ISSUED BY THE AUSTRALIAN TREASURY

BACKGROUND NOTE PREPARED FOR THE MEETING OF APEC FINANCE MINISTERS

COOLUM, 2-3 AUGUST 2007

Transparency and sustainability of the public balance sheet

Introduction

Effectively managing risks to fiscal sustainability is essential for economic stability. Risks that are reflected on the public balance sheet have received a great deal of attention in recent years, and substantial progress has been made in improving management of them. There is a sense, however, that further work can be done on managing off-balance sheet risks and APEC finance ministers identified this as a priority in the *Hanoi Medium-Term Agenda*.

As populations age and economies in the Asia-Pacific region prosper, governments are facing growing demand for government services, including infrastructure. For some economies, the investment required in these areas is stretching government resources and encouraging commitments to future service delivery and the use of more innovative financing mechanisms and guarantees. Governments may also face other contingent liabilities, arising from state-owned firms, guarantees to financial institutions (implicit or otherwise), and sub-national levels of government.

If risks associated with off-balance liabilities are not well managed, they can result in obligations that damage the budget position, lead to unexpected increases in taxes or cuts in expenditure, worsen government indebtedness, and amplify the effects of negative economic and financial shocks.

Emerging good practice

Setting objectives and prioritising action

Risk mitigation can involve costs as well as benefits and so governments need to prioritise the risk management actions they take. An explicit commitment to credible fiscal policy objectives can help identify threats to these objectives, prioritise actions to manage them, and assign clear responsibilities for those actions.

A comprehensive understanding of the budget position

The costs and benefits associated with off-balance sheet risks can be difficult to assess. By generating better information on risks, economies can monitor overall risk exposure and help ensure that new policies are properly assessed, taking into account all the related costs. Significant improvements can be made by adopting accrual accounting standards, although economies need to assess for themselves whether this more complex approach is appropriate to their circumstances.

Centralising the collection of information on contingent liabilities within a central government agency can help provide an overall picture of public finances and risk, and can enable government to limit its overall risk exposure.

Investors, credit rating agencies, multilateral institutions and economic commentators are also interested in information on the underlying economic exposures that may not be evident in public balance sheets. Publicly providing analysis of the fiscal risks faced by government can foster confidence and credibility, which can generate real economic benefits in the form of greater investment and lower borrowing costs.

Medium- and long-term fiscal analysis is a useful tool for untangling the likely consequences of current commitments and policies. For example, ageing populations can affect savings behaviour, labour supply, capital flows and demand for different government services. The solutions can involve public finances, financial market liberalisation and innovation, greater labour force participation, and productivity growth. While long-term analysis will yield different conclusions for each economy, it can demonstrate that small changes made now can generate large improvements in the long-term fiscal position, thereby galvanising public support for change.

Governments can be selective in the way long-term analysis is used by focusing on the largest expenditure and revenue items — such as pensions, healthcare, debt servicing, and tax revenue — and on the linkages between them.

There is a risk that the disclosure of implicit obligations may lead the potential beneficiaries of that obligation to increase their risk-taking ("moral hazard") and hence increase the government's potential liability. For example, if government guarantees the repayment of loans, lenders may look to the quality of the guarantee and may pay less attention to the credit-worthiness of borrowers. While incorporating implicit obligations into fiscal analysis is necessary for a more accurate projection of public finances, two strategies for governments to overcome possible moral hazard are to only publish aggregate information or only publish values based on actual outcomes to date.

Frameworks for enhancing fiscal sustainability

Approaches to risk management involve addressing risks at their source and sharing risks with the private sector where possible. Where these actions do not reduce risk exposures to acceptable levels, governments can ensure that residual risks are appropriately monitored and managed.

Addressing risks at their source may involve developing market-oriented policies that foster sustainable economic growth, competition and investment. For example, a strong investment climate supported by well-functioning financial systems can foster private-sector involvement in infrastructure, health insurance, pensions and other social services. This approach not only delivers a government's social and economic objectives, but reduces the need for fiscal measures such as guarantees that may entail higher degrees of risk.

Governments can reduce their exposure to contingent liabilities by directly shifting some risks to the private sector. Examples include privatising state-owned enterprises and moving from government-sponsored defined-benefit pensions to private plans based on voluntary or mandatory contributions.

Where addressing risks at source or shifting them to the private sector is not possible, governments can ensure that residual risks are appropriately monitored and managed. One strategy is to require guarantees and concessions to be considered through budget processes in the same way as other forms of government expenditure. In this way, economies can assess whether setting aside funds – either notionally or through real-money funds – is necessary based on the expected costs of contingent liabilities.

Addressing key off-balance sheet fiscal risks

There are key off-balance sheet liabilities that typically present the greatest risks to fiscal sustainability, including public pensions, public-private partnerships (PPPs), state-owned enterprises, sub-national levels of government, and guarantees.

In many economies, a significant threat to fiscal sustainability comes from pensions for public employees and the general population. The combination of defined-benefit schemes and ageing populations has created imbalances between the needs of the public and governments' capacity to pay. This has led governments to encourage private saving, raise the age of eligibility for full pension benefits, modify pension payment formulas, and foster the development of private insurance markets (particularly for health care and unemployment).

Many governments now enter into PPPs with firms to provide public services previously provided exclusively by the state. If these arrangements are not carefully assessed, they may not represent value for money, bypass expenditure controls, and create liabilities which may grow to a point where they jeopardise the government's fiscal stability. The most common benefits of PPPs are lower ongoing operating costs — rather than lower initial investment costs. These benefits usually come from sound management and appropriate risk sharing. In this regard, some governments have introduced rules that require PPPs to compete for budget funding with other capital projects.

Government guarantees — implicit or explicit — to pay outstanding debts or amounts to maintain the solvency of other public or private entities (for example state-owned enterprises or sub-national levels of governments) can also threaten fiscal sustainability. Risks related to state-owned enterprises and sub-national levels of government are generally lower when they have clearly defined market objectives, are adequately resourced to meet their responsibilities, and where central agencies are well informed of their financial positions. Experience also suggests guarantees are likely to be more effective when their expected costs are identified and assessed against competing calls on government resources.

Pathways for improved fiscal sustainability and transparency

There are tools available to help economies assess their fiscal transparency practices. The IMF's benchmark — the Code of Good Practice on Fiscal Transparency — and accompanying manual highlights practical, real-world examples of good practice. If requested, the IMF can conduct an assessment and make recommendations for further development. To date, 13 APEC economies have undertaken this assessment, known as the fiscal module of the Reports on Observance of Standards and Codes (ROSCs).

There is no similar centralised source of guidance on fiscal sustainability. The development of voluntary principles that recognise economies are at various stages of economic development could assist economies in this area. The voluntary principles may include:

- fostering well-functioning markets to reduce fiscal pressures on governments;
- establishing a clear framework of accountability and responsibility for addressing fiscal risks;
- collecting and reporting information about on and off-balance sheet risks across the whole of government;
- assessing the potential consequences of current and emerging fiscal risks or long-term pressures to determine the best ways to manage these risks;

- including risk in government measures of fiscal performance to help governments understand the true nature of their fiscal position;
- improving transparency through reporting off-balance sheet risks to the public; and
- creating fiscal space or provisioning – even notionally – for expected future payments, especially for liabilities with a high probability of realisation in the near- to medium-term.