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Jadwa Investment

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Q1 2023 Budget Performance Report

Spending surge triggers small deficit

- The central government recorded a small fiscal deficit of SR2.9 billion in Q1-23, driven by a 29 percent surge in spending. Revenue climbed by just 1 percent, with VAT receipts helping to offset a 3 percent drop in oil revenue.

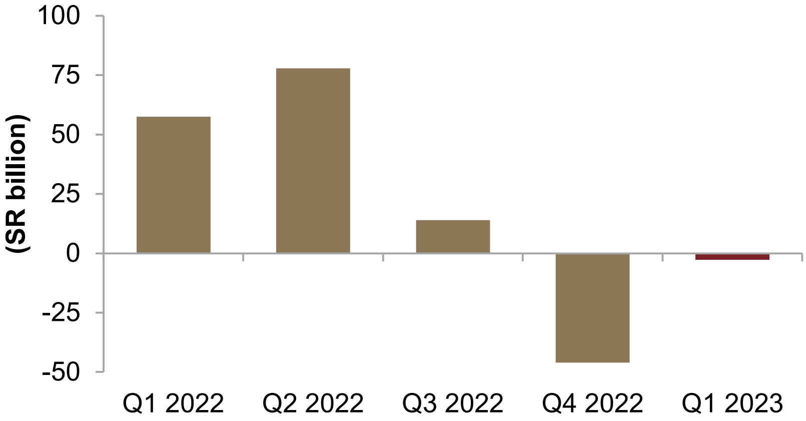
- The spending surge was broad-based, with no single factor driving the increase. That said, the biggest nominal increase was in procurement costs, with a 75 percent leap in capital spending sucking in a broad range of imported inputs.

- While this new wave of spending raises questions about sustainability, we think there is some room for additional government outlays this year and in the future. Spending as a share of non-oil GDP has fallen over the past decade, and the strength of the non-oil economy should help to increase the denominator in the years ahead. The fact that capex was a big driver of the spending increase is also positive.

- The spike in spending means that a modest fiscal deficit is now in prospect for 2023. Despite some domestic banking liquidity tightness, there is plenty of scope to increase external borrowing to meet fiscal financing.

- In fact, the medium-term outlook for the fiscal finances has improved with Aramco's announcement that it intends to start paying a "performance-related dividend" probably from Q1-24 onwards. The formula involves a payment of 50-70 percent of Free Cash Flow, net of the base dividend and external investments. This could be worth an additional 2 percent of GDP to the government.

Figure 1: Q1 2023 saw the government post a small fiscal deficit



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The central government recorded a small budget deficit in the first quarter. Revenue grew, but spending growth was far stronger.

The central government recorded a small fiscal deficit of SR2.9 billion in the first quarter of 2023 (Figure 1). The deficit is in contrast to the Q1-22 surplus, but is some way smaller than the Q4-22 deficit. The deficit was triggered by a surge in government spending (up 29 percent) against a backdrop of a 1 percent gain in revenue. The deficit has a number of mitigating factors, which we discuss below.

Revenue:

Table 1: Government Revenue (SR million)

Revenues	**Q1 2022**	**Q1 2023**	**Change (%)**
Oil revenue	183,699	178,605	-3
Non-oil revenues, of which;	94,260	102,339	9
-Taxes on income, profits and capital gains	4,112	7,188	75
-Taxes on goods and services (including petroleum product charges and harmful product tax)	60,419	63,087	4
-Taxes on trade and transactions (customs duties)	5,064	5,501	9
-Other Taxes (including Zakat)	3,178	4,120	30
-Other revenues	21,487	22,443	4
Total	**277,959**	**280,944**	**1**

Oil revenue was supported by a strong showing from refining, which partially offset the impact of lower crude revenue.

VAT receipts remained the bedrock of non-oil revenue, though the contribution from taxes on foreign firms was also up sharply.

Starting with revenue, the government's oil income was SR178.6 billion in Q1, down 3 percent on the same quarter of 2022 (Table 1). The 3 percent decline is less than one would expect given the differentials in crude pricing and production during the two periods. Based on that alone, the fall in revenue should have been around 20 percent (though any such comparisons are hampered by lags in Aramco's payments to the government). The likely explanation here is that oil revenues were boosted by higher refining margins, as well as additions to refining capacity. Margins were significantly wider in Q1-23 versus Q1-22 (roughly 38 percent higher based on global indices, Figure 2). While downstream profits are taxed at only 20 percent, this appears to have provided a significant offset to the loss of crude oil revenues.

Part of Aramco's transfer to the government was in the form of a

Figure 2: Wider refining margins helped to support oil income (index)

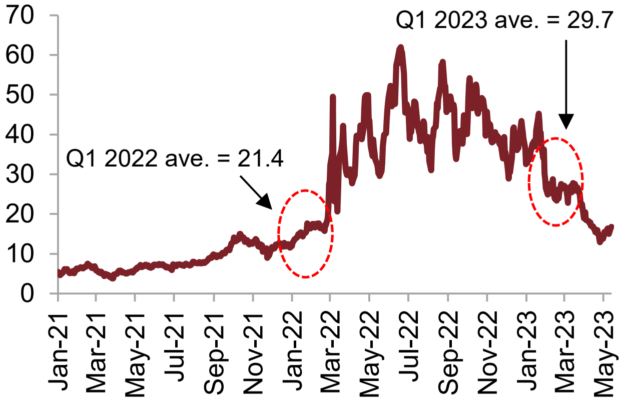
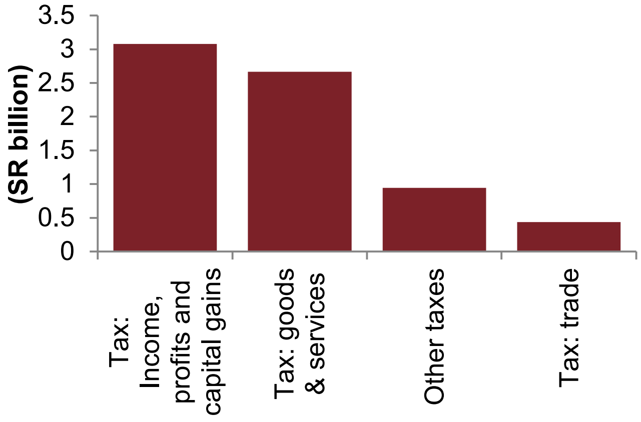


Figure 3: VAT returns and taxes on foreign firms helped on the non-oil side



Difference between Q1 2023 and Q1 2022

SR68.6 billion dividend, reflecting the government's 94 percent interest in the firm. Dividends are calculated with reference to Aramco's definition of Free Cash Flow (FCF) which amounted to SR115.9 billion at the end of Q1, around a billion riyals higher than in Q1-22 (Box 1). Here too, wider refining margins (and capacity) probably played an important role in boosting FCF in Q1-23.

The yield from VAT grew by 4 percent, year-on-year.

For non-oil revenue, the main segment remains 'taxes on goods and services' (62 percent of the total). This increased by 4 percent, year-on-year, reflecting steady growth in points of sale and e-commerce transactions, offset slightly by cash transactions, which are in structural decline. There was also an encouraging surge in revenue from 'income, profit and capital gains' (taxes applied largely to foreign firms, Figure 3).

Non-oil revenue increased by 9 percent year-on-year, more than offsetting the decline in oil revenue.

These and other gains saw non-oil revenue increase by 9 percent during the quarter, year-on-year. This was enough to offset the 3 percent decline in oil revenue, and allow an overall revenue gain of 1 percent.

Box 1: The changing shape of dividend payments

Dividend payments are lagged, with the previous quarter's dividend being paid to the government in the current quarter (clearly flagged in Aramco's accounts). Thus, SR68.6 billion in dividends was generated for the government in Q4-22 and paid in Q1-23. There are however, a couple of complications regarding future dividends.

Aramco announced that it would be paying a "performance-related" dividend, on top of the base dividend, likely starting from Q1-24.

First, the government transferred 4 percent of its Aramco stock to Sanabil (the PIF's venture capital arm) in April, thereby reducing the central government's future claim on Aramco's Free Cash Flow. Had this occurred in Q1, it would have cost the central government a modest SR3 billion. Far more meaningful is Aramco's announcement that it intends to pay a "performance-related" dividend in addition to the base dividend. Aramco's President said the dividend would be in the range of 50-70 percent of the remaining FCF after the base dividend is paid and excluding any external investments. The performance dividend will be paid after the company's full-year accounts are finalized (presumably some time in Q1-24 or possibly Q2-24).

There are a number of variables affecting this dividend, but it could be worth an additional 2 percent of GDP to the government.

If one takes the mid-point of this range (60 percent) and applies it to the company's Q1-23 FCF on an annualized basis (SR463 billion), and then subtracts say SR20 billion for external investment, this would yield a dividend of around SR90 billion net of the base dividend. This would leave around SR80 billion for the central government given its new 90 percent share. This is a sizeable amount of money (2 percent of our estimate of 2023 GDP).

Yet the dividend outlook is further clouded by news that the government is planning to sell more of its Aramco stock. At this stage, the size, timing and method of any sale are all unclear. The proceeds would presumably be transferred to the PIF, which is driving Vision 2030 capital projects.

Expenditure:

Spending saw a 29 percent year-on-year increase, reaching SR284 billion.

The most eye-catching developments in the fiscal accounts were around spending, which showed a 29 percent year-on-year gain (Table 2). Outlays reached SR284 billion in Q1, which was equivalent to 28 percent of our estimate of Q1 nominal GDP (about a percentage point of GDP higher than in Q2-22). The data chime with Q1 GDP figures, which show ‘government activities’ expanding by 4.9 percent, up from 2.4 percent a year earlier.

Procurement costs showed the biggest nominal gain. This in turn reflected a 75 percent jump in capital spending, and with it a range of imported inputs and services.

All line items saw substantial growth, with ‘use of goods and services’ providing the biggest nominal impact (an SR22 billion year-on-year gain). This in turn was at least partially driven by a 75 percent surge in capital spending, which will have sucked in substantial amounts of imported inputs. In recent years, central government capex has drifted downwards as the PIF has shouldered the burden of much Vision-2030 investment. Yet there are still plenty of basic infrastructure projects—roads, bridges, power plants, water treatment facilities—which need to be rolled out to meet the needs of a rising population. This is particularly so in and around Riyadh, whose population continues to expand at a rapid rate.

Equally striking was the seven percent gain in ‘employee compensation’, which remains far and away the biggest single element of spending (roughly 47 percent). In recent years this item has been well contained, and indeed last year it even fell to around 20 percent of GDP, the lowest ratio since 2013. The pick-up is not easy to explain, given official data showing a *fall* in civil service employment during 2022. If this is so, then wage inflation and additional end-of-service payments would be the obvious explanations for the increase.

Social benefits’ payments also shifted higher, reflecting last year’s Royal Order, which granted more resources to social security.

Elsewhere, social benefits also spiked, growing by more than 50 percent year-on-year. This largely reflects the impact of the July 2022 Royal Order allocating additional resources to the Citizens’ Account and other social security channels to mitigate the impact of rising prices. In addition, there were large gains for ‘subsidies’ which is mainly food items and excludes energy; ‘financing’, which has risen in line with higher interest rates; and ‘other items’.

In short, there were across-the-board gains in spending, with no one item explaining the rise (Figure 4). The key question is whether large increases in government spending are sustainable.

Overall, the surge in spending was striking, but we think there is enough ’fiscal space’ to accommodate it.

There are a few points to make here. First, space has been created for additional government expenditure. The primary deficit as a share of non-oil nominal GDP (our preferred metric) has declined over the past ten years, from around 55 percent to 30 percent (Figure 5). Burgeoning non-oil activity will power further increases in the denominator in the years ahead, providing additional room for government outlays. Second, the country is in the midst of an economic transformation and it is natural that the state should take

Figure 4: Spending rose sharply across the board

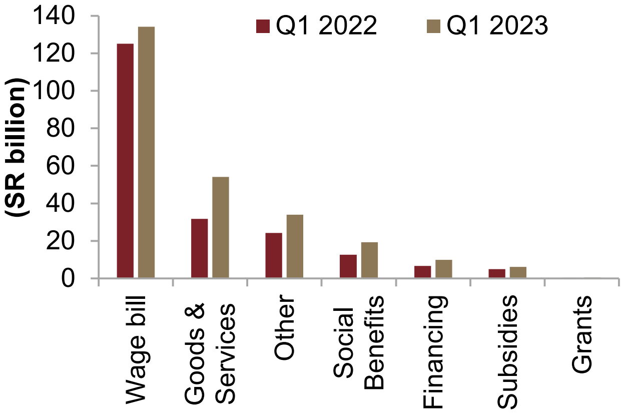
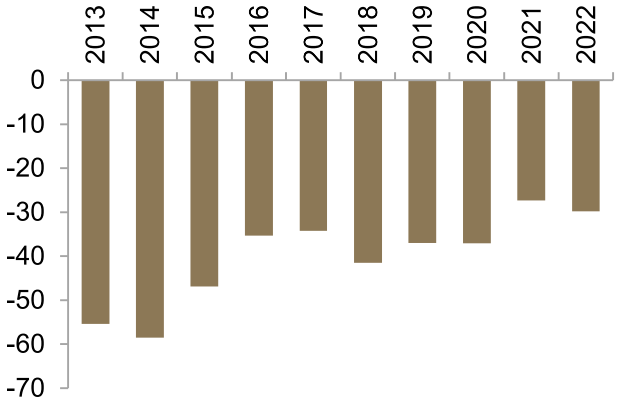


Figure 5: The primary non-oil fiscal deficit has trended down over the past decade



Primary fiscal deficit percentage of GDP

It is natural that the government should be at the forefront of the economic transformation under way…

the lead, both in investment and in providing support to those impacted by the transition. In time, it is expected that the private sector will increase investment (indeed, this is already happening), allowing the state to reduce its role.

Table 2: Government Expenditure (SR million)

Expenses	**Q1 2022**	**Q1 2023**	**Change (%)**
Compensation of Employees	125,173	134,066	7
Goods & Services	31,810	54,102	70
Financing Expenses	6,606	9,928	50
Subsidies	4,876	6,062	24
Grants	341	505	48
Social Benefits	12,670	19,205	52
Other Expenses	24,155	34,007	41
Non-Financial Assets (Capital)	14,836	25,979	75
Total	**220,467**	**283,855**	**29**

… and in any case there is plenty of room to increase external debt financing.

Finally, we do not see any problems around deficit financing. True, there is still a general shortage of liquidity in the banking sector (moderating recently). Yet there is plenty of headroom for external debt issuance: central government external debt actually fell during the quarter, easing to SR343.8 billion, which is equivalent to just 9 percent of our projection for 2023 nominal GDP (this happened despite the fact that the government chose to finance the Q1 deficit through external borrowing). An external debt load of less than 10 percent of GDP is something that most Emerging Market governments would envy. In any case, appetite for Saudi sovereign debt is strong and its rating profile is good and improving.

Outlook:

Returning to the near-term outlook, spending is clearly set to be higher than we originally expected this year. If the Q1 figure was annualized, then expenditure would be just 1.9 percent over budget, but this is unrealistic given that Q4 almost always shows a spike in spending. Meanwhile, non-oil revenue is expected to show decent growth, as ever-expanding consumption boosts tax receipts.

The Q1-23 results mean that a small fiscal deficit might now be on the cards for 2023. However, given the prospect of a performance-related dividend from Aramco, the 2024 outlook has improved.

The main uncertainty lies with oil revenue. This will obviously be impacted by the estimated 500,000 bpd cut to Saudi production from May onwards (as part of a broader OPEC Plus agreement), but the performance-related dividend has improved the 2024 outlook. Against that, the reported plans to offload more Aramco stock could mean a modest hit to the central government’s future oil revenue, depending on the size of any divestment.

On the basis that any stock sale does *not* go ahead in 2023, a small fiscal deficit (of maybe a couple of percentage points of GDP) appears likely this year, but with a potential return to surplus in 2024. We will have more detailed analysis of the fiscal outlook in our next Macroeconomic Update.

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