Oil Subsidies in Mexico

PAUL SEGAL argues that oil subsidies in Mexico are both extremely popular and wholly unjustifiable

The popularity of oil subsidies arises from a very natural sense of oil nationalism, which developed in many producer countries over the twentieth century through painful struggles with international oil companies. Mexico was at the leading edge of the wave, in 1938 becoming one of the first countries in the world to nationalise its oil industry. While the 1917 constitution had already declared that subsoil resources belonged to the nation, this proposition was never fully accepted by the international oil companies that extracted the oil: nationalisation was the result of their refusal to respect domestic laws and institutions, and the corollary of this difficult experience was the constitutional amendment of 1960 that banned concessions. Since then, the national oil company Pemex has been the sole producer of Mexican oil.

Given this history – shared in several important respects with many oil producers – it is no surprise that Mexicans have a strong sense of ownership of their oil. While references to 'oil nationalism' are often disparaging, its first and most important meaning is this legitimate concern for self-determination. The view that oil should be cheap in those countries that produce it seems to follow naturally from this sense of ownership. But this is unfortunate because, as I will show, oil subsidies are both inefficient and inequitable, and do not properly express the right to the benefits of the oil that citizens can legitimately claim.

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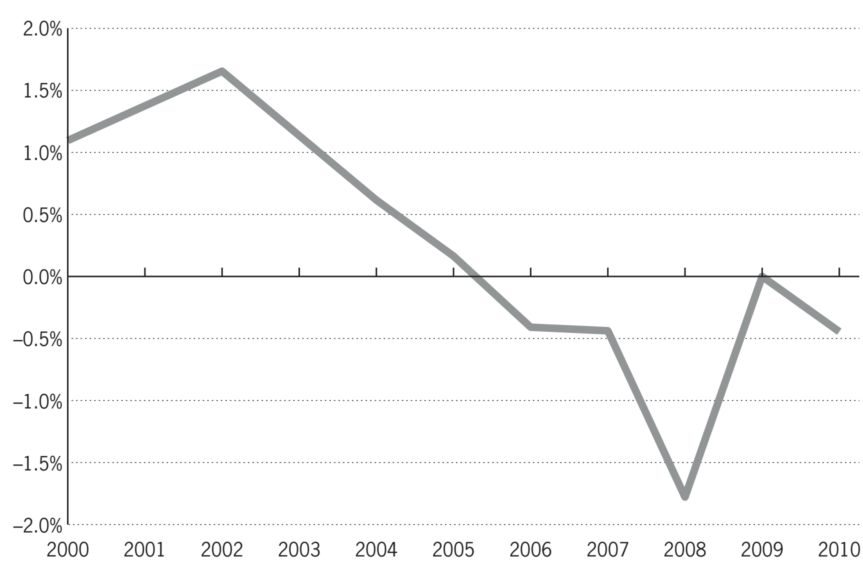
Mexico is a major producer of oil, but it is also a large economy. Oil revenues have comprised between 7 percent and 10.5 percent of Mexico's gross domestic product (GDP) in recent years. (For brevity I use 'oil revenues' in Mexico to refer to hydrocarbon revenues more generally, which are dominated by oil.) The Mexican economy is therefore not as dependent on oil as the major exporters of the Middle East, where oil production is worth more than the non-oil economy, or Venezuela, where it comprises up to a third of GDP. But oil provides 30 to 40 percent of Mexican government revenues. For this reason it is highly significant.

Figure 1: Petrol Tax (IEPS) as Share of GDP; negative indicates subsidy



Source: Secretaría de Hacienda y Crédito Público (SHCP), http://www.shcp.gob.mx/

The cost of petrol within Mexico is set by the government using an implicit tax known as IEPS (Impuesto especial de productos y servicios), which includes a mechanism for smoothing the domestic price relative to changes in the international price. I describe the tax as 'implicit' because the government is the sole vendor of petrol so it receives the entire net price of petrol sold. To the government's credit, it estimates the opportunity cost and reports the difference between the price and this opportunity cost as the tax or subsidy. The petroleum component of IEPS as a share of GDP is shown in Figure 1. It was indeed a tax up until 2005, in which year it was worth 0.2 percent of GDP in revenues to the government. But with rising oil prices it had already fallen from its peak of 1.7 percent of GDP in 2002, and by 2006 it had become negative, i.e. a subsidy, of 0.4 percent of GDP. In 2008, when oil prices reached a peak, it cost the government 1.8 percent of GDP. The subsidy disappeared in 2009 when international oil prices fell, but they reappeared in 2010 as these prices recovered.

This 'cost' to the government is not, of course, the same thing as the cost to the country, because that 1.8 percent of GDP was effectively being handed back to citizens. But such subsidies do imply a cost to the country, because they are inefficient. This is easy to see if one considers the simple experiment of exchanging \$1 of fuel subsidy for a cash benefit of \$1. With the cash benefit the recipient can choose to spend the \$1 on fuel, in which case she is in the same position as with the subsidy. But she can also choose to spend some share of the \$1 on something else. The fuel subsidy implies forced expenditure on fuel as opposed to on other goods and services that might be preferred. The result is over-consumption of fuel relative to other products.

Fuel subsidies are also regressive because richer people tend to spend a higher share of their incomes on fuel, largely because richer people are more likely to own cars. Mexico in 2006 was no exception. Table 1 presents government estimates of the distributional incidence of fuel subsidies, in particular the extent to which each decline of the population benefits: in 2006, more than 70 percent of the benefits of fuel subsidies went to the top 30 percent of the population. Surprisingly, in 2008, when fuel subsidies grew massively, the estimates imply that their impact was much less regressive. They were still absolutely regressive in that the rich gained more from them than did the poor, with the richest 10 percent gaining over 10 times as much as the poorest 10 percent. But in relative terms, the picture is much less clear. In 2008 the bottom 10 percent received 1.7 percent of market income and 2.1 percent of the subsidy, while the top 10 percent received 46.1 percent of market income and 24.9 percent of the subsidy. So relative to income, the gain of the top 10 percent was smaller than the gain of the bottom 10 percent. This is unusual; so much so that one might legitimately doubt the accuracy of the estimates.

Table 1: Benefit Incidence of Subsidies on Gasoline and Diesel due to IEPS: share of total benefit received by each decile

	Share of total benefit received by decile	
Decile	**2006**	**2008**
1	0.80%	2.10%
2	1.70%	3.80%
3	2.80%	5.00%
4	3.70%	6.80%
5	4.50%	8.50%
6	6.70%	9.20%
7	8.40%	11.30%
8	12.40%	12.20%
9	18.80%	16.10%
10	40.20%	24.90%
Total	**100%**	**100%**

Source: SHCP 2008 and 2010.

Despite the regressiveness of fuel subsidies – at least in absolute terms even if not relative to income – there remains a perception among some that they are an appropriate form of social assistance. For instance, a government newsletter (SHCP) at the beginning of 2010 justified the fuel subsidies of 2008 as 'supporting those who have least, because it is they who suffer most from the effects of the international recessions,' describing the subsidies as 'part of a packet of counter-cyclical policies proposed by the Federal Executive to support the family economy against the global crisis'. As we have seen, the view that fuel subsidies are a plausible mechanism for helping 'those who have least' is impossible to justify.

Perhaps even more oddly, the same newsletter insisted that, by keeping the price of gasoline and diesel below that in the USA, it 'maintained, in this respect, a competitive position for the national productive apparatus.' This is another common misperception: that cheap fuel, by subsidising domestic industry, makes that industry more 'competitive'. Just as in the case of consumption, if you want to subsidise your industry a fuel subsidy is a highly inefficient way to do it: such a subsidy incentivises an inefficient reliance on fuel rather than other inputs, reducing overall value added.

Despite this, we know that oil subsidies are popular because we know how difficult it is for governments to remove them. The withdrawal of such subsidies has often met with violent popular resistance, sometimes including riots. In Bolivia, for instance, a World Bank/UDAPE document concluded that 'the elimination of hydrocarbons subsidies is one of the policies that has met with the fiercest opposition from society and is therefore avoided by the government, in view of the repercussions this may have on the population and productive sectors.' A recent attempt by the government of Evo Morales to reduce subsidies in Bolivia ended in failure, the policy withdrawn in the face of widespread protests.

If fuel subsidies are both inefficient and inequitable, how can a government go about reducing and removing them? Part of the problem is that, in addition to a legitimate sense of ownership of their oil, Mexican citizens, like those of many oil producers, are somewhat suspicious of the benefits they receive from the government. So appeals to the fact that removing fuel subsidies will enable a rise in government expenditures, or a reduction in taxes, do not immediately convince. Too often such an appeal is met by the response that, if the money is not spent on subsidies, it will disappear into the pockets of government officials, or down the black hole of government inefficiency.

What is needed, therefore, is a strategy that convinces citizens that the fiscal savings will benefit them. The challenge is particularly keen when oil prices rise. Such a rise necessarily makes an oil-exporting country richer. But when the only direct sign that citizens see is a corresponding rise in fuel prices, with no obvious translation into benefits for them, then the call for subsidies is understandable. One possible solution is a 'resource dividend', that is for hydrocarbon revenues to be given directly to citizens as an unconditional cash transfer. Such a policy would be both highly progressive and poverty-reducing, as well as efficient. Since the dividend would rise when oil prices rise, citizens would feel the benefit of higher oil revenues. Other taxes would have to rise to compensate for lost government revenues, and in this respect the fiscal system of oil producers would come to look more like that of a non-oil-rich country – which would be no bad thing.

Alaska's Permanent Fund Dividend is closely related, as is Bolivia's Renta Dignidad, a universal pension for the over-60s paid for with hydrocarbon revenues – which, pre-dating the proposed reduction in subsidies mentioned above, could not be presented as a quid pro quo for their elimination. But perhaps the most interesting recent development on this front is in Iran. On 20 December 2010 the Iranian government cut fuel and other subsidies, with petrol prices nearly quadrupling to 38 US cents per litre. Households were given a one-off cash payment of about US$80 each, and since then all Iranians living in the country have been entitled to, and nearly all receive, a monthly cash transfer worth about $45 per person from the government. These unconditional transfers are officially known as 'cash subsidies', presumably to cement the perception that they are a replacement for the lost fuel and other subsidies.

Mexico, like many oil producers, needs a way to wean itself off inefficient and inequitable fuel subsidies. Policies that enable Mexican citizens to see the benefits of their oil independently of the fuel prices that they pay may help to reduce the political pressure behind such subsidies. ■