



A Reply to Professor Alfredo Paloyo

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Professor Alfred Paloyo (Paloyo hereafter) wrote a critical reply to the initial paper by Felipe, Largoza, and Sauler, on the Philippine corruption scandal. We have several points to make in response to Professor Paloyo's comments.

Professor Paloyo misrepresents the Felipe, Largoza, and Sauler (FLS) position on corruption, which was that the corruption scandal does not preclude the Philippines from engaging in policies to promote growth. They were not attempting to argue that persistent corruption would do no harm to the environment for private investment. They cite evidence of large scandals not creating economic collapse—this is not inconsistent with the papers Paloyo cites, but rather makes a different argument. The main paper Paloyo discusses, Mauro (1995), is specifically about persistently corrupt environments across regimes—again, a different point from that FLS made, not to mention that it is from 30 years ago (is there no newer, seminal evidence available?). And, of course, FLS are arguing that the corruption related to this scandal has negatively impacted the Philippines course to this point—projects not built, and so forth.

Paloyo acknowledges the operational details laid out by FLS are correct. But if we all agree that this is the true reality for government spending and taxes, why do FLS and Paloyo propose different frameworks for

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understanding macroeconomic policy? The reason is that the neoclassical framework that Paloyo prefers claims that incorporating correct understanding of how things work operationally into policy strategy will lead to doom. Under this view policy makers, the public, the voters, authoritarians ... all of the above ... will destroy the economy if they begin the policy design process from the point of view of a correct operational understanding. So, to make sure nobody will ever “bite the apple,” the neoclassical framework, and the textbooks the framework’s authors write for millions of economics students, pretend that the apple does not exist.

If somebody does come to understand that “the apple exists,” the neoclassical response is to invoke fear (of economic consequences like hyper-inflation), pass the knowledge off as irrelevant (“pay no attention to the man behind the curtain”), or use guilt by association. Paloyo is no exception here, as he unsurprisingly invokes all three.

He first uses guilt by association, accusing FLS of being MMTers (i.e., followers of Modern Money Theory – MMT) while at the same time he offers no critique of the details of FLS’s explanation of monetary operations. His critique of MMT appears to be that the standard neoclassical literature on debt sustainability (he cites several canonical papers) have “carefully examined and largely rejected on both theoretical and empirical grounds” the “older chartalist and functional finance traditions” that MMT economists frequently cite favorably. We are familiar with the neoclassical papers he cites, but we can find no discussion in them of these MMT-preferred literatures.

The core result from the “chartalist” literature—that governments can in fact create their own currency (and create a demand for it by imposing taxes payable in this currency), thereby not requiring taxes or bond sales to finance spending, in fact, Professor Paloyo already admits multiple times is at least operationally accurate. While this neoclassical literature argues against primary deficits without regard to macroeconomic implications—i.e., ignoring intertemporal budget “constraints” and/or the inflationary impact—the fact is that neither the chartalist nor the functional finance positions argue for this, either.

The functional finance literature, in particular, is inherently in opposition to the sort of policy strategies this neoclassical literature finds fault with. Indeed, it is the functional finance strategy—to bind the government deficit to outcomes like an inflation target rather than to a debt ratio value—that

is within the MMT literature the framework for implementing the operational, tactical reality that Chartalism reveals. The latter is not itself a policy strategy, but is instead an explanation of how spending and taxes “work” operationally in the real world—it is not a “proposal” and certainly not a policy strategy for how to organize budget and debt positions. It is not something a mathematical model could prove or disprove, while we already have numerous instances of historical and legal research confirming its existence in the real world across centuries and even millennia.

Paloyo argues, within the context of the neoclassical literature he cites, that the constraints on government are inflation and an intertemporally sustainable debt ratio. (This is where he invokes the irrelevance of knowing that “the apple” exists.) We agree with the former— inflation and, more generally, real resources are the appropriate constraints on the government’s budget. The latter turns out to be in fact redundant under a functional finance fiscal strategy, since such a strategy would call for a smaller primary fiscal deficit (or a larger primary fiscal surplus, depending on the circumstances) if inflation were above (or projected to be above) its target. In other words, stabilizing the debt ratio such that the debt-service ratio does not rise unsustainably (which is the purpose of debt ratio stabilization in the neoclassical literature), and is consistent with the inflation target, is “built-in” to the functional finance strategy.²

Paloyo attempts to make the neoclassical intertemporal budget constraint framework appear so rational, so reasonable, and so consistent with development, when in practice it has been used so often in irrational, unreasonable ways that have frequently stunted growth and made existing recessions worse in many countries.

Where is the analysis that says when a nation can raise its debt ratio safely from, say, 30% to 35% or from 50% to 55%? Can they? Have any of them,

² In Paloyo’s presentation of the government’s intertemporal budget constraint, and its present value, he claims that it is accounting, not theory and not ideology. For sure, the intertemporal budget constraint is certainly an accounting *identity* (and therefore, not a “constraint” other than to say that the equality must always hold), and taking its present value is simply a mathematical operation (and can be a convenient way to show the evolution of the identity through time with different assumptions). However, to claim as the neoclassical literature does that this present value, once taken, holds significance for agents’ behavior in, say, government bond markets, is *undeniably* a theoretical statement.

ever? (The answer is “Yes” because literally dozens have done this, and much more, sometimes for very good reasons like ensuring basic income and public services during the COVID pandemic.) Meanwhile, Paloyo uses the worst, most extreme theoretical examples against MMT – theoretical, because there are no real-world examples of nations issuing debt in their own currency having to default, their economies collapsing, simply for pursuing full employment policies.³

There is no theoretical grounding for selecting one size of debt ratio over another in the neoclassical framework. Literally any debt ratio, provided that it is intertemporally stable, sustainable. The caveat is that whether a nation is currently on such a path can change as the difference between the interest rate and growth rate change, since the size of the primary surplus necessary to stabilize the government debt service ratio will be affected. The only way to be sure that the current path is sustainable and avoids fiscal dominance (that is, the debt ratio growing without bound to conflict with monetary policy tightening goals) if the central bank embarks on a tightening path, is for the government debt ratio to remain small.⁴

Hence, rather than being the reasonable framework Paloyo and others present, it is instead used to justify tight fiscal rules such as in the Maastricht criteria, used to justify efforts to gut the social safety net, and used by the IMF and other international institutions to require smaller deficits in exchange for aid, loans, and so forth. In a very real sense, the framework is used to ensure that the “reasonable view” Paloyo presents for enabling more growth in developing nations never actually is recommended by IMF or other important institutions in the international financial architecture.

We appreciate that Paloyo included in his paper a simple, stylized macroeconomic model to illustrate his arguments. While it is simple and stylized, it is not different in important ways from the standard models that macroeconomists regularly use – note that it does not include banks

³ Every example of defaulting on the domestic currency in the last 60+ years according to the Bank of England and Bank of Canada database on government debt default involves war (from outside or from within), productive collapse for some other reason, and so forth, or international institutions like the IMF requiring default on domestic debt as part of the conditions for receiving its support to help with foreign currency debts.

⁴ Of course, the functional finance strategy would also avoid the unsustainable path of the debt service ratio, as we explained above.

and does not even include private debt. It was a lack of understanding of private debt that led the entire profession of neoclassical economists to famously miss the build-up of the largest household debt bubble of all time in the 2000s, while simultaneously labeling the period as “the Great Moderation.” The inherent interaction of government and private sector financial positions in real-world accounting and accounts is nowhere to be found in Paloyo or the literature he favorably cites. The fact of the matter is that growth must be financed, and without a sizeable current account surplus in the Philippines, this is left to either the private or government sectors.

Because the neoclassical literature and its models ignore private financial positions, they do not recognize or understand why a fiscal partner (itself tied to an inflation target in a functional finance strategy) in macroeconomic policy is necessary. If private finance is modest and sustainable, then manipulating the economy with the central bank’s interest rate target can work fine. But if private sector debts are too high, raising interest rates to slow the economy can push the sector to fragility and instability. Cutting interest rates to exit recession may not be enough or even appropriate for a private sector that needs to deleverage more.

Neoclassicals, finally, at least now acknowledge the need for fiscal policy when the central bank’s interest rate target touches zero (the so-called “zero lower bound” or “ZLB”), but the reason why the central bank has the interest rate so low is found within the private sector’s financial positions that the neoclassical models ignore. And the need for fiscal action lies in the fact that a government deficit is a non-government sector surplus and that a government deficit creates saving for the non-government sector—this is accounting, not theory—which is similarly ignored. The accounting fact that fiscal stimulus and monetary stimulus have the direct opposite effects on private sector financial positions (fiscal stimulus comes from more private disposable income; monetary stimulus comes from more private borrowing at lower interest rates) should be integral to any discussion of the macroeconomic policy mix, but again standard neoclassical models ignore private financial positions.

We agree with Paloyo that the key issue for the Philippines is that it is a small, open economy with significant vulnerabilities. However, the standard neoclassical framework on debt sustainability he presents has for decades been a straitjacket for many developing countries trying to grow

faster, provide improved services and infrastructure, and become more complex, while the international governance organizations frequently use it to punish. For the most part, only those countries that somehow generate large current account surpluses can escape because they can then avoid burdening the private sector with financing growth while the neoclassical views on debt sustainability frown on government financing. The Philippines' vulnerabilities require significant investments. Building a more complex economy that can export higher value-added products requires significant investments. Who can bear this financial burden if the country does not enjoy a large current account surplus, particularly one built on higher value-added goods and services? This is a serious question that deserves a serious answer, not a framework that ignores the private sector's financial positions and also inherently returns the answer "no!" if the debt ratio rises 5 or 10 percentage points.