FISCAL RISKS
AND FISCAL RULES

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HOW GOVERNMENTS ACCUMULATE FISCAL RISKS

The Budget Misstates the Government’s Financial Condition

- Revenues and expenditures are not accurately reported
- Liabilities (such as arrears) are excluded from the budget
- The budget excludes extra-budgetary funds

Budget Policy is Not Sustainable

- Commitments (such as pension rights) are made without regard to future resources
- Budget relies on short-term measures to balance revenues and expenditures

Budget Does Not Include Contingent Liabilities

- Guarantees and other contingent liabilities are excluded from the budget
- When contingent liabilities are called, government must pay regardless of its fiscal condition or other demands on the budget.
BASIC FISCAL RULES TO COMBAT FISCAL RISKS

Misstatement of financial condition

- Accounting rules and principles
- The accrual basis
- Published financial statements
- Independent auditors

Budget Policy is not Sustainable

- Medium-term expenditure framework
- Fiscal targets and constraints
- Rules and procedures for enforcing the targets

Budget Does Not Include Contingent Liabilities

- Include Contingent Liabilities in financial statements
- Set Aside resources to pay future claims
- Limit the volume of contingent liabilities
DO BUDGET RULES WORK?

• The Enron fiasco calls budget rules into question

• Recent experience with Maastricht-type fiscal rules suggest that economic conditions and political will will play a big role in determining their efficacy
GOVERNMENT AND ENRON

Old View

If CEOs kept their books the way government does, they would be in jail

New View

If government managed its finances the way Enron did, it would be insolvent, but the budget would show a surplus

Balanced View

- The culture of auditing is similar in business and government
- Accounting standards are a necessary but inadequate bulwark against financial prevarication
- Governments may have a weaker incentive than business to lie about their financial condition
- Because of their easy access to capital and the lack of a strong budget constraint, affluent governments may have less incentive than poor governments
## THE ENRON SYNDROME

<table>
<thead>
<tr>
<th>Enron Practice</th>
<th>Government Parallel</th>
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<tbody>
<tr>
<td><strong>1. Special Purpose Entities</strong></td>
<td>Government Sponsored Enterprises (GSEs) have trillions of dollars of debt that is not on federal financial statements</td>
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<tr>
<td>Partnerships created to remove debt from Enron’s balance sheet</td>
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<td><strong>2. Contingent Liabilities</strong></td>
<td>Federal exposure to contingent liabilities includes insurance programs, loan guarantees, price guarantees that total trillions of dollars</td>
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<td>Enron was liable in the event special purpose partnerships were unable to service their debt</td>
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<td><strong>3. Aggressive Earnings Management</strong></td>
<td>“Smoke and mirrors” during the Gramm-Rudman-Hollings years to meet prescribed budget targets</td>
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<td>High-priority, comprehensive action to show rising earnings that meet the Street’s expectations</td>
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<td><strong>4. Shell Corporations</strong></td>
<td>In the early 1990s, during the crisis in the banking sector, Congress created the Resolution Financing Corporation whose sole purpose was to borrow billions of dollars off-budget</td>
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<tr>
<td>Enron created entities whose sole purpose was to dress up financial statements, reduce taxes, etc</td>
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<td><strong>5. Swaps, loans, etc.</strong></td>
<td>New York State “sold” Attica prison to a corporation it created. New Jersey did the same thing for a section of the New Jersey Turnpike</td>
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<td>Corporations “sold” services to one another enabling each to book additional revenue</td>
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SHIFTING THE BUDGET TO THE ACCRUAL BASIS WOULD NOT AVERT AN ENRON FIASCO

• Enron reports its finances on the accrual (GAAP) basis
• The accrual basis does not remedy the “Off Balance Sheet” problem
• The accrual basis entails numerous, often complex, assumptions about future events
• These assumptions are subject to judgment and manipulation
• The assumptions often dominate the relationship between firms and outside auditors
• It is more difficult for ordinary people (taxpayers, media, etc.) to understand accruals than cash flows
• Analysts often rely on cash flows to assess a firm’s performance and condition
SCOPE OF THE BUDGET AND FINANCIAL STATEMENTS

**ENRON**  
By creating partnerships in which it claimed to have less than a 3% interest, Enron removed debt from its balance sheet and presented itself in a much more favorable financial position than was warranted.

**IMF CODE**  
“The budget documentation, final accounts, and other fiscal reports for the public should cover all budgetary and extra-budgetary activities of the central government, and the consolidated fiscal position of the central government should be published.”

**OECD**  
“The budget should contain a comprehensive discussion of the government’s financial assets and liabilities…”
CONTINGENT LIABILITIES

**ENRON** Although the liabilities of many partnerships were not consolidated in its financial statements, Enron was responsible in case of default. Enron’s downfall was accelerated when it had to assume the debt of its partnerships.

**IFAC** To qualify as a contingent liability, the likelihood that a future expenditure will result should be more than remote. It would be desirable, however, to report contingent liabilities where the likelihood of actual expenditures is remote but the amount potentially at risk is very large.

**IMF** Statements describing the nature and fiscal significance of central government contingent liabilities should be part of the budget documentation.

Contingent liabilities complicate fiscal management because of the inherent uncertainty about their fiscal impact. Contingent liabilities will only be recognized under cash accounting if and when the contingent event actually occurs and a payment is made. Even under accrual accounting, many contingent liabilities would not be recognized as liabilities unless they can be quantified and are judged likely to require a future payment by the government. They should instead be disclosed in supplementary documents.
CONTEMPORARY BUDGET INNOVATIONS TO STRENGTHEN FISCAL DISCIPLINE

- Fiscal Targets Limit the Budget Deficit or Public Debt
- Multi-year Frameworks Constrain Annual Budget Decisions
- The Accrual Basis for Accounting and Budgeting
- Accounting or Budgeting for Contingent Liabilities
- International Standards (Transparency Codes, Accounting Principles, etc.)
- Two Stage Process for Budget Framework and Estimates/Appropriations

**Question:** Why are these rules more effective than traditional budget rules?
DUE PROCESS IN BUDGETING

- Due Process is Expressed in the classical Principles of Budgeting: Comprehensiveness, Actuality, Accuracy, etc.
- Conventional budget rules are procedural, not substantive
- They are neutral whether the budget is balanced
- They *assume* that if proper procedure is followed, the outcomes must be correct
- The role of international organizations is to assure compliance with due process
DUE PROCESS IS AN INADEQUATE BASIS FOR FISCAL DISCIPLINE

• **Affluent Countries**: Public expenditure averages 20 percentage points higher relative to GDP than in the Postwar Period

• **Emerging Market Countries**: Vulnerable to Shocks that destabilize public finance

• **Poor Countries**: Chronic imbalance of resources and development needs
DO BUDGET RULES RULE?

- Contemporary studies show a strong correlation of fiscal rules and budget outcomes
- Some studies focus on electoral systems, the party structure and governance
- Most focus on the rules for compiling, adopting, and implementing the budget
- Recent studies distinguish between rules based on delegation of power and those rules based on political commitments or contracts
- The studies conclude that *delegation* is suitable for majoritarian regimes and *commitment* for coalition governments
IS FISCAL INSTITUTIONS HYPOTHESIS SELF-CONFIRMING?

• Fiscal institutions include both formal and informal rules
• If informal rules were excluded, fiscal institutions cannot explain variances in budget outcomes
• The most important informal rule is the political commitment to maintain discipline
• Without political commitment, politicians who make the rules can break the rules
• If political commitment is defined as a fiscal institution, the Hypothesis cannot be refuted
• When there is political commitment, fiscal discipline is maintained: When fiscal discipline is weak, it is because political commitment is lacking
CYCLES IN BUDGET POLICY

• US General Accounting Office studies of Australia, Germany, Japan, Mexico and the United Kingdom

• The Netherlands: from Dutch Disease to Dutch Model

• Germany: From Fiscal Prudence to Fiscal Profligacy

• Self-correcting Behavior in Budgeting

• The United States as an Extreme Case in Fiscal Correction
THE INTERACTION OF BUDGET RULES AND POLITICAL WILL

• Budget Rules are effective to
  – Prevent politicians from taking particular actions
  – Impose outside, independent review of political action
  – Raise the political costs of taking certain actions

• Not all contemporary innovations are effective:
  – Fiscal targets depend on enforcement
  – Multi-year frameworks depend on attentive media and public
GROWTH

• As a country develops, demand for public services rises and spending increases as a share of GDP

• Much of the increase is in entitlements and other “sticky” expenditures

• New spending does not displace old spending on inefficient civil service, SOE’s, subsidies, etc.

• As a consequence, fiscal stress may rise despite the greater resources available to government
EMERGING MARKET COUNTRIES: GROWTH AND SHOCKS, cont.

SHOCKS

• Emerging market countries are vulnerable to shocks due to capital flows and other factors that aggravate cyclical downturns

• In contrast to affluent countries, emerging market countries have difficulty maintaining a counter-cyclical fiscal posture

• International organizations often pressure these countries to take Pro-cyclical measures.
EMERGING MARKET COUNTRIES: GROWTH AND SHOCKS, cont.

RULES

• Fiscal institutions may be of great value to emerging market countries

• Fiscal institutions should aim at fiscal sustainability through economic cycles

• International organizations should devise measures to buffer countries that have robust fiscal institutions against shocks
THE SPECIAL PROBLEMS OF POOR COUNTRIES

• The fiscal institutions literature concludes that poor countries have severe budgetary imbalances due to inadequate budget rules.

• The reverse is more likely: Poor countries have inadequate fiscal rules and budget imbalances because they are poor.

• Poverty Generates pathological budgetary behavior such as:
  – Escapist Planning
  – Unrealistic Budgets
  – Repetitive Budgeting
  – Cashbox Budgeting
  – Informal Budget Systems

• Modernizing budget institutions in these countries should concentrate on basic rather than avant garde practices.