Inflation tax and the burden of public debt

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(Representational Image)

By Nikhil Damodaran

It was only a month ago that a low CPI inflation of 4.06 per cent for the Indian economy indicated some relief for households amidst the pandemic. This inflation figure means that in comparison to January last year, prices have gone up by 4 per cent for the basket of goods that a consumer typically purchases. This seems a reasonable number to expect and is not a bad scenario for the consumers. Who needs prices to rise after all?

The answer is simple. The government does, especially a government with an increasing level of public debt and a large fiscal deficit. This could explain the need to hike prices of petrol, diesel, and LPG in the midst of a pandemic. Let me explain how a large fiscal deficit gives incentives for the government to increase taxes on essential commodities.

This is a concept called inflation tax. With the inflation tax, the government could increase prices either by increasing taxes on essential commodities or asking RBI to print more money. The result of increasing such taxes is that they get passed on to consumers as general increase in prices. The most obvious contender for such a general increase in taxes is universal inputs used by most consumers in a country.

A key universal input in the production process includes fuel. An increase in their prices would largely increase transportation cost and directly affect our day-to-day expenses. There is more. Fuel acts as a universal input for production too. Farm products are moved from villages to urban centres and this transportation relies on diesel. A hike in fuel price affects agricultural sector as farmers/distributors have lesser profit, so they pass it on to consumers.

Let us take a simple example. Think of Rs 100 which is in your wallet. When inflation is less, you could potentially buy 2kg rice with that amount. But when the government increases taxes on fuel or on basic food items, the same Rs 100 rupee fetches you 1kg rice at higher prices. Now imagine this happening across the board for all the commodities. This is a general inflation. So, why does the government tax food and fuel to increase inflation? The government does this to erode the real value of government debt.

Continuing our example of rice purchase, let us suppose that we borrow `100 from our neighbour to buy rice before the inflation episode took place. We could purchase 2kg of rice. In the interim, the government increased the fuel price because of which the general level of prices increased. When we repay our neighbour, he could not buy 2 kg rice for the same amount of money. What happened in the interim is that prices of all goods increased. This benefited you the borrower and worked against your neighbour, the lender.

Now, if we apply this concept to the entire economy, the increase in fuel prices is indicative of a strategy by the government whereby it is pressured by a need to pay out its debt. In other words, now the government is the borrower who gains from inflation in the economy. This could partly explain the constant increase in fuel prices despite the reduction in crude oil prices. Moreover, this strategy is also adopted by States who have the power to levy VAT on fuel.

Even though inflation tax is an indirect strategy for sustaining fiscal deficit, it is adopted by policy makers all over the world. The more direct way to pay for the borrowings is to earn money. However, given the projections, the likelihood of increase in GDP, so that the government could generate enough revenue, remains bleak. In such circumstances a more indirect approach is mandated and that is what we are witnessing.

The existing claim by the government is that they provide sizable fuel subsidies and hence, greater taxes on fuel to pay out for the subsidies. How big is 'sizable' is certainly an opinion, but if we compare the total revenue the Centre generates from fuel taxes, then it is around `3 lakh crore while the subsidy on these is only around Rs 40,000 crore.

Thus, the subsidies are paltry in comparison with the tax revenues. Moreover, of the Rs 40,000 crore subsidy on fuel around Rs 35,000 crore is expected to subsidise LPG for poorer households. So, a part of the subsidy is necessary and needs further increase to counteract the possible increase in fuel prices.

Signs of poor management

The continuous increase in fuel prices over the last few years points to systematic mismanagement of public debt. This is how our taxes are paying for the government's extravagance. This is the sort of economics which masks administrative inefficiency

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