

# Creating fiscal space for social protection through energy subsidy reform

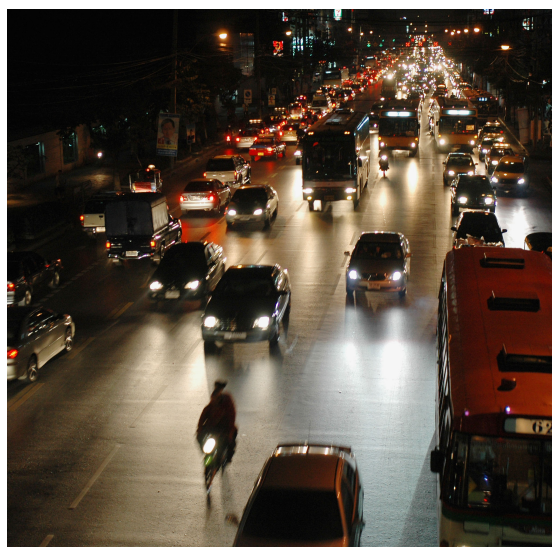


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## Islamic Republic of Iran

*Iran is an example of how oil exporting countries can create fiscal space to expand social protection and to help mitigate inequality and reduce poverty.*

Iran carried out comprehensive energy subsidy reforms as part of a broader structural reform agenda to foster inclusive growth and job creation. From December 2010 to 2016 the government progressively decreased the energy subsidies; as a consequence, domestic oil prices increased gradually reaching 90 per cent of international prices. The decrease in energy subsidies contributed to the additional fiscal space for other areas such as the social and health sectors. To ensure a buy-in for the reform, the government simultaneously expanded its social protection spending, launching a universal cash compensation scheme (Sdralevich et al, 2014) and since 2014 supporting the extension of health coverage through the Health Transformation Plan (HTP), aiming for universal coverage.



### Main Lessons Learned

- Using the additional fiscal space liberated from an energy subsidy reform, the government extended social protection through a universal cash transfer and a social health protection scheme.
- The introduction of a universal cash transfer scheme to all segments of the population was instrumental for increasing the social acceptance of the subsidy reform by the population.
- The universal cash transfer and health care schemes achieved redistributive effects and helped significantly reduce poverty and inequality among Iranians. The Gini coefficient improved from 0.41 in 2010 to 0.37 in 2011, while poverty decreased by 50 per cent.

SDG 1.3 aims to implement nationally appropriate social protection systems and measures for all, including floors, and by 2030, achieve substantial coverage of the poor and the vulnerable.

Social protection floors (SPFs) guarantee access to essential health care and basic income security for children, persons of working age and older persons. 185 countries have adopted the Social Protection Floors Recommendation, 2012 (No. 202), to achieve universal social protection.

This note presents a successful country experience of expanding social protection.

Social Protection Floors in Action: 100 success stories to achieve Universal Social Protection and SDG 1.3

## 1. How was the reform carried out?

Subsidy reform has been on the policy agenda since the late 1980s. With domestic oil prices being significantly lower than international, Iran had very high levels of energy consumption and one of the highest energy intensities<sup>1</sup> in the world, with energy subsidies estimated at about 20 per cent of GDP. In Iran, fossil fuel subsidies accounted for the largest portion of \$100 billion spent every year on subsidies. It contributed to fossil fuel consumption twice that in other Middle East countries.

### Iranian Government's Subsidy Reform Objectives

- Reduce domestic consumption and misuse of fuel subsidies to green the environment.
- Use social protection to increase the social acceptance of the reform, and to further reduce inequalities.
- Compensate enterprises for a loss in competitiveness through fiscal policies and other measures.

Iran's reform was driven by at least two main reasons: (1) to decrease the domestic consumption of hydrocarbon while reducing air and noise pollution; (2) to increase redistribution among Iranians as energy subsidies are usually regressive in nature, benefiting the rich more than the poor.

To make the subsidy reform socially acceptable to the general population, the savings generated from the subsidy reform were used to implement social protection programmes. To make the reform acceptable to enterprises, the authorities also introduced measures to increase the competitiveness of enterprises (e.g. subsidized loans for the adoption of new, energy-saving technologies and credit to mitigate impact of energy price increase on production).

The subsidy reform included two phases. In December 2010, the Iranian authorities launched the first phase of a subsidy reform programme. It focused on energy and other basic products such as wheat. The authorities decided to opt for a one-time price adjustment. Prices of all major petroleum products and natural gas as well as other basic necessities such as electricity, water, and

bread, increased substantially. As a result, the consumption of subsidized products initially declined. Domestic consumption of liquid fuels fell by about 3 per cent in 2011 compared to 2009. Consumption of wheat also fell in 2011 for the first time in a decade. Last but not least, the reform significantly reduced the price differential to neighbouring countries and thus also reduced the smuggling of oil and of other oil dependent products (Sdravovich et al, 2014).

After a smooth start in December 2010, the second phase of the reform, which involved a new round of price increases, was postponed in mid-2012 following the economic deterioration and increased financial burden due to the additional international sanctions. Only in 2013, under the new government of Hassan Rouhani, Iran revived its reform efforts and the parliament passed the second phase in 2014, which increased energy prices by an additional 20 to 25 percent.

## 2. Mitigating measures

### ➤ Universal Cash Transfer

To mitigate the price increase effect of the subsidy reform and increase the social acceptance of the reform, the government introduced a universal cash transfer for households. About 80 per cent of the savings made through the subsidy reform were redistributed through cash transfers. The monthly transfer amounted to 29 per cent of median household income, or about \$45 extra per month per person (WEF, 2017). The funds were distributed through bank accounts and ATMs that were set up in villages where such infrastructure was lacking. The cash transfer benefited all Iranians, but had the highest poverty reduction effect on the 2.8 million poor Iranians, the majority of which are rural residents. The cash transfer more than doubled their monthly budgets (that were at less than \$45 on average). The table below illustrates the positive impact that the cash transfers had in terms of poverty, whereas rural poverty more than halved between 2009 and 2012. As a result of the redistributive elements of the universal cash transfer, inequality, measured by the Gini coefficient, has improved from 0.41 in 2010 to 0.37 in 2011, with a particularly sharp drop in inequality in rural areas (Sdravovich et al, 2014).

<sup>1</sup> Energy intensity is a measure of the energy inefficiency of an economy. High energy intensities indicate a high cost of converting energy into GDP.

Year	Headcount Ratio				Poverty Gap			
	Rural	Urban	Teheran	Total	Rural	Urban	Teheran	Total
2009	13.4	9.8	6.2	10.2	17.9	12.4	8	13.2
2010	10.3	7.2	5.6	7.8	13.5	8.7	5.5	9.5
2011	6.3	5.2	2.8	5.2	2.9	2.9	1.4	2.9
2012	5	5.4	4.4	5.1	1.1	1.2	0.3	1

Source: Salehi Isfahani, D. (2016), (pp. 186-195)

Year	2009	2013
Income share held by lowest 10%	2.1	2.85
Income share held by highest 10%	31.41	29.08
Gini Coefficient	42.00	37.40

Source: WDI, World Bank (accessed on 05.09.2017)

Initially, the authorities leaned towards targeting the transfers to the poor, but as it was considered administratively difficult to identify the target population and to properly screen the recipients, this plan was abolished. Also, including upper-income groups supported the buy-in among the biggest consumer group. Against this backdrop, everyone qualified for the compensatory transfers that was equal for all applicants and introduced a progressive redistributive element.

During the reform implementation the government launched a broad consensus-building process involving all key stakeholders (government, parliament, academia, business, etc.). The president, parliament, and government interacted extensively with the public for nearly 18 months from the start of the reform. Moreover, the reform was preceded by an extensive public relations campaign to educate the population on the growing costs of the energy subsidy to the country and on the benefits expected from the reform.

In addition to the cash transfer, authorities introduced a multitier tariffs system on electricity, natural gas, and water to moderate the impact of the price increases on small users, mostly the poor. Unit tariffs on electricity, natural gas, and water use were set using escalating schedules. Tariff schedules were further differentiated by region with prices set at lower rates in regions with naturally higher demand (e.g. hot regions need air-conditioning).

### ➤ Universal health coverage

A second domain that benefited from the additional fiscal space that was created in the context of the subsidy reform was the health sector. Inspired by other countries that have achieved universal health coverage in the past (e.g.: Thailand, Turkey) the Government of Iran decided to design and adopt the Health Transformation Plan

(HTP) in 2014, using parts of the funds released through the subsidy reforms for its financing. The HTP included different interventions and aimed to increase population coverage of basic health insurance, increase quality of care in the Ministry of Health and Medical Education affiliated hospitals and reduce out-of-pocket (OOP) payments for inpatient services. According to WHO and ILO statistics, Out-of-Pocket payments were one of the main flaws of Iran's health system with OOPs constituting often more than 50 per cent of payments. The HTP national plan introduced multiple interventions to improve access to healthcare and quality of health care services through (Moradi-Lakeh M., Vosoogh-Moghaddam A., 2015):

- Free basic health insurance to all Iranians that were previously not covered by the national social health insurance scheme;
- Reducing out-of-pocket (OOP) payments for inpatient services at the MoHME hospitals;
- Protection and support of patients with chronically disabling disease(e.g. end-stage renal disease, thalassemia, haemophilia and multiple sclerosis), and those who are in need;
- Promoting doctors to deliver medical services in neglected and remote regions;
- Improving quality of care through increasing specialists and improving medical facilities;
- Improving the medical services (incl. family programmes) for nomadic people & rural regions;
- Expanding health services to suburban areas;
- Improving the family physician program through a pilot project in 2 provinces;
- Expanding the family physician program to cities with population of 20 000-50 000 inhabitants;
- Strengthening inter-sectoral collaboration to improve medical service delivery;
- Increasing health literacy of people and enhancing self-care.

Despite the latest oil price shocks in 2014/2015 negatively affecting government revenues, funding through the budget of the Ministry of Health (MOH) was extended from 6.7 per cent in 2013 to 10.3 per cent of GDP in 2015 (Mousavi S. M, Sadeghifar J. 2016).

### ➤ Enterprise Development

Last but not least, funds generated in the course of the subsidy reform were also allocated to enterprises to help increase their energy efficiency in production. The

authorities selected 7,000 enterprises that were most affected by the subsidy reform to receive some form of targeted assistance to restructure their operations. This included direct assistance as well as sales of limited quantities of fuels at partially subsidized rates to moderate the impact of the price increase on the input costs of enterprises in the industrial and agricultural sectors (Retschler J, Bazilian, M, 2017).

### 3. Challenges remaining and next steps

At the beginning of 2018 the Government started preparing measures to cut the universal cash benefits, with plans to transform the system into a targeted scheme, following IMF's advice expressed in its 2017 Article IV consultations. The new scheme is expected to target low- and middle-income families only. The targeting of beneficiaries will likely undermine the achievements with regards to inequality and poverty. Targeting often fail to deliver its promise and there is a tendency for high levels of exclusion and inclusion errors. At the same time, administratively, targeting is relatively costly, and less funds are therefore available to finance the benefits for the population.

Despite concerns that larger universal cash transfers, such as in the case of Iran could harm the economy by reducing incentives for people to work, Djavad Salehi-Isfahani (2016) finds no evidence to support such a claim. While younger age cohorts slightly reduced their number of hours worked as they used the extra money from the cash transfer for extending schooling and learning at an academic institution, other age groups expanded their working hours. On the other hand, there is clear evidence that the universal cash transfer led to a reduction in poverty levels and inequality, particularly increasing the income of poor and rural households. With the support to help enterprises cope with higher energy prices, the Iranian government moreover enabled businesses to convert to more efficient and cheaper energy sources, and thus supporting jobs and economic activity in the longer run. With the support provided to the Health Transformation Plan that started in 2014, the government added another component of its support from the revenues generated through the subsidy reform and thus expanded its social protection measures that all in all support inclusive growth and equity.

Nonetheless, the reform has yet to fully exploit its potential. After a smooth start in December 2010, the second phase of the reform was postponed in mid-2012

following deteriorating economic conditions and challenges in implementation. Economic growth decelerated, inflation rose, and the exchange rate depreciated to record levels, making it more difficult for authorities to pass on international energy prices to its domestic market. The subsidy reform, which was designed to be fiscally neutral, faced cash-flow imbalances, as revenues from energy price increases fell short to meet the committed cash transfers to households. Energy consumption, while falling shortly after the reform has been implemented, has been on the rise again, as high inflation reduced the real cost of energy. High inflation also deteriorated the real value of the cash transfers, reducing the benefits to the lower income groups. While there are clearly a series of factors affecting the performance of the economy and the cash transfer programme, additional measures would be needed to maintain the real value of transfers and to strengthen the link between domestic and international fuel prices permanently. Establishing an automatic pricing formula, publishing of detailed information on the pricing mechanism and passing on the price setting process to an independent institution could be an effective way for authorities to distance themselves from the price setting (IMF, 2014).

The health care system has brought some improvement and received the funding it needs to undergo serious reforms, including increasing the medical services quality and satisfaction among its members, yet some problems remain and will need to be addressed in the medium and long run. Iran has a combination of 17 insurance funds with different bases for membership, resulting in incomplete population coverage, overlap in population coverage, inappropriate service coverage, relatively high out-of-pocket payments and public dissatisfaction. (Mousavi S. M, Sadeghifar J. 2016).

Finally, if the Government manages to keep transferring a share of its resource wealth to its population, it is expected to continue its successful track record with regards to reducing inequality and poverty and providing income security for its population through an inclusive policy approach.

Taxing natural resource extraction is one of the many alternatives that countries have to expand fiscal space for social protection. Governments normally use a mix of taxes and social security contributions to fund social protection, combined with other options.

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### Social Protection Floors in Action: 100 success stories to achieve Universal Social Protection and SDG 1.3

This brief was written by Stefan Urban of the ILO.

The Social Protection Floors in Action brief series is edited by Valerie Schmitt and Loveleen De, Social Protection Department, International Labour Organization (ILO).

For more information, contact: [socpro@ilo.org](mailto:socpro@ilo.org)







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## INTERNATIONAL LABOUR OFFICE

4, route des Morillons  
1211 Genève 22  
Switzerland

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