

# The Subsidies Conundrum

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- Iran has subsidized petroleum products, basic foodstuffs, medical goods and utilities since 1980, first to manage hardships during the eight-year war with Iraq, and then to prevent political and economic challenges after the war.
- Since the 1990s, four presidents have tried to cut back subsidies that are estimated to cost Iran between \$70 billion and \$100 billion annually.
- In 2010, President Mahmoud Ahmadinejad won parliamentary approval for a controversial plan to phase out subsidies. The cutbacks came at a time the government already faced serious economic troubles and tougher international sanctions.
- Under the plan, universal price controls were replaced with small cash payments to families and direct support of industries. From its onset, cash payments have been available to everyone—wealthy and poor alike—though the government has repeatedly asked the wealthy to refrain from signing up, albeit few have done so. With 95 percent of Iranians receiving the payments, the program has been much more costly than anticipated.
- Price increases in gasoline and other products along with more robust sanctions and loose monetary policies subsequently contributed to a dramatic rise in inflation, which reached 40 percent by 2013. Although by 2015 the inflation was reduced to around 15 percent, rising prices had dropped the value of cash payments—which have remained steady—to one third of their original value.
- President Hassan Rouhani pursued additional subsidy cuts after taking office in 2013. Despite raising energy prices twice, the government still faced a budget shortfall in funding the cash payments by 2015. The near universality of cash payments continues to drain the state budget.
- Energy prices remain below free market levels. If reform ultimately succeeds, however, the program could help reduce waste, shrink state outlays, enhance efficiency and productivity, and help redistribute income.

## Overview

The 1979 revolution was carried out in the name of "the oppressed," and the Islamic Republic has been a welfare state committed to "social justice" ever since. The government introduced rationing soon after Iraq's 1980 invasion generated new

economic hardships. To appease a war-weary society after the conflict, the theocracy kept consumer prices for energy, basic foods, medicines and utilities (water, power and sewage) well below market prices. But the economic burden soared as the new theocracy initially encouraged population growth, which almost doubled the population from 34 million to 62 million in a mere decade. The cost of subsidies, in turn, also soared.

The Islamic Republic has long been vulnerable economically. Politicians in both the executive and legislative branches have been reluctant to take badly-needed reforms for fear of political backlash. President Akbar Hashemi Rafsanjani's austerity plan in the early 1990s sparked riots across the country, forcing him to shelve free market reforms and subsidy cutbacks. President Mohammad Khatami was unable to mobilize support from conservatives in parliament for either subsidy reforms or a plan to gradually increase gasoline prices. Under Ahmadinejad, the announcement of gasoline rationing triggered unrest and attacks on gas stations in 2007.

Ahmadinejad proposed new subsidy reforms in 2008, but the plan was deferred until after the 2009 presidential election. He had to wage a heated political battle, and a compromise was eventually reached with the intervention of the supreme leader, in 2010. Yet for the first time, Iran's major political factions agreed that the burden of subsidies was unsustainable, despite fears of severe economic and political consequences.

Subsidy reform encountered significant roadblocks in the first three years, largely because cash payments under the program exceeded significantly the revenue the government recouped from price hikes. Rouhani continued providing monthly cash payments and resumed subsidy cuts after taking office. But by 2015, Iran's government still faced substantial challenges in financing the cash payments.

## **The case for reform**

Subsidies have been costly. They were estimated to eat up around 25 percent of Iran's gross domestic product (GDP) of \$335 billion in 2009. Subsidies for energy products alone accounted for 10 percent of Iran's GDP in 2010, according to the World Bank. Iranians paid as little as 38 cents for a gallon of rationed gasoline, cheaper than bottled water. Gas cost 10 cents per liter, while a liter of bottled water cost around 25 cents.

Without reforms, costs would have only continued to grow as Iran's population increased – even though innovative programs by previous presidents brought the population growth rate down, from a height of 3.9 percent in 1986 to 1.3 percent in 2008. In 2010, as he was simultaneously pushing subsidy reforms, Ahmadinejad also called for new population growth, including a \$950 incentive for each new baby and a \$95

annual stipend until the child turns 18. But a higher birth rate could be a further drain on the economy, and even conservatives moved to block institutionalizing his initiative.

The subsidies program was plagued by two fundamental flaws. First, cheap prices fostered wasteful behavior. By 2010, Iran's energy consumption had increased five-fold in 30 years, while the population had only doubled, according to former International Monetary Fund economist Jahangir Amuzegar. Official Iranian figures claimed energy consumption had actually increased nine-fold since 1976. Cheap gas had, in turn, contributed to chronic pollution, environmental decay and massive traffic overload in urban areas.

Second, subsidies helped everyone, not just the poor. Those benefitting the most from subsidies were middle and upper income Iranians. Iran's richest 30 percent reaped the benefits of 70 percent of government subsidies, according to Iran's ministry of economics and finance.

## **The plan**

The first phase of subsidy reform began in December 2010, codified by the Targeted Subsidy Reform law. It included the following provisions.

- Subsidies would be phased out over five years, ending in 2015.
- The government could cut back up to \$20 billion of subsidies within the first year. In subsequent years, parliament would have to approve additional amounts through the annual budget process.
- Immediate cutbacks could affect the price of petroleum products, wheat, rice, cooking oil, milk, sugar, postal services, as well as airline and railway services. The government had discretion on which subsidies to cut first.
- Medical services and products would not be affected by the plan.
- In lieu of subsidies, the government would distribute small sums of cash to individuals.
- A new government body – a subsidy reform organization – would hold most of the funds that were once allocated for subsidies. It would plan and supervise the distribution of cash payments as a substitute for subsidies. Parliament insisted on making the organization subject to audit.
- The funds accrued from subsidy cuts would be divided:
  - 50 percent for direct cash payments to people who qualify for aid;

- 30 percent to industries that rely heavily on subsidies, and to improve the energy sector and public transportation;
- 20 percent directly to the Treasury to cover government costs of implementation and reduce dependence on oil revenues.

## **The politics**

Ahmadinejad's reform plan was widely interpreted as a policy reversal. He won the presidency in 2005 on a platform of increased social services and aid to the poor – and putting Iran's oil wealth on the dinner table. But his cash payments did little to improve living standards or reduce growing income gaps. The purchasing power of Iranians, particularly the poor and middle class, weakened as inflation spiked, hitting nearly 30 percent in 2008, according to the Central Bank of Iran. Critics argued that Ahmadinejad's profligate spending also drained the Treasury of billions from oil revenues, while contributing little to improve Iran's aged and ailing infrastructure.

Unlike his two predecessors, Ahmadinejad initially rebuffed proposals for reform by the World Bank and International Monetary Fund. But tough economic realities apparently changed his mind. His original proposal called for an even more drastic plan to eliminate subsidies within three years.

Many economists and members of parliament argued that Ahmadinejad's original shock-therapy strategy would have dire consequences. They urged a more gradual transition to avoid a dramatic spike in inflation for families and industries that relied on highly subsidized energy supplies and already faced a competitive disadvantage due to sanctions. Parliament also wanted supervisory power over distribution of funds, which Ahmadinejad rejected. After a year of intense debates, a compromise bill – lengthening the transition and creating the subsidy reform organization (SRO), which was subject to parliamentary oversight through its audit authority – was passed in 2010.

## **Results**

The government implemented the changes in December 2010. Energy prices tripled and bread prices doubled overnight, offset by the monthly cash transfers to Iranian households that replaced subsidies. At first, the reforms yielded positive results. Consumption of liquid fuels fell three percent in 2011 compared to 2009 due to price increases. Within the first few months of the program, the number of Iranians living below the poverty line declined by five percent as a result of the cash payments.

But by 2012, the program already faced severe setbacks. The system for distributing monthly cash payments, set at 455,000 rials (worth roughly around \$40 in 2012) per person, was wracked with flaws. The government originally decided to divide the

population into three income brackets and distribute financial assistance to the bottom two. But Iran did not have an effective data-collection system on family income. Most data was gathered by self-reporting to Iran's Statistical Center, and many families did not want to disclose their assets for tax and other reasons. The government then revised its plan and indicated it would distribute cash payments to a wider segment of society. Without a reliable method to target low-income families, more than 70 million people – or 95 percent of the population – signed up for the program and began receiving cash payments. The government recouped funds from higher energy and food prices, but the cost of the cash payments exceeded these funds by one third.

The government began printing money to cover the deficit, causing inflation to skyrocket. The declining value of the rial reversed some of the program's initial gains. Other expensive programs as well as greater sanctions against Iran also created economic shocks in the country, further contributing to inflation and the rial's devaluation.

The second phase of subsidy cuts was scheduled to begin in 2012, but parliament voted to suspend the reforms as economic growth stalled and inflation continued to rise. As a result, monthly cash payments continued, but the government did not pursue further price increases for subsidized goods. By 2013, inflation had jumped to nearly 40 percent.

## **Sanctions impact**

The United Nations, the United States and the European Union tightened sanctions against Iran after the subsidy reform program went into effect, notably U.S.-imposed financial sanctions in December 2011. The new sanctions were at least partially responsible for the spike in inflation and the decline of the rial after 2010.

The regime had calculated that reducing subsidies and increasing petroleum prices would force consumers to change excessive consumption habits, thereby mitigating the effects of sanctions. While subsidy reform has decreased the rate of increase in consumption, however, it has not decreased consumption.

The new round of sanctions had a particularly damaging effect on Iran's lucrative oil and gas industry, forcing Iran to delay or cancel development projects and reduce crude oil exports. At the same time, the industry did not reap the intended benefits of subsidy reform. The 2010 subsidy reform law specified that 30 percent of the revenues recouped from subsidy cuts would go to key industries – including the oil and gas sector. But Ahmadinejad did not comply with that ratio, as the cost of cash payments surpassed the revenue that price increases generated.

## **Rouhani's reforms**

Since taking office in 2013, President Hassan Rouhani has attempted to reverse some of the economic damage from the Ahmadinejad years. While his administration has criticized the implementation of the subsidy reform program, it has pursued new rounds of price hikes and continued providing cash payments to the population. Rouhani has also inherited some of the same challenges that undercut the program under Ahmadinejad. In particular, the administration's inability to find an effective way to target cash payments to the poor remains a problem.

Rouhani's administration initiated new rounds of energy price increases, though at a more gradual pace than under Ahmadinejad. In 2014, the price of rationed gasoline rose to 7,000 rials per liter and 10,000 rials per liter for unrationed gasoline (amount in excess of 60 liters per month per car). In 2015, the government eliminated the rationing system and set the price for all gasoline at 10,000 rials per liter—an amount that was still far below the free market price.

In its 2015-16 budget, the Iranian Parliament (Majles) mandated that the administration target its cash payments and reduced the total amount of cash the government could disperse. Previously, in April 2014, the government sought the help of Iranian celebrities and clerics to engage in a campaign encouraging wealthier Iranians to refrain from reapplying to the program. Less than three million listened, while around 73 million people re-registered. The government eventually began to slowly remove individuals from the program itself, aiming to drop close to another four million by March 2016. Individuals who believe they were wrongly cut off from cash payments, however, have the opportunity to contest their removal.

Under Rouhani, Iran's central bank also took steps to reduce inflation and control the money supply, according to the International Monetary Fund. Inflation was already on its way down before Rouhani took office and, by mid-2015, it dropped to 15.6 percent from 40 percent in early 2013. Despite progress, Rouhani's government still faced a budget shortfall in 2015. The cash transfer program remains unable to pay for itself through price increases and continues to drain from the support program intended for industries.

## **Trendlines**

- Although President Rouhani has made some progress in reversing the economic damage of the Ahmadinejad years, subsidy reform is far from complete. The universality of cash payments remains problem, though the administration is slowly removing individuals from the program.

- Despite subsidy cuts, energy prices remain below market prices. Therefore, further price hikes may be necessary. To avoid a backlash, Tehran must avoid a further drop in employment, a slowdown in the economic growth rate and a significant increase in inflation.
- Iran is poised to regain access to billions of dollars in assets as part the final nuclear deal, which lifts sanctions in exchange for Iran scaling back its nuclear program. The funds could help Iran cover its deficit, but the additional cash may also reduce pressure to prioritize subsidy reforms.
- Subsidy reform alone will not solve Iran's chronic economic problems. To improve Iran's overall fiscal health, the government also needs to pursue structural changes and other free market reforms to reduce inefficiencies plaguing state-owned or state-affiliated industries. The government otherwise may still be forced to support key sectors that depend on the state's protection or business.

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