

# Ugly face of fuel subsidies

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From all angles, Malaysia, now the only net oil-exporting economy in Asia-Pacific other than Brunei, looks better placed than ever to benefit from high oil prices. After all, in terms of energy efficiency, it now takes 0.4 barrels of oil to produce RMI,000 of gross domestic product (GDP), while it required 0.9 barrels to achieve this 17 years ago. Moreover, in terms of energy mix for domestic use, there has been a marked shift away from oil (94% in 1965 to 39% today) to natural gas (0% to 50%).

This strengthens the buffer against the risk of rising oil prices because oil, being the most heavily used fuel globally, still dictates the price trend. Any price movement is likely to be the steepest and sharpest for oil before spilling over to other primary energy forms. While the oil consumption ratio in Malaysia has dropped, investment in exploration has, on the other hand, maintained oil production growth at 2.4% for the past 10 years. This has sustained the amount of light sweet Tapis crude — of which the price premium over heavy sour has widened during the latest oil shock — for export, which is a boon for Malaysia.

However, we are playing devil's advocate here. We think oil-exporting Malaysia might not necessarily emerge eventually as a winner because of the potential economic drag posed by fuel subsidies. The oil windfall granted Malaysia the luxury of fuel subsidies to shield the

economy from high oil prices. Yet ironically, fuel subsidies undermine the positive effect of high oil prices for the net oil exporter.

## An extensive subsidy mechanism

In Malaysia, fuel subsidies are more far-reaching than generally thought. For one, electricity is subsidised nationwide — albeit to varying degrees — as natural gas is provided at 25% of the commercial price to the power sector. In terms of final energy consumption, industry is the only sector that is weathering high oil prices alone. Fishermen are subsidised at a 31% rate and even selected segments of the transport sector receive subsidies. At the same time, fuel at petrol pumps is priced at a subsidised rate of 7% to 40%. But these are only the explicit subsidies.

Implicit subsidies exist as well. As Petronas has stakes in an extensive network of downstream oil-related businesses such as transport (for example, shipping), petrochemicals, chemicals and fertilisers, it seems that these businesses could enjoy implicit subsidies or preferential rates. In fact, our transport team points out that some transport companies benefit from extremely favourable hedge positions for fuel compared with other players in the industry.

Subsidies ease the margin crunch from rising costs for businesses and soften the erosion in purchasing power. Without subsidies, the impact on the economy would be severe. Yet with subsidies, the outcome may be worse. Sub-

sides work by cushioning the impact of an oil shock now by diffusing the blow over a period. As taxpayers inevitably have to pick up the tab, the effect of granting subsidies may turn negative when: 1) the future payback is more painful than if the economy has been left to weather the shock because subsidies augment demand and increase the subsidy handouts unnecessarily; 2) subsidies are not benefiting the targeted segments; 3) subsidies can cause fuel shortages; and 4) the opportunity cost of subsidies is much higher than the benefit.

## Distorted prices, distorted demand

In the short run, higher prices should lower demand. But if prices are kept artificially low, users will continue to guzzle oil. For the first half (1H) of 2005, the volume of crude petroleum and petroleum imports rose at a double-digit rate of 32.8% year-on-year and 11% y-o-y, respectively, even though economic growth and oil demand elsewhere appeared to be slowing. The growth spikes in Malaysia's oil consumption in the past two oil shocks are also, in our view, no coincidence as suppressed prices encouraged hoarding (in anticipation of further price rises) and profiteering. Interestingly, global oil consumption during historical oil shocks, by contrast, is usually sustained around the same level or slows.

## Falling into the wrong hands

The subsidy system is multi-tiered and different sectors are charged different prices for the

same product. As sectors cannot be relied on to select the more expensive product for themselves and markets cannot be separated, arbitrage arises both within the country and across borders. Domestically, this means that subsidies that are meant to be progressive end up being regressive and not allocated where the need is greatest. Indeed, anecdotal evidence shows that there has been an increase in demand for subsidised diesel at the pumps at the same time as industrial demand for unsubsidised fuel has declined. This suggests a leakage of subsidies to the industrial sector. From an economic standpoint, sustaining the purchasing power of demand at the grassroots level has a greater multiplier effect on the economy than cushioning the profit margin of industrial players.

More importantly, subsidies also appear to have leaked out into neighbouring countries. We examined several factors but found none that could explain the spike in Malaysia's oil consumption. For one, the pace of electricity consumption growth in January-May 2005 (5.9% y-o-y) was similar to the 5.8% in the preceding five-month period. On the other hand, although transport sector output rose 10.4% y-o-y in the first quarter of 2005 from 9.3% in 4Q2004, industrial production, a major user of energy, decelerated to 3.9% y-o-y in 1H2005 from 9% in 2H2004.

Yet, Malaysia's oil demand data provided by Asia-Pacific Economic Cooperation for

CONTINUES ON PAGE 59

# Suffering economic fallout

FROM PAGE 56

January-May showed a rise of 25.1%. By comparison, oil demand growth in August to December 2004, prior to the period when Thailand and Indonesia reviewed their subsidies, rose a meagre 1.9%. It is possible that, to some extent, the growth in excess of the "normal pace" could be due to leakage to neighbouring countries.

## Higher oil prices versus no oil

The diesel quota allocated by the government to stem illegal usage proved to be insufficient to satisfy both the black-market and legal users earlier this year. The situation has now improved. However, if arbitrage cannot be fully contained going forward, the public market will always be hit hardest should a shortage arise. High oil prices lead to the survival of the fittest as production is adjusted to the rising costs. A quota system could exert a double whammy. If a diesel shortage does result from a diesel quota, this would lead to reduced output and a heavy fiscal burden at the same time.

## Counting the costs

We think the government would be better off spending the funds allocated for subsidies di-

rectly in the economy. The economic impact is likely to be greater. The government estimates that fuel subsidies amount to RM6.6 billion (Minister in the Prime Minister's Department Datuk Mustapa Mohamed, however, gave a higher subsidy figure of RM8.9 billion — *Editor*). To put this into perspective, the total (based on the RM6.6 billion) is about 19% of Petronas' net profits for the financial year ended March 31, 2005, and 7.4% and 23.3%, respectively, of the government's estimated operating and capital expenditure in 2005. To keep prices low, the government has also foregone a fuel sales tax, which amounted to RM7.9 billion, 8% of revenue.

We estimate that if this money were spent in the economy, growth would improve by 3.2 percentage points. Moreover, if the funds are allocated to targeted grassroot sectors where the multiplier effect is significant, the impact would likely be greater. We cannot be sure that using fiscal latitude on fuel subsidies would reap the same economic result given the arbitrage effects, uneven redistribution impact and quota system. Furthermore, such an inefficient allocation of current expenditure jars with the government's ongoing efforts to achieve fiscal consolidation by

clamping down on white elephant-type infrastructure. If the subsidy mechanism is abandoned, the fiscal deficit would register a massive improvement of 3% of GDP in total, we estimate.

If this money [subsidy and fuel tax exemption] were spent in the economy, growth would improve by 3.2 percentage points

## Bottom line

In our view, fuel subsidies debilitate the positive effects of the oil trade surplus as they fritter away the oil wealth without much economic achievement. However, while fuel subsidies need to be gradually removed, they really reflect a broader issue — the heart of the problem is the practice of rent-seeking.

To be sure, redistributive subsidies can be benign but fuel subsidies, as we have

shown, are just too inefficient to be that. However, any movement towards the full removal of the fuel subsidy would probably be resisted by rent-seekers. In Indonesia, such resistance had caused then President Megawati to renege on her decision to reduce subsidies in 2003. Indeed, the practice of rent-seeking has persisted because the costs of subsidies have been widely dispersed among taxpayers, while the benefits from fuel subsidies have been concentrated among select groups.

This means that those who benefit from the fuel subsidies have a greater incentive to ensure the subsidies are maintained than the taxpayers who have to cover the cost of the subsidies have the motivation to scrap them. In our view, rent-seeking results in economic inefficiency and the fuel subsidy is just one example. As long as the government does not take any steps to roll back the subsidies, the net oil exporting economy will just have to endure the economic fallout that its oil wealth has ironically helped to sponsor. ■

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