

Downsizing fuel subsidies

Subsidies have long been used in many countries, both developed and developing, to encourage production of some goods and services and/or to lighten the burden on consumers. Many developing countries have resorted to fuel subsidies since 2004 to protect consumers from rising fuel prices. Malaysia has been subsidising liquefied natural gas (LNG) since January 1990, diesel since October 1999, and petrol since June 2005.

The main problems with price subsidy are that (a) it tends to encourage over-consumption and wastage, (b) price distortions cause serious misallocation of resources, and hence economic inefficiency, (c) it impedes supply and demand adjustments, and (d) it is a source of strain on national budgets.

Fuel subsidy removals would force the consumers to pay market prices for fuel, making them more cost-conscious and raising fuel efficiency. One of the many causes of rising oil prices in the world today is excessive consumption attributed to fuel subsidy practiced in many developing countries, including China.

Evidently, fuel consumption in developed countries has been falling significantly in recent years, but rising sharply in developing countries. The decline in developed countries has been more than offset by the rise in developing countries. If fuel subsidies are removed everywhere, fuel consumption would fall, thereby removing one of the major sources of price pressures.

It is pertinent to note that fuel consumption is taxed, not subsidised, in most developed countries, to penalise excessive consumption and to ensure fuel efficiency. Some developing countries, including India, are also taxing petrol, while subsidising diesel consumption, to be more equitable.

Abrupt removal of subsidies would cause considerable pain for consumers, especially those on tight household budgets. Since fuel is a strategic item, any sharp increase in fuel price would lead to price increases all over, with severe inflationary consequences. A gradual removal, based on a clear timeline and price formula, would do the trick.

Removal of fuel subsidies would raise costs, but since all countries across the board are affected, relative competitiveness of countries may not suffer much. Economic growth would suffer in the short run, as countries raise interest rates in the face of inflationary pressures, but economic efficiency will improve over time due to improvements in resource allocation.

The fact that Malaysia is a net exporter of oil does not really make a difference to the case for eliminating the fuel subsidy. As an oil exporter Malaysia, of course, gains from the rising price of oil in the world market, but the point is that the oil revenue belongs to the future generation as well. Using the oil revenue to finance the fuel subsidy is tantamount to trading off the future for the present to the extent that resources are shifted from investment to consumption.

Evidently, fuel subsidy has made a hole in the country's budget, contributing to the fiscal deficit, which stood at 3.2 per cent of gross domestic product (GDP) in 2007 when the price of petrol was at less than one-half of what it is today. One can imagine the budgetary strain fuel subsidy would cause this year at crude oil prices of about USD130 per barrel, if nothing were done to restructure the subsidy scheme.

Last year, fuel subsidy cost RM8.77 billion, with crude oil prices averaging USD79. The fuel subsidy sum for 2008 was estimated at RM18.31 billion based on the assumption that the price of crude oil would hover around USD105 per barrel. By the first week of June 2008, however, the price of oil had hit USD127 per barrel, way beyond earlier assumptions.

There are thus strong economic grounds for scrapping the fuel subsidy, but care must be taken to ensure that the subsidy system is undone in a gradual and orderly way so as not to impose undue hardship on people, especially the poor.

Seen in these terms, it is not difficult to understand why many governments in the region, including Indonesia, Malaysia and China, have recently resorted to subsidy cuts, which have resulted in higher retail prices of fuel.

Malaysia could have done much better, notwithstanding the fact that the government could start with the right foot by raising fuel prices by 30 sen in February 2006 when the price of crude oil had hit USD67 per barrel. There have been talks of further price hikes as the price of crude oil soared beyond USD100 per barrel in December 2007, but there were none, presumably because the general elections were around the corner.

Another increase was not totally unanticipated after the general elections, given the rising trend in the price of crude oil. Early announcements had made people believe that fuel prices would be adjusted in such a way that consumers will have to pay market prices by August.

Consumers were caught unawares when the price of petrol jumped by a hefty 79 sen in the first week of June. An increase of 41 per cent for petrol and 63 per cent for diesel will have severe inflationary consequences. It is instructive to note that the 30 sen increase in February 2006 had led to 4.8 per cent inflation in the following month.

It was estimated that the subsidy cutback on 5 June would yield a fiscal saving of RM13.7 billion. The net saving will be much smaller after deducting rebate payments for motor vehicles that were implemented purportedly to soothe the pain. If rebates were taken into account, the actual increase is said to be 23 sen, not 78 sen, per litre. It would have been better if the increase was 30 sen with no rebates, as was the case previously.

The argument that the rebate has made the exercise more equitable is untenable, as the poor do not benefit from directly fuel subsidy in the first place, for they do not own vehicles, but do suffer from the inflationary consequences of subsidy cuts. What is sadly missing is a long-term strategy to phase out fuel subsidy gradually, which calls for a clear time frame and a pragmatic pricing mechanism.

Emeritus Professor Datuk Dr Mohamed Ariff is the executive director of the Malaysian Institute of Economic Research