

# Saudi-American Forum

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SAF Item of Interest

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## **Winds of Change**

by Massoud Derhally

“It was a jolt,” is how Adel Al Jubeir, the foreign policy advisor to Crown Prince Abdullah of Saudi Arabia, described the terrorist attacks on the Kingdom in early May. Indeed it was, and the effects of these attacks are yet to be determined. After September 11, Saudi-US trade plummeted in 2002, with US exports to the Kingdom falling 40% in the first six months of the year.

However, it’s not just its relationship with the US that preoccupies the Kingdom. Saudi Arabia, the country with the world’s largest oil reserves, continues to suffer from fragile fiscal accounts, an over reliance on oil and dependence on a foreign workforce. All of these variables, coupled with the recent attacks on the Kingdom, are worrying to businessmen and analysts, who are keen to see a faster pace of privatization, economic reform, greater transparency and lower unemployment.

In an effort to overcome these hurdles to growth, the Kingdom has been trying to diversify its economy to realize sustainable growth by increasing the weight of the private sector and by making the country more attractive to foreign investors. The Saudi private sector is said to be moving to the fore of economic development and diversification efforts as the government makes reassuring noises about curtailing its own spending.

Efforts to diversify the economy’s production base appear to be moving along and new doors are being opened to foreign investors. The investment environment, long restrictive in the Kingdom, is said to be getting better. After rejecting a proposed 10% tax on expatriates, who number 7 million, it came as no surprise when the Saudi Shura consultative council agreed to lower the tax bracket on foreign corporations’ profits.

The council, a 120 member advisory body, without binding legislative powers, reduced the tax rate from 45% to a maximum of 25%, making Saudi Arabia the country with the lowest tax bracket on corporates in the region.

Explaining the decision not to tax individuals and the new decision regarding corporates, Ihsan Bu Hulaiga, a Saudi economist says, “Majlis Al Shura did not like the idea of taxing salaried individuals because of a number of considerations, [such as] the impact on the economy and, in particular, on the demand for goods and services, especially when you are talking about more than 7 million individuals.” He adds: “The proceeds wouldn’t be that high to justify the inconveniences of collecting the money, upsetting some people and making the work environment less attractive to the professionals and the people that the economy would need here.”

Altering other components of the taxation law could easily offset this relatively small loss of revenue, says Bu Hulaiga, and this is what happened. “We crossed out all articles that have to do with taxing income of salaried individuals and what we have now is 25% across the board for businesses in Saudi Arabia,” he explains. Some analysts say that, in the short term, lower tax brackets may affect the Kingdom’s ability to manage its growing debt, estimated at US \$173 billion, equivalent to nearly 100% of annual gross domestic product (GDP).

However, Johnny AbedRabbo, a senior economist at National Commercial Bank, says: “While it is true that lower tax brackets imply decreased revenues for the government, the new law would effectively reduce taxes by 5% only, which will not have a significant impact on government revenues. On the upside, the lower tax rate should encourage more foreign companies to set up shop in Saudi Arabia, which ultimately will boost tax revenue.”

The aim of the new measure, which will become effective after approval from the cabinet, is to attract more foreign direct investment (FDI). FDI in the Kingdom since September 11, 2001, is pegged at \$4 billion, less than half of the \$9.2 billion from the period between April 2000 and early September 2001.

Spearheading the drive to attract overseas investments in the Kingdom is the governor of the Saudi Arabian General Investment Authority (SAGIA), which was established in 2000, Prince Abdullah bin Faisal bin Turki Al Saud.

The Prince says he would have liked to see a further tax cut than what was tabled by the Shura council. “We at the investment authority feel it would be very useful to encourage investors in this period by reducing tax further,” says Prince Abdullah.

“The best way for a market like Saudi Arabia, at this stage, is to tax foreign corporations like the zakat formula applied to local corporations (2.5% of total annual revenue.) This, to us, is a matter of principle. We treat all investors the same, we don’t distinguish where they come from and we provide the same service to them,” he adds. The Prince stresses that the Saudi market has tremendous potential and the income from the tax is not as important as the positive impact of the reduction on the market.

“We want to make the investment climate better and investment opportunities greater. The market is much more important than budgetary issues. The GDP is much bigger than the government budget or sector.”

Bu Hulaiga agrees with the Prince. “What would improve the investment climate here would be to remove a number of administrative and structural obstacles,” he says.

Since it was formed in 2000, SAGIA has licensed around 1,800 industrial, agricultural and service projects worth SR51 billion (\$13.6 billion). Observers say the flow of investment would be much greater if laws barring foreign investment in sectors like telecommunications, oil exploration, security, retail and wholesale, education, and land and sea transport were lifted. These sectors are among 16 activities that are still barred to foreign investors.

The Prince, who has been a proponent of reform and removing barriers, is cautiously upbeat. Asked how he would characterize the foreign investment climate, he says, "It's not the foreign investment climate; it's the investment climate as a whole. The issues that face investors are the same for foreigners and locals. You would be surprised how similar they are. I feel it [the environment] is improving, but it is not ideal, not what we would like."

Should Saudi Arabia increase the pace of its privatization, and the scope of companies to be privatized, the potential is great. "You are talking about \$1 trillion and that's just looking at demand now, and some of the current projects and linking them to the population growth," the Prince explains.

"The calculation of what is going to happen in-between and what impact it will have on small and medium size [enterprise] activities and industry has not even been made. Of course we are optimistic, but in the whole of the Arab world we need to speed up these things." But there are still bottlenecks in the system. "For us, it is a mindset that is changing. In Saudi Arabia, we have no problem with the direction [of change]," he says. "The problem is with the speed and rate of change," he adds.

Emphasizing the sheer scale of the task, Abdullah cites from an article he read recently. "You have to have a 6-7% [economic] growth rate for the next 20 years and while Saudi Arabia has always had good basic infrastructure, basic needs change," he says.

Indeed they do. Unemployment, according to unofficial estimates, is 31%. Driving his point home, Abdullah explains how the Ford Motor Company, with its 110,000 workers, sold more than the GDP of Saudi Arabia in 2002, and how Spain, to which Saudi Arabia used to give aid in the late 1970s and early 1980s, is now bigger than all 22 Arab economies. "This is primarily because it [Spain] opened up its investment market. We believe in liberalizing markets," emphasizes Prince Abdullah.

Although there are no publicly declared target figures for attracting funds from abroad, the Kingdom makes no secret that it would like to see billions pour in. Saudi Arabia badly needs to overcome its dependence on high oil prices, which make budget planning a nightmare, and find more predictable sources of revenue.

For example, at the start of 2003, Saudi Arabia budgeted a \$10.4 billion budget shortfall, but in April projected a surplus of more than \$13 billion because of the spike in oil prices. In 2002, the Kingdom reduced a projected budget deficit of \$12 billion to \$5.6 billion, also on high prices. All well and good whilst prices are high, but what happens when they drop?

Now, with the war in Iraq winding down and Iraq's return to international oil markets imminent, the Kingdom is again closely watching the price of a barrel. Oil accounts for 40% of the country's GDP and a lack of economic diversification and continued dependency on oil could slow economic growth, and slow economic growth is not such a good thing for a country with a rapidly increasing and young population where 50% of people are under the age of 15, according to some estimates.

This is all the more reason to expedite the process of privatization. It is also all the more reason to remove the barriers that deter foreign investment flows, and to reform public enterprises and the labor market, which will eventually pave the way for WTO membership.

In April, the IMF advised the Kingdom that high oil prices would only bring temporary respite and urged the government to carry on “expeditiously” with plans to eradicate the budget deficit by broadening the tax base outside the oil sector and cutting back on spending. In order to improve the outlook, SAGIA’s Prince Abdullah says that in any market or society there are several things that governments should be striving to do. “There is a generation born every day and their demand is growing, and if you don’t do something everyday, tangible or intangible to help increase the economic growth rate then you score a poverty point,” explains the Prince.

“If you don’t do something for utilities and general services you lose money and competitiveness at the household level, the business level and the government level. If you don’t do something for social services, education, training and health then you score a backward point. We believe the only thing that will activate all these things and allow them to be available is direct investment and this is the premise from which we move.”

Prince Abdullah’s job has no doubt become more difficult with the recent terrorist bombings in the Kingdom. The attacks say some, will affect the Kingdom’s attempts to attract FDI and liberalize its economy. “The mandatory evacuation of all dependents and non-essential personnel at the US Embassy is going to cause a mass exodus of US private sector workers and also other Westerners, I predict,” says a senior American advisor in the Kingdom.

“The only way that I can see for the Saudi government to ameliorate this catastrophe and get their development efforts back on track is to give full and complete cooperation to the US investigators who will be coming over. We are all in this together now, and it is time for all departments of the Saudi government to extend their fullest cooperation to the US in solving these crimes and apprehending the true culprits.

“The longer the US and other western nations keep the Kingdom on the ‘Do Not Travel To List’, the worse it is going to get for Saudi economic development efforts. I am encouraged by the Crown Prince’s strong words. I hope they are followed by equally strong and cooperative action on the part of all arms of the Saudi government.” James Akins, the former US ambassador to Saudi Arabia believes the recent attacks on compounds where Americans were housed will have an effect on American investments in the kingdom, and on other foreign non-Arab investments as well, but doesn’t think “they will be of crucial importance.”

“Much more important will be how much progress is made on reaching an Arab-Israeli peace which Arabs can consider honorable,” says Akins. “If we show that our policy is independent and fair and is not dictated by Ariel Sharon, then I think things could improve considerably.”

“Much will also depend on how we proceed with the re-building of Iraq. If our actions are seen as both honorable and effective then I think the appeal of Al Qaeda and others like it will fade. If we continue being subservient to Sharon and if the rebuilding of Iraq goes sour and both, alas,

are probable, then the future of American investment in the Kingdom, indeed in most of Dar Al Islam, will be bleak,” he continues.

While Akins believes the Saudis must do something about their internal security, an issue that was put in the spotlight by Robert Jordan, the new US ambassador to Saudi Arabia, he has harsh words for Jordan.

“The American Ambassador was right in thinking this, but he was incredibly wrong and insensitive to have said as much publicly. The same points could have and should have been made in private to Crown Prince Abdullah and Prince Sultan.”

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