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OPINION

UK Inflation

Time for the UK to tax inflation

Measures targeting salary increases or excess prices would provide the Bank of England with another policy instrument

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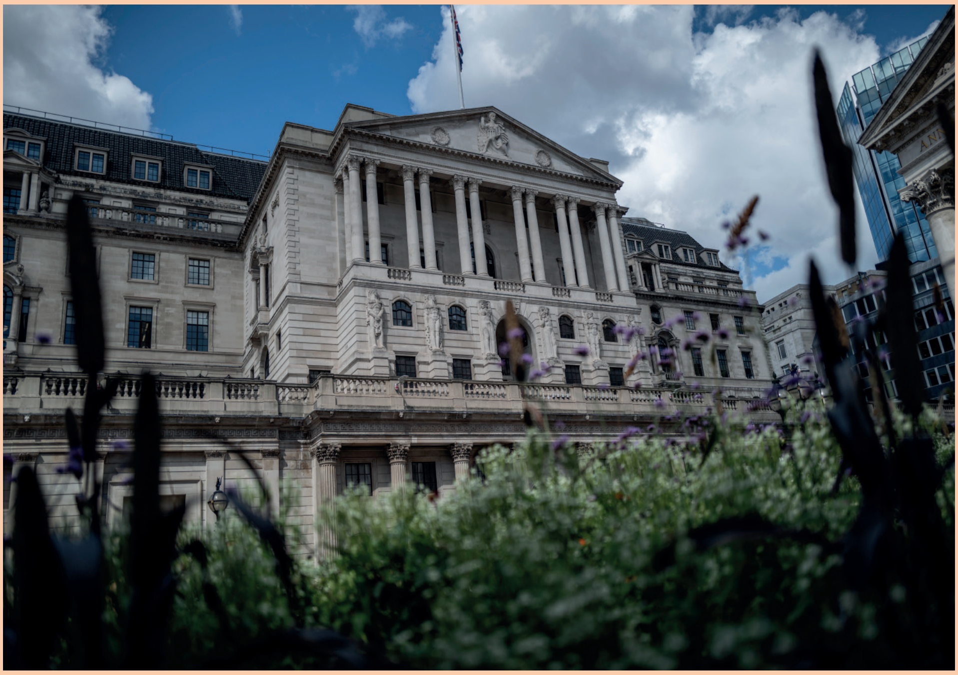

The Bank of England should receive more help in its pursuit of low and stable inflation © Charlie Bibby/FT

In recent weeks there has been significant relief that the headline rate of inflation in the UK has come down meaningfully. However, wage growth and core inflation are still well above what is necessary to achieve a 2 per cent inflation target. Although the fall in price inflation should lead to a fall in wage inflation, the Bank of England's Decision Maker Panel survey still shows expected wage growth and price inflation over the next year at over 5 per cent.

It appears that we are seeing "tit-for-tat" behaviour in which workers try to maintain living standards while firms try to maintain profit margins. This is now associated with higher embedded inflation expectations. In order to reduce the extent to which each firm and each worker expects the general level of prices and wages to go up, we might choose to leave it to the BoE entirely, who could then be slow to cut rates even as unemployment rises.

When I appeared before the Treasury select committee in July, they asked how the government might help the BoE bring inflation down while keeping unemployment to a minimum. At a time when high wage growth has been associated with labour shortages, boosting supply is obviously helpful.

In addition, it would be desirable if the government buttresses its promise to leave the inflation target unchanged to the end of this parliament by saying it would do the same for the duration of the next term if re-elected (the opposition should make the same commitment).

The government might also consider a measure that would directly operate to bring inflation expectations down without necessitating a rise in unemployment. This would be a tax on inflation. For example, they might announce a baseline reference level of the growth of average hourly earnings over the next year of 3 per cent. They could then implement a tax whereby each firm who grants a wage increase above 3 per cent would be required to pay a 100 per cent tax on the excess.

Concretely, if a firm awards a wage increase of 5 per cent, it would cost it 7 per cent as it would have to pay extra tax equivalent to the difference between the wage increase granted and the baseline reference level.

Such an announcement is highly likely to bring inflation expectations down, moving wage and price inflation comfortably lower without the unemployment rate needing to move higher. The BoE could reward such a policy by ensuring that interest rates are lower than they might otherwise have been. To be clear, this tax is not designed to tighten fiscal policy — the revenue could be redistributed, for example, as a per-worker subsidy.

When looking for a tax on inflation one could, in principle, introduce a "tax on excess price increases" rather than wage increases. Society already believes that it is appropriate to tax activities where the individual or firm does not fully take the adverse impact on others into account. Tobacco consumption and polluting actions are both examples of this. When a firm increases the price on a good it sells, it does not fully allow for the economy-wide inflationary effect and so an inflation tax seems desirable.

The appropriate tax rate would vary over time. It could easily be much lower (indeed close to zero) when inflation expectations subside. That way one could minimise any associated distortions. Indeed, if the measure was always revenue-neutral (and so had no direct fiscal implications), one might even consider handing over the setting of the appropriate rate to the BoE as an extra policy instrument.

Of course, one would need to deal with the administrative difficulties that come with any new tax and the inevitable problems of implementing such a scheme. But a government that delivered the much more complex furlough scheme during a lockdown should not allow itself to be deterred by teething difficulties. As a policy prescription, it has a distinguished pedigree dating back to the early 1970s and previous advocates have recommended that it could be a part of the standard PAYE process. There is some evidence suggesting that an inflation tax helped in the transition of some formerly Soviet economies to market economies while the IMF has recently published some research recommending that it deserves more attention.

With inflation expectations dislodged, and the possibility that we might see a sequence of supply shocks again in the future, the time has come to help the BoE more in its pursuit of low and stable inflation. A tax on inflation alongside the use of the interest rate tool should improve their chances of success.

The writer is chief investment officer at PGIM Wadhwani and on the Chancellor's Economic Advisory Council. This article is written in a personal capacity.

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