

# The political economy of Labour's fiscal rule

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I could do a blow by blow account of the [exchanges on Twitter between Jonathan Portes, Simon Wren-Lewis and me](#) concerning Labour's Fiscal rule last night. There would, I suspect, be little advantage. Instead I am interested as to why this difference has arisen, and why Labour finds itself stuck with such a wholly inappropriate policy, which Jonathan Portes says can hardly be differentiated from anything the LibDems or Osborne have said or done. Answering this question will, I think, also explain why Simon Wren-Lewis thinks I deliberately misunderstand him, which I most assuredly do not.

That reason can, I think, be found in something that another awkward macroeconomist, David Blanchflower, wrote in 2012 [when he said](#):

*In the summer of 2008, just before the crash of Lehmans, Olivier Blanchard, now chief economist at the IMF, published an NBER working paper entitled 'The state of macro is good', which made no mention of bubbles or any real world data. In it he argued that 'macroeconomics is going through a period of great progress and excitement' outlining what a typical article in macro looks like. No mention here of trying to test against data from the real world: calibration is just making things up because the model doesn't actually fit the real world.*

*"A macroeconomic article today often follows strict, haiku-like, rules: It starts from a general equilibrium structure, in which individuals maximize the expected present value of utility, firms maximize their value, and markets clear. Then, it introduces a twist, be it an imperfection or the closing of a particular set of markets, and works out the general equilibrium implications. It then performs a numerical simulation, based on calibration, showing that the model performs well. It ends with a welfare assessment."*

*I have no idea what haiku-like rules are. I have been especially struck by the totally ludicrous claims made by Chari and Kehoe who seem to have entirely missed the plot. If economics is not, what Harberger in 1993 called an 'observational discipline', it is nothing.*

*"Over the last three decades, macroeconomic theory and the practice of*

*macroeconomics by economists have changed – for the better. Macroeconomics is now firmly grounded in the principles of economic theory”*

As I [noted very recently](#), this last point is what I think the Portes / Wren-Lewis rule to be. It is a rule written to re-establish the neoclassical economic order of central banks running monetary policy in pursuit of a form of financial stability that favours one very particular group in society, who are already very favoured because neoclassical economics assumes that they should be. That is its goal, from start to finish.

The haiku is the assumption that neoclassical macroeconomics is right, and that all that policy should be used to prove is that the theory must work. So, remembering always that Portes has said he doesn't do politics, let's look at this.

In essence, what Portes and Wren-Lewis have done with their fiscal rule is ask what does current macroeconomic theory say about fiscal rules? And they have noted that it says central banks should be independent; the control of inflation should be paramount; interest rates should be used to control inflation and fiscal policy should be avoided because governments should balance budgets, with the logic used being based on the microeconomic theory of the firm, even if that is wholly inappropriate in this case. Of course, I am simplifying, but that's it, in a nutshell.

And what Portes and Wren-Lewis are saying with their fiscal rule is that in reality we have an aberration at present from what theory suggests to be the norm. We are not in a state of what macroeconomics would think to be equilibrium as a result. And so, in standard macroeconomic style, as summarised by Blanchflower and Blanchard, what they do is add a twist to re-establish the norm. They suggest unlimited fiscal policy be used until inflation is induced which then requires that the independent central bank reclaim control of the economy by the use of interest rate policy once more. This is their plan in a nutshell. Again, I simplify, but not much.

But I do not accept that this is the goal of macroeconomics. That is what Simon does not understand. And that I do not think that this is the right-ordering of economic policy is so far beyond his comprehension that he thinks that for me to believe so is illogical.

Except it isn't. I don't believe in independent central banks. In fact, I do not believe we have ever had one. [I have evidenced that](#). Simon [worked for its creation](#). We see the world very differently.

Nor do I believe we need significant inflation for any reason, let alone to restore monetary policy.

And third, like Keynes, I believe in long term low interest rates. And by low, I mean very low.

And why do I do that? Because I think that to raise interest rates would trigger a credit

crisis of untold magnitude in the UK, and beyond. And I cannot countenance that social cost. That's because I do politics.

And it's also because low interest rates help growth.

And low interest rates also stop the trickle (or flood) up of wealth: they are rents, after all.

Fourth, despite thinking this I think that full employment is the key to economic policy, and not inflation and interest rates, which are decidedly secondary in priority. By saying so I could not more resoundingly reject the Portes / Wren-Lewis view if I tried.

And fifth, I do not think my policy will produce lower growth in employment or more austerity as Simon claims. Far from it, in fact. There are, again, multiple reasons.

Start with the fact that focussing on interest rates is not the way to create employment. Focussing on employment does that.

And then note that seeking to create a boom, as Portes / Wren-Lewis are doing, surely guarantees a bust, and austerity. And I really think we should avoid that.

But then also note that I do not think tax and spend and interest rates are the only tool in the armoury. As we now know we can also use QE. So we are not solely dependent on borrowing to balance budgets, and we are not dependent on the whims of markets as Portes / Wren-Lewis assume. Used properly for fiscal purposes, in association with a national investment bank, QE breaks the relationship between deficit funding and the whims of bond dealers, for good. But the Portes / Wren-Lewis rule ignores that fact.

So, I do not share their assumptions. That does not make me illogical as Simon claims. Nor should it be the cause for Jonathan Portes to sigh. Instead, it means I have a different argument with different aims and different policy instruments that I suggest would have different consequences.

So let's do the politics. What does Labour want? The Portes / Wren-Lewis variant on Osbornomics or Cableomics? Or a policy that targets full employment in a stable economy that is transformed by the Green New Deal for the long term well-being of this country by using the government power to create funds for this purpose, if that proves to be necessary?

I know which I want.

I hope Labour can see the difference. We should all be hoping that.