[Fiscal financing regimes and nominal stability: an historical analysis]

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This paper studies how governments finance increases in spending and why this matters for inflation. Economic theory predicts that inflation behaves very differently depending on whether governments eventually raise taxes or cut spending to pay for fiscal expansions, or instead allow higher inflation to reduce the real value of public debt. The paper refers to these arrangements as fiscal financing regimes.

The analysis focuses on Britain and compares two strikingly different historical periods: the Gold Standard era (1717–1914) and the era of the Great Inflation (1965–1982).

The paper uses a narrative historical approach, drawing heavily on Budget speeches to identify how policymakers expected fiscal expansions to be financed. This qualitative evidence is complemented by quantitative analysis showing how government finances and prices actually responded to fiscal shocks in each period.

During the Gold Standard era, British policymakers consistently treated higher government spending (usually on wars) as something that would eventually be paid for through higher taxes and primary budget surpluses. While borrowing was used extensively in wartime, there was a strong and enduring commitment to servicing and repaying debt in peacetime. This commitment was embedded in institutions such as sinking funds and later reinforced by balanced-budget norms. Consistent with this regime, fiscal expansions were followed by higher primary surpluses after a delay and they did not lead to permanent increases in the price level.

By contrast, no comparable commitment existed during the Great Inflation era. In the decades after WWII, fiscal policy was primarily used to manage demand, support growth, and address unemployment or balance-of-payments pressures. Stabilising public debt was not an objective. Expansionary fiscal policies were not followed by offsetting future surpluses. Instead, higher inflation played a key role in stabilising the real value of government debt.

The paper also documents that many contemporaries outside government – particularly financial journalists and market participants – believed that large fiscal deficits were contributing to inflation in the 1970s. These beliefs appear to have influenced financial markets, especially long-term government bond yields.

Overall, the paper shows that inflation outcomes depend not only on monetary policy but also on how fiscal policy is expected to behave over time. Britain’s experience illustrates that when governments are not expected to stabilise their finances through future surpluses, inflation can become the mechanism through which public debt is effectively financed.  These findings help explain both Britain’s long period of price stability under the Gold Standard and the inflationary breakdown of the post-war era.