

Considerations for Research on Energy Subsidies

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I. Introduction

Work on removing energy subsidies is currently high on the OECD and IEA agendas. The ongoing G-20 work programme as well as the OECD Green Growth Strategy called for developing a better understanding of the effects of fossil fuel subsidies on trade, environment and the overall economy.

The importance of addressing costs of environmentally harmful subsidies, especially for fossil fuels, was highlighted by the G-20 member states at the Pittsburgh Summit in September 2009, when the G-20 called on the OECD and IEA to carry out research into the phase-out of fossil fuel subsidies. The OECD's *Green Growth Declaration*, which was adopted at the 2009 OECD Ministerial Council Meeting, also stimulated new analysis and policy measures on environmentally harmful fossil fuel subsidies, increasing the attention of their impact on trade and environment for the most part as well as in the current economic crisis.

While BIAC recognizes the importance of fact-based analysis of environmentally harmful subsidies, we would encourage the OECD and IEA to carry out analysis of energy subsidies broadly to assess their environmental effectiveness and economic efficiency. This BIAC paper does not seek to define which subsidies are efficient and which are not. Instead, this paper offers several broad based-business considerations that we encourage the OECD and IEA to consider in future research on such issues.

II. Considerations for Research

In BIAC's view, open markets represent the best framework for an efficient deployment of energy resources, investment and sustainable growth. Subsidies can have potentially large budgetary implications and, when they are used, should therefore be time-bound and carefully targeted. However, appropriate incentives, if put in place in the right policy framework, can promote efficient use of energy resources and the market penetration of promising technologies that are in early stages of development. For example, subsidies can help support the shift from traditional to new energy sources which are in early stages of commercialisation and where affordability is a key barrier, or where existing infrastructures make it difficult to introduce new energy sources.

In general, BIAC believes that *all* energy subsidies should be examined in a cost-benefit analysis in order to avoid discrimination and economic and environmental inefficiencies. BIAC would recommend that the OECD and IEA consider a broad-based cost-benefit approach in their future analysis on energy subsidies. Such analysis should not focus on fossil fuels in isolation. We would therefore appreciate broader analysis on energy subsidies as a whole, covering all parts of the energy sector. As business operates to develop and deliver a new product or infrastructure often at a global level, a clear understanding of the way subsidies are designed and impact over the lifespan of various business activities is essential.

Recognizing the complexity of the issue, BIAC recommends that the following points be given due consideration in future analysis of energy subsidies:

Definitions

Subsidies are generally put in place by governments to reduce the price of energy, though they may reflect different policy objectives, such as to provide energy access to the poorest parts of the population, or to adjust for international energy prices in national contexts. Incentives are market tools intended to implement policies that have not yet reached their economic competitiveness, acting to create demand for a new product or service in order to allow (more rapid) deployment.

However, subsidies and incentives can take different forms. It is therefore important to consider how exactly to define subsidies and incentives in order to assess their drawbacks or benefits. In the case of subsidies for hydrocarbon production, for example, these “subsidies” can in fact be legitimate tax incentives to encourage investment by governments, which do not result in additional hydrocarbon production and instead allow for a transition from one “regime” to another.

Access and general availability

General availability is essential for creating an open atmosphere where potential investors – domestic and international and across the spectrum of industry sectors – can see the broad outlines of what is possible and know that they will be treated in a similar fashion for a similar position. It is important that governments do not adopt policies that unfairly protect their domestic industries. Non-discriminatory policies in supporting green growth are essential, and the use of subsidy schemes should fully comply with the WTO agreement on subsidies as a minimum. Work that would assure common international subsidy discipline and avoid governments competing in subsidising specific national sectors could be an approach forward. As an integral part of sustainable growth and development, it is important to encourage countries to export and trade in a non-distortive environment. Awarding subsidies and incentives only to domestic industries should therefore be avoided.

Transparency

Transparency of subsidies underpins credibility and fair treatment. Visible proportionality between the size of the incentive and the projected benefits will keep the pressure in minimizing waste. Clear rules and a uniform and non-discriminatory application of these rules are important to maintain or restore a level playing field for businesses around the

world. Ideally, procedural safeguards should be included in subsidy legislation. Transparency of the process and in the context of international markets of goods is important to establish a level playing field.

Temporary nature of incentives

On the assumption that political leadership will engage in continuous improvement in their particular policy framework, incentives should never be permanent, as difficult as that might be politically. Incentives should be used in order to launch innovation and enable a phase-out of non-effective and costly energy sources. Incentives should be transitional incentives, decreasing over time, to move technology towards market competitiveness.

Transition

It might not be feasible to remove energy subsidies for either conventional or new sources overnight or agree on measures to fully internalize external costs. Attention must therefore be paid to developing acceptable transition periods taking into account national and regional characteristics. Some key elements of successful reform include: availability of quality data, packaging of phase out in broader structural reforms, and well-targeted, time-limited compensation for those that are adversely affected.

Consumption

OECD analysis should also consider consumption subsidies. Governments need to find better ways to avoid putting additional pressure on the poor and not use blanket subsidies which often benefit the middle class or wealthy in developing countries. Since the main users of fossil fuel subsidies are today in energy exporting countries where subsidies are used as a social support and income transfer mechanisms, governments need to find alternate means to achieve this. This requires more sophisticated tax systems and building broader investment policy frameworks.

III. Concluding remarks

Subsidies present a challenge for governments seeking to promote optimal competitive outcomes. Properly used, subsidies can preserve and enhance a competitive marketplace by correcting critical market failures and help efficient firms to survive and thrive. Improperly used, they can tip the balance of competition toward inefficient firms in order to promote trade protectionism as well as nationalistic and political objectives at the expense of efficiency and innovation. An important point to be considered for both subsidies and incentives is their financing, including overall impacts on governments' budgets, other parts of the economy, and to what extent the economic and environmental payback is eventually positive or negative. In addition, key considerations for business are: transparency, considerations of lifecycle investments, and avoiding distortions between local and international actors.

Achieving the right balance is thus essential. We encourage the OECD and IEA to involve all relevant experts, including in the areas of trade, competition, environment, etc., in future research in this area.