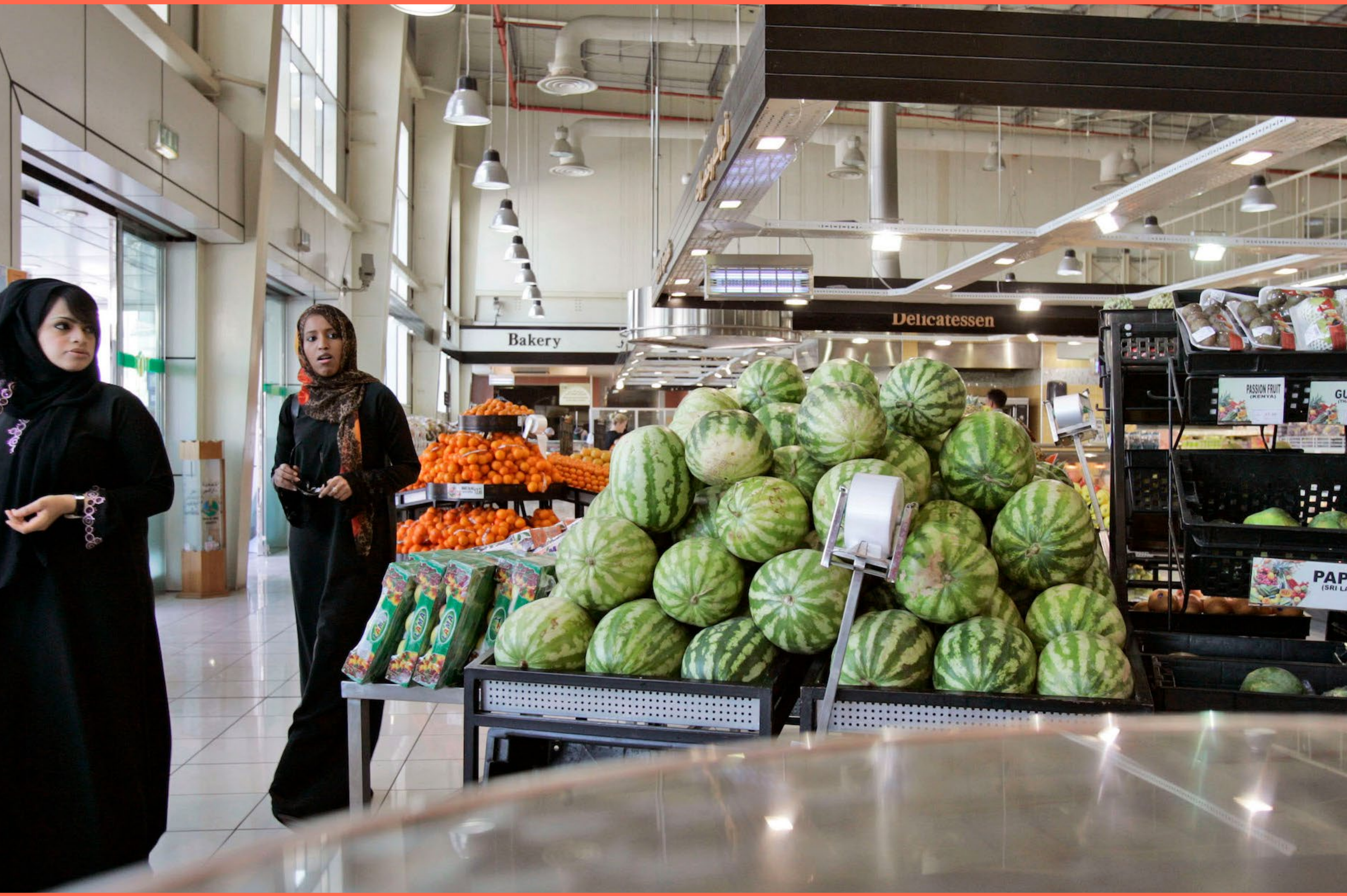
The Arab Gulf States Institute in Washington

Building bridges of understanding



The AGSIW *Visions of Change* Series

Subsidizing Basic Commodities in the Gulf Arab States: Distortive and Regressive

Omar Al-Ubaydli

The Arab Gulf States Institute in Washington
Building bridges of understanding

August 24, 2018

The AGSIW *Visions of Change* Series

Subsidizing Basic Commodities in the Gulf Arab States: Distortive and Regressive

Omar Al-Ubaydli

Issue Paper
#5
2018

The Arab Gulf States Institute in Washington (AGSIW), launched in 2015, is an independent, nonprofit institution dedicated to providing expert research and analysis of the social, economic, and political dimensions of the Gulf Arab states and how they impact domestic and foreign policy. AGSIW focuses on issues ranging from politics and security to economics, trade, and business; from social dynamics to civil society and culture. Through programs, publications, and scholarly exchanges the institute seeks to encourage thoughtful debate and inform the U.S. policy community regarding this critical geostrategic region.

Cover Photo Credit: AP Photo/Kamran Jebreili

The AGSIW *Visions of Change* Series

As Gulf Arab governments adjust to fiscal deficits driven by lower oil prices, the state, traditionally the leader in economic development, is under pressure to utilize available finance from the private sector. In labor markets, the state will need to reassess its role in providing the bulk of job creation for Gulf citizens, as well as question its reliance on low-wage foreign labor. These recalibrations of the Gulf economic development model have been under discussion in the "visions" of national development plans for some time. But the necessity of expeditious structural reforms is now far more pressing. Diversification away from resource-dependent state spending will require changes across the economies, and the societies, of the Gulf Arab countries.

This paper is a part of AGSIW's *Visions of Change* series, examining how the Gulf Arab countries are addressing reduced hydrocarbon revenue and responding to pressures to liberalize their economies. This series engages how these efforts are unfolding across the region, by sector and country, to underline the challenges, opportunities, and risks of innovation and economic change.

About the Author

Omar Al-Ubaydli is a non-resident fellow at the Arab Gulf States Institute in Washington as well as the program director for International and Geopolitical Studies at the Bahrain Center for Strategic, International and Energy Studies (Derasat). He is additionally an affiliated associate professor of economics at George Mason University and an affiliated senior research fellow at the Mercatus Center. His research interests include political economy, experimental economics, and the economics of the GCC countries. Al-Ubaydli previously served as a member of the Commonwealth of Virginia's Joint Advisory Board of Economists and a visiting professor of economics at the University of Chicago. He regularly publishes his research in international peer-reviewed academic journals, and his mainstream media articles appear in Arabic and English-language newspapers and blogs such as Al-Hayat, Newsweek ME, Forbes Opinion, and US News. Al-Ubaydli earned his BA in economics from the University of Cambridge, and his MA and PhD in economics from the University of Chicago.

Executive Summary

The Gulf Arab countries allocate a large amount of funds toward subsidies for basic commodities, which include energy, water, and various foodstuffs. These policies are counterproductive and should be phased out: They impose a large financial burden on the state at a time when fiscal responsibility is a priority; they systematically support the rich rather than the poor; they distort prices in a manner that leads to overconsumption and the adverse consequences of the overconsumption are compounded in that many of the subsidized commodities have negative effects on the environment. This paper uses economic theory to demonstrate the negative implications of subsidies.

Introduction

Governments have been using subsidies for decades.[1] For most of the 20th century and well into the 21st, the Gulf Cooperation Council countries have exhibited a strong affinity for subsidies to commodities, such as fuel and basic foodstuffs.[2] In principle, governments deploy subsidies to these kinds of goods for the dual goals of raising living standards among low-income groups and diminishing inequality. This makes them highly popular among consumers. However, the positive attitude toward subsidies typically rests upon erroneous assumptions about the alternative.

In particular, recipients usually compare subsidies to an identical state where the only difference is the absence of the subsidy, without allowing for the redeployment of the funds elsewhere. This virtually guarantees that recipients will favor their continuation, in a manner that is analogous to the comprehensive distaste people express toward paying taxes when the alternative that they imagine is simply the absence of the tax, rather than the presence of a different tax.[3] This paper explains the ineffectiveness of subsidies and describes the superior alternatives available to policymakers.

The Financial Burden of Subsidies

Before presenting the economic theory of subsidies, it is worth highlighting how much of a financial burden they impose upon the GCC countries. Table 1 shows energy subsidies in the GCC countries in 2013 and 2016 as a percentage of gross domestic product, where energy includes gasoline, diesel, kerosene, natural gas, and electricity.

1 Peter A. Diamond and James A. Mirrlees, "Optimal Taxation and Public Production II: Tax Rules," *The American Economic Review* 61, no. 3 (1971): 261-78.

2 Bassam Fattouh and Laura El-Katiri, "Energy Subsidies in the Middle East and North Africa," *Energy Strategy Reviews* 2, no. 1 (2013): 108-15.

3 Joseph A. Biegeleisen and David L. Sjoquist, "Rational Voting Applied to Choice of Taxes," *Public Choice* 57, no. 1 (1988): 39-47.

Table 1: GCC Energy Subsidies (% of GDP)

	2013	2016
Bahrain	6.9%	3.8%
Kuwait	7.3%	6.8%
Oman	7.4%	3.0%
Qatar	5.1%	3.8%
Saudi Arabia	9.4%	4.4%
UAE	2.0%	0.7%

Source: International Monetary Fund. Energy subsidies include gasoline, diesel, kerosene, natural gas, and electricity.

These figures were very large in 2013; while they were considerably lower in 2016, they remained significant. It is too early to calculate the effects of the most recent round of subsidy cuts in 2018, but the expectation is that again, despite a considerable decline in the subsidies, they will remain large in size.

Table 2: GCC Fiscal Balance (% of GDP)

	2014	2016
Bahrain	-8.0%	-13.7%
Kuwait	22.3%	0.3%
Oman	-1.1%	-21.6%
Qatar	15.3%	-3.9%
Saudi Arabia	-3.4%	-17.2%
UAE	1.9%	-4.1%

Source: International Monetary Fund.

Table 2 shows the fiscal balances of the GCC countries as a percentage of GDP. This data demonstrates how pressing the need is for fiscal reforms: In 2016, three of the six countries had double-digit deficits as a percentage of GDP, and oil prices are extremely unlikely to approach pre-2014 levels of $120 per barrel. Therefore, purely as an accounting strategy, and without reference to the deeper economic consequences, eliminating subsidies appears to be a fruitful approach to tackling these budget deficits. The rest of this paper explains why – independently of any fiscal concerns – eliminating subsidies constitutes a sound economic strategy.

Price Interventions and Productive Exchange

To analyze subsidies in the Gulf countries, it is necessary to understand four main economic principles.

Principle 1: When consuming a product only affects the consumer (no externalities), subsidies lead to socially detrimental overconsumption.

Principle 2: Under these circumstances, despite subsidies making society worse off, subsidies always make the person receiving them better off.

Principle 3: When consuming a product negatively affects others (negative externality), then people will overconsume compared to the socially optimal level of consumption.

Principle 4: When consuming a product negatively affects others, the tendency for people to overconsume can be corrected by taxing the product.

Subsidies cause a distortion of prices, described as creating a "wedge" between the price paid by the consumer and the price received by the seller. Without subsidies, these two figures are equal. Subsidies push consumer prices below seller prices, and this leads to overconsumption. The societal losses caused by subsidy-induced overconsumption are called "deadweight losses."[4]

In reducing costs to the consumer, subsidies create a misalignment of incentives, whereby the benefit to the consumer is more often taken into account in personal decisions, neglecting the greater societal cost. A subsidy is welcomed by the consumer, since it lowers the price that he or she pays for a product. Compared to an alternative of no subsidy, from the perspective of a consumer, a subsidy is always desirable.

Many goods exhibit "externalities," meaning that people other than the consumer are affected by the act of consumption. For example, when a person listens to music loudly at his home, his neighbors suffer noise pollution. Alternatively, when a family makes their front porch beautiful, their neighbors benefit from a positive visual externality.

4 Arnold C. Harberger, "The Measurement of Waste," *The American Economic Review* 54, no. 3 (1964): 58-76.

Taxes can address misaligned incentives between individuals and society by creating a price distortion that counteracts the incentive distortion stemming from the externality. Taxes that are deployed to correct for negative externalities are described as being "Pigovian," after the British economist who developed the relevant theory, Arthur Cecil Pigou.[5]

While a tax can correct for overconsumption caused by a negative externality, a subsidy exacerbates it, as it encourages even more consumption.

Analyzing Subsidies in Isolation

Socially Damaging Overconsumption

Some of the basic commodities that are subsidized in the Gulf have no salient externalities, such as flour and chicken. In these cases, a direct application of Principle 1 means that subsidies will cause socially undesirable overconsumption.

Many subsidized commodities exhibit negative externalities due to their pollutive effects, such as fuel and electricity. Based on Principle 2, Gulf governments should consider Pigovian taxation to remedy the ensuing overconsumption; yet instead, they amplify it by deploying subsidies.

Further, the subsidies will generally be partially funded by taxation of other commodities, which may itself be distortive, unless it happens to be focused on commodities that have negative externalities.[6] In the specific case of the Gulf countries, government revenue is mostly from oil, but an increasing proportion comes from fees imposed on a variety of activities, such as hiring migrant workers, registering a commercial entity, and so on. For example, a value-added tax, which was launched in Saudi Arabia and the UAE in 2018, and is scheduled to be rolled out in the rest of the Gulf countries over the coming two years, is expected to generate revenue equal to around 1.5 percent of GDP.[7]

Many subsidized commodities exhibit negative externalities due to their pollutive effects, such as fuel and electricity.

This raises the question: Why does the government bother subsidizing basic commodities at all? The government does so because these subsidies improve the living standards of consumers, according to Principle 2. Unlike Ferraris or caviar, basic commodities are consumed by everyone, including the poorest segment of society, and so by lowering the price of such commodities, subsidies help alleviate poverty.

Why not just give people the money directly, rather than introducing distortive subsidies that exacerbate the wedge caused by the negative externalities? At present, governments should almost certainly do this. A mixture of administrative and political factors that are beyond the scope of this paper likely explain why such a system has not been adopted.

5 Arthur C. Pigou, *The Economics of Welfare* (London: Palgrave Macmillan, 2013).

6 Lucas W. Davis, "The Economic Cost of Global Fuel Subsidies," *The American Economic Review* 104, no.5 (2014): 581-85.

7 Babu Das Augustine, "VAT to Boost GCC Government Revenue," *Gulf News*, June 14, 2017.

Regressive Effects on Income Distribution

Picking basic commodities to subsidize because the poor are guaranteed to consume them is not the same as picking the commodities that the poor consume in greater volume than the rich. This is especially true in the case of the Gulf bundle of subsidized commodities; in fact, they are all goods that the rich consume more than the poor.

In the case of fuel, for example, higher income households have more cars, consuming more fuel. Richer people live in bigger houses and often have multiple homes, consuming more electricity and water. Their higher levels of per capita food consumption also mean that they consume more flour, chicken, and meat.[8]

If Gulf governments want to use subsidies to reduce inequality, they should subsidize goods systematically consumed by low-income households, such as economy brand bread, bus tickets, or instant noodles.

This means subsidies are "regressive," meaning that they accentuate income inequality between the rich and poor, rather than diminishing it. Modern tax systems, especially income and capital gains taxes, are designed to redistribute income from the rich to the poor, making them "progressive"; yet subsidies to basic commodities do the exact opposite.[9]

If Gulf governments want to use subsidies to reduce inequality, they should subsidize goods systematically consumed by low-income households, such as economy brand bread, bus tickets, or instant noodles.

Summary

Compared to simply having no subsidies, subsidies lead to overconsumption of commodities, exacerbating the distortive effects of negative externalities associated with fuel and electricity, such as environmental degradation, and necessitating additional distortionary taxation to fund the subsidies, such as a value-added tax. Moreover, they widen the gap between rich and poor. However, an individual always prefers a subsidy to no subsidy, and will resist attempts to remove it if the alternative on offer is simply no subsidy, let alone a Pigovian tax. Therefore, governments cannot rely on bottom-up initiatives to eliminate subsidies.

Analyzing Subsidies and the Alternatives

Fortunately for policymakers, there exist socially desirable alternatives to subsidies that may garner enough public support to permit their elimination.

8 Javier A. del Granado, David Coady, and Robert Gillingham, "The Unequal Benefits of Fuel Subsidies: A Review of Evidence for Developing Countries," *World Development* 40, no. 11 (2012): 2,234-48.

9 David Coady, Robert Gillingham, Rolando Ossowski, John Piotrowski, Shamsuddin Tareq, and Justin Tyson, *Petroleum Product Subsidies: Costly, Inequitable, and Rising* (Washington, DC: International Monetary Fund, December 15, 2010).

Homogenous Direct Transfers

The government can calculate how much it spends on subsidies per household. Since basic commodities are consumed more by high-income households, the average subsidy level will exceed the subsidies that low-income households benefit from, while being less than the subsidies accruing to high-income households.

Therefore, the government can choose to transfer this amount directly to each household while canceling subsidies, eliminating the price wedge in basic commodities.[10] Such a move would be "revenue neutral," meaning that it would cost the government no more or less than the subsidy; but it would eliminate the overconsumption in the no-longer-subsidized basic commodity (without eliminating the distortive taxation in the commodities required to fund the direct transfers).

Such a policy would also be neither regressive nor progressive, unlike the regressive status of subsidies to basic commodities (in fact, in the proportionate sense, it would be mildly progressive).

An additional advantage of direct transfers is that they are in principle less costly to the government due to the freedom that cash affords consumers. Suppose a consumer purchases 10 gallons of gasoline a week, and the price is subsidized by $1 per gallon, meaning that the government is spending $10 per week on that consumer. If the consumer is offered the choice of a $10 per week direct transfer plus unsubsidized gasoline, versus no direct transfer and a $1 per gallon subsidy on gasoline, both of which cost the government exactly the same amount, the consumer would always prefer the former. This is because the direct transfer allows consumers to purchase what they were purchasing in the presence of subsidies, meaning that their former standard of living remains within reach; but it also allows them to purchase other goods that they may prefer to gasoline, given the choice. Therefore, a $1 per gallon subsidy on gasoline is actually worth less than $10 per week to the consumer, due to the fungibility of cash. This can imply mild savings for the government; however, realistically in the case of the Gulf countries, the implied amounts of cash would be too small for the fungibility saving to be significant.

The problem with direct transfers is that they require a system for delivering such funds to households – one that both limits fraudulent claims and ensures those who qualify for the funds receive them. In most countries, this could be easily implemented via the existing income tax system; this is not an option in the Gulf, where there are no income taxes. Bahrain recently adopted a variant of such a system after lifting meat subsidies, and it set up a registration system using national identification cards, with direct bank transfers from the Ministry of Finance at regular intervals.[11]

10 Sanjeev Gupta, *Equity and Efficiency in the Reform of Price Subsidies: A Guide for Policymakers* (Washington, DC: International Monetary Fund, December 15, 2000).

11 "Bahrain to Remove Meat Subsidies from September 1 as Cheap Oil Hits Budget," *Reuters*, August 16, 2015.

Means-Tested Direct Transfers

If a government wants to ensure that direct transfers are progressive, meaning that they systematically help low-income households, then they have the option of making them means tested (income contingent), with poorer households receiving a larger direct transfer. This refinement requires a more sophisticated population registry that has accurate income data. It also creates a larger incentive for fraud, since households may wish to claim lower income levels to secure larger transfers. Therefore, the bureaucratic cost of means-tested direct transfers is considerably higher than for homogenous ones.

Vouchers

In both homogenous and means-tested direct transfers, the government has the option of using in-kind transfers, realistically in the form of vouchers that can be used to purchase basic commodities, as opposed to financial transfers. The relative merits of the two options depend upon there being specific reasons why society might benefit from ensuring that people consume specific commodities.

For example, in the case of food, there may be some goods whose consumption serves the general interest, such as low-sugar foods, which help in limiting obesity.[12] Under such circumstances, using in-kind transfers increases the likelihood that such goods will actually be consumed by the recipient, as the recipient may spend an unconditional cash transfer on other goods. However, the ability of the government to prescribe certain types of consumption via the issuance of vouchers is undermined by the existence of secondary markets, whereby voucher recipients can sell the vouchers, or the goods that they claim with the vouchers, to other consumers.

...in the Gulf, vouchers do not offer any significant advantage over direct financial transfers, means tested or otherwise.

Regardless, none of the basic commodities subsidized in the Gulf countries fall under the category of goods whose consumption should be encouraged (quite the contrary, in fact). Therefore, in the Gulf, vouchers do not offer any significant advantage over direct financial transfers, means tested or otherwise.

12 Theresa Marteau, Richard Ashcroft, and Adam Oliver, "Using Financial Incentives to Achieve Healthy Behaviour," *British Medical Journal* 338 (April 9, 2009).

Summary

Whereas removing a subsidy will virtually always draw the ire of its recipients, direct transfers can be used to compensate consumers while eliminating the price distortions that cause overconsumption, thereby making the adjustment away from subsidies politically acceptable.[13] They can also be deployed as a progressive redistribution device. However, their implementation requires a costly supporting administrative structure that is prone to fraud.

Conclusion

In a nascent economy where the government has a small civil service supporting it, subsidies to basic commodities are a potentially effective way of raising the living standards of consumers, because many of the preferable alternatives are beyond the means of a small bureaucracy. However, in modern economies, they are fundamentally unsound policies that should be eliminated as quickly as possible.

In particular, subsidies lead to overconsumption from a societal perspective. This drawback is accentuated in that many buyers do not account for the adverse environmental consequences of consuming them, as in the case of fuel, power, and water, meaning that they are overconsumed even in the absence of an artificial subsidy (though admittedly, some people have an intrinsic sense of environmental awareness, which drives them to responsible consumption levels). Beyond this, subsidies to basic commodities are also regressive, meaning that they widen inequality. Therefore, they function as de facto redistribution from the poor to the rich.

A wide array of research supports the notion that direct transfers, means tested or otherwise, are a superior method for raising living standards of the recipients, most importantly because they avert the need to introduce distortionary consumption habits for the subsidized goods.

However, given the presence of subsidies in the Gulf countries for several decades, the shift to alternatives should be done gradually, to minimize disruption to the economy. Many long-term contracts have been written based on the assumption that basic commodities will receive significant subsidies. To avoid a surge in insolvency, governments are best advised to produce a clear, multiyear plan for the gradual removal of subsidies, and adhere to it.

13 Tammi Gutner, "The Political Economy of Food Subsidy Reform: The Case of Egypt," *Food Policy* 27, no. 5 (2002): 455-76.