Managing Fiscal Risks—Discussion on the papers by G. Schwartz and R. Monteiro

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"INTERNATIONAL SEMINAR ON STRENGTHENING PUBLIC INVESTMENT AND MANAGING FISCAL RISKS FROM PUBLIC-PRIVATE PARTNERSHIPS"

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- Discussion on the papers by G. Schwartz and R. Monteiro -

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I. Introduction

1. The involvement of private sector corporations to build and operate public projects has become an increasingly widespread practice in the EU countries. While in its modern form, the Private-Public Partnership agreements (PPPs) are a relatively recent phenomenon, currently representing a significant share of public investment only in the UK, Portugal and Greece, there is a large scope for further increases across the EU countries, in particularly in the twelve recently acceded Member States.

2. While investment through the PPPs has a sound microeconomic rationale (increased efficiency without compromising public objectives), they can lead to fiscal risks, related to e.g. inappropriate risk distribution, poor planning and implementation of the project which if realised may have a significant negative effect on government finances. These risks can be significantly amplified if the microeconomic rationale for PPPs is ignored and instead, decision for carrying out public investment through PPPs is motivated by the purpose to put capital spending outside government budgets in order to bypass budgetary constraints and/or incentives to shift liabilities to the future. In such a case, cost-efficiency is not prioritised and as a consequence it may occur that PPPs are carried out even when they are more costly than purely public investment, leading to likely higher public expenditure and greater fiscal risks.

3. The papers by G. Schwartz and R. Monteiro present an overview of fiscal risks related to the PPPs and make suggestions for their efficient management. After briefly

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recalling the economics of the PPPs, Section II discusses the findings of main both authors through the prism of two inter-related policy principles: (i) ensuring transparent reporting of the PPP related government liabilities and (ii) establishing an appropriate institutional set-up. Section III points to fiscal risks related to the PPP projects carried out at the subnational government level, which deserve substantial attention amid its increasing importance.

II. Managing fiscal risks: policy principles

4. The main implication for public finances of choosing PPPs as opposed to traditional public investment is that of converting up-front fixed expenditures into a stream of future claims permitting to smooth out the cost of public investment.[2] The rationale for the use of PPP schemes is that of increased microeconomic efficiency as opposed to traditional public investment. This can be achieved by shaping the structure of incentives, e.g. the allocation of obligations and risks between the two parties, in such a way to achieve cost efficiency without compromising public objectives concerning the quality and characteristics of the goods/services provided by the asset. However, given that the use of PPPs may be effective in releasing finance constraints on public investment in presence of formal ceilings on budget deficits, the set-up of the incentives should also take account of macroeconomic stability that can be endangered in event of adverse developments regarding the PPP related fiscal risks.

5. Both authors stress that the decision to undertake an investment project should be motivated by the microeconomic efficiency gains not available through traditional public investment. However, as pointed by Monteiro, instead of choosing the PPPs for its benefits, undertaking the PPPs can be motivated by the lack of long-term budgeting leading to a perception of the PPPs as zero-cost projects by the public policy makers. Similarly, public policy-makers may have incentives to ignore the efficiency gains rationale and undertake public investment through the PPPs in order to shift the liabilities of the incumbent government to the future ones. Furthermore, resorting to the PPPs projects can serve as a means to bypass budgetary ceilings and targets. At the EU level, there is a risk that the PPPs may be increasingly used by some EU governments to evade the SGP constraints on public deficits. Overall, such behaviour could lead to (i) cost-inefficient PPPs and/or to (ii) excessive exposure to risks by the public sector, which if materialised could negatively affect the government finance. Amid such background, transparent reporting of the PPP related government liabilities and

[2] European Commission (2003).

establishment of an appropriate institutional setting are the corner stones for managing fiscal risks concerned.

II.1 Transparent reporting of the PPP related government liabilities

6. The fiscal matrix below frames different types of government liabilities related to the public investment and PPPs on the basis of the framework proposed by Polackova (1998). The typical categories of liabilities falling under the identified four definitions are reported in the table. *Non-contingent explicit liabilities*, such as 'Maastricht debt' and government expenditures as stated in budget law are those normally entering national accounts and considered in standard fiscal analysis. Among the *explicit but contingent liabilities*, the typical category is that of government guarantees and insurance schemes. Government guarantees serve the purpose of covering risky activities carried out by specific types of agents or for specific types of activities. Common examples of government guarantees are those issued through contracts on the debt of public corporations or private firms entering relations with the government e.g. through PPPs for the realisation of public purpose investment projects and/or on service purchase contracts. As for the *implicit (non-contingent) liabilities* there is no legal commitment to provide such services in the future, while there are expectations grounded in past government behaviour that the government will provide such services, e.g. maintenance and refurbishment of the public capital stock. The *implicit contingent liabilities* concern all the cases of government bail-out of public and private corporations, therefore also related to the investment through the PPPs. Such obligations, however, depend on the expectations by the public or pressure by interest groups.

Table 1: Fiscal risk matrix – liabilities related to public investment

	Direct *Obligation in any event*	**Contingent** *Obligation if a particular event occurs*
Explicit *Government liability created by a law or contract*	• Maastricht debt • Govt expenditure as stated in budget law	• State guarantees on service purchase contracts (demand risk) • State guarantees issued to public or private investors and service providers
Implicit *A "political" obligation of government that reflects public and interest group pressures*	• Future recurrent costs of public investment projects	• Non-contractual claims arising from private investment, for instance in infrastructure

Source: The author. Based on a framework by Polackova (1998) and European Commission (2004).

7. Investment through the PPP projects thus involves *direct* and *contingent* liabilities. On the one hand, a substantial share of the liabilities arising from a PPP is known and therefore, the flow of future regular payments from the budget over the long-term is certain. On the other hand, fiscal support by the public sector in order to reduce the investor's or lender's risk exposure, gives rise to contingent liabilities of the public partner. Contingent liabilities related to the PPPs mainly result from credit guarantees, minimum revenue guarantees, foreign exchange guarantees letters of comfort and other commitments to contain credit risk or other types of risk.

8. Transparent disclosure of all of the PPP related liabilities would lead to a better management of the risks. Disclosing the complete information on the future planned disbursements related to the PPP project as well as regarding the size of guarantees and other insurance schemes in supplementary documents to the budget would go a long way towards the containment of an excessive accumulation of such types of liabilities. Most national accounting manuals recommend the disclosure of information concerning guarantees and other types of contingent liabilities in supplementary documents to the budget. Supplementary information on contingent liabilities is also recommended by the IMF Code on Fiscal Transparency. Finally, documentation attached to the budget may be requested by National Parliaments that have to approve the budgetary law. Disclosed information on contingent liabilities may range from short statements describing the major characteristics of existing government guarantee and insurance schemes to detailed reports possibly including estimates of their economic impact on public finances. As rightly pointed out by Monteiro, disclosure of this kind of information leads the public eye to scrutinise the risk management by public entities, putting pressure to improve prevention measures and risk mitigation. Further steps, not explored by the authors, such as constraining the rate of growth of such liabilities would require the introduction of institutional features enabling to monitor and lead to containment of fiscal risks.

9. In the context of risk allocation between the public sector and private entity in relation to a PPP project, which may be influenced by the Eurostat accounting rules as well as by the provisions of the Stability and Growth Pact, it is worth considering whether there is a trade-off between the statistical treatment of PPPs and the stock of contingent liabilities. On the one hand, it has been argued by the authors that the current Eurostat treatment of the PPPs creates incentives to move spending off budget and liabilities off balance sheet and that the accounting rules should be stricter. On the other hand, authors could explore whether a tighter treatment of the PPPs with regards to the government balance sheet recording may create incentives for transferring a higher share of risk exposure to the private partner, giving rise to additional contingent

liabilities. This in turn could lead to an excessive risk exposure by the private party and likely increase the probability of calls on the guarantees.

II.2 Establishing an appropriate institutional set-up

10. In order to ensure that the PPPs are done for the right reason as well as to guarantee the subsequent cost efficient implementation of a project, institutional arrangements together with legal and regulatory set-up are of the utmost importance. For the purpose of avoiding risks to fiscal discipline, Monteiro and Schwartz emphasise the establishment of the so-called multi-stage gateway process, an institutional arrangement that would empower the Finance Ministry vis-à-vis the line Ministries to stop or suspend a PPP project during its preparation and negotiation, as well as during the construction and operation if certain conditions are not met.

11. Another part of the solution for managing fiscal risks related to the PPPs is to change the perceptions of the public policy-makers through an appropriate budgeting of the expected fiscal commitments and the assessment of fiscal risks. For this purpose Schwartz puts forward the introduction of medium-term planning by means of medium-term fiscal, budgetary or expenditure frameworks, while Monteiro suggests the use of a long-term budgetary framework. Indeed, the long-term character of the PPP projects and of related liabilities requires a long-term analysis of their budgetary impact. Indeed; regardless of the rules governing the recording of the PPP project, both, direct and contingent liabilities could be included in the long-term sustainability analysis of public finances as it is for example currently being carried out by the European Commission.[3] Thus, the part of the planned future disbursements *(direct explicit liabilities)* would be appropriately budgeted on the primary expenditure side over the entire period concerned by the payments. On the other hand, given the nature of uncertainty created by contingent liabilities and consequently, difficulties related with their inclusion in the sustainability analysis, their assessment in this context should take a form of a sensitivity test. The analysis of the long-term commitments can subsequently be translated into medium-term frameworks, earmarking the required payments over the medium-term, which would raise the cost awareness and reduce the incentives to shift liabilities to the future by incumbents.

12. In order to prevent excessive exposure to the PPP related fiscal risks arising from contingent liabilities, the latter should be treated together with other contingent liabilities of the government. For example, in the countries where quantitative limits for

[3] See European Commission (2006).

contingent liabilities are established, e.g. on annual basis, the PPP related contingent liabilities should be included in the stock of such liabilities and be subject to the quantitative ceiling. Analogously, where in place, the same standards regarding their disclosure should be applied.[4]

13. The quality of the institutional set-up including budgetary rules and frameworks to contain the fiscal risks is subject to the availability of information regarding the PPP related liabilities. In turn, the efficiency of the institutional set-up depends crucially on the political commitment to the fiscal discipline by the government. If the government has incentives to honour its commitment to fiscal discipline, the introduction of a gateway process or appropriation of PPP related liabilities through budgetary framework is likely to be instrumental in managing the fiscal risks. Given that such frameworks imply widening the coverage of the existing fiscal rule or introduction of a new one, in the countries where already the existing fiscal rules are not fully respected or political commitment to fiscal discipline is lacking, such strategies are rather unlikely to be successful regardless of the set-up. Instead, in such a case it is rather more likely that the investment through the PPPs may not be motivated by the microeconomic efficiency gains, but by incentives to circumvent the budgetary ceilings and targets. In this context, the authors could explore the track record regarding a country's fulfilment of budgetary plans and the outcomes related to the gateway processes (e.g. frequency of projects suspended, stopped or renegotiated, etc.).

III. <u>Policy challenge –the PPPs at subnational levels</u>

14. Given the current developments in the involvement of subnational governments into investment through the PPPs, the two papers would benefit from shedding some light on this increasingly important aspect. Namely, while the first generations of the modern PPP projects have been implemented at the national level, there is an increasing tendency of the subnational governments to engage in the PPP projects. In some countries this is due to the process of decentralisation and consequently, increasing autonomy of local and regional governments, especially if they lack the financial means for public investment.

15. The fiscal matrix above is complemented by risks resulting from sub-national levels of government, relevant in the context of public investment through the PPPs. In this context, the *explicit but contingent liabilities* also include guarantees on debt and other obligations issued by subnational governments. Moreover, since the *implicit*

[4] See European Commission (2004) and IMF (2006).

contingent liabilities concern all the cases of government bail-out of public and private corporations, they also include claims by subnational governments to assist in covering their own debt, guarantees or arrears, some of which could be related to the engagement in the PPP projects.

16. Since the involvement of the subnational governments in the PPPs may entail non-negligible consequences for fiscal discipline also on the general government level, these developments should be subject to disclosure requirements. This is particularly the case since the PPPs are complex contracts that require substantial institutional capacity and expertise, which the subnational governments are less likely to have. Thus, the characteristics of public service, mentioned by Monteiro, that weaken the position of the public sector as a partner and are one of the main sources of PPP related fiscal risks, are amplified at lower government levels. Experience with the past PPP projects at the central government level would benefit the lower government levels planning to carry out such projects. Setting-up of a centralised institution/office at the national level for the the PPPs, together with the requirement that all such projects at all levels need to pass through it and/or establishment of common criteria to be applied through all the phases of the PPPs at all levels, would undoubtedly at least partly solve the problem as it would provide the necessary support to eliminate the deficiencies of public sector procurement and contractual management.

Table 2: Fiscal risk matrix – liabilities related to public investment, including subnational governments

	Direct *Obligation in any event*	**Contingent** *Obligation if a particular event occurs*
Explicit *Government liability created by a law or contract*	• Maastricht debt • Govt expenditure as stated in budget law	• State guarantees on service purchase contracts (demand risk) • State guarantees issued to private investors and service providers • State guarantees on debt and other obligations of subnational governments
Implicit *A "political" obligation of government that reflects public and interest group pressures*	• Future recurrent costs of public investment projects	• Non-contractual claims arising from private investment, for instance in infrastructure • Claims by subnational governments to assist in covering their own debt, guarantees, arrears (PPPs at subnational level)

Source: The author. Based on a framework by Polackova (1998) and European Commission (2004).

17. The presence of moral hazard at lower government levels further increases the probability of mismanagement of PPP projects at the local or regional level. Compared to the central government, fiscal discipline at the lower levels of government is undermined by the perception that the central government will ultimately bail out the subnational governments in case of their insolvency.[5] Thus, by assuming a bail-out by the central government in the case of a mismanaged project, the subnational governments may engage more easily into such projects and may - given the abovementioned lack of institutional capacity and expertise – expose itself to excessive risk through inadequate allocation of risk or excessive issuance of guarantees to the private sector partner.

IV. Concluding remarks

18. In the future, increasing share of public investment is likely to be financed through the PPPs. *Inter alia*, this will also be due to the increasing competition between budgetary priorities such as budgetary pressures resulting from the population ageing and, where relevant, increasing autonomy of sub-national governments with limited financial resources, which in turn may create new fiscal risks.

19. The two papers present a very good overview of issues related to their management, identifying the key principles for appropriate monitoring of PPP related liabilities. Given the complex character of the relationship between public and private partner in a PPP project, which the statistical treatment may not fully capture, the future work in this area should aim at strengthening the incentives for the countries to improve the disclosure of the PPP related liabilities and to include them appropriately in budget documents. On the basis of this, an improved assessment of public finance sustainability should be made leading to increased cost awareness of all the stakeholders, increasing incentives for fiscal discipline. Similarly, the disclosure requirements should concern also subnational levels of government.

[5] See Rodden et al. (2003).

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