

POLICY *Brief*

Achieving the G-20 Call to Phase Out Subsidies to Fossil Fuels

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Introduction

One might expect governments would leap at any opportunity to save themselves money while also reducing carbon dioxide and other harmful emissions. Yet progress on phasing out fossil-fuel subsidies has been painfully slow. The recent announcement by the Leaders of the Group of Twenty (G-20), (who met 24-25 September, 2009 in Pittsburgh, PA) finally gives recognition to that opportunity. In their communiqué, the G-20 Leaders noted that:

“Many countries are reducing fossil fuel subsidies while preventing adverse impact on the poorest. Building on these efforts and recognizing the challenges of populations suffering from energy poverty, we commit to ... Rationalize and phase out over the medium term inefficient fossil fuel subsidies that encourage wasteful consumption.”

There is much more to implementing reform than political statements and off-the-shelf solutions. The G-20 countries need to establish standardised and regular reporting on fossil-fuel subsidies and an international framework for monitoring them. Effective reform measures require clear objectives and timeframes; rigorous and thorough research to identify subsidies and evaluate their effects; a coherent package of policies; a communications strategy combined with extensive consultation with stakeholders; and a process for reviewing progress towards reform. In short, a lot of hard work remains to be done.

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WHAT DO THE G-20 MEAN BY FOSSIL-FUEL SUBSIDIES?

The countries that are represented by the G-20 include several economies—China, India, Indonesia, Russia and Saudi Arabia—that subsidize the end-use prices of one or more fossil fuels. These *consumer subsidies* are relatively easy to identify. They occur when fossil fuels are supplied to consumers at prices below a reference or “world” level. The fossil fuels most commonly subsidised are petroleum products for private transport, kerosene and liquefied petroleum gas (“bottled gas”) used by residential consumers, and fossil fuels used by power generators and certain industries considered to be of strategic importance. Additionally, many of the Organisation for Economic Co-operation and Development (OECD) countries provide indirect support for consumption, such as through subsidies for airline service to remote areas.

In addition, most, if not all, of the G-20 countries are believed to provide support that benefits producers of fossil fuels. Producer subsidies can take many forms, including direct grants, preferential tax treatment, below-market payments for access to publicly-owned resources, subsidized or government guaranteed loans, and government assumption of liability for accidents.

HOW BIG ARE FOSSIL-FUEL SUBSIDIES?

The International Energy Agency (IEA) has provided occasional estimates of the scale of consumer subsidies to fossil fuels and electricity within the 20 largest developing countries. Using 2005 data, the IEA estimated that these subsidies were worth \$220 billion (all dollar amounts are U.S. dollars). By 2007, these had increased to \$310 billion, principally due to increases in world fuel prices (see Figure 1 on page 3). Approximately 75 per cent of the subsidies were to fossil fuels and the balance to electricity, much of which is generated from fossil fuels. It is clear that these estimates are incomplete. They ignore consumer subsidies in other countries and the producer subsidies believed to be provided in almost all countries.

What we know about producer subsidies is much more limited. A few detailed studies have been undertaken, for example by Earthtrack (who estimated U.S. subsidies for the energy sector at between \$37 and \$64 billion in 2003) and by Greenpeace (whose estimates for the EU in the late 1990s were over \$10 billion per year).

It is difficult to postulate a global figure for fossil-fuel subsidies, but the GSI estimates that the annual figure could be at least \$500 billion—the majority (around \$400 billion) from subsidized end-user prices, and the balance from producer subsidies. Roughly \$500 billion a year is equivalent to 1 per cent of world gross domestic product, the figure that the Stern Review¹ estimated was required to limit global warming to no more than a 2° Celsius rise in temperature.

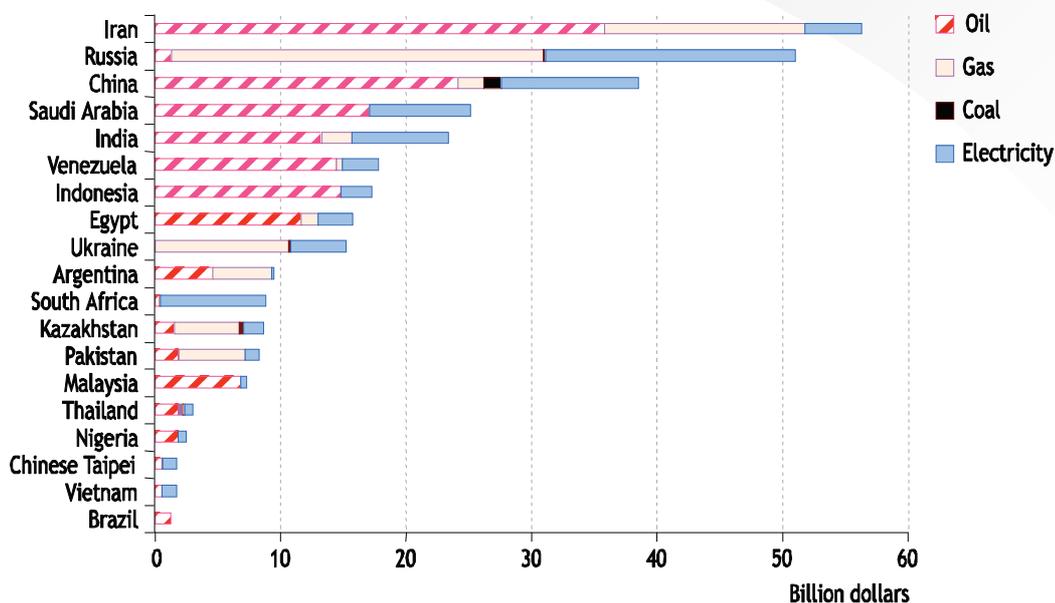
¹ Nicholas Stern, *Stern Review: The Economics of Climate Change*, HM Treasury, United Kingdom, 2006.



HOW BIG ARE FOSSIL-FUEL SUBSIDIES?

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FIGURE 1: ENERGY SUBSIDIES BY FUEL IN NON-OECD COUNTRIES, 2007



Source: International Energy Agency (IEA)

WHAT IMPACT WOULD THE REMOVAL OF FOSSIL-FUEL SUBSIDIES HAVE?

Governments are realising that taxing carbon with one hand while with the other hand continuing to subsidize consumption of the fuels that contain it makes no sense. The G-20 communiqué recognises this fact:

“Inefficient fossil fuel subsidies encourage wasteful consumption, distort markets, impede investment in clean energy sources and undermine efforts to deal with climate change.”

A recent study by the OECD found that removing just the consumer subsidies to energy in the 20 largest developing countries over the next decade would reduce global greenhouse gas emissions by 2 per cent in 2020, rising to 10 per cent in 2050².

There has been little exploration of the social and economic impacts of removing subsidies to fossil fuels. A survey of the existing research³, commissioned by the GSI, shows that in addition to climate and other environmental impacts, subsidies can have complex economic and social consequences. They are an enormous drain on government finances, they are often diverted to purposes for which they were not intended, and they often promote smuggling and corruption.

² Burniaux et al., *The Economics of Climate Change Mitigation: How to Build the Necessary Global Action in a Cost-Effective Manner*, OECD, 2009.

³ Jennifer Ellis, *Approaches to Assessing the Impacts of Fossil Fuel Subsidy Reform*, will be released in November 2009.

BUT AREN'T SOME OF THESE SUBSIDIES GOOD?

Debate over subsidy reform is hampered by misconceptions and the influence of special-interest groups. In the case of consumer subsidies, their defenders are quick to argue that, by lowering the cost of fuel and electricity for the poor, the subsidies meet social policy objectives. But, typically, most of the benefits go to the wealthy (for example, those who can afford motor vehicles and those who are connected to the electricity grid and who have high rates of ownership of electrical goods.) Similarly, subsidies for domestic production of fossil fuels are often justified in the name of energy self-sufficiency, which is erroneously equated with national security.

At best, fuel subsidies are a blunt instrument for dealing with social problems. Governments would generally be better served by phasing them out and compensating the poor using more targeted instruments. As for production subsidies, many simply enrich producers, and all in the end are self-defeating—by accelerating domestic production in the short and medium term, they exhaust the domestic resource earlier than would have occurred otherwise.

WHAT IS NEEDED FOR REFORM?

Greater transparency

In their communiqué, the G-20 refer only to consumption subsidies, notably those provided through regulated or subsidized prices, which are common in many developing and transition countries. Invoking these kinds of subsidies may have simply been for purposes of illustration, and not meant to signal that the initiative would address only them. But the sooner the G-20 clarify this matter the better.

To focus only on consumption subsidies in developing countries and countries in transition would, in our opinion, doom the initiative from the start. To be seen as fair and equitable, all G20 countries need to show that they are serious about phasing out their subsidies to fossil fuels, whether those subsidies are provided through artificially reduced prices, subsidies for fossil-fuel-consuming activities, or to fossil-fuel production.

Unlike for agriculture, there is no international framework for regularly monitoring and analyzing subsidies to energy. Analysts have had mainly price data to work with and have, therefore, concentrated on the most visible subsidies to consumption. More indirect subsidies to consumption, and subsidies for production, have consequently received much less attention.

Policy Recommendation 1: The G-20 countries need to establish standardized and regular reporting on fossil-fuel subsidies and an international framework for monitoring them.

Awareness of the size, extent and effects of subsidies to fossil fuels is still not adequately appreciated by policy-makers. Greater awareness of these consequences should lead to the avoidance of some new, poorly-designed policies being adopted, and pressure for the reform of existing ones. It has been a prerequisite for negotiating all multilateral subsidy phase-out agreements to date, but it would only be the first step. The bigger challenge will be the political one.

WHAT IS NEEDED FOR REFORM?

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An understanding of the political motivations behind subsidies

As explained by Stanford University Professor David Victor in a study⁴ commissioned by the GSI, the political logic that keeps subsidies to fossil fuels in place differs according to circumstance. Consumer subsidies are usually broad-based (though often benefit the richer segments of societies), transparent and generally hard to reform without provoking street protests. Producer subsidies may be having some depressing effect on end-user prices, but their main effect is to boost local production. Oil producers who receive tax breaks do not generally pass on those tax breaks to consumers through lower prices. They pass them on to shareholders in their companies or use the increased profits to develop new oil fields. Those corporations and their shareholders do not need to take to the street, as they tend to have more direct access to the political levers of power.

Policy Recommendation 2: Policy-makers need to understand the complex political motivations and interest groups behind each subsidy in order to plan effective communication and consultation strategies for successful reform.

Learning from past experience

Many national governments, G-20 countries included, have attempted reform of some fossil-fuel subsidies with varying degrees of success. A review⁵ carried out for the GSI on some of these experiences draws on common elements to provide policy guidance for planning effective reform measures.

Policy Recommendation 3: Planning an effective subsidy reform strategy requires:

- clear objectives and timeframes;
- rigorous and thorough research to identify subsidies and evaluate their effects;
- a coherent package of policies (including flanking measures to cushion any negative effects of reform);
- a communications strategy combined with extensive consultation with stakeholders;
- the creation of an ongoing monitoring system; and
- a peer review process for reviewing progress.

⁴ *On the Political Economy of Fossil-Fuel Subsidies*, will be released in October 2009.

⁵ The GSI has reviewed and commissioned case studies for reform of fuel-specific subsidies in Ghana, France, Senegal, Indonesia, India, Poland and Brazil. The first of these reports will be released in October 2009.



WHAT ARE THE NEXT STEPS?

The G-20 communiqué asks their Energy and Finance Ministers to develop implementation strategies and timeframes, and report back to Leaders at the next Summit, which will take place in Huntsville, Ontario, Canada in June 2010. In addition, the G-20 have asked international financial institutions to offer support to countries during this process, and for the IEA, OECD, Organization of Petroleum-Exporting Countries and the World Bank, to take the lead in responding to this mandate. In particular, the communiqué requests these organisations to provide:

“an analysis of the scope of energy subsidies and suggestions for the implementation of this initiative...”

Before embarking on this project, the G-20 would be wise to avoid duplicating work being done elsewhere. One year ago, the GSI launched a specific three-year initiative focused on quantifying and reforming subsidies to fossil fuels. 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 of some of the poorest economies of the world.

The GSI's five-step work program provides the basis for responding to G-20s' needs:

- 1. identify the various policies that are supporting the production or consumption of fossil fuels;**
- 2. quantify the subsidy equivalents of those policies;**
- 3. assess the economic, environmental and social impacts of fossil-fuel subsidies, and of their reform;**
- 4. develop strategies for reforming those subsidies that are having perverse effects; and**
- 5. promote reform through political outreach and awareness-raising.**

Views on subsidy reform tend to be contradictory; the benefits of subsidy reform are widely trumpeted, but it is a commonly-held view that reform is difficult if not impossible. The reality is more mundane. Subsidy reform is possible. But it will require painstaking, structured work and political leadership. The GSI welcomes the opportunity to collaborate with G-20 governments and international governmental organizations to put reform into practice.

FURTHER DETAILS AND CONTACT INFORMATION

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.

See the GSI's Subsidy Primer for a plain-language guide to subsidies on: www.globalsubsidies.org.

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