

SOME BENEFITS OF REDUCING INFLATION IN TRANSITION ECONOMIES

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EXECUTIVE SUMMARY

We study the interactions between inflation and the tax system in Poland and in Ukraine. The study is based on Feldstein's (1997, 1999) analysis. The goal is twofold. First, we evaluate the welfare effects of reducing inflation in these countries. Second, our analysis points out that the tax system in these two transition economies is, from the point of view of the issues discussed here, superior to the tax system in developed market economies. It therefore implies that transition countries should avoid replicating other tax systems and take advantage of the unique opportunity to design and entrench the features of their tax system which are superior to those in other countries.

The framework we use was developed by Feldstein (1997, 1999), who analysed the benefits of reducing inflation under the current US tax code. To date, this framework has been applied to developed countries only: United Kingdom (Bakhshi, Haldane and Hatch, 1999), New Zealand (Bonato, 1998), Spain (Dolado, Gonzalez-Paramo and Vinals, 1999), Canada (O'Reilly and Levac, 2000) and Germany (Tödter and Ziebarth, 1999).

Traditional approaches to evaluating the costs of inflation assume the tax system is not at issue. Instead, they typically concentrate on money market distortions (e.g. Lucas, 2000), effects on private and public contracts (Fischer and Modigliani, 1978 is a classic reference), roles of money (Konieczny, 1994) and the effects in the labour market (e.g. Akerlof, Dickens and Perry, 1996). The idea is that tax-induced distortions can be eliminated through a redesign of the tax system. Feldstein (1997), however, points out that eliminating tax-induced costs by redesigning the tax system is impractical. Tax-system reform is a complex process with many stakeholders. Central banks have little say in the design of tax rules. Therefore, a more fruitful approach is to analyse the costs of inflation in the context of existing tax rules and the distortions they induce.

We also briefly review the literature on the welfare costs of inflation and apply it to transition countries. We argue that, in the long run, the optimal rate of inflation in formerly planned economies should be the same as in mature market economies. There is a variety of opinions in the literature as to what the optimal rate of inflation should be. They vary from deflation equal to

about 3% (Friedman, 1969, Lucas, 2000) to about 3-4% (Akerlof, Dickens and Perry, 1996). The academic literature has been recently stressing the benefits of targeting the price level, rather than the rate of inflation (Svensson, 1999 showed that a price level target delivers lower variability of both nominal and real variables). Of price level targets, the best is price stability, i.e. a policy which maintains a constant price level. This assures the proper operation of money as a unit of account; it also reduces the likelihood of persistent deflation of the kind observed recently in Japan.

Inflation, operating in conjunction with the tax system, has four basic effects on welfare. It distorts: the intertemporal consumption choice (i.e. saving for old age), the money market, the real cost of servicing government debt, and the housing market. Of these the most important is the intertemporal distortion. Due to taxation of investment income, the after tax return to savings is inversely related to inflation. Hence the higher is inflation, the more expensive is retirement consumption and the lower are savings for old age. This distortion reduces per-year welfare in developed countries by almost 0.5% of GDP for each percentage point of inflation. Assuming that future welfare is discounted at the real interest rate of 3%; the present value of the benefit from reducing inflation by 1% is about 15% of GDP.

Our results point out that the situation is different in transition economies. The estimates of the welfare effect for Poland are four to seven times smaller than in developed countries; the estimates for Ukraine are three times smaller. This is due to the fact that the tax structure in these countries is superior to that in mature market economies. The crucial difference is the limited scope of taxes on investment income. It reduces the intertemporal consumption distortion and so changes in the inflation rate have smaller effects.

The most important policy conclusion here is a warning pertaining to the welfare consequences of taxing investment income. This discussion has so far been avoided in most transition countries, but the recent introduction of interest taxation in Poland suggests that, as has happened elsewhere, the “Sutton” approach to taxation may, eventually, prevail (Willie Sutton, a US bank robber, was reportedly once asked why he robbed banks. His answer: because that is where money is). It is clear that transition countries have high revenue needs, which induces the fiscal

authority to search for a new source of revenue. What the current paper points out, however, is that they have the benefit of designing institutions without the burden of the past. This often leads to superior institutions. For example, Cukierman, Miller and Neyapti (2002) find a high degree of central bank independence in transition economies.

The distortionary effects of inflation discussed here can, in principle, be eliminated (or, in the case of the housing market, reduced) by eliminating inflation. This is the basic argument of Feldstein (1997, 1999): given the fiscal structure, design the monetary policy so as to maximize consumer welfare. For transition economies the choice, however, is the reverse: given the monetary policy, design optimally the fiscal code. The reason for this situation is straightforward. For accession countries, like Poland, the next goal is to adopt the Euro. This goal will be realized within the time framework discussed here (a generation). Therefore the European Central Bank will set the rate of inflation in Poland. While the professed goal of the ECB is price stability, in practice it means inflation around 2%. Recent concerns about the possibility of deflation in the US and in Germany are likely to ensure that actual price stability will not be targeted in the foreseeable future. Moreover, given the large productivity gap between accession countries, their rate of inflation will be higher than in the rest of the European Union due to the Olivera-Tanzi effect. Combined with the segmentation of credit markets (Feldstein and Horioka, 1980) the interest rates in accession countries will be higher than in the rest of the Euro area. Other countries, for example Ukraine, will be able, in principle, to choose the long-run inflation rate independently. In practice, it is not likely they will target a rate of inflation lower than in the European Union, in particular because, as evidence in Filer and Hanousek (2000, 2002, 2003a,b) suggests, the bias in inflation measurement is large in transition countries.

On the other hand, the choice of fiscal policy is up to the fiscal authorities in these countries. The European Union leaves member countries, at present, wide latitude to set their own tax rules. A likely argument for introducing taxation on investment income would be that additional revenue is needed and “that is how things are done in developed countries.” Our analysis stresses this would be a mistake as the current tax system is worth preserving. Thus the optimal policy is to avoid the temptation and not tax investment income.