



POLICY BRIEF #68

The Fiscal Cost of Holding Down Fuel Prices in India After the Middle East War

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Abstract

This paper examines the macroeconomic and fiscal implications of the recent Middle East conflict-induced surge in global oil prices for India, a highly import-dependent energy economy. It highlights how supply disruptions and rising prices are affecting fiscal and external balances, while exposing structural vulnerabilities stemming from high import dependence and limited strategic reserves.

The paper shows that India's policy of shielding consumers from higher fuel prices through tax reductions, subsidies, and constrained price pass-through has provided short-term relief but entails significant fiscal costs, estimated at about 0.6 per cent of GDP annually.¹ These measures also weaken price signals, encourage inefficient energy use, and disproportionately benefit higher-income households. At the same time, declining petroleum tax revenues and limited adjustment for inflation have eroded the tax base and reduced the alignment of fuel prices with their social and environmental costs.

The analysis argues that maintaining current pricing policies is increasingly unsustainable if high oil prices persist. It calls for a gradual restoration of price pass-through, targeted support for vulnerable households, and reforms to strengthen energy security, including expanding strategic reserves and accelerating diversification away from imported fossil fuels.

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¹ Note: This estimate covers the incremental fiscal cost on petrol and diesel arising from the oil price shock. Natural gas and LPG subsidies, treated separately, represent an additional explicit subsidy burden of approximately 0.20 per cent of GDP

The Fiscal Cost of Holding Down Fuel Prices in India After the Middle East War

Sanjeev Gupta* and Pratik Tiwary#

1. Introduction

The war in the Middle East and the resulting disruption to oil and gas supplies have delivered a significant shock to the Indian economy, which relies heavily on imported oil to meet its energy needs. If sustained, the surge in international prices and supply constraints could have important implications for both growth and inflation. Should the Strait of Hormuz remain closed for an extended period or there are protracted delays in restoring production in oil-producing countries, the consequences for India over the next six to twelve months could be far-reaching.

Thus far, India has largely shielded domestic consumers from higher petrol and diesel prices, absorbing the impact through subsidies embedded in the pricing framework and reductions in taxes. This policy has reflected the concern that a full pass-through of higher international prices could trigger social unrest, particularly in an election period. However, sharply curtailed supplies of liquefied petroleum gas (LPG) have led to rationing for commercial users and the emergence of a black market for cooking cylinders, affecting both households and businesses. The limited availability of LPG has raised the cost of living for the urban poor and contributed to job losses in the service sector reliant on affordable energy.

Higher oil prices erode household purchasing power when incomes do not keep pace and increase transportation costs across the economy. The evidence suggests (Choi et.al. 2017) that these effects are present in both advanced and developing economies, with higher transport costs serving as a key transmission channel through which oil price increases dampen consumption. In the current context, supply disruptions have also affected the availability of fertilizers, which could weigh on agricultural output in the upcoming planting season. In addition, shortages of other petroleum-based inputs are likely to push up the prices of several essential goods.

This note shows that, given India's heavy reliance on imported energy, maintaining current petroleum prices is increasingly difficult to sustain. The fiscal costs of maintaining current policy are at least 0.6 per cent of GDP annually, which would divert scarce budgetary resources from development priorities and, if financed through borrowing, contribute to rising public debt. The policy is also regressive, as the primary beneficiaries of petroleum subsidies, especially petrol users, tend to be higher-income households. Persistently high import volumes at elevated global prices would widen the current account deficit, placing additional pressure on the rupee. Moreover, this approach sits uneasily alongside efforts to accelerate the transition to cleaner and more sustainable energy sources. Thus, a gradual and

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well-communicated move toward greater pass-through of international prices, combined with targeted support for vulnerable households, particularly those reliant on LPG, would help reduce fiscal risks while preserving social protection. The current crisis also underscores the importance of accelerating structural reforms to reduce dependence on imported oil, as well as taking steps to build up petroleum reserves and diversify petroleum supplies.

The remainder of this note is organized as follows. Section 2 examines the role of petroleum imports in India’s external balance. Section 3 describes the domestic fuel-pricing framework. Section 4 compares fuel prices in India and the United States to illustrate the misalignment of India’s domestic petroleum prices. Section 5 reviews trends in petroleum-related revenues. Section 6 estimates the fiscal costs of maintaining current price policies and compares them with those in other Asian economies. Section 7 concludes.

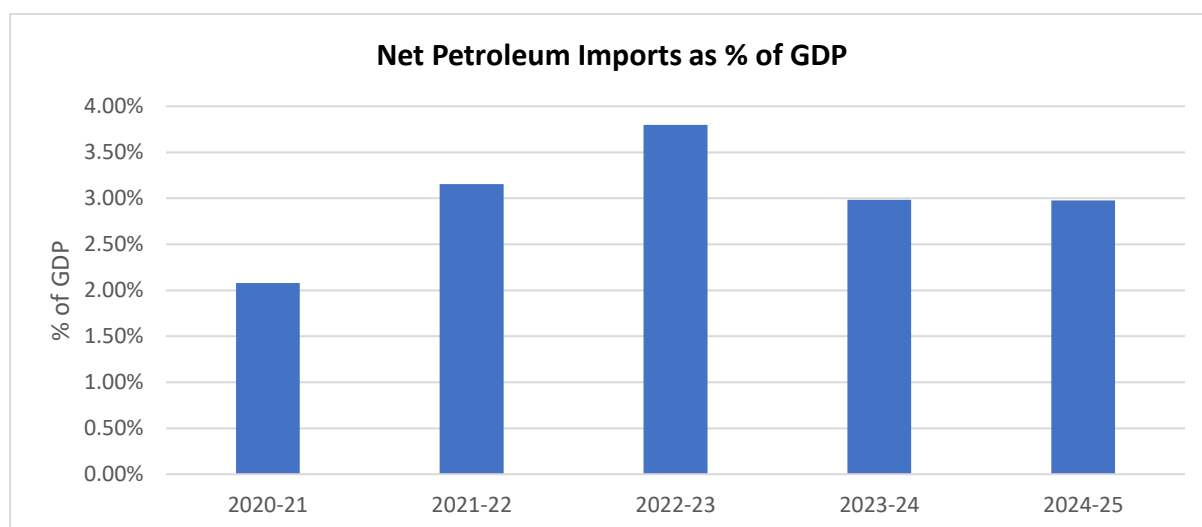
2. India’s Petroleum Imports and Strategic Reserves

In recent years, India’s net imports of petroleum products have hovered around 3 per cent of GDP (Figure 1). An exception was 2022–23, when India increased imports of discounted Russian crude following the war in Ukraine, while simultaneously exporting refined petroleum products to European markets facing supply constraints.

The relatively stable share of net petroleum imports in GDP suggests that the petroleum intensity of the Indian economy has not declined, indicating that policies aimed at transitioning toward green energy have yet to have a substantial macroeconomic impact.

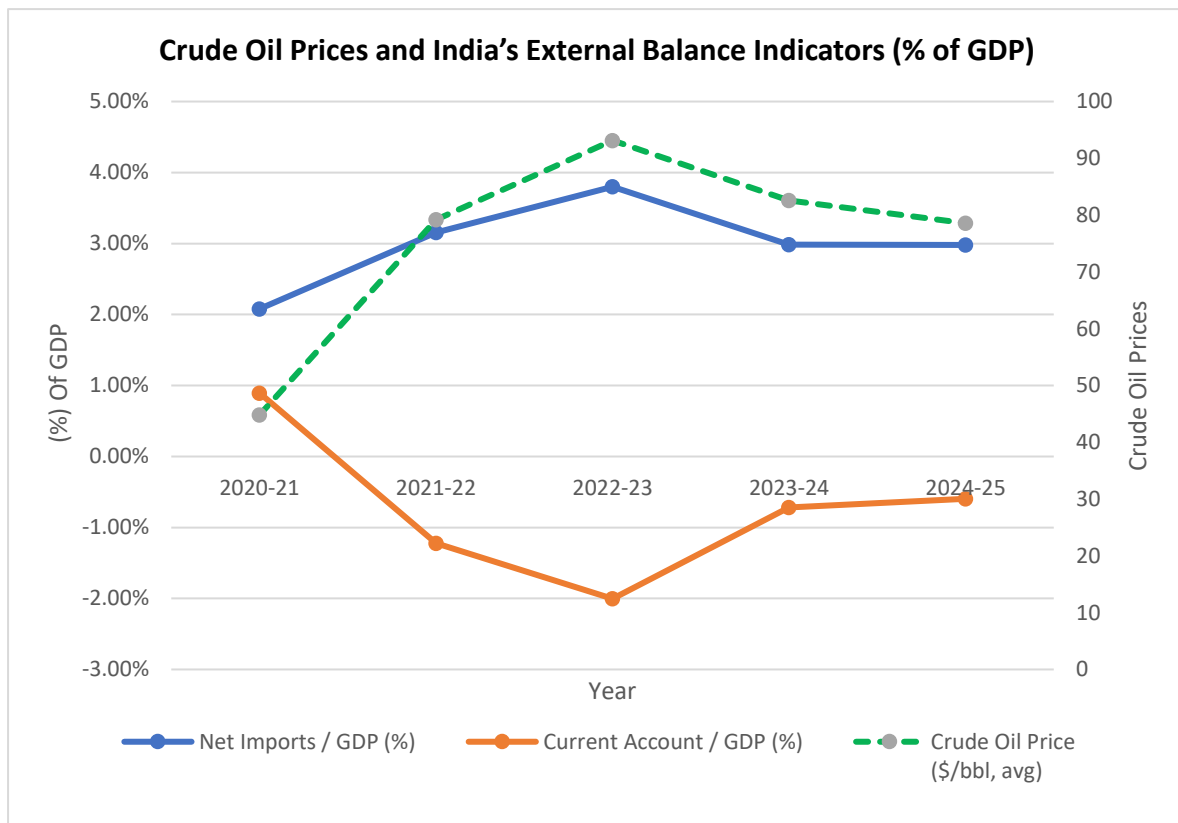
Movements in India’s current account are closely correlated with net petroleum imports. Periods of lower imports have generally coincided with improvements in the current account balance (Figure 2). Similarly, fluctuations in international crude oil prices are strongly associated with movements in the current account (Figure 2).

Figure 1: Net Petroleum Imports as % of GDP



Source: Petroleum Planning & Analysis Cell, RBI, Authors’ Calculations.

Figure 2: Crude Oil Prices and India's External Balance Indicators (% of GDP)



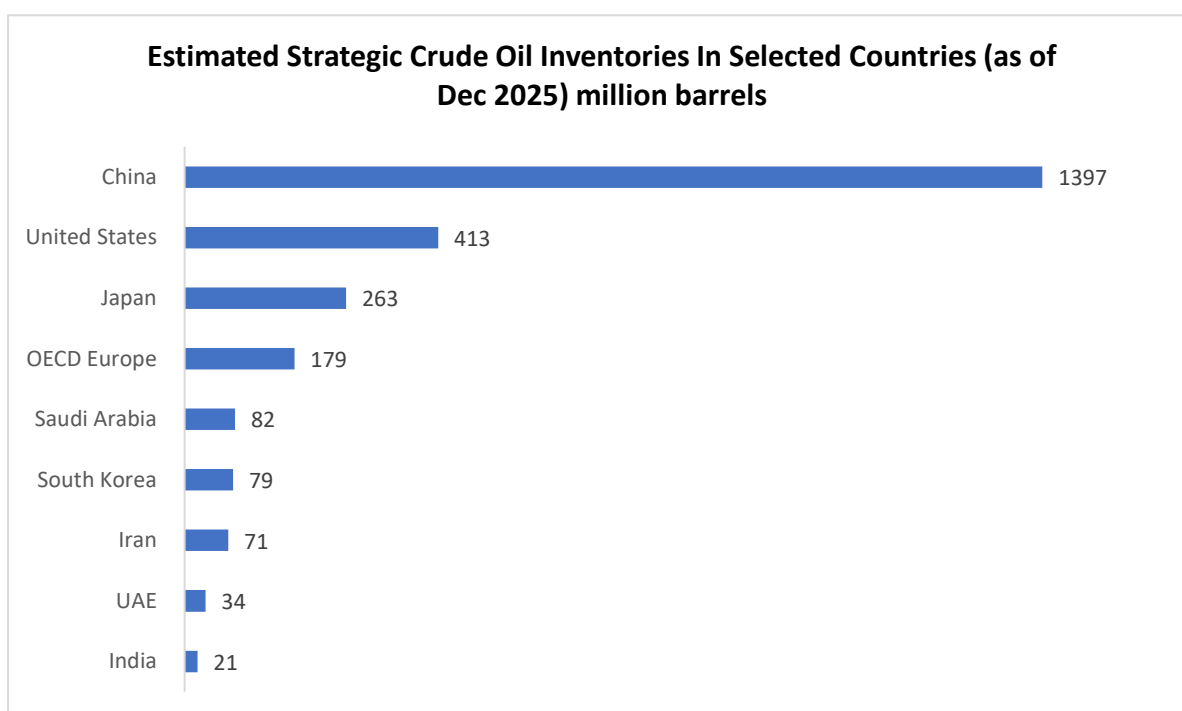
Source: Petroleum Planning & Analysis Cell, RBI, Authors' Calculations.

At the same time, India's strategic petroleum reserves remain limited relative to the size of its economy (Figure 3). They are a small fraction of those in major economies, less than 2 per cent of China's, about 5 per cent of the United States', 8 per cent of Japan's, and 27 per cent of Korea's. The recent supply disruptions highlight that current reserve levels are insufficient to ensure energy security in the face of supply shocks.

This combination of high import dependence and limited strategic reserves amplifies India's exposure to external energy shocks.

India's structural vulnerability has deepened over time: domestic crude production fell by approximately 2.5 per cent in 2024–25, and oil wells have seen a cumulative output decline of around 26 per cent over the past decade, pushing import dependence to an estimated 89 per cent of total oil needs as of 2025 (Carnegie Endowment for International Peace, 2026; Council on Foreign Relations, 2026).

Figure 3: Estimated Strategic Crude Oil Inventories (Dec 2025)



Data sources: U.S. Energy Information Administration, Short-Term Energy Outlook (STEO), March 2026

Note: Other estimates derived from the International Energy Agency, China National Bureau of Statistics, Vortexa Analytics, Kayrros, Kpler, Argus Media, and Global Trade Tracker. Drawn from Chartbook Newsletter by Adam Tooze.

3. India's Domestic Fuel-Pricing Regime

India's domestic fuel-pricing system can be characterized as a layered framework in which different products are subject to varying degrees of market pass-through, taxation, and explicit subsidy. While pricing has gradually shifted away from the administered pricing mechanism toward partial deregulation, the state continues to play a central role.

Petrol and diesel prices are only partly determined by global crude prices and refining costs. Retail prices remain heavily influenced by central excise duties, state-level sales taxes, and periodic policy interventions.² Domestic LPG prices are linked to international benchmarks but are partially insulated through targeted subsidies and compensation to oil marketing companies.³

² Central excise duties on petrol and diesel were reduced in two tranches in November 2021 and May 2022 by a total of ₹13 per litre for petrol and ₹16 per litre for diesel. In addition, oil marketing companies reduced retail prices by ₹2 per litre in March 2024. These measures indicate that, despite formal deregulation, fuel taxation continues to be used as a tool for managing inflation and protecting consumers (Government of India, 2025)

³ Despite an increase of about 21 per cent in international LPG benchmark prices (Saudi CP) between July 2023 and November 2025, domestic LPG prices declined by roughly 22 per cent over the same period. This divergence points to a deliberate policy of insulating household consumers from global price volatility (PPAC, 2026).

Household piped natural gas (PNG) and compressed natural gas (CNG) used in transport are protected through administered pricing and allocation mechanisms. Overall, India operates a system of selective rather than full pass-through. While this hybrid model has helped manage inflation and protect vulnerable consumers, it has also resulted in a fragmented and highly politicized fuel-tax structure (PRS Legislative Research, 2018, 2021; PIB, 2023a; PIB, 2026). In practice, this pricing framework has required continued support from the central budget in the form of energy subsidies.

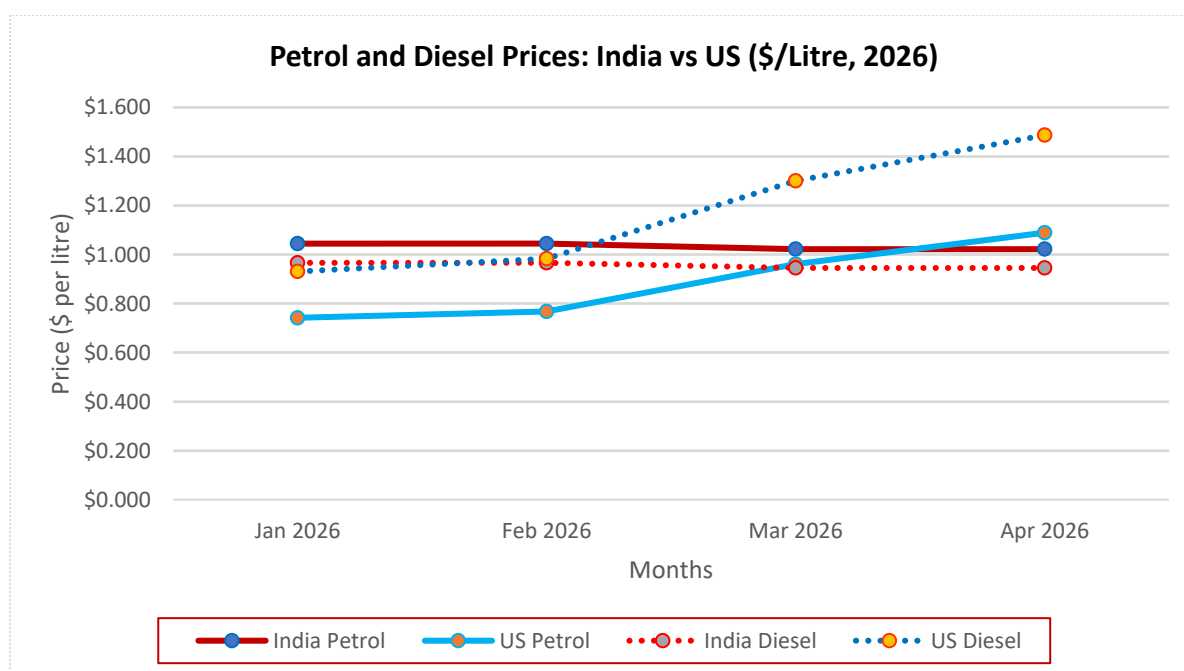
The implications of this pricing framework become evident when comparing India’s fuel prices with international benchmarks.

4. Comparison of Petrol and Diesel Prices with an International Benchmark

As an illustration of how India’s fuel pricing diverges from international pricing, it is useful to compare average retail prices of petrol and diesel (including taxes) with those in the United States (Figure 4). In the United States, fuel prices adjust frequently, often daily, reflecting market conditions. This contrasts with countries such as India and Germany, where governments have mitigated price increases through reductions in excise taxes.

In the aftermath of the Middle East conflict, fuel prices in the United States, despite its status as a net exporter of petroleum products, have risen. In January 2026, petrol prices in India were higher than in the United States, but this relationship had reversed by April 2026. A similar pattern is observed for diesel, with the price gap widening during March and April.

Figure 4: Petrol and Diesel Prices: India vs US (\$/Litre, 2026)



Source: Petroleum Planning & Analysis Cell, U.S. Energy Information Administration (EIA), Authors’ Calculations.

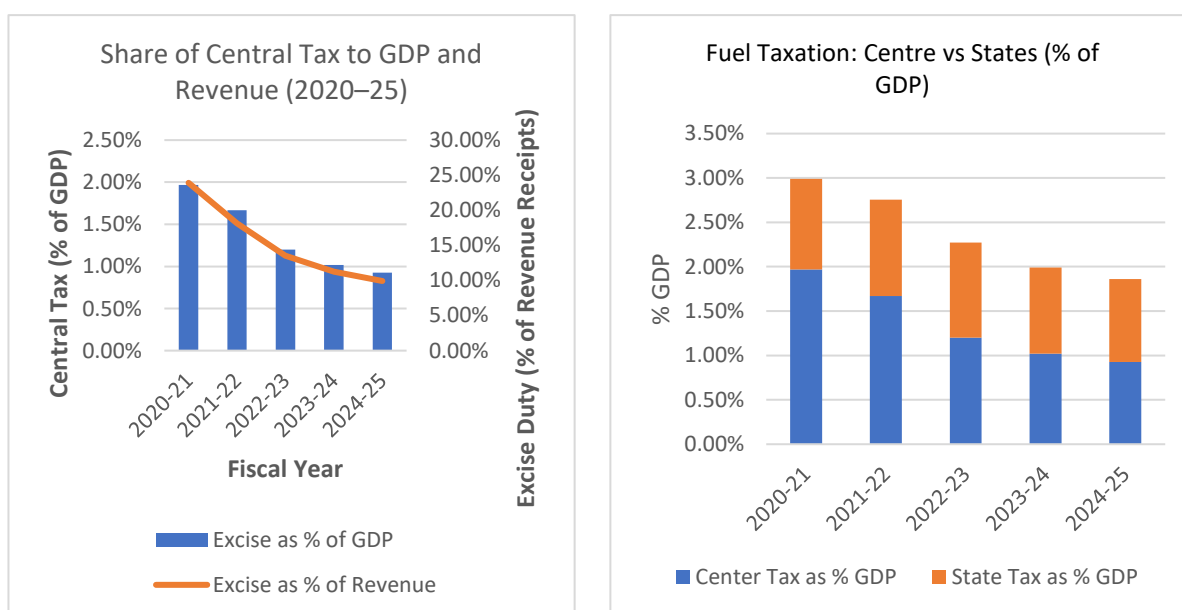
5. Petroleum Revenues

Between 2020–21 and 2024–25, the share of central petroleum taxes, comprising excise duty, CGST, and IGST on petroleum, in central government revenue declined sharply from over 22 per cent to nearly 9 per cent (Figure 5). As a share of GDP, these revenues fell by half to below 1 per cent.

This decline suggests that central excise duties have not been adjusted in line with inflation. Although state-level sales tax collections have risen modestly over time, total taxes on petroleum products across both the center and the states have fallen from about 3 per cent of GDP in 2020–21 to less than 2 per cent in 2024–25. As a result, current pricing does not fully reflect the social costs of petroleum consumption, including environmental damage, health impacts, and congestion. Black and others (2025) estimate that these social costs exceed 4 per cent of GDP in India and have increased further in the wake of the Middle East conflict.

These trends highlight the fiscal and environmental consequences of maintaining current pricing policies.

Figure 5: Central Petroleum Taxes and State Sales Taxes as Share of GDP (2020–21 to 2024–25)



Sources: PPAC; RBI;

Note: Central petroleum taxes comprise excise duty, CGST and IGST. CGST and IGST revenues arise from petroleum-sector products already within the GST framework, principally LPG, lubricants, naphtha and petroleum services. Petrol, diesel, crude oil, Aviation Turbine Fuel. and natural gas remain outside GST. Revenue Receipts include tax and non-tax revenue of the Central Government.

6. Fiscal Costs of Not Passing Through Price Increases

Oil prices have risen from about \$60 per barrel at the start of 2026 to roughly \$100, an increase of more than 50 per cent. In the absence of a full or partial pass-through to domestic prices, sustained high oil prices are placing increasing strain on the fiscal position.

As noted earlier, India's retail petrol and diesel prices have remained broadly unchanged since January 2026. The government is absorbing the gap through forgone excise revenue, under-recoveries on LPG and natural gas, and compression of oil marketing company margins.⁴

Using the methodology of Black and others (2025), we estimate the fiscal cost of this policy. Assuming that a 50 per cent increase in crude oil prices translates into a 25 per cent increase in the supply cost of petrol and diesel, given limited short-term adjustment in refining and distribution margins, and applying this to projected 2026 consumption, the fiscal cost amounts to approximately US\$28 billion, or 0.58 per cent of GDP on an annual basis.⁵⁶ This estimate may be conservative, as the rupee has depreciated against the dollar in early 2026 and because of the likely underestimation of consumption⁷.

In nominal terms, this estimate is broadly comparable to the FY2025–26 central budget allocation for agriculture and exceeds the central government's allocation for public health. It is also roughly three times larger than explicit fossil fuel subsidies in 2024 (0.20 per cent of GDP), which were largely concentrated in domestic natural gas (IMF, 2026b).

Cross-country comparisons highlight India's relative fiscal exposure (Figure 6). Fiscal costs in India of maintaining unchanged prices are somewhat lower than in several energy-importing economies in Southeast Asia, such as Indonesia, Malaysia and Thailand, although the latter has allowed a partial pass-through. In contrast, Pakistan, the Philippines, Sri Lanka and Vietnam have already adjusted domestic prices in response to rising costs. By comparison, advanced Asian economies (such as Korea) and China face lower fiscal costs, reflecting lower fuel intensity. Across emerging market and developing economies more broadly, the median fiscal cost of maintaining unchanged fuel prices is estimated at about 0.9 per cent of GDP annually (Clements and Gupta, 2026).

Government intervention to limit energy price increases is common, given the large share of energy in household expenditure and the political sensitivity of fuel prices. Countries with sufficient fiscal space have often responded by capping prices or reducing taxes. Europe provides a recent example: following the surge in energy prices after Russia's invasion of

⁴ Specific daily under-recovery figures (₹26/litre petrol, ₹81.90/litre diesel, ₹2,400 crore/day combined) and the March 2026 excise cut directed at OMCs, not consumers. To the extent OMCs are government-owned under-recovery costs are ultimately borne by the budget.

⁵ A numerical illustration based on official price build-up data shows that the crude oil (base price) component typically constitutes around 40–50 per cent of the retail price of petrol and diesel in India, with the remainder comprising refining and distribution costs, dealer commission, and central and state taxes. For example, data published by the Petroleum Planning and Analysis Cell (PPAC) indicate that the base price (linked to crude oil) accounts for a substantial share of the final retail price, while taxes and other components make up the rest. Analytical estimates, such as those by the Observer Research Foundation, similarly find that crude-related costs account for roughly 40–47 per cent of retail fuel prices, supporting the assumption used in our analysis.

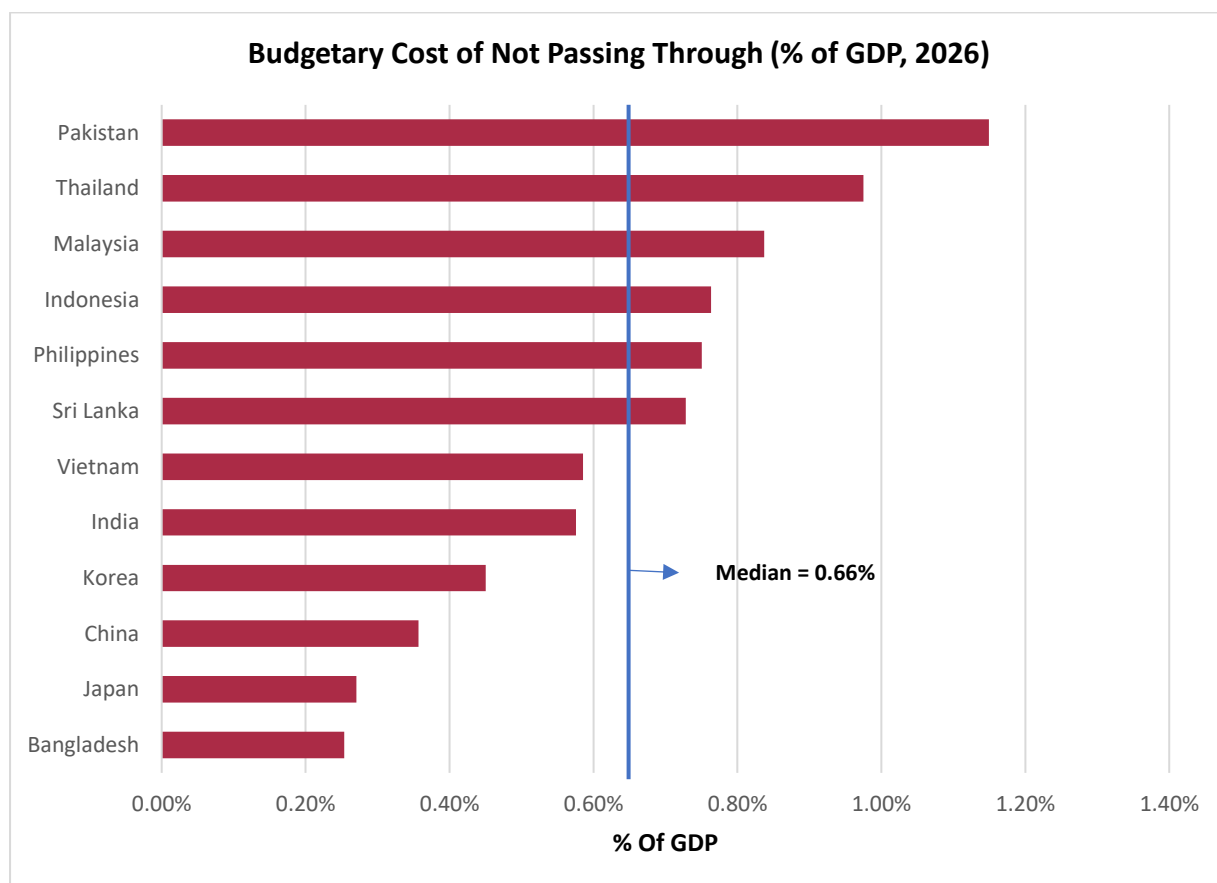
⁶ Natural gas and LPG subsidies represent an additional explicit subsidy burden of approximately 0.20 per cent of GDP.

⁷ Panic buying of petrol and diesel has pushed up their sales in April (Sharma, 2026)

Ukraine in 2022, most governments introduced measures to limit price increases at an average fiscal cost of about 4 per cent of GDP (Gupta and Clements, 2023). These countries could do so because they had fiscal space which did not undermine their debt sustainability or market access (IMF, 2018). Once again, 19 European countries have cut energy taxes in response to Iran war despite elevated debt levels (Financial Times, 2026). These steps have only amplified scarcity by blunting price signals and have failed to help those most in need.

Such policy responses are more difficult to sustain in emerging and developing economies, including India, where fiscal space is more limited. Prolonged price suppression can also encourage energy-intensive consumption patterns, increasing vulnerability to future external shocks.

Figure 6: Estimated budgetary cost of shielding consumers in selected Asian economies



Sources: Black and others (2025); IMF World Economic Outlook (April 2026); and authors' calculations.

Note: Estimates assume a 25 per cent rise in the supply cost of gasoline and diesel, applied to projected 2026 consumption of petrol and diesel. GDP figures are IMF 2026 projections from the latest WEO. Countries are ranked by fiscal cost as a share of GDP (descending).

7. Concluding Comments

Thus far, India has shielded consumers and producers from higher international fuel prices in the wake of the Middle East war. While this approach has provided short-term relief, it has shifted the burden onto the budget, weakened price signals, and heightened macroeconomic vulnerabilities, particularly through pressures on fiscal and external balances.

India's gross debt-to-GDP ratio has declined since the COVID-19 pandemic, falling from over 84 per cent to about 81 per cent in 2024 and 2025, and is projected to ease further to around 80 per cent by 2026 alongside a narrowing fiscal deficit. However, continuing the current fuel-pricing policy would entail significant fiscal costs, especially if elevated oil prices persist due to prolonged supply disruptions even after the conflict subsides, thereby adding to public debt. Over time, this would crowd out priority spending while disproportionately benefiting higher-income households.⁸ At the same time, suppressed prices weaken incentives for energy efficiency and complicate the transition to cleaner energy.

Looking ahead, a gradual and well-communicated move toward greater pass-through of international prices, combined with targeted support for vulnerable households, particularly those reliant on LPG, would help reduce fiscal risks while preserving social protection. The petroleum taxation framework also needs to be revisited to prevent erosion of the tax base (in particular the failure to adjust taxes for inflation) and better reflect the social costs of consumption; in this regard, bringing petroleum products into the GST framework could help. The current crisis further underscores the need to accelerate structural reforms to reduce dependence on imported oil, expand petroleum reserves, and diversify energy sources. Without such reforms, India will remain highly exposed to future energy shocks, with rising fiscal and external risks.

⁸ Using data from a nationally representative survey of over 124,000 Indian households and an input–output framework to capture both direct and indirect fuel consumption, Datta (2010) finds that taxes on transport fuels (petrol and diesel) are progressive in India — that is, the burden falls disproportionately on higher-income households, since ownership of private vehicles is concentrated among the upper expenditure deciles. More than 80 per cent of Indian households do not purchase petrol or diesel directly. The study confirms this result across both rural and urban sectors and when indirect consumption through prices of other goods is taken into account. Only kerosene taxes are found to be regressive, as poorer households rely on kerosene for lighting. In addition, there is ample international experience that fuel subsidies are badly targeted, mainly benefiting higher-income groups and are fiscally costly (see Coady, Flamini, and Sears, 2015).

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