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The Political Economy
of Fuel Subsidies
in Colombia

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ENVIRONMENT WORKING PAPER No.61 - THE POLITICAL ECONOMY OF FUEL SUBSIDIES IN COLOMBIA

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ABSTRACT

Colombia has made progress towards eliminating fuel and diesel subsidies and reducing discretionary spaces allowing for artificially low fuel prices, but challenges remain. Colombia has provided explicit and implicit subsidies to gasoline and diesel since 1983, costing the government up to 1.6% of GDP. This paper discusses the political economy of fuel subsidies in the country to understand why reform has been so slow. It focuses on the groups benefitting from the subsidies and their political participation, as well as other economic impacts that have limited the political will to eliminate them. The Colombian case serves as an example of the difficulty of fully eliminating fuel subsidies once they are already established.

Keywords: Fossil-fuel subsidies, political economy, Colombia

JEL Classification: H23, O13, Q48.

RÉSUMÉ

La Colombie a fait des progrès pour éliminer les subventions accordées aux carburants et au gazole et réduire les possibilités de faire baisser artificiellement les prix des carburants, mais certaines difficultés demeurent. La Colombie applique depuis 1983 des subventions explicites et implicites à l'essence et au gazole, représentant jusqu'à 1.6 % de son PIB. On trouvera dans le présent rapport une analyse de l'économie politique des subventions aux carburants qui permettra de mieux comprendre la lenteur de la réforme dans ce pays. Le rapport s'intéresse aux groupes qui bénéficient de ces subventions et à leur participation politique, ainsi qu'aux autres impacts économiques qui ont entamé la volonté politique de les supprimer. L'exemple de la Colombie illustre la difficulté d'éliminer complètement les subventions aux carburants une fois établies.

Mots clés : Subventions aux combustibles fossiles, économie politique, Colombie.

Classification JEL : H23, O13, Q48 :

FOREWORD

Fuel subsidies are inefficient and environmentally harmful. However, their use is widespread. Colombia has provided explicit and implicit subsidies to gasoline and diesel since 1983, costing the government up to 1.6% of GDP. This paper, prepared by Helena Garcia Romero and Laura Calderon Etter of the consultancy firm Fedesarrollo (Colombia), discusses the political economy of fuel subsidies in Colombia to understand why reform has been so slow. It focuses on the groups that benefit from the subsidies and their political participation, as well as other economic impacts that have limited the political will to eliminate them.

The paper is a contribution to the “Lessons on Environmental Policy Reform” project of the OECD Working Party on Integrating Environment and Economic Policies.

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THE POLITICAL ECONOMY OF FUEL SUBSIDIES IN COLOMBIA

1. Introduction

Subsidies to fossil fuels are in many cases both environmentally harmful and an inefficient way of achieving special outcomes. They are, however, commonly used in many countries. Fuel subsidies are easy to deliver and sometimes easy to observe by recipients. Nevertheless, while seeming to benefit the general population, they end up benefiting specific groups, and once a subsidy is created, interest groups and investments solidify around it and make change difficult (Victor, 2009).

In Colombia, gasoline and diesel have been explicitly or implicitly subsidised since 1983. Starting in 1998, the government has tried unsuccessfully to eliminate the fuel subsidy. In 2003 the government attempted again to gradually eliminate the subsidy. It based its decision on the fact that the subsidy was highly regressive (85% of high income households benefitted, compared with 14% of middle income households and 1% of low income households) and costly for the state. Eliminating the subsidy would result in higher tax revenue for the national and local governments and higher dividends from the national oil company Ecopetrol. These funds could be used for other development programmes; higher (gasoline) costs would be borne mainly by higher income households. Further, the one-time only political cost would help secure future fiscal and macroeconomic stability. However, subsidies still exist, albeit at a lower level (see Figure 1), and the last steps to eliminate them are proving difficult.

Public opinion holds a very dim view of increases in fuel prices. Colombians do not understand why the country, despite its status as an oil producer and exporter, has the highest gasoline prices in Latin America behind Uruguay, Brazil and Chile. Their obvious points of comparison are Venezuela and Ecuador, two countries with extremely low fuel prices and high government subsidies.

Not only does the public reject price increases, but there is also debate about whether fuel subsidies even exist. Since the subsidies are no longer explicit and the amount subsidised has at times been lower than the taxes paid, a common perception is that there is no subsidy.

This paper describes the history of fuel subsidies and their beneficiaries, together with the gradual process of eliminating them and what can be expected going forward. It is divided into four main sections: Following this section, Section 2 describes the history of fuel subsidies in the country, Section 3 analyses the main beneficiaries of the subsidies and Section 4 concludes.

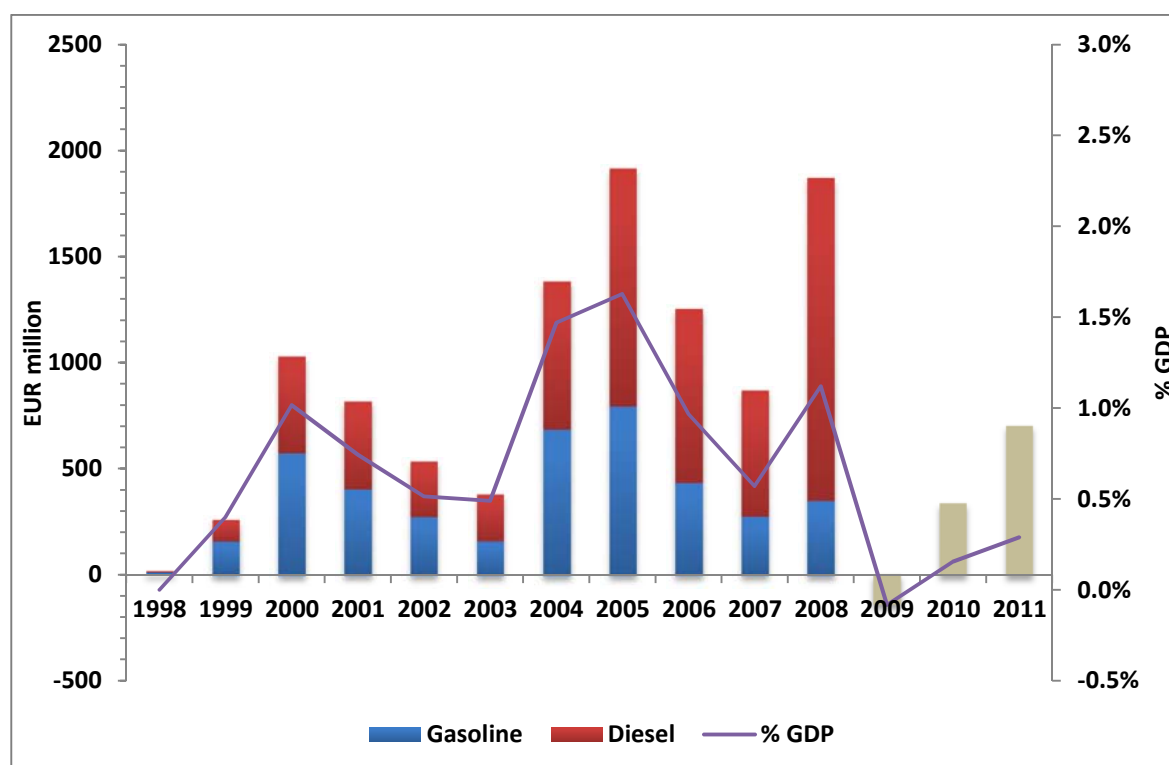
2. Fuel subsidies in Colombia

Fuel prices in Colombia have always been regulated by the Ministry for Mining and Energy (MME), which determines monthly prices for diesel and gasoline. From 1983 to 1996, the national government paid an explicit subsidy for gasoline called a “social dividend”. When it decided in 1999 to change the formula for setting fuel prices, the subsidy became implicit. Whereas the previous price structure took into account production and transportation costs and taxes, the new formula introduced the opportunity cost of selling oil abroad; it also included commercialisation margins. While the new formula allowed for moderate pass-through of changes in international prices to consumers, it only applied between January and July 1999.

After that date, the MME assumed responsibility for setting the price level (taking the formula as a base) according to its own criteria and government interests (Rincón & Garavito, 2004).

After these changes, the subsidy became the difference between the export parity price (or opportunity cost) and the producer's income set in the MME price resolutions. The total subsidy was the difference between both prices, multiplied by the quantity consumed. From 1998 to 2008, Ecopetrol paid for the subsidy, which was deducted from the dividends it paid the government. The subsidy was thus not reflected in the national budget as a fiscal cost, making it easier to sustain. As Figure 1 shows, the amount of the subsidy increased (particularly for diesel) between 1998 and 2008. The subsidy represented on average 0.8% of GDP; reaching a maximum of 1.6% of GDP in 2005.

Figure 1. Fuel subsidies 1998-2011



Note: there are no data for 2009-2011 on how the subsidy is divided between gasoline and diesel.

Source: Rincón & Garavito, 2004; Suescún, Masmela, & Trejos, 2011; Ministry of Finance and Public Credit (MHCP), *Marco Fiscal de Mediano Plazo* 2009, 2010, 2011.

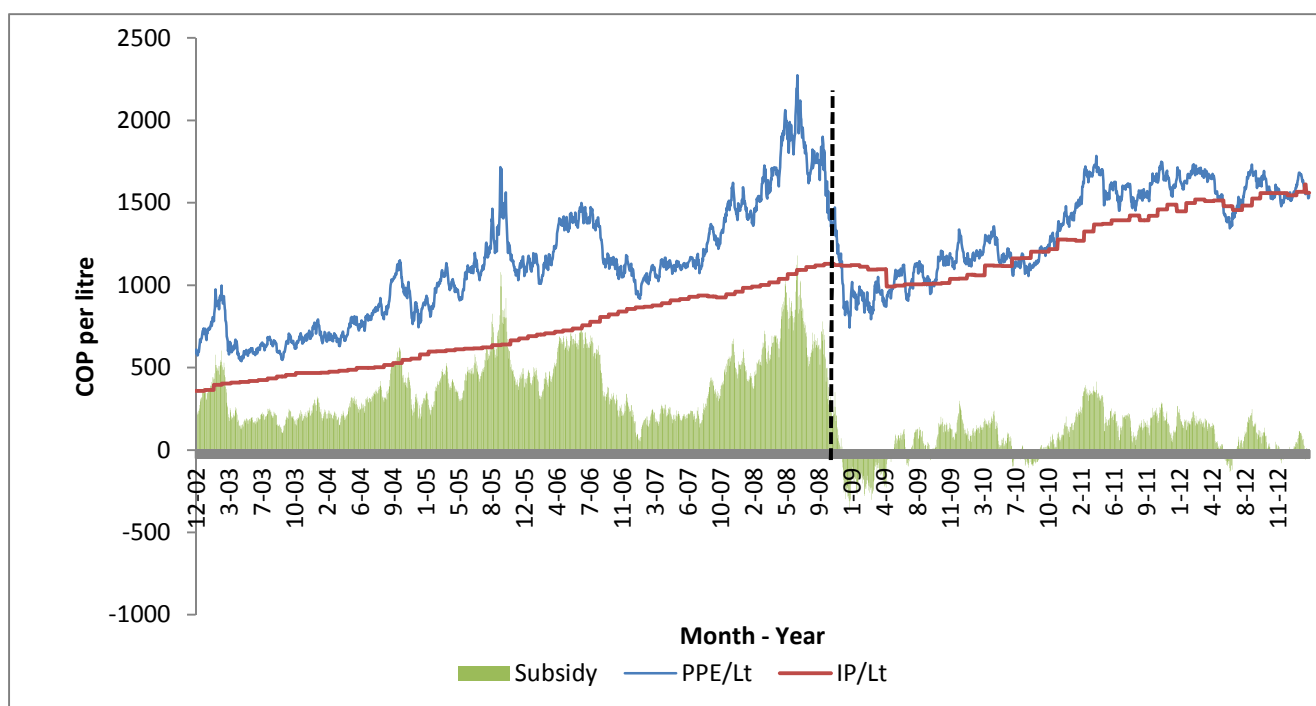
In 2003, the status of Ecopetrol changed from being a state company to a mixed company with public and private investors. Financing the fuel subsidy was no longer desirable, since the company needed financial autonomy to expand its operations (i.e. exploration and refineries) and increase its competitiveness. This new situation, along with the high costs of the subsidy, led the government to announce its gradual elimination. The gasoline subsidy would be eliminated over one year and the diesel subsidy over three years, causing a 20% price increase (holding everything else constant).

However, the plan was delayed due to political pressures. The problem was that in addition to the fuel price increase caused by the subsidy elimination, increasing oil prices and the appreciation of the Colombian peso also pushed the price upwards. In the end, Ecopetrol funded the subsidy until 2007, when it began looking for private capital to fund its exploration and exploitation activities, leading its board to demand more transparent accounting. Since then, Ecopetrol has paid full dividends to the government, which has funded the subsidy through its Fuel Price Stabilisation Fund (FEPC).

In 2008, the spike in international oil prices forced the government to disburse as much as EUR 2 063 million (1% of GDP) to finance the fuel subsidy. A new policy was subsequently designed to allow for price stabilisation without delving into national budget resources. The FEPC was created as a self-financing mechanism to reduce the volatility of fuel prices for consumers by smoothing variations in international oil prices. The fund sets the price level (income) for producers using a moving average from the previous three months. When the parity export price is below the set level, the fund saves, since the price paid by consumers is higher than the price paid to producers. When the parity export price is above that level, the fund dissaves, since it has to pay higher prices to producers without passing them on fully to consumers.

The FEPC was originally funded with savings from Ecopetrol and the Oil Savings and Stabilisation Fund (FAEP). However, the continuous increase in prices ate up these resources, forcing the government to fund the deficit¹ and implicitly subsidise fuels again. In 2011, the FEPC had a deficit of EUR 772 million (0.3% of GDP), which was larger for diesel than for gasoline (diesel subsidies represented 65% of the total subsidy). Figure 2 and Figure 3 show the improvement of the FEPC over the previous subsidy scheme: Even though a deficit still exists, it is smaller (see the total amount in Figure 1) than it was until 2008.

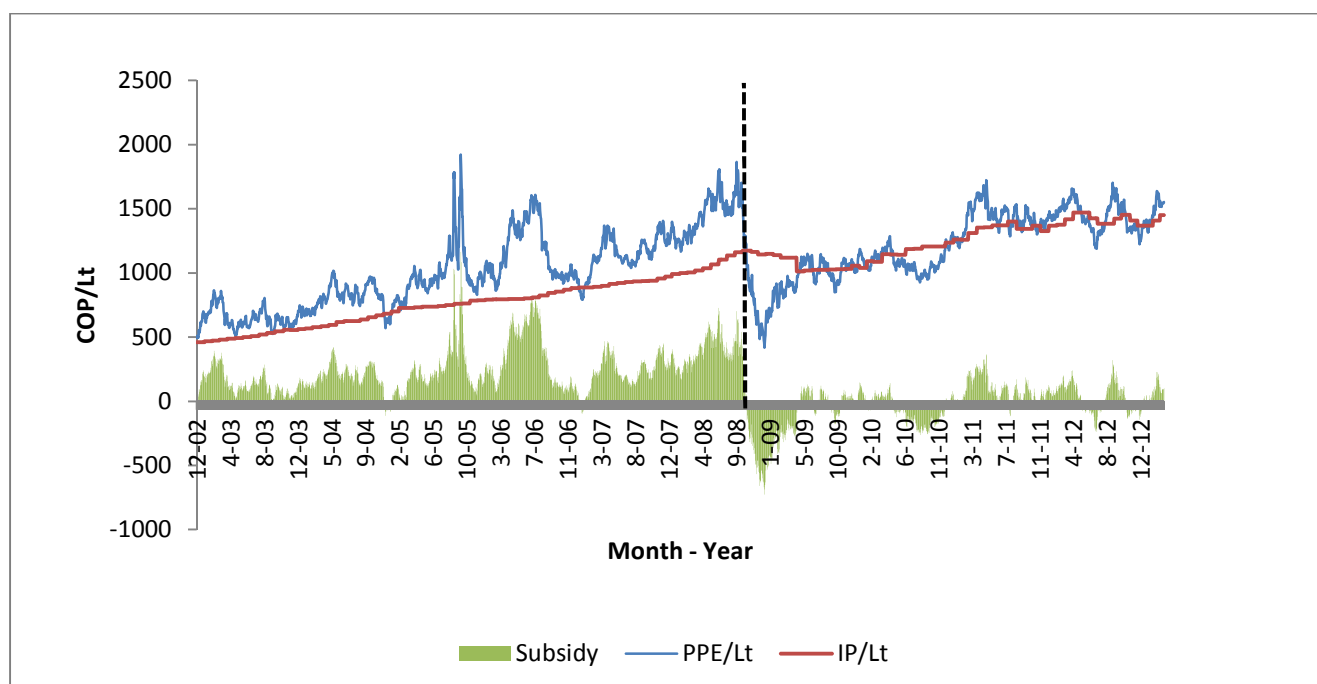
Figure 2. Diesel subsidy over time



Source: MME.

¹ The law (“Decreto 4863” from December 2011) states that if the FEPC does not have enough resources to meet its obligations, the national government will finance them through extraordinary credit operations. This occurred in 2011, when the FEPC received a loan from the MHCP for EUR 720 million (MHCP, 2012). The repayment term for these extraordinary credit operations must be under one year, but if the FEPC does not have the resources to pay back, the MME can extend the term’s validity (“Decreto 2713/2012”).

Figure 3. Gasoline subsidy over time



Source: MME.

It is important to note that as long as the subsidy was funded by Ecopetrol and did not imply any fiscal expenses, there was no real hurry for the government to eliminate it and bear the political costs. In 2008, when the subsidy started to be funded by the national budget, the MHCP started pressuring the MME to eliminate it. This was brought about by the opening of Ecopetrol to private investors and the establishment of a corporate governance regime.

In 2010, FEPC resources were exhausted, not only as a consequence of high international prices, but also because the MME did not take proper mitigating actions. Gasoline and diesel prices were frozen for seven months in 2009 and six months in 2010, entailing fiscal costs of EUR 20.7 million per month. Yet the FEPC cannot function if consumer prices do not fluctuate to compensate for international price variations (Suescu, Masamela & Trejos, 2011).

To avoid a re-occurrence of these situations, new formulas to calculate producer income regarding gasoline and diesel were implemented in November 2011 and November 2012. While these formulas are also based on producers' opportunity costs, the manner in which the MME sets producers' income is more transparent. Furthermore, the formulas reduce the space for discretionary price setting and allow for gradual price increases in situations of higher international oil prices. The FEPC deficit is expected to amount to EUR 550 million (a 28% decrease thanks to the new formulas) and will most likely be covered by national budget resources.

In January 2013, a fiscal reform changed the tax structure for gasoline and diesel. Value added tax (VAT) and global tax were merged as a single excise tax (fuel tax) of EUR 0.44 per gallon. This measure reduced consumer prices by 2.3% for gasoline and 0.45% for diesel and further reduced the space for discretionary price setting by the MME. Before the fiscal reform, the Ministry determined the tax base for VAT on diesel and gasoline every month, using it as an instrument to control prices. Instead of a 16% tax according to the value, the tax was effectively 9% for gasoline and 8% for diesel.

As these events show, important progress has been made in reducing gasoline and diesel subsidies, but challenges remain. The FEPC is still in deficit, financed by a national government credit. Whether it is ever repaid remains to be seen. Further efforts to increase prices are met with strong resistance on the part of the media and particular interest groups.

Special regimes also remain. Border zones with Venezuela and Ecuador pay lower prices than the rest of the country. In addition, certain sectors or activities (such as industrial fishing, aquaculture, fuel used for electricity generation and the navy) and geographic areas (such as the Amazon region) have volumes reserved for them at lower prices (quotas). The elimination of these special regimes is not on the agenda.

The following section discusses the interest groups that benefit from fossil fuel subsidies.

3. Target groups

Strand (2013) develops a political economy model of fuel subsidies where governments choose to provide subsidies to obtain political support. Gasoline subsidies are assumed to be substitutes for other types of public goods. Governments then choose the mix of public goods and fuel subsidies maximising votes at the lowest fiscal and administrative cost.

In many developing countries, the difficulty of providing more complex public goods can explain the generalised use of fuel subsidies. Public transport is one such “complex” public good. Strand’s model also includes a level of uncertainty in the provision of other public goods,² while fuel subsidies occur with certainty. Depending on consumers’ utility function, they may prefer fuel subsidies to uncertain public goods.

In Strand’s model, gasoline subsidies target middle income and higher income households that own cars. Strand makes a distinction between middle income and lower income households. Middle (and upper) income households are more politically active, give financial contributions to politicians and have higher rates of car ownership. The model assumes that individuals with lower incomes do not give financial contributions, have lower political participation but care about public goods aimed specifically at them.

Another politically important distinction in the context of democracies is that while middle income individuals often exhibit very high voting frequency, lower income individuals have more volatile and typically lower voting frequencies. This is particularly true in young democracies like Colombia,³ where often only the most literate – and usually higher income – groups have high voting propensities.

Given that a higher rate of gasoline consumption per household with cars makes fuel subsidies more expensive, the government prefers to provide public goods over subsidies.

This section analyses the data for Colombia to see whether Strand’s model captures the dynamic behind fuel subsidies. It presents not only the subsidy’s direct benefits, but also indirect benefits that can explain why fuel subsidies have been so difficult to eliminate completely.

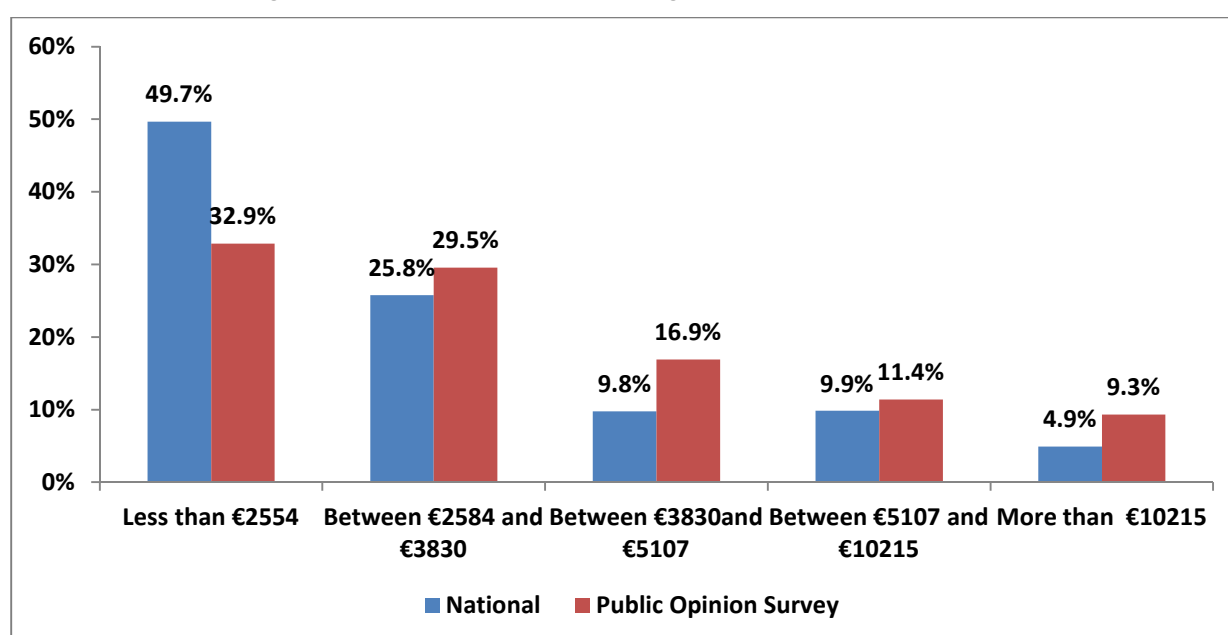
² For example, most of the money is depleted through corruption and waste, or diverted to other uses, or the public good has (or is perceived to have) little value to middle income households owning cars.

³ According to the Polity IV rankings, “young democracies” are defined as those countries that since 1960 have held regular, contested elections; adopted relatively “open” processes of executive recruitment; and placed “effective” constraints on the executive (Kapstein & Converse, 2008). General Rojas Pinilla’s dictatorship of Colombia ended in 1957.

3.1 Voters in Colombia

Data from the 2010 Electoral Observation Mission (MOE) illustrate the voting behaviour of different socioeconomic groups. Figure 4 shows voter distribution by income level and the national income distribution. Middle and upper income levels have a higher participation rate in elections than lower income groups. While almost half of Colombia's population belongs to the lowest income bracket, only 32% of voters belong to that income group. Conversely, the highest income bracket, comprising 5% of the population, accounts for 9.3% of voters – almost double its weight. Middle income groups account for 45.4% of the working population and 57.8% of voters.

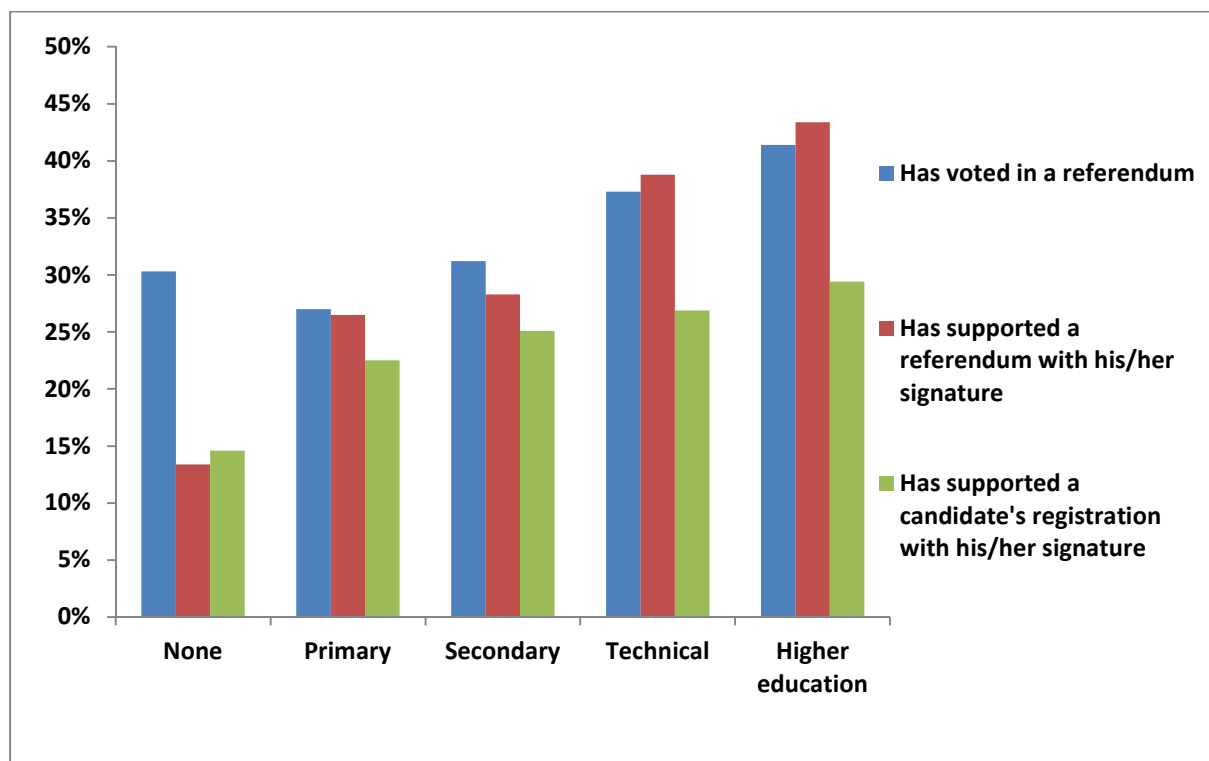
Figure 4. Voter distribution according to annual household income



Sources: «Encuesta de Opinión Votantes», C&C-MOE, 2010; Departamento Administrativo Nacional de Estadística (DANE), 2010.

These results are consistent with voting behaviour and political participation according to education level (see Figure 5). People with a higher education diploma (university or graduate degree) tend to participate more in politics than those with no education or a primary school diploma.

Figure 5. Political participation by highest education level attained

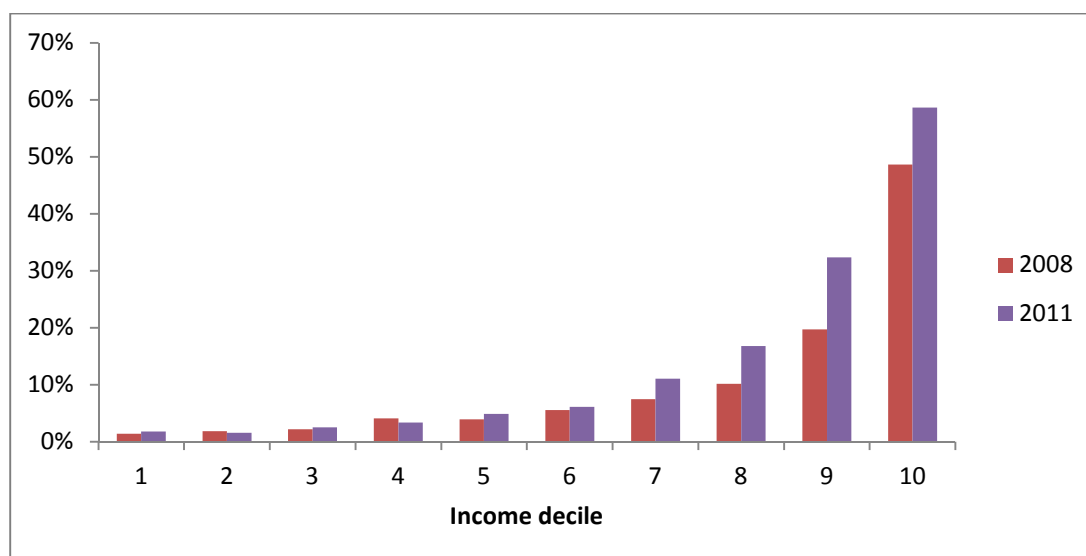


Source: «Encuesta de Opinión Votantes», C&C-MOE, 2010.

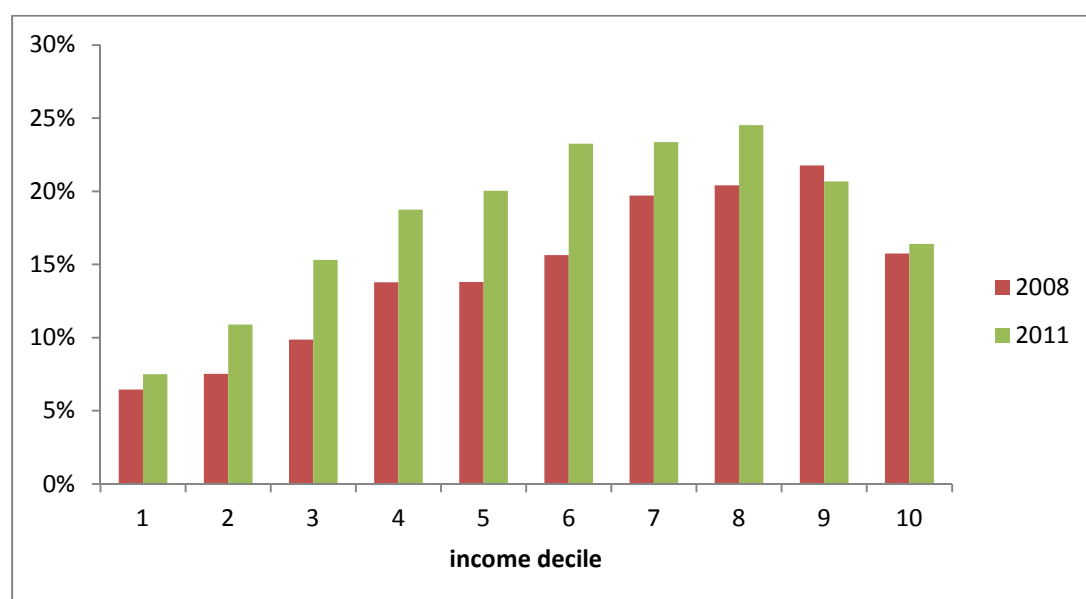
3.2 Gasoline consumers

Voters with higher income and political participation rates are also vehicle owners who benefit from a gasoline subsidy. In 1998, when the decision to terminate the subsidy was taken, 85% of high income households, 14% of middle income households and only 1% of low income households benefitted from the subsidy.

Today, 60% of individuals in the highest income decile own a car, compared with less than 10% of deciles 1-6 (see Figure 6). Comparing 2008 and 2011 shows a similar distribution, but a large increase in car ownership (from 49% to 66%) for deciles 7-9. The percentage of households that own a motorcycle also rises with income, but dips in the highest quintile (Figure 7). Both car and motorcycle ownership rose significantly between 2008 and 2011. Added to the fact that the subsidy came out of the national budget after 2008, this may explain the political push to finally eliminate the direct fuel subsidy. More car and motorcycle owners mean that more fiscal resources are required to maintain it.

Figure 6. Car ownership by income decile

Source: "Encuesta de Calidad de Vida" (ECV), DANE, 2008, 2011.

Figure 7. Motorcycle ownership by income decile

Source: "ECV", DANE, 2008, 2011.

These data are in line with fuel expenditures by decile (Table 1), where the households with more income spend more on fuel: the highest decile spends almost three times as much on fuel for private transport than the lowest decile (ECV, 2011). Nevertheless, poorer households spend a larger fraction of their income on fuel.

Table 1. Percentage of income spent on fuel per income decile

Decile	Average total monthly household income (EUR)	Average monthly expenditure on fuel for private transport (EUR)	Percentage of income spent on fuel for private transport
1	71.0	28.53	40.20%
2	216.0	31.80	14.72%
3	317.2	35.40	11.16%
4	412.5	39.24	9.51%
5	498.4	30.88	6.20%
6	618.9	31.67	5.12%
7	779.6	41.84	5.37%
8	990.9	49.27	4.97%
9	1 331.4	54.19	4.07%
10	3 933.8	110.67	2.81%
Average	917.0	45.35	4.95%

Source: "ECV", DANE, 2010.

Based on these data and according to Strand's model, one can argue that the Colombian government preferred to give fuel subsidies to these groups to obtain their political support in lieu of providing more complex public goods. As the country's economy and government capacity have improved, subsidies have decreased and are gradually disappearing. On the other hand, the increase in car and motorcycle ownership also made the subsidy fiscally unsustainable, leading to reforms to finally eliminate it.

3.3 *Public transport users*

The transport sector uses mainly diesel; 80.2% of all diesel consumption is used to transport goods, 15.7% for public transport and 4.1% for private transport. Private transport accounts for 40% of gasoline consumption (Unidad de Planeación Minero Energética [UPME, 2012]).

A look at the household expenditure data in Table 2 shows that lower income households spend a larger proportion of their income on public transport (ECV, 2011) and benefit more from diesel subsidies than higher income households. In general, public transport prices are regulated by municipalities. One way to keep these regulated prices low is to control the price of diesel. In this sense, diesel subsidies help subsidise public transport indirectly.

Table 2. Percentage of income spent on public transport per income decile

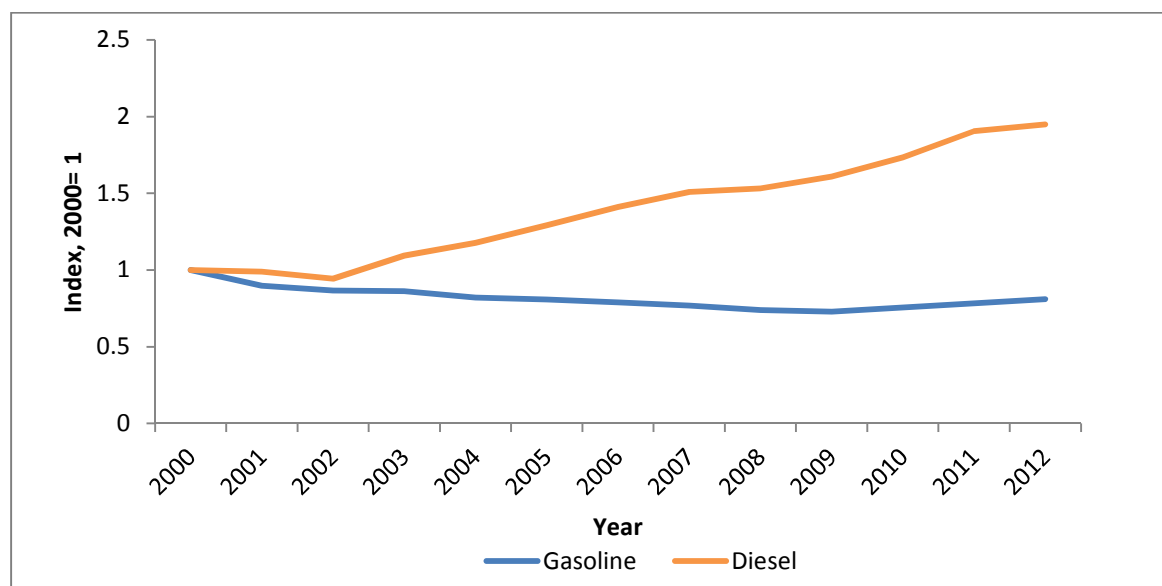
Decile	Average total monthly household income (EUR)	Average monthly expenditure on public transport per household (EUR)	Percentage of income spent on public transport
1	71.0	23.0	32.4%
2	216.0	24.3	11.2%
3	317.2	31.6	10.0%
4	412.5	35.4	8.6%
5	498.4	36.5	7.3%
6	618.9	37.9	6.1%
7	779.6	46.0	5.9%
8	990.9	49.9	5.0%
9	1 331.4	51.4	3.9%
10	3 933.8	59.6	1.5%
Average	917.0	39.6	4.3%

Source: "ECV", DANE, 2010.

For the government, mixing gasoline and diesel subsidies was a way to cater to both income groups. Gasoline subsidies decreased because it was harder to argue for maintaining them, rather than using those

resources for other types of investments. Gasoline therefore became more expensive than diesel, leading to an increase in diesel consumption and a decrease in gasoline consumption (Figure 8).

Figure 8. Evolution of gasoline and diesel consumption over time



Source: Data from Asociación Colombiana del Petróleo (ACP), 2011.

3.4 *The goods transport sector*

The transport sector is perhaps the strongest group defending fuel subsidies. The sector consists of many small private trucking companies and a few integrated companies. More than 200 000 truck owners are members of different associations and federations; the most important are Asociación Colombiana de Camioneros (ACC), Asociación de Transportadores de Carga (ATC) and the Federación Colombiana de Transportadores de Carga por Carretera (Colfecar) (Chávez, 2012).

Transporters are the largest consumers of diesel and fuel represents one-third of their total costs. They argue that any increase in fuel prices translates into higher prices for consumers. They are very capable of coming together through their associations and federations to demand lower fuel prices. Since the 1998 announcement of the fuel subsidy elimination, 27 protests and strikes have paralysed the country.

There is a long history of conflict between the government and the goods transport sector. Transport associations have traditionally lobbied for protection. They have obtained certain measures. These include barriers to entry (the number of incoming trucks and trailers is limited by law) and regulated prices: until 2011, a price table established the minimum price paid by transport companies to drivers to move one tonne of goods from one point to another for every major city and port in the country. These two elements have led to a very inefficient sector, with low investment levels and no incentive to lower costs.

Nevertheless, in recent years, the government has strived to open and make the sector more competitive. In January 2011, the price table was eliminated in the midst of large-scale protests that blocked the entrance to major cities and paralysed goods transport across the country. The government postponed enforcing the measure until July 2011, but did not back down.

Since the transport associations realise that their sector will no longer be highly protected, they react strongly to any measures that push in that direction, including increasing fuel prices. Every time the government announces a price increase, the associations threaten to strike and it (often) backs down. In

February 2013, the transport associations joined with the coffee growers to protest the new diesel prices brought about by the fiscal reform.

In this context, the government meets opposition every time it attempts to completely eliminate price subsidies.

3.5 Local governments

A possible measure to mitigate the impact of eliminating the fuel subsidy is to restructure the taxes charged on fuels. However, local governments receive 7.1% of their income from the gasoline surtax. Some municipalities, particularly small ones with limited capacity to collect other taxes, receive up to 40% of their income from this source.⁴ Any effort to restructure fuel taxes needs to ensure their income does not change or the reform will not be successful.

The 2012 fiscal reform changed the tax structure for fuels. It merged the VAT and the global tax and lowered the rate. This means a reduction in revenues per gallon for the national government, but the surtax that goes to local governments is unchanged.

Once again, the national government has been willing to assume the costs of maintaining low fuel prices by collecting less tax and funding the FEPC.

3.6 Effects on the economy

From a broader perspective, fuel subsidies have been maintained to some extent to avoid macroeconomic costs through inflation. As mentioned, fuel (and particularly diesel) prices impact directly on transport costs and indirectly on every other good in the economy, with a potentially adverse effect on inflation. Fuels for private transport enter the consumer price index (CPI) directly, as 2.9% of the total index, and indirectly through public transport, as 6% of the total index (DANE, 2009). According to Rincón (2009), a 10% increase in the domestic price of gasoline and diesel has a 0.85% effect on inflation. This effect could nevertheless be offset by a decrease in other taxes if the reform is revenue neutral.

The link between fuel prices and inflation means that the government may have chosen not to eliminate the subsidy earlier in an attempt to meet its inflation targets.

4. Conclusions

1. Fuel subsidies in Colombia have a long history. As the last decade shows, eliminating these types of subsidies is very difficult once they are already in place. Interest groups and investments solidify around them and make change difficult.
2. Nevertheless, gasoline subsidies have decreased relatively smoothly, especially compared to diesel. Since gasoline subsidies mainly benefit middle and upper income households, a possible explanation is that these households are less likely to mobilise to maintain them. Additionally, in line with Strand's model – where governments give fuel subsidies to middle and upper households in lieu of more complex public goods – it can be argued that in the past decade the Colombian government has improved its capacity to provide public goods (for example, security) while reducing gasoline subsidies.

⁴ “Datos de Desempeño Fiscal”, Departamento Nacional de Planeación (DNP).

3. Lowering diesel subsidies has proven politically more difficult for two main reasons: more low income households use diesel (through public transport). So do more sectors of the economy, meaning that the political cost of increasing prices would be heavier. In addition, the goods transport sector – a large and organised group with high mobilisation capacity – consistently blocks reforms.
4. In addition to particular groups that have lobbied to retain the subsidies, macroeconomic concerns have reduced the government's resolve to eliminate them. One school of thought is that since fuel and transport enter the CPI, any increase in price – particularly in high international price scenarios – could have inflationary effects and prevent the central bank from achieving its inflation target.
5. An important driver for subsidy reduction in Colombia was that Ecopetrol ceased to pay the subsidy in 2008, when it started to be paid by the national budget. This increased the finance ministry's natural motivation to push for subsidy elimination.
6. Colombia has been making progress towards eliminating the subsidy and reducing spaces for discretion to maintain artificially low fuel prices. However, challenges remain. The upcoming 2014 elections and political campaigns underway make it difficult to further increase fuel prices. The appreciating currency has hurt traditional economic sectors, such as coffee and other export oriented industries, making it unlikely that the subsidy will be fully eliminated in the short term. Finally, there is currently no discussion regarding the elimination of special regimes for diesel.

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