H M Treasury

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CLASSIFICATION OF EXPENDITURE

PUBLIC AND PRIVATE SECTORS:

NEW BODIES, PARTNERSHIP, JOINT VENTURES,

PRIVATISATION & NATIONALISATION

CONTENTS

Introduction

This note provides guidance on whether a body should be classified to the public or private sectors. The note does so in the context of:

- the establishment of a new body, especially when government, a non-departmental public body (NDPB) or a public corporation is involved in setting it up;
- privatisation;
- nationalisation; and
- joint ventures, partnerships and stakeholder relationships between one or more public sector bodies and private sector bodies where the new body being formed is a separate institutional unit in its own right.

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Who Decides

Decisions on which sector an actual or proposed body should be in are made by the independent Office for National Statistics (ONS). The ONS may be approached via HM Treasury. More straightforward cases may be settled by HM Treasury (GES after consultation with WGA team).

Decisions are made in accordance with international guidelines set out for European Community member states in the European System of Accounts (ESA95), published by EUROSTAT. ESA95 is legally binding for certain purposes, including some returns to the EC.

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Status of this document

This document may be made publicly available on request. It has been agreed with the ONS. It does not represent any fundamental change in where the boundary between the public and private sectors is drawn. It supercedes the previous version of this note - CLASS(97)5.

'Public Sector' in other contexts. This note describes the use of public sector in ONS's National Accounts, Whole of Government Accounts (WGA) and for public expenditure control. The phrase may have different meanings in other contexts, such as tax legislation. This paper does not define the boundary for resource accounts produced by central government departments: for example such accounts exclude non-departmental public bodies that are classified to central government and report to the department's minister.

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Further Guidance

There is a range of other guidance notes on public expenditure issues. All are available from HM Treasury Public Inquiry Unit, Tel 020 7270 4558, Fax: 020 7270 5244

Departments should contact in the first instance their normal Treasury expenditure division contact. These should address further questions on classification to the Classification Branch (020 7270 5337) in the General Expenditure Statistics (GES) team.

The Office for National Statistics publishes lists of bodies classified to each sector in *Sector Classification for the National Accounts.*

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Delineation of the public sector

Within the public sector there are a number of different sub-sectors to which a body could be attributed. In the UK the following categories are used:

- Central Government: includes Government Departments and their Agencies; the devolved administrations in Scotland, Wales and Northern Ireland; Non-Departmental Public Bodies, and any other non-market bodies controlled and mainly financed by them;

- Local Government: those types of public administration that only cover a locality and any bodies controlled and mainly financed by them;

- Public Corporations: market bodies controlled by either Central Government or Local Government. This includes government-owned companies, trading funds, and NHS trusts.

Central Government plus Local Government is called General Government.

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Market bodies

Public corporations are defined as government-controlled market bodies.

A market body is one which produces goods and services for sale and at least 50% of its income is derived from sales. The 50% criterion should be applied by looking over a range of years to avoid frequent reclassifications through minor fluctuations in one year, which are not repeated or expected to be repeated in the future.

Sales are defined as payments for goods and services at economically significant prices. Such prices are economically significant in the sense that they influence the amounts demanded and supplied. A difficult issue is determining whether payments made by a government unit to another public unit in respect of work done should be classified as sales or as grants. In general the payments would be classified as sales if they are related to specific volumes or values of output under arms-length contracts and are not paid if that output is not delivered. Payments made by government bodies for general running costs or to cover an overall deficit are treated as grants. Bodies funded mainly by grants are non-market bodies and so will be either part of general government or a private not-for-profit institution.

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Institutional Units

To be classified in its own right, a body must be a separate institutional unit. It needs to have its own legal form and be able to lead a separate existence. So, for example, it needs to be able to:

- make decisions in an autonomous way;
- enter into contracts;
- own assets and dispose of them;
- employ staff;
- make payments from its own bank account; and
- draw up accounts.

If it is not a separate institutional unit then it is classified as an integral part of the parent body to which it belongs. Generally an institutional unit is classified to one sector. If an institutional unit performs activities typical of more than one sector then it is first necessary to ask whether the unit can be split into two or more separate institutional units. For example, this might be true for a Government agency that is split into two divisions: one performing policy advice and regulatory work; and the other selling services. If separate accounts are kept for the two divisions then it might be reasonable to view the agency as being two separate institutional units.

Quasi corporations are constructions in national accounts to handle government bodies that have significant sales of goods and/or services but are not separate institutional units. They are constructed when the income and expenditure of the market activity can be measured separately from the rest of the body. This activity is treated as a quasi corporation and classified to the public corporations sector. This treatment need not concern departments since it is a device used in national accounts to put all significant market activity in the corporations sector; there are no actual consequences for how departments operate. Also there are only minor consequences for fiscal aggregates and balances since these are recorded at the public sector level, rather than at the general government level.

Legal Form. Of itself, the legal form of a body is not a guide to its sector classification. Public sector bodies may take many forms, including: charities, trusts, companies limited by guarantee, and profit distributing limited companies.

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Key Questions for Sector Attribution

A unit is classified to the government sector if it is mainly financed by compulsory payments from other units enforced through law, and is mainly engaged in providing goods and services for the benefit of the whole population and in redistributing income and wealth. Some non-profit institutions might have some of the characteristics of government units but be mainly financed through government grants rather than directly through taxes or funds directly voted to the organisation. In these cases the unit is classified to Government if it is controlled and mainly financed by government.

Public corporations are units that are financed by sales of goods and services and which are controlled by a government unit or another public corporation.

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Control: general issues

If the body is controlled by general government (that is: central or local government, including NDPBs) or a public corporation, then it will be in the public sector. If not, then it will be in the private sector. References in this guidance note to control by government or Ministers include references to control by NDPBs and public corporations.

So the key question that needs to be addressed to determine whether a body is in the public sector or the private sector is "who controls the body?". In determining who controls a body, it is worth considering the overall reasonableness of the decision, for example by considering whether viewed in the round, it is credible that the body should be seen as being in the private sector or public sector.

ESA 95 defines control as the ability to determine general corporate policy by choosing appropriate directors if necessary. It goes on to say that control exists through ownership of more than half the voting shares or, in the case of government, through special legislation or regulation empowering the government to determine corporate policy.

UK accounting standards also rely on control to determine whether a body should be considered as part of a group and include a set of tests designed to determine whether control exists. These tests are broadly consistent with the ESA95 principles stated above, but provide additional guidance on how the principles can be interpreted, and have been adapted for defining the public sector. The following tests are taken into consideration in deciding whether the public sector controls a body:

- for corporate entities, the tests as set out in Financial Reporting Standard 2.

- the Crown is a quasi-member of the entity and the Crown, the Monarch or Ministers (on behalf of the Government) have the right to appoint or remove directors holding a majority of the voting rights at meetings of the board on all, or substantially all matters.

A quasi-member is defined as follows:

- Parliament or the Crown has established the entity under Act of Parliament or Royal Charter; or

- Parliament, via HM Treasury, has a right as a result of legislation to receive dividends or quasi-dividends; or

- Parliament would be responsible for any overall liability (deficit on accumulated reserves) arising from the operations of the entity.

Directors refer to the members of the governing body of the entity.

The Board refers to the governing body of the entity.

- the Crown has the right to exercise dominant influence over the undertaking:

by virtue of provisions contained in the undertaking's memorandum or articles, an Act of Parliament or through the activities of the body being substantially restricted by specific legislation;

by virtue of a control contract.

"dominant influence" refers to influence that can be exercised to achieve the operating and financial policies desired by the holder of the influence, notwithstanding the rights or influence of any other party.

"memorandum or articles" refers to the governing instrument.

- the Crown is a quasi-member of the entity and Ministers control a majority of the voting rights in the undertaking.

- the Crown has a participating interest in the undertaking and:

it actually exercises dominant influence over the undertaking; or it and the undertaking are managed on a unified basis.

A "participating interest" is an interest:

conferring any right to share in the profits or the liability to contribute to the losses of the undertaking; or

giving rise to an obligation to contribute to the debts or expenses of the undertaking in the event of a winding up.

Abstaining from Control. Where a department has a continuing right to exercise overall control but chooses not to do so, that still amounts to control.

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Direct Control

Direct control may be evidenced by the ability to appoint the directors, or a majority of directors, or the key directors who determine the policy of the organisation. A right to be consulted over appointments, or to have a veto over appointments, does not necessarily give direct control but is relevant when considering classification in the round.

Inevitably, appointments made to a public sector body before privatisation were made by the public sector and this is no barrier to privatisation, assuming that the length and other terms of appointment are normal. Where a new body is being formed that is intended to be in the private sector, any government involvement in appointments should be kept to a minimum. Where government does have to make some of the initial appointments so that there is a nucleus of a board for a new body, subsequent appointments before the body goes live should normally be left to the initial appointees or to 3rd parties.

Multiple Sponsorship. Where a body is owned or controlled by a number of public sector bodies it is the overall weight of the public sector that counts. So: if five public sector bodies have a right each to appoint one director, and there are seven directors, the body will be in the public sector.

Special Shares / Reserve Powers. The existence of very narrowly defined powers, directed primarily at preventing undesirable changes of ownership, or the disposal of material assets, or to permit the appointment of a limited number of directors in companies with national defence or other strategic importance, need not amount to control. In addition, time limited (typically up to five years) special shares have been used to prevent take-overs in order to give a newly privatised business a period of stability in which to settle in. This is not considered control. Similarly, in cases where shareholder equity does not exist, government may have reserve powers that do not impact on general corporate policy. This is also not considered control. The actual use of special shares or reserve powers results in public sector classification at the time such powers are utilised. The example case for PrNFCs is the National Grid.

Special Terms in the Body's Constitution. A body's memorandum and articles may have terms that require government consent for certain actions, or before the memorandum and articles may be changed. Where such restrictions are time limited - say up to five years - and are intended to give an initial period of stability to a new body, then they need not amount to control. Permanent restrictions over important parts of the body=s work would normally amount to control. It is necessary to consider whether such controls are active or passive in the sense of setting out the purpose and operational guidelines for the body when it is set up (passive control); or defining circumstances in which Government could intervene and make decisions affecting how the organisation is run (active control). Active control would amount to actual control; whereas passive control need not do so.

Special Regulation. For as long as regulation is over external actions - such as price regulation, and regulation of markets - it is unlikely to amount to direct control. Where regulation to extend to internal management – for example pay levels or borrowing - then it could be seen as taking control.

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Ownership

Ownership is an important criterion partly in its own right and partly because ownership can give control.

Where the public sector owns more than 50% of the shares it will have control.

Ownership can also be defined in the public sector, for entities that are not companies, by reference to the existence of a participating interest. As noted earlier, this is defined as an interest:

- conferring any right to share in the profits or the liability to contribute to the losses of the undertaking; or
- giving rise to an obligation to contribute to the debts or expenses of the undertaking in the event of a winding up.

However, situations may arise where a body will not be controlled, even though government has a participating interest, because government does not have the ability to appoint the majority of the directors or actually exercise dominant influence. In order to demonstrate that government is actually exercising dominant influence over a body, the extent of the influence from government will need to be stronger than is typically seen in an arms-length relationship.

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Indirect Control

The government could exercise indirect control over a body. This is less of an issue in the case of a profit-distributing company as - in the absence of special legislation - it normally serves its share-holders. But it can be harder to see who controls a body that does not distribute profits to shareholders (not for profit institutions (NPIs)) such as charities, trusts and companies limited by guarantee.

In this case, the other tests referred to would need to be considered, such as whether legislation gives the Secretary of State the right to exercise dominant influence over the body.

Indemnities. Of themselves, government indemnities do not necessarily mean that a body is public sector - especially if they are time-limited, narrow and unlikely to be called. However, wide-ranging indemnities will suggest that the government sees the function as a State function. In the case of an NPI, wide ranging indemnities suggest that the department would see the NPI as closely linked to government. In the case of a business, government guarantees of its borrowing would be viewed as akin to government equity if the government guarantees would be called before the equity of the private investors.

In addition, propriety may require the Secretary of State to exercise a measure of control in order to protect the department's vote against the risk that the indemnity is called; that control may be enough to put the body in the public sector.

Pensions. Normally there should be a clean break on pensions at the time of privatisation or transfer.

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Privatisation

The essence of privatisation is that the government lets go. It is a policy question whether government is able and willing to let go of all or part or none of a body. In some privatisations, a government business could be sold and simply left to operate as one enterprise in a competitive market. In others it will often be necessary to consider whether to restructure an existing public sector body so that any part over which government plans to retain control remains in the public sector while the rest is privatised.

Where the government does let go of a body, the government no longer has managerial control over the body or its use of resources. Instead, the government leaves decisions to be taken by the body, with the privatised body and its private sector backers taking responsibility for the consequences of running their own risks. Letting go means that the Government's relations with the privatised body should be the same as with any other private sector body. Government may be a purchaser from the privatised body; it may enter into freely negotiated contracts under which it pays for certain desired outputs for the public benefit; and it may regulate the industry.

Date of Privatisation. For floatations, privatisation takes effect on the day that dealings in shares open on the Stock Exchange. For trade sales it is when contracts are completed.

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Nationalisation

To some extent, nationalisation involves the reverse of the guidance on privatisation.

Nationalisation could be clear and direct, for example by the purchase of a majority shareholding with the intention of obtaining control. But it is possible that nationalisation could be found to have taken place as the result of a series of steps which do not individually give overall control but whose cumulative effect is to move a body into the public sector, for example:

- acquisition of a minority shareholding;
- a change in legislation which amounts to State control.
- an accumulation of other controls as mentioned above.

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Joint Ventures, Partnerships

A joint venture is when two or more partners form a formal consortium to progress some activity. One model would be when the partners set up a company and take shares in it.

Where a joint venture is controlled by the public sector, the whole of it will be classified to the public sector, and all of its borrowing will score in public sector net debt, for example.

The criteria for control of a joint venture are the same as for control of a company.

Joint ventures often involve partnership agreements setting out the control rights of each partner. The rights given to a Government partner in a joint venture can appear to be significant in terms of the issues discussed in this paper. However such rights should not necessarily mean that the body has to be classified to the public sector provided that the rights are similar to those enjoyed by the private sector partner and exist solely to protect the Government's financial stake in the joint venture. Government rights giving control over the joint venture in order to further Government policies (such as locating an operation in a particular part of the country) or to avoid political problems (such as big pay increases for directors) could be enough to tip the balance in favour of classification to the public sector.

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Subsidiaries of Public Bodies

Where Nationalised Industries, other public corporations (including NHS Trusts), trading funds and NDPBs set up bodies, these will only be in the private sector if they meet the criteria discussed above. References to control by government in this note should include references to control by other public bodies.

UK subsidiaries of public bodies should be consolidated with the parent body for public sector accounts. Special factors apply to overseas subsidiaries, and HM Treasury should be consulted.

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Example cases

This gives some example of bodies in the public and private sectors

Central Government

Most government departments, executive agencies, and non-departmental public bodies (NDPBs) that are not trading funds or other trading body classified as public corporation; central funds such as the Consolidated Fund, National Loans Fund, National Insurance Fund, and Exchange Equalisation Account (foreign exchange reserves); Devolved administrations of Scotland Wales and Northern Ireland; Office for National Statistics; Health authorities; Intervention Board; Forestry Commission;

Local Government

Local authorities; police and fire authorities; transport authorities; GLA; all state schools except City Technology Colleges;

Public corporations

Post Office; Transport for London; British Nuclear Fuels; National Health Service Trust hospitals; Trading Funds; Royal Mint; Companies House; Land Registry; Manchester Airport; Forest Enterprise; Tote; Patent Office

Financial corporations

Bank of England (Issue Department and Banking Department); note that the Bank of England is outside the public sector for statistical purposes

Other banks; insurance companies and pension funds

Private Non-financial corporations

Railtrack; The Stationery Office, Chessington Computer Centre;

Private sector not-for-profit bodies

Universities, Further Education Colleges, most charities; National Trust

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