UNESCWA

Expert Group Meeting - “From plan to implementation for achievement of the Sustainable Development Goals: Budgeting in support of effective institutions”

Identifying and Managing Fiscal Risks

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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:

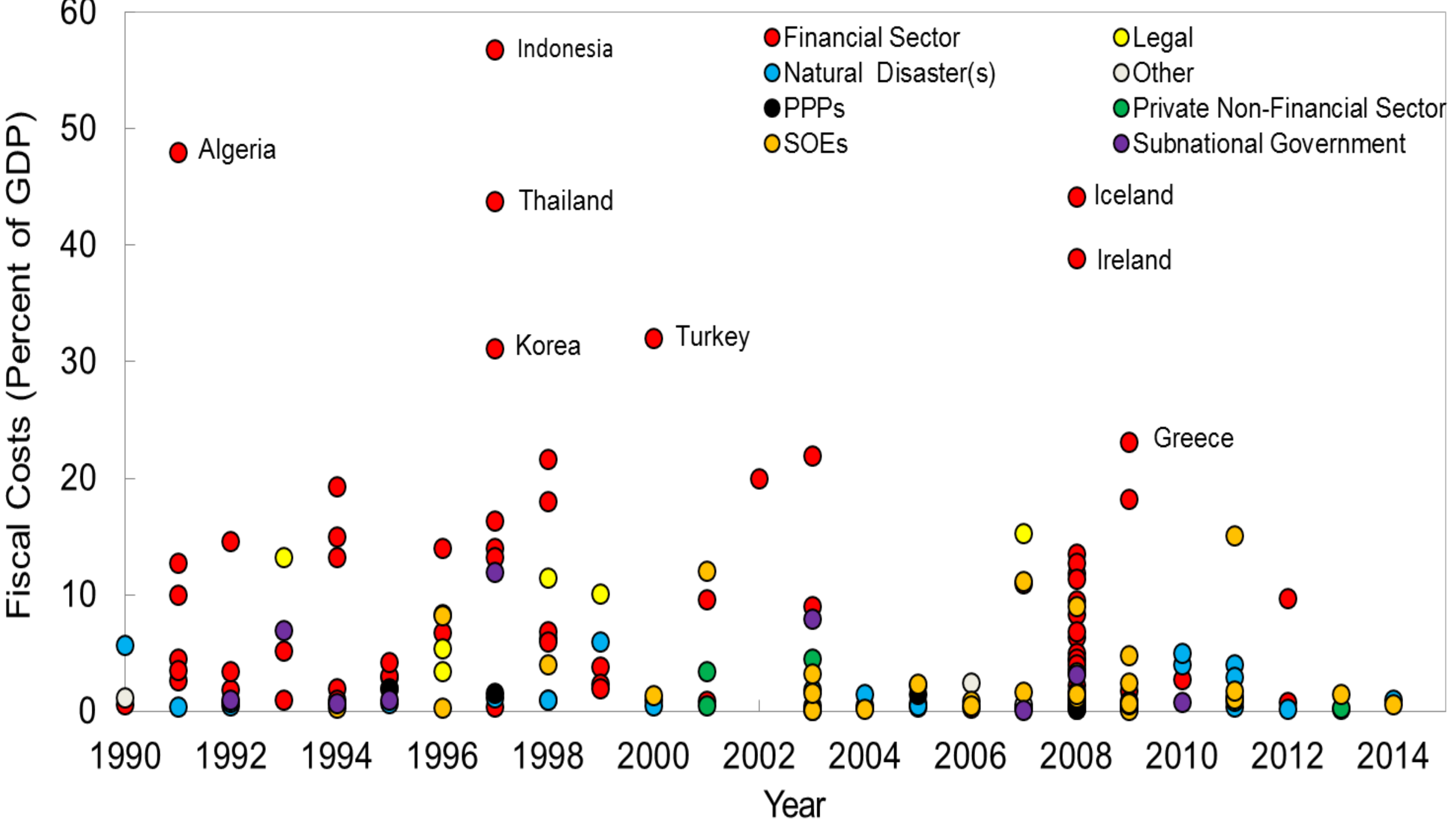
- Public corporations,
- Sub-national governments.

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)



Bova, E., M. Ruiz-Arranz, F. Toscani, and H. E. Ture, 2016, “The Fiscal Costs of Contingent Liabilities: A New Dataset,” IMF Working Paper 16/14 (Washington: International Monetary Fund).

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

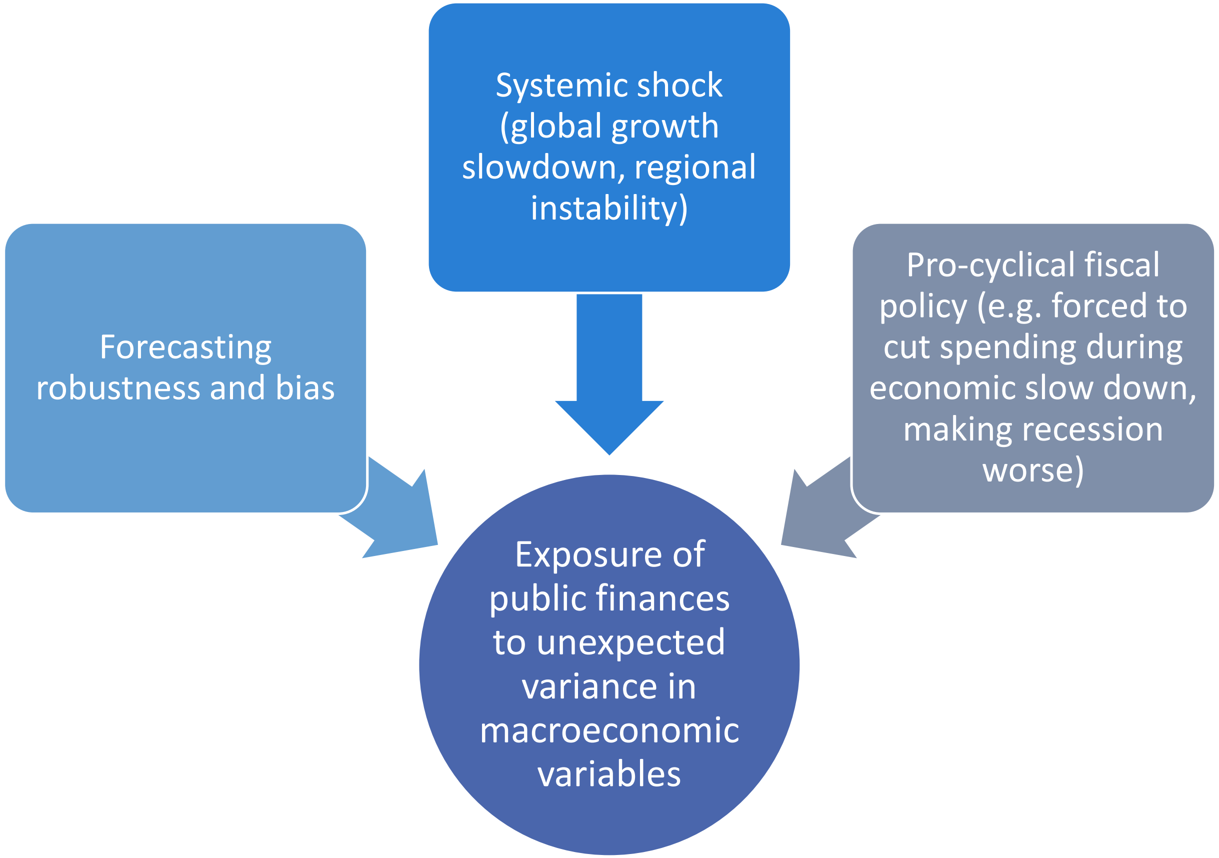
* e.g. failing PPP; bailouts of SOEs, banks, and sub-national government; natural disasters

Explicit

* Based on a firm legal obligation or declared policy

* e.g. government guarantees; PPP related min. guarantees; deposit insurance; legal claims.

Macroeconomic Risks



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

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.

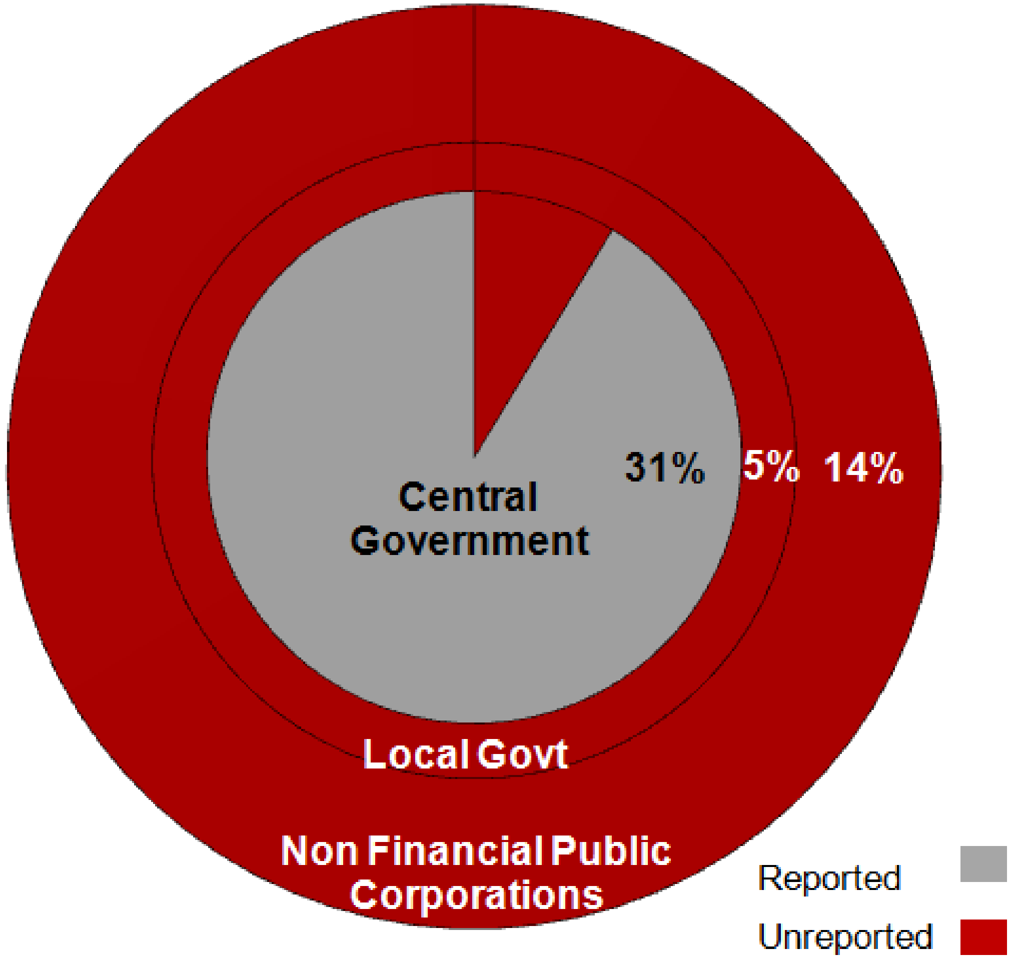
The Inadequacy of Conventional Budgeting for Exposing Fiscal Risks

Cash basis of budgeting	Short term budget horizon	Incentive to overestimate revenues, underestimate costs, risks
Pressures to reduce fiscal deficits/debt (e.g. to meet fiscal rules or targets) often lead to off-budget devices that increase risk	Off-budget instruments such as guarantees, PPPs	Implicit contingent liabilities typically not considered

Understanding the Fiscal Position: Beyond the Budget

Coverage of Public Sector Entities

(% of GDP)

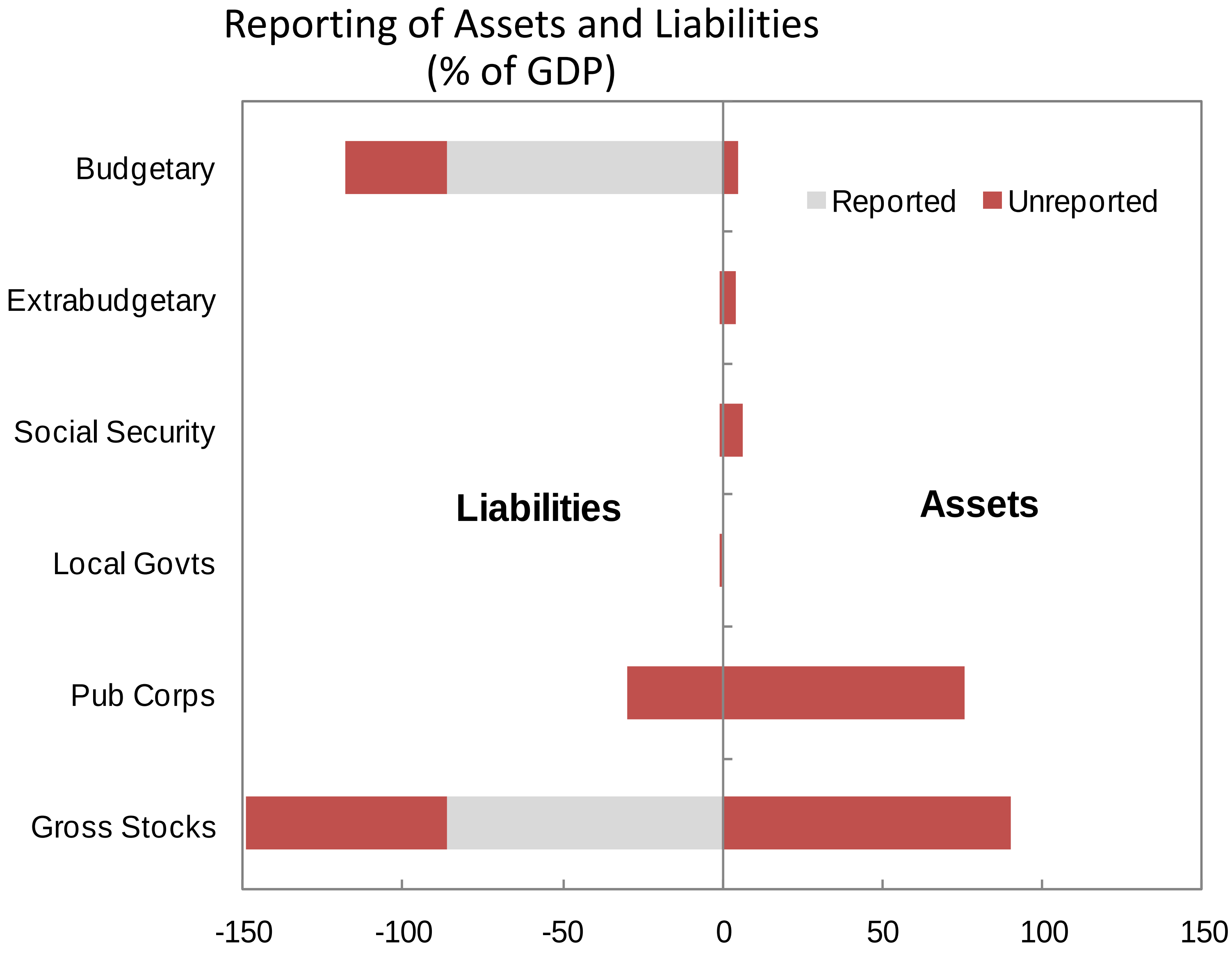


Coverage limited to central government budget

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

Data from a sample country

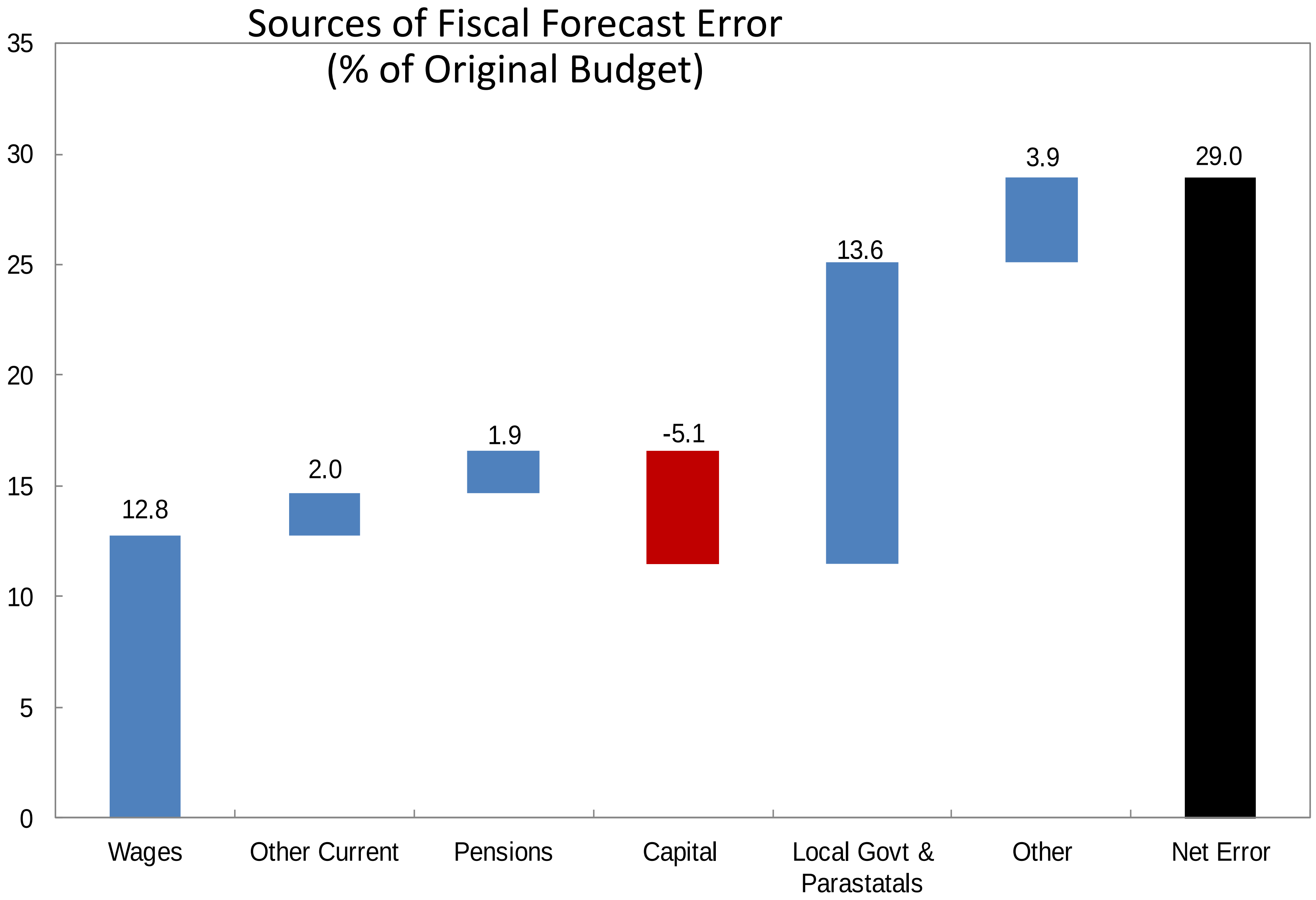
Understanding the Fiscal Position: What about the Wealth of the Nation?



No reporting of assets and large unreported liabilities

Data from a sample country

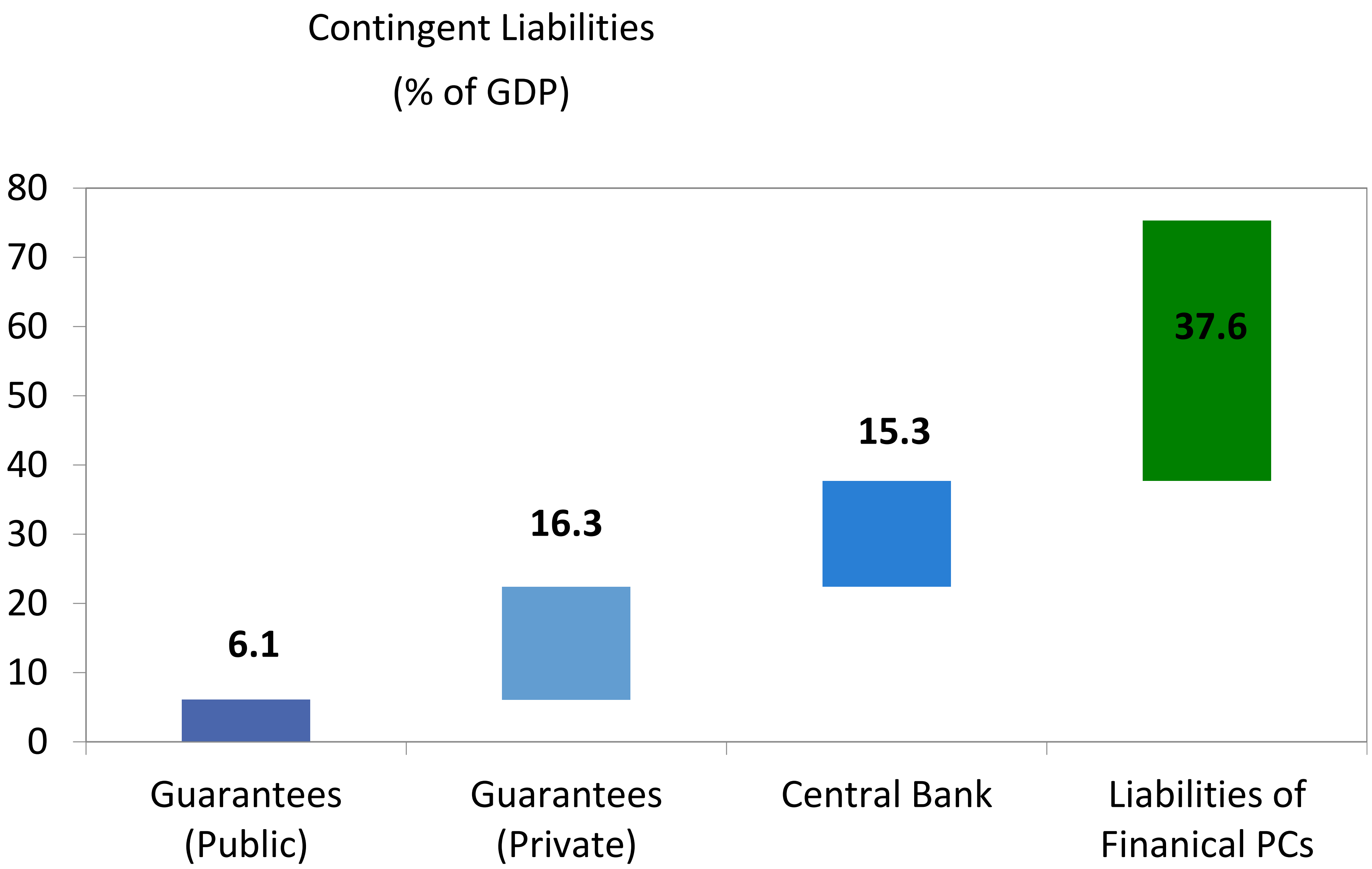
Understanding the Fiscal Position: Assessing the Fiscal Forecasts



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



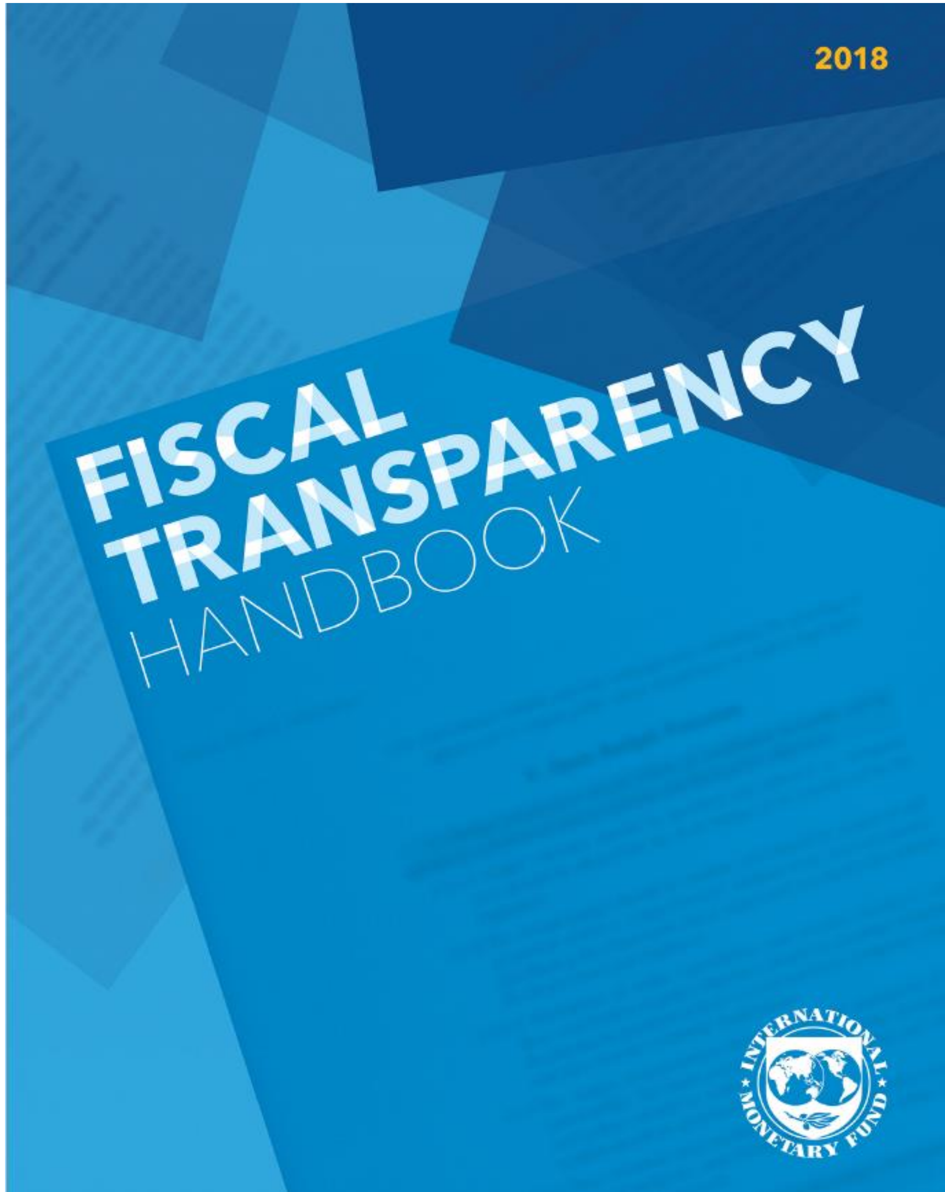
Contingent liabilities are large and diverse

Data from a sample country

The IMF's 2014 Fiscal Transparency Code

Four Pillars of the Code

I. FISCAL REPORTING	II. FISCAL FORECASTING & BUDGETING	III. FISCAL RISK ANALYSIS & MANAGEMENT	IV. RESOURCE REVENUE MANAGEMENT
1.1. Coverage	2.1.Compre-hensiveness	3.1. Risk Analysis & Disclosure	4.1. Legal & Fiscal Regime
1.2. Frequency & Timeliness	2.2. Orderliness	3.2. Risk Management	4.2 Fiscal Reporting
1.3. Quality	2.3. Policy Orientation	3.3. Fiscal Coordination	4.3. Fiscal Forecasts & Budgets
1.4. Integrity	2.4. Credibility		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:

- Treat it (to reduce the probability or expected impact of crystallisation)
- Transfer it to the private sector (for example by insuring against crystallisation)
- Tolerate it (perhaps with an accounting provision to reflect the potential cost)
- 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

Practices Vary Across Countries

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