The Fallacy of the Fiscal Theory of the Price Level, Again

Abstract

This paper argues that the 'fiscal theory or the price level' (*FTPL*), developed by Woodford, Cochrane, Sims and others, is a fallacy.

The source of the fallacy is an elementary *economic* misspecification. The FTPL denies a fundamental property of any model of a market economy, that the budget constraint of any agent, private or public, must be satisfied *identically*, that is, for all admissible values of the variables entering the budget constraint. Instead the FTPL requires the government's intertemporal budget constraint to be satisfied only *in equilibrium*. The FTPL looks for equilibria in which the government can meet its contractual debt obligations exactly, despite having an overdetermined fiscal-financial-monetary programme.

The economic misspecification has implications for the mathematical properties of the equilibria supported by models that impose the structure of the FTPL. Under many circumstances, the FTPL must be 'switched off' for no good economic reason if contradictions and anomalies are to be avoided. When the nominal money stock is exogenous, the FTPL must be switched off because it produces overdetermined equilibria. When the nominal money stock is endogenous, the FTPL has to be switched off unless arbitrary restrictions on the admissible values of the exogenous and predetermined variables entering the government's budget constraint are satisfied. It also has to be switched off whenever there are nominal rigidities and the price level is predetermined. The FTPL implies the anomaly that it can price money in an economy without money. The FTPL has an exact analogue in a 'Household Budget Constraint Theory of the Price Level', or HTPL, which is perhaps more readily recognised as a non-sense.

The issue is not just of academic interest. The FTPL implies that a government can exogenously fix its real spending, revenue and seigniorage plans, and that the general price level will take on the value required to adjust the real value of its contractual nominal debt obligations to ensure government solvency. If some misguided government were to take this seriously and acted upon it, the result, when reality dawns, could be painful fiscal tightening, government default or excessive recourse to the inflation tax.

JEL classifications: E31, E41, E51, E52, E62, E63.
Key words: Fiscal theory of the price level; Ricardian fiscal-financial monetary programmes; government budget constraint; price level indeterminacy.

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