

Accrual concepts are vital to manage Fiscal Risks

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IMF/IPSASB/WBG Conference on “*Transparency and Beyond: Harnessing the Power of Accrual in Managing Public Finances*”. Washington, DC. March 6, 2017

Definition: Contingent Liabilities

- ❑ Contingent liabilities are obligations triggered by a discrete but uncertain event.
(Polackova Brix and Allen Schick)
- ❑ Refers to obligations whose timing and magnitude depend on the occurrence of some uncertain future event outside the control of the government.
(Aliona Cebotari)

I. What Fiscal Risks?

Conceptual Framework

Fiscal Risks can arise from both sides of the Government Balance Sheet

- On the Liabilities Side
 - The Fiscal Risks Matrix
- On the Assets Side
 - The Fiscal Hedge Matrix

Sources of Fiscal Risks

- “Risk” is uncertainty of outcomes caused by future events
- Same risks **work on both sides of the government balance sheet** and may lead to:
 - Higher than anticipated outflows
 - Lower than anticipated inflows
- On the liability side, risks affect direct as well as contingent external debt
- On the asset side risks may erode the value of accumulated assets and reduce the inflows
- Risks often feed each other, delivering powerful pro-cyclical blow to the government balance sheet.

Fiscal Risk Matrix: For Liabilities

Possible sources of fiscal risk for Central Government*

	Direct liabilities	Contingent liabilities
Explicit liabilities (Legal obligation, no choice)	<ul style="list-style-type: none"> • Foreign and domestic sovereign debt • Budget expenditures—both in the current fiscal year and those legally binding over the long term (civil servant salaries and pensions) 	<ul style="list-style-type: none"> • Guarantees for borrowing and obligations of sub-national governments and SOEs. • Guarantees for trade and exchange rate risks • Guarantees for private investments (PPPs) • State insurance schemes (deposit insurance, private pension funds, crop insurance, flood insurance, war-risk insurance) • Unexpected compensation in legal cases related to disparate claims.
Implicit liabilities (Expectations – political decision)	<ul style="list-style-type: none"> • Future public pensions if not required by law • Social security schemes if not required by law • Future health care financing if not required by law • Future recurrent cost of public investments 	<ul style="list-style-type: none"> • Defaults of sub-national governments and SOEs on nonguaranteed debt and other obligations • Liability clean-up in entities being privatized • Bank failures (support beyond state insurance) • Failures of nonguaranteed pension funds, or other social security funds • Environmental recovery, natural disaster relief

* Note: These liabilities refer to fiscal authorities, not the central bank.

Source: *Contingent Liabilities – a threat to fiscal stability*, PREM Notes, no.9, November 1998.

Fiscal Hedge Matrix: Assets and Contingent Financing

SOURCES of Financial Safety	DIRECT (based on the stock of existing assets)	CONTINGENT (dependent on future events, such as value generated in the future)
EXPLICIT (based on government legal powers such as ownership, right to raise taxes and other revenues.)	<ul style="list-style-type: none"> • Asset recovery (workouts, sales of non-performing loans, state equity sales, etc.) • Proceeds from privatization of state-owned enterprises (SOEs) and other public resources. • Recovery of government loan assets (e.g. resulting from earlier direct government lending.) 	<ul style="list-style-type: none"> • Government Revenues from natural resource extraction and sales. • Government customs revenues • Tax Revenues less: <ul style="list-style-type: none"> ➤ Tax Expenditures ➤ Revenues from forward sales (e.g. commodity forward sales) ➤ Hedging instruments and re-insurance purchased by government.
IMPLICIT (based on Government indirect control)	<ul style="list-style-type: none"> • Stabilization and Contingency funds.* • Positive net worth of Central Bank. 	<ul style="list-style-type: none"> • Profits of state-owned enterprises • Contingent credit lines and financing commitments from IFIs. • Current account surpluses across currencies.

Source: Polackova-Brix, Hana and Alan Schick (1998), *Government at Risk*, World Bank. p. 26.

Note: * Can be designed as general or specific purpose funds under direct or indirect control of government.

II. Why do Fiscal Risks Matter?

Fiscal Risks can pose large burdens of public budgets

Average Fiscal Cost of Contingent Liability Realizations, 1990-2014.

(From IMF Dataset on 80 advanced and Emerging economies.)

Type of Contingent Liabilities	No. of Episodes	No. of episodes with identified fiscal costs	Avg. Fiscal Costs (% of GDP)	Maximum Fiscal Costs (% of GDP)
Financial Sector	91	82	9.7	56.8
Legal	9	9	7.9	15.3
Subnational	13	9	3.7	12.0
State-owned Enterprises	32	31	3.0	15.1
Natural Disaster(s)	65	29	1.6	6.0
Private Non-Financial Sector	7	6	1.7	4.5
Public-Private Partnerships	8	5	1.2	2.0
Other	5	3	1.4	2.5
TOTAL	230	174	6.1	56.8

Source: Elva Bova, Marta Ruiz-Arranz, et al. (2016) IMF Staff Working Paper No. WP/16/14.

Fiscal icebergs



Fiscal Risks from State-owned Enterprise (SOE) Liabilities

- SOE liabilities may translate into **explicit** and **implicit** fiscal costs for a national or subnational government.
- **SOE restructuring will impose fiscal pressures**—especially for loss-making SOEs and those with already large outstanding liabilities.
- **Electricity SOEs are exposed to both exchange rate and oil price fluctuations** which makes cost recovery always quite fragile, especially in countries where there has been lack of progress on cost pass-through mechanisms.
- For energy exporters, a significant part of electricity subsidies may be carried on the hydrocarbon sector's balance sheet if **oil and gas is under-priced** into the electricity sector.

SOE

- Carries out non-commercial objectives
- Incurs losses (technical)
- Mispricing

Can result in



- High debt levels
- Arrears (vis-à-vis tax authorities, suppliers, inter-SOE)

May require



- Capital injections
- Bail outs
- Clean ups of SOE balance sheets



Exacerbated by



State

- Mandates SOE to carry out NCOs (sometimes unremunerated by State)

- Allows arrears to accumulate
- Subsidizes lending to SOE
- Guarantees SOE debts



- Moral hazard
- Reduced fiscal space
- High borrowing costs
- Fiscal vulnerability

Fiscal Risk Matrix: How SOEs can contribute to fiscal impacts in future.

	Operating Statement	Balance Sheet	
	Revenues	Direct Liabilities	Contingent Liabilities
Direct	Tax payments Dividend flows		
Explicit obligations		<ul style="list-style-type: none"> • Direct subsidies and transfers, including to cover non-commercial obligations of SOEs • On-lent loans to SOEs 	<ul style="list-style-type: none"> • Sovereign guarantees for SOE debt • Contracts (including PPPs) with guarantee clauses (e.g., securing loan repayments)
Implicit obligations		<ul style="list-style-type: none"> • Arrears owed to the State • Inter-enterprise arrears 	<ul style="list-style-type: none"> • Default of unguaranteed SOE debt (bail outs, capital injections) • Cleanup of SOE liabilities, arrears

Fiscal Risks from Public-Private Partnerships (PPPs)

- This requires combining sector-specific (micro) and economy-wide (macro) analyses of fiscal risks.

PPPs and Fiscal Management

Assessing affordability and managing fiscal commitments

- Fiscal costs & fiscal risks from each project
- Aggregate risks and fiscal stability
- Fiscal rules
- Accounting standards
- Reporting procedures

Assessing project efficiency and PPP mechanisms

- ✓ Cost & benefit analysis
- ✓ PPP vs non-PPP
- ✓ Which type of PPP
- ✓ Bankability / fin. cost
- ✓ Long-term robustness

Limiting moral hazard

- **Debt Sustainability Analysis (DSA)** and **Medium-term Budget Framework (MTBF)**: include potential costs to the budget of all PPP contracts
- **Full disclosure**: Budgetary costs of PPP contracts over time; obligations borne by government and by SOEs

Assessment of Fiscal Risks

- Go beyond estimating aggregate fiscal risks to pointing out the specific sources of such risks and what can be done about them.
- This needs deep sector/utility knowledge that requires collaborative effort between Economists and Sector/Utilities/PPP experts
- The combination of analytical tools (micro/macro) to be used for this fiscal analysis is country specific.

Fiscal Risks Assessments and linkages with Fiscal and Debt Sustainability Analyses

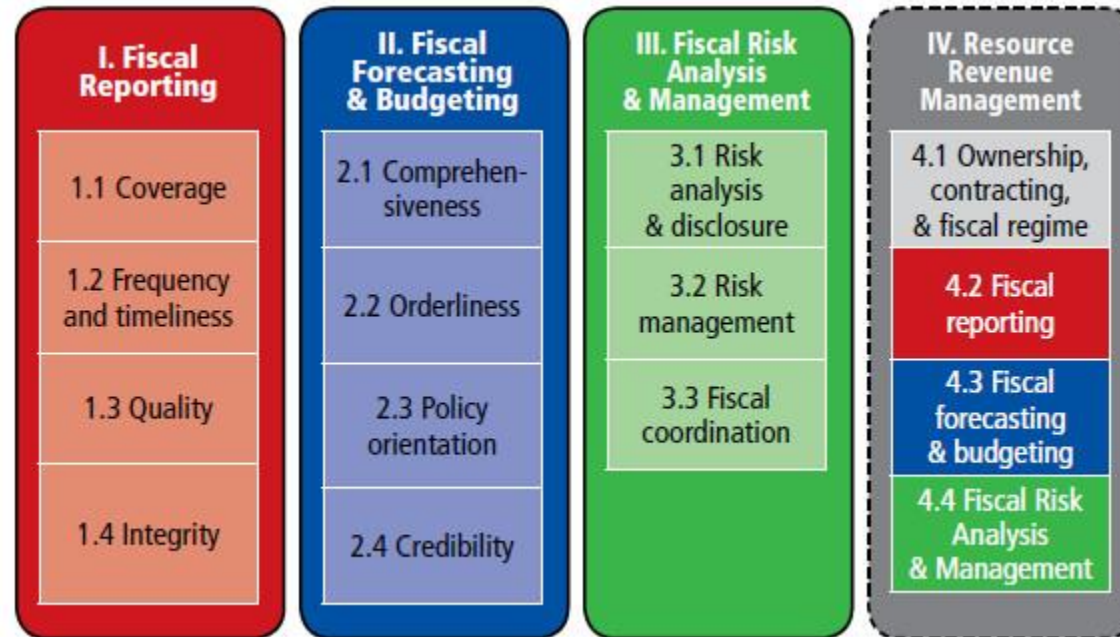
- Allows for better Integration of PPPs in Public Investment Management framework
 - Assessing projects and portfolio of PPP projects.
- Emphasizes the need for PPP fiscal sustainability and financial risks management, improving project selection through more competitive process
 - Projects are selected by their socio-economic impact (rather than *off-budget* characteristics and accounting considerations that generate “hidden deficits”.)
- Linkages with Fiscal Rules.
- Fiscal Sustainability analyses are now able to incorporate commitments and risks accruing from PPPs (incl. scenario analyses and stress tests).

Improving Fiscal Reporting of PPPs

- *The IMF's new **Fiscal Transparency Code*** suggests that “Fiscal reports cover all entities engaged in public activity according to international standards.” Here PPP obligations should be disclosed and actively managed.
- ***International Public Sector Accounting Standards*** (IPSAS), particularly IPSAS-19 provisions (Contingent Liabilities and Contingent Assets) and IPSAS-32, has published public accounting standards based on the “control-criterion” which puts most PPPs, guarantees and other contingent liabilities in the balance sheet of the government.
 - ✓ This practice is compatible with private sector accounting practices
 - ✓ It does not mean that PPP investment will be classified as “public debt”, just better reporting on the government’s contingent liabilities.
- <https://www.ifac.org/system/files/publications/files/ipsas-19-provisions-c.pdf>
- ***Eurostat's*** ESA-95 have been revised towards better scrutiny of PPPs with standards based on the “risks-and-rewards” criterion.

IMF Fiscal Transparency Code (2014)

Pillar 3 covers fiscal risks from PPPs



But, disclosure can only do so much. Investments through PPPs, SOEs, and by line ministries will affect the fiscal deficit.

World Bank is supporting countries to improve CL risk management practices and offers financial instruments to mitigate risks

Support to improve CL risk management

- ❑ Design analytical approaches to identify, analyze, and quantify risks (e.g. credit scoring, scenario analysis, Merton model)
- ❑ Design risk management tools (e.g. limit setting, decision making on when to take on risks, risk-based fees, budgeting, risk reporting and monitoring, etc.)
- ❑ Example engagements: Colombia, Ghana, Indonesia, Peru, Serbia, South Africa, among others.

Financial instruments to manage and mitigate risks

- ❑ Contingent financing (e.g. Indonesia)
- ❑ Hedging products (e.g. Uruguay)
- ❑ Disaster risk management (e.g. *Caribbean Catastrophe Risk Insurance Facility*)

Menu of World Bank Financial Products

Financing

- Grants (IDA)
- Credits (IDA/Blend)
- IBRD Flexible Loan (IFL)
- IBRD Enclave Financing (IDA)
- Local Currency Loans
- Sub-national Finance

Contingent Financing

- Deferred Drawdown Option (DDO)

Credit Enhancement

- Credit guarantees (IDA/IBRD)
- Risk Guarantees (IDA/IBRD)
- Currency swaps
- Interest Rate Swaps

Hedging Products

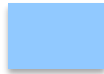
- Interest rate caps and collars
- Commodity price swaps
- Non-IBRD Hedge
- Intermediation of financial products for natural disaster and weather-related risk (IDA/IBRD)

Disaster Risk Management

- Cat DDO
- Insurance pools (IDA/IBRD)
- Catastrophe bonds (IDA/IBRD)

Client Advisory Services (IDA/IBRD)

- Asset management
- Public debt management
- Asset-liability management
- Capital market access strategy & implementation
- Transaction processing, reporting, and IT

 WB financial products to help manage and mitigate fiscal risks and contingent liabilities



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