Worksheet 5.3

Letting Markets Work - the Malaysian Fuel Subsidy Goes bye bye

One of the recurring themes the IB Economics course is the conflict between good politics and good economics. Often when it comes to government, smart economic policy is sacrificed in order to achieve political favor with voters. Whether it's price ceilings on petrol in China, Zimbabwe's slashing of food prices, harmful import restrictions to benefit domestic producers, or the proposed suspension of gas taxes in a time when fuel conservation is really what's needed, politicians often act in economically stupid ways to bolster or hang on to their popularity.

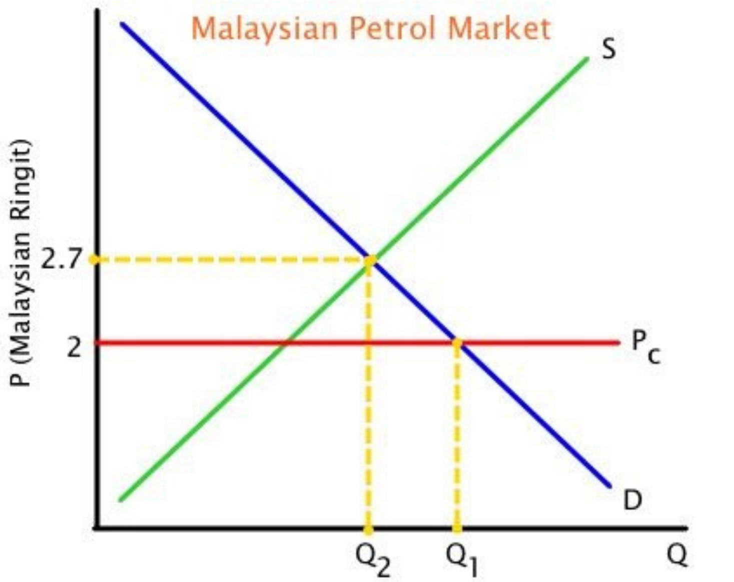
So when a government makes a bold move that is economically sound, it sometimes comes as a surprise. The Malaysian government has for years subsidized domestic fuel prices, which at under 2 Malaysian Ringgit per litre have been the equivalent of roughly $0.60 US per litre, far below the average price in the United States and Europe. Drivers benefited from this subsidy, but were not forced to bear any of the burden of rising oil prices, nor had they any incentive to conserve or switch to more fuel efficient automobiles or alternative forms of transportation. The Malaysian government, on the other hand, has had to allocate more and more of its limited budget towards subsidizing petrol prices.

In 2009, however, all price supports for petrol were cancelled. At the time, the effect of cancelling price supports was expected to be drastic in the Malaysian economy: look at this article, then read the second paragraph.

The subsidy would have cost the Malaysian government 56 billion Ringgit (around $17 billion) in 2009. With the money it saved by ending the subsidy, the government would begin making public transport cheaper and more convenient for commuters who wish to avoid paying for the more expensive petrol to fuel their personal automobiles: read the seventh paragraph from the article.

Malaysia is not the only country taking measures to end government fuel-price supports: read the ninth paragraph from the article.

As more and more countries allow the market mechanism to work, and in the



With petrol subsidy, drivers paid 2RM per liter. After subsidy, price rises to 2.7RM, reducing quantity demanded to Q2.

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short-run fuel prices rise with the price of oil, the chances are that the long-run equilibrium price of petrol will actually begin to fall.

Price controls and subsidies distort market demand. In Malaysia, where a government subsidy kept the price consumers paid around 2 RM, the quantity demanded exceeded the free market quantity. With the removal of the subsidy, consumers will respond by driving less, reducing overall quantity demanded for petrol. As other Asian nations follow suit, global quantity demanded for petrol will decline, while higher prices incentivize producers to increase output. New production facilities will come online, just as drivers begin to find alternative ways to get to work, either through carpooling, public transportation, cycling or walking.

The combined effect of slowing increases in demand (or perhaps even a decline in demand if enough substitution of alternative forms of transportation takes place), and increases in supply as new production facilities come on line will be a stabilization and eventual fall in the price of oil.

The future fall in oil prices is explained in more detail here.

Malaysia's repealing of the fuel subsidy is one example of how markets work to restore equilibrium in a market such as that for oil.

Questions:

1. Why does a subsidy create disequilibrium in a product market like the petrol market in Malaysia?
2. Give two examples of how consumers may respond to the 40% increase in petrol prices once the subsidy is removed in Malaysia.
3. How could making fuel more expensive to consumers in the short-run actually lead to a fall in oil and fuel prices in the long-run?
4. What other policies could the Malaysian government implement to make transportation more affordable to commuters in Kuala Lumpur or elsewhere in Malaysia?

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