The Case for Carefully Reducing Energy Subsidies

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Sub-Saharan Africa, including Angola, is heavily reliant on energy subsidies. This has been justified as a vehicle for promoting growth and competitiveness by lowering the cost of energy to the productive sector. Subsidies are also an easily-administered vehicle to protect the vulnerable against high international fuel prices and give access to affordable electricity and, for oil exporters, such as Angola, to channel some of the oil wealth back directly to the general population. However, the cost of these subsidies is large and the benefits limited. There is therefore a case for reducing energy subsidies, but this can be disruptive and must be done carefully.

Energy subsidies absorb a large share of scarce public resources in sub-Saharan Africa, costing an average of about 4 percent of GDP. According to IMF estimates, fuel subsidies in the region, which include direct price subsidies from the budget and fuel tax revenue lost because of reduced domestic retail prices, averaged close to 2 percent of GDP in 2011. Contingent liabilities and quasi-fiscal deficits linked to state-owned energy enterprises averaged another 2 percent of GDP. To put this in perspective, Angola's budgetary subsidies for fuel and utilities alone in 2011, when international fuel prices were high, were about 7 percent of GDP, or about 15 percent of non-oil GDP. The quasi-fiscal deficit of the energy utility in 2009 was about 1¼ percent of GDP.

Such large spending on energy subsidies crowds out more productive government spending and there is a strong negative relationship in sub-Saharan Africa between these subsidies and public spending on health and education. Over 2008-11, Angola had amongst the highest energy subsidies in the region and also amongst the lowest spending on health and education relative to GDP. Indeed, Angola's spending on energy subsidies in 2011 was higher than spending on health and education combined and almost as large as capital expenditures. IMF's projection that oil prices will weaken over the medium term will make it difficult for the country to meet its large development needs without finding alternative sources of fiscal space and the large energy subsidies provide scope for savings.

Sub-Saharan Africa also needs to reduce energy subsidies to rebuild fiscal policy buffers. The region withstood the global financial crisis reasonably well, largely because it had the macroeconomic policy buffers that allowed it to respond to the crisis: fiscal deficit and debt were moderate, inflation was in single digits, and foreign reserves were adequate. However, much of this policy space has been used up and the global economic outlook remains somber. It is essential that countries rebuild their policy buffers for protection against another global downturn and energy subsidies offer scope for savings. Angola was badly affected by the crisis because it lacked adequate policy space. Angola has since built up its buffers and is in much better position to face another crisis, but would benefit from stronger buffers.

Energy subsidies have been justified as a vehicle for promoting growth and competitiveness. Instead, however, energy subsidies can negatively affect long-term economic growth. They have damage economic efficiency, by misallocating resources through overconsumption and by tilting production towards more energy intensive uses that are typically also less labor intensive. They can lead to under-investment and poor maintenance which, in turn, results in deteriorating infrastructure, persistent shortages, and reduced access. Indeed, per capita electricity generation in sub-Saharan Africa has not increased since the 1980s, leaving the region farther and farther behind the rest of the world. Inadequate electricity supply subsequently forces heavy investment in costly self-generation, further damaging competitiveness. Inadequate power infrastructure in the region has perhaps reduced annual per capita GDP growth by about 2 percentage points. In Angola, electricity tariffs relative to costs are amongst the lowest in the region but access to electricity and distribution line losses amongst the worst.

Energy subsidies are also supposed to benefit the most vulnerable, but it is not the poor who benefit most from them. Fuel subsidies benefit mostly higher income groups because they consume the most. Lower income groups do benefit, but far less. Indeed, it has been estimated that, in 2010, the fifth of the population in sub-Saharan Africa with the highest incomes received nearly half of the fuel subsidies while the poorest fifth received under a tenth. Electricity subsidies are even more regressive than fuel subsidies because access to electricity is highly skewed towards higher income groups. Moreover, though the share of the consumption spent on energy is about the same for all income groups, the poor are more vulnerable than higher income groups as they have less room to absorb higher energy price. The 2009 IBEP household survey in Angola could provide comparable information about the distribution of benefits and the dependence of the poor on energy subsidies.

There are benefits to reducing energy subsidies, but this can also be disruptive. The reduction of energy subsidies would adversely affect competitiveness in the near term and should therefore be accompanied by the improvement in energy services that would benefit competitiveness in the longer term. Similarly, a reduction in energy subsidies could push up consumer prices. However, the extent to which higher energy costs result in a persistently higher inflation will depend on the strength of "second round" effects on wages and the prices of other inputs. These second-round effects can be contained with appropriate monetary and fiscal policies that help anchor inflationary expectations. Finally, lower energy subsidies and higher energy prices will adversely affect the poor and will need to be accompanied by the implementation of alternative safety nets and social protection schemes to protect the most vulnerable. This, however, will take time to implement. For these reasons, reducing energy subsidies, while beneficial, will take time and needs to be done with careful preparation.

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