

Jeffrey Frankel comments on:

The Euro, Stabilization Policy, and the Stability and Growth Pact
OR
Can Rubinomics work in the Eurozone?
Adam S. Posen

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edited by Adam Posen*

American economists' skeptical predictions regarding EMU were in some respects too pessimistic, in light of experience so far. But two predictions have turned out to be accurate:

(1) A permanent 3% ceiling on deficits, without flexibility, e.g., for recessions, **would not be fully enforceable**. The provision for monetary penalties against countries that violate the limits do not increase the credibility of enforcement; it may reduce it. At the same time, the continuing contradiction between word and deed undermines the credibility of other agreed aspects of the European unification project, e.g., vis-à-vis accession of the new ten.

(2) Members of euroland would suffer from occasional asymmetric shocks. In that light, **discretionary fiscal policy would become more necessary now that monetary independence has been lost, not less.**

Adam Posen's paper contains a number of very interesting findings. Perhaps the primary conclusion is that the Stability and Growth Pact has not in fact limited countercyclical responses of fiscal policy among EMU members since 1999. That is in part due to the willingness to violate the limits of the SGP, especially on the part of the larger countries. He finds that the countries that are smaller and have high ratios of trade to GDP have found the SGP less onerous, for several reasons. In the first place, fiscal policy has less of an effect on the domestic economy in a country where much spending leaks out because it falls on imports or other internationally traded goods. Thus they are giving up less.

In the second place, the larger countries -- Germany, France, and Italy [and perhaps Spain should be added] -- felt the loss of monetary autonomy more keenly, and felt the need to compensate with active fiscal policy, whereas most of the smaller countries had already given up monetary autonomy to Frankfurt years ago, and had come to terms with it. Actually, Adam finds that even the smaller countries did not have a statistically significant decrease in counter-cyclicality in fiscal policy during 1999-2003,

despite the SGM. But with so few observations, we may have to settle for point estimates rather than statistical significance. He finds that three of the larger countries Germany, Spain, and Italy actually show an *increase* in countercyclicality under EMU. This is consistent with the idea that they have relied more on the fiscal policy tool now that the monetary policy tool is gone.

In the third place, the larger countries can get away politically with breaking the rules in a way that the less powerful countries cannot. These are all important points, some which are not widely recognized.

Is Europe less well-suited to expansionary consolidation than the U.S.?

The United States is even larger than the large European countries, and has a lower ratio of trade to GDP. If the author's generalizations are correct, why, then, did the US pursue and achieve fiscal discipline during the course of the 1990s? That question can be broken down into two questions: The question of politics is: Why were tough fiscal measures -- raising tax revenue and cutting the rate of growth of spending -- taken in the US? The question of economics is: Why did the new fiscal policy apparently succeed in helping to raise the growth rate -- the "expansionary consolidation" of Giavazzi and Pagano (1990)? These two questions are more closely linked than is at first apparent. If fiscal policy is defined in terms of tax revenue or the budget balance, then of course an important component of the improvement was the result of rapid growth; in other words causality goes in both directions. But assume we limit our definition of fiscal discipline to specific policy measures. An important reason why President Clinton and Treasury Secretary Rubin took the measures they did was that they believed it would help the economy. Given that this turned out to be right, one does not need to say a lot more about the politics.¹ So the main question is the economics: "why did Rubinomics work in the US and not in Europe." Here my view diverges a bit from Adam's. And so it is here that I will devote most of my comments.

Adam's answer to the question posed in the title of his paper is essentially "No, Rubinomics cannot work in Europe." He argues that the main channel of Rubinomics runs from fiscal consolidation to lower interest rates and thereby to higher investment, and that this channel is less operational in continental Europe. One reason he gives is that the US, unlike Europe, is a large net debtor internationally, so there can be a large default premium built into the interest rate which fiscal consolidation then works to reduce. I see two problems with this argument. First, high domestic debt (and unfunded future pension liabilities) can in theory drive up the default premium as easily as high foreign debt. Secondly, the US -- despite its debts both domestic and foreign -- has never (as yet) had to pay a perceptible default premium on its debt. Even when its fiscal policies have been at their most irresponsible, the dollar has retained its status as premier reserve currency and the US treasury bill market has retained its extra attractiveness to international investors.

Perhaps a better argument for why the interest rate channel does not work in continental Europe is that the money markets and securities markets are less well-

¹ Nonetheless interesting is the story of how, after the 1992 election, the Rubin view came to win out over the priorities of other Clinton advisers -- Clinton (2004), Rubin (2002, p.131), and Woodward (1994). The most effective argument was that the bond market would react negatively, if investors heard that all the spending programs contemplated during the campaign were to be carried out in full.

developed and less flexible there. Interest rates are traditionally considered to be not as responsive to a given reduction in national saving, and investment is not as adversely responsive to a given increase in interest rates.² In other words, the LM curve is flatter and/or the IS curve is steeper, so crowding out is less of an issue. But this argument won't necessarily get you there either. The national saving identity must hold one way or another. There are other channels of crowding out besides the interest rate channel that has long been emphasized by the macroeconomics textbooks, including stock markets and the exchange rate. In the case of continental Europe, there may be channels that work through the quantity of credit extended to firms -- without showing up in interest rates or other price measures. If banks are lending to Airbus, then they are not lending to private start-up companies.

Furthermore, the generalization that the interest rate channel is not fully operational in continental Europe may no longer be true. Table 1, from Chinn and Frankel (2003), reports estimates of an equation for the determination of the long-term real interest rate in the United States and five European countries. The estimated effect of contemporaneous debt is stronger in Germany than in the United States, though weaker in the other four European countries. The more striking result is that the estimated effect of the *expected future* change in debt is statistically significant in all four large countries of the euro-zone, and the effect is actually stronger than in the U.S. -- in magnitude, significance or both. This is important, because the possibility of expansionary consolidation lies in expected future deficits, not in contemporaneous deficits. While contemporaneous deficits in standard textbook theory drive up short-term interest rates and lead to crowding out of investment and other sectors, this effect can only be a partial offset to the expansion in government spending and consumption. On net the contemporaneous effect is expansionary. (More on the two effects below.)

² Adam's example of Italy is particularly interesting here. As he points out, some combination of EMU and fiscal discipline did succeed in sharply reducing real interest rates in Italy, and yet there was no investment boom.

Table 1: *Determinants of long term real interest rates in the US and Europe*

	US	Germany	France	Italy	Spain	UK
Constant	-0.001 (0.008)	-0.122*** (0.038)	-0.022 (0.027)	-0.081 (0.041)	-0.043* (0.023)	-0.034 (0.030)
Inflation	1.00	1.00	1.00	1.00	1.00	1.00
debt ratio	0.060** (0.019)	0.182*** (0.047)	0.027 (0.040)	0.109 (0.062)	0.031 (0.051)	0.067 (0.044)
expected change in debt ratio	0.144** (0.061)	0.112*** (0.032)	0.177** (0.073)	0.324** (0.106)	0.289*** (0.048)	0.066 (0.110)
output gap	0.388** (0.174)	0.608** (0.219)	0.252 (0.202)	0.297 (0.484)	0.218 (0.223)	-0.316 (0.324)
Foreign interest rate	0.096 (0.122)	1.529*** (0.327)	0.923*** (0.241)	0.390 (0.446)	1.204*** (0.145)	0.815** (0.348)
N	15	15	15	15	15	15
Adj.R ²	0.32	0.51	0.82	0.77	0.82	0.55
DW	2.24	2.50	2.47	1.70	2.47	1.44

Source: Chinn and Frankel (2003)

Notes:

OLS regression using annual data, in levels

(Newey-West robust standard errors in parentheses).

Percentage variables defined in decimal form. N is the number of observations.

Adj.R² is the adjusted R-squared.

*(**)[***] denotes significance at the 10%(5%)[1%] level.

Three regimes that have been proposed to achieve fiscal discipline

In any case, I don't think I accept the premise that expansionary fiscal consolidation is made possible by some structural feature in the United States that is absent in Europe. The most powerful pieces of evidence are the fiscal records of the 1980s and the present decade. The fiscal consolidation of the 1990s was the exception, not the rule. By this I mean not just that the second Bush Administration in 2001 launched an irresponsible fiscal expansion, which in many respects was modeled on that of the first Reagan Administration in 1981. I mean also that there has not been an economic price paid in terms of higher interest rates and slower growth, and least not yet. In other words, as with the achievement of fiscal discipline in the 1990s, there is both an interesting political question (how have they been able to do this, politically?) and an interesting economic question (why haven't financial markets responded yet?). As surely as expansionary consolidation seemed to work, both politically and economically in the United States in the 1990s, the return of a "tax-cut and spend" philosophy failed to have both the political and economic consequences during the period 2001-04 that one would have predicted. This suggests that there was something different about US policy in the 1990s, more than that there is something permanently different about the US.

I suggest that the key lies in the political economy regime that is adopted to achieve fiscal discipline. Everyone at least pays lip service to fiscal discipline, even when seeking to justify large deficits. The question is how it is achieved, in a world where there are always interest groups clamoring to receive benefits in the form of tax cuts and spending.

I see three categories of regimes that have been proposed as mechanisms for achieving fiscal discipline. The first is "*Starve the Beast*," the rationale that the Republicans gave to the regime that I call tax-cut and spend, in the first Reagan and second Bush administrations. (More precisely, in both cases, it is the rationale they began to give in the second or third year of these administrations, after the clear failure of events to bear out their initial rationale -- that reductions in tax rates would lead to so much economic growth that the budget will get better rather than worse.) *Starve the Beast* is the argument that large tax cuts, though they will create temporary deficits, will soon force cuts in spending because "Congress can't spend money it doesn't have."

The second category of proposed mechanisms is *rigid rules*. Two prominent examples are the balanced budget amendment that was rejected in the United States (the proposal was part of the "Contract with America" in the Gingrich revolution of 1994) and the SGP that was adopted in Europe.

The third regime is the one that was actually in place in the 1990s, which I will call the "*regime of shared sacrifice*." This category of mechanisms includes laws and guidelines to facilitate fiscal discipline by spreading the pain relatively easily. Three of the important mechanisms used in the 1990s were (i) caps on the rate of growth of discretionary spending (which were adopted in the Budget Enforcement Act of 1990 and extended by the Clinton Administration in 1993); (ii) PAYGO (the Pay As You Go rule, also legislated in 1990 and 1993, which said that any congressperson proposing a tax cut or entitlement spending increase had to show how to pay for it); and (iii) the principle of preserving the on-budget surplus under the slogan "Save Social Security first" (proposed

by Clinton in the State of the Union message in 1998, and accepted by both parties until George Bush assumed office in January 2001). My claim is that what was different about the 1990s in the United States is that the regime in effect, Shared Sacrifice, is a regime that works, whereas the other regimes do not.

Let us begin with the rigid rules, and why they don't work. As everyone knows, any gain in credibility that is achieved through a rigid rule carries a loss in flexibility. With rigid monetary rules such as dollarization or a currency board, the government loses the ability to respond to recessions or overheating by mitigating moves in monetary policy. With rigid fiscal rules such as a balanced budget amendment, the government loses the ability to respond to such disturbances by mitigating moves in fiscal policy.

Less often appreciated is that commitments to ever more stringent rules eventually run into negative returns even when the payoff is measured solely by credibility. This is especially true when the commitment is made by an elite that may not have democratically sought or received sign-off from the people. Which is more credible: a statement by a central banker that he will resign if he misses a particular monetary target, or a statement that he will shoot himself? The latter commitment is less credible, precisely because it is a stronger statement than the first, and is too strong to be believable. The same is true of a balanced budget amendment (BBA) and the SGP. A severe and inflexible commitment not to step over a particular line with respect to the budget deficit carries such high costs that it is not credible in the first place. This is the underlying explanation for Adam's important finding that the SGP has in fact not reduced the fiscal activism in euroland by even a little.

Let us consider, next, why Starve the Beast does not work. It is not literally true that a government cannot spend money it doesn't have. Governments do it all the time, and on a very large scale. (Only under a rigid balanced budget rule would it be true, and that we have just considered.) But the claim is that cutting taxes and creating budget deficits puts strong political pressure on the government to cut spending, because people don't like the deficits. But "strong pressure to cut spending" compared to what? For the claim to be meaningful, it should be stronger pressure than under the alternative of the 1990s regime, the one I have called "Shared Sacrifice."

In support of my claim that Starve the Beast is a sham I offer a graph, some econometric citations, an apriori argument, and a fascinating fact.

Fig.1

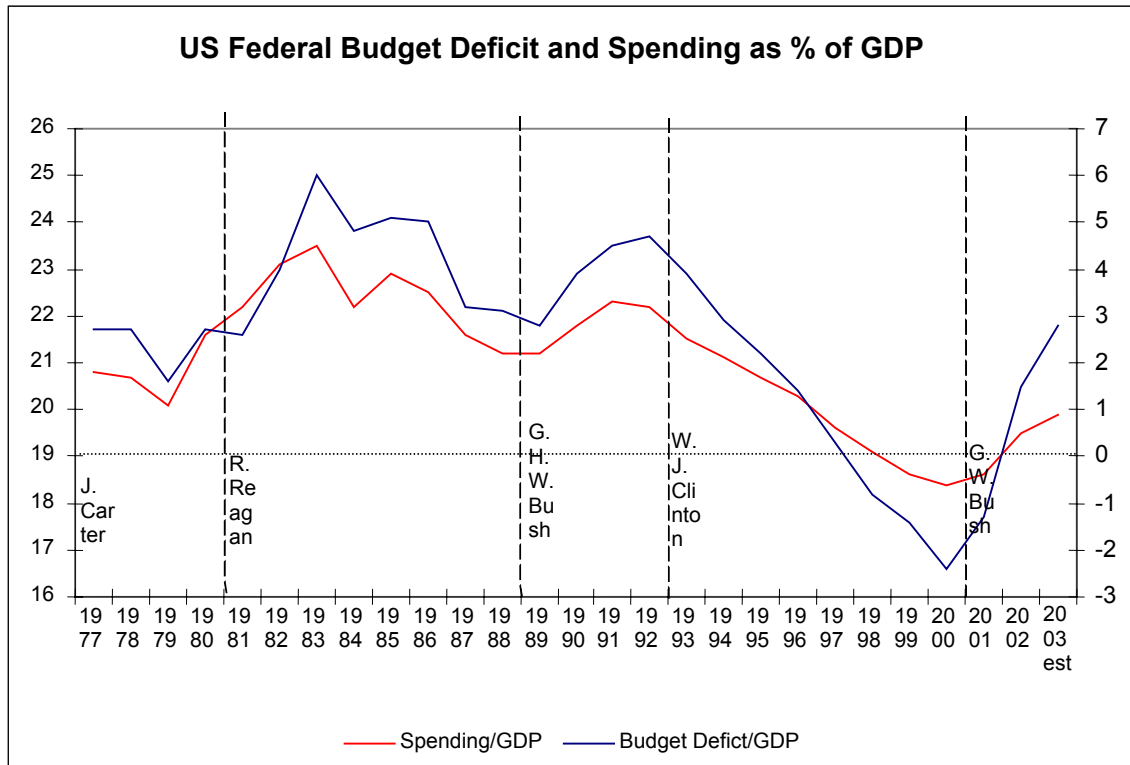


Figure 1 illustrates the budget over the terms of the last five presidents. The first striking lesson is: When a Republican president comes in, the budget deficit takes off. It may sound surprising, but there it is. Ronald Reagan becomes president in 1981 – the budget deficit shoots up. George Bush I takes office in 1989 – the same. George Bush II arrives in 2001 – the same. In between, during the Clinton Administration, the budget deficit is eliminated, and replaced with a record surplus. Now, you might think this pattern was entirely because of Republican tax cuts and Democrat tax increases, if you fell for the line that the Republican Party is the party of small government. But the striking pattern in the budget is not entirely, or even primarily, due to taxes. The figure also shows federal spending, by presidential term. When a Republican becomes president, spending increases sharply. It is true when Ronald Reagan became president, when George Bush I became President, and when George II became President -- 1981, 1989, or 2001. The deficit-spending correlation casts doubt on the claim that their tax cuts were part of a plan to reduce the rate of growth of spending.

Niskanen (2002) and Gale and Kelly (2004) have conducted more formal econometric tests, and they reject the Starve the Beast proposition statistically. It appears that, rather than a positive correlation between tax revenue and spending, there is a negative correlation. The reason is that the historical data exhibit two regimes, one in which budget discipline is achieved through tax increases and spending cuts simultaneously (Shared Sacrifice) and another when budget profligacy is achieved through the reverse policies. The hypothesized combination of tax cuts followed closely

by spending cuts just does not describe American history. Only after presidents have reversed their low-tax campaign platforms (Clinton originally had one too) has progress been made at cutting both government spending and the deficit.

Consider now the a priori case. What is the mechanism through which the Starve the Beast approach is in theory supposed to restrain spending? The mechanism is that if you create huge deficits, citizens will worry so much about the national debt that they will come complaining to their Congressman: "I'm worried about raising taxes on my grandchildren." The Congressman will then be less likely to vote higher spending. Maybe people worry about the national debt, about taxes on their grandchildren. But surely they don't worry about such uncertain prospective future taxes (as hypothesized in the Starve the Beast paradigm) *more* than they worry about *certain taxes today* (as they must, in the Shared Sacrifice paradigm). Unpopular taxes today must put more pressure on Congressmen. Thus, as a political economy argument, Starve the Beast just doesn't make sense, if the alternative is the regime of the 1990s.

It is an ex post rationalization which some Republicans have found it convenient to use in some circles and not in others, but it doesn't describe the motives of those passed the Bush tax cuts. One final piece of evidence, with is also due to Gale and Kelly (2004). Almost half the members of Congress, together with President Bush, have signed a "no new taxes pledge," which, based on the Starve the Beast rationale, would make permanent the new tax cuts and prevent most tax increases. But an examination of the voting records of the signers in Congress shows that they have been *more prone to vote for spending increases* than have the non-signers have been. It is thus hard to believe that their motives are genuinely to force their colleagues to cut spending.

The Shared Sacrifice mechanisms of the 1990s -- spending caps, PAYGO, and "save Social Security first" -- have in common budget neutrality as a criterion for future changes relative to the baseline. The strategy comes from the logic that to achieve budget balance, the country must recognize the need for sacrifice and agree to share the burden. It is the idea that, "If I forgo my tax cuts, you forgo your spending increases." The only way you ever get budget discipline in the long run, is a common spirit along the lines "I would like to get my pork-barrel project funded for my constituents, but I will hold back if everybody else is holding back." The 1990s showed that the principle of shared sacrifice works. Notice the difference from the principle of Starve the Beast. The first is "I will give up the tax cut I want if you give up the spending you want." The second is "I will take the tax cut I want, and in return you give up the spending you want." Which sounds like a more politically plausible route to a deal in Congress?

The problem is that the caps and PAYGO expired in 2001 and that there has been no effort to restore them, at least not from the White House. (Senator Kerry supports a restoration of the caps and PAYGO.)

How has Bush achieved such large deficits? Some pointers for European politicians

I have discussed how Clinton achieved a surplus by the end of the 1990s. How was Bush able to achieve such big deficits? The 2001 recession helped. And it is always easier to give away money than it is to collect money – an important principle of political economy. But there is a third factor: the government made forecasts of future budgets

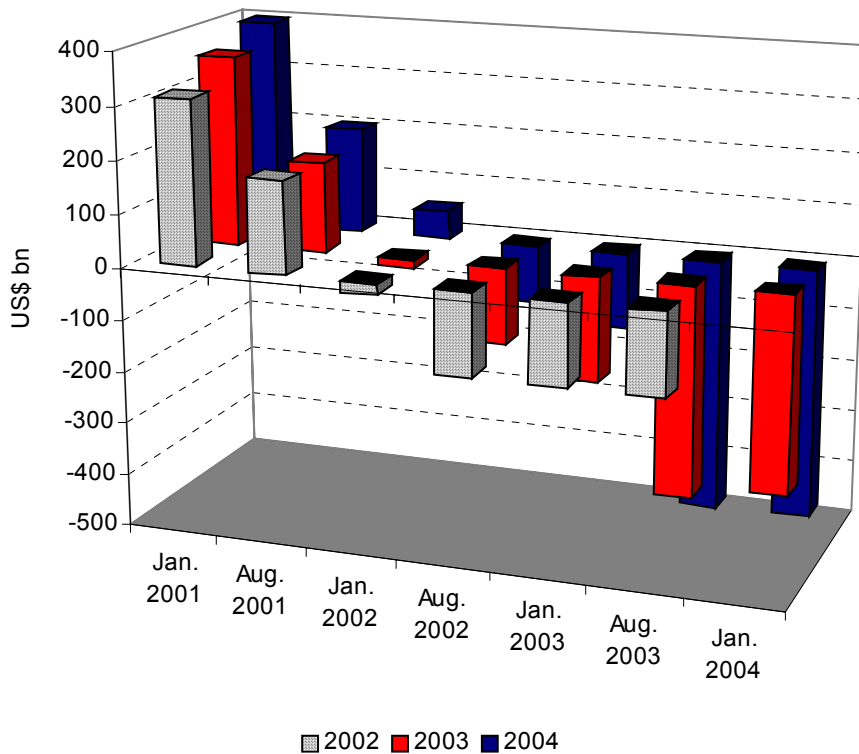
that were overly optimistic, and predictably so. This enabled the White House to say that the country could afford these huge tax cuts. The forecasts were part of the mechanism that allowed this fiscal mess to come about. They release their budget forecasts twice a year and, to date, every time they have been forced to admit that last time they were wrong. And then, every time, they have done it again – “they” being both CBO and OMB. (A qualification: CBO has little choice but to base its projections on current legislation, even where Administration policy and informed prediction both call for costly future changes in legislation, such as new tax cuts.)

When the new Administration came in, in January 2001, it boosted the revenue estimates, helping it claim that we were going to have record surpluses rising as far as the eye could see. The first set of three bars in Figure 2 illustrates. In May 2001 they admitted that the surpluses weren’t going to be quite as big as they had said four months earlier, but they still saw substantial surpluses, and still rising. In January 2002, the same thing: that the surplus was small now, but it was still positive and still rising in the future. (This is after the recession and September 11.) Then in August – whoops! – we were in deficit after all, but it was going to go away gradually in the future. They continued, each time, to be forced to revise.

CBO is still forecasting deficits for the next few years but a path to surplus by 2013. (OMB has decided to stop forecasting at the ten-year horizon.) That is still overly optimistic, for a lot of reasons.³ It is surprising that the press goes on reporting these forecasts, largely at face value. But the misleading forecasts might help explain why voters and market participants alike seem not yet to have fully understood the magnitude of the coming deficits.

³ Frankel (2003, pp. 37-45) lists ten reasons, and also discusses the coining of the word “Rubinomics” by Glenn Hubbard.

Figure 2: Three years of budget forecasts that soon proved overly optimistic



Data Source: U.S. Office of Management and Budget

To justify their large deficits, in violation of the SGP, European leaders might increasingly want to rely on the Bush defense: yes we are running high deficits at the moment, but our projections so that the fiscal situation will improve in the future. It may be helpful to them to hear some elaboration on the tricks that the American authorities have found useful.

- Make unrealistically optimistic economic assumptions. If forecasting record real growth is too obvious -- this trick has been used so often in the past that even the American press will sometimes report it -- instead play with other parameters that affect tax revenues. The OMB in January 2001 raised the predicted share of income going to wages and salaries, a subtle way to achieve this effect.)
- Assert that you will cut spending in the future, even in absolute terms and even if it has been rising sharply as a share of GDP over the last four years, and even if you are proposing expensive new programs. When spending turns out to be higher than your budget forecast, you can always pretend it is a surprise, and ask for a “supplemental appropriation.” If you pretend it is part of national defense or homeland security, the public is unlikely to question it.
- Move/keep pension funds on-budget while they are running a surplus. (When the baby-boomers start to retire next decade, move it back off budget.)

- Whenever you reduce a tax, always give the legislation a phony sunset a few years in the future. If politically important constituents complain that they want a permanent tax cut, reassure them that this is entirely your intention. That does not mean that you have to put it into the budget forecast.
- Switch between 1-year forecasts, 5-year windows, and 10-year windows, depending on which, at a particular moment, allows you to claim that the trend is in the right direction.

Rubinomics, and Expansion vs. contraction

Rubinomics is supposedly the claim that fiscal consolidation has a positive effect on growth. To answer the question whether fiscal contraction can be expansionary, we must consider two offsetting effects: the contemporaneous effect and the confidence effect. They are the same two effects that Adam identifies with Larry Ball and Greg Mankiw, on the one hand, and Alan Greenspan on the other.

In the short run, fiscal expansion is expansionary. But, at the same time, market expectations that the economy is on a future path of a rising debt-to-GDP ratio can put a lot of upward pressure on long-term interest rates today, and that in itself is contractionary. The two effects go in opposite directions -- the contemporaneous Keynesian expansionary effect and the contractionary effect via long-term interest rates. In practice it is hard to separate the two out. Actual moves towards fiscal discipline, rather than rhetoric alone, are usually required in order to influence expectations and achieve credibility.

Table 2 is a stylized account of recent fiscal history in this light. It covers four presidential terms, two for Clinton, and two for Bush. (The fourth term would have been heavily influenced by the Bush legacy of debt whether he was the president again or not.) The effects of contemporaneous fiscal stimulus appear in the first Clinton column and the first Bush column. I would say that Clinton's mildly contractionary fiscal policy had a mildly contractionary effect contemporaneously, and Bush's expansionary fiscal policy had a modest positive stimulus contemporaneously. But now let's talk about expectations, the effects on the economy of expected future fiscal paths, which come through long-term interest rates. They are illustrated in the 2nd and 4th columns. Both Clinton and Bush claimed to be on a good long-term path. Initially it wasn't entirely credible on either part. But Clinton even in his first term got some credibility benefit. In the second term, when the markets saw that these promises were coming true, interest rates declined, the stock market rose, investment boomed, and the economy grew.

Table 2: Stylization of the two channels of fiscal policy, by presidential term

	Clinton Administration		Bush Administration	
Effects on growth	1st term 1993-96	2nd term 1997-2000 & beyond	1st term 2001-04	2nd term 2005-08 & beyond
as, over time, the numbers show the promises of fiscal responsibility ...		to be increasingly credible		to be less and less credible
(1) Effect of contemporaneous fiscal stance, via demand (“Keynesian effect”)	Mild contraction	Mild contraction	Positive stimulus	Approx. neutral
+ (2) Effect of expected future fiscal path, via long-term interest rates (“confidence effect”)	Mild expansion	Strong positive effect	Mild contraction	Strong negative effect
= Overall impact of fiscal policy on growth	Approx. neutral	Positive	Weakly positive	Strongly negative

Clinton set goals by the end of the first administration to cut the deficit in his second administration . These claims of fiscal responsibility became increasingly credible over time, and so long-term interest rates fell (with the help of accommodation from the Fed). I think that in the second term of Bush, we will once again see the emergence of deficit numbers far larger than are currently officially forecast, and that this has not yet been properly absorbed by the public and the markets. Meanwhile, the Fed is beginning to withdraw the extraordinary monetary stimulus of 2001-04. Interest rates will go up, which will start to have a negative effect on the economy.

How might Europe salvage the SGP?

But let us return to the fiscal problems of Europe. What is to be done, if neither Starve the Beast nor a rigid rule works? How can shared sacrifice be formalized and institutionalized?

There are proposals for a BBA or SGP that introduce some much-needed flexibility, allowing cyclical adjustment of the targets, while maintaining a balance of zero on

average. But if you allow more flexibility in the form of cyclical adjustment, then you will lose even more credibility: governments will always claim that their budget shortfalls are due to temporary bad luck in the economy (bad weather, terrorist attacks, the dog ate my homework). They will always be tempted to use the tricks that US policymakers have used so effectively in recent years.

I like, better than does Adam, a proposal that is a formalized version of an institution that Chile now has. The rule is a cyclically adjusted budget balance of, say, zero; but you appoint an independent fiscal authority or commission of experts, by analogy with the Fed and other independent central banks and they are the ones who have the responsibility for saying what constitutes deviations from potential output, for computing the cyclically adjusted budget, for making forecasts, and for announcing whether this year's budget satisfies the rule. The rest of the government still has the responsibility for allocating spending and taxes within the total, as it should in a democracy. I see this proposal as offering the flexibility that the regimes of BBA and SGP lack, while preventing the abuse that the regime of Starve the Beast has so abundantly experienced.

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