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Italy's Accounting Miracle

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The latest murky accounting ploy has received the European Union's stamp of approval. As of 2007, Italy will be able to reduce its official budget deficit with the cash proceeds of new liabilities. The new debt will remain hidden until it comes due. If this is how the EU's revised Stability and Growth Pact will work, it would be wiser to scrap the budget rules altogether. At least then national capitals would not be so tempted to artificially reduce their budget deficits, and citizens would be better informed about the true state of public finances.

Here's how the new gimmick works. Under current Italian law, employees must set aside a tax-exempt fraction of their gross wages, nearly 7%, into a severance scheme called TFR. Instead of creating personal accounts for their employees, each company collects the money in one large fund. When an employee leaves the firm, he recives the money he paid into the fund plus interest, currently about 3%. The TFR is thus debt that companies owe to their employees. That's why firms list it as liabilities in their financial statements. Under the new Italian budget law, though, part of the contributions to this severance scheme will be collected and held by Italy's social security administration to finance public expenditures. When the employee leaves his job or has health problems, the government, rather than the employer, will disburse his severance payments. The bottom line is that, by receiving the contributions for this new, implicit debt, the Italian government expects to reduce its yearly budget deficit by almost 0.5% of GDP. A debt instrument has miraculously become a surplus.

This bookkeeping equivalent of turning water into wine is possible because EU accounting rules for government finances are much looser than the rules that the same governments apply to private firms. The bloc's statistics service, Eurostat, does not consider the future obligations implicit in public pensions as part of government liabilities. Hence, the transfer of the TFR to the Italian social security system is treated like the creation of a new pay-as-you go system.

The Stability Pact's 2005 reform, though, specifically encourages Brussels to pay special attention to fiscal sustainability in the long run, and in particular to the future liabilities implicit in the pension systems. The Commission, however, has paid lip service to the principle of long-run sustainability, while in practice is giving its blessing to the Italian accounting miracle. In so doing, it has shown that the reform of the Stability and Growth Pact will not be enforced.

This creates a dangerous precedent that other member states might be tempted to follow. Germany, for instance, has a "book reserve" system similar to the Italian TFR that automatically applies to a significant portion of its work force. The contributions to the German system are even more attractive as a potential source of government finance since, unlike the TFR, they can only be claimed by the workers upon retirement. Many other Europeans countries have sizable occupational pension plans. The EU is implicitly saying that the proceeds from nationalizing these plans can be used to meet its budget deficit targets. Firms in financial difficulties with occupational pension plans are always tempted to transfer to the state their pension liabilities, together with the annual contributions to the fund. Now myopic governments will have an additional incentive to meet these requests for "state aid." Public revenues increase immediately, while the debt disappears once it is transferred to the public sector.

Europe's public finances can ill afford these kinds of miracles.

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