

Press Release

Subsidizing diesel is more inflationary than raising its price

IRADe Study finds raising diesel price is less inflationary than continuing with the diesel subsidy

Government is reluctant to raise diesel price fully for fear that it might lead to inflation, even though administered price of petroleum products leads to large under-recoveries. Partial financing of under-recoveries by the government is done by direct budgetary support and indirectly by the Public sector oil marketing companies (OMCs) and upstream oil companies (ONGC and OIL). The OMCs have reported that the under recovery during April - June 2012, was around 47,811 Crore, of which diesel accounted for Rs. 29,042 Crore and the total under recoveries for FY 2012-13 for industry as a whole before the recent price changes in diesel, kerosene and LPG were estimated at over Rs. 2,00,000 crore. In the case of diesel, it is evident that the subsidy given in the name of poor has been benefitting diesel car owners, telecom towers, diesel generators and others who do not merit a subsidy.

These high levels of under-recoveries raise the fiscal deficit which in turn leads to higher money supply resulting in higher inflation prompting Reserve Bank to raise interest rate that lowers investment and economic growth rate over time. While steps have been taken by the government to decontrol prices of petrol, LPG and kerosene, diesel continues to be heavily subsidized as a change in status quo may lead to inflation in the short term. To explore this trade-off between short term impact and medium term outcomes, IRADe has developed a macroeconomic model to assess the alternative roadmaps for diesel price reform in India. Simulation with the model shows that

- Continuing with present policy of subsidizing diesel price is not tenable. This could have very large economic costs in the long term.
- Full increase, which is a one shot increase of 30%, in the diesel price leads to some immediate increase in inflation; however, continuing with present subsidy involves a much higher rate of inflation later and which persists over a longer time. The average inflation rate over 3 years will be 6.6 percent if diesel price is decontrolled but would be 9% if diesel subsidy continues. Such high overall inflation hurts the poor even more than the increase in diesel price.
- The trade-off between short term negative impacts and long term benefits is not just with inflation, but also for GDP. The growth rate would be 8% with price decontrol and only 6.5% if we continue with the present policy. The loss in GDP will hurt poor whether they use diesel or not.

The study has also considered the impact of diesel price increase on various prices and expenditure pattern of consumer in rural and urban areas to assess the burden on different consumers, where diesel price is raised by Rs 4.5/litre, i.e. 10% increase from current price.

- In absolute terms, the increase in average expenditure for the rural consumer belonging to the poorest decile is less than Rs. 2 per person per month and for the urban consumer belonging to the poorest decile, the additional expenditure would be less than Rs. 2.5 per person per month. This is because the large number of poor do not consume diesel neither directly nor indirectly.
- The impact on the urban consumer belonging to the richest decile on an average would be less than Rs 15 per month per person. Of course consumers driving diesel vehicles will pay more as they should.
- At present the owners of diesel driven passenger cars get an implicit subsidy compared with petrol driven passenger car owners due to the difference in the price of petrol and diesel arising from differential excise between petrol and diesel and the subsidy on diesel. The subsidy to a diesel car owner after the recent price and tax revisions ranges over Rs 12,500 to Rs 31,000 per year depending on the size of the car.

Thus, there are strong reasons to decontrol diesel price so that it aligns with international price of supplying it. Since Government may not want to raise diesel price at one go, one of the recommendations from the study is to fix upper limit for the subsidy in Rs. per litre of diesel and decontrol the price. That is, the subsidy does not change with the international price but remains capped at certain level.

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About Integrated Research and Action for Development (IRADe) :

IRADe, a regional energy think tank headquartered in New Delhi. IRADe is a fully autonomous Advanced Research Institute, which aims to conduct research and Policy Analysis and connect various Stakeholders including Government, Non-Governmental Organizations (NGOs), Corporations, and Academic and Financial Institutions. Its research covers many areas including Energy & Power Systems, Urban Development, Climate Change & Environment, Poverty Alleviation & Gender, Food Security & Agriculture, as well as the Policies that affect these areas.

For additional information please contact:

Er. Rajiv Ratna Panda,

Project Manager (Energy and Power), IRADe,

rajivpanda@irade.org , +91 11 26676181-Extn-214