Managing subnational fiscal risks

Presentation by Teresa Ter-Minassian at the WB-KDI conference on fostering fiscal sustainability

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Key messages

- This presentation summarizes the extensive discussion of subnational fiscal risks in a **paper “Managing Subnational Fiscal Risks”** by L. de Mello and myself, just published by the OECD as a Working Paper of the Fiscal Federalism Network.
- **Subnational governments (SNGs) face a range of fiscal risks**, which are likely to continue rising in the years ahead. **They should take greater responsibility**, **and strengthen their capacity, to manage their risks.**
- **A comprehensive subnational risk management framework** includes steps to identify, analyse, mitigate, and when appropriate transfer, such risks, as well as to accommodate the materialization of residual ones in a fiscally sustainable manner.
- **National governments (NGs)** should strive to mitigate the subnational fiscal risks created by their own policies, and **their support to SNGs affected by exogenous shocks should minimise moral hazard,** by creating appropriate incentives for SNGs to manage their risks.
- Sound **intergovernmental cooperation systems** are key to an effective management of subnational fiscal risks.

Fiscal risks have asymmetric effects

- **Fiscal risks are on the rise worldwide** as a result of, among other factors, increasing macroeconomic volatility, climate change, uncertainty about the energy transition, increase in endemic diseases, and technological innovation.

- Their repeated materialization can **jeopardize fiscal sustainability** over the medium term.

- **The incidence of risks varies significantly across a national territory**, reflecting differences in geographic, demographic, economic, and social conditions, as well as the characteristics of the country's intergovernmental fiscal relations system, especially the distribution of revenue and spending responsibilities.

- **Therefore, SNGs vary in both their exposure to fiscal risks and their capacity to manage them.**

Main sources of subnational fiscal risks

- Deviations in key macroeconomic variables from the assumptions underlying MTFFs and annual budgets
- Unexpected weather-related and other natural disasters (e.g., earthquakes)
- Uncertainties in the scope and pace of global and national energy transition policies
- Unforeseen endemic diseases
- Unpredictable impacts of emerging technologies (notably, AI) on local economies and labor markets
- Materialization of explicit and implicit contingent liabilities; and
- Weaknesses in budget processes.

Main elements of a framework for the management of fiscal risks by SNGs

- **A sound framework for the management by SNGs of their fiscal risks** would include steps to:
  - **Identify** risks
  - **Assess** and, to the extent possible, quantify them
  - **Prevent or mitigate** them
  - **Transfer** them, when appropriate
  - **Manage effectively residual risks**, when they materialize; and
  - **Disclose** them.

- It requires sound mechanisms of **exchange of information and coordination** among the relevant SNGs' units. The **Department of Finance** should have a preeminent role in the process.

Risk identification and assessment

- Not all categories of risks may be relevant for a specific SNG at any given time or within a given time horizon. **The information needed to assess the relevance of specific risks** varies by type of risk and is likely to be dispersed among different governmental units.

- **Risk analysis, and to extent possible quantification,** involve assessments of both the **probability of materialization** of the risk and **its impact on key budgetary aggregates.**

- **Appropriate approaches to such assessments vary with the type of risk:**
  - Scenario analyses for macroeconomic risks
  - Various tools developed by national and international institutions for the assessment of direct and indirect costs of natural disasters
  - Different tools (credit rating; statistical models; and financial models) developed to assess the probability of materialization of contingent liabilities. Different measures of potential costs are maximum exposure, expected loss, and unexpected loss.

- The choice of analytical approaches in this area should reflect **capacity limitations** of individual SNGs and the **availability of relevant data.**

Risk prevention and mitigation

- **Appropriate approaches to mitigation depend on the type of risk** and are discussed in detail in the paper. **Some examples**:

  - To mitigate **macroeconomic risks**, SNGs can index some of their revenues (excise taxes and user fees) to inflation, avoid unhedged borrowing in foreign currency, and strive to increase the fixed-rate share of their domestic currency debt.

  - To mitigate **fiscal risks from climate change**, SNGs can, among other things:

    - Regulate land use appropriately; control deforestation; provide financial and technical support to farmers in their areas to shift to drought-resistant crops; and invest in improving irrigation networks

    - Strengthen and appropriately enforce building codes; and

    - Increase the resilience of energy and other infrastructures in their communities to the effects of climate change.

  - Main tools to mitigate **risks from contingent liabilities** are aggregate limits on guarantees and a robust approval process for their provision.

Risk transfer and disclosure

- **Risk transfer**
  - **Mechanisms also vary with the nature of the risk**:
    - Larger and financially sophisticated SNG may use derivatives (interest and exchange rate swaps) to transfer some macroeconomic risks
    - A number of instruments can be used by SNGs to transfer (or at least share) risks from natural disasters, including insurance of public assets; regulations mandating insurance of private properties; and issuance of state-contingent debt instruments (SCDIs), such as catastrophe bonds. SCDIs are expensive and therefore should be used mainly for catastrophic events.
- **Risk disclosure**
  - **Risk disclosure requirements** (e.g., the inclusion of a Fiscal Risk Annex in the MTFF and budget documents) **can strengthen incentives and accountability** for risk management by SNGs.

Management of residual risks

- **SNGs need to create fiscal and financial headroom** to accommodate the materialisation of risks that cannot be fully transferred or mitigated, by:
  - **Setting budgetary targets** at levels that, at prudent confidence intervals, ensure that the materialisation of macroeconomic risks does not result in deficits that are not financeable, do not comply with applicable fiscal rules, or significantly jeopardise medium-term debt sustainability
  - **Provisioning** in the budget **for expected losses** from the calling of guarantees
  - Including in the budget an appropriately sized **contingency reserve**
  - Including a sound **escape clause** in fiscal rules
  - Creating **fiscal buffers** such as rainy-day funds and natural disaster funds
  - Arranging **contingent credit lines** with financial institutions to ensure a rapid disbursement of funds to help cover the cost of larger natural disasters.

The role of the national government

- **Overarching principles** to guide NGs' role in the management of subnational fiscal risks**:**
  - NGs should strive to **mitigate the subnational fiscal risks created by their own policies**
  - Their support to SNGs affected by exogenous shocks should **minimise moral hazard;** and
  - NGs should use the powers granted to them by national legislation (including the Constitution) vis-à-vis their SNGs to **minimise the risk of subnational financial crises.**
- **Specific options vary with the type of risk.**

How can NGs help mitigate subnational macroeconomic risks?

- By using medium-term fiscal frameworks (MTFFs) to **signal to SNGs their budgetary, and in particular tax policy, intentions;** and by considering temporary adjustments in intergovernmental transfers to offset the impact on shared revenues of previously unplanned tax policy changes required by stabilisation objectives.

- **By relying mostly on formula-based transfers**, or at least on transfers based on transparently prespecified criteria.

- **By discussing with affected SNGs the impact of unexpected changes in national spending policies**, to assess any need for compensatory measures and at least allow time for subnational budgets to be adjusted.

- By enacting (or encouraging the adoption by SNGs) of soundly designed and consistently enforced **subnational fiscal rules**. By using intergovernmental cooperation fora to foster subnational ownership of such rules through dialogue on their design, implementation and, when needed, reform.

How can NGs help mitigate subnational risks from natural and health disasters?

- **By supporting subnational investments in mitigation and adaptation**
  - By assigning adequate own revenue sources to SNGs
  - Through a steady and predictable provision of special-purpose conditional grants
  - By adopting fiscal rules that allow SNGs' access to investment financing in line with their debt servicing capacity and liquidity needs; and
  - By promoting the development of orderly and liquid markets for subnational debt instruments.

- **By supporting subnational risk transfer efforts**, especially for poorer or rural SNGs
  - By providing subsidies or reinsurance for the insurance of public assets, and for the residents of subnational communities facing especially high and rising costs of insurance against natural disasters; and
  - Through well-designed and clearly defined cost-sharing arrangements, as exist e. g. in Australia and Japan

- **By providing SNGs relevant technical and operational assistance** in a bilateral or multilateral form.

A further research agenda

- **Reliable and internationally comparable information on subnational risk management is sorely lacking.**

- **Since subnational fiscal risks are already significant and rising worldwide, information on their incidence, and on SNGs' and NGs' practices in managing them, is highly desirable**.

- **The collection of such a database would allow dissemination of best practices, as well as lessons on reform strategies in different types of countries and for different types of SNGs**. It may also eventually allow the construction of indices of the quality of subnational risks management, and empirical analyses of its impact on fiscal outcomes.

- **It would be useful to begin with a few pilot country cases, to develop an appropriate methodology for the construction of such a database.** MDBs could cooperate with interested national authorities in carrying out such pilot studies**.**

Thank you for your attention, and please read the cited paper for details