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Subsidy juggling trims India's fiscal overhang

By Kunal Kumar Kundu

NEW DELHI - India released its fiscal data for the full year to March 1013 last week, after a month's delay, coming up with a figure that showed the deficit at 4.9% of gross domestic product, sufficient to have the press rejoice at Finance Minister P Chidambaram's ability to deliver on his promises.

Chidambaram gave assurances a few months back that the deficit would be brought down to 5.2% of GDP. After months of being unable to walk the talk, this was a silver lining on the cloud that was being hoped for.

In reality, however, the silver lining turned out to be an illusion, the achievement a mere accounting phenomenon rather than any real consolidation. As has been happening in the past, the government simply decided to defer their obligational payouts by from the future. More specifically, I am referring to the oil subsidy burden that the government should logically bear, but it prefers the policy of robbing Peter to pay Paul.

The need for oil subsidy arises when the government forces oil companies to sell various petroleum products at less than the cost price. Under recoveries (the gap between the pump price and the cost if the product was to be imported) by the oil companies constitute the subsidy burden. While the government claims that this helps the needy, an International Monetary Fund study clearly points out that oil subsidies mostly serve the rich.

Despite such a dubious outcome, the policy continues to be followed, though of late, the government, forced by its precarious financial condition, has started to take some corrective action. Nevertheless, as long as the pricing disparity stays, the subsidy burden will remain. The government meanwhile unilaterally decided that the oil companies will bear 40% of the subsidy and the government will bear the remaining 60%. As per the data made available by the Petroleum Planning & Analysis Cell (PPAC), the total under recovery during FY13 was 1.61 trillion rupees (US$28 billion).

Product	Under Recovery (Rs. billion)
Diesel	921
PDS Kerosene	294
Domestic LPG	396
Total	1,610

Note: PDS - Public Distribution System. Source: PPAC

Going by its stated formula, the government should have had to pay approximately 1 trillion rupees as its share of subsidy for the 2013 fiscal year that ended in March. In reality, however, they paid 550 billion

rupees to the oil companies during the year and deferred the payment of the remaining 450 billion to the next year.

As per the monthly account data made available by Controller General of Accounts (CGA), India’s fiscal deficit for the full year was 4,899 billion rupees as against the revised estimate of 5,209 billion rupees. However, if we add the unpaid subsidy amount of 450 billion rupees to the deficit figure, India’s total fiscal deficit for the year would have been 5,349 billion rupees or 5.34% of the GDP and not 4.9% as per the official data, indicating a slippage of 0.14% below Chidambaram's target.

Subsequently, the government has announced that the unpaid amount of 450 billion rupees will be paid to the oil companies during the current quarter. However, readers need to be aware of a few of things here to understand the dynamics of subsidy payouts.

First, the government made the announced of the payment of the remaining amount in May. Post the announcement, they issued a letter of comfort to the oil companies. Until this announcement, the affected oil companies were not finalizing their books of account for the financial year 2013, since their balance sheet would have been smeared with red in the absence of this payout. Subsequently they used the comfort letter to close their accounts books.

Another reason why the government was forced to make the payout was that most of the banks had exhausted their sectoral limit of lending to oil companies. The problem is, the borrowing requirement (merely for their working capital requirement) of the oil companies stays elevated since the government dithers on their payment commitment.

Now, with the banks reaching the sectoral lending caps, they are in no position to lend further to the oil companies. Hence this payout is important for the oil companies to ensure that it is business as usual.

Then there’s the third and more important reason for the payout. The government has to raise resources to be able to meet its spending requirements, including its populist, wasteful and poorly targeted social sector spending. Disinvestment, or selling of shares in state-owned enterprises, is an important stream of revenue. For the government to be able to convince investors to buy its stake in the big oil companies, it is imperative that these companies show a profit rather than a loss.

Even this is not the end of the story. For the current financial year, the government had budgeted 650 billion rupees for oil subsidy. After paying out 450 billion rupees as their final installment of the previous year’s subsidy, they would be left with only 200 billion rupees to pay. Now, with an election looming, the government cannot afford to spend more on oil subsidy when the need of the hour is to use as much financial resource as possible to buy votes by increasingly focusing on populist schemes.

A food security bill, for example, is due to be promulgated in the near future. The bill seeks to provide 67% of the population with the right to a fixed quantity of grain at a fixed price through ration shops.

So, the next logical step is to increase the subsidy burden on the oil companies even further. For the current year, the government estimates that the total oil subsidy will be 800 billion rupees. With a mere 200 billion rupees being available, they want to shift the majority of the burden to the oil companies. Hence the current thinking of the finance minister is that the oil companies should absorb the remaining 600 billion rupees, which is the same amount they absorbed in the previous financial year. This would mean that the oil companies would now absorb as much as 75% of the total oil subsidy burden.

But the finance minister is still not done. The election still needs to be managed. Having failed miserably in controlling inflation - though down from January's 7.18% it was running at a still-high 4.89% in April - the government now wants to provide the feel-good factor to the electorate before the elections. This could be achieved by reducing petrol and diesel price. So what do we have now? In order to reduce the price of petrol and diesel, the government wants to move the domestic pricing norm from export parity to import parity.

At present, oil companies are compensated for losses depending on trade parity - the ratio of imports to exports, which is 80:20. This means their losses are calculated to the extent of 80% on the basis of the prices of imported crude and petro-products, and 20% on the basis of domestic output.

The finance minister wants to shift to export parity pricing, since oil companies will then be compensated for losses based on the prices at which they export petro-products - which are lower, since import prices include freight, port and transportation charges. With this sleight of hand, the domestic price of motor fuel would come down while the burden on the oil companies would increase even further, as their business dynamics do not change in any way.

The burdened oil companies are getting increasingly leveraged while at the same time are having less and less of surplus to be able to invest in the future - an imperative for surviving in this investment intensive industry. As they say, there's no free lunch. But that's how Indian politics work.

Kunal Kumar Kundu *is a New Delhi-based economist. His website kunalsthoughts.weebly.com*

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