

HOW INFLATION IS A POLICY NOWADAYS

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Abstract

After World War II, democracies witnessed transformations that were and are much more lenient vis-à-vis the rise in inflation. The main institutional changes that have occurred gradually ever since and can combine nowadays to fuel inflation refer to (i) the shift in ideas referring to equality and redistribution, (ii) the labor market policies, (iii) bringing man's natural environment to the level of importance of the social environment, with a particular focus on climate, and (iv) preserving a large capacity of the government to produce inflation in a context in which political power has granted independence to the central bank in terms of monetary policy. We show how features of society listed under items (i)-(iv) had combined to lead to low and stable inflation during 1982-2008, to lower than desired inflation during 2009-2020, and to the high inflation starting with 2021. The inflation-taming efforts succeeded only when three elements acted jointly: (A) raising the interest rate while no longer considering the inflation-unemployment tradeoff, impacting features (ii) and (iv); (B) adjusting budget deficits and stabilizing fiscal expectations, impacting feature (iv); (C) measures for reviving economic freedom, with an impact on features (i), (ii), and (iii).

Keywords: inflation, redistribution, economic power, political power, public debt.

1. Introduction

The increase in interest rates entails high costs for those in debt. Inflation entails costs for everyone. How could an economist explain to someone in debt that central banks have to raise interest rates and it is not they, at least not always, that should be resented for that? To be honest, I don't think there exists a sufficiently eloquent and, therefore, embraced by people economic explanation in this case. The economic rationale is not readily accessible and, especially, it is not 'wired' to people's day-to-day life. It always involves a longer-term perspective that engages people's patience and goodwill, which have been every so often entreated and which, in most instances, have not been properly rewarded.

In this paper, I have opted for an analysis that places people straight at the core of explanations. In order to depict the ugliness of very high inflation, in the following section I quote Hemingway, a famous writer, then I turn to Mises, a famous economist, to show why inflation, despite its ugliness, can become a way of living depending on the ideas that most of us have. Section third shows what changes occurred in the Western societies after the Second World War and how the new features can combine, depending on the ideas prevailing in the society, to fuel inflation or not. Section fourth describes three necessary measures that have to work jointly to curb high inflation. The final section shows why countries with a relatively high share of taxes in GDP could have difficulties in taming inflation and why, in the case of Romania, increasing the tax-to-GDP ratio to the average EU level would be counterproductive. Data used in the paper come from works listed in the references section and from AMECO.

2. Inflation, our preferences and German cakes

The argument should paint a picture from people's day-to-day perspective. Economists can do that if they strive, but a writer accustomed to perceiving human micro-universes would probably fare much better. For instance, Ernest Hemingway was inspired when depicting the idea also shared by economists, namely that inflation is an adjustment in the rate of exchange between money and goods and that any drastic adjustment has favorable effects for some and dreadful for others. In September 1922, Hemingway traveled with his wife from Strasbourg (France) to Kehl (Germany). He crossed the four-kilometer bridge connecting the two towns and exchanged 10 francs (i.e., less than one Canadian dollar) for 670 German marks. This amount lasted them a day of 'heavy spending'; and they still had 120 marks left (Hemingway, 1922).

For example, a five-course lunch at the restaurant of the hotel in Kehl cost 15 cents, while in Strasbourg it was worth 1 dollar. Hence, 'this miracle of exchange makes a swinish spectacle where the youth of the town of Strasbourg crowd into the German pastry shop to eat themselves sick and gorge on fluffy, cream-filled slices of German cake at five marks the slice. The contents of a pastry shop are swept clear in half an hour'.

Do you think the proprietor of the pastry shop was glad to sell his goods so quickly? No, he wasn't! 'The proprietor and his helper were surly and didn't seem particularly

happy when all the cakes were sold. The mark was falling faster than they could bake'. As we know, the 1922 inflation gained momentum for another year. In September 1922, 1 dollar was worth 800 marks (Hemingway, 1922), while in November 1923, the dollar was pegged at 4.2 trillion marks (Mises, 2006 [1979], p. 63). In other words, the mark was no longer worth anything. Many lessons can be derived from this short account: that inflation can spike out of control; that warfare always has disastrous implications for inflation, as is the case nowadays due to Russia's invasion of Ukraine; that very high inflation results in the destruction of the currency and therefore is not sustainable; that inflation is good for some, but bad for others, etc.

One might say that, in the meantime, we have created mechanisms to make sure we no longer end up in a situation like that of Germany back then. I have referred to Germany, but the Austrian krone or the Russian ruble were undergoing the same process of massive loss in value at the time.

Granted, the mechanisms in place nowadays render unlikely a currency depreciation relative to goods of a similar magnitude to that seen in the aftermath of World War I, amid the collapse of some empires. Yet there are different degrees of evil, it does not necessarily take a debacle for pain to emerge. It is enough for inflation to stick to relatively high readings over a longer period for it to lower the standard of living for most people.

Ludwig von Mises, a direct observer of the hyperinflation in Germany and Austria, who had advised the Austrian government to stop the monetary printing press, wondered in 1959: 'If inflation is bad and if people realize it, why has it become almost a way of life in all countries?' (Mises, 2006 [1979], p. 67). Since then, the Western world has crossed periods of relatively high inflation, such as that of the 1970s, but also periods of low and stable inflation, as was the case from 1982 through 2008. Consequently, if high inflation is bad and if a large part of the people realize it, then we can add a touch to the initial question via two other queries: 'why does high inflation keep rearing its head, sometimes over relatively long time spans?' and 'why do some frown on raising interest rates to levels that would prompt inflation to stick or return fairly quickly to relatively low levels?'.

Mises (2006 [1979], p. 72) came up with an insightful and summarizing answer to the question he formulated: inflation can be a way of life because 'inflation is a policy – a deliberate policy of people who resort to inflation because they consider it to be a lesser evil than unemployment.' And it should be reminded that it is an unsustainable policy. In the preface to the 1953 English edition of the book 'The Theory of Money and Credit', initially published in German in 1912, Mises (2009) [1953] is very clear and states that 'the great inflations of our age are, ... to say it bluntly, government-made'. He also explains, using the context of the time in Western economies, why the government resorts to higher inflation: in order to reduce the real wages imposed by unions above the free market levels; and he is being ironic when saying that John M. Keynes taught the government how to cheat the workers through inflationary policies (Mises, 2006 [1979], p. 70).

I believe that 'inflation is a policy' is also the answer to the question of why relatively high inflation emerges every now and then in Western democracies. And, going further, the answer to the query of why some oppose an interest rate hike becomes apparent as well:

because it is at odds with the policy called inflation, at least for the promoters of that policy. For those who might be immediately prompted to conclude that, in our age, this answer would refer to independent central banks or that I am talking about an unsustainable monetary policy of the central bank, let me say that it would only be a shallow conclusion, as I am about to show. In fact, one of the purposes of this article is to show how difficult can be, in a democracy, the task of an independent central bank to lower inflation and how the long roots of high inflation can be traced back to governments.

If relatively high inflation is a policy, then I need to firmly point out that it can only emerge in strict concordance with prevailing ideas in the society. These ideas alter, over time, certain key elements in the structure of the society, so that a policy could never be at odds with prevailing ideas and with the structure of the society that those ideas shape. Each of us contributes to this structure through our preferences regarding the countless choices we make in any area.

In their effort to win democratic elections, the politicians and the governments they form need to discover as accurately as possible to what extent these preferences are dedicated to general objectives. We could consider there are three overarching objectives that modern governments contemplate: solidarity, economic growth, and sustainability¹. These objectives are not necessarily compatible, since the focus of preferences on economic growth and solidarity can be at odds with sustainability.

In the modern Western world, the extent to which preferences are shifted towards sustainability relative to the other two objectives can differ from one country to another or, for a given country, over time. Anyway, since these preferences are strongly reliant on cultural, social, ideological, and political factors, they are supposedly relatively stable, although changes may occur in the long run by learning. There are countries where preferences seem to be shifted towards the sustainability objective, the same as, in other countries, the preference for sustainability is weaker.

However, we can say that, in the Western world overall, the preferences regarding those objectives led to the fine-tuning of methods to achieve them through the transformation of the capitalist society. In the history of the past 220 years, the time span when inflation and interest rates exhibited the most stability and were comparatively lower stretched between 1873 and 1913, during which time the gold standard functioned in full compliance with the rules it was based on. I can safely say that, during that period, the liberal ideology made the preferences in countries participating in the system shift significantly towards sustainability. This explains why there were only a few hindrances from objectives regarding solidarity or growth to the pass-through of competitiveness requirements from markets (the private sector) into the parameters of economic policies.

1 The three objectives are listed by Crum (2013). Specifically, he refers to the governments' preferences on economic policy-making, which are identified following the public debate. These economic policy preferences regarding the three objectives are taken into account to identify the diversity of nations, on top of the institutional differences of national states, especially in terms of finding a solution about a monetary union that is not based on a political union, as is the case of the euro area.

That system warranted that ‘inflation was a policy’ of low and stable inflation. That warranty incorporated in the gold standard reflected the fundamental principle of freedom from government interventions, strongly anchored culturally, socially, ideologically, and politically. The gold standard implied a highly disciplined fiscal policy and an autonomous monetary policy, without domestic objectives regarding employment or price stabilization. Thus, the latter policy could be compatible with fixed exchange rates and with capital mobility. The gold standard was an anti-inflationary policy. This does not mean inflation could not rise during certain periods. For instance, inflation would rise as a result of the ‘cumulative process’ described by Wicksell and later fine-tuned by Mises and Hayek. In this process, banks set interest rates below the natural level, fueling investment and, ultimately, inflation, and it was the banks again that halted/lowered inflation when it eroded their reserves. The government was not in this process.

3. Inflation and redistribution

The period after World War II, as democracy spread and the number of voters expanded, witnessed transformations that were and are much more lenient vis-à-vis the rise in inflation (i.e., that allowed and allow inflation to be a policy of high inflation). The main institutional changes that have occurred gradually ever since and can combine nowadays to fuel inflation refer to (i) the shift in economic ideas in favor of higher economic equality and privileging redistribution, (ii) the labor market and the strength of unions, (iii) bringing man’s natural environment to the level of importance of the social environment, with a particular focus on climate, and (iv) preserving a large capacity of the government to produce inflation in a context in which political power has granted independence to the central bank in terms of monetary policy. The latter transformation reflects, as I will detail further on, an incomplete awareness by the society of the democratic political milieu’s propensity towards inflation and it cannot guarantee that ‘inflation is a policy’ of low and stable inflation. The said transformations carry the potential to make inflation growth rampant, as proven most recently in 2021 and 2022. I will briefly refer to each of these transformations.

Redistribution is a consequence of the prevailing view of some leftist economists, according to which the market cannot ensure a structure of incentives able to lead to a fair redistribution of production outcomes. A direct consequence of this view is that saving is concentrated among the wealthiest individuals in the society, so that aggregate demand is slowed, which reflects in low economic growth².

2 Hayek shows that the erroneous idea according to which saving reduces consumption, so that the latter cannot keep up with production, is ‘as old as the science of political economy itself’. This idea penetrated into the political economy of socialism shaped as the concentration of savings in the hands of the wealthy, due to the market-made redistribution process, and was initially described by Mikhail Tugan-Baranovsky, in 1894, in Russia, and by John Hobson, who elaborated on it back in 1909 (see Hayek, 1931; Mitchell Wesley, 1927). Keynes took over this idea in the explanation he provided for

In virtue of this concept, the redistribution materializing as social expenditure has steadily outpaced production, as of the 1960s. Hence, it has become a rigid expenditure of governments, which they have to finance, no matter the inflation level. Spending rose in tandem with taxation, so that, nowadays, the ratio of budget revenues to GDP is very high, climbing in some Western economies even towards 45 percent of GDP. On one hand, in the best case, some spending, social spending in particular, is hard to cut, and, in the worst case, its growth is hard to mitigate. On the other hand, raising taxes is difficult and unpopular.

Under these circumstances, excessive redistribution has come to act as a major growth factor of public debt and as a severe challenge for governments to comply with the intertemporal budget constraint. Whenever they fail to observe this constraint, governments produce inflation³. This reality weakens the monetary policy's capacity to tame inflation. The fact that governments can produce inflation, although central banks are independent, is essentially one of the reasons which prompted the above remark, i.e., that awareness by the society of the political power's propensity towards relatively high inflation is incomplete.

The way in which the labor market is regulated is another source of inflation. Back in the 1970s, unions were very powerful and could impose wages above the free market level. During that period, the same as governments, unions had the power to intervene in the market and impose the price of labor. This led to a contradiction (noticed, for instance, by Mises, as already mentioned, but also by Hayek, Friedman, and other economists of the time) between overly high wages tending to reduce employment and the fact that monetary and fiscal policies were accountable for achieving full employment. The outcome was a relatively high inflation.

I believe that, nowadays, union leverage is much smaller, but the role of unions in wage growth has been transferred into law-embedded automated mechanisms, such as the minimum wage, regulations fostering the 'work-shy' and, hence, increased demand for labor relative to supply, etc. But it doesn't matter too much how sticky wages end up exceeding the level that would normally exist in a free market. What matters is that, in some cases, monetary and fiscal policies have the role of ensuring full employment while wages above the equilibrium level push output downwards. Everything is more inconspicuous in the labor market today than in the heydays of unions, but the essence remains: market requirements for competitiveness and sustainability of business are filtered through a set of regulations that put public policy sustainability behind other objectives.

the Great Depression of 1929–33 and it is known as the so-called 'paradox of saving'. In the meantime, various theories of sub-consumption have emerged, in order to justify the preoccupation of modern society and of economists with aggregate demand management and hence with the neglect of hurdles that various policies conceived to foster redistribution pose to supply.

- 3 When they tax in order to redistribute, governments take resources from the private sector to shift them over to certain parts of the private or public sector. When governments raise debt in order to redistribute, but end up raising inflation to reduce that debt in real terms, they shift resources from the private sector over to themselves. In this latter case, governments practically resort to some sort of financial repression.

As regards climate, in various stages after World War II, but most visibly during the 1960s–1970s and more recently in the past years, the natural environment has been brought to the same level of importance for man as the social environment, although developments in the two environments are governed by laws that are very different in their nature (Hayek (1974) made it clear in his Nobel Prize lecture ‘Pretence of Knowledge’). Disregarding the fact that in society we cannot identify laws to show us where society is headed, what changes occur, and how we can control them, we are currently witnessing the revival of the almost ‘religious’ view that we can transform the society to fulfill climate-related objectives. The new religion is called ‘sustainability’ and many government interventions in the economy are permitted in its name. In the name of this environment-related sustainability, the sustainability of (macro)economic policies is implicitly pushed into the background. It is certain that public policies for the hastened ‘greening’ of the economy had a major contribution to the rise in inflation, because, under regulatory pressure, they led to a decline in the supply of gas, oil, and coal, decoupled from the real factors that influenced the demand for such commodities, putting pressure on these commodity prices.

Finally, in order to get closer to monetary policy and inflation, mentioned under item (iv) above, it should be added that most central banks were not independent until the early 1990s. They are now independent from political power in terms of setting monetary policy instruments and can raise interest rates to combat inflation without asking for someone’s permission. This marks significant progress. The aim of independent central banks’ monetary policies is low and stable inflation. And yet, the freedom of monetary policy to independently use its instruments is by no means tantamount to a withdrawal of political power from the inflation matter.

I have already suggested, when referring to redistribution, that the government – although granting independence to the central bank – has maintained its possibility to produce inflation, independently from central bank actions. Insofar as expectations are rational, the government produces a rise in inflation when it increases public debt to a larger extent than the expected discounted present value of future fiscal primary surpluses, as stated and solidly demonstrated by the fiscal theory of the price level. Thus, even though central bank independence in terms of setting the monetary policy has been granted by politicians in order for inflation to be a price stability policy, its implementation remains an issue reliant on the government’s capacity to observe its intertemporal budget constraint⁴.

In turn, as underlined above, the government’s ability to comply with its budget constraint and, hence, to stabilize fiscal expectations remains conditional on solving the difficult task of cutting budget expenditures and/or raising taxes from the already high levels they were brought to by the factors that shifted voters’ preferences to the detriment of sustainability. Insofar as excessive redistribution (in the broad sense, i.e., excessive government

⁴ By contrast, under the gold standard, the possibility for the government to produce inflation was virtually nil, for which reason the system had a clause that suspended the gold standard in case of war, in order to enable governments to produce the inflation needed for lowering in real terms the public debt built up in the process of financing a war.

spending) manages to hamper this government task, it also manages to compound the central bank's task of stabilizing inflation at relatively low levels.

Besides, at present, the central bank has no mechanism to safeguard it from choosing between sustainability and objectives regarding economic growth and solidarity, as long as its objectives, set by parliaments, also include other goals than price stability, leaving the list open.

One might ask: why haven't these features of the society, listed under items (i)–(iv), led to high inflation during 1982–2008 or in the period from 2009 to 2020? The answer is simple. It depends on the strength of each feature and on the way in which they combine. The problem, however, is that the groundwork is laid for the emergence of high inflation episodes, although there may be circumstances when the respective features can combine to favor low and stable inflation.

For instance, such an auspicious combination occurred in the period from 1982 to 2008, which saw a return of the liberal spirit and neoclassicism ideas into the economy, thus enabling (ia) an easing of redistributive policies and a policy fostering supply ('supply side economics'), (iia) labor market deregulation and less concern with increasing social spending, (iiia) the riddance of exaggerations about incorporating environmental issues into government programs and, finally, (iva) the carrying out of monetary policies oriented towards price stabilization and, very importantly, accompanying them by fiscal policies guided by the observance of governments' intertemporal budget constraint. The gradual increase in the economic freedom that emerged in the respective period by altering the mentioned elements was the key to success in stabilizing inflation at low levels.

However, in the period from 2009 to 2019, things changed almost in the opposite direction: (ib) redistribution picked up, spurred by fresh ideals regarding higher economic equality, and new restrictions to supply emerged, (iib) the labor market became more regulated, (iiib) highly ambitious programs were launched to address climate change, and (ivb) in developed economies, monetary policies shifted to quantitative easing (which, in principle, fostered inflation) accompanied by speeches (see Cochrane (2011) for examples) about compliance with governments' budget constraint (which, in principle, nurtured expectations that fiscal policy would not produce inflation). All these components had magnitudes and combined in a way in which they did not manage to engender a rise in inflation from relatively low levels to the inflation target in developed countries. Nevertheless, upon the outbreak of the pandemic, which entailed increases in public debts in 2020, without them being accompanied by similar rises in the expected present value of primary budget surpluses, the fiscal policy in various countries contributed, alongside costlier gas and energy, to the step-up in inflation above central banks' inflation targets.

The elements/features listed under items (i) to (iv) are in close connection with political power⁵, as can be worked out from the analysis regarding the two periods. However,

5 I am using the terms 'political power' and 'economic power' here as they are employed by Friedman and Friedman (2002 [1962]).

in order not to rely solely on examples, the logical connections between elements can be highlighted. Thus, if the public's preferences are massively shifted towards the objectives of solidarity and growth, to the detriment of sustainability, then political decisions favor the heightening of redistribution, interventions in the labor market and in other markets and may render difficult the compliance with the government's intertemporal budget constraint. Problems that were previously solved through private decisions (for example, distribution) are now solved via political decisions (redistribution). Hence, political power grows. In this process, economic freedom (market role) tends to diminish and the private sector's economic power dwindles, as an increasing number of means are displaced from private utilizations. Thus, as pointed out by Friedman and Friedman (2002 [1962], p. 9), a profound consequence is that the economic power of the private sector can no longer counterbalance political power, which means there is no longer a clear separation between the two powers, indicating a weakening of competitive capitalism and of the basis of political freedom. But, in the approach I proposed here, we can also distinguish a consequence for price dynamics: the imbalance between the two powers (which jointly run the economy in a democracy) reflects in magnitudes and combinations of elements (i)–(iv) that can result into relatively high inflation if, due to the said combinations, the government can no longer comply or chooses to no longer comply with its budget constraint for a while⁶.

Under the circumstances, an independent central bank's task of taming inflation is significantly hampered. If the government does not observe its intertemporal budget constraint, then the same inflation target can be attained by the central bank with higher interest rates.

Back in 1935, not long before the outbreak of World War II, Hemingway (1935) wrote: 'the first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists.' Russia, where both democracy and economic

6 I stated earlier that 'the gold standard was an anti-inflationary policy'. Taking the aforementioned arguments into account, we could say that the gold standard was an anti-inflationary policy on each element of those listed under (i) to (iv) because it managed to counterbalance the political and economic powers. Of course, the complex relationship between economic freedom and, on one hand, individual freedom, in general, and, on the other hand, political freedom, does not mean that during the gold standard there was more political freedom. At the time, economic freedom often coexisted with a weak political freedom. Economic freedom is necessary for political freedom, but it is not sufficient (Friedman and Friedman, 2002 [1962]; Mises, 1962). Where economic freedom vanishes, political freedom disappears as well. Consequently, within systems where economic freedom does not exist, such as socialism, there is no such thing as political freedom. In a democracy, the two freedoms coexist, yet the reduction in the private sector's economic freedom by the political power can lead to a decrease in economic power and the limitation of political freedom (great thinkers like Ludwig von Mises, Friedrich von Hayek, Milton Friedman, Rose D. Friedman, Amartya Sen, Jagdish Bhagwati, Gordon Tullock, Alan Greenspan, Francis Fukuyama shed light on the nexus between economic freedom and political freedom).

freedom are feeble⁷, will have the possibility to reflect on the truth of these statements from the perspective of the war it launched in Ukraine. But what could, in the context described here, a mismanaged society in consolidated democracies mean and, specifically, what would inflation be a panacea for?

From the standpoint taken here, a democratic society is mishandled when the balance between political power and the economic power of the private sector is tilted, with the former power outweighing the latter. Against this background, high inflation helps with the repayment of public debt. The latter emerges in the process of rising political power via the expansion of redistribution up to a point from where taxes are too high to be raised further and expenditures cover too sensitive areas to be lowered by those who believe in the extended role of the state. A persistently tilted balance between the two powers means a democracy with relatively low liberalism. Liberalism means equally economic and political freedom, so that its erosion could not be done for a long time solely on the economic component. The erosion of political freedoms would sooner or later follow as well, since economic freedom is a necessary – although not sufficient – condition for political freedom.

4. Three necessary measures to combat inflation: the lesson of the 1980s

In order to avoid that features (i) to (iv) acquire magnitudes and interact in ways which, aside from the potential to speed up inflation, would also lead to the erosion of political freedoms, governments in Western society need to shift to policies enhancing economic freedom. This is the fundamental objective.

In practice, however, the ideal of higher economic equality and the underlying economic theories might prevent governments from seeing clearly enough that they have reached magnitudes and features which, unless reversed, will continue to diminish economic freedom (low EF), produce inflation (high I) and alter political freedom (low PF) (in this exact order), without obtaining a reduction in economic inequality via redistribution.

When, in the years 1982–2008, governments initiated the measures whereby they adjusted the magnitude and the relations between elements (i)–(iv), as I have mentioned above, they created the conditions for the reduction in economic freedom in the period from 1950 to 1970, which had already generated the Great Inflation period, not to result into an erosion of political freedom. In other words, the society used the mechanisms at its disposal to break the low EF – high I – low PF sequence both via an increase in economic freedom and by fighting inflation.

At this point, recapping several facts will help clarify the statement that the decline in economic freedom via excessive redistribution not only entails high inflation and the risk of lower political freedom, but it cannot reduce economic inequality either. First, governments might continue to believe that economic equality and political freedom can coexist.

⁷ According to Freedom House, Russia is an ‘authoritarian political system’ (<https://freedomhouse.org/country/russia/freedom-world/2022>) and, according to Heritage Foundation, its economy is ‘mostly unfree’ (<https://www.heritage.org/index/ranking>).

To an extreme, socialism has shown, however, that economic equality and political freedom cannot live together and has proven that all society can do is choose between economic freedom and political freedom, on one hand, and equality in poverty, on the other hand.

Second, governments see that democracy has led to an increase in budget revenues as a share of GDP, but not to lower inequality as well. Those who advocate massive government intervention might think that the negative relation between the two elements is non-linear and that the budget revenues-to-GDP ratio has not yet reached the critical level from which it would start to reduce economic inequality significantly.

Nevertheless, as Laffer has shown, an increase in tax rates above a certain level no longer collects revenues to the budget, but even diminishes them. Up to the point from which it starts lowering budget revenues, the rise in tax rates continues to alter the private sector's economic freedom and power. From that point onwards, the increase in tax rates continues to diminish economic power and, in addition, it starts producing inflation, because it fuels expectations that the government will need to raise public debt without being able to generate a rise in real primary surpluses to the same extent. Now, only a decrease in taxes could result into additional revenues, which is at odds with the prevailing view that inequality is reduced by raising taxes.

Third, a big and highly-indebted government introduces uncertainty and alters the decision-making process in the private sector. Each entity is worried about what the government will do: will it raise taxes, cut spending or produce inflation? In Romania at least, not one year has gone by without this question dominating the agenda. Whatever the *de facto* economic growth, it is smaller than it could be if the uncertainty and distortions thus introduced did not exist. Hence, the government worsens its unsustainable position.

If governments understand that their sizes have become an issue, they should try to scale down the redistributive activity. The problem is, as shown above, that – if preferences in the society are shifted towards objectives regarding solidarity and growth/employment – politicians will find this task extremely challenging. In other words, although counterintuitive, the rebalancing of the two powers by reducing political power in favor of economic power is difficult. The tendency will be to procrastinate the necessary adjustments.

As it can be already seen, and as I have argued in this essay, postponing the necessary adjustments adds to the inflation fueled by other sources. All the costs and distortions generated by relatively high inflation will rise. But, since we end up anyway with high inflation, and its fiscal component becomes apparent, then we can also see a potential positive consequence thereof, unintended by those who promote the growth of redistribution and of other forms of government intervention in the economy: high inflation might make people understand better why they could prefer the sustainability objective and might encourage the vote for those politicians who favor reforms aimed at enhancing economic power. At least that's what happened after the Great Inflation of 1965–1982, so that, in the low EF – high I – low PF sequence, the latter component no longer showed up, which gives us hope that the society might exhibit the same wisdom again.

It is worth noting that, before this change occurred, several attempts to bring inflation down were made in the US, but they all failed. Those attempts failed because they did not

address all the causes that had determined the inflation, as they resulted from the magnitude and connections of items (i) to (iv). The inflation-taming efforts succeeded only when three elements acted jointly: (A) raising the interest rate while no longer considering the inflation-unemployment tradeoff. This change impacted features (ii), regarding the labor market, and (iv), regarding central bank independence and preserving the government's capacity to produce inflation; (B) adjusting budget deficits and stabilizing fiscal expectations, with an impact on feature (iv); and, finally, (C) measures for reviving economic freedom, with an impact on feature (i), regarding redistribution and the ideas guiding it, as well as on feature (ii), and feature (iii) regarding the balance between the social environment and the natural environment of man.

At present as well, the sustainable reduction of inflation to relatively low and stable levels needs the simultaneous implementation of the actions listed under items (A), (B) and (C), the same as in the post-1982 period. However, although not impossible, replicating that experience is more challenging due to the way in which elements (i) to (iv) combine nowadays in democratic societies. Specifically, the prevailing views on the increased role of redistribution in curbing economic inequality alter the way in which central banks face the short-run tradeoff between unemployment and inflation, with negative consequences for both inflation and employment, as well as governments' capacity to refrain from producing fiscal inflation. Besides, as it has been the case over the past years, our groundless belief that we have the necessary knowledge about how to influence climate relatively quickly may lead to decisions that can trigger big shocks in inflation on the energy and fuel supply side, with a destabilizing effect on the social environment. Finally, the belief that increased redistribution will entail lower inequality is at odds with the revival of economic freedom, whose potential deterioration would not be harmless for the other freedoms.

5. What we should do with fiscal policy in Romania

Bringing inflation down in Romania requires not only raising the monetary policy rate, but also anchoring fiscal expectations by creating a coherent and sustainable policy to narrow the budget deficit. Numerous analysts claim that deficit reduction should be carried out by expanding budget revenues and that it cannot be done to the necessary extent without increasing tax rates. Moreover, it is a widely spread idea that Romania, with a share of tax revenue in GDP (the so-called burden of taxation without imputed social contributions in the European System of Accounts 2010) of only 27 percent, would supposedly have a problem within the European Union. Thus, some propose that Romania should have as a strategy to attain similar values to the EU average, which has ranged between 38 percent and 41 percent of GDP since 1995.

However, in light of those discussed in this essay, I don't think that any country needs to set its objective to raise tax rates in order to push the share of budget revenues in GDP towards the EU average. I don't see any microeconomic foundation for setting such a target. Rather, I believe that those countries with too large a share of budget revenues in GDP have a problem, as they place too heavy a burden on the private sector.

In the period from 1995 to 2020, the averages of budget revenues expressed as a percentage of GDP were similar in Romania to those recorded in the US (26.3), Switzerland (26.1) and Japan (27.2). In the US, the average for the entire 1970–2020 period stood at 26.2 percent of GDP, while in Japan the average for 1981–2020 was 26.6 percent of GDP. All these countries provide very good public services to their citizens. They all have the same social contract as we do: power is conceded by the people to three separate powers, i.e., judicial, executive, and legislative. Where we differ is in terms of the quality of separation among the three powers, in respect to which we have got some catching-up to do, the quality of collection, which we need to increase, and fiscal evasion, which we need to reduce. If we were to achieve these objectives, the share of budget revenues in GDP would widen to more than 33 percent in Romania. The remaining effort should be on the expenditure side, *inter alia* by reducing profligacy.

For the Romanian economy, raising tax rates would be counterproductive in terms of the impact on the private sector's economic power and on economic growth that is already stymied by the pick-up in inflation, which acts as a tax. At the same time, it would be a validation of the erroneous wage-led growth policies seen from 2017 through 2019, which would create moral hazard. The public would realize that, once again, fiscal policy would follow a path imposed by the need to correct previous mistakes, not one deliberately chosen to increase the volume and quality of government-supplied services (an outcome predicted by Hayek for policies not guided by principles).

Households and firms would notice that they would not pay higher taxes in exchange for more goods and services of better quality, as it would be fair, but mainly to help the government sector overcome the financial difficulties it has brought upon itself via those erroneous policies. The period from 1995 to 2021 saw various taxation systems, including steep-slope progressive taxes, but the share of budget revenues in GDP (burden of taxation) exceeded 30 percent only in 1999 (31 percent) and 2000 (30.3 percent). This shows that, amid a fiscal policy not guided by principles, the taxes that the public wishes to pay remain relatively low, no matter how much the tax rates go up (the inflection point on a Laffer curve with tax revenue on the vertical axis and rates of taxation on the horizontal one would occur at a relatively low level on the vertical axis).

At least in certain areas, such as the labor force, taxes are relatively high already, which dents firms' competitiveness somewhat. The rise in other taxes would reduce their competitiveness even more. Also, introducing a progressive income tax would be counterproductive, because it would only be another way to heighten redistribution and reduce savings and work incentives. This does not mean that in other areas there is room for cutting taxes, directly or indirectly, by setting rules not guided by principles. Briefly, exceptions to good general rules (free of purpose rules) discovered in practice should not be allowed, as they introduce distortions and result into the reduction of budget revenues and they are difficult to withdraw. The removal of exceptions is necessary and is highly likely to increase the share of budget revenues in GDP.

In Romania, aside from the adoption of rules guided by principles, fiscal reform should aim for increased taxpayer compliance. The fiscal authority can do this only if it shows that

it is more civilized than those who circumvent the payment of taxes. This civility can grow if the fiscal authority understands that it needs to eradicate the channels enabling evasion. Modernizing the collection system via IT technologies is an absolute must. Then it is required to enhance the quality of spending public money. When taxpayers see that what they pay through taxes returns to them in the form of expected public services and goods, they will be more than willing to comply with the rules.

Any discussion about revenues without connecting it to the mechanisms that push expenditures to increasingly higher levels as a share of GDP is not complete, as it should be. Assessing the issue of the so-called budget revenue insufficiency needs to start from the understanding that revenues are a means, whereas the expenses they must cover represent the objectives. The objectives should be set depending on the means. Unfortunately, in practice, it is pretty much the other way around. Hence there is a need for a reform that no country has in a complete and effective shape, but which Hayek suggested. It is about introducing a rule establishing an individual accountability of the taxpayer in connection to the increase in public spending as nobody is allowed to consume at the other's expense. For example, it can be imagined that any government program setting forth a rise in public spending should include statements and calculations regarding the volume of taxes that citizens will pay from their own money.

It should be possible for these statements and calculations to be assessed by the political opposition and by experts. Thus, voters will know how much an electoral option costs them and that they are ready to pay it from their own money. This measure cannot be applied if there are progressive taxes, since progressivity is a rule of redistribution from high income earners to low income ones. This is not a general rule, because it means that a majority votes for a system that, for the most part, does not apply to it. It overshadows the individual costs of the taxpayer. The lack of an explanation regarding the individual costs of some government programs and progressivity are the main reasons why the large mass of voters accept the continuous increase in the share of expenditures in GDP. For this reason, governments have recorded a steady rise in the share of budget spending in GDP, which was followed by higher taxes and, subsequently, by an increase in public debt. This practice does not favor sustainable policies.

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