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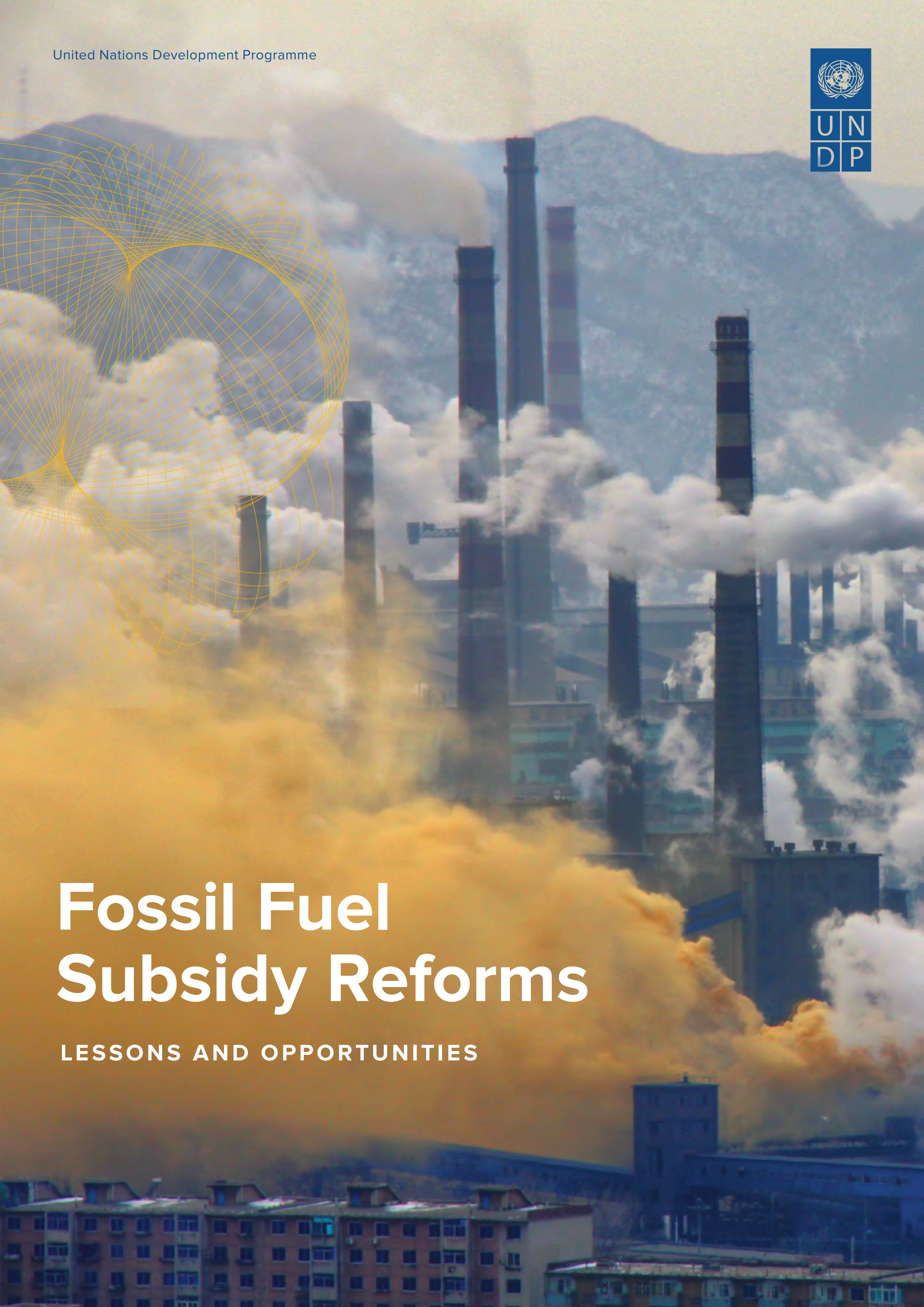

Fossil Fuel Subsidy Reforms

LESSONS AND OPPORTUNITIES

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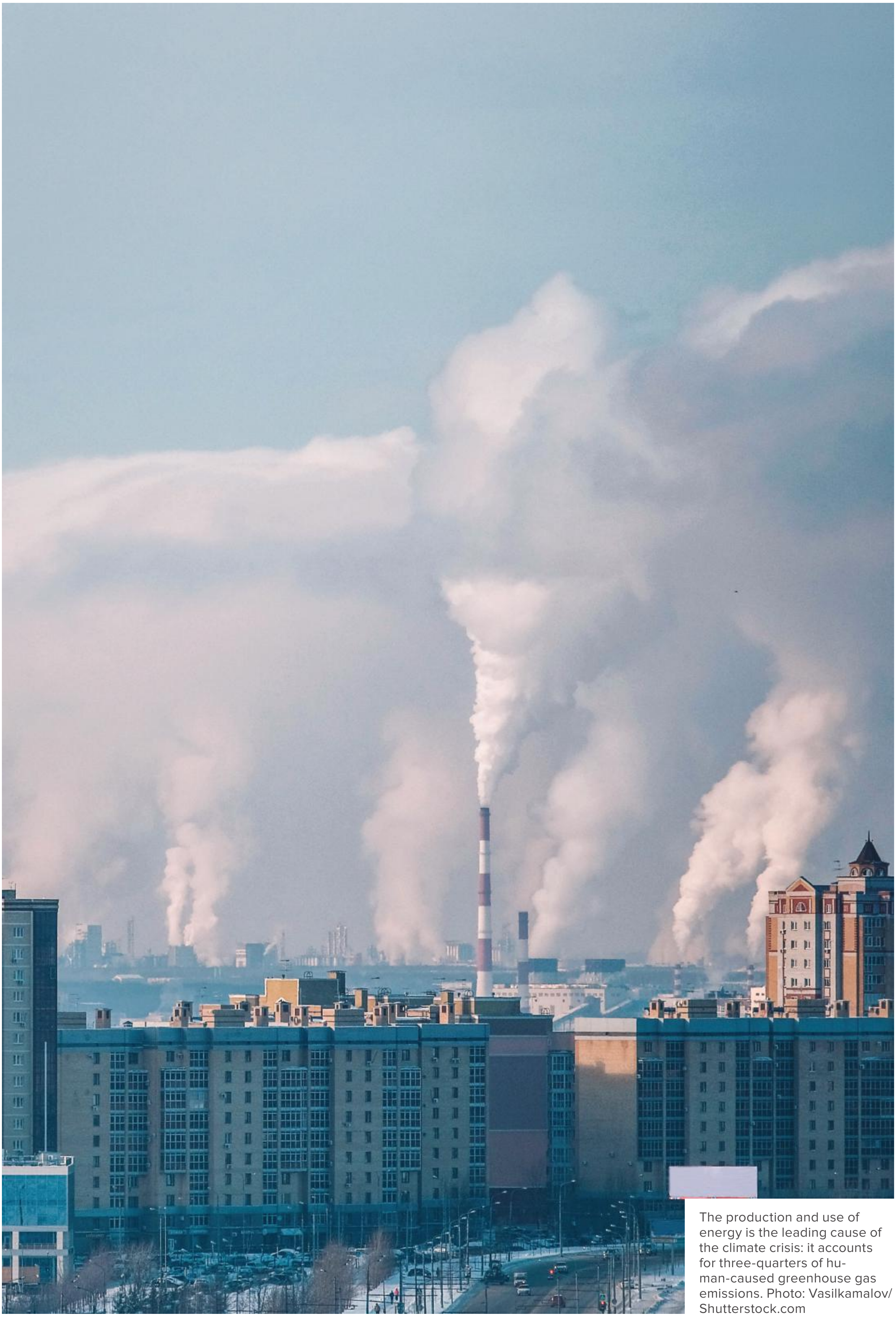

The production and use of energy is the leading cause of the climate crisis: it accounts for three-quarters of human-caused greenhouse gas emissions. Photo: Vasilkamalov/ Shutterstock.com

FOREWORD

We are no longer waiting for climate change to draw near. We are living through it. And it is now “widespread, rapid, and intensifying”. The production and use of energy from fossil fuels is the primary cause of the climate crisis, accounting for approximately three-quarters of global greenhouse gas emissions. Yet Governments across the globe are subsidizing fossil fuels to the tune of approximately $423 billion every year. As a result, both people and planet are paying a heavy price as our climate changes. Our natural world is on track to lose one million plant and animal species, many within decades. People across the world are being forced from their homes as extreme weather increases in frequency, intensity and severity. And exposure to air pollution is estimated to cause seven million premature deaths annually.

To limit global warming to 1.5 degrees Celsius, global greenhouse gas emissions must be cut by 45 per cent by 2030 compared to 2010 levels. To get there, “we need to end fossil fuel subsidies, put a price on carbon and shift taxation from people to pollution” as the United Nations (UN) Secretary-General, António Guterres has put it.

Fossil Fuel Subsidy Reform: Lessons and Opportunities, outlines how Governments across the world can accelerate this clean energy revolution while recognising that reforming decades-old fossil fuels subsidies is a daunting task. Part of the *Future Investment* series, it provides macroeconomic and political insights on how to move public resources away from fossil fuels in a socially equitable and economically sustainable manner. It also outlines the factors that make energy pricing reforms successful, and why. It outlines case studies from countries including Indonesia, Chile, France, Iran -- and Ghana where a conditional cash transfer programme was introduced to link fuel subsidy reductions to the elimination of school fees for primary and secondary education. In doing so, it provides a comprehensive analysis of the critical political economy, distributional impacts and social elements that are sometimes overlooked by policymakers.

Removing fossil fuel subsidies is perhaps more vital than ever as countries across the globe aim to build forward better from the devastating socio-economic impacts of the COVID-19 pandemic. Crucially, Governments can redirect these finances towards green, sustainable development projects that advance the Global Goals.

As a result of the 2021 High-Level Dialogue on Energy (HLDE), the world has a renewed collective will to meet the targets for clean, affordable energy for all set out in Sustainable Development Goal (SDG) 7 -- towards net-zero emissions by 2050 in line with the Paris Agreement. The new Global Roadmap, agreed at the HLDE, calls on Governments, the private sector and civil society to close the energy access gap and accelerate the clean energy transition by tripling investments in clean energy and energy efficiency by 2030. It also calls for a phasing out of coal by 2030 for OECD countries and by 2040 for all others. Moreover, it urges for fossil fuel subsidies to be shifted towards renewable energy investments. This will help to ensure a just and inclusive transition with new green, decent and healthy jobs.

As the UN's development arm, the United Nations Development Programme (UNDP) is the heartbeat of these efforts in developing countries across the world. Because we won't manage to achieve the SDGs without achieving universal access to clean energy, we are stepping up our energy work to help countries accelerate their energy transition. That includes our ambitious commitment to collaborate with our partners to provide 500 million additional people with access to clean and affordable energy by 2025.

With the entire UN system and our partners on hand to support the clean energy revolution, we hope that this report will help Governments across the world to finally turn the page on fossil fuels.

Achim Steiner
Administrator, United Nations Development Programme (UNDP)
Co-Chair, UN-Energy

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KEY MESSAGES

Removing fossil fuel subsidies is a first step towards correctly pricing energy, reflecting the true and full cost of using fossil fuels to society and the environment. However, if poorly planned, fossil fuel subsidy reform can lead to price increases that could disproportionately impact the poorest households and trigger social unrest.

Ensuring social and political acceptability is a key enabler of successful energy pricing reform. Beyond being environmentally impactful, such reforms must be **socially and economically fair.** Such acceptability is influenced by broader social, economic and political trends, including the level of public trust in governmental institutions.

UNDP's research found that **four factors** are key for a successful fossil fuel subsidy reform.

- **A better understanding of the socio-economic contexts of communities likely to be affected by such reforms:** Undertaking successful fossil fuel subsidy reform requires a clear analysis of existing levels of subsidy support, the reasons for their existence in the first place, as well as the distributional impacts of withdrawing it. A key factor is stronger expenditure survey data and accompanying analysis, complemented by qualitative research into local vulnerability and the spill over effects of subsidies.

- **Timing and sequencing of reforms:** Governments should enact a gradual approach to price reform to enable households and firms to adjust wherever possible, while recognizing that windows of opportunity may warrant a step-change in pricing policies.

- **Compensation and wider expenditures, including capacity to deliver:** Fossil fuel subsidy reforms need to include compensatory measures that target the poorest and most affected households, including developing social safety nets. They should focus on reinforcing existing social welfare benefits, including cash transfer mechanisms and temporary basic incomes.

- **Communication strategies and stakeholder engagement:** Policymakers should conduct effective public communication, and deep stakeholder engagement to secure buy in across society and different sectors. Public support is fostered when the environmental effectiveness and/or progressive distributive impacts of reform are clearly explained and demonstrated. One pillar for success is building consensus around key approaches to implementing reforms, working closely with experts and opinion leaders.

SUMMARY

Fossil fuel subsidy reforms risk lowering consumer welfare, particularly among the poorest and most marginalized households, if they do not incorporate targeted support for disproportionally affected groups. Such issues have been brought into sharp focus by a wave of social disturbances in response to price reforms and widening inequalities in countries such as Chile, France, Iran, Bolivia and Lebanon in 2018 and 2019. However, successfully removing energy subsidies is key to strengthening fiscal positions and improving human health in many developing countries, as well as reducing greenhouse gas emissions cost-effectively.

In this context, it is important to note that the emergence of the COVID-19 crisis has only bolstered the underlying rationale for such reforms. In particular, the significant deterioration of public finances in many countries caused by the downturn (and the policy responses to it) has increased the value of the fiscal space created by removing energy subsidies. Moreover, the associated decline in the market price of fossil fuels may help facilitate their timely removal because the impact of removing the subsidy will be felt less by consumers, particularly among fuel-importing countries.

This paper analyses experiences and best practices in energy pricing reform by comparing outcomes and drivers in five case-study countries that were selected to illustrate the impact of different implementation choices across divergent social, economic and political settings. It argues that ensuring the social and political acceptability of these choices is a critical enabler of successful reform. Broader social, economic and political trends also influence this acceptability, including the level of public trust in governmental institutions as part of a renewed social contract.

Such analysis requires a clear understanding of the existing levels of subsidy support and the distributional impacts of withdrawing it, considering specific vulnerabilities and adaptive responses, particularly among the poorest households. In addition, given the high degree of state participation in energy value chains, this study finds that measuring and tracking the removal of energy subsidies has broad and potentially complex institutional ramifications in the energy sector, including for improved accounting and financial management and broader gover-