DRAFT AEG Issues Paper for TFHPSA Consideration: Governments Income Equity on its Investment in Public Corporations

I. Executive Summary

The *1993 SNA* does not make a sharp distinction among some flows between government and their public corporations. This leaves room for compilers to apply rules of thumb or arbitrary decisions that affect the classification and resulting key balances in the statistical system. Governments and their public corporations can take advantage of this lack of clarity to chose different recordings for the same type of transactions. Such reporting could have substantially different impacts on key headline indicators, leading to widely different views of the policy implications as presented in the statistics.

For instance, governments may receive lump sums from public corporations that exceed public corporations' operating profits for the year ("superdividends"), or in contrast, they may disburse capital injections in cash or in kind (including via debt assumption/cancellation) with no expectation of future profits by their corporations. Governments may seek to classify the lump sums received as revenues, and those paid out as financial transactions. Such recording implicitly relies on an asymmetric set of rules (receipts shown as revenues and payments as financial transactions) for flows that may have a similar impact on net worth.

This paper focuses on the government income from its equity investment in public corporations. It suggests to accrue the income/loss of all public corporations. This a change from existing guidelines where such accrual is used to record the income for certain public corporations while the income from other public corporations is recorded only when remitted. Extening the accrual recording to all public corporations would enhance consistency of treatment of equity income among sectors, and among public corporations in the SNA.

The paper reviews existing guidelines on flows between government and public corporations, with the emphasis on income from equity investment in the corporate sector (that comprises public corporations). It highlights the dual recording of income among public corporations, (accrued for certain, remitted for others). It then explores options to treat the government equity income from public corporations. It delineates some questions for discussion under these options. It recommends a preferred treatment and its implications for a revised SNA, noting that analogous changes would need to be made to GFM 2001 and ESA 95.

II. Background and Main reasons for Changes to the *1993 SNA*

Relative to government interactions with quasi-corporations and foreign direct investment, the *1993 SNA* devotes relatively little attention to the treatment of flows between government and its public corporations. The following reviews the existing guidelines on equity income, supplemented with references on subsidies and capital transfers, and on financial flows.

A. Government equity income from investment in public corporations

According to the existing guidelines of the *1993 SNA*, the income resulting from equity financial investment in the *corporate sector* is recorded as follows:

- All of the profit or income of **quasi-corporations** is accrued to the government and household sectors, with the reinvested portion recorded as financial equity investment of government and household sectors in the corporate sector.

  The portion remitted showing as ***withdrawals from income of quasi-corporations*** (D.422) under D 42 *Distributed income of corporations*. To identify D.422 separately (as indicated in *1993 SNA* 7.116) may require information on the size of the entrepreneurial income (*1993 SNA* 7.117). Moreover, D.422 excludes the withdrawal of funds realized by the sale or disposal of the quasi-corporation's assets, accumulated retained earnings, or other reserves. Conversely, funds provided by the owner for the purpose of acquiring assets or reducing liabilities should be treated as transactions in equity, unless it is to cover persistent operating deficits as part of a deliberate government economic and social policy (*1993 SNA* 7.118)

  It is stated in paragraph 4.52 of the *1993 SNA* that the net worth of the quasi-corporation is zero; this is consistent with the whole of quasi-corporation income being accrued to their owners. However, paragraph 4.52 also indicates that the saving of a quasi-corporation is equal to the amount of earning retained in the corporation. This statement is at odd with the quasi-corporation net worth always being zero. How can quasi-corporations have saving if their net worth is always zero?

- Persistent losses of **quasi-corporations** and other **public corporations**, including those of government trading corporations, are treated as government expenses (subsidies); and profits of **fiscal monopolies** are treated as revenues (taxes).

- For **direct investment corporations**, earnings are accrued to the foreign direct investment investors, with the portion that is being reinvested (that is not distributed) recorded as a further equity investment in the direct investment enterprises.

  In that context, the income of nonresident public corporations[1] is accrued. The *1993 SNA* (as well as the *BPM5*) defines direct foreign investment as investment that gives the investor an effective voice in the recipient's management (1993 SNA 7.119). ***Retained earnings*** of a foreign direct investment corporation are to be treated as if they were distributed to the foreign direct investors and then reinvested back into the corporation. The rationale for this treatment is that the investor has sufficient control

[1] This is not the case for *GFSM 2001*.

or influence in the corporation in which it has invested to determine how much of its earnings will be retained or distributed. Retained earnings are a conscious and deliberate investment decision by the investor.

- For the remaining **domestic corporations,** profit or income is recorded when distributed to the owners, that is to the household, the government and nonresident portfolio owners (the portion not distributed is recorded as other changes in the equity of the corpoations) along with other changes in such value.

  As such, the income from the equity investment of government in public corporations other than quasi-corporations and nonresident corporations is recorded only if dividends are declared. ***Dividends*** are a form of property income to which shareholders become entitled as the result of placing funds at the disposal of corporations (*1993 SNA* 7.113). Dividends are viewed as distribution of profits "...encompasses all distribution of profits by whatever name they are called..." although SNA 3.99 recognizes that "the level of dividends is not unambiguously attributable to a particular earning period....". At the same time, a fall in quoted share values on the market on the day of the distribution of a dividend is recorded as a revaluation (K.11) rather than a transaction. Such a treatment, on the one hand, a transaction to record dividend payment) and, on the other hand, a revaluation at the time the dividend is distributed, seems inconsistent. Dividends are similar to the income that a quasi-corporation owner withdraws (*1993 SNA* 7.89).

In other words, the system calls for two types of income treatment on equity financial investment: accrued income to certain owners that have a say or controlling interest in (direct investment, quasi-corporations and domestic public corporations), and remitted income for the others. For the government equity investment in **public corporations**[2], this leads to two different recordings of income depending upon the institutional arrangements of the public corporations. The first category comprises quasi corporations, foreign public corporations and fiscal monopolies whose income is accrued. The second type covers all other public corporations whose income is recorded only when remitted (dividends).

Whatever their institutional arrangements, public corporations have in common that they are not only owned but also controlled by government. In fact, some of the large amounts of funds that flow to and fro the governments and their public corporations stem from that controlling relationship. This makes it difficult to establish adequate reporting as evidenced by the rules of thumbs that have been devised. The rules attempt to delineate income related flows from other flows (subsidies, capital transfers, monopolistic profits) and financial flows as shown in the next two sections.

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[2] Corporations controlled by government, directly or indirectly. Control is generally established with 50 percent ownership, but many times it is exercised by other means. A separate team of the Task Force on Harmonization of Public Sector Accounting is conducting research on the definition of control.

B. Subsidies and capital transfers

When public corporations charge prices that are below the average cost of production as part of a deliberate government economic or social policy, they will incur regular losses. When regular government payments to public corporations for these persistent losses (that is negative operating surpluses, (B.2)) occur, these payments are recorded as *other **subsidies** on products* (D.319) (*1993 SNA* 7.78c). **Transfers** from government to public or private corporations to cover large operating deficits accumulated over two or more years are recorded as ***other capital transfers*** (D.99) (*1993 SNA* 10.141).

Debt cancellation by mutual agreement is also treated as a capital transfer (*1993 SNA* 10.139 and 12.52). Governments may cancel loans that they have previously lent to their public corporations. Alternatively, **governments may assume debt** of their public corporations (such as loans granted by third parties to public corporations), either with or without a new effective claim by the government on the original debtor.

Hence, public corporations that run quasi-fiscal activities impact government expense at the time of the transfer of funds, instead of at the time the event occurs, which does not seem to be in line with the accrual principle. Distinguishing *other capital transfers* from *other subsidies on products* based on whether the losses accumulated over two or more years or are on a more frequent basis, may seem arbitrary and not fully consistent with a time of recording that reflects accrual principles. Furthermore, the classification of subsidies on products, rather than production, does not seem internally consistent with the description in paragraph 7.78c; however, a change that would reclassify these as subsidies on production would have an impact on GDP.

C. Equity flows

The original investment to establish a public corporation is an injection of equity capital by the government. The establishment of a public corporation (or quasi-corporation) may involve little direct capital, relative to the granting of (exclusive) rights to the corporation over public sector assets.

Privatization involves the (effective) sale of public sector assets to the private sector. In its most direct mode, privatization means the disposal of equity in public corporations, a transaction in equity (F.5), or the disposal of a public corporation's nonfinancial assets (AN.). More complex privatization efforts may effect these transactions using leasing or concession arrangements.

III. Alternative Solutions for Recording Equity Income of Government in its Public Corporations for the SNA Review

This paper considers three options regarding the recording of income for the equity investment of government in their public corporations: maintain the dual recording by expanding or strengthening current rules of recording the income recorded on a "remitted basis"; extend it to other than share public corporations; or adopt a more uniform treatment

across public corporations by extending the accrual of profits or losses to all public corporations.

A. Option 1: Expanding on and strengthening current rules

One option is to strengthen the existing *1993 SNA* on "remitted income' with a view to limit unsound recording between the government and its public corporations. This option would consist of strengthening the following guidelines provided in the *ESA 1995 Manual on Government Deficit and Debt* (MDD) and the *GFSM 2001*:

- Capital injections should (generally) not be booked as 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 are not accrued as expenses in the books of government. Only injections realized in a commercial context, with expectation of a reasonable return on investment, would be classified as transactions in equity.
- Conversely, distributed dividends recorded for a period should not exceed the income of the period (this excludes holding gains and losses). Hence, distributions of superdividends or lump sum payments should 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).

The intent of strengthening these guidelines would be to find further rules that would help in delineating flows that arise from current and capital operations from those that are financial in nature. Particular attention would need to be given to privatization of public corporations, recapitalization of bankrupt public corporations and recapitalization effected by way of debt operations.

However, such efforts are bound to raise the same issues for which the rules of thumb had to be devised. Existing guidelines do not tackle the basic difficulty that dividends and capital injections are net worth neutral events (unlike earnings or losses that affect net worth). Further, they also lead to recording that depends on the time of actual operations, rather than accrual recording and to ambiguity in determining the nature of the flows (e.g., losses of public corporations recorded as subsidies if financed on an ongoing basis by government and, if financed irregularly, to ambivalent reporting between capital transfers or additional financial investment by governments). These weaknesses would have to be acknowledged in an updated SNA text if this option is selected.

B. Option 2: Accrue equity income of public corporations other than shares.

The suggestion would be to accrue the equity income from the investment in these public corporations other than shares. This would be consistent with GFSM 7.140 that distinguishes between public corporations other than shares from those that are quoted in the market; it recommends that their equity liability should be set equal to their net assets. This treatment

extends the *1993 SNA* treatment for quasi-corporations to public quasi-corporations. GFSM 10.19 concludes "that the holding gain is equal to the change in the total value of this measure of the equity, taking into account additions to and withdrawals from equity that may have occurred."

C. Option 3: Accruing the income or loss of public corporations

Another option would be to extend to all public corporations the accrual of income. This treatment, often referred as the "reinvested earnings" approach, currently applies for corporations that are controlled (or influenced) by institutional units that belong to other sectors (e.g., direct investment and quasi-corporations). This method consists of accruing the current income or loss of public corporations and showing an equity investment/disinvestment by the government for the portion of income or loss that has not been transacted (such as through a dividend). To extend the accrual of income or loss to all public corporations that, by definition are controlled by government, would enhance the consistency of treatment of public corporations income in three areas: with public quasi-corporations, with direct investment corporations and with foreign public corporations. This method is used in business accounting to record income from affiliates, (generally defined as at least 20 percent ownership in another entity).

This treatment would recognize that the economic behavior of public corporations, as government controlled corporations, differs from that of other unrelated corporations. As the government has significant influence over its public corporations, it has a measure of responsibility for these corporations that can be better recognized by including its share of net surplus or deficits. The distribution received by government while providing performance in terms of corporations "for profits" objectives may bear little relationship to the performance of the public corporations in terms of other criteria (overall services or goods delivery). Furthermore, by enhancing the transparency of the economic activities carried out by government through their public corporations, this reporting would reinforce the analytical strength of fiscal accounts, and bolster international comparability of government that may use various channels to conduct their fiscal activities across countries.

D. Preferred recommended solution and implications for the SNA

Option 3 is recommended. Using equity accounting, the income would be recorded on a continuous basis in recognition that profits or losses occur continuously over the period.[3] This would help in distinguishing the changes over time in the value of net worth that are due to earnings or losses from those that arise from holding gains or losses. It would show more

[3] This recording is similar to that of interest on a bond. The *1993 SNA* does not equate interest with coupon payments; the fall in a bond's price at the time of payment of the coupon is not a holding loss but reflects a partial redemption in the bond (the redemption of its accrued interest component).

clearly that increases (decreases) in value due to the accumulation (reduction) of retained earnings are not price changes, and do not generate holding gains or losses. Currently in the *1993 SNA*, this increase is recorded as a change in price and therefore is recorded in the revaluation accounts.

Accruing income as though it were distributed and immediately reinvested in equity seems more appropriate. Such a distribution and immediate reinvestment is exactly the fundamental choice that equity owners have and this is explicitly recognized in the *1993 SNA* for direct investment (7.121) and for quasi-corporations.

Adopting accrual of income for government investment in all public corporations would eliminate a major inconsistency of treatment between public quasi-corporations and other public corporations; between public corporations and direct investment; between domestic public corporations and foreign public corporations. It would build a closer link to the source data since equity accounting is used in private accounting where there is more than a 20 percent equity ownership in another reporting unit. As such, the source data provided by accountants reveal a different picture for a (public) corporation's position than the current SNA.

It would also help clarify the distinction between a dividend distribution and a return of equity. The mirror image of this relationship, that is a capital injection (or withdrawal), likewise is not clearly identified. While the current SNA hints that dividends should be related to profits, there is no clear limit or ceiling on the amounts that can be considered a *distributed income of corporations* (D.42). Also, it is not clear that the change in share values on the day of a distribution of a dividend would be due to price, rather than a volume, change. Moreover, the impact of debt cancellation and debt assumption and dividends is not discussed in the current SNA. It would be useful to clarify all of these points for compilers.

E. Possible questions for discussion

Options 1 and 2: maintain existing guidelines

Assuming that the flows are deemed to be dividends, recording such transaction as a current flow (remitted income) is not always straightforward, especially as the dividends may represent large lump payments on previous years' earnings. To what extent should these flows be recorded as current year revenue of the government?

What is the rationale to treat certain losses (those financed on an ongoing basis by government) as subsidies, and other for which the financing is irregular, as capital transfers?

To the extent that persistent losses can be financed through third parry borrowing (often with government guarantees), why should such losses be recognized as capital transfers payments only at the time the government disburses the funds?

In the same vein, how should one delineate profits from fiscal monopolies versus other profitable activities by public corporations?

Is there a justification for a different income treatment between foreign and domestic public corporations (accrued versus remitted)? More generally, what is the rationale for the current recording of income for certain public corporations on an accrual basis, and for others on a "remitted" basis?

> N. B. There appears to be an inconsistency in paragraph 4.52 of the *1993 SNA* between saving and net worth of quasi-corporation. The paragraph indicates that the saving of a quasi-corporation is equal to the amount of earning retained in the corporation; at the same time, it also states that the equity stake of the owner in the quasi-corporation is such that the net worth is always zero. How can quasi-corporations have saving if their net worth is always zero?

Option 3: Accrue the equity income for all public corproations

Should equity accounting be extended to all public corporations? Why or why not?

If equity accounting is applied, how would it affect the current treatment of subsidies as expenses and monopoly profits as tax revenues?

If equity accounting is applied, how would it affect the recording of events such as privatization, debt cancellation, recapitalization, and arrears between government and its public corporations?

IV. Recommendations for Conceptual Changes Agreed by TFHPSA

Apply equity accounting to record the income of government from its equity investment in <u>all</u> public corporations (option 3).

V. Numerical Examples

A. How it would work

To show how the reinvested earning operates, one describes three simple events, looking at the books of government. The extension of the reinvested earning recording relies in practice on a few technical choices to be listed later below.

Basic description

Government would record, in addition to the dividend (D.421), the reinvested earnings of profitable public corporations (D.43.1), with a counterpart as addition to equity (F.5 transaction). The change in the net value of public corporations due to operating profits would be recorded, in the books of government, as a transaction (in equity). Conversely, the

loss making companies would yield an expense/subsidy (D.34.2—or, alternatively, a negative property income, D.43.2) with a counterpart entry in reduction in equity (F.5 transaction).

Hence, changes in their net value would be recorded, in the books of government, as a transaction (in equity). Conversely, capital injections would be recorded as transactions in equity: against cash if realized in cash, or against an incurrence of a liability in case of debt assumption.

The fundamental change is that the **change in equity position observed in the books of the owner** (say, from 100 to 110), originating (other things being equal) on account of the part that is not distributed (10) of the profit on operations during the year (15), **is now a revenue (transaction) instead of a revaluation (as currently)**. We have:

		GOVERNMENT ACCOUNTS	
		Proposed SNA	**Current SNA**
Revenue		15	5
of which: dividend	D.421	5	5
of which: reinvested earnings	D.43	10	
Financing			
Cash	F.2	5	5
Equity	F.5	10	
Revaluation			
Equity	K.11		10
Opening assets		100	100
cash	AF.2		
equity	AF.5	100	100
Closing asset		115	115
cash	AF.2	5	5
equity	AF.5	110	110

The balance sheet is unchanged. What is new is the type of economic flow under consideration to explain those changes: revaluation (K.11) or transaction (F.5). Hence revenue/expense accounts and its balance (within "Statement of government operations" in GFSM 2001) do differ.

More complete numerical example

This section uses a more complete example. Assume that government owns three corporations A and B. Public corporation A earns 10 (also equal to its change in net assets) and distributes 4. Public corporation B losses 25 (also equal to its changes in net assets). Government transfers 3 to B.

Reinvested earnings: numerical example

Government accounts with two public corporations (A and B)

		Proposed			Current		
		A	B	Total gov	A	B	Total gov
	Expense	0	25	**25**	0	3	**3**
D3	*Subsidy*		*3*			*3*	*3*
D.43.2	*Reinvested losses*		*22*	*22*			*0*
	Revenue	10	0	**10**	4	0	**4**
D.42	*Dividend*	*4*			*4*		*4*
D.43.1	*Reinvested earnings*	*6*		*6*			*0*
B.9	**Balance**	10	-25	**-15**	4	-3	**1**
	Balance	10	-25	**-15**	4	-3	**1**
	Transaction assets	10	-25	15	4	-3	1
F.2	*Cash*	*4*	*-3*	*1*	*4*	*-3*	*1*
F.5	*Equity*	*6*	*-22*	*14*			*0*
	Transaction liabilities	0	0	30	0	0	0
F.3	*Debt*			*30*			*0*
	Net impact			**0**			**-16**
	Revaluation assets (+OCV)	0	0	0	6	-22	14
AF.2	*Cash*			*0*			*0*
AF.5	*Equity*	*0*		*0*	*6*	*-22*	*14*
	OCV (+transaction) in liabilities	0	0	0	0	0	30

AF.3	*Debt*			*0*				*30*
	Change in net worth	10	-25	**-15**		10	-25	**-15**
	Change in assets	10	-25	15		10	-25	15
	Cash	*4*	*-3*	*1*		*4*	*-3*	*1*
	Equity	*6*	*-22*	*14*		*6*	*-22*	*14*
	Change in liabilities	0	0	30		0	0	30
	Debt	*0*	*0*	*30*		*0*	*0*	*30*

One observes that the change in government net worth is -15 (because A gains 10 and B loses 25). This is fully booked as surplus/deficit of government ***under the proposed recording***. Currently in the *1993 SNA*, a surplus of 1 is booked (somehow reflecting a cash approach), and holding losses of 16[4].

This examples illustrates two major difficulties: a) the deficit/surplus is very sensitive to the classification decision of the event; and b) revaluation entries occur that do not seem to relate to changes in any "price" on the market.

Additional choices to make

For the application of the reinvested earnings model, there are some choices to be made:

a. Expense losses, or alternatively book them as negative revenue. [But losses are when expense exceeds revenue!]

b. Book reinvested earning (in addition to dividends) or full earnings (of which dividends can be shown). This is largely a presentational issue.

c. Clarify the measure of the profit to distribute. It could be net saving, as currently D.43 is geared at doing (SNA 7.122), or a wider or more flexible criteria (as an example, banks systematically write-off impaired loans as part of their normal activities, but those are recorded as Other changes in volume of assets—it would be normal to incorporate those in the measure of earnings). Whatever is decided, it would have to relate to *1993 SNA* / ESA95 concepts and measurements.

VI. NOTE THE MAGNITUDE OF IMPACT ON GDP AND OTHER MAJOR VARIABLES, IF DATA ARE AVAILABLE

[to be researched]

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[4] unless the debt assumption would be booked as a transfer (as perhaps would be the case following the MDD, but not necessarily the *GFSM 2001*) in case of which the deficit would be -29 and holding gains 14.

VII. CONSEQUENCES FOR CONSISTENCY WITH INTERNATIONAL STATISTICAL MANUALS (GFSM 2001, ESA95 MDD)

The *GFSM 2001* generally aligns with the *1993 SNA*, which means that analogous changes would have to be made. This also would apply to the *ESA 1995* that is an adaptation of the 1993 SNA, with minimal departures. The Eurostat *ESA 1995 Manual on Government Deficit and Debt* (MDD).

VIII. PRACTICAL FEASIBILITY