The Fiscal Theory of the Price Level: a Critique

Abstract

This paper argues that the 'fiscal theory of the price level' (*FTPL*), developed by Woodford, Cochrane, Sims and others, has feet of clay.

The source of the problem is a fundamental *economic* misspecification. The FTPL confuses two key building blocks of a model of a market economy: budget constraints, which must be satisfied identically, that is, for all admissible values of the variables entering the budget constraint, and market clearing or equilibrium conditions. The FTPL asssumes that the government's intertemporal budget constraint needs to be satisfied only *in equilibrium*.

This economic misspecification has far-reaching implications for the mathematical properties of the equilibria supported by models that impose the structure of the FTPL. It produces a rash of contradictions and anomalies. When the nominal money stock is exogenous, applying the FTPL would produce *overdetermined* equilibria. Even when the nominal money stock is endogenous, the FTPL can only be applied when *arbitrary restrictions* are satisfied on the admissible values of the exogenous and predetermined variables entering the government's budget constraint. The FTPL also cannot apply when there are *nominal price rigidities*, regardless of the monetary rule. A further anomaly is that the FTPL implies money can be priced in an economy without money.

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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