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EPW Commentary

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Small Savings Policy Circumventing Tax Sops

Inflation benchmarking of small savings and provident fund interest rates, which is a sound policy in and of itself, has the added advantage of lowering the interest paid when there is inflation and tax exemptions cannot be touched.

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The lull after the budget mela is an apt occasion to discuss small savings and provident fund rates, a critical item for the 'middle class'. This budget continues the policies of the preceding three years. Jaswant Singh has cut the Public Provident Fund rate more than expected, in sync with the drastic drop in market rates last year. But overall neither have the small savings and provident fund rates (henceforth called SSPF) been explicitly benchmarked to inflation, nor have tax exemptions on SSPF deposits been removed. These two main recommendations of the Reddy committee (October 2001) have not been implemented. The Kelkar committee (December 2002) had also forcefully recommended removal of SSPF and other exemptions, as did the Chelliah and Shome committees earlier. Yet once again this recommendation has not been accepted. Tax sops, like agricultural income, cannot be touched, unless perhaps a major crisis induces dramatic change.

Cost-effective policy recommendations on interest rates should be framed keeping these sops in mind. The terms of reference of the Reddy committee had explicitly asked it to choose between inflation versus market interest rate benchmarking for SSPF rates. In this specific regard, by advocating market benchmarking of interest rates, the Reddy committee chose the option that, in my opinion, is likely to lead to higher interest payments on (tax- exempt) SSPF debt over the next several years. The Kelkar committee, with a much wider domain of tax matters to tackle, did the best it could in the circumstances by endorsing the recommendations of the earlier committees.¹ The Kelkar committee's overall stance on how to proceed

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Unlike short-term interest rates which the RBI, like central banks in developed countries, nowadays sets, the setting of SSPF rates reflects both political pressures and social objectives. These schemes were originally devised to provide a safety net for contingencies and retirement income for small savers. But a large number of depositors have become a vested interest, with sufficient clout to keep these tax sops going, despite repeated recommendations to the contrary.

Even when there are no tax exemptions, there are compelling reasons to choose inflation benchmarking for SSPF rates. After all, these schemes exist in many countries, with inducements in varying degrees to provide for contingencies and retirement income, and should therefore be structured so as to be immune to excessive swings in interest rates. While these rates must be made to respond to long run fundamentals, since market rates can vary enormously, mechanical market benchmarking would defeat the very safety net purpose these schemes are meant to serve, as I argued in a memorandum to the Reddy committee [Moorthy 2001]. Suitable inflation benchmarking is likely to provide a relatively more stable source of income. As it stands, the benchmark 10-year G-Sec yield has fallen from 11.25 per cent in December 1999 to 6.08 per cent in December 2002. Such a drop can be described as excessive for small savers.

The case for inflation benchmarking is even stronger when tax sops cannot be removed, as I have also pointed out in my memo. This is because the benchmarking of SSPF rates to G-Sec yields, instead of to inflation, results in an unintentional extra interest payment by the government on these deposits. This outcome can be explained by a simple arithmetic example. This example assumes that there is no tax on interest income, whether paid on a regular or cumulative basis. Further, there is no tax rebate or deduction on the principal, at the time of investment or at maturity. Henceforth, the SSPF rate referred to when discussing this example pertains to a hypothetical tax-free fixed deposit offering the same rate as a G-Sec of the same maturity.² It does not correspond precisely to any specific small savings or provident fund scheme. By contrast, the actual benchmark Public Provident Fund scheme offers a rebate (20 per cent for many years, now lowered) up to the specified limit and carries a variable rate since the interest rate on the whole corpus can be reset every year.

Now consider a situation where SSPF deposits are tax exempt and the long run real rate of interest, determined by economic fundamentals, is, say, 3 per cent. The flat

(average and marginal) tax rate is one-third and so the after-tax real return to depositors is 2 per cent. Economic theory suggests that when there is inflation, the market determined (G-Sec) rate will rise by more than inflation in order to provide savers with the same after-tax real rate of return. This is the after-tax Fisher effect highlighted by Darby (1975): there is neither money nor tax illusion in the determination of market interest rates.³

Starting with no inflation, the G-Sec rate is 3 per cent and the after-tax return is 2 per cent (column B of the table). Now if inflation is 6 per cent, when there are no taxes, the G-Sec rate will rise to just 9 per cent (column C). But when interest income is taxed, the G-Sec rate has to rise to 12 per cent to provide the 2 per cent real return (column D).

The table shows what benchmarking of SSPF rates to G-Sec yields inadvertently does when the latter is taxable but the former is not, as at present. If there were no inflation, all is well. The government pays 3 per cent gross and 2 per cent net on G-Secs, and 3 per cent flat on SSPF deposits since social objectives and/or political constraints require that the latter be tax exempt. The 1 percentage point loss of tax revenue reflects a conscious policy choice or political compulsion, as the case may be. But with 6 per cent inflation, the G-Sec rate rises to 12 per cent. While the after-tax return on G-Secs stays the same, the effective return on SSPF deposits rises by 300 basis points. This can be seen by comparing columns A and E. Under G-Sec benchmarking, the nominal yield on PPF deposits is 12 per cent, as against 9 per cent (3 per cent + 6 per cent) under direct inflation benchmarking of SSPF deposits.

The numbers chosen here are for expositional simplicity and do overstate the cost of market benchmarking. But even with 4 per cent inflation which can be taken as the lower bound of India's long run average inflation under current (RBI) policies⁴ and the same one-third tax rate, the inflation bonus to SSPF deposits is 2 percentage points. With the existing corpus of SSPF deposits of Rs 187,510 crore in fiscal year end 2001 (RBI, *Handbook of Statistics on Indian Economy*, 2001, Table 111), a 2 percentage point bonus leads to a loss of Rs 3,750 crore revenue.. The losses to the government extend beyond SSPF deposits since Relief Bonds and various other tax-exempt bonds are being indexed to G-Secs of the same maturity.⁵

Since G-Secs are held mostly by banks and financial institutions (FIs) and the corporate income tax rate is 35 per cent, as a first approximation, the one-third tax rate is a reasonable estimate. As of March 2001, the distribution of the holding of central government securities was as follows: RBI 8.3 per cent, banks 60.7 per cent, LIC 18.4 per cent, UTI 0.17 per cent, NABARD 0.33 per cent,

Employees Provident Fund 1.6 per cent, and Others 10.5 per cent. This miscellaneous 'Others' category comprises retail individual investors and some financial institutions. (RBI, *Handbook of Statistics on the Indian Economy*, 2001, Table 111).

Since retail investors do not hold most of the bonds, the different personal income tax rates faced by them need not be taken into account. A more in-depth analysis would treat the banks as mere intermediaries (since both interest income and interest expense on bank deposits are tax deductible for banks), and then try to estimate the average tax rate on interest income from these bank deposits, taking into account Section 80L, other exemptions and the extent of evasion. A more sophisticated treatment would compute the average marginal tax rate, as in Barro and Sahaskul (1983), since this is the tax rate that should matter for the after-tax rate of return on savings. However, such computations may not be feasible, given the available data, nor particularly useful.

In all fairness to the Reddy committee, it advocated the joint adoption of (i) G-Sec benchmarking and (ii) removing tax exemptions on SSPF deposits. But pragmatic and prescient policy entails making conditional recommendations. When recommending (i) and (ii) together, the Reddy committee should also have specified whether it was desirable to adopt (i) piecemeal in case and (ii) did not go through. In this regard, the Kelkar committee was more prescient. It concluded by clearly stating that "The Task Force would like to place on record that the various recommendations relating to income tax in this report are interwoven and therefore indivisible. The recommendations must be seen as a package and piecemeal recommendation must be avoided at all cost" (p 113). One may not agree with Kelkar that piecemeal recommendation should be avoided at all cost. Further, one can make alternative recommendations whenever joint implementation is not possible. Nevertheless, the Kelkar committee should be commended for drawing attention to the dangers of piecemeal recommendation.

The above theoretical example shows that inflation benchmarking would lower interest payments compared to G-Sec benchmarking. It does not correspond to the current Indian scenario: since market rates have dropped so sharply, for the last two years G-Sec benchmarking is most likely to have yielded a lower SSPF rate(s), for a wide range of inflation formulae. The data needs to be evaluated by comparing interest rates based on various gilt and inflation benchmarks over the last few years to confirm this conclusion. However, the current drop in gilt yields reflects the weakness in the world and Indian economy, over and above the drop in inflation. Current gilt yields in India

hardly correspond to a long run equilibrium in which the economy grows at potential and the real interest rate cannot be affected by monetary policy. The example used here corresponds to such a long run equilibrium and is indicative of the extra interest burden over a suitably long horizon.

In short, inflation benchmarking, which is a sound policy in and of itself, has the added advantage of lowering the interest paid when there are tax exemptions and inflation. To modify Deng Xiao Ping's famous statement, one should use a white cat to catch black mice.

Table: Impact of Taxes on Market Determined Interest Rates

| | A* | B | C | D | E* |
|-----------------------------------|----|-----|-----|-----|----|
| Tax rate | 0 | 1/3 | 1/3 | 1/3 | 0 |
| Inflation (per cent) | 0 | 0 | 6 | 6 | 6 |
| Nominal interest rate (per cent) | 3 | 3 | 9 | 12 | 12 |
| After-tax nominal rate (per cent) | 3 | 2 | 6 | 8 | 12 |
| After-tax real rate (per cent) | 3 | 2 | 0 | 2 | 6 |

Notes

1 "Given their sensible and comprehensive treatment of tax exemptions relating to savings, this Committee is of the view that the best way to proceed is a judicious adoption of the best recommendations culled from these Reports, with only some slight modifications designed to enhance consistency and ease of implementation, rather than an elaborate 'reinvention of the wheel' as it were (Kelkar Committee Report, p 92).

2 Analysis of this issue should eschew the word sop or concession and instead specify the exact tax treatment (ETT, to coin an acronym!) of the deposit in question, since tax sops cover the entire gamut of rebates, deductions and exemptions on principal and/or interest, at source or at maturity.

3 Individuals can have a substantial degree of tax illusion in identifying their tax burden, as evident in the resistance to taxes that impinge directly on individuals, e.g., income taxes and retail taxes. While the Kelkar committee recommendations on indirect taxes were largely accepted, those on direct taxes were not. Corporate taxes and excise taxes are easier to levy since individuals do not directly perceive the tax burden and cannot easily identify its incidence. Such tax illusion can prevail along with a sophisticated financial market that incorporates taxes and inflation into its pricing so as to ensure an adequate real return to savers.

4 The RBI's *Report on Currency and Finance* (2000-01) discusses the conclusions of several empirical studies and concludes that 5-6 per cent inflation is optimal (ch V 7). It is outside the domain of this article to discuss whether there is a growth maximising inflation rate, a view that requires careful scrutiny. However, for the purposes of this discussion, it should be pointed out that it is not feasible (nor desirable) to index the entire Indian tax code for inflation. Hence, lack of such indexation creates tax distortions whose adverse effects rise with the inflation rate and which are substantial, even at 5-6 per cent inflation. Even a fully anticipated inflation of the textbooks leads to 'unanticipated' consequences, such as discussed here. The distortions resulting from not indexing long-term capital gains to inflation are enormous.

5 Shortly after the budget, the revenue secretary announced that UTI's tax-free 5-year bond would be pegged at 25 basis points above the 5-year G-Sec to yield 6.75 per cent, equivalent to above 10 per cent for those in the 33 per cent bracket.

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