Unit III Sem. VI

Q.1. Meaning and Objectives of Public Debt.

countries, it may comprise mainly the borrowings raised internally from the local authorities, institutions and individuals. In this regard, American economists like Taylor have clearly emphasised the internal debt on one side while others in India favoured foreign debt. Any how, both are the main constituents of public debt.

(a) ☐ **MEANING OF PUBLIC DEBT**

Generally, public debt refers to loans raised by a government within the country or outside the country. Every government like individuals has to borrow when its expenditure exceeds its revenue. But it is not a source of revenue like taxes. Of course, in wider sense, the term public revenue covers all types of income. Hence, public revenue includes the money borrowed by a government. The amount borrowed by the government during any given year constitutes the income of that year. We may call, therefore, public debt as 'revenue' of the government. The loans raised or any debt incurred or received in a year constitute the income of the government like other taxes levied or collected in a year. But the basic difference between the public debt and other sources of revenue is that while public debt has to be paid back by the government ; the other types of income are not to be paid back. The government collects taxes from the public without any commitment or promise. But public loans or debts are collected by the treasury or government from banks, institutions and individuals on the conditions given in writing that these would be repaid and interest would be paid regularly either yearly or half-yearly as per terms of the loan. The terms of interest on these loans have also to be selected under these conditions.

However, the concept of public debt has been defined by various economists. Prof. J.K. Mehta has rightly mentioned, *"Public revenue, therefore, consists of the money that the government is not obliged to return to the very individual from whom it is obtained. Public debt on the other hand, carries with it the obligation on the part of the government to pay money back to the individuals from whom it has been obtained."*

According to Prof. Findlay Shirras *"National Debt is a debt which a state owes to its subject or to the nationals of other countries." Similarly, Prof. P.E. Taylor defines, "The debt is the form of promises by the Treasury to pay to the holders of these promises a principal sum and in most instances interest on that principal. Borrowings is restored to in order to provide funds for financing a current deficit."*

Prof. Carl S. Shoup defines public debt or government borrowing as, *"the receipt from the sale of financial instrument by the government to individuals or firms in the private sector to induce the private sector to release manpower and real resource and to finance the purchase of those resources or to make welfare payments or subsidies."*[2]

Cont. — (b)

Q.2 ☐ **DIFFERENCE BETWEEN PUBLIC DEBT AND PRIVATE DEBT**

There are similarities and dissimilarities between private and public debt. The government is almost in the same position as is a private borrower in case of acquiring public borrowing. Public authorities borrow funds to acquire certain resources. Similarly, private individuals make use of the borrowed funds to acquire certain resources. Both public and private borrowing involves diversion of funds from one type of use to another. The government may borrow either for consumption or for investment purposes like a private borrower. The public authorities and private in-

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2. *Carl. S. Shoup, 'Public Finance'.*

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dividuals also pay interest on these borrowings. Despite these similarities, there are many dissimilarities between these two kinds of debt. The main points of difference between private and public debt are given as under :

1. The government is sovereign and it has the power of compulsion. In the times of war or economic crisis in the country, the government can compel the people to lend money to the government. Under these circumstances, the government may refuse to pay back the debt though such position never occurs. But in the case of private debt, no private individuals can force or compel another private individuals to lend him.

2. The government prevails for a longer time and it is possible to take loans for a longer period while a private person can borrow only for a short period of time.

3. The loan taken by the government is generally spent on productive purposes but an individual may spend the money borrowed both for productive as well as for non-productive purposes.

4. The government may borrow from the sources inside the country as well as from the external sources like foreign countries. But it is very difficult to borrow from the external countries for a private individual.

5. The government generally borrows money to spend for the welfare of the society. The government utilises the loans for the development schemes which have been started for the common welfare of the community. But the private debt is not used for the society, and its main aim is profit earning. In other words, it is done to maximise the profit.

6. The government repays its loans through taxing the people. Additional taxes are imposed on the public to repay the borrowed money. In this way, the creditors have their own contribution that they have paid taxes for the repayment of loans. In other words, the burden of the public debt is shared by the public collectively. But on the other hand, it is impossible for a private borrower to levy taxes. He has to repay his debt either out of his personal earning or out of his savings or by borrowing from other sources.

7. Rate of interest paid by the government is very low as compared to rate of interest paid by a private borrower. The government can reduce the rate of interest payable on public loans but for a private borrower it is not possible. He has to pay the rate of interest which he has promised to pay at the time of borrowing.

8. The public debt makes its effect on the production and distribution of wealth and income in the country. But, the loan taken by a private person makes no such effect, because of being a small amount.

9. The credit of a government is very high and it is possible for it to borrow the amount at cheaper rates. But it is not possible for the private person as the government is more trust-worthy than a private individual.

10. The government can repudiate the payment of loans taken by it from the public in some critical conditions but for a private individual, it is very difficult to refuse payment of loans under any circumstances. The state, however, normally take this step in very rare circumstances because such an act will greatly damage the reputation of the government.

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OBJECTIVES AND IMPORTANCE OF PUBLIC DEBT

In the past, the way of living was very simple, and the borrowing was not very significant. The government budgets were very small. The government also followed the policy of non-intervention in economic system. But in modern times, especially after the world depression of 1929-30, the public authorities started to take keen interest in the economic development of their respective countries. Thus, public borrowing has become *sine qua-non* for the economic development of a nation. The government activity is expanding vastly and without public borrowing, it is not possible to work on such heavy projects. In this way, it has become part and parcel of the instrument of fiscal policy for the economic development of under-developed as well as for the developed countries. Now-a-days, no matters for an extra ordinary increase in public debt as it brings to the economy the capability of repaying the debt as it is spent on productive purposes. The crucial objectives of public debt are being mentioned as below :

1. For the Maintenance of Balance between Expenditure and Revenue. The most important aim of public debt raised by the government is to fill the gap between the revenue received by the government and proposed expenditure during the year. The government may borrow money from internal or external resources, whenever the income of the government falls short of its expenditure. This income of the state is over and above all taxes and other revenue resources. But debt incurred is the income of the state for the year alone. Hence, it will have to be repaid through taxation or other resources. The government borrow money from internal as well as from external sources in order to meet certain unforeseen calamities like floods, famines etc.

2. Fighting Depression. Depression is a competition of falling prices, slackness of productive activities and no hope for profitability in the economy. To eradicate the evils of depression, public debt is the most indispensable tool of financial management. Depression does not mean that there is no money with the public. But the money remains un-utilised due to the lack of entrepreneurship. Nobody is ready to invest money as there is less profit or very low expectations. At such a stage, the government can utilise this money by raising loans and increasing the public expenditure on public works in the country. This would increase the effective demand of the people through the combined operation of multiplier and acceleration. In the other side, the private enterprise may be willing, but due to shortage of funds, he may not be in a position to enhance production and thereby to raise output and employment. In this situation, the government may borrow from the banks and release the funds for supplementing the private enterprise. The government may be able to lift the depressed economy to recovery which in turn leads to prosperity, either by ensuring new money or by activising the idle resource by raising loans. As a result, it would help in checking the falling prices and divert the economy to the path of growth and prosperity. Hence, public debt plays vital role during the period of depression.

3. To curb Inflation. It is a condition of rising prices in the economy. It is a serious threat to the smooth and harmonious development of the economy. In other words, inflation is a phenomenon where too much money chases too few goods. By raising public debt, the government can withdraw a large volume of money from the public and check prices from rising. Some modern economists suggest the taxation as the

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better mode of curbing the inflationary trend as compared to public debt. It is because money received through public borrowing increases the liabilities of the government for its repayment if the amount taken has not been properly utilised in productive channel. But such a surplus revenue amount may easily be left idle in the treasury to curb the inflationary pressures. As the monetary policy alone is not very much successful to curb the inflation, fiscal policies of which public debt is the major tool, has attained greater significance since the First World War period. Hence, the best way to curb public spending is to borrow from the public and leave a smaller amount with the public. So the main object of public debt should be to influence the investment and consumption for maintaining stability in the economy.

4. Financing Economic Development. Under-developed countries always face the problem of funds. Taxation capacity of such a nation is also very low. Moreover, taxation is resented if heavily imposed on the public. But to save the economy from the vicious circle of poverty, the need for finance is necessary. Under such circumstances, public debt is the only way but left with the government. The government may borrow from the persons within the country who are able to lend or from the resources outside the country and both are to finance development expenditures i.e. bring the change in structure and creation of social overheads etc. In this way, an public borrowing has to play double role as a source of capital formation and as anti-inflationary measure in under-developed countries.

5. To meet Unprecedent Expenses. Sometimes, the government raises loans to meet the unprecedent events like famines, floods, earthquakes and epidemics etc. The funds are raised by the government as the government is committed to incur a much large expenditure. Again, such cases of emergencies and calamities lead to a sudden spurt in expenditure of the government.

6. To Check the Cyclical Fluctuation. After world depression, every government is conscious about the various cyclical fluctuations which occur in the economy. These cyclical fluctuations generally lead to many disastrous consequences. Therefore, to control these cyclical fluctuations, is one of the chief objectives of the debt policy of the government. By raising loans, the government can finance the production activities when it tends towards recession, thus, preventing it from the evils of depression.

7. Unpopularity of Taxation. Public is least interested in paying taxes to the government. Any kind of tax is resented by the public whether old or new. They always oppose the enhancement of old rates of taxation as well as the imposition of new taxes. At this critical juncture, the government adopts the easy process of resorting to public debt to save its skin from the public opposition.

8. War Finance. Modern age is an atomic age. In the age of atomic warfare, international tension is increasing day by day. A country needs a huge amount to maintain its defence services and up-to-date equipment if it wants to protect itself from its enemies or from foreign aggression. So for this purpose, government borrows money. According to Findlay Shirras, *"....no specific can be too great that are required to preserve national security and independence and a loan expanded on armies or fleets employed for such a purpose is quite as well and profitably employed as if it had been laid out on [illegible] in promoting manufactures or trade."*[3] Modern

3. Findlay Shirras, 'Public Finance'.

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warfare requires huge amounts of money and they are not met by taxation alone because heavy taxation may have disastrous effect on production. Besides, taxation cannot be raised beyond a certain limit. Therefore, public loan borrowing is a better method to collect the resources than revenue. Therefore, government may resort to public borrowings to raise additional resources and transfer resources from the civilian sector to the military sector within the country and outside the country.

9. To Finance Public Enterprises. Public sector is directly under the control of the government as public sector has been recognised to play a major role in the economic development, growth and prosperity. For financing public enterprises, the government may borrow. So at first, the government need finance to meet the needs of these enterprises and, hence it, borrows. Only taxation is not sufficient for these purposes. Therefore, modern governments have been resorting to extensive borrowings.

10. For Better Allocation of Resources. To avoid the misallocation of resources, the government may act to put the existing level of resources at an optimum level. Mis-allocation of resources is generally created by monopolistic competition. The government has to take over these monopolistic firms or encourage the entry of other firms so that the mis-allocation of resources may be checked. For this, the government has to provide long term finance and the government itself has to borrow to meet the needs of such firms,

11. Expansion of Education and Public Health Services. In modern time, governments are welfare governments who are responsible for the expansion of education and health services which further improves the efficiency of the people. For this purpose, generally, government borrows from internal or external resources in order to meet these requirements.

12. Creation of Infra-structures. Generally, public government borrows for the creation of infrastructures in an economy. They include the development of railway, communication, dams etc. These types of investments are not much attractive for the private businessmen and fail to create social overhead gains for the society.

SOURCES OF PUBLIC BORROWING

There are two major resources of public borowings internal and external. Internally, the government can borrow from individuals, commercial bank, financial institutions, charitable trusts and the central banks in a country. Externally, the government can borrow from individuals, banks, international financial institutions and foreign governments. Here, it is necessary to mention that the tue effects of public borrowings will depend upon the sources of borrowed funds to a greater extent. However, we shall brief these different sources of borrowings.

1. Borrowing from Individuals. When individuals purchase government bonds, they are diverting funds from the private use to the government use. In such a case, there is a little direct effect in curtailing either consumption or business investment. In other words, individuals may be able to subscribe to government bonds either through curtailment of current consumption or through diversion of Finds meant for one's own business or diverting funds into government bonds from securities. Generally, sale of government bonds to individuals should not curtail either consumption or business expansion. To a greater extent, these bonds will be absorbed out of funds that would have been lying idle or would have been used to buy other securities. In short, every individual possesses a very small amount to be spent on small project while the government may use the entire amount in building a big project.

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2. Borrowing from Non-Banking Financial Institutions. Borrowing from the Non-Banking Financial institutions is another source of borrowing. They are insurance companies, trusts, savings banks etc. Buying government bonds, these institutions reduce their idle cash balances, when they make investment in government bonds. They prefer government bonds because security is provided by the government and they possess high negotiability and liquidity. The rate of interest paid by the government is relatively low. As a result in, many cases these institutions may prefer high risk and high return securities, especially in the equity shares. However, when the non-banking institutions buy government bonds, they do so to reduce their cash holdings.

3. Borrowing from Commercial Banks. Individuals and non-banking financial institutions take up government bonds out of their own cash funds. But commercial banks can do so by creating additional purchasing power which is popularly known as credit creation. The banking system can make additional loans upto an amount several times as great as the excess cash reserves and required reserves ratio. This credit creation is possible because the loans the bankers make, are typically added to the borrowers account and are, in turn, paid to persons having accounts with other banks. Result of this process is that so long as the cash is not withdrawn from the banks, it serves as the basis for the expansion of loans.

The creation of credit by commercial banks can subscribe to the government loans. The banks need not contract their other loans and advances. The banks whenever have excess cash reserves, they are able to absorb an amount of government bonds greater than the excess cash reveres. Therefore, in this process of creating additional purchasing power, if the banks place it at the disposal of the government to finance the latter's expenditure; pressure of inflation will be generated provided the economy is working at full employment previously.

4. Borrowing from the Central Bank. The central bank of the country can subscribe to government loans. This action is similar to the system of creating purchasing power by the commercial banks. The central banks credit the account of the government by purchasing government bonds. The latter pays to its creditors out of its accounts maintained with the central bank. Those who have received cheques from the government on the central bank will deposit the amount in their banks. Consequently, these banks find themselves with large cash reverses which becomes the basis for additional loans and advances. It must be mentioned here that the borrowing from the central bank is the most expansionary of all the sources for not only the government secures funds for its expenditure but this banking system gets additional cash. This amount can be utilised as the basis for further credit expansion. On the contrary, the borrowings from individuals and financed institutions are merely transfer of funds from private to government use and so, it will not be expansionary in their effect on the economy.

☐ BORROWING FROM EXTERNAL SOURCES

Government may borrow from other countries, apart from borrowing from individuals and financial institutions within the country. The borrowings can be used to finance war expenditure or to [illegible] defence equipment or to pay for the development projects [illegible] pay off adverse balance of payments. In the past, floating of loans for specific projects like railway or dam construction was taken up by individual,

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banking and other financial institutions. But in recent years, two important external sources of government borrowing are prominent as (*i*) international financial institutions like I.M.F. and I.B.R.D. ; the I.D.A. and the I.F.C. These institutions give loans to member countries for a short-term period covering temporary balance of payment difficulties and for long term for development projects ; (*ii*) government assistance from friendly nation which is mainly used for development projects. In modern times, developing countries like India, external source of borrowing has become significant. India has also received massive assistance from the 'Aid India Club'.

CLASSIFICATION OF PUBLIC DEBT

Public debt can be classified into different categories in many ways. The difference arises on account of many factors, such as to the market in which the loans are floated, conditions of repayment, purpose of borrowing for which they are raised etc. Its classification or different forms of public debt have been underlined :

1. Internal and External Debt.
2. Productive and Irredeemable Debt.
3. Redeemable and Irredeemable Debt.
4. Short-term and Long term Debt.
5. Funded and Un-funded Debt.
6. Voluntary and Compulsory Debt.
7. Marketable and Non-marketable Debt.
8. Gross and Net debt.

1. Internal and External Debt. Internal debt refers to the public loans floated within the country while external debt refers to the obligations of a country to foreign government or foreign nationals or foreign internationals. According to *Prof. Dalton "A loan is internal, if subscribed by persons or institutions within the area controlled by the public authority which raises the loan ; external, if subscribed by persons or institutions outside this area."*[4] For instance, in the case of internal loans, the national government borrows from the individuals and institutions within the country. External debt has been defined by Prof. Findlay Shirras as "External debt means the transfer of wealth from the lending to the borrowing exists when the loan is made, and a transfer in the reverse direction when interest periodically paid or when the principal is repaid". For external loans, as presently, Government of India is borrowing from international financial institutions such as World Bank, IMF, friendly foreign governments and from the international markets.

It is, generally, observed that an internal debt is better than external debt as resources remain within the country. In this case, it simply involves the transfer of resources from people to the government and the total resources as a whole remain the same. On the contrary, in the case of external debt, there is transfer of resources from the lending country to the borrowing country and as a result, total resources of the borrowing country initially increase but when external debt is repaid, there would be again shift of resources from the borrowing country to the lending and the resources available with it tend to fall.

There is a prejudiced view against external loans on political grounds by putting the agreement that [illegible] interference in the internal affairs and foreign control

4. H. Dalton, 'Public Finance'.

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on the economy. But this type of view point is incorrect and misleading as it involves the drain of wealth from the country. As the loans are taken from external resources, the native country has to pay a heavy sum of money annually as an interest on the loan. In this way, huge amount goes to the foreingers for nothing. On the other hand, if one country borrows from the domestic market, there is no drain and country's wealth remains within the country. At the same time, it has been noticed that external borrowings have become necessary and desirable in the present circumstances to bring out the cherished goals to promote the economic development. Until this external debt is not properly and productively used, it may cause great hardships to the country by accumulating her debt burden beyond her repaying capacity.

2. Productive and Unproductive Debt. Productive debts are those which are used for projects which yield an income to the government *i.e.*, railway, construction, irrigation schemes, power schemes, establishment of heavy industries like iron and steel, cement and fertilisers etc. In the opinion of Prof. Findlay Shirras, "Productive or reproductive loans are debts which are fully covered by assets of equal or greater value, the source of the interest is the income from the ownership of these as railways and irrigation works." In other words, all public debts are invested in social and economic overheads which are fruitful to the society and further generate the economic growth. Thus, productive debts add to the total productive capacity of the country. Besides, the principal and the interest, both are repaid out of the income derived from the various projects in which the public debt has been invested. In short, productive debt should not be considered as a burden on the government as well as tax payers.

Unproductive debts, on the other side, are those which do not yield any income. To quote Findlay Shirras, "Dead weight or unproductive debts are those which have no existing assets". Actually, such debts do not add to the productive capacity of the country. For example, debts raised to finance war is unproductive. Similarly, debts incurred to provide famine relief or drought are considered as unproductive. This is the reason that this debt is known as a 'dead- weight debt'.

3. Redeemable and Irredeemable Debt. Redeemable debts refer to those loans which the government promises to pay off at some future date. As against this irredeemable debts are of those principal amount which are never returned by the government although it pays the interest thereon regularly. Therefore, the difference between the two kinds of debts is that when a loan is redeemable, the government has to make some arrangements for its repayment. Money has to be arranged for this purpose. If it is decided to pay it off from tax money, fresh taxes have to be imposed. Under these circumstances, it is not wise to go on borrowing without paying off debt little by little. Such a policy would plunge the state into heavy and deep growing public debt. It would also result mounting of interest burden and raising heavy taxation on the tax-payers. Hence, redeemable debt seem to be reasonable and preferable to irredeemable debts on the ground of sound finance and convenient method of payment.

4. Short-term and Long-term Debt. Short-term debt may be called which may mature within a period of three to nine months. They are like treasury bills and advances from the central banks. Interest on such repayable amount are generally low. On the contrary, long-term debts are repayable in a long period say, roughly after ten years or more. Usually such types of debts bear a higher rate of

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interest. Similarly, in between short-term debts and long-term debts, there is a medium-term debt also.

5. Funded and Unfunded Debt. Funded debts are long-term debts which are repayable after a year at least or are not redeemable at all. In other words, it is a kind of definite period debt. A proper agreement of repayment is made. Moreover, a fund is maintained by the government to secure the money and to pay it back. According to Prof. Findlay Shirras, "Funded debt is a debt which is repayable at a distant date and for the payment of interest on which regular provision is made."

Unfunded debts-on the contrary, are those that are paid off within a year. Treasury bonds are unfunded debt because they are for three to six months and are never for a longer period of one year. Generally, unfunded debts are incurred for the purposes of filling the temporary gaps in the budgets. This is because the rate of interest on such loans is lower than that on funded debts. Thus, government prefers to go for unfunded loans to meet the requirements of lenders. Such loans are always in anticipation of public earnings.

6. Voluntary and Compulsory Debt. Voluntary Debt is a debt which is paid without any legal enforcement. However, it means when the people voluntarily and willingly subscribe to government loans. Actually, they are subscribed to the government by the people at their own accord, ability, will and convenience. Compulsory debt, however, implies force. But they are most unpopular in modern democratic society. *Prof Dalton* has also observed that "a compulsory or a forced loan is a rarity in modern public finance since it combines the disadvantages, while lacking the advantages of both tax and a voluntary loan".

Sometimes, a public loan may be compulsory *e.g.*, during a war or other emergency or for some great national purpose. During the period of emergency, people have no interest to buy the government bonds as the faith in the stability of government has shaken. Thus, pressure of one kind or another is used by the government to sell its bonds. But, it is seldom in the present public finance system.

7. Marketable and Non-marketable Debt. The distinction between marketable and non-marketable debt basically depends on the negotiability of government loans between interest bearing and non-interest bearing loans. In other words, marketable debt is one in which the securities are negotiable in the open market while non-marketable debt is that where securities cannot be sold in the stock exchange markets. Its main objective is to prevent fluctuations in their prices.

8. Gross and Net Debt. Gross debt consists of the total amount of debt outstanding at any time whereas net debt is the balance amount of gross debt minus sinking funds or other assets ear marked for repayment of debt.

6 DANGERS OF PUBLIC DEBT

Public debt is not always blessing. Excessive use of it creates a lot of monetary crises in the economy. Adam Smith opposed any use of public debt. Expressing his view point, he writes, "Public debt leads to extravagance, encouraged resort to war and induced generally disadvantageous economic conditions for the nation which employed it". Similarly, C.E. Bastable observed, *"A nation cannot, any more than an individual, depend continually to its liabilities without at least coming to the end of its resources."* Therefore, public debt has been considered hazardous for the

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5. C.E. Bastable, 'Public Finance'.

economy. It is no longer a cake eating feast but rather a careful and efficient brain to handle the management of the public debt. Prof. Findlay Shirras opines, "Government must remember that borrowing is not a short cut to prosperity and a policy of borrowing must be retreated except for what can reasonably be regarded as productive expenditure." However, the dangers of public debt are undermentioned :

1. Extravagance. Public debt, generally, is considered as an easy money which leads to reckless borrowings. This provides incentives to the governments to implement those schemes also which require abundant expenditures. The temptation of over. Borrow always offers dangerous results like bankrupty or repudiation of debts.

2. Loans for Unproductive Purposes. It has been observed that governments find no difficulty in borrowings and this makes the brighter chances of unproductive loans whose burden falls on the common masses of the society. Excessive expenditure on war and armaments are the good examples of such loans.

3. It hampers the Economic Development of a Country. Though loans are easily borrowed but it is exclusively difficult to repay with interest. Generally, government taxes more and more to repay the debt and this raises the unnecessary burden on the tax-payers. This brings instability in the economy which in turn hampers the economic development of the country.

4. Adverse Effects on Production and Distribution. Unproductive public loans have become a permanent feature of burden on the economy which leads to unfavourable effect on production and distribution of the country.

5. Challenge to the Political Freedom. Foreign loans and assistance gives the clear cut evidence of diplomatic motives behind it. Instead of promoting international peace and understanding, it leads to deep conflict among countries. The friction, further challenges the political freedom. Thus it sows the seeds of hatred and national independence ruins.

6. Flow of National Wealth. Foreign loans result in the drain of wealth out of the country.

The study of the disadvantages of public debt, sometimes suggests that neither dependence nor ignoring it is good. It has a mixed blessing. Even then, it is agreed that government should not resort to it and public expenditure should primarily be met through taxation. In other words, government should borrow only when it is a must.

☐ LIMIT OF PUBLIC DEBT

Q5 **EFFECTS OF PUBLIC DEBT**

Public debt operations like taxation and public expenditure involve the transfer of purchasing power from one section of the society to another. According to Prof. *Dalton,* "When the government floats a loan, money is transferred from the purchasers of government securities to government and finally to those on whom the government spends this money. When the interest on the public debt is paid, it is merely the transfer of purchasing power from those who are taxed for this purpose to the holder of securities and when the public debt is repaid, there is another transfer of purchasing power. In modern times, it is generally accepted that taxation and borrowing can be utilised for either type of expenditure depending upon the circumstances. The economic effects of the government expenditure which is financed by public borrowings are different from the effects of similar expenditure financed by taxation as (*a*) The wealth of tax-payers is curtailed by taxation and loans do not reduce the wealth of the lenders but it merely changes its form. (*b*) The funds are transferred from public to the government compulsory in case of taxation but under borrowing such a transfer of funds is voluntary.

We can divide the effects of public debt on the economy in the following two categories :

1. Revenue effects of public debt.
2. Expenditure effect of public debt.

Firstly, the people have to change their budgets, if the money is raised by means of loan. It may not reduce the consumption expenditure directly as in case of taxation because it is not out of current incomes but out of past savings. It is generally seen that public loans are purchased by the people but it is sure that raising of

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On the other hand, the benefits conferred on people by the expenditure of the money raised by public loans have another kind of effect on the economy. It is not essential that the benefits are always different from those conferred by spending the money raised by taxes, provided the borrowed money is utilised for the same purpose as the money raised by taxes itself. Here, it must be remembered that the effect of public debt basically depends upon the purpose for which debt is taken, the terms and conditions at which the debt is floated, sources of borrowings, types of loans, volume of public debt and interest rates etc. Let us briefly explain the effects of public debt on consumption, production, distribution and other sectors of the economy.

(*i*) Effects of Consumption

Consumption of the individuals has been greatly affected by the public debt. Although, it is assumed that people purchase securities out of their past savings but it is not always necessary. It can be possible that people buy government securities by curtailing their expenditure on current consumption. In this way, consumption is affected in the same manner as it is affected by taxes. But when the people buy government securities out of their past saving, it has limited effects. This has no direct effect on the present expenditure of the people. Generally, motivation to save through bonds and securities of small amounts keep the people away from spending more and more on consumption and as a result of those people reduce their consumption or cuts its size. They realise the additional feelings of security. Consequently, the net effect of public debt is to increase the percentage of total income spent on consumption and further an expansionary effect on the economy.

(*ii*) Effect on Investment

Public debt may also affect adversely the incentive of investment. The commercial banks have excess cash reserves. So the sale of bonds to these banks increases the purchasing power through credit creation. Hence, it should not curtail its investment. On the contrary, the sale of these bonds to the individuals reduces the funds which they have kept for the expansion of their own business activities. There will be no adverse effect if the individuals purchase these bonds out of their surplus funds. However, there is an indirect effect of the public debt. The growth of public debt may give rise to the fear of increased taxes on future. If the people feel that the public debt may result in higher taxes in future, the profitability of investment in the long-run will appear to be less.

(*iii*) Effect on Production

Public debt affects the production if it is taken in enormous forms. There is hardly any significant effect if the size of public debt is small. People purchase securities out of their surplus income and it does not affect the capital used for investments. But if the public debt is big in size, it will affect the production because its payment is made by diverting capital for the private investments. Such purchase of government securities reduces the private capital which in turn checks the economic development. The government imposes heavy taxes for the repayment of such heavy public debts. It affects the people's willingness to work. Besides, the existence of huge debts creates the fear of the imposition of levies or even repudia-
ion of debt. In [illegible] adversely affect the people's desire to work and
hus [illegible] effects of public debt must consider the effects

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of the expenditure of borrowed money as state is mostly guided by the larger interest of the society as a whole. Therefore, when public borrowing is utilised to meet current deficits or war expenditure, it causes diversions which reduce production.

(iv) Effect on Distribution

Public borrowing leads to transfer of purchasing power from one section of the society to another. Generally, rich section of the society purchases government securities, but the burden of tax falls upon the common people *i.e.* poor people. Thus, public bororwings increase the inequalities of income and public debt adversely affects the distribution of income. If the bond-purchasers and the tax-payers are the same persons, the redistribution of income will not occur thus, increasing the gap of inequalities of income. Prof. *Dalton* calls it direct real burden. Its effect can also be assessed by the way in which the public debt is used. If the money borrowed is spent on the welfare schemes of poor people, it will decrease the inequality of income and it will ensure equal distribution of income among different sections of the society. But on the contrary, if the public borrowings and spending create inflation, its favorable effects on distribution of income can be neutralised due to rise in prices. To quote Prof. Findlay Shirras,"It is sometimes said that public debts tend to make permanent differences between the interest receiving and the interest paying classes and in this respect are open to social objective."

(v) Effect on National Income

Public debt will have very mild effect on the economy under usual circumstances while the net effect of a programme of government expenditure financed by borrowing is almost liable to be expansionary. This effect will be more expansionary than that arising from the financing of the same expenditure by taxation. This carries no adverse effect of borrowings on consumption and investment. In other words, when investment is reduced, it relatively reduces output of capital goods. On the contrary, if government expenditure is incurred on capital goods, it provides incentives for accelerated production and it gives rise to national income. Further, if the government bonds are purchased by central bank, and the commercial banks, the borrowing and the expenditure of the borrowed funds will have a considerable expansionary effect in the economy.

(vi) Effect on Resource Allocation

The public debt unlike tax finance, has little effect on resource allocation. To a greater extent, public borrowing curtail business investment activities while decline of investment varies from one industry to another. In this way, allocation of resource are not much affected by the manner of financing these units.

(vii) Effect on Liquidity

Public debt is generally represented by bonds which are highly negotiable. Therefore, those people who hold bonds possess highly liquidity form of assets. These assets (bonds) can easily be converted into cash whenever any individual needs more funds for any purpose of transactions, precautionary and speculative motives. So, public debt is responsible for the existence of highly liquid form of assets. Further more, another important effect of the highly liquid government bonds can [illegible] of commercial central banks. In times of inflation,

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the central bank attempts to adopt various devices like bank rate, open market operations to restrict the commercial banks to reduce their credit expansion. However, it must be noted here that commercial banks can increase the cash/reserves through disposing of their government bonds.

(*viii*) Effect on Private Sector

All public expenditures increase the level of demand for the goods produced by the private enterprises as every unit of money spent raises the purchasing power of the people. It puts more money into circulation. However, when this type of public expenditure is financed through taxes, current consumption is reduced but on the other hand, when it is financed through public borrowings, current consumption is not reduced because idle savings are utilised in purchasing of bonds. Therefore, if the government uses the public borrowings in purchasing of goods and services produced by the public sector enterprises, the demand for goods in private sector may increase to the extent that government spends borrowed funds for purchasing of these goods and services.

Similarly, if the borrowed money is utilised on salaries and wages of the government officials, it may further increase their purchasing power enlarging its demand for goods produced by the private sector enterprises without affecting the supply of the goods and services. In this way, the effect of expenditure of borrowed funds is considered favourable.

(*ix*) Effect on the Working of the Money Market

Public debt affects the money market when the demand for money in private sector is on the higher side and the state government fixes higher interest and vice-versa. Therefore, there is a severe competition with the private investors if the government borrows from the general public. This is because total available supply of investment funds increases in the market. On the other side, if government borrows from the banks, there are chances to give rise to currency expansion.

(*x*) Effect of External Debt

Usually, in the case of internal debt. there is not much deeper effect on the economy as repayment of loans or payment of interest only involves a transfer of purchasing power from one set of people to another within the country. But external bororwings and loans have favourable as well as unfavourable effect on the economy as a whole. If external borrowing has been used for productive purpose, it will help to build capacity for accelerating the rate of growth of the economy. Again, if external loans supplement the national resources and make possible higher rate of investment, it does not cause may difficulties. Rather it would lead to increase the output and in turn raise the standard of living. In short, increase of external indebtedness and other liabilities do not create problems for borrowers, if it is properly utilised for raising the productivity. Its capacity to serve the debt is linked with the performance of the economy as a whole which in turn depends upon the increase in per capita production.

CONCLUSION

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Unit III

REDEMPTION OF PUBLIC DEBT

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Redemption of public debt mean repayment of a debt. Public debt is to be repayed by the government with the time fixed for its repayment just as the private individual or organisation has to repay the loan. It is better for the government to clear the debt as soon as possible because mounting public debt has a demoralising effect on the people apart from the fact that public debt is subject to higher rates of taxation. Therefore, the government in any case, should pay the interest on the loan although in some cases the principal amount is not repaid. If the government fails to honour its promise *i.e.* not paying the interest, its creditworthiness will be lost and it would not be in a position to raise new loans when circumstances warranted.

There are different methods used by a government to redeem its debt. Some methods are extreme ones such as repudiation of debt, while others may not be redeemed at all but payment of debt with the help of floating another debt. Thus, various methods of redemption of public debt which are commonly adopted are explained as follows :

1. Repudiation of Debt. It is the easiest way for the government to get rid of the burden of payment of a loan. Similarly, it means that the government refuses to pay

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the interest as well as the principal. In such cases, government do not recognise its obligation to pay the loan. It is certainly not paying off a loan but destroying it. In a normal case, government does not do so as it is obvious that the government will shake its confidence among the people and also in the eyes of other nations. It also creates other problems that is, the government faces the difficulty in getting new loans. So in normal circumstances, a government does not want to reduciate its debt. But in extreme circumstances, a government may be forced to repudiate its internal or external debt obligations. Internally, it happens when the country is facing financial ruin, bankruptcy or change in political set up. Externally, when the government is facing the shortage of foreign exchange. If it is repudiated, this may bring social revolution, economic blockade and military action. This process is very dangerous. Debt repudiation is not popular in modern age. This practice was only adopted by U.S.A. after the civil war and the U.S.S.R. after the revolution. Repudiation is the most extreme method of redeeming debt. This type of policy should be avoided at all costs.

2. Conversion of Loans. Conversion of loans is another method of redemption of public debt. It means that an old loan is converted into a new loan. Under this system, a high interest public debt is converted into a low interest public debt. In this system, when the rate of interest in the market falls, the government gives notice to the lenders to take their money back, so they are compelled to accept the lower rate of interest. The government borrows more money to pay such debts at low rate of interest and pay to the lenders. In this way, the debt is not liquidated for ever but high burden is replaced by a low burden debt. A decline in the rate of interest helps the government to some extent because the burden of debt is reduced. It also helps the tax-payers as they have to pay low rate of interest on their debt. This method is held just to reduce the interest by conversion of public debt, as it helps the lender either to take money back or to get renewed at low rate of interest. In this way, conversion of a loan is always done through the floating of a new loan. Thus, the volume of public debt is not reduced. Prof. Dalton felt that debt conversion does relax the debt burden. However, a few important points should be kept in mind. They are (1) Conversion should be simple one. (2) Conversion may not increase the capital amount of public debt. (3) Close eye should be kept on rate of interest.

3. Utilization of Budgetary Surplus. When the government earns a surplus in the budget, it must be utilised for paying the debt. Surplus occurs when public reserve exceeds the public expenditure. But this method is rarely found. Generally, the government employs the budget surplus to purchase its own bonds from the market and securities from the people. This results in an automatic liquidation of its debt liability.

4. Terminal Annuity. In this method, government pays off the public debt on the basis of terminal annuity into equal annual instalments including interest alongwith principal amount. This is the easiest way of paying off the public debt. With the passage of time, burden of debt goes on decreasing and at the time of maturity, most of the amount is paid off. This method is almost similar to the sinking fund.

5. Refunding. It implies to issue of new bonds and securities by the government in order to repay the matured loans. It is, thus, a process of replacing maturing securities with new ones. In some cases, bonds may be redeemed before the maturity date, when the government intends to rearrange the maturity of outstanding debts

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or when the current rate of interest is low. Generally, short term borrowings are made in anticipation of tax collection to meet current expenditure on long-term borrowing. But the excessive burden of new expenditure does not permit the retirement of the debt by means of revenue newly raised or by means of the long-term borrowing. Thus, it raises the necessity for refunding the loans by old lenders and renewing the loans at lower interest rates for future period. Usually, this method is resorted to at such a time when the burden is too heavy on the government and it is not in a position to raise funds from other sources.

This method posseses the major drawback as government is tempted to postpone its obligation of debt redemption. This leads to continuous increase in burden in future.

6. Compulsory Reduction in Rate of Interest. Another method of debt redemption is the compulsory reduction in rate of interest. During the period of financial crisis, rate of interest is unilaterally reduced on the basis of compulsion. This method is not possible to adopt in the ordinary circumstances of the country.

7. Additional Provision of Taxation. Generally, new taxes are imposed to collect the revenue. These funds can be utilised to repay the loans as well as interest. With this method, redistribution of income can easily be transferred from tax payers to the hands of bond-holders.

8. Sinking Fund. First of all, this method was established by Huge Walpole in England. Soon the practice was adopted by different countries. This method is the most systematic and best method of repaying public debt. It is used by almost all the governments of the world. In this system, the government establishes a separate fund known as *'sinking fund'*. A fixed amount of money is credited by the government to this fund. So by the time, the debt matures, the fund accumulates enough amount to pay off not only the principal amount of the debt but also the interest on the loan as well.

Sinking fund is of two types as (*a*) Certain Sinking Fund, and (*b*) Uncertain Sinking Fund. A 'Certain Sinking Fund' is one in which the government credits a fixed sum of money annually. 'Uncertain Sinking Fund', on the other hand, is one in which the amount is credited, when the government secures a surplus in the budget. There is one danger of this method *i.e.* a government who is in need of money, may not have the practice to wait till the end of the period of maturity but may utilise the fund for the purpose other than the one for which originally the sinking fund was instituted.

In modern times, the sinking funds are not accumulated. But some funds are kept every year for repayment of some part of the debt in the same year. The amount is not put in a fund allowed to be accumulated but is used every year either to pay off the bonds which are maturing or to buy off bonds from the market. In short, sinking fund is a slow method of debt redemption. Thus, Dalton prefers capital levy. He also prefers that sinking fund should be made from current revenue of the government and not out of loans.

9. Capital Levy : This method has been the most controversial method of debt repayment. Capital levy provides for imposing "all at once" tax on all the capital value possessions of the people. All capital goods are taxed above the capital possessions of minimum limit of value. This method has been suggested by economists Ricardo, Pigou to levy the capital to pay heavy debts taken during the time of war and other emergencies. According to *Prof. Ricardo*, "A country which has ac-

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