Investing in reform

A new bond could beat our addiction to fossil fuel subsidies

Fossil fuel subsidies are woven into the fabric of many economies, holding back the transition towards clean energy. **Tom Hale** and **Pete Ogden** propose a new form of financial instrument – 'SPARC bonds' – that could overcome the political and economic barriers to reform.

The International Energy Agency reported this summer that the price of making the global transition to a clean energy economy has risen by some 10 per cent over the past year because we have failed to act decisively on the issue. The cost of this additional investment now stands at US$44 trillion.

Most of this money will come from private investment. However, in order to shift private capital from dirty to clean energy, we must use our limited public resources wisely. Perversely, we currently do the opposite: countries spend some $500 billion annually to subsidise fossil fuels, a sum which exceeds the amount spent on promoting clean energy by more than 6:1. With governments actively tilting the playing field toward dirty fuels, it is difficult to see how we can engineer a transition towards clean energy.

There are other costs as well. In 2011 the government of India, where 400 million people live on less than $1.25 per day, spent $40 billion – 2.2 per cent of GDP – subsidising dirty energy. In some countries, particularly in the Middle East and North Africa, fuel subsidies can account for as much as 20 per cent of GDP. Channelling that money towards more socially beneficial causes would be both a fiscal boon and a development windfall.

So why don't governments act? Many have tried, but few have succeeded. This is because fossil fuel subsidies are about much more than energy: they are deeply woven into the political economy of some countries. Subsidies benefit certain fossil fuel producers and consumers, whose interests in maintaining the status quo become vested over time.

Moreover, subsidies are often justified by governments as a way to provide for those in need. However, fossil fuel subsidies are actually, on average, highly regressive. According to the IMF, the richest 20 per cent of the population in developing countries capture six times more in fuel subsidies than the poorest 20 per cent.

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SPARC BONDS: DIRECTLY ADDRESSING THE POLITICS OF FOSSIL FUEL SUBSIDIES

What can be done? At the global level, the G20 committed in 2009 to phase-out inefficient subsidies, but has yet to deliver on this promise. More productively, the IMF, World Bank and OECD help countries to understand the problem and design reform programmes, but outside entities – even those with substantial expertise and resources – often struggle to gain leverage against powerful interest groups rooted in domestic politics.

To overcome these formidable political obstacles, domestic reformers need stronger policy tools. A new financial instrument – a Subsidy Phase-out and Reform Catalyst (SPARC) bond – could leverage private capital markets to provide exactly this kind of tool.

SPARC bonds would function just like a standard bond, allowing governments to raise money from private capital markets by promising to pay investors a fixed amount in the future, but with a critical exception: these bonds would only be made available to countries willing to repay them with the savings accrued from phasing down their fossil fuel subsidies.

The scale of such bonds could be vast. Say a country spends $10 billion per year on fossil fuel subsidies. With a SPARC bond, it could commit to lowering that amount by $1 billion per year over 10 years – that is, saving $1 billion in the first year, $2 billion in the second year, and so on. That revenue stream, over a decade, would be worth $55 billion ($1 billion plus $2 billion plus $3 billion and so on). Discounted for time and risk, these prospective savings could underpin a significant bond sale, which would allow a government to finance infrastructure investment, social spending, cash transfers, or whatever else is needed for successful reform.

If issued on governments' behalf by a multilateral development bank, SPARC bonds would be extremely attractive because they could make capital available at better than market terms. Seed money and guarantees from donor governments could make them even more appealing. Furthermore, because fossil fuel subsidies are so large at present, the bonds could provide a government with a vast war chest to invest as required to overcome the political obstacles to reform.

THE RIGHT TOOL AT THE RIGHT TIME

SPARC bonds can succeed where other reform programs have failed because they directly address the politics around subsidies, allowing reformers to build new coalitions for subsidy reform and mitigate the concerns of vested interests. Suppose that a politician wants to spend less public money on fossil fuels and more on education. She could propose spending a portion of the funds from a SPARC bond to build new schools right now. This could attract a new and potentially powerful untapped coalition of students, parents, and teachers – as well anyone involved in the construction and maintenance of the new schools themselves – to the cause of subsidy reform. At the same time, a second portion of the revenue could be directed toward building a new port, which might ease any resistance from industry.

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Governments could also increase public spending on social services to compensate citizens for increased prices, as Indonesia did when it ramped up public expenditure on rice and health insurance to offset rising energy prices for families during a successful period of subsidy reform. The money could be directly rebated to taxpayers, allowing families to decide for themselves how best to adjust to the true cost of fossil fuels.

For some countries, carrying an AAA rating would be enough to make SPARC bonds attractive; for others, some additional support would be needed. But if donor countries are currently willing to help build a new solar power plant in a developing country, would it not make just as much environmental and economic sense – if not more – to incentivise the removal of fossil fuel subsidies in that same country?

> **"If donor countries are willing to help build a new solar power plant in a developing country, would it not make as much sense to also incentivise the removal of fossil fuel subsidies?"**

The timing is propitious as well. Developed countries are struggling to meet their Copenhagen accord pledge of mobilising $100 billion of public and private climate finance per year by 2020. SPARC bonds would be a huge boost to this effort, and would help to galvanise international negotiations as they approach the December 2015 deadline for reaching a new climate agreement.

Countries also face a late-2015 deadline for negotiating a set of sustainable development goals, which will succeed the millennium development goals, through the United Nations. UK prime minister David Cameron recently co-chaired a high-level panel that called on countries to include the phasing-out of fossil fuel subsidies as one of the new global development targets, and the idea has since gained some traction in the negotiations. To make this target credible, however, countries will need to be able to identify new tools and resources for achieving it: here, SPARC bonds can again offer a path forward.

For too long, people have railed against the follies of fossil fuel subsidies to no avail. The leaders of all of the world's major economies have repeatedly pledged to do away with them. Now is the time to get serious about helping to arm reformers with the arsenal they need in order to prevail.

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