Algemene Rekenkamer

Summary of the original audit report and eight accompanying diagrams

Risks to public finances - insight and control

Original title

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Contents

This document serves as summary of the audit report 'Risks to public finances – insight and control' (*Risico's voor de Overheidsfinanciën*), published by the Netherlands Court of Audit (NCA) June 2012. The first chapter discusses the background to the audit and sets out the audit aims, the audit questions, the audit method, the scope of the audit and the format of the eight accompanying diagrams. The second chapter sets out the summary diagram and discusses our conclusions on guarantees and trend related expenditure.

1 About the audit

1.1 Background

Our strategy document for 2010-2015 (*Strategie 2010-2015*) identifies the sustainability of public finances as a key long-term theme. One of the first reports we published that reflected our enduring interest in this theme was entitled *State property: volume and value* (*Staatsbalans: zicht op staatsvermogen*, 2011). This report painted a picture of the public sector's assets and liabilities and the way in which the government balance sheet is drawn up. The report was compiled in response to a request from the Dutch House of Representatives.

The report showed that the government balance does not at present include a contingency provision, even though international accounting standards suggest that it would prudent to maintain such a reserve. The term 'contingency provision' refers to liabilities the timing and/or value of which is or are uncertain. Generally speaking, a provision must be made if the management of an organisation feels that it is exposed to an unavoidable risk that could lead to costs being incurred in the future (this is known as the principle of prudence). Given that the government balance sheet does not include a contingency provision, it does not provide comprehensive information on the extent of the risk to which the State is exposed.

This finding prompted us to organise, in conjunction with the Ministry of Finance, a discussion meeting for members of the Senate and the House of Representatives. This issue was also the subject of correspondence between the Minister of Finance and the House of Representatives. It was made clear to us from these contacts that Dutch parliamentarians are in need of a full picture of the risks, and the different types of risk, to which the public finances are exposed. The audit on risks to public finances is intended to meet this need.

1.2 Information on public finances

The government is responsible for informing the House of Representatives as clearly as possible about any changes in the public finances. The House is kept informed in a variety of ways:

- Topical information is published several times a year, in budget memoranda and related documents, on changes in the level of public debt and the State's financial assets.
- Every year, the government publishes ministry annual reports and the Central Government Annual Financial Report, in which it accounts for government income and expenditure. The House of Representatives is also given a list of government guarantees. In chapter 2 of the *Central Government Annual Financial Report for 2011*, the Minister of Finance described the type of information that he felt should be viewed in conjunction with each other in order to obtain a full picture of the state of public finances.
- A State balance sheet is published every year. This contains information for the House of Representatives on public-sector assets and liabilities at the end of the year under review.
- The Netherlands Bureau for Economic Policy Analysis publishes ageing studies, at least once every four years, on the long-term sustainability of public finances.
- The Netherlands Bureau for Economic Policy Analysis publishes, also at least once every four years, a study containing a number of medium-term scenarios, including scenarios for the public finances.
- Occasional use is also made of other means of supplying the House of Representatives with information carefully targeted to the House's needs. The publication of a report entitled *Schokproef Overheidsfinanciën* (2011) is an example.

Although these sources give a good impression of changes in the government balance sheet, the public debt and the long-term sustainability of public finances, they do not provide as much information on the risks to public finances. The government does not publish a regular, comprehensive report containing information collated from these sources on the risks to public finances. In other words, the members of the House of Representatives are not able to see at a glance to which risks the public finances are exposed, what the potential impact would be of the materialisation of these risks, and how they can be managed.

1.3 Nature of the audit

1.3.1 Aim

Our audit is intended to form a first tentative step in the presentation of a comprehensive picture of the risks to public finances,[1] and the action the government can take in order to manage them. We hope in doing so to reveal the linkages between various types of risk to the public finances and the relevant management tools. Explicit government guarantees are a major concern in this context. Because we wish to present our findings as compactly as possible, the report consists primarily of a series of diagrams accompanied by brief explanations.

Our objective in producing this outline is to ensure that a comprehensive summary of the risks posed to the public finances is made available to those responsible for planning the government's financial and economic policies and to the members of the House of Representatives, who need to decide on these policies. This should enable the government to adjust its policies to the risks associated with the (partially correlated) shocks and developments affecting the country, and with the government balance sheet, the public debt and the sustainability deficit.

1.3.2 Audit questions and method

We formulated the following two audit questions based on the audit aims outlined above:

- What are the main risks to the public finances, and how can these best be managed in our opinion?
- What are the potential consequences of the above for the Dutch government balance and public debt?

In order to answer these two questions, we interviewed a number of experts in various specialist fields within the broad domain of public finance. What we learned during these interviews helped us to select the specific risks to public finances examined in this audit. We also performed desk research into the risks to public finances. We presented our findings during a private meeting of experts organised in May 2012.

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[1] The term 'risks to public finances' is taken to mean national and international social, economic and/or financial shocks and/or developments that are reasonably likely to occur and which may have an adverse impact on the government balance and the public debt. There is no fixed time horizon, as this may vary from one type of risk to another.

1.3.3 Scope of the audit

Our audit focused largely on government guarantees. As far as explicit guarantees are concerned, the Court has full powers of audit. In relation to the other themes addressed in this audit, our powers are more restricted. Despite this, we decided nonetheless to include these themes in this audit, given their relevance to the formation of a comprehensive picture of the risks to public finances.

Because of the limited time and resources available, we were forced to set limits to our audit, which is why the audit report does not cover all the risks affecting public finances. We were compelled to make certain choices in this respect. First of all, we did not look at unforeseeable shocks such as natural disasters and nuclear catastrophes. Even with regard to the more foreseeable risks, we were forced to make a selection. For example, we did not conduct a thorough examination of the financial risks relating to climate and energy, nor did we analyse all the guarantees issued by the government. Instead, we concentrated on the most important (i.e. in terms of their financial value) guarantee schemes. At various points in the report, we refer to analyses performed by other bodies, who performed more detailed investigations than we were able to do. If we undertake any follow-up audits on this subject, we will need to broaden and deepen the initial outline of the audit.

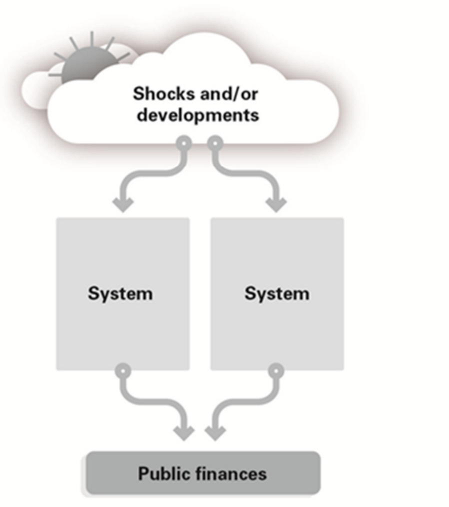
Our audit does not contain any judgements about the fact that the government has assumed certain financial risks during the past few years, nor as to whether these risks are adequately managed. Moreover, we have not attempted to do anything other than simply identify the scale of the risks, taking third-party data as our main input. In certain cases, our findings are clouded in uncertainty. We did not analyse the likelihood of the risks outlined in the report actually materialising in practice.

Finally, we wish to point out that, for the purpose of this audit, we concentrated exclusively on the *risks* that certain shocks and developments could potentially pose to the Dutch public finances. We did not assess the opportunities and the (social or financial) benefits associated with the same shocks and developments.

1.4 Format of the accompanying diagrams

We present our audit findings with the aid of eight diagrams: one general or summary diagram plus seven separate diagrams for each individual 'system', i.e. European guarantees[2], the financial sector, the housing market, the business sector, the healthcare industry, pensions and the economy, in each case accompanied by a brief explanation.
Although the summary diagram provides more general information than the seven detailed diagrams, all of them have the same format, as is illustrated by the following figure.

Figure 1 Format of diagrams



The top layer consists of social, financial and economic *shocks and/or developments* that entail certain risks to the public finances. The term 'shocks and developments' refers to sudden events, such as a crisis in the financial industry, or gradual processes such as the ageing of the population, which are more or less independent of government policy and are potentially capable of leading to additional government expenditure and/or lower government revenue.

The *systems* are shown in the middle layer of the diagram. In the summary diagram, this layer comprises the seven systems discussed in more detail in the report. These systems have been subdivided into three domains; the economy is both a system and a domain.

[2] By this, we mean the programs that are introduced to counter the European financial crises (such as the European Stability Mechanism (ESM), but also the activities of the IMF and the ECB in this respect).

The middle layer in the seven detailed diagrams shows the various actors involved in the system and the relationships between them. This part of the diagram also shows the maximum, theoretical impact of the risk to public finances that is described. The impact is expressed both in absolute terms and as a percentage of the gross domestic product (GDP).

The effects on the *public finances* are shown in the bottom layer of the diagram. These effects are expressed in terms of the potential change that might be caused to the government balance or the public debt, as the case may be. The terms 'government balance' and 'public debt' are used in the report in line with the definitions applying to the Economic and Monetary Union (EMU) as a whole. Thus, the EMU debt is defined as the aggregate value of the outstanding loans owed by central government, the social security funds and local authorities, less their debts to each other. The EMU balance is defined as the aggregate revenue of central government, the social security funds and local authorities, less their aggregate expenditure.[3]

The seven system diagrams also include green and red text boxes. The green boxes explain what opportunities, if any, are available to the government for managing the risks in question. The red boxes explain the extent of the risk posed to the public finances.

In the report each of the diagrams is accompanied by explanatory notes. These are worded in the form of a response to the following four key questions:
1. What external shocks and/or developments are the causes of this risk?
2. How is the system organised?
3. What are the potential consequences for public finances?
4. How can the risks be managed?

The answer to the first question is an explanation of the shocks and developments listed at the top of the diagram. The second question is about the actors and the relationships between them, as shown in the middle layer of the diagram. The third question addresses the potential consequences for the public finances of the materialisation of the shocks or developments in question. This refers to the bottom layer in the

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[3] According to the EMU definitions, all financial transactions are charged to the debt directly rather than through the balance. In practice, central government of course also incurs expenditure that is not offset by revenue, and this therefore leads to a worsening of the government balance of income and expenditure. So as nonetheless to give a clear impression of the consequences, regardless of the accounting method used, the diagrams show the financial transactions as being routed through the balance.

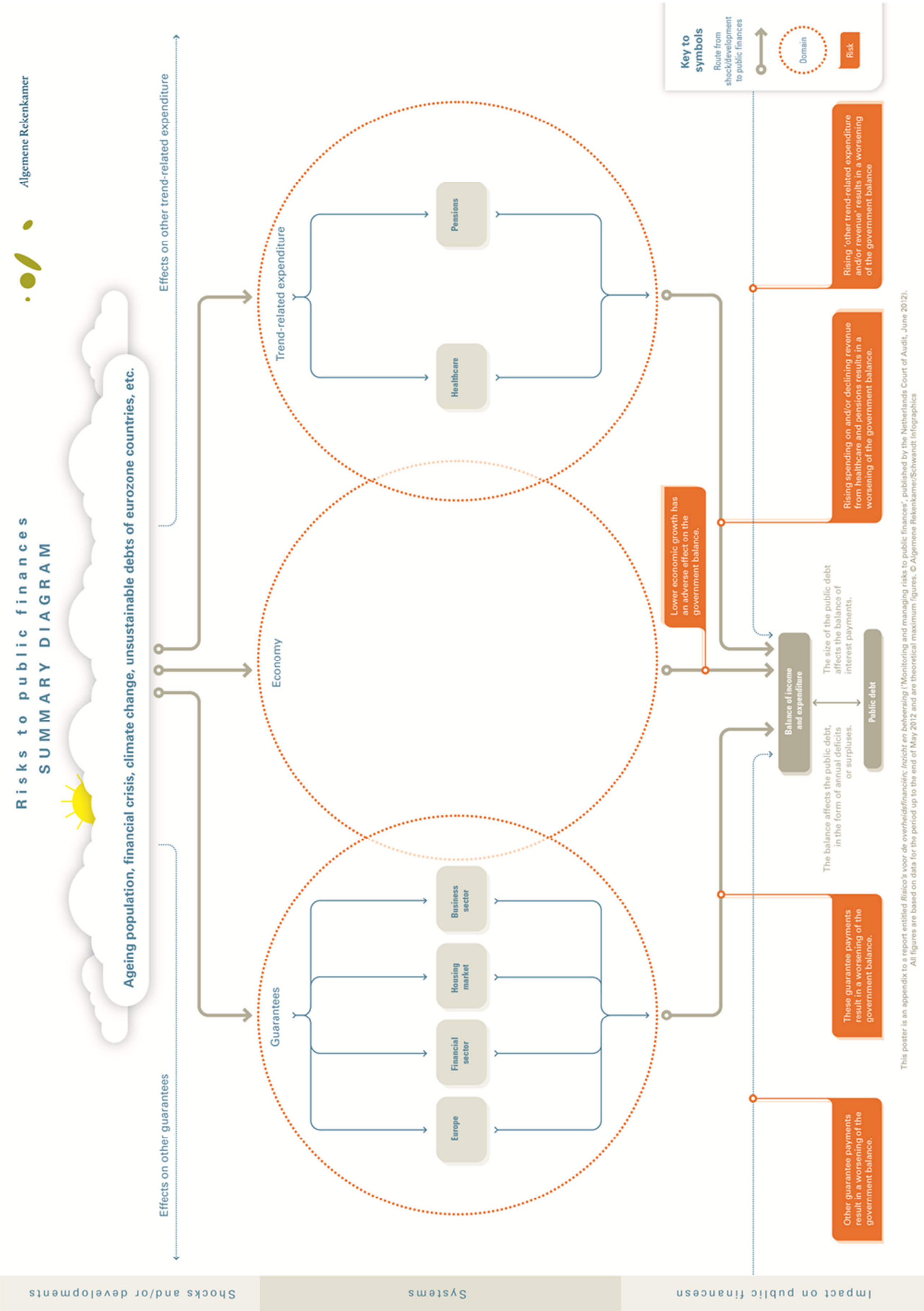
diagram (including the red text boxes). The fourth question relates to the management tools, which are shown in the green text boxes in the diagram.

2 Summary diagram

The top layer of the summary diagram consists of a mass of thick clouds, to emphasise the wide range of social, financial and economic shocks and developments potentially confronting central government. This is illustrated by a number of examples. Many of the shocks and developments are interrelated. A hike in interest rates, for example, not only affects the public debt, supplementary pensions and the amount of mortgage interest deducted from home-owners' taxable incomes (implying that it has an effect on public finances as a whole), it may also cause shocks in the financial industry as well as financial problems among eurozone countries.

The sun is intended to show that certain shocks and developments are also capable of exerting a beneficial effect on public finances. Such positive shocks and developments do not fall within the scope of our audit.

The middle layer of the diagram consists of three domains harbouring seven different systems. Europe, the financial industry, the housing market and the business sector all form part of the 'guarantees' domain. Healthcare and pensions together form a domain defined as the 'trend-related expenditure'. The 'economy' is a separate domain of its own.

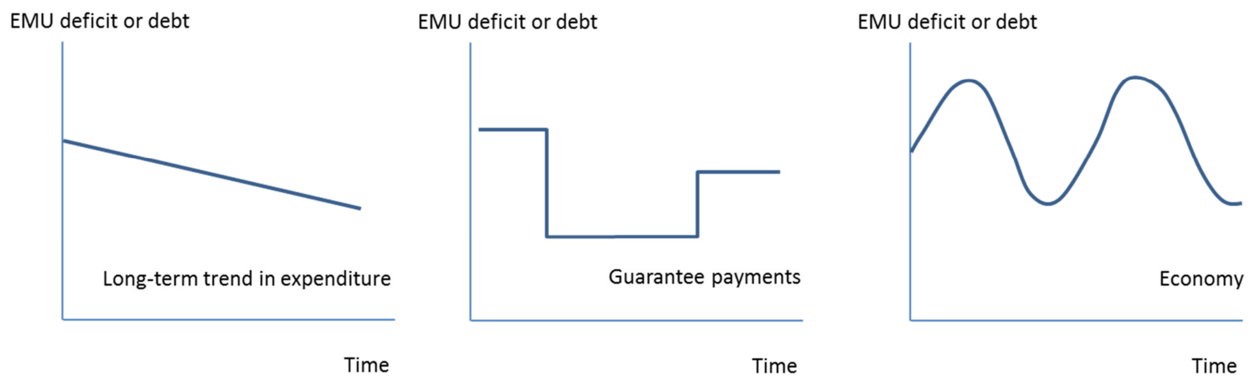

Risks to public finances
SUMMARY DIAGRAM
Algemene Rekenkamer
Ageing population, financial crisis, climate change, unsustainable debts of eurozone countries, etc.
Effects on other guarantees
Effects on other trend-related expenditure
Guarantees
Europe
Financial sector
Housing market
Business sector
Economy
Trend-related expenditure
Healthcare
Pensions
Key to symbols
Route from shock/development to public finances
Domain
Risk
Lower economic growth has an adverse effect on the government balance.
Balance of income and expenditure
Public debt
The size of the public debt affects the balance of interest payments.
The balance affects the public debt, in the form of annual deficits or surpluses.
Other guarantee payments result in a worsening of the government balance.
These guarantee payments result in a worsening of the government balance.
Rising spending on and/or declining revenue from healthcare and pensions results in a worsening of the government balance.
Rising 'other trend-related expenditure and/or revenue' results in a worsening of the government balance
This poster is an appendix to a report entitled Risico's voor de overheidsfinanciën; Inzicht en beheersing ('Monitoring and managing risks to public finances', published by the Netherlands Court of Audit, June 2012).
All figures are based on data for the period up to the end of May 2012 and are theoretical maximum figures. © Algemene Rekenkamer/Schwandt Infographics
Shocks and/or developments
Systems
Impact on public finances

The main reason for classifying the systems in three different domains is that the three sets of systems all have different effects on public finances (i.e. the bottom layer in the diagrams):

- Guarantees lead to expenditure only after a shock has occurred: if a shock occurs, the government has to pay. Although there is only a slight risk that the government will have to pay and although the extent of the risk is unquantifiable, if the situation in question does occur, the impact on public finances is both large and reasonably easy to quantify. To a certain extent, the risk is foreseeable where explicit guarantees have been given (see the next section for a definition). However, there are also certain risks that are unforeseeable, where the guarantees in question are implicit (see the next section for a definition).
- Assuming there is no change in government policy, there are more or less bound to be long-term trends in expenditure. However, these is slow, stealthy process of change. Long-term trends in expenditure are explicit and foreseeable. The pace of change is slow and no one has a clear idea of their impact. For example, the annual percentage rise in spending on old-age pensions is relatively low, but because public pensions will continue to rise year in, year out if government policy remains unchanged, the rise – however low it may be – may nonetheless pose a serious long-term risk to public finances.
- There is a direct positive correlation between the third domain, the economy, and public finances. In other words, if the economy is in a healthy state, then so are public finances, and vice versa.

Figure 2 shows the different ways in which changes in the three domains affect public finances.

Figure 2 Different domains have different effects on public finances



2.1 Guarantees

A government guarantee is a financial commitment made by the government to a contractual party that results in a payment if either the contractual party or a third party is affected by a certain specified event. The government can use guarantees to implement certain policies where no cash is available to pay for them. In this sense, guarantees appear to be a form of cheap – even free – policy-making. However, that is not how it works in practice, as there is always a possibility that a guarantee will lead to some form of government expenditure.

For the purpose of our audit, we have divided the guarantees into two categories:

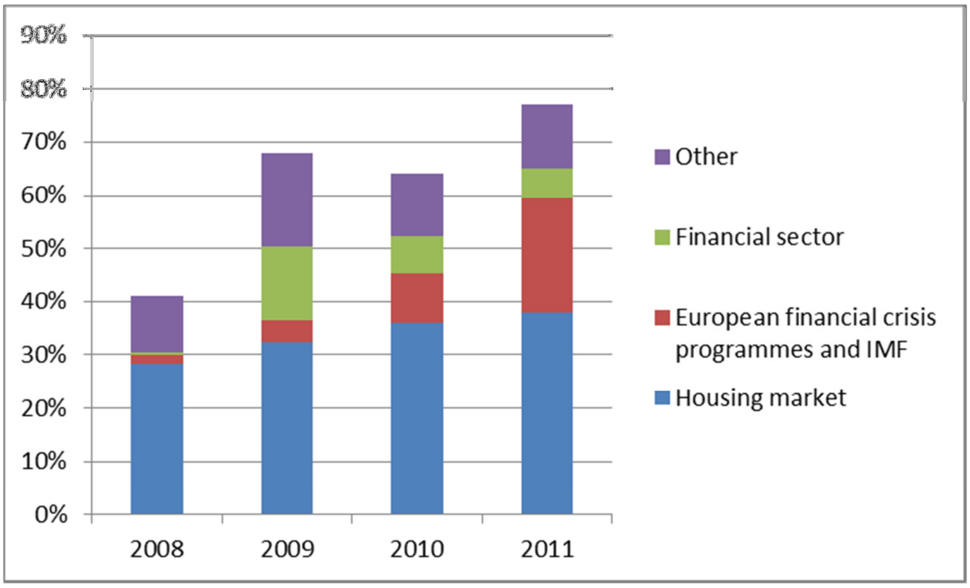
1. *explicit guarantees*, where it is clear from the outset that the government is the guarantor; and
2. *implicit guarantees*, where there is no formal record stating that the government has taken on a commitment, but where the public interest is so great that it is assumed that the government will intervene if anything goes wrong.

Explicit guarantees may be further subdivided into the following two categories:

1. *Direct explicit guarantees*. Here, the government is the first party to be sued for payment once the risk in question materialises. Generally speaking, the government sets a maximum limit (or 'ceiling') for these guarantees before taking them on. Export credit insurance is an example of a direct explicit guarantee.
2. *Indirect explicit guarantees or 'secondary guarantees'*. Here too, it is agreed in advance that the government will stand surety, but the guarantee is intended to be a safety net. Another body is the primary guarantor and is therefore liable for payment in the first instance if the guarantee is invoked. In such cases, it is not customary to set a ceiling for the government's liability. The government's role as a safety net in the system of national mortgage guarantees is a good example of an indirect explicit guarantee.

The following graph shows the value (expressed as a percentage of GDP) of the explicit government guarantees issued during the past four years.

Figure 3 Explicit government guarantees as a % of GDP, 2008-2011



Source: Dutch central bank (2012a), Annual Report 2011

Figure 3 shows that there was a rise in the value of the explicit government guarantees issued between 2008 and 2011, primarily in relation to the housing market, the European debt crisis and the financial industry. Explicit government guarantees worth 77% of GDP were issued in 2011, representing a figure of approximately €465 billion. Figure 3 does not include implicit government guarantees.

The categories into which the guarantees are divided in Figure 3 are similar to the systems in this particular domain in our own classification. However, we did not restrict ourselves to explicit guarantees, as we are interested in the system or policy field as a whole and the role played by the government goes beyond the issue of guarantees, whether explicit or implicit. That is why we have included in our analysis, for example, the interest-rate risks to which the government is exposed in relation to the tax-deductibility of mortgage interest, the implicit guarantees and the back-up facility for the financial sector. Finally, our 'Other' category relates primarily to private-sector companies, which means that we did not include all guarantees in these category (these are included in Figure 3).

2.2 Trend-related expenditure

The term 'trend-related expenditure' refers to government spending that may rise very slowly over the next few decades if there is no change in government policy, and in doing so may exceed the projections in the sustainability figures published by the Netherlands Bureau for Economic Policy Analysis. We have identified spending on healthcare and pensions as being the main risks in this particular domain. This is not to say that these are the only risks in this domain. Other risks include the costs associated with climate change, for instance.