Simply Explained: The Fiscal Theory of the Price Level
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Over the course of my research on the relation between ballooning government debt and inflation, I have come into contact with and worked on a macroeconomic modeling framework known as "the fiscal theory of the price level." There is much confusion over what fiscal theory represents and claims, which has occasioned substantial prejudice against it by economists. It is also quite confusing to many people how the mechanisms work in the real world. The purpose of this short write-up is to clarify, in plain terms, what fiscal theory claims and the basic intuition behind how it works.

At the heart of fiscal theory is a concept known as "Ricardian equivalence." The "Ricardian" part of the name comes from the famous English economist David Ricardo who first presented this idea. The "equivalence" component comes from the notion that economic agents are indifferent between debt and taxes, or that these things are equivalent in their eyes. A few assumptions are required for this result to hold. The following are the most relevant to our discussion: first, the overall level of government spending over the foreseeable future must be constant. If it is even expected to rise or fall, this result fails. Another necessary feature is that tax revenue has to be raised via "lump-sum" taxes, meaning the value of the taxes doesn't depend on the choices of individual consumers.[1] If these assumptions hold, then the "real macroeconomic equilibrium is independent of whether the expenditure is financed by lump-sum taxation or by debt."[2] This means that the allocation of resources in the economy is unaffected by the government's decision as to *when* it levies taxes and how much debt it initially decides to saddle itself with to finance the spending. Hence, the pure *timing* of taxes is irrelevant to economic outcomes.

Why is this the case? Imagine that the government hands you a piece of paper that gives the holder a claim on future government revenue, stipulating that it will pay out X. Given our assumptions above (constant spending plus lump-sum taxes), you know for a fact that this extra spending the government engages in so that it can pay you the promised X will eventually be financed by assessing a lump-sum tax on you of exactly X. Hence, you'll be right back where you started: you've been given X, but then X will soon thereafter be required of you. For any rational person, this doesn't change how much they can afford over the foreseeable future, which means they shouldn't change how much they consume.[3] In other words, this piece of paper given

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[1] Three other conditions are necessary: agents must behave as though they're "infinitely lived", there must be "perfect capital markets", and "future taxes are foreseen." For reference, please see Turnovsky, Stephen J. Methods of Macroeconomic Dynamics. MIT Press, 2000, p. 238.

[2] Ibid.

[3] Romer, David. Advanced Macroeconomics. 1st ed. New York: McGraw-Hill, 1996, pp. 66–67.

to you by the government is not a real increase in your lifetime income.[4]

So what happens when we assume that government spending and tax policy ("fiscal policy") does not meet the requirements for Ricardian equivalence? Go back to our previous example and assume the following alteration: the government, once again, hands you a piece of paper that gives the holder a claim on future government revenue, stipulating that it will pay out X. Maintain the assumption that government spending stays constant. Now, in contrast to the previous example, imagine that the government makes no commitment to raise taxes later on down the line to cover the X dollars it doles out upon maturity of the claim. Now what? In this case, with no future prospects of a countervailing tax hike, you are X dollars wealthier after obtaining the claim, which will induce you to buy more goods and services. However, since the supply of goods and services hasn't changed, we now have X more dollars chasing the same amount of goods and services as before. With greater demand for the same amount of products, the price level will rise. This gives us inflation. Fiscal theory says that this inflation will continue until balance is restored between what the government owes and what it is expected to raise in resources to pay back what it owes.

Why does any of this matter? One major reason it matters is that central banks around the world use quantitative models whose results *assume* that the government follows a spending and taxation policy (fiscal policy) that is "Ricardian," which requires that real debt relative to GDP remains forever bounded within some specified range.[5] This assumption serves as the jumping off point for the kind of optimal policy design that central banks use to help them determine how to set interest rates at any point in time (monetary policy). The problem is that, when the model ceases to assume Ricardian fiscal policy, the prescription for optimal monetary policy changes.

Here's an illustration. Under a Ricardian fiscal regime, the optimal prescription is, essentially, that the central bank follow an interest rate *rule* that abides by something called the "Taylor principle," which stipulates that it should raise short-term interest rates more than one-for-one to the rate of inflation. If fiscal policy is non-Ricardian, following the Taylor principle gives rise to the possibility of "explosive" inflation dynamics.[6] This means that inflation could reach a point where it grows exponentially, which is anything other than "optimal" monetary policy. The reason this occurs follows from the logic above. Imagine a similar scenario to our previous example, but the interest rate on the claims that the government issues begins to rise. For clarity, assume that these claims are re-financed frequently, and at ever higher interest rates each time. Barring any counterbalancing tax hikes, the higher interest rate increases your wealth, which induces you to spend more, which will push prices higher. If the central bank responds

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[4] In macroeconomist parlance, the claim is not "net wealth."

[5] Woodford, Michael. Interest and Prices: Foundations of a Theory of Monetary Policy. Princeton, NJ: Princeton University Press, 2003, p. 312.

[6] Ibid, p 315.

according to the Taylor principle, it raises interest rates even more, causing even greater inflation, and so on and so forth until inflation exhibits explosive dynamics. Thus, when faced with a non-Ricardian fiscal regime, where the government spends money without raising corresponding revenue, the central bank must set monetary policy so as to "accommodate" government deficits. This means responding to inflation by raising interest rates less than one-for-one.

An additional component of fiscal theory that matters for how inflation is determined is the length of the maturity of the government's debt, meaning how long the holder of a claim to government revenue must wait to receive their payout. This is known as the "maturity structure" of the debt. As the maturity structure gets longer, it changes how the issuance of debt without any corresponding future surpluses ("unbacked debt") affects the trajectory of inflation. It turns out that, when the government finances deficits by issuing more "long-term" debt (debt that doesn't get repaid for a decade or more), inflation rises over the immediate term by less than it would with the same deficit financed by shorter term debt. In the case of short-term debt (1 year or less to maturity), a surprise deficit leads to an immediate spike in inflation, after which point it returns to baseline (assuming spending does too). In the case of long-term debt, the same deficit (and all else equal) can lead to a much smaller spike in inflation that becomes spread out relatively smoothly over the length of the debt's time to maturity. The intuition here is also quite simple: if I receive an unbacked claim to government revenue that comes due tomorrow, my wealth has increased by whatever dollar amount I'm owed tomorrow. In the case of long-term debt, although I anticipate being X dollars richer 10+ years from now, the value of my claim also falls as other market participants and I anticipate inflation to take place between now and the time that I receive the payout. This fall in the value of my claim partially offsets the increase in wealth I expect from it, which means less inflation.

To this end, when a government issues long-term debt, the central bank may be able to reduce inflation in the short run by raising interest rates. However, it cannot do so indefinitely. If the central bank raises interest rates, in the case where a government issues a substantial amount of long-term debt, prices of outstanding long-term debt may fall by enough to cause inflation to decrease over the short-term. However, with the higher interest rates on newly issued debt, absent corresponding future surpluses, inflation will eventually pick back up again. This represents a famous result where, under a non-Ricardian regime, the central bank can control the timing of inflation, but not the long-term magnitude.[7]

The mechanism here doesn't require that the government finances its debt repayments by printing off money (i.e., raising seigniorage revenue). The heart of the matter is changes in perceived wealth among holders of government debt as a consequence of the government's refusal to adjust budgets in accordance with the tax revenues it expects to receive. The mechanism also doesn't require that the debtor nation be in control of the money supply in which

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[7] Cochrane, John H. "Long-Term Debt and Optimal Policy in the Fiscal Theory of the Price Level." Econometrica 69, no. 1 (January 2001): 69–116

it issues the debt. It does require, however, that the debt not keep up with inflation (that the entirety of the debt portfolio isn't "real" debt).

As the ratio of debt to GDP rises, and as interest on debt exceeds the growth rate, fiscal policy becomes increasingly relevant to the determination of inflation. In the United States, where debt to GDP continues to grow without any auspicious prospects of extinguishment, it is increasingly important that we recognize that there is a relationship between our deficits and affordability issues. Without serious adjustments to fiscal policy, we can expect continued frustrations of the Fed's efforts to fight inflation.