COUNCIL on FOREIGN RELATIONS

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INSIGHTS FROM A CFR WORKSHOP

Fuel Subsidy Reform

May 26, 2015

In May 2015 the Council on Foreign Relations' Maurice R. Greenberg Center for Geoeconomic Studies held a workshop on fuel subsidy reform. The workshop, hosted by CFR Senior Fellows Jennifer Harris and Michael Levi, was made possible by the support of the Alfred P. Sloan Foundation. The views described here are those of workshop participants only and are not CFR or Sloan Foundation positions.

INTRODUCTION

Subsidies that encourage fossil fuel consumption cost governments an estimated $500 billion annually and have vexed policymakers for years. By depressing the price of fossil fuels—especially of petroleum products used in transportation but also other fuels (notably coal, natural gas, and oil for electricity generation)—such subsides encourage wasteful consumption, burden budgets, and distort global energy markets to the detriment of energy producers and consumers alike.

The implications are stark. Fuel subsidies are concentrated in a handful of vulnerable countries, mainly in the Middle East and North Africa, which are already grappling with the fiscal effects of lower prices for crucial exports such as crude oil, amid simmering social upheaval and a consistent threat from Islamic extremism. Continued subsidies that drain national coffers, spur additional domestic consumption, and threaten future resource availability for export present a security risk to countries such as Saudi Arabia, Kuwait, Iraq, Iran, and the United Arab Emirates.

Subsidy-driven consumption also tightens global energy markets, thus penalizing energy consumers around the world and slowing global economic growth. More broadly, by encouraging inefficient consumption of fuels for transport and power, fuel subsidies increase global greenhouse-gas emissions, making it more difficult to curb atmospheric carbon concentrations.

The sharp decline in oil prices beginning in July 2014 offers a window of opportunity to roll back entrenched subsidy schemes, since lower energy prices should make it easier to adjust domestic tariffs to something closer to market prices. Notably, countries such as India, Indonesia, Egypt, Kuwait, Oman, and Bahrain have recently taken steps to start unwinding some subsidies. Others, such as Venezuela, have acknowledged the need to overhaul fuel subsidies. Some countries, however, including Saudi Arabia, still resist calls to raise the cheap domestic energy price.

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In that context, the Maurice R. Greenberg Center for Geoeconomic Studies at the Council on Foreign Relations (CFR) convened an international and interdisciplinary group of roughly twenty experts in Washington, DC, in early May for an all-day workshop. This report summarizes the highlights of the discussion and the views of workshop participants, even when that is not explicit. (The report reflects the views of workshop participants alone; CFR takes no position on policy issues.) Participants discussed the scale and scope of the problem, explored why subsidy reform has proven so difficult, and identified possible ways for developed countries to help subsidizing countries implement technically and politically viable and durable reform.

YES, SUBSIDIES ARE A BIG PROBLEM

Globally, fossil fuel consumption subsidies totaled an estimated $548 billion in 2013, virtually the same as the $544 billion the International Monetary Fund (IMF) estimated in 2012. The 2013 figure, the latest for which full data is available, will likely represent a high-water mark for now for fuel subsidies, given the sharp decline in fossil fuel prices in the second half of 2014, which persisted in early 2015.

Some workshop participants questioned whether, in the context of $75 trillion in global economic activity, policymakers, including those in the Group of Twenty (G20), should be focusing attention on a $500 billion issue. The overwhelming consensus of workshop participants was that fuel subsidies do represent a serious problem for three reasons.

First, while representing only a fraction of global economic activity, fossil fuel subsidies are overwhelmingly concentrated in just a few countries and regions: ten nations account for about three-quarters of all fuel subsidies, and five of those are in the Middle East and North Africa. The budgetary and fiscal effects of such energy policies for countries already facing a host of economic and security challenges are daunting. Overall, among the forty-odd countries that subsidize fuel consumption, the cost of such policies represents about 5 percent of national gross domestic product and, on average, about 25 percent to 30 percent of government revenues. In many subsidizing countries, governments spend more on subsidizing cheap energy than they do on health or education. The existence of market-distorting energy subsidies also tends to depress foreign direct investment in those countries, thus lowering future growth prospects.

What Is In A Name?

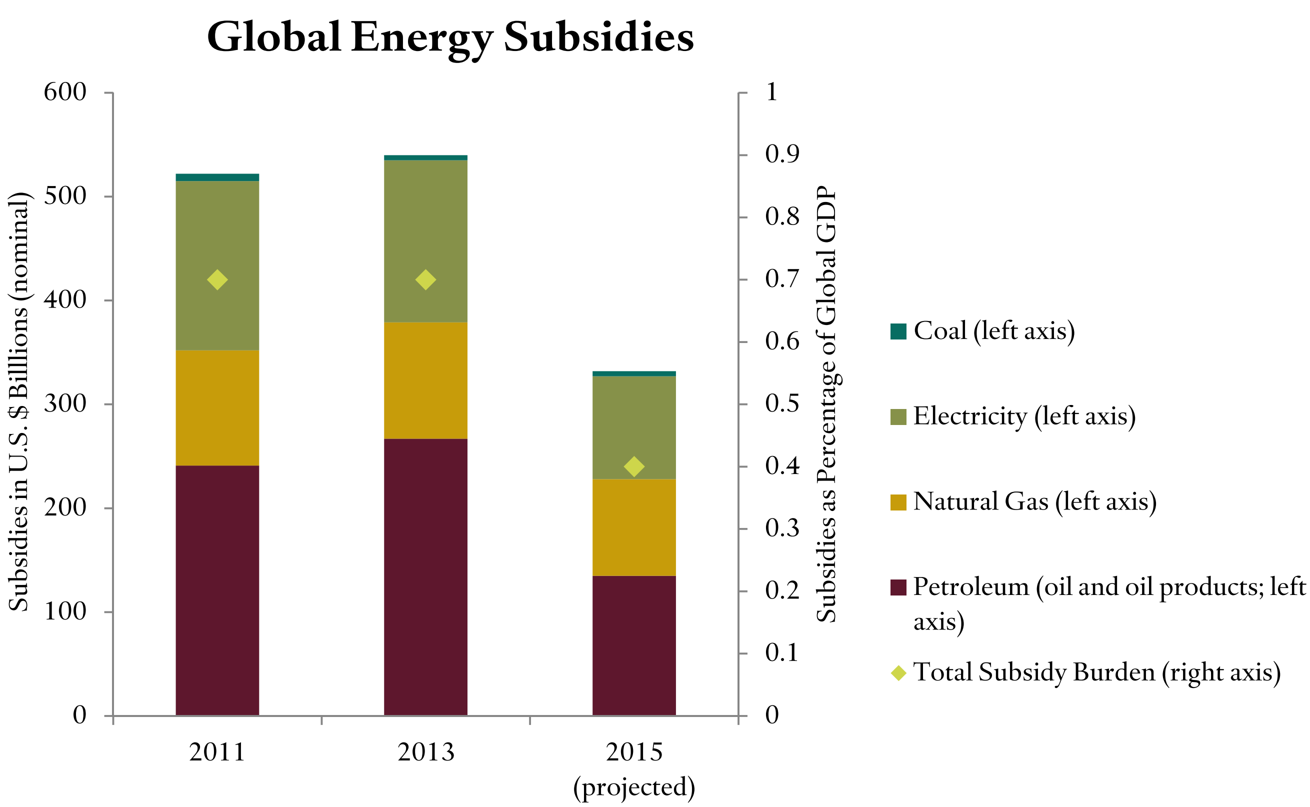
Simply determining what, exactly, constitutes a fossil-fuel subsidy is surprisingly difficult. Workshop participants, while aware of the widespread use of fossil-fuel subsidies to encourage production (prevalent even in many developed countries) focused on the role that consumption-based fossil fuel subsidies play in distorting energy markets.

Most participants, guided by prevailing international norms, defined subsidies as domestic energy prices that are kept lower than prevailing, global prices: the so-called price gap approach. Not everybody agrees. Some big producers, such as Saudi Arabia, deny they offer fuel subsidies. Instead, Saudi Arabia argues that it merely provides fuels for the local market at the cost of production (acknowledging "subsidies" could create legal problems at the World Trade Organization). But the semantics severely complicate efforts to reform Saudi Arabia's domestic energy pricing in international forums such as the G20. That prompted some suggestions that, in order to encourage reform in Saudi Arabia and other big exporters, the terminology should be tweaked to something like "energy price reform" or dealing with "producer support." One benefit of overcoming resistance to reform in big oil-exporting countries, some participants argued, is that it would make it much easier for energy-importing countries in their regions to overhaul their own support schemes.

Other participants suggested embracing a broader view of fossil fuel subsidies that would compare local energy prices not just to global benchmarks, but also to the hypothetical, all-in cost of such fuels if they were to include the full social cost in pollution, health effects, and contribution to climate change. Most participants rejected such an expansive definition, however, as muddling the issues.

Second, some participants noted, these subsidies drive the additional consumption of an estimated 3 million to 4 million barrels of oil per day compared to global average consumption of about 92 million barrels a day. Returning those extra barrels to the market would increase energy market liquidity, lower average global oil prices (some studies suggest on the order of 5 to 10 percent), and spur greater global economic growth by as much as 0.7 percent per year through 2050.

Finally, some participants sought to focus the discussion of subsidy reform on its environmental consequences: by some estimates phasing out fuel subsidies would reduce global greenhouse-gas emissions by as much as 10 percent relative to what they would otherwise be. While only a minority of participants viewed lowering carbon emissions as a principal driver for subsidy reform, it does appear to be an added benefit of such reforms.



Source: International Monetary Fund; CFR calculations.

WHY ARE SUBSIDIES SO HARD TO UNWIND, AND WHAT CAN BE DONE?

For years, policymakers and multilateral financial institutions such as the IMF and the World Bank have urged countries to phase out fossil fuel subsidies. The G20 declaration in 2009 and those in subsequent years have included an aspirational goal of phasing out subsidies. Yet despite widespread acknowledgment that many fossil fuel subsidies are both expensive and inefficient, they have proven remarkably resistant to reform, with only a handful of countries recently embarking on even a partial adjustment of domestic energy prices to more closely reflect international market prices.

To better understand the difficulties inherent in removing subsidies and craft strategies to help countries phase them out, some participants suggested dividing subsidizing countries into two groups: those whose leaders understand the problem but cannot fix it, and those whose leaders do not fully understand or accept the problem in the first place.

For countries in the first group, obstacles to subsidy reform are both political and technical: removing economic subsidies is often perceived as a risky, unpopular move with broad swathes of society, and implementing market-oriented prices requires a degree of technical capacity that many national governments simply do not have.

It's the politics—just not the politics you might think.

The political barriers to reform are themselves twofold. Most attention, both among international policymakers and among national decision-makers, is focused on the risk of popular unrest as a result of removing subsidies that provide a generous birthright in the form of cheap energy. Fears of popular discontent are a particular concern in already fragile countries, especially those in the Middle East and North Africa, which since 2011 have been roiled by popular protests—many of which have led to regime change.

Yet empirical evidence, one participant noted, does not support the perception that subsidy reform is a major driver of public unrest. By one measure, in the last seven years, fuel and energy prices were a primary component only in about 4 percent of popular protests. However, many participants stressed that the location of such unrest matters greatly: in authoritarian countries, the constrained space for expression means that even sporadic demonstrations of antigovernment sentiment driven by discontent over energy prices can snowball and transform into a political threat. Energy-price fueled protests in Myanmar in 2007 and Indonesia in 1998 still stand as cautionary tales for would-be reformers in other countries.

Some governments, while recognizing what needs to be done, simply do not have the capacity to implement reforms.

In reality, participants argued, the bigger political obstacle to subsidy reform lies in the fact that the bulk of the economic rents from cheap energy typically accrue to a small segment of entrenched, politically well-connected segments of society. Such vested interests have both the motive and means to block efforts to roll back energy subsidies. For instance, the Egyptian military's deep involvement in the energy-intensive cement and fertilizer industries has been a brake on reform efforts by the Egyptian government. Similar hurdles prevail among Ukrainian oligarchs, many of whom are heavily invested in energy-intensive industries.

OTHER TAKEAWAYS FROM WORKSHOP PARTICIPANTS:

- Subsidies and efforts to reform them are both contagious. Some energy-importing Middle Eastern countries mimic neighbors and embrace cheap energy as a birthright, despite little or no domestic energy production. Other participants noted that initial stabs at reform, once shown viable and beneficial, often prod neighbors to undertake reforms themselves.
- The United States is among the loudest voices calling for reform. Yet such admonitions are undermined by continued production subsidies for fossil fuels in the United States.
- The G20 has been at the forefront of calls for reform, but may not be the best forum to actually drive progress. Fossil fuel subsidies are a second-tier issue when the G20 is confronted with other more immediate or urgent crises.
- Subsidy reform has a narrow base. One participant suggested enlisting "the Bonos of the world, the Bill and Melinda Gateses of the world," to highlight the role that energy subsidies play in curtailing investment, development, health, and education in dozens of countries.

What Matters Is Knowing How, Not Knowing To

Beyond politics, technical and bureaucratic shortcomings also undermine subsidy-reform efforts. Some governments, while recognizing what needs to be done, simply do not have the capacity to implement reforms that would simultaneously rationalize energy prices while shielding the most vulnerable parts of the population from the effects of higher prices. Direct cash transfers to low-income families, for example, are a vital component of most successful subsidy-reform efforts around the world, notably in Iran. Yet such schemes require a well-developed banking system, fluid intragovernmental communications and information-sharing, and a minimum of liquidity in order to fund cash transfers even before the full fiscal benefits of subsidy reform are apparent.

Another technical obstacle of particular importance in ensuring the durability of subsidy reform, is the establishment of a politically independent, automatic price-setting mechanism that can replace government-dictated energy prices with tariffs that follow market gyrations.

There are two ways in which, many participants agreed, international institutions such as the IMF and the World Bank could lend technical expertise to help overburdened bureaucracies successfully implement reforms: by establishing a comprehensive communications strategy to help explain to lower-income segments of society that subsidies largely benefit the already well-off and well connected, in order to get political buy in; and by leveraging technical ability to establish cash-transfer mechanisms and independent price-setting schemes free of political interference. These strategies, most participants agreed, would help protect the vulnerable while spurring more durable subsidy reform. (For more on communications strategies, see Isobel Coleman's August 2014 CFR Policy Innovation Memorandum, "How to Make Fossil Fuel Subsidy Reform Succeed.")

To ensure that subsidy reforms stick when global energy prices rebound, most participants agreed that it is important to front-load as many benefits as possible. That can include providing upfront loans from international financial institutions to guarantee prompt cash transfers, leveraging multilateral investment funds and member-state capability to drive foreign direct investment and job creation in energy, and, enlisting the oversight of credit ratings agencies to, in the words of one participant, “reward good actors” who make progress on this front. The overarching goal should be to ensure that the short-term costs of subsidy reform are offset by tangible and rapid benefits.

Your Job Is On the Line

For government leaders unaware of the true economic cost of subsidies, or unwilling to acknowledge it, international delegations can facilitate communication between ministries to bring home the budgetary effects of subsidies and facilitate data-sharing in stove-piped administrations.

Some participants also noted that bilateral missions from individual countries could help bring home to governments the national security costs of continuing to subsidize fossil fuels. For leaders consumed by worries over stability or security—particularly relevant in much of the Middle East, especially in Egypt but also Iraq and Saudi Arabia—explaining that reform is the path to “keeping yourself on the throne,” as one participant said, could elevate subsidy reform in national policymaking even when economic and environmental arguments fall on deaf ears.

Some participants, for example, warned that Egypt's nascent subsidy-reform effort could falter given the Egyptian government’s overriding concern with security. By linking the dysfunctional energy market to governmental concern over energy shortages and the threat they pose to domestic stability, international interlocutors would be better able to underscore the urgency of bringing the reform process to term. This spoke to a broader theme raised throughout the workshop: efforts to effect subsidy reform are usually confined to economic policymakers, but to be truly effective, they require the steady engagement of national security leaders as well.