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Despite Output Freeze, Oil States Will Face People's Wrath

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On Tuesday, February 16 the governments of Saudi Arabia, Russia, Qatar, and Venezuela agreed to freeze their oil production at "near record" levels. If the deal holds, this will mean that the price of oil will continue its current downward trend for the foreseeable future.

It is also a signal that low prices won't rebound any time soon. This can have serious political implications, even if its value is muted by the fact that production has been flat in these countries.

Simply put, if oil does not recover, many countries will face serious financial hardship. At current prices, no OPEC country could balance their budget. The Saudi government has cut politically popular subsidies and considered an initial public offering for shares in its state oil company, Aramco.

Ecuador is pumping oil at a loss at current prices. Venezuela's hardships have been well documented by others here at the *PanAm Post*. Oil-dependent US states like Alaska, North Dakota, and Oklahoma have seen budget shortfalls as revenues from new shale oil drilling have dropped.

Unlike their nation-level counterparts, states must balance their budgets, which means a choice between budget cuts and tax increases. Both face popular opposition. Resource-dependent governments simply do not plan for prolonged periods of low prices.

Some may argue that any deal between oil-rich countries on production levels cannot matter, because countries will cheat on any deal. And indeed they will. Oil experts, in their academic histories of petroleum, have documented cheating on almost every oil production deal in recent history.

But it doesn't matter. If anything, cheating puts downward pressure on prices, not upward. A country that cuts production without cooperating with others would lose market share without raising the price. This is the economic equivalent of shooting oneself in the foot.

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The economic history of Latin America is replete with stories of countries dependent on a single resource suffering dearly when prices drop. Politicians rarely put the excess money during good years into reserves to spend when prices get low.

This dynamic persists across different resources, from Oklahoman oil to Brazilian coffee to Dominican sugar. With their high variance, taxes on such commodities are not reliable revenue streams that can be tapped in both good and bad years. If a country or state relies too much on them, they will face budgetary nightmares at some point.

While prices remain high, windfalls burn holes in the pockets of those with the power to redistribute tax revenue. In a sense, natural resources make a country feel more wealthy than it really is.

When people see an industry boom, they pressure the government to commandeer a portion of the profits for public use, which can hurt the long term health of the industry and the prosperity that it can bring to a country.

Indeed, famed economist Richard Gordon found no windfall profits whatsoever in mineral extraction when one accounts for failed investments. With no windfall to redistribute, today's oil states face painful choices about which cuts to make, or whether it's worth mortgaging future oil revenues to pay for current spending.

The Saudi-Russian agreement is a sign that we face a period where oil states that chose to spend profits while prices were high will need to make tough, unpopular choices. Subsidies for basic commodities like food and fuel will need to be cut. These are subsidies, however, that can make the difference between scraping by and living in misery for many of the world's poor.

There will be a political backlash against cuts. In some corner of the world, thousands will take to the streets. Governments already struggling to maintain stability will face further hardship without having any goodies to hand out in exchange for support. And all of this comes because of past decisions to misspend resource revenues.