

ACCRUAL BUDGETING AND FISCAL CONSOLIDATION IN THE E.M.U.

F.JAVIER SALINAS*

Abstract. Drawing on modern macroeconomic literature focussing on the study of politico-institutional determinants of public policies, this paper analyzes the institutional design of the European fiscal policy laid down by the Treaty of Amsterdam and the Stability and Growth Pact. Both documents provide countries in the EU, and in particular those which have adopted the Euro, with a common code of fiscal conduct that is expected to uphold discipline in the management of government finances. Nevertheless, a simple review of this code of conduct shows the existence of serious drawbacks mainly derived from the asymmetry between the treatment given to outcomes of fiscal policy in comparison with that given to the procedures followed in generating them. It seems that the current design of the European fiscal co-ordination system disregards the findings of modern macroeconomics and neglects the relationship between budgetary processes/institutions and outcomes in fiscal policy. Moreover, this paper argues that, in the implementation of the broad reforms needed to achieve a sustainable fiscal consolidation, there are political complementarities (in the sense that the ability to gain political consent for one reform depends on the acceptance of other reforms) between the setting up of new fiscal policies of expenditure containment and new fiscal procedures.

All in all, this analysis points to a sorely needed procedural reform in public sector budgeting as the best contribution to pursuing the stabilization of European public finances: the fuller use of accrual concepts in budget reporting. Much more than an isolated technical exercise, the shift to accrual budgeting could be quite a useful tool to facilitate wider reforms aimed at improving public sector financial management and performance while enhancing transparency and accountability.

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I.-INTRODUCTION

The purpose of this paper is to call attention to the important role that reforms in current national budgetary procedures play in ensuring that the fiscal consolidation undertaken in the EMU is a sustainable and credible process. Along this line, an argument is made for the fuller use of accrual concepts in Member States' budget reporting.

The paper concludes that accrual budgeting should be considered as a crucial contribution to pursuing the stabilization of European public finances. Much more than an isolated technical exercise, fuller use of accrual concepts in budget reporting is quite a useful tool to facilitate wider reforms aimed at the sorely needed

improvement of public sector financial management and performance while enhancing transparency and accountability.

The paper is organized as follows: Section 2 reviews modern macroeconomic literature focussing on the study of politico-institutional determinants of public policies. Normative developments of this literature point to three main institutional arrangements that should be conducive to fiscal discipline:

- 1). The existence of rules tying fiscal authority hands.
- 2). Hierarchical budget procedures.
- 3). Budget transparency.

Elaborating on the aforementioned pioneering work, section 3 analyzes the institutional stability framework of the European Economic and Monetary Union. The Treaty of Amsterdam and the Stability and Growth Pact provide countries in the EU, and in particular those which have adopted the Euro, with a common code of fiscal conduct that is expected to uphold discipline in the management of government finances. Nevertheless, from a political economy point of view, a simple analysis of this code of conduct shows the existence of shortcomings mainly derived from the asymmetry between the treatment given to outcomes of fiscal policy in comparison with that given to the procedures followed in generating them. It seems that the current design of the European fiscal co-ordination system disregards the findings of modern macroeconomics and neglects the relationship between budgetary process/institutions and outcomes in fiscal policy. Moreover, it is argued that, in the implementation of the broad reforms needed to achieve a sustainable fiscal consolidation, there are political and economic complementarities between the setting up of substantive (reduction of

expenditures programs) and systemic (changes to budgetary processes) budgetary arrangements.

Section 4, after briefly recognizing the growing importance being given to fiscal rules and hierarchical budgetary institutions in the EMU, takes a closer look at the accounting transparency required by the current system of multilateral surveillance of national budgetary policies, and points to the potential benefits derived from a shift to accrual budgeting.

Section 5 closes the paper with some concluding remarks.

II.- BUDGET INSTITUTIONS AND FISCAL PERFORMANCE

There has been recent lively literature in modern macroeconomics explaining the large variance of cross-country fiscal experiences in coping with similar economic events by focussing upon the procedures which lead to the formulation, approval and implementation of government budgets¹. In the words of Alesina and Perotti, on the issue of cross-country differences in fiscal positions the central question to be asked is: " Why did certain OECD countries, but not others, accumulate large public debts (when the economies of the OECD countries are relatively similar)?" These authors advance their own hypothesis to answer this question: " it is difficult to explain these large cross-country differences using economic arguments alone...We believe, instead, that politico-institutional factors are crucial to understanding budget deficits in particular, and fiscal policy in general." (Alesina and Perotti 1995, p.2).

Consistent with the above premise, two strands of research derive from the positive analysis of this literature:

a) One avenue of research focuses on political conflict and polarization as a source of public-sector deficits, i.e. it analyzes political environments where policy makers have incentives to create large deficits (Alesina and Drazen 1991).

b) The other describes the weaknesses of political institutions and specifically of budgetary institutions allowing large deficits to emerge (Alesina and Perotti 1996).

These two strands of research should be regarded as complementary since they both lead to the same basic conclusion: " budget procedures and budget institutions have significant impact on fiscal outcomes" (Alesina et al. 1999, p.255). The basic argument underlying this conclusion is that -in contrast to what is commonly assumed in traditional models of public finance- governments should not be regarded as unitary actors. Instead, governments are collective entities consisting of many different actors who do not need to share the same goals. In the current political context, at least there is a distinction between spending ministers and the minister responsible for the budget inside the executive branch of government, and between the executive and the members of the legislature. Standard social choice theory informs us that unstructured collective decision making of individuals with conflicting goals is irrational, unstable and unpredictable. Therefore, institutions play the role of generating stability and predictability. Yet, in addition to that, institutions "distribute power and channel flows of information, and in doing so they shape the outcome of the policy process. This is why institutions regulating the budget process affect fiscal discipline" (von Hagen, 1996, p.273).

The improvements made in the understanding of the political economy of fiscal policy have allowed this literature to distill a normative approach in searching for those institutional arrangements that should be more conducive to fiscal discipline. Here the empirical findings point to these three main insights.

- a) Rules which establish ex ante constraints on fiscal policy, typically defined in terms of an indicator of overall fiscal performance, should lead to more fiscal discipline (Kopits and Symansky, 1999).
- b) Hierarchical institutional arrangements may be conducive to fiscal discipline. Budgetary institutions are considered more "hierarchical" if they encompass rules that: 1) attribute strong agenda setting powers, or veto powers to a single minister (usually the Treasury or Finance Minister) over the spending ministers; 2) set strong prerogatives to the government vis-a-vis the legislature in the approval of the budget; 3) limit the prerogatives of the Executive to introduce modifications in the budget in the moment of the implementation of the budget law. (von Hagen 1992).
- c) Transparent procedures stand out as probably the most important institutional arrangements fostering fiscal discipline. Application of fiscal rules without appropriate arrangements that guarantee transparency is likely to lead to circumvention and distortions, which ultimately erode the effectiveness of rules. The budgets of modern economies, particularly those of countries with large public sectors, are very complex. Politicians do not always have incentives to produce the most transparent budget. By strategically manipulating

information, they can appear as fiscally-restrained even when they actually are fiscally undisciplined for opportunistic reasons. Lack of transparency helps to create confusion and ambiguity about the real state of public finances, by hiding as much as possible of the current and future tax burdens, overemphasizing the benefits of spending, and underestimating the extent of current and future government liabilities. Moreover, there is the possibility of the existence of real liabilities not included in the budget, and of implicit fiscal guarantees by the central government to state and local governments, public enterprises and the banking sector (I.M.F. 1998).

In summary, two lessons can be learned from the aforementioned pioneering work in modern macroeconomics: 1) to uphold discipline in the management of government finances, budget procedures matter; 2) in the effort to achieve sustained fiscal consolidation, it is worth searching for those institutional arrangements that should improve fiscal performance.

III.- INSTITUTIONAL DESIGN OF FISCAL POLICY IN THE EMU

In the light of the political economy of government fiscal performance, the analysis of the institutional stability framework of the European Economic and Monetary Union (EMU) offers important insights and raises relevant questions. In the context of this paper, the institutional stability framework of the EMU is contemplated in terms of the budgetary rules that both the Treaty and the Stability and Growth Pact embody. The Treaty refers here to the consolidated version of the Treaty of

the European Union provided by the Treaty of Amsterdam, which came into force on 1 May 1999. The Stability and Growth Pact (SGP) consists of a Resolution of the European Council (Amsterdam, 17 June 1997)² and two ECOFIN Council Regulations³: Council Regulation (EC) No. 1466/97 and Council Regulation (EC) No. 1467/97 both of 7 July 1997.

First of all, it is worth mentioning that the aim to achieve sound government finances as an indispensable requisite for macroeconomic stability figured high on the agenda of the founders of the EMU. At the same time they held the belief that the overall macroeconomic policy mix of the euro-area would result essentially from the interaction of the single monetary policy on the one hand, and the specific budgetary developments (and wage trends) in the participating countries on the other. Despite the progress towards fiscal consolidation made in virtually all Member States of the EU in the recent past, there was the feeling that additional progress was required at stage three of the EMU for the following reasons:

- 1) Sound fiscal policies and low tax burdens facilitate the task of monetary policy to maintain price stability.
- 2) Durable fiscal consolidation, by fostering low interest rates, will generate a crowding-in of private investment, will help a self-sustaining, non-inflationary economic growth process, and eventually higher employment.
- 3) In many countries, budgets close to balance or in surplus are sorely needed in order to regain the necessary room for manoeuvre to cope with adverse economic developments.

Proven budgetary discipline will strengthen the confidence of economic agents that a rising deficit, while allowing automatic stabilisers to play their role fully, will not permanently disrupt the public finances, thereby avoiding any adverse effects emanating from the financial markets.

- 4) Fiscal retrenchment will allow speedy reductions in the public debt ratios as well as in the debt service burden. It will facilitate the lowering of the tax burden, the restructuring of government outlay, and will make it possible to prepare budgets for facing the strains that are expected to emerge after the middle of the next decade in view of ageing populations.

To this end, Member States anchored the continuity of budgetary adjustment to the signing of the Treaty and the adoption of the SGP in June 1997. They both provide countries in the EU, and in particular those which have adopted the euro, with a common code of fiscal conduct that is expected to uphold discipline in the management of government finances. Nevertheless, it seems rather obvious that the founders of the EMU have established a stability framework that completely disregards the lessons offered by the literature on politico-institutional determinants of government budgets.

As mentioned above, a widely voiced rationale for the current stability framework has been to offset Member States' bias towards excessive deficits (Eichengreen, 1993, p.1348). The experience accumulated in past decades has shown that increased debt ratios limit the scope for fiscal policy to act as a stabilizing instrument, reduce the effectiveness of monetary policy, increase fiscal crowding out,

raise the tax burden and make funding social security liabilities more difficult. The search for a solution has led to the laying down of an economic constitution which discourages unsound fiscal practices and builds an institutional framework that fosters macroeconomic stability conducive to sustained growth in output and employment. Thus, the rules of fiscal restraint enshrined in the SGP try to lead Member States' budgets to balanced positions or in modest surplus in expansions, with deficits widening to as much as 3% of GDP in contractions.

However, this rationale has drawbacks as well as positive aspects. On the positive side, one may point to the setting up of an economic constitution providing commonly shared rules of fiscal restraint for all Member States. In contrast with the existence of a single monetary policy, in stage three of the EMU budgetary policy remains an exclusive competence of Member States. In a monetary union there are no longer interest rate differentials that used to penalize misguided fiscal behaviors on the one hand, and on the other, as national financial markets become more integrated, sovereign issuers can draw on a larger and more liquid capital market. Consequently, for national policy-makers, borrowing becomes a more attractive option than non-deficit spending as a means of financing public expenditure. This feature by itself calls for subjecting national budgetary policies to common rules of budgetary discipline suitable to overcome any existing deficit bias in the euro area as a whole. Moreover, when the fiscal authority is dispersed, fiscal profligacy pursued by individual members of a monetary union may have negative external effects on their neighboring economies. In theory, market forces could act as an effective deterrent against errant fiscal choices. Yet in practice, there is no evidence that the discipline exerted by financial markets has been sufficient to induce governments to always take heed of

long-term budget constraints. Therefore, there are sound arguments for supplementing market forces with commonly shared rules of fiscal discipline (Masson,1996 , p. 99).

Indeed, there are those who underestimate the risks and consequences of a public debt crisis and the likelihood of interest rate spillovers, that it downplays the inflationary consequences of high public debt, and too quickly conclude that fiscal restraint rules for the EMU are not desirable (von Hagen and Eichengreen, 1996; Eichengreen and Wyplosz, 1998). Their underlying argument seems to reflect the idea of an unavoidable trade-off between fiscal consolidation and structural reforms. In the words of Eichengreen and Wyplosz: " (national) leaders have a fixed amount of political capital that they can allocate to politically costly fiscal reform or politically costly labor market reform. To the extent that they invest in one, they have fewer resources left to devote to the other" (Eichengreen and Wyplosz, 1998,p.69). Nevertheless, this stance is not warranted. The experience of those countries within the EU which have been front-runners in redressing fiscal imbalances, while at the same time implementing wide-ranging structural measures, gives the lie to the idea that the two policy lines should be addressed as alternative options. It is obvious that the core of structural reforms is the efficiency gain to be achieved. Similarly, fiscal consolidation programs focused on tax reductions are certainly critical for the compensation of efficiency losses that have been accumulated through decades of unrelenting growth in the size of governments. In addition, the restructuring of government expenditure away from current transfers and in favor of public investment is a powerful tool by which to revitalize the growth potential of European national economies, and consequently their manpower absorption capacities. Therefore, not only is there no trade-off between fiscal

consolidation and structural reform, but rather they should be pursued as complementary and mutually reinforcing means of the same strategy.

On the negative side, one of the most compelling drawbacks of the current EU stability framework lies in the asymmetry between the treatment given by the wording of the above mentioned code of conduct to outcomes of fiscal policy, in comparison with that given to the procedures followed in generating them. The ambiguity of the single reference made to fiscal procedures in comparison with the specific evaluations of deficits and public debt seems odd. This single reference can be found in article 3 of the Protocol on the procedure applicable in case of excessive deficit where it is established that: "The Member States shall ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from this Treaty". One must reach the conclusion that the current EU stability framework completely neglects the relationship between processes and outcomes in fiscal policy. The EU, while requiring from member-countries the fulfillment of certain budgetary goals, leaves national authorities with the choice of the most adequate budgetary procedure for attaining these goals, as if budgetary processes were either neutral or irrelevant to these goals. Here, the objection made by Eichengreen and Wyplosz to the SGP because " it suppresses the symptoms without eradicating the disease" is valid. As these authors correctly point out: "if EU policy-makers fail to remove the underlying disorder -identified by the institutional school...- then imposing numerical caps on budget deficits only encourages devious behavior to meet the letter but not the spirit of the law." (Eichengreen and Wyplosz, 1998, p.76)

In line with the shortcoming outlined above, the current design of the EU stability framework shows problems of credibility. Attaining and preserving sound government finances as a means of strengthening the conditions for price stability and sustainable growth in the EU requires a clear and strict co-ordination of national fiscal policies. Yet, this co-ordination faces the problems that characterize the production of public goods. Decentralized stabilization policies may entail free-riding behavior so that Member States may not be willing to provide necessary fiscal stimulus or restraint, because a large part of the benefit would accrue to other countries, or because their fiscal position may already satisfy their domestic needs. To overcome these problems, the ECOFIN Council is required to formulate broad guidelines for the economic policies of the Member States and to monitor economic developments within a multilateral surveillance system linked to financial sanctions. In this regard, it should be stressed that there is a sharp difference between two kinds of Member States' commitments enshrined in the present institutional framework⁴ (North, 1993). With regard to the financing of public sector borrowing requirements, the Treaty implies a commitment of the signatory States the credibility of which is based on imperative grounds; i.e. it is an imperative commitment. The Treaty explicitly stipulates a prohibition on overdraft facilities or any other type of credit facility with the European Central Bank or with national central banks in favor of any public sector institution at the national or Union level. It also prohibits the ECB and the national central banks from purchasing debt instruments directly from these institutions (unless this is based on prudential considerations). Furthermore, the Treaty, by its "no bail-out clause", prohibits that the debts of public sector institutions of any Member State could be assumed by the Union or by any other Member State. In consequence, all the mentioned restrictions on the financing alternatives of public sector borrowing are legal

commitments that impose themselves upon Member States by the very existence of the binding rules enshrined in the Treaty. In principle at least, this implies that the enforcement of this commitment relies not on the will of Member States but on the Court of Justice (under articles 169 or 170), and that generates greater confidence.

As opposed to the binding rules affecting the financing of public debts and deficits, the multilateral surveillance of national budgetary policies set out by the present institutional framework is basically a non-binding procedure. The guidelines for economic policy are set out in a (non-binding) recommendation of the ECOFIN Council. The same is true if the economic policies of a Member State are inconsistent with the guidelines of risk jeopardizing the proper functioning of the EMU: the best the Council can do is to address a confidential or public recommendation to the Member States concerned. Therefore, co-ordination relies exclusively on exchange of information, publicity, and peer pressure (European Commission, 1997). The enforcement of the SGP relies on the possibility of sanctions -acting as a deterrent- against non-compliant Member States. But the imposition of sanctions does not substitute for the lack of appropriate policy co-ordination (Cangiano and Mottu, 1998, p25).

As regards the excessive deficit procedure, the Treaty does not entrust the judgment on what constitutes an excessive deficit to the Court of Justice. Instead, the power is given to the Council (without however depriving the Court of its powers under article 173 to review the legality of Union acts). But here also there may be some doubts on the effectiveness of the procedure under some circumstances (Saint Paul, 1999, p.317; Zabalza, 1999, p.320). Firstly, Member States would strive to avoid

excessive deficits prior to being subject to sanctions, even with "creative accounting" or "accounting fudges" if necessary. Secondly, imposing sanctions and fines on a country facing genuine economic difficulties would worsen its situation and induce negative reputation effects. Finally, there is the fact that the concept of an "excessive deficit" itself is not susceptible to definition in terms of rules, but requires the exercise of judgment. Contrary to common belief, the excessive deficit procedure is not automatic in identifying an excessive deficit in a Member State. It starts on the basis of the monitoring of public finance criteria that give room for interpretation (Italianer, 1993, p19). In addition to that, sanctions are not automatic, but require qualified majority approval among participating members. As a result, decisions of this sort will certainly be highly politicized. The long-term success of the EMU may be jeopardized if the excessive deficit procedure has frequently to be invoked (Wildavsky, 1993, p145). This adds political uncertainty -with regard to the priorities of the governments that will be in power at the moment of taking these decisions years hence- to the risks already implicit in the underlying scenarios. In short, on these grounds it seems rather obvious that, under the present stability framework, the commitment of Member States to avoid excessive deficits is only a motivationally credible commitment as long as they continue to want to honor it at the time of performance, and that generates limited confidence.

In close relationship with the preceding analysis, it must be emphasized that the current stability framework of the EU appears relatively weak, just because it does not sustain substantive targets of fiscal consolidation with effective budget processes. It is obvious that budget targets are not self-executing. Action is needed by Member States to achieve them. Loosely speaking, these actions can be of two types: substantive arrangements, and systemic arrangements (PUMA 1997, p.37).

Substantive arrangements are policy decisions adopted with the aim of reducing or eliminating particular expenditures or programs, or to increase revenues. Systemic arrangements are changes to budgetary processes aimed at improving the resource allocation process and the performance of public sector programs.

No doubt, to undertake the necessary actions to achieve sound medium term fiscal positions, the political will of Member States -the determination to take effective policy actions to control deficits- is the essential ingredient. However, as Harden warns: "it is important to clarify precisely what this means. Political will is about government getting what government wants. But the complexity of budgeting means that what government wants, in an operational sense, emerges from the budgetary process itself...In this sense... the structure of the process itself affects the substantive outcomes"(Harden 1993, p.77). Therefore, substantive and systemic budget arrangements are seen as complementary tools of the same policy line, in economic and political terms alike. In economic terms, because the effectiveness at a macroeconomic level of the former depends, at least partially, on the implementation at a microeconomic level of the latter. In political terms, because the ability to gain political consent for substantive changes in budgeting depends, at least partially, on the acceptance of effective budgetary procedural changes. In the end, failure to reinforce the achievement of budget targets with effective procedural arrangements may be interpreted as a lack of political will of Member States to commit themselves to a difficult process of sustained fiscal consolidation. Although the will of politicians currently in charge of national decisions is to comply with the fixed budgetary targets, the establishment of budget procedures conducive to fiscal discipline is an essential

condition for fiscal stability, and becomes the most credible way of showing the actual political will of Member States.

All in all, one can draw two tentative conclusions from the analysis set out above. 1) Evidently, budgetary discipline and policy co-ordination are basic requirements for the stability of the EMU and enforcement to comply with both is necessary. Nevertheless, to ensure that fiscal consolidation in the EMU is a sustainable and credible process, it is of vital importance that in each Member State effective ways of guaranteeing the national budgetary objective of fiscal discipline exist. This requires attention to be focused on national budgetary procedures. 2) In the search for improved budgetary procedures, each Member State, according to its own peculiarities, should pay attention mainly to three categories of budgetary institutional arrangements: a) fiscal rules; b) hierarchical institutions; c) transparent procedures.

IV.- FISCAL TRANSPARENCY AND BUDGET REPORTING IN THE EMU

In the current EMU context, there are clear signs of the growing importance being given to fiscal rules and hierarchical budgetary institutions. Unfortunately, what also seems clear is that Member States still have a long way to go to adapt their budgetary procedures to the fiscal transparency standards required by the present situation.

The very wording of the Treaty shows in itself the basic role given to fiscal rules in the functioning of the EMU. It is also true that budget reforms recently made by Member States have reinforced the position of the finance ministers

and point therefore in the direction of building more hierarchical institutions (Zapico-Goñi, 1993, p.122). Be that as it may, the potentiality of these arrangements for uprooting old rules and habits is put into question if they are not implemented hand in hand with budgetary practices exhibiting a high degree of fiscal transparency. Fiscal transparency refers here to the "openness toward the public at large about government structure and functions, fiscal policy intentions, public sector accounts, and projections. It involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities - whether undertaken inside or outside the government sector- so that the electorate and financial markets can accurately assess the government's financial position and the true costs and benefits of government activities, including their present and future economic and social implications (Kopits and Craig, 1998, p.1). In this sense, fiscal transparency is fundamental to sound fiscal policy and there is a wide consensus on associating fiscal transparency with the successful promotion of good governance.

Transparency in government operations has several dimensions, but this paper will reduce the scope of its considerations only to the dimension of accounting transparency. In this regard, it must be emphasized that how government transactions are recorded -namely, on a cash or an accrual basis- has important implications for the transparency of fiscal performance. On a cash basis, transactions are recorded when financial receipts or payments actually take place. By contrast, on an accrual basis, transactions are recorded as they occur, regardless of whether the transaction is an in-kind or a for-cash payment: i.e., accrual-based measurement records transactions in the period revenues are earned, resources are consumed, or liabilities are increased. Although the cash-based approach is helpful for assessing the first-order impact of government borrowing, reliance solely on this basis has the risk of resulting in

a misstatement of the magnitude and timing of fiscal operations. Major areas where non-transparency may arise are the exclusion of information on the accumulation of arrears, transactions in kind, and the cost of borrowing at a discount. By comparison, the accrual based approach is fundamental for gauging the macroeconomic effects of fiscal policy -as well as the resource implications for the management of specific government programs- especially over the medium to long term. In spite of cash still being the predominant basis of recording worldwide, it simply does not provide sufficient information to assess a government's financial requirements, and, while complete and consistent information is not a guarantee of good decisions, incomplete information almost necessarily results in bad decisions. This is the reason behind the action taken recently by a number of countries that have sought to complement the traditional basis with, or shift altogether to, a modified accrual basis. This is also the main argument behind the advocacy of the International Monetary Fund for governments to move towards an accrual basis that would help to address deficiencies of the existing cash basis and to enable a greater degree of harmonization with other macroeconomic statistical systems (IMF, 1998, p.58).

The political economy of government budgeting explains why, under certain circumstances, governments may want to "cook the books". For example, on certain occasions governments may be tempted to present their fiscal "reality" by using "creative" accounting that could help to convince people that:

- outlay growth is less than it really is;
- budgetary deficit is less than actually is;
- liabilities to be met by future generations are less than they really are;

- their past investments decisions are really still of value to future generations even though they are truly worthless;
- their performance compares favorably with a previous government's past performance; etc.

In this regard, the cash basis of accounting presents itself as a very limited tool for reliable information by keeping the door open to a number of ways to present fiscal reality differently from the way it really is. Three of the most common ways are understating liabilities, overstating assets, and unconsolidated financial statements.

One of the major shortcomings of the cash basis is that it fails to provide governments with complete information on all that they owe. It fails to provide complete financial information. In consequence, spending controls can be circumvented by the simple method of deferring payment and it leads to the possibility that important amounts owing by governments go unreported. Cash-based budgeting allows the cost of some programs, including retirement, insurance, and credit, to be inaccurately reflected in the budget. For instance, if outlays for credit programs are reflected in the budget only when cash is disbursed, then the full amount of direct loans is reported as an outlay, ignoring that many would in fact be repaid. By contrast, for loan guarantees, no outlay is reported when guarantees are made, thus ignoring the fact that some of the guaranteed loans will eventually default and require governmental cash outlays. Cash-based measurement thus overstates the cost of direct loans and understates the cost of loan guarantees in the year they are made. This not only skews the cost comparison between these two similar programs but also misrepresents their relative costs in comparison with other federal spending and leads to disadvantageous patterns of funding loan guarantees rather than direct loan programs. Similarly, one may conclude

that for governmental insurance programs, cash-based measurement may provide incomplete or misleading information because the annual net cash flows currently reported in the budget may not adequately match premium collections with the expected costs of insurance commitments. Furthermore, increasing attention paid to the solvency of Social Security programs has generated interest in whether accrual-based information could serve to highlight long-term issues in the annual budget process.

Another common method used to make up fiscal reality is to overstate financial assets. For example, the value of public loans is often overstated. Unlike commercial loans, many government loans go hand in hand with concessions such as below-market interest rates. Yet they are often recorded at face value, neglecting the fact that when a government lends at rates lower than it pays to borrow money, it does so at a cost. If accounted for on a cash basis, there is little impact in the year the loan is made, but over time such costs accumulate. Actually, the costs of the concessions linked to public loans are grants that should be recognized when loans are made. If they are not, the loans embodied in government financial statements will be overstated.

Finally, a third way of misleadingly reporting financial positions and results of public finances is by excluding something that was formerly included within the ambit of government financial statements. The most extended formula for doing so is the creation of separate state-owned enterprises or corporations. Unless those corporations are consolidated with government accounts, their assets, debt and operations are excluded from the financial picture reported by government financial statements. Furthermore, if the government sells property to those corporations and they

finance the purchase with debt, the result will be that the government creates revenues while off-loading debt (Hillier, 1997).

Although some governments have begun to produce accrual-based information on government activities, the challenge, however, remains of how to integrate this information into the budget process so that it effectively supports policy decision-making and management reform objectives. Regardless of these type of obstacles, the term accrual budgeting is applied without distinction in reference to the use of the accrual-based method of budget reporting: transactions being recognized and measured in the budget according to accrual principles. The shortcomings of financial reporting practices according to cash-based and separate account principles justified the view of proponents of accrual budgeting as a useful, if not critical tool, in addressing performance management challenges. In particular, accrual budgeting is viewed as an effective tool for providing more timely recognition of the complete costs of government activities, an important factor in assessing performance. Accrual budgeting is credited with supporting broader management reform efforts in several ways.

Firstly, accrual budgeting is presented as useful in facilitating more competitive and businesslike approaches within the public sector. It is considered, for instance, that accrual budgeting makes it easier to compare performance among alternative suppliers, both public and private. It allows for more valid comparisons of performance helping in the identification of inefficient areas as well as in the determination of the most efficient method of delivering government goods and services. Moreover, accrual budgeting is described as important to fostering cultural change that heightens awareness of financial and performance management issues.

Since the budget really matters to department managers, the fact of including accrual-based information in the budget may increase the stakes associated with its preparation and use, and may induce departments to monitor their accounts more closely to avoid breaching appropriations.

Secondly, advocates of accrual budgeting view it as a useful tool to encourage the more efficient and effective use of resources by both, providing better information and incentives with respect to total resources consumed in the provision of goods and services, and better reflecting the cost of capital assets.

Thirdly, accrual budgeting is presented as potentially playing a key role in the shift towards a more decentralized performance-focused public management. By providing a tool to match costs with the provision of goods and services, accrual budgeting may become the basic support of these more decentralized management systems that emphasize managerial flexibility as a means of improving efficiency and effectiveness.

In short, the method of budget reporting represents something more than a technical decision about how to measure costs; rather it means important choices about the types of controls and incentives that are important in the decision-making process. Governments traditionally have relied on cash-based budgeting which reflects the focus of traditional budgeting on control. However, as governments increased their concern about the long-term cost implications of current commitments and undertook broad management reforms, they started to recognize the limitations of cash-based budgeting and nowadays attention has turned to accrual budgeting as a

potentially crucial contribution to the sorely needed improvement of public sector management. Actually, advocates of accrual budgeting argue that the only way to really affect decision-making is to move beyond financial statements and performance reporting to using accrual information as the basis of resource allocation (GAO, 2000, p.61).

To date, the adoption of accrual budgeting initiatives in the Member States of the EU is quite diverse (Pina, 1996, p.79). Since 1993, the Swedish state sector has used full accrual as the general basis for accounting. In the Netherlands, an accrual framework is being applied only in agencies -a new sub-unit of government created in 1992- where it was deemed useful in promoting results-oriented management. The Resource Accounting and Budgeting of the United Kingdom applies commercial style accounting practices to central government financial reporting and to budgeting. Resource budgeting is to be in effect from financial year 2001-02. Resource accounts consisting of five financial schedules prepared on an accrual basis are to replace the traditional cash-based appropriation accounts and become the main form of accountability to Parliament. Parliamentary approval for departmental funding is expected to operate on a dual cash and accrual basis. In France, accrual budgeting has been introduced at local level. In Spain, there is a methodological duality in governmental accounting systems: an accrual accounting system for financial statements and a modified cash system for budget transactions (Montesinos and Vela, 1997, p.22).

Nevertheless, the major factor to highlight in the European panorama is the surveillance of budgetary positions and the surveillance and co-

ordination of economic policies set up by the Treaty and the SGP. This requires a comprehensive information system providing decision-makers with the necessary data on which to base their decisions (2268th ECOFIN-Council meeting, 5 June, 2000). These information requirements include information on the developments in the Euro-area and the EU as a whole, but the main focus is on developments in individual Member States since it is at this level that concrete policy action may have to be adopted. To bridge the gap between the traditional European System of integrated economic Accounts (ESA) dating from 1979 and the new informational needs of the EMU, in June 1996 the European Council decided to replace the old ESA by a new ESA-95. Implemented in 1999, this change has meant the introduction of several novelties in the macroeconomic information system, one of the most outstanding ones being the introduction of full accrual basis. For most Member States, considering the context of the surveillance of budgetary positions, this change operated in the ESA makes it increasingly urgent to bring forward the fuller use of accrual concepts in budgeting. Otherwise, it will be difficult to come up with reliable macroeconomic figures of the government sectors (on accrual basis) from the microeconomic information systems of governmental accounts (on cash or modified cash basis) (Montesinos, 1996, p.65). Here, reliable and comprehensive information on public finance developments of Member States will be crucial not only for effective monitoring and the decisions that might have to be taken in response by the EU, but also for the close follow-up and the decisions that markets surely will take.

V.- CONCLUDING REMARKS

In the context of the EMU, fuller use of accrual concepts in budget reporting of Member States is a must for making operative the multilateral surveillance of national budgetary positions. Without the appropriate system of governmental accounting, the application of the fiscal rules laid down by the Treaty and the SGP would probably lead to circumvention and distortions, which ultimately would erode the effectiveness of these same rules.

Yet the current importance of generalizing accrual budgeting in Member States of the EU goes beyond this consideration. The shift from a more traditional basis of accounting to an accrual basis embodies an important political economy component. First of all, it paves the way for wider reforms aimed at improving public sector financial management and performance while enhancing transparency and accountability. Furthermore, by providing better information and incentives with respect to total resources consumed in the implementation of expenditure programs, it fosters more timely reaction to facing the long-term implications of current commitments that could endanger the soundness of public finances. Last, but by no means least importantly, by implementing higher standards of fiscal transparency, it will provide world markets with greater confidence in the actual political will of Member States in honoring their commitments to fiscal consolidation.

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FOOTNOTES

*F.JAVIER SALINAS: Professor of Applied Economics. University of Valladolid, Valladolid, Spain. Phone/fax: + 34-983.355103. Email: salinasi@der.uva.es. This paper is part of the research project SEC 98-1085 of Spain's CICYT.

¹Eichengreen (1992), Poterba (1994), Bayoumi and Eichengreen (1995), Bohn and Inman (1996), focus their analysis upon the different fiscal rules implemented in the U.S. states. von Hagen (1992) and von Hagen and Harden (1994) study the different nature of European budgetary models. Hausman and Stein (1996) and Alesina et al. (1999) also follow the latter approach in their study of Latin American countries' fiscal performance.

² This resolution provides guidance to the Council and Member States on the application of the pact.

³ One on the Excessive Deficit Procedure, and the other on the multilateral surveillance system.

⁴ This distinction is taken from North (1993). D. North distinguishes two ways of making commitments credible. First, commitments are imperatively credible if the act of commitment was connected to a mechanism that results in institutional ties by which performance according to the rules is coerced. Second, commitments are motivationally credible if the actors involved hold on to their intention to follow their original claim and act accordingly. Indeed, the confidence provided to third parties by the former is greater than the confidence provided by the latter.