Contingent Government Liabilities
A Hidden Fiscal Risk

Many governments have faced serious fiscal instability as a result of their contingent liabilities—that is, fiscal obligations contingent on the occurrence of particular events. But these obligations are not budgeted and accounted for, nor are they considered in conventional fiscal analysis.

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IF A COUNTRY'S banking sector fails, or its subnational (state or local) governments find themselves unable to meet their obligations, or a large state-guaranteed infrastructure project runs into difficulties, the central government comes to the rescue. Whether a government is obligated by law or simply forced by circumstances to provide public financing to cover such contingencies, its contingent liabilities can lead to large increases in public debt. Thus, fiscal adjustment aimed solely at keeping projected expenditure levels down is insufficient to prevent fiscal instability in countries with large, unbudgeted contingent liabilities. Credit-rating agencies and investment banks are therefore beginning to pay more attention to contingent liabilities in assessing sovereign creditworthiness.

Governments today are exposed to greater fiscal risks and uncertainties than ever before. There are four reasons for this: the growing volume and volatility of private capital flows, the transformation of the state's role from financier to guarantor of services and projects (see the article "Private Infrastructure, Public Risk," by Mateen Thobani in this issue), the moral hazard that may result from guaranteeing outcomes to be delivered by the private sector, and the fiscal opportunism of policymakers. Transition and developing economies face particularly large fiscal risks. Failures in their corporate and financial sectors are exacerbated by these countries' dependence on foreign financing, opaque ownership structures, inadequate disclosure of information, and weak regulatory and enforcement systems; moreover, their governments are often subjected to intense political pressure to bail out failed companies or financial institutions.

Framework of fiscal risks

Any study of a country's fiscal position is far from complete if it overlooks the obligations the government has taken outside its budgetary system. All sources of fiscal risk must be addressed if governments are to avoid sudden fiscal instability and to realize long-term policy objectives. Fiscal risks can be direct or contingent, explicit or implicit (Box 1).

Direct liabilities are obligations whose outcome is predictable, while *contingent liabilities* are obligations that may or may not come due, depending on whether particular events occur. The probability of their occurrence may be exogenous to government policies (for example, if they are related to natural disasters) or endogenous (for example, if government programs create moral hazard). *Explicit liabilities* are specific obligations, created by law or contract, that governments must settle. *Implicit liabilities* represent moral obligations or burdens that, although not legally binding, are likely to be borne by governments because of public expectations or political pressures.

Conventional fiscal analysis tends to concentrate on governments' *direct explicit liabilities*. These include repayments of sovereign debt, budget expenditures for the current fiscal year, and longer-term expenditures for legally mandated obligations (such as civil service salaries and pensions and, in some countries, the overall social security system).

Direct implicit liabilities are often a presumed, longer-term consequence of public expenditure policies and are not captured in government balance sheets. In countries with pay-as-you-go pension schemes, for example, future pensions constitute direct implicit liabilities. Their magnitude is determined by how generous pension benefits are, how many people are eligible to receive them, and at what age pensioners become eligible, as well as by future demographic and economic developments.

Contingent explicit liabilities are legal obligations for governments to make payments only if particular events occur. Because their fiscal cost is invisible until they come due, they represent a hidden subsidy and a drain on future government finances, and complicate fiscal analysis. State guarantees and financing through state-guaranteed institutions may, in the short run, be more attractive than outright budgetary support because of their hidden nature. Such contingent explicit liabilities, however, may well turn out to be more expensive in the long run. Moreover, they may create moral hazard in the markets, particularly if governments

Box 1

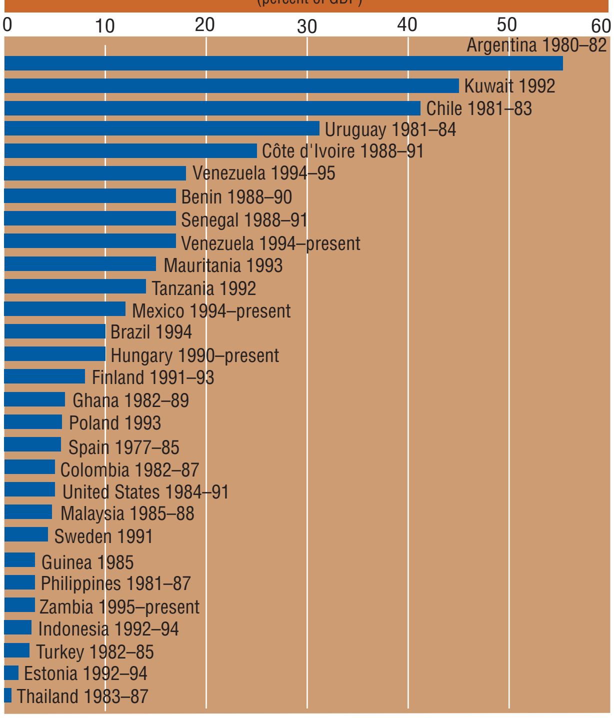
The fiscal risk matrix

Liabilities	Direct (obligation in any event)	Contingent (obligation if a particular event occurs)
Explicit Government liability as recognized by a law or contract	• foreign and domestic sovereign borrowing (loans contracted and securities issued by central government) • budgetary expenditures • budgetary expenditures legally binding in the long term (civil servants' salaries and 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 (mortgage loans, student loans, agriculture loans, small business loans) • trade and exchange rate guarantees issued by the state • state guarantees on private investments • state insurance schemes (deposit insurance, income from private pension funds, crop insurance, flood insurance, war-risk insurance)
Implicit A moral obligation of government that reflects public and interest-group pressures	• 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 required by law • future recurrent costs of public investments	• defaults of subnational government or public or private entities on nonguaranteed debt and other obligations • cleanup of liabilities of entities being privatized • banking failure (support beyond state insurance) • failure of a nonguaranteed pension fund, employment fund, or social security fund (protection of small investors) • default of central bank on its obligations (foreign exchange contracts, currency defense, balance of payments stability) • bailouts following a reversal in private capital flows • environmental recovery, disaster relief, military financing

Chart 1

Costs of resolving past banking crises

(percent of GDP)

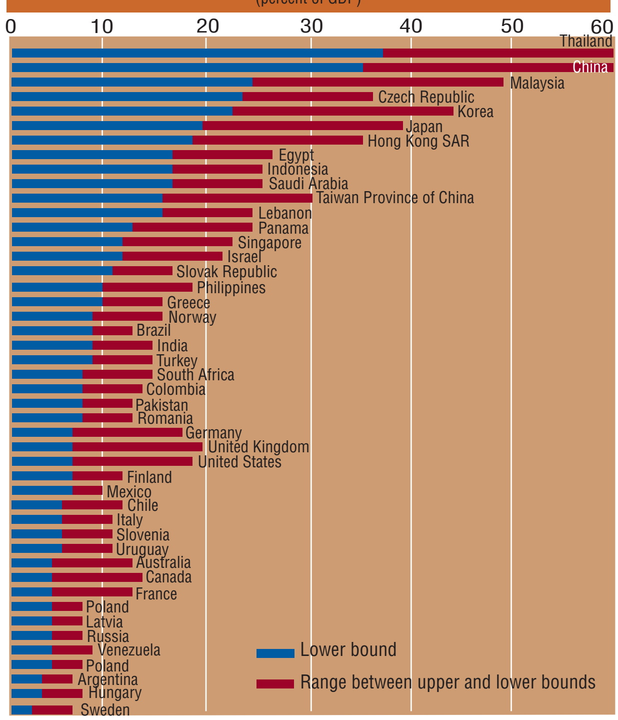


Sources: Claudia Dziobek and Ceyla Pazarbaşioğlu, 1997, "Lessons from Systemic Bank Restructuring: A Survey of 24 Countries," IMF Working Paper 97/161 (Washington); Gerard Caprio, Jr., and Daniela Klingebiel, 1996, *Bank Insolvencies: Cross-Country Experience* (Washington: World Bank).

Chart 2

Estimated contingent liabilities related to banking sector

(percent of GDP)



Source: Standard and Poor's, Sovereign Ratings Service, December 1997.

Box 2

Government practice for contingent liabilities

Contingent as well as direct implicit liabilities are quantified and recognized by governments that have established an institutional framework for fiscal discipline. Good examples include the multiyear budgeting and reporting practices of Australia, Canada, Germany, and the Netherlands.

Australia and New Zealand include contingent explicit liabilities and contingency expenditure provisions in government financial statements. Italy and the United States make budget appropriations for the net present value of the future fiscal costs of issued loan guarantees and direct loans. The risks and reserve adequacy of federal insurance schemes are reported by the U.S. General Accounting Office. 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.

Gradual improvements have been achieved in several other countries, often with the World Bank's 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. The governments of Colombia, Malaysia, and the Philippines have reviewed the risks of guaranteed infrastructure projects, estimated their loss exposure, and started to negotiate tighter contracts that pass more risks on to private developers.

guarantee all, rather than a part of, underlying assets (such as a credit to an enterprise) and all risks, rather than selected political and commercial risks. State insurance schemes, for example, often cover uninsurable risks of infrequent but potentially enormous losses; these schemes redistribute wealth because they tend not to be self-financed, through fees, but rely on government financing.

Contingent implicit liabilities are not officially recognized until *after* a failure occurs. The triggering event, the value at risk, and the amount of the government outlay that could eventually be required are all uncertain. In most countries, the financial system represents the most serious contingent implicit liability. Experience has shown that, when the stability of a country's financial system is at risk, markets usually expect the government to provide financial support that far exceeds its legal obligation. Chart 1 shows the costs of resolving past banking crises, while Chart 2 shows the estimated fiscal cost of future banking crises.

Fiscal authorities are also often forced to cover the uncovered losses and obligations of the central bank, subnational governments, state-owned and large private enterprises, budgetary and extrabudgetary agencies, and other politically significant institutions. Debts incurred by Brazil's provincial governments cost its federal government $19 billion in the 1980s and $55 billion in the 1990s. Over the past 10 years, Argentina, Colombia, Mexico, and Russia have bailed out subnational governments when the latter's deficits or arrears have become unsustainable.

The greater the weaknesses in a country's macroeconomic framework, financial sector, regulatory and supervisory systems, and information disclosure practices, the larger the country's contingent liabilities. Such weaknesses increase the risks associated with private capital flows because of difficulties in asset valuation and distortions in intermediation and borrowing behavior.

The value of predictability

In some cases, it may be better for a government to provide direct budgetary support than a guarantee because of the value of predictability with respect to future public financing requirements. This is particularly true for governments that have restricted or unreliable access to borrowing, limited ability to manage risk, and low risk tolerance. Although reserve funds may partly reduce the fiscal damage that can result when contingent liabilities fall due, they create other problems. Therefore, the design of government programs should take into account the volatility of public financing requirements and the impact of the programs on the government's overall risk exposure.

The first condition for creating and sustaining fiscal stability is the identification and classification of the full range of fiscal risks. Armed with an understanding of the possible consequences of all types of fiscal risks, policymakers may at least avoid assuming those likely to create problems in a politically meaningful time frame. But external pressure may be needed to encourage them to avoid fiscal risks whose consequences would occur far off in the future. Policymakers are more likely to behave in a fiscally responsible manner when the media, the general public, investors, credit-rating agencies, and multilateral institutions are aware of all facets of fiscal performance and impose sanctions on governments that expose themselves to excessive risks and attempt to conceal those risks.

Box 3

Systemic measures

Fiscal policy

- consider full fiscal performance beyond the budget and debt
- identify, classify, and analyze all fiscal risks in a single portfolio
- determine the government's optimal risk exposure and reserve policy according to its risk preference and risk-management capacity

Public finance institutions

- internalize and disclose the full fiscal picture
- monitor, regulate, and disclose risks in the public and private sectors

There are a number of ways to impose fiscal discipline on a government. The ministry of finance and the supreme audit institution may have the authority to publish the size and attributes of contingent and other fiscal risks, control the relationship between off-budget activities and policy priorities, and disclose the efficiency of both direct and contingent forms of government support. Full disclosure of fiscal information enables markets to analyze and measure the fiscal risks taken by a government and, indirectly, helps the government in its risk assessment. The IMF and the World Bank can contribute to future fiscal stability in member countries by enforcing requirements for broader fiscal disclosure and helping countries to address extrabudgetary fiscal risks in a systematic manner.

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Reducing fiscal risks

Fiscal analysis must factor in the cost of implicit subsidies provided by contingent support programs. For instance, arrears and other obligations of institutions guaranteed and owned by the state may claim 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, the fact that a government has balanced its budget and kept public debt down for years does not, in itself, prove that the government has been fiscally prudent, nor does it assure future fiscal stability.

To identify potential future fiscal pressures, contingent fiscal risks should be analyzed in the order of their significance, based on the stock of existing government programs and promises (Box 2). The analysis should focus on risk factors and ways of controlling the government's risk exposure and make it possible to determine the costs of alternative government programs.

An adequate institutional system requires that a government treat any noncash program involving a contingent fiscal risk like a budgetary or debt item. Most important, the system has to make the potential fiscal cost of off-budget programs visible ex ante. Accrual-based budgeting and accounting systems help fiscal discipline but are neither sufficient nor necessary in their entirety. Rules on state guarantees and insurance programs and on the behavior of state-guaranteed and public agencies and subnational governments are critical.

Box 3 lists systemic measures to promote understanding of fiscal risks by policymakers, the public, and the markets, while Box 4 summarizes specific steps that can be taken to control fiscal risks on a program-by-program basis.

Given the increasingly serious fiscal implications of contingent government liabilities, the IMF and the World Bank should extend the scope of their fiscal analysis to address contingent fiscal risks; require countries to disclose information on their exposure to all types of fiscal risks; and help countries reform their analytical, policy, and institutional frameworks to encourage governments to give at least as much attention to contingent government liabilities as to spending programs. F&D

This article is based on Hana Polackova, 1998, Government Contingent Liabilities: A Hidden Risk to Fiscal Stability, World Bank Policy Research Working Paper 1989 (Washington).

Box 4

Measures for individual programs

Fiscal policy	Public finance institutions
Before accepting • assess the fit with policies • consider financial risks • announce the program limits to minimize moral hazard	**Before accepting** • evaluate the risks, estimate the potential fiscal cost, and set additional reserve requirement • design well to minimize government risk
When accepted • stick to the preset limits	**When accepted** • risk is budgeted, accounted for, and disclosed • monitor risk factors and reserve adequacy
When to be executed • execute within the preset limits • if implicit, assess the fit with policy priorities and desired market behaviors	**When to be executed** • compare and report the actual fiscal cost versus the estimates, evaluate performance, and punish for failures