

SNA REVIEW: GFS LIST OF ISSUES

December 18, 2003

Task Force on Harmonization on Public Sector Accounting

1. During its October 3, 2003 meeting, the Steering Group of the Task Force on Harmonization of Public Sector Accounts (TFHPSA) assigned Working Group II the task of advising it in the context of the SNA review and agreed to:

- I. Address a first list of five priority issues:
 - (1) Super-dividends, capital injections, and reinvested earnings;
 - (2) Privatizations and restructuring agencies, and securitization;
 - (3) Contingent assets (state guarantees), constructive obligations, and provisions;
 - (4) Public-private sectors delineation; and
 - (5) Tax revenue, uncollectible taxes, tax credits.
- II. Keep abreast of on-going work in other fora on issues with GFS-related topics (military expenditure; leasing, concessions and similar arrangements (Public Private Partnerships); natural resources exploitation; pensions etc.); and
- III. Tackle new issues as needed, in particular when raised by a TFHPSA participant.

2. The above issues illustrate the usefulness of adding in the SNA a specific chapter on the general government and the **public sector**. Such an addition will culminate the efforts already achieved through the *GFSM 2001* to keep fiscal statistics in harmony with developments in the System of National Accounts. The *GFSM 2001* has already attracted interest from economists, as well as from accountants (see GFS-IPSAS convergence project of Working Group I of the TFHPSA). Eurostat has produced a large and growing volume of jurisprudence on *ESA 1995* fiscal data.

3. The public sector chapter of the SNA will: (1) present the enhanced *GFSM 2001* framework: revenue, expense, net operating balance, net transactions in nonfinancial assets, financing, revaluations, other changes in volume, stocks of assets and liabilities; (2) show the links with SNA categories; (3) spell out analytically useful subcategories and groupings; and (4) expand on some GFS specific issues (e.g. sector classification, categorization, consolidation). This would ultimately imply issuing a new *GFSM* manual adapting to the minor expected revisions. The TFHPSA will be able to supply the ISWGNA AEG with background material and drafts as required.

I. PRIORITY LIST OF ISSUES

Item 1: Super-dividends, capital injections, and reinvested earnings¹

4. These issues relate to **the relationship between public corporations and governments**, and more generally between corporations (and quasi-corporations) and their controlling shareholders whether or not they are government [**i.e. the income—revaluation boundary**]. Public corporations frequently pay lump sums to government, exceeding their operating profits for the year in question (superdividends). In contrast, they can receive capital injections in cash or in kind (including via debt assumption/cancellation) with no expectation of future profits. What should be the criteria for classifying these transactions as financial or non-financial? The *ESA95 manual on government deficit and debt* as well as the *Government Finance Statistics Manual 2001 (GFSM 2001)* provide some useful guidelines. Some of the elements that need to be discussed are:

- Should not distributions of superdividends or lump sum payments be classified as financial transactions? Otherwise governments would be able to manipulate the timing of their revenues, irrespective of the time of the underlying event (the profit accrued);
- Should not capital injections (generally) be booked as non-financial transactions (even though they are always net worth neutral for the corporation in question and also for government)? Prudence suggests that these transactions should be expensed because they cover past or future losses of public corporations, which have failed to be (or will not be) accrued as expenses (subsidies) in the books of government;
- Another approach - more systematic - would be to accrue the profits and losses of all public corporations in the books of governments, hence extending to public corporations the “reinvested earnings” (D.43) treatment currently applicable in the *1993 SNA* to foreign direct investment (SNA 7.119-7.122). The changes in government net worth resulting from public corporations profits and losses that currently transit via the revaluation accounts would transit via the income accounts. This corresponds to the treatment used by accountants when applying the equity method of consolidation. The same would apply to quasi-corporations; and
- The recording of dividends as non financial transactions in the *1993 SNA/GFSM 2001* leads to anomalous revaluation entries at time of dividend distribution. It also risks underestimation of income in the national accounts when buybacks substitute for dividends.

¹ Although consideration is being given as to whether the current treatment of reinvested earnings on foreign direct investment should be retained.

Item 2: Privatizations and restructuring agencies, and securitization

5. The issues relate to **privatization agencies/ Restructuring agencies/ securitization [i.e. the government—financial intermediation boundary]**. The sectorization of following entities requires discussion:

- *ad hoc* structures specialized in managing portfolios of assets or debts;
- Privatization agencies established to manage portfolios of assets (financial or nonfinancial) to be disposed of;
- Restructuring agencies (sometimes called “bad banks”) that acquire non-performing loans or other impaired assets from banks (public or private) in distress at above the market price, allowing the latter to exhibit a satisfactory solvency ratio (Cooke ratio²); and
- Special purpose vehicles (SPV) created by governments, possibly registered abroad, which borrow on the market and acquire so called “assets” from governments, such as flows of future revenue (tax).

Are such entities financial intermediaries, are they government units, or are they simply ancillary units? Another issue is the recording of their transactions with government, such as the passing of privatization proceeds or of realized losses (see item 1 above).

Item 3: Contingent assets (state guarantees), constructive obligations, and provisions

6. The issues relate to **contingent assets, liability provisions and constructive obligations [economic asset boundary]**. The economic asset boundary may be relaxed slightly to accommodate contracts which have a market value or which could be transferable.

- Governments sometimes provide guarantees that are likely to be called and, accordingly have a substantial market value at the time of creation;
- Business accounting recognizes as liabilities, obligations that, whilst not legally enforceable, are nevertheless expected to result in outflows: constructive obligations and provisions (other than on assets). For example, pension obligations may well be *de facto* constructive obligations, but this alone should not necessarily prevent expensing them; and
- The *1993 SNA* does not recognize provisions (except consumption of fixed capital) because they are not interactions between units, but instead are seen as events internal to a unit. Provisions attached to economic assets of the balance sheet could be conceived as a valuation issue. But recognition of other provisions as liabilities would require finding counterpart holders of the assets—which may be more difficult.

Could not the notion of “past events” for defining liabilities in business accounting be also incorporated in the SNA?

² The Cooke ratio for banks is the equity position as a percentage of risk-weighted assets (Basel accords).

Item 4: Public-private sectors delineation

7. The issues relate to **public sector and general government sectorization boundaries**, especially the notion of control and market/non-market criteria.

- The control criterion is essential to business accounting, as it defines the boundary for consolidation. In *1993 SNA*, the notion of control, which defines the public sector boundary, is more elusively defined. Weak areas refer to special purpose vehicles (SPV), notably created in the context of Public Private Partnerships (PPP) or securitization. Another difficulty relates to how “control” is determined (including the link with the “financed” concept): for example, the sectorization of government-financed universities as units of government, non-profit institutions servicing households or market producers?;
- Another issue relates to the market versus non-market criteria. The notion of “economically significant price” is perceived by some as vague. Some tend to equate the government/public corporation to their legal status (is it an incorporated entity)? The *ESA 1995* has established a rigid rule of 50% of costs to be covered by sales. Is a rigid rule useful? Is 50% high enough? What should be included as costs (*ESA 1995* excludes interest)? What is the criterion for sale recognition: when is a payment by government a transfer or a purchase of service (the case of hospitals or schools)?
- Another issue is the link between the market/nonmarket boundary and the commercial/noncommercial boundary (quasi-fiscal operations); and
- The general government boundary defined by statisticians may be used by accountants.

Item 5: Tax revenue, uncollectible taxes, tax credits

8. The issues relate to **the recording of taxes** (tax credits, valuation of taxes, time of recording).

- **Tax credits.** OECD Government Revenue statistics and *GFSM 2001* are in agreement to treat a tax credit as expense (instead of being deducted from revenue) only for amounts that are actually paid by tax authorities to the tax payer. However, due to technological developments, some governments increasingly apply automatic deductions from tax payer’s bills (netting tax credits from the tax payer’s obligations), actions tantamount to benefits. The source data may not allow separate recording of expenses, reducing international comparability. What would be the criteria and mechanisms for expensing tax credits? Tax allowances are also close substitutes for tax credits;
- **Valuation of taxes.** Taxes not expected to be paid should not be allowed to improve the government’s operational results. An estimated uncollectible amount based on experience (e.g. using a “ratio” technique based on coefficients of collection observed *ex post*) should be deducted from the gross amount under the accrual principle (“net recording”). An alternative method allowed by Eurostat, with identical impact on the deficit, consists of recording that same amount (or the difference between accrued taxes and cashed taxes) as a capital transfer (“gross recording”). Accountants record provisions, as a matter of prudence, against tax revenues. The *1993 SNA* is imprecise as to the treatment of the uncollectible amount. The *ESA 1995* was amended, by way of legal act, to derecognize the uncollectible amount but

allowing the gross recording (capital transfer) option. *GFSM 2001* is more prescriptive than the *1993 SNA* and precludes the capital transfer option. One issue is whether this uncollectible amount should be deducted from revenue (*GFSM 2001* preference) or should the option to show an expense also be recommended, as in the amended ESA 1995. A second issue is whether all unpaid taxes should be treated just like uncollectible taxes or whether some unpaid taxes could transit via the other change in volume accounts. A third issue is the method of valuation, including the recording of a tax item actually paid but well after the period of income; and

- **Time of recording.** The accrual principle calls for recording taxes when the obligation to pay arises, which can be interpreted as when the economic event or activity takes place. The issue is not controversial for taxes on production. For taxes on income and wealth the issue is open to debate. Some argue that the time of the assessment is preferable for households as it would be this moment that affects their behavior. Regarding taxes on corporations, should one also envisage negative taxes: for quarterly data or for taking account of “carry forwards”? Another issue is the types of criteria and recommendations, for accruing a tax (paid once a year) over the period instead of booking it at one point in time.

II. OTHER ISSUES OF GFS INTEREST

9. There is substantial interest concerning property income recording on indexed instruments.³ **Property income on indexed instruments [income—revaluation boundary].** The current situation where changes in principal are recorded as interest (D.41) creates an asymmetrical treatment between foreign exchange indexed bonds and foreign currency bonds. In addition:

- The treatment of debt indexed to other volatile prices also seems to be a problem, with negative interest recording and a questionable revaluation—income boundary; and
- From a wider perspective, the fiscal accounts are sensitive to the currency in which governments borrow (domestic versus foreign currencies), while by arbitrage the real cost of those debts could be close or the same. This may warrant revisiting the current treatment of foreign currency bonds. It also relates to the more general question as to whether property income should capture real or nominal interest.

This issue is especially important for governments because of their policy focus on a headline transaction balance. In this context, the SNA provides an accounting disincentive for many governments to borrow in local currency.

10. While other questions are of interest for GFS, with potential impact in the SNA Review, some are not a priority in the short run. The TFHPSA will keep abreast of the other GFS related topics that the ISWGNA has already sponsored in separate fora. Groups that have been closed covered interest accrual (on fixed coupon instruments) and inflation accounting. Work continues on: military expenditure (capitalizing military equipment

³ Also of interest to balance of payments

purchases and expensing consumption of fixed capital); leasing, concessions and similar arrangements, such as Public Private-Partnerships, buy-operate-transfer (BOT) schemes, mobile phone licenses, etc.; mineral exploration expenditures and subsoil assets (sale of exploitation licenses); social protection (especially employer insurance (pension) schemes, as well as social security and social assistance); bad loans; and public debt definitions, valuation and recording.

11. Other related areas that may be clarified in a revised SNA could be: clarification of the definition of “government unit”, consolidation, revisions, the recording of equity liabilities (including “tracking shares” that are shares that pay dividends based on earnings on the operations of part of a corporation—GFS application: privatization vouchers) and mutual funds and defined contribution schemes. The priority of these topics could be considered by the TFHPSA as the work on the SNA review proceeds.