



Kingdom of Bahrain
National Audit Office

DEFINITION OF PUBLIC DEBT & ITS RELEVANCE FOR SUPREME AUDIT INSTITUTES

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INTRODUCTION

The Importance of Public Debt

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Public Debt (PD) is one of the most important issues occupying many of the world's governments today. It is directly related to the work of Supreme Audit Institutions (SAIs) as their fundamental goal is to ensure the proper management of public resources. The nature of SAIs work requires a profound understanding of PD and its components. PD and the economic situation of a country are interlinked. In the current climate of profound economic and social challenges caused by the Covid 19 pandemic, levels of PD have been affected. Therefore, the understanding of what constitutes PD has gained even further in importance.

“Practice varies from country to country and, within a given country, central and local governments may follow different rules.” IMF working paper (WP/15/238)

Despite its importance, however, there is no globally adopted definition of PD. While economists agree on uniform methodologies for some economic indicators such as Gross Domestic Product (GDP), unemployment rate and inflation rate, this is not the case for PD. This represents a major challenge to SAIs which are responsible for monitoring levels of PD and providing an objective assessment of the real debt situation.

“While key macroeconomic indicators such as Gross Domestic Product (GDP) or Consumer Price Index (CPI) are based on internationally accepted methodologies, indicators related to the debt of the public sector often do not follow international standards and can have several different definitions.”

IMF Staff Discussion Note (SDN/12/09)

Accordingly, the point made in the IMF Staff Discussion Note that measuring PD differs from country to country raises questions about the validity of indicators for evaluating PD, such as the ratio of PD to GDP (PD / GDP), and other indicators that may be used by SAIs. In this article, scientific proposals will be presented that help SAIs define PD in such a way to assess its levels objectively. This is in line with the '*Lima Declaration*', the Magna Carta of government auditing approved by the International Organization of Supreme Audit Institutions (INTOSAI), which states that one of the specific objectives of SAIs work is to ensure "the proper and effective use of public funds".

INTOSAI PD DEFINITION

How do SAIs identify PD?

In its report issued in the year 2000, the INTOSAI PD Committee concluded that the definition of PD varies according to its purpose: if it is used to focus on accountability, the definition will be limited to the balance of PD as issued by the government organization that falls within the audit scope; in contrast, economists always need a comprehensive, Macro PD definition when studying the contributions of PD to a country's national economy.

Although the committee's report indicated that SAIs exercise their own judgment regarding the obligations that must be included in the PD balance, it did not provide a clear definition of the PD components. Therefore, determining PD components must be carried out according to the scope of the audit assignment. Financial audit needs a broad Macro definition by which the actual total of the PD is determined, so it will include all financial obligations of the government during the fiscal year, including the financial obligations of the central as well as local governments, in addition to the obligations of independent government bodies and other obligations that fall within the scope of government liabilities. However, performance audit, such as audit of the management of bonds or treasury bills or audit of internal PD, may need a less comprehensive Macro definition containing fewer components of PD than that used in financial audit.

MACRO & MICRO PUBLIC DEBT DEFINITION

New Perspective

SAls need to form an accurate picture of the actual level of government PD. To ensure that the level of borrowing and the related risks are within acceptable levels, a unified definition between SAls is required. This definition should be inclusive of all aspects of PD so that it contributes to conducting audit assignments objectively. In addition, as SAls sometimes need to audit only one component or a specific type of PD, a PD definition that is less Macro is required which may serve the purpose of such audits. Accordingly, the types of PD definition in this article will be classified into two basic categories as follows:

A) Macro PD Definition: PD is defined by including all federal and local government loans, independent government agency loans, government company loans, and all liabilities to suppliers and manpower at the level of federal and local governments, independent government agencies, and government companies.

B) Micro PD Definition: PD is defined by including some components of the PD mentioned in definition (A) above, for example if the scope of audit is the following:

- audit of a specific component of PD, such as audit of bonds or treasury bills ... etc.
- audit of a specific category of PD, such as internal or external PD, long-term or short-term PD, etc.

Macro PD definition application

It is possible for SAls to apply the Macro PD definition when conducting audit at State level. This definition gives a more comprehensive and accurate picture of a government's PD level, its financial solvency and its ability to cover its PD. In addition, it helps to measure a government's ability to manage PD effectively and efficiently. Furthermore, this definition follows the PD definition in the statistical system, in which all registered liabilities of the government, which carry payment obligations, are included. ¹

The definition of PD in the statistical system is Macro as it covers the entire public sector, central government, local governments and public sector institutions, whether independent or not, and is in line with international standards that require States to report PD in its Macro scope to the IMF for instance for the purpose of borrowing.

Although this definition may be inconsistent with the definition of PD in State law, it should not prevent SAIs from using it, given its compatibility with best practices and the fact that it provides a more accurate picture of a State's real and entire debt situation, and especially since a working paper issued by the IMF argued that PD law should help to show the true amount of PD to ensure accountability and transparency in public debt management.

“The key objective [of the legal framework] should be to help ensure that the quantum of public debt and contingent liabilities is clearly reported on and performance under the medium-term debt strategy is monitored and evaluated.”

IMF working paper (WP/15/147)

Measuring the true size of PD, evaluating PD management activities, assessing the ability of a State's economy to bear the level of PD and its rate of growth, and appraising the possibility of achieving the goals of low PD costs and an acceptable level of PD risk, is mandated with this definition. It refers to the basic directives of controlling PD at Macro level, and the same directives should be covered by a definition of PD in a PD legal framework, especially since the definition of PD according to State law may not give an accurate picture of the true amount of PD due to a narrow definition of PD in this law only including a limited number of PD components.

¹ (Public Sector Debt Statistics: A Handbook for Minerals and Users, p. 7) This guide has been jointly prepared by the following nine organizations: The Bank for International Settlements, the Commonwealth Secretariat and the European Central Bank, the Organization for Economic Cooperation and Development, the Statistical Office for European Communities, the International Monetary Fund, and the Club Secretariat Paris, United Nations Conference on Trade and Development and the World Bank Group.

The following is an example of situations where the PD definition in its Macro scope should be used:

- 1) Determine the actual balance of PD at State level.
- 2) Determine PD instruments (development bonds, treasury bills, loans received from funds, loans received from local banks), calculate their balances and match them with the government financial records.
- 3) Calculating the PD interest accrued by the government and matching it with the PD interest registered in the final account of the State during the fiscal year.
- 4) Calculating other economic indicators that depend on determining the balance of PD, such as the ratio of PD to GDP, and the extent of their occurrence within the internationally accepted range, which are important indicators for determining the effectiveness of a State's performance in managing PD.
- 5) Measuring the benefits of PD based on its actual balance and its impact on total State development.

Micro PD definition application

Micro PD definition can be applied by SAIs for the purpose of auditing a specific component of PD and measuring its management effectively, such as assessing the effectiveness of PD management of bonds and treasury bills, or the management of development fund debts. This definition helps to focus on a specific instrument of PD, and is in line with the methodology of defining PD according to the objective of the audit scope, referred to by the INTOSAI PD Commission, which may focus on a government's ability to pay principal debts according to time periods, or on the productivity of using PD. The following are types of PD Micro definitions and their components:

- 1) **External & Internal PD:** PD is defined according to the source of borrowing, whether it is internal or external.
- 2) **Productive & Unproductive PD:** PD is defined according to how much of PD has been incurred in the creation or development of State assets in comparison to how much of PD was used to finance the operating expenses of the government apparatus.

3) **Long-Term & Short-Term PD:** PD is defined according to maturity periods.

METHODOLOGY TO DETERMINE WHICH DEFINITION SHOULD BE USED ACCORDING TO AUDIT SCOPE

The Methodology

A simple mechanism can be applied to determine which PD definition should be used for an audit assignment, which follows these:

- 1) Determine the objectives and scope of the audit assignment.
- 2) Determine whether there is a need to use the Macro or Micro PD definition, according to the objectives and scope of the audit assignment specified in Step No. 1.
- 3) If the Macro PD definition is applied, then PD should include all government liabilities.
- 4) If the Micro PD definition is applied, then PD should only include those components that will be audited according to the specific objectives and scope of the audit assignment.

“PD audit is a very important subject due to the impact PD can have on the economic performance and social situation of a country, especially as many economies are currently facing exceptional challenges caused by the covid 19 pandemic. This calls for a clear definition of PD that serves the specific audit objectives and the scope of the audit assignment. According to the INTOSAI PD Commission report mentioned earlier, the key to determining which components of PD should be included in its definition is to first determine the purpose of using the definition.

This article attempted to classify the types of PD definitions into two basic categories, Macro and Micro PD. It further attempted to develop a methodology for determining which type of PD definition is to be used in line with the objectives and the scope of the audit assignment, and in line with best practices and international guidelines issued by international financial organizations such as the International Monetary Fund and the World Bank Group.”

