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What do falling Crude Prices mean for India's Fiscal Deficit?

Summary of a Roundtable organised by Observer Research Foundation

INTRODUCTION

The Observer Research Foundation, CRM held a focus group meeting on the topic 'What do falling Crude Prices mean for India's Fiscal Deficit?' on February 9, 2007. Shri S C Tripathi, former Secretary, Ministry of Petroleum & Natural Gas, Government of India, chaired the discussions. Participants included stakeholders from the Ministry of Petroleum & Natural Gas, the Private Sector, the Public Sector, Research Institutions and Industry Associations. This policy brief highlights issues discussed and the broad conclusions reached.

BACKGROUND

India's Fiscal deficit of Rs 1,40,955 crores in 2001-02 equivalent to 6.1 per cent of GDP was the highest in recent years but has fallen ever since. India's 2003-04 budget defied the trend of budget estimates of revenue receipts being consistently overestimated compared to actual receipts. The actual revenue collections exceeded not only the budget estimates but the revised estimates as well. This significant improvement in public finances since 2002-03 has been attributed to policy efforts at fiscal consolidation as well as the upturn in economic activity. But is there another side to the success story? Is part of the credit due to high crude oil prices?

Under the Administered Price Mechanism (APM), which was in place until April 2002, prices of petroleum products were determined on the basis of a cost plus formula with a more or less stable burden of duties and taxes that were dependent more on trade volumes rather

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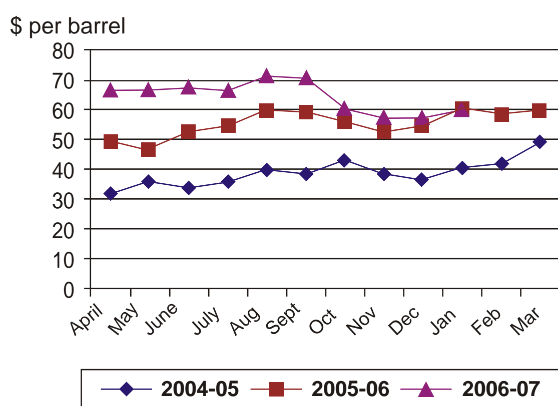
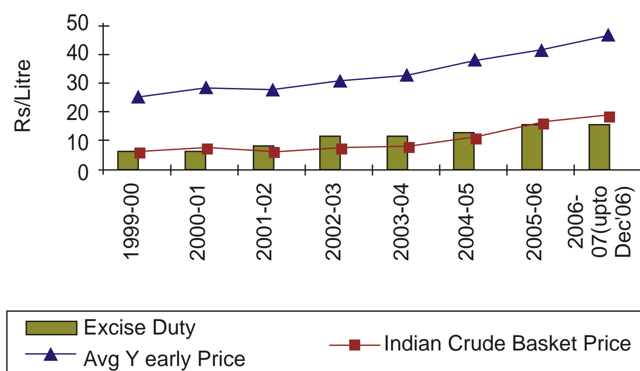
than fluctuations in market prices. The post APM period began with an ad-valorem structure of duties and taxes which in effect meant that revenues from the oil sector moved in tandem with the dramatic rise in international crude prices.



Source: Statistics compiled & adapted from Petroleum Planning & Analysis Cell.

As crude prices soared, cess on crude production was first doubled to Rs 1800 in April 2002 and then raised to Rs 2500 per tonne in April 2006. The excise duty on petrol in Delhi increased from Rs 5.32 per litre in 2000-01 to Rs 15.11 in 2006-07, a rise of almost 300 per cent. For diesel the corresponding increase was from Rs 2.55 to 5.19, a rise of 200 per cent. The price of the petrol in Delhi nearly doubled between 1999 and 2006 while the excise component increased three times in the same period. At present, 52 per cent of the price paid for petrol at the pump in Delhi consists of duties and taxes. This figure was as high as 56 per cent during peak prices.



Source: Statistics compiled & adapted from Petroleum Planning & Analysis Cell.

The net result was that the contribution of the Petroleum Sector to Central Revenues (even when not fully accounting for the contribution from all segments) rose from Rs 46,603 crores in 2001-02 to Rs 87,647 crores in 2005-06. The impact on state revenues was as great. Had crude prices remained at 2002 levels, revenue collections by the Centre would have been at least Rs 20,000 to Rs 25,000 crores lower.

However, what was disconcerting about this rise in collections was that the increase in revenue mobilization was not used to finance the increasing subsidy burden on kerosene and LPG. Instead, the subsidy to the oil companies was kept constant at Rs 2,930 crores and the balance was made up by either the oil companies by way of intra and inter company adjustments or transferred to future budgets by way of oil bonds. Oil bonds for Rs 14,500 crores were issued in 2005-06 and Rs 28,300 crores for the current year. The projected shortfall for 2006-07 by way of under recoveries is Rs 49,000 crores. What is pertinent is that this is so in spite of Rs 12,500 crore secured by way of price discounts on crude, Rs 3,225 crores available from the sale of ONGC shares, shift from import parity to trade parity and 2.5 per cent cut in custom duty on petrol & diesel. Oil bonds issued to cover these liabilities not only postpone the resolution of the issue but also compound the medium to long term economic and financial costs even if they help balance fiscal budgets in the short term. As the oil bonds issued by the Government do not qualify for statutory liquidity ratio (SLR), they trade at a discount to a Government security of comparable tenor.

In the era of rising crude prices, the excise duty on petrol was rationalised from a high ad-valorem rate of 23 per cent to 8 per cent while the fixed component was increased from Rs 7.50 per litre to Rs 13 per litre. Now would a high fixed component be justified or sustainable in the era of falling crude oil prices?

A recent Cabinet note from the Ministry of Petroleum & Natural Gas has sought extension of the subsidy scheme on domestic LPG and PDS kerosene until March 31, 2010. The current subsidy scheme expires on March 31, 2007 and in the absence of an extension, the prices of kerosene and LPG will have to be raised sharply. What is significant is that the Ministry has sought that the Budget would have to meet the full subsidy on these two products from next fiscal, against the existing norm of providing it on a flat-rate basis. Assuming crude oil prices at this year's level, the Ministry of Finance would have to set aside about Rs 28,600 crore ($ 6.4 bn) as subsidy on LPG and kerosene alone in Budget 2007-08. This will immediately impact the deficit targets under the Fiscal Responsibility & Budget Management Act.

ISSUES

- Should crude prices fall again as they have been doing what would be the net impact on the revenues to the Centre?
- Is a high fixed component in the excise duty structure justified in era of falling crude oil prices, as it would hurt the consumer to protect revenue mobilisation for the exchequer?

- Shouldn't the transfer of current liabilities to the future by way of bonds be the weapon of last resort? Could the transparency in provisions for subsidies be improved?
- How could tax collections from the Petroleum Sector be managed so that they are in the long term rather than the short-term interests of the economy in a situation where volatility in crude prices is expected to be the norm?
- Aren't policy makers introducing APM through the back door with continued manipulation of petroleum product prices without withdrawing the 1997 notification announcing the phasing out of APM between 1998 and 2002?
- How could the petroleum tax regime be managed so that revenue mobilised may be utilised to provide fiscal incentives for the Energy Sector that is vital for the economy?
- How would India's reform process progress when legacy issues continue to impede deregulation?

The collective thoughts of the distinguished gathering at the focus group meeting are synthesised broadly into the following categories:

Revenue mobilization from the Petroleum Sector

- Justification for current tax structure
- Shift of Income from the Infrastructure Sector

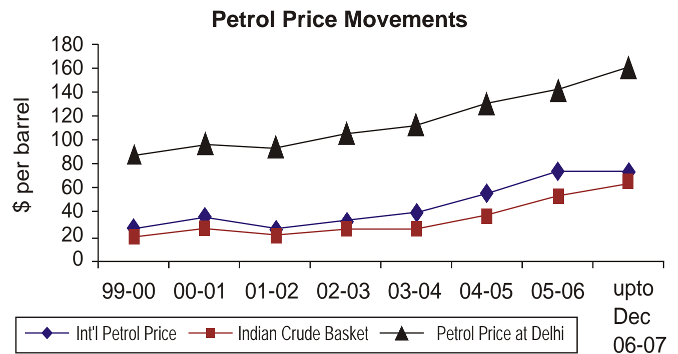
Implications for the reform process

- APM through the back door?
- Implications for competitiveness in the retail segment

REVENUE MOBILIZATION FROM THE PETROLEUM SECTOR

Justification for current tax structure

There is no doubt that high crude oil prices have contributed to improving India's public finances in the short run. The pass through burden in the consumer price of petrol in India is as high as 1.25, which means that more of the rise in international crude price is passed on to the retail price of petrol. The paradox is that the retail price actually does not really reflect the market price because of high levels of taxation. In diesel, the pass through is lower at about 0.66.



Source: Statistics compiled & adapted from Petroleum Planning & Analysis Cell

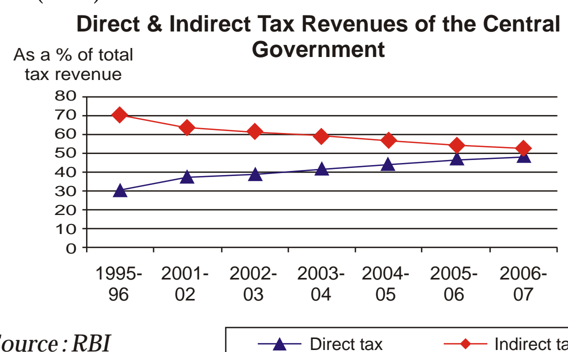
As illustrated in the above figure, the difference between crude and petrol price is about $10-12 per barrel in the international market whereas, in India, it is around $70-90 per barrel. As a result, the price of petrol in Delhi is at least twice the price of petrol in the international market.

The high level of taxes on petroleum products translates into 30 per cent of central tax revenue in net terms and 23 per cent in gross terms. The states mobilise about 30 to 55 per cent of their revenue from the Oil Sector.

There are some signs of improvement as far as the Central government is concerned. The contribution of excise duty in total tax collection has come down from 38 per cent in 2002-03 to about 30 per cent in 2005-06. However, the share of excise duty from Petroleum Sector in the total Central excise duty has increased significantly from 18 per cent in 1997-98 to 42 per cent in 2005-06.

The share of indirect taxes in tax mobilisation by the States has remained at about 87 per cent of total tax collections since 1995-96 in contrast to the Central Government, which has reduced the share of indirect taxes from 70 per cent to about 52 per cent. This is a trend seen in developed countries and as India develops increasing direct tax revenue may equal or even exceed indirect tax revenue in the future.

The vagaries of sales taxes on petroleum products levied by the States in the range of 20 per cent to 32 per cent could be avoided by bringing all petroleum products under the VAT regime. This would bring down the price of petroleum products to world's average level and also pave the way for implementation of Goods and Services Tax (GST) in 2010.



Source : RBI

Within the excise component in Central tax structure on petroleum products, specific duties have been frozen at the time of high prices rather than the time of low prices. If the specific component remains high while crude prices fall, the government would effectively be protecting its revenue at the expense of the consumer. Higher tax collections on account of high crude prices are an aberration especially when they cannot be justified by actual increase in subsidies. They can, however, be justified, if they are used effectively to cushion the shock arising due to crude price volatility or for developing alternatives to oil.

There is no doubt that tax on petroleum is a very convenient way of raising revenues. The transaction cost of collecting the tax revenue from millions of consumers is extremely low and in addition revenue is assured, as the price elasticity of demand for petroleum products is low. However ease of collection may not be a rational justification for increasing or sustaining high levels of tax on petroleum products.

There is lack of transparency on what happens to the taxes that have been collected, or on how and to whom subsidies are actually dispensed. In such a situation, there is a tendency on part of the governments to become profligate on the expenditure side. The comfort of assured revenue from the Oil Sector is leading to complacency in mobilizing other sources for revenue.

There would be no quarrel over high taxation if there is transparency over why the revenue is being raised. If it is for the purpose of cutting down consumption of petroleum products or if it is for subsidizing the consumption of economically challenged sections of the population, both of which are socially relevant expenditures, there would be no argument against high taxation. The problem arises when the taxation and the revenue streams are structured with little or no transparency at the end use of the revenue spectrum. This also impacts the efficiency of end use of the subsidized products and leads to diversion and leakages.

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There have been forecasts that a $10 per barrel rise in oil prices would reduce the GDP by 0.5 per cent and increase inflation by 1 per cent. In 2003-04 crude was $27/bbl, in 2004-05 it was $38-39, in 2005-06 it was $55 and this year it is around $60. The respective figures for GDP growth rate at factor cost (1999-00 prices) were 8.5, 7.5, 9.0 and 9.2 (Quick Estimate). The GDP seems to have defied forecasts.

The extent of revenue generation, partly on account of high oil prices, has brought in liquidity to the system. In addition, the increased share of the Service Sector in the GDP has weakened the close link between oil prices and GDP. However this weakening may not continue indefinitely. Life style changes induced by income growth in the Service Sector such as increase in the use of personal transport may increase consumption of oil in the future.

In medium to long term, it is neither in the interest of public finances nor the Ministry of Finance that the oil prices are high. Oil prices have a significant impact on other revenues and expenditures of the government. Lower selling price of petroleum products leads to lower profits, lower corporate tax collections and dividends. Sustained high oil prices will eventually affect GDP and lead to lower income and further lower corporate tax and income tax from other sectors.

Shift of Income from the Infrastructure Sector

High taxation of petroleum products is causing a significant transfer of income from what is essentially an Infrastructure Sector. While increased revenue mobilisation ensures that the government remains complacent about social schemes even when they have demonstrate large-scale leakages. And scrutiny mechanisms tend to become lax. The transfer of income from an Infrastructure Sector may not be in the long-term interest of the country, especially when it comes to investment in energy infrastructure in the interests of the long term energy security interests of the country.

Historically, oil companies have ploughed back reserves for the creation of extensive petroleum infrastructure. In the current environment all reserves are being squeezed out of the oil companies through the burden sharing mechanism. Consumers, Oil Companies and the Government supposedly share the burden of high crude oil prices equally. But the Government passes its share of liabilities to the future by issuing oil bonds to downstream companies. When bonds at the disposal of oil companies trade at a discount compared to paper of comparable tenor, how does an oil company generate funds for investment in infrastructure? Any incentive for efficiency gains in the Upstream Sector is also wiped out

as the Government corners the surplus of upstream oil companies.

According to the Ministry of Finance, development cess collected from PSU oil companies is diverted towards subsidies to the fertilizer segment. Using development cess, which is intended for capital investment for revenue expenditure, is counterproductive.

India is said to be 'poised' for major investment in Petroleum Sector, but if, government policies for revenue generation do not change, no investment will flow into energy infrastructure by PSU oil companies that dominate the market. For proof, one does not have to look beyond the fact that the Private Sector has doubled refining capacity, while the Public Sector has not been able to commission the 11 billion tonne capacity expansion planned in the Tenth Plan.

IMPLICATIONS FOR THE REFORM PROCESS

APM through the back door?

Petroleum product prices continue to be manipulated despite the fact that the 1997 notification announcing the phasing out of Administered Price Mechanism (APM) between 1998 and 2002 has not been withdrawn. The Government appears to prefer introducing APM through the back door rather than letting the market decide. Is this also because a complete shift towards either the market mechanism, or a proper APM regime will reduce the ability of the Government to protect its revenues?

> It is one thing for companies to indulge in monopolistic and predatory pricing tactics but quite another for the Government to do the same. In such a situation the affected parties do not have any forum for redressal of their grievance, as the regulatory mechanism is yet to fall in place.

With 'back door APM', oil companies are not only running into huge losses but are also made victims of policy uncertainty and discrimination with no avenue for recourse. Despite limitations of the APM regime, it provided policy certainty that was a vital incentive for investments. During the APM regime, PSU companies interpreted growth as investment and invested extensively in infrastructure, even when there was no pressing demand for infrastructure. But under the current situation - APM by back door - no company knows how much resource it has or how much it should invest.

A more serious allegation may be laid upon the Government. The Government has not only reintroduced subsidy through back door but has also distorted the market by keeping the private players completely out of the scheme. There is no parallel anywhere in the world of introducing subsidy in to the system that was supposedly market determined and not make it available to all players. This can only be interpreted as the Government becoming party to regulated pricing and restrictive trade practices. It is one thing for companies to indulge in monopolistic and predatory pricing tactics but quite another for the Government to do the same. In such a situation the affected parties do not have any forum for redressal of their grievance, as the regulatory mechanism is yet to fall in place.

Implications for competitiveness in the retail segment

The current policy on pricing petroleum products is a major stumbling block in investment decisions of players in the segment, both from the Private Sector and the Public Sector. In addition, current policies go against the primary motive for introducing reforms, which is to bring benefits to the consumer in terms of better quality of the product and better service.

The range of taxation on petroleum products is so wide that it is difficult for competition to come into play in the retail segment. High taxation is also a barrier to entry of new players into the segment. Central and state level taxes do not offer any flexibility for oil companies to recover their costs from the consumer, which makes it impossible to introduce efficiency in the system. Without efficiency in the system it is almost impossible to offer better products and services at affordable prices.

The Government's mechanism for sharing the burden of high oil prices effectively takes more from the company that makes more money. This has loaded the system with all possible inefficiencies. In addition, continued government intervention has introduced many layers of bureaucracy into the system.

Between products, the level of taxation is completely disproportionate to end-use of the product. For petrol the level of taxation is extremely high whereas for Aviation Turbine Fuel (ATF), the excise duty is only 8 per cent. This is substantially lower than diesel, a product of mass consumption. This anomaly illustrates the complexity of pricing petroleum products. From the perspective of the Aviation Industry, low taxes on ATF may be vital to the growth of this industry that contributes to employment and economic growth. But from a social perspective, low taxes on ATF are nothing more than a subsidy to the affluent segments of the society.

It is likely that carbon is priced after 2012 when the second Kyoto commitment period expires. In that case

fuel substitution policies have to be reviewed and a rational policy for pricing gas has to be put in place. Carbon pricing would also have an impact on diesel consumption, because a large share of diesel consumption is for auxiliary electricity production.

Finally despite of the introduction of reforms, the inertia within the Government is so large that any short-term change that is successfully implemented, be it subsidy or taxation, becomes precedence for long-term policy, irrespective of its purpose. This mechanism for making policy can therefore become devoid of rationality and would not be in the long-term interest of the country.

Key Conclusions

- There would be no quarrel over high taxation if there is transparency over why the revenue is being raised and how it is being utilised. Investment of Petroleum Sector revenues in alternative sources of energy, or for the promotion of efficient use of energy and public transportation would be in the interest of the country's long-term energy security. Similarly transparent administration of subsidies is a better way of determining effective costs to the system and by corollary promoting end use efficiency.
- Provision of energy services such as lighting, heating and motive power using renewable energy technologies rather than the provision of particular petroleum fuels at subsidised rates to the energy deprived sections of the society, would not only reduce the subsidy burden on the economy but also provide an incentive for investment in renewable and efficient energy technologies.
- Transfer of income from the Infrastructure Sector is not in the long-term interest of the country as it significantly reduces investment in energy infrastructure.
- APM through the back door has made the policy environment so uncertain that no Public or Private Sector company may be willing to make long term investments in energy infrastructure.
- Introduction of discriminatory subsides in a system that is supposedly market determined has made the Government party to restrictive trade practices. This goes against the primary objective of introducing competition and efficiency in the system, which is to offer the consumer better products and services at affordable prices.

This policy brief is based entirely on comments and suggestions of distinguished participants of focus group meeting titled 'What do falling Crude Prices mean for India's Fiscal Deficit?' held on February 9, 2007 at Observer Research Foundation. The distinguished participants included Mr. S. C. Tripathi, former Secretary, Ministry of Petroleum & Natural Gas; Mr. Sunjoy Joshi, Advisor (Energy), ORF-CRM; Mr. Dipankar Mukherjee, Secretary, CITU; Mr. V. Raghuraman, Sr. Advisor-Energy & Technology, Confederation of Indian Industries; Mr. Uma Shankar Prasad, Chief Manager, ONGC; Mr Ajay Tyagi, Secretary, Petroleum and Natural Gas Regulatory Board; Mr. Ram Singh, Director (Finance), Petroleum Planning and Analysis Cell; Mr. Manu Sehgal, Joint Director (Planning), Petroleum Planning & Analysis Cell; Mr. P. Raghavendran, President (Refinery Business), RIL; Mr Amarjit Singh, Secretary General, India Energy Forum; Mr. Karni Singh Bhada, Essar Group; Mr Suresh Mathur, Essar Group; Mr. Swagat Bam, Vice President (Corporate Affairs), RIL; Mr. Volker Bauer, Resident Representative, Hanns Seidel Foundation.

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