

The Political Economy of Oil Subsidy in Nigeria

By Jean Balouga*

Introduction

Nigeria is blessed with vast quantities of oil and is the sixth largest oil exporter in OPEC. This has generated billions of dollars in revenues over the last fifty years since oil was found in Nigeria. However, as in most developing countries, this has not translated into an improved welfare condition for the people. Instead through inefficiencies, corruption, abuse of natural monopoly powers, mismanagement, smuggling, bureaucratic bottlenecks and excessive subsidizing, the supply of refined crude oil products in the country has virtually collapsed.

After many years of control and uncertainty surrounding the sale and purchase of petroleum products in Nigeria, the government is now deciding to emulate other developing and developed nations to fully privatize and liberalize the country's downstream sector which is managed by the National Petroleum Corporation (NNPC) on behalf of the government. This issue of full deregulation of the downstream subsector in Nigeria is a contentious one that has generated a lot of arguments among the people. Until 1973, the downstream sector of the Nigerian oil industry was deregulated. The nation's first refinery in Port Harcourt was a private initiative of the Shell Oil Company. If there were no policy reversals and the introduction of uniform pricing of petroleum products, Shell would probably have had additional refineries across the country. Perhaps, this would have been followed by Chevron, Elf, etc., all having functional refineries.

Full deregulation, which the government wanted to implement from December 2009, is one of the main plans of the reform programme in the oil industry. This would be the third attempt by government to deregulate the subsector. However, the efforts at deregulation and withdrawal of fuel subsidies have always been met with skepticism and strong resistance. Opposition to this policy from the Nigeria Labour Congress (NLC) and the Trade Union Congress (TUC) has been ferocious, in addition to spirited criticisms from segments of the political class. Nevertheless, pronouncements from top government officials suggest strong determination by government to carry through this policy decision this time around.

The Failure of Regulation

Government control of petroleum product prices has been a major issue before now, especially in the face of the unprecedented failure by government to get existing refineries working to full capacity. For many years now, and with the near-total collapse of the refineries, Nigeria, a major producer of crude oil in the world has depended on the importation of petroleum products to meet its domestic needs. Investors, who had wanted to invest in the establishment of refineries, were scared away by what they saw as unfriendly pricing, leaving product marketers with low or no margins, except when government stepped in with a heavy subsidy that ate deeply into its treasury.

Although started with the best of intentions, the subsidies have become a real problem for governments who attempt it. The problem is that crude oil prices are very volatile and have risen to astronomical heights. Since the subsidies are usually in the form of fixed prices for fuel, the burden on government could easily become unbearable. The over N1.3 trillion spent on the subsidy this year alone in Nigeria amounts to 20 percent of the federal budget - a scenario which is absurd, in a country like Nigeria, in dire need of crucial infrastructure.

For a policy that is apparently aimed at helping the poor, it really does not do a good job. Research on twenty developing countries (excluding Nigeria) shows that although the poorest people benefit a little from the subsidies, the bulk of the benefits go directly to the richest 10 percent. In the sample of the countries in the study, only 7.1 percent of the subsidy benefits go to the poorest 10 percent of the population. The top 10%, on the other hand, gets 47.6 percent of the benefits, with the top 20% getting 67.5% of the total subsidies. The skew is worse when you consider only gasoline. The bottom 10 percent gets only 3 percent of the benefits from gasoline subsidies, while the top 10 percent gets 61.3 percent. However, the top 20 percent gets an outstanding 80.7 percent of the entire benefits of gasoline subsidies. The number gets a lot worse if you examine only African countries. The bottom 10 percent gets only 2.2 percent of benefits from gasoline subsidies, with the richest 10 percent getting 70 percent, and the richest 20 percent, 87.2 percent.

The underlying reason for this pattern is the amount of gasoline each group actually buys. The argument is not that poor people do not use gasoline, they do. Rich people just buy a lot more. The poor enjoy some subsidy, but the policy is

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really inefficient at targeting the poorest. This pattern is true for oil-producing countries as well as Bolivia and Cameroon among the countries studied. There is no reason to believe that Nigeria is different. Another thing to note is that these numbers represent the direct benefit from public purchasing fuels. It does not include the part of the subsidy cornered by various ‘cabals’ or other indirect effects. The really interesting thing is that this pattern does not depend on local refining capacity. This implies that somehow, figuring out a way to refine all crude oil locally will not solve the problem. The question just changes from “should we spend so much subsidizing fuel that mostly benefits the rich?” to “should we lose so much subsidizing fuel that mostly benefits the rich?”

Energy prices have been imposed by governments on the basis of general policy objectives, such as promoting development or social equity, protecting national industry, etc. Having recognized the significance of energy for development, many governments subsidize electricity or various fuels, so that their price to the final consumer is lower than the cost of production and delivery. In many developing countries, energy prices and tariffs are much lower than in industrialized countries, although the cost of producing and delivering energy is by no means lower.

For the developing countries this has the double effect of discouraging energy conservation and creating a barrier to the introduction of new forms of energy, renewables in particular, which are not equally subsidized. Moreover, generalized subsidies (as opposed to targeted subsidies), although originally meant to alleviate poverty, actually favour the richer layers of the population. Only the rich can afford consuming substantial quantities of energy; thus, they have little incentive to spare energy or to use it more effectively, yet the resulting general costs are spread among the entire population. Poor people often have no access to commercial energy anyway, and political prices of energy as a whole discourage private entrepreneurs from extending energy services to areas judged not profitable enough.

Basically, there are two main problems with imposed energy prices. The first is that they do not allow the market to function. They have no place for competition and, therefore, either the final user pays a higher price, or public finance spends more money, or both. The second problem is that imposed energy prices are generally not instruments of an *energy* policy, but rather of other policies (social, industrial, or others). As a result, they distort the energy market and orient it towards undesired solutions. Specifically, subsidized energy prices will diminish or cancel the advantage of increasing the efficiency of energy utilization and encourage waste. Since such subsidies are generally applied to traditional fuels or energy forms, they act as disincentives for new energy sources, renewables in particular, and for new ways of producing energy, such as decentralized power production or cogeneration of heat and power. Imposed energy prices are an obstacle to the introduction of sustainable energy systems.

Prices of conventional fuels and electricity need to be based on marginal-cost pricing theory. In this way, price “forces” the consumer to use energy efficiently. If economic support has to be given to any economic agent(s) then, instruments other than “political” energy prices need to be used.

Although it is agreed that energy subsidies are generally wasteful in many countries, marginal-cost pricing application often meets with severe difficulties. Increasing the price of largely used commodities is always unpopular and often politically sensitive. People used to paying little for the fuel they use are likely to consider a sharp rise in its price unacceptable. Political crises have been triggered in the recent past by increases in the prices of energy. For example, increases in electricity tariffs in Ghana generated a wave of protests, resulting in their prompt suspension by the government and in Indonesia, mass protests by students forced former President Soeharto to resign in May, 1998 for introducing unpopular economic policies, including the removal of fuel subsidies.

However, even when the market operates fully, the price paid by the final consumer also includes taxes, that, in some cases (e.g., petrol in European countries), constitute a large fraction of the final price. It is quite common that different mechanisms are present for different energy sources (e.g., free market prices plus taxes for petroleum products and coal; regulated maximum prices plus some market elements for electricity and gas). Petroleum products and, to a large extent, coal are more amenable to market mechanism (apart, of course, from the regulation of their environmental performance, which is open to a number of options, as exemplified by the various approaches to the reduction of Sox emission).

With respect to petroleum products, Nigeria appears to have consistently engaged in de-competitive strategies through politics of hypocrisy. Our past approach to delivery of petroleum products has been based on subsidies and distortion of market forces. We failed to recognize the many business opportunities that the availability of crude presents to us. Within five decades, the potential competitive advantage that we have had has been made irrelevant through our hypocrisy that breeds corruption. Consequently, we have the shame of an oil-producing nation that imports virtually all her refined requirements. The more we got cheap refined products over the years, the more the opportunity cost.

Because of our hypocrisy successive governments' policies have ensured that we remain poor, because we could not compete. The refineries, as a symptom of the rot in government's business, could not develop sophistication in their business operation and the nation could not provide the business environment needed for global competitiveness. The refineries, for most of the time, were operating very inefficiently, therefore, unsustainably. They were run like a civil service. Presently, the four refineries in Nigeria, most of the storage depots, about 5,000 kilometers of pipelines, four jetties and two import terminals are owned by the federal government, through NNPC. When the four refineries operate at full capacity, they can only meet about 60 percent of national demand for petrol. In the past 20 years or so, they have operated under 40 percent capacity and currently supply only about 20 percent of Nigeria's gasoline demand.

As far back as June, 2003 government figures indicated that for each litre of petroleum products, N12 was spent on subsidy. This implied a subsidy of N74 billion or 1.42% of GDP. By the end of 2007 with subsidy shooting up to N450 billion, it went up to 3% of GDP. It is indubitable that we are really subsidizing inefficiencies, fraud and racketeering in the whole production and distribution chain and in that context, given the competing needs for scarce resources, government felt the need to do something.

The Need for Deregulation

Considering the fact that there are significant investment opportunities in Nigeria's downstream sector if well managed, the focus of government now is to fully deregulate the sector through the licensing of private refineries, the privatization of the existing ones and the removal of subsidies. Taking a cue from other countries that have privatized, particularly those in South America the Nigerian government intends to go ahead with this policy even against the backdrop of widespread disapproval on the part of ordinary citizens.

The question now is: why do governments around the world struggle to remove such policies? The answer is that the suffering from the removal is spread across all income groups. Everybody is better off from the removal of subsidies but at the same time everybody is worse off. This suffering is felt most by the poorest, who need to be given palliatives.

Dismantling the natural monopoly of the NNPC by privatizing, removing price controls and creating a competitive environment, are expected to reduce the cost government incurs in subsidizing the sector which runs as high as N1 trillion annually. Hopefully, government will use the resources freed up to handle the socio-economic and welfare needs of Nigerians. The Ghanaians, for example, who ended fuel subsidies in 2003 eliminated fees for attending primary and junior secondary schools and funded health-care programmes in the poorest areas.

Conclusion

The arguments in favor of deregulation are clear, but so are the arguments against. The principal argument for deregulation is that markets appear to be right more often than regulations and regulators. This is probably true on many occasions, but it is certainly not always true. The basic problem here is that many real-life markets not only do not function with the flexibility and efficiency that they display in our textbooks, but they cannot; and when these situations arise, the regulators must be called in.

Sir Alan Walters posits that government intervention is "normally suggested" when there are increasing returns to scale, indivisibilities, technological external effects, and/or market failure connected with uncertainty. The key word above is 'normally'. What it means is that there can be situations in which regulation is not advisable, even though all the above-named irritations are present to some extent. The problem is detecting, acknowledging, and/or estimating their strength and scope (Banks, 2000: 95).

After deregulation (if we have to), we have to make it work by providing the enabling environment and framework for efficient production, distribution and supply (i.e., re-regulate). Then, we will have petroleum products at prices dictated by the dynamics of the industry and markets. And then we will have a platform for a competitive strategy.

It is reported that government has concluded and fine-tuned all the perceived grey areas with stakeholders in the oil and gas sector on the planned deregulation of the downstream sector and was only waiting for the right time to implement it. For sure, deregulation should not be implemented now, because presently the monetary policy rate (MPR) is 12%, unemployment rate is 23.9% and economic infrastructure is grossly inadequate in addition to a volatile political situation.

The Way Forward

Arguably, the first challenge is deciding to deregulate. The remaining challenge is that of coming out

with an appropriate action plan on the process and timeframe for the deregulation.

The Committee, set up to create a framework for the implementation of the deregulation process, must adopt a consultative approach, and be transparent in its dealings in order to avoid the pitfalls of certain recent privatization experiences in the country. In addition, a detailed and honest comparative study of countries that have undergone similar reforms can assist in selling the idea to groups opposed to deregulation.

Without reforms, creating a sound investment climate and promoting economic growth is but a wild dream. Support for property rights and reduction in the cost of doing business without competition leaves much to be desired. Private firms will only participate if changes are credible. A privatized sector unleashes competition, increases efficiency, investment and production.

However, the free market is not everything. Effective as market forces are in optimizing the allocation of resources for short and medium-term objectives, the market is known to be short-sighted, not to respond spontaneously to long-term signals. As the World Bank puts it, “..liberalizing energy markets, however important, may not be the complete answer...” Long-term and social signals should be introduced by government thereby promoting sustainability in the energy field, while using market mechanisms to the best of their potential. Hence, while “deregulation” is needed to allow space for private initiative and competition, “re-regulation” is needed to establish a set of rules that allow the market to function properly by correcting its imperfections and by accounting for the social costs of the energy system.

Another important element to be considered is the level at which energy policies should be formulated, specified and implemented. In the past, just one level (the national level) was considered in most countries. Energy policies were the responsibility of the central government, and other levels of government (e.g., regional, provincial, or local) were called in occasionally, only at the implementation stage. Recent trends, in both industrialized and developing countries, point toward a much more decentralized approach. This is exemplified by the so-called “subsidiary principle” adopted by the EU, which states that all decisions need to be taken and implemented at the lowest (most decentralized) level that is possible or practical. Central governments often retain only the powers of setting the guidelines, orientating and coordinating energy policies, as well as looking after the part of the legislation that must be common to all the country, while progressively more decisions are taken at the local level. This sharing of responsibilities has the double advantage of better adaptation to the local conditions and of involving stakeholders more directly in the process. Of course, the degree of decentralization depends on the size of the country and on its general organization, but there is hardly a small country today that does not find it effective to delegate some of the power in the energy field (and obviously in others) to smaller units, down to individual villages.

The approach must include a degree of flexibility, and it is necessary to set up a system to monitor, frequently and accurately, the results of policy measures, in order to correct them in a timely fashion.

There has been a lack of accountability (e.g., the \$ 12 billion Gulf War windfall) and we do not have anything to show for previous reductions in subsidy. This should not repeat itself.

There is evidently a lack of coherence and consistency in enforcement of government policy in the household energy sector. In 2000 demand for fuelwood in Nigeria began to exceed supply. This situation might be made worse by a return of large segments of the population to the use of wood and charcoal as fuel for cooking due to a price increase of kerosene and LPG.

Regulatory boards and commissions are important actors in the governance of the energy structure of many countries. Although in many cases such boards and commissions are independent from government, their role increases with the degree of liberalization of the energy market. They have become major players in many countries, including the UK and, among the developing countries, e.g., Argentina.

The Nigerian Government, which may remove subsidies in phases, should have a timetable in utilizing the subsidies to alleviate the sufferings of the masses, for example: First six months, free treatment of malaria and typhoid. Next: rehabilitation of major roads and provision of mass transport services (bus, railways), etc. In order to “force” government to order the decision between the government and labour should be done before and agreed to by the National Assembly.

Finally, McKenzie and Tullock (1978:393) admonish that because excessive realignments in any direction can have unforeseen circumstances what government must do in structuring social order is to measure the costs in one area against the costs in the other and choose the social organizer which is most efficient for the particular problem at hand.

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