Fiscal Rule Stretching in Europe During Crises

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Abstract

Elected governments have incentives to stretch accounting rules to classify loss-making endeavors, such as public industries and pension schemes, as off of the public balance sheet. Doing so improves the appearance of the government to cost-conscious voters as fiscally restrained in the near-term. We expect rule stretching to be especially prevalent during financial crises given their typical expense and the type of policy options available to assist troubled financial institutions, such as bad banks nationalization are often hard to classify as in or outside of the government sector. To test this proposition, we examine revisions that to government debt and deficit figures made by the European statistical agency–Eurostat. These revisions frequently occur because this politically independent agency re-classifies organizations as within the government sector, when a national government had originally classified it as off. We find that debt figures are more likely to be revised upward for years close to national elections. This effect is strengthened further by financial market stress.

1 Introduction

2 Political budget cycles and fiscal gimmicks

De Castro, Pérez and Rodríguez-Vives (2013) Alt, Lassen and Wehner (2014)

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3 Cost-shifting during financial crises

Gandrud and Hallerberg (2016)

4 Hypotheses

H_1: Debt revisions will be greater for years closer to national government elections.

H_2: Debt revisions will be even greater for years closer to elections when there is high financial market stress.

5 Empirical tests

To test these hypotheses we gathered all of the revisions that Eurostat made to EU member debt and deficit figures from 2003 through 2013. [WEBSITE URL] Eurostat publishes revisions bi-annually–typically once at the end of April and again again in late October. These revisions cover government finance statistics released within the previous four years. We created a variable of cumulative revisions over these four year periods. This variable ranged from -1.1 and 12.7 percent of GDP for debt statistics and -4.5 and 1.1 percent of GDP for deficit statistics. It is important to note that all of these revisions were not due to revisions in the denominator, i.e. GDP. Eurostat reports these types of changes separately. As De Castro, Pérez and Rodríguez-Vives (2013) found for similar Eurostat data in shorter pre-financial crisis sample, there is a clear tendency for debt statistics to be revised upward and deficit statistics downward, indicating that policies are more expensive than initially reported.

To test whether governments are more likely to stretch the rules closer to elections, we use Gandrud's (2015) election timing variable, where the election year is recorded as zero.

To examine how responding to financial market stress may exacerbate governments' fiscal accounting rule stretching behavior, we included Gandrud and Hallerberg's (2015) continuous "FinStress" measure of real-time perceptions of financial market stress. This measure is created by analyzing monthly content from Economist Intelligence Unit texts on banking and financial markets using a statistical method called kernel principal component analysis. Unlike previous post-hoc dichotomous measures of financial crisis (e.g. Laeven and Valencia, 2012; Reinhart and Rogoff, 2010), the authors argue this measure captures what we are most interested in when trying to understand policy choices: what stress policy-makers perceived and so responded to at the time. It also does not rely on ad hoc methods of determining when a crisis ended, but instead charts its perceived intensity over time. To make this measure comparable with our other variables, we found yearly averages. FinStress is able to vary between zero and one, with higher values indicating more perceived financial market stress. In the sample it varies between 0.12 and 0.76.

Table 1: Linear Regression Prediction of Debt Revisions

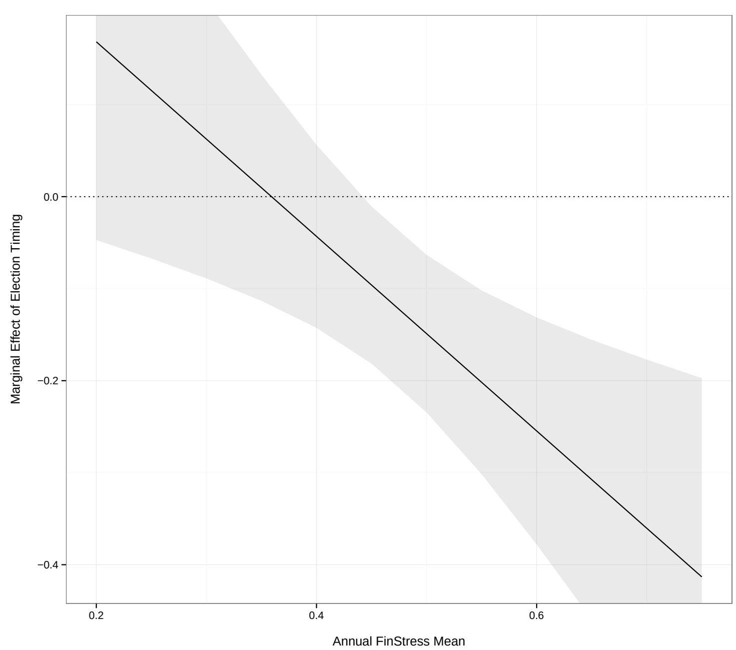
	Dependent variable:		
	Cumulative Debt Revisions		
	(1)	(2)	(3)
Yrs. Since Original	0.307***	0.304***	0.306***
	(0.064)	(0.064)	(0.064)
Yrs. to Election	−0.126**	−0.122**	0.380*
	(0.051)	(0.051)	(0.215)
FinStress		−0.543	1.119
		(0.612)	(0.923)
Yrs. to Elect. * FinStress			−1.057**
			(0.441)
Constant	0.935***	1.217***	0.511
	(0.299)	(0.436)	(0.525)
Country FE?	Yes	Yes	Yes
Observations	817	817	817
R^2	0.290	0.290	0.296
Adjusted R^2	0.271	0.271	0.275
Residual Std. Error	1.821 (df = 795)	1.822 (df = 794)	1.816 (df = 793)
F Statistic	15.447*** (df = 21; 795)	14.776*** (df = 22; 794)	14.469*** (df = 23; 793)
Note:			*p<0.1; **p<0.05; ***p<0.01

6 Conclusion

Table 2: Linear Regression Prediction of Deficit Revisions

	Dependent variable:		
	Cumulative Deficit Revisions		
	(1)	(2)	(3)
Yrs. Since Original	-0.068^{***}	-0.067^{***}	-0.067^{***}
	(0.021)	(0.021)	(0.021)
Yrs. to Election	0.005	0.004	-0.116
	(0.017)	(0.017)	(0.072)
FinStress		0.217	-0.180
		(0.203)	(0.307)
Yrs. to Elect. * FinStress			0.253^{*}
			(0.147)
Constant	-0.159	-0.272^{*}	-0.103
	(0.099)	(0.145)	(0.175)
Country FE?	Yes	Yes	Yes
Observations	817	817	817
R^2	0.247	0.249	0.251
Adjusted R^2	0.228	0.228	0.230
Residual Std. Error	0.606 (df = 795)	0.605 (df = 794)	0.605 (df = 793)
F Statistic	12.451^{***} (df = 21; 795)	11.939^{***} (df = 22; 794)	11.577^{***} (df = 23; 793)
Note:			*p<0.1; **p<0.05; ***p<0.01

Figure 1: Marginal Effect of Election Timing (years to election) at Various Levels of Financial Market Stress on Debt Revisions



Shadded area represents 95% confidence interval.

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