Chapter 2 : Conceptual Issues

2.1 Conventional fiscal adjustment programme which aims at reduction of fiscal deficit and debt does not necessarily prevent fiscal instability as it does not emphasise the hidden fiscal risk associated with contingent liabilities of the government. Both at national as well as international fora, it has been recognised that in the context of fiscal stability and sustainability, the policy makers should identify, classify and understand the full range of fiscal risk involved in contingent liabilities.

2.2 Contingent liabilities are obligations triggered by a discrete event that may or may not occur. The distinction between government's contingent and non-contingent liabilities is that nominal obligation and the settlement date of the latter are fixed at the date of issue, whereas in case of former (contingent liabilities), the contractual obligation is dependent on its timing and amount, on the occurrence of an event such as, default by the principal obligant / borrower.

Explicit and Implicit Contingent Liabilities

2.3 Contingent liabilities could be explicit or implicit. Explicit liability is recognised by law or contract whereas implicit obligation of the government mainly reflects public expectations. State guarantees issued on behalf of sub-national governments and public and private sector entities fall in the category of explicit contingent liabilities. Credit guarantees, trade and exchange rate guarantees offered by the State, state insurance schemes such as, for deposits, crops, floods, minimum returns from pension funds etc., are also in the category of explicit contingent liabilities. A government provides a guarantee on behalf of an entity when it does not have the requisite creditworthiness/track record to raise capital or contract a loan on its own and therefore, seeks protection under the overall umbrella of the government. Thus, contingent liabilities are the contractual obligations of the government to provide for any eventuality of default by the borrower either on principal amount borrowed or interest payment on such amount or both.

2.4 Implicit contingent liabilities would include, (i) Defaults of sub-national governments and public entities on non-guaranteed debt and other obligations, (ii) Liability clean-up in entities being privatised, (iii) Bank failures (support beyond state insurance), (iv) Failures of non-guaranteed pension funds or other social security funds, (v) Default of central bank on its obligations (foreign exchange contracts, currency, defence), (vi) Collapses due to sudden capital outflows and (vii) Environmental recovery, disaster relief, military financing.

2.5 Implicit contingent liabilities are not recognised until a failure occurs.. In most countries, in the financial system, what is most serious is the contingent implicit liability. Markets expect government support far beyond its legal obligation if financial stability is at risk as the Asian crisis amply demonstrated. Fiscal authorities are also often compelled to cover the losses and obligations of the central bank, sub-national governments, state- owned or large private enterprises, the failure of which would threaten the system. Implicit contingent liabilities grow with weakness as in the financial sector, macro economic policies, regulatory and supervisory system and information disclosure. In the context of international private capital flows such weaknesses elevate risks of asset bubbles and over borrowing.

2.6 Explicit contingent liabilities are generally recorded only when the contingency is evident, i.e., when the guarantee must be redeemed and the necessary budget provision made. The general ledger system used for accounting can also have a subsidiary system devoted to registering and tracking the status of guarantees. As the guarantees become due to be redeemed, the necessary action is initiated to make provisions in the budget.

Fiscal Risk

2.7 Governments often issue guarantees to cover part or all of the risk that a borrower will fail to repay a loan or other guaranteed asset or that an institution will fail to fulfill its obligations. Common examples include state guarantees of debt and other obligations of sub-national governments and various public and private entities, such as, budgetary institutions, credit and guarantee funds, development banks, and enterprises. Guarantee and credit issued through a state-guaranteed intermediary are particularly risky because they allow the government to pursue unannounced policy decisions, involve a problem of management incentives, and are difficult for governments to monitor and control. The hidden subsidy to the beneficiary of a guarantee, and the subsequent potential cost to the government, are positively correlated with the coverage (part risk, size, and duration of the underlying asset. In addition, the probability of a default may be very high if the guarantee contract does not specify risk-sharing by both the government and the other parties in terms of both the financial coverage (part *versus* all of the loan) and risk coverage (specific political or commercial, *versus* all risks). Government guarantees routinely cover all risks fully. Such guarantees distort the markets and are called with high probability. The risk a government assumes can be estimated based on the experience of governments of different capacities, simple rules, and, where appropriate, more sophisticated methodologies such as actuarial, econometric, loss estimate, and option pricing models. Assessment of risks allows governments to reflect the potential fiscal cost associated with guarantees in their choices of policies and forms of support and in the design of a guarantee contract. Since passage of the *Credit Reform Act,* the United States provides good examples of government analysis and the design of credit guarantees.

2.8 Governments extend umbrella guarantees to eligible persons or entities borrowing for a specific purpose, such as university studies, a mortgage, farming, and small business development. The rationale for these guarantees and the assessment of their risks and potential long-term cost are similar to those for the individual guarantees discussed above (and are also true for trade and exchange rate guarantees and guarantees on foreign sovereign borrowing and private investments).

2.9 State insurance schemes often constitute a major risk to future fiscal balances. Common state insurance programmes cover bank deposits, crops, war risks, minimum returns from pension funds, and floods, earthquakes, and other natural disasters. Although most of these programmes cover losses that occur very infrequently, when the losses do occur, their total magnitude may be enormous. The risk pool under these programmes, particularly in small markets, is very limited, thus, there is some justification for government's involvement. State insurance schemes rely on net government financing from general taxes, rather than on insurance fees, and thus redistribute wealth.The analysis of risks and potential fiscal burdens associated with state insurance schemes requires sector data and sophisticated models (such as the hydrologic model used to estimate the probabilities of floods in a given year), and loss

estimation methodologies and options pricing models to assess the riskiness of the returns of a pension fund. A qualitative analysis of the risk factors is, however, sufficient for the government both to design a sound insurance scheme that would not seriously distort market behaviours and to make a rough estimate of its potential fiscal cost.

Guarantees and Risk Weight

2.10 The question of honouring guarantees given by the governments depends on the investment project and its risk evaluation, the corpus of funds maintained to meet such obligations, the risk bearing capacity of a particular government and the magnitude of guarantees in relation to cash flows to the exchequer. The risk of default may be inversely correlated to the financial health of the institution for which government has stood guarantee or the financial viability of a project in case the amount assured is tied up to that project. In a strictly theoretical sense, the higher the amount of guarantee above an `optimal level' (could be viewed as adverse selection), the greater may be the degree of credit risk associated with the guarantees and hence greater chances of default. Any delay in honouring guaranteed obligations in the form of timely payment of interest and/or repayment of the principal guaranteed by the government can lead to loss of credibility in the market. In that eventuality any further guarantees by government may not be readily accepted by the investors to hedge the credit risk.

Risk Sharing

2.11 Loan guarantee programmes may either cover the full amount of credit arrangement or a fraction or a fixed amount. The nature of the investment guaranteed may have a bearing upon the sharing of risk between the government and the investors. For instance, if the credit guarantee is tied up to a project, the creditor will try to pass on the degree of risk to the government depending on his risk perception of the project. The creditors would like to pass on the full amount of risk to the government if they perceive an investment project to be loaded with high degree of risk and vice-versa.

Contingent Liabilities and Gross Fiscal Deficit *

2.12 Conventional fiscal accounting treats contingent liabilities as obligations that occur primarily in the future with the invoking of the guarantee and the subsequent generation of cash flow from budget. The deficit measure prescribed by the United Nations in System of National Accounts (SNA), and the International Monetary Fund in Manual on Government Finance Statistics (GFSM), lay emphasis on the current flows of goods and services ignoring the current financial commitment of the government, which may translate into future transfers between the public and the private sectors of the economy. The GFSM recommends that government guarantees on debts be excluded, unless the government is called upon to take over and service that debt. Thus, with regard to loan guarantees, only payments arising out of default by the borrower are treated as expenditure items. Thus, while conventional deficit measures will (subject to a number of caveats) accurately describe the change in the government's nominal liabilities resulting from the need to finance cash expenditures, the change in its liability from noncash policies -that is, the extension of contingent claims- will generally be ignored. As a result, fiscal accounting systems will provide insufficient data for adequate budgetary control over such policies. Moreover, constraints on conventionally defined levels of expenditures and the deficit may have the unintended effect of creating the incentive to substitute noncash expenditure through the issue of loan guarantees or other means. As a result, conventional

budget methodologies may lead to improper analysis of the trade-off between current cash expenditure policies and the issuance of contingencies.

2.13 In addition, the design of macroeconomic policy will depend on an appropriate measure of the macroeconomic impact of the government's fiscal activities. The impact of such contingency programmes as social welfare, deposit insurance, and loan guarantees, while controversial, is likely to be significant. Thus, insofar as conventional measures of fiscal impact ignore these noncash fiscal activities, they may under-represent the government's effect on the macro economy.

2.14 Extended deficit measures can be defined to gauge the government's fiscal impact. Deficits can be defined that measure the intergenerational transfers implied by contingency programmes (and other government policies), or that sum of government activity, including contingencies, over an infinite horizon. The choice will depend on the relevant planning horizon of the budget authority and the private sector. However, either alternative is likely to be impractical given the data requirements, as well as require a choice between polar views regarding the determinants and the horizon relevant for private sector consumption and savings.

2.15 Nonetheless, the value of government contingencies should be measured, especially so that adequate budgetary controls may be applied. Two alternatives have been proposed that correspond closely to the underlying focus of the extended deficit measures: actuarial balance, which would represent the liability from the government's (long-term) perspective; and actuarial fairness or a contingency's subsidy value, which measures the transfer to current participants. In the latter case, a number of alternative measurement strategies can be defined, with the choice depending on the type of contingency in question and the data available. These measures can be used to form the basis of the appropriate budgetary control over the government's provision of contingencies, as well as the analytic device for gauging their impact.

2.16 In the context of the above discussion, it is pertinent to point out that the Committee has confined its scope only to explicit contingent liabilities in the nature of guarantees and obligations such as letters of comfort, assured payment arrangements etc.

The discussion in this Chapter is based on the paper ***' Contingent Government Liabilities': – A Hidden Risk for Fiscal Stability*** *- by Hanna Polackova,* Policy *World Bank* Research Working Paper 1989.

[*] This section draw heavily from paper by Towe Christropher M., on *"Government Contingent Liabilities and Measurement of Fiscal Impact*", Published in the `**How to Measure Fiscal Deficit' edited by Mario. I, Blejer and Adrienne Cheasty, 1993, IMF.**