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Low oil prices: An opportunity for fuel subsidy reform

Consumer fuel subsidies are not only economically costly, but also environmentally destructive and highly inefficient for social welfare goals. The recent decline in oil prices presents an opportunity for governments to reduce consumer fuel subsidies without risking a backlash from consumers and vested interests. Once removed, subsidies could be replaced with more efficient social policy.

Fossil fuel subsidies, policies to artificial lower prices on fuel for consumption, are estimated to cost governments around the globe approximately $500 billion per year.

In addition to high costs, fuel subsidies produce a host of negative economic impacts – encouraging wasteful energy consumption, creating fiscal burdens on developing country budgets, disproportionately benefiting wealthy households, and increasing health and environmental costs of fossil fuels. Despite the potential economic and environmental gains from removing fuel subsidies, reforms have proven politically difficult. From Nigeria to Venezuela, governments have repeatedly failed to raise artificially low fuel prices.

In a recent briefing paper for the Center on Global Energy Policy at Columbia University, we summarise lessons from fuel subsidy reforms, with specific attention to the opportunity presented to would-be reformers by recent declines in oil pricing.

In this blog post, we make the case for fuel subsidy reform, summarising the political constraints to reforms and how low oil price environments can relax them. We conclude with an agenda for researchers and practitioners.

Why reform fuel subsidies?

According to the International Energy Agency, in 2013, fossil fuel subsidies rose to $550 billion. Before implementing fuel subsidy reforms, Indonesia spent around 20 percent of its 2013 total budget on subsidies, exceeding spending on social programmes and capital expenditures combined.

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> Fuel subsidies promote inequality

The environmental consequences are also serious. Low prices encourage excessive consumption, contributing to air pollution and climate change. It is estimated that eliminating gasoline and diesel subsidies could **cut CO_2 emissions by roughly 4.5 billion tons** – around 13 percent of total CO_2 emissions in 2012.

Fuel subsidies are an inefficient form of social policy. Rather than alleviating poverty, benefits from **subsidies largely accrue to households at the top of the income distribution**.

The Indonesian case illustrates this clearly. About two-thirds of poor households do not consume any gasoline at all. The **richest 10 percent of households absorb 40 percent of subsidy benefits, while less than 1 percent goes to the poorest 10 percent**. Fuel subsidies promote inequality through generous transfers to the richest households.

Barriers to reform & low oil prices as an opportunity

If the costs of fuel subsidies are high, why is reform so difficult? One barrier is *popular opposition* (Victor 2009; Overland 2010; Cheon et al 2013; Cheon et al 2015).

Subsidies furnish visible benefits to fuel consumers, and their removal has immediate negative impacts on consumer purchasing power. In contrast, benefits of removing fuel subsidies – reduced public debt or funds for public infrastructure investments – generate less obvious or delayed benefits.

Low oil prices offer a window for reforming fuel subsidies without the risk of significant public backlash. Although reducing or eliminating subsidies will increase consumer costs, lower prices mean that the effect of removing subsidies is less dramatic. Therefore, low oil prices ease the pain of adjustment and allow governments to implement policy reforms that would otherwise create major political turmoil under high oil prices.

Reform & reversal: Lessons from Indonesia & Malaysia

Indeed, until the recent drop in oil price, popular opposition unravelled many reform efforts. In 1998, Suharto of Indonesia announced **increases in diesel and gasoline prices of 60 and 71 percent**, respectively, spurring massive protests in a fatal blow to his regime. Yudhoyono achieved partial success in fuel subsidy **cuts in 2004 and 2008, only to reverse them**, facing popular protests in 2010. Their most recent successor, Widodo, has benefited from the plunging oil price, abolishing gasoline subsidies and **capping diesel subsidies at 1,000 rupiah ($0.08) per litre in January 2015**.

Similarly, in Malaysia, Razak's government had announced increases in gasoline and diesel prices in September 2013. Protests by political opposition, trade unions, and non-governmental organisations, however, ensured the **reforms were partial and reversible** by successor governments. Back then, the partial and reversible by successor governments. Back then, the spot price of a barrel of Europe Brent was at $111.60. When the government decided to abolish fuel subsidies entirely in 2014, the price of Europe Brent was around $79.44 and decreasing rapidly.

Partial reforms improve efficiency whilst protecting key constituents

In addition to popular opposition, *vested interests* complicate fuel subsidy reforms (Overland 2010; IISD 2013; Vagliasindi 2013). To give an example, **low gasoline prices benefit truckers** with gasoline engines, while **low diesel prices benefit farmers** who use diesel in their tractors and irrigation pumps. Out of self-interest, these groups often lobby against reforming subsidies .

Low oil prices similarly reduce interest group pressure to maintain fuel subsidies. Under low oil prices, the cost to vested interests of subsidy removal is less severe. Although groups may anticipate oil prices to increase in the future, low current prices limit the cost of removing subsidies. Rational interest groups will therefore shift political efforts towards more pressing issues.

Widodo was able to advance ambitious reforms partly because Indonesia's opposition-dominated parliament was **weakened by political debates** over local and regional elections. Even so, Widodo **shielded critical constituents from the effects of reforms, capping subsidies on diesel** instead of abolishing them because diesel is the main fuel for public transport and fisheries. Even during a low-price environment, where opposition would be muted, certain sectors were still protected.

> “ Low oil prices similarly reduce interest group pressure to maintain fuel subsidies. ”

In Malaysia, the liberal fuel pricing policy is still in a precarious position, partly because **hardliners within Razak's own party stand to undermine his reforms**. Similar to Indonesia, special **considerations were made for public transport and fishing**, shielding them from the effects of reforms. As the frustration felt by motorists at petrol stations and other consumers suggests, however, the government will need to continue **treading carefully as to avoid overburdening the middle and lower middle classes**, particularly in the scenario that oil price begins to rebound.

Higher-capacity governments can implement more effective social safety nets.

The third political problem we highlight is *low institutional capacity* (Victor 2009; Cheon et al 2013). Government that can implement a range of public policies will find less costly alternatives to fuel subsidies that can meet social welfare goals. For example, effective governments can administer large direct monetary transfers, to low-income households. If the government can implement a cash transfer scheme, it can avoid the distortionary effects of subsidies on energy prices while continuing to give visible and salient benefits to the people.

However, the implementation of cash transfer schemes requires institutional capacity. If not done properly, a cash transfer scheme may fail to produce benefits for the poor. Here again, oil prices can be helpful. When oil prices are low, the size of the cash transfers or other benefits required to compensate for the higher fuel prices is smaller compared to times of high oil prices. Low oil prices mean that the government need not implement ambitious social policies; instead, modest benefits should be enough to secure popular support for replacing fuel subsidies with other policies.

While a government may lack the capacity to successfully implement ambitious policies, limited institutional capacity need not cripple the government's ability to offer modest benefits to the people hurt by the fuel subsidy removal. Along with fuel price reforms, Widodo has launched social-protection programs such as **Indonesia Health Card**, **Indonesia Smart Card**, and **Family Welfare Fund**, lending substantial credibility to his **commitment to improving social services**.

Indeed, Malaysia's Razak knew full well the importance of putting social programmes in place after removing fuel subsidies, after earlier attempts to increase gasoline and diesel prices in September 2013. Although his partial reforms came with increased cash transfers to compensate the poor for their losses, there were still a lot of **protests by the political opposition, trade unions, and non-governmental organisations**. After oil prices declined, Razak was able to push through more ambitious reforms.

An agenda for research & practitioners

The current low oil prices present an opportunity to eliminate economically costly and environmentally destructive fuel subsidies with limited social and economic backlash. In the cases of Malaysia and Indonesia, national governments swiftly removed fuel subsidies when prices dropped and eliminated the threat of public unrest and popular opposition.

Low oil prices do not remove all political barriers to policy change. In Indonesia, for example, the diesel subsidy mechanism remains intact, even though the subsidy has now been capped at a lower level.

What should governments do to dismantle fuel subsidies? The Indonesian case suggests that, reformers could benefit from exploiting political windows of opportunity, such as a divided opposition in parliament. When fossil fuel prices are low, governments have opportunities to replace subsidies with more efficient social policies, such as cash transfers, without risking a strong public backlash.

What is more, the Malaysian case demonstrates that a phased or piecemeal reform, based on careful considerations of expected costs and benefits, can be compatible with decisive action. Dismantling the subsidy mechanism altogether, ensures that successors cannot easily reverse reforms, a strategy that could be emulated elsewhere.

Sharing stories of success and failure and identifying best practices from careful data analysis and investigation, can help other governments avoid pitfalls to effective reforms. Detailed political economy analysis of reforms in specific countries would provide reformers with the resources to formulate politically viable, long-term strategies. Furthermore, international peer review mechanisms and transparency around fuel subsidies could bestow reputational benefits to reforming governments– a benefit that has proven important in the political calculations of governments.

> “Current low oil prices present an opportunity to eliminate economically costly and environmentally destructive fuel subsidies with limited social and economic backlash ”

To date, there is no comprehensive database of gasoline, diesel, electricity, natural gas, LPG and other fuel prices. While compiling such a database is a necessary first step, it must be accompanied with systematic study of institutions that regulate fuel subsidies.

A comparative analysis may offer new insight into reforms that are effective even in countries with weak regulatory structures. This is an opportune moment to study the subject, since the drop of international oil prices has spurred progress on subsidy reforms across the world.

Further reading

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