

The political economy of ending fossil fuel subsidies

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Key Messages

- Fossil fuel subsidies are large – almost four times the size of all international aid. By encouraging greater fossil fuel consumption, they make climate change worse and add to the misery of outdoor air pollution. They also drain government budgets that could be put to better use.
- However, removing fossil fuel subsidies is extremely hard. The current approach to supporting fossil fuel subsidy reform is highly technical – but the main challenges are political.
- A new approach to understanding the political economy of subsidy reform could deliver ways of supporting changes that are both technically and politically feasible. It requires policy-makers and their international partners to:
 1. **Analyse the politics of subsidies** rather than treating it as only a technical problem;
 2. **Build coalitions of actors in favour of reform** – including the private sector and civil society;
 3. **Change the system.** Either liberalise the fuel supply system or regulate prices in a transparent and automatic manner that guarantees no subsidies over time;
 4. **Deliver benefits for most.** Ensure that the money saved through subsidy reform is used to deliver benefits for a majority of the population;
 5. **Emphasise a politically attractive alternative ‘offer’ to fossil fuel subsidies** – for example universal health care, free education or other politically attractive programmes.

1. The problem with fossil fuel subsidies

Energy subsidies can be a wonderful thing! They are the reason millions of European households were able to heat their homes during the 2022/23 winter. As Putin's invasion of Ukraine led to spiralling oil and gas prices, governments across the world stepped in to put a ceiling on these. This ceiling means there is a gap between the price at which energy is sold and the cost of obtaining it – in other words a subsidy, paid by the government to protect consumers from unaffordable energy prices.

Given the energy crisis, governments have few other options in the short term to protect citizens. But the costs of this approach are enormous. Liz Truss's short-lived premiership in the UK proposed capping energy prices for two years at an estimated cost of £150 billion (even the subsequently curtailed six-month subsidy will cost billions). The EU put in place a similarly generous subsidy for its consumers. Some of this will be funded through new windfall taxes and revenue caps on the vast profits fossil fuel companies have made, but most will be paid by taxpayers for years to come.

The huge cost of today's energy subsidies has focused attention on the challenge of making energy affordable. But this is not a new problem. Governments around the world have been trying to keep down the price of energy for consumers for decades, and the way they have done this is by subsidising fossil fuels and electricity. In 2019, the EU spent €50 billion on subsidising fossil fuels. Dozens of countries – from Iran to Indonesia, Egypt to Ecuador, Nigeria to the Netherlands – subsidise fossil fuels. Some spend a large percentage of their country's budget doing so. Meanwhile, soaring oil and gas prices have led to a huge increase in subsidies as governments try to protect citizens. Globally, in 2022, governments around the world spent over \$1,000 billion on subsidising fossil fuels, almost four times the amount spent on all international aid.

Subsidising fossil fuels is problematic for many reasons.

- In the midst of a climate crisis, **making fossil fuels cheaper than they would otherwise be encourages greater consumption** – the opposite of what is needed globally.
- **Subsidising fossil fuels kills people.** Outdoor air pollution is responsible for around 3.8 million premature deaths every year. Most of this pollution comes from particulates and other toxins emitted from burning fossil fuels, particularly coal.
- **Subsidising fossil fuels drains country budgets.** In 2021, Indonesia spent 20% of its entire budget on subsidising energy, more than it spent on education; in Nigeria, the cost of subsidising petrol is three times the budget for health.

Given such problems, there has been an international movement to end fossil fuel subsidies. In 2009, the G20 nations agreed to take measures to 'eliminate inefficient fossil fuel subsidies'; the G7 made a similar commitment. The World Trade Organization has also called for an end to such subsidies, as have the past two Conference of the Parties meetings on climate change. And yet fossil fuel subsidies are now larger than they were

¹ Energy subsidies include both subsidies on fossil fuels and those on electricity. Where electricity is generated from fossil fuels, electricity subsidies are indirect fossil fuel subsidies. However, this Brief focuses on fossil fuel subsidies rather than electricity.

2. The current approach to FFSR

International organisations, notably the World Bank and the International Monetary Fund, have long tried to help countries reform their fossil fuel subsidies. They usually provide this help when the country is facing a fiscal crisis and can no longer afford to continue the subsidies. The approach taken is a professional, technical and economic one, consisting, broadly, of three components:

1. Analyse the nature of subsidies:

A detailed analysis is conducted of the nature of the subsidies. Which fuels or energy sources are subsidised? How much? Through what mechanism? Who benefits from the subsidies and/or who would their removal hurt most? Such analysis is provided to the government to explain the need for reform and to inform thinking about the best approach.

2. Propose price increases tied to cash transfers:

Fossil fuel subsidies typically come into play when governments hold the price of a fuel, whether it be petrol, diesel, liquid petroleum gas or electricity, below its cost of supply. The cost of supply is the import price if the fuel is imported, or the cost of production if it is locally produced. The only way to eliminate such subsidies is to increase the price. Hence, FFSR usually entails one or more price rises to eliminate the gap between the price and the cost of supply. Such price rises are painful, particularly for the poor. They also have second-round effects on many prices, including the price of food, as the cost of transport rises. Hence, it is often recommended to compensate for the pain of the price rises through targeted cash transfers, particularly to the poorest.

3. Use a formula to determine prices or liberalise so that prices are market-driven:

Price increases remove subsidies temporarily. Preventing them from coming back requires a mechanism that ensures that prices always track the cost of supply. There are two ways of implementing this: either the government can set fuel prices using a formula that takes account of movements in international prices and the exchange rate; or it can liberalise the sector, allowing market actors to supply fuel competitively, which, at least in theory, ensures that domestic prices track international ones.

These three components of FFSR – analysis, compensation and system change – are all sensible, technical solutions to the problem. And sometimes they succeed – but all too often they fail. Analysis is done but not acted on. Or reforms are introduced, with or without cash compensation, but quickly reversed after a backlash. A pricing formula is announced only for the government to renege on its use soon thereafter. Liberalisation is promised but not delivered. History is littered with examples of failed or partial FFSR. But why do governments behave this way? The answer lies in the politics of FFSR.

'Subsidising fossil fuels is an abrogation of human rights.'

Mary Robinson, Former President of Ireland and former United Nations High Commissioner for Human Rights

3. The politics of FFSR

To understand why FFSR is so hard, it is necessary to understand why fossil fuel subsidies exist in the first place and why they persist once introduced. Subsidies exist for three reasons. First, leaders wish to protect their citizens from high and sometimes volatile prices. Fixing prices at low levels creates the appearance of stability and makes fuel affordable. Second, the people of countries that have significant fossil resources feel, understandably, that these resources belong to them. Politicians respond by providing cheap fuel. Cheap fuel therefore becomes part of the social contract between leaders and those over whom they rule. Third, poorer countries often lack a high quality bureaucracy capable of providing more sophisticated public goods such as good education and health care. At the same time, fuel prices can be changed at the stroke of a pen, making this a much easier way of providing a popular benefit to voters.

These factors explain why fossil fuel subsidies exist but not why they persist, often for decades. This happens for two reasons. First, reform invariably entails price increases. These are always unpopular – and the larger the price rise, the more unpopular they are. FFSR requires governments to impose harm on their voters in return for the promise of something better down the line. But the track record of governments in delivering public goods and services for citizens may make the latter sceptical about such promises. Meanwhile, price rises provide an opportunity to those opposed to the government to garner support. It is not surprising that most governments avoid reform if they can.

The second reason subsidies persist is more pernicious: some people make a lot of money from them. Subsidies create distortions and distortions create opportunities. According to official statistics, Nigeria consumes 50 million litres of petrol every day. But everyone knows that millions of litres flow across the borders to neighbouring countries where the prices are much higher. Those organising the smuggling do not want subsidies to be removed. The same is true for those who control access to subsidised fuel: decisions about the allocation of scarce resources can make some players very rich. Rich enough to fund the election campaigns of politicians, who, in turn, are disinclined to pursue reform.

'Climate change is an existential challenge for the planet. Yet, astonishingly, governments still subsidise fossil fuels. Neil McCulloch's wonderful, short book explains why it is hard to end fossil fuel subsidies, but also charts a politically savvy way in which it could be done.' Ban Ki-moon, former Secretary-General of the United Nations'

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4. A new approach to FFSR

If FFSR is to have a better chance of success, it needs to marry a sound technical approach with a better understanding of the political economy of reform. External actors – whether donors or civil society – can help in several ways:

'Understanding the politics of why fossil fuel subsidies persist is essential to the design of effective reforms.'

*Vivien Foster,
Chief Infrastructure
Economist, World Bank*

1. **Analyse the politics.** There are endless reports analysing the technical aspects of fossil fuel subsidies in different countries. However, although everyone acknowledges that reform is fundamentally a political process, there is far less rigorous analysis of the politics of reform. Providing this could help reformers – but it would also help external actors to provide support in a more politically savvy way.
2. **Build coalitions.** Successful reform usually entails reformers building a coalition of support around the needed reforms. External support, by contrast, tends to focus on technical assistance. Much more attention should be paid to supporting dialogue and facilitating coalitions to demand reform.
3. **Change the system.** FFSR is rarely just about removing subsidies. It is really about a far more fundamental transition in the energy system. This makes it more complex – but it also provides an opportunity. Linking FFSR to a long-term vision for energy access, security and sustainability makes it much more politically palatable.
4. **Deliver benefits for most.** FFSR will always have winners and losers. Too often, though, donor support focuses overwhelmingly on protecting the poor. This is important – but it is not only the poor who vote. Politically feasible reforms are always imperfect, providing benefits to groups that may not be the poorest but whose interests must be taken into account.
5. **Emphasise the 'offer'.** Voters support FFSR when they believe they will get something better. Successful reformers construct politically attractive 'offers'. For example, President Joko Widodo in Indonesia used the savings from subsidy reform to deliver free health and education to millions. External actors can help by supporting the political offer as well as helping compensate the losers.

Case Study - Lessons from subsidy reform in Indonesia

In 2014, presidential candidate Joko Widodo (known as Jokowi) said he would abolish fuel subsidies if he were elected. This was surprising: reforming fuel subsidies was politically toxic – no sensible politician talked about doing this. But Jokowi had a card up his sleeve – in fact two. He said that, when he abolished subsidies, he would provide the population with free health and education. He won by a landslide.

When in power, he immediately abolished petrol subsidies, saving the government \$16 billion. This was then spent on infrastructure and social programmes. He also put in place a formula for adjusting petrol prices to ensure that subsidies did not re-emerge over time.

In 2016, international fuel prices started to rise. But in Indonesia it was politically inconvenient to increase domestic prices according to the formula, so the formula was abandoned. As the gap between international and domestic prices increased, the government told the national oil company, Pertamina, to pay the difference – effectively reintroducing subsidies. By 2018, Pertamina was losing billions of dollars subsidising fuel. But having ‘abolished’ subsidies, Jokowi couldn’t then admit that they were back, so when the 2019 election campaign came around there was one topic Jokowi would not talk about ... fuel subsidies.

The experience of Indonesia shows that, if leaders communicate well and have a politically attractive ‘offer’, it is possible to reform subsidies and deliver major benefits. But making such reforms stick requires governments to change the pricing system for fossil fuels in a way that is hard to reverse when price changes are politically inconvenient.

5. Recommended reading

McCulloch, N. (2023) *Ending Fossil Fuel Subsidies: The Politics of Saving the Planet*.

Rugby: Practical Action.

<https://practicalactionpublishing.com/book/2642/ending-fossil-fuel-subsidies>

Rentschler, J. and Bazilian, M. (2017) ‘Principles for Designing Effective Fossil Fuel Subsidy Reforms’. *Review of Environmental Economics and Policy* 11(1): 138–155.

doi:10.1093/reep/rew016

Skovgaard, J. and van Asselt, H. (2018) *The Politics of Fossil Fuel Subsidies and Their Reform*. Cambridge: Cambridge University Press.

<https://www.cambridge.org/core/books/the-politics-of-fossil-fuel-subsidies-and-their-reform/B8CB7D383F33AD9AF9CC82EB50A74DE5>

For more on fossil fuel subsidies see <https://fossilfuelsubsidytracker.org/>

About this Policy Brief and The Policy Practice



This Policy Brief is based on TPP Director Neil McCulloch's book *Ending Fossil Fuel Subsidies: The Politics of Saving the Planet*.

The physical book is available for purchase from:
<https://practicalactionpublishing.com/book/2642/ending-fossil-fuel-subsidies>
TPP has also paid for the book to be Open Access, so it can be downloaded for free from the same site.

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