Impact of Fiscal policy on economic growth: A case of EU countries

Dr. Brian Stewart

PHD in Microfinance

University of Leeds, UK

ABSTRACT

Aims: The research article aims to investigate the fiscal policy impact on economic growth while drawing evidence from the European Union (EU) countries.

Method: To conduct this research, a secondary quantitative methodology was adopted, and the data was collected that included the EU countries from 2007 to 2021. The results had been analysed through the STATA software, which provides the GLS regression results and the testing of heteroskedasticity and autocorrelation issues.

Findings: The results of the study state that income tax has a significant and negative effect on the GDP growth of EU countries. At the same time, the inflation rate has an insignificant and positive influence on the growth of GDP. Moreover, consumption expenditure has an insignificant and negative impact on gross domestic product growth in the European Union countries. The limitation of this research is that it has not focused on the effects of relaxing fiscal pressure on the EU as a whole rather than segmenting it into either public or private sectors.

Keywords: economic growth, fiscal policy, EU countries

INTRODUCTION

The global public authorities have responded to the economic and financial crisis of the last decade by implementing effective fiscal policy (Maşca et al., 2015). Fiscal policy is mainly targeted for short-term objectives. Unfortunately, it has been found that the long-term consideration of fiscal policy is not significant or favourable due to its collateral effects on the countries' economic growth (Adedoyin et al., 2020). The economy's upward trend has re-established itself due to increased public expenditures.

Fiscal policy is the use of taxation and government spending that influences the state's economy. Worldwide, governmental institutions use fiscal policy to promote strong and sustainable growth of the economy to reduce poverty (Monamodi, 2019). Makin et al., (2021), fiscal policy affects governmental spending by impacting the taxation costs on the future generation of the business. Reportedly, European Union does not have a significant central fiscal authority. Its budget is only 2 percent of the Gross domestic product (GDP), and budgetary autonomies remain under the hands of the parliament member states (VoxEU, 2022). Monamodi, (2019), the fiscal policy contains the attributes that facilitate the countries in improving their economy by adjusting the governmental spending and revenues. The government can impact the economy by either decreasing or increasing economic activities in the short term.

European Union (EU) has included 27 countries and became a member country in 1995 (Kirchherr et al., 2018). In 2008, the crisis resulted in departing the United Kingdom from the list of the EU countries that have affected its economic revenues and business trade. Chugunov et al., (2021), Fiscal policy may influence the exchange rates by using the governmental expenditure or taxation costs for lowering the economy. It may happen through interest rate fluctuations, price changes, and income changes (Monamodi, 2019). There is a relationship between the monetary policy and exchange rates as an increase in the exchange rates, the imports decreases, and export increases. For instance, if a central bank implements a monetary policy, the money supply increases by increasing the general price levels (Khordehfrosh et al., 2015). Maşca et al. (2015), small dimensioned public sector has a positive influence on the economic growth came as the result of productive investments compared to non-productive investments.

In order to get a sustainable fiscal policy, it is needed to reduce the public debt or to cautionary increase the public debt. Under the crisis of economic instability globally, the fiscal policy has turned the deprivation state by boosting economic growth (Elyassi, 2021). These policies helped during the crude oil crises in the 1970s and the great crises of the 1930s. After these eras, monetary policies have received much attention in re-establishing the economic output of the depriving states. The fiscal policy supports the structural transformation and investments in underdeveloped or low-income countries (Twinoburyo et al., 2018). Increasing the public expenditures causes the policymakers face challenges in implementing such changes as they may affect the public revenues. In order to create an Economic and Monetary Union (EMU), the members of the EU have agreed to independence over both the exchange rate and monetary policy. They have also agreed that fiscal policy will be placed in the hands of the governmental institutions to reduce the excessive deficits in one place.

The objective of this paper is to investigate the impact of the fiscal policy on the Economic growth of the European Union Countries.

LITERATURE REVIEW

Economic stability is pivotal in boosting the country's GDP (Hardy et al., 2019). Economic growth works by creating higher tax revenues and spending less money to get economic benefits. Economic growth works by improving or increasing the market values of the services and goods produced by an economy in a certain period (Soliyev et al., 2021). Statisticians have measured the growth by calculating the real gross domestic product rise. Reportedly, the Annual Growth rate in the European Union between 1996 till 2022 is 1.64 percent on average that reaching an all-time high of 14.10 percent in the second quarter of 2021 (Trading Economics, 2022). Germany has the largest national economy in EU 2020 with 4.3 trillion dollars. The European Union's economic policy has created a stable and prosperous eurozone in its selected countries. Monamodi (2019) mentioned that the official exchange rate, real interest rate, inflation, and M2 money supply are the factors that are linked with the fiscal policy implementation. Fiscal policy has shown great importance in influencing governmental expenditure and its revenues in boosting the economy of the European Union countries.

European Central bank (ECB) has coordinated Eurozone monetary policy, i.e., fiscal policy that has included controlling the euro common currency supply and interest rates. The primary mandate of the ECB is to bring stability in the prices which targeted 2% inflation by buffering against the consequences of destabilising deflation (Investopedia, 2022). The governments of the EU countries have adopted the fiscal policy to increase taxes and also dictated a decrease in the government spending to decrease the money circulation. A study stated that the fiscal policy affected the aggregate demand by changing the taxation costs and government spending that influenced the household income and employment rates (Auclert et al., 2018). These factors are associated with investments and consumer spending. Fiscal policy has impacted the money supply of the countries in the EU by fluctuating the inflation rates and interest rates simultaneously. Investopedia, (2022), fiscal policy contributes its part in expanding the business revenues of the states in the short term by considering the cost of debt, relative consumption costs versing saving costs, net exports, and employment rates. It is true that monetary and fiscal policy impact GDP by influencing aggregate demands. The Economic Survey of Belgium 2022 showed that Medium-term sustainability challenges of fiscal policy after the Ukraine war could be addressed by limiting the labour market (OECD, 2022). The improvement in public spending has reduced complications after implementing fiscal policy. It is reported that the government of Italy has taken many beneficiaries after the implementation of the fiscal policy by generating revenues up to 31.7% compared to the business revenues in 2013 (Italy Fiscal Balance, 2022).

Bergman et al. (2016) pointed out that the national fiscal policies can help promote sustainable growth alone by considering the public finances in the European Union or whether taking the support of the good governance. The fiscal rules effectively reduce the primary structural deficits at all the government efficiency levels. Balanced budget rules are most effective to firm fiscal rules (Azzimonti et al., 2016). Other institutional aspects have capabilities to enhance the effectiveness of the fiscal policy. The fiscal crises in the EU countries have triggered the design and implementation of stricter fiscal rules to reduce the rates of challenges. Treaty on Stability, Coordination, and Governance (TSCG) had introduced new public frameworks or rules for financial management, which signatories to the treaty which was agreed to be implemented into their national legislation and laws (Vlad, 2016). Since the introduction of the fiscal policy in the EU countries, it has been observed that the government efficiency varies widely across

the member states. In a study by Song et al. (2020), the era of COVID-19 has highly impacted the countries' GDP globally. For such reason, the fiscal policy focused on two important aspects: pandemic-related taxes and automatic stabilisers. Hutchins Center Fiscal Impact Measure (FIM) has measured the state, federal and local tax by subtracting the values from the economic growth (Brookings, 2021). Fiscal policy has boosted the economy and the EU countries' GDP during 2020 and 2021. FIM has measured that there is a direct relationship between the fiscal policies on the GDP, which can be beneficiated during the economic crises. The hypothesis of the study is provided under:

H01: there is an impact of the fiscal policy on the economic growth of the European Union Countries.

Conceptual Framework

The conceptual framework provides a visual representation of an assumed relationship between the variables. It is generally based on the literature review of past studies and theories. The conceptual framework of the current paper is presented below:
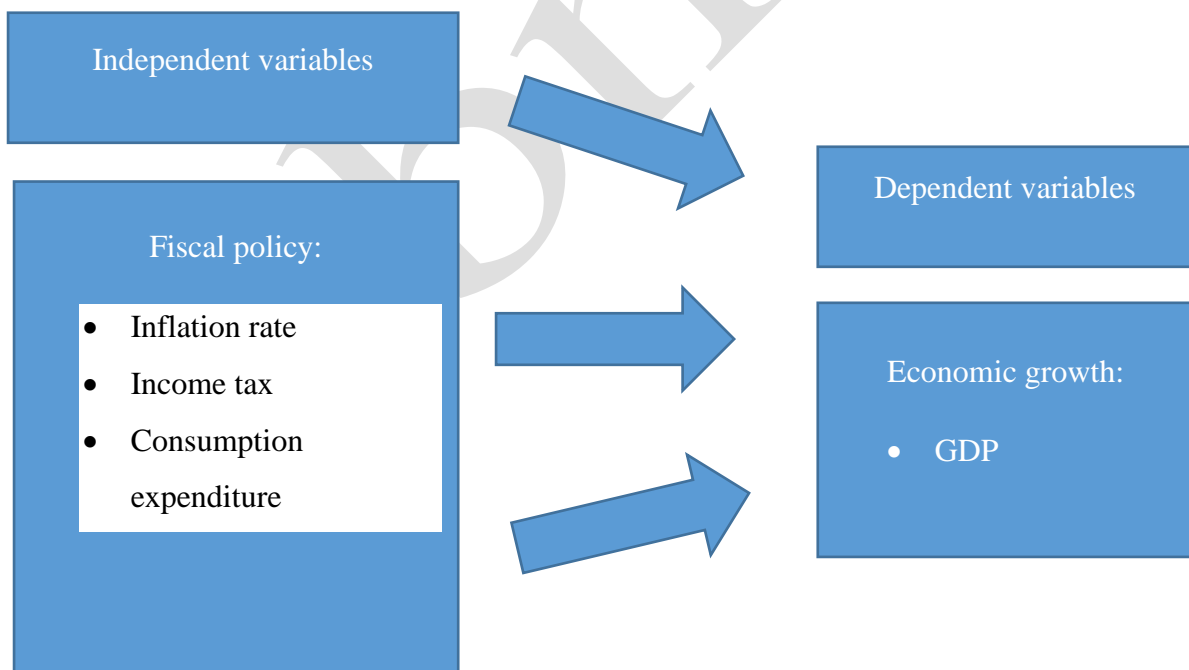
Theoretical framework

Fiscal policies effectively boost the economic growth of the European Union countries (Monamodi, 2019). Its emphasis is on implementing strong fiscal rules and designing the

institutions accordingly. The economic developmental theory defines the systematic explanation of interrelationships between the economic variables (Witt, 2016). The purpose of this theory is to explain the causal relationships to understand the basis of policy better. It focuses on economic growth by considering the innovation prompts. This theory effectively focuses on the variables of the current study to analyse the factors that are related to the economic growth of the EU countries. Bjørnskov et al. (2016) economic development of the states is based on the availability of resources and the selection of the appropriate economic policies. The governmental support helps the business organisations produce more revenues than in past periods (Kreiss et al., 2018). In addition, the business organisations contribute a higher percentage of the financial stability that works in stabilising the state's economy. The Keynesian theory argues that economies do not stabilise themselves in the least time and require active interventions that work in boosting the demand of the economy in a short period of time (Appelbaum, 2017). This theory sufficiently highlights the aspect that increased government spending may call for governmental restraints. It prevents increasing demands that may spur inflation. Keynesian theory is appropriate in defining the fact that fiscal policy significantly influences government spending and may reduce the possibilities of inflation. By the adoption of the theory, the governmental bodies in the EU countries could be forced to cut deficits and save monetary values for the next down cycle in the economy.

METHODOLOGY

This research methodology presents the techniques and tools that the examiners utilise for addressing the research problem (Ghauri et al., 2020). The researchers have taken the bits of help of research philosophy for assessing the research topic. This research study has focused on selecting secondary quantitative research methods to investigate the impact of the fiscal policy on the economic growth of the European Union Countries. For the data collection methods, the researchers have screened the World Data Bank for extracting the data for the past 14 years by looking at European Union countries like Germany, Netherlands, Belgium, France, Spain, Sweden, Romania, Austria, Portugal, and Italy. The range of data was selected between 2007 and 2021. The European Union countries' data were selected and analysed using the Generalised Least square (GLS) model. This model has helped in assessing the relationship between the study variables. The selected variables of the study are enlisted below:

- GDP growth
- Inflation rate
- Income tax
- Consumption expenditure

Those mentioned above are the independent variables. At the same time, economic growth is a dependent variable. Moreover, the investigators have selected regression analysis for assessing the parameters of the linear regression model. It was used for analysing the impact between the independent and dependent variables of the current study that can lead to justified outcomes and conclusions. This technique was suitable for analyzing the fiscal policy's impact on the economic growth of the European Union countries in the selected period of 14 years. The chosen secondary quantitative research methods were suitable for extracting reliable data for investigating the specific research problem.

$$GDP = a + \beta_1 inf + \beta_2 IT + \beta_3 CE + \epsilon \dots$$

RESULTS

Descriptive statistics

The table presented below concerns the descriptive statistics and the aims of these statistics to review the raw data and information into a basic and explanatory form that provides the appropriate output (George and Mallery, 2018). As presented in the table below, 150 observations were formed in the dataset recognized as the panel data set. At the same time, the data is collected from the ten countries of the EU countries from 2007 to 2021. Moreover, concerning the descriptive statistics, the mean value of the GDP growth is computed as 0.401, which redirects that the average level of GDP growth throughout the EU countries is 0.401%. At the same time, the standard deviation is 3.391% which redirects to a decline and increase in the GDP growth. Furthermore, the mean value of the income tax is 43.457%, which indicates the average income tax level among the selected countries. The standard deviation is 10.999 while reflecting a possible increase or decrease of the 10.999% in the mean value.

Further analysing the table below, the mean value of the inflation rate is computed as 1.684%, which follows the standards deviation of 1.453 and determines the inflation rate's incline or decline by 1.453%. The fourth component is the consumption expenditure. The mean value of

the consumption expenditure is 27.303, which determines an average increase in capital expenditure in EU countries. While the standard deviation is computed as 0.950, reflecting the decreases and increases of the mean value.

Variable	Obs	Mean	Std. Dev.	Min	Max
GDP growth	150	0.401	3.391	-11.267	9.307
Income tax	150	43.457	10.999	15.326	59.828
inflation rate	150	1.684	1.453	-1.545	7.851
consumption expenditure	150	27.303	0.950	25.684	28.943

Correlation analysis

The correlation analysis is referred to as the statistical technique utilized to examine the connection between the variables, like the change in the one variable can impact or cause the changes in the other variable. The correlation technique evaluates the three-factor: strength level and significance. The significance is determined using the P-value, where the value of the coefficient signifies the level and strength (below <0.05 = *) (Gogtay and Thatte, 2017). The table presented below concerns the correlation analysis, where it can observe that the income tax has an insignificant relationship with the GDP growth, and the strength and level of income tax also have a weak and negative association with GDP. Moreover, the inflation rate has an insignificant, weak interconnection with GDP. However, there is a positive interconnection between these two variables as the coefficient value is computed as 0.1016. Consumption expenditure also has an insignificant, weak, and positive relationship with the GDP, with a coefficient value of 0.0137. Other than that, consumption expenditure has a significant interconnection with income tax. However, the strength among the variables is weak.

	GDP growth	Income tax	inflation rate	consumption expenditure
GDP growth	1.0000			
Income tax	-0.0856	1		
inflation rate	0.1016	-0.0739	1	
consumption expenditure	0.0137	-0.3525*	-0.1342	1

Diagnostics test

Diagnostics tests are comprised of the heteroskedasticity test and the autocorrelation test. These are the test utilized to evaluate whether the regression's GLS (generalized least squares) model or the OLS (Ordinary least squares) model of the regression will be used. It is highlighted in the research of Charpentier, Mussard and Ndiaye (2019) that the Heteroskedasticity test indicates that residual variance is not equivalent over the measured value range. The modified Wald test is applied to evaluate the heteroskedasticity in the data set. These are the two hypotheses one is the null hypothesis, and the other is the alternative hypothesis. Moreover the null hypothesis is $H_{o} =$ there is no issue of heteroskedasticity, whereas the alternative hypothesis is $H_1 =$ there is the issue of heteroskedasticity. To accept the null hypothesis, the Modified test value must be above 0.05 (Baum and Lewbel, 2019). Then there is the autocorrelation test, which processes the association of the observations among the dissimilar opinions in time and consequently seeks the trend or the pattern over the series of time (Martini, Rivola and Troncossi, 2018). To evaluate the autocorrelation in the data set, the Wooldridge test is applied, where the null hypothesis is $H_{o} =$ there is no issue concerning the autocorrelation and the alternative hypothesis is $H_1 =$ there is the issue of autocorrelation. For accepting the null hypothesis, the Wooldridge test value must be above 10% (Torres-Barreto, 2018). The table below shows that the heteroskedasticity test's null hypothesis will be accepted as the value of the Modified Wald test is calculated as 0.2006 and above 0.05, which is the predetermined threshold. Apart from that concerning the autocorrelation, the alternative hypothesis will be accepted. It can be stated that there is autocorrelation issue present as the value of the Wooldridge test is calculated as 0.0006, which is lower than the 10%. The GLS regression model will be adopted to clear the autocorrelation issues.

	Prob>chi2
Modified Wald test	0.2006
Wooldridge test	0.0006

Regression analysis

      GLS Regression model for GDP growth.

GLS (generalized least squares) regression model denotes the method that examines the undefined aspects of the parameters in the linear model of regression analysis when there is a definite point of association amid the residuals in the model of regression analysis (Mansour, 2020). The table below concerns the GLS regression model of the GDP growth. The probability P>|z| is computed as 0.000 and must be 0.05, which presents the significance of the regression model. Moving to the research results, income tax [C= -.023; p=0.00] is found to have a significant influence on GDP growth as the p-value is below 0.00. Moreover, the coefficient value is computed as -.023, which determines that income tax has a negative effect on the GDP growth of EU countries. Concerning the inflation rate [C= .017; p=0.778], it is found to have an insignificant and positive influence on the growth of GDP. It demonstrates that the inflation rate positively influences the overall GDP growth. Other than that concerning the consumption expenditure [C= -0.487; p= 0.28], it is found to have an insignificant and negative influence on gross domestic product growth in the EU countries.

GDP growth	Coef	Std. Err.	z	P>|z|
Income tax	-.0230749	0.003571	-6.46	0
inflation rate	.0172185	0.06109	0.28	0.778
consumption expenditure	-.0487331	0.045113	-1.08	0.28
_cons	2.941367	1.400085	2.1	0.036

DISCUSSION

The research aims to examine fiscal policy impact on the EU countries economic growth. The results of the study state that income tax has a negative as well as significant effect on the GDP growth of EU countries. In contrast, the inflation rate has an insignificant and positive influence on the progression of GDP. Moreover, consumption expenditure has an insignificant and negative impact on gross domestic product growth in the EU countries. Other than that, by relating this study with the other previous studies, Macek and Janků (2015) conducted a study that investigates the fiscal policy impact on economic development contingent on institutional

situations. The researcher collected the data from the Organisation for Economic Co-operation and Development (OECD) nations, taking the time 2000-2012. The results of the study state that taxation has a negative influence on the progress of the country's economy. The study also states that taxation is harmful to the country's economic development that has the worse institutional circumstances.

Other than that, the study of Hodžić, Demirović and Bečić (2020) is based on the association between economic growth and fiscal policy in CEE countries. To conduct this study, the researcher collected the data from the 21 (CEE) Central and Eastern European countries from the period taken was 2000 to 2018. The outcomes of the study state that a rise in taxation but not in expenditure creates a positive effect on economic development and growth. Other than that, the researcher indicates that the study's key findings are a positive and significant concurrent association between economic development and the general level of taxation. Along with that, there is no association between economic growth and administration final consumption.

CONCLUSION AND RECOMMENDATIONS

It has been concluded from the above discussion that a fiscal policy impacts government spending via the tax burden it places on the next generation of businesses. According to reports, despite the European Union lacking a sizable central fiscal authority, the fiscal policy has features that help the countries improve their economies by modifying governmental spending and income. Economic growth works by increasing tax revenues while reducing spending on goods and services. Along with that, economic growth works by enhancing or raising the market values of the goods and services that an economy produces during a specific period. According to the research's findings, income tax has a substantial and detrimental influence on the GDP development of EU nations.

In contrast, the inflation rate has a negligible and beneficial effect on GDP growth. Additionally, consumer spending has a negligible and detrimental impact on expanding the EU countries' gross domestic product. Concerning the recommendations, the policymakers should also support smart macroeconomic measures that guarantee effective public purse management. It can be accomplished by properly tracking public spending and receipts; as a

result, government receipts will rise, the public deficit and debt will decrease, and economic development will speed up.

The main limitation observed in this case is that it has not focused on the effects of relaxing fiscal pressure on the EU as a whole rather than segmenting it into either public or private sectors. Moreover, the study did not focus on the concept of debts and their impact on the EU fiscal policy. Due to it being a factor in influencing economic growth prospects, its absence in the journal contributes to a limitation of this study. The future implications, in this case, are regarded to be based on the impact of fiscal policies on the EU sector, and its impact is on the financial capabilities of the EU's main economic driving sectors. The future implication will be based on the growth's ability to accommodate human consumption and the overall sustainability of the financial model implemented by the EU. Better specifications of the econometric models will also be included in the future implications citing its relevance in assessing the fiscal policy impact on the EU's economic growth.

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