Unit-4 Public Debt

Meaning of Public Debt:

Modern governments need to borrow from different sources when current revenue falls short of public expenditures. Thus, public debt refers to loans incurred by the government to finance its activities when other sources of public income fail to meet the requirements. In this wider sense, the proceeds of such public borrowing constitute public income.

However, since debt has to be repaid along with interest from whom it is borrowed, it does not consitute income. Rather, it constitutes public expenditure. Public debt is incurred when the government floats loans and borrows either internally or externally from banks, individuals or countries or international loan-giving institution

Classification of Public Debt:

The structure of Public Debt is not uniform in any country on account of factors such as catagories of markets in which loans are floted, the conditions for repayment, the rate of interest offered on bonds, purposes of borrowing etc. In view of these differences in criteria, public debt is classified into various catagories —

1. Internal and external debt — Sums owed to the citizens and institutions are called internal debt and sums owed to foreigners comprise the external debt. Internal debt refers to the govt. loans floated in the capital markets within the country. Such debt is subscribed by individuals and institutions of the country.

On the other hand, if a public loan is floated in the foreign capital markets, i.e., outside the country, by the government from foreign nationals, foreign governments, international financial institutions, it is called external debt.

2. Short term and long term loans — Loans are classified according to the duration of loans taken. Most government debt is held in short term interest-bearing securities, such as Treasury

Bills or Ways and Means Advanced (WMA). Maturity period of Treasury bill is usually 90 days.

Government borrows money for such period from the central bank of the country to cover temporary deficits in the budget. Only for long term loans, government comes to the public. For development purposes, long period loans are raised by the government usually for a period exceeding five years or more.

3. Funded and unfunded or floating debt – Funded debt is the loan repayable after a long period of time, usually more than a year. Thus, funded debt is long term debt. Further, since for the repayment of such debt government maintains a separate fund, the debt is called funded ~~be~~ debt.

Floating or unfunded loans are those which are repayable within a short period, usually less than a year. It is unfunded because no separate fund is maintained by the government by ~~the government~~ for the debt repayment. Since repayment of unfunded debt is made out of public revenue, it is referred to as a floating debt. Thus, unfunded debt is a short term debt.

4. Voluntary and compulsory loans – A democratic government raises loans for the nationals on a voluntary basis. Thus, loans given to the government by people on their own will and ability are called voluntary loans. Normally, public debt, by nature, is voluntary.

But during emergencies (e.g. – war, natural calamities, etc.) government may force the nationals to lend it. Such loans are called forced or compulsory loans.

5. Redeemable and irredeemable debt – Redeemable public debt refers to that debt which the government promises to pay off at some future date. After the maturity period, the govt. pays the amount to the lenders. Thus, redeemable loans are called terminable loans.

In the case of irredeemable debt, government does not make any promise about the payment of the principal amount, although interest is paid regularly to the lenders. For the most obvious reasons, redeemable public debt is preferred. If irredeemable loans are taken by the government, the society will have to face the consequence of burden of perpetual debt.

6. Productive (or reproductive) and unproductive (or deadweight) debt – On the criteria of purpose of loans, public debt may be classified as productive or reproductive and unproductive or deadweight debt. Public debt is productive when it is used in income-earning enterprises. Or productive debt refers to that loan which is raised by the government for increasing the productive power of the economy. A productive debt creates sufficient assets by which it is eventually repaid. If loans taken by the government are spent on the building of railways, development of mines and industries, irrigation works, educatio etc., income of the government will increase ultimately. Productive loans thus add to the total productive capacity of the country.

Public debt is unproductive when it is spent on purposes which do not yield any income to the government, e.g., refugee rehabilitation or famine relief work. Loans for financing war may be regarded as unproductive loans. Instead of creating any productive assets in the economy. That is why unproductive ~~to~~ debts are called deadweight debts.

- Methods of Redemption of Public Debt:

Redemption of debt refers to the repayment of a public loan. Although public debt should be paid, debt redemption is desireable too. In order to save the government from bankruptcy and to raise the confidence of lenders, the government has to redeem its debts from time to time.

Sometimes, the government may resort to an extreme step is, of course, violation of the contract. Use of repudiation of debt by the government is economically unsoun there, instead of concentrating on the repudiation of debt, we discuss below other important methods for the retirement or redemption of public debt –

1. Refunding – Refunding of debt implies issues of new bonds and securities for raising new loans in order to pay off the matured loans (i.e., old debts).

When the government uses this method of refunding, there is no liquidation of the money burden of public debt. Instead, the debt servicing (i.e. repayment of the interest along with the principal) burden gets accumulated on account of postponement of the debt-repayment to save future debt.

2. Conversion – By debt conversion we mean reduction of interest burden by converting old but high interest-bearing loans into new but low interest-bearing loans. This method tends to reduce the burden of interest on the taxpayers. As the government is enabled to reduce the burden of debt which falls, it is not required to raise huge revenue through taxes service the debt.

Instead, the government can cut down the tax liability and provide relief to the taxpayers in the event of a reduction in the rate of interest payable on public debt. It is assumed that since most taxpayers are poor people while lenders are rich people, such conversion of public debt results in a less unequal distribution of income.

3. Sinking fund – One of the best methods of redemption of public debt is sinking fund. It is the fund into which certain portion of revenue is put every year in such a way that it would be sufficient to pay off the debt from the fund at the time of maturity. In general, there are, infact two ways of crediting a portion of revenue to this fund.

The usual procedure is to deposit a certain (fixed) percentage of its annual income to the fund. Another procedure is to raise a new loan and credit the proceeds to the sinking fund. However, there are some reservations against the second method.

Dalton has opined that it is in the rightness of things to accumulate sinking fund out of the current revenue of the government, not out of new loans. Although convenient, it is one of the slowest methods of redemption of debt. That is why capital levy as a form of debt repudiation is often recommended by economists.

4. <u>Capital Levy</u> – In times of war or emergencies, most governments follow the practice of raising money necessary for the redemption of the public debt by imposing a special tax on capital.

A capital levy is just like a wealth tax in as much as it is imposed on capital assets. This method has certain decisive advantages. Firstly, it enables a government to repay its (emergency) debt by collecting additional tax revenues from the rich people (i.e. people who have huge properties). ~~The rich~~ This then reduces consumption spending of these people and the severity of inflation is weakened. Secondly, progressive levy on capital helps to reduce inequalities in income and wealth. But it has certain clear-cut disadvantages too. Firstly, it hampers capital formation. Secondly, during normal time this method is not suggested.

5. <u>Terminal annuity</u> – It is something similar to sinking fund. Under this method, the government pays off its debt on the basis of terminal annuity. By using this method, the government pays off the debt in equal annual instalments.

This method enables government to reduce the burden of debt annually and at the time of maturity it is fully paid off. It is the method of redeeming debts in instalm-ents since the government is not required to make one huge lump sum payment.

6. <u>Budget surplus</u> – By making a surplus budget, the govern-ment can pay off its debt to the people. As a general rule, the government makes use of the budgetary surplus to buy back from the market its own bonds and securities. This method is of little use since modern governments resort to deficit budget. A surplus budget is usually not made.

7. <u>Additional taxation</u> – Sometimes, the government imposes additional taxes on people to pay interest on public debt. By levying new taxes, both direct and indirect, the govt. can

allocate the necessary revenue so as to be able to pay off its old debt. Although an easier means of repudiation, this method has certain advantages since taxes have large distortionary effects.

8. Compulsory reduction in the rate of interest:- The government may pass an ordinance to reduce the rate of interest payable on its debt. This happens when the government suffers from financial crisis and when there is a huge deficit in its budget.

There are so many instances of such statutory reductions in the rate of interest. However, such practices is not followed under normal situations. Instead, the government is forced to adopt this method of debt repayment when situation so demands.

Growth of Public Debt:

Borrowing by public authority is a modern practice. In the past, whenever there was an emergency, usually a war, the monarch relied on the hoarded wealth or borrowed on his own personal credit. Books on ~~his own~~ history abound in instances of fabulous hoards and accounts of loots and sacks of hoarded wealth either from kings treasuries or from temples and churches. But this method of finance is not suited to modern conditions. It will be inadequate and uneconomical.

The system ~~can~~ of public credit, making it easy for the state ~~to~~ borrow, has led to tremendous increase in the indebtedness of modern states. Take the case of India. While the total public debt of the country at the end of March 1951 stood at Rs. 2,054 crores, it was expected to shoot up to Rs. 87,062 crores by the end of March 1986 (Budget Estimates), i.e., more than 42 times in 35 years.

Causes of Increase in Public Debt:

1. The most important cause of increase in public debt is war or war-preparedness. Nations attach a great importance to their territorial integrity and they consider no sacrifice

too much to defend their country. Every war, therefore, leaves the country under greater debt.

2. The increase is also due to fairly frequent budget deficits on current account. The deficits arise from the necessity of maintaining full economic activity in the economies which may have ceased to expand.

3. Increase in public debt is also due to the undertaking of welfare schemes by governments in modern times.

4. In Public utilities, where there is no convenient profit check, no right control over cost can be maintained and there is are more losses than gains. They also add to the weight of public debt.

5. In recent years, urge for economic growth has induced the under-developed countries to contract debts both internally and externally. The volume of public debt has consequently swollen.

Purposes of Public Debt:

① **Bridging gap between revenues and expenditure** – It often happens that towards the end of the financial year, government experiences shortage of funds. To cover this gap between revenue and expenditure, the government raises temporary loans or gets 'ways and means' advance from the Central Bank. In India, the government issues what are called 'Treasury Bills' which are repayable after three months.

② **Financing public works programme** – During depression, the government has to launch public works programme to provide employment. In this way, money is injected into the economy to lift the depression. For this purpose, it becomes necessary to raise public loans to ensure economic stability.

③ **Curbing inflation** – When inflation is rampant and it h desired to bring down the prices, the government issues public loans. In this way, money or purchasing power is drawn from the public. Reduction in money supply will bring down prices.

(4) Financing economic development — The underdeveloped countries are now very keen on speedy economic development, which involves huge investment. They are unable to raise adequate finances through taxation. Hence resort to public borrowing becomes necessary.

(5) Financing the public sector — Economic system, which is becoming increasingly popular, is that of mixed economy. For several reasons, economic, political and social, there has to be a rapidly expanding public sector. The financing of this sector is not possible without resort to public borrowing.

(6) War finance — A modern war is a very costly affair. To prosecute a modern war by taxation is simply out of the question. Public borrowing becomes essential. Thus, public borrowing is necessitated by the requirements of filling the gap between revenue and expenditure, public programme, economic development and war finance.

- Burden of Public Debt:

In order to asses the burden of public debt, we shall have to consider the nature and the purpose of the public debt. If the debt is taken for productive purposes, e.g., for irrigation and railways, it will not mean any burden. On the other hand, it will confer a benefit, provided the scheme has been successfully executed. But if the debt is unproductive, it will impose both money burden and real burden on the community. The measure of the burden will depend on whether the debt is internal or external.

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The govt. then makes payments to contractors, govt. servants or to those people from whom it buys goods and services. Money is, thus transferred from some sections of the community to the other sections. In this case, there is obviously no direct money burden of the debt on the community as a whole. But there will be a direct real burden (i.e. sacrifice, hardship or loss of economic welfare) on the community depending on the nature of these transfers of wealth. If by these transfers wealth comes to be more evenly distributed i.e., wealth is transferred from the rich to the poor, then public debt will be considered beneficial instead of being burdensome. If, on the other hand, the public debt enriches the rich at the expense of the poor, it imposes a real burden.

Let us analyse carefully the nature of the transfer. In order to repay the interest and the principal of the debt, the govt. must levy taxes. What the tax-payers pay, the bond-holders receive. The bond-holders are generally rich people. But the tax burden does not exclusively fall on the rich, unless it is very sharply progressive which is seldom the case. The tax burden falls on the rich and the poor both, and, in the case of indirect taxes, it may be more on the poor than on the rich. The net result may be that the wealth is ~~co~~ transferred from the poor to the rich. This means a net loss of economic welfare.

This burden is accentuated by the fact that the transfer is from the young to the old (the bond-holders, the creditors of the government, are generally advanced in age) and from the active to the passive members of the community. "Here", says Dr. Dalton, "If nowhere else in the sphere of public finance, the voice of equity rings loud and clear. There is also a general presumption on grounds of production (besides those on the grounds of distribution) against the enrichment of the passive at the expense of the active, whereby work and productive risk-taking are penalized for benefit of accumulated wealth." Thus, internal debt has adverse repercussions both on production and distribution of wealth. This is its direct real burden.

Its indirect real burden will lie in the check it imposes on production. The production is likely to be checked, if the desire and ability to work and save are reduced. If the repayment of debt involves very heavy taxation, it is likely to reduce the ability and the willingness to work and save.

Burden of External Debt:

The external debt also involves a series of transfers of wealth but not within the same country like the internal debt. This makes all the difference. When the loan is raised, wealth is transferred from the lending to the borrowing country; and when it is repaid the transfer is in the opposite direction. The account of money paid by the debtor country towards interest and the principal is the measure of the direct money burden on the community. But if we want to know the direct real burden (i.e. loss of economic welfare), we shall have to consider the proportions in which the rich and poor contribute to these payments. The government will raise the required money by taxes. If the taxes fall largely on the rich, the direct real burden will be less than it would be if the incidence is largely on the poor.

The payment that we make to the foreign creditors gives him a control over our goods and services. He does not take away our money it is of no use to him. He buys with those money goods in our country. In the absence of debt payments, these goods would have been enjoyed by ourselves. This means a diminution of economic welfare; hence a direct real burden. The indirect burden of the foreign debt lies in the check to production of ~~the foreign debt lies in the~~ wealth in the economy. Taxes imposed, in order to raise funds for debt payment, may reduce public expenditure in the directions which would have stimulated production. Hence, production may be checked.

International payments can be made only by exporting goods. For this purpose, a country must produce more. Hence it is said that production is stimulated. But production is stimulated only in certain directions. There is no general increase in production and employment. Factors of production are limited. If they are needed in the export industries, they will have to be drawn from the other industries which must consequently shrink. Thus, there is only a diversion of resources and ~~not~~ ~~not~~ no net increase in production and employment.

• **Role of Public Borrowing in a Developing Economy:**

A developing economy has to tap all possible sources to mobilise sufficient financial resources for the implementation of its economic development plans. It has to utilise revenue surplus for the purpose, seek external aid, pitch up its level of taxation and public borrowing are the two major instruments of resources mobilisation. Public borrowing has one advantage over taxation. Taxation, beyond a certain limit, tends to affect economic activity adversely owing to its disincentive effect. There is no such danger in public borrowing. It does not have any unfavorable repercussions on economic activity by being disincentive, partly because of its voluntary nature and partly because of expectation of return and repayment. According to expert opinion, taxation should cover at least current expenditure on normal government services, and borrowing should be resorted to finance government expenditure which results in creation of capital assets. In that case, growing public debt will not be a burden on the economy, because such a debt is self-liquidating. But there is a limit to public borrowing, which is considered safe. Additional taxation is also necessary to implement the development plans.

The classical theory frowned upon public borrowing.

It was thought that the use of resources by the government was less productive than their use in private hands. But the classical reasoning was based on the assumptions of full employment, inelasticity of money supplies and unproductiveness of public expenditure. These assumptions, we know, are not valid today. Public borrowing for financing productive investment generates additional productive capacity in the economy, which otherwise would not have been possible. It is used as an instrument to mobilise resources which, in an underdeveloped economy, would otherwise have gone into hoards or invested in real estate or jewellary. Public debt would thus divert the flow of resources into the right channels.

Thus, in an underdeveloped economy public borrowing, if prudently managed and skillfully operated, can become a powerful instrument of economic development. Besides, growing public debt provides the people opportunities to hold their wealth in the form of safe and stable income-yielding assets, i.e. government bonds. Growth and composition of public debt provides the monetary authorities with assets which they can manipulate to give effect to a monetary policy considered desireable in the content economic development. Thus, monetary policy, which is considered essential for achieving the objectives of economic policy, becomes vitally related to public debt management. The management of public debt is used as a method ~~of~~ to influence the structure of interest rates. This, a growing public debt, in an underdeveloped economy, has become a powerful tool of developmental monetary policy.

There are two important ways in which the governments of underdeveloped economies raise resources through public loans —

@. Market borrowing, i.e., sales to the public of government bonds (long-term loans) and treasury bills (short-term loans) in the capital market.

(b) Non-market borrowing, i.e., issue to the public of debt which is not negotiable and is not bought and sold in the capital market, e.g., issue of national savings certificates and national plan bonds and accepting deposits in the government post office.

- **Voluntary or Forced Loans:**

Most of the types of public loans are voluntary. But, if the voluntary loans do not prove sufficient for the purpose, forced loans become necessary and are resorted to. An important example of forced loans familiar in India is that of Compulsory Deposit Scheme (CDS). Compulsory borrowing is a compromise between taxation and borrowin
Like a tax it is a compulsory contribution to the governme
but like a loan, it is to be repaid with interest.

Compulsory loans have a special advantage in the
context of an inflationary situation and are superior to
voluntary public ~~loans to~~ borrowing. They sterilize funds,
whereas voluntary public loans result in the creation of
readily ~~cl~~ cashable bonds. They are monetized to increase
liquid assets in the community which produce an inflation
effect. Also, lower rate of interest can be paid on compulso
loans, thus reducing the cost of public debt. But a contin
-ous policy of compulsory borrowing may arouse public
resentment. Normally, it is the voluntary public
programmes which should be chiefly relied upon. borrowin