2016

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Lengthy Oil Slump Could Force Saudi Arabia's Hand on Economic Reforms (interview), World Politics Review, January 26, 2016
https://hdl.handle.net/10945/48226

Lengthy Oil Slump Could Force Saudi Arabia's Hand on Economic Reforms

The Editors | Tuesday, Jan. 26, 2016

Saudi Arabia's Minister of Petroleum and Mineral Resources Ali Ibrahim Naimi at the 10th Arab Energy Conference, Abu Dhabi, United Arab Emirates, Dec. 21, 2014 (AP photo by Kamran Jebreili).

Editor's note: This article is part of an ongoing WPR series (http://www.worldpoliticsreview.com/series/4/commodities-cycle) on the impact of falling oil and commodities prices on resource-exporting countries.

In a recent interview with The Economist (http://www.economist.com/saudi_interview), Saudi Arabia's deputy crown prince, Mohammed bin Salman, talked about the kingdom's plans to roll out a value-added tax, as well as the possibility of privatizing Aramco, the state oil company, as ways to increase non-oil revenues in the face of the drop in global energy prices. In an email interview, Robert Looney, distinguished professor in the Department of National Security Affairs at the Naval Postgraduate School, discusses the economic and political impact of the oil slump on Saudi Arabia.

WPR: What impact has the ongoing oil slump had on the Saudi budget and public spending, and what are the implications for economic and political stability?

Robert Looney: In preparing the 2016 budget, the Saudi authorities have accepted the reality that oil markets may not recover for three or four years. After running a budget deficit of $93 billion in 2015, the 2016 budget will be the first of what will likely be a series of austerity budgets. The hardest-hit areas will be defense and security, which will be cut by 30.5 percent, and health and social development, with reductions of 34.4 percent. These are targets, however, and if past experience is any indicator, they may be revised significantly upward depending on events.

A number of fiscal reforms were also introduced in the 2016 budget, including the beginning of a five-year effort to significantly reduce subsidies on fuels, electricity and water. The government is also considering ways of increasing non-oil revenues through government fees and a sales tax or possibly a value-added tax.

The 2016 budget will not set off a recession, but it is likely to bring the rate of gross domestic product growth down to 2.3 percent in 2016, from 3.0 percent in 2015 and 3.8 percent in 2014.

If the falling growth rates and reduced subsidies result in widespread discontent and public protests, the government will no doubt increase expenditures through tapping both the domestic and international bond markets. Privatization of state assets like public lands or even Aramco, the state oil company, is another option. The authorities are also likely to better target existing welfare payments to poor and middle-class Saudis who will be hit hardest by austerity and subsidy cuts.

WPR: What steps is Saudi Arabia taking to diversify its economy and reduce its dependence on oil revenues, and how effective have they been so far?

Looney: Although a goal since the 1970s, diversification has been largely confined to areas that benefited from tax breaks and low-cost energy provided by the government, such as petrochemicals, fertilizers and plastics. Little in the way of successful diversification has taken place outside these areas. Efforts in grain production were abandoned due to water depletion.

Because the energy-related industries have created few jobs for Saudis, the government has attempted to encourage further diversification by upgrading infrastructure, strengthening education and skills, improving access to finance, and improving the business environment. These have had only limited success in expanding the private sector and job creation.

WPR: What kinds of economic reforms must Saudi Arabia implement to wean the private sector off of public largesse, and what are the implications for Saudi society?

Looney: Saudi Arabia will need to transition from its current public sector-led economic model to one that is fundamentally market-based. More openness and competition are needed to force improvements in productivity and a more efficient allocation of the kingdom's resources. Foreign investment has fallen off in recent years, and reforms such as lifting restrictions on foreign ownership will be needed to attract the required amounts of capital into job-creating activities such as wholesale and retail trade, manufacturing, health care and finance.

These changes will shift the kingdom from a patrimonial to an entrepreneurial society. This will not be an easy or smooth transition and could take several generations to complete.

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