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T7 Task Force Climate and Environment

POLICY BRIEF

G7 COUNTRIES MUST URGENTLY PHASE OUT FOSSIL FUEL SUBSIDIES

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Abstract

The world's governments have pledged to fight climate change, yet many still subsidize fossil fuels, the combustion of which increases GHG emissions. Phasing out these subsidies is thus vital to combating climate change. What this Policy Brief proposes is that G7 Governments reaffirm their commitment to end their fossil fuel subsidies by 2025 at the latest and financial support in any form for coal production or consumption by mid-2023. Parallel to these efforts, the Policy Brief calls upon G7 Governments to take the lead in providing full inventories of their fossil fuel subsidies, including those provided through their tax systems, and undertake comprehensive evaluations of those support measures. Improving transparency on the real costs and benefits of fossil fuel subsidies is necessary for informing public policies and triggering public debate. The results of these evaluations should then be used to drive comprehensive, evidence-based reforms of fossil fuel subsidies.

Challenges

Governments all over the world have pledged to fight climate change, particularly since signing the Paris Agreement in 2015. At the same time, however, it is still quite common that the very same governments spend millions or even billions of euros on direct subsidies and tax expenditures that incentivize the production or consumption of fossil fuels. In 2022, in order to partially shield drivers from sharply rising gasoline and diesel prices, most G7 members, and many of their sub-national governments, have either suspended excise taxes on these fuels, or are contemplating doing so.¹ This creates a lose-lose-lose situation: many of the subsidies in place increase emissions of climate-warming greenhouse gases and air pollutants that damage human health. The subsidies also reduce the fiscal space of governments to implement more effective policies. On top of that, subsidies may worsen income inequality, as wealthier parts of the society benefit more than disadvantaged groups – even though poorer households tend to spend more of their disposable income on energy than richer households, on average.

Phasing out fossil fuel subsidies is vital to mitigating climate change. Scientists agree that a business-as-usual scenario of fossil fuel consumption is very likely to degrade the environment, destroy human habitat and even shorten human lifespans. The scale and impact of fossil fuel subsidies pose significant challenges on the path to achieving the United Nation’s Sustainable Development Goals (SDGs).

Phasing out fossil fuel subsidies has proven to be a difficult task, but it is necessary and possible. The underlying objectives, such as fighting poverty or protecting domestic industries, can be achieved by other means, often better targeted and at a lower cost.

Having pledged on several occasions, particularly in 2016 at their summit in Ise-Shima, to eliminate inefficient fossil fuel subsidies by 2025,² G7 Leaders need to prove that they are not backsliding on that commitment by showing even more ambition. At the very least, they need to reaffirm their commitment to end their fossil fuel subsidies by 2025, which has been made more urgent by the need to reduce dependency on fossil fuels imported from hostile nations. It should also be within their power to end financial support in any form for coal production or consumption by mid-2023.

Against this backdrop, transparency on the real costs and benefits of the subsidies in question is key to informing public policies and triggering public debate. Several intergovernmental and non-governmental organizations estimate the costs of fossil fuel subsidies. Those at the higher end use non-standard definitions of subsidies, or count the face value of credit-related support as a “subsidy”, which tends to inflate the amount. Globally, identified fossil fuel subsidies have ranged between about USD 300 to 500 billion a year since 2015. Those estimates are probably too low, however. They mostly include subsidies related to the underpricing of fossil fuels through administrative pricing, export controls or taxes, or direct price-related

subsidies. What is typically left aside (because of a lack of the necessary data) is the subsidy portion of preferential loans and loan guarantees facilitated by governments, and any hidden support provided to state-owned energy companies.

The most detailed and consistent estimates for the G7 countries come from the Organisation for Economic Co-operation and Development (OECD). According to [FossilFuelSubsidyTracker.org](https://www.fossilfuelsubsidytracker.org/), the fossil fuel support provided by the G7 countries totals around USD 57 billion a year, most of it, except for Japan, provided in the form of tax expenditures — i.e. preferential tax treatments granted in the form of reductions, exemptions, deductions, credits, deferrals and similar measures.³

Comprehensive assessments, such as cost-benefit analyses and impact evaluations, to identify the impact of fossil fuel subsidies on public policy objectives as well as their side effects are vital to drive evidence-based reforms. These types of assessments are, however, strikingly rare. Indeed, one key factor behind the shortage of assessments is deficient government reporting. This is particularly true when it comes to tax expenditure measures since numerous countries do not report the fiscal cost of tax expenditures at all or publish only incomplete reports. Closing these reporting gaps is a necessary step towards more and better evaluations and, hence, towards fossil fuel subsidies reform.

Proposals

G7 Leaders at their Summit at Schloss Elmau (26-28 June 2022) have the opportunity to make a definitive statement reaffirming their commitment to phase out “inefficient” fossil fuel subsidies at latest by the end of 2025. To avoid the appearance of ambiguity, they should at the same time make clear what types, or under what conditions, they would consider a fossil fuel subsidy *not* inefficient. If they are not able to come to a collective agreement on that, it would still improve clarity of their intentions if they each explained how *they* understand the term.

Because coal is the most carbon-intensive and most polluting fossil fuel, the need to phase out any and all support for its production and consumption is urgent. We strongly urge G7 Leaders to set an even earlier deadline of mid-2023 for ending all subsidies to it. In our view, there are no “efficient” subsidies to coal that should be exempt from such a commitment.

In parallel, the Leaders should announce their intention to increase the quantity and quality of fossil fuel subsidy evaluations. They should also incentivize the elaboration of such studies by independent researchers and institutions, for instance, by making data available for such purposes.

This said, even in countries with good data and existing evaluations, phasing out fossil fuel subsidies can be challenging. Hence, G7 governments should formulate evidence-based approaches, with clear and transparent rules, that give policy makers formal justification for the implementation of such reforms.

We hereby propose a three-stage process to drive the reform of fossil fuel subsidies, through which governments would:

1. Improve the quality and accessibility of fossil fuel subsidies data.

The availability of accurate and detailed estimates of fossil fuel subsidies is crucial and yet far from being fully realized. The first step is to prepare a complete inventory of support measures benefiting the production, transport, or consumption of fossil fuels, and to quantify any that have not yet been quantified.

Whereas more and better data are needed across all components of fossil fuel subsidies, this is particularly true when it comes to the support provided through the tax systems. Tax expenditures account, by far, for the largest component of fossil fuel subsidies in the OECD's Inventory of Support Measures for Fossil Fuels, which covers 50 OECD, G20 and European Union Eastern Partnership economies. Indeed, 63% of the more than 1300 total measures documented in the Inventory are support measures granted through the tax code, representing 62% of total support by value (OECD, 2021). Yet, even across G7 economies and other OECD countries, data quality is often poor and these figures very likely underestimate the real magnitude of fossil fuel subsidies. According to the Global Tax Expenditures Database (GTED), for instance, several tax expenditure provisions across G7 economies are not quantified.⁴ The 5-year average ratio of estimated to overall reported tax expenditures for G7 members is 73%, with the UK providing revenue forgone estimates for only 43% of the reported provisions.

The picture is significantly bleaker when it comes to low- and middle-income countries. According to the GTED, 115 out of a total of 218 jurisdictions worldwide have never released any data on their tax expenditures since 1990, most of them belonging to these country income groups. Moreover, although 83 out of the 103 reporting countries release some fossil fuel subsidies-related estimates, the detail and scope of the information provided is highly heterogeneous, with several countries publishing very limited information.

Improving the quality and accessibility of the data would make a substantial contribution to boosting the number and quality of evaluations of fossil fuel subsidies, and the G7 member countries should be frontrunners in this regard (Brosio et al., 2017; Diaz de Sarralde et al., 2018; Steenblik, 2020).

2. Comprehensively evaluate their fossil fuel subsidies measures.

Evaluations are crucial for domestic policy so that the fiscal cost of these measures can be assessed against their effects and potential externalities. All too often, once a tax provision related to the production or

consumption of a fossil fuel is implemented, it becomes entrenched and left in place indefinitely (in contrast with government grants), even after it has outlived its original purpose. All tax provisions benefitting fossil fuels should therefore undergo a thorough review. These reviews should cover the environmental as well as the socio-economic effects of the measures, including potential distributional effects. For instance, Martin et al. (2014) perform an econometric evaluation of carbon taxation in the United Kingdom and find that the carbon tax reduced energy intensity by 18.1% and electricity use by 22.6%, without triggering any adverse effect on employment, revenue or plant exit.

More analysis would also help shape discussions in international forums, such as the Asia-Pacific Economic Cooperation (APEC) and the World Trade Organization (WTO). APEC is currently implementing a voluntary standstill agreement on fossil fuel subsidies, but is still at the stage of deciding which measures qualify as fossil fuel subsidies and which, if any, of those could be exempt from the standstill. Under the roof of the WTO, the associated Trade and Environmental Sustainability Structured Discussions (TESSD), are planning discussions on fossil fuel subsidies this year in anticipation of developing a negotiating mandate by the time of their planned Ministerial Conference in 2024. In both organizations, improved information on the nature and scale of fossil fuel subsidies, and their environmental and trade effects, would be highly beneficial.

3. Use the results of such evaluations to drive comprehensive evidence-based reforms of fossil fuel subsidies.

The political economy behind the implementation of fossil fuel subsidies is complex and, at the same time, crucial. Lobbying by powerful interest groups and stakeholders can play an important role in blocking or slowing down the reform process.

Ideally, the decision for the continuation or elimination of a specific subsidy should be based on empirical assessments on the effectiveness and efficiency of the provision. Yet, even in the rare cases where these evaluations do exist, their results are often ignored, and support measures that had been proven ineffective have been kept in place. As underscored by a recent study of Nigeria's fossil fuel subsidies by McCulloch et al. (2021), lack of awareness about the existence of subsidies and their negative impacts works against the public's acceptance of fossil fuel subsidies reforms, especially those that involve energy price increases. Moreover, the more complex the subsidy system, the more difficult the task of improving understanding. Hence, the evaluations of the existing fossil fuel subsidies and plans to eliminate them should be complemented by an effective communications plan.

Applying an evidence-based approach, with clear and transparent rules, could give policy makers a formal justification for the reform of fossil fuel subsidies, which will make a substantial contribution to the G7 commitments towards net zero emissions and climate neutrality and, at the same time, to tackle inequality.

Implementation

With less than three years to meet their 2025 phase-out pledge, G7 members must make the reform of fossil fuel subsidies a top priority of their domestic policies as well as their joint agenda. This requires taking concrete steps in this direction, including legislative action aiming at annual and comprehensive reviews of all fossil fuel subsidies as well as the implementation of obligatory sunset clauses. Regarding joint action, the G7 should support the elaboration of joint standards for the evaluation of fossil fuel subsidies.

Given the economic and political weight of G7 members, the Group's decisions will likely influence other countries and international organizations. As explicitly mentioned on the G7 website, "the decisions made by the G7 have a tangible political impact". This is particularly relevant in the case of fossil fuel subsidies reforms since climate change is a global issue for which international coordination is crucial. Hence, if no action is taken, the Elmau G7 Summit would be yet another lost opportunity for the G7 to lead by example.

The German presidency of the G7 should increase the *momentum* within the group. As mentioned by the German Chancellor Olaf Scholz, "We will use our G7 presidency to make this group a pioneer. A pioneer for a climate neutral economy and an equitable world." Climate neutrality and net zero emissions (another commitment that the German government as well as the G7 as a group has pledged) are ambitious goals. Without the elimination of fossil fuel subsidies, they simply become a utopia.

Finally, we are aware of the deep impact that the Russian invasion of Ukraine has on the worldwide supply and the prices of fossil fuels. In addition, the current oil and gas price hike comes at a time when several advanced economies were already facing upward pressure on energy prices and rising inflation. For instance, US petrol prices are up 36 percent from January 2020, and European gas futures jumped almost 70 percent to €142 per megawatt hour after the invasion began; a year ago they were €16 (Brower et al., 2022). Against this backdrop, politicians are tempted to introduce new or expand existing fossil fuel subsidies to compensate those who are hit hardest by the energy price increase. However, alternative options to protect the most vulnerable groups of society while still phasing out fossil fuel subsidies should always be preferred, since the current situation does not render these reforms less necessary. Lump-sum payments such as the ones granted by the US government to help households weather the COVID-19 pandemic provide a good example.

Endnotes

¹ Sources: • **Canada:** Moore (2022); • **France, Italy, Germany and the rest of the EU:** Transport & Environment (2022); • **Japan:** Odo (2022); • **United Kingdom:** Cooban (2022); • **United States:** Smith (2022).

² Ise-Shima Leaders' Declaration, G7 Ise-Shima Summit, 26-27 May 2016, p.28; accessed at <https://www.mofa.go.jp/files/000160266.pdf>

³ The Fossil Fuel Subsidy Tracker is a joint website of the OECD and the International Institute for Sustainable Development (IISD).

⁴ The Global Tax Expenditures Database (GTED) is joint initiative led by the Council on Economic Policies (CEP) and the German Development Institute (DIE). It gathers the official and publicly available tax expenditure data worldwide in an online database, to improve reporting, enhance scrutiny, and, ultimately, contribute to the design of effective and fair tax expenditure systems across the world. The GTED is accessible on www.GTED.net. For more details, see Redonda et al. (2021).

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