BELOW THE LINE

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The euro's problems have absorbed most of the European Union's energies in recent years. Many economists had cautioned that a common currency would not function without strong coordination and the centralisation of national fiscal policies. Yet in the early stages of economic co-operation, member countries were reluctant to give up fiscal sovereignty. The EU instead devised an elaborate system of budget surveillance and fiscal rules in the 1992 Maastricht Treaty and 1997 Stability and Growth Pact, limiting government deficits to 3% and debt to 60% of GDP in member states.

Governments soon found ways to fudge their fiscal data when struggling to comply with the deficit limit. In 2002 the European statistical agency (Eurostat) challenged Portugal, which refused to provide information on some €7.4bn of subsidies to seven public enterprises, including Metro Lisboa. By classifying subsidies granted regularly to cover accumulated losses as equity purchases, the government moved them 'below the line', outside the deficit, which was the key indicator governed by the stability pact. Then Greece, following earlier revisions of its fiscal data in 2004, achieved notoriety in 2010 after revising its deficit more than five-fold from the budget projection to 15% of GDP, plunging the eurozone into an existential crisis.

The factors that led EU governments to fudge budget figures and how this

EU members used fiscal gimmicks to fudge their deficits and mask public subsidies for years before the eurozone plunged into crisis

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misrepresentation was achieved in public accounts are revealed by data for 14 EU countries from 1990–2007. This shows that:

- Despite reporting rules and elaborate monitoring, two accounting components – the net acquisition of 'shares and other equity' and the 'net incurrence of other liabilities' that captures mainly 'other accounts payable' – were used to systematically manipulate deficit figures and evade stability pact fiscal rules.
- Political incentives resulting from the electoral cycle and the state of the economy systematically undermined compliance with stability pact limits.
- The scale of fiscal 'gimmickry' depends on the degree of transparency in the domestic budget process.
- Electoral incentives to evade supervision by tampering with accounting figures reached about 1% of GDP.
- Non-compliance with the stability pact was not 'all about Greece'. Greece was an extreme case, the least transparent of the countries, but the patterns appear whether or not Greece is included in the data.

In the Portuguese case, 2002 was an election year and an example of the pattern in low-transparency countries, where fiscal gimmickry is used to increase political support. Countries with higher fiscal transparency generally observed stability pact requirements for fiscal reporting, but occasionally violated deficit limits. When larger deficits loomed in an economic downturn, low-transparency countries also systematically circumvented reporting rules using creative accounting. Despite common supranational rules and monitoring, domestic institutions, politics and economic cycles explain much of the variation in the use of such fudging exercises.

Originally, according to Webster's dictionary, 'gimmick' was a slang term for something that a con artist or magician had his assistant manipulate to make appearances different from reality. It retains that meaning in the fiscal context.

There is no straightforward way to measure fiscal gimmicks. As deliberate attempts to mislead, they are designed to be unobservable. However, detailed work on the gap between a change in ↘

GIMMICK JUNKIES

Portugal:

Greece:

€7.4

BILLION
to seven public enterprises including Metro Lisboa, 2002

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PERCENT
of GDP average under-recording of military expenditure, 1997-2003

Gimmickry
Noun, pejorative: the use of any clever device, gadget, or stratagem, esp. one used to deceive
Collins Dictionaries Online

a government's debt and its budget deficit, the so-called stock-flow adjustment, can provide telling clues. This is defined for a year t as $SFA_t = D_t - D_{t-1} + B_t$, where the first two terms are the annual change in gross debt (D) and B is the budget balance, in which a deficit is expressed as a negative number. Since an increasing deficit would increase debt, a positive SFA indicates that the change in gross debt exceeds the magnitude of the budget deficit (or decreases by less than a surplus). If countries maintain a positive adjustment over time, this may suggest that deficit data are being manipulated.

Two SFA components are plausible sources of gimmicks. 'Shares and other equity' transactions become one source when, for instance, payments to cover recurring losses by a state-owned company are treated as equity purchases instead of current transfers. 'Other accounts payable' is another, encompassing goods and services that have been delivered but not yet paid for.

With cash accounting, the accumulation of such arrears can make the deficit look better. With the EU's system of accrual accounting, this can be achieved through under-recording at the time of delivery, which reduces the reported deficit without causing a corresponding reduction in debt (if the bills are actually paid). That shows up as an irregularity in the annual change of other accounts payable: the SFA increases with a negative net change. For example, a 2004 audit by Eurostat uncovered such under-recording of military expenditures in Greece, averaging 1% of GDP annually between 1997 and 2003.

Gimmicks are constrained by budget transparency: more transparent institutions make it easier for auditors, markets and the public to see through government decisions to misrepresent fiscal quantities.

Combining data on fiscal disclosure practices from the Organisation for Economic Development and Co-operation, the International Monetary Fund and the International Budget Partnership shows that fiscal transparency is crucial in determining whether EU governments resort to data manipulation in response to upcoming elections, deteriorating economic conditions and the imposition of fiscal rules.

The data reveals a strong electoral cycle in gimmicks, diminished or eliminated by higher transparency. Each additional year left in the electoral term reduces the SFA by about 0.5% of GDP for Portugal and Italy. By contrast, if in 2002 there had been two additional years left in Portugal's electoral term, the SFA would have been about 1% of GDP lower.

What produced this pattern? Abuse by accounting for subsidies as equity purchases and, to a lesser extent, the under-recording of deliveries stand out. These two components account for over half of the changes estimated in the SFA.

The misuse of equity injections to disguise subsidies (and thus deficits) via the SFA became more significant after the introduction of the stability pact. Once again, this effect, like that of economic slumps and election pressures, is absent where fiscal transparency is greater. Greece was not a special case; rather, it was the extreme case of a general, and comprehensible, pattern.

It seems inescapable that attempts at fiscal policy co-ordination in economic unions will struggle – or even fail – in non-transparent environments. The 2012 Fiscal Compact adopted by most EU countries emphasises complex 'second-generation' fiscal rules based on structural indicators, which are notoriously subject to differing interpretations and different methods of calculation. This approach is especially worrying, given the tremendous difficulties the EU encountered in monitoring and attempting to enforce a seemingly simple 3% deficit limit, and makes fiscal transparency even more essential.

The compact places more emphasis on the deficit than the stock of debt: it requires countries to incorporate the structural balance rule, but not the limits on debt, into national law. Without major improvements in fiscal transparency, this approach may not bring about the budgetary discipline sought by the designers of the compact. Indeed, the structural balance rule could instead turn out to be counter-productive. ●

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