



A fine balance: Lessons from India's experience with petroleum subsidy reforms

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ARTICLE INFO

JEL Classification:

D31
E62
H53
I38
O23

Keywords:

Oil price decline
Petroleum subsidies
Petroleum taxation
India
Fiscal reforms
Developing countries

ABSTRACT

India's energy sector is passing through a significant transformation, triggered by recent international developments in global oil prices. Historically, diesel, kerosene and Liquefied Petroleum Gas (LPG) have been subsidised leaving a small net balance from petroleum taxes for the government, and poor financials for the oil companies. However, all this changed when crude prices declined from over \$100/barrel in June 2014 to \$50/barrel in June 2017. Concurrent reforms undertaken by the government have radically reduced subsidies from \$24.6 billion in 2013 to just \$1.16 billion in 2017. This paper shows how reforms involved the strategic application of three different policy 'levers' – retail prices, tax rates and subsidies – with beneficial outcomes for the three main stakeholders – oil companies, the government, and the poorest consumers – the latter through keeping subsidies intact for LPG and kerosene which are used by the poor. It examines policy interventions by the Indian government across these different levers at different points of time. The analysis reveals that petroleum subsidy reform involves much more than simply raising retail prices. The paper brings out policy recommendations from the Indian experience for countries that wish to implement structural reforms in pricing, taxation and subsidies.

1. Introduction

The Indian government responded quickly to falling crude oil prices in 2014 by implementing several measures on petroleum prices and taxes on petroleum products with an aim to remove subsidies. The success of these reforms is evident from the fact that the total subsidy bill reduced from \$24.6 billion¹ in 2012–13 to a near 15-year record low of \$1.16 billion in 2016–17.² What is of significance in the Indian experience is that subsidy reforms were not just raising of retail prices, but much more than that. For example, taxes comprise a large share of retail price and allowing market price would require careful decision-making on taxes, particularly if subsidy was to be still continued for some products. Table 1 below gives an idea of the different components of retail price, differing tax-rates and how the 'under-recovery'³ happens. In this paper, going beyond market pricing, we discuss several strands of petroleum reforms – would the new retail prices be discovered freely in the market, and how will be the new found rents be shared between the government and oil companies. In India, the retailing of diesel, petrol, LPG for domestic use and kerosene for Public

Distribution System (PDS) has been in the hands of three government owned Oil Marketing Companies (OMCs) – Hindustan Petroleum Corporation (HPCL), Indian Oil Corporation (IOCL) and Bharat Petroleum Corporation (BPCL). As the above four products have been subsidised, the government took pricing decisions.

The government also partially financed 'under-recoveries' along with requiring public sector upstream companies such as Oil and Natural Gas Corporation (ONGC), Oil India Limited (OIL) and Gas Authority of India Limited (GAIL) to give price discounts to state-owned refiners⁴ in order to keep prices low. Reforms had actually been set into motion in January 2013, when the government allowed a monthly price hike in diesel price by 0.8 cents/litre. This gradual hike was later extended to other fuels. Resultantly, subsidies have been eliminated for diesel and petrol and are very low even for the remaining two subsidised fuels, LPG and kerosene (used by the poor). OMCs are now operating with substantially greater freedom and are reaping higher profits.

Another part of the reform agenda has been to improve public finances through increasing excise duty rates (following the fall in oil

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¹ Exchange rates from Reserve Bank of India as of 29 September 2017: \$1 equivalent to 65.35 rupees.

² Ministry of Petroleum and Natural Gas (2017), P.80. It was \$1.12 billion in 2002–03. Financial years.

³ Under-recovery has been discussed in detail in Section 2. In a nutshell, it is the subsidy to the consumers, inclusive of un-recovered profit of the OMCs, which was later partially compensated by the government and upstream companies.

⁴ Ministry of Petroleum and Natural Gas (2010), P.1.

Table 1

Price build-up of June 2017 (US \$ cents/litre, LPG in cylinder of 14.2 kg).

Source: Ministry of Petroleum and Natural Gas (2017), pp. 57–58.

	Cost price ^a	Taxes & commissions	Total	Retail price	Underrecovery/subsidy
Diesel	26.01	27.26	53.27	55.94	2.67 surplus
Petrol	26	38.27	64.27	66.91	2.64 surplus
LPG	505	47.63	552.63	446.65	(-) 105.85
Kerosene	26.65	2.39	29.04	20.17	(-) 8.87

^a Cost to OMCs inclusive of marketing margin charged by them.

prices) on petroleum products. During 2014 and 2017, the excise duty on diesel went up by 5 times from \$0.05/litre to \$0.26/litre, and that on petrol by 2.5 times from \$0.14/litre to \$0.33/litre, resulting in a fiscal bonanza for the government with net accruals to it from this sector going up by a whopping 8 times from \$6 billion to \$47 billion (2014–17). As we see later, benefits have been passed on to consumers, too. All the rural poor without access to clean cooking solutions, are now being provided subsidised LPG access. The distribution of subsidy on LPG and kerosene is also set to become more efficient following a system of direct cash transfers to eligible low-income consumers.

The Indian experience demonstrates that successful petroleum subsidy reforms require interventions across multiple levers such as taxation and subsidy to protect the interests of vulnerable sections of society - which is of vital relevance to poor countries. With the drop in crude prices, following options have become available to the countries that wish to do away with subsidies that drain the public exchequer:

- Retain subsidies and pass on the benefit of decline in crude prices to consumers by a drop in retail prices
- Sustain the prices, and boost taxation income by raising the taxes on petroleum
- Sustain the prices, and allow the OMCs to earn profits
- A mix of the above.

The last option is the most difficult as it involves careful calibration of multiple levers. The Indian case falls in this category and offers lessons to the oil importing, emerging economies as to how to reform this sector while protecting the interest of all the stakeholders. Alongside, the welfare agenda has been promoted by adoption of technology such as biometric based unique identities, and reforms in delivery of subsidy through cash transfer. This paper analyses the following research questions:

a) What were the components of Indian petroleum subsidy reform from 2014 to 2017?

b) How did India balance the competing interests of different

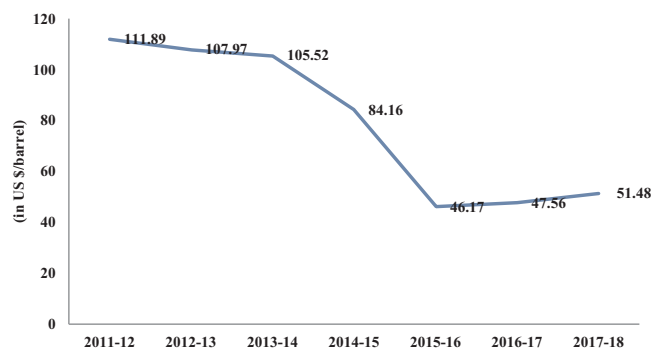


Fig. 1. Price of crude oil (Indian Basket) (in US \$/barrel). Note: Price of 2017–2018 is upto 31 May. The graph only tracks yearly average prices and movements between time-periods are not tracked.

Source: Ministry of Petroleum and Natural Gas (2017), P.50.

stakeholders during their implementation?

c) What lessons can be learned from India's experience?

The structure of this paper is as follows. Section 2 briefly discusses the trend in India's crude oil prices over the period 2014–17 (as per the Indian basket of crude oils adopted by the government for determination of domestic prices), and its historical petroleum subsidy policy. Section 3 discusses reforms introduced in taxation, pricing and subsidies, while Section 4 discusses their impacts on the profits of India's National Oil Companies (NOCs) and the public exchequer. Section 5 concludes with take-aways from India's successful pricing reforms.

2. Crude oil and petroleum product pricing in India

2.1. Crude oil prices

Crude prices have been falling since mid-2014, and what was believed to be a temporary phenomenon has now lasted over three years, and a bearish outlook prevails. For 2016–17, the price of the Indian crude oil basket closely mirrored global crude prices as it comprised of Oman/Dubai and Brent (dated) prices in the ratio of 71:29.⁵ Indian crude prices averaged \$84/barrel in 2014–15, 20% below the previous year, and more than 50% lower in the year 2016–17 over 2014–15. Fig. 1 below shows how the prices, which were high until 2013–14, fell to 2010–11 (\$85.09/barrel) levels in 2014–15, and yet lower in FY17.

The Indian crude basket price is the main determinant of product prices as the refining process does not have any major value addition.⁶ India has been importing over 80% of its petroleum requirements at global oil prices, and for over 15 years, even domestic Exploration and Production (E&P) companies, including the NOCs, have received international prices for their production.⁷ On the other hand, retail prices of major products have been priced neither on the basis of cost of crude, nor on a market basis, but by the government through an informal arrangement with state-owned companies. As discussed later on, in India the consumers of 'sensitive' petroleum products – fuels used in transport, cooking and lighting – have been protected from high prices.⁸ This applies to most other fuels – e.g. coal prices in India have been set by the government, apart for a small share auctioned on the market. One unintended consequence of non-cost reflective prices is the inelasticity of demand to price changes. Resultantly, the share of fossil fuels in primary energy rose steadily from 72% in 1981 to 81% in 1990–91 and to 90% in 2016–17.⁹ If the Indian energy mix has to evolve as per competitive strength of fuels and consumer choice, allowing retail prices to reflect cost is of paramount importance.

2.2. Defining petroleum subsidies in India: under-recoveries

Petroleum subsidies in India have interestingly been called 'under-recoveries'. This is because OMCs are made to procure refined products at market-derived prices but sell them at a discount. The subsidy is computed on the basis of the price at which they would have been sold if OMCs were allowed to earn 'normal' profits (inclusive of marketing margin). As the 'under-recovery' so calculated also has an element of profit, it is not pure subsidy, hence the term 'under-recovery'. The three OMCs are compensated through the Union Budget of the Government of India (central government) and contribution from upstream companies who, as discussed above, received international prices for their crude production. The government contribution was by way of cash subsidy

⁵ Ministry of Petroleum and Natural Gas (2017), P.50.

⁶ Ministry of Petroleum and Natural Gas (2006), P.1.

⁷ Jain (2011), P. 19.

⁸ Sensitive petroleum products refer to diesel, petrol, LPG and kerosene. They have been considered 'sensitive' because rise in their price evokes reaction across multiple interest groups.

⁹ BP Statistical Review (2017).

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