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Comment Jason McDonald

The issue of how governments should manage their contingent liabilities is receiving increasing attention internationally (see Polackova-Brixi and Schick 2002). Dr. Llanto's chapter contributes to this burgeoning literature with a valuable examination of government-contingent liabilities in the Philippines. The chapter analyzes the fiscal risks associated with contingent liabilities, many of which are associated with private financing arrangements of public infrastructure, and proposes some possible management solutions.

This increasing attention appears to be driven by two fiscal problems associated with governments using contingent liabilities. The first is the possibility of increasing the adverse implications of macroeconomic risks. Where such risks are not transparent, investors face increased uncertainty as to the true extent of a government's fiscal liabilities. Further, the fiscal risks inherent in contingent liabilities may be systematically related—for example, guarantees over exchange rate values in different contracts can easily crystallize at the same time. Finally, contingent liabilities have no overt budgetary constraint (unlike traditional spending) that can hinder macroeconomic control.

The second fiscal problem is the potential microeconomic distortions from government's using contingent liabilities where no market failures exist. In such cases, contingent liabilities contain an implicit subsidy (equal

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to the market value of the contingent liability less the present value of any expected cash flows to government). This subsidy occurs regardless of whether the contingent liability is called upon and becomes an outlay. The subsidy is also substitutable with other forms of government assistance—such as tax concessions or direct outlays. Governments could, for example, pay other financial institutions to take on many fiscal risks contained in contingent liabilities rather than retaining the risk themselves. All risk has its price.

However, contingent liabilities tend to be more costly policy instruments for meeting government objectives compared to traditional spending, particularly because they are less transparent. Neither of the international financial reporting standards—the International Monetary Fund's Government Finance Statistics or the Generally Accepted Accounting Principles—provide users of government financial reports with much assistance in properly valuing contingent liabilities. Since they are less transparent, governments have an incentive to provide them over traditional expenditures. Contingent liabilities are also very often difficult to measure, making them hard to rank for budgetary purposes. Sometimes they require highly specialized and costly skills to evaluate—resources likely to be scarce in the public sector of even highly developed economies. Contingent liabilities should be seen as a form of financing for government activities, like traditional debt. However, they are significantly less liquid and subject to information problems compared to debt. Contingent liabilities are worth more to a more risky recipient, leading to a severe adverse selection problem. They also have clear moral hazard problems since recipients are absolved from the responsibility of managing the risks covered by the contingent liability.

What is to be done about contingent liabilities? The chapter outlines some best-practice management practices that can be usefully adopted. Integration of debt and contingent liability management—effectively increasing central agency control of expenditure—has been persuasively suggested in other papers (for example, Currie and Velandia-Rubiano 2002). Debt managers are more likely to have the financial skills for assessing and pricing contingent liabilities (see, for example, Hagelin and Thor 2003). Improved budgetary reforms—such as provisioning and charging agencies for supplying contingent liabilities—can also change the incentives facing government agencies. Such steps can improve the information provided to government for decision making.

However, it is questionable whether many governments face sufficient incentive to reduce the use of contingent liabilities, even if they were provided with the correct financial information. Therefore a key to improved management of contingent liabilities by governments must include increased disclosure. While the chapter tends to focus on improving competition and regulation in order to reduce *demand* by businesses for contingent liabili-

ties, increased transparency has the potential to reduce their *supply* by government.

Finally, the chapter raises an interesting question about the efficient extent of contingent liabilities provided by government. For efficiency, risks need to be distributed to those best able to manage them. Governments may be better at managing risks when they have better information. As noted in the chapter, this implies that governments should at least bear *sovereign risks,* such as those associated with governments changing policy to reap rents from large infrastructure projects. However, there is an interesting question about how much sovereign risk the government should be expected to bear if private investors choose to invest in countries with *generally* risky regulatory environments. In such cases, general regulation failure acts like a general tariff—and it is by no means certain that selective tariff exemptions (or regulatory guarantees) for specific projects will improve economic efficiency.

Overall the chapter provides an excellent benchmark for similar studies of other countries—although, while reading the chapter I wondered why so much of the information it contained was not routinely issued by all governments.

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Comment

Shigeki Kunieda

Contingent liability is recognized as one of the important causes of fiscal instability in developing countries. Various measures to manage contingent liability and fiscal risk are actively discussed by international financial institutions and academic researchers (Brixi and Schick 2002).

The Llanto chapter provides a valuable survey on the Philippine contingent-liability problem (especially its depth and seriousness). The policy proposals discussed in the chapter are comprehensive and consistent

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