European inflation

A stubborn, taxing problem
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Governments' attempts to boost revenues keep inflation high

STICKY. Obdurate. Stubborn. Inflation in the euro area has been called all these things. Despite slow growth and low interest rates, it has remained stuck above the European Central Bank's (ECB) target of below 2% for the past six months. Some economists think that January's revised inflation figures will at last show it falling below the magic number. But even if this happens, why has it taken so long?

When economies slow, firms come under pressure to cut their prices. But governments, facing disappointing tax revenues, come under pressure to hike indirect taxes and charge more for public services, such as rubbish collection or health care. France and Portugal have raised taxes on tobacco recently. Germany has raised the price of health care. All such measures feed into the cost of living. Thus, even as their straitened economies cry out for looser money, European governments are reinforcing inflation, making an interest rate cut by the ECB less likely.

In its latest monthly bulletin, the ECB tries to work out how much indirect taxes and administered prices add to euro-area inflation. It points out that tobacco prices in November last year were 11.6% higher than in the previous November, adding 0.25 percentage points to that month's inflation rate of 2.2%. In short, were it not for the rising cost of smoking, the ECB would have hit its inflation target.

The bank also looks at a range of prices that are often set by administrative fiat rather than market forces. These “administered prices” cover sewerage and rubbish collection; medical, dental and hospital care; the post; trains; education and social protection. Wise governments administered them upwards at the rate of 3% per year last year, much faster than inflation overall. In some months of 2003, these prices added almost 0.2 percentage points to the headline rate of inflation.

There may be many reasons why tobacco taxes and “administered prices” have risen so steeply in recent quarters. European governments no doubt care deeply about their citizens' blackened lungs, not just their own red-inked budgets. But if the ECB were to see through these hikes to the rather slower rise in market prices—to pay more attention, in other words, to its own research—it might be tempted to cut rates and stimulate growth. Government revenues would rebound, and taxes and charges might remain on hold. Even Europe's beleaguered smokers could puff away without worrying so much about the cost.

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