

# *Managing the Public Balance Sheet*

A POLICY INSIGHT



# Foreword

**Balance sheet management has not been an area of focus for governments until very recently, but this is changing as governments around the world experience low growth in tax revenues and inexorable pressure on spending.**

For most governments, financial management has been focused on the fiscal deficit or surplus – the difference between in-year tax receipts and spending – and the consequential effect on borrowing.

Managing tax and spending effectively is very important, but good financial management involves more than managing short-term cash flows and governments have a duty to deliver effective stewardship of the public finances. That means managing for the long term, delivering sustainable economic growth, ensuring intergenerational fairness and creating the conditions for future prosperity.

Building on its work on trust by citizens in public finances, ICAEW believes that integrated financial statements that support effective balance sheet management are an important part of discharging this duty of stewardship. The balance sheet shines a light on the liabilities that have been incurred and the assets available to deliver services or generate revenue. Both can be considerable: in the UK Whole of Government Accounts there are assets of £1.7tn and liabilities of £3.7tn, equivalent to 91% and 194% of GDP respectively.

Future generations will bear the consequences of the decisions of today, so it is therefore vital that governments have the right expertise to understand how their assets and liabilities will change as a result of policy-making.

This report is intended to help governments and parliaments understand how good balance sheet management can improve the overall management of the public finances and the questions they should be asking to make the most of their integrated financial reports, such as:

- What assets do they have and are they getting the best use out of them?
- Should governments increase or decrease investment?
- What are their liabilities and how are they going to settle or service them?
- Could refinancing offer opportunities to save money?
- How fast are liabilities increasing, and could their growth be slowed?
- Do governments understand the financial effect of decisions, in particular on their balance sheets?
- And are they using the balance sheet to help improve future decision-making?
- How can government take advantage of emerging technologies such as distributed ledgers (eg, blockchain) to transform the timeliness and quality of balance sheet information?

This publication uses numbers from the UK's published financial statements under IFRS (the 'Whole of Government Accounts') and financial reports published by the Australian, Canadian, French, German and New Zealand governments to highlight areas where better balance sheet management can help governments to use resources more effectively.

## STEWARDSHIP

ICAEW believes that governments have a duty to serve the public trust through effective stewardship of the economy.

To deliver future prosperity and intergenerational fairness over the long term, good balance sheet management is of vital importance.



*Michael Izza*

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Chief Executive  
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# *First, find your balance sheet*

## **Integrated financial statements provide a record of the financial consequences of decisions.**

Analysed into revenues earned, expenditures incurred, assets created and liabilities owed, integrated financial statements provide decision-makers with the information they need to make decisions, and stakeholders with the information they need to hold decision-makers to account.

At least they do in the private sector; in the public sector it is generally different.

Many governments around the world still use cash accounting for their internal and external financial reports, missing out on key information about assets other than cash and on liabilities other than debt.

Very few use internal financial reports similar to those available inside private sector organisations of similar scale. And only a handful have published accruals-based integrated financial statements to provide a comprehensive financial picture to ministers, to elected representatives and to the public.

Our work on trust by citizens in public finances shows that only one in five Europeans have trust in their respective governments' abilities to manage their public finances effectively.<sup>1</sup>

Without balance sheet information to use to support good financial management, governments are unlikely to be in a position to challenge this perception.

The good news is that this is changing.

Several countries, including Australia, Canada, France, New Zealand and the UK, have started to publish integrated financial statements (see Table 1), while a number of other countries have announced plans to do so. These include EU members such as Austria, Cyprus, Portugal and Spain; South American countries such as Brazil, Chile and Peru; and Asia-Pacific nations such as China, Indonesia, Japan, Malaysia and Vietnam.

The number of countries preparing balance sheets is likely to increase. In particular, the OECD and the International Federation of Accountants<sup>2</sup> have found that 75% of OECD members have now adopted some form of accruals-based accounting, up from a quarter in 2003.

## **DIFFERENT APPROACHES**

Full adoption is likely to take many years, so it may be some time before the majority of countries start to produce integrated financial statements.

There are a variety of different approaches, with the UK being the only country so far to prepare integrated financial statements that encompass the entire public sector (ie, including devolved administrations and local government, as well as central government and the Bank of England). This contrasts with France for example, which includes public corporations and its central bank in its financial statements, but excludes regional and local governments, as well as public sector pension liabilities.

### **INSIGHT**

Balance sheets can help improve public financial management – but only if governments know what is in them.

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<sup>1</sup> ICAEW-PwC 'EU Perspectives: Government Accountability and Reporting: Citizen's Attitudes and Financial Markets Scrutiny', December 2014

<sup>2</sup> OECD-IFAC report, 'Accrual Practices and Reform Experiences in OECD countries', February 2017

**CONVENTIONS**

Although different accounting conventions make comparisons difficult, this is more than outweighed by the benefit of information about assets and liabilities.

Australia, Canada and New Zealand all include federal/central government and agencies, including their central banks and central government pension obligations, but they also exclude assets and liabilities of state/provincial governments as well as of local authorities.

New Zealand and Australia have gone one step further than the UK in using monthly or quarterly internal financial reports prepared on an integrated basis. This supports better decision-making during the course of each financial year.

As the IMF noted in its 2013 study 'Another Look at Governments' Balance Sheets: The Role of Nonfinancial Assets' (available from [imf.org](http://imf.org)), the lack of consistent balance sheet data from countries makes direct comparisons difficult. Despite that, there are valuable insights to be gained, irrespective of the methodology used.

**IFRS AND ACCRUALS-BASED IPSAS**

Governments deciding to prepare integrated financial statements can choose to adopt International Financial Reporting Standards (IFRS), as used by the majority of listed

companies around the world, or they can adopt accruals-based International Public Sector Accounting Standards (IPSAS). IPSAS have many similarities with IFRS, but are not the same.

The UK has adopted IFRS for its Whole of Government Accounts (WGA), while Australia has adopted Australian accounting standards that are based on IFRS.

France has adopted accruals-based IPSAS, while Canada and New Zealand have adopted country-specific versions of accruals-based IPSAS.

**THE IMPACT OF TECHNOLOGY**

Fortunately for governments, emerging technologies such as distributed ledgers (eg, blockchain) have the potential to transform the speed and accuracy with which integrated financial statements can be prepared. These technologies also have the potential to make consolidation of financial information across government a much more straightforward exercise so that in the future more countries will have the ability to prepare accounts on a whole of government basis.

**Table 1 - Countries producing integrated financial statements**

Country	Scope	Date	Assets	% of GDP	Liabilities	% of GDP
UK	Whole of Government	31 Mar 2016	£1,742bn	91%	(£3,728bn)	(194%)
	Central Government <sup>1</sup>		£1,184bn	62%	(£2,789bn)	(145%)
Australia	Commonwealth Government	30 Jun 2016	A\$594bn	36%	(A\$1,008bn)	(61%)
Canada	Central Government <sup>2</sup>	31 Mar 2017	C\$434bn	22%	(C\$1,060bn)	(54%)
France	Central Government	31 Dec 2016	€978bn	44%	(€2,181bn)	(98%)
New Zealand	Central Government	30 Jun 2016	NZ\$293bn	116%	(NZ\$197bn)	(78%)

<sup>1</sup> Central government extracted from segmental analysis within the Whole of Government Accounts.

<sup>2</sup> France liabilities exclude central government pension obligations amounting to €2.1tn (106% of GDP).

Sources: HM Treasury - Whole of Government Accounts 2015/16; Commonwealth of Australia - Consolidated financial statements 2015/16; Government of Canada - Annual financial report 2015/16; Republic of France, - Compte général de l'État 2016; Government of New Zealand - Financial statements 2015/16.

# Assets and liabilities

Accruals-based financial statements are a key financial tool that supports management of the balance sheet.

Countries such as the UK, France, Australia and New Zealand have taken the lead in developing accruals-based financial statements and are starting to use them to inform financial decision-making.

## UK

The UK has published a set of Whole of Government Accounts for the past seven years. These are prepared in line with international financial reporting standards (IFRS). They differ significantly from the UK's official government accounting, which is based on ESA 10, the EU equivalent of the UN System of National Accounts 2008 (SNA 08).

The major differences include a statement of revenue and expenditure that reflects long-term expenditure, as well as in-year spending, and a balance sheet that includes assets and other liabilities, as well as debt. There is also a statement of cash flows and a statement of recognised gains and losses.

The UK's financial statements include local and central government and so present a comprehensive financial picture of public sector activities in the UK.

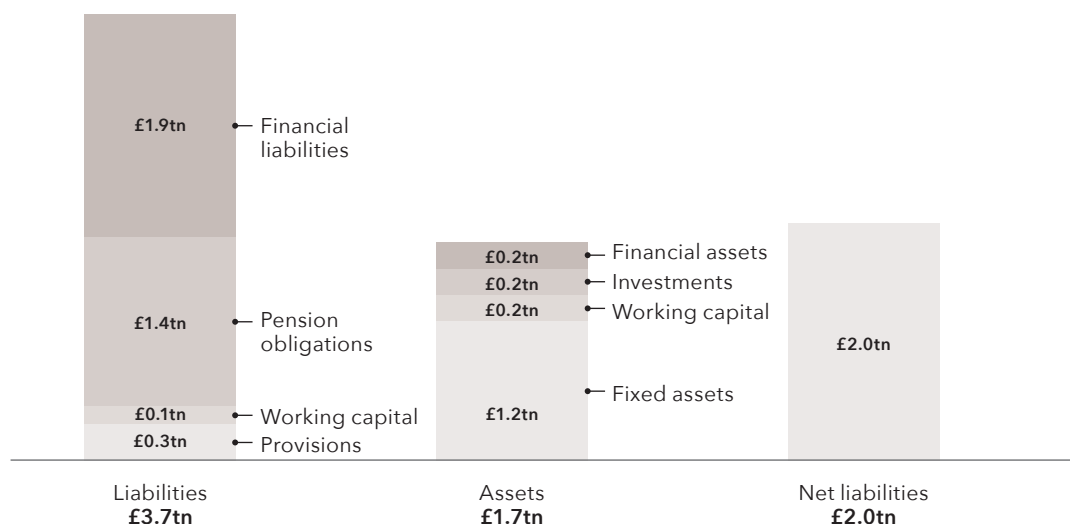
Table 2 - UK assets and liabilities

At 31 March 2016	£bn	/ GDP
Fixed assets	1,171	61%
Financial investments	209	11%
Liquid financial assets	198	10%
Working capital assets	164	9%
<b>TOTAL ASSETS</b>	<b>1,742</b>	<b>91%</b>
Working capital liabilities	(136)	(9%)
Financial liabilities	(1,862)	(95%)
Pension obligations <sup>1</sup>	(1,425)	(74%)
Long-term liabilities	(305)	(16%)
<b>TOTAL LIABILITIES</b>	<b>(3,728)</b>	<b>(194%)</b>
<b>NET LIABILITIES</b>	<b>(1,986)</b>	<b>(103%)</b>

<sup>1</sup> Public sector employee pension entitlements.

Source: HM Treasury - Whole of Government Accounts 2015/16.

Figure 1 - The UK public balance sheet



**INSIGHT**

Based on its balance sheet, New Zealand appears to be in a much better fiscal position than the UK, with assets exceeding liabilities rather than the other way around.

**NEW ZEALAND**

New Zealand has gone one step further than other governments by using financial statements prepared in accordance with accruals-based international public sector accounting standards (ISPAS) as its primary financial reporting framework.

New Zealand also prepares and publishes monthly financial statements that include a full balance sheet, enabling it to actively monitor movements in assets and liabilities and to embed balance sheet management into the way it operates.

Although they don't incorporate local government, they do include state-owned enterprises and public agencies.

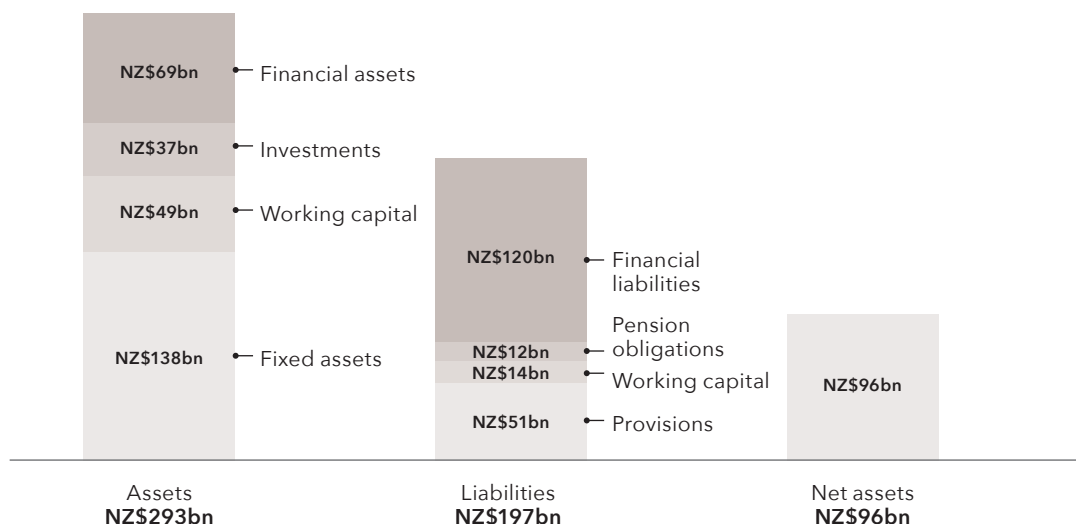
**Table 3 - New Zealand assets and liabilities**

At 30 June 2016	NZ\$bn	/ GDP
Fixed assets	138	55%
Financial investments	37	15%
Liquid financial assets	69	27%
Working capital assets	49	19%
<b>TOTAL ASSETS</b>	<b>293</b>	<b>116%</b>
Working capital liabilities	(14)	(5%)
Financial liabilities	(120)	(48%)
Pension obligations <sup>1</sup>	(12)	(5%)
Long-term liabilities	(51)	(20%)
<b>TOTAL LIABILITIES</b>	<b>(197)</b>	<b>(78%)</b>
<b>NET ASSETS</b>	<b>96</b>	<b>38%</b>
Owned by other stakeholders	(7)	(2%)
<b>NET WORTH</b>	<b>89</b>	<b>36%</b>

<sup>1</sup> Public sector employee pension entitlements.

Source: Government of New Zealand - Financial Statements 2015/16.

**Figure 2 - New Zealand balance sheet**



# Infrastructure and public property

One of the primary investment decisions that governments need to make is how much they should invest in infrastructure.

Generally, investing in infrastructure is considered to be economically beneficial, but with limited resources governments need to focus on ensuring that the investments they make produce the best returns for the economy and society.

A balance sheet allows governments to track publicly-owned infrastructure assets and, in theory, the opportunity to measure the financial benefits to the economy and the incremental tax or other revenues generated.

In addition to economic infrastructure, public property assets include office buildings, hospitals, schools and other facilities used to provide public services.

There is also social and affordable housing, often owned by local authorities. Most governments have substantial land holdings, while many also have natural resources that can be exploited to generate revenues.

There is very little data on how effective governments are at managing their generally large portfolios of property and natural resources. It is unclear whether taxpayers get a good return on the investment in those assets, whether financially or in terms of effective public service delivery.

Similarly, there is little analysis of the overall effectiveness of government investments into other fixed assets, from IT systems through to military equipment.

With very few governments publishing balance sheet data, there is little analysis on whether adequate returns are being obtained on investment in their diverse range of public assets.

## UK

In the UK, the majority of transport infrastructure is publicly owned, while most other economic infrastructure – energy, water, telecommunications – is in the private sector.

Table 4 - UK fixed assets

At 31 March 2016	£bn	/ GDP
Network Rail	280	14.6%
Highways England	110	5.7%
Local authority roads	65	3.4%
Scottish Water	52	2.7%
Other infrastructure	66	3.4%
<b>Economic infrastructure</b>	<b>573</b>	<b>29.8%</b>
Land and buildings	406	21.2%
Investment and assets for sale	18	0.9%
<b>Property</b>	<b>424</b>	<b>22.1%</b>
Military equipment and systems	54	2.8%
Assets under construction	53	2.8%
Equipment, vehicles and other	49	2.6%
IT systems and development	18	0.9%
<b>Plant and equipment</b>	<b>174</b>	<b>9.1%</b>
<b>TOTAL FIXED ASSETS</b>	<b>1,171</b>	<b>61.0%</b>

Source: HM Treasury - Whole of Government Accounts 2015/16.

Available data indicates that the UK is investing less into its economic infrastructure than comparable economies, with only £13bn added to transport and other infrastructure assets in 2015/16. This is surprising given the importance of infrastructure in supporting a £1.9tn UK economy.

Additional investment has been announced. However, as ICAEW established in its *Policy Insight on Funding UK Infrastructure* published last year, it is much easier to announce increased infrastructure investment than it is to deliver it.

## INSIGHT

Capital asset management and investment systems and processes are rare in the public sector.

Could they help direct investment to where it is needed most?



**INSIGHT**

Measuring the financial and social returns obtained from investments in infrastructure and other assets would help governments to make choices about how they invest.

**FRANCE**

France now publishes financial statements in accordance with accruals-based ISPAS, which include a balance sheet for central government.

Table 5 shows fixed assets reported in that balance sheet.

**Table 5 - France fixed assets**

At 31 December 2016	€bn	/ GDP
Road infrastructure	125	5.6%
Concession assets <sup>1</sup>	203	9.1%
<b>Economic infrastructure</b>	<b>328</b>	<b>14.7%</b>
<b>Land and buildings</b>	<b>61</b>	<b>2.8%</b>
Military equipment	38	1.7%
Assets under construction	30	1.3%
Vehicles and equipment	5	0.2%
Development and IT	28	1.3%
<b>Plant and equipment</b>	<b>101</b>	<b>4.5%</b>
<b>TOTAL FIXED ASSETS</b>	<b>490</b>	<b>22.0%</b>

<sup>1</sup> Toll roads, water, railways, airports.

Source: Republic of France - Compte général de l'État 2016.

The amounts in the French Government's balance sheet are not directly comparable with the UK for several reasons.

Firstly, the UK numbers include local government (comprising just over one third of the total assets in Table 4), while the French numbers (Table 5) are for central government only.

Secondly, the accounting standards applied, and the accounting policies adopted, are different, for example with respect to the valuation of land, which may explain why France reports much lower values for land than the UK Government does. In addition, the UK Whole of Government Accounts incorporate assets of publicly-owned corporations (such as Network Rail), while the French financial statements treat such companies (such as SNCF, the French railway operator) as financial investments.

One clear distinction between the UK and France that their respective financial statements highlight is their different models for operating infrastructure, with the UK owning railways and not owning airports, while France retains ownership but grants concessions to private operators.

Even so, the questions that the balance sheet provokes are similar to that for the UK:

- Is investment into fixed assets generating appropriate returns, whether financially or socially?
- Could assets be used more effectively, or investment better directed, for the benefit of French citizens?

# Financial assets

Financial assets owned by the state can generally be classified into two categories: long-term financial investments and liquid financial assets.

In some cases, as with sovereign wealth funds, long-term financial investments are made with the explicit aim of generating financial returns and continuing capital growth. However, in many cases, financial investments are made for other reasons, for example in the provision of loans to support new and growing businesses, lending to banks to support the financial sector, and strategic investments in particular sectors of the economy.

In addition, equity investments in private sector businesses may have arisen as a consequence of retaining a share in formerly state-owned businesses or where a government has decided to rescue a failing private enterprise.

Liquid financial assets include cash and bank balances used to pay for government spending, foreign currency holdings used for central bank operations and gold and other assets used as stores of value, in particular to back the issue of domestic currency.

Even though there is generally good information on financial assets owned by government and the financial returns obtained, very few governments routinely appraise the performance of their financial investment against commercial investment benchmarks or even against internal targets for expected financial returns.

## UK

The UK Government's portfolio of financial investments at 31 March 2016 totalled £220bn, including lending to banks, to business and to students, as well as equity and other financial investments.

Combined with cash, gold, bank deposits and other balances of £180bn, the UK public sector has a total of £400bn invested in financial assets.

**Table 6 - UK financial assets**

At 31 March 2016	£bn	/ GDP
Student loans	62	3.2%
Equity investments	45	2.4%
Residential mortgages	35	1.8%
IMF and EIB	28	1.5%
Other investments	39	2.0%
<b>Financial investments</b>	<b>209</b>	<b>10.9%</b>
Foreign currency reserves	83	4.3%
Short-term deposits and loans	73	3.8%
Cash	26	1.3%
Gold holdings	9	0.5%
IMF special drawing rights	7	0.4%
<b>Liquid financial assets</b>	<b>198</b>	<b>9.7%</b>
<b>TOTAL FINANCIAL ASSETS</b>	<b>407</b>	<b>21.2%</b>

Source: HM Treasury - Whole of Government Accounts 2015/16.

At £6bn, annual investment income generated by the government's financial assets of £407bn is equivalent to a financial return of 1.5%.

This low level of return is partly due to liquid financial assets that are held for cash management purposes and do not generate much, if any, income.

It also reflects the inherent subsidies in lending by government comparable to the rates that might be expected in the private sector, for example in the provision of student loans or in low cost loans provided to small businesses.

## INSIGHT

Financial investments should benefit governments by providing financial returns in excess of the cost of debt used to finance them.

But without clear reporting, how would they know?

Controversially the UK Government has not done well out of its decision to hold onto its investment in RBS, a poorly performing nationalised bank, with a £10bn write-off recorded during 2015/16. It has stated that it is waiting in the hope that values will recover to make back the losses incurred, which contrasts with how a more rational investor would have long-since crystallised losses and re-invested in better performing assets.

This may be an example of where sales proceeds from this type of asset could be better used to invest in infrastructure to generate more economic activity and hence produce higher tax revenues. Or, as some commentators have called for, the UK might consider creating a sovereign wealth fund, with the explicit aim of generating long-term value on behalf of the UK taxpayer.

The UK National Audit Office, in its June 2016 report on financial assets recorded in the WGA balance sheet (available from [nao.org.uk](http://nao.org.uk)), questioned the government's fiscal strategy for selling financial investments, noting that: 'Market conditions and the economy ... could have a significant impact on the value obtained from asset sales and the long-term impact on the public finances'.

## GERMANY

Germany does not publish accruals-based financial statements at a country level, but it is possible to obtain some information from its national accounts on the financial assets held by the general government sector of federal, state and local institutions.

**Table 7 - Germany general government**

At 31 December 2015	€bn	/ GDP
Equity investments	361	11.9%
Loans to banks and businesses	146	4.8%
Loans overseas	104	3.4%
Other investments	21	0.7%
<b>Financial investments</b>	<b>632</b>	<b>20.8%</b>
Short-term deposits and loans	160	5.3%
Foreign currency reserves	126	4.2%
Cash	73	2.4%
<b>Liquid financial assets</b>	<b>359</b>	<b>11.9%</b>
<b>TOTAL FINANCIAL ASSETS</b>	<b>991</b>	<b>32.7%</b>

Source: Deutsche Bundesbank, Financial accounts for Germany 2015.

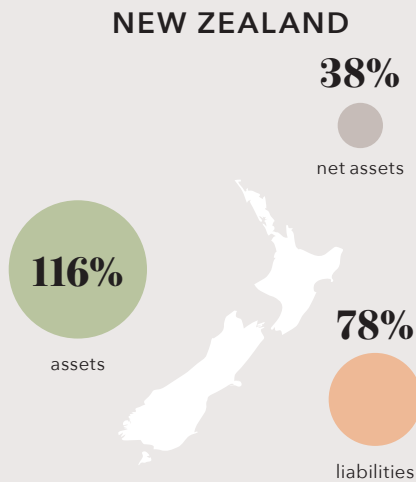
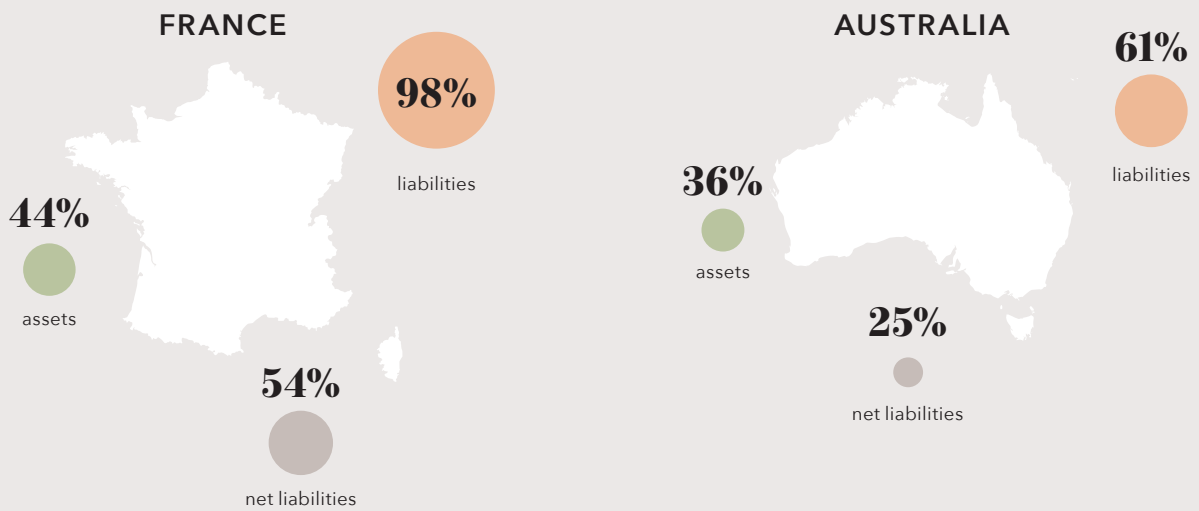
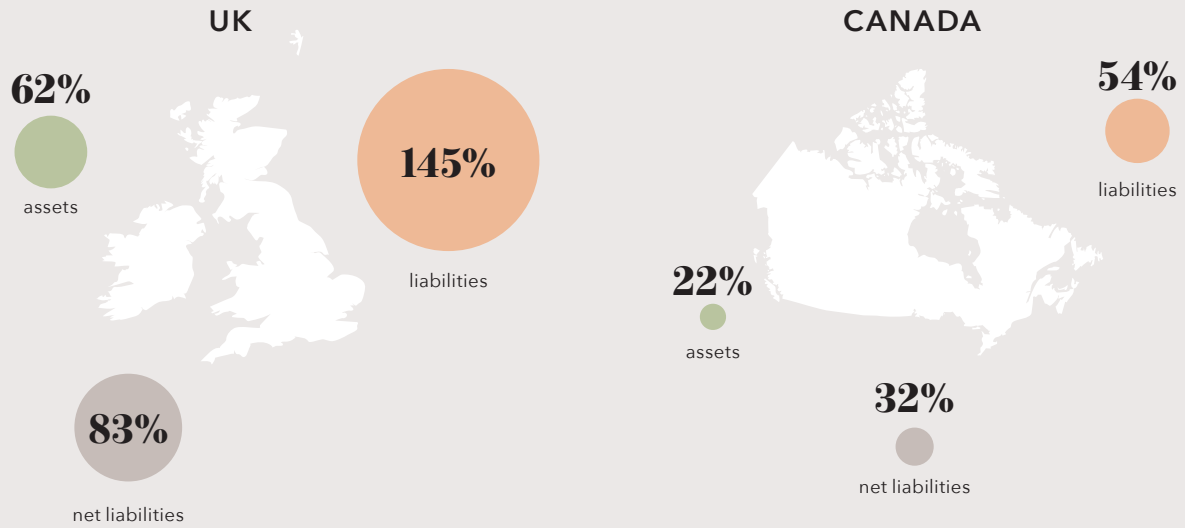
Table 7 does not provide a complete picture of the financial assets controlled by the German public sector. In particular, it excludes €106bn in gold reserves together with other financial assets of the German central bank as well as state-owned banks.

However, the general government summary does provide a starting point for a debate on how financial assets are being managed. For example:

- Should Germany consider establishing a formal sovereign wealth fund to manage its portfolio of investments?
- Are financial returns adequate, or could funds be better used elsewhere?
- Is the right level of short-term liquid financial assets being held?

# Central government balance sheets

(ASSETS AND LIABILITIES AS A SHARE OF GDP)



# Working capital

**Most businesses seek to reduce their investment in working capital to the minimum necessary to operate effectively.**

Governments are no different in principle – every amount unnecessarily tied up in working capital could be better used elsewhere.

## UK

Although taxes due and accrued for UK central and local government combined do not appear unreasonable at two to three months of a year's total tax revenues, electronic filing should enable taxes to be collected more quickly than that.

The UK is increasingly using electronic filing to accelerate tax payments, completing existing processes, such as deducting income taxes from salaries as they are paid. There are plans to accelerate corporate tax receipts further in 2018/19, but this is controversial due to the approach being adopted. (For more information on Making Tax Digital visit [icaew.com/MTD](http://icaew.com/MTD)).

Management of working capital liabilities is more sensitive given the need for governments to set a good example by ensuring suppliers are paid on time.

The preparation of a comprehensive balance sheet allows the UK Government to analyse the amounts being invested in working capital and consider how the management of those assets could be improved.

**Table 8 - UK working capital**

At 31 March 2016	€bn	/ GDP
Taxes due and accrued	115	5.9%
Receivables	24	1.3%
Prepaid expenses	15	0.6%
Inventories	10	0.7%
<b>Working capital assets</b>	<b>164</b>	<b>8.5%</b>
Tax refunds payable	(30)	(1.5%)
Other payables	(51)	(2.6%)
Accrued expenditure	(55)	(2.9%)
<b>Working capital liabilities</b>	<b>(136)</b>	<b>(7.0%)</b>
<b>NET WORKING CAPITAL</b>	<b>28</b>	<b>1.5%</b>

Source: HM Treasury - Whole of Government Accounts 2015/16.

## FRANCE

Like the UK, France's national government has billions of euros tied up in working capital assets.

Although not directly comparable with the UK, because its accrual-based financial statements are prepared using different accounting conventions and exclude regional and local governments, France's central government now has much better information available to use to assess how well it is managing its working capital.

# Financial liabilities

Table 9 - France working capital

At 31 March 2016	€bn	/ GDP
Taxes due and accrued	60	2.7%
Receivables	25	1.1%
Prepaid expenses	9	0.4%
Inventories	30	1.3%
<b>Working capital assets</b>	<b>124</b>	<b>5.5%</b>
Tax refunds payable	(49)	(2.2%)
Other payables	(121)	(5.4%)
Accrued expenditure	(78)	(3.4%)
<b>Working capital liabilities</b>	<b>(248)</b>	<b>(11.0%)</b>
<b>NET WORKING CAPITAL</b>	<b>(124)</b>	<b>(5.5%)</b>

Source: Republic of France - Compte général de l'État 2016.

One aspect of the balance sheet that is monitored by all governments is the level of external debt. However, it is important to realise that measurements of debt under ESA 10 or SNA 08 do not necessarily reflect all financial liabilities. For example, lease obligations or financing contracted through public-private partnerships may not be included.

Managing debt is an important element of a finance ministry's responsibilities. A balance needs to be struck between obtaining the lowest possible interest rates through short-term funding and issuing long-term debt that reduces the level of refinancing required each year.

For many developed economies experiencing extremely low interest rates, there is an opportunity to lock-in those low rates for a substantial period of time.

Some countries, such as the UK, have been rebalancing towards longer-term debt and increasing the average maturities of their public debt portfolios.

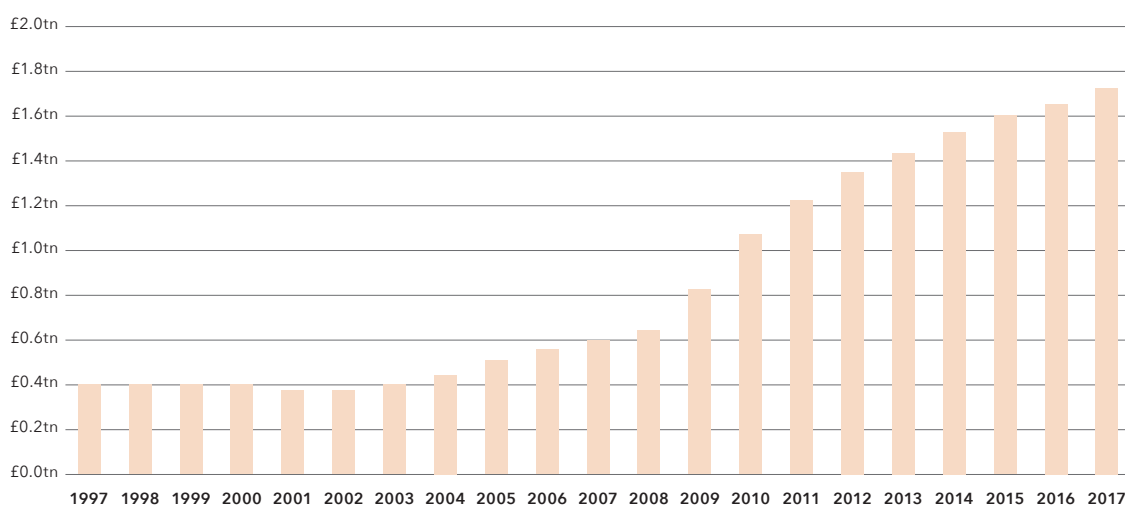
Active management of a country's debt portfolio is critical as every extra pound, euro or dollar that goes into servicing that debt means less will be available for public services or investment.

## INSIGHT

More attention needs to be focused on debt management strategies, which can have a very significant impact on the long-term cost of finance for those countries with large debt burdens.

Debt management strategies need to be continually updated and reviewed as the economic environment can change rapidly.

Figure 3 - UK debt since 1997



Source: US Treasury, Eurostat, Japan Ministry of Finance, UK Debt Management Office.

## UK

High levels of borrowing in the UK over the last decade have led to a significant growth in the amounts owed by the UK state to financial investors.

Figure 3 illustrates how UK general government consolidated gross debt has increased over the past 20 years. In cash terms debt has more than quadrupled, while as a share of GDP it has doubled from 44% to 87%.

General government consolidated gross debt is similar, but not the same as debt in financial statements. At 31 March 2016 this was £1,652bn compared with the £1,750bn in the financial statements as shown in Table 10.

Fortunately for the UK public finances, this increase in debt has been mitigated by a period of low interest rates. Debt interest in 1997 was £26bn on £0.41tn of debt, a rate of almost 7%, compared with £35bn in 2017 on debt of £1.71tn, equivalent to just over 2%.

The UK's Debt Management Office (DMO), a unit of HM Treasury that manages debt on behalf of the UK Government, has the task of raising new finance to get the best value for taxpayers. It has been able to take advantage of very low interest rates to issue increasing amounts of long-term debt, extending average maturities to an average of 18 years - much longer than comparable economies.

A substantial proportion of the UK's existing debt falls due for repayment over the next few years, presenting the DMO with further opportunities to lock-in low rates and keep debt financing costs low. Despite this, interest costs are likely to increase as additional borrowing adds to the total amount of debt and interest rates start to increase from their current historic low levels.

**Table 10 - UK financial liabilities**

At 31 March 2016	£bn	/ GDP
Gilts	(1,048)	(55%)
Treasury bills	(78)	(4%)
Bank deposits	(361)	(19%)
National Savings	(135)	(7%)
Bank loans and other debt	(128)	(6%)
<b>Debt</b>	<b>(1,750)</b>	<b>(91%)</b>
Bank notes in circulation	(68)	(4%)
PFI and finance leases	(44)	(2%)
<b>Other financial liabilities</b>	<b>(112)</b>	<b>(6%)</b>
<b>FINANCIAL LIABILITIES</b>	<b>(1,862)</b>	<b>(97%)</b>

Source: HM Treasury - Whole of Government Accounts 2015/16.

Investors pay an up-front premium for gilts linked to the retail price index, which has the consequence of increasing the UK Government's exposure to increases in the rate of inflation. Given many economists expect inflation in the UK to start to increase in the near future, the DMO may want to consider whether it has the right balance between fixed-interest and index-linked debt.

This picture is complicated by the Bank of England's purchases of gilts as part of its quantitative easing programme, which has reduced the level of gilts owed to external investors and increased the level of bank deposits. This has been worth around £13bn per year in savings on the interest rate differential.

However, this benefit comes with a consequence: a significantly increased exposure to changes in interest rates.

This highlights the need to continually monitor and update debt management strategies in the light of this exposure. The last published UK government debt management strategy was in 1995 so it is definitely due for a refresh.

## FRANCE

Agence France Trésor, France's debt management agency, has a very different approach from its UK counterpart, keeping maturities short to maximise the benefit of low interest rates.

**Table 11 - France financial liabilities**

At 31 December 2016	£bn	/ GDP
Marketable securities	(1,504)	(68%)
Treasury bills	(134)	(6%)
Deposits	(102)	(5%)
Bank loans and other debt	(32)	(1%)
<b>FINANCIAL LIABILITIES</b>	<b>(1,772)</b>	<b>(80%)</b>

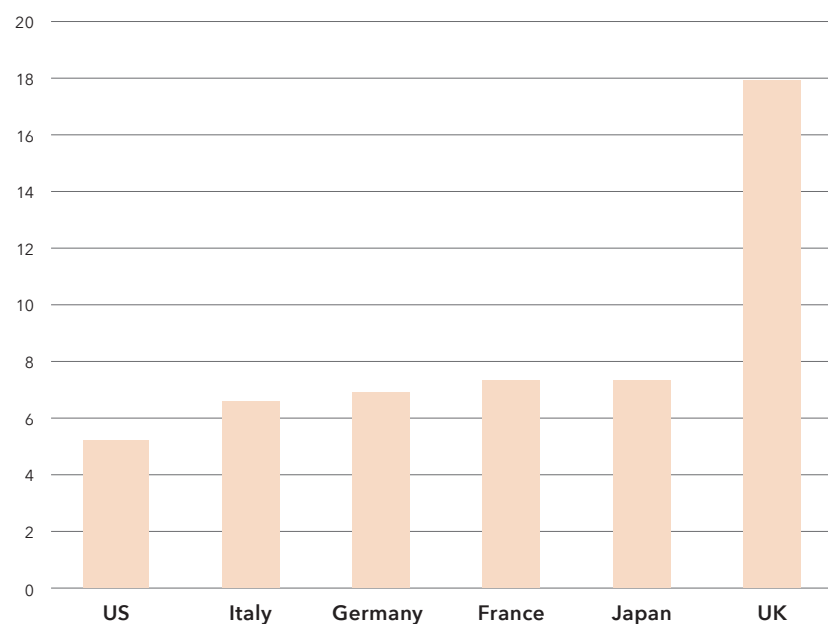
Source: Republic of France - Compte général de l'État 2016.

The average maturity of French debt is 7.5 years, much less than that of UK debt. This means that the French Government has been able to benefit from interest rates below 0.5%, much lower than the UK with its strategy of issuing debt for longer maturities.

However, this benefit is counterbalanced by a much greater exposure to changes in interest rates than the UK, leaving France's public finances much more vulnerable to an increase in interest rates.

As a consequence, a key question currently facing the Agence France Trésor is whether it might make sense to seek to increase maturities from their current position in order to lock-in low interest rates on long-term debt for much longer periods than it currently does.

**Figure 4 - Average maturities (years)**



Source: US Treasury, Eurostat, Japan Ministry of Finance, UK Debt Management Office.



# Public sector pensions

## INSIGHT

Decisions in the 20<sup>th</sup> century to provide defined benefit pensions to public sector employees have resulted in very large liabilities being built up.

Integrated financial statements shine a light on these liabilities and provoke the question: are they affordable?

**One of the most significant 'missing' liabilities from most countries' reports on their public finances are the accumulated pension entitlements of public sector employees.**

Depending on whether they are funded or unfunded, this can make a significant difference to the overall financial position.

Many, but not all, developed countries have substantial unfunded pension obligations, which present increasing problems for their public finances as former public servants live longer in retirement.

Although actions, such as reducing the generosity of pension entitlements and increasing the retirement age, can make some difference, the scale of the obligations remains substantial.

Together with commitments to pay for state pensions in many countries, the increasing level of cash payments to pensioners reduces the amounts available to provide public services and other support to citizens.

There are many lessons for both developed and developing countries around the need to ensure that citizens are adequately provided for in retirement.

## UK

At £1.5tn or 80% of GDP, net public sector pension obligations owed by the UK public sector to current and former employees are substantial.

Unlike private sector employers, the UK Government has a policy of not establishing pension funds. This 'pay as you go' approach uses taxes and contributions from current employees to pay for pension payments to retired employees. As a consequence, UK central government has been fully exposed to increasing longevity among public sector employees in retirement.

**Table 12 - UK public sector pensions**

At 31 March 2016	£bn	/ GDP
NHS	(444)	(23%)
Military, police, fire services	(302)	(16%)
Teachers	(312)	(16%)
Civil servants and others	(263)	(14%)
<b>Unfunded plans</b>	<b>(1,321)</b>	<b>(69%)</b>
<b>Funded plans</b>	<b>(104)</b>	<b>(5%)</b>
<b>NET PENSION OBLIGATION</b>	<b>(1,425)</b>	<b>(74%)</b>

Source: HM Treasury - Whole of Government Accounts 2015/16.

The exceptions are local authorities and a number of other public bodies, such as the BBC and the Bank of England, which have established pension funds with investment portfolios designed to grow to meet future obligations to pay pensions. These bodies have been able to mitigate some of their long-term exposure by increasing contributions now to mitigate the increased obligations in the future. As a consequence they have built up assets of £266bn, reducing their exposure from accumulated pension entitlements estimated at £370bn to net obligations of £104bn at 31 March 2016.

The UK Government has made some attempts to manage this liability by acting to reduce benefits payable. These include a change in indexation of pensions in retirement from RPI to CPI, which was calculated to have reduced the liability by £126bn in 2010/11. Other changes, including raising retirement ages and changing from final salary to average salary, have further reduced the long-term cost, albeit this principally affects future entitlements rather than the existing accumulated entitlements recorded in the balance sheet.

Many commentators have highlighted how the size of the pension obligations have been inflated by a low-interest-rate environment, reducing the discount rate used in the calculation and hence increasing the amount recorded for the liability. It is important to realise that discounting affects the proportion of the total obligation that is recognised in the balance sheet at a point in time and that the eventual cash outflow will be greater than the amount recorded. This will be added to as further entitlements are earned.

The UK Government's approach to managing its liabilities for public sector pensions is an area that deserves much greater attention than it currently receives.

Should it re-evaluate its policy of not funding central government public sector pension plans, perhaps by establishing pension funds for new employees entering the workforce today? What contingency plans exist to address low-economic-growth scenarios when tax revenues do not increase as expected?

## AUSTRALIA

Australia has now closed most of its federal superannuation schemes to new members, with new civil servants (from 1 July 2015) and new military personnel (from 1 July 2016) participating in defined contribution plans instead. The parliamentary scheme closed to new members in October 2004.

Members of the new schemes receive employer contributions of 15.4% in addition to employee contributions.

**Table 13 - Australia public sector pensions**

At 31 June 2016	A\$bn	/ GDP
Commonwealth employees	(206)	(12.5%)
Military	(132)	(8.0%)
Parliament, judges, others	(13)	(0.8%)
<b>Pension obligations</b>	<b>(351)</b>	<b>(21.3%)</b>
<b>Pension assets</b>	<b>36</b>	<b>2.2%</b>
<b>NET PENSION OBLIGATION</b>	<b>(315)</b>	<b>(19.1%)</b>

Source: Commonwealth of Australia financial statements 2015/16.

By closing most of the federal government's defined benefit pension plans to new members, Australia expects to gradually reduce its exposure to the risks associated with these plans. On the other hand, new employees will not have the same guarantees that previous generations of employees have had about the pensions that they will receive in retirement.

Ending the 'pay as you go' approach to pensions will mean a period where the Australian federal government will be paying for contributions to current employees at the same time as still paying the pensions of retirees. This will be phased in over the next 20 to 30 years, mitigating the cash funding requirements of the changeover.

## Other long-term liabilities

### INSIGHT

Long-term liabilities constrain governments by obligating them to pay cash in the future in preference to other policy choices, reducing the opportunity to cut taxes or to use money for other priorities.

**In addition to short-term creditors, debt and pension obligations, most governments will have other liabilities that will need to be settled in the future.**

Known as 'provisions' for accounting purposes, these liabilities include estimates for likely payments to settle legal claims, disputed tax refunds, obligations to clean up environmental damage and other obligations incurred as a result of past events that are expected to result in payments being made.

Settlement of long-term liabilities uses cash that would otherwise be available to provide public services. Actions to minimise these liabilities, and to prevent new liabilities occurring, can have a real long-term benefit for citizens. The recording of these liabilities in a balance sheet helps by reflecting the cost of policy decisions being made.

In some cases, there are significant uncertainties about the estimates used for these liabilities - meaning that the eventual payments could be significantly different.

### UK

In the UK, there are substantial long-term liabilities, although they are much smaller than financial liabilities and employee pension obligations.

The largest is the obligation to clean up nuclear facilities and deal with nuclear waste, a liability that continues to grow as the agencies involved continue to investigate the scale of the problem and update their assessments of the costs expected to be incurred over the next 125 years.

The liability for clinical negligence claims arises for a good reason: switching from one-off cash settlements (funded by debt) to managing the costs of care over the long term should save money overall. This decision means that the provision will increase each year. However, the level of claims that add to the liability each year is a concern and deserves attention.

Table 14 - UK provisions

At 31 March 2016	£bn	/ GDP
Nuclear decommissioning	(182)	(9.5%)
Clinical negligence claims	(58)	(3.0%)
Pension Protection Fund	(27)	(1.4%)
Tax refund claims	(13)	(0.7%)
Litigation and other	(25)	(1.3%)
<b>TOTAL PROVISIONS</b>	<b>(305)</b>	<b>(15.9%)</b>

Source: HM Treasury - Whole of Government Accounts 2015/16.

### NEW ZEALAND

New Zealand's central government balance sheet appears to be in a good financial shape overall, which is perhaps one of the reasons it has decided that it can afford to operate a comprehensive no-fault accident compensation scheme on behalf of its citizens.

This liability is now one of the most significant obligations that the central government needs to manage.

Table 15 - New Zealand provisions

At 31 June 2016	NZ\$bn	/ GDP
Accident compensation	(39)	(15.5%)
Other insurance	(3)	(1.2%)
Employee entitlements	(4)	(1.4%)
Emission credits	(2)	(0.9%)
Other provisions	(3)	(1.1%)
<b>TOTAL PROVISIONS</b>	<b>(51)</b>	<b>(20.1%)</b>

Source: Government of New Zealand financial statements 2015/16.

# Balance sheet risks

**Balance sheet risks include the possibility that the amounts recorded for assets and liabilities may turn out to be different.**

Asset values might fall below the amount at which they are recorded, while there are often uncertainties involved in calculating the value of certain liabilities, particularly long-term liabilities where there is a wide range of possible outcomes.

In addition, there are risks relating to items not recorded in the balance sheet. These contingent liabilities may become payable in certain circumstances and can be substantial. For example, many developed countries provided substantial guarantees to their banking systems during the financial crisis in 2008, which could have resulted in very significant higher cash outflows if the banks concerned had failed.

Despite that, issuing guarantees and indemnities can be a good use of the public balance sheet, taking on risk to encourage economic activity and development that might not otherwise be possible.

## UK

The UK's public balance sheet contains significant risks. This includes losses on its investments in nationalised banks (see Table 6) and significant uncertainties relating to nuclear decommissioning liabilities (see Table 14).

In comparison, quantified contingent liabilities are relatively small in comparison with the size of the overall balance sheet, as shown in Table 16.

Unquantified contingent liabilities include exposures to further failures of private sector pensions plans guaranteed by the National Protection Funding, reinsurance cover provided for terrorist incidents, civil nuclear exposures and litigation risks.

**Table 16 - UK contingencies**

At 31 March 2016	£bn	/ GDP
Taxes subject to challenge	(49)	(2.6%)
Guarantees and insurance	(12)	(0.6%)
Clinical negligence	(27)	(1.4%)
Other exposures	(16)	(0.8%)
<b>CONTINGENT LIABILITIES</b>	<b>(104)</b>	<b>(5.4%)</b>
Guarantees	(69)	(3.6%)
Indemnities	(16)	(0.8%)
<b>REMOTE CONTINGENCIES</b>	<b>(85)</b>	<b>(4.4%)</b>

Source: HM Treasury - Whole of Government Accounts 2015/16.

## AUSTRALIA

The Australian federal government's largest contingent liability relates to the Committed Liquidity Facility provided by the Reserve Bank of Australia to authorised banks as part of Australia's implementation of the Basel III accord that requires banks to have increased levels of liquidity.

Guarantees and indemnities relate to infrastructure and other projects by the federal government, but do not include projects guaranteed by state and territory governments or by local authorities.

**Table 17 - Australia contingencies**

At 31 June 2016	A\$bn	/ GDP
Committed Liquidity Facility	(224)	(13.6%)
Guarantees and indemnities	(14)	(0.8%)
International institutions	(19)	(1.3%)
Litigation and other risks	(5)	(0.3%)
<b>CONTINGENT LIABILITIES</b>	<b>(262)</b>	<b>(15.9%)</b>

Source: Commonwealth of Australia financial statements 2015/16.

## INSIGHT

Risk management is about more than just addressing known risks. Governments can also choose to take on risk to advance their policy objectives.

# *Manage your balance sheet before it manages you*

## INSIGHT

Governments with growing economies can and do operate with relatively high levels of negative equity.

But, the higher the level of negative equity, the more vulnerable they are to potential adverse economic shocks.

**Many developed countries have significant liabilities in excess of their assets in their public balance sheets. The UK, for example, has net liabilities of £2tn.**

Despite this 'negative equity', most countries are able to borrow as needed to fund their operations and investment needs. This is because of an unmeasured intangible asset - their sovereign ability to raise taxes from the population into the future.

This market confidence explains why most governments in developed countries can continue to borrow very cheaply, while developing countries without significant natural resources pay much higher rates to obtain funding.

Although beneficial for the governments concerned, the ability to obtain funds as needed has meant that governments have not been subject to the same pressures as businesses or other organisations to manage their balance sheets effectively.

As more governments start to prepare accruals-based financial statements, there is starting to be a real opportunity to embed balance sheet management into public sector financial governance.

Assets are resources that can be used to generate a return - whether financial or social. Governments need to ask whether they are getting the returns they need or ask if the money invested could be better used elsewhere?

Liabilities need to be serviced or settled, taking money from other priorities and constraining the ability of governments to provide public services and support their citizens. Governments need to ask whether they can reduce their existing liabilities and how they limit the growth of new liabilities.

If both assets and liabilities can be managed more effectively, then resources can be targeted at where they can do the most good.

Fortunately technological advances are going to make the preparation, consolidation and audit of government integrated financial statements easier. Distributed ledger technology has the potential to overcome data quality and structure issues. Investment will be needed, but in the future more and more governments will be able to quickly and accurately produce a balance sheet.

It is, therefore, important that policymakers, and those holding policymakers to account (including parliaments and assemblies), make managing the public balance sheet a key priority for financial management and governance.

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## *Key insights*

- Balance sheets can help improve financial management - but only if governments know what is in them.
- Once you can report your public balance sheet, you can start to use it to support decision-making.
- Asset management and capital investment systems and processes are rare in the public sector. Could they help direct investment to where it is needed most?
- Measuring the financial and social returns obtained from investments in infrastructure and other assets would help governments to make choices about how they invest.
- Financial investments should benefit governments by providing financial returns in excess of the cost of debt used to finance them. But without clear reporting, how would they know?
- More attention needs to be focused on debt management strategies, which can have a very significant impact on the long-term cost of finance for those countries with large debt burdens. Debt management strategies need to be continually updated and reviewed as the economic environment can change rapidly.
- Decisions in the 20<sup>th</sup> century to provide defined benefit pensions to public sector employees have resulted in very large liabilities being built up. Integrated financial statements shine a light on these liabilities and provoke the question: are they affordable?
- Long-term liabilities constrain governments by obligating them to pay cash in the future in preference to other policy choices, reducing the opportunity to cut taxes or to use money for other priorities.
- Risk management is about more than just addressing known risks. Governments can also choose to take on risk to advance their policy objectives.
- Governments with growing economies can and do operate with relatively high levels of negative equity. But, the higher the level of negative equity, the more vulnerable they are to potential adverse economic shocks.

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