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Subsidy Reforms in the Middle East and North Africa

Strategic Options and Their Consequences for the Social Contract

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Abstract

After independence, energy and food subsidies became a cornerstone of the social contracts in the Middle East and North Africa (MENA) countries. Governments spent heavily to reduce poverty and strengthen their own legitimacy. However, as government rents faded, subsidy spending became financially unsustainable and foreign donors pressed for reforms. Yet, reform has been challenging for all the governments as subsidies affect all consumers, therefore raising the risk of government delegitimisation. Several publications have analysed the subsidy reforms of various MENA countries, but few have systematically analysed their impacts on the prevailing social contracts. This paper shows that reforms in a key policy field such as subsidy spending can affect the nature of social contracts profoundly and distinctly, depending on the reform strategy. It assesses the reform processes that took place in Morocco, Egypt and Iran primarily between 2010 and 2017, thus before the United States once more tightened sanctions against Iran and before the COVID-19 pandemic broke out. We argue that governments applied distinct strategies to reduce subsidy spending without provoking major social unrest to reforms, with the effect that the social contracts of the three countries changed in quite different ways. Morocco's government removed most subsidies, especially those that predominantly benefitted the middle-class. It explained the need for reforms, engaged in dialogue with society and implemented some compensatory measures for the poor. Thereby it succeeded in preserving substantial features of its prevailing social contract. The Egyptian government, in contrast, dismantled subsidy schemes more radically but without systematic information and consultation campaigns. Also, its compensatory measures remain limited, which shows that the government no longer relied on social benefits as a means of legitimisation. Instead, by using repression and a narrative of collective security, the emerging social contract has been transformed from being a *provision* to being a *protection* pact. Finally, Iran replaced subsidies with a generous quasi-universal cash transfer scheme, which was more cost-efficient and egalitarian. Even if inflation and external shocks eroded these benefits, the reform paved the way to a more inclusive social contract, at least for a couple of years. Lessons learnt from past social transfer reform strategies will be all the more interesting for MENA governments once they embark on post-COVID-19 reconstruction strategies, which are likely to compensate households for financial losses made during the COVID-19 crisis and help them make a new start in economic terms.

Keywords

Subsidy reform; government spending; social contract; government legitimacy; social policy; Middle East and North Africa; Morocco; Egypt; Iran; protection; provision; political participation; subsidies; social cash transfers; public dialogue; information of public policies; repression; compensation measures.

Contents

Abbreviations

AfDB	African Development Bank
EGP	Egyptian pound
GDP	gross domestic product
IEA	International Energy Agency
IMF	International Monetary Fund
IR	Iranian rial (currency)
LPG	Liquefied petroleum gas
MEME	Ministére de l'Energie, des Mines et de l'Environnement (Ministry of Energy, Mining and Environment, Morocco)
MENA	Middle East and North Africa
PJD	Justice and Development Party (Morocco)
PPP	Purchasing power parity
RAMED	Regime d'Assistance Médicale pour les Économiquement Démunis (Medical Assistance Scheme for the Economically Deprived, Rabat, Morocco)
US	United States
USD	Unites States dollar

1 Introduction

For decades, countries in the Middle East and North Africa (MENA) have been spending almost 7 per cent of gross domestic product (GDP) on direct and indirect social transfers, and single countries, notably Yemen, up to 14 per cent (IMF [International Monetary Fund], 2013, p. 50).[1] Yet, the effects on poverty and inequality have been dissatisfying[2] especially because most of the spending was in the form of subsidies (6 per cent of GDP on average) rather than direct social transfers (only 0.7 per cent of GDP on average). Subsidies reduce the prices of core commodities such as energy, food, water or public transportation. Direct transfers, in contrast, are paid to households in the form of, for example, social assistance. This pattern is not limited to the resource-rich MENA countries with large rents from export of fossil-fuels (for example, Iran or the Gulf states), but prevails equally in MENA countries where such rents are much smaller (for instance, Egypt) or even non-existent (such as in Morocco and Tunisia).[3]

Subsidies used to be a core element of the populist-authoritarian social contracts that almost all MENA countries developed after independence (Loewe, Zintl & Houdret, 2020; Hinnebusch, 2020). Social contracts are sets of agreements between societal groups and their sovereign on rights and obligations toward each other. Typically, they stipulate the government to maintain protection (security of citizens), provision (social and economic services), political participation or a combination of these in exchange for citizens accepting the rule of the government. The early, post-independence social contracts of MENA countries were meant to provide for autonomy from Europe, socio-economic transformation and nation-building but also stability of authoritarian government. Food and energy subsidies were a main element of these social contracts (Loewe et al., 2020). They lowered the cost of living of low-income households and thereby reduced poverty and inequality. Subsidies also supported local firms in their competition on world markets by providing cheap energy and primary products (Rougier, 2016). In both cases, subsidy spending helped governments defend the legitimacy of their rule in the absence of meaningful political participation.

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1 MENA countries spent even more than 9 per cent of GDP on food and energy subsidies between 2009 and 2013 (Sdralevich, Sab, Zouhar, & Albertin, 2014).

2 Food subsidies in Egypt reduced income poverty rates by just a third in 2009, while energy subsidies reduced income poverty rates by less than a fifth in 2004, even though both programmes together consumed 8 per cent of GDP at that time (Silva, Levin, & Morgandi, 2012). Direct social transfer programmes, in contrast, reduced income poverty rates by little more than 3 per cent and the Gini coefficient by less than 1 per cent at that time but they also accounted for much less than 1 per cent of GDP. And Egypt is by far the best-performer in that regard: Yemen’s energy subsidies, for example, reduced income poverty rates by just 5 per cent in 2009 even though they consumed almost 14 per cent of GDP (Silva et al., 2012, Figures 14, 21 and 22). In Tunisia, subsidies reduced poverty rates by 3.6 per cent and the Gini index by 1.1 per cent (INS, CRES & AfDB [Institut National de la Statistique, & Centre de Recherches et d’Etudes Sociales, & Banque Africaine de Développement], 2013).

3 The average spending of oil-exporting MENA countries on gasoline and diesel pre-tax subsidies fluctuated between 3 per cent and 5 per cent of GDP between 2009 and 2013, while the average spending of oil-importing MENA countries on gasoline and diesel pre-tax subsidies fluctuated just slightly lower between 2 per cent and 4.5 per cent of GDP (Sdralevich et al. 2014, Figure 2.3). The spending of oil-exporting countries on food subsidies ranged from 0.1 per cent of GDP in the United Arab Emirates to 2 per cent of GDP in Algeria and about 3.5 per cent of GDP in Iraq, while the respective share was equally dispersed in the oil-importing countries (0.2 per cent of GDP in Lebanon but 2.5 per cent of GDP in Egypt) (Sdralevich et al. 2014, Figure 2.10).

Over time, however, subsidies have become a heavy burden for all MENA governments because their rent income has decreased while the number of inhabitants in their countries has continued to rise. In addition, it became evident that subsidies benefit the rich rather than the poor, and incentivise users to consume more food and energy – with negative effects on health, the environment, and employment. International finance institutions (such as the World Bank and the International Monetary Fund (IMF)) therefore started to push early on for subsidy reform, especially in the poorer countries of the region. These efforts were met with resistance because reductions in subsidy spending not only affect low-income households but also middle-class[4] consumers, micro and small businesses, and in some countries also larger companies in energy-intensive sectors (Rentschler, Kornejew & Bazilian, 2017).[5] National rulers were therefore concerned that subsidy reform would delegitimise them, provoke revolt, and ultimately undermine their social contract with citizens. It has only been fairly recently, and under severe fiscal pressure, that several MENA governments have engaged in extensive subsidy-reducing reforms. However, since they have used different reform strategies, it is likely that social contracts were changed in different ways – depending, for example, on the inclusiveness of reform implementation.

While the role, size, and (socio-economic and environmental) impact of subsidy reform has been widely discussed in the literature, a systematic assessment of the various different reform strategies and their different impacts on the prevailing social contract is missing.

In the following paper, we explore the dynamics of subsidy reforms conducted between 2010 and 2017 in three MENA countries: Morocco, Egypt and Iran. We show that the social contracts of these countries, which were quite similar before, have developed in different directions as a result of variations in subsidy reforms. We focus primarily on the pre-2017 period since reforms were initiated during that time frame. Although we reflect on policy implications during the post-2017 period, reform outcomes remain volatile due to changes in US politics towards the Middle East and the effects of the global COVID-19 pandemic. All three governments substantially reduced their subsidy spending, but they used different strategies in their efforts to reduce the likelihood of major social unrest (namely, unrest that could threaten their rule). Opposition to reform was present in all three countries, but governments aimed to contain it through different measures. While it is not surprising that social contracts change as a result of such policy interventions, we show that the very different strategies used to reform subsidies can be decisive for the direction in which social contracts develop.

Hence, we explore two questions:

- What have the governments of Morocco, Egypt and Iran done to make reforms pass with as little social unrest as possible?
- What do their respective strategies mean for the transformation of social contracts?

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4 We use the term "middle-class" in line with the large body of political economy literature even though the concept is still vaguely defined. Here, middle-class is defined by income (notably above the poverty-line but not yet abundant) and by occupation (formal, unlimited employment in white or blue collar jobs) (see, for example, Cammett & Salti, 2016).

5 Egypt, for example, provided particularly generous energy subsidies to energy-intensive sectors such as aluminium, cement, steel and glass even though these sectors were dominated by large (often monopolist) companies (Loewe, 2013b).

Our assessment draws primarily on academic literature, data from reports, published statistics, and mass media articles.

The comparison of Morocco, Egypt and Iran shows that five strategic options – or combinations of those – can help governments overcome possible challenges to subsidy reform: i) creating awareness and acceptance of the need for reform; ii) initiating a national dialogue on implementation alternatives; iii) setting up mechanisms to compensate potential losers; iv) proving the credibility of governments in their ability to bring reforms to an end; and v) repressing opposition to reforms.

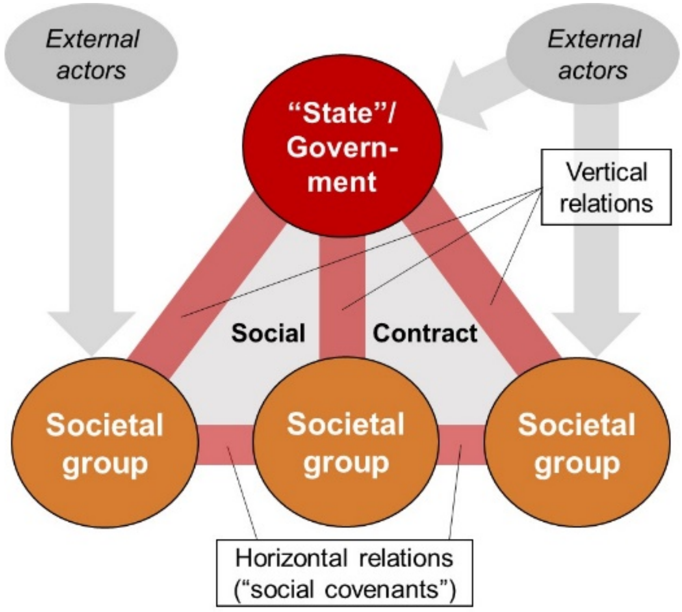
The three cases show different emphases on these five elements by each focusing differently on one of the three types of government deliverables: *protection, provision* and *participation*. The government of Iran focused on *provision*, which had always been at the core of social contracts of MENA countries. It compensated households with a quasi-universal direct cash transfer scheme, which broadened the social basis of the country's social contract (at least for a couple of years). The government of Egypt, however, shifted its focus more towards *protection* as the main source of its legitimacy in Egypt's new social contract. It replaced subsidies by far less generous conditional cash transfer programmes, used repression, and legitimised its policy by calling for compliance for the sake of security and national stability. Morocco emphasised *participation* without sacrificing too much of the delivery of *provision* in order to preserve (at least) the fundaments of the country's old social contract. Its government established a new conditional cash transfer scheme. Relative to the other two cases, more emphasis was, however, put on raising awareness of the necessity and acceptance of reform, thus strengthening public information, an important element of *participation* (Loewe et al., 2020).

This paper proceeds as follows: Section 2 presents the definition and framework of analysis of social contracts. Section 3 summarises the literature on subsidies, their strengths and weaknesses, challenges with reform and ways to manage it. Section 4 elaborates on the genesis and size of subsidies in MENA countries and their role in the social contracts. Section 5 examines the reform strategies in the three MENA countries. Section 6 concludes by providing implications for the emerging social contracts.

2 Social contracts

For our research purposes, we define a social contract as the "entirety of explicit or implicit agreements between all relevant societal groups and the sovereign (i.e. the government or any other actor in power) defining their rights and obligations towards each other" (Loewe et al., 2020, p. 3). Social contracts add to the legitimacy of governments and allow them to stay in power without excessive use of repression (see Figure 1). Thereby, they create dynamic equilibria in state-society relations and make politics more predictable. But they are often re-negotiated and adapted – for example when the relative power of the contracting parties changes or when one party is disappointed by the results of the existing social contract (McCandless et al., 2018).

Figure 1: Model of a social contract



Source: Loewe et al., 2020

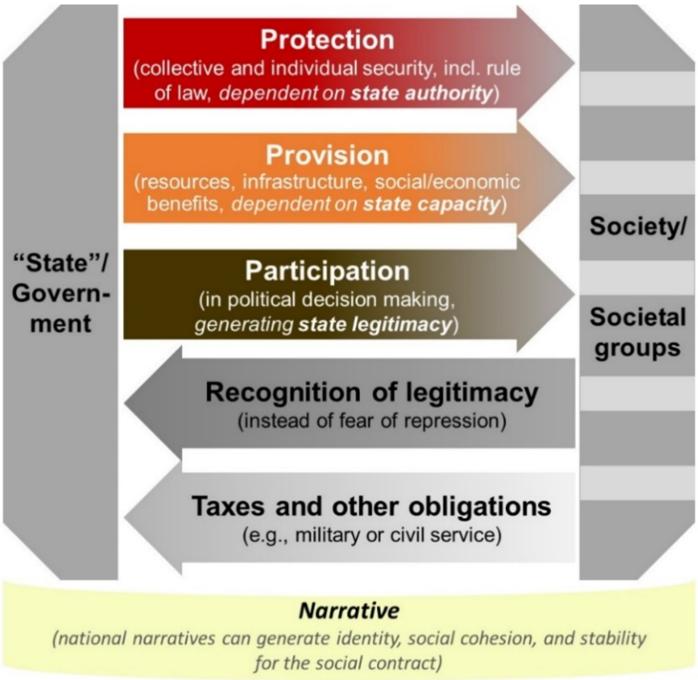
All countries with effective governments have social contracts but these differ substantially in the rights and obligations that they ascribe to the government and the various societal groups. The government has to deliver one or more of the following three "Ps":

Protection (which includes collective security against external threats, individual security against physical threats such as criminal acts, as well as legal security such as the enforcement of human and civil rights);

Provision of basic services such as access to resources, infrastructure, social services (for example, health and education), social protection and economic opportunities;

Participation of society in political decision-making processes at different levels (see Figure 2).

Figure 2: Deliverables in a social contract



Source: Loewe et al., 2020

This creates an incentive for social groups to recognise the incumbent government as legitimate, to pay taxes or other obligations, not just out of fear of oppression.

Failing to provide any or several of these deliverables leads to societal discontent and political instability known as "state fragility" (Grävingholt, Ziaja & Kreibaum, 2015, p. 1282). In the decades after independence, almost all governments of MENA countries, for example, emphasised protection and provision but neglected participation (Hinnebusch, 2020; Heydemann, 2020).

However, social contracts are all but static. While their main function is to render the relationship between state and society more predictable, they are renegotiated again and again in more formal and more informal processes. The result of these renegotiations can be that social contracts remain more or less as they are, are adapted, or are replaced by new ones. Of course, the result always depends on the relative negotiation power of the various contracting powers (that is, the government and the different societal groups). A fundamental reform of a social contract is thus typically due to i) stark changes in the distribution of power between the contracting parties; ii) a remarkable change in the preferences of one of the more powerful parties; iii) growing awareness on either side that the existing social contract does not fulfil its expectations, which may lead to revolutions, coups d'état, radical constitutional reforms, or similar (McCandless, 2018).

After independence, almost all MENA countries had quite similar populist-authoritarian social contracts (Hinnebusch, 2020). Above all, the republics in the region – but successively also the monarchies – legitimised the rule of authoritarian government on the basis of provision and protection. In particular, they provided social benefits for large parts of the population (energy and food subsidies, free health care and education, social housing, jobs in the public sector, public procurement) in order to compensate citizens for their lack of political participation.

To a large extent, these benefits were financed by rent income from abroad (from hydrocarbon exports, other natural resources, politically motivated transfers from abroad, remittances and other sources such as the Suez Canal rents in the case of Egypt). As a result, when external rent incomes declined while the population in MENA countries continued to grow, MENA governments faced budgetary problems. As a result, more or less all of them started to cut down the provisions stipulated by the existing social contracts, namely social benefits for the poor, while transfer programmes (such as energy subsidies) that benefitted more powerful societal groups such as the rich and the urban middle classes were kept in place.

The uprisings – which rocked most of the MENA countries from 2010 onwards – can therefore be seen as a protest against the erosion of the previous social contracts: falling social benefits and higher taxes along with continued low political participation. After the uprisings, however, the social contracts of MENA countries evolved in different directions. The rest of this paper is meant to illustrate how these differences result from governments' choice of reform strategies with respect to key policy fields such as social policies/subsidy reforms.

Of course, the COVID19 pandemic brought about yet another change in social, health and other policies and possibly also politics. In the following, however, we ignore these more recent effects because it is still too early to say what effect exactly they have actually had on the social contracts of MENA countries. Subsequent in-depth research could provide answers to this question.

3 Rationale, effects and challenges to subsidy reform

Governments have different options to overcome the challenges associated with subsidy reform, which, we argue, distinctly affect the existing social contracts. Before we reflect on this issue, we would like to briefly review the literature on why subsidies are widely used and what economic and social effects they trigger.

3.1 Goals of subsidies and distortionary effects on the economy

Subsidy estimates vary widely depending on the choice of benchmarks, measurement assumptions, and scope. A subsidy can be defined as the provision of financial support that lowers the actual selling price of a product. By a narrow understanding, this support is an explicit transfer (documented in the government budget) or a tax reduction at any stage in the value chain of a product that enables its producer or trader to sell it cheaper. By a broader understanding, a subsidy can also refer to the sale of a product owned by the government (such as oil or gas) at a price that is below the price that the government could achieve elsewhere (for instance, on world markets). This latter case would not show up in the government budget because the subsidy causes only opportunity costs (for example, foregone revenues) and is therefore more difficult to detect (IMF, 2013, p. 23).

Differences also exist in the way subsidies are measured. For energy subsidies, the International Energy Agency (IEA), for instance, uses the price-gap approach by calculating the difference between a reference price and the price paid by users. The IMF, which offers the largest database on energy subsidies in developing countries, quantifies “pre-tax” subsidies (that is, the price-gap measure) and the “post-tax subsidies (that is, including the cost of externalities) (see Barany & Grigonyte, 2015, for more detail on different methodologies). None of these approaches is perfect or covers all types of subsidies, a reason why caution is required in interpreting data.

Governments have diverse motives for the provision of subsidies (Rougier, 2016; Victor, 2009):

- To improve households’ access to basic commodities (such as energy, high-caloric food);
- to lower the cost of living and thereby reduce poverty and income inequality;
- to incentivise the purchase of goods with positive long-term or external effects;
- to stabilise prices and thereby reduce second-round effects of business cycles specifically during price hikes (for example, energy, food);
- to enable local industries to compete on world markets (for instance, through access to subsidised energy);
- to create rents for cronies owning industries that are particularly energy-intensive (for example, steel); and
- to buy legitimacy (social benefits in exchange for lack of political participation).

However, subsidies tend to have unintended negative side effects on the economy (Sovacol, 2017):

- High fiscal burden: Subsidies place heavy pressure on state budgets (Verme & Araar, 2017; Sdralevich et al., 2014), making it difficult to fund other social programmes or productive investments. In Egypt, for example, spending on energy subsidies exceeded that on education and health combined (Sdralevich et al., 2014).
- Limited effects on poverty and inequality: Empirical evidence shows low targeting efficacy and hence only marginal effects on poverty and inequality (at least compared with direct cash and in-kind transfers) (INS, CRES & AfDB, 2013; Loewe, 2013a; Verme & Aaraar, 2017; Couharde & Mouhoud, 2018). The large majority of both energy and food subsidies actually benefit the middle- and higher-income groups much more than the poor (see, for instance, Coady et al., 2010) – mostly because the poor spend a higher share of income on food and energy but far less in absolute terms. For instance, in Tunisia, only 12 per cent of government spending on food subsidies benefitted the poorest 16 per cent of the population, while in Egypt, the poorest quintile of the population received 19 per cent of the food subsidies in the period 2008-2009, while the richest quintile received 21 per cent (Ghoneim, 2012). In Egypt, 86 per cent of gasoline subsidies benefitted the top 20 per cent of all income earners, while only 1 per cent benefitted the bottom 20 per cent (Sarangi, Abu-Ismail, & Arajui, 2018).

- Leakages and losses: Subsidy systems also tend to suffer from shortcomings in transfer efficiency. In Egypt, some 30 per cent of subsidised food did not reach consumers because subsidised flour or bread got lost somewhere in the distribution system (Blomquist, 2006).

- Negative long-term effects on competitiveness: In the short-term, subsidised energy can provide especially capital-intensive firms with advantages over competitors from other countries. But, over time, such advantages can turn into disadvantages (Bauer et al., 2013) mainly because local firms do not feel enough pressure to invest in productivity improvements. Once their competitors find ways to produce in less energy-intensive ways, the comparative advantage for local firms disappears (IMF, 2013, p. 16).

- Adverse incentives: Subsidies create adverse incentives in consumption, production, and investment. They discourage investment in energy efficiency and renewable energy. Many companies in the MENA countries prefer energy-intensive over employment-intensive modes of production. While it is unclear to what degree high unemployment rates in the region are due to subsidies, they play at least some role. Energy subsidies also reduce incentives to use and invest in public transportation to reduce individual traffic, or in energy infrastructure to reduce energy losses (El-Katiri & Fattouh, 2017; Sdralevich et al., 2014).

- Over-consumption of the subsidised goods: Energy subsidies raise resource depletion (oil, natural gas, coal) and create negative environmental externalities (IMF, 2013, p. 19). Not surprisingly, the MENA region has the highest energy intensity of economic growth worldwide, which is not an “oil rich country phenomenon alone” (Fattouh & El-Katiri, 2013, p. 110). Likewise, food subsidies lead to waste (Capone et al., 2016) and increase the risk of malnutrition and over-nutrition. In Egypt, for example, they have significant effects on child and maternal overweight in urban areas because mainly high-caloric items are subsidised (bread, flour, sugar, oil) (Ecker, Al-Riffai, Breisinger, & El-Batrawy, 2016).

- Lastly, subsidies create incentives for the large-scale smuggling of fuel to countries with higher energy prices (El-Katiri & Fattouh, 2017).

3.2 Challenges to reform and how to address them

Acknowledging the manifold negative effects of subsidies on the economy and society raises the question of why governments – particularly in the MENA region – have continued paying them for decades. Literature argues that removal is an extremely challenging task from a political economy perspective for three main reasons.

First, the existence of subsidy-regimes creates lock-in for governments. Many of them have built up these schemes not only to support vulnerable households or firms but also to buy legitimacy. The removal of subsidies can therefore be a risk for social and political stability and for regime survival (Inchauste & Victor, 2017; Lockwood, 2014).

Second, many countries lack the administrative capacity needed to set up compensation mechanisms for the losers of reform. Very few low- and middle-income countries have social transfer schemes with efficient targeting mechanisms (Inchauste & Victor, 2017), one of the reasons why subsidy schemes have been so popular in MENA countries in the past.

Third, many citizens are not even aware of the many problems associated with subsidies. As a result, they are often against reform, even if it harms them only marginally (IMF, 2013, p. 23).

Reform would require policymakers to overcome these challenges. Drawing on existing literature, we argue, that the following elements contribute to addressing the challenges of subsidy reform. Each of them addresses one or more of these three challenges.

Information: The government can run public information campaigns in the media to *create awareness and acceptance of the need for reform*: i) sensitise the population on problems associated with subsidies; ii) explain that in the long-run reform is better for all societal groups; and iii) inform at an early stage on the rationale, goals, design, and possible effects of the implementation strategy, to make subsidy reform acceptable to all relevant segments of the state and the society (Worley, Bryan Pasquier, & Canpolat, 2018).

Dialogue: The government can initiate a "social dialogue between and among different interest groups" (Karshenas, Moghadam, & Alami, 2014, p. 726) i) on the weaknesses of the existing subsidy schemes; ii) on possible ways to reconcile the interests of the various social groups and identify an acceptable compromise; and iii) on different options of reform implementation (in terms of speed, sequencing and so on) (IISD [International Institute for Sustainable Development], 2013).

Compensation: The government can set up compensatory mechanisms to mitigate at least part of the losses that some social groups may suffer from subsidy cuts (Clements et al., 2013; IISD, 2013). These mechanisms can, for example, be in the form of targeted or universal direct cash transfer programmes, extension of public health or education services, or increase in the minimum or average wage levels, each having advantages and disadvantages. Direct cash transfers tend to fare better on average than subsidies in terms of allocative efficiency and distributive justice. However, their targeting efficiency and equity depends highly on the targeting criteria and can be, in extreme cases, even worse than the targeting efficiency of food subsidies. In theory, targeted cash transfer programmes need smaller budgets than universal subsidy or universal direct cash transfer schemes for the same achievements in terms of poverty or inequality reduction because they pay out benefits to the target population only. In practice, however, identifying target group members is extremely difficult in countries with large informal sectors and, hence, causes either very high costs or targeting errors. All targeted cash transfer schemes in the MENA countries allocate high shares of their budget to non-poor households, including the richest quintiles. In addition, the targeting process opens a door to corruption. Governments might therefore consider setting up universal direct cash transfer schemes instead, which have large errors of inclusion but small errors of exclusion and progressive effects on income distribution. Investment in education, health or infrastructure can have positive long-term effects on social and economic development but bears the risk that some parts of the vulnerable population will not benefit.

Government commitment: Governments can use various different measures to strengthen their own credibility of being willing and able to implement reforms in order to convey that resistance is futile (Kyle, 2018). Of course, it is difficult to assess a government's level of commitment when resistance to reform is suppressed (see below). But the government's commitment becomes obvious if willingness to implement reforms comes with risks for regime survival, for example if the government proceeds with reform despite country-wide protests or if it connects its own destiny with the reform.

Repression: Governments can, of course, also repress opposition to reform through verbal expressions, legal restrictions or police/military action. In many cases, the threat of force suffices to hold back reform opponents (Moerenhout, 2018).

As we will see in the next section, how these strategies are used and emphasised to manage the reform process affect the social contract of a country in different ways.

4 Subsidies in the MENA

Subsidy schemes in the MENA region have a long and convoluted history and have become an integral part of the social contracts. Below we provide a short overview of their genesis and role as well as a snapshot of the scale of subsidies across the region.

4.1 Genesis and role

The first subsidy schemes in the MENA emerged during and after World War II. Subsidies were initially meant to stabilise local consumer prices at a time when world market prices fluctuated heavily (Gutner, 1999; Schewe, 2017). Motives changed during the 1950s when populist-authoritarian leaders seized power in most Arab republics. They promised autonomy from Europe and socio-economic progress to back nation-building, stabilise their autocratic rule, and transform feudalistic societies. As a result, they established social contracts that built on the provision of social benefits to citizens (including subsidies on energy, food, water, public transportation and housing, as well as employment in the public sector) as compensation for limited political participation. These policies became so popular that the more conservative monarchies in the region felt the need to establish their own rent redistribution schemes (Hertog, 2017; Rougier, 2016; Vidican 2014).

During the 1960s and 1970s, the subsidy systems grew significantly in scope and scale. They were increasingly seen as a cornerstone of the social contract between state and society. At the end of the 1970s, MENA governments subsidised some or all of the following: bread, wheat, sugar, tea, cooking oil, milk for children, medicine, electricity, local transportation, light oil, meat, fish, chicken, rice, beans, lentils, soap, housing, petrol, diesel and inland transportation. Governments preferred to use subsidies because of their ease to administer, availability to the entire population, and flexibility in case policy priorities changed. In contrast, direct cash transfer schemes typically required skills in targeting and did not allow for quick changes in policy focus.

The rise in subsidy spending has been enabled by the steep rise in external rent incomes from different sources, including, among others, exports of energy and natural resources, international traffic (such as Suez Canal user fees), tourism and budget transfers (for example, development aid provided by international and Western donors) (Escribano, 2013; Heydemann, 2007; Kamrava, 2014).

Some MENA countries already tried to reduce subsidies in the late 1970s, especially under external pressure from the IMF or the World Bank. However, in response to domestic opposition, most of these initiatives were subsequently reversed. In 1977, for example, Egypt's government decided to cut subsidies on white bread and flour and to eliminate all subsidies on rice, cooking oil, gasoline and cigarettes. This step was in contrast to President Sadat's earlier promise to provide prosperity for all, and hence provoked riots led by public sector workers and students. To restore stability, the President reinstated the subsidies and even extended the system to additional products (Gutner, 1999; Jain, 2014).[6]

4.2 Scale

In 2011, the MENA region accounted for about half of all energy subsidy spending worldwide (Sdralevich et al., 2014). Altogether, MENA countries spent USD 258 billion on food and energy subsidies (both consumption and production subsidies on a pre-tax, on-budget basis) representing 9.3 per cent of regional GDP, or 24 per cent of total government spending (IMF, 2013).[7] Egypt, for example, spent at least 9.5 per cent of GDP in 2013 on energy, food, water and medicine subsidies according to Abdalla & Al Shawarby (2017), while the IMF (2013) estimated that its spending on explicit energy subsidies alone (that is, not even including tax reductions or food subsidies) was 11 per cent of GDP in 2011. Yemen spent more than 14 per cent of GDP on subsidies in several years. Saudi Arabia, Algeria, Iran and Iraq spent between 10 per cent and 13 per cent of GDP on explicit energy subsidies in 2011 (IMF, 2013, p. 50).

Most MENA countries spent much more on energy subsidies (4.5 per cent of their respective GDP on unweighted average) than on food subsidies (1.1 per cent) in 2011 (Silva et al., 2012, p. 48). 50 per cent of all energy subsidies were paid on petroleum products, 23 per cent on natural gas, and 26 per cent on electricity (Sdralevich et al., 2014). In some countries, food subsidies had played a much more important role in the past. Egypt, for example, spent up to 8 per cent of its GDP on food subsidies during the 1970s (Abdalla & Al-Shawarby, 2017) but only 2 per cent in 2011 (Sdralevich et al., 2014, p. 11), while Iraq still spent 5.5 per cent of GDP in 2011 (Silva et al., 2012, p. 48).

In contrast, by 2011, MENA countries spent, on average, less than 1 per cent of their respective GDPs on direct cash and in-kind transfer schemes, and the targeting of these schemes was highly problematic. In some MENA countries, even direct cash transfer programmes benefitted high and middle-income people more than the poor (Loewe, 2010, p. 239).

Recent figures on total subsidy spending are difficult to come by, but they have probably declined since 2011, especially for fossil fuels. Globally, governments spent USD 260 billion on fossil-fuel consumption subsidies in 2016, which was much less than in 2014, when they spent USD 455 billion (IEA [International Energy Agency], 2017). Yet, MENA

6 The very same reaction was also the initial reflex of other MENA governments in response to the popular protests from 2010-2011 (Schlumberger, 2021).

7 In 2011, the unweighted average of MENA countries' spending on food, energy and water subsidies was only 7 per cent of their respective GDP (Silva et al., 2012). The difference is probably largely due to countries with a high GDP such as Saudi Arabia spending disproportionally much on subsidies.

countries still accounted for about 48 per cent of these expenditures. Further, these figures cover only explicit subsidies paid on the production and purchase of energy products but not the free or price-reduced provision of government-owned resources (for example, raw oil in energy production).

5 Subsidy reform in Morocco, Egypt and Iran

Since the mid-2000s, policymakers in the MENA countries have been discussing more intensively the need to reform subsidy schemes, mainly due to:

- Strong fluctuations in food and energy prices during the economic crises from 2007 to 2009;
- growing budgetary problems due partly to high subsides but also increasing expenditures in other fields, misuse of government money, and insufficient domestic resource mobilisation through taxes and fees; and
- pressure exerted by foreign donors on MENA governments to rationalise their spending.

After 2010, several countries – especially Iran, Egypt, Jordan, Morocco and the United Arab Emirates – took major steps towards reforming subsidies. The vulnerable political landscape after the Arab Spring uprisings and the fact that these reforms were, and are, ongoing in spite of omnipresent challenges, lead us to explore some of these cases in more detail. We focus here on Morocco, Egypt, and Iran, because of the following:

- Reforms in these three countries are more advanced;
- their governments have been able to promote reforms fairly quickly and provoked only low- and medium-scale protests that did not constitute a real challenge to the rule of governments – at least until recently;
- but the three countries followed different reform pathways, likely to result in different manifestations of the new social contracts.

Even if reforms started at different points in time, the political and economic framework conditions of reform were similar in these countries, a reason why we can still compare and contrast their strategies and outcomes.

Our lines of inquiry are therefore orientated on two questions: i) What have these countries' governments done to make reforms pass with as little social unrest as possible? And: ii) What do their respective strategies mean for the transformation of social contracts?

We argue that the government of Morocco implemented subsidy reforms in the least disruptive way, which helped to preserve at least part of the country's existing social contract (as part of a strategy of so-called "authoritarian upgrading"). It did so by allowing for some more political *participation* (at least at the communal level) and by shifting in terms of *provision* somewhat from universal subsidies to more targeted direct transfers. The government of Egypt followed a less cautious path, transforming the country's social contract from a "provision pact" to a "protection pact" where the government's responsibility towards society is increasingly narrowed to delivery of individual and collective security rather than social and economic benefits for everybody in society. The government of Iran, in contrast, refocused on provision. It tried to make subsidy reforms widely acceptable for large parts of society, thereby preserving some of the essence of the country's previous social contract. Yet, the resulting social contract was more egalitarian, as subsidies were not replaced by a targeted but by a quasi-universal direct social transfer scheme. We discuss these implications in more detail in Section 6 after examining below each reform strategy in detail.

5.1 Morocco

Energy prices have always been higher in Morocco than in other MENA countries. Nevertheless, its fuel subsidy budget increased tenfold during the 2000s (Achy, 2012). As Morocco imported 90-95 per cent of its energy resources in the past (MEME [Moroccan Ministry of Energy, Mining and Environment], 2011), subsidies have continued to put pressure on the government's budget. In 2012, Morocco's subsidy bill peaked at 6.6 per cent of GDP, higher than its spending on investment or its combined spending on education and health (Verme, El-Massnaoui, & Araar, 2014).

Therefore, in 2012, the Moroccan government began a systematic process of reforming subsidies, the goal being to dismantle the subsidy regime fully by 2017 (Verme et al., 2014). By 2021, all subsidies had been removed except those on liquefied petroleum gas (LPG, typically butane gas used for cooking and heating), flour, sugar and water, which are primarily consumed by low-income groups.

In 2013, a new pricing system was put in place for gasoline, diesel, and fuel oil, allowing local prices to rise with price changes on world markets (Verme & Araar, 2017). As a result, gasoline prices increased by 20 per cent, diesel by 14 per cent and fuel oil by 27 per cent (Sdralevich et al., 2014, p. 45). By 2015, subsidies for these products were removed entirely (see Table 1).[8] Electricity prices were also increased by 3 to 5 per cent except for those consuming less than 100 kW per month (Merrill, Bassi, Bridle, & Christensen , 2015). This decision reduced subsidies by almost 2 per cent of GDP and lowered the fiscal deficit to 6 per cent of GDP (from 7.3 per cent in 2012) (Merrill et al., 2015).

By 2019, the share of subsidies in GDP had dropped to 1.6 per cent (IMF, 2019) and the government of Morocco continued – even during the COVID-19 pandemic – to bring this figure further down ("Maroc", 25 October 2020).

The increase in prices was, however, not followed by major opposition from consumer groups. The fact that world energy and food prices were comparatively low during the reform phase was beneficial in reducing the impact on consumers. More importantly, price increases were introduced only gradually following an extensive communication strategy

8 Fuel oil used for electricity generation was also included in this price indexation system; related subsidies were replaced by a direct lump-sum transfer to the national utility for three years (2014-2017) (Verme & Araar, 2017, p. 103).

and stakeholder dialogue (see below).[9] Moreover, to minimise the impact on vulnerable groups, the reform left out prices for LPG consumed mostly by (poor) households and by the agriculture sector (a strategic source of income and employment for Morocco), and for sugar and flour (Royaume du Maroc, Cour de Comptes, 2014).

As such, while Morocco (along with Jordan and Mexico) remains among the countries with the lowest LPG prices worldwide (Gittleson, 2012), the government was successful in achieving acceptance for reform, protecting the poor, avoiding social backlash, and buying itself time to identify optimal compensation mechanisms. Estimates show that if LPG prices increase by 30 per cent, poverty rates are likely to increase by 9 per cent (Verme & El-Massnaoui, 2015) and the impact on small industrial producers and farmers is also likely to be significant. Further, reform was implemented at a time when Morocco also invested heavily in renewable energy as a way to reduce its dependence on imported fossil-fuels and its vulnerability to changes in world energy prices (Vidican Auktor, 2017). Expanding the use of energy efficiency instruments (a key component of Morocco's new energy strategy) also contributed to reducing energy consumption and financial burden on consumers.

Table 1: The reform of energy subsidies in Morocco

	2012	2013	2014	2015
	Price increase	**Partial indexation**	**Complete indexation**	**Complete indexation**
Government spending on energy subsidies as a percentage of GDP	6.5	4.6	3.5	1.4
Gasoline	+2 dirham/litre (DH/L)	Subsidy fixed at 0.8 DH/L	Subsidy eliminated	Subsidy eliminated
Diesel	+1 DH/L	Subsidy fixed at 2.6 DH/L	Partial indexation	
Fuel oil (N2)	+988 DH/L	Subsidy fixed at 930 DH/L	Subsidy eliminated	
Fuel oil for electricity generation			Subsidy eliminated + compensation directly to utility company	

Source: Adapted from the Moroccan Ministry of the Economy and Finance, 2016, p. 8

Aside from the gradual implementation of reform and the systematic alignment with other reforms in the energy sector, the following aspects may also have contributed to the population's acceptance of higher prices: i) extensive information; ii) dialogue with selected representatives of society; iii) compensation for those affected by higher prices; and iv) government commitment. Repression played a limited role in Morocco.

9 A gradual approach is desirable when large price increases are needed (Coady, Parry, Sears, & Shang, 2017), avoiding overburdening the population.

Information

In addition, Morocco implemented a comprehensive and well-orchestrated communication strategy (El-Katiri & Fattouh, 2017) channelled through public TV and radio discussions, newspaper articles targeted to different audiences including educated youth, advertisements, and debates. This campaign explained the scale and distribution of subsidies[10], the economic reasons for reform, the different reform steps and ways to shelter the poor from negative effects, and the multiple benefits that could be captured as a result (El-Katiri & Fattouh, 2017). In addition, the government promised the population that they would increase energy prices only gradually and continue the subsidisation of LPG, sugar, and flour, which is particularly important for the poor. Efforts to engage in dialogue and to provide information contributed not only to improving awareness, but also to building support for reform.

Dialogue

To avoid political backlash, the government also engaged in dialogue with representatives of important social groups (Verme & Araar, 2017). In 2012, it established three commissions (including government, trade unions, and civil society representatives) to assess options for reforms, their possible macroeconomic effects, and how to mitigate negative effects (Verme & El-Massnaoui, 2015). The leadership of the Justice and Development Party (PJD), which currently commands the executive branch of the government, and the popularity of prime minister Benkirane of the same party have been critical for keeping reform going, making it acceptable for many citizens and ensuring that no additional political opposition gained momentum (Merrill et al., 2015; Daragahi, 2015). The PJD also played a role in appeasing stakeholders such as trade unions, which protested against reforms several times.

Compensation

Before the reforms, the budget of Morocco's direct cash transfer schemes had been smaller than the MENA average and reached just 15 per cent of the households in poorest quintile of the population (Silva et al., 2012). For this reason, the government developed specific measures to compensate professional categories most significantly hit by subsidy reforms, such as passenger/merchandise transporters and the industrial sector (Verme & El-Massnaoui, 2015).

In addition, two existing nationwide social protection programmes were expanded. *Tayssir* (Arabic for "facilitation") provides cash transfers to poor families (identified by geographical and categorical targeting) with children between ages 6 and 15 on the condition that they attend school on at least 80 per cent of school days. The programme is active in rural areas with poverty head-count rates above 30 per cent and school absenteeism above 5 per cent. The programme extended its outreach from 80,000 families in 2009 to 466,000 families in 2014 (Nazih, 2018).[11]

10 The Moroccan government conducted a survey in 2010 finding that more than 70 per cent of the population were unaware of the existence of fossil-fuel subsidies (Chen, Liverani, & Krauss, 2014). For instance, most buyers of 12 kilogramme cooking LPG bottles were unaware that the real market price was over 100 Moroccan dirhams instead of the standard retail price of 40 Moroccan dirhams (Chen et al., 2014).

11 After 2014, the coverage of *Tayssir* has not substantially widened any more (Machado et al., 2018).

The other programme is the Regime d'Assistance Médicale pour les Économiquement Démunis (RAMED (Medical Assistance Scheme for the Economically Deprived, Rabat)), which grants free medical treatment to its members. Membership is free for households living below the national poverty line and highly subsidised for households living barely above the poverty line. The number of members increased from 5.1 million individuals in mid-2013 to 8.4 million in early 2015 (Merrill et al., 2015, p. 43) and to 11.46 million in 2017 (Machado, Bio, Soares, & Osorio, 2018), the aim being to cover a third of the population in the long term (Verme & El-Massnaoui, 2015).

However, both programmes face severe difficulties in targeting and budgeting. They fail to disburse transfers on time, to cover at least a large majority of households below the poverty line and to exclude at least households with very high income from benefits (Verme & El-Massnaoui, 2015; AfDB [African Development Bank], 2016; Nazih, 2018).

To address these issues, the government has been working since 2013 on a new identification system for the population (the National Population Registry), supposed to be implemented in 2019 but still experiencing delays ("Coronavirus: Le Maroc multiplie", 2020). Further, the debate on whether to use universal or targeted cash transfers to compensate the poor is still ongoing (Jebari, 2016). In response to the COVID-19 crisis, households working in the informal sector and workers with a social security number who lost their jobs, or who work less than before, received compensation. This new circumstance created momentum for improving the social targeting system, with the adoption of Law 72.18 in June 2020 approving a new mechanism, the Unified Social Register, aimed at identifying households wishing to benefit from social support programmes (Ahdani, 2020). Therefore, it remains to be seen whether the targeting problems will be solved (El Arif, 2018), and thus if acceptance of the reform will persist in the medium-term.

Government commitment

While it is difficult to distinguish to what extent government commitment (as defined earlier) played a role in the Moroccan case, several factors may have been important in increasing the government's credibility in implementing reforms, such as extensive information campaigns that contributed to transparency in implementation, and wider reforms in the energy sector to improve energy security.

Repression

In Morocco, protests against subsidy reform have been dispersed and did not escalate for several years, a reason why repression was only moderate between 2012 and 2017. This context facilitated government's focus on solutions associated with the subsidy reform rather than on using heavy-hand repression to de-escalate social tensions. While uprisings have increased since 2017 – especially in the northern part of Morocco – they were not triggered by subsidy reforms. Instead, other concerns, such as unemployment, health services, civil rights, treatment by the authorities, political participation, education and corruption, featured more prominently among protest movements (Aznague, 2018). These recent uprisings were however met with increased repression, raising questions about the government's ability to protect "the rights and dignity of its citizens" (Chahir, 2021).

5.2 Egypt

Few other MENA countries have spent so much on food and energy subsidies as Egypt (26 per cent of total government spending, 8.7 per cent of GDP in fiscal year 2012/2013 according to Sdralevich et al. (2014), and even more than 35 per cent of the government's spending or 12.5 per cent of GDP according to Griffin et al. 2016). Given that, in 2014, the government budget deficit peaked at 13.7 per cent and total public debt surpassed 100 per cent of GDP, decision-makers acknowledged that subsidy cuts could not be further avoided. This decision was reinforced by evidence that the poorest 40 per cent of the population benefitted least from subsidies (only 43 per cent of the food subsidies, 3 per cent of gasoline subsidies, 7 per cent of natural gas subsidies) (Abdalla & Al-Shawarby, 2017; Sdralevich et al., 2014).

Attempts to reform subsidies were made, however, even earlier than 2014. First reform steps were taken under President Mubarak who in 2008 increased the price of diesel by 25 per cent, and in 2010 the price of sugar by 200 per cent and that of edible oil by 120 per cent.[12] Further reforms were implemented after the uprisings in 2011 by the Muslim Brotherhood government of President Mursi (Kienle, 2015, p. 20) and even more so after the army coup in July 2013 brought President Al-Sisi to power. As a result, the price of electricity for households rose by 16 per cent while gasoline prices rose by 112 per cent (Sdralevich et al., 2014).

However, the most substantial reforms were started after the presidential elections in 2014. By that time, the government had already eliminated large parts of the opposition and reinforced repression. Step by step, the government reduced all energy subsidies. As a result, by 2017 the price of petrol had gone up by 387 per cent relative to its 2010 level, and the price of LPG (mainly used by low-income households for cooking) rose by 650 per cent (see Table 2). Total government spending on energy subsidies decreased between 2013 and 2016 from USD 269 to USD 96 per capita in constant 2019 prices (IEA, 2020).

While end-consumer prices are still below international levels, the price increase strongly affected large parts of the Egyptian population, in particular because the government also had to float the Egyptian pound (EGP) and introduce a value-added tax (Moerenhout, 2018). All three measures were taken in order to fulfil the requirements for getting a USD 12 billion loan in 2016 from the IMF plus the same amount from bilateral donors. After 2016, government spending on energy subsidies increased again to USD 158 per capita in 2019 (IEA, 2020).

12 See also time series at http://en.thefuelprice.com/Feg and at http://www.thecropsite.com.

Table 2: The reform of subsidies in Egypt 2010-2017

	2010	2012	2013	2014	2016	2017	*Change 2010-2017 (%)*	*2017 (percentage of international benchmark price)*
Average consumer prices (2010 = 100)	100	118	129	142	178	220	*120*	*100*
Government spending on energy subsidies per inhabitant in constant 2019 prices	208	270	269	213	96	224	*107*	*n/a*
Government spending on energy subsidies as a percentage of GDP	6.9	7.0	7.1	6.3	3.3	9.1	*132*	*n/a*
Consumer electricity (kWh)								
(1-50 kWh)	5	5	5	7.5	11	13	*160*	*7*
(51-200 kWh)	11	11	12	14.5	19	22	*100*	*13*
(201-350 kWh)	16	16	19	30	42	55	*244*	*31*
(351-650 kWh)	24	24	29	40	55	75	*213*	*43*
(651-1000 kWh)	39	39	53	71	95	125	*221*	*71*
(beyond 1000 kWh)	48	48	67	84	95	125	*160*	*71*
Gasoline 80' (1 litre)	0.9	0.9	0.9	1.6	2.4	3.7	*306*	*41*
Gasoline 92' (1 litre)	1.8	1.9	1.9	2.6	3.5	5	*186*	*25*
Gasoline 95' (1 litre)	1.8	5.9	5.9	6.3	6.3	6.6	*277*	...
Diesel (1 litre)	0.8	1.1	1.1	1.8	2.4	3.7	*387*	*27*
Natural gas (1 litre)	0	0.4	0.4	1.1	1.6	2	*1900*	...
LPG (for cooking) (12.5 kg)	0	4	8	8	15	30	*29900*	...
Baladi bread (1 loaf)	0.1	0.1	0.1	0.1	0.1	0.1	*0*	*14*
Subsidised cooking oil (1 kg)	3	3	3	7.35	10	12	*300*	*91*
Subsidised sugar (1 kg)	1.25	1.25	1.25	4.5	7	8	*540*	*100*

Note: In 2016, the Egyptian Pound was devalued to half of its former price, also reducing the effects of the subsidy reform.

Sources: Ecker, Trinh Tan & Al-Riffai, 2014; Farouk, 2017; IEA, 2020; James, 2015; Ketchley & El-Rayyes, 2017; Kienle, 2015; Adel & Ismail, 2017; Sdralevich et al., 2014; time series at http://en.thefuelprice.com/Feg and http://www.thecropsite.com; own calculations

These reforms had painful effects not only on the poor but also on the middle-class. Yet, they did not provoke major social unrest.[13] The outcome can be traced back to several key factors: i) fear of renewed political turmoil and instability; ii) strong state-led repression of opposition movement; and iii) strong government commitment to implement reform

13 Exceptions were smaller local protests that ended when the government promised to take back part of the reform. In addition, only some groups from the lower urban class became involved (in addition to some leftist activists and taxidrivers) but hardly anybody from the middle or lower-middle class (Abdellatif & Fakhry, 2017; Ketchley & El-Rayyes, 2017).

whatever it takes. Public information and awareness campaigns were also used, at least at the beginning, but in a less consistent manner than in Morocco and without any substantial societal dialogue. Specifically, although initially in 2014 the Egyptian government engaged in communication campaigns to explain the rationale for reform, its interest in integrating societal actors in the reform process faded later on. Furthermore, information on the next reform steps was often unsystematic, incomprehensive and sometimes even misleading (see below). Moreover, the compensation schemes were limited in scope and scale and therefore unable to absorb much of the negative effects of subsidy reforms.

Information

The government informed the population regularly, especially early on, using various media channels on the reasons, goals and next steps of the subsidy reform (El-Katiri & Fattouh, 2017; Ketchley & El-Rayyes, 2017). Yet, information often came at short notice, was at times incomplete or contradictory, and sometimes the government even did the opposite of what it had previously stated it would do. For example, in 2013, it announced cuts on energy but not on food subsidies (El-Katiri & Fattouh, 2017; James, 2015). Food subsidies were, in fact, not reduced in 2014, but a limit was set on the quantity of subsidised food items that households could buy at reduced prices.[14] But, starting just two years later, subsidies on food other than bread were gradually reduced, and a substantial numbers of households lost the right to buy subsidised food.[15] For a while, bread continued to be exempted from both the rationing and the price increases, but then the government also limited the purchase of subsidised bread to five loaves per person and day (James, 2015, p. 10; Ketchley & El-Rayyes, 2017). Likewise, the government initially promised to exempt LPG from subsidy cuts because many low-income households use it for cooking, but in 2014 the price of LPG also went up by 87 per cent (Moerenhout, 2018).

Dialogue

The decision to eliminate all energy and almost all food subsidies within just five years was taken unanimously by President Al-Sisi who has gained almost absolute authority in Egyptian politics. The only tangible opposition movement, the Muslim Brotherhood, was brutally repressed and other political groups (liberals, socialists, democrats) were largely discouraged from organising public demonstrations. The small opposition parties in parliament stayed silent on the issue (Abdellatif & Fakhry, 2017). Open debate only took place within the army itself. The army leadership was in favour of subsidy reforms while some segments were against them, mainly because a number of army-owned enterprises used to benefit considerably from the old subsidy system (El-Katiri & Fattouh, 2017; James, 2015, p. 5). However, the army leadership held the sway and no public consultation with society representatives took place. Interestingly, this strategy contrasts not only with the strategy of the Moroccan government but also with the strategy that earlier governments of

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14 The government issued smart cards for all eligible citizens allowing the purchase of subsidised goods with a value of up to 15 EGP per person per month (Abdellatif & Fakhry, 2017; James, 2015; Sdralevich et al., 2014).

15 See Abdalla Al-Shawarby (2017) and Abdellatif & Fakhry (2017) for more detail. The price of subsidised cooking oil, for example, increased by 300 per cent within just three years, while the price of subsidised sugar increased even by 540 per cent (see Table 2). By February 2017, overall food price inflation reached 42 per cent per year compared to just about 15 per cent before 2011 (Ketchley & El-Rayyes, 2017).

Egypt had used. In the late Mubarak years, the government opted for communication and negotiation to promote a social insurance reform that ultimately failed (Loewe & Westemeier, 2018).

Compensation

At the beginning, the government promised to set aside 15 per cent of the savings from reform for "social investments" such as cash transfer programmes, targeted food subsidies, free health insurance for the poor, and other social protection programmes to compensate the poor (El-Katiri & Fattouh, 2017; James, 2015, p. 17).

Until the beginning of the COVID-19 crisis in 2020, however, little happened in that regard. The government's spending on social transfers did not increase by much, food subsidies were cut rather than extended, and the free health insurance for the poor will not be implemented in all governorates until the year 2032 (Loewe & Westemeier, 2018). At the beginning of the reforms, the government extended food subsidies to 20 more items in order to compensate the poor for energy subsidy cuts (Abdellatif & Fakhry, 2017); but starting in 2016, it gradually reduced almost all food subsidies except for bread. Some authors also argue that the increase of public sector wages in 2014 was meant as compensation for subsidy cuts but benefitted only the middle-class (El-Cassabgui, 2017; Moerenhout, 2018).

The only immediate measure taken to compensate households for the reduction of subsidies was the establishment of two cash transfer schemes in 2015 with World Bank financial support: *Karāma* (Arabic for dignity) provides proxy means-tested cash transfers of 350 EGP per person per month to elderly and severely handicapped people, and *takāful* (Arabic for mutual support) grants proxy means-tested transfers of 325 EGP per family per month (plus 60-100 EGP for every child) to poor families on the condition that children go to school regularly. The programmes are meant to replace existing social assistance and social pension schemes, which suffer from significant deficits in terms of coverage, efficiency and effectiveness (Loewe, 2014).

However, the new schemes do not perform much better. In early 2020, they covered about 2.5 million households or 10 per cent of the population ("2.5 million families benefit", 2020). Yet, this number is just a third of the number of people living below the national Egyptian poverty line (World Bank, 2020) and in 2018, only 45 per cent of beneficiaries were from the poorest income quintile (17 per cent were even from the richest income quintile) (Breisinger et al., 2018; El-Badrawi & Corkery, 2017). The old transfer schemes had covered 4 per cent of the population and, at most, 20 per cent of the poor (Loewe, 2010). Moreover, the transfers provided by the *karāma* system are equivalent to about 73 per cent of the current national poverty line, while those provided by the *takāful* system correspond to just 25 per cent. This is just slightly higher than transfers provided by the old cash transfer schemes (20 per cent of the national poverty line; see Loewe, 2010). As a result, the new schemes increased the consumption of beneficiaries by only 8.4 per cent and lifted only 11 per cent of them out of poverty (Breisinger et al., 2018). Lastly, the budget for these new schemes is just about USD 1.4 billion per year or 0.5 per cent of GDP (El-Badrawi & Corkery 2017; UNICEF [United Nations Children Fund], 2019), while the government saved several percentage points of GDP by reducing subsidies.

Government commitment

The government repeatedly insisted that it did not want to alter any element of the subsidy reform even under pressure from protests (El-Katiri & Fattouh, 2017). In other words, people would have to accept the reforms or challenge the Sisi government as such. Thus, the government linked the reforms to its own destiny in order to strengthen its own credibility (Moerenhout, 2018).

Even if the economic situation in the country was much better than many Egyptians perceived it to be, the Sisi regime was able to paint it in a dark light. Thereby, Sisi was able to portray himself not only as the saviour of the country, but as a guarantor of stability. The president often highlighted that his policies were essential for the stability of Egypt and that Egyptians knew well what instability meant: they only had to look at the destiny of Syria, Yemen or Libya (El-Katiri & Fattouh, 2017). And he warned that reforms were inseparable from his own rule. Finally, he could point to international organisations not only supporting his subsidy reforms but also making further support dependent upon them (Adly, 2020). As a result, most Egyptians accepted the Sisi regime and its political stand as a price for stability.

Repression

Of course, large parts of population were still not in favour of reforms because they had benefitted markedly from subsidies. However, violent state repression discouraged opposition (Abdellatif & Fakhry, 2017). In addition, the whole country found itself in an atmosphere of nationalism and glorification of political leadership. The hopes of large parts of the population were on restoring stability and growth (El-Katiri & Fattouh, 2017) and the political leadership capitalised on this atmosphere. When local protests broke out on 6-7 March 2017, they were not brutally suppressed; instead, the security police distributed bread and the government urged everyone to consider the country's delicate situation and be ready for shared sacrifice (Ketchley & El-Rayyes, 2017). The apparent generosity was counterbalanced by threats of repression and low tolerance to criticism targeted towards the government. Specifically, the president, assured the population that, if need be, the army could "deploy all personnel across the entirety of Egypt in just six hours" (Sakr, 2016). As a result, planned protests often do not even materialise because of fears of police aggression. More than 2,000 Egyptians were detained after the crackdown on protests on 20 September 2019 alone. Observers believe that these protests had mainly been provoked by subsidy cuts and commodity price hikes, which was all the more credible against the background that the government afterwards considered reinstating subsidies for rice and pasta for almost 2 million Egyptians (Yee & Rashwan, 2019). Also, individuals claiming that President Al-Sisi should step down were jailed (Ioanes, 2019; Mansour, 2021) and a journalist was detained just because of publishing an animation related to the revolution in 2011, resulting in prisons being currently overcrowded (Michaelson, 2021).

5.3 Iran

Iran, a major exporter of fossil-fuels, had one of the largest subsidy programmes worldwide. By early 2010, the value of subsidies equalled 20-25 per cent of GDP (IMF, 2014; Mostafavi-Dehzooei, Salehi-Isfahani & Heshmatpour, 2020). Most subsidies in Iran relate to the sale of government-controlled energy and food products below world market prices. They are thus foregone revenues rather than real expenditures (Harris, 2017). Even if Iran's government budget deficit never exceeded 2 per cent of GDP, increasing budgetary pressures due to economic sanctions and decreasing revenues from oil exports contributed to the government's decision to engage in subsidy reform (Salehi-Isfahani, 2017).

The reform, focused especially on energy products and bread, started in 2010 and continued at a gradual pace in 2012 and 2014, just a few years before the reforms in Morocco and Egypt. The government decided to increase fuel and natural gas prices to at least 90 per cent, respectively 75 per cent of export-parity prices, and power tariffs to full cost-recovery levels (Kojima, 2016). As a result, the price of gasoline rose by 400 per cent and diesel by 900 per cent (Salehi-Isfahani, Stucki & Deutschmann, 2015). Bread prices doubled (Salehi-Isfahani, 2014).

Due to external shocks (that is, intensifying sanctions, sharp depreciation, and high inflation) economic downturn followed and the early benefits from reform were eroded after only a few years. Already in 2012, the reform was halted due to criticism in the parliament.

A second phase of price increases started in 2014 (see Table 3), decreasing fuel subsidy spending from 10.5 per cent in fiscal year 2012/2013 to about 4 per cent of GDP in fiscal year 2015/2016 (IMF, 2015). Energy subsidies decreased from USD 1,384 per capita (in constant 2019 prices) in 2012 to USD 453 in 2016 (IEA, 2020). In 2016, subsidies for gasoline had been fully eliminated, while subsidies for diesel still existed (IMF, 2017). Later, however, energy subsidies increased to previous levels (USD 1,039 per capita in 2019, as per IEA (2020)) so that energy prices are again well below world-market levels. This is mainly due to international sanctions that accelerated local inflation and currency devaluation, which reduced the real value of nominal energy prices fixed by the Iranian government.

The first reform phases were met with only limited opposition. Two factors played a larger role in this outcome: i) comprehensive information of citizens on the rationale and goals of reforms; and ii) clear compensation process to shift subsidies to direct cash transfers as part of the goal to make government spending more efficient and more egalitarian, compensating both poor households as well as the middle-class.

Since 2018, however, unmet social and economic expectations have led to larger protests.[16] Unrest peaked in November 2019, when the government announced that the price of gasoline would increase once more, by 50 per cent, in response to budgetary pressures created by

16 The main source of these protests has been the increase in the price of eggs (but also of other basic commodities, including energy) and the release of the draft budget presented to the parliament in December 2017. The budget showed an increase of allocation to the Guards and the ayatollahs' foundations, while subsidies to the poor were to be decreased ("Protests have engulfed several cities", 2018).

renewed international sanctions (Fassihi & Gladstone, 2019).[17] It soon became obvious, however, that the real source of the social unrest was not the subsidy reform – not least because energy subsidies had started to increase again in real terms after 2016. Instead, the protests were due to more general socio-economic and political concerns among Iranians, triggered by renewed international sanctions and Iran's costly military intervention in Syria.

Table 3: The reform of energy subsidies in Iran

	December 2010		April 2014	
	RIs/unit	USD/unit	RIs/unit	USD/unit
Regular gasoline within quota[a] (litre)	4,000	0.4	7,000	0.3
Regular gasoline outside quota (litre)	7,000	0.7	10,000	0.4
Super gasoline within quota[a] (litre)	5,000	0.5	8,000	0.3
Super gasoline outside quota (litre)	8,000	0.8	11,000	0.4
Diesel within quota (litre)	1,500	0.1	2,500	0.1
Diesel outside quota (litre)	3,500	0.3	5,000	0.2
Residential kerosene (litre)	1,000	0.1	1,500	0.1
Residential furnace oil (litre)	2,000	0.2	2,500	0.1
Residential LPG sold in 11-kg or smaller cylinders (kg)	1,000	0.1	2,100	0.1
Residential LPG sold in larger cylinders[b] (kg)	5,000	0.5	6,500	0.3
Natural gas for electricity generation[c] (mcf)	22,653	2.2	22,653	0.9

Notes: Between 2013 and 2018, the Iranian rial (IR) depreciated to a quarter of its former value with the effect that most of the subsidy reform was nullified.

[a] The quota for private car owners is 60 litres per month. In February 2015, the quota for inter-city taxis was decreased from 900 to 750 litres per month, and for taxis capable of running on both gasoline and natural gas from 600 to 500 litres. The quotas for city taxis are 500 litres for gasoline-only and 300 litres for bifuel.

[b] The price of LPG sold in larger cylinders was raised to RIs 6,000/kg in July 2013.

[c] The price of natural gas for the power sector has remained at RIs 800/cubic metre.

Source: Kojima, 2016, p. 67

Information and dialogue

The early acceptance of price increases by the Iranian population was partly due to an effective information strategy that contributed to trust building. Authorities engaged in a months-long public dialogue to explain the rationale for reform and describe how reform was to be implemented. The fact that the rich benefitted most from energy subsidies was the central message in the "massive government advertising campaign" (Salehi-Isfahani et al., 2015, p. 5). Once reform was announced, the size of the compensation and the way in which it was to be channelled was explained in detail.

17 The government was forced to turn to deeper subsidies reforms as a result of its inability to obtain credits internationally and unwillingness to lower expenditures by increasing taxes on Revolutionary Guard-linked businesses and reducing financial benefits to powerful religious foundations (Daragahi, 2019).

Compensation

The government specified that 50 per cent of the savings from subsidy reform were meant to finance a new scheme paying out direct cash transfers to low- and middle-income households. 30 per cent were promised to enterprises that were particularly hard hit by the subsidy cuts. The remaining 20 per cent were meant to reduce the budget deficit (IMF, 2014). However, the government realised that it was challenging to identify low- and middle-income households properly. In addition, 30 per cent of all households did not fulfil the formal requirements of transfer receipt (present birth certificate, have bank account, and so on). Therefore, the government decided to turn instead to a quasi-universal cash transfer scheme, for which 97 per cent of the population registered by 2014 (Kojima, 2016). Even though it was not the initial intention of the government to set up a quasi-citizen grant to replace energy subsidies, it soon understood its benefits and promoted the new cash transfer scheme as a superior instrument to include the entire population, thereby improving social cohesion.

Soon after the announcement of subsidy reform in 2010, the president also stated that 445,000 Iranian rials per person (USD 40 in 2011, but USD 90 in purchasing power parities (PPPs)) would be deposited per month in the existing or newly created bank accounts of all registered individuals even before the reform started, but that this amount could be withdrawn only after prices had been raised. For a family of four, this was about 28 per cent of the median per capita expenditures and greater than the monthly expenditures of 2.8 million Iranians (Salehi-Isfahani et al., 2015). The amount was immediately available on the day of the subsidy reform so that households did not face a gap between the reduction of subsidies and the payment of compensations. Thereby, the government built trust in its intention to protect those negatively affected and avoided potential social protests against the reform (Kojima, 2016; Verme & Araar, 2017). This effort paid off, as individuals did not rush to withdraw the funds on the day prices were increased (Salehi-Isfahani, 2011). Per capita income growth was clearly pro-poor for a number of years, a reason why reforms were very popular among large parts of the population (Mostafavi-Dehzooei et al., 2020). Even the IMF applauded it for being able to win support not only from the poor but also the more sceptical middle class (Harris, 2017).

The transfers were also effective in reducing poverty and inequality. Despite the sanctions that were levied on Iran and their negative effects on economic growth and inflation, Iran's national poverty line head-count rate went down from 14 per cent in 2009 to 8 per cent in 2013 (respectively from 23 per cent to 11 per cent by the international USD 4 in PPP poverty line) (Salehi-Isfahani et al., 2015). Meanwhile, food consumption increased by 8 per cent per year despite significant food price increases (IMF, 2014).

After 2013, however, the positive effects of the subsidy reforms on poverty rates were reduced by inflation (Enami, Lustig, & Taqdiri, 2016). The real value of the cash transfers decreased by two-thirds by 2020 (Mostafavi-Dehzooei et al., 2020). Although often linked to the cash transfers themselves, the inflationary pressures have been shown to be mostly related to the renewed international sanctions that provoked a steep depreciation of the Iranian currency (Gharibnavaz & Waschik, 2015). The same pressures, however, also reduced the value of nominal energy prices again, with the effect that in 2019 Iran was back close to where it had started with social transfer reforms in 2010. After another sharp increase in energy prices, social unrest erupted once more in November 2019, which made the government establish a second cash transfer scheme, this time targeting only the lower

70 per cent of the population and being less than proportional to family size (Mostafavi-Dehzooei et al., 2020).

Government commitment

When first announcing the reform, president Ahmadinejad named the process “the most sweeping economic ‘surgery’ in Iran’s modern history” (Guillaume, Zytek, & Farzin, 2011, p. 3). The IMF (2014, p. 4) has also qualified it as “the most courageous move to reform subsidies in an energy exporting country.” While the other factors discussed above (communication and compensation) contributed to improving credibility to implement reforms, it remains difficult to assess to what extent government commitment (as defined earlier) played a role.

Repression

The initial lack of revolt against reforms cannot only be explained by the compensation strategy; rather, it was also due to the use of repression and control. During the first phase of the reform, 800 checkpoints and sites were secured (Kojima, 2016). Gas filling stations, shopping malls, and the entire Tehran bazaar were guarded by security forces and riot police (Moerenhout et al., 2017). The government also threatened transportation workers with fines and union membership withdrawal if they took to the streets while the media was ordered to not criticise the programme (Kojima, 2016; Moerenhout, Vezanis, & Westling, 2017). At the end of 2019, national protests (triggered by increases in gasoline prices) were brutally repressed.

6 Conclusions on the transformation of social contracts

Our three case studies show that in spite of the common challenges posed by subsidies across the region we can observe differences in how policymakers engaged with the problem of reform (see Table 4) – and these differences impacted social contracts in quite different ways.

The government of *Morocco* prioritised policies to avoid major social unrest. On the one hand, it established some new elements of rudimentary *participation* (namely public dialogue between state and society) in order to ensure peaceful acceptance of higher prices. The government explained why reform was essential for long-term development and started a discourse with key stakeholders. On the other hand, it continued to deliver on *provision*, though in a different form than before. It implemented reforms gradually, left some subsidies in place for products that were most crucial for the poor and established some new social programmes to compensate losers of reform with limited income. Even though these programmes were rather small in scope and scale, the reform strategy has created hope that a new social contract that is more egalitarian, more efficient, and perhaps more participatory than the old one, could emerge.

Table 4: Comparison of the three country cases

	Morocco	Egypt	Iran
Situation before subsidy reforms started			
Dependency on energy imports	Imports 90-95% of energy needs	Has become net energy importer	Major exporter of fossil-fuels
Costs of subsidies	About 7% of GDP in 2012	About 14% of GDP in 2012	About 13% of GDP in 2010
Government budget deficit	Peaking to more than 7% of GDP	Peaking to 14% of GDP	Always less than 2% of GDP
Scope of subsidy reforms			
Energy subsidies	All kind of energy subsidies except for LPG	All kind of energy subsidies, but the effect was halved by the devaluation of the Egyptian pound in 2016	Most kinds of energy subsidies, but the effects were to a great amount nullified by two currency devaluations, in 2013 and 2018
Food subsidies	All subsidies except for flour and sugar	Threshold for total amount of food subsidies received	Not yet
Measures taken to prevent resistance			
Policy dialogue	Considerable public debate	No public debate at all	No larger public debate
Information	Extensive information provided to the population	Limited and even inconsistent information	Extensive information provided to the population
Compensation	Means-tested social transfers for low-income households (but limited in scope and scale and hence not very effective in protecting the poor)	Means-tested social transfers for low-income households (but very limited in scope and scale and hence almost ineffective in protecting the poor)	Very generous unconditional quasi universal cash transfers (benefitting more than 95% of all households)
Self-commitment of the government	Clear signal given by government that there was no alternative to subsidy reform	Clear signal given by government that it would implement reforms against all possible opposition	Clear signal given by government that it would implement the reforms for the better of the country
Repression	Hardly any intimidation related to reform	Intimidation of possible protesters	Limited intimidation
Effects of reform			
Transformation of the social contract	Attempt to retain as much as possible from the existing "social contract" while still making it more affordable	Replaced "provision contract" by "protection contract"	Made social contract more inclusive

Source: Authors

Egypt implemented more drastic reforms. Its subsidy scheme had been more generous than the Moroccan one but its reform was also implemented in a more radical and less participatory way. The government relied heavily on repression and instilled the fear of instability. Compensation remained small. This means that Egypt's government under President Al-Sisi does not build any longer on the provision of social benefits as a means to buy legitimacy. Instead, it mainly offers the promise to provide for security and stability in exchange for (once again) citizens' acceptance of its authoritarian political order. These reform choices led to a new social contract, which is even less egalitarian than the old one but more repressive and, hence, probably also less sustainable. As Rutherford (2018) argues, Egypt's state-society relations have transformed from a "provision pact" to a "protection pact".

Iran's strategy for reform was again different. The government embarked on ambitious subsidy reforms but invested most of what it saved from reform into a quasi-universal direct cash transfer scheme, which was much more efficient and egalitarian than subsidies, at least for a couple of years. Although implemented in a top-down manner with elements of repression, reform was extensively communicated and the implementation process carefully designed. Thereby, the government preserved its strong commitment for *provision* and, hence, for the core of the country's old social contract.

An end to the reforms has not yet been reached in any of the three countries. Thus, it remains to be seen whether reform can be sustained in the near future and whether the population will continue to accept the reforms and the changes that they have brought to the social contracts. The COVID-19 pandemic has placed additional pressure on government budgets, due to the urgent need to spend on health, social protection, and economic support. In addition, the renewal and intensification of international sanctions on Iran have triggered a new wave of inflation that has undermined the progress achieved and is heavily threatening the sustainability of the expensive, new quasi-universal cash transfer scheme. What is certain is that if the subsidy reforms are not sufficiently integrated in the countries' long-term development strategies – that is, if jobs, economic opportunities, and social assistance fail to materialise – their sustainability will remain fragile, especially in the face of repression and economic crisis.

These cases, and others in the literature, suggest that while governments choose different strategies for reform depending on domestic framework conditions and resources, across the board three elements remain essential for minimising negative effects on households and the economy:

- Dialogue with society on the design of reforms;
- information of citizens on the rationale and goals of reforms; and
- generous and carefully designed compensation schemes for the social groups affected most negatively by reforms.

Proof of government's commitment to reforms (for trust building) and the use of repression also result in preventing major revolts against reforms in the short run. Yet, it remains to be seen how sustainable the effects of these two elements can be in the long run, especially if emphasis is placed on repression.

Ultimately, subsidy reforms present a unique opportunity to establish functional social protection systems. The choice of compensation programmes is decisive for the way in which reforms alter the existing social contract. Many governments opt for targeted transfers because they believe they cannot afford to pay benefits to others than the poor. However, targeting the poor is difficult and, hence, either very expensive or defective, or both. In addition, the targeting costs are high, and there is a large potential that households are favoured/disfavoured on political grounds or personal connections (Harris, 2017).

The main alternative is to provide flat transfers to all households, as Iran did. Of course, such universal transfers are not cheap because they are also channelled to rich households. But, with targeting costs and possibilities of manipulation and corruption close to zero, universal transfers are more reliable, more effective in terms of poverty reduction (because they have hardly any error of exclusion) and in terms of social inclusion and cohesion (Hertog, 2017). Moreover, universal transfers compensate all parts of society (not only the poor) for losses caused by cuts in subsidy spending, which can be crucial for the well-being of the middle-class and for the political backing of reforms.

Of course, it is important to adequately determine the level of universal transfers. Iran, for example, set a very high level at the beginning with the effect that the bulk of savings by cutting subsidies was soon eliminated. Today, due to high inflation rates, the real level of transfers has fallen considerably. It is possible, however, to find a compromise: If, for example 10 per cent of the direct and indirect benefits of subsidies have been flowing to the poorest 40 per cent of the population, the government could set the level of universal lump-sum transfers such that all transfers cost a quarter of what subsidies used to cost. In this case, the net benefit/loss of the poorest 40 per cent would be zero on average, and only the three richest income quintiles would incur net losses. Alternatively, the government could spend on universal direct transfers even half of what it used to spend on subsidies. In this case, the poorest households would even gain from the reform, the poorer parts of the middle-class would gain as much as they lose, and only the richest 40 per cent of the population would suffer a net loss. Further, half of the spending on subsidies could be used for other social programmes or for infrastructure.

The most important argument for universal transfers is, however, that their rationale is an entirely different one than that of targeted transfers. Targeted transfers tend to be seen as an expression of paternalism and charity, both by policymakers and recipients. Universal transfers, in contrast, are not granted on the basis of need but of citizenship. They are perceived as an expression of a social contract that gives equal rights to all citizens. Universal transfers therefore strengthen the trust of citizens, the reliability and legitimacy of the government and the link between citizens and the government.

Ultimately, this means that Morocco and Egypt could also make their social contracts more inclusive if they set up universal cash transfer schemes or at least more generous targeted cash transfer schemes. A more generous social policy (though still more efficient than the subsidy scheme) could thus be a way to make the social contract more acceptable for the majority of citizens and hence more sustainable. The ongoing COVID-19 pandemic challenges the sustainability of subsidy reforms as the negative social and economic effects become more visible. Therefore, it remains to be seen how robust the new social contracts will be in the face of a looming economic crisis. In this context, we would expect that the delivery of governments on provision and participation will be all the more important.

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