



Food and energy subsidy reforms in Iran: A general equilibrium analysis[☆]

Mohammad Reza Gharibnavaz^a, Robert Waschik^{b,*}

^a Department of Economics and Finance, La Trobe University, Bundoora 3086, VIC, Australia

^b Centre of Policy Studies, Victoria University, Melbourne 8001, VIC, Australia

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Abstract

In 2010, the Iranian Government launched several market-oriented reforms, including the removal of distortions on heavily subsidized food and energy products. We use a microconsistent CGE model with 20 urban and rural households to model the actual characteristics of the food and energy subsidy reforms as implemented by the Iranian Government, calibrated to econometrically estimated income elasticities, and accounting for variations in sources of income and family size across households. Results suggest that food and energy subsidy reforms accompanied by lump-sum payments to households could result in aggregate welfare gains of over 45 per cent, with low income households experiencing welfare gains of well over 100 per cent. Reforms are accompanied by an increase in real government revenue of over 30 per cent. So while the subsidy reform programme is likely responsible for at least some of the inflationary pressures currently being experienced by the Iranian economy, it should not be seen as being responsible for the Iranian government's current fiscal difficulties, nor should it be blamed for the recent contraction of the Iranian economy, both of which are more likely due to the effects of international sanctions and the steep decline in the value of the Iranian Rial.

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* Corresponding author. Tel.: +61 3 9919 1062.

E-mail address: Robert.Waschik@vu.edu.au (R. Waschik).

1. Introduction

Independent of its level of development, almost every country has government programmes to reallocate income, goods and services to the most vulnerable members of society. Many such programmes involve subsidization of household consumption of basic foodstuffs and energy commodities which introduces a wedge between consumer and market prices, a pervasive feature of developing and low-income nations ([International Monetary Fund, 2008](#)). However, many authors ([Adams, 1998](#); [Dutta & Ramaswami, 2004](#); [Farajzadeh & Najafi, 2004](#)) have argued that such consumption subsidy schemes are economically inefficient since their benefits accrue primarily to high-income households due to the lack of targeting. Likewise, energy subsidy programmes result in an unnecessary burden on the public budget and often benefit mainly higher income households.

If the main purpose of food and energy subsidy programmes in developing countries is to improve the welfare levels of low-income households, there may be more efficient policies to achieve the same objective. For instance, income transfers to the poor which are not as distortionary as consumption subsidies can be considered as one alternative policy for food and energy subsidy reform. In this context, many developing countries have turned their attention to the removal or reform of subsidy schemes in recent years in an attempt to improve economic efficiency. However, without any accompanying and offsetting income transfer, the reform or removal of subsidy programmes can bring about unfavourable effects on needy and vulnerable households in these countries ([Amegashie, 2006](#)).

Iran was ranked first among Middle East and North African (MENA) nations in terms of subsidizing food and energy commodities as a share of GDP, granting US\$66 billion worth of energy consumption subsidies in 2009 ([World Bank, 2008](#); [International Energy Agency, 2010](#); [Clements et al., 2013](#)). Iranian consumers of energy commodities rely heavily on implicit subsidies which have increased progressively over the past few decades. While the major objective of food and energy subsidies is to increase household purchasing power and to guarantee a minimum level of welfare for the truly needy segment of the population, the existing subsidies in Iran do not differentiate between low and high income groups.

In December 2010, the Government of Iran launched a targeted subsidy reform scheme to phase out public food and energy subsidies and replace them with countrywide cash transfers ([Hassanzadeh, 2012](#)). The reform increased fuel and agricultural prices by up to 20 times and made Iran the first major oil-exporting country to eliminate public subsidies to basic food and energy commodities ([Guillaume, Zytek, & Farzin, 2011](#)).

Unlike subsidy reforms in Indonesia, Nigeria, Bolivia, and Pakistan which had been faced with massive public opposition and consequently abandoned, Iran's subsidy reform survived its first two years without any considerable pressures on the government ([Salehi-Isfahani, Stucki, & Deutschmann, 2012](#)). However, the impact of the consumption subsidy reform on vulnerable households has remained a source of concern. At the same time, the presence of significant macroeconomic shocks due to the effective tightening of international sanctions, including a steep decline in the value of the Iranian Rial, makes it difficult to evaluate the effects of Iran's subsidy reforms. For example, the Government of Iran has recently argued that the income transfers which were an integral part of its reform programme have imposed "... a considerable financial burden on the already deficit-ridden fiscal budget" ([Amuzegar, 2013](#)). As such, it is important to have a clear understanding of how the subsidy reforms will affect aggregate economic activity in Iran, as well as their effect on output of subsidized and non-subsidized commodities, the welfare of different households at different income levels in different regions, and the government budget, all

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