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Subsidy Reform in the Middle East and North Africa: A Summary of Recent Progress and Challenges Ahead

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Subsidies—especially on energy products—are widely used across the Middle East and North Africa (MENA) and their cost has been rising in response to recent commodity price increases and greater social demands, often contributing to a widening of current and fiscal deficits. As a result, subsidy reform has gained a new momentum in the region, mainly in oil-importing countries but also in some oil exporters. This paper draws from reform experiences in MENA, as well as in the rest of the world over the last two decades. To ensure sustained progress, MENA countries that have started reforming subsidies need to complete the scaling-up of social safety nets, implement automatic price-setting mechanisms, and restructure the energy sector. Countries that have not yet undertaken reform should start laying the groundwork for it, notably by raising transparency and awareness about the cost of subsidies and preparing the infrastructure for social safety nets.

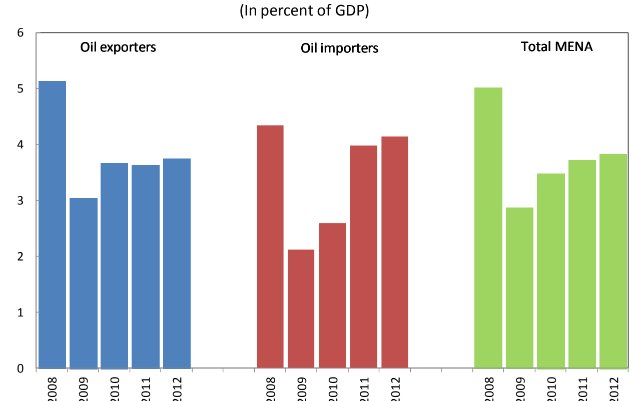
Subsidies in MENA: Pervasive, Costly, Ineffective

Subsidies play a special role in the MENA, where for decades, generalized price subsidies have been part of the "social contract." They often take the place of cash transfers and other forms of direct income support, which are not widely used. Social safety nets (excluding subsidies) are not well developed and generally underfunded, representing on average less than 0.7 percent of GDP in public spending. As a result, governments in MENA tend to cope with shocks by scaling up subsidies or increasing public sector employment and wages, as they have done in response to the greater social demands that have accompanied the wave of political transitions across the region. In many oil-exporting countries, low energy prices are regarded as a reflection of the low extraction cost, which is not perceived as a cost to the budget. In some countries, the sense of entitlement is deeply rooted and low energy prices are considered a right of citizenship and a key element of legitimacy, which substitutes for political participation.

The cost of subsidies in MENA is very large. Relative to other regions, spending on subsidies—estimated on the basis of the gap between international and domestic prices—is, on average, much higher—a burden that is increasingly difficult to carry. Energy subsidies represented the largest part. Pre-tax energy subsidies in 2011 cost $236.5 billion, equivalent to 48 percent of world subsidies (8.6 percent of regional GDP). They amounted to $204 billion (8.4 percent of GDP) in oil exporters and $33 billion (6.3 percent of GDP) in oil importers. For 2012, the available estimates for diesel and gasoline show that pre-tax subsidies on these products, which alone represent about half of total energy subsidies in MENA, were 3.8 percent of regional GDP (Figure 1). Food subsidies are also common, though much less costly, at about $22 billion or 0.7 percent of GDP in 2011.

Subsidies are intended to achieve several objectives. Given underdeveloped social safety nets, governments in MENA rely excessively on generalized subsidies to support real incomes and fight poverty through affordable prices on widely consumed products, and to shield the population from shocks caused by large swings in commodity prices and exchange rate fluctuations, particularly in oil-importing countries. In oil-producing countries, subsidies are also the instrument for sharing natural resource wealth among the population. In many MENA countries, governments assist certain industries and support employment in the private sector by means of producer subsidies, such as below market-price energy inputs.

Figure 1. MENA: Total Pre-Tax Subsidies on Diesel and Gasoline, 2008-12
(In percent of GDP)

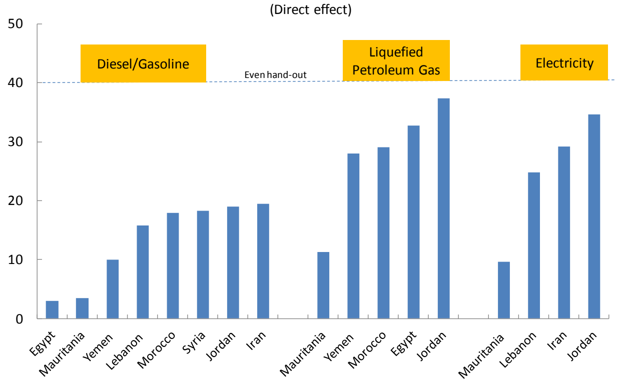


Sources: National authorities; and IMF staff calculations.

However, subsidies are often ineffective and biased against the poor. Generalized price subsidies—the most common form in MENA countries—are neither well targeted nor cost-effective as a social protection tool. Though they may reach the poor to some extent, they benefit mostly the better off, who consume more of the subsidized goods, particularly energy products: in 2008, in Egypt, the poorest 40 percent of the population received only 3 percent of gasoline subsidies (Figure 2).

Moreover, subsidies—especially those on energy products—impose welfare costs by distorting relative prices in the economy, which fosters overconsumption and resource misallocation. This, in turn, reduces exportable resources and thus limits wealth accumulation for energy-exporting countries, and weakens the current account of energy-importing countries. In addition, overconsumption leads to adverse impacts on traffic congestion, health, and the environment, and to inefficient specialization of domestic production, often in less labor and high energy-intensive industries.

Figure 2. Share of Energy Subsidies Benefiting the Bottom Forty Percent of the Population [1/]
(Direct effect)

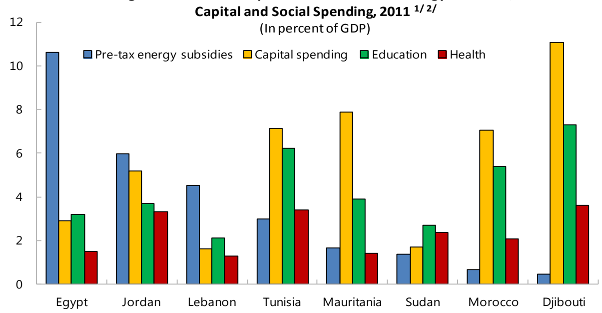


Sources: IMF and World Bank reports; Djavad Salehi-Isfahani, Bryce Wilson Stucki, and Joshua Deutschmann, *The Impact of Iran's Subsidy Reform on Households: Evidence from Survey Data*, 2013; and IMF staff calculations.
[1/] Based on household survey data conducted between 2003-09.

Subsidies also discourage investment in the energy sector, and encourage smuggling and black market activity, which can lead to shortages of subsidized products.

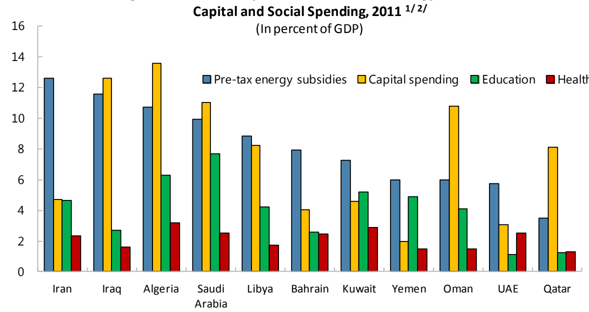
Finally, subsidies hurt growth. Although they can be used to provide short-term support to the productive sector, in the long run subsidies have a dampening effect on growth potential, through price distortions, under-investment in labor-intensive and energy-efficient sectors, crowding out of productive spending on human and physical capital, and higher inequality linked to inefficient support of the poor (Figures 3–4).

Figure 3. MENA Oil Importers: Total Pre-Tax Energy Subsidies, Capital and Social Spending, 2011 [1/ 2/]
(In percent of GDP)



Sources: Benedict Clements, David Coady, Stefania Fabrizio, Sanjeev Gupta, Trevor Alleyne, and Carlo Sdralevich, *Energy Subsidy Reform: Lessons and Implications*, 2013; IMF, *Middle East and Central Asia Regional Economic Outlook*; and World Bank World Development Indicators.
[1/] Includes petroleum, electricity, and natural gas subsidies.
[2/] Education and health refer to data ranging between 2007-2011.

Figure 4. MENA Oil Exporters: Total Pre-Tax Energy Subsidies, Capital and Social Spending, 2011 [1/ 2/]
(In percent of GDP)



Sources: Benedict Clements, David Coady, Stefania Fabrizio, Sanjeev Gupta, Trevor Alleyne, and Carlo Sdralevich, *Energy Subsidy Reform: Lessons and Implications*, 2013; IMF, *Middle East and Central Asia Regional Economic Outlook*; and World Bank World Development Indicators.
[1/] Includes petroleum, electricity, and natural gas subsidies.
[2/] Education and health refer to data ranging between 2007-2011.

Recent Reform in MENA Is Encouraging

Fiscal pressures have triggered a wave of reform, mostly in oil importers. Since 2011, most progress in reforming subsidies has been made by Egypt, Jordan, Mauritania, Morocco, Sudan, Tunisia, and Yemen (Annex). Reforms have focused on raising fuel prices and electricity tariffs, while food subsidy reform has received less attention, reflecting the relatively small fiscal cost of these subsidies and their high social sensitivity. While countries' experiences have common features, they differ in terms of preparation, breadth of reform, and pace of adjustment:

- Reform in most countries was in general based on well-prepared plans, which were part of a wider fiscal consolidation strategy, and in some cases was supported by public communication campaigns;
- Some of the countries that increased prices sharply saw these gains wiped out by high international oil prices and exchange rate depreciations. In contrast, Jordan, Mauritania, Morocco, and Tunisia adopted a price adjustment mechanism to bring domestic fuel prices up to international levels.
- Reform was accompanied by some compensation, either the introduction or strengthening of targeted mitigating measures such as cash transfers, or less effective measures such as public sector wage increase; and
- In all these countries, the IMF supported subsidy reform through policy advice and technical assistance.

Though more limited, there was also progress in oil exporters. Since fiscal pressures are currently less evident in many oil-exporting countries there is not yet a sense of urgency for subsidy reform, but it is increasingly being considered. In 2010, Iran launched a comprehensive subsidy reform, which is still under way. In the same year, Saudi Arabia increased the average price of electricity for non-household users. More recently, Bahrain, Dubai, and Qatar have started raising fuel and electricity prices in an effort to ease the burden on the budget and address economic distortions, while Kuwait is planning to eliminate diesel subsidies.

Recent experience also shows that the push for reform in MENA must still overcome many obstacles. The special role played by subsidies constitutes an important one, but there are more. Though beneficial to growth in the long term, the removal of subsidies will, in the short term, have inflationary effects and adversely affect the competitiveness of industries that rely on subsidized products and services as inputs. In most oil exporters, the sheer size of subsidy programs makes them particularly difficult to reform. Political stability concerns also play an important role, because many governments see subsidy reform as a potential source of unrest, particularly in the current context. Moreover, for some large oil exporters, such as Libya and Iraq, political instability and lack of security make it very difficult to start a subsidy reform program.

Political economy factors pose perhaps the biggest challenges. Obstacles can take the form of resistance on the part of a small but organized group of potential losers from reform; the lag between the immediate loss of subsidies and the future benefit from more targeted and efficient social spending; and the lack of trust in the state's capacity to introduce and manage social safety nets while not misusing the savings. These areas of resistance can be addressed through appropriate reform design, including building an objective case for reform; increasing transparency and leveraging communication campaigns; creating coalitions of beneficiaries from reforms; and embedding subsidy reform in a wider reform plan.

Much Remains to Be Done

The recent reforms need to be consolidated. The paper conducts a cross-country analysis on 25 reform episodes across the world to identify success factors, and then maps these against recent reform episodes in MENA (Box and Table 1). For governments in countries that have started reform, this exercise offers some pointers for building on progress already achieved, by:

- Completing the scaling-up of well-targeted social safety nets;
- Setting a clear timeline for raising domestic prices gradually to international levels;
- Depoliticizing the pricing by introducing, or implementing more rigorously, automatic price-setting mechanisms—possibly coupled with smoothing features; and
- Tackling subsidies in the energy sector (which may require restructuring of the sector) that result in losses to state-owned electricity companies.

Elements of Successful Subsidy Reform

There is no single recipe for success in subsidy reform, and governments should tailor reform strategies to their individual country situations; however, the paper identifies a number of factors that have often accompanied successful episodes:

✓ Thorough preparation, including careful planning of the pace and breadth of reform, with technical assistance from international stakeholders;

✓ Strong commitment of the government to reform, which can be achieved by building pro-reform consensus, through communication and coalition building;

✓ Introduction or scaling-up of effective social safety nets to mitigate the impact of subsidy reform on the vulnerable;

✓ Favorable economic conditions, particularly relatively high economic growth; and

✓ A multiparty government that builds consensus for reform among different parties.

In those countries that have not yet started reform, there are measures that can be taken to prepare the ground for future action. In particular, governments can improve transparency as to subsidy costs and beneficiaries, and gather data and information on household consumption and poverty that will help establish or improve social safety nets. Past reform cases have shown that the preparation, consensus building, and implementation of well-designed subsidy reforms take several years. Thus, governments should start acting now to give themselves the chance of building a long-lasting and durable reform.

Table 1. Implementation Status of Most Recent Subsidy Reforms in MENA Based on Key Factors for Success

	Preparation	Gradual Pace of Adjustment	Breadth of Reform	Consensus Building and Communications Strategy	Role of Partners	Mitigating Measures
Egypt	✓				✓	✓
Jordan	✓	✓	✓	✓	✓	✓
Mauritania	✓	✓	✓		✓	✓
Morocco	✓	✓	✓	✓	✓	✓
Sudan					✓	✓
Tunisia	✓	✓	✓	✓	✓	✓
Yemen	✓				✓	✓

Source: IMF staff reports for Article IV Consultations.

For all countries, addressing the social impact of reform is key. Particularly in Egypt, Jordan, Libya, Morocco, Tunisia, and Yemen, where political transitions are underway, policymakers and international stakeholders must move carefully and choose the reform mix and sequencing that strikes the right balance between fiscal and efficiency returns and the mitigating measures. This may mean, for example, starting with price increases that have less impact on the poor and proceeding at a later stage with the phasing out of the socially sensitive food subsidy. Good timing in the scaling-up of existing social safety nets or introducing well-targeted mitigating measures is therefore crucial.

For more information, see *Subsidy Reform in the Middle East and North Africa: Recent Progress and Challenges Ahead*, available in July 2014, at http://www.imf.org/external/ns/cs.aspx?id=276.

Subsidy Reform in MENA:
Recent Progress and Challenges Ahead
Most Recent Subsidy Reforms in MENA

Table 1. Oil Importers

Country	Recent Measures	Main Mitigating Measures	Next Steps
Egypt	2012–13: prices for 95 octane gasoline increased by 112 percent for high-end vehicles; fuel oil for non-energy-intensive industries by 33 percent and for energy-intensive industries by 50 percent. January 2013: electricity prices to households increased by 16 percent on average, natural gas and fuel oil prices for electricity generation rose by one-third. July 2014: fuel and natural gas prices increased by 40-80 percent; electricity tariffs increased by 10-50 percent.	Electricity tariffs unchanged for the lowest consumption bracket. Some additional social expenditure envisaged in the budget for the fiscal year 2014/15 to cover a higher number of beneficiaries of social security pensions.	Introduce further price increases with the aim of eliminating subsidies in five years. Finalize the distribution of smartcards. Expand priority social programs and targeted cash transfer.
Jordan	June 2012: electricity tariffs increased for selected sectors (banks, telecommunications, hotels, mining) and large domestic corporations and households. November 2012: elimination of fuel subsidies. January 2013: monthly fuel price adjustment mechanism resumed. August 2013 and January 2014: electricity tariffs increased by 7.5–15 percent for selected consumers. January 2015: electricity tariffs increased by up to 15 percent for selected consumers. In February 2015, the authorities repealed half of the 2015 electricity tariff increase.	Cash transfers to families below a certain income threshold (70 percent of the population) if oil prices are above $100.	Gradually increase electricity tariffs, diversify energy import mix and develop new energy sources with lower generation costs.
Mauritania	May 2012: new automatic diesel price formula introduced, bringing domestic fuel prices up to international levels. January 2012: electricity tariffs increased for the service sector. August 2014: gas prices increased—ranging from 15 to 50 percent. Another price hike is expected end-2014 to remove the gas subsidy	Gradual reorientation of social safety nets toward well-targeted cash transfer schemes, but progress has been very slow.	Ensure diesel pricing formula is applied automatically. Eliminate electricity subsidy. Develop a nationwide cash transfer program that includes strengthening public sector governance in emergency response.
Morocco	June 2012: diesel prices increased by 14 percent, gasoline by 20 percent, and industrial fuel by 27 percent. September 2013: started implementation of a partial indexation mechanism of certain petroleum products. As a result, diesel prices increased by 8.5 percent, gasoline by 4.8 percent, and fuel by 14.2 percent. February 2014: gasoline and industrial fuel (excluding fuel used for electricity generation) subsidies eliminated, their prices are reviewed twice a month. June 2014: removal of subsidies on industrial fuel used for electricity generation. February, April, and July 2014: the per-unit subsidy of diesel was reduced. January 2015: subsidy of diesel completely eliminated.	Gradual strengthening of the existing social safety nets and their targeting to vulnerable groups through improvements in education, health, and assistance to poor widows and the disabled. Supporting public transport. Direct transfers to electricity company to last four years while measures are taken to ensure the financial viability of the company.	Continue implementing the comprehensive subsidy reform (remaining products are butane gas as well as sugar and flour) combined with cash transfers and other social assistance programs.
Sudan	June 2012: gasoline, diesel, and liquefied petroleum gas prices increased by 47 percent, 23 percent, and 15 percent, respectively; jet fuel liberalized. September 2013: diesel prices increased by 74.7 percent, gasoline by 68.0 percent, and liquefied petroleum gas by 66.7 percent.	Public sector wage increase of about SDG100; a monthly grant allocation of SDG150 for about 500,000 urban poor families (end-2014 target); lower health insurance premium for about 500,000 poor families; and an exemption of school and transportation fees for disabled people.	Gradually phase out the remaining subsidies on petroleum products and other staples while strengthening the social safety net through higher social spending and a more coherent and better targeted social net.
Tunisia	September 2012: gasoline and diesel prices and electricity tariffs increased by 7 percent, on average. March 2013: further 7–8 percent price increase, on average for the same products. January 2014: energy subsidies to cement companies were reduced by half and then eliminated in June 2014. Electricity tariff and natural gas prices increased for medium and low-voltage consumers with a 10 percent rate hike in January 2014 and May 2014. July 2014: gasoline prices increased by 6.4 percent and diesel prices by about 7 percent.	Introduction of an additional lifeline electricity tariff for households consuming less than 100 kwh per month. Creation of a new social housing program for needy families. Increase of income tax deduction for the poorest households. Increase and expansion of the cash transfers program for poor families.	Gradually phase out energy subsidies by increasing electricity tariffs and fuel prices. Continue expanding and improving the targeted household support strategy. Operationalize the unified registry system for vulnerable households.
Yemen	2011–12: gasoline prices increased by 66 percent and diesel and kerosene prices doubled. 2013: diesel price unified across users, including the electricity sector. June 2014: private sector companies allowed to directly import diesel for their own use at international prices. July-September 2014: The prices of diesel and gasoline increased by 50 percent and 20 percent, respectively. These are net increases after the partial reversal of a larger adjustment introduced in July.	Increase in the Social Welfare Fund transfers to the poor by 50 percent in December 2014. Coverage of the Social Welfare Fund (SWF) was expanded to 500,000 additional families.	Adopt a fuel pricing mechanism that would allow domestic prices to move in response to increases in international prices. This will help reduce further energy subsidies. Strengthen support through an expansion of the SWF. Increase in infrastructure investment.

Table 2. Oil Exporters

Country	Recent Measures	Main Mitigating Measures	Next Steps
Kuwait	In Jan-15, government raised diesel and kerosene prices (+50%) and instituted monthly price review mechanism.	n/a	n/a
Qatar	Diesel prices up in May-14 by 50%. Starting to improve desalination technologies and awareness of sustainable energy use.	n/a	n/a
United Arab Emirates (UAE)	Gasoline price highest in GCC (still below international levels). Abu Dhabi increased water (+170%) and electricity (+40%) tariffs in Jan-15.	n/a	n/a