Identifying and Managing Fiscal Risks

Xavier Rame, Public Financial Management Advisor
Definition of Fiscal Risk(s)

Fiscal risk is the possibility of deviations of fiscal outcomes from what was expected at the time of the Budget or other forecast.

Fiscal risks are factors that may cause fiscal outcomes to deviate from expectations or forecasts:

- The exposure of the central government...
- ...to short-to medium-term variability...
- ... in the overall levels of revenues, spending, the fiscal balance, and the value of assets and liabilities.

Fiscal risks include central government exposure to risks from:

- Public corporations,
- Sub-national governments.
Why Do Fiscal Risks Matter?

- Can be very large, and threaten both immediate fiscal solvency and long-run sustainability
- Asymmetric, and tilted toward the downside
- Not independent, but highly correlated with each other
- Associated costs can be highly non-linear and disruptive

**Fiscal Costs of Contingent Liabilities**

(Percent of GDP)

- Indonesia
- Financial Sector
- Natural Disaster(s)
- PPPs
- SOEs
- Legal
- Other
- Private Non-Financial Sector
- Subnational Government

Categories of Fiscal Risks

Fiscal risks are factors that may cause fiscal outcomes to differ from expectations

General economic risks
* related to general economic forecast parameters
* e.g. domestic demand shock; trade volume shock; commodity price shock

Specific fiscal risks
* Difficult to isolate using general economic forecast parameters
* Give rise or contribute to uncertainty about specific fiscal outcomes

Institutional risks
* Constrain the effectiveness of fiscal risk management
* e.g. lack of expenditure control; poor cash management; poor revenue collection

Other specific risks
* Arise from changing conditions linked to a specific source
* e.g.: change in asset and liability values; tax avoidance; demographic change

Contingent liabilities
* Arise from the occurrence of a specific event

Implicit
* Based on expectation or pressure to provide support
* e.g. failing PPP; bailouts of SOEs, banks, and sub-national government; natural disasters

Explicit
* Based on a firm legal obligation or declared policy
* e.g. government guarantees; PPP related min. guarantees; deposit insurance; legal claims.
Macroeconomic Risks

Systemic shock (global growth slowdown, regional instability)

Exposure of public finances to unexpected variance in macroeconomic variables

Pro-cyclical fiscal policy (e.g. forced to cut spending during economic slowdown, making recession worse)

Key macroeconomic variables

- GDP growth, inflation rate, exchange rate, interest rates, key commodities price...

How to forecast them?

- International best practice
- Independent entities
- Comparisons with other countries / International consensus

Sensitivity analysis

- Constructing different scenarios / studying the sensitivity of various hypotheses
- Making them available during the discussions of the budget
- Separating short from long-term impact

Forecasting robustness and bias
Specific Fiscal Risks

Risks specific to revenue, spending and balance sheet

- Guarantees
- Other explicit contingent liabilities: legal claims, uncalled capital, indemnities, warranties...
- Public Private Partnerships
- Financial sector
- Natural resources
- Disasters
- Tax expenditures
- ...

Risk may be increased as by-product of actions taken to meet fiscal targets

- Extra-budgetary expenditure
- Quasi-fiscal activities
- Unfunded pensions (nationalization of private pension funds)
Institutional and Structural Risks

**Institutional risks**
- Inadequate PFM law
- Dual budgeting
- No medium term fiscal framework
- Ineffective fiscal coordination arrangements
- Lack of data
- Lack of capacity to monitor and manage risks

**Structural risks**
- Revenues dominated by one or two (volatile) sources
- High ratio of non-discretionary spending to total spending
- Excessive earmarking of revenues

Constrain effectiveness of risk management and increase the probability of negative event occurring, or the cost if it does occur.
The Inadequacy of Conventional Budgeting for Exposing Fiscal Risks

<table>
<thead>
<tr>
<th>Cash basis of budgeting</th>
<th>Short term budget horizon</th>
<th>Incentive to overestimate revenues, underestimate costs, risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pressures to reduce fiscal deficits/debt (e.g. to meet fiscal rules or targets) often lead to off-budget devices that increase risk</td>
<td>Off-budget instruments such as guarantees, PPPs</td>
<td>Implicit contingent liabilities typically not considered</td>
</tr>
</tbody>
</table>
Understanding the Fiscal Position: Beyond the Budget

Coverage of Public Sector Entities (% of GDP)

- Central Government: 31%
- Local Govt: 5%
- Non Financial Public Corporations: 14%

Coverage limited to central government budget:

- No fiscal reports on fiscal activities representing about 19% of GDP (or 40% of the total fiscal activities)

Data from a sample country
Understanding the Fiscal Position: What about the Wealth of the Nation?

Reporting of Assets and Liabilities (% of GDP)

- Budgetary
- Extrabudgetary
- Social Security
- Local Govts
- Pub Corps
- Gross Stocks

No reporting of assets and large unreported liabilities

Data from a sample country
### Understanding the Fiscal Position: Assessing the Fiscal Forecasts

**Sources of Fiscal Forecast Error**

(% of Original Budget)

<table>
<thead>
<tr>
<th>Source</th>
<th>Error Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages</td>
<td>12.8</td>
</tr>
<tr>
<td>Other Current</td>
<td>2.0</td>
</tr>
<tr>
<td>Pensions</td>
<td>1.9</td>
</tr>
<tr>
<td>Capital</td>
<td>-5.1</td>
</tr>
<tr>
<td>Local Govt &amp; Parastatals</td>
<td>13.6</td>
</tr>
<tr>
<td>Other</td>
<td>3.9</td>
</tr>
<tr>
<td>Net Error</td>
<td>29.0</td>
</tr>
</tbody>
</table>

Wages, local government, and public corporations are the biggest risks to fiscal forecast.

Data from a sample country
Understanding the Fiscal Position: Identifying Key Risks

Contingent Liabilities (% of GDP)

- Guarantees (Public): 6.1
- Guarantees (Private): 16.3
- Central Bank: 15.3
- Liabilities of Financial PCs: 37.6

Contingent liabilities are large and diverse

Data from a sample country
The IMF’s 2014 Fiscal Transparency Code

Four Pillars of the Code

I. FISCAL REPORTING
   1.1. Coverage
   1.2. Frequency & Timeliness
   1.3. Quality
   1.4. Integrity

II. FISCAL FORECASTING & BUDGETING
   2.1. Comprehensiveness
   2.2. Orderliness
   2.3. Policy Orientation
   2.4. Credibility

III. FISCAL RISK ANALYSIS & MANAGEMENT
   3.1. Risk Analysis & Disclosure
   3.2. Risk Management
   3.3. Fiscal Coordination
   3.4. Fiscal Risk Analysis & Management

IV. RESOURCE REVENUE MANAGEMENT
   4.1. Legal & Fiscal Regime
   4.2 Fiscal Reporting
   4.3. Fiscal Forecasts & Budgets
   4.4. Fiscal Risk Analysis & Management
Fiscal Risk Management Framework

Step 1: Identify and quantify risks
- Identify sources of risk
- Calculate fiscal exposures
- Estimate likelihood of realization

Step 2: Decide whether to mitigate risks
- Direct controls and limits on exposures
- Regulation, incentives and other indirect measures
- Transfer and risk sharing measures

Step 3: Decide whether to provision for risks
- Expense fiscal costs in the Budget
- Budget contingencies
- Set aside financial assets in buffer funds

Step 4: Decide whether to accommodate residual risks
- Take into account in setting debt objective
The UK example: the ‘four Ts’ of fiscal risk management

Facing fiscal risks, policy makers can choose to:

- **Tolerate it** (perhaps with an accounting provision to reflect the potential cost)
- **Treat it** (to reduce the probability or expected impact of crystallisation)
- **Transfer it to the private sector** (for example by insuring against crystallisation)
- **Terminate the activity creating the risk**
Mitigating Risks: Generic Approaches (in Isolation or Combined)

**Avoid risk**
- e.g. reduce government ownership; restrict unsolicited PPPs; develop private insurance and financial markets; land use planning

**Transfer risk**
- e.g. purchase insurance; defined contribution pensions; compulsory private insurance

**Share risk**
- e.g. partial guarantees, guarantee fees

**Diversify risk**
- e.g. tax reform; financial investment strategies

**Hedge risk**
- e.g. currency swaps

**Reduce risk**
- e.g. stronger financial sector regulation; internal control; early warning systems; crisis management

**Cap risk**
- e.g. limit on guarantee exposures; upper limit on government insurance

**Create space to accommodate risk**
- e.g. reduce debt; set aside financial assets; contingency reserve; contingent credit line
Legal and Administrative Framework for Effective Management of Fiscal Risks

Legal framework should set clear roles and responsibilities for fiscal risk governance and management:

- Within central government (Central Fiscal Authorities (CFAs) MDAs)
- Between government and SOEs
- Between central government and SNGs

It may be desirable for line agencies to have clearly specified responsibilities and capacity to prudently manage the risks to which they are exposed, subject to internal audit, with routine reporting and central monitoring.

CFAs responsible for aggregating information across government, analysing macro risks, fiscal strategy and forecasting, the annual budget, debt management, setting central risk policies, internal and external reporting.

CFAs should have the necessary authority to monitor and manage fiscal risks.

Independent oversight from SAI, independent fiscal institutions, the legislature.
Mix of centralised and decentralised

More advanced economies tend to be more decentralized, allocating more responsibility to MDAs in first instance

- e.g. maintain a register of CLs, monitor SOEs, EBFs PPPs in their sector

A number of countries have set up dedicated units in MOF for fiscal risk analysis and management, others have allocated some responsibilities to the Debt Management Office

Regular internal reporting to Minister of Finance

Some MOFs have set up internal risk management committees