



# POLITICAL ECONOMY

## GOOD PRACTICE NOTE 9

# Assessing the Political Economy of Energy Subsidies to Support Policy Reform Operations

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Gabriela Inchauste  
David G. Victor  
Eva Schiffer



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This is the ninth in the series of 10 good practice notes under the Energy Sector Reform Assessment Framework (ESRAF), an initiative of the Energy Sector Management Assistance Program (ESMAP) of the World Bank. ESRAF proposes a guide to analyzing energy subsidies, the impacts of subsidies and their reforms, and the political context for reform in developing countries.

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## ABOUT THE AUTHORS

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**Gabriela Inchauste** is a Global Lead on the distributional impact of fiscal and social policies for the Poverty and Equity Global Practice of the World Bank and a Lead Economist in the Europe and Central Asia region. Her recent work includes comprehensive assessments of the distributional impact of fiscal policies, ex-ante analysis of the distributional impacts of policy reforms, and diagnostics to better understand the channels through which economic growth, labor market opportunities and public policies can lead to poverty reduction.

**David G. Victor** is a professor of international relations at the School of Global Policy and Strategy and director of the Laboratory on International Law and Regulation (ILAR). He is an internationally recognized leader in research on energy and climate change policy as well as energy markets. His research focuses on regulated industries and how regulation affects the operation of major energy markets. Victor authored “Global Warming Gridlock,” which explains why the world hasn’t made much diplomatic progress on the problem of climate change while also exploring new strategies that would be more effective. Victor is a leading contributor to the Intergovernmental Panel on Climate Change (IPCC), a United Nations-sanctioned international body with 195 country members.

**Eva Schiffer** is a Leadership Expert in the Governance Global Practice of the World Bank. Her work focuses on assessing political economy constraints to reforms and on building the capacity of reform champions to implement difficult reforms. To analyze the political economy and stakeholder interactions concerning specific reforms, Eva developed the Net-Map tool, which is a participatory approach to mapping stakeholder networks, their formal and informal connections and the flows

of influence and interest between actors. She works with governments and change agents across different sectors and regions in overcoming political economy and stakeholder obstacles to reform.

## ACRONYMS AND ABBREVIATIONS

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**ESMAP** Energy Sector Management Assistance Program

**ESRAF** Energy Sector Reform Assessment Framework

**LPG** liquefied petroleum gas

**SOE** state-owned enterprise

## 1. INTRODUCTION

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For decades, policy makers have known that it is important to reform energy subsidies. Yet, in practice, there has been huge variation in the outcomes from reform efforts. Failures are often rooted in the inability of reformers to understand and overcome political barriers. Successes have come where governments and other important pro-reform policy actors have addressed the political economy barriers and opportunities for reform strategically. Further success of reforms will require tools that make it easier to understand and navigate those barriers and opportunities.

As part of a larger World Bank study on the empirical record of subsidy reforms, the goal of this note is to create a framework to collect information that can help explain the history and possible future developments of the political economy of subsidy reform. The purpose of this analysis is to improve the design and implementation of reforms and to integrate political economy concerns from the outset and not in a reactive manner.

The analytical framework proposed in this note is rooted in basic theories of political economy—a framework that can guide empirical research while helping policy makers draw lessons from previous reform efforts.<sup>1</sup> A political economy perspective pays close attention to such factors as the ability of interest groups to organize for or against policy reforms and how institutions, prices, and technical opportunities shape policy decisions and their implementation. This political economy framework has also put

an important spotlight on incentives that affect the behavior of political leaders and administrators.

Annex A provides a framework for interview questions and a strategy for obtaining information through interviews. Much of the critical information about the political economy is difficult to obtain through reports and data sets – while these can provide critical information about the issues that pose problems and for which the underlying drivers need to be explored. Interviews will be essential, especially interviews on politically sensitive topics with seasoned senior officials and observers.

While there has been extensive research on the optimal design of subsidy policies, systematic research on the political economy of subsidy reform is much thinner, yet perhaps more essential to effective policy design and implementation. Among the many insights from that research is that timing and organization are vitally important to the practical success of reform efforts. Other insights concern the reality that much of the academic research on policy reform has focused on first-best policy outcomes that are perhaps rarely observed in the real world. More realistic reforms often have “second-best” (or “nth-best”) characteristics and are best understood in a dynamic framework. Often, the question is not “How can we achieve a result that mirrors global best practice?” but rather “How can we make and maintain progress on the issue of energy subsidy reform?”

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<sup>1</sup> For more insight into the framework and in-depth application to four countries, see Inchauste and Victor (2017), notably chapter 1, which reviews the literature. For more about the foundations of the framework, see Olson (1965), Peltzman (1976), and Stigler (1971). For its application to recent studies of political systems, see Wilson (1973). A discussion of the general experience of using a problem-driven political economy lens to inform WBG strategies and operations, see Fritz, Levy, and Ort (2014).

Reform efforts begin and succeed where they engage effectively with the political economy in a given context. In some cases, that means that there is an existing favorable political economy. In others, creating that dynamic will be one of the main tasks of the reform team—to engage with stakeholders and leadership to increase the space for reform and reduce resistance. By starting the work in areas of favorable political economy, reforms teams can realize initial successes that help create and empower interest groups, institutions, and political dynamics that can be used to beget additional reform progress. Political economy research has also emphasized the importance of two distinct questions: (a) Has the reform been successfully implemented? and (b) Has the result been maintained sustainably over time or have changing circumstances and stakeholder constellations led to a retraction of reforms?

This note comes in three sections. First, the information required for political economy analysis of energy subsidy reforms is presented. Second, a summary is given of the information that can usually be obtained through desk research to provide the context for subsequent interviews and other field research. Third, information that probably requires interviews and field data collection is provided.

The ultimate audience of the proposed types of analysis lies with policy reformers themselves and with external development and policy institutions that are seeking to help governments adopt more sustainable reforms. However, the direct audience for this note are those commissioning political economy analysis of energy subsidies, and technocrats, researchers, and advisers to policy makers carrying out the analysis. Often, a team made up of sector experts and political economy experts will provide a greater depth

of analysis. Significant attention is devoted here to the origins and operation of existing subsidies since that history conditions what is possible for the adoption and sustainability of future reforms.

The main interest and audience for this note is forward-looking—people and institutions who need to understand what is politically possible and how to realign political forces around successful reform. The authors are mindful that this role is perhaps different from other more technocratic roles of agencies and institutions focused on technical analysis and thus they also devote some attention to the processes needed to obtain and manage sensitive information and political insights since mismanagement in that realm can, itself, affect the political prospects for reform and harm the standing of reform agents in the process. In contrast to desk research or analysis of existing datasets, field research on political economy will always be an intervention in the local system, which needs to be managed well to increase and not decrease the space for reform and coalition building.

ESRAF defines an energy subsidy as a deliberate policy action by the government that specifically targets electricity, fossil fuels, or district heating and that has one or more of the following effects:

- Reducing the net cost of energy purchased
- Reducing the cost of energy production or delivery
- Increasing revenues retained by energy producers and suppliers

Examples include government control of energy prices that are kept artificially low; budgetary transfers to state-owned energy suppliers or tax expenditures granted to



energy suppliers to keep costs down to benefit consumers, producers, or both; underpricing of goods and services, such as fuels, land, and water used by energy producers; subsidized loans; and shifting of risk burdens, such as the assumption of risks through limits on commercial liability.

Many forms of subsidies have little effect on energy prices. For example, tax expenditures may increase the profits retained by energy producers and result in large fiscal losses but may have no impact on end-user prices in a deregulated oil market. Because tax expenditures are seldom reported or subject to scrutiny by legislators, they frequently attract little or no attention from the public and policy makers, except in situations of increasing overall fiscal stress. By contrast, those subsidies that lower prices paid by consumers—and the reform of which is likely to raise prices—tend to be much more politicized, making political economy analysis essential. As such, while this note is applicable to all forms of subsidies, it focuses particularly on consumer energy price subsidies.

The rest of the guidance outlined in this note is structured around three intended goals. First is a political explanation for the country's current array of energy subsidies. This first goal treats each major cluster of subsidies as a unit of analysis (a subsidy with significant political and economic effects and organized administratively and politically in a distinct way). The second goal is to understand the history of reform—including whether successes or failures in past reform efforts reveal or constrain what is possible for future reforms. To achieve this second goal, historical episodes of reform are used as the unit of analysis. And a third goal is an assessment of the prospects and viable strategies for reform in the future. This third goal uses the sector and its actors as the unit of analysis and, where appropriate, the overall political economy of the country as the unit of analysis. Most reforms are sector-based, but at times sectoral reforms are anchored in broader country-wide reforms and the rise to power of leaders who have an incentive to pursue country-wide reform.

## 2. INFORMATION REQUIRED FOR ASSESSING SUBSIDIES AND DESIGNING ENERGY SUBSIDY POLICY REFORMS

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Before delving in depth on how information might be obtained, here the authors first identify the six main types of information that will be needed for political economy analysis. Following are the six types of information that are drawn from Inchauste and Victor (2017) and related research cited in that study:

- 1 | Goals and structure of existing subsidies
- 2 | Size of subsidies, who pays for them and who gets them

- 3 | Mechanisms used to deliver subsidies and their alternatives
- 4 | The decision-making structure concerning subsidies
- 5 | Stakeholder interests and dynamics
- 6 | The track record with reform

The first three of these six types of information will lead to an understanding of the country's existing subsidy schemes and the developments

that led to these schemes. The analysis should seek to capture the initial developments that led to the introduction of subsidies, and the major policy changes made since then. The last three kinds of information provide the guidance needed for a forward-looking political economy analysis of those subsidies and their reform, to feed into effective design and implementation of the reform.

### **INFORMATION TYPE 1: GOALS AND STRUCTURE OF EXISTING SUBSIDIES**

The first category of information is aimed at understanding the scale of the subsidies and the scale of distortions they cause in the economy and the political incentive structures. Before assessing whether subsidies are reaching their intended targets, and whether alternative mechanisms could perform better, the scale and incidence of subsidies must be known.

Most countries do not create energy subsidies for their own sake. Instead, subsidies are often initiated with the intention of advancing a potentially legitimate socioeconomic goal—such as keeping energy prices artificially low for economic development, helping the poor meet basic energy needs, or providing input subsidies in the form of cheap energy to certain industries—for which alternative instruments are not seriously considered, preferred, or available. It is important to understand those initial goals of a subsidy program, since they inform how interest groups are organized, as well as the goals that must be achieved with a reform program.

The existence and design of a subsidy also depends on the way that the industries in the country's energy system are organized. The electric power system is organized distinctly

from the rest of the energy system. In cold-climate countries, district heating plays a unique role, often managed at the level of municipal governments. Natural gas, like electricity, is managed by utilities at the level of pipeline transportation and distribution. Because they all have elements of natural monopoly, economic regulation is required for at least some segments of the supply chain for electricity, district heating, and natural gas. By contrast, liquid fuels and coal are typically suited for sale in a competitive, deregulated market. Because petroleum fuels play such a visible and central role in industrial and consumer activity—fuel prices affect the cost of goods and passenger transport, with the former affecting the prices of virtually all other goods, for example—they are often highly politicized.

In most countries, the landscape of energy subsidies has developed over a significant period into a complex mix of producer and consumer subsidies that varies significantly across fuels and energy carriers and that serves a mix of legitimate social and special interest goals. These different forms of subsidy differ with regards to their political and public visibility and their perceived and actual impact on different interest groups and institutions—which affects the political dynamics and stakeholder risks of reform efforts.

### **INFORMATION TYPE 2: SIZE OF SUBSIDIES, WHO PAYS FOR THEM, AND WHO GETS THEM**

At the outset of political economy analysis, it is important to establish “what the problem is” and the detailed contours of the problem to the extent possible (see also Fritz, Kaiser, and Levy 2009). Typically, it is expected that most of the relevant information would be provided by technical and fiscal analysis, either existing



or undertaken in parallel. Described here is the extent of information considered as needed about the nature and incidence of subsidies to then meaningfully explore underlying political economy drivers, constraints, and opportunities.

Ideally, a table of all the main subsidies (or clusters of related subsidies) should be prepared as detailed in table 2 in Good Practice Note 1, and information should be obtained on each one. For each, it is important to know the goals and sectoral focus of the subsidy. Good Practice Note 1 discusses how to quantify subsidies, how they are financed and intended, and who the actual beneficiaries are. For designing a subsidy reform program, the focus varies by energy type and country circumstances. Examples include the magnitude of budgetary transfers, the scale of price adjustments needed, the financial viability of energy supplies, and fiscal losses inclusive of contingent liabilities. This will make it possible to identify those reforms that may yield the greatest benefit. However, as shown below, in the analysis of future opportunities and planning of reform pathways, the identification of priority areas must be combined with an analysis of the political and administrative abilities of the system to implement this reform. This will help avoid situations where the reforms look perfect on paper, but are not feasible to implement in the existing political economy environment. How to estimate fiscal costs of subsidies is detailed in Good Practice Note 2.

Some attention needs to be paid to the unit of analysis. Here the unit of analysis is a major subsidy—that is, a subsidy whose political and economic effects are substantial within the country and which is organized in a distinct way, both administratively and politically. Thus, subsidies and their reform might operate

in clusters. For example, if a country has a large subsidy for diesel fuel because that benefits the trucking industry, then reforms might focus on this subsidy, as well as on other subsidies targeting substitute and complementary products, such as kerosene and gasoline. Quite often it is not useful to treat subsidies within a whole sector as a single type of subsidy. Countries rarely just subsidize a whole sector (for example, all petroleum fuels) in identical ways. Instead, they create complex and politically tailored subsidies that have differential effects on products. Further, subsidies evolve over time, and a policy that started out as a unified and streamlined subsidy can metastasize into a complex system of subsidies, exceptions, and administrative procedures. For example, the Islamic Republic of Iran in 2007 began rationing subsidized gasoline and allocated gasoline according to the vehicle category and ownership. The quotas, as well as exemption categories, increased over time because of political pressure, which transformed the subsidies into a complex system consisting of 45 consumer categories by early 2008 (*Iran Daily 2008*).

Information about the total size of the subsidy helps to set priorities for reform. It can indicate the total costs and benefits, as well as the scale of the effort that may be required for reform.

For each of the major subsidies, it is crucially important to understand, next, who pays the cost. The costs of budgetary transfers, government contingent liabilities, and fiscal concessions are borne by different levels of the government (central, regional, or local). Frequently, energy suppliers—starting with state-owned ones, but in some circumstances also private companies—incur financial losses as they provide energy at prices that are below reference prices (prices that would have

prevailed in a competitive market or, in the absence of adequate competition, benchmark prices as detailed in Good Practice Note 1). This happens when they are not reimbursed for subsidies, either because there is no mechanism for reimbursement or because reimbursements are late or unpaid.

Two main sources of subsidy delivery mechanism merit attention. One is the general government budget—which includes central government and regional authorities. These subsidies are often the simplest to understand and observe because their cost is easy to trace, as long as they are reported as separate line items in government budgets. Thus, the tradeoffs against other government policy goals are immediately apparent. As Good Practice Note<sup>1</sup> points out, state-owned enterprises (SOEs) in the energy sector merit special attention due to several potential factors—such as undue risk-taking, soft budget constraints leading to contingent liabilities, debt cancellations, and tax-exempt operating status—combined with their being politically, organizationally, and economically distinct. The use of SOEs to deliver subsidies poses a different set of challenges and opportunities. On the one hand, they are often one step removed from central government control and will fight to remain in existence and remain relevant. On the other hand, their distinct governance structures often allow for a larger flexibility in how to approach and implement reforms. Governments, elected leaders, and political parties often use their disproportionate influence over SOEs to direct their activities toward politically useful missions while burying the cost of those missions in underinvestment or the larger operational budgets of the SOEs.

Governments often avoid policies that create direct on-budget fiscal consequences for

themselves. Instead, they favor policies that externalize the cost to someone else. Export restrictions, not adjusting a “market-based pricing formula” in a timely manner, and reimbursing subsidies with a long delay and with no interest payments (if they are reimbursed at all) are some examples. In all these cases, energy suppliers often bear the cost. If export restrictions take the form of large export taxes, the government raises revenue and lowers domestic prices at the same time at the cost of investments in the energy sector. Over the long term, some fuel exporters have even turned into importers given the financial losses. Prominent examples are major crude oil exporters—such as Ecuador, the Islamic Republic of Iran, Iraq, Mexico, Nigeria, and the República Bolivariana de Venezuela—that have been forced to import large quantities of petroleum products because their refineries are not financially viable after decades of fuel price subsidies.

Finally, it is important to know who benefits from the subsidy. It is important to distinguish between eligible and ineligible beneficiaries, arguably the most egregious form of the latter being those who engage in criminal activities—such as fuel smuggling and diversion to black markets—to gain financially from subsidies. Where there is pan-territorial pricing and fuel transporters are compensated through an elaborate cross-subsidy scheme, illegal profiteering by truckers can be common. The distributional impact of subsidies and their reforms on households by income is covered in Good Practice Notes 3 and 4. To the extent possible, such information should also be organized politically so that the size of the rent flow can be linked to the organized interest groups (such as artisanal fishermen and private bus services) that seek the subsidy, as well as to more shadowy interest groups profiteering illegally from subsidies. Understanding the



strength of those interest groups and whether and how other groups can overcome political blocks is often pivotal to successful adoption and implementation of subsidy reforms.

As a practical matter, the fiscal data (examined in Good Practice Note 2) and distributional analysis (Good Practice Notes 3 and 4) are not organized by political around which types of interest groups benefit and thus, an analysis of the political economy of subsidies and their reform will need to examine these distributional impacts beyond the standard analysis by income brackets. Understanding who gets the subsidy is important because it can help reveal how beneficiaries are politically organized—and can point to opportunities and challenges to overcoming resistance against the reform. And it is important because it is crucial to understanding whether and how the subsidy actually reaches a socially desirable target. One important dimension is that energy subsidies often benefit multiple social groups. For example, consumer price subsidies may be critical for poorer groups, but they may also benefit elites, such as those who own bus companies or who generally consume more energy (for example to cool or heat their larger homes or to run industrial production), while the cost of the subsidies are generalized across all citizens (as taxpayers and as users of public services).

### **INFORMATION TYPE 3: MECHANISMS USED TO DELIVER SUBSIDIES AND THEIR ALTERNATIVES**

There are four main mechanisms by which subsidies are provided:

- 1 | Budgetary transfers
- 2 | Government-induced transfers between producers and consumers

- 3 | Forgoing taxes and other government revenues

- 4 | Underpricing of goods and services

The mechanisms are summarized with examples in tablet 2 of Good Practice Note 1. As that note describes in detail, how each is delivered is an important determinant of stakeholder groups, their benefits, and likely opposition to or support for subsidy reforms.

Consumer price subsidies are arguably the most visible form of subsidy, and one with the most distorting effect on the economy. How they are delivered affects the extent of subsidy effectiveness and leakage, as well as their unintended consequences. One question is whether energy suppliers are compensated. If they are, how many energy suppliers receive compensation, how that compensation is determined, whether compensation is adequate and delivered on time, and whether the compensation is self-administered (say by the national oil company) all affect the political dynamics of subsidy reforms. Inadequate compensation can lead to contingent liabilities and, over the long term, declining sector performance as the sector becomes increasingly unviable financially (see Good Practice Note 2 for these fiscal dimensions).

Other questions include whether the subsidized energy is rationed and whether there is a price stabilization fund. The price subsidy may be helping to insulate politically well-organized groups—for example, hauling or taxi unions—from the volatility and high cost of an important input. When price controls lead to contingent liabilities that can be shifted to less visible parts of the state budget (or even to actors who are poorly organized politically), the government obtains this

political benefit while seemingly avoiding the cost. A similar logic applies with regard to the incidence of costs over time—where the cost of subsidies can be hidden through such mechanisms as price controls and then shifted into the future (for example, through rising debt loads of the enterprises that bear the costs of persistent under-investment in infrastructure that wears out only slowly) that might be favored by political leaders who have shorter time horizons.

While political visibility is important to those designing and implementing subsidies, it is crucial to look closely at what the beneficiaries of subsidies actually know and the conditions under which visibility waxes and wanes (see Good Practice Note 4 for a review of qualitative methods that can be used for assessing people’s perceptions). Not all subsidies are well known and visible to average citizens—in the Arab Republic of Egypt, Jordan, Lebanon, and Tunisia, for example, surveys revealed that many citizens were unaware of the extent to which a number of fuels were subsidized.<sup>2</sup> Even price controls may fall victim to opacity if prices have been frozen for a long time, although they suddenly become visible when efforts are made to lift controls precisely when they are most costly and reform is most valuable (that is, when reference prices are much higher than subsidized prices).

This can lead to the paradoxical situation where, as long as the subsidies are in place, and incur cost to the budget, energy suppliers, or both, ordinary citizens are not aware of the price subsidies and do not give the government credit for them. However, should the government attempt to remove the price subsidies and reform the system, the pain of

this loss will be felt by many and pose a political risk to the government. When subsidies have existed for a long time, they may be particularly invisible. A first step toward reforms often requires that the subsidies and the fiscal costs become better known—transparency is a first step toward a more complete reform.

Subsidies can be highly targeted so that only the intended group obtains the benefit. The challenge in doing so is much higher for liquid fuels than for network energy (electricity, natural gas, and district heating). A frequently cited example is lifeline rates for network energy, where the challenge is resisting the political pressure to expand the size of the lifeline block and the level of service that is “lifeline.” Smart cards that mete out low-cost electric power supplies represent a variation on lifeline rates. Quota cards for petroleum fuels—for which diversion is much easier—have met with varying success. When the cards are for fishing boats, which can be used to smuggle subsidized fuels out of the country, the problem controlling diversion becomes especially acute. In some countries, the availability of targeted income support—such as unconditional cash transfers—has allowed reduction or elimination of some energy subsidies, since it is almost always better to support a household’s income directly than to offer indirect benefits through subsidized energy.

Targeting has proved to be extremely important for reformers. Often it is politically not feasible to remove an energy subsidy completely. However, a scheme that allows for better targeting makes it possible to tailor the subsidy to the political environment and also to ensure that legitimate social goals (for example, poverty alleviation) are not

<sup>2</sup> See the MENA SPEAKS surveys (Social Protection Evaluation of Attitudes, Knowledge, and Support [SPEAKS] in the Middle East and North Africa [MENA]) a set of nationally representative opinion surveys that collected cross-country data about citizens’ perceptions and aspirations concerning social safety nets (Silva, Levin, and Morgandi 2013). The surveys were conducted by the World Bank in partnership with Gallup in Egypt, Jordan, Lebanon, and Tunisia.





## INFORMATION TYPE 4: THE DECISION-MAKING STRUCTURE CONCERNING SUBSIDIES

The information required for the political economy analysis of political and administrative decision making is discussed next. The information gathering begins with a basic overview the organizational structures of the executive, legislative, and judicial branches. The goal is to identify which arms of government have the authority to regulate the energy market and make decisions about the direct allocation of subsidies, regulation of prices, and other decisions that create subsidies. Further, it is important to identify which specific units within these arms of government are involved in or drive the decision-making processes.

The analysis focuses on two aspects. First is the question of decision-making control. Are subsidy-relevant policy decisions based on a decree, such as an executive order or in the direct control of SOEs, or do they emerge from logrolling<sup>3</sup> and political debate within legislative bodies? And if they are instituted and their structure is defined by decree, can the executive decisions be reviewed or overturned—such as through legislative or legal action?

Second is the question of how organized interest groups can make their influence felt within government. Do they mobilize voters who, in turn, can help determine the electoral success of parties? Do they have the power to mobilize populations to protest and take to the streets, possibly in violent protests, challenging the government? This has been the case in more than 30 countries in recent years, often leading to a reversal of policies. If so, that may inform the kinds of subsidies that

government adopts—such as highly visible price controls enacted close to election time. Or, do interest groups affect the logic of political survival for policy makers in different ways—such as through lobbying, campaign contributions, or direct roles in government? In some SOEs, for example, there are seats on the governing board reserved for organized interests, such as labor.

A prevalent problem that complicates policy making is opposition *within* a government. The opposition may be largely ideological or political, but can also involve – typically hidden – private interests. Such cases involve government officials (perhaps working with executives of national oil companies) who orchestrate diversion and smuggling of subsidized fuels. These individuals will not be organized officially, but can have very strong incentives to block subsidy reforms. Also, government officials may be collecting informal payments in exchange for renewing tax expenditures, below-market land leases, and other forms of producer subsidies. By their clandestine nature, information on such vested interests is difficult to gather. These observations suggest, however, that it is important to bear in mind that governments are rarely monolithic and reformers within governments may be facing strong opposition from their own colleagues.

In addition to a current picture of governing systems, it may be useful to include a brief outline of how the existing decision-making structure arose—if that information helps to reveal major changes or lock-in effects. Big changes in governing structures—or in ruling parties—can realign the logic of political survival for leaders and reveal opportunities and difficulties in subsidy reform. Those changes

<sup>3</sup> 'Logrolling' refers to the practice of exchanging favors, especially in politics by reciprocal voting for each other's proposed legislation.



may also reveal—through past attempts, successful and not, at reform—how reformers can realign political forces. Information of this type may be useful in interviews, for example, to help elicit information about “what went right” and “what went wrong” with earlier reform efforts.

### **INFORMATION TYPE 5: STAKEHOLDER INTERESTS AND DYNAMICS**

The 2017 World Development Report: Governance and the Law, which explores how unequal distribution of power in a society interferes with policies’ effectiveness, defines better governance as the process through which state and non-state groups interact to design and implement policies, working within a set of formal and informal rules that are shaped by power. In this regard, political economy analysis is about how groups organize effectively to get what they want—and which groups fail to organize or to amass sufficient influence and thus end up paying the cost or not benefiting. Analysis of the political economy of reform involves understanding the relative power of those groups. Thus, any political economy analysis requires analyzing and mapping the goals and capabilities of major organized, as well as unorganized, interest groups. It also requires understanding how the groups are organized internally to use their capabilities to advance their goals and how they connect to each other. Further, it is important to understand how the different groups connect to each other, which coalitions they form, how their interests overlap, and how strong their connections are.

Throughout different reform episodes in different countries, various interest groups have organized themselves, formed coalitions among groups, and influenced the reform outcomes. Understanding those important political phenomena requires looking inside each of the major organized political forces. How did the major interest groups arise and what holds them together? How does influencing government subsidy policy help the group remain organized and deliver benefits to its members? How do they connect to the political forces in the given context and what fuels their influence?

In addition to organized interest groups, hidden interests ones can be just as powerful, if not more so (and often involve individuals in influential positions in business and politics). Those engaged in making illegal financial gains from subsidies are not visible and do their best to cover their tracks. In extreme cases, as with kerosene in Nigeria mentioned earlier, their illegal profits may even dominate virtually all potential intended benefits of the subsidies.

It is axiomatic in the study of political economy that broad and diffused interests tend not to be well organized politically, whereas more concentrated interest groups can mobilize more readily and effectively to advance their narrower self-interested cause. This basic logic inspires a simple political economy framework, which could broadly characterize the political equilibrium of a country’s subsidy policy at any point in time. Table 2 shows how the benefits of subsidies may be analyzed and categorized into four cases.

**TABLE 2: Characterizing Subsidy Policy Benefits: Basic Framework**

	Citizen benefits are large	Citizen benefits are small
Special interest benefits are large	Case 1	Case 2
Special interest benefits are small	Case 3	Case 4

Source: Reprinted from Inchauste and Victor (2017), chapter 1.

Ultimately, the goal is to understand the interplay of these social groups with the incentives of the government as it embarks on adopting policies that would move the country toward an equilibrium that is closer to case 4, bearing in mind that this could have large political costs.<sup>4</sup> Those interactions will depend on the level of organization and political power of the groups, and it will also hinge on the ability of the reformers in the government to choose their political allies and to blunt the political influence of groups that could block adoption or reverse the implementation of energy subsidy reforms.

When governments are confident in their mandate and feel secure in power, they can often get things done even over the opposition of powerful groups. When political leaders are more insecure in their tenure, the policy may need to be more directly responsive to the underlying political economy. Earlier work on Indonesia, for example, has shown that politically powerful leaders have been able to take politically unpopular subsidy reforms, but when electoral fate is less secure, leaders are less willing to adjust these politically popular (yet fiscally costly) policies (Beaton, Lontoh, and Wai-Poi 2017). In doing research on such factors, it is crucial to remember that matters of political succession and control are internal to a country, and it is problematic for international institutions to be seen as working on reforms that could be construed

as meddling with national sovereign choices or interfering with the national political process.

To design feasible reforms and implementation plans, it is crucial to figure out where the current political equilibrium lies at any particular point in time in a country. Then, for each type of case, the proposed framework provides some theoretical intuition about the circumstances that could lead to a change in that equilibrium, and thus the likelihood that an energy subsidy reform would be more (or less) successful. Each of these cases is discussed below and accompanied by a set of hypotheses on the likelihood of reform. The aim is to provide a theoretical framework to assess the extent to which these circumstances are in place at any given point for a country interested in reform and design interventions accordingly.

In what follows, only those cases where costs accrue largely to the government (taxpayers) and benefits to citizens and special interest groups are considered. In practice, costs to citizens and special interest groups also play an important role in political economy analysis. For instance, when energy producers incur large financial losses, or when private businesses have to spend too much on backup generators. Inclusion of such costs may complement the characterization of the political equilibrium described in table 2.

It is also important to note that subsidy scenarios are seldom static. This is especially

<sup>4</sup> Note that not all interest groups will be politically organized. Moreover, even within governments there may be different positions with regards to subsidy policy.



true of fuel price subsidies, where costs are driven largely by world fuel price movements, which exhibit high volatility. For the same fixed fuel price, the unit subsidy may be large or small, depending on the world fuel price at any given point in time. It would therefore be useful to trace how a particular subsidy has recently moved from one case to another, as described below, and how the case is likely to evolve in the future, for example based on future world price forecasts.

### **CASE 1: Large Benefits to Both Special Interests and Citizens**

An example of case 1 is large price subsidies, such as in countries where retail prices are low for all users even when global prices are high. Large users benefit exponentially, but average citizens also see a significant contribution to their household budgets. Large benefits to so many typically lead to fiscal unsustainability.

Special interest groups may also capture large benefits where there are large tax expenditures and other non-price subsidies detailed in table 2 of Good Practice Note 1. These are much less visible than price subsidies, but the government's revenue loss, contingent liabilities, or both could be considerable.

The theoretical intuition is that such cases of massive energy subsidies exist because citizens enjoy the benefits they reap without being too concerned about the cost of the support or the fact that a large portion of the benefit goes to special interest or wealthier parts of society, as long as they continue to benefit from the low prices. Especially in cases where the cost of subsidy

is deferred to the future or hidden in complex institutional arrangements, citizens have no strong motivation to collectively pressure government to change policies because they do not feel a problem directly.<sup>5</sup> Moreover, well-organized special interests fear that a change in policy will harm their interests. Each depends on the support of the other for the benefits, and neither will support lowering benefits for the other. Governments tolerate this situation because leaders gain electoral and other benefits from the subsidy and are not forced to deal with the cost.

Reform in this case is more likely when some or all of these conditions are present:

- Government is able to create a strong, simple, and credible narrative that explains how the current situation is harming the country and its citizens, breaking complex economic processes down to a simple relatable logic. This narrative is communicated consistently and broadly.
- Citizens develop a better understanding of how the existing system is harmful to their interest, as it redistributes public funds mainly to the wealthy and special interest. As a consequence, it is more likely that citizens will mobilize in their own collective interest. This process of mobilization can be supported by an inclusive and participatory process of reform implementation.
- Government can make a credible commitment to citizens and interest groups that policy reforms will leave them better off or at least not harm their interests. However, citizens and interest groups often do not trust governments to deliver on

<sup>5</sup> Note that some interest groups may not be receiving subsidies at all, but may be benefitting from the disruption and shortages that subsidies often create. For instance, low diesel prices combined with an unreliable electricity grid and acute power shortages may result in a flourishing market for backup diesel generator sets. Importers of such generator sets may fiercely resist diesel subsidy reforms, power sector reforms, or both. Although they are neither providers nor recipients of subsidized energy, they should not be left out of the political economy analysis.

these commitments. Solving the credibility problem may require having alternative programs in place that provide at least medium-term benefits and that are timed such that new benefits flow in tandem with the loss of benefits from energy subsidies.

- Special interests find it more difficult to mobilize, in effect reducing the political cost to government of reforming subsidies. For example, special interest groups might become disorganized for some reason, or the government might find different ways to satisfy their core aims. The government may apply a “divide-and-conquer” approach toward special interests, identifying which groups may be enticed to support the reform based on how the reform is structured, as in the example of Poland giving support to the local miners in finding new jobs, which enticed unions to support, or at least not actively fight, the reform process.
- The costs of providing benefits rise sharply (for example, if world fuel prices skyrocket). However, in some cases reforms have been successfully initiated during periods of low world market prices, when the difference between the subsidized and non-subsidized energy prices were less marked and the initial implementation of the reform impacted citizens only minimally.
- Governments face any combination of a large revenue shortfall, general fiscal stringency, or balance-of-payments stringency, with energy subsidies being a large part of the problem (Clements and others 2013).
- The costs of subsidies (paid by the government or energy producers) are not sustainable and the quality of energy service delivery is beginning to decline or has declined noticeably, increasingly

offsetting the benefits of subsidies received by consumers.

- External pressure changes the political equilibrium, such as when donors or lenders have exceptional leverage.

By contrast, reform is less likely under the following conditions:

- Governments fear mass mobilization and protest by the public in response to removal of subsidies. This is especially likely when special interest groups are effective in developing compelling narratives of how the reform would harm ordinary people and are able to galvanize citizen protests.
- Powerful government officials’ schemes are making large illegal financial gains from subsidies and stand to lose significantly from reform efforts.
- Governments promise to replace energy price subsidies with cash transfers to average citizens, and fail to adopt a credible sequencing, such that citizens do not believe the promised transfers will materialize.

### **CASE 2: Large Benefits to Special Interests, Small Benefits to Citizens**

Case 2 arises under several circumstances. Many forms of producer subsidies do not benefit citizens noticeably, if at all. An example is tax expenditures for fossil fuels in a deregulated market that trades the fuels across the border. Tax expenditures benefit producers while consumers pay market prices at trade parity irrespective of the magnitude of tax expenditures. In such cases, large tax expenditures provide large benefits to producers at a large cost to the government, and no benefits to consumers. In the case of producer price support, producers may enjoy



large benefits while consumers pay higher prices than otherwise, accepting dis-benefits.

Another example is one in which costs of subsidies are large, but intended beneficiaries do not capture them because of chronic shortages of the subsidized energy. With subsidized liquid fuels, a substantial portion of the subsidies may be captured by those engaged in diversion, black marketing, and smuggling, forcing consumers to pay much higher prices on the black market and reducing their benefits. In the power sector, power shortages are common in many countries, and low-cost electricity that is intended to benefit consumers is not available, forcing businesses to pay much more for electricity by relying on diesel back-up generators. Where underpricing is a cause of power shortages (see pages 35–36 of Good Practice Note 1 for more detail), benefits to citizens of such energy price subsidies might also become small.

Case 2 could also arise when prices are high for all but a handful of consumers, such as select industrial users. The theoretical intuition is that such a policy exists when citizens have little ability to advance their collective interests, while organized lobbies are powerful. In these cases, subsidies are often organized in a way that is less obvious to the general consumer. Subsidies would then flow to special interests to the extent that the well-organized interest groups can exercise leverage over the government—such as when there are family or party ties, or when the interest groups command a vital part of the economy (for example, transport). As a general rule, subsidies of this type may arise and persist because they benefit a powerful but particularly small fraction of the population, or their costs are not large enough to have substantial, broad-based

impacts on the functioning of the economy and the public budget. In some cases, these situations will persist irrespective of the size of the cost because of the entrenched nature of the formal and informal influence of special interest and the lack of good governance in the sector. The benefits to the citizenry as a whole may be small or, more likely, citizens generally pay diffused costs while special interests gain concentrated benefits. From a political economy perspective, these cases can develop and prevail because the concentrated special interest is well organized and close to the sources of power, while the general citizenry is diffused and far from the sources of power.

In these cases, a successful and sustainable reform is more likely when some or all of these conditions are present:

- Governments can credibly provide special interest groups with alternative benefits that meet their interests.
- Dispersed interests that benefit from reform—for example, citizens who would gain from larger government revenue or subsidy allocation being redirected to public goods spending—develop a better understanding of the price they pay and the possible benefit of reform. Building on this understanding, they develop the desire and the capacity to mobilize in their own collective interests. Often this will require strong and understandable communication of the reform team and facilitation of participatory processes.
- The government changes, and special interests no longer have a large influence within the successor government.
- Benefits to citizens from existing fuel subsidies are small because black marketing

is creating chronic and acute shortages of subsidized fuels, and consumers are persuaded that eliminating subsidies will eliminate fuel shortages.

- Fuel prices skyrocket (making the total cost of the special interest subsidy more visible), or governments otherwise face the general need for fiscal stringency. However, during world market price hikes, benefits to citizens will increase and may shift the scenario to case 1, while the willingness of special interest groups to fight reforms will also be heightened—and they may use the general price increases to lobby with groups that are not even targeted by the reform, making them feel that they pay more because of the reform.
- External pressure changes the political equilibrium.

By contrast, a successful and sustainable reform is less likely under the following conditions:

- The total cost of the subsidy is small and thus neither attracts broader public attention nor drains the public budget. On the one hand, in this case the political and financial cost of reform may outweigh its benefits. On the other hand, if the cost of the subsidy has become small because world fuel prices have collapsed, then this could provide a window of opportunity for reform, as has been the case in several countries following the decline in oil prices in 2009 and 2014.
- Special interest groups remain well organized and well connected relative to countervailing groups. Special interest groups develop strong narratives that convince the general public that they will lose based on the reform.

- Chronic energy shortages driven in part by a history of price subsidies result in poor quality of service, and consumers feel they are being asked to pay more for continuing poor service quality. The timing of service quality improvement and energy price increases is especially challenging for network energy (electricity, natural gas, and district heating) because it is much more costly and time-consuming to address shortages of network energy than those of liquid fuels. Table 5 in Good Practice Note 1 discusses tangible benefits that may be delivered to electricity consumers in the short run in exchange for higher prices.
- Tax expenditures and other non-price subsidies are not reported and continue to escape scrutiny.

### CASE 3: Small Benefits to Special Interests, Large Benefits to Citizens

Case 3 generally involves subsidies that are intended exclusively to benefit most households. Examples include low electricity tariffs for residential consumers and low prices of LPG for household use. As with case 1, the fact of providing large benefits to citizens frequently means that the subsidy is not fiscally sustainable for long. In these settings, citizens may be well organized enough to demand subsidies from the government—perhaps because governments, seeking electoral advantage, brandish subsidies as a way to curry broad-based political favor. Also, for some governments, offering subsidies targeted to households in general or the poor more specifically is part of a broader ideology of redistribution.

The theoretical intuition behind case 3 is that subsidies can offer visible political advantages that political leaders might want to use



broadly. Leaders, for example, might need to appeal to large, lower-income segments of the electorate to retain power. They might fear mass uprising from energy price shocks or other events that the public might view as failures of government. The poor, for example, may be organized into parties and be pivotal voters—such as when social solidarity is high or when “social altruism” is inspired by specific, rather than general, consumption needs of the poor. Leaders in this setting might lack alternative mechanisms that could target subsidies more efficiently. For example, if benefiting the poor is electorally important, a government may nonetheless use broad-based energy subsidies because it lacks the capacity to implement targeted cash transfers or other better alternatives. Where government lacks capacity to implement more targeted transfers, these broader subsidies may be the second or (nth-) best feasible solution.

A standard political economy framework would suggest that case 3 is rare. Normally, political economy involves well-organized groups obtaining benefits for themselves while the broader public interest is harmed (case 2). However, there are examples of case 3. A large price subsidy for LPG sold in small cylinders, as historically observed in Morocco and Senegal, is one such example. Household use of LPG is nearly universal in Morocco, benefitting citizens of all income levels. Because LPG has limited applications and the transaction cost of transferring LPG sold in small cylinders to large cylinders or containers for illegal diversion is not small, citizens may be capturing a majority of the subsidy benefits. Put differently, these cases might be called “populist political economy” in logic. These cases are especially likely under governments that have won elections as the result of campaigning with a populist agenda.

Reductions in these subsidies are more likely when some or all of the following conditions are present:

- The poor are no longer pivotal to the electoral success of a government. For example, parties that oppose redistribution may come to power in response to ideological shifts or the perceived poor performance of redistribution policies.
- The government can credibly offer alternative policies to some or all of the citizenry, such as through direct cash transfers or other programs, that allow it to administer alternative systems for transferring benefits to the poor. Political leaders are able to craft and communicate a compelling narrative about the benefits of reform and follow through in realizing alternative systems for social support for the poor.
- The costs of the subsidies rise, such as when international fuel prices rise or subsidized energy leads to substantial increases in consumption. However, although the government may be forced to increase prices in response to higher international fuel prices, the unit subsidy may remain the same or even increase, depending on the relative magnitudes of the price shock on the world market and domestic price increases.
- Politicians’ beliefs change about the “special” nature of energy, and redistributive policies shift to more efficient transfers.
- External pressure changes the political equilibrium, such as when donors with exceptional leverage become important to a government’s political survival or other exogenous shocks require a change in the public budget.

- By contrast, reform is less likely under the following conditions:
- Governments fear mass mobilization and protest by the public in response to removing the subsidies.
- Special interests emerge that, along with the broader public, lobby for continuation of the subsidy (that is, moving the subsidy to case 1).
- Governments continue to perceive that the benefits from the subsidy are crucial to their political survival.
- Governments are ideologically married to the concept of subsidies and not willing to give them up.

#### **CASE 4: Few Benefits to Either Special Interests or Citizens**

In case 4, no interest group, organized or general, benefits exceptionally. Per-household or per-business subsidies may be small, but that does not mean that the total cost of the subsidy is also small. For example, a subsidy of US\$0.01 per liter of diesel fuel may be so small as to be unnoticeable, but if the total consumption is large, the subsidy could still amount to hundreds of millions of dollars a year.

Benefits captured by individual consumers may have been large in the past and fallen recently. Examples include the collapse of the world oil price in recent years in a country with capped prices for petroleum products. In such cases, the fact that subsidy benefits have become small to all parties may provide a good opportunity to reduce or eliminate the subsidy, as many countries did with fuel price subsidies following the collapse of the oil price in 2009 and again in 2014.

While all cases face the possibility of moving to another case, the government stands to lose the most if case 4 moves to any other case, and especially to case 1. For instance, price subsidies dependent on petroleum products which could be characterized as case 4 began to move to other cases in a number of countries at the end of 2017 as the world oil price rebounded by nearly two-thirds from early 2016.

On the other hand, if the cost of the subsidy is small, the pressure to reform the subsidy may also be small. The compelling case for reforming a subsidy in such a case lies in managing the risk of case 4 moving to other cases, and especially to case 1.

#### **INFORMATION TYPE 6: THE TRACK RECORD WITH REFORM**

Ultimately, the goal is to understand not just the political forces that explain the origins and persistence of energy subsidies, but also how they might be reformed. Developing a robust mapping of existing subsidies, as well as the interest groups that favor and oppose these policies, is one foundation for this political economy analysis and the resulting reform strategies.

A complementary approach is to look at what has been tried (or avoided) in past reform efforts, since this history can reveal what is possible and how interest groups organize to enhance their agenda. In developing a history of reform, the analysis shifts to a new unit of analysis: episodes of reform. Here the focus is on recounting the process, timing, and sequencing of previous attempts to reform subsidy policies. The purpose is to understand better how subsidy policy has arrived at the current equilibrium and what paths could be open for reform.



For this purpose, it may be useful to create an analytical table that shows the basic “life history” of reform episodes as detailed in figure 1 below. For instance, subsidies may begin with modest purposes at modest levels, as shown in the lower-right corner. This, for example, could take the form of a risk mitigation strategy to soften the impacts of international fuel price fluctuations in the absence of more sophisticated social protection mechanisms.

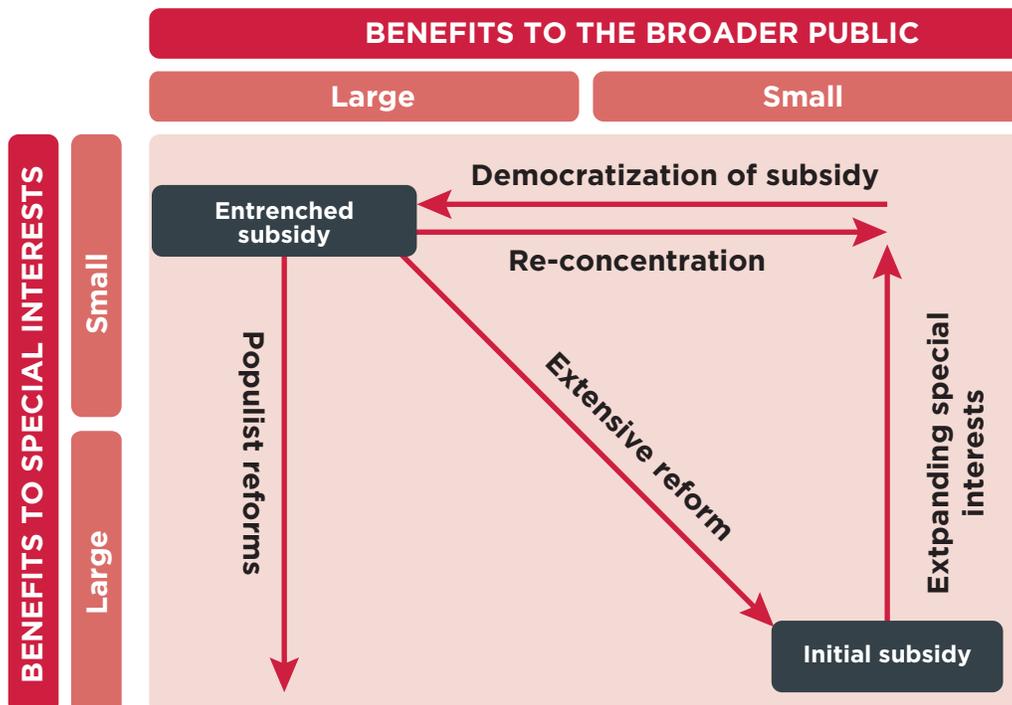
In such a case, well-organized interest groups may realize that a scaling up of those small subsidies would be to their advantage. As a result, the subsidy regime moves north. Standard political economy models would predict that a north-moving subsidy would be a stable outcome—an iconic example of special-interest politics.

However, there are many examples of subsidies that do not remain in the northeastern corner.

Instead, the subsidy is democratized as special interests realize the benefits from a large subsidy. Political leaders—often goaded by the opposition or animated by fears of losing power—also realize the benefits of providing a broad-based subsidy. The subsidy regime thus shifts west and becomes deeply entrenched. These are the most difficult cases for reformers because they lead to the highest costs and are animated by political forces—a combination of leaders who fear the loss of broad-based public support and organized special interest groups that oppose any reduction of the subsidies.

Reformers might focus on re-concentrating the subsidy regime—moving from a very costly broad-based subsidy to one designed to be politically more efficient because it is catering to a smaller number of well-organized interest groups. Undertaking extensive reform, in contrast, may be much harder. Related

**FIGURE 1: Life Cycle of a Subsidy Regime**



Source: Inchauste and Victor (2017), chapter 1.

to this are reform efforts that focus on the parts of the subsidy regime for which reform is possible. In the Dominican Republic, there have been extensive reforms of the fossil fuel subsidy regime because the political interests have proved feasible to manage. However, a reform of the power sector has stalled because the political economy is much less supportive (Gallina and others 2017).

Reformers have also done things that are quite unexpected within the standard political economy framework. They have shifted subsidies from the northwest corner (case 1) to the south (case 3)—removing special benefits while preserving broad-based benefits. This kind of “populist” reform is evident in several of the reform episodes in Ghana, for example. Leaders, keen to retain public office and fearful of swings in the sentiment of the electorate, found it difficult to reform broad-based subsidies, yet were willing to allow the costs of subsidies to flow against well-organized interest groups, such as industry and even the state-owned refinery (Addo, Bazilian, and Oguah 2017).

Understanding the existing political equilibrium in the context of previous reform efforts is

useful to understand the circumstances better that allowed reform to take place in the past, and the likelihood that such circumstances might be put in place once again. Moreover, to the extent that small reform efforts can be used to build the capacity for more extensive reforms, a long-term strategy can be worked out.

While each country presents a specific situation, the factors that have supported or hindered reforms in other countries can provide an interesting context for the analysis of a specific country case. A cross-country comparison of 22 countries, covering 28 reform episodes showed, successful and sustainable energy reforms often had the following in common: (a) a comprehensive reform plan; (b) a far reaching communications strategy; (c) energy price increases that were appropriately phased and often sequenced differently for different products; (d) improved efficiency in SOEs; (e) mitigation measures targeted at the poor; and (e) a depoliticization of the reform to avoid a recurrence of subsidies following the change of political leadership (Clements and others 2013).



### 3. INFORMATION THAT CAN BE OBTAINED FROM DESK RESEARCH

The goal of this note is to guide readers on how to obtain the information crucial for political economy analysis, as detailed above:

- Goals and structures of existing subsidies
- Size of subsidies—who benefits and who pays
- Mechanisms used to deliver subsidies and alternatives
- Decision making structures concerning subsidies
- Stakeholder interests and dynamics
- The track record of reforms

Prior to field research, it should be possible to obtain a lot of information through existing reports and databases, field research databases, including those produced within the World Bank Group’s Governance Global Practice. Because the accuracy of the available literature and databases depends on the resources devoted to their production, the information so obtained in desk research should be verified or assessed in field research as much as possible.

### **MACRO INDICATORS OF SUBSIDIES: GOALS, COSTS, AND BENEFITS**

First and foremost, it is important to populate the entries in table 1. This requires information on the major subsidies—their purpose, fiscal cost, and allocation of benefits. Good Practice Notes 2–4 are a place to start.

### **POLITICAL ACTORS AND INTEREST GROUPS**

Desk research should yield basic background information on the decision-making processes and on the political organization of the major groups that affect subsidy policy. The analysis of relevant interest groups should focus on their support base, ties to government (for example, through ideological or party links), and historical engagement with energy subsidy issues, as well as coalitions and conflicts they are engaged in. More subtle and less well-documented information, such as on the internal organization of those groups, and their pathways for informal influence, may require interviews with relevant stakeholders.

In focusing on political actors, some attention should be given to the role (if any) of foreign actors. Foreign firms may play important roles as investors and operators, which may

expose them differently to the costs and benefits of subsidy regimes. In addition, foreign economic institutions—such as the International Monetary Fund and organized bondholders—may play an important role in influencing national government policy.

### **SURVEY OF EXISTING LITERATURE**

Some countries have been the subjects of extensive research, which can provide useful information. In particular, the existing research may offer considerable value in providing information, or first drafts of information, such as the following:

- The size and basic structure of the subsidy policy, as a cross-check against the information that will be obtained from other ESRAF good practice notes
- Regulations, decrees, decisions, and government announcements relevant to the energy subsidies under discussion
- Identification of the main interest groups that favor or oppose subsidies and why
- A basic history of reform efforts and lessons from those reform episodes and attempts
- An initial list of key observers of the scene and key actors in the process—inside and outside government—who could be interviewed. Interview partners are often found in a “snowball” system, where initial contacts highlight other important actors to interview.

The goal of this prior research is to create a foundation of knowledge, so that subsequent, more detailed work can be more effective. In particular, this prior research will be essential to developing an interview strategy (see annex A) and to laying the foundation for an effective interview program.

## 4. INFORMATION USUALLY AVAILABLE ONLY FROM INTERVIEWS

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The central purpose of interviews is to provide the information that desk research and literature reviews cannot reveal. This information will ultimately provide the content that is schematically summarized in tablet 1, as well as the history and prospect for reforms.

As the research needed to implement this note moves from remote desk studies to interviews, it is crucial to be aware of the political sensitivities surrounding think tanks, institutions, and organizations, including international development organizations. Forward-looking research on the political economy of reform implicates national policy decisions in areas that are intrinsically politically sensitive. Thus, confidentiality and reasonable care with the information gleaned—especially from high-level interviews—will be important. Further, it is important to keep in mind that most interview partners will engage in the interview with a certain agenda or bias.

Annex A offers much more detail on the development of an interview strategy and a checklist for questions. This section focuses on three broad aims for the interviews.

### **FILLING IN FUNDAMENTALS: DETAIL ON PURPOSE, COST, BENEFITS, AND INSTRUMENTS OF MAJOR ENERGY SUBSIDIES**

Building on the first draft of the information prepared based on desk research, critical gaps in this information must be filled in. In particular, interviews within country should check whether the current inventory of major subsidies is complete and whether

information obtained from external desk research is accurate. Often, it is difficult to understand from a literature review alone what the real political purpose and impact—past or present—of a subsidy is or how the mechanisms for subsidy actually work in detail. Subsidies that involve transfer pricing or contingent liabilities may also be hard to detect from the outside.

A particularly important aspect of interviews is to assess counterfactuals. For example, if a subsidy is delivered via a blunt mechanism—such as an across-the-board price control—were alternative mechanisms unavailable? Were there political or other reasons for picking this mechanism? Such information about the choice of subsidy instrument, in turn, affects the political benefits and costs of a subsidy and may narrow the range of viable reform options.

### **INFORMATION CONCERNING POLITICAL INTEREST GROUPS**

To the extent possible, initial desk research will reveal the major interest groups that are relevant. However, it is unlikely that such prior research will offer much insight into why these groups favor or oppose subsidies or into how the groups are organized and what coalitions and conflicts they engage in to advance their policy goals. Obtaining such information usually requires talking with a wide range of stakeholders and observers. Observers of the political scene—even if they are not specifically focused on energy policy and fiscal matters—can be especially valuable in this regard.



It is particularly important to focus on the “glue” that holds the interest groups together. Are they organized because they are small and concentrated—such that each member knows the benefit of being organized, and large members will incur most of the cost of organization? Or does something else hold them together? Do they have a clear position with regard to the subsidy reform? How are the different interest groups connected to other groups and to the government?

## OVERALL POLITICAL ECONOMY ASSESSMENT

The introduction to this note identified three different goals for this political economy analysis, each with its own unit of analysis. Meeting all three of those goals—an assessment of the political economy of the current subsidy regime, an assessment of historical reforms, and an evaluation of plausible future reform strategies—requires seasoned political judgment. Obtaining that judgment—informed by the particulars of the current subsidy regime and past efforts at reform—is difficult, yet is the most vital outcome from the interviews.

Particular attention is needed in conducting open-ended interviews using questions that assess plausible future reform strategies. This requires thinking through who can share information on what, and what potential interests and biases the interviewee has. The task of those performing political economy analysis is to cross-check those judgments against areas where more detailed analysis is possible. Further, as these interviews are being undertaken, it is important to remember that most interviewees will answer from their own, often limited perspective, and they might introduce their own biases, interests, and prejudice to the picture. Since there will be no

“neutral” observer in most cases, it is crucial to triangulate among a variety of viewpoints in this phase of the analysis.

## FORWARD-LOOKING SCENARIO ASSESSMENT AND ITERATIVE LEARNING

The biggest challenge and most powerful use of strategic political economy analysis comes with the need to take what has been learned from the past and develop reasonable scenarios for predicting the future success of reforms. The political organizations and actors involved are complex living systems that cannot as easily be predicted as machines or static, well-bounded technical entities. Thus, any predictions derived from political economy analysis will be only indicative, and will lead to developing reasonable and likely pathways for future reform efforts, identifying supporting and hindering factors, and pointing out existing and potential change leaders, coalitions, and windows of opportunity for change.

Because of the complexity of the system and the long-term perspective that energy subsidy reform often requires, it is crucial to be prepared for iterative learning cycles, where the initial political economy analysis (together with the information from other ESRAF good practice notes) provides a starting point for planning and implementing reform activities. As implementation starts, the reform team observes the reactions of the political economy system to these initial reform activities and uses these reactions as further sources of information about what is feasible, which drivers will be crucial, and what the strengths and weaknesses of the opponents of the reform are. This then informs future reform efforts. Since a political reform process is embedded in unpredictable and

dynamic political economy environments, it cannot be fully planned out from start to end. Rather, the plan should ensure clarity of direction, a focus on the problems and aspirations that drive the reform, and the space to react adaptively to changed opportunities and obstacles.

Taking these insights into account when designing and implementing interventions can lead to more iterative, adaptive project planning and implementation with a consistent eye on the process, the stakeholders, and the incentives involved.

## ANNEX A: TYPICAL INTERVIEW AND BACKGROUND RESEARCH QUESTIONS

Questions surrounding political economy are usually quite sensitive and complex. Thus, while government reports and data sets provide important starting points, additional information is essential. It is imperative to develop an interview strategy that is based on the information needed and the political and organizational sensitivities in obtaining it.

Below is a list of major categories of information that will be required. The list is organized in layers—beginning with information that should be obtainable from desk research and prior studies, and then leading to a basic history of reform efforts, further political economy interpretations for why those reforms have succeeded and failed, and finally to a future-looking assessment of the political economy opportunities and constraints to different reform scenarios. It is important to be aware of selection bias in focusing on known reforms—and remaining attentive to “non-reforms” (reform attempts that did not happen), since they often reveal just as much about relevant political economy dynamics. The depth of analysis of past reforms and non-reforms depends on the time and resources available to the team. While it is optimal to develop a full storyline of reform episodes and a deep understanding of all influencing

factors, often time and resources will not allow such in-depth work. In these cases, it is recommended to develop a general timeline of reforms (attempted and successful), a few ones, at least one and possibly identify a few efforts for more in-depth analysis.

The questions below can be transformed readily into a set of country-specific questions and an interview strategy. The next step is to identify a range of interviewees who offer diversity across three main dimensions: (a) people who are experts on energy topics versus generalists who are knowledgeable about the political economy of the country; (b) government officials with line responsibilities within ministries (and thus knowledgeable about the details of policies and industries) as well as high-level officials who can speak more broadly about the big picture; and (c) officials within the major branches of government as well as outside observers (such as journalists, civil society non-governmental organizations (CSOs), think tanks, and private sector). On the basis of on this subject, a typical list of sources of good interview subjects includes the following:

- Established experts on energy subsidies in the country. Those with publications on energy subsidies in that country would be



one choice, such as research and policy institutions, academics, and international organizations working on energy subsidies (such as the International Energy Agency and International Institute for Sustainable Development), or in-country experts focused on energy issues. They could be an excellent source of basic information, and may also have some insights into political economy dynamics.

- Ministry officials and legislative support officials at relevant government agencies—. In addition to the ministry or agency responsible for designing and implementing the energy subsidy reform, it is helpful to involve other agencies that are related to the sectors, including ministries of finance, industry, and transportation, since they would most likely be impacted by and influence the reform process. Subsidies for district heating are often handled at the level of municipal governments.
- Leading experts on energy markets in the country, including consultancies that advise investors and policy makers
- Energy staff at major interest groups
- Private sector actors in energy, both international and local, and their representations and associations
- Other stakeholders, such as sellers of diesel generation sets or fuel truckers benefiting from compensation for transportation costs of liquid fuels, e.g. through a freight equalization scheme
- Reporters who cover energy and public finance

- Think tanks in the country that a focus on energy, public finance, and reform efforts more broadly
- Seasoned observers and participants in the political process who can speak more generally about political economy and how it affects policy and reform

After developing a list of interview subjects, those in the country who are familiar with political sensitivities can help to identify the questions that different subjects can be asked and where answers will likely head. Government officials—especially lower-level civil servants—often cannot speak about policy, and thus the questions need to be framed in the domain where the interviewee is both knowledgeable and willing to speak. It can be helpful to align the seniority of the interview team with the level of seniority for the subject. Often the most useful answers from senior officials and observers arise in the context of broader discussions about political economy and broader interpretations of why some reforms have succeeded or failed. For these officials, it would be important to pay close attention to the category (see Broad Questions about Political Economy, below).

Often the best interview strategy unfolds in layers—the first rounds of interviews focus on lower-level experts to ensure that there is a strong base of information about the history and operation of subsidy regimes, complemented by desk research. Later rounds of interviews focus on higher-level officials and interpretations of what it all means. Sequencing interviews in this way also allows the team to be as efficient as possible when requiring the time of senior officials.

## CRITICAL ITEMS NEEDED FROM OTHER ESRAF GOOD PRACTICE NOTES

Provide a checklist of critical items needed from previous notes along the following lines:

- 1 | The major energy subsidies and their sizes as a share of gross domestic product and as a share of total government spending over time.
- 2 | Whether subsidized energy is officially or de facto rationed and, if so, how.
- 3 | How unit subsidies are determined and how subsidies are delivered.
- 4 | Discrepancies between the subsidy design and subsidy implementation, including official prices versus actual prices paid. This should also include analysis of the intended beneficiaries versus those who capture the subsidies in practice, the volume allocated to the intended beneficiaries versus the volume released, and who the ultimate consumers of subsidized energy are.
- 5 | Spending on key social programs (health, education, and social protection) over time to consider the opportunity cost of subsidy spending by the government.
- 6 | The distribution of benefits from subsidies among households by income and expenditure quantiles (such as quintiles or deciles).
- 7 | Who pays those subsidies (for example, government, SOEs, private energy suppliers, or consumers).
- 8 | Where possible, information on how the benefits and costs of subsidies map onto known interest groups.

- 9 | Where possible, information on the goals that each subsidy was originally designed to achieve and what goals it has achieved in practice.

## OVERVIEW OF THE POLITICAL AND ADMINISTRATIVE SYSTEM

Provide a basic overview of the political and administrative system along the following lines:

- 1 | How is the system of the government organized—for example, division of authority among executive, legislative, and judicial powers?
- 2 | How do key players in each arm of the government obtain and retain power? This information is important, since it defines where and how policy actors are amenable or vulnerable to influence by interest groups.
- 3 | How have these governance structures emerged, and are there any recent changes that are relevant?
- 4 | What is the role of major political parties within the system of government, and what are the major party agendas related to energy subsidies?
- 5 | Who has power to regulate practices and prices in the energy sector and what instruments (for example, legislation, and administrative actions, such as executive orders) do they use? Answers to these questions may vary with different parts of the energy system—for example, petroleum versus electricity.
- 6 | For the policy instruments used, what are the major modes by which different interest groups can have influence?



- 7 | What is the level of administrative capacity (over time if relevant) to design and implement different types of subsidy schemes? If government wanted to implement a scheme that would target a subsidy to particular groups—notably the poor—could it execute it effectively?
- 8 | What is the level of public confidence in the government and how does that affect the incentives for the government to adopt particular policies?
- 9 | How informed is the population at large about the costs and distributional impacts of existing energy subsidies? Are there polling data or other indicators of public information? How informed is the broader public about the opportunity cost of public subsidy?
- 5 | What are the major intersections between market and non-market segments of the energy business? For example, the price of fuel oil or coal could be set in global markets, but power utilities may combust these fuels to generate electricity and sell it at regulated prices. Understanding these interactions is often crucial to uncovering who pays for subsidies since those payments often arise at the “seams” between the different elements of the energy system.
- 6 | Who are the main large and small consumers of energy with regards to different sectors? How well are they organized and connected and how strongly could they influence the political decision making process in the country?

## FACTUAL OVERVIEW OF INDUSTRIAL STRUCTURE OF THE RELEVANT ENERGY AND RELATED INDUSTRIES

Provide an overview of the structure of energy and related industries along the following lines:

- 1 | What are the major categories of actors (for example, collections of private firms versus SOEs) along the supply chain?
- 2 | Are there other actors affected by subsidies, such as sellers of diesel generation sets?
- 3 | What are the main historical factors that explain why the energy sector is organized this way—for example, if SOEs dominate, why were they created and why do they persist?
- 4 | What determines prices at different stages in the supply chain?

## HISTORY OF REFORMS

Over the relevant period, develop a list of major “episodes” of reform. An episode is a cluster of related reforms that were adopted in response to broadly the same constellation of political forces. For each cluster, what were the main changes in policy, what form did they take (administrative, judicial action, legislative), and over what period did they occur? Depending on timing and resources, decide whether to perform deeper analysis on all clusters or on a purposeful sample of episodes that are deemed most instructive for the future reform, because they highlight reasons for success and failure and have played out in a similar policy domain. For in-depth analysis, answer the following questions:

- 1 | What was the process through which the reforms were attempted?
  - a. If legislative, who proposed the legislation and who could have amended it? On formal legislative votes, how

large was the majority, and did voting patterns align with other known political divisions?

- b. If executive action, on what authority did the executive take this action and is the use of that authority common? What are the opportunities, if any, for outside interest groups to shape the executive action—for example, through proposal or comment on draft rules?
- c. If judicial action, what cases or actions gave rise to the judiciary exercising its authority, and is such authority seen as an intrusion or commonplace in the shaping of policy? If there is a critical case that led to the action, who brought the case and why?

**2 |** Are the historical episodes of reform seen as relevant to potential current or future reforms? Or is the current or future situation seen as quite different? If the latter, then just an overview of the history of reform and not detailed work on it is probably needed. However, even after radical changes (for example, regime changes from socialism to capitalism, or major democratization) often many old structures remain under the changed surface, which should be explored in the in-country interviews.

**3 |** For each of the episodes of reform analyzed, develop a basic history that includes elements such as these, and for each of these elements be attentive to whether the answers and conditions are still relevant today:

- What are the main elements of the reform? Focus on how the reforms affected interest groups differently.
- Who (or what group) initiated the reform and why? Were these groups already

organized and potent political forces, or did they emerge for the purpose of pushing or opposing the reform?

- What are the main interests that hold the group(s) together, and how do those interests interact with other political interests and agendas?
- How do these interest groups affect political leaders—for example, the ability to muster votes, alter campaign contributions, or threaten political survival through protest?
- If the reform has been initiated multiple times, why did it not mobilize broader support earlier?
- Did the reform begin with a crisis (such as a fiscal crisis) or some other kind of galvanizing or organizing event? If so, how did the event affect the constellation of interest groups?
- If the reform passed, were there major difficulties or differences between intended actions and outcomes that arose during the implementation process?
- If the reform partially passed, which parts were successful, which were held back, and why?
- Can the reforms be easily reversed or altered if the constellation of interest groups favoring or opposing were to change?
- Was there public support for the reform efforts? How do those interest groups and the broader population perceive those efforts today? How would that influence any future efforts?
- How much internal opposition to the reform is there within the government? In particular, are there officials benefiting personally from subsidies who can be



expected to oppose the reform strongly behind the scene? How powerful are these officials?

- Is there a powerful national oil company that is a ‘state within a state’? What is their position on the subsidy reform? Are there executives who are personally making financial gains from the subsidies; and are these critical financial supporters for political parties or individual politicians?
- To what degree is the mass public—such as the poor, the emerging middle class, or other broad-based interests—organized politically? If so, what was their agenda with regards to energy?
- How is the electoral system organized and what incentives and opportunities does this create for or against reforms?<sup>6</sup>

**4 |** Among leading policy makers, are there standard lessons that are thought to have been learned about why these reforms were successful or failed?

## HISTORY OF NON-REFORMS

This section covers situations where subsidies have not been targeted by reform or where reform efforts have failed at early stages. Reforms that matured further but failed to be passed or implemented have been covered in the previous section.

Develop a history of non-reforms along the following lines:

- Over the relevant period, develop a major list of failed efforts at reform. Also, develop a list of major subsidies for which there have been no serious reforms. Are these major non-reforms still relevant today?

- Developing a detailed political mapping for non-events is difficult. However, for each of these “non-reforms,” explain the major interest groups that would have favored and opposed them and why the opposition was stronger or why no effective pro-reform support emerged. How are things similar or different today?

- To what degree were broad-based interest groups (for example, the poor) organized politically—if so, what was their agenda and did that influence the policy outcome? How are things similar or different today?
- To what degree were powerful specific interests (both private and public) organized against the reform?
- To what degree were reform efforts defeated on account of internal opposition within the government? Was there opposition from powerful SOEs with close ties to certain government officials?

- Among leading policy makers, are there standard lessons that are thought to have been learned about why these non-reforms have failed or not been attempted?

## BROAD QUESTIONS ABOUT POLITICAL ECONOMY

Answer the following broad questions about political economy:

- Looking at the past, what have the main barriers to subsidies reform been, and when has it been possible for political leaders to avoid or overcome those barriers?
- If there are major differences in the subsidy regime—such as differences across fuels

<sup>6</sup> E.g. see <https://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/7367.pdf>.

or across energy systems (for example, electricity versus petroleum products)—what explains those broad differences?

## ASSESSING FUTURE SCENARIOS, DRIVERS, AND PATHWAYS FOR REFORM

To increase the usefulness of this analysis for future planning, it is crucial to build a bridge between reform experience, current assessment of the stakeholder landscape, and what that means for future opportunities. Discussions with a broad range of stakeholders on the ground can help the team develop a more solid forward looking analysis. The following questions can be used in discussions in individual interviews or in focus groups:

- In the eyes of the stakeholders interviewed: What would a successful reform look like?
- What would the resulting structure of the subsidy and social support system be?
- What would be the foreseen results for the government budget, the general population (specifically the poor), and the economy?
- Based on the answers to the above three questions and the recommendations from other ESRAF good practice notes, develop a small number of different scenarios related to focus, sequencing, and size of reform, which you describe to interview partners in broad strokes. For each scenario, assess the political feasibility:
  - Who would win and lose, if it was successful?
  - How would different actors relate to the reform (positive, negative, neutral)?
  - What is the capacity of different interest groups to organize support or protest?

- What aspects of the reform are most likely to spur strong resistance?
- Are there administrative and technical gaps in the administrative, technical capacity or resource availability among those who would support the reform and how can these gaps be reduced?

This scenario forecasting allows those actors who are most familiar with the local situation to structure their strategic thinking and share their advice with regard to the present opportunities and risk of the political economy situation.

As the analysis develops toward strategic advice for those designing and implementing reform efforts, it is crucial to identify the change agents that will initiate and move the reform forward. Since different change agents will play different roles, tablet A1 can be a helpful tool for assessing which roles are filled or remain vacant and where the work of mobilizing change agents has to focus. Andrews (2013) distinguished between substantive contributions, relating to those providing ideas to make change happen, procedural contributions, referring to those navigating organizational rules and systems and maintenance contributions, which are the relational roles vital to mobilizing others to participate in the change process and to spread and scale it beyond the initial change agents. These distributed agents can include both front line and high-level staff of the diverse government agencies involved in the reform and may even involve private sector and non-governmental actors, as part of the diverse coalitions that are needed for implementing reforms successfully and overcoming political economy obstacles.



**TABLE A1: Roles of Reform Actors**

Function set	Roles	Who you think will play the role
<b>Substantive contributions</b>	<ul style="list-style-type: none"> <li>• Construct, communicate problems</li> <li>• Come up with ideas for reform</li> <li>• Provide implementation view</li> </ul>	
<b>Procedural contributions</b>	<ul style="list-style-type: none"> <li>• Provide formal authority</li> <li>• Motivate and inspire reform</li> <li>• Empower other agents</li> <li>• Provide financial support</li> </ul>	
<b>Maintenance contributions</b>	<ul style="list-style-type: none"> <li>• Convene small groups</li> <li>• Connect distributed agents</li> </ul>	

Source: Andrews (2013).

However, as stated above, a good political economy analysis in the planning process of a reform does not remove the need for continually monitoring political economy developments throughout the implementation of the reform. The political economy context

will evolve over time, both because of macro-political developments (independent of the reform) and because of the ways that the reform interacts with the existing energy sector political system, increasing or reducing the space for further changes.

## ANNEX B: INDICATIVE LOGISTICS

The extent, scope, and depth of the political economy analysis will be influenced by the time, resources, and personnel available to undertake it. Under constraining circumstances, it is crucial to focus the work on those aspects that are most important to the team. This may lead to trade-offs between focusing on experiences from the past versus the present and forward-looking analysis. Also, as noted above, it may make sense to focus on a select number of past reform episodes (instead of analyzing all in depth) and specific scenarios of future options. Finally, as the initial political economy analysis is a starting point that needs to be updated as the intervention unfolds, in some cases it may be recommended to start with a “good enough” analysis, which allows for solid planning and retain some of the funding for political economy analysis to

allow for updates and targeted analysis of political economy bottlenecks at a later stage.

The team undertaking this analysis ideally combines a political economy analyst, a sector specialist, and an expert with deep knowledge of and connections to the actors in the country. Some of this expertise may overlap with the areas of expertise of the teams working on various aspects of reforms covered in other ESRF good practice notes. The work starts with a review of existing materials and data, followed up by field work, which consists of interviews and possibly focus group discussions.

Finally, the team will need adequate time to analyze and write up the results. In a tight schedule, this could be undertaken in a sequence of two weeks for desk research,

two weeks in the field, and two weeks for analysis and writing. A field guide by the U.S. Agency for International Development (USAID

2016) has a more detailed view on logistics of political economy analysis.

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# Energy Subsidy Reform Assessment Framework

## LIST OF GOOD PRACTICE NOTES

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- NOTE 1** Identifying and Quantifying Energy Subsidies
- NOTE 2** Assessing the Fiscal Cost of Subsidies and Fiscal Impact of Reform
- NOTE 3** Analyzing the Incidence of Consumer Price Subsidies and the Impact of Reform on Households – Quantitative Analysis
- NOTE 4** Incidence of Price Subsidies on Households, and Distributional Impact of Reform – Qualitative Methods
- NOTE 5** Assessing the readiness of Social Safety Nets to Mitigate the Impact of Reform
- NOTE 6** Identifying the Impacts of Higher Energy Prices on Firms and Industrial Competitiveness
- NOTE 7** Modeling Macroeconomic Impacts and Global externalities
- NOTE 8** Local Environmental Externalities due to Energy Price Subsidies: A Focus on Air Pollution and Health
- NOTE 9** Assessing the Political Economy of Energy Subsidies to Support Policy Reform Operations
- NOTE 10** Designing Communications Campaigns for Energy Subsidy Reform