

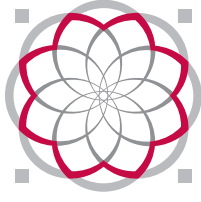
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Arab NGO Network for Development
شبكة المنظمات العربية غير الحكومية للتنمية

A Spill of Flaws: Egypt's IMF-Backed Energy Subsidy Plan

Policy Brief

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A Spill of Flaws: Egypt's IMF-Backed Energy Subsidy Plan

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Executive Summary:

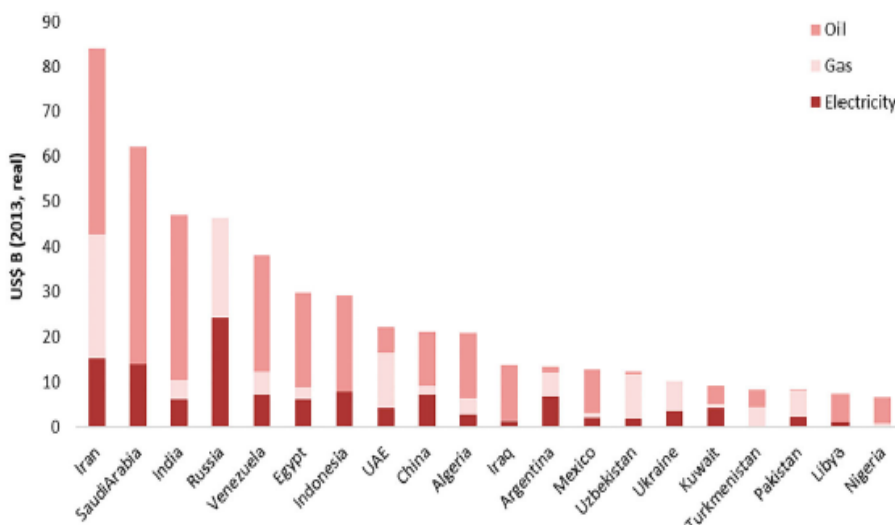
Egypt is one of ten largest countries with energy subsidies (IEA, 2018). As a net importer of fuel, the country is an exception within a league of big oil producers. Energy subsidy is defined as the difference between cost and selling price. And in this policy brief it refers to both electricity and fossil fuel subsidies. The brief differentiates between energy subsidies allocated to consumers and those allocated to producers.

Energy subsidy removal should be an opportunity to identify good subsidies and harmful subsidies. It should also be an opportunity to improve the governance structure of the public entities responsible of the management of the subsidy, in order to eliminate any risk of corruption or public money squandering. Egypt missed this opportunity, so far.

This policy brief argues that the IMF-backed plan to reduce energy subsidy bill is ill-planned, poorly executed and hence failed to create fiscal space in order to compensate the poorest quintiles of the population. It also failed to liberate resources in order to increase public social spending. The guidelines of the OECD, OPEC, IEA and World Bank prepared for the G20- summit in 2010 should provide a good set of recommendations to address the flaws of the IMF- backed current plan. The last section of the paper includes related policy recommendations. A Box is included derived from OECD, OPEC, IEA and World Bank study.

I. Removal of Energy Subsidies in Egypt: Lessons learnt

Figure 1: Egypt ranks 6th (Energy Subsidy bill, in billion of dollars)



Source: IEA, 2014.

Egypt embarked on a program to eliminate energy subsidies in 2014, when international oil prices



were declining. The five-year plan started with rises in prices for all energy types both household and producers.

In 2016, international oil prices took an opposite path. As a response, the plan was extended on a longer period, till 2021. In addition, the IMF changed its narrative ignoring the producers' subsidies all together. Accordingly, in its 2018 Country Report for Egypt released on July 2018, IMF stated, "Most end-June PCs (performance criterion) appear within reach, but the fuel subsidy bill is likely to exceed the target due to higher-than-programmed oil prices during 18/2017". The bill would reach %0.4 of the GDP, according to the IMF projections (July 2018) But there are no further details¹.

Figure 2: Energy subsidies IMF Projections

	2017-18	2018-19	2019-2020	2020-2021
Energy subsidies (bn of (EGP	150.9	115.1	52.8	26.8

Source: IMF, July 2018.

Looking at lessons learnt in Egypt's energy subsidy removal, the paper argues that if applied following the current pattern with no modification, the price increases in the next three years will be harsher on the citizens.

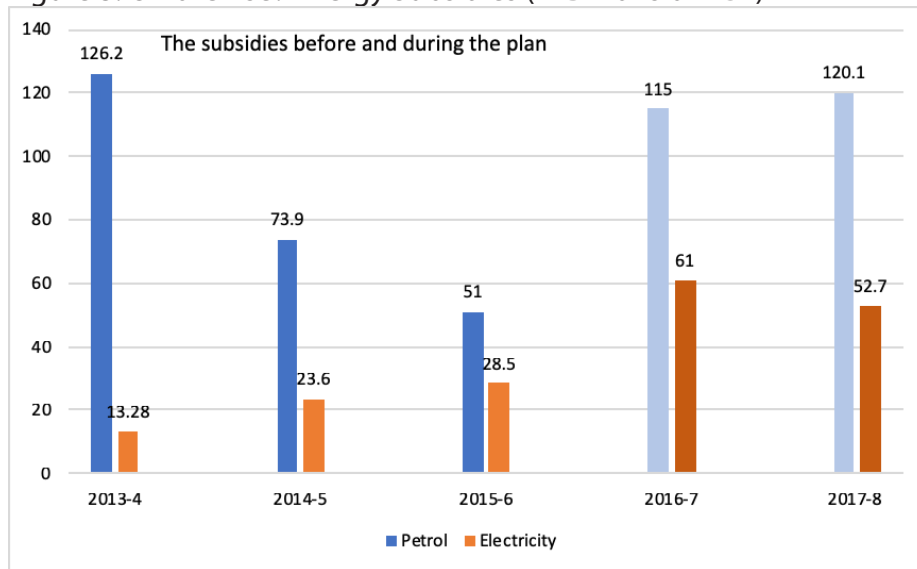
With regard to fossil fuels, in 2014, the prices were adjusted between %78-40 (WB, 2015) Then, four more increases took place. Last in June 2018, fuel prices increased by another 44 percent on average, which raised the pre-tax price-to-cost ratios to about 73 percent for gasoline, diesel, kerosene and fuel oil (excluding fuel oil used for electricity generation and bakeries) (World Bank, 2016, IMF, 2018). An additional increase is expected in 2019. With regard to electricity; six price increases since 2014 led to cumulative average increases of more than %160. Like fossil fuels, for electricity as well another increase is expected in 2019. (given the energy subsidy removal plan is extended to 2021) (Ministry of Electricity, 2017). All these price increases have contributed in rising inflation². It reached an average of %14.5 in 2018. Yet, the energy subsidy bill did not decrease as hoped. On the contrary, figure 3 shows that both electricity and fuel subsidies doubled.

1 We can only track the changes announced in the official gazette, the IFIs documents and the media, after they are implemented.

2 The IMF program introduced in 2016-2017 a bundle of inflation- fueling measures, namely: the devaluation of the Egyptian Pound, the introduction of the Value-Added Tax of 14% in addition to the phasing-out of energy subsidies.



Figure 3: On the rise? Energy Subsidies (in Billions of EGP)



Source: Ministry of finance and IMF, 2018.

Before the IMF program, the first three years, fuel subsidies fell mainly because of declining international oil prices (WB, 2015). After the IMF program, due to the devaluation of the Egyptian Pound (a pre-requisite for the IMF to lend the country), the subsidies have doubled in 2017³-2016. It is expected to continue rising if the oil prices in international markets were sustained at high levels.

The Egyptian government defines subsidy as the difference between cost and selling price. The problem with this definition is that it conceals the fact that the subsidies go to two public entities (for fuel and electricity).

In Egypt, Egyptian Petroleum Company (EGPC) and its subsidiaries are the sole players in the market of producing oil derivative products (IEA, 2018). The subsidies to electricity are similarly allocated to the consumers and producers via the Electricity Holding Company.

Yet these providers of energy products are poorly run. According to Resource Governance Index ranked Egypt's oil and gas sector 60th among 89 countries and 9th among 16 countries in MENA region. Egypt's overall score was 39 of 100. The score was low due to poor revenue management (100/30), in addition to poor national budgeting (100/30).

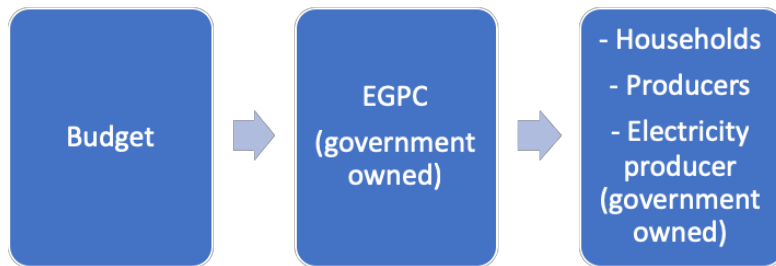
On the other hand, this raises questions over the efficiency of production, because, with this gigantic amount pouring into the coffers of a public entity, there is an inherent incentive to neglect the pursuit for most efficient production methods (The more the company produces and the more the cost is, and the transfers from the budget (i.e. the subsidies) increase.)

In fact, the IEA report (2018) on Egypt highlighted the poor condition of the Egyptian refineries (public) and their need to be modernized. In 2017, a sum of EGP 150 billion was allocated to EGPC, which contributed to a net profit of EGP 10 bn.

3 The pound roughly lost half its value since November 2016.



Figure 4: The subsidies are not allocated directly to the beneficiaries

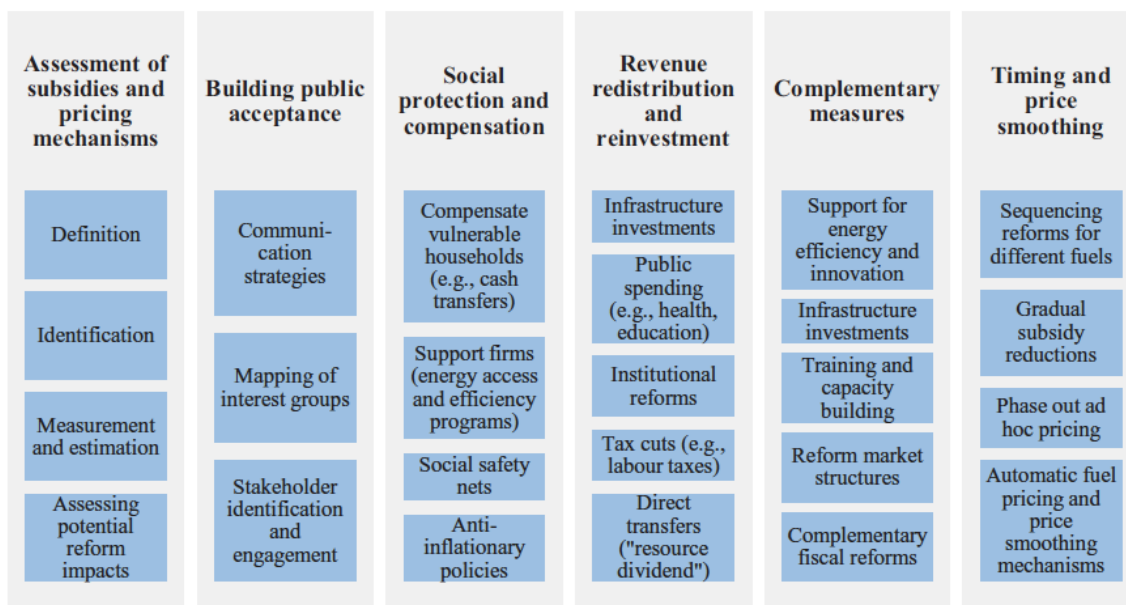


II- Recommendations on Energy Subsidy Removal

There is a body of recent literature on energy subsidy phasing-out that summarizes the best practices over the years; across countries and provides sets of recommendations. These recommendations are in relation to process of policy design as well as highlighting the need for impact assessments/ analysis.

For instance, below Figure 5 puts forward a model strategy of 6 steps. This starts with assessment of subsidies and pricing mechanism. Engaging stakeholders and ensuring effective communication is a crucial component of this step towards building acceptance. Following steps are in relation to redressing negative impacts including social protection, revenue redistribution and complementary measures. The last step envisages the price smoothing.

Figure 5: How to design a policy for energy subsidy reform

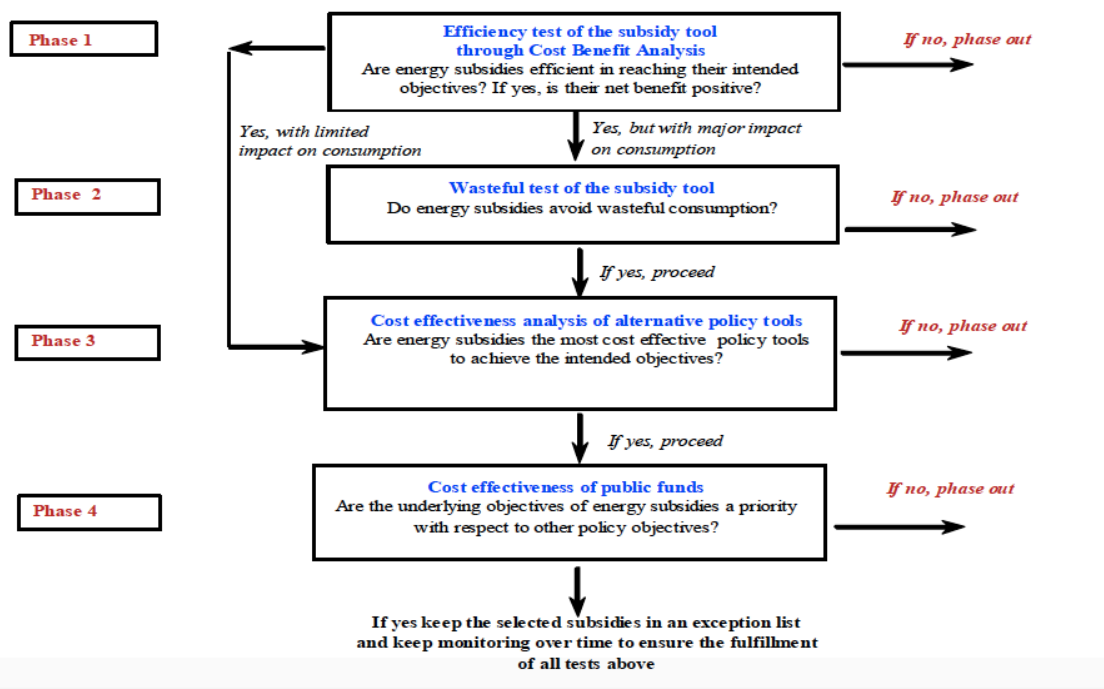


Source: Rentschler and Brazilian, 2017.



Another resource for energy subsidy removal is developed by the International Energy Agency, in collaboration with the Organization of Petrol Exporting Countries, the World Bank and the Organization of Economic Cooperation and Development. The study formulates a road map to phase-out energy subsidy, to be adopted by the G20-. Box 1 summarizes the analyses needed before implementation.

Box1: Decision Tree



Source: OECD, OPEC, IEA and WB, 2010.

According to the same report, the experiences of governments that have managed to successfully reduce fossil-fuel and electricity subsidies highlight some common features that point to strategies for other governments to consider (OECD and others, 2010):

Increasing the availability and transparency of energy subsidies data is essential in overcoming some of the challenges related to reform.

Providing financial support for economic restructuring or poverty alleviation can be essential to smoothing the path for reform of fossil-fuel subsidies.

An important condition for successful subsidy reform is the credibility of the government's commitment to compensate vulnerable groups for energy price increases, and, more generally, to use the freed public funds in a beneficial way.

In light of these studies, and models suggested, the paper identifies three key recommendations for Egypt, that would have lessened the negative impact on the poor, led to better targeting of energy subsidy and increased fiscal space:



1. The government should identify “good subsidies” and “harmful subsidies”. Electricity subsidy for the poor, as good subsidy should be kept, and producers subsidies’ as a harmful subsidy should be removed without distorting relative prices.

“Good” energy subsidies mean they should be exempted from the phasing-out plan. “Bad/ harmful” subsidies should be abolished but with compensation.

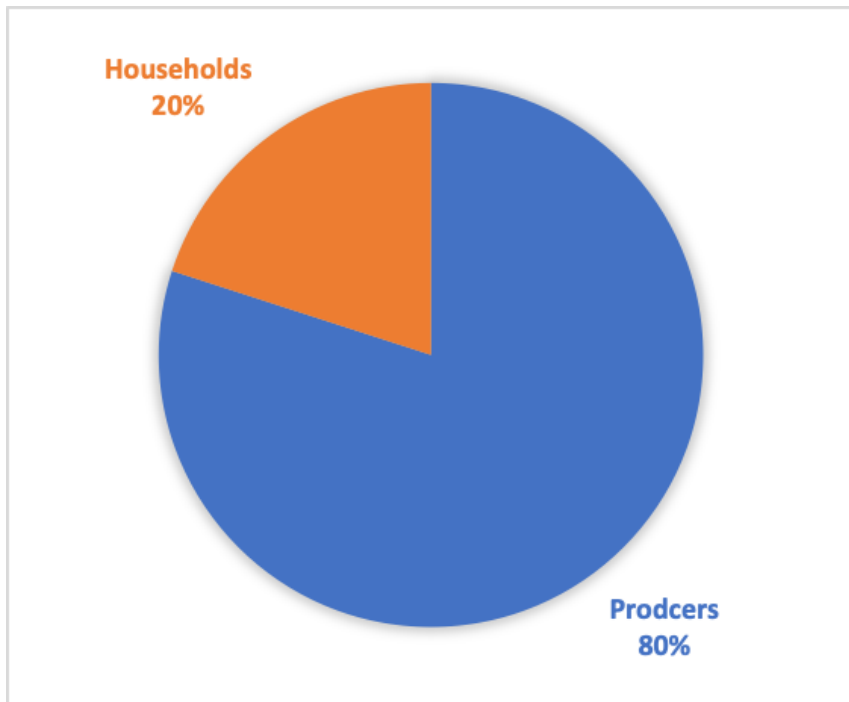
Any subsidy can be justified if the gain in social welfare or environmental improvement that it brings exceeds the net economic cost. (UNEP, 2008). As UNEP notes, “fossil-fuel and electricity subsidies, in some contexts, have helped to eradicate extreme poverty in developing countries and in that regard they may have been a relatively successful tool” (UNEP, 2008). For instance electricity to the poor provides a good example. The access to electricity helps the poor achieve better results in education and divert from high air-polluting energy alternatives (WB, 2010). It helps clinics to keep vaccines and medicines refrigerated, so that they can be offered locally to the poor (UNEP, 2008).

Accordingly Egypt should keep electricity subsidy for the poor. Yet, despite electricity for the poor - being identified by the WB and UN as an example of a “good” subsidy-it was abolished by the IMF-backed plan. In fact, the electricity subsidies remain remarkably regressive, benefitting the rich more than the poor (Shawkat, 2018). In contradiction to the government’s discourse, the electricity bills for the poorest and the middle-income households witnessed a cumulative increase of %218 and %271 respectively, since 2011.

Egypt’s household electricity expenditure became now similar to countries like Australia, USA, Canada and South Africa, although households in these countries consume double to more than triple the amount of consumed in Egypt (Shawkat, 2018).

On the other hand, producers’ subsidies which are harmful subsidies (IMF, 2016) remained substantial. They should be removed without distorting relative prices. Producers subsidies are harmful because they lead to miss-allocation of resources towards energy-intensive industries (Ishak Diwan and others, 2014). In Egypt, they led to a rapid depletion of oil and natural gas, and Egypt became net importer in 2013 (Mainhardt, 2017).

Figure 6: Energy Subsidies Beneficiaries In 2014



Source: Adapted from Griffin, Laursen and Robertson, 2016.

In general, as UNDP research notes “subsidized petroleum products can be provided to producers such as power stations, manufacturers, energy-intensive industries, financial institutions, and other commercial firms. Energy intensive industries – such as cement, fertilizers, and petrochemicals – are likely to benefit the most from such subsidies, as energy constitutes an important component of their intermediate cost” (Fattouh and El-Katiri, 2012). This applies to the Egyptian case.

The same UNDP research notes that energy subsidies are often entrenched in institutional barriers and lock-in mechanisms, which makes it difficult to abolish them.

- This is because subsidies, by definition, entail creation of rents for certain industries, regions, or group of people. Since these rents accrue disproportionately to certain groups (industrialists or particular classes of consumers) while the costs are widely spread, the prime beneficiaries of the rents will always have an interest in defending the continuation of the programs, because the benefits exceed the costs to them (Fattouh and El-Katiri, 2012).

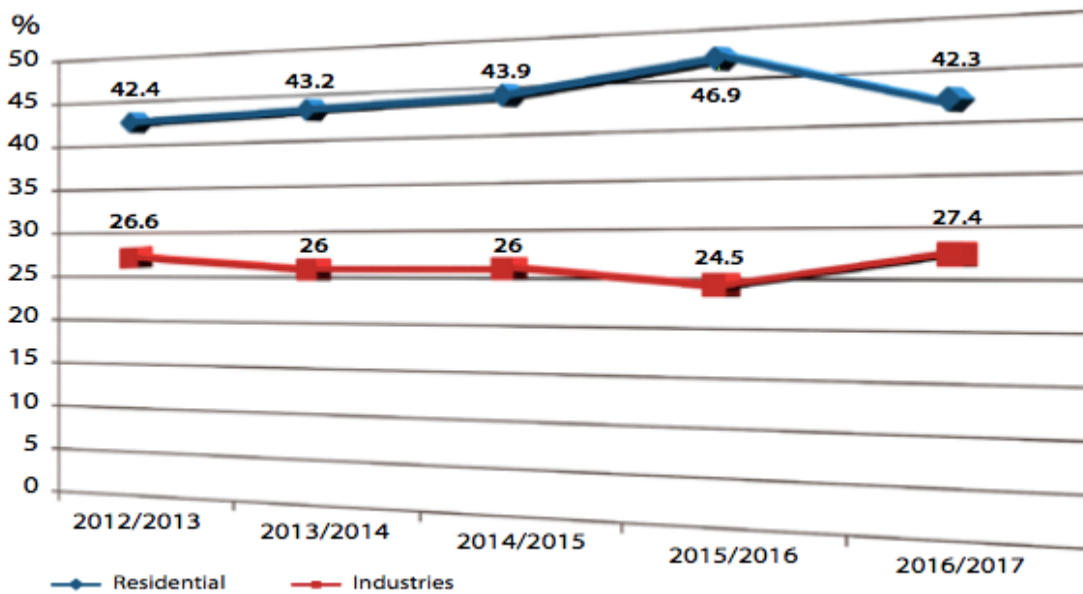
The researchers highlight that these interest groups will have both incentive and power to organize effective political action. Governments usually respond to such lobbying, “rather than to some vague wide general interest” ((Fattouh and El-Katiri, 2012).

As figure 6 shows, at the eve of the phasing-out plan, %80 of the energy subsidies in Egypt went to producers (including electricity production holding company -which also sells to producers subsidized electricity).

Unfortunately, there is not enough data to calculate the share of the producers’ subsidy after 5 years of implementation. But Figure 7 shows that industries witnessed an increase in electricity consumption.



Figure 7: Electricity consumption in Egypt (in KWH)



Source: Ministry of Electricity, 2018.

Energy-Intensive firms are in monopolistic positions. They are mostly owned by politically connected investors (WB, 201). They manage to pass fuel price increases to consumers.

In addition, when Egypt started its plan to phase out energy subsidies, the government did not put into consideration that the relative prices between different types of energy could lead to diverting into the cheaper type, instead of the rationalization of consumption. The result was that the natural gas subsidies are removed, they used to absorb one fifth of the bill (World Bank, 2016). But electricity is still sold to industries below cost and Diesel is still the most subsidized. There seems to be a shift in the energy mixes these companies use, but the overall high level of subsidy remained. For instance, the cement industry switched to coal and fuel oil (that has detrimental environmental effects) (Mainhardt, 2017). As Figure 7 shows the rise in electricity prices decreased the household consumption, but increased the industrial consumption, which may reflect that industries shifted to relatively cheaper electricity (using heavily subsidized diesel) instead of fossil fuels.

IMF 3rd Expert Review (July 2018) refers also to shifting subsidies: "Increasing prices on fuel oil used in electricity generation would simply shift the subsidy to the electricity sector".

2. Communication Strategy should start before the implementation of subsidy phasing-out:

Egyptian experience reveals that the government adopted a communication strategy; yet based on blaming the consumers alone for the subsidy bill of both electricity and fossil fuels. It was successful, but not transparent, nor truthful. It concealed the producers' subsidy altogether, despite it makes



the lion's share of the subsidy bill as shown in Figure 5 (Griffin and others, 2016). It stressed on consumers subsidy/unit of fuel and diesel and LPG.

On the other hand, prior to the implementation in 2014, no official studies were published on the issue. No impact assessment was made for the removal of these subsidies on the poor (fifth and fourth quintile of the population's expenditure) and those defined as the near poor (the third quintile). Last but not least, the Household Income, Expenditure and Consumption Survey, published bi-annually by the official statistics bureau, CAPMAS was due in April 2018, but was not published till the publication of this paper. This survey provides the only official data on population living under the poverty line and in extreme poverty.

In addition to these, the plan was not discussed in the Parliament and was not subject to public debate. In brief, five years after the implementation of the plan, there are no information available on its socio-economic impact.

3. Compensation and social protection should start before the implementation of subsidy phasing-out

Despite their regressive scheme, fuel Subsidies constitute a significant share of the poor's income (OECD, 2010). Thus, removing subsidies may have detrimental effects on the livelihoods of the poor, which is equivalent to a regressive inflation tax (OECD, 2010).

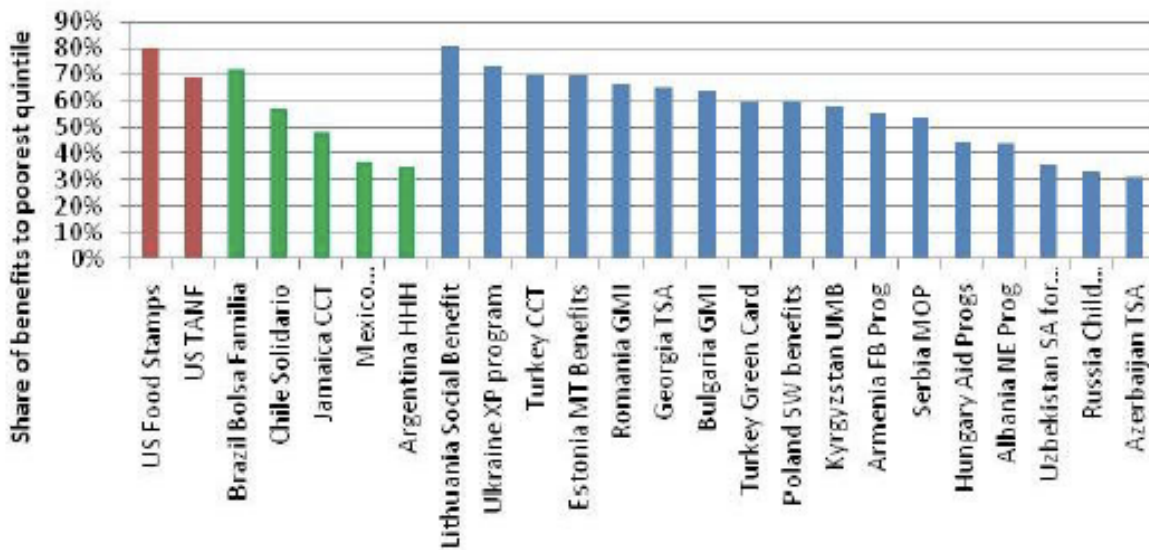
Especially if the poor rely on energy-intensive income-generating activities (Ex: farmers and fertilizers, tuc-tuc drivers, food street vendors).

The IMF recommends that compensation schemes should be designed and set before the reform is implemented especially through Conditional or universal cash transfers (IMF, 2013). In addition to compensating the negative effect of the reform, there should be another mitigation mechanism, by redirecting resources saved towards education and health and improved infrastructure in rural areas (UN, 2008).

In Egypt, this recommendation was only partially followed. Conditional cash transfers were introduced in the same year of the implementation. Despite a rapid pick-up in number of beneficiaries, it is still very low. Beneficiaries only represent %20 of the poorest quintile. The allocation to this program represents a small fraction, only %0.6 of the energy subsidy bill (ministry of finance, 2017). On the other hand, the public spending on education and health shrank in real terms and in percentage to GDP.

Figure 8 shows the share of GDP spent on different compensation schemes in a number of countries. They are all above Egypt's scheme.

Figure 8: Targeting accuracy for different compensation programs



Source: OECD, and others, 2010.

Box 1: OECD-OPEC- IEA- WB Key lessons on phasing-out subsidies that benefit the poor

Temporarily maintain universal subsidies on those fuels that are better targeted to the poor and are more important in their budgets. Gasoline, diesel and LPG have generally proved to be poorly targeted. Kerosene subsidies can also be better targeted, if risks of adulteration with diesel for transport can be avoided or minimized.

- Introduce short term measures to alleviate the impact of tariff increases on the poor.
 - Where poor households are connected to the grid and metering is in place, volume-differentiated tariffs are recommended. Volume-differentiated tariffs charge a lower price per unit for households whose total consumption is below a certain threshold and thus confine the subsidy to low-volume users.
 - Where poor households are not connected to the grid, connection-charge subsidies can be used. Within this context, technical assistance and grants, including OBA, can be deployed in the form of a one-off subsidy per household for part of the amount that is required to establish an initial connection and access to the electricity grid, natural gas heating, etc.
 - Where affordability is a major challenge, a transitional tariff subsidy may be used, which is then phased out as the user contribution increases over time. This is a performance-based subsidy under which households would only pay a percentage of the connection fee until after they acquired compact fluorescent lamps and metered connections, making the household bill more affordable in the short-term.
- Rationalize the fuel mix for electricity and transport and encourage new consumption patterns by switching from traditional fuel to modern energy sources and discouraging private transport in favor of public transport (e.g., through subsidizing urban mass transport).
- Prioritize broader structural expenditures that can benefit the poor, including road and rural-electrification schemes, but also social expenditure (health, education).



Conclusion:

Reviewing the literature on the energy subsidy reforms, there are room for improvements in the Egyptian plan to phase-out the energy subsidies, in order to be more respectful to basic economic and social rights. Almost none of the principles advocated by the UN and the WB and many of the recent literature on the subject were followed by Egypt. Yet, the plan gets the backing of the IMF. The politically connected investors kept their interests less affected by the energy price surges, as warned the IMF experts.

The plan has a severe social impact on small businesses and the poor and middle-income households. that is due to the lack of transparency and accountability, to the poor designing and also due to the lack of appropriate compensation scheme. Above all, the main objective of the energy subsidy phasing-out plan was missed. There were no budget savings, but on the contrary, energy subsidies are crowding out social spending more than ever before.



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