Optimal Structure of Fiscal and Monetary Authorities

David Miller∗1
1Federal Reserve Board – United States

Abstract

Advanced economies combine an elected fiscal authority with an independent monetary authority. This paper illustrates why monetary and fiscal authorities are designed so that monetary independence is beneficial. Replicating the advanced economies’ structure with authorities microfounded by a political economy model shows the structure is the solution to a constrained mechanism design problem that overcomes time inconsistency and results in the highest possible welfare. Goal and instrument independence, singly and in combination, are insufficient to minimize time inconsistency, though their combination is necessary.

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∗Speaker