

Fuel subsidy in Nigeria - issues, challenges and the way forward

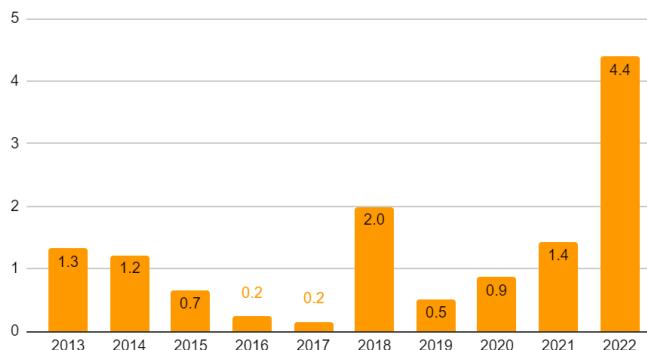


Introduction

The Nigerian economy has been subsided in various ways for many years and this includes fuel, education, electricity, forex etc. Fuel subsidies began in the 1970s and became institutionalised in 1977, following the promulgation of the Price Control Act which made it illegal for some products (including petrol) to be sold above the regulated price. While the concept of subsidy itself is noble, its administration in Nigeria has been plagued with serious allegations of corruption and mismanagement.

Thirteen years after diesel was deregulated, kerosene subsidy was removed in 2016. However, the subsidy on Petroleum Motor Spirit (PMS) has proven to be the biggest challenge to the managers of the Nigerian economy. On an annual basis, a substantial portion of the national inflow is committed to funding the subsidy scheme. Of course there are good reasons for the astronomical growth in subsidy amount - price of crude oil in the international market, volume of PMS consumed albeit debatable, and Naira devaluation are some of the drivers. In view of the significance of the amount committed to funding the subsidy regime, there is a need to have a close look at this scheme.

Nigeria's fuel subsidy payment (N'trillion)



We start-off this discussion with a focus on the challenges of retaining fuel subsidy in its current form and thereafter examine the associated economic issues. We have dwelt more on the solution as most key stakeholders agree that the subsidy regime needs to go, it is clearly not sustainable in its current form. In this paper we have put together a simple and practical solution to this long standing problem and a backup solution which could serve as a stop-gap measure towards full removal. The dual objectives of this solution is to ensure that the most vulnerable population is protected from any negative impact of subsidy removal and at the same time secure the necessary support required to make this happen.

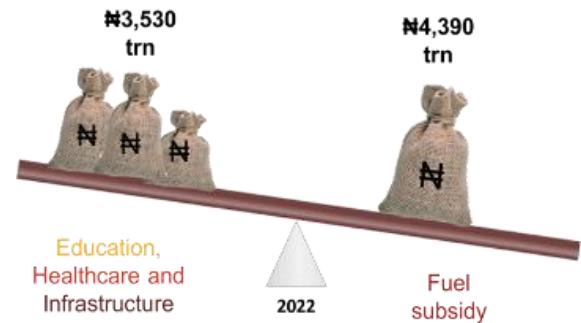
Challenges of funding fuel subsidy in Nigeria

What is really the issue with fuel subsidy in its current form? Here are five major issues, namely:

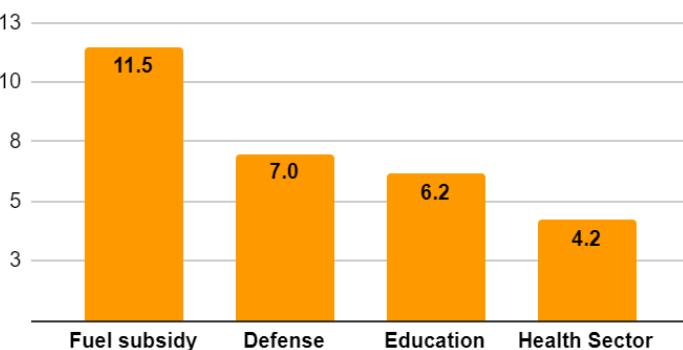
a. Unsustainable financial cost of subsidy:

According to the World Bank, Nigeria's total revenue in 2000 was USD 10.8 billion. By 2010, this amount increased to USD 67.9 billion. Yet the Nigerian government has spent over USD 30 billion on fuel subsidies over the past 18 years. This has had a significant impact on funds available for critical infrastructure and other essential sectors such as education, health, and defence. According to the Debt Management Office, the country's public debt stock is being increased as the government had to borrow N1trn to finance fuel subsidy in the year 2022.

The cost of fuel subsidies far outweighs the benefits to the Nigerian economy



Total fuel subsidy Vs Federal Government allocation to critical sectors in past 9 years (N'trillion)



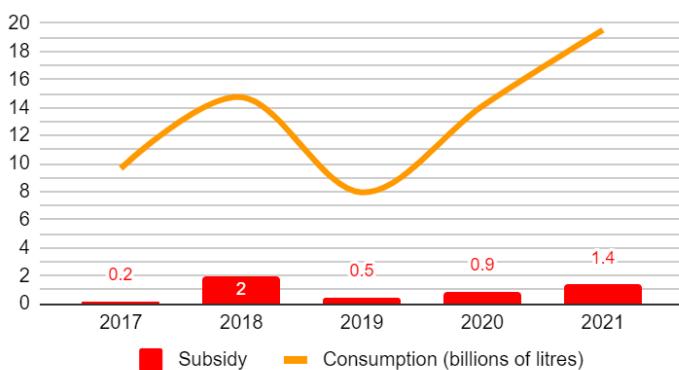
b. Economic distortion:

According to a report, households in the bottom 40% of the income distribution account for less than 3% of all fuel purchases. Furthermore, it is reported that three-quarters of all fuel sold in Nigeria is consumed by private firms, public transportation services, government agencies, and other businesses. Most vehicles used for carrying large numbers of people (such as *molue*) and goods are diesel powered which is already deregulated. Also, Household Kerosene which is mostly used by the poor is no longer subsidised, meaning that the poor are already to a large extent paying market prices for their fuel. This effectively means that the government is subsidising mostly those who can afford fuel (PMS) at market rates and not the poorest of the poor who need subsidy. This is one of the major problems with the way fuel subsidy is being implemented in Nigeria. For the benefit of subsidy to reach its intended recipients, the current structure will need to be reviewed and creatively restructured.

c. Smuggling:

The porous borders between Nigeria and neighbouring countries have created an enterprise for smugglers who purchase large volumes of petrol at a subsidised rate in Nigeria and sell at market prices in neighbouring countries.

Nigeria's fuel subsidy payment (N'trillion) Vs Nigeria's annual fuel consumption (billion, litres)



In June 2022, the Managing Director of NNPC Limited indicated that daily consumption of PMS had increased to over 103 million litres per day and that at least 58 million litres were being smuggled. This means that smugglers and other West African countries benefit more from fuel subsidy than Nigerians. A report published by Chapel Hill Denham, estimates that 15.64 million litres of petrol are smuggled out of Nigeria daily as the retail price of Nigerian petroleum products on average is 3.7 times cheaper than those of its neighbours, and this has given smugglers undue opportunities for arbitrage. The Nigeria Customs Service also affirmed that PMS was being smuggled out of the country in large quantities after it has been subsidised by the Federal Government, adding that the petroleum product is being diverted to as far as Mali.

d. Endemic corruption:

The subsidy point for fuel is importation (or supply) rather than at the pump for eligible users only. Subsidy in the current form encourages arbitrage and other forms of corruption.

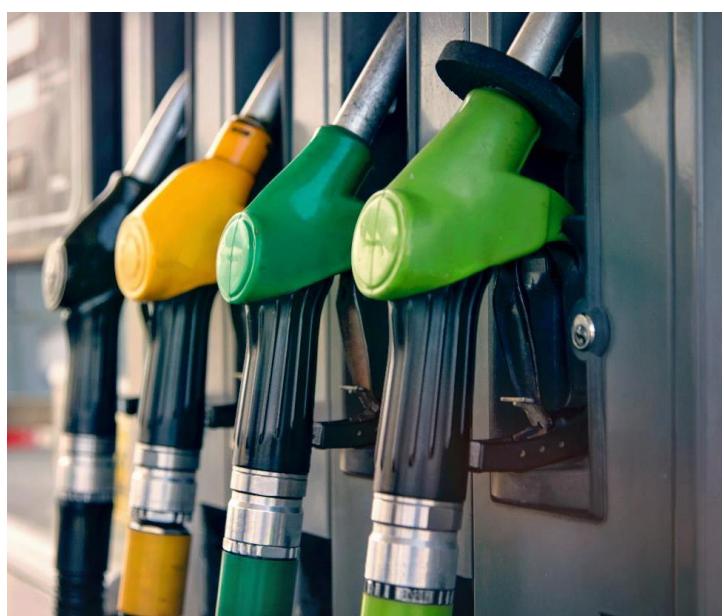
e. Investment:

Nearly 70 years after the discovery of crude oil in commercial quantity in Nigeria, Nigeria's oil and gas downstream sector is yet to develop to the desired levels, despite the recent enactment of the Petroleum Industry Act (PIA). The downstream sector of the oil and gas industry had the least foreign direct investment compared to the midstream and upstream sectors, and the reason for this is not far-fetched. The current subsidy regime and the legal framework of the downstream sector generally discourages investments.

The downstream sector needs full deregulation if it would attract more private investors, and one of the impediments that will need to be removed upon full implementation of the Petroleum Industry Act is fuel subsidy.

f. Climate Change Commitments:

At the COP26 which was held in Glasgow, Scotland in 2021, the President of Nigeria, Muhammadu Buhari signed the Climate Pact thus committing Nigeria to achieving net zero emissions by 2060. A week after the conference, President Buhari signed the Climate Change Bill into law demonstrating the country's commitment to truly achieve net zero carbon emissions. It is a contradiction for a country to subsidise consumption of fossil fuel while at the same time seeking to reduce the country's carbon footprint. Rather than subsidising fossil fuel, the country should encourage green and renewable energy.



Myths or facts: Evaluation of key concerns and popular proposals

a. Relationship between petrol price increases, inflation and cost of living

In Nigeria, the price of petrol is considered as a major driver of the cost of living, as it is used by all including small businesses and many households given the unstable electricity supply. Therefore, any increase in fuel price could directly and immediately impact the prices of goods and services across the country. There is also the psychological impact that it tends to have because of the strong sentiment attached to cheap and affordable petrol. When petrol prices increase, small businesses tend to raise their prices to cover the increased cost of operation which can lead to higher prices for consumers. This can make it more difficult for people to afford basic necessities, lead to a decrease in the standard of living and contribute to poverty and inequality. However, previous attempts to remove the PMS subsidy had mostly been accompanied by hoarding and general scarcity which invariably amplified the impact of the price increase beyond just the subsidy removal.

Overall, the relationship between petrol price increases, inflation, and the cost of living in Nigeria is complex and multifaceted. While petrol price deregulation can contribute to higher costs of living and inflation, the impact can be moderated if complemented with effective policies and well-thought out implementation strategy.

b. Will local refining of fuel products eliminate petrol subsidy?

The general belief is that local refining of crude oil could potentially eliminate the need for petrol subsidies altogether or make the market price affordable.

Currently, Nigeria imports its refined petroleum products due to limited or no domestic refining. According to Blackgold, Nigeria's total import for petroleum products is about \$28 billion per annum. This makes the country's fuel price not only dependent on global oil prices and exchange rates, but also importation and handling charges. Local refining is therefore expected to reduce Nigeria's dependence on imports and potentially stabilise petrol prices

However, other than the costs of haulage, insurance and associated cost of importation, though material does not constitute the most significant component of cost across the value chain. This implies that the pump price without subsidy would still be higher than the regulated price unless the international price of crude oil falls below a certain level.

While local refining will provide a price cushion, it is not a silver bullet that would magically solve the subsidy problem

c. Are palliatives effective?

Fuel subsidy in Nigeria has been fraught with issues of corruption and inefficiency and palliatives have been suggested by some as a possible way to alleviate the suffering of those that will be most affected by subsidy removal. While palliatives may help to mitigate the immediate impact of rising prices such as cash transfers, provision of buses to the Labour Union or other forms of assistance. However, the effectiveness of palliatives depends on several factors.

While palliatives can provide some relief to vulnerable households, it is difficult to identify and sufficiently cover the vulnerable population that will be most impacted, especially given the lack of reliable demographic data. In reality, palliatives can be expensive yet ineffective in addition to their being prone to corruption.

A multifaceted approach that involves evidence-based identification of the most vulnerable population, and a robust palliative administration with in-built controls would provide a more sustainable and long-term solution.

d. Can CNG be a viable alternative?

Compressed Natural Gas (CNG) has been proposed as a promising alternative to petrol in Nigeria due to the country's significant natural gas reserves. This has several potential advantages, including lower cost, reduced emissions, and improved fuel efficiency.

One of the most significant benefits of CNG is that it is considerably cheaper than petrol, which could result in substantial savings for vehicle owners. Additionally, the cost of CNG is more stable than the volatile price fluctuations experienced by petrol. Also, the use of CNG could reduce vehicle maintenance cost due to its cleaner burning properties, which produce fewer engine deposits that clog up the engine over time.

However, the adoption of CNG in Nigeria also presents some challenges. These challenges include the initial investment required to retrofit existing vehicles with CNG engines, the need to establish a robust distribution infrastructure for CNG, and the need for government policies and incentives to promote the use of CNG.

While CNG presents a number of benefits compared to PMS, there are challenges to its adoption making it an unlikely alternative to petrol in the short to medium term.

e. Does it cost Nigeria money to subsidise petrol given that the country produces crude oil?

Despite being a major producer of crude oil, it still costs Nigeria money to subsidise petrol. There is cost associated with crude oil production, as well as the opportunity cost of crude oil for local consumption. In addition, the process of refining crude is expensive, requiring significant investment in infrastructure, technology and expertise which would necessarily be imported.

Therefore, the argument that Nigeria, being an oil producing country should be able to sell PMS at the regulated price without incurring significant subsidy costs is not supported by evidence.

Long / medium term

Stronger Naira and decline in imported inflation

The massive importation of fuel increases the demand for foreign exchange. One of the medium to long term impacts of the subsidy removal is the reduction of fuel purportedly consumed in Nigeria as cheap, subsidised fuel will no longer be available for smuggling. This reduced volume will translate to a reduction in demand for foreign exchange which will lead to a stronger Naira. This will also reduce imported inflation and its pass-through effect, as the cost of importing petroleum products is a major contributor to inflation in Nigeria.

Investment flow to the downstream sector

Removal of subsidy will create an enabling environment for private sector investment in the downstream sector, leading to the development of local refineries and the creation of jobs. This will enhance the country's energy security and reduce dependence on imported petroleum products.

More profitable downstream players

Along with the increase in investment flow to the downstream sector, deregulation of the downstream sector will stimulate increased activities that will lead to more profitable downstream companies. This will result in improved tax revenue both from the companies, their employees, vendors and other players across the value chain.

Product availability

Removal of subsidy will incentivise private sector investment in the downstream sector, leading to increased local refining capacity and improved product availability.

Improved sovereign credit rating

Nigeria's sovereign credit rating has been adversely affected by its low revenue, high debt levels, rising deficit, and vulnerability to oil price shocks. Removal of the subsidy will increase government's revenue, reduce borrowing and the associated deficit, leading to an improvement in the country's sovereign credit rating and lower cost of borrowing.

Leverage on the AfCFTA to legally export refined products rather than crude oil to other African countries

The African Continental Free Trade Area (AfCFTA) agreement provides a platform for Nigeria to competitively export refined petroleum products to other African countries. With the removal of fuel subsidy, Nigeria can leverage the AfCFTA agreement to increase its exports of refined products, generating foreign exchange and enhancing economic growth.

Benefits of subsidy removal

We have examined the short to long term impact of the removal of fuel subsidy on the economy at large:

Short term

Reduces government borrowing and the associated huge deficit

Fuel subsidy has been a major source of government expenditure in Nigeria, with huge sums being spent annually to keep petrol prices artificially low. This has led to the government borrowing heavily to finance the subsidy, which in turn increases the country's deficit. By removing the subsidy, the government can reduce its borrowing and the associated huge deficit, freeing up resources for other important sectors.

Free resources for investment in other critical sectors

With the removal of fuel subsidy, the government can free up resources that would have been spent on the subsidy to invest in other critical sectors such as education, healthcare, security and infrastructure. This will not only improve the standard of living for citizens but also enhance economic growth.

Reduce/remove incentive for smuggling and associated security risk

Subsidy has created a huge incentive for smuggling of fuel to neighbouring countries where they can be sold at higher prices. This has resulted in security risks, as smuggling has also led to illegal refining, pipeline vandalism, and other criminal activities. By removing the subsidy, the incentive for smuggling will be reduced or eliminated, which will lead to a reduction in security risks associated with fuel smuggling.

Possible solutions to the fuel subsidy problem

Having considered the plethora of challenges that have bedevilled the downstream oil and gas sector, specifically the problem of fuel subsidy as it is being currently administered, we propose possible options as follows:

1. Fully deregulate the downstream sector and completely remove petrol subsidy
2. Remove petrol subsidy and provide credible, evidence-based palliatives
3. Redesign the subsidy regime and direct towards only the poorest

Option 1: Fully deregulate the downstream sector and completely remove fuel subsidy

The complete removal of fuel subsidy has been fraught with a lot of challenges ranging from opposition of Labour Unions and pressure groups, lack of political will, notions that cheap fuel is a right (Nigerian being an oil rich country), and the concerns that complete deregulation will generally make life unbearable for the masses. On the other hand, proponents of deregulation assert that deregulation will bring about competition which will result in increased efficiency, lower prices and production costs, and increased supplies.

While this may benefit the economy financially, the fallout might result in social unrest and protracted industrial actions which will hurt the economy. It is important that the government demonstrates care for its citizens while not neglecting the impact of fiscal and economic policies on the national economy.

This option, while being ideal and desirable, will be difficult to implement without significant resistance and economic trade off.

Option 2: Remove petrol subsidy and provide credible, evidence-based palliatives

The only fuel product under consideration is petrol, other fuel products such as diesel and kerosene are already deregulated. Therefore, this option requires the full removal of subsidy on petrol while focusing government palliative on the vulnerable population that will be most impacted by the subsidy removal.

Likely impact –

Removal of petrol subsidy will lead to an increase in the pump price and the direct impact will be felt by way of higher cost of transportation while the indirect impact may be seen in terms of increases in rent and prices of goods and services.

Most impacted population –

The poorest people that will be most impacted are the employed urban poor population, that is, those earning low wages and have to pay for transportation daily to get to work. This population should be the main target of government palliatives.

Recommended palliative –

It is not the poorest people in villages that will be most impacted as they normally have very limited touch point with petrol consumption (they move around by trekking or using bicycles to their farms, shops and market with only a very few owning motorcycles or vehicles). The recommended palliatives are:

1. Increase in minimum wage - this will ensure that there is support by workers and limit the resistance by the Labour Union
2. Increase in the monthly income threshold for PAYE exemption purposes - currently N30,000 per month is exempted from PAYE which can be increased to at least N50,000 per month. This will give extra cash to the employed poor on a monthly basis to cushion the impact of subsidy removal on them. Also, small business owners will benefit by way of higher tax exemption on their equivalent profits for direct assessment.
3. Government should guarantee the provision of fx to importers of diesel at the official exchange rate using the fx savings from the current fictitious petrol consumption that will be eliminated when subsidy is removed. This will bring the pump price of diesel down significantly and in turn moderate the inflationary impact of petrol price increase.

While the minimum wage increase and high tax exemption threshold will affect the revenue of states, the higher revenue to be shared from subsidy savings will more than compensate.

The additional benefit of this proposal is that it can be implemented within a short period of time at a manageable cost while protecting the most vulnerable population in a sustainable manner without being prone to corruption.

Option 3: Redesign the subsidy regime and direct towards only the poorest.

We have established earlier that a general subsidy regime for PMS is largely misdirected and unsustainable because the upper and middle classes typically consume more fuel than the poor. According to a World Bank report, "Nigeria is the only country in the world with a universal price subsidy that applies exclusively to PMS. Universal price subsidies for liquid fuels are almost always regressive, as the rich consume far more fuel than the poor. PMS subsidies are especially regressive because PMS is used primarily in light and medium-duty motor vehicles, which are rarely owned by the poor. Since raising PMS prices tends to have minimal adverse effects on poor households, governments worldwide have typically prioritised eliminating PMS subsidies over those that apply to other fuels. However, Nigeria has done the opposite - eliminating all subsidies for liquid fuels other than PMS."

How to subsidise only the deserving poor



According to the recently released multidimensional poverty report of the National Bureau of Statistics (NBS), Nigeria's poverty index was estimated to be at 0.257, with about 133 million people being multidimensionally poor. This category of individuals are not in a position to purchase vehicles or own generators that will run for several hours in the absence of power supply from the grid. The major touch point that they have with fuel consumption is indirectly through public transportation - and the majority of the vehicles that engage in public transportation run on AGO (diesel) which has already been deregulated.

Hence, it is important that fuel subsidies are targeted at the poorest people to cushion the impact of the associated rise in transportation cost of subsidy removal.

Step 1 - Identify vehicle owners who are eligible for petrol subsidy

A critical element of the plan to subsidise only the poor requires a process of identification and validation of owners of shared passenger transportation vehicles powered by petrol. These individuals will be registered in the usual way for driver/vehicle licences leveraging on the existing data such as National Identification Number (NIN) or Nigerian Communications Commission (NCC) phone/SIM registrations and linked to the vehicles they own using vehicle registration data. This registration will ensure that vehicle owners are captured in such a manner as to avoid duplications and prevent abuse.

Based on a 2018 report by the NBS, there are 11.8m vehicles registered in Nigeria out of which 39% (or 4.6 million) are privately owned while 56% (or 6.7 million) are commercial vehicles, 1.1% (or 135,216) are government owned while 0.4% (or 5,834) are registered for diplomats. According to the National Motorcycle and Tricycle Riders Association of Nigeria, there are about 8 million registered commercial motorcycles in Nigeria. There is also a sizable number of motorboats, but many of these are unregistered due to non-enforcement of Nigerian Inland Waterways Authority's (NIWA) registration requirement.

Step 2 - Nationwide survey to ascertain quantum of fuel consumption

A survey or test run will be conducted across all capital cities to determine average monthly fuel consumption by eligible transporters. The data for the capital cities will be used as proxies for the rest of the country given that the highest fuel consumption is expected to be in the cities.

Step 3 - Registration of eligible individuals and transporters

Having leveraged the data from banking information, tax authorities, lands registry, SIM registrations and the NIN, the database of qualifying individuals will be automatically onboarded on a secure platform which will serve as a national subsidy database.

Private taxis and those that work with hailing apps and vehicles that run on diesel will be excluded from this arrangement. Out of the about 8 million registered commercial vehicles, if the vehicles that run on diesel and those not usually patronised by the poor (ride hailing platforms) are excluded, this will be closer to targeting the individuals who really need fuel subsidy.

Step 4 - Use of technology to make fuel subsidy accessible to only those who need them

After identifying and registering eligible persons, special fuel cards (with similar features like prepaid cards or mobile phone airtime) will be used to administer the subsidy. This will be used only at fuel stations in a similar way as fuel or ATM cards.

Essentially, the cards will be used to offset the difference between the market based pump price and the subsidised PMS for the eligible transporters. This method will provide an audit trail which will be used for effective control and monitoring to prevent and detect abuse.

As an added advantage, the data provided through this registration process may be used subsequently to register the transporters for tax purposes. Government may choose to extend the fuel credit to SMEs who use petrol generators to power their businesses. In addition to the registration through NIN and NCC registration, eligible small businesses will be required to register with the CAC, at least as a business name, and also register with the tax authority in order to access this credit.

Step 5 - Subsidy accounting and funding

To further reduce the use of fossil fuels in the light of Nigeria's net zero commitments, this limited subsidy will be funded through levies to be imposed on petrol consumption by ineligible consumers, mostly the middle class and the rich.

Conclusion

The present practice of fuel subsidy is unsustainable and may lead to a debt crisis in the medium to long term. It is imperative that the government re-strategises its approach and focus on targeting the poorest of the poor, and those who have been identified as being in need of it. Targeted subsidy will reduce corruption, increase government savings and investment in infrastructure, and reduce poverty and hardship.

A wholesale removal of subsidy (option 1) may not be politically feasible and the possible disruption that may follow such a decision may hurt the economy more than the projected benefit from subsidy removal especially in the short term. We recommend either a full subsidy removal with targeted palliative (option 2) or a targeted subsidy scheme funded through a subsidy levy (option 3). Either option 2 or 3 is likely to elicit less opposition from the Labour Union and other key stakeholders that are historically opposed to subsidy removal.

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