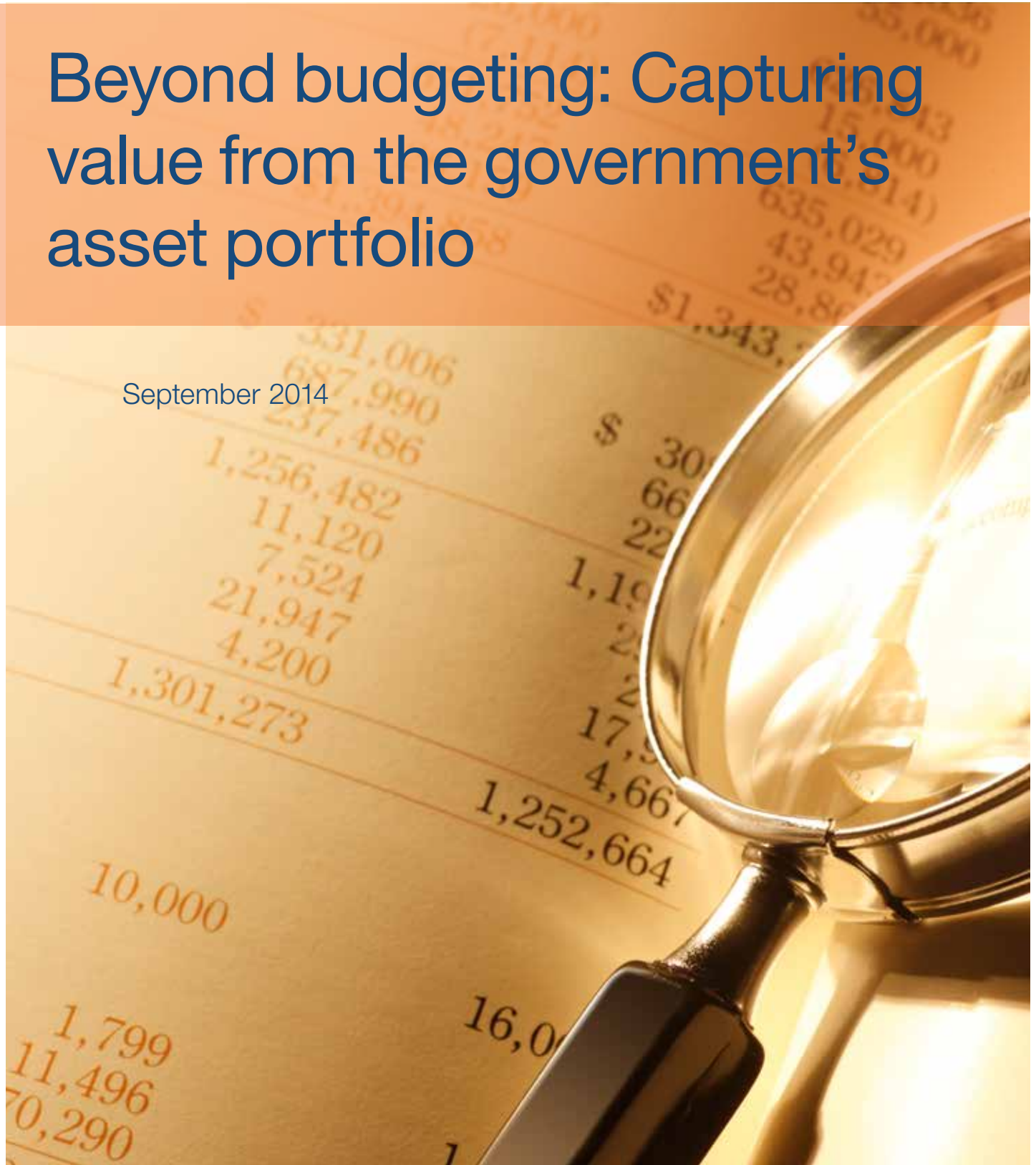


McKinsey Center for Government

# Beyond budgeting: Capturing value from the government's asset portfolio

September 2014



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McKinsey Center for Government

# Beyond budgeting: Capturing value from the government's asset portfolio

Andrew Grant  
David Skilling

September 2014



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## Introduction

Over the past two decades, governments have paid substantial attention to improving the process of allocating resources through the government budget as well as establishing institutions and rules to improve decision-making regarding the fiscal balance. Public and market scrutiny is also commonly focused on the annual budget and the level of public debt. Relatively little attention, however, has been paid to the management of government asset holdings. Indeed, Nobel Laureate Michael Spence noted recently that “The asset side of states’ balance sheets remain largely invisible”. Similarly, the Economist magazine observed that “governments often barely grasp the value locked up in [their assets]”.<sup>1</sup>

Just as a company focuses on its balance sheet as well as its profit and loss statement, so too governments can benefit from a structured examination of their portfolios of assets. For one thing, these asset holdings can be very substantial. The International Monetary Fund (IMF) reports that government assets are commonly between 50–100 per cent of GDP across many of the large, developed and emerging economies, and often significantly higher. To illustrate, productivity gains of just 1 per cent across the asset portfolio would lead to ongoing gains of around 1 per cent of GDP—which would have a significant effect on improving the structural fiscal balance.

The way in which government assets are managed therefore has significant consequences for both economic and fiscal performance. The ability to efficiently manage a large portfolio of assets will have a substantial impact on productivity and GDP, as well as on the fiscal balance and the government’s borrowing requirements. This is particularly important at this point in time, when many governments are facing significant fiscal and economic challenges. This is why we believe that the focus on government balance sheets will be central to the next generation of fiscal policy innovation.

We suggest that the governments consider three balance sheet-focused initiatives that have the potential to unlock significant amounts of value. First, employ a more focused approach to improving capital productivity (i.e., the return on capital invested) across the government’s asset portfolio in order to generate a fiscal improvement independent of spending cuts and tax increases. Second, continue to review government asset ownership positions with a view to identifying further opportunities to release or recycle capital to its best use. Third, develop a more structured approach to the identification and management of key financial risks in the government’s asset portfolio in order to strengthen fiscal resilience. Many governments have undertaken some activities across these three areas, but the scale of the current fiscal and economic challenges mean that additional efforts are now appropriate.

In this paper, we provide an overview of the size and composition of the assets on government balance sheets and outline how focus on the balance sheet can add value by helping governments address key economic and fiscal policy challenges. Further, we describe practical options for strengthening the management of government asset portfolios: tools to enhance the capital productivity of government assets; a process for the ongoing review

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1 Michael Spence, ‘Rebalancing the State’s Balance Sheet’, Project Syndicate, 18 February 2013 [[www.project-syndicate.org](http://www.project-syndicate.org)]; Economist, ‘State-owned assets: Setting out the store’, 11 January 2014. [<http://www.economist.com/news/briefing/21593458-advanced-countries-have-been-slow-sell-or-make-better-use-their-assets-they-are-missing>].

of government asset ownership positions; and better financial risk management of exposures associated with government assets. Governments need to build capabilities to successfully implement these initiatives as well as prioritise the various actions identified.

## Government assets and liabilities

Although only some governments produce formal, comprehensive balance sheets on a regular basis, all governments have substantial portfolios of assets and liabilities. This section provides a sense of the materiality and composition of government asset portfolios.

### The size of government balance sheets

The IMF, the Organisation for Economic Co-operation and Development (OECD) and others provide data on government holdings of assets and liabilities.<sup>2</sup> Although these data have limitations and are not perfectly comparable because of national differences in coverage and methodology, it is clear that government balance sheets are large. For example, the Japanese central government has non-financial assets of 120 per cent of GDP, and the US and French governments have non-financial assets of about 70 per cent and 90 per cent of GDP, respectively. For the countries that the IMF has been able to collect data, government holdings of non-financial assets, on average, are 67 per cent of GDP (with a very wide distribution in the size of asset holdings).

These reported numbers include both central government assets, as well as asset holdings at a sub-national level (e.g., regional and state governments). The IMF notes that sub-national governments often hold more than half of the government's total non-financial assets. The share of assets held by regional and local governments, for instance, is much higher in federal states, such as Canada, Germany, and the US.

Financial assets can also be very substantial. On average, across the advanced economies, government-held financial assets are in excess of 40 per cent of GDP. Taking financial and non-financial assets together, governments have substantial asset holdings. The New Zealand government reports total asset holdings of about 100 per cent of GDP. And many government balance sheets will likely be much larger; for example, it is likely that the Singapore government has total assets of several hundred per cent of GDP with its substantial holdings of commercial and financial assets.

Exhibit 1 notes the scale of financial and non-financial assets, and also shows that total government asset holdings are commonly equal to or exceed the level of gross debt. This suggests that the nature of the government balance sheet is an important element of understanding a country's overall fiscal sustainability. It is not enough to simply look at public debt.

Making precise cross-country comparisons is problematic because of significant differences in accounting treatment and the coverage of reporting. The IMF notes that stocks of non-financial assets tend to be higher for economies with more comprehensive coverage. The variation in asset holdings across governments is as much due to valuation and measurement issues as it is to substantive choices about the level of assets to hold. It is likely that reported numbers of governments are often underestimated.

The data coverage for government assets and liabilities is better for advanced economies. But it is clear that many emerging market governments also have sizable balance sheets. This is certainly true for many Asian governments that have sizable holdings of commercial assets, as well as official reserves. In the Middle East, countries like the UAE and Saudi Arabia have substantial holdings of both financial assets and commercial assets. State capitalism and sovereign wealth funds have become prominent features of the global economy.

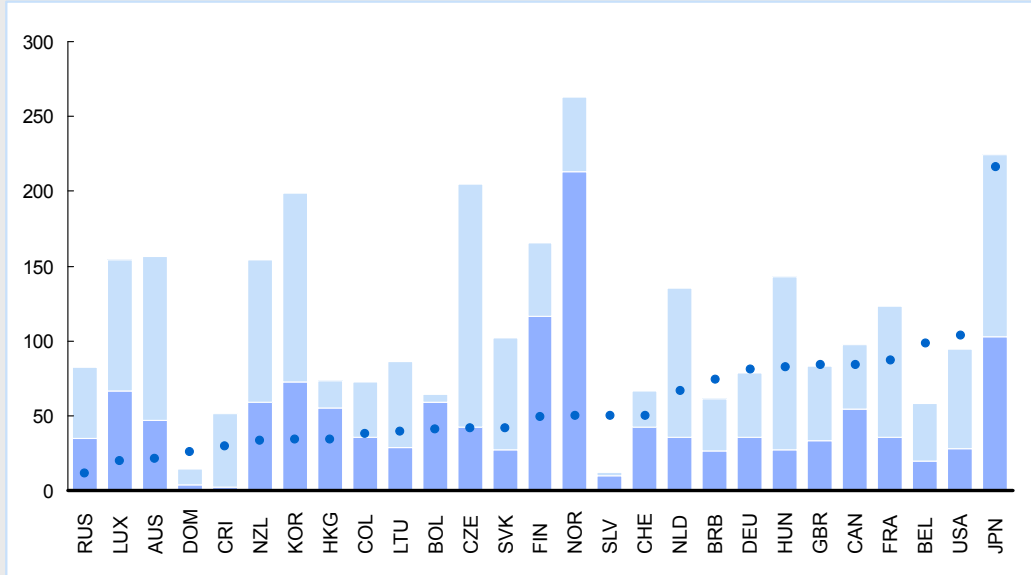
<sup>2</sup> Elva Bova et al., Another Look at Governments' Balance Sheets: The role of non-financial assets, IMF Working Paper 13/95, May 2013.

Exhibit 1

### Total government assets are commonly much larger than government liabilities

Per cent of GDP

- Gross debt
- Financial assets
- Nonfinancial assets



SOURCE: Elva Bova et al., Another Look at Governments' Balance Sheets: The role of non-financial assets, IMF Working Paper 13/95, May 2013

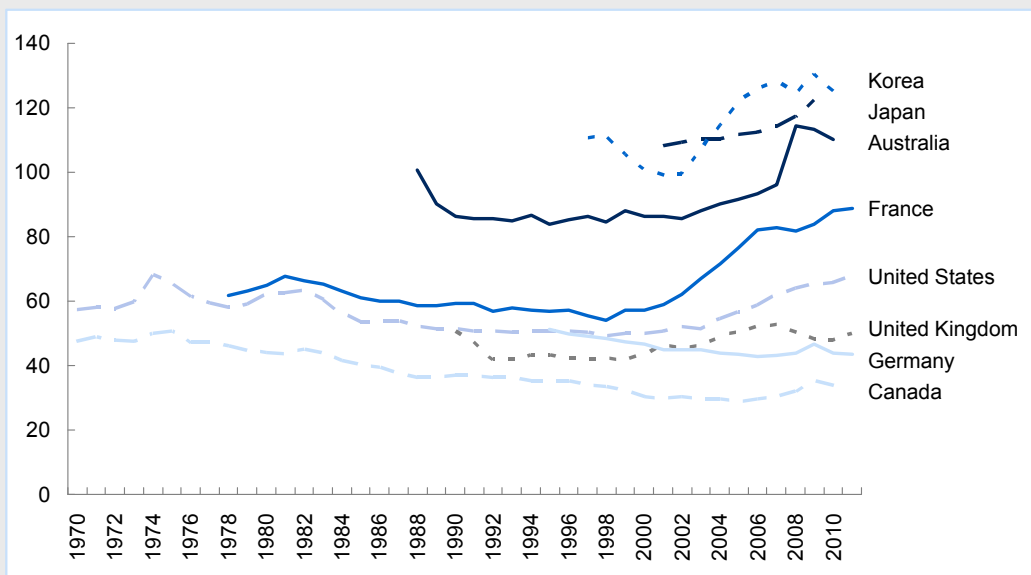
There is also some evidence that government balance sheets have been expanding recently in many countries (Exhibit 2). Some of this increase in asset values over time is also due to increased valuations of land and buildings, as well as increases in the value of natural resources (e.g., oil and gas reserves, minerals).

Exhibit 2

### Available data suggests that government balance sheets are expanding over time

Advanced G-20 economies

Per cent of GDP



SOURCE: Elva Bova et al., Another Look at Governments' Balance Sheets: The role of non-financial assets, IMF Working Paper 13/95, May 2013

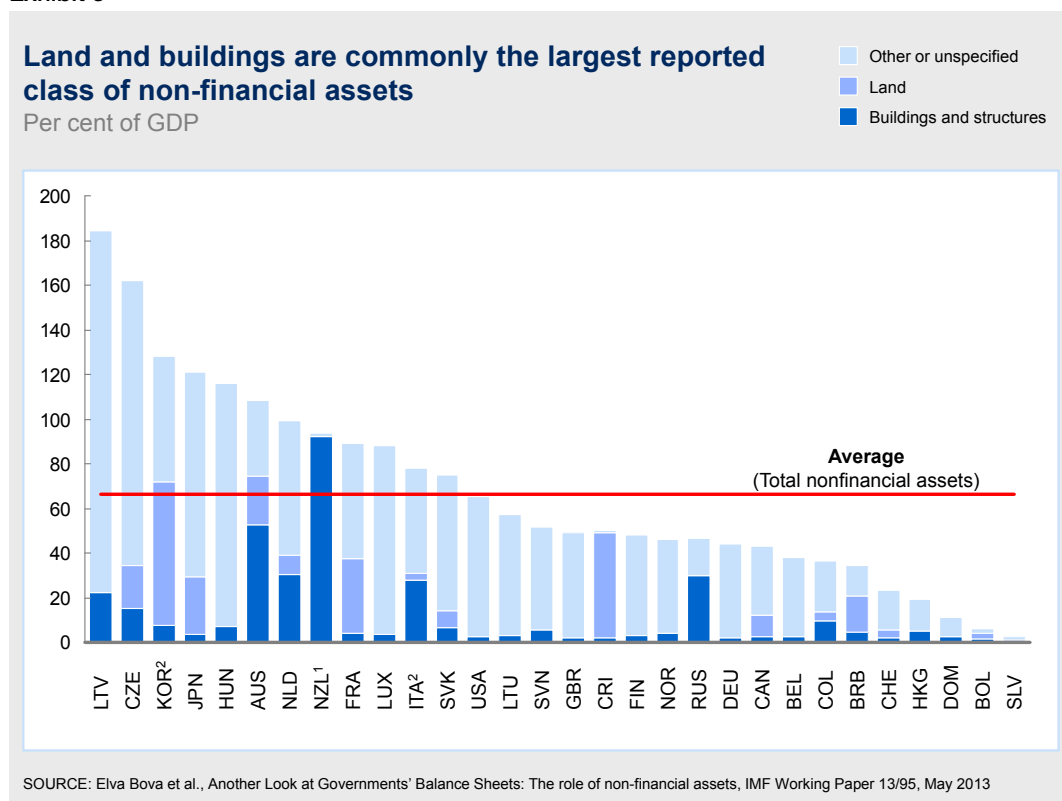
Following a couple of decades of privatisation in many developed countries, many governments have increased their holdings of commercial assets (for example, as a consequence of the nationalisation of financial institutions during the financial crisis). Many governments have established pre-funding schemes for future fiscal liabilities associated with an aging population. In the developing world, many governments are investing heavily in infrastructure assets (among other asset classes), suggesting that a wide range of asset categories on government balance sheets will be growing. Expanding government balance sheets mean that effective management of the balance sheet becomes even more important for economic and fiscal outcomes.

### Composition of the government balance sheet

Governments commonly own a very broad range of assets and liabilities. These assets include financial assets, commercial assets, as well as a range of physical assets (from schools and hospitals to transport infrastructure like roads and rail, and defence assets). On the liability side, there are obvious items in terms of public debt. But governments also have contingent liabilities; for example, guarantees and indemnities offered to various parties.

Recent analysis by the IMF provides some visibility on the key asset classes across a range of countries. As illustrated in Exhibit 3, buildings and other structures are often the single, largest non-financial asset class, followed by land.

Exhibit 3



### Key elements of government balance sheet management

Over the past 20 years, significant efforts have been made to strengthen the processes around annual budgetary decisions as well as to manage the overall fiscal position. There is now a growing body of evidence based on McKinsey research that links the quality of budgetary and fiscal outcomes to the quality of the institutions that have been put in place. Governments with high quality fiscal institutions are better able to exert control over their budgets, both at an aggregate level as well as in terms of allocating resources in the desired way.



Similarly, we believe that adopting a balance sheet perspective also has the potential to generate substantial value. There are opportunities from better managing specific assets, as well as from adopting a structured approach to the management of the overall asset portfolio.

Currently, governments around the world face serious challenges in terms of fiscal sustainability and generating sustained economic growth. Many governments are currently focused on balancing the need for fiscal consolidation and stimulating growth, while also trying to promote longer-term growth through various structural reforms.

Addressing these challenges requires serious, concerted policy action on a variety of fronts. We believe that a balance sheet perspective offers a series of additional insights that will provide new opportunities for governments to address these challenges. In particular, we have identified three focus areas that will make a strong contribution to both fiscal and economic outcomes.

**Capital productivity:** Government investment dollars are scarce, and governments are trying to reduce their borrowing requirement, which means that strengthened productivity of their asset bases is becoming even more vital. It is important that all government assets are subject to a structured and disciplined management approach. How can governments be sure that the capital they have invested is being managed as efficiently as possible and that their asset portfolio is providing the maximum return or contribution that it can? Improving the government's fiscal position through capital productivity initiatives will enable public debt to be reduced without tightening fiscal policy through reducing spending and increasing tax revenues. And strengthened public sector capital productivity will also make a direct contribution to national productivity and income growth.

**Reviewing ownership:** Capital productivity initiatives are likely to reveal government assets that are no longer appropriate for governments to hold. This may be either because these assets are surplus to those required for efficiently delivering public services, or because the government is not the best owner. Although this process of reviewing government ownership needs to be approached carefully, we believe there are opportunities to release or acquire further capital that will be identified through undertaking a structured review of the government's asset portfolio. We also believe that a broad focus is required, which examines the government's overall asset ownership position beyond the government's holdings of financial and commercial assets. An overall portfolio review can deliver additional value. This area is particularly important at the moment given the scale of the current fiscal and economic challenges.

**Financial risk management:** Governments need to navigate an increasingly turbulent economic environment in which shocks can have large, adverse effects on the government's financial position. Many of the most material financial risk exposures that governments face come from the balance sheet, as asset and liability values shift. These exposures can quickly undo serious efforts at fiscal consolidation, and can also reduce the government's ability to act as an economic manager in times of crisis. It is therefore important that governments develop the ability to understand and appropriately manage the full set of financial risk exposures. A structured approach to identifying and managing key financial risk exposures on the government balance sheet is likely to lead to strengthened economic and fiscal outcomes. This will involve a review of the risk properties of the overall asset portfolio, in addition to the risk exposures associated with individual asset classes.

There are examples of best practice across these three areas from different governments, but we believe that there is much potential for many governments—both in the developed world and in emerging markets—to capture increased value. The following three sections describe these three areas in more detail, outlining the specific actions that governments could take to capture additional value. This discussion draws from international experience of governments, and what has been seen to work, as well as best practice in the private sector.

## Capital productivity

Improving capital productivity is an increasingly important issue for governments. Given the size of the government asset portfolio, improvements in the productivity of the capital stock will likely have a material impact on both the fiscal position (now and in the future) and on the economy. In the context of the large size of many government portfolios, a 1 per cent productivity improvement achieved across the asset portfolio is likely to generate annual gains of around 1 per cent of GDP in terms of direct financial returns or a reduced investment requirement. The way in which these government assets are managed is also likely to have a meaningful impact on national level capital productivity and on economic performance.

To make real progress in this regard, it is important to have a working system for recording the government's holdings of assets. Understanding what the government owns is the first step in effective asset management. Specific agencies need to be able to understand what they are accountable for managing. In some governments, there is not much clarity on what is owned and who is responsible for managing various types of assets. Measuring and reporting assets makes it more likely that they will be managed well, both by the Ministry of Finance as well as by the specific agencies.

To structure this discussion, we consider three classes of assets: fixed assets, commercial and financial assets, and working capital. For each of these asset types, we have examined the tools that governments can use to improve capital productivity.

### Fixed assets

This class of assets includes land and buildings (hospitals, schools, and office buildings), transport infrastructure (roads, rail), defence assets, research infrastructure, and so on. From Section 3, we know that these assets represent a substantial share of the government balance sheet (and of GDP). Fixed assets are commonly around 40–60 per cent of GDP in many developed countries; for example, the IMF reports that the US has fixed assets of 66 per cent of GDP, the UK has 49 per cent and Germany has 43 per cent. And these numbers will often be under-estimates of the actual value of the holdings.

Many of these fixed assets will not produce a direct financial return, but are held to deliver various types of public services (for example, the provision of health and education services or to enable efficient transportation). But it is important that these assets produce the relevant returns or outcomes in an efficient manner, and that only capital that is required to efficiently produce or deliver the outcomes is held. Surplus capital can be sold down, and released into other uses—reducing the government's overall borrowing requirement.

This discussion describes three approaches that can be used to drive improved capital productivity with respect to government holdings of fixed assets.

### Asset management

Governments that deliberately act to get the most out of their existing assets can expect to extract significant savings in terms of a reduced requirement to borrow to fund new fixed assets. For example, MGI analysis estimates that making better use of existing infrastructure assets can reduce the investment required in infrastructure by about 15 per cent, a substantial saving for governments that are trying to lower public debt.<sup>3</sup> On average, annual infrastructure spending is about 3 per cent of GDP in the developed world and about 5 per cent of GDP in the emerging world—leading to possible efficiency savings of about 0.5–0.75 per cent of GDP a year. The improvement in capital productivity from such measures has the potential to exceed the fiscal benefits from standard measures of fiscal discipline.

Some of the ways in which these savings can be achieved include through an optimised maintenance plan or through active demand management.

Maintenance planning considers the total cost of ownership over the lifetime of an asset, and finds the optimal balance between short-term maintenance and the costs of investing in

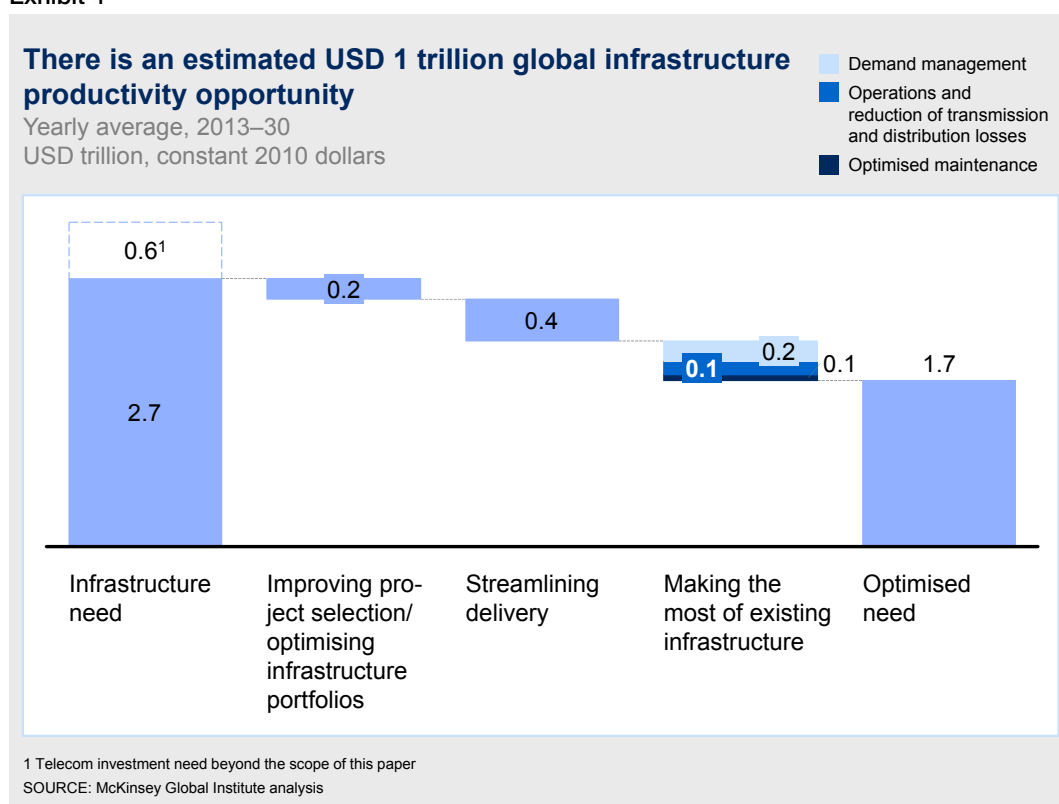
<sup>3</sup> McKinsey Global Institute, Infrastructure Productivity: How to save USD 1trillion a year, 2013.

upgrading or replacing the asset. This requires the integration of decision-making with respect to capital and operating expenditure.

The Public Sector Accounting Board in Canada, for example, requires municipalities and utilities to report all tangible capital assets and to develop plans for replacement and renewal that overcome infrastructure funding deficits. In Denmark, the cost of road maintenance has reduced by over 10 per cent as a consequence of applying this approach. Similarly, the Indian Government has relied on renovation and modernisation of existing power plants to deliver more electricity at a lower cost than would be required if new plants had to be built.

Another approach is to adopt more sophisticated demand management (e.g., congestion pricing to smooth road use). Optimising the use of existing fixed assets is likely to mean that more value can be extracted from existing assets without having to invest further in new assets. Deploying an intelligent transportation system, therefore, may be a much less costly choice than upgrading or expanding an existing road asset

Exhibit 4



### Incentives

In addition to the discipline provided by capital benchmarking, capital productivity can be strengthened by providing the correct finance incentives to local decision-makers to identify and capture value opportunities through efficient asset management.

One common technique is the imposition of a capital charge, so that 'owners' of the assets face the cost of holding that capital (e.g., a 10 per cent charge on fixed assets). This charge creates incentives for the more efficient allocation of capital; at least a portion of the capital charge amount is often retained in the baseline funding of the agencies if the capital invested is reduced, creating an incentive to enhance capital productivity. Capital charging regimes are now used in many central governments, including the UK and New Zealand, as well as in agencies like the National Health Service (NHS) in the UK.

There are a variety of issues that need to be considered in the design of a capital charge regime. These include:

- An agreed valuation framework for establishing asset valuations. The approach to valuing assets needs to be objective so that individual agencies value their assets in an independent way, and in a way that is consistent between agencies.
- A decision on the charge rate to be applied that captures either the cost of capital or the social rate of time preference. In New Zealand, for example, an 8 per cent capital charge rate is currently used.
- The extent to which the asset manager retains the financial gain from a reduced capital base. Allowing the agency to retain a portion of the reduction in capital charge after they sell an asset, which they can use for other purposes, creates an incentive for the agency to be efficient in their deployment of capital. However, if the agency retains all of the gain, the government is less likely to get a return on the capital that it has invested—and this may even create an incentive to under-invest.
- Governments will need to ensure that they do not create overly sharp financial incentives to reduce capital, so that public sector institutions under-invest in capital to the detriment of achieving their mission over the medium-term.

Some governments have successfully employed a less comprehensive form of capital charge. In Finland, for example, the State Real Property Authority charges rent to government ministries and agencies and in doing so captures some of the benefits of a capital charging regime, but in a less complicated way.<sup>4</sup>

### **Capital benchmarking**

A powerful technique to improve capital productivity is capital benchmarking, which measures the amount of capital invested in various assets to deliver particular services, or to generate outcomes, compared to other locations. This benchmarking can be done within a country, to assess how productivity varies across locations (e.g., is capital productivity higher in some hospitals than in others) or across countries. Such benchmarking is often done for government spending, in the context of formal spending reviews, but not commonly for government capital investment.

Capital benchmarking is done routinely in the private sector, and it may be possible for governments to use some private sector benchmarks. Indeed, experience suggests that this benchmarking can be a powerful tool for driving productivity improvements in companies. Understanding and then applying best practice can lead to substantial productivity improvements, and will likely reduce the amount of capital investment required by governments.

The idea of capital benchmarking in the public sector is gradually gaining traction. A Multilateral Development Bank Working Group on Infrastructure has proposed a Global Infrastructure Benchmarking Initiative to establish baselines for infrastructure performance and regular reporting of data on global infrastructure.

The UK Government recently performed a benchmarking exercise through the High Performing Property Initiative with a target of achieving GBP 1 billion–1.5 billion in savings. Each government property provides data on property costs and occupancy which are then compared across government and private sector estates. Savings from rationalising office property by recycling existing space have more than doubled over three years and further savings are expected from reducing the amount of office space occupied (GBP 625 million per year) and improving space utilisation (GBP 518 million per year).<sup>5</sup>

Once the comparative data has been obtained from the benchmarking exercise, work can be done to better understand the sources of the variation—and to identify ways in which improvements can be made, with a particular focus on locations where capital productivity is low. As one example, New Zealand has recently benchmarked the use of real estate and office

<sup>4</sup> McKinsey Global Institute, *Infrastructure Productivity: How to save USD 1trillion a year*, 2013.

<sup>5</sup> National Audit Office (2007), "Improving the Efficiency of Central Government's Office Property", Report by the Comptroller and Auditor General, HC 8 Session 2007–2008.

space across government agencies. This data was used to create baselines that provide formal guidance for agencies in terms of appropriate use of office space, and has reduced the amount of office space that is required. In many cases, this surplus accommodation has been sold or repurposed for other uses.

### Financial and commercial assets

Many governments have substantial holdings of financial and commercial assets, despite the privatisation processes that some governments have undertaken over the past few decades. The OECD recently reported that OECD governments hold about USD 3 trillion in commercial assets (employing about 6 million people), with a further USD 1 trillion in stakes in listed companies where they exert effective control.<sup>6</sup>

The performance of these assets is generally relatively straightforward to benchmark, because these assets are expected to earn private sector returns. The expectation should be for commercial enterprises in public ownership to generate comparable returns to their private sector peers.

Indeed, over the past decades, significant improvements have been made in the quality of management of financial and commercial assets in government ownership. Financial assets are more often governed in ways that reflect good practice in the private sector, and are managed by professionals with private sector experience, and state-owned enterprises (SOEs) are frequently given commercial mandates. This process of improvement has led to substantial fiscal and economic gains being made. SOEs have often moved from being a net fiscal drag, requiring capital injections from the government, to paying sizable dividends to the governments, and financial asset portfolios have increasingly produced strong risk-adjusted returns.

Many governments have also developed institutions to ensure that SOEs face ongoing financial discipline, and that they have appropriate governance arrangements. These often involve holding company type arrangements, in which the portfolio of commercial assets is monitored—and sometimes governed—by a single shareholder organisation. Examples include Temasek in Singapore, Khazanah in Malaysia, and the Shareholder Executive in the UK. These arrangements also include transparency and reporting, so that the performance of these firms can be readily benchmarked against similar firms in the private sector.

Not all governments have moved down this path, and there is scope for improvement in applying some of these approaches to inefficient portfolios. In general, the experience has been that SOEs can be run in a manner very similar to private firms, even where they are involved in providing some public goods and services (e.g., postal services).

Similarly, the professional management of government financial asset portfolios can lead to substantial improvements in the returns that these funds generate. In turn, this performance will commonly have a large impact on the fiscal position given the size of many of these funds. Developing a professional, non-political approach to investment in these financial institutions will likely deliver better returns—which will directly contribute to the government's fiscal position.

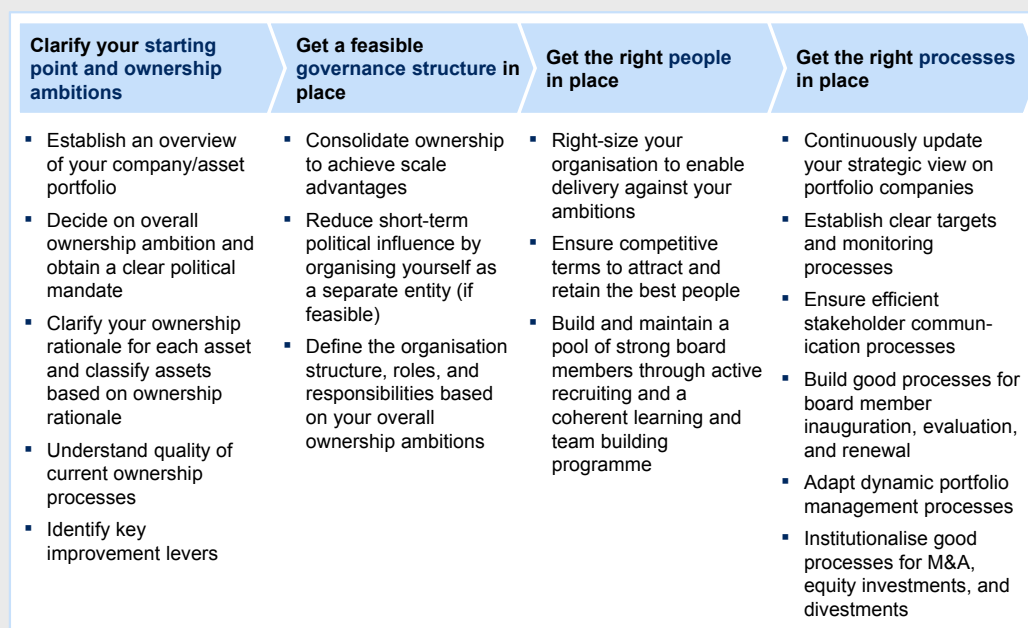
There is an emerging consensus on the characteristics of best practice in the management of these financial portfolios. For example, there should be clear benchmarks, transparency, and it should be arms-length from government in terms of operational decision-making. Exhibit 5 describes some of these practices.

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6 Christiansen, H. (2011), "The Size and Composition of the SOE Sector in OECD Countries", OECD Corporate Governance Working Papers, No. 5.

## Exhibit 5

## Becoming a “best practice” active state owner is about getting the ambitions, structure, people, and processes right



SOURCE: McKinsey analysis

### Working capital

Working capital includes cash and other short-term financial instruments, as well as accounts receivables and accounts payables. Working capital is a more substantial component of the balance sheet than is often recognised. In New Zealand, for example, accounts receivables and advances (e.g., student loans) account for about 15 per cent of the government’s total assets, with cash holdings accounting for another 3–4 per cent. In Australia, advances and accounts receivables account for about 25 per cent of total reported government assets. The use of best practice management practices with respect to these assets can generate sizable savings.

The aim of working capital management is to be efficient in the way that these assets are managed to ensure that they generate the maximum return (or that they allow for less to be borrowed). For many governments, the largest accounts receivables will be associated with tax revenues. There will also be other receivables such as student loan repayments, fines and so on. Identifying ways in which to bring this money in more rapidly, and to reduce the incidence of bad debts, may have a significant effect on the fiscal position.

McKinsey’s work with tax authorities identified major financial benefits from the more active management of the tax receivables amount. The ‘tax gap’ is consistently estimated at between 10–20 per cent of tax collections (about 40–60 per cent of this is from under-reported income by small business and self-employed taxpayers). Exhibit 6 describes some of the major elements of this approach.

There are many practices that can be adopted with respect to the better management of cash. These efforts typically start with the implementation of a Treasury Single Account which pools all government cash into a single account, rather than having it sitting in the various bank accounts of each government agency. This lowers the overall need for cash in the government and can also reduce banking costs and back-office headcount.

After the implementation of the Treasury Single Account, there is potential for more aggressive cash management strategies. These include the joint management of government cash and debt so that cash is raised from the market only when required. What is more, this joint

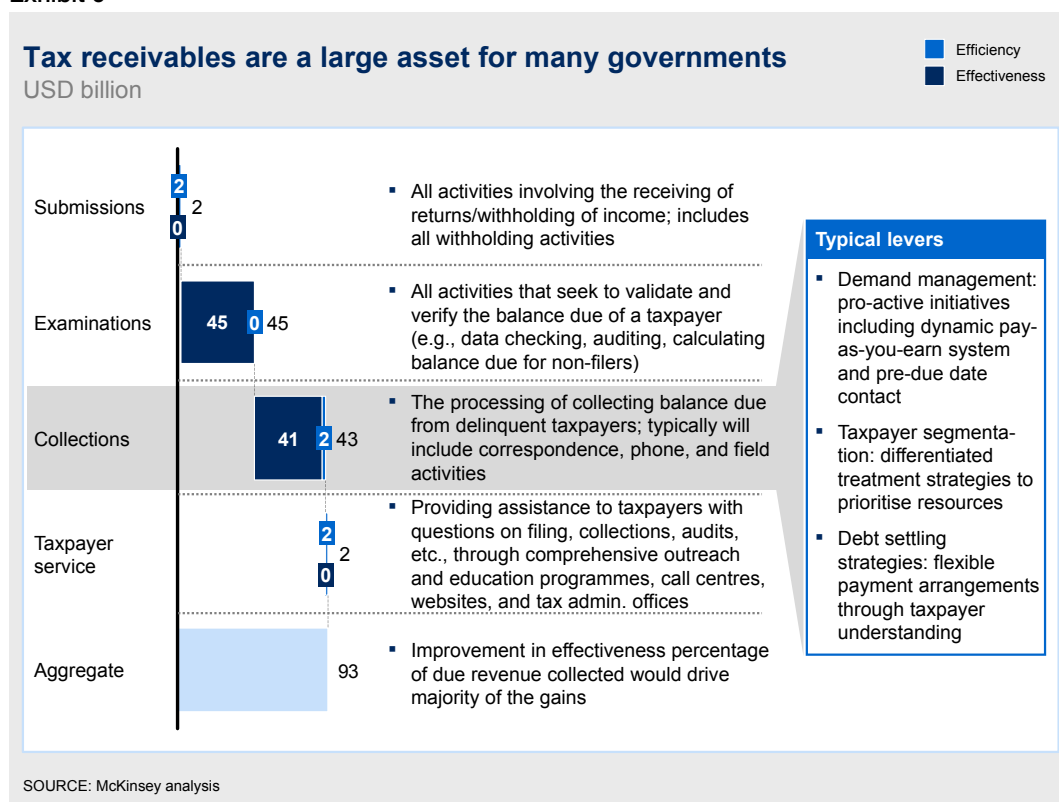
management of cash and debt allows for more sophisticated cash investment strategies that increase the returns earned on these funds.

In addition, management of working capital extends to the way in which accounts payable are managed. A powerful tool in working capital management that government leaders should consider is the centralised payments and debts offset program. The concept is to build a central body and IT system, most likely in the Finance Ministry, to ensure that government payments do not go out to individuals or businesses when they have existing debts with the government. Centralisation is key because payments and debts are often generated in completely different agencies across the government, for example tax refunds versus unpaid court fees.

One example of this is the US Treasury Offset Program (TOP). In 2012, the US Treasury used TOP as the primary tool to collect USD 6.2 billion in delinquent debts owed to federal and state agencies by offsetting outgoing tax refunds and non-tax payments.

By creating a centralised IT system to ‘bounce’ payments against existing debt information such as a tax ID before disbursement, the government can reduce its debt balances directly without the added work of trying to collect receivables. This practice also supports good government principles of squaring an individual’s balance sheet with the government directly. For governments looking to set up a programme, it will be important to consider which types of payments and debts qualify for offsets, the financial IT system, and the communication with citizens and businesses around their payments.

Exhibit 6



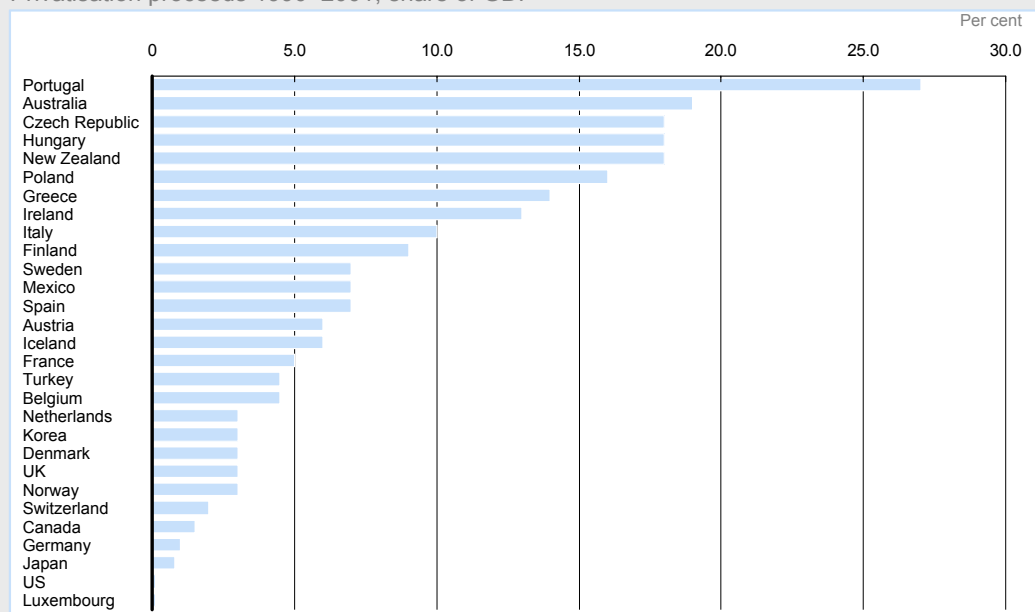
## Reviewing ownership of assets

Over the past few decades, many governments—particularly in the developed world—have undertaken significant programmes to privatise commercial enterprises. Exhibit 7 describes the substantial privatisation receipts between 1990 and 2001 across a range of OECD countries.

Exhibit 7

### Historically, privatisation processes have been a significant source of funding

Privatisation proceeds 1990–2001, share of GDP



SOURCE: OECD estimates

Governments have also found other ways to release capital from their balance sheets, such as securitisation of income streams, auctioning spectrum rights, and selling holdings of gold. This has often been motivated by a combination of economic and fiscal reasons—a sense that private ownership of commercial assets would generate better economic outcomes, as well as allowing governments to pay down public debt more rapidly.

However, the fiscal pressures suggest that these options should be investigated further. The 2013 IMF Fiscal Monitor identifies government holdings of assets as one of a handful of measures that can be pursued to supplement fiscal consolidation efforts.<sup>7</sup> Many governments hold some assets that are capable of being sold, and a systematic review of these asset holdings is likely to identify additional opportunities to release capital. In a similar way to the rigorous spending review processes that many governments have launched to identify budgetary savings, it seems appropriate to undertake an equally rigorous review of the government's capital ownership position.

The extent of the potential gains will likely vary significantly. Some governments have already undertaken substantial privatisation programmes, and may not have many commercial—or other—assets from which value can be realised. And, of course, selling assets will generally lead to a reduced income stream in the future—so care should be taken to ensure that the exercise is financially positive. Governments also need to ensure that privatisation occurs in the context of an appropriate regulatory and market environment, so that the process generates economic and financial gains. Questions of government ownership should be approached in a structured, disciplined manner. It is not a quick fix.

But given the current fiscal context, a systematic review of the government's asset ownership position is likely to be appropriate. And examining the full range of asset holdings may identify opportunities that were not previously considered. Governments hold assets for a wide range of policy reasons, and different governments adopt different attitudes towards ongoing ownership. There is no one-size-fits-all approach that can be applied across all governments—but governments should all be very clear that their asset holdings are appropriate given their particular context.

7 IMF, Fiscal Adjustment in an Uncertain World, Fiscal Monitor, April 2013.

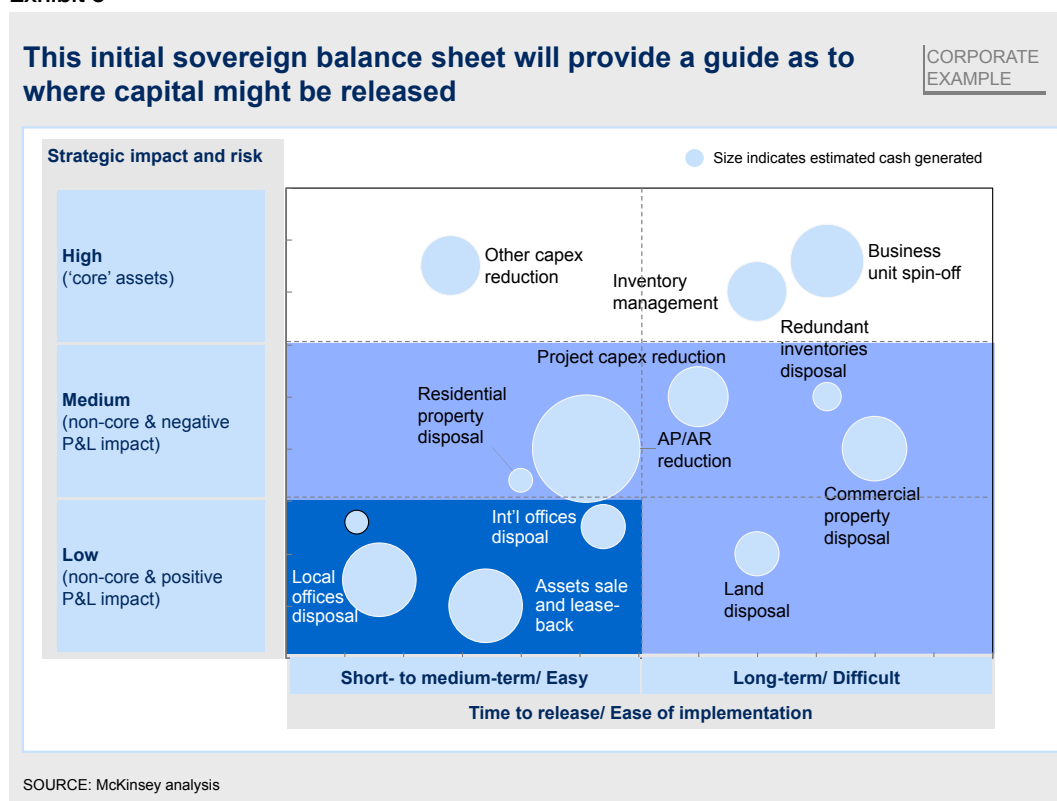


Different governments have developed various approaches for reviewing their ongoing ownership positions. As one example, the Swedish Government specified five criteria that it uses in determining whether the government should remain a long-term owner of any given asset:

- That the asset fulfils a social interest that cannot be solved in the private sector;
- That a clear national interest exists from ongoing government ownership;
- That continued ownership is required to generate long-term value for the government;
- That continued ownership is required to preserve competition (e.g., in natural monopoly situations);
- That continued ownership is required to preserve employment.

Different governments will specify these criteria in different ways. But the key point is that there should be a clear, explicit financial interest and/or policy objective that is served through continued government ownership. Governments should undertake comprehensive portfolio reviews, involving structured analysis of the assets that are owned to determine the extent to which they satisfy the criteria for ongoing ownership. This process should provide guidance in terms of the most likely opportunities for the government to review its ongoing ownership position.

#### Exhibit 8



This ownership review process should be comprehensive. As noted earlier, governments have very substantial asset holdings outside of commercial and financial assets. Adopting a broad focus for this exercise allows for the identification of additional opportunities that would otherwise be missed. For example, the British Government is considering options to monetise its student loan debt portfolio. And the French Government is currently in the process of selling a substantial portfolio of property, as well as some of its extensive wine cellar—and at least part of the proceeds from these sales will be directed to paying down debt.

This ownership review process, particularly if it is framed in broad terms and supported by comprehensive and accurate financial information, is likely to identify additional opportunities to release capital. This will support efforts at fiscal consolidation, allowing for debt to be repaid more rapidly than otherwise (or for debt reduction targets to be achieved, with a smaller contribution required from tight fiscal policy).

One useful example is the New Zealand Government's Investment Statement, which provides a structured assessment of the overall asset and liability portfolio. It is intended to provide transparency on the changing shape of the asset portfolio, identify emerging challenges and opportunities, and frame the key policy choices.

This process of ownership review is also likely to generate indirect benefits. A review of the full balance sheet will provide a better sense of the true state of fiscal sustainability, which may not be apparent from just looking at the public debt position. This will better enable the government to calibrate its fiscal policy and the speed of the fiscal consolidation that it needs to deliver. Better visibility on realisable assets is useful for government decision-making with respect to fiscal policy decision-making. And it is also one part of communicating with financial markets and rating agencies in terms of fiscal sustainability. Governments that have substantial asset holdings may be able to tell a better story to investors, and may be able to secure better borrowing terms.

#### Exhibit 9

### New Zealand publishes a structured assessment of the government's portfolio of assets and liabilities every four years

#### New Zealand 2014 Investment Statement

- Statutorily required **report card** on the government balance sheet
- Prepared at least every 4 years

#### Objectives

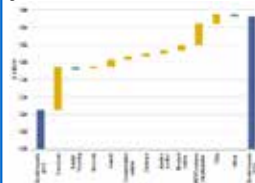
- Highlight **opportunities for improvement** in asset performance
- Promote **greater understanding of balance sheet risk**
- **Improve transparency** of balance sheet performance

#### Content

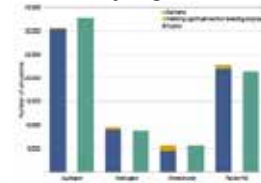
- **Size, composition, trends** in portfolio of assets and liabilities
- **Forecasts** on composition and size for the next 4 years
- **Assessment of utilization** of assets and effectiveness in facilitating delivery of policy outcomes
- Review of **financial and commercial portfolio performance**

#### Example assessment

#### Social assets forecasts by sector for the next 4 years



#### Social assets: Property supply relative to demand by region



#### Insight:

- Auckland has a shortage of social housing, while the rest of NZ has too many houses relative to demand
- Christchurch housing stock requires significant remedial work

#### Recommendation:

- Rationalise asset base in smaller towns and cities to align with expected demand
- Use capital to develop areas with greatest supply shortage and remedial needs

SOURCE: New Zealand 2014 Investment Statement, <http://www.treasury.govt.nz/government/investmentstatements/2014>

However, although undertaking an ongoing review of ownership can generate value, the reality is that governments plan to hold many assets on a long-term basis. The IMF notes that only a small proportion of government holdings of non-financial assets will be realisable. Policy (and sometimes political) considerations mean that many government assets should not or cannot be sold. And, indeed, many government balance sheets are currently expanding. This means that the tasks of improving capital productivity of existing assets as well as managing financial risk exposures should be undertaken in parallel with an assessment of the particular government's asset holdings.

## Financial risk management

After a sustained period of relatively strong fiscal outcomes and reducing levels of public debt in many countries, the global financial crisis had a large, negative effect on fiscal positions as tax revenues reduced and government spending increased. Primary fiscal balances across the OECD worsened by an average of 5–6 per cent of GDP between 2007 and 2009.

In addition to this direct fiscal impact, substantial financial impact from shock also comes through the balance sheet channel. Examples include a failure of a major commercial asset, the loss in value of financial assets, or an increase in the public sector employee pension liability. So although a great deal of attention is paid to the exposure of the government's budget position to shocks, the exposure of the balance sheet to shocks should also be considered in a structured way.

The value of many government assets and liabilities were adversely affected in value by the crisis. The IMF notes that the value of government-owned financial assets reduced by over USD 1 trillion during the financial crisis. Some of this has since been regained, but holes have been left in governments' ability to finance future obligations. These shocks have also had an impact on the ability of governments to undertake appropriate counter-cyclical macroeconomic policy (since governments are less able to stabilise the economy when it is hit by shocks).

Financial risk management will become increasingly important for governments in a global economic environment that is likely to be characterised by ongoing economic turbulence. And this is particularly important in the context of tight fiscal policy; shocks can cause the unwinding of fiscal positions, and reverse the effects of fiscal consolidation—and potentially require further tightening of fiscal policy, which also has negative economic effects. So there is substantial economic and fiscal value to be gained from acting to protect the government's financial position against sudden shocks.

In some cases, it may be that the government can 'look through' the short-term volatility because of its unusually long-term horizon. But this is not always the case, and depending on the shock and the government's financial position, it may be that the shock has fiscal implications. For example, the effects of the crisis are likely to be enduring, causing a structural deterioration in the fiscal positions of many governments (because of the structural impact on the economy).

Understanding the full set of financial exposures, and adopting policies to manage or mitigate these risks, can generate substantial value. This area is also becoming increasingly important because government balance sheets are becoming increasingly complicated, with many more risks and contingent liabilities on them. And the consequences of a negative shock are likely higher than has been the case because of fragile fiscal positions.

Financial risk management is commonly done well with respect to public debt management, and there is a relatively well-developed sense of what best practice looks like. However, this is much less the case for the overall management of the government's portfolio of assets—and we believe that there is value from extending best practice risk management to the government's overall asset portfolio.

Governments can respond in two ways. First, by ensuring that those responsible for managing specific portfolios of assets and liabilities are guided by well-designed risk management policies. For example, guidelines that constrain their individual abilities to create financial risk exposures by borrowing or by entering into derivatives contracts. Most Ministries of Finance will have policies that reflect their respective government's risk appetite, and that constrain individual risk exposures. To the extent that such policies or guidelines do not exist—or are not followed—governments should take action to ensure that the risk exposures created are appropriate.

The second response is to take an overall approach to the government's aggregate financial risk exposure. In addition to ensuring that the risks of individual assets and liabilities are understood and managed, governments need to think about the risk profile of the overall

balance sheet. When all of the financial risk exposures attaching to specific government assets are aggregated into the overall government balance sheet, what is the nature of the overall financial risk exposure—and is this appropriate given the government’s preferences and circumstances? And how do the risks on the asset side of the balance sheet correspond with risks on the liability side of the government balance sheet?

The correlations between the assets matter—if important assets move together in response to shocks, it may be that the Ministry of Finance should be more concerned than if the asset values move in different directions. For financial risk management purposes, the interest is in the risk properties of the overall balance sheet not just the risk properties of individual assets and liabilities.

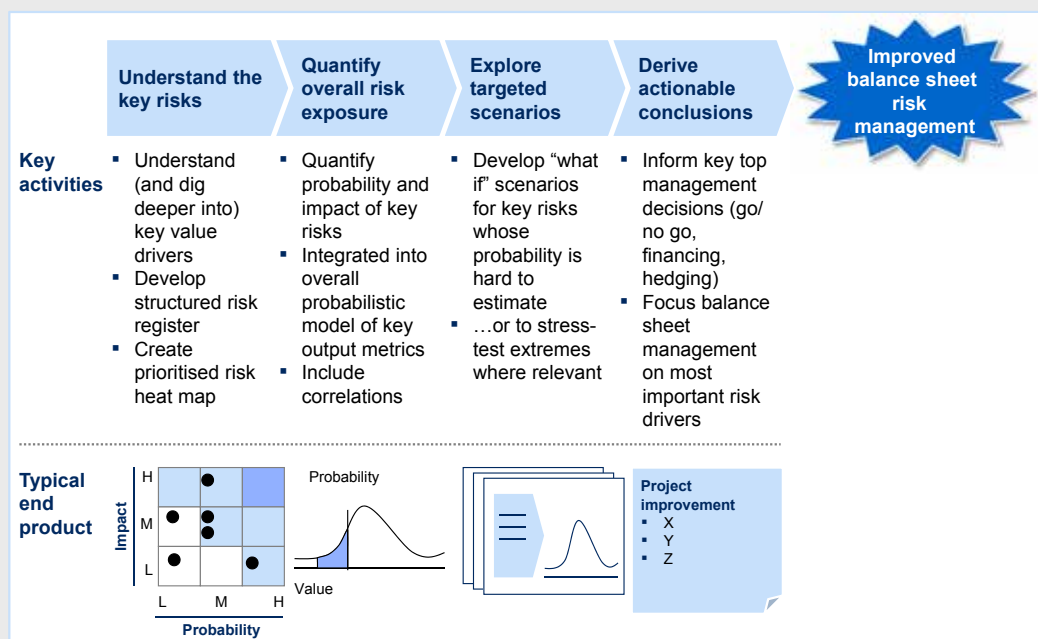
The complexity and scale of financial risk exposures on government balance sheets makes this a complicated exercise. But there are some governments that have made some progress, notably New Zealand, and there is increased interest in approaching financial risk management in a structured way—partly because of the growing size of the financial asset portfolios on government balance sheets.

In the first instance, it is better to see this exercise as an attempt at informing an ongoing process of structured conversation and decision-making. This is primarily about ensuring that key risk exposures are identified and an appropriate response is developed. Exhibit 10 provides a stylised description of the process. This is a process that should be led by the Ministry of Finance, on the basis of comprehensive information about the overall government balance sheet.

The first step is to understand the key sources of risk exposure. This will involve an examination of the exposures associated with major classes of assets and liabilities (including contingent liabilities, such as deposit insurance or bank guarantees). There will likely be some common shocks that impact multiple classes of assets; for example, GDP shocks, movements in the exchange rate or interest rate, financial market movements, and so on. This process will allow for the identification of the key risk exposures against which the government needs to manage, and where these exposures are located on the balance sheet.

Exhibit 10

### Balance sheet risk exposures can be systematically mapped and stress-tested



SOURCE: McKinsey analysis

This analysis should be designed to support a process of discussion and decision-making. Is the government comfortable with the aggregate risk exposures that it faces? And are the major risk exposures being appropriately managed? What are the priorities for action?

Once the key risks have been identified, governments can take appropriate actions to respond. There are a variety of ways in which this can be done. Some of the more common include:

**Actively reduce risk exposure.** This could involve transferring specific risks to another party, by selling some risky positions. This is one reason that is often given for selling down risky commercial assets. It could also involve specifying a lower risk tolerance for financial and commercial asset portfolios.

**Mitigate risks through more active management.** This could be done through regulation (e.g., of the financial industry, to contribute to lowering the risk of triggering deposit insurance guarantees) or through other policy measures. It may also involve changing the terms of risk sharing between the government and individuals or the private sector, reducing various guarantees, or requiring that individuals or corporations increase their resilience to the shock.

**Creating offsetting positions.** This should be carried out in positions where governments have a specific liability (e.g., pension payments for public sector employees), creating a dedicated asset portfolio that is constructed to move in ways that offset changes in the value of the liability. This can provide a natural hedge on the balance sheet for specific classes of liabilities or exposures.

**Governments can choose to absorb risks.** Governments have long-term horizons, and a better ability to borrow, and so may choose to accept the risk exposures that they face. However, governments still need to be thoughtful about absorbing risks despite these advantages. For example, the extent of the aggregate balance sheet risk exposure will inform the extent to which fiscal buffers are required, and the appropriate level of debt to aim for. Different governments will be differently placed in terms of their ability to absorb risk. Small country governments, for example, may have a lower ability than larger country governments with larger economies and balance sheets.

An important part of implementing a financial risk management approach is to establish an appropriate set of institutional arrangements. Many of the actions described involve a comprehensive balance sheet approach to financial risk management. This requires developing some guiding policies for the risk characteristics of the balance sheet. So, in addition to appropriately allocating decision-making rights to individual asset managers, there is also a need to ensure that there is an appropriate macro-level decision-making system in place. The Ministry of Finance needs to have adequate oversight of the key elements of the government balance sheet, and to be able to specify the parameters or guidelines within which different parts of the balance sheet are managed—so that decisions are consistent at an aggregate level.

Although government balance sheet financial risk management is at a relatively early stage of development, there is much that can be learned from the experiences of other governments and from the way in which large corporations manage their balance sheets. Indeed, financial risk management by large corporations will tend to be more sophisticated than is the case for governments, and insights and guidance can be obtained from private sector practices and technologies.

## Building capacity

Given the uneven nature of progress in government balance sheet management in many countries, it is important to consider what capabilities are needed in order for governments to extract significant value from better management of their assets and liabilities. Our hypothesis is that the best approach is a measured, graduated process. Specifically, we suggest that governments structure their approaches around three sets of priority actions.

## **Collecting financial information**

An important first step in being able to efficiently manage government assets is to have quality information on the assets that are owned. For some governments, developing this understanding is still work in progress. For example, several OECD countries are currently unable to report comprehensive valuation data on the ownership of SOEs, an important asset class, which likely means that there has been incomplete reporting on other classes of government assets and liabilities as well. Developing quality financial information may seem like a daunting prospect for some governments and one that will require very substantial investments. However, if this is approached in a measured way, it is realistic for most governments.

In the first instance, the focus should be on developing a working inventory of assets and liabilities. Over time, the quality of this information can be improved. In many cases, at least some of this information will already exist—the task is to collate it, and to ensure that the financial reporting is done in at least an approximately consistent way. It is important to note that the aspiration need not necessarily be to committing to prepare a fully comprehensive, integrated balance sheet, but it must at least be to collect financial information that supports and informs policy decisions.

To the extent that there are gaps, and additional financial information is required, the investment in improving the coverage and quality of government financial reporting should focus on the largest asset classes on the government balance sheet. Governments should ensure that they have good quality data on the most material asset classes, and that there are systems in place to capture large assets. And the financial information that is collected should be directly aimed at supporting policy and management decision-making (rather than for accounting or compliance purposes). There needs to be a practical focus to these efforts.

The Ministry of Finance has an important leadership role in ensuring that increasingly high quality, relevant and comprehensive financial information about the government's balance sheet is being collected. This should include providing guidance on accounting standards, valuation methods, and so on (that can build on international standards), ensuring that individual government agencies are complying with requirements, and prioritising areas for focus.

## **Technical capacity**

Investments also need to be made in technical capacity in both individual government agencies, and in the Ministries of Finance to ensure that appropriate financial reporting can be undertaken, that assets can be managed in an efficient manner, and that high-quality decisions about the asset portfolio can be made. For example, there are some technical skills relating to financial risk management and in areas such as working capital management that may need to be developed over time.

The choice in terms of where to invest in capacity should be driven by a judgement as to where there is most potential value at stake. The Ministry of Finance should play an overall leadership role in ensuring that there are appropriate levels of capacity throughout the system, and leading efforts to build this capacity. Part of this may involve the Ministry of Finance being directly involved in working with agencies, and performing a hands-on advisory and support role, rather than relying on the individual efforts of government agencies.

## **Institutional ownership and accountability**

In addition to ensuring that the technical aspects relating to financial reporting and decision-making are addressed, it is also important to develop clarity as to the location of ownership of different assets, the responsibilities of different agencies, and where decision-making rights are located. In particular, it is important that there is clarity with respect to the relationship between the Ministry of Finance and the individual agencies. To make the balance sheet approach work effectively, the Ministry of Finance will need to have a stronger role than simply a standard-setter and compiler of financial information.

The Ministry should have the ability to monitor and review the financial performance and decision-making of agencies, and to make decisions (or recommendations) with respect to the overall shape and characteristics of the overall portfolio of government assets and liabilities. It is important that the Ministry of Finance has sufficient authority to be able to ensure that the assets are being managed appropriately. This will likely involve ensuring that the Ministry of Finance is given appropriate legal authority (and accountability). Institutional and decision-making clarity is vitally important to successful balance sheet management.

In a softer sense, it is also important that governments develop 'a balance sheet culture' in which agencies think about the asset side of the balance sheet explicitly and as a priority. At the moment, it is more of a secondary consideration and it needs to be elevated. The asset portfolio should be a key part of financial conversations within agencies, and between the Ministry of Finance and agencies.

## Prioritising government action

This paper has described three areas for action: capital productivity; financial risk management; and reviewing ownership. This section focuses on how governments might determine which of these are the priority areas, and how best to get started. The actions suggested in the previous section (such as assembling financial information) are 'no regrets' investments to make, and governments should begin to make moves in this direction.

In order to prioritise, we suggest that governments think about two relevant dimensions: materiality and complexity.

### Materiality

The financial materiality of the various actions depends on the size of the asset portfolio that is affected by the action, and the quality of the current approach to managing these assets. This assessment will be guided by a diagnostic of the existing asset portfolio. It may be for example, that there is opportunity to release substantial amounts of capital from the asset portfolio—and that these gains are more substantial than the ongoing gains from improved management of specific asset classes. Or it might be that an assessment suggests that there are big gains to be had from improving governance of large financial asset portfolios. There is also a time dimension: if the fiscal challenge is immediate, it may be that the preference is to place more weight on the quick wins.

### Complexity

There is variation in the difficulty associated with these various initiatives: some are more demanding than others in terms of requirements for comprehensive, quality financial information. This paper has described the initiatives in order of complexity: the capital productivity initiatives require asset specific information (working capital, SOEs) and involve targeted actions to improve the performance of these individual asset classes. This compares to aspects of the ownership review and financial risk management actions that involve a 'whole of balance sheet' approach, requiring information on the full asset portfolio—a more demanding task. For this reason, many governments have adopted a sequenced approach, commencing with the more targeted initiatives and moving over time to actions that consider the balance sheet in more expansive terms.

## Conclusion

We believe that developing a structured approach to managing the government's portfolio of assets is increasingly important for Ministries of Finance. In addition to running a tight budget process, governments should act to improve the productivity of the assets they own, undertake a structured review of their asset portfolio, and take a more comprehensive approach to managing the government's financial risk exposures.

Ensuring that the balance sheet is efficiently structured, and that financial risk exposures and the balance sheet are appropriately managed, is a vital element of public sector financial

and economic management. This is particularly true as many governments balance sheets increase in size and complexity, and as fiscal pressures grow.

Considering the importance of the balance sheet, we believe that many governments have not invested as much as they should in institutions and tools for managing it effectively. However, this also means that there is value that can be captured. The way in which governments approach this process will vary according to their circumstances and capacity. Developing the ability to implement government balance sheet policy will likely require sustained investment, but it is possible and is likely to be a source of substantial economic and fiscal value. All governments can benefit from starting or continuing on this journey.



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