

Implications of National Savings Schemes on the Economy & the Financial Sector

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National Savings Scheme (NSS) plays an important role in mobilization of savings for meeting the Government's financing needs. However, pricing and tax anomalies in NSS need to be addressed. Addressing these anomalies can save the Government of Pakistan over PKR 100 billion per annum through reduction in debt servicing costs and increase in taxes and penalties on early withdrawal from NSS. Presently government debt servicing at around PKR 1 trillion equals about 50% of the entire government tax revenues. These costs can be significantly brought down. This will also reduce the interest rate risk for the government and help in bringing the interest rates down in the country which will promote economic growth.

Our analysis indicates that there is substantial mispricing in Behbood scheme and Special Savings Certificates. Behbood presently offers a rate of 12.24% p.a. with zero percent tax on it. Over 90% of Pakistani retirees do not have the savings to invest in the Behbood Scheme. They can hardly meet their day to day expenses. The investors who invest in the Behbood Scheme are rich and it is not right that they be provided subsidy by the Government. It is also widely believed that individuals open multiple Behbood Deposit Accounts at different NSS Centers. There is a need to investigate this fraudulent availing of Behbood subsidy. It is not justified to provide subsidy to the very rich through payment of very high interest rates and also making the rate of return paid (12.24 % per annum) on the Behbood deposits tax free.

We have compared the NSS rates in Pakistan with similar Small Savers Scheme in India. In India the average bank deposit rate is about 7.5% p.a. and the average return on Savings Schemes is about 8% p.a. In Pakistan the average bank deposit rate is around 6% p.a. and the average return on NSS is about 10% p.a. (calculated based on the prevailing rates of returns). Thus, the Pakistani government is paying too high a rate on savings schemes, despite the sovereign credit rating that it enjoys which is much higher than the banks' rating. The wide spread of over 4% between NSS rates and bank deposits has a negative impact for the banking system. State Bank of Pakistan has stated in its Financial Stability Review 2009-10: *"more net flow towards NSS tend to shift medium term fund or fixed deposits away from the*

banking system that limits the banks' ability to invest in the medium term projects".

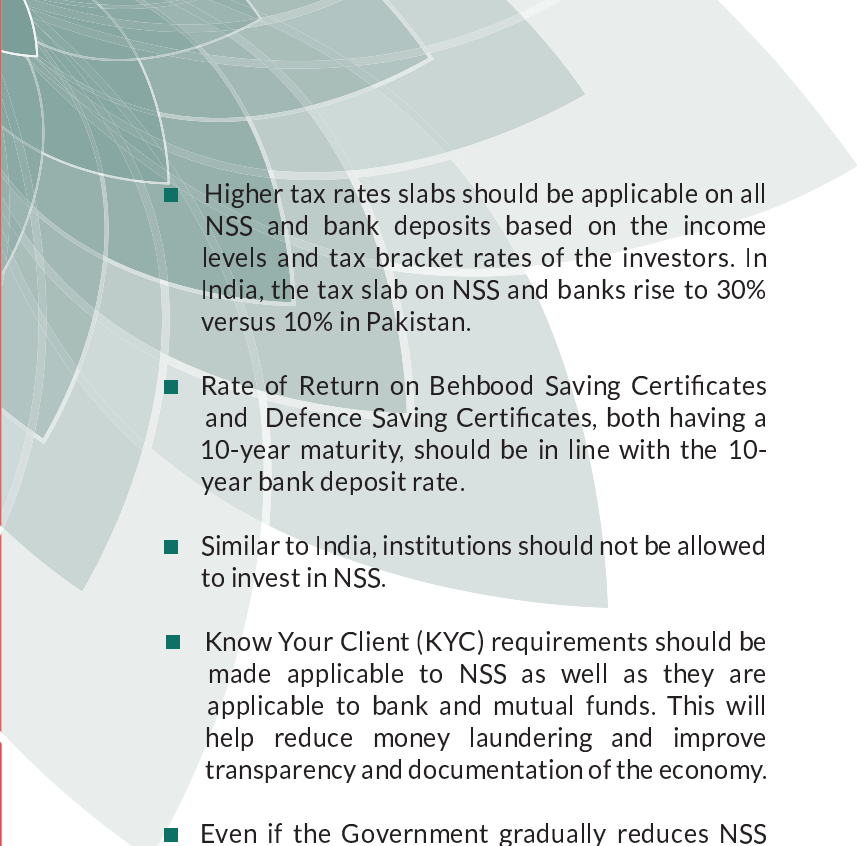
The Penalty structure on NSS is also very low and inconsistent. The penalty on 10-year Behbood Savings Certificate averages only 0.625% in the first 4 years and 0% in the last four years. On the 3-year Special Savings Certificate there is almost no penalty if a saver redeems after completion of 6-months period. Thus in reality this is a 6-month instrument providing the return of a 3-year instrument. Low penalties on withdrawal from NSS also exposes the Government to high interest rate risk as investors switch at any time the interest rates rise. The Effective Penalty rates on exit for saving schemes in Pakistan are much lower versus India.

For all schemes excluding Behbood Savings certificate there is a flat 10% full and final tax rate on income irrespective of the income level of the saver. In India, by contrast, the tax rate is 10% on Income level of up to INR 500,000, which rises to 20% for income levels between INR 500,001 and INR 800,000, and 30% for income levels above INR 800,000. Behbood Savings Certificates are completely tax exempt in Pakistan whereas in India for Senior Citizens Savings Scheme the tax rate rises with the income levels of the savers and reaches 30% for savers with income levels above INR 800,000.

Very high rates on NSS have a strong negative affect on the Private Sector and on the economy. With NSS offering returns of 8%-12% per annum, the Private Sector is forced to borrow at an even higher rate. The very high rates on NSS are slowing down private sector borrowings as the high interest rates become a barrier for business and industrial investment and expansion, thus slowing down the economic growth rate of the country.

Recommendations for the Government of Pakistan

- As in India, NSS rate of return should be linked to bank deposit rates of the same maturity, and not to sovereign bond yields.
- Penalties on NSS for premature redemptions should be raised substantially to reduce interest rate risk of the Government.

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- Higher tax rates slabs should be applicable on all NSS and bank deposits based on the income levels and tax bracket rates of the investors. In India, the tax slab on NSS and banks rise to 30% versus 10% in Pakistan.
 - Rate of Return on Behbood Saving Certificates and Defence Saving Certificates, both having a 10-year maturity, should be in line with the 10-year bank deposit rate.
 - Similar to India, institutions should not be allowed to invest in NSS.
 - Know Your Client (KYC) requirements should be made applicable to NSS as well as they are applicable to bank and mutual funds. This will help reduce money laundering and improve transparency and documentation of the economy.
 - Even if the Government gradually reduces NSS rates and raises penalties, it will still be able to attract the target amounts as banks / mutual funds returns are substantially lower than NSS rates.

The above measures will help the government save over PKR 100 billion per annum on account of reduced debt servicing costs and higher taxes and penalties receipts. This will also revitalize the private sector resulting in improving tax collection and exports, and reducing unemployment rate in the country.