Public Economics

Topic: Public Debt

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Debt

Debt is an obligation or liability that arises when one party, typically an individual, business, or government, borrows money or receives goods or services with a promise to repay or return them in the future.

Debt usually involves an agreement to pay back the borrowed amount along with interest or other fees over a specified period

How Debt Works

The most common forms of debt are loans, including mortgages, auto loans, and personal loans, as well as Credit Cards.

An Example of Debt

When students take out federal student loans to pay for college, they will receive a certain sum of money that they agree to pay back in the future with interest.

Classical view of public debt

The classical economists, who dominated economic thought from the 18th to early 19th centuries, generally held a negative view of public debt. They believed that government borrowing had several drawbacks:

Burden on future generations:

They saw debt as a burden on future generations, who would have to pay taxes to repay the principal and interest on the debt.

This would limit their resources and hinder economic growth.

Reduced investment:

They argued that government borrowing crowded out private investment.

When the government borrows money, it competes with businesses and individuals for loanable funds.

This can drive up interest rates, making it more expensive for businesses to borrow money to invest.

Inflation:

Classical economists also believed that government borrowing could lead to inflation.

If the government prints money to finance its debt, it can increase the money supply in the economy.

This can lead to higher prices for goods

Unproductive spending:

They believed that government spending was often wasteful and unproductive.

They favored a limited role for government and believed that the private sector was more efficient at allocating resources.

. For example; government borrowed money to finance productive investments, such as infrastructure or education, it could lead to future economic growth and higher tax revenues.

Sources of public debt

Governments borrow money to cover spending needs when their income from taxes and other sources falls short. There are two main categories for the sources of this public debt

Internal Debt:

This is money borrowed from sources within the country. Here are some common ways governments raise internal debt:

Selling bonds and treasury bills:

These are essentially IOUs issued by the government.

Individuals, banks, and other financial institutions can buy these bonds, essentially loaning the government money.

The government promises to repay the principal amount borrowed plus interest at a set rate over a specific timeframe

Loans from banks and financial institutions:

Governments can borrow directly from banks and other financial institutions.

Central bank advances:

In some countries, the central bank may provide short-term loans to the government.

External Debt:

This is money borrowed from sources outside the country. Here are some common ways governments raise external debt:

International organizations:

Organizations like the World Bank or International Monetary Fund (IMF) can lend money to governments.

Issuing bonds in foreign markets:

Governments can sell bonds to investors in other countries.

The specific mix of internal and external debt a government uses will vary depending on a number of factors, such as interest rates, economic conditions, and political considerations.

Thank you