

Review

Consequences of fiscal deficit

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The main objective of this paper is to understand and to evaluate recently expressed popular anxiety about fiscal deficits. The paper begins with a discussion of problems involved in measuring the fiscal deficit. A general conclusion is that all interesting measures of the federal fiscal deficit have increased substantially over the past eight presidential terms and are likely to increase further in the near future. The paper goes on to analyze possible connections between fiscal deficits and inflation, economic growth, and fluctuations in the level and composition of economic activity. Fiscal deficit is the difference between current and capital expenditure and current receipts the debt trap. The fiscal policy is intended to play a key role in the prospective economic growth. It is not merely because of the fact that fiscal situation is a major component that determines the macroeconomic stability. Important conclusions are that of the monetary policy, inflation, and aggregate economic activity are all largely independent of the fiscal deficit, but that of the fiscal deficit can have major effects on the division of output between consumption and investment. Key elements in the analysis are the effects of taxation on consumption and investment demands and the relations between real and financial developments.

Key words: fiscal deficit, real exchange rate, financial integration, fiscal sustainability, EU, panel co integration.

INTRODUCTION

Economic problems as consequence of fiscal deficit

Fiscal deficit is the difference between current plus capital expenditure and current receipts. When a government spends more than it receives in taxes and other revenues in a given year, it has a budget deficit (Stiglitz and Walsh 2008) commonly referred to as the fiscal deficit. If a government runs a deficit; it borrows on financing the gap between expenditure and taxation; as a result, the stock of outstanding debt is increased. It is necessary to analyze the cause of fiscal deficits to see when such can or cannot cause economic problems. Investment expenditures such as those on infrastructure yield returns that exceed the interest paid. These expenditures will improve future government revenues e.g. \$100 spent to finance the construction of a stretch of highway may yield additional revenue of \$5 additional revenue to government every year. Likewise, it represents an increase in revenue greater than the Revenue Consequences of Capital Expenditure (RCCE). The fiscal deficit is justified in such a case. Fiscal deficit to finance

capital expenditures on building of bridges, roads, dams, railway lines, water supply systems, etc. can also be justified due to inter-generational distribution of costs so that later generations will also use such services. When deficit is used to finance a revenue deficit, aggregate consumption increases as the government uses the money for consumption expenditure, while there is fall in investment. This will lead to decline in the GDP growth and the growth rate of economy will fall. In such case, the government will spend all its revenue on interest payments leading to potentially serious political and economic problems. However, it is a risk if there are long term deficits and ultimately countries risk falling into the debt trap.

In addition, governments may run deficits due to higher defense spending during wartimes such as in U.S. during the 1970s Vietnam war when it was 8.4% of GDP. Increased social sector spending such as on elderly, and health care expenditures cause higher deficits as well. Similarly, expenditures on healthcare were rising rapidly in 2003, China and India proclaimed increased fiscal

deficits compared with previous year, of 5.6 and 3% of GDP, respectively. In both cases, deficits were used mainly finance increased infrastructure, defence and social sector spending. However, increased government borrowings such as through issuance of bonds increase the interest rates. Thus, the deficit financing of the revenue deficit causes crowding out of potential flow of investment resources to the private sector and also reduces private welfare by reducing private consumption enabling the government to consume more. It is clear that governments running deficits accumulate debt, as the fiscal deficits to finance investment expenditures for future revenues may be justified and those to finance revenue deficits may cause economic problems.

SIGNIFICANCE OF SOURCES COVERING GOVERNMENT DEBTS

When the government runs a deficit, it must borrow to finance the difference between expenditure and revenues. Subsequently, due to borrowings, the government accumulates debt.

Domestic/national debt

Governments may accumulate national debt by issuing bonds that are subscribed to by the private sector in the country. In this case of national debt, there is no subtraction from the net wealth of the nation as the assets of the government are owned by the citizens themselves. Furthermore, national debt also has redistributive effects when only relatively well-off people with savings may be able to subscribe to the bonds and have claims to national debt, considering here crowding out and impact on interest rates.

The national debt can either be repaid through increased taxation or through cuts in expenditure. As mentioned by Stiglitz and Walsh 2008, taxation affects risk taking, the allocation of resources to research and development, and long run rate of growth of economy. Further, taxation affects behaviour of individuals and firms and can lead to changes between pre-tax and post tax decisions. National debt can have inter-generational implications. With the fast increasing population of those eligible for social security and medical care and increasing health care costs in U.S and Europe, the financial costs for social sector is increasing. In addition, some people in Europe criticize, the selfish sixties (1960s) and those who enjoyed benefits of free education and healthcare financed by debt that burdens the present generation. Thus, in most countries, governments are reluctant to incur debt for welfare and social spending on grounds of such claims about inter-generational inequity.

External/foreign debt

Implications of increasing foreign debt may lead to flow of

resources outside of the country due to increased interest payment and therefore reduction in GDP growth. When a government incurs foreign debt, it leads to reduction in the net wealth of the government. Nepal's fiscal deficit stood at 8.4% of GDP and the external debt stood at 6.0% of GDP in 1990. These reduced to 5.7 and 4.0% of GDP, respectively, in 1997. In Nepal nearly 28.6% of the total fixed (capital) investment during the five year plan is through foreign assistance. Foreign borrowings to fund infrastructure can lead to rapid economic growth, but inappropriate and excessive foreign borrowing generate debt service obligations that will constrain future economic policy and growth

In addition, excessive foreign borrowings may lead to debt trap for example, when Africa as a whole pays more to rich countries as way of interest and debt repayments than it receives in foreign aid and loans. When a country is not able to repay borrowings from its own sources, it has to borrow to repay loans. Thus, external debt is more serious problem than national debt as it can impoverish a country. Secondly, external debt is also subject to risk of exchange rate fluctuations that increases external debt repayment when a currency is reduced in value while the external debt is denominated in a foreign currency.

DEFICIT REDUCTION TECHNIQUES

As governments borrow to finance deficit, they are under pressure from external sources such as IMF and World Bank and also through legal agreements such as Gramm-Rudman-Hollings Law of 1985 in U.S and Maastricht Treaty of 1992 in European Union to reduce deficit. The Gramm-Rudman-Hollings Law of 1985 in U.S. had two main provisions – it sets budget deficit targets and automatic series of cuts if the targets were not met. Secondly, any new spending programmed must be explicitly financed either by cutting other programmers or by raising revenues. The Act was later ruled to be unconstitutional, but its two main provisions stayed in force and caused reduction in budget deficit. Maastricht Treaty of 1992 in EU had the budget deficits constrained at 3% of GDP, the gross public debt constrained at 60% of GDP and inflation rate within 1.5% of the three EU countries with lowest inflation rates which ruled out inflationary methods of funding deficits. To reduce deficit governments, either under external pressure (mostly in developing countries) or under legal agreements such as US and EU as shown above, use various means such as dissimulation of assets through privatization, reduce public investments, reduce operation and maintenance (O and M) spending, shift revenue and expenditure over time and run implicit liabilities.

Privatization

William Easterly (1999; pp 58) underlined that governments in developed and developing countries used

privatization receipts to cut deficits e.g. Nigeria by selling equity shares in upstream oil ventures for US \$ 2.5 billion due to IMF stand-by agreements and two World Bank adjustment loans during 1989 - 93. And United States due to fiscal rule of Gramm-Rudman-Hollings Law of 1985 had \$7 billion of asset sales in 1987 (Easterly, 1999; pp 58). Easterly, further notes that there is strong correlation between privatization revenues as a percentage of GDP and IMF/WB adjustment loans, although governments forced to reduce liabilities will reduce assets [through privatization (Easterly 1999 pp 68). Privatization receipts in euro countries after Maastricht Treaty more than quadrupled while it fell in non-euro countries.

Further, Germany reclassified public hospitals into corporate sector in 1997, thereby taking these debts out of general government debt to reduce deficits (Easterly, (1999) Fiscal Illusion: Taking the Bite Out of Budget Cuts, Economic Policy, April 1999; pp 58). Thus, privatization when done for financial reasons rather than efficiency, leads to illusory fiscal adjustment.

Public investment reduction

In periods of restrictive fiscal policies, capital expenditures are the first to be cut. Regarding this issue, during fiscal adjustment, governments cut capital spending (about 35%) by far more than other categories like wages (about 10%). Further, the African countries lowered their budget deficits during 1981-6 to 1990-1 mostly through cuts in capital investments (Easterly, 1999; pp 59). In euro countries, seven of the Euro countries reduced public investments as percentage of GDP, two left it unchanged while only two increased it after Maastricht Treaty.

Further, estimated rates of return on public investments such as infrastructure during 1983-92 by World Bank ranged from 19 (in telecommunication) to 29% (in highways) even State Owned Enterprise (SOE) investments can be profitable. However, due disinvestment by Zambian government in state copper company ZCCM to reduce deficit, the revenues from mining fell from 10.8 of GDP in 1970-4 to 1.6% of GDP in 1990-4 (Easterly, 1999; pp 59). Thus, cutting public investment to reduce deficits may be false economy.

Operation and maintenance (O and M) spending cut

Governments use this technique to reduce deficits e.g. in Philippines-cuts of about 40% in O and M expenditures to reduce deficit during 1983-5 and cuts by about 80% of O and M in Costa Rica during fiscal adjustment 1980s. There were cuts in O and M even in USA, in order to meet Gramm-Rudman-Hollings targets in 1980s (Easterly, 1999; pp 59). Delaying payment to government workers or suppliers to reduce the cash deficit and explicit debt is

another technique although the accrual based net-worth remains same. Postponements of addressing financial crises, unfunded pension liabilities are themselves a hidden form of liability accumulation. Some governments ask the pension funds to lend to them on preferential rates that redistributes the expenditure over time although cutting deficit today (Easterly (1999) Fiscal Illusion: Taking the Bite Out of Budget Cuts', Economic Policy, April Easterly, 1999; pp 61).

The above section shows various techniques used by governments on reducing deficits due to external and internal pressures. These may be illusory as they can shift expenditures over time, increase implicit government liabilities, lead to reduction in growth of GDP and even reversal of fiscal improvements in future. As William Easterly (1999; pp 62) points out, the government maximizes the present value of the stream of present and future utility, subject to budget constraint. Further 'since the government is indifferent about the composition of net value, any externally imposed constraint on a subset of its components (e.g. explicit liabilities) can immediately be substituted by other components of net worth, and has no effect on the optimal path for consumption and net worth. The apparent fiscal adjustment is entirely illusory.

FACTORS ON REDUCING POVERTY

All these data serve on promoting a debate on the role of fiscal policies for poverty reduction. The following main issues need to be addressed and are the focus of the discussions.

BUDGET REVENUES

Economic growth and income generation

The fiscal policy is intended to play a key role in the prospective economic growth. It is not merely because of the fact that fiscal situation is a major component that determines the macroeconomic stability. The essential argument consists on the fact that the capacity of the Albanian economy to generate revenues remains highly limited. Although, in terms of economic growth performance, Albania has developed relatively well compared to the economies of the region, data indicate that the budget revenues are at a lower level compared to the GDP. At the end of 2001, budget revenues in relation to the GDP for some of the countries of the region are as the following:

- (1) Albania 23 percent,
- (2) Romania 31.5 percent,
- (3) FYROM 35.3 percent,
- (4) Bulgaria 40 percent.

Customs revenues continue to play an important role in

Table 1. Income Structure and Potential Growth.

Country	Total of revenues from taxes % of GDP*	Personals income taxes	Income taxes	Social insurance contributions	Goods and service
Albania	19.3	1.1	1.7	3.8	10.8
Bulgaria	30.8	4.7	3.3	8.0	12.8
FYROM	25.0	3.9	0.8	9.2	11.1
Rumania	30.1	4.1	3.0	9.1	10.0
Hungari	38.7	6.5	2.2	13.9	15.1
Italy	42.7	10.7	3.0	12.2	13.0

*note: the total of tax income in the above table includes also the social insurance contributions.

the total revenues of Albania in relation to the other countries with which it compares: At the end of 2001, customs revenues in relation to the GDP and the total budget revenues for some of the countries of the region are the following:

- (1) Albania 2.2, 9.4%,
- (2) FYROM 4.0, 11.2%,
- (3) Romania 1.1, 3.5%,
- (3) Bulgaria 0.9, 2.2%.

The implications of these developments are pointed out in Albania's perspective of the reduction of customs tariffs both in its perspective of free trade with the countries of the region (Table 1). From this analysis, it results that it is necessary to examine the alternatives for the increase of the revenues.

Income structure and potential growth

When analyzing the income structure at the end of 2001 according to the main categories we see: From the analysis of the tendencies noted as of 1997, we notice the following trends:

- (i) Overall, the budget revenues from taxes have grown from 16.6 - 19.3% of the GDP; however, their level is much lower than that of the other countries surveyed in this analysis (obviously this ratio is much lower compared to the economies of the developed countries).
- (ii) Indirect taxes account for the main share of this category of budget revenues: VAT (30.8% of the total tax income), customs revenues (9.4%) and from excises (7%). The growth of revenues in this category of income has come particularly from the increase of VAT revenues, mainly from the increase of its rate from 12 - 20%. Even though this is a slight tendency, the fact is that the revenues from the customs are declining, while the revenues from the excises have grown compared to 1997 and remain almost constant as of 1998. The VAT rate for some countries is as follows: Bulgaria - 20%; Croatia - 22%; FYROM - 19%, (5% farming products, energy, and

transport); Romania - 19% (0% for goods and investments in the free zones).

(iii) The tax on the companies' revenues accounts for 7.6% of the total tax income, as against 4.6% in 1998. The rate of the profit tax 2 that is applied in Albania has been reduced from 30% in 2001 to 25%. This rate is 15% in FYROM, 18% in Hungary, 25% in Romania, 20% in Croatia, etc.

(iv) PERSONAL income tax has marked an increase of about 1% of the total income in 97-98 to 4.6% in 2001. Albania applies a progressive system of personal income tax system. In other countries, this tariff varies from 20% in Yugoslavia to 35% in Hungary and FYROM. Since 1998, Albania began application of taxes over the revenues created from the investments of the depositors (revenues from bank interest rates) and capital investments (over dividends).

(v) Revenues from social and health insurances make up 16.6% of the total income (or 3.8% of the GDP), marking a slight increase during all the period from 1996. The rates of social insurance contributions are much higher than the personal income taxes; on an average, the employers and the employees pay 35 - 45% of the salary fund in contributions.

(vi) Non-tax revenues which are composed almost entirely of the transfer profit of the Bank of Albania are another source of financial support to their country and also at the end of 2001, this category of income ranks third in terms of its size (after VAT and the revenues from customs taxes) with 8.1% of the total budget revenues, or 1.85% of the GDP. Resulting mainly from the high bank interest rates, this category of income will tend to go gradually down (0.5% of the GDP in the developed countries).

(vii) The levels of taxes or contributions in all the categories of income seem to be within the possible limits.

(viii) The level of consumption taxes (regressive taxes which weigh more heavily on the poor strata) are not differentiated.

(ix) Macroeconomic consolidation of the country and the integration trade processes will account for the flow out of a considerable share of budget revenues (tax and non

tax).

Informal economy

A major obstacle on increasing budget revenues is the spread of informal economy. In various documents, its figures vary from 40 - 60% of the GDP. There is no complete study of the informal economy in all its dimensions so far. Studies on the informal labour market indicate a figure which is approximately 25% that is relatively considerable in terms of the dimensions of the total labour market. Bearing in mind that these assessments describe only the informal employment and that it is much more difficult to make a comprehensive assessment of it, because of the under reporting of the level of wages of the employees employed in this system. The author might say that this phenomenon must be more widely spread. Hence, it is also an important source for the increase of revenues from social insurance, which have drawn a considerable part of state transfers (about 2% of GDP), such funds might be reallocated to other fields of social sector and social protection.

Fiscal evasion - (avoidance by private entities of paying taxes and customs dues), apart from having major implications in upsetting the economic structure of the country and deforming the market, has also created an incalculable outflow for the country's finances. It is estimated that figure of fiscal evasion can be as high as about \$ 500 million a year, a figure which is about 50% of the total revenues of the state budget. As can be seen from such data, the chance for increasing the supplementary revenues to the budget from the reduction/elimination of the informal economy is a major source, and, given the current tax rates, probably the only one.

Tax system administrative aspects

Considering the legislative aspect, efforts have been focused on the establishment of a legal fiscal network. This is why there has been no equality among entities in the payment of taxes.

(i) Tax inspectors do not have the required authority to establish equality among tax entities and have not developed the necessary mechanisms to ensure this equality, also for the registered companies, while the number of unregistered companies that exercise economic activity is still very high. Although, it is hard to quantify it in figures, the fact that the media continue to publish reports on the actions (though sporadic) of the tax police and their sequestering of the assets of such companies are evidence to the fact that we do not yet have developed sustainable mechanisms of control. The companies themselves complain that the payment of taxes is more often based on the plan of budget revenues

and not on the real indicators of the profitability of their activity. The reimbursement of the VAT still remains a chronic problem, placing the activity of various subjects in difficulties regarding their liquidities.

(ii) The auditing system of the accounting balances has constantly been a source of abuses, creating difficulties for the tax authorities. Auditing by the tax authorities cannot cover all the registered companies. On the other hand, the responsibility of the accounting experts in certifying the balance sheets of the companies is very undeveloped.

(iii) The customs procedures leave great opportunity for subjectivism by the customs agents, which incur supplementary costs to businesses.

In general, the climate of cooperation among these tax and customs institutions and businesses continues to remain distrustful. On the one hand, entities appeal that they are prevented in their activity by the fiscal authorities through subjective, arbitrary and discriminatory procedures and on the other hand, many companies carry out economic activities outside the fiscal system.

Government budget expenditures

The low level of budget revenues and the considerable increase of the public debt have brought pressure on the fiscal adjustment and have had an impact on the continuous reduction of government expenditures. In real terms, the increase of these expenditures began only after year 2000. Similar to the budget revenues, the expenditures also stand below the average level of the economies in transition. This has dictated the need for a reduction of expenses in all the categories, of which the only item that has grown is the payment of interests (25.3% of budget expenditures in 1998, dropping to 12.7% in 2001), due to the high bank interest rates. Since 2001, the Medium-Term Budget Program (MTBP) began to applied regarding from the point of view of a more effective and strategic management of government expenditures (Table 2). This document serves as an important orientation for preserving fiscal discipline, prioritizing public expenditures, and linking them better with the government policies and encouraging greater technical effectiveness in the allocation and use of financial resources.

(i) Personnel expenses - Employment in the public services has been constantly reduced as a result of the public administration reform. Hence, the expenses for salaries have marked a decline until the end of 2000, although if we see the analysis of figures, we will notice that payments have increased (in nominal terms) by about 50% in 2000, as against 1996. The growth after year 2000 in this category is linked, besides the reform in the increase of salaries, (with more marked increases in the sectors of defense, justice and police) also with the

Table 2. Spending structure.

Total expenditures, % GDP	1998	1999	2000	2001
	30.8	32.7	31.6	31.5
Main categories of expenditures in relation to total expenditures (% of GDP)				
Current expenditures	82.9 (25.5)	79.1 (25.9)	78.1 (24.7)	75.7 (23.8)
Personal	20 (6.2)	18.8 (6.2)	19.5 (6.2)	21.1 (7)
Interests	25.3 (7.8)	21.1 (6.9)	17.3 (5.5)	12.7(4)
Operational and maintenance expenditures	13.1 (4)	12.1 (4)	11.3 (3.6)	8.5 (2.7)
Subsidies and social insurances	17.2 (5.3)	20.5 (6.7)	21.9 (6.9)	23.4 (7.4)
Capital expenses	17.1 (5.3)	20.6 (6.7)	21.3 (6.7)	23.3 (7.4)

(Ministry of Finances, 2001)

reclassification of "bonuses" (about 0.5% of the GDP) which in the past was included in the operational and maintenance expenses.

(ii) In the budget projections was included for the increase of salaries in the sectors of health and education, both considered priority sectors for the reduction of poverty, because the pace of their growth must be higher. Compared to the payments in the other sectors of civil service, the pays in these two sectors continue to be lower. The levels of salaries in these sectors have been identified by the GPRS as critical elements among the causes that have led to the decline in the educational level and the lack of medical treatment, particularly in the rural zones.

(iii) Maintenance and operational expenses - Even though expenses for the categories of the MTBP have been expected to grow (with the growth of GDP rate), their levels are considered insufficient to cope with the maintenance of infrastructure due to the imbalance between and maintenance expenses account for less than 15% of the current expenses.

(iv) Subsidies and social insurance services are affected by the lack of facilities and the necessary basic materials. This is becoming a critical issue also in terms of maintaining physical infrastructure repaired by the donors' funds. For this reason, the MTBP envisions an increase of up to 3.9% in 2004, which will address mainly the sectors of education, health, and physical infrastructure.

(v) Subsidies and social protection transfers - Subsidies have covered textbooks, railway and urban transport, the drainage system (in agriculture), and the programs for the promotion of employment (for employers). Although, subsidies have accounted for only 0.4% of the GDP in 1996, due to the energy crisis (subsidies for the imported energy price) they amounted to 1.2% of GDP in 2001. There has been taken some measures by the Albanian Energy Corporation [KESh] in order to improve the situation of receivables from the debts, but even the public utilities enterprises, (particularly the water enterprise) are debtors to KESh. This may result in an

increase of subsidies for them. In general, this category of expenses is expected to be reduced up to 0.3% of the GDP up to 2004. The social protection transfers are linked mainly with the pension schemes. The financial sustainability of KESh has been depending for a long time mostly on the fiscal transfers. The number of contributors is very low, and the number of contributors of the private farming sector accounts for less than 20% of the total number of contributors in the system. The two measures taken recently by the government (the increase of the pension age and the reduction of the measure of contributions, combined with the increase of the threshold of salary for the calculation of the pension contribution are expected to give results in the improvement of the performance of the insurance scheme. These measures along with the promotion of participation in the voluntary insurance schemes are expected to reduce the share of budget transfers to about 1.4% of the GDP up to the end of 2004 (as against 2% which is at present). There is yet opportunity for improvement also to better target the families benefiting from the economic assistance. The best check systems and their gradual decentralization and transfer to the local authorities, have made it possible to reduce the number of the beneficiary families and increase the amount of benefits for the strata that are really in need.

(vi) Public investments - Public investments have marked a sustainable increase estimated to be 7.4% in 2001. The inclusion of foreign funding in the budget system remains a constant problem. It is estimated that about 30% of the foreign financing remain unreported, which creates problems regarding their financial management, the postponement of the projects (due to the non allocation of the funds as local share, compensation for the VAT, etc.) as well as the lack of transparency. Nevertheless, the main problems in public investments are:

- (a) Lack of professional capacities in the ministries line for the planning and budgeting of projects,
- (b) The inherited practices of the division of budgets on an annual basis and not according to the total cost of projects,

- (c) Lack of consolidated information for projects with foreign and domestic funding,
- (d) Investment projects do not have clear and transparent cost procedures and techniques of calculations. Therefore, there are possibilities for reducing the costs of individual projects and increasing the number of projects,
- (e) The projects monitoring mechanisms, particularly the infrastructure projects still remain very weak, and as consequence is the postponement of projects' implementation within the set deadlines.

Such disadvantages were also obvious during the process on drafting of the GPRS, where in general the line ministers were unable to provide the budget implications for the measures proposed as government actions included in the program. The education expenses of approximately 3.2% of the GDP are lower than those in countries with income under the average level (4.8% of the GDP). In health, public expenditures are calculated to be around 2% of the GDP, or 2/3 of this level in the countries with income levels below average.

FISCAL DECENTRALIZATION

The fiscal decentralization process and the transferring of responsibilities to the local authorities is a new phenomenon that has been developed after 1999. The revenues of the local authorities accounted for only 0.35% of the GDP in 2001 and were raised mainly by the central fiscal authorities and were given to local authorities in the form of unconditional grants. Some local taxes are currently in the process of the transition to the local authorities to be collected by them as taxes on small businesses, on the farming land. A positive impact on revenues is supposed to have the shifting of this function to the local authorities. At any rate, the transition of these functions should be done parallel with the training of the future local administration to be capable of taking over these responsibilities.

The main economic sources on exercising their exclusive functions (maintenance of local roads, lighting of roads and public services, urban planning, transport, collection and processing of waste, water supply, cultural and sport activities and the services of local economic growth) have been ensured mainly through the allocation of funds from the central budget. In this respect, the problems have to do with undeveloped local capacities to estimate the financial requirements based on the real needs. Another aspect of decentralization includes also the development of common functions between local and central authorities in the field of education, health, social protection, public order, and protection of environment. The development of these functions can be done mainly through sectional initiatives and the line ministries should cooperate with the local authorities to develop joint programs.

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