Choice of Small Saving Schemes Menu (and also associated Administered Schemes like GPF, EPF, SDS, Relief Bonds etc.): Defining Long-term Saving Schemes and Scope for Rationalisation

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This paper examines existing small saving schemes, the need and scope for rationalization and proposes menu for saving schemes.

I. Existing Small Saving Schemes in India

The small saving schemes in India are framed by the Central Government under the Government Savings Bank Act, 1873 and Government Savings Certificates Act 1959 and the Public Provident Fund Act 1968. The two other schemes intended to strengthen the domestic savings are Deposit Scheme for Retiring Government Employees (1989) and Deposit Scheme for Retiring Employees of Public Sector Companies (1991). Apart from these schemes, there are also the contractual saving schemes, namely General Provident Fund (GPF), Employees Provident Fund (EPF), and Employees Pension System. All these schemes carry interest rates administered by the Central Government.

At present, the small saving schemes in operation include Post Office Savings Account, Post Office Recurring Deposits, Post Office Time Deposits, National Savings Certificate, Kisan Vikas Patra, Public Provident Fund, Deposit Schemes for Retiring Government Employees and Employees of Public Sector Undertakings. The maturity period of the small saving schemes, currently in operation, varies from a very short period (saving deposits) to over fifteen years (PPF). Certain schemes such as Post Office Savings Account, Post Office Recurring Deposits, Post Office Monthly Income Scheme, Post Office Time Deposits are similar to commercial bank deposit schemes. Schemes like National Savings Certificates and Kisan Vikas Patra have maturity of 6 to 7 years. For Public Provident Funds, the minimum initial maturity is 15 years while for National Savings Schemes it is 4 years. Interest rates on the small saving scheme are fixed by the Central Government from time to time. These were last revised on March 1, 2001. An attractive feature of small saving schemes is favourable tax treatment. While contributions to certain schemes carry tax concessions, returns on almost all schemes have some tax-exemptions (Table A).

Table A: Classification of Savings Schemes According to Tax Incentives Available

Schemes	Gross collections (Rs. crore) 1999-2000	Interest Rate (%)(w.e.f. March,2001)	Tax incentives by way of credit*	Tax Incentives on interest @
Post Office Savings Account	11,117	3.5	Nil	Under Section 10
Post Office Recurring Deposits (5 years)	8,422	9.0	Nil	Under Section 80L (1)(3)(i)
Post Office Monthly Income Scheme (6 Years)	11,960	9.5	Nil	Under Section 80L(1)(3)(i)
Post Office Time Deposits (1 Year)	1,192	7.5	Nil	Under Section 80L(1)(3)(i)
Post Office Time Deposits (2 Years)	273	8.0	Nil	Under Section 80L(1)(3)(i)

Post Office Time Deposits (3 Years)	122	9.0	Nil	Under Section 80L(1)(3)(i)
Post Office Time Deposits (5 Years)	1,232	9.0	Nil	Under Section 80L(1)(3)(i)
National Savings Scheme 1992 (4 Years)	68	9.0	Section 88 (2)(ix)	Under Section 80L(1)(3)(i)
National Savings Certificate VIII Issue (6 Years)	7,451	9.5	Section 88 (2)(x)	Under Section 80L and interest accrued annually can be deemed to be reinvested under Section 88
Kisan Vikas Patra (7.25 Years)	22,397	10.03	Nil	Nil but no TDS
Public Provident Fund (15 Years)	9,658	9.5	Section 88(2)(v)	Under Section 10(11)
Deposit Scheme for Retiring Employees (3 years)	107	8.5	Nil	Under Section 10(15)(iv)(i)
Relief Bonds (5-year)	2,250	8.5		Under section 10

* Tax rebate equal to 20 per cent (upto a ceiling of Rs.12,000) on deposits available under Section 88 and withdrawals completely
exempt under Section 10.
@ Tax deduction upto Rs.12,000 available under Section 80L.
Source: (1) Government of India, Note on " Small Savings Schemes – An Overview".
(2) Budget Documents, Government of India.

Three types of tax incentives are given on various small saving instruments: (i) the interest income earned from the instrument is exempt from income tax under Section 80L, (ii) withdrawals completely exempted from income tax under Section 10 and (iii) tax rebate at the rate of 20 per cent up to a ceiling under Section 88 of Income Tax Act (Table A). Savings under schemes like Post Office Savings Account, Post Office Recurring Deposits, Deposit Scheme for Retiring Employees, Post Office Monthly Income Scheme and Post Office Time Deposits qualify for only tax rebate on interest earnings while other schemes like National Savings Certificate and PPF enjoy tax rebate on investment and interest earnings. Kisan Vikas Patra (KVP) does not enjoy any tax incentives. However, KVP is exempt from tax deduction at source (TDS).

II. Need for Rationalisation of Small Saving Schemes

Over the years, small saving schemes have undergone some changes, particularly in terms of introduction of new schemes/ withdrawal or modification of existing ones and changes in tax rebates, maturity and interest rates. But the regulated character of the schemes has remained unchanged though the financial sector in general has witnessed very significant liberalisation and deregulation. As the small saving schemes constitute a major segment of the financial sector, particularly, in terms of mobilisation of savings, it is important to impart small saving schemes the necessary flexibility for a healthy growth of financial sector.

The distortionary effects of administered interest rates and tax incentives on small saving schemes have often raised policy issues in the context of higher interest costs, fiscal burden, and implications for private investment. Further, the inelastic interest rate structure of small savings has repercussion on financial markets as it provides rigidity to other interest rates in the economy[1]. The tax rebates are also a major source of variation in yield across financial assets, as the large tax concessions distort the pre-tax and post tax returns on financial savings. Relative inflexibility in interest rates on small savings pose problem in the complete integration of financial markets.

The Central government has effected reduction in interest rates on various small saving schemes in recent past, i.e., in January 1999 and subsequently in January 2000 and March 2001. The rationalisation of interest rates on small savings since 1999-2000, has led to some convergence between the commercial bank deposit rates, which are market determined, and the rates on small saving schemes.

The fiscal concessions extended to small savings add to the effective cost to Government. This is reflected in the high effective return to the savers due to tax concessions. The Advisory Group on Tax Policy and Tax Administration for the Tenth Plan has estimated rate of return with and without tax concessions on various saving schemes which are set out in Table B. The effective rate of return in certain cases is as high as over 24 per cent. For other schemes also, the effective rate of return to the depositors in the highest tax bracket is in the range of 17-19 per cent, which would otherwise be around 7 per cent.

Table B: Rates of Return for Selected Assets With and Without Tax Concessions

Asset	Holding period (years)	Relief u/s 10/80L/88	Types of return	Marginal income tax rate			
				0.0	10.0	22.0*	34.5
National Savings Certificate (VIII)	6	88,80L	A	11.5	17.47	20.16	24.01
			N	11.5	10.35	8.97	7.53
Public Provident Fund	15	88,80L	A	11.0	14.07	16.24	19.33
			N	11.0	9.9	8.58	7.21
Unit Linked Insurance Plan	15	88,80L	A	14.25	17.74	20.46	24.37
			N	14.25	12.83	11.12	9.33
Post Office Time Deposit Account	3	80L	A	11.0	12.22	14.1	16.79
			N	11.0	9.9	8.58	7.21
Post Office Time Deposit Account	5	80L	A	11.5	12.78	14.74	17.56
			N	11.5	10.35	8.97	7.53
Indira Vikas@ and Kisan Vikas Patra	5.5		A	13.43	13.43	13.43	13.43
			N	13.43	12.09	10.48	8.8
Financial Institutions Bonds	3		A	10.0	10.0	10.0	10.0
			N	10.0	9.0	7.8	6.55
Financial Institutions Bonds	5		A	11.0	11.0	11.0	11.0
			N	11.0	9.9	8.58	7.21

* Effective tax rate now stands revised downward following the withdrawal of surcharge announced in theUnion Budget 2001-02.
@ Indira Vikas Patra was discontinued. Note: A refers to actual, N refers to no concessions.
Source : Report of Advisory Group on Tax Policy and Tax Administration for the Tenth Plan, Government of India, May 2001.

The need for rationalising the schemes, thus, arises out of the multifarious rate structure and specific tax benefits and relatively inflexibility in interest rates which together have distortionary effect in the financial markets. The fiscal concessions provided on small savings also raise the effective cost of borrowing for the Government. The various Committees/ Groups, which have gone into the issues related with administered interest rate structure, observed that the tax concessions available to small saving schemes place the return on investment from these instruments above other alternative saving instruments. There is, therefore, a general consensus in the recommendations of these Committees for the rationalisation of the interest rate structure of small savings and removal of distortionary effects of tax incentives.

III. Measures for Rationalisation

The small saving schemes need rationalisation to provide flexibility in interest rate and suitable calibration of tax incentives so as to integrate these schemes with rest of the financial system. The schemes may continue to be operated as at present, however, the perceived tax advantages of the schemes need to be rationalised. The trends in small savings show large collections in eighties and nineties because of fiscal concessions. A few Committees have already addressed this issue and made recommendations. The Informal Study Group on Ways and Means of Reducing the Interest Burden in Central Government Budget in their report suggested gradual elimination of tax exemptions on small savings and harmonisation of tax treatment for all savings instruments. The Advisory Group on Tax Policy and Tax Administration (Chairmanship: Dr. Parthasarathi Shome) set up by the Planning Commission has also made similar recommendation for abolition of tax incentives under Sections 88, 80L and 10(15) of the Income Tax Act which are applicable to small saving schemes. The Group preferred that the tax concessions in the form of tax credit should be restricted to 10 per cent, being the minimum marginal rate of personal income tax. The rebate should be further subjected to a ceiling equal to ten percent of the maximum investment permissible under the respective provisions.

IV. Need for Long-term Saving Schemes

While there is a case for restructuring some of the small saving schemes, it is equally significant to retain some of the small saving schemes, which are relatively long term in character and are significant in terms of savings mobilisation. This is advocated on the grounds of stimulating domestic savings, regular resource flow to the Government and with a broader aspect of social security. These aspects are elaborated below.

(a) Savings Mobilisation

The Approach Paper to Tenth Five Year Plan (2002-07) has set 8 per cent growth in GDP during the Tenth Plan period which would require increase in the investment rate to 32.6 per cent of GDP from a level of 23.3 per cent in 1999-2000. This order of investment level requires significant improvement in the domestic savings rate to nearly 29.8 per cent of GDP, from 22.3 per cent in 1999-2000. The stability in small savings collection which constitutes

an important segment of household savings needs to be viewed in the context of above macroeconomic parameters envisaged to achieve higher growth trajectory over the medium term. Past trends indicate significant growth in small savings collection from Rs.792 crore in 1970-71 to Rs.18,920 crore in 1990-91 and Rs. 75,542 crore in 1999-2000. Among the small saving schemes, KVP is found to be the most popular scheme, accounting for 26 per cent of the outstanding deposits in 1990-91 and 39 per cent in 1999-2000, reflecting the investors' preference for medium to long-term saving schemes.

(b) Resources for Government

Resource mobilization through small savings has, of late, emerged as a major source of finance for the Government. The advantage of fund mobilisation through small savings is its medium to long-term maturity profile and as such it could be used to finance projects having long gestation period. The share of small savings in the financing of Centre's GFD increased from 20.4 per cent in 1990-91 to 29.1 per cent in 1998-99. With effect from 1999-2000, due to change in accounting, and also reduced share of Centre in net small savings (from 25 per cent to 20 per cent) the share of small savings in the financing of Centre's GFD has shown a decline. In the case of states, the contribution of small savings in financing GFD ranged between 28.6 per cent to 37.4 per cent between 1990-91 and 2000-01.

(c) Social Security Cover

In India, the social security cover provided through budget is not sufficient, though the Government provides the institutional setting for contractual savings schemes which also serve the purpose of social security. Contractual savings, which are made mainly to provide for old age adds to the social welfare and complement Government efforts in this direction. From this viewpoint, tax concessions may be advisable on contractual saving schemes like provident/pension funds, life insurance, etc., and other social security provisions. Thus, changes in the tax regime and regulatory prescriptions in the financial sector to promote contractual savings with favourable treatment to them and less favourable but *inter se* equal treatment to all non-contractual savings can be advocated[2] .

V. Proposed Menu of Small Saving Schemes

The restructuring process of the saving schemes could be addressed on a two pronged approach, which include a) saving schemes with short-term maturity, b) medium to long-term saving instruments.

(a) Saving schemes with short-term maturity

These schemes which presently include postal savings bank accounts and time deposits, can be retained for the purpose of providing avenues to the rural households for savings mobilisation. The tax treatment to income from such deposits can be the same as on the income from similar bank deposits. The rate of return on these schemes should be made more flexible than now and be kept at par with the commercial bank deposit rates of the same maturity.

(b) Long-term saving instruments

The saving instruments under this category can be of two type (i) saving instruments with tax

exemptions and (ii) instruments without tax benefits.

(i) Saving instruments with tax exemptions

This scheme can be akin to the contractual savings (viz., GPF, EPF, SDS[3] , insurance policies etc.) in terms of maturity and withdrawal. This implies that the schemes can be medium to long-term in nature and would have tax concessions[4] . The existing schemes like Public Provident Funds can be considered under this scheme.

The rate of return on these savings schemes/instruments can be linked to growth rate of GDP. It needs to be recognised that aggregate output growth, interest rate and public debt are linked with each other and need to be simultaneously considered. This is significant from the viewpoint of the long-term sustainability of fiscal policy.

(ii) Saving instruments without tax benefits

The other long-term saving schemes can be in the nature where the returns are taxable. These schemes can be operated mainly to facilitate long-term savings in the economy. In determining the rate of return on these schemes it should be kept in view that as these instruments are non-marketable and as such the market interest rate can not give a lead in fixing the interest rate. However, at the same time the interest rate structure on these instruments can not completely ignore the market element. These instruments can be of two types:

1. Non-Bearer instruments:

These taxable instruments would have a fixed maturity unlike the contractual saving schemes. The rate of return on these instruments can be linked to market interest rates. The instruments can be offered either at fixed rate or at floating rate of return. Instruments like Kisan Vikas Patra and Relief Bonds can be considered under this scheme.

2. Bearer instruments:

On these instruments also return can be taxable but should be lower than the return on the non-bearer instruments. This is on account of the fact that these instruments will have higher liquidity than the non-bearer instruments.

VI. Conclusion

The small saving schemes in force in India carry administered interest rates along with various type of tax incentives. The distortionary effects of administered interest rates and tax incentives on small saving schemes raise policy issues in the context of higher interest costs, fiscal burden, and implications for private investment. The relative inflexibility in interest rate structure on small savings has repercussion on financial markets as it provides rigidity to other interest rates in the economy. The various Committees/Groups have gone into the issues related with administrative interest rate structure and tax treatment of small savings. There is a general consensus in the recommendations of these Committees for the rationalisation of the interest rate structure and removal of distortionary effects of tax incentives of small savings.

The Central government has effected reductions in interest rates on various small saving schemes in January 1999 and subsequently in January 2000 and March 2001. However, the multifarious rate structure and specific tax benefits and their distortionary effects necessitate restructuring of the rate structure and rationalisation of the schemes.

This paper suggests that the saving schemes with short-term maturity which presently include postal savings accounts and time deposits, can be retained for the purpose of providing avenues to the rural households for savings mobilisation. The tax treatment to income from such deposits can be the same as on the income from similar bank deposits. The rate of return on these schemes should be made flexible and kept at par with the commercial bank deposit rates of the same maturity.

The long-term schemes can be of two types: (a) instruments with tax exemptions and (b) instruments without tax benefits. The long-term schemes which are mainly in the nature of contractual savings can be extended tax benefits. Instruments with tax exemptions can be akin to the contractual savings (viz., EPF, Insurance policies etc.) in terms of maturity and withdrawal. These schemes could serve the objectives of providing the social security cover to the investors. The existing schemes like Public Provident Fund can be considered under this scheme. The rate of return on these saving schemes/instruments can be linked to growth rate of GDP.

Instruments without tax benefits can be of two types: (i) Non-Bearer instruments and (ii) Bearer instruments. Non-bearer can have a fixed maturity unlike the contractual saving schemes. The rate of return on these instruments can be linked to market interest rates. The instruments can be offered either at fixed rate or at floating rate of return. Instruments like Kisan Vikas Patra can be considered under this scheme. Bearer instruments can be taxable and should be kept below the return offered on the non-bearer instruments. This is on account of the fact that these instruments will have higher liquidity than the non-bearer instruments.

Table 1: Gross Collections under Various Saving Schemes

(Rs.crore)

Schemes	1996-97	1997-1998	1998-99
Post Office Savings Account	7,963	10,343	10,597
Post Office Recurring Deposits	4,580	5,532	6,778
Post Office Monthly Income Scheme	2,318	4,775	7,867
Post Office Time Deposits (1 Year)	505	738	872
Post Office Time Deposits (2 Year)	96	137	173
Post Office Time Deposits (3 Year)	52	94	54
Post Office Time Deposits (5 Year)	519	664	848
National Savings Scheme 1992	101	85	73
National Savings Certificate VIII Issue	5,124	5,103	5,732
Kisan Vikas Patra	9,650	15,712	17,543
Public Provident Fund	4,634	5,617	7,221

Deposit Scheme for Retiring Employees	138	78	108
Relief Bonds (5-year)	1,071	-	6,214

Source: (1) Government of India, Note on " Small Savings Schemes – An Overview"
(2) Budget Documents, Government of India.

Annexure I
Special Deposit Scheme-1975

Special Deposit Scheme (SDS) was introduced on July 1, 1975 for a period of 10 years. The accretions in the SDS with the Central Government were made by non-Government Provident Funds, Superannuation and Gratuity Funds and surplus funds of Life Insurance Corporation, Employees' State Insurance Corporation, etc. The scheme was extended for 10 years from 1985 and by three years from 1995 and thereafter for 5 years till June 30, 2003. The scheme is operated through Public Sector Banks and RBI Offices. The amount is repayable in 5 equated yearly installments from the date of maturity. The interest rate offered on the scheme was 10 per cent per annum in the beginning, which was raised to 11 per cent on April 1, 1983, and to 12 per cent on April 1, 1986. The rate was reduced to 11 per cent on April 1, 2000 and further to 9.5 per cent on April 1, 2001. The interest income accruing from the deposits under the scheme is exempt from income tax.

Due to high interest rates and tax exemptions, the scheme has been quite attractive. However, on account of high cost of borrowing and repayment burden, the Government decided to gradually reduce the minimum investment prescriptions and phase out the scheme. The minimum investment prescription under the scheme for the non-Government PFs etc. was initially raised from not exceeding 20 per cent of the net accretions to 70 per cent in January 1993, subsequently reduced to 55 per cent in May 1994, 30 per cent in May 1995 and 20 per cent in September 1996. Since March 1997, no fresh deposits are allowed under the scheme except for interest received on the Special Deposits. The corpus of SDS is estimated to be around Rupees one lakh crore.

[1] Monetary and Credit Policy for the year 2001-02, Reserve Bank of India (April, 2001) observes that reduction in fiscal deficit coupled with lowering of interest rates on contractual savings would facilitate a move towards favourable interest rate regime.

[2] Y.V.Reddy (2001), "Pension System in India: A Central Banker's Perspective", Reserve Bank of India Bulletin, January.

[3] Details on the features of Special Deposits Scheme (SDS) are given in Annexure I.

[4] The Project OASIS Report (2000) also favoured retaining tax concessions on long term savings.