Union Government’s Oil Bond Strategy

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Over the last few weeks, petrol prices have crossed Rs 100 per litre in several Indian cities. As prices continue to soar, the government is under increasing pressure to cut high taxes on fuel. However, the government has cited the instrument of oil bonds issued by the earlier regime to justify its inability to reduce the high incidence of taxes on petroleum products. Let us understand what these oil bonds are and how they impact the budget calculation of the government.

In news: Sitharaman rules out excise cut on petrol, diesel: ‘Burdened by UPA oil bonds’
Placing it in syllabus: Economy
Dimensions

- Reasons behind soaring oil prices
- Oil bonds as an alternative to subsidies
- Recapitalization bonds for PSBs in line with oil bonds
- Pros and cons of bonds to PSUs and PSBs and its effect on consumers

Content:

Reasons behind soaring oil prices:

- There are several reasons behind the fuel price rise in India.
- Fluctuation in the final price of oil can be caused by any of the following components, which underlie the retail oil price in India:
  - Global crude oil prices
  - Margin of transportation and refining
  - Central Excise Duty

- Dealer’s Commission
- State VAT (Value Added Tax).

Import Dependency & Rising Global Crude Prices:

- India is heavily dependent upon imports for its oil requirements. India is the third-largest oil consumer in the entire world, with 84% of it being imported.
- Any major fluctuation in the international Crude prices due to events like Iran sanctions or the Syria war directly impacts oil prices in India.
- After a dip in global prices during the firwave of COVID last year, the global crude prices have steadily risen in the past year.
- Under the present dynamic fuel pricing system fuel prices are getting revised on a daily basis. Thus, any hike in the international market is reflected immediately.

Impact of Increased Rate of Taxation:

- high excise duty by center and VAT by states on petrol and diesel is the most important factor behind high oil prices in India. Taxes make up for nearly two-thirds of the retail selling price.
- During lockdown even though International crude oil prices crashed sharply but oil prices kept on increasing as the government imposed additional duties and cesses on oil to generate additional tax revenues.
- The Centre and a number of states have significantly increased duties on petrol and diesel as a way to boost revenues in view of the Covid-induced restrictions that curtailed economic activity.
- State and central levies account for about 55.4% of the retail price of petrol and 50% of the price of diesel in Delhi.
- Central levies alone account for about 32.3% of the retail price of petrol and 35.4% of the pump price of

diesel in Delhi.

- The Centre hiked the excise duty on petrol to Rs 32.98 per litre in May 2020 from Rs 19.98 per litre, and on diesel to Rs 31.83 from Rs 15.83.
- In Short, the tax rate on fuel in India is the highest compared to any other country in the world.

Depreciation of Rupee against the US Dollar:

- The depreciation of the rupee's value is also contributing to escalating fuel prices. India imports the majority of its oil, and a weakening rupee will translate into higher costs.
- Depreciation of the Rupee against the Dollar will increase the volume of Rupee required to make payment in terms of Dollars.
- A corollary of this is that tax collection will further go up. Since retail prices are now linked to the global market, higher fuel prices will translate into heftier fuel bills for customers lining up to fill tanks at fuel stations.
- Since excise duty is a percentage of the base price at which fuel is exported, the greater the price of acquiring fuel, more money will go into the government's kitty.

Dynamic Fuel Pricing System:

- Fuel price decontrol has been a step-by-step exercise, with the government freeing up prices of aviation turbine fuel in 2002, petrol in 2010, and diesel in 2014.
- Price decontrol essentially offers fuel retailers such as Indian Oil, HPCL or BPCL the freedom to fix prices based on calculations of their own cost and profits.
- While oil price deregulation was meant to be linked to global crude prices, Indian consumers have not benefited from a fall in global prices as the central as well as

state governments impose fresh taxes and levies to raise extra revenues.

- This forces the consumers to either pay what they are already paying, or even more.
- The prices were deregulated to make them market-linked, unburden the government from subsidising prices, and allow consumers to benefit from lower rates when global crude oil prices tumble.

Oil bonds as an alternative to subsidies:

- Before fuel prices were deregulated, petrol and diesel as well as cooking gas and kerosene were sold at subsidised rates
- The government would intervene in fixing the price at which retailers were to sell diesel or petrol.
- This led to under-recoveries for oil marketing companies, which the government had to compensate for.
- Instead of paying direct subsidy to oil marketing companies from the Budget, the then government issued oil bonds totalling Rs 1.34 lakh crore to the state-fuel retailers.
- This was done in a bid to contain the fiscal deficit.
- Citing the need to repay interest and principal components on these bonds, the Centre has now argued that it needs higher excise duty to help its finances.

What are oil bonds?

- Oil bonds are special securities issued by the government to oil marketing companies instead of cash subsidies.
- Oil bonds are the debt instruments that the government issues to the Oil Marketing Companies (OMCs) like Hindustan Petroleum, Indian Oil, Bharat Petroleum
- These bonds are typically of a long-term tenure like

15-20 years and oil companies are paid interest. Interest payments will be due at fixed intervals during the tenure of the bond.

- Before the complete deregulation of petrol and diesel prices, oil marketing companies were faced with a huge financial burden as the selling price of petrol and diesel in India was lower than the international market price.
- This ‘under-recovery’ is typically compensated through fuel subsidies allocated in the Union budget.
- By issuing oil bonds the government tries to delay the fiscal burden of subsidy payout to future years.

Recapitalization bonds for PSBs in line with oil bonds:

- Since the Government is the majority shareholder in the public sector banks, it has to provide equity capital if the banks are struggling. This injection of capital is also known as the recapitalisation of banks.
- Recapitalisation bonds are dedicated bonds to be issued at the behest of the government for recapitalizing the trouble hit Public Sector Banks (PSBs).
- The term recapitalisation means giving equity money to cover debt of an entity. In the case of PSBs, their NPAs (debts) will be replaced by equity capital from recapitalisation by the government.
- The recapitalisation is aimed at tackling the twin balance sheet problem in India and also to revive growth and investment.
- From 2017, the union government has issued bank recapitalisation bonds (RCBs) to specific public sector banks (PSBs) as it looked to meet the large capital requirements of these PSBs without allocating money from the budget.
- Since 2017-18, the government has infused more than Rs 2.5 lakh crore of recapitalisation bonds to banks and

paid interest of more than Rs 20,000 crore over these three years.

- These RCBs are similar to oil bonds, since funds mobilized from the sale of the bonds will not come as part of the fiscal deficit. but the interest payment for it will be a part of the fiscal deficit.
- The government so far has issued recapitalisation bonds to public sector banks and EXIM Bank, IDBI Bank and IIFCL worth Rs 3.1 lakh crore, as per Budget documents.
- Special securities worth Rs 2.91 lakh crore issued to public sector banks would begin to mature beginning 2028.

Pros and cons of bonds to PSUs and PSBs:

The following are the benefits of issuing bonds to PSUs and PSBs:

Reducing Present Fiscal Burden:

- Compensation to companies through issuance of such bonds is typically used when the government is trying to delay the fiscal burden of such a payout to future years.
- By issuing such bonds the government tries to reduce its borrowings for fulfilling the budget shortfall in the current year.
- These types of bonds are considered to be ‘below the line’ expenditure in the Union budget and do not have a bearing on that year’s fiscal deficit

Managing Unforeseen Circumstances:

- Governments resort to such instruments when they are in danger of breaching the fiscal deficit target due to unforeseen circumstances that lead to a collapse in revenues or a surge in expenditure.
- Between 2005 and 2010, High crude prices and the blowback from the recession of 2008 increased fiduciary pressure on the government.

- By raising capital through bonds, these payments could be made in a deferred manner without causing a major escalation in prices, thus insulating consumers from external shocks.

The drawbacks of issuing such bonds are:

Increase in Overall Public Debt:

- Though bonds do not have a bearing on that year's fiscal deficit, they do increase the government's overall debt.
- However, they increase the overall public debt since the amount has to be repaid at a future date.

Raises Future Fiscal Burden:

- Interest payments and repayment of these bonds become a part of the fiscal deficit calculations in future years.
- The government has to pay off the oil bonds and the interest thereon that were issued by the previous regime.
- This limits the goals and avenues available to future governments for meeting their fiscal needs.

With the lion's share of interest payments on oil bonds yet to mature, it is incorrect to say that these payouts have driven up prices. As they are spread over a period of time, the debt burden will not be as severe as it is being made out to be.

Moreover, under the Indian budgeting system, it is not possible to pre-pay bonds as the government prepares budgets based on cash flows, and not on an accrual basis. Government bonds are a common procedure since budgetary expenditure is, to an extent, financed through bonds which will have to be repaid over the course of time.

If the government had the cash to make an up-front payment, the premise of taking on debt at interest would be defeated.

Mould your thought: What are the major reasons for the current hike in fuel prices in India? Also evaluate the effect of oil bonds issued by the previous regimes on the current fuel prices.

Approach to the answer:

- Introduction
- Discuss the reasons for the fuel price hike
- Define Oil bonds and why are they used
- Discuss the pros and cons of such bonds
- Discuss the effect of future debt repayment for consumers
- Conclusion