Reforming Energy Subsidies: The Iran Model

HAMID TABATABAI traces the Iranian subsidy reform experience since 2010

A Radical Reform

Removing fuel subsidies is a tricky business. Many governments try and fail, often having to backtrack in the face of public protest or political opposition. Bolivia and Nigeria are only the latest examples. Price increases do not have to be huge to provoke opposition. Iran had that experience a few years ago when a government-decreed 20 percent increase was rolled back after a year by a parliament dominated by a rival political current. It is all the more remarkable, therefore, that in December 2010 Iran itself managed to put in place one of the most radical fuel subsidy reforms ever attempted anywhere and make it stick. Prices of various fuels and related products (electricity, water, and so on) were raised not by a paltry percentage but several-fold, overnight, and all at the same time. And that was only the first round. A second round of increases is now around the corner, to be followed by yet more in due course until domestic prices are brought into line with international prices.

It is true that the starting prices were inordinately low. The country had had a cheap fuel policy for decades. In November 2010 just before the reform was launched, fuel prices in Iran were the lowest of any country in the world, except Venezuela. Petrol cost 10 US cents a litre and diesel fuel only 1.65 cents throughout the country. For many years, Iran's currency, the *rial*, has been subject to a managed floating exchange rate regime that kept it pegged to the US dollar at rates hovering around US$1 = Rls10,000. An unusual turmoil in the foreign exchange market over the past few months has led to an official exchange rate of Rls12,260 and a free market rate nearer Rls20,000. For the sake of simplicity, the *rial* figures in this article are given in equivalent dollar terms using the exchange rate of Rls10,000 for figures referring to the start of the reform over a year ago, and Rls12,260 for current figures.

Gas, electricity and water too were exceedingly cheap, as were a few staple foods such as bread. The result was overconsumption, inefficient production, waste, pollution, smuggling to neighbouring countries and, not least, a lopsided distribution of benefits as the bulk of the subsidies went to the better-off sections of the population who consumed more. By official estimates, price subsidies in recent years had been costing some US$100–120 billion annually – about 30 percent of the GDP – of which 70 percent went to only 30 percent of the population, mostly in urban areas. (It should be noted that the subsidies are mostly implicit, not financed by oil exports or the budget. They arise because domestically produced oil and gas – the sector is nationalised – are sold cheaply on the local market.)

The big idea behind the reform strategy was not to abolish price subsidies as such but to convert them into 'cash subsidies.' The objective was twofold: improving economic efficiency through rationalisation of subsidised prices, and reducing income disparities through cash transfers. These were reflected in the main provisions of the Subsidy Reform Law of January 2010. The Law authorised the government to raise prices of fuel, electricity, water, transport and postal services as well as of some subsidised foods over the five-year period from March 2010 to March 2015. Domestic sale prices of petrol, diesel fuel, and other fuels are to be raised gradually to reach at least 90 percent of Persian Gulf FOB prices. For natural gas, domestic prices should eventually exceed 75 percent of average export price, and for electricity and water to cover their full cost price. In the cases of wheat, rice, cooking oil, milk, sugar, air and rail transport, and postal services arrangements are to be made for the gradual elimination of subsidies over the same five-year period.

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The other side of the coin was the compensatory 'cash subsidies' to a nation of 75 million that had come to regard cheap fuel as a birthright. The Law authorised the government to spend up to 50 percent of the net proceeds from price rises for (i) cash and non-cash subsidies payable to all households nationwide, taking into consideration household income; and (ii) implementing a comprehensive social security system for the targeted population. Cash payments would be made through the banking system to the head of each household. The payments would be exempt from income tax. The Law also set aside 30 percent of the net proceeds to help producers adopt energy saving technologies, to compensate part of losses to companies and municipalities providing utility services, to develop and improve public transport, and to promote non-oil exports. The remaining 20 percent of the net proceeds would go to the government for improvements in infrastructure.

Implementation

Clear as the Law may appear to be, the government's actual implementation of it differed significantly in some key respects. First, for reasons that I have more fully elaborated elsewhere, there was a nine-month delay in launching the reform, which was put off from March to December 2010. This long delay was justified by the government as being necessary to allow better preparation of implementation modalities. It did indeed serve that purpose too but the main motivation was to enable the government to implement the reform more in line with its own views than with those of the parliament, views that it had been unable to get incorporated into the Law. In particular, the delay made it possible to vastly accelerate the pace of reform, as the government desired all along and the parliament resisted.

Secondly, to the consternation of many, the initial price increases decreed by the government went far beyond levels widely presumed. The price of petrol for private cars went up from 10 to 40 cents a litre (an increase of 300 percent) for the first 60 litres of monthly consumption, and from 40 to 70 cents (75 percent) beyond that limit. Diesel fuel shot up from 1.65 cents to 15 cents a litre (800 percent) for purchases up to a certain amount depending on the vehicle concerned and to 35 cents (2000 percent) for more. Similar increases came into force at the same time for gas and other fuel products, electricity and water charges, and bread flour. This price shock took the country half the way towards targeted final prices overnight, instead of gradually over the first two to three years of the reform process as the parliament intended.

Thirdly, household income was not taken into account in the determination of entitlement to the cash subsidy. Every Iranian citizen residing in the country was declared eligible to receive the same amount of transfer. The cash payments to each household thus depended on its size, not its income, and would be paid to the head of the household on behalf of all its members. To claim it, each head of household had to fill out a routine form and provide a bank account into which the money could be deposited.

Finally, with a view to winning public support and cooperation, the monthly transfer amount was set at Rls455,000 (about $45 at the time) per person, an amount that was way above what would have been consistent with the provisions of the Law. As a result, transfers to households consumed 80 percent of the net proceeds from price hikes in the first year of the reform instead of 50 percent, leaving rather little for producers and the government. Put before a fait accompli, the parliament eventually went along and modified the original percentage shares of households, businesses and the government from 50-30-20 respectively to 80-20-0 for the new Iranian year starting on 20 March 2012. There was of course no question of antagonising the public by forcing a reduction of the transfer amount.

At the start of the reform, some 60 million people or 80 percent of the population were participating in the cash transfer programme. This went up to nearly 73 million or 96 percent of the population within a few months after the start of the programme, in part because of the dramatic extent of price increases and the correspondingly high level of cash subsidy.

Minor incidents apart, the reform process took off fairly smoothly. The most important factor was no doubt the cash subsidies, cleverly paid before the higher prices began to hit people's pockets. But an extensive public education campaign preceding the reform played an important role as well. It emphasised the wasteful aspects of the price subsidies and their inequity. It was endlessly repeated that subsidies were not being eliminated but transformed from a bad form – price subsidies on products – to a good form – cash subsidies for households. Reassuring messages emphasised that inflation would not get out of hand, that poverty would be substantially reduced, and that no-one would go to bed hungry anymore. Extra allocations of cheaper fuel were also made in the early months to smooth the transition to higher price fuel. Price controls were reinforced too to moderate ripple effects.

Early Results

The reform process was launched over a year ago and evidence is now beginning to surface on the results. Such evidence, although from official sources, is at times disputed by independent experts and observers, occasionally even by other official bodies. But the picture that emerges is likely to be valid in broad outline.

Inflation. The fear of runaway inflation was the most controversial issue prior to the reform. The Central Bank figures now suggest that while the price shock accelerated inflationary pressures, the impact has fortunately not been as dire as had often been predicted by some analysts and parliamentarians. To take the most common indicator used in the country, the annual rate of urban inflation in the months preceding the reform was 9–10 percent. With the launch of the reform on 19 December 2010, this rate started climbing by about 1 percentage point a month to reach 20.6 percent in December 2011. The acceleration appears to have been entirely due to price reform. The relatively subdued impact on overall inflation – when subsidised prices had been raised several-fold – was due in part to price controls that were intensified when the reform was launched. Price controls have since been relaxed but not entirely withdrawn.

Consumption Pattern. One of the main objectives of the reform was to reduce excessive consumption of subsidised goods and services, notably of fuel. This seems to have been achieved, perhaps even to excess. Official data show substantial declines across the board. Between 2010 and 2011, the years before and after the reform, the average daily consumption of petrol fell from 62.8 million litres to 59.3, or 5.6 percent. The corresponding declines for diesel fuel are from 81 to 73 million litres (10 percent less), for liquid gas from 12.3 to 11 million litres (10.6 percent less), and for furnace oil from 18.1 to 11.5 million litres (36.5 percent less). The savings are all the more remarkable in view of past trends that witnessed growth of fuel consumption of the order of 10 percent a year. Fuel smuggling has also dropped sharply, although some still goes on given the continuing price differences across national borders. Electricity consumption fell by 8 percent, compared to an increase of 10 percent in the previous year. The consumption of wheat and bread flour plunged by over 22 percent, much of it presumably through reduction in wastage.

Production. Such huge drops in consumption had their mirror image in production (and imports), particularly in the small business sector. Caught between higher energy prices, lower consumer demand, and price controls, small businesses felt the pinch and many of them have found it hard to operate profitably in the new environment. Hard evidence on impact on productive sectors is too limited to draw reliable conclusions at this stage and the government and its critics sharply differ in their assessments of the situation. What is clear though is that cash transfers tended to favour consumers more than the producers who did not get their envisaged share of 30 percent in the proceeds from subsidy cuts. And what they did get appears to have been mostly in the form of loan rather than grant.

Income Distribution. Another main objective of the reform was to reduce income disparities. The cuts in subsidies affect household incomes in proportion to their consumption of subsidised goods and services. While some basic foods were among them, the cuts overwhelmingly concerned energy products whose consumption correlates positively with income. The compensatory transfers are however the same for everyone and hence the short-term impact of the reform on income distribution can only have been egalitarian, although the extent of it is not known since no hard data are available as yet.

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Public Opinion. Finally, it may be useful to consider selected results of an opinion poll on the reform carried out by an unidentified official agency. It covers Tehran, the capital city, and sheds some light on the hopes and anxieties of the public about a year ago, soon after the reform was launched. A majority of the respondents (62 percent) were of the view that most people would not be able to cover the extra expenses due to higher prices despite the transfer, even if they reduced their consumption. Some 33 percent thought that they could do so. A similar majority (65 percent) felt that the reform would help 'correct' the consumption pattern, although over a quarter (28 percent) had little confidence that it would. Perhaps most importantly, the respondents were split down the middle between those who had much or very much confidence that the reform programme would be a success (40 percent), and those who had little or very little confidence in the same (39 percent). And more people rated the chances of the cash transfers continuing as little or very little (42 percent) than those who rated these chances as high or very high (36 percent). It should be noted that public opinion in rural and other urban areas that are less privileged than Tehran is likely to be more favourable to the reform as price subsidies tended to favour the better off whereas cash subsidies are the same for everyone, thereby benefiting relatively more those with lower incomes.

What Next?

The Iran model of reforming the system of energy subsidies is a bold attempt at pursuing the twin objectives of enhancing economic efficiency and social justice at the same time. While the extent of its success so far may be judged differently, and its longer-term impact remains to be seen, it has already passed a major test with flying colours: it has survived. This is no mean feat in view of its ambitious scope and scale, more so as it was attempted at a historical juncture in Iran that was far from ideal economically, politically, and in terms of the country's relations with the rest of the world.

The hardest part – getting it off the ground and to cruising speed – may now be past but various challenges still remain. The second phase of the reform is slated to begin shortly. While speculation about the next round of price hikes is rife, no official announcement has yet been made. The parliament has put a cap of 20 percent a year for new increases, which could mean that fuel prices would likely rise by about 40 percent in the second round since there was none during the last Iranian year just ended. It has officially been announced however that the transfer amount would rise by Rls280,000 (about $23) per capita when new prices go into effect.

A further challenge now is to reduce the number of participants in the cash transfer programme so as to leave more funds for distribution to those with lower incomes. The sad fact of the matter is that, as things stand today, there is a trade-off between the coverage of the population and the amount of the transfer per person since the net proceeds that can be distributed to households is determined exogenously. The funds now going to the rich are entirely at the expense of those less well off. The current plan is to urge higher income earners to opt out of the transfer programme voluntarily. Households with an income above a couple of thousand dollars a month (a fairly large amount of money in Iran) are being invited to consider giving up their cash subsidy in whole or in part (the options are the entire amount, half the amount or any addition to the transfer amount in the second phase of the programme). No one knows how they will respond. If enough of them agree to withdraw, the matter will have been settled. If not, the government will have to decide how to proceed.

Two final points may be made about the role and importance of the cash subsidy component of the reform strategy. The first is that the compensatory character of these transfers made it possible for the price reform to go deeper and faster, thereby amplifying the impact of relative price changes on resource allocation. In efforts at price reform, therefore, the scale of price adjustments may not be as critical as it is often presumed to be, so long as the adverse effects can be moderated or removed entirely through compensation, particularly for poorer people.

The second point has to do with a fortuitous outcome of the reform effort, although no one was looking for it as such. Iran has now become the first country in the world to boast of a nationwide basic income that pays every citizen a certain amount of cash on a regular basis, unconditionally. The proponents of basic income are particularly keen to see the experience in Iran succeed in institutionalising an idea that, despite its promise, has been rather hard to sell, not least in the rich countries. ■