Forced Fiscal Regulation: Impact Factors and Efficiency

Valentina BUTMALAI[1]
Alina-Florentina SĂRACU[2]
Irina SUSANU[3]
Alexandru Sebastian CHIHAIA[4]

Abstract

Tax regulation issues have been the focus since the COVID-19 crisis and the subsequent EU energy crisis. From the Keynesian approach, the expansionary fiscal policy of states can contribute to stimulating aggregate demand and, as a consequence, economic growth, on the other hand, the post-crisis macroeconomic policy trend has become fiscal compression (budget consolidation), corresponding to the neoliberal paradigm. This policy has been actively promoted by the supranational institutions of EU, which, with the help of various instruments of fiscal regulation, have effectively imposed budgetary consolidation on member countries.

Considering that the European Commission continues to urge countries to better the sustainability of their public finances and believes that the situation with the tax system is only safe in some EU countries, while in others it finds significant imbalances, particularly high levels of public debt, which need to be corrected by the Stability and Growth Pact mechanisms, the relevance of this study is beyond doubt.

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JEL classification: E62, E63, E65, H87.

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1. Introduction

There are two categories of definitions applied to the concept of fiscal consolidation: on the one hand, there are strict „statistic" definitions which imply the establishment of quantitative criteria for identifying the consolidation and, on the other hand, definitions that can be called „functional", that is, explaining the essence of consolidation. The definitions of this latter type include the definition of the Organization for Economic Cooperation and Development, which interprets

[1] Valentina Butmalai, „Dunarea de Jos" University of Galati, valentina.butmalai14@gmail.com
[2] Alina-Florentina Săracu, „Dunarea de Jos" University of Galati, alina.saracu@ugal.ro
[3] Irina Susanu, „Dunarea de Jos" University of Galati, irina.susanu@ugal.ro
[4] Alexandru Sebastian Chihaia, „Dunarea de Jos" University of Galati, sebastian.chihaia@gmail.com

budgetary consolidation as a government policy oriented towards reducing the budget deficit in order to prevent the accumulation of public debt. (OECD, 2011) That is, we are talking about a policy of adjusting the fiscal sphere and returning to a sustainable policy (OECD, 2010), and possibly a balanced budget. Another interpretation of the concept can be found in another ECOR study (OECD, 2012) which states that budgetary consolidation is a policy of reducing public debt and budget deficits.

Among the „statistic" definitions, for example, there can be distinguished the following: fiscal consolidation is a period of up to one year in which the cyclically adjusted primary budget deficit is reduced by at least 2% of GDP or up to two consecutive years in which the cyclically adjusted primary budget deficit is decreased by 1,5% of annual GDP.

Based on the work of M. Molnar, (Molnár M., 2012) we present the factors that contribute to the government's transition to a fiscal consolidation policy.

State of public finances. First of all, we are talking about the public debt value. The higher the public debt (and the closer it gets to its critical values), the more likely the government is to start the transition to a policy of budgetary consolidation. Determining the critical thresholds is a rather difficult task, but in the EU case, it can be solved relatively simply: The EU has a threshold criterion for the value of public debt (60% of GDP); therefore, a critical value transition can be taken into account. On the other hand, the nominal nature of this criterion is obvious, since for a certain group of countries there is no objective need for budgetary consolidation behind it. When critical amounts of public debt in the economy are reached, interest rates begin to go up rapidly (the main indicator here are usually interest rates on long-term government bonds). (Boeckx J., M. Deroose, 2016) This means that a relatively rapid increase in interest rates, as well as significant spreads of debentures in relation to the most stable securities (usually German ones), it can be a signal that public debt is approaching a critical value and it becomes an incentive to the budget consolidation. This indicator may also be associated with such a criterion for the public finances stability, such as the rate of public debt accumulation. According to EC research, rapidly growing levels of public debt also have a positive effect on the likelihood of government corrective action.

General macroeconomic conditions. The papers of J. von Hagen and R. Strauch assert that the likelihood of a government switching to a consolidation policy also increases if macroeconomic conditions in a certain country are more favorable than in neighboring countries (OECD, 2007). There are also other potential conditions under which the transition to consolidation is most likely: high inflation, swift depreciation of the national currency, etc. (OECD, 2010). Therefore, together with indicators which are directly tied to the fiscal sphere, when making a decision on budgetary consolidation, the government may also take into consideration other macroeconomic indicators. On these lines, it should be noted that these factors (both related exclusively to the fiscal sphere and to the macroeconomic conditions in general) are some kind of premises, such as, and sometimes signals for the national government, to one extent or another, contribute to the transition to fiscal consolidation policy. In other words, these factors are objective and imply a real need for transition to fiscal contraction.

2. Factors Contributing to the Consolidation Success

A very important point, on which virtually all papers on this subject are discussed in detail, is the question of the factors contributing to the success of fiscal consolidation. The effectiveness of consolidation can be construed in various ways. Based on the OECD definition, the main task of consolidation is to prevent excessive growth of public debt and to lower the budget deficit and possibly, to get a balanced budget or even surplus. Through this approach, consolidation can be deemed successful if the state has managed to stop the growth of public debt and/or carry out a balanced budget.

Let us move on to an analysis of the factors that cause the consolidation success both as concerns achieving the stated goals and in terms of the damage (or possible benefits) to the national economy. Based on a number of papers, (Barrios S., S. Langedijk, L. Pech, 2011) we systematize the key factors for the success of fiscal consolidation.

1. Duration of consolidation. Traditionally, it is believed that gradual and long-term budgetary consolidations are more effective. This is explained by the fact that, in the short term, a negative fiscal impulse is likely to cause a decrease in aggregate production, so a “sole” consolidation may not lead to the planned reduction of the deficit due to the fast decline in business activity.

2. Structure and field of application of the consolidation package. A fairly large number of studies conclude that cost-based consolidations are the most efficient and successful (De Geus A., D.-J. Kraan, 2012). In addition, consolidation based on spending is less likely to trigger a recession (Alesina A., A. Ardagna, 2010). The classic recommendation for successful consolidation was the need to cut civil servants' salaries and various social benefits. In general, the cost structure can be very important. Thus, basing exclusively on the reduction of public investment, rather than on expenditure for health, education, social security (which may even enhance) can curtail the effectiveness of consolidation. At the same time, cutting social spending could increase inequality and worsen other social indicators.

When discussing the extent of consolidation, it has been traditionally believed that a larger set of measures contribute to the consolidation success (if we are taking into account the public debt decreases (budget deficit) as a criterion for effectiveness of consolidation, not the impact on economic growth).

3. Public debt level. A number of studies show that, the larger the level of public debt, the more likely it is to succeed in consolidation (Burgert M., R. Hruzova. M. Lisicky, A. Monks, 2016). At the same time, at very high levels of public debt, a favorable effect on the state of the fiscal sphere and the sustainability of consolidation achievements can be exercised by the so-called „cold showers”. In this case, we are talking about a sudden and quite large narrowing in public debt

due to various stabilization measures. As a consequence, the risk premium decreases, and the confidence of economic agents in the government increases. At the same time, it is impossible to be drawn an unambiguous conclusion with regard to the impact of public debt on the success of consolidation, since, according to M. Molnar, detecting the impact of a higher level of public debt depends heavily on the method of calculation (Molnár M., 2012). In addition, for each individual country, the critical amount of public debt may differ: more developed countries can afford to have a sufficiently high public debt without visible negative consequences for the economy, which is much more difficult for relatively less developed countries.

4. Economic cycle phase. It is commonly believed that it is easier for the government to decide on the consolidation beginning in periods following economic recessions (it seems that such a step is easier to explain by the need to take anti-crisis measures). However, theoretical studies in this field argue that consolidation carried out immediately after the economic crisis or on the downswing of the cycle, with a high degree of probability, will be ineffective. At the very least, its negative consequences are likely to be somewhat greater than in "normal" times (Bagaria N., D. Holland, J. van Reenen, 2016). If this mechanism is disrupted by the crisis and not restored, the fiscal contraction can only worsen the economic situation. Furthermore, the possible impact of the cycle on the pro- or counter-cyclical nature of the consolidation often depends on the particular economy (Alberola E., R. Sousa, 2017).

5. Money-credit policy. The most effective monetary policy instrument as concerns the positive impact on fiscal consolidation is a low-key interest, is capable of backing up exports (due to increased price competitiveness) as an alternative channel of economic growth in the face of a possible decrease in demand during tax contraction. Nevertheless, some researchers did not reveal any influence on the interest rate on the consolidation rate (Beetsma R., 2014), and, which can probably be explained by the fact that the structure of the consolidation package is much more important than monetary policy in the hierarchy of consolidation success factors.

6. Labor market structure. According to A. Alesina and R. Perotti (Alesina A., R. Perotti, 1997), the labor market can play an important role in the effectiveness of fiscal policy. This is particularly true for the issue of rising taxes on labor. Thus, an increase in the rates of these taxes a priori leads to a decrease in the amount of wages after the tax is collected. In countries with strong and monopolistic unions, workers' organizations can require higher nominal salaries in order to bring the new salary after taxation equal to the salary before taxation. Eventually, an increase in the cost of entrepreneurs for the employed workforce leads to a certain loss of competitiveness. Even though the tax is temporarily enhanced, it is likely that its impact on salaries will continue (the actual cost of labor will be distorted), since labor markets (especially in countries with strong unions) are characterized by unidirectional salary mobility: they move up quite easily, but very rarely and difficult - down.

7. The availability of independent supervisory bodies. For effective consolidation, it is necessary to have independent supervision and quality tax institutions in the country. According to a number of theoretical and empirical papers, the presence of independent and high-quality supervisory institutions, it reduces the potential risk premium arising from excessive budget deficits (Hallerberg M., G. Wolff, 2016). Consolidation can be more successful if it is based on the opinion of specialist tax councils (or any other body that reviews national budgets and fiscal policy in general). The key principle in the functioning of such institutions is independence from the national government, at least the EC insists on this (Burret H., 2015).

8. Political factors. Political factors may also have a certain influence on the success of consolidation. We are talking about the possibility of occurring some „political business cycles", when governments seek to increase budget spending before elections so as to ensure the support of the electorate. Although from the empiric point of view this premise is not always confirmed, the possibility that political factors influence actual consolidation is quite high. The fact is that not only the government, but also various groups and organizations (for example, pressure groups or lobbying organizations) are involved in the political process of developing taxes on the course of the budget, and, who are interested in a certain nature of the funds distribution.

In this manner, the implementation of fiscal compression policy within the national economy is influenced by a number of factors of a different nature: from the internal economic characteristics of the country to the organization of its political mechanism. Whereas, according to the criteria regarded, EU countries may differ significantly among themselves when taking into account the impact of tax regulation on the member countries economies, it is extremely important to be taken into account the national specific nature of the action of these factors.

3. Effectiveness of Forced Fiscal Compression

The main problem in implementing forced consolidation remains that of evaluating its success. The main way to determine the effectiveness degree of consolidation can however be considered the parameters and ampleness of the public debt reducing in response to fiscal contraction. For example, a fairly common criterion is the narrowing of public debt after two (sometimes three) years from completing the consolidation.

"Government deficit/surplus, % of GDP for 2021-2022"

Table 1

Country	2021	2022
Belgium	-5,5	-3,9
Germany	-3,7	-2,6
Estonia	-2,4	-0,9

Country	2021	2022
Ireland	-1,6	+1,6
Greece	-7,1	-2,3
Spain	-6,9	-4,8
France	-6,5	-4,7
Croatia	-2,5	+0,4
Italy	-9,0	-8,0
Cyprus	-2,0	+2,1
Latvia	-7,1	-4,4
Lithuania	-1,2	-0,6
Luxembourg	+0,7	+0,2
Malta	-7,8	-5,8
Netherland	-2,4	0,0
Austria	-5,8	-3,2
Portugal	-2,9	-0,4
Slovenia	-4,6	-3,0
Slovakia	-5,4	-2,0
Finland	-2,8	-0,9
Euro Zone	-5,3	-3,6
Bulgaria	-3,9	-2,8
Czech Republic	-5,1	-3,6
Denmark	+3,6	+3,3
Hungary	-7,1	-6,2
Poland	-1,8	-3,7
Romania	-7,1	-6,2
Sweden	0,0	+0,7
EU	-4,8	-3,4

Source: drafted by the author based on Eurostat data

The data in Table 1 show that the main task of tax regulation in the countries considered has been fulfilled, the ratio between the EU public deficit and gross domestic product decreased from -4.8% in 2021 to -3.4% in 2022.

Figure 1. Public debt, % in GDP for 2021-2022
Source: drafted by the author based on Eurostat data

As we can also notice from Figure 1, public debt stopped growing at the rate specific to the crisis period. In the European Union, the public debt-to-GDP weight dropped from 88.0% at the end of 2021 to 84.0% at the end of 2022. At the end of 2022, the public debt weight related to gross domestic product fluctuated from 18.4% in Estonia to 171.3% in Greece.

Notwithstanding, the question remains whether this dynamic range meets the criteria for successful consolidation. It cannot be said that the forced fiscal consolidation was unambiguously successful, since the results of cutting public debt are rather contradictory, based on the indicated efficiency criteria. Indeed, the public debt/GDP ratio narrowed in all EU countries except Estonia, Luxembourg, the Czech Republic and Finland, where there were insignificant increases in public debt.

A rather interesting approach for determining the efficiency of the budgetary policy of diminishing public debt was proposed by Yu. von Hagen and G. Wolff. We are talking about comparing the dynamic range of deficit changes and the rate of reduction of public debt. This technique is necessary to determine how much a particular government uses the favorable environment and possible budget surpluses in order to pay public debt. In our case, this approach is not applicable, as in the countries analyzed there were practically no budget surpluses, except for Ireland, Croatia, Cyprus, Luxembourg, Denmark and Sweden, where we have surpluses of 1.6%, 0.4% 0.2%, 3.3% and 0.7%.

Thus, regarding the insignificant rise in the public debt in Estonia, Luxembourg, The Czech Republic and Finland, we can talk about the efficiency of forced budgetary consolidation in all the countries considered.

4. Forced Consolidation in Romania

The main theoretical approaches to the study of discretionary fiscal policy analyzed in this study, they allow us to draw a series of conclusions that can be used for evaluating the effectiveness of a positive or negative fiscal impulse in Romania.

1. As a rule, a non-permanent fiscal impetus in the short term proves to be most effective (this applies to both expansionary and contractual fiscal policy). A permanent positive impetus is less effective and requires mandatory budgetary consolidation in subsequent periods.

2. Fiscal contraction is most effective on an upward cycle wave and less efficient on a downward cycle wave. The reverse situation is typical for positive fiscal impetuses.

3. The budget consolidation is required when there are significant risks to the tax system, which is primarily expressed in a large scale of public debt. The key measure of the consolidation success remains the curtailment of public debt after the completion of fiscal contraction.

4. The structural characteristics of emerging market economies generally help mitigate the negative effects of fiscal consolidation. Nevertheless, individual aspects of the country specific nature may have the opposite effect.

5. Decreasing budget spending as a consolidation measure has the least effect on GDP growth rates, but it can seriously affect the social aspects of the economy. As a consequence, the structure of expenditure measures remains an important factor. Freezing salaries and pensions remains the most popular measure to drop costs. At the same time, other social expenses and expenses for the development of human capital, as a rule, do not go down so significantly.

6. Free monetary policy is a supporting factor for an effective consolidation. It is able to stop some of the negative consequences associated with a lessening of demand in response to a rise in taxes and a decrease in budget expenses.

The negative shock of oil prices and, consequently, of energy, required a tightening of fiscal policy in the country and a budgetary consolidation. This consolidation can be considered as forced, as the fiscal shock on the economy is linked primarily to external factors.

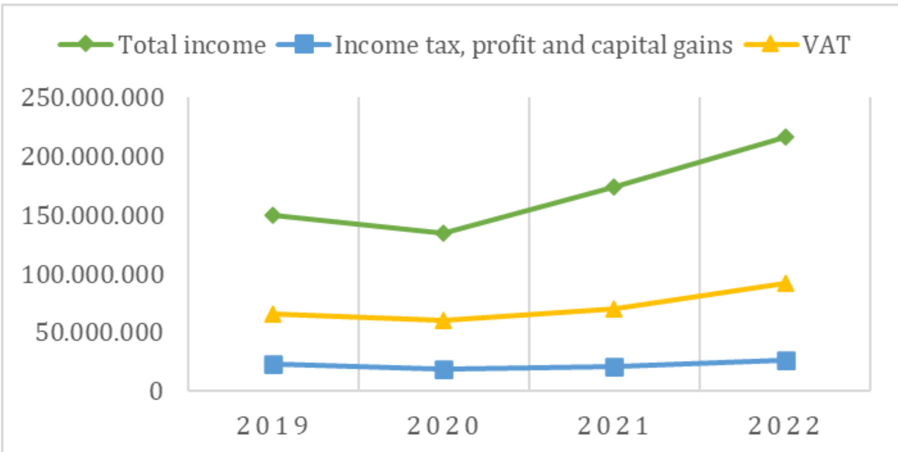

Figure 2. The evolution of the main components of the state budget of Romania, thousands of lei

Source: drafted by the author based on data provided by the Romanian Ministry of Finance

Following the shock of the oil and energy price, it was recorded a gradual growth in income, as we can note from the figure above. There is an increase in revenue from income tax, profit and capital gains and VAT, as well as total revenue. On the one hand, the need for consolidation in Romania is not so pronounced since Romania does not risk losing a significant part of the net transfers from the EU budget, but at the same time in Romania the level of public debt has increased in the last 3 years, and constitute approximately 47% of GDP in during 2020-2022, as we can see from Figure 2. On the other hand, the need to consolidate the budget in Romania is caused by serious risks associated with both the fluctuations in the world oil price and, consequently, the danger of a sudden imbalance of the budget, as well as with other factors, including geopolitical ones.

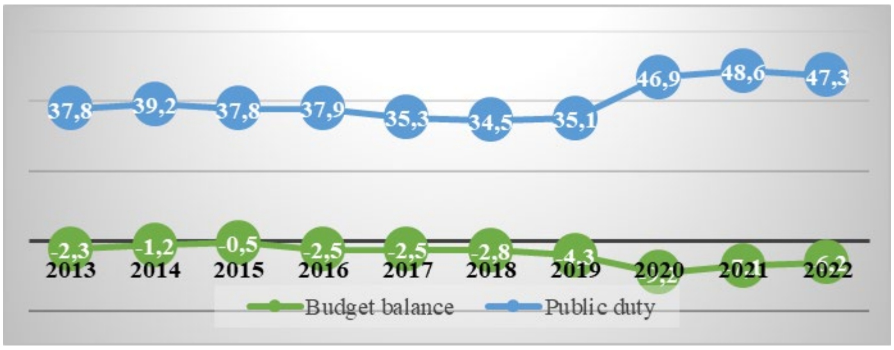

Figure 3. Public debt and budget balance in % of GDP
Source: drafted by the author on the basis of ECB data

The discretionary nature of modern fiscal policy measures is expressed in the change of the cyclically adjusted primary budget balance in 2022, being improved by 2.74 percentage points compared to 2020, which indicates a serious fiscal consolidation as we can analyze in the figure below.

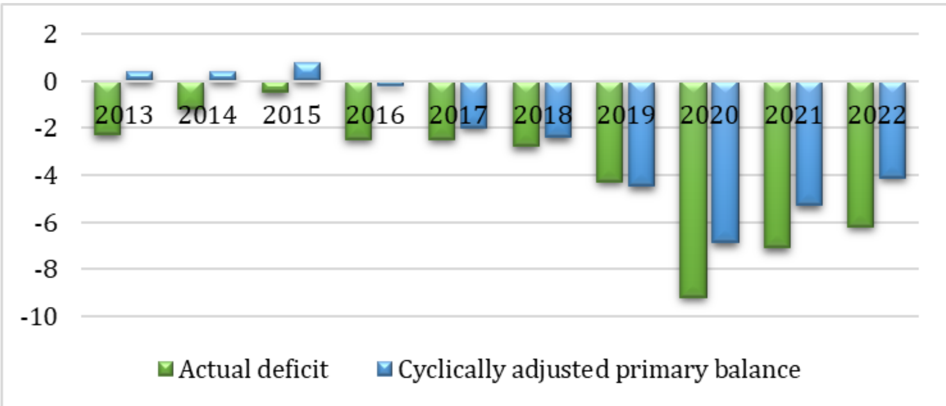

Figure 4. Cyclically adjusted primary balance change (% of potential GDP) and real budget deficit (% of GDP) in Romania, 2013-2022
Source: drafted by the author based on IMF data

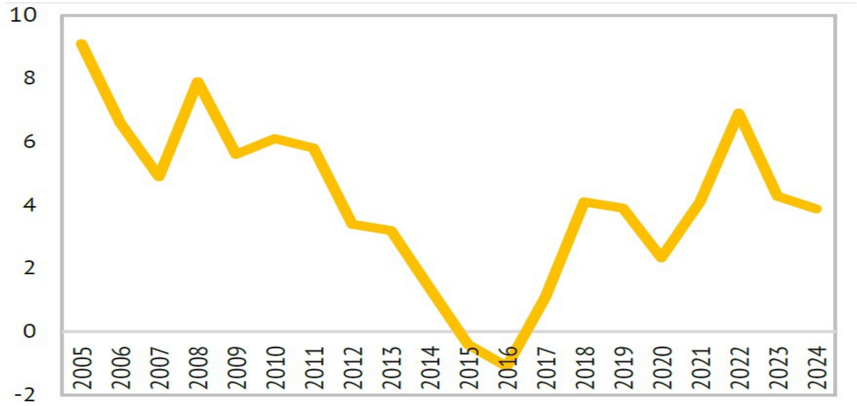

Figure 5. Forecast on interest rates on Romanian public securities (%)
Source: drafted by the author based on data supplied by the Romanian Ministry of Finance

Paradoxically, the Ministry of Finance intends to continue growing public debt. This is all the stranger as the key task of fiscal consolidation is to diminish public debt and reduce risk premium and, consequently, interest rates. The data in Figures 5 and 6 really show the increase in interest rates on public securities, however, the specificity of their growth in Romania is that they are more receptive to the key rate of the Central Bank than to the real danger of non-payment in the country.

Figure 6. Central Bank interest rates on overnight loans, %
Source: drafted by the author based on the RNB data

Theoretically, the interest rate should have a dumping effect during fiscal consolidation, but its high value in Romania will hardly play this role.
As concerns the structure of the consolidation measures, it can be considered the most applicable to the Romanian reality. And first of all, we are talking about the revenue components of the budget, as the expenses elements are more sensitive to non-economic factors (for example, the reduction or freezing of salaries of civil

servants can cause public protests, although theoretically this consolidation tool is among the most efficient). Care should be taken to the vigilantly management of corporate taxes and capital gains taxes. These taxes are of a distorting nature, therefore, their increase might have a negative impact on business activity and then on collection.

Potential risks include an enhancement of the tax burden, as well as risks related to the presence or absence of sufficient political will to implement structural measures with full rights to consolidate the budget. It seems that Romania may lack the political will required for a serious change in the structure of income and expenditure, and therefore there is a danger of the formal nature of consolidation measures. Budgetary consolidation can help restore overall confidence in the country's financial system, but in practice, other fundamental factors have an impact on investor confidence as well as on the dynamics of exports, while the effect of budgetary consolidation on these indicators is insignificant.

5. The Problem of Economic Management Methods in the European Union

The Stability and Growth Pact, adopted in 1997 to ensure that countries continue to meet key convergence criteria after joining the Eurozone, is the institutional basis for tax regulation in the EU. The adoption of such a document was a logical continuation of the basic postulates of the HIA theory. The purpose of adopting the Pact is to ensure the optimal functioning of the monetary union and to minimize the possibility for member countries to govern a discretionary policy.

A special problem that needs a certain theoretical reflection is remaining that of correlating the proposed concept of fiscal regulation with the conventional concepts that characterize management methods in the EU. This problem is particularly relevant when being applied to the dichotomy of supranational and national economic governance. Thus, the "regulation" concept applied at national level can have a slightly different interpretation when it comes to decision-making methods in the field of economic management at the supranational level.

The discussion on management methods in the EU has not yet led to the creation of a unified and generally accepted classification. And although the various classifications have a similar core (for example, the existence of a division into community and intergovernmental methods of governance), it is still difficult to find a comprehensive classification that fits all. The mentioned aspects of fiscal regulation (fiscal harmonization and control over national budgets) are more often considered by the authors as advanced coordination (within normative management). And here is already noticeable the first contradiction. Thus, setting the quantitative criteria and the existence of a certain system of measures for applying these criteria as concerns economic decision-making methods in the EU are rarely considered as direct regulation (since the EU is engaged in direct regulation only in the field of its exclusive competence, which does not include fiscal policy). At the same time, at national level, the alignment of the budget with supranational budgetary criteria can already be considered direct regulation, as it implies standard economic policy instruments: taxes, budget expenses, etc. This problem overlaps with the already mentioned lack of a single, generally accepted classification of management practices in the EU. At the same time, regulation refers to the creation of common rules at supranational level, as well as to the national rules harmonization. No special attention is given to fiscal regulation directly, notwithstanding, it can be assumed that in this scheme, the problems of fiscal harmonization and control over national budgets would be described through the term "coordination". Consequently, when analyzing tax regulation in the EU, the national component should apparently prevail and the supranational impact should be considered as an external factor.

As concerns supranational management and decision-making method, supranational impact is regulation in terms of impact on the national economy. At the same time, it has different forms (based on the division into budgetary control, the harmonization of indirect taxation and the coordination of direct taxation), however the degree of rigidity, compulsoriness and formalization of these forms can be changed (for example, towards the consolidation of supranational legislation in the field of direct taxation), which in essence does not alter the nature of the amended rules impact on the national economy. Such an influence will have the character of regulating economic activity. In this sense, it is recommended to combine various aspects of supranational influence on the fiscal sphere of national states within a single concept - fiscal regulation.

6. Conclusions

This study found that the real, direct and really tangible impact on EU national economies is ensured by the budgetary component of tax regulation. Its fundamental element can be considered the Stability and Growth Pact, which requires member states to maintain budgetary discipline and provides a special regime for enforcing these instructions. Additional elements in this system are the mechanism of the European semester, by means of which supranational bodies monitor national budgets, the Fiscal pact, which implements the requirements for a structural deficit in national legislation, and certain elements of the procedure for macroeconomic imbalance.

Overcoming the fiscal criteria by a country with a certain degree of automation leads to the activation of supranational procedures, first of all the corrective hand of the Stability and Growth Pact, requiring that country to lessen its excessive budget deficit, which from the point of view of the national economy means budgetary consolidation, namely the direct macroeconomic impact will be carried out by government fiscal pressure.

Considering that the consequences of forced fiscal consolidation can be quite serious, it is necessary to be determined how effective the main supranational measures of fiscal regulation can be, as well as what features they possess. The analysis of the main instruments of the Stability and Growth Pact and other mechanisms showed that the excessive budget deficit procedure has the highest and most direct degree of impact on the economy. Nevertheless, the depth and automatic nature of the impact of this procedure and other components of tax regulation differ depending on a number of factors, among which the country position in relation to joining or not joining the Eurozone, the weight of the country in the EU's overall hierarchy, the severity of the budget deficit and the public debt indicators.

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