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How Fuel Subsidies Drag Down a Nation

By ROBERT H. FRANK

WHEN countries adopted bad economic policies in decades past, only their own citizens paid a price. In today's globalized economy, however, the burden falls more broadly.

A case in point is the use of fuel subsidies to protect citizens of developing economies from rising prices. As Keith Bradsher reported in The New York Times last month, many emerging economies employ subsidies that keep domestic fuel prices far below the world price. As a result, these countries consume far more fuel than they would otherwise.

By one estimate, countries with fuel subsidies accounted for virtually the entire increase in worldwide oil consumption last year. Without this artificial demand stimulus, world oil prices would have been significantly lower. Earlier this summer, for example, world oil prices fell by $4 a barrel on news that reduced subsidies would increase Chinese domestic fuel prices by about 17 percent.

It would surely be unrealistic to expect other governments to abandon subsidies just so Americans who drive S.U.V.'s and live in big houses could benefit from lower world energy prices. But those governments might want to reconsider their policy in the light of overwhelming economic evidence that the subsidies create net losses even for their ostensible beneficiaries.

To be sure, higher fuel prices produce economic suffering. The unfortunate reality, however, is that when the price of an imported resource rises in the world market, buyers must take a hit. Subsidizing fuel does nothing to reduce the inevitable suffering, and actually makes it worse.

The problem is that when the price of a good is below its cost, people use it wastefully. In the case of a gallon of gasoline, the cost to a country is the value of every additional sacrifice that its use entails. That includes not just the price of buying the gallon in the world market — say, $4 — but also external costs, like dirtier air and increased congestion. The external costs are often hard to measure but are nonetheless substantial. With reasonable estimates factored in for them, the true cost of using a gallon is clearly greater than $4. By contrast, the price of gasoline to users is simply the amount they pay at the pump. With a $2-a-gallon subsidy in effect, gasoline bought in the world market at $4 would sell for $2, or more than $2 less than its true economic cost.

Consider how this difference might affect a trucker's decision about whether to accept a hauling job. A rational trucker will apply the basic cost-benefit test, which says that something is worth doing if, and only if, its benefit is at least as great as its cost. Suppose the job in question requires 1,000 gallons of fuel, available at the subsidized price of $2 a gallon, for a total fuel outlay of $2,000. If the cost of the trucker's time and equipment are, say, $1,000 for the trip, his narrow interests dictate accepting the job if the shipper is willing to pay at least $3,000. Suppose the shipper is willing to pay that amount but not more.

The problem is that if the trucker accepts the job at that price, the country as a whole will be worse off by more than $2,000. Although the $3,000 fee would cover his own costs, the government would end up paying $2,000 in additional subsidies for the 1,000 gallons consumed. On top of that, the trip would generate additional pollution and congestion costs. So the fact that the subsidy encouraged him to accept the job means that its net effect is equivalent to throwing more than $2,000 onto a bonfire.

Waste is always bad. Anyone who doubts it need only remember that when the economic pie grows, it is always possible for everyone to have a larger slice than before. Using fuel for activities whose costs exceed their benefits makes the economic pie smaller.

Subsidy proponents cite the firestorm of political protest that would erupt if fuel were to sell at the international market price. That fuel subsidies are wasteful, however, implies that there must be less costly ways to keep the peace.

Consider again our trucker who accepted a job that barely covered the cost of his time, equipment and subsidized fuel. Instead of paying $2,000 to subsidize his fuel, the government could give him a tax cut of, say, $1,000, and use the remaining $1,000 to help pay for public services. Because the trucker’s earnings from the hauling job were only enough to cover his costs at the subsidized fuel price, he would be $1,000 better off with the tax cut alone than with the fuel subsidy. The additional support for public services would augment this benefit. In short, a tax cut is always a better way to keep political protest at bay because, unlike a fuel subsidy, it does not encourage shipments whose costs exceed their benefits.

IF a United States president urged developing economies to eliminate fuel subsidies because they result in higher energy prices for Americans, the conversation would probably end very quickly. But this conversation might be reframed.

A good place to start would be to heed the same advice we'd like others to follow. Emerging economies are not the only ones in which prices at the pump substantially understate the true social cost of fuel. For instance, although the United States doesn't have direct fuel subsidies, existing fuel taxes significantly understate the pollution and congestion costs associated with additional fuel use. Adopting some variant of a tax on carbon, as both leading presidential candidates have proposed, would help eliminate this discrepancy.

That would set the stage for our next president to explain to other leaders why eliminating fuel subsidies would make the overall economic pie larger. Because the resulting efficiency gains can be redistributed so that everyone gets a bigger slice than before, the idea should be fairly easy to sell.

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