

## **Classification paper on the Treatment of Receipts.**

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**What's new in this CLASS paper?**

This paper replaces CLASS (97) 1, which dealt with the treatment of receipts for goods and services, licences and levies. However, the principles in this new paper are still fundamentally the same as its predecessor as neither the manuals nor the associated guidance (which the ONS use to make decisions on how income streams should be classified) have changed.

Since the 1997 paper was written the Government's preferred measure of Public Expenditure, and Treasury's own control framework<sup>1</sup> have both changed, and the paper has been revised to reflect this. We have also revised the paper to provide greater clarity on the reasons that a given receipt may be classified in a given way, so that the emphasis is on working out the treatment of an income stream from first principles.

Further Reading:

- The Consolidated Budgeting Guidance sets out the how income streams should be treated within the Department's own budgets.
- The Fees and Charges Guide sets out in greater detail what how a fee should be calculated.
- Chapter 20 of Government Accounting deals with Income and Receipts, and deals primarily with the relation between Supply Estimates and the recording of income in resource accounts.
- The Financial Reporting Manual

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<sup>1</sup> The preferred measure of public spending is Total Managed Expenditure (TME), which is an aggregate taken from the national accounts. The Treasury's control totals are now DEL and AME (Departmental Expenditure Limits and Annually Managed Expenditure).

## Purpose of document

The purpose of this document is to provide advice to departments on how actual or potential income streams should, or may, be classified in the National Accounts, and the impact of this on the Public Sector Finances, and so measures of the fiscal position.

This paper specifically deals with a subset of non-financial transactions; that is the paper deals with certain current non-financial income streams. The paper discusses general issues, provides definitions, and gives advice on the application of those definitions in the public sector context.

This paper does not provide guidance on how to treat income in departmental budgets, which is dealt with in the consolidated budgeting guidance. However before the budgeting treatment of a given receipt can be settled the underlying economic nature of that transaction and its impact on the National Accounts needs to be ascertained – this paper provides guidance on that process. Guidance on financial transactions and capital non-financial transactions is given elsewhere (the CLASS paper on Capital < insert link >).

It is essential that departments speak to the Treasury when considering policies that will lead to new income streams. For further advice departments should approach their normal Treasury spending team contact. Treasury spending teams are invited to discuss classification issues with Russell Coleman (Tel 020 7270 5337) or Robert Spinks (Tel 020 7270 5338).

Ultimately the treatment of a given income stream in the national accounts is for the Office for National Statistics to determine, but whom should only be approached via HM Treasury. HMT can provide advice on classification issues, and departments should discuss issues with their normal expenditure contacts in the Treasury in the first instance. Difficult cases will be referred by HM Treasury to the ONS for a determination.

## Bodies to which this paper applies

This paper applies to all bodies in the central government sector of the national accounts; that is departments, their agencies, NDPBs and other bodies that the ONS lists as being in central government sector. The ONS publish a full list of bodies here < MA23 >.

## General issues about the treatment of receipts in the National Accounts

The National Accounts are prepared according to international guidelines (the European System of Accounts 1995, The System of National Accounts 1993, and supporting manuals), which enable comparisons to be made between countries that use the system.

In National Accounts receipts can be treated in one of two ways; either as

- **Financial transactions** – such as issuing debt, lending or purchasing of shares, which in themselves do not impact on levels of public spending, the current balance or net borrowing, but may impact net debt, or
- **Non-financial transactions**, which may or may not impact on levels of spending but affect measures of Public Sector Net Borrowing and potentially the current balance.

This paper is concerned with current receipts; i.e. a subset of **non-financial transactions** as described above. Current income received by the public sector is treated in one of two broad ways in the national accounts, either

- **Revenue receipts**, which do not impact on measures of spending, rather they finance that spending. Examples are taxes and economic rents, or
- As **negative public expenditure receipts** (negative pe), that is the income reduces measures of overall public spending.

The correct treatment of transactions is a key consideration in the national accounts to ensure that outputs such as GDP and the tax ratio are accurately measured, and in defining and measuring the key public sector balances and aggregates, and so measuring performance against the fiscal rules.

## Revenue receipts

Revenue receipts include the following categories.

### ***Taxes***

International guidance says taxes are:

Payments to Government that are compulsory and unrequited

When applying this guidance, you may find it helpful to think of it in these terms:

A tax would normally be recorded where government receipts arise because of government's power to make laws requiring payments in

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respect of economic or other activities, and which are of a type that cannot be demanded by other sectors of the economy, or where the charge is out of all proportion with the service being provided.

So, for example, payments for services at market prices, and payments of rent on land, interest and dividends, and occupational pension contributions can all be made to other sectors of the economy and so are not taxes.

But levies demanded by industry regulators, the Camelot contribution to the National Lottery Distribution Fund; various licences, and levies demanded by some agricultural bodies, arise only because of laws made by government requiring the payments, and so are not typical commercial transactions, and are usually taxes, (but see section below on licences and levies).

### ***Enforcement/Fines.***

Receipts associated with enforcement activities – e.g. a payment for de-clamping a car - are in the nature of a fine, and hence treated as revenue. Income and expenditure associated with tax collection are not in general to be considered as a service to the individual.

### ***Economic Rents.***

Economic rents arise where Government has ownership rights over land and other natural resources, and receives income in return for providing access to that asset. Rents receivable for land score as revenue receipts, as they are considered as rents for natural assets, as are receipts from charges levied on use of the electro-magnetic spectrum and licences to exploit certain sub-soil assets.

Where the Government obtains an economic rent that is a revenue receipt, but the government's costs in making it available in usable form may be recovered in a fee. So, for example, suppose the government auctions off or otherwise sells access to the radio spectrum:

- that part of the fee, where it is actually calculated distinctly, that covers the costs of keeping the spectrum clean, managing the sale process etc is a negative public expenditure receipt; but
- the balance of the fee – i.e. the surplus that comes from using administrative pricing means or auctions to ration demand or allocate access - is a revenue receipt.

In practice a department should only aim to split the fee payable for services provided from the economic rent where it is sensible to so.

### ***Licences (Revenue)***

Licences that do not offer a significant benefit to the applicant are classified as taxes in national accounts and add to revenue receipts. So for example a licence or registration issued automatically without tests of quality and where the purpose is to assist an agency in its data collection or enforcement work would be considered a tax. So would “licences” that are used primarily to raise money for collective goods and services - see also section on levies below.

Some payments for Government activities are made under the terms of licences, such as the regulation of privatised utilities. This regulation is a service to the community (or cohort of consumer), as a whole rather than to the utilities themselves. So the income from such licences is a tax also.

Some licences do offer a high degree of service to the applicant and in certain cases may be classified as negative public expenditure receipts. See separate section.

### ***Levies***

Where there is a compulsory levy imposed by a public sector body, and the payment of the levy does not bring a clear and direct benefit to the individual payer, the levy scores as tax in the National Accounts (and any expenditure funded by the levy scores as public expenditure). An example might be a compulsory levy on all the firms in an industry, payable in relation to their turnover, collected by a public sector research council which determines and funds a programme of research work relevant to the industry, or a compulsory levy based on staff numbers which was passed to a government body which gave grants to fund training for people working in the industry. That the levy payer is a member of a group which benefits collectively or where many members of the group benefit does not provide a clear and direct link: the levy payer would have to benefit personally for it to be a negative public expenditure receipt in the national accounts.

If the levying body is not in the public sector, or is a public corporation or trading fund, then it may be necessary to impute flows to general government: a flow of tax income, and a flow of public expenditure. This is because in national accounts only government can levy taxes and a tax is a tax, even if a private sector body collects it.

The same might apply if the levy was not explicitly identified as such. For example: suppose a regulated utility was to be required by a government body to start to subsidise one identified group of customers, implicitly charging the rest more. This transaction has characteristics of a levy. So tax and public expenditure might have to be imputed.

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Charges made by certain private sector self-regulatory bodies, such as The Law Society, are payments for services made by one private sector organisation to another.

The administration of a levy is not a service to the levy-payer.

### **Negative public expenditure receipts – general issues.**

This section of the paper looks at receipts classified as negative public expenditure receipts. That is receipts are netted off, and hence reduce levels of total public spending.

For the national accounts to treat an income stream as negative public expenditure then the following conditions must be met:

- there must be a **clear and direct** link between the payment of the charge and the acquisition by the payer of specific goods and services; and
- the **size of the charge** should recover no more than the cost of providing the goods and services.

Only by meeting both these conditions can a transaction be judged to be a receipt that reduces levels of public spending.

These conditions are discussed in greater detail below:

#### ***Clear and Direct Link.***

- The individual paying the charge must receive separately identifiable **goods or services** (e.g. car parking facilities in return for a car park fee).
- The benefits must be individual to the person paying - it is not enough if the benefits accrue to a wide category of persons, or general cohort, of which the person paying is a member.
- The transaction should normally be voluntary.
- And if the reason why the activity exists is to provide benefits to the public as a whole, then the function is in most cases regulatory, (in which case see separate section) or a levy (again, see separate section).

Note that goods and services supplied for payment should be of a sort that are, or could, be provided by the private sector in the market, e.g. car parking facilities; professional inspections (including the testing of an ability or level of performance or the assessment of standards); or prescriptions.

They could also include activities where the State has an actual or effective legal monopoly over, at least some aspects, of the service so long as they provide a service to the individual rather than the public in general or a general fee paying cohort. For example, courts have powers that private arbitrators do not have, but civil court fees are nonetheless payments for services.

### ***The Charge meets Costs.***

To score as negative public expenditure, the charge should not exceed the identifiable costs of providing the goods and services delivered to the individual. Where there is a clear intention to set charges so as to produce receipts in excess of the identifiable costs, or where a charge consistently turns out to produce income well in excess of the identifiable costs, then the government would be deemed to be using its unique position in the economy to levy a tax.

This caveat need not apply to sales in a competitive market (see below).

### **What costs can be included in the calculation of costs if the receipt is to be classified as negative public expenditure?**

In general the costs that are to be used in calculating the charge for services are those detailed under the Treasury's *Fees and Charges Guide*.

These costs include pay, stationery, procurement of goods and services, payments to contractors, utilities, and rent, which are incurred in the direct provision of the service. They include notional costs, such as imputed insurance premia where applicable, depreciation and a cost of capital set at the appropriate rate – either at the standard rate of 3½%, or the risk adjusted market rate where applicable. These costs also include a share of overheads, and the costs of a parent government department only insofar as the parent department provides services to the selling body. Senior management or corporate policy time on the delivery, or management, of the good or service is an allowable cost, but note that the costs of policy work in general are excluded.

Allowable costs do not include capital expenditure as it is made: rather the cost of consuming capital in the production of the good or service should be recovered through the price (through depreciation and the charge for cost of capital). Allowable costs do not include a provision for creating a return beyond the normal return to capital found in a comparable business, assumed to be 3.5% for most statutory services.

### **Prices set in a Competitive Market.**

Where:

- the receipt is from the provision of a good or service that could be classified as negative public expenditure; and
- the price is set by the market; and
- the good or service is being provided in full, fair and direct competition with private sector providers; then

The fact that the value of the receipt is potentially in excess of the costs of production as described above is not material to the treatment as negative public expenditure.

## **Specific cases and issues**

### ***Rent of Land and Rental of Buildings.***

Rentals received for buildings is treated as a charge for a service, and scores as negative public expenditure in TME. Building management charges also score as charges for services.

In contrast receipts of rent for land score as revenue receipts, as they are considered as rents for natural assets.

Where a single payment covers both rentals of buildings and rent of land, departments should aim to separate the two payment streams. Where this separation cannot be done objectively or would involve disproportionate cost, the whole of the income should be classified according to what is likely to be the greater part of it.

## ***Auctions***

Selling goods at auctions does not inherently change the classification compared with selling through other processes. So, in general a negative public expenditure receipt would remain negative public expenditure, and a revenue receipt would continue to score as revenue. However, please note two points:

- if the purpose of the auction is to obtain an economic rent for government by exploiting scarcity value in a non-competitive market – e.g. auctioning space on the radio spectrum, North Sea Oil licences, cherished registration marks - then the charge would remain a revenue receipt; and
- conduct of an open market auction is a service to participants for which a negative expenditure charge may be made. So the part of an auction receipt that covers auction costs may be negative public expenditure so long as it can be identified robustly, even if the rest of the receipt is a revenue receipt.

## ***Advertising/ Sponsorship***

Provision of space for advertising/ sponsorship is a service and the receipt is to be considered negative public expenditure.

## ***Sales of Surplus Capital Goods and sale of Seized Goods.***

National accounts score capital accumulation net of sales. The sale proceeds, measured at the open market value, from the disposal of capital assets reduce recorded levels of capital expenditure. (Note that the budgeting framework by contrast splits sale proceeds into net book value and any profit or loss on disposal – please refer to the budgeting guidance for further details).

However, sales of goods seized through the courts as punishment score as revenue, since they are treated as fine income. However, where assets are disposed of the costs of that sale process are treated as negative, current, public expenditure since they form a service to the buyer.

## ***Insurance, Lotteries.***

Where the government activity for which a charge is made is the provision of insurance or the operation of lotteries or other gambling, special rules apply; HM Treasury should be consulted.

## ***Regulatory Licences***

A licence is legal evidence of a permission to do something that is otherwise forbidden. Registration may be required before a person or enterprise may

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carry out a function, and in this paper references to licences include references to registration. The primary beneficiary of a licensing system is the public at large: for example, a requirement for driving licences protects pedestrians and other road users against unsafe drivers, or a broad cohort of fee payers: such as all businesses who pay a registration fee. In this paper licence also covers a document such as a passport that is only meaningful when it is issued by the State.

**Public Expenditure Treatment.** In the section on revenue receipts the paper discusses that the majority of licences and levies are considered as revenue (tax) receipts. However, where the licence provides a high degree of service to the individual recipient, as opposed to society as a whole, or a general fee paying cohort, and provided that the fee covers only allowable costs, and raises no more than those costs (issuing the licence/ making the registration), it may be treated as negative public expenditure – see below.

### ESA Rules on licences

Under the current European System of Accounts rules (ESA95) all licences are primarily for the benefit of the public as a whole, but:

- in some cases, there is also a significant element of service to the individual fee-payer. Subject to conditions, these may be treated as negative public expenditure; and
- the remaining licences, where there is not a substantial element of service to the fee-payer, are to be treated as revenue.

ESA95 further sets out how certain specified licences are to be treated, having regard to the way they are organised in the majority of EU Member States. However, this does not mean that ONS will treat ostensibly similar licences in the same manner: it may be that there are differences in the way a licence is constructed in the UK, meaning that a different classification to the equivalent licence in other EU member states is warranted.

### Licences with Significant Element of Service to Applicant

The issuance of a licence is a service primarily to the community as a whole. However, in some cases, there may be a significant element of service to the individual applicant, for example:

- the essence of the decision whether to issue a licence or not may be the result of a test of the competence or quality or suitability of the applicant or her/his premises, staff, equipment or products. In such cases, the licence may also be seen as a service to the applicant in that it provides an objective statement of fitness which once obtained allows the holder to operate in the market place, or

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- the licence may be materially useful in the licence-holder's dealings with others, e.g. a passport helps British travellers deal with foreign governments.

In such cases the income might be treated as a negative public expenditure receipt in the National Accounts if it meets the criteria discussed above and further explored below.

### **Setting prices - What costs can be included in the calculation of costs, if the receipt is to be classified as negative public expenditure?**

Activities that may be treated as allowable costs for service type licences include:

- the cost of pre-issue checks of competence, quality, fitness of the applicant or the applicant's premises, factory, vehicles etc;
- the cost of subsequent checks on the accuracy of information provided at the time of issuing the licence;
- the cost of pre-issue checks other than on the applicant. For example, suppose the regulatory body will allow a river to receive a certain amount of pollution: before issuing a licence the body checks whether the river can take more pollution or not;
- the regulatory body's own costs in legal proceedings are covered, including orders for legal costs against it (but not orders for damages);
- post-issue individual monitoring is a service, where this is or could be structured as a marketed service. For example, a licence might permit a licence holder to deposit a ton of pollutants each month. The licence might require monthly audit reports from an independent person to the regulator. Such reports would be objective and could be provided in a market place. (Enforcement or continuing regulation requiring an exercise of discretion and judgment would be outside the boundary); (but see below for the difference between enforcement and monitoring)
- licence fee administration (paperwork) and post-issue administration. It is reasonable for the initial fee to cover the costs of e.g. noting a subsequent change of address, or recording the cancellation of a licence because a court has annulled it;
- management, share of overheads, senior management and corporate policy work on the executive delivery of the licence/service (but not policy in general, even if on a related area).

**Costs outside the Boundary.** Certain costs are outside the boundary of what can be recovered if the fee is still to be considered a charge for a service to the individual:

- policy work (other than policy on the executive delivery of a licence or service);
- recovery of externalities imposed on society by the licence-payer (e.g. pollution reduction charges);

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- public good work, i.e. where there is not a clear and direct link between payment of a fee and receipt of a service - eg using part of the licence fee to finance research even if it is of general interest to many of the people paying the charge, or continuing economic and consumer protection regulation of an industry (see Annex D on levies);
- enforcement. Enforcing licence conditions is similar to enforcing a requirement for non-licence holders to obtain licences. It is thus a form of general policing and hence a government activity.

### **Enforcement vs Individual Monitoring.**

This is a difficult area. Guidance on making the distinction are set out below:

- **Enforcement** is about proactively using State powers of compulsion to do something. An implication is that the potential criminal would know (or not care) that s/he was doing something wrong, and is having actual or potential enforcement done to them.
- **Individual Monitoring** is about measuring. It suggests a process by which an innocent licence-holder makes sure that they stay on the right side of the law. Monitoring is or could credibly be initiated by the licence-holder. Any resultant provision of information to the regulator is incidental and the regulator is a passive recipient.

Some examples:

- a car speedometer is part of monitoring; a radar speed trap is part of enforcement.
- a requirement to provide a monthly certificate from an independent person that the speedometer is accurate is monitoring, as it is a by-product of the motorist satisfying themselves that the speedometer works. Even if the Regulator is (for some good reason) such a recognised independent person, the Regulator's work is a service to the licence-holder. Chasing people who fail to provide a monthly certificate is enforcement. A spot check by the regulator to test speedometer accuracy is enforcement.
- if the firm copies a speedometer printout to the Regulator and the regulator reviews it looking for breaches, this is enforcement; if the Regulator acts on speed limit breaches revealed by the printout that too is enforcement.

Further:

- Ensuring that unlicensed people who need licences/ registration have them is enforcement (other than providing general guidance on the need for a licence and how to apply).
- Enforcement processes are instigated by the enforcers, perhaps in response to complaints, perhaps on a sample or perhaps on all licence-holders.

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- Where the Regulator does the monitoring/ enforcement (eg a routine check of equipment 3 months after a licence has been issued), to be monitoring it should be credible that the person being monitored is also interested in the information and uses it to stay the right side of a licence condition. So monitoring information made available to the regulator is (or could be organised so as to be) a by-product of the processes of the person being monitored acting in good faith to comply with the terms of the licence.
- Where the “monitoring” done by the regulator duplicates monitoring done by or for the licence-holder, that suggests that the regulator is enforcing.
- Where monitoring shows up a breach, the proceedings that follow would be enforcement.
- Random checks to see whether operatives hold a licence are enforcement.

**Calculation of Allowable Costs.** Allowable costs are to be calculated as in the section on sales of services. Since the service is in the testing, the fee should be payable for the consideration of an application, not for the granting of a licence (i.e. unsuccessful applicants should pay).

### ***Mixed Revenue and Negative Public Expenditure receipts***

Generally an income stream is not split into a tax element and a negative PE element, although in certain situations this may be appropriate if for example a service is delivered to an individual and in addition a tax is levied on the consumption of that product or service.

### ***Timing of transactions***

Generally income from sales of services accrues when the service is delivered, and income from taxes accrues when the liability is created. Care should be taken to ensure that income that can be said to accrue in departmental resource accounts can actually be accrued in the national accounts at the same time. Departments should check with their spending team contact in situations involving licences or taxes.

### ***Comparison with the Fees and Charges Guide.***

In general, for a service-type licence where all or part of the receipt may be treated as negative public expenditure, the elements of allowable costs that may be treated as negative public expenditure are the costs that form the “service” under the *Fees and Charges Guide*, except that:

- the costs of enforcement may be part of the service for *Fees and Charges Guide* purposes – provided that there are explicit statutory powers to include such costs in fees - but would point to the income stream being classified as a tax.
- It may be that some general public good work (such as general scientific research) can be charged for through the licence fee as part of the service under the *Fees and Charges Guide* purposes. Again for national accounts purposes this would point to a tax.
- It may be that some cross subsidisation may be allowed under the *Fees and Charges Guide*, subject to consideration of appropriateness and correct legal powers. Again for national accounts purposes this would point to the income being classified as a tax.
- in some cases, there may be other features in services or charges that lead to a difference between what is treated as a service for *Fees and Charges Guide* purposes and what is classified as negative public expenditure under this CLASS paper.

General policy work (other than policy on the executive delivery of a licence or service) is both outside the definition of recoverable costs in respect of a statutory service under the *Fees and Charges Guide* and outside the boundary for negative public expenditure treatment of receipts. In addition, voluntary transactions (such as sales of goods or services (including monitoring where appropriate)) which are not provided under a statutory duty should be unbundled from the fee and charged for as a separate non-statutory service (e.g. a commercial service), if they are to attract negative public expenditure treatment and satisfy *Fees and Charges Guide* requirements.