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# The government slips on oil: it is time to act on prices

*The inflationary consequences of higher prices of petroleum products could be far greater than the inflationary consequences of a modest increase in the size of the fiscal deficit*

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Petroleum product prices are in the news. The second half of May witnessed 16 consecutive increases in the retail prices of petrol and diesel, which added up to an increase of Rs3.80 per litre for petrol and Rs3.38 per litre for diesel in Delhi. Prices reached their highest level in four years on 28 May. These prices were reduced by 1 paisa per litre on 29 May. It could be described as comic relief.

The ridicule that followed prompted modest reductions every day until 5 June, resulting in a cumulative decrease of Rs0.60 paise per litre for petrol and Rs0.45 per litre for diesel. This is a minuscule reduction of 0.75% and 0.65%, respectively, in the peak retail prices, made possible by some softening of world oil prices and a marginal strengthening of the rupee.

The quiet resentment among people is sought to be exploited by protesting political parties in the opposition. The reason is obvious. The next general election, in April 2019, is less than a year away. In late 2018, state elections are due in Chhattisgarh, Madhya Pradesh and Rajasthan. There is reason for concern because almost every household is affected directly by the price of petrol, diesel, kerosene and LPG (liquified petroleum gas), and indirectly through cascading increases in prices of freight and transport that feed into higher prices of necessities.

The anxiety of the government is apparent, while its hyperactivity is visible. Yet, there is no outcome so far, other than words of solace hinting at long-term solutions, hoping that world crude oil prices will not rise further.

Retail prices of petroleum products differ across states in India on account of differences in tax rates. Therefore, retail prices of petrol and diesel in Delhi are used as a point of reference here.

During the period April 2015-April 2017, these retail prices were in the range of Rs60-63 per litre for petrol and Rs50-53 per litre for diesel. On 28 May, retail prices in Delhi were Rs78.43 per litre and Rs69.31 per litre, respectively. This works out to an increase of 30% in petrol prices and 25% in diesel prices. By comparison, in May 2014, the retail prices of petrol and diesel in Delhi were Rs71.41 per litre and Rs56.71 per litre, respectively.

However, world prices of crude oil in May 2018, at $75 per barrel, were almost 33% lower than in May 2014 ($110 per barrel). During this period, the rupee depreciated vis-a-vis the US dollar by about 12%, so the exchange rate cannot explain the difference in domestic retail prices. The explanation must lie elsewhere.

Domestic production of crude meets just about 20% of total demand in India. Such import dependence means that world prices of crude are an important determinant of domestic prices of petroleum products. The average annual world prices of (Brent) crude oil per barrel were $100 in 2014; $52 in 2015; $44 in 2016; and $54 in 2017. These prices, $53 per barrel in early September 2017, firmed up in early 2018 and rose to $75 per barrel in late April.

In this period, the exchange rate depreciated from Rs63.50 to Rs67 per US dollar. Thus, the cost of imported crude oil increased by 50% in rupee terms.

The relationship between world prices of crude and domestic prices of petroleum products in India is complex. Of course, the proportion of imported crude oil in total consumption, refining costs, and freight charges are the basic determinants. But the structure of taxation complicates matters far more.

Petroleum products are excluded from the GST (goods and services tax) regime. The Central government imposes excise duties, while state governments impose VAT (value added tax), or sales tax, at different rates. At present, Central excise on petroleum products is a specific duty at Rs19.48 per litre on petrol and Rs15.63 per litre on diesel. State governments impose VAT, or sales tax, ad valorem (imposed on the pre-tax price plus the Central excise duty), on petrol at rates that range from a minimum of 16% to a maximum of 40% with an average of around 28%. For diesel, the rates range from 12% to 29% with an average of around 20%. Thus, the inter-state variations in retail prices are significant.

It is worth using Delhi as an example, where the VAT ad valorem rate is 27% on petrol and 17% on diesel. If the retail price of petrol is Rs78.43 per litre, VAT at 27% is Rs16.67 per litre, while Central excise duty is Rs19.48 per litre, so that the pre-tax dealer price, which reflects international prices, plus the dealer commission, is roughly Rs42 per litre for petrol. If the retail price of diesel is Rs69.31 per litre, VAT at 17% is Rs10.07, while Central excise duty is Rs15.63 per litre, so that the pre-tax dealer price, plus the dealer commission, is roughly Rs43 per litre of diesel.

In Delhi, therefore, taxes account for 46% of the retail price of petrol and 37% of the retail price of diesel paid by buyers, while the Central government receives 54% of the taxes paid on petrol and 60% of taxes paid on diesel.

There was a period of at least three calendar years from January 2015 till December 2017 during which world crude prices were less than half their average levels in the preceding four years. How was this benefit of low international prices distributed between governments, the Centre and states that imposed taxes and people as consumers?

There was, of course, some reduction in retail prices for consumers. But it was at most Rs10 per litre, in current prices, on petrol and diesel, and only for a part of the three-year period. World prices of crude oil dropped from more than $100 per barrel in May 2014 to $50 per barrel in January 2015 and $30 per barrel in January 2016. But the reduction in retail prices of petrol and diesel was nowhere near these proportions.

Governments did not allow that to happen. The Central government raised excise duties on petrol and diesel several times, while state governments also increased their VAT or sales tax rates on petrol and diesel from time to time. Between May 2014 and May 2018, the excise duties imposed by the Central government on petrol were raised from Rs9.48 per litre to Rs19.48 per litre, and on diesel from Rs3.56 per litre to Rs15.63 per litre.

Given that VAT, or sales tax, imposed by state governments on petrol and diesel was ad valorem, as a percentage of the pre-tax dealer price, including the dealer commission plus the Central excise duty, it meant that the incidence of state taxes increased *pari passu* even without changes in rates.

It would seem that the benefit of the sharp drop in world oil prices accrued in large part to the Central government, as well as the state governments, in the form of a windfall gain over the entire period. It became an important source of tax revenues, almost a soft option, which helped in easing their fiscal problems. The benefit passed on to consumers of petrol and diesel, in lower prices, was disproportionately small.

As world oil prices have risen, despite the hue and cry, there has been no reduction in taxes on petrol or diesel. The specific excise duties imposed by the Central government are unchanged. So are the VAT, or sales tax, rates imposed by state governments. The solitary exception is Kerala, where both petrol and diesel prices have been reduced by Re1 per litre. Governments are obviously not willing to forgo the bonanza of tax revenues that has been their windfall gain from low world oil prices for more than three years.

For the Central government, tax revenues from petroleum products were Rs0.99 trillion in 2014-15, which rose to Rs2.43 trillion per annum in the 2015-16 to 2017-18 period, constituting 14% of its gross tax revenues and 22% of its net tax revenues during this period. For state governments, revenues from taxes on petroleum products are at least as important. Thus, it is clear why, when world oil prices have risen, the cost is borne almost entirely by consumers.

This asymmetry in the most unequal distribution of benefits and costs arising from changes in world oil prices is not new. It goes back a long time—decades—to the regime of administered prices for petroleum products. Governments mopped up windfall gains when world oil prices fell, and passed on the costs to consumers when world oil prices rose, using their surpluses in good times to finance government deficits, instead of using them in bad times to support lower prices for consumers.

The prices of petrol and diesel were deregulated in June 2010 and October 2014 respectively. It would seem, however, that there is little change in substance, as de facto practice circumvents de jure policy.

State governments can and should reduce taxes on petroleum products, as they have reaped windfall gains in revenues on account of their ad valorem rates. The finance minister of Kerala, Thomas Issac, has done so, reducing retail prices of petrol and diesel by Re1 per litre, while probably retaining some of the windfall gain in revenues due to the recent price rise. Finance ministers of other states could easily follow in his footsteps.

The Central government also can and should reduce its excise duty on petrol and diesel. Instead, it is asking state governments to reduce their VAT or sales tax, as their ad valorem rates have yielded a windfall gain in recent months. In doing so, it is guilty of double standards, having reaped windfall gains itself for more than three years. It could, in any case, practise what it preaches, since 22 of the 29 state governments in India are run by the BJP (Bharatiya Janata Party) on its own or with allies.

Moreover, there is a strong case for reducing Central excise duties on petrol and diesel. The fiscal deficit is not quite an alibi. The inflationary consequences of higher prices of petroleum products could be far greater than the inflationary consequences of a modest increase in the size of the fiscal deficit.

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