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GSI Global
Subsidies
Initiative

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Understanding Fossil-Fuel Subsidies in India: *QUESTIONS & ANSWERS*



A GUIDE TO
FOSSIL-FUEL
SUBSIDIES AND HOW
THEY AFFECT YOU.

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The International Institute for Sustainable Development (IISD) contributes to sustainable development by advancing policy recommendations on international trade and investment, economic policy, climate change and energy, and management of natural and social capital, as well as the enabling role of communication technologies in these areas. We report on international negotiations and disseminate knowledge gained through collaborative projects, resulting in more rigorous research, capacity building in developing countries, better networks spanning the North and the South, and better global connections among researchers, practitioners, citizens and policy-makers.

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About GSI

GSI is an initiative of the International Institute for Sustainable Development (IISD). GSI is headquartered in Geneva, Switzerland and works with partners located around the world. Its principal funders have included the governments of Denmark, the Netherlands, New Zealand, Norway, Sweden and the United Kingdom. The William and Flora Hewlett Foundation have also contributed to funding GSI research and communications activities. International Institute for Sustainable Development

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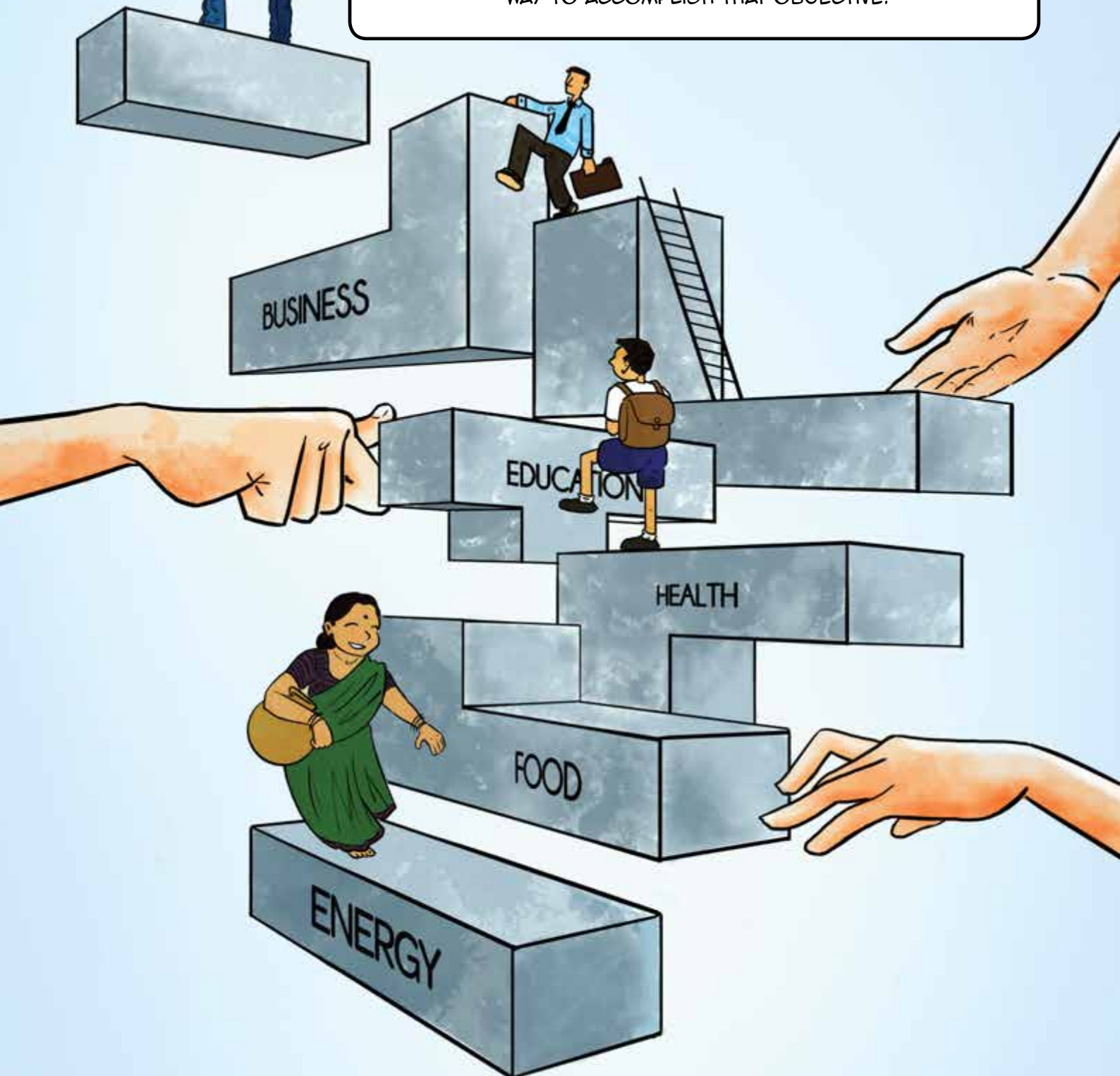
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SO,
WHAT IS A
SUBSIDY?

GOOD QUESTION.

OFTEN, GOVERNMENTS WANT TO HELP THEIR PEOPLE ACHIEVE A CERTAIN STANDARD OF LIVING—A LEVEL THAT ENSURES ACCESS TO FOOD, SANITATION, SHELTER, EDUCATION AND ECONOMIC OPPORTUNITIES. IN ORDER TO MAKE THESE BASIC NEEDS ATTAINABLE, SOMETIMES GOVERNMENTS SPEND PART OF THEIR BUDGET TO REDUCE THE PRICE THAT CONSUMERS PAY FOR A GOOD OR SERVICE. GOVERNMENTS MAY ALSO WANT TO GIVE CERTAIN BUSINESSES A “HELPING HAND,” AND SUBSIDIES—SUCH AS THROUGH GRANTS OR SPECIAL TAX BREAKS—ARE ONE WAY TO ACCOMPLISH THAT OBJECTIVE.

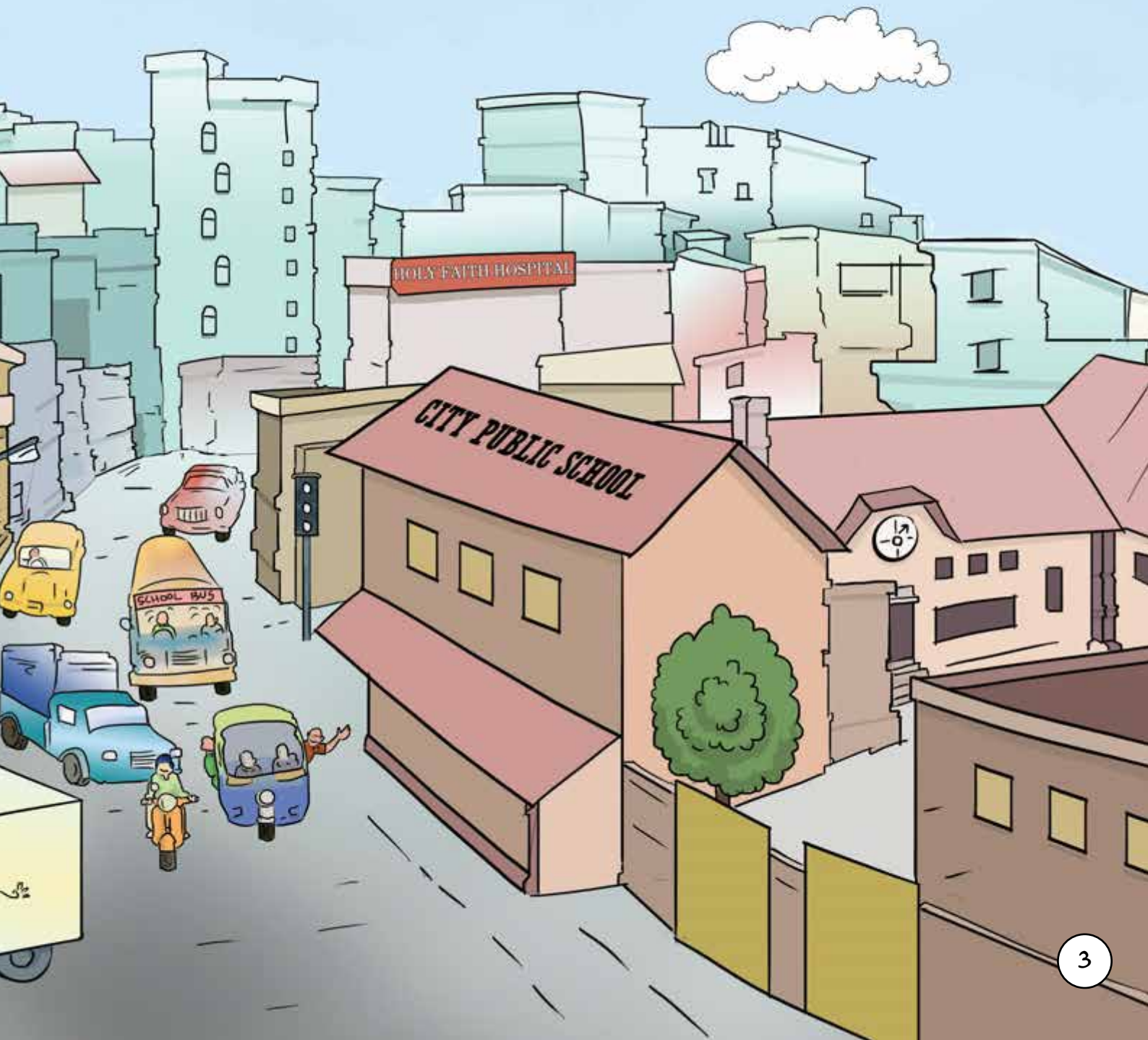




WHAT DOES THAT HAVE TO DO
WITH FOSSIL FUELS?



FOSSIL FUELS ARE INPUTS TO MANY OF THE THINGS WE CONSUME EVERY DAY, SUCH AS KEROSENE FOR LIGHTING, LIQUEFIED PETROLEUM GAS (LPG) FOR COOKING AND DIESEL FOR TRANSPORTATION. SINCE THESE INPUTS ARE VITAL TO THE POPULATION'S WELL-BEING, MANY GOVERNMENTS HAVE CHOSEN TO SUBSIDIZE THEM TO LOWER THE PRICE FOR CONSUMERS.



I SEE. I KNOW THE GOVERNMENT SETS THE PRICE FOR KEROSENE. IS THAT PART OF SUBSIDIZING FOSSIL FUELS?



YES. AND, IN ADDITION, INDIA SUBSIDIZES DIESEL AND LPG.

HERE GENERALLY IS HOW THE SUBSIDIES WORK.

1

DOWNSTREAM PUBLICLY-OWNED OIL MARKETING COMPANIES (OMCs) WOULD LIKE THE PRICE TO BE SET SO AS TO RECOVER THEIR COSTS, I.E. AT THE 'COST PRICE'.

2

GOVERNMENT SETS THE REALIZED PRICE.

3

OMCs MUST SELL FUEL AT THE REALIZED PRICE.



TO HELP MAKE UP THE DIFFERENCE BETWEEN THE COST PRICE AND REALIZED PRICE, THE GOVERNMENT PROVIDES A FISCAL SUBSIDY PER UNIT OF KEROSENE AND LPG (BUT NOT IN THE CASE OF DIESEL).

4

5

BUT THE FISCAL SUBSIDY IS NOT ENOUGH TO COVER THE DIFFERENCE BETWEEN THE COST PRICE AND REALIZED PRICE. THE PART THE FISCAL SUBSIDY DOESN'T COVER IS CALLED *THE NET UNDER-RECOVERY*.

6

TO COMPENSATE FOR THE UNDER-RECOVERY, THE GOVERNMENT PROVIDES FURTHER AD HOC CASH ASSISTANCE TO THE OMCs. THIS IS ALSO A SUBSIDY.

7

THE BULK OF THE REMAINING UNDER-RECOVERY IS THEN TRANSFERRED TO THE BALANCE SHEET OF UPSTREAM AND MIDSTREAM PUBLICLY-OWNED OIL COMPANIES.

8

IF THAT STILL DOESN'T COVER IT, THE OMCs MUST ABSORB THE REMAINING DIFFERENCE.

WAIT... WHAT EXACTLY ARE
OMCs AND NOCs?



REFINE & RETAIL

OMCs (OR OIL MARKETING COMPANIES) ARE THE PUBLICLY-OWNED FIRMS PARTICIPATING IN THE DOWNSTREAM PART OF THE OIL INDUSTRY. IN OTHER WORDS, THESE ARE THE COMPANIES THAT REFINES CRUDE OIL (TURN IT INTO THE PRODUCTS WE USE, LIKE DIESEL AND GASOLINE) AND SELL IT TO THE FINAL CONSUMER.

NOCs (OR NATIONAL OIL COMPANIES) ARE GOVERNMENT-CONTROLLED COMPANIES THAT PARTICIPATE IN THE UPSTREAM, AND IN CASES MIDSTREAM, PARTS OF THE OIL INDUSTRY. FOR EXAMPLE, THIS INCLUDES EXPLORING AND EXTRACTING OIL.



HONESTLY, THESE SUBSIDIES SOUND LIKE A GOOD THING. DON'T THEY MAKE FUEL CHEAPER FOR ME?



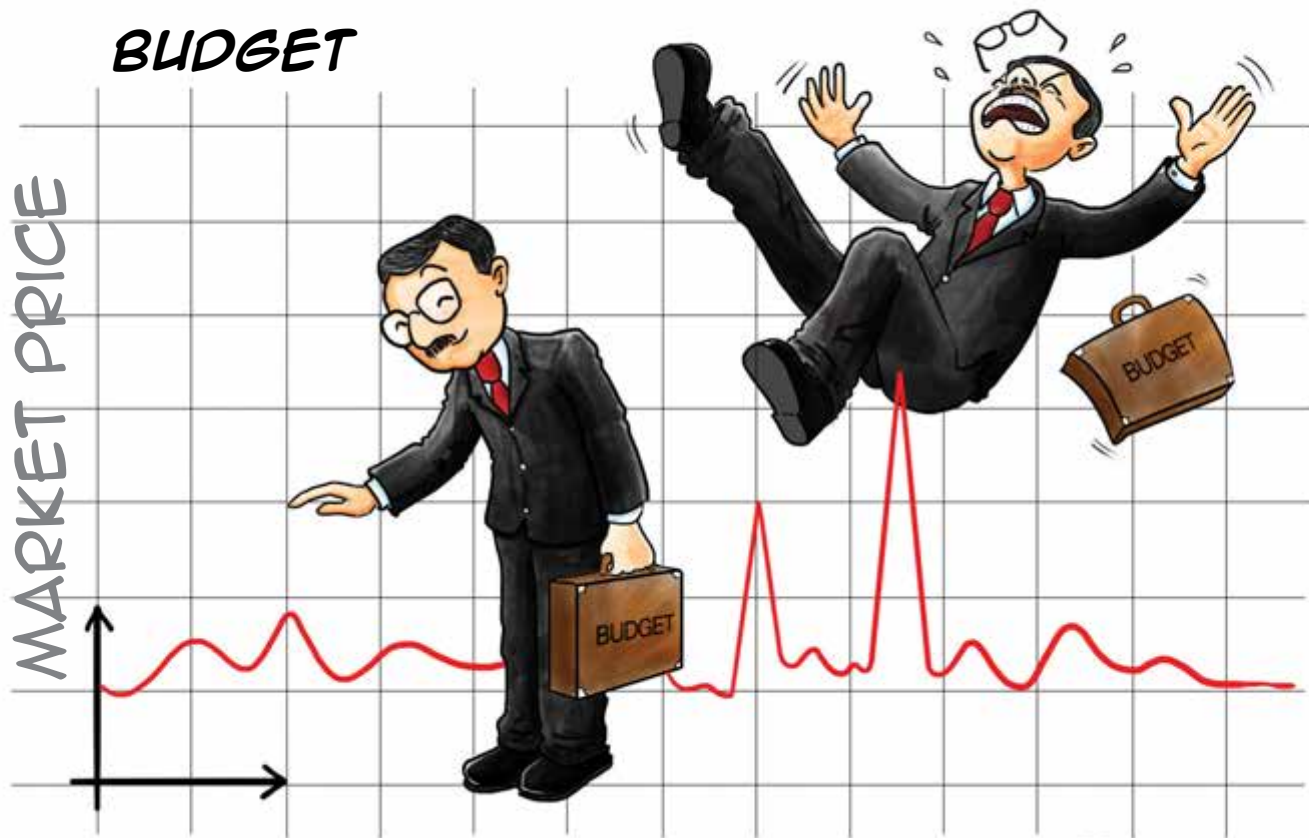
YES.
SUBSIDIES DO TEND TO KEEP PRICES MORE STABLE, PREDICTABLE AND AFFORDABLE FOR CONSUMERS, WHICH MAY SEEM LIKE A GOOD DEAL.

HOWEVER, IT IS IMPORTANT TO NOTE THAT SUBSIDIES DO NOT REDUCE THE COST OF FUELS; THEY SIMPLY MOVE THE COSTS TO DIFFERENT PARTS OF THE ECONOMY. SOMEBODY STILL PAYS, SUCH AS THROUGH TAXES OR REDUCED PUBLIC SERVICES. IN FACT THERE MAY BE HIDDEN COSTS TO THE GOVERNMENT, ECONOMY, ENVIRONMENT AND CITIZENS OF THE COUNTRY.



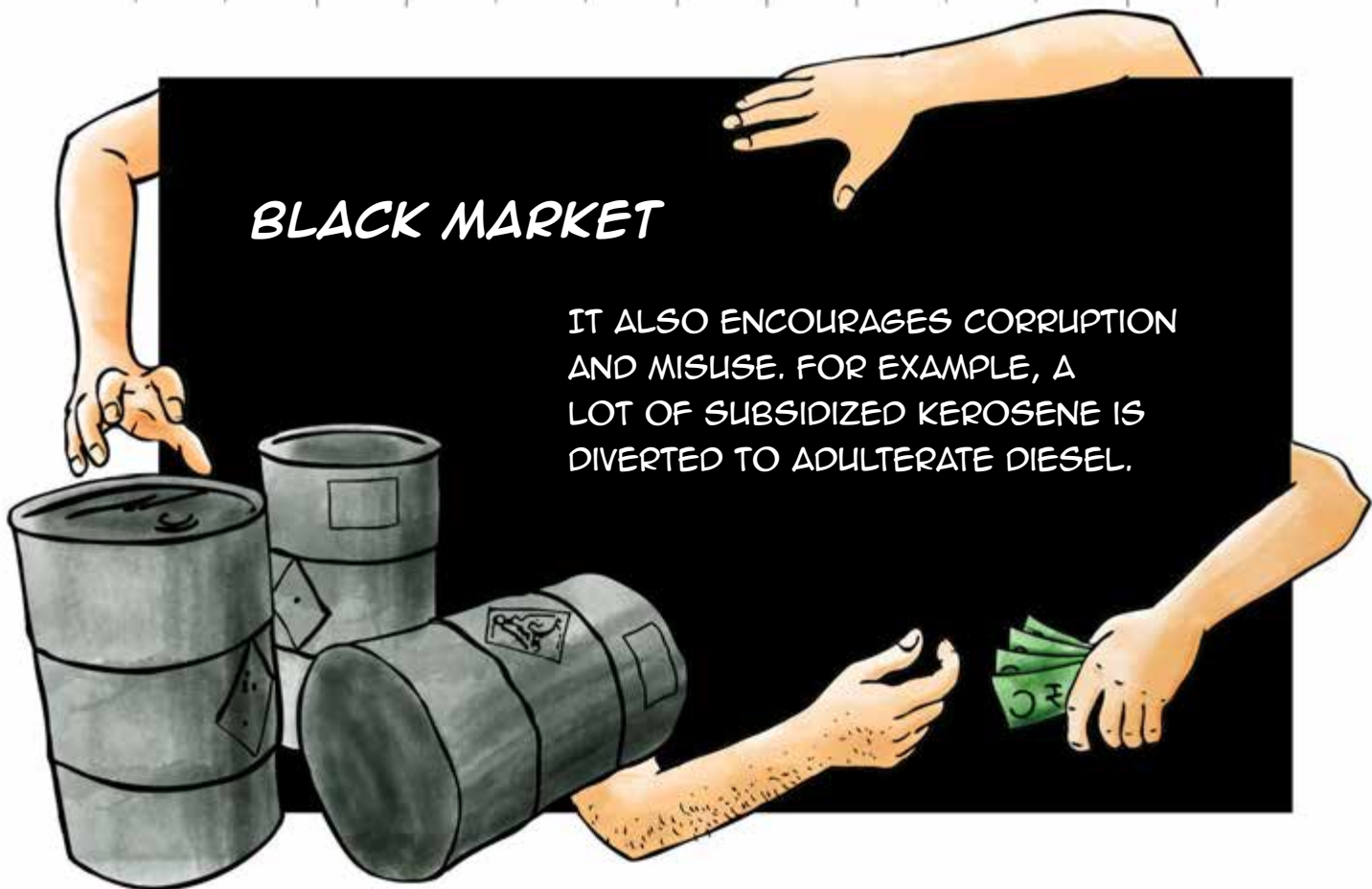
FOR EXAMPLE, SUBSIDIZING FOSSIL FUELS—ESPECIALLY WHEN MARKET PRICES SPIKE—STRAINS THE NATIONAL BUDGET, DRIVING UP THE FISCAL DEFICIT.

BUDGET

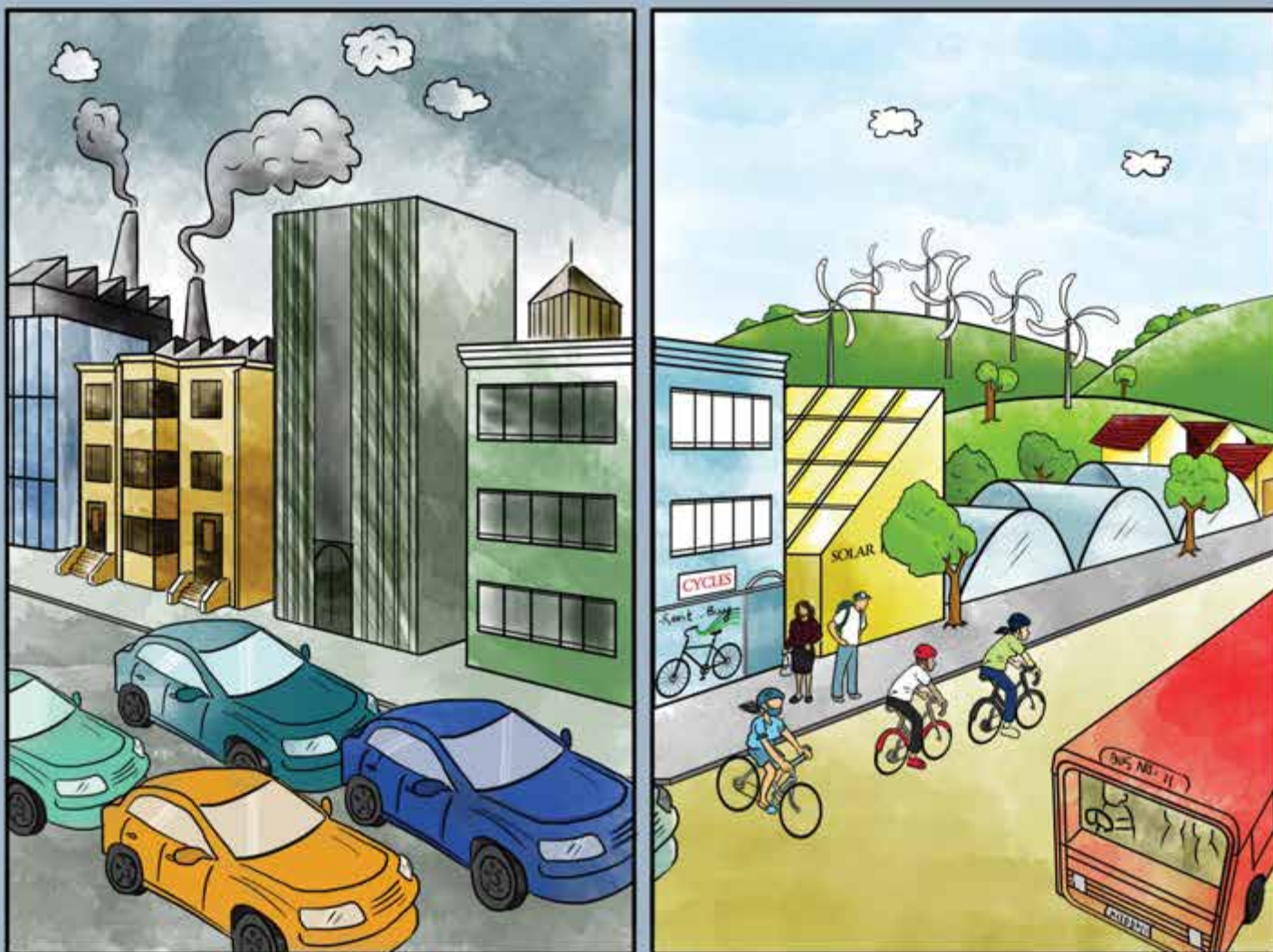


BLACK MARKET

IT ALSO ENCOURAGES CORRUPTION AND MISUSE. FOR EXAMPLE, A LOT OF SUBSIDIZED KEROSENE IS DIVERTED TO ADULTERATE DIESEL.



SUBSIDIES ALSO ENCOURAGE THE OVERUSE OF FOSSIL FUELS. LOCAL AND REGIONAL POLLUTION IS ANOTHER MAJOR CONSEQUENCE: INDUSTRY AND CONSUMERS TEND TO USE FOSSIL FUELS LESS EFFICIENTLY WHEN THEY ARE CHEAPER, INCREASING AIR POLLUTION AND EXACERBATING GLOBAL WARMING.



FURTHERMORE, CHEAP FOSSIL FUELS DUE TO SUBSIDIES REDUCE THE INCENTIVE TO INVEST IN ENERGY-EFFICIENT APPLIANCES AND RENEWABLE ENERGY. OIL COMPANIES COULD ALSO BE INVESTING IN MORE ENERGY-EFFICIENT TECHNOLOGY, BUT UNDER-RECOVERIES DISCOURAGE THEM FROM DOING SO.

UM, CAN YOU EXPLAIN
UNDER-RECOVERY ONE
MORE TIME?

OF COURSE.
IMAGINE THAT YOU'RE AN
ENTREPRENEUR, SELLING
DRINKING WATER AT A
MARATHON RACE...

...SINCE DRINKING WATER IS AN ESSENTIAL COMMODITY FOR RUNNERS,
THE ORGANISERS INSIST THAT YOU SELL THE WATER AT 10/- A BOTTLE.
SINCE THE ACTUAL COST OF EACH BOTTLE IS 12/-,
YOU ARE GOING TO LOSE MONEY.



**BUT THAT'S NOT THE
WHOLE STORY...**



PRETEND, ALSO, THAT THE ORGANIZERS LET YOU RUN A T-SHIRT, MUGS AND SOUVENIR SHOP, THAT IS VERY PROFITABLE. YOU CAN AFFORD TO RUN THE DRINKING WATER STALL, SIMPLY BASED ON THE REVENUE YOU GET FROM THE SOUVENIR SHOP.

OMCs TOO ARE SOMEWHAT DIVERSIFIED—THEY RECEIVE INCOME FROM DIVIDENDS, PIPELINES, OTHER FREELY-PRICED PRODUCTS AND EXPORTS. IN OTHER WORDS, WHILE THEY MAY BE EXPERIENCING AN UNDER-RECOVERY IN CERTAIN DOMESTIC PRODUCT MARKETS, THE OMCs OVERALL AREN'T NECESSARILY EXPERIENCING A FINANCIAL LOSS¹.

¹ While this simple example provides a general explanation, the pricing mechanisms used and the specifics as to how companies calculate their under-recoveries are a bit more complicated and go beyond the scope of this paper. A more in-depth summary of pricing, taxes, subsidies and under-recoveries—especially for diesel—is available in M. Anand's (2012, August) Diesel Pricing in India: Entangled in Policy Maze. New Delhi: National Institute of Public Finance and Policy, pp. 22–30. Available at <http://www.nipfp.org.in/newweb/sites/default/files/Diesel%20Price%20Reform.pdf>

OKAY, THE SUBSIDIES DON'T SOUND LIKE A GREAT DEAL FOR THE OIL INDUSTRY... BUT I PAY TAXES ON FUEL. DOESN'T THAT OFFSET THE COST OF THE SUBSIDY?

THERE ARE VERY GOOD REASONS WHY THE FOSSIL-FUEL SECTOR IS TAXED...

FIRST, THE TAXES ARE COLLECTED WITH THE PRIMARY INTENT OF FUNDING SOCIAL SERVICES TO THE PUBLIC.

SECOND, THE *UPSTREAM* COMPANIES ARE TAXED BECAUSE THE NATURAL RESOURCES THEY EXPLOIT ARE THE PUBLIC'S RESOURCES TO BEGIN WITH, AND SO THE PUBLIC SHOULD BE COLLECTING A PORTION OF THE PROFIT.

THIRD, *DOWNSTREAM* ACTIVITIES ARE TAXED FOR A DIFFERENT REASON: TO PAY FOR ROADS, COVER THE COSTS ASSOCIATED WITH POLLUTION AND ENCOURAGE CONSUMERS TO CHOOSE CLEANER FORMS OF ENERGY.

NOW, HOW YOU SPEND THAT REVENUE IS AN ENTIRELY DIFFERENT QUESTION, AND SHOULD BE DECIDED BASED ON THE MOST EFFECTIVE AND EFFICIENT WAYS TO PROVIDE FOR THE NEEDS OF CITIZENS.



HMM, I CAN SEE THAT THERE ARE SOME DEFINITE DISADVANTAGES TO THESE SUBSIDIES. SO WHAT IS THE GOVERNMENT DOING TO REMOVE FOSSIL-FUEL SUBSIDIES?

THE GOVERNMENT WOULD LIKE TO KEEP TOTAL SUBSIDIES (INCLUDING FOR FERTILIZER AND FOOD) TO LESS THAN 2 PER CENT OF ECONOMIC OUTPUT IN 2013-2014 AND LESS THAN 1.75 PER CENT OVER THE FOLLOWING THREE YEARS. TOWARD THAT END, IT HAS BEEN GRADUALLY INSTITUTING A NUMBER OF REFORMS.

IN JUNE 2010 THE GOVERNMENT LIBERALISED GASOLINE PRICES, WITH PLANS TO SOON DECONTROL DIESEL PRICES AS WELL, BUT—





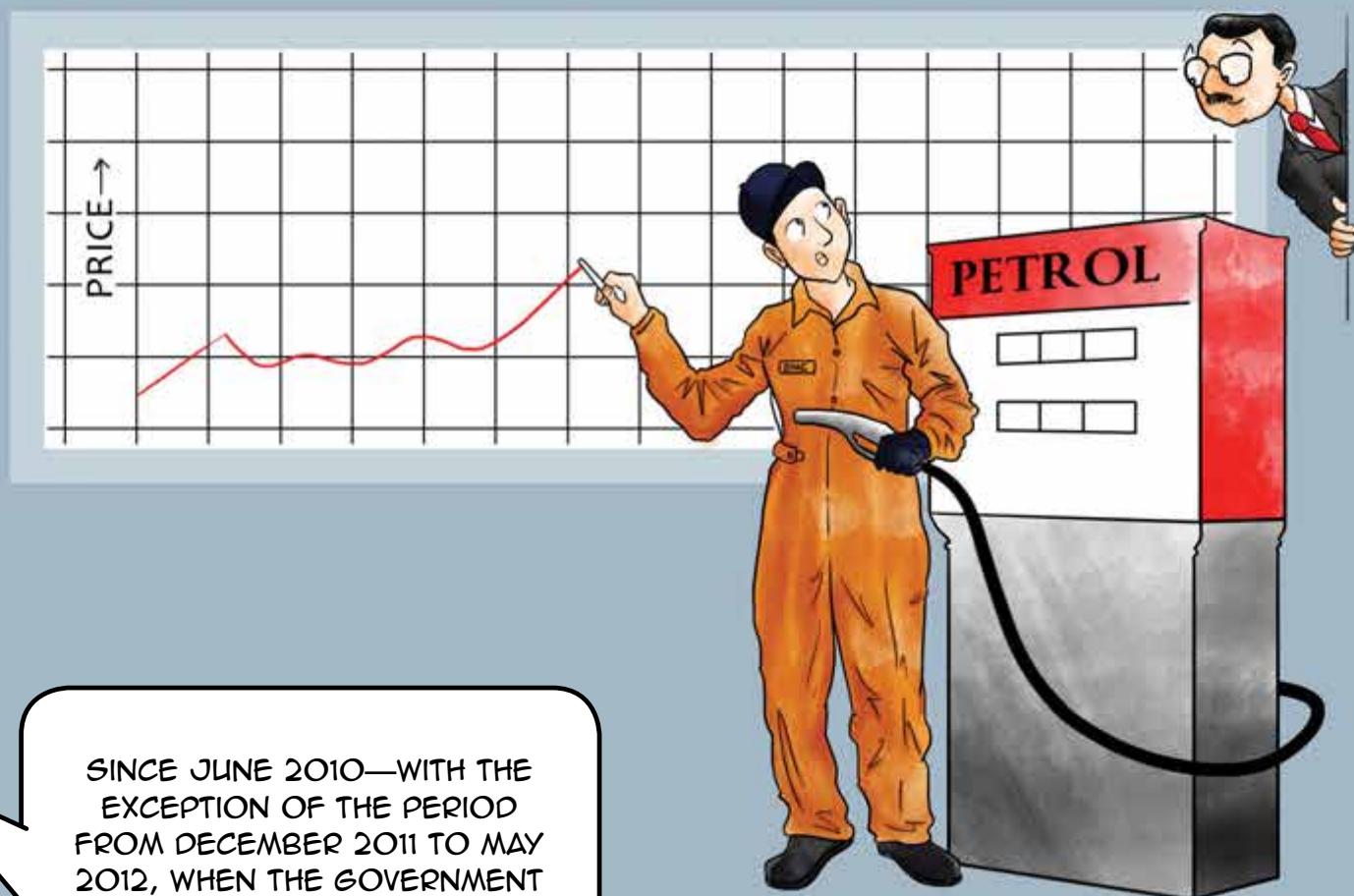
HOLD ON A MINUTE.
WHAT DO YOU MEAN
BY "LIBERALIZE" AND
"DECONTROL"?

WHEN THE GOVERNMENT
DETERMINES THE PRICE
AT WHICH FUELS MUST
BE SOLD, PRICES AREN'T
"FREE" TO MOVE WITH
THE MARKET.

AS THE GOVERNMENT ALLOWS PRICES TO FLUCTUATE A BIT
ON REGULAR INTERVALS, IT IS PARTIALLY LIBERALIZING (OR
"DECONTROLLING") THE PRICE. PRICES ARE COMPLETELY
LIBERALIZED WHEN FORCES OF SUPPLY AND DEMAND
IN THE ECONOMY DETERMINE PRICE.

IN OTHER WORDS, COMPANIES SET THE
PRICE THEMSELVES, BASED ON CONSUMER
DEMAND AND THE COST AT WHICH THEY ARE
ABLE TO SUPPLY THE PRODUCT.

I THINK I UNDERSTAND. SO WHAT WERE YOU SAYING ABOUT DIESEL AND GASOLINE PRICES?



SINCE JUNE 2010—WITH THE EXCEPTION OF THE PERIOD FROM DECEMBER 2011 TO MAY 2012, WHEN THE GOVERNMENT TEMPORARILY FROZE GASOLINE PRICES—DOWNSTREAM OMCs HAVE BEEN ABLE TO CHANGE THE PRICE OF GASOLINE AT REGULAR INTERVALS (BUT MUST STILL SEEK APPROVAL FROM THE GOVERNMENT).

...AND STARTING IN JANUARY 2013 (AFTER A LARGE, ONE-OFF PRICE HIKE IN SEPTEMBER 2012), THE GOVERNMENT HAS BEEN PHASING IN REGULAR PRICE INCREASES FOR DIESEL. MOREOVER, DIESEL IS ALREADY BEING SOLD TO BULK BUYERS AT MARKET RATES.

WHAT ABOUT LPG AND KEROSENE?



THE DISTRIBUTION OF LPG CYLINDERS IS ALSO BEING CHANGED. THE CYLINDERS WILL BE SOLD AT PREVAILING MARKET RATES...



...WHILE THE SUBSIDIES WILL BE DIRECTLY TRANSFERRED TO THE BANK ACCOUNTS OF RECIPIENTS.



ELIGIBLE CONSUMERS ARE ALLOWED TO PURCHASE A MAXIMUM OF NINE SUBSIDIZED CYLINDERS (UP FROM SIX IN 2012); MORE CAN BE PURCHASED, BUT AT THE FULL PRICE. SINCE THE CASH TRANSFERS A CONSUMER RECEIVES WILL STILL BE LINKED DIRECTLY TO HOW MANY CYLINDERS SHE OR HE BUYS, THE SUBSIDY IS EFFECTIVELY REMAINING IN PLACE, IT IS JUST TAKING ON A NEW FORM.

WON'T THE PRICE INCREASE IN THESE FUELS MAKE PRICES GO UP THROUGHOUT THE ECONOMY?

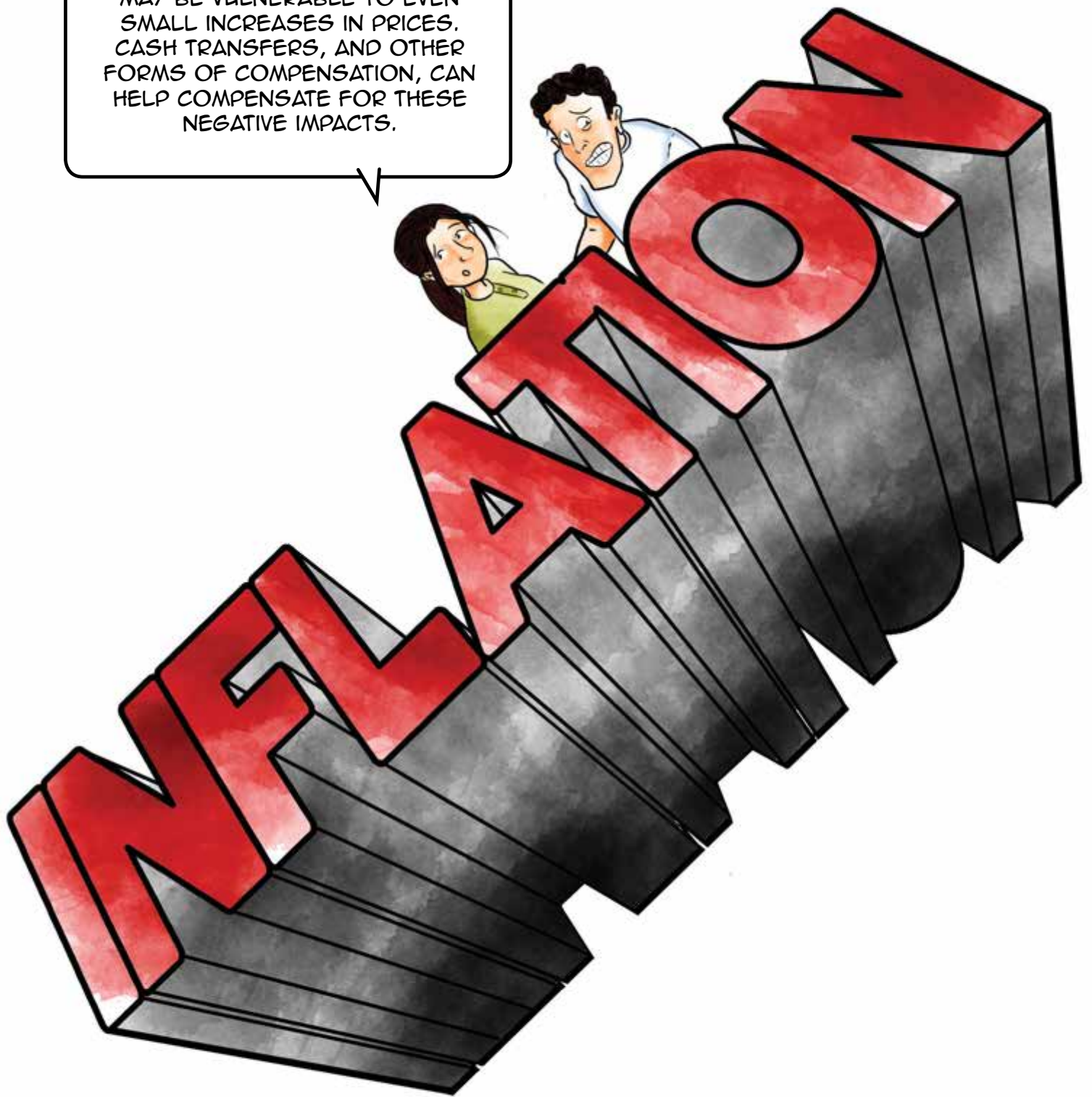
THE ULTIMATE EFFECTS OF FOSSIL-FUEL SUBSIDY REFORM ON INFLATION ARE HARD TO PREDICT. ONE STUDY ESTIMATES THAT AN INCREASE OF 25 CENTS PER LITRE OF FUEL WOULD DECREASE HOUSEHOLD INCOMES BY 5.9 PER CENT. ANOTHER ESTIMATE FOUND THAT EVERY 10 PER CENT INCREASE IN GLOBAL CRUDE PRICES, WHEN FULLY PASSED THROUGH, COULD HAVE A 1 PER CENT TO 2 PER CENT INCREASE IN WHOLESALE PRICE INDEX INFLATION².



SO FAR, NO MOVES HAVE BEEN MADE TO DEREGULATE THE PRICE OF SUBSIDIZED KEROSENE. HOWEVER, THE GOVERNMENT HAS BEEN REDUCING THE OVERALL ALLOCATION OF SUBSIDIZED KEROSENE.

² For a brief overview of existing studies, see K. Lang & P. Wooders (2012, August). *India's Fuel Subsidies: Policy recommendations for reform*. Geneva: Global Subsidies Initiative of the International Institute for Sustainable Development, p. 10. Available at <http://www.iisd.org/gsi/supporting-country-reform-efforts/fuel-subsidies-india>

WHILE THE OVERALL EFFECTS OF REDUCING FOSSIL-FUEL SUBSIDIES ARE POSITIVE, POOR HOUSEHOLDS MAY BE VULNERABLE TO EVEN SMALL INCREASES IN PRICES. CASH TRANSFERS, AND OTHER FORMS OF COMPENSATION, CAN HELP COMPENSATE FOR THESE NEGATIVE IMPACTS.



IT SEEMS LIKE A LOT OF TROUBLE TO GO THROUGH TO ELIMINATE FOSSIL-FUEL SUBSIDIES. REMIND ME OF THE CONCRETE BENEFITS I'LL SEE WHEN ALL IS SAID AND DONE.



WHEN FOSSIL FUELS ARE PRICED ACCORDING TO THE MARKET, THE COUNTRY'S ECONOMY WILL BECOME MORE EFFICIENT. THAT IS:

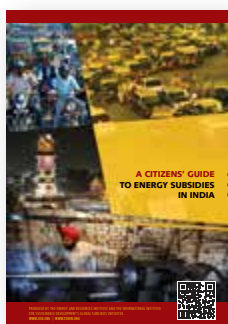
- ◇ Industry, agriculture and consumers will start upgrading to energy-efficient equipment and transport, eliminating unnecessary or excessive use of fuel and switching to competing (often cleaner) forms of energy
- ◇ This will spur GDP growth, improve macro-economic stability and reduce air pollution (and thus public health)
- ◇ And the government will have more funds to spend on priorities like health and education.

THE GOOD CONSEQUENCES THAT FOLLOW ON FROM THESE THREE BENEFITS ARE TOO NUMEROUS TO NAME.





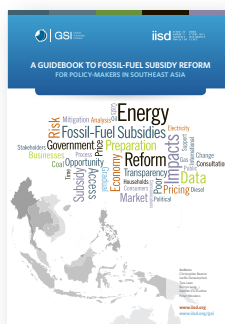
TO DIG A BIT DEEPER INTO ENERGY SUBSIDIES IN INDIA, CHECK OUT:



A CITIZEN'S GUIDE TO ENERGY SUBSIDIES IN INDIA

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TO LEARN HOW GOVERNMENTS CAN BEST GO ABOUT REFORMING FOSSIL-FUEL SUBSIDIES, CHECK OUT:



A GUIDEBOOK TO FOSSIL-FUEL SUBSIDY REFORM FOR POLICY-MAKERS IN SOUTHEAST ASIA

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THE INTERNATIONAL INSTITUTE FOR SUSTAINABLE DEVELOPMENT'S GLOBAL SUBSIDIES INITIATIVE

The International Institute for Sustainable Development (IISD) launched the Global Subsidies Initiative (GSI) in December 2005 to put a spotlight on subsidies – transfers of public money to private interests – and how they undermine efforts to put the world economy on a path toward sustainable development.

Subsidies are powerful instruments. They can play a legitimate role in securing public goods that would otherwise remain beyond reach. But they can also be easily subverted. The interests of lobbyists and the electoral ambitions of officeholders can hijack public policy. Therefore, the GSI starts from the premise that full transparency and public accountability for the stated aims of public expenditure must be the cornerstones of any subsidy program.

But the case for scrutiny goes further. Even when subsidies are legitimate instruments of public policy, their efficacy – their fitness for purpose – must still be demonstrated. All too often, the unintended and unforeseen consequences of poorly designed subsidies overwhelm the benefits claimed for these programs. Meanwhile, the citizens who foot the bills remain in the dark.

When subsidies are the principal cause of the perpetuation of a fundamentally unfair trading system, and lie at the root of serious environmental degradation, the questions have to be asked: Is this how taxpayers want their money spent? And should they, through their taxes, support such counterproductive outcomes? Eliminating harmful subsidies would free up scarce funds to support more worthy causes. The GSI's challenge to those who advocate creating or maintaining particular subsidies is that they should be able to demonstrate that the subsidies are environmentally, socially and economically sustainable – and that they do not undermine the development chances of some of the poorest producers in the world.

To encourage this, the GSI, in cooperation with a growing international network of research and media partners, seeks to lay bare just what good or harm public subsidies are doing; to encourage public debate and awareness of the options that are available; and to help provide policy-makers with the tools they need to secure sustainable outcomes for our societies and our planet.

www.iisd.org/gsi

The GSI is an initiative of the International Institute for Sustainable Development (IISD). Established in 1990, the IISD is a Canadian-based not-for-profit organization with a diverse team of more than 150 people located in more than 30 countries. The GSI is headquartered in Geneva, Switzerland and works with partners located around the world. Its principal funders have included the governments of Denmark, the Netherlands, New Zealand, Norway, Sweden and the United Kingdom. The William and Flora Hewlett Foundation have also contributed to funding GSI research and communications activities.



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