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Contingent Government Liabilities

A Hidden Risk for Fiscal Stability

Hana Polackova

Many governments have faced serious fiscal instabilities as a result of their growing contingent liabilities. But conventional fiscal analysis and institutions fall short in addressing contingent fiscal risks. What approaches in fiscal analysis and standards for public sector management would foster sound fiscal performance? And how can policymakers be made accountable for recognizing the long-term costs of both direct and contingent forms of government activity in their decisions?

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Summary findings

Governments are increasingly exposed to fiscal risks and uncertainties for three main reasons:

- The increasing volume and volatility of international flows of private capital.
- The state's transformation from financing services to guaranteeing that the private sector will achieve particular outcomes.
- Moral hazards arising in markets because the government is perceived to have residual responsibility for market outcomes.

Sources of fiscal risk may be direct or contingent (a liability only if a particular event occurs). Whether direct or contingent, they are either explicit (recognized as a government liability by law or by contract) or implicit (a "moral" obligation reflecting public expectations and pressure from interest groups).

The recent Asian crisis revealed that major moral hazards exist in markets and that sizable hidden fiscal risks may arise from contingent forms of government support.

Governments must understand and know how to handle contingent liabilities if they are to avoid the danger of sudden fiscal instability and realize their long-term policy objectives. They can reduce fiscal risks by incorporating contingent liabilities into their analytical, policy, and institutional public finance frameworks.

Governments can address fiscal risk through three channels in particular, says Polackova:

- By including contingent and implicit financial risks in their fiscal analysis and (to deter moral hazard in the market) by publicly acknowledging the limits of state responsibilities.
- By reflecting the cost of contingent liabilities in policy choices, budgeting, financial planning, reporting, and auditing.
- By developing institutional capacity to evaluate, regulate, control, and prevent financial risk in both the public and private sectors.

Given the increasingly serious implications of contingent government liabilities for the fiscal outlook of countries, Polackova argues that it is time for the World Bank, the International Monetary Fund, and others to:

- Incorporate government contingent fiscal risks in their analysis of a country's fiscal sustainability, policies, and institutions.
- Require countries to disclose information regarding their exposure to contingent fiscal risks.
- Help countries embrace contingent liabilities in their analytical, policy, and institutional public finance frameworks.

This paper — a product of the Poverty Reduction and Economic Management Sector Unit, Europe and Central Asia Region — is part of a larger effort in the region to enhance the Bank's analytical and operational work in public finance. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Alison Panton, room H11-033, telephone 202-458-5433, fax 202-477-1440, Internet address apanton@worldbank.org. The author may be contacted at hpolackova@worldbank.org. October 1998. (31 pages)

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GOVERNMENT CONTINGENT LIABILITIES:

A HIDDEN RISK TO FISCAL STABILITY

Hana Polackova, The World Bank

The findings, interpretations, and conclusions expressed in this volume are those of the author and should not be attributed to the World Bank, affiliated organizations, or members of its Board of Directors or the countries they represent. The author thanks Hafez Ghanem, Sanjay Pradhan, Allen Schick, and Sergei Shatalov for their helpful comments and suggestions. The paper is a short version of a forthcoming, more comprehensive study that further elaborates the policy and institutional aspects of fiscal risks and includes several country case studies of direct and contingent fiscal risks and the quality of fiscal adjustment.

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SUMMARY

i. Governments are facing increasing fiscal risks and uncertainties. Most recently, the Asian crisis revealed how contingent forms of government support create major moral hazard in the markets and severe fiscal instabilities. The main reasons for this situation are: (a) the increasing volumes and volatility of international private capital flows, (b) a shift in the role of the state from directly financing and providing services to guaranteeing that the private sector will accomplish particular outcomes, (c) biases in policy decisionmaking under fiscal constraints, and (d) the existence of moral hazard in the markets because of a perception that the government has some residual responsibilities.

ii. Since off-budget government programs increasingly cause fiscal instabilities, a string of years with a balanced budget and low public debt figures does not necessarily suggest either past fiscal prudence or a good fiscal outlook. Thus, a study of government fiscal position must also examine the obligations taken by the government outside the budgetary system. The fiscal risks governments face are of four types: either direct or contingent, both of which in turn are either explicit or implicit. Governments that want to avoid the danger of sudden fiscal instability and accomplish their long-term policy objectives must have a good understanding of both their direct and contingent liabilities and must be able to handle them appropriately. But do governments have adequate incentives and capacities to deal with not only budgetary but also with all significant fiscal risks? Assistance and even coercion by international institutions may be required.

iii. There are four main ways governments can address fiscal risks: (a) control the contingent as well as direct, and implicit as well as explicit fiscal risks and orient policies toward good quality rather than rapid fiscal adjustment; (b) publicly recognize the limits of the state's responsibilities so as to deter moral hazard in the markets; (c) ensure that institutional arrangements for public finance and standards for budgeting, accounting, financial planning, reporting, and auditing address both contingent and direct liabilities and promote fiscal prudence and equity in all contingent as well as directly financed public programs; and (d) develop and employ institutional capacities to evaluate, regulate, control, and prevent financial risks in both the public and private sectors.

INTRODUCTION

Governments are facing increasing fiscal risks and uncertainties. Two of the reasons for this situation are: first, the international integration of financial markets, which has meant greater volumes and volatility of cross-border flows of private capital; and, second, the privatization of state functions, accompanied by implicit or explicit state guarantees. State guarantees and insurance schemes, as opposed to budgetary subsidies and direct provision and financing of public services, have become a common method of government support. These off-budget programs and obligations involve hidden fiscal costs, with implicit and contingent liabilities that may result into excessive requirements for public financing in the medium and long term.

The third reason is that policymakers pursuing a balanced budget or some deficit target tend to favor off-budget forms of state support that do not require immediate cash and that, at least for some time, hide the underlying fiscal cost. Fiscal adjustment that concentrates on deficit reduction may overlook or elevate the fiscal risks associated with structural policies affecting pensions and health care. Major fiscal risks outside the budget derive from explicit promises and implicit expectations that government will help when various failures occur. The subsequent emergence of moral hazard in the markets can exacerbate these risks. Usually the support governments offer to large weak banks, enterprises, and subnational governments in troubles is outside the budget.

Although it is impossible for governments in a market environment to avoid all fiscal risk, they can control and reduce the risks, but only if they recognize and fully consider them in their policy debates. Whether governments have the incentives and capacities to reflect fiscal risks in their policy choices and to carry out appropriate fiscal adjustment is an important question. The incentives will reflect how well policymakers understand the issues and the pressures they face in dealing with them. The fiscal risks become apparent only when the institutions conducting fiscal analyses look beyond the government's budget and debt to include the contingent and implicit liabilities. The extent of the incentives governments have to make direct and contingent fiscal risks transparent is linked mainly to the definition and measurement of internationally recognized fiscal indicators, to the quality of public awareness, external monitoring, and to the sanctions imposed for concealing relevant data and exposing the state to excessive fiscal risk.

This paper first classifies and analyzes the potential obligations and fiscal risks governments face and their sources. It next outlines the options for reducing fiscal risks in the context of fiscal adjustment, with particular attention to the typology and analysis of specific fiscal risks, the high risk exposure of governments of transition and emerging-market economies, and the quality and bias in government decisionmaking at the time of fiscal adjustment. Several questions are addressed. How can policymakers be made accountable for recognizing the long-term cost of all forms of government activities? How can the moral hazard induced by government interventions be reduced? What standards for public sector accounting, budgeting, reporting, and risk management would foster sound fiscal performance in the long term? A forthcoming, more comprehensive study presents a framework for including direct and contingent fiscal risks in fiscal analysis and applies it to selected countries.

POSSIBLE FINANCING PRESSURES ON THE CENTRAL GOVERNMENT

The Fiscal Risk Matrix

Governments face four types of fiscal risk, each of which is a broadly defined liability that combines two of the following four characteristics: explicit versus implicit and direct versus contingent.[1]

- *Explicit liabilities* are specific obligations of the government established by a particular law or contract. The government is legally mandated to settle the obligation when it comes due. Common examples are the repayment of sovereign debt and repayment of nonperforming loans the state has guaranteed.
- *Implicit liabilities* involve a moral obligation or expected responsibility of the government that is not established by law or contract but instead is based on public expectations, political pressures, and the overall role of the state as society understands it. Examples of implicit liabilities are future public pension benefits that are not specified by law, disaster relief for uninsured victims, and default of a large bank on nonguaranteed obligations.
- *Direct liabilities* are obligations that will arise in any event and are therefore certain. They are predictable based on some specific underlying factors; they do not depend (are not contingent) on any discrete event. For example, future public pensions specified by law are a direct liability whose size reflects the expected amount of the benefit, eligibility factors, and future demographic and economic developments.
- *Contingent liabilities* are obligations triggered by a discrete event that may or may not occur.[2] The probability of the contingency occurring and the magnitude of the government outlay required to settle the ensuing obligation are difficult to forecast. Probability and magnitude depend on some exogenous conditions, such as the occurrence of a particular event (for example, a natural disaster or banking crisis) and some endogenous conditions, such as the design of government programs (an example being the contracts for state guarantees and insurance), as well as on the quality and enforcement of regulations and supervision. The fiscal risk matrix in table 1 provides a typology of the sources of the potential financial requirements central governments face. Under each category are examples of government programs and promises that can create fiscal pressures. Some of the examples apply across all countries (such as sovereign debt), whereas others are more country-specific (such as crop insurance).

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[1] The international accounting standards for governments proposed by the International Federation of Accountants define a liability as a present obligation of the government that entails a form of economic benefits and that arises from past events whose settlement is expected to result in an outflow of government resources (International Federation of Accountants 1998).

[2] International accounting standards define a contingency as a condition or situation whose ultimate outcome is determined only by the occurrence, or nonoccurrence, of one or more future events (International Accounting Standards Committee 1997).

TABLE 1: THE FISCAL RISK MATRIX

Liabilities[a]	***Direct*** *(obligation in any event)*	***Contingent*** *(obligation if a particular event occurs)*
Explicit Government liability is recognized by law or contract	• Foreign and domestic sovereign borrowing (loans contracted and securities issued by the central government) • Expenditures by budget law • Budget expenditures legally binding in the long term (civil service salaries, civil service pensions)	• State guarantees for nonsovereign borrowing and obligations issued to subnational governments and public and private sector entities (development banks) • Umbrella state guarantees for various types of loans (such as for mortgages, students studying agriculture, and small businesses) • State guarantees (for trade and the exchange rate, borrowing by a foreign sovereign state, private investments) • State insurance schemes (for deposits, minimum returns from private pension funds, crops, floods, war risk)
Implicit A "moral" obligation of the government that mainly reflects public expectations and pressures by interest groups	• Future recurrent costs of public investment projects • Future public pensions (as opposed to civil service pensions) if not required by law • Social security schemes if not required by law • Future health care financing if not specified by law	• Default of a subnational government and public or private entity on nonguaranteed debt and other liabilities • Cleanup of the liabilities of privatized entities • Bank failure (beyond state insurance) • Investment failure of a nonguaranteed pension fund, employment fund, or social security fund (social protection of small investors) • Default of the central bank on its obligations (foreign exchange contracts, currency defense, balance of payments stability) • Bailouts following a reversal in private capital flows • Residual environmental damage, disaster relief, military financing, and the like

[a] Of fiscal authorities, not the central bank.

Direct Explicit Liabilities

In most countries, the central government commonly recognizes, quantifies, and discloses direct explicit liabilities. Even so, estimating the size of the government outlays related to these obligations in the medium term is not a simple task.

- Governments usually specify *obligations to settle direct foreign and domestic sovereign debt* in their loan contracts and securities. The future financing requirements mainly relate to the maturity, currencies, and interest rate of the debt instruments. Using these specifications, governments forecast their debt service profile, simulate the tradeoff between risk exposure and the cost of borrowing, and build debt service scenarios for alternative portfolio and macroeconomic developments. Denmark, Ireland, and the United Kingdom provide excellent examples of how to analyze and disclose sovereign borrowing risks.
- *Budgetary outlays* are normally embedded in an annual budget law, which contains 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 practice, the budget is viable only if it is based on good macroeconomic analysis and if the government employs institutional mechanisms for fiscal discipline and control.
- Governments in many countries extend *legal entitlements to a salary and pension* at a specified retirement age to public employees. It is certain these legal entitlements will be a spending item in future state budgets. Their magnitude is based on forecasts of the numbers of public employees and their expected remuneration, pension benefit, and retirement age. Under New Zealand's Fiscal Responsibility Act, the government is required to analyze and disclose such forecasts in budget documents. (Where a government plans to downsize the civil service, it may be obligated to pay redundancy packages, whose overall cost would be contingent on the actual downsizing.)

In contrast to the environment depicted in the fiscal risk matrix (table 1), countries with legal provisions that the government finance future social security benefits, such as public pensions, universal health care, and education, list these as direct explicit rather than implicit items.

Direct Implicit Liabilities

Direct implicit government liabilities often arise as presumed, rather than as legal or contractual, obligations established by public expenditure policies in the medium term. Only governments that are committed to transparent medium-term expenditure planning and long-term fiscal discipline recognize and quantify these obligations. Assuming no policy changes, the implicit cost of demographically driven public expenditures is what in particular poses a danger to fiscal stability in the long term.

- *The completion of public investment projects and maintenance* are only expected, not mandated, by law. Governments analyze and quantify, and are accountable for, the ex-ante estimates and actual multiyear investment and ensuing long-term recurrent costs. Countries such as Australia and South Africa use a medium-term expenditure framework that automatically includes the financing requirements for operations and maintenance in the

fiscal outlook and future budgets. Thus, government obligations to sustain the benefits of public investments are explicit.

- In many countries, *future public pension benefits* are not grounded in any legal document and therefore are not explicit but rather are implicit government liabilities. Assuming that a given pension policy will continue, it is certain that the overall obligation of the government will occur (there are economic, social, and political reasons for assuming that a government would not stop paying the benefits unless it first reformed its pension system). Hence future public pension benefits are a direct liability, even though not in the strict accounting sense. Since the provision of public pensions is recognized as the most striking problem for fiscal sustainability in aging societies, many governments have been analyzing the long-term fiscal implications of their pension policies and of alternative reforms using long-term fiscal and pension models. (A point discussed below is that pension reforms often encourage private sector involvement in saving for retirement because the government provides indirect forms of support, such as guarantees of minimum pension benefits. These guarantees are an explicit contingent liability of the government.)

- Similarly, *future health care and social security* financing can be analyzed as a direct implicit government liability (even if not accounted as such). Research shows that the dynamics of the financing requirement for health care in an aging society is often even more explosive than that for public pensions. Modeling and recognition of the long-term fiscal implications of health care policies and their reforms are critically important for fiscal stability and equity in the long term.

Contingent Explicit Liabilities

Contingent explicit liabilities are a legal obligation of the government to make a payment if a particular event occurs; they are not directly associated with any existing budgetary program. A government's commitment to accept obligations contingent on future events amounts to a hidden subsidy and may cause immediate distortions in the markets and result in a major unexpected drain on government finances in the future.

Although governments recognize each contingent explicit liability in some formal documentation, many have yet to consolidate all these obligations and their total magnitude in one place and to include them in their overall fiscal analysis and expenditure planning. In contrast, many corporations, commercial banks, and insurance companies have made considerable progress in dealing with contingent liabilities in the past 10 years. Similarly, governments have not yet recognized the importance of good design, monitoring, 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 contribute to better policy choices on equity and long-term fiscal stability.

- Governments often issue *guarantees* to cover part or all of the risk that a borrower will fail to repay a loan or other guaranteed asset or that an institution will fail to fulfill its obligations. Common examples include state guarantees of 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 because they allow the government to pursue unannounced policy decisions, involve a problem of management incentives, and are difficult for governments 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 a default may be very high if the guarantee contract does not specify risk-sharing by both the government and the other parties in terms of both the financial coverage (part versus all of the loan) and risk coverage (specific political or commercial, versus all risks). Government guarantees routinely cover all risks fully. Such guarantees distort the markets and are called with high probability. The risk a government assumes can be estimated based on the experience of governments of different capacities, simple rules, and, where appropriate, more sophisticated methodologies such as actuarial, econometric, loss estimate, and option pricing models.[3] Assessment of risks allows governments to reflect the potential fiscal cost associated with guarantees in their choices of policies and forms of support and in the design of a guarantee contract. Since passage of the Credit Reform Act, the United States provides good examples of government analysis and the design of credit guarantees.

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

- *State insurance schemes* often constitute a major risk to future fiscal balances. Common state insurance programs cover bank deposits, crops, war risks, minimum returns from pension funds, and floods, earthquakes, and other natural disasters. Although most of these programs cover losses that occur very infrequently, when the losses do occur, their total magnitude may be enormous. The risk pool under these programs, particularly in small markets, is very limited, one justification for government's involvement. State insurance schemes rely on net government financing from general taxes, rather than on insurance fees, and thus redistribute wealth. The analysis of risks and potential fiscal burdens associated with state insurance schemes requires sector data and sophisticated models (such as the hydrologic model used to estimate the probabilities of floods in a given year), and loss estimation methodologies and options pricing models to assess the riskiness of the returns of a pension fund. A qualitative analysis of the risk factors is, however, sufficient for the government both to design a sound insurance scheme that would not seriously distort market behaviors and to make a rough estimate of its potential fiscal cost. The United States may take the lead in this area as its government adopts the analytical and budgeting method for federal insurance programs proposed by the General Accounting Office (United States, General Accounting Office 1997).

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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).