Full Fiscal Autonomy: The democratic case for independent fiscal policy

BRIEFING PAPER

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Despite recent challenges to the Bank of England's independence, this briefing suggests that over-politicisation is a greater threat to sound macroeconomic policy than empowering technocrats. It therefore makes the case for an independent expert body to guide government borrowing, to ensure more effective and better coordinated fiscal policy.

KEY POINTS

- Delegating monetary policy (interest rate setting) to the Bank of England seems to have improved economic outcomes.
- Yet politicians have retained control over fiscal policy (how much to tax and spend), guided by self-imposed fiscal rules, limiting the government deficit.
- This approach does not work well – most economists think fiscal rules have harmed the UK's economic performance.
- Fiscal rules are in one sense too rigid: they discourage politicians from necessary borrowing to support the economy. In another they are too weak: there have been 14 different rules since 2010.
- This is because fiscal policy has been driven by political considerations rather than economic ones – the very reason that politicians made monetary policy independent and have chosen to retain that independence.
- Independent fiscal policy would delegate technical economic questions to specialists, leaving elected politicians to make allocative decisions.

RECOMMENDATIONS

- An independent Fiscal Policy Committee, staffed by appointed experts, should be established to set an overall government budget.
- The Fiscal Policy Committee should recommend a target range for the deficit, driven by fiscal sustainability and macroeconomic conditions.
- The government should be free to choose the combination of taxes and spending it favours to achieve that target.

This paper was mostly written before the 'mini-Budget' of 23 September 2022, which announced a substantial increase in government borrowing to fund tax cuts, and has caused a spectacular bout of economic turbulence. The government's cost of borrowing has risen and the pound has lost value as confidence has weakened in the government and the economy. The Bank of England has been placed in an invidious position, having to raise interest rates to mitigate the risk that further borrowing exacerbates inflation.

When I started work on this paper, several months ago, I had no inkling that the case for devolving fiscal policy to an independent expert body would become as powerful and as urgent as it has today. The events of recent weeks have highlighted just how damaging the failure to coordinate fiscal and monetary policy can be. As the IMF's Research Director has put it, British macroeconomic policy is like "a car with two drivers at the front and each of them has a steering wheel – and one wants to go left and the other wants to go right".[2] The current crisis has amply demonstrated how a government's fiscal responsibilities and decisions can overshadow and obstruct its wider economic agenda: rancour over its fiscal policies have cost the current Government vital energy and political capital that jeopardise its 'supply side reforms'.[3]

Back in the summer, independent fiscal policy felt like a radical and dramatic step, and as such, politically unrealistic. Now, with the credibility of the UK's entire institutional framework in question – for example, with JPMorgan Chase & Co suggesting this episode could leave a "permanent scar" on the country's fiscal reputation, radical measures may be necessary.[4] There is a significant risk that the new fiscal rules and analysis from the Office for Budget Responsibility that is meant to shame but not bind the Government do not go far enough. And if government cannot recover its credibility, higher interest rates restrict the ability of businesses and the public sector to invest, and leave many households poorer – making the economic growth both major parties crave harder to achieve.

Economic experts have come in for substantial criticism in recent years – reflected clearly in the doubts expressed by Liz Truss over the performance and power of the Bank of England over the summer.[5] In this paper, I argue that excessive politicisation of macroeconomic policy has been a greater issue than the supposed failure of technocrats. Moreover, the division of macroeconomic tools between politicians (who control tax and spending) and the central bank (which controls interest rates) has led to a lack of coordination. As such, if we are to use this moment to review our economic institutions, we should complete the process of delegating demand management to technocrats.

That means independent fiscal policy, joined up with independent monetary policy. An expert Fiscal Policy Committee (FPC) should set a target for government borrowing, based on the needs of the economy and constraints of fiscal sustainability, rather than political expediency. That would leave the government to decide important questions like the size of the state, how best to develop the country's productive capacity and how to ensure equitable outcomes. It may even improve our democratic discourse by shifting the debate to the economic questions that matter.

Some people may ask if handing more power to unelected experts is harmful to public faith in our system of government. The best counter to that argument is that the status quo is leading to higher borrowing costs, slower growth and therefore poorer economic outcomes that do more to erode public confidence in the system than any institutional reform could.

WHAT HAS INDEPENDENT MONETARY POLICY EVER DONE FOR US?

To simplify, managing the economy involves three different tasks. First, the long-run 'supply side' task of increasing the goods and services we are able to produce. This is a function of the size and productivity of our labour force, the technology and physical equipment we have, and how well it is allocated. Supply side policy tries to increase this productive capacity through things like investment, education and training, immigration, trade policy, improving regulation and increasing competition.

Second, the short-run 'demand side' task of ensuring that aggregate demand (from consumers, firms and government) in the economy is broadly in line with its productive capacity. This is a delicate balance. If demand for goods and services remains well below what we could potentially supply, that will cause unnecessary unemployment and lower growth and wages. If demand goes too far in excess of what can be supplied, there will be 'too much money chasing too few goods' and inflation will result. Demand management traditionally seeks to maintain this balance through monetary policy (using interest rates to make it cheaper or more expensive to borrow) and fiscal policy (supporting demand through tax cuts and higher public spending, or limiting it through tax rises and reduced public spending).

Third, trying to produce equitable economic outcomes: making sure that inequality is not too high and that socially harmful activities (like emitting pollution) are appropriately discouraged. This occurs through regulations (like minimum wage laws and workers' rights), as well as taxes and government spending.

Towards the end of the 20th Century, there was a shift in economic policymaking in many rich countries. Governments essentially attempted to wash their hands of the second task – demand management – and delegated it to 'monetary authorities' i.e. central banks. For example, one of the first and most significant acts of the New Labour government in 1997 was to give independence to the Bank of England – passing responsibility for interest rate setting to its technocratic expert, the Monetary Policy Committee. That was part of a broader global trend: by the end of the 20th Century, around 90% of the world's central banks were independent, up from 60% in the 1970s.[6]

Fundamentally, the reason was that governments could not be trusted to manage demand responsibly (or at the very least, that was the perception). The theory goes that governments face an incentive to boost demand excessively to an unsustainable level through spending or tax cuts, especially in the lead up to elections – benefitting politically from a temporary urge in growth and employment, despite increasing inflation in the long-run. Moreover, even if governments are in fact responsible and do not give in to this temptation, the fact that this incentive exists means that governments cannot credibly commit to managing demand without being suspected

of this 'inflation bias', leading to higher inflation expectations in the economy.[7] Economists' response was to recommend delegating monetary policy to an independent body insulated from such political pressures and suspicions.

On the face of it, this seems to have worked. Notwithstanding events of recent months, inflation has been low and stable for the last few decades, presided over by independent central banks. Sceptics attribute this to other factors, such as the weakening of trade unions and globalisation.[8] However, even if central banks cannot claim all the credit, their independence has been shown to be correlated with lower and less volatile inflation, albeit that this correlation seems to have weakened over time.[9] For example, inflation expectations in the bond market fell by 0.6 percentage points in the two weeks following Bank of England independence.[10]

The current bout of inflation has strengthened criticism of central banks[11], seen in some quarters to have been too weak and too slow in their response. In the UK at least, this is rather unfair – the inflation of recent months has been driven by unpredictable events (the Russian invasion of Ukraine, restrictions on the Chinese economy).[i] Early on, it was an understandable judgement – shared by central banks in other countries – to err on the side of protecting the economic recovery from the pandemic rather than raising interest rates early to clamp down on inflation.[12]

That is not to say that central banks are infallible or beyond criticism. Monetary policy is not an exact science, but a matter of judgement under conditions of substantial uncertainty. The question is not whether central bankers always get things right, but whether politicians would be expected to do any better. Even if we accept that central banks have made mistakes in the face of the current crisis, it is quite another thing to conclude that returning monetary policy to politicians would have produce better outcomes or been a more secure basis for macroeconomic management in the future.

The macroeconomic settlement that came with independent monetary policy involved governments largely giving up demand-side fiscal policy.[13] Trying to ensure that the economy achieves its potential output without inflation would be left to central banks. Government tax and spending would be limited to the first and third economic objectives outlined above – supporting long-run productive capacity and mitigating inequalities. To avoid getting in the central bank's way, and to ensure fiscal policy was conducted sustainably, governments submitted themselves to 'fiscal rules' that restrict the amount they are able to borrow, and as such the amount of spending or tax cutting they can do.

FAILURE TO COORDINATE MONETARY AND FISCAL POLICY LEADS TO WORSE OUTCOMES

This division of labour – using monetary policy to manage demand, constraining fiscal policy through rules – has functioned well enough under some circumstances, but has been found wanting in others. Hiving off fiscal and monetary policy from one another

[i] Criticisms of the Federal Reserve may be more reasonable, as the US is less exposed to Russian gas, and there were concerns about government stimulus overheating the economy back at the start of the year.

causes problems when the situation requires close coordination of the two. Too often, in fact, fiscal and monetary policy have worked against one another instead of being mutually supportive as part of a coherent macroeconomic strategy.

This issue becomes particularly acute when interest rates approach the 'zero lower bound'. It is difficult to push interest rates below zero because savers will be reluctant to save and lenders to lend if it costs them money to do so (although interest rates have gone slightly negative in some countries).[14] As a result, when interest rates are very low, as they have been for most of the last decade in the UK[15], central banks have limited room for manoeuvre if they want to support demand. Under such circumstances it would usually make sense for fiscal policy to take over in the shape of tax cuts or higher government spending.

Yet that has not been the experience of recent years. In the UK and much of the EU, governments have been seen by many economists as running inadequate deficits to support the needs of the economy.[16] Ironically, political incentives, which were generally expected to encourage excessive borrowing, have since the financial crisis, led governments to run overly tight budgets. In part, that reflects genuine uncertainty over the risk of default and the long-term economic impact of high government debt. In the EU, it can be linked to particularly tight fiscal rules. In the UK, it is likely a consequence of political dynamics with the Conservatives finding it expedient to present themselves as the party of fiscal responsibility. The failure of governments to spend or cut taxes enough has led central banks like the Bank of England to pursue the 'unconventional measure' of Quantitative Easing (QE) – injecting money into the economy by buying government and corporate bonds. That stimulates demand directly, puts negative pressure on interest rates, and encourages governments to borrow more, if they are willing to take the hint.[17]

That does not mean that the original fears about governments' potential fiscal incontinence were totally misguided. Where monetary policy is not constrained, excessive government borrowing can make the central bank's job more difficult. Some models suggest that the effectiveness of independent monetary policy depends on fiscal policy being "passive".[18] That is, the fiscal authority (i.e. the government) needs to follow monetary policy rather than trying to lead it. The current UK Government's approach looks to be anything but passive – increasing the deficit and expecting the Bank of England to play 'bad cop' in order to control inflation.[19] Yet there are some indications that additional government borrowing may make it harder for the Bank of England to sell off bonds in an effort to unwind QE.[20] Without explicit coordination, the risk of over- or under-shooting, an unnecessarily deep recession or failing to bring inflation under control, is heightened.

Over-reliance on monetary policy can also have negative side effects. Lower interest rates and QE increase the value of assets like stocks and housing. That, in turn, has led to concerns that they have exacerbated wealth inequality. For example, a recent House of Lords Economic Affairs committee report concluded that QE likely increased wealth inequality, though the Bank of England's analysis suggests the impact was small.[21] Moreover, higher house prices have other distributional effects – benefitting owners over renters and the young over the old.[22] In any case, inflating house prices

and financial markets may have negative economic consequences of their own. In some circumstances, fiscal policy could be used to offset these distributional issues, or to provide an alternative tool where appropriate. However, that can only work if fiscal and monetary policy are well coordinated.

AN ALTERNATIVE APPROACH: INDEPENDENT FISCAL POLICY

There is a growing belief that the current process by which fiscal policy is made does not work well. A survey of experts conducted last year found that 39% believed that fiscal rules have harmed the UK's macroeconomic performance, compared to 21% who thought rules had improved things.[23] About 27% said that the government should drop explicit fiscal targets altogether.

Fiscal rules are in one sense too rigid and in another too flexible. In some contexts, they do seem to restrict governments' ability or willingness to take on borrowing, even when it might be economically beneficial. At the same time, governments have a tendency to chop and change their fiscal rules to make them easier to meet. There have been 14 different fiscal rules in place in the UK since the Coalition government came to power in 2010.[24] Economists are increasingly recognising that the system of fiscal rules leaves us with the worst of both worlds – they discourage governments from taking as much fiscal action as they ought to, but they fail on their own terms because they are not tenable when circumstances change.[25]

The explanation for this apparent paradox is the fact that fiscal policy has fundamentally been driven by political considerations over economic ones. In recent years, the political context and the imperative to appear fiscally prudent has created a 'surplus bias' rather than the 'deficit bias' that the architects of fiscal rules envisaged, but all the same it has been economically unfortunate.[26] That may be about to change, as the political environment and calculation has shifted to encourage greater government borrowing, but if so the change of direction comes at an unfortunate time and risks stoking inflationary pressures.[27] Either way, the appropriate response is to try to take more of the politics out of fiscal policy, as central bank independence did for monetary policy.

What would independent fiscal policy look like? My recommendation here draws heavily on a proposal developed separately but motivated by similar concerns by the New Economics Foundation (NEF) for a 'fiscal referee'.[28]

There should be a Fiscal Policy Committee (FPC), staffed by appointed experts, along similar lines as the Monetary Policy Committee. This could take different possible forms. One option is for the FPC to be housed in the Office for Budget Responsibility (OBR). Indeed, we can think of independent fiscal policy as a way of 'beefing up' the OBR, shifting its function from one of merely scrutinising fiscal policy to actively advising and constraining it.

However, it is absolutely critical that the Fiscal Policy Committee is well coordinated with the Monetary Policy Committee. It would be entirely counterproductive to have two distinct technocratic bodies that end up pulling against one another. At the very least, there should be some overlap in membership between the two. A more radical

suggestion would be to make the Fiscal Policy Committee a subsidiary of the Monetary Policy Committee within the Bank of England.

The Fiscal Policy Committee's task should be to set an overall budget for the government. It should recommend a target range for the primary balance – that is, the difference between government spending and revenue excluding interest payments.[ii] In other words, the FPC would tell the government how much it should borrow. In making this recommendation, it should be driven by two considerations. First, fiscal sustainability – how much the government can afford to borrow without risking its ability to manage, refinance and pay off its debts. Second, and perhaps more importantly, macroeconomic conditions – how much demand the government should be injecting or removing from the economy in order to heat it up or slow it down.

It is vitally important that the Fiscal Policy Committee's target should be a genuine target and not a limit. It should give symmetrical consideration to the risk of running fiscal policy too tightly as well as too loosely. If it calls on the government to increase borrowing by, say, £10-15 billion, the government should seek to avoid underspending as much as it tries to avoid exceeding that target.

This still leaves the government with substantial political and economic discretion. The Fiscal Policy Committee would give the Chancellor a target, but would leave it up to them how best to hit it. So that £10-15 billion target of additional borrowing could be made up either through higher spending or through targeted tax cuts. And of course, the government would still have substantial scope to decide *which* taxes to cut or areas to increase spending.

There is a question of how much and what sort of power to give the Fiscal Policy Committee. NEF's proposal envisages an advisory body. With the Chancellor required to write a letter of explanation and offer verbal evidence to parliament if a Budget were to miss the FPC's target borrowing.[29] The concern is that this might not be a strong enough incentive for the government to comply with the FPC's recommendations, offering little more constraint than the existing malleable system of fiscal rules. A stronger approach would be to give the FPC some statutory basis – for example, making it a requirement of Finance Bills that they comply with the targets set by the FPC.

The independence and expertise of the Fiscal Policy Committee is critical to its success. It is vital that appointments to the committee are not politicised. Fortunately, appointments of the leadership of the Bank of England and the Monetary Policy Committee, though made by government, have remained large non-partisan. It should therefore be acceptable to use similar arrangements for the FPC. The NEF, for example, proposes that a certain number of appointments could be made by the government

[ii] A complication here is that the appropriate level of borrowing may depend on fiscal multipliers. For example, borrowing £10 billion to fund an increase in benefits might be expected to have a greater stimulus effect than spending that £10 billion on tax cuts for high earners who are more likely to save and less likely to spend the money. I suspect it is better to go with the more straightforward approach of focusing on the primary balance than expecting the Fiscal Policy Committee to account for such factors. As the New Economics Foundation argues in its paper on fiscal referees, it is better to prioritise "accuracy over spurious precision".

and the remainder by the House of Commons Treasury Committee, which is a sensible approach.[30]

IS IT DEMOCRATIC?

As much as the technical macroeconomic question of how best to run and coordinate fiscal and monetary policy, what I am interested in here are the political implications of that debate. Many people's immediate response to the idea of independent fiscal policy will be to see it as anti-democratic, removing power from the people and their representatives and handing it over to unelected technocrats. I want to argue that is not the right way to think about it, and that in fact such a move might be beneficial to democratic discourse regarding the economy.

The first point to make is that it is generally (though not universally) seen as democratically acceptable to devolve monetary authority to independent central banks. My argument in this paper is that problems have arisen from the fact that one major tool of demand stabilisation has been delegated, but the other – fiscal policy – has not. Moreover, those constraints have caused political problems because central banks have been driven to use extraordinary measures like quantitative easing because they cannot rely on fiscal policy. If we believe that it is democratically legitimate for demand management to be conducted by technical experts, it is arbitrary and perverse to limit that only to monetary policy.

The second observation is that government fiscal policy is *already* constrained by the existence of fiscal rules. The fact that governments create such rules and try to abide by them shows that they do not think it is desirable to debate the appropriate level of government borrowing on a budget-by-budget basis. Creating a Fiscal Policy Committee would effectively move us from 'dumb' fiscal rules, rigidly defined in advance, to 'smart' fiscal rules, utilising expert judgement and responsive to changing circumstances.

Some might object that because the government sets its own fiscal rules, these are subject to democratic deliberation and endorsement. I will go on to discuss whether this is in fact such a good thing. But the decision to make fiscal policy independent can also be made through democratic processes – it can be put in a manifesto for voters' approval or debated in parliament. It is certainly true that delegating fiscal policy is harder to reverse than making a fiscal rule (indeed, that is one of its attractions). However, it is worth noting that in other countries, governments have placed fiscal constraints on their successors in a way that seems to be democratically acceptable. For example, in 2009, a 'debt brake' restricting annual government borrowing, adjusted for the economic cycle, to 0.35% of GDP was written into the German constitution.[31]

The most critical point is that delegating fiscal policy still leaves swathes of economic policymaking within the remit of the government. Recall that we started with three tasks for economic policymaking – increasing productive capacity through supply side measures, demand management, and trying to produce equitable outcomes. Leaving fiscal policy to independent experts only takes away one of these – demand management – and that has already partially been removed through monetary policy

independence. Among the array of critical issues that remain for the government to adjudicate are the size of the state, balancing growth with social and environmental harms, determining the appropriate level of societal consumption and investment, redistribution, whether to prioritise work or leisure and retirement, and creating a well-functioning education and training system.

Indeed, it is possible that by giving us an opportunity to focus on these bigger questions, more appropriate subjects for public debate, fiscal policy independence might in fact enhance the quality of our democratic discourse around economic policy. For many macroeconomists, the politics of the last decade have been deeply disheartening in part because of the dominance of questions of public finance. That has led to misleading household budget metaphors and jibes about the ‘magic money tree’, proxying for quite technical debates about the merits of expansionary contraction and Keynesian stimulus. In recent years, there has been a clear tendency to conflate the public finances with the economy as a whole, to equate the deficit and GDP. We can hope that hiving off questions of fiscal policy to technocrats can help shift the terrain of the discussion to deeper questions of value and vision.

ENDNOTES

[1] Thanks to Scott Corfe, Henry Curr, Pradyumna Prasad, Tom Spencer and Giles Wilkes for comments on an earlier draft of this briefing.

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