Inflation Tax and the Burden of Public Debt

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15th Feb 2021

It was only a month ago that a news of a low 4.06% CPI inflation for the Indian economy indicated some economic relief for households amidst the pandemic. The CPI 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 consumes. Thus, a low inflation is certainly beneficial for consumers but not for the government with an increasing level of public debt. Such are the pressures of a burgeoning public debt and could explain the need to hike prices of petrol, diesel, and LPG cylinders in the midst of a pandemic!

This is a concept called *inflation tax* where a policy maker, such as the government, could increase prices either by increasing taxes or printing more money. The result of an increasing tax is that such taxes get passed on to consumers as general increase in prices. The most obvious contender for such a general increase in price is universal inputs which are used by most consumers in a country. These include commodities which are a staple necessity such as wheat, rice and even onions in our case.

The other 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 – both public as well as private and directly affect our day-to-day expenses. But 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. 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.

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 from 100 Rs. But when government increases taxes on petrol and diesel or on basic food items, then with the same 100 Rs. you might only be able to buy one kilogram of rice. 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 result of an increase in tax on food or fuel which leads to higher prices for everyone is to erode the real value of government debt.

Again, the concept is easily understood by thinking about our borrowings. Continuing our example of purchase of rice, 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. 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. Moreover, this strategy is not only adopted by the center. It is also adopted by the state governments 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 reason for sustaining fiscal deficits by the government it is a very important strategy adopted by policy makers frequently. The more direct way to pay for its borrowings is to earn money like you and I do if we have to 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 in our economy.

Well, there could be more difficult economic reasons of re-distribution which could perhaps explain the incessant 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[1] 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

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

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. Our taxes are paying for the government's extravagance. This is the sort of economics which masks administrative inefficiency.