

# Labour's fiscal rule works under any macroeconom...

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As some will have noted, the blog has had rather more discussion of Labour's planned fiscal rule in the last few days than I might have expected a week ago. The [latest comment worthy of discussion](#) is from Simon Wren-Lewis, who is one of its authors.

I confess I am disappointed by Simon's response. He accuses me of making suggestions that are wrong. I not only disagree, I also think that Simon's responses are incorrect.

Let me address this first. Simon says

*Richard says so many false things about this rule it is difficult to know where to start.*

But he does, saying:

*It is not 'neoclassical'.*

Yes it is: the whole logic of central bank independence is, in my opinion, based on neoclassical thinking. I would suggest it is hard to disagree.

Then he says:

*It does not 'have its roots in microeconomics'.*

Yet again, yes it does. Almost all the macro Simon does has its roots in micro, because that is how it was developed. This is the way neoclassical economics works.

As a result for Simon to say:

*It does not assume 'markets allocate resources efficiently'.*

is also wrong. Micro does that. And, as I show below, Simon assumes that has happened in his analysis.

Whilst to say:

*It does not make any assumptions about how money is created*

is again wrong. It clearly thinks this is a commercial bank operation, which I would largely contest. As a result Simon's suggestion that:

*To say that Labour's rule is based on a microeconomics perspective but MMT has a macro perspective is complete and utter nonsense.*

With respect, I disagree, as I do with this:

*You can justify Labour's rule on the basis of pretty well any macroeconomics you like, as long as you accept that interest rates are stabilising the economy rather than fiscal policy.*

So in other words, you can justify Labour's rule on the basis of any macroeconomics you like so long as it is neoclassical, which has its roots in micro, which does what he says. MMT does not make that assumption. In which case I am not wrong in pointing this out. So I offer a small note to Simon: you cannot win an argument by rigging the assumptions so that you must do so. The assumptions are also fair game. And I apologise for having to waste you, the reader's, time pointing this out.

Having dealt with this issue let me move to Simon's more substantial claim, which is this:

*The bottom line is that Richard tries to suggest that you could have more public spending under an MMT type assignment compared to Labour's fiscal rule. That is also completely wrong, and if anything the opposite would be true.*

This Simon justifies by saying:

*Suppose Labour comes to power in 2022, and nominal interest rates by then are at 2%, and inflation is steady at target. Labour are pledged to substantially increase public investment spending (which is outside the rule), which will put upward pressure on demand, at least initially. That would mean under a conventional assignment interest rates would rise to prevent inflation. But in an MMT world that wouldn't happen. So in an MMT world how do you stop inflation rising? Either current spending would have to be cut, or taxes increased.*

Apart from the fact that the assumptions about 2022 are wildly different from anything I can imagine that is likely to be happening by then, if by chance those assumptions are true Labour is not going to win an election. Why would they? The Tories would correctly be able to claim they had everything under control and in good shape if the assumptions are true. And governments in that situation win elections. Planning for this scenario is, then, politely called a waste of time.

But let me also note something that Simon ignores. What Simon says is that if elected in this scenario Labour would want to invest, and could. His argument is, then that the resources to permit investment must exist, or will be displaced from elsewhere. So two assumptions apply, that he does not state but which he must have made. Either there are spare resources - which must mean unemployed people in reality - because if there weren't the resources to build the investments would not exist; or, alternatively, if those resources were not spare then Labour would have decided that to reallocate resources to investment would be more effective than leaving them in their existing use, presumably related to consumption (by default). And, I stress, that decision can be rational because the multiplier effect on investment produces a yield greater than that from allocating resources to consumption. In other words, the investment creates a return in excess of the value lost by the reallocation of resources to it.

In either case why is there necessarily inflation? The simple answer is there isn't. If there are spare resources (because as [Danny Blanchflower and I would agree](#), the natural rate of unemployment is lower than most neoclassical macroeconomists) then the proposed investment makes use of these and because slack is used there would not need be any inflation.

Alternatively, if resources had to be reallocated from activity not as useful then the additional return the investment generates over that created in the previous use of the resources in turn creates capacity to absorb increased demand, so inflation need not, again, need to follow.

So why does Simon think it does? I can only suggest that this is because Simon has implicitly assumed the market has already optimally allocated resources. In other words, his assumption is that the investment Labour wants to deliver breaks an equilibrium position. Support for this idea is implicit in Simon's language. Note he says:

*Suppose Labour comes to power in 2022, and nominal interest rates by then are at 2%, and inflation is steady at target.*

We have 'normalised' in other words. Equilibrium has been restored, and Labour would simply be upsetting the economic applecart by investing in a way 'outside the rule' with inflation then bound to follow, if that is what you assume, as I suggest Simon does. But as I have noted, that's not going to come to pass. More importantly, the assumption is, as I previously noted, that markets have optimally allocated resources and Labour will be disrupting them. The implication is obvious. It is that 2% interest rates and inflation are a desired normal when it is not at all clear why either should be, except that they might comfortably fit with the neoclassical macro model of optimal conditions created by independent central banks. In other words, Simon is again winning this argument by assuming he already has.

Having then dismissed this argument by showing that the risk of inflation built into Simon's assumptions need not be real, I turn to Simon's next claim, which is:

*There is only one way that public spending for given taxes could be higher in an MMT world compared to Labour's fiscal rule, and that is if inflation was not controlled at all.*

I am struggling here. As I am with this comment:

*That is not what serious MMT economists would recommend.*

Well, of course serious MMT economists do not say inflation should be ignored. That's why some emphasise tax as a way to control it, and others suggest the Job Guarantee. In practice, the reality is MMT economists will necessarily suggest a mix of the two: fiscal policy necessarily and in essence always requires that. But why then Simon's comment that inflation has to be uncontrolled for his rule to be bettered? He's adamant he is right, concluding his comments with this:

*So when Richard says Labour's rule means a Labour government would be committed to austerity policies, by which I think he means low public spending, while his MMT alternative would allow more public spending without raising taxes, he is, once again, just wrong.*

This is just wrong, and seriously so. First, that's because the whole, standard macroeconomic basis for reaching this conclusion is wrong. I have already noted why, above. But, I would also draw attention [to an article by Danny Blanchflower](#) published in 2012 which does, I think, ably argue the same point, quoting in the process Oliver Blanchard, who wrote in 2008 that:

This, of course, is exactly what Simon has done. If evidence that his analysis is neoclassical was required, then this is it.

And what upsets so many macroeconomists is that MMT, and thinking based on it, does not work in this way. Instead of starting with theory it looks at the real world. Modern monetary theory is, of course, theory based, but it starts from observation. As a result it looks to see if there are unused resources and unmet demands in the economy. If there are (and quite clearly that is the case at present in the UK, on both counts) then it argues that the creation of additional credit within the economy to utilise those resources to meet that demand makes sense. Having also noted that the reality must be that the private sector is not using those resources, or meeting that demand as a matter of fact, then it is pointless to rely upon that sector to do so to create optimal economic outcomes for the people of the jurisdiction. If the private sector was going to do that, it would have already done so, but it hasn't. In that case the creation of this additional credit is a task that must fall to the government.

I stress that it is additional credit (and in this context, I make clear that all money is debt and so, by corollary, also credit, because both sides of the transaction have to exist) that is vital here. The aim is to enable things to happen that might not otherwise

do so. So the need is not for additional tax to be raised to fund spending: raising additional tax in the position noted would reduce demand in the first instance, which is precisely the opposite of what is required. In other words, the suggestion Simon makes that taxes would have to be raised to fund investment is, in this scenario, completely wrong: the ordering of events is in reverse of what is required economically.

MMT recognises this. It says that, as a matter of fact, governments have to create credit in the form of new money before taxes can, as a matter of fact, be paid. If they did not do so then the money to make settlement would either not exist or would, as previously noted, have to be withdrawn from the existing active economy, and so reduce activity within it, which is the exact opposite of what an investment strategy would require.

And having suggested that this new credit be created MMT does not then demand that it be withdrawn from the economy by tax. This is because MMT does not think that government spending is funded by taxation, because all government spending is in fact funded by new credit creation in the first instance. This new credit is then either cancelled by way of taxation, which is an essential fiscal function to control inflation (the importance of which to MMT makes a mockery of Simon's claim that MMT is not concerned with inflation control) or it is left outstanding and either formalised as so-called government debt (which is, in fact, the balance of private sector savings balances deposited with the government, and so something quite fundamentally different from its neoclassical representation) or is left on account between the government and its central bank, which is precisely what quantitative easing has done. The idea, then, that tax has to rise to fund additional spending is completely shattered: no such necessary (and I stress the word 'necessary') relationship exists.

This is not to say though that tax might rise. This will only happen if and when the new investment succeeds in its aim of creating full employment at living wage rates within the economy. And of course, at that point the additional wealth to pay the additional tax would have been created. In other words, it would not be an additional cost at that time. But this is the point of optimality on which MMT focuses: its aim is to ensure sufficient credit money is available within an economy to create optimal outcomes for the people of a country when markets will not do that, whatever the reason might be. The focus is not, as Simon has it, on base interest rates and inflation rates. You will note his assumptions did not even make reference to unemployment or real economic conditions. Simon's focus, which is based on the neoclassical belief in central bank independence and a belief that it is interest rates that must control inflation, come what may (which point he acknowledges), is straightforwardly willing to sacrifice employment opportunities to achieve that goal and MMT is not.

That does not mean MMT is indifferent to inflation: far from it, in fact, although I accept that many MMT economies, like some neo-Keynesians (Paul Krugman included), think that an obsession with the 2% inflation rate is unnecessary and a higher inflation target would be quite acceptable. Rather, MMT puts the focus elsewhere. But precisely

because that new focus would put more resources to use in the economy the outcome would be higher growth, lower steady, more tax revenue (assuming a consistent tax base and rates) and, to use the language of neoclassical economics, an equilibrium point at a higher level of overall economic activity that would guarantee to consign austerity to history. I regret to say that there is nothing in Simon's logic that does, despite his claims, guarantee that. Indeed, I think that the exact opposite is likely precisely because he thinks that any increase in investment would have to be matched by withdrawing current funds from the economy in the form of taxation, which would be completely counterproductive to this goal.