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MADAGASCAR

- When oil prices started rising in 2010, the Malagasy government introduced fuel subsidies to keep energy prices low.
- In 2015, as global oil prices fell, fuel subsidies were removed. The government is now focused on sustaining the removal of these subsidies through ESMAP funded technical assistance for restructuring fuel pricing and for developing a strategy to communicate the rationale and approach for revised pricing of fuels.
- ESMAP is also supporting the policy dialogue on mitigating measures to protect the poor from the impact of fluctuating prices.

SUSTAINING THE REMOVAL OF FUEL PRICE SUBSIDIES

Madagascar, home to nearly 25 million people, is among the poorest countries in the world. Close to eighty percent of the population lives below the poverty line, and only fourteen percent has access to electricity. The majority of people use inefficient energy sources such as kerosene, firewood or charcoal which are also polluting and unsafe.

Madagascar is an oil importing country, and relies heavily on fuel oil for electricity generation. The state-owned utility, JIRAMA (Power and Water Madagascar), consumes three-quarters of all fuel oil imports and 20 percent of diesel coming into the country. Lack of access to affordable and reliable electricity has been a major impediment to Madagascar's economic and social development. Infrastructure for energy is outdated, and existing generation, transmission and distribution facilities are not able to meet the growing demand.

When global oil prices started to rise in 2009-10, the Malagasy government capped retail prices of gasoline, diesel and kerosene, which resulted in subsidies being paid to petroleum companies. Between 2013 and 2015, fuel subsidies averaged 0.56 percent of GDP annually, compared to an average of only 0.7 percent of GDP spent on social priority sectors over the same period.

However, fuel price subsidies largely benefited the wealthiest. Over time, the payment to petroleum companies to compensate them for keeping prices low became unaffordable for the government, leading to the accumulation of arrears and reducing available resources for pro-poor expenditures. In 2015, the Malagasy authorities requested technical assistance from the World Bank's Energy Sector Management Assistance Program (ESMAP) to support them in sustainably eliminating fuel price subsidies.

THE BACKGROUND

Energy price reforms in Madagascar cannot be seen outside the country's political upheavals. A *coup d'État* in 2009 and the instability that followed diverted attention from critical economic and political challenges. The investment climate was adversely affected by the instability, key development partners cut ties with the country, the economy stagnated, and poverty worsened. In 2012, 78 percent of Madagascar's population lived on less than $1.90 a day, up from 74 percent in 2005, and approximately 90 percent lived on less than $3.10 a day.

It was during this period of instability that the government implemented the subsidy program. Madagascar's downstream petroleum sector had been formally liberalized in 2004, but once global oil prices started to rise in 2010, the government capped prices at the pump. Mechanisms to compensate petroleum companies were introduced, such as the reduction or suspension of certain taxes and a preferential exchange rate for petroleum imports.

In 2013, the government introduced a new way of determining fuel prices, establishing the so-called reference price structure. The reference price was computed monthly and was based on the import price (global oil price) to which was added the cost of transport, the cost of distribution, taxes, and fees. The government paid the petroleum companies a subsidy equivalent to the difference between the reference price and the pump price, multiplied by the volume of fuel sold by each petroleum company.

THE CHALLENGE

But over time, the subsidies became unaffordable. They constrained the budget and impeded the government's ability to invest in priority sectors. The government started to accumulate arrears in the payment of subsidies to the petroleum companies. To compensate for the arrears, further measures were put in place to compensate importers/distributors including the suspension of payments to the road maintenance fund and VAT, and preferential exchange rates for oil importers.

The fuel subsidy program was implemented while Madagascar continued to grapple with enormous economic and social challenges including high levels of poverty and extreme poverty. The wealthiest households, as the largest consumers of fuel, benefitted most from the fuel subsidy.

As the political situation normalized in 2014 with a return to constitutional order, the government initiated the process of removing fuel subsidies. This move coincided with a sharp decline in global oil prices. In 2015, the Malagasy authorities requested technical assistance from ESMAP for transition to a new regime that allowed for the permanent elimination of subsidies.

THE RESPONSE

ESMAP grants were provided in November 2015 and in July 2016 to fund a technical assistance program and develop policy measures to eliminate pump price subsidies in a sustainable way. The ESMAP program included several components:

- First, in 2015, a stakeholder analysis of the petroleum sector was undertaken, which revealed overwhelming support for the removal of fuel subsidies. Both the government and petroleum companies wanted to end the subsidy programs. Consumers expressed concern over rising prices and questioned how prices were determined. All participants wanted to see transparency in the price structure, communication around the reforms, and mitigation measures to reduce the impact of higher prices.
- Second, a desk-study of the fuel price structure was undertaken. This study recommended that a more in-depth assessment of the fuel price structure should be commissioned to take account of the specificities of the Malagasy market.
- In 2017, an independent downstream petroleum firm was contracted to conduct an in-depth audit of the structure of fuel prices. The assessment considered the appropriateness of costs, benchmarking them against costs in comparator countries. The study was used to inform the government's dialogue with petroleum companies on the reference price structure.
- To support the reforms, a communications strategy is being developed to explain how fuel pump prices are determined and the benefits of removing fuel subsidies. In January 2017, the government took the initiative to communicate to journalists how the fuel reference price structure works.
- In parallel, an analysis has been undertaken to examine how the purchasing power of poor households has been directly or indirectly impacted by the removal of the subsidies. A supporting study on mitigating measures is being prepared to strengthen the dialogue with the government on appropriate social protection measures.

- A lesson sharing workshop with Mexico was organized with ESMAP support in March 2018 in order for Malagasy officials to understand the experience and steps taken by Mexico to liberalize its domestic market for fuels. The government has requested further exchanges with other countries which are reforming their downstream petroleum sectors.

The removal of fuel subsidies was also supported through a two-year program of World Bank lending over 2016 and 2017.

OUTCOMES

ESMAP support resulted in the provision of high quality and timely advisory services to the government related to the removal of fuel subsidies, developing a communications strategy, and supporting the dialogue on mitigating measures.

Since March 2016, fuel pump prices have been adjusted on a regular basis. In January 2017, a price smoothing formula was introduced as an interim strategy. In March 2018, the government negotiated a new fuel price structure, which included a higher tax for petroleum products and lowered margins for the petroleum companies.

The burden of fuel subsidy removal has fallen largely on the wealthiest households. Comparing changes in fuel prices before and after the fuel subsidy removal (i.e. between January 2016 and June 2017), the purchasing power of the wealthiest fell by 1.2 percent, compared with a decrease of 0.5 percent in the fourth quintile, and between 0.3-0.4 percent in the bottom three quintiles. The decline in purchasing power is the result of both direct effects, i.e. the rise in fuel prices, as well as indirect effects, i.e., a rise in prices of goods and services that utilize fuel, such as transport and electricity production. Factoring in both the direct and the indirect effects, the top quintile bears 73 percent of the burden of price increases resulting from the removal of the subsidy. The bottom three quintiles bear 13 percent of the burden, which emanates from kerosene consumption and higher price of food transportation.

Up until 2017, the government implemented a mitigation mechanism in the form of a subsidy to urban transport companies to stabilize urban bus fares. The scheme allowed up to 7,000 registered buses in seven main cities to purchase 30 liters of diesel per day at a subsidized price.

However, this program did little to mitigate the impact of fuel price increases on the poor. First, 91 percent of Madagascar's poor live in rural areas and by design cannot benefit from a program that serves urban areas. Second, even within urban areas, the poor do not use public transport. Less than four percent of urban households in the bottom quintile and less than 10 percent in the second quintile use public transportation while one in four households in the top quintile uses public transportation, with the top quintile accounting for over 90 percent of all public transport-related expenditures.

Following an independent technical audit of the fuel price structure, the government has negotiated a new price structure with petroleum companies to reduce the distributor margins, which were assessed as being high compared with similar countries. Following the issuance of the new fuel price structure in March 2018, the government has agreed to review the reference price structure once more within 6 months to consider additional information on the petroleum companies' financial performance. However, the policy objective of setting fuel prices without recourse to a fuel subsidy remains. To avoid undue volatility of pump prices, the government and petroleum companies have agreed to maintain the price smoothing mechanism.

LOOKING FORWARD

The government has taken important steps toward removing fossil fuel subsidies. Moving ahead, it needs to continue its commitment to the policy objective of permanently removing fuel subsidies, while implementing mitigating measures to protect the poorest from the direct and indirect impacts of higher petroleum prices. Experience in other countries has shown that many fuel subsidy reforms fail due to governments' inability to stick to the plan when the situation is affected by factors such as fluctuation in oil prices or change in the political landscape. Due to Madagascar's history of instability, the government is cautious about taking measures that can trigger public protests.

With the presidential elections scheduled for the end of 2018, there may be pressure to waver on the reform momentum and to keep fuel prices low. Therefore, it is important to introduce a solid strategy that can ensure the permanent elimination of subsidies in the face of oil price fluctuations and political change.

NEXT STEPS

Moving forward, ESMAP will focus on supporting the provision of further independent advisory services to the government on the fuel price structure, drawing on experiences from a broader range of countries and on the expansion of mitigating measures. It will also support a more intensive communication campaign to explain how the pump prices are determined and how the subsidy removal will lead to policy change and the benefit of consumers.

While the government has committed to increasing social priority spending, it is important that these resources should be targeted to the poorest. Further analytical work on ongoing and planned social protection measures is expected to help reinforce this dialogue.

ESMAP's $20 million Energy Subsidy Reform Facility (ESRF) was set up in 2013 to help countries remove fossil fuel subsidies while protecting the poor. ESRF provides technical assistance to governments, develops tools for assessment and decision-making, and facilitates knowledge-exchange for a global community of reformers.

ABOUT ESMAP

The Energy Sector Management Assistance Program (ESMAP) is a global knowledge and technical assistance program administered by the World Bank. It provides analytical and advisory services to low- and middle-income countries to increase their know-how and institutional capacity to achieve environmentally sustainable energy solutions for poverty reduction and economic growth. ESMAP is funded by Australia, Austria, Denmark, the European Commission, Finland, France, Germany, Iceland, Italy, Japan, Lithuania, Luxembourg, the Netherlands, Norway, the Rockefeller Foundation, Sweden, Switzerland, and the United Kingdom, as well as the World Bank.

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