

## MENA Needs Subsidy Reform for Sustainable Development

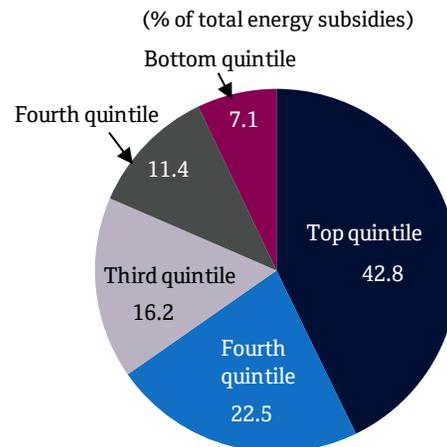
Global spending on energy subsidies totaled USD492bn in 2011. Middle East and North Africa (MENA) countries alone accounted for nearly half of that amount, making the burden of subsidies on public resources quite substantial. While total spending on energy subsidies in MENA reached 8.6% of GDP in 2011, there was significant variation among the countries of the region. In countries like Iraq and Egypt, spending on energy subsidies reached 11% of GDP while it was 3% of GDP in Tunisia. Within the GCC, spending on energy subsidies ranged from 10% of GDP in Saudi Arabia to around 6% in the UAE and 3% in Qatar. Countries in MENA could therefore benefit from reforming their subsidy systems for a number of reasons.

First, large spending on subsidies consumes a large portion of public resources rendering them unsustainable even in the short-run for some countries. Furthermore, for energy-importing countries, subsidies tend to create external imbalances, increasing the risk of a balance of payments crisis.

Second, subsidies could also hamper economic growth as the government directs its resources away from growth-enhancing spending towards paying subsidy costs. In many countries in the region, subsidy costs far outstrip spending on education or health. This can have long-term consequences on the economic welfare of the region’s populations. Moreover, subsidies make the cost of capital artificially cheaper relative to labor wages, creating incentives for firms to switch from labor to capital-intensive industries. This leads to lower job creation in a region with high unemployment and a young population.

Third, empirical evidence suggests that the benefits of energy subsidies tend to be skewed towards high-income sectors of the population. The richest 20% of the population in developing countries is estimated to receive six times more in fuel subsidies than the poorest 20%. In some cases, the numbers can be even more extreme. The IMF estimates that the richest fifth of the population in Egypt captures 71% of the benefits from diesel subsidies compared with 1% for the poorest fifth.

### Distribution of Energy Subsidies by Income Group in Selected Developing Economies



Sources: Arze del Granado et al (2010)<sup>1</sup> and QNB Group analysis

Finally, there are other distortions created by subsidies beyond the direct economic consequences. Subsidies keep fuel prices artificially below the price determined by market forces. This leads to an overconsumption of energy with adverse impact on the environment, health and traffic congestion. It also creates incentives for smuggling as the domestic price is pushed below prices in neighboring countries. For example, reportedly Algerian fuel is smuggled

into Tunisia and Yemeni oil is smuggled into Djibouti.

While the case for subsidy reforms is strong, their success is far from guaranteed. The IMF has recently documented 28 episodes of energy subsidy reforms worldwide. Five of these episodes failed to achieve their objectives while 11 others were only partially successful. Among the successful reform programs, two measures were particularly crucial.

The first is appropriate phasing-in of price increases. Too fast an increase in energy prices can generate a backlash against reforms. This is what led to the failure of the Mauritania attempt to reform energy subsidies in 2008. Conversely, removing subsidies too slowly can result in partial and incomplete reforms.

Second, it is important to provide social safety nets to the poor as subsidies are removed.

Despite capturing a smaller share of the overall benefit, poor households would still be impacted both directly, as subsidies are removed, and indirectly as their removal is likely to result in higher consumer prices, squeezing the real income of poor households. Ideally, targeted cash transfers to the poor should replace energy subsidies but these tend to be complex to administer. However, the positive experience of Iran in 2010 shows that even indiscriminant cash transfers to all segments of the population can play a key role in the success of the reforms and in redistributing the resources from the rich to the poor.

Implementation concerns notwithstanding, MENA countries could benefit from reforming spending on subsidies to rebalance their economies, boost growth and employment and support more sustainable and efficient economic development.

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<sup>1</sup> Arze del Granado, J., D. Coady and R. Gillingham (2010), "The Unequal Benefits of Fuel Subsidies: A Review of Evidence for Developing Countries," *IMF Working Paper*.