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King Abdullah Petroleum Studies and Research Center

The Fiscal Response to COVID-19 in Saudi Arabia

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Instant Insight

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The King Abdullah Petroleum Studies and Research Center (KAPSARC) is a non-profit global institution dedicated to independent research into energy economics, policy, technology and the environment across all types of energy. KAPSARC's mandate is to advance the understanding of energy challenges and opportunities facing the world today and tomorrow, through unbiased, independent, and high-caliber research for the benefit of society. KAPSARC is located in Riyadh, Saudi Arabia.

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Introduction

The COVID-19 pandemic and the efforts to combat it have led to major global disruptions. Policymakers are faced with a dilemma that is not easily resolved. On the one hand, they are striving to protect public health by containing the spread of the virus. On the other, they must ensure the continuation of economic activities to mitigate the economic impact of the outbreak. These conflicting, yet essential objectives provide new challenges for national leaders. How best to manage these trade-offs remains a burning question for decision-makers. Containing the virus requires social distancing, curfews, and quarantine measures. However, economic growth requires being able to trade freely and be economically active. The global economy is unprecedentedly interdependent, but the policies being implemented by countries around the world, including containment measures and economic restarts, are idiosyncratic.

In Saudi Arabia, the government has implemented a series of measures to combat the COVID-19 crisis. This Instant Insight focuses on the effect of the COVID-19 outbreak on Saudi Arabia's fiscal position and provides an overview of the macroeconomic impact of the country's fiscal adjustments. Clearly, the optimization of trade-offs is never easy. There will be a short period of adjustment to the fiscal measures, but they will be beneficial in fostering economic stability over the long term.

The fiscal response to COVID-19

The Fiscal Balance Program (FBP), one of the key realization initiatives of Saudi Vision 2030, the country's blueprint for economic diversification, has made significant progress in diversifying and stabilizing the government's revenues and improving its spending efficiency. Since the FBP's initiation in 2016, non-oil revenues have increased from 186 billion Saudi Arabian riyals (SAR) to 332 billion SAR in 2019. This increase has allowed non-oil revenues to account for a larger portion of the country's total revenues, and, in return, help stabilize its revenue sources and reduce its fiscal deficit from 311 billion SAR to 131 billion SAR over the same period, as shown in Figure 1 below.

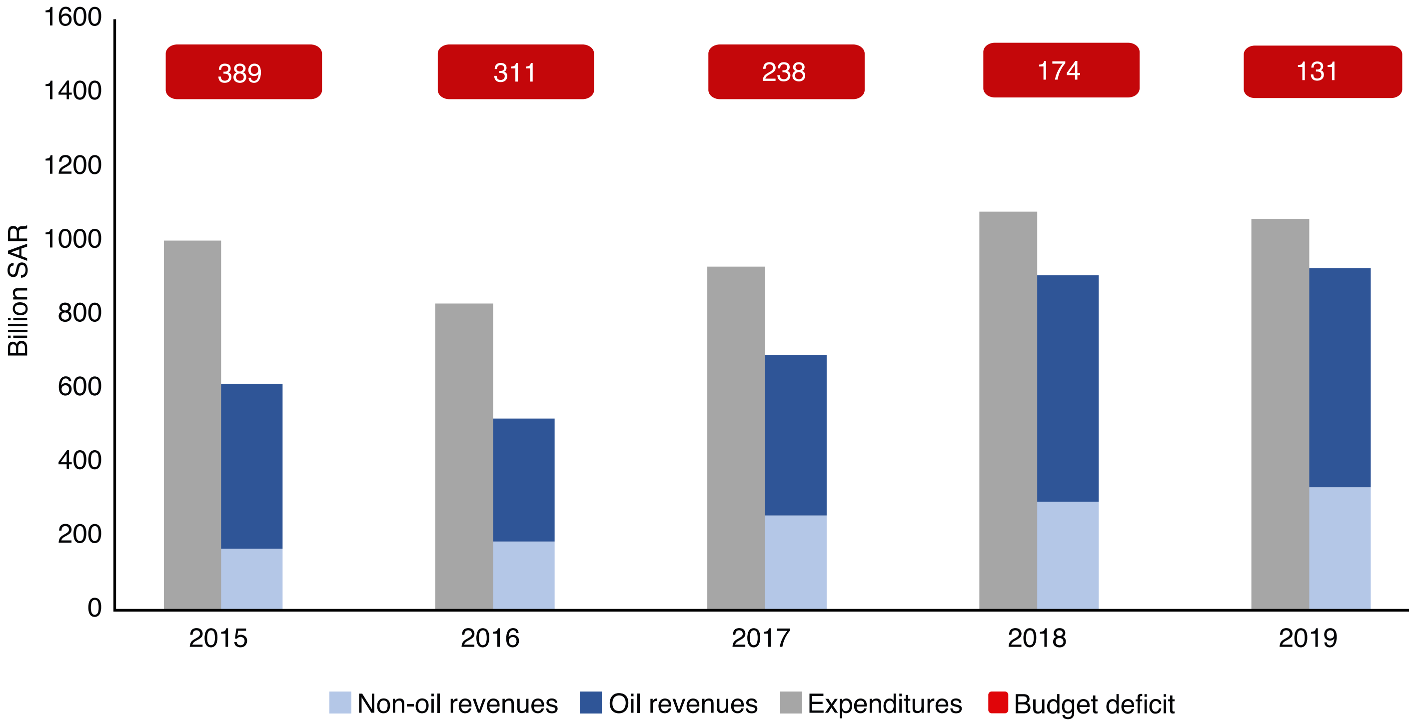
The onset of COVID-19 resulted in unavoidable fiscal shocks to the government's oil and non-oil revenues, and its expenditure:

- Worldwide lockdowns have slowed economic activity, leading to a sharp decline in oil demand and lower oil prices as a result. At the beginning of the year, the price of Brent crude was over $60 per barrel (b), but it soon dropped to around $20/b as more countries started to implement lockdown measures. Saudi Arabia's oil exports were also affected, falling by 22% year-on-year in the first quarter of 2020 (GaStat 2020b). To stabilize the oil market, Saudi Arabia took a leading role in facilitating a historic agreement among OPEC+ members to cut oil production by 9.7 million barrels a day, which helped oil prices to rebound to around $40/b.

- To protect citizens and residents, the Saudi government temporarily suspended many economic activities, such as attendance at schools, universities and workplaces, domestic and international travel, malls, among many other activities. The government's non-oil revenues dropped as a result.

- To protect public health and the private sector, the government has undertaken large but necessary expenditures. These include free healthcare for all COVID-19 patients in Saudi Arabia and active testing programs to help contain the virus. To aid the private sector, the government has launched support initiatives that amount to more than 214 billion SAR. These initiatives include, but are not limited to, covering 60% of the value of national workers' salaries, canceling and postponing private sector dues to the government, and offering a temporary 30% discount on electricity bills for commercial, industrial, and agricultural customers.

Figure 1. Saudi Arabia's fiscal balance (billion SAR).



Source: SAMA yearly statistics (May 29, 2019 release).

To finance the fiscal gap, the government has implemented a series of fiscal adjustments, while keeping in mind the need for stable and sustainable public finances. These adjustments include expanding the country's planned borrowing in 2020 of 110 billion SAR by an additional 100 billion SAR, and suspending the cost of living allowance[1] for nationals in the public sector. The government has also increased the country's value-added tax (VAT) rate from 5% to 15% to stabilize and diversify its revenue sources. It is worth noting that the government has continued to exempt a wide range of goods and services from the VAT. These include health-related products and services, residential real estate rent, international transport, and some financial services, among others.

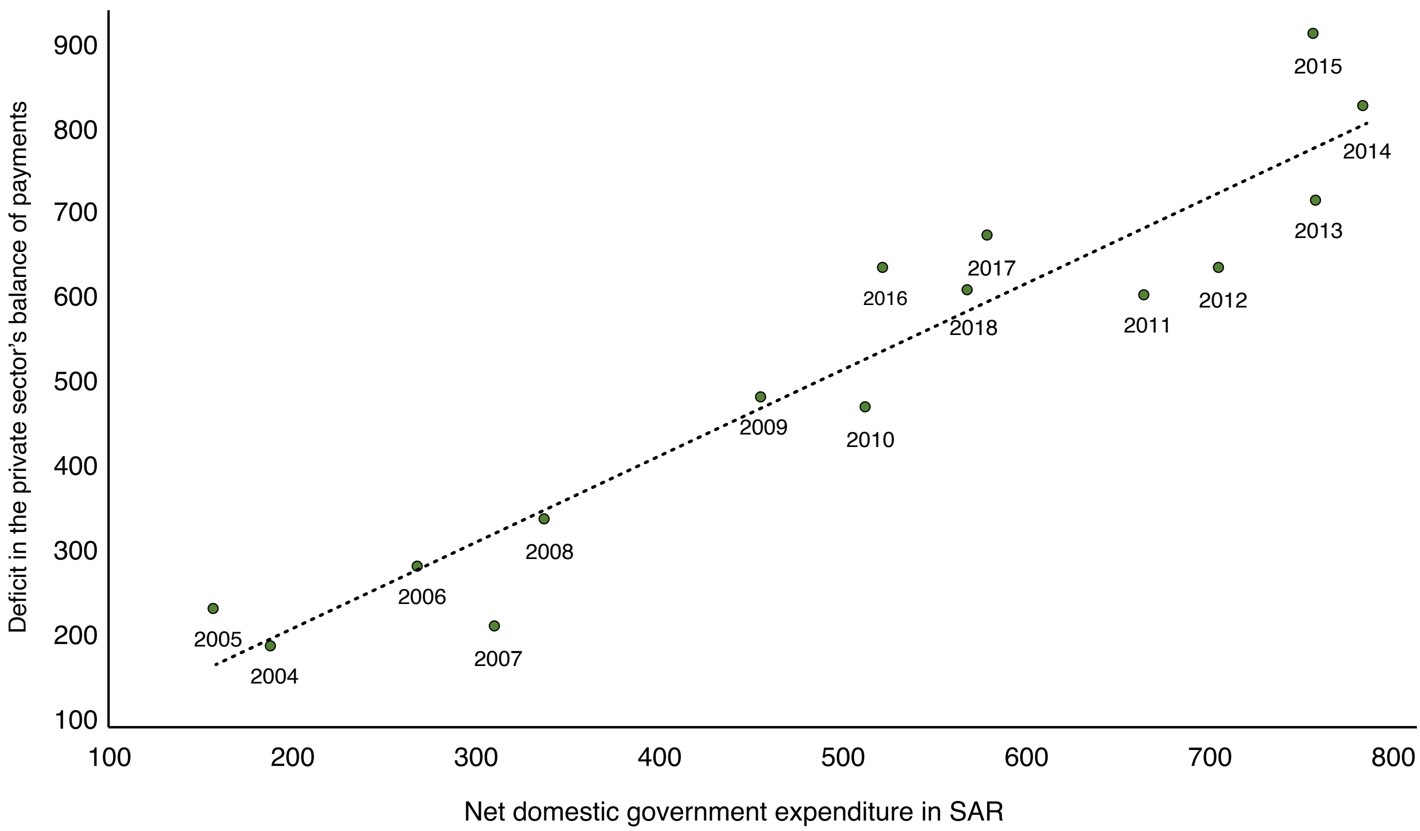
[1] The cost of living allowance was a temporary cash transfer introduced by Royal Decree in early 2018 (Saudi Press Agency 2018) for one year. It was extended by an additional year in 2019, and suspended in June 2020.

The macroeconomic impact of the fiscal adjustments

Given the current structure of the Saudi economy, fiscal policy remains the main driver of private sector growth and one of the enablers of long-term economic development and diversification. The major source of private sector activity is government expenditure on public projects and public sector employees. The private sector is primarily services-based and reliant on imports (imports account for 47% of total consumption) (GaStat 2020a) from international markets to satisfy the demand generated by the government and consumers. Furthermore, it is dominated by expatriate labor, which generates a high level of foreign remittances. Expatriate labor accounts for 80% of private-sector employment (GaStat 2020c).

Figure 2 illustrates the relationship between net domestic government expenditure[2] and the private sector's balance of payments (PBOP) deficit. The near one-to-one relationship indicates that rising net government expenditure leads to an equal increase, on average, in the PBOP deficit. Consequently, when the PBOP deficit is not financed by local revenue, it results in a drawdown on the country's foreign exchange reserves.

Figure 2. Net domestic government expenditure and deficit in the private sector's balance of payments.



Source: SAMA (2020).

[2] Domestic government expenditure in SAR less local revenues in SAR (SAMA 2020).

The shocks to the global and local economies caused by COVID-19 have further accelerated the leakages in the existing structure of the Saudi economy, through a widening of external and internal imbalances. Growing trade imbalances and fiscal deficits are of concern to the Kingdom's external creditors. This could impact Saudi Arabia's international borrowing rate, making it more expensive for the country to access capital. Indeed, the government's fiscal capacity to support the economy over the medium and long term depends on its fiscal space and the size of its foreign exchange reserves.

The Ministry of Finance's (MOF's) decision to increase the country's VAT rate will reduce the government's net expenditure by increasing its non-oil revenues. This will, in turn, lower the PBOP deficit. VAT revenues also have the potential to redirect spending back into high-value sectors. This will be important, as the economic lockdown has had a negative impact on some of these sectors. The MOF stated that budget appropriations are to be reviewed and reallocated, with funds transferred to the health sector as needed.

Finance Minister Mohammed Al-Jadaan said in a statement to the Saudi Press Agency, "While the measures that were taken may be painful, they are necessary and beneficial to protect fiscal and economic stability in the short and long term." While the VAT hike could lead to inflation in the short run and shrink consumption, it should help to improve the country's fiscal space and could result in lower levels of imports. Mitigating the impact of the VAT rise on Saudi Arabia's regional competitiveness is critical to fulfilling these objectives.

Looking forward

Fiscal consolidation efforts, while requiring a short-term adjustment period, could significantly help the Kingdom to control its fiscal deficit and protect the level of its foreign exchange reserves. This, in turn, should support the country's fiscal stability and its resilience in the long run. As fiscal policy remains the main driver of economic growth in the Kingdom, strengthening the country's fiscal space gives the government the capacity to continue supporting the economy. This includes achieving the objectives of Vision 2030, one of which is to diversify the economy away from its dependence on oil export revenues. Continuous revisions to these fiscal measures are necessary to maximize their benefits and minimize their negative impacts on the economy. Innovative tax and customs incentives that encourage the use of domestic goods over imported goods could help to support local industries and create jobs for citizens, reducing the leakage abroad of government expenditure.

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