

# IMF Working Paper

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## Budgetary Transparency for Public Expenditure Control

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**IMF Working Paper**

Fiscal Affairs Department

**Budgetary Transparency for Public Expenditure Control**

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January 2001

**Abstract**

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This paper explains why EMU countries seem unable or unwilling to undertake structural reforms of public expenditure. One of the reasons is political. What public expenditure reforms might be pursued without changing the political system? Without political reforms, technical improvements made to increase budget transparency, such as strengthening budget procedures, integrating accrual into cash accounting, and removing accounting gimmicks, could indirectly affect reforms of public expenditure. Removing gimmicks and helping prevent the emergence of new creative accounting techniques may be a partial substitute for political reforms. Implementation of the Growth and Stability Pact should be dynamically consistent with budgetary transparency. Although other EMU countries resorted as well to budgetary gimmicks to bypass difficult fiscal constraints, the Italian case is used as a reference to clarify these issues. Transparency may help discourage the use of gimmicks.

JEL Classification Numbers: E6, H50, H6.

Keywords: Public expenditure control; political systems and public expenditure reforms; taxation and unemployment; GSP implementation versus budgetary gimmicks; budgetary transparency in Italy.

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<sup>1</sup> This paper was written when the author was a visiting scholar at the Fiscal Affairs Department of the International Monetary Fund, September–November 1999. The paper benefited greatly from the comments of Marco Annunziata, Giorgio Brosio, Adrienne Cheasty, Jorg Decressin, Riccardo Faini, Robert Gillingham, George Kopits, Joseph LaPalombara, Joergen Lotz, Taryn Parry, Giuseppe Pisauro, Barry H. Potter, Massimo Russo, István Székely, and Howell H. Zee. The opinions expressed in this paper are solely those of the author.

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## I. INTRODUCTION

This paper focuses on whether political systems of euro area countries<sup>2</sup> have the capacity to enforce the major public expenditure reforms that are needed to enhance competitiveness in the global market and reduce structural unemployment. These governments need to reduce expenditure in order to reduce their relatively high tax rates on labor and profits, but also to change the composition of expenditure, by increasing the amount of productive expenditure. Some of these countries also need to increase the expenditure aimed at helping the poor escape from their marginalization.

In the 1992–97 transition to the EMU, euro area countries complied with the Maastricht Treaty budgetary constraints mostly by increasing taxes, cutting public investment, and using various budgetary gimmicks. Moreover, mainly in highly indebted countries such as Italy, Maastricht Treaty compliance was helped by lowering interest costs. As inflation was coming down and the introduction of the euro became a more and more credible target, nominal interest rates and spreads on the debt gradually declined. Structural reductions and realignments of current public expenditure other than interest payment played a relatively minor role. Historically, this failure to implement major public sector reforms has been blamed on overwhelming political difficulties.

In democratic societies, it is politically difficult to cut expenditure. Major expenditure reforms, such as the reforms needed in pension programs and, more generally, in the social policy area, are not politically feasible. One way to interpret this difficulty is market failure—elected officials do not have sufficient incentives to internalize the externalities from the impact of wrong policies that are likely to materialize after their term expires.

The political systems of the continental EU countries need to be reformed, if they are to function efficiently. Even if some countries, such as Ireland and the Netherlands (IMF, 1999) and, more recently, Finland, were able to carry out major structural reforms, including the reform of the welfare state, the political systems of most euro countries were unable to pursue stressful structural reforms of the expenditure. These systems should be more responsive to long-term financial consequences than to short-term desires. This would mean facing up to the expenditure reductions required in the new global macroeconomic framework. But properly designing the correct incentive system would be as difficult as reforming the political systems themselves and the political systems appear unable or unwilling to reform from within.

How can these obstacles be overcome so that public expenditure reforms can be made? What can be done to push political systems to implement major public expenditure reforms? And

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<sup>2</sup> In this paper euro area countries include 10 of the 11 countries members of the Union (Luxembourg is excluded). They are Austria, Belgium, Finland, France, Germany, Italy, Ireland, the Netherlands, Portugal, and Spain.

how can public expenditure then be controlled? This paper seeks some answers to these questions.

Section II attempts to explain why continental EU countries are unable or unwilling to undertake the structural reforms of public expenditure needed to reduce tax rates on labor and profit, as a means to increasing their competitiveness in global markets and combating structural unemployment. This section concludes that reforms are likely to be introduced only as the result of external pressures.

Section III suggests that increasing budgetary transparency, by strengthening budget procedures, integrating accrual and cash accounting, and removing budgetary gimmicks that bypass fiscal constraints, may be a partial substitute for public expenditure reforms. Although procedural changes may have only a one-time impact on public expenditure, they may unmask gimmicks for what they are and help prevent the emergence of new creative accounting techniques. Though other EMU countries have as well practiced budgetary gimmicks to bypass difficult fiscal constraints, the paper uses the case of Italy as a reference to clarify the problem. Budgetary transparency may help discourage the use of gimmicks.

## **II. WHY PRESENT POLITICAL SYSTEMS DO NOT CONTROL PUBLIC EXPENDITURE**

### **A. In EMU Countries, Public Expenditure has not been Reformed as Needed**

In EMU countries, the size of general government expenditure should be constrained by two policies: compliance with the European Growth and Stability Pact (GSP) and, in the medium to long term, the need for a substantial reduction in taxes on both labor and profit, to increase competitiveness in global markets and combat unemployment. More generally, structural reforms are required to prevent public expenditure from growing faster than GDP at a time when the aging population is increasing and requiring more social security and healthcare expenditure. Reducing taxes by making large cuts in public expenditure, however, seems to be problematic: the present political systems of these countries seem unable to make the needed structural reforms.

The 1992–97 convergence to EMU requirements showed how difficult it is for these countries to lower budget deficits by reducing public expenditure. In 1997, these countries complied with the Maastricht Treaty budgetary constraints mostly by increasing taxes, lowering interest rates, cutting public investment, and using various budgetary gimmicks (Reviglio, 1998; Caselli and Rinaldi, 1999). Italy achieved a large reduction (6.9 percent of GDP) in the general government deficit during 1992–97 through an increase in receipts (1.7 percent of GDP) and several expenditure cuts (2.0 percent of GDP for interest payment, 1.5 percent of GDP for other current expenditures, and 1.1 percent of GDP for public investment).

Even if the comparison made for the 1993–97 period shows a somewhat larger current expenditure cut other than interest reduction, the contribution of this realignment to the total

budgetary adjustment was relatively minor. It was not sizeable enough to allow the substantial reduction in taxes on both labor and profit required to increase competitiveness in global markets and combat unemployment.

Since 1997, these countries' political systems have further shown their unwillingness to make structural reforms in public expenditure, for example, in their failed attempts to enforce needed pension reforms. Although the governments of France and Germany proposed pension reforms, the proposals were withdrawn when they met with widespread popular opposition, including general strikes. Some reductions in government deficits were achieved by increasing social security contributions (and, thus, the cost of labor). In Germany, to fight unemployment, a reduction of the pensionable age has been suggested, a decision that would increase the expenditure for pensions. Both events suggest how difficult it is to make much-needed reforms of the pension system.

Italy undertook three pension reforms during the 1990s. The first two reforms made major changes to the rule of the system. The latest reform increased the speed of the implementation of the preceding interventions. Although these reforms smoothed the profile of the pension expenditure to GDP, they did not fully stabilize its trend. Moreover, the expenditure level was not brought toward the EU average. Suggestions to reform pensions more deeply were strongly opposed.

The inability to make major structural reforms in public expenditure may not prevent countries from complying with the GSP, which requires only minimal adjustments to public expenditure levels. Balancing the government budget in EMU member countries requires reducing the deficit by about 1–1.5 percent of GDP. This outcome may be reached by minor reductions in expenditure: and, in Italy, by improving tax compliance and reducing the cost of debt servicing.

### **B. Political Systems were Designed to Distribute, not Reduce, Benefits**

As stated, under their present political systems, these countries seem incapable of making structural reforms in public expenditure. This can perhaps be explained by looking at the history of the European political systems. For decades, these systems were based on increases in public expenditure and on benefits to constituents larger than the taxes raised to cover benefit costs. In the period 1970–93, public expenditure in EMU countries increased by 17 percentage points from 36.1 percent to 53.1 percent of GDP; this was almost 7 percentage points of GDP more than the increase in the tax ratio in the same period (10.4 percentage points of GDP, from 33.3 percent of GDP in 1970 to 43.7 percent of GDP in 1993). A large share of the increase in public expenditure was covered by increased net borrowing (an average of about 2.9 percent of GDP in the period).

In the political scenario that prevailed in EMU countries before 1993, politicians were more electable if they promised to provide more public goods without asking to raise taxes to cover their cost. This was possible because a large share of the expenditure was financed by government borrowing; in EU countries, such as Italy, characterized by a persistent high

inflation a sizeable amount of the additional revenue came automatically through the fiscal drag, thanks to the two-digit inflation in the period 1974–83. The public did not perceive the costs of wide structural deficits.

However, in some other countries, such as the United States, public expenditure and taxes are lower (in 1999, 34.4 percent and 30.4 percent of GDP, respectively, against 48.6 percent and 42.9 percent in EMU countries), and in the period 1970–99, tax increases were very limited (Table 1; Figure 1). In the United States, politicians are more electable if they promise to cut taxes, so they continue to offer attractive tax cuts in combination with expenditure cuts that the public would support.

In EMU countries, however, in the 1970s and 1980s, this political framework did not work because the public preferred high expenditure, partially covered by large deficits, as a way of financing the expenditure without apparent costs in the short run (Figure 2). The public did not want to see expenditure reduced, and their reluctance to pay led to the large structural deficits.

Benefits provided by increases in public expenditure and debt built large public institutions. And the benefits fed the political systems. All major industrial countries exhibited a trend of increasing public expenditure and debt until the beginning of 1990s, but the increase was larger in EMU countries. From 1870 to 1990, in what are now OECD member countries, public expenditure as a proportion of GDP increased from 8.3 percent to 44.8 percent (Tanzi and Schuknecht, 1997). In the same period, in the EMU countries, the increase was larger: to 49.3 percent of GDP, as compared to 31.1 percent of GDP in the other European countries. Over the last century, in industrial countries, thanks to increasing public expenditure, the benefits distributed to citizens by the political systems were substantial; the increase, however, was almost 50 percent larger in EMU countries.

The increase in public expenditure was larger than that of taxes (Table 1; Figure 1). In the period 1970–93, in EMU countries, this increase in public expenditure was almost one-third larger. Both increases were substantially larger than in the United States. In the 1970s and 1980s, as taxable capacity became more constrained, increasing public expenditure meant increasing government borrowing and debt. In EMU countries, government debt rose from 33 percent of GDP in 1977 to 67 percent of GDP in 1993.

In 1992, this situation began to change dramatically. The institutional and financial events of 1992–93 (the Maastricht Treaty and the financial crisis in Italy) challenged political systems to reduce budget deficits and stop increasing government debt. The political systems, born and developed under a different framework, however, were unable to produce sizable cuts in current expenditure.

As a mechanism that produces collective choices, a political system is similar to a car engine: born to produce motion. When cheap petrol was no longer available, new engines had to be designed and produced; the old engines were no longer economical. But the two situations

Table 1. EMU Countries and the United States: Public Expenditure, Taxes, and Government Borrowing, 1970-99: An Overview

(As percent of GDP)

	1970	1980	1990	1993	1997	1999	Average		
							1970s <sup>3</sup>	1980s <sup>4</sup>	1990s <sup>5</sup>
<b>Public expenditure</b>									
Continental EU countries 1/	36.1	46.2	49.2	53.1	49.8	48.6	41.3	49.4	50.7
United States	32.2	34.5	36.7	37.5	34.4	34.4	33.0	36.6	36.4
<b>Taxes</b>									
Continental EU countries 1/	33.3	39.8	41.5	43.7	43.6	42.9	36.5	41.4	43.0
United States	27.6	28.6	28.6	28.6	30.2	30.4	28.1	28.5	29.3
<b>Government borrowing (net) 2/</b>									
Continental EU countries 1/	0.3	-3.5	-4.2	-5.6	-2.5	-2.0	-2.2	-4.6	-4.0
United States	-1.3	-1.7	-3.0	-3.9	0.1	1.7	-1.3	-3.1	-2.4

Source: For continental EU countries, European Commission, 1999; for United States, 1999.

1/ 10 country members of the EMU.

2/ (-).

3/ 1971-80.

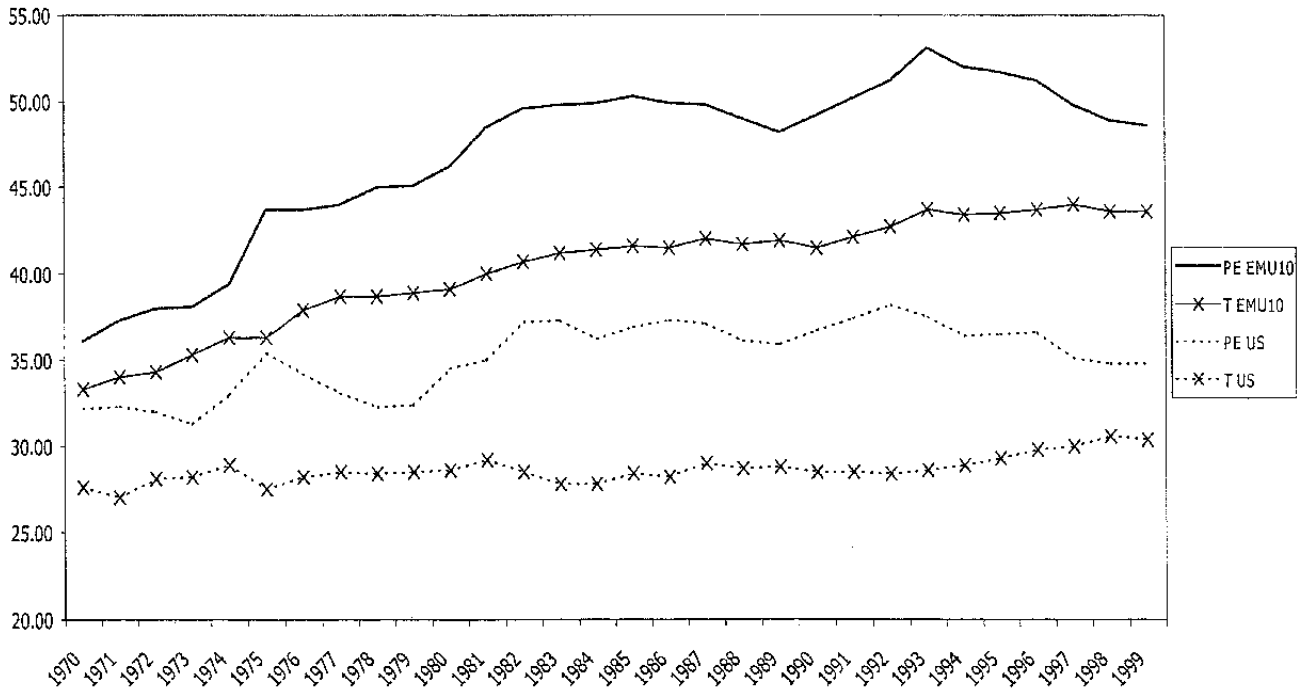
4/ 1981-90.

5/ 1991-99.



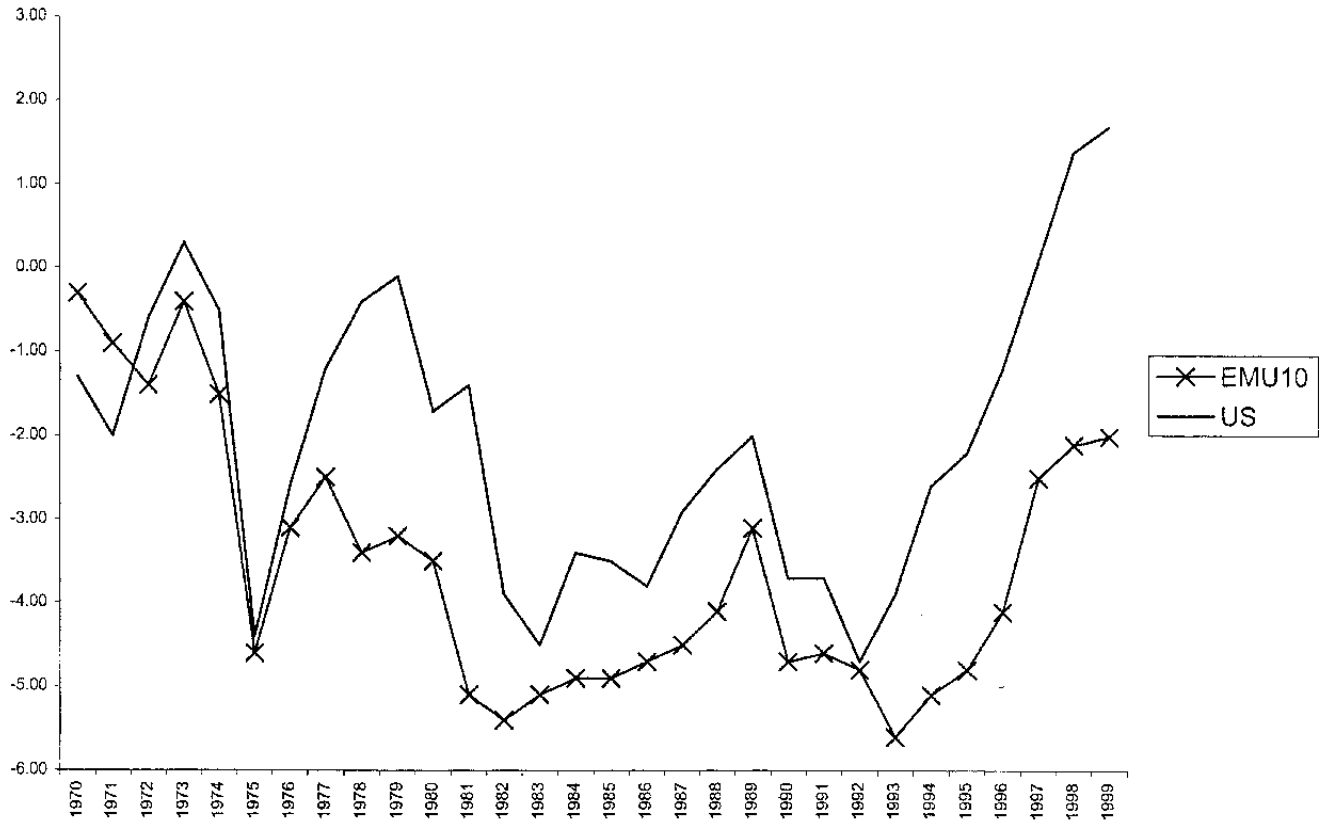
Figure 1. EMU Countries and the United States: Public Expenditure and Taxes, 1970-99

(As percent of GDP)



Source: European Commission, 1999.

Figure 2. EMU Countries and the United States: Government Borrowing, 1970-99  
(As percent of GDP)



Source: European Commission, 1999.

are not completely analogous. Markets encourage the modernization of car designs and production, but not the reform of political systems. These reforms need political impetus. Institutions may, however, prefer the old systems if they allow society's special-interest groups to prevail by blocking decisions that penalize such groups. For example, an aging population and the resulting increase in the median voter age moved preferences against the required social reforms, such as those of pensions and health care, because reforms in these areas could penalize mainly the elderly.

In EMU countries, the reverse budgetary scenario after 1993 forced governments to reduce net borrowing. To reach this goal, public expenditure had to be reduced. Increases in benefits, which in the past made politicians more popular, were no longer available. Political systems were, however, unable to produce sizable cuts in public expenditure because they make politicians less popular and, therefore, taxes could be cut only marginally. This explains why the proposed pension reforms failed in France and Germany and why more ambitious pension reforms were deferred in Italy. It is easier to share benefits than to share the costs of public expenditure cuts.

In the budgetary scenario realized in EMU countries since 1993, politicians can no longer benefit from increasing expenditure that is only partially financed by new tax revenues. According to the GSP, in normal economic situations, government budgets should be balanced, or should be slightly positive on average over the cycle, and there are special rules applying to severe recessions. The automatic stabilizers are allowed to work during the typical business cycle. Under this new framework, the political scenario is moving toward those in other industrial countries such as the United States, where politicians are more electable if they propose cutting taxes. But this cannot be achieved unless public expenditure is reduced, a condition requiring major reforms of public expenditure that EMU countries' political systems seem unable to meet.

### **C. Low Economic Growth and High and Increasing Unemployment Makes Expenditure Cutting Difficult**

In the 1990s, differences in the growth and employment performances in the United States and Europe were large (IMF, 1999a). The U.S. economy expanded at an average annual rate of 3 percent, generating a rise in private sector employment sufficient to reduce the unemployment rate to about 4 percent. In the EMU, average growth reached only 2 percent for the decade; unemployment increased to slightly more than 12 percent in 1997, and has declined only modestly since then.

Both longer-run structural determinants and short-term cyclical influences have contributed to the relatively low rate of economic growth and increased unemployment in EMU countries. The high tax burden, together with labor-market rigidities, social conflicts, the shift in labor demand because of technology, the failure of wages to adjust to the slowdown in underlying productivity growth, weak educational systems, an aging population, and constraints on competition are considered the main causes of slow growth and high

unemployment. However, there is no overwhelming evidence that any one single factor can fully explain low growth and rising unemployment.

Daveri and Tabellini (1997) cite evidence that, in EMU countries, tax increases on both labor and profits were the main causes of the declining economic growth, increasing unemployment, and the growth of the shadow economy, which has been increasing since the mid-1980s. These authors estimate that about one-third of total unemployment could have been avoided if tax increases had not been implemented. This evidence has found further support in recent research that shows a highly significant and very large effect of labor taxes on the unemployment rate in EMU countries (Daveri and Tabellini, 2000). Similar results, although with estimated smaller coefficients of labor taxes on unemployment, were reached by Nickell and Layard (1999), and by Blanchard and Wolfers (1999).

The research of Bleaney, Gemmel, and Kneller (1999) and OECD (1997b) moves in the same direction. Bleaney, Gemmel, and Kneller show that taxes that seriously distort relative factor prices (taxes on income and profit, movable property, and payroll and manpower, as well as social security contributions) reduce growth. OECD finds that high taxes on labor led to a reduction in the demand for labor, particularly for low-skilled labor. Therefore, reducing taxes on labor may increase the demand for labor and reduce unemployment (for an exhaustive review of previous empirical studies, see Zee 1997). These studies give additional empirical support to policy suggestions that taxation reform that minimizes distortions can foster a favorable environment for growth and for employment.

These outcomes should be cautiously considered because they could be the joint product of other determinants, such as the interaction of economic shocks with labor-market rigidities over time. Blanchard and Wolfers (1999) quantified the impact of different labor-market rigidities on unemployment in a group of 20 countries over eight five-year periods from 1960–65 to post-1995. They found that labor-market rigidities produce structural unemployment and magnify the effect of shocks. Moreover, the effects on productivity produced by the expenditure financed by taxes on labor and profit cannot be ignored because the differential effects on productivity produced by them could somewhat offset the negative impact of the payroll tax burden on competitiveness (Atkinson, 1999).

However, in spite of these cautions, the generous social insurance schemes and the associated high payroll taxes are widely considered a major cause of the high unemployment rates that have persisted in Europe over the past 15 years. In the period 1980–95, the tax wedge on labor increased from 34 percent to 42 percent, while taxes on capital declined from 44 percent to 37 percent. The relative increase in taxes on labor vis-à-vis taxes on capital brought out in EMU countries is considered by the European Commission to be an important determinant of the increasing unemployment. Policy suggestions have been developed for restructuring social insurance programs to have less adverse impact on the unemployment rate. Stiglitz (1999) has developed a theory of the dynamics of employment, which suggests how redesigned programs could mitigate fluctuations in unemployment.

How much taxes should be reduced is, however, a debatable issue. To reach the tax-GDP ratios of United States and Japan, taxes in EMU countries would have to be reduced by more than 9 percent of GDP. In any case, to fight unemployment in the EMU countries, taxes on labor should be substantially reduced. A meaningful reduction would, however, be dependent on substantial cuts in public expenditure. Furthermore, major public expenditure reforms will be required to meet new needs, such as those to help the aging population, to protect the environment, and to move the expenditure composition toward more productive expenditure. Without these cuts and changes in expenditure composition, employment and economic growth will continue to suffer. However, as noted, major cuts in public expenditure are politically difficult to make.

#### **D. Needed Reforms of Political Systems are Likely to be Introduced Only in Response to External Shocks**

The relationship between the type of political system and fiscal discipline is discussed below. In general, government coalitions elected by slim margins experience larger fiscal deficits and government debts (Roubini and Sachs, 1989; Hallerberg and von Hagen, 1998 and 1999). This lack of fiscal discipline is also found in governments with proportional representation systems (Grilli, Masciandaro, and Tabellini, 1991; Siniscalco and Tabellini, 1993; Reviglio, 1996 and 1998; Persson and Tabellini, 1999a and b; and Stein, Talvi, Grisanti, 1999).

An important role in controlling government size is also played by the territorial features of the proportional electoral systems. Milesi-Ferretti, Perotti, and Rostagno (1999) discuss several measures of the degree of proportionality of electoral systems and investigate their relation to fiscal policy outcomes. They find that OECD countries with more proportional electoral systems tend to have a higher share of transfers in government expenditure and a higher share of total spending to GDP.

The United Kingdom, which is characterized by a strong "first-past-the-post" political system, has been able to control the size of government. From 1995 to 1997, the average annual British public expenditure was held to 42.3 percent of GDP, against an average of 51.4 percent of GDP in the three major EMU countries (Italy, France, and Germany). Thanks to this relatively small size of government, the British tax-GDP ratio has been about 8 percentage points of GDP lower—comparable to levels in the United States and Japan.

Other studies show that presidential government systems are associated with smaller governments. Presidential systems, such as that of the United States, tend to lead to smaller government both in terms of fewer public goods and less redistribution. Using data from 64 countries, Persson and Tabellini (1999 a and b) find that public expenditure in countries with a presidential system is considerably lower (by about one-third) than in those with a parliamentary system.

Lumping together presidential and parliamentary countries does not take into account political systems that are highly diverse. Most presidential systems are in Latin America

where, typically and for a very long time, they were under military dictatorial rule. France, a country where the size of government is relatively large, has a presidential system, but in the study it is classified as parliamentary, because its government depends on a parliamentary majority. The study does not explain why Japan, where public expenditure is relatively low, has a parliamentary and a quasi-proportional system. The United Kingdom, a country also successful in the control of public expenditure, has a majoritarian but not a presidential system.<sup>3</sup>

The merits of majoritarian systems are their capacity to overcome the short-term desires of politicians and to give more attention to longer-term financial consequences, enabling tougher decisions that reduce the growth in expenditure. By ensuring a longer stay in power, they can persuade politicians to place the longer-term welfare of their constituents over their own short-term electoral interests. Other research suggests that when voters cast party-based votes, collective policy issues are preeminent and those elected do not pursue the small-scale interests of their constituents. These positive trends are found not only in proportional-representation systems, but also in the mixed-member-representation systems, which complement a single-candidate-district mode of election with a second-tier-seat allocation adopted by many countries.<sup>4</sup>

Other studies claim that federalism and decentralization may reduce the size of government. When fiscal decentralization or federalism is correctly implemented, it may help control the size of government because it increases the importance of fiscal considerations in voters' location choices and increases competition among governments; however, if decentralized entities are not held accountable, its benefits may be seriously reduced and the management of public expenditure distorted.<sup>5</sup>

Recent evidence drawn from a large sample of countries (20 Latin American and 17 OECD countries) confirms that decentralization, measured by intergovernmental transfers to local governments as a percentage of total revenues, reduces the size of government only if the degree of vertical fiscal imbalance and borrowing autonomy is low. But it can also increase the size of government if the degrees of vertical imbalance and borrowing autonomy are high (Stein, 1998).

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<sup>3</sup> But it does have an "elected dictatorship," giving quasi-presidential powers to the prime minister.

<sup>4</sup> Shugart (1999), as quoted by Milesi-Ferretti, Perotti, and Rostagno (1999).

<sup>5</sup> The conditions to be expected to have a successful devolution are reviewed in general by Tanzi (1995). For a discussion of why devolution should work and how it should be done, see Rivlin (1992).

The above-mentioned studies show the complex links between political systems and fiscal outcomes, suggesting that the crucial tools in controlling the size and efficiency of government are bringing fiscal decisions closer to voter preferences, and making fiscal decision makers more accountable. To facilitate reforms of public expenditure, the trend should be toward systems with majoritarian elections (instead of proportional) and toward decentralized systems. Presidential systems may help strengthen their capacity to bring about reforms. The same result, however, may be reached by increasing the governing power of the relative majority with a majoritarian electoral system. This conclusion seems well supported by the experience of the major continental euro countries (France, Germany, and Italy), where evidence of a strong relationship between political systems and fiscal outcomes may be easily found.

These reforms, however, are not likely to be made voluntarily by the existing political system, because they might disturb the national political equilibrium or even destroy the smaller political parties. Particularly enlightening is the case of Italy, where, in the last few years, several attempts to reform political institutions have failed, in spite of the need to reform the political system to make it to function efficiently in the new global economy. This scenario is common even to other EMU countries. Reforms are likely to be made only when driven by external economic shocks: for example, Italy's successful 1992–93 implementation of the stabilization program after the devaluation of the Lira.

If the budgetary authorities cannot react to a recession, in part, through monetary instruments—as they have in the past, under the EMU—budget deficits may get out of control, causing GSP violations (Buti, Franco, and Ongena, 1997). This situation will be even more difficult where budgetary positions are structurally weak. When GSP violations occur, public expenditure reforms will be enforced—they will be unavoidable if further tax increases are not considered feasible.

Therefore, reforms of the political systems and institutions may be needed if there is no other way to reach agreement on the required budgetary policies. The EMU authorities may have to compel these countries to implement a predefined multistage reform of their own political systems and institutions, based on national solutions (Perotti, Strauch, and von Hagen, 1997).

### **III. BUDGET TRANSPARENCY MAY HELP PUBLIC EXPENDITURE CONTROL**

#### **A. Better Management, Accrual Accounting, and Elimination of Gimmicks Could Drive Public Expenditure Reforms**

Are there substitutes for the political system reform that will drive public expenditure reforms? Might improving public expenditure management and accounting help overcome the inability of political systems to control public expenditure?

Reforms aimed at improving budgetary transparency—such as the strengthening of budget procedures, integration of accrual into cash accounting, and elimination of gimmicks to

escape from fiscal constraints—may generate results that are qualitatively similar to major changes of public expenditure. They may compel governments to adopt measures to reduce expenditure in an effort aimed at offsetting the impact of gimmicks on the deficit. However, they are not a substitute for fundamental expenditure reforms and should not be considered a panacea, because, in fact, other gimmicks could be used to avoid fiscal constraints.

In most EMU countries, the search for gimmicks to avoid fiscal constraints continues. Budgetary gimmicks reduce transparency and may create (or disguise) structural economic weaknesses that limit medium- and long-term growth potential. Moreover, they allow governments to avoid expenditure reforms. Moving public expenditure accounting closer to economic reality may eliminate some of the loopholes created by the present cash accounting system. Fiscal discipline could, therefore, be tightened, making fiscal constraints effective and compelling governments to implement, at least partially, those public expenditure reforms that the political systems avoid.

In Italy, sustained expenditure cuts and improvements in public expenditure composition could be achieved by integrating cash with accrual accounting and by avoiding budgeting gimmicks. Although the problem of unpaid commitments is mainly Italy's, other EMU countries have used budgeting gimmicks to bypass difficult fiscal constraints. These countries could also benefit from the avoidance of gimmicks to help push governments to reduce public expenditure. These reductions may be sizable, even if they are only a very partial substitute for the structural public expenditure reforms needed to reduce tax rates

### **B. Strengthening Budget Procedures Would Lead to a Better Expenditure Management**

Many studies have examined the role of budget institutions in the fiscal performance of industrial and developing countries. Weak institutions are often associated with a larger deficits, in both industrial economies (von Hagen and Harden, 1996; Alesina and Perotti, 1995a and b, and 1999; de Haan, Moesen, and Volkerink, 1999) and Latin American countries (Alesina, Hausmann, Hommes, and Stein, 1996; and Stein, Talvi, and Grisanti, 1999). Budget reforms may lead to different fiscal policy decisions in different political situations.<sup>6</sup>

It is argued that the fragmentation of the political process, particularly when measured by the number of participants in budget deliberations, affects fiscal policy outcomes (Kontopoulos and Perotti, 1999). Strengthening budget procedures through performance budgeting, program budgeting, or “value for money,” may weaken the effect of proportional

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<sup>6</sup> A review of budgetary procedures introduced in various European countries may be found in OECD (1995); OECD Economic Surveys (various years); and de Haan, Moesen, and Volkerink (1999). For Italy, see Alesina, Marè, and Perotti (1995), and Milesi-Ferretti (1997).



representation on fiscal policy outcomes (Stein, Talvi, and Grisanti, 1999). Entrusting power to a strong finance minister may be effective in reducing the “common-pool” problem typical of plurality systems with cabinet negotiations (Hallerberg and von Hagen, 1999). Moreover, reforms that reduce the power of lobbyists, such as campaign-finance reforms, may help improve fiscal discipline.

To ensure that spending units implement central government decisions aimed at controlling public expenditure, a system of incentives and penalties for public managers is needed. Such a system is not easy to implement where there is no political will for fundamental reform. Experience shows that these mechanisms are sometimes lacking, and the lack of such a mechanism is responsible for the lack of control. More effective monitoring of expenditure, increased responsibility, and administrative autonomy of senior civil servants are required. The number of units involved in the budget process has to be reduced, and their relationship with spending targets and allocated resources should be made easily recognizable. Such reforms are being implemented in Italy. A new legislation, enacted in 1997 to reform the budget process, enables the government to monitor expenditures more effectively, and increases the responsibility and administrative autonomy of senior civil servants. The number of units involved in the budget process has been reduced. Each unit is now responsible for an area of activity within each Ministry and is managed by a single administrative entity. By making the relationship between spending targets and allocated resources easily recognizable, this simplification increases the overall transparency of the budget process. Other mechanisms aimed at increasing the efficiency and improving the performance—such as quasi-markets, user fees, and vouchers—are suggested.

Procedures for monitoring management performance and accountability are needed to ensure that parliament’s spending decisions are implemented, so that the spending generates as high a value as possible to the citizens. Greater budget transparency may help enforce the implementation of national decisions to cut expenditure by decentralizing institutions. Moreover, decentralizing public expenditure management can improve management and transparency, which is a necessary precondition for economic efficiency and effectiveness. Public institutions, such as schools, may be better managed through decentralized operations.

Improved performance may even be achieved with other public expenditure management reforms, such as the so-called agency reforms aimed at enforcing a careful distinction between principal-agent activities within the public sector, and the setting of performance contracts, measurements, and indicators for those operating public services. These improvements may be reflected in increased output, more effective delivery of public services, and more efficient services.

### **C. Computing Accrual Accounting Carefully Would Help Confront Public Expenditure and Debt Problems**

Control of public expenditure could also be improved through changes in fiscal accounting systems. In fact, appropriate fiscal accounting would force public expenditure reforms and cuts, by making it more difficult to pursue budgetary gimmicks used to bypass fiscal

constraints. This outcome may become the result of accrual accounting adopted by the revised *A Manual on Government Finance Statistics* (IMF, 2000). Accrual accounting is already utilized by the EMU countries to comply with the GSP, in line with EUROSTAT rules (National Accounts SEC95).

The switch from cash to accrual accounting would require that changes in payment arrears and public expenditure carryovers (unspent commitments) be included in the measurement of total annual public expenditure. Moreover, previous years' arrears and commitments should also be included in outstanding government debt. With the new accounting, the creation of further arrears would not necessarily be eliminated, however, the countries that use accrual accounting to avoid the fiscal discipline required by external budgetary constraints such as deficit-GDP and debt-GDP ratios would be compelled to enforce more effective budget ceilings.<sup>7</sup> Under the circumstances discussed below, arrears and unspent carryovers would have to be included in the calculation of expenditure, deficit, and government debt. Building arrears would not reduce anymore the operational deficit as they do in a cash accounting system.

Adopting accrual accounting would help assessing budgetary performance, such as government deficit and debt, and enhance the effectiveness of fiscal constraints. As a by-product, governments would be forced to cut public expenditure or raise taxes to offset the resulting computation of arrears and unspent carryovers in the expenditure. In countries where tax increases are politically unfeasible, the only way to change accounting is to make reforms in public expenditure. Accrual accounting can produce expenditure cuts, and allow better cost-price calculations, focusing on expenditure management through a result-oriented system.<sup>8</sup> With cash accounting, public expenditure and deficit are artificially reduced, and incentives for efficiency in expenditure are lacking.

Today, cash accounting allows countries to maneuver the size of unspent commitments (budget carryovers) that do not have to be financed by governments in the same year in which they are recorded, avoiding fiscal constraints that are related only to cash accounting. Although this carryover provision can be justified for capital allocations not yet committed, it is typically not justified for new commitments. This maneuver may be used one time as a gimmick; it can also become a sustained policy, repeated annually until it becomes financially unsustainable.

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<sup>7</sup> In Anglo-Saxon countries, such as the United Kingdom, Australia, and New Zealand, the role of accrual accounting is a strongly debated issue; in the 1980s and 1990s, these countries were able to cut back significantly the size of their public sectors thanks to their political systems and new budget procedures.

<sup>8</sup> The merits and limits of accrual accounting are analyzed by Potter and Diamond (1999); OECD (1997a); and Premchand (1995).

Under the accrual accounting system, new commitments (orders) would be counted as liabilities and added to cash expenditure when the service is delivered, and they thereby incur government debt when the payment is overdue. Central and local governments' new annual fulfilled, but unpaid orders (arrears) would be included as government expenditure in the consolidated general government operating statement. Only commitments concerning yet-to-be-provided services would be excluded under accrual accounting. Unpaid, but fulfilled, commitments should be carefully assessed when accrual accounting is utilized. In practice, however, this assessment may be difficult to perform correctly, as the case of Italy shows.

According to the ESA 95 accounting system followed by the Italian National Statistic Institute (ISTAT), government operations are recorded in accordance with the accrual principle (*competenza economica*). The recording procedure followed by ISTAT is based on the 1993 System of National Accounts (SNA 1993) and is the same as those utilized by all European countries and by most other countries worldwide.

In accrual terms, a transaction must be recorded when it produces its economic effects. Therefore, the timing of recording seldom coincides with the timing of cash transactions. Expenditure commitments are used as an approximation of the accrual principle of recording for all expenditure items that constitute production costs. Uncommitted appropriations (*residui di stanziamento*) are excluded because they do not represent true debits for public administration.

Enforcing these procedures in practice is difficult. Transparency on carryovers necessary to consolidate general government expenditure commitments and revenues and to single out committed appropriations is somewhat lacking. Available data are supplied with a large delay and without necessary details for their analysis. Accrual expenditure is sometimes underestimated.

In 1997–98, the annual average increase in such central government unpaid carryovers reached Lit 41.6 trillion (over 2 percent of GDP), compared to an annual average of only Lit 2.8 trillion for the previous three years (Table 2). These data were reported with a considerable time lag (about 15 months). Local government carryovers increased by Lit 18.2 trillion (0.9 percent of GDP) in 1997, and by Lit 30.4 trillion (1.5 percent of GDP) in 1998.

In 1997 and 1998, the average increase in central government arrears was thus sizable—about almost 15 times the average of the previous three years. The stock of unpaid central government carryovers (*residui passivi propri*) at the end of 1998 was about Lit 201 trillion (20 percent of GDP). To this amount, a stock of local government unpaid carryovers of over Lit 254 trillion (12 percent of GDP) should be added. This latter amount is the sum of the 1998 stock of unpaid carryovers by the regions and the 1997 stock of unpaid carryovers by provinces and municipalities. At the end of 1998, the stock of unpaid health care arrears was estimated to be over Lit 30 trillion (1.5 percent of GDP).

Table 2. Italy: Increase of Unpaid Carryovers and Health Care Arrears, 1994–98

(In billions of lire)

	1994	1995	1996	1997	1998	Average	
						1994–96	1997–98
Unpaid carryovers 1/							
Central government 2/	-148	16,716	-8,000	40,222	42,989	2,855	41,605
Local government 3/	-7,936	965	22,729	18,254 4/	30,481 4/	4,609	24,367 4/
Health care arrears 5/	7,443	278	3,251	9,187	8,835	3,657	9,011

Source: For the unpaid carryovers, see Italy, Ministero del Tesoro (various years, 1996–2000); for the health care arrears, see Italy, Ministero del Tesoro (1999).

1/ As assessed comparing carryovers at the end of the year with the previous year amount.

2/ *Residui propri*.

3/ Regions, provinces and municipalities. Local government include unspecified uncommitted budget carryovers (*residui passivi di stanziamento*).

4/ For 1998, only regions (data for municipalities and provinces are not available).

5/ Regional overruns of the National Health Service.

To comply with the GSP, in line with EUROSTAT rules (National Accounts SEC95), annual changes in unspent carryovers and health care arrears should be computed in public expenditure only when actual services are provided or when legally binding rights exist to exercise commitments at a later date. The process of general government accounting should carefully respect this convention, and should not simply assume that all central and local government unspent carryovers and regional health care arrears do not correspond to actual services or to binding rights to exercise commitments at a later date.

The central government's unspent carryovers could actually be unpaid commitments if they have been fulfilled, but not yet paid. Information on these commitments not yet available should be collected and provided in a reasonable time, together with the information on the composition of general government carryovers.

In the last few years, an important component of central government carryovers has been represented by unpaid transfers to local governments. These transfers were not computed as the central government's unpaid commitments, because they were not legally committed. However, they could become local government's unpaid commitments and should be included in general government accounts. A properly consolidated general government account should not include claims of one level of government on another level of government.

Moreover, accrual expenditure should be carefully forecast, avoiding possible underestimation. For the sake of eliminating new arrears in NHS health care managed by regions from budgetary accounts prepared for the European Union, accrual accounting was utilized. However, this useful innovation did not eliminate new arrears, and these new arrears were not fully recorded in accrual computation. As the 1999–2000 experience clearly shows, 2000 health expenditure calculated in general government accounts was underestimated. The impact on general government accounts produced by actual 1999 health expenditure has not been adequately taken into account, and health institutions have undervalued their accrual expenditure because they have not fully calculated the expenditure financed by suppliers (Reviglio, 2000).

Health care arrears are produced because the institutional system does not assign full expenditure responsibility to regions. The Italian case shows that a devolution of health services not accompanied by adequate fiscal responsibility can produce distortions and excessive spending.

Some recent measures in the financing of health care expenditure attempted to solve the problem of lack of expenditure responsibility by better relating revenues received by the regions to their needs. Moreover, the "State-Region Conference" agreed to end the State financing of regional health expenditures. But this agreement lacks enforcing penalty and does not ensure that new regional deficits will not be created when the standards of the services provided by the regions will continue to be decided by the central government's three-year health plan.

A careful accrual calculation in accounting prepared for the EU would encourage better fiscal discipline because it may be most successful when rules on discretionary spending are set up. Without EU rules, accrual accounting might make the budget situation more embarrassing, but it might not have the same impact on behavior. As the case of Italy shows, accrual accounting should be carefully pursued, avoiding underestimates of expenditure and calculating unpaid commitments correctly. To comply with the GSP, the Italian government increased unpaid commitments together with a very effective control of cash deposits. The unusually large cash deposits in the Treasury, mainly by the regions and local authorities, were gradually reduced and used to offset the inadequacy of new cash transfers from the central government budget. This successful operation, however, was not matched by an equal reduction of expenditure commitments.

Unpaid commitments should be accounted for as expenditure only if they are liabilities from the general government to the private sector. For example, such commitments between central and local governments will disappear in the general government consolidation. Moreover, the liability for items recorded as unpaid commitments should not be taken for granted: the nature of the claim should be carefully assessed, and, if a commitment was not fulfilled, then no liability would exist.

Under accrual accounting, the annual increase in unpaid fulfilled commitments should be included in the operating statement of expenditure, where it corresponds to goods and services or goods delivered that year. Some measure of arrears in receipts, such as tax revenue and social security contributions should also be included under accrual accounting, but they have to be assessed realistically, that is, based on what the government can expect to collect. The stock of the previous years' unpaid commitments should be included in government debt, and the stock of arrears in revenue and social security contributions considered an offsetting item of the debt, should be assessed realistically.

Assessing the arrears in receipts and in expenditures is not an easy task. Governments struggling to reduce the size of deficit tend to overestimate the revenue to be collected and underestimate the expenditure that corresponds to goods and services delivered that year. Therefore, they should be required to specify the assumptions of their valuation, and the assumptions should be scrutinized for their realism on the basis of previous years' treatments. This issue is essentially the same as the one to be faced when forecasts for the new budget are approved.

Budget procedures aimed at reducing recorded expenditures or increasing receipts artificially should not be permitted. For example, procedures designed to bypass fiscal constraints by excluding from expenditure accounting transactions that reduce the net worth of government should not be allowed. Two of these procedures are (1) government acquisition of financial assets matched by new liabilities, and (2) the inclusion, as cash revenue, of the receipts received by government institutions (e.g., social security funds) for bonds issued in the

market through the securitization of unpaid contributions.<sup>9</sup> Both procedures were used in Italy: (1) the valuation of equity capital was increased in public enterprises, mainly in the transportation area, as central and local governments underestimated losses; and (2) in 1999, social security funds were financed through the securitization of unpaid contributions.

The first procedure transforms the losses of public enterprises (e.g., railways, local transportation, and postal service) into capital stock increases in these institutions. Instead of financing public enterprise losses with government transfers included in the expenditure calculation, the losses are indirectly covered by the government increasing the capital stock of the enterprise. According to the established convention, the increase in capital stock of a public enterprise is considered a financial operation aimed at raising government wealth and, therefore, is not included in the expenditure or the deficit. However, capital stock increases of public enterprises aimed at covering their losses do not raise the government's net worth.

The increase in equity capital of Italian railways (*Ferrovie dello Stato S.p.A.*) was a result of the restructuring process aimed at privatization. Thanks to an European Commission intervention, after 2000, the gimmick of underestimating railways losses, which increased the value of equity capital, is not allowed anymore.

The second procedure counted the securitization of unpaid social security contributions as revenue. This procedure is inappropriate for two reasons: (1) the proceeds from the sale of the social security fund's unpaid contributions should not be counted toward reducing the deficit because these contributions were due in the past; and (2) the anticipated receipts were not a definitive payment for the sale of an overdue taxpayer contribution but a loan received by the social security fund. However, the operation allowed the government to record above-the-line social security contributions that were higher (by Lit 5.5 trillion) than originally estimated. This was equivalent to a budget gimmick, and created about Lit 5.5 billion in social security contribution arrears.

Unpaid credits may be calculated in accrual budgeting, but they have to be assessed realistically—based on what the government expects to collect. Furthermore, receipts from the securitization of unpaid social security contributions fund should never be included in government receipts, because they are used to finance government deficits. They are a loan received by issuing bonds in the market, that is, an item of deficit-financing.

After 2000, receipts from the securitization of unpaid social security contributions will not be recorded as general government revenues because the securitization is considered a financial

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<sup>9</sup> According to the Maastricht Treaty, the numbers to establish whether a country met the quantitative performance criteria set out in the Treaty were to be provided by EUROSTAT. Starting with the end of 1999, EUROSTAT has insisted that the portion of the transfer that corresponds to covering operating losses of the companies be recorded above the line. Moreover, the securitization of unpaid contributions was disallowed.

operation. Only new credits expected to be recovered and resulting from the budget of the National Social Security Institute (INPS) are recorded as additional general government revenues.

#### IV. CONCLUSIONS

To function efficiently within the new global economy, political systems of the EMU countries need to be reformed. These reforms, however, are being resisted because they threaten to disturb the political balance, destroy small political parties, eliminate the veto power of components of coalition governments, and increase the governing power of the relative majority. Such changes to political institutions are not likely to be made. Political reforms are likely to take place only when driven by external economic shocks. In the meantime, what public expenditure reforms might be pursued without changing the political system?

Technical improvements made to increase budget transparency, such as strengthening budget procedures, integrating of accrual and cash accounting, and removing gimmicks that bypass fiscal constraints could indirectly affect public expenditure by improving public expenditure management and eliminating gimmicks that bypass fiscal constraints. Strengthening budget procedures would improve managerial performance and the enforcement of legislation. These improvements would make a real contribution to enhanced accountability and budgetary transparency. Better expenditure management may help enforce the implementation of tough policy decisions. This paper has tried to show how the efficiency of budgetary policies could be improved.

This paper reviewed some budgetary gimmicks used in Italy to bypass fiscal constraints. Some of these practices have been recently removed through improvements in budgetary transparency and expenditure management and control.

For example, the government is no longer engaged in underestimating public enterprise losses (e.g., railways losses) in order to increase the value of equity capital or in counting receipts from the securitization of unpaid social security contributions as new revenues. The latter financial operation has recently become a below-the-line operation, because the corresponding social security contributions were due in the past. This treatment, however, did not change budgetary policy, because the government has moved to a new assessment of higher social security contributions than originally estimated by about the same amount as expected to be received from the securitization. It is, however, unclear to what extent this new treatment is a realistic and appropriate practice rather than creative accounting. The interpretation of the GSP should be dynamic in order to prevent new "creative" accounting.

Another example, excluding health overruns from budget accounting, also has been corrected. However, the integration of accrual with cash accounting has yet to be implemented.



Since 1996, Italy has been very successful enforcing budgetary cash limits, providing an effective constraint to the spending process of decentralized bodies and contributing to deficit reduction. A significant amount of liquidity that the decentralized bodies had accumulated on their Treasury accounts was absorbed, but this enforcement led to an increase in carryovers. In recent years, these carryovers did not result in an expenditure increase, because decentralized bodies utilized their cash balances at the Treasury.<sup>10</sup>

In future years, however, this outcome cannot be easily repeated when liquidity stocks outstanding are no longer available. Unpaid carryovers may become expenditure if they are not reduced to zero. This outcome may be attained only when unpaid carryovers are not legally binding and when they may be removed with an administrative decision not requiring a difficult reform of expenditure laws.

Timely, adequate information on revenue and expenditure carryovers allowing a properly consolidated general government account is desirable. Moreover, it would be useful to provide a breakdown, allowing to identify commitments fulfilled but not yet paid. It may also help to specify carryovers that may be deleted simply remodeling future appropriations from those requiring instead difficult reforms of expenditure laws. Accrual expenditure should be forecast, avoiding possible underestimates.

Accrual accounting should discourage the practice of using unpaid commitments to bypass fiscal constraints. This paper tried to show how this underestimation may occur in Italy. Moreover, reporting on general government carryovers is too poor and delayed to allow exhaustive checks and controls of the fairness of budgetary accounting. Factual descriptions to back this conclusion were quoted. A more exhaustive reporting on general government carryovers built on an adequate and timely collection of data may help to improve budgetary transparency.

Although the problem of unpaid commitments is mainly Italian, gimmicks to bypass difficult fiscal constraints are also used in other EMU countries: "creative" public accounting, for example, is used in almost every country. The appropriate recording of both the deficit and the debt would have a huge benefit in terms of transparency in the political and social debate, by showing the government's role in the economy. In other countries, the avoidance of gimmicks may also help to push governments to reduce public expenditure. Albeit sizable, these are only a partial substitute for the structural public expenditure reforms that are necessary to reduce tax rates.

These changes, though technical in nature, may have considerable political impact. They will receive strong political opposition, because they will force the introduction of tougher fiscal constraints, which will have a pro-cyclical impact on countries now experiencing slow growth. They will also be opposed because of the fear that they will reduce the country's

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<sup>10</sup> For this successful maneuver, see Giarda (1998).

credibility and increase its vulnerability in financial markets. The reality, however, is that governments/countries are more vulnerable if they do not change their public finance policies.

This opposition will be unjustified. These reforms need to be made to eliminate structural weaknesses and to achieve medium- and long-term growth. These reforms will make the EMU less fragile, by helping it realize sound macroeconomic policy and prepare for future external economic shocks. Moreover, the expenditure cutbacks that are necessary on macroeconomic grounds may become more acceptable if they produce microeconomic improvements in service delivery.

Improving public expenditure management by strengthening budgetary procedures, integrating accrual and cash accounting, and removing gimmicks that bypass fiscal constraints, will also foster transparency, improve budgetary credibility, encourage further public expenditure reform, and stimulate preparedness for future external shocks. More accurate deficits have to be calculated. Budgetary gimmicks are not consistent with the GFS.

All EMU members should abide by ESA95 rules and follow the same methods for calculating the deficit. These changes should be considered an important component of the second-generation reforms considered by the international financial institutions to be indispensable in promoting higher medium- and long-term economic growth.<sup>11</sup>

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<sup>11</sup> On the new challenge of the second-generation reforms, see Camdessus (1999). See also IMF (1999) and Tanzi (1999).

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