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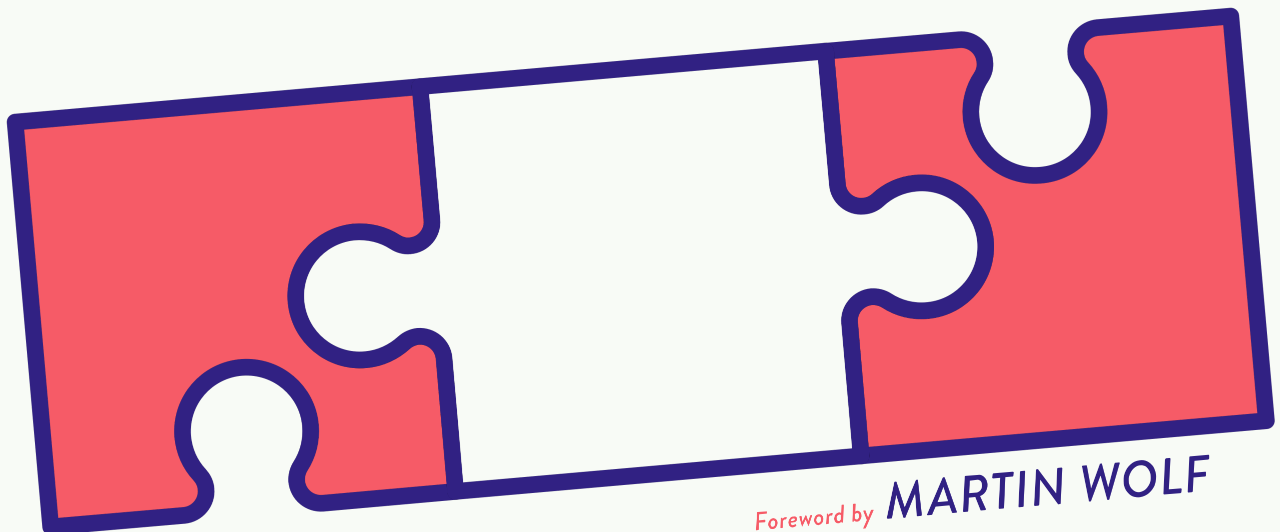

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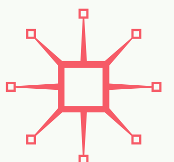

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Foreword

If something is to count, it must first be counted. That is the lesson of this important book.

This is not true, of course, of everything that matters in human life. Many things lie beyond measurement: a child's smile, a parent's love, a widower's grief. But when it comes to contemporary life, numbers are essential: without counting, we could not have modern science; without accounts, we could have neither thriving businesses nor transparent states.

No contemporary institution is more important than the state. In high-income democracies, governments spend up to half of gross domestic product. They provide defence, justice, education, and health, offer insurance against individual and collective risks, redistribute from rich to poor and across generations, fund and build infrastructure, set standards, and regulate almost every aspect of their people's lives. Specialised state institutions perform many other functions, including control over money and monetary policy. Surprisingly perhaps the "neo-liberal" era diminished neither the roles states play nor their expense in any significant way: they remain omni-present.

Yet, as the authors of this book point out, virtually all democratic states, notably including the most important, provide grossly inadequate information, especially financial information, on their activities. Above all, they ignore their balance sheets, in ways that would certainly not be permitted for private businesses. They focus, instead, on their revenues,

expenditures, and market debt, with a single year's gross domestic product used to provide context.

These conventions ignore public assets and most liabilities. This ignorance, in turn, causes huge problems: it makes it hard to evaluate the state's solvency; it obscures the distinction between borrowing to finance consumption and to create valuable long-term assets, and it underplays the implications of expensive long-term spending commitments, such as public sector pensions. This ignorance makes it impossible to manage public sector assets effectively. As a result, opportunities to generate valuable resources for the state are wasted.

The solutions, assert the authors, include the adoption of modern accounting standards, with full balance sheets and accrual accounting. Only once this is done, will it be possible to manage public assets and liabilities successfully.

The implications are potentially radical. It is clear, for example, that long-term solvency demands huge fiscal adjustments in many countries, notably including the US and UK. This is, no doubt, one of the reasons why governments do not want to show the level of transparency that they demand of the private sector.

A better justification for not proceeding with full accounting of the state's financial condition might be that there are so many inescapable uncertainties: discount rates are uncertain, for example, as are future rates of economic growth and demographic developments; and even more uncertain are the chances and consequences of shocks, such as pandemics, wars, and financial crises. Also significant are difficulties in valuing assets, such as non-commercial property, museums, and other civic amenities, or many forms of infrastructure. Important, too, is the reality that some assets are hard to realise or may be impossible to realise at all.

Yet these difficulties, while real, are a poor excuse for not making the effort. The fact that something is hard to value does not mean it can be ignored. Obviously, the effort must be made intelligently, with account duly taken of relevant distinctions, such as those between liquid and illiquid assets or between fixed and adjustable commitments. The British government's efforts to calculate the output of public services are a perfect example of what is both difficult to do and important to attempt.

It is always far better to be roughly right than to be precisely wrong. Ignoring reality, because it is hard to take everything into account, is a big mistake, because it will understate both the risks and the opportunities, probably dramatically so. Only the truth, however difficult that may be to reach, can free us from such errors.

This book is a call for sensible change. It should be answered.

Chief Economics Commentator, Financial Times Martin Wolf
London, UK

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We could not have completed this book without the invaluable data from the IMF and the work done by Vitor Gaspar and his team at the Fiscal Affairs Department, first published in the Fiscal Monitor on Public Wealth 2018 and subsequently updated in the Public Sector Balance Sheet database. Also, the data on the UK economy was analysed by Richard Hughes and his team at the Office for Budget Responsibility and by the Office for National Statistics has been most valuable. We are also grateful to the New Zealand Treasury for allowing us to include extracts of their published material.

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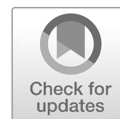
Part I

Purpose and Prologue



1

Purpose and Prologue

1.1 Owning and Owing

The balance sheet – a point-in-time assessment of assets and liabilities – has been at the heart of human decision-making since we developed laws to define what we own and what we owe. We see this in Greek legends, Sumerian clay tablets, the parables of Jesus, the predatory record-gathering of William the Conqueror, the novels of Jane Austen.

As individuals many of our most important financial decisions are about how we manage our personal balance sheets. For example, buying a home; financing education; saving for retirement; providing resources for children or grandchildren. Personal balance sheet information in turn becomes the basis for interactions with mortgage providers, tax authorities, social service providers and divorce lawyers – all of whom can exert significant influence over our lives.

For businesses functioning in a market economy, the balance sheet becomes still more central. It is the financial expression of all that has gone before, and a major determinant of what future paths can be followed. Without an up-to-date, precise understanding of assets and liabilities, a company cannot access the capital that it needs to develop new activities. Worse, the company's stakeholders – owners, employees,

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customers, suppliers, creditors and communities – will not have the information that they need to interact safely with the company. These matters are so important that accurate, timely financial reporting is a universal requirement of company law and subject to extensive regulatory oversight by governments.

There are, of course, arguments that government is different, and that the simple rules that apply to households and companies should not apply. We agree that government is different – but only up to a point.

Governments have unique responsibilities for acting in ways that cannot be addressed by the actions of other economic agents: for example, in applying fiscal policy to create demand at times of recession; of being the lender or guarantor of last resort at times of financial crisis; of mobilising the resources necessary to meet the health needs of ageing populations, or of addressing, or averting, the consequences of climate change.

But none of these functions can be performed by governments unless they enjoy the trust of counterparties and markets that they can deliver on their commitments, and that the money that they issue has value. If that confidence is lost, then financial and monetary systemic collapse are not far behind. Having a strong balance sheet is the bedrock of effective government.

1.2 The Question at the Heart of Government Finance…Where Is the Balance Sheet?

The scale and scope of governments – especially national governments – far exceeds that of even the biggest companies. In advanced economies, governments typically account for 40–50+% of GDP and so employ a large proportion of their country's current and capital resources. How governments fund their activities – from current revenues, borrowings or money creation – determines whether the costs are borne by current or future generations and in what way. Moreover, governments are a huge factor in individuals' balance sheets; private sector pension entitlements are often underpinned by government debt; public sector pensions are direct government obligations.

Yet despite the centrality of a government's finances to the lives of all its citizens, many governments do not produce full financial statements. In effect, they exempt themselves from the reporting obligations that they place on much less important private or public sector bodies. Those that do produce accounts often publish them far too late to be of practical use, or without important information about the value of the assets that governments are employing. And very few countries – perhaps only one – put the balance sheet at the heart of government financial decision-making.

So, government accounting practices are anomalous. The biggest economic agents are financially the least well understood. But what exactly is the problem? Why does it matter? What can we do about it, and what can we expect to achieve?

Exploring these questions is the purpose of this book.

1.3 The Importance of History, and Historical Importance

Our approach to addressing these issues is grounded in history. There are several reasons for this.

First, questions about how governments finance themselves have been around for as long as governments themselves: no government superstructure can exist without finding a means to extract an economic surplus to support its activity. Taxation, borrowing, episodic plundering or systematic colonial exploitation have all featured in many forms in the hundreds of polities, and over the thousands of years, for which we have records. Success in organising public finances might not be a sufficient condition for success as a political entity, but it certainly is a necessary condition. The ability of states through history to adapt (or to fail to adapt) to dynamic change in the demands made on their finances may offer important lessons for the present.

Second, the present challenges facing government finances around the world are rooted in financial management frameworks that are hundreds of years old. Yet the large majority of government activities that they support – the modern welfare state – are much more recent in conception and are continually expanding in scope. This is due in part to the success of the

welfare state in improving longevity, and in part to increased expectations about what the state can or should provide. Our thesis is that the traditional frameworks fall far short of what is required to manage government finances, whether in terms of ensuring long term sustainability, efficiency in management of resources, or intergenerational fairness. Adopting "proper" accounting practices, and putting accounts at the heart of government decision-making, is an essential step in bringing government financial management from the eighteenth to the twenty-first century.

Third, the problems that we are describing affect the world's most advanced economies, including many of the world's largest. Instability in the government finances of major economies – whether expressed through default or monetary collapse – would have major effects on the global economic and financial systems, and even more profound effects on the populations of those countries most directly affected. The broader consequences are unknowable, but would surely be of great historical significance, and not in a good way.

1.4 Why Accounting Is Important for Democracy

A recurring theme of this book is that democratic political processes might not be (or have been) effective in assessing long-term (often intergenerational) matters when taking short term fiscal decisions. This should not be interpreted as a suggestion that alternative forms of government might work better; this would be as repugnant to the authors in principle as it would be unsupported by evidence that autocracies promote better long-term government.

Effective democracy is centred on stimulating a critical debate between multiple competing political entities. But however fair and well-informed the debate, the weight that will be ascribed to its various elements – and by implication, the value associated with short- versus long-term costs and benefits – will be determined by the electorate, over 4- to 5-year electoral cycles. Immediate and broadly relevant factors (tax rates, hospital waiting lists, the cost of living) are likely to take precedence over longer term, more abstract concepts (sustainability of the retirement age, healthcare inflation).

This is not to suggest that electorates or politicians are incapable of taking long-term views, or of making, or advocating, near-term sacrifices in support of these positions. Widespread support across many democratic nations for measures to address global warming demonstrates this point, though it also demonstrates the difficulty of eliciting present sacrifices necessary to meet future targets in full.

To "sell" the electorate on long-term issues like sustainability of public finances, politicians need to establish the long-term problem and the near-term measures to address it, and targets that will define being on track.

The key political test will be: can the democratic process lead to the adoption of much higher taxes, or a substantial change in expectations about public services, especially in countries like the UK and US which have persistently failed to make such adjustments in the past? And as the task gets harder each year, will there be a point of no return, at which radical, disruptive change is forced upon governments through extreme financial stress? And what would the consequences of such a disaster be for democratic government?

Better government accounting, and better use of that accounting, can make a key contribution to putting democratic states back on the path to fiscal sustainability, by identifying emerging problems; by providing policy tools that can ensure that government finances stay within safe limits; and by making intergenerational choices about the allocation of benefits and costs more explicit.

Following through on the opportunities that accounting will highlight will also allow much better scrutiny of the uses to which public assets are put, and will provide information to managers about how best to deliver public services efficiently and effectively. Similarly, accounting will allow better understanding and management of liabilities – including the very large, long-term obligations (for example, pensions or nuclear decommissioning) – which are largely ignored by conventional government financial measures, yet have a direct effect on long-term government finances. The opportunities for improvement in this area are of similar magnitude to the long-term challenges that we face.

Accounting is about transparency and efficiency, which are essential to a successful democracy.

1.5 Eighteenth Century Tools, Twenty-First Century Fiscal Rules

Despite the enormous sums involved, and the complexity of the decisions that governments need to make, the large majority of governments use very simple financial tools to guide their financial decisions.

Typically, two metrics are employed: a measure of the relationship between income and expenditure in a given year (the fiscal deficit/surplus) and a measure of the total amount of government financial debt. These might or might not be embedded in formal "fiscal rules", which we discuss in Chap. 11. To provide a sense of proportion, both are often expressed as percentages of GDP. And to demonstrate sustainability, governments typically offer multi-year forecasts of income, expenditure and anticipated financing activity.

These metrics have several attractions. They are relatively easy to understand and to measure – at least at nominal value (which can itself misrepresent the "true" value of liabilities, a point which has long been understood by the accounting profession). They also allow for relatively straightforward comparisons between national government finances. This is especially important within the European Union and Eurozone, where fiscal rules based along these lines are central to maintaining overall financial stability and "fairness" between member states.

However, there are two big shortcomings with this approach.

First, there is no recognition of the difference between government spending on investment versus consumption. So, purchasing assets which will generate future benefits has exactly the same impact on the fiscal surplus or deficit and on financial debt as spending (say) on social security. At best, distinguishing between current and capital expenditure is covered by second order fiscal rules and largely ignored by policymakers or financial markets.

Second, and more profoundly, it ignores the existence of a government balance sheet. Other liabilities such as public sector pensions are completely excluded from the framework though in some cases they exceed government financial debt. In the same way that asset formation is effectively ignored in measures of expenditure, balance sheet assets are also excluded. Yet as we shall discuss, governments have very large asset holdings, often exceeding total financial debt in magnitude. Taken together,

this means that "net worth" – the difference between total assets and total liabilities, the basic measure of wealth – tends not to feature in a government's assessment of its financial position or performance.

Failing to measure net worth creates several problems. It obscures a government's true financial position, potentially increasing its cost of borrowing (especially in crisis situations, which are more likely to occur without good financial information). It creates a disincentive for public sector investment, as in the absence of a net worth measure, there is no way to capture the effects of investment on the government's balance sheet. More broadly, it deprives society of a key measure of intergenerational fairness, as periodic assessments of net worth provide a measure of whether the government is saving or consuming resources.

As we have suggested, this is especially important in a world where governments are the primary providers of post-retirement benefits.

At an aggregate level, all this might not matter very much as long as governments are living comfortably within their capacity to tax and borrow. However, sooner or later those governments with the most comprehensive systems of welfare provision would be likely to reach the point where the traditional measures of government finances cease to provide an adequate picture of financial viability. This would have serious consequences for the financial health of the state, for intergenerational fairness, or both.

Unfortunately, recent events have sharply increased the near-term pressure on government finances. The confluence of events often referred to as the Global Financial Crisis led to sharp increases in government financial debt. The subsequent response to COVID-19 has had a similar effect. In both cases, the slow economic recoveries experienced in many western countries have protracted plans to return financial debt to more traditional levels (in absolute terms or relative to GDP).

The need to meet zero carbon targets implies further pressure to come on government balance sheets as does the impact of ageing populations.

By adopting improved financial management tools, based on proper management of the balance sheet, governments can maximise their financial capacity, and manage safely within the limits that financial markets and other stakeholders will allow. The time to do this is before the next crisis strikes.

1.6 Credit Risk or Inflation Risk? What Happens When Government Finances Go Wrong

Part of the challenge we face in describing how the public sector balance sheet works and why it matters is that what happens when finances go awry is rather different for a modern government than for a corporation. This is because most governments (or rather, their central banks), issue their own currency. In the absence of legal constraints (for example, a "debt ceiling" embedded in law), governments can meet financial obligations by printing money. This is a relatively recent phenomenon; until the 1920–1930s money was typically backed by central bank gold, and the post-war Bretton Woods system of fixed exchange rates placed similar constraints on national finances. It is also not universally true; Eurozone countries operate on the basis of a currency that is controlled by a supranational central bank which brings the credit risk of individual countries into much sharper focus.

The consequence is that for many countries, shortfalls in financial resources to meet (domestic currency) obligations can usually be resolved through the printing press. Inflation, rather than a classic credit default, is the likely result.

This might sound like a solvable problem. Most inflationary episodes can be addressed through restrictive monetary policy. An overheated labour market can be cooled; unemployment restored (usually with some overshoot) to a level at which wages are stable. Throw in some Rational Expectations (a theory which posits that economic agents make decisions based upon all available information, including about how other agents are likely to react) and the adjustment process will be quicker. Independent central banks with predictable inflation targets and monetary policies are designed to make this process as smooth, and as self-fulfilling, as possible.

The problem is that when inflation is the result of printing money because the markets won't lend it any more, then there is no such self-correcting mechanism. Inflation is ever-accelerating. When money is seen to be without value, and government guarantees of no worth, then the impacts on economic activity, and on personal and public wealth, are catastrophic.

1.7 Delivering Better Public Services, More Efficiently

As we have said, embracing accounting in government is not just about promoting a better understanding of the overall fiscal position, it also provides insights that can improve the effectiveness and efficiency with which government is delivered.

First, the focus on net worth as a key balance sheet metric ensures that government borrowing to finance assets that have an accounting value equal to their cost has an initially neutral effect. The increased borrowing might be in violation of traditional fiscal rules, but would have no immediate adverse effect under a net worth rule.

Second, a focus on government assets is likely to lead to the "recognition" of much currently unaccounted-for public wealth, especially real estate (resulting in stronger balance sheets than previously thought), and also to expose opportunities for more efficient management of these assets. These themes – including a detailed discussion of how better to manage public commercial assets – are addressed further in Chaps. 12, 13, 14, 15 and 16.

Third, "proper" accounting treats all liabilities – debt and non-debt – equally. This has important implications for the management of public sector pension obligations, which are very often unfunded, and which can often exceed financial debt in scale.[1] Current fiscal rules typically allow these to be ignored; they do not figure in EU debt-to-GDP borrowing rules, for example. A focus on net worth brings these very large liabilities into scope of government financial management. This will offer opportunities to begin funding liabilities through a sovereign wealth fund or similar: raising financial debt to invest in higher return assets will be neutral to net worth initially, but will be net positive as returns are realised. Also, a more diversified, financial asset-rich balance sheet is likely to be more resilient, for a given level of net worth. This is discussed further in Chap. 17.

1.8 Which Balance Sheet Are We Talking About?

Through most of this book we make reference to the "government balance sheet" as a general concept. However, this term can have various meanings and it is worth exploring these.

As its name suggests, the Central Government Balance Sheet describes those assets and liabilities which are owned or owed directly by the national government and includes public corporations owned or under the control of the central government. Central Government is important for the goals of this book because of the scale and influence of national governments; if accounting-driven financial management is implemented at this level, then a great deal of what we believe is required will have been accomplished. Central Government is also important as it is the focus of national fiscal policy debate and budgetary actions.

General Government comprises the governmental functions carried out at central plus regional (or state) and local government levels, but does not include the functions of public corporations (which are commercial rather than governmental in nature). The relative scale of central and subnational levels of government varies widely between countries, and the amount of influence that national governments exert over subordinate levels of government will also vary, and may be highly controversial (the US Civil War of 1861–1865 offers an extreme example). So General Government accounts will describe a more complete picture of overall national finances, but might well include activities over which the national government does not exercise control, and will exclude activities carried out by public corporations at all levels of government.

The broadest description of a government's financial position is to be found in the Public Sector Balance Sheet, which adds assets and liabilities from public corporations at all levels of government to those of General Government, to create an overall picture of what is owned and owed by the state. As such, it provides the most complete picture of the "government" financial position, even if it is not managed as a single political or economic unit. It is, however, a useful vantage point from which to assess fiscal sustainability or intergenerational fairness, which are major concerns of this book.

1.9 Why the G7 Focus?

The principles that we are advocating, and the opportunities that they offer for better government, are applicable to governments at all levels, and across all countries; in Chaps. 15 and 16 we look at situations where effective asset management has been central to economic development at a national and local level. But much of the work that we present on government balance sheets and the sustainability of fiscal and policy choices focuses on the G7 countries (see Chaps. 9 and 10). There are three reasons for this.

First, the G7 countries all have high per capita incomes, relatively low economic growth rates, and ageing populations (though over the longer term there is a fairly wide variance of demographic projections). All have extensive (and expensive) systems for delivering healthcare and social security to their populations, which arguably provide aspirational models for less economically developed countries.

Second, these are all big economies, which play an important role in the global economic and financial system. A loss of confidence in the ability of governments in any one of these countries to meet financial commitments would have very serious repercussions indeed. To borrow from the lexicon of "macroprudential" financial regulation, these are all Global Systemically Important countries.

Third, and worryingly, the group has experienced steady deterioration in net worth – the basic indicator of balance sheet strength – to the point where today, only two G7 countries have positive public sector net worth based upon available accounting information (on the narrower General Government measure, only one G7 country has positive net worth). The position has worsened in recent years, with responses to the Global Financial Crisis and the COVID-19 pandemic leading to substantial increases in debt levels. Looking forward, it is clear that all will need to make substantial adjustments to their fiscal position in order to remain solvent. This is particularly true for the US and the UK, where the government's tax take as a percentage of GDP is relatively low, and the required increase correspondingly greater; for example, the European members of the G7 will require less adjustment.

Therefore, the G7 members are amongst those countries which face the greatest challenges created by financial systems and fiscal rules which fail properly to account for, or manage, government assets and liabilities. If the political systems in the G7 countries were to fail to respond to these challenges, the consequences for the wider world would be very severe indeed.

1.10 Conclusion

This chapter has been a very brief review of the issues that this book is intended to address, and how we go about that task.

Subsequent chapters will provide more historical context, discuss how proper accounting should be incorporated within a government financial decision-making framework, examine the quantitative evidence, and set out practical solutions that governments can put in place now to capture the benefits of better financial management in a financially-stressed world. Our goal will be to establish the following points:

- The development of the welfare state since the late 19th century, and its expansion over the last three generations, has greatly expanded the scale and complexity of government, and the demands on government finances and financial management.
- Almost all governments do not employ the readily-available accounting tools which in all other areas of organised human activity are deemed essential to efficiency, transparency and financial sustainability.
- In particular, governments ignore the principles of accrual accounting, which is centred on the balance sheet and net worth, and focus their attention on cash measures – annual deficits and surpluses, borrowing and debt. This distorts decision-making and provides a misleading picture of financial health.
- Governments also pay little attention to the long-term consequences of policy decisions on their costs or revenues, with potentially very serious consequences for financial stability or intergenerational fairness.

- The best available information suggests that despite three generations of relative peace for G7 nations, the financial position of these countries is weak and deteriorating, with major challenges to come. This poses a threat to political and economic stability, at a national and global level.
- By adopting accrual accounting and fully understanding – and disclosing – assets and liabilities, governments can measure their financial position more accurately and completely, and can better incorporate long-term projections of costs and revenues into their fiscal policies.
- Better accounting will also unlock tools for improved financial management of assets and liabilities. The benefits of these might match or exceed current projections of "fiscal adjustment" required in G7 countries – and hence could remove the need for substantial future increases in taxation or reductions in service provision.
- Accounting-driven management should be embedded in the institutions of government, and in the way that politicians, civil servants and the electorate think about public finances. This process must begin soon.

Note

1. E.g., the UK – see UK Whole of Government Accounts 2019–2020; June 2022.