ON RISING PRICES AND BLACK MONEY

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

—Eugene Black

INTRODUCTION

This publication deals with two issues of great public interest now—rising prices and black money. An introductory note on the former precedes a scholarly analysis by Dr. A. K. Sur.

Dr. A. K. Sur, M.A., D.Sc. (Econ) was for 34 years Economic Adviser to the Calcutta Stock Exchange. Since his retirement from the Stock Exchange in 1969 he has been functioning as the Director of the Institute of Company Affairs. He is the author of numerous authoritative works on Company Law, Economics and the Capital Market.

An explanatory note on black money is followed by an article by Professor B. R. Shenoy, the well-known economist. He was formerly the Director and Professor of Economics, University School of Social Sciences, Gujarat University (1954-68); Alternate Executive Director, representing India, at IMF and World Bank (1951-53). He was President of Indian Economic Association in 1957. At present, he is Director of Economics Research Centre, New Delhi.

It is hoped that this booklet will help to give a clear picture of rising prices and black money and evolve suitable policy measures to tackle these national problems.

I

RISING PRICES — AN INTRODUCTORY NOTE

Over the last 15 years, prices have been continuously rising in India. The people affected most by this phenomenon, described by economists as inflation, are the fixed income groups. Among these are the middle classes which are considered to be the backbone of any democracy. Other categories which have suffered most by inflation are the urban poor and the land-less labour.

It is argued by some that inflation is not peculiar to India but is a world-wide phenomenon. The statement as such is true, but a meaningful study shows that the damage caused by rising prices is much more in India than elsewhere. In the first place, the increase in the price level is very high in India. The world price level has increased, in the last eight years, by about 20 per cent. During the same period in India it has gone up by as much as $3\frac{1}{2}$ times the world price level.

The fall in the value of currency, which is another way of looking at inflation, is much more in India than in other countries. If the value of the currency was 100 units in 1959, in 1969 it was only 56 in India as against the following picture of developed and underdeveloped countries:—

Switzerland	74	Thailand	83
Australia	78	Iran	78
West Germany	78	Pakistan	70
U.K.	71	Israel	60
U.S.A.	79		

It is a poor consolation that some of the Latin American countries experienced greater inflation than India.

Another important consideration is that even a 1% increase in price causes more distress to Indian people than, say, a 5%

increase in affluent countries. The reason is the limited capacity of the Indian people to absorb the impact of high prices. Most people in India spend the bulk of their income on food. A middle class family spends about 45 per cent of its income on food while the working classes spend about 60% and some other categories even 90 to 95 per cent. When the general price level increases in a poor country, the food prices increase much more, and, therefore, even a small increase in the general price level causes a great deal of distress to people in underdeveloped countries.

The other important consideration is that the cost of living is really not indicated by the increase in the general price level. While the price level may have risen by 6 per cent a year, the cost of living may have gone up much higher. The following figures from a family budget in Bombay indicates the impact of price rise on common people:

		1961	1971
		Rs. P.	Rs. P.
Salt	per kg.	0.19	0.40
Tea	per kg.	10.00	13.00
Kerosene oil	5 ltrs.	1.40	2.70
Tur Dal	per kg.	0.88	2.25
Detergent	per kg.	2.25	4.50
Coconut	one	0.35	1.20

The extent to which prices have risen in India is shown by one of the numerous distortions in the economy, viz., the shortage of coins. Prices have risen so much over the years that the metallic content of some coins is today much more than their face value. Unscrupulous persons started melting these coins, and a shortage has resulted.

Why do prices rise? Inflation is like fever in the human body. When the bodily system is abused by bad food, irregular food habits, over-eating, insufficient sleep or lack of rest, etc. the individual suffers from fever. The basic cause of fever is mismanagement of the human system. Likewise, when the national economy is mismanaged by the Government, the fever of inflation enters into the body politic. If inflation persists over the years, it merely means that wrong economic policies are followed.

It is important to understand what happens when there is inflation. Money supply is the monopoly of the government. When this monopoly is abused by mismanagement of the economy, the money supply goes up disproportionate to the requirements of the economy. In other words, foodgrains and consumer goods which people want to buy are not available in sufficient quantity while too much money is available with the public. Figures clearly illustrate this in our case. Between 1951 when we started the First Plan, and 1971 money supply has increased from Rs. 2,026 crores to over 7,000 crores, an increase of about 3½ times. In the same period, food production has doubled. The national income has also doubled. The big gap between the increase in money supply and increase in national income is clearly reflected in the price rise.

What is the reason for mismanagement of the economy? In the first place, there is a belief that the government knows how to spend public monies better than the citizens. This results in heavy taxation. In other words, savings of the people are diverted into the coffers of the government. If these monies are used for fulfilling the primary obligations of the government like defence of the country, maintenance of law and order, provision of "social overheads" like roads, etc. then they provide the basic conditions which help to increase production in the country. But when the monies are used by the Government for Public Sector industries and business enterprises, which incur losses, then the country suffers in two ways: First, it is deprived of production which the monies in the hands of the people would have given rise to; second, the public is taxed again to subsidise the losses of the Public Sector.

A few instances show how public funds get wasted in the state enterprises and have contributed to inflation. On an overall investment of about Rs. 3,300 crores in the "running" undertakings of the Central Government, the net result is a loss of Rs. 3.4 crores. Public Sector losses have persisted over the years.

A Madhya Pradesh Minister reported recently that on an investment of Rs. 11 crores, the state government incurred a loss of

Rs. 1.82 crores in the State Transport over the past three years. In Maharashtra, the government spent Rs. 76,000 to rectify an error in a nationalised text-book. The original printing of the book had cost the government only Rs. 51,000. Instances like these can be easily multiplied.

Now the nationalised banks have added to inflation. All the loans are not being applied to productive purposes. As a result, increased bank deposits, which are normally created when a loan is given for productive purpose, do not materialise. So banks have to run to the Reserve Bank of India for funds. The Reserve Bank lending to nationalised banks is deficit financing by the back-door. In other words, money supply is increased in this manner without proportionate increase in production.

The dividend accruing to the government from the nationalised banks in 1970 was less than the interest which the government pays on the compensation it has paid to erstwhile banking companies. In other words, the tax-payer has to subsidise nationalisation by paying higher taxes.

The other main reason for inflation is the belief that the priorities, direction and control of the economy should be determined by the politicians and bureaucrats instead of the people. Too much investment has been made by the Government in heavy industries instead of in agriculture which is our basic asset. The Government has, therefore, created additional monies. The projects take many years to yield fruits. Obviously, the increased money supply in the economy without proportionate increase in goods and services has pushed up the price level.

Inflation is not something which is inevitable. It can and should be curbed and we can really build a strong and prosperous India. But this cannot happen unless a realistic policy is adopted.

II

A STUDY IN THE GROWTH AND CAUSES OF INFLATION IN INDIA*

By

Dr. A. K. SUR

Time was when India was free from inflation. The 1930s were particularly a period when there was an idyllic state of things in regard to prices of commodities. Most prices went cheap, and people were comfortably fed, clothed and housed. Taxes were moderate, and very few people had to clamour against them.

The advent of the Second War brought a change. At first the change was neither bitter nor profound. There was shortage of imported goods, and as such it was the imported articles which were first affected by the trend of rising prices. But so far as indigenous goods were concerned, they were in comfortable supply. Food prices which particularly concern the common man and decide to a great extent the course of inflation were on a downward trend during the initial years of the war. As a matter of fact in January 1941 paddy sold in Midnapore at the rockbottom price of 14 annas per maund. Locally in Calcutta rice could be had at the price of Rs. 2.50 per maund. Most agricultural commodities also went cheap. The official price index of agricultural commodities (base August 1939=100) came down from 127.5 in 1939-40 to 108.6 in 1940-41.

Thus if war be a potent breeder of inflation, then people had very little taste of it during the first three years of the war. Prices first went beyond control after the fall of Rangoon on March 8, 1942. The exodus of population from Burma and the arrival of alien troops in India changed the situation altogether. The price

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situation was immediately affected. It first affected the food plane. India had always a fractional shortage of rice, and this shortage used to be met by import from Burma. Now that Burma had fallen into Japanese hands that source of supply was closed for the time being. Meanwhile the arrival of extra population from Burma and of alien troops from abroad made the Government greatly anxious about the problem of feeding them. There was, therefore, set afoot a campaign for procuring food on Government account. This campaign for procurement was particularly pursued in Bengal, resulting in rice going scarce and the price of it shooting up to as much as Rs. 55 per maund. In 1943 there was a famine and millions did die of it.

Despite some sort of rationing coming into force by Jannuary 1944 and the country having been covered by a barrage of price control measures, the price level however sharply zoomed up. By 1943-44 the index number of agricultural commodity prices touched 268.7 and the general index number 236.5. Meanwhile the cost of living index too was fast rising. Starting from 105 in 1939-40 (base August 1939=100) it went up to 109 in 1940-41, to 122 in 1941-42, to 166 in 1942-43 and 220 in 1943-44. Prices had however no such hectic upswing during the next two years. Thus in 1944-45 the index number of prices of agricultural commodities ruled at 265.4 and the general index at 244.2. There was thus during the year a marginal fall in agricultural prices, though the general index number had looked up slightly. Next year (1945-46) however the general index number (244.9) remained more or less stable, but agricultural prices were up to some extent. The index number of agricultural prices had moved up to 272.6.

It was the termination of the war which first set afoot the real inflationary forces to work in the country. It has to be admitted that the achievement of the Administration in keeping the price system under control during the period of the war was admirable. This will be evident from a comparison of the rise in price level with the rise in notes in circulation. Notes in circulation over the period rose from Rs. 182.36 crores to Rs. 1,162.64 crores. Thus while the notes in circulation rocketed by 538 per cent, the price level, on the other hand, reported a rise of only 144 per cent.

The situation was however difficult to be maintained during the next two years. These two years were a period of catastrophic political turmoil in India. The agitation for independence assumed a new aspect, and it was frequently punctuated with communal riots of a most calamitous character. The situation was indeed propitious for the price system to go out of control. And it was further assisted by the release of the pent-up demand of the war period and the abundance of funds (as is indicated by the notes in circulation and expansion in bank deposits) in the hands of the people. The effect of all this on the price system was almost shocking. During the last year (1946-47) of the British rule in India the index number of agricultural commodities rose to 313-8 and the The rising surge of prices gathered further momentum after the departure of the Britishers in August 1947. The partition of the country brought about a situation of continued inflationary pressure on the economy. It disrupted the productive system of the country generating thereby a serious disequilibrium in the realm of supply and demand. At the same time money supply which tended to remain more or less stable during the closing years of the British rule, all on a sudden spurted up after acquisition of freedom. An overall fall in agricultural and industrial production accentuated the situation. The balance of payments position was also bad, and to aggravate the crisis there was a plethora of industrial disputes in the country.

The partition the country thus posed serious economic problems for the country. While India was left with its industrial structure, its integrity was however broken because of the fact that the sources of raw materials for it mainly fell within Pakistan. Its impact was disastrous both on the industrial and agricultural sectors of the country. Both these sectors suffered heavy setbacks in production. Food production which averaged 43 million tons during 1942-46, slid back to 40 million tons in 1947. Major industries such as jute manufactures, cotton textiles, cement, paper, matches and chemicals showed a decline in output from the previous levels. Apart from inadequacy of raw materials, other factors which affected industries were lack of capital equipment and transport, civil disturbances, and widespread industrial unrest in the country. While production thus went short, the situation was further aggravated by imposition of restrictions on imports necessiated by the gap in the country's balance of payments position. At the same time there was a sharp increase in money supply.

The notes in circulation went up from Rs. 1,222.96 crores in 1946-47 to Rs. 1,303.78 crores at the end of March 1948. This decline in production had its serious impact on inflationary spiral. Simultaneously there were increases in salaries and wages to meet a part of the rise in the cost of living, allowed by private enterprise--supported in many cases by the award of industrial courts and by Government. This had its bolstering effect on purchasing power and as there was not enough of commodities to go round to absorb the same, it had an accentuating effect on the forces of inflation. The Government too increased the controlled prices of basic materials like steel, cement and coal consequent on increased costs. Excises were also imposed on certain commodities As a result of all this the Economic Adviser's index number of wholesale prices rose sharply to 342.3 by February 1948. To check the rise in prices an increase in production was felt necessary, and with that end in view the Government called an Industrial Conference in December 1947, in which production targets were set for important industries and the labour was urged to maintain peace for the next three years.

But the inflationary curve in India showed little sign of being curbed down. Prices experienced a sharp rise from June 1950 mainly as a result of the operation of existing factors plus the abnormal demand for goods generated by the Korean War. There was a world-wide scramble for scarce raw materials and other essential goods. It resulted in the prices of some of the export commodities suddenly spurting up. Speculation was also rife in these commodities and this stimulated the inflationary process The general index number of commodity prices (1939=100) skyrocketed to 462.0 by the middle of April 1951. Thereafter, however, there was a decline in prices and by the end of January 1952 the index number came down to 428.8. The general index number fell from 397.5 in 1953-54 to 377.4 in 1954-55. What had particularly contributed to the downward trend of the time was the increased pressure of supplies stemming not only from bumper crops and growing industrial output but also a larger volume of imports and dishoarding of accumulated stocks consequent on elimination of controls over a wide sector. At the same time consumer demand failed to keep pace with increased availability of certain commodities.

Over the second plan period the general price level recorded a rise of 30 per cent as against a fall of 18.4 per cent during the first plan period. Except for a slight decline of 0.2 per cent in 1957-58 there was a continuous rise in prices throughout the period of the second plan.

Prices continued to move up during the years 1961 to 1963. The upward pressure was mainly brought about by food articles (more specifically rice, pulses, milk and ghee, sugar and gur, tea and coffee). To a large extent it was also due to inadequacy in the availability of food supplies in the context of rising demand, the increase in indirect taxation, and higher prices allowed by the Government in respect of certain controlled commodities. It was during this period that the Chinese made inroads on the borders of India. The emergency measures that followed also accelerated the process of inflation.

India's price system started working almost overtime from 1964-65. The index of wholesale prices (1952-53=100) advanced sharply from 138.9 at the end of March 1964 to 151.0 at the end of March 1965 showing thus a rise of about 8.7 per cent.

There was a two-way movement of prices during 1967-68. Prices continuously rose during the first half of the year, followed by a declining phase during the latter half. In the first phase the index number rose from 202.9 to 224.1 but in the second phase it steadily came down to 200.6.

Now about this time the authorities once again took resort to the Chinese magic of thumping down the index number. The base year for computation of index number was changed from 1952-53 to 1961-62 resulting in bringing down the index number for 1967-68 from 200.6 to 160.3. But this change in the base year for computation of the index number had however no effect on the course of inflation. Inflation continued to make its merry march. The index number of wholesale prices (1961-62= 100) rose to 165.1 in 1968-69 and to 175.4 in 1969-70. Not only that. The price rise acquired a new tempo in 1970. There was an alarming rise in prices since January 1970.

Thus excepting temporary fall or stability of prices for brief spells of time, prices have continuously gone up in India over the past 30 years or so. What may be the causes of this, we have discussed elsewhere in this article. What however we presently want to emphasize here is that continuity of inflationary trends over the period merely brings to the fore the futility of all official policies to keep the price system at bay. This failure is mainly due to a lack of introspection on the part of the administrators. For, had they been endowed with this power of introspection then they would have readily discovered that the Government itself was responsible for the creation and persistence of inflation in this country. In the past (and it is still so) it was the administrative adulteration of levying excise duties on the commodities of daily uses which resulted in a repulsive orgy of inflationary bouts of prices in this country. Other factors which have been responsible for price rise in this country are vaulting deficit financing, surging unproductive expenditure, mounting losses of public sector undertakings, and ever swelling gaps between resources and outlays of the five-year plans. The shifts and makeshifts in official policy relating to the thumping down of prices would be of no avail so long as these factors are there.

Now coming to the phenomenal rise in prices since 1970, what do we find? We find that it is the official policy which is responsible for this. Sometime ago it was stated by a member of the Planning Commission that the increase in prices during the first six months of 1970 was due to nationalisation of the 14 commercial banks because these banks had since nationalisation increasingly advanced money that was used for consumption and not productive purposes. The other factors which were responsible for the current price situation (and which should have also been referred to by the Planning Commission) were the disequilibrium of supply and demand due to shortages of raw materials, slower rate of industrial production, retrogression in the production of commercial crops, labour unrest, and an increase in the disposable income of the rural sector which was mainly used for consumption expenditure. It is not merely the disposable income of the rural sector which has gone up in recent times. The disposable income of the working classes in the urban areas too has gone up recently on account of the wage increases granted, in recent months. Apart from all that the current labour unrest, strikes and hartals had also their effect on production and *per se* on prices.

As a matter of fact, the price situation since 1970 is rather baffling in the face of the much publicized "green revolution" in the country. Notwithstanding larger production of foodgrains during the last two years and prospective bumper crop this year, food prices have neither come down nor have they remained stable. They have, on the contrary, ever gone up. So far as the prices of industrial raw materials are concerned the rise is not surprising in the face of the current shortages of raw materials in the country and the smaller production of some of the commercial crops. But what about food prices? Why are they moving up? That they should move up in the face of larger production of foodgrains and particularly in the face of a vigilantly stricter credit policy against speculation in foodgrains pursued by the Reserve Bank of India, is a development in the economy, the causes whereof need to be probed and found out. In this connection one may recall that only some time ago, the Government of India at the top of its voice declared to the nation that the country was now having a "green revolution" and the large production of foodgrains as a result thereof was to leave its thumping effect on prices. The Government was then optimistic about an impending era of price stabilisation in this country. Evidently the behaviour of prices since then has falsified the optimism of the Government.

Lately the Government has however expressed its concern over the price situation. Of course, this change in the attitude of the Government is due to their having been cornered in Parliament by the Opposition members. The Opposition members pointed out that it was perplexing that while on the one hand the Government was claiming that foodgrains production had gone up substantially, the price index was ever soaring. They were not satisfied even when the Finance Minister, Mr. Y. B. Chavan, explained to them at length the various measures taken by the Government to check the rise in prices. They told the Finance Minister that they were not interested in knowing what measures had been taken by the Government; what they were interested in knowing was what was the result of such measures. The Finance Minister however assured the House that he was aware of the magnitude of the problem and would do all that was possible to contain the price level. But we wonder how would he do it. For one may remember that on thousand and one occasions in the past his predecessors had given similar assurance to the nation to contain the price level, but such assurances were of no avail.

That official policies in regard to price control have evidently failed in this country, there is no doubt. So far as control of prices through adoption of monetary policy is concerned that has utterly failed too as recent history would show. Rather it is suspected that liberlization of credit to the rural sector has resulted in strengthening the bigger landholders and traders and also in diversion of such credit for use in consumer spending. Another factor which is to be noted in this connection is the influence of higher procurement prices on the open market prices of foodgrains. It may be pointed out that this is being done against the recommendations of the Agricultural Prices Commission. What is rather significant in this connection is the increases effected in recent months in the prices of food articles distributed through the fair price ration shops in the Calcutta area. As a matter of fact so long as the Government fails to keep down the prices of foodgrains, there is very little prospect of the forces of inflation taking an about-turn in this country.

There is no doubt that the budgetary policy of the Government has also bred a large dose of inflation in this country. It is deficit financing and the fiat money created thereof which has given a great stimulus to the forces of inflation in the country. Thus deficit financing during the First Plan period amounted to Rs. 333 crores, during the Second Plan period to Rs 954 crores and during the Third Plan period to Rs. 1,150 crores. Over the three annual plan periods deficit financing was resorted to the extent of Rs. 719 crores. It is also proposed to be resorted to, to the extent of Rs. 800 crores during the fourth plan period. Such large doses of deficit financing have evidently bolstered up the economy with fictitious purchasing power—purchasing power which has no backing in goods but which is effective enough to give an artificial prop to prices. This is reflected in the total money supply with the public which from Rs. 2,208 crores in 1956 rose to Rs. 2,834 crores in 1961, to Rs. 4,301 crores in 1965 and to Rs. 6,552 crores in September 1970. That it had definitely a role to play in the growth of inflation in this country is evident from the fact that even in the lean years of recession in economy it rose from Rs. 4,950 crores to Rs. 5,779 crores.

It is well known that much of the inflation in this country is of the cost-push type, that is to say, it has been caused by factors of production trying to increase their share of the total product by raising their prices. Now capital being a factor of production, any rise in the cost of obtaining it will naturally have its effect on the total cost of production and consequently on the prices of the goods produced. Today the cost of capital has gone too fast in the upward direction. Preference capital can be floated only at a rate of 9.3 per cent and debenture capital at 7.75 per cent. The same is also true of the working capital of business. Today this cannot be secured at less than 10 to 12 per cent rate of interest Any manipulation of the credit policy of the country to ensure an "environment of relative price stability" will, therefore, be an infructuous one. Rather by its contribution to the cost of production it will produce the adversely reverse effect of giving further stimulation to the forces of inflation.

A pertinent question that arises in this connection is : Why deficit financing and also credit squeeze? Evidently deficit financing is resorted to, to meet the cost of governmental expenditure. While there is considerable scope for economising administrative expenditure, there has now come a time for serious thinking as to whether India's five years plans are to be reoriented and estimates thereof are to be revised on the downscale. Similarly while nobody would scramble over restriction of credit for speculative purposes, everybody would find fault with the credit policy of the country if it impedes the genuine needs of business. To ensure growth on right lines not only planning is to be pursued on realistic and rational basis, but also correct budgetary and credit policies ancillary to same should be adopted. Otherwise the country and its economy will continue to have trouble as at present.

Excises are also reputed to have a bolstering effect on prices. It is generally found that when an excise duty is levied on a commodity the price thereof rises in excess of the additional levy. Not only that. Other commodities on which there is no levy at all also show a sympathetic rise. Imposition of fresh excises implies perpetuation of the forces of inflation.

So long as real income does not go up, any flow of inflationary income is of no avail to the community. Inflationary income merely renders the people discontent. It is at the root of the new social and political alignment of the day. It is also the provocative cause of labour unrest in the country.

That inflation is a social, political and economic evil, there is no doubt. Like poverty it has the peculiar characteristic of moving in a vicious circle. Take, for instance, the impact of inflation on labour. In the first instance, it makes the labour clamour for more wages, and as labour is an input of production any increase in wages automatically raises the cost of production, and this in its turn bring about an increase in prices. And as the prices further increase, the labour would further clamour for more wages, and more wages would again bring about a rise in prices, and this will be followed by a still further clamour for more wages from the side of labour. The process would thus continue up to eternity.

The same is also the case with governmental expenditure for administration, defence and development. As inflation works, the cost of the budget goes up, and the Government is perforce compelled to resort to additional taxation and deficit financing which in their turn produce further inflation, and as further inflation prevails, the cost of budget further goes up, bringing in its train further doses of additional taxation and deficit financing which in their turn would produce further inflation, and so on.

All this would show that unless the inflationary trend is successfully tackled and effectively curbed, any cry for social, political or industrial stability will merely be a cry in the wilderness.

But inflation has become so complex a phenomenon in India that it is difficult to tackle it. For the necessary sophistication that may be required for tackling it is lacking on the part of the country's administrative and monetary authorities. This is because of the fact that so far economists have failed to furnish us with any well-defined concept of "inflation". Some would take it to be an explanation of the general rise in prices. In other words, they would prefer to call inflation as the cause of price rise. Others, on the other hand, would simply mean by it a general rise in prices. In their view "inflation' is the same as price rise or synonymous with or equivalent of it. Machlup's observation is worth quoting in this connection. He points out that a search of the learned literature would yield scores of definitions of "inflation" differing from one another in essentials or in nuances. Popular literature too reveals no realization of the differences in the meanings experts give to the term. He, therefore, concludes: "Now that inflation has become such a widely debated topic, with many scholars participating in the debate, the popular meaning of inflation denoting an increase in the consumer price index, has been increasingly adopted by the professional economists"

Whatever it may denote, it leaves us however in the dark as to the causes of it. There was a fight for the causes particularly in the post-war period. The economists of the time started to argue whether inflation was caused by the upward push of costs or the upward pull of demand. Those who advocated the demand-pull theory, predicated that prices rise in response to an excess of aggregate demand over existing supply. The exponents of the cost-push theory, on the other hand, assumed that inflation is caused by factors of production trying to increase their respective shares in the total product by raising their prices.

If we closely look into the matter we shall find that both the theories suppose that inflation results from its contribution to a failure to adjust prices or incomes of various groups to the general trends in the economy. For this reason, it is said, that what inflation does to the economy depends to some extent upon the relationship between price movements and the growth in the economy. That is why it is frequently asserted that inflation is the inevitable price of "growth" Of course, the relationship between price level and growth has had a long history. The view held for many years was that when prices rise, output also tends to rise, But Harris wisely points out that "a historical examination of the movement of prices and the rate of growth of the economy does not yield any very clear-cut resuts. Apparently we have had growth of substantial proportions in periods of falling prices as well as of rising prices. We are equally surprised by the extent of growth in periods of falling prices as we are by that in periods of great inflation."

Some light on what Harris says is shed by the Indian data. The 1920s, for instance were a period of growth of Indian economy. But we know that throughout this period prices were dropping. (The general index number, 1873=100, dropped from 281 in 1920 to 171 in 1930). Again, take the case of the first five year plan period. The national income at constant prices was ever rising during this period. And though population too was fast rising during this period, the *per capita* national income too was nevertheless on the upward march. Yet prices throughout the period took a downward turn. The relevant figures are given below for a clearer exposition of it.

A comparison of the index number of prices with the index number of *per capita* income at constant prices of 1948-49 :

Year	Price index	Per capita index
1950-51	493.3	99.8
1951-52	386.9	101.3
1952-53	393.9	103.9
1953-54	386.7	108.8
1954-55	355.4	110.1

The figures in the above table would show that inflation is not an inevitable and invariable result of growth. In other words, it is not a necessary price of growth.

We believe that in our search for the causes of inflation we have to forget for the moment the economists' quarrel about whether it is caused by the demand-pull or the cost-push. It has indeed been rightly observed by some economists that the issue between the two schools is largely spurious. The former, it is said, could never generate a sustained inflation unless the Government is prepared to create additional money required to permit the cost-push without further unemployment. However post-war experience in both the U.K. and the U.S. shows that the velocity of circulation is sufficiently flexible to permit rising prices without a major increase in the "money supply". Rising prices indicate a fall in the value of money. So when we want to establish a connection between an increase in the stock of money and the value of money, we invoke what in economics is called the quantity theory. The cost-push theory implies a rise in the cost of the factors of production. But we shall presently see that rises in the cost of certain factors of production are outside the normal supply and demand mechanism, and as such it cannot be explained by the quantity theory.

We obviously refer here to wages and prices of imported raw materials, the prices of both of which come about in a special manner without any reference to the normal operation of the law of supply and demand. Wages are determined by negotiations between unions and employees and laid down in collective labour agreements. The same applies even more strongly to the prices of imported raw materials. In regard to both these factors of production their contribution is not subject to the impact of the anonymous market forces. The prices of factors of production other than these two, rise when at their existing level the quantity of goods demanded exceeds the restrictive forces by their inhibitive influence on the supply position and also help prices to rise. Inflation is, therefore, a complex phenomenon which is beyond the compass of any precise analytical tools that the economists possess today. We know more about its results than about its causes.

III

BLACK MONEY — AN INTRODUCTORY NOTE

The problem of black money has been with us since the days of the Second World War. It has assumed menacing proportions in the last 15 years. A stage has now come when even the Union Finance Minister has had to admit that there is a "parallel economy" as a result of black money in circulation.

What is black money? There is a great deal of confusion about this. For instance, several years ago a prominent politician mentioned that the black money in circulation was of the order of over Rs. 3,000 crores. At that time, the currency with the public was barely Rs. 2,450 crores!

Black money in economic terms means *unrecorded gains*. In other words, it is income which has escaped taxation. It may be hoarded in cash, but eventually gets itself converted into various assets like property, jewellery and durable consumer goods such as automobiles, refrigerators, etc.

First it arises from illegal activities like smuggling. The second way in which black money is created is by evasion of taxes on legally earned income. Such evasion take place because of unrealistically high rates of taxes which strains human nature and complex tax laws whereby even honest assessees are unable to file correct returns and, therefore, the Income-tax Department makes unrealistic and unjust assessments.

A very low ceiling of income-tax exemption results in a large number of people like taxi drivers, small traders, persons who have part-time jobs in addition to their regular work not filing their tax returns. Their untaxed income also is black money. The number of tax assessees is barely 3 million in our country which is a low figure

Third, black money arises from numerous controls, licences and other governmental regulations. In order to get things done bribes are given to government officers and political intermediaries. These are given either to get something done quickly or to get some favour which is not due to one.

Black money also arises from political activities such as elections where candidates spend well above the ceiling prescribed by the Election Commission. This huge expenses in turn makes them corrupt. Political trade union leaders earn black money behind the back of workers. The politicalised co-operative movement is another prolific source of black money.

The common notion is that black money is only to be found with businessmen. This is wrong. It arises from such activities where the collusion of government officers and/or politicians is inevitable. Therefore, it is shared between these three groups.

So far as the economic effects of black money are concerned, where it is used for productive purposes such as running small enterprises, it helps the economy to grow. This, however, does not change its unethical character. Where black money is employed for conspicuous consumption—easy money is generally got rid of quickly—it adds to the spiral of rising prices. Where it is used for buying property and other assets, it blocks up productive resources.

Next to destruction of the moral fabric of society, the greatest damage black money does to the country is promotion of social injustice by accentuating the gap between the honest and the dishonest. The former remain poor or where they are, while the latter thrive on black money.

On the one hand, there are groups of people such as salaried employees who find that even before they get the salary, the tax is cut at the source and this tax burden rises year after year. On the other hand, people with black money not only escape the growing tax burden but also find that their income and wealth expand at a rate disproportionate to their contribution to growth of national income. The irony of the situation is that every few years the Government comes out with attractive schemes for them to declare their black money while retaining some of it. In contrast, the honest tax-payers are taxed more and more to make up for the lapse of the administration in collecting taxes from the dishonest!

Demonetisation is frequently mentioned as a remedy to eliminate black money from circulation. The idea behind demonetisation is that the Government withdraws the high denomination notes in which black money is held and replaces them with new notes. While surrendering the old notes, the holders have to give satisfactory explanation. In this way, only those who have got honest income will be able to get their currency holdings replaced. In theory demonetisation is an effective answer to black money. But in practice, it will not work in our country now as it did as a surprise measure over 20 years ago. The main reason is that there has been too much loose talk of demonetisation over the past few years. Those who hold black money, mostly in denominations of 100 and 1,000-rupee notes, have taken care to rid themselves of this hot money. They have either converted them into assets which can be easily liquidated or into smaller denomination notes which will not be demonetised. About 48% of our currency is in 100 and 1,000-rupee notes, the 5,000 and 10,000-rupee notes forming about 2% being used mostly for bank transactions. Withdrawal of these notes and replacing them by new notes will take several weeks and seriously disrupt economic activities. Moreover, a new black market in disposal of Rs. 100 and Rs. 1,000 notes will start!

The solution for black money is to be sought elsewhere. It lies in removing the causes. For instance, bulk of smuggling can be eliminated at a stroke by allowing the rupee to float and find its level in the international free markets. A floating currency has been successfully tried in countries like the Philippines and South Korea. We can also do it provided, of course, (a) certain safeguards are taken to ban import of luxuries; and (b) politicians and government officers are prepared to give up power and patronage in issuing import licences.

Removal of all controls and licences and their replacement by necessary regulations will eliminate a major source of black money in the country. The best way of regulating the economy is to allow free competition, i.e. to put the economy in the hands of the consumers.

Tax evasion can be stopped by (a) raising the ceiling of taxable income to about Rs. 15,000 a year; and (b) by lowering the maximum rate of taxation. The government can take proper safeguards to see that money is mostly reinvested in socially desirable projects. It is also necessary to have severe laws to punish tax-evaders once the evasion is found out. Government revenues will not be adversely affected by this policy. So much productive activity will be stimulated, that on an enlarged base, the lower, realistic rate will get more revenue for the Exchequer.

Black money is not something new to India alone. It is to be found in all parts of the world where similar economic conditions obtain. In communist and socialist countries it is a common phenomenon. Economists describe such economies as "split economies".

IV

BLACK MONEY AND BALANCE OF PAYMENTS *

By

Prof. B. R. SHENOY

Black money, also referred to as "No. II money", has been engaging the attention of the Government and the public. Black money, or "No. II money", represents tax dodged incomes of traders, businessmen, industrialists and others; and, necessarily, include corrupt payments accruing to politicians, administrators and the touts and other go-betweens, who, frequently, figure as intermediaries in corrupt transactions in licences, permits and contracts.

An official Committee is presently studying this problem. Is there any really practical device of bringing to book the culprits or is it but a variant of trying to prevent fish from drinking water, are issues which call for a separate study. Our prime concern here will be to indicate, first, whether balance of payments statements provide any evidence of the movement across national frontiers of "No. II money" and, secondly, whether it is possible to assess their order of magnitude?

The problem of "No. II money" is not limited to India, though the proportion of the dealings in "No. II money" to total transactions may be larger in India than in most countries. This problem obtains in many under-developed countries. Part of "No. II money" keeps revolving within India, like open incomes; but a part is smuggled out of the country through the black market in foreign exchange. How does the latter manifest in the balance of payments statements?

Such manifestation in India's balance of payments is unclear, as our trade and payments statistics lack in reliability over certain sectors because of smuggling, under-invoicing and over-invoicing

* *Reprinted from The Chartered Accountant, June 1971.*

and of the presence of a black market in foreign exchange, the transactions in which do not enter the balance of payments net But the balance of payments statements of the European creditor countries and, until 1960, USA, the more common destinations of "No. II money" from India and other under-developed countries, are much closer to reality.

A review of the capital exports of the European creditor countries and, latterly, also of Japan reveals appreciable disparities between, on the one hand, the current account surpluses or deficits, adjusted for changes in monetary gold holdings, and, on the other, capital flows, as recorded in the capital accounts part of the balance of payments statements.

To take an extreme case, during the four years 1961-1964, Switzerland had "goods and services" deficits, which totalled $1,041 million. Nevertheless, she added, during this period, $ 540 million worth of gold to her monetary reserves and, on top of it, financed $ 1,547 million of fresh external investments. The converse of this financial romance is that of USA, in 1960's, when the recorded outflow of capital from the country, $ 62,353 million, was less than the sum of the current account surplus and the exports of monetary gold by $ 7,121 million, or by 10.25 per cent. Other creditor countries are generally between these two extremes.

This raises the question of what happened to the current account surpluses and the monetary gold outflows, which were not balanced by recorded capital exports, as in the case of USA, in 1960's; and of how the excess external investments and the additions to the gold reserves, as in the opposite case of Switzerland, in 1961-1964, were financed.

To answer these questions, we have to examine the content of Errors and Omissions in the balance of payments statements. The international transactions of a country being innumerable and their aggregate amounts enormous, some transactions, inevitably, escape recording; add to this the tendency, under certain circumstances, to elude deliberately the recording of some varieties of transactions. The net amount of these unidentified transactions get collected under the head, Errors and Omissions. The latter comprise two broad streams : first, unidentified private capital movements and, secondly, errors and omissions arising from fortuitous factors or institutional or other limitations.

Private capital movements, including transfer payments, are "in general the least adequately reported"[1]; and may bypass scrutiny more easily than most others. The concealed part of these capital movements *ipso facto,* cannot appear in the recorded balance of payments statistics. To the extent that these capital movements may be financed from the proceeds of smuggled goods—which might happen in a background of grossly unrealistic exchange rates, as obtain in many under-developed countries, to-day—they would leave no trace in the balance of payments statements, since capital movements as well as the proceeds of the smuggled goods are beyond the reach of these statements. But when they are financed from the proceeds of trade, appearing in the Customs returns, or from the recorded "invisible" payments, disparities must arise between the aggregate "debits" and the aggregate "credits", in the balance of payments, such disparities constitute part of Errors and Omissions.

The second category of the disparities in "debits" and "credits" and, hence, in Errors and Omissions, may arise, among other ways, from delays in reporting, errors in recording, or differences in the coverage of the inward or outward payments. With the improvement in the quality of the balance of payments statistics, since the inter-war period, more especially in the case of the developed countries, which had already a lead in this regard over most others, the second category of disparities may be less to-day than in the past.[2] It follows that Errors and Omissions largely represent the first category of disparities, i.e., concealed or unidentified private capital imports or exports.[3]

The answer to our query, then, would seem to be that the surplus foreign exchange receipts are largely accounted for by unrecorded exports of capital, which appear in the balance of payments statements as negative Errors and Omissions; and the foreign investments in excess of the foreign exchange receipts are financed by unrecorded inflows of capital, which appear in the balance of payments statements as positive Errors and Omissions.

Though this phenomenon of unidentified capital flows is as old as balance of payments statistics, their net amounts have been, during the post-war period, frequently, more than marginal. The unidentified capital inflows into creditor countries amounted to 22.6 per cent of the "reverse balance" amounts during the "war liquidation" period (1946-1948), 13.7 per cent during the Marshall Aid period (1949-1952), 15.3 per cent in the immediate post-Marshall Aid period (1953-1959). It was of a similar order in 1960's. Of the total capital inflows during the entire post-war period (1946-1969), $ 15,032 million, Switzerland was the largest recipient with 46.5 per cent of the total, West Germany came next with 22.2 per cent and UK was a close third with 17.1 per cent. Netherlands, Sweden and France were marginal beneficiaries, with Japan following at a distance.

While this is the overall picture for the post-war period as a whole, USA was the most favoured destination of concealed capital until the close of 1950's; she received during the period 81.3 per cent of the total for creditor countries; and Switzerland had followed with but 12.5 per cent. The net flow of unrecorded capital funds into USA was abruptly replaced by a net outflow from 1960. The average pace of this outflow, about $ 1 billion, per year, which continued throughout 1960's, was faster than the preceding inflows and, by the close of 1968, the total outflows had approximated to the total inflows from 1946-1959. But the outflow continues. It was at a record sum of $ 2,924 million in 1969.[4]

The unidentified capital flows from the rest of the world into creditor countries represent, possibly, the savings of countries with depreciated currencies and under exchange control, seeking shelter in stable money centres. This is evidenced by the weightage of preference for the US dollar until the close of 1950's and to the Swiss franc thereafter—both of which have been among the world's most stable currencies[5]—with due attention to the other convertible currencies. Some of the capital flows may be also tax-dodged incomes, which may be deemed to be—by their owners—more safe abroad than at home.

This inference is in line with an OECD finding that the "large item of 'errors and omissions' in favour of the OECD countries in the balance of payments statements" of the latter include three broad categories of capital flows: (i) unrecorded withdrawals of investment capital and investment income by OECD countries from developing countries, (ii) unrecorded short and medium-term investments, i.e., "flight capital", from developing countries, and (iii) unrecorded "flight capital" from the rest of the world.[6]

The OECD finding and our inference lend support to the frequent assertions, which one comes across in India and certain other developing countries, that the corrupt and other tax-dodged incomes, commonly referred to in India as "black" or "No. II" money, are held in secret accounts abroad by their owners—traders, businessmen, industrialists, politicians and administrators, the favourite destinations being Switzerland, primarily, and other creditor countries.

Of the three OECD categories of unidentified capital movements, categories (i) and (ii) are of special interest to us, as they represent perverse capital movements—from the developing to the developed countries—and may detract from the pace of economic growth. Net capital flows from the latter would be, then, less than the recorded capital flows, by the sum of (i) and (ii). As the amounts involved are not just marginal, this phenomenon calls for more attention than it has received. There is no data for ascertaining precisely the sum of (i) and (ii). But some general observations seem permissible in an effort to carry the OECD finding a stage further, in the direction of quantifying this sum.

Briefly, flight capital from developing countries is included in categories (i) and (ii), by definition. It follows—as the world comprises developed and developing countries—that capital flight of category (iii) is from the developed countries. The latter include the capital exporting creditor countries,[7] and capital importing developed countries, which may be designated B group countries.[8] All creditor countries, other than USA have been, however, net importers of flight capital, from 1960 to 1968; so that, during this period, no part of category (iii) capital could come from these countries; it would ensue wholly from USA—which has been exporting this category of capital on a phenomenal scale, in 1960's—and from B group countries.

We have here a case of part of the development aid flowing back to the European aid givers as "No. II money". How can this strange and perverse phenomenon be remedied? This is a vast subject calling for separate attention. But there can be no lasting remedy to capital flight other than the restoration of monetary stability in under-developed countries—the victims of the capital flight—when such flight is not caused by political factors. This demands two basic monetary reforms : first, zero inflation, which is a pre-condition for achieving monetary convertibility at realistic exchange rates; and, secondly, abolition of exchange control and import restrictions, which the first reform will easily permit. It calls for, thirdly, abandonment of indiscriminate import substitution and the adoption of economic policies with a high regard to the doctrine of comparative cost, which underdeveloped countries have discarded with not a little cost in foregone production, employment and income. Extensive disregard of this key economic doctrine must necessarily eventuate in balance of payments difficulties, economic chaos and monetary instability.

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1 *Balance of Payments Yearbook,* 1938, 1946, 1947, IMF, 1949, p. 20.

2 A circumstance which has, doubtless, contributed to the improvement in the quality of the balance of payments statistics is the statutory obligation of member-governments to furnish the International Monetary Fund (IMF)—which came into being in 1946—with these (among other) statistics. Balance of payments statistics are deemed to be among the "minimum necessary" information "for the effective discharge of the Fund's duties" and members are required to avoid "mere estimates" of these statistics See Article VIII, Section 5(vi) of the IMF Articles of Agreement.

3 An IMF assessment, based on a close study of the balance of payments statistics of over 50 countries, is that "errors and omissions are likely to reflect unrecorded or inaccurate data" of private capital movements, private donations and other invisibles. An OECD study has arrived at a similar conclusion. See *Balance of Payments Yearbook,* 1938; 1946, 1947, op. cit., pp. 23 et seq. and *The Flow of Financial Resources to Developing Countries in* 1961, OECD, Paris, pp. 11-12.

4 *International Financial Statistics,* IMF, January 1971, p. 345.

5 The gold parity of the US dollar had changed only once — in 1934—*since* 1937 (*see A History of the Dollar, by Arthur Nussbaum, p.* 154). *The Swiss franc has been no less stable.*

6 *The Flow of Financial Resources to Developing Countries in* 1961; *op. cit., pp.* 11 *and* 12.

[7] These countries include, Belgium, France, Germany, Japan Netherlands, Sweden, Switzerland, U.K. and U.S.A.

[8] These countries include, Argentina, Australia, Austria, Canada. Denmark, Finland, Greece, Ireland, Israel, New Zealand, Norway, Spain, Venezuela, Italy and Puerto Rico.

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—**A. D. Shroff**

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