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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:

1. 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.

2. 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.

3. Terminable Annuities:

When it is intended completely to wipe off a permanent debt, it may be arranged to pay the creditors a certain fixed amount for a number of years. These annual payments are called annuities. It will appear that, during the time these annuities are being paid, there will be much greater strain on the government finances than when only interest has to be paid.

4. Purchase of Government Bonds:

The government may buy its own stock in the market, thus wiping off its obligation to that extent. This may be done by the application of surplus revenues or by borrowing at low rates, if the conditions are favourable.

5. 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.

6. 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.

7. Utilization of Surplus Revenue:

This is an old method and badly out of tune with the modern conditions. Budget surplus is not a common phenomenon. Even when there is a surplus, it is so insignificant that it cannot be used for making any substantial reduction in the public debt.

8. 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.

9. 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.