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RESEARCH REPORT

Diesel Subsidy Reform in India: Lessons learned

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Prepared by Kieran Clarke

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1.0 Introduction

The Indian government's declaration of a formal end to diesel price regulation in October 2014 marked the culmination of a two-year process of price reform. The effective removal of diesel subsidies, although not yet accompanied by comprehensive price decontrol,[1] nevertheless represents an important milestone in the reform of energy pricing in India, and provides policy-makers with a useful case study of successful fossil fuel subsidy reform.

[1] The government still retains the ability to directly intervene in product pricing through its ownership of the public sector oil marketing firms.

2.0 Context

Following the final dismantling of the Administered Price Mechanism (APM) in March 2002, retail prices for all fuels (including diesel) were subject to market-determination.[2] However, faced with rising oil prices and an impending national election, in 2004 the (then) Bharatiya Janata Party-led National Democratic Alliance (NDA) government began to limit the ability of the publicly owned oil marketing companies (OMCs),[3] which account for the majority of domestic fuel sales, to immediately and fully pass through cost increases for several products (including diesel). This policy of ad hoc price control of "sensitive fuel products,"[4] continued by the newly elected Congress-led United Progressive Alliance (UPA) government from fiscal year (FY) 2004/05 onwards, led to "under-recoveries" (defined as the difference between the cost price incurred by the companies and the price realized upon sale to the final consumer), which were then distributed between the government budget, the OMCs and upstream public sector oil companies.[5]

Under this pricing framework, the average diesel under-recovery per litre rose rapidly between FY 2005/06 and FY 2008/09 (from INR 2.9 to INR 8.5 per litre), fell briefly in FY 2009/10, then rose sharply again in the following two years to reach INR 10.4 per litre in FY 2011/12 (the last full year prior to the introduction of concerted price reforms) (Figure 1), or the equivalent of approximately 20 per cent of the total (unsubsidized) unit price. In concert with sustained year-on-year growth in total diesel consumption (Figure 2), this translated into rapid increases both in total diesel under-recoveries, and in the relative contribution of diesel subsidies to total fuel subsidy expenditure. By FY 2011/12, fuel subsidies on diesel, liquefied petroleum gas (LPG) and kerosene reached INR 141,541 crore[6] (USD 22.8 billion), of which INR 81,192 crore (USD 13.1 billion) related to diesel under-recoveries (Figure 3). From its low point of 19 per cent in FY 2009/10, the share of diesel subsidies within total fuel subsidy expenditure expanded threefold, reaching 57 per cent in FY 2011/12 (Figure 4). By FY 2011/12, total subsidy expenditure on diesel alone was more than twice as large as the central budget allocation for flagship social programs such as the National Rural Employment Guarantee Scheme (NREGS) (INR 31,000 crore, or USD $5.0 billion) or Sarva Shiksha Abhiyan (SSA)[7] (INR 21,000 crore, or USD $3.8 billion) (Figure 5).

[2] Kerosene and liquid petroleum gas (LPG) were to be subject to a fixed-rate subsidy, although kerosene pricing was subsequently not adjusted on a market-determined basis even in the period preceding the 2004 reintroduction of price controls, and LPG was only partially adjusted. For further details see Government of India (2010).

[3] Oil Corporation Limited, Hindustan Petroleum Corporation Limited and Bharat Petroleum Corporation Limited.

[4] Initially diesel, LPG, kerosene and petrol (the latter until June 2010, and then unofficially for a period in 2011).

[5] Primarily Oil and Natural Gas Company Limited (ONGC), and to a lesser extent Oil India Limited (OIL) and Gas Authority of India Limited (GAIL). Prior to 2009/10, OMCs were also compensated through the issue of oil bonds.

[6] All figures in Indian Rupees (INR) unless otherwise stated. One crore is equivalent to 10 million. USD/INR exchange rate applied: $1 = INR 62.1326 except in relation to external sector data (dollar values as provided). Subsidy expenditure includes declared under-recoveries for diesel, domestic LPG, Public Distribution System (PDS) kerosene and petrol, and direct subsidies for domestic LPG and PDS kerosene. These figures do not include further costs incurred by the publicly owned OMCs in relation to gas importation and corporate borrowing (due to delays in receipt of compensatory payments), freight subsidies administered under the Freight Subsidy Scheme (2002), central government transfers to selected states with the (nominal) purpose of compensating farmers for diesel consumption during periods of low rainfall, subsidy expenditure on LPG and kerosene supplied to Bhutan, undeclared petrol under-recoveries, or any direct or indirect subsidy expenditure related to natural gas.

[7] The Indian government's principal elementary education program, intended to provide universal primary education for all children between the ages of 6 and 14.

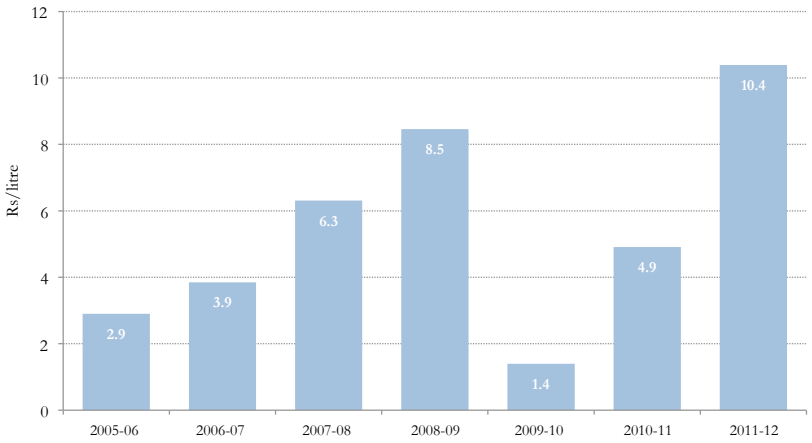

FIGURE 1: AVERAGE UNIT SUBSIDY (2005/06–2012/13) (INR/LITRE)

Source: Ministry of Petroleum and Natural Gas (MoPNG) (2014b)

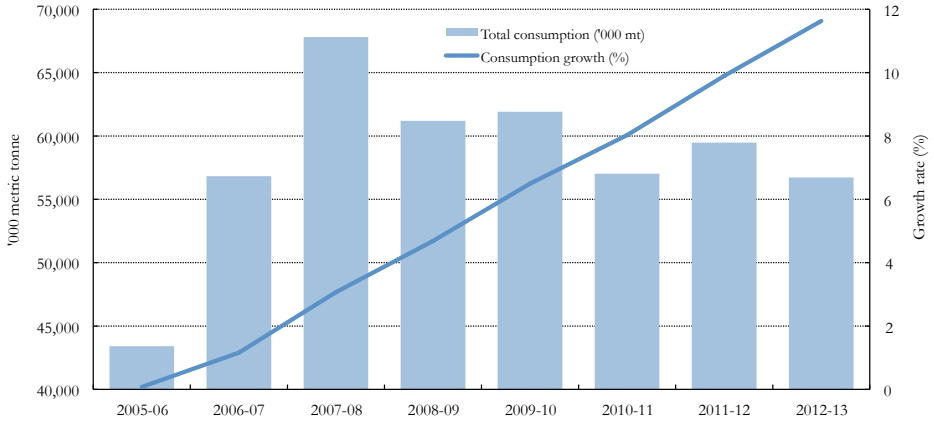

FIGURE 2: ANNUAL DIESEL CONSUMPTION (2005/06–2012/13)

Source: MoPNG (2014a)

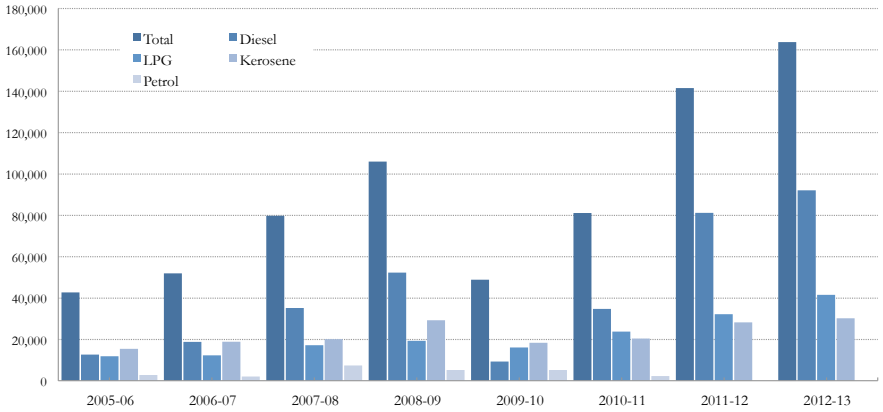

FIGURE 3: TOTAL SUBSIDY BY PRODUCT (2006/07–2012/13) (INR CRORE)

Source: MoPNG (2014b; 2014c)

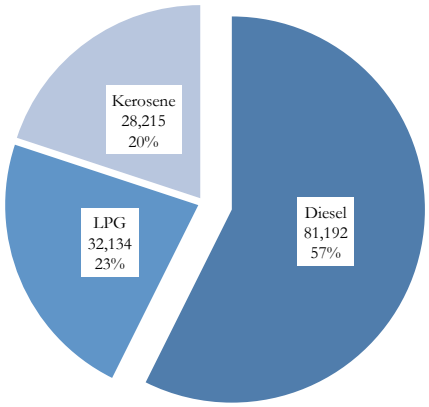

FIGURE 4: SUBSIDY EXPENDITURE BY FUEL (2011/12) (INR CRORE) (PER CENT)

Source: MoPNG (2014b, 2014c)

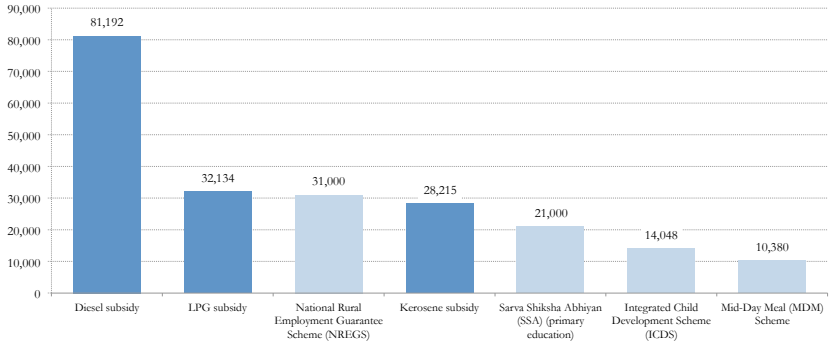

FIGURE 5: CENTRAL FUEL SUBSIDY EXPENDITURE AND SELECTED SOCIAL PROGRAM CENTRAL ALLOCATIONS (2011–12) (INR CRORE)

Source: MoPNG (2014b)

Diesel is the single most consumed petroleum product in India, accounting for almost half (44 per cent) of total consumption by volume in FY 2012/13. Although differing significantly by region, at the national level, transport is the principal user, representing an estimated 70 per cent of total consumption. Within transport, road freight is the single largest consumer (with trucks accounting for an estimated 28 per cent of diesel consumption), followed by various categories of passenger transport (including private cars, buses, commercial passenger transport, and railways, together accounting for over 40 per cent of total consumption). Other significant uses include commercial and private power generation (approximately 10 per cent of total consumption), tractors[8] (7 per cent), pumpsets and agricultural machinery (6 per cent), and other industrial applications (5–7 per cent) (Figure 6).

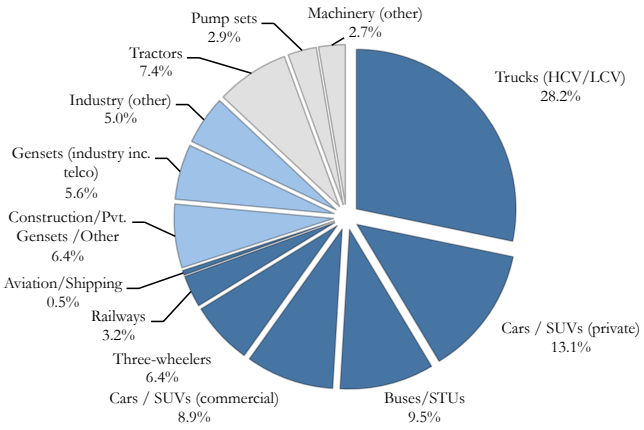

FIGURE 6: COMPOSITION OF DIESEL CONSUMPTION (2012/13)

Source: MoPNG (2013b)

[8] Often used both for agricultural and non-agricultural activities (such as construction).

In relation to social distribution, the benefits of diesel subsidies[9] were largely received by higher income households (Figure 7), with the principal (indirect) benefit to lower-income households coming through lower food prices (with diesel as an intermediate input).[10] In addition, diesel subsidy transfers were highly unequally distributed geographically (reflecting patterns of diesel consumption), disproportionately accruing to wealthier states (Figure 8).

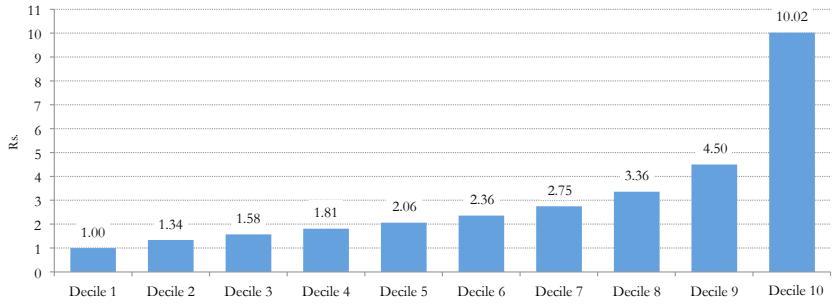

FIGURE 7: SOCIAL DISTRIBUTION OF DIESEL SUBSIDIES (INDIRECT) (2009–10)

Source: Anand et al. (2013)

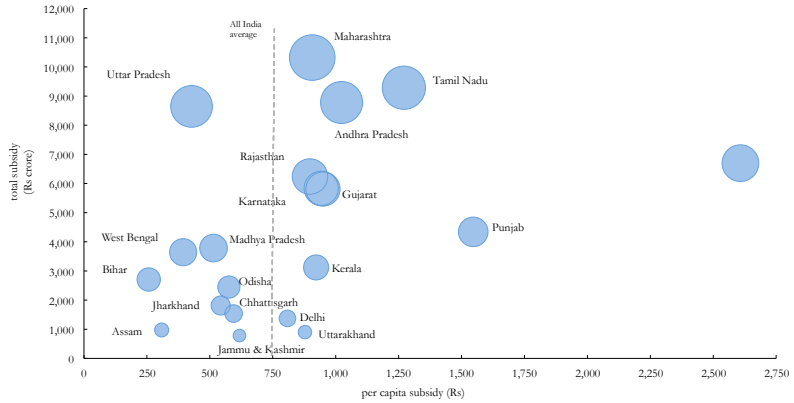

FIGURE 8: SPATIAL DISTRIBUTION OF DIESEL SUBSIDY EXPENDITURE (2012–13)

Source: Census of India (2012); MoPNG (2013a; 2014a; 2014b)

[9] Consisting primarily of indirect benefits—see Anand et al. (2013). Note that calculations presented are for 2009/10 (using input-output tables derived from 2003/04 data), and that the rapid growth of the private diesel vehicle fleet and expanded private generator use had likely substantially increased the direct benefit of diesel subsidies (which Anand et al. estimate as minor for 2009/10, and even more regressively distributed than indirect benefits) in the period immediately prior to reform, with any increase in direct benefits accruing almost entirely to the upper quintile of households by income.

[10] See Anand et al (2013).

Driven by rising domestic consumption and the growth of export-focused refining (in a context of stagnant domestic production), by FY 2011/12 oil imports (predominantly crude) had grown to represent over three quarters (75.9 per cent[11]) of total consumption and constitute a substantial percentage of total imports, accounting for 31.7 per cent (USD 155 billion) of total imports by value (USD 489.3 billion).[12] In concert with several emerging market economies, India's currency experienced a sharp fall in value against the dollar from mid-2011 onwards[13] (Figure 9), which combined with continued oil price strength to significantly increase the country's oil import bill. Partly as a consequence of rapid increases in the dollar value of oil imports (rising by 46 per cent), India's trade and current account deficits both expanded significantly in FY 2011/12, with the deficit in Goods and Services[14] increasing by 51 per cent (from USD 83.2 billion or 4.9 per cent of GDP in FY 2010/11 to USD 125.7 billion or 6.7 per cent of GDP in 2011/12), and the Current Account Deficit (CAD) widening from USD 48.1 billion (2.8 per cent of GDP) in FY 2010/11 to a record USD $78.2 billion (4.2 per cent of GDP) in FY 2011/12[15] (Figures 10 and 11). This pattern continued into the first half of FY 2012/13, with both the current account and trade deficits increasing relative to the same period in FY 2011/12.

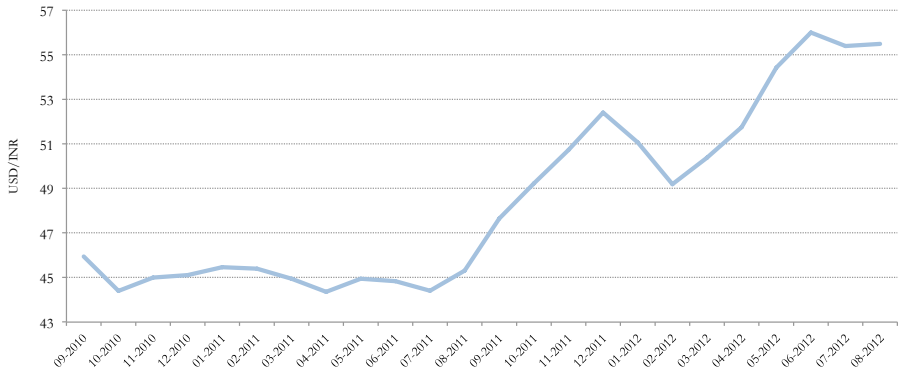

FIGURE 9: USD–INR EXCHANGE RATE (SEPTEMBER 2010–SEPTEMBER 2012)

Source: Bank of England (n.d.)

[11] Increasing further to 77 per cent in FY 2012/13 and 77.6 per cent in FY 2013/14.
[12] Note that the figures for oil imports and exports provided in MoPNG (2014f) and presented in Figure 11 differ from those provided in RBI (2014).
[13] Weakening from around INR 44 to the dollar in July 2011 to INR 56 by May 2012.
[14] Trade Balance plus Services.
[15] Note that all GDP figures relate to national GDP estimates prior to the most recent recalculation.

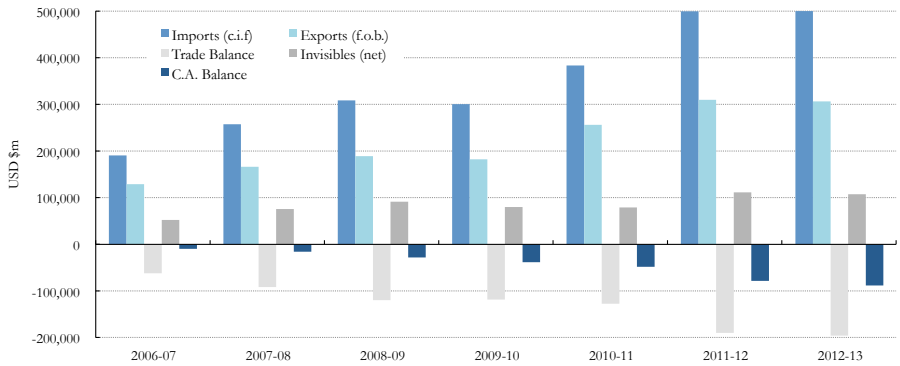

FIGURE 10: IMPORTS, EXPORTS, TRADE DEFICIT, NET INVISIBLES AND CURRENT ACCOUNT DEFICIT (2006/07–2012/13) (USD MILLION)

Source: RBI (2014)

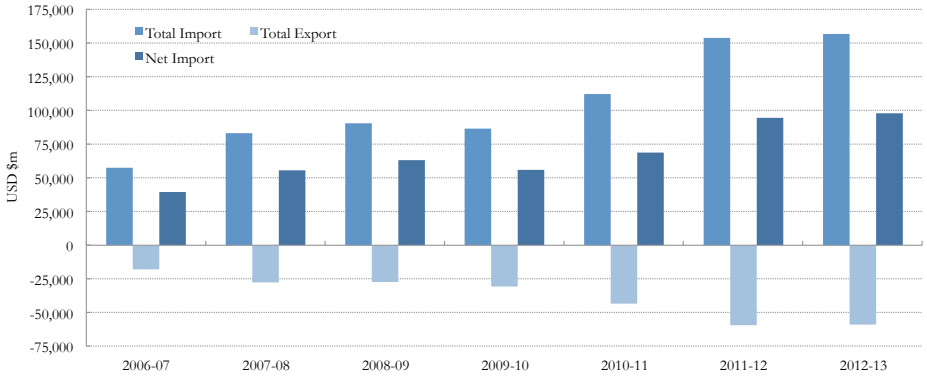

FIGURE 11: PETROLEUM TRADE BALANCE (2006/07–2012/13) (USD MILLION)

Source: MoPNG (2014f)

3.0 Reform Design and Implementation

3.1 Reform Design

The explicit reimposition of price controls for key products from 2004 onwards, and the subsequent rise in fuel subsidy expenditure, led to the formation by the government of several expert committees tasked with providing recommendations for pricing policy reform. Prior to 2011, these included the Committee on Pricing and Taxation of Petroleum Products chaired by C. Rangarajan (2006), the High-Powered Committee on the Financial Position of Oil Companies chaired by B. K. Chaturvedi (2008), and the Expert Group on Viable and Sustainable System of Pricing of Petroleum Products chaired by K.S. Parikh (2009–10), each recommending the progressive decontrol of diesel pricing (alongside a range of additional fuel policy reforms).

While the UPA administration (re-elected for a second term in 2009) did respond to the growing subsidy burden by implementing the formal decontrol of petrol pricing in June 2010[16] and periodically increasing retail prices for diesel, LPG and kerosene,[17] it was not until receipt of the initial report from the Committee on Roadmap for Fiscal Consolidation chaired by V. L. Kelkar in September 2012—and against a background of record subsidy expenditure, burgeoning fiscal and current account deficits, and rapid currency depreciation—that the government announced the first phase of a concerted program to address diesel subsidies.

The Kelkar Committee, which formally submitted its report to the government on September 3, 2012, recommended immediate price reforms for all three subsidized fuel products. In the case of diesel, the committee recommended a price increase of INR 4 per litre, followed by delegation of authority to the OMCs to implement incremental monthly price increases, with the objective of reducing the per unit subsidy by 50 per cent by March 31, 2013, and removing the remaining 50 per cent within the following fiscal year (FY 2013/14).[18]

3.2 Reform Timeline

Following formal receipt of the Kelkar Committee report, the MoPNG submitted a Cabinet note seeking approval for an immediate increase in diesel and LPG prices. On September 13, following a meeting of the Cabinet Committee on Political Affairs (CCPA)—the administration's apex formal decision-making body[19]—the government announced a series of reforms to petroleum policy, including an immediate diesel price increase of INR 5 per litre,[20] a cap on the supply of subsidized LPG cylinders per household[21] and a reduction of INR 5.50 per litre in petrol excise duty.

Subsequent to public release of the Kelkar Committee report (and the replacement of the existing Minister for Petroleum and Natural Gas, S. Jaipal Reddy, in a controversial cabinet reshuffle), the MoPNG then forwarded an additional Cabinet note in January 2013 proposing either a monthly INR 0.60 per litre increase, or a more substantial

[16] With the government also announcing, but failing to implement, the "in-principle" decontrol of diesel prices.
[17] While in some cases simultaneously reducing product taxes, and therefore net fiscal gain.
[18] The committee also recommended immediate increases in LPG and kerosene prices of INR 50 per cylinder and INR 2 per litre respectively, followed by further incremental price increases, with the objective of reducing total LPG subsidy expenditure by 25 per cent by March 31, 2013 (and the remaining 75 per cent by 2014/15), and reducing total kerosene subsidy expenditure by 33 per cent by FY 2014/15.
[19] Alongside the Cabinet Committee on Economic Affairs (CCEA). The CCPA is chaired by the chaired by the prime minister and includes the ministers of Home Affairs, Finance, Defence, Railways, Agriculture and Telecoms.
[20] Consisting of an INR 3.50 reduction in OMC under-recoveries, and a INR 1.50 per litre increase in excise duty. This translated into an increase of INR 5.63 per litre in the benchmark Delhi price (after accounting for local sales tax).
[21] To six per household, with three for the remainder of the financial year.

INR1.00–1.50 per month increase in diesel prices for the remainder of the financial year (to March 2013) followed by monthly INR 1 increases from April 2013 onward until full price decontrol (with similar incremental price increases for LPG and kerosene).[22] On January 17, the government announced the CCPA's decision to allow the OMCs to begin raising diesel prices in monthly increments of INR 0.40–0.50 per month excluding taxes (equivalent to approximately 1 per cent of the total retail price) until under-recoveries were eliminated, and immediately and fully decontrol the price of bulk purchases[23] (while leaving LPG and kerosene prices unchanged, and increasing the per-household LPG cylinder quota[24]).

Bulk diesel prices were decontrolled on January 18 (initially increasing by INR 8.53 including taxes[25]), and were subsequently subject to fortnightly revision on a market basis. Incremental retail diesel price increases by the OMCs began on January 18 (INR 0.50 including taxes), and continued on February 16 (INR 0.51 including taxes). Price rises were then temporarily suspended during the Budget Session of Parliament,[26] with the March increase of INR 0.51 (including taxes) implemented on March 23 following parliamentary recess on March 22. The price rise for April 2013 was delayed due to State Assembly elections in Karnataka on May 5 and the conclusion of the parliamentary Budget Session on May 10, with the scheduled price rises for April and May combined into a single INR 0.90 increase (INR 1.02 per litre including taxes) on May 11. Monthly price rises of approximately INR 0.50 then occurred as scheduled from June 2013 until March 2014,[27] representing a cumulative price increase of INR 5.67 per litre (including taxes). Price increases were then suspended during the period of parliamentary elections,[28] with April's scheduled rise amalgamated into an INR 1.09 per litre increase (INR1.22 including taxes) on May 16.

The newly elected NDA administration then continued the UPA government's policy of incremental monthly increases, implementing four price rises (on June 1, July 1, and August 1 and 31) totalling INR 2.26 per litre (including taxes). In conjunction with a period of exchange rate stability and falling oil prices, this led to the effective cessation of diesel subsidies by September 2014, with the OMCs recording "over-recoveries" from mid-September onwards. On October 18, 2014, the government announced the decision of the Cabinet Committee on Economic Affairs (CCEA) to implement formal decontrol of diesel prices with immediate effect, with the OMCs reducing retail diesel prices by INR 3.37 per litre (including taxes) on October 19. Figure 12 outlines the incremental and cumulative price increases implemented from September 2012 until formal decontrol.

[22] Including an immediate INR 50–100 per cylinder increase in the price of subsidized LPG followed by quarterly increases of INR 50 from April 2013 until total decontrol, and increases in the price of PDS kerosene of INR 0.35 per litre per month or INR 1 per litre per quarter until the end of FY 2014/15 (with the objective of reducing total under-recoveries by 33 per cent).

[23] Bulk purchases are those made directly from OMC installations rather than from retail outlets, and typically constituted 16–18 per cent of total purchases by volume prior to price decontrol. Principal bulk purchasers included the Indian Railways and State Road Transport Corporations (together accounting for approximately half of total bulk purchases prior to decontrol), large industrial consumers (principally for the purpose of captive generation) and defence institutions. Bulk purchases were supplied at a marginally lower unit cost due to lack of dealer's margin (Re. 1) and volume-related discounting by the OMCs.

[24] From six cylinders to nine, with an increase in the allocation until the end of the financial year from three to five.

[25] All prices relate to the benchmark Indian Oil Company (IOC) Delhi rate (including relevant state taxes).

[26] Extending from February 21 to May 10, with a parliamentary recess from March 22 until April 22.

[27] On June 1, July 2, August 1, September 1, October 1, November 1, December 1, 2013, and January 4, February 1 and March 1, 2014. Note that the government rejected the October 2013 recommendation of a committee under Dr. K. Parikh to immediately increase diesel prices by an additional INR 5 (alongside increases in LPG and kerosene rates) to address the rapid increase in diesel under-recoveries experienced in mid-2013.

[28] Occurring across several phases in April and May 2014.

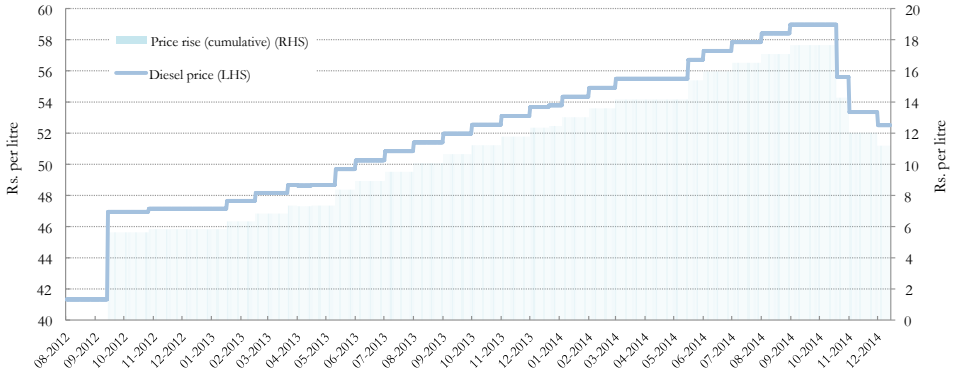

FIGURE 12: RETAIL DIESEL PRICE AND CUMULATIVE PRICE INCREASE (AUGUST 2012–DECEMBER 2014) (INR/LITRE)

Source: MoPNG (2014d; 2015b)

4.0 Impacts

4.1 Subsidy Expenditure

From a record quarterly under-recovery of INR 29,042 crore (USD 4.7 billion) in Q1 FY 2012/13, diesel under-recoveries reduced steadily following the initial price rise in September 2012 and subsequent price reforms from January 2013 onwards, falling to INR 23,669 crore (USD 3.8 billion) in Q2, INR 21,104 crore (USD 3.4 billion) in Q3 and INR 18,246 crore (USD 2.9 billion) in Q4 FY 2012/13, with the pace of reduction accelerating in early 2013 (to INR 10,554 crore or USD 1.0 billion in Q1 FY 2013/14). Driven by a weakening domestic currency (Figure 13), under-recoveries then rose again sharply in the second half of 2013—reaching INR 19,389 crore (USD 3.1 billion) in Q3 FY 2013/14—before declining from early 2014 onwards, falling from INR 15,182 crore (USD 2.4 billion) in Q4 FY 2013/14 (January–March) to INR 9,037 crore (USD 1.5 billion) in Q1 FY 2014/15 (April–June) and INR 2,619 crore (USD 422 million) in Q2 (July–September), before recording over-recoveries (representing a net profit to the OMCs) of INR 721 crore (USD 116 million) in the period of Q3 (October–December) prior to formal decontrol on October 18th (Figure 14).

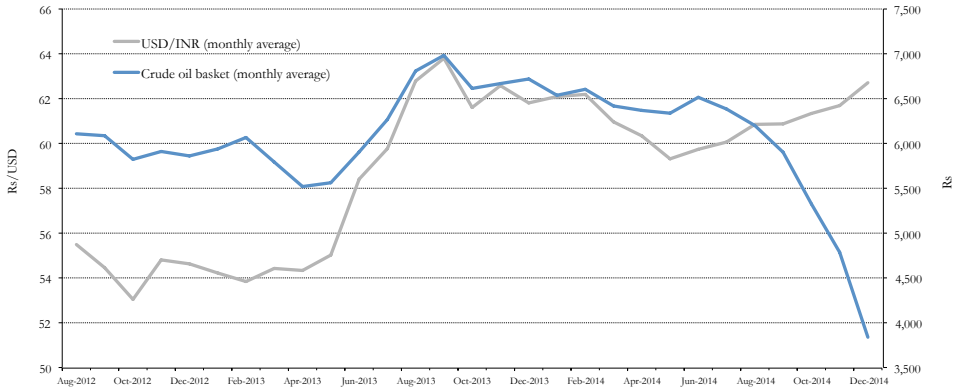

FIGURE 13: USD/INR EXCHANGE RATE AND PRICE OF CRUDE OIL BASKET (INR) (AUGUST 2012–DECEMBER 2014)

Source: Bank of England (n.d.) MoPNG (2014e, 2015a)

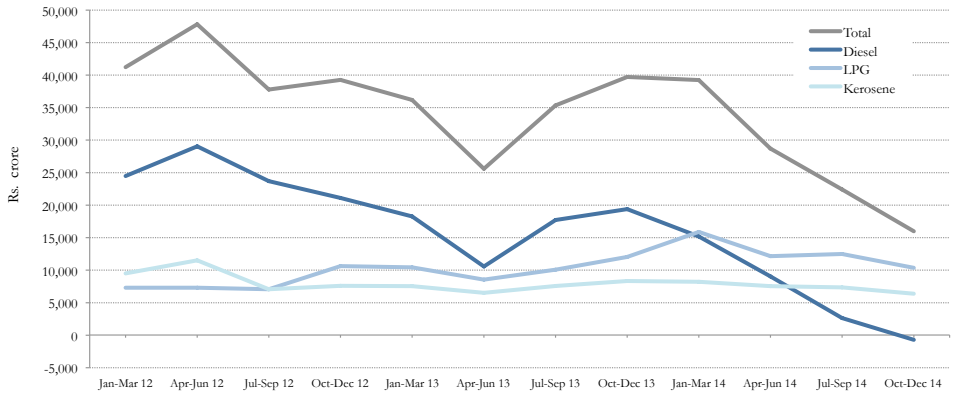

FIGURE 14: TOTAL UNDER-RECOVERY BY PRODUCT (JULY 2012–DECEMBER 2014) (INR CRORE)

Source: MoPNG (2014b, 2014h, 2015c)

4.2 Product Consumption

Both the initial INR 5 per litre increase instituted in September 2012 and the subsequent price reforms instituted in January 2013 (most importantly the total decontrol of bulk diesel pricing) resulted in an immediate and significant reduction in diesel demand relative to trend. Figure 15 demonstrates the direct effect of rising diesel prices on total diesel consumption from September 2012 onwards, with consistently strong monthly year-on-year growth rates moderating in late 2012 before turning negative in February 2013, marking the beginning of a sustained period of flat or negative consumption growth and an effective plateauing of total diesel consumption.

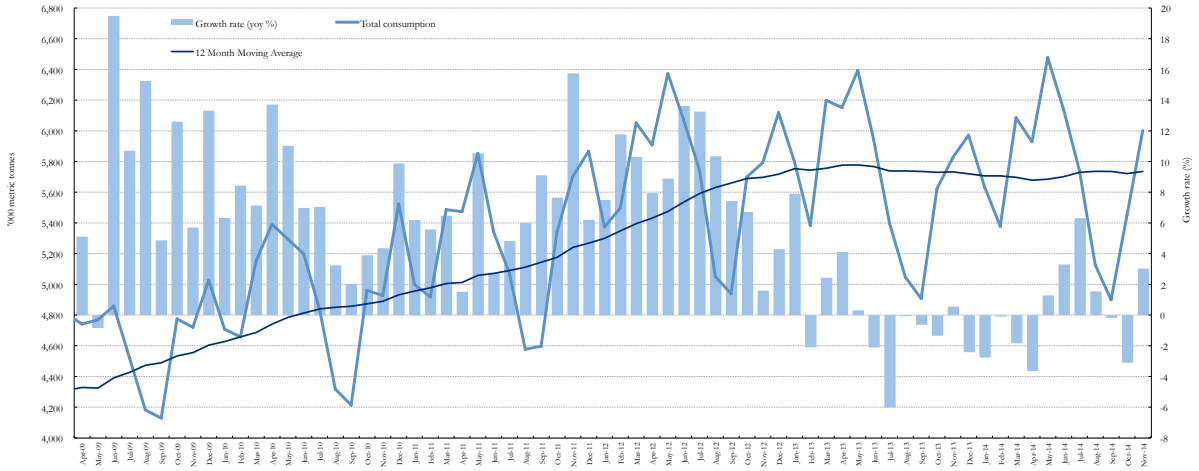

FIGURE 15: MONTHLY DIESEL CONSUMPTION (SEPTEMBER 2012–NOVEMBER 2014)

Source: MoPNG (2014a; 2014i)

In particular, decontrol of bulk diesel pricing in January 2013 had an immediate and measurable effect on overall diesel consumption, with bulk consumption as a percentage of total consumption falling from an average of 17.8 per cent in the six months prior to January 2013 to 10.2 per cent of total consumption in February 2013[29] (Figure 15) (although much of this reduction related to short-term disruption of supply, as bulk consumers such as State Road Transport Corporations switched to purchases from still-subsidized retail outlets[30]).

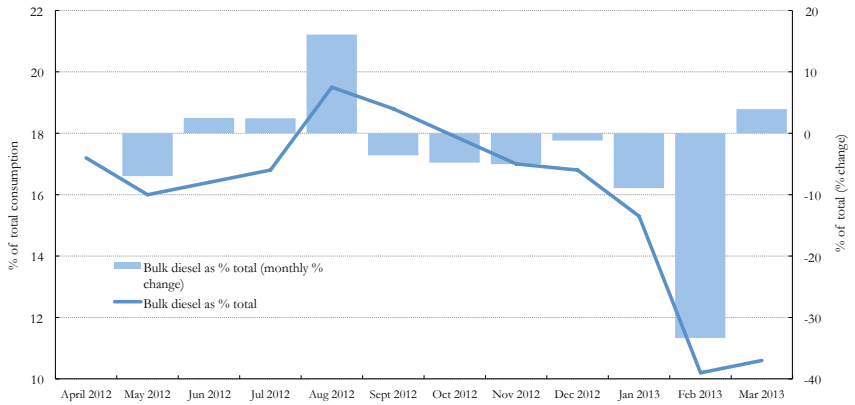

FIGURE 16: BULK DIESEL CONSUMPTION (APRIL 2012–MARCH 2013) (AS PER CENT TOTAL)

Source: MoPNG (2014g)

By effectively capping aggregate diesel demand, the reform of diesel pricing contributed to the eventual stabilization of India's burgeoning external sector deficits, with the country's goods and services and current account deficits both peaking in FY 2012/13 (at USD 130.7 billion [7.1 per cent of GDP] and USD 87.8 billion [4.7 per cent of GDP] respectively), before falling sharply (to USD 74.6 billion [3.9 per cent of GDP] and USD 32.4 billion [1.7 per cent of GDP]) in FY 2013/14. The value of oil and petroleum products within total imports continued to increase in FY 2012/13 and FY 2013/14, rising from 33.4 per cent (USD 164 billion within USD 490.7 billion) to 36.7 per cent (USD 165.2 billion within USD 450.1 billion), before moderating to 33.8 per cent in the first half of FY 2014/15.[31] However, net oil imports stabilized in FY 2012/13 (at USD 103.1 billion) then fell marginally in FY 2013/14 (to USD 102.5 billion) due to the continued growth of product exports.

Through changes in relative prices, diesel price reforms also affected the consumption profile of other fuel products, improving the relative competitiveness of petrol as a transport fuel, but also increasing incentives for the use of subsidized PDS kerosene (intended for household consumption) as a diesel adulterant or substitute. Diesel price rises progressively narrowed the cost differential between petrol and diesel (which had previously expanded to record levels in 2012), reducing the price gap from INR 27.14 per litre in August 2012 to INR 7.68 in mid-October 2014[32] and beginning to arrest the rapidly increasing dieselization of the private vehicle fleet (and its associated

[29] Subsequently remaining at around 10 per cent of total consumption.

[30] In addition, any savings on subsidy expenditure for remaining bulk diesel customers were of limited benefit to overall public finances, as the majority of the remaining bulk consumers were public sector entities which were either unable to immediately and fully pass through the cost increases to consumers (such as Indian Railways), or were themselves final consumers (such as defence institutions).

[31] USD $96.1 billion within USD $315.7 billion, compared to 35.8 per cent (USD 108.3 billion within USD 302.3 billion) in the same period of FY 2013/14.

[32] Before rising again due to diesel price decontrol and increases in excise duty.

effects on urban air pollution). However, the failure to introduce similar price reforms for PDS kerosene led to rapid increases in the differential between kerosene and diesel, rising from INR 26.49 per litre in August 2012 to INR 44.01 per litre in September 2014 prior to price decontrol, and potentially contributing to additional fuel diversion, revenue losses and air pollution.

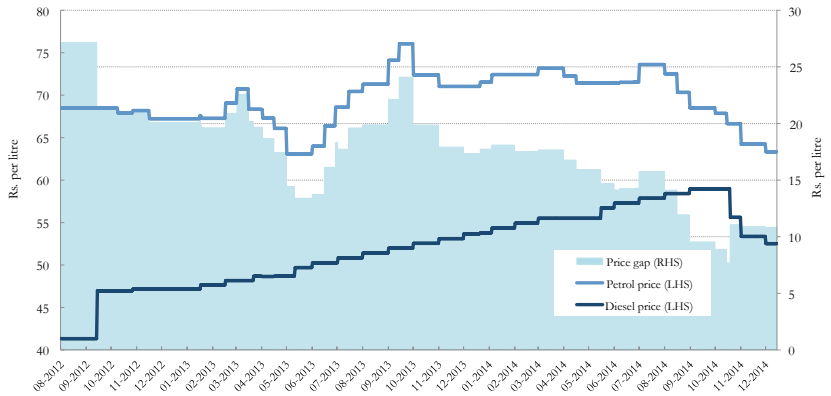

FIGURE 17: PRICE GAP BETWEEN RETAIL DIESEL AND PETROL (AUGUST 2012–DECEMBER 2014) (INR/LITRE)

Source: MoPNG (2014d; 2015b)

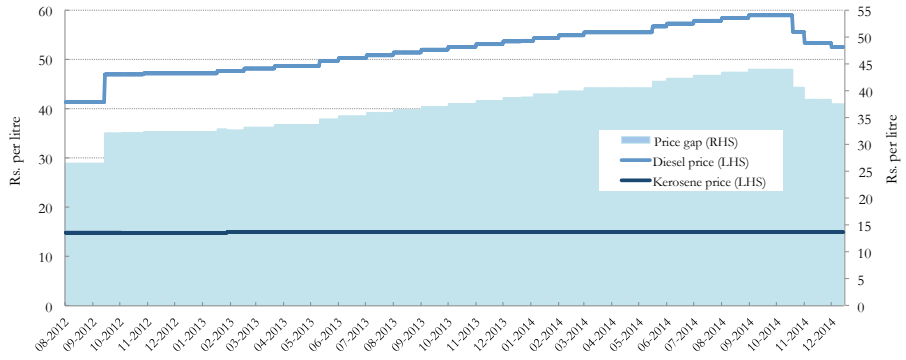

FIGURE 18: PRICE GAP BETWEEN RETAIL DIESEL AND PDS KEROSENE (AUGUST 2012–DECEMBER 2014) (INR/LITRE)

Source: MoPNG (2014d; 2015b)

4.3 Other

The UPA government's initial September 2012 decision to increase diesel prices and introduce a household LPG cylinder quota was subject to criticism from all the main opposition political parties (and several coalition government constituents). Following public demands to partially rescind the diesel price hike and increase the cap on subsidized LPG,[33] on September 18 one of the government's key coalition partners—the Trinamul Congress (TMC), with 19 seats in the lower house of parliament and six ministerial portfolios—withdrew from the UPA coalition in protest, reducing the government to a minority of seats in parliament.[34] The decision was, however, supported by several business associations and much of the financial media, who welcomed it (and the subsequent incremental price decontrol) as evidence of the government's broader commitment to economic reforms. The January 2013 announcement of monthly diesel price rises was similarly opposed by the principal opposition parties (including the BJP) and several government allies; however, the incremental price reforms implemented from January onwards were not the focus of any sustained parliamentary or extra-parliamentary mobilization.

The impact of the reforms on domestic inflation was tempered by the limited value of the retail price rises relative to total unit cost (approximately 10 per cent in the case of the September 2012 rise, and 1 per cent in the case of incremental rises from January 2013), and their distribution over a period of almost two years. Nevertheless, diesel price increases (along with increases in a range of other administrated energy prices) did contribute to the continued persistence of high short-run inflation—a key campaign issue in the subsequent 2014 national elections.

[33] In addition to demands to reverse the government's decision to allow FDI in retail and increase fertilizer prices.

[34] Falling from 273 to 254 seats. The Dravida Munnetra Kazhagam (DMK) (with 18 seats and five ministerial portfolios) subsequently announced its withdrawal from the UPA in March 2013 over the government's position on Sri Lanka's treatment of its Tamil population, further reducing the UPA's number of seats in parliament.

5.0 Lessons Learned

5.1 Key Lessons

India's attainment of formal diesel price decontrol represents a significant policy achievement. The success of the price reforms implemented by the UPA government, involving a substantial initial price rise followed by incremental monthly increases (as recommended by several advisory committees), clearly demonstrate the efficacy of phased price increases in limiting both economic disruption and immediate political opposition. The UPA administration's gradualist approach, subsequently adopted by the newly elected NDA government from June 2014 onwards, was assisted by the comparatively low ratio of subsidy to total (desired) price.[35]

While successful, India's diesel reforms also highlight the potential political costs of delaying price reforms, and reforming under pressure. Crucially, the (then) recently re-elected UPA government failed to grasp the opportunity presented in FY 2009/10—following a sharp fall in the average per-litre subsidy—to decontrol diesel pricing, thereby freeing fiscal space for urgently needed social and infrastructural expenditure (and potentially leading to significantly different economic and political outcomes in the subsequent period). Instead, the growth and persistence of diesel subsidies during the two terms of the UPA administration, and the government's consistent failure to comprehensively address the issue of fuel price reform, led to a scenario where it was effectively compelled to reform by rapidly deteriorating fiscal and external sector conditions (with limited time or fiscal space to manage the attendant political implications).

Under pressure to deliver significant fiscal consolidation but constrained by a tight electoral timeline, the government then engaged in a complex and opaque process of policy calibration, persisting with the implementation of progressive diesel price decontrol (a clear priority due to diesel's budgetary impact, highly regressive social distribution and lower level of direct consumption compared to other fuels) while avoiding price reforms for some energy-related subsidies (such as kerosene and fertilizer), retreating from other elements of its subsidy reform program on the basis of actual or perceived opposition[36] and simultaneously implementing countervailing (and in some cases socially regressive) fiscal measures.[37]

The intrinsic political cost of the diesel reform measures was exacerbated by the UPA administration's failure to clearly and effectively communicate the possibilities of enhanced social expenditure and public investment arising from fuel subsidy reform (partly due to its primary focus on fiscal consolidation), or to explicitly assign fiscal savings from diesel reform to popular social programs (such as the revised food subsidy entitlements provided under the recently enacted National Food Security Act). In addition, even as the administration largely maintained the schedule of monthly incremental diesel price increases, frequent policy changes and speculative statements by government ministers generated confusion about the pace and direction of subsidy reforms, and contributed to a wider perception of indecisiveness and policy incoherence.

While the government succeeded in implementing diesel pricing reforms without generating decisive short-term political opposition, the content of the reforms and the process of their implementation had a diffuse but cumulative negative effect on the government's public standing. Discontent with the government's handling of economic policy,

[35] Despite the high aggregate value of diesel subsidy expenditure, at its peak the per-unit diesel subsidy represented approximately 20 per cent of the total unit cost (in comparison to over 50 per cent for LPG and kerosene), limiting the relative price increase necessary to reduce (and ultimately remove) diesel subsidies.
[36] Most importantly by twice raising the initial per household subsidized LPG cylinder cap.
[37] For example, the INR 5.50 reduction in petrol duty announced in September 2012.

combined with other developments (including a series of corruption scandals), generated a profound anti-incumbency sentiment, resulting in the Congress Party's comprehensive defeat in the 2014 parliamentary elections—a result magnified by India's deeply undemocratic electoral system—and leaving the incoming NDA administration to reap the economic dividend of price decontrol without bearing the political cost.

5.2 Future Prospects

Following formal diesel price decontrol in October 2014, the NDA administration subsequently implemented a series of excise duty increases for diesel and petrol, reversing previous reductions in fuel taxation and representing a significant further positive step towards addressing energy mispricing. However, despite the success in achieving formal "decontrol," the government still retains the ability to directly intervene in product pricing through its ownership and management control of the public sector oil marketing firms. The NDA government has already demonstrated its willingness to exercise this post-reform through its direction to the OMCs not to pass through the full cost of subsequent excise duty increases to consumers (thereby effectively reinstating diesel price controls).[38]

In addition, the new government's continued of a focus on fiscal consolidation has meant that neither subsidy savings nor additional tax revenues generated have been directly earmarked for additional (compensatory) social transfers to lower income households,[39] with allocations to many key social sector programs static or falling in its first full year budget.[40] Like the previous UPA government, the NDA administration has similarly failed to use the opportunity provided by sharply lower oil prices (and accompanying low domestic inflation) to undertake gradual price reform of other subsidized products, or to meaningfully reform subsidy entitlements and distribution mechanisms.[41] It therefore remains to be seen whether the announcement of formal diesel price decontrol marks a defining turning point in the reform of Indian fiscal and social policy.

[38] Following a pattern previously established with the UPA's informal re-control of petrol prices in 2011.
[39] The government has indicated that additional revenues raised through increases in fuel duty will be earmarked for road construction, however the direct and indirect social and distributive implications of this expenditure (if it materializes) are highly contingent on location, form and methods of construction.
[40] Continuing a pattern established in the latter years of the UPA administration.
[41] Instead re-adopting costly and ineffective policies such as the Direct Benefit Transfer for LPG program, designed and partially implemented (then subsequently suspended) by the UPA.

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