

# Accrual concepts are vital to manage Fiscal Risks

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## Definition: Contingent Liabilities

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

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

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
<b>TOTAL</b>	<b>230</b>	<b>174</b>	<b>6.1</b>	<b>56.8</b>

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

# 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).

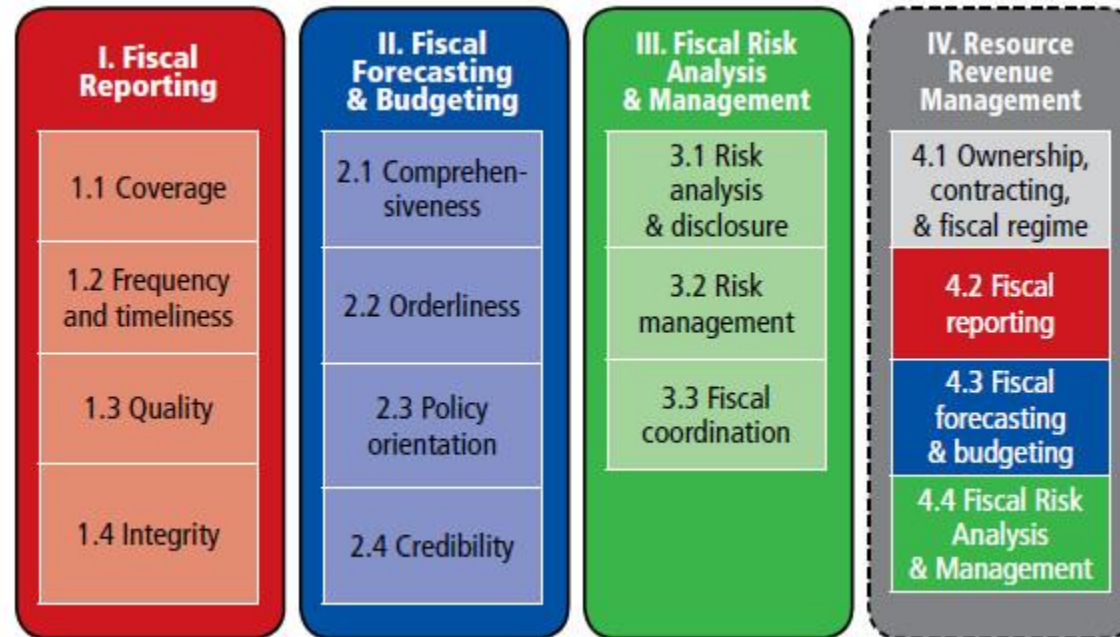
# Improving Fiscal Reporting of PPPs

- *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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