Report of the Expert Committee to Review the System of Administered Interest Rates and Other Related Issues

September 17, 2001

Shri Yashwant Sinha,
Finance Minister,
Government of India,
North Block,
New Delhi.

Dear Sir,

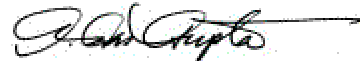
We are pleased to submit the Report of the *Expert Committee to Review the System of Administered Interest Rates and Other Related Issues* constituted by the Ministry of Finance, Government of India *vide* their Office Order No. F.5(7)-PD/2001 dated April 19, 2001.

We, considering the stakeholders' interest, the implications for fiscal management and the Centre-State relations, in all humility, suggest that this report be placed in the public domain and deliberated widely before taking a view on the recommendations.

Yours faithfully,

Y.V. Reddy (Chariman)

Rakesh Mohan (Member)



Anupam Das Gupta (Member)

K.R. Lakhanpal (Member)

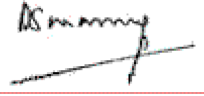
V.S. Senthil on behalf on Vinod Rai (Member)

Samar Ghosh (Member)

R.H. Patil (Member)

Suman Ghosh (Member)

M.G. Bhide (Member)



D. Swarup (Member) **B.K. Bhoi (Secretary)**

ACKNOWLEDGEMENTS

The Committee has been immensely benefited by obtaining documented papers/personal views and by presentations from the special invitees, namely, Shri R.V. Gupta, former Deputy Governor, RBI, Shri S.S.Tarapore, Economist, Dr. A. Vasudevan, former Executive Director and Honorary Adviser, RBI, Dr. Surjit S.Bhalla, Director, Oxsus Funds Management and Dr. Indira Rajaraman, RBI Chair Professor at National Institute of Public Finance and Policy. Moreover, the Committee approached a pool of eminent experts and Finance Secretaries of the State Governments on various analytical issues arising out of the terms of reference. The Committee had the benefit of receiving intellectual inputs from some of these experts, namely, Prof. P.R. Brahmananda, Prof. Mukul G. Asher, Dr. Ganti Subramanyam, Dr. Veena Mishra, Dr. Vivek Murthy, Dr. Ajay Shah, and also from some State Finance Secretaries.

The Committee has also received representations from a wide spectrum of people/organisations associated with small saving schemes, such as, National Savings Organisation, Maharashtra, The All India as well as Maharashtra State Mahila Pradhan and Small Savings Agents' Federations etc. The Committee would like to thank all those who have contributed directly or indirectly in the preparation of this report.

A few Resource Persons from Reserve Bank of India, namely, Smt. Usha Thorat, CGM-in-Charge, IDMC, (Shri H.R. Khan, CGM, IDMC, in her absence), Shri K. Kanagasabapathy, Adviser-in-Charge, MPD, Dr. G.S. Bhati, Adviser, DEAP, Shri K. Venkatappa, CGM, DGBA, and Dr. D.V.S. Sastry, Adviser, MPD were nominated for the smooth functioning of the Committee's work. The Committee would like to place on record its deep appreciation of the services rendered by the Resource Persons by way of preparing technical papers, guiding the secretariat in preparing the draft Report and participating in the deliberations and also other officers attached to various Departments of Reserve Bank of India in preparing a set of background papers.

Dr. B.K. Bhoi, Secretary to the Committee had taken the maximum burden of the Committee's work with utmost dedication. The Committee would like to place on record its deep appreciation of his efforts in assisting the Committee throughout its functioning. The Committee also expresses thanks to Shri Rajib Das and Shri A.G. Khiani who rendered valuable help as part of the Secretariat and to Shri N.S. Pai for word processing.

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Bibliography

List of Abbreviations

CENVAT	–	Central Value Added Tax
CGM	–	Chief General Manager
CPI	–	Consumer Price Index
DEAP	–	Department of Economic Analysis and Policy
DFI	–	Development Financial Institution

DGBA	–	Department of Government and Bank Accounts
EET	–	Exempted, Exempted, Taxed
EPF	–	Employees’ Provident Fund
EPS	–	Employees’ Pension Scheme
FRBM	–	Fiscal Responsibility and Budget Management Bill
ICICI	–	Industrial Credit and Investment Corporation of India
IVP	–	Indira Vikas Patra
IDBI	–	Industrial Development Bank of India
GDP	–	Gross Domestic Product
GFD	–	Gross Fiscal Deficit
GOI	–	Government of India
GPF	–	General Provident Fund
IRDA	–	Insurance Regulatory and Development Authority
KVP	–	Kisan Vikas Patra
LIC	–	Life Insurance Corporation
MIA	–	Monthly Income Account
MIP	–	Monthly Income Plan
MPD	–	Monetary Policy Department
MPKBY	–	Mahila Pradhan Kshetriya Bachat Yojana
NCAER	–	National Council of Applied Economic Research
NGO	–	Non-Government Organisation
NIPFP	–	National Institute of Public Finance and Policy
NPV	–	Net Present Value
NSC	–	National Savings Certificate
NSO	–	National Savings Organisation
NSS	–	National Savings Scheme
NSSA	–	National Small Savings Authority
NSSF	–	National Small Savings Fund
OASIS	–	Old-Age Social and Income Security
OECD	–	Organisation for Economic Co–operation and Development
POSA	–	Post Office Savings Accounts
POMIA	–	Post Office Monthly Income Account
PPF	–	Public Provident Fund
PORD	–	Post Office Recurring Deposits
PRSG	–	Pay Roll Savings Groups
PSU	–	Public Sector Undertakings
PYGA	–	Pay-as-You-Go Approach
RBI	–	Reserve Bank of India
SAS	–	Standardised Agency System
SDS	–	Special Deposits Scheme
SS	–	Small Savings
SSI	–	Small Scale Industries
TDS	–	Tax Deduction at Source
TEE	–	Taxed, Exempted, Exempted
UTI	–	Unit Trust of India
Uts	–	Union Territories

VAT – Value Added Tax
WPI – Wholesale Price Index

Introduction

I.1 Background to the Setting up of the Committee
I.2 Terms of Reference
I.3 Previous Committees and Working Groups
I.4 Meetings and Work Process
I.5 Plan of the Report

Interest rates in the financial sector were substantially regulated in India until the late 1980s. Following recommendations of the Chakravarty Committee (1985), a gradual process of deregulation was initiated. This process gained momentum in the 1990s with the recommendations of the Narasimham Committee (1991). Currently, the structure of interest rates in India has become reasonably flexible, as most of the interest rates relating to banks and financial institutions and debt market have been deregulated. The remaining rates are few which are under constant review.

2. The interest rates relating to small savings and Provident Fund continue to be administered by the Government under various Acts of Parliament[1] . Regulation of interest rates in this segment has not only created distortion in the interest rate structure but has also adversely affected the allocative efficiency of resources. Integration of financial markets remains weak due to existing rigidities in the small saving rates and the consequent market segmentation. Moreover, the size of small savings has assumed a significant proportion of financial savings of the country. There is a policy dilemma with regard to maximisation of receipts through small saving schemes and minimisation of debt service burden to the Central and State Governments. Historically, issues relating to small saving schemes have become highly complex due to involvement of several stakeholders like investors, Central and State Governments, agents and intermediating agencies, etc. There is an urgent need to address these issues and provide a suitable direction for policy actions.

I.1 Background to the Setting up of the Committee

3. Honorable Finance Minister in his budget speech (Para 84) for the financial year 2001-2002, had observed the following, which led to the setting up of the Committee:

Most interest rates in the economy are now market determined. But, their movement downward is constrained by the rigidities inherent in the administered interest rates governing the contractual saving sphere i.e., Provident Fund and Small Savings Schemes .... Iinterest rates provided in all schemes seldom exceeded consumer price inflation by more than 3 per cent between 1980 and 1998. Since then, this difference has risen to 6 to 8 per cent. Not only are such high real interest rates putting an unsustainable burden on both Central and State Governments but the resulting high cost of capital is also inhibiting economic growth all round... I propose to explore a better system for the determination of these rates. I propose to appoint an Expert Committee to provide recommendations on this issue.

[1] Post Office Savings Bank is included in the Union List vide item No. 39 of Seventh Schedule of the Constitution of India. The various Small Savings Schemes are framed by the Central Government under the Government Savings Bank Act, 1873, the Government Savings Certificates Act, 1959 and the Public Provident Fund Act, 1968. For each scheme, statutory rules are framed indicating details such as the rate of interest, maturity period etc. Deposit Scheme for Retiring Government Employees, 1989 and the Deposit Scheme for Retiring Employees of Public Sector Companies, 1991 have been introduced as non-statutory schemes with effect from July 1, 1989 and January 1, 1991, respectively.

4. Subsequently, on April 19, 2001, the Government of India constituted an 'Expert Committee to Review the System of Administered Interest Rates and Other Related Issues' (Annexure 1) with the following:

(i)	Dr. Y.V. Reddy, Deputy Governor, RBI.	Chairman
(ii)	Dr. Rakesh Mohan, Adviser to FM.	Member
(iii)	Shri D. Swarup, Joint Secretary, Budget, Department of Economic Affairs.	Member
(iv)	Shri Anupam Das Gupta, Principal Secretary (Finance), Government of Maharashtra .	Member
(v)	Shri K.R. Lakhanpal, Principal Secretary (Finance), Government of Punjab.	Member
(vi)	Shri Vinod Rai, Principal Secretary (Finance), Government of Kerala.	Member
(vii)	Shri Ashok Gupta, Principal Secretary (Finance), Government of West Bengal.	Member
(viii)	Dr. R.H. Patil, Chairman, Clearing Corporation of India.	Member
(ix)	Shri Suman Bery, Director General, National Council of Applied Economic Research.	Member
(x)	Shri M.G. Bhide, Chairman,	Member

National Institute of Bank Management.

Dr. S. Narayan, Revenue Secretary, Government of India, was co-opted as a member. But, due to preoccupations, he could not attend any of the meetings of the Committee. Shri Samar Ghosh replaced Shri Ashok Gupta on resumption of office as Principal Finance Secretary, West Bengal with effect fromt August 6, 2001.

Dr. B.K. Bhoi, Director, Monetary Policy Department, Reserve Bank of India was inducted as Secretary to the Committee.

I.2 Terms of Reference

5. The Committee was given the following terms of reference:

(i) To suggest criteria for benchmarking of administered interest rates;
(ii) To suggest the periodicity of revision of administered interest rates;
(iii) To examine the feasibility of transferring the entire net proceeds of small savings to the State Governments on a back-to-back basis;
(iv) To make recommendations on other aspects of small savings like designing of instruments, engagement of agents and rules governing the deposits and withdrawals;
(v) To make recommendations on issues related to the interest rates; and
(vi) To make such other recommendations as the Committee may deem appropriate on the subject.

6. The Committee was initially given four months' time to submit its Report. The Committee completed its work in a slightly extended period of five months.

I.3 Previous Committees/Working Groups

7. In order to address various issues relating to administered interest rates, small savings, PF etc., several Committees/ Working Groups were set up by the Government of India and the Reserve Bank from time to time. Mention may be made about Rangarajan Committee (1991), Gupta Committees (1998, 1999), Dave Committees (1999, 2000), Mathur Study Group (2000), Shome Advisory Group on Tax Policy and Tax Administration (2001), OASIS Reports (1999, 2000) and Sehgal Report (2001). These Groups had gone into the issues like feasibility of setting up a body corporate for managing small saving funds, aspects of interest rates, tax treatment, pension problems, the macro-economic implications of the fiscal burden of these schemes etc., and came out with issue-specific suggestions. Major recommendations of the relevant Committees/Groups are presented in the Annexures 2 to 8.

I.4 Meetings and Work Process

8. The Committee held four meetings at RBI, Mumbai on May 4, June 25, August 17, and September 17, 2001. In the first meeting, the Committee discussed the terms of reference and broadly identified the areas on which the Committee should pursue its work. Moreover, the Committee examined the issues raised by earlier Committees/ Working Groups relating to small

savings. On examination of the recommendations of the earlier Groups, the Committee expressed the need to revisit the whole gamut of issues relating to administered interest rates, other aspects of small saving schemes and other related contractual savings. To accomplish the task, the Committee proposed that the Secretariat would prepare a few background papers on the related topics for discussion (Annexure 9). Moreover, a sample survey of ownership of small savings in select States was also mooted. In addition, members representing State Governments were requested to provide material on cost of small saving funds in their respective States.

9. In the second meeting, the Committee discussed the need to resolve the basic issues relating to 'stock' and 'flow' problems associated with the operation of small saving schemes. In this context, it was proposed that the Committee should study the problem of overhang arising out of mismatch between maturity profile of small savings and repayment schedules of loans by the State Governments, find solution to resolve the historically created overhang problem and at the same time prescribe strategies to maintain steady flow of resources to the States in future. There was a proposal to examine the feasibility of complete decentralisation of small saving schemes with respect to fresh flows. In addition, the Committee deliberated on several other issues, such as, medium term vision, transitional arrangement, benchmarking of administered interest rates, periodicity of revision, tax treatment etc. In order to take a definite view on these issues, the Committee proposed to prepare a few technical papers on these topics (Annexure 10) which are enclosed as Part II of this Report.

10. In the third meeting, the draft report was debated in detail among the members. Views were obtained from the members on certain complex issues so as to put in place concrete recommendations of the Committee. Members agreed for one-month extension of time to finalise the Report of the Committee.

11. The Committee discussed the possible options and a set of recommendations before adopting the Report in the fourth meeting.

I.5 Plan of the Report

12. The report is broadly organised into eight Sections. Section II critically evaluates the small saving schemes as they operate under the existing administered regime. Section III provides a medium-term vision. Section IV deals with the issue of benchmarking administered interest rates and identifies possible choices in the Indian context, besides the issue of periodicity of revising administered rates. Section V analyses the maturity mismatch and suggests ways and means to resolve the overhang problem. Section VI deals with the management issues of small saving schemes, such as, rationalisation of taxation, design of instruments, engagement of agents and agency charges, rules governing deposits and withdrawals and some other related issues in this regard. Section VII highlights the implications of Committee's recommendations. Section VIII summarises the recommendations of the Committee.

II. Critical Evaluation of Issues

13. During the recent period, the nominal interest rates have come down significantly. Moreover, the headline inflation rate and the overall long-term inflationary expectations have

also been showing a downward trend. However, the real interest rate, particularly for borrowers, is still perceived by industry and commerce as high. Therefore, while the borrowers demand further reduction in the nominal interest rates, the savers feel deprived of a reasonable return from their long-term financial savings. Thus, there is apparently a policy dilemma as to how these conflicting interests could be reconciled. An appropriate interest rate regime is necessary to promote saving and at the same time, providing a modest real rate of return to savers may be considered as a desirable goal to sustain the overall domestic savings, particularly, the financial savings of the households.

14. The average cost of funds for banks ranges high between 7 and 9 per cent, which is, *inter alia*, due to high reserve requirements. On top of it, the spread between the deposit rate and lending rate in India is also high compared to most of the developed countries. This could be attributed to several reasons. First, the intermediation cost in India is relatively large. The non-interest operating cost of funds among the public sector banks is around 3 per cent. Secondly, relatively high overhang of non-performing assets (NPAs) puts pressure on the lending rates. Thirdly, although banks are given freedom to offer variable interest rates on deposits, there is a general preference for fixed interest rates in the system. This practice reduces flexibility on the part of the banks to reduce their lending rates, as the rates on the existing stock of deposits cannot be lowered. Fourthly, there is a persistent and large volume of market borrowing requirements by the Government giving an upward bias to the entire interest rate structure. Fifthly, the internal business savings of the corporate sector is low, keeping the debt-equity ratio high. Sixthly, the risk premium over risk-free rate with respect to corporate lending has also gone up during the recent period due to prescription of the prudential regulations and uncertainties arising out of corporate restructuring and the uncertain recovery climate. Last, but not the least is the administered interest rates on small savings, which makes the structure of interest rates inflexible downward.

15. These are some of the structural issues, which need to be addressed so as to improve the overall efficiency of the financial system and thereby reduce the spread in the interest rates between savers and investors. The feasibility and scope for reduction in interest rates, particularly for the borrowers are circumscribed by these factors and any resolution on this will have to address these structural issues upfront.

16. The issues relating to small saving schemes in India are quite complex and intricate. The sources of these complexities essentially arise from the changing perceptions about the role of small saving schemes over the years and the conflicting interests of various stakeholders involved with the same. Looking at the historical perspective, it may be apt to observe that the small saving schemes were introduced at a time when the banking and capital markets were relatively underdeveloped and, therefore, were largely confined to rural and a few urban areas. Thus, people looked upon the government as a reliable trustee or banker with whom they could lodge their hard-earned savings. While the same fiduciary bonding is still intact, the banking and capital market have developed significantly over a period of time with a wider coverage.

17. The Committee's recommendations are unanimous and to the extent feasible, explicit and firm. However, since the issues relating to small savings are complex and involves a wide range of stakeholders, the Committee would suggest a wider debate on various issues involving all

stakeholders. Wider consultations (particularly with the States) in respect of Committee's recommendations regarding small savings would be desirable.

18. Government is currently administering interest rates on a number of instruments, such as, General Provident Fund (GPF), Employees' Provident Fund (EPF), various pension schemes, small savings including Public Provident Fund (PPF) etc. The interest rates on these schemes, which were initially conceived to offer reasonable returns to savers, have turned out to be floor rate for deposits of banks and financial institutions. Therefore, these rates need to be rationalised in the larger interest of developing an efficient financial market. The approach to such a rationalisation will have to take into account several factors. First, the commitment to reduce the overall fiscal deficit to a sustainable level in the medium term and the need to reduce dependence on captive sources of funding for the fiscal deficit is well recognised. Secondly, given this commitment, it would be necessary in the long-term to ensure that the funds mobilised under saving schemes be earmarked for productive purposes and the returns on such funds are linked to efficient portfolio allocation. Thirdly, transparency and healthy development of debt markets require de-linking of mobilisation of savings through such schemes and their investment. Against this background, the Committee felt that the rationalisation strategy should recognise the centrality of the interest of the savers in terms of providing a risk free real return for retail savers with special emphasis on old age security. Although the Committee has deliberated on the entire administered structure of interest rates, it has mainly focused its recommendations on the small saving schemes including PPF. However, the recommendations of the Committee pertaining to small savings could, in principle, be extended to other similar schemes administered by the Government.

19. Financial savings play a major role in promoting growth. Therefore, financial saving in general and long-term and contractual savings in particular, should be encouraged keeping in view the long-term investment requirements of the economy. The mobilisation of resources through small savings has emerged as an important element of household financial savings in India over time. The share of small savings as percentage of net financial savings of households has gone up sharply from 7.9 per cent in 1996-97 to 12.9 per cent in 1997-98 and to 13.8 per cent in 1998-99. While recommending measures for rationalisation of schemes, new range of products, revised tax treatment and benchmarking, the Committee keeps in view the need to sustain the flow of savings at the macro level for maintaining stable conditions for growth.

20. Small saving schemes are essentially a basket of diversified and heterogeneous products. Broadly, three types of small saving schemes are currently in operation in India. These are postal deposits, saving certificates and social security schemes like PPF and retirement schemes. A detailed analysis of these schemes is given in Annexure 11. While postal deposits are more akin to bank deposits, the rest are medium-term instruments designed for specific purposes. As the products have different characteristics, a uniform treatment may not be appropriate. *Prima facie*, while the range of products may continue to be diversified and heterogeneous, there is a need to distinguish the various schemes in terms of their purposes and whether they cater to the needs of small savers/investors as they are purported to be. While some deposit schemes appear to be serving the purpose of only raising revenues by providing tax benefits besides other incentives, some long-term schemes in the nature of Provident and Pension Funds serve the purpose of old age security. In principle, small savings should inculcate the habit of thrift among the people and

therefore, be restricted to individuals.

21. With the financial system moving towards complete deregulation of interest rates, it would not be out of place to observe that small savings and other administered rates also should be aligned with market rates at some point of time. In the transition, possibly some form of Government intervention may continue. Enabling conditions, however, need to be created so that the interest rates on small savings may be made flexible and appropriately aligned with the market rates. In fact, a flexible system of fixing interest rates based on sound normative principles is desirable, which can replace any arbitrary nature of such fixations. There should also be institutional arrangements periodically to review and rationalise the range of products and introduce schemes appropriate to small savers on a continuing basis.

22. The basic purpose of small saving schemes should be to inculcate the habit of thrift among the common people, particularly in the rural and semi-urban areas. These instruments also provide safe avenues for small savers who are, by and large, not taxpayers. However, Government offers various fiscal incentives to attract more savings from the urban areas as well. A survey on investors' profile conducted in the State of Uttar Pradesh, which is one of the leading states in the mobilisation of small savings (Annexure 12), revealed that both urban and rural population constitute the investor profile of small savings. Various tax incentives have not only discriminated between tax-paying and non-tax paying savers, but also created distortions in the yield structure of the small saving instruments *vis-à-vis* other debt instruments. Further, the effective cost of resources mobilised under small saving schemes has turned out to be very high for the Central and State Governments. As such, tax-incentives appear to be available on a variety of other debt instruments as well and the *ad hoc* nature of tax treatment on financial instruments has distorted the price discovery and resource allocation processes. It is, therefore, considered necessary that the tax treatment applicable to small savings be reviewed keeping in view the whole tax structure of financial instruments. In principle, while tax incentives should be available and are justifiable to promote long-term savings under social security schemes, other financial instruments should be tax neutral to promote allocative efficiency.

23 Small saving proceeds form an integral part of the budgetary process of Central and State Governments in India notwithstanding some changes in the accounting procedure adopted following Gupta Committee (1999) recommendations. Ideally, the proceeds should form a corpus outside the Budget and should have a separate balance sheet. The asset profiles may be determined on prudential basis duly taking into account the liability profile and commitments on actuarial basis. Returns from diversified portfolios should price the products. Until such a situation emerges, it may be prudent to resolve the overhang problem arising out of mismatch between maturity profiles of small savings and the repayment obligations of the State Governments. The Committee addressed this fundamental issue and has suggested some remedial measures to do away with maturity mismatches in respect of future flows. In this context, one may argue that all fresh collections from small saving schemes can start on a clean slate with matching liabilities and assets.

24. Over a period of time, bulk of the net resources out of small saving schemes has been transferred to the states by way of non-plan loans. If small saving schemes eventually emerge as fully funded independent schemes, the cash flow of funds will depend upon the nature of

investments. In the interim period, the Committee has explored the possibility of transferring the entire net proceeds to the States on a back-to-back basis. In this context, it becomes pertinent to resolve the management issues relating to collection, such as, implicit central Government guarantee, engagement of agents and payment of agency charges and the cost of administering the schemes, rules governing deposits and withdrawals and tax treatment etc.

25 The basic philosophy of small savings is to provide a secure avenue for saving by individuals and promote long-term savings. Such instruments exist in many countries including the U.S.A., and the U.K., but they account for a small proportion of government financing. These governments also offer inflation-linked bonds which provide a hedge against inflation. In India, small saving instruments at administered interest rates have now emerged as an important method for garnering resources to finance fiscal deficit at both the Centre and State levels. This increase in scale has given rise to several problems. First, these are high cost borrowings for the Government. Secondly, their use to finance revenue deficits is non-transparent. Thirdly, repayments are made from fresh mobilisations and thereby the ponzi nature of the scheme persists on an enduring basis. Fourthly, tax incentives provided to the small savers have resulted in loss of revenue to the Central Government and also distorted the term structure of interest rates. Fifthly, there is a serious problem of sustainability of small saving schemes as there is absence of a definite asset profile corresponding to the increasing liabilities. In view of these, there is an urgent need for reforms in this sector with a view to putting in place a suitable mechanism for the productive use of these resources for the long-term gain of all stakeholders. Ideally, there should be a progressive reduction in the number of such instruments besides removal of distortions arising out of tax treatment, so that they become a modest source of financing Government deficit in future.

III. Medium Term Vision

26. From the medium-term perspective, small saving schemes particularly those which are long-term and contractual in nature, should be viewed as an integral part of the Pension Fund reforms for old age security. The medium term vision for social security could in a way take its approach from the angle of providing an overall social safety net. The social safety net in a very broad sense could be viewed as an extended principle of joint family to public policy. All the categories of non-working members get their economic and social needs fulfilled from the support of those who are working in the family. On this basis, a social safety net in a very broad respect should include protection to a variety of needs of the public *viz.*, involuntarily unemployed, widows and destitutes, handicapped, elderly or senior citizens and children. Old age security is thus one of the main elements of a comprehensive social safety net. The public, while they are in their working age group, are generally expected to set aside a part of their income as long-term savings to take care of their needs in old age. Given the myopic behaviour of the public, it is, however, believed that under normal circumstances, the working people may not be left with adequate savings at the end of their working life, unless some institutional arrangements are in place. The provident fund and pension fund schemes provide such opportunity and institutional framework.

27. In India, the Pension Fund reforms have received the attention of the Government in recent years. The Study, Old-Age Social and Income Security (OASIS), commissioned by the Ministry

of Social Justice and Empowerment has brought out two reports, one in February 1999 and another in June 2000, outlining the future of Pension Fund reforms in India (a summary of recommendations of these reports are provided in Annexures 5 and 6). The OASIS study recommendations are more or less in line with the three-pillar approach suggested by the World Bank. The World Bank has further produced a detailed document namely, "India - The Challenge of Old-Age Income Security" in April 2001. The Government of India in its budget 2001-02 has also announced certain steps for improving social security system in India. As the unorganised sector does not have adequate social security coverage, the Finance Minister has further requested the Insurance Regulatory and Development Authority (IRDA) to look into these issues and provide a road map for pension reforms by October 2001. Announcing a new pension programme based on defined contributions for Central Government services after October 1, 2001, the Finance Minister has proposed constitution of a High Level Expert Group to review the existing pension system and to provide a road map for the next steps to be taken by the Government.

28. In view of the complexity of issues and parallel initiatives, which are already in the process, this Committee would not specify anything in particular regarding the future course of social security and pension fund reforms in the country. The essential point the Committee would like to make is that, pending the comprehensive pension fund reforms and a scheme of old age security, any recommendation within the confines of the small saving schemes made in this report, should be purely viewed as interim solutions before moving to a new and comprehensive system. The transformation from the old system to the new system can either happen in parallel, the new system gradually taking over from the old; or from a cut-off date in future, the new system may start replacing the present system. Any strategy regarding this would have to take into account the recommendations of the other related committees set up for this purpose and the fiscal and financial market implications of such moves.

29. The Committee observed that the present system of direct management of long-term funds by the public sector, fixing administered rates of interest with all tax advantages, would not be sustainable in the medium term. Most of these funds in future are expected to be privately managed with larger and diversified investment portfolio and the returns of such funds linked to market based portfolios.

30. In the determination of administered rates of small saving schemes, there could be two options: first, if the funds mobilised under such schemes are continued to be used by the Government, then the rates will continue to remain administered. Government will, however, have to keep the interest rates more aligned with market rates and also rationalise small saving schemes to cater only to the needs of genuine small savers like individuals including Hindu Undivided Families (HUFs). Second, if the funds mobilised under such schemes are separately maintained and investments are made as per agreed investment policy, the portfolio return of these funds would determine the return on such schemes adjusted only for administrative costs. In a way, these funds will become self-liquidating and the return will be market determined. Depending upon the portfolio options, the long-term funds could be used for diversified projects of long gestation including those in the private sector. The medium term objective of the Government should, therefore, be to switch over to fully funded long-term saving schemes managed independently and professionally with a well-conceived investment policy to promote

growth and meet genuine investment demands in the economy.

31. The feasibility of immediately converting the long-term saving schemes into fully funded schemes seems difficult, given the dependence of government on such schemes to meet deficits. Government should evolve some method in a time bound manner to achieve this objective. In the interim, the schemes could be rationalised and the rates on small saving schemes be made increasingly market oriented so that the adverse implications of financial markets segmentation are minimised. The continuation of administered regime of interest rates on small saving schemes in the above context, should, therefore, remain temporary and any benchmarking of these rates should also be treated as an interim measure.

IV. Benchmarking

IV.1 Inflation Rate as a Benchmark
IV.2 Bank Deposit Rates as Benchmark
IV.3 Bank Rate as a Benchmark
IV.4 Yield on Government Securities as Benchmark
IV.5 Floating versus Fixed Rates
IV.6 Periodicity of Reset

32. In order to make the interest rate channel for monetary policy transmission more effective, all interest rates in the economy including small saving rates should respond to monetary policy changes. However, as collections under small saving schemes constitute a significant portion of revenue for the States and also an integral part of the budgetary process involving sharing of resources between the Centre and the States, it may not be possible at the present juncture to make the interest rate on such instruments completely market determined. In the meantime, the Committee explored the possibility of linking the interest rates of small saving schemes to market related interest rates through suitable benchmarking.

33. As fiscal concessions are available to the savers under various small saving schemes, the effective yield of various instruments gets distorted. Further, instruments with same or similar maturity having different tax concessions result in offering different effective rates. Moreover, certain schemes are more liquid than others posing distortions in alignment with the market rates. As such, the term structure of small saving instruments gets vitiated. All these issues make benchmarking more complex.

34. As interest is a future income, it is desirable that small savers may be able to get a positive real rate of return on their savings at a future date. As such, while benchmarking small saving instruments, it is desirable that they are linked to the rate of return on capital or long-term growth rate of the economy. Depending on the different types of maturities, liquidity and illiquidity aspect of the instruments, a risk premium also may have to be embedded while benchmarking. As spelt out in the preceding paragraph, recognising various differences among the existing small saving schemes, it is pertinent to debate on whether a single benchmark will be useful for all types of schemes or whether separate benchmarks are required for individual schemes. It is also essential to deliberate on whether the benchmark should be a lead or a lag rate to which the other instruments have to be linked.

35. The present Committee has debated on the above issues while suggesting benchmarking of the small saving schemes. A further aspect that the Committee has looked into is the relative stability of the benchmarking rate. A stable benchmark rate is that which fluctuates within a narrow range and has a low coefficient of variation. For evaluating the stability, the Committee made use of long-term time series and moving average procedure and examined a number of interest rates, which can be considered as benchmarks. Out of them, the rates which have satisfied stability conditions, have been considered for benchmarking the small saving rates. These are: a) rate of inflation, b) deposit rate of commercial banks, c) Bank Rate, and d) yield on Government securities.

IV.1 Inflation Rate as a Benchmark

36. Though theoretically expected inflation rate, which is a lead indicator, is desirable for benchmarking small saving rates, it is simpler if current inflation rate, as measured by Wholesale Price Index (WPI) (on a point-to-point basis and on average basis), is considered because of the practical problems in arriving at the expected inflation rate. The Committee has also considered Consumer Price Index (CPI) and GDP deflator for benchmarking purpose. Considering the availability of these three indices, which differs from weekly to quarterly, it is felt that current inflation rate measured by WPI is a better indicator, as it is well understood. The basic premise for linking with inflation is to ensure a positive real rate of interest to the investors.

37. Besides the current inflation, the expected inflation as derived from the weighted average inflation with higher weight attached to the current inflation and weights declining with the lags, was also considered. In case of the lagged scheme, it was observed that the length of the lag becomes subjective and depending upon the lag structure, the benchmark rate could be different. The formula for a lagged structure is also complex. Furthermore, considering the nature of target group of small savings, the Committee felt that any benchmark formula should be simple to understand.

38. The Committee discussed in detail, the merits and demerits of using inflation rate as a benchmark. After considering the difficulties in measuring expected inflation, the choice of an appropriate index and a formula simpler to understand by the target group, the Committee did not favour inflation rate as a suitable benchmark.

IV.2 Bank Deposit Rates as Benchmark

39. The Gupta Committee suggested that interest rates offered by banks and financial institutions might be considered for benchmarking some of the small saving schemes. Since the interest rates on deposits except in the case of savings bank are deregulated, interest rates on bank deposits can be viewed as market determined. However, as no conclusive evidence was found regarding the direction of causality among these rates *i.e.,* whether bank deposit rates determine the interest rates on postal deposits or *vice versa*, bank deposit rates are not favoured as suitable benchmark.

IV.3 Bank Rate as a Benchmark

40. Bank Rate leads the other interest rates in the economy and is also a policy variable. Hence, Bank Rate as benchmark is credible and reflects the policy stance of the Reserve Bank. The medium term interest rate signalling is done through changes in the Bank Rate, which affects the cost of funds in the system, and as such the general interest rates in the economy react to changes in the Bank Rate. If linked to Bank Rate, it is generally expected to provide a positive real interest rate, because changes in Bank Rate are contemplated by the Reserve Bank taking into account the macroeconomic developments, developments in various financial markets and inflationary expectations. As such, although it is a policy variable, change in the Bank Rate reflects changes in the macroeconomic environment and it is in that sense, Bank Rate can be viewed as a good benchmark like other market related rates.

41. However, Bank Rate may not be widely accepted as a suitable benchmark for the following reasons. First, Bank Rate in the real sense is not a market related rate. Secondly, there may be need for frequent changes in the Bank Rate as it is essentially a signalling rate and therefore may not ensure stability to the small saving rates. Thirdly, small savers' interest may sometimes come in conflict with the monetary policy stance of the Reserve Bank. Fourthly, Bank Rate as a benchmark can be perceived by some analysts as liable to change due to extraneous compulsions under certain circumstances. Fifthly, as Bank Rate essentially is a short-term rate, there are difficulties in setting the spread for long-term rates, linked to the Bank Rate. In view of the above, the Committee is not in favour of using Bank Rate for benchmarking interest rates on small saving instruments.

IV.4 Yield on Government Securities as Benchmark

42. Where small saving instruments are an insignificant part of government financing, it is quite common to set their yield against a market-determined government security rate of comparable maturity. The much larger relative scale of instruments at administered interest rates as in India raises the risk of circularity; administered interest rates might set a benchmark for government security rates which could in turn feed back into the structure or into determination of administered rate. As against the disadvantage, government securities offer certain advantages as a benchmark. First, yield on government securities is increasingly market determined even if the existence of a large Statutory Liquidity Ratio (SLR) creates huge captive demand for these securities. Second, to the extent that one goal of fixing interest rates on small saving is to provide some assurance of real returns, nominal yields on long-dated securities signal a measure of expected inflation. Third, if the goal in time is to reduce the number and scale of instruments with administered interest rates, an initial linkage with market rates could help these instruments in time to become one with market interest rates. In order to get a cross check on the prevalence of circularity, it would be worth reviving the issue of inflation-indexed bonds. Such securities would provide one measure of the extent to which administered interest rates were still a force in keeping securities interest rates too high.

43. When considering the acceptance of yield on government securities as a benchmark rate for fixing interest rates on small saving schemes, a comparative risk assessment of both the instruments *viz.,* small saving instrument and government dated securities are needed. Though they are perfectly comparable with respect to credit risk, they are not comparable with regard to liquidity and price risks. Government dated securities on account of active secondary market are

inherently more liquid *vis-à-vis* small saving instruments and also carry price risks unless held to maturity. Therefore, government security rates and small saving rates should technically be more or less close to each other. However, a premium for illiquidity may have to be added to the small saving rates. Since, the movements on yield curve are susceptible to various shocks, averaging of yield curves for a particular period is also desirable for evolving the benchmark.

44. After considering all feasible options, the Committee recommends the following benchmarking with regard to alternative instruments:

i) Post Office Savings Bank (POSB) Account has similarities with current account in a commercial bank and therefore, such account-holders may not earn interest on it. In order to promote rural savings, Government is currently giving an interest rate of 3.5 per cent. This is a facility available only to small savers. Keeping in view that even commercial banks are offering 4.0 per cent interest on such accounts, the Committee recommends that the present rate of 3.5 per cent on POSB accounts may continue so long as the inflation rate rules above 3.5 per cent or the savings bank deposit rate of commercial banks is not below 3.5 per cent.

ii) Interest rate on One Year Postal Deposit may be benchmarked to average yield of 364 Days Treasury Bills traded in the secondary market during the previous year.

iii) Interest rate on 5-Year Postal Deposit/Post Office Monthly Income Scheme/Post Office Recurring Deposit may be benchmarked to average secondary market yield of Government securities having a residual maturity of around five years.

iv) Interest rates on 2 and 3 Years Postal Deposit will be calibrated between one and five-year postal deposit rates.

v) Interest rates on all non-bearer certificates would be marginally higher (lower) than the 5-Year Postal Deposit rate depending upon the maturity of the instruments.

vi) Interest rate on present bearer instruments like Kisan Vikas Patra should also be on par with non-bearer certificates after removing the transferability feature of this instrument.

vii) As regards interest rate on relief bonds, the same principles should apply. However, it should be terminated at an early date to avoid distortions.

viii) Interest rates on PPF may be benchmarked to average secondary market yield on Government securities having a residual maturity of around ten years.

ix) Interest rates on other administered schemes like GPF and EPF may follow the principle applicable to PPF.

x) The spread over the benchmark yields for fixing the interest rates on the small saving schemes may have to be suitably calibrated subject to a maximum of 50 basis points depending upon the maturity and liquidity of the instrument, keeping in view the savers'

interest, particularly for long-term instruments. The objective should be to reduce the spread over the benchmark rate over a period.

IV.5 Floating *versus* Fixed Rates

45. The Committee also deliberated on the issue whether small saving schemes would carry a 'floating rate' or a 'fixed rate'. If the schemes carry a floating rate, then the rates will change with every reset. In the case of 'fixed rates', the rates prevailing at the time of initial subscription will be applicable. The problem with the fixed rates in small saving schemes is that they are not marketable and therefore the interest rate risks do not get converted into price risks. Savers may, therefore, be given the option of choosing between fixed and floating rates at the time of entry. However, investors in PPF, GPF and EPF would have the option of floating rates only as it would be difficult to foresee the likely level of interest rate on a long-term basis.

IV.6 Periodicity of Reset

46. Periodicity of reset should essentially take into account the administrative convenience. In case, the benchmark is volatile and subject to frequent changes like government securities yields, inflation rate etc., it would be difficult to change the small saving rates so frequently. Even the moving average rate (say, for six months) might call for frequent changes in the small saving rates. One way to avoid this problem is to reset the rates at a fixed interval i.e., quarterly, half yearly or annual. Small savers, however, want some sort of stability in the rates and therefore, the Committee felt that small saving rates be reset on an annual basis to begin with, which may be reviewed at a later date. Interest rates on small savings may be announced by the Government effective April every year on the basis of technical inputs received from the Reserve Bank of India with respect to the yield on Government securities, and the spread that can be offered.

47. Existing interest rates, instrument-wise and proposed benchmarks are summarised in Table 1.

V. Transferring the Entire Net Proceeds of Small Savings to State Governments: Feasibility and Fiscal Implications

V.1 Role of Small Savings in Financing Fiscal Deficits
V.2 Maturity Mismatches, Existing Arrangements and Future Repayment Obligation
V.3 Implications of the Transfer of Entire Net Collection to States
V.4 Recommendations

48. The small saving collections witnessed a ballooning trend during the decade of the nineties as the gross collections grew at an average rate of around 17 per cent. In nominal terms, the gross collections rose from Rs.18,920 crore in 1990-91 to Rs.75,542 crore in 1999-2000. Despite the growing outstanding small savings liabilities, the Government did not face any funding problems on account of the *Ponzi* nature of such borrowings. As the repayments are deducted from the gross collections before sharing the proceeds between the Centre and the States, and as long as the gross collections are above the repayment obligations, the Government does not face any rollover problem. However, this *Ponzi* type of borrowing arrangement may face problem in the event of a slowdown in the collections of small savings keeping in view the fact that repayments

now account for almost 50 per cent of the collections. As such, the net collection may even fall.

Table 1: Administered Interest Rates: Present Status and Proposed Benchmark

(Per cent)

Sr. No.	Schemes	Prevailing Interest Rates	Proposed Benchmark (average secondary market yield on Government Securities)
1	2	3	4
1.	Post Office Savings Acccount	3.5	3.5 Until inflation rate is above 3.5% or the savings bank deposit rate of commercial banks is not below 3.5%.
2.	Post Office Time Deposit		
	One year	7.5	364 Day Treasury Bills
	Two year	8.0	Calibrated
	Three year	9.0	Calibrated
	Five year	9.0	Govt. Securities with a residual maturity of around 5 years.
3.	Post Office Recurring Deposit (5-year)	9.5	Govt. Securities with a residual maturity of around 5 years.
4.	Post Office Monthly Income Scheme	9.5*	-do-
5.	National Savings Certificate (6-year) (NSC VIII Issue)	9.73	-do-
6.	Govt. Relief Bond (5-year)	8.5	-do-
7.	Kisan Vikas Patra (6-year)	10.03	-do- Transferability should be withdrawn.
8.	National Savings Scheme 1992 (4-year)	9.0	Calibrated
9.	Deposit Scheme for Retiring Govt. Employees, 1989 (3-year)	8.5	Calibrated
10.	Deposit Scheme for Retiring Employees of PSUs, 1991 (3-year)	8.5	Calibrated
11.	Public Provident Fund (15-year)@	9.5	Govt. Securities with a residual maturity of around 10 years.

Note:
1. Tax incentives should be withdrawn across the board except PPF.
2. The spread over benchmark to be calibrated subject to a maximum of 50 basis points depending upon maturity and liquidity of the instrument, particularly for long-term instruments.

* In addition, 10.0% bonus on maturity.

@ Applicable to GPF, EPF.

49. One of the terms of reference before the Committee was to explore the feasibility of transferring the entire net proceeds of small saving to States. The Committee, therefore,

examined the feasibility of the scheme and explored the possible options for devising suitable decentralisation plan of small saving schemes in future. The Committee also felt the need to simultaneously address the 'overhang' problem created historically due to maturity mismatches between small savings deposits and loans extended to States by the Centre against small saving collections.

V.1 Role of Small Savings in Financing Fiscal Deficits

50. Historically, the Central Government played the role of financial intermediary in collection of small savings and their sharing with the State Governments. The amount mobilised through the small saving schemes is accounted under the Public Account of the Central Government. The net amount (gross collections minus repayments) is shared between the Centre and the States and forms part of the borrowed funds for financing the fiscal deficit of both Centre and States. The outstanding amount under small savings collection constitutes the liabilities of the Central Government. The distribution of net small savings collection between Centre and States was 33.3 per cent and 66.7 per cent, respectively during the period 1975-76 to 1987-88 ; 25.0 per cent and 75.0 per cent from 1988-89 to 1999-2000. Until 1998-99, the States' share in net small savings collection was passed on to the States by the Centre in the form of non-Plan loans at interest rates prescribed by the Central Government. Under these arrangements, loans against small savings provided to States by the Centre represented Centre's expenditure and formed part of Centre's gross fiscal deficit (GFD).

51. Resource mobilisation through small savings has, of late, emerged as a major source of finance for the Government. The share of small savings in the financing of combined GFD of Central and State governments rose from 17.0 per cent 1990-91 to 20.0 per cent in 2000-01 (Table 2). The share of small savings in the financing of Centre's GFD (net of States' share of small savings) increased from 5.5 per cent in 1990-91 to 12.0 per cent in 1997-98 before declining to 7.1 per cent in 2000-01, partly due to the revised norm for distribution of small savings between States and Centre. In the case of States, the contribution of small savings in financing GFD was between 28.6 per cent and 37.4 per cent during 1990-91 to 2000-01, and 3 to 4 States accounted for a larger share.

Table 2: Small Savings Collections and Financing of GFD

(Rs. crore)

Year	Centre		States		Combined	
	Net Small Savings*	Net Small savings as ratio to GFD(%)+	Net Small Savings	Net Small savings as ratio to GFD(%)	Net Small Savings	Net Small savings as ratio to GFD(%)
1	2	3	4	5	6	7
1990-91	2,078	5.5	7,026	37.4	9,104	17.0
1995-96	2,771	5.5	9,990	31.8	12,761	16.4
1996-97	4,585	8.2	10,671	28.6	15,256	17.5
1997-98	8,765	12.0	15,732	35.6	24,497	22.1
1998-99	9,247	10.3	23,788	32.0	33,035	21.0

1999-2000	8,979	8.6	26,937	29.7	35,916	19.5
2000-01 (RE)	7,950	7.1	31,799	33.5	39,749	20.0

* Represents Centre's share in the net small savings.
+ GFD of Centre is net of States' share in small savings.
RE: Revised Estimates
Source: Budget Documents of the Central and State Governments.

52. With effect from the fiscal year 1999-2000, a salient change in the accounting system was brought about by creating a National Small Savings Fund (NSSF) in the Public Account of the Central Government. Under the changed accounting system, all small savings collections are credited to this Fund and net amount is invested in the Central and State Government securities as per the norms decided by the Central Government from time to time. The debt servicing of these government securities would be an income of the Fund, while the expenditure of the Fund would comprise the interest cost and cost of management of small savings. Simultaneously, the share of States has been enhanced from 75 to 80 per cent of the net collections with effect from 2000-01. The amount released to States is treated as investment in special securities to be redeemed from the sixth year over a period of 20 years. The investment of net small savings collection in Central Government securities constitutes part of the internal debt of the government.

V.2 Maturity Mismatches, Existing Arrangement and Future Repayment Obligation

53. The proposed scheme of transferring entire net small savings to States on a back-to-back basis concurrently requires addressing the problem of overhang resulting from the mismatches between the terms of repayments by the States and repayments to the investors of small savings. Under the existing transfer mechanism, the States are required to pay back the loans given to them by the Centre against small saving collections in 25 years (including a moratorium of 5 years). This leads to mismatch between loan repayment by the States and repayment to the investors of small savings as the maturity of small saving investment is much shorter. For instance, during 1999-2000, out of gross collections of Rs.75,542 crore, repayments to the investors were made to the tune of Rs.36,889 crore (i.e., 49 per cent) (Table 3). The net amount of Rs.38,653 crore was distributed between Centre and the States. While the share of States was Rs.26,937 crore in 1999-2000, the repayments made by the States to the Centre against the small savings loans were only at Rs.2,475 crore.

Table 3: Small Savings Gross Collections and Repayments

(Rs. crore)

Year	Gross Collection	Repayments	Net	Repayments /Gross Collection (Per cent)	Share in Net Collection		Repayments by States to Centre
					Centre	States	
1	2	3	4	5	6	7	8
1990-91	18,920	9,816	9,104	51.9	2,078	7,026	492
1998-99	62,157	29,113	33,044	46.8	9,247	23,788	2,225
1999-2000	75,542	36,889	38,653	48.8	8,979	26,937	2,475

2000-01 (RE)	86,000	43,000	43,000	50.0	7,950	31,799	..
2001-02 (BE)	93,500	46,500	47,000	49.7	9,000	36,000	..

.. Not available. RE : Revised Estimates BE : Budget Estimates

Source: (1) Government of India, note on "Small Savings Schemes – An Overview".

(2) Budget documents, Government of India.

54. The Central government assumed the responsibility of interest payments and repayment of the principal of small savings to the depositors as also the management cost prior to the setting up of NSSF. Accordingly, the Centre ensured all withdrawals by the depositors after provisioning repayments from gross collections before transferring funds to the States. The State G[overnments made repayment for the loans against the small saving collections to the Centre as per the terms of such loans. Since the setting up of the NSSF in the Public Account of the Centre in 1999-2000, all small saving collections are credited to this Fund and withdrawals by the depositors are made out of the accumulation of the Fund. The balance in the Fund is invested in the Central and State Government securities. The amount released to States is treated as investment in special securities to be redeemed from the sixth year over a period of 20 years.

55. Following the change in accounting practice, the outstanding amount of small savings at Rs.1,76,221 crore at end-March 1999 was converted into NSSF's investment in Central Government securities and is treated as internal debt of the Central Government. Although the amount outstanding is treated as the internal liabilities of the Centre, a considerable portion of the same is attributed to the States' liabilities to the Centre due for repayment over a much longer horizon. As per the Finance Accounts of Government of India (1998-99), the outstanding loan of States against small savings as at end-March 1999, amounted to Rs.1 ,01,211 crore. Once this portion is netted out from the total outstanding of small savings at Rs.1 ,76,221 crore, the balance of Rs.75,010 crore amounts to actual and direct liability of the Central Government.

56. As the small savings collection is growing year after year and distribution is made after meeting the repayments, the mismatch, however, has not been noticeable and as the net collection of small savings has been growing, the Centre's small saving loans to the States have also risen year after year.

V.3 Implications of the Transfer of Entire Net Collection to States

57. The transfer of the entire net proceeds of small savings to States on a back-to-back basis is found feasible within the existing accounting arrangement. However, it is important to recognise broad implications for the Centre and the States. First, the Centre would not get any funds from small saving collections and to that extent , its borrowing requirements from other sources would increase. Second, to start with, States would get more funds from small saving collections and to that extent their borrowing requirements from other sources may decrease. However, though not directly connected to the distribution pattern of small saving collection, it needs to be noted that in a competitive financial environment, small saving growth may not be maintained. In such an eventuality, the net amount available to States, after meeting repayments from gross collections, may turn out to be lower than that of the preceding year, affecting the stability of resource flows to States. In an extreme eventuality, if the gross collections during a year fall short of the repayment obligations, Centre and States' resource position may come under pressure. Third, a

back-to-back arrangement would imply a much shorter repayment period for States than the period up to 25 years under the present system of loans from the Centre.

V.4 Recommendations

58. In order to mitigate the immediate resource shortfall to the Centre, a transitional arrangement for compensatory additional market borrowing may be necessary. On the other hand, as the States will get additional loans against small saving collections, the States should mandatorily prepay their outstanding loans to the Centre. In doing so, States would be effectively replacing the outstanding high cost loans by low cost borrowings in a softening/stable interest rate scenario. Similarly, in case the net collection available for distribution among States comes down because of growing repayments, States may also require some sort of additional borrowing to maintain their resource position. This transitional arrangement may be provided for the Centre and States to raise additional market borrowings to the extent of resource shortfall arising out of switching over to the new system of transferring small savings to States. The simultaneous fiscal consolidation measures initiated at both Centre and States should also help in the process of medium-term adjustment.

59. The maturity mismatches arising out of the maturity structure of small savings deposits and the terms of repayment by the States to NSSF can be eliminated by switching over to the system of back-to-back repayments by the States. However, given the present fiscal position of States and the ongoing fiscal reforms, a back-to-back arrangement, however desirable, may not be advisable at this stage. The combined fiscal position of States has shown deterioration in recent years. The debt servicing obligation is likely to affect State finances adversely. At this juncture, changing the terms of small saving loans and moving towards back-to-back system will imply shortening the maturity of the loan from 5 to 25 years to about 6 years. This may put undue burden on the State Governments. Many State governments have embarked upon fiscal reforms on a priority basis. Government of India has initiated measures to facilitate fiscal reforms at the state level through the Incentive Fund. Accordingly, many of the State governments have drawn up medium-term fiscal plans so as to achieve a balanced revenue account by 2006. Altering the terms of repayment and reduction in the maturity period may pose problems in the fiscal restructuring envisaged by the States in the medium-term. An alternative to minimise the maturity mismatches between the maturity of small savings deposits and the terms of small savings repayments by the States could be rationalisation of the maturity structure of the existing small savings instruments, with elongation towards medium to long-term.

60. It will not be in public interest to allow continuance of *ponzi* schemes on a longer-term basis and hence the Committee felt that at some point of time, the *ponzi* nature of the scheme should definitely stop. The Committee, therefore, suggests that States should be encouraged to adopt a back-to-back arrangement at the earliest so that the overhang problem would not arise for the fresh flows. In the opinion of the Committee, the timeframe for the same may be spread over six years from 2002. During this period, if a State is overburdened with additional repayment of loans, it may be accommodated with additional borrowing from the market.

61. The Committee felt that it would be desirable to continue with the present operational procedure of NSSF with the provision of complete transfer of net mobilisation to States. The

existing administrative machinery and collection process for small savings can continue with post offices/NSSF collecting necessary costs. Further, in case, some States do not wish to have share in small savings, they should be given the choice to opt out of the scheme.

62. As regards transfer of the entire net proceeds of small savings to States, the new arrangement would have the following features:

i) Complete decentralisation would be detrimental to the interests of the State Governments as the resultant risks in investment decision could have an adverse effect on the overall mobilisation of such savings.

ii) Therefore, the NSSF must continue as the conduit for mobilisation of small savings as well as repayment to the investors.

iii) Keeping in view the limited access to the market borrowing programme by the State Governments and the inelastic nature of the sources of revenue available to the States, the entire net proceeds from small savings collected after March 31, 2002 should be transferred to the State Governments.

iv) The Central and State Governments should jointly repay the outstanding small saving liabilities as of March 2002, apportioned in accordance with their respective shares.

v) As the Central Government would have no share from the fresh collections after March 2002, the market borrowing programme of the Central Government may be enhanced to the extent of its annual liabilities.

vi) Similarly, if during 2002-03 and later the net collection available for distribution among the States comes down because of growing repayments, each State Government may be allowed additional market borrowings to maintain its budgeted resources.

vii) Utilising the additional resources in full (on account of 100 per cent transfer of the net proceeds from small savings), the State Governments should mandatorily prepay their liabilities to the Central Government ahead of the schedule, as it would be beneficial for them to replace their high cost liabilities of the past with low cost borrowings in a softening/stable interest rate environment.

viii) In case, some State Governments do not wish to have a share in small savings, they may be given the choice to opt out of the scheme. The net proceeds from such States may form a corpus with the NSSF to be used for investment in Central or other State Government securities.

ix) The Central Government will have to deduct a portion of gross collection to cover actual operational expenses, before transferring the net collections.

VI. Management Issues

VI.1 Rationalisation of Taxation
VI.1.1 Tax Treatment of Short and Medium-Term Instruments
VI.1.2 Tax Treatment of Long-Term Instruments
VI.2 Design of Instruments
VI.3 Engagement of Agents and Agency Charges
VI.4 Rules Governing Deposits and Withdrawals
VI.5 Institutional Arrangements

63. The Committee examined various management issues relating to small saving schemes, such as, rationalisation of taxation, design of instruments, agents and agency charges, and deposits and withdrawals. In addition, the Committee has also discussed an appropriate institutional set up for periodical review and administration of various small saving schemes.

VI.1 Rationalisation of Taxation

64. Under the Indian tax system, broadly three types of tax incentives are provided on the financial savings. These are: (a) deductions, (b) exemptions and (c) tax rebates. The provisions for tax deductions are contained in Section 80L, provisions of tax exemption are detailed under Section 10 and the provisions of tax rebate are provided in Section 88 of the Income Tax Act, 1961. Under Section 80L, the existing tax provisions provide for exemption of income up to Rs.12,000/- from income tax on specified financial instruments (with an exclusive sub-ceiling of Rs.3,000 for interest income arising from Government securities). The financial instruments covered under this Section include bank deposits, Government securities, NSC, post office deposit etc. The income tax provisions as contained in Section 10(11) and 10(15) of Income Tax Act, 1961, provide for unlimited exemption of capital income from income tax, derived from some notified financial assets, such as, Life Insurance Policy, Employees' Provident Funds, Public Provident Funds etc. The incentives in the form of tax rebate are covered under Section 88. Under this Section, investment in specified assets, such as, NSC, NSS, Employees Provident Fund and Public Provident Fund, tax saving units of mutual funds, premia paid on life insurance and infrastructure bonds of IDBI and ICICI are eligible for tax rebate of 20 per cent with an overall limit of Rs.80, 000 (containing an exclusive special sub-ceiling of Rs.20, 000 for infrastructure bonds).

65. Empirically, the impact of tax concessions in promoting savings is different for alternative financial instruments. In general, the tax incentives tend to divert the flow of financial savings in favour of tax preferred financial instruments. However, there is no strong evidence to support that tax incentives facilitate increased financial savings at macro level. In fact, the tax incentives on financial instruments having short and medium term lock-in provisions are evidenced to be used more as a vehicle for tax avoidance by recycling existing savings, than as an instrument for financial accumulation. In contrast, the saving in financial instruments with longer lock-in provisions is undertaken with an objective of smoothening future consumption over the life cycle. The underlying motive is to protect consumption in the event of an anticipated fall in income after retirement, anticipated increase in spending, *e.g.*, children's education etc., as well as unpredictable shock in income. Accordingly, the tax induced financial flows into long-term instruments have a tendency to promote financial accumulation at the macro level.

66. While the Expert Committee is primarily concerned about the reform of administered interest rates on small savings, it also observed that preferential tax treatment on various financial instruments including the ones coming under small saving schemes complicates the issue of effective return to a considerable extent. The Committee is of the view that the existing tax system on financial instruments is distorting the information efficiency of equity and debt markets and providing distorted arbitrage opportunities resulting in misallocation of resources. Therefore, the Committee, while analysing the existing tax provisions relating to small saving schemes, has taken a comprehensive view about the whole structure of taxation on financial instruments. The basic approach of the Committee in this regard is:

(i) To do away with plethora of *ad hoc* exemptions on varied instruments and introduce an element of homogeneity across instruments to ensure a level playing field;

(ii) To make a distinction between short to medium-term instruments and long-term saving, so that long-term saving and accumulation of wealth for old age are encouraged; and

(iii) To do away with the distinction between income from capital gains and dividend/interest for purposes of tax levy so that the tax incidence is uniform upon the 'total return' from instruments. This will eliminate distorted arbitrage opportunities arising out of structuring of a financial instrument.

67. For the purpose of tax treatment, financial instruments are categorised into (a) short and medium term financial savings (savings in financial assets up to 6 years of maturity) and (b) long term financial savings (savings in financial assets having say more than 6 years of maturity). The major financial instruments forming part of long-term security in India are Employees Provident Fund, Public Provident Fund, and Public Pension Fund etc. Financial instruments with short and medium- term redemption period include deposits (bank as well as non-bank), Government Securities, Relief Bonds, National Savings Certificate, National Saving Scheme etc. While the old age security schemes are not marketable instruments and, therefore, illiquid, financial instruments like bonds and debentures, shares and government securities should technically be treated as short to medium-term savings for tax purposes because of their high liquidity and marketability.

68. The tax concessions involve various economic costs. These costs can broadly be identified as cost to the government - in terms of forgone revenue - and cost to the economy - in terms of adverse impact on efficiencies and equity. Incidentally, the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan (Shome Advisory Group, 2001) has come out with certain reform proposals with regard to the personal income tax. While the present Committee broadly agreed with these proposals, it nevertheless would like to suggest certain modifications retaining the tax benefits for long-term savings.

VI.1.1 Tax Treatment of Short and Medium-Term Instruments

69. The twin objectives for providing different types of tax concessions in various Union Budgets, on different financial instruments, have been (a) promotion of savings and (b) diverting financial flows to certain specific sectors.

70. Considering the economic cost associated with continuance of tax incentives on short and medium term financial instruments, and general neutrality of tax incentives on promotion of macro economic savings (particularly in respect of short and medium term financial instruments), it is proposed that:

i) All tax incentives on short and medium term financial assets as provided under Section 80L, Section 88 and Section 10 of Income Tax Act may be withdrawn.

ii) With a view to checking tax evasion, the capital income on financial assets with short and medium term maturity could be subjected to tax deduction at source. The applicable tax rate for this purpose could be the minimum income tax rate, which is currently 10 per cent. A certificate to this effect could be provided to the holder of that financial instrument for the purposes of filing of income tax return to the Income Tax Department. The income tax authority, on the basis of this certificate could realise unpaid part of tax revenue, if any, from the holder of such financial asset and refund the amount to those who have no income tax liability. Investors not liable to pay income tax may submit Form 15H to avoid tax deduction at source.

iii) The tax incidence should be on total return, irrespective of whether it is from dividend/interest or capital gain.

VI.1.2 Tax Treatment of Long-Term Instruments

71. The tax treatment for financial instruments having long-term maturity should differ from that of short and medium-term maturity, considering their role in the promotion of long-term financial accumulation and social security. Best practice of tax policy for long-term savings instruments is to avoid the double taxation of savings inherent in the income tax. Therefore, under the ideal tax system, consumption expenditure instead of income is used as tax base.

72. Funded pension and insurance schemes could be technically taxed at three stages - contributions, accumulation and withdrawals. There are two alternative ways of devising an income tax which uses consumption as a tax base, *viz.,* (a) either the contributions are taxed, while investment income and benefits are not or (b) the contributions and investment income are exempted, while the benefits are taxed. The first is known as TEE (taxed, exempted and exempted) while the second is EET (exempted, exempted, taxed) method. It may be noted that use of consumption as a tax base eliminates the problem of double taxation of saving. Accordingly, the twin principles of fiscal neutrality demand that (a) imposition of tax should not distort the choice between different forms of saving, and (b) tax should not distort the choice between consumption and saving, are ensured under this type of tax treatment of long-term saving.

73. Under the existing income tax provisions, the long-term financial saving of the households is generally exempted from taxation on all the three stages of savings, *viz.*, contribution, accumulation and withdrawals. This liberal tax treatment of long-term savings is not justified considering the implicit revenue loss to the government. Accordingly, it is proposed that

different types of long-term savings should be coherently subjected either to EET or TEE type of tax regime.

74. Both type of tax system provide equal incentive to save, however, the psychological impact of EET, providing tax benefits at the contribution stage, would be greater in promoting financial accumulation. It may be noted that approximately two thirds of OECD countries follow EET system, with some variations, for taxation of savings. The EET method of taxation can be implemented in either of three forms:

(a) Saving in long-term financial instruments would be fully exempted from income tax without any limit.
(b) Saving in long-term financial instruments, subject to a limit, would be exempted from income tax.
(c) Tax exemption on contribution, subject to a limit, would be available in the form of a tax rebate (under Section 88).

75. In each case, full tax exemption would also be provided on the income of institutions managing the long-term savings but the withdrawals at the time of maturity would be subjected to income tax at a rate by which tax credit have been provided.

76. It may be suggested that the option (a) may not be feasible considering the provision for unlimited tax exemption on contribution. Such exemption may induce taxpayers to shift their current tax liabilities, without any limits, to future tax payment. This would significantly reduce the current tax accruals to the Government, putting Government finances under pressure. Between options (b) and (c), the latter is more acceptable from the equity point of view. Under the option (b), withdrawals at the time of maturity, irrespective of the income of the holder, that financial instrument might be subjected to income tax at the maximum rate (bunching of payments). Therefore, option (c) could be adopted with following modification:

i) The tax concession at the time of accrual may be provided under Section 88 of IT Act, providing tax rebate at a rate of 20 per cent on investment up to Rs.60 ,000.
ii) Considering the social structure of the Indian economy and inadequate social safety provisions, the rate of income tax at the time of withdrawal may be kept lower than the rate at which the tax concession was conferred on contribution. Accordingly, all withdrawals at the time of maturity could be uniformly taxed at a rate of 10 per cent.
iii) In order to facilitate financial accumulations and also eliminate the misuse of premature withdrawals for the purpose of tax avoidance; all premature withdrawals, except in the case of death of the beneficiary, should be subjected to a uniform income tax at a rate of 20 per cent - the rate at which the tax concession was obtained at the time of making contribution in the long-term financial assets. Premature withdrawals, in the event of premature death of the beneficiary, should, however, be subjected to fixed rate of income tax at 10 per cent - at par with tax treatment for withdrawal on maturity.
iv) The introduction of EET system, with immediate effect, will make all the existing long-term savings taxable. The incidence of tax on existing long-term savings would fall with retrospective effect. With a view to correcting this situation all the existing

long-term saving schemes may be categorised into 'old' and 'new' schemes. While the fresh accretions into 'old' scheme would stop with immediate effect, the existing tax benefits exempting withdrawals from taxation may continue till the redemption of that scheme. The 'new' schemes for long-term savings should be subjected to proposed tax regime with immediate effect.

v) It is also proposed that the income of the Trust managing the long-term financial savings should be fully exempted from corporate tax.

VI.2 Design of Instruments

77. The Committee felt that the existing small saving instruments might continue. However, for the purpose of tax treatment they are categorised as short and medium-term instruments and long-term savings. Further, interest rate has been made flexible on each instrument through appropriate benchmarking. In this context, it is necessary to offer a wider menu to the investors. Those who are completely risk averse, may like to invest on all short and medium-term instruments at a fixed rate at the time of entry, while risk neutral investors may join those schemes on a floating rate basis based on annual reset of rates. The Committee felt that it would be difficult to take a view on interest rate on long-term savings like PPF. Therefore, the Committee suggests that all investment in PPF would be on a floating rate basis. The Committee strongly felt that Government should not introduce any bearer instrument to mobilise small savings.

VI.3 Engagement of Agents and Agency Charges

78. The R.V Gupta Committee had already dealt with the issues relating to the engagement of agents and agency charges. This present Committee broadly agrees with their recommendations in principle. Accordingly, the Committee felt that the commission payment to Standardised Agency System (SAS) and PPF agents at a flat rate of one per cent might continue. Similarly, commission for Mahila Pradhan Kshetriya Bachat Yojana (MPKBY) agents and Pay Roll Savings Groups (PRSG) at the rate of 4 per cent and 2.5 per cent may also be retained. State Government should give adequate publicity to small savings schemes to create awareness among the people in the rural and semi-urban areas. However, the administrative expenses may be contained at the present level. As the entire net small saving proceeds would be transferred to the State Governments, the agency charges due to Post Office and banks should be paid by the States as may be agreed upon between the Central and State Governments. These expenses would be met from the gross collections of the small savings. However, Central Government should not charge any guarantee fee implicitly given to the schemes.

VI.4 Rules Governing Deposits and Withdrawals

79. The Committee has suggested withdrawal of various tax incentives available under different Sections of Income Tax Act for short and medium-term small savings. However, tax incentives might continue for long-term contractual savings. In view of this, all investors would be given the option to convert their short and medium-term savings into long-term savings without any penalty within a period of say six months or at the most one year. Subsequently, old deposits would be treated similar to fresh deposits with regard to tax treatment. So far as withdrawal is

concerned, there should be a uniform policy for post office deposits similar to bank deposits. Under the new dispensation, which is tax-neutral, deposit flow to banks and small saving schemes would depend on the quality of service rendered by respective organisations. As mentioned earlier, long-term savings would be exempted from tax at contribution stage while withdrawal should be discouraged by imposing a tax. One way to discourage withdrawal is to treat it as a part of taxable income under the existing law. However, loan facility from the long-term savings may be allowed to the investors at a market related rate.

VI.5 Institutional Arrangements

80. In view of various changes in the policy regime with regard to small saving funds, it is necessary to restructure the administrative machinery. Without appropriate administrative reforms, execution of the policy changes might be carried out in an arbitrary manner, which may hamper the overall interest of investors under small saving schemes. Towards this end, the Committee proposes constitution of a National Small Savings Authority (NSSA) under the Ministry of Finance, Government of India, to administer the NSSF with regard to all fresh flows. The Central Government and all the States and UTs would be members of the NSSA. The existing set up within the Budget Division, Ministry of Finance, Government of India can provide necessary infrastructure support as and when it is necessary.

81. The NSSA would be responsible for all fresh mobilisation of small savings, its transfer and the settlement of accounts. It would monitor the entire operations of small savings closely in line with the policy prescriptions. It would be responsible for the following:

a) Introduce new schemes, modifying or withdrawing existing schemes, determining the terms of the schemes like period, eligibility of investors, etc.
b) Reset and communicate interest rate on small saving schemes in relation to the benchmark and the spread over benchmark at the beginning of the financial year according to the criteria laid down by the Committee.
c) Coordinate with State Government representatives to initiate all necessary actions with regard to the deposit of small saving schemes.
d) Determine the methods and forms of transfer of resources on a back-to-back basis to the States/UTs. It will also decide the terms and conditions of the delayed payment with regard to the last date of withdrawal, penal rate of interest, if any, as well as steps to be taken in case of defaults by any States including moratorium on the issue of fresh mobilisation, etc.
e) Issue guidelines for netting out of operational expenses from the gross mobilisation of States/UTs and for making types of investment to be made by the States out of small saving funds.
f) Prepare annual accounts of the NSSF with State-wise details, and submit the same for presentation to the Parliament.
g) Invest the mobilised savings of States, which do not want their share in the small savings.
h) Any other matter relating to the operation of small savings.

82. The NSSA may prepare statement showing sources and uses of funds on a regular basis (monthly or so) for close monitoring of flow of funds relating to small savings. For taking care of

the operations of the Fund, the NSSA would have an Executive Committee consisting of representatives of Ministry of Finance, Government of India, some State Governments and a permanent invitee (not a member) from the RBI in advisory capacity. A nominee from the office of the Controller General of Accounts may also be included in the Executive Committee to facilitate close monitoring of the method of administering interest rate on deposit, collections reported by various operating agencies, the transfer of Fund to State Governments as well as preparation of accounts of the Fund from time to time.

83. There should be up-to-date data dissemination. The NSSA should release data on small savings on a monthly basis with a maximum time lag of two months. Agencies involved in the process should promptly submit returns to the NSSA on a monthly basis. In this context, it may be emphasised that there is an urgent need to computerise the whole process. Without technological improvement, small saving schemes may not be in a position to compete with other financial instruments, particularly with bank deposits.

84. Currently, different small saving schemes are governed by different Acts of the Parliament. As a part of consolidation, a Small Saving Act may be enacted with new features. It should be an umbrella legislation encompassing all aspects of small savings, which will supercede earlier legislations. The new legislation may be drafted in consultation with representatives of major stakeholders. The scheme should be restricted to individuals and the Hindu Undivided families, as they essentially constitute the small savers. The long-term instruments like PPF and retirement schemes could be integrated into the Pension reform of the country.

VII. Implications of Committee's Recommendations

85. The Committee has examined a wide range of complex problems and offers a variety of recommendations which could be viewed as a package. While the Committee's focus has been on the administered interest rates in respect of small saving schemes, the principles are extendable to all administered interest rates fixed by the Government. Secondly, the tax reforms in respect of the instruments of small savings should be treated as a package encompassing all financial instruments as these recommendations, if implemented in isolation or partly, may not serve the purpose of achieving level playing field and removing market segmentation and distortions in pricing. Thirdly, while the recommendations offer interim solutions, Government may have to speed up reforms in long-term saving plans consistent with the Medium-Term Vision suggested by the Committee. In particular, there should be an attempt over time to reduce the number of such schemes besides removal of distortions arising out of tax treatment, so that such schemes become a modest source of financing Government deficit.

86. Small savers would continue to get a safe avenue for investment at a reasonable rate of return. The interest rate would no longer be decided in an *ad hoc* manner. Savers would now have the option of joining any short and/or medium-term scheme at fixed or floating rate of return prevailing at the time of entry. They can also convert their short and medium-term savings into social security schemes on which tax incentives would continue.

87. A few advantages are likely to accrue to the Central Government from the proposed package. First, the loss of capital receipts on account of 100 per cent transfer of net proceeds to the State

Governments is likely to be offset, at least partially, by revenue gain arising out of withdrawal of tax incentives from short and medium-term instruments. Secondly, there may be more mobilisation of resources under GPF and EPF as tax treatment would continue to be favourable for these schemes similar to PPF. Thirdly, the Central Government will continue to recover the cost by way of agency charges for using the wide network of post offices and banks for small saving transactions. Fourthly, the Central Government may reduce its interest burden by replacing the high cost small savings by relatively low cost market borrowing.

88. The State Governments are likely to benefit from the changes on several counts. First, the entire net proceeds from small savings would now be transferred to the States which could be partly used for repayment of outstanding loans to the Centre, thus reducing the interest burden in the prevailing interest rate environment. Secondly, while switchover to a back-to-back system would reduce the repayment period, it would also discourage the States from using these funds for financing revenue deficit. Thirdly, given the incentive structure for social security schemes, the average maturity of small savings may increase in future due to shift in the composition of small savings. Fourthly, benchmarking of small saving interest rates to yield on Government securities would provide an opportunity for the States to choose between market borrowing and small saving schemes to meet their requirements. In the transition period, there may be a likelihood of a fall in mobilisation of small saving schemes. This is likely to adversely affect the resources of State Governments. Alternative funds should, therefore, be made available to the State Governments. Special market borrowing programme could be arranged for the State Governments during the period of transition.

89. The package is consistent with the ongoing reforms in the financial sector. Benchmarking of administered rates to yield on Government securities would make the structure of interest rate more flexible. Financial markets may get integrated further which would be beneficial for overall market development and its functional efficiency. The transmission mechanism of monetary policy through the interest rate channel is thus likely to improve. Withdrawal of tax incentives on short and medium-term instruments may lead to a change in the composition of small savings. This can pave the way for pension reforms in the country and promote long-term savings in the economy.

VIII. Summary of Recommendations

90. The Committee's recommendations are unanimous and to the extent feasible, explicit and firm. However, since the issues relating to small savings are complex and involve a wide range of stakeholders, the Committee would suggest a wider debate on various issues involving all stakeholders. Wider consultations (particularly with the States) in respect of the Committee's recommendations regarding small savings would be desirable. (Para 17)

91. Although the Committee has deliberated on the entire structure of administered interest rates, its recommendations relate mainly to the small saving schemes including PPF. The underlying principles pertaining to these recommendations are , however, extendable and equally applicable to similar administered interest rates in the system. (Para 18)

92. Financial savings in general and long-term and contractual savings in particular, should be

encouraged keeping in view the long-term investment requirements of the economy. Small saving schemes are essentially a basket of diversified and heterogeneous products and therefore there is a need to distinguish the various schemes in terms of their purpose and whether they cater to the needs of small savers / investors as they are purported to be. In principle, small savings should inculcate the habit of thrift among the people and therefore, be restricted to individuals. (Paras 19 and 20)

93. The Committee observed that the present system of direct management of long-term funds by the public sector and fixing administered rates of interest with all tax advantages would not be sustainable in the medium-term. Most of these funds, in future, are expected to be privately managed with larger and diversified investment portfolios. The medium-term objective of the Central Government should be to spell out a well conceived investment policy to facilitate switching over to fully funded long-term saving schemes managed independently and professionally and aimed at promoting growth and meeting genuine investment demands in the economy. The PPF may be integrated into the Pension Funds system that emerges along the lines of action taken towards the reform of GPF, EPF and other old age security schemes. The continuation of administered regime of interest rates on small saving schemes should, therefore, remain temporary and any benchmarking of these rates should also be treated as an interim measure. (Paras 29-31)

Benchmarking

94. In order to prescribe a suitable benchmark, the options before the Committee were: a) real return based on inflation rate/real growth rate of the economy; b) bank deposit rates corresponding to different maturities; c) Bank Rate; and d) average secondary market yield on Government securities. After considering all feasible options, the Committee recommends the following benchmarking with regard to alternative instruments:

i) Post Office Savings Bank (POSB) account has similarities with current account in a commercial bank and therefore, such account-holders may not earn interest on it. In order to promote rural savings, Government is currently giving an interest rate of 3.5 per cent. This is a facility available only to small savers. Keeping in view that even commercial banks are offering interest at 4.0 per cent on such accounts, the Committee recommends that the present rate of 3.5 per cent on POSB accounts may continue so long as the inflation rate rules above 3.5 per cent or the savings bank deposit rate of commercial banks is not below 3.5 per cent.
ii) Interest rate on One Year Postal Deposit may be benchmarked to the average yield of 364 Days Treasury Bills traded in the secondary market during the previous year.
iii) Interest rate on 5-Year Postal Deposit/Post Office Monthly Income Scheme/Post Office Recurring Deposit may be benchmarked to the average secondary market yield on Government securities having a residual maturity of around five years.
iv) Interest rates on 2 and 3-Year Postal Deposits may be calibrated between one and five-year Postal Deposit rates.
v) Interest rates on all non-bearer certificates should be marginally higher (lower) than the 5-Year Postal Deposit rate, depending upon the maturity of the instruments.
vi) Interest rate on present bearer instruments like Kisan Vikas Patra should also be on par

with non-bearer certificates after removing the transferability feature of this instrument.

vii) As regards interest rate on relief bonds, the same principles should apply. However, it should be terminated at an early date to avoid distortions.

viii) Interest rates on PPF may be benchmarked to average secondary market yield on Government securities having a residual maturity of around ten years.

ix) Interest rates on other administered schemes like GPF and EPF may follow the principle applicable to PPF.

x) The spread over the benchmark yields for fixing the interest rates on the small saving schemes may have to be suitably calibrated subject to a maximum of 50 basis points depending upon the maturity and liquidity of the instrument, keeping in view the savers' interest, particularly for long term instruments. The objective should be to reduce the spread over the benchmark rate over a period.

xi) Investors should have the option to choose between the fixed rates or floating rates at the time of entry, excepting investors in provident funds (PPF, GPF and EPF) who would have the option of floating rates only.

xii) The Committee feels that the periodicity of revision in interest rates should be annual, at the beginning of the financial year which may be reviewed at a later date.

a) (Paras 44-46)

Transfer of Entire net Proceeds to States

95. Historically, the Central Government played the role of financial intermediary in collection of small savings and their sharing with the State Governments. The amount mobilized through the small saving schemes is accounted under the Public Account of the Central Government. The net amount (gross collections minus repayments) is shared between the Centre and the States and forms part of the borrowed funds for financing the fiscal deficit of both Centre and States. One of the terms of reference before the Committee was to explore the feasibility of transferring the entire net proceeds of small saving to States. The Committee also felt the need to simultaneously address the 'overhang' problem created historically due to maturity mismatches between small saving deposits and loans extended to States by the Centre against small saving collections. (Paras 49-50)

96. As regards transfer of the entire net proceeds of small savings to States, the new arrangement would have the following features:

j) Complete decentralisation would be detrimental to the interests of the State Governments as the resultant risks in investment decision could have an adverse effect on the overall mobilisation of such savings.

ii) Therefore, the NSSF must continue as the conduit for mobilisation of small savings as well as repayment to the investors.

iii) Keeping in view the limited access to the market borrowing programme by the State Governments and the inelastic nature of the sources of revenue available to the States, the entire net proceeds from small savings collected after March 31, 2002 should be transferred to the State Governments.

iv) The Central and State Governments should jointly repay the outstanding small saving liabilities as of March 2002, apportioned in accordance to their respective shares.

v) As the Central Government would have no share from the fresh collections after March 2002, the market borrowing programme of the Central Government may be enhanced to the extent of its annual liabilities.

vi) Similarly, if during 2002-03 and later the net collection available for distribution among the States comes down because of growing repayments, each State Government may be allowed additional market borrowings to maintain its budgetary resources.

vii) Utilising the additional resources in full (on account of 100 per cent transfer of the net proceeds from small savings), the State Governments should mandatorily prepay their liabilities to the Central Government ahead of the schedule, as it would be beneficial for them to replace their high cost liabilities of the past with low cost borrowings in a softening/stable interest rate environment.

viii) In case, some State Governments do not wish to have a share in small savings, they may be given the choice to opt out of the scheme. The net proceeds from such States may form a corpus with the NSSF to be used for investment in Central or other State Government securities.

ix) The Central Government will have to deduct a portion of gross collection to cover actual operational expenses, before transferring the net collections.

ii) (Para 62)

Management Issues Rationalisation of Taxation

97. For the purpose of tax treatment, financial instruments could be categorised into: a) short and medium-term financial savings (maturity up to 6 years) and b) long-term saving (maturity more than six years). Although this Committee has broadly agreed with the recommendations of the Shome Advisory Group on Tax Policy and Tax Administration, following modifications are suggested for the short and medium-term instruments.

i) All tax incentives on short and medium-term financial assets as provided under Section 80L, Section 88 and Section 10 of Income Tax Act may be withdrawn.

ii) With a view to checking tax evasion, the capital income on financial assets with short and medium-term maturity could be subjected to tax deduction at source. The applicable tax rate for this purpose could be the minimum income tax rate, which is currently 10 per cent. A certificate to this effect could be provided to the holder of that financial instrument for the purposes of filing income tax return to the Income Tax Department. The income tax authority, on the basis of this certificate could realise the unpaid part of tax revenue, if any, from the holder of such financial asset and refund the amount to those who have no income tax liability. Investors not liable to pay income tax may submit Form 15H to avoid tax deduction at source.

iii) The tax incidence should be on total return, irrespective of whether it is from dividend/ interest or capital gain.(Paras 67-70)

98. With regard to long-term savings, the Committee recommends the following:

i) The tax concession at the time of accrual may be provided under Section 88 of IT Act, providing tax rebate at a rate of 20 per cent on investment up to Rs.60, 000.

ii) Considering the social structure of the Indian economy and inadequate social safety

provisions, it is proposed that the rate of income tax at the time of withdrawal may be kept lower than the rate at which the tax concession was conferred on contribution. It is accordingly proposed that all withdrawals at the time of maturity could be uniformly taxed at a rate of 10 per cent.

iii) In order to facilitate financial accumulations and also eliminate the misuse of premature withdrawals for the purpose of tax avoidance; all premature withdrawals except in the case of death of the beneficiary, should be subjected to a uniform income tax at a rate of 20 per cent - the rate at which the tax concession was obtained at the time of making contribution in the long-term financial assets. Premature withdrawals, in the event of premature death of the beneficiary, should, however, be subjected to fixed rate of income tax at 10 per cent - at par with tax treatment for withdrawal on maturity.

iv) The introduction of EET system, with immediate effect, will make all the existing long-term savings taxable. The incidence of tax on existing long-term savings would fall with retrospective effect. With a view to correcting this situation, all the existing long-term saving schemes may be categorized into 'old' and 'new' schemes. While the fresh accretions into 'old' scheme would stop with immediate effect, the existing tax benefits exempting withdrawals from taxation may continue till the redemption of that scheme. The 'new' schemes for long-term savings should be subjected to proposed tax regime with immediate effect.

v) The income of the Trust managing the long-term financial savings should be fully exempted from corporate tax. (Para 76)

Design of Instruments

99. Although existing instruments of small savings would continue, the Committee preferred a wider menu to the investors. Those who are completely risk-averse, may like to invest in all short and medium-term instruments at a fixed rate at the time of entry while risk-neutral investors may join these schemes on a floating rate basis. As it is difficult to take a long-term view on interest rates, investment in PPF would be on a floating rate basis. (Para 77)

Engagement of Agents and Agency Charges

100. The existing rates of commission paid to the agents may continue. The agency charges due to Post Office and banks for small saving transactions may be agreed upon between the Central and State Governments. The Central Government should not charge any guarantee fee. (Para 78)

Rules Governing Deposits and Withdrawals

101. As tax incentives are thus to be withdrawn from short and medium-term instruments, conversion of these savings into long-term savings may be allowed at the option of the investors without any penalty within a stipulated time, say, six months or at the most one year. (Para 79)

Institutional Arrangements

102. A National Small Savings Authority (NSSA) may be constituted at the Centre to administer the NSSF with regard to all fresh flows. To formulate policy in respect of small saving schemes,

the NSSA would have an Executive Committee consisting of representatives of the Ministry of Finance, Government of India, some State Governments and a permanent invitee from the RBI in advisory capacity. A nominee of the Controller General of Accounts may also be included in the Executive Committee. The NSSA may compile data on small savings on a monthly basis and disseminate them regularly. (Paras 80-84)