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Public Debt

INTRODUCTION:

Public debt refers to the borrowings of the government when public expenditure is more than its revenue, the government resorts to borrowings. Public debt has emerged as an important instrument of fiscal policy in recent times. The main instruments of public debt are bonds, securities small savings, treasury bills and long term capital bonds. Public debt may be from internal sources or external sources. In modern times public debt is considered as one of the important sources of resource mobilisation as it has certain merits namely (1) It is the quickest method to mobilise funds. (2) It helps to absorb the surplus funds in the economy during inflation. (3) By using the funds productively economic growth can be accelerated. The advantages induce the modern governments to resort to public debt often. While mobilising funds through public debt the government should take care to avoid use of it for unproductive purposes and the governments should be able to maintain a stable rate of interest. Moreover, public debt involves the repayment of principal amount and interest. Hence it involves financial burden and should be kept within limits.

TYPES OF PUBLIC DEBT:

Public debt is of various types. The major ones are as follows:

(1) **Internal Debt and External Debt:** Public debt which is mobilised within the country is called internal debt. It is in terms of the local currency. It is flexible and can be adjusted according to the requirements of the economy. It can be voluntary or compulsory. External debt on the other hand refers to the loans raised from outside sources. It can be from foreign governments or international institutions. It has to be paid in terms of foreign currency. Often external loans are conditional, while internal loans are certain, external loans are uncertain. Hence it is very difficult to estimate precisely. In the case of internal loans there is diversion of resources from one section to the other while in the case of external loans, there will be addition to the foreign exchange resources at the time of borrowing and there will be depletion of

resources at the time of repayment as the principal amount has to be repaid along with interest.

(2) **Productive and Unproductive Debt:** Loans which are mobilised by the government for productive purposes like development of industry, agriculture, infrastructure etc. are called as productive debt. Such projects will yield substantial revenue to the government and hence repayment of debt will not be burdensome. Such loans are self financing or self liquidating in nature. It is not necessary for the government to levy additional taxes to repay such public debt. Debts which do not result in the creation of additional assets to the economy are termed as unproductive debt. For instance loans raised for the purpose of waging a war or for incurring regular administrative expenditure are said to be unproductive. Such loans are not self financing in nature. Hence additional taxes have to be levied for repayment of such loans.

(3) **Compulsory and Voluntary Debt:** Those debts which are raised by the government through coercion are known as compulsory debts and those which are voluntarily contributed by the people are termed as voluntary debt.

(4) **Funded and Unfunded Debt:** Funded debts consist of securities which can be marketed in the stock exchange. It is a long term debt while the payment of interest is certain, repayment of principal amount is left to the discretion of the government. In the case of unfunded debt, the loan has to be paid back along with interest at the time of maturity. It is short term debt mobilised by the government to meet its temporary deficit.

(5) **Short Term, Medium Term and Long Term Debt:** On the basis of the time period, public debts are classified into short term, medium term and long term debt. While short term debts are for a period of less than a year, a medium term loans are for period of one to five years. Long term debts are for a longer period of time. Long term loans are generally mobilised by the government for developmental purposes.

(6) **Redeemable and Irredeemable Debt:** On the basis of the repayment criterion loans are classified as redeemable and irredeemable. Redeemable loans are those in which date of repayment is specified. Irredeemable loans are those in which the date of maturity is not specified. While the government specifies the payment of interest here, it does not indicate the repayment of the principal amount. Redeemable loans are preferable to irredeemable loans as they involve certainty and convenience.

PUBLIC DEBT AND FISCAL SOLVENCY:

Modern governments are welfare governments. They perform a variety of functions to promote general welfare. To discharge their functions effectively, the government needs substantial resources. Public debt is one of the important sources for the government. Over a period of time, public borrowing has increased considerably. Along with the volume of public borrowing, servicing of public debt has also increased significantly. It is necessary for the government to have an effective public debt management mechanism. The government should repay its public debt at regular intervals to reduce its burden. Fiscal solvency refers to the ability of the government to repay its debt on maturity. If the government is solvent, repayment of debt is not burdensome. Fiscal solvency enables the government to mobilise funds easily. Securing loans at low rate of interest, early redemption, using the loans for productive purposes so that they become self-liquidating in nature etc. are sound policies of public debt management. By redeeming public debt on time, the government can retain the confidence of the lenders and public which will help the government to tap this source more effectively in future. The various methods of debt redemption are as follows:

METHODS OF DEBT REDEMPTION:

(1) **Refunding:** It refers to the method of repaying the old debt through new loans. Generally, long term securities are issued in the place of short term securities. Simply it implies extending the date of maturity. This method does not ensure

reduction in the burden of public debt. On the contrary, there is a possibility of an increase in public debt burden.

(2) Sinking Fund: Creation of a sinking fund is said to be the most systematic and scientific way of redeeming public debt. It implies the creation of a fund for repayment of public debt. Under this method, a part of the current revenue will be set aside every year and will be accumulated to repay public debt over a period of time. Once such a fund is created by the government, it is not necessary to impose new taxes for redemption of public debt. Sometimes, this fund may be used by the government to meet emergencies. They set aside a part of the current revenue for repayment of debt in the same year. Though this method is a slow process of debt redemption, economists consider this as the best method.

(3) Conversion: This method is adopted by the government at the time of maturity of a loan or just before maturity. Under this, the government converts the existing loans into new loans. It resorts to this method whenever the government faces the problem of shortage of funds and when the rate of interest fluctuates. The government might have borrowed at a time when the interest rates were high. When the interest rates fall, the government will convert the old loans into new ones. Such conversion help the government to reduce the interest burden. In real sense conversion is not redemption. It is simply exchange of one loan for the other.

(4) Additional Taxation: Modern governments impose additional taxes to redeem public debt. It imposes an additional burden on tax payers. Moreover, resources will be transferred from the tax payers to bond-holders and the burden on the tax payers may be more.

(5) Surplus Budget: Surplus budget is also used to redeem public debt. Surplus budget refers to the budget in which the income of the country is more than its expenditure. To have a surplus budget, government may impose heavy taxes which involves additional burden on the people. In recent times, governments rarely have surplus budgets. The ever increasing public expenditure always results in a deficit

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QUESTIONS

Define the following:

(a) Public debt. ***(BAF, Oct. 17)***
(b) Productive public debt.
(c) Redeemable public debt.
(d) Funded public debt.
(e) Capital levy.
(f) Unfunded public debt.
(g) Sinking fund.
(h) Fiscal Solvency

Multiple Choice Questions:

(a) External debt implies borrowing from ________. ***(BAF, Oct. 17)***
   (i) Individuals
   (ii) Firms
   (iii) Foreign countries
   (iv) None of the above

[Ans.: (a) foreign countries]

Fill in the blanks:

(a) Debt mobilised from external sources is called ________ debt.
(b) Loans in which repayment of principal amount is not fixed is called ________.
(c) ________ is a one-time tax levied for debt redemption.
(d) ________ budget is used for repayment of debt.

*[Ans.: **(a)** external **(b)** irredeemable **(c)** Capital levy **(d)** Surplus]*

State whether the following statements are true or false:

(a) Productive debts are self-liquidating.
(b) External public debt by and large is conditional.

(c) All public debts are compulsory and burdensome.

(d) Sinking fund creation helps in effective debt repayment.

(e) Public debt is redeemed during inflation.

***[Ans.: (a)** True **(b)** True **(c)** False **(d)** True **(e)** False]*

Match the following:

(A)	(B)
(1) Public debt ***(BBI, April 18)***	**(a)** Foreign exchange
(2) Capital levy	**(b)** Borrowing of the government
(3) Fiscal solvency	**(c)** Very high tax on wealth
(4) External loans	**(d)** Ability to repay public debt

***[Ans.:** (1 - b); (2 - c); (3 - d); (4 - a)]*

(2) Define public debt. Explain the different types of public debt.

(3) Explain the classification of public debt. ***(BAF, April 18)***

(4) What are the various types of public debt? ***(BIM, April 18)***

(5) Explain the methods of debt redemption.

(6) Discuss the burden of internal and external public debt.

(7) Explain the burden of public debt. ***(BBI, April 18)***

(8) Explain the burden of internal public debt. ***(BAF, Oct. 17)***

(9) **Write short notes on:**

(a) Internal and external debt.

(b) Burden of public debt.

(c) Extent of debt burden. ***(BFM, April 18)***