Medium Term Vision

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The medium term perspective to the recommendations of the Committee is very vital and arises out of three important dimensions of the problem relating to the Small Saving Schemes.

First, the Small Saving Schemes represent a mixture of different type of saving instruments, some akin to deposits and others in the nature of old age security schemes. The future of these schemes has to be placed in the light of emerging banking and financial sector development and pension fund reforms.

Second, the tax treatment of Small Saving Schemes has to be viewed in the broader perspective of tax reforms in respect of financial savings/instruments as a whole in the context of developing an efficient capital and debt market as also making the monetary policy transmission mechanism through interest rates policy more effective.

Third, the issues relating to the administration, accounting and share of proceeds between Centre and States have all to be viewed in the light of several options available to structure a comprehensive social security scheme for the country.

This paper attempts to address these issues.

The Committee's terms of reference, in their scope, are generally limited to suggest the mode of fixing administered interest rates including those on Small Saving Schemes, the mode of accounting and sharing of proceeds between the Central and State Governments, to recommend on aspects relating to the nature and administration of Small Saving Schemes. The Committee, however, has also been asked to make recommendations on issues related to the interest rates (in general) and to make such other recommendations as the Committee may deem appropriate on the subject. On this basis, the Committee strongly feels that the recommendations relating to the operation of the existing Small Saving Schemes, in terms of fixation of interest rates, tax treatment and their administration in the immediate context, would have to be viewed essentially as interim measures. Looking at the variety of Schemes and their nature, it is felt that the medium term vision on the future scenario of these schemes should be placed in a very broad perspective of impending pension fund reforms, tax reforms in respect of financial instruments, orderly development of capital and debt markets, improvement in fiscal consolidation and improving the efficiency of interest rate policy as an integral part of monetary management.

There are three important dimensions to be addressed in the above regard which are:

? First, the Small Saving Schemes as they are operated at present represent a mixture of different types of instruments viz., short and medium term saving instruments akin to bank/non-bank deposits and long term savings in the nature of old age Social Security Schemes. While the future prospects for short to medium term saving schemes will depend upon the likely competition emerging in the banking and non-banking sector and the outreach of the banking system to diversified groups of people, the long term saving schemes will have to be viewed in the context of the emerging pension fund reforms.

? Second, the tax treatment of Small Saving Schemes shows that several tax concessions have been provided on an ad-hoc basis and they are incongruent with the incentive structure expected to be built up through fiscal concessions. Besides adding to the effective cost of such schemes to the Government, the tax treatment of these instruments has also resulted, in combination with administered interest rates structure across the instruments, in inefficient allocation of resources caused by information and market inefficiency. The interest rate policy of the central bank in influencing the general level of interest rates in the system also gets constrained and at times vitiated by not only the administered nature of these interest rates, but also by the distortion caused between nominal and effective rates of return on such instruments. The ad-hoc nature of fiscal incentives of financial instruments has also observed to be widespread on various other non-contractual debt instruments and insurance products. Therefore, while addressing tax treatment of small saving instruments, both in the immediate and future contexts, the tax policy on financial instruments as a whole has to be addressed.

? Third is the issue relating to the administration and accounting treatment of these schemes along with the issue of allocation between Centre and States. In this context comes the relevance of looking at the small saving schemes in the light of emerging need and scope of pension fund reforms and the several options available before the government to structure a comprehensive social security scheme for the country.

While issues relating to the tax treatment of Small Saving Schemes are addressed in detail separately, the other two aspects are dealt with in the following paragraphs:

Small Saving Schemes as an Integral Component of Pension Fund Reforms

The Small Saving Schemes as operated at present have three components. In the first category, will fall schemes such as post office saving deposits, term deposits/recurring deposits etc. which are akin to short term savings in the form of bank deposits. The second category of small saving schemes would include the National Savings Scheme, National Savings Certificates, Kisan Vikas Patra, etc. which are in the nature of short to medium-term financial or debt instruments. The PPF is the third category which is in the nature of long term saving plan and comparable to provident and pension funds as a social security scheme for old age. While the objective of the first two categories is to generate current income to meet expenditures in the short to medium-term, the long-term savings are purely in the nature of provision of social security in old age. The long-term saving plans which are at present part of the small saving schemes should be viewed along with the old age security schemes like provident and pension funds for drawing a future vision.

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. In a joint family, the working members generally in the age group of, say 20 to 60 years, provide support to non-working members, may be children, women, elderly, incapacitated etc. Among the women folk, there could be widows and destitutes and even among the eligible working age group that could be treated as working population, there could be members who are involuntarily unemployed. 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 only one of the main elements of a comprehensive social safety net. Given the limited scope of the present Committee's terms of reference, the medium-term vision confines itself to the approach towards old age security and does not address other aspects of 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. However, given the myopic behaviour of the public, it is 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 funds and pension funds schemes provide such opportunity and institutional framework. A list of schemes covered under old age security in India is provided in Annexure–1. Given the present coverage and administrative arrangements for old age security in the form of long term savings schemes (including Provident and Pension Funds), the broad features of the existing long term saving schemes are:

(i) They are basically non-funded schemes. The funds are generally accumulated as part of Government public accounts and the schemes follow a 'Pay as You Go Approach' (PYGA).
(ii) As the funds become a part of the Government's pool, there is no separate deployment of these funds. Given the expenditure pattern and the fact that the Government has a huge revenue deficit, one could surmise that these funds are not being put to productive use which generates a reasonable economic or social rate of return, leave alone a commercial return.
(iii) To the extent a large chunk of long term savings from the public are diverted to the Government, it reduces the availability of these funds for productive deployment in the non-government sector. To that extent, these funds, lying outside the organised capital market activity stunts the growth of capital and debt markets.
(iv) The long term saving schemes also have liberal withdrawal facilities and substantial tax incentives which are not conducive and consistent with the basic objective of promoting accumulation of wealth for old age security. The schemes attract funds more for the purpose of taking tax advantages.
(v) The PYGA may result in fiscal problems at a later stage when fresh accumulations are not sufficient to cover the servicing of matured accounts.

It would be worth quoting the main problems with the existing programmes as identified by the World Bank (India: The Challenge of Old Age Income Security, April 5, 2001):

(i) The compulsory defined contribution scheme for private sector workers is found to have excessive contribution rates, low returns and deficient service. As a result, the scheme is not an effective vehicle for retirement savings and workers are encouraged to remain in the informal sector;
(ii) High contribution rates are partly the result of forced savings for reasons that go far beyond old age, survivorship and disability as evidenced by a plethora of withdrawal options. Moreover, there is little public policy rationale for mandating savings for these

purposes;

(iii) The new, defined benefit (DB) scheme for private sector workers exposes members to inflation risk after they retire and appears to be underfunded;

(iv) Furthermore, the DB formula applied in public and private sector schemes cause inequitable redistribution between workers and encourage early retirement;

(v) The DB scheme that covers civil servants is completely unfunded and has accumulated very large liabilities estimated at close to one third of GDP, even excluding the liabilities of state enterprises that are likely to be quite large;

(vi) Investment policy for funded pension schemes entails providing captive credit that may encourage government consumption rather than savings and does not help deepen private capital markets or allocate long term savings effectively; and

(vii) Tax treatment is inconsistent and discourages contractual savings instruments.

In India, the existing provident and pension funds' annual flows have increased from about Rs.5,055 crore in 1986-87 by more than tenfold to Rs.55,000 crore in 1999-2000 (Annexure–2). As a percentage of total gross financial flows, it has increased from about 16 per cent to 53 per cent and as a percentage of GDP from 1.6 per cent to 2.8 per cent. The lowering of fertility and increasing longevity of population would cause this burden to increase further in the coming years. The World Bank which had studied this problem across countries in 1994, developed a three pillar model for pension funds reform:

The **first pillar** of the proposed model provides a minimum benefit guaranteed through a mandatory and universal allocation plan financed by taxes and managed by the public sector.

The **second pillar** involves individual savings plans with defined contributions being managed by the private sector subject to State legislation.

The **third pillar** provides supplementary **pensions based** on defined contributions and state regulated, privately managed individual funds. These are private pension schemes which are being encouraged to ease the burden of governments. This pillar has received much attention and has been the component of pension reforms in Chile, Latin America and in some OECD countries. In India too, the OASIS Report has been advocating to make this pillar effective.

The World Bank initiatives have greatly led to privatising public pension systems. The Pay-as-You-Go (PAYG) public pension systems which are defined benefit schemes have been replaced by privately managed defined contribution schemes in several countries. Several financial companies have also stepped in as private managers of pension funds investing pensions in overseas capital markets.

In India, the problem has received the attention of the Government in recent years. The Study commissioned by the Ministry of Social Justice and Empowerment, namely, the project Old-Age Social and Income Security (OASIS) has brought out two reports, one in February 1999 and another in June 2000, the recommendations of which are provided separately. 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: A Challenge of Old-Age Income Security,* in April 2001. The Government of India in its budget, 2001-02 has

announced certain steps for improving social security system in India. Mentioning that the unorganised sector does not have adequate social security coverage, the Finance Minister has requested the Insurance Regulatory Development Authority (IRDA) to look into these issues and provide a road map for pension reforms by October 2001. Also announcing a new pension programme based on defined contributions for Central Government services after October 1, 2001, Finance Minister has proposed constitution of a High Level Expert Group in order to review the existing pension system and to provide a road map for the next steps to be taken by the Government.

While these initiatives are yet to fructify into any concrete plan of action, the institutional arrangements for old age security will have to address multi-dimensional issues and options such as:

(i) Whether there should be single scheme for all categories of population or schemes should be designed for different population groups such as the government, the non-government corporate sector, the non-government non-corporate sector, unorganised sector, etc.
(ii) Should the entire scheme be publicly managed by the government or private institutions and trusts should be involved in mobilisation and management of the funds.
(iii) What should be the source of funding - taxation, voluntary contributions or compulsory schemes for working population.
(iv) There could be two options for providing old age security. First, an annuity amount could accumulate during the working life which could be provided at the end of working life. Secondly, there could be a promise of annuity during the life time after retirement. The first is in the nature of provident funds and the second is in the nature of pension funds.
(v) What should be the tax treatment of funds mobilised as also the assets of the funds so that there is an incentive for accumulation and the cost towards contribution and return on funds get optimised.
(vi) Should the government guarantee the old age security or private insurance and guarantees in this sector be encouraged.
(vii) What should be the legislative and regulatory mechanisms for orderly functioning of the old age security schemes, particularly when these schemes are allowed to be independently managed on a fully funded basis.

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 recommendations within the narrow confines regarding the small saving scheme 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 relative committees set-up for this purpose and the fiscal and financial market implications of such moves.

The Committee would, however, like to observe that the likelihood regarding the future course of

pension and provident fund schemes or pension fund reforms is that the present system of direct management by the public sector of these funds, fixing administered rates of interest with all tax advantages, would not be sustained in the medium term. In all probabilities, most of these funds would be privately managed with larger and diversified investment portfolio and the returns of such funds linked to market based portfolios.

Future of Administered Rates

In India, all interest rates were administered in the pre-reform period. When all interest rates are administered, in a perverse sense, there is no segmentation of markets. The relationship 'one interest rate' should bear with other interest rates is purely policy driven. After the reform, most of the interest rates have been freed and are market determined. It is significant to note that Government securities rates were already made market determined. The Small Savings rates of Government including rates on Provident Funds, however, continue to be administered. During the administered regime, the small savings rates are kept relatively at higher levels and combined with tax sops, these rates remained very attractive indeed. When other rates were freed and made market oriented, the non-administered segment of market became very competitive and became resilient to expectations about inflation rates and policy interventions. These rates saw ups and downs and the unadjusted administered rates started looking less attractive when market rates firmed up and looked more attractive when the interest rates softened. The relative attraction got enhanced if the tax incentives are added. Sine January 1999, Government had taken efforts to adjust these rates and the reduction in these rates helped RBI to correspondingly bring down its policy signaling rate i.e., the Bank Rate and thereby the overall interest rates in the system. But, these rates, when tax incentives are taken into account, should still be considered as relatively very high as brought out by many technical papers.

The administered rates by Government were perhaps kept relatively high to attract funds to bridge the widening deficit and maintain adequate flow of funds into the government exchequer. However, given the broad objective of financial sector reform, there is no scope for having a large segment of the financial sector small savings to remain segmented only for the sake of bridging the deficit.

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 have to remain administered since the return on the deployment of these funds by the government is uncertain and perhaps very low. Government will have to keep the interest rates relatively high and keep them very attractive to investors through tax sops or otherwise with all consequential adverse implications for a level playing field in the financial markets. 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.

The feasibility of immediately converting the long term saving schemes into fully funded schemes looks however bleak, given the dependence of government to meet deficits. Government should evolve a time bound programme to achieve this objective. In the interim, the schemes could be rationalised and the rates on small saving schemes adjusted so that the adverse implications of segmentation on financial markets 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.

Administration and Accounting

When the pension fund reforms take shape, it should also be accompanied by the necessary legal and regulatory arrangements for effective monitoring of privately managed funds with proper prudential safeguards and standards of accounting and governance. Perhaps, a new pension regulatory authority has to be constituted (as recommended by the OASIS Project) or the closely related functionary, *viz.*, the Insurance Regulatory and Development Authority has to be provided with necessary statutory powers to regulate provident funds and pension funds also. In the above regard, it may also be necessary to study other country experiences in terms of the legal and regulatory structures.

The Small Saving Schemes, if they are transferred to State Governments, after the transition period, the State Governments will have the choice of continuing the schemes in the present form or assign it to independently managed professional fund managers. The schemes which are in the nature of short-term/medium-term deposits may come in competition with the banking and non-banking sectors and the relevance of Post Office Savings should be left to the market forces. If at all they continue, they must operate in level playing field with the market and no artificial incentives to keep up mobilization of deposits by governments should be permitted. This is neither in the interest of governments nor in the interest of development of debt and capital markets.

Long Term Savings Scheme like PPF should get integrated into the kind of Pension Fund system that emerges along the lines of action taken towards the reform of GPF, EPF and other old age security schemes.

Annexure - I

Government-Sponsored Schemes for Old Age Income Security in India

Compulsory

Programme	Legal Coverage[1]	Effective Coverage[2]	Financing
Employees' Provident Fund	Employees in firms with more than 20 employees	About 5.8 per cent of the labor force	Employer and employee contributions
Employees' Pension Fund	Same as above with some exemptions	About 5.4 per cent of labor force	Employer, Government contributions
Civil Service Pension Scheme	Civil servants at state and federal level	About 3.5 per cent of the labor force	State or Central Government budgets

Government Provident Fund	Civil servants at state and federal level	Most civil servants	Employee Contributions
Special Provident Funds	Certain occupations and employees in Jammu and Kashmir	About 0.5 per cent of the labor force	Employer and employee contributions
Voluntary, Tax-preferred			
Public Provident Fund	All individuals	About 0.8 per cent of the labor force	Contributions
Superannuation Plans	All employees	About 0.2 per cent of labor force	Contributions
Personal Pensions	All individuals	About 0.2 per cent of labor force	Purchase of annuity-like products
Social Assistance			
State Level Social Assistance	Varies by state	Varies by state	State budgets
National Old Age Pension Scheme	Destitute persons over the age of 65 years	About 15.2 per cent of population over the age of 65 years	Central budget

Notes :
1. Legal coverage for EPS/EPF extends to 177 types of establishments.
2. Effective EPS coverage refers to a subset of EPF members.
Source: World Bank (2001), India: The Challenge of Old Age Income Security.

Annexure - II

Table II.1 Provident and Pension Funds (Annual Flows)

(Rs. crore)

Year	Provident and Pension Funds	Gross Financial Assets	GDP at CMP (1993-94 series)
1980-81	2122	12118	144393
1981-82	2480	13621	169495
1982-83	2865	16097	188866
1983-84	3052	18790	219688
1984-85	3759	23549	246883
1985-86	4188	25562	280258
1986-87	5055	31849	313580
1987-88	6509	36106	355417
1988-89	7552	39958	423497
1989-90	9508	48233	487740
1990-91	11155	58908	568772
1991-92	12501	68077	653298
1992-93	14814	80386	747387
1993-94	18323	109597	859220
1994-95	21414	145503	1012770

1995-96	22344	123414	1188012
1996-97	30389	158960	1368208
1997-98	32267	173657	1522441
1998-99	46350	218932	1758276
1999-00	54762	237526	1956997

Source: Central Statistical Organisation

Table II.2 Provident and Pension Funds (Annual Flows)

(Rs. crore)

Year	Provident and Pension Funds	Per cent to G.F.S.	Per cent to GDP at CMP
1980-81	2122	17.5	1.5
1981-82	2480	18.2	1.5
1982-83	2865	17.8	1.5
1983-84	3052	16.2	1.4
1984-85	3759	16.0	1.5
1985-86	4188	16.4	1.5
1986-87	5055	15.9	1.6
1987-88	6509	18.0	1.8
1988-89	7552	18.9	1.8
1989-90	9508	19.7	1.9
1990-91	11155	18.9	2.0
1991-92	12501	18.4	1.9
1992-93	14814	18.4	2.0
1993-94	18323	16.7	2.1
1994-95	21414	14.7	2.1
1995-96	22344	18.1	1.9
1996-97	30389	19.1	2.2
1997-98	32267	18.6	2.1
1998-99	46350	21.2	2.6
1999-00	54762	23.1	2.8

Source : Central Statistical Organisation

Table II.3 Sectoral Break-up of Provident and Pension Funds
(Annual Flows)

(Rs crore)

	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00
Provident and Pension Funds	11155	12501	14814	18323	21414	22343	30390	32267	46350	54762
% to GFS	18.9	18.4	18.4	16.7	14.7	18.1	19.1	18.6	21.2	23.1
% to GDP at CMP	2	1.9	2	2.1	2.1	1.9	2.2	2.1	2.6	2.8
Central Govt. Provident Fund	1221	1286	1611	1790	2003	2261	2335	4383	5737	6750
% to GFS	2.1	1.9	2	1.6	1.4	1.8	1.5	2.5	2.6	2.8
% to GDP at CMP	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3
Public Provident Fund	781	972	1341	1926	2131	2657	3082	4033	5324	7170
% to GFS	1.3	1.4	1.7	1.8	1.5	2.2	1.9	2.3	2.4	3
% to GDP at CMP	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.4

State Govt. Provident Fund	2590	2347	2990	3650	4722	3876	3833	5683	11082	16101
% to GFS	4.4	3.4	3.7	3.3	3.2	3.1	2.4	3.3	5.1	6.8
% to GDP at CMP	0.5	0.4	0.4	0.4	0.5	0.3	0.3	0.4	0.6	0.8
Non-Govt. Provident Fund	5833	6978	7885	9897	10993	11202	18121	14131	19105	19506
% to GFS	9.9	10.3	9.8	9	7.6	9.1	11.4	8.1	8.7	8.2
% to GDP at CMP	1	1.1	1.1	1.2	1.1	0.9	1.3	0.9	1.1	1
Pension Funds	730	918	987	1060	1565	2347	3019	4037	5102	5235
% to GFS	1.2	1.3	1.2	1	1.1	1.9	1.9	2.3	2.3	2.2
% to GDP at CMP	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.3	0.3	0.3

Source: Central Statistical Organisation

* Author thanks Dr. B.K. Bhoi, for providing assistance in procuring relevant references and data.