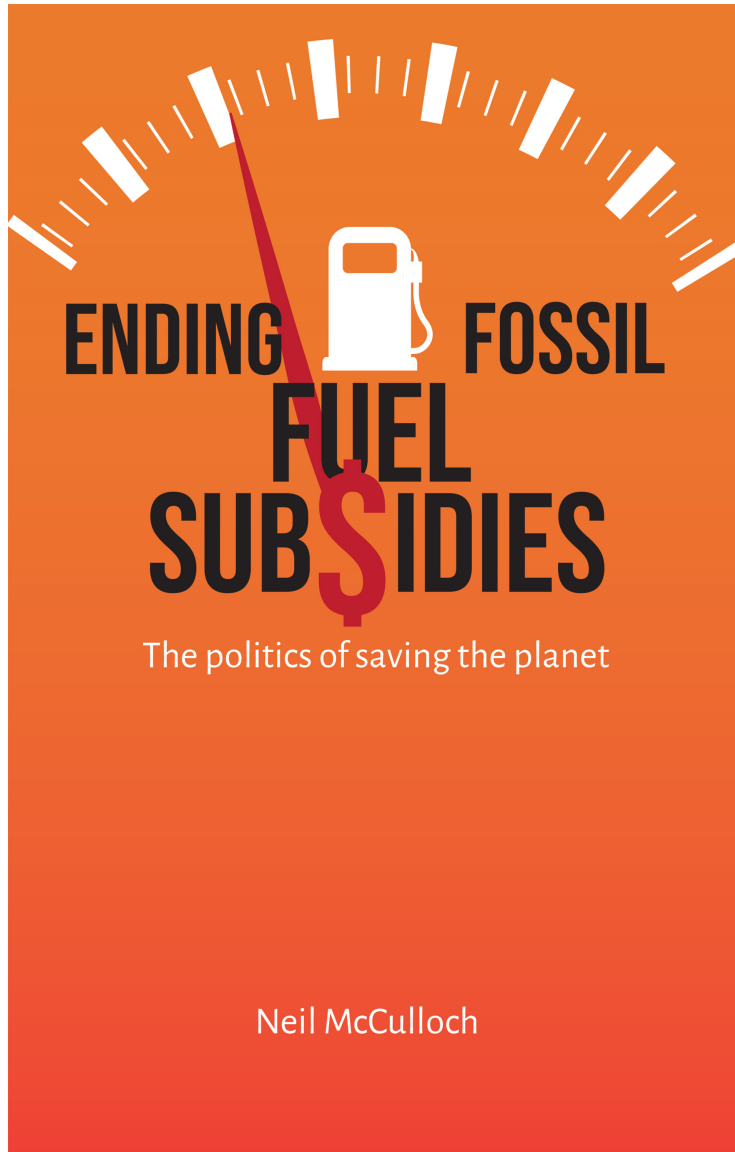


The political economy of fossil fuel subsidy reform in developing countries

Dr. Neil McCulloch

The Policy Practice

10 October 2023



‘Neil McCulloch’s wonderful, short book explains why it is hard to end fossil fuel subsidies, but also charts a politically savvy way in which it could be done.’

Ban Ki-moon, former Secretary General of the United Nations

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1. What are fossil fuel subsidies
2. The impact of fossil fuel subsidies
3. The standard solution
4. Why fossil fuel subsidy reform is hard
5. The current approach by the international community
6. A new approach

What are fossil fuel subsidies?

Consumption Subsidies

- Consumption subsidies arise when the government decides to sell energy at a price that is below the cost of supply. E.g.
 - Selling petrol or diesel for 40c/litre if it costs \$1/litre on the world market
 - Selling electricity for 2c/kwh if it costs 5c/kwh to generate

Production Subsidies

- Production subsidies are where the government explicitly or implicitly subsidises an industry that produces energy
 - Tax allowances or exemptions for fossil-fuel companies
 - Soft loans/guarantees/equity injections for exploration, development or generation

Irish government cuts excise duty on petrol and diesel



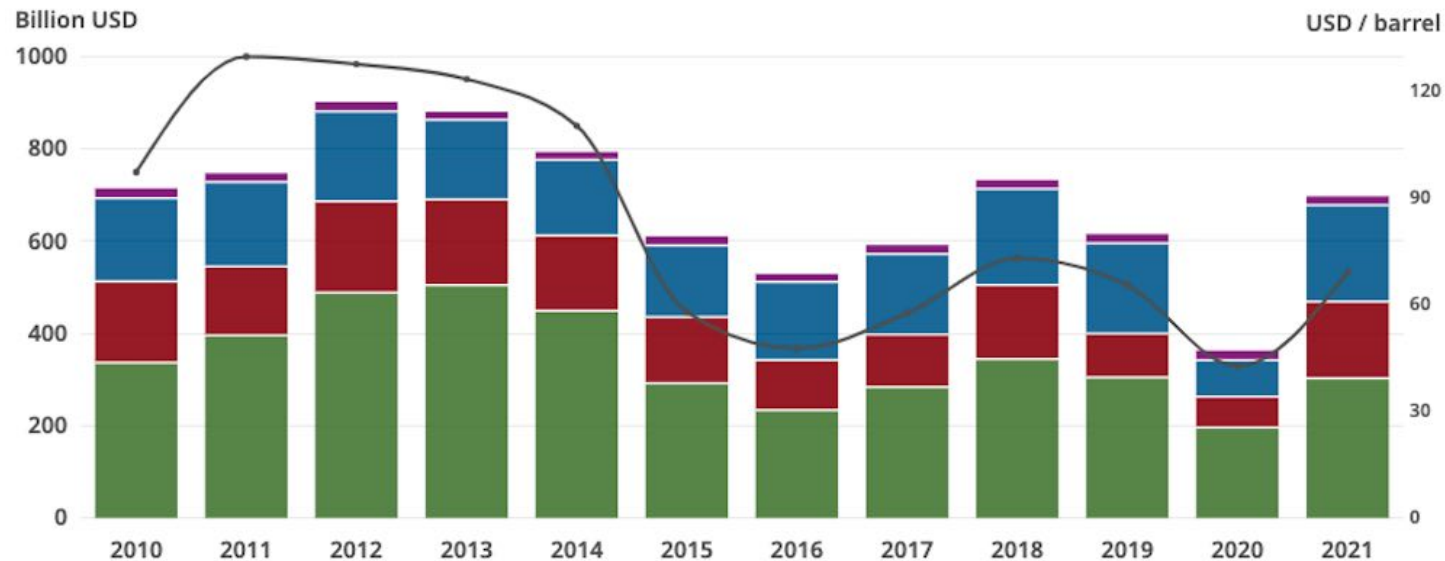
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| The cut in excise duty will be in place until the end of August

Fossil fuel support by energy product

G20-IEA combined estimates (51 economies)

Coal Electricity Natural gas Petroleum Oil price per barrel



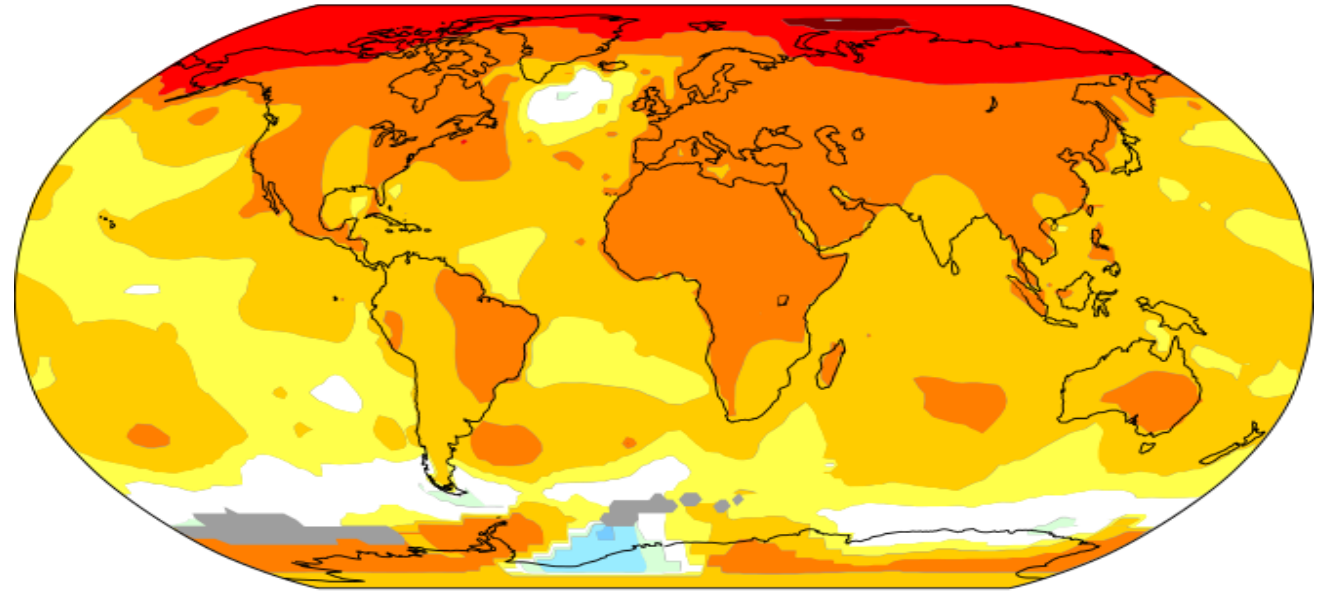
Note: The OECD G20-IEA combined estimates covers 51 economies, representing the total resulting from merging IEA price-gap estimates and OECD G20 Inventory estimates. These are the following: Australia, Brazil, Canada, the People's Republic of China, Germany, France, United Kingdom, Indonesia, India, Italy, Japan, Korea, Mexico, Russian Federation, Republic of Türkiye, United States, South Africa, Algeria, Angola, Argentina, Azerbaijan, Bahrain, Bangladesh, Bolivia, Brunei Darussalam, Colombia, Ecuador, Egypt, Gabon, Ghana, Iraq, Iran, Kazakhstan, Kuwait, Libya, Malaysia, Nigeria, Oman, Pakistan, Qatar, Saudi Arabia, Sri Lanka, Chinese Taipei, Thailand, Trinidad And Tobago, Turkmenistan, Ukraine, United Arab Emirates, Uzbekistan, Venezuela, Viet Nam. Data are expressed in constant 2021 US dollars. Please note that the data for 2021 are on a preliminary basis. • Sources: [OECD Inventory of support measures for fossil fuels](#), IEA analysis.

How big are fossil fuel subsidies?

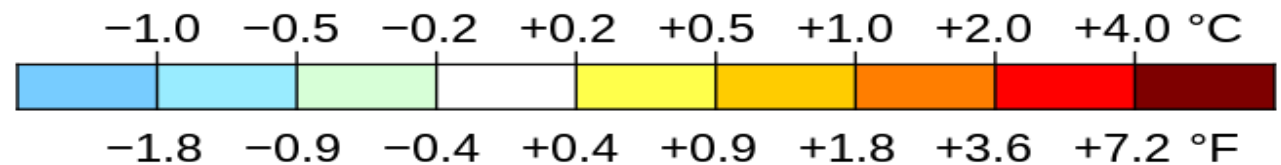
REALLY BIG... ALMOST FOUR TIMES ALL AID

The impact of fossil fuel subsidies

Temperature change in the last 50 years



2011–2021 average vs 1956–1976 baseline



- IMF estimate that CO₂ emissions would be 28% lower if fossil fuels were priced to include their health and environmental cost

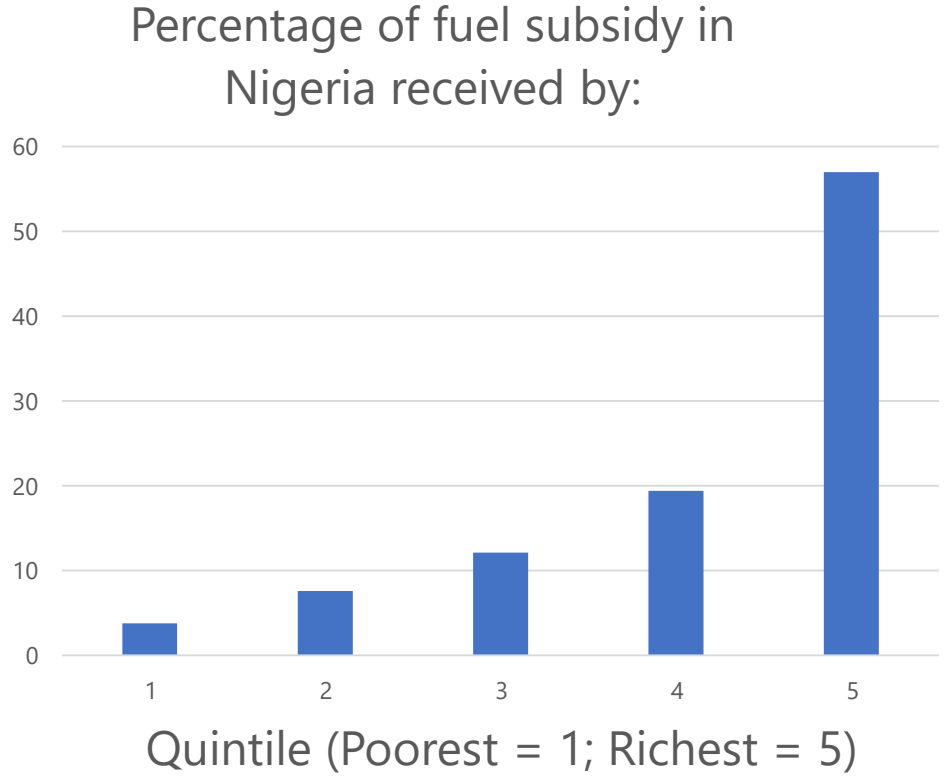
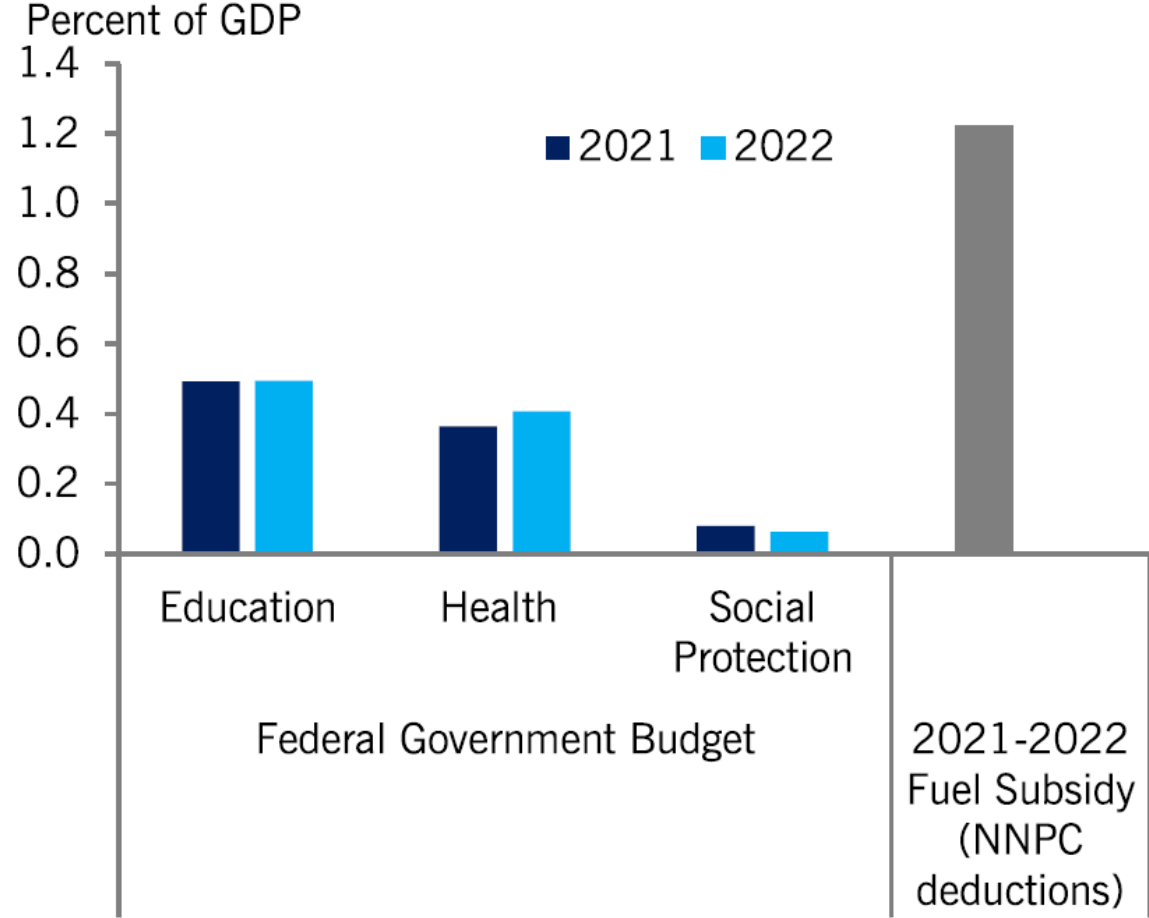
Outdoor air pollution

- In 2017, 3.4 million deaths globally due to outdoor air pollution
- In 2019, around 1.7 million people in India died prematurely because of air pollution
- Around 1.5 and 2.2 million people died prematurely in China every year between 2000 and 2016 as a result of air pollution
- Most of the damage caused by particulate pollution from coal-fired power stations and motor vehicle emissions



FFS have large opportunity costs and are highly regressive

Fuel subsidy compared to government budget allocations in Nigeria 2021-22

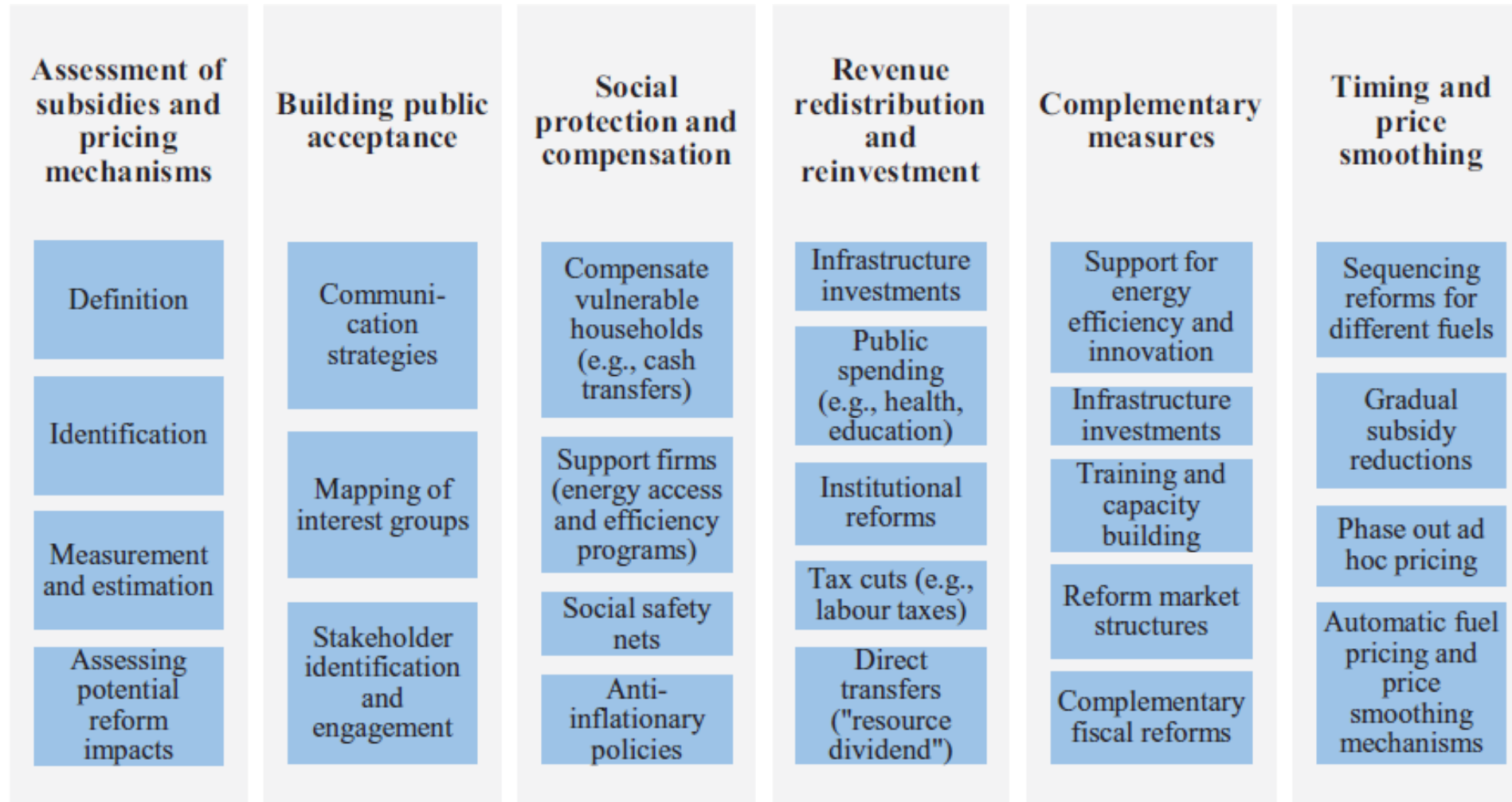


“On average, the top income quintile receives about six times more in subsidies than the bottom quintile.”

Source: World Bank calculations based on OAGF.

The standard solution

Standard solution



Principles for designing Effective Fossil Fuel Subsidy Reforms (Rentschler and Bazilian, 2016)

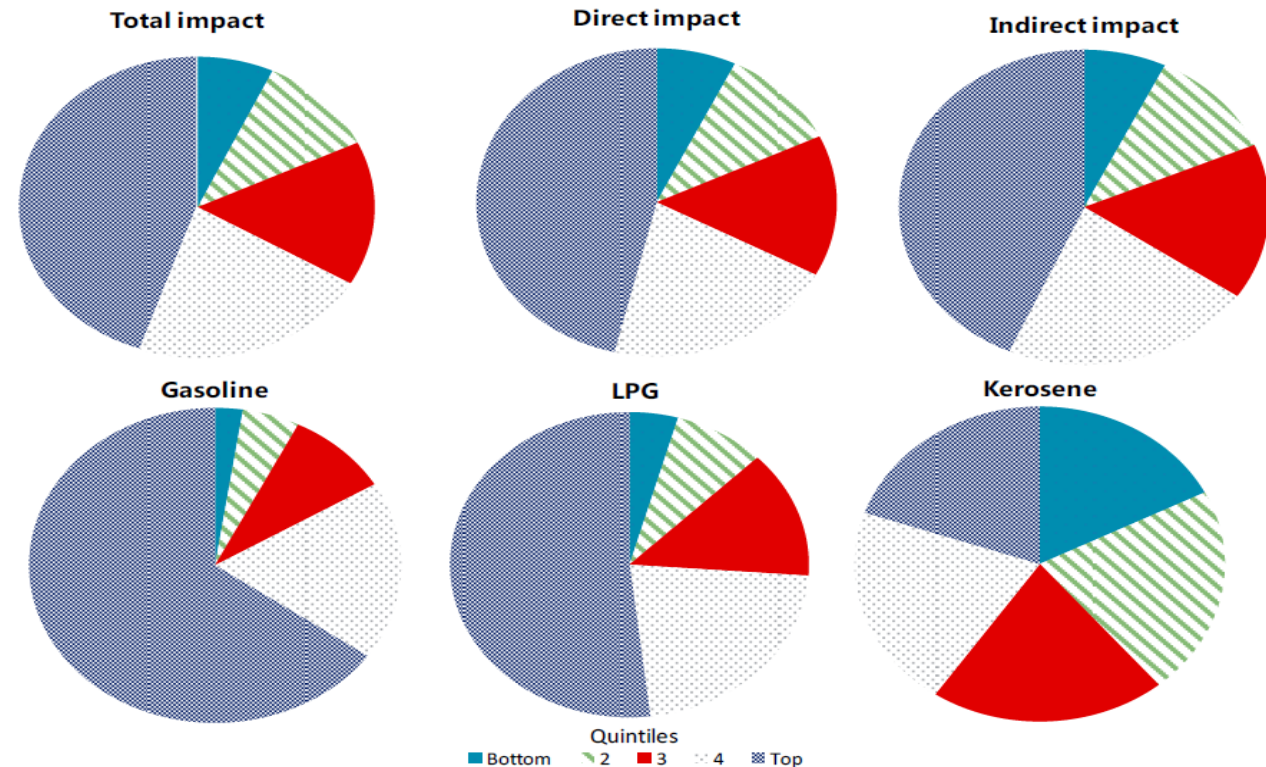
Figure 1 Key elements of an integrated FFS reform (adapted from Rentschler and Bazilian 2016)

Why is fossil fuel subsidy reform so hard?

Why is fossil fuel subsidy reform so hard?

1. It hurts people

- Energy subsidy reform often entails price rises for fuel or electricity – sometimes very large increases. This not only makes energy more expensive – it also feeds into inflation that affects other goods.



Source: Coady et al (2015)

Why is fossil fuel subsidy reform so hard?

2. It breaks the social contract

- Some countries with large fossil resource rents offer cheap fuel as part of the social contract
- Countries with limited institutional capacity struggle to deliver effective services – but delivering cheap energy is easy



Why is fossil fuel subsidy reform so hard?

3. Price increases tend to mobilise opposition to the government more generally

- opposition groups seize upon price increases as indicative of the failure/corruption/incompetence etc of the government and mobilise around them

This can lead to riots ... and may lose you the next election

- Between 2005 and 2018, 41 countries had at least one riot directly associated with popular demand for fuel
- In 2019, major protests related to energy in Sudan, France, Zimbabwe, Haiti, Lebanon, Ecuador, Iraq, Chile, and Iran
- Fossil fuel subsidies arise because of *fixed price regimes* which are supposed to protect the people ... but in fact, prices are *more volatile* in such countries
- Clear evidence that *higher subsidies make a riot more likely*

McCulloch, N., Natalini, D., Hossain, N., & Justino, P. (2022). An exploration of the association between fuel subsidies and fuel riots. *World Development*, 157, 105935. <https://doi.org/10.1016/j.worlddev.2022.105935>



Why is fossil fuel subsidy reform so hard?

4. It is opposed by those who benefit from the current system

- energy intensive users oppose reform e.g. electricity utilities with subsidised fuel
- fuel importers with monopoly rights or groups with the ability to 'round-trip' cargo
- smugglers who can sell outside the country or above the official price

Such groups are often wealthy and politically connected – including often funding the political parties of incumbent governments



Why is fossil fuel subsidy reform so hard?

5. People don't trust that government will give them something better

- In principle, the savings from subsidy reform should be able to more than compensate people for higher prices through:
 - cash transfers
 - public transport subsidies
 - health/education provision etc
- ... but only if the money is used for that purpose. Many governments have a poor track record of delivering real benefits.



Case study: Indonesia

What happened?

- 2014: President campaigns on subsidy reform! Promises health and education cards instead ... and wins
- Immediately abolishes petrol subsidies for Java/Bali/Madura – dramatically reducing burden and transferring \$16 billion to its own budget for infrastructure and social programs – prices are reduced
- 2015: Introduces formula for price adjustment

and then...

- 2016: Stops adjusting prices in line with the formula; single price policy introduced
- 2018: Pertamina losing large sums (\$4 billion); subsidised petrol reintroduced in Java/Bali/Madura
- 2019: Jokowi wins presidency again



What Indonesia did right

1. Leadership really matters
2. Don't just communicate – have an “offer”
3. Timing (price cycle and electoral)
4. Compensate – but with broad targeting

Harder lessons

1. Political window is very short
2. If you don't shift the system, it always comes back
3. Hiding skeletons doesn't make them disappear
4. It's a long game

Case study: Lebanon

What happened?

- *Before the crisis:* petrol was subsidised by enabling importers to buy fuel using the official exchange rate of LBP 1500 to the USD
- *Summer 2021:* As the economy and the currency spiralled downwards, the government could no longer afford to continue to use the 1500 exchange rate – so it increase it, again and again
- In doing so, it created expectations of further devaluation ... so unsurprisingly *fuel importers stopped supplying* (if you know the currency will collapse further a few days – why sell now, you will make much more money by waiting!)
- This led to *weeks of shortages and long queues*. Anger boiled over into violence.
- Then, in October 2021, the *government removed subsidies entirely*. The price skyrocketed ... and the queues disappeared overnight.



• What do we learn?

- If governments fail to address fossil fuel subsidies in a structured, transparent and fair way, the problem doesn't disappear ...
- ... instead subsidy reform will happen in a chaotic, non-transparent and unfair way

Current approaches to support fossil fuel subsidy reform

Meaningless international commitments

G20 and G7 commitments

- In 2009 the Pittsburgh G20 meeting agreed to phase out 'inefficient fossil fuel subsidies'
- And the commitment has been repeated almost every year since
- Fossil fuel subsidies in the G20 in 2009 were \$500 billion. In 2019 they were \$500 billion (and they are a lot more now)

COP26/27 agreed to ...



These commitments are there for show – but they mean less than nothing

Why the WTO is no help on subsidies

Agreement on Subsidies and Countervailing Measures (ASCM)

A Subsidy is defined as ...

1. a financial contribution
2. by a government or any public body within the territory of a Member
3. which confers a benefit.

..but only subject to ASCM if the subsidy is *specific*

Specificity

- *Enterprise-specificity*. A government targets a particular company or companies for subsidization;
- *Industry-specificity*. A government targets a particular sector or sectors for subsidization.
- *Regional specificity*. A government targets producers in specified parts of its territory for subsidization.
- *Prohibited subsidies*. A government targets export goods or goods using domestic inputs for subsidization.

Result ... there has never been a challenge under the ASCM against a fossil-fuel subsidy

Tiny, Technical and Timid

Tiny

- Almost all bilateral funding on fossil fuel subsidy reform goes to one program – ESMAP at the World Bank
- Total value of ESMAP is around \$35 million per year
- Additional diplomatic efforts e.g. G20, G7, APEC
- A few small donor programs e.g. FOSTER, electricity progs
- No major, systematic effort to tackle fossil fuel subsidies

Technical

International efforts are overwhelmingly focussed on

- research/studies
- technical assistance for reforms (via IMF/World Bank)

There is almost no funding for serious political economy analysis or programs to

- Boost awareness
- Facilitate debate
- Build coalitions

Timid

Strong focus on maintaining good diplomatic relationships, which means ...

- not supporting things that are sensitive or unpopular
- not working with stakeholders that the government doesn't like
- Not saying or doing much ... except in places where national/commercial interests matter less

Is fossil fuel subsidy reform pointless?

Martinez-Alvarez et al (2022) use data on gasoline prices and political leadership from 155 countries from 1990-2018 to argue that:

- Leadership has a minimal role on fossil fuel subsidy reform
- 87% of reforms were reversed within 5 years
- Better to focus on incentivizing transition i.e. carrots are better than the stick of fossil fuel subsidy reform

Brilliant and challenging paper BUT:

1. **Carrots have to be paid for!**
Often fossil fuel subsidies are a significant fiscal drag that significantly slow and reduce what incentives can be provided
2. **Leadership does matter** – but not in the sense measured.
What matters is the nature of the political settlement. Leaders can't instantly change that, but they are key in how it evolves

Martinez-Alvarez, C. B., Hazlett, C., Mahdavi, P., & Ross, M. L. (2022). Political Leadership Has Limited Impact on Fossil Fuel Taxes and Subsidies. *Proceedings of the National Academy of Sciences*, XXX, 8.

A new approach to support fossil fuel subsidy reform

It is a political problem, not a technical one

1. Fossil fuel subsidy reform can never be a political objective

- What matters is protecting citizens when they face a crisis

2. What matters to voters are: peace, protection (from disease, inflation) and prosperity

- Governments are right to focus on these objectives – these are the things that voters care about

3. For fossil fuel subsidy reform to be successful it has to be tied to the achievement of political objectives:

- Energy security
- Climate protection
- Air quality
- The hope of better times

A new approach to reform

Serious

- Support serious **research on the politics of subsidy reform**
- For a selected set of countries where FFS are large – **collaborate with bilateral donors to design** major long-term bilateral programmes
- Back international mechanisms to **underwrite subsidy reforms**
- Support an international mechanism to **track and report FFS** for each country globally and progress towards elimination

Political

- Use **Political Economy Analysis** to identify potential allies and feasible pathways of change – **consider the results when formulating advice**
- Encourage integrated programs that both provide technical assistance and capacity but which also **build demand for reform** through:
 - Raising awareness and understanding
 - Facilitating debate
 - Building reform coalitions

Brave

- Combine a supportive approach, that helps countries **bear the costs of transition**, with a willingness to be tough
- Be willing to **talk to and engage with non-government local actors** and organisations that are building coalitions in support of reform
- Be explicit in Development Policy Operations and other engagements that such reforms are critical for **tackling climate change and pollution**

The role for research

1. **Pretty limited**

- Evidence is not what counts in fossil fuel subsidies reform!

2. **Analyse the distortionary impact and harms caused by fossil fuel subsidies**

- Budgets, climate change ... but also air pollution, congestion and other uses

3. **Study the political economy constraints to reform:**

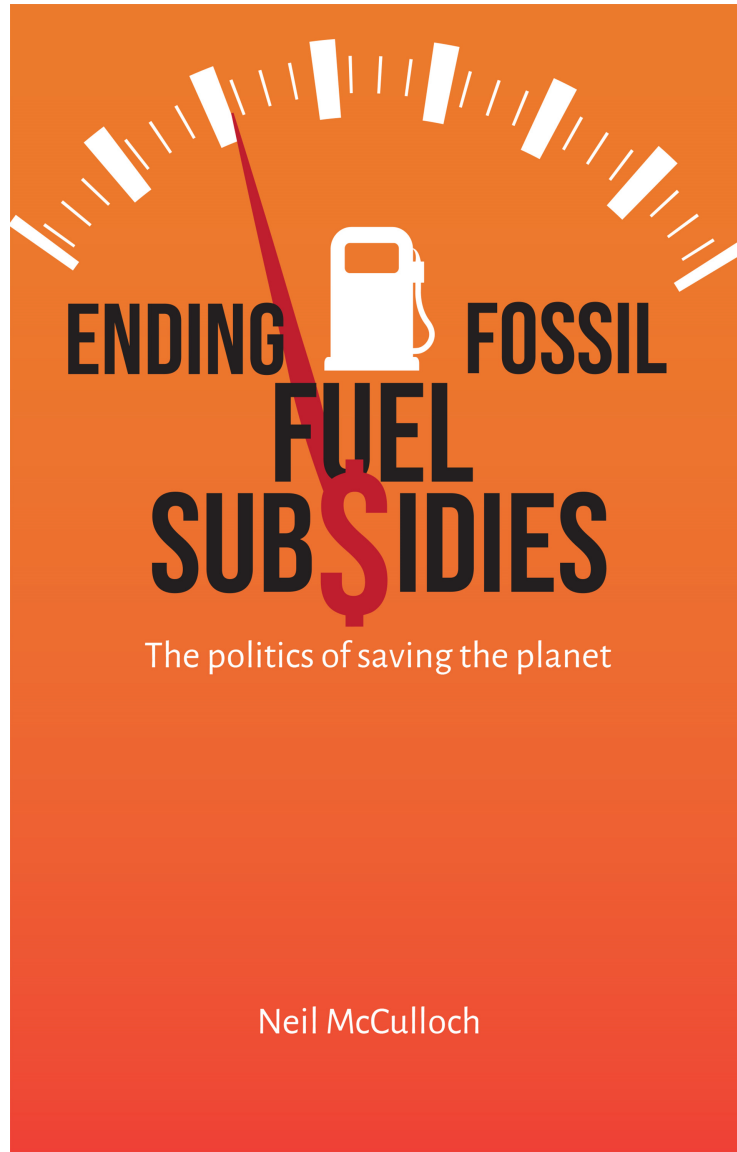
- Who captures the rents along the fuel supply chain and how?
- How do these rents influence political decision-making?
- What are the political implications of fossil fuel subsidy reform?

4. **Examine how successful transitions took place in other countries**

- What were the political strategies employed and how did they vary by context?

How this approach differs

Aspect	Traditional approach	Thinking and Working Politically
Leadership	External team – usually in the World Bank, often in DC	Locally-based team of nationals
Counterpart	Ministry of Finance	Parliament; politicians; unions; private sector; CSOs; media ... and also government departments
Approach	Technocratic	Building coalition; facilitating the reform agenda of local politically engaged actors
Complementary policies	Cash transfer programs	Political attractive 'offers' e.g. UHC, justice
Targeting	The poor and near-poor	Broad swath of non-rich voters; key politically salient groups
Timeline	1 year	5 years
Result	Short-term change – often followed by protest and reversal	Long-term buy-in to a process that gradually, but permanently reduces subsidies



‘This book shows how politicians and citizens together could end fossil fuel subsidies and use the resources to reduce poverty and inequality worldwide.’

Professor Melissa Leach, Director, Institute of Development Studies

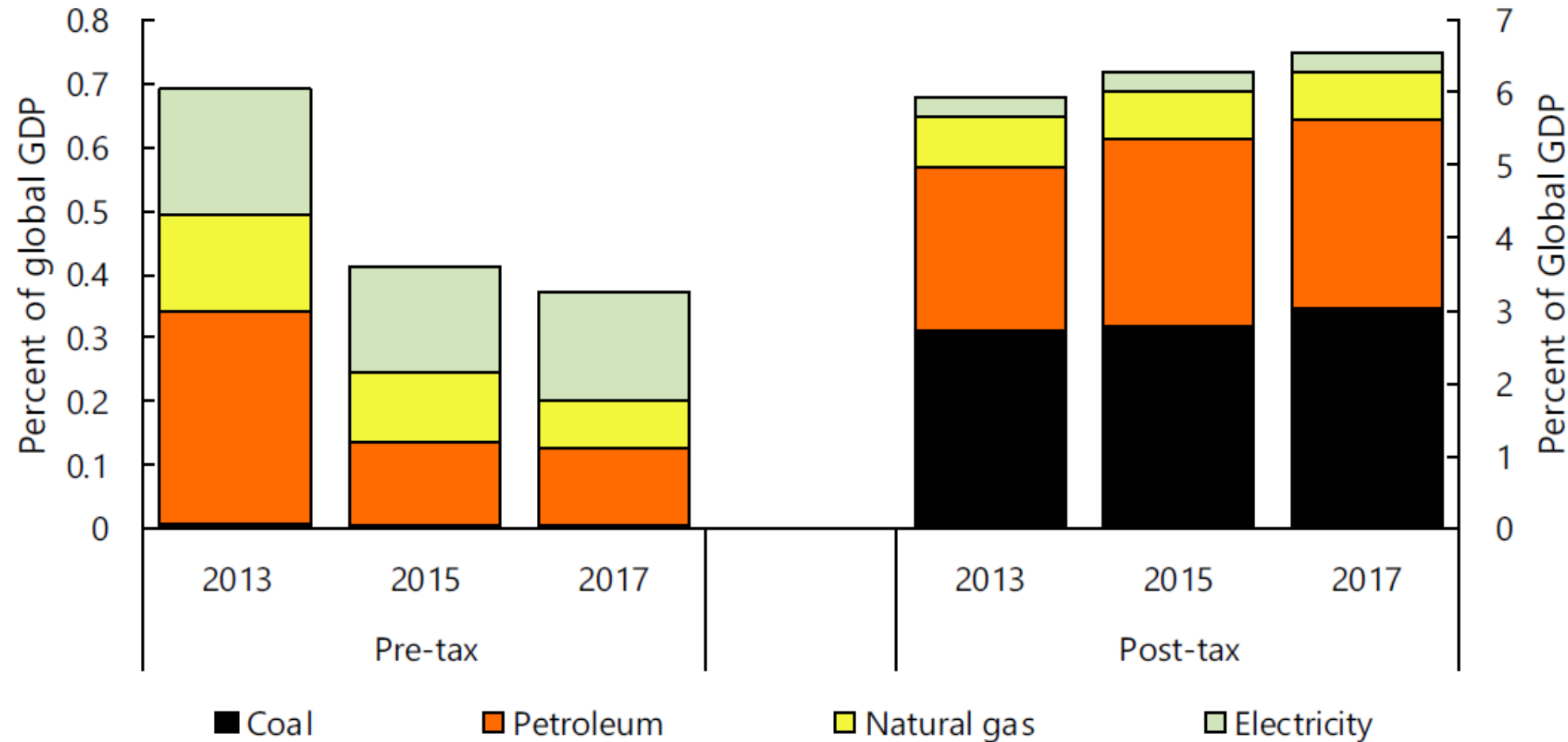
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Thank you

Post-tax subsidies are vastly bigger than pre-tax ones – mostly because of pollution and climate change



Source: Authors' calculations.

Reform is essential for tackling climate change

... and air pollution

