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HOW THE VAT ON FUEL BY STATES CAN BE USED AS A COUNTERCYCLICAL FISCAL POLICY LEVER TO PROVIDE RELIEF TO CONSUMERS

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The change in excise duty by the Centre has a direct and automatic implication on the states as most of them levy ad valorem VAT on diesel and petrol. VAT on diesel and petrol depends on base oil price, transportation charges, dealer commission and excise duty. So when the excise duty is reduced by the Centre, state's VAT revenue gets reduced automatically. Interestingly, after the excise duty cut on fuel by the Centre, the VAT cuts announced by some of the states is only by default.

However, in the cacophony of states VAT revenue getting reduced automatically, 2 aspects get missed.

First, VAT on fuel acts as an automatic stabiliser. Thus when Centre increases excise duty on fuel, states gain in revenue and when centre cuts excise, states forego revenue from fuel. Our estimates indicate that states have gained Rs 49,229 crore from VAT revenue on fuel when oil prices were increasing and the states will forego Rs 15,021 crore when oil price has been downwardly adjusted through excise cut. This implies that gains still outstrip the revenue forgone by Rs 34,208 crore and hence states can further cut the oil prices. Maharashtra has gained the most, followed by Gujarat and Telangana. However, fuel prices in Gujarat are much lower than Telangana and Maharashtra. In fact, the average VAT on petrol in Maharashtra, Telangana and Andhra Pradesh is around 29.6%.

Second, contrary to popular perception, state finances have improved significantly post pandemic indicating states have the necessary wherewithal to adjust taxes if so required. **This is also reflected in lower state borrowings**. For example, one clearly see that the actual borrowing of the states has been lower than the calendar figures for the past few years (except FY20). Even the spread between the 10-year State Development Loans (SDL) yield from 10 year G-sec yield has now narrowed down significantly since mid-Feb'22 (63.7 bps to 35.9 bps currently).

Third, lower state borrowings is also because of a recent policy change that notifies that off balance sheet borrowings of states needs to be adjusted against borrowings. **According to the notification, the net borrowing of states in FY23 will have to be adjusted for the off balance sheet expenditure they had incurred in FY21 and FY22. Some states have huge amount of outstanding guarantees (For instance 11.7% of GSDP in case of Telangana)** which in turn will limit their borrowing for this fiscal. For FY23, the finance commission has also notified that besides 3.5% of GSDP borrowing by states and additional 0.5% of GSDP borrowing contingent on power sector reform, states have also been allowed additional borrowing equivalent to the state government's and employee's share of contribution under the NPS. The inclusion of off-budget expenditures in borrowing might put states under pressure to curtail their budgeted expenditure. However, it must be emphasised that many of these states (Telangana, Rajasthan, Chhattisgarh, Andhra Pradesh, among others) have offered freebies like farm loan waiver, restoring old pension system, etc, which are economically unsustainable given the financially bad shape of many states. Clearly, states seem to be currently living beyond their means and it is imperative that states rationalize their spending priorities in accordance with revenue receipts.

Taking all these factors into consideration and if the cushion of Rs 34,208 crore from oil excise is entirely adjusted such that states have no gain or loss from oil revenue over and above the budgetary estimates, we believe that states on an average can still cut diesel price at least by Rs 2 per litre and petrol price by Rs 3 per litre each without impairing their VAT revenue from oil. Bigger states like Maharashtra which have lower debt to GDP ratio have significantly large fiscal space for lowering their tax on diesel and petrol by even upto Rs 5. **Also, state's own tax revenue to GDP of many states including Haryana, Kerala, Maharashtra, Rajasthan, Telangana and Arunachal Pradesh is higher than 7%. We believe there is compelling reason for these states to adjust taxes on fuel.**

The ultimate solution to reduce the complexities in oil tax structure and bring down extreme volatility in oil revenues due to volatile crude price would be to bring it under the ambit of GST. However, if the two fuels are put under GST, the Centre will have to let go Rs 20,000 crore input tax credit. Thus, a fair methodology would have to be developed for this.

Lastly, the recent measures by the Government would ease inflation by 35-40 bps. CPI inflation for May'22 might come down by 10 bps from our earlier projection to 7.0% and the full impact of these measures will be visible only in the later months. Under current circumstances, domestic consumer price inflation is expected to average at 6.5%-6.7% in FY23. Additionally, these measures are likely to have fiscal implication for the Centre as well. However, considering the conservative budgetary estimates for FY23 the net fiscal implication could be around Rs 66,000 crore to Rs 17.27 lakh crore from Rs 16.61 lakh crore in FY23 BE. **But with higher nominal GDP estimates, fiscal deficit as % of GDP can still be contained closer to 6.4%-6.6% in FY23.**

IMPACT OF EXCISE DUTY CUT ON STATE REVENUES

- The Government has recently cut the excise duty on petrol by Rs 8 per litre and on diesel by Rs 6 per litre amidst rising inflation. The change in excise duty by the Centre has a direct and automatic implication on the states as most of them levy ad valorem VAT on diesel and petrol. VAT on diesel and petrol depends on base oil price, transportation charges, dealer commission and excise duty. So when the excise duty is reduced by the Centre, state's VAT gets reduced automatically.
- However, VAT on fuel acts as an automatic stabiliser. Thus when Centre increases excise duty on fuel, states gain in revenue and when centre cuts excise, states forego revenue from fuel. Our estimates indicate that states have gained Rs 49,229 crore from VAT revenue on fuel when oil prices were increasing and the states will forego Rs 15,021 crore when oil price has been downwardly adjusted through excise cut. This implies that states still will have a cushion of Rs 34,208 crore from oil excise over and above the budgetary estimates. Maharashtra has gained the most, followed by Gujarat and Telangana. However, fuel prices in Gujarat are much lower than Telangana and Maharashtra. In fact, the average VAT on petrol in Maharashtra, Telangana and Andhra Pradesh is around 29.6%.
- Also, contrary to popular perception, state finances have improved significantly post pandemic indicating states have the necessary wherewithal to adjust taxes if so required. This is also reflected in lower state borrowings with the data showing that the actual borrowing of the states has been lower than the calendar figures since FY19 (except for FY20). The spread between the 10-year State Development Loans (SDL) yield from 10 year G-sec yield has narrowed down significantly since mid-Feb'22 (63.7 bps to 35.9 bps currently), indicating that there is not much demand of SDL and states are not borrowing much.
- Lower state borrowings this year is also because of a recent policy change that notifies that off balance sheet borrowings of states needs to be adjusted against borrowings. According to the notification, the net borrowing of states in FY23 will have to be adjusted for the off balance sheet expenditure they had incurred in FY21 and FY22. Some states have huge amount of outstanding guarantees (For instance 11.7% of GSDP in case of Telangana) which in turn will limit their borrowing for this fiscal.

State-wise Overall Fiscal Impact of Oil Excise Cut (Rs crore)

State	Fiscal Bonanza: Gain from Increase in Oil prices during FY22	Automatic Loss: Loss from reduction in excise duty	Overall Fiscal Impact	Debt to GDP Ratio FY22 (%)
Andhra Pradesh	3,546	1,000	2,546	37.6
Assam	188	312	-125	31.9
Bihar	736	311	425	34.0
Chhattisgarh	522	424	98	29.8
Delhi	965	210	756	2.5
Goa	316	62	254	31.9
Gujarat	5,659	852	4,808	21.4
Haryana	2,678	510	2,168	35.3
Himachal Pradesh	544	25	519	43.4
Jammu & Kashmir	648	140	508	56.6
Jharkhand	700	262	438	32.6
Karnataka	3,433	1,194	2,238	25.7
Kerala	1,046	804	242	38.3
Madhya Pradesh	1,797	946	852	29.0
Maharashtra	7,751	2,241	5,510	20.4
Odisha	755	674	81	26.7
Punjab	2,213	363	1,850	53.3
Rajasthan	2,711	1,138	1,572	39.8
Tamil nadu	3,325	771	2,554	31.6
Telangana	4,310	1,098	3,212	27.4
Uttar Pradesh	3,375	1,097	2,278	34.2
Uttarakhand	365	77	288	30.3
West Bengal	1,315	420	895	38.8
TOTAL	**49,229**	**15,021**	**34,208**	-

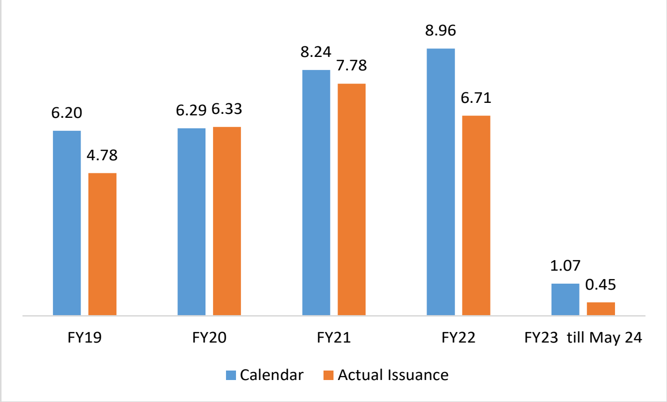
Source: SBI Research

Top States registering decline in VAT per litre

Diesel	Petrol
Telangana	Telangana
Maharashtra	Assam
Odisha	Rajasthan
Assam	Andhra Pradesh
Chhattisgarh	Kerala
Kerala	Madhya Pradesh

Source: SBI Research

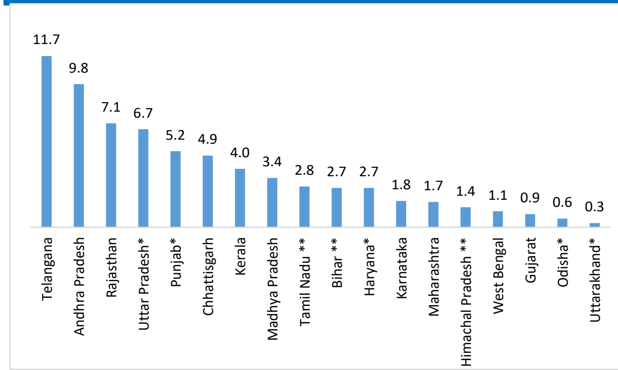
Outstanding State Guarantees (% of GDP)



Source: SBI Research, * FY20, ** FY21 and rest FY23 estimates

- As per the notification, in FY23 the Government has decided to bring borrowings by State Public Sector companies/corporations, SPVs and other equivalent instruments, where the principal and/or interest are to be serviced out of the State Budgets and/or by assignment of taxes/cess or any other state's revenue, into Borrowings made by the state itself for the purpose of issuing the consent under Article 293(3) of the Constitution of India. The net borrowing of state in FY23 will have to be adjusted for the off-balance sheet borrowings they had raised in FY21 and FY22.
- States like Telangana, Andhra Pradesh, Rajasthan, UP, Punjab, Chhattisgarh and Kerala, which have significant outstanding guarantees will have limited space to borrow during the current year.
- Interestingly, many of these (Telangana, Rajasthan, Chhattisgarh, Andhra Pradesh, among others) are among the states that have offered freebies like farm loan waiver, restoring old pension system, etc, which are economically unsustainable given the financially bad shape of many states. Clearly, states seem to be currently living beyond their means and it is imperative that states rationalize their spending priorities in accordance with revenue receipts.
- However, it should be noted that besides 3.5% of GSDP borrowing and additional 0.5% of GSDP borrowing contingent on power sector reform, states have also been allowed additional borrowing equivalent to the state government's and employee's share of contribution under the NPS. This has been done as some states who have adopted NPS are not making necessary contributions under NPS which in turn is leading to understating the actual fiscal deficit of those states.
- Our calculation reveals that every Re 1 cut in VAT on diesel leads to around Rs 9,500 crore loss for states and every Re 1 cut in VAT on petrol on an average leads to loss of Rs 4,500 crore. Thus, states still can cut the diesel price on an average by upto Rs 2 per litre and petrol price by Rs 3 per litre each without impairing their fiscal arithmetic.
- States like Maharashtra, Gujarat, and Karnataka have lower debt to GDP ratio and thus have more fiscal space for lowering their tax on diesel and petrol.
- Moreover, state's own tax revenue to GDP of many states including Haryana, Kerala, Maharashtra, Rajasthan, Telangana and Arunachal Pradesh is higher than 7% and have more fiscal space. These states can reduce their VAT on petrol and diesel more to bring inflation under control.

Outstanding State Guarantees (% of GDP)



Source: SBI Research, * FY20, ** FY21 and rest FY23 estimates

Own Tax Revenue as % of GSDP

State	2020-21	2021-22 (RE)	2022-23 (BE)
Andhra Pradesh	5.82	6.13	6.80
Bihar	4.90	5.16	5.55
Chhattisgarh	6.50	6.87	6.61
Gujarat	4.24	5.09	5.21
Haryana	6.10	7.26	7.42
Jharkhand	4.78	5.71	6.18
Karnataka	5.38	6.48	6.73
Kerala	5.96	6.53	7.41
Madhya Pradesh	5.94	6.21	6.33
Maharashtra	6.06	7.11	7.16
Rajasthan	5.95	6.92	7.37
Tamil Nadu	5.58	5.59	5.75
Telangana	6.88	8.05	8.30
West Bengal	4.63	4.81	4.63
Arunachal Pradesh	5.02	6.47	7.12
Assam	4.50	5.07	4.65
Himachal Pradesh	5.16	5.58	5.65
Mizoram	2.23	2.33	2.03
Nagaland	3.26	3.72	3.67
Odisha	6.31	6.50	6.39

Source: SBI Research, State Budget Documents

- Ultimately the solution could be bringing petrol and diesel under GST. However, both Centre and states are hesitant to do this as Sales Tax/VAT on petroleum products is a major source of own tax revenue for them.
- Also, if the two fuels are put under GST, the Centre will have to let go Rs 20,000 crore input tax credit it currently pockets by keeping petrol, diesel, natural gas, jet fuel and crude oil out of the GST regime. Thus, some fair methodology needs to be worked out to bring oil under GST which would reduce the complexities in oil tax structure and also bring down extreme volatility in oil revenues.

IMPACT OF RECENT MEASURES ON INFLATION

- Steep cut in oil excise duty by the Government will have a positive impact on inflation of around 20 bps.
- Furthermore, edible oil duty cut which was reduced to 5.5% in Feb'22 has been reduced to zero recently. This is likely to ease inflation further by 10-12 bps.
- In addition, duty reduction on other items, including ferronickel, coking coal, PCI coal, coke semi-coke, naphtha and PVC will soften the domestic price inflation by another 5-8 bps. Thus the recent moves will bring down inflation by 35-40 bps.
- CPI inflation for May'22 might come down by 10 bps from our earlier projection to 7.0% and the full impact of these measures will be visible only in later months.
- Under current circumstances, domestic consumer price inflation is expected to average at 6.5%-6.7% in FY23.

IMPACT ON FISCAL

- The recently announced measure to combat inflation are likely to have fiscal implication. The cut in oil excise duty is expected to lead to loss of Rs 1 lakh crore to the Government for an entire year. Thus, for this fiscal it could be Rs 87,000 crore (assuming 10.5 months remaining). However, budgeted amount of Rs 3.35 lakh crore in FY23 compared to Rs 3.94 lakh crore in FY22 RE seems conservative. Thus this could easily be Rs 3.70 lakh crore. Thus additional burden of excise duty cut would only be Rs 50,000 crore.
- In addition, fertiliser subsidy has been increased by Rs 1.1 lakh crore which will directly hit the Centre's fiscal situation. Also, Rs 200 subsidy per gas cylinder (upto 12 cylinders) to around 9 crore beneficiaries of PM Ujjwala Yojna has been announced which is likely to have fiscal implication of Rs 61,000 crore.
- The announcement of duty free import of 20 lakh metric tonnes yearly import of crude soyabean and sunflower oil will also lead to lower revenues for the Government.
- These measures in total will have fiscal implication of around Rs 2.5 lakh crore.
- However, the revenue collection for FY23 are expected to be higher than estimates in the budget as they were on the conservative side. Thus net fiscal implication of these measures could be around Rs 66,000 crore. But with higher nominal GDP estimates fiscal deficit as % of GDP is still expected to be close to 6.4% -6.6%.

Impact of recent measures on inflation (bps)

Measure	decline in bps
Oil excise duty cut	20
Edible oil import duty cut	10 to 12
Other duty cut on raw material	5 to 8 bps
Total impact on inflation	35 to 40 bps

Source: SBI Research

Fiscal implication of recent measures in FY23 (Rs lakh crore)

Measure	**Amount**
Fertiliser subsidy	1.10
Gas subsidy	0.06
PMGKAY	0.80
Oil excise duty cut	0.50
Total fiscal impact of these measures	**2.46**
Higher tax collection owing to higher GST and imports	1.80
Net fiscal implication	0.66
Fiscal Deficit BE	16.61
New Fiscal Deficit	17.27
New Fiscal Deficit (% of GDP)	6.4%-6.6%

Source: SBI Research

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