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Fiscal Deficit and National Small Savings Fund

Central Government of India announced on 29-Sep-11 that it will raise extra borrowings worth Rs. 52,800 cr in second half (H2) of 2011-12. The total borrowing for 2011-12 was pegged at Rs 4.17 lac crore and the government raised Rs. 2.5 lac cr in H1 2011-12. As per budget, the Government was scheduled to raise Rs 1.67 lac core in H2 2011-12 but with extra borrowing is scheduled to raise 2.2 lac crore in H2 2011-12.

Economic Affairs Secretary Mr. R. Gopalan explained that the higher borrowing was on account of decline in tax revenues and small savings schemes. The small savings investments have declined because of higher bank deposit rates leading to shortfall in revenues. He also said that the shortfalls in disinvestment and higher subsidies have been taken into account and the extra borrowing was unlikely to crowd the private sector investment.

This reasoning for extra borrowing led to some confusion in the markets over the role of small savings in fiscal deficit and its overall flow. This paper is an attempt to understand the small savings scheme as a source of centre and state governments' fiscal deficits.

I. NSSF and Fiscal Deficits – A background

Government of India had initiated savings schemes promising fixed rate of interest to push financial inclusion and giving people an avenue to save for their future needs. The schemes are made available to public via post offices, branches of the public sector banks & select private sector banks and small savings agents. The government provides tax benefits on these savings to make them lucrative for investors, thereby encouraging investment in these schemes.

The recent Committee on Comprehensive Review of National Small Savings Fund chaired by Ms. Shyamala Gopinath (former Deputy Governor of RBI) classified these schemes into three broad types:

- Postal deposits - Savings account, recurring deposits, time deposits of varying maturities and monthly income scheme (MIS)
- Savings certificates - National Small Savings Certificate VIII (NSC) and Kisan Vikas Patra (KVP)
- Social security schemes (Public provident fund (PPF) and Senior Citizens' Savings Scheme (SCSS).

As per the report, two most popular instruments are MIS and KVP together accounting for nearly a half of the total outstandings of Rs 7,28,447 cr at end- March 2010 . The social security schemes (PPF and SCSS) and Postal deposits form 25% each of the total amount outstanding.

These savings were earlier accounted under the Public Account of the Central Government and Centre shared the resources with State governments. Prior to April 1999, deposits and withdrawals by subscribers were made from the public account and interest payments to subscribers and interest receipts from the States were recorded in the revenue account of the Consolidated Fund of India. Disbursement of loans against small savings made to the States and repayment of such loans were recorded in the capital account of the Consolidated Fund of India. All the payments against the cost of operating the fund were also debited from the Consolidated Fund.

Following recommendations from RV Gupta Committee, the receipts from these savings were shifted to a separate fund called National Small Savings Fund (NSSF) within the Public Account. This was done to usher transparency in the overall process of small savings schemes and make it more accountable.

Under this new structure, net amount collected under NSSF (gross collections minus repayments) is invested in special securities issued by central and state governments in a ratio decided by the governments. These proceeds form a source for financing the fiscal deficit of both Centre and States. The ratio of sharing between Centre and States was 33.3% and 66.7% during 1975-76 to 1987-88; 25% and 75% from 1988-89 to 1999-2000 and was further changed to 20% and 80% from 2000-01.

We looked at the net collections and applications of NSSF funds since 1999-00 (tables included at the end). There are some interesting points that emerge from the analysis:

- Net Collections in each of the years has been positive except 2007-08 and 2008-09 (Figure 1). In these two years we have net outflows from NSSF perhaps due to rising bank deposit rates. The same reason is given for 2011-12 where there has been a net outflow from NSSF in H1 2011-12. Investments as a % of net funds remain around 90-95% except for the two years viz. 2007-08 and 2008-09.

Figure 1

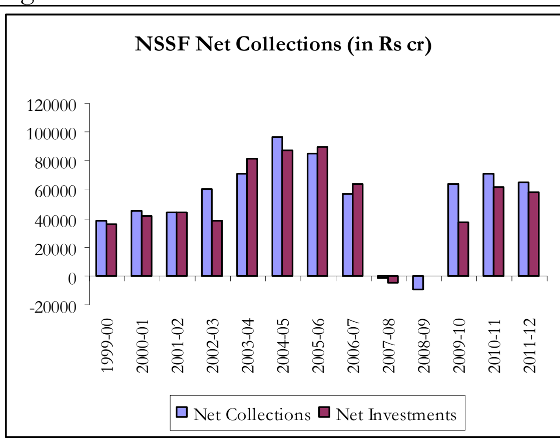
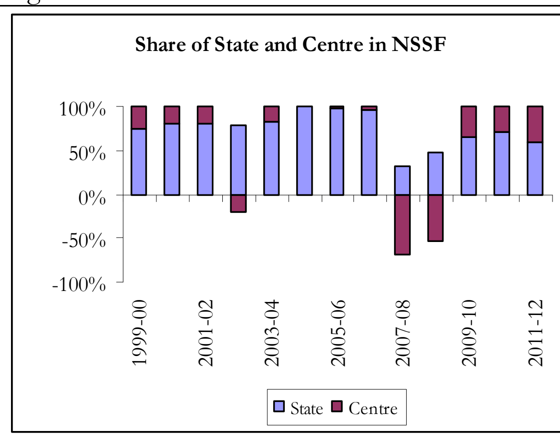


Figure 2



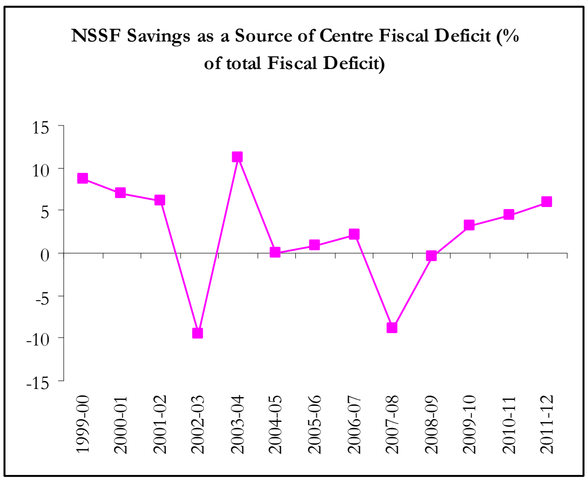
- In investments, we see the prescribed ratios being followed in early years till 2006-07. In 1999-00, state/centre share was 75%/25% which changed to 80%/20% in 2000-01 and 2001-02 in line with prescribed formula in Gupta committee. In 2004-05 the ratio touched 100%/0% with states getting 100% of the NSSF proceeds. In 2007-08, when there is a net outflow from NSSF the ratio changes but even then preference remains with the state (will be discussed later).

- The year 2008-09 was a year of global crisis as well and hence things became complex during that time. However, what is more interesting is that from 2008-09 onwards, the prescribed ratio of 80%/20% between state and centre with states having a choice for 100% of the funds was never adopted. In 2009-10 the ratio is 65%/35%, in 2010-11 it is 71%/29% and is budgeted at 59%/41% in 2011-12. In other words, centre is using more of NSSF funds which is not in line with the prescribed formula mentioned in Gupta Committee. If the 80/20 formula was applied to sharing NSSF resources, centre would have to raise higher funds via other sources primarily market borrowings. Our calculations show that if we take 80%/20% formula, centre would need to raise Rs 5764 cr in 2009-10, Rs. 5393 cr in 2010-11 and Rs12,513 cr in 2010-11 via other sources.

- If we look at the share of NSSF proceeds as a % of fiscal deficit of state and centre we see some interesting trends. States have clearly relied more on NSSF for financing its deficit compared to the centre. However, over the years states have started relying lesser on NSSF funds mainly because of rise in State development loan auctions. NSSF anyways is a more expensive option as here the bonds are issued at fixed 9.5% whereas SDL auctions have been issued at lower rates in recent years.

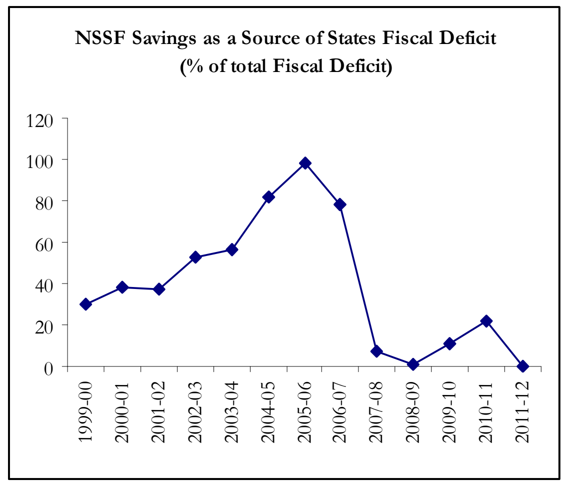
  Centre government has started to rely more on NSSF funds after the global crisis in 2008-09. This is in line with the trend seen above where we see State/Centre ratio of sharing NSSF proceeds diverging significantly from the set 80%/20% ratio.

Figure 3



Source: Budget Documents, RBI

Figure 4

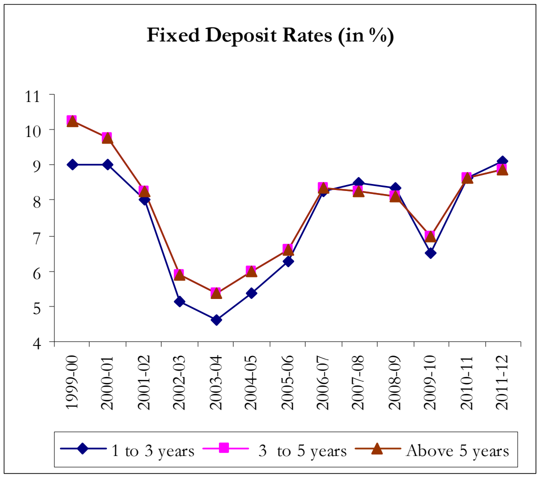


Source: Budget Documents, RBI

II. Lessons from 2007-08 and 2008-09

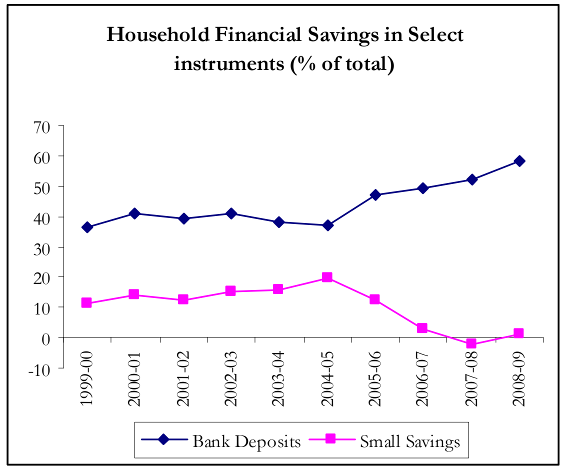
The research above pointed that there were net outflows from NSS in 2007-08 and 2008-09 as well. Again it was because of rise in deposit rates (Figure 5) which led to rise in household investing higher in bank deposits and decline in small savings (Figure 6). However it is important to note that 2008-09 started with a high inflation in H1 and then global crisis in H2.

Figure 5



Source: RBI

Figure 6



Source: RBI

The interest rates rise in H1 leading to rise in bank deposit rates and shift from small savings to bank deposits. The interest rates decline in H2 2008-09 but bank deposit rates remain elevated as deposits are contractual products and banks offer lower interest rates with a lag. Moreover, people shifted to bank deposits in H2 2008-09 because of high risk aversion during that period. Given this background, what was the impact on fiscal position of States and Centre in that period?

- **Impact on Central Government Fiscal Deficit:** Table 1 looks at NSSF and Market Borrowings as a source of fiscal deficit in 2007-08 and 2008-09. As we can see, higher inflows were expected from NSSF in Centre Government Securities. However because of the net outflows from NSSF in both the years we see shortfall in investments in Centre Government securities in final estimates.

Table 1: NSSF and Market Borrowings as a source of fiscal deficit (in Rs cr)

	NSSF			Market Borrowings		
	Budgeted Estimate	Revised Estimate	Final	Budgeted Estimate	Revised Estimate	Final
2007-08	10510	-1802	-11302	111327	136224	159248
2008-09	9873	1323	-1018	113000	319472	331772

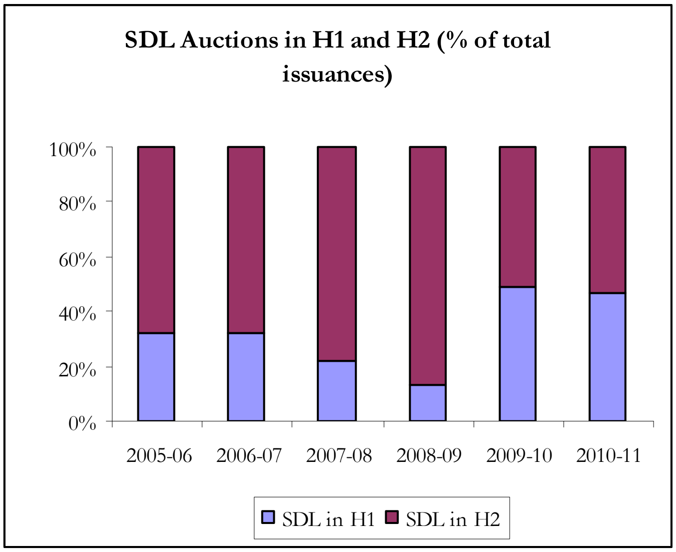
Source: Budget documents

This decline from NSSF as a source of financing fiscal deficit led to rise in overall market borrowings. The market borrowings were higher by nearly Rs 48,000 cr in 2007-08 and around Rs 2.2 lac in 2008-09. In 2008-09, most of the rise was because of global crisis which led to lower tax revenues. The overall impact of NSSF was much lower as shortfall from this account was just Rs 10,891 cr.

- **Impact on State Government Fiscal Deficit:** Unlike Centre, we do not borrowing program of States in advance. However, we can assess the impact from the SGL auctions done during H2 of the two years.

We do see higher SDL borrowing during H2 in 2007-08 and 2008-09 compared to other years (Figure 5). In 2008-09 there was global crisis as well during H2 and higher borrowings also arise because of the crisis. Hence, one can extrapolate that in 2007-08 and 2008-09 there was pressure on state finances because of short-fall in NSSF funds. This led to sudden surge in borrowings in H2 of those respective years.

Figure 7



Source: RBI

III. NSSF Shortfall in 2011-12

In 2011-12, Central government had expected net collection of Rs 65,000 cr from NSSF savings but so far there has been an outflow of Rs. 6190 cr. This outflow is because of higher interest rates on fixed deposits leading people to withdraw funds from their NSSF accounts.

Table 2: Deployments of NSSF Funds (in Rs cr)

	2007-08	2008-09	2011-12 (BE)	2011-12 (Apr-Aug)
Net Collections from NSSF	-1023	-9451	65000	-6190
Investments in Govt. Securities	-4474	-138	58351	
State Govt. Securities	5328	1164	34168	
Central Govt Securities	-11302	-1302	24183	-366.89

Source: Budget Documents, CGA

This has led to a sell-off in Centre securities worth Rs 366.89 cr instead of the investment of Rs 24183 cr the government expected. Further the government expects a net outflow of Rs. 11,000 cr till Mar-12 from the central securities account because of continued outflow from NSSF. The government also anticipated cash surplus of Rs 33,000 cr on 1-Apr-11 but had only Rs 16,000 cr marking a shortfall of Rs 17,000 cr. Together these three shortfalls amount to Rs. 52,182 cr almost equaling the extra borrowing required by government of Rs 52,800 cr in H2 2011-12.

Based on experiences from 2007-08 and 2008-09, one should expect higher market borrowing from states as well. The States expect an inflow of Rs. 34,168 cr via NSSF funds invested in States' securities. The analysis shows that states get first right over NSSF funds and even in 2007-08 and 2008-09, there was some investment in State securities against a sell-off in Centre securities.

In 2007-08, states but got around 11% of the budgeted amount via NSSF funds and in 2008-09 the percentage was 6%. The outflows from NSSF were more severe in 2007-08 compared to 2008-09. Assuming the situation of 2007-08, it can be estimated that states might get around Rs 3400 cr via the NSSF funds and might need to borrow an additional Rs, 30,000 cr. Hence, States might need to borrow Rs. 30,000 cr from the markets because of shortfall in NSSF alone. They are likely to need more funds because of other internal and external factors just like expected in the case of central government.

IV. Conclusion

The announcement of extra borrowings from Central government surprised the markets with 10-year G-sec yield touching 8.44% at closing after trading around 8.34% for most of the day. The yields have continued to harden as markets fear further market borrowing on account of rise in subsidies, further decline in tax receipts tracking global slowdown & rising interest rates and limited scope for disinvestment in volatile equity markets. Our analysis shows that there is likely to be an extra borrowing from states as well because of shortfall in NSSF and other factors highlighted in case of central government. This is likely to crowd out available savings for private sector and put further upwards pressure on interest rates.

Apart from market impact, the analysis shows that both Centre and State Governments have not been following the prescribed ratio for sharing the NSSF funds. The Central government is garnering a larger share of NSSF pool leading to more resources for centre and lesser for the states. This is an additional cause of concern on nature of fiscal balances of the Central government.

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