CHAPTER 1

Introduction: Economic Sustainability of Oil Economies

Giacomo Luciani and Tom Moerenhout

1 What Is Sustainable?

When can oil economies be deemed sustainable? This complex question has been profusely debated in the last 5 years. The timing of this debate is no coincidence. On the one hand, the pace of environmental degradation has aggravated, in terms of air pollution, carbon emissions and the impacts of the planet's warming. On the other hand, volatile international oil markets and the acceleration of the energy transition have challenged the notion that oil revenues are sufficient to sustain oil economies in the near to medium term. With current challenges predicted to pursue in the near future, a more in-depth discussion about sustainability is warranted.

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G. Luciani, T. Moerenhout (eds.), *When Can Oil Economies Be Deemed Sustainable?*, The Political Economy of the Middle East,
https://doi.org/10.1007/978-981-15-5728-6_1

The debate on sustainability in general, and on economic sustainability in particular, suffers from lack of conceptual clarity. What is the meaning of economic sustainability? As technology and the availability of goods and services constantly evolve, no economy is sustainable in a stationary state. Every economy, enterprise and individual needs to constantly evolve and adapt to changing circumstances. What is sustainable today may not be sustainable tomorrow: in the debate about sustainability, a concept of adaptability is implicit. As we cannot predict the future, and economies are constantly subjected to unforeseen shocks, we do not know what will be sustainable tomorrow, or for how long. Oil economies are confronted with this exact challenge. The current reform drive begs the question: What reforms should really be driven?

Adaptability is a function of many things. It is often considered as a function of diversification. Per se, economic logic rather favors specialization in one's comparative advantage than diversification. The increasing importance of global value chains for development emphasizes this economic logic, by moving competition from entire sectors to single stages of production, and even individual jobs. However, changing circumstances (movements in terms of trade) can be unfavorable for the given specialization. Economic history provides several examples of the rapid demise of specific industries due to technological progress or exhaustion of natural resources. In some cases, economic actors whose specialization has been challenged have successfully reinvented themselves, adapting more or less radically to a new specialization; in other cases, this has not succeeded, and economic actors have decayed and disappeared.

The pressure on many Gulf countries is high, but it is not equal as Gulf Cooperation Council (GCC) countries are heterogeneous. Some countries still hold a very strong comparative advantage in oil and gas production, so why should their governments not tailor their economies to this sector and approach their own diversification in the context of the value chain of petroleum products? One might argue that countries with large resource reserves and small populations could then simply accept, for the time being, that price shocks will happen periodically. Other GCC states, however, are faced with declining reserves and sizeable populations. It is in this context, with the additional drivers of technological advancements and environmental unsustainability, that it is more urgent to discuss diversification. As they accelerate diversification of value added and revenue, the pressure is on to invest in those sectors and stages of production that can yield results for some time to come.

2 What Is Unsustainable?

More than understanding what is sustainable, we may more easily know what is not sustainable. Adaptability, after all, is also a function of the ability to identify unsustainable trends early on, and correct them before very large costs are incurred. Current trends may be clearly unsustainable if extrapolated into the future: this is especially the case with respect to environmental impact and some socioeconomic trends such as rising inequalities and poverty. Thus, one way to discuss sustainability is to point to aspects, which are clearly unsustainable. All economies display such traits that are unsustainable; the question is whether they can be corrected on time before they cause excessive costs. It is very likely that some costs will need to be borne anyhow, before issues are corrected; the question is: what type of costs and how large can they be, before they become acutely "unsustainable"?

The lack of economic sustainability and the lack of diversification in oil economies in the Gulf have been discussed for decades and have often been equated. They have also featured in many previous development visions. In recent years, however, and in part due to the oil price collapse and a changing international energy landscape, diversification has become a more pronounced objective. But it appears that the debate on diversification suffers from path dependency, lacks specificity and still insufficiently takes into account the particular political economy constraints of GCC countries.

The first challenge, for example, lies in its definition: diversification of what? Of value added? Of exports? Of revenue? Quite clearly, it is the latter that lies at the basis of the post-2014 obsession with diversification, but a sole focus on revenue can undermine a fruitful discussion about what is possible in terms of policy-making on the medium term. A focus on what is acutely unsustainable would be a significant contribution to this debate on economic sustainability.

3 This Book

The chapters in this edited volume document discussions held in the context of the 2018 Gulf Research Meeting held by the Gulf Research Center at the University of Cambridge (UK). It starts from the acknowledgment that there is no widely accepted definition and measure of sustainability. All authors however try to capture not only political and economic factors, but also social and cultural influences on economic reform in GCC countries.

While authors have argued in total autonomy from each other and some divergent opinions remain, the thrust of the book is to conclude that some GCC economies have made significant progress toward diversification, reducing exclusive reliance on oil with respect to both composition of GDP and exports. This book also investigates a number of pronounced economic sustainability challenges in the Gulf's oil producers, in terms of not only the threats to fiscal balances, but also the nationalization and privatization of labor markets, environmental pressures on GCC countries and soaring income inequalities within Gulf countries.

This edited volume has four parts, discussing various facets of economic sustainability. In a first part, authors provide a holistic discussion of current trends in, and projections about, the sustainability of oil economies in the Gulf. The second part of this edited volume discusses trends in fiscal sustainability, given the quest, and need, of governments in the Gulf to diversify not just the economy, but especially their revenue base. These chapters also tie in fiscal reforms to the goal of Gulf economies to diversify and to adjust labor market structures. The third part addresses labor market policies and labor market reforms. The fourth part discusses strategies of oil economies toward international climate action. This fourth part misses an assessment of environmental consequences of climate change that can threaten Gulf economies. The editors consider it essential that the content of this volume is complemented by such assessments.

4 A Holistic, and Realistic, Picture

In Chap. 2, Giacomo Luciani frames the debate on economic sustainability of oil economies. He questions the popular notion that Gulf economies are not sustainable by discussing the progress on diversification as well as the continued relevance of hydrocarbons. Highlighting that the oil rent is likely to shrink over time, he points out the core challenge of developing taxation and fostering the development of an independent and competitive private sector. He also emphasizes the need for further labor sector reform and the challenges of income inequality.

In Chap. 3, Ishac Diwan argues that the current focus in Saudi Arabia of replacing a rentier economic model with economic diversification in tradables is unrealistically ambitious. Rather, he proposes a Norway-like model where public sector jobs are complemented with private sector employment in middle productivity and high-wage jobs. He discusses the challenges in labor market reform and the trade-off between slow adjustment and large-scale financing of new investment to support this transition.

In Chap. 4, Ali Al-Saffar explores the outlook for producer economies. He discusses current risks and emerging pressures to producer economies, arguing that uncertainties in oil demand and supply have strengthened the need for further diversification. He reviews the results of two scenarios toward 2040, one in which oil demand continues to grow and another where oil demand tapers off. He concludes by pressing the role of a more efficient and productive energy sector in the Gulf's economic reform initiatives.

In Chap. 5, Bassam Fattouh and Anupama Sen argue that the broader characteristics of the current energy transition toward low carbon energy sources will be more important than when oil demand will eventually peak. They expect that the diversification strategy of exporters will be conditioned by the speed of that transition, and that during the transition, the oil sector will continue to play a key strategic role. In reverse, also the pace of the global transition will be influenced by the speed and success of economic diversification in oil economies.

In Chap. 6, Joerg Beutel reveals the usefulness of an input-output approach to better understand the growing importance of intermediates when discussing economic diversification. He compares the performance on economic diversification and sustainable development of GCC economies with a reference case (Norway). He concludes that GCC countries have performed well on diversification, but less so on sustainable development, which includes, among others, the depletion of natural resources and environmental pollution.

In Chap. 7, Manal Shehabi redefines economic sustainability in resource-dependent states by offering a new definition that accounts for the economic challenges of resource dependence. She elaborates on the changing and elusive definition of economic sustainability, and then suggests an alternative definition that centers around volatility and depletion. She discusses the specific policies that successful growth-sustaining policies would imply, such as the regulation of oligopolies and human capital development.

5 Fiscal Sustainability

In Chap. 8, Tom Moerenhout discusses fuel and electricity pricing reform as core tenets of Gulf reform programs. He argues that pricing reforms were successfully used post-2014 to avoid an even more menacing collapse of state budgets. While future reforms will still be needed, he warns for a potential double-edged sword. If the extent and pace of pricing reforms is too ambitious, then it might erode the comparative advantage of industrial consumers and as such complicate efforts to achieve (within sector) diversification.

In Chap. 9, Monica Malik and Thirumalai Nagesh look at fiscal sustainability and the types of fiscal reforms (including the introduction of value-added tax) that have been implemented following the oil price collapse in 2014. They argue that those reforms have been deeper than earlier cycles, but that it remains difficult for many GCC governments to implement a multi-year fiscal reform process given the pressure that his would cause on the private sector and the population.

6 Labor Market Reform

In Chap. 10, Monica Malik and Thirumalai Nagesh discuss the relevance of population dynamics and labor markets to fiscal capacity. They elaborate on the opposition between the existing social contract and fiscal labor market needs in the area of reducing public sector employment. While noting that the greater burden of fiscal reforms has fallen on the expatriate population, they argue that an evolution in the social contract remains essential as governments seek to create private sector jobs for the youth population and downsize the public sector.

In Chap. 11, Martin Hvidt applies a value chain perspective to the question of economic diversification and job creation in oil-producing countries in the Gulf. He suggests that such a value chain perspective can provide more clarity on whether newly created jobs are in the lower or higher value-added segment. He suggests that Gulf countries should aim at creating jobs in the high-value segment, as this will create a virtuous process including the upskilling of the labor force. It will also require a readjustment of the current reliance on expatriate labor.

7 Environmental Sustainability

In Chap. 12, Jim Krane analyzes how oil export-dependent states have adopted three near-term strategies to protect oil rents and revenue. A “dig in” strategy aimed at insulating the oil industry from climate risk and undermining global action on climate change. A “join in” strategy aimed at rational domestic energy policies and with greenhouse gas reduction benefits. And a “throw in” strategy seeks to frame mitigation efforts as more expensive than climate change damages. He provides a case study on Saudi Arabia’s response to global climate action.

8 Sustainability of GCC development

In Chap. 13, Ibrahim Elbadawi and Samir Makdisi review the development experiences of the six countries of the Gulf Cooperation Council, starting from the observation that they have been able to avoid the most explicit consequences of the resource curse. They highlight that the unusual high rents per capita have resulted in a developmental and political equilibrium. The authors conclude that the dependence of GCC countries on such high rents casts a shadow over the future sustainability of this equilibrium, especially under a new emerging global oil order, which will likely be characterized by lower oil prices.

In Chap. 14, Giacomo Luciani and Tom Moerenhout conclude. They underline that no unequivocal and final answer to what determines the sustainability of oil economies exists, but that, equally, not all oil economies should be stereotyped as unsustainable.

If one overall message can be distilled from this book, it is that we should move on from the simplistic branding of the Gulf economies as unsustainable, and tackle the details of which adaptations they might need to undertake. In this approach, developing fiscal tools to greatly reduce reliance of recurrent expenditure on the oil rent, and moving away from a model of low-cost, low-productivity expatriate labor to a model of higher wages and productivity emerge as the two decisive challenges. Both have direct implications for political institutions, which consequently will also need to adapt.