ICAEW
REPRESENTATION 120/21

FUTURE OF THE EU ECONOMIC GOVERNANCE FRAMEWORK

Issued 21 December 2021

ICAEW welcomes the opportunity to contribute to the public debate on the review of EU economic governance published by the European Commission on 19 October 2021, details a copy of which is available from this link.

ICAEW is listed in the EU Transparency Register (ID number: 7719382720-34).

ICAEW believes the EU's economic governance review provides an opportunity to:

- Develop an overall EU fiscal strategy that complements the efforts of member states to develop their economies and public finances.
- Support member states in strengthening their public finances and in developing sustainable medium- and long-term fiscal strategies.
- Put the wellbeing of future generations at the heart of decision-making, not just by delivering net zero carbon, but also by ensuring robust public finances.
- Take concrete steps to embed broader definitions of economic success, such as Beyond GDP, into fiscal frameworks.
- Improve the quality of financial information available to member states and to the EU, including better information on public balance sheets, off-balance-sheet obligations, financial commitments, and future cash flows.
- Accelerate efforts to embed accruals accounting across all member states while harmonising the European government accounting framework, building on the work already undertaken by Eurostat.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 157,800 chartered accountant members in over 147 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical, and ethical standards.

ICAEW's Public Sector team supports members working in and with the public sector to deliver public priorities and sustainable public finances, including over 8,000 in ICAEW's Public Sector Community. ICAEW engages with policy makers, public servants and others to promote the need for effective financial management, audit and assurance, financial reporting and governance and ethics across the public sector to ensure public money is spent wisely.

ICAEW has had a presence in Brussels since 1994, providing technical advice across a broad range of EU regulatory matters and facilitating dialogue among stakeholders on key public policy issues. Headquartered in Brussels, the ICAEW Europe Region engages with professional bodies, firms, oversight authorities and market participants across Europe and approximately 5,000 ICAEW members in EU member states.

ANSWERS TO SPECIFIC QUESTIONS

1. How can the framework be improved to ensure sustainable public finances in all Member States and to help eliminate existing macroeconomic imbalances and avoid new ones arising?

This review of EU economic governance provides a timely opportunity to give serious thought as to how to better support member states in defining long-term fiscal strategies to ensure the resilience and sustainability of their public finances.

We believe a comprehensive long-term fiscal strategy is needed to put the public finances onto a sustainable footing. In a European context, this could call for the adoption of a European-level long-term fiscal strategy based on a mandatory requirement for individual member states to develop long-term plans which could then be subject to review by the Commission.

A long-term, principles-based public finance strategy needs to look 25 to 50 years ahead – covering at least two generations. This would require governments – and by extension all public bodies – to take a longer-term view, balancing current and future needs so that decisions taken now to support short-term fiscal sustainability do not compromise the ability of future generations to meet their needs.

The absence of long-term fiscal strategies at an EU level or in many member states means that many questions have not been properly debated at European or in many cases at a national level. For example, what level of public debt is appropriate to pass on to future generations? Should funds be established to cover social security, public sector pension, health and social care or nuclear decommissioning obligations, or should they be paid for out of future tax revenues? How should tax and welfare systems evolve? How should risks be allocated between government, businesses and individuals? How can public finances be better prepared for future crises?

Developing long-term strategies and debating their contents could assist in gaining public acceptance of (for example) necessary tax increases over the medium- to long-term, reducing the temptation for 'stealth' tax rises that overcomplicate the tax system and distort economic incentives. Member state fiscal strategies could also address whether to build up 'rainy-day' funds or sovereign wealth funds to strengthen public balance sheets.

Governments have historically dealt with many of these issues on a piecemeal basis in the absence of a more comprehensive vision for the public finances. In some cases, decisions are repeatedly deferred with the scale of the problem becoming larger the longer it is left unaddressed. Failing to tackle the challenges which threaten to undermine the sustainability of public finances will not only entrench intergenerational unfairness but will increasingly constrain policymakers in the choices they are able to make.

Changes to EU and national frameworks to support the sustainability of public finances should be guided by a set of key principles, including:

- Stability – fiscal frameworks need to provide funding predictability for bodies across the public sector over different timeframes. This will enable them to plan the delivery of public services with more confidence, implement improvement programmes, and invest in essential economic, social and green infrastructure.
- Resilience – a long-term fiscal strategy must address the need for countries to repair their balance sheets while strengthening their resilience and capacity to withstand future fiscal emergencies. This is particularly important where public sector balance sheets have been weakened by the pandemic and where high levels of debt and other liabilities may amplify their vulnerability to increases in interest rates and inflation.
- Capability – ensuring sound economic governance relies on strong financial management, governance, and accountability across the public sector. Maximising value delivered while keeping costs under control requires appropriate investment in financial skills, financial processes, financial reporting, and audit across the public sector.

2. How to ensure responsible and sustainable fiscal policies that safeguard long-term sustainability, while allowing for short-term stabilisation?

While repairing the fiscal damage from the pandemic must be a key priority, it is important that the economic governance framework considers the medium- to long-term evolution of the public finances of each member state and of the EU.

Higher levels of debt and impaired economic performance following the pandemic will increase the exposure of public finances to interest rates and increase the potential for tax rises in the short- to medium-term. However, spending pressures from demographic change, delivering net zero and other key drivers such as defence will have a much greater impact over the medium- to long-term.

Member states need to develop fiscal strategies that address these fundamental factors driving increases in public spending and the accompanying growth of balance sheet liabilities. Fiscal policies need to address key questions such as whether there are adequate investment funds established to settle liabilities in the public balance sheet such as public sector pensions or to meet off-balance-sheet obligations or financial commitments as they fall due. For unfunded liabilities, obligations, and commitments to be met out of future taxation, is there a clear understanding of what this means for tax policies and for future public investment? Do member states' strategies adequately consider fiscal resilience – will they be able to meet fiscal stress tests in a variety of potential future economic shock or climate change scenarios?

We believe a balanced scorecard approach would enable the EU and its member states to enter a more substantive dialogue about the quality of each country's medium- and long-term fiscal strategies in a way that would be not possible in a framework primarily focused on short-term metrics such as the fiscal deficit in a particular year. Such an approach might potentially score member states running fiscal deficits with (for example) well-developed fiscal strategies based on high quality comprehensive financial information more highly than those in budget balance today but without adequate levels of financial information or a strategy to deal with the costs of an ageing society or the potential costs of climate change.

A balanced scorecard approach would allow the EU and member states to look across the whole of their public sector balance sheets as well as considering off-balance-sheet liabilities, financial commitments, and future cash flows. It would enable consideration of the demographic challenges to public finances from individuals living longer alongside proportionately smaller workforces compared with those in retirement. It would also encourage focus on the level of fiscal resilience and the quality of strategies for taxation, public spending, and debt management.

A key part of any scorecard would be in assessing the quality of the financial information used by member states. Are audited consolidated financial statements prepared in line with accounting standards and on a timely basis? Do they have comprehensive monthly management accounts comparable to the private sector? How rigorous are their fiscal forecasts? Are independent economic and fiscal forecasters in place or do they need strengthening?

Such an approach must be underpinned by further steps to harmonise the European government accounting framework, building on the extensive preparatory work undertaken by Eurostat in recent years. Embedding accruals accounting will help address persistent shortcomings in the timeliness and quality of the financial information available to governments. The current review of the framework provides the opportunity to accelerate reform by setting clear timelines for mandatory government reporting by all member states.

3. What is the appropriate role for the EU surveillance framework in incentivising Member States to undertake key reforms and investments needed to help tackle today and tomorrow's economic, social, and environmental challenges while preserving safeguards against risks to debt sustainability?

Although there is a role for annual fiscal metrics as part of the framework, we believe that the principal focus should be on the quality of member state assessments of their economic and financial positions and of their medium- and long-term fiscal strategies.

Such an approach would provide member states with flexibility in how they aim to grow their economies, for instance using tools such as public investment in infrastructure, whilst also ensuring each member state has a clear understanding of their financial situation and the fiscal resilience needed to address potential future economic shocks. It would help ensure that member states have a comprehensive understanding of their fiscal situations, supported by high quality comprehensive transparent financial information including balance sheets, financial commitments, and future cash flow projections in addition to annual revenue and spending analyses.

How good are member states' assessments of the pressures on public services, health and social care, welfare and social security systems? How resilient are their public finances to potential future economic shocks and can they meet fiscal 'stress tests'? How do they intend to address the cost implications of more people living longer? How can they fund the necessary investment to deliver net zero carbon? How do they intend to reduce inequality and improve the fairness of their tax and welfare systems?

These questions cannot be answered by a single metric of general government deficit or debt, which can only provide a partial picture of fiscal sustainability or resilience. For example, low levels of debt might enable a country to meet numerical measures today, but if it has large financial commitments and an unsustainable approach to demographic change it might be in a worse financial state than a country with higher current levels of debt but that has a fiscal strategy that will enable it to meet its financial commitments in a variety of different scenarios.

4. How can one simplify the EU framework and improve the transparency of its implementation?

As finance professionals, we would like to see a European framework that also encourages clear focus at national (and sub-national) level on areas such as:

- Financial reporting: good decision making requires comprehensive and accurate financial information, and so the framework needs to support and encourage member states to implement best practice accruals accounting and financial reporting and to strengthen their financial management and financial processes.
- Financial strategy: a European fiscal framework needs to ensure that 'short-term' solutions do not impair sustainability over the longer term. Such a framework needs to enable countries to fully consider likely levels of future funding and the anticipated demand for, and cost of, services.

- Reserves: countries need to have healthy levels of usable reserves to meet funding pressures and to support longer-term financial sustainability, including 'invest to save' initiatives.
- Planning and forecasting: across all levels there needs to be the capacity to plan and forecast accurately so as to reduce the risk of unforeseen financial pressures and to provide a more certain base for delivery of policy objectives. Independent fiscal institutions can both improve the quality of forecasting and the confidence of decision-makers in the forecast and projections they are using.
- Effective oversight: at all levels, key decision-makers need to be fully sighted and informed of the overall financial position, of key risks to financial sustainability and of the progress of plans to mitigate those risks.

As further covered in our response to Question 7, we underline the need for an accruals-based, balance sheet approach to public sector financial management across the EU to provide a comprehensive and comparable picture of member states' finances.

5. How can surveillance focus on the Member States with more pressing policy challenges and ensure quality dialogue and engagement?

We believe surveillance must also encourage and be informed by better balance sheet management at national level.

As also stressed by the IMF and the OECD, strengthening balance sheet efficiency can help build a better understanding of countries' exposures to risks, alongside the more traditional emphasis on budgets and public expenditure.

The introduction of the Whole of Government Accounts in the UK, for instance, has provided the basis for a better understanding of the public balance sheet and how assets and liabilities can be managed more effectively.

6. ~~In what respects can the design, governance and operation of the RRF provide useful insights in terms of economic governance through improved ownership, mutual trust, enforcement and interplay between the economic and fiscal dimensions?~~

7. Is there scope to strengthen national fiscal frameworks and improve their interaction with the EU fiscal framework?

Yes. We believe that there is scope to strengthen national fiscal frameworks – and thereby improve interaction with the EU fiscal framework.

We have repeatedly pointed out the need for governments to tackle persistent shortcomings in the timeliness and quality of available financial information. This often contrasts unfavourably with multi-national organisations in the private sector, which would typically expect to have a very clear view of their consolidated financial position within a few days of the end of a financial year and final audited results within a couple of months. The complexity of different financial reporting frameworks used by individual governments can further hamper decision making by making it difficult to understand the full financial picture.

Currently the predominant focus at EU level in relation to government finances is on the extent of government deficit and debt – in itself extremely important, particularly where such levels are already unsustainably high. Hence accountability and reporting remain based on the reporting of National Accounts to Eurostat, providing comparable statistics on the economic activities, deficit and debt of individual member states. While this is clearly extremely important at the macroeconomic level, National Accounts do not provide a full picture of government finances at the entity level. They do not include complete information based on accruals accounting like that provided in private company financial statements. The detailed narrative commentary – i.e.

explanation – and supplementary financial disclosure in the notes to the financial statements are missing. Without all of this a comprehensive picture of a government's finances is lacking.

To really achieve sustainable government finances, it is critical to look beyond public debt to what are effectively liabilities, whether or not governments actually account for them as such. There is a pressing need to account for the whole range of financial, environmental, pension, healthcare and other costs for which national governments are responsible through their political decisions. The sum of such costs for which there is a government obligation to pay 'further down the line' may be significantly larger than the figures currently reported for public debt.

Equally, there is a need to account for government assets, for example infrastructure and real estate, as part of a holistic approach to financial management that ensures optimal performance of these assets in the public interest. Annual financial statements provide transparency and thereby a basis to manage both liabilities and assets. Similarly, financial performance information (included in or derived from financial statements) that reflects the full cost of policies and programmes provides useful insights for the decision-making.

We continue to emphasise the importance of an accruals-based, balance sheet approach to public sector financial management to enable complete and comparable government accounting. Today, there is still no harmonised European government accounting framework. This creates important inconsistencies in how countries account and report on transactions. Over the last years, important preparatory steps have been driven by Eurostat to design comprehensive EU reform and some countries have also made steps forward. The current review of the economic governance framework is an opportunity to catalyse legislative action, setting clear timelines for mandatory government reporting by all member states that is of high quality, consistent and comparable.

We stress that the requirement to produce government financial statements is not an end goal. Rather, the transition to producing such statements is an enabler. It is the basis for developing better management information systems, resulting in better decision-making and ultimately a better use of public money. At both European and national levels, it can enhance the democratic accountability framework for the assessment of the use of public funds. The end goal is the delivery of better public services in the short term and the attainment of sustainable public finances in the mid to long term, creating a positive legacy for the next generations.

We also note that the current review provides the opportunity to look at and learn lessons from what individual governments in the EU and beyond are doing to centralise expertise to manage finance risk and manage contingent liabilities. In the UK, the recent establishment of a Contingent Liability Central Capability Unit within UK Government Investments, should help strengthen contingent liability and risk management across government, providing analysis, advice and expertise. Over the longer term, this should help enhance assessment of the stock of contingent liabilities as well as an understanding of how comparable contingent liabilities are treated and where there may be common themes across such liabilities.

8. ~~How can the framework ensure effective enforcement? What should be the role of pecuniary sanctions, reputational costs and positive incentives?~~

9. ~~In light of the wide-ranging impact of the COVID-19 crisis and the new temporary policy tools that have been launched in response to it, how can the framework – including the Stability and Growth Pact, the Macroeconomic Imbalances Procedure and, more broadly, the European Semester – best ensure an adequate and coordinated policy response at the EU and national levels?~~

10. ~~How should the framework take into consideration the euro area dimension and the agenda towards deepening the Economic and Monetary Union?~~

11. Considering how the COVID-19 crisis has reshaped our economies, are there any other challenges that the economic governance framework should factor in beyond those identified so far?

The review of the economic governance framework provides an important opportunity to embed broader considerations. We focus on several challenges:

- Governments as insurers of last resort: as in the financial crisis a decade ago, the pandemic has shown that there is an implicit guarantee provided by governments that they will step in to prevent a systemic failure. It is arguable that governments do not price this implicit guarantee appropriately or take actions to mitigate the financial risks to which they are exposed. A question to address is whether they should act more like an insurer in the future, charging premiums in advance in order to build up contingency funds for such eventualities. Alternatively, can businesses and individuals be encouraged or required to better prepare by building up 'rainy day' funds in better times, reducing the risk that the government will need to step in?
- Sovereign risk: The pandemic has given rise to significant increases in often already high debt levels of governments in Europe (and around the world): the conditions for government borrowing may become less favourable in the future. This increases the importance of government transparency and communication to markets, particularly given the close interconnection between government debt risk and bank risk in the international financial system.
- The intergenerational contract: As noted in our response to Question 3, long-standing demographic trends raise pressing questions on Europe's future financial sustainability and the fair distribution of resources between generations. Any changes to the EU's economic governance framework must ensure greater honesty and accountability about the intergenerational impact of fiscal matters so that liabilities and obligations are not simply passed on to future generations. To do so, we encourage the refinement of the fiscal framework to ensure that all perspectives are considered, including the interests of those generations that do not have a voice in the debate, particularly if they are likely to be directly affected in the future. This needs to be accompanied by a smarter approach to thinking about the timeframes during which different policy challenges need to be addressed, while ensuring that short-term and long-term policy measures ultimately pull in the same direction. Greater transparency, including over the assumptions and judgements underlying trade-offs, can help enhance accountability between countries while encouraging greater societal scrutiny and more informed public debate on what is intergenerationally fair and possible. Existing initiatives in Japan, Singapore, Finland, Poland and Wales can provide further inspiration.
- Moving beyond GDP: Economic growth, measured as real increases in GDP, continues to remain at the centre of public policy debates, despite intensifying social and environmental challenges. We believe that the current review process must engage seriously with existing initiatives to re-assess definitions of economic success. Alternatives to GDP already exist but need to be more firmly embedded in countries' fiscal frameworks. The Beyond GDP initiative and the broader UN Sustainable Development Goals provide more comprehensive indicators of environmental and social progress. Steps taken by the Commission to improve strategic foresight in policymaking and to monitor the green and digital transition, including through the recently announced resilience dashboards, are welcome but need to be solidified at national level too. We also stress the importance of the findings of the recent the Dasgupta Review which make clear that nature is the foundation of economic prosperity and that countries' economic transformation must recognise this in order to reverse nature loss and preserve our future. Consideration could also be given to the work being undertaken by the Capitals Coalition to develop and implement an approach to decision-making based on a better understanding of the value of entities' impacts and dependencies on natural, social and human capital.

In summary, we believe a revised framework needs to:

- Develop an overall EU fiscal strategy that complements the efforts of member states to develop their economies and public finances.
- Support member states in strengthening their public finances and in developing sustainable medium- and long-term fiscal strategies.
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For further information about this contribution to the public debate on EU economic governance please contact ICAEW's Public Sector team at publicsector@icaew.com or ICAEW's Europe team at europe@icaew.com.