Who finances the financiers?

Twenty years of HM Treasury resource accounts

Mario Pisani

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Jon Davis: Good evening, everyone. My name's Jon Davis; I'm director of the Strand Group at King's College London. What a great pleasure it is to be doing this, this evening. The Strand Group exists to try to understand how government really works – through research, through teaching, through training, and tonight through an event. This is the fourth event of our new – relatively new – Institutions of British Government research seminar programme, and is in partnership with the Institute of Historical Research. A very big thank you to their director, Professor Joanne Fox, for helping us with this.

So, it's a great pleasure to introduce Mario Pisani. Mario is currently deputy director in the Fiscal Group at HM Treasury; he joined the Treasury in 2005 and has worked in macroeconomics, international policy, communications, and as private secretary to the chancellor. But from our point of view this evening – much more importantly – he's a visiting professor at King's.

And through that, he's been a stalwart of our Treasury postgraduate history class, which got underway about five years ago; we're about to start the sixth at the end of this month. And it's something that myself and our respondent this evening, Lord Macpherson, put together back in the wilds of time.

With an increasingly relevant presentation on "Who finances the financiers?", I will waste no more time in handing you over to Professor Pisani.

Mario Pisani: Thanks Jon for the incredibly kind introduction.

I am delighted to be able to deliver this talk tonight.

It's just amazing to see so many people tuning in for it – I hope you enjoy it.

Before I begin, I would like to say thank you to a couple of people.

This lecture is delivered in a personal capacity and does not represent the views of HM Treasury or the UK Government. All errors and omissions are the author's responsibility. Please contact the author at mario.pisani@hmtreasury.gov.uk to obtain a copy of the paper on which this talk is based.

I am incredibly grateful to Nick Macpherson and to you Jon Davis for how you have encouraged me and supported me in researching this topic and preparing this talk.

I also want to say thank you to everyone who has helped me with this – whether it be with comments, getting me some data, or checking my calculations – I am so grateful and while I can't name you all tonight, the published version of this talk includes a full list of acknowledgements.

Special thanks to Nick Hamill in the Treasury finance team, as without him and his copies of the accounts from 20 years ago I wouldn't have been able to do this.

My talk tonight is entitled "who finances the financiers? Twenty years of HM Treasury resource accounts".

[Introduction]

[SLIDE]

In the fifth season of the TV series *The Simpsons*, episode 11 sees the town of Springfield struck by a burglar. Among other things, the criminal steals Marge's pearl necklace and Lisa's saxophone. Homer decides to start a neighbourhood watch group to catch whoever is responsible for the burglaries.

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Homer being Homer, his group quickly starts abusing their powers, and turns into a bunch of vigilantes. Lisa then challenges Homer saying: "if you're the police, who will police the police?".

[SLIDE]

Lisa's comment can be traced back to the early years of the 2nd Century AD and the work of the Roman poet Juvenal.

His original phrase "quis custodiet ipsos custodes" can be translated literally as "who will guard the guards themselves" and was originally used in a very different context. In its modern usage, the question has become "who watches the watchmen?" and it's now used to describe the challenge of controlling those in a position of power.

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Her Majesty's Treasury is the United Kingdom's economic and finance ministry.

In the British system of government, the Treasury holds tremendous power. This power is primarily derived from the Treasury's role in allocating public finance across all government departments. So in this lecture I will try to apply Juvenal's insight to the Treasury itself, and ask "who finances the financiers?".

I will answer this question by analysing the information contained within the Treasury's annual accounts.

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These accounts allow us to understand the full range of resources available to finance the activities of the Treasury. By this I mean not only the financial resources in the form of funding, expenditure, assets and liabilities, but also human resources, organisational culture and institutional partnerships. It is also a good time to do this, as last year marked 20 years since the Treasury started publishing audited resource accounts. My thesis tonight is that the story of the Treasury between 1999 and 2019 is a tale of significant change coupled with surprising constancy.

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This lecture is divided into five parts. First, I will talk about what the Treasury is, and how that has changed since 1999. Second, I will explain how the Treasury has financed its activities over the past two decades. From this will follow, third, a look at the Treasury's core resource – its people. Fourth, I will examine the huge expansion in the Treasury's balance sheet since the financial crisis. And fifth I will conclude by looking at the financial relationship between the Treasury and two of its most important institutional partners in finance, the Debt Management Office and the Bank of England.

1. What is the Treasury?

Let me move into the first part of this lecture.

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I would like to pose a rather straightforward question: what is the Treasury? Please take a second to think about it.

I wonder what image comes to mind. For a lot of people, the Treasury conjures up an image of its current building, with its entrance on Horse Guards Road, looking onto St James's Park. But this is not a location that the Treasury has occupied for very long – in fact, that side of the building only became the Treasury's headquarters in 2002.

For many, the Treasury is synonymous with its leadership. On the political front, this means the Chancellor of the Exchequer Rishi Sunak MP; on the official side, the Permanent Secretary, Sir Tom Scholar. But more than a building or a person, the Treasury is a set of ideas.

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These ideas can be distilled into two central concepts: a common purpose and an organisational structure. And these, in turn, are the main elements of a coherent institution. I would like to take a few minutes to explore how these two concepts – the Treasury's purpose and the Treasury's structure – have evolved over time.

Let me start with the Treasury's purpose: the administration of the government's finances. The history of this function can be traced back hundreds of years, with the official role of the Treasurer – or the person charged with administering the monarch's finances – reliably appearing in historical records since at least the early Norman period. Since the Middle Ages, the Treasury's specific goals have changed hugely over the centuries, of course, but the underlying purpose has remained broadly the same. And that has continued over the past 20 years.

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The first set of resource accounts, for the year 1999-2000, set out nine objectives for HM Treasury. Over the twenty years that followed, the number of objectives decreased, to eight in the mid-2000s and then to three or four from 2008 onwards.

This table shows a comparison between the nine departmental objectives from 20 years ago and the most recent set of Treasury objectives from 2018-19. While the number of objectives listed, and the language used, changed in that time, the substance is remarkably similar. There are some objectives about using tax and spending policies to ensure sound public finances (shaded grey). There are objectives about maintaining macroeconomic and financial stability (shaded blue). And there are objectives about increasing productivity and employment (shaded orange). In recent years, the annual report and accounts have also included a corporate objective – set by the department's management rather than its ministers – which sets out how the Treasury would like to manage itself as an institution (shaded green).

As well as a common purpose, the other thing that defines the Treasury as an institution is its organisational structure. In the period since the end of the second world war, the Treasury has seen recurring institutional reform. And the annual account show that continuing in the last 20 years.

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One way we can see this is by looking at the basis on which the accounts are consolidated each year. The thing to realise is that the accounts are not about "the Treasury" but about "the Treasury Group". The Treasury Group is the parent entity comprising so-called "Core Treasury" – or the main department which most people think about when they think of the Treasury – as well as a range of other agencies and arms-length bodies. In 1999-00 the Treasury Group was relatively simple, it was made up of two organisations: the Treasury and the Debt Management Office.

As this chart shows, the number of entities within the Treasury Group has expanded significantly since 1999. In last year's accounts, there were 19 different public bodies within the Treasury Group, just below the peak two years earlier. Some of this large expansion is because of the government-wide effort to improve alignment in financial reporting around 2011-12. On top of that, new entities were created within the Treasury Group for specific policy or delivery purposes. Some of it is due to functional transfers, where a unit or function has transferred in or out of Treasury, as a result of machinery of government changes – for example when the PMDU moved into HMT in 2007 or PensionWise moved out in 2016.

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The Treasury Group today includes a real mix of organisations with a surprising range of functions covered. As set out here, the 19 entities can be classified into two categories: "Core Treasury and Agencies" and the wider set of arms-length bodies. Some of these have specific functions that are expected to remain part of the institutional architecture for the foreseeable future, such as the Office for Budget Responsibility (which is responsible for forecasting), or the Financial Services Compensation Scheme (which is responsible for compensating bank depositors). But others are expected to have more time-limited functions, such as UK Asset Resolution (which holds legacy banking assets acquired during the financial crisis).

So let me come back to the question of "what is the Treasury?" It seems clear that the Treasury's aim has remained remarkably constant, not only over the past twenty years but for decades before that. It is the Treasury's organisational structure which has seen almost continuous evolution. The Treasury Group of today, with its different agencies, bodies and companies, would seem almost unrecognisable to the Treasury officials of 20 years ago.

2. How is the Treasury financed? Follow the money

I would now like to turn to the second part of this lecture and look at the question of how the Treasury has financed its operations over the past 20 years.

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This should be a simple enough question to answer. But it is not simple. Principally because there is no published time series which shows the amount of funding that the Treasury has received each year for the past 20 years. You may find that surprising. But there are good reasons why. As we just saw, the Treasury Group, as a set of institutions, has changed significantly since the late 1990s. The way in which departmental budgets are measured has also changed in that time. And at various points in the past two decades there have been large one-off receipts and expenditures, which have distorted the Treasury's budget. Because of all these challenges, it is only by using 20 years of published accounts that it is possible to show how the Treasury has financed itself between 1999 and 2019.

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It is worth clarifying upfront the difference between how the Treasury itself is financed and how the Treasury finances the whole of government. While institutionally and operationally the Treasury has full control of "the Exchequer" – or the central funds that are used to manage the flows of government revenue and expenditure – in accounting terms they are separate. So while the Treasury is the financier, in the sense that they can decide how funds are allocated across government, the funds themselves do not flow through the Treasury's accounts, but through the accounts of a number of central funds, such as the National Loans Fund and the Consolidated Fund.

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So what about the Treasury's funding. The starting point, the place where most people would look first, is an annual Treasury publication called *Public Expenditure Statistical Analyses*. This is a rich publication with lots of information regarding public spending. One way it presents information is according to the so-called budgeting framework or in other words data on each department's resource and capital budgets. These are the funds which were originally set out by the Treasury as part of a spending review, they were then voted on and approved by Parliament in the usual supply process, and were then spent by each department. Indeed, this way one can see recent data on the Treasury's expenditure. The problem is that prior to 2016, a different definition was used – HM Treasury was included as part of the so-called "Chancellor's Departments", which comprised the Treasury, HM Revenue and Customs, and National Savings & Investments. So this only provides an incomplete picture. An alternative source could have been past spending review publications, but the problem with that approach is that the data would have been based on planned expenditure rather than actual outturn. Instead, one can use the Treasury's annual resource accounts, because each year's publication sets out the actual expenditure incurred in the preceding financial year.

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As shown in this table, in 1999-00 the Treasury's resource spending was £266m, and then £274m and £235m in the two years that followed. It was around this time that the budgeting regime changed to differentiate between two different types of public spending, the so-called "DEL and AME". Let me explain: DEL stands for *Departmental Expenditure Limit* and covers all administration and programme spending which can be reasonably controlled; AME stands for *Annually Managed Expenditure,* which is spending that is less predictable and controllable. From 2002-03 onwards the Treasury's resource budget is reported using this split. This shows that, up to 2007-08, the Treasury's DEL spending ranges between £167m and £212m, while the AME budget ranges between £24m and £192m. The capital budget is small compared to the resource budget, with the one exception of the Treasury's decision to refurbish its building and re-locate headquarters using a 35-year PFI contract.

It is after the financial crisis of 2008-09 that things get complicated. As the table shows, from that point onwards, the Treasury's budget becomes a lot larger and more volatile. This is particularly the case for the AME budget, which increases from millions to billions, and ranges between £42bn in 2008-9 and minus £49bn (so negative expenditure) in 2014-15. I have not shown it here, but the capital AME budget also expands dramatically: in fact, as recently as 2006-07 the annual accounts declared that (I quote) "HMT Group has no capital AME" – only two years later in 2008-09 capital AME spending reached £85bn.

The reason for these huge increases in spending are apparent: they are the consequences of the financial stability interventions that the Treasury took during the financial crisis. These interventions included, among other things, the purchase of shares in large UK banks, the provision of loans to firms in distress, and in some cases outright nationalisation. This means that, from that point onwards, the biggest single items in each year's accounts involve assistance to financial institutions or financial stability interventions. A dissection of the public finance implications of the banking crisis is beyond the scope of this lecture. But it is a fascinating topic – which others such as the OBR have tackled with great insight – and for the aficionados I can recommend the detail set out in successive annual report and accounts from 2008 onwards.

How can we abstract from these distortions? Looking at the Treasury's DEL spending in isolation does show a less volatile picture, but it is also not completely free of distortions. For example, between 2012 and 2014 the Treasury recorded significant negative spending within DEL, primarily due to income from misconduct fines imposed in the wake of the LIBOR and FX scandals.

So across both AME and DEL there is a bit too much noise in the data to be able to answer the question of how the Treasury funded itself – rather than how it funded its policies. But there is a way. The annual accounts also set out, each year, how much of the Treasury's spending went on so-called administration costs. This is defined as "the costs of running a central government department … that do not relate to the delivery of front-line services." It is primarily made up of pay for the department's civil servants, as well as accommodation and other administrative expenses. It is therefore the closest thing to something that will help us understand how the Treasury itself is financed.

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This chart shows administration costs for HM Treasury between 1999 and 2019. In the paper I have data for both the Treasury Group and Core Treasury – here I have only plotted the latter. With the exception of 2002-03 (when costs increased as a result of the PFI contract on the Treasury's main building), administration costs for Core Treasury have never exceeded £150m per year. Most frequently, these costs have come in somewhere between £100m and £130m per year. The key point here is that administration costs are remarkably less volatile than the wider definitions of Treasury spending (in DEL and AME), because it takes out the financial impact of the Treasury's various policies over this time.

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We can also look at how the change in the Treasury's administration budget compares with growth in the wider public sector and the economy. The answer is – it compares pretty favourably. As set out in this table , the increase in administration costs between 1999 and 2019 was equivalent to total growth of 79%, which equates to average annual growth of 3.1% per year. In the wider public sector, over the same period, total managed expenditure grew by 127% or an average of 4.4% per year. Over the same 20-year period, nominal GDP grew by 3.8% per year on average. Another way to present this is by deflating Core Treasury administration costs, to calculate the real terms growth rate. This shows that administration costs grew by 23% over the 20 year period, or real annual growth of 1.1% on average.

Let me bring this section together – and answer the question of how the Treasury has financed its operation in the past two decades. To do this we need to look through the vagaries and distortions inherent in the reporting of public spending. We are able to do this by focusing on the Treasury's administration costs. My main insight is that, despite the long time period covered, how much the Treasury has evolved as an institution, and the policy interventions undertaken, there is a remarkable degree of constancy when it comes to the cost of running the Treasury. Unsurprisingly, the Treasury has been quite good at keeping costs down.

3. Who are the financiers? People at HM Treasury

[SLIDE]

Now let's move on to the next part of my talk. As Nick Macpherson said in his excellent lecture *The Origins of Treasury Control* – "the Treasury is only as effective as the people within it". So in this section I will look at what the Treasury's accounts tells us the organisations biggest cost-driver – its people.

Let us take a recent year for illustration. In 2018-19, staff costs at Core Treasury amounted to £125m, compared to total net administration costs of £150m.

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As this table shows, the number of people employed has fluctuated over the years. In most years, staff totals have ranged between 1,100 and 1,300 staff. In the earlier years, 1999 to 2002, a smaller Treasury had fewer staff; in recent years and during the financial crisis, the number of employees has grown higher, as a result of the significant pressures placed on a department facing significant policy challenges.

The annual accounts also have data on the Treasury's senior civil servants, which is available for most of the past 10 years. Again, we see a remarkable degree of stability, with the senior civil service at Treasury ranging between 90 and 120 members since 2007-08. In recent years there have been some who have questioned whether the proportion of senior to total staff is appropriate for a department with such critical central responsibilities as HM Treasury.

Another interesting insight from the annual resource accounts is the data on staff turnover. This is a well-known Treasury issue. It became especially prominent in 2012, when the then Director General Sharon White undertook a review of the Treasury's response to the financial crisis. She identified high staff turnover as one of the organisational challenges affecting the Treasury's management of the financial crisis. In the run up to the crisis, the turnover rate had fluctuated around 25%, peaking at 38% in 2008. Since then, in the past 10 years, staff turnover at Treasury, as recorded in the annual accounts, has ranged between 21% and 25%, with the exception of the year 2015-16 when it dropped to 13%. While lower than pre-crisis, the turnover rate is still high by Whitehall standards, and the source of some concern among commentators who believe it may lead to higher costs and inefficiencies.

A lot of people leave Treasury each year, for sure, but they are not all leaving because they do not enjoy it there.

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In fact if you look again at these images of Treasury staff, which I got from Google Images, everyone looks really happy.

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The annual accounts also report key results from the annual civil-service-wide people survey. This is a huge effort, first launched in 2009, and which in recent years has seen over 300,000 civil servants take part. The main metric that people look at is the so-called *employee engagement index*. This is an aggregate measure which brings together answers to a number of questions on job satisfaction. For the Civil Service as a whole, the median departmental engagement score has ranged between 56% and 62% in the ten years up to 2018. For the Treasury, the employee engagement score has ranged between 65% and 75%. As shown in this table, Treasury has consistently been among the top three most engaged departments. And it the last five years it has been the top-scoring main department when it comes to employee engagement.

So what do the accounts tell us about the Treasury's people? The department is relatively small by Whitehall standards, its total staff averaging around 1,150 people in the past 20 years. Since 1999, the total number of people employed at Treasury has grown, with peaks around the financial crisis of 2008 and following the vote to leave the European Union in 2016. Turnover is relatively high. But the annual people survey shows that the Treasury's staff are engaged and positive about their work.

4. The Treasury's balance sheet – a tale of two halves

Moving on.

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Finance is about flows (resources in and expenses out), but it's also about stocks (assets and liabilities). In the fourth part of this lecture, I want to look at what the Treasury's annual resource accounts tell us about the Treasury's balance sheet. Again, this is a story of two halves: before and after the financial crisis of 2008.

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This can clearly be seen in this chart, which shows the Treasury's assets, liabilities and the difference between the two (so-called net assets or taxpayers' equity). In fact, it is actually quite hard to see what's going on in half of the chart: this is because the balance sheet expanded so much following 2008 that the plot of the data in the years before then looks miniscule in comparison with the later years.

It is much easier to look at the two periods separately.

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This chart shows the first period, or the years between 1999 and 2007. The Treasury's balance sheet is rather unremarkable. On average the Treasury Group held assets of between £1.5bn-£2.0bn. The largest subcategory of assets was *investments*, which made up between 75%-95% of total assets. And within investments, the single biggest item was the Treasury's ownership of the Bank of England. On the other side of the balance sheet, liabilities ranged between £100m-£400m per year, with the largest subcategory of liability being *trade payables.* The resultant net asset balance fluctuates around £1.5bn.

From 2007-08, the balance sheet changes considerably.

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This chart shows the Treasury Group's assets increase dramatically in the space of three years, reaching over £100bn by 2009-10. The increase in liabilities is less marked, peaking twice above £30bn, but more frequently ranging between £2bn-£9bn.

Looking at the assets side of the balance sheet, we can see that the changes are overwhelmingly driven by the financial stability interventions that took place during the financial crisis. This can be seen by looking at the two largest asset classes.

The first is financial assets (the orange series in the bar chart here). At its peak in 2009-10 this category of assets amounted to £65bn. This was primarily made up of holdings of shares in the banks that were recapitalised in 2008 – some £60bn of shares in the Royal Bank of Scotland and Lloyds Banking Group – as well as holdings in the fully-nationalised entities Northern Rock and Bradford & Bingley. Since the peak in 2009-10, HMT has disposed of many of these financial assets, with the latest set of accounts showing holdings of £24.5bn.

Second, there are loans and advances. In 2009-10 this category amounted to £57.5bn, with the vast majority accounted for by loans to Northern Rock, Bradford & Bingley, Dunfermline Building Society, and various Icelandic financial institutions operating in the UK. Loans peaked in 2013-14 at £68bn, following the consolidation into the Treasury Group of UK Asset Resolution or UKAR (as mentioned earlier – this is the holding company tasked with the disposal of legacy assets from the crisis). There were also additional loans to other financial institutions and the bilateral loan to Ireland during the European sovereign debt crisis. Since then, loans have reduced considerably, to £9bn in the latest set of accounts for the year 2018-19. It is worth remembering that the vast majority of these loans were aimed at supporting the commercial banks themselves during and after the financial crisis – as they primarily represent lending to their customers, for example in the form of mortgages.

There is a third asset class, in most years smaller than the other two but of considerable size, *derivative financial assets* (these are financial instruments settled in the future whose value is a function of an underlying item – they are labelled on the chart here as "derivatives"). This category has fluctuated significantly since 2008-09, from less than £500m to as much as £51bn in 2016-17. Over the years, there have been a number of items within this category. But the vast majority is accounted for by the impact of the Bank of England's policy of quantitative easing, which is 100% indemnified by HM Treasury. For example, in the latest set of accounts, this single item accounted for £45bn. And, because loans have been repaid and shares have been sold, this derivative is now the single biggest item on the Treasury's balance sheet. I will be saying a bit more about the relationship between the Bank and the Treasury in the following section.

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Let me briefly say a word about the Treasury's liabilities in the years since the financial crisis – as you can see from this chart, they are much smaller than the assets. Provisions increased significantly in the first couple of years. In 2007-08, the bulk of the provision is made up of the obligation to repay the Bank of England for the loan they extended to Northern Rock ahead of its nationalisation by the government. In 2008-09 there is £25bn provision to cover potential future losses arising from the Asset Protection Scheme (a financial stability intervention during the crisis). In the early years covered here there is also an increase in financial guarantees (once more, the biggest component are financial stability interventions like the Credit Guarantee Scheme). From 2012-14 another notable liability class is *debt securities in issue*, which primarily consists of securitised debt instruments issued by Northern Rock and Bradford & Bingley to fund their loan book.

To summarise this section, what do the last 20 years tell us about the Treasury's balance sheet? There are three key insights. First, the size of the balance sheet increased significantly after 2007-08. Second, the large increase in assets and liabilities was overwhelmingly driven by the financial stability interventions during the financial crisis. And third, even recently, while the balance sheet is gradually getting smaller, it is still large, with the single largest asset being the derivative financial asset resulting from the Bank of England's policy of quantitative easing.

5. Partners in finance: the DMO and the Bank

Let us stay with the Bank.

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Because in the fifth part of this lecture I would like to talk about two other institutions, which alongside HM Treasury can be considered to be "financiers" within the public sector: the UK Debt Management Office (DMO) and the Bank of England. Both institutions are important partners to HM Treasury. They both also have interesting histories. In fact, before 1997 their history is a common one, because before then the Bank was responsible for managing the government's debt. So today I will only scratch the surface – and focus specifically on how these organisations are financed and their links to the Treasury.

Let us start with the DMO. The DMO is an executive agency of HM Treasury. Its main responsibility is for raising finance for government by conducting operations in sterling wholesale debt markets and managing the Exchequer's daily cash management requirements.

The proposal for creating a debt management agency was announced in 1997. In the first few days after the Labour government was elected, the Chancellor Gordon Brown surprised commentators by granting to the Bank of England operational independence for setting interest rates.

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The details were set out in a letter from Gordon Brown to the then Bank Governor Eddie George in May 1997. But the letter also included another, much less publicised but very important, announcement – I have pulled out the key quote here – regarding the Bank's role as the Government's agent for debt management which was taken away from the Bank and given to the Treasury.

Consultation and legislation followed, and the DMO was established on 1 April 1998. As we saw earlier, the DMO is the only other organisation which has been part of the Treasury Group every year for the past 20 years.

The DMO are a crucial part of HM Treasury. As we all know, the government cannot always fund its expenditure from its receipts – in fact the UK has only achieved a budget surplus in three of the last 30 years. This means that the government has to borrow – in recent years quite a lot. The DMO is in charge of operationalising such borrowing from investors, and for managing the government's wholesale debt portfolio.

The DMO is led by their Chief Executive Officer Sir Robert Stheeman. He is employed by HM Treasury, as a member of the Senior Civil Service, where he reports to the Treasury's Permanent Secretary. Ministerial responsibility for the DMO and debt management policy rests with one of the Treasury's ministers, the Economic Secretary to the Treasury John Glen MP.

The DMO's own finances are relatively straightforward. They are financed from within the Treasury Group's own resource budget, which I discussed earlier in this lecture. The DMO's budget can be split into administration and programme costs. The bigger of the two is administration costs, which covers staff salaries, accommodation, and other business-related activities. It also covers technology, which is an important cost-driver, as the DMO is largely self-sufficient in terms of maintaining its financial markets and trading systems.

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As shown in this table, these costs have most frequently ranged between £7m-£14m (as a reminder, we saw that over the past 20 years the Treasury's administration costs were between £120m and £170m).

As with the Core Treasury, staff are the main cost driver for the DMO. Looking at their staffing levels, we see an increase from around 35 full-time staff in the early years to over 100 in recent years. On staffing, one difference from the Treasury is that the DMO tends to employ a greater percentage of their staff on a non-permanent basis, as its technology needs often require specialist IT skills.

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The increase in DMO staffing levels over the past 20 years needs to be set against the large increase in terms of the DMO's activities. The gilt programme has increased more than five-fold, while cash management turnover has increased ten-fold. An interesting calculation involves looking at the administration cost of raising £1m through the gilt programme – this has fallen significantly from £315 per million at the start of the period to £115 per million at the end of the period. Which is impressive. Now,

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Turning next to the Bank of England. The Bank was established in 1694, in the period known as the English financial revolution. The original concept was based on the idea of a private bank whose main business would be to lend money to the government. The funds were needed urgently, to finance the war against France, and a deal was struck – a large loan for the government and a secure income stream for the Bank.

This meant that the government and the Bank had locked themselves into an enduring relationship. And indeed, the links between the Bank and the Treasury were reinforced even further following the nationalisation of the Bank in 1946. To this day, HM Treasury is the sole shareholder of the Bank, and Treasury ministers appoint the Governor, deputy governors and all independent members of the Bank's Court (or their Board).

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This means that the Treasury has a number of different perspectives on the Bank:

- The Treasury owns all of the Bank's capital, so it stands behind the institution should it experience severe financial losses, and also benefits when the Bank generates a profit;
- The two institutions are policy partners when it comes to macroeconomic or financial sector policies;
- The Treasury also acts as the legislative and governance sponsor for the Bank; and
- The Treasury is also a customer for some of the services provided by the Bank (as is the DMO).

The Bank is financed through a combination of different mechanisms. First, there is the Bank's policy functions – or the areas working on financial stability and monetary policy. They are funded through the so-called *Cash Ratio Deposit scheme*. This scheme mandates banks and building societies to place interest-free deposits at the Bank of England, which then get invested in interest-bearing assets to generate income. The legal powers which require private sector banks to take part in this scheme are approved and legislated by the Treasury. Second, the costs incurred by the Prudential Regulation Authority – a subsidiary entity of the Bank of England – as well as the costs relating to supervising financial markets infrastructure – are recovered via a levy on the financial services industry. Again, the powers to impose this levy on industry stem from government legislation overseen by the Treasury. Third, the Bank recovers any costs incurred in the provision of its remunerated activities. These include banking services, lending operations and other services, which are supplied to both private sector and public sector customers. And one of its public sector customers is

HM Treasury itself, which for example pays the Bank for the management of the government's foreign currency reserves. Fourth, there is production of banknotes. The cost of producing cash – both banknotes and coins – is only a tiny fraction of its face value, so the process results in a significant income stream, known as seigniorage. From this seigniorage the Bank deducts the costs incurred in the production of banknotes, and then pays the remainder into the Exchequer. Finally, the Bank's market transactions undertaken for policy purposes can also generate income.

So we can see that, unlike the Treasury, the Bank is not funded through the parliamentary supply process. However, across four of these sources of income for the Bank – the cash ratio deposit scheme, the industry levy, the remunerated activities and banknote production – there is a strong link between HM Treasury and the Bank of England. It is thanks to the Treasury's legislative powers that the Bank is able to charge the private sector for many of its activities. This means that while the Bank may not be funded through the usual public spending process, it is nonetheless funded with public money.

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If we look at the two institutions' balance sheets, we also see a strong link between the Treasury and the Bank. As we saw earlier, in the years before the financial crisis of 2008, the Treasury's single biggest balance sheet item was its ownership of capital in the Bank of England. This asset is valued on the Treasury's books as the Bank's net assets – or the difference between its asset and liabilities. It grew from £1.3bn in 1999 to £5.5bn in 2019. This follows the Treasury's one-off injection of capital into the Bank which took place last year. Since the financial crisis, as we saw earlier, the Treasury's balance sheet expanded significantly. And in 2018-19 the biggest item was the derivative financial asset which results from the Bank's policy of quantitative easing. The policy was first introduced in 2009, and it involves the purchase of financial assets funded through the creation of central bank money – as of March 2019 the Bank held some £445bn of assets purchased in this way. The assets are held by a subsidiary of the Bank, and their valuation on the accounts fluctuates as the market value of the assets moves up and down. Because of the large scale of these asset purchases relative to the Bank's own capital base, the Treasury provides a full indemnity against any losses. And because ultimately the Treasury is the entity holding the underlying risk, the net value of these various financial instruments is recognised on the Treasury's accounts as a financial derivative. Given the current market value of the assets purchased by the Bank, at the most recent reporting date this derivative was in a net asset position – valued at £45bn at the end of March 2019.

So looking at the balance sheets, over the past 20 years, again tells a story with a lot of change and some continuity: for both in 1999 and in 2019 the largest items on the Treasury's balance sheet involved the Bank of England or its policies.

A recurring theme of this lecture is that economic policy institutions tend to spend a significant proportion of their budget on staff costs. This was true for the Treasury and the DMO, it is also true for the Bank. The number of people employed at the Bank has fluctuated over the decades, in line with the Bank's remit. So while staff numbers were around 2,500 in 1999 and around in 4,400 in 2019, the Bank's mandate is now much broader. In particular, in the late 1990s, the creation of the Financial Services Authority led to some staff being transferred out of the Bank and further reductions thereafter; in the mid-2010s the creation of the Prudential Regulation Authority resulted in a larger transfer of staff back in. Over the past 20 years, the Bank's expenditure budget has increased from £207m is 1999-00 to £646m in 2018-19.

To summarise this section. The history of the Treasury is a story about managing Britain's public finances and national debt. And, as well as the Treasury, that story features the Bank of England and, in recent years, the Debt Management Office. The relationship between these three institutions is crucial to understanding the financial history of the Treasury over the past 20 years. This applies to their incomes and expenditures, as well as their human and financial capital.

Conclusion

I would now like to conclude.

[SLIDE]

Going back to the beginning of this lecture, and Lisa Simpson's question:

"if you are the police, who will police the police?"

Homer replies in typical fashion:

"I don't know, Coast Guard?"

It sounds slightly ridiculous that the answer to the questions of who should watch the police should be a completely different public order institution. But curiously, if we were to instead ask "who finances the financiers?", the simple answer is Parliament – a completely different public institution. Of course, the more sophisticated answer is that while Parliament votes to supply the funds that Treasury needs, it is the Treasury itself who ensures that these funds are appropriate. Crucially, my argument tonight is that the Treasury has done a good job of this. The administration budget – the closest thing to the cost of running the Treasury as a department – has grown by just around 3% a year on average since 1999 (or about 1% after adjusting for inflation). This is a slower rate of growth than seen across the wider public sector and the economy as a whole.

In answering the question of "who finances the financiers", and looking at 20 years of Treasury resource accounts, I hope to have also been able to provide a few other insights of interest.

[SLIDE]

First, as an institution, the Treasury has retained its central purpose of managing the public finances. But its organisational structure has changed significantly, and the Treasury Group of today is much broader than 20 years ago.

Second. Just as the cost of running the Treasury has increased only modestly, staff numbers have not fluctuated hugely. While in the late 1990s the Treasury had a staff of below 1,000 people, in most years since then the number of employees has ranged between 1,100 and 1,300. The evidence on staff engagement and turnover also points to a strong institutional culture.

Third, the realisation that the Treasury's policies – as separate to its operations – have involved significant financial flows, primarily as a result of the global financial crisis of 2008. The crisis saw huge amounts of public expenditure channelled via the Treasury to support the financial sector. And the corollary of this spending was the massive increase in the Treasury's balance sheet.

Indeed, in terms of the Treasury's finances, the 2008 crisis stands out as the single most salient event of the past 20 years. The crisis represented a turning point in the relationship between the financial sector and the state. It came at the apogee of the era of self- and light-touch regulation. There is now a clear recognition that the Treasury is the ultimate guarantor of the financial system, as the only institution that can balance the interests of the taxpayer and the banking sector, across multiple generations. This is a fascinating theme that I am sure many others will explore better than I can.

Fourth, we have learnt something about two other institutions which, alongside the Treasury, can be considered public sector suppliers of finance – the Debt Management Office and the Bank of England. This included some surprising realisations. Despite the many changes and challenges of the past two decades, the DMO is the only entity that has been part of the Treasury Group for the whole period; while the main asset on the Treasury balance sheet, both in 1999 and 2019, relates to the Bank or its policies.

Finally, we can ask, where are the Treasury's accounts heading to in years to come? I expect this month will see the publication of the next set of annual accounts, for the financial year 2019-20. Some things will not change. The expansion of the Bank's QE programme in March this year will ensure this remains the Treasury's largest balance sheet item for some time to come. I expect the new accounts will show a continuation of the winding down of the assets acquired during the 2008-09 crisis. But just as the legacy of the financial crisis begins to fade away, other development will begin to have their own impacts on the Treasury's accounts. So I expect new liabilities will have been incurred in relation to the financial settlement required to achieve exit from the European Union. I also expect that the accounts will begin to show the impact of the Covid-19 crisis – as some of the earlier interventions to support the economy took place in March of this year. In many ways, the impact of these events will differ hugely from what we have seen in the last 20 years. In other ways, there will be similar: the largest public spending schemes will not be visible in the Treasury's accounts but those of other government departments, the size and complexity of the Treasury's balance sheet will increase, and there will continue to be a key role for the DMO and the Bank of England working alongside the Treasury. But this is all for another lecture, sometime in the future.

In thinking about who finances the financiers, and the evolution of the Treasury over the past 20 years, I hope to have revealed a tale of significant change coupled with surprising constancy. I hope that in 20 years from now an equally interesting story will be told through an analysis of the Treasury's resource accounts.

Thank you.

Jon Davis: Thank you very much, Mario. Already I can't wait for the next one. Right now I'm going to hand over to Visiting Professor Macpherson. Nick, your thoughts.

Nick Macpherson: Jon, thank you; and Mario, well done. Anybody who can make sense of the Treasury's accounts every year has done extremely well.

I'd just like to comment on a few themes, from my perspective as someone who had the misfortune – or maybe good fortune – of signing off those accounts over a twelve-year period.

The first point I'd make is that if you're in the Treasury, you're always hankering after a world where you can simplify the organisation. Mario showed this story of ever more bodies being accumulated in the Treasury; but actually, if you work in the Treasury, you kind of want to be rid of all these bodies, and return to the Treasury's core function, which is as the nation's finance and economics ministry. But events always get in the way, and Mario highlighted the late 1990s, which was definitely the point where the Treasury became smallest in terms of its number of officials. And that, indeed, followed one of those periodic reviews which happen once every ten to twenty years; but definitely the late '90s were the trough, I think, in the number of Treasury employees in the postwar period.

What people tend to forget is that it didn't get so small by design. A lot of it was a reflection of the very high staff turnover which has always bedevilled the Treasury – and the complete failure to recruit anybody. I think in the late '90s we really recruited very few people indeed, and therefore we had to put that right; and I think in the year 2000 we recruited 100 people from universities.

Coming back to the coherence of the Treasury as an organisation… It *is* pretty incoherent, when it comes to what's within the Treasury's perimeter and what's not. So the Debt Management Office is part of the Treasury; National Savings and Investments, as it's now called, is a department – it's a non-ministerial department – so that's outside the perimeter, even though its function is pretty much identical to the DMO: it's about raising money.

Similarly, it's quite strange that the Bank of England is consolidated into the Treasury's accounts, but the reserves which the Bank manages on the Treasury's behalf live in some separate account somewhere else. The point I'm making here is that it's no wonder that Mario has had to give this lecture, because it's virtually impossible to understand how these structures fit together.

Now, strange though it may be to say it, accounts do matter, and the move to resource accounting was a major step forward. Up until the late '90s – for the last 150 years – we'd been using Gladstonian accounting systems where cash was king. One of my regrets is that

I've never managed to get anybody – apart from the Public Accounts Committee, once a year – remotely interested in the resource accounts; and even the *Financial Times*… When Chris Giles gives his latest updates on where public borrowing is going, he is totally focused on cash, and what used to be known as the PSBR, and the funding challenge.

But mentioning funding makes me want to give a big plug to the Debt Management Office. This is the most extraordinarily efficient organisation in the public sector. Strangely, heads of the Civil Service, and those sort of here-today, gone-tomorrow Cabinet Office ministers who are obsessed with efficiency, never seem very interested in mentioning it in despatches. But they should, because as Mario points out – and it's not down to the DMO; it's down to the British people, who've elected governments who want to borrow on an extraordinary scale – the DMO has financed more debt since the turn of the century than all previous governments put together. And that is quite a frightening number, but they do a fantastic job; there are real economies of scale in terms of how the DMO carries out its activities.

But I should also give an honourable mention to my old friends at the Bank of England. Mario has pointed out that the Bank of England is actually quite expensive compared to the Treasury, and certainly it's got a lot more expensive over the last twenty years, as it has expanded. Nevertheless, it's good to have it consolidated in the Treasury's accounts; and the Treasury, occasionally, is a beneficiary of the monopoly profits which the Bank extracts from the banking system. (I should declare my interest: I chair a small bank, so I'm also aware of how the Bank is funded.)

But it is, I think, fair to say – just to finish on a current subject – that one of the facts which Mario interested me, certainly, in was the size of the derivative, which is the current value of QE [quantitative easing] to the taxpayer – the point being that so far, because interest rates have got lower and lower, the Treasury has tended to benefit from QE. That can't go on for ever, and just as that derivative at the present time Is valued in a nice, big, positive number running to tens of billions of pounds, that could change. And I think one of the really interesting subjects for the future – not just from the point of view of the Treasury's accounts – is the unwinding of QE, and the impact it has on the public sector's balance sheet.

Anyway, that's enough from me, and I can see my old friend Ed Balls travelling along in the back of a taxi, so I'm hoping he is going to make a contribution at this point.

Jon Davis: Thank you so much, Nick. Well, yes – Professor Balls – would you like to contribute?

Ed Balls: Well, it is the nature of the modern world during this pandemic and its aftermath, with the huge advantage of Zoom being that you can end up taking part in an important and erudite seminar from the most unusual of places – including in the back of a car driving though Ealing.

So here I am; and I was so keen to be here at the beginning of Mario's contribution tonight, although I was there at the beginning of the whole-of-government accounts reform, what is now well over twenty years ago. And when we came into government in 1997, there were some reforms we came in with a clear view about, and there were some which I think the Treasury decided to take the opportunity of a potentially reforming government, with a large majority, to drive forward. So things like Bank of England independence, or the move towards a current-capital split in fiscal accounting, or multi-year spending reviews – those are things which had been set out by Labour pre-1997. As you will know, the advent of the Debt Management Office was something injected into our thinking by Gus O'Donnell, twenty-four hours before the general election in 1997, much to the annoyance of the Bank of England.

One other thing which we had initiated – and I had long conversations with Andrew Likierman, pre- the '97 election – was that we wanted to make sure that we were using all of the government's capital assets well, and we suggested the drawing up of a national asset register, which was a bit of an obsession of Gordon Brown – I'm not fully sure where that came from. But it threw up, in the first year of the government, some interesting facts – such as the fact that the British government owned Ipswich Town Football Club's car park, and a racing stud somewhere in the south of England, and a number of other things.

But one of the other things which was injected into this – two things. One, a focus on long-term fiscal planning and projections – and we were persuaded that we ought to have an element of the budget process, which was asking the question: thirty, forty years out, is our fiscal planning affordable, taking that very long-term view? And then the other thing was whole-of-government accounts, and the move towards thinking more carefully about how we managed capital assets, and how we thought about resource budgeting. And I don't think this was something which – let's be honest – had ever been particularly salient in British political debates. And I'm not sure whether Tony Blair or Gordon Brown would ever have used the phrase "whole-of-government accounts", other than Gordon using it in one of those lengthy elements of his Budget statement, when he was trying to destabilise the opposition. But it was something which we began, and has carried on since. And I think that the Civil Service is sometimes very good at seeing an opportunity and taking it; and Mario and his team saw that opportunity back then, and twenty years on we've made huge progress in the way in which the government, nationally and locally, manages capital assets and thinks about sustainability.

So I'm very happy for the New Labour government in '97 to take the credit for the Bank of England's independence and the fiscal rules. The whole-of-government accounts? Absolutely not, other than to facilitate Mario's genius and his team's insight. And the fact that, twenty years on, we're talking about this as an important reform, which has more road to run, is something of great significance – and to the extent that any of the credit rubs off on us, we'll take it.

Jon Davis: Thank you very much, Ed. It is remarkable, in the history of Labour economic policy making, how much of it gets done in the back of a taxi.

Ed Balls: By the way, Jon, that was not true about the five tests… but there we are.

Jon Davis: OK. Questions are starting to come through. I'll start with this one:

The relative transparency of the methods used to finance the Bank of England and the Treasury's administration costs encourages the former to employ too many people, and pay them too much, and the latter to employ too few people and to pay them too little.

Discuss?

Mario Pisani: Great question – thanks, also, very much, to Nick and Ed for your responses.

It was hard enough to go through twenty years of Treasury accounts and work out all the moving parts, and try to come up with something that was vaguely comparable over the time period. And that is when you think that really, there's some sources of income here and there, but most of the Treasury's funding comes from the supply process. I wouldn't like to think how much harder it would be to do that for the Bank; I have read some sets of the Bank's annual accounts, and partly because of all the very many sources of income that they have, and also because of the return they make on their own assets held, it's quite complex.

I would say that there's something in the question – that the Treasury' accounts now are very transparent. The first set of accounts, from 1999-2000 – of which there aren't many copies; they're not online – are only about thirty-five pages; the latest set of accounts for the Treasury are over 200. The Bank's accounts are long as well; I've not gone all the way back, so I'll restrict my comment to the relative degree of transparency between the Bank's accounts and the Treasury's accounts. I don't know whether Nick wants to say something about the other point made in this question?

Nick Macpherson: I'd be very happy to, because Mario – being a loyal civil servant – it's his job to explain government policy, and upsetting the Bank of England is not in his job description. So I'd just like to say I completely agree with the person asking the question. The Bank, effectively, taxes the banking system, so it can raise as much revenue as it wants. Now actually, it's quite controlled, and quite public-spirited, and I've got a huge amount of time for the people who run the Bank, and even more for its board, the Court [of Directors]. Nevertheless, if you don't have a budget constraint, you will always tend to employ more people, and pay them rather more, than organisations which do.

And also, I think it's fair to say that the Bank of England comes out of a different tradition; until it was nationalised by the Labour government in 1946, it was very much a private organisation, with all the habits of such an organisation. I can remember just having lunch with colleagues back in the early 1990s, and they lived a very different lifestyle (good wine cellar… The Treasury, obviously, doesn't have a wine cellar). But equally, it's also the Treasury's fault. The Treasury tends to pay itself less than other government departments, and then it's surprised that people tend to leave it; and I have to say I'm probably one of the guilty men who have occasionally delighted in the "hair-shirtism" of Her Majesty's Treasury.

And one of the strange things – and Ed alluded to this – is that the Treasury, when it's handing out harsh medicine to other departments, always thinks it must treat itself even more harshly, because this will increase its credibility. But no politician I ever worked for was remotely interested in this. They said, look, you can fiddle the figures; you of all people should be able to demonstrate that the Treasury's spending is on a downward path; but I want a strong Treasury with lots of people in it – and that was true of Gordon Brown; it was true of George Osborne.

So in answer to the question: yes, you're right.

Ed Balls: Jon, I can just confirm that Nick Macpherson held both of these views: he was always concerned that we, like George Osborne, wanted to increase the size of the Treasury; and he was always critical of the Bank's profligacy even before he became the chairman of a private bank, and therefore one of their direct paymasters. So his views pre-date his current vested interest.

Jon Davis: Thank you very much. OK, another question:

I'd like to ask about the administrative costs numbers: are they gross or net? And did the proportion of admin costs accounted for by the PFI payments change over time?

Mario Pisani: Really good question. I can recommend the 2002-2003 accounts for a good description of this – it's not one of the ones that is online, so you'll need to look for a printed copy (there is one in the Treasury). It would be great to hear a bit from Ed about the decision to refurbish the building. When I started this project, I thought: what are the big things that are going to be in this period? And obviously I knew that earlier on, the Treasury had decided to move from the east end of the building to the west end of the building, and that was a big PFI contract. In summary, the PFI contract had three impacts: the accounts had to recognise a very large, tangible, fixed asset, because the value of the building increased a lot when it was refurbished; secondly, they had to recognise a big liability, because of the obligation to pay the PFI contract over thirty-five years; and because the liability was larger than the asset, that resulted in a one-off increase in operation costs – which is why, when I showed the chart of admin costs, you saw a very large peak in 2002-2003.

That's basically the answer to that; and on the question of whether they're net or gross, all the admin costs I've shown are net – of all factors that have been netted off in each year.

Nick Macpherson: I think the Treasury was always going to be redeveloped by PFI; I can remember Ken Clarke was very attracted by PFI in the mid-1990s. The only change, I think – which happened when Labour got in – was that we were going to be decanted into this crumbly building next to where MI6 lived – I don't know if I'm allowed to say where MI6 lived, but anyway, somewhere south of the river – and Labour got in and concluded, quite rightly, that they might be late for votes if they were stuck in a traffic jam south of the river. So the actual approach to PFI changed. On an optimistic note, I was always looking forward to the date when the PFI would be fully paid off, which I think is something like 2035, and that's actually getting quite close. And at that point, the Treasury's going to have a bit of a windfall. So don't spend it all at once, Mario.

Ed Balls: As Nick says, there's no doubt that Gordon Brown saw it as a plot to decant the whole of the Treasury's civil servants miles down the river; it was clearly an attempt to undermine his effectiveness, and the effectiveness of the Treasury, so he soon put a stop to that. But actually, the fact that the Treasury never decanted miles away was to everybody's benefit; and the Treasury ended up with a massively better building through a PFI process which had been championed by John Major and Ken Clarke, and then by, in particular, Sir Andrew Turnbull – Lord Turnbull – as permanent secretary. And I think Andrew Turnbull did a brilliant job, and it was a substantial focus of his attention, and we were all very pleased with the outcome.

Jon Davis: Well that's lovely. We do have more questions coming through, but I'm conscious of the time, and I think that we will finish it there. Professor Balls, Professor Macpherson, Professor Pisani – I thought that was a tremendous presentation. Thank you all for joining us.