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LESSON NO. 1.1

PUBLIC DEBT

I. Introduction
II. Objectives
III. Meaning
IV. Compensatory aspect and Classical view of Public Debt of debt policy
V. Justification for Public Debt
VI. Sources of Public Borrowing
VII. Forms of Public Debt
VIII. Significance of Public Debt
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I. Introduction

Public debt, both internal and external, as a means of financing economic development assumes a significant role in modern times. In recent years, Government's expenditure has been increasing faster than its ability to raise resources. It is so because now its activities are not so restricted as only to maintain law and order and protect the country against external aggression there have expanded intensively as well as extensively. Therefore, when expenditure exceeds revenue, these is a deficit in the budget of the government. This deficit can be bridged either by raising revenue from taxation or by borrowing from the public or by depreciating the value of money in the hands of the people. So far as taxation is concerned, both in developed and the developing countries, there are certain limits beyond which taxation cannot be raised without adverse effects on the levels of investment and production and consequently on the rate of economic growth. Further, the method of deficit financing by the creation of new money may be inevitable under certain conditions. But after a certain level, it leads to inflation and other evils.

Therefore, the most appropriate method, preferred by all the countries alike in mobilising their financial resources is the method of debt finance.

II. Objectives:

After having gone through this lesson, you would be able to:

(i) understand the meaning of public debt.
(ii) explain the classical view of public debt.
(iii) learn various forms of public debt.
(iv) know the principles of debt management.

III. Meaning

Public debt is not fundamentally different from taxation. It may be defined as a kind of deferred tax through which public enjoys the advantages of the public expenditure much before it is met out of the current revenue. It refers to those obligations of the state as a borrower and private investor of capital where state promises to pay the lender the amount borrowed with interest after a given period of time. It excludes inter-state borrowing within the country, unpaid salaries of public officials and pensions to be paid on retirement.

There have been different views regarding public debt. In the opinion of Hume and Adam Smith, debt was a cause in leading a nation towards disaster. A Government should normally meet all of its expenditure out of its current revenue and if really necessary, then only under certain exceptional circumstances, a government could be justified in raising some resources through loans.

Harold M. Groves mentions that on account of certain favourable conditions such as the appearance of money and credit economy, development of industry and trade, security of the creditors, etc. public borrowing has emerged as an important institution.[1] Prof. Carl C. Shoup defines public debt or government borrowings as, "the receipt from the sale of financial instruments by the government to individuals or firm in the private sector to induce the private sector to release manpower and real resources and to finance the purchase of those resources or to make welfare payments or subsidies. Besides, in the developing countries it is used not only for meeting the huge wasteful war expenditure or for recovering the deficiency of effective demand but also for combating inflation generated in the process of growth." Thus, it ensures growth with stability.

Now-a-days public debt is regarded as income of the state. It is also a method through which the government may finance public services without reducing the real wealth of individuals. It is comparatively a recent development.

IV. The Classical Views of Public Debt

Public debt was favoured by the economists in the eighteenth century because they had great faith in the role of the state in the economic activities and their favourable attitude towards public debt was a part of the Mercantilist doctrine. But in the laissez faire state of the nineteenth century and the early part of the twentieth century, public debt was condemned by the early classical economists mainly because of their lack of faith in the role of state in economic

1. H.M. Groves, *Financing Government* (New York, 1952), p.565.
2. R.N. Bhargava, *India's Public Debt Policy,* 'Indian Finance' LXXVIII (9th July, 1983), p.165.

activities. Besides, Public spending was considered by them to be wasteful and unproductive. J.B. Say said, "There is this ground distinction between an individual borrower and a government borrowing that, in general, the later borrows capital for the purpose of barren consumption and expenditure." Obviously, in this socio-political climate public finance had very little to do. Huge revenue were un-necessary for the conduct of minimum government functions-the policy of minimum spendings implied to policy of minimum taxation. This was the traditional belief of public finance associated popularly with Gladstone in England and Jefferson in America. David Hume opposed debt and opined, "Nations once began to borrow, would be unable to desist until they reached the point of bankruptcy."[4] Adam Smith thought borrowing encouraged the sovereign to wage needless war and the ability to engage in loans finance makes for irresponsibility in the sovereign. Ricardo characterized national debt as ''one of the most terrible scourage which was ever invented to effect a nation." He also pointed out that the important burden of the national debt was not in the annual interest transfer, but in the loss of original capital. He believed that interest payments on public debt are in the nature of internal transfers and that public debt does not shift the real cost of government expenditure forward in time.

Subsequent thinkers like Malthus, Mills, Sidgwick and Cairnnes had some liberal views about the consequences of debt. But they were not whole heartedly in favour of debt creation. The opposition to public debt was on the ground that public expenditure is wasteful and unproductive.

The classical theory of public debt came to be formulated in the last decades of the nineteenth century. H.C. Adams and C.F. Bastable who may be taken to be the best representatives of the classical theory of public debt, refuted the idea that the burden of public debt cannot be shifted on the future generation. C.F. Bastable has clearly stated that by creation of debt rather than taxing, the burden is carried forward in time and that the analogy between private debt and public debt is quite right and that there is no significant difference between private debt and external public debt."[5]

From the above analysis, it is clear that the attitude and analysis about the public debt changed substantially from the time of Smith to the time of Bastable.

Compensatory Aspect of Public Debt

The General Theory of Empolyment, Interest, and money which keynes published in 1936 attacked the classical idea that a free enterprise economy is self-equilibrating at the full employment level. Instead, he argued, such an economy may tend toward anunder employment equlilibrium, in which case there are resources in the private sector, that may be underemployed for relatively long period of time in the absense of corrective or compensatory action by government.

The financing for these government income creating spendings may come from borrowing, especially when it takes the form of specially when it takes the form of selling securities to the banking system. Private spending is not affected by public debt. This may follow from:

(i) by borrowing idle funds of the people.

(ii) by borrowing from banks in which case private fincancing will not suffer.

(iii) Still it is better if public debt is financed through borrowings from the central bank.

V. Justification for Public Debt or Rationale for Public Debt

Borrowing by the government has been increasing year after year and the public debt of a country has been mounting as a result of that. With the augmentation in wealth and taxable capacity of a country not only the tax revenue but also its public debt has been expanding. The increase in public debt has been mainly due to the failure of a government to live within its means on account of heavy demands for public expenditure both under ordinary as well as extra ordinary circumstances. The growing complexity of war and other unexpected emergencies have increased the sphere of government's activity, in order to meet these increased expenses the governments have leaned towards public borrowing.[2]

Public debt is necessary to finance such projects which promise a return sufficient enough for meeting the debt charges, the payment of interest on the borrowed funds and the repayment of the capital instalments. Even the classicals, who disliked public borrowing, were liberal enough to sanction public debt for purposes of revenue yielding activities only. Besides, building up the economic infrastructure, (Such as canals and other irrigation works, railways, roads and bridges or installation of power plants, etc.) which is the base for economic development, requires more than what the government procures through taxes.

Public debt acts as a balancing wheel that controls the tempo of the business cycle. In periods of depression, when aggregate demand is not enough to accelerate the level of production and employment, compensatory fiscal policy suggests an increase in the public expenditure on public work, etc. with the help of borrowing idle savings from the hands of the people to create an effective demand and to promote economic recovery. Public debt helps to combat inflation because in this situation effective demand is more than available supply of goods and services and consequently the government is able to transfer extra purchasing power from the hands of the people.

The price spiral, enlargement of administrative services, increase in wages and dearness allowances, enhanced expenditures on defence and development of financial organisations are some of the factors that contribute to the pressing necessity for public borrowing. There are certain other understandable off shoots of the political aspect of the economy which have increased the proportion of borrowing. Some of these are : financial mismanagement, wasteful public expenditure, political corruption and inability to formulate and execute appropriate tax programmes. The government, as a result, has to meet the consequent loss through borrowing.

The borrowings of the modern governments, specially in the developing countries, have increased due to governments reinforced active participation in the economic development of their economies. On the one hand, the limited availability of funds for investment from the private sector and on the other, the need for increasing the role of capital formation for development purposes have led the government to expand resources through loans both internal and external. If the government tries to finance all its expenditure through taxation, the burden on the present generation will be unduly heavy. In order to avoid it, the government undertakes investment funded through loans.

In other words, Public debt is necessary (a) to meet temporary deficits when the income of government and of the country has declined owing to slackness in the economy, (b) to meet the situation when expenditure has increased enormously and cannot be met out of current revenue as, for example in times of war or an economic crisis, (c) to achieve equity over time, and (d) to change the volume or pattern of expenditure/saving in the interest of economic stability, or for achieving full employment.

Self-Check Exercise-I

Q.1 What do you know about the classical view of public debt?

Ans: ....

....

....

Q.2 Why pubic debt has increased now-a-days?

Ans: ....

....

....

VI. Sources of Public Borrowing

Sources of public borrowing are internal and external. Internally the governmental authorities borrow from (i) Individuals and private corporations to whom bonds with fixed interest are issued. (ii) Non-banking financial

3. R.N. Bhargava, *The Theory and Working of Union Finance in India* (Allahabad, 1971) p. 215.

institutions, such as insurance companies, Unit Trust, Private Mutual Funds companies and other financial corporations etc. (iii) Commercial banks who lend to the government in the form of advances by creating additional money; (iv) Central bank which substantially lends to the government in the form of advances by creating new money (cash). Externally, the governments can borrow from (i) International financial institutions, (ii) friendly countries, and (iii) commercial borrowings and supplier's credit.

VII. Forms of Public Debt

Public debt may take various forms. Loans may be classified according to whether they are voluntary or compulsory, or according to use for which they are intended, according to duration, or according to origin.

(1) Voluntary and Compulsory : In the case of voluntary loans, people are free to purchase government bonds if they choose to do so and there is no compulsion to lend money to the government. Normally, public debt is voluntary but during emergencies, the government compels the public to subscribe to forced loans. When emergencies such as war, famine, etc. arise, government enforces borrowing through legal compulsion because voluntary loans fail to extract the required amount of funds for the purpose. A compulsory loan is also known as "refundable taxation" because on the one hand like a loan, government promises to repay the sum with little or no interest to the contributors and on the other hand, like taxation, it is a compulsory contribution to the government. It is fixed by law and levied on terms which could not be accepted voluntarily by the contributors. "The tax element consists of difference between the terms of a voluntary and a compulsory loan. Suppose a voluntary loan could be raised at 5 percent interest, but government raises equivalent amount through a compulsory loan offering 3 percent interest. In case, 2 percent reduced interest on the compulsory loan is akin to a tax, Government can achieve the same result by offering 5 percent interest on the loan and taxing people to the same extent instead of offering 3 percent and imposing only equivalent tax to pay this lower rate of interest."[3]

Compulsory loans are advantageous because they help in mobilising the resources which would not be availed of through voluntary loans. They enable payment of lower interest rate, thus reducing the cost of financing the government debt.

However, a continued policy of compulsory loans is neither feasible nor advisable in the under-developed countries in as much as it invites political opposition and loss of faith in Government's economic efficiency. The technique of compulsory savings will reduce private demand and divert resources to the government, thereby, reducing the inflationary tendencies. Many countries adopted compulsory saving policy during World War II. In India, the 'Compulsory Deposit Scheme' was introduced in 1960. Later, in 1964, this was replaced by the 'Annuity Deposit Scheme'. Again on July 17, 1974 the Government of India introduced the 'Compulsory Deposit Scheme' for income tax payers and 'Additional Emolument Compulsory Deposit Scheme' to combat inflationary tendencies in the economy.

(2) Productive and Unproductive : Sometimes public debt is classified into productive and unproductive debt. Productive debt is that which is incurred for the purpose of constructing capital assets that yield a revenue to the government, for example expenditure on railways, irrigation, etc. The income thus yielded can be used to repay the debt and therefore, debt borrowed for such purposes is called a productive debt. On the other hand, public debt incurred to cover budgetary deficits on revenue account or for purposes which do not yield any direct income to the government including capital expenditure that is not productive, such as construction of hospitals, school buildings or expenditure on poor relief, etc. is called unproductive debt. However, this classification of public debt is not accepted now-a-days. The government never spends its revenue in a way which is unproductive from the social welfare point of view. The expenditure on schools or hospitals or on the development of backward classes does not yield direct revenue to the government, but it confers benefits on the community which are more important than income derived from remunerative capital investment. Thus, it is clear that public debt is mainly borrowed for productive purpose and expenditure-incurred out of it is productive as it is used for public welfare.

(3) Redeemable and Irredeemable : On the basis of maturity pattern of a debt, public debt may be classified as redeemable and irredeemable. The former is repayable at some definite future date. After the maturity period, the government pays the amount to the lenders. It is also known as a terminable loan. In the case of irredeemable debt, the principal is not repayable on any definite date, but the government may repay it at its will. However, interest on both types of debt is payable at the stipulated rate at stated intervals. The advantage of an irredeemable debt is that it is not compulsory for the government to repay it and, is therefore, specially suited for financing expenditure on capital assets that will yield regular income to pay interest on the debt.

(4) Funded and Unfunded : The classification is based primarily on the duration of the debt. The public debt of the government, which is repayable or redeemable usually after more than a year, is known as funded debt. Unfunded debt, on the other hand, is that public debt of a government which is repayable within year. The unfunded debts are commonly used for temporary purpose. They permit the government to secure funds at low rate of interest. Such securities are mostly purchased by banks and other financial institutions. They generally accelerate the rate of inflation in the economy. During and after the second world war period, most of the developed countries such as the U.K., and U.S.A., borrowed large amounts of unfunded debt at very low rate of interest i.e. 1% as against 2.5% to 3% for the funded debts. In India, unfunded debt includes Treasury Bills, deposits in Post Office Saving Bank, Ways and Means Advances from the Reserve Bank, etc.

(5) Internal and External : This is a classification according to the place or location of the loan. When public loan is subscribed entirely by the people of the country and the repayment is done in home currency, it is called internal debt. Internally the government can borrow from individuals, financial institutions, commercial banks and the central bank. External debt is that debt which is borrowed by the foreign country (from individuals institutions or government). The repayment of external debt is usually done in foreign currency. Sometimes it may also be repayable in home currency. Generally we borrow from the International Institutions, such as International Monetary Fund (JMF),International Bank for Reconstruction and Development (I.B.R.D), the International Development Association (I.D.A), World Bank and from foreign countries like the U.S.A., the U.K., West Germany, Japan, etc.

The income of all the developing countries, including India is very low. Because of low income, internal savings are low and hence investment is also very low. The vicious circle can be broken by accelerating the rate of investment. This creates a gap between the level of investment and the level of savings as local savings are not enough. This gap can be bridged through external debt which enables us to invest savings of foreigners in our own country. Further, an under-developing country like India faces extreme shortage of foreign exchange. For rapid economic development, we depend on the developed countries for capital goods, technical skills, some essential chemicals and raw materials etc. Foreign loans are also needed to meet the shortage of foreign exchange. The receipt and repayment of an external debt usually affects the terms of trade. It finances that expenditure which cannot be met by the country's export earnings and makes higher rate of investment possible and thereby contributes to an increase in the productive capacity of the country.

Sometimes external debt creates some political problems. Through such loans foreign government try to interfere with the economic or foreign policy of the country.

VII. Significance of Public Debt

The case for borrowing can be examined from two angles, the first relates to the use of borrowing as a method of financing as compared to taxation and the second relates to the choice of borrowing in preference to the other non-tax sources, namely, the creation of money.

1. Taxes versus Loans

Most economists agree that, for its normal budgetary requirement a government should raise funds through taxes, because if it does not tax now, it will have to tax in the future. Meanwhile, a growing debt will shake people's confidence in its financial stability. Besides it, a public debt is usually subscribed out of savings, while a tax is likely to be met, partly or wholly, by reducing expenditure. Thus, in general, taxes reduce private expenditure while loans do not. If a government finances its entire expenditure through loans, there may be continuous under-saving and excess of expenditure by the people. This may lead to an artificial boom in which a low volume of savings available for investment will check production. Thus boom will get out of control and the State may be forced to tax to restore a balance between savings and spendings. Therefore, it is desirable to meet expenditure of a normal recurring type through taxes.

Smaller units of government expenditure are often subject to heavy, non-recurrent expenditure for public improvements which will last over a period of years. This type of expenditure is productive and should usually be financed by loans. The volume of this expenditure is also usually too large to be financed out of current revenue. If taxes are imposed to finance it the activities are not likely to be extended to the optimum, since people will be forced to economize and unduly reduce private spending leading to a depression. Further, heavy taxes will discourage effort and enterprise, thereby reducing production and employment. Since the benefits of such expenditure will be spread over a long period, too heavy burden should not be imposed in present, otherwise it will lead to inequity over time. If non-recurring non-productive expenditure is heavy in amount, it may be financed out of loans which may be liquidated gradually. If it is of small amount, it could be financed out of taxes.

It is that we should decide between loans and taxes by finding out as to who benefit from the expenditure. For posterity the tax method is superior, because the present generation is forced to save more and so posterity succeeds to large savings. But the criterion is very difficult to apply in practice.

The tax method reduces future income less than the loan method because under the tax method people generally reduce their expenditure. Taxation, relatively speaking, implies the shifting of income from the present to the future. On the other hand, borrowing implies the shifting of incomes from the future to the present. It may be desirable to alter the income streams to achieve stability over time. If present incomes are more because of a boom, then future incomes may fall when the boom is over. In such a case, the state may use the tax method which will reduce present income. Thus, loans or taxes could be used as a counter-cyclical device to reduce the intensity of economic fluctuations.

In the times of war, the government needs money for additional expenditure. Credit expansion, carried beyond certain limit, tends to become a highly inequitable tax and causes transfer of real income within the community and makes the re-establishment of peace-time economy after the war more difficult. Therefore, it is desirable to transfer resources to the government for financing the war only through loans or taxes. In the beginning loans can tap the liquid funds in the money market. When new taxes are levied and the rates to the existing ones are increased, the revenue does not increase all at once. The tax method maintains the morale of the people. But taxes discourage work and enterprise and, if unduly increased, they may reduce the annual national dividend. Therefore, in the general scheme of war finance, people may be asked for compulsory savings money and the saved money can be borroud. It will avoid adverse effects on production, provide extra demand and would sustain employment when war expenditure suddenly diminishes on the termination of hostilities. This will reduce industrial dislocation and would help in establishing a prosperous peace-time economy.

Since taxes are paid by reducing current consumption, they reduce demand. But when they are replaced by loans, consumption and demand expand and create more employment. Therefore, when employment is falling, taxes should be reduced and more funds should be raised through loans. Within reasonable limits, taxes should be reduced through expansion of credit. But in the period of rising employment, the reverse procedure may be followed. This will tend to give stability to the system and would avoid wide fluctuations in employment. Taxes reduce production by discouraging effort and enterprise. If they are replaced by loans the discouragement of effort and enterprise will disappear to some extent. The production will increase. It would provide more employment and this, in turn, will increase the demand for goods and services. In the period of depression, the loan method will sustain production, employment and demand. The conclusion emerges that the state should use tax method more in a boom and loan method more in a depression.

2. The Choice between Borrowing and the Creation of Money

If new taxes are not supposed to be imposed, the government can raise funds through borrowing or creation of money. The latter method has two advantages; it has no contractionary effects, whatsoever and it does not give rise to interest charges or problems arising out of servicing and retirement of debt. Therefore, in periods of depression, in which non- tax methods are used in order to lessen contradictory effect of the rising of funds, the case for creation of money is particularly strong. Borrowing is objectionable because it does exercise some contractionary effect, although such effect is much less than in the case of taxation.

In full-employment periods, borrowing is always preferable to money creation, in depression periods, however, there is a stronger case for money creation and the use of borrowing will necessitate a large deficit to obtain a given degree of recovery. If society accepts money creation as acceptable and there were no danger of irresponsible use of it, the case for it would be strong. Under the existing attitude, its advantages are weakened by the possibility of general loss in public confidence and subsequent misuse of the policy. Because of psychological factors, the central bank's borrowing form of money creation is preferable to the printing of additional paper money.

Therefore, it may be concluded that the state has to play a key role in stimulating the role of capital formation so as to promote the rapid development of the economy. As far as the internal resources are concerned, taxation has been discarded out of the fear that after a certain limit higher taxation will result in discontentment. It will adversely affect the incentives to work. Deficit is to be kept within the safe limits lest hyper-inflation should block economic development. Borrowing seems to be one of the most feasible instruments in the hands of the government for mobilising resources.

Self-Check Exercise-II

Q.3 Distinguish between internal and external debt.

Ans: ....

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Q.2 How taxes different from loan?

Ans: ....

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VIII. Burden of Public Debt

The term burden of public debt is ambiguous. A distinction is generally made between financial or primary burden and real or secondary burden. When a loan is obtained by the government the level of taxation in the economy has to be increased in order to meet the interest charges so long as

4. Quoted by Groves H.M., *Financing Government* (New York, 1962), p. 565.
5. Bastable, C. F., *Public Finance* (London 1885), cited in Buchanan. J.M., *Principles of Public Debt* (Illionois, 1958), p. 107.

the debt continues to exist. The income of the people is transferred to the government to the extent of the increase in the tax level. The consequent loss in the income of the people may be called the financial burden of the public debt.

The higher level of taxation caused by the rising public debt may have some repercussions on the economy in the form of adverse effects on the capacity and willingness to save. These effects may be called the real burden or secondary burden of the public debt.

Sometimes, the concept of burden is explained in terms of the notion of abstinence or pain-cost doctrine and opportunity cost. When the loan is obtained by the government, resources are transferred from private hands to the government and those who contribute to the government loans abstain from consuming current income and undergo the pain of abstinence which may be called a burden caused by the incurring of public debt. But this concept of abstinence was replaced with the opportunity cost concept by the neo-classicals. On the basis of the principle of the opportunity cost, it is said that the public debt entails a burden because when a loan is raised by the government, people are prevented from putting their resources to other purposes, the marginal productivity of which might be more. However, the concept of burden based on abstinence and opportunity cost does not make any sence if people contribute voluntarily to the public loans.

The Modern Theory of Burden of Public Debt

The modern theory of public debt or the new orthodoxy as Buchanan puts it, is an offshoot of the economics of depression or the Keynesian economics. The economic anamoly created by the great depression of the 1930s, led to the development of the new theory of public debt. The modern theory states that a huge public debt is a national asset rather than a liability and continuous deficit spending is essential to the economic prosperity of the nation. A.H. Hansen, the exponent of modern fiscal theory, declares that public debt is an essential means of increasing employment and has become an instrument of economic policy today.

The modern theory of public debt is concerned with macro-economic variables and not with individual utilities, economists treat the whole economy as one unit. They are mainly concerned with internal debt as they regard external debt as a definite burden since repayment of principal and interest

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6. Moulton G. H., *The New Philosophy of Public Debt* (Washington, 1963), p. I.

to foreign countries are entailed, such repayment involves a transfer of real goods and services from the debtor to the creditor country in the payment of interest and principal amount. Until a few years ago, the modern version of public debt remained unchallenged. The contention of its exponents was that internal debt is no burden on the economy since "we own it to ourselves." It is only a transfer from one group to the other rather than exhaustive payments. What the tax payers lose, the bondholders gain and the net position for the economy as a whole remains the same.[6]

The Keynesian economics has also discarded the notion of debt burden on basis of income creating potentialities. Debt creation brings into the exchequer unutilised resources and the productive employment of these resources leads to an increase in the national income. Tax payments, necessary for servicing the debt are met out of the increased income and therefore it is not burden on the economy. Prof. J.M. Buchanan in his book *Principles of Public Debt* declared that the 'New Orthodoxy' has produced three main propositions which are as follows :

1. The creation of public debt does not involve any transfer of the primary real burden to future generations.
2. The analogy between individual or private debt and public debt is fallacious in all essential respects.
3. There is a sharp and important distinction between an internal and an external public debt.[7]

After Keynesian era there were some economists who also accepted the central idea of the new orthodox that the burden of public debt rests on the generation living at the time of debt creation. However, their emphasis was on the transfer of secondary burden to the individuals of the future generation. As D Mc. Wright stated, that "an internally held public debt imposes no economic burden on society, is not entirely true. The burden has been enormously exaggerated but it would be foolish to deny that it does not exist.'' However, they also suggested that proper methods of taxation can reduce this burden to some extent, but they never attacked their (New Orthodox's) central ideas.

This *'No burden thesis'* came to be recognized during the thirties and forties of the twentieth century largely due to the works of Keynes and his supporters. The doctrine that public debt for the social welfare of the community and its burden cannot be shifted to the future generations remain without much dissent till the later fifties of the twentieth century. Recently,

7. Buchanan J.M., *The Public Finance* (Illionois, 1965), p. 4.

some of the economists and politicians have begun to feel that the burden can be shifted to the future generation i.e., present generation may have no burden.

Buchanan's Thesis : Revolt against the 'No Burden Hypothesis'

The dissent from the 'no burden' thesis has arisen with the publication of J.M. Buchanan's Principles of Public Debt in 1958. Professor Buchanan holds that the financing of a project by the government by means of borrowing does shift a burden to the future generations. According to him the concept of burden should be interpreted in terms of the individual attitudes towards their economic well-being rather than in terms of changes in private sector outputs and real income because of the inheritance by the later generations of a larger or smaller amount of capital instrument. Buchanan argues that during the period in which the project is financed and borrowing takes place, no burden of any kind is created : individuals who give loans to the government voluntarily exchange liquid funds for less liquid government bonds instead of using the funds of acquiring consumption or investment goods since this is done voluntarily by the individuals concerned, they do not feel themselves worse off. When, however, the bonds are repaid in the future, funds are taken from the taxpayers to change bonds into cash of the bond holders; as a result, the taxpayers feel themselves to be worse off, but the bond holders are not better off since they have now merely changed bonds for cash. In other words, as the bond holders are not worse off by changing cash into bonds so also they cannot be better off later by the changing of bonds into cash. But in the later periods the taxpayer's future generations are worse off-since tax is a compulsory payment. As a result, the society as a whole becomes worse off during the future. It is in this sense that the burden is shifted to the future generations.

Bowen, Dawis, Kopf Thesis : Bowen, Dawis and Kopf (B.D.K.) consider a society with a changing composition over time and define in terms of the life-time consumption of different generations of taxpayers. They demonstrated that even if a project is financed wholly by a reduction in consumption by generation I, a burden is nevertheless shifted to the future generations. Thus suppose, a country producing only timber, in year 1900, quantum of 100 tons of timber is consumed by the government for meeting, say, war needs and the "project" is "financed" wholly by a reduction of 100 tons of timber consumption by generation I. Supposing that the life span of each generation is 44 years and assuming that the reduction in the consumption of timber made by each generation at the time of its appearance is met by a corresponding increase in its consumption before it passes away, the pattern of timber consumption by three generations will be as follows :

Years	Generation	Timber Consumption (in tons)
1900	I	–100
1944	I	+100
	II	–100
1988	II	+100
	III	–100

It should be noted from the above illustration that though the government consumption of timber has been financed wholly by a reduction in the consumption of timber by generation I still the *Consumption of every generation is deferred by 44 years :* and this will continue until the debt floated by the government for consuming the timber initially is matched. The deferred consumption, according to BDK, is a burden even though the whole of the initial consumption of timber by the government is matched by a corresponding decrease in the private consumption.

Modigliani's Burden Thesis : Prof. Modigliani's analysis of the burden of public debt is different from that of his predecessor. He is of the opinion that pubic debt is a burden on the future Generation because of the loss of partial capital formation and the consequent reduction of the potential future income. The community's income need not fall simply because of the fall in the private capital formation. If government's capital formation increases through borrowing methods and the borrowed funds are utilised productively, the income of the nation is bound to rise. Therefore, the important problem is whether the borrowed funds are employed productively and contribute to economic development. Modigliani himself accepts that through productive capital formation, the burden that falls on the future generation might be fully or partly off set.

Musgrave's Thesis of Inter-Generation Equity : R.A. Musgrave explains the same problems that has been examined by 'BDK', but his assumption regarding the reactions of the tax payers and the lenders are fundamentally different. Musgrave feels that the burden of debt financed expenditure shifts via reduction in private investment. He constructs a case in which, regardless of the reduction of generation I, loan finance, always divides the cost among generations whereas tax finance can never do so. In the sense, loan financing does shift (equitably) the burden to the generations to come.

Musgrave is concerned with a long-lived government facility the cost of which is to be distributed equitably amongst those who make use of it.

Suppose that the project has a life of three periods and each generation has a life span of three periods. As period I opens, generation I already in its last period, is on the scene : as also Generation II, with one more period to go and generation III in its initial periods. In the second period, there exists generation II in its last period as also generation III and IV. In the third period, there will be generation III, IV and V respectively in their third, second and first periods.

The problem is how to take from the generations in question their "due" shares of the cost of the project, namely, the following :

Generation	I	1/9th
"	II	2/9th
"	III	3/9th
"	IV	2/9th
"	V	1/9th

The 'due' share being proportional to the period or periods for which the services of the facility are enjoyed by each generation. Musgrave's solution requires generation I to pay 1/9th of the cost in form of taxation and so on. As to financing the project in its year of construction, 6/9th must be covered by loan; but no part of the loan can be demanded from generation V, since it is already in its last period, and thus could never be repaid. Generation I is vanishing at the end of the first period so 6/9 is financed by loans from generations II and III, who are repaid before they vanish. Thus everybody gets his moneyback, except to the extent that he is required to pay tax, and tax is distributed over time in accordance with the degree of service use.

From the above explanation it is clear that there had been taxation and the total cost of the period had been taken from them. GI, GII, GIII in Ist period, no cost would have been transferred to subsequent generations.

However, now a days most of the economists argue that the best intelligible discussion of the concept of debt burden is found in Domer's writing. Domer refused to accept the absolute size of any nation's public debt as a realistic index of its burden concept. He observed that the rate of growth of national income will have to be reviewed along with the rate of growth of national debt. If the national income remains constant but the volume of public debt is accompanied by simultaneous constant relative increase in the national income, there will be an automatic increase in tax collection. He argued that if the national income increases by a constant relative rate, taxation rate will often become constant and will not vary at all whatever be volume of the debts.

Domer assumed initially that the burden of the debt or the average tax rate covering interest charges to income, or the ratio of the debt to income multiplied by interest rate paid on bonds proceeding with simple mathematical relations, he arrived at the formula for debt as under :

Tax rate = L/n, i

where L = fraction of national income borrowed

i = interest paid on bonds and

n = relative annual rate of growth of income.

From the above analysis it is clear that the tax rate, given constant rate of interest, depends usually on the ratio of money income on the debt.

From this analysis, it is very clear that for the first time, a systematic attempt has been made to link up the burden of a country's debt with growth of its national income.

Secondary Burden of Public Debt : New economists analysed the secondary burden of public debt in terms of the effects on incentive to save, work and invest on account of the tax friction caused by existence of a large public debt.

1. Pigou Effect or Wealth Effect : The existence of a large public debt implies large holding of wealth by people in the form of government securities. Due to this, the incentive to save will be adversely affected, because already sufficient amount is held by them. However, it is difficult to measure that to what extent the incentive to save is affected by the existence of a large public debt.

2. Kaldor Effect : The existence of a large public debt also has adverse consequence on incentive to work, invest and accumulate. However, in practice, it is difficult to establish how far this has affected the incentive to work, invest and accumulation.

However, there are some economists who are of the opinion that there are several advantages and disadvantages of the offset of the existence of a large public debt. A.H. Hanson thinks that a large public debt provides a certain amount of security in times of depression. It acts as a built-in-stabilizer and that is kind of National Insurance.

A.P. Lerner also tried to show that without the creation of debt, usually public expenditure is impossible and that only alternative to debt is depression or widespread poverty. He also emphasized that even in the absence of a large public debt, tax friction may take place for other reasons. Less public debt means more private debt, the servicing of which will have the same inflationary effect and to meet this inflationary threat, an increase in the tax on income and wealth becomes inevitable. Some times this tax rate may be much greater than what would be required to service the public debt. The only way to prevent these evils, he says, is to maintain a state of depression in which people are too poor to accumulate wealth. Further he is of the opinion that when unemployment is fought by deficit spending and as such the amount of public debt increases, the so-called burden of the debt should be weighed against the burden of unemployment which would be there if deficit spending programme had not been undertaken. And if this is done, the burden of the debt may appear to be much smaller and even nil or negative.

Does Borrowing Shift Burden of Government Activities to Future Generations

A long debated question which has given rise to a great deal of controversy in recent years is whether the system of financing a project by means of public debt shifts the burden to the future generations. One traditional argument is this : If taxes are used to finance a project, persons pay for the project now; if funds are raised by borrowing the present generation escapes the cost and the burden is shifted to the future generation which pays the interest and the principal. Hence the public debt shifts the burden to the future generation.

The 'No Burden Thesis' is once again established. Lerner in an observation also warns that it is not quite right to say that public debt does not matter at all. R.N. Bhargava also emphasized this 'No burden analysis' in the context of internal debt. 'If posterity inherits the burden of paying interest and principal of the debt, it also inherits a corresponding and equivalent right to receive this interest and principal. Thus its liability to pay is matched by an equivalent right to receive that payment and in the case of external debt, the posterity will have to use a part of its current resources for servicing the debt, that is, a part of total output of goods and services produced within the country will have to be used for servicing the external debt. However, these depend upon the purposes for which the debt is incurred. If the debt was obtained for development purposes the posterity benefits from this expenditure. In the absence of foreign loans, this expenditure would not have been incurred and national income and output would have been adversely affected. If foreign loans were incurred to fight against war then the lack of foreign loans might have meant defeat and slavery. Thus posterity would benefit from the independence of the country that it inherits. Similarly, if foreign loans were incurred for the useful consumption purpose, there would be improved health and efficiency of the people and against the burden of servicing foreign debt we have to balance the advantage posterity inherits from a more efficient and healthy working 'force'.

What emerges from the foregoing discussion of the burden of public debt is that the existence of a large debt is neither an evil nor a blessing by itself. It has both adverse effects and favourable effects on the economy. It is an instrument of public policy. But, it is one which should be used with care. All that the non-burden thesis says is that the burden of public debt need not be a matter of concern so long as the nation's income contributes to rise. The burden would be measured only with reference to the growth of national income and the growing public debt need not cause any concern so long as the national income rises adequately. Ruling out the fear of debt when national income is rising E. Domer says, "If all the people and organizations who work, study, write articles and make speeches, worry and spend sleepless nights-all because of fear of debt-could forget about it for a while and make their efforts trying to find ways of achieving a growing national income, their contribution to the benefit and welfare of humanity and to the solution of the debt problem would be far greater." [8]

IX. Principles of Debt Management

Debt Management means the formulation and implementation of a debt policy regarding the forms of public debt to be issued, terms on which new bonds are to be sold, the pattern of maturities of the debt, ownership pattern of debt and methods of redemption of public debt. Hence the management of public debt is concerned with the decision regarding floatation, refunding and retirement of debt as to gain the greatest economic advantages or to create the least economic disadvantages. The objectives of debt management are to manage public debt in a way that meets the governments gross funding needs at the lowest possible long-term cost, with due regard to the underlying risks.

Debt management is guided by the following principles :

(i) Management must be capable of generating the necessary funds from the lending market without undue coercion and that at the lowest feasible interest cost. This principle suggests that debt should be managed in such a manner that necessary funds are available from the lending market. Besides, it is also needed that these funds are procured at the minimum interest cost.

(ii) Public debt should be managed in such a way that the needs of the investors are satisfied. An efficient debt management policy not only keeps the interest rates on government bonds low but should also devise the pattern of interest rates on government obligations which conform to the preference pattern of the investors.

(iii) Refunding and flotation of debt should be managed in such a way that the economic stability is not disturbed.

(iv) Public debt policy must be co-ordinated with fiscal and monetary policy.

(v) Public debt policy should maintain a suitable structure of maturity.

(vi) There are two important issues relating to management of foreign debt. These are (a) the extent of government regulation of foreign debt and (b) the appropriate

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8. E. Domer, 'The Burden of the Debt and National Income' *American Economic Review.* XXXIV (December, 1944) cited in *Readings in Fiscal Policy* (London, 1955), p. 50.

composition of debt. How much foreign debt can be sustained depends on the growth rate of economy and its export performance. The growth rate of the economy must be faster than the rate of interest on long term borrowings. In order to avoid the liquidity problems, it is necessary that the rate of growth of exports should be higher than the rate of interest.

X. Effects of Public Debt

(i) Public Debt and Consumption: The existence of public debt has an important effect on consumption. Those who hold government bonds representing the latters obligation to pay consider these bonds as personal wealth. This wealth would not have arisen if the government had financed its expenditure through taxation. The net result is that the possession of government bonds will induce them to speed not only their current income but also in excess of their current income since they hold wealth.

(ii) Public debt and Liquidity: public debt is represented by bonds which are highly negotiable. Those who have bonds have highly negotiable and highly liquid form of assets.

(iii) Public Debt and Production: Public debt is generally favourable to promote production, income and employment. But the fear created by plausible higher does of taxation or even capital levy in future to repay the public debt may discourage the investors.

(iv) Public Debt and Distribution of Income: Public debt is said to promote inequality in the distribution of income. It is held that a large amount of public debt increases inequality of income distribution in favour of the bond holders. Since bond holders are generally rich, this leads to move inequality in distribution in income.

Self-Check Exercise-III

Q.5 Write two principles of debt management.

Ans: ....
....
....

Q.6 Write effects of public debt on consumption and production.

Ans: ....
....
....

1. Bhargava, R.N., *The Theory and Working of Union Finance in India* (Allahabad, 1977), p. 219.

LESSON NO. 1.2

METHODS OF REDEMPTION OF PUBLIC DEBT

I. Introduction

Most of the economists believe that debt redemption that is the repayment of pubic debt is desirable for the government.

The need to repay public debt exercises a sort of check on the recklessness of the government. A weak government may borrow large amounts to finance its expenditure because public debt does not impose a burden on the subscriber to increase his income. However, the government will have to tax the people to pay interest on the debt even if it postpones repayment of the principal. A government that continuously borrows to finance its expenditure will be faced with a rising interest bill, it will not be able to postpone imposing the burden of taxation indefinitely. The need for debt redemption exercises beneficiary effect on the fiscal policy of the government, as it is then forced to increase taxation to finance its regular current expenditure.

II. Objectives: After having gone through this lesson, you would be able to: (i) define the concept of debt redemption. (ii) explain the various methods of debt redemtion.

III. Meaning and Need for Debt Redemption

Debt redemption[1] implies repayment of public debt which the government borrows to finance its expenditure. Debt redemption is advantageous because it cancels outstanding claims against the government and places it in a stronger position to secure new loans at moderate rates of interest. The repayment of debt reduces the tax burden by eliminating debt charges and keeps the treasury in a strong position, provided that the redemption of debt is conducted in a manner that will not excessively burden the economy. If the governments know in advance they must redeem their debts according to the terms of their loan contracts, imprudent spending is less likely to occur and public financing can be kept under more rational control.

2. For details see Buchler, A.G., *Public Finance* (New York, 1948), pp. 714-715.

Debt redemption enhances the credit worthiness of the government. When the government borrows, it promises to repay the loan at a stated time in the future. It has to redeem the debt to honour its pledged word. Debt redemption also produces a salutary effect on the people who think that, if the government is borrowing, it is simultaneously making efforts to repay the loans.

An advantage of debt repayment is that the problem of debt management becomes less difficult to handle as the amount of debt decreases. Government may also have more freedom of choice as to interest rates and can give more weight to consideration of monetary policy. As the banks find it less necessary to furnish credit to governments, they should be able to give more thought to the credit needs of private borrowers and to serve them more effectively.[2]

Debt redemption saves the cost of debt administration and cost of collecting taxes to service the debt. This is desirable when there is full employment in the economy and the resources needed in debt administration and tax collection can be diverted to produce useful commodities and services that will increase the welfare of the people.

Debt repayment is deflationary to the extent that (i) funds are taken from the tax payers or other revenue sources for debt retirement that would be spent or invested in a manner that would increase the flow of community income, (ii) those receiving payments on the debt fail to restore the funds obtained to the income stream, and (iii) that the deposits of commercial banks are reduced as public loans are redeemed. If funds for debt payment are taken from tax payers or groups who are not utilising them to increase investment or consumption and are distributed to the government's creditors who will employ them to increase production or consumption, the redistribution of funds will encourage higher levels of economic activity. While debt repayment, in general, has deflationary tendencies. It may thus also have certain stimulating effects upon the economy. This means that the repayment of public debt is not necessarily socially disadvantageous. In a boom period, debt retirement may help to slow down the inflationary trend and bring the economy under control.

It is generally believed that the existence of public debt provides income to the rentier class by imposing a burden on the young and enterprising class. It is because of two reasons (i) the government has to tax industry and enterprises to pay interest to the debt holders and (ii) the bond holders are benefitted by the interest which is an unearned income for them. It is therefore argued that the repayment solves this problem as it gives relief to industry and enterprise and income of the debt-holders also disappears. However, some economists believe that for repayment, the government has raised larger resources which imposed a concentrated burden as against the spread out burden involved in the payment of interest on the debt. The repayment of the debt will not abolish the income of debt holders. They will invest that income in some other form of securities which will create at least equivalent income. Besides the debt-holder supports the government by lending in time of need out of his/her saving after reducing the consumption expenditure and therefore it is morally undesirable for the government to penalise him for supporting it. Further, a large part of the interest and principal paid to bond holder is received back in the form of taxes by government. So, here arises the need for incentive taxation so that, heavier taxes should be imposed on unearned income as compared to income from work and enterprise.

Self-Check Exercise-I

Q.1 What do you mean by redemption of public debt?

Ans: ....
....
....

Q.2 Why it is necessary for the government to repay the public debt?

Ans: ....
....
....

IV. Methods of Redemption of Public Debt

The government can adopt several methods to redeem its debt.

1. Conversion or Refunding/Fresh Borrowing : The government may redeem its public debt by converting it into a new debt or it may issue conversion loan to the holders of existing debt. Alternatively, it may borrow in the open market and use the funds to repay the old debt. Generally, the government adopts this method when at the retirement of the debt the government has not the capacity to repay or when the current interest rate is lower than the rate which the government is paying for the existing debt and in this way government may reduce its interest expenditure. Strictly speaking, this is actually no retirement because the government incurs fresh obligations to repay old ones and there is thus no decrease in the total amount of public debt.

Sometimes a distinction is made between refunding and conversion of debt, though some times both of them are used to mean the same thing. In the strict sense, refunding refers to the repayment of debt through fresh loans, i.e., the method of paying off an old loan carrying a higher interest rate through a new loan carrying a lower interest rate whereas conversion involves a change in the rate of interest or other details of the lenders

The government may pass an ordinance to reduce the rate of interest payable on its debt.

2. Additional Taxation : The government imposes new taxes to get revenue to repay the principal and interest of the loan. This is the simplest method of debt redemption.

3. Sinking Fund Method : The most commonly used device for the actual retirement of a debt is that of the sinking fund. The government sets aside a small amount every year from the revenue budget and this accumulates at compound interest so that it may equal the amount of the public debt by the time of its maturity. Thus, the burden of taxing the people to repay the debt is spread out evenly over the period of the accumulation of the fund. The government has, therefore, not to impose a concentrated burden, if it were to repay the debt by raising funds through taxation in one year only.

The sinking fund is viewed by classicists as a device for increasing wasteful expenditure. In the last of the eighteenth and in the beginning of nineteenth centuries, there was much discussion about the repayment of debt. The controversy centred largely around the use of sinking fund as technique for automatically reducing debt. The classicals, generally did not approve of the sinking fund principle. They stressed the diversion of sinking funds to current unproductive uses, this will result into expansion of the budget and preference for repayment through an excess of revenue over expenditure not obtained by the establishment of a sinking fund.

The modern sinking fund frequently does not provide for accumulating funds until the debt matures; rather it is a type of cash register through which funds flow to purchase debt according to pre-arranged plan. The sinking fund, if it is truly used as an accumulation for debt retirement, has advantage of investment and management of large sums of money, it has the advantage of being useful to maintain the market for debt issues of the government unit. However, in the modern times, sinking fund is regarded as one of the best methods of redemption of public debt-because the burden of taxation is spread out evenly over the period of the accumulation of the fund.

However, the applicability of the sinking fund method depends on the conditions of the economy. Since debt redemption through sinking fund method is deflationary measure, it should be resorted to only in an inflationary situation. If there are unemployed resources in the economy, debt redemption, whether through sinking fund or any other method will aggravate the problem. The proper course for the government in such a situation is to increase its expenditure, to expand employment and output either by an increase in currency in circulation or by borrowing from the public.

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3. R.N. Bhargava, *The Theory and Working of Union Finance in India, op. cit.,* pp.222-223.

Dr. R.N. Bhargava suggested that instead of making a fixed annual allocation from the revenue budget to a sinking fund maintained for debt redemption, the Government may use a surplus in the revenue budget to buy its loans in the market. In this case, however, the provision for debt redemption will depend upon the state of the revenue budget. This method is, therefore, less certain than the practice of making a fixed allocation every year in the revenue budget to the sinking fund maintained for debt redemption. If the Government uses its budget surplus for debt redemption this practice will imply, and people will expect that, when there is a deficit in the revenue budget, the government will not impose additional taxation or reduce its revenue expenditure but will meet the deficit by borrowing funds from the public.[3]

4. Inflation or Currency Expansion : This method amounts to confiscation. It implies a fall in the value of the monetary standard due to currency expansion or inflation in the economy. Therefore, the real value of public debt depreciates. If there is hyper-inflation in the economy then the value of the country's currency and also its public debt will become almost negligible. Under this method the debt holders are taxed in proportion to the debt held by them in order to repay the debt. This is very tax for the tax-payers but is related to the extent of their debt holding. Those who supported the government in the past by lending their savings are penalised, whereas those who chose other forms of investment escape the burden of taxation necessary to redeem public debt. Accordingly, this method is exceedingly inequitable and for that reason, undesirable from the fiscal view point. When the government resorts to this method of liquidating its public debt, it loses confidence of the public and it may be difficult for the government to borrow funds again.

5. Repudiation : The most extreme solution to the problem of government debt is repudiation. In this case the government refuses to repay the public debt and in this way liability for public debt is extinguished. In the federal system, the states being sovereign so far as debt is concerned, can repudiate their debts if they wish. The bond holders will be having no redress. This is actually no retirement but confiscation of the bond holders to the extent of their holding. A particular group of wealth owner is penalised. Other groups even benefit through reduction in taxation, as thereafter the government will not have to pay interest on the public debt. This procedure is exceedingly inequitable as those who supported the government by investing their savings in public debt suffer irrespective of their ability as compared with the owners of other forms of wealth. When the government repudiates its public debt, it loses the confidence of the public and it will find it extremely difficult to raise further loans in future. When an external debt is repudiated, it may provoke aggressive action by the foreign governments who may also try to organise opposition against the home government by giving financial support to the opponents of the home government. In 1918 the Russian government repudiated its public debt amounting to 3,000 million. Normally a government never repudiates its public debt as it is an indication of its insolvency. Debt repudiation may be undertaken following a violent political or social revolution or when a government finds it impossible to honour its debt obligations.

6. Serial Bonds : The serial bonds are financial bonds that mature in installments over a period of times. It provides for establishing a scheme for annually retiring a state amount of the issues. The annual payments are usually uniform as they facilitate budgetary provision. The serial bond has become a popular method of retiring local government debt. Many states actually require its use by their local sub divisions.

The disadvantage with the method is that it does not permit government to cease retirement of debt during periods of depression. The payments need not be made when the national income falls below a given level. The post-war United States loan to Great Britain includes this concept of debt repayment.

The advantage of the serial bond has been obtained by the federal government through arranging maturity dates, that is, a portion of the debt matures at regular intervals. Russia once obtained the advantage of gradual and regular retirements of refunding through using the lottery scheme. To compensate for the disadvantage of uncertainty (the bond holder cannot be certain that the number of his/her bond will be called), additional prizes are offered to the lucky bond holders in the lottery of repayment.[4]

7. Capital Levy : This is a direct tax upon the capital rather than income of the tax payers.The government may retire its public debt by levying a heavy additional tax only once, or at the most twice. This special heavy tax to repay public debt is generally called a capital levy as it is assessed on the value of capital held by the rich people. Sometimes, when the heavy tax is levied on an index of ability other than capital, it is also known as special levy. It is also a capital levy over the sinking fund method it is that in the case

4. For details see Lindholm R.W., *Public Finance and Fiscal Policy, An Analysis of Government Spending, Revenue and Debts* (New York, 1950), p.628.

of the latter method the government has to impose the burden of taxation to repay public debt over a period of years, whereas in the former case the burden of taxation is imposed once for all and, therefore gives some psychological relief to people that there will be no more taxation for the purpose of repaying debt. In times of war or emergencies, the money necessary for the redemption of the public debt is raised by imposing a special tax on capital. During and after the First World War, capital levies were frequently proposed and sometimes enacted either as a means of securing additional tax revenues or as a method of repaying government debts. Dalton recommended this method very strongly. It was advocated as a method of liquidating the unproductive war debts. Debt redemption by imposing a very high taxation on property has been advocated. They are usually advocated as a means of disposing of onerous debts. In the recent capital levies, certain property was often exempted, especially the property of less wealthy. The rates of the taxes were commonly progressive. It has sometimes been proposed that the capital levy should be laid only on wealth arising for war enterprise, but it would probably be impracticable to separate such wealth from all other property for taxation.

If such a capital levy were practicable, it might be utilised to provide enough funds to finance a war or some other emergency expenditure. But European experience with the capital levy shows that it could probably be employed only as a minor source of revenue, as suggested by Prof. A Comstyck.[5] One of the best known capital levies was imposed by Germany in 1916 in the form of an emergency tax at rates that progressed from 10 to 65 percent on taxable capital. This had provided about 18 per cent of the total tax receipts in 1921, and then declined its importance. If a highly productive capital levy were used at the beginning of a war, it would lessen the need for borrowing and would tend to discourage the continuance of war, because the owners of the taxed property at least would immediately feel the effects of the war expenditures. In fact, it might have a demoralizing effect upon middle and upper income classes, as Keynes intimated.[6] The idea behind this is that increased levels of public debt are accompanied by mounting private wealth, which is increasingly concentrated on the wealthy elite. There is no burden on future generations because only existing wealth is subject to the capital levy.

5. *Taxation in the Modern State,* Longman 1919, p. 212.
6. See Buchler A. G., *Public Finance, op. cit.,* p. 635.
7. *Ibid.,* p. 635-36.

Advantages of Capital Levy :

A capital levy, according to its advocates, would have several advantages. It would raise a large sum by a special property tax that might be assessed only once, although the tax might be paid in convenient instalments. A capital levy would fall heavily on the wealthy classes who generally have most of the resources to pay taxes. These classes usually buy large amount of government loans and a tax on their capital would compel them to bear the burden of the levy. A capital levy imposed in lieu of borrowing would tend to reduce debt and keep the budget in better balance. This tax should also, if collected at steeply progressive rates from property owners, tend to reduce inequalities in the distribution of wealth.

A capital levy could be employed to equalise the distribution of wealth on ethical grounds as weapon of economic warfare to combat over-saving and under-consumption, thus striking at what are popularly regarded as causes of economic instability. The proposal raises the issues of the capital levy primarily as a regulatory measure and of the validity of theory of business cycles that would call for its application.[7]

As a result of the imposition of a capital levy, as R. N. Bhargava observes, it may be possible to reduce the level of taxation and this may give relief to earned income and may thus encourage work and enterprise. A very large national debt may also weaken the financial position of the government and may at some times make it difficult for the government to raise loans in an emergency situation when its financial needs may be very great. When a nation is engaged in a war, soldiers take lives for the sake of the nation and it may, therefore be necessary for political reasons to resort to a capital levy so that the sacrifice of soldiers and others during the war may be matched by the sacrifice of the capitalists who are asked to part with some of their capital to pay the public debt. It may, however, be noted that the payment of interest on internal debt is not a loss to the community. It is largely a problem of distribution. The government taxes one group of people in order to pay interest to another group, some of whom may belong to the former group itself. Since taxation is imposed in accordance with the principles of taxation and public expenditure is incurred in accordance with the principles of expenditure there is no inequity involved from the distributional view point in the payment of interest and the imposition of taxes to pay it. Further the advantage of reduction in public expenditure that used to be incurred in paying interest on the debt, would to a great extent, be balanced by a reduction in the future

8. *The Theory and Working of Union Finance in India, op. cit.,* pp. 224-225.

yield of taxes on income and wealth.[7]

Disadvantages of Capital Levy :

However, as H.M. Groves[8] mentioned, like the excess profit and the income tax the capital levy is weaker on its administrative side. Although the tax might be equitable, it is very difficult to apply. Probably, the most difficult part of a tax on capital is that of finding a fair value of property involved.

There are certain disadvantages of a capital levy or special levy which may produce extremely adverse effects on the economy. They force a relatively small section of the population to meet an expenditure that is theoretically undertaken for the general welfare. A general capital levy might also be so heavy as to exert a deadening effect upon initiative and enterprise and seriously penalize saving.

Another important disadvantage of capital levy is that it produces a concentrated burden on the community whereas in the sinking fund method the burden is spread over number of years. Thus, the capital levy is discriminatory because it imposes burden on those who own capital on that particular date and relieves those who are likely to acquire or build up capital in the future.

Besides as R.N. Bhargava[9] observes, the capital levy may also hit industries by reducing the amount of capital that may be available for their use. So far as joint stock companies are concerned they will have to be exempted from the capital levy otherwise great inequity will result. If, however, the capital levy is imposed on joint stock companies it would adversely affect the operations of many of them as they would not be able to liquidate capital assets to pay the levy. This, in turn will produce adverse effect on national output and income. In the case of private business, the extent of hardship will depend upon whether the owners have any liquidating assets to meet the liability of their capital levy. Otherwise they will be forced to sell their businesses to people who are relatively less competent to manage them. It is sure that capital equipment will remain intact even after the imposition of a capital levy, but the existing owners may find it difficult to borrow in a dislocated money market and may be forced to sell their business at distress price to those who possess liquid cash but not business brains as the two do not always go together. The imposition of a capital levy may also dislocate the securities market as many owners of capital may be forced to sell their securities

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9. *The Theory and Working of Union Finance in India, op. cit.,* pp. 225-226.
10. *Ibid,* p.236.

hurriedly to meet the tax liability. However, this difficulty could be overcome to a considerable extent if the government agreed to realize the capital levy in the form of securities or other assets. These could be passed on to a special institution to be created to hold such assets on behalf of the government and to liquidate them gradually so as to prevent the dislocation of the securities market.[10]

Self-Check Exercise-II

Q.3 What is sinking fund method?

Ans: ....
....
....

Q.4 What are advantages of capital levy?

Ans: ....
....
....

V. Summary

In the end, we can say that, Debt redemption means repayment of public debt. The government can redeem the public debt by converting it into a new debt; by imposing new takes to get revenue to repay the loan; by using sinking fund method or by imposing a capital levy. However, debt there is not much choice between the various methods of redemption. Every method has its own merits and demerits. Besides other considerations, a government will certainly do well to try to retire part of its debt every year so that it may not be forced to impose heavy taxes on the people at the time of maturity.

While considering the different methods of debt redemption and its problems, the benefit of external debt on the economy must also be taken into account. Debt servicing would not be a problem if the growth of external public debt is accompanied by a higher rate of growth of the economy. Increase of internal indebtedness and of debt service liabilities, even when large, do not necessarily imply difficulties for borrowers. Increase of service payment has to be measured against the additional capacity created in the borrowers' economy. As Kindleberger observes, in the short run, capacity to repay is indicated by the foreign exchange impact of the investment undertaken, whether it is export-increasing or import decreasing. Over time the only determinant of the capacity to repay is the loan's contribution to the productivity of the economy as a whole and the capacity of the system to skim off the necessary portion of that productivity in taxes on pricing and reallocation of resources so as to transfer the debt service abroad."[11] If the public debt is productively employed and the economy gets stronger, particularly in the direction of increasing the exports or decreasing the imports, we can say that the loan has the capacity to repay.

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11. Charles P. Kindleberger, *Economic Development* (New York, 1951) p. 266.

M.A. (ECONOMICS) PART II PAPER-III

SEMESTER-IV ECO-403 : PUBLIC ECONOMICS

LESSON NO. 1.3 AUTHOR : DR. VIPLA CHOPRA

FISCAL POLICY

Structure

1.3.1 Introduction

It is now widely recognized that the state has a sine qua non in the regulation of economic activity along the desired lines. Fiscal policy is traditionally concerned with the determination of state income and expenditure policy. However, in recent times, public borrowing and deficit budgeting have also become a part of fiscal policy. Thus all the budgetary instruments like taxes, public spending, borrowing and debt management constitute the fiscal policy. Fiscal policy tries to achieve its objectives by regulating the working of the market mechanism while retaining the mechanism itself.

1.3.2 Objectives

After having gone through this lesson, you would be able to:

(i) define the concept of fiscal policy

(ii) Know the objectives and various instruments of fiscal policy.

(iii) Discuss the role of fiscal policy in attaining full employment; economic growth; controling inflation; and for the redistribution of income and wealth.

(iv) describe the relationship between fiscal policy and monetary policy

1.3.3 Meaning and objectives of Fiscal Policy

In simple words, fiscal policy refers to the instruments by which a government tries to regulate or modify the economic affairs of the economy keeping in view certain objectives.

The concept of fiscal policy has been defined by different economists as follows:

Harvey and Johnson define fiscal policy as "changes in government expenditure and taxation designed to influence the pattern and level of activity."

According to G.K. Shaw, "We define fiscal policy to include any design to change the price level, composition or timing of government expenditure or to vary the burden, structure or frequency of the tax payment." Prof. Gardner Ackey defines it as, "Fiscal policy involves alterations in government expenditures for goods and services and the level of tax rates. Unlike monetary policy, these measures involve direct government entrance into the market for goods and services (in case of expenditure) and a direct impact on private demand (in the case of taxes). Samuelson and Nordhaus define it thus : "By fiscal policy, we mean the process of shaping taxation and public expenditure in order (a) to help dampen down the swings of the business cycle and (b) to contribute toward the maintenance of a growing, high-employment economy free from high and volatile inflation." (Economics, 1985, p. 174). Fiscal policy, thus conceived, is a branch of economics which has undergone revolutionary changes with "historical shifts of emphasis from revenue to welfare and more recently, from cyclical stabilisation to secular growth."

Objectives of Fiscal Policy

Fiscal policy in under-developed countries has a different objective to that in advanced countries.

The objective of fiscal policy in developed economies is to maintain the condition of full employment, economic stability and stabilise the rate of growth. For an under-developed economy, the main purpose of fiscal policy is to accelerate the rate of capital formation and investment.

To achieve economic stability in developed countries, functional finance by regulating the volume of public expenditure go a long way but this device is not relevant to solve the problem of under-developed countries at length because lack of resource mobilisation is the major hindrance in such economies. Thus the technique of "Activating Finance" i.e. mobilisation of resources through taxation, borrowing and deficit financing is advocated to achieve the economic growth and stability.

Prof. Nurkse believed that savings and per capita income were very low in under-developed countries. The few rich indulge in conspicous consumption. A major portion of savings is dissipated in unproductive channels like property, speculation, hoardings, jewellery, gold etc. But fiscal policy diverts these all into productive channels. Further he believes that the incremental saving ratio can be raised through government expenditure in creating social and economic overheads, banking and credit institutions and in establishing new industries. This will raise the level of employment, output and income in the economy. Taxation in an underdeveloped country acts as a useful instrument for reducing private consumption and transferring idle resources for capital formation.

Following are the main objectives of a fiscal policy in a developing economy :

1. Full employment.
2. Price stability
3. Accelerating the rate of economic development
4. Optimum allocation of resources
5. Equitable distribution of income and wealth.
6. Economic stability
7. Capital formation and growth
8. Encouraging investment.

The nature of economic fluctuations in under-developed countries is different from those in the developed economies. In a developed economy, the problem is not so much of promoting growth as that of achieving economic stability. In view of these peculiar characteristics of under-developed economies, these economies require a steady rate of growth to overcome large fluctuations in income and prices. It follows that in under-developed countries stability cannot be separated from economic growth. Growth and stability present more challenging problem than a merely compensatory fiscal policy. Thus, Government has to follow a policy of 'Activating Finance' and try to increase resources for economic development.

The objectives of fiscal policy in under-developed countries are :

- (i) To maximise the rate of capital formation and to lead the economy on the path of rapid economic progress.
- (ii) To make available the maximum flow of human and material resources consistent with current consumption requirements.
- (iii) To guide the allocation of existing resources into socially necessary lines of development.
- (iv) To reduce the extreme inequalities in wealth, income and consumption standards which undermine productive efficiency, offend justice and endanger political stability.
- (v) To mop up the excess purchasing power so as to mobilise savings for investment.
- (vi) To eliminate as far as possible sectorial imbalances in the economy.

1.3.4 Instruments of Fiscal Policy

Contra-cyclical fiscal policy occupies the centre place for maintaining full employment without inflationary and deflationary forces. Thus, the various instruments or measures which influence the economic stability of an economy are :

- (i) Budget
- (ii) Taxation
- (iii) Public Expenditure
- (iv) Public Works
- (v) Public Debt.

(i) Budget :- The budget of a nation is a useful instrument to assess the fluctuations in an economy. Different budgetary principles like annual budget, cyclical budget and fully managed compensatory budget have been formulated by the economists.

(ii) **Taxation :-** Taxation is a powerful instrument of fiscal policy in the hands of public authorities which greatly affect the changes in disposable income, consumption and investment.

(iii) **Public Expenditure :-** The active participation of the government in economic activity has brought public spending to the front line among the fiscal tools. The appropriate variation in public expenditure as compared to taxes have more direct effect upon the level of economic activity. The increased public spending will have a multiple effect upon income, output and employment exactly in the same way as of increased investment has its effect on them. Similarly, a reduction in public spending, can reduce the level of economic activity through the reverse operation of the government expenditure multiplier.

(iv) **Public Works :-** Keynes has highlighted public works programme as the most significant anti-depression device because

(i) they absorb hitherto to unemployed workers.

(ii) they help to create economically and socially useful capital assets as roads, canals, power.

(iii) they increase the purchasing power of the community and thereby stimulate the demand for consumption goods.

(v) **Public Debt :-** Public debt is a sound weapon to fight against inflation and deflation. It brings about economic stability and full employment in an economy. The government borrowing may assume any of the following forms :

(a) Borrowing from Non-Bank Public

(b) Borrowing from banking system

(c) Drawing from treasury

(d) Printing of currency notes (i.e. Deficit Financing).

Self-Check Exercise-I

Q.1 Define fiscal policy

Ans: ....
....
....

Q.2 Write about the instruments of fiscal policy.

Ans: ....
....
....

1.3.5 Fiscal Policy and Full Employment

When the economy suffers from involuntary unemployment, i.e. unemployment of idle resources and manpower, three alternative fiscal policies measures may be used to attain full employment which are -

(i) Deficit Spending i.e. increased government expenditure without increase in taxation.

(ii) Deficit without spending i.e. decreased taxation without increase in government expenditure and

(iii) Balanced Budget Multiplier i.e. spending without deficit.

Deficit Spending :

When the sum of private consumption, private investment, government consumption and government investment is less than full employment income and as such there is a deflationary gap in the economy causing unemployment, the government may increase its expenditure either on consumption or on investment without an increase in taxation and thereby incur a deficit in the budget, the deficit being covered either by the creation of new money or by government borrowing. For example, marginal propensity to spend is 3/4 in the society and, hence, multiplier is 4, a deficit government expenditure of Rs. 1000 which is invested and spent in total will generate a national income of Rs. 4000 i.e., by multiplier times the initial injection of money into economy. This point has been shown with the help of diagram 1.

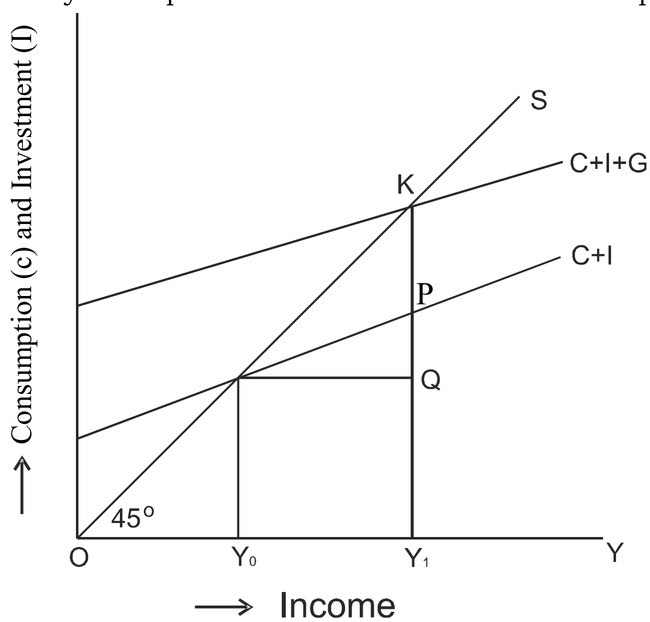

Diagram 1

In Fig. 1, C + I is the consumption - investment expenditure function in the absence of government action, OY measures national income (C + I + G denote the combined private and government expenditure function. KP = Government Expenditure. By increase in government expenditure national income increased to OY_1. The additional generation of income due to increase in KP amount of public expenditure is Y_0Y_1. PQ is additional amount of consumption. The expansionary effect of deficit spending will be greater if it is financed by creation of new money than by borrowing. The additional income will consequently increase employment.

Deficit without Spending :

The second device by which the government can remedy the problem of unemployment is by the reduction of taxation without any increase in government expenditure and thereby creating a budget deficit. When taxation is decreased, the disposable income of the people is increased. This will result in an ultimate increase in national income through successive doses of private expenditure. This is shown in Diagram 2, where a tax reduction of amount AB raises the consumption - investment function, and income, as a result, rises by BC which will generate additional employment.

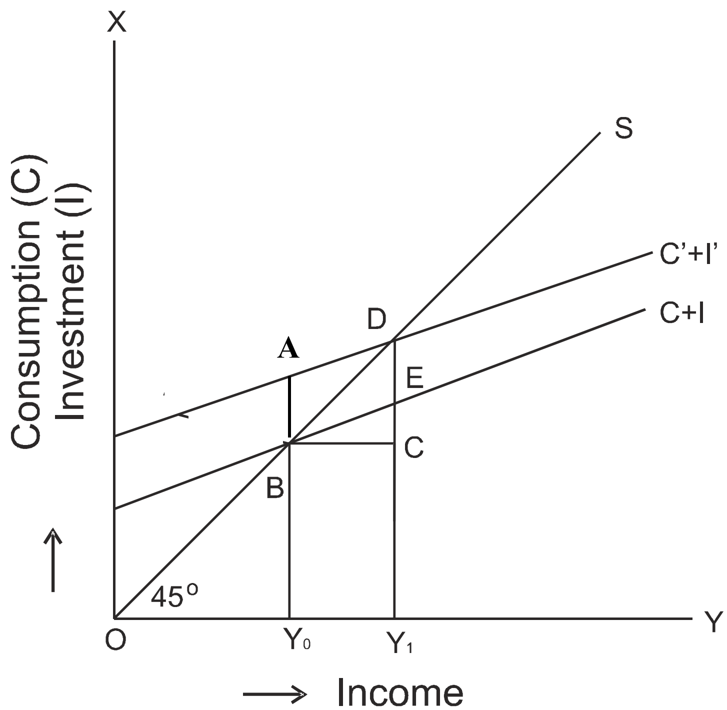

Diagram - 2

Balanced Budget Multiplier

The third alternative expansionary fiscal policy measures is the balanced budget multiplier. Here an increase in government expenditure is matched by an equal increase in taxes but still there is net increase in the national income, if we assume that the marginal propensity to spend is same for both the tax payers and the people who receive the money spent by government. An increase in government expenditure financed by an equal increase in taxes leads to a net increase in the national income and hence in employment and output.

1.3.6 Fiscal Policy and Economic Development

Economic growth implies a long-period expansion of the gross national product in real terms. Economic growth does not end with achievement of full employment. Level of full employment varies in different countries. Production capacity can be increased in many ways and, thus, every economy aims at higher rates of growth. Thus deficit financing becomes an essential fiscal instrument in raising the level of full-capacity output as a long-run policy. Long-run growth depends on many factors like volume of employment, technical skill, physical capacity etc., all these will be fully exploited. The physical capacity is higher in developed countries than in under-developed ones. In the former, labour is generally fully utilised with production capacity left unutilised while in the under-developed countries, labour can not be fully employed because of shortage of capital formation. Thus fiscal policy in developed countries is more concerned with increase of labour employment, but in backward economies, it is basically devoted to development of infrastructure which helps to generate capital formation.

The role of fiscal policy in advanced countries is to maintain full-employment, and economic stability while its role in developing countries is to accelerate. Therefore, to achieve the maximum possible rate of economic growth is essentially a Post-Keynesian analysis of fiscal policy. In under-developed countries, active intervention of the state is inevitable for the promotion of saving and investment which in turn promotes economic growth. Thus the government should devise such a fiscal policy for the promotion of investment and saving in under developed economies. Moreover, these countries face the problem of foreign capital. By increasing the incremental saving ratio, the marginal propensity to save through public finance, taxation and borrowings, the problem can be solved.

1.3.7 Fiscal Policy and Inflation

To meet the chronical situation of inflation and deflation, compensatory fiscal policy is adopted. Compensatory fiscal policy refers to those fiscal actions that are directed to compensate for this undesireable development in the private economy so that a high level of employment can be maintained without inflation or deflation. When there are inflationary tendencies, the government should take steps to reduce its expenditure by having a surplus budget and raising taxes in order to stabilise the economy. In deflationary situation the government should adopt methods to raise expenditure through reducing taxes, public borrowings and deficit budgets. Since the stabilisation function of government budget is to maintain full employment with price level stability, compensatory fiscal policy becomes the main instrument of achieving this objective.

Musgrave describes the basic logic of compensatory fiscal policy in three rules, (a) If involuntary unemployment prevails, increase the level of demand so as to adjust aggregate expenditures upward to the value of output produced at full employment. (b) If inflation prevails, reduce the level of demand so as to adjust aggregate expenditures upward to the value of output measured in current, rather than rising prices. (c) If full employment and price-level stability prevail, maintain the aggregate level of money expenditures to prevent unemployment and inflation. The effect of compensatory fiscal policy in relation to inflation and deflation on the economy is created by three principal means, viz., (i) changes in the amount of government expenditure, (ii) changes in the amounts of taxes and transfer payments and (iii) changes in the amount of budget deficit and budget surplus. To cure the economy of inflation and deflation, a combination of these fiscal instruments is generally used.

If the economy suffers from instability of the type of deflation, i.e., a falling trend of price level due to depression arising out of decline in the aggregate demand in the economy, investment in production will fall and, hence involuntary unemployment will develop. Under such a situation, fiscal policy should be used to increase the level of aggregate expenditure in society. Fiscal policy directed to increase aggregate expenditure will raise the level of demand and will lead to rise in prices and larger production to meet additional demand. Thus fiscal programmes to remedy depression have to be so designed as to result in deficit budget, i.e., larger spending than earnings of the government.

During inflation, the economy faces a situation of too much money chasing too few goods. To cure the economy from such a situation, excess purchasing power has to be eliminated. Thus the fiscal policy can be designed to either.

- (i) reduce government expenditure with taxes constant; or
- (ii) increase taxes or reduce transfer payments or combine both policies.
- (iii) Combine a policy of increasing taxes or reducing transfer payments with that of reducing government expenditures so that private spending is reduced.

On the other hand A.P. Lerner and his followers have given the compensatory fiscal policy an extreme form. In their view, public finance must be "functional finance" whereby all fiscal instruments are to work in the direction of maintaining an adequate level of national income in preference to every other consideration. When the economy suffers from inflation, the functional finance will suggest a surplus budget with reduced government expenditure, increased taxation, reduced transfer payments and increased borrowings. This will reduce the private consumption and investment expenditures and check inflation.

Anti-Inflationary Fiscal Policy

Inflationary phase of trade cycle is the reverse order of unemployment and deflationary situation. Under inflationary situation, private expenditure go on increasing even after full employment is reached. Since there do not remain unutilised capacity and idle resources or manpower, the increase in aggregate expenditure cannot add to production but only raises the price level. However, due to increased incomes in society, government revenues would rise and would lead to budget surplus. But this surplus is often not sufficient to counter the inflationary pressure of over-investment. The normal budget surplus that could be created due to automatic rise in revenues and fall in deflation - oriented public expenditure is no likely to be anywhere near the excessive rise in private expenditure. Therefore a deliberate budget policy and fiscal action must be evolved to meet the situation. The alternative fiscal remedies are :

(i) reduce effective demand to a level where aggregate expenditures become equal to the value of output at stable prices.

(ii) reduce private consumption by imposing new taxes or raising rates of taxes.

(iii) curtail all non-development expenditure of government.

(iv) combine tax-expenditure measures. If economy suffers from acute inflation, decrease in government expenditure should be combined with increase in tax rates and imposition of new taxes.

Thus Budget surplus is the main instrument to check inflation. But the creation of budget surplus is not always feasible, when inflation arises due to war expenditures or compulsions of public expenditure for economic development in under-developed countries. Hence in such cases the revenue side has to provide the main fiscal measures. Taxation as an anti-inflationary fiscal device has also serious limitations.

The fiscal policies must be supplemented by monetary and debt policy.

1.3.8 Fiscal Policy and Redistribution of Income and Wealth :

In developed countries inequalities of income and wealth, while still substantial have narrowed down. This has been possible by a combination of increases in productivity and redistributive government.

The case do developing countries is quite different. There is worsening poverty with increasing GNP. Traditionally, fiscal policy has been considered to take care of income redistribution. For this purpose it is considered as "the most effective and least disruptive instrument of the state for bringing about distribution." The fiscal redistribution is brought about in two ways. The first instrument is progressive income taxes which take relatively larger shares from the rich than from the poor. The other is the expenditure programmes which transfer income to the poor through various measures.

Now, increasing doubt is expressed about the efficacy of the fiscal system as a weapon of social justice. It is now being realized that fiscal systems of developing countries have failed to redistribute income in favour of the poor. On the contrary, it has accentuated the inequality and the short term effect of economic growth on income distribution may cause greater inequality.

Redistributive Role of Taxes

The tax system can influence income distribution in two ways which have been called by R.M. Bird as (i) Primary redistribution and (ii) Secondary redistribution. The first is concerned with pre-tax income distribution - through policies affecting employment and the implicit taxes and subsidies which distort relative prices need to be considered. All these taxes and subsidy measures which have the effect of raising the level of employment should be taken as improving income distribution. Payroll taxes, exemption from import duties for imported capital equipment, tax and other incentive policies to induce more investment through lower capital prices are measures which reduce employment as they encourage the relative expansion of capital-intensive lines of production. In developing countries where considerable unemployment exists and capital is scarce, a reversal of this policy is needed.

The secondary redistribution takes care of post-tax income distribution after it has been initially distributed by the working of the economic system. Here the major instrument of tax policy is a global progressive personal income tax. In most poor countries, income tax is only a class tax with scattered coverage. Hence the potential of income tax to produce large revenue is likely to be realized only in the long run.

Redistributive Role of Public Expenditure

The problem of distribution cannot be tackled by taxes alone. Even the complete removal of all taxes on the poor would not make them much better off. It is for the simple reason that the poorest section of the society, particularly in rural areas, is only marginally associated with the economic life of the nation and thus little affected by taxes. What is needed therefore is to reduce the regressivity of taxes where it exists in order not to aggravate the inequality and to emphasize the importance of government expenditure. Redistribution of income through public expenditure can be effective only when the poor get larger benefits in absolute terms than the rich.

Self-Check Exercise-II

Q.3 How fiscal policy can control inflation?

Ans: ....
....
....

Q.4 Discuss redistributive role of taxes

Ans: ....
....
....

1.3.9 Fiscal Policy Vs Monetary Policy

The divergent views on the relationship of money supply and level of economic activity resulted in the formulations of different sets of policies for the control of economic oscillations. The doubts have been frequently raised about the monetary policy from the angles of its effectiveness, the desirability of the ways in which the policy works and the value of the actual compatibility of its aims. A very significant factor which affects the effectiveness of monetary policy is the duration of the lags of monetary policy. In addition, there are certain institutional difficulties in the effective operation of the monetary policy. The effectiveness of the monetary policy is also limited by the decisions of the individuals and business units about the income, spending and assets. Still another factor to account for the limited efficacy of the monetary policy is inflation and particularly the cost push inflation. The fiscal policy too has its weaknesses. It is often considered to be quite rigid, insensitive and cumbersome.

Anderson and Jordan laid down, tests to know the relative effectiveness of monetary policy and fiscal policy. On the basis of strength, predictability and promptness they found that monetary policy has a relatively greater effectiveness than the fiscal policy. Now the attitudes of the two divergent groups of economists have been considerably softened. An appropriate monetary - fiscal policy must be evolved for the achievement of different macroeconomic goals. During the period of boom or inflation, the fiscal restraints are likely to generate greater unemployment. Therefore, the monetary action is likely to tackle the situation much more effectively. The expansion of income and output and the maintenance of price stability can be ensured through a proper mix of monetary and fiscal action. When the economy is in a state of recession or depression, the easy money supply should be supplemented by a policy of tax reduction and expansion in government expenditure. When the system is close to a boom, the greater reliance upon monetary rather than fiscal action can yield desired results. For achieving other goals fiscal policy is more powerful than monetary policy.

Self-Check Exercise-III

Q.5 How fiscal policy and monetary policy are related?

Ans: ....
....
....

1.3.10 List of Question

1.3.10.1 Short Questions

1. Define Fiscal Policy.
2. Give two major objectives of Fiscal Policy.
3. Explain two instruments of Fiscal Policy.
4. What do you mean by balanced budget multiplier ?
5. What is deficit without spending ?

1.3.10.1 Long Questions

1. What are the goals of fiscal policy in the context of economic development of developing economies ?
2. Suggest a suitable fiscal policy for equitable distribution of income and wealth in developing countries.
3. Discuss the role of fiscal policy as an anti-inflationary measure.
4. Write short notes on :
   (a) Fiscal policy and full employment.
   (b) Fiscal policy and inflation.
5. Write briefly on Monetary Policy Vs Fiscal Policy.

1.3.11 Suggested Readings

Raja J. Challiah : Fiscal Policy in Underdeveloped Countries.
J.R. Gupta : Public Economics in India.
S.K. Singh : Public Finance in Theory and Practice.
R.K. Lekhi : Public Finance.
R.A. Musgrave : The Theory of Public Finance.

Lesson No. : 1.4 Author : Prof. J.R. Gupta

BUDGETARY DEFICITS

Structure of the Lesson

I. Introduction
II. Objectives
III. Deficit Budget : Meaning
IV. Concepts of Deficit
V. Summary
VI. Technical Terms
V. References

I. Introduction

In this lesson the students would know the meaning of different concepts of deficit which are commonly used. An attempt is particularly made to make the distinction between the revenue deficit and fiscal deficit clear.

In the lesson first of all an attempt has been made to clarify the different components of budget deficit i.e., deficit on revenue account and deficit on capital account. Thereafter, the term fiscal deficit has been explained taking different examples from the Indian budgets. These impact money supply and prices in the economy.

II. Objectives

The main objective of the lesson is to acquaint the students about usage of the different terms relating to budget deficit and examine their implications for money supply and prices. The usage of the term 'deficit', both in western sense and Indian sense has been explained.

III. Deficit Budget : Meaning

The term deficit budget is used in different senses in different economic systems. To designate the deficit budget of the Government the usage of the term fiscal deficit has become very common. Before the concept of fiscal deficit was evolved, we have been talking about revenue deficit i.e., deficit on revenue account, capital deficit i.e., deficit on capital account, budget deficit i.e., overall deficit, monetized deficit, deficit financing, etc. To understand the genesis of fiscal deficit, we shall have to first analyse its anatomy or components.

In fact the term fiscal deficit in the budget documents of the Government of India was perhaps first used in 1991, by the then Finance Minister, Dr. Manmohan Singh. Before him we have been talking about budgetary deficits and deficit financing. But deficit financing has been defined differently in the Western sense and in the Indian sense. And a proper interpretation of the usage of term deficit financing in the two senses would enable us to understand the concept of fiscal deficit.

In the Western sense, financing of the budgetary deficits denotes the technique of financing a deliberately created gap between public revenue and public expenditure, the method of financing resorted to is being borrowing of a type which results in a net addition to aggregate expenditure in the economy. However, in the Indian sense we have been defining deficit financing in terms of the overall budgetary deficit which means the aggregate of the deficit on both the revenue account and capital account. In the post 1991 reform period the term deficit is used in different senses. As per the First Five Year Plan:

The term 'deficit financing' is used to denote the direct addition to gross national expenditure through budget deficits, whether the deficits are on revenue account or on capital account. The essence of such a policy lies, therefore, in Government spending in excess of the revenue it receives in the shape of taxes, earnings of state enterprises, loans from the public deposits and funds and other miscellaneous sources. The Government may cover the deficit either by running down its accumulated balances or by borrowing from the banking system (mainly from the Central Bank of the country and thus creating money).

The Government may cover this deficit by: (a) running down its accumulated cash balances, (b) borrowings from the Central Bank or (c) creating new money.

Thus, in advanced countries deficit financing mostly takes the form of additional credit creation through the banking system. Hence, borrowing by Government either results in the activisation of idle deposits held in banks or by the private individuals themselves or in the creation of deposits by banks which purchase Government securities or bonds. Therefore, in the Western sense deficit budget means excess of expenditure over current revenue, i.e., market borrowings do not constitute part of Government revenue, whereas in the Indian sense hitherto market borrowings were considered part of Government receipts.

From the above discussion, it is clear that the concept of budgetary deficit may involve different technicalities which may give rise to different interpretations, though in a layman's language it implies excess of public expenditure over public revenue.

Self-Check Exercise-I

1 Explain the meaning of deficit financing in the western sense.

IV. Concepts of Deficit :

The few concepts of 'deficit' which are currently in vogue are discussed below:

(a) Revenue Deficit or Deficit on Revenue Account/Current Account

The traditional budgeting is divided into two accounts, viz., revenue account and capital account. Revenue account implies the current revenue or revenue on current account. It includes the usual receipts of the Government from tax and non-tax sources. While tax receipts are obvious, non-tax sources include the usual administrative revenue, commercial revenue from public enterprises including revenue from social and economic services, fees including court fees, fines, etc. which the Government usually receives in a particular year.

Expenditure on revenue account or current account is the component of Government expenditure which it has to incur for purchasing goods and services for consumption purposes in a particular year. That is why sometimes this expenditure is also called consumption expenditure. The main components of revenue account expenditure are salaries including pensions, interest payments and subsidies. In fact the concept of revenue account might become clearer when we define capital account. Revenue deficit implies excess of revenue account expenditure over revenue account receipts. Since expenditure on interest payments is considered to be due to the past action of the Government (in the sense that interest on already borrowed money will have to be paid), therefore, revenue account deficit net of interest payments is sometimes termed as *primary revenue deficit.*

(b) Deficit on Capital Account

In India the main source of capital account receipts has been public borrowings which were resorted to by the Government in the past to build capital assets. In developing countries like India, where the Government has to play a crucial role to build economic and social infrastructure, the Government may have to generate enough surpluses on its own for investible purposes. It goes to the credit of the Government of India that in spite of wide spread poverty it has been generating more revenue than expenditure on revenue account up to 1970's. And these surpluses i.e., excess of receipts over expenditure on revenue account were being transferred to capital account to be used for building capital assets. Since the Government cannot finance its entire expenditure on capital account with revenue surpluses the Government resorts to borrowing. Capital account includes expenditure on (a) gross fixed capital formation i.e., building and construction as well as machinery and equipment, (b) increase in inventories including store and stock of food grains, (c) repayment of public debt and (d) capital transfers i.e., grants for capital formation to the States, Union Territories or the Local Governments, gratuity and commuted value of pensions and other capital transfers. Therefore, borrowings are the major source of revenue on capital account. The other sources of revenue on capital account may be selling of assets or what we call now is disinvestment of public sector enterprises.

To understand the distinction between expenditure on revenue account and capital account, it would be better if these expenditures are defined in terms of the quantum of assets and liabilities created during a particular period. Receipts which increase the Government liabilities (like public borrowings) or reduce the public assets (like receipts from disinvestment of public sector expenditures) should be termed as receipts on capital account. Conversely any public expenditure which increases public assets like expenditure on investment, renewals, repairs, increase in inventories, etc. or reduces the public liabilities (like repayment of public debt and payment of commuted value of pension and gratuity) should be termed as expenditure on capital account. All other usual types of expenditure and receipts should be termed as those on revenue account. For example, take the case of payment of pension. The payment of regular pension is like payment of regular salary. Therefore, this expenditure is termed as expenditure on revenue account. But payment of commuted value of pension (in lump-sum) reduces the liability of the government in future, therefore expenditure on commuted pension is termed as capital account expenditure. It should be born in mind that because of its nature, capital account has to be in deficit, particularly in developing countries like India, which is no harm, because the money so raised is spent for building capital assets.

(c) Budget Deficit

The total budget is defined as the sum-total of revenue account budget and capital account budget. Obviously total budgetary receipts would include receipts both on revenue account as well as those on capital account. And total budgetary expenditure would mean the sum-total of expenditure on both revenue account and capital account. In this context before 1991, we have been talking about total budgetary deficit, which was financed by drawing down of previous balances, borrowings from the Reserve Bank of India, printing of new money, etc. These moves always led to net addition in money supply/money expenditure in the economy and was termed as deficit financing. Obviously, deficit financing was always inflationary that is why it was mostly dreaded.

Self-Check Exercise - II

1 Discuss the different components of budget deficit.

(d) Fiscal Deficit

Fiscal deficit is the difference between total receipts (excluding net borrowings) and total expenditure. In other words, borrowings are not considered as part of government receipts. As already stated in the beginning, this is what deficit financing means in the Western sense. For example, as per Keynesian prescription to fight great depression Government should create the deficit budget which may be either financed through the creation of new money or through borrowings of idle funds which were lying idle with the people or banks and need to be activated.

In a free enterprise economy, the Government's income is from taxation; any expenditure in excess of tax receipts must be financed by borrowings or newly created money.

Obviously deficit financing defined in the Indian context and in the Western sense carried different economic connotations having different economic implications. For example, deficit financing defined in the Western sense has to be less inflationary.

Coming specifically to the concept of fiscal deficit reduction of which carries the hallmark of every sound budget. As already stated broadly it denotes the difference between total receipts (net of borrowings) and total expenditure. That is part of the budget which is financed through public borrowings is termed as fiscal deficit.

Gross fiscal deficit is defined as the difference between revenue receipts (net) plus non-debt capital receipts and the total expenditure including loans net of repayments. This is a measure, which captures the entire shortfall in the non-debt resources for financing the Central Government operations.

To some commentators, however, "fiscal deficit is defined as the difference between total government expenditure (current and capital) and revenue receipts. It may be decomposed into debt-financed deficit and money-financed deficit depending on whether it is met by borrowings from the public or from the Reserve Bank of India". Thus, if we deduct monetized deficit from the fiscal deficit, this may show debt-financed deficit. This view is useful for monitoring the growth of public debt which may lead to a situation of debt-trap after a certain limit. The Government of India has also been trying to put a cap on Government borrowing with the help of Fiscal Responsibility and Budget Management Act.

To reduce the fiscal deficit, the two sides, i.e., receipts and expenditure, must match. Now let us see what the Government is doing. Coming to the management of public expenditure first. Total expenditure has two sides: revenue account expenditure and capital account expenditure. As already said expenditure on revenue account comprises mainly of salaries (nearly 60-70 per cent), interest payments (30 per cent) and subsidies. Expenditure on interest payments on public debt, because of past commitment can not be curtailed. So far the Government has failed to downsize, therefore, the axe has to fall on subsidies. One must have come acrossed the often repeated rhetoric of the Government while presenting every budget that it would slash the quantum of subsidies so as to get hold over ever burgeoning fiscal deficit. But, alas, this measure has its own political compulsions and the result is ever increasing swelling of fiscal deficit. Thus, revenue account expenditure being broadly committed and of non-plan nature is very difficult to curtail. This results in ever burgeoning revenue deficit.

Coming to the second component of public expenditure i.e., expenditure on capital account. It is the major casualty. The public expenditure on capital account has been witnessing a downward trend. Not only public expenditure on economic infrastructure, viz., power, transport, communication, etc., is being slashed even social infrastructure like education and public health are getting step motherly attention of the Government. While the former i.e., economic infrastructure is being handed over to the private sector, the neglect of the latter i.e., social infrastructure has been causing a great social and economic tensions. In fact when one examines the trends of public expenditure of the State Governments one would find that the States have found an easy way to cut capital expenditure and plan expenditure since they have no control over non-plan expenditure, which is of committed nature.

Now coming to the receipts side of fiscal deficit, which includes tax and non-tax sources as well as receipts from disinvestment of public sector enterprises. Tax revenue of the Central Government as proportion to GDP has been varing between 10 percent to 11 percent since 2008-09, while non-tax revenue like fees and fines is mainly realized by the State Governments. Now what the Central Government is doing and even Finance Ministers are admitting that in order to reduce the fiscal deficit, they are disposing of Public Sectors Undertakings (PSUs) and showing an increasing proceeds from disinvestment of public sector enterprises as government recepits. It is another thing that these proceeds are not being materialized. Now the point to debate is that proceeds from disinvestment are receipts on capital account because these proceeds directly lead to the depletion of Government assets. Therefore, a simple logic demands that these capital account receipts should be used for capital account expenditure i.e, either for retiring the public debt or for reinvestment in remaining public sector enterprises. However, presently the Government has been using these receipts to meet the needs of revenue or current expenditure so that fiscal deficit is contained. The critics have rightly termed this as a 'Myopic Approach' to managing fiscal deficit. In the process we are eating our own assets. The main sufferers would be the future generations who would inherit less capital stock. The Government which is a custodian of the interest of future generations appears to have become callous to their interest.

Insofar as the other receipts are concerned, i.e. tax and non-tax receipts, which are broadly receipts on revenue account, these have their own economic logic. In India, already the tax rates have been quite high (though there is a scope to widen the tax-net and tax base) and in view of the globalization, privatization and liberalization these have to be further slashed so as to improve the competitive strength of the Indian economy. Therefore, the Government will have to look towards non-tax sources notably user charges.

Self-Check Exercise-III

1 How India tends to contain fiscal deficit?

(e) Primary Deficit

Primary deficit which is defined as fiscal deficit minus interest payments is usually termed as the main culprit of fiscal mismanagement. Interest payments are said to be due to the past action of the government and hence unavoidable. But other items of expenditure are due to the current action of the Government and are, therefore, controllable to some extent. However, it may be emphasized that interest receipts are also due to the past contract of the Government. Therefore, the correct definition of the primary deficit should be:

Primary Deficit= Fiscal Deficit—Interest Payment+ Interest Receipts

However, in the Reserve Bank of India Bulletins, primary deficit does not take into account interest receipts. Therefore, primary deficit figures as shown by the Government are underestimates to some extent.

(f) Net Fiscal Deficit and Net Primary Deficit

Sometimes, for analytical use a distinction is made between gross fiscal deficit and net fiscal deficit, and gross primary deficit and net primary deficit. While fiscal deficit, defined as above, could be termed as gross fiscal deficit, net fiscal deficit may be defined as fiscal deficit net of 'loans and advances', mentioned in capital account of the budget. That is 'loans and advances' are not meant for consumption purposes. By the same logic one can say that other expenditure on capital account which is meant for the creation of capital assets should also be taken into account. If that is done, it will again bring us close to the earlier classification of deficit budget i.e., deficit on revenue account and deficit an capital account. Similarly one can work out the net primary deficit by subtracting 'Loans and Advances' from the primary deficit.

(g) Monetized Deficit

To finance the deficit budget, the Central Government, apart from other measures, borrows from the Reserve Bank of India which directly add to money supply. This is due to the fact that borrowings from the Reserve Bank of India by the Central Government are simply book entries against which the latter can make the necessary payments.

Thus, monetized deficit is the increase in net Reserve Bank of India credit to the Central Government which is the sum total of net increase in the holdings of treasury bills of the Reserve Bank of India and its contribution to the market borrowings of the Government. Monetized deficit is the borrowings made from the RBI on the net addition to the securities placed with the RBI. But it should be remembered here that the monetized deficit, defined as above, may not be a perfect index to measure the inflationary pressure of the central budget, because loans from the general banking sector also add to the liquidity and hence to the inflationary pressure of the economy. Similarly overdrafts to the States have also similar inflationary tendencies to generate.

Unauthorized Overdrafts: In the Indian context overdrafts, particularly unauthorized overdrafts, constitute another source of financing budget deficits.

The extraordinary form of borrowings commonly known as unauthorized overdrafts, is unauthorized in the sense that no prior arrangements for borrowings are entered into between State government and the RBI. Such borrowings arise, either because the limits agreed to between the State and the RBI for ways and means advances and special ways and means advances are exceeded or because these advances are not repaid within a period of three months as per the rules. When a State government resorts to such unauthorized overdrafts the RBI draws the attention of State governments to this fact and requests the latter to clear the overdrafts as quickly as possible. It keeps the Central government informed.

Why do State governments resort to unauthorized overdrafts? In most cases the State governments are simply unable to raise resources to finance their plan expenditure. Further many of them violate all canons of financial management.

Actually these overdrafts do not constitute regular resources at all. Unauthorised overdrafts have the same effect as that of deficit financing of Union government. Both raise the money supply in the country and are responsible for pushing up price level. There is however one slight difference. Deficit financing initially consists of a short-term borrowings in the form of treasury bills but is made permanent by converting the treasury bills into long term securities. On the other hand unauthorized overdrafts have to be repaid ultimately by the State government or by the Centre, if the concerned State government does not have the necessary finances.

The overdrafts are cleared through adjustment against Central assistance to the concerned State for plan schemes sanctioned by the Government of India or through advance payment made by Centre to the States in respect of the States' share of taxes and grants in-aid. Sometimes the Centre may grant ways and means assistance to States to enable them to clear their unauthorized overdrafts. For this purpose the Centre may sell adhoc treasury bills to the RBI to clear the overdrafts of a state Government. In other words, a loan by the RBI to the State Government becomes ultimately a loan from the Central Government to the State Government. The amount of overdraft thus cleared by Central Government is treated by the Centre as an ad hoc loan to the States.

The Fifth Finance Commission condemned the system of unauthorized overdrafts on the ground that no country with a unified currency system could afford to have more than one independent authority taking measures, which result in increase in money supply. In other words unauthorized overdrafts run counter to the principle of sound monetary management. In India the problem of unauthorized overdrafts became quite serious during the middle of the Fourth Plan. From £ 240 crores in 1969-70, ways and means advances rose to a record high of £ 600 crores by end-March 1972 due to extensive unauthorized overdrafts. The Central Government took a serious view of the situation and ordered the Reserve Bank to discontinue overdrafts to the States from May 1970 except for a temporary period of 7 days. By march 1973, the ways and means advances of RBI to the States declined from £ 600 crores to £ 94 crores.

Despite stringent measures taken by the Union government unauthorised overdrafts gradually increased again and in 1981-82, they were as high as Rs. 1060 crores. But if we add the ways and means advances taken by the States, their debt to the RBI came to a huge amount of Rs. 1741 crores. This entire liability was taken over by the Central government which asked the RBI to keep a strict watch on the ways and means advances to the States. With the financial discipline imposed by RBI unauthorized overdrafts came down to about Rs. 60 crores at the end of 1982-83. This stress on the financial discipline on the part of the States was also the compulsion of the IMF loan, under which the government had committed itself to a limit for net bank borrowing. Naturally the States could not go about merrily piling up the overdrafts. An important step towards phasing out the monetisation of debt was taken with the enactment of the FRBM Act, 2003 that barred the Reserve Bank from subscribing to the primary issuances of the government from April 1, 2006.

(h) Structural Deficit

The Eleventh Finance Commission (XIFC) considered that the structural deficit as the main bane of fiscal mismanagement. It is defined as a product of "the discretionary policy actions of an expansionary fiscal stance of the Government". Obviously, structural deficit is expected to persist when the Government resorts to competitive populism resulting to needless subsidies without commensurate efforts to raise the required resources. Rising interest rates on public borrowings in the eighties was another structural factor contributing to fiscal imbalance. This has led to sustainable growth of public expenditure. On the revenue side also virtual stagnation in the level of non-tax revenues and falling buoyancies of gross tax revenue from 1.15 during the eighties to 0.91 during the nineties in case of the Centre, and from 1.12 to 1.04 in case of the States would provide valuable insight into the character of the imbalances in the public finances in India. It brings out clearly that deficits at both levels of the Governments are mainly structural. Until and unless corrective long term measures are undertaken, structural deficit is expected to persist. According to the XI FC, structural deficit registered "an increase during the 1980's accounting for more than 100 per cent of the FD of the Centre in the late eighties. Following the reforms initiated in the wake of the balance of payments crisis of 1991, the structural deficit went down, yet accounted for over 80 per cent of the FD. Structural factors were found to be dominant in the case of States also."

From the above discussion, it is clear that one can define the term of budgetary 'deficit' in a number of ways. Each definition or concept of deficit has its own logic and analytical use. Depending upon the policy perspective for sound fiscal management and the stage of the economy each concept has its own relevance and limitations.

Self-Check Exercise-IV

Q.1 Define the concept of primary deficit.

Ans: ....

....

....

Q.2 What do you mean by monetized deficit?

Ans: ....

....

....

Q.3 Define the concept of structrual deficit.

Ans: ....

....

....

V. Summary

It may be summarized that the term deficit has been used in different senses. Where as in western sense deficit budget means excess of expenditure over current revenue, i.e., market borrowings do not constitute part of Government revenue, whereas in 'budget deficit', the term hither to used in Indian sense, market borrowings were considered part of Government receipts. Thus in the western sense the term of deficit implies 'fiscal deficit', which is less inflationary.

VI. Technical Terms

Receipts on revenue account: Government revenue from all sources including tax and non tax sources like fees, fines, prices, etc.

Receipts on capital account: Government receipts on account of borrowings and/ or selling government assets.

Monetized deficit: That part of the deficit budget which leads directly to the increase in money supply.

Debt financing: Financing of the deficit budget through borrowings.

Accumulated cash balances: Cash deposits of a country which have been accumulated over the past, lying within or outside the country, e.g. sterling balances of India in UK.

Commuted pension: The amount received by government employee at the time of retirement as an option to receive a certain portion (presently 40 percent) of his expected pension for 10-15 years.

Primary Deficit : Fiscal deficit less interest payments

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Important Questions for your Practice

Long Questions

1. In the Indian context the term 'Revenue Deficit' is more important than 'Fiscal Deficit'. Explain.
2. What are unauthorized overdrafts? How they affect the Indian economy.

Short Questions

1 Define the term monetized deficit.

2 What is FRBM Act?

3 What is debt financing?Define primary revenue deficit.

SUGGESTED QUESTIONS

Section A

1. Explain clearly the conditions under which public debt is a better source of finance as compared to taxation.
2. Do you agree with the view that public debt imposes a burden on the posterity? Give reasons for your answer.
3. Explain the various methods of debt redemption. Which of them do you consider most appropriate? Give reasons for you answer.
4. Comment on the desirability to redemption of public debt and critically examine the use of capital levy as a method of debt redemption.
5. Explain the meaning of public debt. Give the brief history of public debt in India.
6. State and explain the necessity of public debt in a developing country life India.
7. Discuss the internal and external public debt burden in India.
8. Write an essay on public debt of State Governments in India.
9. What are the goals of fiscal policy in the context of economic development of developing economies.

SHORT ANSWER TYPE QUESTIONS

Section B

1. Burden of public debt.
2. Need for public debt.
3. Modern theory of public debt.
4. Taxes versus loans.
5. The choice between borrowing and creation of money.
6. Which method of debt redemption is most appropriate?
7. Can the problem of public debt be solved by the method of repudiation?
8. Advantages of capital levy.
9. Disadvantages of capital levy.
10. Sinking fund method.
11. Role of foreign assistance in India.
12. Differentiate Revenue and Capital Budget.
13. Define fiscal policy.
14. Objectives of fiscal policy.

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