The *Journal of South Asian and Middle Eastern Studies* is published under the .uspices of the Pakistan American Foundation, 421 St. Augustine Center, /illanova University, Villanova, PA 19085. (610) 519-4738. All correspon-lence should be addressed to the Editor.

The *Journal* is published quarterly, and its annual subscription is $30; J.S. Institutions: $35; foreign subscription: $40.

Journal of South Asian and Middle Eastern Studies

Vol. XXVII, No. 3 Spring 2004

Iran too, of course, must be considered in this overall scenario. Although this regionally powerful state has its own important and legitimate interests, much of the argument made about why Turkey might be brought around to favor an independent Iraqi Kurdistan can also be made for Iran. Indeed, Turkey and Iran, who share a long history of pragmatic compromise in the modern Middle East, might find their joint agreement on and sponsorship of an independent Iraqi Kurdistan yet another reason to continue their relatively peaceful relationship.

Journal of South Asian and Middle Eastern Studies Vol. XXVII, No.3, Spring 2004

Saudization: A Useful Tool in the Kingdom's Battle Against Unemployment?

Robert Looney*

If we the GCC states, had a sound economic perspective in the interest of our people, problems such unemployment would never crop up. There would not have been issues like Kuwaitisation and Saudisation.[1]

Ahmed Al-Jarallah, Editor-in-Chief, the *Arab Times*

Introduction

Saudi Arabia along with the other GCC (Gulf Cooperation Council) countries faces a challenging set of problems that need to be addressed if political and military stability is to be maintained in the region. The first problem involves attaining and maintaining economic growth rates that are least sufficient to keep pace with the rise in population. For Saudi Arabia, low economic growth has become a chronic problem: Gross Domestic Product (GDP) increased by only 1.6 percent between 1990 and 2000 while growth in the country's population grew at an annual rate of 2.7 percent during that period, thus producing a declining trend in per capita income.[2]

This low rate of growth cannot be attributed to a lack of capital formation. In fact, the rate of investment is relatively high in Saudi Arabia. The Sixth Development Plan (1995-2000) for instance envisaged a total capital of around 472 billion riyals ($125.8 billion), including nearly 212.7 billion riyals ($56.7 billion) from the private sector. It had also

*Robert E. Looney is a professor of economics, and Associate Chairman of the National Security Affairs department at the Naval Postgraduate School in Monterey, CA. He has written twenty books on various aspects of development together with articles appearing in a number of scholarly journals.

[1]Ahmed Al-Jarralah, "Opinion Column," *Arab Times*, January 11, 2004.

[2]Unless otherwise indicated, all economic data are from the Saudi Arabian Monetary Agency, Annual report, various issues.

targeted an economic growth of 3.8 percent over the plan period. By the end of the plan, actual investment increased by around two percent to 481 billion riyals ($128.2 billion) including nearly 292 billion riyals ($77.8 billion) from the private sector, an increase of around 37 percent over the projected level.[3]

Thus, even though the Plan overachieved in terms of investment, it underachieved in terms of what really counts, real economic growth. The ineffectiveness of investment to sustain growth appears to be structural, stemming in part from a weakening of the linkage between public and private expenditures together with a decline in the ability of public expenditures to stimulate real output.[4] Given the inability of the public sector to directly stimulate real non-oil output, all of the pressure to provide expanded employment opportunities and output is now placed on the private sector.

Job creation is then the second major problem facing the region. Ironically, even though the Saudi economy is heavily dependent on foreign workers (4.6 million or 71 percent of the country's workforce), the unemployment rate among Saudis is 8.2 percent, reaching 32 percent among younger workers.

Finally, the third challenge relates to maintaining the pace of economic reforms. Here the Saudis have initiated a series of measures designed to attract foreign investment, deregulate many key industries and liberalize the economy to qualify for membership in the World Trade Organization (WTO), as well as to facilitate further economic integration with the country's fellow GCC members.

If carried out successfully, the economic reforms should remove many of the constraints currently impeding growth and job creation in the private sector. This is critical, given the current inability of public expenditures to perform this task.

The country's three main challenges, restoring rates of growth above that of the population, expanding job creation and implementing a comprehensive reform package appear to be relatively compatible – good progress in the reform area should assure higher rates of

[3]Nadim Kawach, "Saudis Need to Adopt More Reforms to Spur Growth," *Gulf News*, August 17, 2003.
[4]Robert Looney, "Can Saudi Arabia Reform its Economy in Time to Head off Disaster?" *Strategic Insights*, III:1, January 2004. <http://www.ccc.nps.navy.mil/si/2004/jan/looneyJan04.asp>.

economic growth and through that more jobs. But will they be jobs for Saudis? Apparently the government is not confident this will be the case because it is simultaneously broadening and expanding its Saudization program -- the Saudi Government appears to feel that if jobs cannot be created through high rates of investment then they must be forced through quotas.

More formally, as implemented in Saudi Arabia, Saudization is a development strategy that seeks to replace foreign workers with Saudis. To date this has been largely accomplished through various employment quota targets. For example, the currrent guidelines of the Shura Council (a consultative body) dictate that 70 percent of the workforce must be Saudi by 2007, with Saudization accelerated in some industry sectors.[5] Saudi Arabia is not alone in adopting a program stressing employment for native workers over foreign.[6] Kuwaitization, Emiratization, Qatarization and Omanization are to one degree or another being implemented in the neighboring GCC countries. Nor is Saudization new – it has been tried numerous times in the past.

The purpose of this note is to examine the country's Saudization program. What are its main components? How will it be implemented? More importantly, is Saudizaton compatible with the country's general approach to economic reform?

Reforms -- The Government's Response to the Economy's Slowdown

In addition to a series of new economic reforms and initiatives, the government's response to the country's economic problems has also entailed a fairly extensive set of educational, political and social reforms. In their totality, the reforms appear to be influenced not only by the deteriorating economic conditions, but also by concern that the current environment[7] in Saudi Arabia is conducive to terrorist recruitment[8] and activity.[9] Hopefully, the reform package as a whole will

[5]Grant Smith, "Saudization: Development and Expectations Management," *Saudi-American Forum*, October 31, 2002.
[6]Cf. Onn Winckler, "The Immigration Policy of the Gulf Cooperation Council (GCC) States," *Middle Eastern Studies*, 33:3, July 1997, pp. 480-493.
[7]"Lack of Reform in Saudi Arabia Even Bigger Threat than Terrorism," *IPR Strategic Business Information Database*, November 11, 2003.
[8]Richard Beeston, "Bin Laden Finds Recruits in the New Saudi Underclass," *London Times*, July 18, 2003.
[9]"Closed Society Breeds Terror," *Gulf News*, January 12, 2004.

create a more open, transparent environment within which stronger civic institutions can develop and, in time, will increase economic and political freedom and lessen the terrorist threat to the nation.[10] No doubt the process will be slow,[11] but there are signs that it is moving ahead. Specific measures noted by the Saudi Government include:[12]

Economic Reforms

The main thrust of the new wave of economic reforms is to open up the economy. Not only is it hoped that efficiency will be increased through freer markets, but also that new jobs will be created by the expanded flow of foreign direct investment. The opening of the economy is also one of the main pre-requisites of WTO membership, as well as full integration with the GCC countries.[13]

1. In November 2002, the Saudi government announced plans to privatize twenty major sectors. Since that announcement, Saudi telecom has been partially privatized.
2. The postal system is in the process of being privatized, and future plans include privatization of the National Insurance Company (NCCI) and Saudi Arabia Airlines (SAA).
3. A new insurance law was passed on July 14, 2003 to provide a legal structure governing insurance.
4. A Copyright Law was passed on June 9, 2003 to comply with the provisions of the World Trade Organization's agreement on trade related aspects of intellectual property rights.
5. A Capital Markets Law passed in July 2003 to regulate the Saudi stock market, and a governing/oversight body is being established to regulate stock market activity.
6. The energy sector has been opened up to foreign investment. Agreements worth more than $7 billion have been reached with international oil companies for investments over the next few years.

[10]Cf Khalid Alnowaiser, "Terrorism in Saudi Arabia:Causes and Solutions," *Arab News*, January 10, 2004.
[11]Zvi Bar'el, "Even the Saudi Public Discourse on Reforms is Conducted in Secrecy," *Haaretz.Com*, (January 7, 2004).
[12]"Saudi Arabia's Progress on Economic, Educational and Political Reforms," *PR Newswire*, November 7, 2003.
[13]Robert Looney, "The Gulf Co-operation Council's Cautious Approach to Economic Integration," *Journal of Economic Cooperation*, 24:2, April 2003, pp. 137-160.

7. A new Commercial Court System is being developed to ensure the efficient resolution of commercial disputes.

Educational Reform and Countering Extremism

No doubt educational reform is one of the main keys to future economic and political success for Saudi Arabia. Recent reforms include:

1. Textbooks and curriculums are being updated. Two pilot programs have been established (in Riyadh and Jeddah) to experiment with new teaching methods, while new teacher training manuals have been produced.
2. Two thousand *imams* who have violated prohibitions against preaching of intolerance have been suspended from their positions.
3. The Ministry of Islamic Affairs has initiated a three-year program to educate *imams* and monitor religious education to ensure that extremism and intolerance are purged.

Financial Oversight

More for anti-terrorism than economic ends, the Saudi government has initiated a series of new regulations covering charities and financial institutions:

1. Saudi charities are currently barred from sending any funds abroad.
2. The government has adopted new laws to combat money laundering and terror financing – *Rules Governing Anti Money Laundering and Combating Terrorist Financing, May 2003.*
3. The Kingdom has implemented all 40 recommendations regarding money laundering and all 8 regarding terror financing of the international Financial Action Task Force (FATF).
4. On September 21-25, 2003 Saudi Arabia hosted a team from the FATF to perform a joint evaluation on the procedures the Kingdom has taken to combat money laundering and terror financing.
5. Saudi Arabia's new laws in this are now among the strictest in the world.
6. A Financial Intelligence Unit has been established to track suspicious flows of funds.
7. Accounts have been frozen and suspects arrested.

8. Saudi Arabia and the United States established a joint task force in August 2003 to deal with terror financing. This task force operates as an integrated unit and brings the resources of both governments together. This task force is in addition to the joint task force established in May 2003, to fight terrorism.

Building Civic Participation

This is a relatively new area for Saudi reforms and only a very first beginning is underway:

1. A center for national dialogue has been established to bring together thinkers to publicly discuss issues of concern to Saudi Arabia and to provide recommendations for dealing with the challenges the country faces in the economic, social and political arenas.
2. An association for journalists has been established, and associations for other professional and trade groups are expected to be established.
3. An independent, private human rights organization has been established.

Broadening Political Participation

As with civic participation, political participation is in its infancy in Saudi Arabia. Yet a beginning has been made:

1. On October 13, 2003 the cabinet approved plans to streamline local and municipal governments, including the establishment of Municipal Councils in which half the members are elected and half appointed.
2. Student councils are being set up in public schools to begin educating young Saudis about civic responsibilities and participatory governance.

Saudization

Running parallel to these reforms is the country's Saudization program, focused on three main goals:[14]

[14]Grant Smith, "Saudization: Development and Expectations Management," *Saudi-American Forum*, October 31, 2002.

1. Increase employment for Saudi nationals across all sectors of the domestic economy.
2. Reduce and reverse over-reliance on overseas foreign workers.
3. Recapture and reinvest income which otherwise would have flowed overseas as remittances to foreign worker home countries. Over the last 10 years expatriate workers in the kingdom have remitted about SR585.4 billion.[15]

Achieving these goals will be an extremely difficult task. For one thing, such efforts in the past have met little success. For example, the Sixth Development Plan (1995-2000) targeted the creation of nearly 319,500 jobs for Saudis through replacement of foreigners, but despite the efforts noted above, the number of foreign workers grew by around 58, 400.[16]

In addition the country's demographics present a severe challenge. In 2004 one out of every two Saudis was less than 15 years of age, and an estimated 60 percent of the population is less than 20 years old. The education system has largely failed to prepare the country's youth for jobs requiring technical expertise. Compounding this problem is that many graduates refuse to take assignments that are considered commonly as menial, further enlarging the ranks of approximately six million expatriate workers. As noted above, this is occurring in an environment where youth unemployment may be reaching 30 percent. In reality, barely 2 percent of Saudi youths who attend Saudi University and/or technical institutes are fully qualified to assume demanding posts. An estimated 50 percent of Saudi youth drop out of primary school. All of these factors severely constrain the available recruitment pool for businesses.[17]

Current Efforts at Saudization

The Saudization program's particular focus is on youth where unemployment reaches 32 percent compared to 8.2 percent among Saudis as a whole. In addition, the government has taken the initiative to increase participation of Saudi women in the labor market where currently only

[15]"Expats Remitted SR585 Billion in 10 Years," *Arab News*, January 10, 2004.
[16]Nadim Kawach, "Saudis Need to Adopt More Reforms to Spur Growth," *Gulf News*, August 17, 2003.
[17]Joseph Kechichian, "The Direction of a New Generation in Saudi Arabia," *Gulf News*, January 8, 2004.

10.2 percent of women now hold jobs. These demographic realities place intense pressure on Saudi authorities to create at least 160, 000 jobs annually.

While Saudization in one form of another has been around for years, its pace, along with other reform efforts has recently picked up. In the mid-1990s:

1. A law was issued requiring private businesses employing more than 20 people to increase the number of Saudi nationals in their workforce by 5 percent every year.
2. The employment of foreigners in twenty-two, mostly administrative professions was banned.
3. The government increased fees on the recruitment of expatriates, with the money going into a special fund set up to help "nationalize" jobs.

More recent initiatives have included:

1. In 2001, the Ministry of Labor and Social Affairs targeted a goal for 2002 of 25 percent Saudization in the private sector. This was in line with the goal defined by the current Five Year Development Plan (2000-2005) that seeks to provide 817,000 jobs for Saudis by creating new opportunities or by replacing expatriates with Saudi citizens. The move was also in line with a government policy which calls for increasing Saudi manpower in the private sector by five percent annually.
2. The current set of Saudization laws were enacted in 2002. Companies with 20 or more employees are now required to employ Saudis up to at least 30 percent of their workforce.
3. In January of 2003 the Shura Council began to apply Saudization metrics to companies working in the Kingdom that are directly owned by Saudi Aramco as well as those implementing Aramco projects. The Saudization level of contractors must now be included in annual performance reports submitted by the Ministry of Petroleum and Mineral Resources. While they may increase the complexity of foreign competitive bids for oil and gas projects, from the Council's perspective the measures move bid selection toward achieving the country's national labor force interests.[18]
4. Early in 2003, the Saudi Ministry of Labor ordered the accelerated Saudization of the 9,771 bank jobs held by expatriates.
5. In July 2003, the government announced its decision to reduce the number of expatriate workers to 20 percent of the total population in a decade, in order to open up jobs for its nationals.

Finally Saudi Aramco is assisting the implementation of Saudization by holding the companies it concludes contracts with to certain quotas of Saudis: 35 percent for construction companies, 50 percent for services companies and 60 percent for importers, industrialists and engineering offices.[19] For their part, in 2002 Aramco established a center to train Saudis working for contractors. The program is geared to upgrading professional skills and teaching specific skills particularly in the areas of drilling and oil well maintenance.[20]

While Aramco is developing innovative programs to facilitate the Saudization of the labor force, the predominance of Saudization employment elsewhere in the kingdom is still through the use some sort of quota system or by directly banning expatriates from working in certain activities. Currently 34 areas are closed to expatriate workers including:[21] training managers, public relations officers, administrative assistants, purchase managers, secretaries, operators, warehouse supervisors, debt collectors, customer service accountants, tellers, postmen, data handlers, librarians, book sellers, ticket kiosk keepers, taxi drivers, auto salesman, janitors, internal mail handlers and tour guides.

Looking into the future, these recent Saudization initiatives imply that up to three million foreigners living and working in Saudi Arabia may have to leave the kingdom in the next decade. According to a February 2003 notice by the Manpower Council:[22]

1. The number of foreign workers and their families must not exceed 20 percent of the Saudi population by 2013. In this regard the num-

---

[18]Grant Smith, "Saudization: Development and Expectations Management," *Saudi-American Forum*, October 31, 2002.
[19]"Saudi Aramco Spearheads Saudization Drive of Contracting Firms," *Saudi Economic Survey*, January 8, 2004.
[20]"Saudi Paper Says Aramco Plans to Saudize 3,600 Jobs in Oil Industry," *BBC Monitoring International Reports*, November 3, 2003.
[21]Jasim Ali, "GCC Insights: Challenges Facing Economies in 2004," *Gulf News*, January 7, 2004.
[22]Omar Hasan, "Three Million Expats Face the Axe in Saudi Arabia," *Agence France Presse*, February 4, 2003.

ber of foreigners in the Kingdom is currently estimated at between six to seven million, compared to around 17 million Saudis. Based on the current Saudi population growth rate of about 3.2 percent annually, Saudis are expected to reach 23 million by 2013 and accordingly foreigners must not exceed 4.5 million.
2. The decision also stipulates a quota system for foreign nationalities in which any single nationality must not exceed 10 percent of the total expatriates.
3. The System will particularly hit Asians from India, Pakistan, Bangladesh and the Philippines in addition to Arabs from Egypt, Sudan and Syria, whose numbers exceed the required 10 percent.

Impact on the Economy

Like any major policy initiative, Saudization clearly creates some disturbances, with some sectors like transport[23] anticipating a catastrophe. The ultimate goal of development and hopefully higher growth comes with a cost in the form of short term transitional disruption.[24] It is a bit too early to gauge the impact of Saudization on the economy at this point. There are two main concerns. First, many firms may feel that Saudization will reduce their competitiveness and for that reason may decide to leave the Kingdom for a more business friendly environment. These would most likely be firms in the service sectors such as banking where in early 2003, the Saudi Ministry of Labor ordered the accelerated Saudization of the 9,771 bank jobs held by expatriates. Many bankers spoke out stating that the Saudization of all banking jobs would likely cause a brain drain and a loss of business to other regional banking centers, particularly Dubai.[25] The country's poor regulatory environment only compounds this problem with a reportedly 2,500 Saudi companies opening up shop in Dubai, rather than in the Kingdom.[26]

[23]"Trucking Industry in Saudi Hurt by Saudization," *Middle East North Africa Financial Network*, November 30, 2003.
[24]Grant Smith, "Saudization: Development and Expectations Management," *Saudi-American Forum*, October 31, 2002.
[25]Grant Smith, "Saudization: Development and Expectations Management," *Saudi-American Forum*, October 31, 2002.
[26]Kate Kuxford, "Poor Regulatory Environment in Saudi Arabia Leads Local Companies to Set up in UAE," *World Markets Analysis*, December 19, 2003.

The *Arab World Competitiveness Report, 2002-2003* lists several industries, among them acyclic hydrocarbons, insulated wire or cable, polymers or ethylene, and structures and parts of structures, as current underachievers that might be vulnerable to a loss in competitiveness stemming from Saudization. These industries might have an especially difficult time absorbing an increased share of Saudi workers. On the other hand, Saudization advocates such as Saudi economist Ihsan Bu-Hulaiga contend that because only 15 percent of the expatriates can be classified as skilled, the new Saudization quotas will not create a vacuum in the domestic labor market.[27] His contention is that the domestic market is currently saturated with foreigners, some of whom are unemployed, unskilled and or illiterate. They simply compete with Saudi job-seekers to force down wages.

In contrast, many businessmen have been lukewarm concerning the quotas and targets established by the Saudization program. In particular they have called for a review of the Cabinet resolution setting the Saudization quotas that all private businesses must abide by, especially the section requiring that any establishment employing more than 20 workers must increase the rate of Saudization by 5 percent per annum. Many businessmen correctly contend this may not always be possible given the fact that the supply of Saudi workers is not enough to cover the needs of the private sector. Currently, in early 2004, the required Saudization quota for companies is 30 percent.[28]

Perhaps in a response to private sector concerns the Shoura Council indicated in early 2004 that it may approve a new law that will allow employers to fire Saudi works if they prove inefficient, subject to the condition that the dismissal is not arbitrary. The Ministry of Labor and Social Affairs is also contemplating[29] the reformulation of regulations that could check the outflow of Saudis working with the private sector -- workers wishing to join another private establishment would be required to present a clearance certificate from their previous employers. While no doubt favored by firms, restrictions of this type are not

[27]Quoted in Omar Hasan, "Three Million Expats Face the Axe in Saudi Arabia," *Agence France Presse*, February 4, 2003.
[28]"Shoura Council Reviewing New Labor Law," *Arab News*, January 23, 2004.
[29]"Shoura Council Reviewing New Labor Law," *Arab News*, January 23, 2004.

well advised since they are inconsistent with the functioning of efficient labor markets.

The second main area of impact from Saudization may be a reduction of foreign direct investment (FDI) in the Kingdom. Here foreign firms may feel that Saudization not only puts them at a disadvantage compared to their foreign competitors, but that the whole Saudization program itself is unpredictable, with rules and quotas changing randomly. This element, combined with increased concern over domestic terrorist violence may drastically reduce the inflows of FDI. Perhaps concern over Saudization's impact on foreign investors underlies the Kingdom's recent decision to reduce the tax on foreign investors from 45 to 20 percent.[30]

Incentive-Based Saudization Strategies

Several important lessons come out of the experiences of the other GCC countries in creating employment opportunity for national workers:[31]

1. The capital intensity of the oil sector makes it extremely difficult for that sector to create an adequate number of jobs for nationals and still remain competitive.
2. Developing new employment opportunities rather than substituting local workers for foreign is the only long term solution for accommodating a growing labor force.
3. It is extremely difficult to create additional jobs without expanded volumes of foreign direct investment.
4. Training new entrants for likely job openings is the key to a successful national employment policy.
5. A largely expatriate workforce remitting large proportions of their earnings makes sustaining high levels of domestic demand difficult.

[30]"Saudi Arabia Cuts Income Tax on Foreign Investors," *Khaleej Times*, January 14, 2004.
[31]CF. Robert E. Looney, *Manpower Policies and Development in the Persian Gulf Region*, (Westport, Conn: Praeger, 1994); Cf. Onn Winckler, "The Immigration Policy of the Gulf Cooperation Council (GCC) States," *Middle Eastern Studies*, 33:3, July 1997, pp. 480-493.

As with the other GCC countries, most of Saudi Arabia's new entrants to the workforce will have to go into the private sector. In this regard job creation for locals is much easier in a growing economy, perhaps relying on significant inflows of foreign direct investment and technology.

Saudi Arabia's manpower problem is similar to that of the other GCC countries in that there is a pronounced mismatch between education and employability. To avoid a loss of competitiveness in an economy possessing a pool of skilled and relatively cheap foreign labor Saudis will have to be trained and or retrained in competencies needed in the market place.

The Role of Market Forces and Incentives

In more general terms, instead of quotas the Saudization should be implemented more through market forces and incentives. Saudization should not be approached as a zero sum problem, but instead implemented in a growth oriented environment assisted with expanded foreign investment, induced in part through an expanded and reformed education/training program. In short, Saudization should be implemented in a manner that provides jobs for Saudi nationals in an environment characterized by increased competitiveness and strong non-oil growth. Here economic theory[32] provides some general propositions and guidelines for possible action:

1. From the perspective of private sector firms, the demand for Saudi native workers is inversely related to the cost of their hiring and firing. It is also inversely related to the cost of employing low-skilled expatriate workers. Since a reduction in the number of low-skilled employees likely reduces the marginal productivity of national workers, an increase in the cost of employing low skilled workers would reduce the demand not only for these workers but also for Saudi workers.
2. If skilled expatriate workers are sufficiently substitutable with Saudi workers, then demand for Saudis should be positively related to the cost of employing skilled expatriates -- increases in these costs would lead firms to reduce their demand for skilled expatriate workers and

[32]Assuming a Cobb-Douglas Production function incorporating technological change and limited substitutability between Saudi and expatriate workers.

to substitute them with national workers.

3. Finally, the demand for Saudi workers is also positively related to their level of human capital, the stock of capital and technology because increases in these factors should raise the return on employing an additional national worker.

4. The supply of national workers to the private sector should depend on the compensation relative to their reservation wages (the minimum wage one is willing to accept for their work). Reservation wages in turn are determined by the wage, social benefit and employment policies of the government. If the public sector provides relatively high wages, social benefits and job security to nationals, then the reservation wage and benefits will be relatively high for the private sector.

From these supply and demand considerations several policies can be adopted to increase job opportunities for Saudi workers in the private sector. These may be grouped into three broad categories depending on whether they directly affect: (a) wages and employment costs, (b) acquisition of human capital or (c) investment in capital and technology. These policies are structural and market-based, in contrast to quantitative measures, such as job quotas, which may adversely affect competitiveness and non-oil growth by raising costs and limiting employment flexibility.

Policies Affecting Wages and Employment Costs

Reducing the relatively high wages in the public sector is likely to lower the reservation wage and increase the willingness of nationals to acquire skills or human capital valuable to private sector employers. Announcing and enforcing the strict limits on public sector hiring is likely to further lower the reservation wage by decreasing the likelihood that the public sector will act as the employer of first and last resort for nationals.

Separating wages and social benefits in the public sector and providing benefits to all working nationals–not just to those employed in the public sector–is likely to reduce the incentive for nationals to seek public sector employment and lower the reservation wage to the private sector. Moreover, giving time specific subsidies for the employment of nationals will likely increase private sector demand for them by lowering their employment costs. However the fiscal cost will need to be less

than the employment benefit for the policy to be welfare improving. (These subsidies could be financed, for instance, by fees or income taxes on skilled expatriate workers).

Relatively higher firing costs for nationals, including lengthy appeal and investigation of dismissals, raises their relative cost of employment, thus reducing demand. Therefore, establishing a clear set of rules for the appeal of dismissals, including fines or penalties associated with wrongful dismissals, and a mechanism for the rapid resolution of appeals is likely to lower the relative cost of employing Saudis, and reduce the disparity in labor mobility between Saudi and expatriate workers across sectors.

If skilled expatriate workers are sufficiently substitutable with Saudi workers, then increasing the relative cost of hiring skilled expatriate workers such as by imposing income taxes or fees on the employment of skilled expatriates, is likely to result in substitution away from skilled expatriates and towards nationals (assuming that the employer will cover the cost of paying the income tax of his expatriate workers). Such taxes or fees should only be applied to skilled expatriates and not to low-skilled expatriates because the latter complement the productivity of nationals. If taxes or fees are applied to low-skilled expatriate workers then the cost of hiring them will increase and the demand for national workers is likely to increase.

Skill Development

Enhancing the human capital of Saudis and the acquisition of skills that are valuable to the private sector is likely to increase demand and employment. To this end, providing education including vocational training, reforming school curricula encouraging firms to establish internships, awarding scholarships as well as targeted training vouchers and fostering self employment will likely build necessary skills and expertise among prospective national workers.

In order to compete on a global level and on the strength of the national labor force, the Saudi economy will probably have to diversify, and that will include employment in more hazardous industries for Saudi nationals. The construction sector for example, one of the most dangerous industries, will require thousands of skilled Saudi workers to fulfill its Saudization target. This will necessitate significant improvements in safety and health conditions in the workplace in order to attract Saudis. Similarly in the oil and petrochemical industries, which contribute up to 90 percent of the Kingdom's income, a comprehensive occupational safety and health strategy must be established.[33]

Here, subsidies might be used to entice Saudis into jobs through training contracts. The government could play an active role in assisting the process. The newly created Human Development Resources Fund[34] should play a greatly expanded role in assisting this effort. For example employers could be responsible for providing the necessary skills training, while the employee will commit to completing the program. If the employee leaves before training ends, he or she will have to reimburse the cost of the training to the employers, which would then be partially refunded to the Fund.

For its part in November 2003, the government allocated SR3.7 billion for the training of more than 100,000 young Saudis. Plans are to establish 20 technical colleges capable of accommodating 60,000 trainees and 39 technical training institutes designed for 40, 000 students. There are also tentative plans for expanded vocational training in the military. These plans look for the military to admit 10, 000 trainees annually. The first three months will be allocated for basic military training during which time the skills of the trainees will be examined to identify suitable professions. Technical training will be given in the last nine months and the trainees will be given professional certificates.[35]

Investment in Capital and Knowledge

Facilitating the adoption of new technologies and the accumulation of capital is also likely to increase private sector demand and employment of Saudi workers by raising their productivity. In this regard, the establishment of regional knowledge and technology intensive clusters of industries might be of great help. Moreover, shifts in government expenditure away from welfare-state type activities towards economic services, and research and development should lead to higher productivity and investment.

[33]International Labor Organization, *Saudi Arabia: Managing Markets in Transition* (Geneva, ILO, forthcoming 2004).
[34]*Human Resources Development Fund*, <http://www.hrdf.org.sa/ver2/index.htm>.
[35]P.K. Abdul Ghafour, "Govt. Allocates SR3.7b for Training of Young Saudis," *Arab News*, November 5, 2003.

Innovative Approaches

Several innovative approaches have successfully drawn on a number of aspects of the above described outline. An area of great potential for the training of Saudis for skilled positions is the country's offset program. The Economic Offset Program is a Saudi government initiative designed to achieve the following goals within the framework of foreign investment for major civil and defense projects: (a) economic diversification, (b) manpower development, (c) strategic self-sufficiency, (d) technology transfer, and (e) investment opportunities.

BAE Systems is a major company that participates in the offset program -- it is one of the largest private sector employers of Saudis in the Kingdom. In December 2003 the company announced that Saudi employees constituted 52 percent of their workforce (2,386 out of 4,579). Increased Saudi employment came as a result of the continued recruitment of young Saudis to join training programs to become aircraft technicians, engineers and other specialists. After periods of intensive instruction the Saudis then work along side expatriates, many of whom have 25 or more years of experience.

> Saudi Arabia is the center of operations in the Middle East for BAE Systems and the company envisages Saudis playing an important role in developing the company's business throughout the Arab World.[36]

Perhaps the most innovative area of Saudization has originated with the government itself. The country's Human Resources Development Fund (HRDF) provides grants for qualifying, training and recruiting Saudis for work in the private sector. After workers are trained and qualified, HRDF can subsidize a percentage of the salaries of those skilled workers hired by the private sector. Funding for these activities comes from a SR150 fee levied on work permits. Early signs suggest that the program is rapidly catching on with employers.[37] Given public education's limited capacity[38] to develop skilled professionals, much of

[36]"Saudis Comprise more than Half BAE Systems Workforce," *AME Info*, January 19, 2004.
[37]Molouk Y. Ba-Isa, "3,500 Saudis Recruited under HRDF Program," *Arab News*, June 9, 2002.
[38]Ihsan Buhulaiga, "Challenges and Prospects of the Saudi Labor Market," *Arab News*, January 20, 2004.

this task will have to be undertaken by the private sector. The HRDF is certainly a step in the right direction and no doubt its funding should be expanded to reflect its contribution to the country's future.

Costs and Benefits

The costs of achieving Saudization are no doubt considerable – training, recruiting, etc. are real expenses that must be borne for the program's success. On the other hand, these are costs that any aspiring country must accept as part of the development process. They would not necessarily put the Kingdom at any competitive disadvantage considering the fact that competing countries are bearing essentially the same burdens.

While critics of Saudization tend to focus on these costs, little attention is paid to the benefits associated with the program. A notable exception is Kevin Taecker.[39] Taecker's approach attempts to quantify the shifts in domestic demand associated with various national/expatriate compositions of the workforce. The idea is straightforward: with Saudization money that would be remitted (9% of GDP or $14 billion in 1999 alone) to families outside the Kingdom is now spent domestically.

Not only do expatriates spend a smaller percentage of their income domestically, but perhaps more importantly it is for a fairly narrow and meager basket of goods and services, leading to a very low domestic expenditure multiplier of 0.8. That is for every 1000 riyals earned and spent locally by an expatriate another 450 in income is produced as this spending circulates through the economy. For Saudis the expenditure multiplier is estimated at 2.5 or 1,500 in extra income generated for each 1000 riyals of Saudi expenditures.

As noted, in 1999 expatriate worker remittances were around $14 billion. Assuming that expatriates send one-half of their incomes out of the country, this would suggest these workers earned around $28 billion. Taking the effects of the difference in Saudi and expatriate household expenditure multipliers, the total annual cost of relying so extensively on expatriate labor are around $47 billion (the differences in multipliers 2.5 – 0.8 times $28 billion).

[39]Kevin R. Taecker, "Myths and Realities About Unemployment in Saudi Arabia," *Saudi-American Forum*, March 30, 2003.

These factors begin to hit home when one makes a couple of simple calculations. If met, the Saudization goal of reducing the number of expatriates by 2% annually for the period 1999-2004 (The Sixth Plan Period) would shift $2.7 billion of income from expatriates to Saudis. By 2004 this income spent locally would raise annual incomes by $4.6 billion. As Taecker notes:[40]

> The Saudi private sector will be the main beneficiary. The bulk of these effects will be reflected in the form of increased purchases of goods and services form local business. The $4.6 billion would represent more than 6.8% of 1999 private sector GDP – a real and substantial reward for doing their part to meet the plan's modest goals.... Thus, there is a virtuous economic cycle implicit in successful Saudization. By leading the economy overall to higher economic multipliers it stimulates business growth and hiring, pushing the economy even higher.

Looked at in this light, Saudization, though benefiting the private sector, is essentially a public good, replete with free rider problems – some firms will not voluntarily Saudize, but rather simply reap the benefits of expanding domestic markets provided by those firms who actively increase Saudi employment. In this case, rather than simply imposing mandatory quotas on firms, the government might consider several incentive based strategies.

Taxes. Determine industry norms for Saudization and pay proportional bonuses to firms above the norm and set proportional taxes on those firms below the norm.

Allow Trading in Offsets. This approach would be similar to that used in the United States by the U.S. Environmental Protection Agency[41] to deal with emissions. In the Saudi context limits could be set on the number of expatriates in a certain industry. Thus if an industry is at its limit and a new firm wished to enter that line of business it would have to negotiate a deal with an existing business to hire qualified Saudis, or pay for training programs to make more Saudis

[40]Taecker, *op. cit.*, p. 8.
[41]Cf. J. Barkley Rosser and Martina Rosser, *Comparative Economics in a Transforming World Economy*, (Chicago: Irwin, 1996), p. 37.

this task will have to be undertaken by the private sector. The HRDF is certainly a step in the right direction and no doubt its funding should be expanded to reflect its contribution to the country's future.

Costs and Benefits

The costs of achieving Saudization are no doubt considerable – training, recruiting, etc. are real expenses that must be borne for the program's success. On the other hand, these are costs that any aspiring country must accept as part of the development process. They would not necessarily put the Kingdom at any competitive disadvantage considering the fact that competing countries are bearing essentially the same burdens.

While critics of Saudization tend to focus on these costs, little attention is paid to the benefits associated with the program. A notable exception is Kevin Taecker.[39] Taecker's approach attempts to quantify the shifts in domestic demand associated with various national/expatriate compositions of the workforce. The idea is straightforward: with Saudization money that would be remitted (9% of GDP or $14 billion in 1999 alone) to families outside the Kingdom is now spent domestically.

Not only do expatriates spend a smaller percentage of their income domestically, but perhaps more importantly it is for a fairly narrow and meager basket of goods and services, leading to a very low domestic expenditure multiplier of 0.8. That is for every 1000 riyals earned and spent locally by an expatriate another 450 in income is produced as this spending circulates through the economy. For Saudis the expenditure multiplier is estimated at 2.5 or 1,500 in extra income generated for each 1000 riyals of Saudi expenditures.

As noted, in 1999 expatriate worker remittances were around $14 billion. Assuming that expatriates send one-half of their incomes out of the country, this would suggest these workers earned around $28 billion. Taking the effects of the difference in Saudi and expatriate household expenditure multipliers, the total annual cost of relying so extensively on expatriate labor are around $47 billion (the differences in multipliers 2.5 – 0.8 times $28 billion).

[39]Kevin R. Taecker, "Myths and Realities About Unemployment in Saudi Arabia," *Saudi-American Forum*, March 30, 2003.

These factors begin to hit home when one makes a couple of simple calculations. If met, the Saudization goal of reducing the number of expatriates by 2% annually for the period 1999-2004 (The Sixth Plan Period) would shift $2.7 billion of income from expatriates to Saudis. By 2004 this income spent locally would raise annual incomes by $4.6 billion. As Taecker notes:[40]

> The Saudi private sector will be the main beneficiary. The bulk of these effects will be reflected in the form of increased purchases of goods and services form local business. The $4.6 billion would represent more than 6.8% of 1999 private sector GDP – a real and substantial reward for doing their part to meet the plan's modest goals.... Thus, there is a virtuous economic cycle implicit in successful Saudization. By leading the economy overall to higher economic multipliers it stimulates business growth and hiring, pushing the economy even higher.

Looked at in this light, Saudization, though benefiting the private sector, is essentially a public good, replete with free rider problems – some firms will not voluntarily Saudize, but rather simply reap the benefits of expanding domestic markets provided by those firms who actively increase Saudi employment. In this case, rather than simply imposing mandatory quotas on firms, the government might consider several incentive based strategies.

Taxes. Determine industry norms for Saudization and pay proportional bonuses to firms above the norm and set proportional taxes on those firms below the norm.

Allow Trading in Offsets. This approach would be similar to that used in the United States by the U.S. Environmental Protection Agency[41] to deal with emissions. In the Saudi context limits could be set on the number of expatriates in a certain industry. Thus if an industry is at its limit and a new firm wished to enter that line of business it would have to negotiate a deal with an existing business to hire qualified Saudis, or pay for training programs to make more Saudis

[40]Taecker, *op. cit.*, p. 8.
[41]Cf. J. Barkley Rosser and Martina Rosser, *Comparative Economics in a Transforming World Economy*, (Chicago: Irwin, 1996), p. 37.

employable in the industry. In the United States environmental example such a deal is known as an "offset." The same principle could be applied in Saudi Arabia to gradually increase the proportion of Saudis in the workforce.

No doubt there are other similar incentive based plans that could facilitate the increased employment of Saudi nationals without hampering economic growth.

Conclusions

Saudization does not have to be incompatible with some of the Kingdom's new economic reforms geared towards increasing the economy's diversity, competitiveness, growth potential and employment generation capacity. For one thing, the larger domestic markets stemming from the replacement of expatriates by Saudis should complete the country's reform efforts in that it should:

1. Facilitate growth in the non-oil segment of the economy.
2. Provide a stimulus to the private sector to invest more in the domestic economy.
3. Create conditions for attracting foreign investment

For its part, the government's strategy for expanding employment opportunities, while complementing other reform efforts, should be built around the following actions:

Increasing the relative attractiveness of working in the private sector by lowering the wage differential between the public and private sectors; making social benefits available to all working nationals, irrespective of sector of employment; and announcing strict limits on public sector employment.

Reducing disparities in labor mobility by creating a level playing field between the hiring and firing national workers vis-à-vis expatriate workers.

Encouraging skill acquisition among nationals by strengthening educational and vocational trading, providing time-specific incentives, such as subsidies and scholarships, and promoting self employment.

Facilitating improvements in productivity and investment in capital by outsourcing government services, and extending majority foreign ownership in non-free trade zone areas.

Using price based rather than quantity based market interventions by charging, for instance, fees for employing or income taxes on skilled expatriate workers.