Inflation: Social Costs

An economy which is experiencing inflation has to bear many costs either in the form of Social or economic loss arising from the effects of inflation. Social cost of inflation simply refers to the total cost on society including both private costs and any other external cost arising out of inflation. The social costs of inflation broadly fall into two categories:

A. Costs of Expected Inflation

B. Costs of Unexpected Inflation

A. Costs of Expected Inflation: Costs of expected inflation also known as anticipated costs of inflation refers to those social costs of inflation faced by the society caused by expected or predictable inflations. In short, expected inflation is the inflation component that economic agents expect to occur. The following are the Costs of Expected Inflation may be classified as below:

1. **Shoe-leather Cost:** Increased shoe-leather cost is one of the impacts of expected or predictable inflation. Shoe- leather cost refers to the cost of time and effort that people spend trying to counteract the effects of inflation. The term comes from the fact that walking to the bank more regularly during inflation will wear out shoes more quickly. The shoe-leather cost is now used more generally to describe all the costs associated with having to hold small amounts of cash.

2. **Menu Costs:** In economics, a menu cost is the cost to a firm resulting from changing its prices. The name stems from the cost of restaurants literally printing new menus during high inflation in order to keep up with economy-wide changes. However, economists use it to refer to the costs of changing nominal prices in general.

3. **Inconvenience**: Another cost of inflation is the inconvenience of living in a world where prices are changing and brings changes in the value of rupee. Money is used as a yardstick for measuring economic transactions and therefore, when an economy experiences inflation, that yardstick is changing in length.

4. **Relative price distortions:** A fourth type of cost of expected inflation is the distortions of relative price leading to misallocation of resources. Since market economics rely on relative prices to allocate resources efficiently, inflation leads to microeconomic inefficiencies.

5. Unfair tax treatment: Another cost of inflation results from the tax laws. Many provisions of the tax code do not take into account the effects of inflation. Inflation can alter individual's tax liability, often in the ways that lawmakers did not intend.

B. Costs of Unexpected Inflation: Unexpected inflation also known as unanticipated inflation is the surprise component of inflation which people haven't incorporated in their pricing, costing, etc leading to what is known as Costs of Unexpected Inflation.

Unanticipated inflation reduces the validity of the information on market prices for economic agents. It leads to the cost of unequal distribution of wealth and income among individuals such as between lenders and borrowers where one tends to benefit at the expense of the other.

Unanticipated inflation also hurts individuals on pension. Workers and firms often agree on a fixed nominal pension when the workers retire. Since pension is deferred earnings, the workers are essentially providing the firm a loan. Like any creditor, the worker is hurt when inflation is higher than anticipated. Like any debtor, the firm is hurt when inflation is lower than anticipated.