

# NAVIGATING POLITICAL HURRICANES IN THE MENA REGION: ENERGY PRICING REFORM IN A CONTEXT OF CHANGING SOCIAL CONTRACTS

Tom Moerenhout

Nikos Vezanis

Chris Westling

APRIL 2017



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Tom Moerenhout\*  
Nikos Vezanis  
Chris Westling

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\***Tom Moerenhout** was the lead author and is a CGEP research fellow, PhD candidate at the Graduate Institute of International and Development Studies, and Saudi Aramco fellow at the Oxford Institute for Energy Studies. He is also an associate at IISD's Global Subsidies Initiative.

\***Nikos Vezanis** was a contributing author and a second-year MIA student at Columbia University SIPA with a concentration on global energy management and a focus on international finance and emerging markets.

\***Chris Westling** was a contributing author and is a dual masters candidate at Columbia University SIPA and the London School of Economics, studying energy economics and policy.

COLUMBIA UNIVERSITY IN THE CITY OF NEW YORK



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# EXECUTIVE SUMMARY

This paper analyzes the political economy of energy pricing reforms in the Middle East and North African since the Arab Spring. As low energy prices have historically been a cornerstone of the social contract in most MENA countries, increasing energy prices is predominantly a political economic challenge. As the subsidy-based welfare distribution system has become too costly to maintain, all importing countries have started increasing energy prices in recent years. Similarly, as a result of fiscal stress (among others because of recent low international oil prices), exporting countries have embarked on energy pricing reforms.

This paper investigates the conditions under which governments across the MENA region with very different political economies were able to implement price increases. It assesses six specific countries in the region (Tunisia, Morocco, Egypt, Jordan, Saudi Arabia, and Iran) and explains for each country (1) why reform was necessary, (2) how political coalitions affected reform planning and implementation, and (3) how social contract dynamics affected the reforms.

- Fiscal crisis has been the main reason for all countries to implement energy subsidy reforms. It is not only a convincing argument to garner support from the wider population but also an effective political tool to either convince or sideline powerful stakeholders. Because of the severity of fiscal challenges, key political debates in countries focused on how and at what pace to pursue reform, rather than whether price increases were needed at all.
- Most countries in the MENA region seek to substantially alter their economic model and, consequentially, their social contract. Indicative is the unusual effort spent on communication campaigns to explain to the people the rationale of and need for reforms. This demonstrates a more responsive government in the wake of the Arab Spring.
- At the same time, many countries have not only used the carrot (communication campaigns and mitigation measures) but also the stick to control the reaction to reform and guarantee its implementation. As countries rely more on repressive measures, governments are under greater pressure to deliver results from the subsidy reforms to maintain political and public support. The use of repressive measures demonstrates the intention of governments to maintain power and advance less on the political side of a transformation of the social contract.
- The success of current and potential future reforms depends on economic progress and the ability to implement new, targeted social safety systems. Most reforms rely on the promise of tangible economic results. Countries that can point to results have an easier time reforming further. Countries with continued economic turmoil seem to have a harder time maintaining government credibility.
- Most countries are attempting to deliver more targeted social safety systems, which has proven challenging in most MENA countries both from a political economic and technical-institutional standpoint. Because of this, some countries use other subsidies (like food subsidies) as a way to mitigate the negative impacts of energy pricing reform.
- Saudi Arabia did not use any communication campaigns, nor did it foresee mitigation measures or plan for more targeted social safety net development. Because of a particular mix of political conditions, Saudi Arabia's social contract proved to be elastic, but further reforms are now linked to the implementation of a new cash transfer scheme. Whereas Saudi Arabia has unprecedented social and economic reform ambition, further pricing reforms may depend on the evolution of the international oil price.

Because of severe fiscal stress, otherwise reluctant stakeholders had to accept that reform was no longer avoidable. While there were bargaining games in every country on how to go about reform, there seemed to be a region-wide understanding to target the distortions from the subsidy regime. This marks a paradigm shift, as it affects the entire social contract upon which MENA states have been traditionally governed. As governments touched one cornerstone of the social contract, they seemed aware of the need to innovate politically. Contrary to a history of relative irresponsiveness, the power balance has recently shifted more toward the people, and governments seem well aware of it. How they deal with this challenge varies, but ultimately their ability to achieve economic diversification and growth, reduce the shrinking of middle classes, and counter high unemployment may decide whether there will be a second Arab Spring.

# INTRODUCTION

The Middle East and North Africa region is going through an era of political storms that has seen governments overthrown, economic systems severely challenged, and the traditional relationships between states and their citizens thrown into question. Critically, in recent years, most countries in the Middle East and North Africa (MENA) region started implementing considerable energy price increases, marking a historically dramatic change to the economic system viewed as a critical lynchpin between governments and citizens. The provision of subsidized food, housing, energy, and others historically had been at the base of the welfare distribution system that was seen as having grown too costly for governments to maintain, strained by changing markets and demographics. Energy subsidies in particular brought high opportunity costs and high fiscal costs, encouraging domestic consumption whether global energy was cheap or expensive. Even governments in the hydrocarbon-rich, exporting countries of the Persian Gulf took significant action to raise domestic prices of fuel and electricity. While the immediate reaction to the Arab Spring was to extend public expenditure to ease the sorrows that sparked protests in the first place, governments in most countries became aware of the need to rethink their domestic political and economic systems.

Despite the apparent necessity, energy pricing reform remains a challenge. Success often depends on a profound understanding of political economic conditions. While low energy prices have long been a critical part of the implicit social contract between citizens and government in most MENA countries, they have encouraged and sustained energy-intensive industrialization as a primary means to diversify the economy. The underpricing of energy formed a key tool in the complex system of patronage but also created black markets for fuel and associated powerful interest groups. Reforming energy prices fundamentally affects the status quo in all these spheres. Notwithstanding these considerable political economic challenges, most MENA governments started adjusting the subsidy regime by implementing energy price hikes, finding support in part from the steep drop in oil prices that began in mid-2014.

Critical questions about the sustainability of reforms remain. Will the will to test the social contract wither if energy prices recover? Can importing countries maintain political credibility, deliver results, and thereby achieve a sustainable level of political stability? While the answers to these questions will become clear with time, this paper investigates the conditions under which governments across the MENA region with very different political economies were able to implement price increases. We will analyze six specific countries in the region—Tunisia, Morocco, Egypt, Jordan, Saudi Arabia, and Iran—and attempt to explain in each country: (1) why reform was necessary, (2) how political coalitions affected reform planning and implementation, and (3) how social contract dynamics affected the reforms. We will discuss how governments utilized sticks (power) and carrots (communication campaigns and compensation measures) to push reforms forward. It is our objective to critically question whether and to what extent implementation strategies are slowly changing the nature of the social contract toward a more responsive and accountable government that is able to address socioeconomic challenges and drive economic diversification.

# THE POLITICAL ECONOMY OF ENERGY PRICING REFORM IN THE MENA REGION

## I Energy Pricing and the Political Economy of MENA Countries

The implicit social contract between citizens and government in most MENA countries was—and still remains—characterized by the government’s commitment to the distribution of welfare among its citizens. In all MENA countries, such a distribution was achieved via massive public employment and across-the-board underpricing of energy, food, housing, and other essential goods and services. In exchange, citizens accepted the country’s authoritarian leadership. In resource-rich countries, this meant that governments were given the prerogative to extract, manage, and trade the country’s (predominantly hydrocarbon) resources.

While there is no single definition for a fossil fuel subsidy, or an internationally accepted typology of subsidy types, there is a general subsidy definition in the WTO Agreement on Subsidies and Countervailing Measures (ASCM). This sizeable membership makes the subsidy definition in the WTO of particular relevance to the debate on fossil fuel subsidies, which are used worldwide in both developing and industrialized countries. The WTO definition stipulates either price or income support, or that there is a specific financial contribution such as (potential) direct transferring of funds, foregone government revenue, or government provision of goods and services. With regard to the MENA region, there is explicit disagreement over the term *subsidies*. Often, subsidies in exporting regions have been calculated based on an opportunity cost approach (that is, the foregone revenue from trading hydrocarbons due to excessive domestic demand). Exporting countries have argued subsidies is an improper term because the cost of producing fuel is often still lower than the low retail prices (even if these retail prices are well below international market prices). As such, this paper frequently uses *underpricing*, because it indicates the government objective to increase prices is to lower domestic demand.

Underpriced energy was considered essential to maintain stability—directly by keeping prices constant (independent of any fluctuation in world prices) and indirectly by keeping inflation in check. While low prices were a necessity for poor households, untargeted subsidization led to the rich consuming a considerably higher share of subsidized energy. Thus, richer citizen-consumers became accustomed to a high standard of living incentivized by such across-the-board subsidies, a phenomenon often referred to as a rentier mentality. This resulted in an increase in domestic energy demand, which decreased the availability of resources for export in the cases of hydrocarbon-rich states. Despite the high opportunity and fiscal costs, the implicit social contract resulted in a stable political system that captured the citizens’ loyalty to the government.

At the same time, many MENA governments tried to use their comparative advantage in resource extraction—their high levels of hydrocarbon resources—to diversify their economy toward resource intensive sectors. In such countries, energy intensive industries were considered the logical path to diversifying economies away from a predominant reliance on hydrocarbon exports. The private sector, however, was never a politically powerful player, as the power balance between the government and the private sector tilted heavily in favor of the former. The government provided low-cost energy, barely imposed taxes, and indirectly supported domestic consumption through the relatively higher wages prevalent among many public sector jobs. The private sector generally has not been a contributor to public revenue in MENA states and mainly provided low-skilled jobs that were not of interest to the increasingly educated youth. In addition, the private sector frequently competed with citizens for low-cost energy (Moerenhout 2015).

While the subsidy system provided a workable and politically stable environment for years, the negative impacts of the subsidy system in general, and energy underpricing in particular, put increasing pressure on the social contract. In many countries, the system was unable to deliver on its promise of equitable welfare distribution as energy prices rose or populations grew, pushing the region toward crisis. The Arab Spring was the clearest demonstration of the failure of the “state project” across the region. While there is a multitude of reasons for the Arab Spring, the calls for dignity and socioeconomic justice have been widely acknowledged as two key drivers (Ozekin and Akkas 2014). Gradually, it became clear that to reinvent a sustainable “state project,” countries would need to adjust the various distortions that the previous political system had created, including by delivering more targeted social safety nets.

Reforming energy subsidies is at the heart of such efforts. Such reforms free fiscal capacity and reduce the growth in domestic energy demand, and in the case of hydrocarbon-rich states, free up resources for export. However, energy pricing is among the most controversial policies to reform structurally. Most countries around the world have reformed energy prices only when they approached or hit a moment of fiscal or economic crisis. This was no different in the MENA region. Of course, the particular timing of reform varied among countries according to factors such as the international oil price, whether they were net hydrocarbon importing or exporting countries, and other geopolitical dynamics. Generally, most countries reformed energy prices when the fiscal pressure of across-the-board subsidies was simply becoming too burdensome to remain unaddressed.

## II Evolutions in the MENA Region since 2011

In the wake of the Arab Spring, governments came to realize how urgent a genuine reform process actually was. In the years following the uprisings, the international oil price hit historically high sustained prices of more than \$100 per barrel, and many of the non-Gulf MENA countries, such as Tunisia and Egypt, became net importers as domestic demand increased. Indeed, many MENA nations faced rising domestic energy demand associated with population growth and energy intensive industrialization. Demand growth in the residential sector was not only a result of an increase in population but also because of wasteful consumption due to the rentier mentality. Not only in MENA countries but in nearly all countries that subsidize energy consumption across the board, energy subsidies are regressive, with higher-income households collecting a much larger share of subsidized energy than lower-income households.

Moreover, many countries implemented wide patronage packages to ease popular discontent during and in the wake of the Arab Spring, expanding public expenditures in the midst of an already fiscally dire situation. The extension of public employment and the increase of public sector salaries locked in additional expenses for years to come. As fiscal deficits rose and pressure on state coffers increased, so too the need to reform prices to avoid a potential fiscal catastrophe.

The fall in international oil prices that began in the summer of 2014 affected the MENA region significantly. Fuel-importing countries welcomed the fiscal breathing space, as the price gap between underpriced domestic and international fuel decreased. Nevertheless, governments saw an opportunity to reform pricing policies further. Meanwhile, hydrocarbon-exporting states, including those in the Gulf Cooperation Council (Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman), received less revenue from fuel exports, creating impetus for domestic reforms for them as well. With Saudi Arabia signaling (at least initially) that it was unwilling to shoulder broad export cuts to pressure oil prices higher, other hydrocarbon-exporting countries in the MENA region saw pricing reforms curbing excessive domestic consumption.

### III Decision to Implement Pricing Reforms and Initiate a Reform Process

In the short term, it appeared that the social contract in MENA nations was more elastic in the wake of energy price increases than many analysts had thought. Citizens appeared to be more accepting of structural reforms than had been anticipated. This acceptance stems in part from a greater understanding of why energy subsidies needed to be reformed to transition to a more sustainable economic model. As will be discussed in the sections on individual states, government communications campaigns appear to have helped raise the understanding of the failures and costs of the existing subsidy system. But to say that the decision to implement price increases was solely driven by fiscal considerations would be wrong. In many cases, other political economic considerations played an important role in creating more acceptability for pricing reform. For example, in some cases, additional supports for reform came from endogenous factors that increased national identity and loyalty between citizens and the regime beyond the implicit social contract. This realistic assessment of political change corresponds with the emphasis on timing as a key factor to making energy subsidy reform successful. Some governments used “the stick” to bluntly prevent any protests from arising and offered ad hoc compensation measures to cushion the impacts of pricing reforms.

However, further reforms and energy price hikes geared toward greater diversification of the economy inevitably bring more strain on the citizens’ welfare and the industry’s competitiveness in ways that can drive them toward mobilizing effective political action, regardless of an individual government’s willingness to exert power. There is sufficient precedent to indicate that a slowing down or reversal of pricing reforms is a real prospect if the dynamism of stakeholder trade-offs is not taken into account, or when fiscal health is regained (such as an increase in oil prices that replenishes the coffers of oil-exporting countries). For this reason, MENA countries ought to invest more in social safety net development, to structurally move away from the old, untargeted subsidy regime. While the political culture seems to be slowly shifting toward a more accountable and responsive government, including a relatively more participatory approach in governing the economy, the institutional setup to deliver subsidies in a more targeted manner is still in the early stages. Whether the implicit social contract in many of the MENA countries can evolve without profound political instability may very well hinge on a government’s ability to mature its social protection mechanisms and deliver tangible economic progress.

# COMPARING MENA COUNTRIES: SIMILAR CHALLENGES, DIFFERENT DYNAMICS

An analysis of political economic drivers reveals that most MENA countries face similar questions but different dynamics when deciding on energy subsidy reform. All of them do so to free up fiscal space and reduce domestic energy consumption. For importers, this is often because the subsidy burden is too high, while exporters seek to protect their resource base from domestic consumption so they can generate external revenue. The following country profiles will examine reform efforts and implications, starting with (1) “Why reform was necessary,” which strongly correlates to the large-scale fluctuation in oil prices, economic and fiscal indicators, and resource indicators.

Subsequently, we will address the political, economic, and social challenges of political economies that, to varying degrees, are linked to low fuel prices. MENA countries that have reformed energy prices in recent years appear to have used a same palette of policy options, even though the success of energy pricing reform depended on different combinations. It is important here to note the difference between a one-off increase in energy prices (in which they were all successful) and an actual pricing reform process (which is much more complicated). Both political patronage and economic industrialization rely in part on low energy prices. We will discuss (2) “Political coalitions and economic impacts” to understand to what extent these drivers were relevant in respective countries and how they were dealt with during reform.

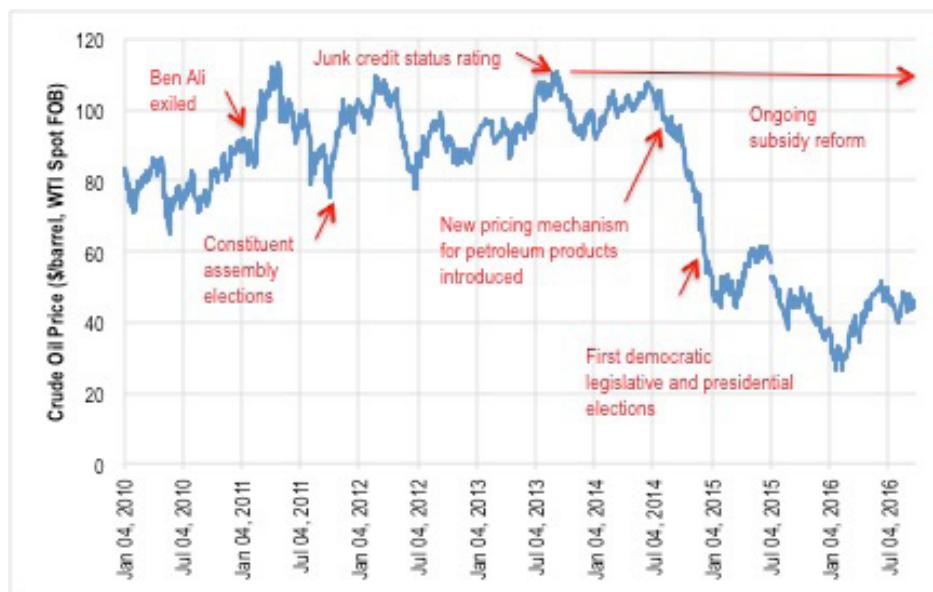
On a wider moral scale, it is worth noting that the Arab Spring has impacted different countries to varying degrees. Whereas it generally strengthened the social contract in favor of the people, the dynamic varied significantly across the region and across time. Nonetheless, given the wide social impact of energy subsidy reforms, and the subsequent effect they can have on the social contract, measures to deal with popular backlash take central role for reformers. For each country, (3) “Social contract dynamics” will be examined by looking at the reforms’ impact on the social contract, the use of state power—“the stick”—to limit opposition, and the use of communication campaigns and social safety nets—“the carrot”—to compensate for the loss of welfare.

Certain countries have acted opportunistically by using the stick and responding to particular events that increased public acceptability for reform. Others, however, have shown more long-term ambition and have devoted more attention to the moral impacts of energy subsidy reform (and therefore have invested more in communication campaigns and social safety net development). The following country profiles list the respective importance of various measures in discussing these political, economic, and social dimensions of reform.

# RECENT EXPERIENCES WITH ENERGY PRICING REFORM IN THE MENA REGION

## I. Tunisia

Figure 1: Tunisia: Chronology of Subsidy Reform



Source: Authors.

Tunisia's fossil fuel subsidy reforms have been defined by the economic demands of the newly empowered electorate and by the delicate fiscal situation that the country had been left in after President Ben Ali fled the country in early 2011. The country has seen dramatic reductions in subsidies (that endured a major election in 2014) with increased investment in social safety nets for vulnerable communities.

Subsidy reform in Tunisia has the stated goal of full removal of subsidies for liquefied petroleum gas (LPG), gasoline, and diesel, but has been targeted to limit early direct impacts to consumers (Leiva et al. 2015). Energy subsidies for the cement industry began to be phased out in January 2014 and were eliminated by the end of the year. Tariffs for gas and electricity were raised steadily beginning in 2014. In January 2014 the government also introduced new pricing mechanisms for petroleum products. The new system would raise prices 0.10 Tunisian dinars if international prices increase by more than 10 dinars per barrel in a year, thus roughly linking the prices to real prices. While several price increases had been planned for 2015, they were canceled due to the drop in international oil prices (Kojima 2016).

### Tunisia 2012–2014 Key Energy Price Increases

Gasoline	7% (2012 average), 7–8% (2013 average), 6.4% (2014 average)
Diesel	7% (2012 average), 7–8% (2013 average), 7% (2014 average)
Electricity	7% (2012 average), 7–8% (2013 average)

### *Why reform was necessary*

While not a major oil and gas producer compared to its neighbors Libya and Algeria, Tunisia has had a surplus energy supply since 2000 (Leiva et al. 2015). Domestic production is on the decline, however. The government wants to diversify energy sources and has seen dramatic reductions in oil (71 percent to 45 percent) and increases in natural gas (28 percent to 45 percent) between 1990 and 2011. The current government's plan, outlined in their INDC, set goals of a 14 percent share of renewables in electricity generation by 2020 and a 30 percent share by 2030 (Ministry of Environment and Sustainable Development 2015). In 2013, 98 percent of electricity generation came from fossil fuel power stations.

On average, energy subsidies in Tunisia had accounted for approximately 3 percent of GDP in the years leading up to 2015. While Tunisia experienced half a century of economic growth and relative stability postindependence (Leiva et al. 2015), there was very little social freedom and by the time the Arab Spring broke out in Tunisia in late 2010, youth unemployment had become (and remains) a looming concern.

Political insecurity and high levels of government debt led to a continual downgrade of the country's credit rating. By April 2013, all three major credit bureaus had cut Tunisia's credit rating to junk territory (Amara 2013). That same year, the government began a large-scale reform of the energy subsidy system.

### *Political coalitions and economic impacts*

The self-immolation economic protest of a street vendor in rural Tunisia in December 2010 set off a wave of protests in the country that eventually toppled the national government and spread throughout the MENA region. In the wake of the Arab Spring, a new political spectrum of left-leaning secularists and right-leaning religious conservatives emerged. The latter won a plurality in the October 2011 elections to establish a constituent assembly to draft a new constitution. After an extended process, the constitution was approved and the election rules were set out. Against the backdrop of the first subsidy reforms, secular politician Chokri Belaid was assassinated in February 2013—an unexpected act of political violence in a country that had gone through a nearly bloodless revolution—putting further pressure on the coalition government.

By the time of Tunisia's first normal legislative and presidential elections, which took place from October to December 2014, the country's political dynamic had shifted on the religious–secular axis toward a more secular coalition government that generally favored reform. Proponents of reforms have tried to maintain the reform momentum today, although that was not always easy as the oil price dropped and the subsidy burden fell to an acceptable level in terms of GDP percentage.

### *Social contract dynamics*

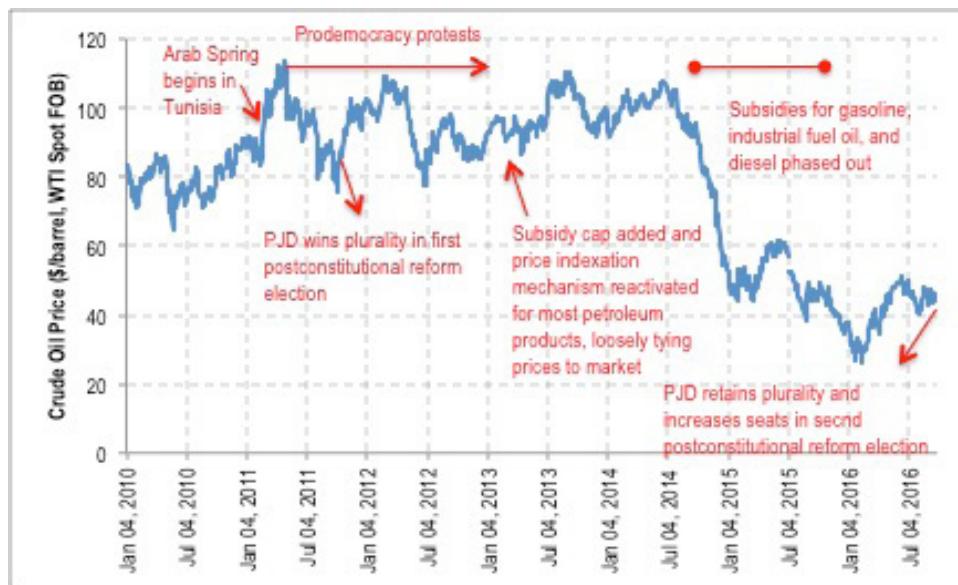
The political economy of subsidy reform in Tunisia has not always been straightforward. In 2013, protests broke out in Tunisia over proposed subsidy reductions. While food subsidy reduction dominated the political discourse, energy subsidies also proved to be a lightning rod. In 2013, the country experienced the largest protests since the revolution in 2010, an uneasy sign of things to come (Amara 2013). Complicating the issue were accusations of foreign intervention through supposed IMF pressure to reduce the subsidies in exchange for a US\$1.78 billion loan from the fund to improve the country's struggling financial situation (Arnold 2013). The Tunisian Organization for Consumer Protection, a consumer advocacy group based in Tunis, called for mass protests over both fuel price increases and inflation.

The reforms continued regardless, both through internal shifts within the interim coalition government and through the 2014 election. A significant communication strategy was used to stress that the highest-income households in Tunisia were benefiting over forty times more from energy subsidies than the lowest-income households (Leiva et al. 2015). Communication oriented toward policymakers focused on the fact that despite economic stagnation immediately after the revolution, energy subsidies rose from 0.9 percent of GDP in 2010 to 2.8 percent of GDP in 2012, largely as a result of rising international oil prices. Beginning in 2013, the government initiated a national energy dialogue to host public debates and increase public involvement in the country's energy policy outlook from the present to 2030.

In order to limit the economic impacts of reform on vulnerable communities, the government has attempted to replace subsidies with targeted compensation. For instance, the price of LPG (widely used by the poorer segments of society in MENA countries) has not been changed since 2011, and the price of kerosene has remained unchanged since 2010. As far as electricity goes, a new lifetime rate was granted in January 2014 for consumers using less than 50 kWh a month. This is in addition to a previous lifetime rate for those consuming less than 100 kWh a month (Kojima 2016). A mid-2014 policy expanded transfers to vulnerable households by 10 percent with a stated goal of increasing the number of households receiving benefits by an additional 30,000 (Kojima 2016).

## II. Morocco

Figure 2: Morocco: Chronology of Subsidy Reform



Source: Authors.

Throughout its history, the Kingdom of Morocco has provided and maintained a subsidy regime in various forms. Recently it has embarked on an ambitious reform process led partially by financial necessity and partially by political ideology, and which has been sustained by the collapse of global oil prices.

Under the newly empowered Justice and Development Party (PJD)-led government, Morocco embarked on a series of subsidy reforms in 2013, before international oil prices began to plummet in mid-2014. On September 16, 2013, a price indexation mechanism was reactivated and a subsidy cap was added to the three products managed by the stabilization fund—gasoline, diesel, and fuel oil. The price differential beyond this was passed on to the consumer via domestic price increases. Collectively, this reduced the deficit by nearly 2 GDP percentage points (El Massnaoui and Verme 2015).

On February 1, 2014, the government ended price supports altogether for gasoline and industrial fuel oil. The portion of industrial fuel oil that was used for the production of electricity was included in the price indexation system starting on June 1, 2014. The former subsidies in place for fuel oil electricity generation were replaced with a balance transfer program to the national electricity company (ONEE) for a three-year period with a built-in phase-out mechanism. Consumer electricity prices could rise at a gradual pace throughout this period by about 3.5 percent annually, while rates for households consuming less than 100 kWh per month remained entirely unchanged (El Massnaoui and Verme 2015).

The government has reformed subsidies for diesel as well. In October 2014, the subsidies for diesel were reduced to 0.80 Moroccan dirham (MAD) per liter from MAD 2.15 per liter. In November 2015, the prices of diesel and all other petroleum products were fully liberalized. Significantly, LPG was kept out of this reform process, as it represents an important fuel for the poor.

### Morocco 2012–2014 Key Energy Price Increases

Gasoline	20% (2012), 4.8% (2013), subsidy eliminated (2014)
Diesel	14% (2012), 8.5% (2013), subsidy eliminated (2015)
Industrial fuel	27% (2012), 14% (2013), subsidy eliminated (2014)

### *Why reform was necessary*

The subsidy system in Morocco began in 1941 as a means to reduce the price volatility caused by World War II. After Morocco's independence in 1956, the stabilization fund, tasked with administering subsidies, continued on and expanded its reach into new industries. Up until 1974, the delivery vehicle remained financially autonomous from the government of Morocco, receiving funding via taxes on industries that benefited directly from the subsidy regime. A combination of the volatility in oil prices in the 1970s and a 1986 law that imposed government taxes on imported petroleum weakened the fund's financial state, and balance transfers from the government became necessary for the first time. The removal of some subsidies and deregulation in the late 1980s and 1990s stabilized the fund, and petroleum derivatives were finally indexed to international prices during this period (El Massnaoui and Verme 2015).

In 2000, the government suspended indexation when oil rose above US\$30 per barrel. A compensation fund was created to establish subsidized fixed prices of gasoline, diesel, fuel oil, and LPG. Fuel oil and LPG—with their political relevancy at the consumer level (that is, they are widely used by the poor)—received the largest share of subsidies. This system remained in place until 2014 (El Massnaoui and Verme 2015).

As the price of oil increased steadily following the 2008 financial crisis, so did the burden of government subsidies. By 2012, fuel subsidies accounted for 6.6 percent of Morocco's GDP and 17 percent of its investment budget (Kojima 2016). The government, having already been forced to make several upward price adjustments to reduce the burden of unprecedently high oil prices, intensified those efforts gradually since the governmental change in 2013.

### *Political coalitions and economic impacts*

During the events of the Arab Spring, the constitutional monarchy experienced relatively high levels of stability even as governments throughout the MENA region were toppled or countries were thrown into civil war. Some mass protests took place in Morocco in 2011 and 2012 as part of the Arab Spring, and the demands of protestors varied among calls for reform of the monarchy's constitutional role, an end to corruption, an independent judiciary, and the expansion of economic opportunities. A constitutional reform expanding the prime minister's authority and curbing the then near-absolute powers of the monarch was proposed. A referendum on the constitutional reform passed in July 2011 with 98 percent of the vote (Thakore 2014).

As a result of the reform, early elections were held in November 2011 with minimum seat requirements for women and legislators under the age of forty. A plurality of seats was won by the PJD, a center-right pro-monarchy Islamist party, whose leader, Abdelilah Benkirane, subsequently became prime minister. The pre-reform petroleum product price adjustments (along with their indirect impacts on the costs of food and other goods) became a focus of small protests in 2012 with blame now being put on the PJD rather than the monarchy. The multicity protests, however, drew only a few thousand people cumulatively, and in general the reforms have not sparked any significant unrest (El-Katiri 2013).

Morocco's approach—especially compared to its fellow MENA countries—is a textbook example of more gradual reform that highlights the importance of reform leadership. In Morocco, the prime minister and the finance minister (Boussaid) were among the strongest proponents of reform. As one of the early initiatives of the newly elected government, it was constant focus of the Benkirane administration, which explained the situation as often as possible. "The prime minister explained it to the people, continuously," said Morocco's minister of general affairs, Nizar Baraka, who oversaw part of the reform process (Daragahi 2015). The party's major opposition group, which called for mass protests against the subsidies (which remained largely unrealized), also contributed to fostering internal governmental consensus within the PJD (El Yaakoubi 2014).

Data indicate the reforms have been successful. In March 2016, Moody's released a report praising the future financial outlook of the country, in part due to the subsidy reforms (Moody's 2016). Successful results in combination with the persistence of food subsidies, cooking oil subsidies, and reduced rates for households consuming less than 100 kWh per month have been highlighted as key to reducing impacts to the poorest households, and to all consumers in general. In October 2016, the PJD was able to retain a plurality in the national elections, and even increased their number of seats by eighteen. This was considered a significant vote of confidence in subsidy reform and its results.

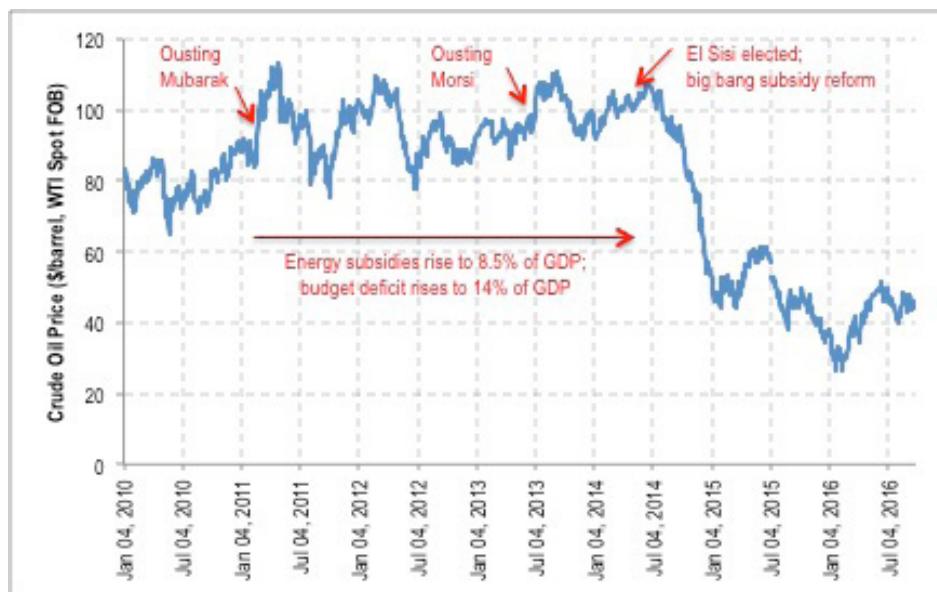
### *Social contract dynamics*

To be successful, Morocco relied on educating its people through communication campaigns and compensating stakeholder groups for their loss. Leaving LPG out of the reform process was a first, important step to accommodate the concerns of the poor. While the recent drop in global oil prices was certainly helpful to the reform process, the process appeared stable before July 2014 as well. This was achieved through both a careful long-term rollout that minimized the negative impacts to vulnerable communities and through the measured communications strategy from the government explaining the need for such reform.

In 2015, Mohamed Boussaid, Morocco's minister of finance, claimed that “the subsidies system was useful in the time when Morocco started out just after independence. There were a lot of people in need, and it was the role of the state to stabilize prices. But the subsidies became unsustainable. The idea now is to target those in need of help and support while trying to get at the market price. But the approach needs to be progressive, not aggressive” (Daragahi 2015). The communication strategy also stressed the inequitable socioeconomic distribution of the subsidies' benefits, which disproportionately benefited the top quintile of the population (El Massnaoui and Verme 2015). This communications strategy informed the population of the importance of the reform, and the ensuing protests were small.

### **III. Egypt**

Figure 3: Egypt: Chronology of Subsidy Reform



Source: Authors.

Note: Egypt reformed energy prices a second time in August 2016.

Since the rise of international oil prices and the Arab Spring, which hit Egypt hard, the Egyptian government has reformed prices substantially. Initial reforms were made by President Mohamed Morsi, but it was under President Abdel Fattah El-Sisi that the most significant price increases in decades were made. The reasons were both fiscal and to reduce resource demand.

Faced with a bleak economic picture, the Morsi government initiated reforms on a number of subsidies. It increased gasoline prices for high-end vehicles (112 percent), and fuel oil for non-energy-intensive industries (33 percent) and energy-intensive industries (50 percent). In 2013, it also increased household electricity prices (by an average of 16 percent), and natural gas and fuel oil prices for electricity generation (by 33 percent) (Sdrazlevich et al. 2014, 45). Given the prospect of popular resistance, the government abandoned plans with the IMF for wider-scale reforms.

Yet, immediately after his election in June 2014, President El-Sisi hiked energy prices that affected all of Egypt's society. Diesel prices were increased by 64 percent, gasoline-80 by 78 percent, and gasoline-92 by 40 percent (Clarke 2014). In addition, natural gas and fuel oil prices increased by large margins (Griffin et al. 2016). Only LPG prices remained constant, again to accommodate the poor.

	<b>Key 2014 Reforms</b>	<b>Key 2016 Reforms</b>
<b>Gasoline</b>	78% (gasoline-80), 41% (gasoline-92), 7% (gasoline-95)	47% (gasoline-80), 35% (gasoline-92), price allowed to float (gasoline-95)
<b>Diesel</b>	64%	N/A
<b>Kerosene</b>	64%	31%
<b>Natural gas</b>	33–204% (energy-intensive industries), >200% (low users), 500% (medium users), 700% (high users)	+/-50% (low to medium users), 33% (heavy users)
<b>HFO</b>	50% (cement), 30% (bricks, other users), 40% (bakeries and food)	7% (most users)
<b>Electricity</b>	<50% (low users), +/-17% (commercial and other residential)	Up to 40% residential, up to 20% commercial (mainly medium and heavy users)
<b>LPG</b>	N/A	87%

### *Why reform was necessary*

By the time President El-Sisi implemented considerable energy subsidy reforms in July 2014, Egypt had gone through years of political instability caused by and aggravating the structural problems associated with its political and economic system. Like most other countries in the MENA region, Egypt's main way of distributing welfare had been to offer across-the-board subsidies for essential goods and services, combined with high rates of public employment. This scheme became problematic in the 2000s, putting pressure on Mubarak's government to consider subsidy reforms in 2010. As soon as the Arab Spring hit the region, these plans were abandoned (El-Katiri and Fattouh 2015).

When the Muslim Brotherhood and Morsi won the 2011–2012 parliamentary and presidential elections, the fiscal pressure of the subsidy regime was on the rise. This was largely due to a record high international oil price and the dire economic consequences of the Egyptian revolution. The numbers are striking. Combined energy subsidies amounted to about US\$21 billion or 8.5 percent of Egypt's GDP annually in 2012–2014. This accounted for nearly 20 percent of public expenditure. Half of these subsidies went to petroleum products, one third to natural gas and the remaining 15 percent to electricity (Griffin et al. 2016, 2–3). Generally, expenditure on fuel subsidies grew with an annual compound growth rate of 26 percent between 2002 and 2013 (Clarke 2014). Despite the 2012–2013 reforms, the real prices of all refined products actually decreased (Clarke 2014). Between 2010 and 2013, the budgetary deficit and public debt grew respectively from 8 percent of GDP to 14 percent and from 73 percent of GDP to 89 percent. Furthermore, economic growth had slowed down structurally, from about 5 percent pre–Arab Spring to 0.5 percent post–Arab Spring (James 2015).

The problem was not only fiscal but also resource related. Due to industrialization and a population boom, Egypt became a net energy importer. During the Morsi reign, the country was often confronted with fuel supply shortages. El-Sisi focused a lot of attention on diversifying available energy sources in order to decrease the price. Because of energy subsidies, the Egyptian General Petroleum Corporation (EGPC) had incurred massive debts to foreign operators that restricted the funds available for investment in new oil and gas projects. Egypt has been repaying that debt to open new possibilities to explore and develop new natural gas and oil projects. It has also been developing a new refinery, encouraging the replacing of oil products with natural gas (among others via LNG imports), and investing heavily in new renewable capacity.

### *Political coalitions and economic impacts*

In the aftermath of Morsi's ousting and the continued economic peril in Egypt, a nationalistic sentiment gave El-Sisi more acceptability to push through tough reforms. Having been elected with 90 percent of the vote on a seemingly unified nationalistic discourse, El-Sisi invested his political capital immediately in subsidy reforms, which were implemented within one month after his election. He surrounded himself with a mainly technocratic cabinet that was proreform, thereby reducing internal opposition (James 2015). While other political parties had reservations to the pricing reform, they were neither heard by the ruling coalition nor were they very vocal. In general, the absence of fierce political opposition demonstrated at least some awareness of the dire necessity of subsidy reforms (Ahram Online 2014). This awareness did not reduce by 2016, even though public support for reforms suffered from a lack of economic progress.

El-Sisi's elections also widened the political coalition to the military. Having been the military's leader before his election to the presidency, El-Sisi knew the relevance of the military in Egypt's state apparatus. As president, he involved the military in large-scale infrastructure projects and negotiated with them regarding what fuels to include.

For example, the decision not to include LPG initially was not only because of its importance to poorer Egyptian households, but also because subsidized LPG directly or indirectly benefited the military and security establishment. El-Sisi had many informal discussions with the military leadership and, in the wake of strong lobbying, decided against LPG subsidy reform in 2014 (James 2015).

El-Sisi also tried to get the private industry to accept reforms. Whereas most private sector players did not have much bargaining power, the transport industry was the most vocal stakeholder. While political leaders tried to make sure they would not increase prices too much in times of uncertainty, minibus fares in Cairo still doubled after the announcement of the energy pricing reforms (Clarke 2014). This was a thorn in the eye of the government after it had tried to guarantee that public prices would not increase too much. The transport sector resorted to strikes and protests in Cairo, Sinai, and Alexandria (Clarke 2014). Energy-intensive industries were impacted as well. After facing targeted reforms in 2012–2013, further reforms mainly affected glass, ceramics, and cement manufacturing (Griffin et al. 2016). However, industry did not have a very powerful position as it has generally benefited more from the government than vice versa.

Finally, President El-Sisi also used the stick. As El-Sisi arrested Morsi in the 2013 coup, the army cracked down on the Muslim Brotherhood, killing hundreds and arresting thousands, effectively pushing the movement back underground. This power display in combination with the prohibition on public protests discouraged demonstrations in the wake of the pricing reform implementation (Fahim 2014). After 2014, El-Sisi further closed space for civil society to develop.

### *Social contract dynamics*

During the Arab Spring, the Egyptian people showed they were able and willing to unite against a government that failed to deliver on its part of the social contract—the distribution of welfare. When Morsi and the Muslim Brotherhood prioritized power consolidation and the passing of an Islamist constitution instead of economic reform, millions of protesters demanded another regime change. Elected on a nationalistic platform, El-Sisi used the nationalistic sentiment to increase public acceptance of subsidy reforms. Yet as energy subsidy reform fundamentally did affect citizens' welfare, El-Sisi invested considerable attention to developing social safety. From one side, he has educated citizens about the problem of energy subsidies and installed mitigation measures. From another side, he has used repression to inhibit large-scale protests against the reform.

The level of coordinated communication campaigns on the side of the government toward the people was in stark contrast to the lack of consensus-building and communication efforts during Morsi's reign. Most importantly, at any given time, El-Sisi made clear that subsidy reform was going to happen and that there was no alternative. The government used budget negotiations to communicate about subsidies and the urgency of reform. While continuously referring to the inequitable nature of energy subsidies, the government did not shy away from admitting that reform was an unpopular measure in need of shared sacrifice (ERPIC 2014; El-Katiri and Fattouh 2015). The strength of the communication campaign was in the consistency of messaging and the level of engagement with stakeholder concerns. For example, it made an implicit promise to redistribute wealth by linking the savings from reforms to the need for more investment in health and education (El-Katiri and Fattouh 2015).

El-Sisi, however, also offered immediate compensation measures. After the arrest of Morsi, Egypt implemented two stimulus packages with financial assistance from Gulf countries. Among the various measures, it included a salary increase for public sector jobs (Muthuthi 2014). Even though this raised the deficit and is a prime example of a classic rentier policy, it did ease the sorrows of public employees. A second, highly relevant measure was the freezing of

food prices and expansion of the food subsidy system to include twenty new food products (Clarke 2014). This eased the concern that fuel price increases would result in food insecurity. While most subsidized food is still consumed by higher-income households, Egyptian food subsidies are more equitably distributed than its fuel subsidies. Finally, like in some other MENA countries, the pricing reforms in July 2014 and the wider reform process ahead did not include LPG, which is used by many low-income households. Given Egypt's dire situation in 2016, the government finally did include LPG.

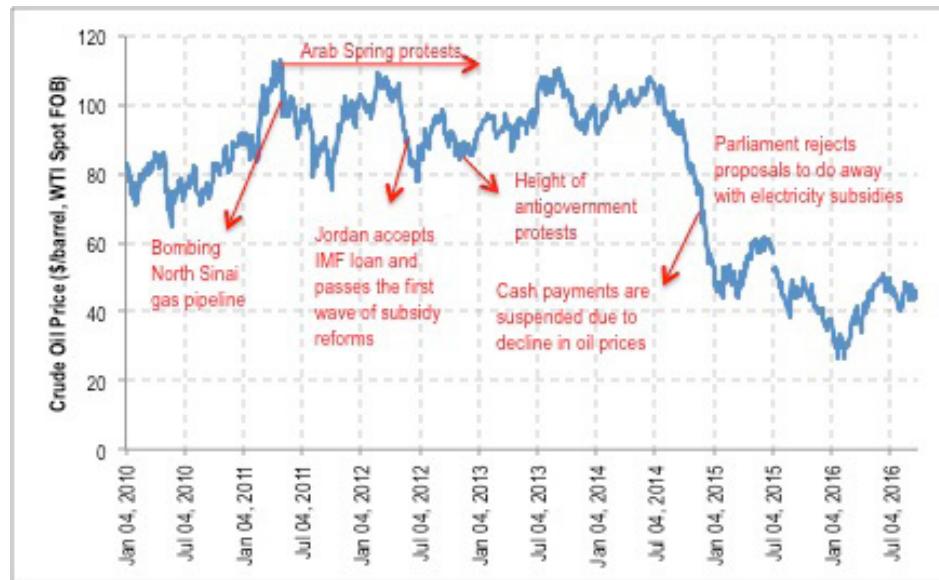
While El-Sisi was able to implement sizeable reforms, a long and burdensome reform process remains. The July 2014 reforms created much frustration and a lack of credibility in relation to the government's ability to use savings (El-Katiri and Fattouh 2015). Particularly among the poor and lower middle-income households, reforms significantly reduced the government's popularity (Clarke 2014). Developing sound social safety nets that can better target assistance is now a priority for the Egyptian government. Egypt's social security system suffered from low coverage with self-employed or informal sector workers excluded from poverty and income support. At the time of reform, safety nets only reached 15 percent of the lowest quintile and actually benefited the rich more (James 2015). In 2013, Morsi failed to present a plan on how to strengthen social safety nets, and the onus is now on El-Sisi. This means institutional innovations in the fields of social data collection and social support distribution. In 2015, Egypt concluded an agreement with the World Bank for a US\$400 million program to develop two key national social safety net programs (World Bank 2015b). As their development is slow and Egypt is in a precarious situation, the government currently envisions the food subsidy system as key to mitigating higher energy prices.

In reality, the Egyptian government continues to struggle with a credibility problem. El-Sisi replaced his whole cabinet in 2015 as a result of concerns over corruption, including corruption related to social safety nets. While he was praised by the media for his handling of the crisis, it did result in a lack of public confidence in the government's competence. In addition, El-Sisi's use of repression and force to limit protests and other freedoms is a growing cause of discontent. Whereas the use of the stick was crucial to get through the difficult days of the July 2014 subsidy reforms, it could soon become a factor that challenges El-Sisi's legitimacy.

The Egyptian economy has also failed to pick up. The tourism sector is in crisis, and new job opportunities are limited due to foreign investment problems. This comes at a moment when financial support from the Gulf has been put on hold because of the fiscal challenges GCC countries are facing themselves. Notwithstanding, the collapse of the international oil price reduced pressure and allowed the government to plan further subsidy reforms in the coming years. With a new IMF loan, a devaluated currency, and an investment wave from Saudi Arabia, Egypt hopes to improve on its macroeconomic stability. However, the jury is still out on whether El-Sisi's reform process can be implemented as desired without resulting in political instability. If not, Egypt's population may, in addition to lamenting El-Sisi's hardline security tactics, fundamentally question his competence in resolving the dire economic situation.

#### IV. Jordan

Figure 4: Jordan: Chronology of Subsidy Reform



Source: Authors.

The government of Jordan, like those of other MENA countries, had traditionally provided subsidies to residents and enterprises, including for energy products. As with other states, the costs of insulating the Jordanian population through subsidization increased dramatically with spikes in global commodity prices. This ultimately prompted Jordan to seek assistance from the IMF in the form of a US\$2.1 billion loan accompanied by a reform package that involved fossil fuel subsidy reforms (Abdelrahim 2014). The first wave of reforms was passed in May 2012 (IMF 2015). The Jordanian government successfully raised the price of LPG sold in 12.5-kilogram cylinders by 54 percent, kerosene and diesel by 33 percent, and regular gasoline by 14 percent (Kojima, 2016). Today, electricity pricing reform remains especially difficult for Jordan, even if price increases are unquestionably necessary to reduce Jordan's deficits.

#### Jordan 2012–2014 Key Energy Price Increases

Gasoline	14%
Diesel	33%
Kerosene	33%
LPG	54%
Electricity	7.5–15% (2014 consumer dependent), up to 7.5% (2015 consumer dependent)

### *Why reform was necessary*

By early 2012, Jordan had found itself in a difficult economic situation. Starting in 2011, the country had suffered a number of exogenous shocks. High oil prices and extensive disruptions to the flow of natural gas from Egypt—caused primarily by pipeline bombings and sabotages in the Sinai Peninsula—had dramatically raised the price of Jordan's fuel imports. At the same time, the Arab Spring and the global economic downturn adversely affected tourism, worker remittances, foreign direct investment, and government spending as a response to mounting social pressures (World Bank 2015a). In 2011, Jordan's GDP growth fell to 2.6 percent from the 6.1 percent decade average, and the current account deficit widened to 12 percent in 2011 from 7 percent in 2010. Moreover, the budget deficit kept growing at a rate of around 8 percent.

In addition to budgetary dimensions, however, subsidy reforms were also motivated by social equity concerns. As seen in other cases with energy subsidies, a 2008 household survey showed Jordan's fuel subsidies disproportionately benefited the rich. Overall, energy subsidies received by the richest 20 percent of households were about 20 percent higher than those received by the poorest 20 percent of households (IMF 2014).

Jordan's energy subsidy reforms were also resource related. The stakeholder perhaps most severely affected by the country's long-term subsidy policies is Jordan's National Electric Power Company (NEPCO). Between 2011 and 2013, NEPCO lost US\$7 billion due to the Jordanian government's insistence on providing petroleum products and electricity for consumers and producers below market prices (Milbert 2014). A reduction of fuel subsidies and an increase in electricity tariffs would help the utility company get back on its feet. The operating losses suffered by NEPCO due to tariff subsidies were 4.6 percent of GDP in 2013 and 4.5 percent in 2014. Returning NEPCO to cost recovery by 2017 is one of the cornerstones of the IMF's stand-by agreement with Jordan (Sdrazlevich 2014).

### *Political coalitions and economic impacts*

There is a general consensus among Jordanian policymakers on the need for Jordan to pass energy (including electricity) subsidy reforms given the dire state of NEPCO. In recent years, Jordan's budget has become more reliant on foreign aid and public debt. In part because of loss of economic opportunity and the Syrian refugee crisis, Jordan's government has invested a lot in maintaining a nationalistic discourse. The ability to implement reforms without incurring severe stakeholder backlash can be attributed to the government's institution of prudent compensation measures in the form of cash transfers, the ability of Jordanian authorities to retain a positive image and promote unity among Jordanians, and, quite possibly, the sharing of agency inherent in the IMF's involvement in the program.

However, disagreement remains on the pace of reforms and how they could alienate parts of the Jordanian population. Protests in the wake of the Arab Spring were fairly regular in 2011 and the beginning of 2012. They were also a regular occurrence in the aftermath of the elections in January 2013 and turned violent in some rural areas. They have since abated and not led to a general escalation on a national scale. The reaction to raising electricity prices was largely subdued, even after a similar move to eliminate fuel subsidies triggered the unprecedented November 2012 events, which led to protesters calling for the fall of the regime. Yet the parliament have become cautious about future reforms. While it is clear the road ahead for Jordan will depend on its capability to sustain its debt, unwillingness persisted on the side of Jordan's parliament in 2015 to augment electricity prices by 15 percent. The parliament's decision to pursue a more modest proposal of 7.5 percent demonstrates the difficulty for Jordan to reform its electricity pricing.

Furthermore, reforms have an impact on the productive sector, even though this was expected to be limited for manufacturing companies that had already been affected by the June 2012 increase. The impact is estimated to have been stronger for energy-intensive sectors, such as the phosphate industry, but relatively limited for the less energy-intensive sectors that make up the bulk of Jordan's nonprimary exports. However, these effects must be seen in the perspective of the better provision of electricity in Jordan compared to neighboring countries (Sdralevich 2014). Thus, competitive concerns are less of a priority in Jordan than in some other countries.

### *Social contract dynamics*

Apart from political (reform of the election law, restraining of the king's powers, etc.) and economic grievances (fuel subsidies, food prices, wages, etc.), the Jordanians' heritage represents a significant source of societal polarization. A large, yet unknown, proportion of the Jordanian population are of Palestinian descent. Distrust of the Muslim Brotherhood and affiliated organizations after the second regime change in Egypt in July 2013 further silenced both opposition voices and Palestinian groups. This explains why King Abdullah's public relations campaigns have often included slogans such as "The New Jordan" (al-Urdun al-Jadid), "Jordan First" (al-Urdun Awwalan), and "We are all Jordan" (Kulluna al-Urdun). By weaving all citizens into a unified social fabric, the Jordanian authorities hope to increase support for the economically tumultuous processes (BTI 2016).

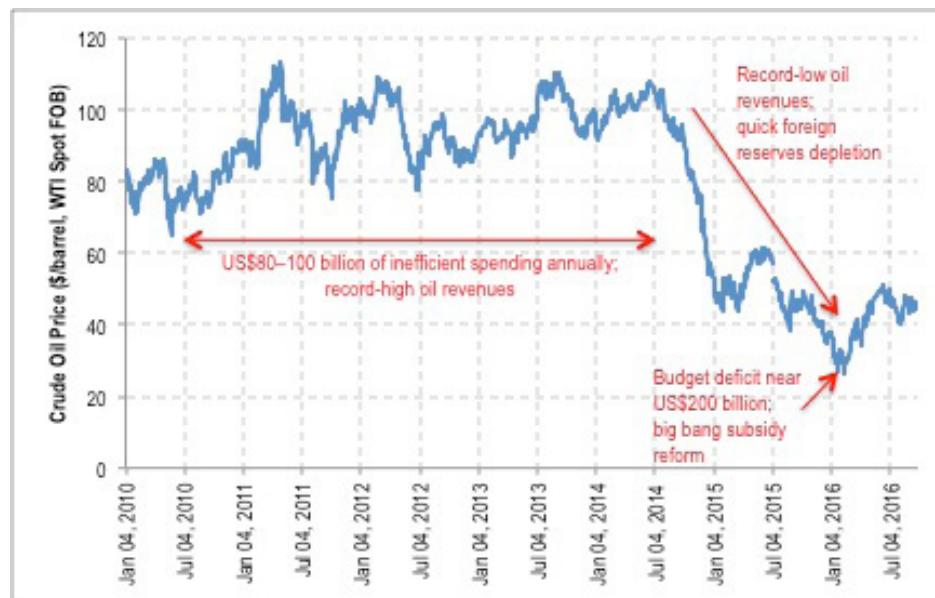
With respect to residential energy consumers, one of the greatest challenges for subsidy reform has been the historically volatile nature of Jordanian household expenditures, which has shown a strong correlation between the effects of energy price hikes and poverty levels. While a large number of Jordanian households are not considered poor from the perspective of their annual per capita consumption, they do face "transient poverty" in the sense that they experience poverty during at least one quarter of the year. As a result, a small shock to their monthly consumption could effectively push a lot of people into poverty (World Bank 2015a). Implementing subsidy reforms while retaining average household incomes at steady levels and not disproportionately affecting low-income citizens has been one of the toughest challenges faced by Jordan's authorities.

To help households cope with price deregulation, the government introduced a cash transfer program covering as much as 70 percent of households. Cash was transferred to households earning less than US\$14,000 a year at a rate of US\$100 per person for up to six members per household annually, provided that the oil price was above US\$100 a barrel. As a result, the program suspended payments in late 2014 due to the decline in oil prices. To sharpen targeting, the government later tightened the eligibility criteria by adopting proxy means testing that took into account not only wage income but also consumption and asset indicators. In 2014, the government specified asset thresholds for cars, land, and real estate ownership. The government further developed the national unified registry database in the Income and Sales Tax Department to link it to other databases and rank families according to proxy means test scores (IMF 2014). These criteria helped the Jordanian government to better target social safety assistance, both in terms of its reach and its timing.

The current system forces high energy users to pay exponentially more for electricity than poor households. Poor Jordanian households get virtually free electricity (Sowell 2016). As a result, NEPCO continues to amass debts, creating a difficult situation for the government. When factoring in the large influx of refugees from Syria, it is evident that Jordan still has many challenges to overcome in its effort to balance fiscal prudence with social cohesion.

## V. Saudi Arabia

Figure 5: Saudi Arabia: Chronology of Subsidy Reform



Source: Authors.

As Saudi Arabia's budget deficit soared due to the decline in oil revenues, the kingdom decided to enact pricing reforms in the winter of 2015–2016, while it still had low debt and access to financial means. Besides spending cuts, privatization measures, and new tax revenues, the country reformed energy prices of gasoline, diesel, natural gas, and electricity. The price increases affected nearly all consumer groups. Energy-intensive industries such as petrochemicals and cement saw their production costs rise significantly. Depending on the fuel, prices rose by as much as 133 percent. Both diesel and gasoline in transport were raised by at least 50 percent, in total opening up about US\$4.3 billion of savings for the government. Fuel prices in the power sector were also increased. Crude oil and methane were hiked 40 percent and 67 percent, respectively, and heavy fuel oil and diesel saw increases of 100 percent and 225 percent (Fattouh et al. 2016). The associated increase in electricity costs was mainly carried by households with medium to higher levels of consumption. The lowest consuming households were spared from electricity price increases (Fattouh et al. 2016). Though the country's leadership has indicated it intends for reforms to continue, the recently agreed-upon OPEC production cut could increase oil revenues and therefore potentially reduce support for further domestic reform.

## Saudi Arabia 2015 Key Energy Price Increases

Gasoline	67% (lower-grade gasoline), 50% (premium gasoline)
Diesel	54% (industry), 109% (commercial transport), 225% (elec gen)
Methane	67% (elec gen)
Ethane	133%
Crude oil	40% (elec gen)
HFO	100% (elec gen)
Electricity	0% (low users), 66% (medium users), 150% (heavy users)

### *Why reform was necessary*

Mounting fiscal pressure due to the drop in international oil prices pressed Saudi Arabia to enact energy price reforms at the end of 2015. In the years leading up to the summer of 2014, the kingdom received significant revenues from its oil and gas sales resulting from the record-high oil prices around US\$100 per barrel. However, these years also included periods of political instability in which GCC governments hiked public spending to ease public dissatisfaction. The kingdom invested in physical and social infrastructure, and while it tried to diversify its economy, it still remained heavily reliant on oil and gas revenues. In an unusually honest disclosure, Prince Mohammad bin Salman Al Saud revealed that during those years, contract requirements were less stringent, ultimately leading to US\$80–100 billion of inefficient spending annually (Waldman 2016). In short, the period of high oil prices—and therefore revenues—could be seen as a period characterized by a significant amount of corruption and inefficient spending instead of an opportunity to kick off the drive for economic diversification.

Youth unemployment was one of the most pressing concerns in Saudi Arabia as the oil price began to collapse. The price started dropping in the summer of 2014 as a result of oversupply from unconventional shale sources in the United States and newly started production in Iraq and Libya. At the same time, global demand curtailed with the European crisis and the Chinese economic slowdown. In this context, Saudi Arabia took the explicit decision not to lead an OPEC production cut to maintain its market share. Normally, when prices decline so dramatically, market watchers expect OPEC to step in and restrict production in an attempt to raise prices. Practically, this means that the country with the largest reserves and the highest level of exports (Saudi Arabia) would carry the highest level of cuts and thus act as the swing producer. However, Saudi Arabia decided not to cut production at that time, allowing international oil prices to fall in the expectation that US shale oil and other non-OPEC production would shut down in the wake of falling revenues.

As lower oil prices continued, Saudi Arabia struggled more and more under declining revenues. Having spent money inefficiently during the 2010–2014 period and still heavily reliant on oil and gas revenues, the country was now depleting its foreign reserves at a pace in which some warned it could hit insolvency by early 2017 (Waldman 2016). With a budget deficit of nearly US\$200 billion, the government embarked on pricing reforms intended to reduce demand and open up resources for exportation. Particularly, they targeted the trend of dieselization of power generation, which has been widely recognized as an option with high opportunity costs. Eventually Saudi Arabia did agree to production cuts in late 2016, which, if sufficiently large and implemented, could increase prices and reduce fiscal burden on exporting countries.

### *Political coalitions and economic impacts*

Many Saudi stakeholders with patronage ties built on low energy prices are negatively impacted when prices are increased. Prince Mohammad was able to use low international oil prices and the threat of insolvency to advance energy pricing reforms at a time when political opposition forces had little credibility.

Reform efforts found support from a number of factors that strengthened the idea of a coherent Saudi Arabia: a waning relationship with the United States over Washington's rapprochement with Iran, the rise of Iran as a regional superpower and rival, Saudi Arabia's profiling as a Sunni leader in a proxy war in Yemen, and Saudi Arabia's support to states like Egypt. At the same time, reform had become widely accepted as necessary across the entire MENA region. By the time Saudi Arabia reformed energy prices, many MENA countries such as Morocco, Tunisia, Algeria, Egypt, Jordan, the United Arab Emirates, and Iran had already initiated similar efforts. This helped create the perception that reforms were necessary for economic growth, not just to cover losses as a result of wasteful spending.

Both internally and to the public, Saudi Arabia coupled the idea of pricing reforms to economic revival and diversification. The kingdom appears serious about having a holistic program for economic diversification away from oil and governmental accountability. In April 2016, under the leadership of Prince Mohammad, Saudi Arabia announced the "Vision for the Kingdom of Saudi Arabia." This vision includes a comprehensive plan for the transformation of the national economic, political, and social system, and provides economic objectives as well as social and education reforms. It also focuses on governmental accountability and the tackling of corruption (Hamade and Shahine 2016). The key question, though, is whether the political culture and institutional capacity can evolve to allow for these reforms to thrive and yield results. As Fattouh et al. (2016) point out, when international oil prices increase, the support for domestic reforms could crumble. It is yet to be seen whether Prince Mohammad can maintain his reform-minded coalition in a higher oil price environment and the subsequent difficult path ahead in terms of economic diversification and the development of targeted social safety measures.

### *Social contract dynamics*

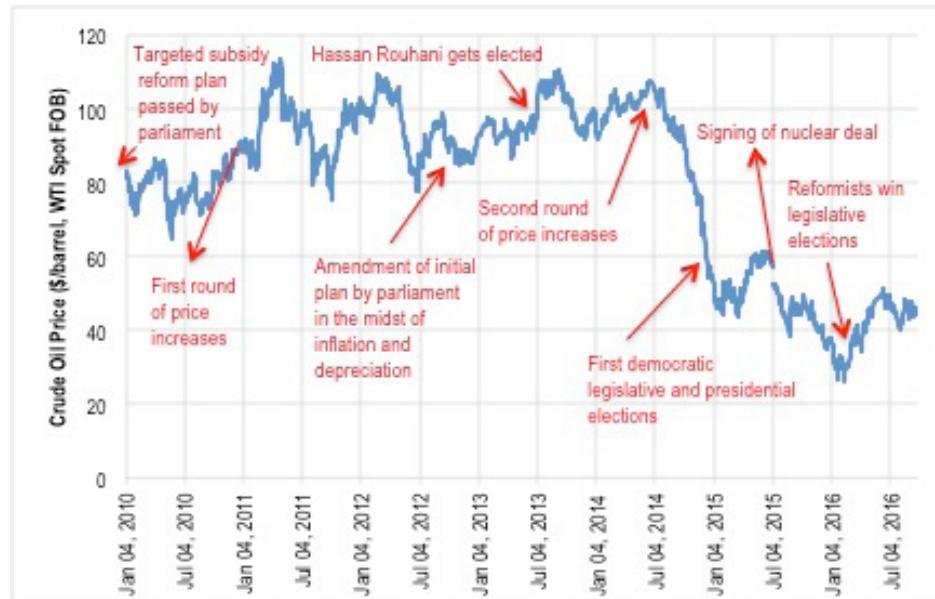
The fiscal crisis alone was not sufficient to convince normal Saudi citizens of the need for pricing reforms, particularly since the extent of the crisis was initially hidden from the public. As the social contract is built on the provision of low energy prices and other goods and services to citizens, reforming prices was politically controversial. However, unlike other countries in the region, Saudi Arabia implemented reforms overnight, without a communication campaign and without any compensation measures. Fattouh et al. (2016) argue that the social contract proved elastic because of the other aforementioned issues that strengthened national unity, but that further reforms could prove difficult if no communication campaign and mitigation measures were introduced.

The mixed reactions on social media and the protests in the wake of shock water pricing reforms offer a cautionary tale. Because of these protests and the overall handling of the water price reform, Prince Mohammad sacked the water minister in April 2016 (The National 2016). It seems there is now a growing understanding on the part of government of the need to provide more social safety assistance. Also in April, Mohammad announced a plan to soften the impact of higher prices via a cash transfer program aimed at low- and middle-income households (Nereim 2016).

While many of the pricing reforms were substantial reforms of an unprecedented scale, prices still remain among the world's lowest and thus remain a burden on government coffers, Saudi Aramco, and the Saudi Electricity Company. Therefore, Saudi Arabia aims to continue reforms as part of a more structural process. As new gasoline price increases were to be announced early 2017, Saudi Arabia seemed set on finally implementing mitigation measures via a cash transfer scheme. Early rumors indicated that the cash transfer would be for all, except for the wealthiest. It would be implemented in the first half of 2017 alongside the gasoline subsidy reforms (Mahdi et al. 2016).

## VI. Iran

Figure 6: Iran: Chronology of Subsidy Reform



Source: Authors.

Iran's fossil fuel subsidy reform attempts have been gradual and relatively uncoordinated from 2010 to 2014. In October 2010, the Ahmadinejad government decided to take a "big bang" approach, substantially increasing prices overnight. This was known as the Targeted Subsidies Reform Act, which intended to replace food and energy subsidies with targeted social assistance. While it was known that reform would happen (discussed later in this section), it was not known exactly when—most likely to prevent hoarding. At the same time, the government introduced its cash transfer program. Because of internal opposition, the parliament amended the Reform Act in three ways in 2012. First, it introduced a price ceiling on fuel prices at 90 percent of the FOB prices and rejected a proposal to further increase prices in 2012. The parliament also amended the proposed compensation allocation of cash transfers to 80 percent of Iranian households instead of the original 50 percent figure (Hassanzadeh 2012). Finally, the parliament blocked Ahmadinejad's efforts to create a fund that would allow for unchecked use of a portion of the reform's revenues by the government.

The second round of price increases did not take place until April 2014, but they were not as large as the hikes seen during the first phase. Because of currency depreciation, energy prices in US dollars actually declined from December 2010 to April 2014, and the prices of kerosene, furnace oil, and LPG for household use remained very low. The reform process is still ongoing, with budget for the fiscal year ending in March 2016, but an increase of 5 percent for petroleum product prices has been approved (Kojima 2016).

### Iran 2010 and 2014 Key Energy Price Increases

Gasoline	0% (governmental fleet, industrial and agricultural vehicles), 400% (domestic vehicles of engine <2000 cubic cm; additional 75% in 2014), 700% (other)
Diesel	<800% (public transport, industry and production), 2000% (free market)
Natural gas	45% (public sector); 1500% (elec gen), 4300% (industrial)
Electricity	750% (maximum public sector), 200% (Industry); >300% (household cooler region)

#### *Why reform was necessary*

By 2010, the costly nature of fossil fuel subsidies had made reform unavoidable. In 2010, subsidies for energy products alone accounted for 10 percent of Iran's GDP, according to the World Bank. Iranians paid as little as 38 cents for a gallon of rationed gasoline, which was cheaper than bottled water. As in many other MENA countries, cheap prices fostered wasteful consumption. Iran's energy consumption had increased five-fold in thirty years. Finally, cheap energy had contributed to recurrent pollution and environmental decay in urban areas (Nikou 2016).

According to Gholamreza Mesbahi Moghadam, chairman of the parliament's committee on the economy, some of the key motivations for passing the reforms were high-energy demand, unsustainable energy-intensive production nation-wide, and unfair allocation of wealth as a result of subsidies. Subsidies resulted in the annual rate of energy consumption rising by 8 percent while population growth was at 1.3 percent. Meanwhile, production structures, which were based on cheap energy, had led to an outdated industry. Finally, poorer residential consumers received less assistance from the government due to their lower consumption levels (Press TV News 2015).

#### *Political coalitions and economic impacts*

Since the onset of reforms, there has been an ongoing process of contestation between statists who want to retain government control and reformists who want to pursue a more business-oriented strategy. Often, these two opposing forces battle in the parliament and administration, causing Iran's subsidy reforms to occur in bursts, with significant revisions on the initially proposed plans. At times it appears Iran's gradual and contested road toward fossil fuel subsidy reform reflects the internal struggle among stakeholders striving to be on the right side of the Islamic republic's shifting social contract.

The reformists—seen by many as the more moderate, progressive, and business-friendly group in the parliament—objected to attempts by Ahmadinejad's camp to consolidate more power in government hands, retain the statist model, and allocate smaller proportions of reform revenues to household cash transfers as well as to industrial and agricultural support. The election of reformist Hassan Rouhani in 2013 has been perceived as a step that will minimize such deadlocks in the future and make reforms easier (Black 2016). Nevertheless, the apparent ability of the Iranian parliament to check the government can be undoubtedly factored as a strong institutional guarantee on subsidy reform success. The aforementioned process of parliamentary contestation is believed to have minimized social unrest and backlash to the measures by addressing popular grievances and shaping a more balanced social contract.

The role of energy-intensive industries in Iran's economy was also a point of contention. The Reform Act foresaw a compensation mechanism to help energy-intensive industries transition toward a higher price environment. It was decided that 30 percent of savings from subsidy reform would be used to support industries and producers, among

others with credit lines to reduce the impacts of higher energy costs and provide subsidies to help the adoption of energy-saving technologies (Hassanzadeh 2012). To assess which enterprises were worthy of government support, the authorities conducted a systematic analysis of more than 12,000 enterprises. Of these, 7,000 enterprises were selected to receive targeted assistance such as cash transfers to companies and fuel sales at discounted rates (Guillaume et al. 2011).

### *Social contract dynamics*

Passed in 2010, the Reform Act preceded the Arab Spring but followed the Green Movement, which demanded the removal of President Ahmadinejad from office after his 2009 election was considered fraudulent by protesters. During this difficult time, the Iranian government tried to maintain social peace by establishing a pro-Arab Spring narrative, by using the stick to deter protests, and by investing in compensation measures and communication campaigns.

The subsidy reform was met with protests that coincided with the Arab Spring demonstrations in the region. Nevertheless, it could be argued that the Iranian government's treatment of the Arab Spring was exceptional in that it was endorsed as a continuation of the spirit of the 1979 Green Revolution (Rafati 2012). In the case of Iran, instead of obstructing the government's legitimacy, the Arab Spring—"a widespread awakening of nations toward Islamic goals," as Khamenei referred to it—caused instabilities in the region that helped the government consolidate its power through its ability to guarantee stability in an otherwise unstable political landscape (Yahmaian 2015). Along with high inflation, increased conversion of local currency to gold and foreign currencies due to depreciation fears, widespread bankruptcies of energy-intensive firms, and a bearish Tehran Stock Exchange, the 2010 protests caused the Reform Act to be postponed from March until October 2010 (Kojima 2016).

When reforms were finally implemented, the government used both repressive and compensatory measures to control and appease the population. The Iranian government's use of the stick appeared an important catalyst in making reform pass. During December 18 and 19, 2010, all major gas filling stations, shopping malls, and the entire Tehran bazaar were closely guarded by security forces and riot police. Around 10,000 inspectors were hired to help prevent mass protests. The government threatened transportation workers with fines and union membership withdrawal should they attempt to strike. Iran ordered the media to not criticize the program (Kojima 2016).

Communications campaigns were used to educate Iranians on the increasing costs of low energy prices and the benefits of the reform. A special spokesman was appointed, politicians and social leaders were mobilized to speak in favor of the reform, and a broad range of educational programs were presented in the Iranian media. Concurrently, the president and senior officials spoke frequently about the inefficiencies as well as the social inequity caused by cheap energy. Furthermore, households were exposed to the new prices before increases took place. For example, electricity bills showed the true unit cost of energy in addition to the current lower cost. In addition, the cash transfer scheme to Iranian households was widely advertised (Guillaume et al. 2011).

That cash transfer program was perhaps the most important reason why reform passed. Prior to reforms, the authorities announced a cash transfer of around US\$80 to households for the first two months. While the handouts were initially announced as dependent on each household's income, size, and place of residence, the government diverged from those plans and opted to make cash transfers uniform across all households (eventually about 90 percent of households received cash transfers). Despite the government seemingly managing to keep the social contract in tact at first, over time these large price increases were accompanied by a downturn in the economy due to intensifying sanctions, sharp depreciation of the local currency, and high inflation. These factors invited much criticism from groups within the parliament that were expecting more gradual reforms considered economically wiser as they would keep inflation in check. This is one of the reasons reforms were less stringent after 2012.

Since it was implemented, the targeted subsidy reform program has gradually taken the form of a cash transfer program. The Ahmadinejad administration was accused of economic recklessness after reforms began, with critics warning that the program would lead to a serious increase in inflation and encourage budget losses (Khajehpour 2013). And indeed the Rouhani administration inherited a lot of debt to commercial banks from the previous administration. The bad state of government finances was exacerbated by the combined effect of international sanctions and the drop in oil prices. As a result, the Rouhani government has recently been forced to slash monthly payments to one third of Iran's population (Vatankhah 2016). Nevertheless, with the 2017 presidential elections around the corner, there are reasons for Rouhani to shy away from further unpopular measures.

Whether or not the Iranian government will be able to sustain the current cash transfer program will depend on its capability to do so without provoking widespread popular backlash. Perhaps a key prominent determinant of the latter will be the political and economic implications of Iran's 2015 nuclear deal with the United States, a development at the center of Rouhani's political legacy. It is difficult to predict what (if any) new direction President Trump will take, though he has always been critical of the Iran deal. If Iran's rapprochement with the West continues and it reaps substantial economic benefits for Iranian households and bolsters optimism and national unity, further reforms will be politically feasible. Though it may be early to call, the reformists' victory in the February 2016 legislative elections has been seen by many as a clear verdict of the Iranian people in favor of the deal (Nada 2016).

# CONCLUSION

The reform of energy prices across the MENA region represents a significant change in the implicit social contract that has governed the region for decades. Before, untargeted subsidies in general and underpriced energy in particular were a cornerstone of the distribution of welfare by the government in exchange for its citizens' loyalty. Now, however, this cornerstone does not appear as sacred. In all countries, energy prices were reformed as a measure of last resort. Underpriced energy not only led to wasteful consumption but was also regressive by disproportionately reaching the richer parts of the population.

- Fiscal crisis has been the main reason for all countries to implement energy subsidy reforms. It is not only a convincing argument to garner support from the wider population but also an effective political tool to either convince or sideline powerful stakeholders. Because of the severity of fiscal challenges, key political debates in countries focused on how and at what pace to pursue reform, rather than whether price increases were needed at all.

There is no doubt that the reform of energy prices has proven to be politically challenging. Yet in most countries, there was a combination of political economic conditions that strongly increased the acceptability of reform. Because of such severe fiscal stress, otherwise reluctant stakeholders had to accept that reform was no longer avoidable. While there were bargaining games in every country on whether to increase certain fuel prices and by how much, the actual decision to significantly alter the subsidy regime marked a paradigm shift, made necessary when the distortions of that subsidy regime became clear across the region. Among others, a lack of economic diversification and growth, the shrinking middle classes, and higher unemployment among an increasingly educated youth showed that the state and the old, untargeted subsidy regimes were unable to deliver on its side of the social contract. Subsidy reforms were often framed in wider programs to tackle these measures, though their actual implementation also often relied on the use of repressive tactics.

- Most countries in the MENA region seek to substantially alter their economic model and, consequentially, their social contract. Indicative is the unusual effort spent on communication campaigns to explain to the people the rationale of and need for reforms. This demonstrates a more responsive government in the wake of the Arab Spring.
- At the same time, many countries have not only used the carrot (communication campaigns and mitigation measures) but also the stick to control the reaction to reform and guarantee its implementation. As countries rely more on repressive measures, governments are under greater pressure to deliver results from the subsidy reforms to maintain political and public support. The use of repressive measures demonstrates the intention of governments to maintain power and advance less on the political side of a transformation of the social contract.

This process had been going on for years, and the Arab Spring provided firm proof of the existence of a serious existential crisis in the MENA region. Whereas many stakeholders had and continue to have patronage linkages to the subsidy regime (including low energy prices), the Arab Spring unequivocally demonstrated the limits of the system. The quest for dignity and socioeconomic justice and growth meant that touching the social contract was necessary. Even though subsidies have been the main form of social security and welfare protection, their reform is necessary to make them less wasteful and more efficient in spurring new economic opportunities.

- The success of current and potential future reforms depends on economic progress and the ability to implement new, targeted social safety systems. Most reforms rely on the promise of tangible economic results. Countries that can point to results have an easier time reforming further. Countries with continued economic turmoil seem to have a harder time maintaining government credibility.

- Most countries are attempting to deliver more targeted social safety systems, which has proven challenging in most MENA countries both from a political economic and technical-institutional standpoint. Because of this, some countries use other subsidies (like food subsidies) as a way to mitigate the negative impacts of energy pricing reform.

In times of abundant resources, political survival implied not touching the subsidy system. Now, however, given the obvious distortions the subsidy system has created, political survival means reforming that subsidy system, and thus, the social contract. As governments touched one cornerstone of the social contract, they seemed aware of the need to innovate politically. Contrary to a history of relative irresponsiveness, the power balance has recently shifted more toward the people, and governments seem well aware of it. This dynamic is certainly unequal in various countries, particularly with fuel-exporting countries having initiated ill-prepared reform.

- Saudi Arabia did not use any communication campaigns, nor did it foresee mitigation measures or plan for more targeted social safety net development. Because of a particular mix of political conditions, Saudi Arabia's social contract proved to be elastic, but further reforms are now linked to the implementation of a new cash transfer scheme. Whereas Saudi Arabia has unprecedented social and economic reform ambition, further pricing reforms may depend on the evolution of the international oil price.

Often, the most difficult times arrive after pricing reforms. In many countries, implementing higher prices was to some degree opportunistic. Governments now need to develop more targeted social safety nets. This not only requires a continued shift in political culture but demands complex intragovernmental cooperation and institutional innovation. Governments also need to deliver visible and tangible economic growth, which is at least as challenging as developing targeted social security given that energy-intensive industrialization was promoted for many years.

It remains to be seen whether governments can actually encourage the development of a political economic context in which true reform success is possible. Undoubtedly there are promising signs across the region, but looking forward, questions remain about the commitment of oil-exporting countries to reforms if and when prices rebound. For import-dependent nations, there will be questions about whether they can maintain political credibility, deliver results, and thus, maintain sustainable political stability. The governments of the MENA region should be able to weather these storms, but it will require a further transformation of the social contract and a skillful steering of the countries' political economic realities.

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