

Inflation shoe leather costs and average inflation rates across countries

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Abstract

Cross-country differences in average inflation rates among 30 countries are well explained by differences in estimated “shoe leather” cost functions relating these costs to the inflation tax. The shoe leather costs are estimated by means of the standard Cagan, semi-log demand for real balances modified to take account of variations in reserve ratios and the effects of these variations on the demand for the monetary base. The results are consistent with optimization on the part of an efficient government theory but are not adequate to discriminate between efficient government models and many others for which shoe leather costs play at least a substantial role in policy-makers’ decisions. The imposition of the semi-log form does not seem critical in arriving at these conclusions, although this form tends to produce more reasonable-looking Laffer surfaces than more flexible forms.

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1. Introduction

Inflation varies dramatically among many countries. Many would interpret this as reflecting differences in countries’ fiscal management, but that idea has been difficult to back up

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empirically. This paper offers an unusual fiscal explanation of differences in average inflation rates across countries: use of the inflation tax is directly related to the capacity or ease each country has in collecting the inflation tax. We calculate steady-state Laffer surfaces for a group of 30 countries, ranging from typically high- to low-inflation ones, based on estimated parameters of these countries' demands for currency and deposits. These parameters can also be used to measure the "shoe leather" costs of inflation. The results suggest that relative ease of inflation-tax collection — at least as measured by estimated maxima and estimated shoe leather cost schedules — is a powerful explanation of differences in average inflation rates across countries, while other fiscal explanations of inflation have performed poorly.

Section 2 outlines the issues and provides summary information about correlations of inflation with fiscal variables across time and across countries. Section 3 defines the shoe leather costs and the model with this paper estimates these costs. Section 4 illustrates and discusses the basic calculations for higher (average)-inflation in Argentina and the same results are presented in tabular form for the full group of 30 countries in Section 5. Section 6 considers more general specification of steady-state social cost of inflation taxes than will have been used in the previous sections. Section 7 sums up and discusses alternative interpretations of the evidence.

2. Inflation rates and fiscal variables

Are differences in inflation across countries caused by differences in public finance needs and practices? A reliable connection between inflation and fiscal variables has been difficult to establish empirically. Consider Table 1, which presents correlations of annual inflation and three fiscal variables for the 30 countries we consider in this study: budget surplus (a), government expenditure inclusive of interest payments (b), and (mainly tax) revenue (c). Around two-thirds of the correlations are of "correct" sign according to conventional theory. Only some of the correct-sign correlations are statistically significant, while some of the wrong-sign correlations are large.

It may not be obvious what is the "correct" correlation sign between inflation and each variable. The hypothetical fiscal connection between inflation and these fiscal variables arises from the expectation that countries' budgets contain an inflation-tax component. How the inflation tax is managed is interpreted diversely in the literature. In one view, inflation revenue is a last-resort, stop-gap revenue source that countries turn to after operating too long on an unsustainable debt path. In another view, the inflation tax is a sustainable component of the budget package which, if not stumbled upon (as in the "high-inflation trap" of Bruno and Fischer, 1990), may be chosen as part of an intertemporal optimization strategy on the part of public officials. The outcome of this optimizing choice is sometimes hypothesized in the literature to be socially efficient, although much recent literature has emphasized political factors that may bias choices away from the optimum ones. The efficient government model and what might be called "rational" political models (rational policy-makers maximizing intertemporally but not optimally in the social sense) have the more clear-cut implications concerning the expected link between inflation and the fiscal variables.

2.1. Efficient government models

The efficient government model depicts policy-makers as choosing tax instruments so as to minimize the present expected value of distortions from government revenue collection, a policy which amounts to equalizing marginal distortions of tax instruments (and therefore the settings

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