Chapter 3

Fiscal Risks

3.1 Framework

Fiscal risks are factors that can cause a government's fiscal performance to deviate from what was forecast. From a policy making perspective, downside risks, that is, risks that would make public finances worse, rather than better, are considered more important.[1] Fiscal risks are typically interpreted as potential events or trends that would result in a one-off or persistent increase in spending, or a one-off or persistent loss of revenue. In either case, this would contribute to higher public debt.

The source of a fiscal risk can be either **exogenous** or **endogenous**. Exogenous risks are those risks which largely fall outside the direct influence of government policy, such as for example natural disasters. On the other hand, endogenous risks are those risks which can be generated by government activities, or if the actions of government can influence the probability of them occurring. An example would be the issuing of government guarantees, since such risk can be avoided by their non-issuance in the first place. The usefulness of distinguishing between different types of risk is that endogenous risks can be controlled by limits on government activity, while in the case of exogenous risks, mitigation instruments may be the only option.

Further distinction can be made between those fiscal risks which are **isolated**, that is are likely to occur alone, or else **correlated**, that is when a risk is more likely to materialise in conjunction with other risks. The latter can happen when risks share a common trigger, or when the crystallisation of one risk is itself a trigger for another. For example, a severe economic downturn may affect several revenue and expenditure components of the budget, whereas the risk of an adverse court judgement is more of an isolated nature. When a risk is isolated, simple calculations may suffice to estimate its possible effect, but when the risk is correlated, a fiscal stress test is desirable to provide a more comprehensive assessment.

The nature of the risk may also vary according to whether it is **discrete**, that is linked to a specific event, or else **continuous** which relates to the gradual accumulation of pressure resulting from a stream of events. For example, the cost associated with the realisation of a government guarantee is of a discrete nature. On the other hand, higher costs for social care due to rising longevity is of a continuous nature. In the case of continuous risks, these can be incorporated in the overall fiscal framework by

[1] Factors which would improve the state of public finances are labelled as upside risks.

employing conservative assumptions, particularly as their build-up generally provides timely warning.

The relevant timeframe for the risk can also be different. The fiscal risk can be mainly applicable to the **medium-term** (over the next five years) or else the **long-term** (referring to a period of between 5 and 50 years).[2] This distinction may help prioritise the government's actions and indicate the extent of room for manoeuvre, which is generally higher in the case of long-terms risks.

The **probability of crystallisation** of a fiscal risk can be categorised as 'low' (less than 40%), 'medium' (between 40% and 60%) or 'high' (exceeding 60%).[3] Such probabilities are subjectively determined.[4] In the absence of quantitatively estimated probabilities, such approach would still be very useful, as it can provide a reasonably accurate demarcation between the more and the less likely risks. Allocating significant time and resources to achieve higher precision in terms of probabilities may not be cost-effective, apart from possibly leading to an illusion of false precision.

The **impact on net debt** can be 'low' (below 1% of nominal GDP), 'medium' (between 1% and 10% of nominal GDP) or 'high' (exceeding 10% of nominal GDP).[5] Applied to Malta, this would translate into thresholds of approximately less than €120 million for 'low'; between €120 million and €1.2 billion for 'medium'; and above €1.2 billion for 'high'.[6] Such ranges are rather wide. Fitting the various risks into their most suitable band, is thus more manageable and meaningful particularly when precise point estimates are not available.

3.2 Fiscal risks

A comprehensive understanding of the sources, likelihood and scale of fiscal risks is critical to ensuring that governments meet their fiscal objectives with confidence and

[2] These are the timeframes adopted by the Office for Budget Responsibility in the United Kingdom as part of the Fiscal Risks Report (July 2017). The report is available on https://obr.uk/frr/fiscal-risk-report-july-2017/.
[3] The Office for Budget Responsibility uses more granular breakdown, as apart from these categories, there is also 'very low' when the probability is less than 10%, and 'very high' when it exceeds 90%.
[4] This is the approach used by the Office for Budget Responsibility (UK).
[5] These are the thresholds used by the Office for Budget Responsibility (UK).
[6] These figures are based on the value of Malta's nominal GDP in 2018.

avoid future disruptive policy changes. The availability of such analysis also contributes to improve fiscal transparency.[7] To this effect, the Fiscal Council has considered a myriad of fiscal risks which normally feature in the economic literature and which are deemed to be relevant in the case of Malta (see Table 3.1). Most of these risks, which are listed in alphabetical order, feature in reports dealing with the Maltese economy, such as those prepared by the European Commission, the International Monetary Fund, the Central Bank of Malta and credit rating agencies.

Table 3.1: Fiscal risks

Risk	Explanation
Ageing	Healthcare costs and pensions can accelerate faster than projected with improvements in longevity and entitlements.
Brexit	Turbulence and disruptions can be created if the UK leaves the EU without a clear arrangement in place.
Cost pressures associated with existing policies	Current policies could lead to acceleration in expenditure growth due to rising demand or upward price pressures.
Deviations from key forecast assumptions and judgements	The actual fiscal outturn may be much worse than previously assumed in case of a strong optimism bias.
Downturn in the financial sector	Relocation, liquidation or subdued growth of firms operating within the financial sector.
Downturn in the property market	Collapse in the housing and / or commercial property market due to sharp fall in prices and / or volume of transactions.
Downturn in the remote gaming sector	Relocation, liquidation or subdued growth of firms operating within the gaming sector due to legislation changes abroad.

[7] Refer to Chapter 2 in this Report for further details.

Economic recession	Negative real GDP growth recorded over consecutive periods.
End of the IIP programme	Termination of the revenue streams generated from this programme.
Geo-political uncertainties	International uncertainty can impact negatively investment plans of foreign-oriented business in Malta.
International tax harmonisation	Malta's attractiveness for tax domiciliation purposes can be adversely impacted by international agreements.
Legal cases	Adverse court decisions such as in relation to tax due, expropriation, or investment projects.
Lower dividends from state owned enterprises	Lower or no dividends may be received from government's shareholdings.
Natural disasters	Examples may include events such as earthquakes, severe storms, major fires or tsunamis.
Nominal GDP growth which is not tax-rich	Growth can be driven by categories of incomes and expenditures which carry a much lower tax intake than others.
Pressure on existing infrastructure	Bottlenecks which depress future growth and the quality of public services can result because of lack of adequate infrastructure.
Public sector upward wage pressures	There could be demands for higher public sector wages.
Public-Private Partnerships	New agreements can create new expenditure commitments beyond what is currently anticipated.
Realisation of government guarantees	Government may be forced to make up for any contract deficiency as stipulated in the guarantee.

Realisation of non-guarantee other contingent liabilities	Expenditure increases which may be driven by new requests due to implicit arrangements for government assistance.
Rising global protectionism	Protectionism makes it more difficult and / or more expensive to trade.
Sharp tightening in global financial conditions	Rising borrowing costs due to a generalised increase in interest rates.
Shortages of labour	Widespread unfilled job vacancies can hamper production levels and impede future growth.
Significant deceleration in Malta's potential output growth	The country's average long-term growth rate can be much lower than that experienced in recent years particularly if growth in labour supply and investment slows down.
Slow progress in addressing structural weaknesses	Lack of significant progress in addressing areas which inhibit or restrain economic growth.
Structurally weak growth in main trading partners	Prolonged period of subdued demand for Malta's exports of goods and services pushing the burden of growth exclusively on domestic demand.
Sudden changes in fiscal priorities	Political preferences driving changes in fiscal priorities away from fiscal sustainability.
Support needed by state owned enterprises	Government may need to shore up the financial situation of its entities to ensure they continue operating.
Support needed by the financial sector	Government may be forced to intervene in the financial sector for financial stability purposes.

The Council considers useful that, in due course, the Ministry for Finance builds on this list, possibly also by expanding the list, and providing its expert views, supported by more information and possible quantitative estimates to support the Ministry's views on the likelihood and potential impact of each risk. The result would be a fiscal risk register, which clarifies the nature of the risk, presents the likelihood of crystallisation and the impact it could have on public finances if it materialises. This deliverable is also in line with the recommendation provided by the IMF as part of its Fiscal Transparency Evaluation. The risk register could also be supplemented by the measures being taken by the Government to manage such risks effectively.