

Fiscal Rules and Long-Term Inclusive Growth

The Global Council
on New Economics
for the 21st Century:
Towards a Common
Good Economy

The Global Council on New Economics for the 21st Century: Towards a Common Good Economy is a new international council with the Government of Spain as the inaugural host and the University College London (UCL) Institute for Innovation and Public Purpose (IIPP) as the main academic partner.

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About the Council

The Global Council on New Economics for the 21st Century: Towards a Common Good Economy is a new international council co-chaired by Professor Mariana Mazzucato and Carlos Cuerdo, Spain's First Vice-President and Minister of Economy, Trade and Business, with the Government of Spain as the inaugural host and University College London (UCL) Institute for Innovation and Public Purpose as the main academic partner.

The Council proposes an intervention at the level of economic thinking itself. Important work has been done by vertical commissions and high-level panels on specific issues — tax, inequality, debt, climate, water. The Council complements rather than duplicates that work, addressing the cross-cutting assumptions in economic theory and modelling that constrain progress in areas such as housing, public services, the climate transition, inequality, and multilateral governance.

Its framework is centred around four interdependent principles — justice, equality, sustainability, and global solidarity — and translates these into practical reforms, grounded in lived experience and focused on building fairer, more resilient, and cooperative economies.

The Council's work is organised around eight questions:

1. What should we value, measure, and reward?
2. How should finance serve the economy?
3. What does fiscal responsibility actually require?
4. What state capabilities must be rebuilt?
5. Whose interests do rules serve?
6. How should value be created and shared to reduce inequality from the start?
7. How can lived experiences be reflected in the design of policies?
8. How can we harness the power of technology and artificial intelligence (AI) for the common good?

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Key messages



1. Defining fiscal responsibility primarily through deficit and debt targets can be self-defeating. Cutting spending in a weak economy reduces growth and investment and can leave the ratio of debt to gross domestic product (GDP) higher, not lower.



2. Fiscal rules shape these outcomes. When governments must meet deficit, debt or expenditure targets, public investment is often cut first. Short forecast horizons compound this problem by recording investment costs before the returns emerge.



3. What public money does matters. Investment in infrastructure, technology and innovation builds productive capacity, but so does spending on health, education, care, skills and social protection. Fiscal frameworks need to protect both.



4. How the fiscal position is measured also matters. Debt measures record what the state owes but not necessarily the assets it creates through spending. Public sector balance sheets and net worth offer a fuller picture, while investments should be assessed over the full period in which they generate returns.



5. Countries do not face the same fiscal constraints. Access to foreign exchange and the currencies in which governments borrow, exposure to volatile capital flows and the structure of the international financial system all shape fiscal space. The same fiscal rule can therefore have very different consequences across countries.



6. Governments can improve fiscal frameworks now. They can protect essential and productive spending through the business cycle; account for public assets and longer-term investment returns; steer investment through procurement and public finance; raise revenue fairly; and reduce exposure to volatile external finance.



7. Domestic reform is not enough where the binding constraint is external. International rules must provide greater space for productive investment through better-designed lending programmes and debt sustainability assessments, reliable access to liquidity, earlier debt resolution, long-term public development finance and stronger international tax cooperation.



8. Stability when shocks hit also depends on global and regional cooperation. Buffer stocks and coordinated stabilisation measures can reduce price shocks before they reach national budgets, preserving fiscal space.



9. Fiscal responsibility should ultimately be judged by whether public finances strengthen the economy's capacity to grow, withstand shocks and meet public obligations over time, not by whether a single fiscal number falls in the short term.

01 Fiscal responsibility: the right goal, wrongly defined

Economic growth depends on public investment, private investment, innovation and a trained workforce. Without them, economies stagnate, innovation and job creation slow, and living standards suffer. Fiscal rules therefore need to distinguish wasteful spending from the productive spending that allows these investments to flourish.

Fiscal rules matter because governments must be able to meet their obligations over time, and the credibility of public finances affects borrowing costs across the economy. But does defining fiscal responsibility primarily as reducing deficits and debt actually serve that objective?

1.1 The conventional view of deficits and debt misreads public finance

The conventional approach treats the public budget much like a household budget: spending must be matched by income, borrowing is a burden, and cutting spending is prudent. This logic is embedded in fiscal rules centred on deficit and debt ceilings, in adjustment programmes, and in the treatment of public investment.¹

Keynesian analysis emphasises the role of investment in driving growth. Public investment need not wait for an equivalent rise in tax revenues: by supporting growth, it can expand the future tax base. Capitalist economies are also prone to recurrent downturns, and unless government steps in, a downturn can turn into a full recession. Countercyclical public spending is therefore central to stability. Even in the booms, government has often led the way on high risk, capital-intensive innovation, from the information technology revolution to key advances in health and in artificial intelligence today.²

Yet the models that continue to shape fiscal policy assume that economies tend to return to full employment, which makes demand shortfalls temporary and leaves little role for public spending beyond the short run.³ Financial frictions have been incorporated more extensively since the 2008 crisis, but without changing this framework fundamentally.⁴ As a result, conventional approaches struggle to account for the lasting output losses that can follow spending cuts, or for the productive capacity that public investment creates.

1.2 From the cost of cuts to a better definition

In many parts of the world the focus on lowering deficits has ended up raising the debt-to-GDP ratio, because the damage to long-term growth reduces the denominator or slows its growth.^{5,6} Done strategically, as part of an industrial and innovation strategy that catalyses private investment, public investment raises productive capacity, stimulates innovation and strengthens the future revenue base. A credible approach to fiscal responsibility therefore needs to account for these effects over time.

This brief asks: “What does fiscal responsibility actually require?” Section 2 examines the assumptions behind the conventional view, section 3 explains how they became embedded in fiscal rules, and section 4 compares the constraints governments face. Sections 5 and 6 set out domestic and international reforms.

Box 1. What counts as productive public investment?

Productive public investment is spending that builds the physical, technological, institutional, human and social capabilities on which future growth depends. Health and education systems, care, skills and social protection belong alongside roads, grids and research: a hospital without staff, a school without teachers or a grid without maintenance cannot deliver its intended benefits.

Current and capital spending are therefore complementary, and a rule that protects one while squeezing the other defeats its own purpose. Here, “essential spending” means current and capital spending with clear long-term economic and social value, particularly in health, education, care and social protection. These investments yield returns over different periods, so no single timeframe is appropriate for assessing them all: the horizon should reflect the nature of the investment.^{7,8}

02 Debunking five myths about public finance

The five myths that follow are the assumptions behind defining fiscal responsibility primarily as reducing deficits and debt. Each fails when tested against the evidence.

Myth 1. Austerity always restores growth and brings debt down

What the evidence shows: Consolidation in a weak economy can deepen the downturn and make debt harder to reduce.

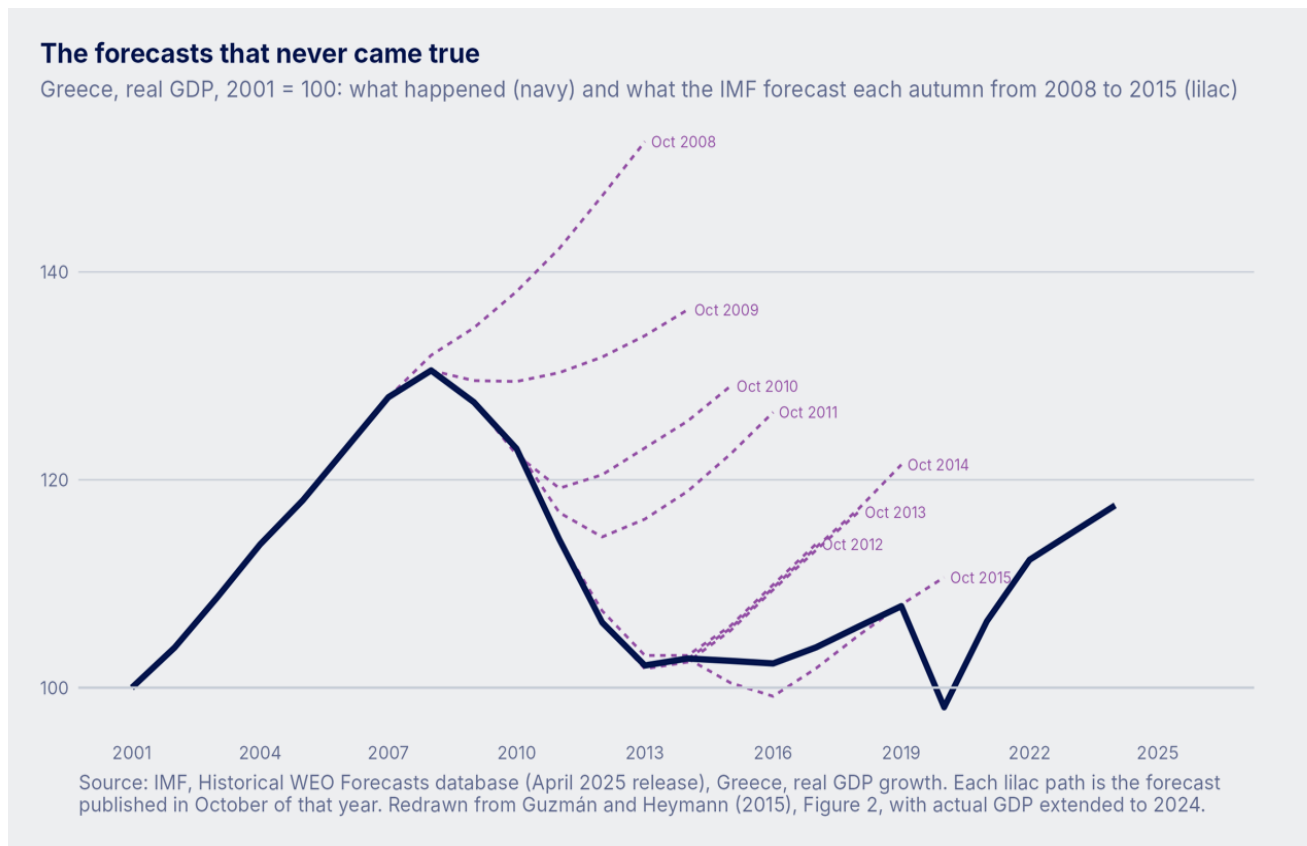
Austerity rests on a longstanding policy orthodoxy: that fiscal consolidation restores confidence, encourages private activity and ultimately strengthens growth and the public finances.⁹

The record after the global financial crisis did not match these expectations. Fiscal consolidation reduced output and raised unemployment, with larger effects where economies were already weak.¹⁰ The International Monetary Fund (IMF), in its reassessment of the post-2010 European adjustment, found that forecasters had assumed fiscal multipliers of about 0.5, substantially underestimating the effects of consolidation: countries planning larger adjustments experienced larger-than-expected falls in output.⁵ Similar patterns have been documented in emerging economies and across IMF programmes.^{11,12} In low- and middle-income countries, compressing expenditure in a downturn is supposed to reassure investors and speed recovery. It does neither: the cuts are procyclical, markets do not respond as predicted, and recovery is slower.¹³

The effects can also last beyond the initial downturn. By reducing public and private investment, consolidation can weaken productive capacity and leave output below the path it would otherwise have followed.⁶ This also makes debt harder to reduce, since weaker growth reduces the denominator of the debt-to-GDP ratio. The costs of austerity extend beyond the economy: consolidation after 2010 is associated with rising support for extreme parties and falling trust in institutions.¹⁴

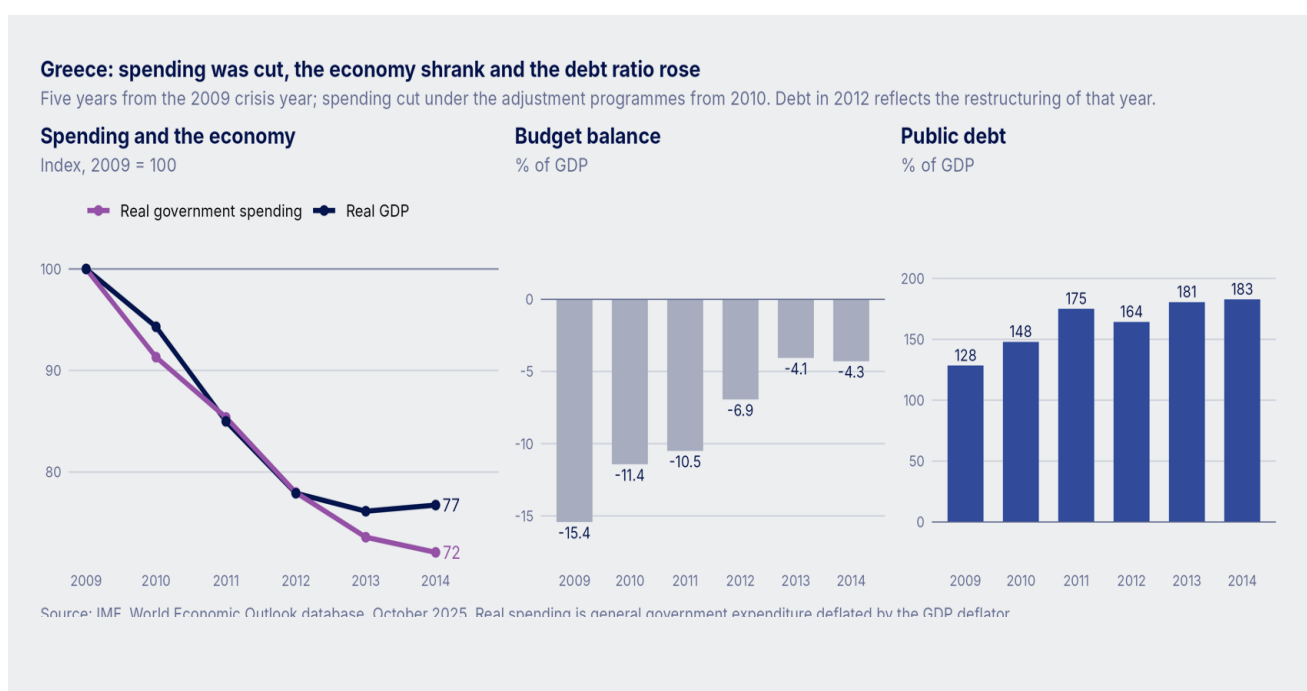
Greece illustrates the problem. From 2008 onwards, successive IMF forecasts repeatedly projected a recovery while output continued to fall below expectations (Figure 1).^{15,16} Between 2009 and 2014, real government spending fell by 28 per cent and the economy contracted by 23 per cent. The deficit narrowed from 15 to 4 per cent of GDP, but the debt ratio rose from 128 to 183 per cent as GDP fell sharply (Figure 2).^{17,18}

Figure 1. IMF real GDP growth forecasts and outcomes for Greece, 2008–2015



Source: IMF, Historical World Economic Outlook (WEO) Forecasts database (April 2025 release); reproduced from Guzmán and Heymann (2015).

Figure 2. Greece: government spending, real GDP, fiscal balance and public debt, 2009–2014



Source: IMF, World Economic Outlook database, October 2025.

Myth 2. There is a safe limit for public debt

What the evidence shows: Debt sustainability depends on growth, interest rates, currency, maturity and who holds the debt, not a universal threshold.

The influential claim that public debt above 90 per cent of GDP sharply reduces growth was found to rely on a spreadsheet error and methodological choices that substantially affected the result.¹⁹ Once corrected, the evidence did not support a universal threshold at 90 per cent of GDP beyond which growth consistently weakens.¹⁹ Research finds that sustainable debt levels vary widely with growth, interest rates and institutions.²⁰

The relationship between the interest rate and economic growth is particularly important. When the interest rate on government debt remains below the growth rate, the debt ratio can stabilise or fall without large primary surpluses.²¹ Financing conditions also depend on the monetary and financial context. Governments that borrow in their own currency, with deep domestic markets and a central bank able to provide liquidity, generally have greater influence over their borrowing conditions than countries dependent on foreign currency or external financing.²² Figure 3 summarises the main factors that determine whether public debt is sustainable.

Figure 3. Factors affecting public debt sustainability



Source: Authors' elaboration.

Myth 3. Public investment crowds out private investment

What the evidence shows: Well-directed public investment can raise productive capacity and crowd in private investment.

The crowding out claim holds that public borrowing competes with private borrowers for a fixed pool of savings, raising interest rates and displacing private investment. The evidence points the other way. Across 17 advanced economies, an unanticipated rise in public investment of 1 per cent of GDP raises output by about 0.4 per cent in the same year and 1.5 per cent after four years, raises private investment, and can lower the debt ratio, with the strongest effects when the economy is below capacity and the investment is well managed.²³ A wider literature similarly finds that public capital can raise the returns to private capital rather than substitute for it.²⁴

The effect can extend beyond the initial fiscal multiplier. Studies of public research and development (R&D) and mission-oriented innovation identify a supermultiplier: public investment generates demand, which induces additional private investment and expands productive capacity, reinforcing the initial increase in output over time.²⁵

The fixed pool-of-savings assumption also does not describe how investment is financed in modern banking systems. Bank lending creates deposits rather than allocating a pre-existing stock of savings.²⁶ Nor does public borrowing drain the private sector: as a matter of accounting, a public deficit adds to private sector financial wealth, which is one reason public spending supports rather than displaces private activity when demand is weak.

Myth 4. Governments must budget like households

What the evidence shows: Governments shape economic activity and their own revenue base, while the constraints they face depend on monetary and external conditions.

A household's spending does not change its income. Government spending directly affects national income and the government's own tax base, so spending cuts can also reduce tax revenues. The constraints that bind are instead real ones: productive capacity, skilled labour, materials, inflation and, for many countries, foreign exchange.²⁷

How tightly these constraints bind differs across countries. Governments that borrow predominantly in a currency they issue, supported by their own central bank and deep domestic financial markets, have greater control over domestic financing conditions and do not face liquidity risk on that debt.^{21,26} Countries that borrow in foreign currencies must also obtain foreign exchange to service debt and pay for imports.²⁸ Section 4 examines how these differences shape fiscal space.

Myth 5. Only capital spending builds future capacity

What the evidence shows: Health, education, care and skills also build productive capacity, and underinvestment creates future economic and fiscal costs.

Public accounts classify spending as either current or capital. Capital expenditure creates assets that appear on the public balance sheet, while most spending on health, education, care and skills is recorded as current expenditure. But the accounting category does not determine the economic effect. Spending in these areas can improve health and skills, support labour force participation and make physical and technological investment more productive.⁷

Reducing preventive health, education or care spending may lower expenditure today while weakening capacity or increasing costs later. Social protection also supports incomes and demand during downturns, limiting longer-term economic damage.⁸

03 When fiscal rules undermine investment

The assumptions discussed above are embedded in the rules used to assess and constrain public finances. Fiscal rules set numerical limits on budget aggregates in order to signal commitment and constrain government discretion. By 2021, more than a hundred countries operated at least one, up from a handful in 1990.²⁹ They typically set limits or targets for deficits, debt or expenditure. Most focus on headline aggregates that say little about what public spending is for or what it produces.¹

These rules operate at both national and supranational levels. National frameworks include debt brakes, expenditure ceilings and balanced budget rules, while the European Union (EU) combines national rules with common deficit and debt limits. Its reference values of 3 per cent of GDP for the deficit and 60 per cent for debt continue to anchor the framework despite lacking a clear theoretical or empirical basis.³⁰ Similar assumptions also shape international assessments of public finances, including IMF programmes and debt sustainability analysis.¹⁶

3.1 The rules can reinforce downturns, and their effects differ across countries

Fiscal targets become particularly restrictive during downturns. Government revenues fall as economic activity weakens. If meeting a deficit or expenditure rule then requires spending cuts, those cuts can reduce activity and revenues further, reinforcing the downturn and making the fiscal target harder to reach.^{13,31}

Fiscal rules operate within an international financial system that gives countries different room to respond to shocks.¹³ Section 4 examines how access to finance and foreign exchange shapes these differences.

3.2 A single number cannot see what spending is for

When fiscal rules constrain a single aggregate, public investment is easier to postpone than other expenditure and bears a disproportionate share of any adjustment. IMF analysis notes that public investment is often cut during recessions as governments seek to meet fiscal targets. Research finds that flexible fiscal rules can protect investment during consolidation; excluding net public investment from deficit limits is one proposed way to reduce this bias.³²

Protecting capital expenditure alone is insufficient. Fiscal rules also need to protect current spending that builds productive capacity and countercyclical spending that prevents lasting economic damage.³³ The test should be what spending achieves, rather than its accounting category.

3.3 The measure, the horizon and the cost of inaction

The choice of fiscal measure creates a second problem: conventional debt measures record liabilities without fully accounting for the assets they finance. If a government borrows to build a hospital, for example, net debt rises by the amount borrowed while the hospital does not appear in the measure. Net financial liabilities go further by recognising financial assets such as public loans and equity stakes, but still exclude physical assets. Net worth provides a broader measure by recording both what the state owns and what it owes (see Figure 4).

The difference is substantial. IMF balance sheet analysis of 31 countries found public assets worth around twice GDP that are not captured by conventional debt statistics.³⁴

The time horizon matters too. Short forecast periods capture the immediate cost of investment but only a fraction of its return. The UK Office for Budget Responsibility estimates that a sustained increase in public investment of 1 per cent of GDP raises potential output by around 2.5 per cent in the long run. Very little of this appears within a three-year forecast.³⁵ The appropriate horizon also differs by investment: infrastructure, education, research and climate investment generate returns over different periods. Fiscal assessment should reflect those periods rather than applying a single short horizon to all spending.

Short horizons can also obscure the cost of inaction. Delaying investment can create higher future costs, particularly in areas such as climate, preventive health and early years provision.^{7,36} Public finances should take this into account, which means treating the cost of inaction as a fiscal concept in its own right: not investing today creates future liabilities through remediation, lower productivity, weaker revenue and greater exposure to shocks.

Box 2: The United Kingdom: a self-imposed rule, and what it has cost

The UK has invested less than its peers for a generation. From the turn of the century to 2019, UK general government investment averaged just over 2.5 per cent of GDP, compared with 3.7 per cent across advanced economies in the Organisation for Economic Co-operation and Development (OECD).³⁷ Total investment, public and private, was the lowest in the Group of Seven (G7) in 24 of the 30 years ending in 2022. Matching the G7 median over 1990–2022 would have meant approximately £1.9 trillion more investment in real terms.³⁸ Public investment has repeatedly been cut during fiscal consolidation, with net debt targets reinforcing incentives to use it as the adjustment variable.³⁷

The fiscal framework introduced in October 2024 addresses part of this problem. Its stability rule requires the current budget to be in balance or surplus by the third year of the forecast, while the investment rule requires public sector net financial liabilities (PSNFL) to be falling as a share of GDP by the same point.^{39,40} Replacing net debt with PSNFL matters because financial assets such as public loans and equity stakes now count against the liabilities incurred to finance them. The September 2026 reduction in the Green Book discount rate from 3.5 to 3 per cent similarly gives greater weight to benefits that accrue further into the future.⁴¹ Both are welcome steps.

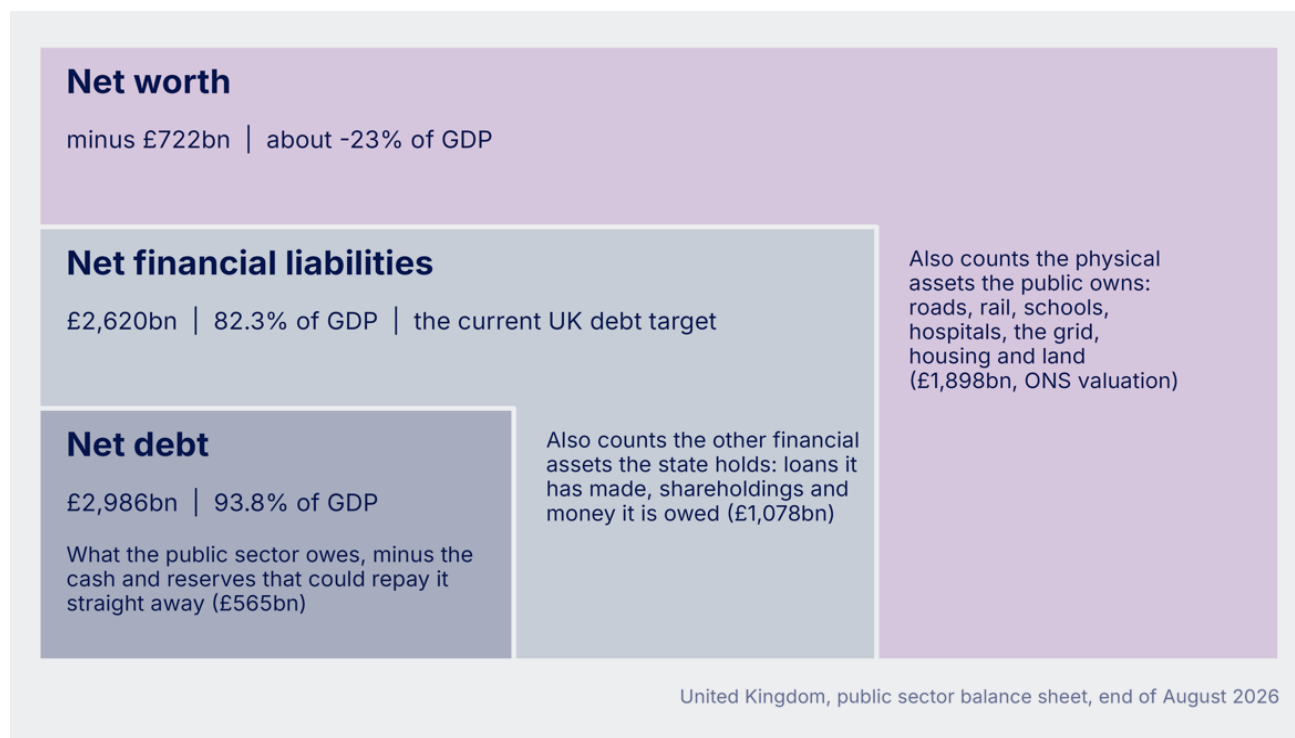
But the framework retains two important limitations. First, PSNFL recognises financial assets but not physical assets. Second, the rule is still assessed at a three-year horizon. Investments whose fiscal and economic returns materialise over longer periods therefore affect the rule before most of their benefits appear. As fiscal headroom narrowed during 2026, these features increased the tension between meeting the rule and maintaining investment.^{42,43}

The three measures tell different stories about the same balance sheet (Figure 4). At the end of August 2026, net debt stood at £2,986 billion, or 93.8 per cent of GDP; net financial liabilities at £2,620 billion, or 82.3 per cent; and net worth, which also counts the roads, railways, schools, hospitals, grid, housing and land the public owns, at minus £722 billion, about minus 23 per cent of GDP.⁴⁴

If the state borrows £1 billion to build a grid line, net financial liabilities rise by £1 billion, while net worth stays roughly the same, because the public now owns an asset worth about that much. That is why a net worth measure suits an investing state: it says whether the state is getting richer or poorer, not only how much it owes. The Office for Budget Responsibility's 2021 review reported UK public sector net worth of minus 34 per cent of GDP in 2019–20.⁴⁵ IMF economists have since proposed net worth as a fiscal anchor "more conducive to public investment and economic growth".⁴⁶

The UK case shows why reform must address both the fiscal measure and the assessment horizon.

Figure 4. Measuring the public balance sheet: net debt, net financial liabilities and net worth



Source: Office for National Statistics (ONS), Public sector finances, UK: August 2026.

04 Why fiscal space is not equal for all countries

Governments do not face the same fiscal constraints. Their room to spend depends on domestic economic conditions, but also on their access to finance and foreign exchange and their position in the international financial system. A finance minister in London or Berlin operates with very different constraints from one in Pretoria or Brasília.

4.1 The difference: currency, capital flows and multilateral rules

Governments that borrow in their own currency, with deep domestic financial markets and a central bank able to provide liquidity, have considerably more control over their financing conditions. Fiscal rules, accounting conventions and forecast horizons are largely domestic policy choices and can be changed. Most advanced economies have this degree of policy space; euro-area members occupy a different position because monetary authority is exercised at the supranational level.³⁰

The constraint is tighter for countries that depend on foreign currency financing. They must obtain the foreign exchange needed to service external debt and pay for imports, while their borrowing costs and market access are more exposed to global interest rates, capital flows and their position in the international currency hierarchy.^{13,28} Countries can face similar pressures even when they borrow in their own currency if foreign investors hold a large share of that debt: changes in global financial conditions can trigger capital outflows, currency depreciation and higher domestic borrowing costs.⁴⁷

These external constraints are real, but their severity can be influenced by policy. The currency and maturity of public debt, reliance on foreign investors, capital account regulation and the development of domestic financial markets all affect exposure to external shocks.⁴⁸ Capital account management can reduce vulnerability to volatile flows, while longer maturities and a stronger domestic investor base can make government financing less sensitive to changes in global conditions.^{13,47}

Domestic and external constraints also interact. Governments facing high or volatile external financing costs may adopt tighter fiscal rules in an effort to maintain market access, making apparently self-imposed limits partly a response to international conditions. At the same time, access to international liquidity is itself shaped by multilateral rules. The 2021 allocation of \$650 billion in Special Drawing Rights (SDRs), for example, was distributed according to IMF quotas rather than financing need, directing the largest shares to countries with the largest quotas.⁴⁹

4.2 Unequal room to act, and its cost

Table 1 sets out four sources of constraint. The pandemic showed how large these differences can be. Between 2019 and 2020, government spending as a share of GDP rose by 7.6 percentage points in advanced economies, compared with 2.5 points in emerging market and middle-income economies and 0.7 points in low-income developing countries (Figure 5).⁵⁰ Many developing countries faced rising sovereign spreads despite much smaller fiscal responses, sharply limiting their ability to respond countercyclically.¹³

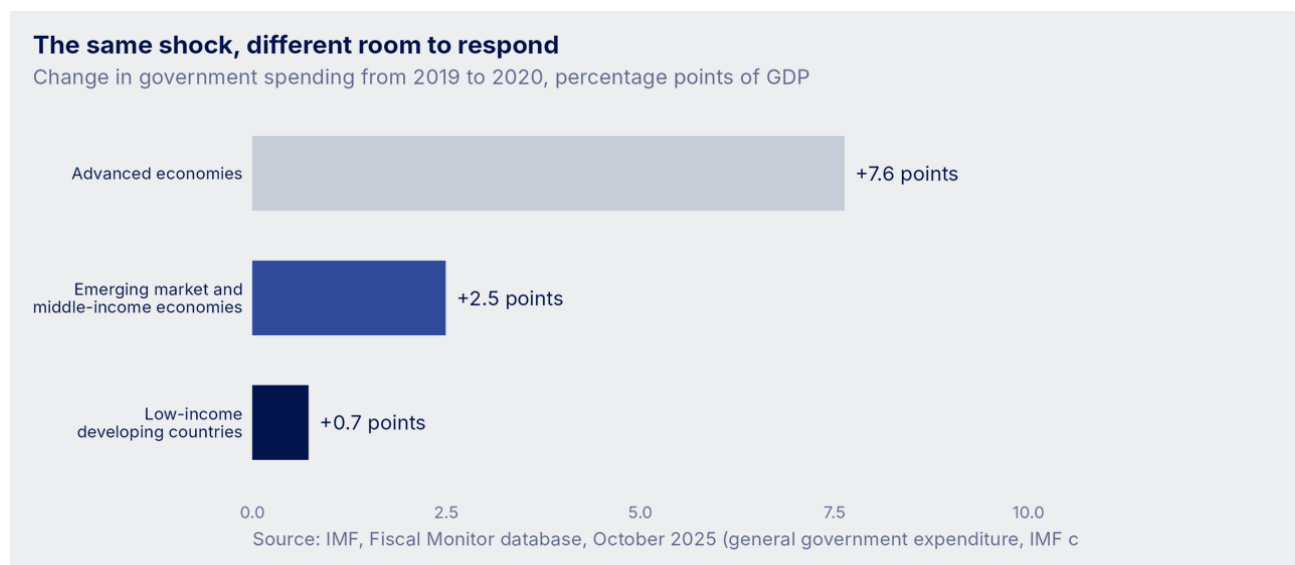
Table 1. Different sources of fiscal constraint

Source of constraint	How it works	Where it matters most	Policy response
National fiscal rules	Deficit, debt or expenditure limits can constrain spending without distinguishing its purpose or return	Countries operating numerical fiscal rules	Change the rule, measure and horizon
Supranational and international frameworks	EU fiscal rules, IMF programmes and debt sustainability assessments can constrain national fiscal choices	Euro-area members; countries borrowing through IMF programmes	Reform supranational and multilateral frameworks; protect productive and essential spending
Position in the international currency system	Reliance on foreign currency creates a need to earn or borrow foreign exchange and increases exposure to external financing conditions	Countries dependent on foreign-currency financing	Increase domestic currency financing; strengthen international and regional liquidity arrangements
Exposure to global capital flows	Foreign holdings of domestic assets and open capital accounts transmit changes in global financial conditions into exchange rates and borrowing costs	Financially open developing and emerging economies	Manage volatile capital flows; lengthen debt maturities; strengthen the domestic investor base

Source: Authors' synthesis of the analysis and policy proposals.

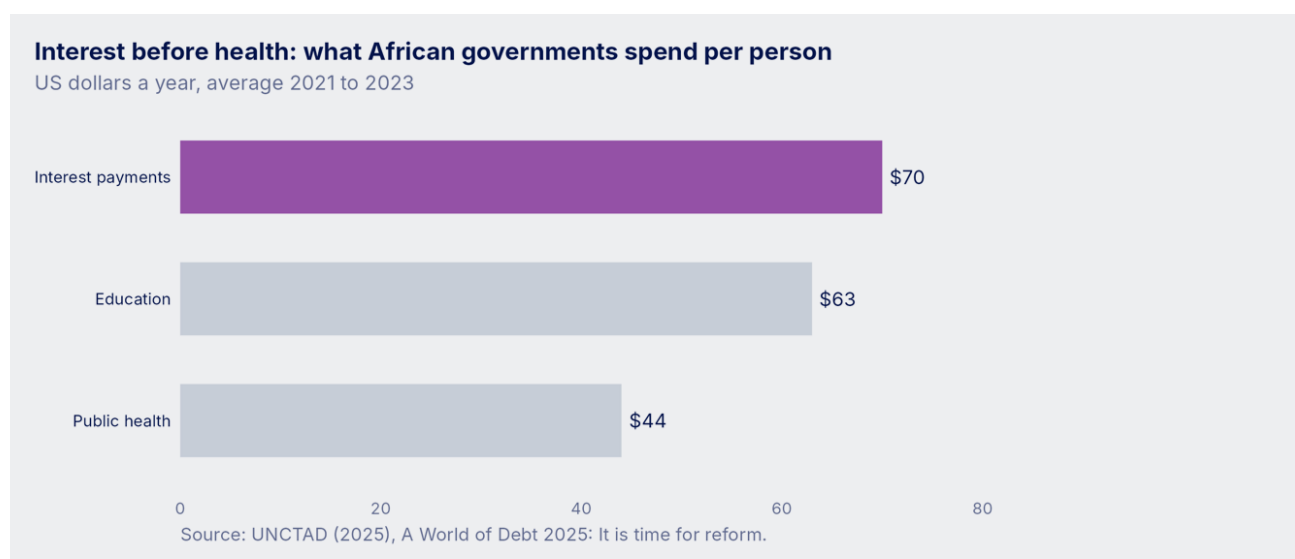
Debt servicing costs further constrain public spending. In 2024 developing countries paid a record \$921 billion in net interest; 61 of them spent 10 per cent or more of government revenue on interest, and 3.4 billion people now live in countries that spend more on interest than on health or education.⁵¹ In Africa, annual spending over 2021–2023 averaged \$70 per person on interest payments, against \$63 on education and \$44 on public health (Figure 6).⁵¹

Figure 5. Change in government spending as a share of GDP, 2019–2020



Source: IMF, Fiscal Monitor database, October 2025 (general government expenditure, IMF country group aggregates).

Figure 6. Government spending on interest, education and health in Africa, average 2021–2023



Source: UN Trade and Development (UNCTAD) (2025), A World of Debt 2025: It is time for reform.

Box 3. Brazil: protecting investment under tighter financing conditions

Brazil's 2023 fiscal framework replaced Constitutional Amendment 95 of 2016, which had imposed a twenty-year freeze on real primary federal spending, with a primary balance target and, for the first time, a floor for public investment.⁵²

But changing the fiscal rule does not remove Brazil's wider financing constraints. High domestic interest rates increase the cost of servicing public debt, while an open capital account exposes domestic financing conditions and the exchange rate to changes in global interest rates and capital flows.^{13,47}

Brazil illustrates why the source of the constraint matters. Protecting investment within the fiscal rule can prevent it from becoming the automatic adjustment variable — the first item cut to meet a short-term target — but maintaining fiscal space also requires attention to financing costs and exposure to volatile capital flows.

05 Five policy levers governments can use

Governments have significant scope to change how fiscal responsibility is defined and implemented. Where constraints are primarily domestic, the reforms below can be made nationally. Where external financing constraints bind, they remain important but need the changes to the international system set out in section 6.

Lever 1. Stabilise what matters

Fiscal rules should protect essential and productive spending through the economic cycle rather than making it the adjustment variable when revenues fall. This means judging expenditure by what it does, not simply by whether it is classified as current or capital, and protecting both public investment and the spending on health, education, care and skills that makes that investment productive.^{1,32} Countercyclical spending and social protection should also be protected when private demand falls, rather than cut precisely when they are most needed.

Lever 2. Measure what the state owns

Fiscal policy should track what the state owns as well as what it owes. Public sector net worth brings physical and financial assets onto the same balance sheet as liabilities, making it possible to see whether fiscal decisions are building or depleting public wealth.^{34,46} Governments should publish comprehensive public sector balance sheets, move towards accrual accounting and assess investments over the period in which their returns arise.

This also changes the incentives around public assets. Selling land, buildings or infrastructure may reduce measured debt in the short term, but it does not necessarily improve the public balance sheet if an asset of equivalent or greater value is lost. A net worth perspective makes that trade-off visible. The same approach should recognise the cost of inaction where postponing investment creates larger future liabilities.

Lever 3. Invest with direction

The direction of investment matters as much as its volume: public funding directed towards a clear mission, with conditions on the private partners it supports, can mobilise complementary private investment. Procurement can create demand and shape markets, while public development banks can provide patient, long-term finance where private finance is insufficient. Coordinating these tools around clear goals can strengthen demand, encourage further private investment and expand productive capacity over time.^{25,53}

Public support for private investment should also be designed to secure public value. Conditions attached to loans, guarantees, subsidies or contracts can require reinvestment, access, knowledge sharing or other outcomes appropriate to the support provided.⁵⁴

Lever 4. Align the fiscal framework with the growth strategy

A stronger revenue base is part of fiscal responsibility, but how revenue is raised matters. Progressive taxation of high incomes, wealth, capital gains and economic rents can raise revenue while reducing inequality and placing less of the burden on consumption and productive activity. Environmental taxation can also change incentives by shifting the tax burden away from labour and towards pollution and resource use.⁵³ Evidence does not support a simple trade-off between progressive taxation and growth.⁵⁵

Tax policy should therefore be considered alongside industrial, fiscal and environmental policy. A broader and fairer revenue base gives governments greater scope to strengthen the fiscal position through revenue rather than cuts to investment and essential services, while the tax system itself can help steer investment towards longer-term productive activity.

Lever 5. Manage the external constraint

For countries exposed to global financial cycles, fiscal space also depends on how the state finances itself. Capital account management can reduce exposure to volatile flows and create more room for countercyclical policy.^{13,47} Debt management can reduce vulnerability through longer maturities and greater reliance on domestic currency financing.

Governments should also develop a broader domestic investor base to reduce reliance on foreign portfolio investors and exposure to sudden capital outflows. This can make financing more stable, although it does not remove the fiscal cost of servicing debt.^{28,47}

Monetary policy is part of the same picture. High interest rates raise government debt-service costs and, where rates are used to attract or retain capital, can increase the tension between domestic financing conditions and external stability. Fiscal, monetary, capital account and debt management policies therefore need to be considered together.

Box 4. Mexico: financing an ambitious industrial strategy

Plan México depends on sustained public investment, which means the fiscal framework, revenue base and growth strategy need to pull in the same direction. However, physical public investment fell sharply from 3.2 per cent of GDP in 2024 to 2.2 per cent in 2025 as part of the fiscal adjustment.⁵⁶ GDP grew by 1.1 per cent year-on-year in the first half of 2026.⁵⁶ Moody's downgraded Mexico's sovereign rating in May 2026.⁵⁷

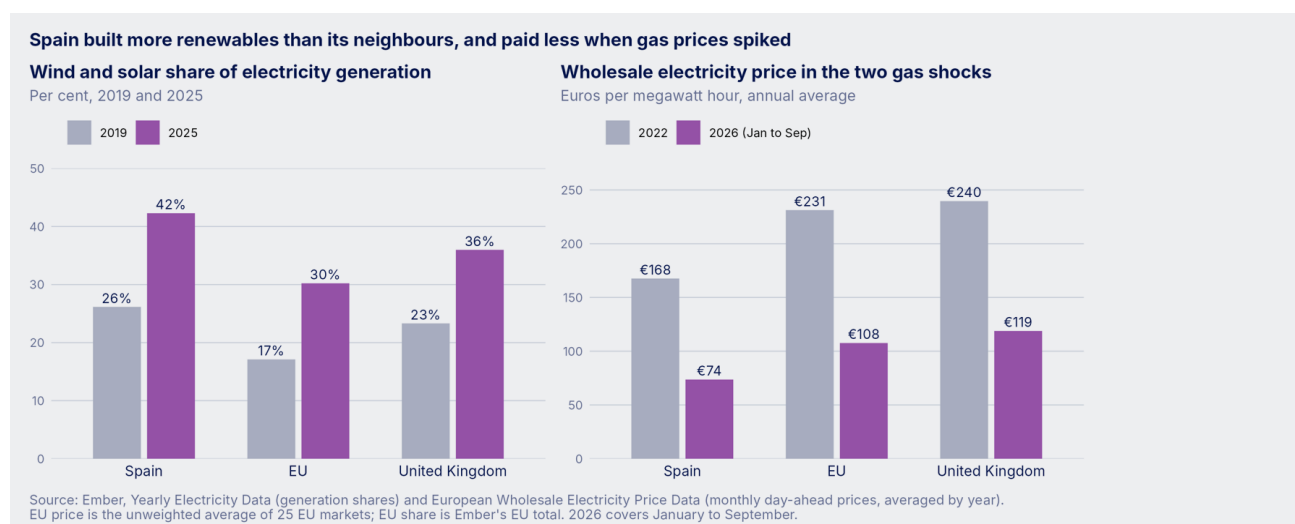
The 2027 budget partly reverses that cut, providing for physical investment of 2.6 per cent of GDP while reducing the pace of fiscal adjustment: the public sector borrowing requirement is targeted at 3.9 per cent of GDP rather than the 3.5 per cent previously planned.^{58,59} Hacienda has explicitly recognised the underlying problem, arguing that excessively rapid adjustment can weaken economic activity and productive investment, reducing revenues and worsening debt dynamics.⁶⁰

This matters because Plan México requires investment in infrastructure, water and energy alongside stronger domestic productive capacity, skills and public services. Public investment can provide the infrastructure, demand and certainty needed to mobilise complementary private investment.⁵³ Mexico's fiscal framework already recognises part of this principle: the Constitution and fiscal legislation link public borrowing to productive public investment.⁶¹

But a tension remains. IMF staff's October 2026 Article IV concluding statement raised concerns about the debt path while also highlighting infrastructure gaps, regulatory uncertainty and governance weaknesses as constraints on private investment.⁶² In Hacienda's medium-term projections, physical investment falls from 2.6 per cent of GDP in 2027 to 1.5 per cent in 2032, with investment explicitly adjusted to meet deficit targets.⁵⁶ For context, OECD general government investment averaged 3.5 per cent of GDP in 2023, although its coverage differs from Mexico's budgetary measure of physical investment.⁵⁹

The Mexican case shows why an investment-led industrial strategy cannot also make public investment the adjustment variable: cutting it can weaken activity and tax receipts.

Figure 7. Wind and solar generation and wholesale electricity prices in Spain, the EU and the United Kingdom



Source: Ember, Yearly Electricity Data; Ember, European Wholesale Electricity Price Data. EU price is the unweighted average of 25 EU markets; EU share is Ember's EU total. 2026 covers January to September.

Box 5. Spain: investing to reduce exposure to energy shocks

Public investment can also reduce dependence on volatile imported inputs and make the economy less exposed when external shocks arrive. Spain's energy investment provides an example.

Europe's dependence on imported gas made the energy shock following Russia's invasion of Ukraine particularly costly. Gas-fired generation can set the wholesale electricity price when it is the marginal source needed to meet demand, transmitting increases in gas prices into electricity prices and through the wider economy.^{63,64,65} Energy prices are therefore systemically significant: shocks can spread across the many sectors that depend on energy.⁶⁶

Spain used its recovery plan to accelerate investment in renewables, hydrogen, storage and electricity networks, alongside measures to mobilise complementary private investment.^{67,68} Wind and solar increased from 26 per cent of electricity generation in 2019 to 42 per cent in 2025, compared with 17 to 30 per cent across the EU and 23 to 36 per cent in the United Kingdom (Figure 7).⁶⁹

Spain also experienced lower average wholesale electricity prices in the periods compared. In 2022, its average price was around €168 per megawatt hour (MWh), compared with €231 across EU markets and €240 in the UK.⁷⁰ The 2022 difference cannot be attributed to renewable capacity alone: Spain and Portugal also operated the Iberian mechanism, which temporarily capped the price of gas used in electricity generation.⁷¹ In the first nine months of 2026, the corresponding figures were €74, €108 and €119.⁷⁰ By then, the Iberian mechanism was no longer in place. Greater renewable generation reduces the number of hours in which gas is needed at the margin, reducing exposure to movements in gas prices, although other factors also affect wholesale electricity prices.^{72,73}

Further investment in grids and storage can reduce the remaining exposure to gas prices by making better use of renewable generation when and where it is needed.^{68,74} The recovery plan also combined investment in energy infrastructure with training and just transition measures for workers and affected regions.⁶⁷

The fiscal value of this investment extends beyond the direct return on the assets themselves. Reducing exposure to volatile imported energy can lower the economic and fiscal costs of future supply shocks. A fiscal framework that records the initial investment cost but not the value of greater resilience misses part of that return.

06 Increasing fiscal space through international reforms

Domestic reforms can widen policy space, but countries cannot address external financing constraints alone. Access to international liquidity and long-term finance, the terms of debt resolution and many of the rules governing adjustment are set internationally. Reform at this level would therefore make the domestic levers in section 5 more effective, particularly for countries that do not borrow in an international reserve currency.

Lending programmes that protect investment. IMF programmes can reinforce fiscal constraints when adjustment targets underestimate the effects of spending cuts or when public investment bears the adjustment. Debt sustainability assessments can create a similar problem when they account for the debt incurred but not adequately for how productive investment affects future growth and revenues.^{12,16,75} Programme design should use realistic fiscal multipliers, protect productive investment, align conditionality with national investment strategies and recognise capital account management as a legitimate policy tool. Debt sustainability analysis and Article IV surveillance should also make greater use of public balance sheets and the growth effects of investment alongside conventional debt indicators.

Fiscal rules that create space for investment. The EU framework should allow greater space for productive public investment within national fiscal plans. This could include accommodating time-limited investment

programmes within net expenditure paths, treating the deficit and debt reference values as safeguards rather than policy targets, and developing a common European investment capacity alongside national spending.⁷⁶

Liquidity, debt resolution and long-term finance. Countries need access to liquidity before external shocks become debt crises, and timely resolution when debts become unsustainable. More regular and needs-based SDR allocations, stronger regional liquidity arrangements and earlier and more comprehensive debt restructuring would reduce the need for prolonged adjustment during crises.^{49,77} Multilateral development banks can complement this by providing long-term finance for national investment strategies, including through national development banks. Their contribution should be assessed by the additional investment and development outcomes they enable, not only by the volume of private finance they mobilise.⁷⁸

International cooperation on revenue. Countries' ability to strengthen their domestic revenue base also depends on international rules. Cooperation on corporate taxation, taxation of high-net-worth individuals and measures to curb illicit financial flows can reduce revenue losses and increase the resources available for public investment and essential services.

Stability when shocks hit. International cooperation can also reduce the scale of external shocks before they reach national budgets. Energy and food prices are systemically significant: large increases can spread across the economy, raising inflation and generating fiscal pressures.^{64,79} International and regional arrangements such as buffer stocks and coordinated stabilisation measures can help limit price shocks, while emergency liquidity can ease their financing consequences. Acting early can preserve fiscal space and reduce the need for adjustment after a shock.

07 Fiscal responsibility means investing for the future

Fiscal responsibility should create the foundations for long-term, inclusive and sustainable growth. That requires investment in productive capacity, people and resilience, and a fiscal framework that recognises the returns those investments generate over time.

The evidence in this brief shows why the conventional focus on deficits and debt is too narrow. Cutting spending in a weak economy can make debt harder to reduce. Rules focused on a single aggregate can make investment the first thing cut. Short horizons record costs before returns, while debt measures can record what governments owe without recording what they own. And the same rules operate very differently across countries because access to finance, foreign exchange and international liquidity is profoundly unequal.

A more responsible framework would protect productive and essential spending through the cycle, measure public wealth alongside debt, assess investment over the period in which its returns arise, and align fiscal policy with the wider growth strategy. It would also recognise that domestic reform can only go so far where constraints are imposed through the international financial system.

Redefining fiscal responsibility is therefore not about spending without limits. It is about judging public finances by what they build: whether they expand productive capacity, strengthen resilience and create the conditions for sustained prosperity and sound public finances over time.

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TOWARDS A COMMON GOOD ECONOMY