

Financial Reporting Advisory Board Paper

NATIONAL ACCOUNTS UPDATE/PRESENTATION

SNA Revision

State-of-play of revision items for the July meeting of the AEG

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The international Advisory Expert Group on National Accounts will meet for the third time on 18-22 July 2005.

SNA Revision items treated by Canberra II (Assets in the national accounts)

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FRAB members are invited:

€# Take note of state of the discussion of the revision issues to be discussed by the AEG in July.

€# To make any general or specific comments as they wish, especially on the recommendations from the Task Force on the Harmonisation of Public Sector Accounts

R&D and patented entities (SNA items 9 and 10)

Issue

The 1993 SNA does not recognize the output of R&D as capital formation, but as intermediate consumption. The questions posed for the revision of the SNA are: Should the outcome of R&D be capitalized as a “knowledge asset” in principle? If yes, should all of R&D, including basic, non-market and freely disseminated research, be capitalized or only applied research and experimental development? How could this be measured in the national accounts?

State-of-play of discussion

This issue has been discussed at all five Canberra II meetings, by the Eurostat SNA Task Force and twice by the Eurostat National Accounts Working Group (NAWG) members. Both the Canberra II Group and the NAWG have been largely in favour of changing the SNA and capitalizing the outcome of R&D in principle.

There have been different opinions, however, on the scope of R&D expenditures to be capitalized. The majority of Canberra II is in favour of capitalizing all R&D, although many would conceptually prefer to exclude the outcome of freely available non-market or basic research from the asset boundary. However, given the small amount involved and the practical difficulty of exclusion, it is felt that it would be better to capitalize all of R&D. In the NAWG the views on the scope seemed to be evenly split between those who favour including all of R&D and those who would prefer to only capitalize market R&D.

As for feasibility, a majority of the Canberra II members thinks that the practical problems of producing sufficiently good and comparable R&D estimates for national accounts can be overcome. This has also been the view of a majority of the NAWG, although a minority thinks that this is still not feasible and that it would be better to leave this issue to a satellite account.

Originals and copies (issue of annual licence to use) (SNA item 11)

Issue

Originals and copies were included on the Canberra group’s agenda for two reasons. The first of these was to confirm whether the position adopted by the task force on software was appropriate for other instances where originals were sold in the form of copies, such as the case with literary and artistic works. The second was because of some concerns, expressed at the 2002 OECD National Accounts Meeting, that the recommendation of the OECD/Eurostat Task Force on Software that payments for licences to use software could

be recorded as investment, would lead to a double-counting of investment (both originals and copies being recorded as gross fixed capital formation). This was despite the widely held view that the recommendations made were fully consistent with the SNA on originals and copies (paras 6.1443-6.147) and with the SNA position on software (para 10.92).

State-of-play of discussion

The issue has been discussed by the Canberra II Group at three meetings and the Group has concluded that the recommendations made by the Task Force for licenses-to-use (copies) are applicable generally and should stand but that minor modifications are needed to the recommendations made for licenses-to-reproduce, which implies a small change to the current SNA.

An issues paper was submitted for the December 2004 meeting of the AEG, spelling out the following recommendations:

- 4# The Group concurred with the view of the OECD/Eurostat Task Force that copies are the outcome of new production. As such, expenditure on copies, when conditions for capital are met, are recorded as capital formation and not as a part sale of the originals.
- 4# On licenses-to-reproduce, the Canberra II Group has come to a slightly different position to that of the Software Task Force. The Group has concluded that, where licenses-to-reproduce are not operational leases, the sale of the lease should be considered as the sale of all of or part of the original. This will require a slight modification of SNA 6.146. The Canberra Group is considering what should constitute an operational lease vis-à-vis the sale of a part whole of an asset in the issue regarding licenses and leases.

The AEG came to the following conclusion at its December 2004 meeting:

- 4# The AEG agreed that copies generated for issue under licenses to use represent new production.
- 4# The AEG agreed that when they display the characteristics of fixed assets, copies issued under license to use should be recorded as gross fixed capital formation.
- 4# The Canberra II group is asked to recommend in which cases when payments for a license to use are made over several years represent the acquisition of an asset rather than a series of payments for services and the consequence for recording other transactions.
- 4# When a license to reproduce is issued under terms similar to an operational lease, the payments made are treated as payments for services.
- 4# When the holder of an original divests itself of part or all of the responsibility to issue and service copies under licenses to use by means of a license to reproduce, this constitutes the sale of the corresponding part of the asset. Having two possible treatments for licenses to reproduce could affect the classification of assets (to be considered by Canberra II) and the borderline between goods and services in trade figures. This should be brought to the attention of BOPCOM.

The Canberra II Group picked up the requests of the AEG at its March 2005 meeting, especially on the treatment of regular (annual) payments for copies. Input to the discussion was provided by

a paper by N. Ahmad which proposes to adopt the following recommendation of the OECD software task force:

If a copy (license-to-use) is acquired via regular annual payments, the payments should be recorded as finance lease transactions if it can be established that the purchaser intends to use the copy repeatedly in production until the end of its economic life. Intent can be determined if significant associated costs are incurred on acquisition. For example, for software, the costs involved in training or developing new systems based on the software. For other copies however establishing intent is likely to be less common.

The Group agreed to all the proposals in the paper, except that the reference to intention to renew annual software licences should be bolstered by describing the sort of evidence to look for in determining an intention to use for a long period of time, such as training, development of application programs, etc.

Next steps

This clarification will be submitted for the July 2005 meeting of the AEG.

Documents

4# N. Ahmad (2005): The treatment of annual licenses-to-use. Paper presented at the March 2005 meeting of the Canberra II Group.

4# N. Ahmad (2004): The treatment of originals and copies in the national accounts. An Issue Paper Prepared for the December 2004 Meeting of the AEG (doc. SNA/M2.04/06).

4#

Databases (SNA item 12)

Issue

The 1993 SNA discusses the treatment of databases as a special case of software as indicated in the following paragraphs.

Computer software

10.92 Computer software that an enterprise expects to use in production for more than one year is treated as an intangible fixed asset. Such software may be purchased on the market or produced for own use. Acquisitions of such software are therefore treated as gross fixed capital formation. Software purchased on the market is valued at purchasers' prices, while software developed in-house is valued at its estimated basic price, or at its costs of production if it is not possible to estimate the basic price.

10.93 Gross fixed capital formation in software also includes the purchase or development of large databases that the enterprise expects to use in production over a period of time of more than one year. These databases are valued in the same way as software, described above.

Unfortunately implementing the recommendation that the acquisition and production of large databases should be recorded as fixed capital formation has proven to be difficult. There appear to be two principal reasons for this. The first concerns the definition of a database and the second relates to the quantitative meaning of 'large' in the SNA.

The AEG agreed that the present SNA recommendation that large databases should be treated as fixed capital was ambiguous because “large” was not specified. This word will be dropped.

It also agreed that a single category in the first level classification of assets will be included for “software and databases” with a subsequent disaggregation into “software” and “databases.”

Cost of capital services in the production account (SNA item 15)

Issue

In a production process labour, capital and intermediate inputs are combined to produce one or more outputs. The national accounts production account shows how goods and services are produced by adding value to other goods and services (value added and intermediate consumption). The generation of income account shows compensation of employees, which is the contribution of employees to value added, and the balancing items are gross operating surplus and gross mixed income.

The latter are the return to the producer and reflect, at least in part, the contribution of non-financial assets owned by producers and the rent they have paid for the use of non-produced assets, but there is no explicit identification of the inputs from the producer's non-financial assets in the way that there is for labour and intermediate inputs.

The issue therefore is if, and if yes, how, the contribution of non-financial assets to the production process should be explicitly identified in the accounts.

State-of-play of discussion

The outcome of the discussions at several Canberra II meetings has been that a majority of the Group is in favour of including the cost of capital services as an 'of-which' item in the production account.

Next steps:

Based on the previous discussions in Canberra II, Eurostat, the OECD and the AEG, The Canberra II meeting in March 2005 reviewed the issue on the basis of a paper by P. Schreyer, E. Diewert and A. Harrison. The outcome has been the following:

- 4# Canberra II confirms its general support for introducing measures of the cost of capital services into the national accounts. This introduction should not change the basic structure of the accounts. Furthermore, cost of capital services measures should not be introduced into the national accounts in an isolated manner. This introduction is the opportunity for statistical offices to create a consistent and transparent set of capital-related data that serves both the analysis of income and wealth and the analysis of production and productivity.
- 4# The SNA should be updated in a way that would allow countries who feel that their estimates are robust enough and the interest in the results is strong enough to include estimates of capital services as an "of which" item in the production account. For other countries it is proposed to implement capital services measures outside the core accounts, but in consistency with measures of consumption of fixed capital and stock estimates that are already present in the core of SNA 1993.
- 4# On the question of the appropriate rate of return to be applied in calculating capital services (exogenous vs. endogenous) no explicit recommendation is given. Rather it is recommended that the final choice between the approaches is left to the implementing statistical office.

4# Capital services measures should be comprehensive in the sense that they cover all non-financial assets, except valuables. This includes identifying capital services for inventories and land.

4# Capital services from the assets of non-market producers should only be included as on of which item if the output of non-market production is measured using capital services rather than CFC, otherwise it should be shown as an addendum item.

4# Mixed income should be split into capital and labour components for the purpose of this presentation, in order to allow the formation of aggregate labour and capital inputs.

It was agreed to put these recommendations in an issues based on the current document and to present it to the AEG meeting in July 2005.

Return on capital for government owned assets (SNA item 16)

Issue

The 1993 SNA states that by convention there is a zero net operating surplus for non-market producers, which implies there is no return to capital on their assets. During the development of the 1993 SNA it was proposed to change this and the proposal has recurred now for the revision of the SNA in the light of work to integrate the capital services approach to the contribution of non-financial assets to production.

State-of-play of discussion

A majority of the Canberra II Group is in favour of changing SNA and to record a return on capital on the assets of non-market producers when measuring their output. The following recommendations were submitted to the AEG for its December 2004 meeting:

- a) A return to capital should be estimated for non-financial assets of non-market producers (principally but not exclusively those owned by government) whether they are
 - i. of the type used by employees in the course of their work (e.g. computers, vehicles),
 - ii. those which provide a service to the economy at large (e.g. roads),
 - iii. those which provide a service to the community at large (e.g. recreational facilities such as a city park);
- b) This return to capital should reflect the value of the asset; if the asset has an elevated value because it is rich in historical or cultural associations, the return to the asset will reflect this higher value;
- c) The capital services corresponding to these returns to capital should be used instead of consumption of fixed capital in calculating the value of output of non-market producers when this is estimated as the sum of costs incurred;
- d) The definition of an asset needs to be clarified to ensure that assets which provide benefits to the economy or community as a whole and not just to the owner of an asset are included.

The outcome of the AEG meeting in December 2004 was the following:

“There was strong support in principle for including a return to capital, viewed as an opportunity cost, in the measurement of non-market output. However, concerns were expressed about the rate of return to be chosen and availability of data for capital stock.

In terms of the range of assets which could be covered, most participants favored including those assets in the generation of government output similar to those assets used in market production. A smaller number favored including roads and other infrastructure assets. Progressively fewer favored including assets such as city parks serving the community at large and land.

It was agreed that these range of positions of the AEG should be sent to all countries (and inserted on the website) seeking reactions on both conceptual and practical grounds.”

This issue was also discussed at the last two meetings of the NAWG. The conclusion has been that in contrast to the AEG and the Canberra II Group a majority of the NAWG continues to be against including a return to capital in the measurement of non-market production, mainly for practical reasons, but also on conceptual grounds.

Next steps

Reflecting the outcome of the last AEG, the ISWGNA has decided to conduct a global consultation to determine the views of national statistical offices, central banks and other interested parties on the measurement of output of government and other non-market producers. This consultation has just been launched and essentially invites replies to the following questions.

“When summing costs to make estimates of output of for non-market producers what should be used to reflect the cost of using non-financial assets:

- a) Consumption of fixed capital, which is the current recommendation, or the cost of capital services?
- b) If the cost of capital services is chosen, should it apply to all non-financial assets owned by the non-market producer or just some of them?”

Goodwill and other non-produced assets (SNA item 22)

Issue

The 1993 SNA only records purchased goodwill which it defines as “The difference between the value paid for an enterprise as a going concern and the sum of its assets less the sum of its liabilities, each item of which has been separately identified and valued.” (SNA 1993, Annex ch. 13, p. 310). Internally generated goodwill that is not evidenced by a purchase or a sale is not recognised as an economic asset.

Purchased goodwill for corporations and unincorporated enterprises are treated differently in the present SNA: Purchased goodwill related to the sale of a corporation is represented by the excess of the purchase price of its shares and other equity over their value just prior to the sale/purchase. Purchased goodwill for the sale/purchase of an unincorporated enterprise is represented by the excess of the purchase price of this enterprise over its net worth (derived from its separately identified and valued assets and liabilities).

The main questions asked in the context of the SNA revision are: Should goodwill continue to be recognized only when purchased or should internally generated goodwill be recognized? Should purchased goodwill be treated the same way for corporate and unincorporated enterprises? Should the balance sheet recognize assets such as brand names, trademarks, franchises, etc.?

Obsolescence and depreciation (SNA item 23)

Issue

During and following the production of the OECD Manual “Measuring Capital” (published 2001) there has been a debate on whether there was a substantial difference between the SNA definition of depreciation and other definitions and measurements of depreciation as used in productivity literature.

Consumption of fixed capital (i.e. depreciation) is defined in the 1993 SNA in general terms as the decline, during the course of the accounting period, in the current value of the stock of fixed assets owned and used by a producer as a result of physical deterioration, normal obsolescence or normal accidental damage. It is referred to as time series depreciation because it is defined in terms of the change in value of an asset over time.

It has been pointed out however, that productivity literature, on the other hand, tended to define depreciation not as the change in the value of an individual asset over time but as the difference in value of two assets that are identical, except one is older than the other by the same length of time as the accounting period (cross section depreciation). Obsolescence was thereby excluded because it was not affecting the relative values of the different vintages of the otherwise identical assets; depreciation was therefore restricted to wear and tear.

The question has therefore been whether there really is a difference between the different existing definitions of depreciation, especially with respect to obsolescence, and if the SNA needs to be changed.

Pension schemes (SNA item 2)

Issue

In the 1993 SNA, promises to pay future pension benefits are not recognized as liabilities of social security schemes and unfunded employer schemes. The review will investigate the analytical relevance of recording these liabilities in the national accounts and, if appropriate, formulate recommendations regarding their valuation and measurement.

State-of-play of discussion

The recording of pensions is one of the most important items for the SNA review, especially for EU countries. Following the work of the Electronic Discussion Group (EDG) on pensions chaired by the IMF and (since autumn 2004) by the US BEA (Bureau of Economic Analysis), a proposal was put forward to treat unfunded employer schemes as if they were funded, to use an actuarial valuation of cost of labour for funded schemes, and to allocate (in most cases) the net assets of the pension fund to the employer (these proposals are only relevant for defined benefit schemes).

The Eurostat SNA Review TF wrote in September 2004 to the EDG Chair to postpone any decision at the AEG meeting of December 2004, as originally scheduled. The issue was then discussed in the three meetings of the task force in November 2004, February and April 2005, as well as at the FAWG in November 2004 and May 2005.

On 2 December 2004, Eurostat sent to the AEG (Advisory Expert Group), under an exceptional procedure, a “communication” on pension outlining 6 options. As well as different locations for the data in the accounts, the problem noted was whether it makes sense in many EU countries to separate government benefits to its former staff from the general social security scheme. The accounting structure was provided in a January 2005 annex.

The issue of unfunded pension schemes will be continued at the promised international task force organised by the IMF and now scheduled for September 2005. A call for paper is launched for mid July 2005. A proposal would then be made to the AEG meeting in January 2006.

Non-performing loans (SNA item 4) and application of accrual principles to the debt in arrears (SNA item 38)

Issue

The financial crises of the 1990s led to renewed interest in the question of how nonperforming loans (NPLs) should be accounted for in macroeconomic statistics. The *System of National Accounts 1993 (1993 SNA)*, in particular, does not reflect the existence of NPLs in either the flow accounts or the balance sheets. The origin of the problem is that the current *1993 SNA* records loans at nominal value irrespective of

changes in their quality in terms of credit risk (the risk that a borrower fails to meet its obligations) and other changes in the market. In addition, the *1993 SNA* recommends that interest on NPLs continue to accrue, even if the contractual payments are not made. As a result, the accounts may provide a seriously overoptimistic view on the financial positions of holders of nonperforming loans.

State-of-play of discussion

Recommendations on non-performing loans were submitted for the December 2004 meeting of the AEG:

The AEG agreed that loans should continue to be recorded at nominal value for both creditors and debtors. In addition, memorandum items should be shown at market value; these should be mandatory for at least financial institutions and government as creditors.

More clarification is required in respect of:

- i. The definition of which loans are non-performing;
- ii. The exact nature of the memorandum items (whether market-equivalent value or nominal value less expected provisions for impairment);
- iii. A worked example of the accounts showing the memorandum items;
- iv. Harmonization of terms used in various manuals;
- v. The implications for the recording of FISIM; and
- vi. Whether similar treatment should be extended to other financial instruments (in particular trade credits).

The AEG also discussed the issue of debt arrears and came to the following conclusions:

Time of recording and treatment of arrears should be harmonized in the various macro-economic statistics.

No transactions should be imputed when a liability goes into arrears (i.e., the debt continues to be recorded in the original instrument).

If the original contract provided for a change in the characteristics of a financial instrument when it goes into arrears, this change should be recorded as a reclassification in the other change in volume of assets account.

If the contract is renegotiated, the consequences are to be recorded as new transactions.

It was suggested that consideration of these issues should be included in the paper concerning non-performing loans which the IMF has agreed to prepare.

Next steps

The IMF agreed to prepare a paper addressing these issues which will be discussed at the July 2005 meeting of the AEG.

Documents

4# Issue paper by IMF addressing the AEG's request for clarifications

4# R. Freeman (2004): The Treatment of Nonperforming Loans in Macroeconomic Statistics, An Issue Paper Prepared for the December 2004 Meeting of the Advisory Expert Group on National Accounts (doc SNA/M2.04/07)

4# IMF (2004): Application of Accrual Principles to Debt Arrears, An Issue Paper Prepared for the December 2004 Meeting of the Advisory Expert Group on National Accounts (SNA/M2.04/19)

Superdividends, capital injections and reinvested earnings (SNA item 34)

Issue

The issue arises from problems with the present SNA to properly record fiscal data in the case of super dividends from and capital injections in public corporations. The ESA 95 Manual on deficit and debt and the GFSM 2001 provide pragmatic rules, but do not eliminate all practical difficulties and manipulation attempts, especially in the EDP context. To solve the present problems it has been proposed to extend the current SNA treatment for reinvested earnings to and from the rest of the world to the relationship between public corporations and general government (and possibly to all sectors).

State-of-play of the discussions

Within the Task Force on Harmonization of Public Sector Accounting (TFHPSA), working group 2, proposals for the revision of SNA regarding *Capital injections, superdividends and reinvested earnings* have been discussed at three meetings. The third meeting of the TFHPSA was held in Paris on 2-4 March 2005. The TFHPSA decided to postpone submitting a paper for AEG decision pending clarifications.

The issue has also been discussed at three Eurostat SNA task force meetings in Luxembourg (November 2004, February and April 2005) and at the FAWP (November 2004, May 2005).

The issue was also discussed by the NAWG at its meeting in March 2005. A majority of the NAWG members speaking on this issue were against the proposal of extending the reinvested earnings approach to public corporations and general government or even beyond.

Next steps

The TFHPSA has sent out a note to the AEG, in which it describes the further steps as follows:

The task force intends to complete and transmit a paper on Issue 34 to the Advisory Experts Group (AEG) for consideration during its January 2006 meeting. The paper will provide a menu of recommendations on the full treatment of these transactions, in particular superdividends and capital injections. The primary recommendation will be to refer to the “reinvested earnings” (SNA account D.43) treatment, which is currently reserved for direct foreign investment. (§7.120 and §14.152). The TFHPSA has also discussed an alternative approach. In case the “reinvested earnings” would not be accepted, we would not like to end up with the status quo, which is very unsatisfactory. The alternative secondary approach will also be presented in the paper..

Documents

4# TFHPSA (2005): Note for the Advisory Experts Group On Issue 34: Government Transactions with Public Corporations (Earnings and Funding: Super Dividends, Capital Injections and Reinvested Earnings), May 2005.

4# Eurostat (2005): Capital injections, superdividends and reinvested earnings – AEG 34, TF
Chair summary of the state of play as of 4 May 2005

Market/non-market, public sector/private sector delineations (SNA item 36)

Issue

The issue is to clarify the SNA definition of the public sector, to give relevant guidance for the correct identification and classification of public sector entities and to clarify the SNA guidance in identifying units engaged primarily in either market or non-market activities.

State-of-play of the discussions

Within the Task Force on Harmonization of Public Sector Accounting (TFHPSA), working group 2, proposals for the revision of SNA regarding *the private/public and the market/nonmarket delinations* have been discussed at three meetings. The third meeting of the TFHPSA was held in Paris on 2-4 March 2005.

The work of the Task Force on Harmonisation of Public Sector Accounting (TFHPSA) is notably progressing and further clarification is provided, bring closer statistical standards to accounting standards, specifying indicators of control (for corporations and for NPI's) and assessing the practice of economically significant prices.

The six recommendations of the TFHPSA cover the following questions: recommendation 1 – how to determine if an entity is in the government sector or in the public sector; recommendation 2 - government control on corporations, recommendation 3 – government control on nonmarket NPIs; recommendation 4 – economically significant prices, market and non-market producers; recommendation 5 – definition of sales (specific case for sales of financial intermediaries) and recommendation 6 – definition of production costs.

These recommendations are spelt out in the issue paper to the July 2005 meeting of the AEG. The NAWG will need to review whether the clarification of economically significant prices implies a change to the ESA 50% rule.

Next steps

The AEG will discuss the recommendations of the TFHPSA in July 2005.

Documents

4# TFHPSA (2005): Government/Public Sector/Private Sector – Delineation Issues (AEG 36),
Paper for the July 2005 AEG

Retained earnings on mutual funds (SNA item 42)

Issue and proposed change to the SNA

In the 1993 SNA property income is received by the owners of financial assets and tangible non-produced assets, mainly land and subsoil assets. It accrues when the owners of such assets put them at the disposal of other institutional units. Property income in the form of retained earnings is treated as reinvested earnings on direct foreign investment (D.43) and attributed to insurance policy holders (D.44) in the case of life insurance policies and pension funds. In both cases they are treated as if they were distributed to the investors and then reinvested by them. In the SNA interest accruing on loans, deposits, etc. is also treated as paid out to the owners of these loans deposits, etc. and reinvested. The 1995 ESA extended this treatment also to retained earnings from investments into mutual funds.

It is recommended to adopt a similar treatment for mutual funds also in the updated SNA and in the new BPM6, i.e. to record retained earnings of mutual funds as if they had been distributed to investors and reinvested into the funds. It is here proposed to record these reinvested earnings as a new income category “property income attributed to holders of mutual funds shares” (D.46). The main reasons for these proposals may be summarised as follows:

- €# The treatment would bring consistency with the recording of other collective investment schemes that have similar features;
- €# The question has also been raised within the balance of payments statistics¹.
- €# The amounts of cross-border transactions and positions in mutual funds are usually much smaller than between the institutional units within a national economy. However, the inclusion of mutual funds into the accounts alters substantially the household accounts and to a smaller extent the GNI.
- €# Accordingly, using the updated measures on household income and saving would produce a more meaningful economic analysis of household consumption and saving ratios, which are presently underestimated in the SNA 1993.

Next steps

An issue paper with this proposal will go to the July 2005 meeting of the AEG. The AEG will be asked to discuss and decide the following questions:

- €# Does the AEG agree on the principle of recording retained earnings in mutual funds in a similar way to life insurance companies and pension funds, and thus avoid the risk of noticeable distortion of household disposable income that keeping present SNA treatment would create?
- €# Does the AEG agree that SNA 1993 could also be amended as regards the classification of property income payable to holders of mutual fund shares, if useful?
- €# Does the AEG agree on a new definition of mutual funds that would allow them to be considered as financial intermediary corporations, taking also into account those funds issuing monetary liabilities?

Documents:

4# Eurostat (2005): Retained earnings of mutual funds. Paper for the meeting of the AEG in July 2005.

¹ See *BOPTEG issue notes # 19 and # 19A*.

PAPER FOR THE JULY 2005 AEG

GOVERNMENT / PUBLIC SECTOR / PRIVATE SECTOR

DELINEATION ISSUES (AEG 36)

18 May 2005

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ACRONYMS

GBE	Government business enterprise
<i>GFSM 2001</i>	<i>Government Finance Statistics Manual 2001</i>
<i>ESA 95</i>	<i>European System of Accounts 1995</i>
IFAC	International Federation of Accountants
IPSAS	International Public Sector Accounting Standards
NPI	Nonprofit institution
PPP	Public private partnership
PSC	Public Sector Committee (IFAC)
SNA	<i>System of National Accounts 1993</i>
SPV	Special purpose vehicle
TFHPSA	Task Force on Harmonisation of Public Sector Accounting
WGII	Working Group II (for SNA review), TFHPSA

Executive Summary

A. Introduction

As part of the work programme of the Task Force on Harmonization of Public Sector Accounting, this paper investigates two issues about public sector entities. Firstly, whether the current SNA principles and guidance lead to a clear identification and delineation of public and private sector statistical units. Secondly, whether within the public sector, units are correctly classified as either non-market (general government) or market (corporations).

The investigation is carried out with a view to promote harmonization in the classification of public sector organizations between economic and financial accounting reporting. An important step in harmonization is an accurate delineation firstly, of the public and private sectors, and, secondly, of the general government sector and the two public corporations sectors[11]

B. The Public Sector

The public sector is defined in System of National Accounts 1993 (the SNA) as the national, regional, and local governments plus institutional units controlled by government units. Problems arise in relation to identification of the latter units and further clarification in the SNA on these units is recommended.

A governmental controlled entity might be an entity that can be a source of financial gain to the government that controls it because it produces goods and services and sells them at market prices (referred to as corporations in the SNA) or it might be an entity that cannot be a source of financial gain to the government regardless of the prices for which it sells the goods and services it produces (nonprofit institutions). Governments exert control over these two types of entities differently.

Control of corporations

In the SNA, a government controls a corporation if it has the ability to determine the general corporate policy. In the International Public Sector Accounting Standards (IPSASs) issued by the International Federation of Accountants Public Sector Committee, a government controls a corporation if it has the power to govern its financial and operating policies so as to benefit from its activities. It is recommended that the definition of control in the SNA [SNA 4.30] be further elaborated along the lines of the definition similar to those found in the IPSASs.

The difference in the definitions is relevant to corporations for which the government involvement is as a fiduciary, such as for pension funds for government employees.² The classification of such units in the SNA is not entirely clear and the proposed change to the SNA definition of control may result in the classification of these units to the private sector.

Control of nonprofit institutions

² An electronic discussion group (EDG), hosted by the International Monetary Fund (IMF) is examining pension schemes, <http://www.imf.org/external/np/sta/ueps/index.htm>.

More clarification on which non-market nonprofit institutions are part of the public sector in economic accounting could be provided. For non-market NPIs, the requirement to be mainly financed by government could be included in a list of indicators of control, along with other supporting material as recommended.

C. General Government Sector – Economically Significant Prices

Once the coverage of the public sector is clearly defined, there is a need to classify public sector entities as either engaging in market or non-market production, i.e., as being in the public corporations sector or general government sector respectively. In the SNA, an institutional unit is a market producer if it charges economically significant prices for all or most of its output. The definition of an economically significant price is, however, quite general and further guidance along the lines suggested would be more helpful.

D. Conclusion and Recommendations

It is recommended that the SNA definition of control be extended to align more closely with the financial accounting definition of control in the IPSASs.

The main recommendations are:

Public sector boundary:

- ∄# Extend the discussion of control in the SNA to include:
 - Indicators of control of corporations
 - Indicators of control of non-market NPIs

General Government Sector:

- ∄# Clarification and elaboration in the SNA of:
 - Distinction between market/non-market production based on the concept of economically significant prices

There are also some areas in the SNA where guidance on the identification and treatment of units, which are relevant for the boundaries of the public and general government sectors, is absent or insufficient; this leads to interpretation and inconsistency of treatments across countries. These issues include, for instance, Special purpose vehicles (SPVs) that have become important, particularly for securitization operations, but they can be used for a wide variety of purposes.³ In addition, it is possible for a government to form a joint venture with another government (public joint ventures), and with a private entity or entities (public-private joint ventures). Potentially, there may be more than one institutional unit and their sectoring is not covered in the SNA. However, while the detail of this will depend on other issues and is not available for this paper, guidance in the SNA is required on how to evaluate and classify these three cases

³ Working Group II (WGII) of the TFHPSA has an interest in these units as part of its consideration of privatisation and restructuring units.

Recommendation 1: for a decision tree

In practice, when a decision for classifying an entity - in the government sector or in the public sector - is to be made, it is recommended to follow three steps and answer three questions:

1. Is the entity an institutional unit?

If the entity does not meet the criteria (see §14) to be considered an institutional unit, it is part of the unit that controls it⁴.

2. Is the institutional unit part of the public sector?

If the unit is controlled by a government unit it is part of the public sector. If not, it is neither a general government unit, nor a public corporation (part of the public sector).

3. Is the public institutional unit market or non-market?

Does the public unit sell its output at economically significant prices?

If yes, it is to be classified as public corporation (in S.11 or S.12).

If no, it is to be classified in the general government sector (S.13).

Recommendation 2: Government control on corporations:

Definition: control is defined as the ability to determine the general corporate policy of the entity. Public corporations – corporations controlled by government units - are to be classified in the non-financial or financial corporations sector according to their main activity.

Indicators: eight major indicators of control are to be considered. In some cases, a combination of indicators is necessary:

Indicator 1: ownership of the majority of the voting interest (p. 17)

Indicator 2: control of the board or other governing body

Indicator 3: control of the appointment and removal of key personnel

Indicator 4: control of key committees of the entity

Indicator 5: golden shares and options (p. 18)

Indicator 6: regulation and control

Indicator 7: control by a dominant customer

Indicator 8: control attached to borrowing from the government (p. 20)

⁴ See also the discussion on AEG issue 25 on Institutional units.

Recommendation 3: Government control on non-market NPIs:

Definition: control is defined as the ability to determine the general policy or programme of the NPI. Non-market NPIs controlled by government are allocated to the general government sector.

Indicators of control: five major indicators of control are to be considered:

- Indicator 1: appointment of officers (p. 22)
- Indicator 2: other provisions of enabling instrument
- Indicator 3: existence of contractual agreements
- Indicator 4: degree of financing by government
- Indicator 5: level of risk exposure

Recommendation 4: Economically significant prices, market and non-market producers

Market producers sell most or all of their output at prices that are economically significant.

Non-market producers are producers that provide most of their output to others free or at prices that are not economically significant.

Economically significant price is important because it is the criterion that is used to classify output and producers as market or non-market. Economically significant prices are defined as prices that have a significant influence on the amounts the producers are willing to supply and on the amounts purchasers wish to buy. These prices normally result when:

The producer has an incentive to adjust supply either with the goal of making a profit in the long run or, at a minimum, covering capital and other costs

Consumers have the freedom to purchase or not purchase and make the choice on the basis on the prices charged.

It can be presumed that these prices result when the units are private corporations. When there is public ownership, these objectives may be modified for example because of public policy purposes, and thus cause difficulties in determining whether the prices are economically significant or not.

It is assumed that units that operate with economically significant prices are operating in line with market conditions. In the case of financial intermediaries, the interest rate that they charge is assumed to be close to the market conditions. Units that do not use economically significant prices are working in an environment where supply and demand are controlled by other factors usually because of the interjection of government policy into economic behaviour. In the SNA, production that results in products being offered for sale at economically significant prices is described as market output and other production is referred to as non-market production. A production unit is described as a market producer or a non-market producer according to whether the majority of its production is market or non-market, respectively. The only units that operate as non-market producers are those in government and those designated non-profit institutions serving households (NPISH). It is thus particularly important to be clear whether units set up by government or in which government has a controlling interest are to be designated as market or non-market producers.

Governments frequently act to produce goods and services other than those characteristic of government. In order to determine whether these are produced in a market or non-market manner, it is useful to consider

a taxonomy which specifies which units are the consumers of the goods and services in question and whether the public sector is the only supplier. The following indicators could be considered in making the decision to classify these producers as either market or non-market.

Production sold primarily to corporations and households

When production is sold primarily to corporations and households, in order to qualify as a market producer, the majority of its costs (including consumption of fixed capital and a return to capital) would normally be covered by the value of its sales and consumers are free to choose on the basis of the prices charged. Although there is no prescriptive numerical relationship between the value of output and the production costs, one would normally expect the value of output to average at least half of the production costs over a sustained multi-year period. Because economic circumstances vary considerably, it may be desirable to accept a lower threshold to achieve consistent economic measurement over time and across countries.

For the same reason, the distinction between market and non-market may be made for a group of entities undertaking similar activities rather than on a case-by-case basis. Examples may be higher educational institutions or transport systems.

Production sold only to government

The 1993 SNA describes some services typically required by all units as ancillary services. These include activities such as transportation, purchasing, sales, marketing, computing, communications, cleaning, and maintenance. A unit that provides some or several of these services exclusively to its parent unit or to other units in the same group of units may be described as an ancillary unit. Ancillary units provide all their output to their owners for use as intermediate consumption. The 1993 SNA treats these units as integral to their parent units. This practice is under review. The cases below consider units providing services (or goods) other than those considered as ancillary services. They include cases where government is purchasing services (including health services) on behalf of households or of corporations.

Only supplier

If a public producer is the only supplier, it is treated as a non-market unit unless it competes with a private producer in tendering for a contract to government on normally accepted commercial terms.

One of several producers

A public producer is considered a market producer if there is evidence that it competes with other producers in the market.

Production sold to government and others

Some public sector units sell some of their production to government and some to other non-government units.

Only supplier

For the unit to be treated as a market producer, either the sales to non-government units is more than half of total output or the sales to government satisfies the tender condition above (“Only supplier”, see also § 91).

One of several producers

A public producer is considered a market producer if it competes with other producers in the market.

Mixed ownership

When there is mixed public and private ownership, the greater the degree of private ownership the greater the presumption that the output is market output, but this criterion is not definitive.

Recommendation 5: definition of sales

In order to compare output of corporations with their production costs to assess if prices are economically significant, the output is measured as equal to the business notion of sales (plus if necessary the changes in inventories), excluding taxes on products (D.21) and subsidies on products (D.31), except those subsidies that are also granted to all private producers for this type of activity (in all cases, payments to cover an overall deficit are excluded). Own-account production is not considered part of sales in this context.

Warning: the case of financial corporations (what are ESP, and sales, for financial corporations?) is specific and still under discussion in the TFHPSA and in other fora. A proposal will be made later on to the Advisory Expert Group.

Recommendation 6: definition of production costs

Production costs are the sum of intermediate consumption, compensation of employees, cost of capital services,⁵ and other taxes on production. Other subsidies on production are not deducted.

⁵ If the term “capital services” would not be included in the updated SNA, it would be replaced by the consumption of fixed capital plus the interest on productive capital.

I Introduction

1. The Task Force on Harmonization of Public Sector Accounting (TFHPSA) is examining the harmonisation of the economic and financial accounting⁶ reporting of the economic activities and the classification of public sector organizations. One area of harmonization involves the scope of the organizational units that are covered by the two systems.

2. The scope of economic and financial reports about the public sector is defined in terms of organizational entities, with these entities having in common that they are controlled by government. In economic statistics, entities are referred to as institutional units or statistical units. In financial accounting, they are referred to as reporting entities. The public sector is the universe of government controlled statistical units in the SNA and, in the IPSASs, it is a single reporting entity to the extent that it represents the universe of governmental controlled entities. In the SNA, the public sector is defined as the units of the general government, public non-financial corporations, and public financial corporations sectors [SNA 19.37]⁷. In financial accounting, the IPSAS Board (ex-Public Sector Committee of the International Federation of Accountants) states that the public sector “refers to national governments, regional (e.g., state, provincial, territorial) governments, local (e.g., city, town) governments and related governmental entities (e.g., agencies, boards, commissions and enterprises).”⁸

3. This paper investigates two issues about public sector statistical units in economic accounting and proposes changes to the SNA:

≠# To clarify the SNA definition of the public sector and relevant guidance for the correct identification and classification of public sector entities.

≠# To clarify the SNA guidance in identifying units engaged primarily in either market or non-market activities for the correct delineation of government from other public units.

II The present SNA

II.1 Sectors

4. In the SNA, institutional units are aggregated into sectors according to the similarity of their economic objectives, functions, and behavior and the types of units that may control them. The SNA defines the public sector as encompassing three sectors ∞ the general government sector, public financial and non-financial sectors.

⁶ “Economic statistics” and “economic accounting” are used here as interchangeable terms for macroeconomic statistics and the methodological foundation underlying them. The principal manual reflecting the goals and methodological standards of macroeconomic statistics is *System of National Accounts 1993*, which will be referred to as “the SNA.” The *Government Finance Statistics Manual 2001 (GFSM2001)* is identical with the SNA with regard to the identification and grouping of institutional units. The one difference between the *GFSM2001* and the SNA relevant to this paper is consolidation.

⁷ References to the SNA will be given as [SNA x.y], where x is the number of the chapter and y is the number of the paragraph in chapter x. References that do not follow quotations are paraphrases of the cited paragraphs.

⁸ IPSAS Board (ex-International Federation of Accountants), *Handbook of International Public Sector Accounting Standards, 2003 edition*, p. 10.

A. The Public Sector

5. Institutional units can be classified as being public or private units or being owned or controlled by public or private units. The grouping units owned controlled by public units is referred to in the SNA as the public sector. It consists of all government units, all nonprofit institutions (NPIs) controlled and mainly financed by government, and all public corporations.⁹ Statistics on the public sector provide information on the total resources controlled by governments and the purposes and efficiency with which those resources are employed.

6. The public sector is defined in the SNA as the national, regional, and local governments plus entities controlled by government units. Determining exactly what is meant by the public sector is part of the first issue in paragraph 3. The definition of control can be improved resulting in greater certainty in the correct sector treatment of the related governmental entities. As will be seen in section IV, there is some uncertainty about the exact meaning of some of the terms used to define government units, NPIs controlled and mainly financed by government, and public corporations.

B. The General Government Sector

7. Institutional units also can be classified as being either market or non-market producers. Such a classification is important for economic analysis because units subject to market forces operate differently than units not subject to market forces. Many units engage in both market and non-market production, but usually one type of production predominates so that a classification of mixed units is not needed. It is sufficiently accurate to treat each unit as being either a completely market producer or a completely non-market producer.

8. All corporations and some NPIs are predominantly market producers. All government units and most NPIs are predominantly non-market producers. Within non-market producers, some units finance their activities primarily through taxes and other compulsory transfers, and other units finance their activities primarily through voluntary transfers. The first group consists of all government units and NPIs controlled and mainly financed by government. This group is referred to in the SNA as the general government sector.

9. Determining exactly what is meant by the general government sector in the SNA is part of the second issue raised in paragraph 3. 0As will be seen in later sections, there is some uncertainty about the exact meaning of some of the terms used to define institutional units and the exact definition of economically significant prices.

C. The Corporations Sector

The corporations sector comprises institutional units that are market producers. The sector includes all corporations and some NPIs.

II.2 Institutional Units in The Public Sector

10. The heart of the statistical system of the SNA is a set of accounts that presents (1) stocks of assets and liabilities in a balance sheet for the total domestic economy and its major sectors at the beginning and end

⁹ This definition is equivalent to the definition cited in paragraph 2 because all corporations are either financial or non-financial corporations and in chapter IV of the SNA it is clear that the phrase “units of general government” includes NPIs controlled and mainly financed by government.

of an accounting period and (2) the principal economic activities occurring within the accounting period in several flow accounts. A statistical unit known as the institutional unit is used for the compilation of these accounts. The total domestic economy is the aggregation of all domestic institutional units, and each sector is an aggregation of certain domestic institutional units with specific characteristics.

11. An institutional unit is “an economic entity that is capable, in its own right, of owning assets, incurring liabilities and engaging in economic activities and in transactions with other entities.” [SNA 4.2] Such a unit “is able to take economic decisions and engage in economic activities for which it is itself held to be directly responsible and accountable at law,” including entering into contracts. [SNA 4.2] Because an institutional unit can engage in economic activities on its own account, it can buy and sell goods and services, own assets, and incur liabilities in its own name. Another implication is that either a complete set of accounts reflecting the unit’s activities exists or it must be possible and meaningful to compile such a set of accounts. [SNA 4.2] Finally, an institutional unit must be resident in the domestic economy.

12. An institutional unit is either (1) a household or (2) a legal or social entity whose existence is recognized by law or society independently of the persons or other entities that may own or control it. [SNA 4.3] For the purpose of this study, only legal or social entities are of interest. Three main types of legal or social entities are identified in the SNA: government units, corporations, and nonprofit institutions. [SNA 4.5]

Government units

13. Government units are “legal entities established by political processes which have legislative, judicial or executive authority over other institutional units within a given area.” The principal economic functions of government units are (1) to assume responsibility for the provision of goods and services to the community or to individual households at prices that are not economically significant, and (2) to redistribute income and wealth by means of transfer payments, financing both of these activities primarily from taxation or transfers from other government units. [SNA 4.104]

14. In order to apply the general definition of an institutional unit to identify government units, the SNA offers the additional guidance that a government unit must:

≠# Have funds of its own, either (1) raised by taxing other units resident in or engaging in economic activities in its area of authority or (2) received as transfers from other government units; [SNA 4.104(a)]

≠# Be able to own assets [SNA 4.125] and incur liabilities by borrowing on its own account; [SNA 4.104(a)]

≠# Have the authority to disburse at least some of its funds in the pursuit of its policy objectives; [SNA 4.104(a)] and

≠# Be able to appoint its officers, independently of external administrative control. [SNA 4.125]

15. All government units supply most of the goods or services they produce or purchase for resale to consumers free or at prices that are not economically significant. Roughly speaking, economically significant prices can be characterized as market prices. [SNA 4.24(b)] Thus, producers whose prices are not economically significant are referred to as non-market producers. Despite being non-market producers, government units may engage in some market production. By definition, the amount of market production must be less than the amount of non-market production, and it usually is much less. The treatment of such market production depends on the organization of the government unit. Economically significant prices are discussed further in section V.

B Corporations

16. Corporations are legal entities that are (1) created for the purpose of producing goods or services for the market, (2) collectively owned by other institutional units, (3) intended to be a source of profit or other financial gain to their owners and (4) recognized at law as separate legal entities from their owners. [SNA 4.23 and 4.47]

17. Producing for the market means that the goods and services produced by the unit are sold or otherwise disposed of at economically significant prices¹⁰. [SNA 4.24(b)] The definition of these prices is discussed further in section V.

18. The owners, known as shareholders, can be any type of institutional unit, including households, government units, and other corporations. The total value of a corporation is allocated in some manner among the shareholders, usually in proportion to the number of shares owned.

19. Any profit or other financial gain earned by a corporation belongs directly or indirectly to the shareholders. Financial gains can be passed directly to the shareholders as a dividend or similar distribution or the corporation can retain them. Any[12] amount retained by the corporation increases the value of the corporation and indirectly the value of the shares. [SNA 4.24] Similarly, any loss suffered by the corporation decreases the value of the shares.

20. As institutional units, corporations must be responsible and accountable at law for their own actions implies that they are legally independent of their shareholders. Legal independence implies the ability to buy, sell, lease, and mortgage property in its own name and the power to sue and be sued without recourse to the owners. This independence usually means that the liability of shareholders with respect to the corporation's actions is limited to the amounts invested in the corporation.

21. Legal independence does not mean that corporations make decisions autonomously. In fact, the requirement that shareholders must own corporations means that their activities have to be controlled in some manner by the collective decision of those owners. If there is a large number of owners, each with a small percentage ownership share, then the corporation's decisions will be relatively autonomous. If, however, there is only one owner, then that owner will be able to direct the corporation's activities in whatever detail desired. Nevertheless, even corporations wholly owned and controlled by a single unit are responsible for their own actions, are required by law and the tax authorities to produce complete sets of accounts and, therefore, constitute separate institutional units. [SNA 4.38]

22. In the SNA, the concept of corporations includes companies, partnerships, cooperatives, proprietorships, and other legal forms of organization in addition to organizations formally designated as corporations as long as they produce for the market, are owned by other units, can be a source of financial gain to their owners, and are separate legal entities. [SNA 4.23] Conversely, many entities known as corporations by the governing law are not corporations in the SNA because they do not produce for the market or cannot be a source of financial gain for their owners. [SNA 4.48] For example, many governments and NPIs are legally organized as corporations.

23. Corporations are formed in accordance with the laws of a specific locality. A corporation may normally be expected to have a centre of economic interest[∞] i.e., to be resident[∞] in the country in which it is created and registered. When it also has one or more branches engaged in significant amounts of

¹⁰ For the purpose of using economically significant price to distinguish among market and non-market producers, the prices should exclude taxes and subsidies on products, except these subsidies that are granted to all producers for the same type of activity.

production over long periods of time in other countries, such branches are treated as quasi-corporations that are separate institutional units resident in the countries in which they are located. [SNA 4.24]

Public corporations

24. Corporations can be owned or otherwise controlled by government units as well as by other types of institutional units. Corporations controlled by government units are referred to as public corporations. Control is defined as the ability to determine general corporate policy, typically by appointing appropriate directors. Owning more than half the shares of a corporation usually is sufficient to control the corporation, but other methods of control are possible. For example, a government may be able to control a corporation as a result of special legislation giving it the right to appoint the directors regardless of the number of shares owned. [SNA 4.30]

C. Nonprofit institutions

25. NPIs are legal or social entities created for the purpose of producing goods and services whose status does not permit them to be a source of income, profit, or other financial gain for the units that establish, control, or finance them. The articles of association by which they are established must be drawn up in such a way that the institutional units which control them are not entitled to a share in any profits or other income they receive. [SNA 4.54] Some NPIs may be created as legal corporations. They are, however, treated as NPIs in the SNA because they cannot be a source of financial gain to the units that establish, control, or manage them.

26. NPIs can be market producers. The term “nonprofit” derives from the fact that the members of the association controlling the NPI are not permitted to gain financially from its operations and cannot appropriate any surplus that it may make. It does not imply that an NPI cannot make a profit from its productive activities. [SNA 4.56] For example, nonprofit universities, hospitals, and credit unions might charge prices that are sufficiently high to be judged economically significant. [SNA 4.58]

27. NPIs that do not charge economically significant prices are non-market producers; they must rely principally on funds other than receipts from sales to cover their costs of production or other activities. Their principal source of finance may be investment income, regular subscriptions paid by the members of the association that controls them, or donations from third parties, including government units. [SNA 4.60]

Nonprofit institutions controlled and mainly financed by government

28. Some non-market NPIs are controlled and mainly financed by government. To be nonprofit institutions, these units must be properly constituted legal entities that exist separately from government. Governments can establish NPIs, reserve the right to appoint the directors and otherwise direct the activities on the NPI, and provide any necessary financing. It is likely that an NPI controlled and mainly financed by a government is carrying out the government’s policies using government resources and effectively is a part of that government. Once established, however, the government cannot profit from the NPI’s activities or retain a claim on its assets.

29. Governments may find it appropriate to create NPIs to carry out a specific function rather than use a government unit because NPIs are seen as more detached and objective and less subject to political pressures than government units. [SNA 4.62] Possible examples are NPIs engaged in research or development and NPIs that set and/or maintain standards in fields such as health, safety, the environment, accounting, finance, and education.

30. As with corporations, control of an NPI is the ability to determine its general policy or program, typically by having the right to appoint its officers. [SNA 4.62] The SNA does not define “mainly financed.” It was previously observed, however, that a non-market NPI must rely principally on funds other than receipts from sales to cover their costs of production or other activities, and that one source of these funds can be donations from government units. It is presumed, therefore, that “mainly financed by government” means that a government unit is the principal source of the funds used by a non-market NPI to cover its costs of production and other activities.

III Identification of Public Sector Units: the notion of control

31. Although the preceding sections present reasonably clear notions of what an institutional unit is and how to classify them as public or private units, there are a number of improvements that could be considered.

A. Definition of an institutional unit

32. Institutional units are defined so that they will adequately support macroeconomic analysis. The measurement and analysis of production is perhaps the primary goal of economic statistics, and the classification of institutional units in the SNA into market and non-market producers is vital for that goal. A second design aspect is that the variety of possible analytical tasks requires a coherent set of statistics regarding the full range of economic activities. The definition of an institutional unit as a unit that can engage in economic activity is crucial for such a coherent set of statistics. The current definition needs some elaboration so that institutional units can be identified with greater certainty.

- a. Having balance sheets, a complete set of accounts, owning assets and incurring liabilities can be done by entities that are not institutional units. The relationship between these characteristics and the concept of an institutional unit needs to be defined more clearly.
- b. In some cases social security and autonomous pension funds may not be institutional units if the definition is strictly followed, but the needs of economic analysis are better met if they are classified as institutional units. The definition of an institutional unit should make it clear why they are so classified.

B. Definition of Control

33. Establishing the definition of control is the most important issue for determining if a unit is a public or private unit. A public corporation is a corporation that is controlled by a government unit or another public corporation, and a NPI is a public unit if it is both controlled and mainly financed by a government unit.

34. The IPSASB defines control¹¹ to be “the power to govern the financial and operating policies of another entity so as to benefit from its activities”. The definition is also supplemented by a number of indicators. The SNA defines control “as the ability to determine the entity’s general corporate policy, by appointing directors if necessary” [SNA 4.30]. As the IPSAS definition applies to a particular reporting entity in question, it is possible for units in the public sector by the SNA definition to be totally excluded

¹¹ The definition is in the International Public Sector Accounting Standard (IPSAS) issued by the IPSAS Board (ex-IFAC PSC): IPSAS 6 – *Consolidated Financial Statements and Accounting for Controlled Entities*

from the sector under the IPSASs.¹² Nonetheless, enhancement of the SNA definition, based on the IPSASs would result in more harmonized reporting in a number of respects. For example:

- 4# a classification to the private sector of those government employee pension funds where governments act in a fiduciary capacity,
- 4# specifying that control must be presently exercisable (i.e. power conferred by existing legislation, etc) and that general regulatory powers applicable to a whole class of entities or industry may not imply control of an individual unit.

Government Control of Corporations

35. In many cases, it will be clear that a government unit controls a corporation because it is the sole owner or it has the exclusive right to appoint directors. There easily can be, however, cases in which the government is not the sole owner. In those cases, it may not be obvious that there is a controlling owner. In addition, governments can strongly control the economic actions of corporations by exercising their sovereign powers.

36. A corporation is in the public sector if a government unit or a public corporation controls the entity; otherwise it is in the private sector. The SNA defines this control “as the ability to determine the entity’s general corporate policy, by appointing directors if necessary” [SNA 4.30].

37. It is recommended that the above “basic” definition be amended so that control is defined “as the ability to determine the general corporate policy of the corporation”.

38. It is further proposed that the existing reference to ‘the appointment of directors, if necessary’ (and other additional explanatory text) be incorporated into the SNA so as to improve the basic definition by addressing some of the difficulties discussed above and make it operationally similar to the equivalent concept in the public sector accounting standards. The conceptual basis of the current definition is therefore not changed in any material way by the supporting text outlined in the box below.

Supporting text:

39. Government units and or public corporations may be able to determine the ‘general corporate policy’ of a corporation in a variety of different ways depending on the institutional arrangements in place. The expression “general corporate policy” as used here is understood in a broad sense to mean the key financial and operating policies relating to the corporation’s strategic objectives as a market producer.

40. Since governments exercise sovereign powers through legislation, regulations, orders and the like, care needs to be applied in determining whether the exercise of such powers amounts to a determination of the general corporate policy of a particular corporation and therefore control of the corporation. The laws or regulations applicable generally to all units as a class or in a particular industry should not be viewed as amounting to control of these units. Government authority to determine the general policy of a corporation usually comes from legislation or other instrument that is specific to the individual corporation, identified by its name, over which control is exercised.

41. The ability to determine the general corporate policy does not necessarily include the direct control of the

¹² For example, in some federal systems several governments may each have minority interest in an entity. Such an entity would be in the public sector by the SNA definition whereas under the IPSASs no government would consider it a controlled entity, resulting in it being excluded from enumeration in the public sector altogether.

day-to-day activities or operations of a particular corporation. The officers of such corporations would normally be expected to manage these in a manner consistent with and in support of the overall objectives of the particular corporation.

42. The ability to determine the general corporate policy of a corporation also would not include the direct control over any professional, technical or scientific judgments, as these would normally be viewed as part of the core competency of the corporation itself. Thus, the professional or technical judgment exercised by a corporation set up to certify aircraft airworthiness would not be considered controlled in respect of individual approvals and disapprovals, though its broader operating and financial policies, including the airworthiness criteria, may well be determined by a government unit as part of the corporation's corporate policy.

43. Following on from the above, the determination of the general corporate policy of a corporation acting as a *bona-fide* trustee would not amount to control of the trustee's execution of its professional functions as a fiduciary. In such instances, the institutional units typically involved would be the trustee (say in the form of a particular corporation in question), the trust property or activity (say in the form of another corporation) and the beneficiaries (say individuals or householders). If a government unit (or another public corporation) did determine the general corporate policy of the corporation in question, then this would not amount to control of the trust property or activity. This is because the trustee, in executing its fiduciary obligations, would be obliged to act strictly in accordance with the trust deed. The trustee would act in the interests of the beneficiaries and not at the behest of its controlling entity (in matters subject to the trust of course). Accordingly, the public corporation in question would not be viewed as controlling the trust property or activity and the latter would therefore be classified to the private sector. Two examples where this may apply relate to government employee pension funds and public trustees.

44. In the above case, if the beneficiaries were public sectors entities then a classification of the trust property or activity to the public sector would be appropriate. The general principles described here in relation to a public corporation performing as a *bona-fide* trustee would also apply if the unit in question were of a different type (e.g. a government unit or an NPI controlled by government).

45. When governments control corporations in the manner discussed here, they generally do so for public policy purposes as this is fundamentally the reason for government's existence. Governments therefore always benefit in the process of controlling other entities, irrespective of the success or otherwise of the public policies in question. Although all such benefits can ultimately be linked to the fundamental reason for government's existence i.e. formulation and execution of public policy, it is also possible to view a subset of these benefits in a financial or monetary sense (such as entitlement to dividend income or exposure to financial loss). In this view, if a government controlled a corporation it would also be able to benefit by being able to determine the corporation's profit distribution policy or by applying its share of the funds to alternative uses through a liquidation of the corporation, for example. An analysis of benefits along these lines may be helpful in establishing the existence of control in some circumstances; however, the wider notion of benefits emanating from the fundamental reason for a government's existence always exists. Therefore, a determination of the existence of government control over a corporation can also be done independently of the benefits involved.

46. Since the arrangements for the control of corporations can vary considerably it is neither desirable nor feasible to prescribe a definitive list of factors to be taken into account; however, the following indicators could be taken as a guide:

Some indicators of control:

Indicator 1 – ownership of the majority of the voting interest

47. The ownership of the majority of shares if decisions are made on a one-share one-vote basis needs to be considered. The shares may be held directly or indirectly and the aggregate ownership of the whole public sector needs to be considered as a number of different public sector entities may hold shares. Such a situation could be relevant temporarily in cases when the government has taken control of a private company in difficulty.

48. A single institutional unit owning more than a half of the shares, or equity, of a corporation is able to control its policy and operations by outvoting all other shareholders, if necessary. Similarly, a small, organized and coordinated group of shareholders whose combined ownership of shares exceeds 50 per cent of the total is able to control the corporation by acting in concert.

49. In cases where decisions are not made on a one-share one-vote basis (i.e. the ownership is on a different basis to control), the classification to the public sector would be based on whether the control provides a majority voice.

Indicator 2 – control of the board or other governing body

50. The controlling entity may have the ability to appoint or remove a majority of the board or other governing body as a result of existing legislation, regulation, contractual, or other arrangements. This may be determined by examining the arrangements and considering, where necessary, the total public sector influence. There may be appointees of different levels of government and of different public corporations that need to be aggregated to assess the overall situation.

51. Even when the public sector does not control the appointment of directors, they may have the right to veto proposed appointments. This can be seen as a form of control if it influences the choices that can be made. This right of veto may also be relevant to other indicators below.

52. Another body, including a subset of the board itself, may be responsible for appointing the directors. In these cases it is necessary to look at the composition of these other bodies to see whether these are majority public sector or not. There may also be timing issues if the government (or the public sector more widely) appoints the first set of directors but does not control the appointment of replacement directors. The body would then be public sector until the initial appointments had expired, provided there was no control of the next set of appointments.

53. There may also be circumstances where the key financial and operational policies of the entity are actually established and limited by existing legislation, regulation or other instrument, thereby making the issue of board appointments less critical or even irrelevant.

Indicator 3 – control of the appointment and removal of key personnel

54. In cases where control of the board or other governing body appears marginal or inconclusive, the appointment of key executives, including the chief executive, chairperson and finance director may be considered. Non-executive directors may also be relevant if they sit on key committees such as the remuneration committee determining the pay of senior staff.

Indicator 4 – control of key committees of the entity

55. Sub-committees of the board or the governing body could determine the key operating and financial policies of the entity. These sub-committees could be examined to establish whether any have a majority public sector membership. This can happen under the constitution or enabling instrument if it specifies that

some public sector members of the board must be on the sub-committee.

Indicator 5 – golden shares and options

56. The government may own a “golden share” in some companies, particularly those that have been privatized. In some cases, this share gives the government some residual rights to protect the interests of the public and, for example, prevent the company selling off some categories of assets. For example, the share may confer the right to appoint a special director who has strong powers in certain circumstances. The government may also have indicated that they do not expect to exercise the power of the golden share in normal circumstances and the companies’ owners/shareholders accept the existence of the golden share voluntarily. Control is defined in recommendation 2 of this paper as “the ability to determine the general corporate policy of the entity”. Thus the power covered by such a golden share as described above, is not of itself indicative of control. However, if the powers covered by the golden share did confer on the government the ability to determine the general corporate policy of the entity in particular circumstances, and those circumstances currently existed, then the entity would need to be reclassified to the public sector from the date in question.

57. The existence of a share purchase option available to a government unit or a public corporation in certain circumstances may also be similar in concept to the golden share arrangement discussed above. If the purchase option was exercised, then this should be taken into account if it results in having control. Prior to the exercise of the option, it will also be necessary to consider whether the circumstances in which the option may be exercised currently exists, the volume of shares which may be purchased under the option and the consequences of such exercise means that the government currently has “the ability to determine the general corporate policy of the entity” by exercising that option.

58. As a general principle, the public/private determination of an entity’s status should be based on the existing ability to determine corporate policy exercised under normal conditions rather than in exceptional economic or other circumstances such as wars, civil disorders or natural disasters. Any ability to control an entity in such circumstances would not give rise to control in the absence of such circumstances.. However, when exceptional economic or other circumstances arise, the ability to control is activated and a reclassification would be justified during the period of such abnormality.

Indicator 6 – regulation and control

59. The borderline between general regulation (of a kind that would normally apply to all entities within say a whole class or industry group) and the control (of an individual corporation as discussed here) can be difficult to judge sometimes. There are many examples of government involvement through regulation, particularly in areas such as monopolies and privatized utilities, but regulatory involvement itself is not necessarily control. Therefore, it is possible for regulatory involvement to exist in important areas, such as in price setting, without the entity ceding control of its general corporate policy.

60. Where regulations are accepted by the entity (i.e. the entity chooses to enter into or continue to operate in a highly regulated environment) this suggests that they are not equivalent to control. However, when the regulation is so tight as to effectively dictate how the entity performs its business, then this could amount to a form of control. Fundamentally, if an entity retains unilateral discretion as to whether it will take funding from, interact commercially with or otherwise deal with a public sector entity, other than abide by laws and regulations applicable generally, then the entity has the ultimate ability to determine its own corporate policy and is therefore not controlled by the public sector entity.

Indicator 7 – control by a dominant customer

61. If all of the sales of a corporation are to a single public sector customer there is clear scope for dominant

influence. All of such sales may also be to several public sector customers in which case there is again potential for dominant public sector influence.

62. Whether such influence by a dominant customer is tantamount to control may be difficult to judge. Where not all of the sales are to public sector customers, the presence of a minority private sector customer usually implies an element of independent decision-making by the corporation; hence would not be considered controlled. In general, if there is clear evidence that the corporation could not choose to deal with non-public sector clients because of the public sector influence, then public control is implied.

Indicator 8 – controls attached to borrowing from the government

63. Lenders often impose controls as conditions of making loans. If the government imposed controls through lending or the issuing of guarantees that are more than would be typical when a healthy private sector entity borrows from a bank, they may indicate control. Similarly, control may be implied if only the government (and not the banks) was prepared to lend. The overall significance of any such borrowing from government, in relation to the magnitude of the corporation's other borrowings and equity, would also need to be taken into account.

Indicator 9 – other controls associated with the entities constitution and other rules

64. There are often a number of formal legal documents underpinning an entity. These need to be examined for indications of control although it is difficult to cover all eventualities. The following list suggests points to watch for to check whether under the existing arrangements the government can:

- ## determine aspects of how the body delivers its outputs
- ## have a final say in the disposal or acquisition of fixed assets
- ## be entitled to share of proceeds of asset disposals that goes beyond the repayment of previous government support for capital formation
- ## close or restructure the body
- ## prevent the body from ending its relationship with government
- ## change the constitution of the body
- ## decide what sort of financial transactions the body can undertake, or limit them
- ## prevent the body from receiving certain types of income from other sources
- ## exert numerous minor controls over how the body is run
- ## exert financial control as part of a system of controlling public expenditure (this may require more frequent and more detailed financial reporting than would be the case more generally)
- ## control dividend or other distribution policy
- ## set pay or remuneration rates
- ## approve mergers or acquisitions (other than for regulatory reasons provided for under existing arrangements).

Totality of all indicators

65. In many cases, a single indicator alone could be sufficient to establish the existence of control beyond doubt. In other cases, a number of separate indicators could each be indicative of control, but lack conclusiveness as individual indicators. In these instances, the total impact of all such indicators should be taken into account to establish whether overall control effectively exists, even when none of them provide such an indication on their own.

66. A decision based on the totality of all indicators as described here must necessarily be judgmental in nature, rather than one based on the principles of exact science. Of course, there has to be consistency of approach in classification decisions for such judgments to be effective.

Government Control of Non-market NPIs

Background and Current definition

67. NPIs controlled and mainly financed by government are allocated to the general government sector. In this context, control is defined ‘as the ability to determine the general policy or programme of the NPI by having the right to appoint the officers managing the NPI’ [SNA 4.62].

Proposed revised definition and supporting text

68. It is proposed that the reference to ‘and mainly financed by government’ be replaced with the term ‘non-market’ (or perhaps even ‘mainly non-market’) and that the reference to ‘the right to appoint the officers managing the NPI’ be repositioned under a new ‘indicators of control’ sub-heading.

69. The amendment does not change the conceptual basis of the current definition but it does it make it operationally more consistent with that used in the accounting standards. As a result of these changes the paragraph above would read as follows:

Non-market NPIs controlled by government are allocated to the general government sector. In this context, control is defined as the ability to determine the general policy or programme of the NPI.

70. In addition, further text could be added in the revised SNA so as to provide guidance on the factors that may indicate control of NPIs. The text in the box below is recommended:

Some indicators of control:

Indicator 1 – appointment of officers

71. Under the provisions of the NPIs constitution, articles of association or other enabling instrument, the government may have the right to appoint the officers managing the NPI.

Indicator 2 – other provisions of enabling instrument

72. Even though government may not have the right to appoint the officers managing the NPI, the enabling instrument may contain other provisions that effectively allow the government to determine significant aspects of the general policy or programme of the NPI. For example, the enabling instrument may simply specify and or limit the functions, objectives and other operating aspects of the NPI, thus making the issue of managerial appointments less critical or even irrelevant. The government may retain the right to remove key personnel, veto proposed appointments, require prior approval of budgets or financial arrangements, prevent the NPI from changing its constitution, dissolving itself, terminating its relationship with government, etc.

Indicator 3 – existence of contractual agreements

73. The existence of any contractual agreement between a government and an NPI for, say, the provision of goods or services may contain clauses indicative of the NPI effectively allowing government to determine aspects of its general policy or programme. However, so long as the NPI is ultimately able to determine its policy or programme to a significant extent (for example by being able to renege on the contractual agreement and accepting the consequences, by being able to change its constitution or dissolving itself without requiring government approval other than that required under the general regulations), then it would not be considered controlled by government.

Indicator 4 – degree of financing by government

74. Where an NPI is mainly financed by government, the arrangement needs to be examined in order to establish whether this amounts to effective control of the entity that is the NPI itself, as opposed to control over the application of the financing made available. Generally, if the NPI is able to determine its policy or programme to a significant extent along the lines mentioned in indicator 3 above, then it would not be considered an institutional unit which is controlled by government.

Indicator 5 – level of risk exposure

75. If a government openly allows itself to be exposed to all or a large proportion of the financial risks associated with an NPI's activities, then the arrangement may be examined to establish if control of the NPI itself exists or is implied. Again, the rationale in indicators 3 and 4 above could be applied.

Totality of all indicators

76. In many cases, a single indicator alone could be sufficient to establish the existence of control beyond doubt. In other cases, a number of separate indicators could each be indicative of control, but lack conclusiveness as individual indicators. In these instances, the total impact of all such indicators should be taken into account to establish whether overall control effectively exists, even when none of them provide such an indication on their own.

77. A decision based on the totality of all indicators as described here must necessarily be judgmental in nature, rather than one based on the principles of exact science. Of course, there has to be consistency of approach in classification decisions for such judgments to be effective.

NPIs controlled and mainly financed by government versus NPIs serving households that obtain all or most of their funds from government

78. Governments and NPIs often serve the same goals of providing social services to selected portions of the population free or at very low cost. Sometimes a government unit will provide the funds to support delivery of the services, but a NPI will actually produce the services or procure them from another producer. When that happens, the classification of the NPI depends on the interpretation of government payments to the NPI and the definition of economically significant prices (see section IV).

79. If the government payments are interpreted as a purchase of services or as a subsidy on products (i.e., payment is related to the volume of the goods and services produced) to the NPI, then the NPI is classified as a market producer, either public or private depending on the interpretation of the degree of government control. If the payments to the NPI are treated as non-subsidy transfer payments, then the NPI is a non-market producer. Being mainly financed by government, it is again a public or private unit depending on the interpretation of control. There have been discussions for many years about the guidelines to be used when classifying government payments to NPIs. The SNA needs further guidelines in this area.

Identification of market producers: Economically Significant Prices

80. The second issue in paragraph 3 (part b) asks whether, within the universe of public sector entities, units engaged primarily in either market or non-market activities are correctly identified and classified. Economic statistics use the concept of economically significant prices to distinguish between market and non-market units.

Current definition and difficulties

81. A publicly controlled institutional unit could be either a government unit or a public corporation in the SNA depending on the prices for which the unit sells or otherwise disposes of its output. Market producers sell most or all of their output at prices that are economically significant. Prices are economically significant when they have a significant influence on the amounts the producers are willing to supply and on the amounts purchasers wish to buy. Universities and hospitals, for example, are market producers when they charge fees based on their production costs that are sufficiently high to have a significant influence on the demand for their services. Even if they generate persistent operating losses, they are market producers as long as their fees are determined mainly by their costs of production and are high enough to have a significant impact on demand. [SNA 6.50]

82. Non-market producers are producers that provide most of their output to others free or at prices that are not economically significant. A price is not economically significant when it does not have a significant influence on the amounts the producers are willing to supply or on the amounts purchasers wish to buy. Such prices are likely to be charged in order to raise some revenue or achieve some reduction in the excess demand that may occur when services are provided completely free, but they are not intended to eliminate such excess demand. Once a decision has been taken on administrative, social or political grounds about the total amount of a particular non-market good or service to be supplied, its price is deliberately fixed well below the equilibrium price that would clear the market. The price merely deters those units whose demands are the least pressing without greatly reducing the total level of demand.

Recommendation

83. Applying the definition of an economically significant price can be a matter of some judgment. There have been several efforts since the publication of the SNA to define what an economically significant price is, either attempting to develop general rules¹³ or by examining individual cases. In order to improve the application of the concept, it is recommended that some additional guidance, not rules, be included in the revised SNA along the lines of the boxed text below.

Economically Significant Prices

84. Economically significant price is important because it is the criterion that is used to classify output and producers as market or non-market. Economically significant prices are defined as prices that have a significant influence on the amounts the producers are willing to supply and on the amounts purchasers wish to buy. These prices normally result when:

- a. The producer has an incentive to adjust supply either with the goal of making a profit in the long run or, at a minimum, covering capital and other costs
- b. Consumers have the freedom to purchase or not purchase and make the choice on the basis of the prices charged.

85. It can be presumed that these prices result when the units are private corporations. When there is public control, these objectives may be modified for example because of public policy purposes, and thus cause difficulties in determining whether the prices are economically significant or not.

86. It is assumed that units that operate with economically significant prices are operating in line with market conditions. Those that do not use economically significant prices are working in an environment where supply and demand are controlled by other factors usually because of the interjection of government policy into economic behaviour. In the SNA, production that results in products being offered for sale at economically significant prices (excluding both taxes and subsidies on products) is described as market output and other production is referred to as non-market production. A production unit is described as a market producer or a non-market producer according to whether the majority of its production is market or non-market, respectively. The only units that operate as non-market producers are those in government and those designated non-profit institutions serving households (NPISH). It is thus particularly important to be clear whether units set up by government or in which government has a controlling interest are to be designated as market or non-market producers.

87. Governments frequently act to produce goods and services other than those that are generally characteristic of government. In order to determine whether these are produced in a market or non-market manner, it is useful to consider a taxonomy which specifies which units are the consumers of the goods and services in question and whether the public sector is the only supplier. The following indicators could be considered in making the decision to classify these producers as either market or non-market.

Production sold primarily to corporations and households

88. When production is sold primarily to corporations and households, in order to qualify as a market producer, the majority of the producer's costs (including consumption of fixed capital and a return to capital) would normally be covered by the value of its sales and consumers are free to choose on the basis of the prices charged. Although there is no prescriptive numerical relationship between the value of output

¹³ The European System of National Accounts (ESA 95) adopts a 50 per cent rule to determine the type of producer and the sector for private NPIs, but the TFHPSA does not support so prescriptive a cut-off.

(excluding both taxes and subsidies on products) and the production costs, one would normally expect the value of output to average at least half of the production costs over a sustained multi-year period. Because economic circumstances vary considerably, it may be desirable to accept a lower threshold to achieve consistent economic measurement over time and across countries.

89. For the same reason, the distinction between market and non-market may be made for a group of entities undertaking similar activities rather than on a case-by-case basis. Examples may be higher educational institutions or transport systems.

Other relevant cases of sectoral delineation not covered in this paper

Special Purpose Vehicles

97. Special purpose vehicles (SPVs) are created for securitization, financing public private partnerships,¹⁴ and other specialized activities where a separation from their nominal owner of assets or the right to future revenue is desired. For example, a government unit might transfer its rights to amounts equivalent to future taxes of a specified type to a SPV in exchange for a specified sum. The SPV then borrows using the rights to future government revenue as collateral and uses the funds to pay its obligation to the government. It then repays the borrowed funds using the designated taxes as they are received. The SPV usually is created as an independent entity for this single purpose and will go out of existence when the taxes have been collected and all debts liquidated. Often it is a trust under non-government administration. As such, it is a separate institutional unit, a financial corporation. Its classification depends on who controls the SPV, which could be the government unit, but more likely is an independent trustee. There are no guidelines in the SNA about how to evaluate and classify SPVs.¹⁵ Often, they are simply methods for government units to borrow with the SPV providing a fiduciary role, which implies that the SPVs should be public units or an ancillary unit within a government unit.

Joint Ventures

98. An arrangement described as joint venture may consist of a single institutional unit in which case the existing guidance in the SNA can be followed for classifications purposes. Typically however, a joint venture arrangement may be unincorporated and may consist of several participants. Guidance in the revised SNA as to the need to identify and correctly classify the institutional units involved in joint ventures would be helpful.

Public Private Partnerships

99. This issue has not been dealt with here by the TFHPSA as it is on the agenda of the Canberra 2 group with which it is closely working.

¹⁴ SPVs are specific to individual public private partnership (PPP) projects. An SPV for a PPP is typically a consortium of banks and other financial institutions, set up to coordinate the use of their capital and expertise.

¹⁵ See footnote 2.

TAX REVENUE AND TAX CREDITS

Executive Summary

An accurate recording of taxes – the main resource of the general government sector – on an accruals basis is an important challenge for the system of national accounts. The recording of tax credits (not treated in the present SNA) is a new issue, of increasing importance in some countries. This paper presents proposals to clarify and improve the present SNA provisions, and to allow for the best possible harmonised recording of these transactions, taking also into consideration other developments at international level (GFSM2001, IPSAS etc.).

The paper is presented in three parts: 1. the definition of tax revenue (coverage of taxes and borderline cases), 2. the accrual recording of taxes (acceptable methods for accruals), 3. the recording of tax credits. It can be summarised in 12 recommendations for the SNA update (in bold character), which try to be at the same time clear, concise and sufficiently prescriptive in terms of principles and main guidelines. These 12 recommendations are submitted to the AEG for decision.

Warning: Only paragraphs in bold in the paper are submitted for decision to the AEG as the new drafting proposal for the SNA

Background and main reasons for change

1. The recording of tax revenue and tax credits was one of the five priority issues defined by the Task force on Harmonisation of Public Accounting (TFHPSA) to be dealt with in the context of the search for convergence of accounting systems and of the SNA update. It has been put forward as issue 35 in the list adopted by the Advisory expert group (AEG) for the SNA Updating project. This is an issue which does not imply fundamental changes to the SNA.
2. An accurate recording of tax in the accounts of the general government sector is one of the major challenges of national accounts, as tax in the broad sense (including social contributions) represents in most developed countries between 80% and 90% of government resources. Moreover, international comparisons of the tax burden are increasingly based on national accounts concepts and figures.
3. The existing conceptual framework for recording tax (SNA1993, chapters 3, 7 and 8 especially) is broadly adequate. However some ambiguities exist, and, in any case, the recommendations and guidelines for implementation are not sufficient to ensure homogeneous recordings and valid international comparisons of both the tax burden and the financial balances of the general government sector (the net borrowing/net lending). The SNA update is an opportunity to improve and develop these recommendations.
4. In order to recording tax revenue in general, the main difficulties concern:
 - the exact coverage of taxes, in particular the borderline between tax and other transactions like the sale of a service by the government, other current transfers or, in more rare cases, the disposal of an asset.

- the relevant implementation of the accrual principle involving both the time of recording transactions and the amounts to be recorded.

5. An issue of increasing importance is the recording of tax credits, granted by the government to households and to corporations, which raise borderline issues with the recording of social benefits and subsidies. No provisions exist presently for recording tax credits in the national accounts manuals.

6. This paper incorporates the results of a questionnaire circulated among working team C of the TFHPSA¹⁶ and the comments made during and after the task force meeting in Paris (2-3-4 March 2005). **The paragraphs in bold characters are draft proposals for the updated SNA. The Advisory Expert group is asked to state on the 12 recommendations (in bold).**

Part 1: DEFINITION OF TAX REVENUE

1. General definition

It is proposed to modify the wording of paragraphs 7.48 and 8.43 by the following:

Recommendation 1:

Taxes are compulsory, unrequited payments, in cash or in kind, made by institutional units to government units exercising their sovereign powers. In most cases, the compulsory payment of taxes is conditioned by another economic event, not compulsory by nature, such as the purchase of good or service (taxes on production and imports), and earning of income, or ownership of an asset (current taxes on income and wealth). Taxes are usually described as unrequited because, in most cases, the government provides nothing directly in exchange to the individual unit making the payment, or nothing commensurate, although governments may use the funds raised in taxes to provide goods and services and make transfers to individual units, or collectively to the community as a whole.

However, in certain cases, the government provides something to an individual unit against the payment, in the form of the direct granting of a permit or authorisation (see also below “Borderline with other transactions”). The payment to government is then part of a mandatory process that ensures proper ownership recognition and performance of activities.

The major categories of tax are the following:

D.2: Taxes on production and imports

D.21: Taxes on products

D.29: Other taxes on production

D.5: Current taxes on income and wealth

D.51: Taxes on income

D.59: Other current taxes

D.91: Capital taxes

¹⁶ See the results of this consultation in Annex 1 (p. 11)

A more detailed list of taxes is provided in annex (from table 900, disseminated by Eurostat and the OECD)¹⁷.

The main difference between current taxes on income and wealth (D.5) and capital taxes (D.91) is that the first ones are levied on a regular basis, periodically, whilst the latter are levied at irregular and infrequent intervals, usually based on exceptional events or resources.

Not all compulsory and unrequited payments are taxes. Some payments having these characteristics may be recorded as Other current transfers (D.7, e.g. fines and penalties), or as social contributions (D.61).

Question: Does the AEG approve Recommendation 1?

Controversial point: The reference to the IPSAS concept of “non-exchange transaction” was rejected by the working team.

2. The borderline with other transactions

Reminder of the present SNA1993, §7.55 and 8.45: **Taxes versus fees**

“7.55. One of the regulatory functions of governments is to forbid the ownership or use of certain goods or the pursuit of certain activities, unless specific permission is granted by issuing a licence or other certificate for which a fee is demanded. If the issue of such licences involves little or no work on the part of government, the licences being granted automatically on payment of the amounts due, it is likely that they are simply a device to raise taxes, even though the government may provide some kind of certificate, or authorisation, in return. However, if the government uses the issue of licences to exercise some proper regulatory function – for example, checking the competence, or qualifications, of the person concerned, checking the efficient and safe functioning of the equipment in question, or carrying out some other form of control which it would otherwise not be obliged to do – the payments made should be treated as purchases of services from government rather than payments of taxes, unless the payments are clearly out of proportion to the costs of providing the services. The borderline between taxes and payments of fees for services rendered is not always clear cut in practice, however.”

This paragraph, broadly relevant, refers only to taxes and services and not to the case of non-financial non-produced assets. The task force proposes to clarify the implementation in treating the three following cases in recommendation 2:

Recommendation 2:

a) **The case of licences and permits delivered by the government**

- **Record as tax:** when, against the payment of an amount legally defined, a licence / permit is automatically granted by the government, exercising its sovereign powers, as a mandatory condition to perform an activity or acquire an asset / a good, and with the government unit performing little or no work – other than a minimum control of the legal capacity of the acquirer to do so (for instance, by not having been convicted of a crime) – the payment should be recorded as a tax.

¹⁷ This is provisional. The author intends to send another table to the AEG, showing the bridge between the table 0900 (SNA based) and the Revenue Statistics (OECD) and taxes in GFS (IMF), in accordance with the task force proposal.

For example, most licences to own or use vehicles, boats or aircrafts, to hunt, shoot or fish, permits to open a café or restaurant etc., to the extent that their acquisition do not require a specific examination, test, check of competence (other than the minimum check of the legal capacity to do so) correspond to this definition.

When the purchaser receives in return a service, or an asset, increasing immediately his economic utility (or his well-being), the payment should be recorded as a required transaction in the following way:

- **Record as purchase of service**: If the issuance of the licence or permit implies a proper regulatory function of the government – exercising control on the activity, checking competence or qualifications of the persons concerned etc. –, and when a service is provided in return to the payment, the payment should be recorded as the purchase of a service produced by the government, unless the payment is clearly out of proportion to the costs of producing the service¹⁸ for all or any of the entities benefiting from the services.

Examples: most driving or pilot licences, firearm licences (to the extent that, in many countries, they are subject of serious examination and control of the government), payments for passports, airport fees, court fees etc.

Warning: The following proposal (last paragraph of Recommendation 2, “Record as the purchase of an asset”) was submitted to the Canberra II group on the measurement of non-financial asset, meeting on 31 March – 1 April 2005. The Canberra group has expressed an opinion during this meeting, which is not disseminated now and not reflected below This is still under discussion and to be confirmed in the next Canberra II group meeting (September 2005). Thus, this paragraph as such is not submitted to the AEG for decision, but for information (an opinion of the AEG would be welcome).

- **Record as purchase of a non-financial asset**: If the licence or permit meets all the conditions and characteristics of an economic asset (See SNA1993, §13.12), making it a “store of value”:
- over which ownership rights are enforced by institutional units
- from which economic benefits (in the form of income or holding gains) may be derived by the owner over a period of time,

the payment should be recorded as the purchase of an asset. One of the characteristics of the licences or permits to be recorded as assets is that their number is strictly limited.

Question: Does the AEG approve Recommendation 2 (only paragraphs in bold character)?

Recommendation 3:

b) The case of certain fees

In all cases where fees are directly linked to a service - the service is provided in return to the fee - the payment is to be recorded as a purchase of a service (consistently with SNA1993, §7.55 and 8.45:”Taxes versus Fees”). A few significant examples are:

¹⁸ The extent to which this criterion (the proportionality test) applies to non-produced non-financial assets (as for produced assets) is under review.

- **Public museum or library admission fees (at a price which is usually not economically significant¹⁹):** they are a typical case of payments made by households for a service provided by a government unit. They are not tax but payments for a non-market service. Other payments for non-market output may be: admissions to public universities, to public hospitals, to public concert halls etc.

- **Waste collection and garbage disposal:** as a consequence of the above recalled definition (SNA93, §7.55 and 8.45) fees collected by the government for assuming this task (whether or not this task is then sub-contracted to a corporation) should be analysed as a purchase of a service to the extent that:

- . they are mainly assessed on the value of the work to be carried out and not to the value of the property as such
- . it is possible to identify the value of the fees

- **Television and radio fees:** payments for the public service of radio-television are to be recorded as the purchase of a service made available to users (the fee payment is to the government or to a public corporation according to the sector classification of the public unit providing the service)

- **Road tolls:** they are normally to be recorded as the purchase of a service (the use of a road).

Question: Does the AEG approve Recommendation 3?

3. Tax burden and compulsory levies

International comparisons are often made on the “tax burden” or “total tax revenue” (OECD, Revenue Statistics) or on “compulsory levies” (European Commission, Eurostat). These concepts, identical in principle, are not defined in the present SNA. They are usually not considered SNA concepts. However, they are usually quantified on the base of SNA concepts, like the general government sector or, for the denominator of the ratio, the gross domestic product (GDP).

This is a controversial issue: To the question “Should such a definition be taken on board in the updated SNA?” the Working team C answered: Yes:11 – No:5. However, this proposal was rejected by the task force plenary meeting in Paris (2-3-4 March 2005). Therefore, the issue is not submitted for the SNA update.

Part II: THE ACCRUAL RECORDING OF TAXES

Reminder of the present SNA provisions:

- §2.64: “The general principle in national accounting is that transactions between institutional units have to be recorded when claims and obligations arise, are transformed or are cancelled – that is, on an accrual basis.”

- §3.99: “Following the general rule, distributive transactions are recorded at the moment the related claims arise. As a result, for example, compensation of employees, interest, rent on land, social contributions and benefits are all registered in the period during which the amounts are built up. Equally, entries for taxes are made at the moment on which the underlying transactions or other flows occur which give rise to the liability to pay. This implies that taxes on products and imports are recorded at the times the products in question are produced, imported or sold, depending on the basis for taxation. Current taxes on income are recorded when the income to which they pertain is earned although taxes deducted at source may have to

¹⁹ In general, these payments rarely cover more than one third of the costs of producing the service.

be recorded when they are deducted. With respect to some distributive transactions, the time of accrual depends on the unit's decision when to distribute income or make transfer. (...)"

Task Force statement: These basic principles are confirmed. However, the guidance provided in §7.59-60 and 8.49-50 for respectively taxes on production and current taxes on income and wealth appeared to be not sufficient. The task force's proposal is to replace it by three new paragraphs dealing with 1. the general definition of accrued taxes 2. the time of recording taxes 3. the amounts to be recorded.

NB: Even though this paper does not deal explicitly with the case of social contributions, the rationale and recommendations in this section for an accrual recording of taxes would be similar for social contributions.

Recommendation 4:

Paragraph 1: **Accrued taxes**

Like most transactions in the SNA, taxes are to be recorded on an accrual basis (see also SNA chapter 3). **Accrual recording means that flows are recorded when economic value is created, transformed, exchanged or extinguished and not when cash payments are made. If this principle would be understood as requiring to record *due amounts* of taxes (as the consequence of the underlying economic event, and under the existing tax law), this should not in any case lead to the recording of uncollectible taxes in the total revenue of the general government²⁰.**

Uncollectible taxes comprise two elements: one element (often referred to in public finance as the "tax gap") can be described as the amounts of taxes due that the government is not aware of, due to the underground economy, fraud, evasion, non-compliance with the tax law and error. An additional element is the amount of tax due, expected to be collected under the tax law and known by the government, but that is not finally paid due to bankruptcy or to mutual agreement between the government and the debtor, as a consequence of economic difficulties affecting the situation of institutional units, including households, in the context of a recession for instance. This additional element is referred to hereafter as "taxes unlikely to be collected". Taxes unlikely to be collected should not affect government net borrowing / net lending.

The implementation of the upper general recommendation for the recording of taxes on an accruals basis leads to the consideration, in turn, of the two questions:

- the time of recording (recommendations 5 and 6)
- the amounts to be recorded (recommendation 7)

Question: Does the AEG approve Recommendation 4?

Recommendation 5:

Paragraph 2: **Time of recording**

Taxes should be recorded when the activities, transactions or other events occur which create the liability to pay taxes - in other words, when the taxable events occur - and not when the payments are actually made. This time usually is when income is earned or when a transaction (such as the purchase of goods and services etc.) generating the liability occurs, to the extent that the tax liability can reliably be measured.

²⁰ The total revenue of the general government is understood as including capital transfers.

Question: Does the AEG approve Recommendation 5?

Recommendation 6:

In practice, some flexibility is permitted in two cases where the tax assessment cannot be done in a reliable way before the time of assessment:

- **Parallel economy:** some activities, transactions or events escape the attention of the tax authorities, temporarily or permanently according to the particular economic and social context. It is then difficult to put in relation the liability to pay taxes and the taxable economic event. The amounts of tax to be recorded can be determined only when some tax assessment is made on another basis, and the time of the taxable event may never be determined. In this case, the relevant time of recording may be then the time of the tax assessment or payment.

- **Taxes on income:** taxes on income may be paid 1/ in the same time as the income is earned (this is normally the case of the pay-as-you-earn type of tax) or 2/ at a later point in time, depending on the tax system, which may require first the set-up of a roll or another form of tax assessment. In the first case, the link between the tax liability and the taxable event is quite clear and the accrual recording is straightforward, except that a final settlement of the tax liability may be determined in the following accounting period. In the second case, the liability to pay income taxes is determined in an accounting period subsequent to that in which the income accrues and becomes taxable. The moment of the tax assessment is the time when the tax liability is measured and known in a reliable way, taking into account possible changes to the tax rates and the final settlements.

Therefore, in these two cases, an acceptable time of recording the taxes may be the time when the taxes were assessed as due in a reliable way (and not the time when the economic event generated the obligation to pay taxes). This time is not necessarily the accounting period in which the payment is received. Finally, in the specific case of prepaid taxes on income, the accounting period of the payment may be considered as the relevant one.

Question: Does the AEG approve Recommendation 6?

Recommendation 7:

Paragraph 3: **Amounts to be recorded**

The amount of accrued taxes may be understood as due amounts of taxes (or amounts of taxes due to be paid), especially when the amounts are available from tax assessments. However, recording accrued amounts of taxes - at the time they are due or generated - should not lead to recording amounts that are known to be uncollectible, or are unlikely to be collected. Furthermore, the balancing item of the general government sector should not be artificially improved by the recording of amounts of taxes which are never collected.

There are two basic methods of valuing accrued amounts of taxes:

1. The **time-adjusted cash** method: available amounts are amounts actually paid. Nevertheless, these cashed amounts of taxes should be recorded at, or shifted to, the time the tax liability was incurred, not the time the payment was actually made.

2. Methods based on assessments of due taxes: there are two statistical methods which may eliminate the effect of taxes unlikely to be collected on these assessments²¹. None of these methods should be using the other changes in the volume of assets account:

- **Net recording of tax:** amounts assessed as due are to be adjusted by a coefficient reflecting the assessments in the recent periods that were never collected. Thus, the amounts of accrued tax are written down according to this adjustment, in such a way that taxes unlikely to be collected are not recorded as government revenue.

- **Gross recording of tax:** amounts assessed as due – based on realistic assessments - are entirely recorded as taxes. But the discrepancy between this due amount of tax and the actual cash receipts shall be treated as a capital transfer in favour of defaulting payers.

In particular, when retained at source by the employer (PAYE system), current taxes on income, wealth etc. should be included in the compensation of employees (wages and salaries) even if the employer did not in fact pass them on to the general government. The households sector is then shown as paying the full amount due on to the general government sector. The amounts actually not paid have to be neutralised by a capital transfer from general government to the employers' sectors.

In accordance with the general revision policy of national accounts, the amount of government tax revenue assessed for a given year may be revised the following year, according to better information on actually collected taxes.

Finally, a combination of methods is possible, according to the different types of taxes. In principle, the statistical methods used to achieve accrual recording of tax should ensure that, in a long-term perspective, cumulative tax revenues (net of related capital transfers) are equal, whether compiled on the basis of cashed amounts or on the basis of assessed amounts. However, in practice, the shifting of recording tax backwards over time may have the consequence that cumulative tax revenue is higher on an accruals basis than on a pure cash basis, as a result of the general economic growth (in volume and in price).

Reminder (in the case of gross recording of due taxes based on assessments): the recording of due amounts of taxes in the non-financial accounts is to be balanced by an Other receivable (F.7) entry in the financial account, differently to cashed taxes, balanced by an entry in F.2.

Question: Does the AEG approve Recommendation 7?

Part III: THE RECORDING OF TAX CREDITS

Recommendation 8:

1. Definition: the tax credit as a specific type of tax relief

Most tax systems include elements of social redistribution, through the tax schedule (increasing tax rate), the choice of tax unit (individual or family taxation) and tax relief. Tax relief aimed at redistribution may be designed to reduce the amount of tax that households pay according to certain

²¹ In the same spirit, the IPSAS recommends to disclose information on the tax gap, but not include it in the amount of tax revenue.

characteristics, such as the number of children. Moreover, tax relief may also be designed to encourage certain activities, such as participation in the labour force or investment in research and development.

Tax relief can generally take the form of a tax allowance, exemption or deduction - which is subtracted from the tax base, - or of a tax credit – which is subtracted directly from the tax liability (otherwise due). Tax credits can sometimes be payable, in the sense that any amount of the credit that exceeds the tax liability (otherwise due) will be paid to the taxpayer (or non-taxpayer). In contrast, some tax credits are non-payable, and so are limited to the size of the tax liability (otherwise due).

Corporations may also benefit from the granting of tax credits.

Question: Does the AEG approve Recommendation 8?

Illustration of a common tax arrangement and wording:

+ Gross income (or declarable income)	
- Tax exemptions	<u>Tax relief</u> refer to all exemptions, allowances and credits
= Net income tax base	
- Tax allowances	
= taxable income	
* tax rate	
= Tax claim / liability (otherwise due)	
- Tax credits	
= Tax revenue	

Recommendation 9:

2. The recording of tax credits: general recommendation

A tax relief that is embedded in the tax system should be recorded as reducing tax revenues. This is the case of tax allowances, exemptions and deductions, as they enter directly into the calculation of the tax liability. This is also the case for non-payable tax credits, as their value to the taxpayer is limited to the size of their tax liability (otherwise due).

Question: Does the AEG approve Recommendation 9?

Recommendation 10:

3. The special case of payable tax credit

Payable tax credits occur in cases where the total amount of the credit exceeds the amount of tax liability (otherwise due) and so the element of the credit in excess is paid by the government to the taxpayer. The amount actually paid by the government is to be recorded as government expenditure (as subsidy D.39, or social benefit D.62), while the rest is reducing the tax liability (otherwise due). Actual government payments due in the context of tax credits will not, in any case, be deducted from the reporting of global tax revenue.

(Initial consultation of working team C on this recommendation: Yes: 9,5 – No: 3,5)

Question: Does the AEG approve Recommendation 10?

The issue of recording “payable tax credits” is controversial: a global alternative proposal - minority view in the TFHPSA, but majority view in the IPSAS Board - is to gross up the tax revenue of government and to record all “expenses paid through the tax system” (IPSAS) as expenditure. (Eurostat has organised a consultation on this subject, the result of which will be made available).

Recommendation 11:

Conditions and criteria:

The recording of a tax credit as negative tax in national accounts should meet some conditions and criteria reflecting basically that the tax credit is embedded in the tax system and that there is a close relation between the subject of the tax credit and the category of tax:

- 1. The tax credit measure must appear as part of the tax law, tax calculation and of tax statements (tax consistency).**
- 2. Could be deducted only from a given tax liability (otherwise due), amounts that are calculated on the same base as the tax - usually the income – and over the same period of time. For example, possible VAT reimbursements to specific categories of the population, should not be recorded in national accounts as a deduction from their tax on income.**
- 3. The amount recorded as negative tax – to be deducted from tax (otherwise due) – cannot exceed the amount of tax due by the beneficiaries on an individual (household or corporation) basis. Thus, individual tax information must be used in order to calculate the amount of credit to be expensed. The element due in excess is an expenditure of government, and will not be deducted in the reporting of global tax revenue (individual character of tax credits).”**

Question: Does the AEG approve Recommendation 11?

Recommendation 12:

Clarification in the case of certain transactions (social benefits):

To draw the line between tax credits and social benefits paid through the tax administration, it is made clear that social benefits that come in replacement of the labour income (income substitutes) should systematically be recorded as government expenditure, even if granted through the tax administration. Would be always recorded this way the following social benefits: old age pensions, disability pensions and unemployment allowances.

The rationale of this recommendation is that these social benefits are not an element of social redistribution embedded in the tax system and do not meet the conditions and criteria listed above to be recorded as tax credits (reducing tax). Recording these benefits as tax reducing would distort the assessment of relevant aggregates (public social expenditure, tax burden) and damage international comparisons.

(Initial consultation of working team C on this recommendation: Yes:7 – No: 5)

Question: Does the AEG approve Recommendation 12?

ANNEX 1

QUESTIONNAIRE ON TAX REVENUE AND TAX CREDITS

SUMMARY OF REPLIES

In February 2005, 17 replies (see below) were collected from the Working Team C of the Task Force on the two first parts of the questionnaire, whilst 13 replies were collected for the third part (recording of tax credits). This brief summary of the replies intends to provide an indication of the opinions in Working Team C. It was not always easy to express an opinion under “Yes” or “No”: a minority of replies expressed a partial agreement with the draft proposals. In these cases, I have shared the point (0,5 for Yes and 0,5 for No). In rare cases, no answer was made to the question.

Part 1 and 2: 17 replies were collected, from Austria (NSI), Portugal (NSI), Korea (CB), Sweden (MoF), Bulgaria (MoF), UK (MoF), UK (NSI), Canada (NSI), USA (BEA), New Zealand (NSI), Israël (NSI), Denmark (NSI), Hungary (MoF), Australia (MoF), OECD (Revenue Statistics), IMF (STA-GFD), IMF (J.Pitzer)

Part 1: Definition of tax revenue	YES	NO
Question 1 (general presentation of the section)	17	0
Question 2 (draft of the basic definition)	15	2
Question 3 (to use IPSAS concept of “Non-exchange transaction”)	5	12
Question 4 (to provide in annex the full table 900 list of taxes)	13,5	2,5
Question 5 (borderline between tax and licences - permits)	11	6
Question 6 (borderline between tax and certain fees)	15	2
Part 2: The accrual recording of taxes		
Question 7 (general presentation: 3 new § instead of 1)	13,5	2,5
Question 8a (draft §1: definition of accrual)	13,5	3,5
Question 8b (draft §2: recommendation for time of recording)	15	0
Question 9 (draft §2: recommendation for some flexibility)	10,5	6,5
Question 10 (tax gap)	11	3
<i>NB: Question 10 was ambiguous (in 2 parts). Therefore, replies may be also ambiguous (or not provided).</i>		
Question 11 (draft §3: recommendation for amounts to be recorded)	10,5	5,5
Question 12a (accrual adjustment to revenue better than through expenditure) ¹²		3
Question 12b (compulsory levies to be defined in updated SNA)	11	5

Part 3: 13 replies were collected on 31 January 2005, from Bulgaria (MoF), UK (NSI), UK (MoF), New Zealand (NSI), Sweden (MoF), Australia (NSI), USA (BEA), Denmark (NSI), Korea (CB), Hungary (MoF), Israël (NSI), OECD (Revenue Statistics), IMF (STA-GFD)

Part 3: The recording of tax credits:	YES	NO
Question 13: (Definition a): tax credit and tax relief)	7,5	5,5
Question 14 (b)Recording of payable tax credits)	9,5	3,5
Question 15 (Relevant conditions and criteria)		
	a) 10	1
	b) 11	0
	c) 9	2
	d) 10	1
Question 16 (supplementary criterion: income substitute)	7	5

Questionnaire "SNA 93 / ESA 95"

Table 0900: Detailed tax and social contribution receipts by type of tax or social co

country:
currency:
prices:

code of transactions	code of sectors	General government
		SES13
TRD2	TAXES ON PRODUCTION AND IMPORTS	
TRD21	Taxes on products	
TRD211	Value added type taxes	
TRD212	Taxes and duties on imports excluding VAT	
TRD2121	Import duties	
TRD2122	Taxes on imports, excluding VAT and import duties	
TRD2122A	Levies on imported agricultural products	
TRD2122B	Monetary compensatory amounts on imports	
TRD2122C	Excise duties	
TRD2122D	General sales taxes	
TRD2122E	Taxes on specific services	
TRD2122F	Profits of import monopolies	
TRD214	Taxes on products, except VAT and import taxes	
TRD214A	Excise duties and consumption taxes	
TRD214B	Stamp taxes	
TRD214C	Taxes on financial and capital transactions	
TRD214D	Car registration taxes	
TRD214E	Taxes on entertainment	
TRD214F	Taxes on lotteries, gambling and betting	
TRD214G	Taxes on insurance premiums	
TRD214H	Other taxes on specific services	
TRD214I	General sales or turnover taxes	
TRD214J	Profits of fiscal monopolies	
TRD214K	Export duties and monetary comp. amounts on exports	
TRD214L	Other taxes on products n.e.c.	
TRD29	Other taxes on production	
TRD29A	Taxes on land, buildings or other structures	
TRD29B	Taxes on the use of fixed assets	
TRD29C	Total wage bill and payroll taxes	
TRD29D	Taxes on international transactions	
TRD29E	Business and professional licences	
TRD29F	Taxes on pollution	
TRD29G	Under-compensation of VAT (flat rate system)	
TRD29H	Other taxes on production n.e.c.	
TRD5	CURRENT TAXES ON INCOME, WEALTH, ETC.	
TRD51	Taxes on income	
TRD51A+TRD51B	Taxes on individual or household income including holding gains	
TRD51A	Taxes on individual or household income excluding holding gains	
TRD51C1	Taxes on individual or household holding gains	
TRD51B+TRD51C2	Taxes on the income or profits of corporations including holding gains	
TRD51B	Taxes on the income or profits of corporations excluding holding gains	
TRD51C2	Taxes on holding gains of corporations	
TRD51C3	Other taxes on holding gains	
TRD51C	Taxes on holding gains (1)	
TRD51D	Taxes on winnings from lottery or gambling	
TRD51E	Other taxes on income n.e.c.	
TRD59	Other current taxes	
TRD59A	Current taxes on capital	
TRD59B	Poll taxes	
TRD59C	Expenditure taxes	
TRD59D	Payments by households for licences	
TRD59E	Taxes on international transactions	
TRD59F	Other current taxes n.e.c.	
TRD91	CAPITAL TAXES	
TRD91A	Taxes on capital transfers	
TRD91B	Capital levies	
TRD91C	Other capital taxes n.e.c.	
TRD2+TRD5+TRD91	TOTAL TAX RECEIPTS	

Payable Tax Credits

(Comments by Graham Jenkinson and Bob Kilpatrick)

Two arguments have been developed for the treatment of payable tax credits. These are shown below:

- The case for the gross treatment from Graham Jenkinson of the UK
- The case for the split treatment from Bob Kilpatrick of the US

The gross treatment argument by Graham Jenkinson

First a few comments and background. When governments want to support people or activities they can do so in a variety of ways five of which are listed below:

- €# a payment can be made to every eligible entity (or on behalf of the entity) without any financial assessment as to whether they need it.
- €# a payment can be made to eligible entities on the basis of a financial needs assessment (commonly called a means test)
- €# entities may be given a tax allowance which reduces their income which is subject to tax. (Tax allowances are always non payable - that is they reduce tax but do not trigger payments to the entity)
- €# entities may be given a non-payable tax credit which reduces their tax payable
- €# entities may be given a payable tax credit which is deducted from their tax payable and will result in a payment to the tax payer when the tax credit exceeds the tax payable.

Currently the first two are generally described as social security benefits, while the last three are considered part of the tax system and are administered by the tax authority. In the future this distinction may be lost. The UK and several other countries may combine their social security and tax systems so that people have a single point of contact with government. Then all of these may be bundled together and there would be a single net payment each month between the individual and government.

With this in mind we should be looking at the reality of the arrangement and not take account of the language being used. Some things called “tax credits” may be equivalent to social benefits administered by the tax authority. They should be accounted for in the same way irrespective of what they are called or how they are administered.

Your note gives examples based on the consistency argument to justify the split treatment for payable tax credits. In the wider context described above the consistency argument can lead in a different direction. The case for tax credits to be scored as social benefits rests on the economic reality of how they are delivered and to whom. A simple case is “the working mother’s tax credit”. Suppose there are two mothers, one working and one not. If government policy is to help mothers, then this can be realised through a straight payment of social benefit, subject to proof that the recipient is a mother. The government may choose to administer these payments through the tax system and calls them tax credits. This tax credit is netted off the tax bill of the working mother if she pays enough tax, and is paid direct to the non-working mother (and the working mother if she has an insufficient tax bill).

So the effect of the tax credit is identical to the social benefit in terms of the net income of the mothers.

The other consistency which we should be aiming for is consistency with GAAP accounting and it appears that the accountants are heading towards a gross accounting treatment.

As you remarked Chris Heady said that it is impossible at a theoretical level to distinguish between taxes and social benefits except for the sign. The issue then becomes whether the national accountants want

guidance which attempts to do this or whether all of the categories above should be grouped together and treated the same way. This latter idea is pretty radical and is not on the table even though it has some intellectual attraction.

So if we don't treat them the same way how do we draw a clear distinction. There has been little dispute in TFHPSA that items 1 and 2 should be seen as social benefits and items 3 and 4 as negative tax. The issue then focuses on item 5 - payable tax credits. I would argue that the in reality payable tax credits may have an almost identical result to means tested social benefits - item 2. The only difference is their name and who administers them. So they should be accounted for the same way reflecting this economic reality. Logically this would have to be treatment as a social benefit.

I should qualify the views expressed above as being those of a national accounts expert and not an agreed UK view but hope this helps to present the other side of the argument.

The split treatment argument by Bob Kilpatrick

We would like to reiterate our support for the split method for recording payable tax credits, which we supported in the questionnaire and at the meeting. We do not agree with recording the gross tax credit as an expense (or as a reduction in revenue). To ensure that the tax credits are embedded in the tax system, we also support a set of indicators (Recommendation 10, although we asked one question about it above) and the classification of three major social benefit programs as expenses (Recommendation 12).

The fundamental reason to support the split method is that it follows from the definition of tax revenue in Recommendation 1: “. . . compulsory, unrequited payments . . . made by institutional units to government units exercising their sovereign powers.” A payable tax credit reduces the tax liability otherwise due to the government from some individuals or corporations. Because this reduces the amount of compulsory, unrequited payments made by institutional units to government units, it should be recorded as reducing tax revenue. The reduction in compulsory, unrequited payments to the government is recorded as reducing tax revenue under the split method, but it is recorded instead as an expense under the gross method.

The flaw in the above reasoning is demonstrated by considering the case where an unambiguous social benefit is administered through the tax system, only making an actual payment to the recipient when the tax liability is insufficient to cover the social benefit amount due. The social benefit might be to compensate for a handicap, and the purpose solely to compensate for degraded life style and to meet associated extra expenses resulting from the handicap. The purpose is expressly not to encourage a return to work. So if a recipient was not a tax payer, the benefit would be paid direct. If the recipient was paying tax, the benefit would be netted off the tax liability and either a net amount would be paid direct to the recipient, or if the tax liability was larger than the benefit, a smaller amount paid to the tax authority by the amount of the benefit.

Such a scheme may be efficient and would certainly reduce the amount of “compulsory unrequited payments made by institutional units to government units.” According to Mr Kilpatrick's reasoning, it should therefore be recorded as negative tax revenue, reducing the tax bill where the liability is sufficient to cover the cost of the benefit. So the split treatment logically leads us to only measure the net effect on the tax system, and benefits would not be shown separately. This would misrepresent the gross flows reflecting different policy effects, and significantly reduce the ability of policy analysts and economic analysts to understand economic and social developments.

Chris Heady said that it is impossible at a theoretical level to distinguish between taxes and social benefits except for the sign, and therefore a person cannot say that one is the right way and the other is not. We agree with his theoretical analysis. The basic implication, we believe, is that at a theoretical level there is no one right way to define tax revenue. The task force is nevertheless recommending a definition of tax

revenue for practical reasons, because a common definition is essential for compiling statistics in a comparable and consistent manner even though it has theoretical weaknesses. Given a definition of tax revenue, payable tax credits ought to be recorded in a way that is consistent with the definition. Therefore, given the definition of tax revenue in Recommendation 1, we conclude that the split method is the right way to record payable tax credits.

Furthermore, because the split method of recording payable tax credits is consistent with the definition of tax revenue, it is consistent with the method of recording non-payable tax credits and other tax expenditures.

¶# The split method of recording payable tax credits is consistent with the method of recording non-payable tax credits. For individuals or corporations who pay tax, both payable and non-payable tax credits reduce the compulsory, unrequited payments they make to government. Under the split method, the reduction in compulsory, unrequited payments to government is recorded as a reduction in tax revenue for both types of tax credit. In contrast, under the gross method, the reduction in compulsory, unrequited payments to government is recorded as a reduction in tax revenue only for non-payable tax credits; for payable tax credits, it is recorded as an expense. Only the split method would record the same effect in the same way.

This difference in treatment would be especially striking if a non-payable tax credit was made payable. The change in law would not affect someone whose tax liability otherwise due was greater than the credit both before and after the change in law. The change in law therefore should not affect the amount of tax revenue recorded for that taxpayer. Under the split method, the same reduction in tax revenue for that taxpayer would be recorded both before and after the change in law. Under the gross method, however, a reduction in tax revenue would be recorded before the change in law whereas an expense would be recorded after the change in law. Only the split method would record the same effect in the same way.

An example is the child tax credit in the U.S. It was a payable tax credit only for households with three or more children when it went into effect in 1998; it was a nonpayable tax credit for households with one or two children (over 95 percent of the effect was on tax revenue under the split method). The child tax credit was made payable for all households in 2001. Under the gross method, the credit for taxpayers with one or two children would presumably be considered a non-payable tax credit during 1998-2000 and thus recorded as a reduction to tax revenue, but it would change to an expense in 2001. Under the split method, the credit would be recorded as a reduction to tax revenue in all years (for households who paid tax).

These two paragraphs emphasise the author's view from the world of tax revenue. When the child tax credit was made payable for all households in 2001, this represented a change in policy. Previously, the non-payable tax credit was an incentive to work for households with one or two children – if there was no work and associated tax liability, then there was no incentive payment. In 2001, changing the credit to a payable one changed the nature of the incentive. Now there was no incentive to work, but there was a recognition that any household with children deserved a social benefit paid irrespective of work status. Mr Kilpatrick sees the advantage of the split treatment as preserving a consistent story over time in terms of net tax revenue. And so he finds the proposed gross treatment not reflecting a change that he sees as the important feature of the flows in the economy. But what comes over as a defence of the legitimate view of the tax revenue specialist, becomes an accusation from the national counts perspective of the economy as a whole, revealing flows in the economy which can be used to monitor economic and social policy.

This feature becomes particularly important to the national accountant when tax credits paid to corporations are considered. Payable tax credits will be seen as subsidies, not social benefits. Recording

them as negative tax will result in a different measure of GDP from that obtained from recording the flows on a gross basis.

€# The split method of recording payable tax credits is consistent with the method of recording other tax expenditures and other tax provisions. For example, the U.S. has both (a) a payable child tax credit and (b) a personal exemption for each dependent. Both reduce the compulsory, unrequited payments made by households with children who pay taxes to the government. Therefore, according to the definition of tax revenue in Recommendation 1, tax revenue should be reduced by both (a) the part of the child tax credit that reduces the tax liability otherwise due and (b) the personal exemption. Tax revenue is reduced by both provisions under the split method, but under the gross method the provisions are recorded differently. Tax revenue would be decreased by the personal exemption, whereas expense would be increased by the child tax credit.