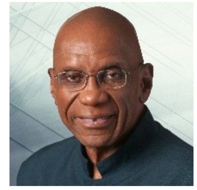

Economic Letter May 2022

There Isn't Much Government Can Do About Inflation

The wave of inflation that is sweeping across the Caribbean and the world at large is something that our populations are obliged to adjust to. The only kind of inflation which small countries like ours can dampen is caused by a devaluation of the local currency. Our economic managers can dampen the inflation caused by devaluation with measures to bring the foreign currency market into balance and reduce pressure on the value of domestic money. That may be easier said than done, but at least it is within the government's power to do.

Inflation that is imported from abroad, whatever the cause, is another matter. Trying to alleviate its effects involves subsidizing domestic prices of imported items, for which no funds have been allocated in the government budget. It is true that government will benefit from increased revenues from sales taxes, value added taxes, import duties and any other tax that is calculated as a percentage of imports and purchases. However, a little arithmetic shows us that the additional revenue is insufficient to compensate for the import price increase.

Consider an item which costs $100 which is subject to a ten percent sales tax. Let us suppose the price increases by eight percent to $108. The sales tax increases from $10 to $10.80, an increase of 80 cents. That is all the additional revenue available to government to compensate someone who needs to purchase the item. This compares with the after tax price of the item, which has increased from $110.00 to $118.80, an increase of $8.80.

Government does not have the option of reducing the sales tax significantly, because that would leave a gaping hole in the public sector budget. Caribbean countries typically derive something in the region of two-thirds of tax revenue from sales taxes, value added taxes and import duties. Any significant reduction in the rates on these taxes, which all affect final prices to the consumer, would have to be at the expense of a cut in some item of government expenditure on capital works, wages or purchases of materials, equipment and supplies. Government might be able to borrow as a stop-gap measure, but accumulating debt to subsidise prices will damage government's credit worthiness.

Price fixing by the government should be avoided, for practical reasons. In practice price controls stimulate the emergence of informal markets; we have seen that where price controls are pervasive or sustained for a long time, most of the business migrates to the informal market. There is also a problem in determining the level at which to fix prices. Invariably, government will be motivated to set a price below what would emerge in the market otherwise. That might not necessarily be the full amount of the import price increase; in a depressed economy merchants may absorb as much of the increase as they can manage, for fear that they would otherwise lose customers who could not afford the full amount of the import price increase. If government fixes at a lower price than this, some merchants will go out of business, and others will sell on the informal market to stay alive.

Promoting the use of solar photovoltaics and wind power for generating electricity is the one area where Caribbean Governments may lessen the impact of volatile oil prices. However, this is only a distant possibility; at the moment the levels of renewable energy on the grid are too low to have a notable mitigating effect on electricity prices anywhere in the region.

*Previous Economic Letters may be found on my website, **DeLisleWorrell.com**.*