

The Italian Budget Procedures: Analysis and Proposals

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1 Introduction.

The Italian public debt is currently around 125 percent of GDP. Italy is not the only OECD country with a very high debt; however, several other high debt countries, such as Denmark and Ireland, have implemented rather swift and successful fiscal adjustments in the mid eighties. On the contrary, the Italian timid adjustment started by the Amato government has not stopped the growth of the debt/GDP ratio.

A recent academic literature has investigated which politico-institutional factors can explain the large variance of fiscal policy experiences in the OECD countries in the 80's.¹ One factor which has been emphasized is budget institutions, namely all the rules and regulations according to which budgets are drafted, approved and implemented. In fact, recent work by von Hagen (1992) and Von Hagen and Harden (1994) suggests that different procedures are associated with different budget outcomes.

Given this background, it is very natural to ask the question of whether budget procedures have contributed to the current conditions of Italian public finances and whether these procedures can be improved. This is in fact the question which we address.

One of the main arguments of this paper is that complexity, lack of transparency, and convoluted laws and regulations make it very difficult to handle the Italian public finances and make debt reduction policies particularly difficult. On the contrary, this complexity and lack of transparency make it easy to engage in creative budgeting, allow overexpansion on the spending side, and obfuscate the level and distribution of the tax burden on the revenue side.

In our view, it is unrealistic to expect that an appropriate budget procedure can eliminate permanently all bad accounting habits. A government, or a parliament, that are determined to run a loose fiscal policy will always be able to do so. However, a budget procedure can do two things:

- 1) make it possible for responsible governments or parliaments to run fiscal policy in a clear and transparent way;
- 2) make it more difficult for irresponsible governments or parliaments to hide their irresponsibility.

In our view, the way to attain these goals is not more regulation of an already convoluted system, but a simpler and more structured process. Thus, we make several proposals that aim at simplifying the preparation, presentation and discussion of the various budget documents. The goal is to make it easier to detect and allocate the blame for irresponsible fiscal behavior. A second set We also make a set of proposals aimed at reinforcing the role of the Treasury minister within the executive, and of the executive relative to Parliament.

¹See Alesina and Perotti (1995a,b) for surveys.

The goal of this second set of proposals is to entrust the process to the agent that normally has the best information and incentives to enforce fiscal discipline.

This paper is organized as follows. Section 2 reviews some theoretical, academic literature which provides some intellectual points of reference for the discussion which follows. Section 3 identifies what in our views are the most important areas in which the Italian budget procedures can be improved, and presents our proposals. Section 4 discusses the lessons from a fascinating recent fiscal reform in New Zealand. Section 5 briefly discusses two recent proposals of reform of the Italian budget procedures. Section 6 concludes.

2 Budget Institutions: Theory.

One can distinguish between two types of budget institutions: ² laws that prescribe targets on the budget, such as balanced budget laws, and procedural rules.

2.1 Balanced Budget Laws.

Two theoretical arguments suggest that a balanced budget law would not be optimal. The first one is related to stabilization policies. Standard Keynesian anti-cyclical policies prescribe tax cuts, expenditure increases, and deficits during recessions, and tax increases, expenditure cuts, and surpluses during economic expansions. ³ A second theoretical argument which runs against the balanced budget law idea is the tax smoothing theory of budget deficits (Barro (1979), Lucas and Stokey (1983)). According to this theory, budget deficits and surpluses should be used to "smooth" the distortionary cost of taxation, so that deficits should be permitted when spending is exceptionally and temporarily high, for instance during wars, natural calamities, emergencies etc., or when revenues are temporarily low, for instance during recessions. Thus, a law that prescribes a balanced budget in every year would excessively constrain the use of budget deficits and surpluses as the buffer needed to implement the optimal tax smoothing policy.

Theoretically, one could think of a 'contingent' balanced budget law, with escape clauses to permit a certain amount of tax smoothing. However, a well understood argument in the debate on rules vs. discretion' suggests that rules have to be simple. Complicated rules can easily be circumvented and present monitoring problems, so that in the end they become almost useless.

On the other hand, several arguments suggest that actual policies are not dictated

²This section is largely based on sections 1 and 3 of Alesina and Perotti (1995b).

³Note, however, that the feasibility and desirability of this type of fine tuning have been questioned, starting with the famous argument on "long and variable lags", by Milton Friedman.

only by principles of optimal taxation, but are the result of various politically induced deficit biases (see the survey by Alesina and Perotti (1995a)). In this case, a balanced budget law may be a second best solution. One would have to trade-off the distortions of the balanced budget law on the optimal tax policies, against the reduction of politically induced distortions on actual policies.

We feel that balanced budget laws are neither necessary nor sufficient to insure fiscal discipline, particularly if applied to a non transparent budget process. Balanced budget laws can generate incentives for creative budgeting, which more or less easily can circumvent the law. Instead, appropriate procedures may not require numerical targets, so that one may maintain flexibility on the budget balance front (needed to implement tax smoothing policies) without giving up fiscal discipline. To evaluate this claim, we now turn to procedural issues.

2.2 Procedural Rules.

One can identify three phases in the budget process:

- 1) the formulation of a budget proposal within the executive;
- 2) the presentation and approval of the budget in the legislature;
- 3) the implementation of the budget by the bureaucracy.

We focus mostly on the first two aspects, although we will touch upon the third one as well, particularly with reference to recent reforms in New Zealand. Two issues are crucial in our view: first, the voting procedures leading to the formulation and approval of the budget; second, the degree of transparency of the budget. Voting procedures are clearly important because they establish who and when has an influence on the final budget outcome. Transparency is equally important and perhaps, in the case of Italy, even more important, since creative budgeting and strategic ambiguity can circumvent even the most stringent voting procedures. In fact, the two issues are strictly connected: voting procedures have an impact on the final outcome if the latter can be monitored because it is transparent. We begin with voting procedures.

2.2.1 Voting Procedures.

We focus upon a crucial trade-off between two types of institutions. One type, which we label, for lack of a better word, authoritarian, limits the democratic accountability of the budget process. The second type, which for lack of a better word, we call collegial, has the opposite features. Authoritarian institutions are those that, for instance, give strong prerogatives to the Prime Minister (or the Finance, or Treasury Minister) to overrule spending ministers within intergovernmental negotiations on the formulation of the budget. Also, authoritarian institutions limit in a variety of ways the capacity of the legislature to amend

the budget proposed by the government. Collegial institutions emphasize the democratic rule at every stage, like the prerogatives of spending ministers within the government, the prerogatives of the legislature vis a vis the government, and the rights of the minority opposition in the legislature.

One can identify a trade-off between these two types of institutions: authoritarian institutions are more likely to enforce fiscal restraint, avoid large and persistent deficits and implement fiscal adjustments more promptly. On the other hand, they are less respectful of the rights of the minority, and more likely to generate budgets heavily tilted in favor of the interests of the majority. Collegial institutions have the opposite features. Authoritarian institutions heavily favor the government majority; collegial institutions emphasize consensus building in the budget formation process. Collegial institutions create incentives for compromise between the majority by the minority, leading to moderation in policy making, but also to delays in policy implementation. Authoritarian institutions deliver more prompt policy making but more polarized policies, that is, policies more tilted towards the majority supporting the government.

This trade-off can have important positive and normative implications. From a positive standpoint the evidence suggests that authoritarian institutions promote fiscal restraints. (see Von Hagen (1992)). From a normative point of view one may argue that, generally speaking, institutional choices close to the extremes of this institutional trade-off are unlikely to be optimal. Also, this institutional choice depends upon the initial conditions. For example, a country with a high debt/GDP ratio, contemplating an institutional reform should look more favorably toward authoritarian institutions than, *ceteris paribus*, a country with a low debt/GDP ratio.

The theoretical literature on these issues is typically inspired by American institutions, and focuses almost exclusively on the American Congress. However, if viewed *cum grano salis* this literature can shed light on other countries, and on Italy in particular. Much of this research is based, directly or indirectly, upon a view of the budget as the result of conflicting interests of representatives with geographically based constituencies. In particular, it addresses two problems: the determination of the size of the budget and the allocation of projects amongst different districts. Weingast, Shepsle and Johnsen (1981) provide one of the clearest discussions of these basic problems. They argue that representatives with geographically based constituencies ask for spending programs which benefit their district and are financed nationwide. Thus, representatives do not internalize the true costs of financing such projects. As a result, the budget is over expanded.

In a very influential body of research, Baron (1989, 1991) and Baron and Ferejohn (1989a,b), study how different voting rules influence the size, allocation and efficiency of the budget, within the context of 'pork barrel' spending. They emphasize a distinction between closed rules and open rules in amendments. A closed rule is one in which a

proposal made by a member of the legislature has to be voted immediately up or down. If it is approved, the "game is over;" if it is rejected a new member of the legislature can make another proposal which is voted again up or down. An open rule is one in which the proposal made by the member selected is subject to amendments on the floor.

A proposal involves the choice of a budget and an allocation of benefits amongst districts, i.e., representatives. The critical differences between the two procedures is that a closed rule attributes more power to the first agenda setter. In fact, with a closed rule the agenda setter needs only to offer to the minimal majority (50 percent plus one) enough benefits to make them prefer the proposal to the continuation of the process with the proposal of another agenda setter, if the first proposal is rejected. Each legislator knows that voting against the proposal on the floor, even if it generates relatively little benefit for his district, may lead to an even worse proposal next period. Thus the threshold of acceptance is relatively low. This implies that relatively inefficient proposals can pass,⁴ and the agenda setter may obtain the lion's share of benefits within the winning majority. In fact, even a relatively inefficient budget (i.e., low aggregate benefits relative to taxation) is enough to keep a bare majority sufficiently happy relative to the continuation of the voting process.

With an open rule the power of the agenda setter is diminished, and he will take that into account when making a proposal. When making the first proposal the agenda setter faces a trade off. If he offers a universal program, with benefits for every district, he may get immediate approval because no legislator would want to amend. However, this strategy is expensive, since it saves relatively small benefits for the district of the agenda setter. On the other extreme, if the first agenda setter makes a proposal which distributes benefits to a bare majority, there is a relatively high chance that a member of the minority will be selected next period to make amendments, and he will object to the proposal, attempting to form another majority. Similar considerations apply to members of the first majority who receive relatively small net benefits from the first proposal. In equilibrium, those who are selected to make a proposal will balance these two incentives and will propose budgets which have some probability, between zero and one, to pass in the next vote, depending upon who is selected to make amendments.

These considerations provide the intuition for several results: 1. An open rule creates delays in the approval of a proposal, where 'delays' means that more than one vote is needed for a budget to pass. 2. A closed rule leads to the adoption of more inefficient budgets, namely budgets where the ratio of aggregate benefits over aggregate taxation is lower. 3. A closed rule leads to the adoption of 'majoritarian' allocation rules, i.e. such that the benefits are allocated to a '50 percent plus one' fraction of the legislature. open

⁴Efficiency is defined as the ratio of aggregate benefits of the budget to aggregate costs.

rules may lead to a distribution of benefits in which more than the minimum majority of legislators receive positive net benefits. 4. With an open rule the distribution of benefits within the winning majority are more egalitarian than with a closed rule.

These results highlight very clearly several aspects of the trade-off between authoritarian and collegial procedures. A closed rule achieves a quick approval of proposal, at the cost of implementing 'unfair' and more inefficient budgets. Budgets are unfair in the sense that they are tilted in favor of those who make the first proposal, and always distribute benefits to the smallest possible majority. For simplicity and tractability, in the formal literature reviewed here, the power to make proposals is attributed randomly, and every legislator has the same probability of being called to make the first proposal. In the actual practice of parliamentary democracy, the executive has the prerogative of making the first proposal. Thus, arrangements similar to a closed rule favor the executive while an open rule weakens it. ⁵

This 'Americanist' literature provides very useful insights for our study of Italian budget procedures. However, three caveats limit its direct applicability:

- 1) This literature is static, namely it addresses the size and composition of the budget, not the budget balance, i.e., the intertemporal distribution of spending and taxation. ⁶
- 2) The second limitation of this literature lies in its emphasis on 'pork barrel projects,' i.e., on public projects with geographically concentrated benefits. While this emphasis was empirically grounded three decades ago, it is less and less so in recent years. Table 1 shows the share of OECD budgets devoted to projects that can be considered 'pork barrel' and geographically based is shrinking, relative to transfer programs and entitlements which are broad based. Clearly, some transfer programs have a geographical base: for instance disability pensions have been used in Italy as an indirect transfer from the North to the South. However, the emphasis placed by this formal literature on pork barrel projects is disproportionate relative to the current relevance of these projects in the budget.
- 3) A third problem is the almost exclusive emphasis of this literature on the legislature, with reasonably little attention to the executive. One can argue whether or not this emphasis is justified for the case of the US, but, in our view, it is beyond doubt that one needs to focus more on the formulation of budgets within the government, in Parliamentary democracies such as Italy, and particularly in situations where the role of the legislature is limited in

⁵Another issue, addressed in Ferejohn and Krehiel (1987), is the order of voting in the budget process. Intuitively, one may argue that voting first on the overall size of the budget and then on its composition should lead to more fiscal restraint than the opposite sequence of votes. However, these two authors show that this intuitive result does not necessarily hold. In fact, strategic legislators, when voting on the size of the budget, will anticipate how the first vote will influence the second vote in the allocation. Although this is a theoretically interesting result, in our view one should read the Ferejohn and Krehiel's paper as a useful warning against oversimplifying the effects of certain procedures on final outcomes.

⁶Severe technical difficulties appear if one extends these models of legislative voting procedures to a dynamic setting. For some initial progress along this line see Chari and Cole (1993) and Velasco (1994).

Table 1: Government consumption and transfers, as shares of GDP.

	govt. cons. 1965	transf. 1965	govt. cons. 1990	transf. 1990
Australia	12.71	NA	17.24	10.40
Austria	13.36	14.93	17.79	20.19
Belgium	13.68*	14.61*	15.13	20.49
Canada	14.38	6.17	20.03	13.19
Denmark	16.41	6.98	25.22	20.50
Finland	13.66	7.61	21.05	12.28
France	14.36	15.70	17.92	23.30
Germany	15.20	13.71	18.38	19.53
Greece	11.72	6.89	21.08	14.59
Ireland	14.37	NA	17.20	14.31
Italy	14.54	12.65	17.41	19.16
Japan	8.18	4.93	9.14	12.03
Netherland	15.40*	16.41*	14.47	27.85
Norway	15.05	9.13	21.03	20.61
Portugal	12.28	3.53	16.73	13.24
Spain	8.47	6.25	15.47	15.92
Sweden	17.76	9.87	27.36	21.52
Switzerland	16.68	7.70	19.97	12.10
U.K.	19.39	5.85	18.89	12.28
U.S.	10.64	9.14	13.65	17.37

Source: OECD. *: 1970.

how it can amend the budget proposed by the executive. Note, however that some of the literature on committees, procedural rules, order of voting, closed vs. open rules, can be applied *mutatis mutandis* to the decision process within the government.

2.2.2 Transparency of the Budget.

The budgets of modern economies are very complex, and certainly in the case of Italy, too complex. This complexity, partly artificially created, helps in various practices that hide the real balance (current and future) of costs and benefits for the taxpayers. Politicians have incentives to hide taxes, over emphasize the benefits of spending, and hide government liabilities, equivalent to future taxes. Politicians have little incentive to produce simple, clear, and transparent budgets.

At least two theoretical arguments support this claim. First the theory of fiscal illusion, illustrated particularly clearly by Buchanan and Wagner (1977). According to this view, the voters typically overestimate the benefits of public spending and underestimate the costs of taxation, current and future. Lack of transparency of the budget can increase the voters' confusion and reduce the politicians' incentives to be fiscally responsible. Elsewhere (Alesina and Perotti (1995a)) we have raised some doubts about the role of "fiscal illusion" as the main explanation of large and persistent deficits, such as those of countries with debt/GDP ratios of 100 percent or more. However, lack of transparency and voters' confusion can certainly interfere negatively with effective budget control, particularly when substantial fiscal adjustments are needed.

The second argument does not rely on voters' irrationality and confusion. Several papers, although in different contexts, (e.g., Cukierman and Meltzer (1986), Alesina and Cukierman (1991)) highlight the benefit for the policymakers of a certain amount of ambiguity even when they face a rational electorate. The idea is that by creating confusion and, in particular, by making it less clear how policies translate into outcomes, policymakers can retain a strategic advantage versus rational, but not fully informed voters. This informational advantage would disappear with transparent procedures. In particular, at least up to a point, the less the electorate knows and understands about the budget process, the more the politicians can act strategically and use fiscal deficits and overspending to achieve opportunistic goals.

Rogoff and Sibert (1988) and Rogoff (1990) make a similar point in the context of political business cycle models. They show that if the voters cannot easily observe the composition of the budget (either on the spending and/or on the financing side), then policy makers can follow loose fiscal policies before elections and increase their chances of reappointment.

In summary, the theoretical literature reviewed in this short section is quite useful in

addressing the issue of voting procedures, and in fact our discussion on this point for the Italian case, in sections 3.6 and 3.7 below, is clearly based upon these theoretical results. On the other hand the treatment of the issue of transparency in the theoretical literature, although quite interesting, is somewhat distant from the details of the budget process, much more so than the treatment of voting voting procedures. Once the policymakers incentives to be strategically ambiguous are well understood, one is left with the rather difficult task of understanding how, in reality, policymakers obfuscate the budget and what to do about it. Thus, in addressing the issue of transparency in the Italian budget process (sections 3.1 to 3.5 below), our links with the theoretical literature are somewhat less specific.

3 The Italian Budget Process: Problems and Proposals.

3.1 The Budget as "Legge Formale".

3.1.1 The problems.

A unique feature of the Italian budget process is that the Legge di Bilancio (LB) can only reflect existing legislation, and therefore cannot decide new taxes and new expenditures (art. 81 of the Constitution, comma 3). Quite simply, this implies that the LB cannot fulfill its main role, namely to provide a clear and transparent venue for the fiscal manoeuvre of the government. Thus, all the interventions that should implement the Government's fiscal policy must be carried out in the Legge Finanziaria (LF) and Provvedimenti Collegati (PC). Once passed, these become existing legislation and therefore can be incorporated in the LB. This is done by amending the LB with the Nota di Variazioni, which is changed hastily to reflect the latest changes to the LF and PC, as they are modified during the budget debate.

To accomplish all this, the order of votes during the budget session, as established by the Regolamento Senato, art 129, comma 4, is the following,

- 1) art. 1 of the LB, i.e. the 3 titoli on revenues and the titolo on "Accensione di Prestiti";
- 2) art. 1 of the LF, containing the target Saldo Netto da Finanziare (SNF);
- 3) the rest of the LF, together with the PC;
- 4) the full LB is voted on last, after incorporating the last version of the Nota di Variazioni that reflects all the changes to LF and PC intervened during the debate.

It is obvious that this process creates confusion and uncertainty, as the Nota di Variazioni and the LB change daily with the fate of the articles of the LF and, especially, of the PC. In particular, this process derails the attention from substantive issues, towards procedural issues.

Thus, the first crucial problem of the budget process can be summarized as follows:

Problem 1.

Because the LB can only reflect existing legislation, the fiscal manoeuvre must be carried out in the LF and in the PC. This introduces enormous procedural complications and greatly increases the uncertainty surrounding the fiscal manoeuvre.

3.1.2 Proposals.

We are not sure about the rationale for art. 81, comma 3 of the Constitution. Originally, it might have been intended as a fiscal-discipline device. However, the fact of the matter is that the government must be able, somewhere in the budget process, to carry out its fiscal manoeuvre, and therefore to set new taxes or expenditures. Given this, the budget process should just create the conditions for this to happen in the most transparent and informed way.

What is perhaps most surprising is that these enormous complications are completely unnecessary. They all stem from article 81 of the Constitution, and they would all go with it. Thus, our first proposal is extremely simple: comma 3 of article 81 of the Constitution should be abolished. Under this proposal, there would be no distinction between LB and LF. They would all become a single document, on which the government and Parliament can focus to discuss substantive issues. To summarize:

Proposal 1.

Article 81, comma 3 of the Constitution should be abolished.

3.2 The Regulation of the Finanziaria.

3.2.1 The problems.

Not only the Government cannot carry out its fiscal manoeuvre in the LB, but the existing legislation severely limits even the fiscal manoeuvre that can be carried out in the LF. Article 11 of l. 468 establishes that the LF can only:

- 1) change the tax *rates*;
- 2) set the Ricorso al Mercato and the SNF for the Amministrazione Centrale (AC), in commitment terms;
- 3) define the allocation of funds to multi-year expenditures ("rimodulazione");
- 4) set the fondi speciali;

5) define the appropriations for public employment contracts; and a few other things.

When combined with art. 81 of the Constitution, the effect of art. 11 of law 468 is that the two most important budget documents, the LB and the LF, cannot contain legislation on exactly the types of interventions that are especially needed in times of fiscal reform, i.e. structural changes to the tax and expenditure systems. For instance, the reform of the pension system or the simplification of the tax system cannot be part of the LF.

We are aware that this was exactly the original intent of the 1988 reform: avoid the phenomenon of the "Finanziarie omnibus", which on several occasions the Government had used to "sneak in" all sorts of measures without adequate Parliamentary debate. However, in our view this attempt has backfired, by forcing the Government to resort to other means to carry out its fiscal manoeuvre, thus increasing the complexity of the process. For instance, in 1990 and 1991 the Government presented only 3 PC, but the PC concerning revenues had about 80, very heterogeneous articles. In 1993, the PC consisted of 75 pages, and the LF of only 8 pages, plus 80 pages detailing the Tabelle. Thus, the 1988 reform simply implies that the same interventions are now split between two separate documents.

The uncertainty surrounding the budget process has increased, too. The success of the fiscal manoeuvre set out in the LF, in particular the attainment of the target SNF, depends on a legislation that is discussed and passed quite independently of the LF itself. This increases the uncertainty surrounding the budget process and the incentives to resort to emergency measures. For instance, in 1989 only a few of the PC presented by the Government passed by the end of the budget session; in order to formally attain the target figure for the SNF, the Government had to issue several emergency decrees replacing the PC that had not been passed. We can summarize the position on the present structure of the LF as follows:

Problem 2.

The combined effect of art.81, comma 3 of the Constitution and of art. 11, law 468 is that the two most important budget documents, the LB and the LF, cannot address some critical aspects of fiscal policy. contain important legislation that is indispensable to any modern fiscal policy-making. In order to carry out the fiscal manoeuvre, the Government must then resort to a third type of legislation, the PC. This introduces further procedural complications, further uncertainty in the budget process, and creates great incentives to resort to emergency legislation.

3.2.2 Proposals.

The transparency of the budget process is diminished, rather than enhanced, by the current system that progressively takes away legislative instruments from the Government (first the LB, then the LF). We believe it would be much more straightforward to acknowledge explicitly the fact that sometimes during the fiscal year, in some budget document, a Government must be able to propose all the types of measures that modern policy-making requires, and that it would be much better to allow it to do so in a unitary way rather than in a fragmented and obscure way that only invites budget gimmicks on the part of the Government and Parliament.

Thus, we believe art. 11, comma 3 of law 468 should be abolished. Together with Proposal 1, our proposal would then imply that the current four budget documents, the LB, LF, PC, and the Nota di Variazioni, would collapse into a single budget document, which Parliament would have plenty of time to discuss and approve. From now on, we will refer to this single budget document that we propose simply as "the Budget", to be distinguished from the current Legge di Bilancio, which is one of the four documents that we propose to merge.

Proposal 2.

Art. 11, comma 3 of l. 468 should be abolished. One single document, "the Budget", should contain all elements of the fiscal manoeuvre that the Government deems necessary to achieve its goals.

3.3 The role of "Programmazione".

3.3.1 The problems.

The budget session that starts in September is not supported by an informed presentation of the trends and of the alternative scenarios that lie before the Government and Parliament. Instead, precious time and energies are devoted to the preparation and discussion of the Documento di Programmazione Economica e Finanziaria (DPEF),⁷ which has a heavy - and outdated - emphasis on planning, and of other documents.

The preparation and discussion of the new Budget that we have envisioned above should be guided by sound and reliable figures of the path fiscal policy would take in the absence of interventions, and by a reliable estimate of the costs and benefits of alternative inter-

⁷The DPEF has been introduced with the reform of 1988. The formal deadline for its presentation is May 15. However, this document has frequently been presented to Parliament much later, in June or even July.

ventions. It is our contention that, at present, all the budget documents that precede the budget session fail to provide such a guidance.

Currently, the Bilanci tendenziali in the Disegno di Legge di Bilancio and in the DPEF⁸ not always provide reliable and user-friendly information on the path of fiscal policy in the absence of interventions. We will focus here on the treatment of inflation. With the current Italian debt/GDP ratios the target fabbisogno is highly sensitive to the assumptions about inflation and interest rates. Credible forecasts of the inflation rate are therefore crucial. However, the rate of inflation, and therefore interest rates, tend to be consistently underpredicted by substantial amounts. As a result interest payments are in general the most important source of forecast errors among expenditures (see Table 2).

Table 2: Forecasts and outcomes, selected variables.

	π planned	π outcome	i planned	i outcome	G planned	G outcome	I planned	I outcome
1989	4.0	6.6	8.1	11.1	32.9	33.4	7.6	8.9
1990	4.5	6.1	9.2	11.3	33.2	33.6	8.9	9.6
1991	5	6.4	9.8	11.6	33.7	32.8	9.6	9.9
1992	4.5	5.4	10.0	12.3	34.6	33.4	10.2	11.1
1993	4.5	4.2	11.7	11.9	31.9	32.4	12.0	11.6
1994	3.5	4.0	8.7		30.7	30.9	10.6	10.5

Source: Commissione Tecnica Spesa Pubblica (1994) and Ragioneria Generale dello Stato (1994). π : inflation rate. i : average nominal interest rate on outstanding debt. G : expenditure of State Sector, net of interest expenditure, in percentage of GDP. I : interest expenditure, State Sector, in percentage of GDP.

In addition, because the DPEF is mostly a planning document, it often fails to keep a clear distinction between trends and plans. In fact, large parts of the Bilancio tendenziale

⁸There are two possible types of bilanci tendenziale. The "Bilancio tendenziale a legislazione vigente", assumes that the existing legislation will not change. The "Bilancio tendenziale a politiche invariate", instead, assumes that the existing policies will be continued. The difference between the two concepts consists in the treatment of the effects of expenditures and revenues that, according to existing legislation, should not be repeated next year. The first type of Bilancio tendenziale assumes that these expenditures and revenues will indeed be discontinued. The second assumes that all existing policies will be maintained. The Bilanci tendenziali in the Disegno di Legge di Bilancio and in the DPEF are at legislazione vigente.

that it contains ⁹ are based on planned figures for macroeconomic variables. ¹⁰ This is true for instance for public wages - which incorporate the effects of planned wage settlements - and interest expenditure - which incorporate the effects of planned inflation rates, and therefore planned nominal interest rates. As a consequence, the Bilancio tendenziale can fail to provide a reliable picture of the trends of fiscal policy and of the needs for intervention.

A good example of the confusion this might generate is in the 1993 DPEF. The same target inflation rate, 3.5 (down from 4.5 in the previous year), is explicitly assumed for the projections on both the trend and the target interest expenditure (p. 15). ¹¹ This reduction in the inflation rate by 1% is also explicitly recognized as the crucial factor in the reduction in interest rates. ¹² Finally, the document assumes that the lower interest rates will lead to a reduction in the target interest expenditure relative to the trend expenditure (pp. 22-23). ¹³ It is hard to gather a clear picture of the behavior of interest expenditure and of the effects of the planned interventions from these three logically inconsistent statements.

A detailed Bilancio tendenziale at existing legislation is contained in the "Disegno di Legge di Bilancio", to be presented to Parliament each year by the end of July. However, it receives very little attention, because it is soon to be amended by the effects of the interventions in the drafts of the LF and PC. In fact, the Bilancio in the Relazione Provisionale e Programmatica (RPP) of September already incorporates these effects. Moreover, the Disegno di Legge di Bilancio is not associated with a description of the macro framework, which instead appears in the DPEF. Finally, the Disegno di Legge di Bilancio presents detailed figures by ministries, but does not contain aggregate figures on, say, broad categories of expenditure or the SNF. Thus, the Bilancio tendenziale in the Disegno di Legge di Bilancio too provides little guidance to the subsequent process.

Note that when the discussion of the LF starts, Parliament has already seen at least three bilanci tendenziali: in the DPEF, in the Disegno di Legge di Bilancio, and in the RPP. These Bilanci tendenziali differ in the timing, in the coverage (the Disegno di Legge

⁹The DPEF contains a Bilancio tendenziale a legislazione vigente, in cash terms, for the SS and the Public Sector. It also contains a Bilancio tendenziale a legislazione vigente, in commitment terms, for the AC. In both cases, the Bilancio tendenziale covers a three-year period.

¹⁰Giarda (1989) p. 27 provides an interesting and informed treatment of this issue.

¹¹"Nella determinazione del quadro macroeconomico assunto come riferimento per la determinazione delle tendenze e degli obiettivi di finanza pubblica, si prevede una decisa riduzione del tasso di inflazione nel 1994."

¹²"Al contempo una minore inflazione accelera la riduzione degli oneri degli interessi e contribuisce così alla riduzione del fabbisogno pubblico."

¹³"In assenza di interventi, la spesa per interessi relativa allo scenario tendenziale e' stata determinata assumendo che alla fine dell'anno in corso il tasso nominale lordo dei BOT sia pari al 10,5 per cento....Si ritiene, invece, che l'attuazione della manovra correttiva proposta consenta di ipotizzare per la costruzione del quadro programmatico un profilo dei tassi inferiore al precedente."

di Bilancio is only on the AC, the DPEF mainly on the SS, the RPP on both), and in the amount of the planned fiscal manoeuvre they incorporate. However, it is clear that these differences do not provide any additional and useful information: rather, they only contribute to blur the picture.

While there is no lack of information on bilanci tendenziali, when Parliament votes the LF and LB, it has seen three different Bilanci tendenziali, but it has never seen a systematic evaluation of the alternative scenarios of fiscal policy. For instance, the DPEF's and the RPP's of 1993 and, especially, 1994 contain several pages on the reform of the pension system, and, in the case of the RPP's, with minute details of the planned intervention. However, they never illustrate the budget saving effects of different values of the various policy instruments, like retirement age, indexation rules, etc. It is difficult for Parliament and for the media to evaluate the fiscal manoeuvre in the absence of any information on possible alternatives.

The DPEF also sets the objectives for the incoming Government's fiscal manoeuvre,¹⁴ and in particular the target value for the fabbisogno of the SS and the SNF of the AC.¹⁵ However, because this occurs so early in the budget process, the details are largely left to the future. In fact, the DPEF sets only very aggregate objectives, and contains only a very vague description of the measures the Government intends to implement, usually without any quantification of their projected savings.

For example, Table 3 reproduces some figures from the Bilancio tendenziale and the Bilancio programmatico for 1994, 1995 and 1996 from the 1993 DPEF.

Notice the huge expenditure cuts (more than 10%, once the growth of GDP is taken into account) and the drastic reductions in the fabbisogno for all three years (in particular, note that the planned interventions would have led to a near halving of the nominal fabbisogno in 1996!)

The DPEF described these interventions as follows: "Per quanto riguarda le spese, i provvedimenti proposti riguardano, innanzitutto, l'organizzazione e il funzionamento delle pubbliche amministrazioni, per eliminare doppioni, sprechi, sovrapposizioni.... Si ritiene infatti possibile ottenere risparmio con una razionalizzazione e un riordino delle attività e delle strutture pubbliche, anche senza incidere, se non a fini di eliminazione degli sprechi, sulle prestazioni rese dai poteri pubblici ai cittadini....Un'altra parte della manovra inciderà, pur se in misura minore, sui trasferimenti alle famiglie."

This passage exemplifies well three typical aspects of the budget process at this stage. First, notice the total absence of any minimal attempt at quantifying the interventions.

¹⁴In fact, the main objective of the DPEF is to provide a Bilancio programmatico for the SS, in commitment terms, over a three-year period.

¹⁵Because the DPEF mostly refers to the SS, the target SNF generally receives only scant attention. For instance, in the 1994 DPEF there was no mention of the AC accounts, and therefore of the SNF.

Table 3: 1993 Stabilization plan.

	1994 trend	1994 planned	1995 trend	1995 planned	1996 trend	1996 planned
revenues	537.2	540.2	562.1	576.6	580.6	598.1
outlays	529.7	501.7	559.3	521.5	580.4	532.6
interests	183.5	176.0	192.8	173.9	197.5	171.9
fabbisogno	182.7	144.2	190.0	127.8	197.3	106.4

Source: DPEF 1993. Outlays exclude interests. All figures are in billions of liras.

Second, the expected savings from razionalization are clearly unreasonably high, especially in the current Italian situation where the main source of fiscal problems is an exceptionally high expenditure on transfer programs.¹⁶ Third, and as a consequence of the second point, the DPEF sounds as if these extremely large budget cuts could be achieved without costs.

It is clear that there are only political advantages for Parliament from subscribing to such an ambitious yet seemingly painless program. But then the DPEF sets the budget process on the wrong foot: it invites vagueness and excessive optimism exactly at the time when what is needed is a clear description of the trends of fiscal policy and an illustration of the costs associated with alternative scenarios.

One might argue that these problems are such more in theory than in practice, because the DPEF is only a short and generic document that does not constrain the future fiscal manoeuvre and to which all the agents involved pay only lip service. This is not always so. Art. 11, comma 6 of l.468 the LF cannot "determinare tassi di evoluzione delle spese medesime, sia correnti che in conto capitale, incompatibili con le regole determinate...nel DPEF" (l. 468, art. 11, comma 6). Although the wording of this clause is unnecessarily vague (and concerns only expenditure), the Risoluzione del Senato of July 1991 has established that, for the first of the three years covered by the LF, the SNF must reach the objective set in the DPEF. In fact, the "disegno di legge di Bilancio" presented in July usually does respect the SNF implicit in the DPEF. This has also been true for the

¹⁶For instance, in 1992 37% of the general government expenditures was on public pensions!

LF. Note, however, that although the SNF in the LF is usually very close to the DPEF, its *composition* is not always so: for instance, in 1991 the SNF in the LF was practically identical to that of the DPEF, but revenues and current expenditures exceeded the DPEF figures by about 11,000bn and 20,000bn respectively, while capital expenditures were lower by about 7,000bn.

Thus, to the extent that it is actually binding for the subsequent stages of the budget process, the DPEF is not only a loss of time and resources but also genuinely misleading, because it makes creative accounting practically unavoidable.

We can summarize the main problems we have discussed in this part as follows:

Problem 3.

At present, the budget process fails on the two most important steps before the discussion of the budget. First, there are too many Bilanci tendenziali, but none provides a clear and reliable picture of the trends of fiscal policy. Second, at no stage of the budget process is information provided that allows an appreciation and evaluation of the effects of alternative policies.

Problem 4.

Because the DPEF sets only the aggregate objectives of the fiscal manoeuvre, and at an early stage of the budget process, it only provides a very vague description of the Government's plan, without any realistic quantification of its expected savings. Thus, at the time Parliament votes on the target figure for the SNF, which becomes binding for the subsequent budget process, there is practically no notion of the means to attain it and, therefore, of whether it is realistic. This invites creative accounting at subsequent stages of the budget process.

3.3.2 Proposals.

We believe that all efforts should be concentrated on enhancing the two truly valuable roles of a document like the DPEF: provide a detailed and reliable information on the trends both of the economy and of the budget, which the Government and Parliament can use to locate the needs for intervention, and put clearly before the Government and Parliament the possible alternatives, with their associated costs and benefits.

Macroeconomic planning should not play any role at this stage. In fact, we believe that one problem with the existing budget process is exactly that the ability of the Government to manage the economy is greatly overestimated. Besides, the Bilanci programmatici beyond the first year currently play no role whatsoever in the budget process. Even from a

merely formal point of view, they are not binding. Nor could they have been, given the average turnover of Italian governments.

We also believe that the DPEF, and any subsequent document, should abstain from three-years projections of the economy. The emphasis on long-run projections is another legacy of the planning tradition of the '60's and '70's: long-term planning obviously needs long-term forecasting. However, exactly like the notion that the economy can be planned, the notion that it is possible to forecasts macroeconomic variables reliably three years into the future is empirically questionable. Even international organizations, like the IMF or OECD, with all their expertise and manpower, nowadays tend to abstain from long-term forecasts, and in any case are aware and honestly underline the shaky grounds on which they are based. The RGS clearly does not have more expertise than IMF or OECD to engage in long-term forecasting.

Therefore, the DPEF should be divested of all its planning and long-term forecasting implications and should just be merged with the Disegno di Legge di Bilancio. The new document should focus on the much more modest, but much more useful, task of disseminating reliable information on what will happen to the budget in the absence of interventions, and what the effects of possible interventions are.

This information should be accurate and user-friendly. Relatively reliable and impartial forecasts on macroeconomic variables are easily available from international organizations and forecasting firms. The credibility of the budget projections would be greatly enhanced if the RGS used these (presumably) impartial forecasts. For instance, the official inflation forecasts underlying the computations in the Bilancio tendenziale could be the average of the inflation forecasts of three organizations, for instance OECD, IMF and DRI.¹⁷

A possible objection to our proposal is that it still leaves the Government complete freedom to determine the effects of the forecasted values of macroeconomic variables on the evolution of budget variables. We will come back to this problem in section 3.4, where we propose ways to minimize the incentives to manipulate budgets forecasts and to overestimate the effects of interventions.

The new Bilancio tendenziale should also be user-friendly. This means that it should have exactly the same format as the new Budget that we propose above, so that for each item in the budget one can compare the trend with the figures proposed by the Government.

At present, the RPP largely duplicates, with greater detail, the DPEF. It presents the Bilancio tendenziale, the underlying macroeconomic trends, and the fiscal manoeuvre in the LF and PC. Only this last part provides a new service. In fact, we believe the RPP

¹⁷A common objection to this proposal is that the RGS has informational advantages on outside organizations in forecasting variables like the rate of inflation, since it is in the best position to forecasts those measures that affect the rate of inflation. However, the ability of fiscal policy to quickly influence variables like the inflation rate and interest rates is clearly overrated. In any case, this objection does not apply to the preparation of the Bilancio tendenziale, which should not be based on planned figures.

should simply be regarded as the document that accompanies and describes the Budget.

Proposal 3.

The DPEF and Disegno di Legge di Bilancio a legislazione invariata should be abolished. Their successor should not contain any Bilancio programmatico or any long-term forecasts. It should only contain two bilanci tendenziali, at existing legislation and at existing policies, with exactly the same format as the new Budget we propose, so that the two documents can be immediately compared. This document should also contain a description and quantitative evaluation of alternative scenarios of policy interventions. The RPP should be limited to accompany and describe the Budget.

Proposal 4.

The macroeconomic forecasts underlying the preparation of the Budget and of the successor of the DPEF should be derived from international organizations and forecasting firms.

3.4 Reducing the scope for creative accounting.

3.4.1 The problems.

As many observers have noted, the Italian budget process does not lack formal constraints on the ability of the Government and Parliament to increase the size of the deficit. The combined effect of various articles of the l. 468 is that an increase in the deficit of the AC can only result from three factors (see Onofri, Pisauro and Siniscalco (1994), p.90):

- a) an increase in expenditure or a fall in revenues at existing legislation;
- b) an underestimate of expenditures or overestimate of revenues of new legislation;
- c) an increase in capital expenditure.

Furthermore, the LF is also subject to an overall constraint on the SNF:

- d) the SNF in the LF cannot exceed the corresponding figure in the DPEF.

It is patently clear that these constraints, in many cases even stronger than in the legislation of most other countries, have been totally ineffective in controlling the growth of expenditure. But one can go a step further: these constraints have created perverse incentives that have made the formation and presentation of the budget even more complicated and less transparent and, ultimately, have contributed to the the loose fiscal policy stance of the last two decades.

Quite simply, the counterpart of formal constraints on the budget is creative accounting to circumvent these constraints. This is a common phenomenon in all countries, and to some extent it is unavoidable. But it is our contention that the peculiarities of the Italian

budget process have greatly exacerbated the extent of and the distortions created by the practice of creative accounting.

Roughly speaking, there are four types of distortions that fall under the heading of creative accounting:

- 1) postponement of expenditures or anticipation of budget savings;
- 2) shifting of expenditure from the current to the capital account;
- 3) underestimate of expenditures and overestimate of revenues;
- 4) recording of debt "below the line".

The first source of creative accounting is the narrowness of the coverage of the sector for which the target deficit is defined. This creates incentives to engage in the first type of distortions, by shifting expenditure and debt off-budget, to agencies outside the sector whose deficit is set by the budget documents. The mechanism is well known, and has been described in several contributions (see for instance Giavazzi (1994), Commissione Tecnica per la Spesa Pubblica (1994), and Ragazzi (1994)). The classic examples are transfers to INPS, USL and Regioni. The channels are slightly different, although the logic is the same. Because of the systematic underestimate of the financial requirements of INPS in the LF, INPS must resort to building up its debt at the Treasury Account. Because the deficit of the Treasury Account is not part of the target SNF (which is defined on the AC only), this allows the latter to be formally respected (note, however, that the figure for the fabbisogno, which refers to the SS, is affected.)

Similarly, USLL and Regioni are encouraged to incur liabilities with commercial banks, whose repayment will be taken up by the State. This achieves a significant postponement of the expenditure, without any effect on the SNF or fabbisogno until the debt will have to be repaid. Similar stories apply to state-owned enterprises like IRI and, a particularly conspicuous case, EFIM, all of which are outside both the AC and the SS.

It is important to realize that this stratagem also causes a distortion of type 2). In fact, under existing accounting rules, the repayment of the principal of a debt, when it occurs, is recorded in the capital account. Only the interest expenditure affects the current account of the budget. Thus, these procedures allow not only a significant postponement of the recording of an expenditure, but also its transfer to the capital account. This is important because capital expenditures can be financed through debt, and because they can be more easily further postponed to the future through the mechanism of "rimodulazione".

A second channel through which distortion 1) (the postponement of expenditure) is implemented is the often unorthodox use of the Provvedimenti Collegati that we noted above and, especially, of Fondi Speciali. One major problem with Fondi Speciali was that they had become an all-purpose reserve of funds, whose destination could be changed at

will to satisfy the need to cover new expenditure. The 1988 reform established fairly strict guidelines for the use of unutilized Fondi Speciali. Perhaps more importantly, it introduced the Fondi Speciali Negativi: the effects of a future piece of legislation that reduces expenditure or increases taxation must be recorded as accantonamenti to a Fondo Speciale Negativo, which once the piece of legislation has been approved will make available a corresponding accantonamento to a Fondo Speciale Positivo, to be utilized when the accompanying legislation increasing expenditure is passed. The original purpose of this instrument was to set explicitly reductions in some expenditures against corresponding increases in other expenditures.

However, the need to satisfy the SNF has led to a use of the Accantonamenti Negativi that is far from the original intent. First and foremost, the Accantonamenti Negativi are often extremely vague and unrealistic in their assumptions about the savings of future legislation. Parliament will have to reckon with the effects of future legislation a later stage, after the budget session, with its pressure to meet the target SNF, is over. It is therefore only natural that the Government and the Parliament itself will try to defuse the tension by simply postponing the difficult choices to the future. Second, against the letter of the law, the Accantonamenti Negativi are often not linked to a piece of legislation already presented in Parliament. For example, in 1991 the LF had AN for 20950bn in 1993 and 34770bn for 1994. However, in 1991 no legislation had even been conceived to support these savings. Needless to say, these savings never materialized (see De Joanna (1993), p. 137).

More generally, the third type of distortions - underestimating expenditure and overestimating revenues - is likely to arise any time that the budget can defer the specifics of interventions that contribute to the SNF. Examples of obviously inadequate or downright unreasonable explanations of projected savings abound. A particularly egregious one is the decreto-legge that was one of the 4 PC to the LF of 1992, projecting revenues for 15,000bn from privatization, which, according to the Corte dei Conti, was not supported "ne' da una relazione tecnica dalla quale possano trarsi indicazioni sui criteri seguiti per la quantificazione degli introiti previsti, ne' da una rigorosa valutazione delle operazioni da compiere e dei tempi di realizzazione." (from De Joanna (1993), p. 141).

Unreasonable estimates of budget savings can derive from unreasonable forecasts for some underlying macrovariables or from unreasonable evaluations of the quantitative effects of the legislation under exam. Currently, both the forecasts and the criteria to evaluate the effects of the legislation remain all internal to the RGS. The Government should now accompany new legislation with a technical note explaining its projected effects (art 11-ter l. 468, commas 2 and 5). Otherwise, according to the Regolamento Senato, art. 76-bis, this legislation is inadmissible. In addition, the appropriate committees can ask the Servizi Studi of the two chambers to verify the Government's estimates.

However, the Government is required to present a technical note only for legislation

that increases expenditure or decreases taxation. Thus, the requirement of a technical note does not impair the Government's ability to overestimate budget savings. In addition, the requirement has not always been respected, particularly for the case of Government amendments to legislation on the floor (see De Joanna (1993), p.113). Even for draft laws presented by the Government, in the period January 1, 1989 to April 15, 1992, out of 382 drafts subject to this obligation, 60 were not accompanied by any technical note drafted by the Government. In 161 cases, there was no verification by a Servizio Studi (see Casarico (1994), p. 230).

But the crucial problem is still that all the forecasts and criteria to evaluate the effects of legislation remain all internal to the RGS. As far as we know, there is no macro model of the Italian and international economies that the RGS uses on a consistent basis to generate its forecasts, produce the various budgets, and estimate the effects of interventions. This might not be too much of a problem, as it is not clear that large macro models have a better track record than judgmental forecasts. But even judgmental forecasts are presumably based on some criteria and information, and neither are usually made explicit.

The fourth type of distortions, writing debt "below the line", is in principle the easiest one to eliminate. For this reason, its persistent, widespread use is also the hardest one to explain, except maybe that the complexities of the present system provide the ideal environment for this type of budget gimmicks.

The case of "crediti d'imposta" is a good example. Each year, a substantial part of tax payments consist of overpayment that have to be returned to the taxpayers. Clearly, the tax payments corresponding to overpayments are not current revenues, but a liability of the Central Administration, and as such they should be considered a means of financing the fabbisogno, not of decreasing it. Instead, in the present arrangement they are considered tax revenues, and concur with all the other revenues towards meeting the target SNF and fabbisogno.

Similarly, securities issued by the Cassa Depositi e Prestiti, which is part of the SS, are not counted as debt "above the line", and therefore do not increase the SNF and fabbisogno. The recent saga of EFIM provides a stark example of this. In 1994, the Cassa Depositi e Prestiti was authorized to issue securities for 10,500bn to finance the repayment of EFIM's debt. Not a lira of this debt increased the fabbisogno (see Ragazzi 1994, p. 17). Note that, had the Cassa Depositi e Prestiti financed this repayment through mutui rather than securities, this transaction would have shown up in the fabbisogno. Even in this second case, however, the involvement of the Cassa Depositi e Prestiti would have allowed an important budget gimmick, by moving the operation from the current to the capital account.

Note that a byproduct of this practice is the long-noticed absence of a correspondence

between the fabbisogno and the change in debt. For instance, between 1977 and 1993 the stock of debt increased by at least 100,000bn more than the sum of yearly fabbisogni (see Onofri, Pisauro and Siniscalco (1994), p. 98). The resulting discrepancy between the stock of debt and the sum of fabbisogni makes it difficult to evaluate the macroeconomic significance of the two measures.

To summarize, the present structure of the budget process incentivates creative accounting on four grounds in particular:

Problem 5.

The narrowness of the coverage of the sector whose balance is explicitly set by the budget documents encourages the shifting of expenditure and debt off-budget, thus postponing expenditure to the future and shifting it to the the capital account (distortions 1) and 2)). Thus, it makes the target figures on the fabbisogno and the SNF practically meaningless from a macroeconomic perspective. In addition, it confuses the debate on the fiscal manoeuvre.

Problem 6.

The practice of referring to the effects of future legislation in the LF has led to a substantial anticipated recording of budget savings to achieve the target SNF. However, because these savings are uncertain and often do not materialize, the whole budget process becomes more uncertain and less transparent.

Problem 7.

Two factors contribute to the systematic overestimate of the effects of the legislation included in the LF, in the PC, and in all the connected legislation:

- a) There is no mechanism to enforce a certain quality or quantity in the information accompanying the legislation.
- b) The effects of this legislation are calculated by the same agency, the Treasury, that also prepares the legislation in question.

Problem 8.

In the present arrangement, the Government is allowed to record certain liabilities below the line. This distorts the real figure for the fabbisogno, and creates a large discrepancy between the stock of debt and the sum of past fabbisogni.

3.4.2 Proposals.

We believe that the past experience of the budget process has taught a very clear lesson: a strict and detailed regulation is no cure to the type of creative accounting emphasized above. If anything, it exacerbates the distortions that induce creative accounting.

The solution to problem 5 is clear: the budget must include all those agencies whose deficit falls outside the current definition of the SNF. We believe that no amount of regulation will ever alleviate this problem: nothing short of a budget on the Public Sector, which includes local governments, will ever put a stop to the practice of shifting expenditure and debt off the budget. The Maastricht Treaty recommends a less inclusive budget, on the General Government rather than the Public Sector. The former excludes those agencies providing market services, like the Post Office, the Telephone Company, and the Railways, on the ground that they are normally financed without recourse to public debt. However, this is clearly not a good assumption in the current Italian situation, given the standard practice of bailing out these agencies by budgeting large transfers from the SS every few years.¹⁸

Of course, we are aware that such a budget would pose large technical problems. We discuss briefly these problems in the next section. Here, we emphasize that it might be more useful to concentrate the debate and scarce resources on tackling these technical problems, rather than taking them as given and resorting to all sorts of ineffective regulations in order to overcome them.

We emphasize that the AC budget should not only be accompanied by a budget covering a larger definition, but it should simply be eliminated. The reason is that one should not provide the media and politicians with the opportunity to focus on figures on, say, the AC deficit which, in the current Italian situation, are practically meaningless from an economic point of view. Because the public, the media, and even many members of Parliament would not have sufficient information to fully understand, or would have an incentive to manipulate, the difference between alternative definitions, they would be constantly coping with different figures for the seemingly same phenomenon, like the deficit, and the resulting debate would be even more confusing.

Similarly, problem 6 - the incentives to effectively postpone expenditures or anticipate revenues - cannot be solved by further regulation. As long as the budget can record the savings of future, non-existing legislation, there will always be an incentive to resolve the conflicting claims on the budget by simply referring to unreasonable future budget-saving measures. Of course, at present this problem is compounded by the fact that, because of the limits discussed above, the LF must refer to future legislation in order for the Government

¹⁸Thus, we believe that even those agencies that have been incorporated, like the Ferrovie dello Stato, but still receive large and systematic transfers from the Government, should be part of the Budget.

to carry out its fiscal manoeuvre.

Therefore, in our view the solution to problem 6 is fairly straightforward: quite simply, the Budget should not be allowed to make any reference to the effects of future legislation, whether already presented in parliament or not. At the same time, however, following proposal 2, the Budget must be allowed to incorporate any measure the Government deems necessary to achieve the target fabbisogno.

The solution to problem 7 lies in subjecting the forecasts and the evaluations of the RGS to some form of scrutiny. Rather than creating a new Government agency that supervises and controls the RGS, we believe the solution is the same we stated in proposal 4. The forecasts used to evaluate these effects must be derived from international organizations or forecasting firms. Also, the budget effects of new legislation must be calculated by an independent agency or, if one believes that the RGS might have informational advantages, must at least be verified by independent agencies. This must apply to all types of interventions, whether they increase or decrease expenditure and taxation. However, to prevent an excessive cluttering of the legislative process, this obligation might apply only to those interventions whose projected savings exceed a certain minimum amount.

Finally, the solution of problem 8 too is conceptually very simple: all debt of the Public Administration should be accounted for when computing the fabbisogno. In our view, this is the only acceptable practice if the fabbisogno has to retain any macroeconomic meaning, as a measure of the savings absorbed by the public sector. Note also that proposal 5 also drastically reduces the opportunities and incentives to write debt below the line.

In practice, of course, difficulties are likely to arise due to the fact that it might not always be clear what exactly constitutes a liability of the public sector. For instance, technically speaking the crediti d'imposta are liabilities only once they are recognized as such, which may even require passing an *ad hoc* legislation. We believe that these technical issues are relatively minor: for instance, in the case of securities issued by the CDP there can be no doubt that they constitute a liability. In any case, for the more dubious cases one could envision a system whereby *all* liabilities, including *all* crediti d'imposta, must be treated the same way in the budget. An eventual exception must be justified by the RGS, and this justification must be certified by one or more independent agencies.

Proposal 5.

The AC budget should be eliminated. All budget figures should cover the Public Sector.

Proposal 6.

No part of the Budget can refer to expenditure cuts or tax increases in any piece of legislation that is not already included in the Budget itself, and will have been passed when the Budget is passed.

Proposal 7.

- a) Any piece of budget legislation is inadmissible if it is not accompanied by a document explaining the assumption behind its projected effects.
- b) The effects must be calculated by an independent agency, outside the Public Administration. If this is not possible, the evaluations of the RGS or of the Technical Services of the two Chambers must be certified by one or more independent agencies.

Proposal 8.

All new liabilities of the public sector must be counted as part of the fabbisogno. Eventual exceptions must be justified by the RGS and certified by one or more independent agencies.

3.5 The need for more accountability and expenditure controls.

3.5.1 The problems.

An important, but little appreciated, feature of the present system is its emphasis on aggregate balances, like the SNF and fabbisogno, as measures of the budget stance. As we have argued above, the process that leads to these target balances is a sure recipe for creative accounting. But there is a second drawback: when it comes to deciding the measures needed to achieve the target balances, no distinction is drawn between expenditure cuts and tax increases. However, from a macroeconomic perspective expenditure cuts and tax increases can have very different effects, on both the economy and the likelihood of success of the fiscal adjustment (see Alesina and Perotti (1994 and 1995c)). As a simple, but important, example, an increase in labor and social security taxes to meet a certain target fabbisogno is likely to lead to a fall in competitiveness, as wages increase to compensate for the higher taxes. However, the same improvement in the fabbisogno, achieved with a cut in redistributive expenditures or public wages, is likely to lead to an improvement in competitiveness, as wage claims in other sectors of the economy also remain moderate.

However, the present system is heavily biased towards tax increases, rather than expenditure cuts. The complicated and contrived structure of the budget process (Problems 1 and 2) and the tendency to set targets for the SNF and fabbisogno without an adequate consideration of the planned interventions (Problem 4) imply that the target SNF and fabbisogno can usually be achieved only by resorting heavily to creative accounting and to last-minute, emergency legislation. Clearly, significant and lasting expenditure cuts cannot be studied, decided and implemented in an emergency situation and under pressing time constraints. The only feasible action is to increase tax rates, or to resort to once-off levies. It should therefore come as no surprise that the last part of the budget session, as well as most of the Bilancio d'Assestamento, are usually all taken up by tax measures. The debate

on the 1995 LF and the midyear fiscal manoeuvre of 1995 are good examples of this. After plans for a pension reform were scrapped in the fall of 1995, the Government had to hastily rewrite the LF, and focused heavily on tax increases. Out of the 20,000bn of deficit reduction in the midyear fiscal manoeuvre of 1995, 15,000bn were the result of tax increases. The remaining 5,000bn were just a shifting of debt off-budget, to local governments.

Making the budget process more amenable to expenditure controls and expenditure cuts requires three crucial preconditions.

- 1) It must be possible to match closely an expenditure with the subject that bears responsibility for that expenditure.
- 2) It must be possible to impose cash limits, and to enforce them.
- 3) There must be a unified direction for all phases of the budget process, that can internalize the macroeconomic constraints and reconcile conflicting claims on budget resources.

In this section we address the first two issues. We analyze the third issue in the next section.

As many observers have note (see in particular Onofri, Pisauro and Siniscalco (1994) and Giarda (1995)), in the current system it is often difficult, if not impossible, to match an expenditure with the subject that ultimately bears responsibility for it. For instance, the budget of the Treasury Minister contains scores of items for which the expenditure responsibility lies in different ministries. This has two consequences. First, in many cases, it is very difficult to locate precisely the programs that are responsible for expenditure over-runs, and therefore the areas where intervention is needed. Second, it is very difficult to determine exactly who should bear the accountability of expenditure for each program.

Cash limits obviously make sense only if a reliable cash budget exists. Although now the LF and LB also contain a cash budget, much more is needed for the implementation of cash limits on expenditure, for the following reasons:

- a) at present, carry-overs from the previous years become known only in March. Thus, when Parliament passes the LB and LF, the cash budget is in reality still in a sort of limbo;
- b) the Treasury Account has a considerable leeway in changing the availability of cash resources to different programs, in particular through a clever reshuffling of the "giacenze di tesoreria" between different programs;
- c) there are enormous problems in tracking the cash budgets of almost any agency outside the SS, in particular local governments and USL;
- d) the cash forecasts of Enti di Previdenza, in particular INPS, have in the past repeatedly proven surprisingly off the mark.

These are the same problems that also hamper the enforceability of cash expenditure limits: as long as the cash budget of the Public Sector is uncertain and flexible, it is impossible to enforce any mechanism that limits spending.

Problem 9.

The complexities of the budget process and the tendency to set targets for the SNF and fabbisogno without an adequate consideration of the planned interventions heavily skew the fiscal manoeuvre towards tax increases rather than expenditure cuts.

Problem 10.

A crucial prerequisite for expenditure controls is the establishment of a reliable cash budget. However, because in the present arrangement spending responsibilities are often not matched with programs in the budget, it is impossible to establish and enforce cash controls and limits. A reliable cash budget is also precluded by other practices, in particular:

- a) the uncertainty generated by carry-overs;
- b) the use of "giacenze" by the Treasury;
- c) the lack of reliable cash forecasts of local governments, USL, and other decentralized agencies;
- d) the often sub-standard cash forecasts of Enti di Previdenza, in particular INPS.

3.5.2 Proposals.

The common element to the problems pointed out in this section is that the system needs to be reoriented towards expenditure controls and cuts.

The solution to problem 9 is clear: among the binding targets discussed and voted in the Budget, one should have not only an overall balance like the fabbisogno, but also a target figure for expenditures, broken down into different types of expenditures. In order to avoid the phenomenon of capital expenditures being cut in order to make room for current expenditure, the Budget should contain limits on capital expenditure and on those types of current expenditure that are not open-ended entitlements (which by their nature cannot be cash-limited).

The solution to Problem 10 is a cash budget by cost centers, as has been advocated and proposed, among others, by the Commissione Tecnica per la Spesa Pubblica and Giarda (1995). This last contribution also contains a detailed and informed analysis of the problems and the existing proposals.

The technical problems associated with the construction of a cash budget for the Public Sector, some of which are listed in Problem 10, may seem daunting. However, in our view this is the area where the returns could prove to be the greatest. Whether or not one endorses the idea of a cash budget for the Public Sector as the only budget, being able to forecast and budget the cash expenditure of local governments and Enti di Previdenza seems a long overdue necessity. To this end, and given the past performances of INPS in forecasting its outlays, it might be necessary to require that cash forecasts of decentralized agencies be certified by independent agencies. In addition, we believe that carry-overs for current expenditure should simply be eliminated: any amount committed but not spend should become a budget savings. We also favor a much more limited use of the giacenze di Tesoreria. To this end, every program should have its own account, with very limited or no possibility to compensate overruns in one program with unused giacenze in another program. Rather, the initial overruns in a program should be met by a contingency reserve fund; after a certain point, the cash limit should kick in. We are aware that this proposal would reduce the efficiency of the cash management at the Treasury Account. However, given that the reshuffling of giacenze has often been used as a gimmick to formally meet a certain target fabbisogno, we think that this is a cost that has to be paid for a more transparent budget process. In addition, other proposals that we make strongly reduce the incentives for entities outside the State Sector to borrow and increase their giacenze at the Treasury; thus, the scope and the size of the phenomenon of giacenze would greatly diminish to start with.

Proposal 9.

The Budget should be in cash as well as commitment terms. It should contain targets not only on the fabbisogno, but also on different types of expenditure. It should be based on cost centers, and should involve a drastic reduction in the current number of Capitoli.

Proposal 10.

- a) carry-overs for current expenditure should be abolished;
- b) each program should have a separate account at the Treasury, with very limited or no transfer of cash resources across programs;
- c) possibly the single most important goal of the RGS in the near future should be the improvement of the data collection system for local governments, USL and other decentralized agencies, in order to be able to construct a reliable cash budget for the General Government in a relatively short period of time;
- d) the cash forecasts of Enti Previdenziali should be entrusted to or certified by an independent agency.

3.6 The Government and the Budget Preparation.

3.6.1 The problems.

An important reason why it is difficult to control and cut expenditure, as opposed to increasing taxes, is the absence of a unified direction during the various phases of the budget process. While tax increases cannot be "attributed" to any particular ministry, expenditure cuts are always more specific. Therefore, they require the direction of an agent that can allocate the burden of fiscal retrenchment to the various ministers. However, the current budget process is, in the terminology of section 2, too "collegial", along two dimensions.

First, currently three ministers (Treasury, Finance, and Budget) share responsibility for the process, with only a marginal prominence for the Treasury minister. Thus, there is no single minister that internalizes the macroeconomic constraints and takes responsibility for resolving conflicting claims on the budget's resources.

Second, the bargaining process between spending ministers and the other three ministers (and the Treasury minister in particular), a critical process that leads to the drafting of the LF, is somewhat unregulated. The Treasury minister is often unable to limit the claims on the budget from spending ministers. An important example is the recent disagreement between the Labour and the Treasury ministers on the reform of the Italian pension system, in the 1994 budget session. As a result of the unregulated bargaining process and the relatively high (by international standards) influence of spending ministers¹⁹ the Treasury minister does not have enough strength to overrule objections to its position.

Problem 11.

The responsibility for the budget process is dispersed between 3 ministries. Thus, there is no single agent at the center of the process that can internalize the macroeconomic constraints.

Problem 12.

The relationship between the ministries in charge of the budget (in particular, the Treasury minister) and the spending ministers is too collegial and unstructured. The system lacks a way to limit and reconcile conflicting claims on the budget from spending ministers.

3.6.2 Proposals.

The budget process has to be made "authoritarian", particularly in view of the major fiscal adjustment that Italy will have to undergo in the next decade. Our proposals aim at reducing the collegiality of the process along both dimensions pointed out above.

¹⁹On this point, see Von Hagen (1992).

First, we do not see the need for three ministers dealing with the budget. After all, given the identity: $\text{Deficit} = \text{Spending} - \text{Revenues}$, one of the three is determined as a residual! We have already discussed our objections to the outdated notions of macroeconomic management and planning embedded in the Budget ministry. Because at best it does not seem to be doing anything useful, this ministry should certainly be abolished. In our view, even the tasks currently carried out by the Finance ministry can be taken over by the Treasury. Thus, we propose the elimination of the Budget and of the Finance ministries. The Treasury minister should have sole responsibility for all budget issues. This would include preparing all budget documents, preparing the Bilancio tendenziale, setting target values for the fabbisogno and expenditure, handling the budget debate, and reconciling conflicting claims on budget resources from the spending ministers.

Second, in order to limit the influence of the spending ministers, the prerogatives of the Treasury Minister have to be clearly specified. We believe that, in defining this crucial aspect of the reform, one should have a "long horizon". While a high-debt country might need particularly authoritarian budget institutions, more stringent checks and balances should be reinstated when fiscal responsibility is achieved. Thus, in order to optimize over the trade-off between authoritarian and collegial rules, we propose below to adopt two different procedures. More authoritarian procedures would apply when the debt/GDP ratio is beyond a certain threshold, for instance 60%, as in the Maastricht criterion. More collegial rules would apply when the debt/GDP ratio is below this threshold. This simple structure would have two significant benefits. First, it permits to benefit from the different types of procedures when they are most needed. Second, it creates the correct incentives for those who typically favor deficits to restrain themselves when the debt/GDP ratio approaches the threshold. Thus, we propose:

Proposal 11.

The Finance and Budget Ministries are abolished. Their functions are taken over by the Treasury Ministry. The Treasury Minister has sole responsibility with the whole budget process. In particular, he opens the budget preparation process by proposing to the Cabinet Ministers the overall balance, total spending and total revenues.

Proposal 12.

Depending on the level of the debt/GDP ratio, two procedures regulate the relationship between the Treasury minister and the spending ministers. When the debt/GDP ratio is above a certain threshold (for instance, 60%):

- 1) The target level of spending and surplus proposed by the Treasury minister cannot be relaxed during the budget preparation process;
- 2) Negotiations over the composition of spending are bilateral between the Treasury min-

ister and the spending ministers;

3) The composition of the budget is approved by majority voting at the end of the process by the Council of Ministers but the Treasury minister has veto power.

If the debt/GDP ratio is below the threshold, the previous rules are modified as follows:

1) The targets on spending and deficits proposed by the Treasury minister can be relaxed by a two-thirds majority of the Council of Ministers;

2) As above;

3) As above, except that the veto power of the Treasury minister is eliminated.

3.7 The Legislative Approval Process.

3.7.1 The problems.

Among experts of the Italian budget process, there seems to be deep disagreement concerning the effects of the Parliament's responsibility on the current Italian fiscal disaster. Currently, Parliament can increase current expenditures relative to the Government proposal as long as they are covered by increases in revenues. Also, if the SNF in the Government proposal is already close to the SNF in the DPEF, Parliament is also effectively limited in its ability to affect the overall SNF. Some ²⁰ argue that, particularly in recent years, Parliament has rarely, if ever at all, worsened the balance in the LF relative to the original Government proposal. Others ²¹ argue that Parliament bears a large share of responsibility. This issue is difficult to resolve: it is true that Parliament has had minimal impacts both on the balances and even on the composition of expenditure and revenues (see De Joanna (1993), Appendix for some evidence on this point). However, this might simply reflect the fact that the Government proposals already take into account the likely response by Parliament, for instance by avoiding proposing budget cuts with little likelihood of success. In fact, regardless of whether the Italian Parliament has actually relaxed fiscal discipline relative to the Government's proposals in recent years, we believe that Parliament's prerogatives to increase spending pose a threat to the feasibility of a tight fiscal stance based on spending cuts.

While we propose below to limit the extent of Parliamentary amendments, our proposals to radically simplify the budget process will greatly enhance the role of Parliament as an informed controller of the Government. Currently, in fact, the cumbersome budget procedures greatly reduce the amount of clear and usable information available to Parliament. Thus, we identify two problems:

²⁰See in particular Onofri, Pisauro and Siniscalco (1994).

²¹See in particular Ragioneria Generale dello Stato (1994).

Problem 13.

Parliament can increase spending above the Government proposal.

Problem 14.

A cumbersome procedure limits the ability of Parliament to effectively monitor the Government's actions.

3.7.2 Proposals.

Regarding the issue of Parliamentary amendments, once again one has to trade-off the advantages of authoritarian and collegial institutions. In high-debt situations, the benefits of authoritarian procedures outweigh those of checks and balances. In low-debt situations, the opposite holds. Thus, we believe that in this area too different procedures should be adopted for high- and low-debt periods.

The purpose of the proposal we make below is to attribute stronger powers to the Government in periods of fiscal emergency. The proposal also raises the stakes of a Parliamentary rejection, by forcing the Government to resign in case the Budget does not pass. Legislators of the parties supporting the Government would know that, in case they defected and voted against the budget, they would also threaten the survival of the Government itself. Also, the proposal creates a stringent status quo for delays in budget approval.

The solution to problem 14 is contained in our previous proposals that vastly simplify the budget process. This would greatly enhance the ability of Parliament to monitor the Government on the basis of an informed representation of the fiscal manoeuvre.

Proposal 13.

When the debt/GDP ratio is above the 60% threshold:

- 1) At the beginning of the process the legislature votes on the budget balance and the level of spending and taxation. A two-thirds majority is required to reject the Government proposal on the budget size. A *closed rule* is adopted: no amendments are allowed on the size of the budget.
- 2) If the Government proposal is rejected the Government is required to resign.
- 3) If the Government resigns the legislature has to adopt a budget with an automatic cut of every Capitulo of expenditure of five percent relative to the previous year, after adjusting all expenditures by the expected inflation rate. When a new Government is formed, it has to follow the same procedures described above to prepare a budget proposal, but with an accelerated schedule.

- 4) If the budget is approved, the legislative discussion begins. The legislature cannot propose amendments that increase the level of spending, or increase the level of the deficit.
- 5) Amendments are approved by simple majority rule.
- 6) When no more amendments are presented, or at the prescribed last possible day (whichever comes first), the legislature takes a vote (with a simple majority rule) on the budget composition. If the budget is rejected, the original budget proposed by the Government is adopted.

When the debt/GDP ratio is below the threshold level, these rules should be modified as follows:

- 1) As above, except that a simple majority is required to reject the Government proposal.
- 2) Deleted: the Government must propose a revised budget with accelerated procedure.
- 3) Does not apply.
- 4) The legislature cannot propose amendments that increase the size of the deficit, or reduce the size of the surplus.
- 5) As above.
- 6) As above.

Proposal 14.

The simplification of the budget process that would be brought about by proposals 1 to 10 greatly enhances the ability of Parliament to monitor the Government.

3.8 Budget Implementation and Spending Controls.

3.8.1 The Problems.

An exhaustive discussion of the implementation of the budget would require an analysis of the organization and reform of the bureaucracy, a task which goes beyond the scope of the present paper. However, we think that a few points are in order.

Currently, the emphasis of bureaucratic control is on ex-post interventions and on a legalistic approach. The typical example of this is, of course, the current role of the Corte dei Conti. This body has, on paper, fairly substantial powers. For instance, every four months it must transmit a technical note on every piece of legislation that increases expenditure or decreases revenues. These notes, however, only express the Court's position on the legislation, but are not binding. Moreover, the timing is obviously awkward if the purpose is to impose budget discipline.

One solution, advocated by many,²² is to further enhance the role of the Corte dei

²²See, for instance, Ragioneria Generale dello Stato (1994) and our discussion in section 6.

Conti, by anticipating the timing of its intervention. Even if this were feasible, a host of questions remain open. What happens if the Government and the Corte dei Conti are on two different positions regarding the legitimacy of a certain budget item? How is the conflict resolved? What power would the Court have to enforce its position? These issues have to be defined very precisely, to avoid a lengthy stalemate on one side, and the possibility of loopholes on the other. Yet, to our knowledge, these issues have never been addressed with the precision they require.

Thus, we do not believe in the idea of entrusting the realization of a greater budget discipline to a very detailed regulation of the role of a watchdog of the Government and Parliament, however qualified it might be. This approach inspires the whole current budget process, and it is obvious that it has failed.

Problem 15.

The whole philosophy of the budget process is based on detailed regulation of a cumbersome process. This inevitably leads to a widespread use of irregular practices aimed at circumventing the regulations and at taking advantage of the lack of transparency of the system. In turn, the current process is heavily biased towards ex-post controls to check these practices.

3.8.2 Proposals.

More generally, we think that the entire philosophy of budget implementation and controls should change: from an "ex-post approach", based on detailed regulations and controls, to an "ex-ante approach", based on incentives. In fact, the spirit of all our proposals was to decrease the opportunities for Government and Parliament to do the "wrong" things when preparing and discussing the budget, and to increase the incentives to do the "right" things.

But we think that this idea should go a step further. It should also apply to the implementation of the budget, down to the final link of the chain. Ex post, legalistic controls are unlikely to be successful, particularly if applied to a bureaucracy with job security, whose salaries and careers are virtually unaffected by performance, and almost exclusively determined by seniority.

To be effective, a reform of the budget process which, like ours, is based mostly on the idea of controlling expenditure, must be coupled with a system of bureaucratic incentives for cost containment. A system of incentives could generally work as follows. Each office or department of the bureaucracy should work on contracts which specify certain output at given costs. Salaries, promotions and job security should be linked to a successful delivery

of the output specified in the contract.

A more detailed specification of proposals for a bureaucratic reform of this sweeping magnitude goes beyond the scope of this paper. However, in the next section we briefly describe the salient features of a recent reform in New Zealand, which has taken decisive steps exactly in this direction.

Proposal 15.

The whole philosophy of the budget process should shift from heavy regulation and ex-post controls to simplification and ex-ante incentives.

4 Lessons from New Zealand.

Starting in the mid-eighties, New Zealand has gone through a process of dramatic institutional reforms, second only to reforms in Eastern Europe. These reforms have included trade liberalization, fiscal reforms, a new Central Bank law, and a major reform in bureaucratic procedures and in the budget process.

The budget reform, introduced in 1988 and completed in 1994 with the Fiscal Responsibility Act, is an imaginative and sweeping attempt at restructuring the bureaucratic organization. The key idea of the reform has been a move from a system of 'input control' to one of 'output control'. The relationships, top to bottom, between various levels of bureaucracies and departments is based upon contract-like agreements prescribing the delivery of a prespecified output. The goal was to structure the bureaucracy as much as possible as a large private company. The Government is viewed both as an owner of the agency (i.e., bureaucratic bodies) interested in the efficient use of resources, and a purchaser of prespecified outputs at certain prices. The goals of this radical reform were to increase the efficiency of the bureaucracy, leading to substantial cuts in government spending for given delivery of services, and to increase the transparency of the budget process.

The main aspects of the reform in New Zealand, and, specifically, those more relevant for Italy can be summarized as follows: ²³

- Each Minister is responsible for specifying the performance of his Chief Executive Office; a contract-like agreement establishes the output expected by the Chief Executive; in turn, he is responsible for guiding his bureaucracy toward the achievement of this output goal.
- The Chief Executives do not have permanent tenure. They are appointed every five years. Their performance, based upon output delivery is evaluated every year. Bonuses and discretionary salary increases reward good performance that may also lead to the

²³For an excellent description of the New Zealand reform see Scott (1995).

renewal of the contract for three additional years.

- The Chief Executives are freed from almost all inputs controls and have a vast authority in using financial and human resources to deliver the output prescribed by their performance agreement with the Ministers.
- The Chief Executive Officers are, by law, the employing authority of all their subordinates. Labor regulations within the bureaucracy are very similar to those in the private sector. For instance, department heads can negotiate performance pay agreements and bonuses with individual bureaucrats and pay cuts are allowed for poor performances.
- Performance information at various levels of the bureaucracy is gathered in a very decentralized system and centralized by a Strategic Human Resource Manager Center which is supposed to enhance competence-based approaches to hiring, firing and personnel development.
- The entire focus of the management system, linking departments and sub-departments are outcomes, rather than inputs; this focus on the delivery of outputs "required the removal of extensive webs of controls over internal management decision making and the use of inputs" (Scott (1995) p. 44). The critical point of the output approach is that an Agency or Department takes full responsibility for delivery of an output, at a certain 'price' with prespecified penalties and rewards and performance evaluation.
- A bureaucratic output is anything that can be contracted for by the Department or Agency as a supplier to the Government, or third parties, as a purchaser. Output should be "individually unique, internally homogeneous, capable of being costed and not involving a large element of overlap with other outputs." (Scott (1995) page 44.)

Given the critical role played by outputs in this bureaucratic reforms, one needs to pause to consider two critical issues. First, outputs do not coincide with outcomes. For instance, in public health an 'output' is the number of hospital beds over the population size; an 'outcome' is an improvement in health statistics. Since the Government is ultimately interested in outcomes, rather than outputs, an even more radical reform would establish outcomes based managerial criteria for bureaucratic Agencies and Departments. The problem is, that too much uncertainty and random shocks affect the relationship between output and outcomes, and it would be difficult to enforce penalties based upon outcomes. A second major problem involves the definition of outputs, particularly when quality is a critical factor and when costs of output production are very uncertain. Output based content create incentives for the bureaucracy to reduce quality. The solutions to this problem include: 1) specification of quality controls within the contract, whenever possible; ii) promotion of competition amongst public agencies and with private suppliers whenever possible. Uncertain costs can be dealt with, at least up to a point, with contingent contract specifying acceptable ranges and schedule of penalties for deviations from the range.

- The government budget is presented using the same format of the budget of a large private corporation;
- The Treasury Minister maintains a leading and critical role in the budget preparation process;
- The Government has to present three months before the beginning of the fiscal year (July 1) a "Budget Policy Statement" which illustrates simply and concisely the guidelines of the upcoming budget.
- The Parliament scrutinizes the budget along three dimensions, as summarized by Scott (1995):
 - i) scrutiny of the Government's intentions for the current years as expressed in its budget proposals,
 - ii) examination of the actual performance of departments or reported in their annual reports
 - iii) examination of the performance of state owned enterprises and other nondepartmental government entities.

The emphasis of the scrutiny is a comparison of actual performance with planned performance.

- In December, the Government has to provide a half-year Economic and Fiscal update.

As the reader may have noted, several of these points are similar to those contained in our proposals. It is still relatively early to judge the results of this broad reform. Reviewers have pointed out areas which need 'fine tuning', in particular tightening of output definitions. Also, some commentators feel that too much autonomy is granted to the chief Executives.²⁴ However, overall the reform looks like a success. The transparency of the process has greatly increased and "expenditures for operating activities for the fiscal year which ended in June 30, 1992 ... declined by 1.5 billions NZ dollars, on a base of 31 billions." (Scott (1995), p. 100.)

There is one critical lesson for Italy from this reform experience. Complicated webs of controls by bureaucrats over other bureaucrats, where salary or promotion incentives are minimal or nonexistent, will never improve efficiency and save money. Incentive schemes need to substitute for excruciating, complicated and ultimately useless procedures of controls. One should reward and punish civil servants at every level for the delivery of output, and let them relatively free to optimize over the use of resources available to them.

²⁴See Scott (1995) p. 100 on this point.

5 Two Recent Reform Proposals for the Italian Budget Process.

5.1 The Proposal of the Ragioneria Generale Dello Stato.

This proposal touches upon all critical aspects of the budget process:

1) The budget preparation: including the structure of government, the relationship government-parliament, the budget presentation and its transparency; 2) The budget implementation: with particular emphasis on the issue of control of the public administration.

As for the budget preparation, the proposal focuses on four issues:

- 1.1) Restructuring of Government composition;
- 1.b) Reform of the budget document;
- 1.c) The voting process in the Parliament on the budget;
- 1.d) Reorganization of the Ragioneria.

For the budget implementation, the proposal sketches a rather complex web of bureaucratic controls.

5.1.1 Restructuring of Government Composition.

The proposal suggests that:

- a) The number of ministers should be fixed by law and reduced to nine. In particular, the functions of the Ministro del Bilancio and of Ministro delle Finanze should be incorporated within the single Ministro del Tesoro e dell'Economia.
- b) The number of Segretari and Sottosegretari is at the discretion of every government; so for instance, the Ministro del Tesoro could have a Segretario del Bilancio, one of Finanza and as many others as the government sees fit.

Comments.

This proposal goes in the right direction by unifying the supervision of the budget process within a single Minister. ²⁵ However, by letting the number of Secretaries unspecified, it may lead to a multiplication of them, with the possible effect of watering down the centralization of the budget process which is the original aim of this part of the proposal. Also, the proposal is silent on the intragovernment procedures for the budget preparation and discussion. For instance, it is not specified what kind of veto power the Ministro del Tesoro, would have vis a vis spending ministers. More generally the proposal does not explicitly

²⁵We disagree with the name attributed to this minister. We suggest simply "Ministro del Tesoro". The addendum "dell'Economia" suggests a view of government control and planning over the economy which is unnecessary.

attribute a leading role to the Ministro del Tesoro in the budget formation process.

5.1.2 Reform of the Budget Law.

The proposal suggests the institutions of two budgets: a "Bilancio Politico" and a "Bilancio Amministrativo". The former, organized in broad aggregations of expenditures, is approved by Parliament. This budget identifies for each chapter of expenditure the share which can be executed only after "corresponding resources" are obtained. The latter, much more detailed, is shown to Parliament only at "scopo conoscitivo", but is not voted upon.

The proposal also suggests a variety of points which have several goals. First, on the revenue side, a clarification in the presentation of what are truly fiscal revenues, and what is an increase in debt. Second, a clear identification of the revenues items which are "una tantum" rather than permanent. Third, elimination of "special funds", to cover various additional spending programs, within each fiscal year. Fourth, measures directed to prevent strategic manipulation of multi-year spending programs to create room for new expenditures.

Comments.

The motivation of this part of the proposal is laudable: simplification. However, the proposal stops way too short of the needed more radical restructuring of the budget preparation. The proposal does not deal with the relationship between "Legge Finanziaria", "Bilancio Tendentiale" and "Bilancio Programmatico". That is, it does not provide enough indications for a more general simplification and clarification of the entire process. For instance, it does not address the issue of how the bilancio Tendentiale is formed, under which assumptions, whether this document is needed, whether it should be used as a benchmark etc. It does not address the issue of how economic projections needed to evaluate the macroeconomic consequence of the budget are formulated.

5.1.3 Voting Rules in the Parliament.

The proposal is that the Parliament should not be allowed to amend the Government's budget. Not only the Parliament should not increase spending or cut taxes, but it should not even change the budget composition. Using the terminology used in our theoretical section, the proposal is to adopt a "closed rule" in the budget approval process.

Comments.

This proposal does not show enough appreciation of the issue of constitutional "checks

and balances” and of the trade off between what we called above ”authoritarian” and ”collegial” procedures. The proposal is extremely ”authoritarian”. While this procedure may be appropriate in a ”fiscal emergency” it is unlikely to be optimal for a ”normal” situation. In other words, this proposal is too influenced by the current state of Italian public finance. Institutions cannot and should not be changed too frequently, thus an institutional reform should ”optimize” over a horizon which is not unduly influenced by a specific situation. This proposal also places much of the blame on the current state of the Italian public finances on the Parliament. One can argue, however, that much of the blame lies within the government, in the bureaucracy and in the administration of the pension system. By focusing too much attention on the Parliament per se, one may miss the critical role of the other parties involved.

Equally importantly, the proposal is silent on the issue of what happens if Parliament rejects the budget proposed by the Government. As we argued above, this is a crucial issue: we consider it a mistake to leave it open to ambiguity and different interpretations.

5.1.4 Reorganization of the Ragioneria.

This part of the proposal, rather involved and rich of organizational details, is inspired by two basic principles: 1) Greater independence of the Ragioneria from political influence; and 2) The central role of the Ragioneria in the entire budget process, including its implementation.

Comments.

We fully agree with the principle of greater independence of the Ragioneria, following the model of independent Central Banks. In fact, in some respect, the proposal does not go far enough in guaranteeing independence. For instance, Article 3 of the proposal states that the Ragioniere can be dismissed by a simple majority (50 percent + 1) of the Council of Ministers. This requirement does not seem stringent enough; a qualified majority, or even unanimity, seems more appropriate. As for an increase in the power of the Ragioneria, we feel that the proposal underestimates (perhaps strategically) the current critical role of this institution. The entire budget process begins with the ”Bilancio Tendentiale” prepared by the Ragioneria. This document sets the stage for everything which follows. As we argued above, the criteria which lead to the formulation of this document are not sufficiently clear and transparent. In other words, the Ragioneria’s influence derive on a quasi-monopoly of information and expertise of even the most obscure corners of the budget. More independence and an increasing role of the Ragioneria should be coupled with i) a substantial increase in the transparency of the budget; ii) an increase in the resources available to

the Parliament to gather information. The model of the American Congressional Budget Office might be a good example to follow. In other words, the authority and prestige of the Ragioneria should not emerge from its monopoly on information on a cumbersome process, but from its reputation of independent technical agency supervising the preparation of a transparent easy to interpret budget.

5.1.5 Controls of Budget Execution and of Local Government Finances.

The proposal suggests a reorganization of the control procedures and envision a complex web of two bodies of controllers: the "Controllori Finanziari" and the "Contabili Pubblici". The former are controlled by a "permanent commission" within the Treasury Minister. The latter are controlled by "Ispettorato Generale della Finanza". An additional body of public accountants would supervise and certify the budget of local governments. These accountants would constitute a new "Ente" called "Ente Nazionale Di Certificazione E Valutazione Pubblica". These accountants would be supervised by a Commission of thirteen members.²⁶ This new system of control would not substitute the role of the Corte Dei Conti. The proposal goes on specifying in fine details the role of each of these controllers.

Comments.

We totally disagree with the spirit of this part of the proposal. We feel that this is precisely the wrong way to go, if the goal is to improve the efficiency and accountability of the Italian bureaucracy. The proposal is based on something that looks like a "Reductio ad Infinitum" of 'controlled' and 'controllers' within the same bureaucracy. As we argued above, we should instead think about using reputable private accounting firms to certify the accuracy of the budgets of local governments, or even of branches of the Central administration. More importantly, the proposal is completely insensitive to the idea of introducing market oriented ideas into the bureaucracy. Rather than creating an excruciatingly complex web of controls on budgets produced by bureaucrats who cannot be fired and whose salaries are totally unrelated to performance, one should go in the direction of creating incentives for the bureaucracy to work efficiently and honestly. The example of New Zealand, which we described above, provides an excellent example of how to go in the direction opposite to the one taken by the "ragioneria". In summary, what we find rather disappointing in this part of the proposal is its complete impermeability to any ideas of incentives at work within the bureaucracy.

²⁶Members of this commission would include entrepreneurs and union members. We find this idea rather peculiar: what do union member and entrepreneurs have to do with certifying he accounts of local governments?

5.2 The Proposal of the "Technical Commission".

This proposal ²⁷ focuses on three areas:

- 1) Institutional constraints on spending increases;
- 2) Reorganization of the government structure;
- 3) Transparency of the budget.

5.2.1 Institutional Constraints on Expenditures.

On this point the proposal suggests various changes in the Constitution to and an improvement on the procedures of control. As for the Constitutions, the proposal argues that:

"Il quarto comma dell'articolo 81 Costituzione dovrebbe essere rafforzato escludendo per qualsiasi componente della spesa statale, anche di investimento, l'indebitamento come forma di copertura delle nuove o maggiori spese. Un tale vincolo, ovviamente, non comporterebbe l'obbligo di paraggio del bilancio. Il saldo, infatti, subisce i riflessi della situazione preesistente e, inoltre, può variare a causa dell'andamento spontaneo delle voci di entrata e di spesa il cui ammontare non è predeterminato dalle leggi."

The proposal also increases the role of the President of the Republic to challenge the Constitutionality of spending programs.

As for the control procedures the proposals suggest, in particular that: a) the Corte Dei Conti should be made capable of intervening much earlier, beginning during the budget discussion in the Parliament; b) the role of controller of the Parliament should be increased particularly with reference to calculations of the "bilancio tendenziale"; c) elimination of financing means of current expenditures based upon future and uncertain increases of revenues; d) stipulation that revenues from privatization cannot be used to finance expenditures; e) changes in multi-year spending programs cannot increase expenditures; and f) the ex-post verification of the Parliament on the budget implementation should become an important moment of Parliamentary control.

Comments.

We are somewhat skeptical of the usefulness of Constitutional rules to limit spending. The long quote which we reported above well captures our concerns. This quote begins with some 'tough' language, but ends up with a 'soft' tone, explaining that the 'tough' language does not mean, indeed, a balanced budget prescription. We feel that Constitutional rules

²⁷As it appears in Onofri, Pisauro and Siniscalco (1994).

like this one simply promote creative budgeting to circumvent them. As a result, they achieve relatively little in terms of budget discipline, but decrease transparency. As a matter of fact, in the introduction of this proposal, one reads the following evaluation of the current situation:

”Provando a dare una valutazione, il quadro complessivo dei vincoli sulle decisioni in materia di spesa appare alquanto stringente.”

Despite these ”vincoli ... stringenti” the Italian public finances are in total disarray. One should also remember that entitlements (together with interest payments) have been, by far, the fastest growing component of government outlays, not only in Italy but in virtually all OECD economies. Thus, the proposed Constitutional rule imposes a tough constraint on the least problematic part of the budget, leaving the rest untouched.

We note a striking difference between this proposal and that of the Ragioneria. The Ragioneria wants to minimize the role of the Parliament in the entire budget process. This proposal wants to reinforce the role of the Parliament as a controller, in the spirit of ”checks and balances”. While we share the appreciation of the role of ”checks and balances”, we are concerned about the proposed increase in the role of Parliament in the budget preparation phase, both because it is most likely impractical and in light of our discussion of authoritarian vs. collegial rules.

5.2.2 The Structure of the Government.

This part of the proposal is based upon the view that most of the responsibility for the Italian fiscal imbalance lies within the Government, not so much in the relationship between Government and parliament. Thus, while the proposal argues for reinforcing (by means of a new Constitutional law, perhaps) the limits to the power of amendments of the Parliament, it focuses mostly on the structure of government itself. The proposal has two key ingredients: a) strengthening the position of the Prime Minister as the central player in the budget preparation; and b) reorganization of the economic ministers, so that a single minister has responsibility for overall spending and taxation.

Comments.

We agree with the spirit of this part of the proposal. The crucial point is, in our view, the reinforcement of one minister who has the ”political responsibility” of the budget, above the spending ministers. The proposal views the Prime Minister, as the individual who should have this responsibility. An alternative would be to make the single economic minister (the Treasury minister) the one with the ultimate political responsibility of the budget. As we argued above, we have some sympathy for this alternative for three reasons: a) the

Prime Ministers may be more sensitive to short run electoral pressures, while the economic minister may be relatively less sensitive, b) the Treasury Minister may have more technical competence than the Prime Minister, or, at least, he should have, almost by definition; and c) it may be useful for the Prime Minister to have a "scapegoat" and "blame" on the Treasury Minister "tough" fiscal measures when necessary.

5.2.3 Transparency.

This part of the proposal suggests a variety of detailed improvements on the organization of the budget, the most important of which can be summarized as follows: a) better coordination of data and balances among the budget the "legge Finanziaria" the DPEF, and multi-year projections, and more realistic evaluation of appropriations; b) inclusion of "out of budget" activities, and in particular financing of Tesoreria to INPS within the budget; c) coordination and correspondence between planned deficit and increase in the stock of debt; d) budget restructuring so that all spending authorizations are allocated within the responsibility of the Ministry with the political responsibility over them – this would greatly reduce the role of the Treasury as a monopolist of information and budget supervision; and e) better presentation and classification of the difference between capital and current expenditures.

Comments.

Parts of this proposal go in the right direction in advocating more transparency in the budget process. However, other parts read a bit too much as simple exhortations to "do a better job". For instance:

"L'entità degli stanziamenti nella legge di bilancio va determinata senza artificiose sottovallutazioni dei costi delle leggi vigenti e senza artificiose sopravvalutazioni degli effetti delle manovre."

What incentives would be introduced to improve the current situation on this point? As we argued above, we feel that a more radical approach to simplification and transparency is needed. More generally, while we feel that all of these proposals are quite sensible, particularly the elimination of "off budget" items, they do not go far enough. Finally, we do not share the proposal's enthusiasm for multi-year budgets. Multi-year budget plans are often a scapegoat, to justify delays on current adjustments, based on future budget projections and promises of very little reliability. As we argued above, the role of multi-year budgeting should be vastly de-emphasized. Note that, Von Hagen (1992) finds that in a sample of OECD countries the extent of the use of multi year budgeting is totally uncorrelated to the fiscal position of different countries.

6 Conclusions.

Our proposals are based on three guiding principles. First, the system does not need more detailed regulation, which sooner or later will be circumvented, but a sweeping simplification, which allows a more informed participation in the process by all actors involved. Second, the system must have a center of gravity that can internalize the macroeconomic constraints and can take responsibility for the whole process; in other words, the process must be made more authoritarian, especially in times of fiscal emergency. Third, the emphasis must be shifted from regulation and ex-post controls to incentives, at all stages of the preparation, presentation, discussion and especially implementation of the budget.

Our main proposals can be summarized as follows:

- 1) The number of documents and stages of the budget process should be reduced drastically, to three. First, a document presenting the trends of fiscal policy in the absence of interventions and the scenarios corresponding to alternative policy interventions. Second, the Budget containing the fiscal manoeuvre. Third, a mid-year budget.
- 2) Economic planning should play no role in the budget process;
- 3) In the executive, all budget issues should be the prerogative of the Treasury minister, who would also have veto power on spending ministers. The powers of the Treasury minister should be strengthened when the debt/GDP ratio is high. The Budget and the Finance ministers should be abolished.
- 4) The powers of Parliament should be limited, especially when the debt/GDP ratio is high.

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