

CHAPTER 1

BASICS OF PUBLIC FINANCE

Introduction

Governments, all over the world have started number of public projects. To provide social facilities, the government requires adequate revenue. Public Finance, therefore, deals with the income and expenditure of public authorities. It deals with the financial operations or finances of the government. The government raises revenue from internal as well as external sources to incur huge expenditure on various functions the government has to perform. Public finance is thus concerned with the use and accomplishment of essential monetary resources of the government. Public finance deals with how and through what different sources the government gets income, how it spends it and how it controls and administers its incomes and expenditures. Therefore, the subject matter of public finance deals with public revenue, public expenditure, and public debt.

Definition and Scope of Public Finance

- Public finance is a very old science and different economists have defined it in their own ways.
- 1. Is concerned with the income and expenditure of public authorities and with the adjustment of one to the other.” Huge Dalton
- 2. Deals with the provision custody and disbursement of resources needed for conduct of public or government functions.” Lutz
- 3. Is a science which deals with the activity of the statement in obtaining and applying the material means necessary for fulfilling the proper functions of the state.” Carl Plehn
- 4. Is the study of the principles underlying the spending and raising of funds of public authorities.” Findley Shirras
- 5. Studies the economic activity of government unit.” Buchanan
- 6. Deals with expenditure and income of public authorities of the state and their mutual relations as also with the financial administration and control.” Bastable

All of them say that it is a study of income and expenditure of the central, state, and local governments. Government performs many functions which the individual can not or do not perform. Therefore, raising of funds for the expenditure and their disbursement constitutes the subject of Public finance.

Scope of Public Finance

The subject matter of the public finance is classified under five broad categories.

1. Public Revenue
2. Public Expenditure
3. Public Debt
4. Financial Administration and Control, and
5. Economic Stability and Growth.

(1) Public Revenue

Revenue includes all incomes irrespective of the source they are obtained from. Thus, in the wider sense, we can include taxes as well as borrowings under public revenue. But in the interest of the clarity, public revenue includes only those incomes which do not carry with them the obligation of repayment for the state. Thus, public revenue implies raising income by way of taxation.

(2) Public Expenditure

Public expenditure is the end and aim of the collection of revenues. public expenditure are concerned with

- o Principles and problems relating to the expenditure of public funds.
- o The fundamental doctrine that governs the distribution of the expenditure among various heads.
- o Various effects of public expenditure on total employment, total income, aggregate investment, output, distribution and general price level etc.

- o Through public expenditure, the government contributes to the financial flows of the economy and conditions the demand and supply patterns. Public expenditure is also used as a tool for implementing welfare, growth, stabilization and other policies, by the government.

(3) Public Debt

A public authority can obtain income through loans and public borrowings.

- ✓ The study public debt also includes:

- (i) Methods and objectives of public borrowings;
- (ii) Management of public debt

(4) Financial Administration and Control

- ❖ Public finance also examine the mechanism by which the above processes are carried on. With out a study of relevant dimensions of financial administration the subject of public finance remains incomplete.

- ✓ Thus financial administration and control include the following:

- (i) Study of budgets and their procedure.
- (ii) Budget as a instrument of securing certain objectives, such as promotion of employment, economic growth with stability, welfare of the weaker sections, infrastructural development for promoting private investments, etc.
- (iii) Financial and physical controls through different fiscal tools for controlling private expenditure in the economy to avoid the effects inflation deflation, recession etc.

(5) Economic Stability and Growth

- The study of public finance includes fiscal policy of the government in dealing with inflationary and deflationary situations, instability of the price level, promotion of full employment, growth of economy, welfare of the people, etc.

Difference between Public Finance and Private Finance

Finance in general means public as well as private finance. Public finance relates to the money-raising and income-expenditure functions of the government. Private finance refers to the income-expenditure phenomenon of an individual or private business. By private finance mean the financial problems and policies of an individual economic unit.

Similarities

- (1) **Satisfaction of Human Wants;-** Both the public and private finance have the same objective, i.e., the satisfaction of human wants. Public finance is concerned with

the satisfaction of social or collective wants, whereas private finance is concerned with the satisfaction of personal or individual wants.

(2) **Maximum Advantage from expenditure**;- Both the public finance and private finance try to secure maximum advantage or maximum benefit. An individual or a corporation or a private business firm tries to obtain maximum advantage from his expenditure. Similarly, the government also tries to obtain maximum good of the people by incurring expenditure on the society.

(3) **Borrowings**;- Another similarity between the public and private finance is that many times both have to be obtained from the market in the form of borrowings whenever the expenditure of either the government or any individual or firm exceeds their income/revenue.

(4) **Engagement in Similar Activities**;- Both the private and public sectors are engaged in activities that involve lots of purchases, sales and other transactions. Similarly, they are engaged in production, exchange, saving capital accumulation, investment, and so on. In order to finance these operations, the government, creates money, raises loans and makes payments etc. Similarly, a private economic unit lends, borrows, receives payments, makes payments and so on. In these respects, therefore, both the public and private finance are quite similar to each other.

(5) **Scarcity of Resources**;- The scarcity of resources is also an important factor which is common to both. They have unlimited objectives, whereas the resources are limited.

(6) **Problem of Adjustment of Income and Expenditure**; - Another similarity between public and private finance is that both the public as well as private sectors face the problem of adjustment of income and expenditure.

Dissimilarities

(1) **Motive**;- The motive of private finance is personal interest or benefit, whereas the motive of public finance is social benefit or public welfare.

(2) **Adjustment Approach of Income and Expenditure**;- Another dissimilarity between the individual's private finance and the government's public finance is that

every individual tries as far as possible to adjust his expenditure to his income because his expenditure depends on his income. Conversely, the government first prepares its budget. In other words, the government first determines its expenditure and then devises ways and means to raise the requisite revenue to meet its expenses.

(3) Nature of Resources:- The resources (private finance) of an individual are more or less limited, whereas the resources of the government (public finance) are enormous. Government can raise resources from tax sources as well as non-tax sources. The government can borrow from internal as well as external sources.

(4) Coercive Methods:- An individual (private finance) cannot use coercive methods to raise his income, Whereas the government (public finance) can use forceful methods to collect revenue. In other words, to collect revenue, the government imposes taxes at a high rate on the people irrespective of their capacity to pay. Private individuals or bodies have no such powers.

(5) Secrecy of Budget:- Public finance is an open affair as the government gives utmost publicity to its budget by publishing it in newspapers and by showing it on television. For example, the Ethiopian government tells to the public the yearly approved budget by parliament, whereas private finance is a secret affair. An individual tries to keep his accounts secret as he does not want his competitors to know his real financial position.

(6) Long/Short-term Consideration: - Another point of difference between private and public finance is that the private individuals incur expenditure in those areas of business which give quick returns. They, as individuals keep in view short-term considerations. On the contrary, government incurs expenditure keeping in view the long-term considerations, such as construction of dams, multi purpose hydro-electric projects, etc.

(7) Elasticity of Finance:- Public finance is elastic in nature-as compared to private finance. Public finance can be increased by imposing various taxes as public finance is open to drastic changes. Private finance on the other hand, cannot be increased as there is not much scope for changes in private finance.

(8) Deliberation in Expenditure:- The pattern of expenditure of an individual is governed by habits, customs, status, personal needs etc. On the contrary, the pattern of public expenditure is governed and controlled by deliberate economic policy of the Government

(9) Right to Print Currency: - The government has a right to print currency which is legal, whereas private individual does not enjoy such a right.

PUBLIC REVENUE

PR is very necessary for the govt. to perform its various functions for the welfare of the society. Increasing activities of the government are the cause of increasing public expenditure. Methods of public revenue and their volumes have significant impact on **production & distribution of wealth & income** in the country. It has effects on the **nature and the volume of economic activities and on employment**. According to Dalton, the term “public revenue” has two sense- **wide and narrow**.

- In its wider sense it includes all the incomes or **receipts** which a public authority may secure during ***any period of time***.
- In its narrow sense, it includes only those sources of income of the public authority which are ***ordinarily*** known as “**revenue** resources”.
- To avoid ambiguity, thus, the former is termed “**public receipt**” and the latter “**public revenue**”.
- As such, receipts from public borrowings is mainly excluded from public revenue.

Sources of Public Revenue

The important and common sources of public revenue are:

- Taxes
- Income from currency
- Sale of public assets
- Commercial revenues
- Administrative revenues
e.g., Fees, fines, licenses.
- Grants and gifts

Basic Categories of Government Receipt

- Revenue Receipts

- Capital Receipts
- Revenue Receipts

It includes “routine” and “earned” ones

1. Tax-revenue
2. Non-tax revenue.

I. Tax Revenue Receipts

- Tax revenue itself is divided into three sections:

i. Taxes on income

It covers corporation tax, income tax and similar other taxes, if any, in force.

ii. Taxes on property and capital transactions

taxes on specific forms of wealth and its transfers such as estate duty, wealth tax, gift tax, house tax, land revenue and stamps and registration fees, etc.

iii. Taxes on commodities and services

This section includes taxes on production, sale, purchase, transport, storage, and consumption of goods and services.

2. Non-tax Revenue Receipt

i. Currency, coinage and mint:

- This category covers the receipts of Currency Notes Press, Mints and Profit from circulation of small coins.

ii. Interest receipts, dividends and profits:

- Interest receipts on loans by the government to other parties,
- Dividends and profits from public sector undertaking.

E.g contributions from railways and posts and telecommunications,

iii. Other non-tax revenue:

- It covers revenue from various government activities and services such as from administrative services, public service commission, police, jails , agricultural and allied services, industry and minerals, water and power development services, transport and communications, supplies and disposal, public works, education, housing, information and publicity, broadcasting, grants-in-aid and contributions etc.

II. Capital Receipts

Capital receipts of the government take money forms. The most important one comprises of **borrowings** which can be classified in terms of their **origin and maturity**

- on the basis of origin, public borrowings may be external (outside the country), or internal (with in the country).
- In terms of maturity, there may be, "long term", "medium term", or "short term" loans with specific demarcation of boundaries for each.

They may be

- marketable or non- marketable,
- interest-free or interest bearing, etc.
- Some capital receipts may be in the form of grants and donation.

Sources of public revenue in Ethiopia

- i. Tax revenue
- ii. Non-tax revenue

i. Tax revenue

Direct Taxes Examples

- Personal income tax
- Business income tax
- Capital gain tax
- Rental income tax
- Interest income tax
- Tax on dividend and lottery
- Rural and urban land use fees.

In direct taxes: Examples

- Customs duties
- Turnover tax
- Excise tax
- VAT

ii. Non-tax revenue

- Administrative revenues
- Government investment income
- Dividend
- Privatization proceeds
- Capital income form sale of goods and services

PUBLIC EXPENDITURE

PE is incurred by public authorities - either for the satisfaction of collective needs of the citizens or for promoting their economic and social welfare. It is incurred by the government for the attainment of public good. Every government has to maintain law and order, armed forces for providing protection, schools, health of the people, arranging for cheap food, cloth and low-cost housing for the poor and so on. All these mixed activities which are increasing every year require huge funds. Therefore public expenditure, deals with the expenditure which a government incur for its own maintenance, the society and the economy and helping other countries.

Current and Capital Expenditure

- Technically, in the structure of a budget, most governments classify public expenditure into two:
 - (i) Current expenditure, and
 - (ii) Capital expenditure
 - Current expenditures
 - They are also referred to as non-developmental expenditure.
 - All sorts of administrative and defense expenditure
 - They are intended for continuing the existing flow of goods and services and maintaining the capital of the country whole.
 - Capital expenditures
 - Capital expenditures contribute to increased productive capacity of the nation.
 - They are also known as development expenditure.
 - Example: Expenditures on construction of dams, public works, state enterprises, agricultural and industrial development.

Objectives of Public Expenditure

- Dr. Dalton divided the aims of public expenditure into two parts:
 - (i) Security of life against the external aggression and internal disorder and injustice.
 - (ii) Development or up gradation of social life in the community.

- ✓ The public authority works in many ways for the benefit of the people. The government organizes the generalized services like public health and education. The whole society is benefited by these functions of the state.
- ✓ Secondly, in modern times, the responsibilities of the government are increasing every year. Though, through public expenditure the government influences directly or indirectly, the industrial and commercial system of the nation thereby helps towards the economic and social development of the society.
- ✓ Public spending should be designed to optimize the level of investment in such a way as to maintain full employment--with growth.
- ✓ Public spending may be incurred at an increasing rate in the backward region to uplift their economy.

Reasons for Growing Expenditure

1. ***Population growth.*** The growth in the numbers particularly in developing countries has been a major cause of the continuous rise in public expenditure. Along with growth in the numbers, the responsibility of government relating to public services has been multiplied. To check the growth of population, again, the government has to incur a huge expenditure.
2. ***Increasing urbanization.*** As the rural areas cannot subsist the growing population, there is a continuous rush to the urban areas. The size of cities is becoming larger and larger, while newer urban habitations are springing up. The maintenance of complexity of life has, therefore, become costlier and the government has to squarely face the problem.
3. ***Maintenance of law and order.*** Along with the growth of population, urbanization and complexities of modern economic and sociopolitical life, law and order problems have also multiplied. The government responsibilities of internal protection of people from breach of peace by antisocial elements have gradually become multi-sided requiring government expenditure of more and more funds.
4. ***Welfare activities.*** Previously, public expenditure was limited by only a few functions of government, viz, the defense, maintenance of law and order and administration. But, presently, the countries have emerged as modern welfare states where the greatest good of the greatest number is the main objective of statehood. The government now has to assume such responsibilities as family

and child welfare, social security like old age pension, unemployment benefit, sickness benefit, etc. housing for the poor, welfare of handicapped and backward classes, rehabilitation of displaced persons, subsidy on food and production inputs, etc. Public expenditure on welfare programmes has, therefore, become tremendous with the passage of time.

5. ***Provision of public goods and utility services.*** Public goods are those that are consumed equally by all. They cannot be sold in the private market. Defense and police services, justice, roads, irrigation and flood control projects, public parks, etc. are all examples of public goods. They involve huge investment and have to be provided by the government. Moreover, there has been a growing trend of public utility services like railways and other transport services, postal, telegraph and telephone services, electricity services, etc. Coming under the government sector. They all involve heavy expenditure on installation and maintenance.
6. ***Servicing of public debt.*** A substantial part of the huge expenditure program of government is met from public borrowings. This is because resources cannot be mobilized from taxation beyond a limit. Hence, modern states incur considerable internal and external public debt. The repayment of debt and obligation to pay service charges become huge.
7. ***International obligation.*** Finally, the modern states have to maintain many international socio-political and economic links. They have to maintain diplomatic relations, economic links with international institutions like I.B.R.D. (the International Bank for Reconstruction and Development), I.M.F. (International Monetary Fund) etc, Socio-cultural and academic exchange relations, linkage with development programs of the type of economic co-operation, gifts and donations, regional economic integration and membership of other international organization like UNO (United Nations Organization), etc – all these involve a considerable amount of public expenditure.
8. ***Defense:-***Due to the invention of nuclear weapons there is always a danger of foreign aggression. International political situation is uncertain and insecure. As such, every nation has to prepare itself for a strong defense. The defense

expenditure in the form of expenditure on war materials, maintenance and growth of armed forces, pension to retired war personnel etc. are, are perpetually rising.

9. ***Transport and Communication:*** With the expansion of trade and commerce, the state has to provide and maintain a quick and efficient transport system. Transport being a public utility, the state has to provide it cheaply also. The government has to spend a lot on constructing new railway lines, good roads, new roads, highways, bridges and even canals to connect different areas with a smooth transport system as a precondition of growth.
10. ***Rising Trend of Prices:*** Public expenditure is also increasing in every country due to rising trend of prices. The reason is that the government has to buy goods and services from the market at higher prices. The government has also to increase the salaries, dearness allowance etc., of government employees leading to a rapid increase in government expenditure.
11. ***The Rural Development Effect:*** In an underdeveloped country, the government has also to spend more and more for rural development. It has to undertake schemes like community development projects and social measures. The government also incurs expenditure on imparting training to personnel for implementing rural development programmers.

Canons of Public Expenditure

It used for the fundamental rules or principles governing the spending policy of the government. According to Prof. Findley Shirras, the canons are:

- ✚ Canon of Benefit
- ✚ Canon of Economy
- ✚ Canon of sanction
- ✚ Canon of Surplus
- ✚ Canon of Elasticity
- ✚ Canon of Productivity
- ✚ Canon of Equity
- ✚ Canon of certainty.

1. **Canon of Benefit.** Public expenditure should be so planned and implemented as to bring about the greatest possible benefit to society. This canon is simply a reminder to the public authorities that whatever they spend they should do it according to the principle of maximum social advantage. What it means is that all such expenditures which do not bring benefit to society should be avoided. Thus, all non-essential expenditures should be cut to the minimum. Benefit from public expenditure may be identified with achievement of proper allocation of economic resources, proper distribution of income and wealth in society and stability of price level and growth of economy. This canon also points to the need of undertaking a cost-benefit analysis of the competing schemes of public expenditure before the final selection of investment project is made.
2. **Canon of economy.** Public expenditure should be incurred carefully so that there is no wastage of funds. Since resources are limited in the society, they have to be most properly utilized. Economical use means most proper utilization. Hence the canon remains a constant reminder that resources must not be misused or wasted. Most important reasons of wasteful expenditure are faulty planning, faulty execution, corrupt practice and delay due to time lag between plan and execution and, hence, escalation of prices. These types of wastage have to be avoided at any cost. It must be noted here that benefit to society cannot come without proper pursuit of the canon of economy.
3. **Canon of sanction:** This canon suggests that no public spending should be made without the approval of proper authority. Only obtaining prior sanction is not sufficient. It must be properly inspected and examined whether the sanctioned amount of money is being spent properly on sanctioned items or not. As a rule, therefore, money must be spent on the purpose for which it is sanctioned by the highest authority and accounts properly audited.
4. **Canon of surplus.** This canon requires that expenditure of public authorities should be kept within the limits of current revenues. If possible, the expenditure should be less than the earnings of government so that the surplus so generated can be used when there is unavoidable deficit. Surplus can be generated either by controlling expenditure or by increasing current revenues. Of late, however, there has been much change in the thinking around budget policy. The occurrence of

depression and the need for achieving price stability and economic growth often requires deficit financing, i.e. excess of expenditure over current revenues. Hence, a choice of surplus or deficit budget is decided by the merit of the case. This canon is, however, an important reminder of the fact that the government should not overspend and run into debts and that a deficit spending should be avoided as far as possible.

5. **Canon of elasticity.** Canon of elasticity requires that the rules of public expenditure should not be too rigid to achieve the real purpose and that it should be allowed to vary according to the needs and circumstances. For example, if the economy suffers from unemployment and deficiency of demand, there should not be a rigidity that the budget should be balanced. Under such situation, the government should go for a deficit budget and inject additional purchasing power into the economy so that effective demand is increased and factors of production are employed on larger scale. Or in case of emergent situations like flood relief, sanctioning authority should be vested with the lower rank spending unit since there is no time to secure sanction from higher authorities. Flexibility of expenditure should be provided under such circumstances.
6. **Canon of Productivity:** This canon or principle implies that the expenditure policy of the Governments should be such that would encourage production in a country. That means a large part of public expenditure must be allocated for development purpose.
7. **Canon of Equity:** One of the foremost aims of public expenditure is also to ensure the just and equitable distribution of is more significant for the countries where the gap between the highest income and the lowest income groups is very wide. Underdeveloped countries like India, have given this aim a significant and particular importance in the economic activities of the State and in their fiscal policies.
8. **Canon of certainty.** This canon requires that public authorities should clearly know the purpose and extent of public expenditure. The spending unit should be certain as to the amount and objective of public expenditure. This requires a proper expenditure plan well thought out beforehand. The canon of certainty is followed through the preparation of budget. The budget details the amount and purpose of expenditure for the whole financial year. It is through the budget that

the spending authorities have proper knowledge of the use of public funds. In the absence of such a certainty, fiscal discipline cannot be maintained and there will be unnecessary wastage and overspending.

Effects of Public Expenditure

In modern government Public Expenditure regarded as a means of securing social ends. Public Expenditure produces many direct and indirect socio-economic effects.

- The effects of public expenditure;
 - Effects of public expenditure on production.
 - Effects of public expenditure on distribution.
 - Effects of public expenditure on employment.
 - Effects of public expenditure on economic stability.
 - Effects of public expenditure on economic development.

Effects of public expenditure on production.

(i) Effects upon ability to work, save and invest

Ability to work, save and invest depends upon the health and efficiency possessed by the persons. Health and efficiency depends upon the level of consumption and level of consumption depends upon the public expenditure incurred by the government. Public expenditure on education, medical services, cheap housing facilities, means of transport and communication etc, will increase the efficiency of persons to work. Some of the expenditure, like the expenditure on free education, unemployment benefit and free medical facilities etc., are helpful in increasing the purchasing power of the people especially of the low income groups and hence it helps to protect and promote the efficiency of the people and their ability to work and save. Public expenditure on increasing the salaries and wages of the people and the supply of goods and articles at cheap rates to them will increase their purchasing power, standard of living, health, efficiency and hence their ability to work and save may increase.

Likewise, public expenditure on the maintenance of law and order, creates confidence in the minds of the people and hence it encourages them to make investment in productive activities. As production increases, income of the people also increases; hence their ability to work, save and invest also goes up. Thus it is evident that public expenditure can promote ability to work, save and invest and thus promote production and employment.

(ii) Effects upon willingness to work, save and invest

Public expenditure also affects the willingness of the people to work, save and invest. Pension, provident fund, interest loan, free medical and unemployment allowances and other government payments provide security to a person and, therefore, reduce the willingness of persons to work and save, when a person knows that will be looked after by the government when he is not in a position to earn any income. In the absence of any saving, the question of investment does not arise at all.

On the contrary, expectation of larger amenities and higher standard of living would stimulate people to work hard. It is this encouragement which would encourage them to save more and to invest their savings for production purposes. Expenditure on benefits such as sickness benefits would certainly increase the desire of the people to work more, since they are assured of relief if they fall sick due to hard work.

(iii) Effects on diversion of resources

Public expenditure also affects the diversion of resources. Government incurs public expenditure in the form of giving financial assistance to productive sector. In the same way, if the government wishes to attract productive resources to a particular area or region, it will start giving variety of incentives in the form of tax holidays and other allowances or concessions etc. to the industrialists.

II. Effects of public expenditure on distribution

Public expenditure also helps the government in bringing about equitable distribution on income and wealth. Not only taxation policy but public expenditure policy can also remove inequalities in the distribution of income and wealth. To bring about equitable distribution of income and wealth, the government should impose higher taxes on the richer section of society and the amount realized from them should then be spent on the poorer section of society by way of providing social amenities, and subsidies to them. Public expenditure has, thus, an important role in reducing economic inequalities in the society.

III. Effects of public expenditure on employment

Public expenditure affects employment as well as employment opportunities. It can increase employment in the country. Therefore, the public expenditure policy of the government should be so devised as to create additional jobs both in the public and private sectors. The following expenditures of the government increase employment opportunities.

(i) Heavy expenditure in the public sector

For the economic development of the country, the government should make investment in public sector such as heavy engineering, iron and steel coal etc. Production goods sector provides direct employment to the people by creating millions of jobs. Thus it clearly becomes the responsibility of the state to prevent a situation of unemployment.

(ii) Expenditure on public utilities

Public expenditure incurred by the government on public utilities, such as supply of water, electricity, telephone services, etc., create a large volume of employment.

(iii) Public expenditure to encourage small-scale industries

To promote employment in small-scale industries, the government should provide tax incentives and allowances to such industries. The government should incur public expenditure on small-scale sector in the form of cheap credit, supply of raw materials at concessional rates, free technological assistance, helping these industries in the marketing of goods etc. In this way, large employment is created in the small-scale sector.

(iv) *Public expenditure to create employment in backward areas*

To create employment opportunities in backward regions, the government should promote industries in the public sector and private sector in backward areas. To encourage industries in the public as well as private sectors, the government should grant deductions and concessions to such industries. If public expenditure is directed towards the promotion of industries in the public and private sectors in backward areas, not only will additional jobs be created, but the markets will be also widened and there will be all round economic development of the country.

IV. Effects of public expenditure on economic stability

Economic stability is judged by the behavior of prices. Price stability is related to the manner in which price behaves in an economy. There should be a normal rise in price because normal is considered as a sign of a healthy economy problem arises whenever there are price fluctuations. Price fluctuations may be known as abnormal economic situations.

There may be 2 state of abnormal price behavior:

(i) Inflation,

(ii) Deflation or depression, and

(i) Effects of public expenditure in Inflation

Inflation is a state of rising money supply, rising demand but stable supply. Public expenditure may be useful in controlling inflation. In this situation the aim of the government should be to spend than its revenue. Inflation may be averted by reducing public expenditure on civil services, defense, interest payments etc. The funds acquired by means of a surplus budget may be used to provide capital to those sectors which experience shortage of capital so that the total productive capacity of the economy may increase. Therefore, public expenditure should be incurred on minor irrigation projects, better quality of seeds, manure, etc., in the field of agriculture. In the field of industries, public expenditure may be incurred on providing facilities for the establishment of new industries and for the expansion of the existing ones.

(ii) Effects of public expenditure in deflation/depression

Depression is a state of falling price, falling money supply and falling demand. Falling prices cause losses among business-men and manufactures and this leads them to curtail production and employment. Thus, a large number of workers are thrown out of employment. In such a situation, the government should employ workers on public works projects. The employed workers receive wages from the government and can thus increase the demand for various commodities. The increased demand leads to increase in production. Thus, the objective of public expenditure during depression should be to create effective demand for consumer goods, which would create employment and thus, would help to maintain economic stability.

PUBLIC DEBT

NATURE AND KINDS OF PUBLIC DEBT

Public debt is of recent growth and was unheard of prior to the 18th century. In modern times, however, borrowing by the States has become a normal method of government finance along with other sources such as taxes, fees, etc. The government may borrow from banks, business houses, other organizations and individuals. Besides, it can borrow within the country or from outside. The government loan is generally in the form of bonds (or treasury bills if the loan is required for short periods) which are promises of the government to pay to the holders of these bills the principal sum along with interest at the stated rate. Borrowing is resorted to in order to provide funds for financing a current deficit.

Public debt is also sometimes referred to as government debt. It is a term for all of the money **owed** at any given time by any branch of the government. i.e. federal government, the state government, and even the municipal and local government.

Public debt is a debt or loan taken by the govt. from

- own people
- Foreign countries or both.

Classification of public debt

- Source of Borrowing
- Purpose of the loan
- According to nature
- Funded and unfunded debt
- Time Duration of loan

1. *Source of Borrowing (internal debt and external debt).*

There are two sources of public debt, internal and external. Internal debt refers to public loans floated within the country, while external debt refers to the obligations of a country to foreign governments, or foreign nationals or international institutions. Though external debt is becoming very common these days, there has been general prejudice against foreign debt, based on ignorance and faulty economics.

2. *Purpose of the loan (Productive and unproductive debt)*

Public debt is said to be productive if the investment yields an income which will not only meet the yearly interest payments of the debt but also help repay the principal over the long run. All public debt can be said to be productive in another sense too. The government may undertake certain projects through loans which may not be productive in the sense given above but which may be really useful to the community - for example, a railway line connecting a backward region, an irrigation work to prevent famine conditions in an area, and so on. In this sense all public debt is productive. But in many cases, public debt may be contracted during war-time to finance war. Such debt is unproductive because it does not create an asset; it is a dead-weight debt or a useless burden on the community.

3. *According to nature: Compulsory and voluntary debt*

When the govt. borrows from public by using forceful method,. For example, the loans raised during an emergency e.g. war. When the govt. borrows money from the public,

individuals and institutions by issuing securities like bonds etc., it is called voluntary debt.

4. Funded debt and unfunded or floating debt.

Broadly speaking, funded debt is a long-term debt, undertaken for creating a permanent asset and the government normally makes arrangements about the mode and the time of repayment. Unfunded and floating debt is a relatively short-period debt meant to meet current needs. The government undertakes to pay off the unfunded debt in a very short period, say, within six months. Treasury bills are examples of unfunded debt. The rate of interest on unfunded debt is lower.

5. Time Duration of loan (short, medium, and long term loan).

According to time duration of the loan, public debt can be classified into short term, medium term, and long term loans. Short term loan is usually incurred for a period varying from three months to one year. Usually government gets such loans from the central (national) banks by using treasury bills. These loans are also called 'ways and means advances'. Such loans are obtained to overcome temporary deficits in payment to be made by the government in the course of one year to pay salaries etc. Medium term loans are those which are obtained for more than one year but less than ten years. Usually the governments borrow only long term loans for more than ten years. The maturity period is long so that the rate of interest tends to be higher on the long term loan than short term loan. Long term loans are incurred to finance development schemes.

Effects of PD

Public borrowing from individuals and firms has effects on all aspects of economic life

- Effects on Consumption
- Effects on Production and Investment.
- Effects on Distribution
- Effects on National Income
- Effects on Liquidity
- Effects on Money Market

1. **Effects on consumption:** - The effect of public debt on consumption depends upon how it is financed by individuals. If they lend to the government out of their idle savings, consumption is not affected. If they buy out of past savings it has only a limited impact on present expenditure. But if they lend by cutting present

savings, it may make them feel less secure and so they may reduce consumption. But if the people feel that they have invested in government securities which are considered safe investment, they may actually increase their consumption.

2. **Effects on Production and Investment:** - The effect of public debt on production depends upon whether it affects private investment or not. If people buy government bonds by selling their shares or debentures in private individual firms, there is an adverse effect on private investment. But if the money borrowed by the government is for productive purpose, overall production is not affected. But if it is used for wasteful or non-productive purpose, total investment is affected negatively. If people buy government bonds by taking away their bank deposits, bank's lending capacity is reduced and this again affects private investment. Private investment is not affected only when it is financed by people out of their idle funds. If the government uses the funds for productive purpose, it can repay it out of income generated by these projects. But if public debt is used for unproductive purposes, it can be repaid only by through additional taxation in future which affects future consumption as well as production by reducing future disposable incomes. However, if public debt is used for welfare schemes, it may increase people's efficiency to work and thus improve productive capacity.
3. **Effects on Distribution.** Effects on Distribution. Public debt is bound to have effects on distribution of income because it involves transfer of purchasing power from one sector to another. Usually government bonds are purchased by the richer section. But the burden of tax to repay the debt falls on all sections including the poor. To that extent the inequality of income will increase. If the bond hold erand taxpayers are the same people, theoretically there will be no effect on redistribution of income. Hence redistribution of income effects of public debt depends upon whether the taxpayers and the bond holders are the same people or not. However if the public debt is used for public welfare programmes especially the poor, inequalities of income deceases. But if public borrowing creates inflation, the beneficial effects of redistribution will be neutralized as prices rise.
4. **Effects on Liquidity.** Effect of public debt on liquidity is favorable because the governments bonds are liquid assets which can be sold in the market whenever the bondholders need money. So public debt increases the volume of liquid assts

in the country. Secondly the larger quantity of such liquid government bonds can result the failure of monetary policy. For example, when national bank tries to control inflation through monetary policy tools like bank rate, the commercial banks can increase their cash reserves by selling government bonds.

5. **Effects on Money Market.** Effects on Money Market. The government has to compete with the private sector for fund. Usually if the rate of interest paid by private sector on borrowing is high, the government also will have to rise its interest rate to attract public funds. On the other hand if the state tries to borrow from commercial banks and national banks, more than what is available at current rate of interest it results in currency expansion.

Burden of Public Debt

Public borrowings are to be paid along with interests. Govt. imposes new taxes upon the people to repay the loans and meet the annual interests on such loans. The sacrifice of the people in the form of tax payment is the **burden of public debt**.

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

The burden of public debt into:

- Burden of internal debt
- Burden of external debt

i) Burden of internal debt

Internal debt involves a series of transfers of wealth within the country, i.e., from lender to government and then later on at the time of redemption from government to lender. Money is thus transferred from one section of the community to other sections. In this case the money burden on the economy is zero. But there may be real burden on the community. In order to repay the interest and the principal amount of the debt, the government has to levy taxes. What the taxpayers pay the lenders receive. The lenders are generally rich people and tax burden is fall on poor especially in the case of indirect taxes. The net result may be that the wealth is transferred from poor to rich. This is the loss of economic welfare.

ii) Burden of external debt

External debt also involves a series of transfer of wealth from the foreign lender to the borrowing country, and when it is repaid the transfer is in the opposite direction. As the borrowing country paid interest to the foreign lenders, a direct money burden is fall on the whole community. This burden depends on the rate of interest. If the rate of interest is high, the money burden, is also high and vice-versa. The community is also suffered from real burden of external debts. The real burden of the external debts depends on the nature and use of these debts. If it is used for productive purpose, the real burden of these debts will be less. If external debts to be used for non-productive purposes, much real burden will have to be borne in order to repay such a debt. As a result the production, consumption and distribution of income is badly affected. Moreover, the foreign lender has direct involvement in the economic activities of the country.

REDEMPTION OF PUBLIC DEBT

Redemption is a way of escape from the burden of a public debt. Redemption means repayment of loans. The various methods available to the government to pay off its debt are:

- A. **Repudiation of Debt.** Repudiation of debt means simply that the government refuses to pay the interest as well as the principal. Repudiation is not paying off a loan but destroying it. Normally, a government does not repudiate its debt, for this will shake the confidence of the general public in the government. However, in extreme circumstances, a government may be forced to repudiate its internal or external debt obligations. For instance, internally the country may be facing financial ruin and bankruptcy and externally, it may be faced with shortage of foreign exchange. Generally, a government may not repudiate its internal debt lest it should lead to internal rebellion: those who have lent to the government would obviously rise against the government. However, the temptation of a government to repudiate its external debt obligation may be strong at certain times. Of all the methods of redeeming debt, repudiation is the most extreme.
- B. **Conversion of Loans:-** Another method of redemption of public debt is known as conversion of loans, that is, an old loan is converted in to a new loan (in a broad way, conversion is the same as refunding debt; i.e., repayment of a debt through a new loan). Conversion may be resorted to:

- (i) When at the time of redemption of a loan, the government has not the necessary funds, and/or
 - (ii) When the current rate of interest is lower than the rate which the government is paying for its existing debt, so that the government can reduce its interest obligations.
- Conversion of a loan is, always done through the floating of a new loan. Hence, the volume of public debt is not reduced. Really speaking, therefore, conversion of debt is not redemption of debt.

C. **Serial Bond Redemption** The government may decide to repay every year a certain portion of the bonds issued previously. Therefore, a provision may be made so that a certain portion of public debt may mature every year and decision may also be made in the beginning about the serial number of bonds which are to mature each year. This system enables a portion of the debt being paid off every year. A variant of this type of bond redemption is to determine the serial number of bonds to mature every year through lottery. While under the first variant, the bond-holders know when the different sets of bonds would mature and could take up the bonds according to their convenience, under the second variant, the bond-holders are uncertain about the time of repayment and they may get back their money at the most inconvenient time.

D. **Sinking Fund**. Sinking fund is probably the most systematic and, therefore, the best method of redeeming public debt. It refers to the creation and the gradual accumulation of a fund which will be sufficient to pay off public debt. Suppose the government floats a loan of Birr 10 billions, redeemable in say, 10 years, for the purpose of road construction. At the time the government is floating the loan, it may levy a tax on petrol, the proceeds of which would be credited to a fund known as the sinking fund. Year after year, the tax proceeds as well as interest on investments will make the fund grow till after 10 years it becomes equivalent to the original amount borrowed; at that time, that debt will be paid off. One danger of the sinking fund method is that a government, in need of money, may not have the patience to wait till the end of the period of maturity but may utilize the fund for purposes other than the one for which originally the sinking fund was instituted.

