ACHILLES CATCHES UP WITH THE TORTOISE: AN EXPENDITURE RULE TO BRIDGE THE GAP BETWEEN FISCAL OUTTURNS AND TARGETS

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Achilles runs ten times faster than the tortoise and gives him a start of ten meters. Achilles runs those ten meters, the tortoise runs one; Achilles runs that meter, the tortoise runs a decimeter; Achilles runs that decimeter, the tortoise runs a centimeter [...] and so on ad infinitum, with Achilles never overtaking the tortoise.

(J.L. Borges, *Other Inquisitions: 1937-1952*,
NY Washington Square Press, 1966)

The implementation of annual and medium-term fiscal plans in Italy over the period 1998-2008 has been less than satisfactory: slippages in the first year were seldom made up for in subsequent years, and targets were seldom attained. Failures were mostly due to higher-than-planned expenditure. Given the already heavy tax burden, future fiscal consolidation will have to rely on expenditure restraint. We argue that the introduction of multi-year expenditure ceilings, in line with best practices in other European countries and with recent proposals to reform European fiscal governance, could improve Italy's fiscal performance.

1 Introduction

Since 1998 Italy's fiscal policy objective has been a budget position close to balance, as called for by the Stability and Growth Pact. Unlike Zeno's tortoise, this target is not moving. Even so, like Achilles with the tortoise, Italy seems unable to catch up with it.

In the last few years, with the global financial crisis and recession, the distance between Italy's fiscal outcomes and its medium-term target has increased. As in many other countries, the crisis has left a legacy of a larger general government deficit and an increasing debt.[1] Unlike other countries, Italy took only limited measures to support the banking system, thanks to its comparative solidity. Together with prudent fiscal policy, this moderated the rise in the debt, but even so its GDP ratio has returned to the peak levels reached during the 1990s, with potentially negative implications for potential economic growth.

Looking forward, the impact of population ageing on the public finances will complicate fiscal consolidation and debt reduction. Thanks to the pension reforms already enacted, Italy is not among the countries whose public finances will suffer the most from population ageing. But there still remain problems. Health-care spending, for instance, does not depend on demographics alone but on other drivers as well (technology, demand elasticity), which are largely overlooked in the official projections. To date, assistance to dependent elderly people has been provided informally

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[1] Unless the recession-induced loss of output is quickly made good, the increase in deficits may turn out to be long-lasting, given that the GDP share of the expenditures that are not cyclical (such as pensions) is larger than before.

within families, but greater women's labour market participation may bring a significant increase in the demand for public provision or financing and so produce greater-than-estimated spending.

In this context, deficit and debt reduction must rank at the top of Italy's fiscal policy "to do" list. Tax and social security revenue is already very high in proportion to GDP by international standards (in 2009 it was 4 percentage points higher than in the other EU countries) and as compared to past experience. Accordingly, primary spending will have to be significantly reduced in relation to GDP. And as public investment is already close to the lowest level in decades, the cuts will have to bear on current outlays. Strong gains in efficiency will be needed to guarantee the provision of essential public services.

In the decade before the crisis, real general government primary current expenditure rose by about 2 per cent per year, against a real GDP growth rate of 1.5 per cent. The government aims at inverting this trend. The latest official planning document, for 2011-13, posits a reduction of the deficit to 2.2 per cent of GDP, to be achieved primarily via a 2.7-point cut in primary current spending (to 40.8 per cent, from an estimated 43.5 per cent in 2010). This implies a contraction of almost half a percentage point per year in real terms.

If Italy is to attain the medium-term objective of a near-balanced budget, as it reaffirmed in the 2010 update of the Stability Programme, expenditure restraint must continue beyond 2013. Assuming continuing real economic growth of 2 per cent per year as indicated by the government for 2012-13, and stable GDP ratios of capital spending and the fiscal burden, the current primary expenditure ratio would have to be cut by nearly 2 percentage points in 2014-16 to achieve a balanced budget in 2016. The real growth rate of current primary spending would be 0.4 per cent per year (Banca d'Italia, 2010). Overall, current primary spending would remain constant in real terms over the period 2011-16. Bringing the year of budget balance forward would require a negative average annual growth rate; postponing it would permit a positive rate.

On the basis of Italy's poor track record in implementing fiscal plans (Section 2), the reform of European economic governance can provide the opportunity to reform the fiscal rules, procedures and institutions for effective spending control and significant gains in spending efficiency (Section 3). To this end, international best practices are considered (Section 4) and recent changes to Italy's fiscal framework are discussed (Section 5) with a view to designing reforms that can enable Achilles to finally catch up with the tortoise (Section 6).

The paper concludes that the reform of Italy's fiscal rules, procedures and institutions should focus on the main challenge to the public finances, namely to keep public spending under control while making more efficient use of public resources. The establishment of multiyear limits to expenditure growth may prove to be an effective solution.

2 Italy: lessons from past fiscal performance

Italy's implementation of the medium-term plans set out in the Economic and Financial Planning Documents (EFPD) drafted from 1997 to 2005 was quite unsatisfactory.[2] The primary surplus targets set three years ahead became progressively less ambitious. At first they were consistent with Italy's March 1998 undertaking at the ECOFIN Council to rapidly lower the debt ratio toward 60 per cent of GDP, as called for by European agreements, by maintaining a primary

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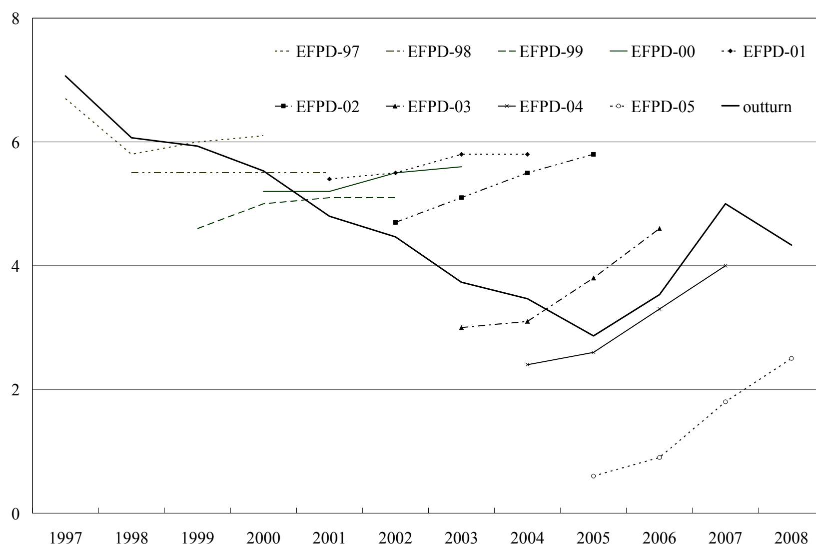
[2] This analysis is based on Balassone *et al.* (2011). The plans considered are those post-EMU (insofar as the 1997 plan, *de facto*, assumed Italy's qualification); those presented after 2005 are excluded because of the large impact of the global crisis on their execution.

Figure 1

General Government Primary Surplus:
EFPD Targets (1997-2005) and Outturns
(percent of GDP)



surplus of at least 5 per cent of GDP.[3] Later Planning Documents lowered the three-year-ahead target, down to the 2.5 per cent planned for 2008 in the 2005 EFPD.

Even so, fiscal outturns over 2000-07 fell short of targets by a significant margin (3.1 percentage points of GDP, on average; Figure 1). Only the target set in the 2005 EFPD for 2008 – the least ambitious – was met, thanks chiefly to better-than-expected economic growth. Plans always started with an optimistic view of concurrent fiscal developments. On average, the projected primary surplus for the year in which the plan was drafted was higher than the outturn by almost 1 per cent of GDP.

In other words, a significant portion of the slippage with respect to the medium-term targets came right in the first year, but in general the subsequent EFPDs did not provide for corrective action: the curves in Figure 1 do shift down and to the right over time, but they do not steepen; the fiscal effort planned in year *t* for year *t+1* (the planned improvement in the balance) basically shows no correlation with the gap between the balance in *t* (as assessed that year) and the target set the previous year. The primary surplus shrinks from 6.6 per cent of GDP in 1997 to 0.3 per cent in 2005.

Between 1998 and 2008, the change in the primary balance attained in the first year of each EFPD plan fell short of target by 0.6 percent of GDP, on average: the ratio of expenditure to GDP was 0.8 points and the revenue/GDP ratio 0.2 points more than planned.[4]

Errors in forecasting nominal GDP had only a small impact on the gap. In the period 1998-2008 nominal growth averaged 0.4 percentage points less than projected. Assuming as a rough approximation that in the short run primary expenditure is independent of price and real macroeconomic developments (*i.e.*, its elasticity to GDP is zero), then if GDP had grown as forecast, the expenditure overrun would have amounted to 0.6 points.

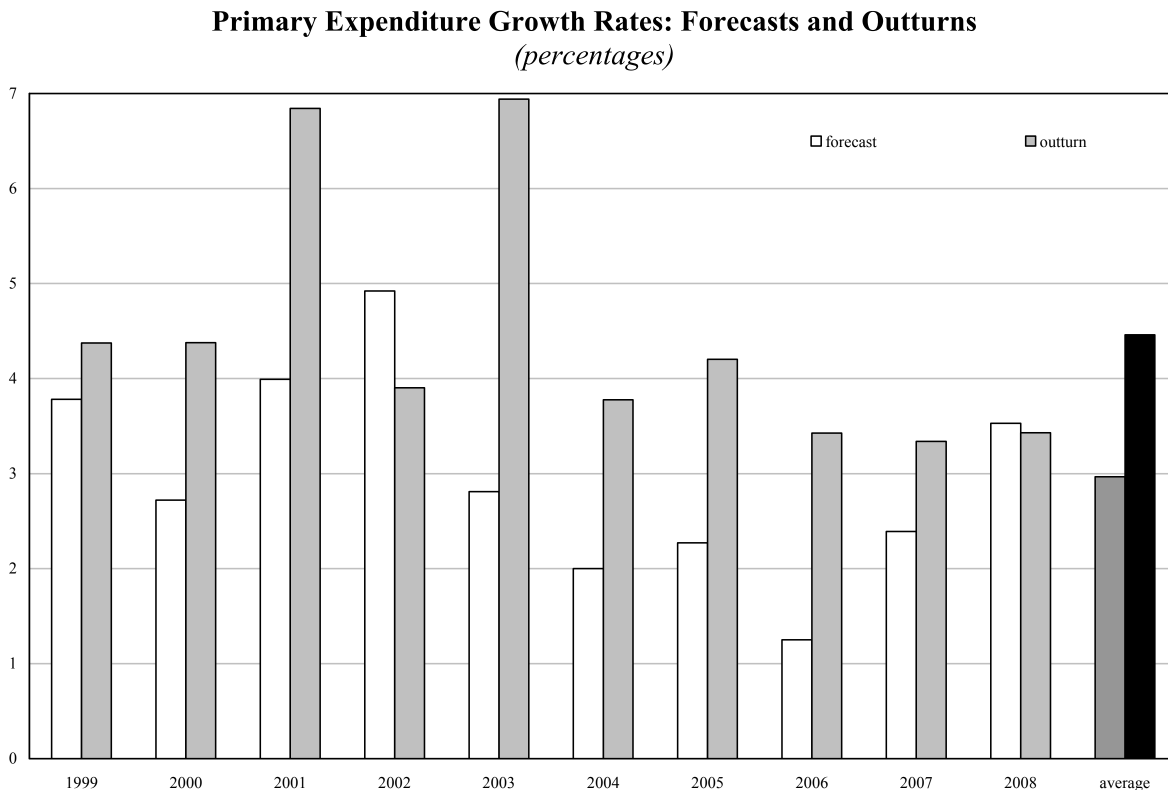
Slippages in 1998-2008 depended mainly on nominal primary expenditure. Except for 2002 and 2008, the actual increase in primary spending each year was always greater than had been planned the year before. Over the whole period, the average nominal growth in primary

3 "L'Italia nella moneta unica con sei impegni", *Corriere della Sera*, 22 March 1998. Since interest payments were nearly 5 per cent of GDP, this was broadly consistent with the Stability and Growth Pact objective of budgetary balance or surplus in the medium term.

4 This calculation is based on data from the annual Planning and Forecasting Report – the last planning document released each year – since the EFPDs often did not specify targets for revenues and expenditure.

Figure 2

Primary Expenditure Growth Rates: Forecasts and Outturns
(percentages)



expenditure was 4.5 per cent, just above nominal GDP growth (4.4 per cent), against a target of 3 per cent (Figure 2).

Analysis by expenditure item or level of government is impossible, owing both to changes in the economic classification of expenditure over time and to lack of information in the planning documents.

However, the fastest-rising expenditure component is local government spending: from 1998 to 2008 central government primary current expenditure grew by 5.1 per cent per year (3.3 per cent net of transfers to other public bodies, which increased by 7.2 per cent per year), local government expenditure grew by 7.5 per cent per year, social security institution outlays by 5.4 per cent.

Inertia in public spending also explains the large impact of lower-than-forecast GDP growth, which accounted for about two thirds of the total shortfall *vis-à-vis* the three-year-ahead primary balance targets. Generally speaking, the Documents projected a significant acceleration in economic activity over the planning horizon, with GDP growth in the third year about twice as high as in the first year. In reality, however, growth was often constant over the forecasting horizon (independent forecasters were only marginally less inaccurate; see Balassone *et al.*, 2011).

The data prompt a number of observations.

(a) There may be several factors behind the overoptimistic forecasts of fiscal developments: the general difficulty for both official and independent forecasters in assessing the persistency of low GDP growth after the early 1990s; a possible bias in the official forecasts; and the poor quality of the data on fiscal developments available during the year.

(b) Given the composition of the gap, the focus should be on expenditure control.

(c) The failure to respond to the systematic undershooting of fiscal targets underscores the need for a mechanism for the correction (at least partial) of budget overruns in subsequent years.

(d) The rapid growth of local government outlays calls for better coordination between different levels of government, especially as further decentralization is planned.

Concerning the quality of current fiscal data (point (a)), Law 196/2009 has initiated a programme to harmonize accounting standards at all levels of government and to introduce an integrated financial reporting system for the whole of general government. There is some uncertainty concerning the time frame for the implementation of these provisions, but they should significantly improve the quality and timeliness of the fiscal information available during the current year. Like other countries, Italy might well consider involving independent institutions in macro-fiscal forecasting to reduce the risk of an optimistic bias in the official projections underpinning medium-term plans (Debrun *et al.*, 2007).[5]

Far-reaching reforms of the public financial management system are also needed to deal with points (b) to (d). Again, the experience of other countries can be useful. Concerning point (b), some countries have enacted expenditure rules setting multi-year ceilings for total spending and its main components. The Swedish framework, which includes multi-year ceilings on transfers from central to local governments, is especially important with respect to the issue of coordination between levels of government (point (d)). Concerning point (c), some countries, such as Germany and Switzerland, have introduced automatic mechanisms to offset budget overruns over subsequent years.[6] In the rest of the paper we shall focus mostly on the role of expenditure rules.

3 The reform of European governance

Following the global economic and financial crisis, a clear, broad consensus has emerged on the need to increase and improve economic policy coordination within the EU and to rectify the shortcomings of the present European framework. On 29 September 2010 the Commission presented a proposal for reform of – *inter alia* – the European fiscal framework and – as a complement – national fiscal rules, procedures and institutions.

The role of national fiscal frameworks was already highlighted by the European Council in 2005 when the first reform of the Stability and Growth Pact went into force, but no action followed the statement of general principles.[7] However, the recent Commission proposal does include a Directive setting minimum requirements for national fiscal frameworks in reference to public accounting and statistics, macroeconomic and fiscal forecasting, numerical fiscal rules and medium-term orientation of fiscal planning.

Within the preventive part of the Pact, the European Commission proposes to include expenditure dynamics among the variables for assessing the appropriateness of the path of fiscal adjustment towards the medium-term budget objective. More specifically, the annual growth rate of expenditure is to be considered adequate if it is lower than or equal to a prudent estimate of GDP growth (respectively for countries that have not or have already achieved their medium-term target)

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5 The EU Commission also refers to independent institutions as an instrument to enhance transparency in fiscal reporting and budgetary policy.

6 See Franco and Zotteri (2010).

7 "[… N]ational budgetary rules should be complementary to the Member States' commitments under the SGP" and "domestic governance arrangements should complement the EU framework for fiscal surveillance. National institutions could play a more prominent role in budgetary surveillance to strengthen national ownership, enhance enforcement through national public opinion and complement the economic and policy analysis at EU level" (Council of the European Union, 2005; p. 21).

or if any spending above this prudent estimate is financed via discretionary revenue measures. The prudent estimate of GDP growth should be based on regularly updated projections over a ten-year horizon.

The final report of the Van Rompuy Task Force, released on 28 October 2010, approved the Commission's general approach with reference to the role and characteristics of national fiscal frameworks and suggested supplementing the minimum requirements with further desirable (but not strictly compulsory) features, including top-down budgeting and the introduction of "public bodies (e.g., fiscal councils) tasked with providing independent analysis, assessments and forecasts related to domestic fiscal policy matters" (Van Rompuy Task Force, 2010, p. 13).

The setting of minimum requirements at the European level is intended to guarantee an adequate reference standard and coherence between the European fiscal framework and each national fiscal framework, while allowing for national preferences and characteristics. According to the Commission, national reforms for compliance with the proposed Directive should come into force by the end of 2013. National numerical fiscal rules should be conducive to compliance with the European rules. Mechanisms for effective and timely monitoring should be put in place.

In the light of the developments illustrated in the previous section, two elements of the Commission proposals stand out as crucial for Italy: the key role of expenditure dynamics in the preventive part of the Stability and Growth Pact and the importance of medium-term planning in the national framework.

The provision for an explicit role for expenditure dynamics within the European fiscal framework greatly strengthens the argument for introducing an expenditure rule in Italy, where fiscal slippage depends mainly on the expenditure side (point (b) in Section 2). It is yet not clear which expenditure items will be used, but a broad aggregate for all of general government will presumably be adopted.

Concerning the medium-term orientation of fiscal policy, the Commission suggests a national reference planning period of at least three years. Plans should include both (i) "comprehensive and transparent multi-annual budgetary objectives in terms of the general government deficit, debt, and any other summary fiscal indicator, ensuring that these are consistent with any fiscal rules" introduced at national level and (ii) "detailed projections of each major expenditure and revenue item, by general government sub-sector, for the budget year and beyond, based on unchanged policies" (European Commission, 2010, p. 13). The latter aspect should help enhance coordination between different government tiers (point (c) in Section 2).

Even if this is not included in the Commission proposal, it could be useful for Italy – given the unresolved problems mentioned in Section 2 – to introduce an automatic mechanism for the compensation in subsequent years of slippages in the early stages of the implementation of medium-term plans (point (d) in Section 2).

4 The control of public spending in other European countries

Achilles does not run at the same speed in all EU countries. When assessing stability programmes the Commission uses charts similar to that in Figure 1.[8] Among the eleven countries that adopted the euro from the outset, France, Portugal and to a lesser extent Belgium and Germany run into difficulties comparable to those of Italy in implementing medium-term fiscal plans. However, the other members have better records and sometimes even outperform their plans.

[8] Available at: http://ec.europa.eu/economy_finance/sgp/convergence/programmes/

The ability to attain national medium-term targets appears to be correlated with the strictness of the fiscal rules, as measured by the Commission's index:[9] from 1998 to 2008 the lowest values of the index are recorded by Ireland, Italy and Portugal; intermediate scores by Austria, Belgium, France and Germany; the highest scores by Finland, the Netherlands and Spain (the first two countries are those that rely most heavily on expenditure rules).

The introduction of expenditure rules is relatively recent.[10] The rationale for them is manifold:[11] (i) government has more direct control over expenditure than over revenues or the fiscal balance; (ii) expenditure rules are easier to explain to the general public and to assess, thus enhancing transparency and accountability; (iii) they leave automatic stabilizers on the revenue side free to operate, which is consistent with tax smoothing and cyclically-adjusted budget targets; (iv) they can restrain the tendency to increase spending during upturns, making them a good companion to the Stability and Growth Pact, which lacks adequate incentives for fiscal discipline in good times, when spending is the main source of pro-cyclicality (Balassone *et al.*, 2010); (v) they can be instrumental in forcing a reduction in the tax burden; (vi) they provide a solid link between the annual budget process and medium-term fiscal strategy.

Some recent studies find evidence of a positive effect of expenditure rules on fiscal discipline.[12] Holm-Hadulla *et al.* (2010) show that fiscal outturns tend to be closer to the Stability Programme targets in the countries that have expenditure rules in place. Turrini (2008) and Wierts (2008) find that expenditure is less procyclical in the EU members that have expenditure rules.

With an expenditure rule, the government announces the maximum level of spending deemed consistent with fiscal sustainability over a medium-term horizon and commits not to exceed it. As a consequence, expenditure rules must be geared to the attainment of a medium-term budget target. Otherwise tax cuts could easily substitute for the extra spending disallowed by the rule, with no net benefit to the government accounts. Concerning the annual budget, under a top-down approach the expenditure ceilings set by the rule enter into budget preparation at an early stage and are the reference first for programme appropriations and then for line items.

When designing an expenditure rule, four issues are especially important.

(a) The rule's effectiveness in promoting fiscal sustainability depends on scope, *i.e.*, the share of public spending that is subject to it. There are reasons to exempt some items: for instance, it can be argued that automatic stabilizers on the spending side (mostly, unemployment benefits) should be left free to work just as much as those on the revenue side; and it may be necessary to exempt those outlays that cannot be controlled over the short term (e.g., interest payments) or that are planned over a longer horizon than the rule (e.g., investment programs). In Finland, the Netherlands and Sweden (the three European countries with the longest experience with expenditure rules) interest payments are not covered (Table 1); Finland excludes automatic stabilizers; in all three countries public investment is given special treatment, though not exempted outright; and in all three the rule applies to central government and covers transfers to other government levels.

(b) The degree of flexibility to be allowed must be given some consideration. Since the purpose is fiscal sustainability, what should be kept under control is the structural level of expenditure. Thus occasional increases in outlays should be allowed. Typically, flexibility is obtained by approving ceilings that are slightly above actual expenditure projections. The need for flexibility

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[9] See Iara and Wolff (2010).

[10] See the review in Ljungman (2008).

[11] Mills and Quinet (2001); Dában *et al.* (2003); Deroose *et al.* (2006); Wierts (2008).

[12] Control of expenditure can be obtained also without rules. In Germany, for instance, the ratio of primary expenditure to GDP was lowered by 3.4 percentage points between 1998 and 2008, without any expenditure rule. In fact, over that period Germany recorded the slowest expenditure growth in the euro area (Hauptmeier *et al.*, 2010).

Table 1

Expenditure Rules in Finland, the Netherlands, and Sweden: Main Features

Country	Coverage				Time Span *(years)*	Discipline	
	Social Security	Interests	Local government	Percent of Total Expense		Rolling vs. Fixed-Term	Revisions
Finland	in part	no	no	36	4	fixed-term	every 4 years
Netherlands	yes	no	transfers	80	4	fixed-term	every 4 years
Sweden	yes	no	transfers	64	3	rolling	every year

also depends on the coverage of the rule (if automatic stabilizers are included, greater flexibility is needed) and on the way the ceilings are set (nominal ceilings, used in Sweden, require less flexibility than those set in real terms, as in Finland and the Netherlands). Since uncertainty increases with the time horizon, flexibility margins should be wider for the later years of medium-term plans. Of the three countries considered above, Finland has the greatest flexibility margins.

(c) The rule can be set for a fixed term or on a rolling basis. Finland and the Netherlands use the fixed term: at the start of the legislature spending ceilings are fixed for its entire four-year duration. In Sweden, every year the expenditure ceiling to be applied three years hence is set, the ceilings applying before that having already been decided in previous years. Fixed-term systems are more rigid, but they have the advantage of avoiding yearly debate within government coalitions, imposing medium-term planning on government and parliament, and assigning full responsibility for fiscal policy during a legislature to the winning coalition (with rolling ceilings, at the start of the legislature the new government inherits the ceilings set by the previous one).

(d) Finally, the method used to determine the ceilings and the legal status of the expenditure rule also need consideration. The literature on fiscal rules suggests unambiguously that transparency and credible penalties are essential to effectiveness.[13] Yet the method for computing the ceilings in Finland, the Netherlands and Sweden is not disclosed. And in all three countries expenditure ceilings stem from political commitment and have no legal status.

More recently, in 2009, Austria too introduced expenditure limits for the federal government. This followed a sweeping institutional reform in 2007 (Steger, 2010). The limits are fixed by law for four years. They are stated in nominal terms for about three-quarters of federal spending, while for the most volatile items limits are set contingent upon pre-specified indicators. Expenditures are classified in five areas, and limits are set for each area, while the allocation of resources within each area can be revised after the first year.

5 The reform of public financial management in Italy

The Italian fiscal framework has undergone a number of major reforms over the decades, most significantly Laws 468/1978, 362/1988, and 94/1997 and the 2007 reclassification of the state

[13] See, among others, Kopits and Symansky (1998) and Inman (1996).

budget by missions and programmes. Budgetary procedures are increasingly influenced by the European fiscal framework. In particular, the ESA-based general government budget balance has become the reference variable for fiscal policy, replacing the state sector borrowing requirement. Further changes have been induced by the government decentralization.

These developments have produced a number of positive effects. Deadlines are better observed (e.g., it has been many years now since the budget law was not approved by parliament by the mandated deadline). Forecasts are more accurate. There is greater coordination between levels of government. Medium- and long-term issues are now more prominent in the policy debate. All in all, the changes to the fiscal framework contributed to the success of fiscal consolidation in the 1990s and strengthened the government's control over fiscal developments, avoiding the ample fiscal slippages of previous decades.

There remain some problematic aspects, however (De Ioanna and Goretti, 2008). At the macroeconomic level, notwithstanding the framework designed for fiscal consolidation, it has frequently proven difficult to actually attain the objectives. At times forecasts turned out to be overoptimistic. The room for maneuver created by better-than-expected budgetary developments was not exploited to achieve better fiscal outcomes. The reduction in the debt/GDP ratio was achieved in part through operations on assets that have not improved the net wealth position of government.[14] At the microeconomic level, there is inertia in the allocation of public resources: the spending structure adapts slowly to the changing needs of citizens. Public expenditure analysis has shown that there is a great deal of room for improvement in the efficiency of resource use.[15]

The reform of the fiscal framework at the end of 2009 (Law 196/2009) is intended to strengthen budgetary rules, procedures and institutions for greater consistency with sound and sustainable public finances. The new framework should be more effective in avoiding deficits and should improve the allocation of public resources. As noted in Section 2, Law 196 requires the harmonization of accounting standards at different levels of general government, the creation of a comprehensive data base, and the institution of a new fiscal planning cycle (with specific rules ensuring coordination among levels of government). It also modifies the content of planning documents and envisages an important change in the accounting standard for the state budget (from the current dual cash and accrual basis to cash only).

The introduction of the European semester requires further legislative changes, in particular to the content and the timing of the main official fiscal reports (Banca d'Italia, 2011). In February 2011 new legislation was passed by the Chamber of Deputies and transmitted to the Senate for final enactment.

As to the management of public expenditure, Law 196 moves toward tighter expenditure control. In particular, it envisages ceilings on discretionary expenditures, formalizing the practice introduced in mid-2008 with the new, three-year fiscal package. It also provides that the Ministry of the Economy and other ministries can stipulate agreements concerning the targets to be achieved over the three-year planning period.

The legislation now under discussion moves a step further. It purports to extend the expenditure ceilings beyond discretionary spending, but whether such limits can be modified, and under what circumstances, is not specified.

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[14] The reduction in the ratio between 1998 and 2007 came mainly from privatization receipts and the restructuring of liabilities (more than 11 out of 14.4 percentage points). The potential of such one-off debt-reduction measures is now much smaller.

[15] Commissione Tecnica per la Finanza Pubblica (2008) and Ministero dell'Economia e delle finanze (2009).

6 An expenditure rule?

The introduction of a formal rule setting multi-year ceilings for public expenditure would be consistent with the crucial role of expenditure control to fiscal consolidation in Italy. It would make the targets more visible and increase the political penalties for expenditure slippage. An expenditure rule would also be consistent with the European Commission's proposal on the preventive part of the Stability and Growth Pact, namely to make expenditure dynamics one of the variables the Council considers in assessing the adequacy of the adjustment path towards the medium-term objective for the structural general government budget balance.

The main features of such an expenditure rule could be the following.

(a) It should apply to overall current and capital primary expenditure, excluding only outlays directly related to cyclical developments. In Italy such cyclical items are relatively small (unemployment benefits amounted to 0.4 per cent of GDP in 2007 and 0.7 per cent in 2009). It would exclude only interest spending, which depends on factors not directly under government control. It would be useful to specify the ceiling for capital spending, in order to avoid the risk of excessive curbs on public investment in order to achieve compliance with the overall ceiling:[16] past experience, in Italy and elsewhere, indicates that expenditure cuts tend to be concentrated on items that are not protected by powerful interest groups or likely to induce strong opposition by voters.[17]

(b) The rule should apply to the expenditure of central government and social security institutions, including transfers to sub-national governments. Overall, it would cover about 90 per cent of total general government primary expenditure. With the completion of decentralization, a rule on the budget balance would apply to sub-national governments; expenditure control at regional and local level would be the responsibility of each local authority, which would use its own rules and procedures for expenditure planning and control.

(c) In order to reduce uncertainty in implementation, the ceiling should be expressed in nominal terms.

(d) There is a need for safety margins and for mechanisms for correcting overspending or compensating for it after the fact. Specific corrective mechanisms could be designed for certain expenditure items. For instance, overspending on pensions could be offset via adjustments in the retirement age. An overall correction clause should also be considered.

(e) The ceilings should extend over three years. They should be updated on a rolling basis in the course of one legislature and renewed at the beginning of the next.

The government would set the expenditure targets based on the targets for the budget balance and the projected revenues of central government and social security institutions. The government would have to take the measures required to close the gap between expenditure trends and targets.

The expenditure rule should be assigned an important role both in budgetary planning and execution and in the parliamentary process. Specifically, budget voting in parliament should be "top-down": first discussion and approval of the overall level of primary expenditure, next its subdivision between current and capital spending, and finally the allocation of spending to specific programmes and line-items. After the passage of the expenditure ceiling, no amendment increasing

[16] Central government capital spending (2.7 per cent of GDP in 2009) includes both direct investment (0.6 per cent) and capital transfers to local governments and publicly owned companies. It is crucial to distinguish transfers for investment from transfers for the settlement of past debts: only the former deserve the same status as central government direct investment.

[17] Balassone and Franco (2000) and references therein.

the outlay for a specific programme or line-item could be passed without a companion amendment reducing expenditure on other programme or items by the same amount.[18]

Such a rule necessitates spelling out the detailed linkages between the overall expenditure ceiling for central government and social security institutions and the line items in the budget. The introduction of the expenditure rule will require accurate and transparent forecasts, whose quality would have to be systematically assessed. It is crucial to avoid underestimating the resource requirements of core services.

Instituting a macroeconomic rule like the one considered here requires comprehensive revision of the procedures for planning and managing public expenditure. Each department's budget allocation would become a rigid limit within which to operate. As Law 196/2009 mandates, the standard is now cash- rather than accrual-basis accounting. Spending commitments would still have to be monitored in order to assess their consistency with cash ceilings, including on a multi-year basis.

The reforms to tighten expenditure control should be complemented by action for efficiency in resource use, along the lines indicated by Law 196 governing the spending review process. Indicators of performance need to be devised for public administrative and service units, such as schools, hospitals, courts. Zero-based budgeting procedures must be devised for evaluating the adequacy of each expenditure item, regardless of past spending levels. These changes would make the allocation of resources more responsive to the changing needs of citizens. They would help set priorities for resource allocation, so as to keep expenditure control from conflicting with the provision of core public services.

In the framework of multi-level fiscal governance, coordination is crucial.[19] The introduction of a ceiling on central government and social security expenditure would therefore have to be complemented by a budget rule for the sub-national governments. A budget balance rule would apply to regional and local governments, which would be allowed to borrow only for capital spending, as the constitutional amendment of 2001 specifies.[20] Recourse to debt financing would be planned considering the targets for the overall general government balance.[21] The expenditure and revenues of sub-national governments would depend on their own decisions. Linking revenues and spending decisions closely would make the regional and local governments fiscally accountable.

[18] Currently, the law provides that the budget balance be voted first, and that spending and revenue plans adopted thereafter must be consistent with the balance decided.

[19] Different countries have chosen different ways of ensuring proper coordination between government tiers. Such federal countries as Austria, Belgium and Germany have adopted an approach based on bilateral negotiations and agreements. In Germany there is an ad hoc institution for *ex ante* coordination between the federal government and the Länder (the Finanzplanungsrat). See, among others, Joumard and Kongsrud (2003).

[20] The implications for stabilization policy are not considered here. In any case, pro-cyclicality can be mitigated by appropriate tax bases, central government transfers and rainy-day funds (Balassone *et al.*, 2007).

[21] Bardozzetti *et al.* (2008) point to the need for a more detailed definition of the golden rule that is enshrined in the Italian Constitution (there are two main unresolved issues: the role of amortization and that of non-investment capital spending). All the other rules that now apply to local government debt should be gradually phased out. Strict regulation is needed to monitor opportunistic financial innovation to circumvent the rule.

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