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Fiscal Effects and Reforms – Petro-fuel subsidy in India

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Abstract

The administered price of petroleum products in India is much lower than their actual market value. Huge subsidy burden is borne by the government in order to compensate the mounting under recoveries of the public sector oil companies, causing a mammoth fiscal cliff on the government budget. Many measurers have been recommended to propel the reform process for subsidy abolition or reduction in some cases, but political compulsions are putting constraints on the execution of such recommendations. Both short terms as well as long term measures are needed to be adopted in order to continue the much needed reform for petro-fuel subsidy payments on behalf of the government in order to avoid the mounting fiscal slippage.

Key Words: Subsidy, under recovery, fiscal Cliff, reform, Political Compulsion.

Introduction: India meets bulk of its petroleum demand through crude oil import and supplies various petroleum products on a lower price after refining at home bearing huge amount of subsidy, thus creating a wedge between consumer prices and producer cost. In the first part of this discussion, the nature and extent of petro-fuel subsidy in India are discussed. In the second part the problem related to the barrier of fiscal cliff which is generated due to huge fuel subsidy offered by the government are analysed. The third part of the discussion is based on some necessary reform measures for subsidy allocation adopted by the government and the eventual obstacles faced for the execution of those reform measures. At last a conclusion is drawn.

I

Fossil fuel price subsidy in India in the year 2010 was over US $ 20 billion, fifth rank in the world. Almost 70 percent of the country's fossil fuel price subsidies in that year drained to create a lowered oil price. In August, 2013, the then Petroleum Minister M. Veerappa Moily said in a written reply in the Parliament that the estimated demand for 2013-14 of petrol, diesel and LPG was 16,335 million tones (MT), 73,500 MT and 16,712 MT respectively. He also added that 78.75 percent of crude oil demanded in India was required to be imported. So there was a sustaining crucial role of the strength of the currency of the importing nation in the international market.

As per the working group report for the 12th Five year Plan, the estimated demand for petroleum products during 2016-17 will be 186.2 million MT. The net import of LPG and lubes was 6093 thousand MT of Rs. 30,402 crore value and 1409 thousand MT of Rs. 8877 crore value respectively during 2012-13. Petroleum subsidy contributed nearly 26 percent of the total subsidy value (including food and fertilizer) offered by the government of India in the year 2010-11. There should be more efficient use of petroleum fuel following a way of minimized use that complies with the market price mechanism. The petrol price was deadministered in June 2010, but still there are heavily subsidized LPG, diesel and PDS (Public Distribution System) Kerosene. In the financial year 2011-12, three major public sector oil companies were forced into Rs. 1.32 trillion under-recoveries producing a colossal volume of subsidy burden on them and eventually to the government.

The pricing system of petro-fuel in India guided by the method of Trade Parity Pricing (TPP) which is comprising of 80 percent Important Parity Price (IPP) and 20 percent Export Parity Price (XPP). As there is an excess refining capacity in India, the country is a net importer of crude oil but a net exporter of petroleum product. Petro-products produced in India are so priced as if they are imported directly from Arabian Gulf, really a faulty method. Converting this price to Indian rupee IPP is achieved with an additional mark-up of customs duty and import charges. Naturally the administered price of petroleum products in India other than petrol and aviation fuel is much lower than TPP. This gap is known as underrecovery which is compensated by the government as subsidy sometimes partially or sometimes absolutely. But it is very hard to explain that such underrecoveries can be accepted as loss.

Quantum of subsidies and underrecoveries in the petro-fuel sector in the financial year 2010-11 can be obtained from the official source of the Ministry of Petroleum and Natural gas. PDS kerosene got a fiscal subsidy of Rs 931 crores with underrecovery of Rs. 19484 crore. In the same period domestic LPG enjoyed fiscal subsidy of Rs. 1973 crore with underrecovery of Rs. 21,772 crore. In case of petrol and diesel, the extent of underrecovery went upto Rs. 2227 crore and Rs. 34,706 crore respectively in the year 2010-11. So it is quite clear that such mammoth figures of underrecoveries occur as subsidy provides only a part of the gap between the cost price and the administered selling price of the petro-products.

II

India is facing a steep fiscal cliff due to fuel subsidy since 2010-11. 2.5 percent of its GDP drained out in form of state subsidy for food and fuel. Rs. 81000 Crore contributed in fuel subsidies, within which Rs. 3000 crores was direct cash subsidies in the year 2011-12. Bulk of such subsidies was used to make up underrecoveries of the Public-sector oil companies. In 2010-11, total expenditure on subsidies grew by 26.7 percent compared to the previous year. In the Union Budget 2012-13 governments cleared its intention to maintain the level of gross subsidy to under 2 percent of GDP and reducing to 1.75 percent over the following three years. But the fact occurred just reverse. By July 2012, the government of India reportedly spent most of the budget allocation for fuel subsidy (US $7.6 b).

The economic theory suggests that unwarranted subsidies lead to inefficiency and a negative impact on GDP per capita. The continuous depreciation of the value of Indian rupee in 2013-14 increased the import bill remarkably. One US dollar was exchanged for almost Rs 70 during the second and third quarter of the financial year 2013-14 which caused rising current account deficit and rapid inflation. All these events produced a cumulative impact of fiscal slippage.

Rupee fell a record low on August 2013, putting pressure on Indian's import bill. At that moment an increase in the per barrel crude oil price created a dual impact on the largest component of India's import expenditure. The subsidy burden rose enormously causing widening budget deficit to around 5 percent of the GDP in the fiscal year 2013-14. Country's total fuel subsidy cost in the financial year which ended on March 2013 was Rs 1.6 trillion ($ 23.5 billion). The total fuel subsidy rose by Rs. 200 billion in the next financial year (2013-14) with an assumed exchanged rate of Rs. 68 and Brent crude oil price at $109 per barrel.

III

As it was mentioned in the previous part of the discussion that the government of India spent most of its subsidy allocation in budget by July 2012, i.e just at the beginning of the second quarter of that fiscal year, one can easily conclude that the government was in no way to control the subsidy volume, rather at the verge of a fiscal slippage. So serious efforts of fiscal reforms in the field of fuel subsidy is needed. From the beginning of the second decade of the running century, government of India is on a serious thought about fuel subsidy reform. In 2010 Kirit Parikh Committee set up by the government recommended some crucial reform measures. They were absolute deregulation of petrol and diesel prices and gradual or phase wise abolition of subsidy of domestic LPG and Kerosene under Public Distribution System (PDS). Later Kilcare Committee Report 2012, recommended the elimination of diesel subsidies over a two year period followed by full price deregulation in 2014. But here one should agree with the opinion that in a country like India where around 30 percent of households have consumption level below the national poverty line, government should adopt enough awareness programmes among the people before starting to withdraw any type of facility already in practice.

So any version of reform should be preceded by the campaign on behalf of the government pointing at the target and urgency of that reform process. Massive pressure of fiscal burden along with changing international financial scenario; those are able to magnify the burden of subsidy is also harder to consume as a concept by the common people. Government here should be patient and analytical to its citizens regarding the mass campaign about the fiscal cost and regressive nature of fuel subsidy benefit. So the reform programme should be clear and communicative. There should be a clear timeline of subsidy elimination. As the subsidy reform will cause remarkable increase in fuel prices, such a policy should be adopted gradually, allowing much time space to the common people in order to improve the efficiency of their domestic kitchen energy management.

Actually public anger, coalition politics and political influence have made the Indian policy makers cripple. So once reforms take their gear up, decelerate immediately after. Let us discuss the issue of capping the number of LPG cylinders of 14.2 kg for each household (connection) per financial year. If the cent percent value of the imposed subsidy was to be eliminated, government needed to increase the price of Rs. 410 per cylinder to almost 200 percent. So a quantity ration system was imposed which made the limit of six cylinder per connection at the subsidies rate per year, from September 2012. The intention of the then congress led UPA government was quite clear. The removal of subsidy on consumption above the level of six cylinders would not put a large impact on the lower income households as they tend to consume less LPG as kitchen fuel. But the result of such reform measure yielded a disastrous outcome to the coalition government. On January 2013 the Cabinet Committee of Political Affairs raised the cap on supply of subsidized LPG from 6 per year to 9 per year. Again just after one year on January 2014, the annual cap on LPG at a subsidized rate increased to 12 cylinders per year just before the general election. So here reform was unable to overcome the political cliff.

Next the issue of Direct Benefit Transfer (DBT) in form of direct cash transfer which the UPA2 government at the centre adopted as a tool of inclusive growth turned as a failure in case of LPG subsidy. Consumers needed to receive their LPG subsidy value directly to their bank accounts. In the mean time they had to pay the market rate of around Rs. 1200 per cylinder to their distributor against the issued bill. For this each consumer had to obtain an Aadhar Card (Unique Identification Card) from the government and attach his or her respective Aadhar Number to his or her bank account. Such a programme was also suspended on January 2014, following a verdict of Hon'ble Supreme Court and mass harassment for availing an Aadhar card. The DBT scheme on LPG, at the moment of suspension covered 17 million consumers covering 291 districts in India with transaction amounting to Rs. 3000 Crores. So clearly the government's reform process was put on the back burner.

Now the case of diesel subsidy can be viewed. Here also reform is urgent. There is a wide gap between deregulated petrol price and semi-deregulated diesel price in India. Relatively cheaper diesel is causing remarkable substitution of diesel vehicles for petrol carts, specially the SUVs. So increased consumption of subsidized diesel is multiplying the already heavy fiscal cost of diesel subsidy. The complete removal of subsidy on diesel was possible in mid-2014 if a gradual increase of Rs. 0.5 per month in the price of diesel could be regularized from mid 2013. But still it is a reform target, rather achievement.

Conclusion: From the above discussion it is quite clear that there is a problem of political rollback in case of reform process regarding both the nature and mode of delivery of the subsidy benefit to the people on behalf of the government. Some definite and determined steps are needed to be executed. So many recommendations both short term and long term can be put forward regarding this issue. The problem of exclusion and inclusion should also be addressed properly. In case of PDS kerosene so many actual BPL consumers are deprived from the PDS facility where as there are so many fake BPL cards exist all over the country. Here some pilot studies should be performed to find the areas of the country where cash-transfer will be more beneficial. A cross-section of both rural-urban and poor-middle income group of the population should be monitored in the said areas of study. A serious framework of monitoring is an essential part for evaluating the performance of any cash-transfer programme. An independent evaluation authority in order to carry out domestic surveys or the cash-transfer programme should be set up. Capping of subsidized LPG cylinders is obviously an efficient quantity based control of subsidy which can help to increase the penetration of LPG as a more energy efficient and less polluting kitchen fuel. A calibrated decontrol is necessary over a span of time for the subsidy-free price of the LPG. In addition to that an improved and intensive BPL survey work has to be adopted over the next few years for efficient cash/benefit transfer to the actual needy section of the fuel users.

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