Energy Subsidies and Social Protection

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The global economy is heavily reliant on energy subsidies for fuel and electricity. A recent IMF report addresses the case for their reduction and lessons learned from successful reform efforts. Protecting the poor is an important part of a successful reform strategy.

The worldwide cost of energy subsidies in 2011 - including direct price subsidies, foregone tax revenues and quasi-fiscal parastatal deficits - reached nearly 2 billion dollars or nearly 3 percent of global output and 8 percent of fiscal revenues. Sub-Saharan Africa spends about the same proportion of its output on energy subsidies. In Angola, the cost of the energy subsidies is substantially higher, about double as a share of GDP.

Energy subsidies are typically justified as a vehicle to protect economic growth and consumers against the impact of high international oil prices, but the accumulated evidence paints a different picture. Energy subsidies damage growth by misallocating resources through over-consumption by and encouraging under-investment and poor maintenance in the energy sector. They have probably reduced annual output growth by about 2 percent. Energy subsidies are also poorly targeted and overwhelmingly benefit the rich. Nearly half the benefits go to the richest fifth of the population, while the poorest fifth receive less than a tenth of the subsidies.

There would therefore seem to be a strong case for reducing these subsidies and redirecting the resources saved towards other budget priorities. However, reducing energy subsidies is potentially disruptive and efforts to reduce them have typically met with stiff public opposition and ended in failure. Businesses are concerned about the increase in production costs and loss of competitiveness and consumers are concerned about the impact on the cost of living. The poor in particular are concerned about losing what few benefits they do receive. And yet, some countries in Africa, like Ghana, Kenya, Namibia, Niger and Uganda, have managed to reduce their energy subsidies and redirect the resources saved to other priorities. What are the lessons to be learned from their experience?

First, careful preparation and sequencing of subsidy reform is critical. It takes time to build consensus for reducing subsidies among all stakeholders. Implementation should also be gradual to give time for stakeholders to adjust. In Namibia, fuel subsidies started to be scaled back in 2001, three years after the adoption of a consensual policy paper. In Kenya, electricity sector reforms efforts started in the mid-90s and were implemented in 2005.

Second, strong institutions are needed to sustain the reforms. In Tanzania, the establishment of a specialized regulatory entity, not only to issue licenses and technical regulations, but also to keep the public constantly informed about prices and to review the proper functioning of the market seems to have played an important role in sustaining subsidy reforms.

Third, durably reducing electricity subsidies involves more than price increases. Prices in the Africa region are higher than elsewhere. Breaking through the vicious cycle of under-investment, poor maintenance, and high costs requires creating an environment conducive to seizing the considerable scope for efficiency gains. Low levels of public debt in many countries provide an opportunity for significant investment in cheaper sources of energy production. Energy distributors have considerable scope to reduce distribution losses and improve revenue collection rates. And a strong, knowledgeable, independent regulator can play a critical role in assessing how much subsidy removal is done by price adjustment versus cost containment.

Fourth, it is important to introduce compensatory measures for those most affected and demonstrate how the savings will be used. For instance, the key to securing private sector acceptance of higher electricity tariffs in Kenya was a commitment to use the funds to expand the provision of power and its reliability, and delivery on that commitment.

The poor need particular attention. Though the poor benefit less from energy subsidies, they are more vulnerable to their removal. A successful reform strategy will therefore need to put in place an alternative form of support that is better targeted to the poor. This alternative support can be narrowly targeted to, say, public transport or cooking fuels which have a relatively larger weight in the poor's consumption basket. Or, the Government can take the opportunity to redirect a larger portion of the savings from lower energy subsidies to poverty reduction, which in turn would support inclusive growth. Such a scheme would take time, adequate funding and administrative structures to establish.

A number of countries have experimented with large-scale cash transfers schemes that provide relatively small cash transfers to a large proportion of the poor and the experience so far has been positive. In Africa, South Africa introduced cash transfer program in the 1990s. Its child support programs reach now 8 million children while other programs reach a quarter of the population. Ethiopia introduced a scheme in 2005 that now reaches 7½ million people. Kenya's scheme reaches a million. Mozambique's recently introduced scheme reaches two million people. In other regions, Mexico supports 6 million and Brazil's reaches 12 million families.

Preliminary estimates from UNICEF are that reaching 400,000 poor households in Angola (roughly 2 million people) with a small and regular transfer of $66 per month would cost less than $450 million per year.

In Angola, the combined direct and indirect cost of energy subsidies is high and the resources better used for other budget priorities. The public infrastructure program to improve the reliable availability of electricity will go a long way to allaying concerns about reducing energy subsidies. So will moves to protect the poor.

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