Who’s Really Paying for Oil?*

C.P. Chandrasekhar and Jayati Ghosh

We used to hear a lot about how the government has to bear a high subsidy burden for oil products. Along with that, there would be discussion of how these wasteful subsidies on food and fuel are “inefficient” and prevent the growth that would result from cutting them and so giving private investors the signal that the government is willing to move against such “populist” measures.

In truth, the opposite has been true for a while now – at least in the petroleum sector. Far from having to pour its fiscal resources into oil subsidies that it can ill afford, the central government in particular has been a net recipient of substantial income from the oil sector. At least for a decade now, the total of customs and excise duties received on oil products by the central government alone has been significantly more than the sum of “under-recoveries” of the petroleum companies and all direct subsidies to consumers. In addition, the profits of the publicly owned oil companies provide another source of revenue for the government.

So petroleum products in India have not really been “subsidized” since the government has taken back much more in the form of taxes than it has provided in the form of subsidies that are supposed to keep retail prices low. And of course, state governments add their own sales taxes on petrol and diesel. In the period of low global prices, this has been the source of an extra bonanza for the government.

As a result, Indian consumers have ended up paying higher prices for petrol and diesel than their counterparts in the United States and Japan, both countries in which per capita incomes are many multiples higher. This high price of basic fuel is also quite remarkable policy for a country that has been struggling with relatively high rates of inflation, as fuel is a universal intermediate whose costs feed into all other prices, including especially those of essentials like food.

We do not have published data on the disaggregated structure of the oil prices. However, in 2009, the then Minister of Petroleum in the UPA government informed Parliament that the composition of retail petrol prices in Delhi included 31 per cent for excise duty of the central government and 17 per cent for sales tax imposed by the central government. Since then, things have only got significantly worse, especially in the current fiscal year when excise duties on petroleum products have become the big moneyspinner for the government as other revenues have fallen well below the budget projections.

Taking advantage of the dramatic fall in global oil prices, the Modi government announced that it would decontrol fuel prices and end the subsidies on petrol and diesel that compensated for under-recoveries of oil companies, thereby sharply bringing down its fiscal spending under that head. Because of the good fortune of low world prices, at the time this actually meant no increase – and even a slight fall – in domestic retail prices.

However, since then the government has actually been reversing that effect by adding on taxes that prevent the domestic retail prices from falling as global prices continue to fall. In effect, therefore, oil prices in India are still controlled by government – only they are controlled so as to deny consumers the benefit of price declines. Deregulation apparently only means that consumers must take on the burden of global oil price increases; any benefits of falling global prices will be negated by tax increases.

From around July 2014, oil prices in international markets started falling quite sharply, and indeed the rapid pace of decline has surprised even those who anticipated some “softness” in this commodity. Oil importers like India are obvious beneficiaries of this process. As Chart 1 indicates, the weighted average price of Indian oil imports has fallen by around 45 per cent in the past three months, from around US$100 per barrel on 2 October 2014 to around US$55 per barrel on 31 December 2014.

However, after an initial decline, domestic prices have not declined. In fact they have stayed around the same level despite further declines in the global price of crude oil of more than 30 per cent. To some extent this is because the oil companies did not pass on the benefits of lower prices of crude oil, but simply added on to their profits (something that could have been prevented if prices were still regulated). But the real culprit since then has been the central government, which has raised excise duties no less than three times since early November.

Chart 2 shows the cumulative impact of these increases: on 12 November, 2 December and 1 January, which increased the excise duty over this period by Rs 6.95 (unbranded) to Rs 8.10 (branded) per litre on petrol and Rs 5.96 to Rs 8.25 for diesel. This is expected to provide an additional sum of approximately Rs 10,000 crore to the government, which it claims it will spend on highway construction.

Since fiscal revenues are fungible, this is a debatable point. It could equally plausibly be argued that the money will finance any other likely expenditure of the government, such as building the enormous memorial to Sardar Patel that is planned to be the biggest statue in the world. So it is absurd to say this additional tax revenue is required to fund public investment (such as on roads) that would otherwise not have occurred.

Chart 1

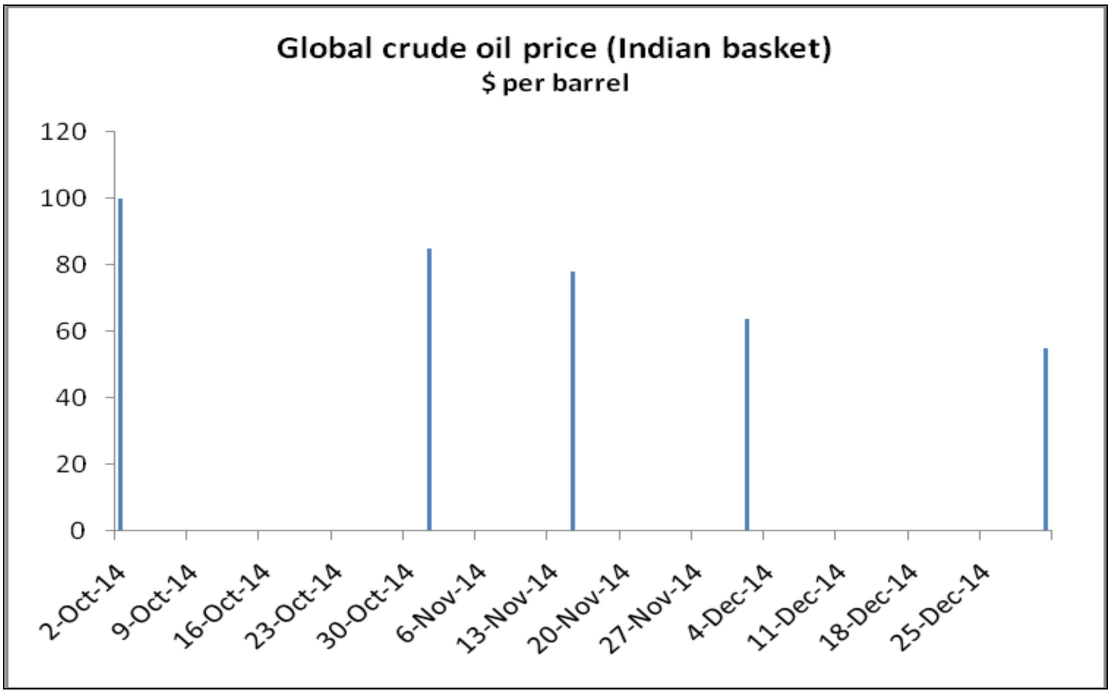
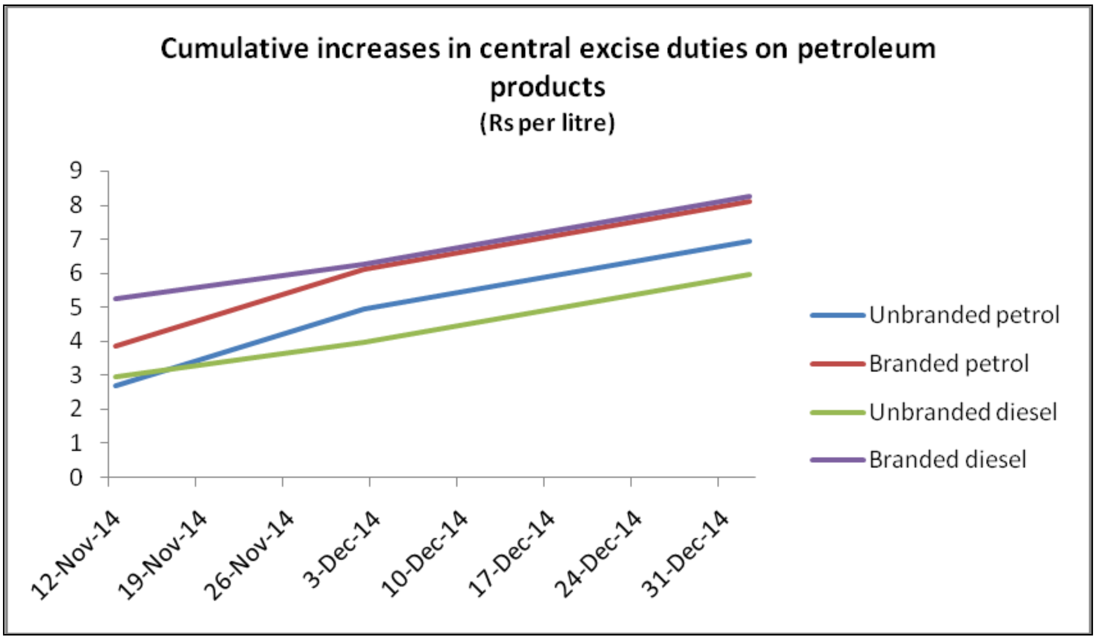


Chart 2



The real purpose of this strategy is clear: it is to help the Finance Minister meet his target of the fiscal deficit at 4.1 per cent of GDP, despite falling revenues relative to projections (for all categories except the oil duties). This additional use of regressive revenue-raising measures falling disproportionately on the poor is being combined with savage cuts in the budgeted expenditure on essential social spending such as on rural development, employment, health, education and nutrition.

Why is this attempt to constrain the fiscal deficit to this predefined limit seen to be necessary? Partly it is to appease foreign investors, who are apparently wedded to this pre-declared number, even though it has no particular sanctity. But the official reason is that controlling the fiscal deficit is necessary to control inflation, because a larger fiscal deficit leads to excess demand pressures that cause aggregate price levels to go up. And since inflation adversely affects the poor, that is claimed to be a" pro-poor" measure.

But don't fuel prices matter for inflation? And if fuel prices affect costs of cultivation and of transport, then obviously they affect the prices of essential commodities in particular. So a policy like this actually operates to keep fuel prices high for workers and the poor in general. In other words, they are the ones paying the price in terms of continued high petrol and diesel prices, while the government and the oil companies (public and private) reap the benefits of the low world price.

The politics of this is openly expressed in the Mid-Year Review of the Finance Ministry (14 December 2014), which gloats that nominal wage increases have been suppressed over the past few months. Indeed, they have slowed so much that they are now falling behind the rate of inflation, translating into real wage declines. The review notes that the "combination of softness in the economy and reductions in MGNREGA expenditures (declines of 3 and 36 percent in the last two years) have played a key role" in ensuring this. The review expresses the hope that rural wages will continue to decelerate, thereby further dampening inflationary pressures.

Since declining real wages are seen by this government as a cause for celebration, lower inflation is not supposed to help the poor. Instead, by getting lower wages and paying more for essential items, the poor are contributing to “acchhe din” for a few.

*** This article was originally published in the Business Line on January 5, 2015.**