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DISTRIBUTIONAL IMPACTS OF ENERGY SUBSIDY REFORM IN INDONESIA

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*This report investigates the potential macroeconomic, environmental and distributional impacts of gradually phasing out energy consumption subsidies in Indonesia. It underlines the importance of the redistribution schemes to the households to make the phase out progressive.*

*Action required: WPCID delegates are requested to provide comments and determine whether the paper can be endorsed for declassification once comments received are taken into account.*

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## **NOTE BY THE SECRETARIAT**

This report presents an analytical framework that assesses the macroeconomic, environmental and distributional consequences of subsidy reforms. The framework is applied to the case of Indonesia to study the consequences of a gradual phase out of all energy consumption subsidies between 2012 and 2020.

This report was prepared by Olivier Durand-Lasserve and Jean Chateau of the OECD secretariat, in collaboration with Rob Dellink of the OECD secretariat and Lorenza Campagnolo from FEEM. Preliminary results of the paper were presented at the WPCID meeting held in December 2013. The report has benefited from valuable comments on an earlier draft by Shardul Agrawala, Nils-Axel Braathen, Florian Egli, Florens Flues, Michael Förster, Nathalie Girouard, Florian Kitt, Ana Llana Nozal, Walid Oueslati, Mauro Pisu, Jehan Sauvage and Petar Vujanovic of the OECD Secretariat. François Chantret, Marie-Jeanne Gaffard and Zoey Verdun provided excellent editorial assistance.

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## Executive Summary

1. Phasing out subsidies on energy consumption is advocated for both economic efficiency and environmental performance improvements. Since energy subsidies directly or indirectly reduce the prices paid by consumers, they provide incentives to burn more fossil fuel, and consequently to emit more CO<sub>2</sub> (IEA, 2010 and 2011) and other air pollutants. To the extent that this reduction in the price of energy, relative to the prices of other commodities, alters the production structure and household decisions, it is a well-known source of economic efficiency loss (Burniaux and Chateau, 2011).

2. As a G20 member, Indonesia pledged in 2009 in the Pittsburgh declaration to “*Rationalize and phase out over the medium term inefficient fossil fuel subsidies that encourage wasteful consumption*” (G20, 2009). Historically, energy subsidies were introduced in Indonesia, as in a number of emerging economies, for distributional purposes, as an indirect way to provide financial support to the poorest households (IEA, OECD, OPEC & World Bank 2010). Energy subsidies support the poor both directly, by reducing their energy expenditures, and indirectly by lowering the energy costs of firms, thereby reducing retail prices and increasing the purchasing power of households. In practice, such subsidies have frequently proven to be a blunt instrument for redistributing wealth and reducing inequalities. The main reason is that energy subsidies cannot specifically target the poorest households: the subsidies are largely directed at energy sources that poor households either do not consume (e.g., gasoline), or do not have access to (e.g., electricity).

3. This report develops an analytical framework that assesses the macroeconomic, environmental and distributional consequences of energy subsidy reforms. The framework is applied to the case of Indonesia to study the consequences in this country of a gradual phase out of all energy consumption subsidies between 2012 and 2020. The energy subsidy estimates used as inputs to this modelling analysis are those calculated by the International Energy Agency, using a synthetic indicator known as “price gaps”. The analysis relies on simulations made with an extended version of the OECD’s ENV-Linkages model, a global dynamic Computable General Equilibrium (CGE) model. This model describes the interactions between economic activities across sectors and regions, with an emphasis on energy-related economic activities. The model also incorporates the links between economic activity and Greenhouse-Gas (GHG) emissions. To conduct the distributional analysis, the ENV-Linkages model was enhanced with a specific module for assessing the consequences of policy shocks for different household groups. In order to capture important feedback effects of the policy reform on the behaviour of households, special attention was paid to the demand response effect for specific household groups, which in turn affects the macro economy. The model includes more than 10,000 Indonesian household groups, each group having its own preferences and owning a fraction of the national income. The baseline consumption level and income patterns of each household group are based on the IFLS4<sup>1</sup> household budget survey data.

4. The examination of budget survey data provides an initial assessment of the distributional performance of the current Indonesian subsidy schemes. In absolute terms, middle and high income households receive a proportionally larger amount of subsidies than low income households. However, the subsidies still benefit poorer households more than proportionately, as they are more evenly distributed than incomes. Consequently, according to our analysis, a phasing out of energy subsidies, without any income redistribution scheme targeting low income households, is bound to be detrimental to low income households.

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<sup>1</sup> The fourth edition of the “Indonesia Family Life Survey” realised in 2007 (Strauss et al., 2009).

5. The phasing out of energy consumption subsidies was simulated under three stylised redistribution schemes: direct payment on a per household basis, support to labour incomes, and subsidies on food products. In practice, other uses of the avoided subsidy payments may also be considered, not least the reduction of government deficits or the expansion of public services, such as education and health care. Unfortunately, this wider set of compensating policy reforms could not be simulated in the model, which focuses purely on redistribution schemes that directly affect the incomes and expenditures of households, excluding in-kind social transfers.

6. The modelling results in this report indicate that if Indonesia were to remove its fossil fuel and electricity consumption subsidies, it would record real GDP gains of 0.4% to 0.7% in 2020, according to the redistribution scheme envisaged. The redistribution through direct payment on a per household basis performs best in terms of GDP gains. The aggregate gains for consumers in terms of welfare are higher, ranging from 0.8% to 1.6% in 2020. This is due to significant improvements in terms of trade, in particular in the scenario where the phasing out of energy consumption subsidies is multilateral.

7. Both GDP and welfare gains arise from a more efficient allocation of resources across sectors resulting from phasing out energy subsidies. Meanwhile, a redistribution scheme through food subsidies tends to create other inefficiencies, which partially offset the macroeconomic benefits of phasing out energy consumption subsidies. When households are compensated with cash transfers or payments proportional to labour incomes, the positive impact on aggregate welfare and GDP is reinforced by increased savings and capital accumulation, whereas food subsidies tend to be detrimental to savings and capital accumulation.

8. Household heterogeneity also matters to explain the differences in macroeconomic impacts between the various scenarios. In particular, compared to the labour support schemes, the cash transfer scheme reallocates income to populations with higher saving rates, thereby ultimately creating more savings and GDP growth.

9. The main reason why the phasing out of those subsidies is detrimental to poor households is through the effects of the reform on final consumer prices, i.e. the changes on the expenditure side matter more for households than the changes on the income side. However, the simulations also show that the redistribution scheme ultimately matters in determining the overall distributional performance of the reform. Cash transfers, and to a lesser extent food subsidies, can make the reform more attractive for poorer households and reduce poverty. Mechanisms that compensate households via payments proportional to labour income are, on the contrary, more beneficial to higher income households and increase poverty. This is because households with informal labour earnings, which are not eligible for these payments, are more represented among the poor.

10. The analysis also shows that phasing out energy subsidies is projected to reduce Indonesian CO<sub>2</sub> emissions from fuel combustion by 10.8% to 12.6% and GHG emissions by 7.9% to 8.3%, in 2020 in the various scenarios, with respect to the baseline. These emission reductions exclude emissions from deforestation, which are large but highly uncertain and for which the model cannot make reliable projections. The IEA estimates that in 2010, CO<sub>2</sub> from forest fires were about 60% of total GHG emissions. Hence, the emission reductions achieved by the energy subsidy phase out are substantially lower when including deforestation emissions.

11. While they are not quantified here, other environmental co-benefits or co-costs associated with phasing out energy subsidies could also be expected, such as improvements in air quality or increase in traditional biomass burning.

12. Some additional simulations show that the price-responsiveness of demand, one of the key uncertain parameters in the model, has a strong effect on the emissions reductions achieved by the phase out reforms, but little influence on their macroeconomic and distributional consequences.

## 1. Introduction

13. In many emerging countries, governments subsidise fossil fuel consumption to keep domestic prices low so as to make energy more affordable for consumers and firms.<sup>2</sup> According to the International Energy Agency (IEA)'s measurement and definitions (see box 1), in 2012 worldwide fossil fuel consumption subsidies totalled USD 544 billion, including USD 135 billion for electricity (IEA, 2013).<sup>3</sup> The consumption subsidies are large in some non-OECD countries. In some cases, they represent a substantial share of a government's budget.

14. For years the OECD, but also the IMF and the World Bank, have recommended that governments "*rationalize and phase out over the medium term inefficient fossil fuel subsidies that encourage wasteful consumption*" (G20, 2009). The reason is that they can induce wasteful energy consumption, be a source of economic inefficiency, and contribute to greenhouse gas (GHG) emissions. They also often fail to tailor to the most vulnerable parts of the population since they massively leak to well-off household categories.

15. In several oil-importing countries, the incentive to reform energy subsidy policies has increased in recent years, due to the surge in international energy prices and a fast increase in domestic energy demand. As a result there was an increased pressure on current accounts and government budgets.

16. Even though the idea of reducing energy subsidies gains traction, the reforms are still difficult to implement from a political perspective. This is not surprising since consumption subsidies are often the main instrument to redistribute wealth, in the absence of social security schemes, and they are a crucial support for some categories of households, especially among the poorest whose consumption is close to the minimum level for subsistence. But redistribution schemes which reallocate the budget that is not spent on energy subsidies can play a crucial role to make subsidy reforms acceptable and equitable (World Bank 2014). Examples of redistribution schemes could include cash transfers to households, tax cuts on non-energy products expenditures, or improved public services. Unfortunately, not all compensating policy reforms could be simulated in the model, which focuses purely on redistribution schemes that directly affect the income and expenditures of private households.

17. Identifying which household groups win or lose from a fossil-fuel subsidies phase out is at the heart of the political acceptance of such a reform. Consequently, the analysis of macroeconomic and environmental impacts is insufficient when considering energy subsidy reforms. Such analysis should be complemented by a deeper look at the distributional consequences and the possibilities for designing compensatory measures to alleviate negative outcomes in terms of inequality and poverty.

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<sup>2</sup> Meanwhile, many developed countries partly subsidise fossil fuel consumption, not directly by lowering final prices, but through tax concessions to consumers (OECD, 2013)

<sup>3</sup> Note that in this report, the terms fossil fuel consumption subsidies and energy consumption subsidies are used interchangeably. They embody all actions of governments to lower the final price of coal, oil, gas or fossil-fuel based electricity for both households and firms.



18. The ability of policy to reduce inequalities will be characterized throughout the report by its progressivity. A policy is progressive if its net benefit as a proportion of wealth decreases with wealth<sup>4</sup>. When considering income groups, progressivity is associated with higher benefits, as share of income, for lower than for higher quantiles. Progressivity is also associated with a lower dispersion of wealth across the population after the policy reform is conducted.

19. Indonesia is an interesting case study for investigating energy consumption subsidy reform. Firstly, Indonesia subsidises the consumption of electricity and oil products for both households and firms. It has kept its large energy subsidies inherited from its previous role as an important oil producer, while it has now become an oil-importing country. Secondly, for years subsidy reforms have featured prominently in Indonesian political discussions, and even more so in a context of high oil prices, which increases pressure on the government's budget and reinforces the incentive for a reform. Thirdly, the subsidy reform could help Indonesia to fulfil its commitment made in the 2009 Copenhagen Accord and 2010 Cancún Agreement to reduce its GHG emissions by 26%, with respect to a baseline scenario (and by 41% below baseline with sufficient international support). Fourthly, Indonesia was chosen because of the availability of public household budget survey data.

#### **Box.1 Fossil fuel consumption subsidy : definition and measurement**

The IEA (1999) has defined energy subsidies as “any government action that concerns primarily the energy sector and that lowers the cost of energy production, raises the price received by energy producers or lowers the price paid by energy consumers.” Fossil-fuel consumer subsidies are actions of the government that lower the price of fossil-fuel-based energy paid by firms and households. Fossil-fuel-based energy sources include coal, oil and natural gas. It also includes electricity if it is produced from fossil fuels.

The IEA estimates fossil fuel subsidies using a price-gap approach, which compares end-user consumer prices with reference prices corresponding to the full cost of supply or, where available, the international market price, adjusted for the costs of transportation and distribution. This approach captures all subsidies that reduce consumer prices below those that would prevail in a competitive market. Such subsidies can take the form of direct financial interventions by government, such as grants, tax rebates or deductions and soft loans, and indirect interventions, such as price ceilings and free provision of energy infrastructure and services.

Simple as the approach may be conceptually, in practice calculating the size of subsidies requires a considerable effort in compiling price data for different fuels and consumer categories as well as computing reference prices. For traded forms of energy, such as refined petroleum products, the reference price corresponds to the export or import border price (depending on whether the country is an exporter or importer) plus internal distribution margins. For non-traded energy products, such as electricity, the reference price is the estimated long-run marginal cost of supply. Value-added Tax (VAT) is added to the reference price where the tax is levied on final energy sales. However, other taxes, including excise duties, are not included in the reference price. So, even if the pre-tax pump price of gasoline in a given country is set by the government below the reference level, there would be no net subsidy if an excise duty is levied that is large enough to make up the difference. The aggregated results are based on net subsidies only for each country, fuel and sector. Cases where the final price exceeds the reference price were not taken into account. In practice, part of the subsidy in one sector, or for one fuel, might be offset by net taxes in another. Subsidies were calculated only for end-user consumption, to avoid the risk of double counting: any subsidies on fuels used in power generation would normally be reflected at least partly in the final price of electricity. All the calculations for each country were carried out using local prices, and the results were converted to US dollars at market exchange rates.

Source : based on IEA (1999, 2006) and Burniaux and Chateau (2011)

<sup>4</sup> In general, income or expenditures are used as a measure of wealth.

20. This report, based on a simulation approach, proposes an analysis of the distributional impact of energy subsidy phase out policies in Indonesia under various redistribution schemes. The aim of the report remains to help to understand the essential driving forces that determine the answer to the two following questions: What type of redistribution schemes can make the phasing out of such subsidies pro-poor and progressive?; and What are the trade-offs between the macroeconomic and environmental impacts of the reform and its distributional consequences? Such a perspective will allow us to draw conclusions that can extend, beyond the Indonesia case, to energy subsidy reforms in other countries.

21. To assess welfare impacts for each household group and to conduct distributional analysis, an augmented version of the ENV-linkages Model - the OECD multi-region, multi-sector and multi-period CGE model - has been elaborated. In the standard version of ENV-Linkages, regional economies feature a single representative household portrayed by a single demand system and earning the whole regional income (see Chateau et al., 2014a). This standard model can therefore only evaluate welfare impacts of policies at the country level. In the augmented version of the model, the representative Indonesian household is replaced by multiple household groups, each having its own income, expenditures and preferences. The improvement of the model for this study has been set up in such a way that multiple households can in principle also be characterized for other regions. This is possible once household survey data are collected and a procedure is available to reconcile this data with the national accounting data of the model.

22. In this modelling framework, the Indonesian household groups are influenced by the changes in both consumer prices and incomes induced by the phasing out of energy subsidies. The reforms directly affect the energy prices and indirectly the prices of other goods. These indirect price effects come from the increase in energy costs faced by firms. However, the reform also affects the disposable income of households. Firstly by changing wage and non-wage incomes, itself the result of changes in firm behaviour following the reform, and secondly by changing transfers and income taxation as part of the compensatory mechanism. To the extent that these changes in prices and incomes are different across households, the reform is expected to have distributional consequences.

23. The impacts of the phase out policies on different household groups depend on their characteristics, in particular on their expenditure structures, their sources of incomes and their ability to adjust their demand to changes in incomes and prices. For instance, the higher the budget share for energy products and the lower the reaction of energy demand to price is, the more a household may suffer from the effect of the phase out, unless their income is sufficiently raised by compensatory measures.

24. It is important to realise that the model used is stylised. Firstly, while substantial efforts have been made to produce a dataset that reflects the income and expenditure information available in the household budget survey, some extrapolations were necessary. Secondly, there is uncertainty about the behaviour of the households and consequently on the projected adjustments of their consumption patterns to price changes. Nonetheless, the modelling improvements overcome the major barrier to a fully integrated analysis, i.e. the specification of differentiated endogenous responses of households to policy shocks. This integrated approach is superior to the more limited ex-post analysis of distributional effects that is often carried out with microsimulation models.

25. This report is organised as follows. Section 2 puts forward the role of the energy subsidy system in Indonesia and the possible consequences of its reform. The methodology used for simulating energy subsidy reforms is presented in Section 3. The household data set constructed for the simulation analysis is described in Section 4. Then, Section 5 presents the phasing out policies that are simulated. The results of the policy simulations are presented in Section 6 and analysed in terms of economic, environmental and distributional performances. Section 7 concludes. Additional technical material is provided in the various appendices of this report.

## 2. OVERVIEW OF THE ENERGY CONSUMPTION SUBSIDIES IN INDONESIA

26. The Indonesian government subsidises the consumption of electricity and oil products for both households and firms. These subsidies, as measured using the price gap approach (see Box 1) are large given that the country is a net energy importer. In 2011, Indonesia was ranked the 10th country in the world in terms of total government expenditures on fossil fuel consumption subsidies (see Figure 1) following mostly big energy exporters (e.g. Iran, Saudi Arabia, Russia, Iraq, UEA and Venezuela) and larger economies (e.g. China and India). Figure 2 shows that Indonesia, was ranked 18<sup>th</sup> for the share of energy subsidies in terms of gross domestic product (2.5%). The only oil-importing countries with a higher share were Egypt, Ukraine, Pakistan and Bangladesh. However, in Indonesia the subsidies per capita, amounting to USD 88, were higher than in Bangladesh and Pakistan.

27. Energy subsidies absorb a considerable amount of budget resources. In recent years spending on subsidies became very high. For example, in 2011, energy subsidies rose to 29% of the Central government's expenditures (Dartanto, 2013). Furthermore, spending on energy subsidies was, in 2012, slightly higher than the government's investment in infrastructure (Diop, 2014). Finally, until 2010, the Indonesian government spent more on energy subsidies than on defence, education, health, and social security combined (Cheon et al., 2013).

28. Indonesia's trade and financial situation is very sensitive to changes in international oil prices and domestic energy demand. Recently, a combination of increasing oil prices and the stabilization of raw material prices, which traditionally represent a large share of Indonesian export, gave way to a significant worsening of the country's trade position. This situation led to a current account deficit in 2012, after almost 15 years of surplus, and to a small depreciation of the Rupiah.<sup>5</sup>

29. The energy subsidies, which are a burden and a source of unpredictability for the economy, also perform badly in terms of redistribution. Given that commercial energy consumption increases with income, the subsidies benefit wealthier households more (Mourougane, 2010). According to IEA (2012), in 2010 27% of Indonesians did not have access to electricity<sup>6</sup>, mostly in rural areas (IEA, 2012). Agustina et al. (2008) mention a World Bank calculation which estimated that in 2007, 70% of fuel subsidies were received by the wealthiest 40% of households.

30. Fuel subsidies, by encouraging fossil-fuel burning, increase GHG emissions, as well as local air pollution. However, it is important to note that in Indonesia, energy related CO<sub>2</sub> emissions have a rather limited but increasing contribution to overall GHG emissions. In 2010, they represented about 20% of total GHG emissions while the contribution of CO<sub>2</sub> from tropical forest was around 61%. Energy related emissions of CO<sub>2</sub> from fuel combustion have increased rapidly over the recent period (4.1% annual growth rate from 2005 to 2010). Appendix A provides more detailed information on the links between energy consumption and GHG emissions.

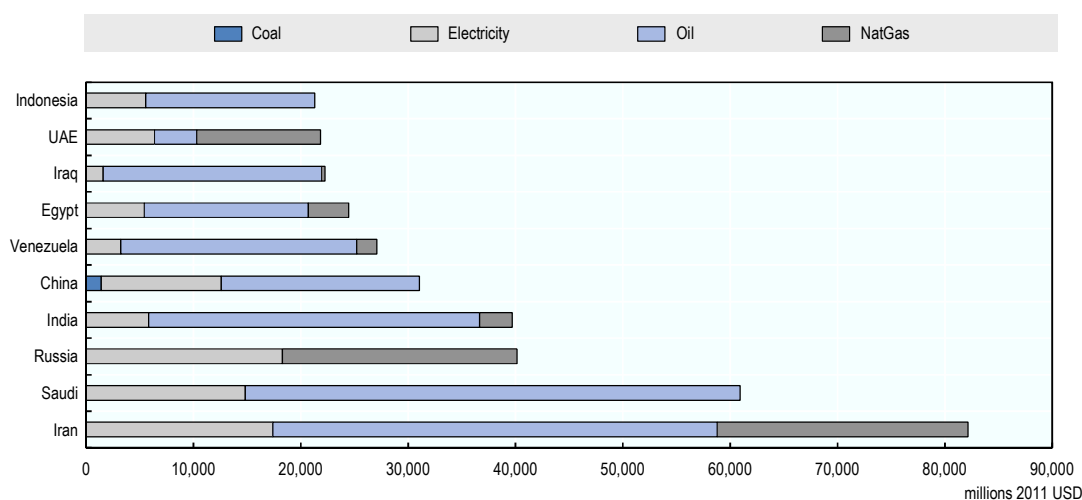
31. There has been a large increase in the CO<sub>2</sub> emissions from the power generation and transportation sectors (7% and 7.6%, respectively, in annual growth rate from 2005-2011). Driven by an expanding demand from households and industries, power generation has increased at a quick pace, while still relying largely on oil and coal technologies. Fuel consumption for transportation has also increased

<sup>5</sup> IMF World Economic Outlook data base, April 2014.

<sup>6</sup> See <http://www.worldenergyoutlook.org/resources/energydevelopment/definingandmodellenergyaccess/> for the IEA definition of access to electricity

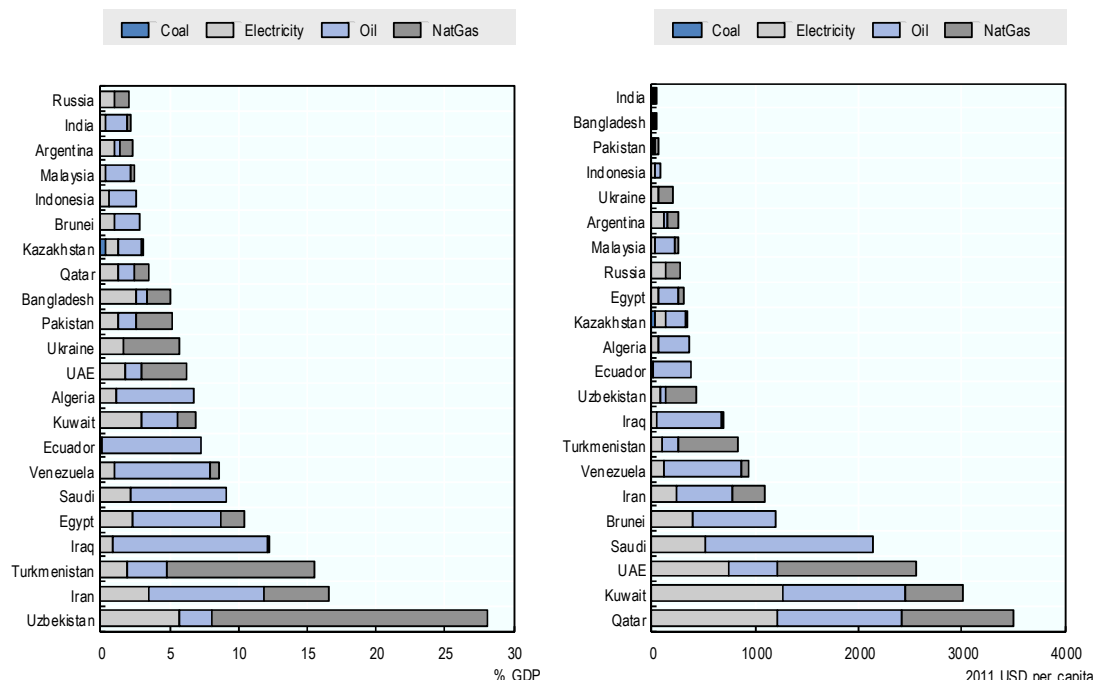
considerably (at 7.7% annual growth rate from 2005-2011), with a large contribution from trucks and buses.

**Figure 1. Top 10 countries for energy consumption subsidies in 2011**



Source: IEA (2012)

**Figure 2. Energy consumption subsidies per capita and as share of GDP in 2011 in selected countries**



Source: IEA (2012)

32. In 2011, traditional biomass still represented almost 74% of final energy use in the residential and service sectors due to the high reliance on this fuel type by households. There is thus a concern that a

reform of energy consumption subsidies might increase deforestation due to the substitution to wood from kerosene whose price would increase. Even if some (relatively old) empirical studies discard this effect (Dick, 1980; Pitt, 1983), its potential negative impact on overall GHG emissions should not be ignored even if they are beyond the scope of this paper.

### **Box 2 Fossil fuel subsidy reforms in Indonesia**

Since the late 1990s, there have been substantial efforts in Indonesia to reduce energy consumption subsidies. Since the early 2000s, the fossil fuel subsidy mechanism has been progressively reformed. In 2001, fuel prices for industrial users were anchored to 50% of international prices (Dartanto, 2013). In 2004-2005, as a result of an increase in international prices there was a rise in fossil fuel subsidy expenditure (Dartanto, 2013; Mourougane, 2010).

In 2005, energy consumption subsidies were partially cut and energy prices for households and small businesses were very strongly increased (Dartanto, 2013; Mourougane, 2010). On the one hand, the higher consumer prices introduced in 2005 lifted temporarily the pressure on public finances. But on the other hand, the fact that the price setting mechanism was made independent of market price made the arrangement unsustainable in the context of surging international oil prices; and consequently successive readjustments were needed.

To limit the impact of the 2005 reform on the poorest households, the Bantuan Langsung Tunai (BLT) unconditional cash transfer programme was introduced (Mourougane, 2010; Miranti et al., 2013). This programme, working through the postal system, concerned more than 19 million households who received a monthly a payment equivalent to USD 10 during 12 months in 2005-2006.\*

In 2008, electricity subsidies ceased for large industrial consumers and for households beyond a certain consumption threshold (Mourougane, 2010) in order to limit the pressure on public finances. During the same year, the Gasoline, Diesel and LPG prices were increased. As a compensation for households, a new wave of BLT was run over 9 months in 2008-2009. In addition, some existing anti-poverty programmes mechanisms were reinforced, including distribution of rice and control on rice prices, education and school support and to small businesses. In 2010, the average electricity price increased for most consumers, including households (IISD, 2012). In 2012, there was an attempt to prohibit government and four-wheeled vehicles from using subsidized gasoline. However, the attempt was abandoned due to strong public opposition. In the end, only government vehicles were excluded from the subsidies (IISD, 2012).

In 2013, there was a revision of the budget of the Indonesian government; it introduced repeated cuts in fossil fuel subsidies, increasing diesel and gasoline prices by 22% and 44%, respectively (IEA, 2013). However, even with such an increase, fuel prices still remain largely subsidized in Indonesia and the pressure on public finances and current account remains high.

*Note: \* Statistics about the BLT programme can be found on the ILO website:*

[http://www.ilo.org/dyn/illossi/ssimain.viewScheme?p\\_lang=en&p\\_geoaid=360&p\\_scheme\\_id=3162](http://www.ilo.org/dyn/illossi/ssimain.viewScheme?p_lang=en&p_geoaid=360&p_scheme_id=3162)

33. There have been several quantitative assessments of the macroeconomic, environmental and distributional impacts of a phase out of energy subsidies in Indonesia and selected references are presented in Table 1. Nevertheless, to our knowledge there has not been any study taking into account the three impacts simultaneously, or considering the reforms in a multi-period setting.

34. The results of the various studies are not fully comparable, as they correspond to different base years, energy subsidy reforms and modelling approaches. The studies do not agree whether the impact on GDP is positive or negative, but the effect can be substantial: the ranging is from +3.7% to -2.4%. The assessments simply based on a Social Accounting Matrix (SAM), which is essentially an Input Output (IO) approach, give negative effects on GDP, primarily because these models are not suited to account for the redistribution of the government budget that is no longer spent on subsidizing energy.<sup>7</sup> The CGE

<sup>7</sup> Furthermore, in the SAM approach, the households' expenditures are constant and the proportions of inputs used in the various production sectors are fixed. A drop in subsidies involves a negative shock a decrease in households demand and a contraction of output and GDP. In the CGE models, it is possible to operate

approaches, (Magné *et al.*, 2014, Yusuf *et al.*, 2010), on the other hand give positive impacts, as the termination of subsidies leads to a reallocation of inputs, consumption and government budget that increases economic efficiency (reducing the deadweight losses due to the subsidies). When assessed, the impacts on CO<sub>2</sub> emissions are quite substantial ranging from -17.0% in (Magné *et al.*, 2014), to -6.7% in Yusuf *et al.* (2010).

**Table 1. Selected assessments of the impact of energy demand subsidy reforms in Indonesia**

Authors and method	Type of reform	Macroeconomic impact*	Impact on CO <sub>2</sub> from fuel combustion*	Distributional impact*
IEA (1999): Partial equilibrium model (feedback on GDP)	Phase out of all energy consumption subsidies (with 1995 as a base year)	GDP increases by 2.4%**	-10.97% in 2020	n/a
World Bank (2006): Household micro data	October 2005 package (fuel price adjustment and cash transfers)	n/a	n/a	Progressive largely through gasoline expenditures effects; progressivity improved by the cash transfers
Clements <i>et al.</i> (2007): SAM complemented with information on household group,	25% of final consumer price increase	Real output reduction of 1.6% on the short run no reduction on the longer run	n/a	Poverty increase but limited on the short run. And even more limited on the longer run. The urban households are more affected. The poverty
Yusuf and Resosudarmo (2008): SAM + information on many household groups	October 2005 package but with alternative recycling schemes	GDP decreases from 1.72% to 2.42%	n/a	Progressive and more detrimental to urban high-income households. Poverty effect can be offset by recycling schemes e.g. by cash transfers
Yusuf <i>et al.</i> (2010) CGE model	Phasing out of energy subsidies	GDP increases by 0.43%	-6.7%	n/a
World Bank (2011) Descriptive statistics based on survey	n/a	n/a	n/a	Richer households receive more energy subsidies (in absolute terms) than poorer households, especially for gasoline subsidies.
Widodo <i>et al.</i> (2012): SAM model	Removal of fuel subsidies by IDR 1 billion	GDP decrease by IDR 88 million but support to some sectors of the economy can mitigate this effect	n/a	Rural households less affected. Recycling schemes that supports agriculture protect rural household through income and lower-class urban households through expenditures.
Dartanto (2013) CGE model combined in top down fashion with survey data	25% to 100% removal of fuel subsidies with alternative recycling schemes	n/a	n/a	25% removal of fuel subsidies increases poverty by 0.26 percentage points. But recycling with government development spending reduces poverty even if they are 50% less important than the subsidy removal.
Magné <i>et al.</i> , (2014)	Multilateral phase out of all energy demand subsidies (gradual, achieved in 2020)	GDP increases by 3.7% in 2035	-17% in 2035	n/a
* w.r.t. baseline				
** 10 years after the reform, based on the result of the IEA (1999) that estimates to 0.24% the annual additional GDP growth rate.				

Source: Authors' review, inspired by Mourougane (2010)

35. The studies in Table 1 are generally in line in terms of their evaluation of distributional impacts. The direct effect of the subsidies phase-out reform, due to the increase in final consumer prices, will benefit more proportionally to low and middle income households. This progressivity is largely due to the decrease of subsidies on gasoline (World Bank, 2006, 2011). In the SAM-based models, mainly because of the negative effects on GDP, the reform increases poverty. In addition, the reform affects the urban more

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substitutions between inputs and the subsidy reform can give way to a more efficient reallocation of the production factor which can be beneficial GDP and households' welfare.

than the rural poor (Clements et al., 2007; Yusuf and Resosudarmo, 2008; Widodo et al., 2012). However, it also appears, from the various studies that redistribution schemes, for instance with cash transfers or subsidies on food products, can be efficient in alleviating poverty. For Dartanto (2013), investing in infrastructure and introducing cash transfers can contribute, using only 50% of the government's expenditures saved via the subsidy reform, to a significant reduction in poverty. It shows that the subsidy reform can both reduce poverty and consolidate the government's budget.

### 3. The modelling approach

36. The modelling approach developed for this report is designed to assess the impacts of phasing out the energy consumption subsidies on the welfare of households through their income and expenditure.

37. Because households are different, both in terms of their income structures and their expenditures pattern, they will be affected differently by the reform. At first sight, households that spend a relatively large fraction of their income on energy will be, *ceteris paribus*, more penalized by the subsidy phase out because of the direct effect of higher energy prices. However, it is not straightforward to assess the total effect for these households, as all the indirect effects through changes in commodity prices and income have to be taken into account.

38. The "expenditure effect" is primarily due to the change in final consumption prices of the energy goods, consecutive to the subsidies phasing out reform. But other commodity prices, in particular those of energy intensive goods, are also influenced, to the extent the reform will modify energy cost faced by the firms. In turn, as consumers shift away from energy and energy-intensive goods, demands for other commodities are affected as well. In addition, the reform will lead to various adjustments throughout the economy, causing prices to change. For instance, final fuel prices will not only be influenced by the changes in the subsidies, but also as a result of a new equilibrium between supply and demand. Last, in a budget neutral setting, prices may be affected by a decrease in taxes and an increase of subsidies on specific goods. The magnitude of these tax and subsidy changes depends on the budget resources that were made available by the initial phasing out of energy subsidies.

39. Households will also be impacted through changes in their earnings, as the subsidy reduction may impact the rate of return on labour, land or capital.<sup>8</sup> The relationship depends on the structure of production, including the degree of substitutability between energy and other inputs, and on the ability of households to change their sources of income. In a budget-neutral setting the phasing out of the subsidies may also include additional transfers or changes in income tax, which further alter the disposable income of certain categories of households.

40. To capture how the policies affect the sources of income of the various household groups and the affordability of the various goods they consume, it is necessary to combine a micro-level representation of households' incomes and consumption with a macroeconomic model that translates policy shocks into changes in final prices, and remuneration rates of production factors, taxes and subsidy rates. A

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<sup>8</sup> The main reason is that the phasing out policy will decrease the quantity of energy used as input in the production sectors. It will change, in turn, the marginal productivity of the production factors, such as labour, capital and land, which are combined with energy in the production activities. Finally, the remuneration rate of the production factors, which is equal to their marginal productivity, is impacted by the policy reform.

simultaneous representation of the effects described above can only be obtained by fully integrating multiple households into a detailed multi-sectoral model ([ENV/EPOC/WPCID\(2013\)20](#)).

41. The macroeconomic model used in this paper is the OECD ENV-Linkages model (Chateau et al., 2014a). ENV-Linkages is a dynamic global and multi-sectoral computable general equilibrium (CGE) model, which focuses on the linkages between different sectors in different economies and is especially suited to assess the direct and indirect effects of policy shocks. For this study ENV-Linkages has been improved by directly integrating a module describing the behaviour of more than 10,000 representative household groups for Indonesia. In other regions, the final consumers are portrayed by a single representative household.

42. The characteristics of the representative household in terms of preferences and endowments are based on national accounting data. The characteristics of the multiple households groups for Indonesia are based on integrating this macroeconomic information from the social accounting matrices with the fourth edition of the “Indonesia Family Life Survey” (IFLS4) realised in 2007 (Strauss et al., 2009).<sup>9</sup>

43. The household-level information from the survey data and the social accounting matrices from the model were reconciled to specify the parameters of the household module for Indonesia, ensuring that the sum of incomes and expenditures across the various household groups are consistent with country-level totals that are used in ENV-Linkages. Details about the reconciliation procedure are given in Appendix B.

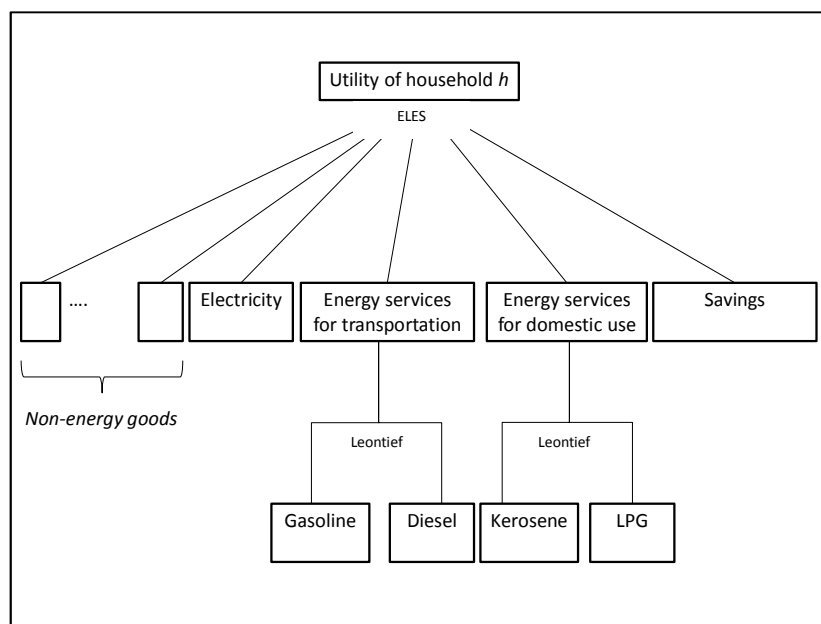
44. For consistency, the household-specific demand systems are based on the preferences of the single households used in the standard version of the model. They are based on the same form of extended linear expenditure system (Chateau et al., 2014a) that represents demand for the various goods and services. The household-specific demand functions are calibrated using the survey data and the aggregate elasticity values of the CGE model that describe how consumers respond to changes in income or relative prices (see Appendix C for more details).

45. The structure of the individual Indonesian households’ demand function is represented in Figure 3. In the standard version of the ENV-Linkages model, the representative Indonesian household consumes a single non-electric fuel aggregate. However, in the extended version of the model, taking advantage of additional information on fuel use provided in the survey, each household group can consume four types of non-electric energy goods: kerosene, liquefied petroleum gas (LPG), gasoline and diesel. Moreover, energy demands are aggregated into two categories: the first one represents energy use for transportation and the second one energy services for domestic use (lighting and cooking). The first aggregate combines gasoline and diesel; the second aggregate combines kerosene and LPG. The proportion of fuels within these aggregates are household-specific and calibrated on the reconciled survey data.

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<sup>9</sup> This survey which covers to 83% of the Indonesian population is representative at the national level. But it is not representative at the provincial level as some provinces are not covered (Strauss et al., 2009).



**Figure 3. Structure of Indonesian household group's level utility function**

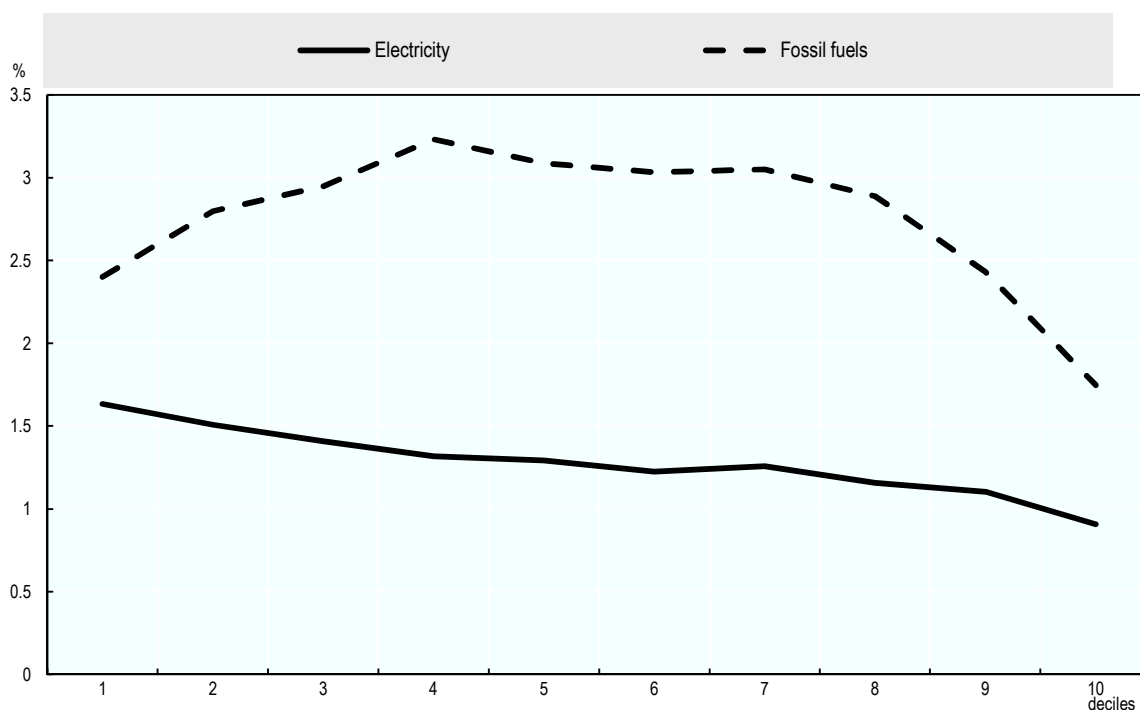
46. The households earn incomes from the remuneration of production factors they own. The endowments of labour, land and natural resources of each household group are assumed to be fixed, but the endowments in capital are endogenously determined as a result of households' savings decisions. The households also receive income from the government through transfers.

47. The direct integration of the full set of Indonesian households within the mathematical formulation of the ENV-Linkages model is impossible because the high number of equations representing individual households exceeds the capacity of the modelling framework. For this reason, based on the decomposition algorithm of Rutherford et al. (2006), the CGE and the household-level models have been formulated separately and adjusted iteratively until convergence (see Appendix D). This key advantage of this approach is that the model can endogenously represent the behaviour of many household groups, taking into account not only the effect of the macroeconomic reactions on individual households' income and expenditures, but also the feedback effect of their differentiated response on the macro economy. Such feedback effects are potentially significant, and missing in more traditional models that perform the distributional analysis ex-post through a stand-alone microsimulation model.

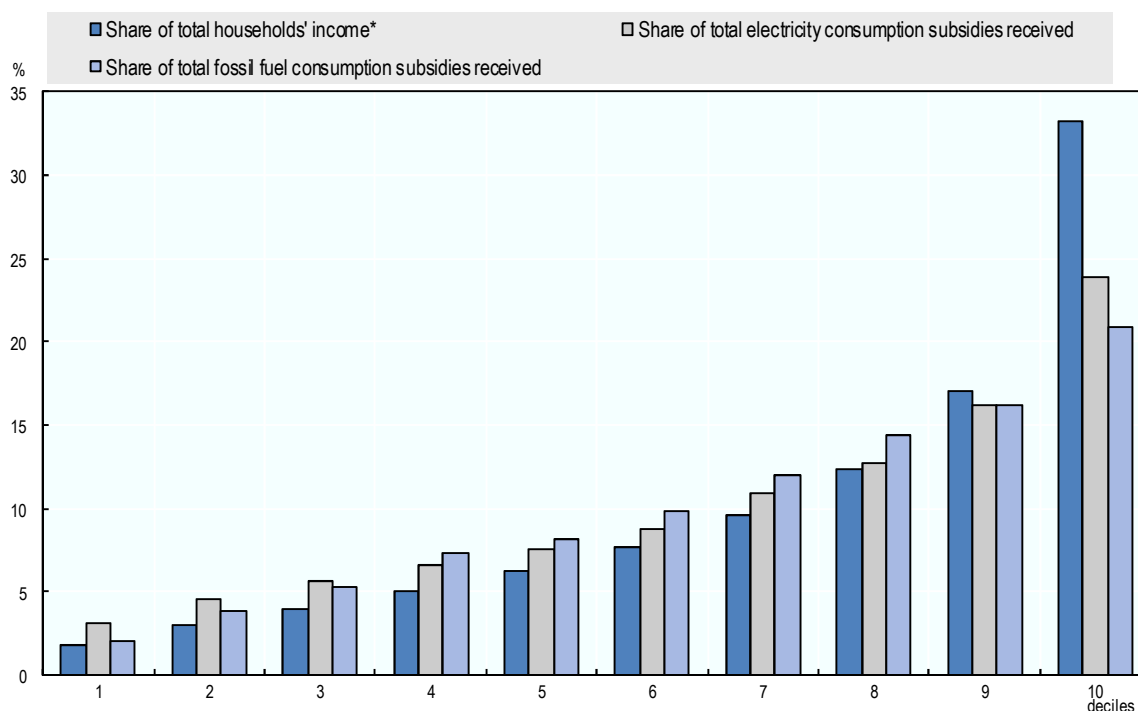
#### 4. Overview of the Reconciled Household survey data

48. It is important to present the reconciled household data that are used as inputs in the model. Firstly, because this data set is a construction, elaborated from different sources, sufficient information must be provided to make comparisons possible with other data. Secondly, by considering the budget shares of energy in total consumption by household quantiles, it will be possible to evaluate whether, based on these data, the current subsidy scheme is progressive or regressive. Thirdly, a presentation of these data will help to understand which element of the household heterogeneity drives the distributional impact in the various scenarios.

**Figure 4. Shares of energy in total expenditures by income decile group**



Source: Authors' calculations based on IFLS4 and ENV-Linkages

**Figure 5. Share of each income decile in total energy subsidies received and in total income**

Note: \* e.g. the incomes of the 10th decile households represent 33% of the total incomes of all the Indonesian households.

Source: Authors' calculations based on IFLS4 and ENV-Linkages

49. The reconciled household data are a key input for simulating the distributional impacts of the phasing out of the fossil-fuel consumption subsidies. In particular, the budget shares of energy consumption drive the effects on the household groups through expenditures. Three points need to be underlined concerning the reconciled household data.

50. First, the households who provided no information on any income or expenditure category or on housing (19% of the respondents) were dropped during the processing of the survey data<sup>10</sup>. If the poor households with no commercial energy consumption were overrepresented in these categories, the budget shares of energy for the poor might have been overestimated.

51. Secondly, the imputation of the IFLS4 survey data into social accounting categories can miss some important information. For instance, it was not possible to properly identify in IFLS4 data which households had access to electricity and whether electricity consumption corresponded to the payment of subsidized energy. Consequently, the simulations might overestimate the impact of an energy subsidy phase out, particularly for the rural poor households, which have often no access to electricity.

<sup>10</sup> This was a modelling choice. The other alternative was a full reconstruction of the income, expenditure and housing data for some household categories.

52. Lastly, during the reconciliation with social accounting data, the income and expenditure shares of each household in IFLS4 are adjusted<sup>11</sup>.

53. Despite the attention paid to ensure the consistency of the reconciled survey data, the assessment regarding the distributional impacts of the current subsidy scheme remains illustrative, because survey data are always unsatisfactory to catch-up well the information concerning the two extremities of the households distribution (the poorest and the wealthiest). In addition, the robustness of the policy simulation results to the income and consumption structure of the various groups is subject to the quality of the reconciliation process.

54. Figure 4 shows that, the budget shares of fossil fuels (kerosene, LPG, gasoline, diesel) are below 3.3%, and that of electricity is below 1.6% for all the income deciles. These estimates are low, compared with other survey data (BPS, 2011). This is a direct consequence of the reconciliation process where the more robust macroeconomic information is inconsistent with the information of the survey, aggregated over all households. To overcome this problem, households' energy expenditure has been adjusted to match the aggregate energy expenditures of the social accounting data.

55. The budget share of fossil fuels increases with income until the 4th decile and then decreases after the 5th decile, reaching its lowest level in the last decile. This non-monotonous relationship is roughly in line with the World Bank (2006). The budget share of electricity uniformly decreases with income, although one could expect to see, as in other survey data survey data (BPS, 2011), the smallest budget shares for the low income households, reflecting the lack of access to electricity for the poor, especially in rural areas. Thus, it seems that our reconciled data overestimate the electricity consumption of low income households.

56. As Figure 5 shows, until the 8th income decile, the share of the total subsidy payment received (the light grey bars for electricity and the light blue bars for fossil fuels) is higher than the total share of households' income (the dark blue bars). It means that the subsidies reduce inequalities between the lower 8 deciles and the top 2 deciles. In general, the lower the decile, the more the share of subsidy received exceeds the share of the group's income in total Indonesian households' income. Based on these considerations, even if in absolute terms the subsidies benefit the wealthiest households the most (since energy consumption increases with income), the subsidy scheme can be labelled as progressive. However, the progressivity is not very strong, and insufficient to contribute substantially to the reduction of the income inequalities observed in Indonesia.

57. Table 2 gives the budget shares for urban and rural households by energy type and by income decile. Total energy expenditures are a higher fraction of consumption expenditures for urban than for rural households. The budget share of the fuels used in transportation (gasoline and diesel) tends to increase with income up to the 8<sup>th</sup> decile. Consequently, subsidies on these products can be regarded as regressive. The share of expenditures for domestic fuels (Kerosene and LPG) and for electricity decreases with income, showing that subsidies on these products are clearly progressive.

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<sup>11</sup> For instance, the shares were scaled down for energy consumption. Lower share for energy consumption will induce in the simulations less direct effect on the household groups through expenditures as a response to an energy subsidy phasing out compared with what could be expected from the original IFLS survey data

**Table 2. Budget shares of energy products for urban and rural households**

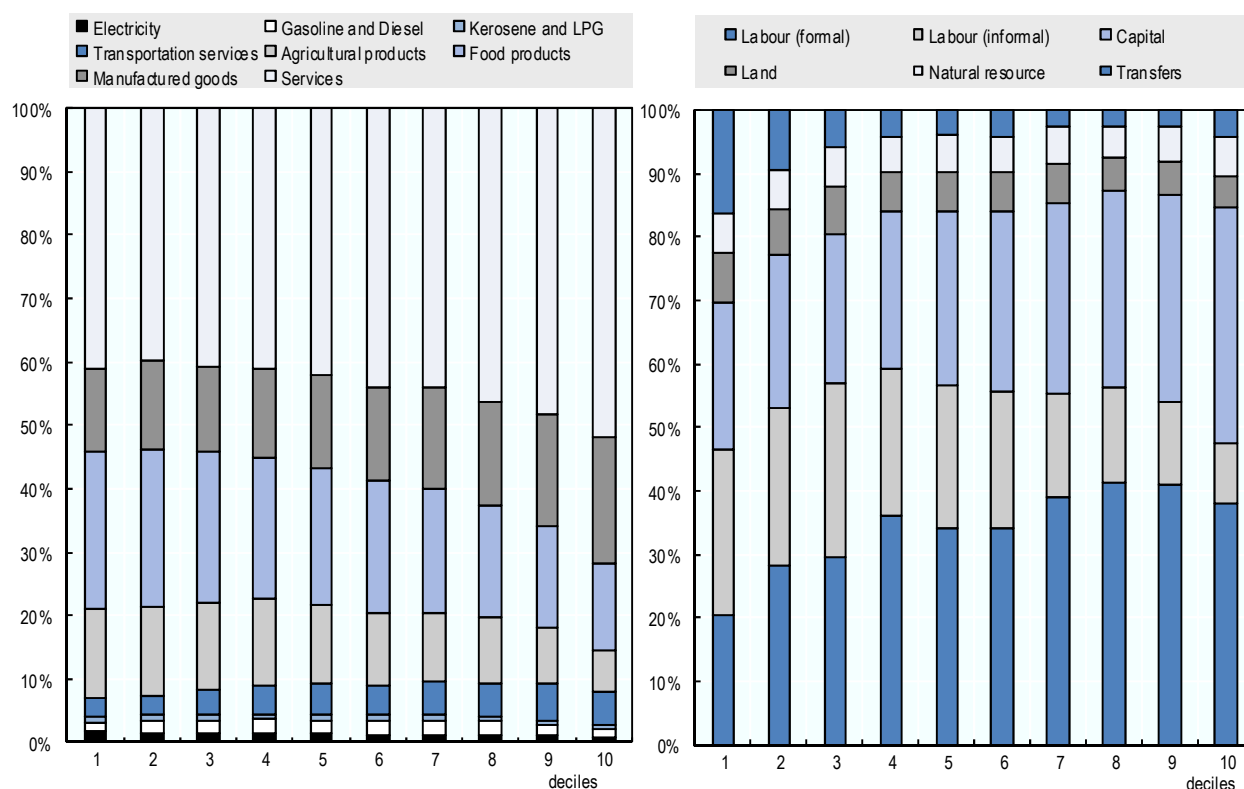
Decile	1	2	3	4	5	6	7	8	9	10
<b>Urban and rural</b>										
Electricity	1.6	1.5	1.4	1.3	1.3	1.2	1.3	1.2	1.1	0.9
Fossil fuels	2.4	2.8	2.9	3.2	3.1	3.0	3.1	2.9	2.4	1.7
Gasoline and diesel	1.3	1.8	2.0	2.4	2.0	2.1	2.2	2.2	1.7	1.3
Kerosene and LPG	1.1	0.9	0.9	0.8	1.1	0.9	0.8	0.7	0.7	0.5
<i>Total Energy</i>	4.0	4.3	4.4	4.5	4.4	4.3	4.3	4.0	3.5	2.7
<b>Urban</b>										
Electricity	2.0	1.6	1.5	1.4	1.5	1.4	1.3	1.4	1.2	0.9
Fossil fuels	3.2	3.4	3.4	3.8	3.6	3.7	3.5	2.9	2.4	1.7
Gasoline and Diesel	2.0	2.3	2.3	2.8	2.4	2.6	2.6	2.2	1.7	1.2
Kerosene and LPG	1.2	1.1	1.2	1.0	1.2	1.1	0.9	0.8	0.7	0.5
<i>Total Energy</i>	5.2	4.9	4.9	5.2	5.1	5.1	4.8	4.3	3.6	2.6
<b>Rural</b>										
Electricity	1.5	1.5	1.4	1.3	1.2	1.1	1.2	0.9	0.9	0.9
Fossil fuels	2.0	2.5	2.7	2.8	2.7	2.5	2.6	2.8	2.5	1.9
Gasoline and Diesel	1.0	1.6	1.9	2.1	1.7	1.7	1.8	2.1	1.8	1.4
Kerosene and LPG	1.0	0.9	0.8	0.8	0.9	0.7	0.7	0.7	0.7	0.5
<i>Total Energy</i>	3.5	3.9	4.0	4.1	3.8	3.6	3.7	3.7	3.4	2.8

Source: Authors' calculations based on IFLS4 and ENV-Linkages

58. Figure 6 shows that the budget share of food consumption (food products and agricultural products) decreases with income. The low shares result from the reconciliation of the IFLS4 with social accounting data, where the aggregate shares of food and agricultural product consumption for Indonesia are relatively low. However, the reconciliation preserved the ratio of 2 between the shares of the first and last decile that was observed in the original IFLS4 survey data.

59. Figure 6 also shows how the structure of income varies between the decile groups. Firstly, the share of income devoted to capital is higher for the top deciles. Secondly, even though the total share of labour income is relatively stable across deciles, the share of formal labour income increases with total income.<sup>12</sup>

<sup>12</sup> Following Miranti et al. (2013), we defined formal sector employees as regular employees and employers with permanent workers, while informal sector employees cover all employees with status of non-permanent, unpaid, casual and family workers.

**Figure 6. Structure of expenditures (left) and incomes (right) by income decile**

Source: Authors' calculations based on IFLS4 and ENV-Linkages

## 5. Description of the illustrative Phase-out policy scenarios

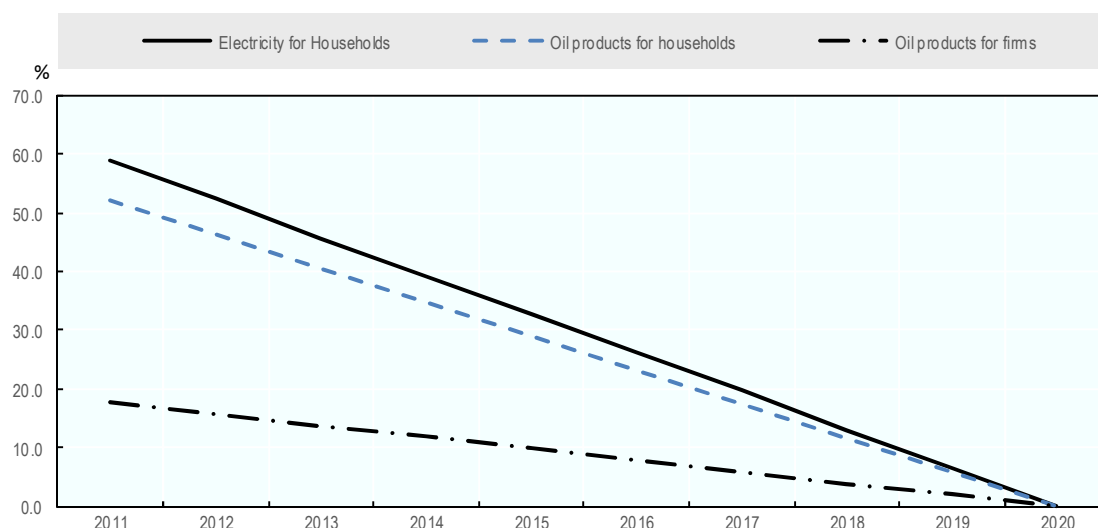
60. The macroeconomic projections follow the OECD Economic Outlook and the corresponding long-term projections (Chateau et al., 2014a). The energy assumptions used in the *baseline* scenario are those of the current policy scenario (CPS) from the World Energy Outlook 2013 (IEA, 2013; Chateau et al., 2014b). For all the regions, all the energy policies, assumed after 2011 in the CPS scenario, are taken into account except the reforms to the consumers' energy subsidies.<sup>13</sup>

61. Following the illustrative scenario designed for the simulations contained in the joint report by IEA, OECD, OPEC & World Bank for the G20 (2010), and in line with Burniaux and Chateau (2011), the policy scenarios assume that, between 2012 and 2020, Indonesia implements a gradual (e.g. linear) phase out of all electricity and fossil fuel subsidies for households and firms (Figure 7). The reform applies to the existing electricity and other fuel subsidies for household's final energy demands and the intermediate oil product consumption subsidies for firms. The subsidies to firms for their intermediate consumption of oil

<sup>13</sup> More detail on the calibration procedure can be found in Chateau et al. (2014b) who describe how the IEA scenarios are reproduced in ENV-Linkages.

products are lower than the subsidies on electricity and oil consumption received by households. Therefore, the phase out is expected to have much larger impacts on households than on firms.

**Figure 7. Trajectories on energy consumption subsidy rates in the policy scenarios**



Notes: (1) For households the subsidy rate for oil products is an aggregate rate over the average oil product consumption basket, including Kerosene, LPG, Gasoline and Diesel. (2) The subsidy rates given here are gross (S) and not net (NS). To compute the net subsidy rate, tax rates (T) on energy products must be subtracted ( $NS=S-T$ ).

62. The scenarios differ by the compensating scheme for households they assume. Each of them is budget-neutral and financed by the decrease in subsidy expenditures. The compensating schemes include cash transfers, subsidies on food products, and a decrease in labour income taxation. Note that the scenarios are relatively stylized, since, for each of them, the compensation given to households is based on a single redistribution instrument although several could be used in practice. For instance, cash transfers and food subsidies can be combined. Furthermore, other destinations of the avoided subsidy payments may also be considered, not least the reduction of government deficits or the expansion of public services, such as education and health care. Unfortunately, this wider set of compensating policy reforms could not be simulated in the model, which focuses purely on redistribution schemes that directly affect the income and private expenditures of households.<sup>14</sup> Nonetheless, the illustrative scenarios presented in this report give precious insights about the strengths and weakness of the components of potential fuel subsidy phase out policy reforms.

63. In the *cash transfer* scenario, the subsidy reform is compensated by unconditional cash payments on a per-household basis. Each household receives the same amount. Given the high level of existing income inequality, such a redistribution mechanism is a powerful instrument to reduce relative income inequalities, even if absolute income differences are unchanged. Another key attractiveness of this redistribution scheme is that cash transfers do not distort relative prices, as they are not linked to specific sources of income or expenditures. They are therefore economically efficient. However, in practice cash transfers may not be easy to implement. This scenario, albeit stylised, relates to the Bantuan Langsung Tunai unconditional cash transfer programmes, implemented in Indonesia in 2005-2006 and in 2008-2009 to compensate the decrease in energy subsidies (see Box 2).

<sup>14</sup> The reason for this is technical: the private welfare effects of changes in the provision of public services cannot be evaluated by the model. Hence, only redistribution schemes that directly affect private welfare and leave government expenditures unchanged can be consistently compared in the modelling framework.

64. In the *food subsidy* scenario, the phasing out is accompanied by an increase in the subsidies on food products. The rationale for this scenario is that if cash transfers are not an option, subsidies on energy can be replaced by support for other basic commodities that are less carbon-intensive. The downside of this option is that it artificially alters market prices and is an imperfect way of supporting poor households. This reform is expected to benefit poorer households more than proportionately, given that the budget share of food decreases with income (see Figure 6). Even if it has larger food product coverage, this scenario relates to the Rice Subsidy for the Poor programs, known as Raskin, that were introduced in Indonesia on several occasions since the late 1990s<sup>15</sup> and also to the distribution of rice and support to rice price that were used following the 2008 energy price rise (see Box 2).

65. In the *labour support* scenario, the households are compensated by receiving payments proportional to their labour income from the formal sector; this can take the form of reduced tax rates on labour, or if the compensation is larger than the existing tax rate, a subsidy on labour income. This stylised scenario assumes that such labour subsidies will be made available to the worker of the formal sector only, excluding those of the informal sector. The policy in this scenario is in line with the OECD *green growth strategy* (OECD, 2011) that recommends devoting extra fiscal resources from green taxation to lower labour income taxation. While the labour support scenario may be close to the cash transfers scenario in developed economies, in countries with a large informal sector and high unemployment rates such a policy reform may not reach the poorest households. The decrease in labour income taxation is regarded as levelling relative income inequalities in OECD countries, given that the share of rental income increases with total income. Consequently, the decrease in labour taxation can limit the potential regressive effect of a green tax reform. However, this type of scenario is expected to have very different implications in emerging countries like Indonesia where the informal sector is very important, and may not be effective as a support measure for the poorest households.

66. The *cash transfer multilateral* scenario corresponds to the *cash transfer* scenario, but in a context of a global multilateral subsidy phase out. This scenario aims at showing that the outcomes of the reform in Indonesia depend on whether other countries also decide to phase out subsidies. If the phase out is multilateral, the global energy demand will decrease and so are the world energy prices, these import price reductions can in turn partially offset the inflationary impact of the subsidy reform on final energy prices, thus limiting the detrimental effect of the decrease in energy subsidies for households.

## 6. Simulation results

67. For each phase out scenario, the outcomes of the models are compared to the *baseline scenario*, where the subsidies remain at their 2011 levels. Besides the distributional impacts, the economic efficiency and environmental impacts of the policy reform will also be considered. The efficiency of the reforms will be assessed by looking at both the variations in GDP and the variations in the aggregate consumers' real income equivalent (as a welfare indicator). Climate benefits are measured by the changes in GHG emissions. Other environmental benefits, such as improved local air quality, can unfortunately not be assessed within the current framework.

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<sup>15</sup> Statistics about the Raskin programme can be found on the ILO website:  
[http://www.ilo.org/dyn/ilossi/ssimain.viewScheme?p\\_lang=en&p\\_geoaid=360&p\\_scheme\\_id=3153](http://www.ilo.org/dyn/ilossi/ssimain.viewScheme?p_lang=en&p_geoaid=360&p_scheme_id=3153)



## 6.1 Overview of the size of the redistribution of the avoided subsidies

68. Table 3 shows the magnitude of the impact of the phase-out policies, including the redistribution of the avoided subsidy payments, on transfers, subsidies for food products, and labour incomes in the various scenarios. In the *cash transfer* and *cash transfer multilateral* scenarios, the budget resources redistributed through the cash transfers for households is projected to increase from 0.5% to 2.5% of GDP between 2012 and 2020. In the short and medium run, the volume of redistribution under these scenarios are of a similar magnitude as the two waves of the BLT cash transfers programmes that were introduced in 2005-2006 and 2008-2009 in Indonesia, which represented approximately 0.8% and 0.3% of GDP, respectively. However, as progressively all subsidies are phased out, by 2020 a large amount of budget resources that were previously used to subsidise energy is available for redistribution. The long-run budget redistribution would be very large in comparison to most of the major cash transfers programs that have been introduced in other countries so far (ILO, 2013). In the *food subsidy* scenario, the redistribution implies an increase in subsidies for the consumption of food and agricultural products that will reach an average rate of 16% in 2020. In the *labour support* scenario, the subsidy on labour earnings reaches an average rate of 4.8% in 2020.

**Table 3. Effect of the phasing out on transfers and subsidies in the various scenarios**

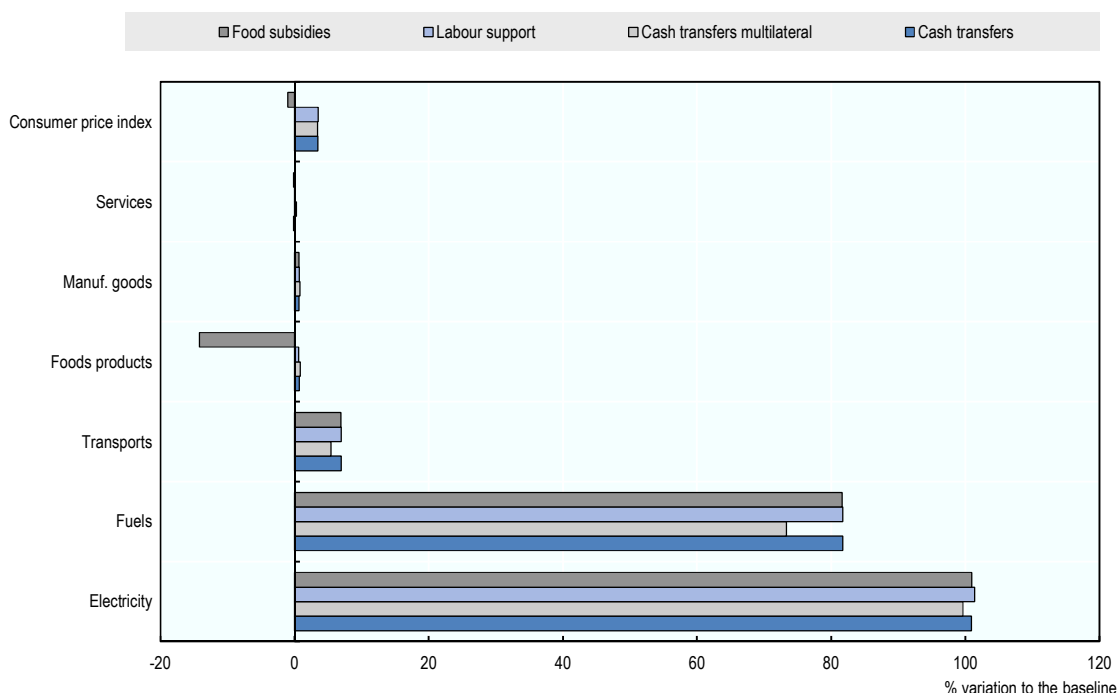
	2011	2012	2014	2016	2018	2020
<b>Cash transfer &amp; Cash Transfer multilateral scenarios</b>						
Cash Transfers to households (as % of baseline GDP)	0.0	0.5	1.2	1.7	2.1	2.5
Subsidy rate on food and agricultural products*	-	-	-	-	-	-
Subsidy rate on labour income**	-	-	-	-	-	-
<b>Food subsidies scenarios</b>						
Cash Transfers to households (as % of baseline GDP)	-	-	-	-	-	-
Subsidy rate on food and agricultural products*	0	3.2	8.3	12.0	14.9	16.2
Subsidy rate on labour income**	-	-	-	-	-	-
<b>Labour support scenarios</b>						
Cash Transfers to households (as % of baseline GDP)	-	-	-	-	-	-
Subsidy rate on food and agricultural products*	-	-	-	-	-	-
Subsidy rate on labour income**	0	0.9	2.5	6.2	4.2	4.8
Notes: * Aggregate rate over the average agriculture and food product good basket in addition. In addition, this rate is gross (S) and not net (NS). To compute the net subsidy rate, an average tax rate tax rates 5.7% on agriculture and food products must be subtracted. ** Average rate, over both formal and informal labour revenues.						

## 6.2 Macroeconomic impacts

69. The direct effect of the energy subsidies reform, regardless of the redistribution mechanism scenario, is that energy prices for all consumers (firms and households) are raised. The consumer prices of other goods are also indirectly affected through changes in producer costs, which reflect changes in energy costs, and adjustments of all relative prices to ensure that general equilibrium is maintained. The second set of channels through which the reform impacts households is through changes in income. The third set of channels is through the redistribution of the government budget that is no longer spent on subsidizing fossil fuels, which characterize each of the scenarios considered here. By considering the entire chain of impacts on demand and supply for each good and service, the model projects the quantitative impact of the reforms on GDP.

70. Figure 8 shows the changes in final consumer price indexes for various groups of commodities in 2020, as deviations from the baseline. The *cash transfer*, the *cash transfer multilateral* and the *labour support* scenarios give way to a significant increase (close to 3.5%) in the real consumer price index (CPI), which represents a basket of all consumed commodities.<sup>16</sup> In contrast, the *food subsidy* scenario leads to a decrease in consumer prices, as the reduced consumer price of subsidised food products dominates the increase in the price of the other products.

**Figure 8. Effect of the energy subsidies' phasing out on final consumer prices in 2020**



71. Unsurprisingly, as the final energy commodity prices are directly targeted by the subsidy phase out, they are most impacted. In 2020, in all scenarios, fuel and electricity prices are respectively about 80% and 100% higher than in the *baseline*. The increase in fuel prices is slightly more limited in the *cash transfer multilateral* scenario because of an indirect effect through global energy markets. In this scenario, the phasing out of energy subsidies in other regions negatively affects global oil demand and consequently lowers international oil prices. This reduction in price partly compensates the domestic impacts of the subsidy phase out on final energy prices. However, the small difference in fuel prices with the other scenarios shows that this effect remains limited.

72. The prices of non-energy commodities are affected indirectly by the phase out. Firstly, through change in production costs, which in turn reflect mainly the changes in energy costs. Secondly, as households and firms substitute away from energy they will increase their use of other goods and services. The price of transportation services is the most affected because of the high dependence of the sector on motor fuels, though the price increase remains limited to 7% with respect to the baseline. For the other non-energy goods, the increase is lower than 1%. These relatively modest indirect impacts on non-energy commodity prices are largely due to our assumption that the base-year energy subsidies rates were

<sup>16</sup> The model only calculates real prices and does not reflect monetary information such as inflation. Nominal prices would be increasing by the sum of the CPI change plus the inflation rate. Furthermore, please note that all prices are relative to a *numéraire*, which is a basket of export prices of OECD countries.

significantly lower for firms than for households. Because of this assumption, the phase out corresponds to a much bigger energy price shock for households than for firms.

73. The negative impact on food prices in the *food subsidy* scenario, observed in Figure 8, stems from the indirect effects of the tax and subsidy system through the redistribution scheme. In this scenario, the phasing out of energy subsidies is compensated by fiscal support on food prices. Under the assumption that government resources are identical to those of the *baseline* scenario, this subsidy, which reaches an aggregate rate close to 16% over the food product basket (see Table 3), significantly lowers final food prices.

74. As a result of higher energy prices, demand for energy goods will decrease for final consumers, as shown in Table 4. The large decreases observed are directly related to the values of the own price elasticities of demand, which follow Chateau et al. (2014a), and are close to -1 (see section 6.5 for a sensitivity analysis on this parameter). However, changes in the demand for other goods and services are *a priori* indeterminate because they result from a mix of an income effect (through changes in transfer payments and earnings from production factors) and a substitution effect (through changes in relative prices).

**Table 4. Total households' demand variations for aggregated good categories in 2020 by scenario**

	Cash transfers	Cash transfers multilateral	Labour support	Food subsidies
Electricity	-47.8	-47.3	-48.2	-49.3
Fuels	-42.7	-39.7	-42.8	-44.2
Transports	-3.7	-2.0	-3.1	-5.6
Foods products	2.0	2.1	1.6	12.1
Manuf. goods	2.3	2.5	3.1	0.1
Services	3.5	3.5	4.4	1.1
Note: % deviations, w.r.t. the baseline				

75. The phase out also affects the real return on production factors net of the factor tax rates as shown in Figure 9. The changes in net return reflect variations in the relative marginal productivities of the factors induced by the policy. In the case of labour productivity in the *labour support* scenario it also reflects changes in the subsidies on formal labour.

76. The lower real return on capital induced by the phase out policy, which appears on the longer run, is related to higher household savings created by the subsidy reform<sup>17</sup>: as will be explained later in this section, the policies are projected to increase the savings of households. The higher savings increase the capital stock and thus decrease its marginal productivity.

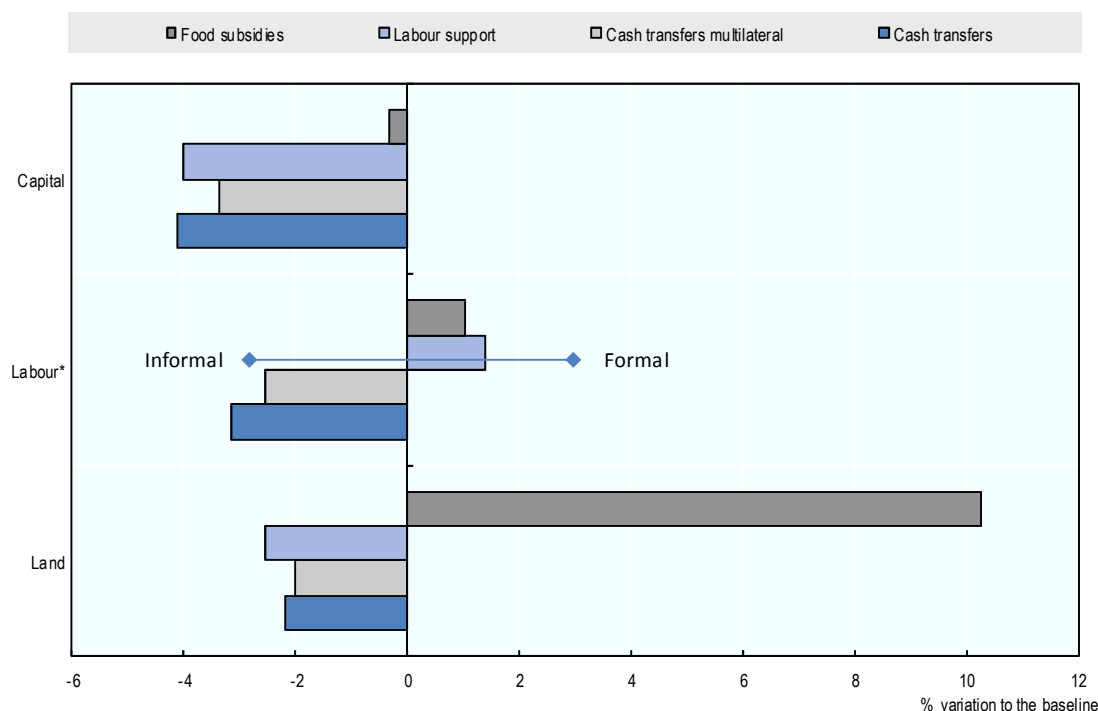
77. The net return on labour is negatively impacted in the *cash transfer* and *cash transfer multilateral* scenarios. A decrease in net return, which, as in the case of capital can be explained by complementarities between energy and labour, leads to a decrease in the marginal productivity of labour. In the *labour support* scenario the subsidy to labour will increase the net return on labour, but the situations are different for the formal and informal sectors. Informal labour is not part of the official tax system, and hence does not receive the labour support subsidies and its rate of return decreases, reflecting the lower marginal labour productivity. Formal labour is subsidised at a rate close 6.8%, which dominates the decrease in labour marginal productivity and hence yields a higher net return. These differentiated effects on different segments of the labour market are illustrated in Figure 9, together with the effect on the whole labour

<sup>17</sup> Except in the *food subsidy* scenario where savings decrease.

market. In the *food subsidy* scenario, the subsidies on food products are beneficial to the agricultural sector and to its workers, positively affecting real labour remuneration at the national level.

78. The relative decrease in the return on land in all the scenarios except *food subsidy* is due, as for labour and capital, to the complementarity with energy in the production process. But as expected, in the *food subsidy* scenario, the food subsidies that compensate for the energy subsidy phase out support the demand for food products and thereby increase the return on land.

**Figure 9. Net real return rates by income sources in the various scenarios in 2020**



\* In the labour support scenarios, in addition to the average remuneration rate of labour; the remuneration rates of formal and informal labour are distinguished.

79. Figure 10 shows that the impact of the energy subsidy reforms on GDP is positive in all the scenarios. However, the gains remain very limited, until 2020 they are not higher than 0.7% above the baseline. These limited gains are explained by the modest share of energy consumption in total household consumption, which limits the potential impacts of the subsidy reform on the overall economy. The best scenarios in terms of GDP are subsidies reforms together with cash transfer redistribution schemes. As the subsidy phase out improves the efficiency of the economy and increase the growth rate of the economy, they lead to GDP gains, whereas the *food subsidy* and the *labour support* scenarios have smaller GDP gains, which eventually start to fade away.

80. To explain the macroeconomic performance of the policy in the inter-temporal modelling framework, it is necessary to make the distinction between “static” and “dynamic” mechanisms. The static mechanisms relate to reform-induced changes in the efficiency of production factors and consumption goods allocation for a given stock of capital. Typically, subsidies create inefficiencies (deadweight loss) in the allocation of consumption goods and factors, and removing them tends to have a positive direct effect. In addition, the redistribution schemes influence the efficiency of the policy, when they affect other existing taxes. The dynamic mechanisms come from the impact of the policy on households’ savings. A

reform, whose consequence is an increase in aggregate savings, and consequently capital accumulation in the economy, will have better long-term GDP growth performances.<sup>18</sup>

81. The subsidy removal has a positive direct impact on the economy, since it reduces allocation inefficiencies. However, depending on the scenario, the recycling schemes adopted may create new inefficiencies in the economy. The lump-sum transfers used in the *cash transfer* and *cash transfer multilateral* scenarios do not create inefficiencies because they do not influence production factor allocation. Similarly, given that total labour supply is exogenous, the redistribution through changing the net sum of taxes and subsidies on labour in the *labour support* scenario does not affect the supply of labour from households and is in that sense equivalent to a lump-sum transfer. However, in the *food subsidies* scenario, the redistribution consists of reducing existing food taxes during the first years and then introducing subsidies on food products as the avoided energy consumption subsidy payments become larger than the baseline tax revenues on food products. The reduction of food taxes tends to have an immediate positive impact on the economy, as an existing price distortion is reduced. This explains the slight better growth performance in this scenario than in the other scenarios during the first year of the model horizon. However, the subsidies on food products appear after a few years and create inefficiencies that partially offset the positive impact of removing energy consumption subsidies.

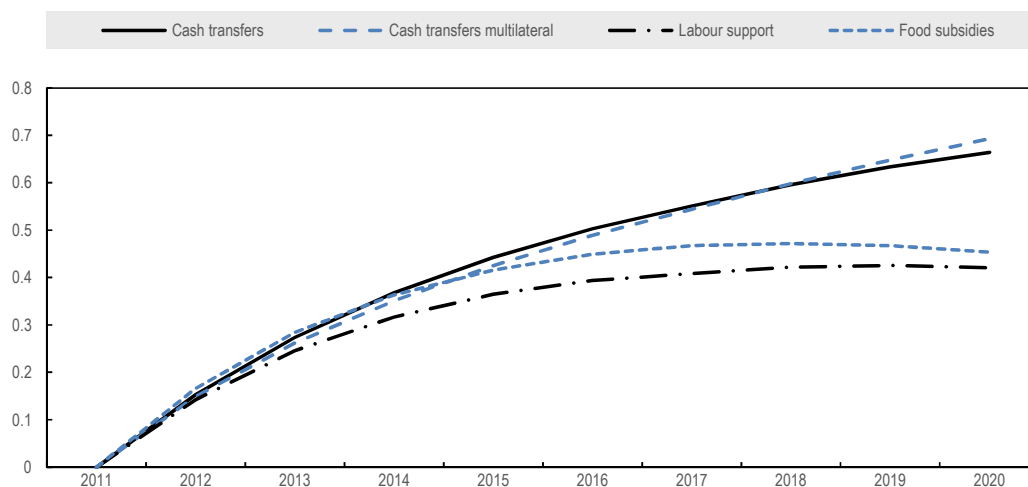
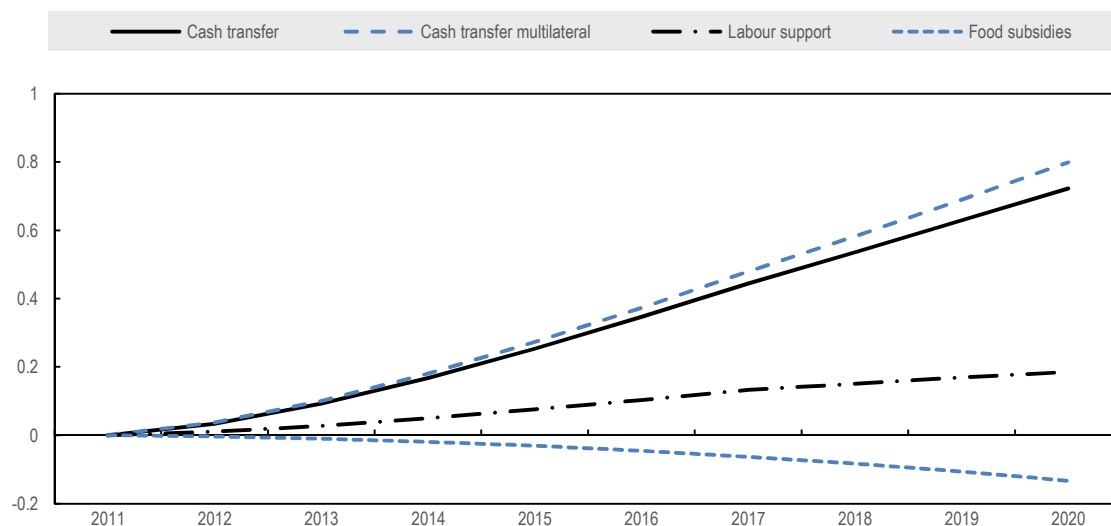
82. Figure 11 shows that the policies have a significant impact on the capital stock by presenting the ratio between the two most important production factors, capital and labour (in efficiency units, i.e. including human capital). The *cash transfer*, the *cash transfer multilateral* and the *labour support* scenarios induce more capital accumulation. In these scenarios, households receive additional income and part of it is saved. However, the impacts on capital accumulation are more pronounced with cash transfers than with labour support. This difference stems from the heterogeneity of households. The budget redistribution schemes target different parts of the population (all households in the cash transfer scenarios, and households with formal labour income in the labour support scenario) which have different marginal propensities to save. Consequently, the choice of the redistribution scheme affects total savings: for the same amount redistributed, the *cash transfer* mechanism will give way to higher aggregated savings.<sup>19</sup>

83. Savings rates, and hence capital accumulation, are also influenced by the changes in consumption prices. As seen in Figure 8, the consumer price index increases in all scenarios except the *food subsidy* scenario. Hence, consumers are induced to substitute away from consumption toward saving. The food subsidies, in contrast, make consumption more attractive, thereby pushing savings rates down.

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<sup>18</sup> In particular if, as in this study the current account is fixed.

<sup>19</sup> For instance, in the base-year, a labour support mechanism that accrues the formal labour income revenue by 1% gives way to 0.16% increase in aggregate savings. If an equivalent amount is redistributed with cash transfers, the aggregate savings increase by 0.33%.

**Figure 10. Real GDP as percent deviation to the baseline in the various scenarios****Figure 11. Capital to efficient labour ratio, as % variation from the baseline**

### 6.3 Distributional impacts

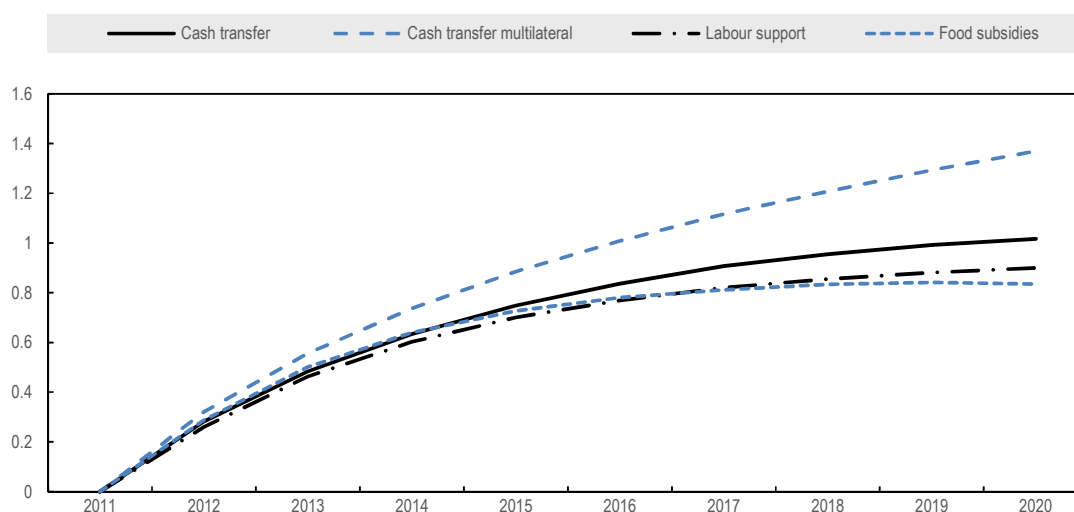
84. The measure of welfare used to assess the distributional impacts of the phase out of fossil fuel subsidies is the equivalent income<sup>20</sup> (EI) which translates the welfare reached by a household group in a policy scenario into the level of income that would have been necessary to reach the same level of utility in the baseline scenario. The variation of the EI between a policy scenario and the baseline is called equivalent variation in income (EV), it represents the additional income that would have been necessary to reach the same level of welfare in the baseline scenario. A first criterion used in this report to regard a

<sup>20</sup> This welfare measure excludes the welfare derived from the provision of public goods, as this cannot be measured properly. As long as the provision of public goods is constant across scenarios, as is the case in the scenarios investigated in this paper, the change in welfare from private consumption equals the change in total welfare.

policy as progressive is that the EI are more evenly distributed than the baseline incomes<sup>21</sup>. A second criterion is that the EV, as a percent of the baseline income, decreases with income.

85. The total welfare changes for all households together are displayed in Figure 12. The gains are more important than the effect on GDP shown in Figure 10. They range between 0.8% and 1.4% in 2020, while the corresponding range for GDP gains is from 0.4% to 0.7%. The difference between the two indicators is that the welfare measure fully takes into account the terms of trade improvements consecutive to the reform. This effect is stronger in the *cash transfer multilateral* scenario, since lower international oil prices reinforce the decreased value of energy imports. Consequently, this scenario outperforms all the others in terms of welfare improvements.

**Figure 12. Total households' equivalent income variations in the various policy scenarios**



86. Table 5 shows statistics of the distribution of equivalent incomes for the year 2020 under the various scenarios. Two dispersion statistics, the Gini and the Theil indexes, provide insight on whether the policies give way to higher or lower overall inequalities than in the *baseline*, and can, in this sense, be regarded as progressive or regressive. In the *cash transfer* and *cash transfer multilateral* scenarios, the Gini and the Theil indexes significantly decrease; therefore with regards to these criteria these scenarios can be regarded as progressive, in the sense that poorer households benefit more than richer households from the reforms. The dispersion statistics hardly change in the *food subsidy* scenario, which therefore can be regarded as distribution neutral, but they increase in the *labour support* scenario which appears to be regressive.

87. The inter-quantile ratios show that the progressivity of the *cash transfer* and *cash transfer multilateral* scenarios comes from the fact that they are relatively beneficial to the poorest decile. First, in these two scenarios, the gap between the upper and the lower quantiles decreases. The ratio between the 99<sup>th</sup> centile and the 1<sup>st</sup> centile shrinks from 45 to about 39, and the ratio between the 95<sup>th</sup> and the 5<sup>th</sup> centile decreases from 14.2 to 12.7 as the lump sum payment is a relatively large part of their total income. In addition, in these scenarios, the households in the 5<sup>th</sup> centile have a welfare increase of more than 9%. The increase in welfare is also very important in the 10<sup>th</sup> centile. This means that these policies are primarily

<sup>21</sup> Note that by construction, in the baseline scenario, the EI is equal to income.

beneficial to the very poor. A diminishing ratio between the higher and lower quintiles and a significant welfare increase are also observed, but to a lower extent, in the *food policy* scenario. However, the *labour support* scenario sees an increase in the ratios between higher and lower quantiles.

**Table 5. Equivalent income dispersion statistics across households in 2020 by scenario**

Scenario		Baseline	Cash transfers	Cash transfers multilateral	Labour tax	Food subsidies
<b>Inequality indexes*</b>						
	Gini coefficient*	0.445	0.436	0.436	0.450	0.443
	Theil Index	0.348	0.336	0.336	0.357	0.346
<b>Inter-quantile ratios</b>						
	Decile 8/Decile 3	2.4	2.3	2.3	2.4	2.3
	Decile 10/Decile 1	8.2	7.6	7.6	8.4	8.1
	Centile 95/Centile 5	14.2	12.7	12.7	14.6	14.0
	Centile 100/Centile 1	45.2	39.0	38.8	46.4	43.8
<b>Average equivalent income variations (in %) per quantile groups</b>						
	Centile 5	-	9.1	9.3	-1.2	2.1
	Centile 10	-	6.8	7.0	-0.9	2.5
	Centile 90	-	-0.1	0.3	1.5	0.0
	Centile 95	-	-0.2	0.1	2.0	0.2
Note: *The inequality indexes are computed on the per capita and not on the per household distribution of equivalent incomes						

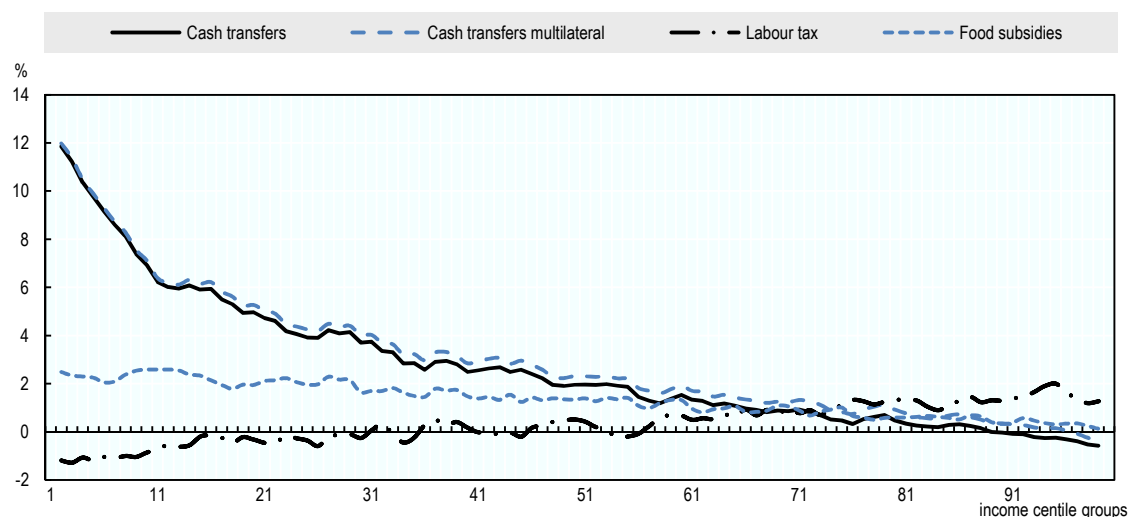
88. Figure 13 shows for the various scenarios the EV by income centile groups in 2020 and thus provides more details about the distribution of the gains and losses due to the policies. As the EV are expressed as percent deviation from the baseline, a scenario with decreasing EV for the increasingly higher income quantiles can be interpreted as progressive as it denotes that the lower the initial income, the higher the proportion of income-equivalent gained from the policy.

89. All the scenarios yield positive welfare impacts (the EV is positive) for the majority of the household centile groups, showing that most of the household groups gain from the reform. This reflects, at the household group level, the positive macroeconomic impacts of the scenarios. In addition, except for the *labour support* scenario, the EV is higher for the lower centile groups, confirming that these scenarios are progressive.

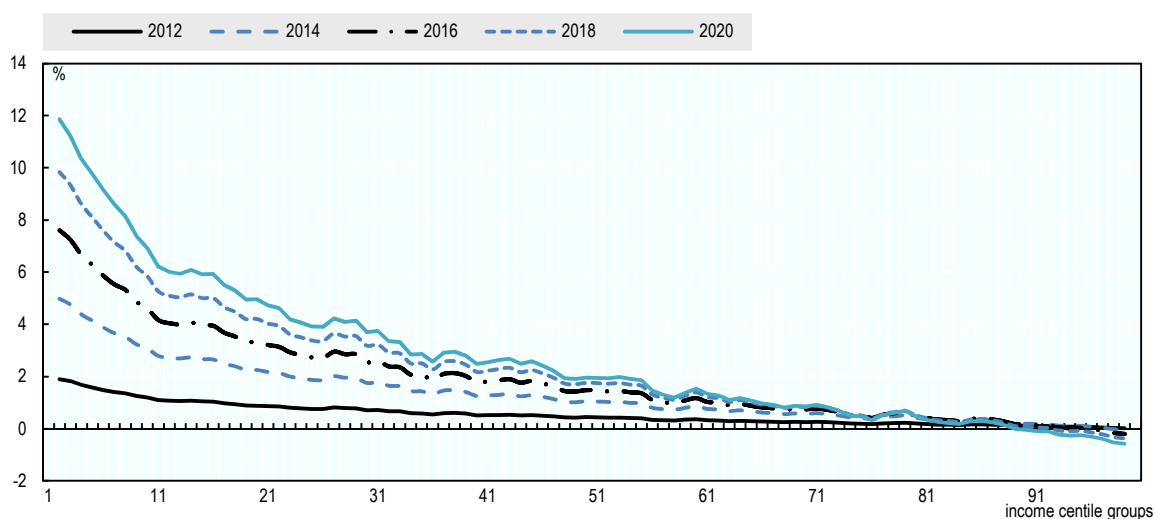
90. The *cash transfer* and *cash transfer multilateral* scenarios have very similar impacts across the household groups. They are the most progressive and they benefit all household groups except the very rich. This result is largely due to the natural progressivity of unconditional cash transfer schemes (the payments received by the households are identical and therefore represent a much higher share of income for poorer households than for richer ones) reinforced by the fact that in Indonesia, the initial level of inequality is high.

91. The *food subsidy* scenario is the only scenario investigated that is beneficial to all income centiles. The relative benefit of the reform is higher for the lower centile, due to their larger share of income going toward food and agricultural product consumption (see Figure 6). The *labour support* scenario is regressive, and detrimental to lower income household groups.



**Figure 13. Welfare variations by income centiles in 2020 in the various policy scenarios**

92. The evolution of the EV by income centiles through time in the *cash transfer* scenario is displayed in Figure 14. The distributional pattern is more or less constant throughout the years, and the effects amplify over time, in line with the larger policy shock. In addition, for low-income households, the policy has a significant positive impact in the short run, as welfare improvement is more rapid during the first years after the reform. In addition, these figures show that even a partial phase out of energy consumption subsidies complemented by cash transfers can be progressive.

**Figure 14. Dynamic of welfare variations by income centiles in the cash transfer scenario**

93. To identify the main drivers of the distributional impacts of each reform the welfare changes of the household groups is decomposed into the following effects:

1. The direct effect of the *final price* changes, i.e. the change in expenditures that would have occurred in the absence of household demand response.

2. The effect through change in *labour income*: the change in income that comes from the variation in the return on labour. This latter reflects not only the change in labour marginal productivity, but also, in the case of the *labour support* scenario, the introduction of the subsidies on labour.
3. The effect of the change in *non-labour incomes* (i.e. incomes from capital, land and natural resources).
4. The effect through higher *transfers* that increase households' disposable income. The indirect component of this change is provided by the fact that as government tax revenues change, the government budget is balanced by endogenously adjusting the transfers to households. In the cash transfers and cash transfers multilateral scenarios, this also includes the direct effect of the redistribution scheme.
5. The effect through *demand adjustment*, which takes into account the impact on of the adjustment of consumption and savings made by the households as a response to the changes in incomes and relative prices.

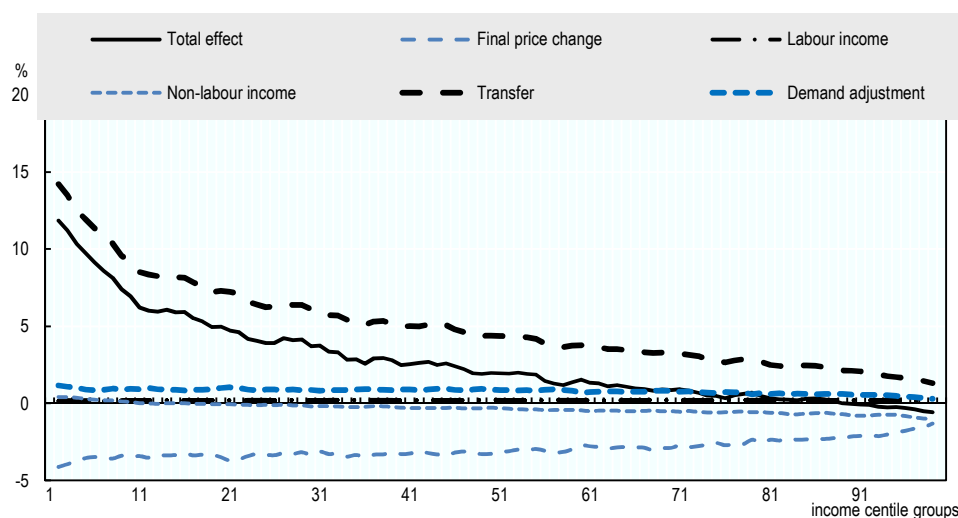
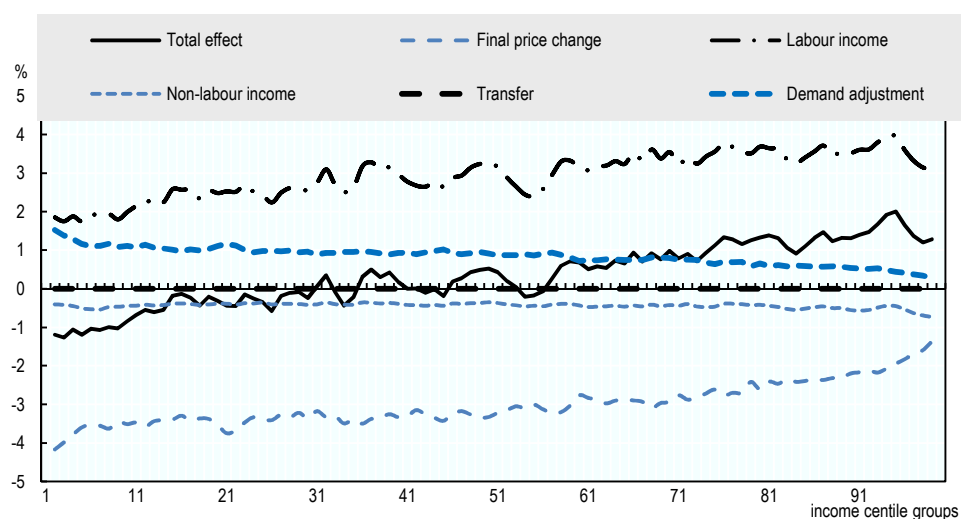
94. These components are shown in Figure 15 for the *cash transfer* scenario. The model simulation projects that the direct effect of the policy through changes in final prices is regressive. The effect is equivalent to a 5% decrease in income for the lower centile groups, but to less than 3% for the wealthiest groups. The effects through labour and non-labour incomes are quite small and more or less distribution neutral. The effect of demand adjustment is positive and distribution neutral.<sup>22</sup> Note that the large predominance of the transfer effect makes the assessment about the progressivity of the cash transfer reform very robust to the statement, made in section 2, that the initial energy consumption subsidy scheme is progressive. The overall progressivity of the cash transfer scenarios is hence almost entirely due to the changes in transfers.

95. When considering the effects under the *labour support* scenario, in Figure 16, it appears that the regressive impacts through changes in net labour incomes reinforce the regressivity of the final price effect. This result is counter-intuitive given that the effect of labour income was distribution-neutral under the *cash transfer* scenario, translating relatively homogenous shares of labour incomes across the household centiles. However, the explanation comes from the very nature of the budget redistribution scheme. Transfers proportional to labour income, as used in the *labour support* scenario are regressive, as the incomes from formal labour are a higher proportion of total incomes for higher-income households than for lower-income households (see figure 6).

96. Figure 17 shows that under the *food subsidy* scenario, the final price effect changes sign. In this scenario, the subsidies on food products are sufficiently progressive to offset the regressive impacts of the increase in final energy prices. The progressivity of the food subsidies is due to the higher budget shares of food for poor households relative to rich households (see Figure 6). In addition, in this scenario, the non-labour income effect is relatively progressive, due to the positive impacts of the food subsidies on land returns (see Figure 9) and to the relatively high proportion of incomes from land in low-income households' incomes<sup>23</sup> (see Figure 6).

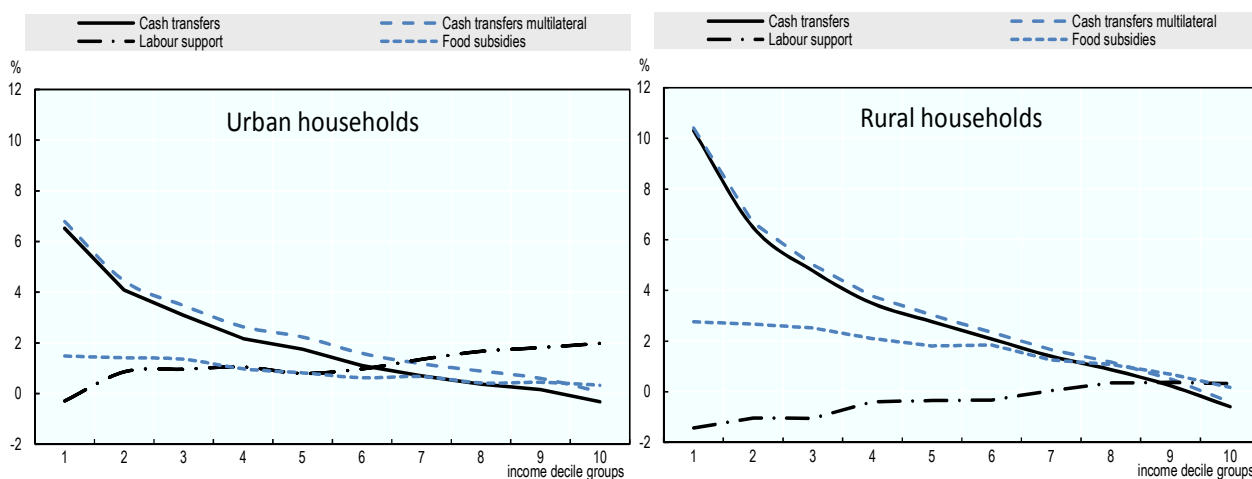
<sup>22</sup> This neutrality comes from the fact that the income and price elasticities of demand of the various household groups were calibrated to the same value (the value used in the single household version of ENV-Linkages). If sufficient data can be found, follow-up analysis could investigate the impacts of the policy reform in a setting where households have different elasticities.

<sup>23</sup> However, this result is not necessarily robust, as the land incomes of low income rural households may be overestimated in the reconciled household survey data. It is likely that the land incomes of urban high-income landowners are underestimated.

**Figure 15. Decomposition of welfare effects across income centiles in the cash transfer scenario****Figure 16. Decomposition of welfare effects across income centiles in the labour support scenario**

**Figure 17. Decomposition of welfare effects, by income centiles in the food subsidy scenario**

97. The phasing out of fossil-fuel subsidies has different impacts in urban and rural areas, as shown by Figure 18. Until the 9<sup>th</sup> decile, the *cash transfer* and the *food subsidy* scenarios are more beneficial to rural than to urban households. The main reason is that, according to our data<sup>24</sup>, the rural households have a lower share of their initial budget for energy expenditures and therefore they are less affected by the impact of the reform on final energy prices. The *labour support* scenario, in contrast, is less beneficial to the rural households, because of the greater importance of the informal sector in these areas. The *food subsidy* scenario; due to the higher share of food product consumption in rural than in urban areas, and to an increase in land returns; is more beneficial to rural than to urban households<sup>25</sup>.

**Figure 18. Welfare impacts for the urban and rural household by income decile in 2020**

<sup>24</sup> BPS (2011) also found higher value shares for food and agricultural products in rural than in urban areas.

<sup>25</sup> Note that this result might be influenced by a potential underestimation of the role of self-consumption and in-kind private transfers for rural households.

## 6.4 Environmental impacts

98. Table 6 shows that the policy reform is projected to lead to a 7.9% to 8.3% reduction in GHG emissions at the 2020 horizon when compared with the baseline. The reduction of GHG is mainly due to a 10.8% to 12.6% decrease in energy-related CO<sub>2</sub> emissions, in line with the decrease in energy consumption (ranging from 10.9% to 12.7%). However, the emission reductions exclude emissions from deforestation, which are large but highly uncertain and for which the model cannot make reliable projections. The IEA estimates that in 2010, CO<sub>2</sub> from forest fires were about 60% of total GHG emissions (Appendix A). Hence, the emission reductions achieved by the energy subsidy policy phase out are substantially lower when including deforestation emissions.

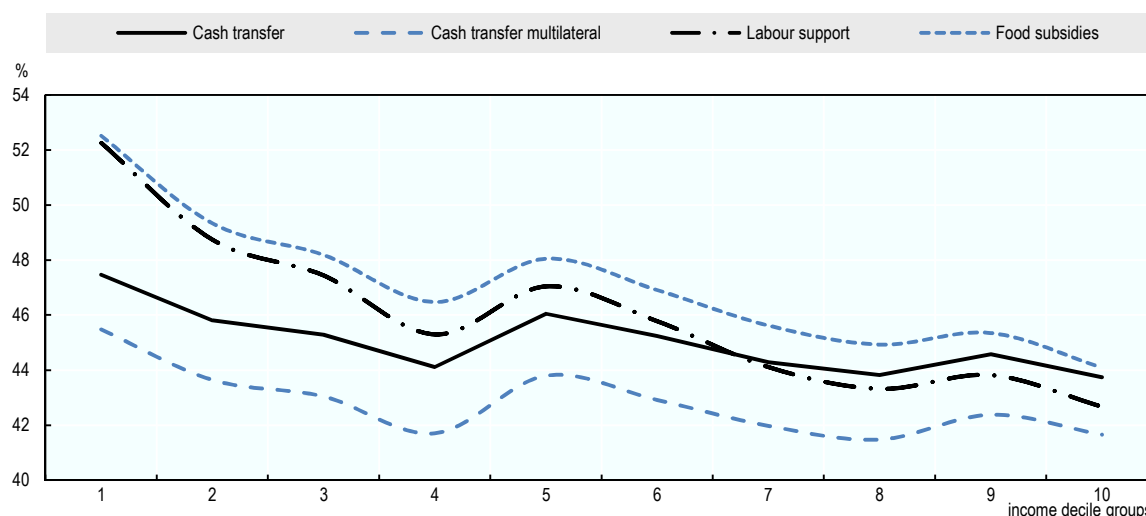
Largely, the emission-reduction efforts are achieved by energy conservation and not by a reduction of the CO<sub>2</sub> intensity of energy. The mitigation effort is borne by households, who reduce their energy consumption by 42% to 46%, whereas energy consumption by firms declines by only 4.9% to 6.2%. This effect is mainly due to the much lower energy consumption subsidy rates for firms than for households in the baseline.

**Table 6. GHG emission and energy consumption reduction in 2020 w.r.t. the baseline by scenario**

Scenario	Cash transfers	Cash transfers multilateral	Labour support	Food subsidies
All GHG*	7.9	7.3	8.3	7.9
CO <sub>2</sub> emissions*	11.8	10.8	12.3	12.6
Total energy consumption	12.1	10.9	12.5	12.7
Households	44.6	42.4	44.8	46.0
Firms	5.8	4.9	6.2	6.2

\* Not including the emissions from tropical forest fires and the 10% of biofuel combustion emissions, which is the fraction assumed to be produced unsustainably

99. The reduction of energy consumption achieved varies across household deciles, as shown in Figure 19. The *cash transfer* scenario leads to a lower energy consumption reduction for the lower income quantile. This sort of rebound effect is due to the increase of income, which stimulates all demands including energy consumption. On the one hand, the low income households have a direct incentive to consume less energy due to increased final prices. On the other hand, their income increases by the cash transfers, which tends to stimulate energy consumption and to offset, for these groups, a part of the emissions reduction that was due to the direct effect through energy prices.

**Figure 19. Rate of reduction of energy consumption by household decile in the various scenarios**

### 6.5 Sensitivity of the results to the households' demand elasticities

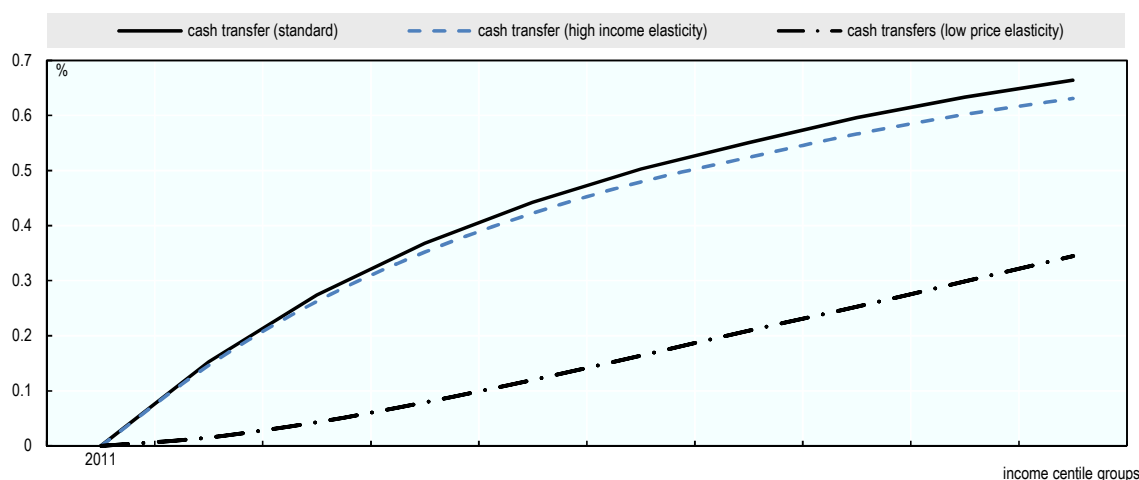
100. The simulation results may be largely driven by the assumptions about the households' income and price elasticities of energy demand. In particular, the large amount of emissions reduction realised by households in the various scenarios is largely related to the calibration of the price elasticities of households' electricity and fuels demands close to -1 (cf. Chateau et al., 2014a)<sup>26</sup>.

101. To assess the robustness of the results to the values taken by households' income and price elasticities of energy demand, a sensitivity analysis is conducted on these parameters. This sensitivity analysis is done for the *cash transfer* scenario. The simulation results already presented will be regarded as the "standard" case and compared to two other values of the incomes and price elasticities of demand, each corresponding to a case.

- A "high income elasticity" case, where the households' income elasticities of electricity and fuel demand that are close to 1 in the standard case are doubled.
- A "low price elasticity" case, where the households' own price elasticities of electricity and fuel demand that are close to -1 in the standard case are halved.

102. The GDP trajectories obtained for the *cash transfer* scenario under the various elasticity values is displayed in Figure 20. The GDP changes remain positive. They are rather robust against the income elasticity of energy demand. However, the price elasticity of demand plays a greater part. A lower price elasticity of energy demand implies significantly lower GDP gains. Two reasons can be invoked. First, a lower elasticity of demand decreases the initial deadweight losses due to the energy consumption subsidies, which limits the efficiency gains obtained with the phase out. Second, as the consumers are less responsive in their energy consumption, they have more difficulties to adjust their behaviour. In particular, they increase their savings less and thus contribute less to the growth of the capital stock.

<sup>26</sup> This value is used in many CGE models like ENV-Linkages, while partial models for the energy sector often use values closer to -0.5 (Webster et al., 2008).

**Figure 20. Real GDP sensitivity to demand elasticities in the cash transfer scenario**

103. Table 7 shows that the price elasticity strongly influences households' energy consumption, as could be expected, and consequently their CO<sub>2</sub> emissions. With the price elasticity of households being divided by two, their energy consumption reduction is half as strong as the in standard case. Consequently, the impact on total CO<sub>2</sub> emissions and total GHG emission is less pronounced. In contrast, the income elasticity does not influence the results much.

**Table 7. GHG emission and energy consumption reduction in 2020 w.r.t. the baseline in the sensitivity analysis**

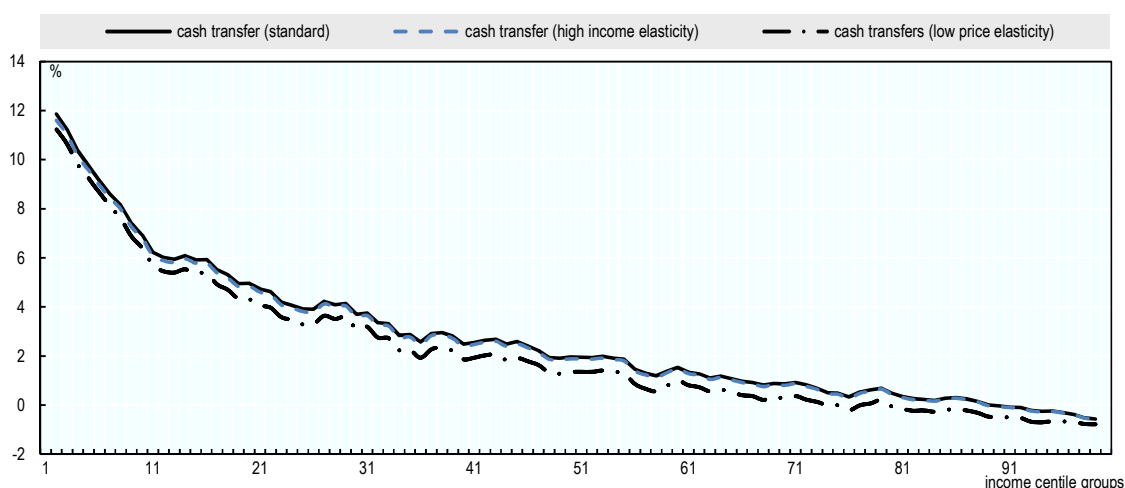
Scenario	Cash transfers (standard)	cash transfer (high income elasticity)	cash transfers (low price elasticity)
All GHG*	7.9	7.6	6.8
CO <sub>2</sub> emissions	11.8	11.4	4.5
Total energy consumption	12.1	11.6	7.2
Households	44.6	42.9	23.5
Firms	5.8	5.5	4.0

\* Not including the emissions from tropical forest fires and the 10% of biofuel combustion emissions, which is the fraction assumed to be produced unsustainably

104. Even if the price elasticity of demand largely influences the environmental and economic performance of the cash transfer policy, it has very limited effect on its distributional performances. Table 8 shows that the dispersion statistics of the equivalent incomes of households are robust to the price elasticity. The overall distributive pattern is also robust, as shown in Figure 21. Of course, this result does not extend to the situation where different income and price elasticities are assumed for different household groups. There is unfortunately insufficient information to investigate such a situation.

**Table 8. Sensitivity of welfare dispersion statistics in 2020 to demand elasticity values**

Scenario	Baseline	Cash transfers (standard)	cash transfer (high income elasticity)	cash transfers (low price elasticity)
<b>Inequality index</b>				
Gini coefficient	0.445	0.436	0.436	0.437
Theil Index	0.348	0.336	0.336	0.337
<b>Inter-quintile ratios</b>				
Dec8/Dec3	2.4	2.3	2.3	2.3
Dec10/Dec1	8.2	7.6	7.6	7.6
Cent95/Cent5	14.2	12.7	12.7	12.7
Cent100/Cent1	45.2	39.0	39.0	38.9

**Figure 21. Sensitivity of welfare gain by centile in 2020 to demand elasticities in the cash transfer scenario**

## 7. Conclusions

105. This paper provided a quantitative assessment of fossil-fuel subsidy reforms in Indonesia. It introduced an enhanced modelling framework, by combining the OECD's dynamic general equilibrium model ENV-Linkages with a dedicated module for assessing the distributional consequences of reform for specific household groups in Indonesia.

106. The illustrative simulations investigated in this report suggest that it is possible to reconcile the economic environmental and distributional performances of the policy reform. The phase out of energy consumption subsidies contributes to a 10% to 12% decrease in energy-related CO<sub>2</sub> emissions and to a 7.3% to 8.3% decrease in GHG emissions at the 2020 horizon compared with the baseline. These emission reductions exclude emissions from deforestation, which are large but highly uncertain and for which the model cannot make reliable projections. The IEA estimates that in 2010, CO<sub>2</sub> from forest fires were about 60% of total GHG emissions. Hence, the emission reductions achieved by the energy subsidy policy phase



out are substantially lower when including deforestation emissions. Since most of the initial subsidy rates for energy consumption were relatively low for industries and high for households, the emissions-reduction effort is mainly driven by households who decrease their energy consumption by 42% to 46%. All the scenarios give way to positive impacts on GDP at the 2020 horizon (+0.4% to +0.7% in 2020 with respect to the baseline), due to a decrease in the deadweight loss associated with the subsidies and also, in some scenarios, to higher savings and investment. The good economic performance of the *cash transfer* scenarios does imply a somewhat smaller improvement in environmental performance, as the general level of economic activity is larger. The food subsidies recycling scheme is the best option in terms of emissions reduction, though this is largely due to the less positive impacts on GDP.

107. Concerning the distributional impacts, the scenario projections suggest that for households the direct effect of the subsidy reform, arising from higher energy prices, is regressive, especially in urban areas, and that the effect through incomes is distribution neutral. However, the redistribution schemes can make the total effect of the reform progressive and pro-poor. The *cash transfer* scenario is the most progressive one of the scenarios investigated here. As cash transfers increase the incomes in the lower income quantiles, they lead to a lower decrease in energy consumption and associated CO<sub>2</sub> emissions for these household categories. The budget redistribution using food subsidies is less progressive than with cash transfers, and the effect on GDP is less positive, as the food subsidies generate new inefficiencies and induce less savings and investment. Transfers proportional to labour income, as used in the *labour support* scenario are regressive, as income earned from formal labour represents a lower proportion of total income for higher-income than for lower-income households. This poor distributional performance comes along side less positive impacts on GDP than in the case of food subsidies, but gives way to comparable levels of emission reduction.

108. However, it is necessary to consider the feasibility of such mechanisms and their performance with respect to other mechanisms that were not included in this paper's policy scenarios. Cash transfers, if used as the sole way to compensate households for the phasing out of the energy subsidy, would reallocate a fraction of domestic wealth almost equivalent to the one previously managed by energy subsidies: more than 2.5 % of GDP. The feasibility and the transparent implementation of such massive cash transfer programmes over long periods of time can be questioned. Alternatively, cash transfers might be limited and targeted to more specific household groups. However, over time the mechanism is not without problem, as entitlement to the cash transfers can create dependence to these and interplay with the activity choices of households at the expense of their contribution to economic growth. In addition, the implementation of large-scale and long-lasting cash transfer systems represents, for the public authorities, a challenge comparable to the implementation of a full-scale social-security system. For these reasons, cash transfers can be also considered as a transitional response to the decrease in energy subsidies. In this case, their role is to limit the detrimental effects on poor households in the short and medium term, while they would be replaced in the longer run, by alternative destinations for the avoided subsidy expenditures.

109. In addition, even though not captured in the scenarios investigated, subsidy reform could be an opportunity to reallocate government expenditures to the development of infrastructure and public services and public goods. If well-designed, this could create positive economic and social externalities, boost potential growth through increases in human capital, and reduce inequalities and poverty in the long run. However, simulating such policies, as well as their economic, environmental and distributional impacts, remains a challenge and is beyond the current capabilities of the modelling framework.

110. Lastly, this report represents an advance in the work of the OECD on the distributional impacts of environmental policies. The methodology developed, integrating detailed information on household behaviour in a full-scale socioeconomic model, is set up such that the analysis can be expanded to other countries. Countries like Egypt, Ukraine or Thailand, and to a lesser extent India and China, also rely on energy subsidies to households, however differences in local circumstances will influence the numerical

results and warrant separate studies. But more generally, the modelling framework lends itself well to the analysis of the trade-off between economic efficiency, environmental effectiveness and equity in both OECD and non-OECD countries.

111. However, there are severe limitations in the availability of suitable data, also for OECD countries, and reconciling detailed budget survey data into the macroeconomic model is very time consuming. Hence, future research could also be oriented towards less data intensive approaches by focusing on fundamental mechanisms at play in the trade-offs between economic, environmental and social performance of green growth policies. Such stylised analysis could for example focus on looking at different portions of the labour markets (e.g. through differentiating skill categories) or use synthetic indicators of household heterogeneity to mimic distributional consequences. Finally, distributional consequences of green growth policies extend beyond households, and it may also be worthwhile to study the differences in regional and sectoral impacts of green growth policies, thereby creating a link to competitiveness issues.

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## Appendix

## A GHG emissions and energy consumption in Indonesia

Table 9. Historical GHG emissions by source in Indonesia

	1990	2000	2005	2010	As % of GHG emissions in 2010	CAAGR (%) 2000-2005	CAAGR (%) 2005-2010
<b>Total GHG</b>	1101	1444	2829	1926	100	14	-7
<b>CO2 emissions</b>	858	1185	2412	1615	84	15.27	-7.71
Fuel Combustion	146	273	336	410	21	4.23	4.09
Fugitive	10	8	6	4	0	-7.92	-5.88
Industrial processes	8	13	15	18	1	3.62	2.94
Others*	694	891	2055	1183	61	18.20	-10.46
<b>CH4 emissions</b>	152	168	260	219	11	9.12	-3.36
Energy	37	46	49	68	4	1.44	6.83
Agriculture	82	79	98	94	5	4.51	-0.82
Waste	26	40	51	56	3	4.94	2.03
Others**	7	3	62	0	0	78.03	-66.20
<b>N2O emissions</b>	89	91	157	91	5	11.55	-10.23
Agriculture	55	60	81	66	3	6.17	-4.09
Energy and ind. processes	4	4	5	4	0	1.22	-1.81
Others***	30	26	71	21	1	21.98	-21.32
<b>Other GHG (HFC, PFC, SF6)</b>	2	1	1	1	0	0.46	3.99

\*Sum of direct emissions from tropical forest fires and of 10% of biofuel combustion emissions, which is the fraction assumed to be produced unsustainably (IPCC Source/Sink Category 5).

\*\*Includes industrial process emissions and tropical and temperate forest fires and other vegetation fires (IPCC Source/Sink Categories 2 and 5).

\*\*\* Others include N2O usage, tropical and temperate forest fires, and human sewage discharge and waste incineration (nonenergy) (IPCC Source/Sink Categories 3, 5 and 6).

Source: IEA CO2 Emissions from Fuel Combustion Statistics

Table 10. Historical energy-related CO2 emissions by sector in Indonesia

	1990	2000	2005	2011	% of CO2 emissions in 2011	CAAGR (%) 2000-2005	CAAGR (%) 2005-2011
<b>CO2 emissions</b>	146	273	336	426	100	4.23	4.04
Power generation	22	61	92	138	32	8.43	7.04
Other energy use	25	28	31	28	6	2.55	-2.10
Industry	44	76	98	118	28	5.19	3.14
Transport	32	65	74	115	27	2.61	7.60
Other	23	43	41	28	7	-1.02	-6.18

Source: IEA CO2 Emissions from Fuel Combustion Statistics

**Table 11. Historical final energy demand and fuels for power generation in Indonesia**

	1990	2000	2005	2011	Share in 2011 (%)	CAAGR (%) 2000-2005	CAAGR (%) 2005-2011
<b>Power generation (Mtoe)</b>	8.9	28.0	39.2	57.7	100.0	6.9	6.7
Coal	2.3	8.4	13.4	21.9	37.9	9.8	8.5
Oil	4.0	4.6	9.3	10.4	17.9	15.1	1.7
Gas	0.2	5.8	4.1	8.3	14.3	-6.6	12.3
Hydro	0.5	0.9	0.9	1.1	1.8	1.4	2.5
Biomass & Waste	0.0	0.0	0.0	0.1	0.1	29.7	44.2
Other renewables	1.9	8.4	11.4	16.1	27.9	6.3	6.0
<b>Final consumption (Mtoe)</b>	79.8	120.3	134.2	158.3	100.0	2.2	2.8
Coal	2.1	4.7	8.3	11.2	7.1	12.4	5.1
Oil	27.2	49.0	53.4	64.4	40.7	1.7	3.2
Gas	6.0	11.5	13.6	16.6	10.5	3.4	3.4
Electricity	2.4	6.8	9.3	13.7	8.7	6.4	6.8
Biomass & Waste	42.0	48.3	49.6	52.3	33.0	0.5	0.9
<b>Industry (Mtoe)</b>	18.1	30.6	35.5	44.9	100.0	3.0	4.0
Coal	2.1	4.6	8.3	11.2	25.0	12	5
Oil	5.5	9.3	10.1	10.0	22.2	2	0
Gas	1.9	5.2	7.1	12.5	27.9	6	10
Electricity	1.3	2.9	3.7	4.8	10.6	5	4
Biomass & Waste	7.2	8.6	6.3	6.4	14.2	-6	0
<b>Residential and services (Mtoe)</b>	42.4	54.6	59.1	61.7	100.0	1.6	0.7
Oil	6.5	11.0	10.2	7.0	11.3	-1.6	-6.1
Gas	0.0	0.0	0.0	0.2	0.3	3.0	27.2
Electricity	1.2	3.9	5.6	9.0	14.6	7.6	8.2
Biomass & Waste	34.7	39.7	43.3	45.6	73.9	1.8	0.9
<b>Transportation (Mtoe)</b>	10.7	21.9	25.1	39.2	100.0	2.8	7.7
Oil	10.7	21.9	25.1	38.9	99.2	2.8	7.6
Gas	0.0	0.0	0.0	0.0	0.1	-23.1	30.3
<b>Other</b>	8.6	13.2	14.5	12.5	100.0	2.0	-2.5
Oil	4.5	6.9	8.1	8.6	68.9	3.3	1.1
Gas	4.1	6.3	6.5	3.9	31.1	0.5	-8.1

Source: IEA World Energy Statistics and Balances

## B Reconciliation of the budget survey and CGE data

112. The household-level information from the survey data and the national accounting data from the model are reconciled in order to produce, for the base-year, a data set where individual incomes and expenditures are consistent with country-level totals that are used in ENV-Linkages. First, the incomes and expenditure categories from the survey data are assigned to social accounting categories. This step involves matching the micro accounting categories used in the survey with the macro accounting categories of the CGE model (Ivanic, 2004). For instance, categories the goods whose consumption was reported in the survey have to be mapped into the goods categories used in the CGE model. In the second step, the data are adjusted so as to ensure that, for each expenditure and incomes category, the sum over household is equal to the country-level total. This procedure is based on two successive cross-entropy minimization problems<sup>27</sup>: one for the incomes, one for the expenditures. As a result of these problems, the household-

<sup>27</sup> See Golan and Judge (1996) for details about cross entropy minimization problems.

level data are modified, but the weights of each household in total consumption that were given by the survey data are preserved. Note that some adjustments to the reconciliation problem have been necessary in order to ensure that, at the household level, the saving rates are consistent with the capital incomes.

### ***B.1 Imputation of the survey incomes and expenditure to the social accounting categories***

113. The expenditure module of the IFLS4 budget survey collects information on food, non-food goods and services on a weekly base, household items monthly and durable goods bought in the analysed year. For the sake of comparability with the national accounting data, the value of self-produced or not purchased goods was not considered as part of total expenditures as well as gifts given outside the household (Reimer and Hertel, 2003).

114. To map the survey's categories into the detailed (25 items) product categories used in ENV-Linkages, the approach used depended on the type of good considered. Special attention was paid to the imputation of energy product consumptions. The kerosene and the electricity expenditures could be obtained by a direct mapping with the corresponding survey category. Given that the IFLS4 survey does not isolate expenditures for gasoline, diesel and LPG, the expenditures for these products had to be extracted from broader consumption categories using additional information included in the survey. For the households owning a LPG stove, the LPG expenditure was approximated by total fuel expenditures. The gasoline and diesel consumptions were derived from the transportation expenditure categories of the survey (since the latter include the expenditures for "gasoline and the like") and from information about the vehicle ownership.

115. A specific imputation method is also used for housing services. The survey provides a detailed breakdown of expenditure components including actual housing rents and estimated ones for self-owned or occupied dwellings. Special attention is devoted to the latter category that usually is not considered for the income and expenditure computations in a micro framework. When rent is clearly a cost for tenants and it contributes to income of housing owners, the macro framework, classifies the ownership of the dwellings as an industry that sells housing services to tenants and receives a gross-rent at competitive prices (UNECE, 2011). This value, net of current expenses, also enters in the income computation of housing owners. In the choice of the imputation model, we followed the literature on estimation of dwelling services (EC, 2010) that considers location and household characteristics (rural/urban area, household size, availability of electric equipment and other facilities) as main explanatory variables, and expresses the rent in a logarithmic scale to better capture the non-linearity in the relation. Subsequently, we replaced the missing data with the average of generated values across imputations.

116. For the other goods and services, a simplified imputation method, using two-steps was used. First, the survey's expenditures were mapped into 5 broad categories (agricultural products, food products, manufactured goods, transportation and services). Then, the breakdown of these broad categories into the more detailed ENV-linkages categories was done with a proportional allocation based on the aggregate consumption structure in the ENV-linkages base year (2011) consumption expenditure for Indonesia.

117. The IFLS4 also collects information on total income received by all household's members, surveying the five main components of income: flows connected to economic activities (cash and in-kind), remuneration due to assets ownership, value of services produced for own consumption, transfers and inter-household flows (e.g. gifts). Expected, but not materialized earnings are excluded from income computation as well as holding gains/losses and irregular gains: e.g. lottery winning and lump sum pensions (UNECE, 2011).



118. The labour market section describes the occupation status of individuals (employed and self-employed), the sector of occupation and the remuneration (wages and net-profits, respectively). For the sake of micro-macro harmonization, the considered sectoral aggregation is: agriculture, electricity, manufacturing, transportation, construction and services. When the information about occupation was completely missing, we dropped the observation; instead, the missing yearly salary was integrated using the monthly data multiplied by the number of working months in the year. Sectoral information, in addition to province and urban/rural locations, was used for replacing the few left missing data using the conditioned mean technique. The year-end bonuses were included in the computation of yearly wage.

119. The salary section was merged with more specific information on net-profits of household businesses (farm and non-farm). Regarding the farm activity, the difference between incomes and total production costs was used to fill the numerous missing data gaps on net-profits. For firm businesses, incomes used for household consumption were considered a more reliable estimate of net-profits; they were elicited as the sum of “the value of production used for household consumption, the value of business net income used on household expenditures and the amount of cash left over” (Strauss et al., 2009); when missing, we used the net-profit data. Moreover, net-profits both for farm and non-farm businesses were complemented taking into account yield loss experienced and income generated from other production assets (purchases, sales and rent of land, livestock, buildings, etc.) in order to obtain the total income from production.

120. The property income consists of the incomes generated by household financial and non-financial assets not used in the production process. As anticipated before, the imputed rent (net of housing costs) from owned/occupied dwellings is an important component of income and is considered as the remuneration received for self-produced services.

121. The incomes are more difficult to be matched with the Social Accounting Matrix (SAM) categories. The main problems come from the choice of mapping procedure of business profits and wages from the survey to capital, labour, natural resources and land remunerations in the SAM. Following Ivanic (2004), we consider wages directly as labour remuneration as well as a portion of profits in farm and non-farm business computed using the average wage, sector and region specific. The left over profits from business and self-employed activities, in addition to property rents and dividends are accounted as generalised capital factor remuneration (capital, land and natural resources). The repartition of this aggregate is operated using the sector specific ratio of capital, land and natural resources coming from the CGE model.

122. The transfer aggregate includes monetary flows from government and non-profit institutions in the form of conditional and non-conditional support programs. Only 300 households report positive transfers, therefore for the other observations we imputed an average transfer depending on household size and income decile. We excluded from the computation inter-household flows.

### ***B2 Reconciliation procedure***

123. After the imputation process, the discrepancies between the aggregate figures in the CGE model and the total over households in the survey data have to be eliminated by reconciliation. The reconciliation procedure was designed to fulfil the following requirements:

1. For each good category, total the expenditure over the households must add-up to the CGE base-year value.
2. For each income category (labour, capital, etc.), the total over the households must add-up to the CGE base-year value.

3. At the household level, the total disposable income must be equal to the sum of expenditures and savings.
4. For all the households, the ratio between savings and capital incomes must be the same.

124. Requirements (1) and (2) are standard for the micro macro data reconciliation. But (3) was specified due to the inconsistencies observed at the household level between declared incomes and expenditures. Last, (4) was imposed, for the sake of the multi-period modelling exercise, in order to avoid in the baseline big reallocations of capital ownership between the households. Such reallocation would have significantly affected the dynamic of inequalities in the baseline and blurred the distributional analysis. A low savings rate is translated into a low marginal propensity to save (see Appendix B) and consequently into low capital accumulation in the baseline scenario. Identical savings to capital incomes ratios across households are used to avoid massive reallocation of capital incomes from households with low initial saving rates and high contribution of capital in their income to households with high saving rates with low initial contribution of capital in their income. A consequence of this rule is that there are no households with negative savings after the reconciliation.

125. The reconciliation procedure used to meet the four requirements was based on cross-entropy minimization problems (Golan and Judge, 1996) and can be summarized as follows. First, the expenditures are reconciled using cross entropy. Then, the household-level capital incomes and savings are computed by allocating the CGE model aggregate saving proportionally to the share of each household in total capital incomes as observed in the survey. Last, the non-capital incomes of households are reconciled with the survey using cross entropy minimization.

### C Calibration of the household's preferences parameters based on the survey

126. Each household group  $h$  containing population  $pop_h$  has the following type of utility function<sup>28</sup>:

$$u_h = \sum_i \{ mpc_{h,i} \cdot \ln(c_{h,i} - pop_h \cdot \theta_{h,i}) + mps_h \cdot \ln(s_h - pop_h \theta_{h,s}) \}$$

with  $c_{h,i}$  the consumption of good  $i$ , and  $s_h$  the savings. The preference parameters are the marginal propensities to consume  $mpc_{h,i}$ , the marginal propensity to save  $mps_h$  and adjustment parameters  $\theta_{h,i}$ , and  $\theta_{h,s}$ .

The household's demand for consumption good and the saving behaviour results from the utility maximization under budget constraint:

$$(c_h, s_h) = \operatorname{argmax} \left\{ u(c_h, s_h) \mid \sum_i p_i s_{h,i} + s \leq yd_h \right\}$$

The demand for good  $i$  and the savings are given by:

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<sup>28</sup> This form is very close to the utility function used for ELES demand system. The main difference is the adjustment term  $\theta_{h,s}$  for savings. This term is used here to make possible the survey replication for alternative Frisch parameters. This property would allow us to do sensitivity analysis on the price elasticities by changing the Frisch parameters.

$$c_{h,i} = pop_h \cdot \theta_{h,i} + \frac{mpc_{h,i}}{p_i} (yd_h - \sum_{i'} p_{i'} \theta_{h,i'} + \theta_{h,s})$$

$$s_h = pop_h \cdot \theta_{h,s} + \frac{mps_h}{p_i} (yd_h - \sum_{i'} p_{i'} \theta_{h,i'} + \theta_{h,s})$$

127. The household-group utility functions are calibrated on the consumption in volume ( $\bar{c}_{h,i}$ ), consumption good prices<sup>29</sup>, ( $\bar{p}_i$ ) and savings ( $\bar{s}_h$ ) taken from the reconciled survey; and also based on assumption about the income elasticities of demand ( $\eta_{h,i}$ ) and income elasticity of savings ( $\eta_{h,s}$ ) and for the Frisch parameter ( $fr_h$ ). By default, the Frisch parameters are equal for all the households, and the income elasticity parameters are based on the value used for the representative household in the standard version of the model.

First, the marginal propensities to consume and to save are:

$$mpc_{h,i} = \eta_{h,i} \cdot \frac{\bar{p}_i \bar{c}_{h,i}}{yd_{h,i}},$$

$$mps_h = \eta_{h,s} \cdot \frac{\bar{s}_h}{yd_h}$$

Then, based on the Frisch parameter, the  $\theta$  parameters are calibrated with formulas

$$\theta_{h,i} = (\bar{c}_{h,i} - mpc_i \frac{yd_h}{\bar{p}_i \cdot (-fr_h)}) / pop_h$$

$$\theta_{h,s} = (\bar{s}_h - mps \frac{yd_h}{\bar{p}_i \cdot (-fr_h)}) / pop_h$$

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<sup>29</sup> The consumptions in volume are retrieved from the households expenditures using the CGE price base year price.

**D The model's decomposition algorithm**Iteration  $k$ 