Ministero dell'Economia e delle Finanze

Bundesbank Lecture 2006

Money and Public Expenditure

Lecture by Minister of Economy and Finance
Tommaso Padoa-Schioppa

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I. Introduction

1. It is a great honor to have been invited to hold this Lecture, following such very distinguished predecessors as Alan Greenspan and, last year, Jean-Claude Trichet. It is also a pleasure, because of the three good reasons I have to feel at home. Firstly, I am once again a guest in the 'Temple' of central banking, where I have been so many times, in different capacities, over the last thirty-five years. Secondly, as a long time resident of Germany, I return to the country where I took part in the most innovative event of contemporary monetary history, the creation of a new currency and new central bank for Europe. Thirdly, and most importantly, I am given the pleasure to see again old time friends and colleagues in this room.

Movements of officials between Finance Ministries and Central Banks have a long tradition in Europe and elsewhere. Most often the move has been from Ministries to Central Banks, as in the case of both ECB presidents and many members of the ECB Governing council. Out of the last five Bundesbank Presidents, four were closely associated with finance ministries (federal or regional) before taking office in Wilhelm Epstein Straße. In my case, the passage was in the opposite direction and, let me say, uphill. Not a new event in the Italian experience, since the time of Luigi Einaudi.

My new assignment has derailed my life from the intellectually active retirement I had planned and has put at risk whatever capital of reputation I may have accumulated in a lifetime. One year after emerging from the relative simplicity of the task of controlling a public money I have been immersed – to the risk of drowning, I can assure you - into the

complexities of controlling public spending. Both these activities lie at the heart of economic policy and the topic of my lecture today will be to draw comparisons and parallels between them. I shall try to look at some of the logical, historical, institutional, practical differences between controlling money and controlling public expenditure.

2. Money and public expenditure share a fundamental and long-recognized feature: they both have an essential public-good character that triggers a need for collective action. Society has to meet this need through appropriate institutions and procedures. Through time and space they both have taken disparate shapes, drawing on a millennial history of economic, political and philosophical reflection on the matter of good governance of money and public expenditure.

In the short span of my professional life, I have seen radical changes in the field of monetary systems, changes that would have been difficult to anticipate. Not only has the very nature of money drastically changed since my first days in central banking (just think of the final severance of the link between the quantity of money and gold), but the principles, the institutional arrangements, the theoretical basis of monetary control have undergone a complete transformation. To be true, the control of public expenditure too has gone through profound changes; suffice here to recall the evolution in the scope of local authorities in the allocation of public resources and the advancement of means-testing in the administration of social security. Yet, the practice of controlling public expenditure remains more controversial in its motivation and scope, more divisive socially and politically, more complex in terms of institutional arrangements and procedures, less sophisticated from a technical point of view. The process of institutional reform, it seems to me, looks as more or less complete for central banking; it is way behind, to say the least, in the field of budgetary policy.

The essential argument I submit to you today is that the field of public expenditure still lacks a satisfactory conceptual framework and still needs a fundamental reflection, similar to those occurred on the principles and practices of monetary policy. I will use the term ‘expenditure’ loosely, without distinguishing among its components, means of financing, or even between the net (deficit) and the gross concept of it (the overall amount of resources commanded by the government in its different levels). ‘Expenditure’ for me

here is the focal point of the permanent struggle that exists, in a democratic society, between the person responsible for preserving the public treasury, on the one hand, and, on the other hand, the many components of society that have legitimate claims on it: political parties, interest groups, even various components of the same government.

3. I will organize my remarks under five headings, which I will title as follows: channels and counterparties; pathologies in control; the art of saying 'no'; cuts versus reforms; choosing under constraints. Let me put each of these five themes in a nutshell and then develop them one by one.

First, *channels and counterparties of control.* A reflection on the different nature of the counterparties to monetary and budgetary policy and on the way they have evolved over time highlights some key differences and similarities between the core business of the central bank governor and that of the finance minister. For the former, the counterparty is the market; for the latter it is usually individuals, of groups thereof. This affects profoundly the nature of the control action and the problems one may encounter in exerting it.

Second, *pathologies in control.* The comparison between controlling money and controlling public expenditure becomes clearer by examining some examples of malpractice. Poor control of money and public expenditure can be equally harmful for growth and welfare, but the mechanisms are different and the awareness of them is unevenly spread among the public.

Third, *the art of saying no.* Rejection or, more simply, saying, as Bartleby, 'I prefer not', is the essence of control. Rejection takes different modalities in the two fields, partly as a result of the fact that, unlike public expenditure - which is materialized in various forms and instances, all perceived to be different - money has a universal character, is handled by everybody in its essential role of medium of exchange.

Fourth, *cuts versus reforms.* These two approaches to control expenditure are different and to some extent complementary. Exploiting their synergy, however, has always proven difficult. Unlike monetary control, public expenditure governance possesses inherent allocative and redistributive elements that prevent delegating the function to an independent agent as it is done for central banking.

Fifth and final, *choosing under constraints*. It is in the public interest that certain 'technical' constraints on budgetary policy are set, because this may be the best way to prevent imbalances and distortions, which clip the wings of the economy. At the same time, such constraints help society express and implement its preferences in a transparent and democratic way. Here is where I see a challenge for future reflection and policy: drawing a clearer line between the technical and the political dimension of public expenditure control, and designing appropriate institutions to facilitate compliance with such criteria and constraints. My short experience in government suggests that the distinction already operates in practice to some extent, and that times are ripe to make it more explicit.

II. Channels and counterparties of control: market vs. individuals

4. In the beginning things were simple: money and public expenditure essentially *coincided*. For the sovereign money creation was the most readily available instrument to appropriate the resources necessary to spend, often in order to build military power. The history of ancient Rome, told us so well by outstanding German historians, abounds of examples of emperors financing their armies by diluting the gold content of coins; in today's terms, printing money.

The linkage between money creation (seigniorage) and public expenditure outlived the ancient world and persisted for centuries; even quite recently, it was a fundamental feature of socialist economies. In market-based systems, instead, such link was weakened by the strengthening of tax administrations and by the creation of financial markets. The latter allow governments to finance their expenditure without resorting to money creation. More recently, and in particular after the experience of the Long Inflation of the 1970s, the separation between money and public spending has been sanctioned conceptually and institutionally by the doctrine and legislation of central bank independence, a process largely inspired by the successful example of the Bundesbank.

Speaking before this audience, I suppose we all agree that monetary control has definitely evolved for the better as a result of these changes. There is now a solid consensus that central banks should be sheltered from day-to-day political interference and left free in the use their instruments, but should also be given a clear mandate and be held accountable to

society and its elected bodies. Most central banks - in industrial countries and, increasingly, in emerging economies - pursue the same market-based approach in regulating the quantity of money, using a short-term interest rate as operational target. This practice has become standard and is underpinned by a deep-seated agreement on price stability as the primary objective of monetary policy.

As you see I have not lost the Frankfurt habit of indulging in modern central bankers' mantra. However, I will immediately disappoint you by saying that, from this viewpoint, I do not see much difference among the different 'strategies' so often and passionately discussed in the profession, be they called inflation targeting, two-pillared structure, or the more nuanced approach preferred by the Fed. In all cases, the pursuit of price stability is buttressed by institutional arrangements that delegate monetary control to an independent and accountable central bank.

All of this is very different from the central banking *Zeitgeist* of my prime, when direct lending to commercial banks played a central role in the regulation of the quantity of money and fervid was the intellectual and political debate on the scope of monetary policy and the desirable institutional arrangements to run it.

5. From my present perspective the evolution in monetary policy I have witnessed – and to some extent engineered - is interesting because there are significant – and, I claim, insufficiently analyzed – parallels between money and public expenditure. Parallels concern particularly the effects on the economy of control, or lack thereof, of money and expenditures respectively. Let me pause on this point.

As I have mentioned, both have a public good dimension, rooted in a failure of a free market mechanism to deliver optimal outcomes. Allow me not to dwell on the theoretical aspects of this important and complex point. Rather, let me stick to the practical features that money and expenditure share as far as their 'transmission mechanism' is concerned. Indeed, for both, the short-term benefits originating from an expansion are likely to be larger than those prevailing over long horizons – indeed the latter turn out to be nil or negative for a monetary expansion and often illusory for an expansion of current expenditures. The analogy extends to two well-known theoretical properties, pertaining to the long-run effects of money and spending respectively: the

neutrality of money and the Ricardian equivalence of tax and deficit financing of public expenditure.

With regard to money, the reason is that over long time spans prices tend to be more flexible than in the short run and, as a result, any real effects of monetary injections tend to eventually vanish, as economic agents ultimately base their decisions on *relative* prices, not on their nominal level. Hume first proposed the concept of monetary neutrality, though he neither called it this way nor proved it empirically.

With regard to public expenditure, at least two arguments are worth mentioning. The first is the "equivalence" proposition, due to Ricardo and elaborated more recently by Robert Barro, according to which debt-financed budgetary expansions become ineffective once economic agents have internalized the future tax implications of the deficits. The second is provided by a growing body of recent empirical analyses, showing that tax-financed expenditure increases are detrimental to labor and growth, particularly over long horizons after individual behavior has adjusted to the new regime. According to this view, to which I only partly subscribe, once again economic agents modify their behavior to the conditions stemming from public intervention. The logic of both views hinge on a time inconsistency problem, linked to expectations, which has been used as an argument to favor delegating monetary control to an independent agency; an argument that – it seems to me – operates in a similar way for both money and public expenditure.

6. There are, however, also important differences, which relate to the nature of the counterparties to monetary and budgetary policy. Take money first. After the abandonment of commodity currencies and the advent of fiat money and financial markets, monetary-policy today no longer operates vis-à-vis an individual and specified counterparty, be the soldier receiving the *solidus*, or the issuer of a debenture a commercial bank brings to the discount windows, or else the Treasury Department of the central government. In modern monetary policy, the counterparty is impersonal, faceless, and the creation of money is completely de-linked from any specific act of spending. The counterparty is the generality of the market, thousands of financial actors sitting in trading rooms or corporate offices. The market is instantly informed by computer screens that the central bank has changed the reference rate, or launched a repurchase operation.

Turn now to public expenditure. Here there is no faceless counterparty, no de-linking from specific acts of spending. This is not the case, and, I suspect, will never be. Deciding on whether and how to spend public money will always involve a direct reference to specific goods, services, interest, human beings: an intimate reference, I would say, since it has concrete and even personal implications to which I shall return. Be they parts of government (for example when cutting an appropriation to a local authority or a fellow minister), labor representatives (when a salary increase is denied to civil servants), or leaders of particular organized interests, it is always individuals or well-identified groups that are denied (or accorded) resources when the finance minister decides it has to reduce (or it can increase) public expenditure.

The identification of the counterparty implies, *inter alia*, that there will always be an important aspect of allocation and redistribution implicit in the control of aggregate public expenditure. Indeed, granting finance to a sector or a program almost invariably implies denying funds to another. The decisions of a finance minister are at the same time technical (what is the total expenditure compatible with fiscal sustainability, or with economic efficiency) and political (where, to whom funds are to be granted within a given envelope).

Unlike the central banker, the finance minister has to explain and justify not only why public expenditure cannot surpass a certain level, but also why that amount is distributed in a certain way. Contrary to the money stock, whose distribution is comfortably delegated by the central banker to the market, the allocation of expenditure is an integral part of the responsibility (of the *pain*, I am inclined to say) of the finance minister whose signature appears in the front page of the budget law.

III. Pathologies in control

7. Pathologies in the control of both money and expenditure can be severely harmful to growth. The mechanisms, however, are different and worth recalling.

The most fearsome failure in monetary control is, of course, the profligate creation of money that leads to inflation and even hyperinflation. This pathology was the first to be recognized as such. Yet, for a long time its awareness did not prove sufficient to avoid its recurrence because monetary financing of public deficits was a standard feature of the

institutional setting. When acute political instability, often in concomitance with wars and revolutions, deranged the control of public expenditure (and of tax collection), the only way out was the resort to the central bank's printing press. The devastating effects were apparent to all citizens and eventually paved the way for public support to an independent central bank, prevented by law from providing monetary financing of budget deficits. Let me note, in passing, that independence of central banks is not to be taken for granted. Parliaments and the public can always change their mind, and many economists – most notably the proponents of the fiscal dominance theory of price stability stemming from the seminal paper by Sargent and Wallace – are convinced that they will, if fiscal imbalances become too large.

Inflation, i.e. an erosion of the allocation function of the *numéraire* not as dramatic as hyper-inflation, took longer to be recognized as a pathology, both in theory and in practice. In the 1960's plenty of theoretical growth models advocated a quantum of inflation as beneficial for capital accumulation (those by Tobin and Sidrauski are the best-known examples). The diverse monetary policy responses to the oil shocks of the 1970's and 1980's show that, back then, monetary accommodation of supply shocks was viewed by several central banks as a sensible strategy to minimize output losses from supply shocks. Moving from there to the currently prevailing view that any departure from price stability is harmful to economic activity and social welfare was a lengthy and difficult process. Radical changes in monetary theory and equally profound transformations in central banking institutions were the result of this process.

Poor monetary control leading to an insufficient quantity of money is a not less harmful pathology. Again it takes two forms. First, the creeping form of generalized deflation, when the general price level falls as a result the insufficient quantity of money provided by the central bank. Second, the crisis type of credit crunch and asset deflation, when several solvent but illiquid financial intermediaries go burst, with the devastating effects on economic activity famously experienced during the Great Depression.

8. Now, in the case of public expenditure poor regulation in both directions is harmful to growth and welfare, just as in the case of money. The problem finance ministers typically fight with is to curb *excessive* public expenditure, but the *insufficient* provision of some

indispensable public goods – from infrastructures to education, from research to healthcare – also damages development and competitiveness. It often happens, in fact, that under-spending, at least in some areas, is the eventual consequence of earlier profligacy. I see examples in Italy today. This is why, as I will argue in a moment, expenditure cuts, which are necessary to reduce public debt as a proportion of GDP, cannot be seen separately from a process of reform to improve the *quality* as well as the *distribution* of public expenditure.

For public expenditure, the notion of 'excess' is less straightforward than for money – where the excess can be unambiguously identified through its direct implication: inflation. Indeed, public spending can be 'excessive' with reference to at least three different benchmarks:

- excessive with respect to *tax revenues*, this is the issue of deficit spending that leads to the unsustainable accumulation of public debt;

- excessive with respect to the *public service* offered to the citizens, this is the inefficiency in the public sector, fostered by waste, inappropriate organization and poor administration that open opportunities for X-inefficiencies;

- excessive with respect to *private spending*, i.e. to the allocation of privately-supply goods and services. This is the issue of the 'optimal size' of the public sector in the economy.

Excessive public spending in any of the three meanings is harmful to growth and welfare. Let me briefly touch on them in turn.

9. Too much expenditure with respect to *tax revenues* leads to fiscal imbalances. Their macroeconomic implications are, in theory, as well understood as those of inflation and, in practice, avoiding them is part and parcel of the widely-agreed recipe for sound economic policy-making. However, between excessive deficits and excessive money there is a crucial difference: the damages of the former hit the general public with a longer time lag than those stemming from the latter. In the euro area, the problem is compounded by the fact that the common currency has shut down the most visible warning signal: currency depreciation. In Italy, for example, the foreign exchange crisis of September 1992 was an extremely powerful trigger of action in the budgetary field. As a result, public awareness

of the harmful implications of excessive public expenditure (excessive in the deficit-spending sense) is less widespread than the understanding of the inflationary damages from excessive money.

10. Poor control of public expenditure has harmful implications for growth through the micro channel of the *inefficiency* in the provision of goods and services. Resources are wasted if ill-devised organization and inadequate administration result in 'bad value for money' for the tax payer (often to the benefit of the Niskanenan, if not Hobbesian, bureaucrat) and even in the sheer dissipation involved by useless public-spending programs. In monetary control there used to be an analogous pathology, which no longer applies in the market-based regulation of money: the re-financing of clearly insolvent intermediaries. In both cases, resources are diverted from better uses, cutting back productivity and reducing welfare.

11. Finally, economists have argued that public expenditure can be 'excessive', and hence detrimental for growth, even when it is not debt-financed and no X-inefficiencies occur.

According to some, the alleged harm would simply stem from distortions caused by indirect taxation and disincentive effects of income taxation. While I fully recognize the danger of an oversize public sector, I do not see the distortion-disincentive argument as sufficient ground for claiming that public expenditure is bad per se. The issue remains controversial, at least as regards the pinning down in practice of the 'excessive' level, as shown by the wide spectrum of revealed social preferences for the general level of taxation and the corresponding level of public services. Recent analyses have suggested that the "Nordic" social model can perform as well as the "Anglo-Saxon" one on grounds of efficiency, while it clearly outperforms it on grounds of equity.

Different notions of 'excess' in public spending underpin yet another mechanism that makes the awareness of the damages from excessive spending less pervasive in the society than the appreciation of the scourges of inflation. It is a fallacy of composition in the citizens' perception of public expenditure. Inflation is a general feature of the economy, typically perceived as such by the public. It is, therefore, generally appreciated that lowering inflation regards, so to say, inflation in its entirety. Conversely, for public

expenditure, the acceptance of the fact that its 'total' level is excessive (in any of the three notions discussed above) can happily go along with the deep-seated belief, held by its direct or indirect beneficiaries, that each particular segment is not excessive and cannot possibly be reduced. The burden of adjustment must fall on the other, 'genuinely excessive', components. This perception indeed stems from the fact that, as I will argue, for every citizen money public expenditure is 'less universal' than money.

IV. The art of saying 'no'

12. Learning to say 'no' effectively and with style, without being misunderstood or antagonizing the recipient of the unpalatable answer, is a basic interpersonal skill that one never stops honing. The psychology is invariant whether the addressee of the denial is a friend, a work colleague or dependent, or, the case I want to focus on, a claimant on public resources. The art consists in making the negative answer, if not agreeable, at least *accepted*, something one can try to attain through a proper mix of prior consultation (or at least the perception of it) and ex-post explanation.

Being able to say 'no' is a crucial and difficult ingredient of successful control of both money and public expenditure. Once again we find basic analogies. First and foremost, in both cases an inter-temporal dimension is involved: a trade-off between today and tomorrow, short and the long run, this generation vs. the future ones. In the frequent cases when denial is sooner or later unavoidable, saying 'no' today is immediately unpleasant (for the speaker and the listener), but paves the way for a better future (again, for both and their offspring).

13. Beyond this fundamental analogy, the 'no' about money and the 'no' about public expenditure are expressed in very different forms and institutional settings. These days I tend to recall and repeat all too often that saying 'no' to someone means to say 'yes' to someone else. For example, in our ageing Europe, saying a marginal 'no' to pension beneficiaries today means saying 'yes' to their grandchildren. Similarly, opposition to specific expenditure-cutting measures should, before even being considered, be accompanied by equivalent suggestions for cuts in other areas or to raise the revenue. This 'balanced budget constraint' is a form of intellectual, political and economic discipline

which, in my view, should govern any sensible debate on expenditures. My very short experience in government suggests me that finding ways to internalize this discipline is a crucial challenge facing budgetary policy in our days.

As I said, the 'no' of monetary control today is said to a faceless market, no longer to individuals. This stems from historical evolution and also reflects the universality of money: there is nobody above ten years of age, or even less, who does not own and deal with money in its everyday experience. The daily contact with it is accompanied by the understanding that money comes, so to say, *before* the act of spending and as such is, and is perceived to be, generic, one and the same thing. This, of course, holds in qualitative terms; in quantitative terms, individual relations with money vary widely across society, as we all know.

14. The creation of money happens by means of private contracts between the central bank and its counterparties. Once the law has established the institutional framework for the conduct of monetary policy, the daily control of the quantity of money takes place through open-market operations, which have the legal and operational structure of private transactions. Money is intrinsically fungible, and thus the market can take care of its distribution, once it has been injected in the economy.

By contrast, public expenditure is not fungible. It comes in different forms that serve specific purposes, each of them benefiting someone more than others. Some form of 'universal' public expenditure can be found in economics text books, when the notion of public good is explained. Yet, even the text-book examples of non-excludable, pure public goods in reality turn to be favored by specific parts of society. Take the example of defense, which is typically put forward as the case in point of public expenditure equally benefiting all citizens. In reality, defense is perceived to 'benefit more' certain categories of citizens, such as the military directly employed in the army or the shareholders and workers of defense contractors.

More generally, at each point in time citizens do not directly experience public expenditure in an undifferentiated way, as they do with money. Rather they come across public expenditure in the piecemeal fashion of bilateral relations. These relations can be grouped into two general classes: benefiting from specific goods and services provided by

public entities (or publicly financed or subsidized); being employed by public entities.

In everyday life, all citizens benefit from a vast array of public expenditures, often being aware of it. The form and the intensity of the benefit vary widely across individuals, depending on their preferences and characteristics such as age, residence and occupation. It is thus hardly surprising that, for each citizen, public expenditure has little, if any, universal character. It is, instead, a loose common denomination for quite heterogeneous elements. The specificity, or lack of universality, of public expenditure is even more marked on the production side of public goods and services. Public employees who see their job in jeopardy as a result of a reduction in the public supply of a particular good or service have a specific 'private' interest and feel unjustly singled out by the cut, no matter the general interest behind it.

15. All public services have (or should have) a public good element, bring a benefit to society at large, including those that only have an indirect relation with the production or consumption of a particular type of public expenditure. Even those who do not like opera enjoy the improved mood of publicly-subsidized opera goers. Yet, the interest in each type of public expenditure and the perception of its worth in terms of tax levied to finance it, vary widely across society. Each citizen (or group of citizens) has a strong interests in only a relatively narrow part of the spectrum of public goods and services and consequently defends their continued or expanded provision from the curbing needed to control expenditure.

The implication of all this is that, by contrast to the general, impersonal 'no' said in monetary control, for public expenditure the denial is invariably perceived as addressed to a well-defined category, which typically enjoys a specific political representation and feels inclined to use it to resist the cut. This fundamental difference in the art of saying 'no' about money and public expenditure lies at the heart of the different political implications, institutional arrangements and decision-making process that underpin the two types of control.

V. Cuts versus reforms

16. Unlike in monetary control, public expenditure control takes place not through *private*

transactions but through *public* acts, typically bills approved by Parliament and administrative decisions and procedures implementing those acts. In virtually all countries the bulk of law-making through which public expenditure is controlled is clustered in the yearly Budget.

Budget procedures vary across countries, as do forms of government and electoral laws. These institutional features determine the way the various interests in society coalesce in the political decision to approve the Budget law. Economic research has shown that these institutional features have profound influences on the level and composition of public spending. This however is not an issue I want to discuss today. Irrespective of the specific feature of the budget procedures, there is one aspect that makes the modus operandi of public expenditure control different, and more complex, than that of monetary control.

17. In the monetary field, once a given change in policy has been decided, there is essentially only one way in which it can be implemented; for example, a monetary restriction unambiguously requires the central bank to curtail its plan for repurchase operations and to adjust the reference rate accordingly. This lack of ambiguity in the operational implications of a policy decision is the result of a long reform process in central bank operating procedures that has eventually led most central banks to adopt broadly similar operational "styles". Consequently, the debate on central banks tactics in recent years has concentrated on other issues, such as timing (i.e, whether gradualist or preemptive approaches should be preferred) and communication (preannouncement of rate changes, vs. surprising the markets).

In the field of public expenditure, control requires a further, important choice, concerning *how* to implement a restriction, specifically between two approaches that I will label, for simplicity, "cuts" and "reforms".

The first approach is to affect expenditure decisions directly, at the level of spending units, at the central or at the local level. It consists in imposing limits, in the form of guidelines or ceilings, to the different budget items, or cash limit to the disbursements these units can make ("cuts"). The effectiveness of this approach hinges on the flexibility on the underlying government structure. In the most extreme case, ceilings

and limits are set leaving the legal and regulatory provisions governing the expenditure dynamics unchanged, simply superimposing the cuts on them, by law or decree. This approach typically produces quick, clearly visible short term effects on the expenditures as recorded by official statistics. However, of the underlying structure is not flexible enough, it tends to generate unrecorded obligations by the public administration towards a number of parties (suppliers, workers), in the form of arrears or other forms of debt. Occasionally, it also forces certain unavoidable expenses to be abruptly stopped, though necessarily only temporarily: this is the case, for example, when the object of the cut are key maintenance expenses on the capital stock necessary to provide certain public utilities or services (roads, rail, power or water supply). In either case, the benefit to public expenditure is transient, often leading to equal or even higher expenditures later.

The second approach ("reforms") consists instead in intervening in the expenditure generating mechanisms; for example, better internal control mechanisms can be introduced to government offices, or stricter result-based remuneration and recruitment systems for public employees can be set up, or, going more deeply, the network of government offices through the country can be streamlined. In this case the short run impact may be small or negligible, while the beneficial effect builds up only overtime. For this and other reasons, there is often more political opposition to reforms than to cuts, particularly if the latter are perceived by public administrators as transient, and thus not requiring a change in normal spending practices.

The reformist approach goes hand in hand with the need of ensuring the quality of public expenditure. In a changing economic and social environment, the combination of efficiency in the provision of public goods and fairness, or equity, can only be achieved through a constant action of reform. Modernizing the State, the administration, the organization of public services is difficult: technically, because it requires identifying the way institutions and their functioning need to be modified; politically, because old and inefficient structures give rise to privileges and rents, which their beneficiaries do not call by this name and fight hard to protect, defending the status quo.

The conclusion to which I am coming based on my recent experience is that cuts and reforms are complementary approaches. Indeed, reforming the institutions responsible for public expenditure (ministries, local administrations, universities) so as to make them more flexible and efficient is the only way to make cuts effective and permanent.

Improved efficiency and clearer definition of entitlements free resources for better uses. However this complementarity proves difficult to apply in practice, for a simple reason: while the voice of their opponents is immediately heard, benefits from reform typically become apparent only after a long lag. This difference in time horizons severely strains the political process.

VI. Choosing under constraints

18. I now come to the last and conclusive theme of my argument. Controlling expenditure always has to balance technical arguments and constraints, with the legitimate and competing claims (often drawing on very different ideological *Weltanschauungen*) on the resources managed, directly and indirectly, through the political processes. Balancing the two elements is a difficult exercise, as I experience on a daily basis.

Political economists have blamed the difficulty on the fact that the time-horizon of a typical political cycle is shorter than the one relevant on average for the society as a whole, in turn leading the legislature to attribute a smaller weight to the long-run implications of public expenditure policies than it would be socially desirable. Empirical evidence shows that discretionary public expenditure tends to rise before the elections irrespective of the political orientation of the incumbent government, and also in spite of the weak evidence of a relation between the size of pre-election spending and the election outcomes. The politicians' short horizons and the long lag between reforms and their beneficial effects gives rise to a pervasive tension in expenditure control.

For Faust, the lure of Mephistopheles' services is greatly enhanced by the fact that the price – albeit a terrible one – is to be paid later. For politicians, the lure of the support obtained through public expenditure is similarly enhanced by the fact that public debt will be paid (o reneged) by next generations, often well after the end of one's political career. As to myself, having inherited a public debt larger than GDP, and having committed myself and my government to comply with sound fiscal principles, I scarcely can afford even to contemplate the possibility of accepting Mephistopheles' services.

This political-economic interpretation has led to the proposal of delegating (part of) budgetary policy to an independent and accountable institution, shaped along the lines of a modern central bank and endowed with a specific mandate to be autonomously

pursued, as is price stability by monetary policy. Despite its intellectual appeal, such an institutional device has never found practical application and stands little prospects to find one in the future. Even assuming that consensus could be built on a mandate for an independent fiscal authority, as I have argued, its policies would unavoidably have allocation and redistributive implications that, in a democracy, can only be assessed on the basis of the electors' mandate. No technocrat, however benevolent and well-versed in Harberger's triangles, can replace the political mediation necessary to solve redistributive issues without severely impinging on the foundations of democracy.

19. I think a more promising approach is to view the compliance with the constraints posed by the sustainability of public finances and the efficient functioning of a market economy as the basis to endow democratically elected policy-makers with the freedom to allocate and redistribute the available resources. I believe that the two functions – respecting the budget constraints and fulfilling economic efficiency on one side, implementing the citizens' desires in the field of public expenditure on the other – should be seen as complementary, not conflicting.

To this aim, the success achieved in building stronger monetary institutions in the last quarter-century suggests there is need and scope for designing stronger budgetary institutions. This analogy suggests areas of reform to set up institutional mechanisms for determining medium-term budgetary deficit paths ('sustainable') and expenditures and revenues envelopes ('efficient' as well as consistent with the 'allocation preferences' of the society). These are natural choices because the indications from economic analysis are clearer, and the potential damages from pure discretion stronger.

One avenue worth exploring is the definition of processes to set multi-year binding commitments for these variables which enjoy supra-legislative status and possibly the same wide support that constitutional provisions usually have. In some cases these magnitudes already tend to be sheltered from current politics; for example, in Italy the Parliament approves every year multi-year targets for the main aggregates of public finances, to which Governments should – in principle – be bound in preparing the yearly legislation. Also the short-term political game for the appropriation of resources would be facilitated if these magnitudes were set in advance – much like in tennis, where the game

is easier if the end-court line is clearly visible. My recent experience suggests a growing awareness of the benefits that such institutional arrangements could bring about even in a country like mine that traditionally lacks a systematic track-record for an efficient and effective control of public expenditure.

VII. Finally, a plea and a hope

20. As I close these remarks, I realize I have probably expressed more doubts than certainties; surely I have advanced more questions than I was able to answer. Though perhaps disappointing, this fact not only reflects the state of my own reflection on these issues, but also matches the feelings I had when moving from the tidy, clear-cut, well-disciplined world of monetary control to the much more complex, often confused, uncertain, even treacherous one of public expenditure control. For this reason I hesitate to label "conclusions" my final remarks, in which I want to express a plea and a hope.

The pleas is addressed to the many central bankers in this room, most of which are involved, at various titles, in functions related to controlling money in the euro area. The process of institutional reform I have advocated for expenditure control needs to be supported by much more theorizing, empirical study and institutional analysis than is available at present. It took thirty years of efforts to go from the seminal ideas of Friedman, Prescott and Lucas to the statute of the ECB, the institutional expression of those ideas. In the case of central banking, most of the work was carried out in academic departments and in central bank research sections. Symmetry and fair burden sharing would suggest that, when the time comes to reforming the public expenditure process, economy and finance ministries should play their role; but I doubt this will be the case.

Staff of ministries, no matter how highly qualified, are often too focused on short term decision making, too sensitive to the needs of politics, or simply too overburdened, to be able to engage in abstract elaboration. Once again, I submit, a significant contribution could come from central banks. Eurosystem central banks, perhaps, since an improvement of the institutions governing the expenditure and budget processes in euro area countries will be vital, in the coming years, for the successful survival of the euro.

Finally, a hope. Much, probably too much – as I realized after I finished drafting – of this lecture is devoted to the meaning, the reasons, the ways of saying "no"; "no" to

more money, “no” to more spending. As justified or even inevitable as this may be, one must recognize that a permanent inclination to negate is hardly the best way to make us economic policymakers more popular, or for that matter to brighten the reputation of a discipline – economics – that so many people insist calling “dismal”. It is my hope that the successful pursuit of reform in the governance of public expenditure, following that in central banking, will facilitate in many countries, starting with my own, a mindset change that will make promoting good public financial policies easier and more acceptable to the society, eliminating or at least softening the tensions that this still tends to generate. This means, first and foremost, making discipline (financial discipline, in this case) more deeply felt within each individual, rather than imposed from outside. This is, I believe, the essence of the culture of stability that this country, Germany, and this institution, the Bundesbank, have so much contributed to promote.