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OPINION

Fiscal flexibility

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Could finance ministers learn a few tricks from central bankers?

IT IS now widely accepted that monetary policy is best set by an independent central bank, insulated from political pressures. But fiscal policy still remains in the hands of politicians. Indeed, most people would regard with horror the notion that tax rates might also be set by a band of unelected officials. Yet that is exactly what some economists are now calling for.

For example, Alan Blinder, an economist at Princeton University and a former vice-chairman of America's Federal Reserve, has argued* that the institutional framework around monetary policy should be extended to fiscal policy. To understand why, consider the arguments in favour of central-bank independence.

Monetary policy affects the economy only after a long lag, so policymakers need a long time horizon. Short-sighted politicians might try to engineer a boom before an election, hoping that inflation would not rise until after the votes have been counted. An independent central bank shielded from political pressures is more likely to give priority to price stability; as a result its policies are seen by financial markets as more credible. An independent central bank can therefore deliver both lower inflation and more stable growth.

Similar arguments can be applied to fiscal policy. Tax changes also have consequences that stretch far into the future. But politicians' time horizons stretch only until the next election; all too often they are tempted to cut taxes ahead of an election, which can later cause the economy to overheat. Mr Blinder concludes that the tax system would be simpler and more efficient if it were left to an independent agency, in the same way as monetary policy.

This idea has now been adopted by the Business Council of Australia † as a way to make fiscal policy more flexible, while still maintaining discipline. At present fiscal policy is generally seen as less effective than monetary policy in steering the economy. This is partly because, in most countries, it takes ages to get parliamentary approval for changes in taxes, so tax rates cannot be altered as fast as interest rates. As a result, tax cuts in response to a slowdown have typically arrived too late, fuelling the next boom rather than cushioning the impact of a recession.

During the 1970s and 1980s, not only did fiscal fine-tuning fail, but budget deficits rose alarmingly. In recent years most governments (with the notable exception of Japan) have accordingly focused almost exclusively on trimming or eliminating their deficits. Governments in the euro area have, under their stability pact, set a limit on budget deficits of 3% of GDP. Some American economists favour a strict balanced-budget amendment.

But by reducing the ability of fiscal policy to respond to developments in the economy, such

constraints could put an excessive burden on monetary policy to prevent economies from either overheating or diving into recession. Central banks may enjoy their new powers, yet it could be argued that monetary policy is not well suited to this role, as its effects on the economy are felt only after long and variable lags. Some studies suggest that fiscal policy is better suited to steering nominal demand, because once implemented (where the delays currently lie), it affects the economy more swiftly than changes in interest rates. Furthermore, the effects of monetary policy tend to be spread less evenly across the economy than those of fiscal policy. For example, high interest rates and hence a stronger exchange rate squeeze manufacturers more than other producers.

Tuning up

Nobody is now suggesting a return to 1960s-style fiscal fine-tuning. But there would be advantages if fiscal policy could be made more effective. Several countries, such as Australia and New Zealand, have pioneered reforms to make fiscal policy more transparent and accountable. This helps to reduce the influence of short-term political interests. But the dilemma is how to make fiscal policy more flexible, in order to take pressure off monetary policy, while still maintaining long-term discipline.

The Business Council of Australia proposes that an independent body should be given the power to make small adjustments to tax rates in response to the state of the Australian economy without the need for parliamentary approval. This would both reduce the lags in fiscal policy and insulate it from political pressure. The government would still determine the size of the welfare state and the structure of the tax system (eg, it would decide how progressive the income-tax schedule should be). It would also set a broad long-term goal for the budget deficit. The independent fiscal authority would then be given discretion to increase or reduce income-tax rates across the board within a narrow band of, say, a percentage point either side of existing rates. If it felt the economy was overheating, say, it could raise taxes; if a recession loomed, it could cut them.

This would ease the burden on monetary policy. Nor need it always imply a tighter fiscal policy. Suppose, for example, that in the autumn of last year, when there were fears that global financial turmoil would drag the American economy into recession, policymakers had responded by cutting taxes rather than interest rates. The likely result is that America's economic and financial imbalances would now look less serious. The cut in interest rates last year, which has only now been reversed, pushed share prices higher and encouraged households and firms to borrow more and save less. The bigger these imbalances become, the more painful it will be to unwind them. In an economy already displaying signs of financial excess, a tax cut delivered by an independent tax agency might have been safer than looser money.

The idea of an independent fiscal authority deserves serious consideration. It may seem radical and undemocratic. But that, remember, is what many governments once said of demands to make their central banks independent.

* "Is government too political?". *Foreign Affairs*, Nov. 1997.

† "[Avoiding boom/bust](#): macro-economic reform for a globalised economy". Business Council of Australia, discussion paper 2, October 1999.