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Center for Civil Society Studies

Lester M. Salamon
Director

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Mr. Ivo Havinga
Economic Statistics Division
United Nations Statistics Division
Two U.N. Plaza
New York, NY

Dear Ivo:

Thank you for taking the time to meet with me during my recent visit to New York and for arranging the meeting for me with Paul Cheung, the new director of UNSD.

As agreed during that meeting, I am writing to you to clarify a number of issues surrounding the treatment of Nonprofit Institutions (NPIs) that I believe it would be fruitful to address in the revision that is now under way of SNA 1993. These issues surfaced in the process of developing the recently issued United Nations *Handbook on Nonprofit Institutions in the System of National Accounts* and have apparently re-surfaced in the course of the consideration of harmonization of public sector accounting that has been taken up as part of the SNA revision process.

Thanks to the SNA revision effort that is now under way, it may be possible to resolve some of these issues in a way that produces a clearer and more symmetrical treatment of NPIs than is currently available in SNA 1993. As reflected in the *NPI Handbook*, this is important for at least two reasons. First, the NPI sector is an increasing focus of public and private action, making it highly useful to develop a better understanding of its scale and composition. Second, the NPI universe has grown so substantially that the current treatment of nonprofit institutions produces distortions in the picture that SNA provides of the corporate and general government sectors to which many NPIs are now allocated.

With the *NPI Handbook* and the recent work of the Task Force on Harmonization of Public Sector Accounting (TFHPSA) as a guide, it may now be possible to articulate a more satisfactory way to handle NPIs within the core SNA structure, thus obviating the need for a special satellite account on NPIs. The purpose of this letter is to initiate a conversation toward this end with the goal of clarifying the treatment of NPIs in the revised SNA, particularly as it may be affected by the work of the TFHPSA. Hopefully, this conversation can be continued in any of several possible venues—in the meetings of the TFHPSA, in a special one-day meeting of the principals involved in the SNA revision to examine the treatment of NPIs in the revised SNA, and/or in the preparation of an Annex on NPIs to parallel the one being prepared on the Public Sector by the TFHPSA as part of the SNA revision process.

More specifically, let me first review the issues that prompted the development of the *NPI Handbook* and its proposal for an NPI "satellite account," then comment on how the work of the TFHPSA might resolve at least one of these issues, and finally suggest how the preliminary proposal of this Task Force could resolve the other issues as well if it were applied symmetrically.

Problems with the Current Treatment of NPIs in the SNA

As you know, the decision to produce a *Handbook on Nonprofit Institutions in the System of National Accounts* was motivated by a desire to get a clearer and more complete picture of the full universe of NPIs than was available through the core SNA. Under the SNA 1993 sectoring rules, many of the largest NPIs are allocated to either the general government or the corporate sectors depending largely on their source of income. This occurs, at least in part, because the sectoring rules that are part of SNA 1993 are difficult to apply to NPIs. In particular:

- The criterion of "controlled and mainly financed by government" used as the basis for allocating NPIs to the general government sector has been difficult to apply in practice because of the ambiguity of the "controlled by" portion of the criterion. This has led a number of statistical agencies to allocate NPIs to the general government sector chiefly on the basis of the source of their income. Since substantial numbers of the largest and most significant NPIs receive substantial public sector funding even though they remain privately, and not publicly, controlled, this produces a potentially serious distortion of the general government sector and a fairly sizable under-estimate of the true size of the NPI sector itself since these entities are nowhere identified as NPIs in the national accounts structure (e.g. they are excluded from NPISH). This is particularly problematic in the countries of Western Europe, where sizable nonprofit sectors, accounting often for 10 percent or more of paid employment, exist but with heavy public sector funding.

- The criterion of being "market producers" used to allocate NPIs to the corporate sectors (either financial or non-financial) has also been problematic. In practice, this criterion has been applied chiefly on the basis of the sources of NPI revenue. However, even NPIs that have substantial sales revenue (e.g. universities) often also have considerable "non-market output." What is more, these institutions are not fundamentally market institutions even when they secure significant shares of their income from market sources. This is so because they are not "owned" or controlled by shareholders and are prohibited from distributing profits to owners, directors, or officers. This gives them a distinctly different production function from true, for-profit firms. Allocating these institutions to the corporate sector, whether financial or non-financial, on the basis of their receipt of sales revenue thus causes distortions to the picture that SNA provides of the corporate sector and further understates the scale of the NPI sector. What is more, because of the significant scale of these institutions, these distortions are often quite sizable. For example, work recently completed by the National Bank of Belgium in implementing the UN *NPI Handbook* reveals that the output of the NPI sector increases by a factor of 600 percent—from roughly €3 billion to roughly €18 billion—when the NPIs buried in the corporate sector in the Belgian national accounts are added to those reported in the NPISH sector.

Task Force on Harmonization of Public Sector Accounting Proposed Solution

Fortunately, the Task Force on Harmonization of Public Sector Accounting (TFHPSA) formed as part of the SNA revision process has formulated an approach to defining the "public sector" that may offer a solution to both of these "problems." In particular, this Task Force, in its preliminary work, has suggested moving away from "financed by" as the criterion for allocating units to the public sector and clarifying the definition of "controlled by" as the basis for such allocation. The clarifications suggested in a January 6, 2005, draft produced by one of the Task Force's working teams would, moreover, usefully narrow the range of NPIs that would be allocated to the general government sector and therefore leave a much larger portion of nonprofit institutions to be included in an expanded NPISH sector.

I generally like the "indicators" that this working team has generated for determining "controlled by" in the context of NPIs, but I would prefer, on grounds of symmetry and clarity, if they tracked more closely the language and indicators recommended for determining "controlled by" government in the case of corporations. Except for indicators 1 and 5, which relate to ownership of shares, most of the other indicators applicable to corporations would also apply to NPIs. This is consistent with the comments of the New Zealand representative to the TFHPSA), who also recommended combining the "definitions and tests" of control for corporations and non-market NPIs. The outcome of this suggestion would be to leave in the general government sector those NPIs that really do represent governmental efforts to off-load functions to semi-autonomous "QUANGOS" that the governments still control while moving out of the general government sector those NPIs that may receive substantial public sector funding but nevertheless constitute true, autonomous entities in control of their corporate policies.

Extending the Task Force on Harmonization of Public Sector Accounting Solution

For sake of symmetry also, I would urge that the same or similar language be introduced to determine the allocation of NPIs to the corporate sectors. Under this scenario, NPIs would only be allocated to the corporate if they were "controlled by" true market producers, i.e. profit-seeking entities that secure the overwhelming preponderance of their revenue from market sales. This may still leave in the corporate sector those

NPIs that the SNA now identifies as "serving business" while keeping out of the corporate sector those NPIs that receive some revenue from sales of services but nevertheless are not fundamentally commercial enterprises and that receive non-market revenue as well.

Consistent with the above suggestions, I would also recommend re-naming the current NPISH sector the NPI Sector. The term "serving households" is an ambiguous term. In some sense, all entities in the economy could be characterized as "serving households" in the sense that households contain the ultimate beneficiaries of economic activity. Calling this the NPI sector would make the language symmetrical with that used for the General Government and the Financial Corporations and Non-financial Corporations sectors.

Next Steps

I would be eager to discuss these suggested clarifications of the SNA treatment of NPIs with the TFHPSA or with others involved in the revision process. I would also be willing to take part in the special seminar or discussion session that you suggested to explore these matters in greater depth with you and others playing leadership roles in the SNA revision process. Finally, I would like to propose an annex to the SNA on NPIs similar parallel to the annex on the public sector proposed by the TFHPSA and would be willing to work with you and others on such an annex if this proposal were accepted. Such an Annex could incorporate material now in the *NPI Handbook* and make suitable adjustments in the light of the SNA revisions currently under consideration.

I look forward to discussing these matters with you and thank you again for the opportunity to offer these clarification suggestions.

Yours truly,

Lester M. Salamon
Director

Cc: Paul Cheung
Rob Edwards
Carol Carson
Lucie Laliberté
Helen Tice