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Time for review of fuel subsidy

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ONE of the most difficult things to accept is the need to change because human beings are creatures of comfort. Familiarity is supposed to breed contempt but in the case of subsidies, the longer the familiarity with subsidies the more it breeds contentment.

The subsidy for petroleum products is one of the most important subsidies and the largest provided by the Government. Nothing puts a broader smile on the faces of people than the knowledge that things are free or are heavily subsidised.

Subsidies usually are granted to consumers when the price does not truly reflect the costs of bringing it to the market.

The difference between the real, or true, costs and the actual price at which the product is sold is the size of the subsidy. In a recent statement, Prime Minister Datuk Seri Dr Mahathir Mohamad said the Government was considering whether the price of petrol should be raised.

The Prime Minister was reported as saying that it would not be possible to continue subsidising petrol, partly because of the sharp increase in crude oil prices. The Ministry of Finance is conducting a study on the matter. Since 1999, oil prices have increased to US\$30 (RM114) a barrel. Some changes to the subsidy for petroleum products are in the air.

The total size of the bill for subsidies has been increasing sharply. In 1997, the total subsidies provided amounted to about RM961.2 million, and rose to RM1.242 billion in 1998.

Subsidy for petroleum products amounted to about RM228 million in 1997 and RM499.6 million in 1998. It is anticipated that the petroleum products subsidy will substantially increase this year.

What is the extent of the subsidy? As shown in Table 1, the price of unleaded petrol (RON 97) in Peninsular Malaysia is 110 sen per litre and 106 sen per litre for unleaded petrol (RON 92). Diesel is priced at 65.10 sen per litre and LPG at 118.0 sen per litre.

The prices without the subsidy for RON 97, RON 92, diesel and LPG are 155.79 sen per litre, 151.77 sen per litre, 106.38 sen per litre and 183.82 sen per litre, respectively. The subsidy for petrol (RON 92), therefore, amounts to 41.63 per cent, diesel 63.41 per cent and LPG 55.78 per cent. These are quite hefty subsidies (see Table 1).

Malaysians have been enjoying higher subsidies for petroleum products than their neighbours. We should be looking at our neighbours to get a better perspective for the subsidy on petroleum products (Table 2).

Malaysia's petrol, diesel and LPG prices are, with the exception of Indonesia, the lowest amongst Asean countries.

Petrol prices in Singapore are 160 per cent higher and in Thailand, 35 per cent higher, than in Malaysia. Diesel prices are 77 per cent higher in Singapore and 69 per cent higher in Thailand than in Malaysia. The prices of LPG are 205 per cent higher in Singapore but 10 per cent lower in Thailand compared to Malaysia.

The subsidy for petroleum products is substantial when compared to the allocation for development expenditures of some of the social programmes. In 1998, for example, the development expenditure for health amounted to RM716 million compared to about RM500 million for the subsidy on petroleum prices which is about 70 per cent of the health expenditure and about 48 per cent of the allocation for housing (see Table 2).

What are the reasons for the study to review the petroleum prices and

for the likelihood that the scheme of subsidy will be altered?

First, crude oil prices have been increasing and since 1999, having reached US\$30 per barrel. These price increases have not been passed on to consumers.

Second, the size of the bill for the subsidy, as has been noted earlier, has been rising. This year, the anticipated bill for the subsidy for petroleum products will probably exceed RM1 billion, even larger than the subsidy for padi. And at the 1999 level the subsidy is about seven times more than the subsidy given for text books loan scheme (RM70.9 million).

Third, subsidising petroleum products can lead to distortion in the market and run counter to some other developmental objectives. Cheap petrol can induce consumers to be less economical in their consumption of petrol for transport.

The use of personal cars can be excessive when petrol prices are very low. The total transportation costs, therefore, will be low, inducing a greater increase in car usage and traffic flows especially in congested areas in the city. Also as costs of personal transport are low, there is much greater reluctance to use public transport.

Fourth, the smuggling of petrol will become a lucrative activity. With the sizeable differences in the prices of petroleum products between Malaysia, Thailand and Singapore, there is a very strong temptation to smuggle Malaysian petroleum products to neighbouring countries. Smuggling is a fact of life in the border areas and indirectly leads to subsidising our neighbours.

Fifth, there are distributive or equity reasons for reviewing the subsidy for petroleum products.

Everyone who buys petrol will enjoy the subsidy and this will include mainly car owners, taxi drivers and owners of taxis, lorry drivers and owners of lorries, motorcyclists and factories and plants that use petrol and diesel.

In designing subsidies, there is always the assumption that they are intended for specific groups. But subsidies can be a blunt instrument as the beneficiaries can include those who are not among the intended groups.

The key principle of the petroleum products subsidy is that it should benefit, if possible, only or mainly the low income and poor groups (households and individuals).

Those who have the means, the high income groups, should either not enjoy the subsidy or only a small proportion of the well-off should enjoy the subsidy.

As it stands, the presumption, even without the right kind of statistics, is that the subsidy is enjoyed far more by the non-poor and those who are much better off.

The richer should not be excessively or disproportionately subsidised.

Consider the magnitude and issue from another angle: What can be done with the petroleum subsidy?

Absolute poverty in Malaysia has declined from about half in 1970 to about seven per cent in 1998. The financial crisis has had only a marginal impact on absolute poverty.

Use a poverty line income of RM467 per month for a household of five. With the subsidy of petroleum products for 1998 reaching almost RM500 million, this is about a million times the poverty line income.

Imagine the benefits that could accrue to the poor if a sizeable portion of the subsidy could be channelled to the poor.

Consider the plight of the hardcore poor, defined as those households with half of the absolute poverty line income.

There were an estimated 67,300 hardcore poor households in 1997 or 1.4 per cent of the total poor households.

Savings in subsidies could also be channelled towards development projects which will raise the income of the very poor and lifting them above the poverty line.

It appears that if about RM15 million of the subsidy is passed on to all the hardcore poor households, then their household income would be raised up to the poverty line income.

So spending slightly more than RM15 million of the subsidy in 1997 would have eradicated hardcore poverty in the country.

What would be the impact on prices if there is an increase in the prices of petroleum products? This will be dealt with in a second article.

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