UNIT- IV

Public Debt: Meaning, Classification and Method of Redemption!

Meaning of Public Debt:

Modern governments need to borrow from different sources when current revenue falls short of public expenditures. Thus, public debt refers to loans incurred by the government to finance its activities when other sources of public income fail to meet the requirements. In this wider sense, the proceeds of such public borrowing constitute public income.

However, since debt has to be repaid along with interest from whom it is borrowed, it does not constitute income. Rather, it constitutes public expenditure. Public debt is incurred when the government floats loans and borrows either internally or externally from banks, individuals or countries or international loan-giving institutions.

What is true about public borrowing is that, like taxes, public borrowing is not a compulsory source of public income. The word **'compulsion'** is not applied to public borrowing except in certain exceptional cases of borrowing.

Classification of Public Debt:

The structure of public debt is not uniform in any country on account of factors such as categories of markets in which loans are floated, the conditions for repayment, the rate of interest offered on bonds, purposes of borrowing, etc.

In view of these differences in criteria, public debt is classified into various categories:

i. Internal and external debt

ii. Short term and long term loans

iii. Funded and unfunded debt

iv. Voluntary and compulsory loans

v. Redeemable and irredeemable debt

vi. Productive or reproductive and unproductive debt/deadweight debt

i. Internal and External Debt:

Sums owed to the citizens and institutions are called internal debt and sums owed to foreigners comprise the external debt. Internal debt refers to the government loans floated in the capital markets within the country. Such debt is subscribed by individuals and institutions of the country.

On the other hand, if a public loan is floated in the foreign capital markets, i.e., outside the country, by the government from foreign nationals, foreign governments, international financial institutions, it is called external debt.

ii. Short term and Long Term Loans:
Loans are classified according to the duration of loans taken. Most government debt is held in short term interest-bearing securities, such as Treasury Bills or Ways and Means Advances (WMA). Maturity period of Treasury bill is usually 90 days.

Government borrows money for such period from the central bank of the country to cover temporary deficits in the budget. Only for long term loans, government comes to the public. For development purposes, long period loans are raised by the government usually for a period exceeding five years or more.

iii. Funded and Unfunded or Floating Debt:
Funded debt is the loan repayable after a long period of time, usually more than a year. Thus, funded debt is long term debt. Further, since for the repayment of such debt government maintains a separate fund, the debt is called funded debt. Floating or unfunded loans are those which are repayable within a short period, usually less than a year.

It is unfunded because no separate fund is maintained by the government for the debt repayment. Since repayment of unfunded debt is made out of public revenue, it is referred to as a floating debt. Thus, unfunded debt is a short term debt.

iv. Voluntary and Compulsory Loans:
A democratic government raises loans for the nationals on a voluntary basis. Thus, loans given to the government by the people on their own will and ability are called voluntary loans. Normally, public debt, by nature, is voluntary. But during emergencies (e.g., war, natural calamities, etc.,) government may force the nationals to lend it. Such loans are called forced or compulsory loans.

v. Redeemable and Irredeemable Debt:
Redeemable public debt refers to that debt which the government promises to pay off at some future date. After the maturity period, the government pays the amount to the lenders. Thus, redeemable loans are called terminable loans.

In the case of irredeemable debt, government does not make any promise about the payment of the principal amount, although interest is paid regularly to the lenders. For the most obvious reasons, redeemable public debt is preferred. If irredeemable loans are taken by the government, the society will have to face the consequence of burden of perpetual debt.

vi. Productive (or Reproductive) and Unproductive (or Deadweight) Debt:

On the criteria of purposes of loans, public debt may be classified as productive or reproductive and unproductive or deadweight debt. Public debt is productive when it is used in income-earning enterprises. Or productive debt refers to that loan which is raised by the government for increasing the productive power of the economy.

A productive debt creates sufficient assets by which it is eventually repaid. If loans taken by the government are spent on the building of railways, development of mines and industries, irrigation works, education, etc., income of the government will increase ultimately.

Productive loans thus add to the total productive capacity of the country.

In the words of Findlay Shirras: "Productive or reproductive loans which are fully covered by assets of equal or greater value, the source of the interest is the income from the ownership of these as railways and irrigation works."

Public debt is unproductive when it is spent on purposes which do not yield any income to the government, e.g., refugee rehabilitation or famine relief work. Loans for financing war may be regarded as unproductive loans. Instead of creating any productive assets in the economy, unproductive loans do not add to the productive capacity of the economy. That is why unproductive debts are called deadweight debts.

Methods of Redemption of Public Debt:

Redemption of debt refers to the repayment of a public loan. Although public debt should be paid, debt redemption is desirable too. In order to save the government from bankruptcy and to raise the confidence of lenders, the government has to redeem its debts from time to time.

Sometimes, the government may resort to an extreme step, such as repudiation of debt. This extreme step is, of course, violation of the contract. Use of repudiation of debt by the government is economically unsound.

Here, instead of concentrating on the repudiation of debt, we discuss below other important methods for the retirement or redemption of public debt:

i. Refunding:

Refunding of debt implies issue of new bonds and securities for raising new loans in order to pay off the matured loans (i.e., old debts).

When the government uses this method of refunding, there is no liquidation of the money burden of public debt. Instead, the debt servicing (i.e., repayment of the interest along with the principal) burden gets accumulated on account of postponement of the debt- repayment to save future debt.

ii. Conversion:
By debt conversion we mean reduction of interest burden by converting old but high interest-bearing loans into new but low interest-bearing loans. This method tends to reduce the burden of interest on the taxpayers. As the government is enabled to reduce the burden of debt which falls, it is not required to raise huge revenue through taxes to service the debt.

Instead, the government can cut down the tax liability and provide relief to the taxpayers in the event of a reduction in the rate of interest payable on public debt. It is assumed that since most taxpayers are poor people while lenders are rich people, such conversion of public debt results in a less unequal distribution of income.

iii. Sinking Fund:
One of the best methods of redemption of public debt is sinking fund. It is the fund into which certain portion of revenue is put every year in such a way that it would be sufficient to pay off the debt from the fund at the time of maturity. In general, there are, in fact, two ways of crediting a portion of revenue to this fund.

The usual procedure is to deposit a certain (fixed) percentage of its annual income to the fund. Another procedure is to raise a new loan and credit the proceeds to the sinking fund. However, there are some reservations against the second method.

Dalton has opined that it is in the Tightness of things to accumulate sinking fund out of the current revenue of the government, not out of new loans. Although convenient, it is one of the slowest methods of redemption of debt. That is why capital levy as a form of debt repudiation is often recommended by economists.

iv. Capital Levy:
In times of war or emergencies, most governments follow the practice of raising money necessary for the redemption of the public debt by imposing a special tax on capital.

A capital levy is just like a wealth tax in as much as it is imposed on capital assets. This method has certain decisive advantages. Firstly, it enables a government to repay its (emergency) debt by collecting additional tax revenues from the rich people (i.e., people who have huge properties).

This then reduces consumption spending of these people and the severity of inflation is weakened. Secondly, progressive levy on capital helps to reduce inequalities in income and wealth. But it has certain clear-cut disadvantages too. Firstly, it hampers capital formation. Secondly, during normal time this method is not suggested.

v. Terminal Annuity:

It is something similar to sinking fund. Under this method, the government pays off its debt on the basis of terminal annuity. By using this method, the government pays off the debt in equal annual instalments.

This method enables government to reduce the burden of debt annually and at the time of maturity it is fully paid off. It is the method of redeeming debts in instalments since the government is not required to make one huge lump sum payment.

vi. Budget Surplus:

By making a surplus budget, the government can pay off its debt to the people. As a general rule, the government makes use of the budgetary surplus to buy back from the market its own bonds and securities. This method is of little use since modern governments resort to deficit budget. A surplus budget is usually not made.

vii. Additional Taxation:

Sometimes, the government imposes additional taxes on people to pay interest on public debt. By levying new taxes—both direct and indirect— the government can collect the necessary revenue so as to be able to pay off its old debt. Although an easier means of repudiation, this method has certain advantages since taxes have large distortionary effects.

viii. Compulsory Reduction in the Rate of Interest:

The government may pass an ordinance to reduce the rate of interest payable on its debt. This happens when the government suffers from financial crisis and when there is a huge deficit in its budget.

There are so many instances of such statutory reductions in the rate of interest. However, such practice is not followed under normal situations. Instead, the government is forced to adopt this method of debt repayment when situation so demands.

WHAT IS PERFORMANCE BUDGET?

Performance budget also referred to as performance-based budgeting is a practice of preparing the budget based on the evaluation of the productivity of the different operations in an organization. Operations which are contributing the most to the profitability, the larger share of the budget is allocated to that division. It leads to optimum utilization of resources such as finance, skills of the staff, use of the productive time etc.

Basically, performance budget requires an evaluation of the performance and productivity from one budget period to another budget period. Hence, it is the process of identifying the results achieved by each division of the organization.

Furthermore, performance budget does not focus on the individual activities which are necessary for developing strategies. Instead, the core focus is the achievement of the overall goal of the division. This helps the managers to frame the strategy of the division. Hence, performance budgeting is based on the concept of zero-based budgeting.

Generally, not for profit organization and the government departments use performance budget. It is used to justify the application of money. Not for profit and government earns through taxes levied on the citizens and lack of correct information may result in an ineffective performance budget which affects the entire project.

APPROACH

Performance Budget focuses on the **“results”**. The final outcome is analyzed. Performance budgeting is a motivating tool for the staff.

It asks the question that “Why the money is being spent?”

PROCESS OF PERFORMANCE-BASED BUDGETING

SET GOALS

The organization shall make the list of the goals. The goal here indicates the end result. The goals should be clear to each employee of the organization. Clear goal and communication of the same results into successful implementation of performance-based budgeting.

Thus, this step is planning and budgeting.

PERIODIC EVALUATIONS

The next step is the periodic evaluation of the performance to achieve the desired goals of the organization. The organization shall develop a systematic step by step approach for evaluation. Performance measurement is subjective which differs from person to person. Hence, the organization shall try to quantify the result based on the outcomes.

Thus, this step is a measurement of results.

Performance Indicators

Performance indicators help in evaluating the effectiveness and efficiency of the program. A performance indicator is a standard for measurement. The selection is based on the extent of the following:

- It’s relevance
- Cost-effectiveness
- Comparability
- Representative

ACCOUNTABILITY

The organization is going to be accountable for the result or outcomes. The primary focus of the performance budget is the outcome and not the inputs. Likewise, the staff is accountable for organizational goals. Besides, performance-based budgeting expects to achieve a level of results based on the given level of resources.

Thus, this step is called evaluation and communication of results.

PERFORMANCE-BASED VS TRADITIONAL BUDGET

The amount of money to be spent for the particular purpose for example on staff salary, office supplies, equipment etc. are included in the traditional budget. However, what is to be accomplished by each dollar spent is indicated by the performance budget. Previously, the organizations were not following the performance-based approach. However, currently, the organizations follow the performance-based approach.

EXAMPLE OF PERFORMANCE BUDGETING

1. 30% reduction in death ratio of HIV-Positive patients by the end of 2020.
2. 20% increase in production in 2018 by staff training on a monthly basis.
3. 50% reduction in infant mortality rate by implementing robust vaccination centers in all different parts of the country by 2022.

ADVANTAGES OF PERFORMANCE BUDGET

In the advanced world, the management of money becomes one of the important factors for any organization. The performance budget plays an important role to achieve efficiency.

SET ACCOUNTABILITY

In the public sector organization and not for profit organization, performance budget helps to increase the accountability. The employees have to quantify a particular goal based on the priority and the tax payer’s money. Unquestionably, taxpayer and the donors have interest in knowing where the money is spent. It evaluates the benefit accruing to the citizens and society.

CLEAR PURPOSE

Performance budgeting indicates clearly the objective on which the money is going to be spent. By making the purpose clear, it becomes easier to assess the performance and correct the deviations.

IMPROVEMENT IN PERFORMANCE

The performance budget improves the performance of the programs on a continuous basis. In addition to, it leads to the overall operational efficiency of the organization. Also, it overcomes the limitations of traditional budgeting.

TRANSPARENCY

Performance-based budgeting helps in bringing the transparency in the budget preparation. The performance budget helps in taking better financial decisions for the allocation of resources. It reviews the operational efficiency of the projects. Hence, one can say, it links the entire process of planning, implanting and evaluation of the results.

DISADVANTAGES OF PERFORMANCE BUDGET

SUBJECTIVE

Since the performance budget is subjective in nature, it creates disagreement amongst the management. Also, social projects are with a long-term vision. It is difficult to quantify in money terms. The costs may differ from one government body to another government body.

Therefore, The more use of result based approach helps in improvement of the budgetary process, accountability, and administration of the organization.

STRONG SYSTEM OF EVALUATION

The performance budget requires a strong system of accounting. Therefore, the reporting system has to be strong for its successful implementation.

MANIPULATION OF DATA

Staff may manipulate the data. Further, the calculation of the financial information is not reliable because of the errors in preparation.

Therefore, Proper internal control system helps in maintaining the accuracy of the data.

DIFFICULT FOR LONG-TERM

The time period between the allocation of resources in the project and the achievement of the result might be more than a year. Undoubtedly, it makes difficult to measure the results of the projects in long-term.

Therefore, dividing the project into small parts may help in simplifying the evaluation process.

Without a doubt, over a period of time Performance Budget became popular overall in the industry.

Source: https://efinancemanagement.com/

What is zero-based budgeting?

As the name says "Zero-based budgeting" is an approach to plan and prepare the budget from the scratch. Zero-based budgeting starts from zero, rather than a traditional budget that is based on previous budgets.

With this budgeting approach, you need to justify each and every expense before adding it to the actual budget. The primary objective of zero-based budgeting is the reduction of unnecessary cost by looking at where costs can be cut.

To create a zero base budget involvement of the employees is required. You can ask your employees what kind of expenses the business will have to bear and figure out where you can control such expenses. If a particular expense fails to benefit the business, the same should be axed from the budget.

Differences between Traditional Budgeting and Zero Base Budgeting

- In traditional Budgeting, the previous year's budget is taken as a base for the preparation of a budget. Whereas, each time the budget under zero-based budgeting is created, the activities are re-evaluated and thus started from scratch.
- The emphasis of the traditional budgeting is on the previous expenditure level. On the contrary, zero-based budgeting focuses on forming a new economic proposal, whenever the budget is set.
- Traditional Budgeting works on cost accounting principle, thereby, it is more accounting oriented. Whereas the zero-based budgeting is decision oriented.
- In the traditional budgeting, justification of the line items and expenses are not at all required. On the other hand, in zero-based budgeting, proper justification is required, taking into account the cost and benefit.
- In traditional budgeting, the top management take decisions regarding any amount that will be spent on a particular product. In contrast, in zero-based budgeting, the decision regarding the spending a specific sum on a particular product is on the managers.
- Zero-based budgeting is better than traditional budgeting when it comes to clarity and responsiveness.
- Traditional budgeting follows a monotonous approach. On the contrary, zero-based budgeting follows a straightforward approach.

What are the steps to create a Zero based budget?

- Identifying the decision units that need a justification for every line item of expenditure in the proposed budget.
- Preparing Decision Packages*. Each decision package is an identifiable and separate activity. These decision packages are connected with the objectives of the company.
- The next step in ZBB is to rank the decision packages. This ranking is done on the basis of cost-benefit analysis.
- Finally, funds are allocated on the basis of the above findings by following a pyramid ranking system to ensure maximum results.

*Decision packages mean self-contained proposals or module seeking funds. Each decision package comprises the explanation of the activity, the amount involved, the need for the item, the benefit arising from the implementation of the proposal, the expected loss that may be incurred if it is not done and much more..

Zero Based Budgeting Advantages

- **Efficiency:** Zero-based Budgeting helps a business in the allocation of resources efficiently (department-wise) as it does not look at the previous budget numbers, instead looks at the actual numbers
- **Accuracy:** Against the traditional budgeting method that involves mere some arbitrary changes to the earlier budget, this budgeting approach makes all departments relook every item of the cash flow and compute their operation costs. This methodology helps in cost reduction to a certain extent as it gives a true picture of costs against the desired performance.
- **Budget inflation:** As mentioned above every expense is to be justified. Zero-based budget compensates the weakness of incremental budgeting of budget inflation.
- **Coordination and Communication:** Zero-based budgeting provides better coordination and communication within the department and motivation to employees by involving them in decision-making.
- **Reduction in redundant activities:** This approach leads to identify optimum opportunities and more cost-efficient ways of doing things by eliminating all the redundant or unproductive activities

Although this concept is a lucrative method of budgeting, it is also important to know the disadvantages as listed below:

Zero Based Budgeting Disadvantages

- **High Manpower Turnover:** The foundation of zero-based budgeting itself is a zero. Budget under this concept is planned and prepared from the scratch and require the involvement of a large number of employees. Many departments may not have adequate human resource and time for the same.
- **Time-Consuming:** This Zero-based budgeting approach is a highly time-intensive for a company to do annually as against incremental budgeting approach, which is a far easier method.
- **Lack of Expertise:** Providing an explanation for every line item and every cost is a problematic task and requires training for the managers.

Conclusion

Zero-based budgeting targets at presenting true expenses to be incurred by a department. Although this budgeting method is time-consuming, this is a more appropriate way of budgeting. This includes all-inclusive analysis of the budget proposal and if the managers make irrelevant variations so as to achieve what they want, they are probably exposed.

Source: https://cleartax.in/s/zero-based-budgeting