TOO MUCH OF A GOOD THING: SUBSIDY REFORM AND TAX INCREASES DEFY ACADEMIC THEORY ON THE RENTIER MIDDLE EAST

Jim Krane, Ph.D.
Wallace S. Wilson Fellow for Energy Studies

September 2019
Introduction

In the oil exporting countries of the Middle East, four recent developments challenge the conventional academic theories that model the region’s governance parameters. First, at least nine Middle Eastern governments have partially retracted energy subsidies that provided citizens with cheap fuel, electricity, and desalinated water.

Second, Saudi Arabia, the United Arab Emirates (UAE), and Bahrain imposed a 5% value-added tax (VAT) on goods and services, including energy and food. Other countries, including the three remaining Gulf monarchies as well as Egypt, Algeria, and Iran, have levied VATs or announced plans to do so. For autocratic regimes that fund their national budgets with oil and gas export rents, the imposition of taxes and retraction of subsidies run counter to social contract stipulations enshrined in the rentier literature.

A third development also confronts theoretical conventions about linkages between rent and Middle Eastern autocracy. It turns out that rentier theory’s claim about oil’s influence on politics also works in reverse. Yes, oil rents probably do increase the durability of autocratic regimes, but autocratic governance (at least in oil-exporting Middle Eastern countries) also appears to increase demand for oil. That is because regimes stay in power not just by distributing oil rents, but also by distributing oil itself, a practice that stimulates demand. The Middle East’s oil-exporting states tend to be both autocratic and oil-intense, a notion that has largely been ignored in the literature (Figure 3 and Table 1).

The fourth development is that the growing burden of domestic demand for oil and gas has begun to threaten the core rentier structure. High rates of energy demand growth are eventually incompatible with steady exports. It now appears that a common manifestation of rentier social policy, energy subsidies, risks undermining the rentier economic structure—the rent lifeline that funds the state.

These four developments are interconnected. Recent tax increases and subsidy reforms address the energy intensity incubated by subsidies. The state’s policy prescriptions aim to reduce domestic consumption and preserve exports. These activities would not seem remarkable in a participatory governance setting where economic and social policymaking sometimes require corrective retrenchment. But in the rentier Middle East, they run contrary to four decades of scholarship.

Academics have long held that the oil kingdoms of the Middle East are subject to a strict set of governance conditions. Rulers cultivate support from their citizens by providing them with welfare benefits and subsidies, funded through export rents. These rents were sufficient to eliminate taxes and other forms of extraction, thus allowing regimes to avoid accountability links with taxpayers. Energy subsidies have been described by scholars as “rights of citizenship,” provided by regimes in exchange for public acquiescence to autocratic rule. The no-tax, no-vote social pact was supposed to be sacrosanct. Were the state to break its side of the bargain, the entire pact was liable to unravel.
These tenets proved robust during the 1986-2004 oil bust period, when oil rents were strangled by a 20-year glut in global supply. Despite intense fiscal privations that squeezed rentier distribution, none of the six Gulf monarchies raised energy prices or re-imposed taxation that had been phased out during the boom period.\(^7\)

Initial signs that longstanding subsidy policy and theoretical tenets were weakening came in 2010 when Iran launched a major increase in energy prices. Dubai followed with a more modest reform in 2011.\(^8\) Increases elsewhere, delayed by pan-Arab uprisings, began to unfold in 2014 (Figure 1).

Price increases were greeted by an uproar in social media. In Saudi Arabia, commentary ranged from outright support to vehement opposition, including personal attacks on ministers, technocrats, and even royal family members. Cautious Saudi opponents of the reform began tweeting pictures of King Abdullah unaccompanied by text. The portraits evoked the late ruler’s patronage of the poor as commentary on his successor’s turn toward extraction. Physical protests broke out in populous oil and gas exporting states, including Iran and Algeria, as well as in Oman, where citizens picketed the Ministry of Oil and Gas after gasoline price increases.

The outcry over rising prices met with stepped-up repression in most of the affected countries.\(^9\) The use of mild repression to quell breaches of the state-society pact is predicted by early rentier works, while later writing argues that the state prefers to head off dissent with patronage and consultation.\(^10\) The ongoing crackdowns on speech along with the state-directed murder of a Saudi dissident in Istanbul provided further evidence that benevolent characteristics of Gulf autocratic rule were eroding.

These developments suggest that a reassessment and update to theory is due. Rents certainly remain of primary importance to governance in these autocratic export states, but some rules that theorists have advanced over the past four decades now appear more like guidelines; and guidelines can be disregarded when circumstances allow.

**Evidence: Subsidy Reform and Tax Increases**

The subsidy reform that swept the Middle East after the 2014 decline in oil prices is undeniable. Over a four-year period, at least nine countries raised prices on energy products that, in most cases, had been fixed at low levels for many years. Reformers include all six of the wealthy Persian Gulf monarchies (Saudi Arabia, UAE, Kuwait, Qatar, Oman, and Bahrain), petroleum exporters Algeria and Iran, as well as Egypt, a mid-sized producer that is currently a net importer. These price increases have been covered elsewhere,\(^11\) but Figure 1 provides detail.

As Figure 1 shows, the initial increases took place alongside a decline in the crude oil market price, providing a fiscal impetus—as well as political cover—for reform.\(^12\) However, some of the largest increases came in 2018, well after oil prices had recovered much lost ground. This suggests that the subsidy rollbacks were driven by determination to stem demand growth. By late 2018, with Brent prices nearing $85 per barrel, none of the countries had rescinded the increases in domestic energy prices except Oman, where 2017
protests led the government to cap gasoline prices for 10 months. In 2018, the government revived a small gasoline subsidy and restricted it to low-income Omanis, forcing expatriates and higher income citizens to buy fuel at unsubsidized prices.\(^{13}\)

What about the tax increases? In January 2018, Saudi Arabia and the UAE approved the Gulf’s first-ever value-added tax, imposing an extra 5% price hike on nearly all goods and services. Bahrain joined them in 2019. The remaining monarchies announced plans to impose VATs of their own by 2021. The Saudi imposition of a VAT and higher utility and fuel prices was partly offset by the launch of the Citizen’s Account program, a government cash transfer that has provided monthly payments ranging from $80 to $250 to the lower-income half of the citizen population.\(^{14}\)

Where subsidies have not been completely lifted, their provision has often been narrowed to citizens, or even poor citizens, as the examples in Oman and Saudi Arabia illustrate. The UAE and Qatar had long ago split electricity and water tariffs, retaining cheaper (or free, in Qatar) power and water for citizens. Bahrain and Kuwait have also developed differentiated prices based on citizenship. So even as citizens are asked to pay something for a previously free service, or pay a bit more than was customary, foreigners have shouldered much larger increases. These actions appear to violate rentier claims about the inviolability of subsidies, even as they conform to academic portrayals of citizenship as a source of economic privilege.
Subsidy Reform and Tax Increases Defy Academic Theory on the Rentier Middle East

Figure 1. Timeline of Energy Subsidy Reforms in the Middle East Since 2014

Note: Energy prices were raised by governments in at least nine oil-exporting countries across the Middle East and North Africa since 2014.

Evidence: Energy Intensity

The main driver of tax and subsidy reform is the rising consumption of exportable hydrocarbons within these states. Four decades of compounding demand growth now diverts substantial amounts of oil and gas away from export markets (Figure 2). In 2008, two of the six GCC states—Kuwait and the UAE—became net importers of natural gas. Were demand growth of oil not slowed or halted, some or all of the six countries would see their oil exports—the economic underpinning of all six—put at risk.

Figure 2. Average percentage of GCC Oil Production Consumed Domestically, per Decade

![Graph showing average percentage of GCC oil production consumed domestically per decade from 1965-1969 to 2010-2018.]

Note: Domestic energy consumption as a percentage of output has climbed steadily over the decades in the six Gulf Cooperation Council countries—Saudi Arabia, Kuwait, Qatar, Bahrain, the United Arab Emirates, and Oman.


Documentation of the so-called “cannibalization” phenomenon has been produced by financial analysts and think tanks but has yet to be scrutinized in the rentier theoretical literature. In fact, rentier theory has been largely disengaged with the use of energy within rentier states, including the intensity of that use. Giacomo Luciani, one of the few early rentier theorists to engage with domestic consumption, wrote in 1987 that oil “has value only to the extent that it is exported.”

Minimizing oil’s domestic role was probably justified in the 1980s and 1990s, the classic period of rentier scholarship, when the Gulf states remained underdeveloped and lightly populated. Circumstances have changed. Energy products such as electricity and refined fuels have been distributed for decades at low, fixed prices that have encouraged demand for the domestic oil and gas used to produce them. In-kind energy distribution has, over
time, greatly influenced residents’ consumption behavior and preferences, as well as the physical shape of the built environment. The rentier economies of the Gulf exhibit per capita oil consumption that ranks among the highest in the world (Table 1). That condition is a direct outgrowth of the pervasive and structural role of oil and gas in the formation of many of these states\textsuperscript{19} and their governance bargains, which have imposed deep influences on their institutional design and outcomes.

A useful way to envision these effects is as a second stage in the resource curse. Oil rents first helped tribal autocratic systems to survive modernization, and those systems, in turn, launched policies that made their states extremely energy-hungry. In other words, oil bolstered autocrats and autocrats bolstered oil.

The Middle East has maintained nearly 6\% yearly growth in consumption over the four decades since 1973, a much faster rate of growth than the 2\% world average. Over time, Middle Eastern oil economies became less competitive on an energy basis relative to importing economies. Higher prices outside the region encouraged improvements in energy efficiency. Meanwhile, unfettered availability of cheap oil in the Middle East incentivized wasteful behavior and energy-intensive economic choices. These resulted in an energy-intense building and capital stock and distinct physical, institutional and sociological outcomes.

All of the autocracies depicted in the bottom right quadrant of Figure 3 (the most energy-intense and least democratic) are oil exporters. Table 1 also shows that most Middle Eastern exporters were less democratic and consumed more oil per-capita than the average in the OECD and the world. Thus, a reassessment of oil’s role on the state is due—not only as an example of a historic omission from the rentier literature, but also because energy intensity is a product of rentier governance, caused in large part by the distributive mandates of the rentier social contract.
Figure 3. Oil and Gas Rents as a percentage of GDP vs. Levels of Democratic Participation

Note: Countries that receive large shares of oil export rents in their overall GDPs tend to be those with lower levels of democracy. As this scatterplot shows, there were few democracies with more than 10% of their GDP comprised of oil export rents. Data is from 2017.

Source: Oil rents: World Bank World Development Indicators, 2019; Democracy index: Economist Intelligence Unit, 2019.
Table 1. Middle East oil exporters tend toward lower democracy and higher oil demand than the average globally or in the OECD

<table>
<thead>
<tr>
<th></th>
<th>Oil demand per capita</th>
<th>Democracy Index</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(Barrels of oil/person/yr)</td>
<td>(1 to 10, min-max)</td>
</tr>
<tr>
<td><strong>OECD avg.</strong></td>
<td>13.3</td>
<td>8.1</td>
</tr>
<tr>
<td><strong>World avg.</strong></td>
<td>4.8</td>
<td>5.5</td>
</tr>
<tr>
<td>Libya</td>
<td>12.2</td>
<td>2.3</td>
</tr>
<tr>
<td>Iraq</td>
<td>7.9</td>
<td>4.1</td>
</tr>
<tr>
<td>Algeria</td>
<td>3.7</td>
<td>3.6</td>
</tr>
<tr>
<td>Kuwait</td>
<td>38.2</td>
<td>3.9</td>
</tr>
<tr>
<td>Oman</td>
<td>14.8</td>
<td>3.0</td>
</tr>
<tr>
<td>Qatar</td>
<td>32.8</td>
<td>3.2</td>
</tr>
<tr>
<td>Bahrain</td>
<td>15.5</td>
<td>2.7</td>
</tr>
<tr>
<td>UAE</td>
<td>34.7</td>
<td>2.7</td>
</tr>
<tr>
<td>Iran</td>
<td>8.7</td>
<td>2.5</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>36.6</td>
<td>1.9</td>
</tr>
</tbody>
</table>

Note: 2017 data
Source: Oil demand data: International Energy Agency, 2019; Democracy index scores: Economist Intelligence Unit, 2019

Conclusion: Theoretical Amendments

The evidence shows that rentier governments have begun engaging their citizens with energy policymaking in ways that do not follow the script laid out by rentier state theory. Governments that (probably unintentionally) incubated high energy intensity in their economies are now revoking supposedly sacrosanct energy benefits. Citizens are largely accepting their losses without making demands for democracy. These developments imply that rentier theory needs updating.

First, as regards subsidy reform, we should acknowledge that the domestic subsidization of primary exports comprises an encumbrance on the economy. Left intact over the long term, domestic resource distribution can undermine the rent stream and destabilize the governance structure. Regimes should be expected to take action to lessen the strain.

Second, academics’ central misunderstanding about subsidies is that they are inflexible. By portraying subsidies as rights, theory implies that they cannot be reformed without upsetting stability. On the contrary, I argue that subsidies are ultimately more destabilizing to rentier systems than the corrective retrenchment actions that have occurred since 2014. Citizen benefits can be more accurately depicted as “customary privileges” that may be restricted in ways that once appeared illegitimate: toward low income citizens or
“reasonable” levels of consumption, or replaced by alternate handouts. As long as aggregate patronage remains roughly constant, regimes appear to have some control over the type of welfare goods and services they provide. In other words, social contracts are less rigid than portrayed in the rentier literature.

These amendments provide a theoretical allowance for the reforms that have already begun in the rentier heartland of the Gulf. Thus modified, theory can anticipate the likelihood for regimes to continue to streamline social welfare policies in the interest of preserving power.

How should theory deal with the extraordinary oil intensity of the Gulf monarchies? Scholars should acknowledge that the resource curse hypothesis that declares “oil bolsters autocracy” has a follow-on stage, whereby autocratic policies incentivize domestic oil demand. That is because energy is leveraged as a tool of state development and political control.

The practices of rentier policymaking have expanded beyond the boundaries assumed by academics. We may be witnessing the top-down imposition of a new social contract featuring increased regime flexibility in social policy, implemented under a heightened level of repression. These developments do not signal a reduced regime reliance on rents or the demise of rentier or “allocative” governance. World Bank data show a continued large role for oil rents in GDP and for rent distribution via public wages in these countries.

Instead, the levying of low-level taxation and reductions in energy benefits look more like coordinated course corrections. Regimes are streamlining bloated social contracts to contain the distortionary effects of policies that have remained in place since the 1970s. At that time, poverty alleviation was a much larger concern. Today, oil intensity is a countervailing worry for younger ruling elites updating rentier governance for new generations.
Appendix: Additional Data

**Figure 4.** Residential Electricity Tariff — First Consumption Tier

<table>
<thead>
<tr>
<th>Country</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abu Dhabi (ADWEA)</td>
<td>1.36</td>
<td>1.81</td>
<td>2.03</td>
<td>1.68</td>
</tr>
<tr>
<td>Bahrain (DEWA)</td>
<td>0.80</td>
<td>0.42</td>
<td>0.42</td>
<td>0.73</td>
</tr>
<tr>
<td>Egypt</td>
<td>0.28</td>
<td>0.46</td>
<td>0.62</td>
<td>1.23</td>
</tr>
<tr>
<td>Iran</td>
<td>0.70</td>
<td>0.75</td>
<td>0.67</td>
<td>1.35</td>
</tr>
<tr>
<td>Kuwait</td>
<td>0.00</td>
<td>0.20</td>
<td>1.00</td>
<td>2.03</td>
</tr>
<tr>
<td>Qatar</td>
<td>0.67</td>
<td>1.00</td>
<td>2.03</td>
<td>2.03</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>1.00</td>
<td>1.00</td>
<td>2.00</td>
<td>2.00</td>
</tr>
<tr>
<td>Sharjah (SEWA)</td>
<td>0.00</td>
<td>0.20</td>
<td>1.00</td>
<td>2.00</td>
</tr>
<tr>
<td>UAE’s Northern Emirates/FEWA</td>
<td>0.00</td>
<td>0.20</td>
<td>1.00</td>
<td>2.00</td>
</tr>
</tbody>
</table>

**Note:** Electricity prices have increased across the Middle East since 2014. Local prices for the first (lowest) tier of consumption are shown, converted to US cents. Prices increase for higher levels of consumption. Prices shown are those paid by citizens in Abu Dhabi, Bahrain, Dubai, Qatar, Sharjah and the UAE’s Northern Emirates/FEWA. Expatriates paid higher tariffs in most of those jurisdictions.

**Source:** Baker Institute, individual utilities
Figure 5. Fuel Price Changes in Selected MENA Countries

Note: Transportation fuel prices have increased substantially since 2014 in the four countries shown here.

Source: Baker Institute, national statistical data
Subsidy Reform and Tax Increases Defy Academic Theory on the Rentier Middle East

Figure 6. Electricity Generation Cost vs. Residential Tariffs in Abu Dhabi

Note: Electricity prices have risen in Abu Dhabi for citizens and expatriate residents. Prices shown here are for first consumption tier. Prices increase further for larger levels of consumption. Note that the expatriate base tariff in 2018 was close to the actual cost of electricity.

Source: Abu Dhabi Department of Energy, 2019

Endnotes

1 This paper was published in slightly different form under the title “Subsidy reform and tax increases in the rentier Middle East,” in a collection of articles titled The Politics of Rentier States in the Persian Gulf in The Project on Middle East Political Science’s POMEPS Journal, January 2019.


Subsidy Reform and Tax Increases Defy Academic Theory on the Rentier Middle East


9 Human Rights Watch, Freedom House and Amnesty International reported losses in civil liberties and political freedoms, and increased state repression since 2010 in several Arab countries, including much of the Gulf. Bahrain and the UAE saw the largest decreases in personal freedom, according to Freedom House.


Subsidy Reform and Tax Increases Defy Academic Theory on the Rentier Middle East

12 Krane, “Political Enablers of Energy Subsidy Reform in Middle Eastern Oil Exporters.”

13 In 2018, the Omani government launched its National Subsidy System which allows for low-income Omani citizens to buy up to 200 liters of gasoline each month at a price capped at 180 baisas (47 US cents) per liter. Some 300,000 Omani citizens had registered as of October 2018. See: National Subsidy System website https://nss.gov.om/site/home.


