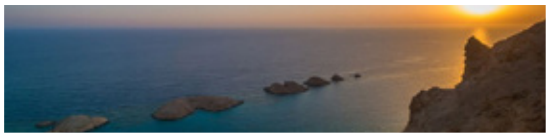
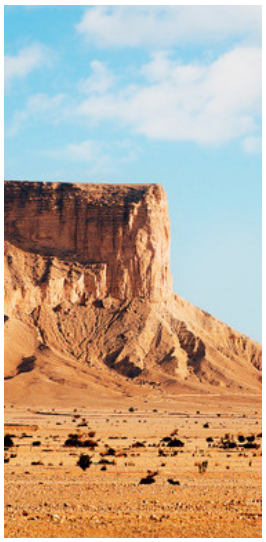
Kingdom of Saudi Arabia Budget Report

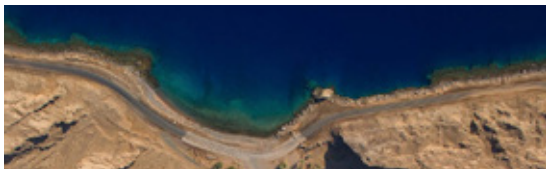
A review of KSA 2019 budget and recent economic developments

December 2018



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Foreword

Abdullah Hamad Al Fozan
Chairman and Senior Partner
KPMG in Saudi Arabia

Welcome to KPMG Saudi Arabia's first ever budget report for the Kingdom of Saudi Arabia (KSA). We are pleased to present our analysis on the budget statement for the fiscal year 2019, announced on Tuesday, 18 December 2018.

There is no doubt that the Government of Saudi Arabia is moving forward, driven by its ambitious vision to diversify the economy away from oil. The government has succeeded in keeping the reform implementation on track, in terms of fiscal consolidation, growth stimulation, improving the investment environment and increasing the private sector's participation in the economy. We expect political support for this trend to be maintained.

The government has maintained its expansionary fiscal policy for 2019, with an expenditure budget of SAR 1,106 billion, supported by the recent trends in oil prices and production. We, at KPMG, view Saudi Arabia's all-time largest budget as a reflection of the leadership's commitment to continue the implementation of Vision 2030 programs to achieve fiscal, social and economic targets.

The planned budget focuses on investments in infrastructure and entertainment industries, policies to support the private sector in tourism and empowering small and medium-sized enterprises (SMEs).

We expect 2019 to be a positive year for the Saudi economy. According to the Ministry of Finance (MoF), real GDP growth is expected to reach 2.6 percent in 2019 as a result of the recent increase in oil production and deeper implementation of structural reforms. Inflation is expected to reach 2.3 percent due to a decreasing VAT registration threshold and continuing gradual increase in domestic energy prices.

Spending in 2019 focuses on creating jobs, with the government focusing on multiple initiatives such as closing the gap between the private and public sector wages and increasing the participation of women in the labor market. However, it is essential that the reforms are prioritized to avoid delays.

Total public revenue is forecast to reach SAR 975 billion in 2019, 9 percent higher than total expected public revenue in 2018 (SAR 895 billion). Oil revenues are expected to represent 68 percent of total revenue in 2019.

The budget deficit in 2019 is expected to be SAR 131 billion (4.2 percent of the estimated 2019 GDP), compared to SAR 136 billion (4.6 percent of GDP) in 2018, reflecting the government's commitment toward achieving a fiscal balance in 2023. Public debt in 2019 is expected to reach SAR 678 billion, 21.7 percent of the estimated 2019 GDP, compared to SAR 560 billion (19.1 percent of GDP) in 2018.

KPMG shares the same view as the government in improving private sector engagement and associated privatization initiatives. The government is aiming to strengthen the private sector and also enhance its contribution to achieve its goals and targets, in line with Vision 2030. It is crucial to communicate and engage more with the private sector so that it plays a bigger role in the non-oil sector and the Vision Realization Programs (VRPs). Additionally, the government should maintain labor policy efforts to boost private sector employment.

The introduction of Value Added Tax (VAT), in January 2018, to increase non- oil revenue, increased inflation rates and had a moderately unfavorable impact on private consumption in the short term. Going forward, as per MOF budget statement inflation is expected to ease in 2019, as the impact of VAT implementation and effects of fuel subsidy cuts start to ease out despite planned fuel price reform in 2019.

It is also vital to gain trust and confidence of domestic as well as foreign investors, especially by increasing transparency. This was also evident from the issuance of the first-ever pre-budget statement (on 30 September 2018), intended to strengthen the Kingdom's trend towards greater disclosure and transparency.

The government's efforts and focus towards achieving sustainability and fiscal balance shall be beneficial for businesses and public policy planning. The story of the budget this year show-cases our optimistic outlook for KSA and we are excited to be a part of this journey.

Executive summary

2019 Budget

Key findings

Saudi Arabia announced its largest ever planned budgeted spending for the year 2019, crossing the one trillion mark for the first time, with a projected expenditure of **SAR 1.1 trillion.** Spending in 2019 will focus on creating jobs and will have a positive impact on existing and new sectors including transport, health and mega projects.

The focus is on maintaining financial stability, supporting the private sector and propelling economic growth more broadly. Hence, this budget is a reflection of the leadership's commitment to the implementation of Vision 2030 and related programs. Active communication and engagement with the private sector will be crucial.

Real GDP growth is expected to reach **2.6 percent** in 2019, in anticipation of improved investor and consumer sentiment. It will also be supported by an increase in public capital expenditure, which is budgeted to be **SAR 246 billion**, an increase of **20 percent** compared to 2018.

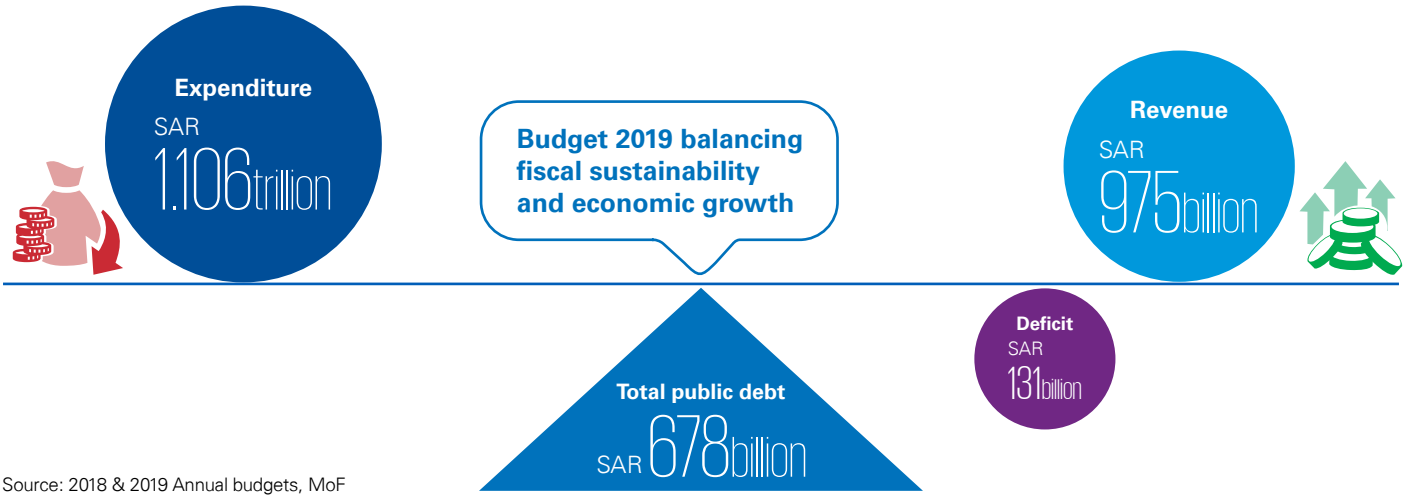
The budget deficit is set to fall to **SAR 131 billio**n in 2019, compared with **SAR 136 billion** in the previous year, which reflects the government's commitment to achieving economic targets and a fiscal balance by 2023. This decline is mainly attributable to greater efficiency in public spending and increasing non-oil and oil revenues.

Non-oil revenue is expected to reach a new high of **SAR 313 billion** in 2019, compared to **SAR 288 billion** expected in 2018, an increase of **9 percent**. This boost is being driven in part by the introduction of VAT in 2018, as part of government efforts to diversify public revenues. It is critical to balance fiscal consolidation objectives against supporting economic growth, particularly activity in the SME sector.

Executive summary

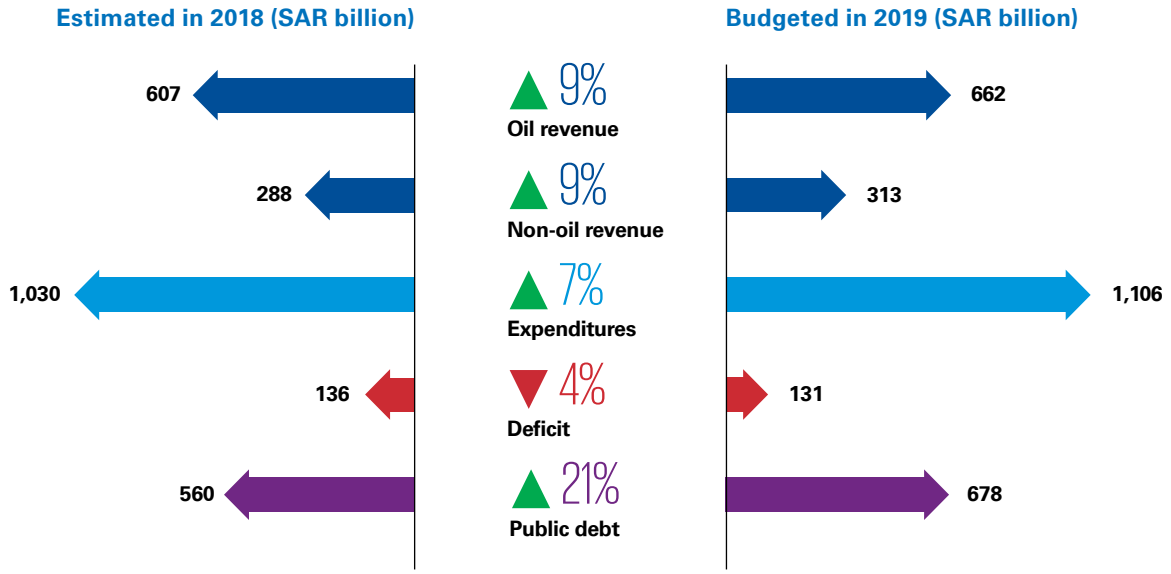
2019 Budget

Saudi Arabia 2019 budget



Source: 2018 & 2019 Annual budgets, MoF

Change in budget 2018-2019



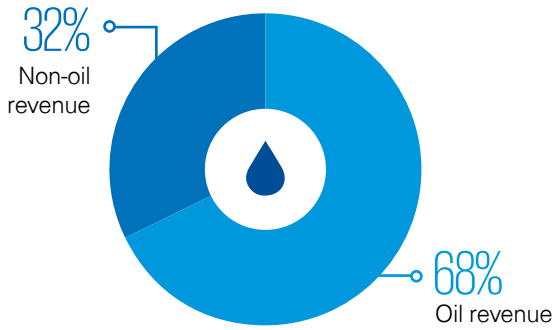
Source: 2018 & 2019 Annual budgets, MoF

Highlights

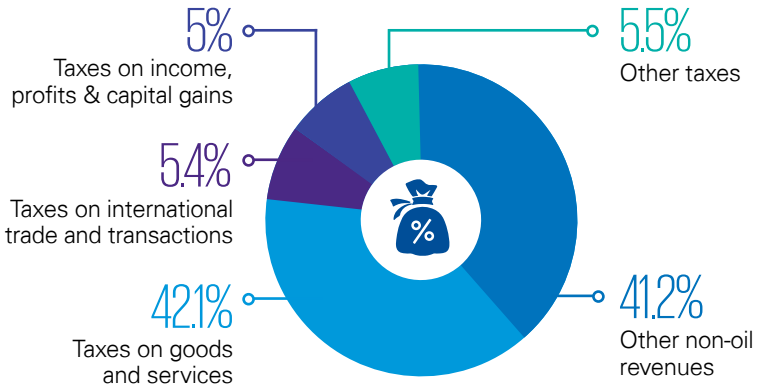
The government is aiming to diversify its revenue streams. In addition, Saudi Arabia is supporting its 2030 goals by allocating an expenditure budget of SAR 1.1 trillion in 2019, out of which SAR 246 billion are allotted for capex to backup its infrastructure projects. In terms of the fiscal deficit, the government is moving toward accomplishing its goal of fiscal balance by 2023, with an expected deficit of SAR 131 billion in 2019.

Saudi Arabia 2019 revenue

Public revenue, SAR 975 billion



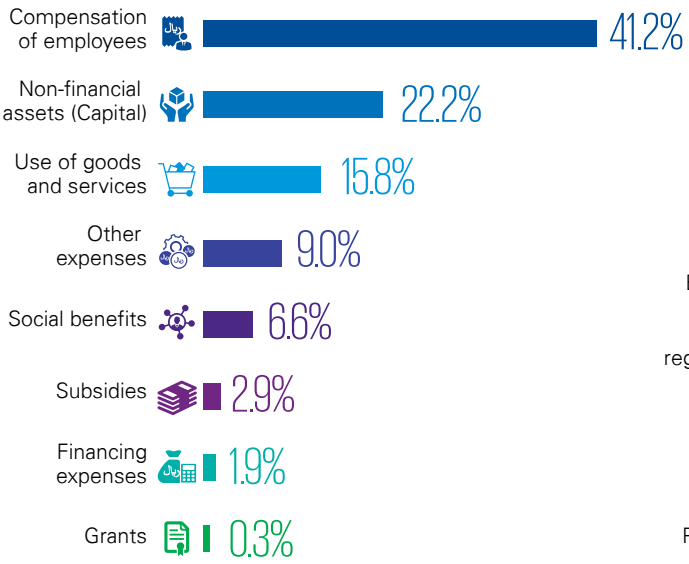
Non-oil revenue, SAR 313 billion



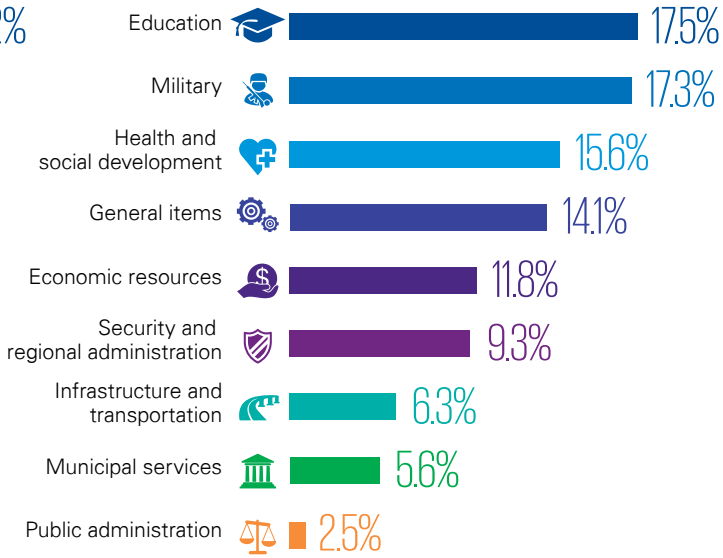
Source: 2019 Annual budget, MoF

Saudi Arabia 2019 expenditure

Expenditure by component, SAR 1.1 trillion



Expenditure by sector, SAR 1.1 trillion



Source: 2019 Annual budget, MoF

2019 Budget

Overview of KSA's 2019 budget

The government has set an optimistic target for economic growth with a focus on economic diversification along with private sector empowerment, simultaneously maintaining fiscal sustainability and achieving fiscal balance by 2023 through the Fiscal Balance Program (FBP). With the aim to achieve the policy goals of Vision 2030, the Saudi cabinet approved the budget for fiscal year 2019 (FY2019) on 18 December 2018. It comprises minor amendments to the pre-budget statement that was released on 30 September 2018.

In an effort to boost economic growth, the Ministry of Finance (MoF) aims to increase the budget expenditure for 2019 by 7 percent to SAR 1,106 billion, as compared to projected spending of SAR 1,030 billion for 2018. This is, by far, the largest budgeted spending in the nation's history. Higher capital expenditure, coupled with various government initiatives – such as the Citizen Account Program, the Private Sector Stimulus Package, etc. are aimed at speeding-up structural reforms and supporting private sector development, thereby triggering economic growth and creating jobs for Saudi nationals.

As per MoF, real GDP growth of the Kingdom is expected to reach 2.6 percent in 2019, as a result of implementation of vision 2030 programs and increased infrastructure spending. In addition, inflation is expected to go down to 2.3 percent in 2019, as the impact of VAT implementation and effects of fuel subsidy cuts start to ease out. Moreover, widening the tax net is likely to help the country diversify its revenue stream and, coupled with the government's effort to improve the efficiency of expenditure, this should also help with the government objective of achieving a fiscal balance by 2023.

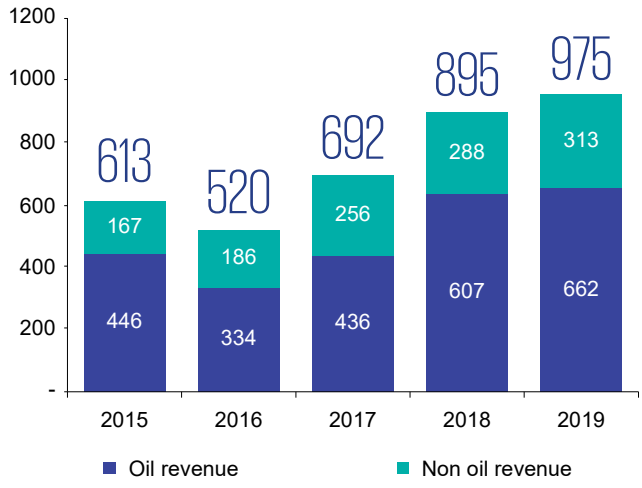
Public revenue

Saudi Arabia is currently focusing on increasing its non-oil revenues by initiatives, such as the introduction of VAT. Oil is nevertheless expected to remain a significant contributor to public revenue.

According to MoF, total public revenue is expected to increase 8.9 percent to reach SAR 975 billion in 2019, as compared to SAR 895 billion in 2018. Oil is expected to remain a major contributor to the Kingdom's revenue, with a share of 68 percent in 2019 (with a value of SAR 662 billion) while share of non-oil revenue is anticipated to reach 32 percent, valued at SAR 313 billion. (Figure 1)

We believe that it is a good step to increase non-oil revenue through a prudent tax policy which contributes to government income. However, the government should continue to closely monitor potential adverse impact. For example, rising prices (as a result of tax policy changes) could undermine consumer spending and broader demand. It is better for some tax policies such as expat levies to target specific job segments to achieve desired goals.

Figure 1: Public revenue (SAR billion)



Source: 2019 Budget statement, MoF

> For 2019, the Saudi government has announced the largest expenditure budget in its history (SAR 1.1 trillion). The plan remains in line with achieving fiscal balance by 2023 through implementation of fiscal consolidation and revenue reforms. Total public revenues are budgeted at SAR 975 billion for 2019, 8.9 percent higher than the previous year, centered on higher forecasted oil revenues. The growth of non-oil revenues is expected to be driven by an increase in VAT collections and additional expat levies.

Dr. Hussain Abusaaq
Chief Economist and Head of Research, KPMG in Saudi Arabia

Oil revenue

Oil revenue is expected to grow by 9 percent from SAR 607 billion in 2018 to SAR 662 billion in 2019. This increase is expected to be driven by stable oil market conditions and further energy price reforms.

Oil exports and energy price reforms will remain the two key sources of oil revenue, with the former being the major contributor (contributed value of energy price reforms for 2019 is not disclosed by MoF), (Figure 2). This could be attributed to the government's efforts in adjusting domestic energy prices by reducing subsidies and redeploying the resources for other developments. The government is likely to raise domestic gasoline prices in 2019.

The authorities acknowledge that oil as the primary source of public revenues leaves the government balance sheet vulnerable to fluctuations in international oil prices. However, the government is committed to reform agenda and any increase in oil prices is not expected to reduce the government's commitment to diversifying the economy and its own revenue streams.

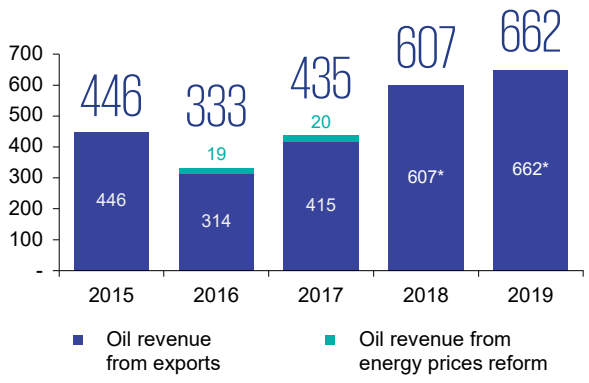
Non-oil revenue

Non-oil revenue is expected to reach SAR 313 billion in 2019, an increase of 9 percent over an expected SAR 288 billion in the previous year. A surge in non-oil revenue reflects the government's ongoing efforts toward diversifying its income streams and reducing dependency on oil. (Figure 3)

An increase in non-oil revenue in 2019 is expected to be primarily driven by higher VAT collections. With an aim to widen the tax net, the corporate-tax-eligibility threshold is expected to be reduced; the threshold for VAT registration for entities will fall from the current SAR 1.0 million annual revenue threshold to SAR 375,000. Implementation is expected to commence from the beginning of 2019. The increase in VAT collections is expected to provide SAR 47 billion in 2019, an increase of 3.1 percent y-o-y from that in 2018. Moreover, an increase in expat levies is expected to contribute SAR 56.4 billion to non-oil revenue, an increase of 14 percent y-o-y that in 2018. The expat levy is expected to increase by SAR 300 per expat dependent and from SAR 500 per expat to SAR 600 per expat (the fee depends on the nationalization rate of the employer's enterprise).

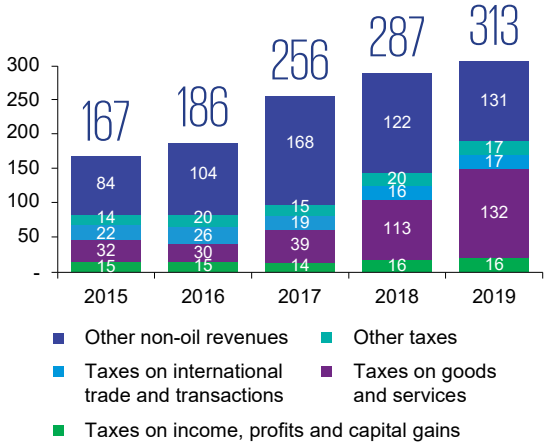
Taxation and broader fiscal adjustments can support revenues and spending efficiency, but should be applied at the right phase of the economic cycle. Since the economy is picking up after the recent contraction in 2017, it is crucial to maintain a cautious tax policy and introduce any future reforms at a modest pace.

Figure 2: Oil revenue components (SAR billion)



Source: 2019 Budget statement, MoF, IMF
Note: *For 2018 and 2019, oil revenue includes energy price reforms and oil exports

Figure 3: Non-oil revenue components (SAR billion)



Source: 2019 Budget statement, MoF

2019 Budget

Public expenditure

As per the MoF, total public expenditure budget has been increased by 7.4 percent to SAR 1,106 billion in 2019, as compared to a SAR 1,030 billion estimate in 2018. In addition, public expenditure for 2019 is focused on funding government programs such as the Citizen Account Program and implementing relevant initiatives to achieve Saudi Vision 2030. This sharp increase in public expenditure clearly demonstrates the government's commitment to driving economic growth and stimulating the private sector.

The government is also focusing on the development of key economic sectors, including education, entertainment, tourism and transport. The government will also support small and medium-sized enterprises (SMEs). These initiatives are designed to diversify the economy and create employment opportunities. Sector priorities for 2019 budgeted expenditure are consistent with recent years, with education, military and healthcare making about 50 percent of total allocations. As per the budget announcement, current expenditures (OpEx), which holds the largest share of public spending, is expected to increase by 4.2 percent to reach SAR 860 billion in 2019, as compared to 2018 estimates (SAR 825 billion). Spending on public employees is projected to decrease by 3.8 percent y-o-y to SAR 456 billion in 2019. The government's intention to develop transport, health and mega infrastructure and economic projects is likely to increase capital expenditure by 20 percent to reach SAR 246 billion in 2019 (SAR 205 billion in 2018).

Figure 4: 2019 Expenditure by component, SAR 1.1 trillion

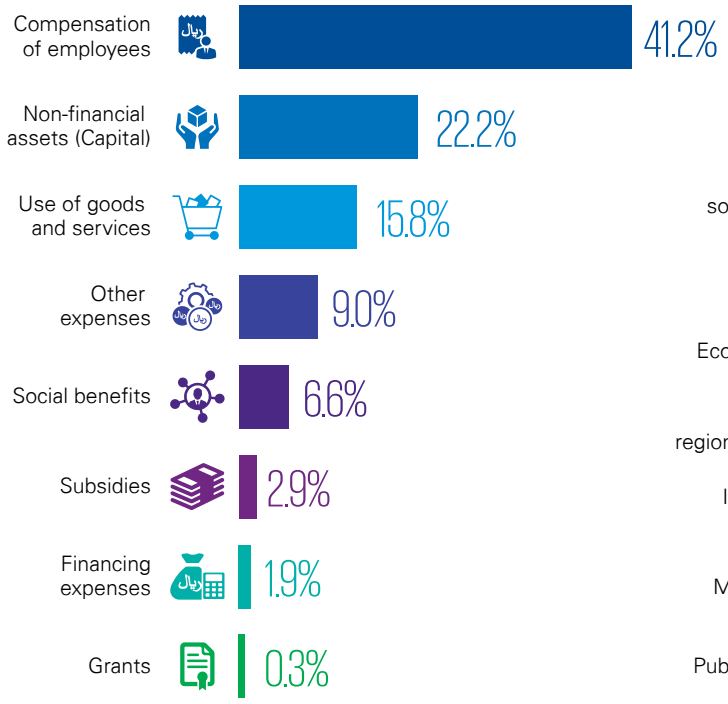
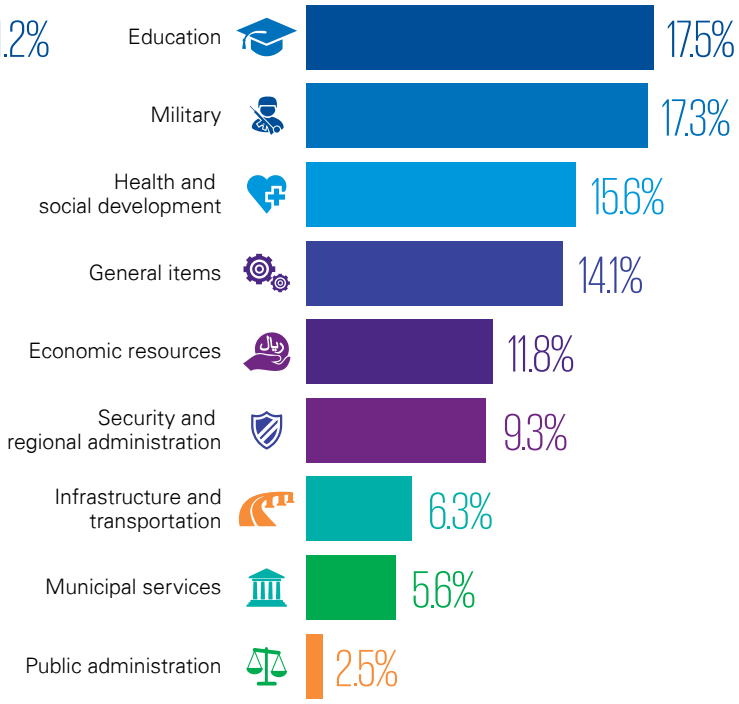


Figure 5: 2019 Expenditure by sector, SAR 1.1 trillion



Highlights

Public expenditure is budgeted to reach SAR 1,106 billion in 2019. CapEx is budgeted to be SAR 246 billion and current expenditures[1] is budgeted at SAR 860 billion in 2019. Education, military and healthcare account for 50 percent of the total budget allocation.

Expenditure by sector

Education

Education is an important pillar of Vision 2030. With the government's constant focus towards enhancing the education system in the Kingdom, the sector continues to receive the largest share of the annual budget expenditure, which stands at 17.5 percent in 2019. For FY19, the government allocated SAR 193 billion to public education, 6 percent lower than in 2018. To further develop education quality, according to the 2018 budget statement by MoF, the Ministry of Education (MoE) has delivered 719 new schools in 2018 and is planning to deliver 1,069 schools in its plan between 2017 and 2019.

We believe that it is imperative for education to be provided with a greater focus on value-added education, which must evolve with emerging technologies, such as Industry 4.0 and Artificial Intelligence, and their required associated skill sets.

Military

Along with education, military spending dominates Saudi Arabia's budget, with the country's military budget estimated to be the third largest in the world in 2017. The government has allocated SAR 191 billion in 2019 to military spending, comprising 17.3 percent of total budget (figure 5), and 12 percent lower than that in 2018. Part of the funding is being directed toward a new national security strategy designed to improve the operational capabilities of the defense forces. In particular, investment spending is being focused on upgrading existing military hardware assets (air, land and sea), while also providing CapEx that will support defense manufacturing localization.

Healthcare and social development

The healthcare sector holds the third largest share of 15.6 percent in the budget expenditure of 2019. The budget allocation for the sector has grown by 8 percent to reach SAR 172 billion in 2019, as compared to SAR 159 billion of 2018. Public spending on the healthcare sector is primarily channeled towards new initiatives, such as increasing the life expectancy, reducing obesity and localization of the pharmaceutical industry.

The government is also diverting the funds towards creating a robust healthcare infrastructure by building new hospitals. For example: the Ministry of Health (MoH) has launched 25 new hospitals from 2016 to 2018 and has plans to build 35 hospitals during 2019.

The MoH has also developed a significant separate program for upgrading capacity and capability (including infrastructure) in existing hospitals. A recognition of the positive role the private sector can play, combined with funding constraints, is also a key driver behind the MoH's investment in bringing private sector best practice into different types of healthcare facilities – new operating models are being designed to attract private sector participation.

Infrastructure

Infrastructure projects (including transport) are allocated SAR 70 billion in 2019, 6.3 percent of the total budget and 28 percent higher than 2018. The upward trend is primarily driven by the ramping up of spending on the Riyadh metro (6 lines covering 176 km) and the upgrading of King Abdulaziz International Airport, Jeddah, among others, as they enter the final phase of construction.

Going forward, the government aims to direct the expenditure towards the CapEx commitments made under Vision 2030, which could help develop the Kingdom's infrastructure and boost its potential economic growth. Furthermore, spending on infrastructure development will not be limited to the Government's annual budget allocation. The private sector is expected to play a wider role in infrastructure development, funding, financing and operations. To that end, the government has adopted a policy of procuring infrastructure projects through a PPP mechanism. As a first step in this direction, the government has formulated a centralized framework through the National Centre for Privatization (NCP), for approval and oversight of PPP projects in Saudi Arabia.

Note: [1] Current spending (OpEx) contains employee compensation, social benefits, use of goods and services and others

2019 Budget

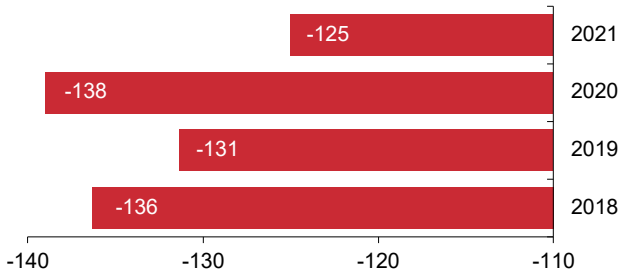
Highlights

The budget deficit in 2019 is expected to be SAR 131 billion, compared to SAR 136 billion in 2018, reflecting the government's intention to reach a fiscal balance by 2023. Public debt is expected to reach SAR 678 billion in 2019, 21 percent higher than 2018. According to global benchmarks, the level of debt is relatively low. It is expected that the deficit will be financed largely by issuing domestic and international bonds, and withdrawals from the government reserve.

Fiscal deficit

The budget deficit in 2019 is expected to be SAR 131billion (4.2 percent of 2019 expected total GDP), compared with SAR 136 billion (4.6 percent of GDP) in 2018. Reduction in the fiscal deficit (in nominal terms as a percentage of GDP) is expected to be driven by the fiscal reforms taken by the government, coupled with expectations of firmer average oil prices in 2019. The government's continuous effort towards reducing the budget deficit is to achieve the target fiscal balance by 2023. (Figure 6)

Figure 6: Fiscal deficit (SAR billion)



Source: 2019 Pre-budget statement, MoF

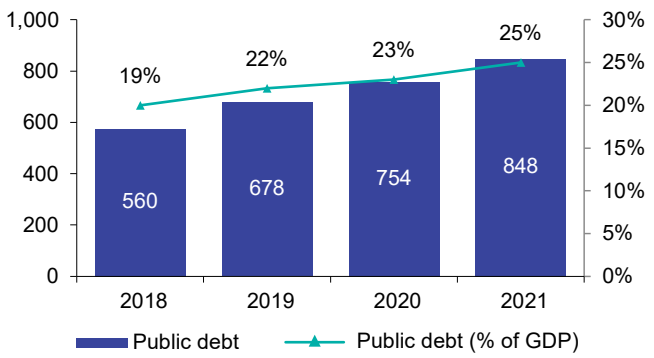
Public debt

Public debt in 2019 is expected to reach SAR 678 billion, 21.7 percent of the estimated GDP in 2019 and 21.1 percent higher than the previous year (SAR 560 billion) (Figure 7). The debt-to-GDP ratio remains below the government's National Transformation Program 2020 target, wherein a ceiling of 30 percent was put on public debt as a percentage of GDP. The budget deficit is expected to be financed through the issuance of domestic and international sovereign bonds, and withdrawals from the government reserve.

The government has increased the proportion of international debt in its balance sheet during 2016 - 2018 to reduce potential adverse effects of issuing domestic debt, such as decreasing liquidity and crowding out the private sector.

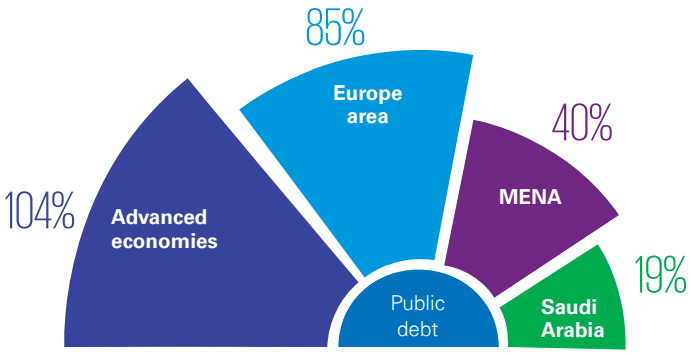
We believe, that in 2018, the country's debt-to-GDP ratio remained significantly lower than many of its peers (Figure 8). Indeed, in part owing to the government's recent fiscal commitments and reforms, Fitch Ratings assigned A+ credit rating for Saudi Arabia in June 2018, which clearly reflects the strength of the fiscal position of the Kingdom.

Figure 7: Public debt (SAR billion)



Source: 2019 budget statement, MoF

Figure 8: Public debt as percentage of GDP in 2018 (%)



Source: 2018 Financial stability report, SAMA

Macroeconomics

Gross Domestic Product

Vision 2030 realization

Saudi Arabia's Crown Prince, Mohammad bin Salman Al Saud, announced Vision 2030 on 25 April 2016, which has the aim of diversifying economic growth and generating new sources of revenue. This ambitious vision of development seeks to unlock the private sector's capabilities, which are expected to lead to greater private sector contribution to the national GDP, to reach a total of 65 percent by 2030.

Other goals include the efficiency of government spending, digital transformation and focusing on sectors such as IT, telecom, manufacturing, healthcare, tourism and retail, which are being supported by the expansionary budget of 2019.

Vision 2030 looks to boost the Kingdom's digital transformation agenda. KPMG's 2018 Saudi Arabia CEO Outlook refers to the country's focus on investments in technology areas such as artificial intelligence (AI), augmented reality (AR), data mining, and cloud technology. In effect, Vision 2030 aims to create a healthy digitalized and connected ecosystem.

The Vision Realization Programs (VRPs) have been designed to achieve strategic goals, objectives and targets. The programs will be adjusted every five years; currently there are 12 announced comprehensive executive programs. The government has also outlined comprehensive economic and social reforms, to be implemented by the Council of Economic and Development Affairs (CEDA).

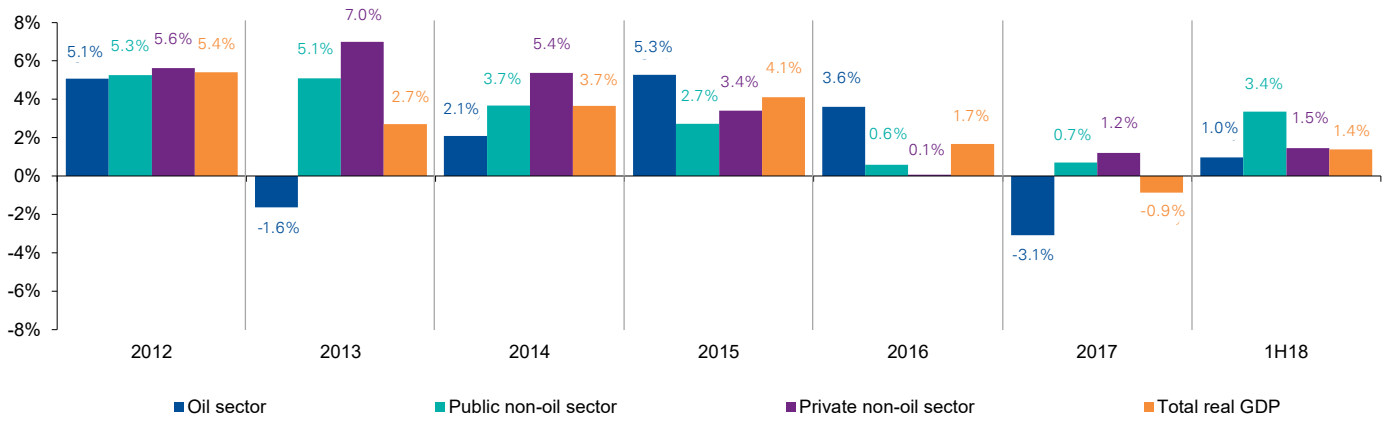
These programs are expected to contribute to GDP growth in the future, especially in terms of encouraging consumer spending and increasing investments through privatization.

Real Gross Domestic Product (GDP)

According to MoF projections, real GDP is expected to grow by 2.3 percent in 2018, following a 0.86 percent contraction in 2017 (Figure 9). The recovery in 2018, in line with expectations, can be attributed to higher oil prices in the first nine months of the year, increases in oil production and fiscal stimulus packages.

The 2018 Saudi Arabia CEO Outlook mentioned that 72 percent of Saudi Arabian CEOs are confident in the prospect of economic growth, and 92 percent are confident in the growth of their companies and industries. 94 percent of Saudi Arabian CEOs are more confident about the global economy in comparison to the 67 percent of CEOs in other countries.

Figure 9: Annual real GDP growth breakdown (%)



Source: National accounts, GaStat

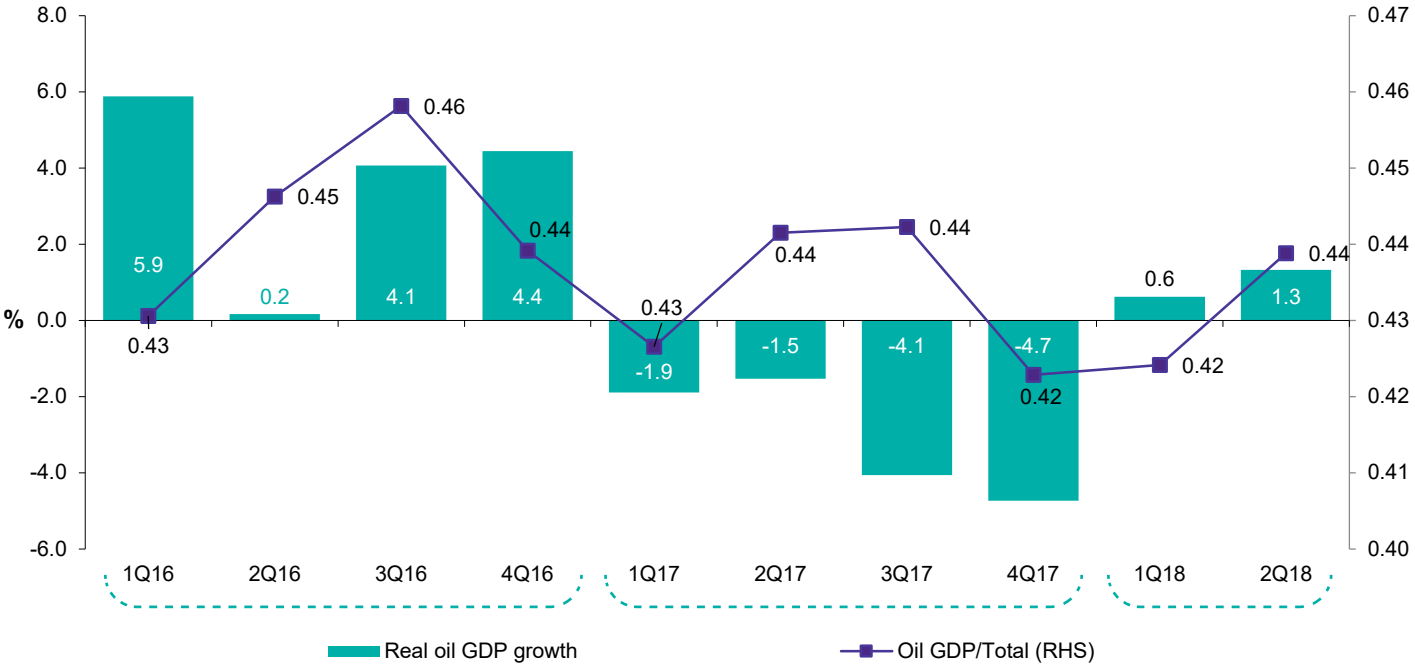
> In line with Vision 2030, the government is moving toward a diversified economy that is less affected by oil price volatility and government spending, through implementing 12 economic and sector development programs, in addition to announcing fiscal stimulus programs.

Ismail Daham Alani
Head of Public Sector, KPMG in Saudi Arabia

a) Real oil GDP

Real oil GDP grew at an average of 1 percent y-o-y in 1H18 mainly due to an increase in crude oil production and refining projects such as the Jazan refining plant. Furthermore, in October 2018, KSA started operating a new pipeline connecting Bahrain Petroleum Company (Bapco) with Saudi Aramco, to efficiently transport up to 350,000 barrels of crude oil per day. According to the General Authority for Statistics (GaStat), real oil GDP growth in 2Q18 was 1.3 percent y-o-y, contributing 44 percent to the total GDP (Figure 10). In June 2018, the Organization of Petroleum Exporting Countries (OPEC) and Russia agreed to increase oil supply by 1.0 million barrels per day to compensate for the shortfall from Venezuela and Iran. It is worth mentioning that OPEC and Non-OPEC countries decided on 5 December 2018 to cut 1.2 mb/d starting from 1 January 2019 for an initial period of six months, aimed at supporting oil prices.

Figure 10: Real oil sector GDP growth and oil sector contribution to GDP



Source: National accounts, GaStat

Gross Domestic Product

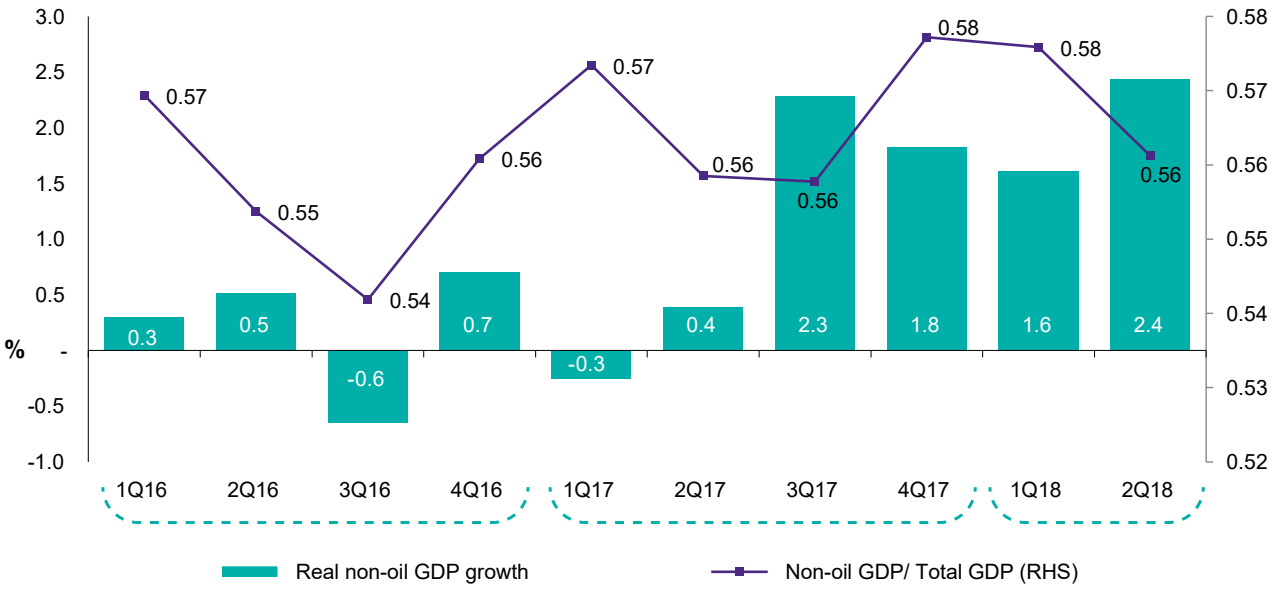
b) Real non-oil GDP

Saudi Arabia's economy is diversifying away from oil, and going forward, growth is expected to be supported by the services and manufacturing sectors. The efforts and initiatives being enacted under Vision 2030 could potentially take the Kingdom away from oil and create a diversified economy that is less affected by commodity price volatility.

Real non-oil GDP is estimated to have grown by 2 percent in 1H18. This growth can be attributed to public spending and investments. In addition, actual real non-oil GDP annual growth for 2Q18 was 2.4 percent, contributing 56 percent of the total GDP (Figure 11). This is an encouraging sign after three quarters of decline in real non-oil GDP growth.

Reforms and improved confidence in the country are aimed at encouraging an increase in private sector investment from local and foreign investors. Such investments could lead to higher potential growth in GDP. Moreover, further implementation of VRPs, especially the Privatization Program and Financial Sector Development Program, are expected to boost non-oil sector growth in the medium and long term.

Figure 11: Real non-oil sector GDP growth and non oil sector contribution to GDP



Source: National accounts, GaStat

Inflation in KSA

Inflation in KSA during 2018

Saudi Arabia implemented VAT in January 2018 to generate alternative revenue streams. The VAT rate, at 5 percent, for most goods and services such as food and beverages, domestic transportation, hotels, private education and private healthcare, put upward pressures on prices.

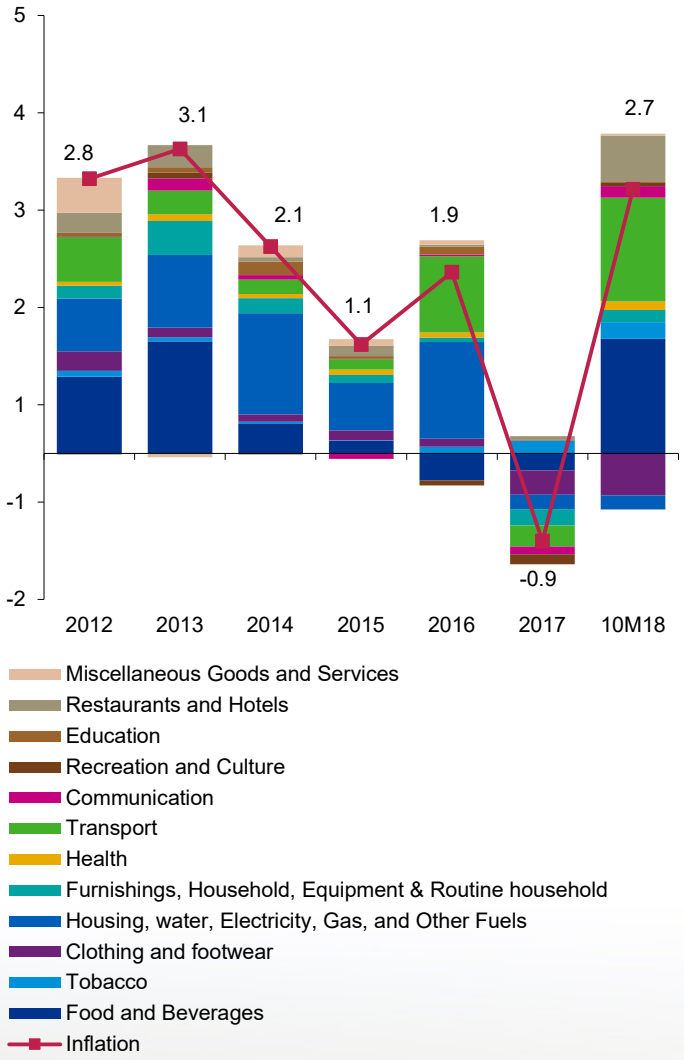
According to the GaStat monthly consumer price index (CPI) report, the average inflation rate until October 2018 was 2.7 percent, while the MoF expected rate was 2.6 percent in 2018, as compared to an average deflation of 0.8 percent in 2017 (Figure 12). This cost-push inflation is primarily attributed to the VAT introduced by the government, higher energy prices and fuel subsidy cuts.

The increase in demand due to higher government spending and the introduction of the Citizen Account Program has also driven inflation in 2018.

Inflation in the housing sector, however, continued to decline during 2015 to 1H18, primarily due to the Ministry of Housing's Sakani* program and other initiatives. As the supply of available houses increased, prices started to fall. Moreover, in October 2018, actual rental prices for houses declined by 6.3 percent y-o-y.

Going forward, inflation is expected to slow in 2019, as the impact of VAT implementation and effects of fuel subsidy cuts start to ease out. As shown in Table 1, inflation is expected to stabilize at 2.05 percent from 2020 to 2021.

Figure 12: Annual inflation rate and the contribution of each division to the total inflation (%)



Source: CPI monthly reports GaStat, KPMG analysis

*Note: A program provided by the Ministry of Housing and the Real Estate Development Fund to allocate 280,000 residential products (for the year 2017).

Highlights

The economy witnessed an increase in inflation during 2018 (expected to reach 2.6 percent), mainly attributed to the introduction of VAT and energy and fuel subsidy cuts. Inflation is expected to record an annual average rate of 2.05 percent during 2020 to 2021, expected to decline from 2.3 percent in 2019.

The impact of VAT on consumer spending

VAT implementation in the nation was intended to boost non-oil revenues as part of the policy mandate designed to diversify revenue streams away from oil. Lower oil revenues during 2015-2017 were at the center of the sharp deterioration in fiscal accounts. As stipulated by the General Authority of Zakat and Tax (GAZT), several sub-sectors such as residential rent, student housing rent, insurance services and life reinsurance were exempted. VAT has also increased operational costs for businesses, which have generally been passed on to consumers.

The expansion of VAT in January 2019, which shall include businesses with turnovers between SAR 375,000 and SAR 1.0 million, is expected to cause another minimal one-off price rise. In the long run, however, it is not expected to cause a significant or sustainable increase in underlying inflation.

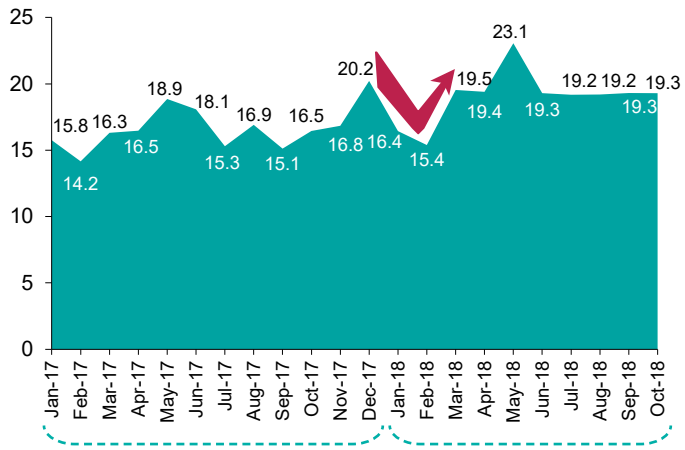
Moreover, while the volume of POS transactions (which provides a good proxy for broader consumer spending) increased ahead of VAT introduction, they reverted a little higher than their long-term average soon after (Figure 13). Consumption was also supported by the government's launch of the Citizen Account Program and the cost of living allowances, which helped to reduce the impact of VAT for qualified Saudis in the low and middle income brackets.

Table 1: Inflation projections

Inflation rate in KSA (2018-2021)				
%	2018	2019	2020	2021
Inflation rate	2.6%	2.3%	2.1%	2.0%

Source: 2019 budget statement, MoF

Figure 13: Point of sales value (SAR billion)



Source: Monthly statistical bulletin, SAMA

The impact of VAT on businesses

The introduction of VAT is part of Saudi Arabia's transformation journey to create an economy that is more recognizable and diverse by global standards. VAT is collected on behalf of the government by VAT registered businesses. Since the implementation of VAT, SMEs have been impacted the most, largely owing to the relatively high cost of compliance. Beginning in January 2019, SMEs which fall under the category of gross revenue of SAR 375,000 and higher are required to provide their accounting records annually.

Furthermore, records such as contracts, purchase orders, delivery notes, export and import documents are required to be documented and disclosed to GAZT upon request and expected to be aligned with supporting documentation. Additionally, these entities are required to maintain records of cash flow management, including the collection and remittance of VAT. Thus, VAT has increased the reliability and accessibility of SMEs' accounting records during 2018.

Unemployment

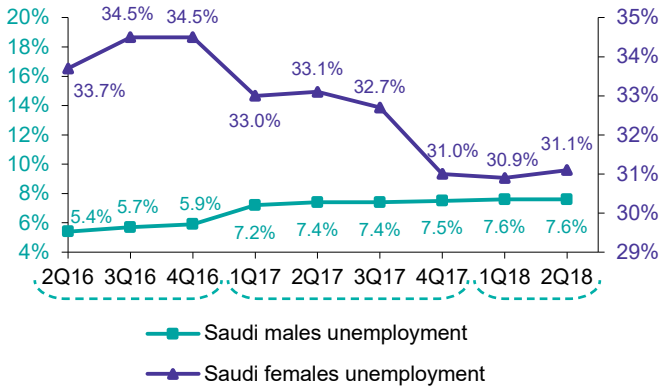
Saudi unemployment

The labor market in Saudi Arabia is diverse in terms of nationalities and in relation to unemployment rates. Data from GaStat's Labor Market Bulletin for 2Q18 indicated the overall (Saudi and Non-Saudi workers) unemployment rate at 6.0 percent, unchanged as compared to that in 2Q17. However, Saudi unemployment increased marginally, reaching 12.9 percent in 2Q18 as compared 12.8 percent in 2Q17.

The unemployment rate for Saudi women was 31.1 percent, a decline of 2.0 percentage points as compared to that in 2Q17 (Figure 14). This decline has occurred despite a rise in the participation rate from 17.4 percent in 2Q17 to 19.6 percent in 2Q18 (Figure 15). This latter factor is in line with Vision 2030's objective of increasing female participation to 30 percent by 2030.

The authorities will remain committed to policies designed to increase Saudi male and female employment levels given the working age population will continue to expand rapidly.

Figure 14: Saudi males and Saudi females unemployment rates



Source: Labor force statistics, GaStat

Highlights

The labor market in the nation is diverse in terms of nationality. Saudi unemployment rate reached 12.9 percent in 2Q18. To combat this, the government has taken many steps to increase greater Saudi labor force participation in the private sector, introducing new nationalization initiatives in 12 retail sub-sectors during 2018. The government aims to reduce the Saudi unemployment rate in the future.

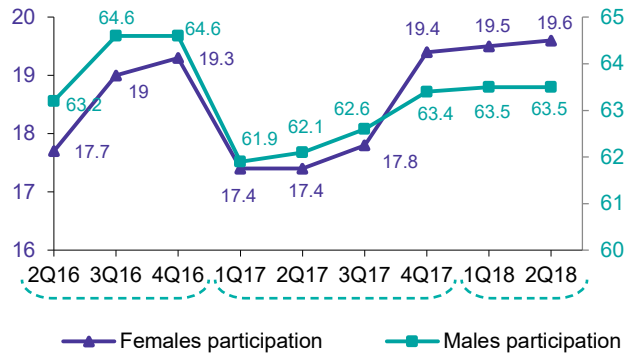
The country has taken multiple steps to boost its citizen's contribution to the private sector, including filling the wage gap between Saudis and non-Saudis by imposing expat levies on non-Saudis.

The government introduced new nationalization initiatives in 12 retail sub-sectors in September 2018 in an effort to create additional employment opportunities for Saudis. In addition, the Ministry of Labor and Social Development (MLSD) launched 68 initiatives in October 2018 to motivate the private sector to expand nationalization and to raise the participation rates of the national workforce. These initiatives will target individuals, SMEs and also large and mega-sized enterprises.

The number of non-Saudi employees in the country has also declined by 6.2 percent in 2Q18, as compared to that in 2Q17, reaching 9.98 million expats in 2Q18 (Figure 16). This is primarily due to rising living costs in the country and strict job restrictions imposed by the government.

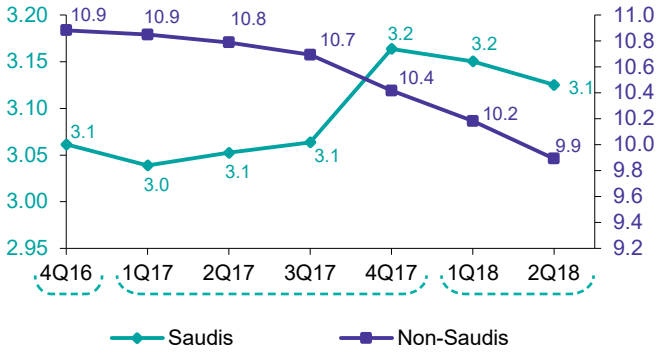
The government is expected to continue facing challenges in encouraging participation of Saudi nationals in the labor force. This could primarily be due to the mismatch in wage levels and required skills in the private sector. Nevertheless, government initiatives and a relatively a stable economic environment is expected to support reducing the unemployment rate in the future.

Figure 15: Saudis participation by gender (%)



Source: Labor force statistics, GaStat

Figure 16: Employed persons (Millions)



Source: Labor force statistics, GaStat

Macroeconomics

Economic indicators

Highlights

During 2019 to 2020, the economy is expected to grow. In addition, the public deficit is expected to narrow, reaching the objective of fiscal balance by 2023.

Table 2: Economic indicators

Key statistics						
	2015	**2016**	**2017**	**2018**	**2019**	**2020**
Economic output:						
Nominal GDP (SAR billion)	2,454	2,419	2,575	2,938	3,125	3,263
Nominal GDP y-o-y	-13.5%	-1.4%	6.4%	14.1%	6.4%	4.4%
Real GDP y-o-y	4.1%	1.7%	-0.9%	2.3%	2.6%	2.7%
Revenue (% of GDP)	25.0%	21.5%	27.0%	30.46%	31.2%	31.0%
Oil revenue (% of GDP)	18.2%	13.8%	16.9%	20.6%	21.2%	19.7%
Non-oil revenue (% of GDP)	6.8%	7.7%	7.2%	9.8%	10.0%	10.2%
Budget:						
Revenue (SAR billion)	613	519	692	895	975	1,005
Oil revenue (SAR billion)	446	334	435	607	662	645
Non-oil revenue (SAR billion)	167	186	256	288	313	332
Expenditures (SAR billion)	1,001	830	929	1,030	1,106	1,143
Surplus / (Deficit) (SAR billion)	-388	-311	-238	-136	-131	-138
Surplus / (Deficit) (% of GDP)	-15.8%	-12.9%	-9.3%	-4.6%	-4.2%	-4.2%
Gross public debt (SAR billion)	121	317	443	560	678	754
Gross public debt (% of GDP)	4.9%	13.1%	17.2%	19.1%	21.7%	23.1%
Trade and external sector:						
Export (SAR billion)	763	688	832	1072	1065	1017
Oil export (SAR billion)	573	511	638	861	854	806
Current account (SAR billion)	-213	-89	57	273	265	205
Current account (% of GDP)	-8.7%	-3.7%	2.2%	9.30%	8.48%	6.28%

Source: MoF, GaStat, SAMA, IMF

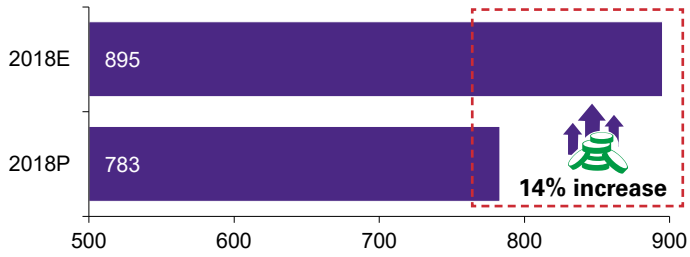
2018 Budget vs. estimates

In recent years, the government has intended to reduce its large dependency on oil to generate revenues by introducing taxes and fees to boost non-oil revenues. In addition, it has recognized the need to rationalize expenditure to enhance the effectiveness of spending. The country has been successful in reducing its fiscal deficit.

Public Revenue

According to the MoF 2019 budget announcement, public revenues are estimated to reach SAR 895 billion in 2018, 14.2 percent higher than the original budget projection and 29.4 percent higher than actual total public revenues in 2017 (Figure 17). The actual public revenue for the first nine months of 2018 (9M18) was SAR 663 billion, 47 percent higher than 9M17 (SAR 450 billion).

Figure 17: Public revenue budgeted vs. estimated in 2018 (SAR billion)



Source: 2019 Budget statement, MoF

"KSA public revenues are estimated to reach SAR 895 billion in 2018, while oil revenues are expected to reach SAR 607 billion, comprising 68 percent of total revenue. Non-oil revenue is expected to amount to SAR 288 billion in 2018, comprising 32 percent of total revenue, 12.4 percent greater than the actual non-oil revenues of 2017. This increase is attributed to the implementation of a number of non-oil initiatives, VAT being the most important one. Moreover, estimated expenditures in 2018, at SAR 1,030 billion, were one of the highest in KSA's history."

Nicholas Soverall
Head of Tax, Riyadh - KPMG in Saudi Arabia

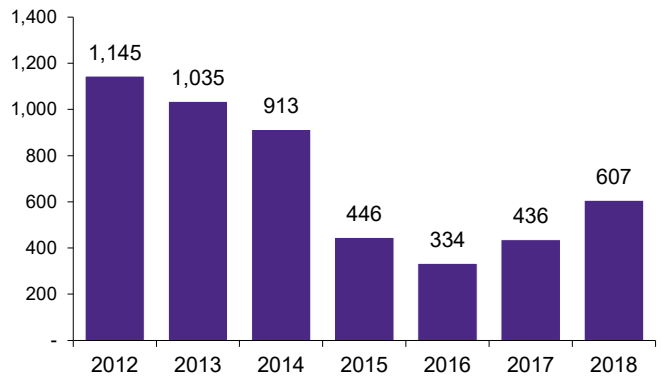
Oil revenue

According to MoF's 2019 budget announcement, oil revenue is estimated to have reached SAR 607 billion in 2018, representing 68 percent of total revenue. This increase can be attributed to shifting fundamentals in the global oil market during 2018. The country's oil market circumstances have changed with prices and production both increasing, until October 2018. According to MoF, actual oil revenues for 9M18 were SAR 452 billion, 47 percent higher than those in 9M17 (SAR 307 billion). (Figure 18)

Non-oil revenue

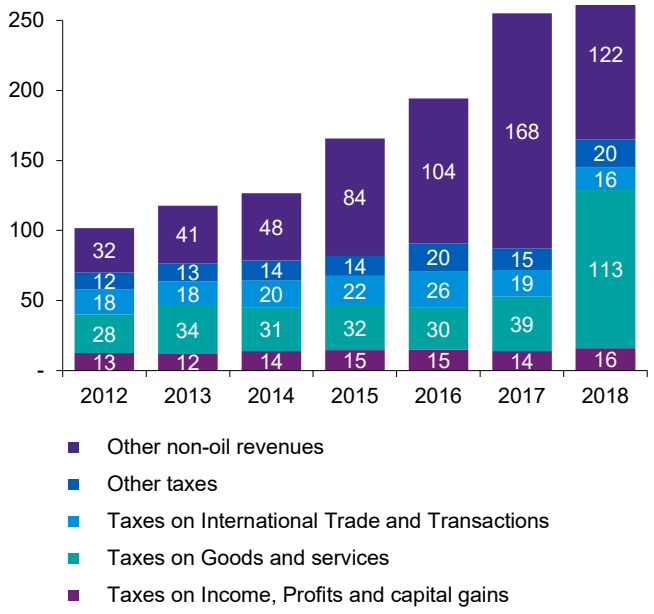
According to MoF's 2019 budget announcement, non-oil revenues were estimated at SAR 288 billion in 2018, 12.4 percent greater than the actual non-oil revenues of 2017. This increase is mainly attributed to the implementation of VAT (introduced on 1 January 2018), the monthly increase of SAR 200 per person on expat levies, and introduction of selective taxes (such as excise taxes on tobacco and soft drinks). Integration of systems and cross validation between GAZT and Customs in 2018, significantly enhanced government collections and reduced the variance between budget (SAR 291 billion) and estimates (SAR 287 billion). Actual non-oil revenues for 9M18 were SAR 211 billion, 48 percent higher than 9M17 (SAR143 billion). (Figure 19)

Figure 18: Oil revenue (SAR billion)



Source: 2019 Budget statement, MoF

Figure 19: Non-oil revenue components (SAR billion)



Source: Budget statements, MoF

2018 Budget vs. estimates

Public expenditure

Efforts have been made by the Bureau of Spending Rationalization, including the introduction of 'Eitimad', an online platform developed to enhance the efficiency and transparency of government spending. In the time period of 2016 to 2018, it is evident that discipline and efficiency has improved in terms of the gap between budgeted and actual expenditure. (Figure 20)

The government is moving on the right track by increasing transparency, announcing a pre-budget statement for the first time in 2018. A clear communication plan on how funds are going to be distributed, and in which sectors, is required, so that the private sector reacts in the best possible manner. This would increase overall transparency and increase foreign and local investors' confidence.

In support of Vision 2030, KSA had a total public expenditure of SAR 1,030 billion in 2018. According to MoF, actual total public expenditure for 9M18 was SAR 712 billion, 25 percent higher than that in 9M17 (SAR 572 billion).

The 2018 budget estimated CapEx was SAR 208 billion in 2017, and SAR 205 billion in 2018. (-1.2 percent lower than 2017). The CapEx budget was mainly driven by the country's infrastructure development, such as completing the Riyadh metro, Haramain high-speed railway and the renovations on King Abdulaziz international airport.

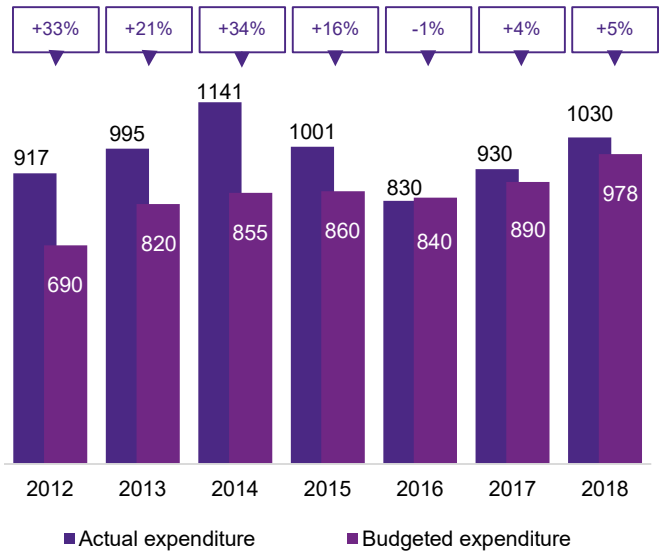
Furthermore, in 2018, estimated social benefits expenditure increased by 57 percent compared to actual social benefits in 2017. This was mainly due to the launch of the Citizen Account Program. In terms of expenditure by sector, education and military spending are the two largest components, with an allocation of 41.1 percent of the total budget.

Table 3: Expenditures by sector

SAR billion	2018B	2018E	Variance	Share of total
Public administration	26	27	3.8%	2.6%
Military	210	218	3.7%	21.2%
Security and regional administration	101	106	5.0%	10.3%
Municipal services	53	54	1.9%	5.3%
Education	192	205	6.8%	19.9%
Health and social development	147	159	8.2%	15.4%
Economic resources and public programs	105	106	1.0%	10.3%
Infrastructure and transportation	54	55	1.9%	5.3%
General items	89	100	12.4%	9.7%
Total	**978**	**1030**	**5.3%**	**100.0%**

Source: 2019 Budget statement, MoF

Figure 20: Budgeted expenditure vs. Actual expenditure (SAR billion)



Source: 2019 Budget statement, MoF

Fiscal deficit

KSA's actual fiscal deficit declined between 2015 and 2018, reaching SAR 136 billion, or 4.6 percent of GDP, this year. This represents a 43.1 percent decrease as compared to the actual fiscal deficit in 2017, which stood at SAR 230 billion. The actual fiscal deficit in 9M18 was SAR 49 billion, 60 percent lower than the actual fiscal deficit of SAR 122 billion in 9M17. (Figure 22)

Public debt

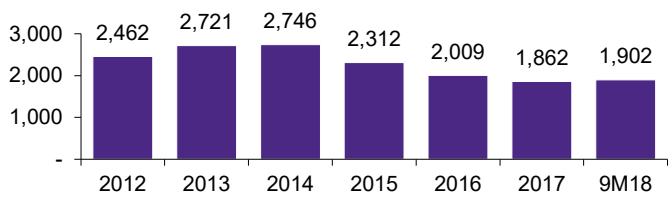
Public debt issuance over 2016–2018 occurred amid low oil prices and a weak budget deficit position. The fall in government fiscal reserves over this period, which undermined investor confidence, combined with a weaker external accounts position, exerted pressure on the USD/SAR exchange rate peg. Increasing international debt issuance to finance projects nevertheless provided means to diversify financing options, protect reserves and enable the government to deepen domestic capital markets. (Figure 23)

The government has recently financed part of its deficit through bond issuance. It issued bonds in 2015, for the first time since 2007, and established the Debt Management Office (DMO) in 4Q15 to secure part of its financing needs.

According to the MoF, Saudi Arabia issued debt of SAR 53.1 billion during 9M18, resulting in an outstanding debt of SAR 549.5 billion for 9M18. Total public debt is expected to reach SAR 560 billion on 31 December 2018 (additional SAR 10.5 billion for 4Q18). (Figure 24) According to SAMA, public reserves have increased by SAR 40 billion in 9M18. (Figure 21)

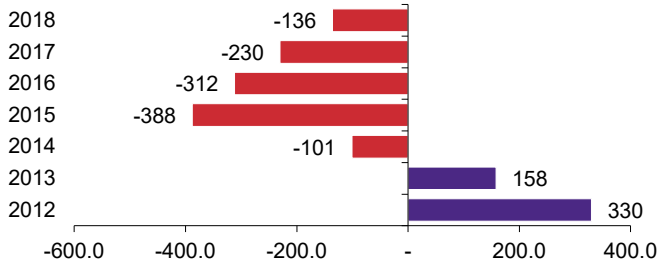
Overall, the economy is expected to fund its fiscal deficit by issuing debt of SAR 120 billion, 41 percent of which shall be through domestic debt issuance to local banks (SAR 48.7 billion). The weightage of international debt increased from none in 2015, reaching 59 percent of total debt in 2018 (SAR 71.3 billion).

Figure 21: End of period public reserves (SAR billion)



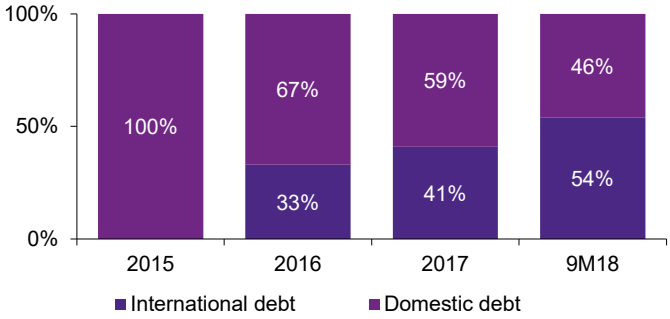
Source: Monthly bulletin August 2018, SAMA

Figure 22: Fiscal balance (SAR billion)



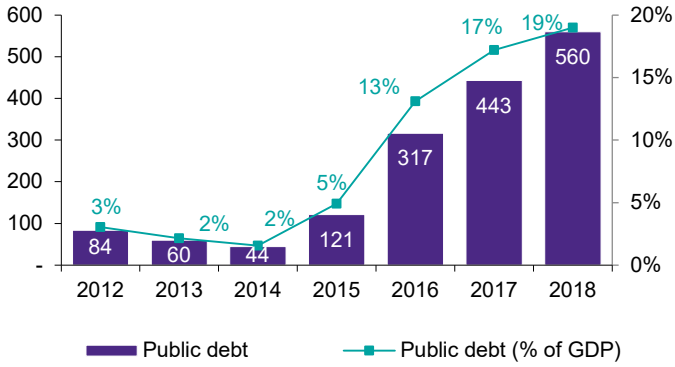
Source: Historical data, MoF

Figure 23: Public debt breakdown (%)



Source: Historical data, MoF

Figure 24: Public debt (SAR billion)



Source: Historical data, MoF

Risks and challenges

Impact of global economic growth and oil dependency

During the last few decades, government spending has largely been dependent on revenues from oil, which has a high level of volatility, due to fluctuating global oil prices. Moreover, recent global economic developments such as the ongoing USA and China trade war is expected to have a negative impact on global growth. The 2018 KPMG Saudi Arabia CEO Outlook report states that 74 percent of CEOs in Saudi Arabia ranked 'return to territorialism' as one of the top three risks posing the greatest threat to their organization's growth. Additionally, a slowdown in the Chinese economy is expected to lead to lower demand for Saudi oil and petrochemical products and subdue the oil-dependent economic growth. To mitigate this challenge, the government has stated a mandate to increase the share of non-oil exports to non-oil GDP from 16 percent currently, to 50 percent by 2030.

Labor market

As part of the goals stated under the National Transformation Program, the government intends to decrease the unemployment rate to 9 percent by 2020 and to 7 percent by 2030. In addition, the country also seeks to increase women participation in the workforce to 30 percent. The unemployment rate among Saudis is high, particularly among females which increased to 31.1 percent in 2Q18 from 30.9 percent in 1Q18.

Challenges are foreseen as Saudi citizens continue to prefer government sector jobs. But, the government is focusing on increasing the budget for MLSD to help mitigate the gap between the labor market requirements and the qualifications of job seekers. It is also working towards addressing the mismatch of wage levels and requisite skills between the national workforce and the private sector. This is being done with the launch of 68 initiatives to enhance nationalization in the private sector and SMEs. However, most of the job openings that are being targeted by initiatives such as the expat fees initiative and nationalization programs require lower education levels and more vocational training, whereas statistics from GaStat have indicated that as of 2Q18, 51 percent of all job seekers have diplomas or higher academic degrees.

> KSA government has deep awareness of its current risks and challenges. The government has demonstrated countless efforts over recent years to better position KSA to overcome these challenges. Key highlights of these efforts include economic reforms and stimulus of market sectors, investing and establishing mega projects for long-term diversification of income, increasing revenue to cover growing budgeted expenditure and increasing efficiency of public spending.

Khalid Yasin
Head of Client Services, KPMG in Saudi Arabia

Impact of local economic conditions

Some of the initiatives of Saudi Vision 2030 are targeted towards increasing the contribution of non-oil revenue to the total public revenue by attracting foreign investors, increasing the foreign direct investments (FDI) from 3.8 percent of the GDP to 5.7 percent by 2030, and enhancing the business environment through adopting international and certified regulations. However, updates to policies need to be articulated and managed in a comprehensive manner and interdependencies must be identified. Frequent updates could lead to investors' hesitation and therefore unexpected impacts on overall business sentiment. In addition, new regulations should be combined with transparency, effective communication, and well defined plans for their adoption to improve investors' confidence and boost investments in the private sector.

Tighter monetary policy

The US Federal Reserve Board expects to raise interest rates twice in 2019, and SAMA's repo reverse rate is also expected to increase simultaneously to maintain the SAR/USD exchange rate peg. However, higher interest rates could have a negative effect on the country by constraining the government's expansion plans, increasing borrowing costs and weakening the private sector's growth.

Keeping momentum of economic and social reforms

With an increase in oil prices, the willingness to implement deeper reforms may lessen. Any delay in the implementation of the reforms could postpone the timeline for achievement of Vision 2030 goals, including diversifying the economy and supporting the private sector. Furthermore, these reforms, when implemented, could raise inflation and reduce consumer spending. Hence, it is important that emphasis is laid on prioritizing reforms and increasing synergies and effective communication between the authorities.

Glossary

Term	Definition
Bapco	Bahrain Petroleum Company
CAP	Citizen Account Program
CEDA	Council of Economic and Development Affairs
DMO	Debt Management Office
FBP	Fiscal Balance Program
GaSTAT	The General Authority for Statistics
GAZT	The General Authority of Zakat and Tax
GDP	Gross Domestic Product
MLSD	Ministry of Labor and Social Development
MoE	Ministry of Education
MoF	Ministry of Finance
MoH	Ministry of Health
PIF	The Public Investment Fund
SAMA	Saudi Arabian Monetary Authority
SAR	Saudi Riyal

Appendix

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