

PROVIDENT FUND

BY UDAYAN RAY

The government is having a hard time paring PF rates. How to make the most of this window of opportunity.

Go for Max

It looks as if the government is caught between a rock and a hard place. Last fortnight, the labour minister, Sahib Singh Verma, assured Parliament that there would be no reduction in provident fund rates, currently pegged at 9.5 per cent per annum. This comes some two months after the finance minister announced immediate cuts in the rates for small savings from 9 per cent to 8 per cent.

Most investors expected the PF rates to be brought down to the level of small savings rates soon after the budget announcement. However, in an election year, it is obviously difficult for politicians to give precedence to economics over politics. And the government does not want to run the risk of angering the millions of employees in the organised sector by reducing PF rates. The Central Board of Trustees, the body governing the Employees' Provident Fund Organisation (EPFO), has failed to agree to any cuts and is likely to meet again this month to take a decision.

Can you profit from the government's dilemma? Assuming the labour minister keeps his word, a 1.5 percentage point differential between the risk-free small sav-

ings retirement options—say public provident fund (PPF) and PF—provides you a window of opportunity. We suggest you seriously consider voluntarily increasing your provident fund contribution from the mandatory 12 per cent of basic plus dearness allowance (if applicable). Here's why.

The tax advantage. "Enhanced PF contributions will earn the same tax benefits as the mandatory PF contributions," says Madhu D, assistant vice president, Benefits Consulting Group, India Life Hewitt, a private PF management company. This means these contributions will get Section 88 benefits and will be tax-free at the time of withdrawal. Also, the interest accrued on the savings will be tax-free compared to other forms of risk-free savings like National Savings Certificates, where interest up to Rs 12,000 is exempt from tax under Section 80L.

The amount you invest in an option also depends on factors like risk and liquidity. As far as risk in PF is concerned, rest assured that the government will back

the fund; no government is likely to survive a US-64 type crisis in the pension sector. "It is important to know that while the PF is legally not guaranteed by the government, for all practical purposes it is has government backing," says Rohit Sarin, partner, Client Associates, a Gurgaon-based wealth management firm.

This leaves you with the issue of liquidity. "PF money will not be available for quite a long period. This means you cannot take advantage of investment opportunities available in the next 15 years," warns Mukul G. Asher, professor, Public Policy Programme, National University of Singapore. So, consider enhancing PF contribu-



MADHU KAPPARATH

ROHIT SARIN

Client Associates

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tions only after taking care of liquidity needs. "It makes sense to increase the contributions to up to Rs 70,000 (the upper limit for Section 88 investments in PF)," says Ramesh Gupta, professor, Indian Institute of Management, Ahmedabad. This is applicable for people with annual income below Rs 5 lakh.

Power of compounding. Once you have decided to enhance your PF contribution, you will have to continue making the enhanced contribution till the end of the financial year. You can review the situation and decide on continuing the enhanced contributions or not, when the rates are decided again next year. "Making enhanced contributions this year will mean that you will have a higher base for better compounding effect in the subsequent years," says Sarin. So, thanks to a higher rate, you get a higher base next year on which rates for subsequent years can work on to give the compounding effect.

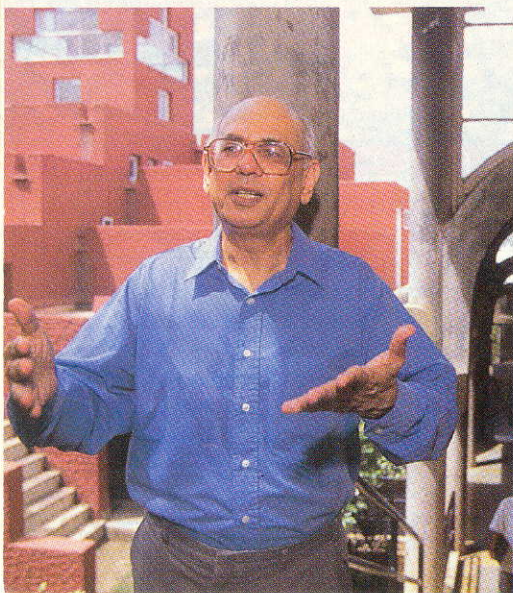
But whether or not you enhance your PF contribution in the coming days will depend on what the government's decision on interest rates. Assuming the differential of 1.5 percentage points remains, the decision to enhance your contribution should be a short-term one—only for the 2003-04 financial year. You can review this decision when the rate for the next year is decided. "The rate of 9.5 per cent is not sustainable and it is essential not to make long-term strategies on the basis of such considerations," warns Asher.

The government may be in a quandary about how and when to reduce rates, but that's no reason for you not to profit in the short term. ■

MUKUL ASHER

Professor, Public Policy

A rate of 9.5 per cent is not sustainable, so don't opt for long-term strategies on the basis of this.



PUNIT PARANJPE