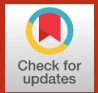

Inflation and public finances in the 2020s

Editor's introduction to the thematic issue of Public Sector Economics

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Editor's introduction
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* The views expressed are those of the author and not necessarily those of the Bank for International Settlements.

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The last time inflation and public finances were intensely discussed as a joint topic of economic research and policy analysis dates back to half a century ago. After the final collapse of the Bretton Woods system in March 1973 and the first oil shock in October of the same year, many advanced economies started experiencing stagflation – stagnating growth with rising unemployment and inflation. To cushion the rise in unemployment and the fall in real incomes, fiscal and monetary policies turned expansionary. Budget deficits, public debt and money supply increased rapidly, and real interest rates turned negative for much of the 1970s. Many advanced economies found it difficult to finance growing budget and balance of payments deficits. The UK government, for instance, faced a currency crisis with annual inflation approaching 25% and 10-year bond yields exceeding 16% in 1975. Macroeconomic dislocations in less developed economies were an order of magnitude larger: in Brazil, annual inflation increased from 30% in 1975 to over 235% in 1985, and budget deficit ranged from 6-12% of GDP (Garcia et al., 2018); in former Yugoslavia, inflation accelerated from 27% in 1975 to 90% in 1986, and public sector deficit averaged 15% of gross social product in 1983-86 (Lahiri, 1991).

Stagflation ended in the mid-1980s, after advanced economy central banks regained credibility by tightening monetary policy and reining in inflation, and after fiscal authorities managed to consolidate public finances. Countries such as Germany and Switzerland, which maintained prudent fiscal policies after the collapse of Bretton Woods and adopted a new nominal anchor – monetary targeting – largely escaped the Great Inflation and fiscal instability (Mihaljek, 2021). Their success partly paved the way for emphasis on stable public finances along with central bank independence and the anchoring of inflation expectations through inflation targeting.

In the three decades that followed, inflation and public finances were rarely analysed jointly. From 1990 until 2019, inflation in advanced economies averaged 2% per annum, and until the Great Financial Crisis (GFC) public finances were generally not a major source of macroeconomic instability. In the period of "great moderation" before the GFC and deflation after the GFC, some inflation was in fact welcome for public finances. With stable inflation expectations and moderate wage growth, inflation mechanically enlarged the tax base and nominal GDP without boosting government expenditure, so fiscal indicators such as the overall balance, its ratio to GDP, and the ratio of public debt to GDP tended to improve.

With the widespread rise in inflation since mid-2021, a new generation of policymakers rediscovered in practice the powerful interactions between inflation and public finances. A series of shocks, including global supply chain disruptions and labour shortages following the recovery from the Covid pandemic, as well as energy and food supply dislocations due to the war in Ukraine, raised inflation in many advanced and emerging market economies to levels not seen since the 1970s. In addition, large fiscal stimulus packages implemented during the Covid pandemic and following the start of the war in Ukraine raised government

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spending sharply. The resulting rise in public debt, together with geopolitical tensions, has made the overall macroeconomic outlook more uncertain, with the risk of stagflation arising for the first time since the 1970s. In this environment, interactions between inflation and public finances, and monetary and fiscal policies more generally, moved again to the centre stage in policy analysis – though only to a limited extent so far in empirical and theoretical research.

To fill this gap at least partially, in September 2022 the editors of *Public Sector Economics* launched a call for papers on the subject of inflation and public finances in the 2020s. Six papers were selected, analysing different aspects of taxation, public expenditure, and fiscal policy in both advanced and emerging market economies. One paper was published in the preceding issue of this journal, and five are included in this issue. One common message of these contributions is that inflation has significant implications for the design of tax and benefit systems, as well as for fiscal positions and their macroeconomic impact. For example, governments often respond to inflation-induced falls in households' purchasing power with various subsidy schemes, which are typically poorly targeted, costly, and tend to heighten the inflationary risks and undermine fiscal positions in the medium term.

In "Tax distortions from inflation: What are they? How to deal with them?", published in the preceding issue of this journal, Sebastian Beer, Mark Griffiths and Alexander Klemm show that even relatively low rates of inflation create distortions with significant economic consequences, because tax systems are in practice not neutral with respect to inflation. For example, with a real rate of return of 2% on savings and a tax rate of 25% on savings income, the effective tax rate on real savings returns reaches 100% when inflation rises to 6% per year. And in corporate income taxation, inflation raises effective tax rates for equity-financed investments, but lowers them for debt-financed investment, with the impact from interest deductibility dominating the loss in the value of depreciation allowances. The incentive to finance investments with debt thus intensifies as inflation rises.

In the paper "Inflation and public finances: an overview" that opens this issue of the journal, I analyse how inflation affects fiscal outcomes and identify the potential sources and consequences of fiscal instability in a high-inflation environment. The main argument I develop is that high inflation initially boosts government revenue faster than expenditure and may thus create an impression of healthy public finances. Greater sensitivity of tax revenues to inflation is partly structural, as modern tax systems have become much more reliant on VAT, and as digital technology facilitates collection of indirect and direct taxes and strengthens tax compliance. However, government expenditure also catches up quickly when inflation is persistently high, so the initial positive effect of inflation on fiscal positions quickly dissipates. The main risk in this situation is that the impression of abundant tax revenues and the initially slower adjustment of expenditure could lead politicians to advocate new public spending programmes or tax cuts, which could be difficult to reverse and would damage public finances in the longer term.

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Inflation also has major distributional consequences, which Orsetta Causa, Emilia Soldani, Nhung Luu and Chiara Soriolo analyse for OECD countries in their paper "A cost-of-living squeeze? Distributional implications of rising inflation". Drawing on national micro-based household budget surveys, they estimate that the declines in household purchasing power between August 2021 and August 2022 ranged from 3% in Japan to 18% in Czechia. Rural households were hit particularly hard, notably by energy price shocks, often more than low-income ones. This heterogeneity in the effects of inflation suggests the use of targeted support measures, which can limit the burden on government budgets by preserving, for instance, price signals for energy savings while providing a financial lifeline to most vulnerable households. The authors also underscore the need to consider factors such as the area of residence for effective targeting of fiscal support.

The remaining papers of this thematic issue are country case studies.

In "Short- and medium-term fiscal positions in a high-inflation environment: the case of Croatia", Frane Banić, Dominik Ivan Pripužić and Pave Rebić add inflation shocks to standard fiscal reaction functions. They find that an inflation surprise indeed has a favourable effect on the primary balance in the short term, and explain this effect by the high buoyancy of nominal tax bases with respect to inflation on the one hand, and the absence of formal indexation of public expenditure on the other. In the medium-term, however, inflation is likely to have a negative effect on the primary balance by raising government expenditure more than tax revenues. Fiscal policymakers in Croatia thus cannot take too much comfort from the current favourable state of public finances: without consolidation measures, fiscal positions could deteriorate in the medium term as inflation and policy rates are likely to stay elevated for a while.

In her study "A nexus between fiscal policy and inflation: a case study of Indonesia using SVAR model", Julie Ann Basconcillo analyses how public spending affected inflation and personal consumption in Indonesia over the past two decades. Her findings indicate that inflation responses differed across spending categories, with shocks to spending on subsidies more likely to lead to higher inflation than those on the government's own consumption or transfers to households. But even spending on subsides did not always have a statistically significant effect on inflation. Equally surprisingly, government spending shocks did not have statistically significant effect on private consumption. In other words, while the inflationary consequences of fiscal expansions in the case of Indonesia may be smaller than feared, they do not seem to boost private consumption either. The main macroeconomic consequence of fiscal expansions may thus have been a steady rise in government debt.

Finally, in "Unexpected inflation and public pensions: the case of Hungary", András Simonovits analyses the effects of different inflation indexation schemes and evaluates the impact of accelerating inflation on the decision to delay

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retirement. He highlights flaws in the design of pension benefits in an environment of high inflation (which are not unique to Hungary) and argues for, among other remedies, a more frequent intra-year annual adjustment of benefits when inflation is high.

As the Editor of this thematic issue, I would like to thank the authors for their outstanding effort in preparing this set of stimulating and analytically rich papers. I am very grateful to the reviewers for their insightful comments and patient reading of multiple versions of manuscripts. This issue would not have been possible without the great team from the Institute of Public Finance – Mihaela Bronić, Marina Nekić, Katarina Ott and Branko Stanić – to whom I extend heartfelt thanks for their guidance, expertise, and patience. Last but not least, I am grateful to the Editorial Board of *Public Sector Economics* for giving me the opportunity to arrange this special issue.

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