CHAPTER - 2

THEORY OF PUBLIC DEBT
2.1 Introduction

Ideas about the public debt from ancient to modern times constitute a fascinating chapter in the history of thought. Indeed, the theory of public debt has a long and chequered history. Even before the advent of classical school mercantilists expressed clear-cut views on public debt, some of them were over-optimistic and others over-pessimistic. There were economists, while adopting the middle course, neither favoured public debt as a blessing nor denounced it as harmful to society. Among economists there is a broad agreement on the institutional elements of public debt but the theory of public debt has been matter of controversy for the last two hundred years. It is widely believed that the resurgence of the "transfer hence no burden" argument followed the Keynesian Revolution of the 1930s and was strengthened by the Post-Keynesian emphasis on deficit financing. The important role of public borrowing in economic development is a relatively recent phenomenon and is 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 and the widespread popularity of Keynesian theories have largely contributed to the importance of public debt theory in economic development.

2.2 Pre-classical Theory of Public Debt

Long before the classicists there was a group of economic thinkers who favoured the royal expenditure and thereby favoured public debt. Their optimism, based upon the ideas generally considered true in those days, was that the debt for public expenditure was beneficial to the country because all government expenditures were considered to be good. Their ideas were based on the ground that creation of public debt was meant for the creation of artificial wealth. Nine years before Adam Smith's Publication of "An Enquiry into the Nature and Causes of Wealth of
Nations", Sir James Stewart discussed the subject of the public credit in his "Principles of Political Economy". He was one of the first theorists to hold the view now upheld by the adherents of the "New Orthodoxy" that public debt should function as the balance wheel of the economy.

Jean Bodin was one of the earliest writers who wrote in 1576 favouring the royal expenditure beneficial to the country. He thought public debt supports art and artificiaries, relieves the poor and removes the dislike of taxes and duties. Sir William Petty was another writer who nearly a century later in 1667 favoured the public expenditure on the ground that 'public works give employment to the poor'. Both Bodin and Petty did not see the unproductive aspect of war expenditure financed by debt. All public expenditures are not good. The war expenditure and expenditure for consumption purposes are the good examples of unproductive expenditure of the State. If these expenditures are incurred by the State, the government will become irresponsible and ruin the economy of the State. Melon, while writing his 'Essai politique Sur le Commerce' in 1736 showed an extreme optimism on the role of public debt. Melon, however, disagreed with Voltaire who believed in an unlimited public debt. About debt Melon said, "the debts of the state are the debts of the right hand to the left hand, of which the body will not be weakened at all, if it has the necessary quantity of nourishment and if it knows how to distribute it". George Berkeley was perhaps the most optimistic English writer on the public debt. He considered public funds as mines of gold and believed that the property of England was mainly due to her public credit. But he might be wrong in his thinking if there is no proportionate increase in production as a consequence of the growth of debt.
Richard Price was another writer who showed extreme optimism about public debt in his book called "Observations on Revisionary Payments." He argued that sinking fund gives miraculous results. His ideas have a profound influence even upon the wise statesmen and financiers like William Pitt and Alexander Hamilton. In the second half of the Eighteenth Century Isaac Pinto in his "An Essay on Circulation and Credit" expressed the beneficial effects of the public debt. He thought that national debt was national wealth. Pinto further expressed the view that public funds serve as money and as wealth multiplies continually, the national debt gives nourishment to commerce and becomes basis and remedy of the luxury to which in some instance it gives birth. As public funds increases, it gives nourishment to industry, commerce and wealth.

In addition to the above mentioned views there were writers who adopted the mid-way i.e. they neither favoured public debt nor opposed it as harmful to society. On the one hand they laid stress on debt redemption as the best means of maintaining the national credit and on the other they thought of relieving the people from heavy taxation due to heavy interest payments. Archibald Hutcheson and Gould too were apprehensive about increasing national debt. Hutcheson in his book "Computations Relating to the Public Debt of April", 1717 was greatly alarmed at the debt of nearly £50 millions. At that time and urged redemption through sinking fund. Gould after some years favoured the redemption of debt and suggested the maintenance of sinking fund through borrowed money.

David Hume, one of the mentors of Adam Smith, presented a gloomy view of public debt. He thought that its misuse would lead the country inevitably to poverty. To put in the words of Hume, "Nations, once they began to borrow, would be unable to desist until they reached the point of bankruptcy." Hume saw the
brighter side of public debt as well. He opined that national debt furnishes a species of money to the merchants by which they trade upon and lower profit, commodities become cheaper and it leads to greater development of industry in general. Indeed it is an irony of fact that pre-classical economists, in general, viewed public debt as a blessing like that of Post Keynesian economists. Their ideas were probably greatly influenced by earlier mercantilists whose thinking was intertwined with Statecraft.

2.3 Classical Theory of Public Debt

Since classical economists believed in 'Laissez-faire' they have advocated balanced budget and treated public debt a burden on the society. It was thought that public borrowing would deprive the private industry of its resources and thereby it would be deprived. The sovereign might waste the funds on waging useless wars. Inflationary threat, wastage of resources, needless war and inequality of income and wealth, according to them, are the by-products of public borrowing. Adam Smith was the leading classical who exposed the loopholes in the arguments of his predecessors. Adam Smith was both an anti-mercantilist and a pro-laissez-faireist. He was most concerned with the growth of huge national debt of England in the 18th century and criticised the loan finance and unbalanced budget policy. He thought that government expenditure is unproductive as it maintains unproductive loans. Through public borrowing government would snatch resources from industry and commerce and thus deprive a capital-poor society of revenue which would be productively reinvested. From this major ground for opposition to public borrowing stemmed other arguments. Once the Sovereign started to borrow, his political power was increased, because he was no longer dependent on tax exactions from his subjects. Therefore, borrowing encouraged the sovereign to wage needless wars. On
the other hand, if taxes were raised to meet current costs, "Wars would in general be more speedily concluded, and less wantonly undertaken." In short, the ability to engage in loan finance makes for irresponsibility in the sovereign. As against the pre-classical view that England's prosperity was the outcome of its national credit, Adam Smith felt that it was entirely otherwise. In his own words, "The national debt has most assuredly not been the cause of England's prosperity." 

Jean-Baptist Say, who was as vehement against public debt as Smith, had personal knowledge of French debt conditions of the time. He was very much upset by the wastefulness of the government expenditure and was quite opposed to debts and deficits. He was so much informed about the government expenditure that he cited example after example to prove it. The sovereign was engaged in pomp and circumstance; the preservation of etiquette and custom was a very expensive affair. The wealth which passed from the hands of the tax payer to the tax gatherer was consumed and destroyed. He argued that there is a remarkable distinction between an individual borrower and borrowing by the government. According to him, public borrowing is unproductive not just because capital is consumed and lost but also because the nation is burdened with annual interest payments. The former borrower for beneficial employment and the latter is for the purpose of barren consumption expenditure.

At the time of David Ricardo's most important work "The Principles of Political Economy and Taxation", first published in 1817, the debt of England stood at about £500,000,000, became approximately doubled what it had been at the turn of the century. It was appropriate, in these circumstances, that Ricardo in his "Essay on
Funding System" gave preference to taxes over loans. He referred to debt as one of the most terrible scourges which was ever invented to afflict a nation.¹⁸

The credit for giving modern tone to public debt goes to T.R. Malthus. Malthus did not consider public debt an evil and rejected the Ricardian idea of government spending as unproductive. He held that statesmen, soldiers, sailors and all those who live on the interest from the national debt contribute powerfully to distribution and demand and they ensure effective consumption which is necessary to give the proper stimulus to production.¹⁹ He held that a large public debt increases production and promotes expenditure and removes superfluous products from the markets. Malthus, though never favoured national debt, did not plead for an excessive debt. He was aware of the evils of excessive debt which result in heavy taxation.

John Stuart Mill, last in the line of classical thinkers, restated and modified their ideas on public debt. He, in his book, "Principles of Political Economy" 1848 approved the public loans out of additional savings. He thought that a rise in the public loans was justified if private uses of the capital transferred would have been unproductive. In 1848 J.S. Mill could appropriately suggest some further modifications in the body of classical thinking on national debt and deficits. Apparently by this time industry's need for capital was not as pressing as it had been earlier. In some circumstances, Mill said government loans are not charged with pernicious consequences. Further, Mill suggested an "index" for determining whether there are pernicious consequences stemming from government loans. If the loan raises the rate of interest it could be concluded that capital is taken which could have been productively employed, and "those loans are chargeable with the evils which have
been described. But if interest rates unchanged, the pernicious consequences are not evident. Being a supporter of the wage fund theory, he observed that public borrowing is acceptable only when it is provided out of additional savings. If not, it would have to be withdrawn from the wage fund which would mean lower living conditions and efficiency of the workers.

After J.S. Mill, the major classical economists devoted less and less attention to problems of the national debt. This is evidently a direct reflection of the fact that from the time of Mill until 1914 the outstanding British debt remained almost constant and therefore did not attract the attention of Cairnes in 1874 and Sidgwick in 1883. Even the true successor of his and founder of the Neo-Classical school, Marshall did not pay any attention to the problem of public debt in his masterpiece "Principles of Economics" which was brought out in 1890. Marshall's book "Money, Credit and Commerce" published immediately after World War I made only a passing remark on the public debt with no concern over the problem. The Neo-Classicals did not propound a separate theory of public debt. But, the Neo-Classical writers did not favour public debt because of their advocacy of market mechanism. To sum up, classicalists and Neo-Classicalists viewed public borrowing with high eyebrows and uneasiness and favoured its repayment. Their views can be summed up in four statements:

1. Private enterprise is thought to be relatively superior to public enterprise.
2. Borrowing policy expands government activity and invites irresponsible government action;
3. Since they accepted the wage-fund doctrine, and thought the portion of capital which is taken in the form of loan is a share of the fund to be paid to the labourers, the funds given to government would reduce the amount
available for payment of wages and consequently the workers would suffer; and

4 The supply of money is fixed and inelastic. It could not be ignored that the tradition was set aside when grave emergencies such as war arose and forced the governments to resort to debt because, it was not a question of theoretical principles but of practical hard necessities.²¹

2.4 Keynesian Theory of Public Debt

The economic philosophy of public debt in modern finance shows a radical departure from the Laissez-faire notions. The modern theory of public debt or the "new orthodoxy" as Buchanan puts its, is an offshoot of the economics of depression or the Keynesian economics. The economic anomaly created by the great depression of the 1930s gave way to the development of a new theory of public debt. The traditional view that continually unbalanced budget and rapidly rising public debt would imperil the financial stability of the nations, gradually gave way to the new conception that public debt is a national asset rather than a liability and that "continuous deficit spending is essential to the economic prosperity of the nation."²²

In this section views of "new orthodoxy", a term coined by Buchanan to refer to the views of Harris, Hansen, Pigou, Lerner and others, are discussed.

The epoch-making book, "The General Theory of Employment, Interest and Money" published in 1936 by John-Maynard Keynes, forms the basis of the new thinking. The Keynesian attack on the classical principles of budgeting and public finance was a logical extension of the Keynesian attack on the view that the economy tends to equilibrium at full employment. If there were unemployed resources which the private sector would not or could not employ, these resources might be
put to work by the state by means of additional public outlay which need not be matched by additional government Revenue. Orthodox financial rules must be abandoned, even as Orthodox economics must be abandoned. Hence it was argued that borrowing by the government for the purpose of spending with a view to generating effective demand was not considered as a burden on the society as it would activate idle savings in the private sector and generate income and employment opportunities.

In testifying before the Colwyn committee, Keynes as early as in 1925 warned the country against premature or excessive repayment of debt. Keynes thought that debt should not be repaid blindly, rather it should be determined according to the effect upon expenditure and saving. Keynes argued for a programme of public works as a means of raising aggregate effective demand in the context of the great depression. He preferred the public expenditure on public works to be financed by printed money rather than borrowing or taxation as the latter methods would result in reduction in aggregate demand and thereby worsen the unemployment situation.

The repayment policy of public debt may be unwise if the demand for gilt-edged securities is large. If the state has a demand for the money, if the state itself is in the gilt-edged market as a borrower, directly or indirectly, for productive purposes, then in order to make that productive borrowing easier there is a good deal to be said for paying off the debt. But if there is no natural outlet for the sum released for repayment of debt, then it is a mistake to repay debt. Keynes himself did not elaborate the role of fiscal policy in the maintenance of full employment. Infact, Keynesian views on public debt and fiscal policy was developed by Alvin Hansen and found its determination in A.P. Lerner's functional finance.
Hansen held the view that fiscal policy had been forced to serve as a compensatory device more by accident than by design. Public finance had been broadened by the political necessity of coping with unemployment. Most of the "principles," intended to cover debt policy had been borrowed from private finance, but the analogies were misleading. If one adopts wholeheartedly the principle that governmental financial operations should be regarded exclusively as instruments of economic and public policy, the concept of a balanced budget, however defined, can play no role in the determination of that policy. He contended that success or failure of public debt policy can be determined only in relation to the aggregates of national income and their distribution.

Government outlay financed by debt creation will increase the level of national income, regardless of productivity of the assets which may be acquired. More over the importance of public debt in the establishment of the credit system in Western European Countries and in the United States had not been fully appreciated. Hansen also pointed out that the limits to public debt must be determined in relation to nation's taxable capacity, the danger of price-inflation and the distribution of income. The limits are flexible and not rigid. The implementation of compensatory fiscal policy required a recasting of traditional budgetary policy in order to view the expenditure and receipts side of the government budgets in relation to the total level of economic activity.

Lerner, another Keynesian, held the view that the tools of government finance should aim at economic stability and hence public debt operations should be used by the government for maintaining economic stability. Further he held that government lending should be used for maintaining economic stability in
democracies. Besides Lerner held the view that attainment of full employment is the ultimate aim of every debt programme. The problem of burden of debt should be judged in terms of the burden of unemployment which would have existed in the absence of public borrowing.  

Lerner also argued that a mounting public debt will escalate its service cost. It should not be considered bad purse. Moreover, taxes should not be imposed for meeting interest bill, unless they are necessary to keep private spending to prevent inflation. So long as there is no fear of inflation, borrowing from the central bank can be used for servicing public debt. Its corollary is that if there is a fear of inflation, public debt may be serviced by borrowing from the public and taxing the people. Besides this he viewed that public debt will not pose any danger to society so long as functional finance maintains a proper balance between the total demand and current output. Lerner was also of the opinion that internal debt incurs no burden simply because it is a transfer of funds from one pocket to the other, or from the left hand to the right. Thus, internal debt is no burden on the economy since "we owe it to ourselves." Hence assets are liabilities.  

The expenditure of the capital budgets in the Scandinavian countries had influenced Hansen to a great extent. Similarly, Lerner's law did not provide workable guides for the formulation of budget policy. Lerner provided three instruments for stabilisation-taxation, expenditures, and the purchase and sale of debt instruments, but he did not provide criteria for choosing among them. Even then their contributions had laid a solid foundation for an expansionary fiscal policy based on the principles of functional finance.
Harris maintains that "How great a burden the debt" will depend upon the rate of interest, the tax system, the weight of other expenditures of government and above all upon the national income. Hence it is difficult to judge on a priori basis the burden of public debt which is to be weighed against the benefits that hang over it. 

A C Pigou, in an often quoted statement, puts it: "Though twenty five years ago (i.e., the idea that the burden is imposed on future generation) could claim some respectable support it is now everywhere acknowledged to be fallacious" Pigou further goes on to elaborate on an idea that can be labelled as Keynesian "On occasioned public works, if financed by loan, but not by taxes may constitute a valuable means of combating unemployment" A few important points may be noted regarding the statement of Pigou quoted above:

1. The payment of interest to bond-holders from the tax revenue is a mere transfer from one set of people to another,

2. Pigou is concerned with only groups or sets of people. One, a set of interest receivers, and another, a set of tax payers, but not with individuals who constitute the sets,

3. At the individual level, the taxpayer will assuredly be burdened by the debt, but since the tax payments exactly equal interest receipts the future generation as a whole, does not feel any burden. In such a set up taxes paid to service the debt represents merely a transfer, and

4. Pigou clearly speaks of the efficacy of loan finance in the context of unemployment in the economy.

In Domar's view burden of public debt is the additional taxation levied to service the debt. The ratio of taxation to national income constitutes the burden of
public debt. If public debt is growing faster than the national income, an increased proportion of nation’s income has to be diverted for debt servicing, whereas if the national income is growing faster than the public debt a small portion of the increased national income is required for servicing public debt. The former situation constitutes a real burden and the latter does not. Therefore, "The problem of debt burden is a problem of an expanding national income".34

2.5 Post Keynesian Theory of Public Debt

The Post Keynesian theories of public debt were formulated against the background of rising public debt and the developed nations going through a phase of inflationary price rise. Government expenditure also was rising at a rapid rate and non-developmental component of it was quite high. These recent trends in public debt again revived the controversy of whether public debt is a burden and how to measure the burden of public debt. It is now widely acknowledged that the economics of public debt in modern public finance was powerfully influenced by the Keynesian revolution which produced theoretical results entirely different from the body of economic thought existing at the time of its emergence.

James M. Buchanan’s “Public Principles of Public debt (1958)” challenged the validity of new orthodoxy that public debt is no burden on the economy and no matter how it is financed cannot be shifted to future generations. The major assault of Buchanan was directed at the three major tenets of the “new orthodoxy”,

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, and
3. The external debt and internal debt are fundamentally equivalents.55
His discussion is built around certain assumptions which are as follows:

a. Full employment of resources,
b. Debt instruments are purchased through a transfer of existing monetary units to the government and not to prevent or to promote inflation,
c. Effect of sale of government securities on the interest and price structure is negligible,
d. Funds used to purchase government securities are drawn wholly from private capital formation, and
e. The purpose for which debt is issued is irrelevant to the analysis.

Buchanan held that the financing of a project by the government by means of borrowing does shift a burden to the future generations and started the attack on the traditional position by denying that the present generation bears the burden of public debt, because people purchase the government securities on voluntary basis. They postpone present consumption to the future when they redeem their securities and earn interest compensation. The present generation does not undergo a sacrifice whereas future generations experience a sacrifice through compulsory tax payments for redeeming the bonds and paying interest. The taxes are, therefore, the actual net burden on future generations. He further maintains that the concept of burden should be interpreted in terms of individual attitudes towards their economic welfare rather than in terms of changes in private sector output and real income because of the inheritance by the later generation of a large or small amount of capital instruments.
James M. Buchanan further argued that "when the present generation buys government bonds, they surrender their funds voluntarily and it is a transaction in which they exchange current purchasing power for promises on the part of the fiscal authorities, of an income in future. Thus the cost of servicing is shifted to the future generations", who may suffer the consequences of wasteful government expenditure and who reap the benefits of useful government expenditure.\(^{38}\)

Alan T. Peacock, while criticizing Buchanan, says that this theory has been developed with a classical model in the mind and that he has tried to rehabilitate the old classical theory on a narrow front.\(^ {37}\) He points out that Buchanan has excluded from his analysis the effect of public debt on price levels, interest rates and incentives.

A.R. Prest argues that Buchanan's contribution to the debt literature is significant and concedes by implication much of Buchanan's argument of the shifting of the burden. He says that "although the sins of the present generation rest on their descendants, they themselves are the legatees of the sins of their own ancestors" and adds that on this sort of basis there is no net handing down of burden from one generation.\(^ {38}\)

Bowen-Davis-Koof (BDK) in a joint article supported James M. Buchanan but felt that (i) Buchanan did not define real burden in a satisfactory manner, (ii) defined generation in such a manner that the same person could be considered a member of many sets of generation, (iii) Relied on what Rolph called a proof by Indirection. The authors tried to rectify these deficiencies and opined that "if the real burden of the debt is defined as the total amount of private consumption goods given up by
the community at the moment of time the borrowed funds are spent, the cost of the public projects simply must be borne by the generation alive at the time the borrowing occurs. The authors felt that the real burden of debt-financed expenditure can (at least in part) be transferred to future generations. They feel that possibly some transfer of real income between generations is the existence of marketable bonds.

**Modigliani's Thesis**

Modigliani is of the opinion that public debt is a burden on the future generation because of the loss of partial capital formation and the consequent reduction of potential future income. Government borrowing transfers funds from private hands to the government which leads to a fall in private capital formation. He argues that society bears no burden in the current period when public expenditures are financed out of private savings because people invest only to consume in latter periods. In a full employment economy, suppose, government borrows Rs 100, this will reduce private sector capital formation by the same amount. If the effective rate of return on private investment is equal to 5 per cent, then the potential future income is reduced by Rs 5 for every Rs 100 borrowed by the government and this asset holding of people in the form of government bonds will certainly affect their willingness to save and there will be a fall in the rate of savings in the economy. Besides, people consider government securities as real wealth and gradually they reduce rate of saving over time. He summaizes his burden thesis as follows.

1. An increase in public debt whether internal or external is generally advantageous to those present at the time of the increase,
Such an increase will generally place a gross burden on those living beyond that time through a reduction in aggregate stock of private capital. If the marginal productivity of capital is positive this will in turn cause a reduction in the flow of goods and services.

These conclusions hold in the reverse when public debt is retired:

If the rate of interest on public debt is a good approximation of the rate of marginal productivity of private capital, then the gross burden on the future generation can be measured by the interest charges on the public debt; and the gross burden on the future generation can be offset by the extent to which the government expenditure financed by debt contributes to the real incomes of this generation.\(^{42}\)

The community’s income need not fall simply because of the fall in the private capital formation and increases by adopting borrowing methods and productive utilization of borrowed funds. So the important issue is whether the borrowed funds are employed productively to contribute to economic development.

Modigliani himself accepts that through productive capital formation the burden that falls on the future generation might be offset fully or in part.

Vickery in his theory tried to analyse the effects of debt finance on the future level of real income for the society as a whole. He criticised the BDK thesis on many grounds, suggested that BDK thesis needlessly goes round about and is largely irrelevant.\(^{43}\) Paul Sotovsky says that the burden of public debt can be measured in terms of the relations which debt or any attribute of it bears to the wealth and income of the population, the size of the government budget and to other such factors. The size of the national debt by itself, does not indicate its burden.
argued that "the burden of public debt can be so shifted if by burden is meant what individuals consider a burden. The balance of private costs and private benefits be corrected for change in disposable income occasioned by the public debt." He maintained that debt-financing of government expenditure may reduce the income of future generations but not in the way suggested by BDK. BDK defended that they had chosen to analyse the burden in terms of distribution of life time consumption.

Mishan calls Modigliani and others as "burden mongers" and points out that they have failed to consider that the gross burden may be offset by secondary effects, that is, future returns derived from present public expenditures. According to him, the inter-generation debt burden analysis have failed to distinguish adequately between 'primary' and 'secondary' burdens and between the debt 'burden' and debt 'effect'.

As Herber explains, "changes in consumption - saving patterns, capital formation, inheritance patterns, net worth positions, the types of governmental expenditures which are financed with the debt are financial burdens through market adjustments. Similarly, essentially primary results refer to burdens - real and financial - and secondary results refer to the effects of debt financing which will influence the nature of the burdens." 

Musgrave holds the view that in a perfect system with rational tax payer behaviour and pure credit market, it will be equally advantageous for the government to use tax or loan finance. Musgrave argues that loan finance is required to distribute costs i.e. necessarily spreads the burden among the various generations while tax finance burdens the present generations. His approach is based on the
"benefit taxation" or benefit principle of equity for financing of durable capital items lasting over several generations of tax payers. However, in his example of five generations leading to the conclusion that the total cost is divided between the five generations in accordance with benefits received, his assumption "that the loans advanced by any one generation must be repaid within its life span" is rather unrealistic because inheritance does not seem to invalidate the orthodox position.47

Bhargava points out that as the capacity of the society to absorb the burden of increased taxation without adverse incentive effects is enlarged on account of increased output that can be secured in future due to borrowing and financing capital equipments especially in less developed countries, the net burden over time will be reduced. If there is any burden at all that can be shifted to the future generations, it is the subjective burden and real burden46

The theory of public borrowing according to the modern economists like Richard Goode, is the explanation of conditions under which its resort is conducive to economic development of a country. According to him, a better argument in favour of internal borrowing is to avoid it to pay for government consumption expenditures. Domestic borrowing is a case of utilisation of national saving. The act of borrowing by the government makes it unavailable to private entrepreneur for private investment. So financing of consumption by internal borrowing will lead to a curtailment of saving and investment. On the other hand, borrowed money when used to finance public investment causes no such reduction, all that will happen is the change in the composition of capital formation. Goode has rightly pointed out that "the inference is that failure to restrict borrowing to finance of investment will retard economic growth. A weakness of the argument is that not all outlays
classified as investment actually contributes to growth, while some expenditures usually classified as government consumption promote growth.49

Ratchford maintains that an internally held public debt is an economic burden even when taxes are paid to service the debt in the same ratio as the bonds are held. This is true because of the friction of levying and collection of the tax and because of the difference in the subjective effects of paying taxes and receiving interest. Most important, however, is the fact that such a debt is a burden because when joined with progressive tax system, it subsequently restricts investment and thus lowers national income. Other elements of burden are the facts that a debt limits the government’s freedom of action, tends to restrict social expenditure and may preclude effective control of the monetary and banking system.50

In the modern theory of public debt the socialist objection to the creation of a large public debt relates to its aggravating influence on the inherent tendency for income and wealth to be distributed inequitably in a free enterprise economy and even a mixed economy. Creation of a large public debt develops a rentier class which receive interest on the government bonds. With the growth of the rentier class, the gulf between the haves and the have-not increases giving rise to increased inequalities in the society. A rapid growth of public debt is, therefore, likely to intensify inequality in wealth distribution.51

In recent writings of economics on public debt the main focus of discussion is rising public debts and how to measure the burden and what is the impact of rising public debt on inflation. The 1980’s witnessed an increased interest in public debt writings in economic literature. This is so because in the 1980’s public debt all over the world has been rising faster than GDP in all countries with a few
exceptions. If the public debt rises faster than the national income, it is a matter of concern. Economists of these days are concerned with the optimality of the public debt. In recent years due to satisfaction of more merit and social wants, more production of public goods has led to increased government expenditure which has not be financed by rising taxes but by increase in debt financing. In this context the views of some economists in recent years can be studied. Robert J. Barrow in his article argues that debt financing can lead to rise in consumption and what is important is that the use of loan funds by the government. Debt finance always needs to be serviced and, therefore, the government should at least be efficient enough to cover the costs. Barrow further argues that if government borrows on an increased scale the recycling of incomes would lead to increase in savings and the saving rate also has to increase. If the saving rate does not increase, it puts a limit to public-debt rise. As rising public debt then has to be monetised as done by all governments and consequently debt monetisation leads to inflation.

Barrow also discussed the issue of public debt solvency. He argued that credit worthiness of the government can be measured and if government debt leads to government asset creation, then by privatisation of the assets the debt solvency problem can be reduced in magnitude.

Boskin M. J. in his article has tried to assess the real value of government asset created through debt receipts. Boskin argues that when price rise takes place the nominal value of public debt falls and the real value of government assets increases. Hence in a inflationary situation the market value of assets created through debt finance rises and hence the government debt which can be potentially utilised and then potential income of the government debt can be calculated by taking its potential wealth into account.
Barsky et al. (1966) examine the interaction between income uncertainty and income taxation in the face of a debt-financed 'taxcut'. This simulation results indicate that the marginal propensity to consume out of tax-cut coupled with future income-tax increases, appears closer to Keynesian values that ignore future taxes than to Ricardo-Barrow values.

As regards external debt the modern economists feel that external debt leads to a flow of resources from the country to abroad. What is important, therefore, is not the rate of return of the use of external debt but the balance of payments position. Trade balance should match. Then the burden of rising external debt will pose no problem to a country.

It is evident from the review of literature presented above related to debt and its co-related issues, and discussed both in theoretical and empirical application, were designed specially for dealing with debt accumulation in industrial economies. Corresponding literature in the context of developing countries is quite limited. In this regard, some broad observations can be made.

In developing countries like India the natural expectations theoretic view that domestic debt accumulation does not affect private savings appears to have little practical relevance. As M. Rakshit has observed (1) Individual economic units can hardly be as rational or have as much as information as is presumed, (2) The distribution of tax burden is not closely to be linked with the pattern of holding of public debt. It follows, therefore, that the possibility of households responding to debt accumulation by anticipating higher taxes in the future, and consequently, with the reduced "permanent" income lowering consumption rather than savings, is farfetched in the context of developing economies.
References


4. Group in the sense that they developed their ideas in different ages, i.e., Jean Bodin in 1576, Sir William Petty in 1667, Melon in 1736 and similarly Bishop Barkley, Richard Price, Isaac Pinto in different ages.


25 Minutes of Evidence of Colwyn Report, cited by S.E. Harris, p 536.


40 Ibid, p 705


42 Ibid, p. 731


54 Sunita B. Gupta, "Dynamics of Public Debt in India", *An Analysis of Its Determination and Effects on Savings and Investment*, Op cit, p. 70