

Fiscal adjustments: lessons from recent history¹

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1) Introduction

In the aftermath of the Great Recession, many OECD countries now need to reduce large public sector deficits and debts.

This is not the first time that the “world” faces this problem. It happened in an even more dramatic fashion in the past century after the first and second world wars. In the first case, several episodes of large inflation (e.g. France) or hyperinflation (e.g. Austria Germany Hungary) wiped out the debts partly or completely, and in other cases (e.g. England and the US) the debt to GDP ratio did not decline as much and it increased dramatically with the Great Depression. The experience after the Second World War was less painful. Many countries grew out of their debts relatively painlessly and by the late sixties, debt to GDP ratios had generally come down to manageable levels.²

These two historical experiences do not offer much guidance for today. Large inflations, let alone hyperinflations, are (fortunately) unlikely to be repeated; too much has been learned about their evils. Fast and sustained growth is (unfortunately) not the most likely outcome in the short run; at least these are not the most commonly accepted forecasts. Thus, deficits will not come down and debts will not stop growing without discretionary fiscal tightening. In this respect, the evidence drawn from several episodes of fiscal adjustments in the late eighties and nineties (following the recessions and the large increase in public spending of the seventies and early eighties) is a more useful benchmark.

The conventional wisdom about the political economy of fiscal adjustments goes more or less as follows. Deficit reduction policies cause recessions which (in addition to the direct political costs of tax increases and spending cuts) create political problems for incumbent governments. The latter therefore see fiscal adjustments as the kiss of death. They postpone them and when they implement them then they pay at the polls. In fact many governments do the opposite, namely, they try to increase deficits to win elections. Thus we should expect more fiscally “loose” governments to stay in office longer and fiscally prudent one to be voted out of office.

² See Alesina (1988) for a discussion of several post war episodes of large debt reductions.

This view, which is a combination of textbook Keynesianism with “conventional” notions of naive voters’ behavior, is largely imprecise to say the least. If it were true, we would face a dark near future. We would observe governments postponing hard medicines and when they eventually come in the form of tight fiscal policies, they will induce recessions and political losses of good incumbents. We would then have a sort of so called W recovery associated with political turmoil with losses for fiscally responsible governments.

Fortunately the accumulated evidence paints a different picture. First of all, not all fiscal adjustments cause recessions. Many even sharp reductions of budget deficits have been accompanied and immediately followed by sustained growth rather than recessions even in the very short run. These are the adjustments which have occurred on the spending side and have been large, credible and decisive. Second and this is most likely a consequence of the first point, it is far from automatic that governments which have reduced deficits have been routinely not reappointed. Governments which have initiated thorough and successful fiscal adjustment policies have not systematically suffered at the polls. This has been especially the case when the electorate has perceived the sense of urgency of a crisis or in some cases in the presence of an external commitment. On the contrary fiscally loose governments have suffered losses at the polls

Thus, according to recent evidence there could be reasons to be less pessimistic than what the conventional wisdom sketched above would imply. However, the problem is that that wisdom is so “conventional” that it is often difficult to convince politicians and their economic advisors that it may be “conventional” but untrue. In addition it takes some decision to overcome various “blocks” to fiscal adjustments and not all governments have the capacity and political will to do so. Thus relatively painless (economically and politically) fiscal adjustments might be possible; whether government will take the opportunity remains to be seen

This short paper is organized as follows: Section 2 discusses the evidence on the effects of fiscal adjustments on growth in the short run. Section 3 investigates the effects of fiscal adjustment on the popularity of governments and their prospects for reappointment. Section 4 discusses when and under what circumstances governments will initiate fiscal adjustments, presumably because it is more politically advantageous to do so. Section 5) discusses

whether or not fiscal rules may help the adjustment process and enforce fiscal sustainability. The last section concludes.

2) Do fiscal adjustments always cause recessions?

The answer to this question is a loud no. Starting from the early nineties, several authors have noted how large and decisive deficit reduction policies in several European countries were accompanied by increases in growth, the opposite of the standard Keynesian story.³ How can that happen?

Theoretically, expansionary effects of fiscal adjustments can go through both the demand and the supply side. On the demand side, a fiscal adjustment may be expansionary if agents believe that the fiscal tightening generates a change in regime that "eliminates the need for larger, maybe much more disruptive adjustments in the future" (Blanchard (1990)).⁴ Current increases in taxes and/or spending cuts perceived as permanent, by removing the danger of sharper and more costly fiscal adjustments in the future, generate a positive wealth effect. An additional channel through which current fiscal policy can influence the economy via its effect on agents' expectations is the interest rate. If agents believe that the stabilization is credible and avoids a default on government debt, they can ask for a lower premium on government bonds. Private demand components sensitive to the real interest rate can increase if the reduction in the interest rate paid on government bonds leads to a reduction in the real interest rate charged to consumers and firms.⁵ The decrease in interest rate can also lead to the appreciation of stocks and bonds, increasing agents' financial wealth, and triggering a consumption/investment boom. On the supply side, expansionary effects of fiscal adjustments work via the labor market and via the effect that tax increases and/or spending cuts have on the individual labor supply in a neoclassical model, and on the unions' fall-back position in imperfectly competitive labor markets.⁶

³ Giavazzi and Pagano (1990) were the first to argue that fiscal adjustments (deficit reductions) large, decisive and on the spending side could be expansionary. This was the case of Ireland and Denmark in the eighties which were the episodes studied by Giavazzi and Pagano (1990), but there were others as then discussed and analyzed by Alesina and Ardagna (1998). There is quite a rich literature that studies the determinants and economic outcomes of large fiscal adjustments. A non exhaustive-list includes Ardagna (2004), Giavazzi, Jappelli and Pagano (2000), Hughes and McAdam (1999), Perotti (1999), McDermott and Wescott (1996), Von Hagen and Strauch (2001), Von Hagen, Hughes, and Strauch (2002).

⁴ For models that highlight this channel, see Bertola and Drazen (1993) and Sutherland (1997).

⁵ See Alesina et al (2002) on the effects of government spending on private investment.

⁶ See Alesina and Ardagna (1998) and Alesina et al (2000) for a review of the literature.

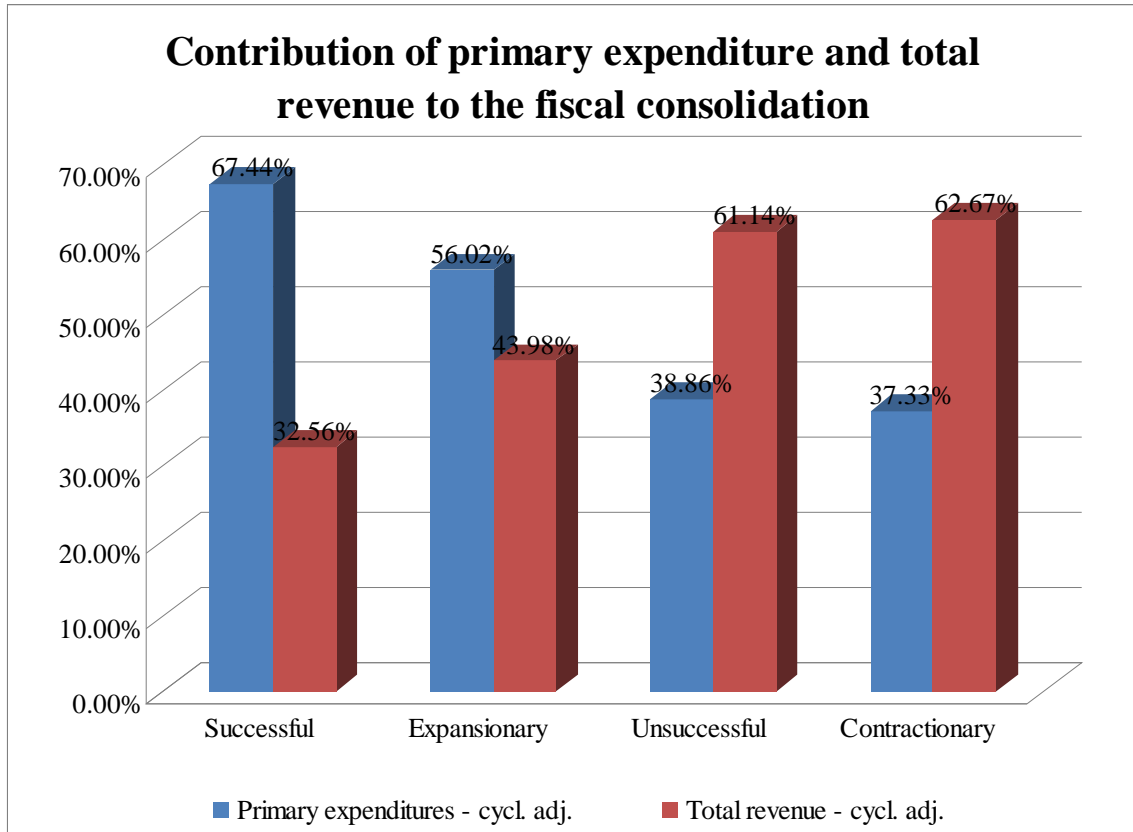
Empirically a recent paper by Alesina and Ardagna (2010) has investigated the evidence on “large” fiscal consolidations on a sample of virtually all OECD countries from roughly 1980 onward.⁷ They define a period of fiscal adjustment as a year in which the cyclically adjusted primary balance improves by at least 1.5 per cent of GDP. This definition selects 107 periods of fiscal adjustments. Of these, 65 last only for one year, while the rest are multi period adjustments.

The critical question is whether they are associated with an expansion in economic activity during and in their immediate aftermath and whether they are associated with a reduction in the public debt-to-GDP ratio. These authors define an episode of fiscal adjustment as “expansionary” if the average growth rate of GDP, in difference from the G7 average (weighted by GDP weights), in the first period of the episode and in the two years after is greater than the value of 75th percentile of the same variable empirical density in all episodes of fiscal adjustments. They define a period of fiscal adjustment as successful if the cumulative reduction of the debt to GDP ratio three years after the beginning of a fiscal adjustment is greater than 4.5 percentage points (the value of 25th percentile of the change of the debt-to-GDP ratio empirical density in all episodes of fiscal adjustments).

The results are strong and fully confirm those obtained in earlier samples from previous research. Spending cuts are much more effective than tax increases in stabilizing the debt and avoiding economic downturns. In fact, in several episodes, spending cuts adopted to reduce deficits have been associated with economic expansions rather than recessions. The results are very robust and they do not change significantly as result of small changes of the definitions. Table 1, adapted from Alesina and Ardagna (2010) briefly summarizes the results. Each pair of columns represents the share of the fiscal adjustment (i.e. reduction of primary deficit) arising from spending cuts or tax increases as a share of GDP as an average of all fiscal adjustments in the sample. In the case of successful fiscal adjustments about 70 per cent of it came from spending cuts and in the case of expansionary almost 60 per cent. Instead in the case of unsuccessful and contractionary more than 60 per cent of the adjustment was on the tax side.

⁷ This paper also summarizes the previous related evidence on the same point. The exact sample dates depend on data availability.

Table 1



One of the most striking results of Alesina and Ardagna (2010) is that fiscal adjustments on the spending side are almost as likely to be associated with high growth (i.e. a successful episode) than fiscal expansions on the spending side, where fiscal expansion are defined in a reverse way relative to fiscal adjustments, (namely an increase of primary budget deficits by at least 1.5 per cent in a year.) These results are fully consistent with recent (and more econometrically sophisticated) research which shows that “spending multipliers” are low and most likely less than one.⁸ Additional research along similar lines⁹ suggests that (perhaps unsurprisingly) not the spending cuts which have led to sharper and more permanent debt/GDP ratio reductions are those which have stopped the growth of entitlements and government wages.

3) The political consequences of fiscal adjustments

What happens to governments which engage in the kind of fiscal adjustments of large size such as those examined in the previous paragraph?

This is the question addressed by Alesina, Perotti and Tavares (1998) using the evidence from OECD countries. Contrary to the conventional wisdom these authors do not find that that governments which reduce deficits drastically and systematically lose, either in terms of losing popularity or in terms of losing the next election.

The definition of “losing” politically depends on the nature of the political systems. The authors investigate various alternative definitions of government “changes”, from a change in the identity of the Prime Minister, to changes in the coalition running the government, to loss of a majority. They do not find any systematic relationship between the occurrence of large reduction of budget deficits and electoral success of the government. These authors also find some evidence that the popularity of the governments react more positively to fiscal adjustments on the spending side, possibly because of an average they associate with lower, or no costs in terms of output loss.

⁸ See Blanchard and Perotti (2002) and Ramey (2009) amongst others. Romer and Romer (2007) find very strong effects of tax changes on output but do not investigate the effects of spending.

⁹ See for instance Alesina and Ardagna (1998)

Research in progress which updates those results to the most recent available data confirms the previous result: it is impossible to find systematic evidence of predictable political losses following fiscal adjustments.

Note that if fiscal contractions were politically costly, then fiscal expansions should be politically rewarding, particularly close to election times. This is indeed the argument put forward by the political business (and budget) cycle literature.¹⁰ What does the evidence say? Brender and Drazen (2005, 2007) show convincingly that political budget cycles exist only in "new democracies"; they argue that in more experienced democracies voters punish those politicians who opportunistically manipulate fiscal policy to be reelected. In other words, there is no evidence that in established democracies, governments successfully use budget cycles as a strategic electoral tool.

Thus, while strongly held, the view that governments which follow loose fiscal policies are rewarded by voters does not survive a careful statistical analysis.

4) When do governments adjust?

If it is the case that certain types of fiscal adjustments are not necessarily costly in terms of lost output or lost votes, why are they often delayed and politicians often appear as very reluctant to implement them?

I can think of two related reasons. The first one is that "vote-counting" is not the only political factor at play. Certain constituencies may be able to "block" adjustments because they have enough political energy (time, organization, money). This is sometimes referred to as an issue of diffuse benefits and concentrated costs. Fiscal adjustments which fix budget problems are beneficial for the country as a whole but certain groups (perhaps privileged by past fiscal favors) may have to pay a higher share of the costs and they are especially vocal. Which constituency may be more vocal depends on the country. In some cases strikes of (often overpaid and overstaffed) public sector employees may create serious disruptions. In other cases pensioners have a lot of time on their hands, and may be well organized within the union movement, so as to persuade politicians not to

¹⁰ See Alesina and Stella (2010) for a recent review of this literature.

touch pension systems. Lobbyists of certain protected sectors may be especially willing to pay campaign contributions. Tax evaders may cripple the tax collection systems. Interestingly, the rhetoric that some of these groups use is that of the recession threat of a fiscal tightening. Thus textbook Keynesian rhetoric about the evil of any spending cuts is often a good selling point for the protection of certain groups whose income depends on government wages, subsidies or pensions. It is common to hear, say, public employees appealing to the risk of recessions caused by budget cuts as a selling point to defend their members' salaries.

A second and related problem is what Alesina and Drazen (1990) modeled as a "war of attrition" political game. Political conflicts over the allocation of costs of the, say, budget cuts or tax increases lead to a stalemate that requires time to be resolved. Postponing an adjustment may be costly but all sides hope to be able to shield themselves from such costs and the "war" continues until one side gives in. Thus more polarized political systems and fractionalized societies where "deals" and compromises are more difficult to be reached quickly should have a harder time to stabilize. Another implication is that a political consolidation of a stable and secure cohesive majority may be a precondition for a fiscal consolidation. Finally, this model is consistent with the "crisis hypothesis," namely that the idea that a sharp deterioration of the economic situation may lead to reforms, in this case a fiscal consolidation simply because it becomes too costly to continue to postpone and not agree.

So, when do fiscal adjustments normally occur? This is a question empirically taken up by Alesina, Ardagna and Trebbi (2006). They use the war of attrition model as a starting point and consider fiscal adjustments in both OECD and developing countries.

First of all they find support for the crisis hypothesis, namely that a crisis stimulates an impetus for reforms. Obviously one has to be careful about a dose of tautology here: reforms in general and fiscal in particular are unnecessary when everything is going well, conversely they "have" to occur when a crisis hit. But nevertheless it does appear that a long prolonged malaise is more difficult to be cured than a sharp deterioration of a disease. In addition, and perhaps more interestingly, Alesina et al (2006) examine under which political conditions a crisis is more likely to lead to

stabilization. Stabilizations are more likely to occur when a crisis hits and with a “strong” government in office, a government which can overrule political opposition to policy changes and act decisively. For instance, stabilizations are more successful and easier to come by in presidential systems, in systems in which the executive faces fewer institutional veto points, in periods of unified government in which the same party holds the executive and the legislature, and in systems in which the majority of the ruling party (or parties) is large. These authors also find that a stabilization is more likely to occur immediately after an election, presumably when the new government enjoys a mandate and when new elections are a long time away. External inducements to stabilization sometimes work, sometimes they do not. The effect of IMF conditionality is mixed.

One major impediment to large fiscal adjustment is that the public might believe that they imply large social costs for the disadvantaged. The answer that fiscal adjustments do not need to interfere with social programs, pensions, transfers is weak. The share of public spending that goes towards such program is simply too large to be unaffected and, in addition, the internal dynamics of the programs and the demographic of some of them often makes it impossible to adjust without touching them.

Does this mean that fiscal adjustments need to have large social costs? Not necessarily. Table 2 shows that the degree of efficiency of welfare states varies greatly. This table for Eurostat shows the proportion of family taken away from the risk of poverty from existing welfare states. Some social safety nets are expensive but very effective (northern European countries). Some are somewhat less expensive but much less effective (Southern European countries). The latter are also those countries with more serious fiscal problems. In these countries fiscal adjustments accompanied by welfare reforms which improves on the efficiency and the targeting of safety nets can achieve both fiscal sustainability and an even better protection of the truly disadvantaged.

Even in countries with more well functioning welfare systems the size of fiscal adjustment required to achieve improved sustainability can be achieved without affecting the welfare of the poor.

In summary the rhetoric about immense social cost of fiscal adjustment is blown out of proportion and it is often used strategically by certain groups, not necessarily the most disadvantaged, to protect themselves.

5) Fiscal rules and delegation

Can fiscal rules help achieve fiscal stability?¹¹ Let's begin with rules which state a limit on deficits

- a) These rules are effective only when a credible punishment for non compliance is in place. An example of at least partially working rules was those adopted as a prerequisite to enter the monetary union in Europe. The credible punishment was exclusion from the union. When the risk of exclusion was real those rule certainly helped and had an effect. After that, when the ins were in, they became virtually unenforceable and the Growth and Stability Pact was soon broken by several countries. Generally speaking it is rare that credible rules can be imposed from outside on sovereign countries and the credibility of outside rules is rare.
- b) Self imposed rules or outside rules without a credible punishment can help well intentioned governments to achieve fiscal sustainability. Such governments can appeal to these rules to strengthen their resolve against opponent of fiscal tightening. However these rules will have virtually no bite without the resolve of the government. Thus without a political will rules have no bite
- c) One unintended consequence of these rules is that they may generate incentives for creative accounting i.e. for artificially achieving the target. The problem is not so much that a, say 4 per cent deficit appears as a 3 per cent one using hidden corners of the budget. The problem is that reducing transparency in the budget process may have medium term substantially negative consequences in terms of budget control.
- d) While the evidence on budget rule for national government is mixed as best, the evidence for budget rules for sub national levels of government is more encouraging. In this case the credibility of such rules comes from the enforcement of national governments.¹²

¹¹ The book of collected essays edited by Poterba and Von Hagen (1999) is an excellent source for a review of several issues of budge rules and budget institutions.

¹² See Poterba (1995) for work on the states in the US.

In addition to numerical rules on deficits there have been long discussions about procedural rules. My view is that probably the most important one is transparency in the budget and in budget documents. Transparency makes it more difficult for pressure groups to hide wasteful programs. A counterargument sometime used is that a certain lack of transparency may help policymakers achieving behind the scene deals. When politicians are well intentioned these deals may in fact help, but otherwise they are very deleterious. On balance in the long run transparency is a better recipe for financial sustainability.

Two other procedural rules have been discussed in the literature. One is a rule such that at the beginning of the budget discussion a bottom line written in stone for the deficit is set in advance in order to anchor the parliamentary debate. A second rule is to limit the number and type of amendments admissible in Parliament giving more authority to the agenda setter, namely the government and specifically the Finance Minister. These two rules may help but of course one needs to evaluate from the point of view of democratic theory, of “checks and balances” and avoidance of a dictatorship of the majority. In certain countries however the risk is the opposite, namely of an excessive attempt at broad consensus rather than government by majority rules.

Finally there is the question of delegation of certain aspect of fiscal policy to independent agencies. Independent monetary authorities who set monetary policy are now rather common around the world and certainly the ECB and the FED enjoy large degree of policy intendance. Fiscal policy is instead highly politically controlled and independent agencies have virtually no role in setting targets for fiscal policy. Why such stark difference? ¹³ Politicians prefer not delegate redistributive policies. The reason is that they are critical to build minimum winning coalition amongst voters. Packaging redistributive flows from income groups to income groups, regions to regions, lobbies to lobbies is what politics is mostly about. This is a reason while fiscal policy is virtually never delegated to independent agencies even though it is plagued by time inconsistency problems just as much, if not more than monetary

¹³ This issue has been recently studied by Alesina and Tabellini (2007, 2008)

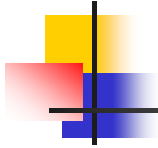
policy¹⁴. To be sure monetary policy has redistributive aspects as well. But these redistributive flows are less clear and direct than those caused by fiscal policy such as, for instance, an increase in the progressivity of the income tax or a tax or subsidies for this or that sector or this or that income group. For these reasons politicians may be more willing to grant independence to Central Bank more than they would with an independent Treasury.

A similar argument applies to delegation to supranational authorities. National governments in the Euro area have delegated monetary policy to a supranational entity, the ECB, but have been very reluctant to delegate aspects of fiscal policy. As discussed above the Growth and Stability Pact was extensively violated even before the crisis (deficit emerging during the crisis are not a violation of the pact). But in addition regardless of whether it was necessary or not, coordination of fiscal policy in response to the crisis has proven to be non-existent. Fiscal policy remains a fully national policy and I do not expect this to change anytime soon.

¹⁴ See Blinder (1997) for arguments in favor of the social optimality of delegation of certain aspects of fiscal policy and, along similar lines, Council of Australia (1999).

Table 2

Expensive but ineffective welfare systems



per cent of households at risk of poverty *before* and *after* social transfers (2003)

	before	after
Sweden	29	11
Finland	28	11
Holland	22	12
Denmark	32	12

	before	after
Germany	24	16
France	26	12
Belgium	29	16
Italy	22	19
Spain	22	19
Greece	24	21
U.K.	26	18

Source: Eurostat

Conclusions

Fiscal adjustments, even large ones, which reduce budget deficits, can be successful in reducing relatively quickly debt over GDP ratios without causing recessions. Fiscal adjustments based upon spending cuts are those with, by far, the highest chance of success. Politicians are typically reluctant and often delay the adoption of restrictive fiscal policies making the adjustment even more costly.

Fiscal adjustments do not need to have large social cost if they are accompanied by welfare reforms when needed. Fiscal rules can moderately help well intended governments but one should not place too much faith in them. Without a political will to engage in fiscally sustainable policy there is virtually no rule which can induce an unwilling government do to so. Only in rare occasions external constraint may help but it is more the exception rather than the rule.

Finally, it is worth discussing whether current experience of expansionary fiscal policy followed by (hopefully soon) retrenchment, suggest that we use fiscal policy as a countercyclical tool. This would be the lesson to learn from this cycle according to the authoritative views of Blanchard, Dell’Ariccia and Mauro (2010) from the IMF. I think that one has to be cautious and raise two caveats on this prescription.

First as I have tried to show above the composition of fiscal policy matters. Thus an anticyclical fiscal policy based upon spending increases in recessions and tax increases to correct the deficits during expansions is likely to be counterproductive in addition to implying a creeping up of the size of government already around 50 per cent of GDP or more in European countries.

Second the political distortions which I have sketched above which delays reduction of deficits plus the unavoidable “long and variable lags” associated with fiscal policy in a democracy even in the case of fiscal expansions make this tool very awkward for business cycle management.

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