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Contingent liabilities—a threat to fiscal stability

Many governments have faced serious fiscal instability as a result of their contingent liabilities. But conventional fiscal analysis fails to address contingent fiscal risks. What should be done?

Contingent government liabilities are associated with major hidden fiscal risks. Thus fiscal adjustment that targets deficit and debt reduction does not necessarily prevent fiscal instability. Banking problems, for example, have often unexpectedly drawn on public resources.

Fiscal risks and uncertainties are increasing for four main reasons. Private capital flows are increasing and becoming more volatile. States are moving from financing services to guaranteeing outcomes. Moral hazard in markets is on the rise. And policymakers are engaging in fiscal opportunism. Transition and emerging market economies face particularly large fiscal risks because they depend on foreign financing and have opaque ownership structures, limited information disclosure, and weak regulatory and enforcement systems. These shortcomings escalate financial and corporate failures that in turn put pressure on governments to offer bailouts.

Thus any study of a country's fiscal position is incomplete if it skips over obligations made by the government outside the budget. Fiscal risks are of four types: direct or contingent, each of which is explicit or implicit (table 1).

A simple framework

Direct liabilities are predictable obligations that will arise in any event. *Contingent liabilities* are obligations triggered by a discrete but uncertain event. Relative to government policies, the probability of a contingency occurring and the magnitude of the required public outlay are exogenous (such as a natural disaster) or endogenous (such as implications of market institutions and government programs for moral hazard in markets).

Explicit liabilities are specific government obligations defined by law or contract. The government is legally mandated to settle such an obligation when it becomes due. *Implicit liabilities* represent a moral obligation or expected burden for the government not in the legal sense, but based on public expectations and political pressures.

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Beyond the budget and debt

Direct explicit liabilities are the main subject of conventional fiscal analysis. These liabilities include sovereign debt, expenditures guided by budget law in the current fiscal year, and expenditures over the long term for legally mandated items.

Direct implicit liabilities often arise as a presumed consequence of public expenditure policies over the long term. Given their implicit nature, these obligations are not captured in government balance sheets—yet they are usually high for demographically driven expenditures. For example, in a public pay as you go scheme, future pensions are a direct implicit liability, the size of which reflects the expected generosity of and eligibility for benefits and future demographic and eco-

Table 1 Possible sources of fiscal risk for central governments

	Direct liabilities	Contingent liabilities
Explicit liabilities	• 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)	• Guarantees for borrowing and obligations of subnational governments and public or private entities (development banks) • Umbrella guarantees for various loans (mortgage loans, student loans, agriculture loans, small business loans) • Guarantees for trade and exchange rate risks • Guarantees for private investments • State insurance schemes (deposit insurance, private pension funds, crop insurance, flood insurance, war-risk insurance)
Implicit liabilities	• 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	• Defaults of subnational governments and public or private entities 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 • Default of central bank on its obligations (foreign exchange contracts, currency defense) • Collapses due to sudden capital outflows • Environmental recovery, disaster relief, military financing

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

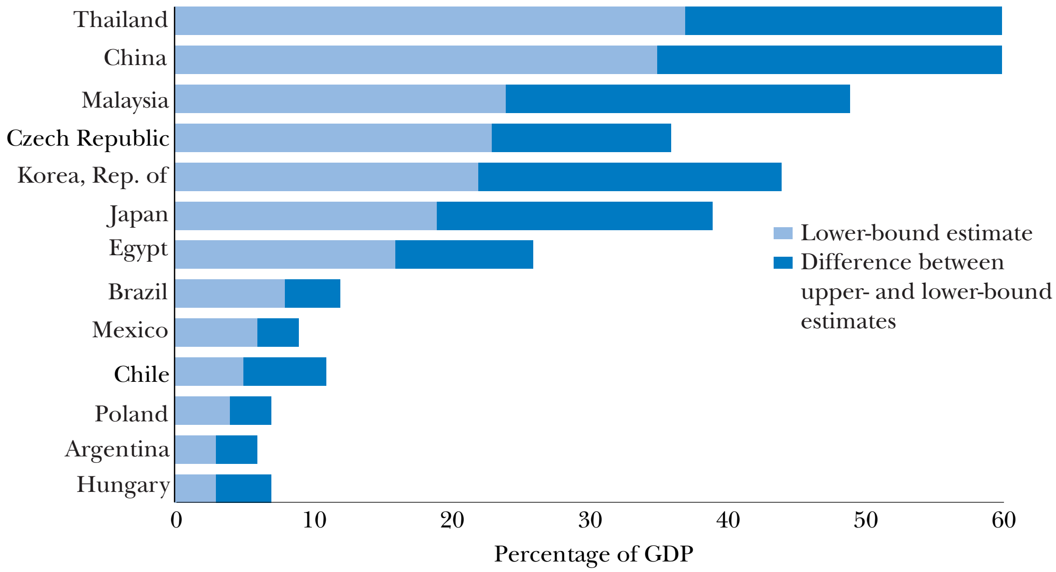
nomic developments. In industrial countries estimated net public pension liabilities for 1995–2050 range from 5 percent of 1994 GDP (United Kingdom) to 114 percent (France).

Contingent explicit liabilities legally oblige government to make a payment if a specific event occurs. (For details on risks specific to infrastructure, see PREMnote 10.) Because their fiscal cost is invisible until they are triggered, contingent explicit liabilities represent a hidden subsidy, blur fiscal analysis, and can drain future government finances. Nevertheless, government guarantees and financing through government-guaranteed institutions are more politically attractive than budget support even if they are more expensive later. Contingent government obligations can create immediate moral hazard in markets, particularly if the government guarantees all rather than part of the underlying assets, and all rather than selected political or commercial risks. State insurance schemes often cover uninsurable risks of infrequent losses that are enormous in magnitude. Thus, rather than financing themselves from fees, such schemes redistribute wealth and rely on government financing.

Contingent implicit liabilities are not officially recognized until a failure occurs. The triggering event, the amount at risk, and the required government outlay are uncertain. In most countries the financial system is the most serious contingent implicit government liability. Markets expect government support far beyond its legal obligation if financial stability is at risk (figure 1). Fiscal authorities are often also compelled to cover the uncovered losses and obligations of the central bank, subnational governments, state-owned or large private enterprises, budgetary and extrabudgetary agencies, and other institutions of political significance.

Contingent liabilities grow with weaknesses in the financial sector, macroeconomic policies, regulatory and supervisory systems, and information disclosure. With private capital flows, for instance, such weaknesses elevate risks of asset bubbles and overborrowing.

Figure 1 Contingent government liabilities are especially high for bank bailouts



Source: Standard and Poor's.

The first step toward fiscal stability is for policymakers to identify, classify, and understand the full range of fiscal risks

The value of certainty

Contingent support programs have uncertain public financing requirements. Reserve funds reduce the potential harm when contingent liabilities are called but create other problems. Thus governments should design programs that have less volatile financing requirements and lower exposure to risk. Governments that are risk adverse, have limited capacity to manage risk, and cannot borrow easily should abstain from contingent support programs altogether.

Understanding, incentives, and capacity

The first step toward fiscal stability is for policymakers to identify, classify, and understand the full range of fiscal risks (see table 1). Understanding the consequences of these risks will encourage policymakers to avoid those that are bound to surface in a politically meaningful timeframe. For risks beyond that timeframe, fiscally sound behavior may depend on coercion. Policymakers are more likely to make fiscally sound decisions if media, the public, investors, credit rating agencies, and multilateral institutions understand the government's fiscal risks and if they punish the government for exposing the state to excessive risks and for concealing those risks.

Coercion to pursue fiscal discipline beyond the budget and debt can be multifaceted. The ministry of finance and 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 increase the efficiency of direct and contingent forms of government support. Disclosure of full fiscal information enables markets to analyze and measure fiscal risks and so indirectly assist the government in risk assessment. The International Monetary Fund (IMF) and World Bank can contribute to fiscal stability by enforcing broader fiscal disclosure (for example, following the IMF's Fiscal Transparency Code) and helping countries systematically address fiscal risks outside the budget and debt.

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 state-guaranteed and -owned institutions 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 budget system. Thus a string of years with a balanced budget and low public debt neither suggests that the

Table 2 Systemic measures to promote broad understanding of fiscal risks

Fiscal policy	*Public finance institutions*
• Consider full fiscal performance beyond the budget and debt • Identify, classify, and analyze all fiscal risks in a single portfolio • Determine government's optimal risk exposure and reserve policy according to its risk preference and risk management capacity	• Internalize and disclose the full fiscal picture, including fiscal risks • Monitor, regulate, and disclose risks in the public and private sectors

government has been fiscally prudent nor ensures future fiscal stability.

To identify potential fiscal pressures, contingent fiscal risks should be analyzed in order of significance, based on existing government programs and promises. Analysis that focuses on determinants of risks and ways of controlling government risk exposure makes it possible to compare the costs of alternative government programs.

Budget institutions should require government to treat noncash programs involving contingent fiscal risks like any other spending item, and to make the potential fiscal cost of off-budget programs visible in advance. Accrual-based budget and accounting systems support fiscal discipline but are not entirely sufficient or necessary. More crucial are rules on disclosure of fiscal risks, on dealing with state guarantees and insurance programs, and on the behavior of government-guaranteed and public agencies and subnational governments.

Systemic measures to promote understanding of fiscal risks by policymakers, the public, and markets are listed in table 2. Steps to control fiscal risks on a program-by-program basis are listed in table 3.

Table 3 Measures to control risk in individual programs

Fiscal policy	*Public finance institutions*
Before accepting	
• Assess the fit with policies • Consider financial risks • Announce program limits to minimize moral hazard	• Evaluate risks, estimate the potential fiscal cost, and set additional reserve requirement • Design to minimize government risk
When accepted	
• Stick to set limits • Monitor risk factors and reserve adequacy	• Budget, account, and disclose the risk
When executed	
• Execute within set limits • If implicit, assess the fit with policy priorities and desired market behaviors	• Compare and report the actual fiscal cost relative to estimates, evaluate performance, and punish failures

Agenda for the future

Given the increasingly serious fiscal implications of contingent government liabilities, the World Bank and IMF should take several steps. Analysis should be broadened of fiscal sustainability and of policies and institutions to address contingent fiscal risks. Countries should be required to disclose information on their exposure to all types of fiscal risk. And countries should be aided in reforming their analytical, policy, and institutional public finance frameworks to treat contingent government support programs as attentively as any spending program.

Further reading

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you want to participate in the Quality of Fiscal Adjustment Thematic Group, which focuses on the analysis, management, and fiscal implications of contingent government liabilities.