

Conference Summary: International Conference on Fossil Fuel Subsidy Reform | Paris October 13, 2016

Energy subsidies, and in particular fossil fuel subsidies, are often used to lower the cost of energy for end consumers, both industrial and domestic, in many cases leading to the growth of energy intensive industry. Price subsidies are frequently justified on the grounds that low costs of cooking, electricity, and transport help low-income households meet their basic needs. However, the bulk of the more than \$300 billion the world is estimated to have spent on fossil fuel subsidies in 2015 was captured by consumers other than poor households. The huge fiscal costs of subsidies have also led to a realization that they need to be better targeted, reduced, and possibly eliminated. Many governments have taken advantage of falling fuel prices on the global market in recent years to reform energy subsidies.

In support of these efforts, on October 13, 2016, the International Energy Agency (IEA) invited a group of policy makers and experts to take stock of fossil fuel subsidy reforms (FFSR) worldwide and discuss progress towards phasing out subsidies. Topics at the one-day conference, which followed Chatham House rules, included the state of play of international FFSR peer-review processes and on the specific challenges faced by the transport and electricity sectors. The IEA also used this occasion to release its latest in-depth study, “Fossil Fuel Subsidy Reform in Indonesia and Mexico.” The international participants brought perspectives of diverse approaches and lessons learned, with government representatives from Mexico and Indonesia highlighting their experience¹. In doing so, the country representatives painted a fuller picture of the reform process by highlighting (i) issues to consider in embarking on the FFSR process; (ii) the challenges in implementing reforms; and (iii) the international peer review learning experience.

In Indonesia and Mexico, the trigger for subsidy reform was a combination of declining production of fossil fuels, rising demand, exchange rate devaluation, and large fluctuations in fuel prices. Being major oil and gas producers, both countries were especially affected by price volatility. The increasingly unsustainable subsidy budget and the realization that phasing out subsidies would increase fiscal space, induced a shift in the countries’ priorities.

First rocky steps on the energy subsidy removal path

Conference participants noted that there are many reasons a government takes the decision to start reforming fossil fuel subsidies. Reform drivers include the significant impact on state budgets that cause a fiscal imbalance and the lack of incentives to invest in and implement energy efficient systems when energy prices are artificially low. Subsidies discourage investment in the energy sector, while promoting black markets and smuggling-out of fuels. The result is supply shortages and power blackouts, leading to high economic costs and even higher costs of energy—fuel shortages cause queues and high black market prices, while power outages force businesses to resort to expensive private diesel power generation. In terms of political economy, the influence of third parties like lobbies and interest groups can counteract the government’s narrative and dampen the political will to tackle energy subsidies. The associated loss in credibility and trust in the government can have a long-term impact on the appetite for changes to energy policies. Studies also show, that in oil- and gas- abundant countries there is a correlation between discretionary mechanisms and high subsidies, which further affects the likelihood

¹ Delegates from Argentina, Australia, Brazil, Chile, China, Denmark, Ethiopia, France, Germany, Indonesia, Japan, Malaysia, Mexico, Morocco, New Zealand, Portugal, Switzerland, Turkey, United Kingdom, and United States attended the conference, as well as representatives from ASEAN, CAF, GIZ, IADB, IISD/ GSI, IMF, IPECC, OECD, OLADE, and the World Bank.

of removing subsidies. Discussants also noted the indirect effects of higher energy prices on inflation through higher costs of intermediate goods, as well as external factors such as congestion and pollution.

The process of implementing reforms

Mexico's strategy of gradual price increases to remove subsidies proved effective. The country has been successful in phasing out gasoline and diesel subsidies over time. Thanks in part to the oil price collapse, energy subsidies in 2015 accounted for only 0.33 percent of the GDP, compared to four years earlier, when subsidies totaled 1.95 percent of GDP—including 1.01 percent for gasoline and diesel and, 0.61 percent for electricity. The historic 2014 Hydrocarbons Law calls for a temporary maximum price regime for gasoline and diesel until 2017, and deregulates prices thereafter.

Political buy-in from legislatures and ministries has been crucial for the successful implementation of energy subsidy reforms. Governments are interested in designing efficient measures to avoid social unrest and compensate their citizens, in particular through compensatory payments that targeted the poor. Indonesia, for instance, has used the savings from fuel price subsidy reduction for infrastructure development and social protection programs. Over time, the country was able to balance the effects of high economic growth and increasing demand for energy with fiscal stability. Since 2014, Indonesia has successfully reduced fossil fuel subsidies from 3.1 percent of GDP (2014) to just 1 percent in 2016. This sharp ongoing drop reflects the falling oil prices since 2014 and the government's policy aim of removing gasoline subsidies and limiting diesel subsidies, and gradually phasing out the kerosene price subsidy in favor of LPG.

Conclusions

- Gradual price increases are preferable to big-bang approaches.
- Adoption of an automatic pricing mechanism is a good first step, but it requires very strong political commitment.
- A key challenge is developing and implementing a sustainable policy response to fuel price volatility and significant market price increases in the future caused by currency depreciation, world price hike, or both.

The international peer review learning experience

The G20 peer review process is seen to have a positive effect on the quality and depth of progress reports of participating countries. The system of pairing countries in the review process resulted in more detailed reviews of policies as well as a constructive analysis of subsidies. Furthermore, the preparation of reviews can be a salutary learning experience for both the country under review (including the ministries and departments involved) and their counterparts in the paired country. For example, such a process led to a common understanding of what subsidies were and whether they could be considered "efficient" and associated fuel consumption "wasteful". Additionally, the peer review process can have a direct impact on the transparency of the government itself. Some countries developed a regular feedback mechanism, which involved statistics departments, NGOs, and other agencies in the dialogue. While these are positive steps, the participants acknowledged that not every government feels comfortable being scrutinized and placed under the international spotlight while implementing reforms.

As part of an overall G20 agenda discussion, some participants proposed the idea of a target phase-out date for inefficient fossil fuel subsidies as a follow-up to the peer review process. Additionally, they suggested inclusion of trade experts in discussions with finance and energy ministries. Participants also suggested developing a central repository for peer review and country progress reports and establishing a mechanism for monitoring follow-up actions of the peer reviews.

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