Reforming fossil fuel subsidies in Asia

Han Phoumin
JAKARTA

Energy is heavily subsidized across the globe and energy subsidies exert an extensive economic burden on many countries, particularly on developing economies.

The Economic Research Institute for ASEAN and East Asia (ERIA) and the International Energy Agency estimate that fossil fuel subsidies amounted to US$51 billion in Southeast Asia in 2012. It is widely accepted that fossil fuel subsidies encourage wasteful energy use and burden government budgets. They also defer investment in energy infrastructure and efficient technology and undermine renewable energy undertakings.

While some ASEAN countries, India and China have acted to remove the subsidies, governments must be cautious in doing so as removing subsidies can often be politically sensitive.

On one hand, energy subsidies incentivize consumption and can result in increased energy demand. Conversely, when the subsidies are inefficient, they can lead to fiscal pressure, harmful emissions and potentially hamper sustainable green growth in East Asia Summit (EAS) countries. Reducing subsidies should encourage more energy efficient consumption, have positive impacts on international energy prices and energy security and make renewable energy and technologies more competitive. The environment and society should also benefit from reductions in local pollution and greenhouse gas emissions.

To support ASEAN and East Asian countries in carrying out sound energy policy reform, ERIA, in cooperation with energy research institutes from the EAS region, has undertaken a study on, "Energy Subsidies Removal in the East Asia Summit Region" at a time when countries in ASEAN and East Asia, such as Malaysia, Indonesia, Thailand, China and India, are embarking on energy reform by removing their energy subsidies.

The key findings suggest potential economic impact of removing the energy subsidies:

In Malaysia's case, removal of either a petroleum or gas subsidy or both would improve economic efficiency and increase gross domestic product (GDP) by up to almost 1 percent in the short term. The immediate impact would be that the budget deficit would be greatly reduced after removing the government-funded petroleum subsidy.

In Thailand's case, the removal of fossil fuel subsidies, with reallocation of the money saved from subsidies to households and the government budget, is projected to have a negligent impact on the country's GDP in the short term. Hence, policymakers do not need to be concerned about possible negative effects when deciding whether to implement the reforms.

In India's case, the government wants to remove subsidies for liquefied petroleum gas (LPG) as LPG is used as the primary cooking fuel by urban and rural households, as well as commercial establishments. However, the LPG subsidy seems to benefit the rich more than the poor as most of it goes to urban dwellers (who receive a 69 percent share of the LPG subsidy). The study's findings suggest that removing the LPG subsidy would have little impact on the rate of economic growth. This supports the removal of the energy subsidy if the government wishes to pursue it.

In China's case, the country's total energy subsidies in 2010 accounted for 4.7 percent of the GDP. The coal subsidy was the highest, accounting for 1.97 percent of the total GDP, followed by the electricity subsidy, which accounted for 0.73 percent of the total GDP.

The study focused on the removal of energy subsidies in China's iron and steel industries. The findings suggest that removing energy subsidies will induce costs, and thus require technological innovation for higher energy efficiency through aggressive policy support. The study also suggests that removing the energy subsidy could correct negative environmental externalities and improve social welfare in China.

The above studies, however, point out that removal of the energy subsidies will induce costs at all levels and households will be worse off in the short term as a result of higher prices. Therefore, carefully crafted compensating policies are needed.

For leaders and policymakers, energy subsidy reforms are a challenging task as they have positive impacts in the long term, but negative impacts on the economy and society in the short term. Therefore, the study offers the following recommendations:

While energy subsidy reforms have shown positive impacts in the long run, they need to be well targeted for those who need energy for their basic needs for cooking, lighting and transportation. In the short run, the removal of energy subsidies will affect the basket of consumption, especially the inflation of commodity prices that are related to the transportation costs to produce commodities, products and services. In this regard, a well-designed program to target and safeguard the poor will be needed, either through well-targeted fund transfers to the poor or through energy consumption rations for the poor. Among the case studies, the Malaysian government has prepared for this, but it needs to keep monitoring how the subsidy' funds reach the intended beneficiaries and recommend any corrective actions that may be required during the course of program implementation.

Another important point is that the government will need to publicize cash transfers to support the poor during the gradual removal of energy subsidies. Transparency will gather public support in the reform process. Public campaigns and education outreach on energy subsidies removal will be needed to clearly show how energy subsidies impact welfare, discourage investment, reduce competition and obstruct ASEAN's goal of achieving higher incomes.

In addition to the energy subsidy policy reform, the governments of the ASEAN countries, India and China have carried out other reforms, such as reforms to promote energy efficiency and energy security through increasing the renewable energy share, and reforms to achieve the right mix of power generation, including the option of using nuclear energy in the future. Meaningful reform, therefore, will take a holistic view of the energy issues, and many ASEAN countries, India and China are on the right track with the policies they have embarked upon.

The writer is an energy economist at the Economic Research Institute for ASEAN and East Asia (ERIA). The views expressed are his own and do not reflect ERIA's position.