UNIT 14 SOURCES OF PUBLIC DEBT

Structure

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14.0 OBJECTIVES

After going through this unit, you will be able to:

- understand the sources of public debt;
- understand the sources of public debt in India;
- analyze the impact of internal public debt on the economy;
- know the impact of external public debt; and
- analyse crowding out of public investment and activity.

14.1 INTRODUCTION

As discussed in Unit 13, Public debt is the debt which State owes to it subjects or to the nationals of other countries. Public debt arises due to borrowing by the government The government may borrow from banks, business organisations, 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 carries with them the promises of the government to pay interests, to the holders of these bonds at stipulated rate of interests at regular intervals, or lump sum at the end, in addition to the principal which has to be repaid at the stated time.

14.2 SOURCES OF PUBLIC DEBT

The borrowings of the government may be from within the country or from outside the country or both. Government debt can be categorized as internal debt, owed to lenders within the country, and external debt, owed to foreign lenders. Thus, there are two major sources of public borrowings: (i) Internal and (ii) External.

Internally, the government may borrow from citizens, commercial banks, other financial institutions in the money market and from the central banks. Normally the government of the country has a large variety of debt obligations. Therefore public debt may be defined in several different ways covering their attractive combinations and to suit the purpose of the definitions. Thus, at one extreme it may include all financial liabilities of a government (including its currency) while at the other extreme, it may include only a few of them. A clear-cut stand has also to be taken regarding inter-governmental obligation like loans from the central government to the states. Similarly, a decision is required as to whether the central bank of the country is to be considered a part of the government or not for the purpose of estimating the volume and composition of public debt.

It would be helpful if we have a brief idea of the type of obligations, which the government of a country usually incurs.

Firstly – there is the currency itself generally, however the government creates a part of the currency; the rest is created by the central bank of the country. Therefore, the entire currency circulating in the market can be a part of public debt only if the central bank is classified as a part of the government sector. In any case, currency obligation normally remains dormant or inactive and the government does not 'pay them off' – at the most one set of currency is replaced by another set and that is all.

Secondly – Other set of obligations of government constitutes it short-term debt; these obligations are normally of maturity of less than one year at the time of issue and consist of items like the treasury bills.

Thirdly – some obligations do not have any specific maturity but may be repayable subject to various terms and conditions. They are referred to as floating debt. Examples of this category include provident fund, small saving reserve funds and deposit and so on. In India, the Government of India has also issued certain special securities to meet its obligations towards international institutions like the International Bank for reconstruction and development and the International Monetary Fund. These special securities may be called Special floating debt.

Fourth category of government obligations consists of the permanent or funded debt such loans have as maturity of more than one year at the time of issue. In practice their maturity is usually between three and thirty years. Some of them may even be non-terminable (or perpetuities) so that the government is only to pay the interest on such debt without ever repaying the principal amount.

Fifthly – obligations owned to foreigner's government, institutions, firms and individuals are called external loans. They may have a variety of terms and conditions.

Thus, depending upon the purpose and contact, institutional arrangements and so on, different people could define public debt differently. At one extreme all financial obligations of the government including the demand debt (that is currency obligations) are sought to be included in the definition of public debt, while in other cases only

some of the above-mentioned categories of obligations are considered. In general, however, the currency obligations of the government are usually excluded from the definition of the public debt and only the floating, funded, external and other obligations are included in it.

External debt (or **foreign debt**) is that part of the total debt in a country that is owed to creditors outside the country. The debtors can be the government, corporations or private households. The debt includes money owed to private commercial banks, other governments, or international financial institutions such as the IMF and World Bank. IMF defines it as "**Gross external debt, at any given time, is the outstanding amount of those actual current, and not contingent, liabilities that require payment(s) of principal and/or interest by the debtor at some point(s) in the future and that are owed to nonresidents by residents of an economy.**"

Generally external debt is classified into four heads i.e. (1) public and publicly guaranteed debt, (2) private non-guaranteed credits, (3) central bank deposits, and (4) loans due to the IMF. However the exact treatment varies from country to country. For example, while Egypt maintains this four head classification (2) in India it is classified in seven heads i.e. (a) multilateral, (b) bilateral, (c) IMF loans, (d) Trade Credit, (e) Commercial Borrowings, (f) NRI Deposits, and (g) Rupee Debt.

14.3 SOURCES OF PUBLIC DEBT IN INDIA

Public debt in Indian context refers to the borrowings of the central and State governments. Debt obligations of the Central government are broadly divided into three categories (1)Internal debt, (2)External debt and (3) Other liabilities. For analytical purpose, however, other liabilities are to be included in internal debt.

14.3.1 Debt Obligations of the Central Government

1) **Internal Debt**

This includes: (a)current market loans, (b)bonds, (c)Treasury Bills, (d)special floating and other loans, (e)Special securities issued to reserve Bank of India, (f)Ways and means Advances, (g)Securities against small savings, (h)Small savings, (i) Provident Funds, (j) Other accounts and (k)Reserve Funds and Deposits. As shown in Table 1, internal debt has risen considerably over the years.

a) **Market Loans:** These have a maturity period of 12 months or more at the time of issue and are generally interest bearing. The government issues such loans almost every year. These loans are raised in open market by sale of securities or otherwise.

b) **Bonds:** This category comprises gold bonds 1998, compensation and other bonds such as national Rural Development Bonds and Capital Investment Bonds.

c) **Treasury Bills:** Treasury bills have been a major source of short term funds for the government to bridge the gap between revenue and expenditure. They have a maturity of 91 or 182 or 364 days and are issued every Friday. Treasury bills are issued to the reserve Bank of India, State governments commercial banks and other parties.

d) **Special Floating and Other Loans:** Special floating and other loans represent the contribution of Government of India towards the capital of international

financial institutions such as International Monetary Fund, International Bank for Reconstruction and Development and International Development Association. These are non-negotiable, non interest bearing securities and the government of India is liable to pay the amount at the call of these institutions.

e) **Special Securities Issued to RBI:** The government takes loans temporary nature from the Reserve Bank and issues special securities which are non negotiable and non interest bearing. Such borrowings are short term (not more than 12 months.

f) **Ways and Means Advances:** The Government of India takes ways and means advances from the Reserve Bank of India to meet its short period expenditure. These debts are purely temporary in nature and usually repaid within three months.

g) **Securities Against Small Savings:** Under the new accounting system of national small savings fund (NSSF) a substantial part of small savings have been converted into Central government securities with effect from the fiscal year 1999-2000. Securities against small savings accounted to Rs.2.02,271 crore at end march 2003.

h) **Small Savings:** Small savings have consistently increased in volume during recent years due to the rising money incomes in the economy and also due to the various innovative schemes introduced by the government. Some of these schemes involved attractive tax concessions (like 6 years National Savings Certificates) and people were thus lured into channeling substantial amounts of money through these schemes.

i) **Provident Funds:** Provident funds are divided into two categories: (i) State Provident Fund and (ii) Public Provident Fund Public Provident fund was framed under the Public Provident Fund Act 1968 for the benefit of general public. Deposits in Public provident Funds are repayable after 15 years. Facilities of loans and withdrawals are available.

j) **Other Accounts:** these include mainly Postal Insurance and life annuity Fund, Hindu Family Annuity Fund, borrowing against Compulsory Deposits and Income –Tax Annuity Deposits, and Special Deposits of Non Government Provident Fund.

k) **Reserve Funds and Deposits:** Reserve funds and deposits are divided into two categories. (i) interest bearing and (ii) non interest bearing. They include depreciation and Reserve Funds of railways and Department of Posts and Department of Telecommunications, deposits of Local funds, departmental and judicial deposits civil deposits etc.

2) **External Debt**

External debt is usually raised in foreign currency and a substantial part of it is also repayable in foreign currency. The Government of India has raised foreign loans from a number of countries like USA, UK France former USSR, Germany, Japan etc., and international financial institutions like IMF, IBRD and IDA etc.

Aggregate Liabilities

As shown by table 14.1 below aggregate liabilities which include internal debt and external debt)rose from Rs.19,193 crore at end-March 1971 to Rs.3,14,558 crore

at end march 1991 and further to the high figure of Rs.15,61,876crore at end march 2003. It was budgeted to increase to Rs. 17,80,064 crore by end march 2004.

Table-14.1: Public Debt of Government of India

(Rs. Crore)
At the end of March

Item	1981	1991	2003
Public Debt(1+2)	59,749	3,14,558	10,94,813
1. Internal Debt	48,451	2,83,033	10,37,163
of which			
Market loans	15,549	70,520	6,21,470
Bonds	339	1,739	_
Treasury Bills	12,851	8,031	11,547
Special Floating and other loans	1,540	6,566	23,624
Special securities issued to RBI	585	67,101	65,424
Ways and Means Advances	_	_	5,176
Securities against small savings	_	_	2,02,271
Small savings	7,976	52,899	1,49,166
Provident funds	2,645	11,670	54,394
Other accounts	3,332	45,336	11,77,467
Reserve Funds and deposits	3,634	21,922	86,035
2. External Debt	**11,298**	**31,525**	**57,650**

Source: Report on Currency and Finance, 1985-86, vol.1, Tata Services Limited, Statistical Outline of India, 2003-2004

14.3.2 Debt Obligations of the State Government

To meet their increasing requirements of expenditure, the state governments have also to incur large debts like the Central government. Debt obligations of the state governments are divided into four categories. (1) Internal debt, (2) Loans and advances from the central government, (3) Provident funds, and (4) Special securities issued to National Small Savings Fund (NSSF) etc. The debt obligations of the State governments are presented in Table 14.2.

As it is clear from Table 14.2, the total debt of the State governments has increased considerably over the years from Rs. 23,959 crore in 1981 to Rs.1,10,289 crore in 1991 and further to. Rs 5,04,248 crore at the end of March 2002. A major proportion of his debt is constituted of loans and advances from the central government. This indicates the heavy dependence of the states on the center.

Internal debt is divided into (a) Market Loans and Bonds, (b)Ways and means advances from Reserve Bank of India and (c) Loans from banks and other institutions.

Table 14.2: Debt Position of States

(Rs. crore)
outstanding as on March 31st

Items	1981	1991	2001
I. Internal Debt (a to c)	**4,443**	**19,211**	**1,22,002**
(a)Market loans	2,988	15,618	85,551
(b)Compensation and other Bonds	59	8	_
(c) Ways and Means Advances from RBI	482	679	4,101
(d)Loans from banks and other financial institutions	914	2,906	32,350
II Loans and advances from the Central Government	**16,980**	**74,117**	**2,30,195**
	_	_	**59,229**
III Special Securities issued to NSSF	**2536**	**16,961**	**92,822**
IV Provident Funds etc.			
	2185	14,002	77,171
Of which	**23959**	**1,10,289**	**5,04,248**
State provident funds			
V total Debt (I to III)			

Source : Reserve Bank of India, Report on currency and Finance 1989-90 Vol II and Reserve Bank of India, *Handbook of Statistics on Indian Economy* (Mumbai 2001)

Check Your Progress 1

1) What are the main sources of public debt?

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2) What are the main sources of internal public debt?

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3) What is external public debt?

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4) What are the main sources of public debt in India?

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14.4 IMPACT OF INTERNAL PUBLIC DEBT

The public debt of a country affects its economy in two ways. It has its 'revenue effects' as well as 'expenditure effects' In the first place, its raising of money by a loan makes the people change their budgets. Though, it may not affect the consumption expenditure directly as the taxation does, because people use their past or present saving to buy the public securities. But in some cases they may increase their savings and cut down their current expenditure to buy the loan. Obviously public debts affect consumption expenditure. This is therefore, the first effect of public debt.

Secondly, the benefit, conferred upon the people by the expenditure of the money raised through public loans, is the effect of public debt. These benefits may not always be different from the benefit that expenditure of tax income may confer, provided that the same use is made of borrowed money as is made of tax revenue. But except in rare cases, borrowed money is always used in different ways so that of tax revenue. However the difference is not always very radical. For instance, tax revenue may be used to pay the salaries of teachers, while borrowed money may be utilized for the construction of school buildings. The effects of spending, the proceeds of taxation and of borrowings are the same. But in some cases, the difference is clear-cut. The borrowed funds are used to finance expenditure of capital nature, such as for the construction of plants for generating the atomic energy, whereas the tax proceeds are used to finance current revenue expenditure, the effects of former expenditure are different to that of latter. Let us now discuss the effects of public debt on consumption, production, distribution and on private sector.

14.4.1 On Consumption and Investment

When people purchase government securities, it is not always necessary that they do it out of past savings. Sometimes people buy these securities out of their present income, which they would have otherwise utilized on the consumption of other commodities. Since they get an opportunity of buying government bonds of small amounts, they refrain from consuming something and buy them. Therefore, in this way the consumption is affected in the same way as it is affected by taxes. But,

when the people buy government securities out of there past savings it has its specified effects. This does not directly affect the expenditure of the people at present. And, when people buy government securities out of the idle savings, the expenditure in the present remains the same. Private investment also remains unaffected in such conditions. If however, it comes from bank deposits, it reduces the money with the bank. The banks have, therefore, less money to lend to private business. Hence private investment is affected.

It is generally believed that the public borrowings have adverse effects on investment. However, if the government borrows from Commercial Banks or the Central Bank of the country, it will provide extra purchasing power to the community and therefore, it will provide extra purchasing power to the community and therefore, it will not press for any curtailment of funds for investment. But when purchases of securities by banks without excess of reserves or from individuals is made out of the funds meant for business expansion, it results in decline in investment. It is however, to be noted that as long as the interest rate is static and government bonds offer special privileges to bond holders over those envisaged in existing securities, possibility of reduction in private investment is very slight.

There will be no contractionary effect at all, if the bonds are sold to the Central Banking System, or the Commercial Banks if they have excess reserves, or to lenders who purchase them out of funds which would otherwise lie idle.

14.4.2 On Production and Distribution

If people buy government securities by withdrawing money from industrial concerns, or by selling debentures and shares of industrial concerns, private investment is adversely affected. The net effect on investment will depend upon how the money is used by government. If the government utilizes this money in public undertakings, the total investment available for production may not be adversely affected, but if the government utilizes it on non-productive works, the total investment may be adversely affected.

If the people buy government securities from idle funds, private investment are not affected, but if they buy from bank deposits, private investment may be adversely affected, because the lending capacity of the bank may be reduced due to reduction in deposits.

The lending capacity of bank is generally elastic. The power of bank to create loans depends upon the policy of the central bank of the country. When the latter encourages for the creation of credit, the likelihood of the expansion of credit is immense. It can expand credit on the strength, of *ad hoc* or newly created securities. Thus the government borrowings may not reduce investment in private sector, provided there are enough funds for productive purposes. Moreover, the government will utilize the loans proceeds for making the payments to contractors for goods and materials purchased and in paying salaries to its employees. This will release purchasing power and increase bank deposits, which can be utilized for making loans to private sector. Hence, government borrowings from banks may not affect investment in private sector.

If government uses the borrowed funds for unproductive purposes, it can only be repaid through additional taxation in future, and this additional taxation in future may affect consumption. Those utilized for the welfare schemes, increase the efficiency of the workers and that of production. When production increases, income of

community also increases, and hence, additional taxation may not affect consumption. If the loans are utilized for productive purposes directly, they increase the income of the community. Hence, the consumption is not affected, but it increases. Moreover the interest along with principal can be paid out of increased income.

The purchaser of government securities are mostly the rich people of the community, But the burden of taxes, imposed for finding money for interest payments fall on the poorer classes also. Therefore the tendency of public debt would be to increase the inequalities of incomes. Hence the public debt may not have the desirable effects upon distribution. However, if bondholders and the tax are the same, then there will be no distribution of income. Therefore, the inequalities of income will not increase, but it is generally not true. Hence some redistribution of income will take place as long as the taxpayers and the bondholders belong to different groups, and as explained above, the inequalities of income may increase.

If public debt is utilized to provide more economic welfare to the lower income groups then the inequalities of income will decrease and a more equal distribution of income between different sections of the community would take place, However if the loan finance created inflation, some of the good effects upon the distribution of income may be neutralized because of rise in prices. Thus, if the loan proceeds are spent on welfare schemes, the effects on distribution are whole-some.

14.4.3 On Private Sector

All public expenditure increases the demand for goods, because it increases the purchasing power of the people and puts more money into circulation. When this expenditure is financed through taxation, current consumption is not reduced. If the government utilizes the borrowed money in purchasing goods and materials produced in private sector the demand for goods in the private sector may increase to the extent that the government spends borrowed funds for this purpose. Again, a portion of the borrowed funds may be utilized on salaries and wages of government officials, who may purchase the goods produced in the private sector. Hence the effect of expenditure of borrowed funds is that the demand for the products of industries in private sector increases, without adversely affecting the supply. Hence, the effects of public debt are said to be favourable.

14.4.4 On Resource Allocation and National Income

Unlike tax finance, there is little effect of public borrowing on resource allocation or composition of national production. But, when investment level is reduced, it causes decrease in the relative output of capital goods as against the total output in periods of full employment. On the contrary, the capital goods on which the government expenditure is incurred finds greater incentives for their accelerated production and, thus, there is also a rise in national income. The consequent increase in national income will not only be of high level in proportion to the enlarged investment but also will be a multiple of the increment of the investment due to multiplier effect, and thereby create larger employment prospects.

14.4.5 On Liquidity and Money Market

People who buy government securities possesses highly negotiable and highly liquid from of assets, which can be converted for any purpose transactions, precautionary or speculative motive – at any time and, thus, public debt creates highly liquidated assets

Besides, in time of inflation, the central bank of the country adopts bank rate, open market operations and other devices, which restrict the commercial banks "credit creation capacity". However this effect is generally nullified because the commercial can increase the reserve at any time by way of disposal of bonds.

Further, existence of large amounts of public debts accounts for increase in interest obligations of the Government. However, *increase in interest rates has a net expansionary or concretionary effect upon the economy, which depends on the relative propensity to consume of the taxpayers and bondholders and the effects of the tax upon investment.*

Existence of public debt affects the money market in the following manner. If demand for funds from the private sector is on a higher level, government will have to fix higher interest rates to attract purchase of its securities, and vice versa. So when Government borrows from public, it competes with private investors. Thus, it has to confirm to the general pattern of demand, supply and prices as any other borrower in the market. Ultimately, both Government and the private sectors in order to acquire funds in the market. If the State tries to borrow (especially from Commercial Banks and Central Bank) more than the available supply at the current rate of interest, this may lead to currency expansion.

14.5 IMPACT OF EXTERNAL PUBLIC DEBT

External borrowing in the economic development of developing countries have made possible the import of high priority goods or (capital goods) or goods to be used to create and build capacity for accelerating the rate of growth of the economy. It effects both consumption and investment favourably. Again, imports of foreign goods raises the total available supply of commodities so also the national income and ultimately helps in the betterment of people's standard of living. Further, these imports on the one hand, reduce the demand of similar indigenous goods in the present and on the other their investment would increase output in future. Thus these imports are anti-inflationary, though; this effect may be felt more in future. Again, if the goods and services are imported by the Government and sold to the public then it reduces currency circulation in the economy. Hence, it enables the state to increase the extent of deficit financing which can further be used for accelerating the growth and development of the economy.

Foreign capital supplements the national resources and makes possible a higher rate of investment than otherwise would be possible. If this higher investment raises the rate of growth of the economy, the increasing external liabilities need not cause any concern. Increase of external indebtedness and debt servicing liabilities even when large, do not necessarily create difficulties for borrowers The increases of debt servicing payments have to be measured against the development which has occurred in the borrower's economy. The basic condition of debt servicing capacity is the continuing increase in per capita production. It means the capacity to pay debt-servicing charges depends upon the continuing increase in per capita production.

Check Your Progress 2

1) What are the impacts of public debt on consumption?

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2) What are the impacts of public debt on the production?

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3) How does public debt affect the private sector?

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4) What are impact of public debt on resource allocation and national income?

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5) What is the impact of public debt on the working of the money market?

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6) What are the effects of foreign loans on the economy?

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14.6 CROWDING OUT OF PRIVATE INVESTMENT AND ACTIVITY

In economics, **crowding out** theoretically occurs when the government expands its borrowing to finance increased expenditure, or cuts taxes (i.e. is engaged in deficit spending), **crowding out** private sector investment by way of higher interest rates. Thus the term "crowding out" refers to the reduction in private expenditure on consumption and investment caused by an increase in government expenditure, which increases aggregate demand, and hence interest rates. The amount by which private expenditure fall with a given increase in government expenditure is called the crowding *out effect.* When government expenditure displaces or crowds out an equal amount of private expenditure, the crowding out effect is said to be *complete* or *total.* On the contrary, the government expenditure may reduce private expenditure by less than the increase in government expenditure then the crowding out effect is partial or incomplete. If private expenditures do not fall at all with increase in government expenditure, the crowding out effect is zero.

To the extent that there is controversy in modern macroeconomics on the subject, it is because of disagreement about how financial markets would react to more government borrowing. If increased borrowing leads to higher interest rates by creating a greater demand for money and loanable funds and hence a higher "price" (*ceteris paribus*), the private sector, which is sensitive to interest rates will likely reduce investment due to a lower rate of return. This is the investment that is crowded out. The weakening of fixed investment and other interest-sensitive expenditure counteracts to varying extents the expansionary effect of government deficits. More importantly, a fall in fixed investment by business can hurt long-term economic growth of the supply side, i.e., the growth of potential output. However, this crowding-out effect is moderated by the fact that government spending expands the market for private-sector products through the multiplier and thus stimulates – or "crowds in" – fixed investment (via the "accelerator effect"). This accelerator effect is most important when business suffers from unused industrial capacity, i.e., during a serious recession or a depression. Crowding out can, in principle, be avoided if the deficit is financed by simply printing money, but this carries concerns of accelerating inflation.

Crowding out of another sort may occur due to the prevalence of floating exchange rates. Government borrowing leads to higher interest rates, which attract inflows of money on the capital account from foreign financial markets into the domestic currency (i.e., into assets denominated in that currency). Under floating exchange rates, that leads to appreciation of the exchange rate and thus the "crowding out" of domestic exports (which become more expensive to those using foreign currency). This counteracts the demand-promoting effects of government deficits but has no obvious negative effect on long-term economic growth.

In the United States during the late 1990s, another kind of crowding out of exports occurred: large increases in private fixed investment and consumer spending encouraged high interest rates, a high dollar exchange rate, and hurt exports.

Crowding out is most serious when an economy is already at potential output or full employment. Then the government's expansionary fiscal policy encourages increased prices, which lead to an increased demand for money. This in turn leads to higher interest rates (*ceteris paribus*) and crowds out interest-sensitive spending. At potential output, businesses are in no need of markets, so that there is no room for

an accelerator effect. More directly, if the economy stays at full employment gross domestic product, any increase in government purchases shifts resources away the private sector. This phenomenon is sometimes called "real" crowding out. The negative effects on long-term economic growth that occur when private fixed investment are crowded out can be moderated if the government uses its deficit to finance productive investment in education, basic research, and the like. The situation is made worse, of course, if the government wastes borrowed money on such things as "pork barrel" projects and tax cuts for the political allies of the current politicians.

There are three type of crowding out:

a) **Physical Crowding Out**

Physical crowding out occurs when the government demand for factors and inputs increases in the event of their inelastic supply. This raises their prices and makes private investment schemes unviable and unprofitable thereby reducing private expenditures. Thus physical crowding out results from a shortage of real productive resources. For example, the government increases direct public sector expenditure by starting new industries. It pays higher wages to attract technical experts from private sector industries and increases the demand for other resources, thereby reducing private investment. If the economy is at the full employment level, any rise in government expenditure will inevitably crowd out an equal amount of private expenditure.

Physical crowding out is a temporary and short run phenomenon. In the long run, there is the possibility of increasing real resources. The government can also stimulate private investment by selective industrial subsidies and adopting appropriate fiscal and monetary measures.

b) **Fiscal Crowding Out**

Fiscal crowding out occurs when a rise in government expenditure from a budget deficit raises aggregate demand. Given a constant money supply, the interest rates rise. The simulative effect of government deficit (or expenditure) will crowd out in greater or lesser degree a certain amount of private investment. The fiscal crowding out is usually explained in terms of the Keynesian analysis. The mechanism is that the rise in government expenditure raises the aggregate demand. This sets in motion the multiplier process, which raises nominal income. The rise in nominal income requires more money for transactions purposes. Further as investment increases, the demand for labour also rises which increases wages and prices. The degree to which prices rise depends on the extent of unemployment prevailing in the economy. The nearer is the economy to the level of full employment level, the higher will be the price level. When the economy is in full employment, the price level rises in proportion to the increase in government expenditure. The rise in price level leads to the rise in nominal income which in turn, diverts money balances for transactions purposes and decreases the quantity of money available for speculative purposes. As the money supply is fixed, the residual money supply contracts and interest rates rise. The rise in interest rates causes a fiscal crowding out of private investment with the increase in government expenditure. In a full employment situation, the fiscal crowding out is complete because government expenditure equals private expenditure which it displaces. If there is liquidity trap, there is no crowding out.

c) **Financial Crowding Out**

Financial crowding out occurs when the government increases its expenditure and

finances it by selling new bonds in the money market. When the government sells bonds, the prices of securities fall and interest rates rise. as a result, the private sector postpones or curtails some schemes because obtaining funds has become dearer. Thus the government expenditure crowds out private investment spending. Total financial crowding out occurs when the bond financed government expenditure equals the same amount of displaced private investment.

Check Your Progress 3

1) What is the meaning of crowding out effect?

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2) What are types of crowding out effect?

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14.7 LET US SUM UP

There are two major sources of public borrowings: (i) Internal and (ii) External. Internally, the government may borrow from citizens, commercial banks, other financial institutions in the money market and from the central banks. Normally the government of the country has a large variety of debt obligations. Depending upon the purpose and contact, institutional arrangements and so on, different people could define public debt differently. At one extreme all financial obligations of the government including the demand debt (that is currency obligations) are sought to be included in the definition of public debt, while in other cases only some of the above-mentioned categories of obligations are considered. In general, however, the currency obligations of the government are usually excluded from the definition of the public debt and only the floating, funded, external and other obligations are included in it. External debt (or foreign debt) is that part of the total debt in a country that is owed to creditors outside the country.

Public debt in Indian context refers to the borrowings of the central and State governments. Internal loans in India includes: (a) current market loans, (b) bonds, (c) Treasury Bills, (d) special floating and other loans, (e) Special securities issued to reserve Bank of India, (f) Ways and means Advances, (g) Securities against small savings, (h) Small savings, (i) Provident Funds, (j) Other accounts and (k) Reserve Funds and Deposits.

Government of India has raised foreign loans from a number of countries like USA,UK France former USSR, Germany, Japan etc., and international financial institutions like IMF, IBRD, IDA etc. Aggregate liabilities of GOI (which include internal debt

and external debt)rose from rs.19,193 crore at end-March 1971 to Rs.3,14,558 crore at end march 1991 and further to the high figure of Rs.15,61,876 crore at end march 2003. It was budgeted to increase to Rs. 17,80,064 crore by end march 2004.

The impact of public debt can be seen on consumption, production, distribution, investment, resource allocation and national income, liquidity, working of the money market etc., foreign loans also effect the economy.

"Crowding out" refers to the reduction in private expenditure on consumption and investment caused by an increase in government expenditure, which increases aggregate demand, and hence interest rates. The amount by which private expenditure fall with a given increase in government expenditure is called the *crowding out effect.* In economics, **crowding out** theoretically occurs when the government expands its borrowing to finance increased expenditure, or cuts taxes (i.e. is engaged in deficit spending), crowding out private sector investment by way of higher interest rates. There are three type of crowding out: (a) Physical crowding out occurs when the government demand for factors and inputs increases in the event of their inelastic supply. This raises their prices and makes private investment schemes unviable and unprofitable thereby reducing private expenditures, (b)Fiscal crowding out occurs when a rise in government expenditure from a budget deficit raises aggregate demand. Given a constant money supply, the interest rates rise. The simulative effect of government deficit (or expenditure) will crowd I\out in greater or lesser degree a certain amount of private investment, (c) Financial crowding out occurs when the government increases its expenditure and finances it by selling new bonds in the money market. When the government sells bonds, the prices of securities fall and interest rates rise. as a result, the private sector postpones or curtails some schemes because obtaining funds has become dearer. Thus the government expenditure crowds out private investment spending.

14.8 KEY WORDS

Internal Debt : Internal debt is owed to lenders within the country Internal debt in India includes (a) current market loans, (b) bonds, (c) Treasury Bills, (d)special floating and other loans, (e)Special securities issued to reserve Bank of India, (f)Ways and means Advances, (g) Securities against small savings, (h) Small savings,(i) Provident Funds, (j) Other accounts and (k) Reserve Funds and Deposits.

External Debt : Gross external debt, at any given time, is the outstanding amount of those actual current, and not contingent, liabilities that require payment(s) of principal and/or interest by the debtor at some point(s) in the future and that are owed to nonresidents by residents of an economy."

Crowding Out : The term crowding out" refers to the reduction in private expenditure on consumption and

investment caused by an increase in government expenditure, which increases aggregate demand, and hence interest rates. The amount by which private expenditure fall with a given increase in government expenditure is called the *crowding out effect.* In economics, **crowding out** theoretically occurs when the government expands its borrowing to finance increased expenditure, or cuts taxes (i.e. is engaged in deficit spending), **crowding out** private sector investment by way of higher interest rates.

14.9 SOME USEFUL BOOKS

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Musgrave Richard A (1977), *Essays in Fiscal Federalism*, Greenwood West Port.

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14.10 ANSWER/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) See Section 14.2

2) See Section 14.2

3) See Section 14.2

4) See Section 14.3

Check Your Progress 2

1) See Sub-section 14.4.1

2) See Sub-section 14.4.2

3) See Sub-section 14.4.3

4) See Sub-section 14.4.4

5) See Sub-section 14.4.5

6) See Section 14.5

Check Your Progress 3

1) See Section 14.6

2) See Section 14.6

14.11 EXERCISES

1) What are the sources of public debt? Explain.

2) What are the sources of public debt in India. Explain

3) What are the impacts of public debt on the economy? Explain in detail.

4) What is crowding out effect? Explain in detail giving the types of crowding out effect.