Economics

The Gulf Oil Kingdoms Are Having Their Own Oil Crisis

Decades of subsidies have led to profligate overuse of oil and gas by Saudi Arabia and its neighbors. They're trying to correct that now, but it's not easy.

By Justin Fox
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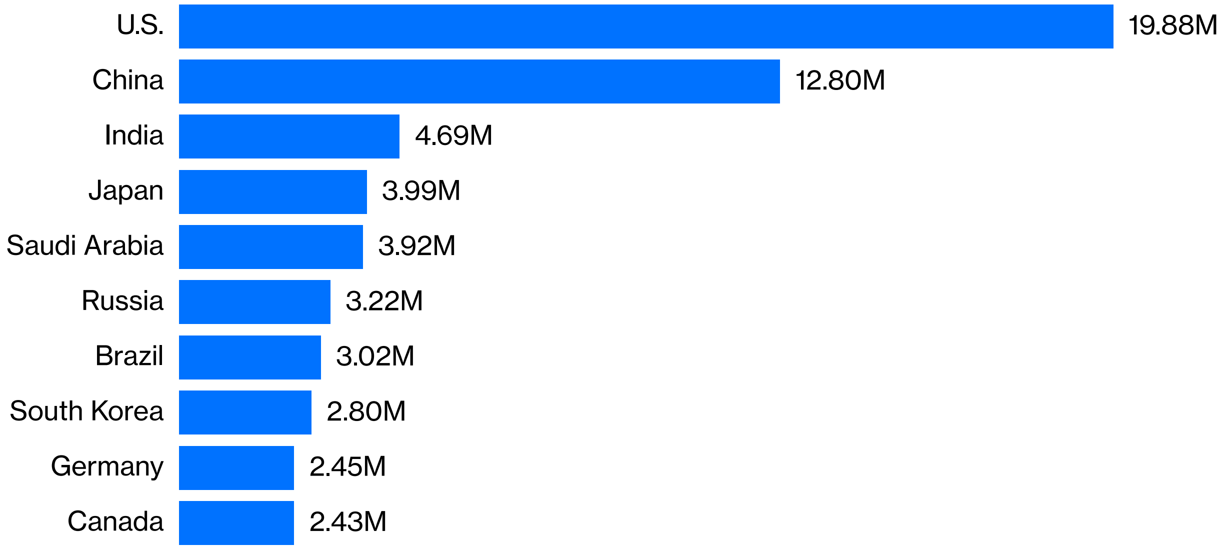
Time is running out. *Photographer: Ali Mohammadi/Bloomberg*

Countries one through four on the list of the world's biggest oil consumers in 2017 are pretty much who you'd expect them to be – the world's four biggest economies. [1] No. 5 is something else:

The Biggest Oil Users
Consumption in barrels per day, 2017



Source: BP Statistical Review of World Energy

Saudi Arabia has just 33 million people, less than one-fourth as many as Russia, the country just below it on the list. Yes, it's rich, but its gross domestic product ranks in the high teens worldwide, not fifth. By global standards, then, it clearly uses an inordinate amount of oil.

That amount, though, was actually down in 2017 from the year before. And therein lies a story, one that is told – quite well – in a new book titled "Energy Kingdoms: Oil and Political Survival in the Persian Gulf." It's by Jim Krane, a former journalist who is now a fellow at Rice University's Baker Institute for Public Policy in Houston, and it combines a concise history of the region's oil and gas boom and its consequences with an illuminating critique of the two main political science theories that have attempted to explain what oil riches mean for the region's politics.

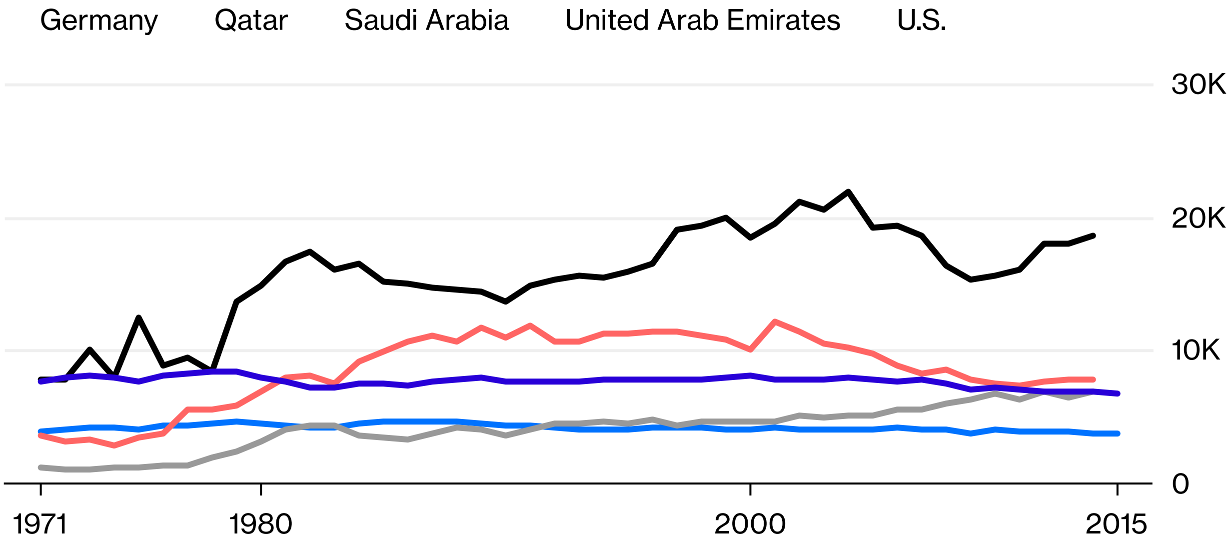
The first was modernization theory, which held that affluence would lead to political reform and eventually democracy. It's been totally wrong so far; Saudi Arabia and its Arab neighbors along the Persian Gulf are still ruled by the same monarchies as when the first oil wells were drilled in the region in the 1930s. [2] Rentier state theory, developed in the 1980s, helped explain why. "As long as the populace received a generous share of the oil proceeds, ruling would be left to the rulers," Krane summarizes. "Avoiding taxation was key."

Things have been changing lately, though. Saudi Arabia and the United Arab Emirates both imposed 5 percent value-added taxes on goods and services last year, Bahrain joined in this year, and all the other Gulf monarchies are considering similar moves. Posing an even bigger challenge for rentier theory – and, admittedly, for the Gulf monarchies as well – are recent attempts to wean residents from the huge energy subsidies that were put in place, to some extent inadvertently, back when the oil started gushing.

It is this subsidy story that is the heart of Krane's book, and if you're interested you really should read the thing, or at least the short update published last month by the Project on Middle East Political Science. But in the meantime, how about taking a look at a few charts?

Guzzling Energy in the Gulf

Energy use in kilograms of oil equivalent per capita

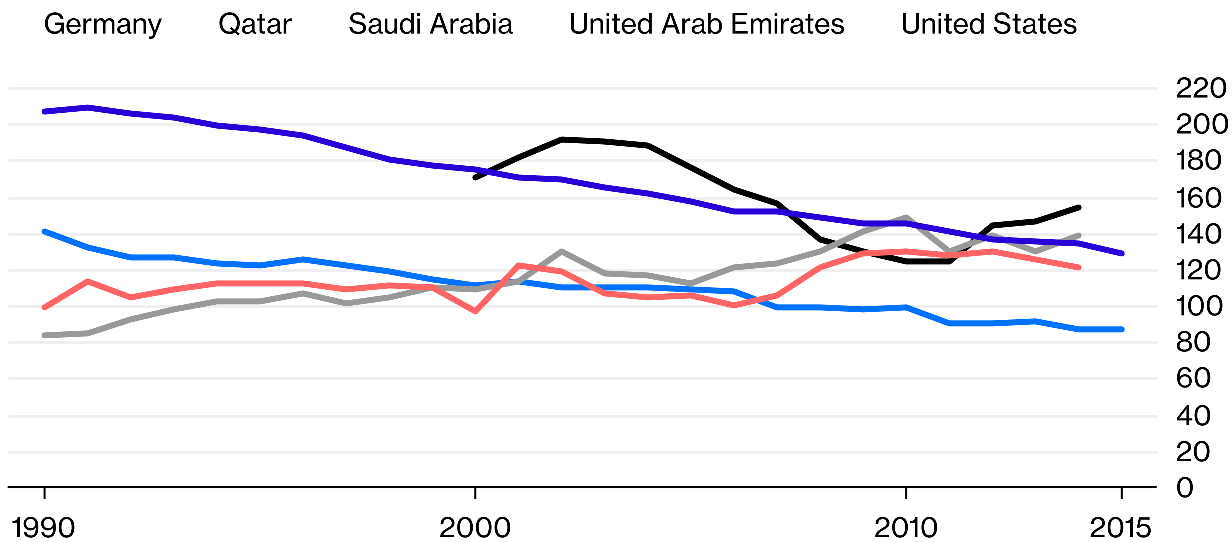


Sources: World Bank, International Energy Agency

Qatar uses almost five times as much energy per capita as Germany does. 3 Then again, U.S. per capita energy use is about the same as Saudi Arabia's – the Gulf states aren't the world's only energy guzzlers. But at least Americans' energy use isn't rising, and it helps power an economy that keeps growing more energy-efficient, in the sense that energy use per dollar of GDP has declined for decades and is continuing to do so. The same is not true for Saudi Arabia and its neighbors.

Diminishing Returns to Energy Use in the Gulf

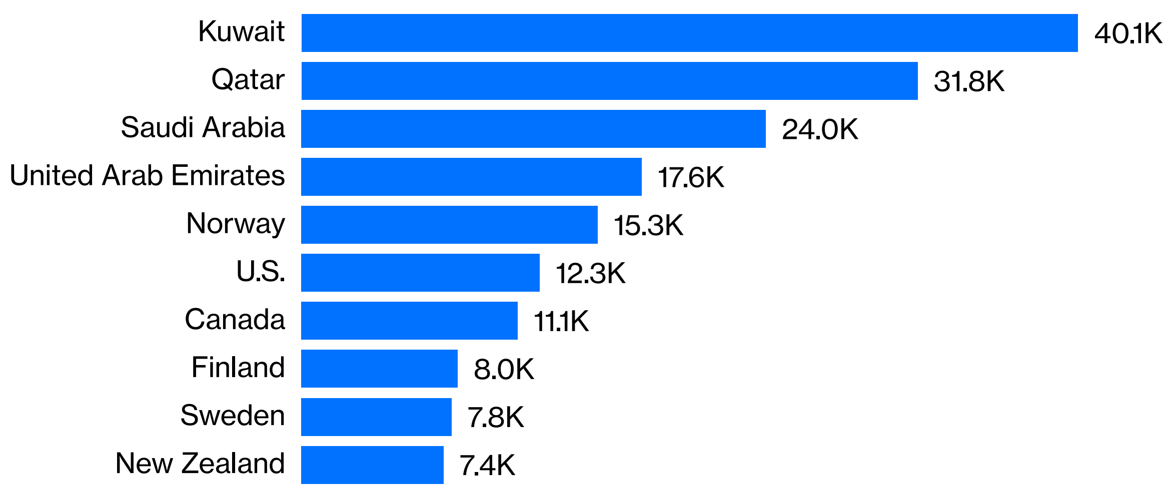
Energy use in kilograms of oil equivalent per $1,000 of gross domestic product*



Sources: World Bank, International Energy Agency
*In constant 2011 U.S. dollars adjusted for purchasing power parity.

One reason for this is that people in the Gulf kingdoms use huge amounts of energy just to stay comfortable.

Air Conditioning Is Big in the Gulf States
Average household electricity consumption, in kilowatt-hours per year



Source: World Energy Council

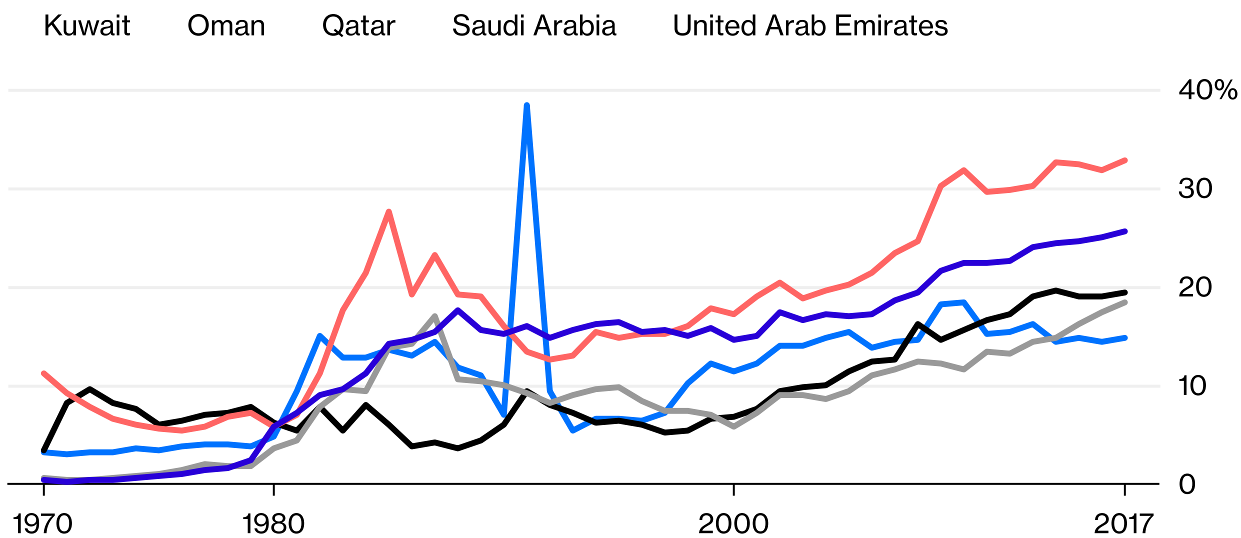
Yes, it's really hot there, but Krane found that residents of similarly hot Arizona use about half as much electricity as foreign nationals living in Abu Dhabi, the largest of the United Arab Emirates, and one-fifth as much as Abu Dhabi nationals do. Not coincidentally, Arizonans pay twice the rate per kilowatt-hour of electricity that Abu Dhabi expats do and seven times as much as Abu Dhabi nationals. Among the consequences of cheap electricity in the Gulf are uninsulated dwellings and electricity-hogging lifestyles. Desalination of water is another big consumer of electricity, and a seemingly unavoidable one, but again it's heavily subsidized, with water often free for citizens.

This electricity is generated mainly by burning natural gas, of which there's lots in the area. Western oil companies' penchant for burning off gas because it was hard for them to transport and sell it was one of the things that led the Gulf kingdoms to kick them out in the 1970s, Krane writes, and using the gas to generate power locally was smart. Underpricing that power was less smart: Kuwait and the United Arab Emirates now use so much natural gas that they have become net importers, and Kuwait has even begun importing coal.

As for the oil that made the region rich, some is used to generate electricity (mainly in Saudi Arabia, where oil accounts for just under half of generation); some powers, and is a feedstock for, industry; and lots and lots goes into the region's many large automobiles (Saudi Arabia is the fifth-biggest export market for U.S. cars and light trucks, the U.A.E. is the ninth-biggest and both ranked higher a few years ago). The share of the region's production available to be sold abroad has been shrinking for decades.

Less Oil Left Over to Export

Oil consumption as a percentage of oil production



Source: BP Statistical Review of World Energy

All of this sounds bad. It is bad. If things continue this way for much longer, it's hard to see how the Gulf states can avert an economic crisis. But attempts to normalize energy prices in countries that have long subsidized them can lead to political crisis. The rise of Hugo Chavez and his ultimately disastrous reign in Venezuela can be traced to fuel price increases implemented there in 1989. Past attempts to normalize energy prices in Saudi Arabia, in 1985 and 1999, were quickly abandoned in the face of public opposition.

In 2010, though, Iran – where the supplanting of oil exports by domestic consumption is even further along than in the Arab Gulf kingdoms – implemented a reasonably successful reduction of subsidies. President Mahmoud Ahmadinejad went on television to declare that “we’re now using four times more energy than necessary for our current standard of living,” then backed huge increases in fuel and electricity prices. But the increases were designed in a tiered fashion that kept prices low for modest users and were coupled with cash grants to all households to soften the blow. There was one big design flaw, in that new prices weren’t indexed to inflation, which in high-inflation Iran soon rolled back much of the increase, but the program did provide a template for other countries in similar predicaments to follow.

Saudi Arabia, not usually a big fan of things Iranian, did just that in 2016. It was one of the first big moves by Mohammed bin Salman, then the deputy crown prince. “The MbS plan resembled that of Ahmadinejad, except that the Saudi treasury would capture a larger portion of energy sales revenue, because cash handouts would be tilted toward the poor,” Krane writes. It was also accompanied by big increases in water prices and … a big crackdown on dissent that you may have heard something about.

The interplay of forward-looking reform and often-brutal repression has of course since come to define what I guess can be called the MBS era in Saudi Arabia, and at the moment reform is on the back foot, with further energy-subsidy rollbacks getting shoved into the future. As Krane put it in an email:

> Saudi Arabia is catching hell internationally right now, with JASTA, NOPEC, [4] the Khashoggi murder, the humanitarian catastrophe in Yemen, and now the US nuclear revelations. I doubt Saudi policymakers want to further inflame a tough situation by antagonizing citizens.

The longer it puts off action, though, the bigger the future shock in store for Saudi Arabia. That’s the quandary. And before we non-Gulf-kingdom residents get too smug about this, it’s worth considering that it may simply be a more extreme version of the quandary faced by the rest of the world in trying to reprice energy in a way that reflects the societal cost of carbon emissions. French President Emmanuel Macron recently tried to increase and rationalize fuel prices, only to back down in the face of mass opposition. This isn’t going to be easy anywhere.

1 Measured using gross domestic product based on purchasing power parity.

2 OK, I'm excluding Iraq, which is Arab, is Saudi Arabia's neighbor and has a teeny-weeny bit of Gulf frontage but generally stands apart from the oil kingdoms to its south.

3 As best I can tell, these per capita calculations count all residents, not just citizens — which makes a big difference in a place like Qatar.

4 JASTA is the Justice Against Sponsors of Terrorism Act, which expands the ability to sue foreign states for terrorist acts and became law in 2016 over President Barack Obama's veto, and NOPEC is the No Oil Producing and Exporting Cartels Act, which would allow antitrust lawsuits against the Organization of the Petroleum Exporting Countries.

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WTI Crude
55.59 USD/bbl. ▲ +0.11 +0.20%

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Generic 1st 'NG' Future
2.85 USD/MMBtu ▲ +0.01 +0.32%

RR1
Generic 1st 'RR' Future
10.62 USD/cwt ▲ +0.28 +2.71%

XW1
Generic 1st 'XW' Future
94.00 USD/MT ▲ +0.75 +0.80%