Executive summary

It is now well-documented that subsidies to fossil-fuel production and consumption distort costs and prices and lead to inefficiencies in the economy. In addition, the combustion of fossil fuels results in high levels of CO_2 and other greenhouse gas (GHG) emissions, as well as air pollution and related health problems. These can inflict a high cost on society.

Policy makers are now better informed and more aware of the negative fiscal, social, environmental and climate-related impacts of government support to fossil fuels. Therefore, reducing and reforming economically-inefficient and environmentally-harmful fossil-fuel subsidies has become a key issue on the political agenda of governments across the world. The significance of this agenda has risen particularly over the past ten years in the context of the international climate change debate and the shift to a low-carbon economy. Fossil-fuel subsidies, however, are still persistent and politically difficult to reform.

The European Union's Eastern Partner (EaP) countries – Armenia, Azerbaijan, Belarus, Georgia, Republic of Moldova (hereafter “Moldova”) and Ukraine – are no exception. However, there is relatively little data availability and transparency on this issue in the EaP region. While fossil fuels continue to dominate the region’s energy sector there is limited public discussion on the negative implications of government support to fossil fuels and possible benefits of its reform.

This report aims to fill the data gap and provide a basis for discussion on fossil-fuel subsidy reform in the EaP countries. These data are now available in the OECD database on government support to fossil-fuel production and consumption. The inclusion of the EaP countries in this database is an important milestone in achieving transparency. It recognises efforts of the EaP governments to disclose information on government support volumes that go to the energy sector in these countries.

The report analyses fossil-fuel subsidies provided to producers and consumers of coal, oil and related petroleum products (particularly in the transport sector), natural gas, as well as electricity and heat generated on the basis of these fossil fuels in the EaP countries. This analysis is an update of the 2010-15 subsidy estimates in the EaP region produced earlier by the OECD and covers the period 2016-19.

The current Inventory and this report focus on two major groups of subsidies: (i) direct transfers of funds to producers and consumers of fossil fuels; and (ii) tax expenditure (that is, reduction in tax liability compared with a “benchmark” tax system, such as the reduction or exemptions of value-added taxes [VAT] or excise taxes on fuel consumption). These two types of subsidies affect government budgets directly while other subsidies, such as those provided through setting tariffs at below-market price levels, are less visible to the population at large.

Major findings

Ukraine has the largest number of support measures

The analysis identified 65 measures of direct transfers of funds and tax expenditure (and revenue foregone) in the EaP countries. Ukraine has put in place the largest number of support measures (26) while Armenia has the smallest number (6). The other four countries have between seven and ten subsidies per country.

Fossil-fuel subsidies through budget transfers and revenue foregone declined in half of the countries

The mapping shows a distinct decline in fossil-fuel subsidies in the form of budget transfers and revenue foregone in Armenia, Georgia and Ukraine. Fossil-fuel subsidies in Armenia peaked in 2013 and 2014, reaching USD 42 million. They declined to USD 5 million in 2019 as most subsidy schemes were eliminated. In Georgia, quantified subsidies amounted to USD 33 million in 2013. They declined to USD 15 million in 2019, although new social support schemes were introduced in the meantime. In Ukraine, the cumulative value of budget transfers and tax expenditure surpassed USD 5 billion in 2012 but had declined by more than 50% by 2019. However, at USD 2.2 billion in 2019 the size of subsidy remains significant and is the largest among the EaP countries, including as a share of GDP. This suggests that Ukraine still has a long way to go in its energy subsidy reforms. Subsidy values in Moldova have fluctuated over the review period. Meanwhile, data gaps in the bottom-up assessment of fossil-fuel subsidies in Azerbaijan and Belarus preclude clearer conclusions on general trends.

Most EaP countries use budgetary transfers to subsidise fossil fuels

Budgetary transfers prevail in most EaP countries. In Moldova, tax expenditure is the main support mechanism. It takes the form of reduced VAT rates for natural gas, electricity and heating to households and public institutions, as well as for liquefied petroleum gas (LPG) consumption.

Ukraine and Azerbaijan have the largest amount of fossil-fuel subsidies as a share of GDP

In relative terms, when comparing annual fossil-fuel subsidies (budget transfers and tax expenditure) as a share of gross domestic product (GDP) with the national budget deficits in the EaP countries, Ukraine and Azerbaijan stood out in 2018. In Ukraine, fossil-fuel subsidies alone reached 2.3% of GDP, exceeding the 1.9% budget deficit. Similarly, in Azerbaijan, subsidies constituted almost 2% of GDP in 2018 and exceeded the 0.3% budget deficit. This represents an important potential for reform. Reducing fossil-fuel subsidies can lower the burden on the budget and can help reduce the budget deficit. Such savings can be re-allocated to other more urgent social and environmental priorities supported by the state.

Most subsidies target the residential sector and go to natural gas

Most subsidy measures support the residential sector, with a significant portion allocated to the oil and gas production sectors as well. Support to natural gas also features strongly; it is the main fuel used in generating electricity and heat in the region. Subsidies provided through below-market price tariffs often benefit all consumers in the residential sector and not only socially vulnerable households.

Energy pricing is still highly regulated in the EaP countries

Understanding fossil-fuel subsidies requires a good grasp of the underlying energy pricing and taxation policies as they are among the major channels for providing support to the energy sector. Energy pricing, and particularly energy tariffs, is highly regulated in the EaP countries. Keeping energy tariffs at below-market price levels encourages increased consumption of fossil fuels and gives rise to “indirect” subsidies that are more difficult to measure and reform. The market of liquid petroleum products is the most deregulated energy segment in the region. At the same time, the tax system in the countries has been rationalised and simplified. This, in turn, has led to increased tax collection and more transparent taxation practices

The policy landscape has changed and a number of reforms have been put in place

During the four years covered by the analysis, the landscape of fossil-fuel subsidies in the EaP countries has changed considerably. Several measures were eliminated, while new ones were introduced. Examples of such changes include:

- In 2016, Armenia phased out excise exemption for compressed natural gas worth around USD 9 million per year. A year later, it cancelled VAT exemption for diesel imports worth USD 17.6 billion.

- Belarus terminated VAT exemptions for natural gas and electricity for households in January 2016, ending a subsidy worth USD 200 million per year.
- Georgia's government introduced new budget transfers to provide gas subsidies for households living on the border of Abkhazia and South Ossetia. It also provided electricity subsidies for families with four and more children, and other socially vulnerable consumers and households living in high mountainous areas. Still, fossil-fuel subsidies in 2016-19 declined compared to the previous period of 2013-15 when subsidies peaked.
- Ukraine eliminated several budget transfers recently but, at the same time, introduced new ad hoc measures to deal with emergencies and arrears in the energy sector.

Major recommendations

Embrace a holistic approach to reform of fossil-fuel subsidies

Reforming fossil-fuel subsidies is crucial to reducing GHG emissions and hence meeting climate change goals. The governments in the region should build on reforms to date but need design further reforms more holistically. Fossil-fuel subsidies are usually a long-term problem that demand structural solutions. The reform has to be well-designed and its short- and longer-term consequences need to be clearly understood. Experience from many countries shows that targeted support measures (e.g. to vulnerable households) deliver better results and ensure better energy affordability than untargeted subsidies applicable to all. Transparency and stakeholder dialogue are the cornerstone of subsidy reforms.

Review recovery measures put in place in response to COVID-19

The COVID-19 crisis that hit in 2020 made countries painfully aware of the opportunity for reforming the subsidies. In response to the crisis, governments needed to mobilise significant additional funds to support their health systems and economies. The EaP governments reacted quickly and sought to protect their citizens and businesses by putting in place crucial rescue and recovery packages. The analysis shows that most such measures in the energy sector are largely concentrated in the end-use electricity sector. This is where countries and utilities have made commitments to avoid hardship during the crisis. These commitments include payment moratoria, late fee interest suspensions, additional assistance with bills or bans on disconnecting customers in arrears. The short-term justification for action is clear. However, governments must review the measures to ensure they do not develop into inefficient, longer-lasting subsidy programmes.

Undertake further study on "induced transfers"

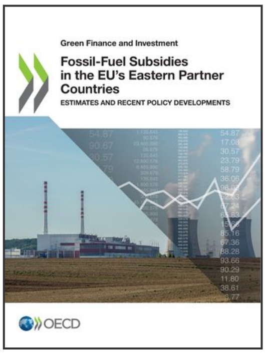
The debate around energy subsidies in the EaP countries and their reforms is closely linked to keeping social tariffs below market prices. Any analysis would be incomplete without examining these "induced transfers". Such transfers usually involve regulations that mandate fossil-fuel companies to sell their products to certain categories of consumers (e.g. vulnerable households) at below-market prices. To complete the fossil-fuel subsidy picture, more analysis on induced transfers will be needed.

Improve reporting and transparency

Official government reporting on fossil-fuel subsidies in the EaP countries remains highly insufficient. Improving the transparency and credibility of data on fossil-fuel subsidies, including on tax expenditure in the energy sector, can help decision makers and the public at large design better reform measures. Such work can create significant value if undertaken by countries on their own.

Draw on this analysis for international reporting obligations

The EaP countries report on fossil-fuel subsidies within the frameworks of the United Nations Sustainable Development Goals (SDGs) and the World Trade Organization (WTO). They may wish to consider using data and estimates in this OECD analysis as a starting point for such reporting obligations.



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