Macro economics

GCC countries begin to tackle subsidy reform to alleviate fiscal burden

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Highlights

- **With Brent hovering around $50/bbl, energy subsidy cuts are being seen as one solution for rising budget shortfalls across the GCC.**
- **Heavily subsidized energy prices placed all six GCC countries among the world's top ten energy consuming countries on a per capita basis.**
- **Savings from subsidy cuts could be spent more productively on education and healthcare.**

Energy subsidies face headwinds from low oil prices

For decades, GCC countries have had some of the world's most generous energy subsidies. With oil prices reaching new lows, authorities are increasingly turning to subsidy reform to help reduce large fiscal deficits. The cost of GCC energy subsidies have long been perceived as unsustainable in the long-term as has the strong growth in energy demand. Fiscal deficits are expected across the GCC as oil prices dropped below $50/bbl; this is well below the breakeven price of most GCC countries. While most GCC countries can finance deficits for some time with substantial sovereign wealth funds, moves to rationalize budgets remain critical in the medium to long term.

GCC countries have already started trimming government expenditures in part by introducing cuts in energy subsidies to alleviate the fiscal burden. According to IMF estimates, energy subsidies in 2015 in the GCC range from 1.1% of GDP in Oman to 4.6% in Saudi Arabia (KSA). While the recent drop in oil prices has reduced the cost of energy subsidies, the negative impact on oil revenues has been larger. For example, Bahrain's subsidy bill shot up from 17% to 34% of oil revenues and KSA's from 11% to 20% between 2013 and 2015.

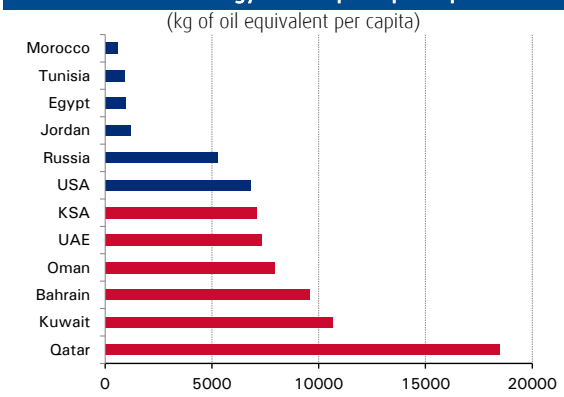
While the primary objectives of energy subsidies is to redistribute hydrocarbon wealth, promote industrial growth and improve the standards of living of GCC citizens, they also bolster wasteful energy consumption, deplete oil resources and reduce oil revenues, not to forget the environmental damage linked to excessive energy consumption. However, there are other more effective means to redistribute the hydrocarbon wealth in an effort to improve standards of living, and boost economic growth, integration and equality.

Low energy prices promote inefficient energy consumption

Low energy prices placed all six GCC countries among the top ten energy consuming countries on a per capita basis in the world, with Qatar topping the list at around 18,500 kg of oil equivalent per capita (koe/capita). Subsidies for gasoline and electricity constitute the biggest chunk of the energy subsidies.

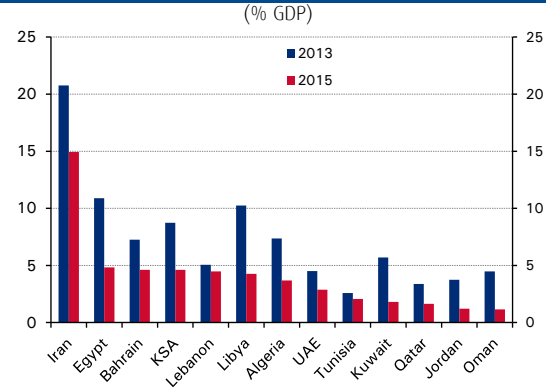
Gasoline prices in the GCC are heavily subsidized and among the lowest worldwide. Prices in KSA are the lowest in the GCC at $0.16 per liter, followed by Kuwait, Bahrain and Qatar at $0.23, $0.27 and $0.27 per liter

Chart 1: Energy consumption per capita



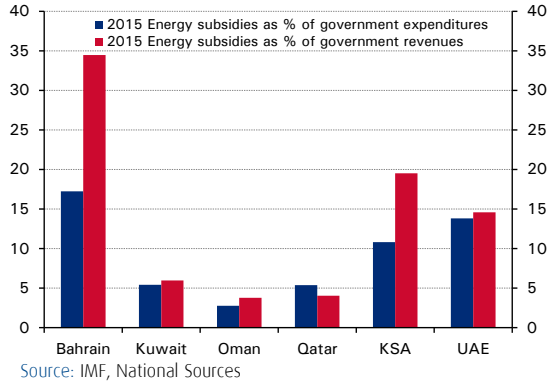
Source: World Bank, World Development Indicators

Chart 2: Energy subsidies 2013-2015



Source: IMF, National Sources

Chart 3: Energy subsidies & govt. finances



Source: IMF, National Sources

respectively. Gasoline prices in Oman and the UAE are the highest in the GCC at $0.31 and $0.47 per liter, though they too remain well below gasoline prices charged in the US, China and Turkey. The latter has the most expensive gasoline at $2.54 per liter.

GCC countries started lifting gasoline and diesel subsidies, though steps remain timid and small relative to the size of the GCC energy subsidies. In May 2014, Qatar raised diesel prices by 50%, followed by Bahrain and Kuwait in early 2015. Most recently, Dubai lifted subsidies on gasoline and diesel prices. Prices would be set by the government but linked to international market prices. Despite IMF recommendations, KSA remains the exception, showing no intention so far of deregulating fuel prices.

Electricity subsidies constitute almost half of the energy subsidy bill, with heavy reliance on natural gas as a main resource for production. As per the General Subsidies Initiative, established in 2005 by the International Institute of Sustainable Development and dedicated to analyzing subsidies, GCC electricity production has grown at an average of 7% annually between 1999 and 2008. As demand for electricity continues to grow, most of the GCC countries cannot sustain the high reliance on cheap natural gas for long and hence are facing higher production costs as the electricity prices to consumers remain low.

Electricity prices in Kuwait have been fixed at $0.007 per kWh since 1966, although the Electricity Policy Research Group at the University of Cambridge estimated the cost of electricity production at $0.14 per kWh, or 20 times higher. The electricity price in KSA is slightly higher at $0.013 per kWh. In January 2015, Abu Dhabi increased electricity tariffs by 40% for expats from 15 fils/kWh to 21 fils/kWh for consumption of up to 20 kWh. For nationals, electricity tariffs remain highly subsidized.

The residential sector is the biggest consumer of electricity in the GCC along with the commercial and public services sectors, rendering subsidy cuts more difficult. With the exception of Qatar and the UAE, more than 50% of the electricity supply is consumed by the residential sector. Kuwait residential sector consumes 58% of the total electricity supply versus only 17% for the industrial sector.

Unfortunately, in developing countries, spending on energy subsidies is higher than spending on productive social sectors like education and healthcare. Iran's energy subsidy bill reached 15% of GDP in 2013 versus expenditures on healthcare and education of less than 4% of GDP, respectively. KSA's energy subsidies to GDP reached 4.6%, more than double its expenditures on healthcare.

The IMF has estimated a broader measure of energy subsidy costs, one that includes the environmental cost (environmental tax). By this measure, energy subsidies include the direct fiscal cost plus a tax for the negative externalities of energy consumption, like air pollution, traffic and car accidents. The IMF estimates the GCC energy subsidies in 2015 to be around $59 billion compared to a post environmental tax subsidy of $175 billion.

Impact of energy price reform

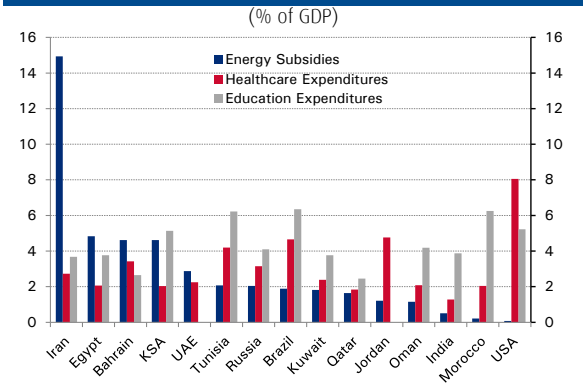
Calls by the IMF and other international organizations urging GCC governments to introduce subsidy reforms have intensified following the sustained oil price drop. Given that energy subsidies in the GCC make up a significant share of government expenditures, the advantages of subsidy cuts are multiple; the main benefit is a direct positive fiscal

Table 1: Energy Subsidies in % of 2015 GDP

	Energy subsidies*				Post environmental tax subsidies
	Oil	Gas	Electricity	Total	
Kuwait	0.96	0.46	0.39	1.82	7.79
Qatar	0.46	0.53	0.66	1.64	6.37
KSA	3.72	0.00	0.82	4.54	13.23
UAE	0.44	1.86	0.59	2.88	6.58

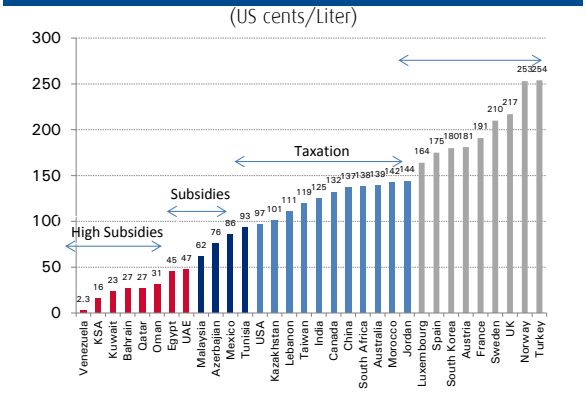
Source: IMF, * NBK Estimates

Chart 4: Energy subsidies & social expenditures*



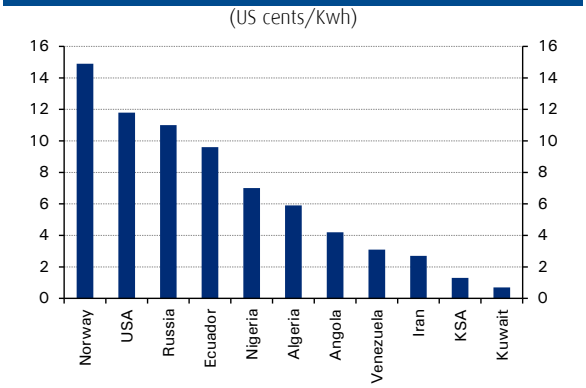
Source: IMF, World Bank * 2013 or most recent data available

Chart 5: Retail prices of gasoline



Source: GIZ, 2014

Chart 5: Retail prices of electricity



Source: Baker Institute Policy Report 58, May 2014

impact from lower expenditures and higher oil revenues as more energy sources would be available for exports. Other benefits include the more efficient use of energy resources, the developments of sustainable sources of clean energy, as well as a number of multiple environmental benefits such as cleaner air.

The social impact of energy reforms and subsidy cuts is large as well. With more income to spare, GCC governments can focus on improving the quality of education; tailoring education to better meet the needs of the private sector can reduce the reliance on the government sector as the primary employer and on high-skilled expatriate labor.

A subsidy reform initiative is more likely to be successful if subsidy cuts are combined with a compensation scheme to the households. Indeed, the IMF's recommendations are for governments to include compensation to the most vulnerable households in the form of a direct cash transfer. Subsidy cuts should also be gradual, phased in over several years to limit the negative impact on economic activity and household welfare.

Table 2: Electricity usage

Country	Residential usage % of total electricity supply	Commercial & public service usage % of total electricity supply	Industrial usage % of total electricity supply
Bahrain	49%	39%	12%
Kuwait	58%	25%	17%
Oman	52%	35%	10%
Qatar	23%	17%	31%
KSA	51%	27%	18%
UAE	39%	36%	9%

Source: Chathamhouse, "Saving Oil and Gas in the Gulf", August 2013

Table 3: Subsidy-related reform measures

Bahrain	Authorities announced increase in natural gas prices for industrial users (+11%) and employee medical insurance fees (paid by employers) in early 2015.
Kuwait	In Jan-15, government raised diesel and kerosene prices (+50%) and instituted monthly price review mechanism.
Oman	No reform measures recently announced.
Qatar	Diesel prices up in May-14 by 50%. Starting to improve desalination technologies and awareness of sustainable energy use.
KSA	No reform measures recently announced.
UAE	Abu Dhabi increased water (+170%) and electricity (+40%) tariffs in Jan-15. Dubai lifted subsidies on gasoline and diesel prices on August 1st 2015.

Source: IMF, Regional Economic Outlook, May 2015, NBK

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