

Guide to Transparency in Public Finances

Looking Beyond the Core Budget

4. Contingent Liabilities



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Introduction

For more than a decade, civil society organizations around the world, as well as international financial institutions, have been pushing for governments to provide the public with more comprehensive budget information. The International Budget Partnership’s (IBP) Open Budget Survey examines the accessibility in countries around the world of eight key budget reports that governments should publish in order to enable civil society, oversight institutions, and members of the public to participate effectively in budget processes and hold governments accountable for how they use public money. In two companion guides to the briefs listed below – the *Guide to Transparency in Government Budget Reports: Why Are Budget Reports Important, and What Should They Include?* and the *Guide to Transparency in Government Budget Reports: How Civil Society Can Use Budget Reports for Research and Advocacy* – the IBP describes the importance of each key budget report, the information that it should contain, and how civil society organizations can use them.

This is one of five briefs that goes beyond the eight key budget reports covered in the guides to examine other areas of public finance that are less well understood and especially vulnerable to efforts to shield them from public scrutiny. The other briefs are:

- ➔ Extra-budgetary Funds
- ➔ Tax Expenditures
- ➔ Quasi-fiscal Activities
- ➔ Future Liabilities

All of the briefs examine the following questions:

- ➔ What are these issues or activities, and why are they of interest?
- ➔ What information should the government include in budget documents and other reports on these issues in order to provide a comprehensive picture of the government’s fiscal position and increase the public’s understanding of how their money is being utilized?
- ➔ How can civil society groups use information contained in these documents to achieve their research and advocacy goals?
- ➔ Where can further information, country examples, and “model reports” be found?

The briefs are based on existing guidance and practices related to these areas of public finance gathered from various sources. In some cases, concrete examples are scarce, as these are new and complex areas of public budgeting.

The IBP will continue to build on this material and identify further public finance issues and activities that are typically shielded from public scrutiny but may have a major bearing on a country's public finances. Any additional briefs will be added to the IBP's website at: <http://www.internationalbudget.org>.

Contingent Liabilities

Government liabilities are a measure of fiscal risk. Contingent liabilities, whether explicit or implicit, can affect the government's fiscal position and, therefore, its capacity to meet its spending obligations. Civil society organizations should ask governments to include information on the purpose and potential fiscal impact of contingent liabilities in budget reports, and they could carry out their own analysis of the rationale and potential impact of such liabilities on the allocation of scarce budget resources.

A. What are contingent liabilities, and why are they of interest?

Government liabilities are amounts of money that a government owes, such as that for the repayment of sovereign debt and for payments owed to suppliers of goods and services. In this sense, comprehensive information on government liabilities is key to understanding and assessing the level of fiscal risk that a government faces and thus should be reported publicly. Contingent liabilities are amounts that the government may owe, but the amount, or indeed the existence, of the liability will depend on future (and uncertain) events. Government guarantees are a common form of contingent liabilities. The government may guarantee a loan, but it will only be liable to make the payment if the recipient of the loan defaults. So, when financial statements are produced, it is often not known whether the government will have to repay all or some of the loans that it has guaranteed.

Contingent liabilities are also significant because a government may be considered to be the insurer of last resort, and so its implicit or assumed guarantees may be very wide. For example, in the wake of the latest global financial crisis, many governments guaranteed loans made by commercial banks in their country. In other instances, governments are expected to make significant payments to deal with the aftermath of such natural disasters as floods or earthquakes.

The International Public Sector Accounting Standards (IPSAS) Board defines a contingent liability as:

- A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- A present obligation that arises from past events but is not recognized because:
 - (i) It is not probable that an outflow of resources embodying economic benefits or service

potential will be required to settle the obligation; or

(ii) The amount of the obligation cannot be measured with sufficient reliability.

(IPSAS Board 2011: pp. 584-585)

The “past event” may be the provision of a government guarantee for a loan, and the “future event” could be the company defaulting on the loan, requiring the government pay the loan on behalf of the company. By the above definition, such liabilities are only required to be disclosed or recognized in the government’s accounts if it is likely that the government will have to repay the loan, or if the amount of the eventual payment can be estimated reasonably accurately.

The International Monetary Fund (IMF) Manual on Fiscal Transparency (2007: p. 59) includes the following examples of different types of government contingent liabilities (with added explanations). Explicit liabilities are specific obligations of the government established by a particular law or contract. Implicit liabilities involve a moral obligation or expected responsibility of the government that is not established by law or contract (see also Polickova 1998: p. 3).

Explicit contingent liabilities

- ➔ Guarantees on commercial bank deposits for cases in which the government has agreed to provide low-interest loans or short-term funds to support commercial banks in difficult economic or financial conditions
- ➔ State insurance programs the government sets up to protect local farmers, for example, against the impact of natural disasters on agricultural production
- ➔ Loan guarantees through which the central government backs loans made to other arms of government or public corporations
- ➔ Demand/revenue guarantees in public-private partnership contracts in which the government commits to a specified minimum level of income for a contractor in cases where future demand cannot be accurately predicted
- ➔ Statutory commitments in the form of such entitlements as pensions or social benefits, when the number of beneficiaries may not be known in advance

Implicit contingent liabilities

- ➔ Banking system bailouts, in which governments may consider it prudent to rescue their banking systems even though no formal guarantees have been provided, as was done in response to the latest financial crisis
- ➔ Coverage of liabilities of privatized entities in cases where the government may consider it necessary to compensate the new owners of privatized companies for unexpected liabilities, even if such support was not included in any formal contracts, to ensure the success of future privatization programs
- ➔ Environmental and disaster relief in cases in which the government might compensate the victims of exceptional environmental or other disasters, even without any legal or formal obligations
- ➔ Guarantees of debt obligations of subnational governments through which the central government may guarantee loans to subnational governments, even where there is no formal policy or other requirement to do so

For example, the Indian government provides a variety of guarantees for its own programs, state governments, other public sector institutions, cooperative societies, and banks. These may cover loans, including the associated interest, and the repayment of share capital and minimum dividends for investors in state entities. In addition, the central government sometimes provides performance guarantees for Indian companies operating in foreign countries, or guarantees to railways and electricity boards that public sector customers will pay their invoices on time.

In recent years the governments of some countries have greatly curtailed the level of loan guarantees they provide. Botswana's state-owned enterprises are supposed to be run on a commercial basis and have been told that if they need loans, these will have to come from commercial banks. In Uganda the Non-Performing Assets Recovery Trust was established in 1994 to salvage bad loans from the Uganda Commercial Bank and the Uganda Development Bank, which were subsequently privatized.

B. What information should the government include in budget documents and other reports on contingent liabilities?

The IMF (2007: pp. 77-79) recommends that information on contingent liabilities should be included in budget documents, describing their significance and nature. Such information should include the policy rationale behind the government's choice to provide a specific guarantee, their total amount,

their intended beneficiaries, and the likelihood that the liability will in fact be incurred. Quantitative estimates of their potential fiscal impact should be published, as well.

In contrast to these guidelines, the South African government states that it “is not possible to determine the portion of these guarantees which will realise as liabilities to the National Government” (National Treasury 2009: p. 81). However, some other countries provide information on the value of outstanding loans as of the date of the financial statements, which represents the maximum liability the government could face. In Namibia only summary information is provided and then only in the annual report of the central bank. The Bank of Namibia’s Annual Report for 2002, for example, provided a summary of central government loan guarantees that indicated an increase of nearly 16 percent over the previous year and a total guarantee level amounting to almost 12 percent of GDP. Around three quarters of the total value of these guarantees was to cover foreign loans (IDASA 2005).

The Indian government’s recently approved accounting standards on guarantees require it to disclose a number of details, including the maximum amount for which guarantees have been given during a specific year, details of commissions and fees, whether a reserve fund exists for the purpose of paying the loans, and the designated authority for guarantees within the government (GASAB 2010: pp. 5-6). The U.K. government provided extensive detail in the Treasury’s Resource Accounts for 2009-10 on the possible liabilities arising from financial sector bailouts in the wake of the financial crisis. However, in some cases it deemed maximum potential liabilities “unquantifiable” (HM Treasury 2010).

C. How can civil society use this information for research and advocacy?

Information on contingent liabilities provides only some indirect help to civil society organizations in understanding the level and composition of funds spent by their governments, though the level of a government’s contingent liabilities may be of particular interest to those who are concerned about government debt and related issues. However, if available information on contingent liabilities indicates that the government is providing significant support to private sector companies through guarantees and other instruments that result in contingent liabilities, civil society organizations could use this information to make the argument that the government should be spending more money directly on poverty reduction, rather than on the relatively wealthier business community.

This is particularly true in cases in which implied guarantees are used to facilitate the provision of loans to wealthy or influential individuals, who are then not required to repay them. For example, the 2009 banking crisis in Nigeria resulted in large part from many of the major banks providing loans to friends or colleagues of the banks’ chief executives or board members that were not repaid. The government bailout of these banks would suggest, in retrospect at least, that these loans had been implicitly guaranteed by the government and so should have been reported as part of its contingent liabilities. This would have allowed civil society organizations to campaign for using the public funds for poverty reduction rather than to support powerful members of the elite.

D. Relevant materials, websites, and “model reports”

- ➔ Government Accounting Standards Advisory Board. *Indian Government Accounting Standard (IGAS) I: Guarantees Given by Government: Disclosure Requirements* (pp. 142-146). Delhi: Government Accounting Standards Advisory Board. 2010.
www.gasab.gov.in/pdf/IGAS%20I_Guarantees_Final.pdf

- ➔ HM Treasury (United Kingdom). *HM Treasury Resource Accounts 2009-10*. London: The Stationery Office. 2010.
<http://www.official-documents.gov.uk/document/hc1011/hc02/0261/0261.pdf>

- ➔ IDASA. *Budget Transparency and Participation: Nine African Case Studies*. Cape Town: IDASA. 2005.
<http://www.idasa.org/media/uploads/outputs/files/Nine%20African%20Budget%20Transparency%20&%20Participation%20Case%20Studies.pdf>

- ➔ International Monetary Fund. *Manual on Fiscal Transparency* (esp. pp. 47-48). Washington, D.C.: International Monetary Fund. 2007.
<http://www.imf.org/external/np/pp/2007/eng/051507m.pdf>

- ➔ International Public Sector Accounting Standards Board. *IPSAS 19: Provisions, Contingent Liabilities and Contingent Assets*. New York: International Accounting Standards Board. 2011.
<http://web.ifac.org/media/publications/0/2011-ifac-handbook-of-inter/ipsas-19-provisions-cont-3.pdf>

- ➔ Organization for Economic Cooperation and Development. *Best Practices for Budget Transparency*. Paris: OECD. 2002.
<http://www.oecd.org/dataoecd/33/13/1905258.pdf>

- ➔ Polackova, H. *Contingent Government Liabilities: A Hidden Risk for Fiscal Stability*. World Bank Policy Research Working Paper 1989. Washington, D.C.: World Bank. 1998.
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=604971

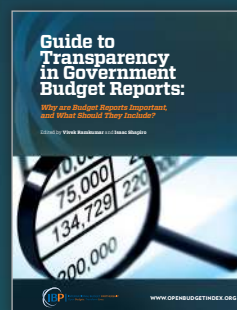
- ➔ Republic of South Africa National Treasury. *Consolidated Financial Information for the Year Ended 31 March 2009* (p. 81). Pretoria: National Treasury. 2009.
<http://oag.treasury.gov.za/Publications/04.%20Consolidated%20Financial%20Information/06.%20For%20fin.%20Year%20ending%2031-03-2009/Consolidated%20Financial%20Information%202008-09/2010-08-18-Consolidated-Financial-Annual-Report.zip>

The Open Budget Initiative

This guide is part of a series that looks at public finance topics in terms of transparency and accountability. The Open Budget Initiative may produce additional guides around other important related topics in the future.

1. Extra-budgetary Funds
2. Tax Expenditures
3. Quasi-fiscal Activities
4. Contingent Liabilities
5. Future Liabilities

This series is a companion to two earlier **Open Budget Initiative** guides on public budget transparency — one for governments and one for civil society organizations.



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