Sustainable Public Finances: EU Perspectives

Seven key insights

Drawn from a discussion series with senior policymakers and stakeholders
Governments need to restore citizens’ trust in public finances. How to do so has been at the heart of discussions in our joint ICAEW-PwC series on ‘Sustainable Public Finances – EU Perspectives’.

We believe that governments have an opportunity to promote greater confidence in the way they manage their public finances – for today and for tomorrow. A key building block is the provision of high-quality financial information. This information underpins the ability of governments to fulfil their role as stewards of the economy while ensuring the provision of public services. Access to – and understanding of – high quality financial information enables citizens and investors to hold governments to account.

This report sets out key insights from our discussions with senior European and international policymakers and stakeholders in Brussels over the last two years. From the start, our aim has been to enhance shared understanding of the key issues and to identify opportunities to help improve public finances and restore confidence in their sustainability.

We would be delighted to receive your comments on this publication, send them to europe@icaew.com

A digital version of this publication is available at icaew.com/publicfinances and pwc.com/euservices
Our insights are structured along seven major themes:

1. Achieving more with less
2. The power of the balance sheet
3. Creating the right environment for growth
4. Investor confidence and global comparability
5. The value of audit insights
6. Building financial capacity
7. Empowering public scrutiny

The debate on how to manage public finances better is not limited to Europe: it is a global one. As such, perspectives from Europe may also help inform discussions elsewhere, encouraging global improvements in the public interest. We hope that this report can facilitate the conversation, highlight some of the key changes needed and set out some steps forward.
Many governments continue to face significant challenges: they need to deliver operational and policy priorities while getting their budget deficit and debt levels down. More has to be done with less. To do this, the way public finances are managed needs to be transformed. This requires focus on today and tomorrow to prevent existing challenges becoming even more intractable.

While there are important differences between the public and private sector, similar professionalism needs to be applied to the management of public finances as is expected in successful companies. Any entity – whether a country or a company – needs to have the appropriate systems and processes in place to produce high quality financial information so as to ensure the best management of resources.

Effective public financial management depends on a number of different elements, including access to high quality financial information, comprehensive budgeting which also takes into account value-for-money considerations and proper evaluations of whether monies spent have achieved the objectives set. A robust accountability system within individual government departments through internal control and audit is also essential. More broadly, elected officials, supreme audit institutions, media, investors and taxpayers all have critical roles to play in ensuring transparency and accountability of public finances – thereby also helping to keep governments’ focus on achieving more with less.
Governments need to know what they own and what they owe. A balance sheet provides this overview. To draw up a balance sheet, governments need to have access to accurate and reliable financial information. Such information facilitates the effective management of public finances, enabling the delivery of immediate policy objectives and enhancing longer-term planning. It is therefore vital that accruals-based accounting systems are in place. Accruals accounting gives a far more comprehensive picture of a country’s assets and liabilities than cash-based accounting does. It provides information about the income which needs to be raised for known commitments or expected future outcomes.

In Europe, many countries still rely on national statistical accounts as a way to assess and present financial data. National accounts are a tool for evaluating, analysing and forecasting future economic development and growth at both a micro and macro level. Financial statements, including a balance sheet, produced according to agreed accounting standards, give a wider picture of a country’s assets and liabilities at a given point in time, thus providing insights into likely future funding requirements. Only a few governments in Europe and around the world currently undertake this exercise. Yet, there is much that can be gained by having more than one well-founded viewpoint on a country’s financial health, performance and potential economic future.
A well-functioning public sector is vital for the long-term success of countries, delivering key public goods and creating a supportive environment for businesses and their employees. To ensure the continuing capacity to fund, for example, advances in healthcare and to benefit from increasing longevity, the way public finances are managed needs to be transformed. Enhanced public sector financial management, transparency and accountability are key elements to achieving this transformation. This is underlined further by the economic importance of the public sector in the EU, where the share of economic activity represented by the public sector accounts for almost half of GDP.

Access to accurate and reliable financial information is fundamental. But it is not sufficient in and of itself. Information must be used – whether to help governments take decisions on public spending and future planning or to facilitate a better understanding of the potential financial impact of broader policy choices. Failure to get to grips with the quality of financial reporting in the public sector can ultimately become a challenge for financial and political stability, as illustrated by the public response to austerity measures across a number of countries.
The international nature of capital markets makes enhanced financial transparency and comparability a global concern. Europe’s debate on better public sector accounting needs to be seen within this international context. Deficiencies in the financial information reported by some governments, hindering fair assessments of fiscal capacity, were made clear during the financial crisis. The significant rises in certain government bond yields at the height of the crisis focused attention on the differential credit risk between government instruments that had often been perceived as virtually risk-free. This is no longer the case.

While governments raise debt on financial markets in the same way as organisations in the corporate sector, levels of transparency between the two sectors can differ profoundly. This limits the capacity of holders of government debt to thoroughly compare and assess the underlying risk of their investment. Critical intermediaries and investors need to understand factors such as a country’s trade balances, the wider economic environment or the functioning of the tax system. But the publication of financial statements should provide greater transparency and comparability. Creditworthiness ultimately needs to reflect underlying financial fundamentals, based on a clear view of existing and future liabilities.

Greater engagement of financial market actors in the debate on better government reporting would help to align the interests of investors and bondholders in accurate and comparable financial information with that of citizens in ensuring more efficient scrutiny, accountability and management of the public purse.
Independent audit in the public sector is a critical way of enhancing democratic accountability and financial management. This is not new – indeed Aristotle saw the value of audit in the public sector for functioning democracies, writing that where ‘offices handle the public money, there must of necessity be another office that examines and audits them.’

Audits of financial statements are important to rebuild confidence in the reliability of government financial statements. Public sector audit can provide citizens and the wider public with assurance about the use of public monies and policymakers with guidance on how the management of public funds can be further improved. Public sector auditors also play a key role in helping to focus attention on ensuring better value for money, helping to achieve more with less. At the centre of this approach is a shift away from focusing solely on compliance towards a model that places greater emphasis on the results of public expenditure.

Auditors can also help more widely in improving public finance management, for instance by supporting governments moving towards an accruals-based accounting model by helping preparers, by assessing the proper application of standards and by acting as an independent sounding board.
A culture of sound financial management can be built with time and resources. Producing and using accurate financial information to ensure more efficient deployment of public resources requires an appropriate level of financial capacity. Governments need to build up robust accounting systems based on best international practices.

Hiring and developing the appropriate technical expertise is a critical investment in the future of a country but it comes at a cost. It is important to consider the overall case for change as the full benefits of reformed public sector financial management might be difficult to quantify and only apparent over the mid- to long term.

Building up financial skills is a wider task, not limited to those charged with producing financial information and managing public finances. Transparency is about making information understandable. It is important that all those using financial information should have the necessary skills to meaningfully interpret such information for their purposes.
Improving public finances is not easy. Citizens want to understand the reasons for cuts to public sector expenditure and to be given a realistic picture of what the future may hold. The danger that citizens will feel alienated by policy decisions because they do not understand the reasons for reform is a real one. The provision of objective information is necessary to build understanding and facilitate acceptance of reform. Empowering citizens and their elected representatives to scrutinise public sector finances can help establish a culture of democratic accountability, based on a shared understanding of a country’s assets and liabilities as well as the risks and responsibilities faced by governments.

Other actors also have a role to play in helping to keep governments accountable. The media plays a key role as intermediary between governments and citizens – but faces challenges in turning complex, technical information into compelling articles that catch the public’s attention. Snappy headlines can, in some cases, reinforce negative stereotypes and encourage a downward cycle in the perception of public finances, even if important improvements have been made.

Civil society organisations often also act as unofficial watchdogs, for instance publishing examples of severe mismanagement of public funds or taking a name and shame approach to generate wider public attention. In doing so, they fulfil an important role. But this should not be to the detriment of their ability to encourage positive reform by, for instance, encouraging constructive policy debate or identifying other opportunities to enhance the democratic accountability of public finances.
Organisations that participated in the 2014–2016 ‘Sustainable Public Finances: EU perspectives’ series:

Audit Scotland
Bloomberg
Centre for European Policy Studies (CEPS)
Court of Audit, The Netherlands
European Banking Federation (EBF)
European Commission
European Court of Auditors
European Federation of Financial Analysts Societies (EFFAS)
European Group of International Accounting Networks and Associations (EGIAN)
European Parliament
Eurostat
Federal Government, Belgium
HM Treasury

IBR-IRE
ICAEW
International Federation of Accountants (IFAC)
Ministry of Finance of the Slovak Republic
Ministry of Finance, Czech Republic
Moody’s
Politico
PwC
Representation of NRW to the EU
Supreme Audit Office, Poland
UN International Standards of Accounting and Reporting (ISAR) Chair
University of Kristianstad, Sweden
Wall Street Journal

This report is part of a joint ICAEW-PwC initiative on Sustainable Public Finances – EU Perspectives, which encourages greater debate among key policymakers, business, the accountancy profession, academia, media and the wider public on how to enhance public sector accounting and financial management in Europe.

More information at: icaew.com/publicfinances  pwc.com/euservices
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