PORGMUN 2019

ADDRESSING THE IMPORTANCE OF OIL REVENUE IN MIDDLE EASTERN ECONOMIES

Forum: Arab League

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January 2018

INTRODUCTION

In the wake of the discovery of the first oil concessions at the turn of the 20th century in Iran (formerly known as Persia), a wave of exploration, extraction and exploitation has been set off, changing the region's - and the world's - history. Essentially, oil revenues became the cornerstone of the economic functioning of the majority of the Middle Eastern countries, facilitating their transformation from largely agricultural to rentier economies. Hence a blatant economic modernisation along with a notable growth in wealth in the Middle East had been stimulated.

Apart from dominating the sphere of domestic development, the discovery of vast oil deposits proved pivotal in the context of international community, as oil has frequently been a decisive factor in the determination of foreign policy. In 1960 the governments of Saudi Arabia, Kuwait, Venezuela, Iraq, and Iran established the *Organisation of the Petroleum Exporting Countries* (OPEC) for the purpose of negotiating on matters of oil prices, oil production and concession rights. Today, OPEC represents a considerable political and economical force, accounting for 82% of the oil reserves in the world. Accordingly, the Middle Eastern dependence on its vast and seemingly endless oil deposits became deep rooted and firmly implanted in the economy of the Middle Eastern countries.

This reality, however, links the indigenous resource abundance to undesirable political and economic outcomes as the 'global energy composition' is undergoing a structural transformation, prompted by decarbonisation policies and increasing ecological awareness. These changes could, and most likely will, greatly affect the world's main oil producing regions, whose macroeconomic features make them vulnerable to a shifting global energy market. Despite the long-standing recognition of the problem, some nations in the region still remain overwhelmingly reliant on hydrocarbon revenues. However, planning for a less carbon dependant future should be at the forefront of the Middle Eastern countries 'to do' list.

DEFINITION OF KEY TERMS

Middle East

A 'transcontinental region,' which, in a broad meaning, covers Ethiopia in the south, Turkey in the north, Afghanistan and Pakistan in the east to Morocco in the west. However, since the criteria to determine the boundaries of the Middle East differ considerably, it is difficult to limit the Middle East to a geographic area with hard borders.

Organization of the Petroleum Exporting Countries (OPEC)

An intergovernmental organisation formed in 1960 in Baghdad. Its founding nations are Iran, Iraq, Venezuela, Saudi Arabia and Kuwait. Algeria, Angola, Ecuador, Equatorial Guinea, Gabon, Libya, Nigeria, Republic of the Congo, and United Arab Emirates joined in the latter stages of its development. Indonesia and Qatar are former members. The mission of the OPEC is ‘’to coordinate and unify the petroleum policies of its Member Countries and ensure the stabilisation of oil markets in order to secure an efficient economic and regular supply of petroleum to consumers, a steady income to producers and a fair return on capital for those investing in petroleum industry.’’

MENA

Is an acronym referring to the Middle East and North Africa region. The term is roughly synonymous with the term Greater Middle East. Specifically, MENA includes the Levant countries (Israel, Jordan, Lebanon, Syria and Palestine), the Gulf Cooperation Council countries (Oman, Qatar, Bahrain, Oman, Kuwait, Saudi Arabia and United Arab Emirates), North African countries (Algeria, Morocco, Egypt, Tunisia, Libya), Iraq and Iran.’

The Rentier State Theory

Is an analytical framework explaining the interplay of oil, economics and politics in MENA oil producing countries. It has been first postulated by Hussein Mahdavy in 1970 in the context of future economic development in the Middle East. By definition, rentier state is a state which obtains most of its national revenues from the rent of indigenous resources to external clients. Essentially, its economy relies on a substantial external rent and thus does not necessarily require a strong domestic productive sector. Countries in the MENA region including Saudi Arabia, Kuwait, United Arab Emirates, Iran, Iraq, Algeria, etc., all of whom are also members of OPEC, are examples of producers with rentier economies. African states such as Ghana, Angola, Uganda, Nigeria and South Sudan are also earning income from the trade of natural resources and thus would be categorised into the ‘rentier’ section.

The Paris Agreement

An agreement within the United Nations Framework Convention on Climate Change (UNFCCC), which seeks ‘’to strengthen the global response to the threat of climate change by keeping a global temperature rise this century well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius.“

GENERAL OVERVIEW

Historical Background

The beginnings of the oil industry in the Middle East date back to the early years of the twentieth century, when oil had been discovered in Iran and, subsequently, in Saudi Arabia, Kuwait and Iraq. Its global importance had been immediately recognised not only by the Admiralty in London, searching for new sources of supply for its oil-powered naval ships, but also by other European capitals, leading to a brief skirmish between the Western oil companies and the oil possessing countries.

What’s more, the Middle East had been dominated by the Turkish Ottoman Empire. With the outbreak of the First World War, however, the Ottomans joined Germany and Austria-Hungary in their fight against the Allies, and suffered defeat alongside them. This led to the dissolution of the Ottoman Empire in 1921, marking a turning point in the relations between the Arab World and the West. On the basis of the Sykes-Picot Agreement, drawn during the war in 1916, the region had been divided into spheres of influence between the British and the French, which was negotiated in secret and contrary to the principles of self-determination. Accordingly, the Ottoman Empire and its defeated ally Germany lost all oil rights they might have otherwise claimed. The three victors of the war (Britain, France and the United States), on the other hand, apportioned Iraqi oil amongst themselves. Britain, as the dominant colonial power, came out with nearly a half share.

The vast Middle Eastern oil fields had, in essence, emerged as a subject of wide interest, stimulating and spurring on the competitive and rival tendencies of the external actors. During the Second World War, the control of oil remained to be a determinant of how the subsequent events unfolded. As a result of the trouble that the Great Depression had put the nations of the Persian Gulf in, a widespread search for water had been incentivised. However, instead of water, additional oil reserves had been discovered. This further stimulated the widespread demand for its exploitation, namely by American and European companies, which had been later expedited by the postwar economic boom. Even though the nations of the Middle East originally welcomed concession agreements designed by the oil companies, they soon realised that they're being exploited. Oil producing countries, led by Venezuela, hence decided to limit the supply of oil and thus gain control over its price. These countries subsequently joined together in OPEC and gradually took over oil supplies.

The process of confiscating oil production operations in the prospect of deriving more revenue from oil as a private property and assuming control over oil resources within the oil producing countries is referred to as the process of nationalisation and had been carried out by local governments. The shift in the power as the Middle East began to be aware of the significance of its position became apparent during the Suez Crisis in the 1950s.

As Middle Eastern nations realised the strength of their bargaining position due to the Western nations' growing dependency on oil, they began to renegotiate existing deals with Western oil companies for a greater share of the oil profits. In 1973, Arab producers wielded their power even further when they used their control of oil to influence the political agenda and instigated a Western oil embargo. Consequently, oil supplies became scarce and prices nearly quadrupled.

Current Situation & The Problem

Endowed with half of the world's known oil reserves, the Middle East has long been the centre of the global oil market. It controlled the world's main energy supplies and appeared to be set fair for long-term economic success. Specifically, for five regional oil exporters (Libya, Saudi Arabia, Kuwait, Iraq, Oman), more than 40% of their GDP stemmed from oil and government activities that were based on oil revenues. Along with the rest of the Middle Eastern countries, activities in non-oil and non-government sector were often also linked to oil. In fact, the primary source of fiscal and non-oil fiscal revenues were themselves mainly related to oil. '*'For instance, direct oil revenues in Qatar amount to about 67 percent of total fiscal revenue, but more than 90 percent of total fiscal revenue should be considered as oil revenue, because practically all investment income and the bulk of corporate income tax comes from Qatar Petroleum3. In Qatar, non-oil fiscal revenues only derive from corporate income tax of 10 percent levied on foreign companies, withholding tax of 5 percent to 7 percent levied on certain payments to non-residents, customs duties of 5 percent, and some fees.*"(IMF, 2015)

In the light of the macroeconomic indicators listed above, the persistently high reliance of oil exporting countries on oil rent is rather indubitable. Ever since the 1980s, the demand for oil had gradually risen, and between 2000 and 2014, prices boomed. Accordingly, diversification of the Middle Eastern oil exporters economy had been regarded as unnecessary. The evolution from rentier to production states thus hasn’t been incentivised as some oil exporters still opt for the perpetuation of rentier economies.

However, Middle East’s future in terms of oil exports might be constrained substantially as the outlook for rentiers in the region might not be as auspicious as the current large reserves and rather strong prices imply. It is the environmental damage accompanying the exploitation process of the Middle Eastern oil reserves that calls for the implementation of decarbonisation policies and innovation in low-carbon technology. What’s more, by signing the Paris Agreement dealing with greenhouse gas emissions mitigation and planning to limit global warming ‘well below’ 2°C (covering the period from 2020 onwards), the Arab world has indicated a level of commitment in terms of reducing the GHC emissions.

As a result, MENA exporters should implement economic diversification strategies as a structural path and function in compliance with this trajectory in order to achieve the objectives of the Paris Agreement on the climate change and thus to ensure both political stability and socio-economic prosperity. On the other hand, sticking to the promises made in Paris and thus conducting a rather aggressive decarbonisation of the global economy could be dramatic for the societies and economies of the MENA region.

Projections, Possible Scenarios

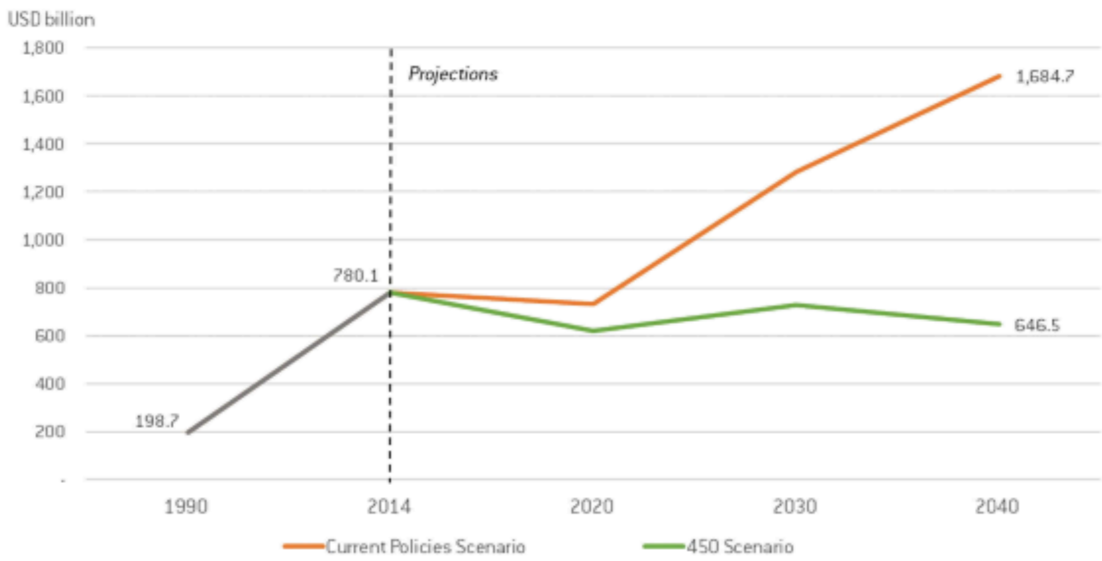
The International Energy Agency (IEA) developed two projections, assessing possible future scenarios.

1. If we assume no alterations to the current energy policies will occur, the IEA expects global oil demand to increase gradually. Rising demand would then, rather unsurprisingly, result in an increase of MENA oil exports.

2. In case of the adoption of the so-called ‘450 scenario’ that is consistent with having a 50% chance of limiting the global temperature to less that 2 degrees Celsius and thus is in accordance with the Paris Agreement goal, the IEA expects global oil demand to sharply fall after 2020. However, despite the falling global demand, the IEA predicts stable MENA exports, as MENA oil is eminently competitive on the global market. Accordingly, in terms of export volumes,

MENA oil exporters appear to be relatively resilient to weaknesses in global demand triggered by decarbonisation. However, revenues depend on both volumes and prices. And it is the aspect of oil prices that seems to be the most worrying. This means that even if Middle Eastern oil export volumes would not succumb to instability over the next three decades, oil revenues would decline by 2040 due to the lower oil prices.

Figure 10: *Middle East forecasted oil revenues, IEA scenarios (real prices)*



Source: Bruegel based on International Energy Agency (2016).

MAJOR PARTIES INVOLVED

OPEC

As an international organisation composed of 14 countries accounting for an estimated 44% of global oil production and 73% of the world's oil reserves, OPEC plays a crucial role in terms of the Middle Eastern oil industry.

First and foremost, OPEC is in favour of the decarbonisation policies, acknowledging the importance of environmental protection. As the OPEC Secretary General Mohammad Barkindo stated: ''*Let me stress that OPEC is greatly supportive of the development of renewables. Many of our countries have vast sources of solar and wind, and significant investments are being made in these fields.''*

The organisation thus signed the Paris Agreement, stating that the world can expect to see ''further shift'' towards renewables in the coming decades. What's more, the Middle East dominated group repeatedly stated that with oil prices falling again, it considers the possibility of tightening in output.

Saudi Arabia

According to the human development report by UNDP, Saudi Arabia is amongst the world's top three crude oil producers, a leader in OPEC's production quotas decisions and, in fact, the most active member of OPEC. However, since Saudi Arabia still remains to be highly dependant on oil revenues, the government's budget is, accordingly, highly vulnerable to oil price volatility. This reality explains Saudi Arabia's motives for seconding the limitation of output by as much as 500,000 barrels per day (December, 2018).

While one of Saudi Arabia's key objectives is the maximisation of revenues, it also aims at the maintenance of volumes above a certain level and avoidance of the loss of market share. Considering Saudi Arabia's trade-offs are, to an extent, impacted by market conditions, future development within OPEC and internal conditions of the country, its oil policy is not 'constant' and the aforementioned factors are being projected in its overall functioning.

United States Of America

With a long-standing national interest in petroleum affairs, the United States of America emerged as the world's biggest oil producer. Accordingly, its relevance in terms of oil revenues is rather indisputable.

On June 1, 2017, the United States withdrew from the Paris Agreement. Considering that the process of withdrawal can only begin the day after the 2020 U.S. presidential elections, the United States are, for the duration of its 'official membership', obligated to maintain its commitments under the Agreement.

Generally, the American strategy is based on a resolve to assure the flow of oil to the West at reasonable prices. This approach includes the reduction of momentary interruptions in oil supply and fluctuations in pricing by relying on oil producing states with excess capacity.

European Union

The oil exporters that make up the Organisation of Petroleum Exporting Countries account for EU's 40% total crude oil imports (Saudi Arabia, Nigeria and Libya being the biggest individual suppliers). Hence it actively communicates with these countries (to mitigate disruptions to oil supply).

TIMELINE OF KEY EVENTS

- **1859 –** discovery of the first commercially viable oil in the USA
- **May 26, 1908 –** Oil discovered in Persia
- **March 11, 1910 –** Oil found in Egypt
- **1916** – Sykes-Picot Agreement
- **1921** – dissolution of the Ottoman Empire
- **June 27, 1927 –** Oil discovered in Iraq
- **May 19, 1933** – California-Arabian Standard Oil Company formed (gained rights for the exploration of Saudi Arabia at the prospect of searching for oil deposits)
- **July 2, 1951 –** largest oil deposit found (Ghawar Field in Saudi Arabia)
- **29 October 1956 – 7 November 1956** – Suez Crisis
- **September 1960** – formation of OPEC
- **November 19, 1973** – OPEC imposed a ban on petroleum exports to the USA and to other countries that supported the state of Israel during the Arab-Israeli conflict
- **January 25, 1978 –** Iranian Revolution (high oil prices)
- **September 22, 1980** - outbreak of the Iraq-Iran war (struck Kirkuk's and Tehran's oil refinery)
- **August 2, 1990** – The Gulf War
- **1998** – America's oil 'fracking' revolution
- **December 2015** – The Paris Agreement

PREVIOUS ATTEMPTS TO SOLVE THE ISSUE

The issue of the so-called ''oil addiction'' amongst the countries of the Middle East has been generally recognised as pressing and prominent. In fact, the need for economic diversification plans and decarbonisation policies has been a part of MENA oil exporter's rhetoric for a long time. Kuwait's government, for instance, has been already proposing the idea of economic diversification during the 1950s. Yet still, after nearly 70 years, oil remains to embody more than 60% of Kuwait's GDP, representing more than 70% of its fiscal revenues. The fact that oil exporters often contemplate such strategies in times of low oil prices, and once the prices recover, they opt for its immediate dismissal, lies at the core of the problem as a whole.

A major leap forward in terms of the extensive efforts to address the issue of the environmental protection, specifically global warming, has been the quick entry into force of the Paris Agreement in December 2015. The adoption of the Paris climate accord marked the first time when both developed and developing countries committed to act in order to preserve the environment.

At the prospect of boosting non-hydrocarbon exports from less than 5 per cent to 9 per cent of total exports by 2019, Algeria launched the *New Economic Growth Model* strategy (2016). Furthermore, Oman's *Ninth Five Year Development plan* and Saudi Arabia's *Vision 2030*, both implemented in 2016, had been also designed with the aim of achieving a certain form economic diversification. In case of Oman, reduction of oil in GDP from 44% to 26% and the activation of the public-private partnership is what forms its proposed policy. Saudi Arabia, on the other hand, is planning to generate 9.5 GW of new renewable energy as well as increase foreign direct investment from 3.8% to 5.7% of GDP.

Moreover, Iraq and Kuwait also instituted their development policies, which are recognisable under the terms *Private Sector Development Strategy* (Iraq) and *Kuwait Development Plan*, both of which focus on the expansion of the private sector. Kuwait then further proposed the 'creation of public-private partnership to carry out infrastructure projects.' Not to forget, Qatar also articulates hydrocarbon policies in its *National Vision 2030* plan (2008); *''Managing the optimum exploitation of hydrocarbon resources, expanding industries and services with competitive advantages derived from hydrocarbon industries...''* Considering that all of the aforementioned policies have been implemented rather recently, with the earliest, *National Vision 2030,* being launched in 2008, its effectiveness can't be yet fully evaluated.

QUESTIONS A RESOLUTION SHOULD ANSWER

- What transformative policies and economic strategies should MENA countries undertake in order to diversify away from oil? How to manage the persistent over-reliance of MENA oil exporting countries on its oil rent?

- Should MENA oil exporters pursue structural processes of diversification from rentier to production states? If so, what is the adequate approach?

- Should Middle Eastern countries pursue the decarbonisation pathway agreed in Paris?

- What has to be done in order to function in accordance with the Paris Agreement and be capable of abiding by its quotas without deviation?

APPENDIX

The Paris Agreement (official document) available at: https://unfccc.int/sites/default/files/english_paris_agreement.pdf

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