FUELING Risk

Energy subsidies in low- and middle-income countries can take a big toll on their fiscal health

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THE SHARP rebound in international petroleum prices since the end of 2008 has again exposed the fiscal risk to many low- and middle-income countries that subsidize fuel prices. Two years ago, an article in *F&D* projected an escalation of fuel price subsidies if countries continued to restrict the pass-through of international price increases to domestic consumers (see “Oil Subsidies: Costly and Rising,” in the June 2010 issue of *F&D*).

Those risks are now a reality.

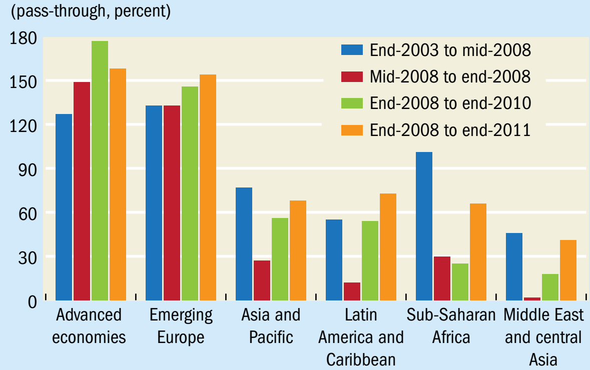
After peaking in mid-2008, international prices plummeted over the following six months. But much of that decline has now been reversed. Sustained price increases over the past three years left international prices at the end of 2011 at about 80 percent of their mid-2008 peak. Since the second quarter of 2012, prices have moved up and down.

As during the sharp international price increases up to mid-2008, many low- and middle-income countries have struggled to pass recent price increases through to domestic consumers, with most of them allowing less than 70 percent pass-through over the past three years (see Chart 1). Pass-through levels were especially low in oil-exporting countries, half of which—many in the Middle East and central Asia—passed through less than 55 percent of international price increases. By contrast, advanced and emerging European countries passed through much more of the increases.

Chart 1

Absorbing increases

Many low- and middle-income countries have not fully passed recent fuel price increases through to domestic consumers.



Source: IMF staff calculations.
Note: Pass-through is calculated as the increase in domestic prices divided by the increase in international prices (both denominated in domestic currency).

Large fiscal costs

The cost of incomplete pass-through is a sizable fiscal risk for many countries (see Chart 2). For example, in half the countries in the Middle East and central Asia, the cost exceeded 2.3 percent of GDP at the end of 2011, while half the countries in sub-Saharan Africa had costs exceeding 1.3 percent of GDP.

A key difference with the low pass-through during the most recent price increase is that it was partly attributable to the relatively high fuel tax levels in many countries at the end of 2008. As prices began to fall in the second half of 2008, many countries passed through very little of the decline to consumers in an attempt to recoup past revenue losses—over this period, pass-through fell below 30 percent in most low- and middle-income countries. As prices rebounded, countries with tax levels above historical norms lowered them to prevent sharp increases in domestic prices.

For many countries with low pass-through over the past three years, tax levels are still sizable and can be maintained as long as future international price changes are fully passed through to domestic consumers. This is especially true in many countries in sub-Saharan Africa, where current tax levels are substantially higher than in many other low- and middle-income countries. However, many other countries with diminished pass-through levels have already reached low tax levels, and further mitigation of the price increases would require lower taxes. Other countries are already subsidizing fuel consumers.

Falling tax levels and rising subsidies are particularly worrisome in parts of sub-Saharan Africa where revenues from fuel taxes are a significant source of finance for public expenditures that are important for both poverty reduction and growth (such as education, health, and physical infrastructure). About half of Middle Eastern and central Asian countries have traditionally subsidized consumers and continue to do so. A large number of countries in other regions are also subsidizing consumers.

The existence of subsidies among some members of the Group of 20 advanced and emerging economies is contrary

Employee adjusts prices at gas station in Chongqing, China.

to the commitment set out in the September 2009 Pittsburgh communiqué, which called for a phase-out of "inefficient fossil fuel subsidies." Renewed efforts to abolish subsidies in these countries can help promote similar reforms elsewhere.

Politically sensitive

Removal of subsidies can deliver substantial economic and social gains. Price subsidies encourage higher fuel consumption and waste—for instance, many oil-producing countries have some of the world's lowest retail prices, resulting in fuel consumption (as well as associated congestion and pollution) levels well above those of higher-income countries. As well as diluting incentives for improving energy efficiency, subsidies can result in cross-border smuggling and domestic shortages. Their high fiscal cost crowds out high-priority public expenditures and private investment, and most benefits from subsidies are captured by higher-income groups.

But subsidies persist, in part because of two factors: the lack of reform credibility and the adverse impact of price increases on the most vulnerable. People often do not believe that governments will use budget savings to benefit the broader population. In oil-exporting countries, the public often sees cheap energy as the primary route to sharing in oil wealth. Also, although higher-income groups capture most of the benefits from lower fuel prices, subsidy reform can still result in a sizable increase in the cost of living for low-income households, and higher poverty.

Past experiences with subsidy reforms provide important lessons. A public information campaign that highlights the shortcomings of fuel subsidies and directly links subsidy reform to increases in priority public expenditures (such as education, health, and physical infrastructure) can help increase public support for reform.

Transparently recording the magnitude of subsidies is a key component of this process. This reform strategy has been used in a number of countries that have successfully reduced fuel subsidies, including Ghana, Indonesia, and Jordan. More recently, Iran has started to gradually increase its domestic fuel prices, which were among the lowest in the world, has introduced a near-universal cash transfer program to mitigate the adverse impact on the population, and has initiated support for energy-intensive sectors to finance investments in energy-efficient technologies.

Where an effective social safety net exists, expanding the budget for these programs can address poverty concerns while containing fiscal cost. For countries with less effective safety nets, a more gradual reform approach may be desirable if fiscal conditions allow, while social safety nets are strengthened.

Guarding against recurrence

To prevent the recurrence of subsidies, fuel prices should be fully liberalized. But in the interim, countries could adopt an automatic fuel-pricing mechanism that ensures full pass-through of international price changes to domestic consumers. Such mechanisms have worked well in countries such as Botswana, Chile, Liberia, South Africa, Turkey, and Zimbabwe.

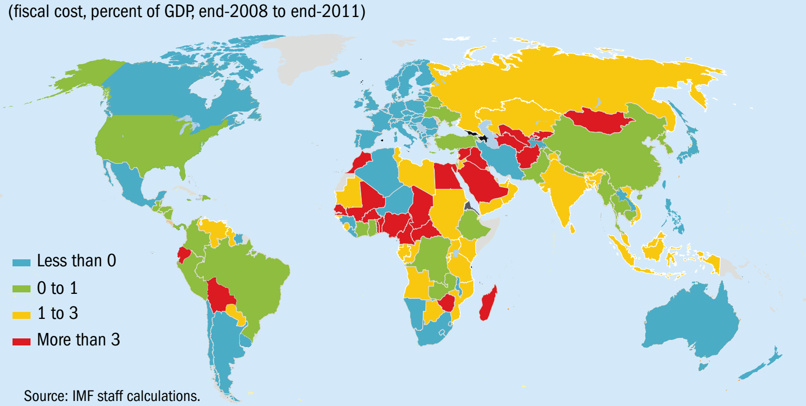
However, adoption of an automatic mechanism is not a panacea. Many countries have adopted such mechanisms only to abandon them when international prices increase sharply. The fragility of automatic mechanisms in part reflects the reluctance of governments to fully pass through large price increases that they believe may be temporary and could cause a social and political backlash. These concerns can be addressed by incorporating price-smoothing rules (such as a cap on the magnitude of domestic price changes) into automatic mechanisms, thus avoiding large increases in domestic prices while ensuring full pass-through of international price movements over the medium term. ■

Chart 2

Big budget hit

The fiscal cost to countries that moderate fuel price increases can be quite high. Generally, a government absorbs price increases by reducing fuel taxes.

(fiscal cost, percent of GDP, end-2008 to end-2011)



Source: IMF staff calculations.
Note: Fiscal cost is calculated by comparing the annual net revenue that would be collected at initial end-2008 tax levels if applied for one year with net revenue at end-2011 tax levels.

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