

Draft of article for Financial Times, February 2002

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There is general agreement that the UK economy over the last few years has been seriously unbalanced, with strong consumption growth combined with a weak manufacturing sector. The Bank of England is torn between these two forces, with only the one instrument - interest rates - at its disposal.

One way to attempt to correct this imbalance is through tax policy. However taxation is the preserve of the Chancellor, and his budgets focus on microeconomic issues and long term budget sustainability rather than demand management. There is an obvious solution to this problem: give some control of fiscal policy to the Bank of England. The Bank would then have more instruments at its disposal, which would enable it to tackle short term imbalances within the economy as part of its stabilisation role.

I suspect most people would view this idea as outlandish: tax policy should be under democratic control, not the control of central bankers. I want to argue that these objections are instinctive rather than reasoned, and that serious consideration should be given to allowing the Bank limited control over fiscal policy.

No one is suggesting that the Bank should not be allowed to change any tax rates permanently. The medium to long term structure of taxation is quite rightly a decision that should be made by democratically elected politicians. But the Bank today cannot in practice change interest rates permanently: the long term interest rate is set by a combination of the Chancellor's inflation target and the fact that we eventually have to follow overseas real interest rates. The Bank's job is to correct short term imbalances, so it only needs temporary control over interest rates and tax rates. Indeed the Bank could even be required to eventually reverse any fiscal action it took, so as to leave the long term budgetary position unchanged in the Chancellor's safe hands.

Nor would the Bank require control over the detail of tax policy. Instead it would just need to operate a handful of key rates, chosen so that they were effective at dealing with the kind of macroeconomic imbalances that typically arise in the UK. Limits could also be placed on the size of changes the Bank was allowed to make.

The objection could still be made that because tax changes are sensitive politically, even limited and temporary changes should be under democratic control. But interest rate changes influence at least as many people as changes in most tax rates. To the pensioner living off modest savings, lower interest rates may be just as important as changes in VAT.

It could be objected that central bankers know nothing about tax. This is to misunderstand the role of the Monetary Policy Committee. Its members need to know little about the minutiae of monetary policy, but a great deal about macroeconomic demand management.

An alternative argument is that fiscal policy is not very good at influencing demand: either it is impotent, too slow, or unpredictable. The key point to make here is fiscal instruments vary tremendously in their effectiveness. Economic theory has emphasised that many consumers can smooth the impact of changes in income tax, suggesting that tax allowances may not be an effective instrument to give the Bank. On the other hand consumers are likely to react to temporary VAT changes, because this directly influences prices. Instruments like stamp duty may also be an effective means of dampening imbalances stemming from the housing sector. It would clearly be inappropriate to give the Bank control over the spending decisions of government departments (which in any case are slow and unpredictable), but changes in many tax rates can be made overnight. There is no reason to believe that the impact of tax changes on the macroeconomy is any more uncertain than the impact of interest rates.

Economists are typically in favour of 'automatic stabilisers' (allowing the budget to go into deficit in a recession), precisely because fiscal policy does impact on demand. It is a belief that politicians cannot be trusted that prevents many from advocating discretionary fiscal stabilisation by governments. The same political problem arose with monetary policy, and has been 'solved' by giving that power to an external agency - the central bank.

There is no reason why a Bank of England with limited and temporary fiscal powers should not work within exactly the same framework as it does today. Its objective would still be to hit an inflation target. It would only use fiscal policy if that instrument were useful at achieving the inflation objective. Faced with the choice of trying to hit 2.5% inflation with either a balanced or unbalanced economy, the Bank would clearly prefer balance, if only because it is more predictable.

There is one final, and in my view compelling, argument in favour of giving the Bank some fiscal powers. The Monetary Policy Committee has built up considerable expertise and a credible track record in managing the UK economy. At present, if and when we join EMU, the Bank of England will lose its power, and this expertise and credibility will go to waste. Loss of national monetary policy is of course the major cost of joining EMU. If the Bank retained some control over fiscal policy it could continue to help stabilise the UK economy within EMU, which I believe would significantly mitigate the cost of entry.

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