Inflation Tax and the Burden of Public Debt

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It was only a month ago that a low CPI inflation of 4.06% for the Indian economy indicated some economic relief for households amidst the pandemic. This inflation number means that in comparison to January last year, prices have gone up by 4% 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 cylinders in the midst of a pandemic when people are already suffering.[1] Let me explain how a large fiscal deficit gives incentives for the government to increase taxes on essential commodities.[2]

This is a concept called *inflation tax*. With an 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 are universal inputs used by most consumers in a country.[3]

A key universal input in the production process includes fuel – both cooking as well as transportation. An increase in the price of petrol or diesel would largely increase transportation cost[4] – both public as well as private and directly affect our day-to-day expenses. There is more. Fuel acts as a universal input for production too. For instance, commodities produced in rural India are transported to urban centers on transportation which relies either directly or indirectly on petrol or diesel. This disproportionately affects agricultural sector as farmers/distributors have lesser profit, so they pass on the increase in diesel to consumers.

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[1] Gasoline prices were at an all-time high of 97.6 rupees ($1.3) a liter in Mumbai Tuesday, while diesel -- the bellwether of industrial activity -- sold for a record 88.6 rupees, data from state-run Indian Oil Corp. show. Taxes make up more than half of that cost and represent a sore point for the inflation-targeting Reserve Bank of India, which has vowed to keep borrowing costs low for as long as needed to support economic growth.

[2] Another piece on the connection between price of crude oil in India and tax revenues.

[3] A case where the prices of these commodities increase due to production or demand reasons could also cause rapid inflation but that is not the result of a government policy. We all remember the rapid fluctuations in onion which have been a household discussion. This was especially true a decade back when the prices of onion were massively fluctuating as hoarders were trying to ride the wave of inflation and earn greater margins.

[4] An exception is the recently launched EMV push by the Delhi government.

Let us take a simple example. Think of the 100 Rs. which is in your wallet. When inflation is less, you could potentially buy two kilograms of rice with the 100 rupee. But when government increases taxes on petrol and diesel or on basic food items, then with the same 100 rupee fetches you one kilogram of rice at higher prices. Now imagine this happening across the board for all the commodities that you tend to purchase. 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.

Again, the concept is easily understood by thinking about our borrowings. Continuing our example of rice purchase, let us suppose that we borrow Rs 100 from our neighbor to buy rice before the inflation episode took place. We could go to the market and purchase two kilograms of rice. In the interim, this government increased the price of petrol, diesel, and LPG because of which the general level of prices increased. When we repay back the money to our neighbor, he could not buy two kilograms of rice for the same amount of money. What happened in the interim is that prices of all goods increased – a general CPI inflation and the money value of goods increased – things become costly. This benefited the you – the borrower and worked against your neighbor – the lender in this case.

Now, if we apply this concept to the entire economy, the increase in fuel prices across the country are indicative of a strategy by the government whereby it is pressured by a need to pay out its debt through inflation tax. 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 secular reduction in crude oil prices in the international market over the last decade.[5] Moreover, this strategy is not only adopted by the center. It is also adopted by the state governments[6] who have the ability to levy VAT on petroleum sales – petroleum sales does not come under the Goods and Services Tax system and remains in transit.

Even though inflation tax is an indirect strategy for sustaining fiscal deficits by the government it is a very important strategy adopted by policy makers frequently all over the world. The more direct way to pay for its borrowings is to earn money like you and I do if we must pay our outstanding loan or venture out for a new housing loan. However, given the GDP projections, the likelihood of increasing GDP so that the government could generate enough revenue to pay out its fiscal deficit remains bleak. In such circumstances a more indirect approach to managing fiscal deficit is mandated and that is what we are witnessing by the government.

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[5] Look at this piece in FT which shows the secular downward trend is crude oil prices.

[6] "About 60 per cent of the petrol price and 54 per cent of diesel is made of state and central taxes. Currently, states choose to levy a combination of ad valorem tax, cess, extra VAT/surcharge based on their needs.
These taxes are imposed after taking into account prices of crude, transportation charges, dealer's commission and the flat excise duty imposed by the Centre" A TOI report.

Perhaps there could be more nuanced economic reasons which explain the need to increase taxes on fuel – none that I can understand, but let's try. The existing claim by the government is that they provide significant and sizable fuel subsidies and these subsidies require 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 central government generates from taxes on petroleum products, then it is around 3 lakh crore[7] while the subsidy on these is only around 40 thousand crore.

Thus, the subsidies are paltry sum in comparison with the tax revenues it amasses on the same products. Moreover, of the 40,000 thousand crore subsidy on fuel and LPG around 35000 is expected to go to LPG which subsidies cooking fuel for a lot of poorer households without private transport or fuel generators. So, a part of the subsidy is necessary and needs to further increase to counteract the possible increase in fuel prices.

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

[7] India's tax revenue from petroleum products: Golden eggs that may kill the goose? – ORF, 18th November 2020.