BUDGETARY POLICY IN THE CONTEXT OF INFLATION

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I

There are two very different concepts of inflation which are often confusingly lumped together. One is *inflation in the nominal wage-unit*, with the price-level in terms of the wage unit remaining unchanged; the other is *inflation of the price level in terms of the wage unit*. Putting it differently, in the first case, all prices, including the money wage rate, increase in tandem, but the real wage rate remains unchanged; in the second case, prices increase relative to the nominal wage rate, resulting in a fall in the real wage rate. These two cases, following Keynes, can be called "income inflation" and "profit inflation" respectively.

The concept of a profit-inflation is inconceivable within a monetarist paradigm, based as it is on the assumption of full employment, which in any given period can occur only at a certain real wage-rate. Within this paradigm then, the equilibrium real wage rate, which ensures full employment, is always maintained, and inflation necessarily takes the form of a *rise in all nominal prices including the money wage rate*. Hence, inflation in the monetarist paradigm does not bring about any redistribution of *incomes* in society, i.e. monetarism deals exclusively with what we have called income inflation.

By contrast, if the level of the money wage is fixed in the short run, which is a feature of all economies that are prone to variability in the state of aggregate demand relative to full employment (or full capacity) output, *and hence of all real economies*, an *ex ante* excess demand at this output raises the share of profits relative to wages, through a profit-inflation that squeezes "forced savings" out of the workers, though such savings add to the wealth not of the workers but of the capitalists. (Monetarism, while ruling out *income* redistribution through inflation, recognizes that inflation causes a redistribution of *wealth* away from holders of cash balances, which means, in effect, from the *rentiers*; but so too does the theory of profit inflation).

The confusion between these two concepts is rampant. It is common for instance to come across persons, or even official documents, that simultaneously hold *both* that inflation is caused by excessive money supply, *and* that inflation hurts the poor. These two views are theoretically incompatible: attributing inflation to excessive money supply is monetarism, according to which however inflation can not hurt the poor.

The current inflationary episode in India, there can be little doubt, is one of profit-inflation, since it is fuelled basically by excess demand for a variety of goods, notably primary commodities, including food articles. Indeed one can say that this is the first time since economic "liberalization" was introduced in 1991 that we are witnessing an excess

demand-caused profit inflation. This is because “liberalization” typically keeps the level of demand deflated, through a variety of instruments including Fiscal Responsibility legislation. The classic fall-out of “neo-liberal” fiscal policy, by way of making the system demand-constrained, was visible right until mid-2002 when the country had 63 million tones of foodgrain stocks (and that too after more than a decade of declining per capita foodgrain output), together with unutilized capacity in most sectors. The current situation marks a contrast to this entire period of demand-deflation-based price stability, during which prices only rose either because world-market price increases were “passed on”, as in the case of oil, or due to administered cost increases caused by the curtailment of subsidies. (The current inflation too is accompanied by inflation in the world market, but can scarcely be attributed to the “passing on” of world-market price increases.)

This transition to a demand-pull inflation, affecting food prices in particular, is reminiscent of the pre-liberalization period. The fact that it has recurred is often attributed in the popular press to an “overheating” of the economy, reflected in the high growth rates. But this “overheating” explanation cannot stand scrutiny. It camouflages the fact that the agricultural sector has actually been discriminated *against.* Its profitability has *declined* ; rural development expenditure as a proportion of GDP has *declined* to a level much lower than in the eighth plan period; per capita foodgrain output has *declined* over a long period, and especially since the beginning of this century; public procurement operations have been wound down and the procurement prices offered for foodgrains have simply not been remunerative enough; and so on. Demand deflation characteristic of the era of neo-liberalism, meant that notwithstanding all this, foodgrain stocks were still piling up. But the adjustment to that situation since mid-2002, through the dumping of huge amounts of foodgrains on the world market and the whittling down of procurement operations, was so pronounced that it has now carried the economy from an *ex ante* excess supply to an *ex ante* excess demand situation. In short, in a situation where both demand and supply are being squeezed, if demand was falling more rapidly than supply earlier, the opposite happens to be the case now, thanks to the very measures of adjustment undertaken earlier.

Now, the basic feature of a profit-inflation is that it is self-limiting, in the sense that, leaving aside the element of speculation, the “forced savings” that such inflation generates, eventually eliminate the *ex ante* excess demand that causes it. (This however is no cause for comfort since the “self-limit” may be reached after millions have died, as happened during the profit inflation marking the Great Bengal Famine of 1943). Of course, even after prices have stopped increasing *in terms of the wage unit*, both prices and the wage unit may still continue to rise in nominal terms, but that does not constitute profit-inflation, and does not lead to any decline in *real* wages.

The end of profit-inflation, in short, may not mean the end of inflation in nominal wages and prices. Let us however, assume for simplicity that it does, i.e. that the wage unit remains unchanged all along. Even so, while profit inflation may come to an end, i.e. prices in terms of the wage unit may *cease to increase,* that still will leave *the level of real wages below what it was before profit inflation began.* Hence the end of profit

inflation does not mean the end of the increased squeeze on the poor, relative to the initial situation; it only means a stabilization of the squeeze at a higher level than initially.

Protecting the poor against profit inflation therefore means much more than simply the end of profit inflation; it means *negating* its effects on their living standards, by making them regain what they have lost through profit-inflation. Hence, even if augmentation of supplies through resorting to imports, as the government is doing now in the case of foodgrains, succeeds in ending inflation in terms of the wage unit, there is still the need to put in additional purchasing power in the hands of the poor so that they regain their earlier real income.

This requires an increase in fiscal transfers to the poor, financed, ideally (for reasons we shall discuss later) by an increase in taxes on the profit earners. And the basic problem with the 2007-08 budget is that it is oblivious of these social demands of a situation of profit inflation.

II

The argument underlying the budget appears to be the following: fiscal rectitude, in the sense of a reduction in the revenue and fiscal deficits relative to the GDP, is necessary for curbing inflation; it has to be achieved however not through additional resource mobilization but through a restriction on government expenditure relative to GDP, for it is only then that the "animal spirits" of the entrepreneurs will not get destroyed by higher taxes, and hence growth will not be curbed. The right policy therefore is to enforce fiscal rectitude through expenditure restraint; and since the sustenance of growth with a curtailed inflation rate is in the interests of the poor, such a policy benefits them as well.

The problem with this argument is that it misses the specificity of a profit inflation, because, in a situation of profit inflation, even if one concedes for the moment the need for fiscal rectitude (on this more later), protecting the poor against inflation requires *not a curtailment but an increase in government expenditure relative to GDP*. As we saw above, if the poor are to regain the losses they incur in a profit inflation, then an increase in government expenditure relative to GDP, aimed at putting transfers in their hands and financed by increased taxes on private profits, becomes necessary.

In short, what a situation of profit inflation requires is *both* the ensuring of appropriate supplies through imports, *and* a transfer of purchasing power from the profit earners to the workers. Fulfilling only one of these two requirements is not enough. If imports are augmented to bring to an end the increase in prices in terms of the wage unit, then the losses of the workers are not recouped. On the other hand, if supplies are not augmented, but only transfers from profit earners to workers take place through a larger but balanced budget, then *the impact on the workers is exactly the same as if no transfers had taken place*. This last proposition may appear odd, but can be shown as follows

Let us take, for simplicity, an economy with only capitalists and workers, producing a homogeneous commodity. If we assume that a fraction s of post-tax profits is saved, that

all taxation is on profits, and that all post-transfer wages are consumed, then denoting the level of real investment by I, the level of real profits by P, and considering a closed economy with a balanced budget (where taxes equal transfers), we must have

$$I = s(1-t)P \quad \ldots \qquad \text{(i)}$$

whence it follows that

$$P = I / s(1-t) \ldots \qquad \text{(ii)}$$

and capitalists' consumption is given by

$$P(1-t)(1-s) = I(1-t)(1-s) / s(1-t) \ldots = I(1-s) / s \qquad \text{(iii)}$$

Now, the given full capacity output must be distributed between investment, capitalists' consumption and workers' consumption. Since investment is given, and so is capitalists' consumption by (iii), the workers' consumption is also given, no matter what the tax rate and the corresponding transfer to the workers.

While the government has seen the need for "supply management", i.e. for importing certain essential commodities to augment domestic supplies (though in a manner so thoughtless as to rob the exercise of any meaning, as we shall see), it has not seen the need for transfers. This is clear from the fact that the budget's quest for fiscal rectitude takes the form of a curtailment of expenditure, including transfer payments.

Not only is there a remarkable sameness about the percentage increases provided for in all major items in the budget, but these percentage increases are roughly the same as the percentage increase in the nominal GDP. Thus gross tax revenue is supposed to increase between 2006-07 (RE) and 2007-08 (BE) by 17.2 percent; tax revenue net of states' share by 17 percent; total receipts and total expenditures by 17 percent; plan expenditure by 18.7 percent and non-plan expenditure by 16.3 percent. True, budget support for the Central plan is supposed to increase by 22.5 percent, but this is because the magnitude of budget support for states and union territories is to go up by a mere 8.5 percent. This in short is a "17 percent budget". Considering the fact that the real GDP is currently rising at over 9 percent and prices at around 7 percent, this 17 percent increase in most budget items matches the 16-17 percent increase in the nominal GDP, leaving their proportion to GDP unchanged.

Not only is the proportion of expenditure in GDP not slated to increase, but those items of expenditure which can be classified under the rubric of "transfers" to the poor, are even slated to decline relative to GDP, and often even absolutely in real terms. Thus the outlay on NREGS is supposed to rise from Rs.11300 crores to Rs.12000 crores, i.e. by a mere 6.2 percent in nominal terms, even less than the inflation rate, notwithstanding the proposed increase in its coverage from 200 to 330 districts. The total expenditure on rural employment is supposed to rise by only 3.5 percent; and the aggregate expenditure on

NREGS, SGRY, and SGSY is supposed to increase by just about 7 percent. (The Finance Minister has even skimped on the Sarva Shiksha Abhiyan where he has, against the wishes of all the Chief Ministers expressed at the National Development Council meeting, brought down the share of Central funding to 50 percent from the previous 75).

The amount earmarked for food subsidy is also supposed to rise by a mere 6.2 percent. The fact that in addition to this meager increase in food subsidy, the budget does not even mention the need for any strengthening of the Public Distribution System, suggests that the imported foodgrains will not be distributed through the PDS, but through open market sales, where they will no doubt be bought up by grateful speculators. The government may have done the right thing by banning forward markets in foodgrains (though why they were introduced in the first place remains a mystery), but it certainly has not done enough to counter speculative pressures.

III

Not only does the budget do nothing about negating the impact of profit inflation on the poor, but it also does little to remove the basic cause of the profit inflation itself, which consists above all in the steady decline in per capita foodgrain output. The Finance Minister said much about agriculture in his budget speech, but did very little. He did talk of reviving extension services, which is a welcome step, but Central Plan outlay on agriculture is budgeted to increase only by 15.8 percent, and the outlays on rural development, and irrigation and flood control by 11.4 and 11 percent respectively. Each of these outlays in other words is expected to decline as a proportion of GDP. True, agriculture is largely the responsibility of the state governments, but in a situation where the Central Plan outlay itself is expected to increase by as much as 31 percent, the modest increases in outlays for sectors connected with agriculture suggest a lack of emphasis that is at odds with the Minister’s rhetoric.

Even more serious than the modest outlays is the lack of mention of any price-support for the farmers. For some time now the government has been arguing that the problem with Indian agriculture is its low level of “productivity”. What exactly is meant by “productivity”, whether it refers to land or labour productivity, is never spelt out. But since low “productivity” is usually linked to the lack of competitiveness of Indian farmers in the world market, quite illegitimately, as it happens, in view of the massive subsidies underlying the so-called “competitiveness” of farmers in the advanced countries, the term “productivity” presumably refers to land and/or labour productivity. This is in contrast to the commonly agreed position in the pre-liberalization period that while an augmentation of land productivity was desirable, that of labour productivity was not (to the extent of course that they did not come as joint products), since the latter would reduce labour demand. The obliteration of the distinction between these two very different notions of “productivity” helps of course in pushing the case for contract farming, corporate agriculture, and corporate retailing of agricultural products, whose impact is dubious on land productivity but significant on labour productivity to the detriment of rural employment.

But even when the talk is about "productivity" increases within *peasant* agriculture that makes it more competitive in the world market, and hence necessarily about increases in land productivity (including shifts to high-valued crops and more "efficient" cropping patterns), what the government's argument (which has been frequently articulated by the Prime Minster himself) misses is that *any such productivity increase requires a certain amount of investment.* And unless the remuneration, net of risk, from agriculture, improves, no peasant will be in a position to undertake such investment. Hence all talk about productivity increase within peasant agriculture is pointless in the absence of an adequate price-support mechanism. This the government has been most unwilling to provide, notwithstanding the fact that in its absence all the other measures of relief and "development" announced by the government have failed even to stop suicides, e.g. in Vidarbha, let alone brought about any actual agricultural revival. The Finance Minister's silence on the issue of ensuring remunerative prices to farmers was thus completely in keeping with this general reluctance of the government to offer price support.

One may be tempted to attribute this reluctance to the fact that any such price-support would require variable import duties which would be incompatible with our WTO-obligations. But this is not true. Our actual tariffs in most cases being way below the WTO-approved tariff-bounds, running a price support regime, sustained through variable import duties, would certainly not violate WTO obligations in the matter of tariffs. It is not the fear of some specific transgression of WTO conditions that deters our government from giving price support to farmers, but perhaps its ideological commitment to neo-liberalism.

On the other hand, *in the absence of a price support mechanism,* tariff changes in *either* direction may work to the disadvantage of farmers. The gains from increases in tariffs may be appropriated by middlemen (which may even be large multinationals), while the effects of such tariff increases in the form of higher prices of downstream goods may even hurt the farmers as consumers. The losses from tariff decreases on the other hand may well get passed down by the middlemen to farmers, a possibility that arises in the context of this year's budget itself since duties on several agricultural goods have been reduced apparently as a means of combating inflation.

IV

Even if the government was not concerned with protecting the poor from the effects of profit inflation, or with preventing the emergence of profit inflation in future through a revival of agriculture, there is still a case for increasing the tax-GDP ratio in a period of profit inflation. This is because since a profit inflation increases the wealth of the capitalists while forcing the workers to reduce their consumption, i.e. it first squeezes the consumption of the workers, then transfers these amounts arising from the reduced consumption of the workers as savings to capitalists, whose wealth increases as a result of this "booty" (to use Keynes' words), it is only fair that such blatantly unjustifiable increases in wealth inequalities should not be tolerated. And this can be done only by increasing the share of taxes in profits, which, since the share of profits in total income is

rising during the profit inflation, would necessarily mean increasing the share of taxes in income. *Whatever is done to these higher tax proceeds, even if they are used merely to build up a fiscal surplus (or reduce the deficit), such higher tax proceeds are a must in a period of profit inflation.* Of course, with imports being allowed to augment domestic supplies (in the sense of adjusting supply to demand at a certain level of price in terms of the wage unit), if these additional tax proceeds are transferred to workers, whether in an equal amount or even to a greater extent than the additional tax revenue, then so much the better from the point of view of income distribution.

A higher fiscal deficit in other words should not be a cause of worry if supply is allowed to adjust to demand at a certain level of prices in terms of the wage unit. In short, the tax-GDP ratio and the ratio of "transfers" to the workers to GDP should both have increased in the context of inflation, together with "supply management" measures. The budget for 2007-08 raises neither the tax-GDP ratio, nor the ratio of GDP being transferred to the poor and the working people. It allows the "booty" to remain in the hands of the rich.