Iran – The Chronicles of the Subsidy Reform: A Review++

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I. Introduction

The paper reexamines the planning and early implementation of energy subsidy reform officially referred to as "Targeted Subsidies Reform" in Iran. On December 18, 2010, Iranian President Ahmadinejad announced the increase in domestic energy and agricultural prices by about 20 times. He described the action as the most sweeping economic "surgery", making it the first oil-exporting country to drastically reduce implicit energy subsidies. The paper also evaluates the sequencing of the arrangement and concludes by reviewing the main challenges for the restoration of macroeconomic stability and the efficient and effective functioning of the corporate sector.

The reform led to quadrupling of the prices of gasoline (1,000 to 4,000 rials per litres), reduced consumption from 66 million to 54 million litres and expectedly witnessed increased total revenue from 24,090 to 78,840 billion of rials. The paper documents the actions taken by several Iranian policy-makers and administrative bodies during the preparation and implementation of the reform.

II. Highlights of the Paper

Section one introduces the paper by reporting that within twenty four hours of an increase in natural gas, electricity, and water tariffs, allowable ceilings for the increase in taxi and transport tariffs were also published. It projects that in the first 12 months of the removal of energy subsidies, Iranian households would have received at least US$30 billion in freely usable cash, and loans of between US$10 and $15 billion would have been granted to enterprises to finance investment aimed at reducing energy intensity.

Section two shows that oil and gas revenues remain the main sources of foreign exchange earnings and fiscal revenues. The share of oil in real GDP fell from 40 per cent in 1960 to 10.5 per cent in the last decade. Oil and gas receipts also accounted for about 72.0 per cent of export revenues and 65.0 per cent of fiscal revenues, and are likely to remain the main sources of financing development projects despite several efforts to diversify fiscal revenues. The paper reveals that

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following the rise in international oil prices after 2002, low domestic energy prices became increasingly out of line with the market value of oil. Besides, high inflation rates and exchange rate depreciation contributed to further erode domestic energy prices.

In section three, the authors report that Iran was selling gasoline at US$.10 per liter while the international price was US$2 per liter. Iran increased importation of gasoline to supplement domestic demand. However, fuel waste and smuggling to neighbouring countries were making news headlines. Understanding how a simple compensatory scheme could be used to win a broad based social support for high price increase was critical to the design and success of the energy reform.

Section four describes the political process and the context in which the landmark approval of "Targeted Subsidies Reform Act" of January 2010 was given. The parliamentary debate which started in 2008 was discontinued in June 2009 before Presidential election. However, following the deteriorating economic conditions, unilateral sanctions against Iran and weak overall reform progress, the parliament approved the Reform Act on January 2, 2010. It was meant to be implemented over a period of five years (2010-2015) but because of the delay, it was extended covering 2011/2012 to 2015/2016. The Article 15 of the Act empowers the government to establish "Subsidy Targeting Organization" to ensure efficient centralized management of the reform.

In section five, the authors provide detailed information on how government long and careful preparations helped to win public support and ensure the success of the reform. Decisions were made on timing and speed of price adjustment, the distribution and form of compensatory payments to population and loans to corporate sector. Key macroeconomic indicators such as inflation and exchange rates were brought under control before the energy reform. The banking sector was also prepared to ensure efficient distribution of compensatory transfers as part of the key aspects of preparation of the reform.

Section six dwells on the massive public campaign to sell the energy reform by educating the public on the rising cost of low energy prices and expected benefits from the removal of the subsidies. The Government appointed a special spokesman to coordinate extensive campaign in support of the reform. Both electronic and print media including websites, public seminars and meetings were used to show how energy waste was due to low energy prices. Also, in the month preceding December 18 price increase, Iranian media reported senior government officials warning against protest. However, lack of clarity on the compensatory modalities at inception created uncertainty and social tension, which was addressed by the public campaign.

In section seven, the paper discusses the implementation of the reform. The President was responsible for the exact timing of the implementation. On December 28, the Iranian media announced that all households received the supplementary Rials 80,000 (US$8) compensation related to increase in bread price. In order to prevent public panic, government officials pledged to intervene in the market if necessary by drawing down the large inventories of major consumer staples. Besides, price controls were imposed on essential products in the immediate days following the start of the reform.

In conclusion, the paper examines the challenges ahead with particular interest on the macroeconomic stability and corporate restructuring. It suggests that Iran's corporate sector must adjust to the much higher energy prices and reduce its energy intensity. The immediate challenge was how to allow a progressive pass-through of higher energy prices by eliminating administrative price controls, reducing excessive export or import tariffs under low and stable inflation. Similarly, reforming Iranian companies towards more energy efficient goods and services was seen not to be an easy task as experienced in other countries.

III. Comments

The paper clearly showed that Iran had similar economic problems when compared with Nigeria, which made its energy subsidies unsustainable in the light of dwindling economic fortunes. Iran was able to prevent vehement public protests as experienced in other countries because of the following:

- Macroeconomic indicators such as inflation and exchange rates were first of all brought under control
- The government established "Subsidy Targeting Organization" in line with Article 15 of the Subsidy Removal Act to ensure efficient centralized management of the reform. Appropriate timing of the implementation of the reform also assisted.
- There was massive public campaign to educate the public on the growing cost of low energy prices and expected benefits from the removal of the subsidies, which accounted for the public support and cooperation
- Allowable ceilings for the increase in taxi and transport tariffs were published

- ➢ Price controls were imposed on key products in the immediate days following the start of the reform
- ➢ Government officials pledged to intervene in the product market if necessary by drawing down the large inventories of consumer staples (buffer stocks)
- ➢ Iranian households were promised compensation of freely usable cash of US$30 billion in the first 12 months of the removal of the energy subsidies and loans of between US$10 - $15 billion to enterprises to reduce energy intensity

The paper explained that despite the success achieved within seven months of the implementation of the energy reform, there were some outstanding challenges. It was tough for the corporate sector to adjust to the much higher energy prices and reduce energy intensity as fast as possible. The proximate challenge was to allow a progressive pass-through of higher energy prices by stopping administrative price controls and reducing excessive export and import tariffs.

In the case of Nigeria, some measures were also taken except the enactment of subsidy Removal Act, compensatory scheme and approved loans for corporate sector before the announcement of the removal of the oil subsidy on January 1, 2012. In this regard, the immediate challenge was how to address mass public protests against the policy resulting from lack of trust for government on the intended usage of savings from the subsidy removal.

IV. Concluding Remarks

In conclusion, Nigeria although with different political structure but similar economic landscape when compared with Iran, is expected to enjoy huge benefits from oil subsidy removal as experienced in Iran and other jurisdictions. Low energy prices negatively affected the execution of the Iranian development projects as is the case in Nigeria. In this context, Nigeria would surely save money from the removal of oil subsidy and be able to lift its economy from the prolonged lackluster performance. However, this would only be possible if all stakeholders in the Nigerian economy give their maximum support and commitment in addition to the following conditions:

- ✓ Massive and continuous public campaign to educate people on the disadvantages of oil subsidies and tremendous benefits of its removal such as execution of targeted developmental projects as well as job creation.

- ✓ Mechanism for government to appropriately intervene in the supply of key food items to boost food supply in times of shortages to moderate food inflation is critical
- ✓ Current government efforts to subsidize purchase of buses and improve transportation system should be sustained
- ✓ Authorities should arrange quarterly review through progress report on the amount saved from subsidy removal and their utilization for developmental projects and provision of services by the three tiers of government (Federal, State and Local). This is necessary to reinforce public confidence in government