Public Debt

Public debt refers to borrowing by a government from within the country or from abroad, from private individuals or association of individuals or from banking and NBFIs.

Classification of Public Debt

(a) **Internal and External:** When a state finds that it is not possible to obtain further money by taxation, it resorts to borrowing from citizens and financial institutions within the country. This is 'internal borrowing'. The state may accumulate funds by raising short-term loans or long-term loans or by both. If the state is passing through a very critical period, then it can borrow all the money which the nation saves. In that case trade and industry will suffer a lot because no money is left to finance them. In the normal period, however, the state can borrow only surplus funds which are left with the businessmen after meeting all the needs of the business.

External loan is that which is raised from international money markets, foreign governments, and from international agencies like International Monetary Fund. When a state is in need of money, it tries to get as much loan as it can from other states. The foreign governments do not advance loans without a limit. They minutely study the budgetary position of the borrowing country, the tax-bearing capacity of the nation, the per-capita income of the people and the purpose for which the loan is desired. If the position of the budget is sound and the taxable capacity of the nation is high, then a foreign government may advance sizable loan to the borrowing country.

(b) **Productive and Unproductive:** The debt that is expected to create assets which will yield income sufficient to pay the principal amount and the interest on it, is known as 'productive debt'. In other words, they are expected pay their way; they are self-liquidating. J.L. Hanson has referred such a debt as 'reproductive debt'.

On the other hand, unproductive debt is the debt that is raised for financing unproductive assets or heavy unproductive expenditures. Such a debt is a deadweight debt. Debt invested on wars or prevention of war is a deadweight debt.

(c) **Short-term and Long-term:** The loans that are repayable within a period of one year, they are termed as 'short-term loans' and if they are taken for more than one year, they are referred to as 'long-term loans'. Following are the reasons for raising short-term loans:

1. If, at any time, the expenditure of the government exceeds the revenue, then she takes recourse to short-term borrowing.
2. If, at any time, the rate of interest in the market is very high and the government is in need of large fund to finance her various projects, then it

raises loan for a short-period of time only and waits till the prevailing high rate of interest comes down.

3. The commercial banks find a very safe and profitable opportunity to invest their surplus funds in the government short-term loans.

If the government is in need of large funds and the short-term loans are not enough, then she takes recourse to long-term borrowing. Long-term loans entail following advantages:

1. Long-term loan provides an opportunity to the state in undertaking large projects like construction of canals, hydroelectric projects, buildings, highways, etc. As these loans are not to be repaid at a short notice, so the government safely spends them on productive projects.
2. Long-term loans are also unavoidable for strengthening country's defence.
3. Long-term loans provide good opportunity for commercial banks and insurance companies to invest their surplus funds. As the rate of interest on long-term loans is higher than on the short-term loans.
4. Long-term loans can be repaid by the government by the time which is favourable or convenient to her. She can also convert these loans at a lower rate of interest later on.
5. If at any time, the rate of interest is low, the government can contract a long-term loan and with the amount thus raised some public work programmes at lower cost.

Causes of Increase in Public Debt

1. War or war-preparedness, including nuclear programmes
2. To cover the budget deficits on current account
3. To undertake public welfare schemes
4. Urge for economic growth
5. Inefficiencies of public organisations and corruption

Purposes of Public Debt

1. Bringing gap between revenue and expenditure through temporary loans from central bank. In Pakistan, the Government issues what are called 'Treasury Bills' which are repayable within one year.
2. To reduce depression in the economy and financing public works programme.
3. To curb inflation by withdrawing the purchasing power from the public.
4. Financing economic development esp. in under-developed countries.
5. Financing the public sector for expanding and strengthening the public enterprises.
6. War, arms and ammunition financing.

Methods of Debt Redemption

1. **Utilisation of surplus revenue:** This is an old method and badly out of tune with the modern conditions. Budget surplus is not a common phenomenon. Even

when there is a surplus, it cannot be used for making any substantial reduction in the public debt.

2. **Purchase of government bonds:** The government may buy her own stocks in the market, thus wiping off its obligation to that extent. This may be done by the application of surplus revenues or by borrowing at low rates, if the conditions are favourable.

3. **Terminable annuities:** When it is intended completely to wipe off a permanent debt, it may be arranged to pay the creditors a certain fixed amount for a number of years. These annual payments are called 'annuities'. It will appear that, during the time these annuities are being paid, there will be much greater strain on the government finances than when only interest has to be paid.

4. **Conversion of high-interest-rated loans to low-interest-rated loans:** A government may have borrowed when the rate of interest was high. Now, if the rate of interest falls, it can convert a high-rated loan into a low-rated one.

5. **Sinking fund:** This is the most important method. A fund is created for the repayment of every loan by setting aside a certain amount every year out of the current revenue. The sum to be set aside is so calculated that over a certain period, the total sum accumulated, together with the interest thereon, is enough to pay off the loan.

Burden of Public Debt

If the debt is taken for productive purposes, for e.g., for irrigation, transportation, railway, roads, information technology, human skill development, etc., it will not mean any burden. Infact, they will confer a benefit. But if the debt is unproductive it will impose both money burden and real burden on the economy.

(a) Burden of internal debt: Internal debt involves a series of transfers of wealth within the country, i.e., from lender to government and then later on at the time of redemption from government to lender. Money is thus transferred from one section of the community to other sections. In this case the money burden on the economy is zero.

But there may be real burden on the community. In order to repay the interest and the principal amount of the debt, the government has to levy taxes. What the taxpayers pay the lenders receive. The lenders are generally rich people and tax burden is fall on poor especially in the case of indirect taxes. The net result may be that the wealth is transferred from poor to rich. This is the loss of economic welfare.

(b) Burden of external debt: External debt also involves a series of transfer of wealth from the foreign lender to the borrowing country, and when it is repaid the transfer is in the opposite direction. As the borrowing country paid interest to the foreign lenders, a direct money burden is fall on the whole community.

The community is also suffered from real burden of external debts. Government has to cover the amount of interest to be paid to the foreign lender by heavily taxing the income of the community. As a result the production, consumption and distribution of income is badly affected. Moreover, the foreign lender has direct involvement in the economic activities of the country.

Role of Public Borrowing in a Developing Economy

1. Taxation should cover at least current expenditure on normal government services and borrowing should resort to finance government expenditure which results in creation of capital assets.
2. Public borrowing for financing productive investment generates additional productive capacity in the economy
3. It is used as an instrument to mobilise resources which would otherwise hoarded in real estate or jewellery
4. It provides the people opportunities to hold their wealth in the form of safe and stable income-yielding assets, i.e., government bonds
5. The management of public debt is used as a method to influence the structure of interest rates.
6. Public has become a powerful tool of developmental monetary policy
7. There are two ways in which the governments of under-developed countries raise resources through public loans:
    a. Market borrowing, i.e., sales to the public of government bonds (long-term) and treasury bills (short-term) in the capital market
    b. Non-market borrowing, i.e., issue to the public of debt which is not negotiable and is not exchange in the capital market, for e.g., National Saving Certificates
8. There are two forms of loans, i.e., voluntary and forced loans. Forced loans or compulsory borrowing is a compromise between taxation and borrowing. Like a tax it is a compulsory contribution to the government but like a loan, it is to be repaid with interest.

Difficulties of Public Borrowings in UDCs

1. In UDCs there are no or very small organised capital and money markets. The resources are too inadequate to fulfil the capital needs of the economy.
2. Resources are hoarded in non-productive sections of the economy, for e.g., real estate jewellery.
3. The savings in rural areas cannot be mobilised effectively because rural incomes do not move through monetary channels
4. The response to government securities is also poor because of rising prices.

Effects of Public Debt on Production, Consumption, Distribution and Level of Income and Employment

1. **Effects on Production:** Public debts are raised to finance productive enterprises of various kinds, e.g., steel works, cement, multipurpose projects, construction of ships, railway lines and highways, heavy electrical and engineering works, mining, oil refining, etc.

2. **Effects on Consumption:** When people subscribe to government loans, they generally have to curtail consumption. Since investment of funds raised by borrowing raises the level of employment and as a result raises the level of consumption.
3. **Effects on Distribution:** Public loans transfer money from rich to government. The fiscal operations of the government are to benefit the poor primarily. The incomes of the poor increase directly through increased employment or it benefits them in directly through the enlargement of social services.
4. **Effects on the Level of Income and Employment:** In modern times, public borrowing is resorted to in order to raise funds for financing agriculture, industry, mining, transportation, communication, etc. It increases employment opportunities, the level of income and standard of living.

Hicks' Classification of Public Debts

1. **Deadweight Debt:** Deadweight debt is one which is not covered by any real assets. In the words of Hicks: "Deadweight is that which is incurred in consequences of expenditures which in no way increase the productive power of the community, yielding neither money revenue nor a future flow or utilities." The loan raised during war period is a deadweight debt because for such debts no real assets exist to balance them.
2. **Passive Debt:** Sometimes government raises loans for spending on such projects which neither yield money income nor help in raising the productivity of the country. They simply provide enjoyments to the citizens such as public parks, museums, public buildings, etc.
3. **Active Debt:** Active debt is one which is spent on those projects that directly help in yielding money income and increasing the productive power of the community.

Hanson's Classification of Public Debt

J.L. Hanson has classified public debt into four main classes:

1. **Reproductive Debt:** When a debt has assets to balance it, it is called reproductive debt. For instance, if a state borrows money for spending it on the construction of canals, railways, factories, etc, it is then able to repay the loan from these self-liquidating projects.
2. **Deadweight Debt:** A debt which is not covered by any real assets is called deadweight debt. Debt invested on wars or prevention of war is a deadweight debt.
3. **Funded Debt:** Funded debts are long-term debts. The government continues paying the annual interest on such loans but makes no promise to pay the principal sum to the lender on any specified date. The examples of funded debts are long-term government stocks, war loans and console.
4. **Floating or Unfunded Debt:** Floating or unfunded debt comprises of short-term loans. It is payable to the lender with interest on or before a fixed date.