Chapter-3
THEORY OF PUBLIC DEBT
Theory of Public Debt

Introduction

Public debt is the debt which the state owes to its subjects or to the nationals of other countries. Public debt arises due to borrowing by the government. The government may borrow from banks, business organizations, business houses and individuals. The borrowings of the government may be within the country or from outside the country, or both. The public debt is generally in the form of bonds (or treasury bills, if the loans are required for a short period), which carry with them the promises of the government to pay interest, to the holders of these bonds at stipulated rate of interest at regular intervals, or lump sum at the end, in addition to the principal which has to be repaid at the stated time. Philip. E. Taylor defines Public debt as “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.”

The government may borrow because current revenue may not be enough to meet its expenditure. Or there may be some sudden and unforeseen expenditure, when tax revenue cannot be increased to the same extent. It may also borrow to finance capital expenditures, as current revenue is usually insufficient for the purpose.

During depression, when private demand is insufficient, the government may borrow the idle savings of the people and spend them to increase the effective demand and there by create additional income and employment in the community. On the other hand, in an inflationary situation, when effective
demand is greater than the available supply of goods and services at current prices, the government should tax more than its need to spend in order to sterilize a part or whole of the excess purchasing power. It may use this surplus to pay debts incurred in times of depression or for meeting unforeseen needs in the future. It is, thus obvious that a sensible public debt policy can be used to check a depression or an inflation.

In recent years there has been an abnormal expansion in the functions of the government and this has increased its revenue and capital expenditures. Modern wars and growth of defence expenditure have also led to increase in public expenditure. In fact, increased public expenditure has been responsible for vast increase in public debt everywhere.

**Fiscal Deficit and Public debt**

Fiscal deficits are prerequisites for the accumulation of public debt, since usually the issue of government liabilities arises from the need to finance the gap between ordinary revenues and total expenditures. However, the existence of fiscal deficits does not necessarily imply that the share of debt in GDP will grow over time. If a fiscal deficit is financed totally by foreign grants or by monetary expansion, then public debt will not grow, and may actually fall, in relation to GDP. Other variables are also important in that relationship, for example, the rate of growth of the economy and the real rate of interest on the existing public debt play a significant role. The time horizon is also relevant. If fiscal deficits are cyclical, and they turn into surpluses during boom
years, then there would be no accumulation of debt and no expansion in the
debt. The main reason to justify the growth of public debt are the following:

1. War Finance

Historically, in industrial countries this has been the main reason for the
large accumulation of public debt as witnessed by the United Kingdom during
the Napoleonic wars and by the United States during the Civil War and the
First and Second world wars.

2. Development Finance

The accumulation of public debt can arise from the need to finance a
‘big push’ in economic development. If a country borrows funds and invests
efficiently, it can be expected to promote enough future growth so that the debt
can be serviced, without difficulties, out of future higher incomes. Such
reasoning is used to justify borrowing on the part of successful private
corporations. It has also been used to justify large deficits and large borrowing
on the part of some developing countries.

3. Availability of Cheap credit

Large borrowing by developing countries between 1974 and 1980 could
be justified by the availability of cheap international credit. Given the low real
rate of interest then prevailing in the international financial market, countries
could borrow to finance the many projects with expected rates of return higher
than the prevailing low real costs of borrowed funds. There were many projects
that passed a benefit cost test given the low real rates of interest.
4. Government Market Power

Public sector borrowing by developing countries has been justified on the basis of the special position of the government as a borrower. The government can borrow abroad at lower rates than private borrowers since it carries a perceived lower risk and borrows large amounts, thus reducing administrative costs. Private borrowers would pay higher rates if they borrowed directly. This arbitrage on the part of the government increases its gross debt while it may not increase immediately net debt if the funds are, in turn, lent to the rest of the economy. But, if the on-lending is done at subsidised rates, the gross debt of the government can also become, at least partially, a net debt. The fact that public as well as private enterprises obtain subsidised credit has made them less careful in project selection and has increased the role of political considerations in that selection.

5. Assumption of Private Sector Debt

In a number of developing countries, particularly in Latin America an important source for increases in the level of Public debt has been the ‘nationalisation’ of private sector liabilities. In many countries governments have assumed the debt acquired by private sector enterprises, including financial institutions. The private sector liabilities were originally guaranteed by the government, but in many other instances the government assumed the debt to avoid massive defaults that could have resulted in an extensive disruption for the domestic economy and a major loss of credit worthiness abroad.
6. Financing Current Expenditure

In many instances governments borrowed for consumption purposes as they could score political gains in the short run by increasing subsidies or public employment without raising domestic revenues. The government obtained immediate political benefits by spending the proceeds of borrowing while the repayment of the debt was in the future and thus a successor government's problem. This public choice reason has certainly played a large role in the growth of public debt.

The industrial countries normally borrowed domestically while developing countries often borrowed abroad. In all countries the most important source of financing public spending is obviously current revenue, a large proportion of which is made up of tax revenues. While taxes would cover a large share of public spending. However, there are many constraints on the level of taxation: Political, structural, administrative, or purely social. These constraints tend to be much more inflexible in developing than in industrial countries. Therefore, the average tax ratio of developing countries tends to be much lower than the average tax ratio of industrial countries - generally less than half.

Experience indicates that it is very difficult to raise the tax level of developing countries significantly, at least in the short or medium run unlike industrial countries. In those developing countries where increase in the ratio of taxes to GDP has taken place, these increases have been relatively small.
Dimensions of Fiscal Imbalances in India

Fiscal imbalance in an economy is measured by the government deficit. Simply put, it is the difference between aggregate disbursements and aggregate receipts. In practice there are different measures of government deficit as discussed below.

Traditional Budget Deficit

Budget deficit = (Revenue Expenditure + Capital Expenditure + net domestic lendings) - (Revenue receipt + grants + foreign borrowings + domestic borrowings excluding 91 days Treasury Bills.

The resources gap is expected to be financed by (a) issuing 91 day Treasury Bills and (b) running down on government’s cash balances with treasury and the RBI. This is a narrow concept of deficit as several other government’s liabilities e.g. current market loans, special securities issued to RBI, other liabilities like small savings, provident funds etc. in recent years became important and have not been included.

In traditional measures of budget deficit, additions of RBI’s holding of government securities are not included. This may severely under-state the monetary impact of fiscal operations. Monetary concept of government deficit is somewhat broader than the traditional measure. It is suitable only for analyzing the monetary impact of fiscal operations.

Fiscal Deficit: Total resource gap or the overall financing requirement in government fiscal operation is the excess of revenue expenditure plus capital
expenditure plus net domestic lendings over revenue receipts. When grants are deducted from overall financing requirements, the residual which represents overall borrowing requirement is the gross fiscal deficit.

**Gross Fiscal Deficit**: 

$$\text{Gross Fiscal Deficit} = (\text{Revenue expenditure} + \text{capital expenditure} + \text{net domestic lending}) - (\text{revenue receipts} + \text{grants})$$

**Net Fiscal Deficit**: Gross fiscal deficit - net domestic lendings

$$\text{Net Fiscal Deficit} = (\text{revenue expenditure} + \text{capital expenditure} - \text{revenue receipts} + \text{grants})$$

**Primary Deficit**: One limitation of fiscal deficits is that they do not reflect an improvement or worsening of the government's net indebtedness. Interest payments are obligatory but reflect past budgets. Primary deficits exclude interest transactions (payments as well as receipts), hence indicate precisely the indebtedness of central government. Primary deficit may be gross primary deficit and net primary deficit.

**Gross Primary Deficit**

$$\text{Gross Primary Deficit} = (\text{Gross fiscal deficit}) - (\text{interest payment} - \text{interest earning})$$

$$= (\text{revenue expenditure} + \text{capital expenditure} + \text{net domestic lendings}) - (\text{revenue receipts} + \text{grants}) - (\text{interest payments} - \text{interest earnings})$$

$$= (\text{non-interest revenue expenditure} + \text{capital expenditure} + \text{net domestic lendings}) - (\text{non-interest revenue receipts} + \text{grants})$$

**Net Primary Deficit**

$$\text{Net Primary Deficit} = (\text{non-interest revenue expenditure} + \text{capital expenditure}) - (\text{non-interest revenue receipts} + \text{grants})$$
Table 3.1 provides the profile of different indicators of fiscal imbalance in respect of central finances from 1990-91. In comparing fiscal deficit since 1990-91, one adjustment was required for figure prior to 1999-00, when lending to States on account of small savings was not channelled through the public account of National Small Savings Fund (NSSF) and constituted part of centre’s fiscal deficit. After this adjustment, the fiscal deficit of the center, first declined from 6.6 percent in 1990-91 to 4.1 percent in 1996-97, raising subsequently from 1997-98 to reach a level of 6.2 percent of GDP in 2001-02. After that, there is a fall in centre’s fiscal deficit relative to GDP when the FRBM rule was enacted in 2003 which reduced fiscal deficit to 3.4 percent in 2006-07.

A similar profile is observed in the case of revenue deficit, which, after declining from 3.3 percent of GDP in 1990-91 to 2.4 percent in 1996-97, rose steadily to 4.4 percent in 2001-02. The year 2002-03 witnessed that although the revenue deficit continued almost at the same level as 2001-02, but after the enactment of FRBM rule the revenue deficit also reduced and reached a level of 1.9 percent in 2006-07. The situation seems to have improved in 2007-08 (B.E.), with the fiscal deficit and the revenue deficit declining to 3.2 and 1.5 percent of GDP, respectively.

The most persistent deterioration is observed in the ratio of revenue deficit to fiscal deficit, which, by indicating the extent to which borrowed resources are used for current expenditures, shows the ‘quality’ of fiscal deficit. In 1990-91, this ratio was about 50 percent. It increased steadily to 75 percent
in 1998-99. Thereafter, there was some improvement, but the ratio again increased back to the level of 80 percent in 2003-04, indicating that three fourth of borrowing has been used for current consumption. But after the enactment of FRBM rule the ratio of revenue deficit to fiscal deficit has been reduced and reached 46.87 percent in 2007-08 (B.E.).

Table-3.1
Trends of Deficit of Central Government

<table>
<thead>
<tr>
<th>Year</th>
<th>Fiscal deficit (As percent of GDP)</th>
<th>Revenue deficit</th>
<th>Primary deficit</th>
<th>Ratio of revenue deficit to fiscal deficit (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-91</td>
<td>6.6</td>
<td>3.3</td>
<td>2.8</td>
<td>50.00</td>
</tr>
<tr>
<td>1991-92</td>
<td>4.7</td>
<td>2.5</td>
<td>0.7</td>
<td>53.19</td>
</tr>
<tr>
<td>1992-93</td>
<td>4.8</td>
<td>2.5</td>
<td>0.6</td>
<td>52.08</td>
</tr>
<tr>
<td>1993-94</td>
<td>6.4</td>
<td>3.8</td>
<td>2.2</td>
<td>59.37</td>
</tr>
<tr>
<td>1994-95</td>
<td>4.7</td>
<td>3.1</td>
<td>0.4</td>
<td>65.95</td>
</tr>
<tr>
<td>1995-96</td>
<td>4.2</td>
<td>2.5</td>
<td>0.0</td>
<td>59.52</td>
</tr>
<tr>
<td>1996-97</td>
<td>4.1</td>
<td>2.4</td>
<td>-0.2</td>
<td>58.53</td>
</tr>
<tr>
<td>1997-98</td>
<td>4.8</td>
<td>3.0</td>
<td>0.5</td>
<td>62.5</td>
</tr>
<tr>
<td>1998-99</td>
<td>5.1</td>
<td>3.8</td>
<td>0.7</td>
<td>74.50</td>
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<tr>
<td>1999-2000</td>
<td>5.4</td>
<td>3.5</td>
<td>0.7</td>
<td>64.81</td>
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<tr>
<td>2000-01</td>
<td>5.7</td>
<td>4.1</td>
<td>0.9</td>
<td>71.92</td>
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<tr>
<td>2001-02</td>
<td>6.2</td>
<td>4.4</td>
<td>1.5</td>
<td>70.96</td>
</tr>
<tr>
<td>2002-03</td>
<td>5.9</td>
<td>4.4</td>
<td>1.1</td>
<td>74.57</td>
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</table>

Enactment of FRBMA

<table>
<thead>
<tr>
<th>Year</th>
<th>Fiscal deficit</th>
<th>Revenue deficit</th>
<th>Primary deficit</th>
<th>Ratio of revenue deficit to fiscal deficit (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003-04</td>
<td>4.5</td>
<td>3.6</td>
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<tr>
<td>2004-05</td>
<td>4.0</td>
<td>2.5</td>
<td>-0.1</td>
<td>62.51</td>
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<tr>
<td>2005-06</td>
<td>4.1</td>
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<td>0.4</td>
<td>63.88</td>
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<tr>
<td>2006-07</td>
<td>3.4</td>
<td>1.9</td>
<td>-0.2</td>
<td>55.88</td>
</tr>
<tr>
<td>2007-08 (B.E)</td>
<td>3.2</td>
<td>1.5</td>
<td>-0.2</td>
<td>46.87</td>
</tr>
</tbody>
</table>

Source: Economic Survey (2007-08) Ministry of Finance, Govt. of India
The following are the main features of the profile of fiscal imbalance in the case of centre:-

(a) After declining in the mid nineties, the fiscal deficit of the center in 2001-02 was 6.2 percent, only marginally lower than its level in 1990-91. In 2006-07 and 2007-08 (B.E.), the fiscal deficit relative to GDP showed a decline.

(b) Revenue deficit relative to GDP, having risen to a historical peak of 4.4 percent came down from 2003-04

(c) The ratio of revenue deficit to fiscal deficit has progressively deteriorated until 2003-04, when it amounted to 80 percent. From 2004-05, again the ratio has deteriorated and reached to 46.8 percent in 2007-08 (B.E.)

As in industrial countries, developing countries can try to tap domestic savings through the sale of bonds in the domestic market. This possibility, however, is very limited and only few developing countries have managed to finance a large proportion of their expenditure through increase in domestic debt. The reason for this outcome are:-

1. Small size of the domestic capital market and the limited role of financial intermediaries.

2. The interest rate policies often pursued by these countries which have constrained the free market determination of the rates, sometimes resulting in negative real rates of return and, therefore, in lack of attractiveness for domestic financial investments.
3. The desire to limit the crowding out of the private sector from an already small financial market.

4. The maintenance of overvalued exchange rates which create incentives for holding foreign currency denominated assets.

5. The high default and political risk perceived by potential bond buyers.

In several cases where deficits have been financed with domestic debt, this has been done through some form of forced lending, which inevitably includes an element of taxation. Similarly, in many cases part of the fiscal deficit has been financed through the building up of domestic arrears. But these arrears normally amount to an increase in government liabilities. They are excluded from the statistics of public debt.

Public spending can be financed through monetary expansion, which will tend to have an inflationary impact. However, there is a limit to the total amount of resources (expressed as a share of GDP) that government can acquire through the inflation tax. There is often a loss in real tax revenues associated with the acceleration of inflation. In addition, acceleration in the rate of inflation tends to increase the risk of holding financial assets (particularly if they are not fully indexed) and to lower the real demand for bonds.

In developing countries, foreign financing acquires an important place.

Foreign financing can come in a variety of ways:

(a) grants (b) concessionary loans (c) Project loans (d) suppliers’ credit and (b) commercial borrowing.
Grants and concessionary loans are very attractive but not costless. In both cases the cost are often political. Project loans and suppliers’ credit may have concessionary elements but may also have hidden costs that make them less desirable than one would assume from the explicit cost. The most important source of foreign financing of public spending in recent years has been commercial borrowing. This borrowing has been done with varying maturities and with variable or fixed rates. Commercial borrowing played a major role in allowing developing countries to maintain levels of public spending higher than would have been possible through domestic sources.

**Internal Sources of Public Debt**

Significant changes have taken place in the financing pattern of deficits in India since the 1980s. Government deficit as a ratio has increased considerably. The major part of this was financed by government domestic borrowings, and resultant increase in public debt concern has been voiced against the growing public debt within as well as outside RBI.

The important sources of internal public debt are

**(a) Borrowing from individuals**

Individuals may be able to subscribe to government bonds either through curtailment of current consumption needs or through diversion of funds into government bonds through securities. Normally, sale of government bonds to individuals should curtail neither consumption nor business expansion. To a large measure the funds will be raised out of the saving that would have been lying idle or would have been used to buy other securities.
(b) Borrowing from Non-Banking Financial Institutions

Financial institutions e.g. insurance companies, trusts, mutual savings etc are more important than individuals. Non-banking financial institutions prefer government bonds because of the security provided by the latter and also due to their negotiability and liquidity. However, the rate of interest happens to be low and hence in many cases financial institutions may prefer high risk securities.

(c) Borrowing from Commercial Banks

Unlike individuals and non-banking institutions, commercial banks lend the government by creating additional purchasing power known as credit creation. The banking system as a whole can make additional loans up to an amount several times as great as the excess cash reserves. This is possible because the loans the bankers make are typical book entries in the names of borrowers who pay in the form of cheques to others who have also bank accounts. So long as the cash is not withdrawn from the banks, it serves as the basis for the expansion of loans.

(d) Borrowing from Central Bank

Government can borrow from the central bank of the country. This action happens exactly similar to the system of creation of additional purchasing power by the commercial banking system. By purchasing government bonds, the central bank credits the accounts of the government. The latter pays to its creditors out of its accounts with the Central bank. Those who have received cheques from the government on the central bank will deposit the amount in their banks. These bank will find themselves with large
cash reserves which would become the basis for additional loans and advances. It will be seen that the borrowing from the central bank is the most expansionary of all the sources for not only the government secures funds for its expenditure but also the commercial banking system gets additional cash which can be used as the basis for further credit expansion.

It may be noted that while the borrowing from individuals and financial institutions are simply transfer of funds from private to government use and therefore, will not be expansionary in their effect on the economy. Borrowings from commercial banking system and the central bank will have an expansionary effect.

**Borrowing from External Sources**

In the context of expansionist economy when borrowing from internal sources does not serve the purpose, the government borrows from external sources only when internal sources are not upto the mark. Even then debt is an obligation and internal obligation is less than an external one.

External borrowing can generally be used to finance defence expenditure, development projects and pay adverse balance of payment. Formerly, the floating of loans for any development projects like railways construction was taken up by individuals, banking system and other financial institutions. However, in recent years apart from this sources, two important sources have become prominent viz
(a) International Financial Institution

The I.M.F, the I.B.R.D and its affiliates, the I.D.A and the I.F.C, are important sources of external borrowing: for short period for overcoming temporary balance of payment difficulties are given by I.M.F. and for long period for development purposes from IBRD, IDA, IFC.

(b) Government assistance generally to assist developmental projects

For developing country India this source of borrowing is becoming important in recent years. But the political aspect, no doubt, is fearful as has been experienced by India in the wake of Indo-Pak war of December 1971, because one country cannot wholly depend upon another country due to political reasons. No country wants interference from another in any policy matter.

Comparative Importance of Taxation, Borrowing and Deficit Financing

Fiscal policy in a developing economy is concerned with Government’s taxing, borrowing and spending policies to achieve rapid economic development with reasonable monetary stability. It has to serve both the objective of capital accumulation and maintenance of stability. Since voluntary saving is very low, the state must play a positive role in stimulating capital formation. As Higgins observes, “The sheer poverty of under-developed countries makes the raising of the propensity to save as well as inducement to invest, a necessary part of fiscal policy.”
Borrowing versus Taxation

In an underdeveloped country which has a very low rate of voluntary savings, compulsory savings through high rate of taxation is perhaps the best means of mobilizing resources for development. Moreover, since economic development must be achieved with minimum inflation, taxation which is the most important source of non-inflationary finance should be given high priority in mobilizing the resources.

The traditional view of public finance is that tax proceeds should be used for the normal and recurring expenditure of the state and that the loan proceeds should be used for building of assets which yield direct return to the economy. Prof. A.C. Pigou, in his classic work on Public Finance observes, "There is a general agreement that ordinary running expenses should be met out of the current taxes."

The scope of raising funds through taxation is limited in developing countries. While indirect taxes are burdensome for the poor, therefore go against equity considerations, direct taxes beyond a certain level act as a disincentive for industry and hardwork. It is common knowledge that high taxes are not complied with. High compliance is associated with lower taxes.

The U.N. Report on the Domestic Financing of Economic Development also observes, "As to the relative share of taxation and government borrowing in the fiscal structure, few general principles can be stated. Taxation should cover at least current expenditure on normal government services. Borrowing is
particularly appropriate to finance government expenditure which results in the creation of capital assets or which is otherwise directly productive."

It should, however, be noted that in a developing economy taxation should go beyond financing normal expenditure and supply a considerable amount of funds for investment in development projects. The traditional view does not fit into the conditions of a developing economy. It is, however difficult to determine the relative share of taxation and borrowing in financing economic development.

Public Debt Versus Surpluses of Public Undertakings

Net contribution of public undertakings to the revenues of central and state government has been increasing; But it is not substantial. The Planning Commission has pointed out in the Memorandum on the Fourth Plan (1966) that by adopting a national price policy, the public undertakings should be made to yield high returns on investment so that their surpluses may be utilized for resource mobilization for development. But even with the best of efforts, in the early stages of economic development, surpluses of public undertakings may provide an infinitesimal part of development finance and even taxation supplemented by the surpluses of public undertakings will not be adequate to finance the ambitious development efforts.

Public debt versus Deficit Financing

Deficit financing has a very limited scope in a less developed economy where unemployment and underemployment are not due to lack of effective demand but due to lack of capital, and technical skill, etc. It should be
employed only in small dose. Monetary stability which is a sine qua non of orderly development, will be disturbed by heavy dose of deficit financing.

A U.N. Report observes, “In the short run and under certain circumstances inflation may make it possible to direct resources into particular development projects, but experience has shown that in the long run it has serious unfavourable consequences for balanced economic growth. Therefore, in the interest of orderly development of the economy, deficit financing should be kept to the minimum. This once again emphasises the fact that non-inflationary borrowing would be increased and to that extent the dependence on deficit financing can be reduced.”

**Burden of Internal Public Debt**

The internal public debt of India has expanded hugely especially since the commencement of the Five Year Plans. The ascertainment of the nature and measurement of the burden of the internal debt provide significant criteria for assessing the stability and strength of the national economy. Assessment of the burden of the debt can be effected in terms of certain important economic variables such as the national income, resources of the banking system, volume of private securities outstanding and so on. However, in our country when R.K. Shanmukhan Chetty delivered his Budget speech (1948) he talked of the debt burden in terms of the size of the dead weight debt which he found to be very small in relation to the resources of the country and its national income, when he maintained that “Our public debt is less than half of our national income” and that “the national debt of the United States of America is more that 1 ½
times its national income and the national debt of the United Kingdom is nearly three times its national income.\textsuperscript{7}

The ratio between the interest payment on the public debt and profits of public enterprises on which the borrowed funds have been spent would be a suitable method for measuring the net economic burden of the Public debt.\textsuperscript{8} However this method cannot be used in view of the fact that borrowed funds are used not only on directly measurable productive industrial projects, but also on social services, power generation, transport, railway development and infrastructure development generally. Consequently it is difficult to measure the profitability of the investment on infrastructure or on social services.

As far as the burden of internal debt is concerned, there may be no direct money burden on the community as a whole, since the payment of interest and increased taxation to meet the burden of debt involve simply a transfer of purchasing power from one group of persons to another. There may not be any net burden at all on the community. But to the extent the creditors (bond holders) and tax payers belong to different income groups, the change in the distribution of income among different sections of the community takes place. The burden of debt is felt by those who become worse off after redistribution.

However, while estimating the burden of public debt, the purpose of loan should also be considered. If a loan is utilized for a productive purpose, it can be paid out of the profits of the investment. So, there is no burden on the community. On the other hand a loan to finance a war may be a dead weight debt and will have to be paid out by way of increased taxation.
The burden imposed by taxation upon the taxpayers will be cancelled by the benefits received by them in the shape of interest on bonds. It should be noted, however, that if the rich pay taxes proportionately less than the proportion of public securities held by them, then there will be a direct real burden on the community. Thus Dalton concludes that there is almost always a direct real burden, because public securities are held mainly by the wealthier classes, and progressive taxation is not likely to be so “sharply progressive as to counter balance, among the wealthier classes, the income derived from public securities”\(^9\). So, there is a net increase in the burden on the community.

The burden of public debt is realised by the community is one other way and, that is, the government will tax enterprise, patriotism, activeness and worth for the payment of public debt, and this increased taxation is for the benefit of wealthier, passive, old, and leisurely class, i.e. those who receive interest in lieu of their credit to government.

Finally, the increased taxation, for the payment of interest charges and the repayment of debt may consequently affect the purchasing power as well as the willingness to work and save. Hence it is of utmost importance that debt repayment should be managed in such a manner that it may not adversely affect production and distribution.

It can be concluded that internal debt imposes a burden upon the community as a whole, and the belief that the internal debt does not impose any burden on the community is theoretically incorrect and practically unrealistic.
Burden of External Public Debt

Public debt constitutes some economic burden upon the society incurring it. "The debt is owed to citizens or governments of other societies payments represent deductions from national product, and the standards of national welfare are thereby reduced. This does not mean that funds borrowed from abroad are unproductive to the borrowing economy. It means simply than investment of funds borrowed form abroad produce less net return to the borrowing economy than would similar investment of funds provided at home."10

The nature of external debt is different from that of internal debt. The burden of external debt can be similar to that of internal debt in one other sense. That is, the government has to pay internal as well as external debt through additional taxation. In the words of Dalton, "as a general rule, an internal debt is likely to involve an additional and indirect burden on a community, an external debt does the same."11

However, in another sense, the burden of external debt is greater to that of internal debt, because in the case of internal debt, interest charges and the repayment of principal are paid within the country, and result in a mere transference of wealth from one section of the community to another, and the tax payer and the receiver of interest are often the same persons. In case of external debt, money is paid to those living abroad for the loan of the capital used in production. Hence, the payment of interest on foreign debt reduce the net income of the debtor country, by transferring a part of its income abroad.
The payment of internal debt has no such effect. Hence external debt imposes a greater burden than that of internal debt.

The direct real burden of external debt also depends upon the purpose for which the debt is incurred. If the external debt is incurred to meet war expenditure, it may be called a dead weight debt, as it is unproductive in nature nor does it help in raising the production of the community. However, if the external debt are short term, the posterity may escape from its burden, as the present generation will repay it. But if external debt is long term the burden falls upon the posterity.

If, however, the external debt is incurred for productive purposes such as import of machinery, raw material, technical know how and other capital goods for the development of industry and agriculture and other sectors of the economy, the debtor country may be benefited to the extent that it may nullify the real burden of external debt. The fruits of accelerated economic growth and additional income generated will help to repay the age old debt without feeling any real burden of such debt.

It can be concluded, that the external debt for productive purposes is not a burden, and hence, it should not be discouraged so long as it is helpful for the development of the community as a whole and in accelerating the growth of the economy.
The Table 3.2 explains the growth of public debt which includes internal and external debt. As regard internal debt, the transfer of funds from tax-payer to bond holders is like the transfer of money from one pocket to another and as a result, there is no burden of internal public debt whatsoever. But this view too is not without flaw. Though the tax-payer and bond holder belong to the same state yet they belong to different income groups and the satisfaction lost by one group may not be compensated by the satisfaction gained by the other group. The internal debt increased from Rs. 283,033 crore in 1990-91 to Rs. 1891346 crore in 2006-07 (B.E) whereas with regard to external debt, while repaying the external debt a net flow of real national product takes place and results in a burden on the society. The external debt has increased from Rs. 31525 crore in 1990-91 to Rs. 76716 crore in 2006-07 (B.E.). It is significant that there were two periods when external debt registered a fall viz during 2002-03, when it fell to Rs. 59612 crore from Rs. 71546 crore the previous year, a decrease of 16.6 percent over the previous year. It reduced further to Rs. 46124 crore in 2003-04, recording a decrease by 22.6 percent. Subsequently it increased and reached the figure of Rs. 76716 crore in 2006-07 (B.E.)

Total public debt is the sum of internal and external debt. If internal and external debt rises, total public debt also rises. The total public debt increased from Rs. 314558 crore in 1990-91 to Rs. 1968062 crore in 2006 –07 (B.E.). The lowest growth rate recorded 6.7 percent in 2005 –06 (R.E.) and the highest growth rate recorded 18.9 percent in 1993-94.
### Table No. 3.2
**Growth of Public Debt of India**

(Rs. in crore)

<table>
<thead>
<tr>
<th>Year</th>
<th>Internal debt</th>
<th>Growth rate (%)</th>
<th>External debt</th>
<th>Growth rate (%)</th>
<th>Total public debt</th>
<th>Growth rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-91</td>
<td>283,033</td>
<td>----</td>
<td>315,252</td>
<td>-</td>
<td>314,558</td>
<td>--</td>
</tr>
<tr>
<td>1993-94</td>
<td>430,623</td>
<td>19.73</td>
<td>473,452</td>
<td>12.00</td>
<td>477,968</td>
<td>18.92</td>
</tr>
<tr>
<td>1994-95</td>
<td>487,682</td>
<td>13.25</td>
<td>509,286</td>
<td>7.56</td>
<td>538,610</td>
<td>12.68</td>
</tr>
<tr>
<td>1995-96</td>
<td>554,984</td>
<td>13.80</td>
<td>512,490</td>
<td>0.63</td>
<td>606,233</td>
<td>12.55</td>
</tr>
<tr>
<td>1996-97</td>
<td>621,438</td>
<td>11.97</td>
<td>542,382</td>
<td>5.83</td>
<td>675,676</td>
<td>11.45</td>
</tr>
<tr>
<td>1997-98</td>
<td>722,962</td>
<td>16.33</td>
<td>553,322</td>
<td>2.01</td>
<td>778,294</td>
<td>15.18</td>
</tr>
<tr>
<td>1998-99</td>
<td>834,551</td>
<td>15.43</td>
<td>572,554</td>
<td>3.47</td>
<td>891,805</td>
<td>14.58</td>
</tr>
<tr>
<td>1999-2000</td>
<td>933,000</td>
<td>11.79</td>
<td>584,371</td>
<td>2.06</td>
<td>991,437</td>
<td>11.17</td>
</tr>
<tr>
<td>2000-01</td>
<td>1,047,976</td>
<td>12.32</td>
<td>659,452</td>
<td>12.84</td>
<td>111,3921</td>
<td>12.35</td>
</tr>
<tr>
<td>2001-02</td>
<td>1,196,245</td>
<td>14.14</td>
<td>715,456</td>
<td>9.58</td>
<td>126,7791</td>
<td>13.81</td>
</tr>
<tr>
<td>2002-03</td>
<td>1,323,704</td>
<td>10.65</td>
<td>596,122</td>
<td>-16.6</td>
<td>138,3316</td>
<td>9.1</td>
</tr>
<tr>
<td>2003-04</td>
<td>1,457,583</td>
<td>10.11</td>
<td>461,124</td>
<td>-22.62</td>
<td>150,3707</td>
<td>8.7</td>
</tr>
<tr>
<td>2004-05</td>
<td>1,603,785</td>
<td>10.03</td>
<td>608,789</td>
<td>31.98</td>
<td>166,4663</td>
<td>10.70</td>
</tr>
<tr>
<td>2005-06 (R.E.)</td>
<td>1,708,885</td>
<td>6.55</td>
<td>683,926</td>
<td>12.34</td>
<td>177,7777</td>
<td>6.76</td>
</tr>
<tr>
<td>2006-07 (B.E.)</td>
<td>1,891,346</td>
<td>10.67</td>
<td>767,169</td>
<td>12.17</td>
<td>196,8062</td>
<td>10.7</td>
</tr>
</tbody>
</table>

Source: Indian Public Finance Statistics, Ministry of Finance, Govt. of India (Various Issues)

Table 3.3 explains the five yearly compound growth rate of public debt. The rate of growth of internal debt is high i.e. 11.8 percent with that of external debt which is 5.2 percent during 1990-2007. The rate of growth of internal debt declines to 8.7 percent in 2000-07 whereas the rate of growth of external debt declines to 2.2 percent in 2000-07. The growth rate of total public debt is similar in the periods 1990-07 and 1990-95.
Table 3.3

<table>
<thead>
<tr>
<th>Year</th>
<th>Compound growth rate of internal debt</th>
<th>Compound growth rate of external debt</th>
<th>Compound growth rate of total public debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-2007</td>
<td>11.8</td>
<td>5.2</td>
<td>11.4</td>
</tr>
<tr>
<td>1990-95</td>
<td>11.5</td>
<td>10.1</td>
<td>11.4</td>
</tr>
<tr>
<td>1995-2000</td>
<td>10.9</td>
<td>2.7</td>
<td>10.4</td>
</tr>
<tr>
<td>2000-07</td>
<td>8.7</td>
<td>2.2</td>
<td>8.5</td>
</tr>
</tbody>
</table>

Should Government Borrow

Such questions as should government borrow? Can a country become bankrupt through public debt? When and how much should the government borrow? etc. are questions whose answers are not fixed, but flexible.

The first traditional argument that is raised against the validity of public debt is its interest burden. The government finances the interest through taxation. Taxes are to be paid compulsorily hence it would bring the expenditure for other purposes down. Public debt causes inflation in times of full employment. During full employment if the expenditure of the government increases, it would create inflation i.e. price rise, which is a social injustice.

If public debt is incurred freely it increases the government expenditure. This increase in expenditure may bring inefficiency in the functioning of the government. When inefficiency occurs it hampers the development. While channelising the funds in the form of public debt the government may accumulate so much debt, that it does not lose the confidence of the people. When the confidence is lost, though it generally does not occur, it may bring political and economic instability and consequently, disaster after disaster.
The government should borrow in times of depression. When the economy is facing stagnation. The use of borrowing is regarded inevitable when a country is facing a major war. In such a situation taxes do not fulfil the need. And any increase in taxes beyond their feasibility may impair incentives to work and reduce over all morale of the people.

In addition, public borrowing has been regarded desirable when governmental activities require capital outlays far in excess of usual expenditure. Finally it can be said that in the context of modern expansionist economy without resorting to public borrowing we can not reach the stage of ‘take off’. We should always be mindful in the use of foreign loans and loans in time of full employment. So far as external debt is concerned, care should be taken of its being without strings. If it, helps economic well being it is welcome. In addition, the challenge of taking millions and millions of people out of hunger and despair\textsuperscript{12} can be faced when the capital in circulation is equally available to all because ‘more than 50 percent of the world’s income is shared by only seven percent of the nations representing 10% of the population’\textsuperscript{13} Debt, therefore is inevitable.
References


5. Ibid

6. Constituent Assembly of India (legislative) Debates, Saturday, 28 Feb; 1948, vol II, No. 9, P-1348.

7. Ibid


12. President; Dr. Bharat Ram, The International chamber of commerce, Address to business leaders attending the discussions on greater trade liberalization, the needs of developing nations and measures environmental control at Vienna on 19.4.71

13. Ibid.