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# Saudization and Sound Economic Reforms: Are the Two Compatible?

## *Strategic Insights*, Volume III, Issue 2 (February 2004)

by [Robert Looney](#)

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If we the GCC states, had a sound economic perspective in the interest of our people, problems such as unemployment would never crop up. There would not have been issues like Kuwaitisation and Saudisation.<sup>[1]</sup>

Ahmed Al-Jarallah, Editor-in-Chief, *The Arab Times*

### Introduction

Saudi Arabia and the other Gulf Cooperation Council (GCC) countries face a challenging set of problems that must be addressed to maintain political and military stability in the region. The first problem involves attaining and maintaining economic growth rates that are at least sufficient to keep pace with the rise in population. For Saudi Arabia, low economic growth has become a chronic problem: gross domestic product (GDP) increased by only 1.6 percent between 1990 and 2000 while growth in the country's population grew at an annual rate of 2.7 percent during that period, thus producing a declining trend in per capita income.<sup>[2]</sup>

This low rate of growth cannot be attributed to a lack of capital formation. In fact, the rate of investment is relatively high in Saudi Arabia. The Sixth Development Plan (1995-2000) envisaged a total capital of around 472 billion riyals (US\$125.8 billion), including nearly 212.7 billion riyals (\$56.7 billion) from the private sector. It had also targeted an economic growth of 3.8 percent over the plan period. By the end of the plan, actual investment increased by around two percent to 481 billion riyals (\$128.2 billion) but included nearly 292 billion riyals (\$77.8 billion) from the private sector—an increase of around 37 percent over the projected level.<sup>[3]</sup>

Thus, even though the Plan overachieved in terms of investment, it underachieved in terms of what really counts—real economic growth. The ineffectiveness of investment to sustain growth stems appears to be structural, stemming in part from a weakening of the linkage between public and private expenditures together with a decline in the ability of public expenditures to stimulate real output.<sup>[4]</sup> Given the inability of the public sector to directly stimulate real non-oil output, all of the pressure to provide expanded employment opportunities, jobs and output is now placed on the private sector.

Job creation is then the second major problem facing the kingdom. Ironically, even though the Saudi economy is heavily dependent on foreign workers, many hired during the oil boom years (4.6 million or 71 percent of the country's workforce), the unemployment rate among Saudis is 8.2 percent, reaching as high as 32 percent among younger workers. Clearly the inability of a youthful Saudi workforce to displace foreign workers is one of the great challenges facing the Saudi authorities—and it is the focus of the country's Saudization program examined below.

Finally, the third challenge relates to maintaining the pace of economic reforms. Here the Saudis have initiated a series of measures designed to attract foreign investment, deregulate many key industries, and

liberalize the economy to qualify for membership in the World Trade Organization (WTO), as well as to facilitate further economic integration with fellow GCC members.

If carried out successfully, the economic reforms, by creating a more competitive economy with increased investment opportunities, should expand the job creating capacity of the economy. This is critical, given the current inability of public expenditures to perform this task.

The country's three main challenges—restoring rates of growth above that of the population, expanding job creation, and implementing a comprehensive reform package—appear to be relatively compatible with one another. Good progress in the reform area should assure higher rates of economic growth and through that more jobs. But will they be jobs for Saudis? The government is not confident this will be the case as it simultaneously broadens and expands its Saudization program.

As implemented in Saudi Arabia, Saudization is a development strategy that seeks to replace foreign workers with Saudis. To date this has been largely accomplished through various employment quota targets. Currently the guidelines of the Shura council (a consultative body) dictate that by 2007 70% of the workforce will have to be Saudi, with Saudization accelerated in some industry sectors.<sup>[5]</sup> Saudi Arabia is not alone in adopting a program stressing employment for native workers over foreign.<sup>[6]</sup> Kuwaitization, Emiratization, Qatarization and Omanization are to one degree or another being implemented in the neighboring GCC countries. Nor is Saudization new—it has been tried numerous times in the past.

The purpose of this article is to examine Saudization—what are its main components and how will it be implemented? More importantly, is Saudization compatible with the country's general approach to economic reform?

## **The Government's Response to the Economy's Slowdown**

### **Reforms**

The main thrust of the new wave of economic reforms is to open up the economy. Not only is this expected to increase efficiency through freer and more efficient markets, but also to create new jobs through the expanded flows of foreign direct investment. The opening of the economy is also one of the main pre-requisites of WTO membership, as well as full integration with the GCC countries.<sup>[7]</sup>

In addition to a series of new economic reforms and initiatives, the government has also created a fairly extensive set of educational, political, and social reforms. The Saudization program's particular focus is on youth with its high rates of unemployment. In addition, the government has taken the initiative to increase participation of Saudi women in the labor market where currently only 10.2 percent of women now hold jobs. These demographic realities place intense pressure on Saudi authorities to create at least 160,000 jobs annually.

Education is a prime target for reforms. In 2004 one out of every two Saudis was less than 15 years old, and an estimated 60 percent of the population is less than 20 years old. The education system has largely failed to prepare the country's youth for jobs requiring technical expertise. Compounding this problem is that many graduates refuse to take what are commonly considered menial assignments, further enlarging the ranks of approximately six million expatriate workers. As noted above, this is occurring in an environment where youth unemployment may be reaching 30 percent. In reality, barely 2 percent of Saudi University (and/or technical institutes) are fully qualified to assume demanding posts. All of these factors severely constrain the recruitment pool available for businesses.<sup>[8]</sup>

In their totality, the reforms appear to be influenced not only by the deteriorating economic conditions, but also by concern that the current environment in Saudi Arabia is conducive to terrorist recruitment<sup>[10]</sup> and activity.<sup>[11]</sup> Hopefully the reform package as a whole will create a more open, transparent environment

within which stronger civic institutions can develop and, in time, increased economic and political freedom lessen the terrorist threat to the nation.[\[12\]](#) No doubt the process will be slow,[\[13\]](#) but there are signs that it is moving ahead.[\[14\]](#)

## **Saudization**

Running parallel to these reforms is the country's Saudization program, focused on three main goals :

1. Increase employment for Saudi nationals across all sectors of the domestic economy.
2. Reduce and reverse over-reliance on foreign workers.
3. Recapture and reinvest income which otherwise would have flowed overseas as remittances to foreign worker home countries. Over the last 10 years expatriate workers in the kingdom have remitted about SR585.4 billion.

If history is any indicator, achieving these goals will be an extremely difficult task. The Sixth Development Plan (1995-2000) targeted the creation of nearly 319,500 jobs for Saudis through replacement of foreigners. However, instead of a reduction in the foreign workforce, the number of expatriate workers actually grew by 58,400.[\[17\]](#)

While Saudization in one form or another has been around for years, its pace, along with other reform efforts has recently picked up. In the mid-1990s:

1. A law was issued requiring private businesses employing more than 20 people to increase the number of Saudi nationals by five percent of the workforce every year. The current required rate of Saudi employees is 30 percent.
2. The employment of foreigners in twenty-two, mostly administrative professions was banned.
3. The government increased fees on the recruitment of expatriates, with the money going into a special fund set up to help "nationalize" jobs.

More recent initiatives have included:

1. In 2001, the Ministry of Labor and Social Affairs set a goal of 25 percent Saudization in the private sector in 2002, a figure consistent with the target set in the current Five Year Development Plan (2000-2005). That Plan seeks to provide 817,000 jobs for Saudis by creating new opportunities or by replacing expatriates with Saudi citizens. The move was also in line with a government policy which calls for increasing Saudi manpower in the private sector by five percent annually.
2. In January of 2003 the Shura Council began to apply Saudization metrics to companies working in the Kingdom that are directly owned by Saudi Aramco as well as those implementing Aramco projects. The Saudization level of contractors must now be included in annual performance reports submitted by the Ministry of Petroleum and Mineral Resources. While this may increase the complexity of foreign competitive bids for oil and gas projects, from the Council's perspective the measures move bid selection toward achieving the country's national labor force interests.[\[18\]](#)
3. Early in 2003, the Saudi labor ministry ordered the accelerated Saudization of the 9,771 bank jobs held by expatriates.
4. In July 2003, the government announced its decision to reduce the number of expatriate workers to 20 percent of the total population in a decade, in order to open up jobs for its nationals.

Finally Saudi Aramco is assisting the implementation of Saudization by holding the companies it concludes contracts with to certain quotas of Saudis: 35 percent for construction companies, 50 percent for services companies and 60 percent for importers, industrialists and engineering offices.[\[19\]](#) For their part, in 2002 Aramco established a center to train Saudis working for contractors. The program is geared to upgrading professional skills and teaching specific skills, particularly in the areas of drilling and oil well maintenance.[\[20\]](#)

While Aramco is developing innovative programs to facilitate the Saudization of the labor force, the predominance of Saudization employment elsewhere in the kingdom is still through the use of some sort of quota system or directly banning expatriates from working in certain activities. Currently thirty-four areas are closed to expatriate workers including: training managers, public relations officers, administrative assistants, purchase managers, secretaries, operators, warehouse supervisors, debt collectors, customer service accountants, tellers, postmen, data handlers, librarians, book sellers, ticket kiosk keepers, taxi drivers, auto salesman, janitors, internal mail handlers and tour guides.[\[21\]](#)

Looking into the future, these recent Saudization initiatives imply that up to three million foreigners living and working in Saudi Arabia may have to leave the kingdom in the next decade. According to a February 2003 notice by the Manpower Council[\[22\]](#) the number of foreign workers and their families must not exceed 20 percent of the Saudi population by 2013.[\[23\]](#) The number of foreigners in the kingdom is currently estimated at between six to seven million, compared to around 17 million Saudis. Based on the current Saudi population growth rate of about 3.2 percent annually, Saudis are expected to reach 23 million by 2013 and accordingly foreigners must not exceed 4.5 million.

The decision also stipulates a quota system for foreign nationalities in which any single nationality must not exceed 10 percent of the total expatriates. Such a system will particularly hit Asians from India, Pakistan, Bangladesh, and the Philippines in addition to Arabs from Egypt, Sudan and Syria, all of whose numbers exceed the required 10 percent.

### *Impact on the Economy*

Like any major policy initiative, Saudization clearly creates disturbances with some sectors like transport anticipating a catastrophe.[\[24\]](#) The ultimate goal of development and higher growth comes with a cost in the form of short term transitional disruption.[\[25\]](#) It is too early to gauge the impact of Saudization on the economy, but there are two main concerns. First, many firms may feel that Saudization will reduce their competitiveness and for that reason may decide to leave the Kingdom for a more business-friendly environment. These would most likely be firms in the service sectors, such as banking, where the Saudi labor ministry has already ordered the acceleration of Saudization. Many bankers spoke out that Saudization of all banking jobs would likely cause a brain drain and loss of business to other regional banking centers, particularly Dubai.[\[26\]](#) The country's poor regulatory environment only compounds this problem with a reported 2,500 Saudi companies opening up shop in Dubai, rather than in the kingdom.[\[27\]](#)

Brain drain is not assured across all segments of the economy, however. Saudization advocates such as Saudi economist Ihsan Bu-Hulaiga contends that because only 15 percent of the expatriates can be classified as skilled, the new Saudization quotas will not create a vacuum in the domestic labor market.[\[28\]](#) His contention is that domestic market is currently saturated with foreigners, some of whom are unemployed, unskilled and or illiterate. They simply compete with Saudi job-seekers to force down wages.

The second main area of impact from Saudization may be a reduction of foreign direct investment (FDI) in the kingdom. Foreign firms may feel that Saudization not only puts them at a disadvantage compared to their foreign competitors, but that the whole Saudization program itself is unpredictable, with rules and quotas changing without warning. This element, combined with increased concern over domestic terrorist violence, may drastically reduce FDI inflows. Concern over Saudization's impact on foreign investors likely underlies the Kingdom's recent decision to reduce the tax on foreign investors from 45 to 20 percent.[\[29\]](#)

### **Incentive-Based Saudization Strategies**

Several important lessons come out of the experiences of the other GCC countries in creating employment opportunities for national workers:[\[30\]](#)

1. The capital intensity of the oil sector makes it extremely difficult for that sector to create an adequate number of jobs for nationals and still remain competitive.
2. Developing new employment opportunities rather than substituting local workers for foreign is the only long term solution for accommodating a growing labor force.
3. It is extremely difficult to create additional jobs without expanded volumes of foreign direct investment.
4. Training new entrants for likely job openings is the key to a successful national employment policy.
5. A largely expatriate workforce remitting large proportions of their earnings makes sustaining high levels of domestic demand difficult.

As with the other GCC countries, most of Saudi Arabia's new entrants to the workforce will have to go into the private sector. In this regard, job creation for locals is much easier in a growing economy, probably relying on significant inflows of foreign direct investment and technology.

### *The Role of Market Forces and Incentives*

Instead of quotas, Saudization should be implemented more through market forces and incentives. Saudization should not be approached as a zero sum problem, but instead implemented in a growth oriented environment assisted with expanded foreign investment, induced in part through an expanded and reformed education/training program. In short, Saudization should be implemented in a manner that provides jobs for Saudi nationals in an environment characterized by increased competitiveness and strong non-oil growth. Here economic theory provides some general propositions and guidelines for possible action.[\[31\]](#)

1. From the perspective of private sector firms, the demand for Saudi native workers is inversely related to the cost of their hiring and firing. It is also inversely related to the cost of employing low-skilled expatriate workers. Since a reduction in the number of low-skilled employees likely reduces the marginal productivity of national workers, an increase in the cost of employing low skilled workers would reduce the demand not only for these workers but also for Saudi workers.
2. If skilled expatriate workers are sufficiently substitutable with Saudi workers, then demand for Saudis should be positively related to the cost of employing skilled expatriates—increases in these costs would lead firms to reduce their demand for skilled expatriate workers and to substitute them with national workers.
3. The demand for Saudi workers is positively related to their level of human capital, the stock of capital, and technology because increases in these factors should raise the return to employing an additional national worker.
4. The supply of national workers to the private sector should depend on the compensation relative to their reservation wages (the minimum wage one is willing to accept for their work). Reservation wages in turn are determined by the wage, social benefit, and employment policies of the government. If the public sector provides relatively high wages, social benefits, and job security to nationals, then the reservation wage and benefits, will be relatively high for the private sector.

From these supply and demand considerations several policies can be adopted to increase job opportunities for Saudi workers in the private sector. These may be grouped into three broad categories depending on whether they directly affect (a) wages and employment costs, (b) acquisition of human capital, or (c) investment in capital and technology. These policies are structural and market-based, in contrast to quantitative measures, such as job quotas, which may adversely affect competitiveness and non-oil growth by raising costs and limiting employment flexibility.

### *Policies Affecting Wages and Employment Costs*

Reducing the relatively high wages in the public sector is likely to lower the reservation wage and increase the willingness of nationals to acquire skills or human capital valuable to private sector

employers. Announcing and enforcing the strict limits on public sector hiring is likely to further lower the reservation wage by decreasing the likelihood that the public sector will act as the employer of first and last resort for nationals.

Separating wages and social benefits in the public sector and providing benefits to all working nationals—not just to those employed in the public sector—is likely to reduce the incentive for nationals to seek public sector employment and lower the reservation wage to the private sector. Moreover, giving time-specific subsidies for the employment of nationals will likely increase private sector demand for them by lowering their employment costs. However the fiscal cost will need to be less than the employment benefit for the policy to be welfare improving. (These subsidies could be financed, for instance, by fees or income taxes on skilled expatriate workers).

Relatively higher firing costs for nationals, including lengthy appeal and investigation of dismissals, raises their relative cost of employment, thus reducing demand. Therefore, establishing a clear set of rules for the appeal of dismissals, including fines or penalties associated with wrongful dismissals, and a mechanism for the rapid resolution of appeals is likely to lower the relative cost of employing Saudis, and reduce the disparity in labor mobility between Saudi and expatriate workers across sectors.

If skilled expatriate workers are sufficiently substitutable with Saudi workers, then increasing the relative cost of hiring skilled expatriate workers such as by imposing income taxes or fees on the employment of skilled expatriates, is likely to result in substitution away from skilled expatriates and towards nationals (assuming that the employer will cover the cost of paying the income tax of his expatriate workers). Such taxes or fees should only be applied to skilled expatriates and not to low-skilled expatriates because the latter complement the productivity of nationals. If taxes or fees are applied to low-skilled expatriate workers then the cost of hiring them will increase and the demand for national workers is likely to decrease.

### *Skill development*

Enhancing the human capital of Saudis and the acquisition of skills that are valuable to the private sector is likely to increase demand and employment. To this end, providing education including vocational training, reforming school curricula, encouraging firms to establish internships, awarding scholarships and targeted training vouchers, and fostering self employment will likely build necessary skills and expertise among prospective national workers.

To complete on a global level, and on the strength of the national labor force, the Saudi economy will probably have to diversify, and that will employ more hazardous activities. The construction sector for example, one of the most dangerous industries, will require thousands of skilled Saudi workers to fulfill its Saudization target. This will necessitate significant improvements in safety and health conditions in the workplace in order to attract Saudis. Similarly the oil and petrochemical industries, which contribute up to 90 percent of the Kingdom's income, need a comprehensive occupational safety and health strategy.[\[32\]](#)

Here, subsidies might be used to entice Saudis into jobs through training contracts. The government could play an active role in assisting the process through programs like the newly created Human Development Resources Fund.[\[33\]](#) The HRDF provides grants for qualifying, training and recruiting Saudis for work in the private sector. Employers could be responsible for providing the necessary skills training, while the employee will commit to completing the program. If the employee leaves before training ends, he or she will have to reimburse the cost of the training to the employers, which would then be partially refunded to the Fund.

After workers are trained and qualified, HRDF can subsidize a percentage of the salaries of those skilled workers hired by the private sector. Funding for these activities comes from a SR150 fee levied on work permits. Early signs suggest that the program is rapidly catching on with employers.[\[34\]](#) Given public education's limited capacity to develop skilled professionals, much of this task will have to be undertaken

by the private sector.<sup>[35]</sup> The HRDF is certainly a step in the right direction and no doubt its funding should be expanded to reflect its contribution to the country's future.

For its part in November 2003, the government has allocated SR3.7 billion for the training of more than 100,000 young Saudis. Plans are to establish 20 technical colleges capable of accommodating 60,000 trainees and 39 technical training institutes designed for 40,000 students. There are also tentative plans for expanded vocational training in the military. Tentatively the military will admit 10,000 trainees annually. The first three months will be allocated for basic military training during which time the skills of the trainees will be examined to identify suitable professions. Technical training will be given in the last nine months and the trainees will be given professional certificates.<sup>[36]</sup>

### *Investment in capital and knowledge*

Facilitating the adoption of new technologies and the accumulation of capital is also likely to increase private sector demand and employment of Saudi workers by raising their productivity. In this regard, the establishment of regional knowledge and technology intensive clusters of industries might be of great help. Moreover, shifts in government expenditure away from welfare-state type activities towards economic services, and research and development should lead to higher productivity and investment.

### *Costs and Benefits*

The costs of Saudization done right are no doubt considerable—training, recruiting etc are real costs that must be borne for the program's success. On the other hand, these are costs that any aspiring country must accept as part of the development process. They would not necessarily put the kingdom at any competitive disadvantage since competing countries are bearing essentially the same burdens.

While critics of Saudization tend to focus on these costs, little attention is paid to the benefits associated with the program. A notable exception is Kevin Taecker.<sup>[37]</sup> Taecker's approach attempts to quantify the shifts in domestic demand associated with various national/expatriate compositions of the workforce. The idea is straightforward: with Saudization money that would be remitted to families outside the kingdom (9% of GDP or \$14 billion in 1999 alone) is now spent domestically.

Not only do expatriates spend a smaller percentage of their income domestically, but perhaps more importantly it is for a fairly narrow and meager basket of goods and services, leading to a very low domestic expenditure multiplier of 0.8—every 1000 riyals earned and spent locally by an expatriate produces another 450 in income as this spending circulates through the economy. For Saudi nationals the expenditure multiplier is estimated at 2.5 or 1,500 in extra income generated for each 1000 riyals of Saudi expenditures.

As noted, in 1999 expatriate worker remittances were around \$14 billion. Taecker's data suggests that expatriates send one-half of their incomes out of the country, this would imply expatriates earned around \$28 billion that year. Taking the effects of the difference in Saudi and expatriate household expenditure multipliers, the total annual cost of relying so extensively on expatriate labor are around \$47 billion (the differences in multipliers 2.5—0.8 times \$28 billion).

These factors begin to hit home when one makes a couple of simple calculations. If met, the Saudization goal of reducing the number of expatriates by 2% annually for the period 1999-2004 (The Sixth Plan Period) would shift \$2.7 billion of income from expatriates to Saudis. By 2004 this income spent locally would raise annual incomes by \$4.6 billion. As Taecker notes:

The Saudi private sector will be the main beneficiary. The bulk of these effects will be reflected in the form of increased purchases of goods and services from local business. The \$4.6 billion would represent more than 6.8% of 1999 private sector GDP—a real and substantial reward for doing their part to meet the plan's modest goals....Thus, there is a virtuous economic cycle implicit in successful Saudization. By



leading the economy overall to higher economic multipliers it stimulates business growth and hiring, pushing the economy even higher.[\[38\]](#)

Looked at in this light Saudization, though benefiting the private sector, is essentially a public good, replete with free rider problems—some firms will not voluntarily Saudize, but rather simply reap the benefits of expanding domestic markets provided by those firms who actively increase Saudi employment. In this case, rather than simply impose mandatory quotas on firms the Government might consider several incentive based strategies.

*Taxes.* Determine industry norms for Saudization and pay proportional bonuses to firms above the norm and set proportional taxes on those firms below the norm.

*Allow Trading in Offsets.* This approach would be similar to that used in the United States by the U.S. Environmental Protection Agency to deal with emissions.[\[39\]](#) In the Saudi context limits could be set on the number of expatriates in a certain industry. Thus if an industry is at its limit and a new firm wished to enter that line of business it would have to negotiate a deal with an existing business to hire qualified Saudis, or pay for training programs to make more Saudis employable in the industry. In the United States environmental example such a deal is known as an "offset." The same principle could be applied in Saudi Arabia to gradually increase the proportion of Saudis in the workforce.

No doubt there are other similar incentive based plans that could facilitate the increased employment of Saudi nationals without hampering economic growth.

## Conclusions

Saudization does not have to be incompatible with some of the Kingdom's new economic reforms geared towards increasing the economy's diversity, competitiveness, growth potential and employment generation capacity. For one thing, the larger domestic markets stemming from the replacement of expatriates by Saudis should complete the country's reform efforts by facilitating growth in the non-oil segment of the economy, providing a stimulus to the private sector to invest more in the domestic economy, and creating conditions for attracting foreign investment.

For its part, the government's strategy for expanding employment opportunities, while complementing other reform efforts, should be built around the following actions:

*Increasing the relative attractiveness of working in the private sector* by lowering the wage differential between the public and private sectors; making social benefits available to all working nationals, irrespective of sector of employment; and announcing strict limits on public sector employment.

*Reducing disparities in labor mobility* by creating a level playing field between hiring and firing nationals workers via a vis expatriate workers.

*Encouraging skill acquisition among nationals* by strengthening educational and vocational training, providing time-specific incentives, such as subsidies and scholarships, and promoting self employment.

*Facilitating improvements in productivity and investment in capital* by outsourcing government services, and extending majority foreign ownership in non-free trade zone areas.

*Using price based rather than quantity-based market interventions* by charging, for instance, fees for employing or income taxes on skilled expatriate workers.

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