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Online ISSN 2424-6166. EKONOMIKA 2018 Vol. 97(2)
DOI: https://doi.org/10.15388/Ekon.2018.1.11783

ON THE CHOICE OF FISCAL ADJUSTMENT TO FINANCIAL CRISES: EXPANSIONARY VS. CONTRACTIONARY POLICIES

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Abstract. *An everlasting debate over the economic policies to be implemented in the face of economic recessions tends to intensify every time such a crisis strikes. Two notably opposite schools have emerged: one that represent those who advocate for quantitative easing and increased government spending, and another that calls for austerity measures and disciplined public finance. The available empirical evidence cannot supply a definite solution to the spending vs. austerity debate if just one answer is to be provided, as there are numerous historical experiences when either strategy had worked or failed. The aim of this paper is to examine and assess the arguments of both schools of economic policies, to highlight the essential drawbacks and limitations of both and to identify the specific conditions under which each of the policy type can bring the desired impact. It is argued that both of the policy approaches rely on particular implicit assumptions and, if implemented recklessly, are liable to fail or create negative side-effects. A discussion of the relative merits and shortcomings of both types of recipes for curing economic recessions is illustrated by the references to the empirical historical cases. The main conclusion that stems out of the analysis is that a somewhat "medical approach" should be followed while attempting "to cure" ailing economies: regardless that the symptoms of a slump might be quite similar, one should start with an attempt to diagnose the underlying causes of the economic malady at hand, followed by the assessment of a "patient's" health status, and only then proceed to the selection of an appropriate "cure" and treatment procedure.*

Keywords: *recession, government spending, austerity, comparative analysis.*

1. Introduction

An everlasting debate over the economic policies to be implemented in the face of the economic recessions tends to intensify every time such crisis strikes. No wonder that the recent global economic crisis has revived a heated debate on whether the policies of government spending and quantitative easing or austerity and disciplined finances should be employed in order to set a given economy on the path to recovery. Two fiercely opposite schools have emerged: one, led by Nobel laureates Paul Krugman and Joseph Stieglitz, represents those who advocate for quantitative easing and increased government spend-

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ing, and another, counting among its ranks such Nobel laureates as Edward Prescott, Vernon Smith and James Buchanan,[1] which calls for austerity measures and disciplined public finance. The available empirical evidence cannot supply a definite solution to the spending vs. austerity debate if just one answer is to be provided, as there are numerous historical experiences when either strategy had worked or failed.

The aim of this paper is to examine and assess the arguments of both schools of economic policy, to highlight the essential limitations and drawbacks of both, and to identify the specific conditions under which each of the policy type can bring the desired impact. The methodology of research is the combination of descriptive and narrative analyses, based on the contrast and comparison of both the theoretical arguments and the empirical evidence of their validity as reported by various empirical studies.

2. Expansionary Policies: Get High and Feel Good

A financial crisis is commonly defined as situation that exhibits several symptoms of an economic meltdown, such us a sharp increase of the share of nonperforming assets, bank runs leading to non-liquidity danger and bank liquidations threats or actual cases, followed by calls for a largescale government intervention to support banks (Caprio et al. 2005; Reinhart and Rogoff 2014). A so-called counter-cyclical policy, designated to overcome a financial crisis and recession, is mainly associated with a fiscal and monetary stimulus: increased spending and quantitative easing. The idea is that during the recession the best way to stop the downslide and induce recovery is to pour money into economy: that should stimulate demand and, accordingly, production on the one hand, and damp interest rates and increase the availability of financial resources for stabilization and growth on the other. During a recession, central banks usually lower interest rates in order to stimulate investment. In many cases, however, interest rates fall so much that they almost reach the floor of 0%. Mankiw (2012) defined this situation as a liquidity trap, and asserts that in such cases, quantitative easing no longer brings effective results, as the financial indebtedness, combined with the fear of uncertain future, makes both the private sector and consumers reluctant to borrow and spend money. Businesses stop building new plants, suspend equipment acquisitions, stop hiring additional workers or even start dismissing the old ones, whereas households cut their spending and refuse to withdraw their money from current accounts despite the falling interest rates, which are caused by the central banks' attempts to foster economic growth. These circumstances allowed J. M. Keynes to conclude that in the short run (assuming fixed prices and sticky wages), aggregate demand decreases and consequently lowers total income, meaning that an economy will remain in decline unless the government steps in and boosts its

[1] In 2009, E.Prescott, W.Smith and J.Buchanan, along with more than 250 other prominent American economists, signed an open letter to president Obama stating that they "do not believe that more government spending is a way to improve economic performance" (https://object.cato.org/sites/cato.org/files/pubs/pdf/cato_stimulus.pdf).

spending. Consequentially, fiscal measures must be employed in order to overcome the adverse effects of a recession.[2] According to the Keynesians, the government is more efficient than the private sector in allocating idle resources throughout the economy during recessions. When a government issues bonds, people who hold surplus money are ready to buy these bonds even at a moderate interest rate, because they are indifferent to holding either bonds or cash. This gives the government an opportunity to allocate the money to those who do not have enough money to spend by promoting public projects, such as building roads, or increasing the welfare payments. Such a fiscal stimulus pushes up the demand, as people get more money to spend on goods and services. The increased demand is expected to pull up the supply side of the economy, which will lead to the increased employment as more and more people are to be employed to satisfy the growing demand. As a result, the government is able to give its economy a considerable push upward if the value of multiplier exceeds 1. The larger the multiplier, the bigger the impact; however, in an open economy, the size of the multiplier depends on a country's financial development, trade restrictions, capital mobility and exchange rate regime. Notwithstanding that, recent research findings (Christiano et al. 2010; Corsetti et al. 2012) have corroborated the following hypothesis: fiscal multipliers tend to rise way above 1 during economic downfalls, especially when interest rates plummet and a liquidity trap becomes inevitable. Expansionary government spending, conclusively, can be regarded as a possibly effective remedy in times of recession, especially when quantitative easing is not working as expected.

One of the most cited historical examples of a successful application of expansionary policies happened during the Great Depression in the US in the 1930s. It is believed that a large fiscal stimulus through public works and farm subsidies, offered under the auspices of F. D. Roosevelt government's "New Deal" policy, followed by the huge government spending on military projects during the World War II, has helped the United States to fully recover from the Great Depression (Leuchtenburg 2009). Another, lesser known but no less spectacular case of a successful application of government spending to overcome economic depression occurred in Sweden. Like most other countries, Sweden suffered severely during the Great Depression: its industrial output contracted by some 25% and unemployment reached a staggering 34%, which, in combination with reductions in wages, caused a series of strikes and other social unrest. In 1933, the newly elected Social Democratic government initiated a package of measures that included the funding of massive public works and extensive state support to the agricultural sector as well as reduced taxes on profits and a "free write-off" system on capital investments. The theoretical framework for such policies was formulated by a group of young Swedish economists led by G. Myrdal, E. Lindahl and B. Ohlin, whose revolutionary

[2] In Europe, where most EU countries face rigorous constraints regarding their monetary policies, fiscal policy might be the only tool available to their governments during recession.

ideas arguably preceded J. M. Keynes. They proposed a "golden rule of balance" for the government budget: it should be balanced not every year but over a business cycle, running surpluses during the good times and deficits during the bad times. Expansionary policies in the times of depression and restrictive policies during times of fast growth, they argued, will elevate the bottoms of depressions and cut off the excessive heights of booms, thus reducing the amplitudes of fluctuations in economic activity. Moreover, the budget deficits in the depression should be about equal to the surpluses during the boom, thus preventing the growth of public debt (Lundberg 1985). These measures, complemented by a depreciation of the Swedish Krona (which started already in 1931 when Sweden abandoned the gold standard it had adopted 7 years ago), had rather spectacular results: the Swedish economy recovered more rapidly than in most other countries. Already in 1936 both the level of production and the real wages in Sweden reached their pre-depression levels, and by the end of the decade, unemployment had dropped down to insignificant numbers (Lundberg 1985; de Vylder 1996). Most notably, the rapid monetary growth did not generate high inflation: the rise of nominal wage rates did not exceed the rise in labor productivity.

The recent global financial crisis of 2008 provided more examples of expansionary policies aimed to heal the ailing economies. In the wake of the crisis, the US government injected $700 billion into its banking industry, followed by an additional $787 billion stimulus aimed at financing unemployment benefits, tax cuts, investments in infrastructure, healthcare and education (Čáslavka and Henn 2012). According to the US Congressional Budget Office, this fiscal stimulus has raised the real GDP between 0.1 and 0.8 percent, lowered the unemployment rate between 0.1 to 0.6 percent and increased the full time equivalent jobs between 0.2 million and 1.3 million (Congressional Budget Office 2012). Another example is China, which, being an export-led economy, felt a severe decline in global demand: in 2008, its government decided to implement a stabilization package worth $568 billion (around 13% of China's GDP), making investments in infrastructure and social programs. Yet another world export leader, Japan, after experiencing a 12.1% drop in its GDP in the last quarter of 2008, spent $554 billion intended for job creation, business loan subsidies and benefits for laid-off workers. Despite some questionable effects of the spending policies that occurred in all the abovementioned countries, the prevalent opinion is that such a fiscal stimulus to the economic system "prevented the Great Recession from turning into another Great Depression" (Čáslavka, Henn 2012, p. 24).

However, some economists point out that spending is not the only and might be not the best way to stimulate economy. A careful examination of the OECD countries' experience during the period of 1970–2007 led American economists Alesina and Ardagna to the conclusion that "fiscal stimuli based upon tax cut are much more likely to be growth enhancing than those on the spending side" (Alesina and Ardagna 2009, p. 15). While this conclusion does not negate the positive impact of enlarged spending on economic

recovery, it does suggest that tax cuts might be more effective in terms of fostering economic growth.

Then, Horton and El-Ganainy (2012) stressed the role of timing as the crucial factor that determines the success or failure of the spending policies. While in theory the suggestion to contract spending during the growth phases and to expand it during hardships sounds fool-proof, there are time lags present in reality: policymakers must first recognize the presence of an economic downturn and then come up with appropriate actions (which might include discussing various responses, drafting laws, enacting legislation etc.) designed to mitigate the negative tendencies and consequences. Then, again, it takes time for the policies to take hold and actually affect the market structure. Even though some stabilizers, such as welfare benefits, engage rather fast, the efficiency of other instruments of expansionary policies wanes as time goes by – and can even become counter-productive if they are implemented after the decline stage is already replaced by growth.

A different angle on the timing of expansionary policies is taken by Mankiw and Weinzierl, who suggest that "there is a hierarchy of instruments for policymakers to take off the shelf when the economy has insufficient aggregate demand to maintain full employment of its productive resources" (Mankiw and Wenzierl 2011, p. 246). They propose that the direct fiscal stimulus should be implemented only when all other policies, especially monetary expansion, fail. They argue that the first step in overcoming a recession is to cut short-term interest rates, the second being to cut long-term interest rates. Instead of increasing government spending to incentivize demand, the third step should be a fiscal policy that encourages investment. Only if those policies fail (or are unavailable), the government should implement a fiscal policy that stimulates aggregate demand: increasing government spending and/or cutting the overall level of taxation.

Another possible limitation to the efficiency of spending policies is related to the demand structure. Keynesian logic implicitly assumes a closed economy, but a similar logic applies, nevertheless, to an open economy as well: a necessary assumption for spending efficiency is that residents spend money on internally produced rather than imported goods. If the income elasticity of demand is considerably higher for imports than for domestic products, then the effect of spending policies will largely be drained down the import channels, and instead of a rapid recovery, this might lead to a worsening of the current accounts of the deficit situation.

Furthermore, even an optimal solution of "spending vs. cutting taxes" puzzle, combined with correct timing and benevolent demand structure, is not sufficient to deal with the major problem of all expansionary policies – the question of the source of financing. Either an action (or a mixture of those) will require substantial budget resources. In the case when there are no budget surpluses accumulated during the fast growth phase or they if they are insufficient, the necessary funds can be generated by either raising taxes (which would contradict the major aim of stimulus) or borrowing money from financial markets

(the latter option effectively meaning higher consumption today at the expense of future generations).[3] Relatively cheap borrowing is prevalently available to large and stable countries, whereas economies that are small, open and more vulnerable to shocks usually face larger interest rates and hence can afford rather limited debts, insufficient to ameliorate a full-scale recession. Moreover, Reinhart and Rogoff (Reinhart and Rogoff 2010; Reinhart, Reinhart and Rogoff 2012) examined the relationship between a state's public debt and GDP changes over the two-century length data sample (from 1790 to 2009), and came to the conclusion that countries exceeding 90% of their debt-to-GDP ratio demonstrate a sharp downslide of economic growth rates. While findings in this field vary across different studies,[4] the general agreement is that excessive amounts of debt are hardly sustainable in the long run (Spilimbergo, Symansky, Blanchard 2008); therefore, a "substantial fiscal expansion is possible only if the resulting deficit can be financed at a reasonable interest rate and at least without leading to a fiscal crisis" (Staehr 2013, p. 301).

Finally, there is the fundamental issue of the very nature of a financial crisis: is it comparable to a flu, which, when contracted by an otherwise healthy organism, causes very a unpleasant sickness, or is a crisis to be regarded as a result of the cumulative processes of structural distortions that had critically weakened the immunity of the economic system? In other words, the question is this: was the healthy economic system weakened by the crisis, or was it susceptible to crisis because it was weakened by unhealthy behavior in the past? In the first case, it is natural to seek the reverse of a decline and restoration to the pre-crisis state. However, in the second case, a financial crisis could be regarded as the manifestation of negative feedback in the economic system that attempts to repair itself, i.e., to restore a healthy structure and readjust the path of development. A number of economists, especially those associated with the modern Austrian school, take the latter point of view, arguing that during the boom times, the economic structure is markedly distorted by malinvestment[5] and overconsumption, occurring contemporaneously (Salerno 2012). In their view, the "reduced loan rate encourages business firms to overestimate the present and future availability of investible resources and to malinvest in lengthening the structure of production, at the same time it misleads households into a falsely optimistic appraisal of their real income and net worth that stimulates consumption and depresses saving" (Salerno 2012, p. 15). This leads to the morbid production and consumption structure that needs to be corrected before the true recovery can begin. In such contention, recession is nothing else than a painful readjust-

[3] According to Uhlig (2010), a government spending stimulus leads to an initial output boom; however, the long-run effects on output are negative, because a government must raise taxes to pay for the incurred debt.

[4] For instance, Herndon, Ash and Pollin (2013) disagree with Reinhart and Rogoff's conclusions: they found that national debt over 90% of GDP leads to the perceptible slowdown but not to the severe slump of growth rates. However, both sets of authors agree on the point of the negative relationship between debt levels and growth rates.

[5] The term "malinvestment" can be traced back to Ludwig von Mises, who claimed that "the essence of the credit-expansion boom is not overinvestment, but investment in wrong lines, i.e. malinvestment" (Mises 1998, p. 555–556).

ment of the economic structures into a normal pattern; consequently, high interest rates and soaring unemployment can be regarded simply as signals that such readjustment is taking place.[6] This implies that "any political attempt to arrest or reverse the decline in factor and asset prices through monetary manipulations or fiscal stimulus programs will retard or derail the recession-adjustment process" (Salerno 2012, p. 38).

3. Austerity: Get Healthy while on Diet?

The term "austerity," also called fiscal consolidation or adjustment, broadly defines stringent fiscal policies as a way to stabilize economy in times of a cyclical downturn. Two main arguments of austerity – that deficit reduction first creates positive future expectations and, second, leads to lower interest rates – are at the core of the so-called expansionary fiscal contraction (EFC) hypothesis, which claims that austerity can promote economic growth. Contrary to spending, which stimulates the economy directly, austerity measures are supposed to set economic recovery mostly via its indirect effects, *inter alia* by ensuring public debt sustainability so as to lower a country's default risk, reduce interest rates and thus encourage private investment (Baker 2010; Haltom, Lubik 2013). In situations when economic booms are fuelled by government overspending, particularly if funded by excessive and prolonged budget deficits, cutbacks of government spending might be the only way to prevent a catastrophe (default on government debt) and calm the financial markets down. If the default on the government debt is feared as possible, it can it can lead to higher bond yields, and this, in turn, will increase the cost of financing the deficit. Budget deficit reduction, on the contrary, is likely to calm financial markets, and "may lead to a reduction in risk premiums built into interest rates, thus increasing demand and perhaps inducing asset price increases" (Gravelle and Hungerford 2013, p. 7). A drop in interest rates might diminish people's propensity for saving, prompting them to withdraw their money from bank accounts and spend it on goods, leading to growth in demand and, subsequently, to economic recovery. Furthermore, it can be expected that the austerity-favoring government policies will provide a signal for both public and private sector to look for ways to increase efficiency in order to maintain their incomes. For example, study of a number of country-specific budget deficit reduction cases, which took place between 1980 and 2005, revealed that spending-cut deficit reductions were followed by the rise of capital accumulation in the private sector, with firms investing more in productive activities (Alesina, Favero and Giavazzi 2015). There might be three different fiscal adjustment approaches toward government deficit reductions: cutting public expenditures, raising revenues or the mixture of the two.

Many authors advocate the tightening of the belt on government spending as the most growth-fostering austerity policy. Alesina and Ardagna (2009) have found that economy-expanding fiscal adjustments are better served by spending cuts rather than revenue rais-

[6] This is similar to how high body temperature signals that an organism is fighting an illness.

ing by tax increases. This conclusion was endorsed by their later studies (Alesina and Ardagna (2012), Alesina, Favero and Giavazzi (2015)). Contributing to the argument, Furth concluded that "fiscal consolidation through spending cuts is less contractionary than fiscal consolidation through tax increases" (Furth 2013, p. 59). Similarly, de Cos and Moral-Benito strongly argue that "cuts in public wages are the key ingredient of fiscal consolidations" (de Cos and Moral-Benito 2013, p. 752). Finally, a careful analysis of the recent economic crisis of 2009–2013 (Alesina, Barbiero et al. 2015) confirmed that the fiscal adjustments based upon cuts in spending are much less costly in terms of output losses than those based upon tax increases. Model-based simulations have indicated that while "the output effect of average tax-based adjustment plans with an initial size of one per cent of GDP is a cumulative contraction in GDP of two per cent in the following three years," spending-based adjustments generate "very small recessions with an impact on output grown not significantly different from zero" (Alesina, Barbiero et al. 2015, p. 384). Yet another argument in favor of spending reductions is that they restrict the potentiality of politicians to channel resources to those recipients that they favor, which might enhance resource allocation efficiency by promoting market allocation mechanisms (Wesbury, Stein 2010).

Another option for fiscal correction is tax increase. Besides what was already said about the evidence that tax increases are more likely to cause a deeper and lengthier recession, it should be added that whether tax hikes expand budget income depends on the current standpoint on Laffer's curve. Revenues will grow only if the tax rate is below the optimal level; otherwise, any increase in tax rates will be followed by a decline in revenue due to stronger tax evasion incentives. On the other hand, raising taxes should not necessary be an "all across the board" type of measure: a hike of indirect taxes (such as VAT) is likely to be less painful to economic agents than an increase of direct tax rates (such as levied on corporate profit or personal income).

Then, again, revenue raising options are not necessarily limited to the tax increases. Governments can raise income by one-off type of measures, like the sale of public land or public ownership in industrial companies. However, while such actions can boost government revenues right away, they might have a negative impact on the budget's inflows in the long-run (Raudla, Kattel 2013).

The mixing of expenditure cuts and tax policies together is often deemed as the worse of choices, mainly because such a mix spreads the pain of adjustment policies across both public and private sectors (Wesbury, Stein 2010). However, some authors claim that a combination of both options, albeit painful, may lead to sustainable economic growth if followed by appropriate growth-enhancing structural reforms, such as deregulation, the liberalization of labor markets and the like (Furth 2013). The example of the Baltic countries (Estonia, Latvia and Lithuania) could be used to support such an argument. When hit by the global financial crisis in 2008, all three Baltic countries engaged in both sharp public spending contraction and substantial tax increases, followed by institutional

and policy changes that attempted to make labor markets more flexible, increase the efficiency of both education and health sectors, promote export-oriented activities etc. Already in 2010, the Baltic states started to recover, and in 2011, they recorded GDP growths between 5.5% and 7.6% (Kattel and Rauda 2013). Today, the Baltic countries are often quoted as model cases of successful fiscal consolidation.

An important issue in fiscal consolidation policies is the pace of the deficit reduction. Deficit reduction should not recklessly be done via on-time-hit type of measures. A carefully designed program of a gradual fiscal "diet" is the way to avoid both damaging the prospects of economic recovery and the explosion of public discontent.

There are three most common counterarguments to the EFC theory. First and the most important one is that cutting budget expenditures or raising taxes, or both, reduces the aggregate demand, thus depriving the already spluttering economy of fuel. Then, if GDP growth slows down faster than the decline of state debt, the fiscal contraction measures might become self-defeating, as the debt-GDP ratio will increase instead of receding.[7] Another objection concerns a fallacy of composition in the argument for austerity. Blyth (2013) argues that in order for fiscal consolidation to be domestically growth-enhancing, there must be foreign countries ready to buy domestic goods and services. If, as happened in Europe during the recent economic crisis, foreign countries are on the course of fiscal consolidation as well, there is no one inclined to spend money, as everyone is inclined to save. Saving by exporting domestic output "isn't a strategy everyone can pursue at the same time" (Krugman 2010). In such case, austerity merely leads to a shrinking regional economy as a whole. Lastly, fiscal consolidation increases income inequality in the country. By cutting public expenditure, governments make public servants and those using public services worse off, leaving business leaders little affected in terms of income (Blyth 2013). Woo, Bova, Kinda and Zhang have shown that "a consolidation of 1 percentage point of GDP is associated with an increase in the disposable income Gini coefficient of around 0.4-0.7 percent over the first two years" (Woo et al. 2013, p. 20). Therefore, austerity policies produce a negative externality in terms of unequal income distribution.

4. Conclusions

To summarize the results, there is no panacea type of remedy to cure financial crisis. Overall, both spending and austerity policies are designed to cope with financial upheavals and their dire consequences, yet in the case of spending, they are explicit and more oriented toward immediate results (boosting short-term aggregate demand and overall output), in case of austerity – implicit and more long-run oriented (ensuring sustainable public debt and economy growth levels). The efficiency of both approaches is situation-

[7] One may point out that the similar counterargument can be applied against the spending policies: if economic growth rates significantly and consistently lag behind growth in government spending, this might lead to the accumulation of growth-slowing or even ruinous public debt levels.

dependent, as argued by theory and shown by empirical evidence. Thus, it can be concluded that a somewhat "medical approach" should be followed while attempting "to cure" ailing economies: regardless that the symptoms of a slump might be quite similar, one should start with an attempt to diagnose the underlying causes of economic malady at hand, followed by the assessment of the "patient's" health status, and only then proceed to the selection of an appropriate "cure" and treatment procedure.

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Received *May, 2018*
Revised *August, 2018*
Accepted *August, 2018*