

REFORMING ENERGY SUBSIDIES

SUMMARY NOTE



Subsidies are intended to protect consumers by keeping prices low. But they also come at a high cost.

Subsidies are expensive for governments—and therefore taxpayers—to finance and can hinder governments' efforts to reduce budget deficits and directly support the poor. They also compete with other priority public spending on roads, schools, and healthcare.

All consumers—both rich and poor—benefit from subsidies by paying lower prices. Governments could get more "bang for their buck" by removing or reducing subsidies and targeting the money directly to programs that help only the poor.

Subsidies encourage excessive energy consumption, which accelerates the depletion of natural resources. They also reduce the incentive for investment in other forms of cleaner energy.

Measuring subsidies

Producer subsidies often arise because energy producers—usually state-owned enterprises (SOEs)—are inefficient and have high costs of production while charging artificially low prices. The subsidy might come from the government's budget, or it may be financed by the SOE itself and reflected in its operating losses or lower profits. In the electricity sector, producer subsidies can also arise because of non-payment of bills and power distribution losses, which weaken the revenues of SOEs and prevent them from expanding energy production.

Consumer subsidies can include two components: a *pre-tax subsidy* and a *tax subsidy*.

What are Energy Subsidies?

Energy subsidies are made up of both *producer* and *consumer* subsidies.

Producer subsidies arise when prices received by suppliers are above a benchmark price or when producers make losses at the benchmark price.

Consumer subsidies arise when the prices paid by consumers are below a benchmark price.

How to calculate the benchmarks?

For internationally traded energy products, like natural gas and petroleum products, the *benchmark price* used to calculate subsidies is the international price adjusted for distribution and transportation costs.

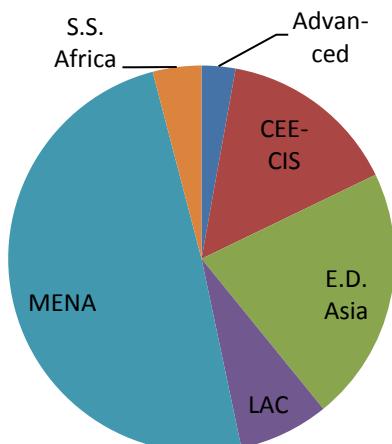
Where the energy product is mostly non-traded, like electricity, the *benchmark price* is the price at which the domestic producer recovers costs, including a normal return to capital.

Pre-tax subsidies exist when energy consumers pay prices that are below the costs incurred to supply them with this energy. Taking gasoline as an example—and remembering it is internationally traded, the pre-tax subsidy is simply the international price of gasoline less the final price paid by consumers at the pump.

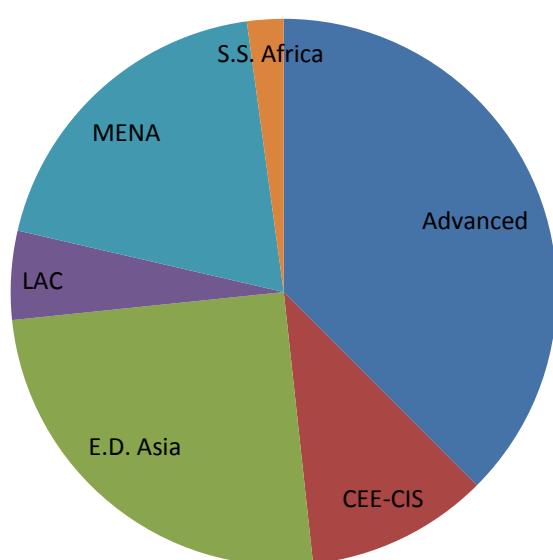
Tax subsidies exist if taxes for energy are below their efficient level. This has two components. First, energy should be taxed the same way as any other consumer products. If energy taxes are lower than this, there is a tax subsidy. Second, some energy products contribute to pollution and global warming—efficient taxation requires that the price of energy should reflect these adverse effects on society. In most countries, taxes on energy fall far short of this, implying the full costs of consuming energy are not reflected in its price, as it should when energy is priced right.

Post-tax subsidies are the sum of pre-tax and tax subsidies. Post-tax subsidies are four times larger than pre-tax subsidies, and advanced economies account for 40 percent of post-tax subsidies. But as a share of gross domestic product, post-tax subsidies are roughly eight times larger in the Middle East and North African region than in advanced economies.

Total pre-tax subsidies
\$480 billion
(0.7% GDP, 2.1% revenues)



Total post-tax subsidies
\$1.90 trillion
(2.7% GDP, 8.1% revenues)



Key:

E.D. Asia = Emerging and Developing Asia

S.S. Africa = Sub-Saharan Africa

MENA = Middle East and North Africa

CEE-CIS = Central and Eastern Europe and Commonwealth of Independent States

LAC = Latin America and Caribbean

Reform efforts

In 2009, the Group of 20 advanced and emerging market economies called for a phase out of inefficient fossil fuel subsidies in all countries, and reaffirmed this again in 2012.

Despite the potential gains, many countries have had difficulty reforming subsidies. When reforms are made, prices increase, and this has often led to widespread public protests.

The absence of public support for subsidy reform is in part due to a lack of confidence in the ability of governments to shift the resulting budgetary savings to programs that would compensate the poor and middle class for the higher energy prices they face.

This problem is particularly challenging in oil-exporting countries, where subsidies are seen as a mechanism to distribute the benefits of natural resource endowments to their populations and where the capacity to administer targeted social programs is typically limited.

Governments are also often concerned that higher energy prices will adversely affect their competitiveness. Subsidy reform can also be complex when it includes trying to reduce inefficiencies and production costs, as is often the case for the electricity sector.

A plan for reform

While there is no single recipe for successful subsidy reform, country experiences suggest that the following ingredients are needed:

- a comprehensive energy sector reform plan with clear long-term objectives with an analysis of the impact of reforms;
- measures to protect the poor through targeted cash or near-cash transfers or, if this option is not feasible, a focus on existing targeted programs that can be expanded quickly;
- transparent and extensive communication and consultation with stakeholders, including information on the size of subsidies and how they affect the government's budget;
- price increases that are phased-in over time;
- improving the efficiency in state-owned enterprises to reduce producer subsidies; and
- institutional reforms that depoliticize energy pricing, such as the introduction of automatic pricing mechanisms.

The IMF paper, *Energy Subsidy Reform—Lessons and Implications* is available at www.imf.org/subsidies