The Need for Subsidy Reform in Algeria

By: [Andrew Jewell]

August 31, 2016

At the start of 2016, the Algerian government raised the price of gasoline and other energy products for the first time since 2005. Yet despite a sizeable 34 percent increase, Algerian gasoline remains among the least expensive in the world, equal to little more than the price of mineral water. And cheap gasoline, as it turns out, mainly benefits the well-off. Why does all this matter? Because it says a lot about subsidies, their lack of fairness, and the need for reform.

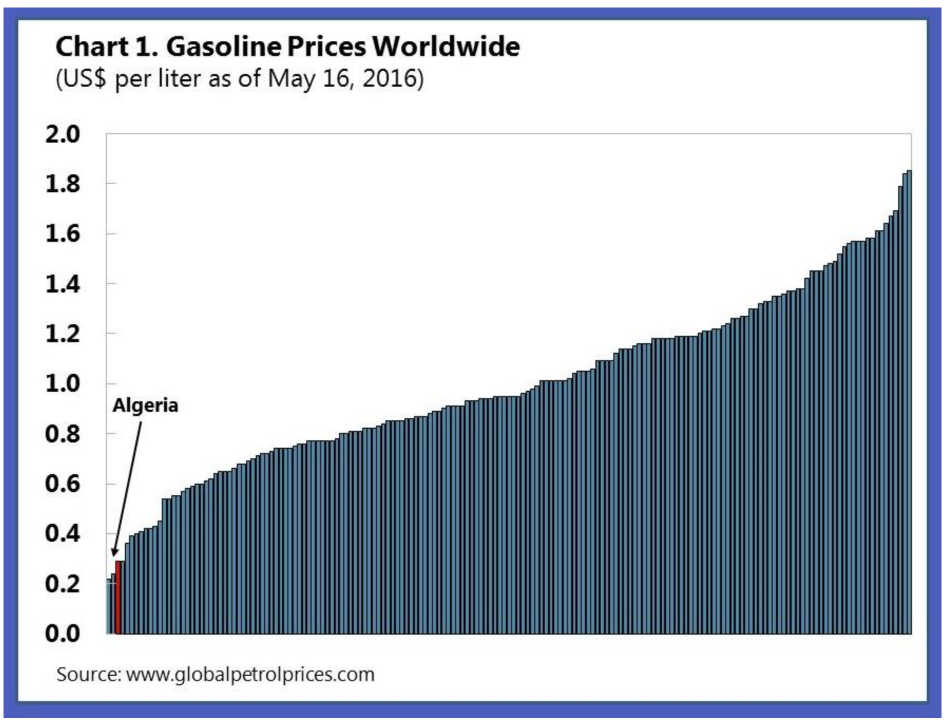


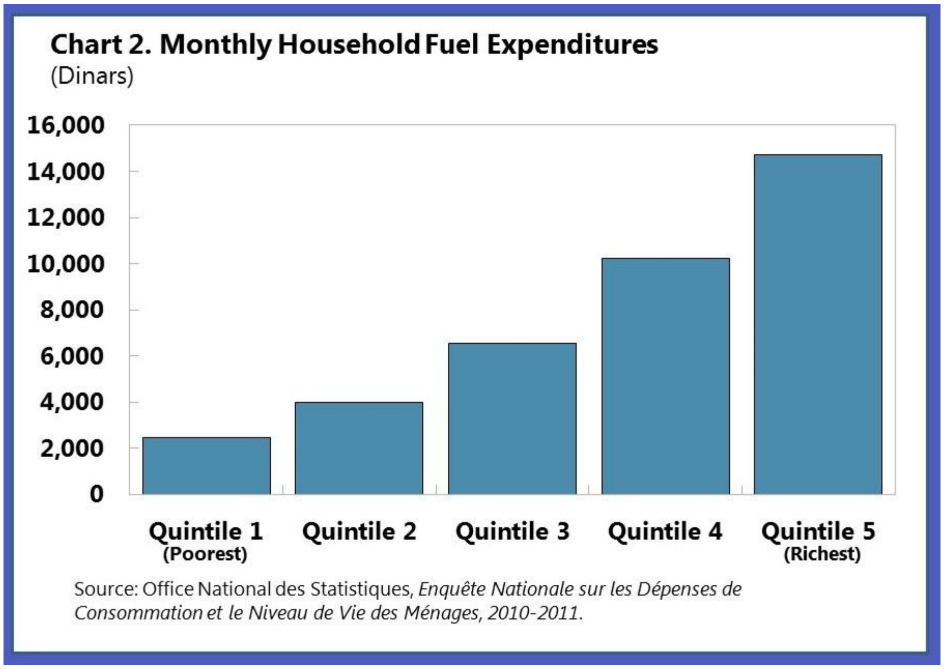
Chart 1. Gasoline Prices Worldwide
(US$ per liter as of May 16, 2016)

Source: www.globalpetrolprices.com

Gasoline, like many other things in Algeria, is heavily subsidized. The government relies on subsidies to help share the country's oil and gas wealth with its citizens. Although the objective is noble, and not all subsidies are bad, trying to redistribute income via untargeted subsidies has disadvantages. A new IMF study examines the key disadvantages of Algeria's subsidy system and proposes an alternative way to support the vulnerable.

Key disadvantages

Most of Algeria's subsidies benefit the rich more than the poor. The graph below provides some striking evidence. The richest 20 percent of Algerians consume six times as much fuel as the poorest 20 percent. This is hardly surprising considering that the affluent tend to drive more. This implies that fuel subsidies are regressive: the richer you are, the more you benefit. Many other subsidies in Algeria are regressive, to varying degrees. For example, electricity subsidies also disproportionately benefit the rich, who are more likely to be connected to the national electricity grid and have larger homes with air conditioning.



Some subsidies have other important drawbacks. For instance, low energy prices have led to a rapid rise in domestic energy consumption, leaving less oil and gas for Algeria to export, reducing revenues for the budget, and aggravating pollution and local traffic congestion. Heavily subsidizing some products also create incentives for smuggling to neighboring countries.

Last but not least, subsidies in Algeria are expensive, which is even more problematic at a time when the country is facing record fiscal deficits following the drop in world oil prices. IMF staff estimate that subsidies cost the government about 14 percent of GDP in 2015—almost as large as the fiscal deficit itself and twice the combined budgets of the health and education ministries. Regressive energy subsidies account for over half the cost.

In short, the Algeria subsidy system fails to provide efficient support to the poor, create distortions that are harmful to the economy and the environment, and crowd out other important expenditures. So what’s a better answer?

A better way forward

IMF staff recommends that Algeria gradually phase out most of its generalized subsidies and replace them with a cash transfer program targeted specifically to low-income households. Targeted cash transfers would be a more efficient way to protect the poor and would be less expensive than subsidies, allowing the government to spend more on things like infrastructure, education, and health, which can boost growth and employment.

Phasing out generalized subsidies will not be a simple task. The reform should be carefully prepared and communicated to the public. Policymakers need to build a consensus on how the burden of adjustment would be shared among the population. Subsidies should be removed as compensating measures to protect the poor are being put in place. To avoid reform slippage, a depoliticized and rules-based mechanism for setting prices should be established—for instance, automatically linking the domestic prices of energy products to world market prices. These are real challenges, but international experience suggests that subsidy reform is doable and beneficial. Indeed, many countries in the region are already well advanced in reforming their subsidy systems, and there's empirical evidence that subsidy reform leads to greater equity and, ultimately, higher and more inclusive growth.

The government has taken a courageous first step by raising energy prices. But there's still a long way to go toward a fairer, more efficient way to support the vulnerable.

****

Andrew Jewell is a Senior Economist in the IMF's Middle East & Central Asia Department, where he works on Algeria. His previous experience at the Fund focused on debt issues in low-income countries. Prior to joining the IMF, he worked for ten years as an economist at the U.S. Treasury Department and for three years as a financial analyst at the Federal Reserve Bank of New York. He holds a master's degree in international relations and economics from the Johns Hopkins School of Advanced International Studies.