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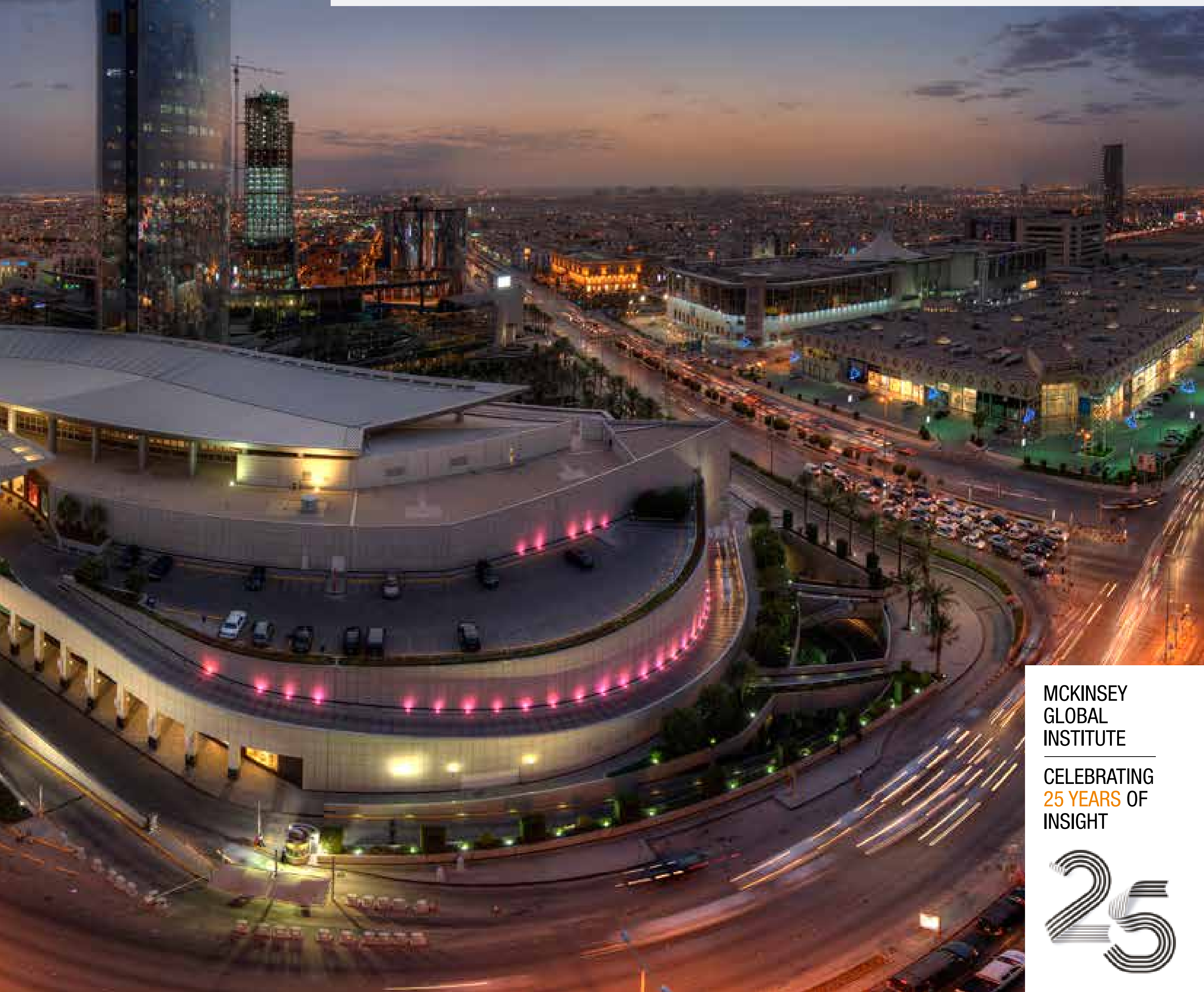
SAUDI ARABIA BEYOND OIL: THE INVESTMENT AND PRODUCTIVITY TRANSFORMATION

DECEMBER 2015

EXECUTIVE SUMMARY



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SAUDI ARABIA BEYOND OIL: THE INVESTMENT AND PRODUCTIVITY TRANSFORMATION

DECEMBER 2015

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IN BRIEF

SAUDI ARABIA BEYOND OIL: THE INVESTMENT AND PRODUCTIVITY TRANSFORMATION

MGI is publishing this report on Saudi Arabia at a time of change in the Kingdom. After a surge in prosperity over the past decade, the economy is at a transition point. We see a real opportunity for the Kingdom to inject new dynamism into the economy through a productivity- and investment-led transformation that could help ensure future growth, employment, and prosperity for all Saudis.

- An oil price boom from 2003 to 2013 fueled rising prosperity in Saudi Arabia, which became the world's 19th-largest economy. GDP doubled, household income rose by 75 percent, and 1.7 million jobs were created for Saudis, including for a growing number of Saudi women. The government invested heavily in education, health, and infrastructure and built up reserves amounting to almost 100 percent of GDP in 2014.
- The Kingdom can no longer grow based on oil revenue and public spending, in the face of a changing global energy market and a demographic transition that will lead to a bulge in the number of working-age Saudis by 2030. Current labor participation is 41 percent, and productivity growth of 0.8 percent from 2003 to 2013 lagged behind that of many emerging economies. Foreign workers on temporary contracts who are paid considerably less than Saudi nationals today constitute more than half the labor force.
- We have developed a model that integrates Saudi Arabia's economic, labor market, and fiscal perspectives. It shows that even if the Kingdom introduces reactive policy changes such as a budget freeze or immigration curbs in the face of these challenging conditions, unemployment will rise rapidly, household income will fall, and the fiscal position of the national government will deteriorate sharply.
- However, a productivity-led transformation of the economy could enable Saudi Arabia to again double its GDP and create as many as six million new Saudi jobs by 2030. We estimate this would require about $4 trillion in investment. Eight sectors—mining and metals, petrochemicals, manufacturing, retail and wholesale trade, tourism and hospitality, health care, finance, and construction—have the potential to generate more than 60 percent of this growth opportunity.
- To enable this transformation, Saudi Arabia will need to accelerate the shift from its current government-led economic model to a more market-based approach. In the labor market, greater workforce participation by Saudi men and women is essential to achieve higher household income. The proportion and number of foreign workers may decline but they would likely benefit from higher wages and better conditions. Faster productivity growth requires better business regulation and more openness to competition, trade, and investment. Improved efficiency of spending and new revenue sources, possibly including taxes and higher domestic energy prices, can help ensure fiscal sustainability.
- All stakeholders, including the private sector, foreign investors, and households, will need to be involved in this transformation. The state will have to embrace a new delivery philosophy while businesses adapt to a more competitive environment and the individual Saudi citizen takes more personal accountability. The transition will be challenging, but the new era of economic growth and employment it could usher in would be more sustainable than the oil booms of the past.

Saudi Arabia A productivity-led transformation

After a decade of sustained oil-based growth, Saud Arabia is at a transition point. Over the next 15 years, the Kingdom will face heightened competition in the energy market and a growing number of working-age Saudis.

To prevent economic difficulties, Saudi Arabia needs to realize the potential of the non-oil economy. A productivity-led transformation, if successfully implemented, could usher in a new cycle of prosperity.

Realizing Saudi Arabia's **full potential** by 2030

2 **GDP could double** again

4 **$4 trillion** to be invested in the non-oil economy, primarily from private sources

6 **6 million additional Saudi nationals** in the workforce

60%
increase in Saudi household income

$800 billion
GDP increase

Eight sectors that will generate growth and jobs

- Mining and metals
- Petrochemicals
- Manufacturing
- Retail and wholesale trade
- Tourism and hospitality
- Finance
- Construction
- Health care

*These sectors could contribute **more than 60%** of the growth needed to double GDP by 2030*

Three pillars to transform Saudi Arabia

A more productive workforce

Increased employment and participation of Saudi men and women in the labor force

Eliminating the mismatch between skills and the needs of the labor market

Economic reform

More competition and greater openness to foreign investment and trade

Simpler, speedier processes to remove hurdles to private-sector growth

Sustainable fiscal management

An overhaul of the existing model based on oil revenue and public spending

More efficient spending and a new focus on value for money

More than half the Kingdom's population is younger than 25
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EXECUTIVE SUMMARY

Saudi Arabia's economy is one of the largest in the world and also one of the least understood. During the decade of 2003 to 2013, it almost doubled in size on the back of a protracted oil boom. At the same time it underwent a significant modernization that brought prosperity and change to Saudi society. Household income for Saudi nationals after adjustment for inflation grew by about 75 percent during the decade, 1.7 million Saudi jobs were created, and $450 billion was invested in health, education, and infrastructure, helping to boost living standards and improve the quality of life.

This growth model, dependent on oil exports and public-sector spending, has been a recurrent topic over the past two decades for Saudi and international economists, many of whom argue that the Kingdom's economy should diversify away from oil to ensure sustainability. Several of the government's five-year development plans have also outlined diversification as a priority objective.

Today, achieving that goal has become essential. Over the next 15 years, the Kingdom is likely to face critical challenges, both fiscally and in its demographics, with heightened competition in the energy market and a big increase in the number of Saudis reaching working age. As a result, the economy is at a transition point. While much of the outside world has focused on the very real challenges, we believe there are also substantial opportunities for the Kingdom to transform its economy to become more sustainable and less oil-dependent.

To examine the implications of these changing internal and external conditions independently of Saudi government and other projections, we built a comprehensive model that integrates the Kingdom's economic, labor market, and public finance perspectives. It suggests that based on current trends, Saudi Arabia could face a rapid economic deterioration over the next 15 years. Even if the government were to react by freezing public spending or intervening in the labor market, household income would nonetheless likely fall, unemployment would rise and there would be growing fiscal strain. This outcome is not a foregone conclusion, however. Another, very different scenario is possible if the Kingdom is able to inject new dynamism into the economy through a productivity-led transformation. Significant reforms in the labor market, business regulation, and fiscal management would be required to realize the intrinsic potential of the non-oil economy. Successfully implemented, these reforms could usher in a new cycle of prosperity for the Kingdom.

Three numbers—two, four, and six—tell the potential benefits. By 2030, GDP could again double in size, adding an additional $800 billion. The non-oil economy could be invigorated by $4 trillion in investment, most of it from private sources, both Saudi and international. And the Kingdom could create as many as six million jobs, enough to absorb the influx of working-age Saudis into the labor market.

The transition required for the Kingdom to adopt the necessary reforms and realize this potential will not be easy. Saudi Arabia will need to shift from its government-led economic and social model to a more market-based approach that brings it into line with other modern economies. The government is already doing this in some areas and has accelerated its efforts in the past few months. In this report we outline a road map that may help the Kingdom attain even more ambitious goals.

For our analysis and conclusions, we have focused purely on economic factors. While we are conscious that the security and politics of the region could affect the potential transition we outline here, we have not taken them into account for the purposes of this report.

A DECADE OF RISING PROSPERITY FUELED BY OIL

Saudi Arabia is the **19TH** largest economy in the world

The Saudi economy moved up from being the 27th largest in the world in 2003 to become the 19th largest in 2014. Its nominal GDP of about $750 billion is larger than either Switzerland's or Sweden's. On a per capita basis, Saudi Arabia's nominal GDP of about $24,000 is a little behind South Korea's and ahead of Portugal's, although the unique features of the Kingdom, including a sizable population of migrant laborers and a huge oil sector, make this figure misleading.[1]

Saudi Arabia is the world's largest oil exporter, deriving about 90 percent of government revenue from oil. The sharp increases in oil prices, which rose from about $30 per barrel in 2003 to a sustained peak of about $110 per barrel in 2011 to 2013 before dropping back in 2014, fueled a doubling of GDP during the decade. At a time of growing indebtedness across major developed and emerging economies since the 2008 financial crisis, Saudi Arabia has been a rare exception: the Kingdom eliminated national debt and increased reserve assets to $732 billion, the equivalent of almost 100 percent of GDP in 2014.[2]

For Saudi households, it was a decade of rising prosperity, with average household incomes rising by about 75 percent in total from 2003 to 2013. This was largely driven by the public sector, which employs more than two-thirds of all Saudi workers and which grew by more than one million employees during the boom decade. In the economy as a whole, 4.4 million jobs were created, of which 1.7 million were taken by Saudis. There were also sizable increases in public social transfers, in particular a new unemployment benefit scheme launched in 2011, as the Kingdom built out its welfare state during the decade (Exhibit E1). The share of household income coming from the government through public-sector wages or social transfers in this period rose from about two-thirds to about 80 percent.

These household figures apply only to Saudi nationals, and not to the growing numbers of non-Saudi migrant laborers, many of them from South Asia. These foreign workers and their families, the vast majority of whom are on fixed, short-term contracts, now constitute one-third of the population. The increase in their numbers during the 2003–13 decade contributed to a 36 percent increase in Saudi Arabia's population, from 22 million to 30 million.

The government used oil revenue to invest in a range of developmental priorities. Public spending quadrupled during the decade, and about $450 billion of public capital investment was deployed in programs to improve education, health, social welfare, infrastructure, and transport.

Projects included a new financial district in Riyadh and the King Abdullah Economic City on the Red Sea, as well as new universities, new metro transit lines, and 81 new hospitals. The number of physicians has almost doubled since 1990, infant mortality has dropped by two-thirds, and life expectancy in the Kingdom has risen by almost seven years to 76 years, higher than in Hungary, Turkey, and China. Education today accounts for about 25 percent of government spending, and about 60 percent of each age cohort goes on to tertiary education, a proportion similar to that in France and Germany.[3]

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1 2014 figures. Central Department of Statistics and Information, Saudi Ministry of Economy and Planning.

2 Central Department of Statistics and Information, Saudi Ministry of Economy and Planning; *Debt and (not much) deleveraging*, McKinsey Global Institute, February 2015.

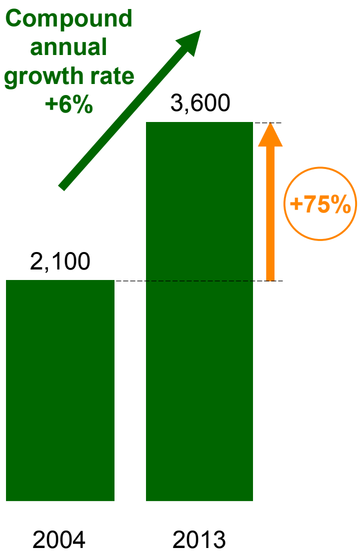
3 Gross enrollment rates for tertiary education, UNESCO Institute for Statistics, 2013.

Not all the investment was spent productively or produced desired outcomes. The overall quality of education remains low. Saudi schoolchildren score poorly in international comparative tests, and the university dropout rate is about 50 percent.[4] Some of the infrastructure spending has been clouded by long delays and budget overruns for large prestige projects. In health care, the Kingdom has among the highest prevalence of obesity and diabetes in the world that all the new hospitals have not been able to reduce.[5]

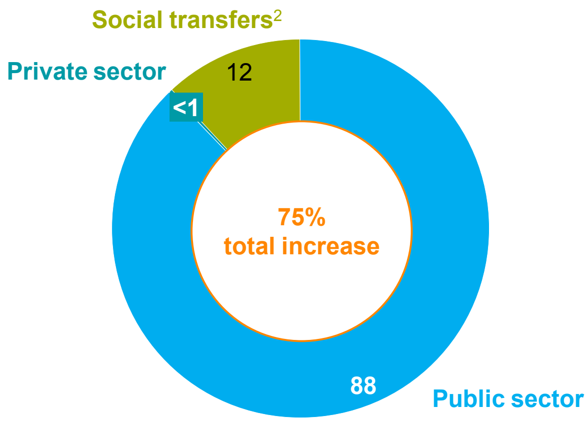
Exhibit E1

Saudi real household income rose by 75 percent during the "second oil boom" decade, driven by higher public-sector employment and wages

Real Saudi household incomes[1]
$ per month, 2013 prices



Sources of Saudi household income growth
% of total 2004–13 growth



1 Households of Saudi nationals only; does not include foreign workers.
2 Pensions, student stipends, and unemployment benefits.
NOTE: Numbers may not sum due to rounding.

SOURCE: Central Department of Statistics and Information, Saudi Ministry of Economy and Planning; Saudi General Organization of Social Insurance; Saudi Ministry of Civil Service; McKinsey Global Institute analysis

About 83 percent of the Saudi population lives in cities, a degree of urbanization that is larger than in some Western European countries. MGI research has shown that vibrant cities are a key driver of economic growth, so the Kingdom's high degree of urbanization is an asset.[6] Most of the urban activity is concentrated in five large metropolitan clusters, of which Jeddah-Mecca-Taif on the Red Sea is the largest, with a population of seven million. Riyadh, the capital, has a population of six million.

A number of important developments in the Kingdom during this period are less well known than the overall macro story. The number of Saudi women participating in the workforce has been rising, albeit from a very low base, and in 2014 reached 1.2 million, or 18 percent of the female working-age population. Of this, 800,000 were employed. This is double the number of a decade previously, in 2003. The fastest job growth for women has come in the private sector, partly driven by the government, which made a push to get women into certain

[4] Eighth-grade students in Saudi Arabia scored an average of 394 in the most recent Trends in International Mathematics and Science Study in mathematics in 2011. The TIMSS average is 500, and scores below 440 are usually interpreted as "poor." *How the world's most improved school systems keep getting better*, McKinsey & Company, 2010.

[5] World Health Organization; International Diabetes Federation.

[6] *Urban world: Mapping the economic power of cities*, McKinsey Global Institute, March 2011.

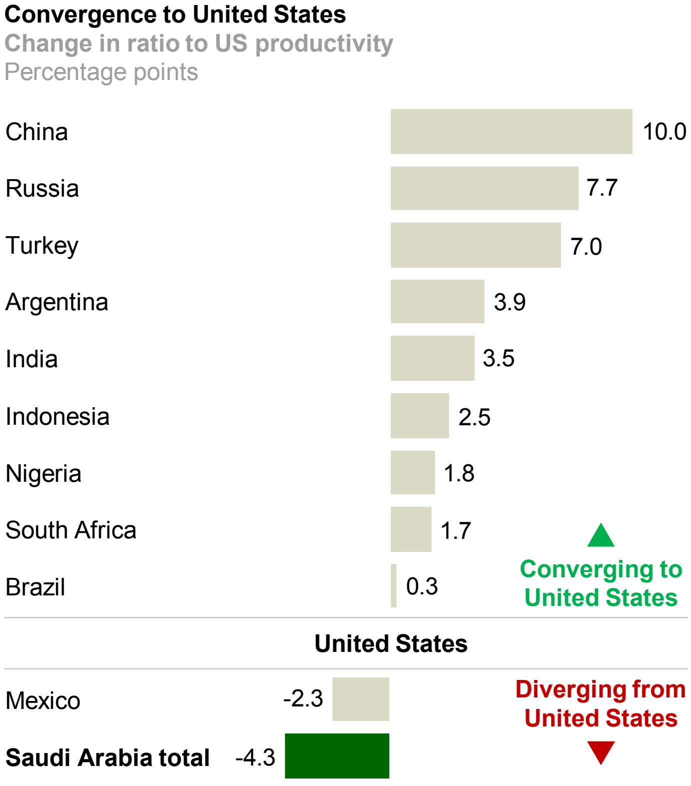
types of employment, especially retail.[7] However, female unemployment totals 33 percent, and the participation rate of women, youths (15 percent), and senior adults (35 percent) still lags well behind that of adult Saudi men (65 percent). Restrictions on mixed-gender work environments and on female drivers create unique challenges and barriers to raising female participation and employment.

The limited role of women is not the only unusual aspect of the Saudi labor force. Foreign workers, largely from India, Pakistan, and Bangladesh, constitute more than half of the total workforce. They tend to be relatively unskilled and are paid far less than Saudi nationals; their average monthly wages of $400 are less than one-third the average monthly wage for Saudi nationals in the private sector, and one-sixth the average for Saudi public-sector employees. One consequence is that Saudi Arabia's track record for labor productivity is weak. Annual productivity growth over the 2003–13 decade was just 0.8 percent, considerably below the 3.3 percent average annual productivity growth of the other G20 emerging economies (Exhibit E2). As a result, the Kingdom did not close a productivity gap with the United States, the world productivity leader, but fell further behind.

Exhibit E2

Productivity growth in Saudi Arabia lagged that of other major emerging economies and fell further behind the United States

G20 emerging markets + Nigeria, 2003–13



1 Unweighted average of all emerging economies in G20 and Nigeria.

SOURCE: The Conference Board Total Economy database; Central Department of Statistics and Information, Saudi Ministry of Economy and Planning; ; McKinsey Global Institute analysis

[7] The Saudi press has reported on stores being closed for refusing to employ women, for example. *Arab News*, "90 bridal shops shut for not employing women," June 8, 2015.

Despite the sizable increase in the number of jobs in the past decade, unemployment of Saudi nationals currently stands at about 12 percent.[8] In part this is because generous family support and unemployment benefits, which can amount up to two-thirds of the minimum public-sector wage, provide little incentive to look for work.

TODAY'S CHALLENGES: A CHANGING ENERGY MARKET AND A DEMOGRAPHIC BULGE

More than half the Saudi population is younger than

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After this decade of prosperity and change, the Saudi economy faces two critical challenges that will put its substantial oil and financial resources to a test. The first is external and relates to oil, today the lifeblood of the Kingdom's economy. The oil market, having boomed for a decade, is volatile. Prices dropped about 50 percent during the second half of 2014, and various forecasters including the International Energy Agency have outlined scenarios for a more competitive global energy landscape in the near to medium term. Global investment in oil is set to increase, and new sources of energy supply such as renewable energy and US shale oil, together with disruptive technologies in the energy sector, mean greater competition for the Kingdom's key export and revenue source.

These market shifts are already being felt. The Kingdom's budget swung from a surplus of 6.5 percent of GDP in 2013 to a deficit of 2.3 percent in 2014 as proceeds from oil exports dropped.[9] With lower oil prices persisting into 2015, the IMF has projected continued fiscal deficits for the Kingdom for the foreseeable future, including a forecast deficit of 22 percent of GDP in 2015.[10] In our model, we assume a gradual return to a $60 per barrel oil price, in line with the futures curve from October 2015, and flat oil production after 2016. (For details of our assumptions please see the Technical Appendix at the end of this report).

The second challenge is internal and relates to the country's demographics and the projected workforce of Saudi nationals. More than half the Kingdom's population is younger than 25, and by 2030 the number of Saudis aged 15 years and over will likely increase by about six million.[11] Based on historical trends in participation, we estimate that this upcoming demographic bulge could bring at least 4.5 million new working-age Saudis into the labor market by 2030. That would almost double its size to about ten million—and more if accompanied by above-trend increases in female labor force participation. To absorb this influx would require the creation of almost three times as many jobs for Saudis as the Kingdom created during the 2003–13 oil boom.

There will also be a growing number of older people to support, which will increase the demands on the country's health system and finances.

These demographic changes come in a country with a dual labor market split between higher-paid Saudi jobs, mainly in the public sector, and lower-paid foreign workers, predominantly in the private sector. The Kingdom has a relatively weak record of private-sector job creation for Saudi nationals, which will be a major challenge and opportunity regardless of the future trajectory of oil prices (Exhibit E3).

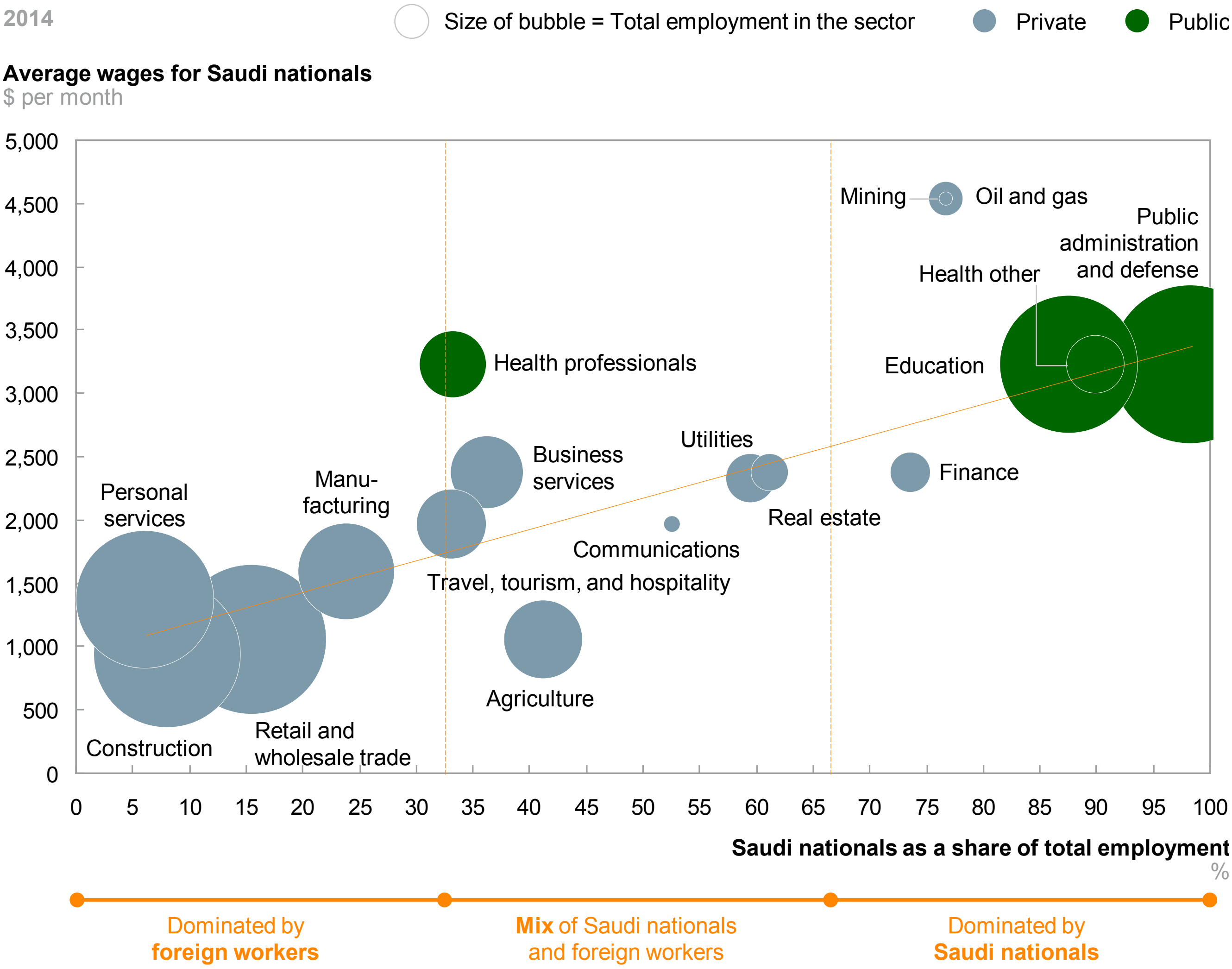
Together, these two challenges pose a threat to the current development model. Our economic model suggests that even if the government were to freeze the level of public expenditure in nominal terms to contain the deficit and intervene in the labor market to stem rising unemployment by limiting the influx of foreign workers, these reactive changes would be insufficient to maintain current Saudi living standards or sound public finances. Even assuming that Saudi nationals replaced foreign laborers in more than 800,000 low-

8 Central Department of Statistics and Information, Saudi Ministry of Economy and Planning.
9 Saudi Arabian Monetary Agency Annual Statistics, 2015.
10 *World Economic Outlook*, IMF, October 2015.
11 In its official statistics, Saudi Arabia's Ministry of Economy and Planning defines the working-age population as comprising people between the ages of 15 and 59.

paid jobs, we estimate that only about three million jobs would be created for Saudis under this scenario by 2030. That would mean a shortfall of at least 1.5 million jobs, and the unemployment rate for Saudi nationals could exceed 20 percent. Real average Saudi household incomes could consequently fall by about 20 percent.

Exhibit E3

Saudi Arabia has a dual labor market, with Saudi nationals in higher-paying public-sector jobs, and non-Saudis in lower-paying private-sector jobs



SOURCE: Central Department of Statistics and Information, Saudi Ministry of Economy and Planning; Saudi Ministry of Labor; Saudi Ministry of Health; McKinsey Global Institute analysis

Such a scenario would in turn have significant implications for the Kingdom's financial stability. The government had very substantial fiscal reserve assets equal to about 100 percent of its GDP in 2014, or twice the size of Russia's reserves in dollar terms.[12] Including those reserves, it has well over $1.4 trillion in assets, including large shares of publicly listed state-owned companies that are currently worth about one-third the total value of the national stock market. Even so, a lack of action could be costly to the economy and the government. For every year of delay, we estimate that the additional cost to the government by 2030 in terms of more expensive operations and lower oil revenues would

[12] Saudi Arabian Monetary Agency; World Bank data on total reserves in 2014.

amount to about 190 billion Saudi riyal (SAR), or $50 billion. Or put another way, it raises the break-even price of oil for the Saudi government in 2030 by $18 per barrel.[13]

Without more comprehensive reform, the Kingdom might accumulate net debt of about 140 percent of GDP in 2030 and could still be running large fiscal deficits. This is even after assuming that public expenditure is frozen at today's levels in nominal terms till 2020, meaning not only no further growth but real declines by 2030, with public spending dropping from about 40 percent of GDP in 2014 to just under 30 percent in 2030.

THE $4 TRILLION INVESTMENT OPPORTUNITY

These outcomes are not a foregone conclusion. There is another path. In the next 15 years to 2030, Saudi Arabia could potentially double its GDP again, increase real Saudi household income by about 60 percent and create as many as six million new Saudi jobs. The GDP increase amounts to about $800 billion, the equivalent of adding Turkey's economy today, or three Finlands. Unemployment would decline to about 7 percent (Exhibit E4). In this report we have projected outcomes for Saudi households. The size and nature of the foreign workforce in Saudi Arabia is highly changeable, and most of these non-Saudi workers do not permanently settle in the Kingdom. Projecting gains in their living standards and income is therefore challenging and subject to specific policy implementation. However, foreigners will benefit—as Saudis will—from changes that will make the entire workforce more productive, thus raising wages and improving working conditions.

This transformation would wean Saudi Arabia off its heavy dependence on oil: under this scenario, non-oil revenue could increase from 10 percent of total government revenue to 70 percent. The change could also fundamentally alter the dominant role of the public sector in society, with wages from private-sector employment rising from 19 percent of total household income to 58 percent.

Achieving such growth would require an acceleration of productivity growth combined with a continued high rate of investment. Together, these would drive a very robust expansion of the non-oil private sector. We estimate the investment needs at about $4 trillion. This is about three times the size of the investment made in the Saudi economy during the 2003–13 oil boom, which in itself was three times the investment of the previous decade. Much of it would come from non-government sources including both Saudi and foreign investors.

While the non-oil private sector is relatively small in Saudi Arabia, it has potential to drive much of the growth. Already during the 2003–13 period, the non-oil private sector outperformed the economy as a whole, albeit starting from a low base. It grew at about 10 percent annually, much faster than the overall 6 percent GDP growth rate. Growth was broadly based, with consumption-based sectors such as transport, communications, retail and wholesale trade, and business services growing the fastest. The non-oil private sector's productivity growth was also more rapid than the rest of the economy, with an average of 2.5 percent per year. Sectors such as manufacturing were among the brightest spots. Between now and 2030, there are opportunities throughout the economy to supercharge this non-oil growth. In this report, we highlight eight sectors that analysis suggests have some of the biggest potential, and could contribute more than 60 percent of the overall growth needed to double GDP by 2030. They are mining and metals, petrochemicals, manufacturing, retail and wholesale trade, tourism and hospitality, health care, finance, and construction.

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[13] Additional cost is calculated as the incremental change in the fiscal balance between 2029 and 2030 in the full potential scenario minus the incremental change in the reactive policy scenario in the same period.

Exhibit E4

In the face of challenging conditions, Saudi Arabia could still double GDP by 2030 under a full potential scenario

Key outcomes in 2014 and 2030
Constant 2013 prices (assumes $60 per barrel oil price)

	The Kingdom in 2014	Reactive policy change	Full potential
Real GDP	$800 billion	$1,200 billion 1.5x or 3% compound annual growth rate	$1,600 billion 2x or 4.5% compound annual growth rate
Real monthly household income[1]	$3,800	$3,000 -20%	$6,000 +60%[2]
Saudis out of work	660,000	2,200,000	800,000
Unemployment rate[1]	12%	22%	7%
Net government liquid financial assets[3]	+$900 billion	–$2 trillion	–$600 billion
Share of GDP	120%	–140%	–30%
Annual fiscal balance	–$17 billion	–$170 billion[4]	+$40 billion[4]
Share of GDP	–2.3%	–12%	+2%

1 Saudi nationals only and does not include foreign workers.
2 After possible taxes (pre-tax increase is 80%).
3 Reserve assets plus government stock-market equity less gross debt (as of end 2014) minus cumulative fiscal deficits between 2015 and 2030.
4 Excludes interest payments if government chooses to finance deficits with debt.

SOURCE: McKinsey Global Institute analysis

- **Mining and metals.** On the western side of the Arabian Peninsula are substantial deposits of metals and non-metallic minerals, including major phosphate resources, gold, zinc, bauxite and high-quality silica, gypsum, limestone, kaolin, and magnesite. They present an opportunity for the Kingdom to develop both additional resource sectors and manufacturing sectors. For now, while the reserves are ample, the mining and metals sector is still largely underdeveloped; combined GDP of the extraction and manufacture of these resources is estimated at less than 3 percent of the Kingdom's GDP. We estimate this sector could triple in value added and potentially create up to 500,000 new jobs for Saudi nationals. To develop the industry, the Kingdom will need to invest more heavily in exploration and create a competitive ecosystem that allows both public- and private-sector companies to thrive.

- **Petrochemicals.** This sector already accounts for two-thirds of Saudi Arabia's non-oil exports, and the Kingdom is competitive in global markets. Saudi Basic Industries Corporation (SABIC), which is 70 percent owned by the government, is one of the top five global chemicals companies, and the Kingdom is home to four of the world's 20 biggest ethylene complexes. We estimate that by reducing current inefficiencies, further integrating its oil refining and petrochemical sectors, and investing in innovation to make higher-margin products, the Kingdom could boost the sector's GDP by up to $30 billion and create thousands of attractive skilled research, engineering, and management jobs.

- **Manufacturing.** Saudi Arabia is a big market for a range of manufactured goods, including automobiles and electrical and mechanical machinery. As with other countries in the region, its needs for now are supplied from abroad. We see the Kingdom as having an opportunity to meet a larger share of its domestic demand, and potentially some regional demand, by leveraging the country's natural endowments, and relatively large market size. Already some private companies are starting to produce locally, including international firms such as Isuzu, which opened a truck assembly plant in the Kingdom in 2012. To ensure competitiveness in these segments would require a skilled and more productive workforce, stronger legal and investment protection, and the removal of a range of obstacles that hinder business, including high import duties, lengthy customs and visa procedures, and gaps in local supply chains.

- **Retail and wholesale trade.** Saudi Arabia's retail sector could boom as online retail and modern formats replace traditional *baqala* neighborhood "corner" stores. Overall, we estimate that retail and wholesale trade have the potential to employ as many as 800,000 additional Saudi nationals over the next 15 years and triple valued added. Retail has been expanding rapidly, at a 12 percent annual rate over the past decade, propelled by the rise in household income. While the workforce now largely consists of low-paid foreign workers, the number of Saudis working in the sector doubled between 2010 and 2014. This is an area where Saudi women in particular have found employment; according to the Ministry of Labor, their number jumped from 10,000 in 2010 to 120,000 in 2014. This reflects a push by the government to encourage Saudization and feminization of retail categories catering to women, such as lingerie or cosmetics. Adapting modern retail formats, migrating rapidly online, and adopting best practices in merchandising, including supply-chain efficiencies such as more automation in warehousing, could significantly enhance productivity and growth.

- **Tourism and hospitality.** Saudi Arabia attracts ten million to 13 million Muslim visitors to the holy sites of Mecca and Medina every year, including more than two million during the annual Hajj pilgrimage period. Overall, however, the tourist industry is in decline; the total number of visitors dropped by 31 percent between 2004 and 2012 as Saudis preferred to vacation abroad. An onerous visa process also may have discouraged some international visitors. We see an opportunity to reverse this trend and develop a thriving private-sector leisure tourism industry for Saudis and foreigners alike that leverages the Kingdom's long Red Sea coastline, a wealth of archaeological treasures, and areas of natural beauty. Religious tourism could also be further developed and cater to tens of millions more pilgrims each year outside the peak Hajj season. Developing tourism, both religious and leisure, will require higher-quality facilities, better safety and service, and greater openness to foreign visitors. Potentially, the sector could employ as many as 1.3 million additional Saudi nationals and increase value add more than fivefold.

- **Health care.** Health care was one of the biggest beneficiaries of public spending during the oil boom, and there was a large-scale buildup of health-care infrastructure including 81 new hospitals. The Kingdom will need to continue spending heavily on health care, especially given the projected increase by 2030 in the number of Saudis over the age of 65. It faces three key challenges that are also opportunities: current suboptimal productivity and financing that could be increasingly covered by the private sector; a health-care workforce that is not structured to tackled the growing prevalence of non-communicable diseases such as diabetes, and an increased need for doctors, nurses, pharmacists, and other skilled professionals. For now, just one in three health-care professionals is a Saudi national, and there are not enough health-care graduates to replace professionals who retire or leave their jobs, let alone fill additional posts. To reverse this trend, several initiatives will be needed to improve the perception of the health-care professions and to provide the educational capacity at colleges, universities, and appropriately equipped teaching hospitals.

- **Finance.** This will be an essential sector to enable economic growth in the private sector and at the same time contribute to it through a substantial expansion of its own. There is significant potential room for growth in lending to small and medium-sized business, as well as in better provision of financial services to households, including mortgages and investment products. Households will have an important role to play in helping to finance the Kingdom's big investment needs indirectly through their savings.
- **Construction.** The eighth sector is construction, which grew significantly over the past decade as the Kingdom built out its infrastructure. Over the next 15 years, further large-scale investments, increasingly from the private sector, should translate into continued demand for construction. For the investment to be productive, the sector must become more efficient, adopting modern techniques and improving operational management to be able to deliver projects on time and on budget. For now, more than nine in ten workers in the sector are foreign laborers. If the current Saudi stigma of working in construction could be overcome, the sector could become an important driver of future Saudi employment.

Saudi Arabia needs a more productive workforce with higher participation if it is to raise output and provide employment for the cohort of young people entering the job market by 2030.

TRANSFORMING THE ECONOMY THROUGH INCREASED LABOR PRODUCTIVITY, A STRONGER BUSINESS ENVIRONMENT, AND SUSTAINABLE FISCAL MANAGEMENT

70%
Gap between public-sector and private-sector wages

The growth of the Saudi non-oil economy in size and in productivity will not happen on its own. It will come about only if it is supported by three strong pillars.

The first is a more productive workforce with higher participation, so that Saudi Arabia can raise output levels across all sectors and provide gainful employment for the large cohort of young people entering the job market between now and 2030. There are already some signs that this is happening. The increased employment and participation of women in the labor force is one. While more Saudi men will also need to participate in greater numbers in the workforce, our analysis suggests that without further increases in female participation, household income growth in Saudi Arabia will be limited.

The Kingdom will also need to overcome an important mismatch between the skills and costs of its labor force. Many of the incentives around work in Saudi Arabia are at odds with creating a more productive workforce: public-sector workers on average earn about 70 percent more than those in the private sector, unemployment benefits and welfare transfers are relatively high compared with wages, and many employers would rather hire low-skilled migrant workers than Saudi nationals, who can cost four to six times as much.

Creating a more productive workforce will also depend on an overhaul of the education system to raise standards in schools, scale up vocational training, and ensure a better transition from education to employment, including for university students.

The second pillar is an economic and regulatory environment that is unambiguous, transparent, and conducive to business. This is essential to bringing in the large-scale private investment needed to finance the transformation. The Saudi economy has been opening up, including with its 2005 accession to the World Trade Organization (WTO) and the recent announcement of plans to allow 100 percent foreign ownership in the retail sector.[14] But Saudi Arabia could do more to enhance its overall attractiveness as an investment destination. That means simplifying sometimes complex regulation, speeding up slow procedures such as customs clearance and visa processing, and improving licensing conditions and legal enforcement of contracts. More than a dozen sectors of the economy, including health-related businesses, remain closed to foreign participation.

The final pillar is sustainable fiscal management. This will be needed regardless of what happens to oil prices. The large number of additional working-age Saudis cannot derive their income from the public sector without substantial deficits even if oil prices were to rise back to $90 per barrel.

The existing fiscal model, which is based on income from oil revenue and public spending, would need an overhaul, not just of its methods but also of its underlying philosophy. At a practical level, Saudi Arabia's government would need to find new sources of revenue as well as becoming significantly more efficient with spending. To achieve the full potential laid out in this report, it is likely that the government would need to increase its investment, especially over the next five years, to cushion the economy as it transitions from the high oil prices of the past decade and to lay the groundwork for the transformation of the economy. The reactive policy scenario projection is predicated upon a prolonged period of declining government spending in real terms, and declining government investment in the economy that would have the effect of reducing the economy's growth potential.

It is not our aim in this report to prescribe which fiscal reforms should be implemented, nor how, nor how quickly. These are political issues for the government to decide. But some clear policy decisions will nonetheless be needed. We outline five of the most significant options. Our analysis suggests that they have the potential to close the Kingdom's projected 2030 annual fiscal gap of about $170 billion, which would likely open up even if the government adopted lesser—albeit still important—changes, including a five-year freeze on public spending in reaction to the changing economic and demographic conditions.

First, it is worth noting that the growth agenda laid out above will likely help reduce the fiscal gap, as faster economic growth leads to higher proceeds from existing non-oil revenue such as customs duties, and revenue from state-owned enterprises. Second, analysis suggests there is room for substantial savings in capital outlays and operating expenditure through more efficient and rigorous procedures. Third, the government could also better manage and monetize the $1 trillion-plus financial and non-financial assets in its portfolio. Fourth, a comprehensive reform of low domestic energy prices aimed at spurring greater fuel efficiency among both producers and consumers could end wasteful use and free up as much as 1.5 million additional barrels of oil per day for export by 2030; calculating oil at a hypothetical price of $60 per barrel, that would amount to 110 billion SAR ($30 billion) annually in additional revenue. Finally, the Kingdom may want to consider the introduction of some taxes that are common throughout the world such as a value-added tax (VAT) or personal income taxes. While levying such taxes would be a departure for the Kingdom and would take time to implement, it would bring Saudi Arabia into line with sustainable fiscal

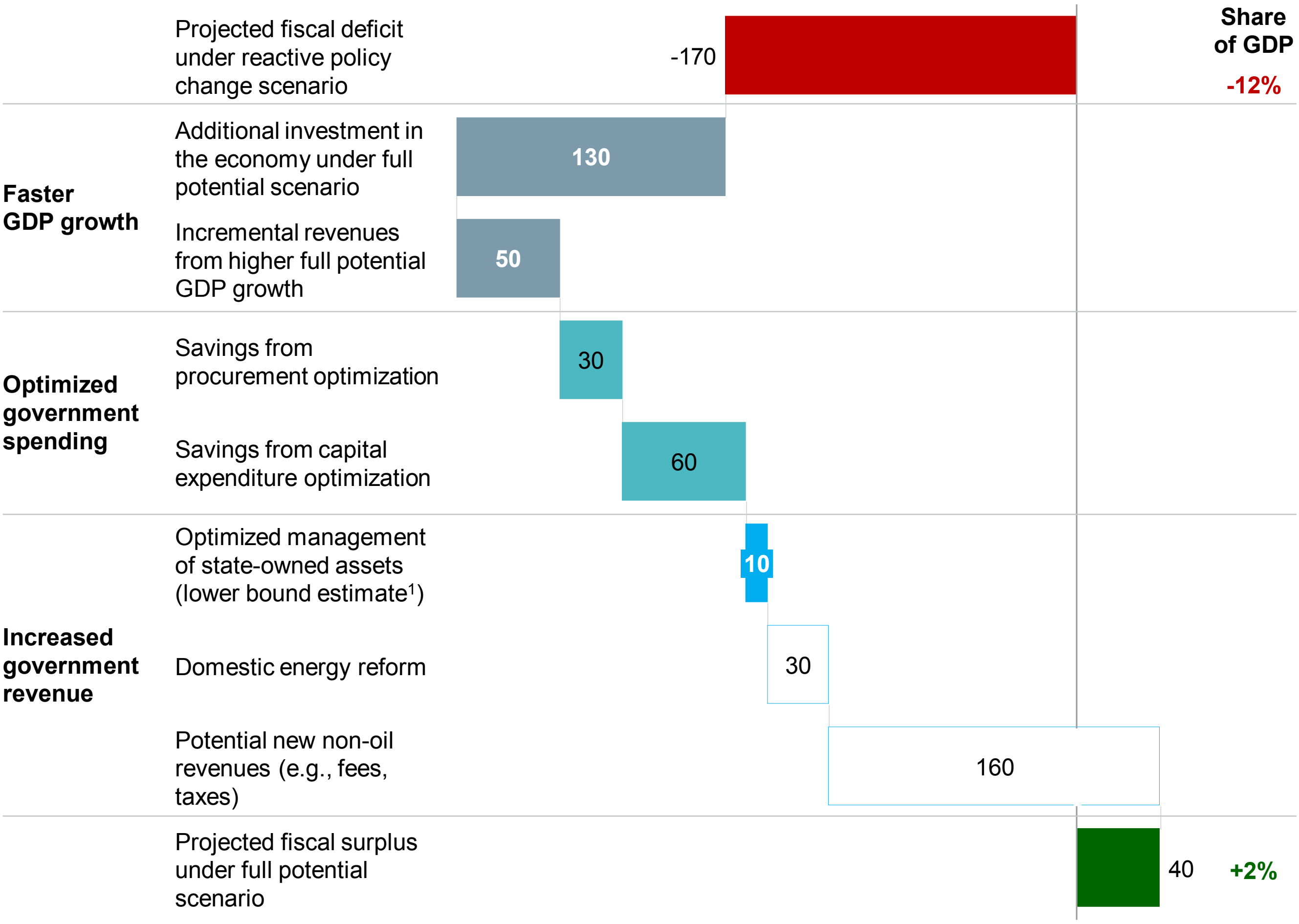
[14] "Saudi Arabia to allow full foreign ownership in retail," Reuters, September 6, 2015.

practices in all developed economies and G20 emerging economies. Taken together, these measures could more than close the projected fiscal gap (Exhibit E5).

Exhibit E5

The Kingdom's projected fiscal deficit could be eliminated by implementing a comprehensive set of expenditure and revenue reforms

Annual budget balance in 2030 for full potential scenario
$ billion, 2015 prices



1 Lower bound estimate as no public information is available on the total value of government assets, including those owned by the Saudi Public Investment Fund.
NOTE: Numbers may not sum due to rounding.

SOURCE: McKinsey Global Institute analysis

IMPLEMENTATION: A CHALLENGE FOR BUSINESS AND HOUSEHOLDS AS WELL AS GOVERNMENT

Without reform, the Kingdom could face unsustainable deficits and fast-rising debt. But beyond the practical measures, a shift of mindset will also be required. This would reorient the Saudi economy away from reliance on the public sector, and toward a greatly increased role for the private sector.

This is not just a government issue, but one that would directly affect business and households. The government would need to reframe its mandate away from providing cradle-to-grave dependence and security to focus on enhancing the potential and productivity of every Saudi citizen. For their part, Saudis would be able to engage in a greater range of business in exchange for a greater obligation to support society through taxes and fees. As is characteristic of modern economies, the government would play its role in contributing to the prosperity and well-being of society, while individuals and the growing private sector would play a bigger part than they currently do, helping to finance the public goods they benefit from privately.

As is always the case with major transformations, how they are put into effect will be decisive. In Saudi Arabia, the government has long been the determinant factor for society. But the potential economic transformation outlined in this report hinges on all parts of society taking greater responsibility for their own economic destiny, and relying less on the state to do it for them. In that spirit, the transformation itself will need to be a collective effort.

Government will by necessity be the initiator of much of the change. It can modernize its approach in three fundamental ways: through a new income model based on facilitating private investment and then sharing in the proceeds; through a new social protection model for citizens that focuses on helping Saudis become productive and well-paid workers in competitive companies; and especially for itself through a sharp new focus on flawless government delivery. This will need to include more effective cross-ministry coordination, and a performance management system that emphasizes the setting of priorities and the accountability for their implementation.

Even if oil prices were to rise again, a transformation would be needed to put Saudi Arabia's economy on a more sustainable footing.

Yet government cannot succeed on its own. Private companies will need to help lead the way. Rather than waiting for easy, guaranteed returns, business will need to invest and share risks. Firms will need to move from relying on low-cost foreign laborers to nurturing and training a Saudi workforce. The productivity gains across any of the sectors we examined will ultimately be the sum of firm-level transformations led by boards and CEOs throughout the Kingdom. International businesses, too, will have opportunities and a role to play in helping to drive change. They will do so as Saudi Arabia opens up not just through their investments, which will bring required capital, but also through the increased competition that international companies will help to stimulate in the economy, and which will accelerate the Kingdom's modernization.

If the changes are to be successful, Saudi households and individuals will also need to embrace them. They will live them in their daily lives, in the form of more work opportunities, better training and skills, higher pay, and greater flexibility. In return, more Saudis of both sexes will need to work in the emergent private sector, and to work more productively. They will need to take a greater role in shaping their own destinies, making important choices about their education and their working lives.

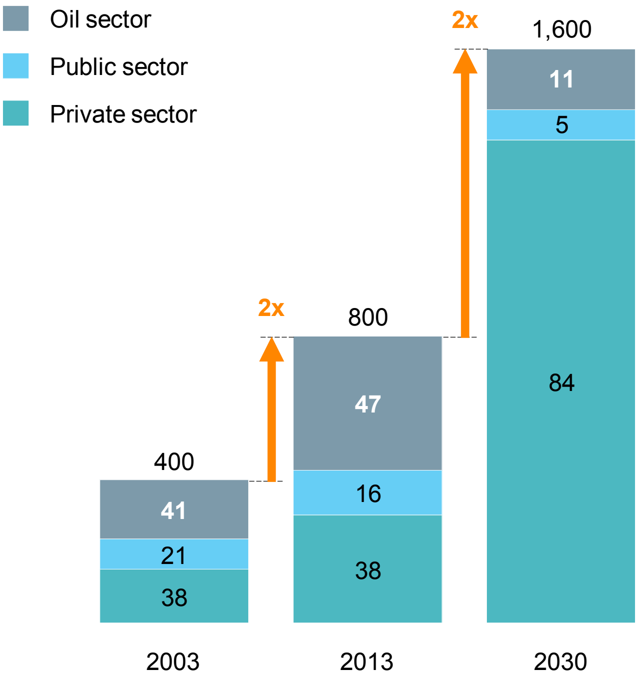
Ultimately, the transformation of the Saudi economy outlined here will be essential to deliver growth, regardless of anything else that may happen. It can create new opportunities for businesses and for individuals, and in the process bring about a fundamental change in the economic role of the state and its relationship with society. Future prosperity will likely depend to a far greater degree on Saudis themselves identifying opportunities to create jobs, start companies, acquire assets, improve their skills, and find gainful employment. As the private sector gains in strength, many more opportunities for well-paid work will become available to those who are willing to seize them. The rewards will come in the shape of greater prosperity for households, and for Saudi society as a whole (Exhibits E6 and E7).

Exhibit E6

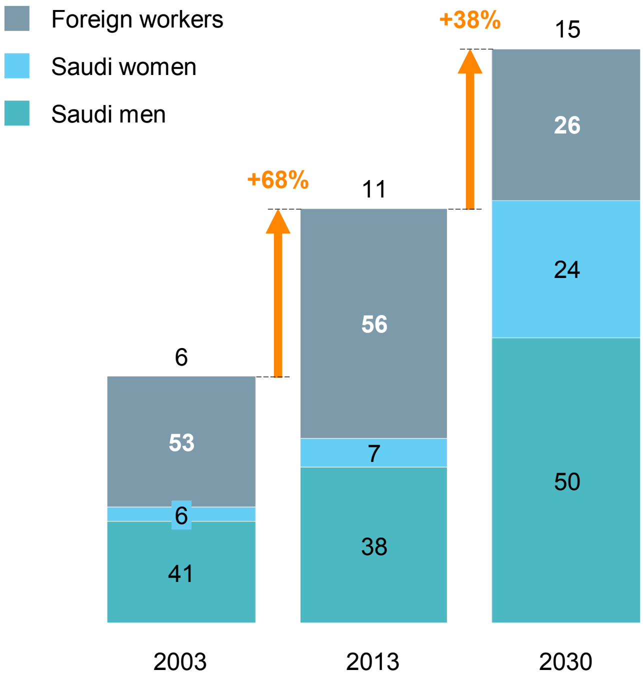
How a full potential scenario could transform the Saudi economy

The private sector becomes the main driver of the economy, and Saudis play a larger role in the labor market

Real GDP by sector, 2003–30
% of nominal GDP; $ billion, constant 2013 prices

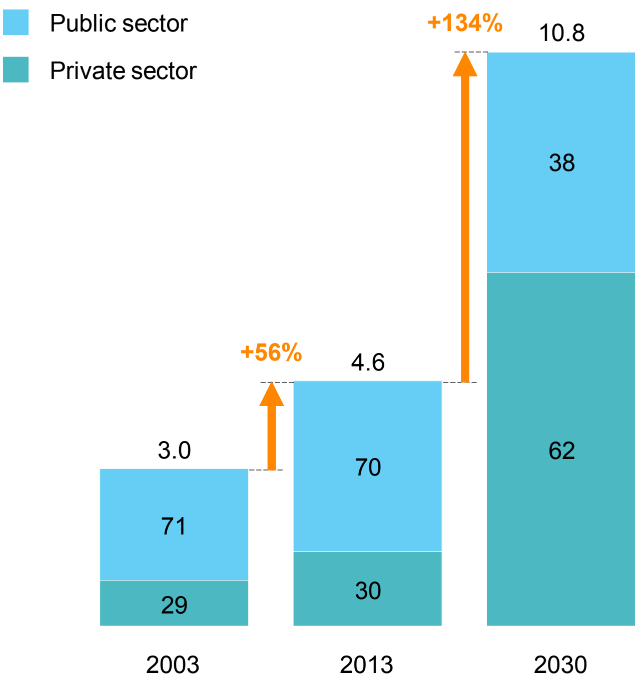


Employment by segment, 2003–30
%; million

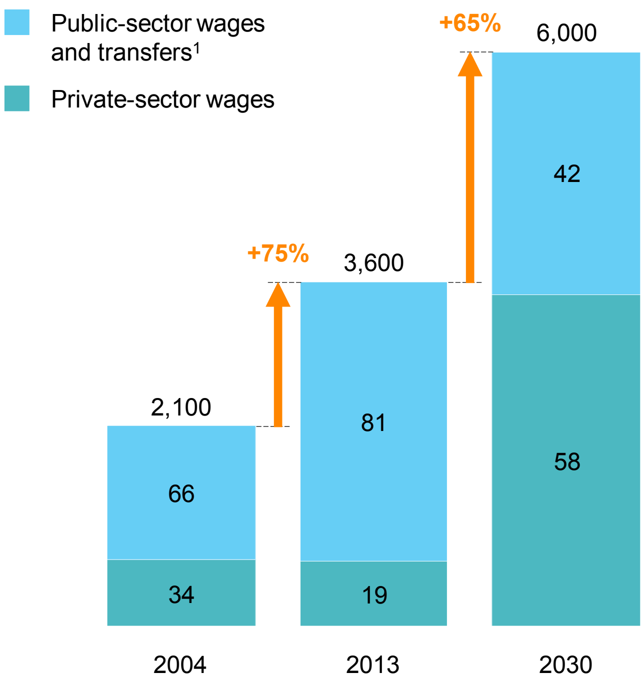


The private sector also becomes the main employer and source of income for Saudi nationals and households

Employment of Saudi nationals by sector, 2003–30
%; million



Real household incomes of Saudi nationals, 2004–30
%; $ per month, constant 2013 prices



1 Includes oil sector.
NOTE: Not to scale. Numbers may not sum due to rounding.

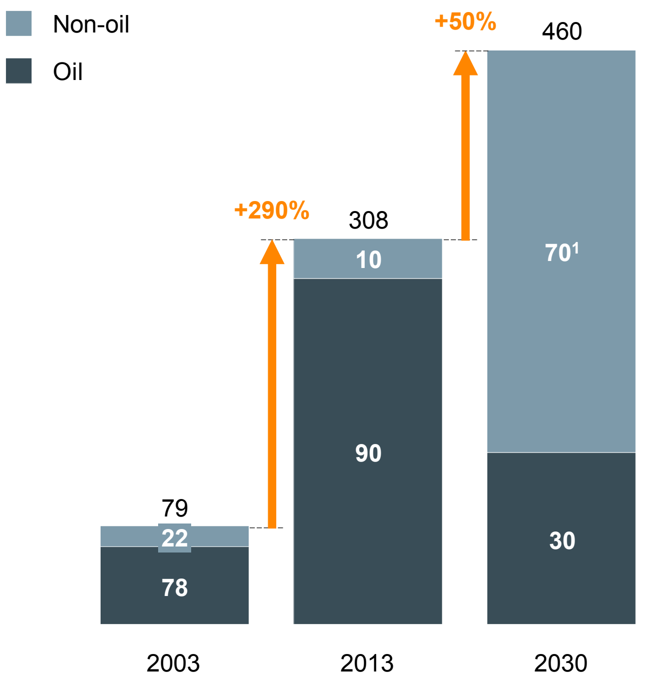
SOURCE: Central Department of Statistics and Information, Saudi Ministry of Economy and Planning; McKinsey Global Institute analysis

Exhibit E7

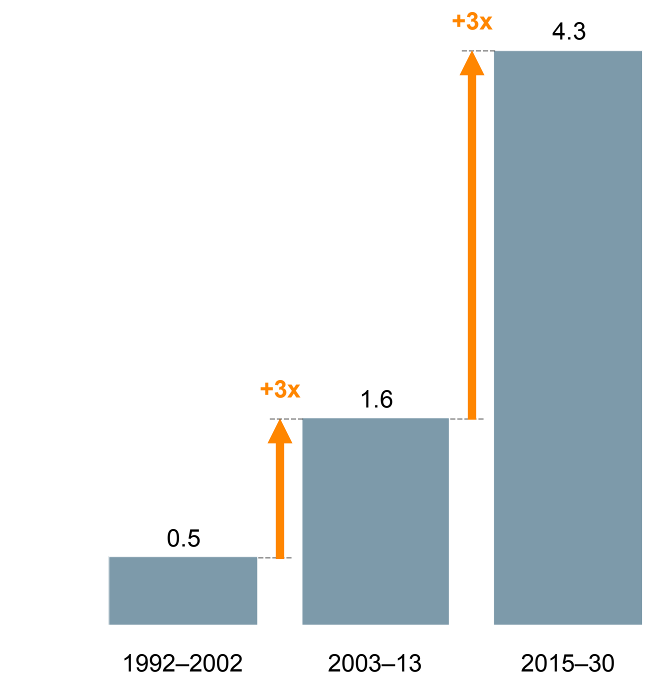
How a full potential scenario could transform the Saudi economy (continued)

Non-oil revenue becomes the main income source for government, and investment triples

Government revenue by source, 2003–30
%; $ billion, current prices

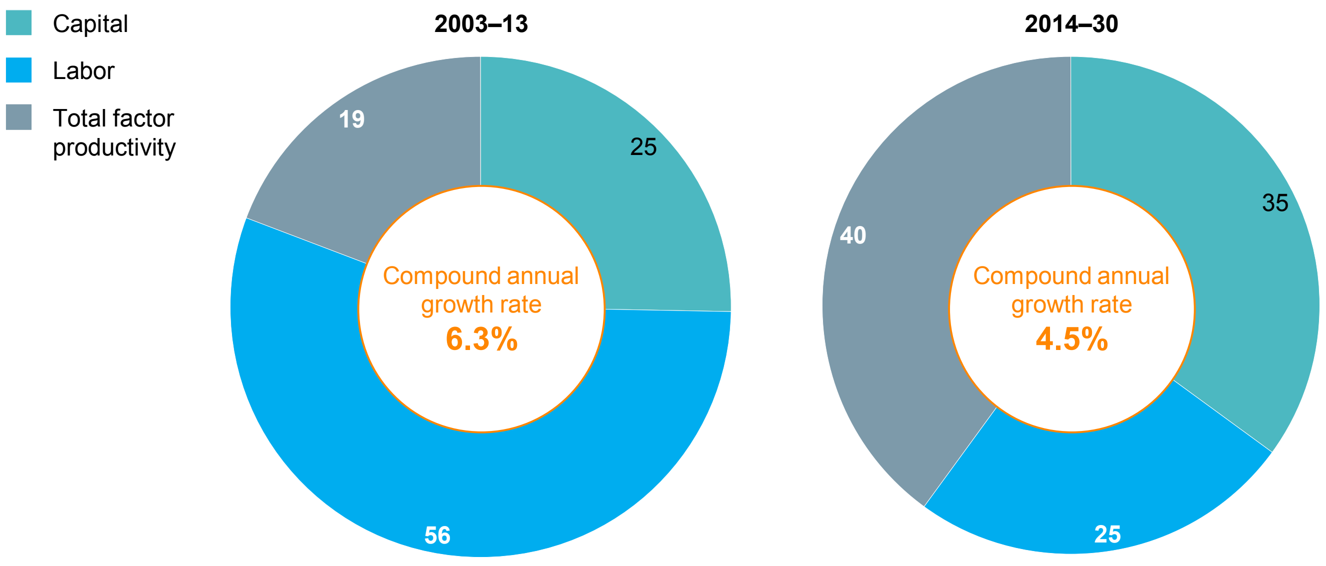


Total investment, 2003–30
$ trillion, constant 2013 prices



Productivity and investment take over from labor input as the main drivers of growth

Contributions to real GDP growth by factor of production, 2003–30
%



1 Assumes introduction of new non-oil revenue such as fees or taxes..
NOTE: Not to scale. Numbers may not sum due to rounding.

SOURCE: Central Department of Statistics and Information, Saudi Ministry of Economy and Planning; McKinsey Global Institute analysis

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The Kingdom of Saudi Arabia is emerging from an oil-fueled decade in a strong position to confront the key external and internal challenges it faces going forward. By tapping into the intrinsic potential of its economy, unleashing the private sector to raise productivity and create Saudi jobs, and introducing a more market-oriented approach to fiscal management and economic development, the Kingdom could not only ride through these more complicated times ahead, but thrive—and thrive in a more sustainable manner than it did during the recent oil boom. There are important signs of economic advancement in Saudi Arabia over the past decade, and a political understanding of the need for change. For the sake of the continued prosperity of the country as a whole, it is important that this understanding translates into bold and urgent action.

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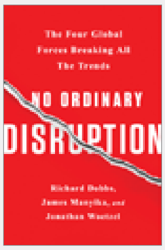

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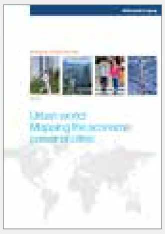

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