W A Wijewardena: Why inflation tax is an evil?

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A popular folk story talks of a villager making a chance meeting of a demon in the forest and using his craftiness to get the demon to work for him. Understandably, the demon being an untiring person proves to be a marvelous worker. His contribution to the villager far exceeds that of even a thousand workers. According to the story, everything is well and good as long as the villager is able to keep the demon under his control. But, on the day the villager loses his grip over the demon, it would set upon the villager and devour him. So, though the villager would have a jolly-good life in the short run, he runs the great risk of losing everything, including his life, in the long run.

Governments' use of inflation as a tax to force-mobilize resources for funding government projects has been equated to the fate of the villager in that folk story. In the short run, a government could forget about all its fiscal problems and enjoy the temporary solace provided by it. But in the long run, when inflation becomes uncontrollable, it will have to sacrifice all its temporary gains. When an initially mild inflation degenerates into an uncontrollable hyper-inflation later, it has been termed as a mass killer. It would destroy the financial infrastructure and, through it, the entire social and economic infrastructure. Rebuilding a nation after this massive destruction would be a very painful and tedious challenge for everyone.

What is meant by inflation tax?

Modern governments have been given monopoly power by their respective societies to produce and supply currency with a single objective: maintaining its value to facilitate its use for transactions, use as a store of value and a unit of account. Governments are required to attain this objective by responsibly regulating its supply. Governments, when performing this task and as a cost-effective measure, have resorted to the habit of issuing paper currency notes and debased metallic coins thereby gaining a unique advantage. That advantage is the ability to produce it at a cost which is simply a fraction of its face value. For instance, a currency note may have a face value of 1000 units of money, but a government does not spend 1000 units of money to produce that note. The total printing cost of that note may be just a fraction, say, 5 units of money. So, in this case, by issuing a note to a value of 1000, the government makes a profit of 995 units of money. Such profits accrued to the government are known as "seigniorage".

Now suppose that the government uses this 1000 note to pay salaries to a teacher. The teacher is required to sacrifice eight hours of her time a day to get that 1000 note as her salary. Her sacrifice is a real sacrifice, because she could have enjoyed that time for her own pleasure. In contrast, the government's real sacrifice is just 5 units of money, the value of real resources it spent on producing the note. So the government enriches itself at the expense of the teacher who now has been given a note with real sacrifice of 5 units for getting eight hours of real services. This type of an unfair transaction is known in economics as an unequal exchange.

Why should the teacher agree to this unequal exchange? That is because she is promised that she could acquire a real basket of goods and services worth of 1000 units of money with that paper. For instance, if a kilogram of rice is 1000 units, she is promised one kilo of rice in exchange for eight hours of her time. If this promise is kept, then, there is no problem. But, if such currency is excessively produced, too much money would chase after too little rice and the price of rice would go up in the market. As a result, when the teacher goes to the market, if the price of rice has risen to 2000 units of money, she could now buy only a half of a kilogram of rice. In other words, she has been forced to give up eight hours of her time for half a kilo of rice.

The reduction in the basket of real goods she is now getting as a result of inflation is similar to a tax she has paid to the government. In this case, the tax is equivalent to four hours of her time. It is not different from a rule requiring the teacher to work four hours a day for the government for nothing! That rule obviously reduces her welfare. She undergoes this reduction of her welfare not on her own accord, but involuntarily. Such involuntary reduction of welfare in favor of the government has been caused by inflation and, therefore, known as inflation tax.

How is the inflation tax imposed?

Governments have appointed either central banks or currency boards as their agents for producing and supplying currency. Unlike currency boards which have to maintain a hundred percent reserve of valuable assets (gold and hard foreign currencies such as Dollars, Euros or Sterling Pounds) for issuing currency, central banks are peculiar animals. They do not have to have a reserve of an equivalent amount and can issue currency simply by making book entries. In other words, they can acquire any asset by assuming a liability on account of the currency they have issued. For instance, if a central bank has to acquire a building, all it has to do is to open its vault and issue the required amount of currency to the seller of the building. After the transaction, the central bank has a building on the asset side of its balance sheet. But, at the same time, on the liability side, there is an equivalent amount representing the currency issue of the bank.

Governments impose inflation tax on the society by borrowing from central banks. When such borrowings are effected, the government would give the central bank a government security such as a treasury bill. The central bank, in return, permits the government to take away an equivalent amount of currency and spend it to make payments. So, on the asset side of the bank's balance sheet, it has a treasury bill. On the liability side, this asset is matched by a new liability called currency issued by the bank. But, to acquire that asset, the central bank has to spend only a fraction of the face value of the asset enabling it to make a huge profit out of the transaction.

Central banks' lending to governments become highly inflationary on another count. That happens when the commercial banks make use of this currency issued by the central banks as seed money to produce more bank money in the form of deposits. When governments spend the currency borrowed from central banks, such currency finally gets back to commercial banks as deposits of the public. Commercial banks, in turn, use such deposits to create more deposits and credit. They create deposits and credit in multiple terms restricted only by the public's preference for currency as against deposits and banks' own need for keeping a safe cash reserve to meet public's demand for cash. In Sri Lanka, commercial banks could create bank money five times higher than the initial amount of currency issued by the central bank. Because of this ability to self-produce in multiple terms, (in Sri Lanka, that multiplier is 5), the seed or reserve money produced by central banks is also called "high powered money".

Thus, the total money in an economy would be much more than what a central bank would issue to the economy. When that money which is known as money supply chases after the limited availability of goods and services, the general price level would elevate to a higher level. If it happens continuously, inflation sets in an economy imposing an inflation tax on the society.

Why is there a preference for inflation tax?

There is a general preference for inflation tax for several reasons.

First, it is easy, quick and convenient to borrow from the central bank, compared to conventional forms of taxes available to a government. Such conventional taxes need to be backed by legislation, take time to generate the tax revenue and have to be enforced by an elaborate tax administration. It also runs the risk of failing to generate the required revenue due to tax evasion and avoidance. But, borrowing from the central bank is just a single transaction and the Treasury could use it immediately for making payments.

Second, because of the limitations of the tax bases in developing countries, there is resource paucity for governments to undertake much needed infrastructure projects. Hence, it has been argued that the governments in developing countries could initiate the development efforts by mobilizing resources through inflation. The initial inflation so created would get reversed once the new economic development increases the production of goods and services and raises the market supply. So, inflation would become a self-destroying process and, therefore, it is argued that there is no danger of using inflation for economic development.

Third, taxes are mandatory payments and therefore, there is resistance on the part of tax payers to pay the taxes. Because of the pressure coming from the lobbying groups, political authorities too sometimes are unwilling to raise the tax rates to generate higher tax revenue. However, the resistance of the citizens to inflation tax is virtually nonexistent. This is because no one realizes that they are paying a tax to the government, when the prices move up. Any resistance by them is not against the inflation tax per se, but against the inflation. That again takes place after sometime when they have been very badly hit by inflation.

Fourth, inflation is said to be bringing about some salutary effects to an economy from the point of view of its long term growth. It re-distributes income in favor of the rich people who normally save a greater proportion of their income than the poor people. So, a country would get the much needed savings as a result of inflationary redistribution. It makes available funds for investment and through investment, ensures long term sustainable growth.

Due to the above reasons, inflation tax has been liberally used by many governments throughout the world.

The evils of the use of inflation tax

Though inflation tax has been preferred by many, it has been criticized on many grounds.

The first criticism is leveled on the ground that, when governments learn of this easy way of funding budgets, they would tend to ignore the more solid and sustainable forms of raising revenue, namely, through taxation. This type of behavior is known in economics as “moral hazard” behavior. The danger of that behavior is that it deprives the society of the opportunity to carry out public expenditure programs based on a solid resource base. It would reduce the government to the same unfortunate position of a student who has passed all his examinations by cheating. Then, one day when he could no longer do so to pass an examination, he would painfully learn that he has no in-built capability to face it on his own strength.

The second criticism has been advanced on the ground of the evils of inflation. They could be summarized as follows:

- Inflation causes the market system to fail in its resource allocation function. This is because, inflation raises all the prices together and, for resource allocation, what is needed is the changes in the relative prices, i.e., the price of one commodity rises, but the price of another should fall to compensate the same.
- Inflation discourages exports by functioning as a tax on exports. At the same time, it encourages imports by providing a subsidy. The end result is a continuous shortage of foreign exchange and pressure for exchange rate to fall in value.
- Inflation also taxes savers and subsidizes borrowers. This happens when interest rates are not adjusted to ensure a positive real rate of interest rate in the market. Hence, savers would find that the real value of their savings falling and borrowers the opposite, along with inflation.
- Inflation also causes an undesirable change in assets structure by favoring unproductive assets like real estate, gems and jewelry and discouraging the much needed financial assets. This happens when interest rates are negative in real terms due to the non-adjustment of the rates to reflect inflation. So, people would shift from value-falling financial assets to value-appreciating real assets.
- Inflation disadvantages the vulnerable groups with low bargaining power such as pensioners, housewives, students etc. It generates social disharmony and social tensions.
- Inflation also raises the costs of local enterprises by raising the prices of inputs and wages. This would adversely affect a country’s comparative advantage.
- Similarly, inflation also puts further pressure on the government budget by raising current expenditure due to increases in the prices of inputs and the salaries of employees. It also causes the revenue to fall behind the increases in the national income.

Therefore, the use of inflation as a measure for funding government budgets is not an advisable strategy for any government.

This was very cogently expressed by Dr. Goh Keng Swee, economic pundit behind Singapore’s economic miracle, in his reminiscences of why Singapore chose to retain the currency board system, as follows:

“Financing budget deficits through Central Bank credit creation appeared to us as an invitation to disaster. There was no effective way of exchange control in an open trading economy like ours to deal with inevitable balance of payments troubles.

……The way to better life was through hard work, first in schools, then in universities or polytechnics and then on the job in the work place. Diligence, education and skills will create wealth, not Central Bank credit.”

There is no better explanation of the evils of inflation tax than the above statement of wisdom. Countries which did not have this wisdom fell through the line and were gripped by uncontrollable hyper-inflation in their economies. The most recent example is Zimbabwe where inflation presently runs at mo re than 3700% p.a. Its Central Bank Governor, Mr. Gideon Gono, recently lamented by equating his country’s hyper-inflation to an economic HIV, an epidemic that would kill people on a mass scale.

Hence, using inflation to fund budgets is just like getting a demon to work for you.