POLICY SPOTLIGHT

Fiscal Dominance—What It Is and How It Threatens Inflation Control

ERIC LEEPER | NOVEMBER 2023

From March 2020 to March 2021, the US Congress passed a series of COVID-related relief bills that raised federal government spending by $5 trillion. Because the legislation was couched as "emergency expenditures," the usual congressional budget procedures and haggling were suspended. The trillions of dollars of congressional fiscal gifts fueled inflation, and the Federal Reserve has been raising interest rates aggressively since early 2022 to combat this inflation. The COVID spending experience—expenditures made with no consideration of how to pay for them—is an example of "fiscal dominance," which is a threat to inflation control and cannot be countered by a return to monetary dominance.

THE CORE MISSION

The mission of monetary and fiscal policy is to do the following:

- determine and control the aggregate price level and its rate of change, inflation; and
- stabilize the level of government indebtedness to ensure those policies are sustainable.

Failure to achieve it means that government policies cannot accomplish any of the myriad of other tasks that societies demand: economic growth, high employment, financial stability, desirable income distribution, public safety, national defense, and so on.

There are two distinct policy arrangements to accomplish the core mission:

1. A monetary policy that aggressively keeps inflation on target coupled with a fiscal policy that raises primary surpluses whenever real government debt is above some desired level
2. A fiscal policy that sets primary surpluses independently of real government debt combined with a monetary policy that ensures interest payments on outstanding debt do not make debt grow too rapidly

CLASHES BETWEEN THE TWO POLICIES CAN AND DO OCCUR

If one policy is dominant, the other must be supportive. In the case of fiscal dominance, fiscal policymakers embarking on a path of deficits can force central bankers to accommodate them.

For instance, when Congress passed its COVID relief bills, the Fed could have chosen not to react to the fiscal disturbance. But because doing so would have come at the cost of not pursuing its mandate of inflation control, the Fed is not economically independent of fiscal policy. This makes fiscal dominance a recurring threat to the Fed's mission and to macroeconomic outcomes.

"POLITICAL DOMINANCE" AS A MORE ACCURATE LABEL

Monetary policy independence is a bulwark but not an impenetrable barrier against fiscal dominance. In the United States, as in the UK, Europe, and elsewhere, governments have chosen independent monetary policy coupled with politically driven fiscal policy. But it makes little economic sense: In practice, fiscal actions can still drive monetary policy choices. For this reason, political dominance may be a more accurate label than fiscal dominance.

EMERGENCIES ARE COMMON PERIODS OF FISCAL DOMINANCE

Governments provided substantial relief during COVID shutdowns to help families that were thrown out of work. That people treated the spending as gifts rather than as loans was intentional, geared toward encouraging consumption spending, rather than saving, to keep the economy going. It is not surprising that $5 trillion worth of gifts financed by an equivalent expansion in government liabilities was inflationary. The Fed is now mopping up after the fiscal party.

Whether the Fed will succeed in reaching its inflation target hinges less on its own actions than on Congress's willingness to tighten fiscal policy. Even an independent central bank cannot control inflation if fiscal policy is dominant. Control comes from an approach that institutionalizes a monetary-dominant regime—fiscal behavior that is compatible with an inflation-targeting monetary policy.

FURTHER READING

Eric M. Leeper, "Fiscal Dominance: How Worried Should We Be?" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, March 2023).

"Hanno Lustig on Fiscal Dominance, Inflation, and the Effects of Long-Term Interest Rate Decline," *Macro Musings with David Beckworth*, September 5, 2022.

Patrick Horan, "An Inflation Primer" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, July 2022).

Veronique de Rugy and Jack Salmon, "Fiscal Sustainability: High Stakes and Low Interest" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, February 2022).

David Beckworth, "The Prospect of Fiscal Dominance in the United States: A New Quantity Theory Perspective" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, October 2021).

ABOUT THE AUTHOR

Eric Leeper is a Distinguished Visiting Scholar at the Mercatus Center and the Paul Goodloe McIntire Professor in Economics at the University of Virginia.