

ABSTRACT

This paper investigates the impact of central bank reform on redistribution, labor taxation and welfare in economies with a small number of wage setting labor unions and governments concerned with maximizing some combination of general welfare and redistribution. By raising central bank (CB) conservativeness such reforms directly reduce the premium of unions' wages over the competitive wage inducing reductions in both inflation and unemployment, and an increase in aggregate welfare.

But such reforms also induce government to adjust the tax rate on labor and redistribution. Depending on whether the tax rate goes down (a disciplining effect) or up (a seesaw effect) the direct beneficial effects of reform are either reinforced or moderated. On one hand, by raising the positive marginal impact of a labor tax on the wage premium, central bank reform deters government from raising the tax. On the other hand, by raising the tax base, such a reform encourages government to raise it. A disciplining effect arises when the reform raises the marginal impact of the tax on the wage premium by a lot and a seesaw effect arises when this increase is moderate. In the first case the beneficial effect of CB reform is amplified and in the second it is moderated opening the door for the possibility that flexible inflation targeting is optimal even in the absence of stabilization policy. Actual changes in the share of redistribution following CB reform are used to discriminate between those two cases.

Keywords and Phrases: Fiscal monetary policy interactions, seesaw and disciplining effects, labor unions, redistributive politics, central bank reform, social welfare

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