Arne Heise

Rules versus Discretion in Post Keynesian fiscal policy

ZÖSS
ZENTRUM FÜR ÖKONOMISCHE
UND SOZIOLOGISCHE STUDIEN

ZÖSS-Discussion Papers
ISSN 1868-4947/115
Discussion Papers
Hamburg 2025

Rules versus Discretion in Post Keynesian fiscal policy

Arne Heise

Discussion Paper

ISSN 1868-4947/115

Zentrum für Ökonomische und Soziologische Studien

Universität Hamburg

Februar 2025

Impressum:

Die Discussion Papers werden vom Zentrum für Ökonomische und Soziologische Studien veröffentlicht. Sie umfassen Beiträge von am Fachbereich Sozialökonomie Lehrenden, NachwuchswissenschaftlerInnen sowie Gast-ReferentInnen zu transdisziplinären Fragestellungen.

Herausgeber/Redaktion:

Zentrum für Ökonomische und Soziologische Studien (ZÖSS)
rouven.reinke@uni-hamburg.de
Universität Hamburg
Fakultät für Wirtschafts- und Sozialwissenschaften
Fachbereich Sozialökonomie
Welckerstr. 8
20354 Hamburg

Abstract

During the neoliberal era, fiscal policy was side-lined: from a political economy perspective, it was seen as biased toward deficit and debt accumulation, while from a macroeconomic perspective, its potential role as a business cycle stabiliser was shifted to monetary policy, in line with the New Macroeconomic Consensus. This consensus codified the restrictive and passive orientation of fiscal policy through rules such as the European Stability and Growth Pact or Germany's 'Debt Brake.'

Following a series of crises, fiscal rules have come under intense criticism, and Keynesian discretionary policy has regained popularity in both theory and practice.

This article aims to provide a Post Keynesian perspective on fiscal policy: rejecting the idea of general equilibrium self-regulation and criticising the inherent limitations of (fiscal) policy, it advocates a functionally-oriented capital budgeting approach which favours an expansionary stance on the long-term budget balance and should not be left to the discretion of policy-makers. Instead, it should follow a transparent, non-overridable rule complemented in the short term by the unrestricted operation of automatic stabilisers and, only in exceptional cases, by discretionary measures to prevent severe depressions.

JEL codes: E12, E62, H30, H60, H62

Key words: Capital Budgeting, Functional Finance, Fiscal policy rule, Post Keynesianism

1. Introduction

Fiscal rules have become ever more important as a governance device in modern democracies (see e.g. Badinger 2009: 829): on the historical event of the formation of a common currency in the European Union (EU), a Stability and Growth Pact (SGP) was agreed upon by those EU member states that form the European Monetary Union (EMU) in order to restrict the deficit spending capacity of individual member states. In recent years, the fiscal rules comprising the SGP have been sharpened and tightened in the ‚Fiscal Compact'. After the huge rise in public debts during the Global Financial Crisis (GFC), Germany introduced a constitutional ‚debt brake' and urged its companion Eurozone partners to do the same within their legislations.

Despite these developments, the discussion about fiscal rules never ended. One aspect under discussion is the effectiveness of fiscal rules in enforcing what they promise to do: Although the SGP, for instance, was introduced prior to the GFC, it could not prevent the rise in public debts in due course (see e.g. Hallet/Hougaard Jensen 2012). Another aspect is the inherent danger of strict rules of preventing the actors bound by the rule to adapt to extraordinary situations: it has been argued, for example, that the SGP forced governments to act pro-cyclically during the GFC instead of helping to stabilise the real economies within the Eurozone (see e.g. Heise 2012). A third aspect under discussion is not the rule as instrument but the content of the rule: should a fiscal rule target the ability of governments to finance its expenditures through deficits (i.e. have a balanced budget orientation) or should it force governments to finance part of their expenditures through deficits (e.g. the so called ‚golden rule')? Last, but not least, fiscal rules can target deficits and debts as much as expenditures.

All these aspects cannot be dealt with in a single paper and will not find generally accepted conclusions. The latter is simply due to different paradigmatic approaches, while the former demands for some self-restriction. I will, therefore, concentrate my elaborations on the inquiry of deficit rules only and will take a Post Keynesian perspective[1]. This is because the literature on fiscal rules from a standard economics perspective is long[2], while it is rather short and inconclusive on heterodox perspectives such as post-Keynesianism[3]. Moreover, deficit rules as opposed to mere expenditure rules better fit one of the most challenging problems of mature economies: high public debts.

The paper is structured as follows: in part 2, the dualistic alternative between rule-based and discretionary policy-making will be exposed to provide the groundwork for the following discussion of fiscal rules in Post Keynesian perspective (part 4). However, before this can be

[1] Post-Keynesianism is often used as a 'broad tent' term, encompassing various, arguably incoherent schools of thought such as monetary or fundamentalist Keynesianism, Kaleckian economics, and neo-Ricardianism, and is typically spelled with a hyphen: post-Keynesianism. However, my use of the spelling Post Keynesianism without the hyphen is intended to specifically refer to monetary or fundamentalist Keynesianism alone.

[2] See among many others e.g. Kopits/Symansky (1998), Wyplosz (2012), Bohn (1998), Schaechter/Kinda/Budina/Weber (2012), Fatás/Mihov (2003a, 2003b), Heinemann/ Moessinger/Yeter (2018), Blanchard/Giavazzi (2004), Debrun/Moulin/Turrini/Ayuso-i-Casals/ Kumar (2008), Alesina/Perotti (1999), Kopits (2001)

[3] Post-Keynesian authors have extensively published on fiscal policy and have criticised specific fiscal policy rules, such as the German Debt Brake and the European Stability and Growth Pact. However, after consulting various sources online, I have not come across a single article that fundamentally explores a post-Keynesian (with as well as without hyphen) approach to fiscal rules.

adequately addressed, a general overview of a Post Keynesian theory of economic policy will be given (part 3) in order to provide a more comprehensive understanding of Post Keynesian fiscal policy in general and fiscal rules in particular. The paper ends with a short excursion applying the expositions to two real-world fiscal rules (part 5) and a conclusion (part 6).

2. Rules versus discretion

Before we can begin evaluating the use of fiscal policy rules from a Post Keynesian perspective, we must first consider the pros and cons of such rules, or, in other words: why should the hands of policy-makers be tied? This leads us to the well-known 'rules versus discretion' debate and the need to clarify what exactly is meant by a 'rule-based' policy as opposed to a 'discretionary' policy.

A rule in the context of fiscal policy has two key characteristics: 1) it involves the numerical dimensioning of fiscal instruments — in our case, the public budget balance. This numerical framework must be 'rational' in the sense that it optimally helps to achieve a specific objective — in our case, keeping the economy on its potential growth path, ensuring full utilization of all factors of production; and 2) it must be credible and enforceable, with sanctions in place for non-compliance, meaning it should be non-overridable.

Discretion in fiscal policy, however, does not simply imply the absence of a rule, nor does it mean fiscal policy is random, arbitrary, or non-rational. Even without a formal rule, fiscal policy must pursue a specific objective. If we assume that the policy under the fiscal rule best serves that objective, economic actors would still expect the political decision-maker to follow that type of fiscal policy, even without the formal rule. The difference is that, without the rule, economic actors cannot rely on the policy being consistently followed, as it is neither enforceable nor non-overridable.

To reiterate, the distinction between rule-based and discretionary fiscal policy is not necessarily about the policy stance itself — whether one is economically functional and the other dysfunctional or less functional. Rather, the key difference is that rule-based policy is enforceable and non-overridable, whereas discretionary policy is not enforceable and thus any implicit rule overridable by policymakers.

But why would the political actor want to deviate from a policy stance that is economically functional? There are two valid reasons — those that can improve economic outcomes in a Pareto sense — and one less valid reason. One valid reason could be that the policy stance turns out not to be economically functional. This scenario takes into account 'model uncertainty,' i.e., the possibility that the economic model from which the policy stance is derived is flawed. The second valid reason is that the economic conditions under which the policy stance was designed (by the political actor) or expected (by the economic actor) have changed significantly, such as in the event of a shock. However, there is also a less valid reason: due to issues of time inconsistency and political economy considerations, an economically functional fiscal policy may not always be politically feasible.

Thus, we have established that the primary objective of rules is to intervene in a given incentive structure: without rules, the political actor may face incentives —due to political economy or time inconsistency concerns — that lead them to pursue policies that are either unwarranted from the perspective of the people (as the principals of the agent, the government) or dysfunctional, causing Pareto-inferior outcomes. It is widely believed that such misaligned incentives often result in a 'deficit bias' in fiscal policy, which needs to be curtailed by restrictive fiscal policy rules (see, e.g., Persson and Tabellini, 2000). However, game-theoretical analysis also suggests that incentives for free-riding behaviour can arise in cases where expansionary fiscal policy is needed.

Another aspect of rules is their ability to provide information about future policy conduct, provided the rules are transparent — i.e., rules will reduce the amount of uncertainty in the system once they are understood by market participants and adhered to by policy-makers.

However, policy rules may also come with costs if the economic model on which the rule is based is faulty or if unexpected changes in economic circumstances cannot be accommodated.

While rule-based fiscal policy avoids the costs of discretion related to time inconsistency and political economy issues, discretionary policy avoids the costs associated with rules, such as model uncertainty or the inability to address unexpected circumstances. To navigate the 'rules versus discretion' debate, one must either strike a balance or find a way to combine both approaches effectively. In this regard, 'policy standards' have been proposed recently (see, e.g., Blanchard, Leandro, and Zettelmayer, 2021: 216ff.). Standards differ from rules in one of two ways (see Schlag, 1985: 382f.): either the 'trigger' — the numerical dimension in the case of fiscal standards — or the 'response' — compliance under the threat of sanctions — is softer or less strict compared to rules. In both cases, the fiscal standard is similar to discretion in terms of credibility and non-overridability. The main difference is that using standards can make the policy stance more visible and explicit compared to discretion.

When striking a balance between the costs of rule-based and discretionary policies, traditional economists often favour a rule-based fiscal policy (see, e.g., Stokey, 2002). This preference is likely because they view problems of time inconsistency and political economy as significant and inherently unavoidable issues. Problems of model uncertainty, on the other hand, are largely overlooked, and issues related to unpredictable shocks are considered to be more temporary.

3. Central features of a Post Keynesian economic policy-making

Keynesian economic policy appears to be tied to discreationary monetary and fiscal policy in order to render an inherently unstable economy more stable. Moreover, wasn't the entire ‚rules versus discretion' literature unleashed by the objective to counter Keynesian interventionsm? Before nearing this question, let's first provide a general overview of the features and characteristics of Post Keynesian economic policy-making (see e.g. Heise 2008; 2009): As noted earlier, Post Keynesianism does not represent a unified theoretical framework, yet anyone drawing on the work of John Maynard Keynes cannot reasonably

endorse the idea of a deterministic world. Complexity becomes apparent in contingent developments, which is why Keynes highlighted fundamental uncertainty over deterministic risk. Issues with information do not merely come from its asymmetric distribution, processing challenges, or random shocks; rather, they define a 'non-ergodic' world (Davidson 1994: 89ff.). In such a world, much of the necessary information is unavailable at the time decisions need to be made. Crucially, the future is not just unknown and unpredictable but also non-existent until shaped by decisions.

a. An alternative theory of economic policy

Keynes clearly understood that, under conditions of complexity and fundamental uncertainty, individuals are unable to do what standard Walrasian economics assumes they can: optimally allocate resources across time and space. It is only through the adoption of conventions and routines (like projecting past developments into the future until new information necessitates adjustments), institutions (such as collective bargaining systems), rules, and inherent human characteristics (like 'animal spirits') that people can act[4]. This underscores the importance of constraints on human behaviour in forming both short- and long-term expectations and establishing confidence in them.

Theoretically, the difference between a Walrasian barter economy and a Keynesian monetary production economy is notably marked by the institution of 'money' and the liquidity premium it carries, which determines long-term interest rates. Politically, the emphasis is on the outcome: a sustained period of involuntary unemployment with no tendency towards self-correction for full market clearance or, simply, an unemployment equilibrium that challenges Say's and Walras' law as the Keynesian 'pattern prediction'.

The principles of Post Keynesian economic policy have several significant implications:

- Unregulated market interaction, even in ideal conditions, does not always lead to Pareto-optimal outcomes and can waste productive capacity, skills, and qualifications for long periods. Providing property rights and contract rules combined with ensuring perfect competition, known as order or regulatory policy (*Ordnungspolitik*), is clearly not enough.
- Economic policy objectives are no longer merely functional derivatives of equilibrium solutions from individual self-interested behaviour but must be normatively selected. Full employment is not the 'natural' result of labour markets in monetary production (i.e., capitalist) economies, nor does any 'natural' income distribution based on productivity measures exist.
- While markets might fail when information is lacking, competition is restricted, or adjustment mechanisms are obstructed, the Keynesian 'pattern prediction' does not

[4] As Keynes (1936: 149ff.) noted: „The outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made. (…) If human nature felt no temptation to take a chance, no satisfaction (profit apart) in constructing a factory, a railway, a mine or a farm, there might not be much investment merely as a result of cold calculation."

result from 'market failure' but from the 'satisficing behaviour'[5] of individual market participants confronting fundamental uncertainty.

- If societal objectives are not automatically achieved, societies as principals and states (or governments) as agents must implement policies to achieve these objectives. This necessitates a quantitative, interventionist policy (*Prozesspolitik*). The political actor should not be seen merely as a 'repairman' correcting 'market failures' but as a *market participant* aiming to modify market outcomes in a desired way.

- The actions of any market participant affect macroeconomic variables such as national income or GDP growth, employment, capital accumulation, and prices or inflation rates. Collective actors or political actors differ only in the scale of these effects, which negates the 'neutral money' and '(fiscal) policy inefficiency hypothesis' of (rational expectation) Walrasian economics.

- As a 'market participant', the political actor has no more direct control over the targeted macroeconomic variables than any other individual or collective actor. To put it differently, in a complex environment — contrary to the traditional Tinbergen-Theil model of economic policy (Tinbergen 1952, Theil 1956) — there are no linear relations between exogenous (instruments) and endogenous variables (targets). Additionally, once the unified political actor is split into two or more independent entities (such as an independent central bank, the government, and other semi-autonomous bodies), coordination problems are bound to occur.

To conclude, the Post Keynesian theory of economic policy emphasizes the necessity and efficacy of quantitative, interventionist policies while also recognizing the limits of *'controllability'*. This leads to a compelling argument for what might be called *'constrained feasibility'* — a middle ground between the extremes of Cartesian *'controllability'* and Hayekian *'non-decisionism'*, forming a *'market participation theory of economic policy'*.

b. Creating market constellations

It is essential to grasp the distinct implications of complexity involving fundamental uncertainty on one side — an aspect that all market participants face equally — and the ability to act with purpose on the other side — something mistakenly believed to be limited to private, individual actors who provide only private goods. However, why should the political actor, acting as a 'political entrepreneur,' not also provide public goods? Just like any private actor (whether as a consumer, producer, or investor), the political actor must accept the possibility of not achieving its goals[6]. No superior knowledge or better information is required

[5] This is to mean that agents can act only ‚bounded rationally' (see Simon 1957, 1959). However, the use of money as the most liquid asset and the introduction of liquidity preferences as expression of the state of expectations and confidence renders human behaviour with respect to resource allocation as 'optimal' as possible. Therefore, the concept of 'bounded rationality' as used here does not merely refer to "*behavioural characteristics* of agents" (Dunn 2001: 568) but encompass fundamental uncertainty. Yet this does not leave decision-making hanging in the air: "'Satisficing' behaviour, making the most statisfactory choice out of those that are reasonably available, is the best we humans can do" (Moore 2006: 105).

[6] And, of course, the political actor may be punished for his misjudgement (by loosing electoral votes) quite as much as the private actor (by loosing money).

on the part of the political actor, but rather a purpose: to produce public goods, or desired market outcomes, that the market does not automatically provide.

The metaphor of 'providing public goods'[7] for 'economic policy-making' is quite useful, as it highlights the constraints faced by the political actor, much like private actors. By supplying high-powered money to the money market, purchasing investment and consumption goods, hiring labour for administrative purposes, levying taxes and contributions, or more generally, participating in market processes, the political actor will indeed influence national income, capital accumulation, employment (both direct and indirect), wage developments, prices, and income distribution. However, the political actor cannot be certain how much of this impact will affect prices versus quantities[8]. Additionally, when more than one independent public body is involved, there is uncertainty about how trade-offs will be managed or whether the effects will be symmetrical regardless of whether they are expansionary or restrictive. Outside the Tinbergen-Theil framework, the political actor loses absolute control, but this does not mean they should completely abstain from involvement:

- First, fundamental institutions must be established and maintained to minimize the costs of economic interactions necessary in a world with extensive division of labour, such as property rights, contract laws, competition laws, and their enforcement. This is widely accepted across the economics profession and calls for order or regulatory policies (*Ordnungspolitik*).
- Decision-making under conditions of complexity and fundamental uncertainty is significantly hindered by 'cognitive scarcity' (Wible 2004: 136ff.) and the multitude of actions available to economic agents. While 'cognitive scarcity' cannot be systematically reduced, the political actor should not exacerbate it either. This necessitates a rule-based, well-communicated, and credible provision of public goods, as opposed to discretionary interventions of the teleological 'market repair' type. This approach could be referred to as the 'governance' variant of quantitative policies (*ordnungspolitische Prozesspolitik*).
- Furthermore, institutions and regulations are necessary to limit the range of actions available to private market participants. Although there is always a trade-off between the uncertainty-reducing nature of such institutions and regulations and the potential costs of reduced adaptability to market changes — which may lead to negative cost-

[7] Public goods can be ‚public utilities' as well as ‚price stability' or ‚full employment'.

[8] In the General Theory, Keynes (1936: 305f.) at great length discusses this issue with respect to monetary policy by elaborating the elasticity of (nominal or, as he called it, money) prices with respect to changes in the quantity of money: “Perhaps the best purpose served by writing them down is to exhibit the extreme complexity of the relationship between prices and the quantity of money, when we attempt to express it in a formal manner. It is, however, worth pointing out that of the four terms e_d, e_w, e_e and e_o upon which the effect on prices of changes in the quantity of money depends, e_d stands for the liquidity factors which determine the demand for money in each situation, e_w for labour factors (…) which determine the extent to which money-wages are raised as employment increases, and e_e and e_o for the physical factors which determine the rate of decreasing returns as more employment is applied to the existing equipment.”

benefit analyses[9] — the justification process of neoclassical institutionalism is fundamentally reversed.

- Lastly, to overcome cooperation problems arising from the presence of multiple independent public (and private, collective) actors, rules, norms, or governance institutions are needed to enforce 'irrationality without regret,' effectively turning non-cooperative games into cooperative ones.

The specific combination of norms and institutions that are purposefully created (external institutions), alongside cultural norms and conventions (internal institutions), forms what has been termed *'market constellations'* (see, e.g., Heise 2008). These help to shape the behaviour of both private and political market participants. Clearly, such 'market constellations' must be designed according to societal objectives. However, facilitating specific market constellations (*Gestaltbarkeit*) should not be confused with 'controlling' specific outcomes (*Machbarkeit*); hence, the concept of *'constrained feasibility'* again becomes relevant.

This is not the place to elaborate on the different market constellations and their systematic impacts on market outcomes in greater detail[10] - suffice here to state that monetary, fiscal, and wage policies are entangled in policy games (see e.g. Nordhaus 1994, Power/Rowe 1998, Rankin 1998, Heise 2008: 27ff.). Institutions must, therefore, be created to transform the non-cooperative structure of these policy games into a cooperative one. Again, the Post Keynesian recommendation of coordination contrasts with the Walrasian assignment approach.

Last but not least, from a Post Keynesian perspective, it is not just cooperation itself that is important but also the norms of content that define this cooperation and form the macroeconomic policy mix that achieves a high and stable level of aggregate demand to combine full employment, price stability, and fiscal sustainability.

4. Fiscal rules and Post Keynesianism

Fiscal policy – here taken as the balance between public expenditures and income in order to achieve certain macroeconomic outcomes – is part of a Post Keynesian tool box to stimulate desired market constellations. Therefore, the exact design and stance of fiscal policy can only be described once the desired market constellation has been determined. However, from a general perspective, the following can be surmised with respect to the significance of fiscal rules in Post Keynesian perspective:

1. It must be distinguished between fiscal policy aimed at influencing the long-term growth path of the economy (termed ‘coarse tuning’ by Malcolm Sawyer 2009: 557ff.) and fiscal policy aimed at stabilising the cyclical behaviour of the economy (‘fine tuning’ in Sawyer’s terms). The former is commonly neglected in mainstream economics as it is assumed that the long-term growth path is independent of fiscal

[9] And this may particularly be the case if, as in reality, institutions and regulations are not the outcome of rational consideration but of power relations (*Realpolitik*).
[10] This has been done in Heise (2006; 2008), Heine/Herr/Kaiser (2006), Herr/Kazandziska (2011).

policy as defined here[11]. From a Post Keynesian perspective, the primary objective of fiscal policy is not to smoothen business cycles but to direct long-term growth according to the targets – full utilisation of factors of production, ecological sustainability, etc. – set in democratic elections. In order to reduce systematic uncertainty and provide no leeway for ideological distortions, the fiscal policy stance should be rule-based.

2. In order to foster target-oriented market constellations, fiscal policy must be coordinated with monetary and wage policy. This can effectively be achieved only on the basis of policy rules that can be monitored and sanctioned in case of non-compliance[12].
3. As the objectives may change and the content of a particular policy rule may prove to be inadequate (due to model uncertainty), rules need to be amendable – it should not (as for instance in Germany) be conceded a constitutional status requiring a super-majority for revision.

Contrary to conventional wisdom (see e.g. Arestis/Fontana 2009, Arestis 2012), Post Keynesian fiscal policy – particularly in its 'coarse tuning' orientation – should be rule-based rather than discretionary. Having stated this, it needs to be emphasised that it is particularly the content of that rule, which is important and need to be investigated in more detail.

a. Functional Finance, Capital Budgeting and sustainability

Abba Lerner (1943) and John Maynard Keynes (1943; 1945) shared a similar view on the long-term orientation of fiscal policy: it should close the gap between savings, which would arise from a desired (e.g., potential or full-employment) national income, and voluntary private investment outlays that companies undertake to maximise their profits[13]. The orientation of fiscal policy is, therefore, 'functional' — as Lerner termed it — in the sense that it should help achieve desired macroeconomic outcomes. This was not to be accomplished through the current budget, which includes public spending on salaries, transfers, or other public expenditures, but through the capital budget (as Keynes termed it), which focuses on public investment spending.

If desired savings were to equal voluntary investment spending — as would systematically occur in a general equilibrium world, at least in the long run — fiscal policy would then follow a balanced-budget rule[14]: 'sound finance' as a special case of 'functional finance' fiscal policy. However, in mature capitalist economies, where desired savings ($S_{desired}$) can — and are likely to — systematically deviate from profit-maximizing voluntary private investment ($INV_{priv\text{-}vol}$),

[11] The father of the famous ‚Taylor rule' – John B. Taylor – clearly states: "the effect of even a permanent increase in government spending on the deviation of real GDP from potential GDP is temporary" (Taylor 2000:25f.).

[12] Some post-Keynesian authors also emphasize the need for cooperation between different macroeconomic actors, yet they advocate for a discretionary role for fiscal policy (see, e.g., Arestis 2012). In my understanding of how cooperation functions (see Axelrod 1984), this presents a contradiction.

[13] What seems straightforward in theory can often prove challenging in practice. The difficulties of estimating potential output (or income) have been widely discussed (see, e.g., Fatás 2019; Heimberger 2019). Nevertheless, there is no reason to believe that a practical method for estimating potential output cannot be developed.

[14] In fact, even in a general equilibrium world a point for some deficit financing can be made: inter-generational burden-sharing once a multi-period utilisation of some public goods (investment) is admitted. However, this argument is not based on a rejection of Barro-Ricardo equivalence.

this discrepancy must be reflected in the public capital budget. In such cases, the budget would need to be deficit-financed (or surplus-financed) based on the positive (or negative) savings-investment gap[15]:

(1) $INV_{pub} = S_{desired} - INV_{priv\text{-}vol}$ ***(public capital budget)***

and

(2) $BAL_{CB} = (t \bullet m - 1)INV_{pub}$ ***(capital budget balance)***

under the side-condition:

(3) $CON_{pub} = T - a\,(Y_{actual} - Y_{trend})$ ***(public current budget)***

and

(4) $BAL_{CuB} = T - CON_{pub} = a\,(Y_{actual} - Y_{trend})$ ***(current budget balance)***

(with BAL_{CB} = capital budget balance, BAL_{CuB} = current budget balance, t = marginal tax rate, m = fiscal multiplier, CON_{pub} = current public expenditures, T = Taxes, $(Y_{actual} - Y_{trend})$ = output gap, a = reaction coefficient)

We will return to the current budget (equation 3) later. The Capital Budgeting rule (equation 1) would not only allow public investment spending to be deficit-financed (equation 2), as in the 'golden rule' proposed by some mainstream economists considering intergenerational financial burden management (see, e.g., Blanchard/ Giavazzi 2004: 3f.), thereby incentivising a shift from consumptive to investment purposes. It would also compel policy-makers to maintain public investment at a level necessary to achieve desired macroeconomic outcomes (equation 1). More explicitly, the Capital Budgeting rule of 'functional finance' would not permit an indefinite amount of public deficit to be justified as investment-oriented expenditure. Instead, it would require public investment to be kept at a functionally necessary level, regardless of the current state of public debt[16].

The savings-investment gap will vary over time — depending on the maturity of the economy and, of course, the desired macroeconomic outcome (income level) — which makes the fixation of a precise numerical rule for the capital budget impractical. However, much like the famous Taylor rule in monetary policy, which likewise does not specify a definite interest rate but rather the appropriate deviation of the policy rate from its (given or assumed) long-term value, the capital budget should not be defined as a constant investment ratio. Instead, it

[15] For the sake of simplicity, a closed economy is assumed. Equation (1) is about public investment expenditures, not about budget balances. In fact, under certain assumptions about the investment multiplier and the income elasticity of taxes, public investment spending may be self-financing and, thus, must not create a structural imbalance (deficit; see eq. 2). However, this need not be the case and the point here to be made is, rather, that the likely imbalance is not the critical aspect. A deficit is not necessary for the macroeconomic outcome to be realised, but it will be shown in a moment that its occurrence pose no structural threat.

[16] Although it is insignificant in terms of aggregate demand which public investments are made, the supply of public goods should naturally be aligned with societal investment needs – infrastructure, sustainability requirements, education, research, etc.

should be expressed as a deviation from its 'natural balance'—i.e., a zero budget balance according to equation (1) and (2) when $S_{desired} = INV_{priv\text{-}vol}$.[17].

Assuming that the determinants of the variables in equation (1) and (2) — the potential growth path, the long-term effective growth path, the marginal tax rate and the fiscal multiplier — are relatively stable, it is possible to specify even a point or range-based numerical target.

But what about the financial sustainability of a fiscal policy approach that may incorporate permanent deficits, even if they are used solely for investment purposes? Would this not undermine trust in the political actor's ability to consistently and unconditionally service debt without losing its capacity to act? This would indeed be the case if such a fiscal policy rule could only be implemented with an ever-rising public debt ratio. In other words, financial sustainability can be defined as the ability of fiscal policy to structurally (i.e., across the business cycle) stabilise a predetermined debt-to-GDP ratio.

According to Evsey Domar's financial arithmetic (see Domar 1944), a sustainable deficit ratio depends on the long-term real growth rate (which is influenced by fiscal policy orientation), the tolerated inflation rate, and the debt-to-GDP ratio to be stabilised. Assuming plausible values for these variables (e.g., a real growth rate of 3%, a tolerated inflation rate of 2%, and a debt-to-GDP ratio targeted at 100%), a permanently deficit-financed capital budget of 5% would be sustainable[18]. If the targeted, tolerated, or expected values differ, the sustainable capital budgeting rule will also adjust accordingly. However, there is no reason to believe that functional finance inherently translates into 'unsound finance' in any tangible way.

The challenge of reconciling ecological sustainability with functional finance is more complex. One could argue that public investment, driven by the Post Keynesian Capital Budgeting fiscal rule, can contribute to ecological sustainability if it is directed toward a 'green transformation' of the economy and society (see e.g. Tørstad et al. 2024, Mang/Caddick 2023). Increased public investment is necessary to reduce the greenhouse gas (GHG) emissions associated with economic growth, helping to relatively decouple GDP growth from GHG emissions (see, e.g., Harris 2013; Goldstein/Tyfield 2018). However, if relative decoupling is insufficient — as many ecological economists insist (see, e.g., Parrique et al. 2017; Kallis et al. 2018) — a trade-off between ecological and socio-economic objectives becomes unavoidable. This trade-off means that the desired national income level, on which the functional finance approach is based, may differ depending on whether environmental or socio-economic goals are prioritised.

Ultimately, only the electorate can decide which goal to pursue. However, if the ecological goal is prioritised (as in zero-growth proposals), this would limit the application of deficit-financed Capital Budgeting, potentially to the detriment of socio-economic goals.

[17] This should not be understood to mean that public investment (INV_{pub}) in this case ought to be zero, but rather that it should be funded through taxes. Alternatively, if deficit-financed for reasons of intergenerational burden management, it would crowd out private investment.

[18] As mentioned before, public investment spending will be, at least, partly self-financing. Taking this effect into consideration, the sustainable capital budget will even be considerably higher.

b. The current budget

It is one thing to *shape market constellations* to foster desired macroeconomic outcomes in the long run and another to attempt to *stabilise business cycle fluctuations* in the short term. Long-term 'coarse tuning' is the subject of rule-based capital budgeting, while the current budget addresses short-term 'fine tuning'. As indicated in equation (4), the current budget (eq. 3) — comprising public expenditures on salaries, transfers, and other consumptive expenditures (but also such public investment which needs to be tax-financed; see footnote 17) — should be balanced as long as there is no output gap, i.e., as long as actual national income equals its long-term trend. Only when there is a negative (positive) output gap may the current balance fall into deficit (surplus) to stabilise short-term aggregate demand in the economy. This typically occurs even without active policy-maker intervention, as both taxes and public expenditures — particularly for social purposes — are generally somewhat income-elastic and thus act as 'automatic stabilisers'.

This automatic mechanism, whose magnitude depends on the size and configuration of the welfare state, can also be interpreted as a rule once the reaction coefficient a in equation (3) is fully determined by the income elasticities of taxes and public expenditures. However, if the automatic stabilizers are deemed insufficient — such as in underdeveloped welfare states or in extraordinary circumstances like great depressions (as opposed to mere recessions in 'normal' business cycles) — the reaction coefficient can be adjusted at policy-makers' own choosing. This is where discretion comes into fiscal policy in a Post Keynesian orientation, and only here. Keynes summarizes the relationship between the capital budget and the current budget well:

"...the capital budgeting is a method of maintaining equilibrium; the deficit budgeting is a means of attempting to cure disequilibrium if and when it arises" (Keynes 1943b: 352f.).

Thus, it becomes clear that, from a Post Keynesian perspective, a deficit is a functional tool for establishing equilibrium in a world that does not automatically converge towards equilibrium.

5. Excursion: Implications for the German 'Debt Brake' and the European Stability and Growth Pact

Let's take a brief look at two examples of fiscal policy rules in practice: the German 'Debt Brake' and the European Stability and Growth Pact. Both fiscal rules set numerical limits on public deficits or debts that must be adhered to in order to avoid sanctions. Under the European Stability and Growth Pact, total (cyclically unadjusted) public deficits are not allowed to exceed 3% of GDP under 'normal' economic circumstances, which implies that structural deficits may not exceed 0.5% of GDP under such conditions. Furthermore, these targets are tightened when public debt levels exceed 60% of GDP[19]. In cases of non-compliance, financial sanctions are automatically imposed unless a qualified majority in the European Council halts the 'excess-deficit procedure'. Additionally, the German 'Debt Brake'

[19] The European Stability and Growth Pact has undergone several revisions, making it increasingly complex and less transparent. However, its core principles and ideological foundation (see Gaspar and Buti 2021) have remained unchanged. For an overview of the latest revision, see Frangakis (2024).

constitutionally mandates that the structural public deficit must not exceed 0.35% of GDP under normal economic conditions. As seen in 2023, non-compliance can lead to a constitutional court ruling that the budget is null and void.

Both fiscal rules — the German 'Debt Brake' being a slightly more restrictive version of the European Stability and Growth Pact—are based on the 'sound finance' principle of mainstream economics, which advocates for small deficit margins to manage intergenerational burdens. The 60% debt threshold of the European Stability and Growth Pact is entirely arbitrary (see e.g. Gaspar/Buti 2021), while the 3% deficit threshold is grounded in the empirically supported idea that automatic stabilisers can function effectively as long as 'normal' recessions do not result in a GDP decline of more than 2% per year (with anything worse being classified as 'extraordinary' economic circumstances).

Recently, both fiscal rules have faced severe criticism, not only from heterodox economists, for being too inflexible in the face of exceptional economic circumstances such as the COVID-19 pandemic, the supply and energy price shocks related to Russia's aggression against Ukraine, and low interest rates following the Global Financial Crisis (see e.g. Gaspar/Buti 2021, Südekum/Hüther 2019). These factors have limited the potential of monetary policy as a stabilization tool and have underscored the need for discretionary fiscal policy to intervene. Moreover, both fiscal rules have been criticized for being detrimental to public investment spending during times of high societal need. However, regarding insufficient public investment, there is no theoretical link between deficit rules and the composition of public spending. In fact, there seems to be only weak empirical support for the argument that investment expenditures are more difficult to protect in democracies during periods of rising public indebtedness than consumptive spending, which more directly affects potential voters. Additionally, both fiscal rules include exemption clauses specifically designed to address extraordinary situations — exemptions that have been utilised extensively in recent years.

Therefore, it is not the existence of fiscal rules *per se* that can be held responsible for the sluggish economic performance in the EU in general and Germany in particular, but rather their excessively tight orientation — a balanced structural budget — and the failure of policy-makers to prioritise investment spending or to tax-finance an economically adequate level of public investment. The content of the fiscal rules leaves no room for a functional approach to capital budgeting, regardless of the state of public indebtedness, while considering desired long-term macroeconomic outcomes.

From a Post Keynesian perspective, both the German 'Debt Brake' and the European Stability and Growth Pact should be amended not in terms of their function as sanctionable rules, but in terms of their fiscally restrictive content. A capital budgeting rule, such as a long-term public (net) investment ratio of 3–5% of GDP, coupled with a structural deficit rule of 1.5–2.5% of GDP, should be introduced, while smaller business cycles could be managed by automatic stabilisers. Furthermore, larger-scale economic fluctuations should be addressed through discretionary interventions that appropriately consider the prevailing economic environment.

6. Conclusion

It is a long-standing myth that a rule-based orientation of fiscal policy centers around a balanced budget in order to contain the ‘deficit bias’ of democratic policy-making (see e.g., Constancio 2020: 366). Similarly, it is another myth that any Keynesian-type fiscal intervention must, therefore, be discretionary in nature and primarily focused on addressing external shocks.

Our elaborations have shown that both myths are unfounded. Fiscal rules may also be necessary to incentivise governments to maintain investment spending during periods of political 'austerity consensus' (see e.g. Farrell/Quiggin 2017) or to prevent free-rider behaviour. A Post Keynesian perspective, which rejects the notion of general equilibrium self-regulation and critiques the inherent ineffectiveness of (fiscal) policy, argues for a functionally oriented, long-term capital budgeting policy. In mature capitalist economies, this policy should be more expansionary concerning the long-run budget balance and should not be left to the discretion of policymakers. Instead, it ought to adhere to a transparent, non-overridable rule, which must be complemented in the short run by the unrestricted operation of automatic stabilizers and, only in exceptional circumstances, by discretionary action to avert deeper depressions.

From a Post Keynesian perspective, rule-based fiscal policy is merely one component of a coordinated macroeconomic effort to create a desired market constellation. The specific features of this desired market constellation should be established through democratic deliberation — primarily focusing on socio-economic or environmental targets — which will provide the context for the precise numerical parameters of the fiscal rule.

References

Alesina, A., Perotti, R. (1999); Budget Deficits and Budget Institutions; in: *Fiscal Institutions and Fiscal Performance*, Chicago, pp. 13–36

Arestis, P. (2012); Fiscal policy: A strong macroeconomic role, in: *Review of Keynesian Economics*, Inaugural Issue, pp. 93–108

Arestis, P., Fontana, G. (2009); Special symposium of discretionary fiscal policy: fiscal policy is back!, in: *Journal of Post Keynesian Economics*, Vol. 31, No. 4, pp. 547–548

Axelrod, R. (1984); *The Evolution of Cooperation*, New York

Badinger, H. (2009); Fiscal rules, discretionary fiscal policy and macroeconomic stability: an empirical assessment for OECD countries; in: *Applied Economics*, Vol. 41, No.7, pp. 829–847

Blanchard, O., Giavazzi, F. (2004); Improving the SGP Through a Proper Accounting of Public Investment, *CEPR Discussion Paper* No. 4220, London

Blanchard, O., Leandro, A., Zettelmeyer, J. (2021); Redesigning EU fiscal rules: from rules to standards, in: *Economic Policy*, Vol. 36, No. 106, pp. 195–236

Bohn, H. (1998); The Behavior of U.S. Public Debt and Deficits, in: *The Quarterly Journal of Economics*, Vol. 113, No. 3, pp. 949–963

Constancio, V. (2020); The Return of Fiscal Policy and the Euro Area Fiscal Rule, in: *Comparative Economic Studies*, Vol. 62, No. 3, pp. 358–372

Davidson, P. (1994); *Post Keynesian Macroeconomic Theory*, Aldershot

Debrun, X., Moulin, L., Turrini, A., Ayuso-i-Casals, J., Kumar, M. S. (2008); Tied to the Mast? National Fiscal Rules in the European Union, in: *Economic Policy*, Vol. 23, No. 54, pp. 297–362

Domar, E.D. (1944); The 'burden of debt' and the national income, in: *American Economic Review*, Vol. 34, pp. 798–827

Dunn, S.P. (2001); Bounded rationality is not fundamental uncertainty: a Post Keynesian perspective; in: *Journal of Post Keynesian Economics*, Vol. 23, No. 4, pp. 567–587

Farrell, H., Quiggin, J. (2017); Consensus, Dissensus, and Economic Ideas: Economic Crisis and the Rise and Fall of Keynesianism, in: *International Studies Quarterly*, Vol. 61, pp. 269–283

Fatás, A. (2019); Fiscal Policy, Potential Output, and the Shifting Goalposts, in: *IMF Economic Review*, Vol. 67, pp. 684–702

Fatás, A., Mihov, I. (2003a); On constraining fiscal policy discretion in EMU; in *Oxford Review of Economic Policy*, Vol. 19, No.1, pp. 112–131

Fatás, A., Mihov, I. (2003b); The Case for Restricting Fiscal Policy Discretion, in: *The Quarterly Journal of Economics*, Vol. 118, No. 4, pp. 1419–1447

Frangakis, M. (2024); Pasinetti and the EU Fiscal Governance Framework: A Debate That Will Not Go Away, in: *International Journal of Political Economy*, Vol. 53, No. 3, pp. 235–251

Gaspar, V., Buti, M. (2021); Maastricht Values, *VOXeu/CEPR Columns* EU Institutions EU Policies (retrievable at: https://cepr.org/voxeu/columns/maastricht-values)

Goldstein, J., Tyfield, D. (2018); Green Keynesianism: Bringing the Entrepreneurial State Back in(to Question)?, *Science as Culture*, Vol. 27, No. 1, pp. 74–97

Hallett, A. H., Hougaard Jensen, S.E. (2012); Fiscal governance in the euro area: institutions vs. Rules; in: *Journal of European Public Policy*, Vol. 19, No.5, pp. 646–664

Harris, J. (2013), Green Keynesianism: Beyond Standard Growth Paradigms, *Global Development and Environment Institute Working Paper* No. 13-02, Tufts University, Medford

Heimberger, P. (2019); 'Output Gap Nonsense': Understanding the Budget Conflict between the EC and Italy's Government, in: *Vienna Institute for International Economic Studies* 17

Heine, M., Herr, H., Kaiser, C. (2006); *Wirtschaftspolitische Regime westlicher Industrienationen*, Baden-Baden

Heinemann, F., Moessinger, M. D., Yeter, M. (2018); Do Fiscal Rules Constrain Fiscal Policy? A Meta-Regression-Analysis, in: *European Journal of Political Economy*, Vol. 51, pp. 69–92

Heise, A. (2006); Limitations of Keynesian demand management through Monetary Policy - Whither Cartesian Policy control; in: Setterfield, M. (ed.); *Complexity, Endogenous Money and Macroeconomic Theory. Essays in Honour of Basil J. Moore*, Cheltenham, pp. 438–460

Heise, A. (2008); *Economic Governance and Employment. Policy, Polity and Politics of Economic Rise and Decline*, Münster

Heise, A. (2009); A Post Keynesian Theory of Economic Policy-Filling a Void, in: *Journal of Post Keynesian Economics*, Vol. 31, No. 3, pp. 383–401

Heise, A. (2012); Governance Without Governmentor, The Euro Crisis and What Went Wrong withEuropean Economic Governance, in: *International Journal of Political Economy*, Vol. 41, No. 2, pp. 42–60

Herr, H., Kazandziska, M. (2011); *Macroeconomic Regimes in Western Industrial Countries*, Abingdon

Kallis, G., Kostakis, V., Lange, S., Muraca, B., Paulson, S., Schmelzer, M. (2018); Research On Degrowth, in: *Annual Review of Environment and Resources*, Vol. 43, pp. 291–316

Keynes, J.M. (1936); *The General Theory of Employment, Interest and Money*, London

Keynes, J. M. (1943); 'The Long-Term Problem of Full Employment'; in Moggridge, D. (ed.); *The Collected Writings of John Maynard Keynes*, vol. 27; Macmillan, London, 1980, pp. 320–325

Keynes, J. M. (1945); 'National Debt Inquiry: The Concept of a Capital Budget (Memorandum by Lord Keynes)'; in Moggridge, D. (ed.); *The Collected Writings of John Maynard Keynes*, vol. 27; Macmillan, London, 1980, pp. 405–413

Kopits, G. (2001); Fiscal Rules: Useful Policy Framework or Unnecessary Ornament?" *IMF Working Paper No. 01/145,* Washington

Kopits, G., Symansky, S. A. (1998)**;** *Fiscal Policy Rules.* International Monetary Fund, Washington

Kydland, F. E., Prescott, E.C. (1977); Rules rather than discretion: The incon- sistency of optimal plans, in: *Journal of Political Economy*, Vol. 85, No. 3, pp. 473–491

Lerner, A. P. (1943); 'Functional Finance and the Federal Debt', in: *Social Research*, Vol. 10, No. 1, pp. 38–52

Mang, S., Caddick, D. (2023); Navigating Constraints for Progress: Examining the Impact of EU Fiscal Rules on Social and Green Investments, New Economics Foundation, London

Nordhaus, W. D. (1994); Policy Games: Coordination and Independence in Monetary and Fiscal Policies; in: *Brookings Papers on Economic Activity*, No. 2, pp. 139–216

Moore, B. J. (2006); *Shaking the Invisible Hand. Complexity, Endogenous Money and Exogenous Interest Rates*, Houndsmill

Parrique T., Barth J., Briens F., C. Kerschner, Kraus-Polk A., Kuokkanen A., Spangenberg J.H., (2019); *Decoupling debunked: Evidence and arguments against green growth as a sole strategy for sustainability*, European Environmental Bureau, Brussels

Persson, T., Tabellini, G. (2000); *Political Economics: Explaining Economic Policy*, Cambridge (MA)

Power, S., Rowe, N. (1998); Independent Central Banks: Coordination Problems and Budget Deficits; in: *Economic Issues*, Vol. 3, Part 1, pp. 69–75

Rankin, N. (1998); Is Delegating Half of Demand Management Sensible?; in: *International Review of Applied Economics*, Vol. 13, No. 3, pp. 415–422

Rother, P.C. (2004); Fiscal policy and inflation volatility; *ECB working paper* No. 317, Frankfurt

Sawyer, M. (2009); Fiscal and interest rate policies in the 'new consensus' framework: a different perspective, in: *Journal of Post Keynesian Economics*, Vol. 31, No. 4, pp. 549–565

Schaechter, A., Kinda, T., Budina, N., Weber, A. (2012); Fiscal Rules in Response to the Crisis—Toward the 'Next-Generation' Rules, in: *IMF Working Paper No. 12/187,* Washington

Schlag, P. (1985); Rules and Standards, in: *UCLA Law Review*, Vol. 33, No. 2, pp. 379–430

Simon, H.A. (1957); *Models of Man: Social and Rational*, New York

Simon, H.A. (1959); Theories of Decision-making in Economic and Behavioral Sciences; in: *American Economic Review*, Vol. 49, No. 2, pp. 253–83

Stokey, N.L. (2002); 'Rules vs. Discretion' After Twenty-Five Years in: *NBER Macroeconomics Annual*, Vol. 17, pp. 9–45

Südekum, J., Hüther, M. (2019); The German debt brake needs a reform, *VoxEU Blocks&Reviews* (retrievable at: The German debt brake needs a reform | CEPR)

Taylor, J. B. (2000); Reassessing Discretionary Fiscal Policy, in: *Journal of Economic Perspectives*, Vol. 14, No. 3, pp. 21–36

Theil, H. (1956); On the theory of economic policy; in: *American Economic Review*, Vol. 46, pp. 360–366

Tinbergen, J. (1952); *On the theory of economic policy*, Amsterdam

Tørstad, V., Nahm, J., Hovi, J., Skodvin, T., Dietrichson, G. O. (2024); Economic recessions and decarbonisation: analysing green stimulus spending in Canada and the US, in: *New Political Economy*, Vol. 29, No.4, pp. 513–531

Wible, J.R. (2004); Macroeconomics, Pragmatism and Cognitive Scarcity: Keynes Should Have Read C.S. Peirce on Probability and Evolutionary Complexity; in: Mooslechner et al. (eds.); *Economic Policy under Uncertainty*, Cheltenham, pp. 122–169

Wyplosz, C. (2012)**;** Fiscal Rules: Theoretical Issues and Historical Experiences. *NBER Working Paper* No. 17884, Washington