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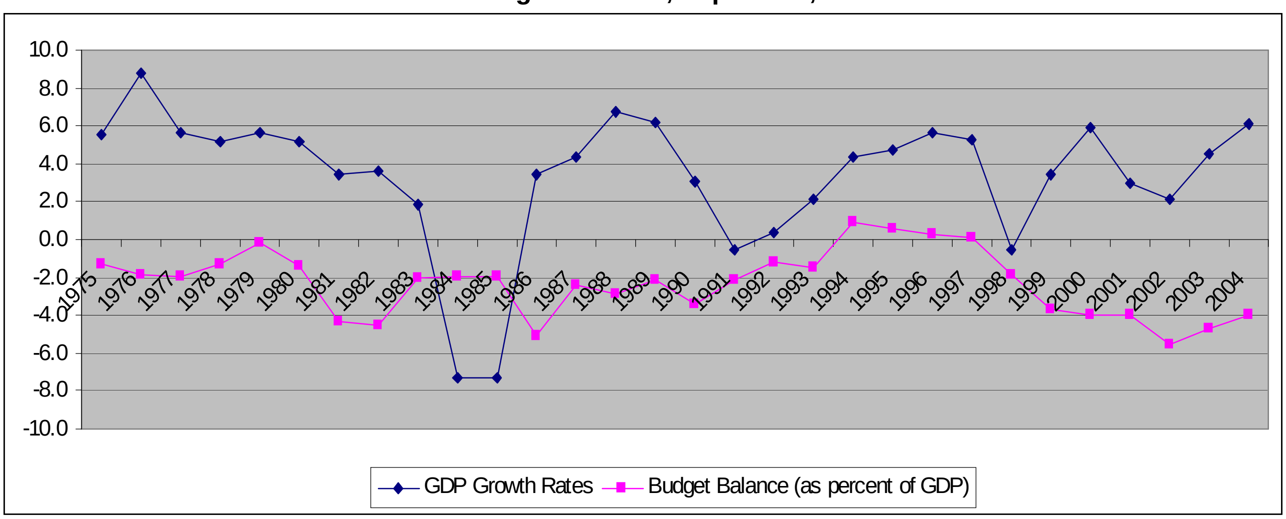
FISCAL RULES: The Way Forward?

Introduction

Fiscal policy in the Philippines is characterized by incessant budget deficits and growing levels of debt. The country recorded budget surpluses only in 1994 to 1997 and this has continuously deteriorated. The persistent deficit positions have resulted to high levels of debt which has peaked to 120.5 percent of GDP in 2003.

One theory advanced is the "fiscal illusion" of voters. The theory states that voters do not understand the intertemporal budget constraints of government. Hence, they overestimate the value of current expenditures and underestimate future tax burden. Policymakers tend to decide on this basis and raise spending more than taxes to please "fiscally illuded voters". Faced with

GDP and Budget Balance, in percent, 1975-2004



Sources: BSP, PIDS, and SEPO database.

Fiscal deficits and high debt levels are problems not only of developing economies, but can likewise be observed in advanced countries. Political economy theory explains the deficit bias of fiscal policy.

huge demands from their constituents, policymakers favor expenditures to maximize benefits, but find it difficult to raise taxes to pay for these benefits. Therefore, the burden of paying for the cost of current benefits by the current generation is shifted to future generations (Alesina and Perotti, 1994).

Likewise, it has been shown that higher expenditures can be linked to electoral cycles as politicians increase spending to improve electoral prospects. Voters reward politicians for expansionary policy in election years without understanding that these will have to be paid for after the elections (Ibid).

There is also the issue of who pays for the cost of fiscal deficits. Reforms are delayed or not adopted, because of disagreements over who should shoulder the cost. Studies have shown that governments with less political cohesion (government with weak political coalitions) have more difficulty in agreeing, therefore fiscal adjustment is delayed and debt continues to grow.

These inherent biases in fiscal policymaking in emerging and advanced democratic countries lead to suboptimal results of excessive deficits, burgeoning debt and crisis-prone balance of payments positions. Discretionary fiscal policy makes the economy vulnerable to external shocks that cause economic performance to tailspin given the shock.

In the Philippine experience, "apart from declining international reserves, crisis years have also been associated with periods of high or increasing public sector deficits and have also been associated with declining or negative growth, such as in 1984-85, 1990-91, and 1998." This is supported by studies of Fabella that argue that the main cause of downturns of the Philippine economy is the government's expansionary fiscal policy (Bautista, 2003).

Thus, some countries, developed and emerging alike, opted to have rules to depoliticize the framework for fiscal policy much like in the depoliticization of monetary policy embodied in the inflation-targeting framework (Kopits, 2001).

This paper aims to look at the viability of fiscal rules as a policy instrument by providing an introduction on fiscal rules using cross-country experiences and showing how rules could be a helpful policy instrument. It also defines the basic elements of a fiscal rule— fiscal targets, coverage, implementation and other concomitant issues; and applies these elements to the Philippine context.

Fiscal Rules: The Way Forward?

A fiscal rule is a statutory or constitutional restriction on fiscal policy that sets a specific limit on fiscal indicators like the budgetary balance, debt, spending or taxation. It imposes specific and binding constraints on the government's range of fiscal policy options. While in practice, most fiscal rules provide mandatory targets on fiscal indicators, the use of procedures and principles such as increased transparency in budget preparation and reporting, accompany the use of numerical targets.

Popularly known fiscal rules include the European Monetary Union's Stabilization and Growth Pact (EMU's SGP) which caps debt-to-GDP ratio to 60 percent and the deficit-to-GDP ratio to 3 percent for EU member countries, and the United Kingdom's Code to Fiscal Stability that pegs current balance to zero and limits debt to 40 percent of GDP.

Fiscal rules are used to avoid the tragedy of commons like that in the EMU (via the SGP) and in federal systems of government. Countries that belong to the EMU have to adhere to certain rules such that their policies do not adversely affect the economies of other member countries they share common institutions with, like a common central bank, currency, and credit ratings among other things.

For example, if Germany runs excessive deficits to increase employment, this will have effects on the exchange rate of the euro, possibly a depreciation as it affects the holdings of euro by other EU countries. The same is true for federal states where the Central government uses fiscal rules to mitigate over-borrowing by each state.

The Brazil experience provides an excellent example of fiscal rules, if properly crafted to suit a country's needs, could lead to fiscal reconsolidation. In Brazil, the sub-national governments[1] were a major source of fiscal imbalance in the 1990s as its debt grew. This was attributed to permissive policy to roll over debt in an environment of high interest rates and the practice of the federal government to bail out insolvent sub-national governments, which created incentives for indebtedness. The introduction of fiscal rules in 1998 together with aggressive restructuring of sub-national debt, resulted to an increase of the consolidated public sector primary balance from 0 to 3.5 percent of GDP in two years. Further, debt service burden eased as total debt service as percent of exports declined from 117.8 percent in 1999 to 63.8 percent in 2003 (WDI, 2005). The introduction of debt ceilings for each level of government, limits of payroll expenditures and procedural norms[2] in its fiscal rules contributed to improved fiscal outcomes.

Colombia and Peru's experience with fiscal rules both have been equally good. Both countries implemented fiscal rules in 2000 and experienced improved budget balances and lower debt service burdens. Colombia reduced its deficit from 7 percent of GDP in 2001 to 4.6 percent in 2003. Peru reduced its deficit from 2.9 percent of GDP in 1999 to 1.8 percent in 2003 and posted a lower debt-service-to-exports ratio from 28.2 percent in 1999 to 21.6 percent in 2003 (WDI, 2005).

Advantages and disadvantages. As seen in the experiences of Brazil, Colombia and Peru, instituting fiscal rules can lead to fiscal reconsolidation. Three basic advantages of fiscal rules account for this result. First, fiscal rules provide stability and predictability in the conduct of fiscal policy. By providing legal ceilings in various fiscal indicators, stakeholders know exactly what fiscal policy stance to expect—whether it will be expansionary or contractionary during a particular year and by what amount the expansion or contraction will be. The specification of such targets or the provision of "intentions", as in the case of procedural fiscal rules in New Zealand, makes future fiscal stance of the government known and predictable. The second advantage is a consequence of the first. If the legal targets are met, credibility is gained resulting to the lowering of risk premia and greater investor confidence, among others. Third, in federal and federal-like systems like the EMU and Brazil, fiscal rules avoid moral hazard problems[3] and tragedy of commons.[4]

However, fiscal rules also have their disadvantages. First, they constrain government's ability to do countercyclical[5] fiscal policymaking. If a country experiences an economic downturn, usually due to an external shock (i.e. spike in oil prices), government may be unable to stimulate the economy to reverse the downturn. It is widely viewed that discretionary fiscal policy is instrumental for government to undertake fiscal policy functions. Hence, when abiding by the

[1] Brazil has a federal form of government that guarantees financial and administrative autonomy to local and state governments and account for half of public expenditures (Goldfajn and Guardia, 2004).

[2] These policies include the matching of expenditure commitments with adequate funding for the year in which they become effective and two consecutive years, prohibition of lending by public financial institutions to their main shareholders, prohibition of issuance of commitments in the last year of the term of office for expenditures to take place beyond that year, and inclusion of tax benefits in the annual budget only if accompanied by measures to offset their budgetary impact in the following two years.

[3] Moral hazard problems occur when an economic agent acts differently after a change in policy. It is apparent in how GOCCs and LGUs tend to be more irresponsible when NG guarantees its debts.

[4] Commons like the currency, credit ratings and interest premia may be sacrificed by the individual actions of federal states and other government entities.

[5] Countercyclical policies are policies that are aimed at reversing a current business/economic trend. To illustrate, fiscal or monetary expansion during periods of recessions or near recessions are considered countercyclical. In the same way, fiscal/monetary policies that reduce economic activity during period of de facto or near overheating of the economy are also considered countercyclical. On the other hand, policies that are supportive of the current business/economic cycle are called procyclical.

rules becomes too difficult; this may lead to the abandonment of the rules, resulting to a loss of fiscal policy credibility and investor confidence.

Further, rules may create incentive for nontransparent behavior of the regulated via “creative accounting.” Agencies tend not to reveal their real fiscal performance because of imminent sanctions. Finally, if a country institutes rules but lacks the institutional capacity to monitor and enforce these rules, the rules simply increase bureaucratic requirements without achieving fiscal stability. A related issue is whether the rules will be implemented by the rule makers. Legislated rules may be changed quite often to meet new policy objectives undermining the fiscal credibility.

A Framework for the ‘Ideal’ Fiscal Rule in the Philippines

Kopits and Symansky’s pioneering work on fiscal rules (1998) identified widely accepted criteria for fiscal rules. They argue that, to be effective, such rules should be: “well-defined, transparent, simple, flexible, adequate relative to the final goal, enforceable, consistent and supported by sound policies, including structural reforms if needed.”

Fiscal rules adopted by other countries vary in design and content. Most of the time, fiscal rules have specific numerical targets usually a limit to balance the budget, and attain a level of debt deemed to be sustainable. The kind of indicator used as a target should provide the needed simplicity to allow ease of monitoring, address the flexibility issues in fiscal policy and ultimately help achieve the final goals of the rules.

Moreover, to address the issues of flexibility and enforceability, procedural rules are adopted. Many rules emphasize transparency and include policies on monitoring and reporting, sanctions for non-compliance, and independent audit mechanisms.

Setting targets. Targets embedded in fiscal rules should be flexible, simple and attainable. Normally broad based indicators are used such as the government budget balance and debt ceilings as a ratio of Gross Domestic Product. Setting these indicators should take into account macro economic volatility and the business and economic cycles.

Sound economic reasoning should be the basis for setting targets. The following should serve as a guide :

1. What is a sustainable and growth-supporting level of debt? How is this defined?
2. What level of debt is achievable in the medium term? What should be the medium-term target period?
3. What annual levels of deficit and debt are consistent with the achievement of the medium-term debt ceiling?

Debt Ceilings

According to economists, there is no simple rule in determining whether, in practice, a government’s debt is sustainable or not. The optimum level of debt varies from country to country depending on several variables such as revenue effort, effective tax rates, structure and behavior of expenditures, the debt structure, growth of the economy and degree of uncertainty.

An IMF assessment of public debt in emerging markets reveal very significant differences between the level of sustainable debt in emerging markets[6] compared to industrial countries. Using three approaches to assessing debt sustainability, the findings show that industrial countries can sustain higher debt levels. In one approach, a benchmark debt stock level is calculated based on present

[6] The IMF defines emerging markets as those that are in the Emerging Markets Bond Index at the beginning of 2002 plus Costa Rica, Indonesia, India, Israel and Jordan. Essentially, these include countries in the Middle East, Africa, and Asia (excluding the four industrialized Asian countries).

discounted value of expected future primary surpluses given the fiscal policy track record of the country. The results show that the median benchmark debt stock level for industrial countries is 75% of GDP compared to 25% of GDP for emerging economies. The differences can be attributed to government revenues, trade openness and quality of domestic institutions and the nature of the political system (IMF, *World Economic Outlook*, 2003).

This implies that debt ceiling targets have to be evaluated considering a country's fiscal and economic structure, and how fiscal policy responds to the level of debt.

Deficit Ceilings

Budget balance targets are also set to support the debt target and provide a sufficient handle on the kind of fiscal restraint desired given the country's fiscal position. The budget balance target must be defined such that it is easy to monitor and control during budget execution. It also must be flexible to adjust to the needs of the economy. The setting of the budget balance rule—its specification and the level is a heavily debated issue.

The EMU's 3 percent deficit cap has sparked a lot of heated discussions among its members. Italy has breached the cap and is about to face disciplinary actions after its explanation for the breach was found to be unacceptable (*Moscow Times*, June 23, 2005). Greece has breached the rule due to its hosting of the Olympics. France and Germany have been habitually breaching the cap. Germany breached the cap because of its continued attempts to lower unemployment from its double-digit levels. In the case of France, the implementation of a tax freeze to stimulate consumption was the culprit. There are legitimate reasons why governments stimulate the economy through expansionary fiscal policies and a deficit cap could stand in the way. A deficit cap should balance between the contradictory goals of fiscal consolidation and flexibility to undertake legitimate counter cyclical fiscal policy. In the case of the EMU, the European Commission had to decide when breaches are legitimate and when they are not. So far, there have been no sanctions imposed on any country that has breached the cap.

To balance flexibility and fiscal restraint, a cyclically-adjusted primary balance is recommended as the target (Creel, 2003). The cyclically-adjusted primary balance is the budget balance exclusive of interest payments and adjusted for booms and busts caused by the natural business cycle and exogenous shocks. The adjustment is done by computing an average output (GDP) growth rate based on historical data and allowing for a larger deficit during below-average growth periods and requiring surpluses during above-average growth periods. The amount of increase in deficit or surplus is pro-rated based on the amount of deviation.[7] Thus, deficit and surpluses cancel out to meet the medium-term deficit target while providing a leeway for discretionary countercyclical fiscal policy, particularly during busts.

Transparency. Well-designed fiscal rules not only enshrine numerical targets but should underpin strong institutional support and procedural rules. Usefulness of fiscal rules hinges on transparency in institutional structure and functions [i.e. degree of transparency of the budget] (Kopits, 2001). It serves to contain or

[7] For example, during the past decade, Philippine GDP growth averaged 5 percent. Assume that the target is a 2-percent primary surplus in the medium-term with a 1:1 adjustment ratio, meaning an increase/decrease of 1 percent in GDP above/below 5 percent would require an increase/decrease of 1 percent in the surplus requirement. (Both, surplus and adjustment ratio are to be determined based on historical data and consistent with the debt target set on a certain date). So under a cyclically-adjusted primary balance targeting framework, a lower-than-average growth rate of 2 percent would allow a primary deficit of 1 percent. (Computed as average GDP of 5 less 2, the actual GDP, results to a GDP deviation of 3. Then, the target medium-term primary balance is subtracted by the deviation to the GDP target; therefore we have 2 minus 3, the target primary balance for the said year is a primary balance deficit of 1 percent.) In the same way, an 8 percent GDP growth will adjust the primary surplus target to 5 percent. This allows for enough leeway for discretionary fiscal stimulation or its withdrawal in the economy during booms and busts without compromising fiscal consolidation. However, the key lies in determining the appropriate primary balance target and the adjustment ratio.

reduce creative accounting which includes covert subsidies at below-cost pricing and off-budget items.

Equally important is transparency in fiscal reporting (Ibid). Fiscal performance reports of all agencies should be made available for scrutiny. This will ensure that information about the fiscal performance of government agencies and corporations can be scrutinized and fiscal managers can be held accountable for their actions. This will put pressure on public officials to meet the said targets as they are essentially statements of policy intentions.

Moreover, transparency and proper accounting of contingent liabilities should be linked to the budget process. National agencies with Build-Operate-and-Transfer (BOT) projects should disclose the amount and probability of default for appropriate action of Congress. GOCCs and GFIs should also provide accurate information on guaranteed debts.

Budgeting process. Most of the country experiences on fiscal rules have some variants of long-term fiscal plan that include multi-year budgets. Multi-year budgeting makes expenditure management and allocation of resources more responsive to national priorities by providing a more predictable environment for program planning and implementation. It will alert policymakers on the needed reforms and adjustments to comply with the rules. It will yield greater fiscal discipline, improved strategic allocation of resources, and gains in operational efficiency. However, this has not yet been institutionalized in the Philippines.

In addition, it is also useful to establish a mechanism to enforce a mid-course correction for unanticipated deviations from target. Based on Brazil's experience, automatic measures were specified to offset the budgetary effect of a deviation such as an automatic reduction in expenditures if revenues do not materialize.

Monitoring and sanctions. Cross-country experience shows that a country's finance and budget departments are in the best position to monitor, authorize, certify and sanction government agencies. Colombia's finance department was in charge of the implementation of its fiscal rule, particularly in certifying current fiscal performance and authorizing agencies to contract additional loans.

However, enforceability of these sanctions is linked to the extent of power given to the enforcing agencies. How much supervision and monitoring functions are required to properly implement these sanctions? At present, finance and budget departments have limited control over physical and financial operations of various public sector entities like GOCCs and GFIs. There has been insufficient information on the operations of these public entities. Hence, monitoring and supervision powers of these enforcing agencies should be made stronger.

There is also the matter of enhancing technical competence of the enforcing agencies in assessing compliance with the rules (including accounting procedures, multi-year framework, etc). Enforcing agencies should have the technical know-how in evaluating and monitoring public entities if they have reached their targets or not.

The next issue is the determination of the nature and extent of sanctions for non-compliance with these rules. Based on country experience, sanctions usually consist of (1) taint in reputation of elected or appointed official; (2) adverse judicial decision which includes penalties borne by the responsible elected or appointed official; (3) financial sanctions levied on delinquent government agency (non-interest-earning deposits for them, suspension of transfer, or outright fines); or (4) personal sanctions imposed on chief financial officials of public, entities (criminal proceedings or salary cuts) (Kopits, 2001).

In the Philippines, the recommended repeal of automatic NG guarantees for GOCC debts will avoid the rise of mismanaged loans except for those that serve economic/social goals. Also, performance-based contracts for GOCCs and GFIs need to be undertaken, made public and enforced with corresponding sanctions for failure to meet targets.

A World Bank study on fiscal responsibility laws for sub-national government discipline (Webb, 2004) outlines modes and timing of controls and sanctions summarized in Table 1.

Table 1. Modes and Timing of Controls and Sanctions

TIMING		AGENTS: On Borrowers	AGENTS: On Lenders
TIMING	**Ex-ante controls**	NG/LGU: -debt ceilings -deficit targets -restrictions on international borrowing LGUs only: -regulations of borrowing based on fiscal-capacity criteria	NG/LGU: -no direct central bank financing -restrictions on international borrowing -regulations by central bank or other financial supervision agency LGUs only: -credit rationing to states -increased capital requirements for lending to LGUs
TIMING	**Ex-post consequences**	NG/LGU: -limits on central bank financing -no bailouts -publication of fiscal results LGUs only: -NG does not condone LGU debt -debt service withheld from transfers to LGUs	NG/LGU: -strong supervision of banks LGUs only: -regulations requiring capital write-offs for losses from LGU debt

Source: Webb, 2004.

Flexibility clauses. Escape clauses that give government leeway to maneuver during extraordinary situations are important provisions of a fiscal rule, but the circumstances when these escape clauses may be utilized should be appropriately and clearly limited. When escape clauses are abused, the rule is rendered toothless, thus, the wordings of escape clauses are crucial. Terms like "emergencies" and "higher state interests" should clearly be defined. If the target system is complete with debt and cyclically-adjusted budget balance caps, it is advised that the escape clause be limited to nationwide natural calamities and unforeseen external shocks that may affect the economy, as there is no other foreseeable reason for temporarily lifting the implementation of the rules.

Coverage. Fiscal rules should instill fiscal prudence in the entire public sector not just the national government. Thus, it should cover all government agencies and corporations with very few exemptions based on good economic reasoning. Of particular importance is the case of GOCCs and GFIs.

GOCCs and GFIs have been an increasing source of government debt due to outright or implied guarantee of the NG. Second to the national government, off-budget accounts and assumed liabilities of ailing state enterprises and poorly chosen BOT projects account for much of the growth in the National Government debt. The state's 14 monitored GOCCs have more than doubled their debt from 1998 to 2004 totaling 1.55 trillion pesos in 2004. Eight of 14 are net losers with only three of them with justifiable reasons since they fulfill economic/social goals that inevitably make them unprofitable, like the National Food Authority.

Table 2. Sources of the Increase in the NG Debt, 1997-2003

Source of Debt Increase	Amount (in billion pesos)	Percent Distribution
Increase in NG debt	2009.45	100
Due to NG deficits	855.69	42.6
Due to assumed liabilities and lending to corporations	428.1	21.3
Due to exchange rate change	377.54	18.8
Due to non-budgetary accounts	320.55	16.0
Due to increase in cash	27.54	1.4

Source: de Dios, et al., 2004.

Inclusion of local government units (LGUs) in fiscal rules is recommended for further study. Implications of its "fiscal autonomy" granted under the Local Government Code (LGC) to the enforceability of the fiscal rules should be looked into.

The setting of target dates is also an important issue. To create an image of commitment to fiscal sustainability and to make such image credible, fiscal rules should not only bind the current administration but also subsequent administrations. This ensures the public and lenders that the debt ceilings are permanent guidelines that bind politicians across administrations and address the inherent deficit bias of fiscal policy.

Other Issues

In most countries, an important prerequisite for successful implementation of fiscal rules is the phase-in of structural reforms that ensure sustainability of the rules – in the face of fragility in the financial system, rigidity of public sector employment and low revenue base. These reform measures often encompass a number of areas such as tax structure and public pensions (Kopits,2001).

Improve the tax structure. Several studies have shown the need to restructure the country's current tax structure. Progress on the comprehensive tax system reforms will be seen as an indication of the administration's resolve to tackle difficult but critical institutional reforms. There is a need for the country to improve its revenue base and make it buoyant to help meet its fiscal targets. Hence, the remaining administrative and policy reform agenda to raise the level of revenue collections should now be aggressively pursued.

Reform the public pension system. A country's pension system is a potential source of fiscal instability because of the implicit guarantee by the national government. Studies have shown that the GSIS and SSS are potential source of contingent liabilities that may undermine the attainment of fiscal targets. Therefore, to minimize this risk on the implementation of fiscal rules, reforms in the pension system are needed.

Conclusion

Fiscal rules are useful instruments for countries to achieve fiscal discipline. They are especially useful because of the deficit bias and pro-cyclical nature of fiscal policy. Although some experts opine that all that is needed is political will and fiscal discipline, rules can be effective in economies that have weak institutions.

Effective fiscal rules have to be designed to address not only fiscal policy objectives, but also consider:

- The structure of the economy and economic cycles in target setting. Targets should be operational and not constrain government from undertaking fiscal functions. Hence, the need for a broad measure such as debt to GDP ratio and an operational target like the primary surplus. The indicator should cover as much as possible the whole public sector.

- Fiscal targets should be supported by institutional and procedural rules which provide a transparent budgeting process, monitoring and reporting systems, and independent audit mechanisms. The targets should be operationalized in comprehensive annual targets and budgets, hence a Medium Term budget framework is useful.

- Likewise, the incentive system must be in place to encourage adherence to rules. Sanctions are needed to oblige actors to obey the rules. This can come in the form of reputational, judicial, or financial sanctions. Sanctions are important, but most important is that sanctions are effectively carried out. Monitoring institutions must have adequate capability and powers to implement these rules.

The literature on fiscal rules advocates the importance of having a broad consensus among the political and government institutions on the design and content of the rules. Hence, in formulating rules, the political and institutional characteristics of a country should be duly considered so that the incentives to adhere to the rules are well-designed. It is even suggested that media, interest groups, and citizens should be involved to make the rules effective. Fiscal rules should also provide the opportunity for the public to look into the fiscal performance of the government and hold government agents accountable for poor performance. Therefore, experts recommend a concerted outreach campaign to get public support and extensive debates to achieve legislative consensus. A "convergence path" must be mapped out which includes clear annual targets, how these will be achieved, and rules to treat deviations from targets (Kopits).

Given the country's experience of poor fiscal position characterized by excessive debts; chronic deficits; declining education, health, and infrastructure expenditures that support growth; and high risk premia; fiscal reconsolidation is necessary to stabilize the macroeconomy and support growth. In view of this, fiscal rules are worth considering in order to change the track of fiscal policy in the country given its fiscal structure and deficit bias.

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This paper was principally prepared by Ms. Ma. Susana T. Bulan, Director General of SEPO, together with Ms. Marianne S. Domingo and Mr. Mark Emmanuel L. Canlas of the Macro Economic Section.