University of Glasgow | Adam Smith Business School

Why the contingent liabilities of governments need to be better reported and monitored

Presentation at the 23rd Annual Meeting of the OECD Working Party on Financial Management and Reporting
Paris, 9-10 March 2023

David Heald (david.heald@glasgow.ac.uk)

Why contingent liabilities are important

1) Contingent liabilities are obligations of government that do not meet the **recognition** criteria of a liability in accounting and/or statistical standards
2) Very little is new in terms of the theorization of contingent liabilities: the threats to fiscal stability were set out clearly by Polackova (1998), Brixi and Schick (eds) (2002) and Irwin (2012)
3) Context has escalated the significance of the public sector balance sheet (Moretti et al., 2021) and of contingent liabilities which can have macroeconomic significance
4) Fiscal transparency is enhanced by systematic **disclosure** of contingent liabilities. Similarly, very little is new in this area. Recommendations and guidance have been provided by several international organizations (e.g., OECD Best Practices for Budget Transparency, Recommendation of the [OECD] Council on Budgetary Governance and Spending Better Framework, IMF’s Fiscal Transparency Code, Public Expenditure and Financial Accountability (PEFA))
5) For the purposes of financial management, the focus should extend to obligations which constitute a fiscal risk to government, even if these do not necessarily satisfy accounting or statistical definitions

Contingent liabilities are a source of fiscal risk

1) Intensified fiscal pressure resulting from external events (such as the 2008-09 global financial crisis, Covid-19, cost-of-living crisis and international conflict) threatens fiscal sustainability
2) Citizens expect public services beyond their willingness to pay taxes or charges, so governments look for non-transparent workarounds which avoid being reported as public expenditure and adding to public debt
3) Public Choice theory characterizes politicians and bureaucrats as selfish maximisers. Election cycles encourage truncated time horizons regardless of the supposedly long time horizons for economic and fiscal decision-making
4) Statistical and accounting measurement systems find it difficult to delimit the responsibilities of government. The boundary of general government (critical for statistical accounting) is porous and can be gamed
5) Attention needs to be paid to the correlation between apparently unconnected guarantees, calls on which may depend on the same macroeconomic event. Similarly, huge numbers of relatively small guarantees (eg mortgage loans) can expose the public finances to large risks

Modes of Government Accounting

Heald and Hodges (2018) analysed government guarantees by distinguishing four modes of government accounting which have different origins and purposes.

1) **Government Financial Reporting**, historically on a cash basis but increasingly on an accruals basis, with reference to externally-set standards, whether these are IFRS or IPSASs. These accounts are audited, usually by a Supreme Audit Institution, and production is often quite slow. International comparability is low
2) **Statistical Accounting**, on the basis of the UN System of Accounts 2008 or the European Union derivative ESA10. International comparability is high and fiscal statistics are produced rapidly. Such fiscal numbers move debt markets. They are monitored by international organizations (IMF and OECD) and by supranational organizations (the EU, particularly in the context of the Eurozone)
3) **Budgeting** is where country differences are most pronounced, reflecting constitutional structures and fiscal history. Who is going to get what and when out of public budgets attracts much more public attention than the accounting and statistical outturns
4) **Fiscal Sustainability Projections** aim to show whether existing public services can be maintained in the future in the light of factors such as adverse demography. Preparing these has become one of the tasks of Independent Fiscal Institutions

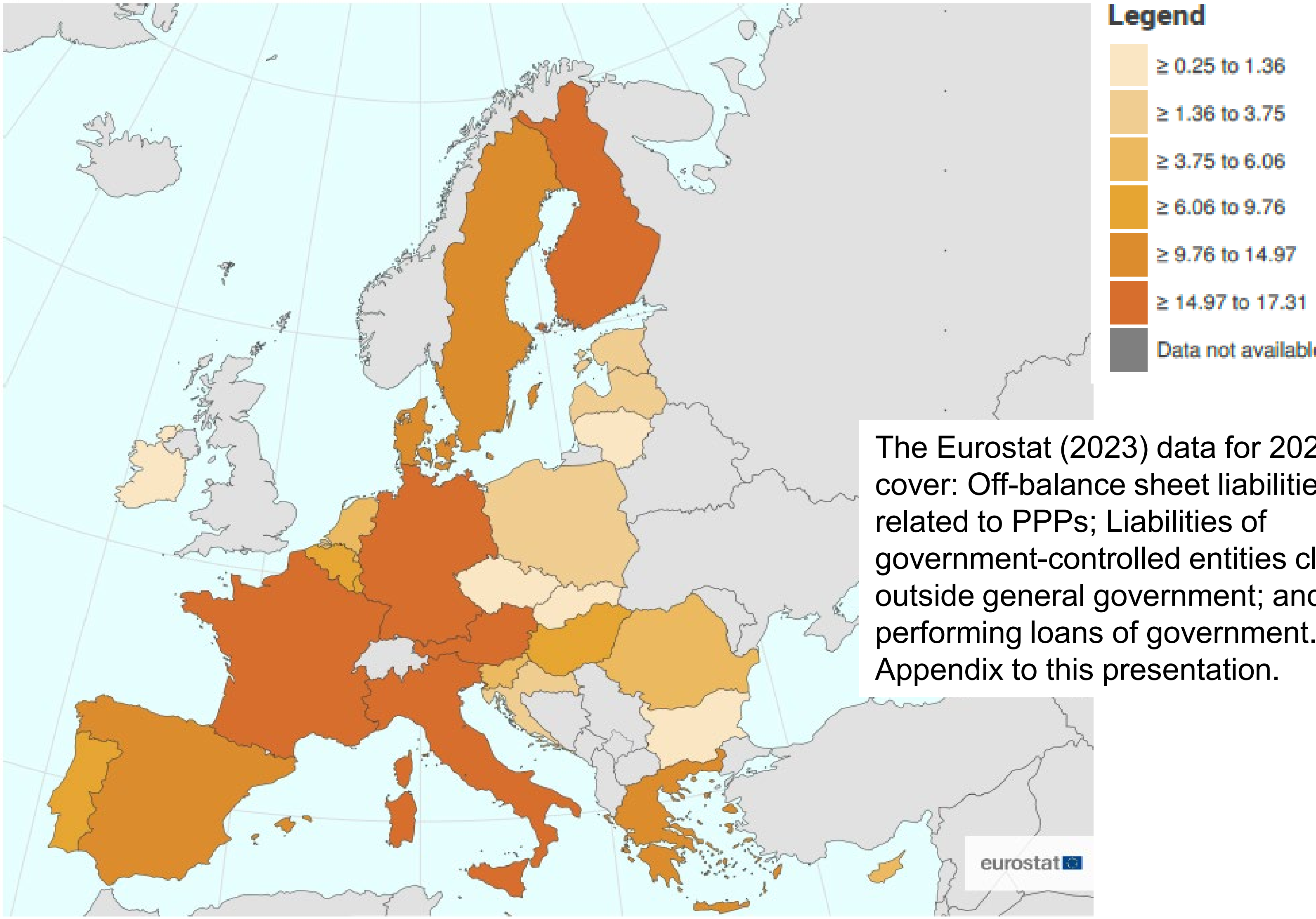
Each mode has its own transparency requirements which are not necessarily harmonized. There are tensions between them (purposes are different) but there can also be synergies (developments in one can expose weaknesses in others)

Contingent Liabilities in Statistical Accounting
Eurostat Monitoring of EU27 Contingent Liabilities

1) Increasing economic integration of the EU has increased the importance of fiscal surveillance. Fiscal statistics are generally restricted to ‘general government’ which has porous boundaries. Activities that pose a fiscal risk can be accidentally or deliberately placed just outside general government, though with government control maintained
2) Eurostat now publishes contingent liability data for the EU27. Data for 2021 were published in January 2023. Caution is required in interpretation:
   a) There are country differences in what falls inside general government and what falls outside
   b) The ownership structure in different countries influences what data are reported, particularly liabilities of government-controlled entities classified outside general government (see Appendix). Governments can be at fiscal risk from privately-owned banks and energy companies
   c) Preparation of the data is a national responsibility and is not audited: some differences might be attributable to differences in data completeness
3) It is the policy context (Six Pack and Two Pack after the Euro crisis) which has made possible the collection and publication of such data

Government Guarantees in the European Union

% of GDP in 2021



The Eurostat (2023) data for 2021 also cover: Off-balance sheet liabilities related to PPPs; Liabilities of government-controlled entities classified outside general government; and Non-performing loans of government. See Appendix to this presentation.

Reporting preferences ladder for government guarantees

Recognized in Financial Statements	Disclosed within notes but not Recognized	Not Disclosed
		No government obligation
	Remote unquantifiable contingent liability	Remote quantifiable or unquantifiable contingent liability
	Unquantifiable contingent liability	
	Remote quantifiable contingent liability	
	Quantifiable contingent liability	
Liability		

The ladder should be read from bottom left (liabilities are recognized in the accounts), then across and up each column. At top right, the public policy objective is achieved without any government obligation being recognized or disclosed (Heald and Hodges, 2018, pp. 787-88).

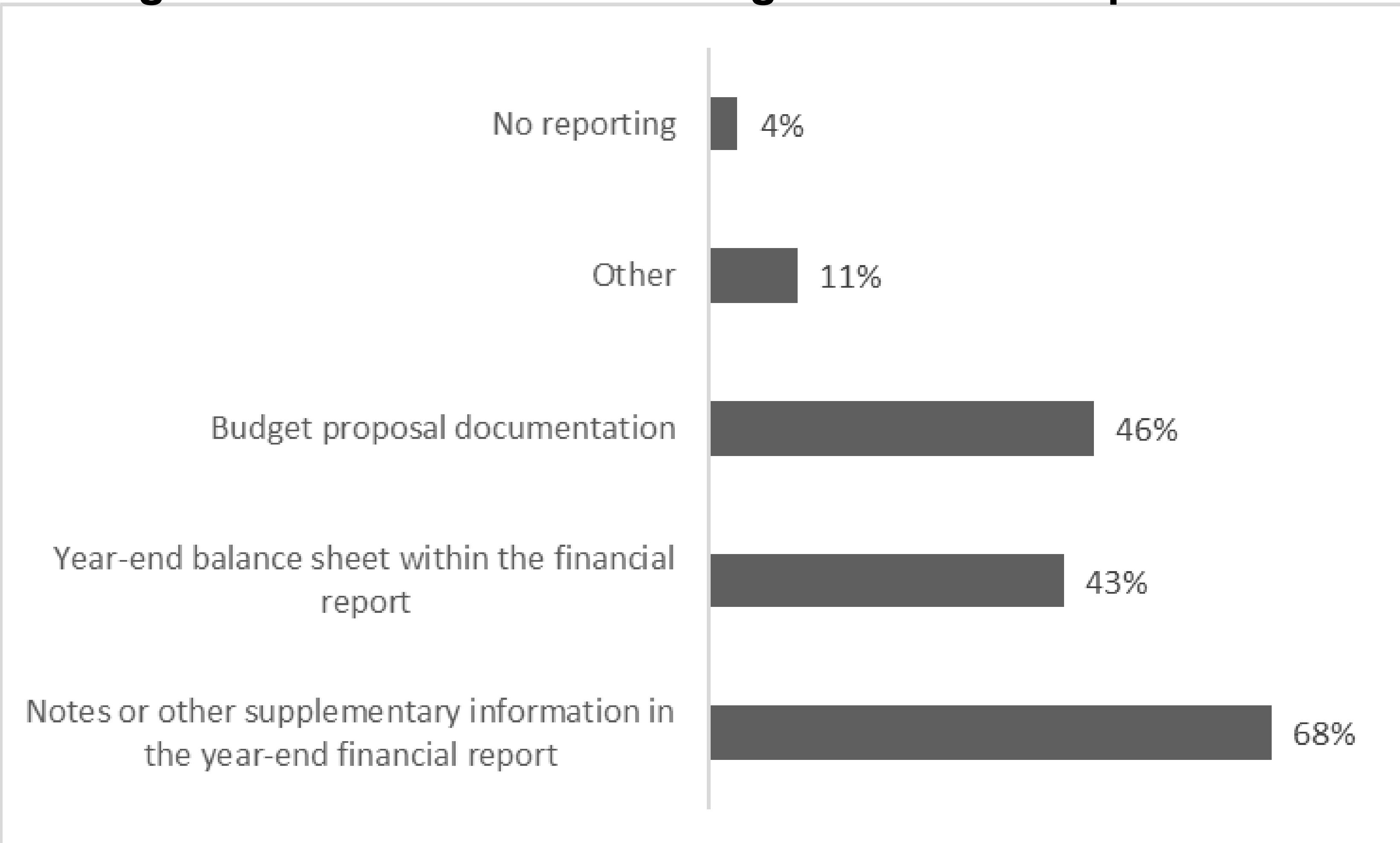
Where similar items appear in the second and third columns, the entries in the second column represent those items which are not required to be disclosed by IAS37 or IPSAS19 but are so required by Ministry of Finance regulations.

It is not only subordinate entities which game the rules. Governments may resent the application of their own pre-announced rules and standards when they bite on actual decisions.

Overview of transparency guidance on Contingent Liabilities

Fiscal document	Balance sheet or appropriation recording	Other type of disclosures	Other policy information
Budget	• Balance sheet provision if criteria met and corresponding accrued charges (accrual budgeting) • Appropriations based on expected losses (cash budgeting)	• Categories of CLs, often focused on explicit • Beneficiaries and other policy features • Gross exposure, and expected losses and revenues	• Rationale, cost/benefit analysis, etc. • Ceiling on stock or flow of guarantees
Fiscal risks report		• Categories of CLs, often including implicit • Likelihood of realization and magnitude	• Prevention and mitigation policies (e.g., risk sharing)
Mid-year report and budget execution report		• New CLs • Use of contingency reserve on realization of CLs	
Financial statements (IPSAS or other)	• Balance sheet provisions if criteria met and corresponding accrued charges (e.g., “more likely than not”)	• Classes of CLs • Estimates (e.g., of financial effect) • Indication of uncertainties relating to the amount or timing of any outflow • Possibility of any reimbursement	
Fiscal statistics (GFS Manual or other)	• Standardized guarantees	• Other types of guarantees and CLs	

Question in 2022 OECD Survey: How is the impact of guarantees and other contingent liabilities reported?



Note: Respondents could choose more than one response.
Source: 2022 OECD survey on Financial Management and Reporting, preliminary results based on responses from 28 out of 38 OECD member countries.

Some examples of concerns

- "Disclosures to the financial statements do not include the debt guarantee provided by the Government to BPI France for EUR 37.7 billion." [Banque publique d'investissement is a public investment bank]

  Cour des Comptes – France, 2021 audit report (ccomptes.fr)

- "Users […] need more detailed information on government's potential exposure to future liabilities as an insurer of last resort; for example, on decommissioning fracking sites."

  Committee of Public Accounts – UK House of Commons, 2019 (parliament.uk)

- "… high costs of higher education have led to an increase in student debt, with total student loan debt reaching US$1.6 trillion in Q2 2022 according the Federal Reserve Bank of New York. Student loan debt now accounts for more than 10% of total outstanding household debt in the United States …."

  OECD Economic Surveys: United States 2022 (OECD)

- Eurostat's data on 'Liabilities of government-controlled entities classified outside general government, % of GDP' provides an insight into vulnerabilities.

  EU member country data for 2021 (Eurostat)

- The IMF's Fiscal Transparency Evaluations, which are requested by member governments and not mandatory, have drawn attention to inadequate reporting of fiscal risks from Public Private Partnerships for infrastructure and from government guarantees. These provide patchy coverage of OECD countries.

  Fiscal Transparency Evaluations (IMF)

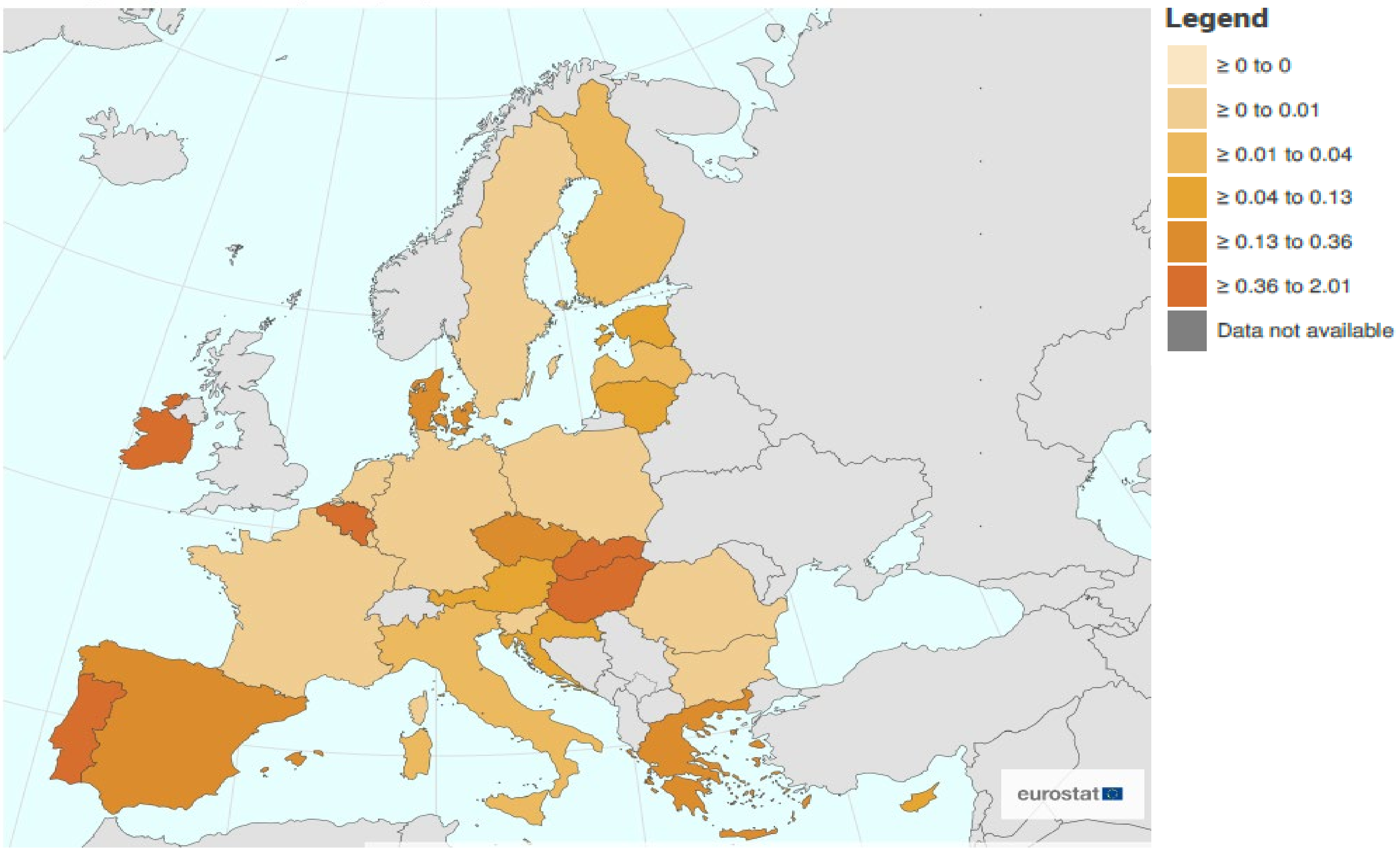
Points to take away and issues for discussion

1) The scrutiny and management of contingent liabilities requires proper recording and disclosure, as well as explicit attention to be paid to them. Contingent liabilities must be managed as well as monitored and disclosed (Razlog et al., 2020 and HM Treasury, 2020)
2) A significant risk comes from entities outside the general government boundary and from sub-national entities within the general government boundary for which data are often incomplete
3) Adherence to internationally-accepted transparency, accounting and statistical standards should increase confidence in how liabilities are **recognized** in the balance sheet and in how contingent liabilities are **disclosed**
4) The preliminary results of the 2022 OECD Survey on Financial Management and Reporting show a mixed picture with regard to conformity with standards and guidance in relation to contingent liabilities
5) Why is that the case? Is it due to a lack of data held by finance ministries or a lack of commitment to implementation? There might be issues in terms of the borderline between (a) obligations which can be provided for on the balance sheet and obligations which remain classified as contingent liabilities, and (b) those which are disclosed as contingent liabilities and those which are not reported at all
6) How can stakeholders in public financial management be mobilized to take an interest in contingent liabilities? This raises the question as to how committees in legislatures, often the primary user of government financial reports, can be equipped to be more effective

Appendix

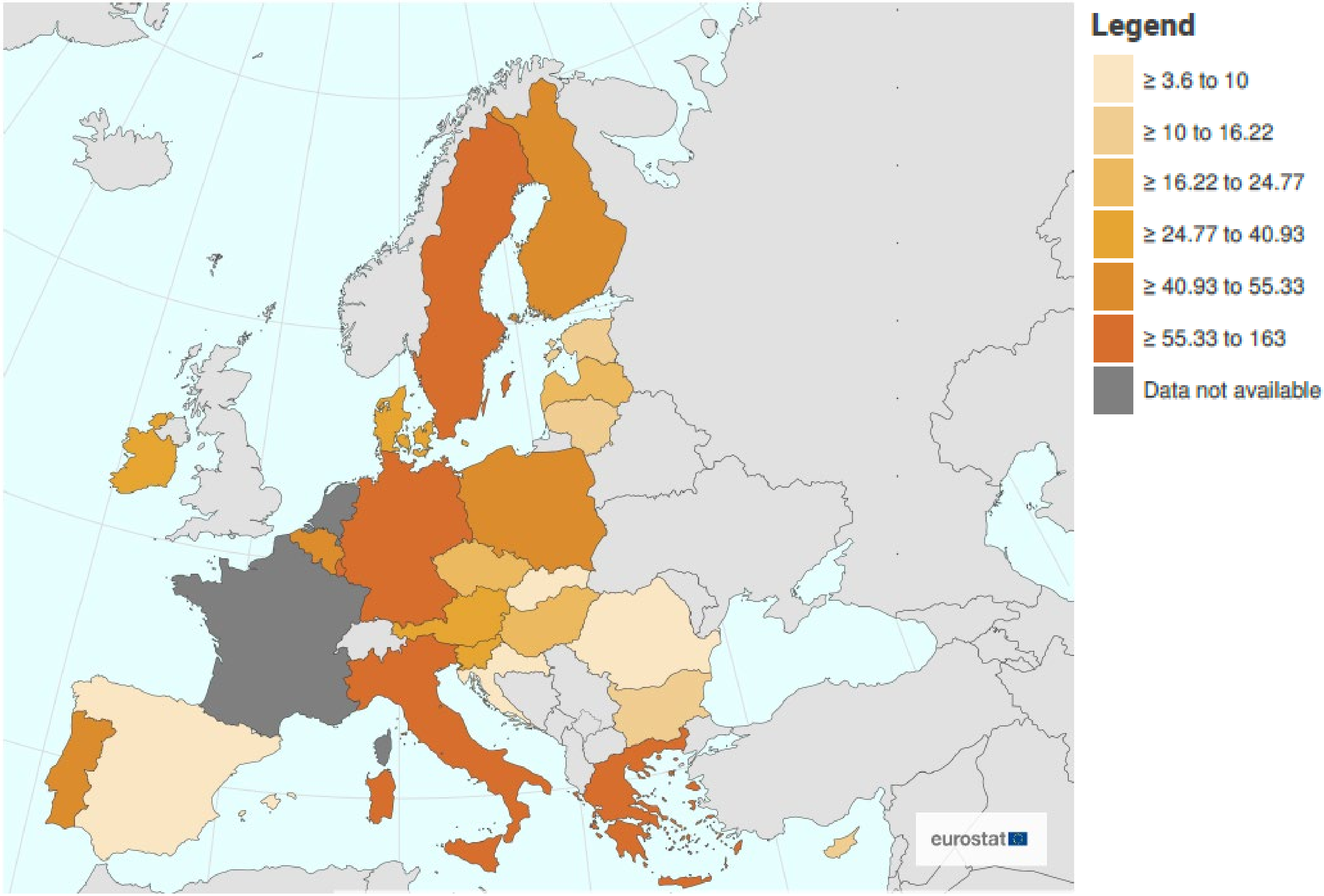
Off-balance sheet liabilities related to PPPs

% of GDP in 2021

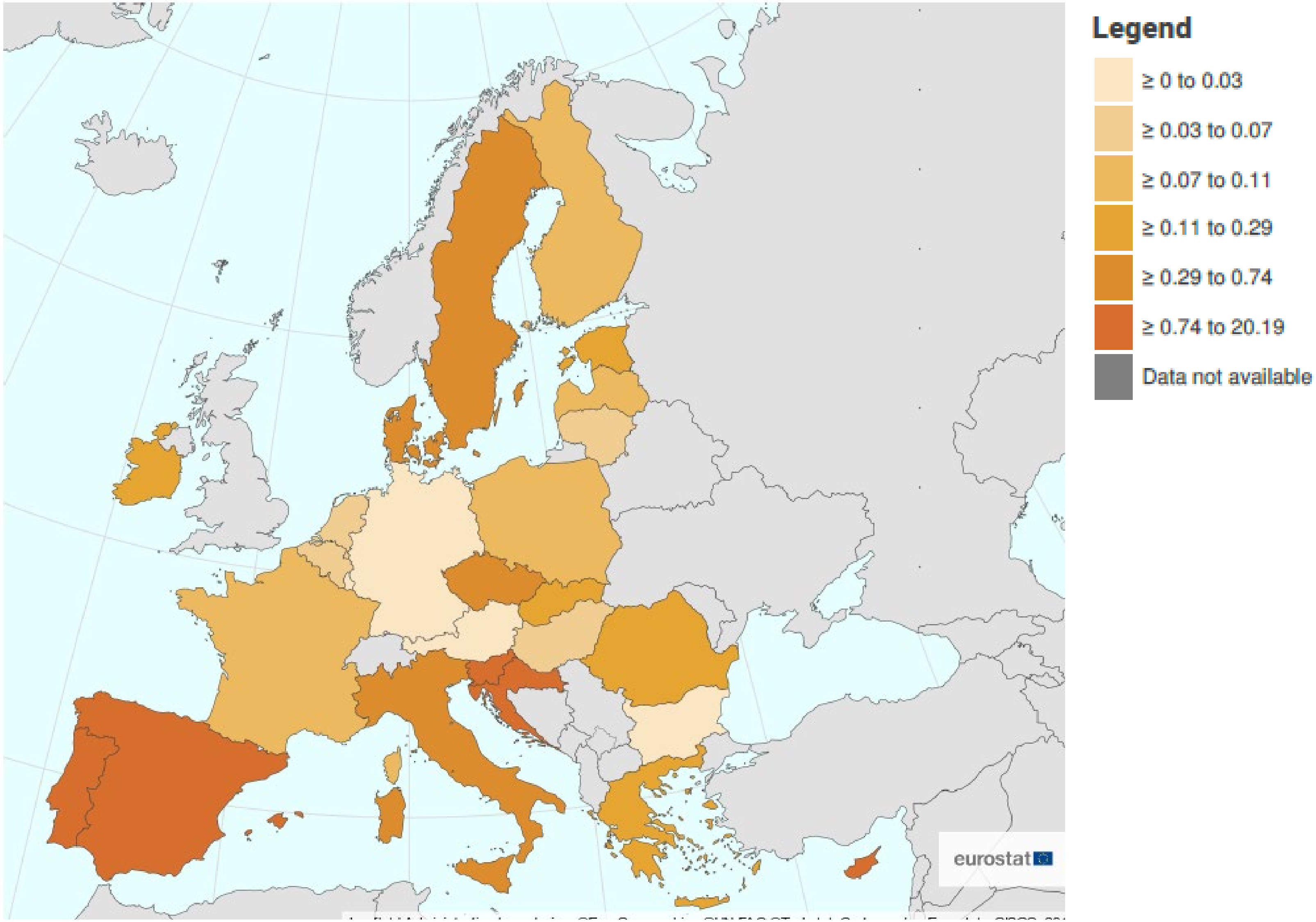


Liabilities of government-controlled entities classified outside general government (non-consolidated)

% of GDP in 2021



Non-performing loans of government
% of GDP in 2021



Cited References

Committee of Public Accounts (2019) *Whole of Government Accounts*, Seventy-Fourth Report of Session 2017–19, HC464, available at: https://publications.parliament.uk/pa/cm201719/cmselect/cmpubacc/464/464.pdf

Cour des Comptes (2022), *Certification des Comptes de L'Etat- Exercice 2021 Synthèse*, available at: https://www.ccomptes.fr/system/files/2022-05/20220524-synthese-certification-comptes-Etat-exercice-2021.pdf

Eurostat (2023) *Contingent Liabilities,* available at: https://ec.europa.eu/eurostat/web/government-finance-statistics/contingent-liabilities

Heald, D. and R. Hodges (2018) 'Accounting for guarantees: perspectives on fiscal transparency from four modes of accounting', *Accounting & Business Research*, Vol. 48(7), 2018, 782-804.

HM Treasury (2020) *Government as Insurer of Last Resort: Managing Contingent Liabilities in the Public Sector*, London.

IMF (undated) *Fiscal Transparency*, available at: https://www.imf.org/en/Topics/fiscal-policies/fiscal-transparency

Irwin, T. (2012) *Accounting Devices and Fiscal Illusions*, IMF Staff Discussion Note, SDN 12/02, Washington DC, International Monetary Fund.

Moretti, D., T. Braendle and A. Leroy (2021) Balance sheet-based policies in COVID-19 fiscal packages: How to improve transparency and risk analysis? *OECD Journal of Budgeting*, Vol. 21(2), 2-67.

OECD (2022) *OECD Economic Surveys: United States, October 2022*, available at: https://books.google.es/books/about/OECD_Economic_Surveys_United_States_2022.html?id=0dSUEAAAQBAJ&printsec=frontcover&source=kp_read_button&hl=en&redir_esc=y#v=onepage&q&f=false

Polackova, H. (1998) Contingent Government Liabilities: A Hidden Risk for Fiscal Stability, Policy Research Working Paper 1989, Washington DC, World Bank.

Polackova Brixi, H. and A. Schick (eds) 2002, *Government at Risk: Contingent Liabilities and Fiscal Risk*, Washington: World Bank and Oxford University Press.

Razlog, L., T. Irwin and C. Marrison (2020) *A Framework for Managing Government Guarantees*, MTI Discussion Paper No. 20, Washington DC, World Bank.