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THE WOEFUL STATE OF SAUDI FINANCES

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Deficits Every Year Since 1983 / What Caused the Financial Mess? / The Impact of the Gulf War of 1990-91 / Can the Saudi Regime Cope with the Financial Crisis? / Future Prospects / Implications for U.S. Policy

Deficits Every Year Since 1983

Saudi Arabia has experienced budgetary deficits in every year since 1983, in sharp contrast with its large surpluses of the previous decade. Between 1983 and 1992 the *cumulative deficits* of Saudi Arabia amounted to $141 billion, while in the previous decade its *cumulative surpluses* had totalled $107 billion. The Saudi balance of payments (the current account) shows a similar trend, going from a cumulative surplus of $163 billion in 1973-82 to a cumulative deficit of $138 billion in 1983-92.[1] 1993 data are not yet available, but there is little doubt that the deficits persisted. We refer here, of course, to state finances, not the private accounts of the extended royal family and some other wealthy Saudis.

In mid-1993 an International Monetary Fund mission which visited Saudi Arabia made five-year projections for 1993-97. The mission projected that annual budgetary deficits would rise from $6 billion in 1993 to $11 billion in 1997. State borrowing to cover the deficits would raise the total public debt from the equivalent of 56 percent of GDP in 1992 to 77 percent in 1997. Annual interest payments on the debt would rise from 7.3 percent of total government expenditure in 1992 to 11.8 percent in 1997. As for the balance of payments, the cumulative current account deficits in 1993-97 would amount to a massive $73 billion, even greater than the $68 billion deficit in the previous five-year period which had been adversely affected by the Persian Gulf War of 1990-91.[2] In short, the IMF mission envisaged a further deterioration in Saudi finances.

How were the budgetary deficits financed? Between 1983 and 1987, the treasury drew on the financial reserves accumulated during the previous years of plenty. Subsequently, borrowing was mainly internal, from the commercial banks and pension funds. Since the Gulf War of 1990-91, however, there has been increasing recourse to foreign loans. The public domestic debt climbed from zero in 1987 to $74 billion at the end of 1993 and the external debt to $20 billion.[3] Saudi Arabia's gross domestic product (GDP) was an estimated $121 billion in 1993.[4] The major state

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enterprises, which during earlier periods had been obtaining cheap finance from the state treasury, have had to turn to commercial banks, domestic and foreign.

What Caused the Financial Mess?

Saudi Arabia's current financial problems stem, in large measure, from the policies it adopted in the 1970s and early 1980s, when it was convinced that the oil boom would last into the indefinite future. It accepted at face value the almost unanimous view of oil analysts that oil prices would continue to rise and the demand for Saudi oil would continue to grow, at least until the end of the century. In other words, Saudi Arabia expected to continue to enjoy the best of both worlds, both higher prices — even when measured in constant (inflation-corrected) dollars — and a growing volume of sales. It was anticipated that the inexorable growth of oil revenues would greatly exceed the precipitous rise in public expenditures, financial surpluses would continue to be the norm, and financial assets (largely held abroad) would continue to accumulate. These were the comforting projections of most analysts.

Based on projections of growing need for Saudi oil, U.S. officials attempted to persuade the Saudi authorities to expand productive capacity to far higher levels in order to reduce future oil shortages. In those days financial experts were terribly worried about the problem of "recycling" the enormous financial surpluses that some OPEC countries would presumably accumulate, especially Saudi Arabia, the world's largest oil exporter and the owner of one-fourth of the world's oil reserves. Reflecting these perceptions, the preamble to the Saudi Development Plan for 1980-85 (announced in 1980) asserted that "The Kingdom is now one of the world's foremost financial powers, in addition to its role as the major oil exporter of the free world."[5]

Following the oil shock of 1973-74, Saudi public expenditures rose precipitously from $2.6 billion 1972/73 to $43.7 billion in 1978/79. Despite the sharp growth in oil revenues, expenditures rose even more rapidly. Fiscal deficits emerged in 1977/78 and again in 1978/79, but these deficits were short-lived. The very sharp rise in oil prices which followed the Iranian Islamic revolution in 1979 and the vast increase in oil revenues again yielded very large Saudi financial surpluses, swamping the deficits of the last years of the 1970s. It is important to stress that, perceptions notwithstanding, the oil shock of 1979 had nothing to do with OPEC or Saudi power to influence the market. The Islamic revolution, as well as the Iran-Iraq war of 1980-88, were exogenous shocks to the market neither foreseen nor planned by OPEC, or by the Saudis. Of course, both OPEC and non-OPEC oil exporters took advantage of the far higher prices to augment their treasuries.

Just as in the 1970s, the vast influx of oil revenues in 1979-81 was soon followed by a further expansion of Saudi public spending, which nearly doubled from $43.7 billion in 1978/79 to $83.7 billion in 1981/82. In the short run, the expansion of spending, as large as it was, lagged behind the precipitous rise in oil revenues, and large financial surpluses emerged. But then the unexpected occurred: oil prices began to soften and demand for OPEC oil declined sharply. Since Saudi Arabia had undertaken to be the swing producer in the cartel, demand for Saudi oil dropped even more sharply. The ensuing decline in Saudi oil export revenues was precipitous, from a peak of $111 billion in 1981 to $45 billion in 1983, and lower in the following years. Saudi deficits emerged and persist to this day. There were, of course, price fluctuations, but the overall price trend during the 1980s was lower, until the Persian Gulf War of 1990-91 reversed the downtrend *temporarily*.[6]

Faced with sharply lower revenues, the Saudi authorities began to implement spending cutbacks. By far, the severest cuts were in the projects budget, mainly the building of infrastructure (roads, ports, airports, power and water, telecommunications, health and educational institutions, etc.), which dropped sharply from a peak of $35 billion in 1981 (about half of state expenditures) to an annual level averaging $12 billion in the latter half of the 1980s. (The projects budgets do not include operations and maintenance which cost an additional $6 to $7 billion annually). The cutbacks in the projects budget affected mainly foreign contractors and their labor force which is almost all foreign. Aid to the poorer Arab countries, which had peaked at over $7 billion annually in the early 1980s, was sharply curtailed to less than $2 billion per annum in the later 1980s. (These figures do not include off-budgetary financial aid to Iraq in its war with Iran during 1980-88.) The military budget was officially cut from $18-19 billion in 1981-84, to $14 billion in 1985-89 (annual averages). However, these figures are somewhat misleading since there are very large off-budgetary military expenditures, in particular, an agreement with the UK for arms imports in exchange for oil shipments of 500,000 barrels per day.

Despite these cutbacks, a whole range of subsidies, current expenditures on civil service salaries, and other state spending which might affect the citizenry were hardly touched. During the heyday of massive oil revenues the Saudi authorities were profligate in their spending on what could be broadly called social welfare. This includes free health and educational services, up to and including graduate studies at universities; non-interest-bearing loans for housing; and highly subsidized rates for electricity, water, and other utilities. Gasoline and other refined oil products were sold domestically at a fraction of international prices. Producers, especially in industry and agriculture, also enjoyed a wide range of grants and non-interest-bearing loans, and various kinds of financial support. While subsidies (direct and indirect) are not uncommon in many countries, their magnitude in Saudi Arabia has few, if any, parallels (as a ratio of GDP). The development of non-oil industries, and of modern agriculture, is virtually dependent on large-scale subsidization, as well as an overwhelmingly foreign labor force. According to one scholar, subsidies — direct and indirect, explicit and implicit — rose from 4 percent of total government spending in 1975 to 72 percent in 1984, or, alternatively, from 4 percent to 68 percent of oil revenues.[7]

Saudi high school and university graduates expect white collar jobs in the state bureaucracy. The large majority of employed Saudis — excluding foreigners — are on the bloated state payroll. This, too, constitutes a serious and growing drain on the state treasury. The system of kickbacks and commissions, mainly benefiting some ten thousand royal princes and others close to the royal family, is another serious drain on the state treasury. Of course, these do not appear in the official budgets. One reputable journal estimated these payments to be as high as $10 billion a year.[8] Saudi oil export revenues in 1993 were $40 billion. Even if these "commissions" are only half of the above estimate, they exacerbate the state's fiscal problems.

Other than limited revenues from customs duties and fees, the Saudi state treasury is largely dependent on oil revenues. There is powerful resistance to taxation. Given the far lower level of oil revenues since 1983 and the inflexibility of reducing expenditures (following the cutbacks in the projects budget and in foreign aid), the inevitable result was a string of large budgetary deficits covered initially by a drawing down of financial reserves, followed by borrowing since 1987. Instead of substantial revenues from foreign investment, the treasury is faced with an ever-growing public debt. Servicing that debt (payment of interest and principal) has become increasingly onerous.

The Impact of the Gulf War of 1990-91

The Persian Gulf War of 1990-91 made a bad situation worse. The UN embargo of Iraqi oil, as well as the destruction of Kuwait's oil facilities, raised oil prices temporarily and also permitted the Saudis to expand the volume of oil exports. Oil export revenues rose from $24 billion in 1989 to $44 billion in 1991. However, war-related expenditures rose far more rapidly, including payments to the U.S. and other allies, as well as higher local Saudi military expenditures. According to Saudi budgetary reports, military and "emergency" expenditures in the three-year period 1990-92 totalled $76 billion. Government oil revenues in that period were almost $100 billion, as compared with $50 billion in the previous three years. The International Institute for Strategic Studies estimated that war-related outlays (including off-budgetary) were $94 billion.[9] The combined fiscal deficits for 1990-92, according to the official reports, were $48 billion, higher than the $39 billion in the previous three years when oil revenues had been lower.

The downward inflexibility of *civilian* expenditures is underscored by the fact that despite the dire threat to Saudi Arabia, the authorities made no attempt to curb civilian expenditures or to impose taxes to help pay for the war. In fact, about a year after the war, the king announced a whole range of price reductions for gasoline, natural gas, electricity and water. Charges on domestic telephone calls were eliminated, and various business charges were reduced.[10] These measures entailed an increase in the already high level of subsidies. Moreover, they implied an even more rapid growth in consumption. This, in turn, entails additional expenditures on electric power stations, water supplies, and telecommunications in order to forestall supply shortages. Not surprisingly, the rise in demand for electricity in the past two years (since the king's announcement of lower prices) has been described as "dramatic." It has been estimated that the growth rate of demand between 1993 and the year 2000 will be 15 percent per annum, requiring a 70 percent expansion of electric power capacity at a cost of $15 billion between 1993 and the year 2000. Saudi electric companies are seeking loans from the U.S. and the UK to finance the investment.[11]

The impact of the Gulf War will be felt for many years. Between mid-1990 and mid-1993, the Saudis placed orders for $30 billion of U.S. military equipment, in addition to large orders from the UK and smaller orders from other suppliers. The Iraqi threat, as well as fear of Iran (and border disputes with Yemen, Qatar and others), have persuaded the Saudis to greatly expand their armed forces and equip them with the most sophisticated and expensive weapons.[12] According to the U.S. Arms Control and Disarmament Agency, Saudi arms imports in the five-year period 1987-91 amounted to $30 billion, exceeding, by far, all other countries in the region including Iraq ($16 billion) and Iran ($9 billion). Syrian arms purchases abroad were $6 billion, followed by Israel ($5 billion) and Egypt ($4 billion). The huge military orders placed by Saudi Arabia since the 1990-91 war will probably ensure its continued dubious distinction as the world's largest arms importer.

In 1987-91, the UK had supplied over one-half ($16.3 billion) and the U.S. about one-sixth ($5.1 billion) of total Saudi weapons purchases. The new orders placed since the war mean that the U.S. will be the prime Saudi arms supplier. As a consequence of the war, Saudi Arabia has greatly expanded its armed forces from about 80,000 throughout the 1980s to 191,000 in 1991.[13] What is abundantly clear is that the massive arms acquisitions and the major expansion of the armed forces will require a large *long-term* increase in Saudi Arabian defense spending on the construction and expansion of military bases, maintenance, spare parts, ammunition, training, housing, and services for members of the armed forces and their families, etc. If Saudi defense expenditures were unusually large in the 1980s (averaging 18 percent of GDP), they will be substantially greater in the foreseeable future.

Closely related to the budgetary deficits are the current account, balance of payments deficits which have persisted since 1983. A Washington-based consulting firm has projected that these will continue in 1994-96, raising the Saudi external debt to over $37 billion by the end of 1996, about twice that of 1993.[14] This projection is based on the assumption that UN sanctions on Iraqi oil exports will continue during this period. If they are rescinded or eased, the outlook for Saudi Arabia is even more pessimistic.

Can the Saudi Regime Cope with the Financial Crisis?

In an apparent response to the deepening fiscal crisis, Saudi Arabia's *announced* budget for 1994 called for a 19 percent cutback in spending, as compared with 1993. If achieved, this would be close to a balanced budget, i.e., a deficit of a little more than one billion dollars, as compared with an estimated deficit of $7.5 billion in 1993.[15] However, the announced budget does not take into account the servicing of obligations already undertaken, notably, payment for the $30 billion in military equipment from the U.S. Payments due to U.S. arms suppliers in 1994 and 1995 total $9.2 billion, and the Saudis are unable to meet these obligations. In order to forestall a sharp reduction in military sales, the U.S. administration has arranged for a restructuring which reduces Saudi payments to American arms manufacturers to $1.5 billion in 1994 and 1995. The balance of over $6 billion due in 1994-95 will be covered by loan guarantees by the Saudi government, which will also pay interest. The loans will formally be taken by a new corporation (set up for this purpose) which will be the borrower from U.S. commercial banks. Through this method the debt will not appear in the Saudi accounts.[16]

In the spring of 1994, the Saudis signed a $4 billion contract with AT&T for the modernization of the country's phone system, and the state-owned airline signed a $6 billion contract for the purchase of civilian aircraft. In both cases, the U.S. government Export-Import Bank will provide the bulk of the financing.[17] In addition to these and other loans, the Saudi Ministry of Finance has been following a policy of very lengthy delays in payments to contractors, mainly foreign, operating in Saudi Arabia. Some contractors have complained of a fifteen-month delay.[18] In effect, the contractors have become unwilling lenders. Payment delays from the treasury are also seriously affecting Saudi businesses.[19]

None of these measures — continued large-scale borrowing and payment delays — attacks the underlying financial and economic problems. This would require far-reaching radical changes, and there is no indication of such changes taking place. These would have to include the imposition of taxes and/or sharp cutbacks in subsidies, military expenditures, and commissions and kickbacks, as well as cutting down the bloated bureaucracy, i.e., firing tens of thousands of Saudis. The state directly employs some 90 percent of Saudis in the labor force. In effect, such measures would raise prices substantially and significantly reduce living standards. The population at large, and Saudi businessmen in particular, strongly resist such measures, and the extended royal family resists the curtailment of its privileged lucrative position.

The growing fiscal problems in the past few years have already had some impact on Saudi living standards. In 1989 the U.S. Embassy in Riyadh reported that "unemployment is emerging as a serious problem." The reference is to high school and university graduates who "have expectations based on the boom years, not present realities."[20] There are millions of foreigners working in Saudi Arabia, but most Saudi graduates refuse to accept jobs involving manual or other "demeaning" labor, expecting white collar government jobs. According to one estimate published in 1993, the unemployment rate among graduates had reached 25 percent.[21] While the government has not fired state employees, financial stringency has sharply restricted new hiring, while more graduates enter the labor market every year.

Official figures show that average living standards (measured by real private consumption per capita) rose very sharply, actually quadrupling between 1973 and 1982. Subsequently there was an erosion, with living standards dropping by about one-sixth between 1983 and 1992.[22] Anecdotal evidence lends credence to these figures. One report notes that "There are long queues for (interest-free) housing loans; (recent) graduates no longer command (state) jobs; unemployment is substantial; and some real poverty stalks the back streets of Jiddah and Riyadh."[23] Another report notes that years of mismanagement, corruption and budget deficits have left schools overcrowded and many young Saudis unemployed....Many can afford little beyond basics....Some Jiddah streets get water only two days a week....Doctors often deliver babies in the emergency room because hospital beds are scarce....Across Saudi Arabia fundamentalism is particularly strong among the young."[24] "Economic troubles are in sharp contrast with the opulent life of the royal family who number in the thousands. The practice of taking up to 30 percent commissions, and other facets of corruption, are (now being) more readily criticized as are the ostentatious life styles of the princes."[25] Yet another report notes the rising discontent which is accentuated by the practices of the princes who "commandeer free seats for themselves and their retinue on Saudi airlines, or import goods without customs clearance...muscle in on commoners' profitable enterprises," and engage in other unsavory practices.[26] The princes also do not pay for water, electricity, and telephone services.[27] Moreover, Saudi banks are forced to lend to members of the royal family who often fail to repay. There are billions of dollars in uncollected loans owed by the princes to the commercial banks. When asked why they lend money to the princes, an (unnamed) Saudi banker responded that the banks "had to respect the wishes of an absolute monarch."[28]

Radical measures to curb spending or impose taxes are severely constrained by the lavish incomes and life-styles of the thousands of princes and some others close to the royal family. At the same time, it is politically almost impossible to expect the ordinary citizen to acquiesce to lower living standards while the royal family and other wealthy Saudis live ostentatiously, and instead of paying taxes continue to drain the state treasury. There are no figures on income distribution, but all indications are that the income gap has widened considerably in the past decade. All of these developments spell trouble ahead for the regime.

The policy of the Saudi government can be summarized as trying to "muddle through" in the hope that external events will extricate the state from its growing economic crisis. In other words, the government hopes that external events — wars, revolutions, or other disturbances in other oil-exporting countries — will allow the Saudis to increase their oil revenues substantially either through higher oil prices or a greater volume of oil exports, or both. In the interim, the government is trying to avoid or at least postpone politically difficult decisions by incurring more and more debt. But barring sharp and painful cutbacks in public and private consumption, state expenditures and imports will inevitably rise. As one analyst phrased it, even before the 1990-91 war, "The real problem is that the country has, since 1973, locked itself into what appears an inflexible situation with very little room for manoeuvre."[29]

The 1990-91 Gulf War greatly aggravated Saudi Arabia's financial problems, both present and future. Moreover, "Spending on education, health and social welfare will rise inexorably in the coming years (barring radical changes in policy, since) the population is growing by over 3 percent per annum. (Moreover)...an ever larger proportion of government resources will have to be devoted to servicing the growing official debt....It will be far from easy to break out of the self-perpetuating circle. Uncomfortable choices will have to be made at some stage. The alarming thing is that the government seems to display no interest in tackling the issue."[30]

Future Prospects

According to this observer's own analysis, the underlying longer-term trends point to low or lower oil prices, at least when measured in constant dollars.[31] There will most probably be price fluctuations due to seasonal factors and the state of the world economy, especially in the main oil-importing countries, and, of course, wars, revolutions, and other supply disruptions will have varying impacts. This was the case during delay. Other industrialized countries should be urged to do the same.

A number of major industrialized countries have been raising taxes on gasoline and some other oil products for fiscal and/or environmental reasons, in order to dampen demand. In this respect the U.S. has been laggard because of domestic political problems. Since the U.S. alone accounts for one-fourth of world oil consumption, and gasoline accounts for close to one-half of its oil consumption, a change in U.S. policies — even a modest rise in taxation — would have a strong effect on world oil markets.

A greater worldwide diversification of oil supplies would substantially reduce the impact of future supply disruptions, especially from the Persian Gulf countries. In fact, this has been occurring. Excluding OPEC, the U.S. and the former Soviet Union, there has been a steady but substantial growth in output. In this broad group of countries (mainly the less developed countries in Asia, Africa, and Latin America, as well as North Sea output), the rise has been very significant, from 7.6 million barrels per day in 1973 (about that of Saudi Arabia) to 15.6 million barrels in 1983 (as compared with Saudi output of 5.4) and 21.8 million barrels (as compared with 8.7 in Saudi Arabia) in 1993.[40]

Much of this increase in recent years has been because of a change in policies in many less developed countries, who now welcome foreign oil companies. The latter have both the resources and the technology needed to find and develop oil (as well as gas) resources. Expanding World Bank facilities for the development of energy resources and their more efficient utilization in the less developed countries would help to diversify world oil supplies, restrain demand, and reduce the impact of future disruptions. Technical and financial aid to Russia and some of the former Soviet republics to develop their energy resources and improve their efficient use would, over time, provide additional insurance and weaken the effects of Middle East oil supply disruptions. The U.S. may not be able to prevent future Saudi oil disruptions, but it can take these and other steps to cope with them when and if they arise.

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Notes

1. Unless otherwise stated, all data are from the Saudi Arabian Monetary Agency, *Annual Reports*, and the International Monetary Fund, *International Financial Statistics*.
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