THE CONSEQUENCES OF TAX INCREASES WITH INFLATION RACING

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We are all obliged to overthink economic and financial problems when inflation is raging. We owe to the latter's influence that the solutions to be chosen may be different from those which would have been preferred with monetary stability and that the results to be expected should also differ. These considerations apply even more when inflation is raging all over the world as it does practically without interruption since the beginning of world war II, of course with differences of intensity in the various countries and in the various periods in which it is possible to sudivide the years 1939-76. In the frame of these ideas I had decided to propose to those organizing this meeting to be allowed to deal with the consequences of tax increases when inflation is raging. They agreed and I will divide my paper in three sections analysing first the consequences of tax increases with monetary stability, second the differences arising with inflation, third the possibilities to cope with unfavourable developments.

I

Tax increases reduce the purchasing power of those paying same but not the purchasing power of the whole economy as long as the proceeds of tax increases are either consumed or invested by the government. Let me add that these activities of the government will not increase only the purchasing power of the beneficiaries of these payments but even of the tax payers mentioned just before provided they are active or provided at least their pension is linked with the wages of those working. In that case we may expect an increase of the purchasing power of the economy involved and the worst a transfer of purchasing power. Of course if the proceeds of the tax increases are paid to the central bank or to other lenders of the Treasury whose propensity either to invest or to consume is limited or if the latter buys from the central bank foreign balances to be hoarded or let or invested abroad we may face not only a transfer but also a destruction of purchasing power.

As taxpayers are much more interested for their own purchasing power than for that of the whole community they do their best to reduce their tax liability and when the latter has been fixed they try to postpone the payment of the amounts involved in order to save the interest they will get in the meantime from their bank, to remain liquid and to take advantage of an eventual tax reduction which will not, at least very often, accrue to those who have already paid the amounts foreseen before the amendment of the legislation.

It has further to be considered that even in the case of the tax payers their payment will not necessarily lead to a diminution of their consumption or even of their investment because in order to avoid same they may either reduce their hoarding, or they may be able to increase their incomes as a consequence of more intensive labour or of a general wage increase linked with a corresponding increase of productivity or of increased prosperity due to the intensification of government activity which will be to the direct or indirect advantage of businessmen, shareholders and wage earners. Those taxpayers involved may also with the same aim contract loans at home or even abroad [2] or at least reduce their cash which will increase the velocity of their receipts. If the tax payers concerned want to aoid anyhow the reduction of their consumption they will disinvest but then there will be no increase of the purchasing power of the whole economy except if the central bank buys the investments involved or if those willing to buy reduce their hoarding or even import funds from aborad. James Tobin [3] expects that the redistribution of national income through tax increases will affect total consumption only to the extent the marginal propensity of the groups affected differs.

The postponement of the payment of tax increases by those obliged to do so provided it is not linked with fines or other disagreable consequences for them does not affect under monetary stability the real purchasing power the taxpayer has to transfer. Those involved may however thus avoid or postpone the contraction of loans saving so the interest to be paid. This has some importance when receipts sufficient to cover the amount of the tax increase due are expected by the taxpayers. On the other hand if the Treasury invests the proceeds of the tax increase in a way increasing the possibilities to produce and to take better advantage of the facilities available a) by increasing the safety of the country, particularly if the latter seems to be endangered, b) by improving the infrastructure even more when investments affecting same have not been carried out in an appropriate way recently as then the results will be important in many connections. The aggregates to be mainly influenced will be the whole economic activity, the incomes of the people, the latter's effective demand either for consumption or for investment or for both, the inventories available and outstanding credits. This upwards evolution of course with the exception of inventories at least until the production of the new investments is to start is due to a combination of the multiplier and of the accelerator whose interaction cannot be examined here. Of course it cannot be said that every tax increase is useful because there are many cases where overtaxation, even if the proceeds are used in the appropriate way, as said before, leads to stagnation, to the discouragement of investment by private people and by firms, to the discouragement of their activity, particularly of married women or of people free to chose their year of retirement and in general of all those who are not the only wage earner in the household involved, last but ot least to frictions between employers and on the other hand workers and employees on wage claims linked with increases of the cost of living caused by the tax increases. The resistance of employers is stronger when monetary stability prevails and when the competition between suppliers of the commodities or of the services involved is strong. The employers are then placed in the dilemma either to pay wage increases avoiding so strikes and unpleasant relations with their workers and employees but making themselves uncompetitive if their competitors have been able to avoid the grant of wage increases for any reason whatsoever because they were in a more favourable bargaining position or because they are abroad where foreign exchange fluctuations may simplify their problems. On the other hand strikes and even more the occupation of plants, which has become rather frequent in many countries and which if lasting may cause great damages, are more unpleasant for the employers not only in the private but also in the public sector. The losses incurred may affect unfavourably the living conditions for a long time upsetting under certain circumstances even the balance of payments.

Let me conclude by stressing that under conditions of monetary stability tax increases may but do not compulsory lead to a the diminution of the purchasing power of the tax payers. This does not mean however that the country concerned notices a diminution of its agregate purchasing power even if the payers of the increased tax have to cut either their consumption or their investment or both. Their cut will be neutralized by the increased expenses of those who will take advantage of increased public expenses except if the proceeds of tax increases are sterilised in one way or the other thus creating no surpluses for any group in the country concerned.

II

When inflation is raging the consequences of tax increases present various differences when compared to those noticed under conditions of monetary stability. As a matter of fact all those who are not influenced by the monetary illusion try hard to postpone their payments and certainly not only for reasons connected with their liquidity and their desire to save on interest account but also with certain other considerations. So those involved know that I) the later they pay the less they will be paying in real terms, 2) that the more they borrow the greater will be their profit, 3] that the rate of interest they are charged is of no importance as every time interest and redemption will become due they will be paying less in real terms realising so a growing windfall profit and as a rule taxfree, 4) that their profits will develop upwards only if they buy appreciating assets or if they proceed to investments chosen in an appropriate way, I mean those promising appreciation and not those whose price and income are not influenced upwards by inflation or even if they conclude agreements for the acquisition of raw materials, semi manufactured goods, spare parts, machinery, means of transportation, fuel etc. whilst insisting on immediate or at least on pretty quick delivery. The latter is required because if the delivery is delayed the seller may refuse same with the justification he is suffering a substantial loss [4]. Of course he may be in due time condemned to carry out the obligation he has assumed plus the payment of a substantial penalty but this will materialize only after a more or less long time when the delivery will be less important for the buyer. The latter will have in the meantime suffered a loss and will have had at least troubles from the late delivery of these commodities needed for the preparation of his own deliveries. The payment of penalties for his own delay except if he preferred to buy at any price in order to avoid being late is rather probable. Of course the payment of tax increases when inflation is raging has to be estimated in real terms and will be of no importance for the tax payer whose liability has been increased if the latter may be paid with the proceeds of the sale of an asset whose price was substantially pushed upwards by the inflation which is raging. On the other hand the government which has decided and carried through parliament the tax increase is keen to secure the quick payment of same for the same reasons, I mean the desire to get the greatest possible purchasing power at its earliest convenience with the hope or even the certitude that in this way its creditors will appreciate they were quickly paid. Of course :

a) they know as every body living when inflation is raging knows that they pay a heavy tax through the continuous diminution of the purchasing power of their cash and of their claims except if the latter are protected by index numbers, gold or foreign exchange, usually U.S. dollar clauses,

b) they appreciate when they get the cash involved as early as possible as they hope they will be able to secure inflation proof assets before the latter's prices will have jumped upwards once more inflicting after their rise a substantial loss to the sellers,

c) they try to exploit the depreciation of the monetary unit by contracting loans if available not protected against depreciation in order to pay with the proceeds the tax increases. If a balance remains from this loan those contracting same buy anything which is for sale at any price. Preference is given as far as possible to the purchase of those assets and of those commodities which may be easily sold when inflation is to end. That experience was paid at a very high price in Germany when inflation ended in November 1923 by those firms and private people who became illiquid and so went bankrupt whilst those whose assets were requested even after the end of inflation were able to hold their profits [5] and to resume business on a healthy basis after the reestablishment of monetary stability.

Tax increases can have satisfactory results for the Treasury when inflation is raging only if they are :

a) paid at once,

b) reevaluated according to the rate of inflation whenever they are paid,

c) affected at once.

a) The payment of tax increases when inflation is raging is connected with many difficulties.

aa) firot with the vote of the law not only in parliamentary regime but also whenever the latter has been abrogated,

bb) second with the assessment by the public services concerned of the amounts due by every individual and by every firm,

cc) third with the encashment of the amounts assessed particularly when a great number of taxpayers have to comply within a short time, even more in countries where the payment of taxes by cheques through the mail is not possible for any reason whatsoever independently of the desire of the taxpayers for the reasons exposed before to postpone their payments as much as possible,

dd) fourth with the dangers of errors in calculation and so of both erroneous assessments and encashment,

ee) fifth with the losses eventually incurred by the taxpayers if overcharged and by the Treasury if the tax increases which were assessed and encashed were lower than they ought to be. In both cases the reimbursement of amounts assessed and paid exceeding the amounts due and resp the payment of the supplement constituting the difference between the amount which was assessed and the amount which ought to be assessed will not lead to the reestablishment of what ought to have been done from the beginning in real terms. The restitution resp. the supplementary payment will be carried out in nominal terms and not as it ought to in real terms except if a machinery has been established for this purpose in advance and is operating in a satisfactory way in order to secure the settlement in real terms. The difficulties in this connection have not to be underestimated particularly at the lower levels both in the center and in the region and it has to be considered that the success or the failure will depend from the way those responsible will act there and from the way the taxpayers will react in order to contribute both ways to the supplementary assessment and payment resp. restitution.

b) Difficulties are also connected with the reevaluation of the tax increases according to the rate of inflation on the day of the settlement or at least of the day before if the calculation is carried out in a daily basis or of the last calculation before the payment is done whenever the calculation is effected less frequently. The more intense inflation is the more often the rate of inflation has to be ascertained as long as the aim of this ascertainment is to reach the payment of the accurate amount in real terms. The choice of the method of calculation and of assessment in combination in both cases with the difficulty of securing the appropriate handling at all levels in view of the necessity of persuading everybody involved and even more public mind of the fairness of the procedure to be applied constitute a very delicate problem inasmuch as in every inflation groups of taxpayers suffer and certainly do not enough have liquidity to afford any mistake of those responsible which would complicate their position even more.

c) Last but not least the tax increases' proceeds when inflation is raging have to be paid out before they have depreciated in real terms, before the benificiaries can claim increased amounts with the justification of depreciation, before the idea that the tax increase has been useless as neither those paying same nor those receiving same are satisfied. This last point has a limited value in inflation as usually very few oppose when new taxes are imposed or when the rates of taxes already encashed are increased. This is due to the knowledge that these new taxes resp. increased rates of old taxes will be unimportant when paid and that in the meantime incomes will have increased and debts will have lost even more of their burden for those involved. Opposition however may be expected from the real victims of inflation without the possibility of recovering through subsidies or even compulsory payments from those who profit from inflation. This is the case of holders of bonds without indexation, of blocked saving accounts and of houseowners whose rents cannot be readapted to new levels owing to the prohibition of rent increases which are imposed in order to curb inflation. In the old days retired people counted to the great sufferers of inflation but this has changed since the end of world war II as pensions have been linked in many cases in an automatic way to the wages and salaries of those working.

When inflation is raging intensely certain taxes as i.a. the income tax lose their importance and are even not ascertained nor collected as long as the amounts involved became unimportant and do not cover the expenses incurred for the whole procedure [6]. The abolition or at least the non enforcement is presented as a grant to tho se concerned whilst it constitutes only the jure consecration of prevailing real conditions. On the other hand with inflation provided it does not generate into hyperinflation progressive taxes become even more progressive as nominal and not real incomes are taxed, as incomes which before inflation became aggressive were quite satisfactory and could so support a rather high income tax rate are no more so when incomes, rents and prices continue rising of course not with the same intensity (it is greater in the case of prices than in the case of incomes and rents) with the result of growing discrepancy between nominal and real incomes [7].

Whilst under conditions of monetary stability income tax constitutes a substantial part of the production cost it is no more so in inflation. The cost and so the price is very much influenced then by turnover taxes and custom duties particularly when paid in advance by the producer or by the supplier, when the amounts involved are substantial, when the time gap between the payment to the Treasury and the payment by the customer to the supplier or the producer is long, also when the price increase in the meantime is important. The payment by the customer creates difficulties leading eventually to the non agreement on the sale because in bargaining particularly when the amounts involved are substantial he has the tendency to disregard the difference of nominal and real terms and the implication of interest calculated in the same currency but with great differences of purchasing power in every case. Of course solutions are usually possible provided both the supplier or producer on the one hand, the administration on the other are handling in good faith. This applies to relatively expensive and easily identifiable goods which may be stocked in a free harbour premise or even provided certain guarantees are available outside the free harbour giving so the chance to the eventual purchaser to see, to try and to compare. When this proves impossible the importer, producer or supplier pays the taxes due and tries to recover same in fixing accordingly his sale prices provided competition is not too strong. The amount paid and claimed in this connection from the customer is adapted in function of the index of the cost of living or of the index of wholesale prices, or of the price of the commodity traded or even of the rate of foreign exchange. Of course there is some danger all over the world that either by law or by court decision these readaptations should be declared void and so prevent the seller from recovering in real terms the amounts advanced in order to facilitate the sale of his commodities. This prepayment is unavoidable in the case of all those numerous commodities which do not fulfil the conditions mentioned before and so constitutes a loss for the taxpayer whilst the Treasury secures in real terms whatever is due to same.

III

There are of course possibilities to cope with unfavourable repercussions of inflation on tax increases a) in favour of the Treasury, b) in favour of the taxpayer.

a

The danger for the Treasury when inflation is raging is that the amounts due following taxincreases will be paid when they will have lost a substabtial part in real terms. The clauses foreseen to fight this loss are in no danger of being declared void as it may happen when their aim is to protect any body except the Treasury.

1. It is possible to stipulate that the payments due to the Treasury from tax increases will be readapted on the basis of the index of the cost of living or of the index of wholesale prices if not paid within the period fixed by law. The amount

due will be increased in function of the last fixing of the indices but it would not be fair to apply same on those payments which will have been effected before.

2. It is possible to readapt the amounts due from tax increases and not paid punctually on the basis of the foreign exchange rate of the day before the payment is carried out. This stipulation has the advantage that for its enforcement no calculations are needed provided of course the rate is a realistic one which is not the rule with foreign exchange control.

3. The punctual payment of the amounts due from tax increases may be furthered if the debtors are granted a reduction when paying before the amounts due are payable as for instance within three days after receiving advice whilst according to law they could pay within ten days.

4. The same reduction may be granted if the debtor of tax increases pays in foreign currencies provided he is not obliged by law to sell same to he banking system as it happens in many cases when foreign exchange control is in force.

5. The payment of tax arrears either forgotten by the Treasury or found out by checking the tax statement of the tax payer or the data available but on the basis of the rates of the day of payment of the arrears and not of the day of the initial payment. That means that if those concerned in the Treasury find out that a taxpayer owes $ 10.000 not paid punctually and that the index of the cost of living has increased in the meantime 15 %, he will have to pay a total of $ 11.500. If however later an arrear debt of $ 2.500 is found out and the taxpayer pays same when the index of the cost of living has jumped to 22 % he will have to pay $ 2.500 increased by 22 % that means $ 3.050 and not $ 2.500 increased by 15 % that is $ 2.875.

b

The danger for the taxpayer if he has been asked to pay more than he ought to and is later reimbursed is he will suffer a loss in real terms. The principles of good faith require however the reimbursement in real terms, on those bases exposed under a. Of course the Treasury will be most reluctant to do so but it seems to the rapporteur that onesided readaptation is not fair and that if tax increases have to be paid in real terms the restitution of amounts not due has to be carried out in the same way.

Conclusion

The consequences of inflation on tax increases may be neutralised as far as their payment or their restitution are concerned but cannot be neutralised as far as inflation is influencing the various data which will be calculated for the fixing of the amounts to be paid. Under these conditions it may be suggested that the tax increases when inflation is raging ought to be limited to those objects where the influence of inflation is not excessive or at least can be ascertained. Let me wonder in this connection if with inflation a capital tax or a heavy turnover tax provided the financing of the payment is secured without strengthening the rate of inflation and without imposing undue social hardship on those affected which is doubtful is not preferable to tax increases on a great scale.

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1. In order to avoid inflationary repercussions from this source.

2. The latter will have the same repercussions as the loans granted by the central bank if the latter buys the foreign balances involved.

3. James Tobin, The consumption function, New Haven 1968 maintains that the marginal propensity to consume out of thé proceeds of the sale of investments is much smaller (0.05-0.07) than the marginal propensity to consume out of current incomes (0.50-0.70).

4. Laesio enormis as a reason of breaking an agreement was already foreseen in Roman law.

5. Cf H. Schacht, Die Stabilisierung der Reichsmark, Stuttgart 1928, pp. 41-64 and D. J. Delivanis, La politique des banques allemandes en matière de crédit à court terme, Paris 1934, pp. 41-9.

6. As in Greece 1941-5.

7. This phenomenon is very important in coutries where wage-and salary increases have been substantially carried out with great sufferers in the case of all wage-and salary earners who became so the main contributors of income tax.

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