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FISCAL RISK MANAGEMENT
SUMMARY

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Fiscal Risk Management

Many governments have faced serious fiscal instability as a result of hidden fiscal risks from contingent and other opaque liabilities. But conventional fiscal analysis often fails to satisfactorily address those risks. What should be done? This note focuses on two relatively-recent sources of fiscal risks: fiscal risks from Public-Private Partnerships (PPPs) and Sub-national fiscal risks.

Fiscal risks come from many sources and in many forms which makes it difficult for governments to identify and categorize them for the purposes of analysis and disclosure. One device that many governments have found useful is the fiscal risk matrix devised by Hana Brixi (Table 1), which classifies government obligations as direct or contingent and as explicit or implicit.

Table 1 A fiscal risk matrix of government obligations (with examples)

<table>
<thead>
<tr>
<th></th>
<th>Direct</th>
<th>Contingent</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Obligation in any event</td>
<td>Obligation if a particular event occurs</td>
</tr>
<tr>
<td>Explicit</td>
<td>Government debt</td>
<td>Government guarantees</td>
</tr>
<tr>
<td>Implicit</td>
<td>Longstanding and popular social spending that government could, in theory, cut.</td>
<td>Obligation to bail out banks that are too big to fail</td>
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Fiscal risks originating from government guarantees or implicit obligations to bail out various entities maybe difficult to factor in conventional fiscal analysis, while at the same time, they create a host of problems. First, like all insurance, government guarantees cause moral hazard: when government insures against the adverse effect of risk, more risk will be taken. Second, because its long-term fiscal effects are usually hard to discern, government guarantees can be used to disguise subsidies to which taxpayers would otherwise object. Third, government guarantees are usually invisible in expansions but convert small crises into large ones during recessions. That can lead to excessive risk taking, fiscal crises, and harsh adjustments.

One cause of these problems is traditional government accounting and budgeting, which focus on cash spending and cash revenues in a single fiscal year and on the stock of conventionally defined debt. When coupled with fiscal rules which target cash-based spending in current year, but not future spending and/or government guarantees, this encourages governments to cut back cash spending and instead assume risks that imply uncertain costs in future years.

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1 This summary note is written by Nina Budina, Tim Irwin and Lili Liu, based on three draft briefing papers: Irwin and Schick (2007), Fiscal Risk Management; Irwin (2007), Understanding the Fiscal Effects of Public-Private Partnerships; and Liu (2007), Managing Sub-national Fiscal Risks.

One way of generating better information about these risks, including guarantees and other implicit liabilities, and creating incentives for prudent decisions regarding risks is to replace traditional cash accounting standards with modern accrual accounting standards. However, while the leading international accounting standards are all converging toward more accurate accounting of risk, they do not require all direct and contingent liabilities to be revealed on the balance sheet and in the calculations of budget deficits. Moreover, adopting the best accounting standards is difficult and takes a long time. Hence countries need not wait until such standards are fully-adopted, but can improve their fiscal risk management separately from the overall standards.

What more could be done? Governments can improve their ability to manage risks by imposing disclosure of major sources of risks, allocating responsibility for taking on risk, developing an adequate risk management strategy, and separating risk analysis and monitoring from risk taking entities. Some governments now prepare periodic statements of fiscal risk that describe factors that could cause fiscal outturns to diverge from forecasts. In addition, many governments undertake medium-term fiscal planning, and a few publish long-term fiscal forecasts—both of which can help focus attention on the possible future costs of current decisions to assume risks and are used for risk analysis and monitoring.

**Fiscal Risks from Public-Private Partnerships (PPPs).** PPPs are popular in most APEC countries because they allow governments to take advantage of private-sector efficiencies and thus get public services cheaper than otherwise. However, while such arrangements usually transfer some of the risks to the private partner, the state often retains important risks. For example, in many PPPs for schools, hospitals, and prisons, the government agrees in advance to pay for the availability of the building facilities, irrespective of future demand. In these PPPs, governments take on debt-like obligations even if they needn’t report any new liability. In other PPPs, including those for toll roads, the government sometimes guarantees the private company a minimum level of revenue from users. Hence under conventional standards, the government usually needn’t report any liability, but it faces a risk of having to pay, perhaps when it can least afford to. This can result in poorly designed PPPs, and introduces a bias in favor of PPPs even when they are more expensive than the alternative of a publicly financed project.

To overcome this bias, governments can undertake value-for-money analysis of PPPs, comparing the prospective costs of PPPs and a public-sector comparator. These value-for-money analyses involve long-term forecasts of government cash flows under public finance and under the PPP. Improvements in fiscal accounting can also help governments understand fiscal risks from PPPs and can increase the chance that PPPs will be well designed and appropriately used. Countries that still report according to cash accounting standards can do much to solve the problem by adopting modern accrual accounting and paying attention both to cash flows and to changes in net worth. Countries that already report according to accrual standards can usually continue to improve their reporting—and encourage the standard setters to improve the standards.

**Sub-national fiscal risks.** Central governments are not the only ones incurring public risk. Widespread decentralization has granted significant spending responsibilities,
taxation power, and borrowing capacity to subnational governments in developing countries. Notwithstanding the desire for hard budget constraints for subnational governments, the central governments’ budgets are often implicated in the fiscal and debt problems of subnationals, if such problems are systemic, negatively affecting service delivery and the nation’s financial system.

The way forward is to develop institutional frameworks for managing subnational fiscal risks. Specifically, a regulatory framework can help expand subnational borrowing, strengthen subnational fiscal discipline, and manage potential risks, while at the same time support reforms in the intergovernmental fiscal system and financial markets for efficient utilization of capital. A central element of the regulatory framework is fiscal transparency including moving off-budget liabilities on the budget and introducing accrual accounting for all levels of the government. Many countries are also moving toward medium-term fiscal frameworks, enhancing the transparent budgetary process at subnational level. Finally, some governments encourage the development of a broad-based subnational credit market to further enforce fiscal discipline at subnational level.