GOOD PRACTICE NOTE 9
Assessing the Political Economy of Energy Subsidies to Support Policy Reform Operations

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ACKNOWLEDGMENTS

This is the ninth in the series of 10 good practice notes under the Energy Sector Reform Assessment Framework (ESRAF), an initiative of the Energy Sector Management Assistance Program (ESMAP) of the World Bank. ESRAF proposes a guide to analyzing energy subsidies, the impacts of subsidies and their reforms, and the political context for reform in developing countries.

The authors thank participants in the study “The Political Economy of Energy Subsidy Reform,” which has largely informed the analysis here, along with participants at a December 2016 workshop that reviewed a draft.

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of influence and interest between actors. She works with governments and change agents across different sectors and regions in overcoming political economy and stakeholder obstacles to reform.

ACRONYMS AND ABBREVIATIONS

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>ESMAP</td>
<td>Energy Sector Management Assistance Program</td>
</tr>
<tr>
<td>ESRAF</td>
<td>Energy Sector Reform Assessment Framework</td>
</tr>
<tr>
<td>LPG</td>
<td>liquefied petroleum gas</td>
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<tr>
<td>SOE</td>
<td>state-owned enterprise</td>
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1. INTRODUCTION

For decades, policy makers have known that it is important to reform energy subsidies. Yet, in practice, there has been huge variation in the outcomes from reform efforts. Failures are often rooted in the inability of reformers to understand and overcome political barriers. Successes have come where governments and other important pro-reform policy actors have addressed the political economy barriers and opportunities for reform strategically. Further success of reforms will require tools that make it easier to understand and navigate those barriers and opportunities.

As part of a larger World Bank study on the empirical record of subsidy reforms, the goal of this note is to create a framework to collect information that can help explain the history and possible future developments of the political economy of subsidy reform. The purpose of this analysis is to improve the design and implementation of reforms and to integrate political economy concerns from the outset and not in a reactive manner.

The analytical framework proposed in this note is rooted in basic theories of political economy—a framework that can guide empirical research while helping policy makers draw lessons from previous reform efforts. A political economy perspective pays close attention to such factors as the ability of interest groups to organize for or against policy reforms and how institutions, prices, and technical opportunities shape policy decisions and their implementation. This political economy framework has also put an important spotlight on incentives that affect the behavior of political leaders and administrators.

Annex A provides a framework for interview questions and a strategy for obtaining information through interviews. Much of the critical information about the political economy is difficult to obtain through reports and data sets—while these can provide critical information about the issues that pose problems and for which the underlying drivers need to be explored. Interviews will be essential, especially interviews on politically sensitive topics with seasoned senior officials and observers.

While there has been extensive research on the optimal design of subsidy policies, systematic research on the political economy of subsidy reform is much thinner, yet perhaps more essential to effective policy design and implementation. Among the many insights from that research is that timing and organization are vitally important to the practical success of reform efforts. Other insights concern the reality that much of the academic research on policy reform has focused on first-best policy outcomes that are perhaps rarely observed in the real world. More realistic reforms often have “second-best” (or “nth-best”) characteristics and are best understood in a dynamic framework. Often, the question is not “How can we achieve a result that mirrors global best practice?” but rather “How can we make and maintain progress on the issue of energy subsidy reform?”

1 For more insight into the framework and in-depth application to four countries, see Inchauste and Victor (2017), notably chapter 1, which reviews the literature. For more about the foundations of the framework, see Olson (1965), Peltzman (1976), and Stigler (1971). For its application to recent studies of political systems, see Wilson (1973). A discussion of the general experience of using a problem-driven political economy lens to inform WBG strategies and operations, see Fritz, Levy, and Ort (2014).
Reform efforts begin and succeed where they engage effectively with the political economy in a given context. In some cases, that means that there is an existing favorable political economy. In others, creating that dynamic will be one of the main tasks of the reform team—to engage with stakeholders and leadership to increase the space for reform and reduce resistance. By starting the work in areas of favorable political economy, reforms teams can realize initial successes that help create and empower interest groups, institutions, and political dynamics that can be used to beget additional reform progress. Political economy research has also emphasized the importance of two distinct questions: (a) Has the reform been successfully implemented? and (b) Has the result been maintained sustainably over time or have changing circumstances and stakeholder constellations led to a retraction of reforms?

This note comes in three sections. First, the information required for political economy analysis of energy subsidy reforms is presented. Second, a summary is given of the information that can usually be obtained through desk research to provide the context for subsequent interviews and other field research. Third, information that probably requires interviews and field data collection is provided.

The ultimate audience of the proposed types of analysis lies with policy reformers themselves and with external development and policy institutions that are seeking to help governments adopt more sustainable reforms. However, the direct audience for this note are those commissioning political economy analysis of energy subsidies, and technocrats, researchers, and advisers to policy makers carrying out the analysis. Often, a team made up of sector experts and political economy experts will provide a greater depth of analysis. Significant attention is devoted here to the origins and operation of existing subsidies since that history conditions what is possible for the adoption and sustainability of future reforms.

The main interest and audience for this note is forward-looking—people and institutions who need to understand what is politically possible and how to realign political forces around successful reform. The authors are mindful that this role is perhaps different from other more technocratic roles of agencies and institutions focused on technical analysis and thus they also devote some attention to the processes needed to obtain and manage sensitive information and political insights since mismanagement in that realm can, itself, affect the political prospects for reform and harm the standing of reform agents in the process. In contrast to desk research or analysis of existing datasets, field research on political economy will always be an intervention in the local system, which needs to be managed well to increase and not decrease the space for reform and coalition building.

ESRAF defines an energy subsidy as a deliberate policy action by the government that specifically targets electricity, fossil fuels, or district heating and that has one or more of the following effects:

- Reducing the net cost of energy purchased
- Reducing the cost of energy production or delivery
- Increasing revenues retained by energy producers and suppliers

Examples include government control of energy prices that are kept artificially low; budgetary transfers to state-owned energy suppliers or tax expenditures granted to
energy suppliers to keep costs down to benefit consumers, producers, or both; underpricing of goods and services, such as fuels, land, and water used by energy producers; subsidized loans; and shifting of risk burdens, such as the assumption of risks through limits on commercial liability.

Many forms of subsidies have little effect on energy prices. For example, tax expenditures may increase the profits retained by energy producers and result in large fiscal losses but may have no impact on end-user prices in a deregulated oil market. Because tax expenditures are seldom reported or subject to scrutiny by legislators, they frequently attract little or no attention from the public and policy makers, except in situations of increasing overall fiscal stress. By contrast, those subsidies that lower prices paid by consumers—and the reform of which is likely to raise prices—tend to be much more politicized, making political economy analysis essential. As such, while this note is applicable to all forms of subsidies, it focuses particularly on consumer energy price subsidies.

The rest of the guidance outlined in this note is structured around three intended goals. First is a political explanation for the country’s current array of energy subsidies. This first goal treats each major cluster of subsidies as a unit of analysis (a subsidy with significant political and economic effects and organized administratively and politically in a distinct way). The second goal is to understand the history of reform—including whether successes or failures in past reform efforts reveal or constrain what is possible for future reforms. To achieve this second goal, historical episodes of reform are used as the unit of analysis. And a third goal is an assessment of the prospects and viable strategies for reform in the future. This third goal uses the sector and its actors as the unit of analysis and, where appropriate, the overall political economy of the country as the unit of analysis.

Most reforms are sector-based, but at times sectoral reforms are anchored in broader country-wide reforms and the rise to power of leaders who have an incentive to pursue country-wide reform.

2. INFORMATION REQUIRED FOR ASSESSING SUBSIDIES AND DESIGNING ENERGY SUBSIDY POLICY REFORMS

Before delving in depth on how information might be obtained, here the authors first identify the six main types of information that will be needed for political economy analysis. Following are the six types of information that are drawn from Inchauste and Victor (2017) and related research cited in that study:

1 | Goals and structure of existing subsidies
2 | Size of subsidies, who pays for them and who gets them
3 | Mechanisms used to deliver subsidies and their alternatives
4 | The decision-making structure concerning subsidies
5 | Stakeholder interests and dynamics
6 | The track record with reform

The first three of these six types of information will lead to an understanding of the country’s existing subsidy schemes and the developments
that led to these schemes. The analysis should seek to capture the initial developments that led to the introduction of subsidies, and the major policy changes made since then. The last three kinds of information provide the guidance needed for a forward-looking political economy analysis of those subsidies and their reform, to feed into effective design and implementation of the reform.

**INFORMATION TYPE 1: GOALS AND STRUCTURE OF EXISTING SUBSIDIES**

The first category of information is aimed at understanding the scale of the subsidies and the scale of distortions they cause in the economy and the political incentive structures. Before assessing whether subsidies are reaching their intended targets, and whether alternative mechanisms could perform better, the scale and incidence of subsidies must be known.

Most countries do not create energy subsidies for their own sake. Instead, subsidies are often initiated with the intention of advancing a potentially legitimate socioeconomic goal—such as keeping energy prices artificially low for economic development, helping the poor meet basic energy needs, or providing input subsidies in the form of cheap energy to certain industries—for which alternative instruments are not seriously considered, preferred, or available. It is important to understand those initial goals of a subsidy program, since they inform how interest groups are organized, as well as the goals that must be achieved with a reform program.

The existence and design of a subsidy also depends on the way that the industries in the country’s energy system are organized. The electric power system is organized distinctly from the rest of the energy system. In cold-climate countries, district heating plays a unique role, often managed at the level of municipal governments. Natural gas, like electricity, is managed by utilities at the level of pipeline transportation and distribution. Because they all have elements of natural monopoly, economic regulation is required for at least some segments of the supply chain for electricity, district heating, and natural gas. By contrast, liquid fuels and coal are typically suited for sale in a competitive, deregulated market. Because petroleum fuels play such a visible and central role in industrial and consumer activity—fuel prices affect the cost of goods and passenger transport, with the former affecting the prices of virtually all other goods, for example—they are often highly politicized.

In most countries, the landscape of energy subsidies has developed over a significant period into a complex mix of producer and consumer subsidies that varies significantly across fuels and energy carriers and that serves a mix of legitimate social and special interest goals. These different forms of subsidy differ with regards to their political and public visibility and their perceived and actual impact on different interest groups and institutions—which affects the political dynamics and stakeholder risks of reform efforts.

**INFORMATION TYPE 2: SIZE OF SUBSIDIES, WHO PAYS FOR THEM, AND WHO GETS THEM**

At the outset of political economy analysis, it is important to establish “what the problem is” and the detailed contours of the problem to the extent possible (see also Fritz, Kaiser, and Levy 2009). Typically, it is expected that most of the relevant information would be provided by technical and fiscal analysis, either existing
or undertaken in parallel. Described here is the extent of information considered as needed about the nature and incidence of subsidies to then meaningfully explore underlying political economy drivers, constraints, and opportunities.

Ideally, a table of all the main subsidies (or clusters of related subsidies) should be prepared as detailed in table 2 in Good Practice Note 1, and information should be obtained on each one. For each, it is important to know the goals and sectoral focus of the subsidy. Good Practice Note 1 discusses how to quantify subsidies, how they are financed and intended, and who the actual beneficiaries are. For designing a subsidy reform program, the focus varies by energy type and country circumstances. Examples include the magnitude of budgetary transfers, the scale of price adjustments needed, the financial viability of energy supplies, and fiscal losses inclusive of contingent liabilities. This will make it possible to identify those reforms that may yield the greatest benefit. However, as shown below, in the analysis of future opportunities and planning of reform pathways, the identification of priority areas must be combined with an analysis of the political and administrative abilities of the system to implement this reform. This will help avoid situations where the reforms look perfect on paper, but are not feasible to implement in the existing political economy environment.

Information about the total size of the subsidy helps to set priorities for reform. It can indicate the total costs and benefits, as well as the scale of the effort that may be required for reform.

For each of the major subsidies, it is crucially important to understand, next, who pays the cost. The costs of budgetary transfers, government contingent liabilities, and fiscal concessions are borne by different levels of the government (central, regional, or local). Frequently, energy suppliers—starting with state-owned ones, but in some circumstances also private companies—incure financial losses as they provide energy at prices that are below reference prices (prices that would have...
prevailed in a competitive market or, in the absence of adequate competition, benchmark prices as detailed in Good Practice Note 1). This happens when they are not reimbursed for subsidies, either because there is no mechanism for reimbursement or because reimbursements are late or unpaid.

Two main sources of subsidy delivery mechanism merit attention. One is the general government budget—which includes central government and regional authorities. These subsidies are often the simplest to understand and observe because their cost is easy to trace, as long as they are reported as separate line items in government budgets. Thus, the tradeoffs against other government policy goals are immediately apparent. As Good Practice Note 1 points out, state-owned enterprises (SOEs) in the energy sector merit special attention due to several potential factors—such as undue risk-taking, soft budget constraints leading to contingent liabilities, debt cancellations, and tax-exempt operating status—combined with their being politically, organizationally, and economically distinct. The use of SOEs to deliver subsidies poses a different set of challenges and opportunities. On the one hand, they are often one step removed from central government control and will fight to remain in existence and remain relevant. On the other hand, their distinct governance structures often allow for a larger flexibility in how to approach and implement reforms. Governments, elected leaders, and political parties often use their disproportionate influence over SOEs to direct their activities toward politically useful missions while burying the cost of those missions in underinvestment or the larger operational budgets of the SOEs.

Governments often avoid policies that create direct on-budget fiscal consequences for themselves. Instead, they favor policies that externalize the cost to someone else. Export restrictions, not adjusting a “market-based pricing formula” in a timely manner, and reimbursing subsidies with a long delay and with no interest payments (if they are reimbursed at all) are some examples. In all these cases, energy suppliers often bear the cost. If export restrictions take the form of large export taxes, the government raises revenue and lowers domestic prices at the same time at the cost of investments in the energy sector. Over the long term, some fuel exporters have even turned into importers given the financial losses. Prominent examples are major crude oil exporters—such as Ecuador, the Islamic Republic of Iran, Iraq, Mexico, Nigeria, and the República Bolivariana de Venezuela—that have been forced to import large quantities of petroleum products because their refineries are not financially viable after decades of fuel price subsidies.

Finally, it is important to know who benefits from the subsidy. It is important to distinguish between eligible and ineligible beneficiaries, arguably the most egregious form of the latter being those who engage in criminal activities—such as fuel smuggling and diversion to black markets—to gain financially from subsidies. Where there is pan-territorial pricing and fuel transporters are compensated through an elaborate cross-subsidy scheme, illegal profiteering by truckers can be common. The distributional impact of subsidies and their reforms on households by income is covered in Good Practice Notes 3 and 4. To the extent possible, such information should also be organized politically so that the size of the rent flow can be linked to the organized interest groups (such as artisanal fishermen and private bus services) that seek the subsidy, as well as to more shadowy interest groups profiteering illegally from subsidies. Understanding the
strength of those interest groups and whether and how other groups can overcome political blocks is often pivotal to successful adoption and implementation of subsidy reforms.

As a practical matter, the fiscal data (examined in Good Practice Note 2) and distributional analysis (Good Practice Notes 3 and 4) are not organized by political around which types of interest groups benefit and thus, an analysis of the political economy of subsidies and their reform will need to examine these distributional impacts beyond the standard analysis by income brackets. Understanding who gets the subsidy is important because it can help reveal how beneficiaries are politically organized—and can point to opportunities and challenges to overcoming resistance against the reform. And it is important because it is crucial to understanding whether and how the subsidy actually reaches a socially desirable target. One important dimension is that energy subsidies often benefit multiple social groups. For example, consumer price subsidies may be critical for poorer groups, but they may also benefit elites, such as those who own bus companies or who generally consume more energy (for example to cool or heat their larger homes or to run industrial production), while the cost of the subsidies are generalized across all citizens (as taxpayers and as users of public services).

**INFORMATION TYPE 3:**
**MECHANISMS USED TO DELIVER SUBSIDIES AND THEIR ALTERNATIVES**

There are four main mechanisms by which subsidies are provided:

1 | Budgetary transfers
2 | Government-induced transfers between producers and consumers
3 | Forgoing taxes and other government revenues
4 | Underpricing of goods and services

The mechanisms are summarized with examples in tablet 2 of Good Practice Note 1. As that note describes in detail, how each is delivered is an important determinant of stakeholder groups, their benefits, and likely opposition to or support for subsidy reforms.

Consumer price subsidies are arguably the most visible form of subsidy, and one with the most distorting effect on the economy. How they are delivered affects the extent of subsidy effectiveness and leakage, as well as their unintended consequences. One question is whether energy suppliers are compensated. If they are, how many energy suppliers receive compensation, how that compensation is determined, whether compensation is adequate and delivered on time, and whether the compensation is self-administered (say by the national oil company) all affect the political dynamics of subsidy reforms. Inadequate compensation can lead to contingent liabilities and, over the long term, declining sector performance as the sector becomes increasingly unviable financially (see Good Practice Note 2 for these fiscal dimensions).

Other questions include whether the subsidized energy is rationed and whether there is a price stabilization fund. The price subsidy may be helping to insulate politically well-organized groups—for example, hauling or taxi unions—from the volatility and high cost of an important input. When price controls lead to contingent liabilities that can be shifted to less visible parts of the state budget (or even to actors who are poorly organized politically), the government obtains this
political benefit while seemingly avoiding the cost. A similar logic applies with regard to the incidence of costs over time—where the cost of subsidies can be hidden through such mechanisms as price controls and then shifted into the future (for example, through rising debt loads of the enterprises that bear the costs of persistent under-investment in infrastructure that wears out only slowly) that might be favored by political leaders who have shorter time horizons.

While political visibility is important to those designing and implementing subsidies, it is crucial to look closely at what the beneficiaries of subsidies actually know and the conditions under which visibility waxes and wanes (see Good Practice Note 4 for a review of qualitative methods that can be used for assessing people’s perceptions). Not all subsidies are well known and visible to average citizens—in the Arab Republic of Egypt, Jordan, Lebanon, and Tunisia, for example, surveys revealed that many citizens were unaware of the extent to which a number of fuels were subsidized.\(^2\) Even price controls may fall victim to opacity if prices have been frozen for a long time, although they suddenly become visible when efforts are made to lift controls precisely when they are most costly and reform is most valuable (that is, when reference prices are much higher than subsidized prices).

This can lead to the paradoxical situation where, as long as the subsidies are in place, and incur cost to the budget, energy suppliers, or both, ordinary citizens are not aware of the price subsidies and do not give the government credit for them. However, should the government attempt to remove the price subsidies and reform the system, the pain of this loss will be felt by many and pose a political risk to the government. When subsidies have existed for a long time, they may be particularly invisible. A first step toward reforms often requires that the subsidies and the fiscal costs become better known—transparency is a first step toward a more complete reform.

Subsidies can be highly targeted so that only the intended group obtains the benefit. The challenge in doing so is much higher for liquid fuels than for network energy (electricity, natural gas, and district heating). A frequently cited example is lifeline rates for network energy, where the challenge is resisting the political pressure to expand the size of the lifeline block and the level of service that is “lifeline.” Smart cards that mete out low-cost electric power supplies represent a variation on lifeline rates. Quota cards for petroleum fuels—for which diversion is much easier—have met with varying success. When the cards are for fishing boats, which can be used to smuggle subsidized fuels out of the country, the problem controlling diversion becomes especially acute. In some countries, the availability of targeted income support—such as unconditional cash transfers—has allowed reduction or elimination of some energy subsidies, since it is almost always better to support a household’s income directly than to offer indirect benefits through subsidized energy.

Targeting has proved to be extremely important for reformers. Often it is politically not feasible to remove an energy subsidy completely. However, a scheme that allows for better targeting makes it possible to tailor the subsidy to the political environment and also to ensure that legitimate social goals (for example, poverty alleviation) are not in some countries, the availability of targeted income support—such as unconditional cash transfers—has allowed reduction or elimination of some energy subsidies, since it is almost always better to support a household’s income directly than to offer indirect benefits through subsidized energy.

\(^2\) See the MENA SPEAKS surveys (Social Protection Evaluation of Attitudes, Knowledge, and Support [SPEAKS] in the Middle East and North Africa [MENA]) a set of nationally representative opinion surveys that collected cross-country data about citizens’ perceptions and aspirations concerning social safety nets (Silva, Levin, and Morgandi 2013). The surveys were conducted by the World Bank in partnership with Gallup in Egypt, Jordan, Lebanon, and Tunisia.
undermined by subsidy reform. Better targeting might make first-best subsidy reforms possible. For example, Peru in 2012 established a fund that provides conditional cash assistance to the poor to enable them to purchase liquefied petroleum gas (LPG) for cooking (www.fise.gob.pe). The eligibility criteria are stringent to ensure that better-off households do not benefit from the program, and each beneficiary is personally visited to ensure that the household is indeed cooking with LPG. Selling a liquid fuel at market prices and helping the poor through cash transfers removes the financial incentives for illegal diversion, black marketing, and smuggling. Improved targeting might also make second-best subsidy reform strategies easier to implement in ways that make dynamic additional reforms possible. It can be the first step in an iterative reform process, building constituency support toward a broader and deeper reform in the future. Targeting can weaken politically powerful interest groups while parallel efforts are made to blunt their influence or compensate them in other, less distortionary ways—allowing further reforms in time.

In summary, these first three categories of information make it possible to understand the landscape of a country’s energy subsidy scheme:

- Goal and structure of existing subsidies.
- Size of subsidies, who pays and who benefits.
- Mechanisms to deliver subsidies and their alternatives.

Table 1 maps out this landscape and is designed to organize information by fiscal, political, and administrative logic. An important point to bear in mind is that there is frequently a marked divergence between how the subsidy is designed and how it works in practice. This applies to who actually bears the cost, who actually benefits, and how subsidies are delivered on paper versus in practice. These in turn affect the costs of subsidies and benefits captured by the intended beneficiaries. In extreme cases, the benefits maybe close to zero or even negative, as with the case of kerosene in box 6 in Good Practice Note 1.

**TABLE 1: Map of a Country’s Energy Subsidy Landscape**

<table>
<thead>
<tr>
<th>Major Subsidy</th>
<th>Goal (s)</th>
<th>Industrial sector</th>
<th>Total Cost</th>
<th>Who Pays?</th>
<th>Allocation of benefits</th>
<th>Delivery Mechanism</th>
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<td></td>
<td>Fiscal</td>
<td>Other</td>
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<td>Actual</td>
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<td><strong>Etc.</strong></td>
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