Economy | Macro-Cap

Petro tax cut: Hit and miss

Policy Announcement:

- The Center has reduced excise duty on petrol and diesel by INR10/liter each, bringing rates down to INR3/liter for petrol and INR0/liter for diesel.
- Current under-recoveries on petrol and diesel are estimated at ~INR 20-30/liter (remains volatile). Despite the excise duty cut, OMCs remain under pressure. In the past, under-recoveries of INR300b were compensated by the government in FY22-23 due to domestic LPG, rather than petrol and diesel. In 2014-15, the amount was INR438b. Over the last 10 years, the amount has ranged between INR120b and INR350b.

Fiscal Impact:

- We estimate the fiscal cost of this measure at INR 1.65t (~0.4% of GDP). The Budget assumes nominal GDP growth of 10% YoY; however, we expect growth closer to 11–11.5%, driven by higher commodity prices (oil, gas, fertilizers), which should lift both WPI and CPI. This could provide a 5bp buffer to the fiscal impact.
- Additionally, fertilizer subsidies could rise by INR1.5t (0.3% of GDP) due to elevated global prices (refer to Impact of oil price shock on GDP, CAD, INR, inflation, and fiscal deficit).
- The combined impact of these two factors (reduction in excise duty on petrol & diesel and possibility of an increase in fertilizer subsidies) could potentially widen the fiscal deficit to ~5.0% of GDP in FY27, compared to the Budget estimate of 4.3%.
- Two offseting factors working in favor of the government are higher inflation boosting nominal GDP and, hence, tax collections, and the possibility of higher-than-budgeted RBI dividend (FY27BE: INR3.2t), which we expect to be an additional INR0.5t. There also remains a possibility of adverse adjustment where capital expenditure may be pruned by ~INR 1tn (from INR 12.2tn to INR 11.2tn), implying modest 2% growth of INR10.95t over FY26RE, possibly from the roads and railways budget (refer to Fuel or Engines Part III).
- Netting the impact of petro and fertilizer subsidies, adjusted for higher nominal GDP (vs. BE), pruning capex, and factoring in the additional RBI dividend, we expect the fiscal deficit to widen by 40bp to 4.7% of GDP for FY27.
- While this would lead to an increase in market borrowings, the Union government would have sufficient levers to bridge the gap. This can be achieved via additional short-term T-Bill borrowings or through 'other liabilities' such as small savings collections, which are expected to remain robust, supported by higher interest rates offered compared to bank FDs (above 7-8% on most of the schemes).

Inflation Impact:

- As the cut in excise duty on petrol and diesel is unlikely to be passed to retail pump prices, there is no direct inflation benefit from this petro tax cut.
- Instead, we believe that if crude prices remain elevated, OMCs may raise retail prices by INR2–4/liter in 1QFY27 (note that OMCs also face a weaker rupee, along with higher imported costs of oil and gas). The direct impact is estimated at 10-20bp for the INR2 and INR4 hike, if at all the hike goes through. Including LPG price increases, the direct impact would be ~26-36bp. Factoring in second-order impacts, inflation could move closer to 5%.

Outlook:

- The government has reduced excise taxes, providing marginal relief to OMCs, but the fiscal impact is significant, with implications for yields and inflation. We believe yields could move closer to 7.1-7.2% over the course of the year, driven by elevated energy prices, sticky inflation, and worsening fiscal and CAD dynamics. The impact would also be reflected in the rupee, hovering slightly below the 95 level.
- The RBI is walking a tightrope between managing growth and inflation. There are clear upside risks to inflation and downside risks to growth. That said, the RBI is likely to maintain a hawkish hold through CY26, while clearly communicating its intent to support growth. Although risks of a rate hike are becoming visible, it may be too early for the central bank to act.

Radhika Piplani – Research analyst (Radhika.Piplani@MotilalOswal.com)
Tanisha Ladha – Research analyst (Tanisha.Ladha@MotilalOswal.com)

The inflation impact: As the cut in excise duty is unlikely to be passed, there is no direct inflation impact from this. Instead, we believe if oil prices sustain at higher levels for extended period, OMCs may be compelled to increase retail prices by INR2-4/liter in 1QFY27. The direct impact on inflation from such retail price hikes is calculated based on the weights of diesel and petrol in the new CPI base, which are 0.32% and 4.49%, respectively, vs. 0.2% and 2.2% in the old series. Based on these weights, the direct impact is estimated at 10-20bp for a price hike of INR2 and INR4. If we also include the hike in LPG prices, with a weight of 1.98% in the new series (vs 0.4% in the old), the net impact of inflation comes to ~26-36bp. Additionally, taking into account the indirect pact of oil and gas through core inflation and food prices, we expect headline inflation to rise by 50-60bp, in the ballpark of 5% inflation.

The fiscal impact: We assume diesel and petrol consumption to grow by 2% and 5%, respectively, in FY27. This implies that the consumption of petrol and diesel will stand at 44,000 MT and 99,519 MT for FY27. Consequently, a reduction of INR10/liter reduction in excise duty on both petrol and diesel would result in a loss of INR1.65t for the exchequer. However, nominal GDP projected in the budget for FY27 is 10%, which, we believe, could be closer to 11-11.5% due to the inflationary impact of oil and gas prices on the CPI and WPI (refer to the earlier section on inflation impact. There may also be pressure on expenditure, driven by the need for additional funds for both petroleum and fertilizer. Accounting for an additional fertilizer subsidy of INR1.5t (MOFSL estimate), over and above the budgeted INR1.7t, the fiscal deficit could exceed 5% of GDP from the budget expectation of 4.3%.

However, we consider this as part of the base outcome. We factor in the following responses from the government:

1. Higher nominal GDP (11-11.5% YoY), rather than 10% mentioned in the budget
2. The possibility of a higher-than-budgeted RBI dividend (FY27BE: INR3.2t), with an expected upside of INR0.5t.
3. A potential reduction in capital expenditure by around INR1t from INR12.2t to INR11.2t (FY26RE: INR10.95t), resulting in modest growth of 2% in headline capital expenditure (possibly from roads and railways budget; for details, refer to Fuel or Engines Part III).

On a net basis, this may lead to an increase in the fiscal deficit from the current INR16.96t to INR18.61t or a fiscal deficit in the ballpark of 4.7% of GDP; higher by 0.4%.

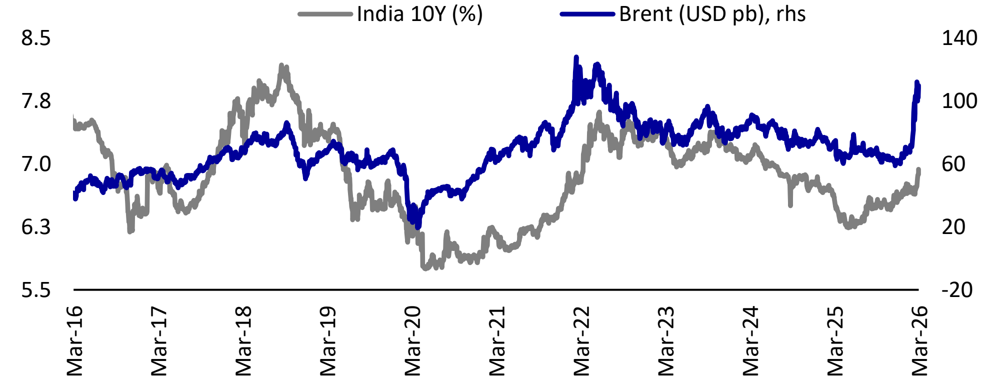
Although this may lead to higher market borrowings, the Union government would have ample levers to bridge the gap. This can be achieved through additional short-term T-Bill borrowings or through 'other liabilities' such as small savings collections, which are expected to remain robust, supported by higher interest rates offered compared to bank FDs (above 7-8% on most of the schemes).

Rising discomfort for RBI; bond yields may rise further: The RBI is walking a tightrope between managing growth and inflation. There are clear upside risks to inflation and downside risks to growth. That said, the RBI is likely to maintain a **hawkish hold through CY26,** while clearly communicating its intent to support growth. While risks for rate hike may start reflecting, it may be too early for the central bank to act. The situation remains fluid, and in such a scenario, the RBI would avoid hastily changing its direction of supporting growth while remaining cognizant of rapidly emerging upside risks to inflation. Liquidity management will remain the RBI's most important lever for another year, as it continues to intervene in the FX market while ensuring adequate liquidity for banks. Sterilization operations will become more significant.

India's 10-year yield has been closely tracking movements in the UST 10Y yields and global crude oil prices, while also reflecting the impact of excise duty on fiscal maths. We expect the 10Y G-sec yields to move toward 7.1-7.2%, with upside risks to fiscal, inflation, and CAD. Globally, as well, yields have picked up sharply over the last one month. This is likely to add to further upside pressure. Going forward, bond market participants will continue to scan global interest rate moves and commodity price trends to determine the trajectory of domestic 10Y G-sec yields.

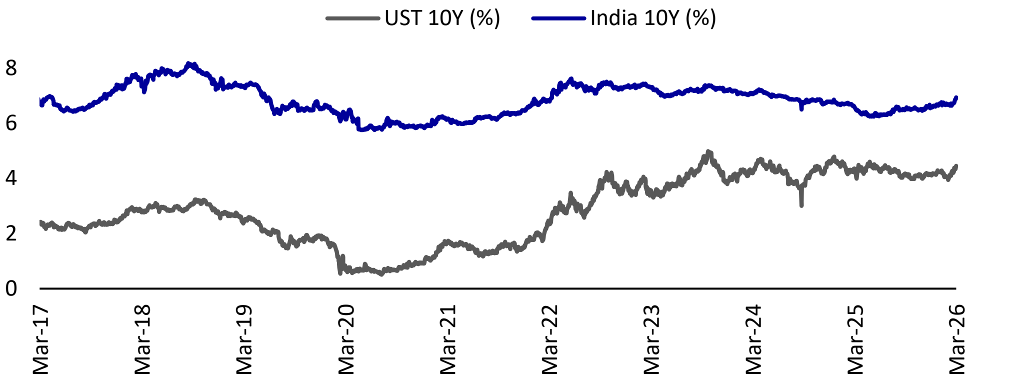
The global monetary policy easing cycle has reversed, which may put additional pressure on rupee to depreciate. It now appears likely that the rupee could reach 97-98 range sooner than previously expected, despite the RBI's FX intervention.

Exhibit 7: India's 10Y yield inches closer to 7%



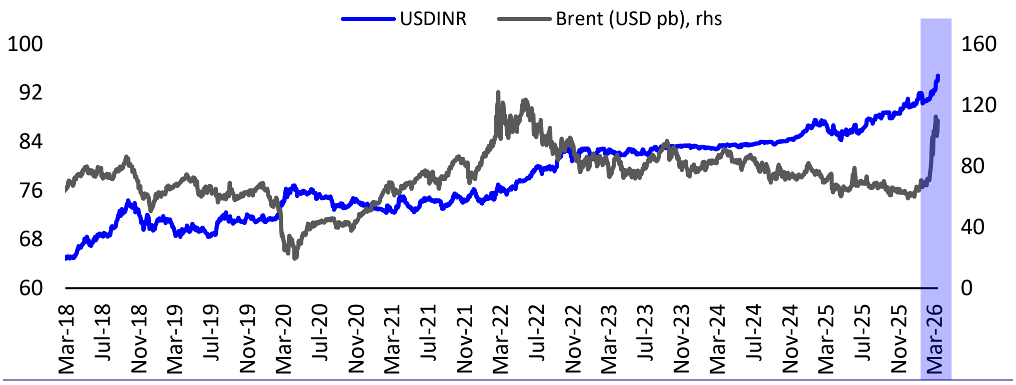
Source: Bloomberg, MOFSL

Exhibit 7: Trend in UST 10Y and India 10Y; US 10Y yields spike ~50bp in 1M



Source: Bloomberg, MOFSL

Exhibit 6: Rupee depreciates above the 94 level with the rise in oil prices



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Contact Person	Contact No.	Email ID
Ms. Hemangi Date	022 40548000 / 022 67490600	query@motilaloswal.com
Ms. Kumud Upadhyay	022 40548082	servicehead@motilaloswal.com
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