

PUBLIC DEBT AND DEFICIT

Chapter 13

CONCEPT

- Refers to the loans raised by the government from within or outside the country.
- Every government has to borrow when its expenditure exceeds its revenue.
- One of the instruments to cover deficits in budget.
- Contrasts to the annual government budget deficit, which is a flow variable that equals the difference between government receipts and spending in a single year.
- Debt is the accumulation of each year’s deficit. Stock concept.
- Obligations of governments, particularly those evidenced by securities. To pay sums to the holders at some future date.
- Utilized for developmental and non-developmental purposes.

Comparison between Public & private Debt

BASIS	PUBLIC DEBT	PRIVATE DEBT
Compulsion	Can compel people & institution	Cannot compel
Repudiation	Govt can refuse	Bankruptcy is the only solution
Time Period	Longer periods	Shorter periods
Rate of Interest	Lower	Higher
Mode of payment	Taxing or borrowing	Mostly savings
Effect on economy	Effect on production distribution	No such effect
Sources	Inside or outside the country	Only from within the country

NEED FOR PUBLIC DEBT

a. Deficit Budget
b. Financing of War
c. Natural Calamities
d. Economic Development
e. Financing of Public Enterprises
f. To check Economic Stability
g. To provide foreign exchange
h. Soft Revenue option

CLASSIFICATION OF PUBLIC DEBT

Type of DEBT	Type of DEBT	BASIS
Internal- within	External- outside	Political boundaries
Productive- yes	Unproductive- no	Yield derived
Redeemable- P & Int	Irredeemable- Int	Principle & interest amounts
Short term- 3-4 months	Long term- 10 yrs. or more	Time period
Funded- yes	Unfunded- no	Fund creation
Voluntary- willingly	Compulsory- forcefully	Choice
Marketable- tradable	Non-Marketable- non tradable	Tradability in stock exchange
Gross- total	Net- total minus sinking	Debt outstanding

DEBT MANAGEMENT

1. Repudiation of Debt
2. Refunding
3. Debt Conversion
4. Reduction in Rate of Interest
5. Terminal Annuities
6. Sinking Fund
7. Budgetary Surplus
8. Capital Levy
9. Additional provision of taxation

BURDEN OF PUBLIC DEBT

The concept has been a source of debate among various economists. According to Buchanan 1958, primary real burden of public debt falls onto future generations. Debt financing postpones the payment of taxes onto future generations(payment of taxes being burden).

Public debt reduces the amount available for private consumption by the community at the time borrowed funds are used and thus it affects the present consumption expenditure.

According to Modigliani, public debt whether raised internally or externally is advantageous to the generation present at the time of increase and will pose a burden on future generation through reduction in stock of capital. (As if the present generation provides resources without reducing the consumption, this means they will be providing resources out of their savings which would adversely affect the capital accumulation for future generation.)

The burden can be measured by the interest to be paid on debt and such burden

BURDEN OF PUBLIC DEBT

Public debt creates real and monetary burden on economy and its public. Public debt tends to increase the disposable income of present generation and decrease the same of future generations by increase in taxes for generation of funds for repayments.

1) Direct Money Burden
2) Indirect Money Burden
3) Direct Real Burden
4) Indirect real burden
5) Inflation
6) Unjustified Transfers
7) Effect on Private Investment
8) Effect on social development
9) Problem of Debt Trap
10) Domination by Creditor Country
11) Burden on Forex
12) Burden of Unproductive Foreign Debt

EFFECTS OF PUBLIC DEBT

POSITIVE

- Mobilization of resources
- Increase in the productive Capacity
- To promote Investments
- Development Expenditure
- Obtaining Foreign Exchange

NEGATIVE

- Inflationary Impact
- Additional Tax Burden
- Adverse impact on savings and investment
- Effects on distribution of income
- Unproductive Debt
- Debt servicing burden

DEFICIT FINANCING

DEFINITION- Financing the budgetary deficit through public loans & creation of new money.

3 ways to cover deficit by Government-

i. By running down its accumulated Cash Reserves
ii. Issue of New Currency by government itself
iii. Borrowing from RBI, which gives loan by printing money.

OBJECTIVES OF DEFICIT FINANCING

1. To Finance War
2. Remedy for Depression
3. Economic Development
4. Mobilization of Resources
5. For Grating Subsidies
6. Increase in Aggregate Demand
7. For the payment of Interest

ADVERSE EFFECTS OF DEFICIT FINANCING

1. Leads to inflation
2. Adverse Effect on Savings
3. Adverse Effect on Investment
4. Inequality
5. Problem of BOP
6. Increase in Cost of Production
7. Change in pattern of Investment

Is Deficit Financing inflationary?

It is said that deficit financing is inherently inflationary. Since deficit financing raises aggregate expenditure and, hence, increases aggregate demand, the danger of inflation looms large. This is particularly true when deficit financing is made for the persecution of war.
This method of financing during wartime is totally unproductive since it neither adds to society's stock of wealth nor enable a society to enlarge its production capacity. The end result is hyperinflation. On the contrary, resources mobilized through deficit financing get diverted from civil to military production, thereby leading to a shortage of consumer goods. Anyway, additional money thus created fuels the inflationary fire. However, whether deficit financing is inflationary or not depends on the nature of deficit financing. Being unproductive in character, war expenditure made through deficit financing is definitely inflationary. But if a developmental expenditure is made, deficit financing may not be inflationary although it results in an increase in money supply.

To quote an expert view: "Deficit financing, undertaken for the purpose of building up useful capital during a short period of time, is likely to improve productivity and ultimately increase the elasticity of supply curves." And the