Public Finance

Saudi Arabia: 2016 budget targets spending cuts, subsidy reforms and non-oil sector investment

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Highlights

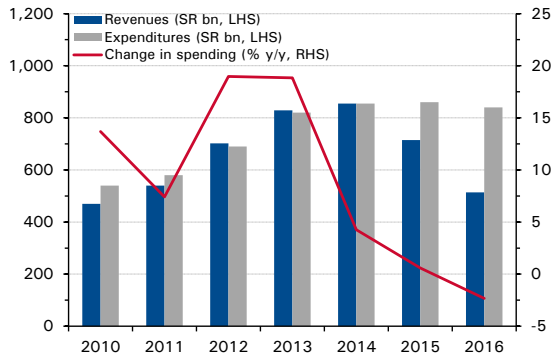
- **2016 budget aims to address fiscal challenge by exercising spending restraint, reforming energy subsidies and tapping new revenue streams.**
- **Budget forecasts a second consecutive deficit, of SR 326 bn ($87 bn), on expenditures of SR 840 bn and revenues of SR 513 bn.**
- **Investment in education and social and economic development to further support and develop the non-oil economy.**
- **Actual fiscal outcomes in 2015 show the kingdom recording its largest ever deficit, equivalent to 15% of GDP, with revenues declining by 42% and expenditures by 14.5% compared to 2014.**
- **Real GDP growth moderated slightly to 3.4% in 2015, while public debt increased to 5.8% of GDP in 2015 from 1.6% in 2014.**
- **Market reaction has been mixed: chemical stocks were under pressure following the news of price hikes to feedstock prices; lower-than-forecast deficit and fiscal reform plans viewed positively.**

Saudi budget aims to put the kingdom on a more solid footing while still supporting the economy

In a much anticipated announcement, the Saudi authorities unveiled on 28 December their budget for 2016. The new budget, which projects a deficit of SR 326.2 billion ($87 billion) on expenditures of SR 840 billion ($224 billion) and revenues of SR 513 billion ($137 billion), took on added importance in light of increased market concerns about fiscal sustainability in the context of the low oil price environment. (Chart 1.) With oil revenues impacted by a further decline in oil prices in 2015 and expenditures elevated due to King Salman's accession bonus and the war in Yemen, 2015 saw increased drawdowns of the kingdom's foreign reserves and, in July, the first issuance of Saudi sovereign debt since 2007. Market anxieties were further compounded in late October by the one notch downgrade of Saudi Arabia's credit rating to A+ by Standard & Poor's.

The 2016 budget looks to address the fiscal challenge facing the kingdom by exercising some spending restraint, all the while maintaining sufficient investment to diversify and stimulate the non-oil economy. In an effort to reduce the fiscal deficit, which is estimated to have ballooned to SR 367.5 billion ($98 billion), or 15% of GDP, in 2015, the authorities penciled in spending cuts of 2.3% compared to the 2015 budget and cuts of 13.8% compared to actual spending outcomes in 2015. Revenue is projected to decline by 15.0% from the 2015 budget and 15.4% compared to

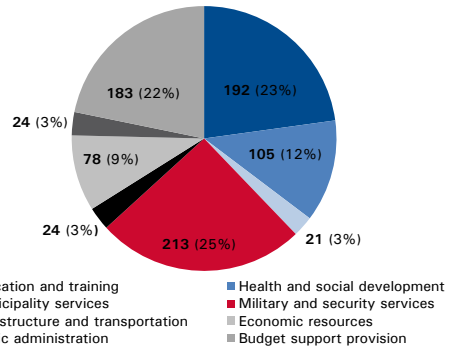
Chart 1: Budget 2016



Source: Saudi Ministry of Finance (MOF)

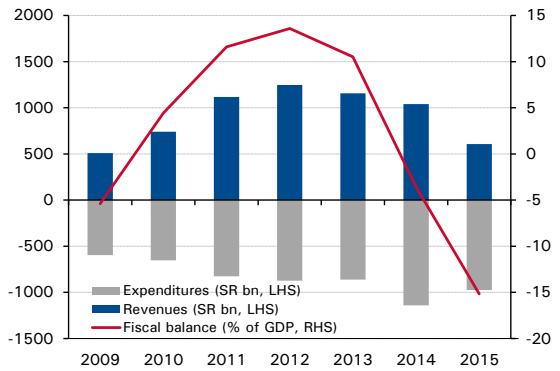
Chart 2: Budget allocations 2016

(SR billion, share in brackets)



Source: MOF

Chart 3: Actual fiscal performance



Source: MOF, Thomson Reuters Datastream; 2015 are prelim. estimates

estimates of realized revenue this year. This, the authorities hope, will bring the deficit down to SR 326.2 billion ($87 billion).

While the oil price assumed in the 2016 budget was unstated, we assume it to be in the region of $40 per barrel (bbl). This is also based on the kingdom maintaining its 2015 oil production average of 10.2 million barrels per day (mb/d).

According to the Ministry of Finance, the deficit will continue to be financed by debt issuance, with the government weighing the option of international bonds in addition to domestic bonds in order to avoid a tightening in domestic liquidity and minimize any impact on private sector growth. To that end, the government is also likely to continue drawing down its foreign reserves, albeit at a slower pace. Reserves had declined by $96 billion, or 13.2%, in 2015, to a still sizeable $635 billion by the end of November.

Despite fiscal consolidation, the government has continued to prioritize education, social and economic development as well as defense and security in their spending plans. Together, education and health/social development will receive 35% of budgetary allocations, which is consistent with their long term share of more than 30%. Military and security spending, meanwhile, will continue to account for the single largest share of government spending with a budget allocation of 25%. The latter is no doubt a reflection of the kingdom's ongoing military involvement in Yemen and sensitivity to heightened geopolitical tensions in the region. (Chart 2.)

While a breakdown of the budget in terms of capital and current expenditures has not been provided, the fact that allocations to infrastructure and transportation, for example, have been cut by 63% to SR 23.9 billion ($6.4 billion)—the largest reduction among spending items—would tend to support the view that the kingdom has begun to rationalize infrastructure spending as its first response to this sustained period of low oil prices.

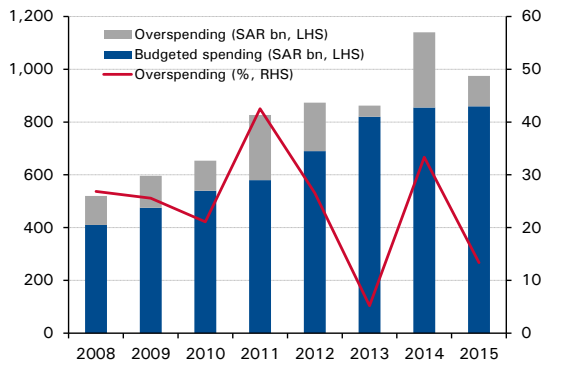
The 2016 budget also introduced a new item entitled "Budget Support Provision" to help address shortages in revenue due to oil price fluctuations. SR 183 billion ($48 billion), representing 22% of the budget, will be set aside for this purpose.

Wide-ranging subsidy and economic reforms planned

In what is being described as something of a milestone, the Council of Ministers has announced a series of revisions and reforms to otherwise politically sensitive issues such as subsidies and taxes. The first reforms were rolled out the day after the budget was announced and include hikes to gasoline prices (20-25%), progressive increases in water and electricity prices (up to 26% and 100% for the highest users, respectively) and rises to feedstock and energy prices for industrial users. Price increases on tobacco and soft drinks products may also follow. The government also plans to gradually phase in a value-added sales tax (VAT) in tandem with other GCC countries.

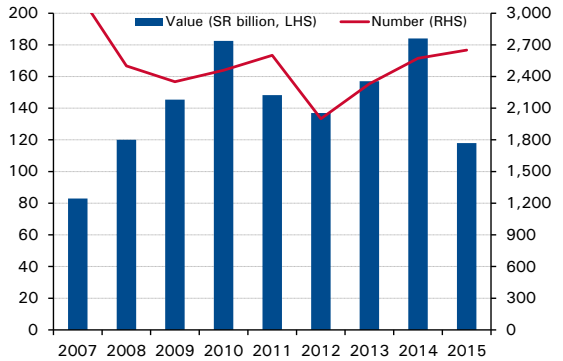
Moreover, the government has proposed a set of structural reforms to be implemented during the next five years. These reforms include: privatizing a range of government entities and sectors; removing regulatory and bureaucratic obstacles in the private sector; improving transparency and accountability; providing partnership opportunities between the private and government sectors; and reforming and

Chart 4: Actual vs. budgeted spending



Source: MOF; Note: preliminary estimates for 2015

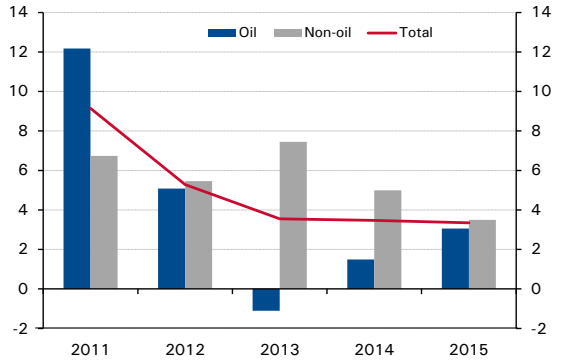
Chart 5: Government contracts



Source: MOF

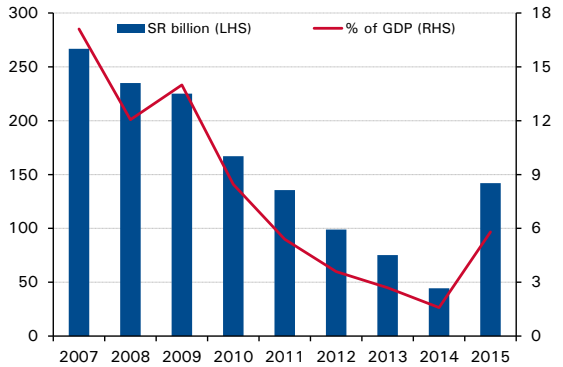
Chart 6: Real GDP growth

(% y/y)



Source: MOF; Note: preliminary estimates for 2015

Chart 7: Public debt (gross)



Source: MOF; Note: preliminary estimates for 2015

developing government performance. In addition, the authorities intend to establish both a unit within the Ministry of Finance to manage public debt, and a National Project Management Agency to review government projects and optimize capital spending.

Further details on these reforms and the government's longer-term plans are likely to follow later this month when the authorities launch the National Transformation Plan (NTP) 2020. The NPT is expected to cover in detail measures the government intends to introduce to diversify government revenue, enhance public sector productivity, cap runaway current spending and accelerate privatization. Energy subsidy reform procedures are likely to feature as well.

Actual fiscal outcomes in 2015 were better than expected

According to the authorities, Saudi Arabia posted a deficit of 15.2% of GDP (SR 367 billion) in 2015. This is the kingdom's largest ever deficit and its second in a row, following 2014's deficit of -2.5% of GDP. (Chart 3.)

Nevertheless, this outcome was better than expected given that the IMF and others (including NBK) were forecasting a deficit closer to 20% of GDP. Actual spending in 2015 is estimated to have fallen by 14.5% from the level in 2014 to reach SR 975 billion ($260 billion). Without the one-offs relating to King Salman's Royal Accession Decrees, which are estimated to have cost the treasury SR 88 billion ($23.5 billion, accounting for 77% of the increase in expenditures) and costs associated with the war in Yemen, spending would have likely gone down further. This is the first time since 2002 that fiscal outlays have actually gone down year-on-year. Moreover, the amount of overspending in relation to the budget actually fell below the 5-year average of 25% and the 33.3% witnessed in 2014 to 13.4% in 2015. (Chart 4.) Increased restraint on the capital spending side is largely responsible; looking at the value of government contracts awarded during the year, the authorities have significantly reduced their outlays from SR 184 billion ($49 billion) in 2014 to SR 118 billion ($31.5 billion), a sizeable drop of 36%. (Chart 5.)

Revenues, on the other hand, were heavily impacted by the 45% decline in oil prices (Brent) witnessed in 2015, falling by a similar rate of 41.6% y/y to SR 607.5 billion ($162 billion). (See Chart 3.) This is 6-year low, and comes despite crude oil production increasing by 5% y/y to a record high of 10.2 mb/d in 2015. Conversely, non-oil revenues, surprised to the upside. These increased by 36.8% to SR163 billion ($43.5 billion) on the back of higher investment and "other" income. Consequently, the share of non-oil revenue to total revenue reached a peak of 26.8%, providing encouragement to the authorities as they push ahead with diversifying the kingdom's income streams.

Real growth moderates slightly to 3.4% in 2015; public debt rises to 5.8% of GDP

Preliminary estimates of real GDP growth in 2015 show the economy continuing to expand at a respectable rate of 3.4% y/y. This was driven by gains in the oil and the non-oil private sector, which grew by 3.1% and 3.7%, respectively. (Chart 6.) This is in line with our own estimates for the year, which see real output growing by 3.5% y/y. In 2016, growth is expected to moderate further on account of lower average oil prices and more restrained government spending. With the government continuing to emphasize investment spending, however, the non-oil economy is expected to perform relatively well.

Chart 8: Stock market

(Tadawul All Share Index)

Source: Thomson Reuters Datastream

Public debt, meanwhile, increased to SR 142 billion ($38 billion), or 5.8% of GDP, in 2015. (Chart 7.) The increase in debt from 2014's low of 1.6% of GDP is the first recorded gain since 2002, and is primarily a result of the government's bond program. Bond issuance totaled SR 98 billion ($26 billion) during 2015.

Market reaction to the budget has been mixed, but budget's nod toward fiscal reform is viewed positively

The main Saudi stock market index, the Tadawul All Share Index (TASI), has been volatile in the wake of the budget announcement, with the government's plan to hike feedstock prices for industrial users prompting a sell-off in the main chemical stocks. (Chart 8.) Along with the chemicals sector, the cement and transport sectors benefit from heavily subsidized input prices.

Nevertheless, as the dust settles, sentiment is expected to improve as the government's commitment to fiscal reform gains credibility. Indeed, among analysts and the economic community, reaction has been generally positive. The deficit was lower than many had predicted, budgeted spending cuts are not expected to greatly impact non-oil growth in the short term and, significantly, the government has finally unveiled a seemingly credible reform plan to put the economy on a more fiscally sustainable footing.

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