

ABSTRACTS

OECD WORKSHOP ON SUBSIDY REFORM AND SUSTAINABLE DEVELOPMENT: POLITICAL ECONOMY ASPECTS

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*Assessing the Benefits of Subsidy Reform from a Sustainable Development Perspective – Economic,
Environmental and Social Aspects*

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Subsidies are the most pervasive and powerful of government policy instruments, yet few people understand their extent or diverse impacts. If the full effects of subsidies were known, taxpayers would not favor many of the ways their hard-earned money is being spent. If candidates campaigned for public office based on the effects of the subsidies they intended to distribute, they would find it hard to be elected. Not all subsidies are bad, but most have direct or indirect negative effects on the economy and budget, the environment and resources as well as equity and global trade. Only more transparency and public awareness of the true nature of subsidies will enable their reform.

This paper presents an integrated assessment framework for identifying the economic, environmental and social impacts of government subsidies. Separate analyses of these three dimensions of subsidies (and isolated policy-making approaches) often lead to trade-offs which prejudice environmental and social objectives. The framework assumes the best policy result is obtained when there is understanding of the distribution of the costs and benefits of subsidies and this information is made available to policy-makers and the public. It seeks to lay bare the full gamut of winners and losers and intended and unintended effects in the economic, environmental and social spheres, highlighting where the trade-offs exist.

The framework consists of a checklist with four components. First, a “features scan” examines the objectives and design of the subsidy, its effectiveness in achieving its stated goals, and its cost-effectiveness relative to alternative policies. An “incidental impacts scan” reviews unintended economic (on prices and budgets), environmental (ecosystems, wastes, pollution) and social (low-income consumers, non-target populations, developing country exporters) effects. The “long-term effectiveness review” assesses whether the subsidy is designed so as to eventually address the underlying problems that gave rise to its creation. Lastly, the “policy reform scan” hypothesises the economic, environmental and social impacts of various scenarios for reform of the subsidy, including outright and phased elimination or changes in design.

As a practical example, this analytical framework is applied to a case study of subsidies to liquid biofuels. Policy-makers may ostensibly support biofuel production for reasons of environmental benefits (reduced emissions), energy security, rural development or balance-of-payments relief. Whether these supports are in the interest of sustainable development is rarely scrutinised. In fact, evidence suggests that support to biofuels has done little to enhance energy security and improve the environment and has only indirectly benefited farmers. Intensive production of feedstock grains, oilseeds and sugarbeets for biofuels can put a heavy toll on ecosystems. Even emissions from ethanol refineries can be significant. In addition to reducing budget expenditures, reform of subsidies and tariffs on biofuels would help to create export opportunities for developing countries.

Sustainability Effects of Subsidies to Forestry
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Prompted by the Rio Summit in 1992, Finland revised its forestry legislation to emphasise sustainability aspects. In earlier legislation, sustainable forestry meant mainly sustainability in terms of timber production and generally ignored environmental and social impacts. The most recent Forest Act considers ecological and social sustainability to be as important as economic sustainability. According to the *1997 Act on the Financing of Sustainable Forestry*, subsidies can only be granted to ensure generally the sustainability of timber production, to maintain the biological diversity of forests, and for forest ecosystem management undertakings. More specifically, subsidies may be given for forest regeneration, prescribed burning, tending of young forests, harvesting of energy wood, forest remedial fertilisation, renovation ditching and forest road construction. But sustainable management of forests is the prerequisite for each forest subsidy.

State subsidies to private forest owners total about €60 million per year. The share devoted to forest ecosystem management has risen steadily, and accounted for 10% of all forest subsidies, a total of €5.7 million, in 2005. Approximately €3.1 million contributed to the conservation of about 3 100 hectares of forest. Other environment-related financing was granted as follows: €1.4 million for forest ecosystem management projects, €0.3 million for mapping of key habitats, €0.2 million for other forest ecosystem management, and €0.4 million for the *Forest Biodiversity Programme for Southern Finland*.

The *Forest Biodiversity Programme for Southern Finland (2002–2007)* relies on forest owners' willingness to protect forests on a voluntary basis with total public and private funding of €60 million over the five-year period. Natural values trading, competitive tendering and forest biodiversity co-operation networks have been piloted in different areas in Southern Finland. Experiences are encouraging as forest owners and other stakeholders have been active in the pilot projects. The results of the programme will be collected and analysed during 2006 with political decisions on the future of the programme to be made in 2007.

Finland, which is a large country with scarce population, also relies on the forestry sector to maintain social sustainability and communities in the Finnish countryside. Forests cover about 2/3 of the country and Finland holds a 20% share of global exports of printing and writing paper. Most Finnish forests are owned by private, non-industrial parties and about 4/5 of domestic wood originates from private family forests. There are about 300 000 private forest holdings with an average size of 35 hectares. Most forest owners are wage-earners, pensioners or farmers. Motivating these forest owners in active, sustainable management of forests is one of the main goals of Finnish forest policy.

The average rotation period in the boreal coniferous forests of Finland is 80 to 120 years. The government encourages private forest owners to invest in silviculture (the long-term development and care of forests) with an annual investment target of €250 million set in Finland's *National Forest Programme 2010*. In the past few years, private investments in silviculture have been about €150-170 million. Voluntary agreements on forest conservation are made between the state and the forest owner, usually for 10 years. By the end of 2005, these agreements covered 14 500 hectares of forest.

Sustainability Effects of Subsidies to Transport
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“Hidden subsidies” – in the form of underpricing of transport services – are a more important source of distortion in this sector than explicit subsidies, which may be justified more often in transport than in other sectors. When the price of transport, including environmental taxes, is not near the social marginal cost, the sector is a burden for society in terms of sustainability. Developing a functioning pricing or subsidy regime for transport, while at the same time encouraging efficient behaviour in the transport sector, is not an easy task.

This paper summarises the magnitude of the environmental and social costs of the European transport sector and concludes that the introduction of a more differentiated pricing regime based on social marginal cost would be a welcome move towards a sustainable sector. This type of pricing regime is a necessary condition for economic efficiency, a topic which has been discussed in European transport policy since the 1960s. However, it was not until the mid-1990s that the European Commission decided on a new pricing policy for the transport sector. These policy developments stimulated a wide array of new research on the external costs of transport.

The most recent studies use detailed bottom-up methods to estimate the marginal costs of transport, including infrastructure costs, congestion and scarcity costs, and accident and environmental costs. These estimates show wide variations across transport systems and indicate which parts of the transport sector do not cover their costs. This has two implications for policy-makers.

First, aggregate accounting of revenues and costs will not give accurate information on the appropriateness of the pricing regime for transport. Large economies of scale with low external effects mean that revenues from the marginal cost-based price for transport will not cover the actual costs of operation. This indicates that the transport sector needs to be subsidised in some cases.

Second, there is a need for a more refined and advanced pricing policy in the transport sector. But European legislation hinders both the introduction of full marginal cost pricing and limits the use of “Ramsey pricing” as a way to regulate the possible abuse of the pricing instrument and discriminate between users from different Member States of the European Union.

In the last five years, the European transport sector has witnessed the introduction of the first generation of more advanced pricing systems. These include the London and Stockholm congestion charging regimes as well as the distance-based heavy goods vehicle charging systems in Switzerland, Austria and Germany. These and other transport pricing regimes now being tested are paving the way for more sustainable pricing and subsidisation in this sector.

Easing Subsidy Reform for Producers, Consumers and Communities: Social Issues and Transition Supports

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The subject of subsidy reform has received considerable attention in recent years. However, much of this attention is focussed on the end points or goals of reform and less attention has been paid to the actual process of reform. It is generally recognised that appropriately targeted subsidy reform will result in improved overall economic efficiency and will increase social welfare. But not everyone will gain in the short run and some individuals and communities may be adversely affected by the policy change, prompting governments to seek ways to cushion the impacts of reform on individuals and communities.

This paper provides a review of the key issues involved in the provision of transitional support as part of the process of subsidy reform. The potential social consequences of reform for individuals include reduced incomes, unemployment, relocation and retraining, while affected communities may experience flow-on effects from income redistribution, economic structural change and changes in social capital. The paper reviews the rationales for transitional support, arguing that such support may be necessary to reduce the opposition to reform, reduce the negative impacts of reform, and to reinforce policy reform.

Governments have a range of options for helping individuals and communities in the transition – including different types of support, primarily involving compensation payments, and active labour market programmes. The paper reviews some OECD experiences with these policy tools and provides some insights to design and implementation of transitional measures. The major lesson from this experience is that transitional supports need to be truly temporary and well-targeted if they are to be effective and maintain policy credibility for the government. Other key insights relate to the timing and sequencing of reforms, concerns over equity versus fairness, and the need to ensure coherence between transitional programmes and the broader policy settings of economies.

Transitional Issues in Subsidy Reform in Agriculture
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Agriculture is acknowledged as one of the most protected sectors in many OECD economies, and one where transitional aids may be needed to achieve subsidy reform. This paper addresses the issue of transitional support in the context of subsidy reform in agriculture, using examples from the European Union context.

Agriculture has proven a sensitive sector within which to seek multilateral agreement on reforms within the context of the World Trade Organisation (WTO). Nevertheless, acceptance of the desirability of further trade liberalisation in agriculture, as part of a wider package, has gained credence within the European Union in recent years. This, combined with domestic and budgetary pressures, has given impetus to domestic policy reform within the sector in individual EU countries.

In managing the reform of the EU Common Agricultural Policy (CAP), one can identify supports that are transitional aid mechanisms with a clear starting point and end point. However, there are many more aids which have been designed to promote structural adjustment through short-term 'investment'. These tend to share some of the characteristics of explicit transitional support. Many of these subsidies currently exist within Pillar 2 of the policy for 'rural development'. But in the latest reforms of 2003-2004, we see some Member States also applying transitional support systems to achieve shifts in the balance of Pillar 1 aids or 'direct agricultural payments'.

In examining how these measures have worked, it is possible to classify them in different ways, such as 1) those that are designed simply to slow down the process of change vs 2) those that are seeking to help ensure change takes place as effectively as possible. In other words, supports which simply 'buy time' for recipients vs. those which directly address transaction costs/barriers to adjustment. There are also those aids whose purpose is mainly socio-cultural and those with clear (often additional) environmental goals. These aspects affect how they are perceived and how they are delivered, as well as their performance.

The arguments for using transitional supports in agriculture relate to the fact that in real-world processes of structural adjustment there is usually:

- non-linear adjustment to pressures for change, so we tend to see irregular patterns and can sometimes identify key 'thresholds' of major shifts between different states of organisation (analogous to concepts in catastrophe theory and evolutionary 'jumpers');
- a level of risk associated with the process of restructuring, in relation to the mix of multifunctional characteristics associated with a particular organisation of economic activity – most notably, its socio-cultural and/or environmental value. The risk is that when organisational systems are changing in response to reform, the mix of other benefits that accompany existing production structures could be lost, perhaps irreversibly.

Another aspect relates to the rationale for intervention when dealing with the small business sector, of which agriculture is an example. This concerns unequal bargaining power in markets, meaning that smaller operators have more difficulty in passing their costs up or down the supply chain. As a result, if new policies significantly increase their direct costs, the effects upon business survival will be disproportionately severe, leading either to consolidation which is anti-competitive in the longer term, or the complete collapse of an industry which may not be easily replaced.

In attempting to evaluate transitional subsidies, it is also important to consider administrative costs. Transitional aids can add significant bureaucracy and complexity to systems and in some cases this can be sufficiently heavy that their net value is debatable. Nevertheless, the evidence would appear to suggest that transitional aids can be both effective and valuable in overall subsidy reform efforts, in certain circumstances.

Reforming Subsidies in Manufacturing: The Finnish Case
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In the late 1980s, the Finnish economy was still characterized by insularity, unfriendly attitudes toward competition, and sector-oriented public support policies. This was true of the manufacturing sector in most OECD countries, where specific subsidies were given to industries such as textiles, steel, non-ferrous metals, shipbuilding, and pulp and paper to help them compete in world markets and to maintain their contributions to domestic economies, whatever the cost to the government.

Many early manufacturing subsidies were based on the belief that there are economies of scale associated with size, which was used by countries to protect infant industries from international competition. In the same vein, OECD countries are now providing government assistance to emerging sectors such as information and communications technologies (ICT) and biotechnology where substantial agglomeration economies are believed to exist. Governments may also provide industry support to meet social policy objectives, such as to reduce regional disparities in income and employment or to encourage the growth of small businesses. The OECD estimates that subsidies to industry (manufacturing and services) still account for 20%-30% of all OECD support to various economic sectors. Within industry, most subsidies are allocated to manufacturing sectors rather than services (with the exception of transport), despite the fact that services account for 70% and manufacturing for less than 20% of GDP in the OECD area.

The severe recession in Finland in the beginning of the 1990s showed that these sector-specific policies had built up rigid structures, which were not able to efficiently accommodate external shocks to the economy. Consequently, a period began for reevaluating sector policies and refocusing supports. In Finland, public support to manufacturing was still high and sector-oriented in the late 1980s, but was set to decline by the mid-1990s. This was simultaneous with an increase in government expenditure on research and development (R&D). By the mid 1990s, Finnish competition legislation was strengthened considerably, regulation was geared towards enhancing competition, and public supports to industrial sectors were shifted towards horizontal measures.

This shift of focus from sectoral to horizontal policy measures in manufacturing was evidenced in many OECD countries. There is a continuing trend away from subsidies for particular sectors towards more horizontal objectives, including regional development, R&D, and small and medium-sized enterprises (SMEs). The other stated goals of industry support are enhancing environmental protection and energy efficiency, increasing competitiveness and exports, and industry restructuring and training.

Among European countries, Finland devotes the highest portion of industry subsidies to R&D in the effort to convert fully to a knowledge-based economy. However, there continues to be debate regarding the justification for continued manufacturing supports, whether current subsidies can be considered temporary transitional or restructuring measures, and whether subsidies can be classified as "good" (R&D, environment) vs "bad" (firm-specific). For example, R&D supports often hinge on the notion that markets are not able to allocate resources efficiently in some cases. Externalities associated with knowledge capital may lead firms to underinvest in knowledge. Government assistance to firms that invest in R&D may be one way of offsetting market failures. Or informational asymmetry between high-technology entrepreneurs and potential investors may necessitate some form of government intervention to fill financing gaps.

There are other problems with horizontal industry subsidies. Problems with the WTO notification system indicate that sector-specific supports are likely being under-reported. There is concern that sector-specific supports may be reported or relabelled to fit under the horizontal themes. In addition, many regional supports, which account for the major share of industry subsidies, may be targeted to particular sectors or firms. Although industry subsidies are declining over time and becoming more diversified in their objectives, they can continue to have distortive effects at national and international levels. In general, industry subsidy programmes need to be carefully designed, closely monitored and properly evaluated if beneficial effects are to be realised.

Whole-of-government decision-making for subsidy reform
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Good governance and sound public management – including both an ethical and transparent government process, and decision-making practices that are sufficiently open to citizens – are key preconditions for successful subsidy reform. Simply put, at the national level, reforming environmentally harmful subsidies requires co-operation between different branches of government at various administrative levels, the private sector and civil society. Similarly, in an increasingly internationalised economy, integration of environmental considerations into multilateral trade liberalisation processes is essential to support the phase out of environmentally harmful subsidies for internationally traded commodities.

Arguably, the nature of the transitional measures established and the mix of stakeholders involved are the most important decision-making aspects of national-level subsidy reform. Empirical evidence from the energy sector suggests that (i) a market for alternative fuels, often itself subsidised, may have to be created as a prerequisite for reform; and (ii) private sector stakeholders respond to marketing stimuli more readily than they react to macroeconomic ones. Ultimately, at the implementation level, subsidy reform will require careful case-by-case assessments – as there is no silver bullet that can be used between, or even within, sectors. Most important of all, however, is strong leadership from government to firmly pursue the public interest.

Multilateral processes provide the most effective venue for reforming those subsidies whose impacts – environmental and otherwise – are felt across national borders. To date the World Trade Organization, with its legally binding rules, has been the main such negotiating venue. Nonetheless, given the complexity of the issues and the stakes at the negotiating table, informal consultations such as the United Nations Environment Programme's 'multi-stakeholder workshops on international fisheries subsidy reform' are playing an increasingly important analytical and consultative role. They bring together a wide range of stakeholders, add new information and analysis, and allow participants to find consensus or develop new approaches in an open, non-negotiating environment.

The appeal of whole-of-government decision-making for subsidy reform arguably lies in its potential to ensure policy coherence – that is, that policy initiatives in different sectors reinforce, as opposed to undermine, each other. Examples of tools that can be used to achieve this goal include systematic reliance on cost-benefit analysis and a long-term approach to policy setting – one that goes beyond electoral cycles and thus where successive incumbent governments become implementers and not masters. Subsidy reform and indeed the broader sustainable development agenda might thus benefit from systematic peer reviews of the extent to which, and the means by which, government policies pursue the above coherence goal.

Integrated Approaches to Reforming Subsidies in the Energy Sector: The US Case
Doug Koplou, Earth Track

Recent years have seen regression rather than progression in the arena of energy sector subsidy reform in the United States. A dramatic increase in energy prices, security concerns over reliance on imported oil, and efforts to "do something" about climate change without legislating carbon constraints, have led to a surge in energy-related legislation at both the state and federal levels. This has greatly increased the scope and value of public subsidisation to the energy sector in recent years.

Unfortunately, there remains a lack of "subsidy accountability" to constrain the growth of these policies. The roots of this problem are many. At the federal level, poor transparency of the tax expenditure estimation process and subsidy tracking programmes that do not fully capture their cost are problematic. Historic spending constraints, such as "pay-as-you go" rules that forced spending offsets to new subsidies, have been allowed to expire. At the state level, there is generally poor policy transparency, especially with regard to non-cash subsidies (tax expenditures, credit support and subsidised insurance). Energy subsidy reform strategies must focus on improved transparency at all levels of government, and must improve co-ordination across groups to overcome the political resistance to change from recipients.

First, federal and state governments should conduct subsidy impact assessments that identify affected parties, validate the expected cost of the policy, and demonstrate that there are no less expensive ways to achieve the same policy goals. Boosting transparency and accountability within the government depends on disclosure of tax expenditure estimation models, and requirements for state governments to publicly track tax, credit, and indemnification activities. Credit subsidy calculations should be adjusted to ensure all programme costs are included, that actual loan performance is tracked more openly, and that the risk category of each respective borrower is more accurately presented.

With regard to the Congress, operating procedures for Conference Committees should be formalised to ensure that bills can be vetted before vote and that entirely new language can't be inserted. There should be rules on legislative amendments that make changes in language visible using text mark-up, and that require sponsors of the changes to describe why they are making the change and who benefits.

Second, forcing subsidy recipients to compete for available subsidies could generate more efficient use of public resources. Subsidy objectives could be defined more broadly, and all possible options to achieve that objective forced to bid against each other. The winner would require the smallest increment of public subsidy for achieving the given policy goal. The competition would also avoid the potential corruption problems that occur any time the available subsidy is capped at below the level it is demanded. Subsidy recipients should disclose the amount and sources of public support they have received as a condition of getting the aid, and sunset provisions should be a core element of subsidy policy.

Third, boosting transparency and accountability from outside of the government can prompt internal reforms, at least in the short-term. External groups have great latitude to leverage existing budgetary information into a much more cohesive and useful resource, regardless of the level of internal change. Realising this potential requires a level of co-operation across non-governmental organisations (NGOs) and foundations that has not historically been present. Many existing technologies to consolidate, compare, analyse and link information via the Internet have been poorly deployed, or not used at all, by these groups. Exceptions are the Environmental Defence Scorecard, and the tracking of political contributions by the Center for Responsive Politics. However, these efforts have not ventured into the less structured worlds of legislation, statute, tax, and credit, where most subsidy activity occurs.

Development of more comprehensive costing models to link existing or proposed subsidy policies to their financial cost and integrated with a policy tracking system is possible. Links between specific provisions of subsidy proposals and the political backdrop (sponsors, political contributions, etc.) could be automated. The result would be a much more comprehensive and holistic view of both current and proposed subsidy policy, and a changed political environment in which subsidy sponsors would need to operate.

Integrated Approaches to Reforming Subsidies in Fisheries: the EU Case
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This paper will provide an overview of the evolution of the subsidy regime of the Common Fisheries Policy (CFP) of the European Union and consider the drivers behind the reforms. It will consider both changes in the EU framework and in the United Kingdom as case studies of implementation. How stakeholder and industry involvement in modifying supports to the fisheries sector has changed over time will be considered, together with what influence this may have had. Political leadership at the EU and UK levels will be reviewed, together with the role of national and European Commission departments other than fisheries in developing and implementing the Financial Instrument for Fisheries Guidance (FIFG) and the European Fisheries Fund (EFF).

Direct payments have been a central instrument of the EU Common Fisheries Policy (CFP), primarily through the Financial Instrument for Fisheries Guidance (FIFG). This is one of the most controversial instruments of the CFP in terms of its environmental impacts. The FIFG has evolved significantly over the last twenty years, shifting from a focus on increasing fishing capacity (vessel rebuilding and modernisation) towards capacity reduction (vessel scrapping), non-capital grants and local management initiatives. However, this trend may now be reversing as the European Fisheries Fund (EFF), the successor of the FIFG from 2007, is currently being negotiated and various provisions for vessel modernisation are taking centre stage in discussions.

While the FIFG framework is important in determining what EU Member States may fund, because of the devolved nature of the instrument the actual use of European and national funds depends on Member State and regional authority decisions. The United Kingdom is an example of an EU Member State that has moved away from supporting vessel rebuilds to 'softer' and less environmentally harmful initiatives. There is also a growing case for introducing a system of cost recovery in the UK. The role of institutions, stakeholders and processes in influencing divergent paths in subsidy reform in fisheries can be a key factor.