Studies, November 2018.

the more attractive option. On the first point, Saudis prefer the higher income and greater job stability that a government sector job provides over the typically lower salary and competitive environment of a private sector firm. According to the most recent labor force survey, public sector wages were around 1.6 times higher than private sector wages at SR11,450 ($3,053) per month. (Chart 4.) However, this *average* wage discrepancy is exaggerated since it does not take into account the difference in skills, whereby a great majority of those working in the private sector are low-skilled with low salaries. Saudi government employees also enjoy typically shorter working hours, greater holiday entitlements, regular promotions and a lifetime guarantee of employment.

In a 2014 survey of private sector employers that asked the question of whether the government was the main competitor in recruitment, more than two thirds of employers agreed at least somewhat with this statement.[7] Many private employers suspect that a considerable proportion of their employees are already on waiting lists for government jobs and could leave as soon as vacancies come up. The survey was also extended to existing private sector employees, 76% of whom admitted that a job in the government sector that provided shorter working hours and increased job security—even at the same level of pay—would be preferred.

Chart 4: Saudi wages in the government and private sectors

(thousand SR per month)

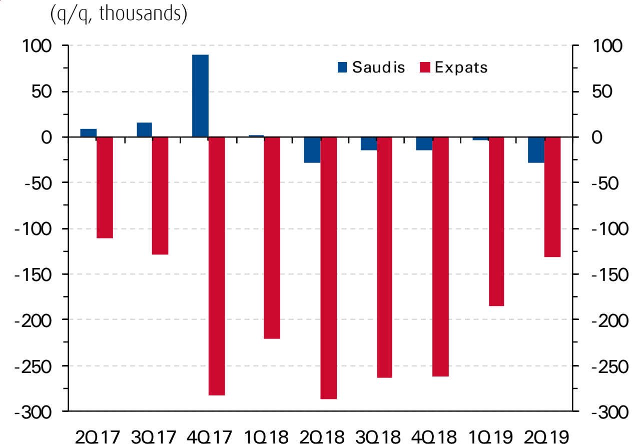


Source: GaStat Labor Force Survey (LFS)

Part of this preference also relates to the implicit social contract between citizens and the government. Citizens consider that they have the right to public sector jobs, and, in turn, the government considers that it has an obligation to provide such jobs. In addition, Saudis, like most other GCC nationals, eschew blue-collar work for white collar, higher status, positions. For example, between 2Q17 and 2Q19, when the authorities rolled out fees and levies on expatriates and took a firmer line with firms on Saudization, a cumulative net total of 1.76 million expatriates left their private sector jobs; a mere 3,035 Saudis took up private sector employment over this period. (Chart 5.)

Chart 5: Saudi and expat private sector employment growth

(q/q, thousands)



Source: GaStat(based on GOSI, MCS records)

This cultural predisposition is particularly strong in richer GCC countries like Saudi Arabia, Kuwait, the UAE and Qatar but less so in Bahrain and Oman, where it is common to see nationals accept lower paid service sector work.

Naturally, foreign expatriates, who left their countries to seek better opportunities in a foreign land, are more willing to work longer hours and for less than their Saudi counterparts. The de-facto minimum wage for Saudis is SAR3,000 a month ($800) versus SAR1,500 a month ($400) for a comparably skilled expatriate worker.[8]

Also, due to the fact that foreigners require a local sponsor for residency, expatriates tend to be much less mobile than Saudis when it comes to changing jobs. Faced with lower employee turnover, lower salary requirements and working condition expectations, it is little wonder that firms eyeing competitiveness and profitability, whether domestically

[7] Hertog, Steffen, Can we Saudize the Labor Market Without Damaging the Private Sector? King Faisal Center for Research and Islamic Studies, November 2018.
[8] International Monetary Fund (IMF) Article IV, August 2018

or internationally, prefer to hire expatriates.

But this is not the whole story, often employers bemoan skills mismatches between what they demand and what the Saudi education system produces. According to the 2018 Global Competitiveness Report, the lack of adequately educated workers and restrictive labor regulations feature regularly among the top three most problematic factors identified by firms for doing businesses.[9] This skills mismatch (which is also common in other GCC countries) is critical for businesses and especially for foreign investors, who tend to be sensitive to restrictive labor policies. Saudis typically graduate university with degrees in humanities, education and the arts. Since these are not in high demand by Saudi firms, it is not surprising that the majority of Saudi unemployed tend to be holders of degrees in these subjects.

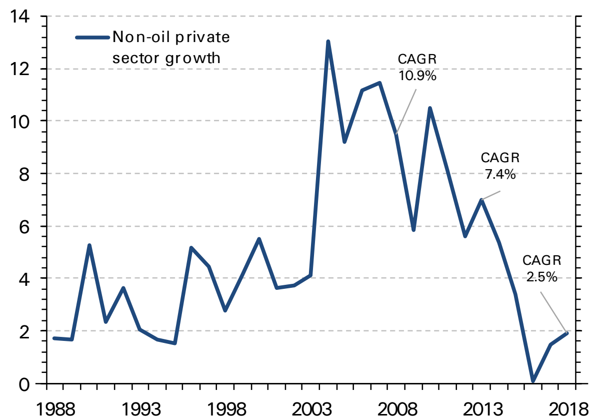
Moreover, the shallowness and limited diversity of the private sector productive base, given the predominance of the hydrocarbon sector, has been another impediment. The private sector, in its current state, is simply not big enough to absorb or provide plentiful job opportunities of the kinds demanded by Saudi nationals.

Labor market rigidities and the elasticity of employment for nationals

Employment elasticity for Saudi nationals in the private sector is known to be low, especially in the short and medium term, meaning that employment responds only slowly to non-oil private sector growth. As the IMF has posited, this is a reflection of adjustment costs—labor market rigidities already discussed such as Saudi nationals' reluctance to take up private sector jobs, rigid labor practices that make hiring and firing more difficult and complicated by higher redundancy costs, and skills mismatches that constrain hiring by the private sector.[10] In contrast, the relationship with expatriate hiring is more elastic, with the response rate for expatriates significantly quicker. In essence, the elastic supply of cheaper, lower-skilled foreign labor has helped Saudi Arabia grow at a rate in excess of what would have been if expat labor was not readily available. But what it means is that the Saudi private sector has not contributed significantly to Saudi employment, a fact not lost on the authorities.

Chart 6: Saudi non-oil private sector real GDP growth

(% y/y; 5-year CAGR denoted; growth at constant 2010 prices)



Source: GaStat National Accounts Indicators

The issue comes into greater focus when non-oil private sector growth slows, as in the years since the 2014 oil price downturn. Average annual growth since 2014 has been 2.5% y/y, compared to 7.4% during 2009-2013 and 10.9% in 2004-2008. (Chart 6.) The non-oil private sector, as a share of total GDP, is, at 39%, barely any different from where it was five years ago; having bottomed out in 2016 at 0.1% y/y, growth accelerated to 1.9% y/y in 2018. These are the slowest rates of private economic expansion in almost twenty-five years, correlating with the observed growth slowdown and contraction in Saudi private sector employment during the last two years.

Saudization: a mixed bag

Faced with a young Saudi population and a large number of entrants into the labor force, private sector development and growth may not be sufficient to absorb the young graduates. Hence, Saudization—the process of increasing the representation and share of Saudi nationals in the private sector workforce through the enforcement of company quotas—has been the government's main employment policy lever to tackle Saudi unemployment and under-employment since

[9] World Economic Forum (WEF) Global Competitiveness report, 2017-18
[10] IMF Annual Meeting of GCC Ministers, Labor Market Reforms to Boost Employment and Productivity in the GCC, 2013.

2011.

Known officially as the 'Nitaqat' program, it is one of the largest quota-based programs of its kind in the world. Saudi companies have to abide by the program's targets or risk being fined. Arguably, Nitaqat can be credited with the huge gains witnessed in Saudi private sector labor force numbers since 2011. For example, there was a ten-fold increase in the annual average number of new private sector labor force workers in the five years following the program's launch in 2011 (202,884) compared to the five years before (20,238). By end-2017, there had been a cumulative increase of 1.17 million Saudis, or 162%. (See Chart 2.)

While creating jobs for Saudis is a commendable objective, a number of side effects were also observed, the most significant of which related to the profitability of Saudi private sector firms. Faced with quotas and penalties for non-compliance, firms did indeed increase the number of Saudis on their payroll, but this came at substantial costs to them—costs of training as well as the higher salaries and benefits that employing Saudis entailed. Many firms were forced to downsize or fold entirely; those that survived may have done so by paring back much-needed capital spending in order to mitigate the additional cost burdens. It has been suggested that one significant opportunity cost of Nitaqat may have even been *decreased* private sector employment, with the exit of nearly 11,000 firms (many could be due Saudization although this is very difficult to ascertain) over the first sixteen months of the program's launch.[11] Other studies have alluded to the potential for reduced productivity as a result of increased Saudization.[12]

In view of some adverse side effects of Saudization on the private sector, the Saudi authorities in the last two years have moved beyond the imposition of quotas and towards the minimization of the sizeable cost differentials between Saudis and expatriates in the private sector. In 2017, several measures were introduced, such as levies and fees on expatriates and their dependents, higher expatriate visa costs alongside further tightening of mandatory Saudization ratios. These measures aimed to raise the cost of hiring foreign workers in order to push the private sector to hire Saudis, but at a cost to businesses. As an example of tightened Saudization, mandatory employment of Saudi females in shops selling women's accessories was introduced followed by 100% Saudization in twelve retail and wholesale sectors, though this was later pared back to 70% as it was deemed too ambitious within the timeframe proposed. (See Table 1.)

Table 1: Overview of Saudization initiatives

Quotas for nationals

- Nitaqat launched in 2011 and extended Saudization quotas to cover 52 industries
- 2017: Mandatory employment of Saudi females in shops selling women's accessories
- Jan 2018: 100% Saudization target within 9 months in 12 retail jobs, but later pared back to 70% of sales jobs in the wholesale and retail sector.

Levies on expatriate workers

- Launched in 2012 at SR200 ($53) per month per foreign worker on firms with majority of expats.
- Extended July 2018 under Fiscal Balance Program (FBP) to SR300 ($80) per month per expatriate employee in a company in which the number of expats is equal to the number of Saudis, rising to SR700 ($187) by 2020. For firms in which the number of expatriates exceeds the number of Saudis, the starting rate is SR400 ($107), rising to SR800 ($213) per expat per month by 2020.
- Feb 2019: King Salman approved $3.1bn to ease the burden of levies on business, but in September 2019 this was extended to a 5-year suspension of the levies on industrial companies—where the state will pick up the costs.

Fees on expatriate dependents

- Starting in 2017, SR100 ($27) per expatriate dependent per month, rising each year by SR100 to SR400 ($107) by 2020.

Visa restrictions

- Expatriate labor visa costs increased alongside visa restrictions

Subsidies

- Subsidizing 30% of total salaries during first 3 years of employment

Training & support programs

- Launch of several training programs.
- Qurrah: childcare program for females in private sector
- Wosool: to facilitate female transportation to work
- Target to increase enrollment in technical and vocational training to 12.5% for high school graduates

Job creation

- Plan to nationalize and create 80,000 jobs in real estate sector, 40,000 in health and 15,000 in IT.

Source: Saudi Ministry of Finance, MLSD, Moody's, Jadwa Investment

[11] Peck, Jennifer, 'Can Hiring Quotas Work? The Effect of the Nitaqat Program on the Saudi Private Sector', American Economic Journal, Economic Policy 2017.
[12] Ramady, M, 'Gulf unemployment and government policies: prospects for Saudi labor quota or Nitaqat', International Journal of Economics and Business Research, 2013

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Recognizing that bridging the wage gap between Saudis and expatriates in the private sector was only part of the problem, the government moved to loosen up some of the other labor market rigidities. Through amendments to Article 77 of the Saudi labor law, the government has begun to make hiring and firing Saudi nationals easier. At the same time, regulations strengthening the rights of expatriate workers were also tightened. Both moves were intended to reduce the preference for firms to hire expatriates over locals.

The government also introduced measures to enhance further Saudization. These include: (i) wage subsidies for employers to hire nationals; (ii) training programs to target women and young job seekers especially; and (iii) childcare and transportation initiatives to help facilitate women's participation in the workforce. Indeed, the increase in female labor force participation rates, from around 18% in 2016 to a historic high of 23.2% in 2Q19, has been one of the more eye-catching success stories of the authorities' labor market reforms. On this metric, the government appears to be closing in on its recently-revised NTP target of 25% by 2020.

A prescription for private employment gains?

Saudization has undoubtedly accelerated in recent years, catalyzed by the recognition that in an era of lower oil prices, tighter revenues and budget deficits, the Saudi state cannot continue to absorb Saudi nationals at the rate that it has been without eroding the kingdom's reserves and fiscal buffers. Public debt, negligible in 2011 is expected to each almost 25% of GDP in 2019 while the kingdom's foreign reserves have declined by more than 32%, by $242 billion, to around $500 billion, from their peak in August 2014.

Admittedly, the kingdom has had to feel its way through employment programs it has had little experience with. Some initiatives, such as Saudization targets in the wholesale and retail sector, have had to be scaled back; others such as the expatriate fees borne by employers in the industrial sector have been suspended and subsidized temporarily by the government in order not to compromise firms' bottom lines and competitiveness amid expatriate outflows and negligible Saudi private sector employment gains. The IMF has led the calls for a slower pace of reform implementation so as not to impact non-oil growth.

At the same time as implementing reforms more gradually, reform efforts need to expand further, especially in measures to reduce the availability and attractiveness of government employment and education and training initiatives to improve the skills and competitiveness of the Saudi workforce. In the former, moves to introduce and extend a private sector allowance to Saudi nationals in a similar fashion Kuwait's 'da'm amala' program for Kuwaitis could be considered but only if the program is well designed, well targeted, and time-bound. The Saudi state has already narrowed the differential between nationals and expatriates in the private sector, but no significant initiative has taken place yet to minimize disparities with the public sector. Public sector employment growth continues to outpace private sector growth (based on administrative records) enticed by salaries that are on average 1.6 times higher and greater non-monetary benefits. In tandem, the government will need to signal soon that public sector jobs and benefits will not increase. Restraining wage growth in the public sector also needs to be prominent in the government's toolkit; it would also have the added benefit of not impacting business growth. The freezing of public sector allowances in 2016 could have acted as such a signal had the government not re-instated them a year or so later ostensibly on concerns that domestic consumption and thus non-oil economic growth was being negatively affected.

There is little evidence so far to suggest that the introduction of the expatriate levies and dependents fees has had the intended effect on Saudization. These jobs have not been filled by Saudis, partly due to the low-skilled and low-paid nature of these jobs. The imposition of the levy has reduced the wage gap between Saudis and expats by an estimated 20% only, which will not entice Saudis in sufficient numbers.

Female employment gains have been forthcoming, though, but more still needs to be done to encourage women, a demographic of hitherto huge untapped potential, to join the private sector labor force. With women securing the right to drive in 2018, a significant boost was provided to employment and future output potential; measures to help with childcare were also welcome. Following the IMF's recommendation, moves are afoot to create programs for female entrepreneurs under the authorities' SME initiatives.

As the nationalization of the labor force progresses, more attention needs to be given to enhancing productivity and promoting the private sector, which should become the main source of employment for nationals. This implies better matching between workers and firms, more flexibility for highly skilled expatriates and better opportunities for foreign investors. Increasing expatriate mobility is an important lever that could be employed. The IMF has suggested reform of the visa system to enable expatriate workers to move more freely between jobs to bid up their salaries and to narrow the wage differential to nationals. This would not only help in the Saudization process over time, but could also bring Saudi Arabia closer to labor market regulations in advanced economies. Cognizant of this, the authorities recently announced a new visa and residency program for skilled foreign workers and owners of capital. Wholesale reform of the sponsorship system, though, would take things further.

In conclusion, the Saudi drive for nationalizing the labor force is a laudable objective. The time-honored socio-economic compact, where the government is expected to guarantee jobs for citizens, is under greater stress in the era of low oil prices and tighter government finances. But, it is perhaps not surprising that the transition to private sector-led employment growth is taking time and facing bumps along the way. The kingdom has, however, taken meaningful steps in the right direction, and aims to move towards a more sustainable socio-economic model.

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