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Economic Adjustment and Reform in the Context of a Rentier State

Bassam Fattouh

Oxford Institute for Energy Studies

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Centrality of Rents and Rentier State Theory

- Rents have been central to shaping the political economy of the Gulf Corporation Council (GCC)

- Basic analytical framework remains Rentier State Theory (RST) despite some important refinements
  - Fiscal independence of state from taxation (no accountability; no representation without taxation)
  - Rents allow ruling families to buy political consent (can be achieved through patronage or repression)
  - Main function of rentier state is to distribute rents through variety of ways (public employment, food and energy subsidies, contracts to private sector)
  - Can explain many of the GCC's economic features: low private consumption, bloated public sector, hidden unemployment, wide economic and price distortions, inflexible and distorted labor markets, uncompetitive private sector which is highly dependent on the state, very costly welfare systems
  - Distributive function at the heart of the implicit social contract between the state and the citizen (many view this as central to the stability of GCC countries)

Economic Reform in the Rentier Context

- Often implied that economic adjustments and reforms difficult (impossible?) in the context of rentier economies as this undermines the social contract giving rise to social and political unrest

- Yet experience shows that in response to the sharp decline in oil price, GCC countries have been able to introduce some limited reforms/adjustment measures with relative ease and without much public opposition so far
  - Some indirect taxes, VAT, administrative fees, cuts in public sector wage benefits
  - Privatizations efforts
  - Perhaps most evident is the increase in energy prices in most GCC countries

- Low energy prices not only one of the many ways to distribute rent to households, but has been central to these states' industrialization strategy based on the competitiveness of energy intensive industries such as petrochemicals, aluminum

- This may suggest that social contract more resilient than originally thought and extends beyond what's implied by RST

But how Resilient is the Social Contract?

- Some key questions:
  - How deep have these recent reforms been?
  - Can these reforms be accelerated without governments facing serious public opposition? Can compensation schemes make the reforms more acceptable?
  - Can these reforms be implemented without greater accountability?

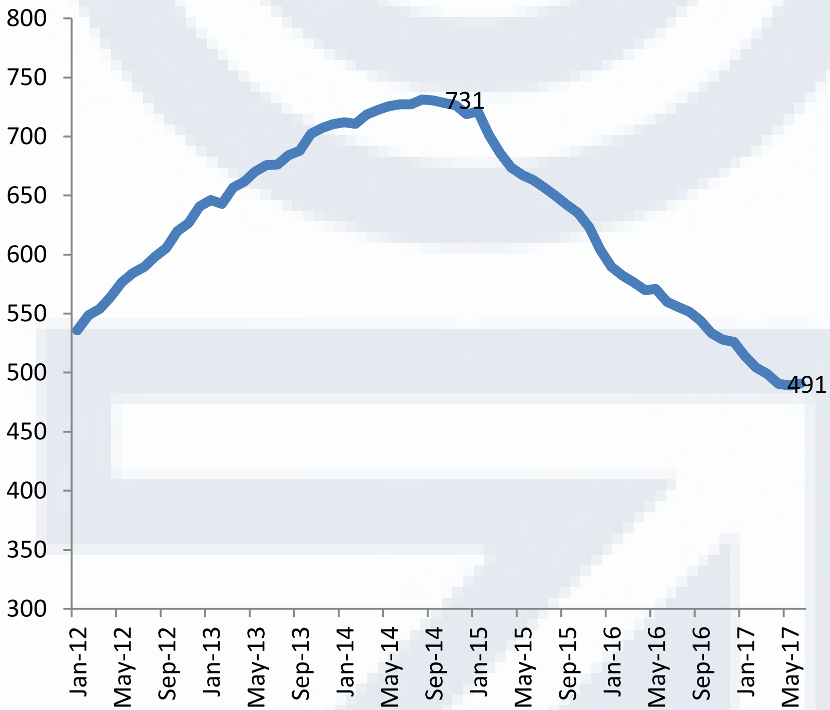
Despite Implementing Adjustment Measures, Fiscal Challenge Persists

- GCC governments' adjustment to a low price environment
  - Draw down on foreign reserves
  - Increase domestic lending
  - Tap international debt markets
  - Increase domestic energy prices
  - Reduce capital spending
  - Reduce current spending
  - Boost non-oil revenues (indirect taxes, VAT, fees)
  - Devaluation (An option not yet exercised)

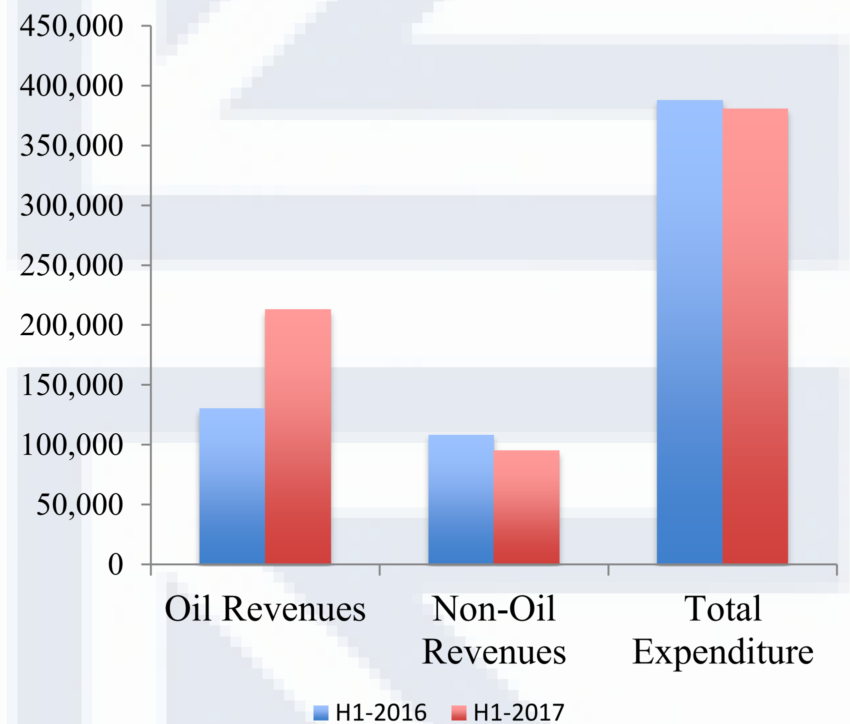
- Measures have not been enough to address fiscal challenge
  - Massive increase in expenditure during boom years + some unexpected expenditure (for instance in case of Saudi Arabia, the Yemen war, support of regional regimes such as Egypt).

Saudi Arabia: The Fiscal Adjustment and Oil Price

Foreign Reserves, Billion US$



Revenues and Expenditures
Million SAR



Building buffers in good times to use them in bad times; but these fiscal buffers are only effective in dealing with temporary shocks

Lower deficit in 2017 H1 compared to 2016 H1, but mainly due to the increase in oil revenues; adjustment in other components has been marginal

Source: Saudi Government, SAMA

How Deep Have These Reforms Been?

Saudi Arabia fuel prices, $

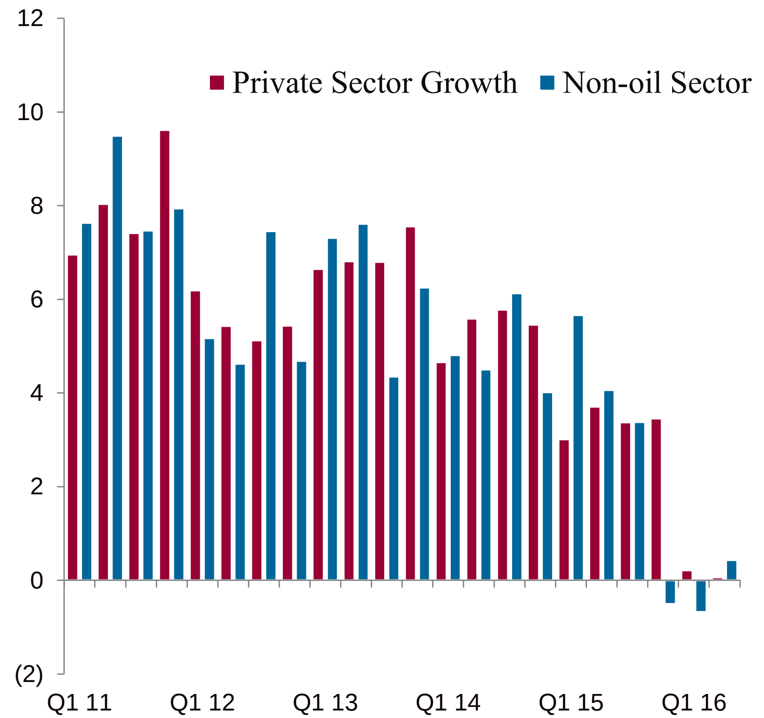
	2015 price	New price	% change
Natural Gas ($/mmbtu)	0.75	1.25	67
Ethane ($/mmbtu)	0.75	1.75	133
Diesel for Industry ($/Barrel)	9.11	14.1	55
Arab Light Crude ($/Barrel)	4.24	6.35	50
Arab Heavy Crude ($/Barrel)	2.67	4.4	65
Kerosene ($/barrel)	23	25.7	12
Premium gasoline ($/litre)	0.16	0.24	50
Regular gasoline ($/litre)	0.12	0.2	67

The increase in prices have been sharp but from a very low base and prices remain a fraction of international prices. The real challenge is increasing prices further from here and fully reforming the energy pricing system

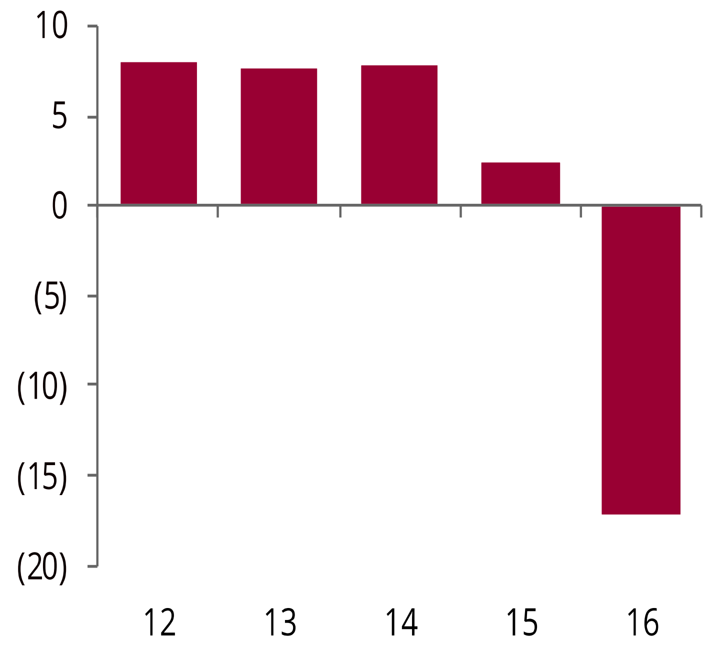
Source: Saudi Government

Economic Adjustment Already Hitting the Saudi Economy

Annual Rates of Private and Non-Oil Sector, %



Gross fixed capital formation, y/y, %



Growth in the private and non-oil sector has stalled putting at risk Vision 2030 which relies heavily on a vibrant private sector

Gross fixed capital formation witnessed a very sharp decline as spending on key projects drops

Source: Saudi Government

The National Transformation of the Economy

Summary of Vision 2030 goals

Theme	Goals	Current	2030
A thriving economy	Private sector contribution (% of GDP)	40	65
	Logistics Performance Index (Rank)	49	25
	Non-oil exports (% of non-oil GDP)	16	50
	Public Investment Fund assets (SR bn)	600	7,000
	Global Competitiveness Index (Rank)	25	10
	Annual FDI inflows (% of GDP)	3.8	5.7
	Domestic output of oil and gas sector (% of total)	40	75
	Kingdom's GDP size (Rank)	19th	Top 15
	Saudi unemployment rate (% of Saudi labour force)	11.6	7.0
	Female participation rate (% of working age females)	22	30
	SME output (% of total GDP)	20	35

A very ambitious plan to diversify economy away from oil and increase role of private sector, but the private sector is currently being squeezed

Source: Saudi Government, Energy Aspects

How Sustainable? The Introduction of Compensation Schemes

- First round of reforms implemented without introducing any compensation schemes to offset the adverse impact on households and industries

- But there is clear realization that any further price increases must be accompanied by compensation schemes to have a good chance of success

- Issue of sustainability of reform agenda directly related to success of introducing such schemes

- Exposes the effectiveness of current institutions in implementing such schemes (after all these institutions are the product of the rentier state; they can't be imported!!!)
  - Information gathering; coordination among the various institutions and the implementation bodies, governance, transparency, etc…

- Failure to implement effective compensatory schemes risks the slowdown or reversal of reforms

Reforms and Income Re-distribution: Case of Saudi Arabia

Illustrative Example: Estimated burden and average Allowance amount in 2017 for a family of 6

	1st Quintile	2nd Quintile	3rd Quintile	4th Quintile	5th Quintile
Average Income (SAR/Month)	0 - 8,699	8,700 - 11,999	12,000 – 15,299	15,300 – 20,159	20,160 +
	4,500	8,500	12,500	17,500	34,500
Estimated Extra Burden (SAR/Month)	(1,000)	(1,100)	(1,300)	(1,500)	(2,000)
Average Allowance (SAR/Month)	1,200	1,200	1,000	600	0
Net Burden or Allowance (SAR/Month)	200	100	(300)	(900)	(2,000)

The cash transfer will involve a major redistribution of income from the high income groups to low income groups; presumption that those high income are supportive of the reforms and willing to carry the burden of adjustment

Source: Saudi Government

Reforms and Shifts in Expectations

- Shift from the ‘cradle to grave’ welfare system to a different system where citizen/private sector expected to bear the burden of adjustment
  - Common belief that current status quo is unsustainable
  - Citizens’ expectations have been revised downwards over time
  - Fear of the alternative
  - Sense of external threats
- But any reform imposes pain and creates losers (as well as winners) what is expected in return?
  - More accountability?
  - Eventually more political openness?

Economic Reforms: Multiple Objectives

- Economic reform: the ultimate objective or a tool?
- It is both: One way of consolidating power (portray the image of a reformer who can can deal with the country's economic and social challenges)
  - Economic reform can lead to more power centralization
- But then delivery on the reforms is key (competency important source of legitimacy)
- What if economic reforms fall short of creating the structural changes required to create the thousands of jobs needed for young people?
- Recipe for social and political unrest as some are predicting? Not Necessarily!!!!
- Back to RST
  - Accountability
  - Reversibility of reform/policies
  - Muddling through and reverting back to the rentier mechanisms (but with reduced rents to go around)

Conclusions

- Realization of importance to implement structural changes but road to deep reform is still long
- Recent energy price increases from very low base; the real challenge is to push these reforms further within a weak macroeconomic and institutional context
- Sustainability and acceptability of reforms highly dependent on developing effective social safety nets and compensation schemes which in turn depend on the quality of institutions
- Relationship between economic and political reform complex:
  - Context specific even within the GCC
  - Whether economic reforms succeed or fail, one can end up with the same political structure
  - But will certainly entail reconfiguration of rentier mechanisms and different circulation of rents with important implications on the structure and long-term performance of the economy