What about fiscal policy?

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Motivation

- Large amount of work and much improvement in monetary policy. What about fiscal policy?
- I have written on many aspects of fiscal policy. Intended to put it together and identify points of agreement and unresolved issues.
- Studying fiscal policy in Chile: Bringing coal to Newcastle. Much sophisticated discussion and implementation since 1985 to 2024.
- (Would be more fun to discuss monetary policy when fiscal policy is not fully responsible. France, US...)
- So selected three (related) issues. Theme: More active use of fiscal policy stabilization. Keeping debt under control.

1. Scope for (quasi) automatic stabilizers ?
2. How costly/dangerous is public debt ?
3. How to go from SDSAs to the design of fiscal rules?

1. Quasi-automatic stabilizers

- On paper: Fiscal policy has many tools, affecting intratemporal and intertemporal decisions. Monetary policy: one (main) tool.
- Recessions may come from many different shocks, involve many distortions (beyond nominal rigidities)
- Monetary policy has limits. ZLB. Maybe less relevant for Chile; came close however during the GFS and again in January 2021.

- In practice: Fiscal policy issues are well documented, given nature of political process: Decision lags. Debt bias.
- Quasi-automatic stabilizers answer the first, and, if well designed, can answer the second issue.
- Must be symmetric. (typically are not). Even if symmetric, must have a feedback, Bohn-like term. (otherwise, unit root for debt)

Relevant for Chile?

- The two main sources of fluctuations: copper prices, demand shocks. (variance decomposition. copper 10%-20%)
- The structural balance rule aims at eliminating the effect of transitory copper prices or transitory cyclical movements on the budget, not the economy
- In the case of copper, substantial resources still accrue to private mining firms (75% of production). (Royalty rate+ corporate rate around 50%)
- Case for a varying royalty rate? Effect of transitory profits on investment, on stock prices? May be weak enough to ignore?
- Case for cyclical unemployment benefits? Extension/level? Limited to the solidarity fund? Too small to make a difference?
- An unexplored tool: A varying VAT rate.

A variable VAT?

- A variable VAT: (current research, 2025) Used in the past, but not as an automatic stabiliser.
- In many ways, replicates monetary policy. Consumption-relevant rate of interest :

$$(1+i)\ \frac{P}{EP(+1)}\ \frac{1+\tau}{1+E\tau(+1)}\ \approx (i - E\pi(+1) + \tau - E\tau(+1))$$

- Can achieve large changes in the relevant rate: A 2% decrease, expected to turn into a 2% increase in a year, implies an additional decrease of 4%. Large effect on durables.
- Differences: No direct effect on investment. If hand-to-mouth consumers: direct income effects. High expected headline inflation. Monetary policy must see through headline inflation and target inflation net of VAT changes.
- Particularly useful if close or at ZLB. Less relevant for Chile than for most Advanced Economies? (went very close in January 2021)

2. How costly/dangerous is public debt?

- Chile: 45% as a "prudent ceiling". Reasonable? (in light of increase from 10% in 2000 to 43% in 2025)
- Empirical approach: The 90% of Reinhart and Rogoff. Unsuccessful. No magic number. Many countries far above 100% of GDP.

  (Current research with Leigh and Mishra: In trying to explain ratings and spreads, given debt and forecast primary balances, very large country effects.)
- What does theory say? Proceed in two steps.
  - Assume debt is not risky: Government can cover interest payments for sure. What are the welfare effects of different debt ratios? Return to the issues in AEA address 2019).
  - Debt is risky. Some probability government cannot cover interest payments. Risk of default, haircut. Large macro costs.

Welfare effects, and r-g

- Brief review. Two effects of debt.

  Macro: Decrease in capital accumulation (assuming non-Ricardian equivalence), or in foreign asset position.

  Distribution: Transfers income between tax payers. (From current taxpayers to future taxpayers—not exactly the same as from young to old). Often the focus of discussion,

- In models with certainty (Diamond), and thus a unique interest rate, a crucial inequality:

  If $r - g \geq 0$, welfare loss.

  If $r - g \leq 0$, "dynamic inefficiency" and welfare gain.

Is this last case an intellectually exciting but exotic/irrelevant possibility?

Welfare effects, and r-g, continued

- Under uncertainty, which is the rate to compare to g? The (risky) average rate of return on capital, or the risk adjusted rate (the safe rate)?
- Answer (AEA address). To a close approximation, the safe rate.

  Not an exotic issue. For Chile since 2005, using 10 year rate, average $(r - g)$ equal to -2%. Close to zero today. (5.4% compared to 2-2.5% + 3%)
- So, at current level, public debt does not have a welfare cost? (To be more provocative: If one assumes $r - g < 0$, should Chile have more public debt, until $r = g$?) One feels not... Why not?
- Arguments against: The safe rate may reflect a convenience yield. (Reis et al) Suppose no uncertainty, all rates the same. but rate on liquid asset may be even lower.
- The rate of return on some investment is high, even risk adjusted. Yes, but true of marginal investment? What does debt displace?

What to conclude? That, so long as there is little default risk, we should not be too worried about a stable debt ratio, within a subtantial range.

Debt and default risk

- The basic dynamic equation. $\Delta b = (r - g)b - s$, where b is the debt ratio, and s is the primary balance.
- The dynamics of debt (and thus the implications for default risk) clearly depend on both b and current and expected future primary balances s
- Assume maximum (politically feasible) primary balance s.
- Assume uncertainty about $(r - g)$. Risk of default if b explodes with positive probability over time. Three effects (current research, with Pablo Bruera)
  1. For b very low($((r - g)^{max}\ b < s)$, no risk. Still, as Chilean debt is an imperfect substitute for other assets, r increases with b. small effect
  2. For b higher ($((r - g)^{max}\ b > s)$, risk. Thus default risk premium. Amplification. Interest rate can increase quickly with b.
  3. Multiple equilibria. Self fulfilling expectations. Default risk, and interest rate can jump. Range can start very low (depends on the size of haircut, nature of investors).

What to conclude? Depends very much on distribution of $(r - g)$ and the politically feasible maximum s. Is 45% the right number for Chile?

3. Adjustment and optimal fiscal rules

- Given current fiscal policy, is debt sustainable? Two steps: Diagnostic. Then : Required adjustment.
- Diagnostic. Obvious answer is a stochastic debt sustainability analysis (SDSA).
- Using the dynamic equation. Constructing a baseline (expected growth, interest rates, programmed spending and tax changes)
- And then introducing uncertainty about r, g, and the primary balance, to derive the evolving distribution of b over time
- Doing it for different horizons, 3-5 years, but also 10-20 years, to get at different issues (aging, structural change: role of copper in 20 years?).
- Of the essence: Independent, technically competent, fiscal council. (Overestimation of revenues, of trend growth. Average negative surprise?)
- Right forum for discussing uncertainty, effect of reforms, how to deal with public investment, adjustment policies

Public investment

- Golden rule: " If public investment, then can be financed by debt. "
- Clearly dangerous. Yes if rate of return to the state, from direct or indirect effect (higher output thus higher revenues) is at least equal to the interest rate on debt
- Clearly not the case for much public investment. May decrease global warming, may increase defense. Good for welfare, but no obvious revenues.
- SDSA is the right tool to assess its contribution to medium run dynamics of debt, taking into account uncertainty. (Higher wages for teachers?)
- May lead to some adjustment of the structural balance for public investment, less than one for one.
- Other approach. A capital and a current account, with appropriate transfers if rate of return to the state is lower than the interest rate. (Blanchard Giavazzi)
- Back to Chile: Treating public investment in the same way as current spending however is too extreme and will prevent some good investment.

From the SDSA to fiscal rules

- Why not use the outcome of the SDSA as the trigger? For example, if $P(\Delta b_5 > x) > z$, then required adjustment.
- Argued for this during reform of EU fiscal rules (Blanchard, Zettelmeyer, Alvaro). Failed. Lack of simplicity, of credibility.
- How to design fiscal rules which come close to generating sustainability in the SDSA?
- Leaving room for stabilisation and other interventions while avoiding debt explosion
- Chile's approach. Belt and suspenders.

  Structural primary balance rule: positive target surplus of 0-1%. May not be enough if $(r - g)b > 1\%$.

  Debt target. When close to or above target, improvement of primary balance of 0.5% per year

  Escape clauses. (less needed, the stronger the automatic stabilizers). Formal process.

Speed of adjustment?

- Probably close to the optimal mapping from SDSA to fiscal rules.

  (Analogy to mapping from inflation fan charts to Taylor rule)
- What is the trade-off?

  Slow (and positive multipliers): even if economy is linear, welfare is quadratic. Slower is better.

  Credibility. Slow less credible? Need a clear path. Given this, credibility may come more from credibility of the debt target.

  (Analogy with discussion of speed of adjustment under inflation targeting.)
- More automatic stabilizers, less need for discretionary fiscal stabilization, less worry about debt.
- The low welfare cost of debt if $(r - g)$ close to zero or negative. So long as default risk is minimal, no need to hurry back to target.

Conclusions

- Back to "Bringing coal to Newscastle."
- Suggested explorations/adjustments at the margin.

  Automatic stabilizers (is there room for more?). Improve trade-off. Stabilization/debt

  Treatment of public investment. Having it fully in the structural primary balance seems too extreme.

  Debt target (may be the right one, but would be good to look deeper). Limited weight/weak attractor.

  True independence of the fiscal council? Use the construction of the SDSA as a place for dialogue.

  On speed. Credibility comes from the credibility of the targets. If credibility is there, do not go faster than needed.

- Various dimensions not explored. Multipliers. Fiscal/monetary coordination. Fiscal dominance. Monetary policy if fiscal misbehaves.
- I wish, on intellectual grounds, I had larger disagreements. It would have made for a more exciting lecture. But, on net, congratulations