

6. Fiscal policy and public debt

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The original Washington Consensus fiscal policy principles involved fiscal discipline, public spending on physical and human capital, and broad tax bases with low tax rates. While these principles remain sound, in this paper we add two new principles supported by theory, evidence, and experience. The first new principle involves using targeted transfers to offset shocks that economic agents cannot insure against, and using transfers and public credit to preserve markets when a market-maker of last resort is needed. This policy will involve fluctuating public balances and infrequent but large public deficits during crises, which in turn requires a second principle to ensure the necessary fiscal space. That second principle is to preserve the special nature of public debt, keeping government bonds safe and liquid, via rigorous fiscal rules and credible fiscal and monetary institutions. For most countries, the existence of a global financial safety net is also essential to the successful implementation of this second principle.

I. Introduction

The original formulation of the Washington Consensus included three priorities for fiscal policy:

- Pursue fiscal discipline to avoid the macroeconomic instability associated with excessive debt issuance or money creation.
- Keep public expenditures focused on basic health, education, welfare, and infrastructure, and away from sectoral subsidies of dubious social and economic value.
- Raise tax revenues from a broad tax base, holding marginal tax rates at moderate levels.¹

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A generation later, most economists are still in broad agreement with these three principles. But academic views and actual practice have since shifted – at times in ways that complement them, but also in some ways that contradict them. After all, in many advanced economies public debt has risen since the Great Financial Crisis of 2007–09 more than ever during peacetime. The governments of both advanced and emerging nations today often react to crises with aggressive countercyclical fiscal policies, as they did both during the Great Financial Crisis of 2007–09 and during the COVID-19 crisis. And the International Monetary Fund (IMF) routinely recommends progressive tax systems and the use of taxes and transfers to redistribute from the rich to the poor as part of the job of stabilising business cycles. In short: there is a great deal more fiscal activism than the Washington Consensus recommended.

Now, it is one thing to try to fulfil both the old and the new role for fiscal policy; it is something else to be able to do it. The new fiscal activism requires that governments be able to borrow in times of crisis, when private sector agents often cannot. History shows that not all governments retain unfettered market access at reasonable interest rates (or any rates at all) during periods of financial strain. Only those with manageable debt levels and strong fiscal institutions do. These are the prerequisites for safeguarding the privileged role of public debt and being able to undertake an activist fiscal policy.

This chapter develops these points and proposes a new and broader perspective on fiscal policy and debt management, adding two principles to Williamson's original formulation of the Washington Consensus: a rationale for the new activism on both spending and taxation, and a revamped perspective on fiscal discipline and public debt.

II. Fiscal activism

At the time of the Washington Consensus, it was widely accepted that countries should run fiscal deficits during economic contractions and surpluses during expansions. This was either because of neoclassical tax smoothing, which dictates that tax rates and their distortions should be constant over time (so that revenues fluctuate with the cycle), or because of Keynesian output stabilisation, in which the government spends or saves in a countercyclical fashion. Those ideas remain valid and widely accepted today. But there are three additional reasons for fiscal activism, which we analyse in what follows.

1. Fiscal policy as insurance, completing markets after the event

People face many risks they cannot insure against, that not only cause large drops in wellbeing when they materialise, but also cause prospective anxiety beforehand. Some of these risks are aggregate, so they cannot be pooled and diversified away by traditional insurance. A recession or a large drop in housing prices affects almost everyone, with no winners around to compensate the

losers. In an ideal world, these risks could be traded and efficiently shared in financial markets, but in the real world they cannot. On the contrary, financial markets often end up amplifying these shocks and concentrating them in the most vulnerable segments of the population.

One common macroeconomic risk involves losing one's job during a recession. Finding a new job can take a long time, even after the recession is over. Another macro risk is a sudden and large aggregate income loss – for instance, during a health crisis like the pandemic – that limits sales for a small business owner. Yet a third one is a large spike in unavoidable spending for households whose rigid consumer basket depends heavily on energy. There is no macro market where the millions of people who find themselves in such situations can insure against these contingencies before the fact.

In principle, government can help households smooth consumption across these different possible events. Before a shock happens, it can set up automatic stabilisers, such as unemployment insurance. Afterwards, it can transfer resources to those affected by uninsurable bad outcomes. In addition to the welfare benefits that follow from standard consumption smoothing, there is an important macroeconomic benefit – with a logic dating back to Keynes – that the literature has emphasised in the past two decades. During a recession, the fear of being hit by uninsured shocks leads people to save more, which in turn lowers aggregate demand and deepens the slump, in what is sometimes referred to as a paradox of thrift.² Public provision of social insurance can sever this amplification mechanism, since the government internalises the effects that prices do not reflect when insurance markets are missing.

The standard objection to public insurance provision is moral hazard: people would lose the incentive to guard themselves against risk. But the shocks in question are macroeconomic, and depend less (or not at all) on individual actions. This reduces the scope for moral hazard. In the standard story, people who have insured their bicycles are then more likely to leave them unlocked or in unsafe locations, with the result that the 'shock' of having the bike stolen happens more often. That is not the case with aggregate shocks, because no single person can make them more frequent.³ Moreover, the government can observe, however imperfectly, the realisation of these shocks, so that people cannot misreport them to boost their insurance payout. All these reasons amount to a case for government to intervene.

Examples of these principles in action are easy to come by. Take unemployment insurance: many governments have chosen not just to have such a system, but to raise its coverage and generosity once a recession begins. Other more recent cases include temporary programmes designed to allow businesses to survive the pandemic downturn, such as the United Kingdom's furlough scheme, and the novel transfer programmes that targeted support to the most affected households during the 2022 energy crisis.⁴

These new policies have often been large – in some cases, very large. Germany, for instance, spent €200 billion, or over 5% of gross domestic product (GDP), to subsidise consumers during the 2022 spike in energy

prices.⁵ The new activism mostly involves transfers to households and businesses. It is very different from the Keynesian activism, consisting of government purchases of goods and services that the old Washington Consensus focused on.

However, the new case for activism has its limits. Such policies ought to provide transfers only to those especially affected by shocks. Looking back at the measures taken during the pandemic or the energy crisis, that was often not the case. This raised the fiscal costs of these programmes while lowering their effectiveness. Moreover, targeting those affected is not the same as targeting those who are poor on average. Insurance is not the same as redistribution. If rich households were affected by the shocks, they could also be recipients of transfers. In practice, this is seldom the case because higher savings and wealth allow the rich to self-insure, but it is still an important principle to keep in mind.

More broadly, the new emphasis on insurance provision need not imply a larger state. The argument is not about the size of the government across the business cycle, but about activism during recessions. The average size of the state could remain unchanged if, during the upswing, government lowered spending and accumulated assets (or repaid debts) to make activism easier to finance during turbulent times. We return to this topic shortly.

The need for and the desirability of these policies varies from country to country. Different societies have different social insurance arrangements to deal with the ‘missing markets’ problem. In some countries, family and kinship ties can be more effective than government in providing insurance. In others, government may get a bigger ‘bang for its buck’ by subsidising private agents or providing public guarantees that spur the emergence of private insurance markets, instead of insuring households directly via transfers. And, of course, the extent to which public insurance crowds out or complements private insurance depends both on context and on policy design.

2. Fiscal policy as market-maker of last resort

Related to the need to create missing markets is the need to sustain existing markets when they are near collapse. Whereas the first new role for fiscal policy focuses on households and businesses unable to purchase insurance, this second role focuses on the markets and institutions that provide the limited insurance that does exist. Under this logic, a fiscal intervention is triggered by the infrequent (but potentially very costly) collapse of certain markets, especially financial markets. Access to insurance disappears precisely when it is most needed – during crises.⁶

The Great Financial Crisis of 2007–09 provides a prime example. Government, broadly defined to include both treasuries and central banks, stepped in to provide emergency credit, subsidies, public guarantees, asset purchases, and capital injections, either to replace the financial markets that had disappeared or to keep markets operating.

This kind of market failure results from financial imperfections that the academic literature has long explored. To take just one example, imagine that lenders will not allow firm or household debt to rise beyond a certain multiple of collateralisable assets such as real estate or physical capital. If a recession then lowers the value of these assets, firms and households can no longer borrow as much as they did before. Households are forced to cut consumption and firms to reduce investment. This in turn deepens both the recession and its associated welfare losses.⁷

Even worse, the literature shows that crises can also become self-fulfilling. Continuing with the same example, if the borrowing constraint depends on the price of the collateral, and that price falls in response to the expectation that households will not consume and firms will not invest, then the tightening of borrowing constraints causes that expectation to be confirmed.⁸

The role for government here is related to, but also different from, the previous role we discussed. An activist fiscal policy can eliminate the bad equilibrium by committing to use government resources to provide public credit or to buy assets, preventing the downward spiral of prices. This can stop the amplification that arises from the fire sale of assets and can avoid the self-fulfilling pessimism that results from the endogenous tightening of borrowing constraints.

But why should government be in the business of providing such support? What can it do that the private sector is not able to do?

For one, government (at least in advanced economies, and sometimes in emerging markets (EMs)) can borrow when others cannot. This means government can become a lender of last resort or a market-maker of last resort, responding to aggregate shocks, when others are illiquid. In the best-case scenario, and if it is credibly and readily available, the fiscal bazooka may not need to be used. The mere expectation that government would intervene to rule out the bad equilibrium keeps the economy locked into the good equilibrium.

Notice how different from the conventional rules this new role for fiscal policy is. The focus here is not on aggregate demand management or on helping firms directly through bailouts. Rather, it is on supporting the normal functioning of financial markets.

Again, this new activist role for the government is subject to caveats. When it comes to financial institutions, moral hazard is at the forefront. Banks may overborrow if they expect the government to step in, and this places a constraint on how much the government can and should do. But this does not mean it should do nothing. Intervention brings benefits; moral hazard can bring costs. Standard economic calculus suggests that the optimal policy should be somewhere in the middle: large enough to make a difference and rule out the bad equilibrium, but not as large as it could be.⁹

A second caveat is that, for political reasons, policies that are meant to be temporary could end up being permanent. For instance, long-run credit subsidies could allow inefficient firms to survive and reduce aggregate productivity.¹⁰ Again, this is not an argument for doing nothing, but rather

for designing policies in a way that ensures they will be as temporary as needed. One way to do that is to introduce state-contingent sunset clauses in the legislation that authorise the initial fiscal intervention. An alternative is to enhance the quality and autonomy of fiscal and monetary institutions, as we discuss shortly.

There is one last constraint on fiscal policy that is central. Government can only step in as a lender of last resort and market-maker of last resort if it retains the ability to borrow during a crisis, when no one else can. The new interventionism implies greater borrowing during turbulent times, a point to which we now turn.

3. The amplitude of the fiscal balance

In principle, providing transfers to those most affected by a recession is consistent with raising taxes on the least affected and conducting a zero-deficit fiscal policy. But completing markets after the fact will often yield larger public deficits. One reason is that insurance should be inter-temporal, across groups that live at different times as well as across groups alive today. The 'less affected' groups are not just a (possibly small) subset of those alive today, but also those who will live through better times (with an expansion in economic activity) after the crisis. Accomplishing this inter-temporal risk-shifting is another dimension in which government can complement private markets.

Being a market-maker or lender of last resort could be accomplished without public deficits: the government could accumulate savings that it then disburses during crises. But that is unlikely to be the first-best policy, because holding those assets in a liquid reserve is typically expensive. Yet for some countries, especially open emerging economies, this may be the only available option. For these countries, an increase in the public deficit (in response to a fire sale after an asset price drop) is likely to be accompanied by a rise in the current account deficit. Being able to borrow abroad to finance that larger deficit is far from guaranteed, especially if the asset price that collapses is the (nominal and real) exchange rate, since this lowers the present value of the government's future revenues when measured in foreign currency.

When public borrowing in times of crises is possible, this need not mean more frequent and larger deficits. On the contrary, it can mean larger surpluses in good times to pay for the larger deficits in bad times. As in our earlier argument, here the case is for a larger amplitude of the public deficit, not for a larger deficit on average.

In addition to the 'risk-sharing-across-time' argument, there is another independent case for running larger deficits during turbulent times. Over the last 20 years, advanced economies have experienced an excess of savings relative to the ability of those economies to channel savings to productive investment projects. This has caused low equilibrium real interest rates, and therefore nominal interest rates have hit the zero lower bound more often. At this point the economy is in a liquidity trap, where the central bank cannot

cut interest rates further if needed to stimulate the economy. It is widely accepted that under the zero lower bound, fiscal policy can and should take over from monetary policy as the main tool to stabilise the economy across the business cycle.¹¹

Moreover, nearly two decades of research on the liquidity trap have yielded novel and varied arguments on why the multipliers of fiscal policy can be enhanced by targeting transfers to groups with different marginal propensities to consume. As a result, the composition of spending and other interventions are key – not just their size, as was the case in older Keynesian analysis.¹² Finally, the last 20 years also saw a widening wedge between the returns to private investment and the interest rate on government bonds. Fiscal and monetary policies may be able to crowd in private investment if they manage to affect this wedge.¹³

An important caveat is that savings and investment move around, and so do real interest rates. When the zero lower bound does not bind, monetary policy – conventional or unconventional – should still play a central role in stabilisation. Moreover, in the years since the Washington Consensus, more nations, especially in EMs, have moved towards flexible exchange rates and reasonably deregulated capital accounts. In those circumstances, monetary policy is more effective than fiscal policy in stabilising output and employment.

III. Preserving fiscal space through prudent debt management

More fiscal activism and a greater amplitude of fiscal deficits and surpluses requires that governments retain their ability to borrow during crises. But this is not something that happens automatically. Rather, fiscal space needs to be built and preserved.

1. Build and respect strong fiscal and monetary institutions

The fact that fiscal policy could be conducted in an optimal way does not mean that it always or often is. Far from it: the political economy of fiscal policy is challenging and intricate.¹⁴ Scholars have documented the tendency of many countries to run a deficit over the whole business cycle, implying a ‘deficit bias’ and a persistent trend of debt accumulation. Also well documented is the common procyclicality of deficits (the opposite of what both old and new arguments prescribe), prompted by the fact that borrowing constraints often become looser in good times and tighter in bad times, especially in EMs.¹⁵ If fiscal policy suffers from both a deficit bias and from procyclicality, then the fiscal space the government requires to play the role of market-maker will be absent.¹⁶

Creating fiscal space is not easy, but both academics and policymakers have learned a great deal since the Washington Consensus on how to create strong and credible institutions to deliver it. On the side of monetary policy,

the expression of these lessons is central bank independence, designed to preserve price stability, prevent fiscal dominance, and keep the public debt reasonably free from inflation risk. On the fiscal side, the debate is much less settled and there exists no one-size-fits-all policy recommendation. Yet there is growing agreement that medium-term fiscal frameworks and fiscal rules (with escape clauses for recessions) can help in this regard.¹⁷

Over the last two decades many countries have adopted fiscal rules of one kind or another, so there are plenty of cases to learn from. There have been both successful and unsuccessful experiences with fiscal rules, in developed and EMs alike. Among advanced nations, the debate within the Eurozone has been particularly rich, with the principles that guide fiscal rules in Europe having been recently updated.¹⁸ Among emerging nations, arguably the most successful experience with fiscal rules is that of Chile, a country that since 2000 has managed to keep public debt low, not lose market access during the Great Financial Crisis of 2007–09 and the COVID-19 crisis, and pursue countercyclical fiscal policies (including some lending and market-making of last resort) during both crises.¹⁹

Research and practice have highlighted one trade-off that is increasingly clear: rules must be sufficiently simple so that they can be understood by citizens and, especially, by market participants. However, at the same time, they must be sufficiently adaptable and flexible to deal with large unforeseen shocks – perhaps via escape clauses. The principle guiding this and other trade-offs is that credible budget institutions and sound public finance management during good times preserve market access during recessions and crises.

2. Transparency and communication to prevent self-fulfilling debt runs

The seminal work of Guillermo Calvo emphasised the potential for multiple equilibria and self-fulfilling sovereign debt crises.²⁰ If debtholders, who are concerned about a higher risk of default (whether via inflation or outright non-payment), demand higher risk premia and therefore higher interest rates, they make it more expensive for governments to service the debt. This increases the risk of default and can make the initial worries self-fulfilling.²¹

Because indebtedness does not have to be very high to place a country in the multiple equilibria region, few nations are immune to these risks. Multiplicity can occur even at low levels of debt, since a very high interest rate can make such debts unsustainable. But multiple equilibria are more likely when debt is high; then, even a small increase in the interest rate investors demand can make default fears self-fulfilling. The maturity of the debt also plays a crucial role. If average maturity is short and therefore a large share of the debt needs to be rolled over every period, then it is more likely that small shifts in expectations can cause the government to become illiquid.²² Self-fulfilling debt panics are also more likely when public debt is denominated in foreign currency, as is often the case in EMs, since in that case the local central bank cannot serve as a lender of last resort.²³

One implication is that the sustainability of public debt should be understood as probabilistic and potentially subject to sharp and sudden changes. Another implication is that public debt management requires communication and steering of beliefs, to select the best possible equilibrium and prevent others from happening. Institutional design can help: constitutions and laws that rule out some policy actions also prevent policy traps driven by self-fulfilling expectations.

3. Protecting the special (and potentially fragile) nature of the public debt

Until recently, the global decline in real interest rates increased fiscal space, since governments could issue more bonds to satisfy the excess supply of private savings. But the demand for publicly issued paper does not depend only on global savings and investment. The government can borrow at lower rates than private agents because of the special features of government debt that give rise to a 'debt revenue'.²⁴ Preserving these special features requires special care and management.

Government debt is the most liquid security in most countries' domestic financial market. Households and businesses facing the uninsured risks we emphasised earlier rely on this liquidity when they save for a rainy day that can arrive when least expected. In turn, the collapse of financial markets, which we also discussed earlier, is often associated with private assets becoming hard to sell and the premium on the liquidity of public debt rising. In fact, the classic expression of the market-maker of last resort involves not the fiscal authorities directly, but rather the central bank intervening to preserve the liquidity of public debt. This kind of liquidity-preserving intervention is very different from monetary financing, which was the chief concern of the Washington Consensus (although drawing the line between the two of them in practice and in real time can be challenging).

Another special feature of government debt comes from its safety, or at least the perception of safety. In crises, if public debt is perceived as safe (as is usually the case in advanced economies) then the government gains fiscal space even as private entities lose it. The upshot is that governments borrow at rates lower than private agents, and also have that borrowing capacity preserved during crises – but only as long as they can keep the liquidity and safety of the public debt.

The 'debt revenue' resulting from the special liquidity properties of public debt has limits; it cannot finance a fiscal deficit of any size, indefinitely. Moreover, the gap between the private real rate of interest and the rate the government has to pay is in itself a function of the size of outstanding public debt. As governments issue more debt to take advantage of that gap, it can shrink, and even disappear altogether – in which case the public debt is no longer 'special'.

Across the world, the degree to which market participants view government debt as safe and liquid is dramatically different. Not even the United States may be able to take the safety of its Treasuries as a given, and surely nor can

the other richest economies of the world, as the 2022 mini-budget crisis in the United Kingdom revealed. Emerging and developing economies face a fickle demand for government bonds. The privileged borrowing position of the public sector can quickly vanish, since the special role of public debt as provider of liquidity can be (and often is) displaced by foreign currency or foreign bonds. Flight to safety at the time of crises manifests itself also as a flight away from the public debt of certain countries and towards that of others. Minimising these problems requires an effective international architecture, a subject to which we now turn.

4. The importance of the international financial architecture

For all countries but the United States, national fiscal and monetary institutions must be complemented with international institutions that help preserve fiscal space and permit fiscal activism. These include the IMF at the forefront, and more recently regional financing arrangements, such as the European Stability Mechanism, the Chiang Mai Initiative in East Asia, and the Latin American Reserve Fund. Rather than discuss what each should do, we focus on what they should strive to accomplish as a whole.

First, and as a global by-product of the need to complete markets, the global financial safety net should provide targeted emergency fiscal support. Not only do some of the arguments that we made about aggregate shocks at the national level translate to the global level, but so do the limitations on what government can accomplish. Globally, this support can help compensate for the fickle nature of fiscal capacity as discussed, by preserving it and helping keep the public debt of the affected country safe.

Second, and as a manifestation of the need for market-making of last resort, the global financial safety net should stand ready to anchor governments to the 'good equilibrium'. It should help prevent the self-fulfilling pessimism that can cause runs on government debt, a spike in interest rates, and a collapse in a government's borrowing capacity. This does not mean, of course, financing each and every fiscal deficit, regardless of circumstances. Instead, it requires a strong commitment to support institutions that are solvent.

Third, and closely related, the Washington Consensus view that the international financial architecture should provide emergency financing during balance of payments crises deserves to be reinforced. These crises need not occur because of excessively expansionary or imprudent fiscal or monetary policies but can occur because of 'sudden stops': bouts of self-fulfilling pessimism that cause capital to flow out and asset prices to drop, impairing international creditworthiness.²⁵

The overall message is that the new fiscal activism, if it is to be feasible and successful beyond the United States and a handful of advanced economies, requires a global financial safety net that is both vastly larger and more agile than what is in place today.

IV. Conclusion

A new London Consensus should supplement the three fiscal policy principles of the Washington Consensus with two new ones:

- Pursue fiscal activism focused on first offsetting uninsured shocks to income via targeted transfers, and second on preserving markets and the flow of credit during crises, above and beyond the standard government purchases meant to regulate aggregate demand.
- Ensure that these larger cyclical budget deficits are sustained by strong institutions, national and international, which keep debt sustainable and preserve the safety and liquidity of government bonds.

Notes

¹ Williamson (1990).

² Keynes (1933); McKay and Reis (2016); Guerrieri and Lorenzoni (2017).

³ Nor can people insure before the fact because the relevant insurance markets do not exist. The only option open to them is to engage in self-insurance: for instance, a small business owner could accumulate large cash reserves or establish access to a sizeable credit line. But that is expensive, inefficient, and creates the aggregate demand effect that deepens slumps. In extreme cases, it is unlikely that a small business owner, for instance, even if very prudent, could have enough cash in hand to keep paying all employees for six months or a year while receiving zero income, as happened during the pandemic.

⁴ Pope and Shearer (2021).

⁵ Bachmann et al. (2022); Lindner (2023).

⁶ Brunnermeier and Reis (2023).

⁷ Kiyotaki and Moore (1997).

⁸ Woodford (1986); Liu and Wang (2014); Céspedes et al. (2022).

⁹ Of course, ruling out bad equilibria can require doing ‘whatever it takes’, as the world learned from Mario Draghi during the Euro Area debt crisis of 2010–14.

¹⁰ Buera et al. (2013).

¹¹ Blanchard (2023).

¹² Eggertsson (2010).

¹³ Reis (2022b).

¹⁴ Alesina and Perotti (1995).

- ¹⁵ Alesina et al. (2008); Ilzetzki and Vegh (2008).
- ¹⁶ Moreover, a well-formulated fiscal policy can lower the frequency with which a market-maker of last resort will be needed.
- ¹⁷ Blanchard et al. (2010).
- ¹⁸ Ilzetzki (2021); Blanchard et al. (2022); European Commission (2024).
- ¹⁹ Céspedes et al. (2014).
- ²⁰ Calvo (1988b).
- ²¹ Lorenzoni and Werning (2019).
- ²² Rodrik and Velasco (2000).
- ²³ Chang and Velasco (2001).
- ²⁴ Reis (2022a).
- ²⁵ Calvo (1988a).

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Response to Ricardo Reis and Andrés Velasco by Olivier Blanchard

I fully agree with the general theme of the chapter: namely, a more active role for fiscal policy – but also, by implication, a crucial role for governance to maintain fiscal discipline and debt sustainability.

When thinking about fiscal policy, I like to start with the three public functions identified by Richard Musgrave: allocation, distribution, and stabilisation. I will talk briefly about the first two, and then focus on the third, which is the subject of the chapter by Ricardo Reis and Andrés Velasco.

I. Allocation

New technologies appear more subject to both increasing returns and externalities than those in the past. Increasing returns are clear in the case of networks. Positive externalities are clear in the form of the many intangibles that, once created, can be shared at little cost with others. Negative externalities are clear in the case of, for example, global warming.

Today, industrial policies are increasingly popular. Some of them are justified; others are not. Economists are, rightly, sceptical of industrial policy, emphasising the difficulty of identifying market failures and avoiding heavy lobbying. But a simplistic ‘no industrial policy’ position is untenable. Redefining the role of the state, and with it the contours, limits, and fiscal implications of the right industrial policy, is very much needed.

II. Distribution

Market inequality has increased, and there are reasons to think it will continue to grow. The traditional advice has been for the state to provide education and training, accept the market outcome, and then rely on redistribution rather than on trying to modify market distribution. For example, economists have typically argued, rightly in my view, that a negative income tax is a better way to help low-income workers than a minimum wage.

However, it may be that we have come to the limit of how much redistribution the state can afford. In European countries in particular, average and marginal tax rates are high, and we may have reached the political limit of redistribution. If so, it may be that more direct intervention in the market process, rather than the redistribution process, is needed. In the context of trade, the idea that it may be better to protect certain jobs, rather than to try to

help those who lose their jobs, is clearly gaining political support. Economists are again rightly sceptical. But a simplistic 'trade is good' position is again untenable. Research on what the state can do to affect market distribution – be it through caps on chief executive officer salaries, subsidies for 'good' jobs, or incentives for firms to create job ladders rather than dead-end jobs – is very much needed.

III. Stabilisation

I believe that the dominant view among economists today is that the main stabilisation tool should be monetary rather than fiscal policy. (This was not always the case. Early Keynesians were much more sceptical about monetary policy and more enthusiastic about fiscal policy.) The currently dominant view must be revisited.

In the simplest version of the now-standard macro model – the New Keynesian model – there is one major distortion, namely nominal price rigidity, which leads to undesirable fluctuations in output in response to shifts in aggregate demand. In such a world, the right policy tool is the interest rate. By moving the interest rate appropriately, the central bank can keep output at potential, and avoid undesirable fluctuations in output. There is no need for fiscal policy to intervene. Obviously, the model is too simple, but the message is a clear and influential one: monetary policy is the right tool, and the onus is on central banks to stabilise output.

In reality, there are many other distortions that monetary policy cannot handle and that fiscal policy can, at least in principle. Take, for example, a decrease in aggregate demand in an economy in which many consumers are liquidity constrained, and thus insensitive to the interest rate. In that economy, monetary policy may work rather poorly, but fiscal transfers to liquidity-constrained households will work well. Or, to take a relevant recent example, think of a large increase in energy prices that decreases the purchasing power of households and leads to a large contraction in demand and output. In this case, fiscal transfers aimed at poor households – or, even better, at poor households who spend a larger fraction of their income on energy – can both boost demand and limit adverse distribution effects. This is something that monetary policy cannot do.

More fundamentally, monetary policy has one basic tool, the short interest rate – or perhaps two if we include quantitative easing, though it is not clear that this, thought of as debt maturity management, should be done by the central bank rather than the Treasury. Fiscal policy, by contrast, has a near infinite range of tools, taxes, or subsidies that can be aimed at specific sectors, or at specific groups of households or firms. It can use tools that work primarily through income effects, such as a cut in taxes, or others that work primarily through substitution effects, such as an explicitly temporary decrease in value-added tax rates. It can do targeted intragenerational transfers, or it can do intergenerational transfers through deficit finance.

While there is uncertainty about the values of multipliers associated with various fiscal tools, the evidence shows that the effects of government spending on output are quick and strong, as is the effect of transfers to poorer households. By contrast, and as we are observing today, both the size and the timing of the effects of monetary policy on economic activity are highly uncertain.

The case for fiscal policy becomes even stronger when interest rates are low, for two reasons. First, the fiscal and the welfare costs of debt become smaller. Debt sustainability is consistent with lower primary balances; indeed, if the interest rate is less than the growth rate, it is consistent with some primary deficits. Meanwhile the welfare cost of debt, due to the crowding out of investment and lower capital accumulation, is also lower when rates are low. Second, if interest rates are at or close to the zero lower bound, the scope for monetary policy to increase demand is sharply reduced. These considerations were highly relevant pre-pandemic, before the fight against inflation sent rates higher. They may well become relevant again in the future.

So, should we rely primarily on fiscal policy for stabilisation purposes? One can think right away of strong counter arguments. First, fiscal measures may work quickly, but they often take a long time to pass through the political process. By the time they arrive, they may well be too late. As a result, fiscal policy is often pro- rather than countercyclical. Second, the larger the set of potential measures, the stronger the role of lobbies, and the more likely fiscal policy will be misused. We saw a striking example of this in the American Rescue Plan Act of 2021, which, because of the addition of measures to satisfy many constituencies, was much too large from a macroeconomic stabilisation viewpoint. Finally, fiscal measures have a legacy: higher deficits lead to higher debt, and governments typically suffer from a deficit bias, leaving adjustment through higher taxes or lower spending to subsequent governments.

Is there a way to design fiscal stabilisation so that it solves this Gordian knot, preserving the ability to use many instruments, while making sure fiscal policy remains responsible? I think there is – and it has to rely on two pillars.

First, greater use of automatic stabilisers. The arguments are again well known. Automatic stabilisers eliminate political lags. Whether they act through unemployment benefits or tax revenues, they make fiscal policy by nature countercyclical. The issue is that they are, almost in their entirety, the accidental result of the progressivity of income tax, of the degree of indexation of the tax system, and of the generosity of unemployment benefits. Their size and their macro relevance vary across countries for reasons which have nothing to do with stabilisation. An economy with more progressive income taxes will have stronger stabilisers. We must thus explore and develop quasi-automatic stabilisers – measures that are triggered by the crossing of some threshold, such as an unemployment rate, or an estimate of the output gap. This in turn raises challenges.

One is that cyclical fluctuations in output have different causes, such as weakness in consumption, investment, or exports. Should we try to design

different stabilisers depending on the apparent source of the fluctuations, or should we be less ambitious and settle for simpler stabilisers, based on, say, the unemployment rate, no matter what the source?

Another challenge is that it is essential to make sure that these stabilisers work symmetrically and have a neutral effect on debt ratios in the long run. This is harder to design than it sounds. If the threshold is a certain value of the unemployment rate, the stabiliser will respond in the same way whether this is an increase in unemployment above the natural rate, or an increase in the natural rate itself – in which case it should not respond. How can the stabiliser be designed as such that a move that reveals itself to have been incorrect automatically repairs itself over time?

It is clear that quasi-automatic stabilisers cannot be the sole fiscal response, and that eventually they must be completed by discretionary policies. This raises yet another issue. Should we think of stabilisers as first aid until the right policies can be designed, or as the main fiscal policy tool? This has implications for their design, too.

To the extent that discretionary measures remain essential, the second pillar must be strong fiscal governance. In addition to the well-documented deficit bias, the larger the set of potential tools, the larger the scope for misuse. For example, to avoid the addition of ever more fiscal measures – as was seen in the American Rescue Plan – the size of the primary balance must be decided from the top down, rather than from the bottom up. And there must be rules that enforce debt sustainability. In this context, the current discussion of revised fiscal rules for the European Union is extremely interesting. We now know what the new rules will be. The work by the European Commission and the subsequent academic and political discussion has led to a shifting consensus. It has shown that, in a constantly changing environment, rules based on simple and invariant numbers, such as those set in the Maastricht Treaty, are either counterproductive or simply do not work and are violated. It has shown that any assessment must be tailored to the specific country and take the form of a debt sustainability analysis.

In essence, and overlapping very much with the analysis by Reis and Velasco, my belief is that fiscal policy should play a more important role in macroeconomic stabilisation. And in particular, improved quasi-automatic stabilisers and fiscal rules to maintain debt sustainability are two promising directions of research.

Response to Ricardo Reis and Andrés Velasco by Chryssi Giannitsarou

Modern fiscal policy is and should be quite different from what it was 35 years ago. The original Washington Consensus stipulated three main priorities in relation to fiscal policy and public debt: (a) fiscal discipline; (b) public spending for health, education, welfare, and infrastructure; and (c) a broad tax base and moderate marginal tax rates. All of these are largely uncontroversial, and I would imagine very few, if any, economists would disagree with the basic principles behind these three priorities. After all, this is what a good parent would advise their children as they move into adulthood: (a) spend wisely; (b) spend as to keep healthy and happy; and (c) have a good source of income to support your spending. Nevertheless, these principles aimed to promote economic liberalisation and market-oriented reforms, and while the Washington Consensus has often been praised for fostering economic growth, it also faced criticism for exacerbating inequality and neglecting social safety nets. The proposed amendments by Ricardo Reis and Andrés Velasco succinctly summarise the recent efforts of the profession to show that it is possible to combine economic growth with fiscal policies that give a bigger role to governments as entities that efficiently offer such safety nets.

The three priorities of the Washington Consensus can also be thought of as a sensible guide for fiscal policy in normal times and in the long run. But as recent experience has shown, we often face large and asymmetric deviations from normal times, in the form of crises and disaster episodes that we can no longer call ‘rare’. Such events generate extreme asymmetries in how their effects are felt by various parts of the population, and the difficulty or non-suitability of applying a ‘one-size-fits-all’ fiscal policy to address them lies at the heart of the two proposed amendments of these priorities by Reis and Velasco. The first, *fiscal activism* – in the forms of insurance, market-maker of last resort and intertemporal reallocation – describes how fiscal authorities have the ability to respond in times of severe crisis, such as the COVID-19 pandemic. The second, *fiscal space via sound debt management*, prescribes ways in which countries can prepare to face such events, by building solid institutions, managing the expectations of the public, and dealing with the aftermath of crises and disasters.

It is easy to agree with these amendments and accept these as equally important priorities for fiscal policy; here, I would like to both highlight but also expand on some important elements implicit in the chapter by Reis and Velasco.

By nature, activist fiscal policy needs to be adaptable, flexible and creative – especially in times of crisis. The experience with rigid fiscal rules, such as the EU's Stability and Growth Pact, have taught us, if anything, that fiscal authorities and governments need to be prepared to change their minds when the facts change. Also, the much talked about sustainability of debt can be quite an open-ended and vague concept in the absence of a plan to create the fiscal space needed to ensure that governments can give intertemporal transfers in times of disasters.

To the extent that governments can act to prevent and mitigate crises, the amended priorities of the London Consensus can be used as guides to address the mother of all crises: that of climate change. The climate crisis, marked by rising global temperatures, shifting weather patterns, and heightened frequency of extreme weather events, represents a call to action that transcends borders. The ethos of fiscal activism as proposed by Reis and Velasco resonates deeply in this context and should prompt governments to assume the role of fiscal insurers against environmental disasters. Just as fiscal activism served as a lifeline during economic crises such as the COVID-19 pandemic, it can provide a framework for addressing future environmental disruptions. In light of the Paris Agreement of 2015, fiscal activism can become the toolkit through which nations translate pledges into tangible action. Governments, in their capacity as insurers and intertemporal risk sharers, should extend support to vulnerable countries, ensuring they possess the resources to fortify their defences against environmental threats. Such a commitment would underpin the ethos of equity, enabling those who bear the brunt of climate impacts to build resilience.

With the spotlight on climate change, the critical issue of biodiversity loss is one that receives less attention due to its slow evolution and less violent manifestation in our everyday lives. At the time of writing this chapter, there are disappointingly few biodiversity-relevant taxes and subsidies. According to the *Dasgupta Review*, in 2021 there were only 206 biodiversity-relevant taxes in 59 countries, raising just 1% of the total revenue from environmentally relevant taxes, and only 146 biodiversity-friendly subsidies in 24 countries.¹ In line with the aforementioned priorities of fiscal policy, governments must broaden their approach to encompass taxes and subsidies – that is, fiscal transfers that target biodiversity preservation and restoration.

A final point relates to the importance of *international* collaboration and cooperation of fiscal policies. This is especially important when it comes to policies focused on environmental or global health crises. While fiscal policies have traditionally been perceived as a sovereign matter, the complexity of environmental crises demands international collaboration. As such, the London Consensus should amplify the importance of leveraging global institutions and mechanisms to align fiscal policies for environmental preservation. The IMF, World Bank, and initiatives like the EU's Emissions Trading System (EU ETS) serve as potential platforms to harmonise fiscal efforts. The role of the IMF extends beyond traditional economic stabilisation

to include addressing climate-related risks and promoting environmentally sustainable economic growth. Direct collaboration with the World Bank facilitates the flow of funds to developing nations, aiding in their transition to sustainable environmental practices. The EU ETS underscores the potential for regional cooperation in decarbonisation.

With international coordination, environmental fiscal policies can enhance the ability of governments to share risk not only across time but also across space. The Paris Agreement stands as a testament to the potential of international collaboration in shaping environmental policy. Nations come together, each contributing according to their capacity, to address the climate crisis. The agreement recognises the differentiated responsibilities of developed and developing nations, encouraging an atmosphere of equity and cooperation. This spirit must extend to all facets of environmental fiscal policies, enabling the mobilisation of resources to aid vulnerable countries, support mitigation and adaptation efforts, and fund green projects that benefit the global community.

The fiscal activism envisioned by Reis and Velasco should extend beyond individual country borders because the urgency of environmental crises requires a new kind of fiscal policymaking – one that embraces international cooperation and goes beyond geopolitical divides. In an ideal world, governments would work in tandem with existing and new global institutions to lay the groundwork for a sustainable future supported by ample fiscal space and sound fiscal policies.

Note

¹ Dasgupta (2021).

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