

# Economic Convergence in Saudi Arabia

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*Despite rapid economic growth over the last few decades, Saudi real incomes per capita have not converged to those of advanced economies. Instead income disparities have widened. Failure to diversify production from the capital-intensive hydrocarbon sector to employment-generating non-oil sectors, coupled with high population growth and a delay in removing restrictions on foreign investment, has exacerbated income disparities. Therefore, an economic transformation and diversification strategy that targets employment-generating economic activities will be key to achieving convergence with advanced economies.*

## Introduction

Saudi Arabia is one of the fastest growing economies in the Middle East and North Africa (MENA) region, yet incomes per capita have not converged with those of advanced economies. Real GDP increased fivefold, from below \$70 billion in 1970 to about \$365 billion by the end of 2007, averaging 5.5 percent a year over this period. Indeed, Saudi Arabia continued to register stellar growth even after the global financial crisis, with real GDP growth averaging 6.5 percent a year over the period 2010-2013, one of the highest among the G-20 economies (Figure 1). However, despite this impressive performance, the standard of living for Saudi nationals, measured by real per capita incomes, are yet to converge to the income per capita levels of developed economies. On the contrary, there has been a widening in income disparities in the country.

This paper discusses the reasons why economic growth in Saudi Arabia has not translated into standards of living comparable to advanced

economies and why income disparities in the country have increased, and then discusses policy options for achieving convergence.

## Economic Convergence

The potential for, and the factors underpinning, income convergence among countries have been a subject of interest in economic literature for some time. The question of economic convergence has traditionally been analyzed based on two influential growth models; the Solow-Swan neoclassical exogenous growth model and the endogenous growth model.

According to the Solow-Swan growth model, the steady-state income level of a country depends on saving rates, population growth, technologies, and preferences. Given that saving and population growth rates are constant in the long run, the model predicts that long-run growth is solely determined by the rate of technological change, which is considered to be exogenous. The key assumption underlying the neoclassical model is that capital is subject to diminishing returns and so poor countries with lower initial capital per capita tend to grow faster compared to those with higher initial capital per capita, allowing them to catch up to rich countries in the long run. This is known as *absolute convergence*.<sup>2</sup>

In contrast, the endogenous theory emphasizes the role of human capital accumulations, and ideas and knowledge spillovers as the key drivers of growth, in addition to a country's characteristics such as natural endowments, government policies, institutional quality, political risk, cultural and religious factors, and so on.<sup>3</sup> Further, this model

postulates that trade and foreign direct investment are the main channels through which ideas and technological knowledge may be diffused. Thus, this theory considers technology as endogenous. Some recent research on endogenous growth has emphasized increasing returns as a possible reason not to expect convergence. This is known as *conditional convergence*.<sup>4</sup> Income per capita in a given country tends to converge to its unique steady-state level determined by that country's fundamentals, which does not imply that poor countries will entirely catch up to the rich and so the long-run income per capital should not be the same across countries.<sup>5</sup>

### Features of the Saudi Economy

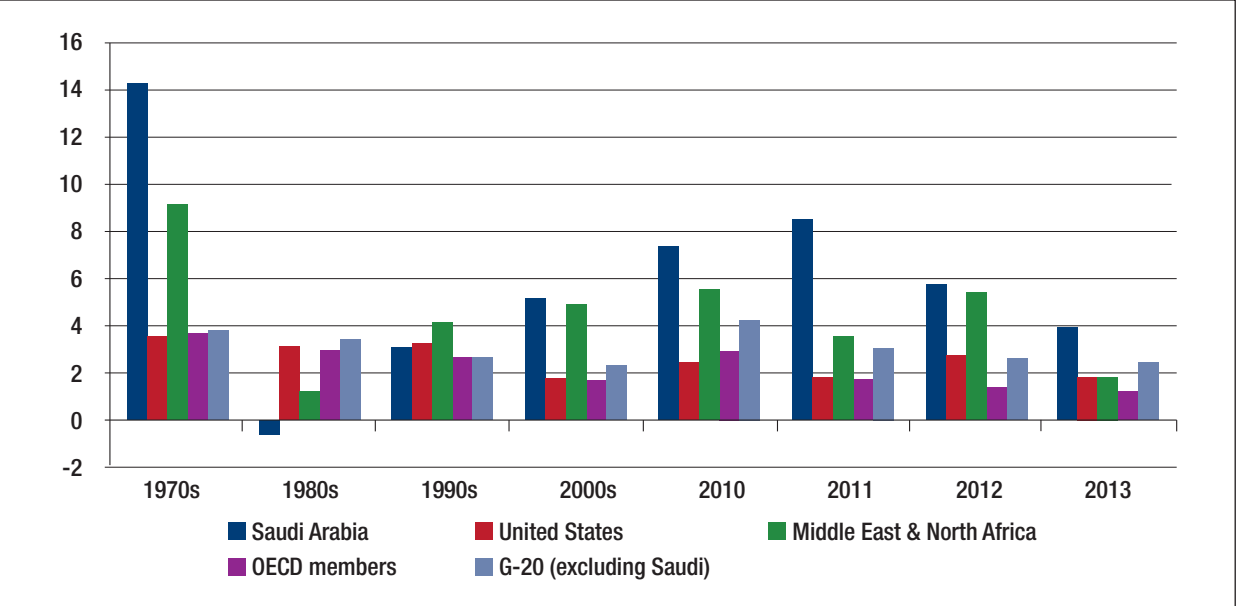
Saudi Arabia holds about 25 percent of the world's proven oil reserves and is the second largest oil producer in the world. This substantial natural resource has provided the country with access to advanced technology and allowed it to strengthen its human capacity. Through successive five-year development plans, the Saudi government has been able to direct its oil wealth toward development objectives, such as investment in social and economic infrastructure, economic diversification,

the financial sector, and macroeconomic stability. Socio-economic indicators have improved significantly. Life expectancy has risen to 75 years, the literacy rate exceeds 80 percent, infant mortality is less than one half of the world average, and primary school enrollment is approximately 90 percent of the school-age population.<sup>6</sup>

Economic growth accelerated significantly after 2000, benefiting from the sharp increase in oil prices and helping stimulate growth in non-oil GDP by increasing government capital expenditure and private sector investment. Between 2002 and 2013, the average annual growth rate of non-oil output was about 6 percent. The strong oil revenue growth enabled the country to achieve fiscal surpluses and accumulate very high international reserves while also reducing the debt burden. By 2013, the debt to GDP ratio declined significantly, to less than 3 percent, down from 100 percent in the late 1990s.

However, while total real GDP growth in Saudi Arabia has been very close to the worldwide median, the picture painted by real per capita GDP is not promising. Per capita incomes in Saudi Arabia are high in comparison with other Middle East and natural resource-exporting countries, but they have failed to converge with that of rich economies.

FIGURE 1. REAL GDP GROWTH RATES (PERCENT)



Source: World Bank, Economic Development Indicators, 2004.

Growth rates in real GDP per capita fluctuated in line with movement in oil prices. During the first oil boom, real GDP per capita grew by about 12 percent per year. However, during the 1980s and 1990s, average growth rates of real GDP per capita were actually negative. In fact, real GDP per capita had declined to around 47 percent of its peak in 1977 and this decline continued for most of the last two decades. The modest growth in the real income per capita was compounded by a high population growth rate, averaging 3.6 percent a year over the period 1970-2013 (Figure 2).

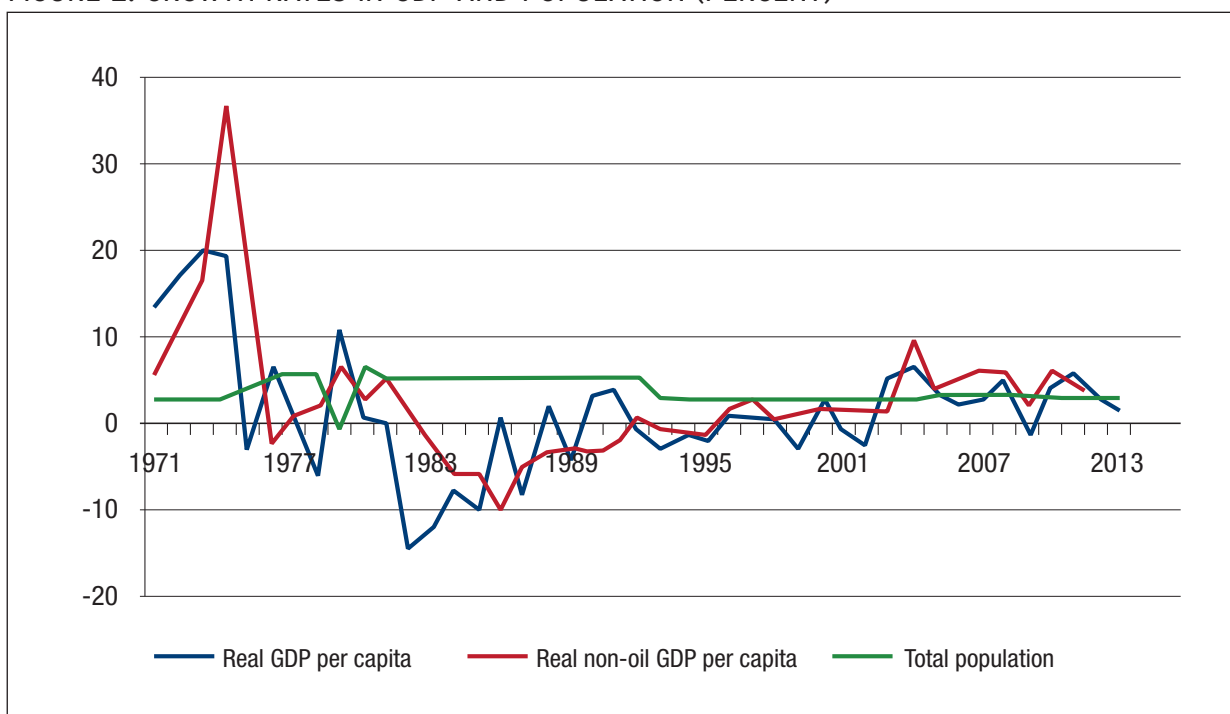
### How Wide Is the Gap?

The income disparity between Saudi Arabia and advanced economies as well as peer countries has worsened. The absolute average difference between the income of the most advanced economy—the United States—and the income of Saudi Arabia was about \$6,825 in 1970, but by 2013 the gap has grown to \$22,129. The Saudi economy, even while improving, was also not able to converge to the averages income levels of OECD economies (the

income gap is about \$8,189). With respect to a peer comparison, real Saudi income per capita was higher than the real income per capita of Norway in the 1970s, but the income gap between the two countries flipped and grew significantly after 1980. As shown in Figure 3, the income trajectories of the two economies have differed, reflecting progress in Saudi Arabia’s economic development and oil market changes. The surge in oil prices in the early 1970s translated into a significant increase in government spending on infrastructure which, in turn, improved the country’s economic performance. During this period, Saudi income per capita was higher than that of the U.S. and Norway. However, the sharp decline in oil prices and oil revenues in the 1980s severely curtailed government spending. Total GDP was halved between 1981 and 1987, when it hit its lowest point for the decade, creating huge income gaps that continued to widen during the 1990s.

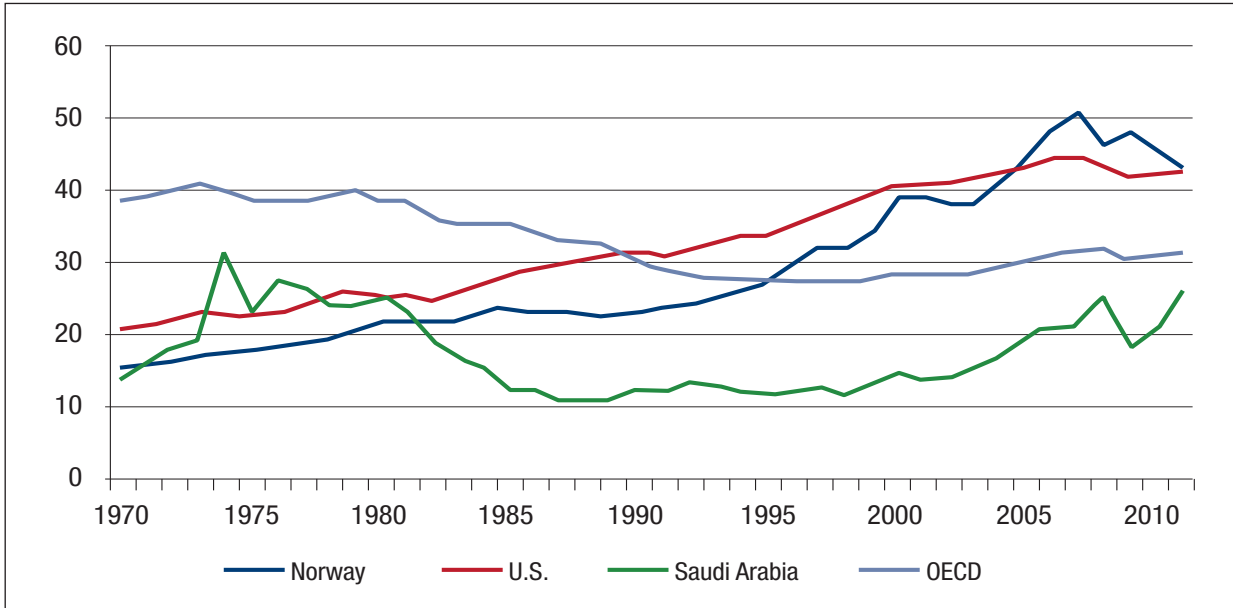
Now, the length of time that would be needed to achieve absolute convergence between Saudi Arabia’s annual average income per capita and that of the U.S. is very long. Assuming that Saudi Arabia

FIGURE 2. GROWTH RATES IN GDP AND POPULATION (PERCENT)



Source: SAMA Annual Report, 2013.

FIGURE 3. REAL GDP PER CAPITA (PPP AT CONSTANT 2005 PRICES)



Source: Penn World Table (version 8.0) and IMF's World Economic Outlook, April 2014.

maintains a high economic growth rate, averaging 4.4 percent a year, its economy would still need about 21 years to reach the levels of income per capita of the U.S., 20 years to reach the levels of income per capita of Norway, and about 10 years to reach the average income per capita of OECD countries.<sup>7</sup> However, given the observable characteristics of these economies are different, the steady-state equilibrium of the Saudi economy would be different. In other words, although Saudi capital accumulation (physical and human) has been more rapid recently, and the technical sophistication of production has greatly improved, differences in other factors such as market structure, institutional differences, values, and preferences would affect long-run per capita income differently across countries.

## What Went Wrong?

Several factors have contributed to a lack of convergence, including the structure of the economy and government policies. Saudi Arabia's dependence on the capital-intensive hydrocarbon sector has encouraged a skewed income distribution. While government economic programs have

aimed to address income distribution, these have tended to favor those in formal employment.

## Structure of the Economy

Despite the Saudi government's significant efforts to diversify its economic base, the economy is still dominated by hydrocarbons, mainly oil. The oil sector accounts for about 30 percent of GDP, 89 percent of total exports, and about 93 percent of budget revenues.<sup>8</sup> The hydrocarbon sector is also capital-intensive and linkages with the economy are limited, so income tends to be concentrated in a few sectors. Diversification policies have thus far not been effective in ensuring a more balanced income distribution. The contribution of non-oil sectors to GDP has increased significantly over time, from about 30 percent in 1970 to about 70 percent in 2013, indicating that the Saudi economy is significantly more diversified today than it was in 1970. However, more critically, the sectors into which the economy has diversified have been in the oil-based, petrochemical and energy-intensive industries, which are also capital-intensive, and therefore have contributed little to employment.

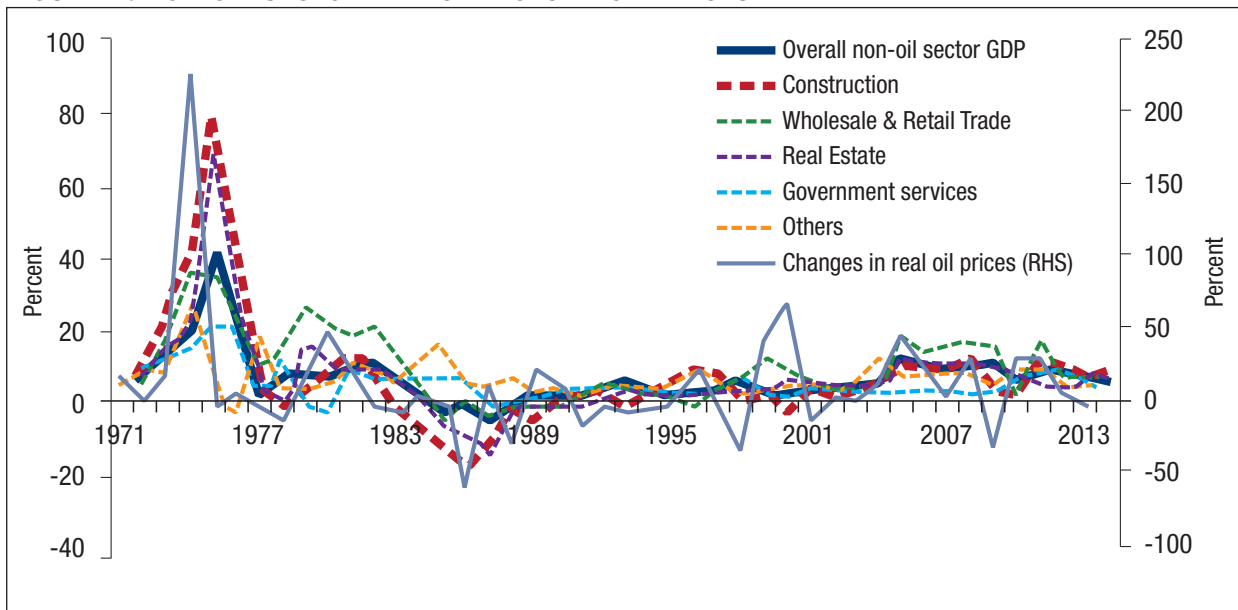
## Government Policies

Delays in removing restrictions on full foreign ownership of investment companies means that development of the non-oil sector has been relying on government stimulus. With fiscal policy playing a central role, this has created a strong link between government spending and non-oil economic activity. In particular, the business cycles of the non-oil sector tend to move in line with the rapid expansion of government spending. Figure 4 shows that growth rates in the four key sectors of the Saudi economy have fluctuated and have been influenced by changes in oil prices, suggesting that the non-oil sector has been unable to escape the “curse of natural resources.”

While the Saudi government started to attract foreign direct investment (FDI) inflows by issuing the first Foreign Investment Law in 1956, FDI inflows between 1970 and 2000 were very small relative to GDP. Spillovers from FDI in terms of technology transfers and job creation were also limited since FDI inflows were directed predominantly to petroleum-related industries. The 2000 law was

enacted to provide the legal setting deemed requisite for attracting more FDI, and to create a specialized investment institution, the Saudi Arabian General Investment Authority (SAGIA). The SAGIA was tasked with issuing investment licenses, facilitating investment procedures through comprehensive service centers in all major cities, proposing measures to improve the investment climate, and promoting investment opportunities more broadly. The minimum capital requirement for starting a business as well as ownership restrictions were completely removed, and the Saudi government now provides a range of investment incentives, such as tax holidays, to encourage foreign-owned firms to invest in the kingdom. These reforms have led to a considerable improvement in the country’s ranking in the World Bank’s Ease of Doing Business Index. In 2010, Saudi Arabia was ranked first among the Arab countries and 13th out of 181 countries.<sup>9</sup> According to the 2013 World Investment Report published by UNCTAD; the country was the second largest FDI recipient in Western Asia.<sup>10</sup> However, FDI inflows still need to be directed towards non-hydrocarbon activity and strengthening the manufacturing sector.

FIGURE 4. NON-OIL SECTOR AND CHANGES IN OIL PRICES



Source: Penn World Table (version 8.0) and IMF’s World Economic Outlook, April 2014.

## Can the Economy Converge in the Future?

The existing Saudi economic structure is more inclined to lead to a widening of income gaps in the absence of a well designed strategy that ensures diversification into income-generating economic sectors.

The inability of Saudi real per capita incomes to reach the levels of developed economies stems from several characteristics of the economy: its heavy reliance on oil revenues as the main source of income, which is exhaustible, and highly volatile, high population growth and unemployment rates, and low rates of return on investments in physical and human capital.

Given these challenges, structural transformation and further diversification of the Saudi economy becomes a necessity rather than a choice. It is clear that the mechanism of sharing oil wealth through public sector employment and subsidies has not succeeded in reducing income disparities. Therefore, there is a need for multi-dimensional, broad socio-economic solutions to put the economy on a sustainable growth path.

The heavy reliance on volatile and uncertain oil revenues has complicated macroeconomic management and government planning. By creating uncertainty about the future, these fluctuations have contagion effects on non-oil economic activity, which in turn have discouraged private sector investment. Furthermore, domestic oil consumption has grown steadily over the last few years to an estimated 3 million barrels per day.<sup>11</sup> This combination of price volatility and high domestic consumption could have adverse implications for fiscal and current account balances in the future.

While the Saudi authorities have been able to manage temporal volatility of oil prices through their countercyclical policy, a persistent decline in pric-

es would have an adverse impact on the economy. Even if the establishment of a sovereign welfare fund has helped the government to smooth spending in the face of exogenous shocks in oil markets, the issue of high unemployment among Saudi nationals would remain.

## What Is the Solution?

It seems that the only solution to these fundamental problems, besides further labor market reforms, education and training reforms, and prioritizing government capital spending, is to boost the participation of the private sector through diversifying the economy in more export-oriented and labor-intensive industries that are not subject to the price and volume fluctuations of the oil markets.

Saudi Arabia has a very young population, with nearly 50 percent under the age of 25, and the total population is projected to double by 2025. According to the latest forecast, the unemployment rate among Saudi nationals is about 11.5 percent. These sizeable economic and demographic challenges are directly affecting labor market prospects. The government needs to create about 3.8 million jobs for Saudis in the next decade. Yet under current conditions, this will be difficult to achieve. The government sector has already reached its upper limit and the *Saudization* program has so far proven inadequate to solve the problem.

To achieve inclusive growth and sustainable development and re-redirect the economy toward its convergence path, the government must implement wide-ranging market-oriented reforms in both real and financial sectors that further improve the business environment, governance, and institutional and policymaking frameworks. More emphasis must be placed on efficiency and productivity, and encouraging entrepreneurship by developing the small and medium-sized enterprise sector is required to make progress on economic diversification. Policies should aim to attract more FDI in more knowledge-intensive industries.

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## Endnotes

1. The views expressed in this paper are those of the author(s) and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.
2. Barro (1991) and Barro and Sala-i-Martin (1991)
3. Romer (1993)
4. Islam (2003)
5. A third concept is club convergence. Some countries within the same region converge to the same levels of income per capita, while other countries tend to diverge in the long-run (Islam, 2003).
6. The World Bank (2014a)
7. The real U.S. GDP per capita, Norway GDP per capita, and the average OECD countries per capita would grow at 1.8, 2, and 2.5 percent per year, respectively.
8. SAMA(2013)
9. The World Bank (2010)
10. UNCTAD (2013)
11. EIA (2014)