FINANCIAL RISKS

Intergovernmental Fiscal Relations and Local Financial Management Course

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Budapest, Hungary

Organized by the Council of Europe, Economic Development Institute of the World Bank, and Fiscal Affairs Division of the Organisation for Economic Cooperation and Development

Hana Polackova, Government Contingent
Liabilities: A Hidden Risk To Fiscal Stability
Contents of Course Material On Financial Risks

1. Managing Fiscal Risk: A Short Course Outline (3 pages)


MANAGING FISCAL RISK:
FISCAL ADJUSTMENT VERSUS PUBLIC RISK

Short Course Outline
Hana Polackova

Objectives:
Build understanding of Bank staff and country officials about:
• fiscal risks that countries face as an extension of and outside the government budget
• why and how to address the problem of contingent and implicit government liabilities in fiscal policy analysis
• how to improve policy-making processes, government institutional arrangements and capacities to mitigate fiscal risks
• contemporary fiscal risk assessment and management techniques

Why Should Governments Worry About Fiscal Risks?
1. International Experiences with a Fiscal Instability Triggered by Contingent or Implicit Fiscal Risks: A Brief Overview

How Does Fiscal Adjustment Interact with Risks?
2. Unique Attributes of Public Risk Management (e.g., the government as an insurer of uninsurable risks, reallocating resources and risk to improve social welfare, short time horizon of politicians)

Tools for Analyzing and Measuring Risk
How Should a Public Institution Define Risk?
1. Expected Value
2. Mean-Variance
3. Safety-First
4. Expected Utility Maximization
5. Other

Risk Analysis
1. Qualitative Risk Analysis
2. Measurement Techniques
   A. Actuarial Analysis
   B. Value-at-Risk
   C. Multi-factor CAPM
   D. Contingent Claims Analysis
   E. Discounting
   F. Non-recourse Financing
   G. Other

Public Versus Private Risk
1. Interplay of Public Risk Diversification and Private Markets
2. Risk Transfer Mechanisms
   A. Direct Loans
   B. Loan Guarantees
   C. Grants
   D. Insurance
   E. Other

Recognizing Fiscal Risks

Remedies in the Budgetary Framework
1. The Medium-term Fiscal Framework
2. The Coverage and Role of Budget in Resource Allocation
3. Budget’s Role in Risk Allocation
4. Budget Regulations
5. Budgeting for Direct and Contingent Fiscal Risks

Approaches through Financial Accountability Framework
1. Accrual Accounting
2. Fiscal Reporting
3. The Significance of Financial Statements
4. Accountability for Handling Risk
5. The Legal Framework – Extending the Public Finance Law Beyond the Government Budget
6. Risk Management and Financial Information Systems

The Division of Responsibilities for Risk Management

1. The Responsibilities and Authority of the Ministry of Finance
2. Monitoring the Government's Risk Exposure in a Single Portfolio of Risks—
   the Role of the Debt Management Office

Sectoral Analysis: Applying Risk Management Tools to Selected Areas of
Government Responsibility

Risk Assessment and Case Studies of Successful Reforms

1. The Liabilities of the Pension System
2. The Risk of Government Guarantees for Infrastructure Projects
3. The Explicit and Implicit Contingent Risk of State-Owned and State-
   Guaranteed Institutions
4. The Explicit and Implicit Risks of the Financial System
5. The Residual Risk of the Obligations of Subnational Governments

Experiences in Risk Management

Best Practices in Corporate Risk Management Today

1. Approaches of Selected Investment Banks, Insurance Companies and Large
   Corporations
2. Risk Culture

Good Practices of Governments in Handling Fiscal Risks

1. Federal Credit Reform Act in the United States
2. Reform in Financial Accountability in New Zealand
3. Budget Policy in Canada
4. Developments in Colombia, Philippines, and Malaysia
5. Intergovernmental Fiscal Relations and Local Government Bankruptcy in
   Mexico and Hungary

What Next?

Special Problems of Developing and Transition Countries in Facing Fiscal Risks

Developing A Plan of Actions to Improve Government Incentives and Capacities to
Handle Fiscal Risks
Contingent Government Liabilities: A Hidden Risk to Fiscal Stability

Governments in many countries have faced serious fiscal instabilities as a result of their growing contingent liabilities. But traditional fiscal analysis and institutions fall short to address contingent fiscal risks. What can be done?

Governments are exposed increasingly to fiscal risks and uncertainties for four main reasons: (a) the increasing volume and volatility of private capital flows, (b) the changing role of state from financing services to guaranteeing that the private sector will accomplish particular outcomes, (c) fiscal opportunism of policymakers, and (d) moral hazards arising in the markets as they perceive the government ultimately responsible for market outcomes. Risks facing governments in transition and emerging-market economies are particularly large. Dependence on foreign financing, opaque ownership, low information disclosure, underdeveloped regulatory frameworks, and weak enforcement exacerbate the scope for failure in the financial and corporate sectors. Such failures, in turn, often generate political pressures on governments to intervene through various financial bail-outs on an ad-hoc basis. Recent international experience has indicated that contingent government liabilities cause fiscal instabilities. Such instabilities are not prevented by fiscal adjustment that concentrates on deficit and debt reduction.

Governments must understand and know how to handle contingent liabilities if they are to avoid the danger of sudden fiscal instability and to realize their long-term policy objectives. But do governments have adequate incentives and capacities? Coercion and assistance may be required. The World Bank can be of help on both these accounts.

A Simple Framework

Governments face four types of fiscal risks: direct and contingent, each of which is either explicit or implicit. Direct liabilities are obligations that will arise in any event. They are not dependent (contingent) on any discrete event and are predictable according to some specific underlying factors. For example, future public pensions constitute a direct liability, the size of which reflects the expected generosity of and eligibility for a benefit, and the future demographic and economic developments.

Contingent liabilities are obligations that are triggered by a particular discrete event (contingency), which may or may not occur. The probability of the contingency to occur and the magnitude of the government outlay required to settle the ensuing obligation depend on exogenous conditions (e.g., the occurrence of a natural disaster or banking crisis) and endogenous conditions, such as the design of government programs and its implications on moral-hazard in the markets.

Explicit liabilities are specific obligations of the government defined by law or contract. The government is legally mandated to settle such an obligation when it becomes due. Common examples include the repayment of sovereign debt and non-performing loans under state guarantee.

Implicit liabilities represent a moral obligation or an expected burden of the government not in the legal sense, but based on public expectations and political pressures. Implicit liabilities include disaster relief for uninsured victims, relief from private non-guaranteed obligations and future public pensions if these are not protected by law.

Based on these characteristics, the Fiscal Risk Matrix in table 1 provides a typology of the sources of future potential financing requirements facing central government. For each category, the matrix shows possible sources of fiscal risk. Some of them apply across countries (sovereign debt), others are country-specific (crop insurance).
Table 1: The Fiscal Risk Matrix

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Direct (obligation in any event)</th>
<th>Contingent (obligation if a particular event occurs)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Explicit</strong></td>
<td>• foreign and domestic sovereign borrowing (loans contracted and securities issued by central government)</td>
<td>• state guarantees for non-sovereign borrowing and obligations issued to subnational governments and public and private sector entities (development banks)</td>
</tr>
<tr>
<td></td>
<td>• budgetary expenditures</td>
<td>• umbrella state guarantees for various types of loans (mortgage loans, student loans, agriculture loans, small business loans)</td>
</tr>
<tr>
<td></td>
<td>• budgetary expenditures legally binding in the long-term (civil servants' salaries and pensions)</td>
<td>• guarantees on borrowing by a foreign sovereign state</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• state guarantees on private investments</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• state insurance schemes (deposit insurance, minimum returns from private pension funds, crop insurance, flood insurance, war-risk insurance)</td>
</tr>
<tr>
<td><strong>Implicit</strong></td>
<td>• future public pensions (as opposed to civil service pensions) if not required by law</td>
<td>• default of subnational government, and public or private entity on non-guaranteed debt and other obligations</td>
</tr>
<tr>
<td></td>
<td>• social security schemes if not by law</td>
<td>• liability clean-up in entities under privatization</td>
</tr>
<tr>
<td></td>
<td>• future health care financing if not by law</td>
<td>• banking failure (support beyond state insurance)</td>
</tr>
<tr>
<td></td>
<td>• future recurrent cost of public investments</td>
<td>• investment failure of a non-guaranteed pension fund, employment fund, or social security fund (social protection of small investors)</td>
</tr>
<tr>
<td><strong>Look beyond the budget and debt</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government <strong>direct implicit liabilities</strong> often arise as a presumed consequence of public expenditure policies in the longer term. Given their implicit nature, these obligations are not captured in government balance sheets. Typically, they are high for demographically driven expenditures. They are quantified and recognized by governments that have institutionalized a framework for fiscal discipline. Good examples include multi-year budgeting and reporting practices of Australia, Canada, Germany and Netherlands.</td>
<td></td>
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</tr>
<tr>
<td><strong>Contingent explicit liabilities</strong> represent the government’s legal obligation to make a payment if a particular event occurs. They represent a hidden subsidy which, as such, may immediately distort behaviors in the markets, blur fiscal analysis and drain government finances in the future. Moral hazard and the probability of default under state guarantees and in state-guaranteed institutions are high if the government guarantees the whole rather than a part of the obligation, and all risks rather than selected political and/or commercial risks. <strong>State insurance schemes</strong> often cover uninsurable risks of infrequent losses that are enormous in total magnitude. Thus, rather than financing themselves from insurance fees, state insurance schemes redistribute wealth and rely on government net financing.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Contingent implicit liabilities</strong> are not officially recognized until after a failure occurs. The triggering event, the value at risk, and the size of government outlays are uncertain. Contingent implicit liabilities rise with weaknesses in the macroeconomic framework, financial sector, regulatory and supervisory systems and information disclosure in the markets. With private capital flows, for instance, such weaknesses raise the risks in assets valuation, intermediation and borrowing behaviors. Experience indicates that fiscal authorities are compelled to cover the cost of the uncovered losses and obligations of the central bank (e.g., foreign exchange contracts), subnational governments, state-owned and large private enterprises, budgetary and extra-budgetary agencies, and any other institution of political significance.</td>
<td></td>
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</tr>
</tbody>
</table>
Box 1  Government Practice for Contingent Explicit Liabilities

In contrast to the leading financial institutions, which have implemented sophisticated risk management systems in the last ten years, governments have yet to embrace and control contingent explicit liabilities in their public finance framework. Many accumulate contingent explicit liabilities to provide unreported support outside the budgetary system, are not accountable for the outcomes and cost, lack information about the risks, and are exposed to an excessive fiscal risk because of poor design and management of the underlying programs.

To improve awareness about contingent fiscal risks, Australia and New Zealand include contingent liabilities and contingency expenditure provisions in government financial statements. Italy and the United States make a budget appropriation for the net present value of the future fiscal cost of issued loan guarantees and direct loans. The risks and reserve adequacy of federal insurance schemes are reported by the United States General Accounting Office outside the budgeting system.

Gradual improvements have been achieved in several other countries, often with the Bank assistance. The Czech government has classified and publicly revealed the sources of its exposure to fiscal risks, and started to analyze their future fiscal implications. Governments of Colombia, Malaysia and Philippines have reviewed the risks of guaranteed infrastructure projects, estimated their loss exposure, and started to negotiate tighter contracts that push more risks onto private developers.

To assess the risks, the governments use their historical experience and, where appropriate, more sophisticated methodologies, such as actuarial, econometric, loss estimate and option pricing models.

Box 2  Contingent Liability of the Financial System

In most countries, the financial system represents the most serious contingent implicit liability of the government. International experiences have indicated that markets expect the government to help financially if stability of the financial system is at risk. In such cases, governments are compelled to intervene financially far beyond their legal obligation either to secure some critical functions of the financial system, or to protect depositors and specific market agents beyond the limits of any state insurance schemes. However, such practices further exacerbate the moral hazard problem in the financial and corporate sectors. The contingent fiscal cost of the domestic banking system is presently estimated by Standard & Poor's at levels under 10 percent of GDP in Argentina, Hungary, Italy, Poland, and Sweden, about 10 to 20 percent of GDP in Greece, Philippines, Singapore, Slovakia, U.K., and U.S. and over 30 percent of GDP in China, Czech Republic, Hong Kong, Japan, Korea, Malaysia, Thailand and Taiwan.

The Value of Transparency

In the choice between direct budgetary support and private sector provision with a state guarantee, certainty in the future public financing requirement has a positive value. The value of certainty in public financing is particularly high for governments that have: (a) restricted or unreliable access to borrowing, (b) low capacities to analyze and manage risk, (c) low risk preference, and (d) strategic cash and debt management. Provision and reserve funds may reduce the potential harm when contingent liabilities fall due. Reserve funds involve, however, an opportunity cost. Therefore, alternative forms of government support can be prioritized, not only based on their contribution to the desired policy objectives and on their long-term cost, but also to reflect the volatility in their financing requirement and their addition to the government's overall risk exposure.

Understanding, Incentives and Capacities to Reduce and Control Fiscal Risks

The first condition for governments to conduct fiscally prudent policies is that policymakers identify, classify and understand fiscal risks. For risks bound to surface beyond a politically meaningful time horizon, fiscally sound behavior may depend on coercion. Policymakers are more likely to gravitate to fiscally sound decisions if investors, credit-rating agencies, multilateral institutions, the media and public understand the implications of hidden fiscal risks and punish governments for excessively exposing the state to, and for concealing, the risks.
Coercion to discipline the government's fiscal behaviors beyond the budget deficit and debt can be internal and external. For internal coercion, the supreme audit institution assesses and publicly explains the existing fiscal risks of each government agency and of the government as a whole. The assumption that voters care about government fiscal risks is not trivial. Public explanation of fiscal risks, however, empowers forces of external coercion. External coercion rests upon three pillars: (a) adequate definition, measurement, and monitoring of indicators of full fiscal performance (beyond the government budget and debt) by international authorities, such as the IMF, World Bank, and sovereign credit rating agencies; (b) external pressure to develop adequate public finance institutions and disclose relevant information; and (c) punishment mechanism for governments that conceal important information.

Measures To Reduce Fiscal Risks

Table 2 lists systemic measures that encourage sound fiscal behavior. These measures mainly aim at promoting understanding of fiscal risks by policymakers, public and markets.

<table>
<thead>
<tr>
<th>Measures</th>
<th>Fiscal Policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Systemic</td>
<td>• consider full fiscal performance beyond the budget and debt</td>
</tr>
<tr>
<td></td>
<td>• identify, classify and analyze all fiscal risks in a single portfolio</td>
</tr>
<tr>
<td></td>
<td>• determine the government's optimal risk exposure and reserve policy according to its risk preference and risk management capacity</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Public Finance Institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>• internalize and disclose the full fiscal picture</td>
</tr>
<tr>
<td>• monitor, regulate and have disclosed risks in the public and private sectors</td>
</tr>
</tbody>
</table>

Fiscal analysis must factor in the cost of implicit subsidies provided in the forms of government contingent support programs. A study of government fiscal position cannot be separated from obligations taken by the government outside the budgetary system. For instance, arrears and other obligations of state-owned and guaranteed institutions may pose a significant claim on public resources in the future. Moreover, the government may have taken advantage of some institutions to finance and implement its policies outside the budgetary system. Thus, a string of years with a balanced budget and low public debt suggests neither that the government has been fiscally prudent nor future fiscal stability.

To identify the future potential fiscal pressures, contingent fiscal risks should be analyzed in the order of their significance, based on the stock of existing government programs and promises. Their qualitative analysis focuses on the factors of risks and ways of controlling the government's risk exposure. This helps the policymakers to (re-)design programs in a way to minimize future spending on contingencies.

An adequate institutional framework requires that the government treat any non-cash program involving a contingent fiscal risk like another budgetary or debt item—from the view point of aggregate fiscal stability, allocative and technical efficiency, and accountability. Adequate rules are needed for issuing, monitoring, and handling state guarantees and insurance programs, for monitoring and financial management of public, state-guaranteed and subnational government institutions, etc. An institutional framework that ignores future fiscal implications of contingent liabilities makes the off-budget forms of government support look inexpensive and politically attractive.

The priority is public disclosure. Comprehensive public disclosure of fiscal risks enables the public and markets to monitor the government's full fiscal performance. The ability of the markets to reflect both direct and contingent fiscal risks in their analyses and behaviors indirectly encourages not only budgetary but overall fiscal discipline. In addition, greater fiscal transparency facilitates parliamentary scrutiny and the monitoring by international institutions, such as the IMF and World Bank. Domestically, the government promotes both fiscal transparency and prudent policy decisions by empowering the ministry of finance and supreme audit institutions to monitor, control and publish the size of
contingent liabilities and other fiscal risks, the extent of conformity between the government's risk exposures and its proclaimed objectives, and the efficiency of both direct and contingent forms of government support. Unlike comprehensive reporting, accrual-based budgeting and accounting systems are neither necessary nor sufficient for fiscal prudence. Accrual standards, however, make the potential fiscal cost of contingent liabilities and hidden subsidies more transparent ex ante.

The pressure and acceptability of fiscal risks of government activities reflects the extent of consistency in four areas: (a) consistency of the government activities with the pronounced role and priorities of the state, (b) consistency in eligibility and management standards applied across government programs, (c) consistency of the risks assumed and reserves provisioned vis-à-vis the risk management capacities of the government, and (d) consistency between the authority of the policymakers to assume contingent fiscal risks and their accountability.

Table 3 summarizes steps to control fiscal risks before, when and after a program or promise is announced.

Table 3: Steps to control the risk of individual government programs and promises

<table>
<thead>
<tr>
<th>Measures</th>
<th>Fiscal Policy</th>
<th>Public Finance Institutions</th>
</tr>
</thead>
</table>
| Before government admits an obligation (program, commitment, promise of support) | • assess how the obligation fits the pronounced role and strategic priorities of the state  
   • consider the choices of policies and forms of support also with respect to the associated financial risks and government risk management capacity  
   • define and communicate the standards for and the limits of government involvement so to minimize moral hazard | • evaluate the program risks individually and in a single portfolio with the existing risks, estimate the potential fiscal cost of the obligation, and set additional reserves requirement  
   • design the program well to protect the government against risks |
| When obligation held                          | • stick to the pre-set limits of the government responsibilities            | • budget, account and disclose the obligation  
   • monitor the program risk factors and reserve-fund adequacy                  |
| After obligation falls due                    | • execute the obligation within its pre-set limits and take lessons for future policy choices  
   • if implicit, assess whether fulfilling the obligation coincides with the state's pronounced role and promotes the desired behaviors in the markets | • compare and report the actual fiscal cost versus the estimates, evaluate performance and punish for failures |

Agenda for the Future

Given the increasingly serious implications of contingent government liabilities for fiscal outlook of countries, it is time to: (a) extend the scope of fiscal sustainability analysis, and analysis of policies and institutions to address contingent fiscal risks, (b) require countries to disclose information regarding their exposure to contingent risks, and (c) assist countries to reform their analytical, policy and institutional public finance frameworks to embrace contingent fiscal risks.

Further Reading:


GOVERNMENT CONTINGENT LIABILITIES: A HIDDEN RISK TO FISCAL STABILITY

A Simple Framework

Hana Polackova, The World Bank
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i. Governments are exposed to increasing fiscal risks and uncertainties. This trend has three main reasons: (a) the increasing volumes and volatility of international private capital flows, (b) transformation of the state from financing of services to guaranteeing that particular outcomes will be accomplished by the private sector and (c) the occurrence of moral hazards in the markets related to the perceived residual responsibility of government. Sources of government fiscal risks are either direct or contingent, each of which can be either explicit or implicit. Most recently, also the Asian crisis showed that major moral hazards in the markets and great hidden fiscal risks may arise from contingent forms of government support.

ii. A good understanding and handling of contingent liabilities are important for governments to avoid the danger of a sudden fiscal instability and to ensure that their long-term policy objectives are accomplished. Particularly, governments would reduce fiscal risks by embracing contingent liabilities in their analytical, policy and institutional public finance frameworks. There are three main channels for governments to address fiscal risks: (a) by controlling contingent and implicit fiscal risks and orienting policies toward a good quality rather than high speed of fiscal adjustment, and, as much as to deter moral hazard in the markets, by publicly recognizing the limits of the state responsibilities, (b) by adjusting budgeting, financial planning, reporting, auditing and other fiscal institutions to incorporate both contingent and direct liabilities, and to promote fiscal prudence and equity across all contingent as well as directly financed public programs, and (c) by developing and employing institutional capacities to evaluate, regulate, control and prevent financial risks in both public and private sectors.

This paper may not represent the views of the World Bank. The team that produced the paper is comprised of Hafez Ghanem, Sanjay Pradhan, Sergei Shatalov, Allen Schick and Hana Polackova. The paper is a short version of a more comprehensive study (forthcoming), which further elaborates both the policy and institutional aspects associated with fiscal risks, and includes several country case studies of direct and contingent fiscal risks and the quality of fiscal adjustment.
INTRODUCTION

1. Governments are exposed to increasing fiscal risks. Fiscal risks have grown mainly through the international integration of financial markets, implying greater volumes and volatility of cross-border private capital flows, and through privatization of state functions accompanied by implicit or explicit state guarantees. State guarantees and insurance schemes, as opposed to budgetary subsidies and to the direct provision and financing of public services by government, have become a common method of government support. Off-budget programs and obligations imply, however, a hidden fiscal cost. Consequently, government off-budget commitments give rise to implicit and contingent liabilities, which may result into excessive public financing requirements in the medium and long term.

2. A process of fiscal adjustment concentrating on deficit reduction may omit or even elevate fiscal risks. Such fiscal risks are associated with structural policies, like pension and health care policies. Outside the budget, major fiscal risks, which are exacerbated by the subsequent occurrence of moral hazard in the markets, relate to explicit promises and implicit expectations that government will help in cases of various failures. Un-budgeted state support to large weak banks, enterprises and subnational governments are usual. Policymakers pursuing a balanced budget or some deficit target tend to favor off-budget forms of state support, which do not require cash immediately and, for some time at least, allow to hide the underlying fiscal cost.

3. In a market environment, governments cannot avoid but can control and reduce fiscal risks. Risks can be controlled only if they are recognized and fully considered in policy debates. But do governments have the incentives and capacities to reflect fiscal risks in their policy choices and pursue a good quality of fiscal adjustment? Incentives of policymakers in handling fiscal risks reflect the extent of their understanding and coercion. Fiscal risks become apparent only if fiscal analysis and institutions extend beyond government budget and debt and include contingent and implicit liabilities. Incentives of governments vis-à-vis direct and contingent fiscal risks mainly reflect the definition and measurement of internationally recognized fiscal indicators, the quality of public awareness and external monitoring, and the extent of punishment for concealing relevant data and exposing the state to excessive fiscal risk.

4. This paper will first classify and analyze potential obligations and fiscal risks facing governments. Second, the paper will examine the sources of various fiscal risks. Third, it will outline policy options to reduce fiscal risks in the context of fiscal adjustment. Particular attention will be given to the typology and the analysis of specific fiscal risks, to the high risk exposure of governments in transition and emerging-market economies, and to the quality and bias in government decision making in time of fiscal adjustment. How to make policy-makers accountable for recognizing the long-term cost of all forms of government activities? How to reduce moral hazard induced by government interventions? What standards for public sector accounting, budgeting, reporting, disclosure and risk management would foster sound fiscal performance in the long term? The paper will attempt to address these and similar questions. Shortly, a more comprehensive study will follow and apply the framework for direct and contingent fiscal risks in analysis of the quality of fiscal adjustment in selected countries.
POSSIBLE FINANCING PRESSURES ON THE CENTRAL GOVERNMENT

The Fiscal Risk Matrix

4. Governments face four types of fiscal risks. Each type of fiscal risk is a broadly defined liability combining two of the following four characteristics: Explicit versus implicit, and direct versus contingent.¹

- **Explicit liabilities** are specific obligations of the government defined by a particular law or contract. The government is legally mandated to settle such an obligation when it becomes due. The most common examples include the repayment of sovereign debt, and repayment of non-performing loans guaranteed by the state.

- **Implicit liabilities** represent a moral obligation or an expected burden of the government, not in the legal sense, but based on public expectations, political pressures, and the overall function of the state as understood by society. Implicit liabilities arise in respect to future public pension benefits if these are not specified by law, disaster relief for uninsured victims, and default of a large bank on non-guaranteed obligations.

- **Direct liabilities** are obligations that will arise in any event and in this sense are certain. These obligations are predictable according to some specific underlying factors. They do not depend (are not contingent) on any discrete event. For example, future public pensions constitute a direct liability, the size of which reflects the expected generosity of and eligibility for a benefit, and the future demographic and economic developments.

- **Contingent liabilities** are obligations that are triggered by a particular discrete event, which may or may not occur.² The probability of the contingency to occur and the magnitude of the government outlay required to settle the ensuing obligation are difficult to forecast. For each contingent liability, both probability and magnitude of the resulting obligation depend on some exogenous conditions, such as the occurrence of a particular event (e.g., a natural disaster or banking crisis), and some endogenous conditions, such as the design of government programs (e.g., the contracts for state guarantees and insurance) as well as the quality and enforcement of regulations and supervision.

5. Based on these characteristics, the fiscal risk matrix in table 1 provides a typology of the sources of future potential financing requirements facing central government. For each category, the matrix lists examples of government programs and promises that constitute a source of future potential fiscal pressures. Some of these examples apply across all countries (such as sovereign debt), others are more country-specific (such as crop insurance).

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¹ In the proposed international accounting standards for governments, a liability is defined as a present obligation of the government arising from past events, the settlement of which is expected to result in an outflow from the government of resources embodying economic benefits (International Federation of Accountants, 1998).

² International Accounting Standards define a contingency as a condition or situation, the ultimate outcome of which will be confirmed only on the occurrence, or non-occurrence, of one or more future events (International Accounting Standards Committee, 1997).
Table 1: The Fiscal Risk Matrix

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Direct (obligation in any event)</th>
<th>Contingent (obligation if a particular event occurs)</th>
</tr>
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<tbody>
<tr>
<td><strong>Explicit</strong></td>
<td>• foreign and domestic sovereign borrowing (loans contracted and securities issued by central government)</td>
<td>• state guarantees for non-sovereign borrowing and obligations issued to subnational governments and public and private sector entities (development banks)</td>
</tr>
<tr>
<td>Government liability as recognized by a law or contract</td>
<td>• expenditures by budget law</td>
<td>• umbrella state guarantees for various types of loans (mortgage loans, student loans, agriculture loans, small business loans)</td>
</tr>
<tr>
<td></td>
<td>• budget expenditures legally binding in the long-term (civil service salaries, civil service pensions)</td>
<td>• trade and exchange rate guarantees issued by the state</td>
</tr>
<tr>
<td></td>
<td>• government loans contracted and public and private sector entities and securities issued</td>
<td>• guarantees on borrowing by a foreign sovereign state</td>
</tr>
<tr>
<td></td>
<td>• state guarantees on private investments</td>
<td>• state guarantees on private investments</td>
</tr>
<tr>
<td></td>
<td>• state insurance schemes (deposit insurance, minimum returns from private pension funds, crop insurance, flood insurance, war-risk insurance)</td>
<td>• state insurance schemes (deposit insurance, minimum returns from private pension funds, crop insurance, flood insurance, war-risk insurance)</td>
</tr>
<tr>
<td><strong>Implicit</strong></td>
<td>• future recurrent cost of public investment projects</td>
<td>• default of a subnational government, and public or private entity on non-guaranteed debt and other liabilities</td>
</tr>
<tr>
<td>A “moral” obligation of Government which mainly reflects public expectations and pressures by interest groups</td>
<td>• future public pensions (as opposed to civil service pensions) if not required by law</td>
<td>• liability clean-up in entities under privatization</td>
</tr>
<tr>
<td></td>
<td>• social security schemes if not required by law</td>
<td>• banking failure (support beyond state insurance)</td>
</tr>
<tr>
<td></td>
<td>• future health care financing if not specified by law</td>
<td>• investment failure of a non-guaranteed pension fund, employment fund, or social security fund (social protection of small investors)</td>
</tr>
<tr>
<td></td>
<td>• default of central bank on its obligations (foreign exchange contracts, currency defense, balance of payment stability)</td>
<td>• default of central bank on its obligations (foreign exchange contracts, currency defense, balance of payment stability)</td>
</tr>
<tr>
<td></td>
<td>• bail-outs following a reversal in private capital flows</td>
<td>• bail-outs following a reversal in private capital flows</td>
</tr>
<tr>
<td></td>
<td>• residual environmental damage, disaster relief, military financing, ...</td>
<td>• residual environmental damage, disaster relief, military financing, ...</td>
</tr>
</tbody>
</table>

The liabilities listed above refer to the fiscal authorities, not the central bank.
Direct and explicit

6. In most countries, direct explicit liabilities are recognized by governments and commonly disclosed and quantified. Even though, the quantitative estimation of government outlays related to these obligations in the medium term is not trivial.

- **Obligations to settle direct foreign and domestic sovereign debt** are usually specified by governments in their loan contracts and securities. Future financing requirements of sovereign debt mainly reflect the maturity, currencies, and interest rate of the debt instruments. Based on these specifications, governments are able to forecast their debt service profile, simulate the trade-off between risk exposure and borrowing cost, and build debt service scenarios for alternative portfolio and macroeconomic developments. Denmark, Ireland and the United Kingdom provide excellent examples in analyzing and disclosing sovereign borrowing risks.

- **Budgetary outlays** are normally embedded in an annual budget law, which relates to the approved activities and policies of the government. In principle, the budget is legally binding and outlays are to comply with the budgeted figures throughout the fiscal year. In reality, the budget is viable only if it originates in a good macroeconomic analysis, and if the government employs institutional mechanisms for fiscal discipline and control.

- **Legal entitlement to a salary and pension** at a specified retirement age are extended to public employees by governments in many countries. Thus, with certainty, these legal entitlements will become a spending item in future state budgets. The magnitude of the subsequent spending requirements can be forecasted from the expected numbers of public employees, their expected remuneration, pension benefit and retirement age. According to its Fiscal Responsibility Act, New Zealand government is required to analyze and disclose such forecasts in the budget documents. (Should the government plan to down-size the civil service, it may be obligated to pay redundancy packages. Such an obligation would be contingent on the fact of down-sizing.)

7. In contrast to the environment depicted in the fiscal risk matrix above, countries that have legal provisions for government to finance future social security benefits, such as public pensions, universal health care, education, etc., would include these items among the direct explicit rather than implicit items.

Direct and implicit

8. Government direct implicit liabilities often arise as a presumed rather than legal or contractual consequence of public expenditure policies in the medium term. Such obligations are quantified and recognized only by governments that are committed to a transparent medium-term expenditure planning and long-term fiscal discipline. Assuming no policy changes, particularly the implicit cost of demographically driven public expenditures pose danger to fiscal stability in the long term.

- **The completion of public investment projects and maintenance** are only expected, not mandated by law. To deliver these, governments analyze and quantify, and are made
the ensuing long-term recurrent cost. Countries, like Australia and South Africa, implementing a medium-term expenditure framework include automatically the financing requirements for operation and maintenance in their fiscal outlook and future budgets, which makes the government obligation to sustain the benefits of public investments explicit.

- In many countries, *future public pension benefits* are not grounded in any legal document and thus, constitute an implicit rather than explicit government liability. Assuming that a given pension policy will continue (and there are economic, social and political reasons to assume that governments would not stop paying benefits without reforming the pension system first), then the overall obligation of the government is certain to arise in any event, hence it is a direct liability (even though it may not be a liability in the strict accounting sense). After the provision of public pensions was recognized as the most striking problem for fiscal sustainability in aging societies, many governments have analyzed the long-term fiscal implications of their pension policies and alternative reforms using long-term fiscal and pension models. (Pension reforms often encourage private sector involvement in saving for retirement through indirect forms of government support, such as guarantees of minimum pension benefits. Such guarantees then represent an explicit contingent liability of the government and are discussed below.)

- Similarly, *future health care and social security* financing can be analyzed (even if not accounted) as government direct implicit liability. Research has shown that, compared to public pensions, the dynamic of the financing requirement on health care in an aging society is often even more explosive. Thus, modeling and recognition of the long-term fiscal implications of health policies and their reforms are critically important for fiscal stability and equity in the long term.

**Contingent and explicit**

10. Commitment of a government to accept obligations contingent on future events represents a hidden subsidy and may cause immediate distortions in the markets and major unexpected drain on government finances in the future. Contingent explicit liabilities represent a legal obligation of the government to make a payment if a particular even occurs. They are not directly associated with any existing budgetary program. Each contingent explicit liability is recognized by the government in some formal documentation. However, many governments do not consolidate the full list and total magnitude of these obligations.

11. In contrast to many corporations, commercial banks and insurance companies, which have made a great progress in dealing with contingent liabilities in the last ten years, governments are yet to comprise contingent explicit liabilities in the overall fiscal analysis and expenditure planning. Similarly, most governments are yet to recognize the importance of a good design, surveillance and management of their programs to control fiscal risks. At the policy level, ex-ante analysis of the risks and future financial implications associated with the contingent forms of government support would contribute to better policy choices toward equity and long-term fiscal stability.
Guarantees are often issued by governments to cover a part of or the full risk that a borrower will fail to repay loan or other guaranteed asset, or that an institution will fail to fulfill its obligations. Common examples include state guarantees on debt and other obligations of subnational governments and various public and private entities, such as budgetary institutions, credit and guarantee funds, development banks, and enterprises. Guarantees and credit issued through a state-guaranteed intermediary are particularly risky as they allow the government to pursue unreported policy decisions, involve a problem of management incentives, and for the government are difficult to monitor and control. The hidden subsidy to the beneficiary of a guarantee, and the subsequent potential cost to the government, are positively correlated with the risk, size and duration of the underlying asset. In addition, the probability of default under a guarantee may be very high if the guarantee contract is not carefully designed with the inclusion of some risk-sharing between the government and the other parties under the contract, in terms of both the financial coverage (part of the loan versus the whole loan) and the risk coverage (specific political and/or commercial risks versus all risks). Governments routinely extend guarantees that cover all risks to the full extent. Such guarantees distort the markets and are called with a high probability. Depending on the capacities of the government, the risk assumed by the government can be estimated according to the historical experience, simple rules and, where appropriate, more sophisticated methodologies, such as actuarial, econometric, loss estimate and option pricing models. The assessment of risks allows the government to reflect the potential fiscal cost associated with guarantees in its choices of policies and forms of support and in the design of a guarantee contract. Following its Credit Reform Act, the United States now offer a good example of government analysis and design of credit guarantees.

Umbrella guarantees are extended to eligible persons or entities borrowing for a specific purpose, such as university studies, mortgage, farming, and small business development. The rationale for these guarantees and for the assessment of their risks and potential long-term cost are similar to the individual guarantees discussed above. This holds also for trade and exchange rate guarantees and for guarantees on foreign sovereign borrowing and private investments.

State insurance schemes often constitute a major risk to future fiscal balances. Common state insurance programs include bank deposit insurance, crop insurance, war-risk insurance, insurance of minimum returns from pension funds, and insurance against floods, earthquakes and other disasters. Most of these programs cover losses that occur very infrequently, but when they occur, their total magnitude may be enormous. The risk pool under these programs, particularly within a small market, is very limited, which also serves to justify the government’s involvement. Thus, rather than financing themselves from insurance fees, state insurance schemes redistribute wealth and rely on government net financing from general taxes. The analysis of risks and potential fiscal burdens associated with state insurance schemes requires sector data and sophisticated models, such as a hydrologic model to estimate the probabilities of floods in a given year, loss estimation methodologies and options pricing model to assess the riskiness of the returns of a pension fund. A qualitative analysis of the factors of risks is, however, sufficient for the government to design a sound

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3 For a detailed discussion of the valuation methodologies for loan guarantees and other contingent liabilities, see Mody and Patro (1996) and Mody and Lewis (1997).
insurance scheme that would not seriously distort the behaviors in the markets and to estimate roughly its potential fiscal cost. The United States may take the lead in this area, as the government adopts its proposed analytical and budgeting method for federal insurance programs (GAO, 1997).

Contingent and implicit

13. Contingent implicit liabilities are not officially recognized and may emerge as a part of the declared policy objectives. Governments accept such liabilities only after a failure in the public sector or market, reflecting either a pressure by the public, possibly interest groups, or just too high an opportunity cost of state non-action.

14. Contingent implicit liabilities often face governments with the greatest fiscal risk. The event triggering such a liability is uncertain, the value at risk difficult to evaluate, and the extent of government involvement difficult to predict. Therefore, it is very difficult to identify and estimate the size of the contingent implicit liabilities. These liabilities are particularly large if the macroeconomic framework in a country is weak, financial sector vulnerable, regulatory and supervisory systems inefficient information disclosure in the markets low.

15. In addition, expectations of government involvement generate moral hazard in the markets. The scope for moral hazard is particularly large in economies, in which the government significantly relieve market agents from the pain of their failure in the past and in which the government and investors do not have a good monitoring capacity over the risk exposure of market agents. Moral hazard may be constrained if the government determines and signals to the markets, in advance and through its actions, the limits of its future potential interventions. To reduce rather than expand the moral hazard, the signals have to imply government responsibility for minimum public goods only and a significant pain for agents who fail. The government needs to assess the costs and benefits of revealing its responsibility for each contingent implicit liability separately.

- In most countries, the financial system represents the most serious contingent implicit liability of the government. International experiences have indicated that the markets expect the government to help financially if the stability of the financial system is at risk. In case of a failure in the financial sector, governments are compelled to intervene financially far beyond their legal obligation either to secure some critical functions of the financial system, or to protect depositors and specific market agents beyond the limits of any state insurance schemes. Such practice further exacerbates the moral hazard problem in the financial and corporate sectors.

- Uncovered losses and default on non-guaranteed debt and obligations by a subnational government, state-owned or large private enterprise, budgetary or extra-budgetary agency,

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4 For 1997, the contingent fiscal cost of the domestic banking system (the level of direct and indirect costs to the government under the worst-case scenario) has been estimated by Standard & Poor's at levels under 10 percent of GDP in Argentina, Hungary, Italy, Poland, and Sweden, about 10 to 20 percent of GDP in Greece, Philippines, Singapore, Slovakia, U.K., and U.S. and over 30 percent of GDP in China, Czech Republic, Hong Kong, Japan, Korea, Malaysia, Thailand and Taiwan (Standard & Poor's, 1997).
or any other institution of political significance, may induce government to provide financing. Governments also accept various obligations of parastatal and public entities subject to privatization. (The government is often liable for obligations of state-owned financial institutions, which makes the obligations of state-owned banks a contingent explicit liability of the government.) The contingent implicit government liability associated with both the financial system and non-guaranteed corporate debt increases with rising amounts and less efficient allocation of private capital.

- Depending on social preferences, some critical social and welfare functions, even when contracted out from the government, are understood as the ultimate responsibility of the government. For example, in case of an investment failure of a non-guaranteed pension fund, employment fund, or social security fund, governments are called upon to assume financing of social services from the budget. Thus, non-guaranteed private provision of social and welfare services poses a contingent implicit financial risk for governments (Heller, 97).

- The ultimate responsibility for currency stability and balance of payment, thus also for the unmet obligations of the central bank, is also carried out by the fiscal authorities. Most recently, Thailand and other Asian countries have shown that fiscal obligations may arise from a fixed exchange rate regime or foreign exchange contracts of the central bank and, ultimately, connect to international bail-out packages. As in most instances listed above, the risk escalates with macroeconomic vulnerabilities and moral hazard in the markets.

- Private capital flows represent a contingent implicit risk to the government in four interrelated forms: (a) policy risk (the risk of exchange rate overvaluation and sterilization), (b) domestic assets valuation risk (asset bubble for real estate, productive and intangible assets, financial instruments, and domestic currency), (c) intermediation risk (interest-rate differential and weakness of the domestic financial system), and (d) borrowing risk (incentives for corporations, banks and governments to over-borrow and borrow short-term).

- Ultimately, environmental damage and disasters create a high demand for public moneys even apart of explicit state insurance programs and guarantees. Many countries face the financial risk of operating and dismantling nuclear plants, disposing nuclear and toxic waste, and accepting the residual cost of environment recovery. In the absence of developed private insurance industries, particularly in countries with the history of a care-taking state, disasters such as floods, earthquakes and draughts induce major political pressures on government to help.

**The Increasing Problem of Fiscal Risks**

The trend, bias, and moral hazard

16. Recent trends have suggested that governments are exposed to expanding fiscal risks. First, the high volumes and volatility of private capital flows and increasing economic dependence of countries on foreign capital have exacerbated the vulnerability of the domestic financial and corporate sector and, implicitly, of the government. Particularly in transition and emerging-market economies, domestic assets have become a subject to rapidly changing preferences of foreign investors. An interplay of policy risk (high exchange and interest rates), domestic assets valuation risk (asset bubble), intermediation risk of the domestic financial system
and borrowing risk (over-borrowing and borrowing short-term by government and market institutions) may lead to a sudden dumping of domestic equity, bonds and currency by investors. Such instances, as recently seen in Mexico, Asia and Russia, bring about a crisis, which is to be solved partly at the expense of the taxpayers.

17. Second, states have been transforming their role from direct provision and financing to guaranteeing that certain outcomes will be accomplished by the private sector. Privatization of state responsibilities and attempts to encourage private sector initiative through the government’s explicit or implicit guarantees has faced governments with an increasing uncertainty about the future public financing requirements. Would a guarantee be called? What will be the outlays of state insurance programs? Would reserve funds be able to cover the contingent losses? Several governments suffered from expenditures above any envisaged limits after a massive failure of projects under state guarantees, deposit insurance schemes busted, banking crisis kicked off, or private credit had proven excessive. In such instances, while developed countries such as France absorbed the fiscal shock by issuing more public debt, many transition and emerging-market countries have faced capital flight and plunged into a fiscal crisis.

18. Third, governments may be biased toward off-budget policies, which imply more financial risk but less immediate financing. Often, particularly in times of deficit reduction and a short-term political horizon, policymakers exploit the fact that off-budget commitments and obligations are not necessarily reported and allow to hide the cost of government policies. In such instances, decision-makers favor off-budget forms of government support, like state guarantees, direct credit, and absorption of private liabilities and bad assets. The many examples of fiscal opportunism involve countries under the European Monetary Union’s (EMU) fiscal ceilings of Maastricht as well as under World Bank and International Monetary Fund adjustment programs. Such forms of government support give rise to government contingent fiscal risks even though he cost and cash consequences may not be seen for many years.

19. Finally, explicit state guarantees and insurance schemes, or any implicit understanding that a government would come to rescue in cases of various market failures generate serious moral hazard problems in the markets. Loans and investments with a full guarantee suffer from insufficient analysis and supervision by creditors. Beneficiaries of poorly designed state insurance schemes tend to expose themselves to excessive risks. For instance in the United States, generous benefits under the federal flood insurance program caused an increase in the construction of houses in flood-prone areas (GAO, 1997). The impact on the behavior in the markets, in turn, makes the government more likely to be called for financial support later on.

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5 The 1992 Treaty of Maastricht sets the following fiscal limits: General government deficit as a net borrowing requirement: 3 percent of GDP; Total gross debt at nominal value outstanding at the end of the year and consolidated within general government: 60 percent of GDP. Both deficit and debt are calculated according to European System of National Accounts ESA78. ESA78 defines only roughly general government and does not require recording of government transactions on an accrual basis and of assets at market value. For description of opportunistic fiscal behaviors of governments under fiscal constraints see Easterly 1998 and Forte 1997.
Fiscal risks and the challenge of transition and emerging markets

20. The fiscal risks facing both implicitly and explicitly governments in transition and emerging-market economies are particularly large. Dependence on foreign financing, vague ownership structures in the economy, underdeveloped regulatory frameworks, and weak enforcement exacerbate the scope for failure in the financial and corporate sectors. Such failures, in turn, often generate political pressures on governments to intervene on an ad-hoc and ex-post basis, through various financial bail-outs. Recent history of repeated bail-outs, coupled with the earlier long tradition of the central plan, has produced enormous moral hazard in the markets. Bank bail-outs and recapitalizations in Hungary and the Czech Republic had to be repeated as long as the government was willing to intervene, while accumulating public liabilities. Consequently, low sovereign debt levels of the Czech Republic have been outweighed by public liabilities amassed outside the budgetary system (Ministry of Finance of the Czech Republic, 1998).

21. Government fiscal risks in transition and emerging-market economies are also exacerbated by the weak disciplining effects of international financial markets there. A small size and short history of the domestic market and weak information disclosure reduce the understanding of risks by investors. This partly explains why, in many emerging-market economies, creditors had tolerated excessive risk exposures of domestic financial institutions and enterprises, before fleeing. As economies integrate with international markets, more reliable data for statistical analysis become available, enhancing thus the ability of both governments and investors to estimate risks with standard methodologies. In contrast to the large risks and information asymmetry in the transition and emerging-market economies, however, risk management capacities there are scarce and costly to build (for instance, it is costly for governments to replace low-paid bureaucrats by financial analysts).

The hidden fiscal risks and the value of transparency and certainty

22. Government commitments and promises outside the budgetary system blur the analysis of past fiscal performance and future fiscal developments. Contingent fiscal risks surface only with a delay and in the form of unexpected public financing requirements. Usually, governments lack information on their particular fiscal risks and overall risk exposure. Often, governments are not accountable for the outcomes and cost of their off-budget commitments of state support. As a result, contingent fiscal risks may accumulate and require large government financing in the future. In few countries, governments are required to assess and compare the full cost of alternative budgetary and off-budget programs, and report the full list contingent liabilities and other fiscal risks. The United States and Italy provide some good examples in risk assessment of state guarantees, and New Zealand and Australia in reporting contingent fiscal risks.

23. In policy decisions, governments often face a trade-off between a direct provision and financing of services versus guaranteeing of private sector provisions. Direct provision and financing of services by the state require higher budget outlays in the short term. Private sector provision with the state guaranteeing certain outcomes, on the other hand, exposes the government to higher fiscal risks and uncertainty about future public financing requirements. If the government pursues a deficit target and short-term results, the latter looks more attractive.
However, once a contingent liability falls due and requires government financing, the government's choices are limited to the following actions: (a) increase deficit, (b) incur additional public liabilities without reporting any deficit increases, (c) cut some envisaged expenditures, (d) levy more taxes, (e) sell state assets, and/or (f) default on some obligations. Each of these actions would challenge government performance and credibility, thus reducing the effectiveness of future policies, compromising political stability, and impairing future performance and growth in the overall economy.

24. In this respect, the positive value of certainty (the cost of uncertainty) in the future public financing requirement is an important factor for government decision making. Alternative forms of government support can be prioritized, not only based on their contribution to the desired policy objectives and on their long-term cost, but also to reflect the volatility in the financing requirement and contribution to the government's overall risk exposure.

25. The value of certainty in public financing is particularly high for governments that have: (a) restricted or unreliable access to borrowing, (b) low risk management capacities, (c) low risk preference, and (d) strategic cash and debt management. Contingent liabilities are potentially very harmful for governments that cannot rely on a continued favorable access to borrowing. Large reserve funds may reduce the potential harm when contingent liabilities fall due. Such reserve funds involve, however, an opportunity cost. Governments with low capacity to analyze and manage risks, and in economies of less predictable outcomes and higher asymmetric information, are ill-prepared to cope with the potential moral hazard and financial uncertainties.

Government risk preference would ideally reflect risk preference of the median voter. A risk-averse government chooses direct provision with lesser volatility in the expected financing requirement rather than a guarantee even if both involve equal risk-adjusted net present fiscal cost and both would deliver equal policy outcomes. Finally, for governments with sophisticated and efficiently managed borrowing and financing strategies, an ad hoc financing requirement involves costly disruptions and efficiency losses.

Fiscal opportunism under debt and deficit ceilings

26. Internationally accepted criteria of fiscal performance, including those of the EMU, IMF and World Bank, are yet to be elaborated to encourage truly sound fiscal performance by governments and fiscal stability in a long-term horizon. Meanwhile, the trade-off between budget deficit and debt target and long-term fiscal stability, between the speed of deficit

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4 In a multi-pillar pension system, the adequacy of government guarantees on returns from private pension funds, depends on the analysis and assessment of the risks of guarantees be called, and on the government capacity to regulate and supervise private pension funds and cope with the problem of asymmetric information without high transaction costs. In the direct provision of pension benefits, total government outlays are predictable, and the government mainly seeks to balance the size of benefits, the retirement age, and contributions to make the pension provision fiscally sustainable. In the guaranteed portion of the pension system, citizens save for their retirement privately, but the government faces a high uncertainty about the amounts and timing of public financing that would be required in case that pension guarantees fall due.

7 In a parallel to a conclusion of the 1997 WDR that governments should adjust the extent of their interventions to the level of their institutional capacities, this paper argues that governments should adjust their overall risk exposure to their risk management capacities.
reduction and the quality of fiscal adjustment, may surface through fiscal opportunism and non-sustainable policies.

27. Examples of opportunistic behaviors in countries under the IMF and World Bank programs and, more recently in countries bidding for EMU membership indicate that a narrow focus on budget deficit and debt compels governments to delay structural reforms and investments, conceal the cost and financing of their programs outside their budgets, and raise temporary revenues. Such behaviors generate uncertainties about future public financing requirements and may endanger future fiscal stability. The focus on cash-based budget, deficit and debt also distorts government decisions about spending priorities and the timing and form of government support.

28. Table 2, lists opportunistic budgetary and accounting behaviors of governments to meet a deficit and debt target. These behaviors involve any or all of the three following types of imprudent government actions: (a) assume excessive liabilities for cash payment, (b) run down public assets, and (c) use excessively off-budget support in public policies. The scope for (a) and (b) are large for governments accounting on a cash basis. In cash-based accounting, expenses and liabilities are accounted not when an obligation is incurred but only when the actual cash transfer is made. Thus, governments collecting a fee for assuming a liability (e.g. for issuing a guarantee or accepting the pension liability of an enterprise under privatization) report such an event purely as net revenue gain. Option (c) is valid under both cash- and accrual-based accounting standards, but restricted by well designed accrual budgeting rules.

29. Accrual-based accounting system, without accrual budgeting, is neither necessary nor sufficient to ensure adequate policy consideration for contingent fiscal risks. Although it encourages governments to prepare a statement of contingent liabilities and financial risks, an accrual-based accounting system generally does not require that contingent liabilities be included in the balance sheet, and the associated risks be evaluated and quantified. International accrual accounting standards require that liabilities be accounted only when an obligation is due with certainty.¹

30. Policymakers are encouraged to make choices according to the risk-adjusted net present costs of alternative policies and forms of government support in an accrual-based budgeting system that is built on accrual-based accounting platform. Accrual-based budgeting requires that net present fiscal cost associated with various government programs and contingent liabilities be

included in budget documents. This way, contingent liabilities enter fiscal analyses and public accountability frameworks from the moment of their recognition by government.

Accrual-based accounting in the public sector has become a trend in the OECD countries. International accrual accounting standards for the public sector are proposed and elaborated by the International Federation of Accountants. Accrual-based accounting is also implied by the proposed update of the IMF Government Financial Statistics methodology. Accrual-based budgeting has been implemented in New Zealand and Iceland, and is on its way in the United Kingdom, Sweden, Netherlands, Canada, and Australia.
Table 2: Government opportunistic behaviors to meet the Maastricht deficit and debt ceilings

<table>
<thead>
<tr>
<th>Behaviors</th>
<th>On the revenue side</th>
<th>on the expenditure side</th>
</tr>
</thead>
</table>
| with the effect of increasing future payables and liabilities of government | To meet the deficit rule:  
- introduce an ad hoc tax to be reimbursed in the future  
- accept cash with the promise of future benefits  
- record revenues gross rather than net of the reimbursements, which are due later  
- exchange some existing public debt instruments for indexed bonds sold at a premium | To meet the deficit rule:  
- postpone inescapable expenditures, such as infrastructure investment, maintenance, etc.  
- favor off-budget forms of government support versus direct financing  
- delay a legal recognition and financing of government purchases and transfers  
- postpone legal recognition and quantification of rebates due to the taxpayers  
- record subsidies as purchases of (bad) assets from corporations and banks at a face value  
- record deficits of state-owned and municipal agencies providing non-market public services outside general government figures |
| | To meet the debt rule:  
- transform indebted government agencies into autonomous legal entities outside the general government while granting them a state guarantee  
- enter repo contracts with public debt | To meet the debt rule:  
- omit the existing net liabilities of public enterprises and agencies which are outside the sphere of general government but beneficiaries of government guarantees  
- favor trade credit as a form of support  
- exclude contingent liabilities from debt reports |
| reducing future receivables | To meet the deficit rule:  
- withhold revenues due in the following fiscal year  
- accept cash in exchange for future tax exemptions | |
| diluting the value of state assets | To meet the deficit rule:  
- record capital gains from a sale of property - possibly with a subsequent renting or lease back arrangement  
- charge a dividend from revaluation of the gold reserves of the central bank  
- charge a higher dividend from public holdings  
To meet the debt rule:  
- sell gold of the central bank  
- sell state assets | To meet the deficit rule:  
- cut operations and maintenance expenditures  
- reduce expenditures on complementary inputs into the service provided by the asset |
31. Contingent fiscal risks may significantly affect the results of fiscal analysis in a country. Contingent fiscal risks may be an important factor also for assessing allocative efficiency in the use of public moneys (the implicit subsidies and risk exposures relative to policy priorities). Finally, in terms of government operational efficiency contingent and implicit forms of government support may be not only risky, but also unnecessarily costly compared to a direct, budgetary provision.

32. The first necessary condition for governments to conduct fiscally prudent policies is that policymakers identify, classify and understand fiscal risks facing the government. Comprehension of fiscal risks and their consequences by policymakers will at least encourage the government to avoid risks bound to surface in a politically meaningful time horizon. For risks enlarging beyond the political horizon, fiscally sound behavior may depend on coercion. Particularly, policymakers are more likely to gravitate to fiscally sound decisions if they face the media and public, investors, credit-rating agencies and multilateral institutions who understand the full fiscal performance and punish governments for exposing the state to risks excessively and for concealing the risks. (See Annex I for a questionnaire to evaluate the problem of government fiscal risks and risk management in a country.)

33. Coercion to discipline the government’s fiscal behaviors beyond the budget deficit and debt can be internal and external. For internal coercion, the supreme audit institution would conduct and publicly explain its assessment of direct and contingent fiscal risks of each government agency and of the government as a whole. Although the assumption that voters truly care about government fiscal risks is not trivial, the public explanation of fiscal risks would also empower forces of external coercion. External coercion to be effective would primarily require that rules applied internationally for fiscal analysis be extended beyond the government budget and debt, and the problem of asymmetric information vis-à-vis governments overcome. Specifically, its basis would be formed by the quality of the following factors: (a) the definition, measurement, and monitoring of sound indicators of a full fiscal performance by international authorities, such as the IMF, World Bank, European Commission, or sovereign credit rating agencies and investors; (b) external pressure to develop adequate public finance institutions and disclose relevant information; and (c) punishment mechanism for governments attempting to conceal appropriate data.

34. The following sections discuss measures that a government can take to reduce its risk exposure and improve the quality of its fiscal performance. These measures are at the policy and institutional levels, both systemic and particular to the various stages of government decision-making process.10

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10 For policies and fiscal institutions to reduce public risks, see Schick, 1998 and Irwin, 1997.
Systemic measures to reduce fiscal risks
35. Table 3 lists systemic measures that encourage a sound fiscal behavior. These measures mainly aim at promoting understanding of fiscal risks by policymakers, public and markets.

<table>
<thead>
<tr>
<th>Measures</th>
<th>Fiscal Policy</th>
<th>Public Finance Institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Systemic</td>
<td>• consider full fiscal performance beyond the budget and debt</td>
<td>• internalize and disclose the full fiscal picture</td>
</tr>
<tr>
<td></td>
<td>• identify, classify and analyze all fiscal risks in a single portfolio</td>
<td>• monitor, regulate and have disclosed risks in the public and private sectors</td>
</tr>
<tr>
<td></td>
<td>• determine the government's optimal risk exposure and reserve policy according to its risk preference and risk management capacity</td>
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(a) Policy

36. For sound fiscal performance the government would include fiscal risks relating to the inter-temporary and residual obligations of the state in its fiscal analysis and decision-making process, and would consider fiscal risks against its risk preference and its financing and risk-management capacities. In this context, the following steps are critical:

Consider full fiscal performance beyond the budget and debt

37. Fiscal analysis and, particularly, the analysis of the quality of fiscal adjustment is correct only if it factors in the cost of implicit subsidies provided in the forms of government contingent support programs. In particular, the analysis of fiscal position of the government cannot be separated from obligations taken by the government outside the budget system. For instance, arrears and other obligations of state-owned and guaranteed institutions may pose a significant claim on public resources in the future. Moreover, the government may have abused some institutions to finance and implement its policies outside the budget system. Thus, a string of years with a balanced budget and low public debt suggests neither that the government has been fiscally prudent nor future fiscal stability.

38. In deciding between alternative forms of support, the government would consider medium-term fiscal impact and allocative and operational efficiency for programs pursued outside the budget to the same extent as for the budget. Medium-term fiscal forecasts, the budget itself, and government financing and borrowing plans are truly viable only if they make provisions for contingent and other fiscal risks.
Identify, classify and analyze all fiscal risks in a single portfolio

39. To understand and prepare for the full range of future potential fiscal pressures, policymakers would take the stock of existing programs and promises, and identify and classify the main sources of fiscal risks as shown in the fiscal risk matrix (table 1). In the order of significance, the government would analyze for each item of the fiscal risk matrix the factors of risks and ways of controlling and reducing the government's exposure to the risks. Qualitative analysis of risks would help the government to formulate and design soundly its new programs and promises.

40. The government would include the stock of contingent liabilities in a single portfolio with state debt and other public liabilities to evaluate correlations, sensitivity to macroeconomic and policy scenarios, and the overall risk exposure. In a single portfolio with its direct liabilities, the government would expose its contingent liabilities to its comprehensive risk strategy and to its guidelines regarding risk exposure, asset and liability management, hedging, and benchmarking. As an input to the analysis of its risk exposure, the government would also analyze information about budget arrears, state guarantees, state insurance programs, subnational government borrowing, obligations of state-owned and state-guaranteed institutions, effects of private capital flows, etc. In contrast to the deficit and debt constraints, indicators reflecting a comprehensive analysis of government exposure to fiscal risks would have a greater predictive value for future fiscal stability. (The forthcoming, more detailed version of this paper includes fiscal risk analysis for several countries.)

Determine the government's optimal risk exposure and reserve policy according to its risk preference and risk management capacity

41. The government would choose its risk and reserve strategy according to its overall risk exposure, risk preference, and the ability to manage risks and absorb contingent losses. Ideally, the government's risk strategy would target the risk preference of the median voter. The government would view new programs also according to their marginal impact on the overall risk exposure and fiscal outlook. The government would accept contingent and implicit forms of financial support only to the extent to which it is able to evaluate, regulate, control and prevent the risks. If it has a low capacity to evaluate and manage risks, then the government would favor a direct subsidy and direct provision rather than a guarantee, budget-financed schemes versus insurance-based systems of services (assuming that such services pass the check against the appropriate function of the state, given the overall capacities of the state). For this purpose, as it will be discussed in the following institutional section, the government will need to enact guidelines for prudent and sound fiscal management.

42. Reserve funds would provide liquidity of guarantees and other contingent liabilities and, thus, protect the government against pressures to increase deficit and debt, cut some envisaged expenditures, and/or default on its obligations if a contingent liability falls due. The benefit of a reserve fund for fiscal stability and government credibility is in a trade-off with the opportunity cost of withholding resources instead of spending them or cutting taxes. The reserve fund offers
the government more financial flexibility in dealing with the unexpected loss profiles if set centrally, for the whole portfolio of fiscal risks, rather than assigned to each risk item separately."

(b) Institutions

43. An institutional framework for public finance encourages the government to pursue sound fiscal performance only if it encompasses both direct and contingent fiscal risks. Public finance management framework that ignores future fiscal implications of contingent liabilities and other off-budget commitments makes such forms of government support look inexpensive and politically attractive.

44. An adequate institutional framework requires that any non-cash program involving a contingent fiscal risk, the government treat like another budgetary or debt item – from the viewpoint of aggregate fiscal stability and allocative and technical efficiency, control, public disclosure, and accountability. Rules are also needed for issuing, monitoring, and handling state guarantees and insurance programs, and for monitoring and financial management of public, state-guaranteed and subnational government institutions. As the role of state transforms from direct provision of services to guaranteeing against residual risks, so does evolve the need of governments to follow the example of the private sector in deepening capacities for fiscal analysis and management beyond the state budget and debt.

**Internalize and disclose the full fiscal picture**

45. Rules and practices in the budget process, financial management and public accountability framework determine the flexibility of policy-makers to have the government to assume immediate and future, both direct and contingent, non-budgeted obligations. Optimally, government choices would reflect qualitative and, where possible, quantitative evaluation of future potential outlays and risks associated with alternative forms of government support, including programs outside the budget, such as guarantees and activities of state-guaranteed agencies.

46. To address the problem of government accountability and fiscal discipline beyond the budget, public disclosure is more important than fully-fledged accrual-based accounting, budgeting and risk measurement systems. Particularly for governments with lower institutional capacities, a system requiring the government to assess the factors of risks, make a rough provision for contingent risks in the budget, and publish a statement of contingent liabilities and the overall risk exposure, is more sensible than the ultimately best institutional framework, involving accrual-based accounting and budgeting standards and sophisticated risk measurement methodologies.

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11 Recently, Australia, Canada and United Kingdom have moved in favor of a central pool of unallocated, government-wide reserves.
47. Accrual-based budgeting and accounting standards make the potential fiscal cost and hidden subsidies of contingent liabilities more transparent ex ante. In this context, quantitative risk analysis reveals the difference between the full risk premium, topped up by the cost of evaluating, managing and monitoring risks, and the fees charged by government for assuming a particular obligation (for instance pension liabilities of a privatized enterprise, a guarantee or state insurance) at the time coverage is extended. By bringing off-budget commitments into the budget and recognizing the hidden subsidies associated with government contingent forms of support, the government better reveals the long-term cost and benefits of its commitments, and enhances public scrutiny over the potential use of public moneys.

48. Public disclosure of fiscal information extending beyond the budget and direct debt enables the public and markets to monitor the government's full fiscal performance, including fiscal risks accumulated outside the budget. Then, market agents, such as investors and credit rating agencies are able to comprise both direct and contingent fiscal risks in their analysis and investment decisions, thus indirectly encouraging not only budgetary but overall fiscal discipline. In addition, greater fiscal transparency facilitates parliamentary scrutiny and the monitoring by international institutions, such as the IMF, World Bank and European Commission. Domestically, the government promotes both fiscal transparency and prudent government decisions by empowering the ministry of finance and supreme audit institutions to monitor, control and publish the size of contingent liabilities and other fiscal risks, the extent of conformity between the government's risk exposures and its proclaimed objectives, and the efficiency of both direct and contingent forms of government support.

Monitor, regulate and have disclosed risks in the public and private sectors

49. Fiscal risks are reduced when governments strive to prevent market failures and minimize moral hazard associated with their programs, commitments and own residual responsibility for market failures. To prevent market failures the government is responsible for the regulatory and law enforcement systems, for monitoring systemic risks in both private and public sectors, and for enforcing public disclosure of performance information in the markets so that risk exposure of both financial and non-financial institutions be transparent and regulative market mechanisms at work. A well developed regulatory and public disclosure systems are particularly important when government embarks on privatization while holding either explicit or implicit obligation to cover residual liabilities and ensure particular outcomes be achieved by the private agents.

50. Prevention of fiscal risks is an issue of analytical tools, incentives and capacities of parliamentarians, civil servants, regulators, supervisors, international institutions and market agents. Future research is to derive simple rules to indicate the dangers to fiscal stability based on indicators such as the total face value of all contingent liabilities, the overall risk-assumed by the government, the size and allocation of foreign private capital, accrual-based budget deficit, etc. Risk monitoring capacities of governments are potentially best developed at central banks.

Requirements and good practices for fiscal transparency have been outlined by the IMF in its Manual on Fiscal Transparency, 1998. The Manual briefly discusses transparency requirements for contingent fiscal risks.
reflecting their role in the balance-of-payments data collection and, in many instances, also in bank supervision. Specific risks may be well monitored by specific regulatory and supervision agencies such as the securities and exchange commissions. Ultimately, the ministry of finance and public liability management office would bear the responsibility for monitoring and for prevention with respect to the overall risk exposure of the government.

Measures to reduce the fiscal risk of individual government programs and promises

51. Whether government programs, promises and exposure to fiscal risks are appropriate depends on the extent of consistency in government policies and actions. Particularly, the following aspects of consistency influence the government's fiscal performance:

- consistency of government programs and promises with the pronounced role and strategic priorities of the state,
- consistency in eligibility and management standards applied across government programs and time,
- consistency of the risks assumed and reserves provisioned under a program with the risk management capacities of the government, and
- consistency between the authority of the policymakers to assume contingent fiscal risks and their accountability.

52. Table 4 summarizes steps for the government to control its fiscal risks before, when and after it announces a program or promise.
Table 4: Steps to control the risk of individual government programs and promises

<table>
<thead>
<tr>
<th>Measures</th>
<th>Fiscal Policy</th>
<th>Public Finance Institutions</th>
</tr>
</thead>
</table>
| Before government admits an obligation (program, commitment, promise of support) | • assess how the obligation fits the pronounced role and strategic priorities of the state  
• consider the choices of policies and forms of support also with respect to the associated financial risks and government risk management capacity  
• define and communicate the standards for and the limits of government involvement so to minimize moral hazard | • evaluate the program risks individually and in a single portfolio with the existing risks, estimate the potential fiscal cost of the obligation, and set additional reserves requirement  
• design the program well to protect the government against risks |
| When obligation held              | • stick to the pre-set limits of the government responsibilities              | • budget, account and disclose the obligation  
• monitor the program risk factors |
| After obligation falls due        | • execute the obligation within its pre-set limits and take lessons for future policy choices  
• if implicit, assess whether fulfilling the obligation coincides with the state’s pronounced role and promotes the desired behaviors in the markets | • compare and report the actual fiscal cost versus the estimates, evaluate performance and punish for failures |

Before government admits an obligation

(a) Policy

Assess how the obligation fits the pronounced role and strategic priorities of the state

53. A decision of the government to offer possible support both outside or through the budget mold the actual role of the state. Therefore, programs outside as well as inside the budget should be, in principle, subject to the same type of policy analysis and considerations. Thus, for contingent support programs such as guarantees of state-guaranteed institutions and funds, the government considers whether their objectives, fit within the pronounced role and priorities of the state and whether they justify the potential, risk-adjusted long-term fiscal cost.
Consider the choices of policies and forms of support also with respect to the associated financial risks and government risk preference and risk management capacity

54. Considering alternative programs and forms of support to pursue particular policy objectives, the quality of fiscal performance would benefit from acknowledging the cost of uncertainty in the future public financing requirement. For the government, as well as a corporation, an unexpected requirement for financing disrupts financial planning and increases the cost of borrowing or, in a worse case, runs the risk that no credit financing will be available. Thus, the government would judge alternative forms of implementing its policies not only according to their potential cost and benefits but also according to the extent of uncertainty they involve for future public financing. In addition, the government would judge contingent forms of support to the extent of asymmetric information and transaction costs. These considerations would be done against the government’s own risk preference, risk management capacities, and reliability of its access to ad-hoc borrowing.

Define and communicate the standards for and the limits of government involvement so to minimize moral hazard

55. Not so much the budgeted expenditures but contingent liabilities, particularly implicit liabilities, as understood by the public and markets, define the outer limits of state responsibilities and have an impact on the behavior of the public and market agents. The more formally and precisely the government defines and signals its responsibilities (its commitment area), the more distinct are explicit liabilities and the smaller are implicit liabilities. The more credibly the government defines its responsibilities and the more significant pain it implies for market agents in case of their failure and relying on government rescue, the lesser is the problem of moral hazard. For example, vis-à-vis local governments in a society with a strong tradition of large public services, the central government may be credible and reduce their moral hazard by signaling that it will ensure the delivery of core services to the citizens of municipalities which go bankrupt but it will not bail-out the municipalities from their debts.

56. The task for the government would be particularly to signalize credibly to the markets which actions are not to be expected from the state in case of various failures. Ultimately, the government will gain the needed credibility and reduce moral hazard in the markets and, thus, also curtail its fiscal risks, by acting upon its announcement (by refusing to submit to the pressures for a bail-out, or provide any support above the pre-defined levels).

(b) Institutions

Evaluate the program risks individually and in a single portfolio with the existing risks, estimate the potential fiscal cost of the obligation, and set additional reserves requirement

57. For alternative government programs, qualitative analysis of the factors of their risks and estimates of their potential long-term fiscal cost and hidden government subsidies prior to any commitment contributes to optimizing the choice and design of government programs. Rough quantification of the risk and potential fiscal cost of government contingent liabilities and
commitments improves the quality of information available to policymakers for their decisions and requires a good qualitative analysis of the underlying risks. Specialized methodologies, such as option pricing, actuarial, rate-setting, value-at-loss, and loss cost ratio, are of great value if a more precise estimate of the potential cost of a particular program is needed. According to the government reserve policy, the risk-exposure added to the overall government exposure by the proposed program would determine the amount of additional resources required for the government reserve fund.

**Design the program well to protect the government against risks**

58. Based on the qualitative risk analysis the government would identify those risks it can reasonably well control, decide which risks to cover under its proposed program of contingent support, and develop effective risk-sharing, regulatory and control mechanisms to monitor performance of the parties under the program. Apart of the exogenous risks, such as drought, the government risk exposure under a program is subject to endogenous risks, which are mainly a function of the program design implying various levels of market distortions and moral hazard. Thus a good design (a good guarantee contract, for instance, covering political rather than commercial risks, only 30-50% percent of the value, and the last rather than the first portion of the loss) reduces the potential fiscal cost of the program. A program that is to be implemented through an intermediary agency, such as a guarantee fund of any sort, and the intermediary agency itself, are more difficult to design, particularly with respect to management incentives and performance monitoring by the government.

59. For some programs, the government may charge risk-based premium, purchase reinsurance from private firms or contract out particular risk management functions. Other programs may be canceled altogether when the government corrects the functioning of the markets through its regulatory policies. For example, deregulation of insurance markets encouraging foreign insurance firms to enter the domestic markets greatly expands the pooling of some risks, making them insurable in the private sector. Risks related to disasters, uninsurable in a domestic market because of a too limited risk pool, become insurable in an internationally integrated market, which allows the government to dis-involve itself from programs such as crop insurance and flood insurance. For the largest financial risks, such as major banking and currency crises, one may argue, the IMF, World Bank and other multi-lateral agencies provide governments with some kind of reinsurance.

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13 The fiscal risks of government programs and promises, for both direct and contingent liabilities, are compounded from various aspects of risks, such as sovereign (political, legal and regulatory) risk, financial credit risk (foreign exchange rate risk, interest rate risk and refinancing risk) and program performance risk (development risk, completion risk, and operating risk). For a more detailed analysis of the types of risk see The Chase Manhattan Bank, 1996. For methodologies to estimate potential fiscal cost see Mody and Lewis, 1997 and Mody and Patro, 1996, GAO, 1997, and Penacchi 1997.

14 Risk evaluation and program design capacity is likely to be best placed with the Ministry of Finance, which would have the authority to approve and disapprove any potential financial commitments of the government. Public debt management office is likely to be best equipped to analyze the contingent fiscal risks in a single portfolio with the government debt portfolio and to decide on hedging and other risk-control instruments. For examples of policies protecting government against excessive risk exposure see Schick, 1998 and Irwin et al, 1997.
When the government accepts and holds an obligation

(a) Policy

Stick to the pre-set limits of the government responsibilities

60. After the government approves a program or commitment, and throughout the life of such an obligation, the main challenge at the policy level is to ensure that the markets and public do not expect any state support beyond the pre-announced limits. For parties potentially benefiting from the program, any indications that the government may provide financial support beyond the pre-announced limits would raise moral hazard and distort behaviors.

(b) Institutions

Budget, account and disclose the obligation

61. On the institutional side, the government faces the challenge of budgeting, accounting and provisioning for, and disclosing, the obligation adequately. To ensure that no unknown contingent liability appears only when it falls due, the public finance law would pronounce valid an obligation only if it had been assessed, budgeted, accounted for and, above all, disclosed at the time of its adoption by the government.

Monitor the program risk factors

62. Throughout the life of an obligation, the government needs to actively monitor its risk factors and the performance of the agents under the program. Monitoring is particularly important with respect to intermediary agencies, such as banks and various credit and guarantee funds, which are used and guaranteed by the state to implement its policy objectives. If it lacks a good monitoring capacity, the government may contract out this task for a performance-based fee. In any case, the cost of monitoring and administration of programs of contingent support may be relatively high and should be reflected in the ex-ante calculations of the potential fiscal cost of the program.

After a liability falls due

(a) Policy

Execute the obligation within its pre-set limits and take lessons for future policy choices

63. The requirement to execute the obligation after it falls due strictly within its pre-set limits is critical for the government particularly with respect to the credibility of future government announcements and to the scope for future moral hazard in the markets. For instance, paying out depositors above the deposit insurance levels indicates to the markets that the government in its actions submits easily to political pressure, to the depositors that banks offering higher yields are “safe” and to banking sector that excessive risks are worth taking.
64. By taking a lesson from a past involvement under its direct and contingent, both explicit and implicit, liabilities the government is able to adjust its role in an incremental manner rather than in an abrupt shift in a crisis. A timely and credible explanation of the adjustments in the state role that will affect future policy choices will prompt the public and market agents to adjust their expectations and behavior. For example, by explaining that the public pension scheme is not fiscally sustainable and that future governments will have to significantly reduce the pension benefit, the government influences saving behavior of people in the labor force.

*If implicit, assess whether fulfilling the obligation coincides with the state’s pronounced role and promotes the desired behaviors in the markets*

65. When public interest groups or market agents suddenly call the government to extend support beyond the originally pre-announced limits of state responsibility, policy-makers need to ask to what extent such support coincides with the pronounced role of state and how it affects future behaviors in the markets. The long-term damage of government acting upon an ad-hoc request may sharply exceed its potential short-term benefit. Acting upon ad hoc requests, however, may be politically attractive and the government is often able to find ways to abuse financial institutions and funds outside the public sector to implement and finance such actions. Thus, the public, investors and international authorities need to monitor the government responses to ad hoc claims of an implicit government liability and punish the authorities for fiscally irresponsible choices.

*(b) Institutions*

*Compare and report the estimated and actual cost of government support, evaluate performance and punish for failures*

66. The requirement to report and compare the ex-ante risk evaluation and the actual layouts associated with a program is critical for accountability of the government. Performance evaluation applies to the government departments and officials as well as to the parties under the program. The punishment may involve government officials, for instance if the ex-ante risk analysis had been distorted by particular interests, the management of state-guaranteed and intermediary agencies implementing government programs, e.g. for exposing the government to unnecessary and excessive risks, and the parties under the program for breach of any agreements.

**CONCLUSION**

67. Governments are exposed to increasing fiscal risks and uncertainties as a result of: (a) the increasing volumes and volatility of private capital flows, (b) the changing role of state from direct provision and financing of services to guaranteeing certain outcomes, (c) biases in policy decision making under fiscal constraints, and (d) moral hazard in the markets associated with expected state interventions. Fiscal risks are particularly large for transition and emerging-market economies, facing greater market opacity and a greater danger of market failures.
68. Potential fiscal risks of governments are of four types: direct and contingent, each of which may be either explicit or implicit. Most government and fiscal analysts concentrate on direct liabilities (direct explicit, such as the public debt and government budget, and direct implicit such as future pension and social security liabilities). Recent international experiences, however, indicate that significant fiscal instability may result from contingent liabilities (contingent explicit, such as obligations of state-guaranteed institutions and deposit insurance, and contingent implicit such as local government obligations, foreign credit of the domestic corporate and financial sectors, and banking failures).

69. A critically important aspect of long-term fiscal stability and equity is that governments publicly recognize the limits of the state and the associated direct and contingent fiscal risks. Public accountability of politicians and civil servants must be defined beyond the state budget to support prudent and efficient fiscal policies and management. Governments need to address the sources of fiscal risks at three levels: (a) by understanding the existing and potential fiscal risks and by pursuing policies toward a good-quality fiscal adjustment, (b) by developing an institutional framework, which involves adequate public disclosure and incentives in respect to fiscal risks, and promotes fiscal prudence and equity in all government programs, including promises of potential support extended outside the budget system, and (c) by building and employing institutional capacities to evaluate, regulate, control and prevent financial risks in both public and private sectors.

70. The paper offered an analytical framework to study contingent liabilities and other fiscal risks of governments and thus to better assess the quality of fiscal adjustment and fiscal outlook in countries. A more detailed version of this paper, which further elaborates both the policy and institutional aspects associated with fiscal risks and applies the analytical framework for fiscal risk assessment to several countries, is forthcoming.
References:


GAO, 1997, Budgeting for Federal Insurance Programs, Report to the Chairman, Committee on the Budget, House of Representatives, GAO/AMID-97-16, Washington, DC.


**The whole picture: coverage**

1. What are the major risks to future fiscal stability? Fill the table below with specific items. These include direct borrowing, guarantees, institutions that are covered by some type of government guarantee, state insurance programs, and all government commitments to spend or intervene financially in the future. In the classification think of direct liabilities (which are considered an obligation of the government in any event) and contingent liabilities (which will be considered an obligation of the government if a particular event occurs), each of which can be either explicit (defined by a law or contracts) or implicit (broadly predetermined by public expectations and pressures by interest groups).

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Direct (obligation in any event)</th>
<th>Contingent (obligation if a particular event occurs)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Explicit</strong></td>
<td>• foreign and domestic sovereign borrowing (loans contracted and securities issued by central government)</td>
<td>• state guarantees for non-sovereign borrowing and obligations issued to subnational governments and public and private sector entities (development banks)</td>
</tr>
<tr>
<td>Government liability as recognized by a law or contract</td>
<td>• expenditures by budget law</td>
<td>• umbrella state guarantees for various types of loans (mortgage loans, student loans, agriculture loans, small business loans)</td>
</tr>
<tr>
<td></td>
<td>• budget expenditures legally binding in the long-term (civil service salaries, civil service pensions)</td>
<td>• trade and exchange rate guarantees issued by the state</td>
</tr>
<tr>
<td><strong>Implicit</strong></td>
<td>• future recurrent cost of public investment projects</td>
<td>• state guarantees on borrowing by a foreign sovereign state</td>
</tr>
<tr>
<td>A “moral” obligation of Government which mainly reflects public expectations and pressures by interest groups</td>
<td>• future public pensions (as opposed to civil service pensions) if not required by law</td>
<td>• state guarantees on private investments</td>
</tr>
<tr>
<td></td>
<td>• social security schemes if not required by law</td>
<td>• state insurance schemes (deposit insurance, minimum returns from private pension funds, crop insurance, flood insurance, war-risk insurance)</td>
</tr>
<tr>
<td></td>
<td>• future health care financing if not specified by law</td>
<td>• default of a subnational government, and public or private entity on non-guaranteed debt and other liabilities</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• liability clean-up in entities under privatization</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• banking failure (support beyond state insurance)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• investment failure of a non-guaranteed pension fund, employment fund, or social security fund (social protection of small investors)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• default of central bank on its obligations (foreign exchange contracts, currency defense, balance of payment stability)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• bail-outs following a reversal in private capital flows</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• residual environmental damage, disaster relief, military financing; ...</td>
</tr>
</tbody>
</table>

The liabilities listed above refer to the fiscal authorities, not the central bank.

2. Is there a precise legal delineation of the public sector (for example in the form of a full list of public sector agencies) and government responsibilities? If yes, note the definition and/or reference to appropriate legal documents.
Selected risks

1. State-guaranteed institutions and directed credit:

- List all institutions that fulfill orders of government to extend financing to enterprises, banks, agencies of any kind, or households. Provide their balance sheets and statements of contingent liabilities.

- What type of government support do these institutions receive? (for example, privatization revenues, cheap financing via central bank, state guarantee on borrowings)

Try to draw a diagram showing the institutions involved in directed credit and the financial and cross-supporting flows.

2. Guarantees

- List all government guarantees, their issuer (the MOF versus another government agency) beneficiaries, creditors, face values, the type of risks and their shares covered, currency of denomination, risk estimates if any.

3. State-owned enterprises and banks

- List all large state-owned enterprises and provide their audited balance sheets and statements of contingent liabilities.

- List all large state owned banks and provide their audited balance sheets, statements of contingent liabilities, and risk-assessment of assets.

Recording and reporting: transparency

1. For each type of direct and contingent liabilities you identified in the table above, register the institutions responsible for final approval, recording, monitoring, and data consolidation.

2. Which institutions can instantaneously retrieve from their databases up-to-date figures of the items listed below. Which documents report such figures? What is the time lag in reporting?

- sovereign debt portfolio (breakdown according to maturities, currencies and interest-rate types)
- debt service profile for the next months and years
- guarantee portfolio (breakdown according to guaranteed institutions, sectors, currencies)
- the total face value of all state guarantees
- the total sizes of state insurance schemes
- the total sizes of reserve funds associated with guarantees and state insurance schemes
- private foreign and domestic borrowing
- sector allocation of foreign credit
3. Which sources of fiscal risks are, according to your view, not reported to:

- Ministry of Finance
- Cabinet
- central bank
- Parliament
- foreign investors
- public

**Institutional arrangements: accountability**

1. Are there any legal requirements on the government to estimate, account and report the future fiscal costs associated with its budgetary policies and off-budget promises (such as guarantees and other contingent liabilities)?
   
   No
   
   Yes - in the budget process
   when the government is called to pay
   when cash is transferred
   other:

2. Which of the liabilities that you identified in the table are not regulated by any law and depend fully on ad hoc government decisions?

3. Describe or provide references for:

   - state guarantees: the requirements for their design (the type of risks allowed to be covered, the extent of required risk-sharing), issuance (only the MOF is authorized?), government control mechanism (required reports from the creditor and beneficiary, audit and valuation requirements), and realization mechanism if they fall due.

   - subnational governments, public sector agencies and enterprises, and state-guaranteed institutions: the financial management and reporting requirements and government control mechanism.

   - demands on government to extend an ad hoc, previously unforeseen financial support: the legal requirements and practice for the deliberation process in government decision making.

4. Is the government legally required to explain the amounts of public liabilities?
   
   No
   
   Yes - to the Parliament
   to the public
   other:
Policy: practice

1. When considering alternative policy choices and forms of government support (such as direct provision and financing versus guarantees), do the Ministry of Finance, Cabinet, central bank or Parliament:
   - quantify the future fiscal cost of alternative options in a single medium-term fiscal framework?
   - describe the risks of alternative options?

2. As it appears, in which areas and under what circumstances is the government expected by the public or by interest groups to provide financial support beyond the budget?

3. List examples when government withstood political pressure and did not provide financial support above the budgeted figures? (For example, when the government refused to solicit financial support for a failed enterprise or bank.)

4. Are public enterprises and banks, state-guaranteed institutions, and creditors/beneficiaries under state guarantees “rewarded” and “punished” according to their management of risks? Provide examples.

Risk management: capacities

1. Describe the capacities of the MOF, other government agencies, public sector institutions and enterprises, and state-guaranteed institution to evaluate and control the risks of government programs and contingent liabilities.

2. Describe the process of designing a state guarantee or state insurance program.

3. How is the required size of the government reserve fund pre-determined?

4. What steps does the MOF and other agencies undertake to prevent fiscal risks arising from the public and private sectors? (For example, are any actions taken if enterprise debt or central bank obligations appear to high?)
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