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Fiscal Sustainability and Sovereignty Issues under an ASEAN Economic Union:

Dr. Roberto B. Raymundo
School of Economics
De La Salle University
Manila, Philippines
roberto.raymundo@dlsu.edu.ph

Abstract: Deficit spending is often justified by the need to get the economy out of a recession. However, it comes with an enormous cost which in the long term destabilizes the macro-economy. Budget deficits financed by monetizing public debt creates inflation. Deficit spending financed by the sale of government bonds to the private sector leads to rising interest rates. While budget deficits funded by foreign loans increases the country's foreign debt which in the long term leads to chronic exchange rate depreciation. Fiscal sustainability requires maintaining a manageable public debt position that allows an economy to continually service its debts, and pay off maturing obligations in order to secure access to new loans if necessary, alongside the implementation of expenditure programs that provide more infrastructure support and social services.

The objectives of the study are to explain how sustained growth is possible, the need for fiscal sustainability and discuss its implications on the impending ASEAN Economic Union. The methodology used is the descriptive approach which discusses both economic indicators and public finance data under a macroeconomic framework. Initial results indicate that, although the ASEAN Economic Union promises more trade and investment within the region, finalizing this agreement presents a serious challenge as it implies interfering with the sovereignty of each member country particularly in the conduct of monetary and fiscal policy. Initial conclusions show that deficit spending for each member country will be subject to the approval of a Central Monetary Authority in the region, alongside tax policy and other legislative measures which will be influenced by a regional body. Attempts at fiscal sustainability will not be a sole concern by each member country, but will be subject to regional approval and supervision.

Key words: Deficit spending; destabilization; monetizing public debt; fiscal sustainability; ASEAN economic union

1. Introduction

The concept of sustainability generally refers to a system of resource use that allows present generations to maximize the benefits, but at the same time ensure that these resources are renewed, replenished or replaced in the long term for further use by succeeding generations. Whether these resources are natural or man-made, it is essential to introduce and implement a system of rules that would facilitate replenishment and prevent its eradication. Mineral, forest, water, land, marine and wildlife resources can be protected, preserved and allowed to regenerate as long as effective rules are enforced in order to prevent excessive, unnecessary, abusive and wasteful usage.

Similarly, financial resources are also subject to rules in order to ensure its sustainable long term use and replenishment. In the private sector, unspent income which is saved in banking institutions is converted into loans that finance private sector investments into the expansion of plant and property and the purchase of capital equipment. As long as loans are repaid, banking institutions can continue to encourage more saving from households and facilitate more lending to businessmen which increases investment, raises productive capacity, creates new jobs and generates economic growth. The economic growth outcome only becomes sustainable as long as increasing household savings is used to finance investments and that banks remain stable, pay a reasonable interest rate on deposits and charge competitive interest rates on loans.

Government on the other hand, relies on a coercive taxation scheme in order to raise funds to finance its expenditures on public services and infrastructure. When government operates on a balanced budget (where public spending is equal to tax revenue) a fiscal balance is maintained without having to create any destabilizing effects on the economy. However if government operates with a budget deficit (spending more than the amount of tax revenue collected), the methods by which this can be financed creates de-stabilizing effects on the economy and compromises its ability to achieve sustained growth in the long term. Large and chronic deficits will require frequent borrowing which accumulates debt and also jeopardizes the sustainability of government's fiscal position in the long run.

Fiscal sustainability refers to a position wherein public debt and fiscal deficits remain within tolerable limits as government continues with its expenditure programs alongside enhanced tax collection efforts. The tolerable limits for public debt and fiscal deficits should allow government to make regular payments on interest and principal for both domestic and foreign obligations, gradually reduce deficit spending operations in the long term and maintain a good credit rating to facilitate easier access to new loans if the need arises. There are various ways be which fiscal sustainability can be measured, however the most simple and straight forward approach is to examine the fiscal deficit to GDP ratio as well as total public debt to GDP ratio. Fiscal discipline under the Stability and Growth Pact of the European Union have recommended year end fiscal deficits to be at 3 percent of gross domestic product (GDP) and total public debt to be at 60 percent of GDP in order to keep fiscal debt within sustainable levels.

Objectives

The objectives of the study are to explain how sustained economic growth is possible, to justify the need for fiscal sustainability and discuss its implications on the impending ASEAN Economic Union.

2. Methodology

The study uses both a historical and descriptive approach in order to determine whether sustained economic growth has indeed occurred and to discuss the consequences of a deteriorating fiscal balance using both economic indicators and public finance data under a macroeconomic framework. In addition, the expected impact of finalizing the

ASEAN Economic Union on fiscal and monetary policy will be discussed including its implications on national sovereignty.

3. Initial Results and Discussion

3.1 Sustained Economic Growth

Sustained economic growth refers to a relatively consistent annual expansion in real Gross Domestic Product (GDP) of approximately 5 to 7 percent for developing countries over a medium to long term period. This range should allow output growth to rise faster than population growth in order to have a substantial impact in improving living standards. It is also expected to generate a higher amount of domestic savings in the entire economy that should fund private sector investments in the medium and long term, and should be a realistic growth target within the reach and capability of developing countries. In addition, growth should be higher than the tolerable inflation rate target (of 2 to 4 percent) to ensure that any gains from output and income expansion are not offset by increases in the general price level.

When economic growth is higher compared to interest rates on government debt, conditions for fiscal sustainability are also met considering that the expansion in output implies larger income and a growing tax base for government. This will lead to more tax collections from both direct and indirect sources and should help close the fiscal gap.

From 1980 up to 2015, the growth target of 5 to 7 percent was achieved by the Philippine economy 14 times out of the entire 35 year period. Growth in gross domestic product was highest at 7.6 percent in 2010, followed by 7.1 percent in 2013, 6.75 percent in 1988, 6.7 percent in 2012 and 2004, 6.6 percent in 2007, 6.21 percent in 1989, 6.1 percent in 2014, 6.0 percent in 2015, 5.85 percent in 1996, 5.2 percent in 2006 and 1997, 5.15 percent in 1980 and 5.0 percent in 2003. All other years during the 1980 to 2015 period had slower growth rates between 1 to 4 percent Negative growth or the occurrence of a recession was experienced in 1984 at (-7.32) percent, 1985 at (-7.31) percent, 1991 at (-0.51) percent, 1998 at (-0.58) percent (Asian Development Bank, 2015). The economic growth performance of the Philippine economy has not been consistent over a medium term and long term period and this may be attributed to several factors ranging from the effects of political instability, massive capital flight, natural calamities, attempts to overthrow the current government, shortages in power supply due to inadequate investments in new plants, election spending every 6 years for national positions and every 3 years for local positions; external shocks emanating from oil price changes, the occurrence of an Asian and a US sub-prime mortgage financial crisis; and artificial credit expansion at low interest rates which has a tendency of creating stock market and real property bubbles that further aggravates the boom and bust cycles in the economy.

3.2 Sustained Economic Growth Financed by Real Savings

When investments in the expansion of plant property and equipment are financed by real savings, the corresponding increase in productive capacity creates sustained economic growth. The growth is sustained as the occurrence of economic boom and bust cycles are minimized. In the absence of artificial credit expansion (or new fiat currency creation), interest rates should be determined by the interaction of the supply and demand for funds in the market. When banks do not have enough loanable funds, and as more firms compete for new loans, interest rates are increased. This encourages more households to save (deferring consumption for some future date). Over a period of several months, as banks accumulate more savings deposits, they consequently increase the amount of loanable funds and encourage firms to borrow by lowering interest rates. Firms will take advantage of the low interest rates in order to fund long term projects. As the economy continues growing, more firms compete for new loans, which pushes interest rates upward, reducing the demand for loans by interest rate sensitive projects. Projects which are less interest rate sensitive will now get access to the new loans which are being offered at slightly higher interest rates. As interest rates increase, this again encourages savings (and deferred consumption) and allows banks to accumulate more deposits to be

channelled into new loans to fund other long term projects in the future.

The natural movement and adjustment of interest rates which depends on the level of savings and the demand for loans ensures that the market corrects itself, particularly in the occurrence of any excessive long term investments (projects which are interest rate sensitive and have long term gestation periods such as capital goods manufacturing) and channels funds into short term investments such as business ventures that produce final consumer goods which require shorter gestation periods.

Market determined interest rates (particularly in the absence of fiat money creation) performs a coordinating function for both long term and short term investments. Higher order (more complex and sophisticated) long term investments in capital goods production will take advantage of low interest rates, while short term lower order (less complex, less sophisticated) investments in consumer goods production will have access to loans when interest rate sensitive borrowers reduce their demand for loans when interest rates begin to adjust upward. Simultaneously, households defer consumption and save more during occasions when interest rates are high. When interest rates fall, households will save less and consume more of their income which will induce growth in consumer goods production.

Market determined interest rates prevent the creation of asset bubbles because of the natural correction done on higher order long term investments. Excessive loan demand by long term investment projects, will lead to rising market interest rates, which would automatically correct the excessive investment. Increasing interest rates for example should reduce the demand for housing and prevent overvaluation of real property in the housing market. Rising interest rates on the other hand, will encourage more saving by households allowing banks to accumulate more deposits which will fund more loans in the future at gradually declining interest rates. The natural correction performed by market determined interest rates reduces the magnitude/ severity of the boom and bust cycle leading to more sustained growth.

3.3 Unsustainable Economic Growth Financed by Artificial Credit Creation

When the Central Bank undertakes credit expansion at artificially low interest rates, economic growth becomes unsustainable in the long term because of an inevitable economic downturn which has to occur and is expected to worsen, the more it is delayed. The creation of new fiat currency and the expansion of credit may lower interest rates and encourage borrowing to finance investments over several years leading to rapid economic growth. However, the prolonged existence of interest rates being kept artificially low eliminates the possibility of any correction being done by the market. When interest rates are fully controlled by a Central Bank and kept artificially low over several years, excessive investments in projects with long term gestation periods are encouraged leading to the creation of asset bubbles. The absence of market determined interest rates eliminate the natural correction which should be done on excessive long term investment projects. Interest rates that are kept artificially low also encourage borrowing to finance excessive consumption and discourage savings.

The natural coordinating function of the interest rate on both long term and short term investment as well as on savings and consumption has disappeared. This leads to a situation wherein both long term and short term investments are both growing alongside massive consumption all fuelled by artificial credit creation. This increases aggregate demand and generates more economic growth funded by the creation of new fiat currency and credit. As more currency and credit circulates in the economy, more borrowing is encouraged, more debt is accumulated, aggregate demand reaches a point where it increases faster relative to the amount of goods and services being produced, leading to rising inflation rates. As long as inflation remains within tolerable limits (roughly 2 to 5 percent), expansionary monetary policy will be allowed to accommodate economic growth. However, when inflation starts rising beyond the tolerable limit, a reduction in either the money supply growth or the actual stock of money will be imposed by the Central Bank to reduce inflationary pressure. This will lead to rising interest rates which will reduce borrowing for

investment and consumption, slowdown economic activity, reduce production and employment and start the recession. The recession becomes more severe when its occurrence is delayed with attempts to prolong economic growth with more fiat money and credit creation.

3.4 The link between Economic Growth, Artificial Credit Expansion and Fiscal Sustainability

The creation of new fiat currency and the expansion of credit can be done by the Central Bank through open market operations, particularly by purchasing bonds issued by the government or commercial banks. When government needs to finance its fiscal deficit, the Bureau of Treasury can issue a debt instrument (bonds, bills or notes) to be sold to the Central Bank in exchange for funds released in the form of newly created fiat currency or as electronic credits in government owned banks. Financing fiscal deficits allows government to continue spending on infrastructure and social services with larger budgets despite the lack of tax revenue. The increased government expenditure stimulates economic growth as funds are used to complete construction projects, pay government wages, salaries and benefits, purchase equipment, supplies and materials, and provide public services. Although fiscal deficits/deficit spending facilitate economic growth, they increase the amount of debt to be paid by every individual in the form of taxes. Taxes whether collected from income, or from the purchase of a good or service has a negative welfare effect because it reduces the ability of an individual to make full use of the gains obtained from productive work. Taxation redistributes income from firms and individuals who produce wealth to others who do not. Chronic deficit spending accumulates debt, destabilizes the economy in the long run, imposes a heavy tax burden on the private sector that produces wealth and compromises the sovereignty of a nation when it is forced to borrow from foreign creditors.

The nature of deficit spending

Deficit spending or the ability of government to spend beyond the amount of taxes it collects is often justified by the need to bring an economy out of a recession, prevent an impending slowdown caused by an external shock, or in most instances allow government to achieve its desired economic growth and employment targets. However, deficit spending comes with a huge cost which in the long term destabilizes an economy.

Deficit spending in the Philippine economy was largest at P314.5 billion in 2010, when government expenditures reached P1.5224 trillion and with tax revenues at P1.2079 trillion. Other years with enormous deficit spending levels were in 2009 at P298.5 billion, 2012 at 242.8 billion, 2002 at 210.7 billion, 2003 at P199.9 billion, 2011 at 197.8 billion and 2004 at 187.1 billion. Deficit spending was lowest at P12.4 billion in 2007. For all other years between 1998 and 2014, the fiscal deficit fell within a range of P50 billion to 164.1 billion (ADB Key Indicators, 2015).

From 1998 to 2014, the ratio of the fiscal deficit to GDP fell within a range wherein the lowest was at -0.2 percent in 2007 and the highest at -5.0 percent in 2002. When the fiscal deficit was largest at P314.5 billion in 2010, the deficit to GDP ratio was at -3.5 percent. The second largest fiscal deficit of P298.5 billion in 2009 showed a deficit to GDP ratio of -3.7 percent, while the third largest at P242.8 billion in 2012 reflected a deficit to GDP ratio of -2.3 percent (ADB Key Indicators, 2015).

The fiscal deficit to GDP ratio was recorded at -1.4 percent in 2013 and -0.6 percent by the end of 2014.

Deficit spending over several decades had generally increased the amount of national government debt. In 2003, the national government debt was at P4.0636 trillion, which increased to P4.6456 trillion in 2004, and declined over the next two years to a level of P4.1966 trillion by 2007. In 2008, the national government debt had increased to P4.766 trillion, and has grown to a level of P5.939 trillion by the end of 2012. Initial estimates for the year 2013 show a national government debt of P5.6788 trillion, which increased to P5.7397 trillion by the end of 2014 (Bureau of Treasury, 2014). The ratio of national government debt to GDP had declined from 55.4 percent in 2006 to 54.8 percent in 2009, 51

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percent in 2011 and 45.4 percent by the end of 2014 (Bureau of Treasury, 2015).

The Philippine government appears to be in a fiscally sustainable position with a national government debt to GDP ratio lower than 60 percent and a fiscal deficit to GDP ratio lower than 3 percent particularly for 2013 and 2014.

Monetizing Public Debt and Public Borrowing

Chronic deficit spending financed by monetizing public debt is responsible for creating inflation that reduces the value of money, increases the cost of all goods and services and reduces the value of real income leading to a decline in living standards. Inflation over several years reduces the value of real wages and salaries, savings, pensions and other retirement benefits. Inflation is a hidden tax and is shouldered by every income earning individual. Deficit spending funded by the Central Bank's creation of new money allows government to continually spend beyond its means and transfer this cost to the general public in the form of inflation and a guaranty of more taxation in the future. Deficit spending financed by monetizing public debt hurts every individual in the economy through inflation, the certainty of more taxation in the future and reduced benefits from government because of larger allocations for debt service payments taken from the national budget.

Deficit spending financed by the sale of government bonds to the general public makes government compete with the private sector for funds leading to rising interest rates. When limits on Central Bank borrowing have been reached, the National Treasury is forced to rely on public borrowing to finance its deficits. Interest rates on government bonds increase during periods when government is forced to borrow from households and private firms (including commercial banks and other non-bank financial institutions). This raises all other interest rates in the economy and increases the cost of borrowing that discourages firms from expanding productive capacity, slows down economic growth and job creation.

Domestic borrowing to finance current as well as accumulated deficits have reached a highest level at P468.1 billion in 2012, followed by P402.9 billion in 2013, and P218.6 billion in 2010. For all other years between the 1998 to 2014 period, domestic borrowing was lowest at P 42.9 billion in 2007 and highest at 162.7 billion in 2014 (ADB Key Indicators, 2015).

Inflation rates have generally increased during periods of huge deficit spending accompanied by large amounts of domestic borrowing. Inflation rose from 5.8 percent in 1997 to 9.4 percent in 1998 when government became a borrower of P76.6 billion coming off a year when it was a lender at P20.3 billion . Inflation increased from 2.3 percent in 2003 to 4.8 percent in 2004 and 6.5 percent in 2005 as domestic borrowing increased from P143 billion in 2003 to P161 billion in 2004 and back to P143 billion in 2005. Inflation increased from 3.8 percent in 2010 to 4.6 percent in 2011 as deficits continued to accumulate from P298 billion in 2009 to P314 billion in 2010 and P197 billion in 2011. Inflation also increased from 3 percent in 2013 to 4.1 percent in 2014 as deficit spending continued from P242 billion in 2012 to P164 billion in 2013 and P73 billion in 2014. Domestic borrowing was at P468 billion in 2012, P402 billion in 2013 and P162.7 billion in 2014 (ADB Key Indicators, 2015).

Although oil price increases and severe weather conditions have an effect on fuel and food prices, deficit spending financed by Central Bank borrowing and the creation of fiat currency will always have an inflationary impact as the increase in currency and credit fuels aggregate demand through larger government spending. Money supply (M1) has continually increased from P258.3 billion in 1997 to P2.3164 trillion by the end of 2014. Money supply had grown by an average of 16.26 percent from P547.6 billion in 2004 to P1.3485 trillion in 2010 under the Arroyo administration. From 2011 to 2014, the money supply had increased by an average of 14.72 percent from P1.4947 trillion to P2.3164 trillion under the Aquino administration. The average annual economic growth rate from 2004 to 2014 is 5.44 percent (ADB Key Indicators, 2015). This shows that the rate at which money supply is being increased is faster relative to the real value of goods and services being produced by the economy.

Interest rates on loans have declined from 18.4 percent in 1998 to 10.1 percent in 2004, 7.7 percent in 2010 and 5.5 percent by 2014. Interest rates on 12 month time deposits have also decreased from 13.3 percent in 1998 to 8.2 percent in 2004, 2.1 percent in 2010 and 1.0 percent in 2014 (ADB Key Indicators, 2015). The declining trend for both interest rates indicate the impact of expanding money supply and credit. Central Bank lending to finance fiscal deficits will increase money in circulation and lead to lower interest rates. If government was funding its deficits by selling bonds to the public, interest rates would increase. However, since interest rates have been declining over the past 17 years, the extent of government borrowing from the public has not been large enough in order to compete with banks and induce an interest rate increase.

Foreign Borrowing

Deficit spending funded by foreign loans increases the country's foreign debt which in the long term, exerts a substantial amount of pressure on its foreign currency reserves and the exchange rate. Future debt payments lead to exchange rate depreciation particularly if foreign currency reserves are inadequate and the export sector is weak. Exchange rate depreciation makes foreign debts larger in domestic currency which in the long term requires a larger budgetary allocation for debt servicing. Foreign borrowing was highest at P152.5 billion in 2009, followed by P143.9 billion in 2003, P133.0 billion in 2010 and P120.8 billion in 2006. For all other years between 1998 to 2014, the lowest foreign borrowing recorded was at P12.3 billion in 1998 and highest at P109.1 billion in 2002. The accumulated total external debt of the country was at $53.608 billion in 1998, $61.372 billion in 2006, $65.2279 billion in 2008, $73.5938 billion in 2010, $79.9494 billion in 2012 and $77.673 billion in 2014 (Bangko Sentral ng Pilipinas, 2015). The use of foreign borrowing to partially finance a fiscal deficit will reduce the dependence of government on the Central Bank as well as on public borrowing . This decreases the threat of inflation and rising interest rates. However, it will lead to a long term depreciation of exchange rates if the export sector remains weak and alongside a lack of foreign investment inflows.

3.5 The Burden of Taxation

Although fiscal sustainability is present in the Philippine economy, it is important to note that fiscal deficits at less than 3 percent of GDP and total public debt at less than 60 percent of GDP still creates a huge debt burden for the tax payers particularly if a large portion of the national budget (roughly 40 to 50 percent) is used for servicing debt, and smaller budgetary allocations are placed on infrastructure, social services, national defence, and law enforcement. Firms and individual income earners will be subject to more taxes and higher tax rates in the near future as public debts become larger. But the tax payer can never expect to get a public good or service commensurate to their payments in view of the larger amount of tax revenue allocated for debt servicing, the inefficient nature of government that allows it to waste resources on overpriced projects and employ redundant workers in oversized bureaucracies and the subsidies to inefficient government corporations (and their overpaid executives) that would have closed down if they were in a competitive market. Taxation reduces the welfare of an individual, eliminates the freedom of choice to decide on how to spend hard earned income, and funds redistribution programs to a sector of the economy that does not create wealth.

3.6 The ASEAN Economic Union and the loss of sovereignty

The formation of an ASEAN Economic Community will require all the ten member countries to allow the freer flow of goods and services, as well as labour and capital throughout the entire region transforming ASEAN into one large integrated market with more than 600 million people and a combined GDP of $2.4 trillion which is expected to increase to $ 4 trillion by 2020. Similar to the European Economic Community, the initiative to form an economic union will follow alongside the adoption of a common currency that will be acceptable to all member countries in order to better facilitate international trade and the movement of both portfolio and foreign direct investments throughout the region. However, the adoption of a common currency will require all member countries to give up their sovereignty particularly in the

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implementation of monetary policy. Each country will have to surrender its power to control and regulate the creation and issuance of its own national currency in exchange for a new common currency that will be issued and controlled by a new Central Monetary Authority within the region.

This new Central Monetary Authority may be based in the member country which possesses the best track record in terms of controlling inflation , generating sustained economic growth, low unemployment and a manageable balance of payments position such as Singapore. The initial use of a common currency may allow less developed countries to borrow from the Central Monetary Authority in order to fund deficit spending. However, if strict fiscal rules are not observed in countries that practice deficit spending, fiscal debt sustainability will be compromised which will give rise to a financial crisis that will threaten the existence of a monetary union. A bail out or an emergency loan package maybe granted by the Central Monetary Authority but subject to severe austerity measures that debt ridden countries will reject. This will threaten the stability of the union unless a common fiscal policy is adopted in the region which will impose region wide fiscal rules that will prevent the accumulation of unsustainable fiscal deficits and public debt. However, this will also require countries to surrender their power to legislate tax policies in view of a Central Authority or an ASEAN Commission that will formulate legislation. Voting on the new legislation will be a role relegated to an ASEAN Parliament composed of representatives coming from the member countries. This effectively removes the power of legislation from each member country and transfers it to an overall ASEAN Commission.

4. Conclusions

Fiscal sustainability requires maintaining a manageable public debt position that allows an economy to continually service its debts, pay off maturing obligations in order to reduce its debt stock, secure access to new loans if needed and reduce the destabilizing effects of financing budget deficits in the long term by imposing fiscal discipline and tax reform. Although the ASEAN Economic Community promises more trade and investment within the region, finalizing this agreement presents a serious challenge as it implies consequently moving into an economic union. The formation of an economic union involves interfering with the sovereignty of each member country particularly in the conduct of monetary policy (which requires a common currency and one Central Monetary Authority within the region). Consequently, this will also affect the sovereignty of each member country in the conduct of fiscal policy. Deficit spending for each member country will be subject to the approval of a Central Monetary Authority in the region, alongside tax policy and other legislative measures which will be influenced by a regional body. Attempts at fiscal sustainability will not be a sole concern by each member country, but will be subject to regional approval and supervision.

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