Cheap Oil's Silver Lining for the Gulf: Project Syndicate Op-ed, 22 Apr 2016

In June 2014, a barrel of Brent crude – the main benchmark of the international oil market – sold for $115. Today, less than two years later, the price is $45 – or even less. Not surprisingly, that collapse has been a massive shock to Saudi Arabia and the Gulf oil sheikhdoms, which rely on oil for some 85% of their revenues. And what they need to realize is that, unlike past price declines, this one will not be transitory.

This "new normal" for oil reflects new realities: China's economic growth – and so its demand for oil – is bound to be lower; the world's energy efficiency will increase, not least because of commitments made in December at the Paris conference on climate change; and disruptive innovation is making shale oil and gas, along with renewable energy sources, far more competitive. With the return of Iran, Libya, and Iraq as major oil exporters, low oil prices must surely be both inevitable and enduring.

Saudi Arabia and the other Gulf states should not let this crisis go to waste. They now have a perfect opportunity finally to undertake comprehensive economic reforms.

Their aim should be a new development model that frees them from dependence on hydrocarbons. The fiscal buffers from past oil revenues can provide the six countries of the Gulf Cooperation Council (GCC) with short-term relief. But they must use that window to launch the structural reforms needed to achieve sustainable economic growth, macroeconomic stability, and the sound and equitable exploitation of their oil and gas reserves.

That means economic diversification, which can be achieved only by reducing the size of government and removing the obstacles that stymie the private sector. A radical reform of the Kafala system, which monitors and regulates migrant labor, would remove a major barrier to labor mobility. But governments must also introduce the legal and regulatory frameworks needed for privatization and public-private partnerships (PPPs). Sadly, only Kuwait and Dubai have so far moved to allow PPPs, while only Saudi Arabia intends to privatize airports (Jeddah and Dammam).

Privatization and PPPs in infrastructure, energy, health, education, transport, and logistics could attract massive domestic and foreign investment. So, too, would legislation to allow full ownership of enterprises by foreigners and the proper protection of their property rights – which would have the added benefit of encouraging expatriates to save and invest locally. Dubai's free-trade zones are a testament to the success that comes with liberalization and the removal of barriers to foreign ownership and management.

Fiscal reform must also be a high priority. Wasteful government expenditures and subsidies account for some 8% of non-oil GDP (5% of total GDP) in the GCC states. Energy subsidies – so ingrained in the GCC economies – distort consumption and production patterns; defeat government attempts at economic diversification; and increase vulnerability to volatile international energy prices. Eliminating the subsidies would not only stimulate investment in energy efficiency and solar power, but would also generate substantial environmental and public-health benefits.

Similarly, if the region's governments were to introduce efficient, equitable pricing of public services and utilities – including water, electricity, and transport – they would create fiscal room to promote job creation with schemes linking education and employment. Instead of government spending crowding out the private sector, there could be development spending to "crowd in" the private sector.

The other imperative is to diversify government revenue. The prevailing tax regime across the Gulf is not fit for purpose, has limited ability to influence private-sector behavior, and rules out counter-cyclical fiscal policy. From 2012 to 2014, the GCC's non-oil tax revenues averaged only about 1.6% of GDP.

As a first step, the GCC states are moving toward new tax regimes in early 2018, including a value-added tax, a corporation tax, property taxes, and taxes on fuel, tobacco, and alcohol. At 5%, the VAT could raise a modest 1.5-2% of GDP in revenue.

But why not go further? A $0.52 carbon tax per liter could raise over $50 billion annually for Saudi Arabia, substantially reducing this year's projected budget deficit of $90 billion.

As a third step, the GCC countries should issue debt and *sukuk* (Sharia-compliant bonds) to finance budget deficits as well as development projects and infrastructure investment. The GCC countries have low levels of government debt and can run moderate budget deficits without jeopardizing fiscal sustainability. But developing their financial markets would allow the private sector to tap the GCC's plentiful financial resources invested outside the Gulf.

Finally, the GCC needs to favor greater exchange-rate flexibility and monetary independence. Traditionally, its governments have pursued expansionary policies during economic booms and tightened their belts in downturns. Pegging their currencies to the US dollar has aggravated this pro-cyclical pattern. While the peg gives GCC currencies credibility, it has prevented real depreciation and fails to reflect the deep structural changes in GCC members' economic and financial links over the past three decades – particularly the shift away from the United States and Europe and toward China and Asia.

Instead, the GCC countries should peg their currencies to a basket comprising the dollar, the euro, the yen, and the renminbi. If the basket also included oil, GCC currencies could depreciate in line with a falling price – and rise if and when it recovers.

The bottom line is that economic diversification – so long preached rather than implemented – is now a necessity for the Gulf’s oil states. As the cliché has it, necessity is the mother of invention. The GCC should embrace it.

[This article originally appeared on Project Syndicate on 22 Apr, 2016 and has been reprinted in multiple newspapers/ magazines afterwards]