



## METHODOLOGICAL NOTE OF ESA 2010 CLASSIFICATION CRITERIA

The compilation and regular updating of the statistical Register of General Government Entities constitutes an obligation of all Member States of the European Union for the proper delineation of the institutional sector of General Government, **as specified by the European System of Accounts – ESA2010 (EU Regulation 549/2013)** on the basis of specific criteria. The new Regulation ESA 2010 entered into force on 1 September 2014, so the first register based on the classification criteria of ESA 2010 is that with reference month September 2014.

The register of General Government Entities includes those entities which according to the criteria of the new Regulation of E.C. 549/2013 (European System of Accounts (ESA 2010)) are characterized as entities of General Government.

The criteria of the Regulation according to which an entity is classified in the institutional sector of General Government are the following:

### 1. Autonomy of the entity

According to ESA 2010, paragraph 2.12:

“An institutional unit is an economic entity characterized by decision-making autonomy in the exercise of its principal function. A resident unit is regarded as constituting an institutional unit in the economic territory where it has its centre of predominant economic interest if it has decision-making autonomy and either keeps a complete set of accounts, or is able to compile a complete set of accounts.

To have autonomy of decision in respect of its principal function, an entity must be:

- (a) entitled to own goods and assets in its own right; it will be able to exchange the ownership of goods and assets in transactions with other institutional units;
- (b) able to take economic decisions and engage in economic activities for which it is responsible and accountable at law;
- (c) able to incur liabilities on its own behalf, to take on other obligations or further commitments and to enter into contracts; and
- (d) able to draw a complete set of accounts, comprised of accounting records covering all its transactions carried out during the accounting period, as well as a balance sheet of assets and liabilities.”

Additionally, according to ESA 2010, paragraph 2.13:

- “entities which, while keeping a complete set of accounts, have no autonomy of decision, are part of the units which control them;

- quasi-corporations are entities which keep a complete set of accounts and have no legal status. They have an economic and financial behaviour that is different from that of their owners and similar to that of corporations. They are deemed to have autonomy of decision and are considered as distinct institutional units.”

If a public sector entity fails to fulfill the above conditions, then it has no autonomy of decision and is classified in General Government. Otherwise, in case of autonomy, one has to examine the criteria for public control and market/non market producer.

## **2. Control of public sector**

In order to be a General Government entity, a unit must be controlled by the public sector. The criteria according to which an entity is considered to be under public control are described in paragraphs 20.309 and 20.310 of ESA 2010.

“20.309 Control of a resident public sector unit is defined as the ability to determine the general policy of the unit. This can be through the direct rights of a single public sector unit or the collective rights of many. The following indicators of control are to be considered:

- (a) rights to appoint, veto or remove a majority of officers, board of directors etc. The rights to appoint, remove, approve or veto a majority of the governing board of an entity are sufficient to determine control. Such rights may be directly held by one public sector unit, or indirectly by public sector units in aggregate. If the first set of appointments are controlled by the public sector but subsequent replacements are not subject to these controls, then the entity remains in the public sector until the time when the majority of the directors are not controlled appointments;
- (b) rights to appoint, veto or remove key personnel. If the control of general policy is effectively determined by influential members of the board, such as the chief executive, chairperson and finance director, then the powers to appoint, veto or remove those personnel are given greater prominence;
- (c) rights to appoint, veto or remove a majority of appointments for key committees of the entity. If key factors of the general policy, such as remuneration of senior staff, pay and business strategy, are delegated to subcommittees, then the rights to appoint, remove or veto of directors on these subcommittees is a determinant of control;
- (d) ownership of the majority of the voting interest. This will normally determine control when decisions are made on a one-share, one-vote basis. The shares may be held directly or indirectly, with shares owned by all public sector units aggregated. If decisions are not made on a one-share, one-vote basis the situation should be analysed to see if the public sector has a majority vote;
- (e) rights under special shares and options. These golden or special shares were once common in privatised corporations and also feature in some special purpose entities. In some cases they give public sector entities some residual rights to protect interests; such rights may be permanent or time-limited. The existence of such shares is not by itself an indicator of control, but needs to be carefully analysed, in particular the circumstances where the powers may be invoked. If the powers influence the current general policy of the entity they will be important to the classification decisions. In other cases they will be reserve powers that may confer rights to control general policy in times of emergency etc, these are judged as irrelevant if they do not influence existing policy,

although in the event that they are utilised they will usually trigger immediate reclassification. The existence of a share purchase option to public sector entities in certain circumstances is a similar situation, and a judgement is necessary on whether the powers to implement the option influence the general policy of the entity;

- (f) rights to control via contractual agreements. If all the sales of an entity are to a single public sector entity, or a collection of public sector entities, there is scope for dominant influence that can be judged as control. The presence of other customers, or the potential to have other customers, is an indicator that the entity is not controlled by public sector units. If the entity is restricted from dealing with non-public sector customers due to public sector influence, then this is an indicator of public sector control;
- (g) rights to control from agreements/permission to borrow. Lenders often impose controls as conditions of making loans. If the public sector imposes controls through lending, or to protect its risk exposure from a guarantee, which are tougher than a private sector entity would typically face from a bank, this is an indicator of control. If an entity requires permission from the public sector to borrow, then this is an indicator of control;
- (h) control via excessive regulation. When regulation is so tight that it effectively dictates the general policy of the business, it is a form of control. Public authorities can in some cases have powerful regulatory involvement, particularly in areas such as monopolies and privatised utilities where there is a public service element. It is possible for regulatory involvement to exist in important areas, such as price setting, without an entity ceding control of general policy. Choosing to enter into or operate in a highly regulated environment is similarly an indicator the entity is not subject to control;
- (i) others. Control may also be obtained from statutory powers or rights contained in an entity's constitution, for example to limit the activities, objectives and operating aspects, approve budgets or prevent the entity changing its constitution, dissolving itself, approving dividends, or terminating its relationship with the public sector. An entity that is fully, or close to fully, financed by the public sector is considered to be controlled if the controls on that funding stream are restrictive enough to dictate the general policy in that area.

20.310 Each classification case needs to be judged on its own merits and some of these indicators may not be relevant to the individual case. Some indicators, such as (a), (c) and (d) in paragraph 20.309, are sufficient by themselves to establish control. For others a number of separate indicators may collectively indicate control.”

If the entity is a non-profit institution (NPI), then ESA 2010 paragraph 20.15 gives a simplified version of the above, as some of the determinants are not applicable to NPIs:

“20.15 Control of a NPI is defined as the ability to determine the general policy or programme of the NPI. Public intervention in the form of general regulations applicable to all units working in the same activity is irrelevant when deciding whether the government holds control over an individual unit. To determine whether a NPI is controlled by the government, the following five indicators of control should be considered:

- (a) the appointment of officers;

- (b) other provisions of the enabling instrument, such as the obligations in the statute of the NPI;
- (c) contractual agreements;
- (d) degree of financing;
- (e) risk exposure.

A single indicator can be sufficient to establish control. However, if a NPI that is mainly financed by government remains able to determine its policy or programme to a significant extent along the lines mentioned in the other indicators, then it would not be considered as being controlled by government. In most cases, a number of indicators will collectively indicate control.”

### **3. Market/non market producer**

Regulation ESA 2010 has two criteria for the assessment of an entity as a market producer, the quantitative criterion and the qualitative criterion. In order to be a market producer, an entity must satisfy both criteria. If a public sector unit fails to fulfill one of the criteria, the entity is classified into General Government.

#### **3.1. Quantitative Test**

According to ESA 2010, paragraph 1.37 “an activity shall be considered as a market activity when the corresponding goods & services are traded under the following conditions:

- (1) Sellers act to maximise their profits in the long-term, and do so by selling goods and services freely on the market to whoever is prepared to pay the asking price;
- (2) Buyers act to maximise their utility given their limited resources, by buying according to which products best meet their needs at the offered price; ”

Also, according to ESA 2010 paragraph 3.19, “the ability to undertake a market activity at economically significant prices will be checked notably through a quantitative criterion (the 50% criterion), using the ratio of sales to production costs. To be a market producer, the unit shall cover at least 50% of its costs by its sales over a sustained multi-year period.”

By commonly-applied convention, the multi-year period means at least 3 years.

“3.19 Economically significant prices are prices that have a substantial effect on the amounts of products that producers are willing to supply and on the amounts of products that purchasers wish to acquire. Such prices arise when both of the following conditions apply:

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

Also in paragraph 3.32 is stated that “according to the quantitative market-non-market criterion, products sold at economically significant prices should cover at least a majority of the production costs by sales.”

### **3.2. Qualitative Test**

ESA10, paragraph 20.22 instructs that in order “to analyse the difference between a market and a non-market producer, in relation to changes in market conditions, it is useful to specify which units are the consumers of the goods and services in question and whether the producer actually competes on the market or is the only supplier.”

#### **i. When most sales are sold to households and corporations:**

The unit is market if the conditions of points (a) and (b) of the above paragraph 3.19 are fulfilled. (“goal of making a profit in the long run or, at a minimum, covering ... costs” and “consumer free to choose” (also in ESA 2010, 20.23)).

#### **ii. When sales are only to government:**

- Ancillary units are part of government. These units provide all of their output to their owners for use as intermediate consumption or gross fixed capital formation (ESA 2010, 20.24).
- If a public producer sells only to government and is the only supplier of its services, it is presumed to be a non-market producer unless it competes with a private producer (ESA 2010, 20.25).
- If a public producer is one of several suppliers to government, it is considered a market producer if it competes with other producers on the market and its prices satisfy the general criteria to be economically significant (ESA 2010, 20.26).

#### **iii. When sales are mainly but not only to government:**

- If a public producer is the sole supplier of its services, it is presumed to be a market producer if its sales to non-government units are more than half of its total output or its sales to government fulfils the tendering condition of paragraph 20.25 (ESA 2010, 20.27).
- If there are several suppliers, a public producer is a market producer if it competes with the other producers through tendering for a contract with government (ESA 2010, 20.28).

### **4. Other Specific Guidance**

While the criteria mentioned above in 1-3 provide general guidance, there is sometimes specific guidance in the regulation that needs to be applied.

#### **Changes in the classification criteria between ESA95 and ESA 2010:**

Under ESA95, an entity is classified to the general government sector if

- a) It is not a separate institutional unit from government, or
- b) It is a separate institutional unit controlled by government, and it is non-market

Market output (ESA95 paragraphs 3.17 and 3.18) is defined as output that is disposed of on the market, and sold at economically significant prices.

In ESA 2010, the ability to undertake market activity will be checked notably through the usual quantitative criterion (the 50% criterion). However, in order to decide whether a producer that operates under the control of government is a market unit some qualitative criteria must also be taken into account. Compared with ESA95, ESA 2010 therefore uses the qualitative properties of non-market producers as well.

Under ESA 2010, in order to decide whether an institutional unit producing under the control of government is market, the 50% criterion must be applied. If the ratio of sales to production costs is above 50%, the unit is considered as having the ability to be a market producer. However, an assessment of its activity and resources remains necessary based on the above mentioned qualitative criteria.

For the quantitative market test, the 50% criterion compares sales and production costs. In this test, ESA 2010 includes in production costs the net interest payable. This factor was not included in the ESA95 market test.