CONTINGENT LIABILITIES IN NEW MEMBER STATES

Fiscal Surveillance in EMU: New Issues and Challenges

Workshop

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Summary

Why contingent liabilities need to be taken into account?

What are the current risk exposures?

Public risk in private infrastructure

Local government risk

Dealing with contingent liabilities on the road to EMU

Why contingent liabilities need to be taken into account?

Contingent liabilities in New Member States tend to arise from:

- dealing with the high cost of transition and structural reforms
- privatization of state functions
- pursuing fiscal adjustment and deficit targets in the short-term
- growing developmental role and autonomy of local governments

Contingent liabilities tend to be a result of:

- an effort to find more efficient ways to achieve policy objectives
- neglect of moral hazard in the behavior in the markets
- fiscal opportunism

They tend to be costly when they surface - in the medium to long term

Issues in capturing contingent liabilities in fiscal surveillance:

- complexity (different forms of contingent liabilities, different parts of government and the public sector)
- “invisibility” – sometimes even to policymakers

How to secure government cooperation (disclosure of relevant information)?

- incentives (rewarding transparency?)
- enforcement

What are the current exposures to risk?

explicit contingent liabilities –

government liability created by a law or contract

implicit contingent liabilities –

a “political” obligation of government that reflects public and interest-group pressures

Explicit contingent liabilities

State guarantees for borrowing of enterprises

- Cyprus, Czech Republic, Malta, Poland and Slovenia - credit guarantees mainly to state-controlled companies

Statutory guarantees on liabilities and other obligations of various entities (including financial institutions such as state-owned banks, pension funds, infrastructure development funds)

- Czech Republic - Czech Consolidation Agency, Ceska Inkasni, Czech Land Fund, Railway Transport Infrastructure Administration, Agriculture Guarantee and Credit Support Fund
- Hungary - State Development Bank, EXIM Bank, Export Credit Insurance Company, Pension Reserve Fund to cover private pension annuity, Deposit Insurance Fund, Credit Guarantee Fund, Rural Credit Guarantee Foundation, Office of Agricultural Market Regime, and environment guarantees of the Privatization Agency
- Estonia, Latvia, Lithuania, Poland and Slovakia - Guarantee/Reserve Funds and the related minimum pension/ relative rate of return guarantees, deposit guarantee, investor protection, and credit/export guarantees

Explicit contingent liabilities (cont.)

State guarantees on service purchase contracts

- Poland (possible obligations arising from the past power-purchase agreements)

Other state guarantees issued to private investors and service providers

- Hungary (guarantees related to the privatization of Postabank)

State guarantees on debt and other obligations of local gov'ts

State insurance programs

Litigation

- Poland (legal claims against the government with respect to weak copyright protection and 1944-1962 property losses)
- Lithuania (legal claims for savings compensation and real estate restitution)
- Slovakia (legal claims by CSOB and the Slovak Gas Company)

Implicit contingent liabilities

Claims by public sector entities to assist in covering their losses, arrears, deferred maintenance, debt and guarantees

- Poland (obligations of state-owned companies – some arising during the restructuring of railways and mines; obligations of hospitals and state agencies)
- Hungary and Malta (obligations of state-owned companies and the related cost of restructuring)
- Czech Republic (environment guarantees issued by the National Property Fund; losses, arrears and debt of the Czech Railways)

Claims by local governments to assist in covering their own debt, guarantees, arrears, letters of comfort and similar

- Poland (local government debt and guarantees related to regional development)
- Lithuania (municipal budget arrears)
- Czech Republic (bail-outs related to hospital arrears)

Implicit contingent liabilities (cont.)

Claims by financial institutions, such as state-owned banks, social security funds, and credit and guarantee funds)

- Latvia (pension and social security funds)
- Slovenia (Small Business Development Fund, regional guarantee schemes)

Non-contractual claims arising from private investment, for instance in infrastructure

- Hungary (possible claims arising from motorway construction concessions – partly implemented through the Road Construction Corporation of the State Development Bank)
- Poland (claims arising from expressway construction concessions)

Other possible obligations, such as environment commitments for still unknown damages and nuclear and toxic waste

- Lithuania (decommissioning of the Ignalina nuclear power plant)
- Cyprus (reunification cost)

Public risk in private infrastructure

New Member States seek private finance for infrastructure to:

- close the infrastructure gap
- improve efficiency
- reduce the fiscal burden

Private investors seek government guarantees and other disguised subsidies - which create contingent liabilities for the government

Implicit government liabilities tend to be high –
the provision of infrastructure services is politically sensitive

Only improvements in efficiency allow for fiscal saving

Disguising subsidies generates fiscal cost later – and may mask the need for structural reforms in infrastructure

The forms of government contingent support to infrastructure:

- guarantees to cover policy risk and/or nonpolicy risk, service purchase agreements, and letters of comforts
- signed by the central government, local governments, or state utilities

Policy risk – relates to unpredictability of government policy (prices, taxes, quantity/quality of output, competition rules)

Nonpolicy risk – relates to areas that are outside government control (construction cost, future demand for services, exchange rate, debt repayment

Service purchase agreements – relate to the government obligation to purchase the output on a take-or-pay basis

Reducing the need for providing contingent support to infrastructure:

- government policy toward competition and ownership
- Investment climate for all firms

The value of transparency and simplicity

- explicit cash subsidy to infrastructure firm or its customers
- capital in the form of equity or debt

Effort to examine contingent liabilities under fiscal surveillance would reduce the attractiveness of disguising fiscal support to infrastructure.

Local government risk

Local government risk – a source of financial stress that could face a local government in the future

Fiscal risk matrix helps identify the sources of future possible financing pressures facing local government.

Fiscal hedge matrix illustrates the different financial sources that can serve local governments to cover their obligations.

Obligations	**Direct** Obligation in any event	**Contingent** Obligation only if a particular event occurs
Explicit Government obligation created by law or contract	Local government debt Arrears (if legally binding) Non-discretionary budgetary spending	Local government guarantees for debt and other obligations of public sector and non-public sector entities Local government guarantees on private investments (infrastructure) Local government insurance schemes
Implicit A moral obligation of government that reflects public and interest-group pressure	Remaining capital and future recurrent cost of local public investment projects The cost of future benefits under the local social security schemes Future spending on goods and services that the local government is expected to deliver	Claims related to local government letters of comfort Claims by failing local financial institutions and other entities Claims by various entities to assist on their non-guaranteed debt, their own guarantees, arrears, letters of comfort and other possible obligations Claims related to enterprise restructuring and privatization Claims by beneficiaries of failed social security or other funds – beyond any guaranteed limits Claims related to local crisis management (public health, environment, disaster relief,...)

Sources of financial safety	**Direct** Based on existing assets	**Contingent** Dependent on future events
Explicit Under direct control of local government (ownership, taxing power)	Local government-owned assets available for possible sale or lease	Local tax revenues less tax expenditures Transfer income from the central government Recovery of loans made by the local government (on-lending)
Implicit Not under direct local government control	Existing funds that are under indirect local government control (local social security funds)	Future profits of enterprises and agencies under some local government control Contingent credit lines and financing commitments from official creditors to the local government

For both matrices, items and their classification vary according to the local conditions.

The two matrices represent an extended balance sheet of the local government.

Compared to the standard balance sheet, the extended balance sheet

- provides information about contingent and direct implicit items that may affect future net worth
- helps understand which local government actions imply progress or regress toward local government long-term fiscal stability
- illustrates how the local government's long-term finances will evolve if certain assumptions hold (such as assumptions in calculating the local implicit pension debt and the value of land).

Conventional fiscal surveillance covers local government debt service burden, deficit, debt level, and cash balances.

This is not sufficient in countries where local government budgets fail to cover all fiscal activities and contingent liabilities are significant.

Addressing fiscal opportunism at the local level

Substitution – contingent instead of direct – to avoid difficult adjustment and painful structural reforms, to escape fiscal discipline, or to implement low-priority programs

Moral hazard – the reliance on central government bailout influences the behavior of:

- local government officials (who may tend to over-borrow, issue too many guarantees, establish and provide backing to local insurance programs, and take on financial risk through commercial activity) and
- the creditors (who may expose themselves to excessive credit risk vis-à-vis local governments)

An effort to examine local government risk as part of fiscal surveillance would help reduce fiscal opportunism at the local level.

Dealing with contingent liabilities on the road to EMU

1. Promote risk awareness

An open discussion of risks and government risk exposures enhances government dealing with contingent liabilities.

Risk awareness through an open discussion and acknowledgement of risks tend to be more effective than the actual results of any sophisticated risk valuation.

To promote the government's own understanding of its contingent liabilities and related fiscal risk, fiscal surveillance could involve a broad analysis of government risk exposures, supported by surveys of local government risks, risks arising in infrastructure, and risk exposures of state-controlled and strategically important companies.

2. Reward disclosure. Punish opacity.

Disclosure benefits scrutiny, fiscal discipline and contestability of resources.

With scrutiny comes pressure for greater discipline.

Disclosure should not be constrained by the weaknesses in the existing financial-reporting standards or by slow progress in their improvement.

Central and local government statements of risk can complement their existing reports.

Fiscal surveillance needs to seek to reward countries that voluntarily expose the full scale of their contingent liabilities and fiscal risk (”upgrade” for transparency rather than “downgrade” for the risks revealed).

Fiscal surveillance could involve punishment for opacity and for excessive risk taking (public statement, contingency reserve fund requirement).

3. Assist in accounting and budgeting reforms

Accrual-based standards are helpful, but neither necessary nor sufficient.

Accrual-accounting standards do not require all direct and contingent liabilities to be revealed and included on the balance sheet and in the calculations of budget deficits

The leading international standards are all converging toward more accurate accounting for risk.

Accrual-budgeting standards possibly effective in revealing newly taken risk, particularly if implemented jointly with accrual-accounting standards

- apply a joint ceiling to the cost of budgetary and off-budget/contingent support for each sector in a fiscal year
- have the budget reflect the full likely fiscal cost of contingent support immediately when approved
- create a contingent-liability fund

Reporting of and budgeting for risk can be done separately.

Fiscal surveillance can encourage further reforms toward better treatment of contingent liabilities and fiscal risk.

4. Assist in fiscal risk management

Fiscal risk management requires:

adequate information

- a comprehensive database of all major risk exposures
- capacity to gather relevant information

ability to understand

- useful analytical frameworks

incentives to act correctly

- disclosure, accounting and budgeting
- accountability for the adequacy of risk analysis and risk management
- risk management strategy
- centralized risk-taking authority
- risk monitoring separate from risk taking

Fiscal surveillance could be linked to assistance in government fiscal risk management.

5. Assist in reducing government risk exposure

Reducing government risk exposure entails three complementary tasks:

- involve the private sector and mitigate risk at source – adjusting market conditions to enable private-sector parties to better deal with risk
- transfer risk – creating risk-sharing arrangements
- manage any residual risk that cannot be mitigated or transferred
  - hedging
  - building contingent-liability funds

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Concluding remarks

The coverage of contingent liabilities under fiscal surveillance could

promote appropriate disclosure and

enhance government dealing with contingent liabilities

in New Member States.