Need for Long-term, Fixed-Income Provident Fund Deposits

While it is necessary to align returns on small savings with other interest rates in the economy, a simplistic focus on lowering savings rates overlooks fundamental weaknesses in provident fund schemes. The option of long-term, fixed-income PF deposits, which are necessary for small investors planning for retirement, is not available.

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The reductions in the interest rates on the Public Provident Fund (PPF) and associated schemes (in particular, the Employees Provident Fund) since 2000 have been heartily welcomed by most economic analysts over the years. After all, interest rates on these deposits need to be aligned with other interest rates in the economy that, until this year, have been falling for several years. Not doing so would fiscally weaken the government of India, and bankrupt the Employee Provident Fund Organisation (EPFO) in which deposits of workers have been placed. From this realistic market-oriented perspective, the ability of the finance minister to push through a reduction in the Employee Provident Fund (EPF) rate from 9.5 per cent to 8.5 per cent in August 2004, despite the opposition from its Left coalition members, is long overdue and welcome.

This author shares the market perspective regarding the needed, continuing alignment of relevant small savings (SS) and provident fund (PF) rates to avoid fiscal bankruptcy.[1] But a simplistic focus only on lowering rates obscures a fundamental weakness in the PF schemes which needs to be highlighted. One can strongly insist that PF rates should be determined by economic fundamentals, and that depositors cannot be arbitrarily given ‘adequate’ and ‘fair’ (euphemisms for high) returns. Nevertheless one can be critical of the manner in which interest rates and payments on these PF deposits, and more so, compulsory EPF deposits have been made, and are still being made. Such a criticism, and the rationale for fixed rate PF deposits is outlined below.

Our Peculiar 15-year Floating Rate Deposit

The world over, retirement schemes are structured to provide fixed income so that for the term of any given deposit, the interest rate does not change. In addition, there may be a floating rate, a combination of fixed and floating rates, and equity linked deposits. Nevertheless fixed rate deposits are the bedrock upon which retirement saving schemes are generally founded. It is primarily through fixed rate schemes and annuities that depositors are able to (i) ensure stable interest income to meet expenses during retirement or (ii) build up a certain accumulated amount (principal plus interest) and thus adequately plan for retirement, based on steady compounding.[2] However, various PF deposits – meant to be the primary source of retirement income in India – are not fixed rate deposits. The interest rate is periodically reset, by the government. But this was not generally known, until the PPF rate was lowered from 2000 onwards, following a long period from 1989 to 2000, during which the PPF scheme paid 12 per cent interest.

Misperceptions about the PPF scheme have been widespread not just among lay people, but even among the financially knowledgeable. To cite a well known personal finance expert, who has explained how PPF deposits, after five years, can be fully ‘recycled’ solely for tax benefits, “This is an annuity of a term of 15 years, requiring 16 contributions” [Shanbhag 1996:137]. Subsequent break-even calculations by this author comparing the pay-off on PPF, versus the fixed rate National Saving Certificate indicate that he is assuming the PPF pays a fixed rate. Another eminent financial management author and personal finance writer states, “PPF deposits earn a compound rate of interest of 12 per cent pa [Chandra 1997:115], instead of stating that PPF deposits earn compound interest, currently at 12 per cent pa.

Even after the PPF rate was lowered, many depositors, based on my casual enquiries, continue to think that the scheme pays a lower interest rate on new balances, but 12 per cent on balances invested prior to 2000. In the *RBI Handbook of Statistics on the Indian Economy* (2004), in Table 124, titled ‘Small Savings Schemes in Force’, the way the information is presented does nothing to dispel the view that PPF is a fixed rate instrument. For 10 instruments, Table 124 lists the prevailing interest rate, the term of deposit, tax status and other features, but does not specify which are fixed and which are floating. Of these, only the post office savings bank account and the PPF pay floating rates (see the table, last row added by author).

The modifed table presented here adds relief bonds and other PF deposits to RBI's Table 124 and drops some instruments (those under Rs 1,000 crore). For PPF, the outstanding amount reported is a small amount (Rs 10,132 crore), only 2.5 per cent of the total reported small savings. However, this figure consists only of PPF deposits with post offices, whereas the bulk of PPF deposits is made with banks. A crude guesstimate of the amount outstanding in PPF deposits with banks would put it in the vicinity of Rs 50,000 crore.[3]

The corpus of EPFO investments and state PF schemes is large, as can be seen in the last two columns of the table (there are other PF schemes not included here, some of which are large, such as the General Provident Fund). More crucial, the PF schemes tend to have a large number of small depositors. With about 39.5 million subscribers and a corpus of Rs 71,838 crore as of March 2004, the average outstanding EPF balance was about Rs 18,200 crore. Combining all the EPFO investments, the average balance was about Rs 32,400 crore.[4] Indeed, most of those in medium-term (five years) fixed rate small savings schemes tend to be relatively high net worth individuals, while those in the longer-term floating rate EPF and similar schemes are relatively small savers, who have borne the brunt of administered interest rate cuts since 2000.

Recent Committee Recommendations

Several committees in recent years (R V Gupta Committee 1999, Y V Reddy Committee 2001 and Rakesh Mohan Committee 2004) have all advocated market benchmarking of SS and PF rates. The presentation of a wide range of relevant data and analysis of various policy issues and choices in both the Reddy committee report [RBI 2001] and the recently released Rakesh Mohan report [RBI 2004] is wide-ranging and very thorough. Nevertheless the policy recommendations of the Reddy and Rakesh Mohan committees can be questioned in one dimension. Although they have recommended giving investors the option of choosing a fixed or floating rate at the time of entry for medium-term small savings deposits (five to seven years), for the critical PPF scheme the Reddy committee recommended continuing with the prevailing floating rate and tax exemptions.[5] The Rakesh Mohan committee has suggested a smoothening of the market benchmarking rate formula of the Reddy committee but otherwise continues with the floating rate and tax exemptions, pending the development of a social security system.[6]

The *Old Age Social and Income Security Report* (OASISR) (2000) had made a far-reaching recommendation to introduce individual retirement accounts, with the option of investing in debt or equity schemes, using professional fund managers, convertible into annuities at retirement age. But in the section 'Reforms to Existing Provisions', the OASISR had recommended: pending the development of an annuities market, replacing the existing PPF scheme (PPF-1) with its suggested scheme PPF-2 for fresh contributions and delinking it from small savings. The proposed PPF-2 would function like a typical professionally managed, fully funded retirement account in which the rate of return "should be driven purely by the investment return obtained by fund managers" (p 41). However, a fund manager determined return by itself does not provide a scope for stable income for retirees, unlike long-term fixed rate PF and other small savings deposits.

The nature of the PPF scheme is critical since it is used as the benchmark for setting interest rates on other schemes, most notably the EPF scheme. The EPF has been facing a solvency problem, as is well known. New deposits into it earn about 6 per cent being invested in G-Secs, while interest to depositors has been accruing at the stipulated 9.5 per cent in the last two years. Hence the cut in the EPF rate to 8.5 per cent, announced in early August, has met with a favourable response from the financial press, just as the previous PPF and subsequent EPF rate cuts have over the years ('Provident Cut', editorial, *Business Standard*, August 11, 2004].

Opposition to the rate cuts have come mainly from unions. The secretary of the Centre of Indian Trade Unions recently wrote,

> By seeking a higher rate of interest on EPF, the trade unions are not asking for any undue reward or favour; they only seek from the government an adequate rate of return to the members of the salaried class for the compulsory impounding of their hard earned savings [Vardarajan 2004].

However, a few market-oriented analysts have been in sync with unions on this issue. Two seasoned commentators Bhusnurmath (2001) and Tarapore (2003, 2004), while favouring market benchmarking in principle, have taken the position that these rate cuts have hurt small savers who depend on them for retirement income. These concerns and criticisms are valid, especially for EPF depositors, despite the generous withdrawal rules and tax exemptions, for two reasons (i) EPF deposits are compulsorily withheld, implying a greater obligation on the government to pay a 'fair' return compared to voluntary PPF deposits (ii) most salaried workers who have low incomes and put

Table: Administered Interest Rate Schemes in Force

(Amounts outstanding in Rs crore)

Scheme	PO Savings Deposit	PO Time Deposit	PO Recurring Deposit	PO Monthly Income Scheme	National Savings Certificate (NSO) VIII	Indira Vikas Patra (IVP)	Kisan Vikas Patra (KVP)	Relief Bonds*	PPF	EPF	State PFs
Amount outstanding	11,545	15,440	28,084	80,915	44,524	6009	1,13,658	57,258	10,132	71,838	112,938
Rate of interest (per cent)	3.5	6.25-7.5	7.5	8	8	See RBI Table	8.41	6-10	8	9.5	8
Maturity period	Ongoing	1-5 yrs	5 yrs	6 yrs	6 yrs	6 yrs	6 -8yr 7mo	Varying	15 yrs	–	–
Fix/float	Floating	Fixed	Fixed	Fixed	Fixed	Fixed	Fixed	Fixed	Floating	Floating	Floating

Notes: (1) Interest rates as of March 1, 2003 and amount outstandings as of end March 2003 for small savings.
(2) EPF outstanding as of March 2004. Total EPFO investment outstanding is Rs 1,28,036 crore.
(3) Information on tax status of principal and interest, TDS and withdrawal rules available from original sources.
(4) Only small saving schemes with amount outstanding in excess of Rs 1,000 crore have been included in this table.

Sources: *RBI Handbook of Statistics on Indian Economy, 2003-04*, Table 124, modified and expanded version; Relief Bonds data from RBI, 'Report on Government Transactions Relating to Individuals', May 28, 2004, www.rbl.org.in; Data on state provident funds from RBI, *Handbook of State Government Finances, 2003-04*.

small amounts into the EPF do not benefit adequately, if at all, from tax exemptions.[7]

Need for Fixed Rate PF Deposits

However, neither the unions nor other critics of the interest rate cuts have criticised the government for the fundamental lacuna in the PF schemes: (a) the lack of clear information that the PPF is a floating rate scheme[8] and (b) the lack of the option of long-term fixed rate PF deposits. Rollover risk will exist, but for the length of the deposit, interest rates can be guaranteed. Merely railing against interest rate cuts obscures both the underlying problem and potential solutions. The small saver lacks the option at present, barring payouts from some LIC schemes, to invest in a long-term (10 years or more) fixed rate deposit. The long-term retail bond market caters almost entirely to financial institutions and high net worth individuals.

I had argued along these lines in my recommendations to the Reddy committee. While much of my article was geared to discussing inflation versus market rate benchmarking of the PPF rate, I did stress the need for fixed rate PPF deposits.[9] That recommendation needs to be fine tuned by adding that PPF depositors be given the option of (i) fixed or floating rates, instead of it being imposed upon them (ii) periodic payment of interest, instead of only at maturity, after a certain age of depositor and/or during rollover of the deposit after a certain period (e g, 15 years), to meet ongoing expenses. Nevertheless, its relevant details are worth citing,

> It is not fair to depositors to pay an interest rate subject to discretionary change on a largely illiquid (allowing for hardship withdrawals) deposit…The popularity of these variable rate schemes is probably due to their tax benefits…Under proviso (3) the formula based R(SSPF) should be locked in every year for new deposits…The administration of these schemes may need immediate revamping so that different interest rates on different deposits from different years can be paid...If it is not possible to implement proviso (3) immediately because the accounting and record keeping is not administratively feasible, the GoI should focus its efforts on revamping the administration of these schemes on an emergency basis so that it can be implemented as soon as possible [Moorthy 2001:3944].

In this context, Datar (2001) raised several objections to my article, some of which were valid, and warranted a reply.[10]

In short, the finance ministry should be moving in the direction of providing easily available long-term fixed rate deposits for small savers and retirees, with interest payable regularly or at maturity. Instead, its decision to introduce the 9 per cent Dada-Dadi bond creates an opportunity for those below the stipulated age floor to avail of such high returns by putting money in others names. Compensating for rate reductions by offering special high rate schemes and continuing with lucrative tax exemptions and/or rebates schemes will result in a continuing drain on the exchequer. EPW

Notes

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1 Ahluwalia (1999), Bhalla (1999) and others, including this author, had been suggesting PF rate cuts.

2 If the deposits are not indexed to inflation, they offer stable nominal interest income. As long as interest rates on these deposits correctly incorporate, on average, inflation expectations, real income is also protected.

3 The Rakesh Mohan report (reprinted as supplement to *RBI Bullettin*, August 2004) provides data on deposits, withdrawals and net deposits annually since 1990-91 in Annex 11. Adding the net deposits yields a cumulative Rs 9,677 for PO PPF deposits, close to the total reported outstanding of Rs 10,132 crore in Table 124. If roughly the same is held in PPF deposits with banks, adding the net deposits yields a cumulative amount of Rs 46,865 crore.

4 The total corpus of EPFO investments of Rs 1,28,036 crore comprises of EPF (Rs 71,838 crore) Employee Pension Scheme (Rs 52,293 crore) and the Employee Deposit-Linked Insurance Scheme (Rs 3,904 crore).

5 "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 these 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 investments in PPF would be on a floating rate basis (Part I, Section VI.2)". One might have thought this option should be given to long-term investors as well since risk averse investors may prefer fixed rates at longer horizons as well.

6 "The Committee, therefore, deliberated on the rationalisation of these schemes where investments are primarily motivated to obtain the benefits of Section 88 and Section 10 of the Income Tax Act. However, as the PPF is a longer-term savings scheme providing old age security, among others, to the unorganised sector workers, the committee considered it would be desirable to continue the scheme in its present form for some time" (p 18).

7 For a good exposition of the union view advocating a general subsidy to enable the EPFO to pay existing rates, along with useful data providing a breakdown of EPFO deposits by size, see Sridhar (2004).

8 The PPF Act (1968) states, "All subscriptions made under Section 4 shall bear interest at such rates as may be notified by the central government in the official gazette from time to time, and the interest shall be calculated in such manner as may be specified in the scheme (p 2)". But it does not state whether the rate is fixed or floating.

9 Tarapore's position is more consistent and closer to that taken here. He points out, "Investors put their funds in PFs over a long period of time and to be paid interest on the outstanding balance the current rate on government securities is patently unfair. (2003)". He suggests that the PF rate be linked to a 10-year moving average of the G-sec yield. Then he also states that a more equitable approach would be to "use a weighted average wherein weights are assigned to each year's principal and interest". However, he does not advocate the simpler solution of providing the option of a fixed rate to depositors.

10 First, Datar (2001) states, "It defies logic to call SS and PF rates as non-market. The difference between government borrowing through SS and PF and other sources is not market and non-market but between wholesale and retail markets" (p 4450). His wholesale-retail classificiation is valid, but I have used the term market and non-market, as in RBI parlance, to classify borrowing at the market rate (mostly the consolidated fund) versus borrowing at the administered rate (mostly the public accounts).
Second, regarding the tax exempt status of certain small savings schemes, he points to a factual inaccuracy in my paper. But as he himself pointed out, with non-applicability of TDS, these schemes become effectively tax free. Third, my recommended formula for a real rate does not have a term premium for longer deposits, as he points out. In trying to cover broad conceptual ground pertaining to the macroeconomics of interest rates, I lumped small savings and provident fund into one broad category SSPF, ignoring term premium and other differences in deposits. Fourth, I had made a conditional recommendation of making SSPF and other interest paying deposits tax free, along with removing all rebates, to avoid distortions in the financial system, partly arising from the joint impact of inflation and taxes on interest income (the after-tax Fisher effect). "...while any flat rate (i e, on all deposits) will avoid the complications... the only rate that ensures this easily is zero [2001:3944]". Whether jointly removing all rebates and making interest income tax free (a Faustian bargain) is revenue positive or negative, I did not attempt to ascertain. To recommend exempting interest income from taxes is not only unfair to salary income, as I had pointed out, but, in retrospect, also myopic. As computerisation brings more people into the tax net, the goal should be to reduce distortions by taxing all interest income with reasonable uniformity, not exempting it all.

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