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Examining legislative challenges to central bank autonomy: macroeconomic and agency costs models

Franklin G. Mixon Jr. [a,*], Kamal P. Upadhyaya [b]

[a] *Department of Economics, The University of Southern Mississippi, Box 5072, USM Station, Hattiesburg, MS 39406-5072, USA*

[b] *Department of Economics and Finance, University of New Haven, West Haven, CT 06516, USA*

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Abstract

This study examines the determinants of legislative threats (from the US Congress) to the Federal Reserve's prerogatives (e.g., budgetary authority, autonomy, secrecy, etc.). Specifically, two *competing theories* of legislative threats – one relating the Fed's management of the macro economy and the other to the Fed's expense preference behavior (i.e., its budget-building activity) – are empirically modeled. The results suggest that aspects of both the "macroeconomic model" and the "agency costs/political model" have merit. However, tests of non-nested hypotheses indicate the superiority/dominance of the latter model in explaining variations in legislative threats from Congress over time (1964–1993).

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1. Introduction

The concept of central bank autonomy has been a matter of debate since the legislative proposals leading up to the *Federal Reserve Act of 1913*. The main channels of academic research in this area (see Waller, 1992) have included direct signaling of monetary policy desires from the administration and Congress to the Federal Reserve (Havrilesky, 1987,

* Corresponding author. Tel.: +1 601 266 5083; fax: +1 601 266 4920.
E-mail address: mixon@cba.usm.edu (F.G. Mixon Jr.).

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1988, 1995), coercion by the administration (Waller, 1991), and central bank appointments (Chappell, Havrilesky, & McGregor, 1993; Havrilesky, 1995; Havrilesky & Gildea, 1991, 1992; Mixon & Gibson, 2002; Waller, 1992, 2000). Much of the recent literature indicates that, despite the Fed's independence, pressures from public and private sources have considerable influence on monetary policy (Froyen, Havrilesky, & Waud, 1997; Havrilesky, 1988, 1990, 1995). The consensus is that there *is* some scope for administrations to succeed in attempts to influence Fed decision-making. As Havrilesky summarizes, "in order to protect its prerogatives the Federal Reserve [as an agent] . . . must respond to pressures [from its principals]. Since one of these prerogatives is . . . autonomy, it follows that the central bank periodically might tactically surrender some autonomy in the near term . . . to protect it . . . in the longer term" (Havrilesky, 1995, p. 187).

An additional area of related research has examined the implications concerning inflation that emerge from central bank (in)dependence. The early consensus (using cross-country data) was that central bank independence promotes lower levels of inflation (see Alesina & Summers, 1993 and Cukierman, 1992); more recent work offers less conclusive evidence of this relationship (Barro, 1999). Still, other research has focused on the expense preference implications of the principal-agent relationship between the Federal Reserve and the US Congress. As Boyes, Mounts, and Sowell (1998) argue, it has long been recognized that agents tend to increase their own utility at the expense of principals. This is "especially true in the presence of asymmetric information and the associated costly monitoring," and the expense preference behavior of bureaus (e.g., the Fed) " . . . may be seen in shirking, taking perquisites, and other budget-building actions unrelated to the task of the bureau . . . " (Boyes et al., 1998, p. 552).

The present paper builds on two areas of recent research concerning influence/control of the Federal Reserve (the agent) by its primary principal (the US Congress). Specifically, our study examines two sets of correlates of *legislative threats* (from the US Congress) to the Federal Reserve's prerogatives (e.g., budgetary authority, autonomy, etc.). Each of these sets of correlates relates to a distinct theoretical construct of Congressional motivations for influencing Fed behavior through legislative threats to its independence. These are (1) macroeconomic factors that relate to the re-election desires of incumbent politicians, and (2) agency costs factors that relate to congressional (i.e., the principal) oversight over central bank (i.e., the agent) activities related to "budget-building" (i.e., expense preference behavior). Our study is unique in that these distinct sets of regressors are tested as *competing theories* in explaining variations in the legislative threat count (using data from Havrilesky, 1995) from 1964 through 1993.

2. Motivations for congressional control of the fed: testing alternative theories

There is an extensive literature concerning legislative and executive branch attempts to influence monetary policy in the United States (see Friedman, 1982; Havrilesky, 1995). Much of it centers around the use of signaling through the financial media, by an Administration, of its monetary policy desires in order to influence the direction and magnitude of the central bank's management of the macro economy (see Havrilesky, 1987, 1988, 1990, 1995; Havrilesky, Sapp, & Schweitzer, 1975). One hypothesis that explains the observed pattern