CHAPTER 1

INTRODUCTION

India's dependence on oil over a period of time has increased substantially. Nearly 80 % of oil[1] is imported and the import bill is playing havoc with the balance of payment as the exports are not sufficient to cover the import bill. In addition an increase in oil prices plays havoc with the government planning and poses significant challenges in framing policy. The government efforts in reducing the common man burden by subsidizing the cost of diesel, Kerosene and LPG has increased the budget deficit over the years. This has led to greater money supply leading to higher inflation. With high imports Indian budget planners would be heavily dependent on international oil prices falling so that the economy could be put on track.

1.1 Indian Annual Budget

The Government of India (GOI) have to perform manifold functions from maintaining law and order, protecting India's territories to implementation of plans for economic and social betterment. Besides, they provide a variety of social services like education, health, employment and housing to the people. Needless to say, GOI requires adequate resources to discharge these functions effectively. The necessary funds are mobilised from the country's resources by way of taxes both direct and indirect, loans both long-term and short-term, to meet the governmental expenditure. It is not as if the government can tax, borrow and spend money the way it likes. Since

[1] Calculated based on production and consumption data of petroleum in Appendix I taken from http://www.indexmundi.com/energy.aspx?country=in&product=oil&graph=consumption

there is a limit to the resources, the need for proper budgeting arises to allocate scarce resources to various governmental activities. Hence, planned expenditure and accurate foresight of earnings are *sine-qua-non* of sound Governmental finance. The Union Budget of India, referred to as the annual Financial Statement in Article 112 of the Constitution of India, is the annual budget of the Republic of India, presented each year on the last working day of February by the Finance Minister of India in Parliament. The budget has to be passed by the House before it can come into effect on April 1, the start of India's financial year.

The Indian Budget consists of Plan and non-plan expenditure[2]. The Plan expenditures are estimated after discussions between ministries and the Planning Commission. Plan Expenditure is designed for asset-building and infrastructure projects. The non-plan revenue expenditure is accounted for by interest payments, subsidies (mainly on petroleum, food and fertilisers), wage and salary payments to government employees, grants to States and Union Territories governments, pensions, police, economic services in various sectors, other general services such as tax collection, social services, and grants to foreign governments. The Non-plan capital expenditure includes defense, loans to public enterprises, loans to States, Union Territories and foreign governments. The Non-plan expenditure is generally considered not so useful at generating assets. However the non-plan Capital expenditure can include funding to states to help development projects in the states. In general, Plan expenditure is more useful and thus a

[2] Government of India, Ministry of Finance, Budget Documents. http://www.indiabudget.nic.in

cut in government spending that impacts plan expenditure may cause stagnation in future.

1.2 Budget at a Glance

Table 1.1: Budget

			2010-2011	2011-2012		2012-2013
			Actuals	Budget Estimates	Revised Estimates	Budget Estimates
			In Rs Crores			
1	Revenue Receipts		788471	789892	766989	935685
	2	Tax Revenue (net to centre)	569869	664457	642252	771071
	3	Non-Tax Revenue	218602	125435	124737	164614
4	Capital Receipts (5+6+7)$		408857	467837	551730	555241
	5	Recoveries of Loans	12420	15020	14258	11650
	6	Other Receipts	22846	40000	15493	30000
	7	Borrowings and other liabilities *	373591	412817	521980	513590
8	Total Receipts (1+4)$		1197328	1257729	1318720	1490925
9	Non-Plan Expenditure		818299	816182	892116	969900
	10	On Revenue Account	726491	733558	815740	865596
		of which,				
	11	Interest Payments	234022	267986	275618	319759
	12	On Capital Account	91808	82624	76376	104304
13	Plan Expenditure		379029	441547	426604	521025
	14	On Revenue Account	314232	363604	346201	420513
	15	On Capital Account	64797	77943	80404	100512
16	Total Expenditure (9+13)		1197328	1257729	1318720	1490925
	17	Revenue Expenditure (10+14)	1040723	1097162	1161940	1286109
	18	Of Which, Grants for creation of Capital Assets	87487	146853	137505	164672
	19	Capital Expenditure (12+15)	156605	160567	156780	204816

20	Revenue Deficit (17-1)	252252	307270	394951	350424
		-3.3	-3.4	-4.4	-3.4
21	Effective Revenue Deficit (20-18)	164765	160417	257446	185752
		-2.1	-1.8	-2.9	-1.8
22	Fiscal Deficit {16-(1+5+6)}	373591	412817	521980	513590
		-4.9	-4.6	-5.9	-5.1
23	Primary Deficit (22-11)	139569	144831	246362	193831
		-1.8	-1.6	-2.8	-1.9

Table 1.1 shows in brief, receipts and disbursements along with broad details of tax revenues and other receipts. It also exhibits broad break-up of expenditure - Plan and Non-Plan (section 9 & 13 in Table 1.1), allocation of Plan outlays by sectors as well as by ministries/Departments and details of resources transferred by the Central Government to State and Union Territory Governments. It also shows the revenue deficit (section 20 of Table 1.1) the gross fiscal deficit (section 22 of Table 1.1) and the gross primary deficit (section 23 of Table 1.2) of the Central Government. The excess of government's revenue expenditure over revenue receipts constitutes revenue deficit of government. The difference between the total expenditure of government by way of revenue, capital and loans net of repayments on the one hand and revenue receipts of government and capital receipts, which are not in the nature of borrowing but which finally accrue to government on the other, constitutes gross fiscal deficit[3]. Gross primary deficit is measured by gross fiscal deficit reduced by gross interest payments. In the Budget documents 'gross fiscal deficit' and 'gross primary deficit' have been referred to in abbreviated form 'fiscal deficit' and 'primary

[3] http://indiabudget.nic.in/ub2012-13/keybud/keybud2012.pdf

deficit', respectively. It also shows liabilities of the Government on account of securities (bonds) issued in lieu of oil and fertilizer subsidies.

In Table 1.1, Ser No 10, the Non Plan Revenue Expenditure which constitutes Rs 865596 Crores will be the major study of this thesis. The details of this expenditure are given in Table 1.2.

Table 1.2 : Non Plan Revenue Expenditure

		2010-2011	2011-2012		2012-2013
		Actuals @	*Budget* Estimates	*Revised* Estimates	*Budget* Estimates
In Rs Crores					
1. NON-PLAN EXPENDITURE					
A. Revenue Expenditure					
1	Interest Payments and Prepayment Premium	234022	267986	275618	319759
2	Defence Services	92061	95216	104793	113829
3	Subsidies	173420	143570	216297	190015
4	Grants to State and U.T. Governments	49790	66311	55322	64211
5	Pensions	57405	54521	56190	63183
6	Police	27339	30595	33302	35611
7	Assistance to States from National Calamity Contingency Response Fund (NDRF)	4179	4525	4525	4620
8	Other General Services (Organs of State, tax collection, external affairs etc.)	16917	18195	19395	21382
9	Social Services (Education, Health, Broadcasting etc.)	35014	20862	19709	20784
10	Economic Services (Agriculture, Industry, Power, Science & Technology, etc.)	28051	25391	23702	24105
11	Postal Deficit	6162	5018	5573	5727

12	Expenditure of Union Territories without Legislature	3775	3592	3735	3875
13	Amount met from National Calamity Contingency Fund/Disaster Response Fund (NDRF)	-3900	-4525	-4525	-4620
14	Grants to Foreign Governments	2256	2301	2105	3114
Total Revenue Non-Plan Expenditure		726491	733558	815740	865596

Table 1.2 gives the detail of Non Plan Revenue Expenditure. It is evident that out of Rs 865596 Crores expenditure for fin year 2012-2013, Defence service is 113829 crores (section 2 of Table 1.2) and Subsidies are 190015 crores(section 3 of Table 1,2). The defence service includes (i) pay & allowance, (ii) expenditure towards administration and (iii) maintenance of weapons & equipments. The Subsidies include fuel & agriculture subsidy. Therefore crude oil price has an effect on expenditure towards revenue expenditure of defence and subsidy.

1.3 <u>International Oil Price</u>

The price of petroleum as quoted generally refers to the spot price per barrel (1 barrel=159 litres) of either West Texas Intermediate (WTI)/light crude as traded on the New York Mercantile Exchange (NYMEX) or of Brent as traded on the Intercontinental Exchange (ICE). The price of a barrel of oil is highly dependent on its grade, determined by factors such as specific gravity and sulphur content. The demand for oil is highly dependent on global macroeconomic conditions. According to the International Energy Agency (IEA), high oil prices generally have a large negative impact on the global economic growth. The Organization of the Petroleum Exporting

Countries (OPEC) was formed in 1960 to try to counter the oil companies cartel, which had been controlling posted prices since the so-called 1927 Red Line Agreement and 1928 Achnacarry Agreement, and had achieved a high level of price stability until 1972. After the collapse of the OPEC-administered pricing system in 1985, oil-exporting countries adopted a market-linked pricing mechanism. First adopted by Petroleos Mexicanos (PEMEX)[4] in 1986, market-linked pricing received wide acceptance and by 1988 became and still is the main method for pricing crude oil in international trade. The price of oil underwent a significant decrease after the record peak of US$145 it reached in July 2008[5]. On December 23, 2008, WTI crude oil spot price fell to US$30.28 a barrel, the lowest since the financial crisis of 2007–2010 began, and traded at between US$35 a barrel and US$82 a barrel in 2009. On 31 January 2011, the Brent price hit $100 a barrel on concerns about the political unrest in Egypt. The Oil price is hovering around $106 in 2013. India's oil import bill leaped 40 per cent to a record $140 billion in 2011-12 as high oil prices shaved off much of the nation's GDP growth rate[6]. Figure 1.1 depicts Oil prices since 1992. It can be seen that the oil price has been steadily increasing since 1992 but for a brief period of 2008.

[4] Petroleos Mexicanos is the biggest enterprise in Mexico and Latin America. http://www.pemex.com/index.cfm?action=content&sectionID=123

[5] http://www.cnbc.com/id/25503130/Oil_Prices_Settle_at_Record_High_Above_145

[6] http://articles.economictimes.indiatimes.com/2012-06-13/news/32215709_1_oil-import-bill-net-oil-oil-prices

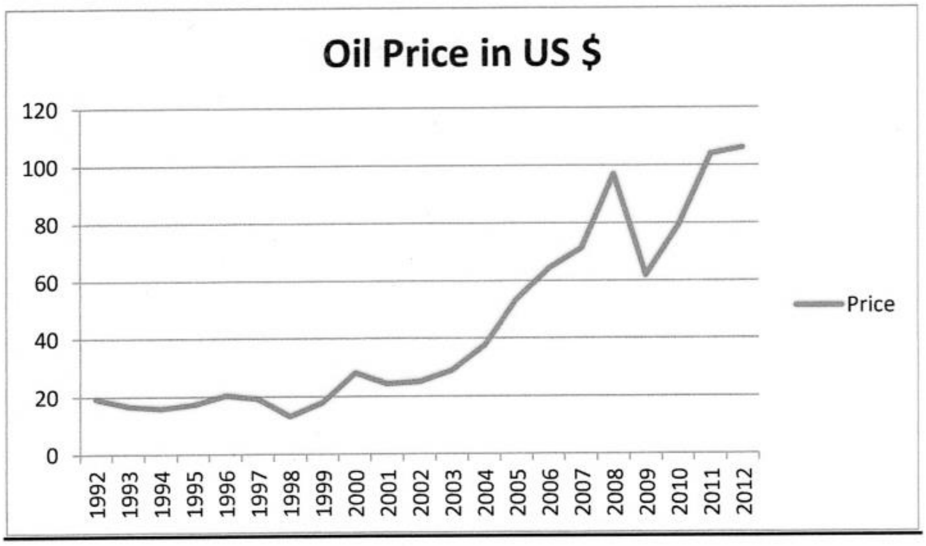

Figure 1.1: Oil Price in US Dollars *Source:* http://www.indexmundi.com

Higher international oil prices lead to inflation in India, as it increase the budget deficit which invariably drives up interest rates and slows down the economic growth. Also, net oil importing countries like India experience deterioration in their balance of payments, putting downward pressure on exchange rates. As a result, imports become more expensive and exports less valuable, leading to a drop in real national income. According to IEA projected in 2008 that there will be a rise in the global demand for crude oil as the developing countries have increased the usage of crude oil. The usage of global crude oil is increasing year by year with an upward moving trend. Figure 1.2 depicts the consumption and production of oil by India since 1980.

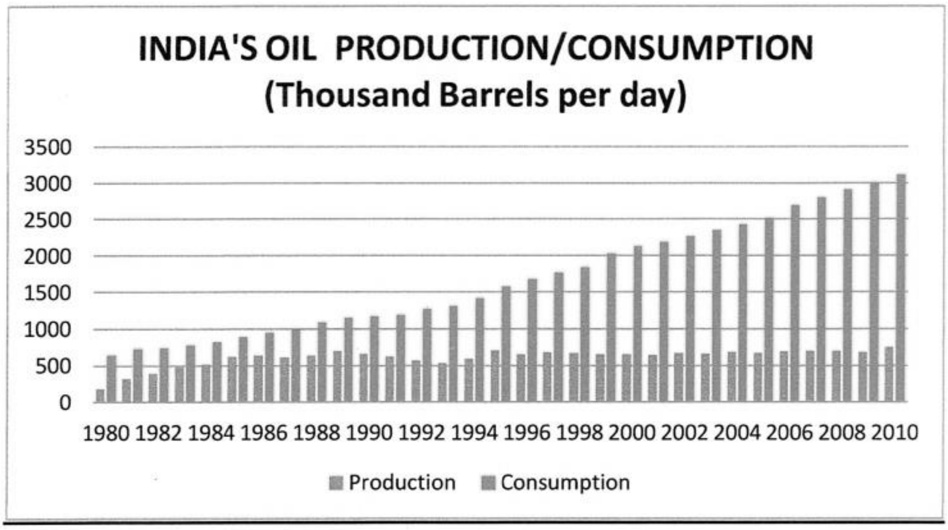

Figure1.2: India's Oil Production and Consumption Source :http://www.indexmundi.com

Figure 1.2 clearly depicts that the consumption is increasing steadily over the last 30 years whereas increase in production has not been commensurate with increase in consumption. This has led to huge import of crude oil pushing the import bill up.

1.4 **Fiscal Deficit**.

A budget deficit occurs when a government spends more money than it makes. In the 1980s, the high budget deficit resulted in large Balance of payment problem. This was resolved by international borrowing resulting in 1991 crisis[7]. The fiscal deficit was experienced for the first time in 1979-80 which was only 0.57[8] percent of Gross Domestic Product (GDP). Today it is

[7] What Caused the 1991 Currency Crisis in India? IMF Staff Papers, Valerie Cerra and Sweta Chaman Saxena.

[8] www.punjabiuniversity.ac.in/cdeiswebsite/papers/30%20Ranjan%20Kumar%20Mohanty%20Fiscal%20Deficit%20Economic%20Growth%20Nexus%20in%20India%20A%20Cointegration%20analysis.final.pdf

more than six[9] percent of GDP. Budget deficit have serious implications as they are covered through borrowings which entail an increase in the interest burden leading to further borrowing. Thus the central finances get into a vicious circle called the internal debt trap. Figure 1.3 depicts the fiscal deficit as percentage of GDP since 1990.

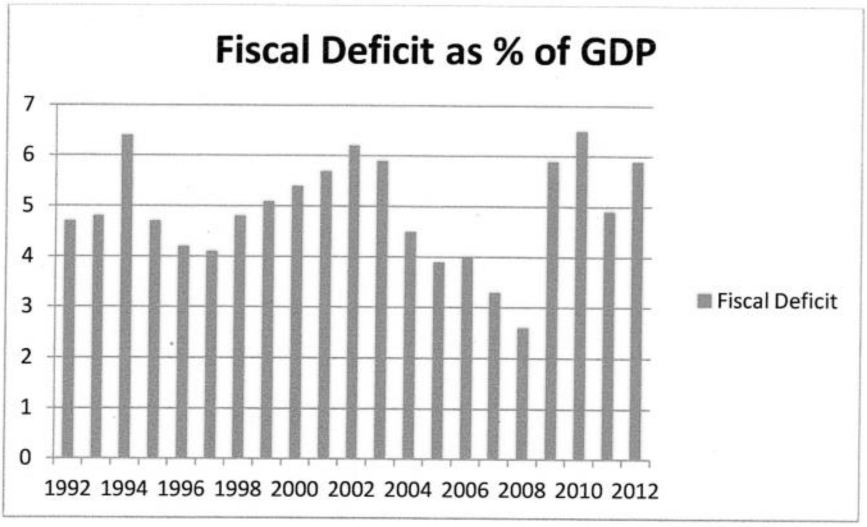

Figure 1.3: Fiscal Deficit as Percentage of GDP Source: http://dbie.rbi.org.in

Figure 1.3 presents the fiscal deficit as percentage of GDP. For a developing country the fiscal deficit should not be more than 3 % of GDP. In case of India it has been hovering around 5% which needs to be reduced. Financing of fiscal deficit by borrowing from the Reserve Bank of India leads additional money supply and inflationary situation in the economy. Most part of the government borrowing is to finance its revenue deficit. Further financing of fiscal deficit through borrowing from market crowds out industry borrowing as both are borrowing from the same pool. Inflation in India is considered as a severe macro-economic problem because of the rapid increase in central and state governments' fiscal deficit, especially increase

[9] http://economictimes.indiatimes.com/fullcoverage/fy-13-fiscal-deficit

in non-plan expenditure on Revenue Account since 1980s[10]. Thus less allocation of resources to Capital Account results in a decline in the creation of productive assets. This leads to slow growth in the economy and inflation since private investments are mainly growth oriented. The Inflation rate since 1980s is depicted in Figure 1.4 below

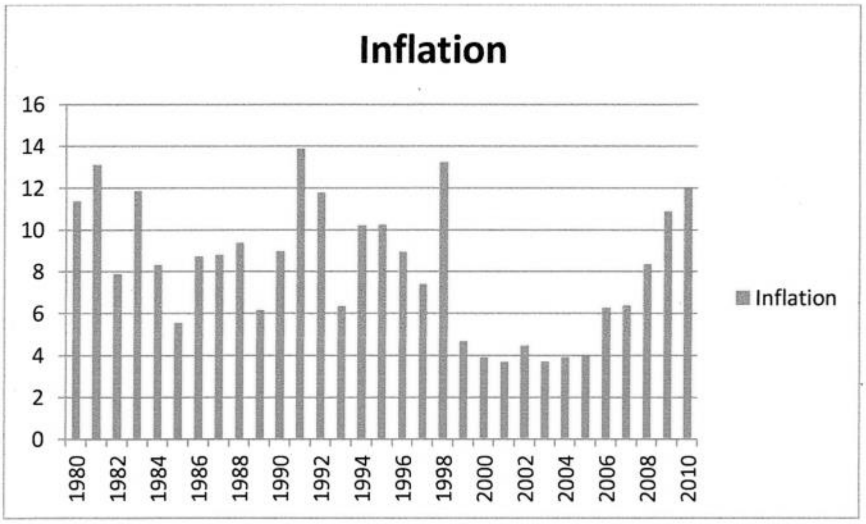

Figure 1. 4: Inflation in India since 1980 Source: http://dbie.rbi.org.in

Figure 1.4 depicts inflation since 1980. The inflation figure has gone as high as 13.8% in 1991 and as low as 3.8% in 2001. The inflation figure has been steadily increasing over the last few years chiefly due to increase in international crude oil price. At present nearly 80% of crude oil requirement of India is imported as the production capacity is only about 7.5 Lakh barrels per day[11], whereas consumption is 32 Lakh barrels per day[12]. The Oil

[10] Government of India, Ministry of Finance, Budget Documents. http://www.indiabudget.nic.in

[11] Calculated based on production data of petroleum in http://www.indexmundi.com/energy.aspx?country=in&product=oil&graph=production

[12] Calculated based on consumption data of petroleum in http://www.indexmundi.com/energy.aspx?country=in&product=oil&graph=consumption

prices are not stable and fluctuate based on international conditions. This fluctuation in the oil prices effect the budgetary planning in a big way. At present the Government of India is giving a subsidy in petroleum sector. The petroleum subsidy, which was budgeted at Rs 23640 crore for FY12 has been revised to Rs 68481 crore[13]. This led to Increase in Government borrowing and the fiscal deficit. This budget deficit increases inflation as the Government had to print more money to cater for the fiscal deficit which increased the money supply in the market. Moreover defence is one of the major consumers of oil and defence expenditure is part of annual budgeting of Government of India. Thus an increase in international oil price increases the subsidy, budget deficit, inflation and the defence budget, creating an impact on the Annual Budget

[13] http://www.capitalmarket.com/CMEdit/story49-0.asp?SNo=544075&sid=49&ssid=139&rbyear