



How Smart Public Assets Management Can Drive the Post-COVID-19 Recovery

Countries need cash to survive the fallout from COVID-19. By tapping hidden value in their balance sheets, they can exit the crisis faster and more sustainably. But success depends on strong political will, writes Hanan Amin-Salem, Ian Ball, Dag Detter and David Walker.



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What does 'generating value from the balance sheet' mean in practice for the public sector? Governments everywhere and at every level own a vast array of commercial assets. According to the IMF, the value of public assets globally is twice that of global stock markets, twice global GDP and much larger than public debt.¹ However, unlike listed equity assets, this public wealth is often unaudited, unsupervised, and unregulated. Even worse, in most countries it is almost entirely unaccounted for.

As a consequence, when formulating their budgets, most governments largely ignore the assets they own and fail to recognize that they could generate substantial yields that open up much-needed fiscal space. Governments could use this headroom to kick-start growth or to buffer themselves from future shocks, without resorting to debt, exhausting existing savings, or being forced to revert to excessively painful austerity measures.

However, incentives to encourage policymakers to take into account the full spectrum of public commercial assets – such that the whole public sector balance sheet can be marshalled to achieving economic recovery – are often missing. Basic tools such as accrual accounting, that are fundamental building blocks to bring about greater transparency and disclosure (of benefits as well as costs), can enable governments to pursue optimal decisions with respect to the management of public assets, benefiting society. Yet these tools are often overlooked. Is the COVID-19 crisis enough to induce governments to finally act?

What is not measured does not count

Cash accounting focuses on a few narrow and unrepresentative numbers; it has led to chronic under-investment in, and under-management of, valuable publicly owned assets. Accrual accounting is consistent with the IMF economic framework for fiscal policymaking; it is almost two decades since the IMF shifted its manual for Government Finance Statistics (GFS) from a cash to an accrual basis. Many countries are following suit, with the Chartered Institute of Public Finance and Accountancy (CIPFA) and the International Federation of Accountants (IFAC) predicting that almost two-thirds of governments around the world will have moved to accrual-based accounting within the next five years.²

But even when countries make such a change to their accounting systems, they often do not go far enough to reap the full benefits. They fail to use the information those systems produce in their fiscal decision making. Why?

In most cases, the political will required to manage public assets better – to provide full disclosure of these assets and to create the incentives to encourage policymakers to act – has been lacking, as the immediate gains were not obvious. In the current urgent circumstances, with so many lives and livelihoods at stake, the case for better stewardship of public assets could not be more pressing.

Why incentives matter

In any organization, including a public financial management (PFM) system, decision makers respond to a broad set of incentives. It is therefore critical that incentives are designed to encourage the right decisions and actions.

Key decisions and actions within a PFM system include:

- major financial and other policy decisions, such as privatizations;
- resource allocation decisions, whether capital or operating;
- revenue-raising decisions;
- financial control decisions in an operating context; and
- asset management decisions.

Incentives should encourage decisions that are aligned both across an organization as well as vertically. For example, fiscally-responsible decisions at an aggregate level should be supported by efficient management of service delivery, including asset utilization, at the operational level.

There are, of course, a wide range of factors that create incentives for better – or worse – decisions. These include governance arrangements, transparency requirements, budget systems, processes and rules, assignment of authority for budget and spending decisions. These incentives may be formal or informal. For a fiscal management system, key incentives relate to how financial performance (flows) and financial position (stocks) are defined and measured.

The goal is to align the interests of managers, investors, financial intermediaries, politicians and the general public. Key to this is the use of measures that reflect performance and position in a comprehensive and reliable manner – this is where proper accounting comes in. ‘Proper’ in this context means accounting that fully reflects all revenues and expenses, as well as the range of physical and financial assets and liabilities. Where key decisions are made on the basis of

Capital charge

A perennial problem of financial management in the public sector is poor asset utilization, which can be most obviously seen in decaying infrastructure. An incentive for better management can be created through the use of a capital charge, which requires government organizations to meet the cost of the capital they employ. The charge rate reflects the opportunity cost to taxpayers of having resources invested in government assets. For example, the New Zealand Government levies a charge of 6% of the net worth (assets less liabilities) of their departments.

This means the measured cost of services includes all costs, and so is better able to be compared with alternative external providers, and it also provides departments with an incentive to dispose of assets that are not productive and to better manage the structure of their balance sheets.

information only about cash flows and debt, there is an incentive to substitute future cash inflows for present ones given the political significance of reported current performance. Perhaps the worst example of this is where future pension benefits are substituted for current wages, which subsequently has the effect of building ever-increasing liabilities that can, ultimately, become unsustainable. Were the performance measures to recognize the incurrence of liabilities, rather than just the cash outlay, the costs of pensions would be recognized in the year the work was done, rather than the year the pension was paid. The consequences of basing key financial decisions on cash flows can be seen in the pension problems faced by many governments.

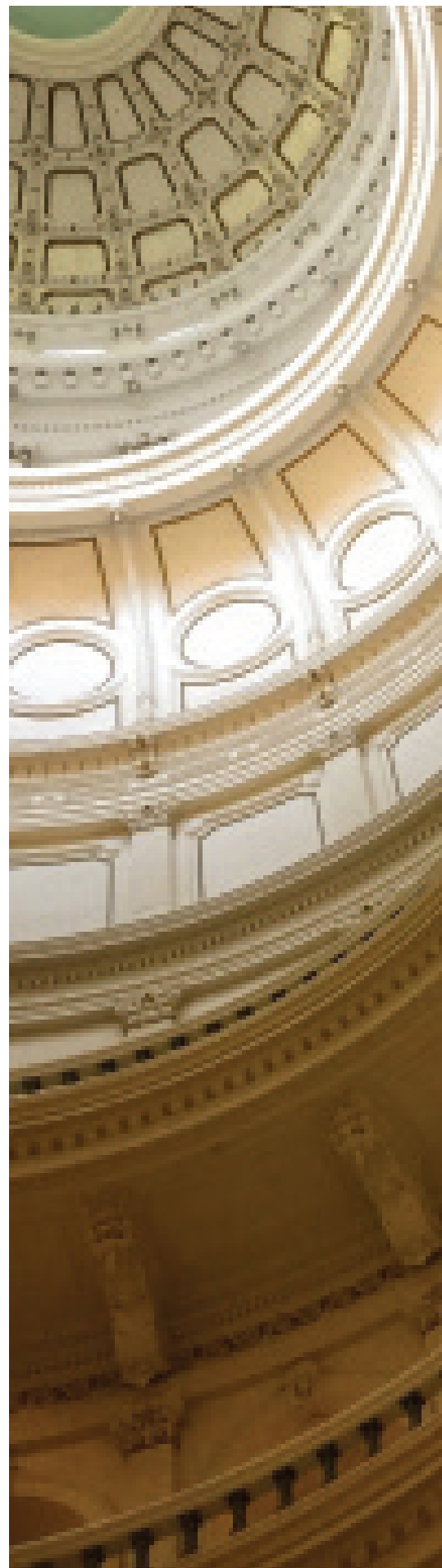
Accrual based-budgeting: The missing link

The current status of accounting within the PFM systems of governments can be characterized as follows:

- many governments budget, make appropriations and report on a cash basis;
- some governments budget and appropriate on a cash basis, but then report on an accrual basis;
- relatively few budget and report on an accrual basis, but appropriate on a cash basis;
- virtually none budget, appropriate and report on an accrual basis.

The decoupling that occurs with accrual reporting and cash-based budgeting largely defeats the purpose of moving to accruals. In order to achieve the right incentives and signals, it is necessary to align the concepts and metrics used in reporting (ex-post) on performance, and those used in stating the expectations (ex-ante) – budgets and appropriations. Budgets and appropriations cannot fully reflect the resources used by governments unless they are also on an accrual basis and capture all the assets and liabilities on the government's balance sheet. In effect, a PFM system that is based only on cash flows and debt ignores critical assets (especially physical assets) and non-debt liabilities (such as public sector pensions) and is therefore inadequate for managing the complex financial operations of modern government.

Those governments that have progressed to reporting on an accrual basis but still budget and/or make appropriations on a cash basis face two significant problems. First, their reporting does not align with their budgeting and appropriations, creating misaligned signals and incentives and, frequently, a sense that the move to accrual reporting was not worth the effort. Second, and more importantly, their budgets and hence their operational decision making continue to effectively ignore the management of assets and liabilities that are not cash or debt. In contrast when budgets are on an accrual basis, it is possible to get a clearer view of the real cost of providing services – which includes such non-cash elements as depreciation or asset impairment – and this in turn provides a more economically realistic picture of value for money, enabling comparison with the cost of providing similar services from an alternative supplier. Such comparisons provide an incentive to consider the value for money of the specific service, encouraging a greater focus on operational efficiency.



New Zealand and COVID-19

The New Zealand Government has had a PFM system with accrual numbers at its core for three decades. During that time, its fiscal position has progressively strengthened (apart from the four years following the global financial crisis and the Canterbury earthquakes) from a position of negative net worth to one, just prior to COVID-19, where net worth was equivalent to just under 50% of GDP.

The Government's COVID-19 strategy took advantage of the strong fiscal position to "Go early, go hard", leading to the effective elimination of the disease and less than thirty deaths. A strong balance sheet, a good health system and a competent state sector have dramatically contained the human impact of the pandemic.

Making major financial decisions and budgeting on the basis of accrual information enables decision makers to see the planned impact of a year's activities on the net worth of the government – net worth being the most comprehensive measure of fiscal position. For example, a privatization might enable the reduction of debt relative to GDP; however, unless the asset is sold for more than its balance sheet value, the privatization will reduce net worth and the government's balance sheet strength.

The value of a balance sheet approach to fiscal decision making is increasingly being recognized. The work of the IMF, reported in the October 2018 Fiscal Monitor, was a major step forward in this respect.

One of the significant potential benefits of using accrual accounting and a balance sheet approach to public financial management is the attention it focuses on the assets on a government's balance sheet, encouraging more reliable information on what assets the government owns and what those assets are worth, and better systems of asset management.

In response to COVID-19, governments have taken a greater role in their economies and increased the size of their balance sheets, yet their fiscal positions are more fragile than before. Under these circumstances, the value that can be extracted from the assets held by governments will become increasingly crucial, whether it is in the revenue generated by commercial assets or the services provided by assets that are held for public policy reasons.

Interacting with the private sector 'wall of money' on equal terms

The weight of international evidence is that government ownership is generally inefficient compared to private ownership in terms of corporate economic performance.³ On average, government-owned operational assets are a third less productive than private firms'.⁴ This diminished productivity hampers economic growth, creates waste, and tends to drive an overreliance on a narrow base of taxes as the major source of government revenues. The most reasonable explanation for the relative underperformance of government-owned operational assets lies in weak governance practices arising from opposing objectives, poor incentive structures, political interference and the lack of public scrutiny.



But if public assets – meaning public commercial assets, rather than public parks or historical heritage sites – were properly accounted for and professionally managed, they could potentially generate additional revenues worth 3% of GDP, boosting government budgets.⁵ Managing these assets better could help offset the growing debt problem facing many governments and support future economic growth, while the additional yields could help fund public goods such as public housing, health care and infrastructure, or even R&D to mitigate the impacts of climate change.

Realizing value from public assets

The largest segment of any portfolio of public commercial assets is real estate. Government-owned commercial real estate assets account for a significant portion of each country's land. But governments typically know about only a fraction of these properties, as they do not have a comprehensive list of the assets nor even a proper underlying cadaster or land registry, a system that defines the dimensions, locations and titles of all land parcels.⁶

Even in an economy such as the United States that is perceived as having a relatively small public sector, the indicative valuations of public real estate in urban areas is substantial. In the case of Pittsburgh, for example, the difference between book value and indicative value was 70 times, according to one analysis.⁷ If professionally managed, this real estate portfolio could generate an additional income well beyond what the city raises in taxes today.⁸

European countries have experimented with managing public wealth for a wide range of different purposes, and with varied results, for almost a century. Sweden became the first country in Europe to introduce active management of public assets with a clear financial purpose. Instead of wholesale privatization, the Swedish government decided to manage the

public portfolio “as if owned by private shareholders.”⁹ This Swedish experiment from 1998 to 2001 included introducing private sector discipline and an equity culture to the management of public assets, and boosted the value of the portfolio by 12% over the three-year period, or almost twice the growth of the local stock market during the same period, resulting not only in a better outcome from vital services but also a substantial dividend to the government, as well as a boost to economic growth.¹⁰

By deploying a similar model, Solidium, Finland's National Wealth Fund, has generated a total return on equity of 8% per annum, and the value of its equity holdings has increased from €5.5 billion to €5.7 billion since 2008, while €5.9 billion was paid as a dividend to the state during the same period.¹¹

At local government level, Hamburg and Copenhagen have both learnt lessons from MTR, the Hong Kong railway company that built an entire subway system the size of New York City by developing the properties adjacent to its stations rather than via taxes.¹² Through their respective Urban Wealth Funds, these two cities have developed tens of thousands of new residential housing units, hundreds of thousands of workspaces and education facilities, as well as new parks and retail and cultural facilities. With the financial surplus from its operations, Copenhagen was even able to help fund part of the extension of the local metro system. Similarly, London Continental Railways (LCR) and Jernhusen (in Sweden) have successfully developed areas around train stations in cities, without using taxes.

While most of these examples come from developed markets, the concept and operational steps are readily applicable to the emerging markets. As a prime example, professional use of public commercial assets was a core component of Singapore's strategy to move the economy from developing to developed status in a single generation.¹³



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How to manage public assets professionally

A public wealth fund (PWF), structured as an independent holding company, can be set up to manage commercial public assets. Using the same tools of financial management as the private sector, a PWF makes it possible for the government to maintain ownership and manage assets professionally, while interacting with the private sector on equal terms. It should emulate the best international standards of listed companies including those pertaining to corporate governance, transparency and incentive structures.

The PWF would serve as the conduit between public and private sector interests, enabling the two sides to speak the same language and to reach a consensus on objectives. It could help sidestep common problems seen with privatizations, PPPs and other financial techniques where the public sector seeks to avoid the commercial risk and debt associated with an investment, thereby giving up the financial upside resulting in an undue transfer of public wealth to the private sector. The structure might therefore help avoid the political backlash that often stems from the interface between the public and private sectors. The establishment of the holding company structure could also better attract private sector funds looking for yield, thereby drawing in the additional resources and expertise needed to help a country or a city develop.

In setting up a PWF, a government needs to pay special attention to three fundamental principles given the inherent weakness of public sector corporate governance, including:

- **Value maximization:** This must be the sole objective; additional objectives distort competition and open the door to financial failure, waste and corruption;
- **Promoting transparency:** Accounting, transparency, risk management and corporate governance standards should be identical to those for a listed holding company, including the adoption of IFRS accounting and the provision of timely quarterly and annual reports, made available online;
- **Ensuring political insulation:** The portfolio should be kept at arm's length from political influence, including avoiding political appointees at every level (as well as on the board and supervisory board levels). This arrangement serves as a protection and deniability for the politicians, if trouble arises. Commercial independence is also the best foundation to attract qualified people from the private sector. A market-based incentive system is vital, but a secondary consideration to a truly professional environment.

Once a PWF is established, its first task is to develop a feasibility study, or asset map, of the entire portfolio of public commercial assets within the relevant jurisdiction. Such an indicative valuation would give a rough understanding of the total value, as well as of the potential yield (assuming professional management), of the assets. The asset map should not take more than a few months to produce, as its main purpose is to create political momentum and a rough business plan.

Impact on sovereign ratings

Could better ratings (which could lead to reduced borrowing costs and potentially greater foreign investment) be a driver for policymakers to pursue the steps outlined in this article to improve the management of public commercial assets?

Unfortunately, the ratings methodologies of the three global rating agencies – S&P, Moody's Investors' Service, and Fitch Ratings – do not incorporate the net worth of the public sector, in large part because they do not have visibility into the full scope of the public sector balance sheet. Since governments do not produce a complete and consolidated picture of all their assets and liabilities, within the proper accounting framework to provide transparency, the agencies do not have the means to make an assessment.

As the rating agencies do not take public sector net worth into consideration in their assessments of sovereign creditworthiness, governments do not in turn produce balance sheets. This Catch-22 situation could potentially be overcome with an external push, perhaps exerted by the IMF were it to conclude that the full public sector balance sheet should be the proper basis for its debt sustainability analysis.

Nonetheless, better management of public assets could still help governments improve their ratings, albeit indirectly and in most cases over a long time span. It is also possible that producing a full set of financial statements could help avoid a downgrade, as was the case for New Zealand in 1991.

Conclusion

Comprehensive and relevant numbers are a prerequisite for financial management. A modern government is a highly complex institution that requires audited numbers and accrual accounting to ensure informed and sustainable long-term decision making and management. Moreover, using the hidden strength in their own balance sheets offers governments a better chance to achieve a sustainable and faster way out of the current crisis, to the benefit of society as a whole.

The hurdles to adoption of tools such as accrual accounting, and the political will to act on the information generated by such systems, has historically been lacking in most countries. For years, the price of inactivity and an absence of imagination in many countries could be discounted. However, the pressures created by the COVID-19 pandemic, which are likely to strain public finances for a generation, demand radical action. Given that the alternative in many countries could be a prolonged period of austerity, rethinking how governments view public assets is now a moral goal, as much as an economic one. Making this change will be difficult for governments in both developed and developing countries. But the evidence is clear: commercial management of assets by a PWF delivers material gains. This time of crisis calls for the most effective use of public assets – if not now, when? ■

¹ <https://www.imf.org/en/Publications/FM/Issues/2018/10/04/fiscal-monitor-october-2018>

² <https://www.ifac.org/news-events/2018-11/65-governments-globally-will-report-accrual-basis-2023-finds-new-report>

³ Megginson, W. and Netter, J. 2001. "From State to Market: A Survey of Empirical Studies on Privatization." *Journal of Economic Literature*, 39 (2): 321-389.

⁴ <https://www.imf.org/en/Publications/FM/Issues/2020/04/06/fiscal-monitor-april-2020>

⁵ <https://blogs.imf.org/2019/06/18/a-global-picture-of-public-wealth/>

⁶ <https://www.imf.org/external/pubs/ft/fandd/2018/03/pdf/detter.pdf>

⁷ Valuations made by Urban 3.

⁸ <https://www.imf.org/external/pubs/ft/fandd/2018/03/pdf/detter.pdf>

⁹ Financial Times, Nov 12 1999

¹⁰ Detter, D. and Fölster, S. (2015) *The Public Wealth of Nations*

¹¹ <https://solidium.studio.crasman.fi/file/dl/i/2DHkmA/j3nrOdWCYA-HZDZJiYjTIQ/Solidiumcorporatepresentation20200331.pdf>

¹² <https://www.mckinsey.com/industries/capital-projects-and-infrastructure/our-insights/the-rail-plus-property-model>

¹³ https://www.citibank.com/icg/docs/1883952_Perspectives_2019_Putting_Public_Assets_to_Work.pdf



