CHAPTER –II
LITERATURE REVIEW

Public debt, from a broader perspective, can be viewed as an integral part of the study of public finance - the science of income and expenditure of governments. Although public finance revolves mainly round the revenue expenditure process, of late, the focus seemed to have shifted to the study of borrowings made by governments. This is due to the ever increasing burden of public debt which is more likely to eat away the chunk of the revenue raised and thereby push the government machinery to a standstill. Hence it is quite appropriate and logical to start with public finance before discussing public debt.

Public finance constitutes a study of the monetary and credit resources of the governments – Central, State and local and their control as well as administration. According to Richard A Musgrave, “the complex problem that centre around the revenue expenditure process of the government is traditionally referred to as public finance”¹ “Public Finance is thus a study of the principles underlying the spending and raising of funds by public authorities.”² It also deals with the provision, custody and disbursement of resources needed for conduct of public or government functions.³

In whatever words people may frame the definitions it seems that there is no considerable difference between the sum and substance of the various definitions. All of them say that it is a study of income and expenditure of the governments - central, state and local. Government performs many functions which the individuals cannot do.
Therefore, raising of funds for the expenditure and their disbursement constitutes the core of public finance.

1. Contents of Public Finance

The contents of the science of public finance can be divided into the following four categories:

1.1. Public Revenue

Huge public expenditure necessitates matching public revenue. As the government has to perform certain functions for the welfare of the public and such functions cannot be performed free of cost, they involve expenditure which requires public revenue. Public revenue consists of all the incomes which the government mobilises during a given period of time. It includes those sources of income of the government, described as revenue resources, which the government raises under the term public revenue. Public revenue includes capital as well as revenue receipts.

1.2. Public Expenditure

Every government has to perform certain functions within its territory for the welfare of the people, which entail public expenditure. Public expenditure becomes the end and aim of the collection of revenue. It is not only the most important but also the central part of the study of public finance. All other branches of public finance revolve around public expenditure. For, public revenue or public debt is not raised for themselves but they are collected and raised for the ultimate aim of public expenditure.
1.3. Public Debt

Public authority can obtain funds through loans, advances and other sources. Public debt basically represents the borrowings made by the government from various sources. It constitutes receipts of capital nature while the provision for repayment of the capital sum constitutes expenditure of capital nature.

1.4. Financial Administration

The scope of public finance is not confined to public revenue, public expenditure and public debt. We have to examine the mechanism by which the above processes are carried on. No financial treatise can be regarded complete unless it considers the problem of financial administration. As Gyaston Gaze has rightly observed, “it is that part of government organization which deals with the collection, preservation and distribution of public fund, with the co-ordination of public revenue and expenditures with the management of credit operations on behalf of the state and with the general control of the financial affairs of the public household.”

Therefore, under fiscal or financial administration, we are concerned with the machinery of the government that is in charge of performing various financial functions of the state. Study of budgets and procedure constitutes an important part thereof.

2. Public Debt – Various Aspects

The important role of public borrowing in economic development is relatively a recent phenomenon and has much to do with the collapse of the principle of laissez faire, the rise of modern welfare states and the imperatives of accelerated economic development of a considerable part of the world. Public borrowing is a debt or loan
taken by the government from its own people as well as from foreign countries or both. 

As mentioned in the Encyclopedia Britannica, public debt refers to “obligations of governments, particularly those evidenced by securities, to pay certain sums to the holders at some future date.” Government needs to borrow when current revenue falls short of public expenditure since current public revenue is usually insufficient to meet the current and development expenditure of the modern government, the government has no alternative except to borrow money.

When a government raises loans internally or externally, it incurs a liability known as ‘public debt’. Public borrowing or public debt is an important source of revenue to a modern government. It is, however, an instrument for temporarily augmenting revenue or purchasing power in exchange for an obligation on the part of the government to repay the principal sum borrowed plus a stipulated rate of interest on it, at a specified future date.

Now-a-days public debt is 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 and it refers to those obligations of the state as borrower and private investor of capital as lender where state promises to pay the lender the amount borrowed with interest after a given period of time.

Another view is expressed by Buchanan who regarded that all public debt (both external and internal) is detrimental to the welfare of both current and future generations of the society.6

Prof. Cal S. Shoup defines public debt or government borrowing as, “the receipt from the sale of financial instrument by the government to individuals or firms in the
private sector induce the private sector to release man power and real resources for the welfare of the public.”  

Similarly, Prof. P E Taylor defines, “the debt is the form of promises by the Treasury to pay to the holders of these promises a principal sum and in most instances interest on that principal. Borrowing is resorted to in order to provide funds for financing a current deficit.”

Prof. J K Mehta has rightly mentioned, “public debt carries with it the obligation on the part of the government to pay money back to the individuals from whom it has been obtained.” Taylor continues “government debt arises out of borrowing by the Treasury from banks, business organizations and individuals.”

It follows from the above discussions that the developmental challenges of modern-day governments have necessitated incurring heavy dozes of public expenditure and thereby huge amount of public debt. As a result, public debt has grown in size and magnitude, resulting in numerous complex classifications, which has placed the topic of public debt at the heart of the public finance.

3. Classification of Public Debt

Public debt has been classified in many ways. The differences arise on account of many factors, such as to the market in which the loans are floated, conditions of repayment, purpose of borrowing for which they are raised, etc.

3.1 Internal and External Debt

Internal debt refers to public loan which is subscribed entirely by the people or institutions of the country and the repayment is made in the domestic currency itself.
External debt is that debt which is borrowed from a foreign country from individuals or governments. The repayment of external debt is usually done in foreign currency. As Prof. Dalton puts, “a loan is internal, if subscribed by persons or institutions within the area controlled by the public authority which raises the loan, external, if subscribed by persons or institutions outside this area.”

3.2 Voluntary and Compulsory Debt

Voluntary debt is a debt which is paid without any legal enforcement. Voluntary debts are subscribed to by the people according to their ability, will and convenience. In a democratic state, normally, public debt is of voluntary nature. Compulsory debt is legally forced. In the case of compulsory debt there is no option to the people but to pay to the government. They may be compelled to pay even through cutting their expenditure on necessities. War-time debts are generally compulsory in nature. Prof. Hugh Dalton has also observed that “a compulsory, or a forced, loan is a rarity in modern public finance, since it combines the disadvantages, while lacking the advantages, of both a tax and a voluntary loan.”

3.3 Productive and Unproductive Debt

Productive debts are those incurred for projects which yield income to the government. This revenue may be used to repay the debt and therefore debt borrowed for such purposes is called productive debt. An unproductive debt is one which does not add to the productive assets of a country. When the government borrows for unproductive purposes like financing a war, or for lavish expenditure on public administration, etc., such public loans are regarded as unproductive. It is incurred to cover budgetary deficit in revenue account or for purposes which do not yield any direct income to the government.
3.4 Redeemable and Irredeemable Debt

Redeemable debts are those loans which the government promises to pay off at some future date. For redeemable debt, the government has to make some arrangement for their repayment. Whereas irredeemable debts are those which are raised without any intention to repay but interest will be paid on such debt. Such loans are also known as perpetual debt.

3.5 Funded and Unfunded Debt

Funded debts or long term debts are repayable after a year or more. It is a debt which is repayable at a distant date and for the payment of interest on which regular provision is made. But, unfunded debts are incurred for a comparatively short term and must be repaid within a year. The unfunded debts are generally used for temporary purposes and permit the governments to secure funds at low rates of interest, thus reducing the cost of mobilizing funds.

3.6 Public Debt and Private Debt

Although both the types of debts are the result of incurrence of deficits-excess of expenditure over income-their implications are widely dissimilar. The Keynesian economists uphold this point of view, while the classicals argue against it, the latter consider public debt as analogous to private one. It was, therefore, considered by them that the national debt is bad and must be limited because there are normal constraints to debt capacity.

In case of private borrowings, the power of borrower over disposable income increases and that of the lender diminishes. Individuals must repay debt and, therefore,
must forego consumption at some future date to repay debt incurred by earlier borrowings. Excessive debt may lead the individual borrower into the state of insolvency. These consequences of debt applicable to private borrowings were supposed to be applicable and with equal intensity to public borrowings. This was the view held by the classical economists. But modern economists point out that the public-private debt analogy was erroneous.

Prof. A H Hansen has viewed the whole issue very clearly, when he states that “An internal loan resembles ordinary (private) borrowings in purely formal way, and it is obvious that every analogy of public borrowings to private borrowings must be completely false.”13 It means that public borrowings are distinctly dissimilar to private borrowings.

4. Theoretical Issues on Public Debt

Government debt arises out of borrowing by the treasury from banks, business organizations and individuals. The debt is in the form of promises by the treasury to pay to the holders of these promises a principal sum and in most instances interest on that principal. Borrowing by the treasury takes place when current revenue receipts are inadequate to maintain a treasury cash balance large enough to meet current cost payments and to retire maturing debt. Borrowing is resorted to in order to provide funds for financing a current budget deficit. Such current deficit borrowing results in a net addition to public debt.

Continuous government borrowing to cover fiscal imbalances results in ever rising public debt, the servicing of which must eventually come out of public revenues in
subsequent years. As public debt accumulates, there is a legitimate concern whether the borrowing government will be in a position to service its debt or not. Ultimately, when financial markets perceive the debt stock of any government as unsustainable, further lending to that government will cease.

In recent years government expenditure is increasing faster than their ability to raise resources, because now their activities are not so restricted as only to maintain law and order and protect the country against external aggression. Therefore, when expenditure exceeds revenue, a deficit arises in the budget of the government. This deficit can be bridged by raising the revenue from taxation (by increasing the existing rates or by imposing new taxes) or by borrowing from the public. Both in developed and developing countries there are certain limits beyond which the taxation rates cannot be raised without adverse effects on the investment level or production and consequently on the rate of economic growth. Further, it taxes the rich and the poor alike which is not desirable for the welfare of any community.

The most appropriate method, therefore, is the method of debt finance, preferred by all the states alike in mobilizing its financial resources. It is because, “choosing the appropriate methods of finance cannot make a bad plan good but it can make it better because using the wrong method can wreck even the best of plans”14

Now-a-days public debt is 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 and it refers to those obligations of the state as borrower and private investor of capital as lender where state promises to pay the lender the amount borrowed with interest after a given period of time.
The fiscal measure of public debt for resource mobilization is of recent origin. Classical economists advocated balanced budget and therefore in their analysis public borrowing found no significant place. They were of the opinion that as far as possible public borrowing should be avoided and if the government is compelled to borrow, government should finance its current expenses entirely out of the taxes and only that project should be financed through public borrowing which is productive in character so that debt would be liquidated ultimately and the whole process will be self liquidating.15

The classical economists assumed the existence of full employment, inelasticity of money supply and the unproductive character of the public expenditure in the analysis of public debt. They were afraid of the fact that public borrowing will compel the government to tax the public and thus the economic system will be disturbed. Hence, ultimately the public borrowing will disturb the optimum allocation of resources in the country.

However, the Keynesian revolution brought a change in the role of public borrowing. Keynes held the view that increases in public debt through multiplier effect would raise the national income; it is because Keynes correlated public borrowing with deficit financing. Keynes authorized government to borrow for all purposes so that effective demand in the economy may increase and thus employment and output may also increase. That is why he did not make any distinction between productive and unproductive expenditures. For Keynes borrowing for consumption will be as desirable as borrowing for investment in productive goods because consumption expenditure will induce investment to rise.
Now a days public borrowing is applied in the development process of a country in a wider perspective. It is used not only for meeting the huge wasteful war expenditure but it is used as an instrument of fiscal policy for mobilizing saving for development purposes as an effective instrument of monetary policy for combating inflation generated in the process of growth, thus ensuring growth with stability.

Besides, public debt also acts as a balancing wheel that controls the tempo of the business cycle. In periods of depression, when aggregate demands is not enough to accelerate the level of production and employment, compensatory theories of fiscal policy suggest increase of public expenditure on public works, etc. after taking idle savings from the hands of the people to create effective demand and to promote economic recovery. Government’s borrowings more than the available supply of goods and services and hence government transfers extra purchasing power from the hands of the people. Thus “……a sensible debt policy can be used to check a depression or a boom”. 16

Borrowing by the government has been increasing year after year and as a result the public debt of the country has been mounting up. This increase in public debts is mainly due to the failure of the government to live within its means, with heavy demands for public expenditure.

Another important factor that has been expanding public loans is to finance such projects which promise a return sufficient enough for meeting debt charges. Even the classical economists, who disliked public borrowing, were liberal enough to sanction public debt for purposes of revenue yielding. Besides, building up the economic infrastructure which is the base for economic development, requires more than what the government procures through taxes.
5. The Burden Concept of Public Debt

It can be seen that since the advent of the Keynesian theory, the public debt of all the countries in the world have been on the rise. It is because of the desire of every government to accelerate economic development in the shortest possible time. This rising public debt has prompted a heated debate among the leading economists of the world about the burden of public debt.

J.M Keynes himself gave expression to his views on the burden of public debt. “I think it is a matter of almost of indifference …….. it looks nice to have a clean balance sheet, and I think it is partly false analogy from private account keeping ; an individual likes to be out of debt. But for the nation as a whole it is merely a book keeping transaction”17

But in 1958, with the publication of “Public Principles of Public Debt” by Prof. J.M Buchanan, the controversy relating to the burden of public debt became once again a subject of lively debate among economists.

The concept of the burden of the public debt is a complicated economic issue. Though attempts have been made by economists like Dalton, Buchanan, Bowen-Davis-Kopt, et al, to define it, there is till no unanimity on the definition. Generally a distinction is drawn between financial or primary gross burden and real or secondary burden. The primary gross burden of public debt refers to the interest payments financed by tax. In other words, it refers to the effects of the interest charges and the consequent increase in the level of taxation. However, if the debt financed expenditure is productive in the sense
that it raises the future real income to a higher level than would otherwise have taken place, this primary net burden cannot be considered a burden at all. The primary gross burden is also termed the financial burden of the national debt. According to David McCord Wright, “the financial burden of the national debts is ………….. to be measured by the effects of the interest charges and the taxes levied to meet them. The relation which the taxes for interest bear to the national money income is the question of primary importance”.18

The real burden or secondary burden refers to the repercussions on the economy, caused by the rising debt, in the form of adverse effects on the capacity and willingness to work and save. According to Lerner, “an increase in the national debt can make the owner of government bonds less willing to work. One of the reasons to put away for the rainy day is weakened …….. because there is more put away already for the rainy day.”19

The concept of burden of debt also involves the notion of abstinence or the pain-cost doctrine. It means that those who contribute to government loans abstain from consuming current income. This is one effect of the burden of public debt. There is also an opportunity cost of public debt. The people who contribute to public debt may invest their financial resources into other purposes where the marginal productivity might be more. But according to J.M Buchanan, an individual who voluntarily buys government securities can be said to have “improved not worsened his lot by the transaction”.20

“The economy ………….. undergoes no sacrifice or burden when debt is created.”21 D.K Mishra assesses, “thus, talk about the future being obliged to pay for the debt financed expenditure of the present is a metaphor, no more. In a developing country
like India floating a public debt for purposes of capital formation is as legitimate, if not more, as floating a private debt to build useful private capital because in either case the new paper assets are matched by real income generating assets”.  

5.1 Pre-classical views

During the 18\textsuperscript{th} century the economists had favorable attitude towards public debt as they had great faith in the role of the state in economic activities. This attitude was shaped by the mercantilist doctrine of the time. Sir James Stuart discussed the subject of public debt in his principles of political economy (1767). He explicitly held that “……the country is neither poorer nor richer, when considered in a cumulative view, than if the same sum had been lent to private people at home.”  

Instead “the effect of public borrowing on national debt is to augment the permanent income of the country out of stagnating money and balance of trade”.

There is no doubt that Keynes ideas on economic policy particularly on taxation, public debt, public works and money as devices for correcting economic maladjustments had their roots in the theory of Sir James Stewart. However, it was very unfortunate that nine years after his publication, Adam smith, with his, “The Wealth of Nations” in1776, overshadowed Sir James Stuart as well as his evolutionist approach to economic analysis.

5.2 Classical Views

David Hume was one of the first English writers to apply his mind on the subject of public debt. He vehemently attacked the maxim that the public is no weaker up on account of its debts, since they are mostly due among ourselves, and bring as much property as they take from another.”
The publication of ‘The Wealth of Nations’ in 1776 was momentous in the history of economics. Adam Smith dismissed the transfer payment arguments as an “apology founded altogether on the sophistry of the mercantile system.” Smith criticized Sir James Stuart’s views on public debt and said that the money loaned to government was something that turned away from serving the function of capital to that of revenue. It means that the money was to be spent and wasted without even the hope of any future reproduction. It seems as if both Hume and Smith believed that the collapse of public credit was inevitable.

David Ricardo was the greatest representative of the classical school. He was convinced of the wastefulness of public expenditure. Yet he favored heavier taxation and disapproved public debt. He supported the view that interest payments, being in the nature of transfer payments within the community, involve no primary burden. This was based on the assumption that future tax payments would be properly utilized in a world of rational individuals. If tax payers living during the period of debt creation fully capitalize future tax payment productively, the payment of interest on the national debt become mere transfers which involve no sacrifice on the part of future generations. Thus, public debt does not shift the burden forward in time. “The arguments of charging posterity with the interest of our debt or of relieving them from a portion of such interest, is often used by otherwise well informed people, but we see no weight in it”.27

However Ricardo was greatly concerned with the negative effects of public debts. He stated in British Parliament in June 1819, “National Debt was an evil which almost any sacrifices would not be too great to get rid off. It destroyed the equilibrium of prices.”28 Hume, Smith and Ricardo rejected the option of public loans because of their
implicit assumption concerning the usage to which governments would put revenues. In their view, all government expenditure was wasteful and unproductive and hence public debt resulted in the destruction of capital.

Malthus, the great dissenter in the classical tradition, was apparently in sympathy with the views of Stuart on the public debt. He argued that a sudden reduction of national debt and the removal of taxation must necessarily tend to increase the national wealth and provide employment for the laboring classes. But, on the contrary, the existence of national debt, by maintaining a body of unproductive consumers contributed powerfully to distribution and demand and ensured “that effective consumption which is necessary to give the proper stimulus to production”.

However, Malthus conceded that public debt contributed to the evils resulting from changes in the value of money and that it would be desirable gradually to diminish the debt, and more specially to discourage its growth in the future.

J.S Mill, on the other hand, claimed that “the public debt has a double burden, one which is borne by the current generation of labourers because resources which would other wise be used to support labourers are withdrawn from private employment, and one which is shifted forward to future generations because of the taxes required for the interest payments”.

Another classical thinker, J.B. Say observes, “there is a grand distinction between an individual borrower and a borrowing government, that, in general the former borrows capital for the purpose of beneficial employment, the latter for the purpose of barren consumption and expenditure.” He believed that the burden of debt would be shifted among a great number of successive years. The only benefit that can be had from
national debt is evident from the statement, “national debt of moderate amount, the capital of which should have been well and judiciously expended in useful works.”

The classical theory found its best expression in the works of H.C Adams, C.F Bastable and P. Leroy Beaulie. They made a distinction between the creation of public debt and the effects of public expenditure. Adams was of the view that debt creation involves no sacrifices on the part of lenders. “A loan calls for no immediate payment from the people ………. The lenders are satisfied, since they have secured a good investment”. He believed that the burden of the expenditure is shifted forward in time. Bastable stated that public credit is only one form of credit in general and is governed by the same principles which control private credit. He also draws a distinction between the loan and the tax. “A loan is voluntary and supplied by willing givers; taxation is levied on the willing and the unwilling alike…………. To make things smooth for the present at the cost of the future is not the duty of the wise and far-seeing statesman” Further more he maintained that “from purely a financial point of view the source of the loan is really immaterial. In any case it is an immediate relief to the tax payer counter balanced by the greater charge in the future”.

It is Paul Leroy-Beaulieu who has provided a concise and careful analysis of the nature of public debt. He refuted the 18th century ideas on public debt. He rightly remarked that a public debt is in and of itself neither a good nor an evil. He criticized the classicist also for their failure to see that public expenditure can be productive. He argues, “a loan will be useful or harmful to the society in general depending on whether the state preserves and usefully employs the proceeds or waste and destroys the capital. In the past, the passions of sovereigns and the mistakes of governments have had for an
effect the disbursing of the greater part of the proceeds of public loan for useless expenditures. This has led many to condemn public credit absolutely, as an instrument of evil. This conclusion is exaggerated. It is as much as to say that it would be desirable for a man to be without sense because he often does not use it properly.40

The classical formulation never achieved domination and the scholars continued to put forward their different views. But the onset of the great depression generated a new thought with regard to public debt which culminated in the doctrines of Lord Keynes.

5.3 Modern View

The economic anomaly created by the great depression of the 1930’s destroyed the very fabric of laissez faire notions. This led to the modern theory of public debt which was initiated with the publication of ‘General Theory of Employment Interest and Money’ in 1936 by Lord J.M Keynes. The Keynesian revolution brought a change in the role of public borrowing. According to this theory, a huge public debt is a national asset rather than a liability and that continuous deficit spending is essential to the economic prosperity of the nation. The classical theory of public debt was based on the unrealistic assumption of full employment and the unproductive nature of public expenditure. Once the hollowness of this theory was understood and preserved the realistic possibility of unemployment, and agreed that government expenditures could be productive and need not necessarily be wasteful, the case for public borrowing was strengthened. Keynes held the view that increase in public debt through multiplier effect would raise the national income. Keynes authorized government to borrow for all purposes so that effective demand in the economy may increase and thus employment and output may also increase. In fact he drew no demarcation line between productive and unproductive
expenditures for the purpose of borrowing as the classicals did. For Keynes, borrowing for consumption will be as desirable as borrowing for investment in productive goods because consumption expenditure will induce investment to rise.

The Keynesian economics has also discarded the notion of debt burden on the basis of income creating potentialities. Debt creation brings into the exchequer unutilized resources and the productive employment of these resources by government leads to an increase in the national income. The tax payments necessary for servicing the debt are met out of this increased income and hence it is no burden on the economy.

As A.P. Lernor points out, “even if the interest on the debt is raised out of current taxes, these taxes constitute only a fraction of the benefit enjoyed from the government spending and not lost to the nation but transferred from tax payers to bond holders.”41 In this respect the society is regarded as being analogues to a family. Here, Lernor regards, as quoted by Hansen, the taxes required to service the debt as nearly transfers like interest “you pay your wife.”42 J.M Buchanan in his book ‘Public Principles of Public Debt’ calls this Keynesian theory “New orthodoxy” and enumerates the basic propositions of the theory 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 external public debt. 43
5.4 Buchanan’s Thesis

1. Since the publication of J.M Buchanan’s ‘Public Principles of Public Debt’ in 1958, the controversy over the burden of national debt has resurfaced. He has spearheaded a powerful attack against the no burden theory of the modern economists.

Buchanan attempts to disprove the modern theory of public debt by establishing that:

1. The primary real burden of public debt is shifted to future generations.
2. The analogy between public debt and private debt is fundamentally correct.
3. The external and internal debts are fundamentally the same.  

But it must be kept in mind that he defines a future generation, “as any set of individuals living in any time period following that in which the debt is created”. He does not mean posterity and he dwells on the question of the possible shiftability or non-shiftability of the debt burden and asserts that primary burden can be shifted forward.

5.5 Bowen - Davis - Kepf – Thesis

In a joint article, the three authors support J.M. Buchanan and try to remove some of the deficiencies of his analysis. According to them, the gross burden of public debt is the reduction in the volume of consumption by each generation. They argue that, “interest payment on the debt represent some burden on each and every generation that must pay taxes for such payments”.  

5.6 Modigliani  Burden Thesis  

Modigliani is of the opinion that public debt is a burden on the future generation because of the loss of capital formation and the consequent reduction of potential future income. When government borrows funds, the capital is transferred from the private hands, causing a fall in private capital formation, which in turn will affect the level of private real income in future periods. He argues that society bears no burden in the current period when public expenditures are financed out of private savings. He believes that an increase of the national debt is advantageous to the current generation. This increase will naturally place a gross burden on those living beyond that time through a reduction in the aggregate private capital, which in turn will cause a reduction in the flow of goods and services. On the other hand, if there is a reduction in the real national debt, it will impose a burden on those present at that time and tend to generate a gross gain for those living beyond. If the government expenditure contributes to the real income of future generation, i.e., through productive public capital formation, the gross burden of the public debt may be offset in part or in toto, or may be even more than offset.

5.7 Musgrave on Debt Burden  

Musgrave feels that the burden of debt financed expenditure shifts through reduction in private expenditure. Public debt reduces the consumption and investment of the future generations. In this case, Musgrave states, the use of ‘pay-as-you-use finance’ for durable public facilities, such as play grounds or highways, yielding services over a period of time. “Where the initial outlay is large, tax payers may not wish to assume the entire cost at once and may prefer to pay over the years as the services of the new facility are enjoyed. This reflects the same motivation underlying the purchase of a house on
mortgage or of an automobile on an installment basis. The option of pay-as-you-use finance increases the flexibility of consumer budgeting and adds to the efficiency of private finance. Precisely, the same result occurs in public finance. The question is only how the principle can be implemented at the public level. However, resources must be found for the initial outlay. This resource must be withdrawn from other uses, which is the immediate burden of a heavy public outlay. If the resources are withdrawn from private capital formation, this burden can be cushioned to a great extend.

5.8 Domar on Debt Burden

A very enlightening discussion on the concept of debt burden is found in Domar’s writings. Domar refuses to accept the absolute size of any nation’s public debt as a reliable index of its debt burden. The problem of rising public debt and the ability to service the interest charges should be viewed in the context of a rising national income. In his celebrated article, ‘The Burden of Debt and the National Income’, Domar showed that the problem of debt is mainly the problem of achieving a growing national income. One must accept the fact that a country is making incessant progress. If the debt grows, national income also grows. He observes that the phrase, ‘the burden of the debt’ if it has any meaning, evidently refers to the tax rate or rates which must be imposed to finance the service charges.

He says, “the greater is the rate of growth of income, the lower will be the tax rate, even though a more rapidly rising income results in a larger absolute magnitude of the debt.” There is no danger to a dynamically growing economy from a growing debt. Thus, the faster the income grows the lighter will be burden of debt. To quote Domar, “if all the people and organizations who work and study write articles and make speeches,
worry and spent sleepless nights – all because of the fear of debt could forget about it for a while and spend even half their efforts trying to find ways of achieving a growing national income, their contribution to the benefits and welfare of the humanity and to the solution of the debt problem would be far greater”.


Only a few economists have analyzed the secondary burden of public debt in terms of the effects on incentive to save, work and invest on account of the existence of a large public debt. Some adverse consequences are the following:

6.1 Pigou Effect or Wealth Effect

The existence of a large public debt implies a large holding of wealth by people in the form of government securities. Under these conditions, the people’s incentive to save would be blunted because already sufficient amount is held by them. They would not be impelled to save for the rainy day, or for their old age, or to leave to their family property, and hence tempted to squander their resources on luxuries. This is called Pigou Effect. This trend may be beneficial in times of depression because increased consumption can help a recovery from depression. However in times of prosperity, it is a positive evil because it adds to the inflationary potential in the economy. In a developing economy, this lack of incentive to save is more harmful. However, in the absence of an empirical study, it is difficult to determine the magnitude of the problem.

6.2 Kaldor Effect

The existence of a large public debt has adverse consequences on incentive to work, invest and accumulate. It is called Kaldor Effect. About this, Lernor comments, “an
increase in the national debt….. can make the owners of government bonds less willing to work. One of the reasons for working, the earning of money to put away, for the rainy day is weakened…… because there is more put away already for rainy day.” Lernor points out that a large public debt badly affects the incentive to invest, because for repayment of debt the government imposes heavy taxes on the community. Additional taxes reduce the net income of investors from their investment and make such investments unprofitable.

7. Effects of Public Debt

The effects of public debt depends up on such factors like the sources of loan, funds, the purposes for which the borrowing is done, the terms and conditions at which the debt is floated, the volume of existing public debt, the interest rates, the types of loans employed and lastly the general economic conditions of the community. In assessing the effects of public borrowing, it should be kept in mind that there is a distinction between the effects of public borrowing (while mobilizing the resources) the effects of public debt (while spending the funds) and the implications of the debt redemption (while repaying both the principal and the interest).

The government may borrow from the general public. In that case, the purchasing power is transferred from the private hands to the public hands and so the public borrowing may tend to curb consumption as well as investment in the private sector. But normally, the individuals purchase government bonds out of their idle cash balances and hence it shall not serve as a good anti-inflationary measure. If the government bonds are purchased by the non banking financial institutions like insurance companies, trusts, etc., it will reduce their cash holdings. This may cause the interest rate to rise and the volume
of investment to decline as the availability of loans in the money market is reduced. The government borrowings may be made from commercial banks which may lead to additions in the quantum of money supply in the country as the banks can use these bonds as collateral for borrowings from the central bank.

7.1 Effects on Consumption

The people purchase public bonds out of their past savings or out of their present income which they could otherwise spent in purchasing some other commodity. In the latter case, people refrain from consumption and buy public loan. Therefore, the consumption is affected in the same way as it is affected by taxes. In times of war there may be pressure to induce individual to curtail consumption and to subscribe government loan. There can be other special inducements offered, such as tax exemption, higher interest rates etc. to encourage people to invest their money in public debts and thus refrain from consumption.

7.2 Effects on Investments – Production

If the people buy government bonds by withdrawing money from their industrial concerns, or by selling debentures and shares of industrial concerns or financial institutions and even commercial banks subscribe to government securities out of funds meant for investment or for accumulation of stocks. Then the investment is adversely affected, leading to adverse effects on production. But if the government uses this money in some productive enterprises, the total investments available for production may not be unfavorably affected. On the contrary, if the government spends it on unproductive works the total investment may be adversely affected, consequently with adverse effects on
production. If the loans are utilized productively, it will increase the income of the community leading to an increase in consumption and there by, an increase in production.

7.3 Effect on Distribution

If the public loans are subscribed by the rich people only and if the government spends that amount on the economic welfare of the poor people, it will lead to narrowing down of inequalities and will lead to an equal distribution of income among the people. But this will not be possible if the burden of public debt along with interest payment falls on the poor people also.

But if the bond holders and tax payers are identical there would not be a re-distribution of income. It means that re-distribution of income will take place only if the tax payers and the bond holders belong to the different groups.

7.4. Effect on Economic Activity and Employment

Public debt has its effects on the economic activities and employment situations in a country. One of the aims of public debt should be to improve the economic activities and employment situations. When public debts are incurred the quality of money in the hands of the people and their purchasing power is curtailed which adversely affects the country’s price level and employment situations. Thus public debt is one of the most effective means of controlling the inflationary trend of the economy. In times of depression when the level of prices, production and consumption decreases, the unemployment increases and the financial institutions are under stress, the government takes loan and spends the money on development programmes. This will increase the
amount of money in the hands of the people and improve economic activities and employment situation and the depression will disappear.

7.5 Effect on National Income

If the borrowed funds are spent on capital goods, it will accelerate production and consequently cause a rise in national income. The increase in national income will be high in proportion to the investment so made because there will be a multiple of the increment of the investment due to multiplier effect.

7.6 Effect on Liquidity

Government securities are highly negotiable and highly liquid form of assets which can be converted into money for any purpose and at any time. Commercial banks who posses these securities can use them for their credit expansion. But in times of inflation the central bank may resort to devices meant to restrict the credit control capacity of the commercial banks.

8. Management of Public Debt

In recent years public debt management has been recognized as an important instrument of the state policy and an inevitable complement to the monetary policy of the central bank. Certainly it affects the nation’s entire financial system, the degree of its prosperity and the relative welfare of its citizens. Thus, public debt management has become an inalienable part of the overall management of the economy.

J.M Buchanan says “public debt management, as such is defined to include that set of operations which must be performed by the treasury department in “maintaining” a
national debt. That is to say, debt management takes place even when no debt is being created and no old debt is being retired, in net terms.”

According to Ursula K. Hicks, “the art of debt management is concerned with the timing and the choice of the most appropriate type of debt and channels for borrowing repayment, or refinancing, having regard to the needs of the economic situation and the relative abundance of funds seeking investments of different varieties. Judicious policy can be made to save both the cause of reducing the budgetary charge of the debt service and the wider interests of fiscal policy”. In other words, public debt management may be taken to refer to any action by the government either by the treasury or by the central bank, with a view to affect the ‘quantity and kinds of a national debt obligations of the government and to bring desired effects up on the working of the economy.’

It must be remembered that, public borrowing is a deferred taxation. Therefore, it is likely to generate sharp pulls by the price instability and disequilibrium resulting from the disturbance on the various sectors of the economy. “The efficient functioning of the public debt management machinery warrants that public borrowing program should be so conducted, the securities should be so issued that the maturity mix-from non-marketable to marketable, from long-term to very short-term securities – should be so determined; the interest rates on the securities should be so fixed; the refunding, conversion and monetization of the debt should be so managed and finally for meeting the interest burden as well as the repayment of the principal ……….without jeopardizing the development process in the under developed countries”.

Now a days, the field of debt management has became so wide as it is difficult to control, both by fiscal and monetary authorities due to the size and composition of debt.
It is clear that the importance of public debt management is increasing rapidly because it has its effects on the economy as a whole.

8.1 Objectives of Debt Management

In managing the national debt, the treasury department has many objectives. The first objective is to reduce the magnitude of the management problem itself. It means funding of as much debt as possible. “As issues mature or become callable, the treasury will simply sell consoles, or very long term bond, in sufficient amounts to secure the necessary replacement funds, paying whatever interest rates the capital market might dictate”. 56

The second objective is that of minimizing the interest cost on the public debt, which comes in conflict with the funding objective. A wholesale refunding of the debt into long term issues is likely to cause an increase of interest costs substantially.

The third objective of public debt management is to accommodate to the fullest possible extent the particular interests of various classes of investors. Public debt may provide an opportunity for the investment needs of certain groups including state and local treasuries. Savings bonds provide a safe investment opportunity to those individuals who like either information or access to more sophisticated forms of investments.

The fourth objective is to bring about an effective co-ordination between the economic activities of the treasury and of the central bank.

8.2 Debt Management in a Developing Economy

In the case of developing countries the various objectives of public debt management may come in conflict. One of the aims of public debt management is to
encourage the mobilization of saving to meet the growing demands of the developing economy. In this case, the rate of interest on government securities should be high enough to induce saving but the aim of the minimization of the cost of servicing the debt warrants a low rate of interest. Again, in order to encourage investments in the economy to speed up the rate of growth it is necessary to adopt cheap money policy. But in order to check the inflation arising in the process of growth, it is desirable to have a high rate of interest. Thus, efficient management of public debt in a developing economy requires reconciliation of the various conflicting objectives, taking into account the immediate demands of the economy.

8.3 Debt Management In the Indian Context

India follows planned economic development unlike many other countries. Therefore, the objectives of debt management in India are different to a certain extent. Firstly it aims to promote saving and thus to provide more funds for investment in the public sector without harming the private sector. Secondly it seeks to ensure large borrowing, keeping the price stability in the economy and thus to promote development within the frame work of overall monetary stability.

In the case of the first objective, the debt management must aim to tap funds from all possible sources in the economy. For this a variety of debt instruments should be used to suit the different types of requirements of the investors. The policy should be flexible enough to offer different terms such as the rate of interest and maturities suitable to the conditions prevailing in the money market and capital market. Here it is necessary to see that the private sector is not adversely affected, while drawing funds for the public sector. It requires a special care in a mixed economy where the role of private sector is very
important. The second objective is perhaps the most important one. The loan operations should support and not disturb the price stability in the economy. The debt policy should have the goal of minimizing the risk of inflation.

Thus, in the Indian context the debt management is not merely those of creating various instruments of debts to finance the deficit in the budget and managing them. But its objectives are achievement of a faster rate of economic growth, stabilization of the prices of government bonds, maintenance of a structure of interest rates in the organized money market and capital markets, minimization of the cost of servicing the debts and restraining the inflationary pressures in the economy.

9. Public Debt in India

In India the topic of public debt became a topic of academic and economic significance only after independence. Prior to that, thanks to a conservative policy followed by the British in the preparation of the budget, a reasonably balanced budget could be maintained and hence the question of public debt didn’t arise at all during the period. But the developmental challenges of the post independent period necessitated the profuse expansion of the public sector and the consequent growth of public expenditure in alarming proportions led to huge deficits year after year. This forced the governments in India to borrow more and more to finance the budgetary and fiscal deficits, ultimately resulting in the uncontrollable growth of public debt.

Nevertheless, the Government of India setup a planning commission in March 1950 and started its first Five Year Plan in April 1951. Public borrowing was regarded as the chief source of mobilizing resources for meeting the huge developmental needs of the
economy. The planning commission remarks, “techniques of borrowing in particular have to be adopted so as to convey to the people the larger purpose for which the loans are being raised and to facilitate their participation in the development programme on the largest possible scale.” The total public debt of the government of India stood at Rs.2,469 crores in 1950-51 which rose to Rs.3,082 crores in 1955-56, the period of the 1st five year plan. The first plan targeted a modest level of public borrowing only. Dr. R. N. Bhargava was of the view that, “in the post independence period, the limit to the government borrowing programme has been decided by its capacity to raise funds through market loans or small savings rather than by its desire to restrict borrowings in pursuit of the orthodox policy of having the minimum of public debt”. To the surprise of all, the mobilization of the domestic resources for meeting the outlay of the first Five Year Plan was an outstanding success of the borrowing programme. According to D.K Mishra, “the successful carrying out of the borrowing programme of the government during 1951-56 was due to the low target fixed by the planning commission, the new orientation of the technique of public borrowing by the public authorities so as to carry to the people the large purpose for which the loans are being raised, the Reserve Bank’s skillful technique of debt management, fuller cooperation between the Centre and the States and the restoration of a considerable degree of stability and a marked feeling of confidence in the capital market.”

The first Five Year Plan was a modest plan, while the second one was a giant plan, a big step for accelerating the tempo of growth in the economy. In this plan also the government placed greater reliance on public borrowing and targeted to collect Rs.1,200 crore, from market borrowing and small savings. A noted feature of the second plan was
that it emphasized the role of small savings in the development effort. By the end of the plan in 1961 the total debt rose to Rs.6,121 crore. The success of the public borrowing during the period was due to two factors. Firstly, during the second plan the conditions of the Indian money market became better and secondly, the opportunities for floating more loans improved because of the establishment of State Bank of India, nationalisation of Life Insurance business and the growth of provident fund institutions. The planning commission had already noted in 1956, “the net accumulation in Provident Funds and similar schemes are already an important source of finance for public loans and it is expected that their importance will grow in the coming years. The nationalization of life insurance which is intended to foster the insurance habit should also prove a growing source of demand for public loans.”

India’s third Five Year Plan commenced with shortage of resources, inflationary trend, acute foreign exchange crisis, etc. Therefore, the public borrowing was targeted modestly to Rs.800 crores from market borrowing and Rs.600 crores from small savings. The total debt increased to Rs.9136 crores by the end of 1965-66. During the three annual plans, the total amount of public borrowing was estimated to be Rs.962 crores but the actual contribution came to be Rs.1,080 crores.

During the fourth plan, the actual public borrowing came to Rs.4,307 crores out of which Rs.3,145 crores were mobilized through market borrowings and Rs.1,162 crores through collection from net small savings. A noteworthy feature of the public borrowing during the period was a significant improvement in collections from small savings which represented the genuine savings of the people, therefore, non inflationary.
The outstanding internal debt of the Government of India stood at Rs.34,109 crores at the end of March 1979. During 1979-80 the government contracted a debt of Rs.3,241 crores and the total debt rose to Rs.40,251 crores at the end of the year. At the end of the sixth plan 1984-85, the total debt stood at Rs.1,13,441 crores which grew by the end of seventh plan in 1989-90, to Rs. 2,68,192 crores. The total debt was estimated at Rs. 6,75,676 crores at the end of the eighth plan in 1996-97. The debt figure reached Rs. 13,66,408 crores in 2001-02, the end of the ninth plan. In 2006-07, the total debt rose to Rs. 24,73,563 crores.(estimate) (Hand book of statistics on the Indian Economy, RBI 2005-6).

10. Finance Commissions on State Indebtedness

The Finance Commissions are appointed by the president of India under article 280 of the constitution. The chief duty of the commission is to study and make recommendations to the president about the financial relationship between the union and states at all levels. Hence the commission studies and makes recommendations about the various aspects of state indebtedness. The significant comments of the last 12 finance commissions about the indebtedness by the states and related issues since their inception are worth noting.

The first finance commission was appointed in 1951. But this finance commission did not dealt with the problem of debts of the states because there were no states but only provinces and most of the provinces had either surplus budgets or small deficits. States in the present sense came into existence in 1956, after the reorganization of the states and hence this study has relevance only with the recommendations of the second finance commission onwards.
10.1 2nd Finance Commission (1957-62)

The Second Finance Commission looked into the problems of states indebtedness for the first time. There had been a phenomenal growth in the number and amount of the loans given by the Government of India to the states. From 1st April 1951 to 31st March 1956, the first Five Year Plan period, the total outstanding debt given by the Government of India to the states rose from Rs.195.41 crores to approximately Rs. 900 crores. These loans were issued for various purposes but largely to implement the plan. The amount of individual loans ranged from small sums to crores of rupees. The rates of interest varied from one to five percent, some of the loans being free of interest. There were other loans, repayable in periods ranging from one to forty years. Under these circumstances, one of the terms of reference of the second Finance Commission was to examine “the modifications, if any, in the rates of interest and the terms of repayments of the loans made to the various states by the Government of India between the 15th day of August 1947 and the 31st day of March 1956.”  

The commission was of the view that “if a scheme has to be subsidized, the subsidy should be given directly and not through reduction in the interest charged. The revenue budget should show the actual interest burden and any assistance sought to be given through concessional rates of interest should take the form of direct subsidy.”

Keeping these things in mind the commission summed up its recommendations to rationalize the interest rate structure. The commission suggested only two rates of interest either 3% or 2.5%.
10.2 3rd Finance Commission (1962-66)

Though 3rd Finance Commission as a part of general observation noticed that mounting interest liabilities for the state governments, arising out of loans is eating up a substantial portion of the current revenue. To quote “the position will worsen in the foreseeable future. As our devolution must take account of the revenue gaps, partly attributable to interest charges, we consider that it would not be out of place if we were to give our appreciation of the position.”

10.3 4th Finance Commission (1966-69)

The 4th Finance Commission was asked, by its terms of reference to assess the assistance required by the states for servicing their debt. The commission was requested to examine the scope of “creation of a fund out of the excess, if any, over a limit to be specified by the commission of the net proceeds of the estate duty on property other than agricultural land accruing to the states in any financial year for the payment of states’ debts to the central government”

The commission recommended that both interest charges and amortisation should be treated as items of revenue expenditure for the purpose of working out budgetary gaps in order to recommend Grants-in-Aid under Article 275(1). The commissions accepted the proposition of debt readjustment, but at the same time recommended an overall assessment of the system of inter-governmental debt operation in India by an expert body before taking any measure to the solution of growing debt of the state government.
10.4 5th Finance Commission (1969-74)

The 5th Finance Commission was asked to look into “the problem of unauthorized overdrafts of certain states with the Reserve Bank of India and the procedure to be observed for avoiding such overdrafts.” The commission felt that this fundamental problem was caused by chronic imbalance between resources available to the states and their responsibilities under the constitution. Secondly the manipulation of taxes by the Central Government in its favor has compounded the problem of resource inadequacy of the state. Consequently, the states resorted to unauthorized overdrafts to meet their plan expenditure and also the increasing burden of central loans.

10.5 6th Finance Commission 1974-79

The 6th Finance Commission was entrusted with the task of making an assessment of the non-plan capital gap of the states on a uniform and comparable basis for the five years ending with 1978-79. The commission observed that there has been a phenomenal growth in the states debt to the centre from Rs.449 crores in 1952 to Rs.9568 crores in 1972. However, the commission found nothing intrinsically alarming about this growth of public debt. The continuous increase in the indebtedness of the states to the center only reflected the assistance provided by the center to the states.

The commission estimated that 19 out of 21 states have non-plan capital gaps and recommended adjustments through consolidation of some loans into uniform types, extension of the period of repayment of some loans and moratorium on the repayment of some loans and writing off of some loans. The commission did not recommend substantial debt write offs of the states on the ground that it would reduce central resources for further assistance to them.
10.6 7th Finance Commission 1979-84

The 7th Finance Commission took up the approach of the 6th Finance Commission with regard to the states indebtedness to the center. It recommended various measures to link the repayment period suitably with the purpose for which central loans have been used by the states. The commission recommended certain measures to reduce the total debt burden of all the states to the centre as at the end of 1977-79, by an estimated amount of Rs.3,075.99 crores. Further, for the five years ending with 1983-84 the repayment liability of the state governments to the centre got reduced by Rs.2,155.80 crores.

10.7 8th Finance Commission 1984-89

The reference frame to the 8th Finance Commission was a much broader one. It was asked for an assessment of the non-plan capital gap of the states on a uniform and comparable basis and remedial measures to reduce the gap of the states, their, relative position and the purposes for which the loans have been utilized and the requirements of the Centre. The commission reveals that growing expenditure needs and insufficient revenue resources with the states made them heavily dependent on Centre to finance their revenue expenditure. In this situation there is no alternative for the states to finance developmental outlays without resorting to borrowings. The commission’s views in regard to the growth in public debt of the states are summed up as in 8th Finance Commission Report (1984). “We see nothing basically wrong in the growth of public debt. With the expanding public functions, no government particularly in developing
economy, can undertake large scale programmes of development without recourse to borrowing. We think, however, that it is but right that the borrowed funds should be used for investment purposes and not for consumption. Investments financed by borrowed funds, need not be strictly productive in commercial sense, but, they should sub serve a genuine public purpose.\(^{66}\)

Thus while commission viewed the role of public borrowing in its right perspective it was still opposed to the idea of writing off loans on the ground that it would reduce the resources available for recycling from the Centre to the state. According to the commission the most pernicious problem of Centre state financial relation was not the indebtedness of the state to the center, but the increasing overdrafts of the state governments.

10.8 9\(^{th}\) Finance Commission (1\(^{st}\) Report 1989-90, 2\(^{nd}\) Report 1990-95)

The 9\(^{th}\) Finance commission’s approach was different from that of the last three commissions. The commission was asked to make an assessment of the debt position of the states as on 31\(^{st}\) March 1989 and suggest corrective measures, keeping in view the financial requirements of the Centre. In its report the commission observes, “unlike in the case of the eighth commission, we have not been asked to estimate the likely non plan capital gap of the states at the end to the period under our consideration. Second, we have been asked to review the entire debt position of the states and not the state’s debt position with particular reference to central loans advanced to them.”\(^{67}\)

The total debt of state governments was estimated to be Rs. 89,461 crores, as on 31-3-1989, of which liabilities to the Central Government form about 63%. The major
cause for the rapid rise in state indebtedness was the key role of borrowing in financing investments under the plan. The commission vehemently opposed the use of borrowed funds to cover part of the revenue expenditure. According to the Commission “except for such diversion of borrowings growth in indebtedness should not cause any worry if investments yield adequate returns to meet interest and for amortisation. In respect of government owned assets, depreciation or amortisation funds are not maintained and hence borrowings contracted for the creation of such assets have to be repaid out of fresh borrowing.”

Thus, the commission took the view that borrowing by the states should be only for those projects which were of self liquidating in nature.


Like the 9th finance commission, the 10th finance commission was also asked to review the debt position of the states with respect to their entire debt and not merely central loans to states, and suggest corrective measures keeping in view the financial requirements of the Centre also. Keeping in mind the corrective measures taken by the earlier Commissions and their effects, this commission held the view that corrective measures should be formulated in such a manner as would provide an in-built incentive for the prudent use of borrowed funds.

The total debt of the state governments was Rs.1,83,886 crores as on 31st March 1994. The commission identified three disturbing features of such high debt profile of states and its management. They are “diversion of borrowed funds for meeting revenue expenditure, use of loans in unproductive enterprises or enterprises which are potentially productive but are beset by poor performance and currently yielding low or even negative
returns and non-provision for depreciation or amortization funds in respect of
government owned assets leading to repayments out of fresh borrowing.”^69

The 10th finance commission kept the following objective in view while recommending
debt relief measures to states.

1) The quantum of relief should be limited,

2) Priority should be given to states under severe fiscal strain and

3) States with better fiscal management should be given an incentive.

 Based on these objectives the commission recommended a scheme for debt relief,
which had two parts. A scheme for general debt relief for all the state linked to fiscal
performance and special relief for states with high fiscal stress and special category states
and states with debt problems warranting special attention.

 With a view to inducing better fiscal management the commission recommended a
scheme of general debt relief for all states linked to fiscal performance. During 1996-97
to 1999–00, twenty states were able to avail the general debt relief recommended by the
Tenth Finance Commission by showing improvement on their revenue balance accounts.


11th finance commission was required to study the debt position of the states and
suggest corrective measures keeping in view the long term sustainability of debt for both
the Centre and the States. The states were burdened with a total debt of Rs. 4,00,754
crores as on 31st March 1999 and was estimated to rise to Rs.4,73,677 crore on 31st
March 2000 and this huge growth in the volume of debt caused fears of its sustainability.
According to the commission, “Given other things, a state which has a higher growth
rate relative to interest rate, can sustain debt at a higher level relative to GSDP.\textsuperscript{70} This can come about only when the state governments make persistent effort to raise additional revenue or by squeezing their expenditure. Fiscal reforms should focus on achieving revenue balance or reducing revenue imbalance to the minimum. The commission, therefore, focused only on debt relief linked to improvement in revenue balance.

So, it proposed the continuance of the existing debt relief scheme linked to improvement in the ratio of revenue receipts of a state to its total revenue expenditure with enhanced incentive.

The commission also identified the steps desirable for reducing the debt burden of the states:

1. Incremental revenue receipts should meet the incremental interest burden and the incremental primary expenditure.

2. A surplus should be generated on revenue account to go into a sinking fund to meet future repayment obligation and

3. State should have balance in its revenue account.

\textbf{10.11 12\textsuperscript{th} Finance Commission (2005-2010)}

The 12\textsuperscript{th} Finance Commission was assigned the task of making an assessment of the debt position of the state as on 31\textsuperscript{st} March 2004 and suggest corrective measures consistent with macro economic stability and debt sustainability. While making recommendations, weightage was to be given to the performance of the states in the fields of human development and investment climate.
The 12th Finance Commission recommended that all central loans to states till 31st March 2004 and outstanding on 31st March 2005 (amounting to Rs.1,28,795 crores) may be consolidated and rescheduled for a fresh term of 20 years, resulting in payment in 20 equal installments, with an interest rate at 7.5 percent. It offered conditional write offs on debt repayments owned by states to the center and concession on the interest rates applicable on that stock. There are two separate sets of conditions for the interest concessions and debt write off. Interest rate reduction to 7.5 % required enactment of Fiscal Responsibility legislation (FRBM Act), with the prominent conditions of elimination of the revenue deficit by 2008-09 and reducing the fiscal deficit to 3% of GSDP or its equivalent.

It follows from the reports of the various finance commissions that they are not against borrowings as such. Instead they hold the view that the government shall borrow keeping in view sustainable development and inter-generational equity. Accordingly the governments are directed to borrow only for productive investments which are self liquidating in nature.

11. Public Debt in Kerala

It was Anizham Thirunal Marthanda Varmma (1729-1758 AD) who laid the foundation of modern Travancore. He set up an organized system of administration for the smooth functioning of the Kingdom. Between 1750-1758 AD, he conducted a careful assessment and survey of all the lands in his kingdom, established customs houses at the frontiers for levying import and export duties, created fiscal monopolies in certain articles like tobacco, pepper, arecanut, etc., He introduced the system of fixed budget for every year. These steps laid the basis of the administrative system of the country.
However, it was consolidated during the reign of Rama Varma (1758-1798 AD). But unfortunately this work of reorganization received a rude set back with the outbreak of the Mysoor wars, which drained the resources of the kingdom. This had serious repercussions especially in the reign of the next king Balarama Varma (1798-1810 AD).

During his reign, he resorted to loans because of the inadequate revenue. Large sums were taken from the public treasury and loans were obtained not only from local merchant but also from, outside centres like Bombay and Madras, as can be understood from the Royal orders in 1801 AD. It is seen that government owed Rs.62143 to a Bombay merchant and Rs.52145 to a Madras merchant and similar sums to some other merchants in the kingdom. The general rate of interest for these loans was 12%.

In later periods, the State of Travancore used to borrow not only from big merchants in and outside the state but also from the temples at high rates of interest. But at every time when such loans were taken, arrangements were made for their early repayment. In 1855-56 AD the state raised an internal loan. A sum of Rs.500,000 was taken from the temple funds to be expended chiefly on religions and charitable institutions.

Public debt, in the present system, first came into existence in 1916. The 5% loan of Rs.14.49 Lakhs for providing funds for the construction of the railway line from Quilon to Trivandrum and repayable on 15th August 1941 was the first loan raised by public subscription. In 1936, the 3.5 percent loan of Rs.50 Lakh, repayable in 1956, was floated for the purpose of financing productive schemes such as the Pallivasal Hydro Electric Scheme and for meeting the share of the Government of Travancore in the loan required for the capital expenditure on the Cochin Harbour work.
11.1 Public Debt in Kerala Since 1956

In the Indian federal setup, the states play a key role in sustaining and accelerating economic growth. The Indian Constitution assigns important responsibilities to states in many sectors such as agricultural development, infrastructure, poverty alleviation, water supply and irrigation, public order, Public health and sanitation. They also have concurrent jurisdiction in several areas like education, electricity, economic and social planning and family planning. In the light of these responsibilities the expenditure of the states form a substantial portion of the total government expenditure in India. The expenditures of the Kerala Government have been increasing rapidly since its formation in 1956. However there are limits to which revenues can be raised to meet continuously increasing expenditures. In fact, once actual taxation reaches the limits of the taxable capacity of the people, an attempt to raise additional resources by further taxation causes tremendous hardship to the people. This has driven the state government to mobilize resources through public borrowings.

The state of Kerala was formed in 1956 by joining the Travancore – Cochin kingdoms, which had surplus budget, and the Malabar region of the Madras Province, which had deficit budget. While doing so the fiscal self-sufficiency and self-reliance were never considered as parameters. Consequently the state of Kerala didn’t have a balanced budget from the beginning itself.\(^71\)

In 1957-58 the total revenue receipts was Rs.31.50 crores, the total revenue expenditure was Rs.32.90 crores and the gross fiscal deficit was Rs.9.84 crores.\(^72\) During 1960’s and seventies the revenue gap continued to grow year by year and therefore the fiscal stringency into which the state has fallen has not been an unexpected phenomenon.
Since the mid-seventies, the state experienced financial crisis on a modest scale. In 1980’s, the revenue deficit grew to unmanageable proportions. Invariably, the state had to use borrowed funds to cover the revenue deficit. The increasing dependence on borrowed funds to meet the revenue expenditure certainly added to the already heavy burden of debt liability of the State. To pay off old debts and their interest, the State had to borrow further. Thus, Kerala’s fiscal scene moved slowly from bad to worse during the 1980’s and thereafter.

12. Review of Literature

Public indebtedness is a complex phenomenon since it is beneficial in certain situation and not in others. The concept of welfare state has driven the modern governments to borrow from different sources both for productive and unproductive purposes. High indebtedness has caused embarrassment to many governments since the second half of eighties. Thereafter, various issues related to public debt have been a topic of hot debate both in the academic and government circles. An attempt has been made here to have an overall view about the works done by the scholars on public debt and is presented in chronological order as given below.

Hugh Dalton (1957) in his classic work discusses the topic of public borrowing in the context of the Second World War. In this respect he finds a distinction between reproductive debt and dead weight debt and goes on to analyze the experiences of major governments, especially the British Government after the second world war, in the light of the then prevailing economic theories.73

J.K. Mehta and S.N. Agarwala (1960) analyse the principles of public debt, its role in
times of depression, and effect on various sectors of the economy. They advocate the ‘early concept’ with regard to the redemption of public debt.\textsuperscript{74}

Harold M. Groves (1962) traces the development of public borrowing and the history of debt management especially the framing of war debt policy in the context of second world war. He has made an in depth investigation of public debt and national income. He also proposes ‘capital levy’ as a means of ‘debt retirement’.\textsuperscript{75}

James M. Buchanan (1965) provides a theoretical view of the principles of public debt. He views public debt as disguised money creation and analyses macro economic policy aspects of public debt.\textsuperscript{76}

K. Venkataraman (1968) presents before us the growth of indebtedness of states during the first three plan periods and the early thinking about serving the public debt. He noticed that during the first three year plans the volume of debt of the state governments increased to an extend that it became a matter of great concern.\textsuperscript{77}

Nanjundappa (1947) found that central loans on state government finance formed 74.1\% of the states total debt. In his view, a rise in debt can be set off by a rise in the income of the states.\textsuperscript{78}

A detailed study by Ghuge (1977) showed that the national debt had grown enormously after 1956 and had became a major influence on the monetary and fiscal policy of the country.\textsuperscript{79}

Thimmaiah (1977) comes to the conclusion that the central loans to the states have caused a sort of financial imperialism of the Central Government that market borrowings of the state government have not been distributed or allocated consistently on the basis of any
objective principle. According to him the mounting burden of union loans to states should be primarily addressed and efforts should be made to reduce both financial and economic burden of such loans.\textsuperscript{80}

K.R. Sarkar (1978) explores the basic concept of public finance in ancient Indian thought specially based on Kaudilya’s ‘Arthasasthra’. He explains the ‘Ayasariram’ (body of income) and ‘Vyayasariram’ (body of expenditure). According to him Kautilya presents the whole economy as one body with its various constituents. To him there was no place for public debt, which was certainly looked down upon. The amount of surplus was the yardstick to determine the success of a government.\textsuperscript{81}

A study by the Birla Institute of Scientific Research (1979) points out that the problem of growing state indebtedness to the Centre is feeding up on itself. According to the study, the debt liabilities of the states are not supported by corresponding income yielding assets. Moreover central transfers to the states are insufficient and the loan grant composition of central loans is disproportionate.\textsuperscript{82}

K K George (1982) analyses the ever growing revenue expenditure of the state of Kerala, causing a heavy revenue deficit year after year ultimately resulting in accumulation of public debt. According to him the only remedy is to raise the quantum of central assistance to the state.\textsuperscript{83}

Bhuyan (1984) analysed the finances of Assam state and revealed that the state had been using its debt raised resources on less productive areas. Hence he underlines that the public debt policy must be accompanied by a suitable monetary policy.\textsuperscript{84}

K.C. Sankara Narayanan and V. Karunakaran (1985) attempted to present a study of the
financial experiences of the Kerala State between 1957-58 to 1980-81. They analysed the trends in the generation of revenue and the expenditure pattern including both the developmental and non-developmental expenditures based on various statistics.\textsuperscript{85}

S.K. Ray (1987) makes an appraisal of the various finance commissions since the 8\textsuperscript{th} and analyses the centre state financial relations and problem of public debt in the light of the Sarkaria Commission Report.\textsuperscript{86}

A Seshan (1987) was the first to warn about the critical fiscal position reaching an unacceptably high level in future. He attributed this phenomenon to an increasing function of public debt.\textsuperscript{87}

Gosh (1988) is of the opinion that the increased public debt and the burden of interest charges have become a major hindrance to development planning both in the public and private sector.\textsuperscript{88}

Rangarajan, et. al. (1989) describe the seriousness of Indian public debt and analyse and explore the dynamic nexus between government deficits and different modes of financing them. They examined the macro economic implications of domestic debt accumulations and also the dangers of resorting to RBI financing, causing a vicious circle of deficit and inflation.\textsuperscript{89}

J.L. Bajaj and Renuka Viswanathan, (1989) in their paper ‘Financial Management in States- Role of Finance Commission’, compare the actual fiscal behavior of the states as against that envisaged by the Finance Commission. They look at the deviations from the commission’s projections-deficits or surpluses that actually emerged as against those expected. They also evaluate the methodology adopted by the 9\textsuperscript{th} Finance Commission
for promoting resource mobilization and controlling expenditure.\textsuperscript{90}

Lizy (1989), in her study on Kerala finances in relation to other states, noted that the debt burden of the various states has been on the rise while the Central loans, forming a major part of the state, has been on the decline.\textsuperscript{91}

In the article ‘Internal Public Debt of Government of India- Growth and Composition’ B.B. Bhatacharaya and Srabani Guha (1990) brought out that internal debt-GDP ratio of the Government of India was rising during the 1970’s and 80’s. But they warn that a stage may come soon when the government will have to raise the ratio of monetized debt, causing inflation or curtail public expenditure. However both the measures are likely to cause disastrous economic and political fall out. They suggest two measures, to raise tax-GDP ratio and to reduce the rate of interest on public debt. They also advocate a strong control on the growth of non-productive public expenditure.\textsuperscript{92}

K.K. George analyses the public finance of Kerala in his article “Kerala’s Fiscal Crisis- A diagnosis” (1990). He identifies relatively low central assistance to Kerala, higher levels of expenditure such as growing share of pension payments and higher share of social and community services and also higher non-plan revenue expenditure as the main causes of the financial crisis in Kerala. According to him, a major policy shift is necessary to get Kerala out of this vicious circle of financial crisis.\textsuperscript{93}

B. Misra (1993), in his book, manifests the multifarious effects of deficit financing and also the management of debt in the Indian context. He also dwells up on the various sources of revenue for the state.\textsuperscript{94}

Aiyer and Kurup (1992) argue in their study that non-developmental expenditure
increased faster in Kerala than in any other state. In 1991-92, 13.6% of the total revenue expenditure of Kerala went towards the payment of interest charges. Even the repayment obligations constituted almost 95% of its non-plan capital outlay. A major part of the public debt of Kerala was the loans taken from the Central Government.  

Sen and Rao (1970) were the members of the Resource Commission appointed by the Government of Kerala to study the various aspects of the state finances. In their opinion, the fiscal problem of Kerala has been aggravated by the use of a large portion of borrowed funds to finance current expenditure. Consequently physical capital formation lagged behind. The increasing interest burden and large plan outlays on social services were the reasons behind this excessive expenditure.  

K.K. George (1993) observed that the debt servicing payments take away as much as 87% of the fresh central loans in the case of Kerala. The outstanding debt of Kerala in relation to SDP reached 37.7% by the year 1987-88 in Kerala. In his opinion, Kerala is caught in a vicious circle of deficits, debt servicing payments and still more deficits. In his earlier study he had pointed out that the mounting debt servicing payments have progressively reduced the net central loans to the state in to a trickle. This reveals the urgent need for debt relief to the states.  

Gulati (1993) argues for better allocation of government expenditure which will contribute to the growth of national income and consequently a sustainable level of public debt.  

K.D. Gaur et al. (1993) quoting A. Seshan’s study on Burden of Domestic Public Debt in India warns that the country is heading for an internal debt trap, having probed deep into the burden of domestic public debt in India. They further attempted to dwell on income
and expenditure of the Central Government and analyze the magnitude of internal and external debts of the union government.  

Jose Jacob (1993) investigated in to the finances of Kerala during the period 1950-1990. He is of the view that the major factor behind the states fiscal crisis is the heavy increase in the non-plan revenue expenditure without raising the resources required to meet it.  

K K George (1993) agrees with R Ramalingam Aiyar and K N Kurup, that the predominance of the non-plan revenue expenditure is the root cause of the financial crisis on Kerala.  

H.L. Bhatia (1994) discusses the nature, the structure and problems of the Indian public debt and the related issues, especially about the obligations of both the central and state governments. He dwells upon the state of public debt before 1951 and after.  

Rengarajan, Basu and Jadhav (1994) viewed the alarming growth of public expenditure from a different angle. They are of the view that a deep analysis touching the micro foundations of the public debt is necessary to unearth the reasons for the growth of domestic debt. They simulated two alternative scenarios for financing the deficit, one by debt financing and the other by monetary financing. According to them debt financing would result in higher interest burden which may invariably lead to a squeeze on budgetary capital outlays and thereby stifling economic growth.  

R.K Patnaik (1996) presents medium prospective that in order to bring about fiscal sustainability, a debt-GDP ratio should be brought down to 50% by the year 2000 from the 54% of 1996-97. This is possible by scaling down GFD to about 3.9% of GDP by 2002.
In his article, Pinaki Chakraborty (1998), Growing Imbalances in Federal Fiscal Relationship, analyses how the relative imbalances of the various components of resource transfers from the centre to the states, viz, tax sharing grants and loans, has changed over half a century. According to him the existing resource transfer mechanism has failed and further states that if the states fail to have greater access to the combined budgetary resources of Central and State governments, this imbalance is likely to worsen further.\textsuperscript{105}

The study by R. Ramalingam Aiyar and K.N Kurup (1992) for the period 1974-90 found that the financial crisis of the states began to worsen since the late 1980’s. The crisis had its origin in the revenue account in which the non-plan revenue expenditure became a major component.\textsuperscript{106}

K.R. Gupta (2000) is of the opinion that the key debt indicators of India’s external debt continued to improve, making it increasingly more manageable since 1990-91. This was due to a conscious debt management policy that focused on high growth rate of exports, keeping the maturity structure as well as the total amount of commercial debt under manageable limit, controlling short term debt and encouraging non debt creating flows.\textsuperscript{107}

Alka Gupta (2001), in her book presents before us a general view of the public debt including their classification, dangers and also the preventive measures against its adverse impact.\textsuperscript{108}

Vathsala Raji (2001) explores the deteriorating financial position of state governments, since the 1980’s and also during the period of economic reforms from 1990-2001. The study enlists such weaknesses as lack of fiscal consolidation and integrity, audit and accountability and sanctity associated with obtaining legislative sanction for the above
N. Kumar and R. Mithal (2002) present a kaleidoscopic view of public debts with special reference to underdeveloped and developing countries. According to A.N. Agarwal (2002) the public debt is the most important source of non-tax income of the government. He studies its nature, its magnitude as also the features of growth, appropriations and the extent of use. He throws a new light on the Indian experience of public debt especially the ways and means advances. S.K. Misra and V.K. Puri (2002) in their book devote a whole chapter on public debt in India. In it they analyze the various implications and consequences of public debt of both the state and Central Governments. B.N Nayan (2002) holds a positive view that the public debt plays a vital role in achieving the targets and objectives of the five year plans. Thus, public debt, one of the types of non-tax receipt, is contributing a major share in economic growth and development of the country. Rajan Varghese (2002) in his research work ‘State Finance- Public Debt of Kerala from 1974-75 to 1996-97’ studied the growth and composition of public debt in relation to the assistance provided by the Central Government during 1974-75 to 1996-97. He also deals with the problem of servicing of public debt in the state along with the debt relief recommended by various finance commissions. Pinaki Chakraborty (2002), in his thesis, ‘Domestic Debt Accumulation in India: An Analysis of the Central Government Experience,’ analyses the trend, composition, ownership and maturity patterns of internal debt. He also examines the problem in the
context of a Debt-GDP ratio and also the sustainability of debt.\textsuperscript{115}

A report by the World Bank (2003) discusses debt management as an operational extension of monetary policy in relation to the experiences of some of the developed countries. It also differentiates the objectives of debt management in some of these countries.\textsuperscript{116}

K.M. Abraham, (2004) in the book edited by B.A. Prakash, portraits the public finance scenario of the state of Kerala from 1983 to 2003. It is a detailed analysis on the state of finance and the fiscal crisis of this tiny state. He traces the various causes of the fiscal crisis and outlines a strategy for fiscal correction.\textsuperscript{117}

M. Seenuvasan (2004) makes a study on the sole item of the interest payment expenditure in the four southern states during the last decade of the 20\textsuperscript{th} century. He argues that a continuous revenue deficit leads to large interest burden on these states and as a consequence, these states are pushed towards borrowing more to meet their repayment needs. In his view, interest payments and salaries and wages have emerged as the major components of expenditure for these states.\textsuperscript{118}

D.K. Sreevastava in his book (2005) discusses the various issues pertaining to the central and state government debts as also the cumulative impact of the excess of growth over interest rates. He deeply analyses the problems related to debt accumulation in the states as well as the views of the 8\textsuperscript{th} to 12\textsuperscript{th} finance commissions.\textsuperscript{119}

The book edited by Rakesh mohan, Umakapila et al (2005) provides a profile of the total expenditure of the Government of India and also the rising fiscal deficit over the 20 years from 1980-81 to 1999-2000. According to them debt service payments have risen
inexorably due to higher and higher revenue deficits caused by wages and salaries, interest payments, defence expenditures, pension and food subsidy as also the expenditures in social services and its negative consequences. In a study conducted by RBI on Debt Sustainability at state level in India, Indira Rajaraman et al. (2005) observed that all states need to raise their revenue buoyancy. According to the study, all states have suffered tax revenue losses to varying degrees on account of competitive tax concessions in order to attract new industrial investments. Though they have tried to address this problem since 1999-2000 through inter-state agreements, they are not able to enforce it. Nevertheless, with the introduction of VAT in all states, these concessions will be eliminated in any case in the coming years. But the revenue losses from prior concessions remain legally in place.

The studies reviewed above invariably highlight the universal phenomenon of the growth of public debt, particularly from a macro perspective. They have been successful, to an extent, in attributing this phenomenon to such generalizations as growth of public expenditure, (war, depression etc.) poor revenue mobilization, absence of prudent fiscal policy and so forth. But unfortunate to say, none of these studies was able to recognize the micro bases of the growth of public debt and proper management of public debt as the key to tide over the crisis situation caused by the ever growing public debt. This emphasizes the need for the adoption of better financial management practices in controlling the growth of public debt leading to a more robust fiscal position.

Coming back to the fiscal scenario in Kerala, the above situation continues to remain the same. A detailed analysis pertaining to public debt touching its various aspects has become imperative in this context. This would identify, the analysis of public debt from
a financial management perspective as important as ever. This opens up new avenues of research so as to fill the above literature gap. It is in this context that the present study is relevant and hence undertaken.

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