The Daily Dish

South American Lessons (Re)Learned

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Eakinomics doesn't get out much and it shows. But every now and then a little exposure to the real world reinforces some old lessons. This month's lesson: Taxes can make a mess of economic incentives.

Eakinomics just spent 13 days in Argentina (aka the country soon to be named Messi), Uruguay, and Brazil. Argentina currently has inflation at 100 percent. Now, you might not think about it, but inflation is a tax. (I promise you that Milton Friedman understood this.) It is a tax on holding money – in this case Argentinian pesos. Every second you hold such a peso it becomes less valuable. As a result, Argentinians work very hard to not hold pesos. Indeed, they are thrilled to be holding dollars.

What happens? There is a dual economy in pesos and dollars, with the cost of having two sets of prices, lots of uncertainties for consumers about the effective price in each currency, and the cost of transferring from one currency to another. Of course, the Argentine government has reflexively done the (wrong) thing that every government does: fix prices. It has fixed the exchange rate between pesos and dollars at 170 pesos for a dollar. On the open (black) market, the going rate is 300 or so, but if you go to an ATM or use a credit card, you get the unfavorable 170 pesos for a dollar.

It is easy to see what the inflation tax is doing. It changes the use of ATMs, the use of credit cards versus cash, the use of dollars versus pesos, and encourages spending pesos now before they devalue. In short, it distorts the entire structure of economic transactions.

Brazil is a more straightforward mess. It chooses to levy a 25 percent surtax on all tourist purchases, even on cruise ships in territorial waters. What happens? Tourists are told these facts at the start of a cruise, so it ensures that no purchases are made in Brazilian waters – these occur in Uruguay and waters north instead. This is the worst of all possible tax

policies – it distorts the location of purchases but does not raise a single real (the Brazilian currency).

The debate over U.S. tax policy is never-ending, but too often focuses on simply higher or lower taxes. That is only a tiny part of the story. Taxes alter the effective prices in the economy, and in the process reshapes the economy itself. This is probably more important than the scale of taxation itself.