Why Inflation is a Hidden Tax

Following the success of the first four articles in our series on the topic of money, we look at why Brits have been hit particularly hard and why inflation is not just a covert form of taxation, it is one that is sharply regressive, in that it disproportionately affects low income groups and the middle classes.

The Root Cause of Inflation

Although there can be many temporary causes, the main driver of inflation is new money creation. Expanding the money supply results in an increase in the general price of goods and services across the economy. This in turn, reduces a currency's purchasing power and, by extension, the value of people's earnings and savings.

In this article, we discuss how 'rising inflation' is being used by governments and central banks as a hidden form of taxation. We will also look at why Brits are feeling the effects particularly hard.

Government Revenue Strategies

Most governments do not want to reduce their spending, even when their public debt is at historically high levels. Generally speaking, governments have three ways of raising revenues: taxation, borrowing or "printing money". Taxation is the easiest option but it has serious drawbacks. For a start, raising taxes is generally a vote-losing policy, since it negatively impacts the personal finances of many voters. This is particularly true in times of broad economic hardship, such as today.

The Challenge of Government Borrowing in Today's Economy

In normal times, raising revenues by borrowing money through the issuance of bonds is an easier option for governments. But it is becoming less and less expedient, due to the sheer scale of most government debt in this post-virus crisis era. In the UK, public debt crossed the 100% of GDP threshold this year for the first time since the early 1960s, after experiencing a whopping 21% percentage point rise since February 2020. It is also becoming more and more costly to service that debt due to the rise in interest rates.

"Printing Money": A Discreet Taxation Method

This leaves governments with option number three: "printing money". This is essentially a discrete form of taxation – so discrete that most people don't realise it is happening. As with any taxation, the end result is that people have less money and governments more. But it is done, not by transferring money from taxpayers' pockets to government coffers, as with normal above-the-board taxes, but by increasing the money supply and, in the process, eroding the value of the underlying currency.

How Money Creation Fuels Inflation

Here's how it works. First, a country's central bank – in the UK's case, the Bank of England (BoE) – buys government bonds from private financial institutions such as banks with money it effectively conjures out of thin air. The UK Treasury has to pay interest on those bonds, but most of it is later reimbursed by the Bank of England. In other words, the government is able to give itself a more-or-less interest-free loan.

This is only possible due to the money created by the BoE. But that money creation process in turn fuels inflation, which then erodes the value of the money people earn and save. For debtors, it reduces the real value of the money they owe; and there is no bigger debtor than government.

Consequences of Excessive Money Creation

The inevitable result of that is that the Western world has been grappling with rates of inflation not seen since the 1970s. That inflation has proven to be a lot stickier than both governments and central banks had initially predicted.

Inflation's Regressive Impact on Society

Inflation is not just a covert form of taxation; it is one that is sharply regressive in that it disproportionately affects low-income groups and the middle classes. This is because their salaries or earnings are less likely to keep up with inflation as those in higher-income brackets, and because they don't own as many assets, which tend to increase in line with inflation. In fact, the Bank of England recently called on workers and employers to exercise "quite clear restraint" in the annual wage-bargaining process to help prevent an inflation spiral taking hold.

The Dilemma of Rising Household Debt

In the presence of negative real wage growth, many households face a stark choice: cut back on non-essential – and in some cases, essential – purchases, and/or take on more debt. Many have opted for the latter, driving personal debt to record highs. Earlier this year, household debt in the UK broke through the £2 trillion barrier and is now almost the same size as the entire UK economy (£2.2 trillion).

The Unique Struggle of Britons with Inflation

Brits are feeling the effects of the hidden inflation tax more than many of their European peers. This is mainly because inflation is staying higher for longer than in many Western European countries. As a matter of fact, "core" inflation in the UK – which excludes volatile or seasonal prices such as food, energy and alcohol – surged earlier this year to its highest level since 1992!

The Stealth Taxation Strategy of the UK Government

In addition, many Brits are bearing the brunt of another form of stealth tax. In April 2021, the Boris Johnson government, with Rishi Sunak as then-chancellor of exchequer, froze tax thresholds and allowances in cash terms. Normally, they are adjusted to keep pace with inflation, but not this time. Late last year, Sunak's successor in 11 Downing Street, Jeremy Hunt, extended the freeze until 2028.

This means that as nominal (but not real) earnings rise, more low earners are dragged into paying the 20% basic-rate income tax (which kicks in at £12,571) while those with earnings nearing £50,000 fall into the higher 40% rate. The Organisation for Economic Cooperation and Development (OECD) recently warned that Hunt's decision to freeze income tax thresholds will pile "significant" pressure on UK households over the next few years, pushing "1.7m people to start paying income taxes and 1.2m people to pay higher rates."

The Triple Squeeze on UK Households

This is happening at the same time that inflation is eroding people's purchasing power. In other words, households are getting squeezed from three different directions at the same time: inflation, the Treasury's stealth tax raid and rising debt costs.

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

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