

# INFLATION & ECONOMIC GROWTH

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"People must come to accept private enterprise not as a necessary evil but as an affirmative good."

Eugene Black

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H. V. R. Iengar I.C.S. (Retd.)\*

It has, unfortunately, become a cliché to say that we are now passing through a crisis. Our history in the last twenty-six years as an independent nation has been characterised by one crisis after another, so much so that the country seems to have acquired some kind of immunity against the disease called crisis. But, on any standard, it would be factually correct to say, without getting involved in semantic niceties, that the times through which we have passed during the last eighteen months have been characterised by strains of exceptional severity particularly in the economic field. It has been a period not merely of high and rising prices, but of grave shortages, shortages not merely of foodgrains, of kerosene, and of cooking oil, which are the daily necessities of the common man, but also of cement, steel, and electric power which are the basic essentials of industrial growth. How to deal with this problem, the pressures of which have been particularly severe on the common man, has been the main preoccupation before the country. The good crops which we have been looking forward to during the current kharif season, and the prospective good crop during the forthcoming rabi season, will give us a temporary respite in the matter of shortages of foodgrains, but this will be only a temporary respite. The problem of inflation will continue to remain with us and will indeed get severely aggravated, unless we take energetic steps to halt the process.

I do not propose to enter into any discussion of what may be called the technicalities of the problem of inflation. I

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\* This is the text of the inaugural address to a seminar on inflation organised by the Institute for Financial Management and Research, Madras, on 14th December 1973. Mr. Iengar, Chairman of the Board of Governors of the Institute, is a former Governor of the Reserve Bank of India.

start with the assumption, which is universally accepted in India, that the present inflation is due to an enormous increase in money supply coinciding with an inadequate increase if not a drop in production in both the agricultural and the industrial sectors. The solution lies partly in a reduction in the money-supply and simultaneously in an increase in production.

Let me take the first point, to start with, namely, the problem of how to effect a reduction in the money-supply. The classic argument of Government is that deflation is out of the question; on the contrary, a vast increase in outlay in the government sector is contemplated during the Fifth Plan period. In Government's view, every item of expenditure in the budget is inescapable. This, they say, is true of Defence expenditure; this, they say, is also true of expenditure on fertiliser plants and steel production. This, again, they say, is true of the expenditure both on the import of crude oil as well as on the exploration of oil. The expenditure on the maintenance of law and order is, of course, an inescapable necessity. Indeed, if I were to be an apologist for Government, I would point out that there is not one single item of expenditure in the budget about which it could not be argued that it is essential for furthering the country's economy. This, of course, is not necessarily true in all cases. For instance, even in the matter of Defence expenditure which is treated as something esoteric, if not actually, holy, it is possible to take a second look at our strategic responsibilities and to come to the conclusion that, having regard to the present international situation, it is not essential, at any rate during the next four or five years, to go in for increasing sophisticated weaponry. Such weaponry is likely to be extremely expensive. But assuming for the moment that all the items of expenditure included in the budget are inescapable, I make the point that I am by no means satisfied that we are getting good value for the expenditure that we are incurring. I speak, in particular, of expenditure by Government because it is the rapid increase in Government expenditure financed in alarmingly increasing proportions by Bank credit that is largely responsible for the increase in money-supply. Our administration has,

over the years, become so increasingly incompetent and corrupt that it would be no exaggeration to say that a good percentage of the Government expenditure in many departments—some say as high as 40 per cent—just goes down the drain. Our development strategy has hitherto consisted in providing financial resources for our projects and examining the extent to which financial expenditure has been made. It is true that targets are put out in physical terms but the emphasis is primarily financial. The picture would be substantially different if we looked at the development strategy from the point of view of the resources provided in physical terms and the results also in physical terms. In the case, for instance, of an irrigation project, the planning strategy should consist not merely in terms of the provision of x-crores for the project, but provide for the construction of a dam with a defined storage capacity, of canals with a defined flow of water, and of subsidiary channels with a defined supply of water to the fields, all within a defined timespan. In the case of a power project, the plan should not merely provide funds for the setting up of power stations, it should provide in physical terms for a defined generating capacity and, what is more important, the assessment should be in terms of actual generation of electric power. It is well known that the power crisis through which the country has been passing is not entirely due to the failure of the monsoon in the catchment areas of storage reservoirs; it is equally, if not more, due to operational inefficiencies in our thermal plants some of which are generating less than half their rated capacity. The physical target should also provide for a ceiling on transmission losses.

There is far too much sloppiness in the functioning of Government departments. It was stated the other day by the Minister in charge of Civil Aviation that out of 29 countries the staff of the Indian Airlines Corporation is the second highest in terms of wages but the lowest in terms of productivity. This is true not merely of the Airlines Corporation but in all offices generally, where sloppiness is becoming increasingly notorious. A Chief Minister of U.P. once complained publicly that the staff in government offices in his state did no more than two-and-a-half hours

of work per day. That is probably true of most States. Except for a few senior officers and a few dedicated workers at other levels, there is far too great a tendency in government offices and nationalised undertakings to think that it does not matter if files are sat upon for months together. There is no feeling that the personnel are engaged in a job of work for the country, no sense of purpose, urgency, or dedication. This is in sharp contrast to what is happening to-day in China. A Captain of a British steamer which unloaded wheat recently at a Chinese port was in Madras recently and contrasted the performance of Chinese dock labour with that of dock labour in India. He said that in China not a single grain of wheat is allowed to be wasted in the process of unloading. In India, on the other hand, there is so much sloppiness and pilferage that the wastage is inexcusable.

I have hitherto been talking about attitudes in government offices and nationalised undertakings. I would not like it to be supposed that I am not unaware of the fact that even in the private sector, by and large, there are similar "leakages" and inefficiencies. From the point of view of the country's economy, particularly in the context of inflation, it makes no difference whether the diversion of resources intended for a project takes place in the public sector or in the private sector. The only difference between the two sectors is that a private sector project will perish if it cannot make a profit, whereas a public sector project can survive for long periods of time even if it incurs losses year after year. This compulsion acts as a restraining factor in limiting the extent of diversion in the private sector. Otherwise, the same human weaknesses, the same lack of what may be called a sense of social purpose, come into play.

These weaknesses show themselves in a variety of ways of which the most revolting and potentially the most dangerous is the lavishness of expenditure in styles of personal living, particularly on occasions such as marriages. It is just not right that while millions starve, a few should gorge themselves. The economic consequence of an absence of austerity in personal living is a reduction in savings which

would otherwise be available for worthwhile expenditure of general social benefit.

All this, namely the absence of a sense of dedication, the incapacity to put in a real hard day's work, the feeling of complete indifference to wider social interests, aggravates the problem of inflation on two counts. First of all, it slows down the productive process; and secondly, because of corruption, it involves the diversion of funds meant for productive purposes to illegitimate consumption channels. I consider that from the point of view of inflation this is one of the most serious problems before the country, namely the growing deterioration in the field of administration and a general and growing slackness in discipline in the country. One of the gravest mistakes which successive governments in our country have committed is not to pay adequate attention to this problem of growing laxity in administration. It is true that we set up an Administrative Reforms Commission, but the reports of that Commission are lying in the limbo of government records so far as the public is aware. And, in any case, while they dealt with forms and procedures, they did not go to the matter which, in my considered judgment, lies in the absence of a dedicated moral leadership.

What is fundamentally the reason for this? Power in our country rests with the politicians who are elected on the basis of adult franchise. With some few exceptions, the politicians have become a byword for a craze for power and, in many cases, for the abuse of their official authority for personal gains. It is considered of paramount importance that a party in power should get re-elected. It is, of course, part of human nature, in all countries, and not merely in India, that political parties like to be re-elected. But there are codes of conduct as to what is permissible in democratic countries. In India everything is fair as in love or war. It is known, for example, that the ceilings fixed for election expenditure are systematically exceeded, but, beyond a case here and a case there, no action is ever taken. Elections have become exceedingly costly and the only way of financing them is through political parties acquiring money from those who are able and willing to

pay. Unfortunately, the present law prevents business houses from giving donations to political parties. So the only way in which politicians can get funds for election is through acquiring black money. The greatest single cause for the proliferation of black money is the hunger of the politicians to get re-elected and the hunger of the businessman to ingratiate himself into favour. The increasing controls over our life have provided a great opportunity for both corrupt politicians and the corrupt businessman. Thus, the whole atmosphere gets fouled and it requires very strong character on the part of the officials not to follow the same standards as their political masters. It is a regrettable feature of administration today that corruption has come to be regarded as just a way of life.

I am not suggesting for a moment that political corruption is peculiar to India. It exists, as the Prime Minister recently remarked, in greater or lesser degree, in most countries of the world. As we know from recent events, it exists to an astonishing extent in the USA. But the point is that in many of these countries the economies are relatively though not of course, absolutely free of government controls and thus have momentum of their own. It is this absence of rigid government controls that enables the USA economy, for example, to move forward and thus not merely increase its G.N.P., but to reduce the disparities of income and other social injustices between the rich and the poor. In India, on the other hand, the state is acquiring an increasing strangle-hold on economic activities and therefore the damage to the economy as a result of corruption and inefficiency is so much greater.

Although the honest officials and the honest politicians are in a minority, they are still, I believe, a substantial minority and it is not too late to reverse the present process. It has to be remembered in this context that the situation in China before the Communist revolution was no better than it is today in India; it was probably very much worse. Nevertheless, the Chinese have succeeded, so far as one can judge from reports of travellers, in eradicating corruption and in infusing people at various levels with a sense of purpose and dedication. I do not believe that this is due to



Communism, but to dedicated leadership and the setting of high examples at the top level. I am convinced that if this could be done, there is still hope for reversing the present trends.

In the matter of discipline, the stakes from the point of view of inflation are particularly high so far as the central and state governments are concerned. The problem for the central government is how to exercise restraint in their undoubtedly sovereign right to print currency notes, in other words, the problem is one of exercising self-discipline in the matter of deficit financing. In another context, I had suggested that, in order to ensure that the maximum restraint is exercised in this matter, the central government should introduce a procedural limitation on themselves by specifically consulting the Reserve Bank of India when it was proposed to go beyond a ceiling indicated in specific terms in the budget proposals, and where the Reserve Bank did not agree, to place the disagreement before Parliament so that there could be a specific discussion on the subject. I regret that this reform which is more important than merely procedural has been turned down by the Finance Minister on the ground that in any case the budget and supplementary budgets are placed before Parliament. My point is that specific reference to the extent of deficit financing is not placed before Parliament as an item which could be independently discussed and that proposals for supplementary taxation, whether in the form of direct taxes or, what is more frequent, though additions to excise duties which governments can make under powers vested in them, do not enable a discussion to be made on the specific issue of deficit financing. I suggest that it is important that this is done. It is not merely a question of self-discipline; there is an additional advantage that Parliament becomes a party to the final decision that is taken. There is all too frequently a disposition on the part of the opposition members to criticise government for increasing taxation or for not making adequate provision for this item and that. It is important that they should realise the implications of the criticisms they make about reducing taxation or increasing additional expenditure.

It is not merely the central government that is involved in deficit financing. More and more, in recent years, there has been a tendency on the part of the state governments to indulge in unauthorised overdrafts on the Reserve Bank well beyond the limits for overdrafts agreed upon between them and the Bank. The sums involved have become very substantial indeed. There is a process by which this dust is pushed under the rug, as it were, because on the last date of the financial year for the Bank the central government takes advances from the Bank and formally lends them to the state governments to cover the unauthorised overdrafts. But the moment the new year starts, the whole sorry process starts again. I am aware that the dimensions of this problem have somewhat been reduced in the last year or two. Nevertheless, the problem does exist and these unauthorised overdrafts add seriously to the inflationary pressures in the economy.

This decline in the standards of public administration which, as I have said above, is aggravating the inflationary situation both by the slowing down of the productive processes and by the diversion of expenditure from capital projects to illegitimate consumption channels has been commented on in very strong terms not only by opposition parties which may be said to have a vested interest in opposing government right or wrong, but by two respected Presidents of India, namely, Dr. Radhakrishnan and Dr. Giri as well as by the first Vigilance Commissioner of the Government of India. Their criticism of the public moral situation in our current political affairs has been couched in very strong language. From time to time criticism has also been made by that noted public servant of whom no one can suggest that he has any personal axe to grind, viz., Mr. Jayaprakash Narayan. In a recent article entitled, "The Problem of Self-renewal in Bihar", he has asked himself the question as to why Bihar which for nearly a thousand years in history was in the vanguard of progress in all fields has now sunk to the lowest possible level. There was a time, he has pointed out, when Pataliputra was one of the most gracious, cultured, and prosperous cities of the then civilised world and today Patna is one of the dirtiest cities in India. He has

also asked himself the question as to why Bihar has become the most corrupt state in India. "From the days of Janaka and Yagnavalkya, Bihar has had the highest moral leadership, but today," comments Jayaprakash Narayan, "for corruption and immorality in political, administrative, business, educational, medical, legal and other fields, Bihar has no equal in the country." The difference between Bihar and other states is merely one of degree. Mr. Jayaprakash Narayan does not end on a pessimistic note. He says, "Optimism has not forsaken me yet. Whenever the regeneration sets in, its impulse will certainly not come from politics — the opposition parties have not proved to be better during the chance they had from 1967 to 1971 — but it will come from the people, from the youth perhaps and from those humble men and women who are engaged now, and who will be engaged later, in selfless service of the people. There is no doubt, much dross in them too, but the discipline of suffering and service, their philosophy of truth, love and compassion, I feel, will wash away the dross, leaving behind the pure metal. How soon will this happen? I do not know, but I know that it will happen. The land of Janaka, Yagnavalkya, Mahavir and Buddha cannot sleep for ever. It is bound to awaken and discover itself anew." I profoundly hope that Jayaprakash Narayan is correct in his prognosis.

## II

I now turn to the second part of my thesis, viz. that as a solution to the problem of inflation, it is vitally important that production is increased not merely in agriculture but also in industry. From the practical point of view, an increase in production is more easily attained, in present circumstances, than a deflation of money supply. I will first deal with the problem of the increase in agricultural production because this forms almost 50 per cent of our total national income.

There seems to be a feeling of complacency that because we had a good monsoon this year we have turned the corner. The fact is that we have turned the corner only for the time being. A study made by the National Council of

Applied Economic Research on the prospects of food supply in India in relation to the projected demand by 1980-81 indicates, on the basis of numerous assumptions, that at that period of time there is no reason to anticipate that the country will not be able to feed itself at current standards even taking the projected increase in population into account. But assuming that this conclusion is a realistic one, all the indications are that before that period we will have several droughts in the country of varying intensity. Studies have been published from time to time by successive Directors-General of Meteorology in India. These studies, the latest of which is in a paper presented by Dr. Koteswaran, Director-General of Observatories, in March 1973, are consistent in one conclusion, namely that while it is not possible, even with the present sophisticated data available with the assistance of weather satellites, to say in what year a drought will occur or how severe it will be when it does occur, we must be prepared to face droughts on the average of once in so many years in different parts of the country. Dr. Koteswaran has said, "the approximate probability of deficient rainfall (deficiency equal to or greater than 25 per cent of the normal) during the monsoon in the various meteorological sub-divisions is as follows:—

Meteorological sub-division	Recurrence period of highly deficient rainfall
Assam ...	Very rare, once in 15 years.
West Bengal, Madhya Pradesh, Konkan, coastal Andhra Pradesh, Madhya Maharashtra, Kerala, Bihar, Orissa. ...	Once in 5 years.
Southern interior Mysore, eastern Uttar Pradesh, Vidarbha. ...	Once in 4 years.
Gujarat, eastern Rajasthan, western Uttar Pradesh, Tamil Nadu, Kashmir, Rayalaseema, Telengana. ...	Once in 3 years.
Western Rajasthan. ...	Once in 2.5 years.

This shows that every part of India outside Assam and the adjacent States faces the probability of a drought at least once in 5 years and some regions like Gujarat, Rajasthan, Rayalaseema and Telengana are liable to drought conditions once in about 3 years.”

A solution of this problem of recurrent droughts is (a) a substantial buffer stock of foodgrains and (b) a well-organised distribution system which can function honestly and efficiently. There is unfortunately reason to think that on both grounds, unless there is a change in attitude, we are likely to fail. The buffer stock of 9 million tonnes which we had over a year ago was rapidly dissipated and the attempt to recreate a buffer stock of wheat failed dismally because of an ill-conceived project for a government take-over in the wholesale trade for wheat. Let me make it clear that I am not, in principle, opposed to a State take-over of the wholesale trade in a primary commodity. That has been done even in so-called capitalist countries. But the problems in India, with its millions of small producers, are administratively highly complex and the success of such a scheme requires a machinery which has both expertise and integrity. This is lacking in India. What should cause greater concern is the absence of integrity and efficiency in the distributive system. The number of ghost ration cards is enormous. According to some press reports, the number of ration cards in Patna is six times the total population of that city. The proportion may vary from city to city, but there is no doubt that the number of ghost ration cards throughout the country is alarmingly high. This indicates a lack of social conscience on the part of the citizens themselves, a moral failure on the part of traders, and these failures would not be possible if the administration was less corrupt and incompetent. I recall in this context that in 1947, when we had food controls in India, Mahatma Gandhi was so revolted by the extent of corruption in the food administration that in prayer meeting after prayer meeting he went on declaring that food controls should be abolished, and so they were, early in 1948. Unfortunately, that decision was taken at a time when there was shortage in the country with the consequence that prices further mounted

up. But that is another story. The point that I seek to emphasize now is that whatever may be our long-term prospects, we must be prepared for recurring droughts and therefore for recurrent shortages in foodgrains production and that the administrative machinery engaged in food distribution must be so geared as to operate both efficiently and honestly. If this does not happen, we will sink lower and lower, with consequences which I would not like to imagine.

On the industrial side, it is recognised by government themselves that the present situation is gloomy in the sense that there has been very inadequate investment in sensitive fields such as fertiliser. We have, of course, difficulties such as shortage of power which is likely to continue over the next few years, and shortages of industrial raw material. But the most important aspect of the current industrial stagnation is the stance of government which is conditioned by irrational ideologies. In the discussions during the last few years and even as recently as a couple of weeks ago, reference has been made to monopoly houses and the need for curbing monopoly houses. Surely there is a difference between big houses and monopoly houses? In the course of the evidence given before the Monopolies Commission set up a few years ago by the Government of India themselves, big industrialist after big industrialist accepted the position that monopolist practices should be severely curbed. But they pleaded that bigness of size as such, if it was not accompanied by monopolistic practices, should not be discouraged. This view was accepted by the majority of the Commission, but in the legislation that was enacted there has been a studied attempt to attack big houses as such, whether they indulge in monopolistic practices or not. I am not saying for a moment that all big business houses consist of angels. Quite a few of them indulge in clearly anti-social practices, but surely there is enough legal authority in the country to deal with such practices? Actually what is happening is a collusion between the politicians and the corrupt business houses for contributions to election funds, with the result that good business houses of repute are denied, on false ideological grounds, the opportunity to expand and diversify.

One of the serious restraints on industrial production is the sad state of industrial relations in the country. Strikes take place all over the place and quite often these have no relation to genuine industrial disputes. They are often motivated, instead, by political considerations, because the leadership of the unions is highly politicalised. Unfortunately, we have several different groups which have considered it expedient to get the support of labour. I am all in favour of genuine trade unions and, when the occasion demands it, I am not averse to strikes and lock-outs. But these should not be resorted to except as the final weapon. Both the President of India who has been a trade union leader for many generations, and the Prime Minister have recently made strong appeals to the trade unions to impose on themselves a moratorium on strikes and have similarly made an appeal to the managements to impose a moratorium on lock-outs but evidently these appeals, although emanating from the highest in the land, have gone unheeded. One would have supposed they would have been heeded at least in public sector projects. The philosophy underlying nationalisation is that the workers get a feeling that their activities are not directed towards enriching the private capitalists, but help in furthering the country's economic progress. In practice, however, such a philosophy had made no appeal to workers in public sector undertakings and repeatedly strikes take place under conditions which hold the entire country to ransom. It is astonishing but nevertheless true that these take place even where wages are extremely high. There are, for example, undertakings where sweepers are paid wages which take them well above the minimum income tax bracket. I am delighted that this should happen, but it is not the case that such enterprises where emoluments are so high are not free from labour troubles. Indeed, it is not the case at all that high wages result in good industrial relations. How this problem has to be tackled has been dealt with in the report of the National Commission on Labour and there is other voluminous literature on the subject. What is basically required is a self-denying ordinance by political parties that they let the trade unions operate as genuine trade unions and not as pawns in the political game.

During a recent lecture by Sir Arthur Lewis, the eminent economist from the West Indies, he pointed out that the prime task today for a developing country was to eliminate the road-blocks to sustained economic growth. I hope that his advice will be taken to heart by Government as well as by the private sector of business. We have all the necessary qualities in our country for sustained economic growth, namely, intelligence, a capacity to acquire skills, a capacity to do hard work, given the right motivation, but the only element which is lacking in both public and private sectors is great moral leadership which will forge these qualities into an effective weapon against the scourge of poverty. If such leadership is not forthcoming, there is little hope that we will be able to prevent inflation from leading us down the slippery path.



## A P P E N D I X

# KEYNES & INFLATION

The recent publication of four volumes of Lord Keynes' private papers prompts again a question frequently heard during the last few years of frighteningly rapid inflation throughout the Western economies. Faced with this situation, what would Keynes have prescribed? Would he, as is not unlikely, have suggested an entirely novel, but effective, remedy, one which has so far eluded the combined intelligences of governments and their economic advisers?

On the record, it would not be beyond his powers. Keynes was, after all, an intellectual prodigy. No single human being has had as great an influence on the economies of the modern world as this man of incomparable genius. He transformed our way of thinking about economics, so much so that standards of living in the Western economies have trebled in the short space of thirty years and serious chronic unemployment is no longer feared. His influence on his fellow economists and on many politicians was so profound that not to be a Keynesian was to put oneself among the company of the damned. Even President Nixon announced recently, although somewhat belatedly, "I am now a Keynesian."

It, was however, always to be doubted whether Keynes himself was a "Keynesian" in the sense that many of his followers continue to attach to the word. With the kind of uncanny prescience that was almost normal to him, he once said: "Twenty years hence governments and treasury officials will still be talking about and applying my doctrines but by that time they will have ceased to be relevant".

How would Keynes have viewed the current inflation? He would certainly not have looked at it with a complacent, tolerant eye. A prominent, American economist, Seymour

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\* An excerpt from an editorial in April/June 1973 "IPA Review" published by the Institute of Public Affairs, Australia.

Harris, has said that in his book, "The Economic Consequences of the Peace", Keynes had written the most powerful indictment of inflation that had ever been penned.

Although his name is frequently associated with inflationary economics, Keynes was, in truth, a fierce opponent of inflation. His feelings about inflation come through at many places in his writings. His main objection to inflation was that it affects quite arbitrarily, and unfairly, the distribution of income and wealth. "A change in prices and rewards, as measured in money, affects different classes unequally, transferring wealth from one to another, bestows affluence here and embarrassment there, and redistributes Fortune's favours so as to frustrate design and disappoint expectation."

He also argued that while the depreciation of money is often a source of gain to the businessman, it tends to discredit private enterprise in the eyes of the community. "To the consumer the businessman's exceptional profits appear as the cause instead of the consequence of the hated rise of prices." He points out the bad and distorting effects of inflation on the psychology and activities of the business community. "He (the businessman) loses his conservative instincts and begins to think more of the large gains of the moment than of the lesser, but permanent profits of normal business".

What, then, would he have been saying about today's world? In spite of his immense intellectual virtuosity, and his love of splitting theoretical hairs with his contemporaries, perhaps Keynes' greatest quality was his massive common sense. He was above all a pragmatist. Unlike the great majority of his fellow economists, Keynes was no cloistered scholar. His main concern was with practical economic problems and in finding workable solutions for them. Indeed, the central proposal that emerges from his most famous and extraordinarily frustrating book, "The General Theory of Employment, Interest and Money" was, paradoxically, a simple, and today an obvious, one: namely, that governments should stimulate and maintain total demand at the level where productive resources, especially of

manpower, are fully employed. Indeed, in the light of hindsight one cannot help wondering whether the theoretical structure of "The General Theory" is all that important. It seems almost as if Keynes, after having decided what was necessary in terms of practical policy, then constructed an intricate and coherent theoretical framework to support it. He once wrote of his own book, "I am in the stage of not liking my book very much. It all seems very angry and much ado about a matter much simpler than I make it appear".

The nagging question recurs. What would the master economist have prescribed for our present economic ills? Having himself, in a sense, created the breeding ground of the modern disease of chronic inflation, what would he have done to cure it?

There is an element of superb intellectual arrogance in any one attempting to put himself in the shoes of the master, but speculation will go on none the less. Might it not be argued that what Keynes proposed in conditions of under-employment and deflation should be reversed to meet the entirely opposite situation of over-full employment and inflation. The essence of the Keynesian remedy for unemployment lay in increased government spending on capital works. Since 1945 most Western governments have followed this advice very effectively —perhaps too much so. The most striking phenomenon of today's Western economies is not merely the large part occupied by government spending (compared with pre-1939), but the steady, almost year by year, expanding claim on resources made by the public sector. This is true of virtually all the Western countries. It would be very easy, therefore, and on the face of it logical, to deduce that in a climate of chronic inflation, the Keynesian remedy for deflation should be turned upside down: that is, the way to remedy inflation is to reduce government spending. Keynes indeed attributed the historic deterioration in the value of money to the "impecuniosity of governments". In other words, he contended that the seat of the trouble was to be found in government spending.

Most economists — and no doubt practically all who would regard themselves as Keynesians — have, however, persisted in arguing that it is quite in order to expand the claims of the public sector on resources so long as those of the private sector are correspondingly reduced. The reduction is effected mainly through taxes and the charges of government instrumentalities which can, in the result, be the same thing as taxes. This, of course, is what has been attempted in the economic policies of the Western countries over the last quarter of a century, but inflation has persisted none the less. Where, then, is the flaw? Perhaps it lies in an over-simplification of the essential Keynesian message.

In an historic pamphlet, "How to Pay for the War", Keynes introduced a concept which he called "the inflationary gap". It soon became a part of common economic parlance, perhaps without any clear insight into what Keynes meant. The concept came to be regarded by some as the simple deficit on government transactions — that is, the difference between total government expenditure and receipts from all sources. Others, perhaps more sophisticatedly, took the inflationary gap to mean the discrepancy between total demand and total supplies. Keynes, however, seemed to have in mind something rather more subtle. The phrase was used for the first time in an official document in April, 1941 in the British Budget Speech on which Keynes is said to have had a great influence. The gap is defined in the Speech as, "The amount of the government's expenditure against which there is no corresponding release of real resources or materials by some other member of the community." For "some other member of the Community" we may read "the private sector".

This definition of the inflationary gap may throw some light on our current dilemmas. Where Government expenditure has already reached a high level it becomes difficult, if not impossible, to balance a further increase with an equivalent reduction in the claims of the private sector. Keynes used to place a great deal of emphasis on the powerful propensity to consume to which human nature is heir. He said that people develop an habitual standard of consumption

that they will not readily forgo and will, indeed, fight tooth and nail to maintain. It would follow that if government policies are directed at lowering this standard — or even curbing its rate of improvement below what, in “the affluent society”, people have come to expect—the consumer will take his own reprisals. Beyond a certain point he will not willingly surrender claims on resources to the government and, what is much more important, he cannot altogether be compelled to do so. If taxes or government charges are raised so that his disposable income is reduced, the consumer will seek ways of frustrating the Government’s intentions, mainly by demanding a higher income, but also by borrowing more or running down his savings.

This reaction is much more apposite today than when Keynes was writing, because of pay-as-you earn taxation and because people generally have more ambitious expectations. With p.a.y.e. the effect of any increase in taxes becomes immediately and painfully apparent to the income receiver.

A rise in wages which has its seeds in a high level of government expenditure is somewhat different from a wage increase which is an automatic consequence of excess demand, that is, a shortage of labour. Nevertheless, it can be equally catastrophic so far as its effects on inflation are concerned. This helps to explain why inflation can persist after excess demand pressures have been removed and even when there is some unemployment. We have become familiar with this phenomenon in the last few years. How much of our recent “cost-push” inflation has its source in the heavy and increasing claims of the public sector?

It is true that modern Governments are under tremendous pressures from their electorates to provide an ever-expanding range of facilities and benefits. But, when the bills are presented, the people are reluctant, and, in effect, refuse, to pay them.

This discrepancy between the demands made by the people on Government and their willingness to meet the costs probably lies close to the heart of the modern inflation.

Keynes viewed inflation as a weapon available to governments for extracting resources from the community which they would not willingly surrender. "Inflation", he said, "is a mighty tax gatherer". We have had a striking demonstration of this in the Australian budgets of recent years where revenue has poured into the public coffers as rising money incomes have elevated even modest wage and salary earners into the high tax brackets. "By a continuing process of inflation" he wrote, "governments can confiscate secretly and unobserved an important part of the wealth of their citizens". This lay behind his view that the ultimate cause of inflation was to be found in the "impecuniosity of governments". Inflation transfers resources to the government by reducing the real purchasing power of the incomes of business and the consumer.

*The views expressed in this booklet are not  
necessarily the views of the Forum of Free  
Enterprise*

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The Forum of Free Enterprise is a non-political and non-partisan organisation, started in 1956, to educate public opinion in India on economic issues, especially on the enterprise and its close relationship with the democratic way of life. The Forum seeks to stimulate public thinking on vital economic problems of the day through booklets and leaflets, meetings, essay competitions, and other means as befitting a democratic society.

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