Syllabus subtopic: Government Budgeting.

Prelims and Mains focus: about the exemptions in this year’s budget and its impact on savings and deficit

News: Getting rid of exemptions under a new tax regime proposed by the budget could make small savings less attractive for individuals and dry up this source of funds for the government.

How do exemptions apply to small savings?

- Small savings schemes are savings instruments such as the Public Provident Fund, National Savings Certificate and Sukanya Samriddhi. These are central government schemes that allow depositors tax exemption on such deposits up to a particular amount in a fiscal.

- The deposits received under these schemes are held with the National Small Savings Fund (NSSF). The Centre offers an attractive tax-free rate of return on these instruments for depositors. Many depositors hold their deposits in a combination of a conventional savings account and small savings schemes to save taxes to get a higher return on deposits.

How are the rates of interest determined?

- The central government fixes the interest rates on small savings schemes. A committee led by former Reserve Bank of India (RBI) deputy governor Shyamala Gopinath has recommended that interest rates of various schemes be 25-100 basis points more than the yields of government bonds of similar maturity.

- A high-level advisory group, however, argued for the need to link the small savings rate with RBI’s repo rate to allow rates to come to market level and not be kept artificially elevated. The government continues to have some
flexibility in determining the interest rate of these schemes.

Okay, but how does the government utilize NSSF?

The government uses NSSF as a source of funds for some of its investments through the National Highways Authority of India (NHAI) bonds and also to finance part of its deficit through government securities. NSSF buys these securities and collects the interest on them. Without exemptions in the new tax regime, this steady source of funds may not be available to the government.

How do small savings impact deficits?

Economists has said how state governments till 2003 could borrow from people in the form of postal savings. The rates on postal savings were above the average interest rates and there was no limit on borrowings for the states. The high interest rate led to a 15.2% growth in small savings rates per annum from 1995-2003 compared to 11% nominal growth. This coincided with high state deficits as there was no fiscal discipline and state governments could borrow as much as they wanted through postal savings.

Will a new tax regime bring fiscal discipline?

The removal of exemptions will have implications for the quality of our fiscal statistics. The magnitude of the impact in the short run would depend on how many people switch to the new tax regime. As more people move to the new regime, the Centre will find limited funds in NSSF, which it could earlier tap to finance its deficit or utilize it for off-budget borrowing. Removing exemptions will bring in self-discipline in the way the Centre uses public money.