Core Principle 2: Risk layering: No single financial instrument can address all risks

A comprehensive financial protection strategy for the government generally brings together pre-and post-disaster financing instruments that address the evolving needs for funds—from emergency response to long-term reconstruction—and are appropriate to the relative probability of events. For example, a government could decide to purchase more expensive risk transfer instruments—such as catastrophe bonds—to ensure immediate liquidity for emergency response to extreme events. But it will raise the much larger amounts needed for reconstruction through budget reallocations and from capital markets through bond issues.

Historically, many governments have relied on post-disaster (ex-post) funding sources. Governments can access these resources without previous financial arrangements that often require highly technical expertise and experience. However, even when such post-disaster arrangements are cheaper than pre-arranged financing sources, they can take a long time to negotiate (such as emergency loans), can be highly variable and unpredictable (like donor assistance), and can endanger development programs that often take many years of preparation (for example due to budget reallocation). On the other hand, risk financing instruments that the government establishes before disaster hits (ex-ante) can avoid these drawbacks but they do require advanced planning, and can be more expensive and limited in amount.

Nevertheless, promoting the use of private insurance in both the public and private sector is crucial to increasing financial resilience across society. Insuring public assets can help better manage the explicit contingent liability of governments and limit the volatility on government accounts. For example, some middle-income countries such as Colombia, Mexico, and Panama already require that public assets have property insurance coverage against natural disasters. Promoting competitive property insurance markets helps shift the burden of post-disaster recovery from households and small and medium-sized enterprises to specialized risk carriers like insurance companies and contributes to increasing the economy's resilience. Governments can build an enabling environment for insurance markets and provide basic risk market infrastructure as public goods. This can include catastrophe risk assessment, supporting the growth and build the capacity of domestic insurers while supporting the sale of reliable, cost-efficient insurance products, as in the example of the South East Europe and Caucasus Catastrophe Risk Insurance Facility. This brings the additional benefit of building a deeper financial sector.

Challenges and opportunities for public financial management of a successful disaster risk financing and insurance agenda

Section II detailed the financial strain that disasters place on governments' budgets. In principle, countries can take advantage of both pre- and post-disaster sources of financing for disasters, but the use of proactive financial protection instruments requires a certain level of experience for advance planning within the government.

Strong public financial management of natural disasters depends on the ministry of finance's capacity to develop financing solutions before a disaster hits. This requires strong public financial management experience and trained officials, including the ability to conduct complete fiscal forecasts that incorporate different disaster scenarios and that are then regularly monitored. This includes a comprehensive overview of the aggregate

fiscal risk arising from various contingent liabilities, for example from natural disasters or from large state-guaranteed infrastructure projects. These elements for fiscal monitoring are, however, not found in most countries. An analysis of over 350 Public Expenditure and Financial Accountability (PEFA) assessments—international assessments reviewing the condition of national public financial management systems—show that most low- and middle-income countries either monitor the government's fiscal position only once a year, with a consolidated overview often missing or incomplete, or do not do any kind of regular monitoring at all.

Adopting a proactive risk financing approach also has multi-year budget implications. Multi-year forecasts for revenues, medium-term expenditure totals for mandatory expenditure, and potential debt financing would need to be in place. This medium-term budget framework is led by the ministry of finance, but requires other ministries to complete the budget plan with specific line items. Information from diagnostic tools such as the PEFA confirms, however, that most developing countries do not have good medium-term budget frameworks in place, which makes it more complicated to ensure that future expenditure is aligned with longer-term, strategic investment decisions.

While post-disaster financing mechanisms, such as increasing taxes and borrowing, do not require advance planning, they do rely on strong capacities in areas like tax administration and debt management. Here, too, evidence indicates that the challenges are significant. For example, increasing the tax burden in the wake of the kind of economic contraction often seen after a disaster can be almost impossible in countries without a well-organized system for defining tax policy and tax administration. Even where processes for budget mobilization are in place, officials may not be familiar with their use as they are only activated in exceptional circumstances.

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