



A comparative study on the targeted subsidy reform in different countries and the Islamic republic of Iran

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ABSTRACT

In the 1950s, the idea of development and the necessity to pay attention to factors of social welfare as well as reduction of poverty highlighted the intervention of governments in economic activities, but since the 1970s and with the formation of the idea of centrality of humanity in development, it was realized that physical assets are not enough to deal with issues arising from underdevelopment in countries, however social issues and policies, and the formation of human capitals are at least as significant as physical assets. Therefore, social support policies in the framework of welfare states and subsidy policies were placed on the top agenda of development programs in different countries. However, what was ignored with regard to payment of subsidies was proper targeting of such policies in a way that most countries were paying their subsidies to general public. Following the debt crisis and global recession in the 1980s and the comparison of the experiences in countries of East Asia, Latin America, South Asia, and Africa, the focus of development approaches was changed to improvement of economic management and acceptance of a greater role for market forces. In this new approach, most countries embarked on reforming their subsidy plans. The main reason for these countries in implementing reform plans was to avoid public subsidies because of their comprehensiveness, population growth, and the increase in the price of goods and services in the global market. In addition, inefficiency of governmental distribution system and negative effects of controlling the price of products for the producers were among other reasons. This article initially provides a definition of subsidy, and its different forms and costs, and will then review the experience of different countries with regard to subsidies. It will eventually investigate the history, objectives, and consequences of subsidy reform plan in the Islamic Republic of Iran.

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Introduction

Based on the facts that have been recorded in the history of different economic systems in the world, most governments have formulated subsidy reform plans at certain periods. Industrial countries in Europe and Asia embarked on targeted distribution of subsidies in two phases: the first phase was after the occurrence of global recession in 1997 and the second phase was after the occurrence of economic crisis in 2008. In the 1990s and after the great economic crisis in East Asia, economic powers in this region adjusted their subsidy policies in order to modify their development strategies towards improvement of economic management. Scholars emphasize that all developed systems have followed the formula of “adjustment and reformation of subsidies” instead of their removal, and all industrial powers have engineered subsidies based on their needs and economic situation. Each of the tested methods for distribution of subsidies in the economic systems of all five continents of the world includes certain worthy details and points. However, it should be noted that these experiences and tests could not be simply imitated for the obvious fact that the subsidy policy of each country is a response to the very needs and is a key to opening the economic stalemate of that country. Thus, undoubtedly, the first condition for the success of a subsidy plan in any country is taking into account the local and national obligations as well as the economic features of that certain country.

Definition of Subsidy

Subsidy is a form of financial aid that is paid to a trade or an economic sector. The major parts of subsidies are paid by the governments to producers or distributors of one industry to prevent recession of that industry, or to prevent price increases in the products, or to encourage employment of more workforces.

Different Forms of Subsidies

1. Based on the government's goal of payment
2. Based on national accounts
3. Based on the reflection of costs in national accounts
4. Based on the subject of aid
5. Based on the stage in which goods or services meet the conditions to receive the subsidies

Costs of Subsidies in an Untargeted Environment

1. Increase in excessive consumption of fundamental goods and high energy consumption with regard to energy carriers
2. Discriminatory benefits of wealthy classes from subsidies
3. Creation of parallel and trafficking markets
4. Reduction of economic growth
5. Environmental pollution as the result of excessive consumption of energy
6. Subsidies belong to future generations as well and should be spent on productive investments

7. The system of subsidy payment disrupts correct models of consumption, production, and investment and the major part of subsidies will be spent on consumption instead of production
8. Drastic increase in the import of energy carriers and thus fragility and dependency of the country's economy

Positive Effects of Targeted Subsidies

1. Directing to Subsidies
2. Elimination of unemployment and investments for future
3. The most significant effect of implementing subsidy reform plan on the society is clarification of economic decisions in the country
4. Subsidy reform plan will lead to careful consumption of energy, thus a form of saving for the future will be created

Conditions for Implementation of Subsidy Removal

The 6 final conditions for removal of subsidies include:

1. Inflation rate must be at its lowest level in the last five-year period ending to reform plan.
2. Existence of trust between government and public and lack of gaps between these two social institutions.
3. The capacity of domestic production must have reached its peak.
4. The employment rate must be at its lowest rate.
5. Economic growth must be at its highest level in the years ending to this plan.

The Experience of Subsidies Reform in Different Countries

China

Chinese government has a long history of paying subsidies in the energy sector in a way that prices control and the fact that consumers only pay a small amount for energy have caused irreparable damage to this sector and have led to its significant inefficacy. The government's objectives for energy policies are as follows:

1. Using various types of energy (oil, gas, and nuclear) and reduction of the share of coal in the energy consumption basket
2. Giving confidence with regard to energy security (saving oil)
3. Increasing the efficacy of energy with the presence of private and foreign investment
4. Controlling the pollutants
5. Freeing the energy sector and its prices through subsidies

Indonesia

Indonesian government uses direct allocation of subsidy to oil products in order to support low-income individuals and impoverished families, thus oil products in Indonesia have the lowest price in comparison to other countries in South-East Asia. These subsidies have caused serious economic, environmental and social damage. Subsidy system reform will provide the possibility to use financial resources for the benefit of poor in a more efficient way. It should be considered that elimination of subsidies reduces air and other environmental pollutions by decreasing excessive consumption of oil products. Indonesian government is seeking to modify the rules and regulations to have logical consumption of energy in the country. Through decreasing subsidies for oil products, the government attempts to reduce its budget deficit and curb the increasing trend in consumption of energy. However, the oil-related subsidies could only be reduced if it will not impose extra pressures to impoverished families. The aim behind implementation of this plan is to pay subsidies to underprivileged. Moreover, the government needs to spend at least part of the oil-related subsidies on attempts to decrease poverty, develop education, expand public transportation, and enhance health services and other social development programs.

The government has proposed a rationing system through which coupons of petrol and kerosene will be given to those eligible and to car owners to benefit from subsidy-prices.

Turkey

In 2001, Turkey introduced a major package including a floating exchange currency rate, reduction of budget deficit, independency of central bank, a plan for reforming financial markets, ICT, and energy with full support of IMF and the World Bank using privatization of main governmental institutes. Privatization of energy market began with free trade policies. In this regard, the Electricity Market Act was ratified in 2001 by the parliament based on which the parliament recognized as the institute for provision of energy market-related rules and regulations. In 2004, the High Council of Planning ratified the Strategy for Modification of Electricity Sector. The Electricity Market Act started to be implemented in 2001 and a free market was created for production and distribution of electricity. In 2002, the four-stage plan for market competitiveness was announced:

1. Granting a permit for establishing natural gas and electricity companies in the private sector
2. In 2003, major consumers were given the right to select their own electricity production company
3. Launch of the Financial Agreements Center for payoff and balance of the trades
4. Full exploitation of the abovementioned financial center

In 2004, the Turkish parliament ratified a plan that modified the costs of domestic production of oil and the prices were freed for consumers. The privatization plan for the Oil Refinery Companies began in 2005 and is still being implemented.

Yemen

The food subsidy program in Yemen included wheat and wheat flour and was first administered through controlled import by the government as well as retail and distribution networks. The prices were regulated through fixed prices as well as the rates above the formal exchange rates in the import-marketing chain. The Ministry of Supply and Trade ratified and supervised the import of wheat and flour and determined the whole amount of import needed to satisfy the Yemenis' consumption needs. The exchange rate for import of flour and wheat was too high and the government paid direct subsidies to importers. The wheat subsidy program is too costly. In order to eliminate the inefficiencies in the subsidy system, the Yemenis government has taken various measures since then.

Algeria

Between 1973 and 1996, public consumption subsidies for food products were among the main axes of social support system in Algeria. In this country, the subsidies were in two forms of explicit (through direct reflection in the budget) and implicit (through preferred currency rates, fixed prices, and profit margins). Grains, milk and sugar were the main subsidy goods. In 1991, subsidies for food products in Algeria were about 5% of GDP and 17% of total government expenses. These high and increasing costs were indicative of the public coverage and the high degree of subsidies allocated to any goods. On the other hand, food subsidies were weakly targeting impoverished classes.

Egypt

Food subsidy program in Egypt started since the World War II. This program was first focused on severe rationing of goods while guaranteeing all consumers' access to them with the lowest prices. In 1941, public subsidies included oil, sugar, tea

and Kerosene. With the passage of time, subsidy goods were increased and reached 18 items in 1980. In spite of public coverage, the cost of subsidy program was little in the 1950s and 1960s. However, the costs of subsidies significantly increased in 1970s. This was intensified with the rapid growth of population and was even worsened with the decrease in the value of national currency. The increasing trend of costs of subsidies continued until the end of the 1970s. In 1980, the ratio of these costs to total expenses of government reached its peak. Since then, this ratio has demonstrated a decreasing trend. When the subsidy expenses reached their peak, it resulted in major economic imbalance as well as in intensification of foreign debts in 1977, thus forcing Egypt to reform its subsidy system with the support of IMF. This led to sudden increase of price in subsidy goods, but although different solutions were proposed, the plan was stopped due to its serious social consequences. The country then adopted a gradual reform plan of subsidy system in the 1980s. In line with the implementation of such policies in 1992, the ratio of population covered by subsidies fell to 86% and this decreasing trend continued. The government modified subsidy programs through providing subsidies for food products. World Bank has formally announced that the program for targeting subsidies in Egypt has failed. Several reasons have been provided for this failure, including inefficiency and inefficacy of the current economic structure in Egypt, high inflation resulted from implementation of the project, and lack of accurate and exact information of families.

Tunisia

Tunisian government started paying food subsidies to support purchasing power of consumers and particularly the impoverished classes as well as to stabilize food prices. These food items included grains, cooking oil, sugar and milk which were all unlimitedly provided to all consumers and below market prices. Wheat market in Tunisia was excluded to importers and the government paid subsidies to producers and supported domestic wheat producers by imposing guaranteed prices and by guaranteeing profit margins. This type of paying subsidies imposed heavy costs to Tunisian government, yet it had poor performance in targeting low-income and impoverished classes in a way that based on absolute value of subsidies, the subsidies for food products were insignificantly targeting the poor.

Malaysia

This Asian country started reforming its subsidy plan in 2008 in a way that the subsidies for certain goods and services were eliminated or targeted and is now paid in cash to low-income classes. Before the implementation of the subsidy elimination act, the Malaysian government was implementing the plan for constructing cheap accommodations in a limited scope. However, after 2010 and 2 years after the subsidy reform plan, the purchasing power of house has increased for mid-income classes. The latest results of the impact of targeting subsidies in Malaysia demonstrate that this plan has transformed government's formulas in the housing sector of this Asian country. In better words, within less than 3 years after initial measures taken by Malaysian authorities with regard to targeting subsidies, the middle class' access to cheap houses is easier.

Poland

Targeting energy subsidies in Poland was part of the economic reform plan after the collapse of Socialist system in this country and was one of the most successful plans among Eastern Block countries. Based on this package, payment of

subsidies to industries was suddenly eliminated as a kind of shock therapy. Financial discipline of the government was under severe controls, the inflation growth of wages was stopped, interest rate was increased, and privatization plan was implemented along with liberalization of prices. In addition, the rules of foreign trade were modified in order to facilitate export and attract foreign investment. The short-term effects of this plan were a 24% decrease in industrial productions and 15.7% increase in unemployment. In contrast, the inflation rate, that was about 2000% in late 1989, decreased to 35% in 1992. With strengthening the private sector, the initial negative effects of this plan were eliminated and this sector became the stimulating engine of economy.

Bulgaria

Before implementing economic reforms, Bulgaria was greatly supporting the energy sector in order to support low-income families and producers. With the beginning of the plans in free economy, such supports were decreased in order to reduce the debts and increase investment. Now families are the only consumers of profits gained from energy subsidies. The expense of electricity subsidies to families is supplied from non-family consumers and only heating services subsidies are provided by government budget. With regard to the price of natural gas consumed by families, there is only one rate for all families and the subsidies are supplied by other consumers. The government has two mechanisms in its reform process to support the poor against balancing prices: First, it increases energy subsidies in winter and second, it has a double-pricing system in which subsidy rate is continued for a certain level of consumption until 2005 and a higher rate applies to higher levels of consumption. The process for reforming energy subsidies in Bulgaria has proved to be highly effective.

History of Subsidies Payment in Iran

Subsidies enjoy a long history in Iran. Government's supportive measures in the agriculture sector began in Safavid era and continued during Qajar era through policies adopted for development of cultivation, among them providing seeds and funds to those who had leased lands. However, direct intervention of government in demand and supply (production) began in 1932 by King Reza Pahlavi through ratification of an act for founding warehouses in Tehran to prevent possible shortages. In 1936, supply of wheat increased significantly as the result of increases in rainfall, resulting to higher supplies than demands. This led to fall of prices. In the same year, the government purchased farmers' wheat with a higher price in order to support them. Until 1942, the government's motivation in intervening in the grain market was to support farmers, to save wheat and to provide bread to the low-income urban population. The first subsidy-based rationing system in Iran was at the time of World War when subsidies were being paid for meat and wheat. For the first time after the Islamic Revolution in Iran, Article 4 of the General policies of First Development Act (ratified in 1989) was about subsidies. Based on this act, changing the system of rationing basic goods was predicted as one of the policies, trying to organize subsidies in the framework of the country's social security system so that they gradually target low-income individuals. General policies of Second Development Act, paragraph B (ratified in 1994) emphasized the continuance of the policy of subsidies payment for basic goods and medicine, to publicize the hidden aspects of the subsidies and at the same time to enhance social security system, insurance, aid, and direct aids whenever necessary.

In the third development plan (ratified in 2000) the subject of subsidies is referred to as well. Based on Article 46, Paragraph A-that has also been approved in the Fourth development Plan- Article 103, the policy of subsidies payment for basic goods including wheat, vegetable oil, sugar and sugar cubes, cheese, medicine, and milk powder would continue in the Third Plan while maintaining the number, volume and price of coupons the same as in the Second Development Plan. Fourth Development Plan (ratified in 2004), chapter 8, deals with the issue of enhancing social security and social justice. Based on the Article 95, the government is obliged to establish social security and justice, decrease social and economic inequalities, decrease the gap between different income groups, establish fair distribution of income in the country, decrease poverty and deprivation, and empower the poor through preparation and implementation of efficient and targeted allocation of resources of social security as well as paid subsidies, comprehensive poverty elimination and social justice plans with specified axes. Eventually, through the formation of a council in the government titled the government's strategic economic council in 2005, the main problems of Iran's economy were investigated and identified. Meanwhile, the issue of targeting subsidies has been one of the main concerns of the country and its politicians in the last two decades and has been investigated as one of the main axes of Economic Reform Plan in the country. After numerous studies and investigations, the discussions led to proposal and eventually ratification of Subsidy Reform Act or Targeted Subsidies Act.

Objectives of Subsidy Reform

1. Efficient allocation of resources, increase of economic efficiency and efficacy through price mechanism and rationalizing the consumption of subsidy goods
2. Development of investments
3. Improvement of production technology
4. Identification of the natural level of the prices of goods and services as the regulating factor of consumption
5. Increasing companies' income and stock dividend
6. Increasing government's income, increasing the transparency of government's budget, and decreasing imbalances in the budget
7. Reforming the income structure and the expenses of agencies that produce subsidy goods
8. Gradual replacement of subsidies payment with social welfare plans
9. Economizing the projects related to energy supply through renewable resources
10. Increasing purchasing power
11. Enhancing executive trend of Article 44 of the Constitution
12. Decreasing the activities in the black market, trafficking, and hoarding goods pertinent to subsidy
13. Decreasing the share of high-income classes and increasing the share of low-income classes from subsidies

Economic and Social Consequences of Subsidy Reform

1. Price increase in production units

2. Inflation and an increase in the costs of production units
3. Possibility of increase in total demand
4. Increase of government's expenses with regard to consumption of energy
5. Transferring the costs imposed by high-income classes to others
6. Re-distribution of relative income and received payments
7. In a consumption-based economy, the cash payment of subsidies will be spent on unnecessary goods. If this is accompanied by a decrease in the subsidies of basic goods, it will lead to a fall in the consumption of such goods, thus risking the health of the society.
8. Cash payment of subsidies can disrupt family expenses
9. Changing working culture (laziness and escaping from duties) can be one of the social effects of paying cash subsidies.
10. The increase in family income will increase the expectations of family members, but increased income will be eliminated due to inflation.

Conclusion

In developing countries, governments usually control prices and they do this at least with the aim of supporting impoverished citizens. There are different ways through which these countries intervene in markets. However, in order to support poor classes, reformation of prices must be accompanied by certain programs of social security. In addition, the experiences gained by different countries indicate that sudden and general elimination of subsidies will bring about detrimental consequences. Therefore, this should be done gradually and step-by-step. In addition, each country applies a certain method or combination of different methods to reform subsidies based on the very special conditions ruling that country. Therefore, it falls upon policy-makers to adopt proper methods of targeting subsidies taking into account the particular conditions in the country as well as experiences of other countries.

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