Small Savings

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

2.20 The Central Government has 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 partially financing the fiscal deficit of both Centre and States. The outstanding amount under small savings collection constitutes the liabilities of the Central Government. The net collections in small savings schemes and Public Provident Fund were being shared with the States in the form of long term loans for financing the State Plan. This sharing arrangement was put in place to encourage the States to join the Centre in a cooperative effort in mobilising savings. The share of States in the net collections has been increased over the years. Prior to April 1, 1987, two-thirds of the net collections in a State were

TABLE 2.4

Trends in Small Savings

Year	Gross Collections		Repayments (Rs. crore)	Net		(4) as per cent of (2)	Transfer to States/UTs
	Rs. crore	As per cent of GDP		Rs. crore	As per cent of GDP		
1	2	3	4	5	6	7	8
1990-91	18920	3.3	9816	9104	1.6	51.9	7026
1995-96	36679	3.1	23930	12749	1.1	65.2	9990
1996-97	38111	2.8	22865	15246	1.1	60.0	10671
1997-98	51889	3.4	27486	24403	1.6	53.0	15732
1998-99	62157	3.6	29113	33044	1.9	46.8	23788
1999-2000	75542	3.9	36889	38653	2.0	48.8	26937
2000-01 (P)	88648	4.2	43291	45357	2.2	48.8	33265
2001-02(BE)	93750	4.1	46550	47200	2.1	49.7	36000

P - Provisional

passed on as long term loans to that State. The share of States was increased to three-fourths from April 1, 1987 and enhanced further to four-fifths of the net collections from April 1, 2000. On similar terms, loans were also released to Union Territory Governments (with legislatures) since April 1, 1994.

2.21 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). 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 special securities of Central and State Government according to the norms decided by the Central Government from time to time. The debt servicing of these government securities is an income of the Fund, while the expenditure of the Fund comprises the interest payments to the subscribers of the small savings schemes and cost of management of small savings. 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 Central Government.

2.22 Following the change in accounting practice, the outstanding amount of balances under small savings amounting to Rs.1,76,221 crore at end-March 1999 was converted into NSSF's investment in Central Government securities and is treated as a part of the internal debt of the Central Government. The amount outstanding is treated as the internal liability of the Centre. A considerable share of this amount is attributed to the States' liabilities to the Centre due for repayment over a much longer horizon. According to 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.1,04,016 crore. Once this portion is netted out from the total outstanding of small savings at Rs.1,76,221 crore, the balance of Rs.72,205 crore amounts to actual and direct liability of the Central Government.

2.23 In recent years, resource mobilisation through small savings has 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 in 1990-91 to 20.0 per cent in 2000-01. 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 the GFD was between 28.6 per cent and 37.4 per cent during 1990-91 to 2000-01, and three to four Sates accounted for a larger share.

2.24 With the rationalisation of interest rates on various small savings schemes since January 1,1999 the rates of interest on the amounts transferred to various State/UTs Governments "against net small savings collections" were reduced concomitantly. Due to falling inflation, the interest rate has been successively reduced from 14.5 per cent to 14.0 percent from January 4, 1999, 13.5 percent from April 1,1999, 12.5 per cent from April 1, 2000 and to 11.0 per cent from April 1, 2001. The adjustment in the interest rates on various small savings schemes and PPF was necessary so as to align them with the overall interest rate structure in the economy. However, the adjustment of these administered interest rates has not been commensurate with the greater fall in inflation. Hence, the real interest rates continue to rule high. Small savings rates determine the benchmark in the retail section of the debt market as they offer a risk free avenue with tax incentives. Higher yields compared to zero risk on these instruments attract the investors away from other non-Government

BOX 2.2

Main Recommendations in the Report of the Expert Committee to Review the System of Administered Interest Rates and other Related Issues pertaining to the transfer of the net proceeds of Small Savings

An Expert Committee constituted by the Ministry of Finance under the Chairmanship of Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India to Review the System of Administered Interest Rates and other Related Issues (henceforth referred to as Committee) found the transfer of the entire net proceeds of small savings to States on a "back-to-back basis"feasible within the existing accounting arrangement. However, the Committee recognised 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. 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. 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 come 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 Expert Committee has suggested new arrangement for transfer of the entire net proceeds of small savings to States with the following features:

(a) 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.

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

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

(d) 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.

(e) 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.

(f) 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.

(g) 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.

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

borrowers, leading the latter to offer higher rates while inviting deposits. In turn, the high deposit rates set the floor for the higher lending rates. A high yield on small savings schemes has therefore been one of the principal reasons leading to high real interest rate in the economy. Given the huge size of the public debt and other liabilities (including small saving schemes) of the Centre and those of the States, the high interest rates and interest payments continue to strain public finances severely.

2.25 The proposed scheme of transferring the entire net small savings collections to States on a back-to-back basis concurrently will need to address 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 investors of as much as Rs.36,889 crore (about 49 per cent) were made. The net amount of Rs.38,653 crore was distributed between the 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.

2.26 Regulation of interest rates in the contractual saving sphere i.e. small savings and Provident Fund has not only created distortions in the interest rate structure but has also adversely affected the allocative efficiency of resources. Administered interest rates have come in the way of integration of domestic financial markets and have resulted in the market segmentation. Besides, there is a policy dilemma with regard to maximisation of receipts through small saving schemes and minimisation of debt servicing burden to the Central and State Governments. Interest rates provided on contractual saving in real terms have ruled high in recent years. The incidence of high real interest rates have entailed unsustainable burden on both Central and State Governments. With a view to address these concerns the Finance Minister in his Budget Speech for 2001-2002 announced the setting up of an Expert Committee to provide recommendations on these issues. The Main Recommendations of the Report of the Expert Committee to Review the System of Administered Interest Rates and other Related Issues pertaining to the transfer of the net proceeds of Small Savings is given in Box 2.2.