Enabling NPIs To Be Identified Throughout the Accounts

At the AEG meeting in Frankfurt, the questions in the description of this issue were raised. The AEG expressed general support for identifying NPIs but without extensive discussion on exactly how this should be carried out. The note that follows, prepared by Karen Wilson of Statistics Canada, recaps the arguments in favour of identifying NPIs throughout the sectors where they appear and attaches relevant paragraphs from the existing 1993 SNA text and the proposed text for the Government and Public Sector chapter.

A recommendation is now needed about where in the hierarchy NPIs would appear as sub-sectors of the general government and corporate sectors. For general government there are two main options:

> **Option 1**. Separate NPIs before the split into central, state and local government.
>
> **Option 2**. Separate central state and local government first and then within each of these show NPIs and [other] government units.

Similarly for corporations there are two options:

> **Option 1.** Separate NPIs before the split into public, national private and foreign controlled corporations.
>
> **Option 2.** Separate public, national private and foreign controlled corporations first and then within each of these show NPIs and for profit institutions (perhaps FPIs) separately.

In terms of compilation it might be easier to work with option 2, but the fact that this might be so for compilation need not mean that the same option must necessarily be used for presentation. However, the range and diversity of NPIs, and the fact that some categories might have no NPIs within them, might argue in favour of option 2 for presentation also.

The assumption is that the same option must be selected for all three sectors affected (general government, non-financial corporations and financial corporations).

Views are sought on which option is to be selected.

Background: the treatment of NPIs in the 1993 SNA

The 1993 SNA allocates non-profit institutions among institutional sectors according to their characteristics, largely on the basis of their source of revenue. (See Appendix 1.) Non-market NPIs that are controlled and mainly financed by government are assigned to the general government sector, and those with significant market activity (i.e., charging "economically significant prices") are assigned to the corporations sector.

According to the 1993 SNA, separate accounts are to be developed and published for only a very restricted group of non-profit institutions: non-profit institutions serving households (NPISH). The NPISH sector is the only place where NPIs are visible under current SNA guidelines.

Delineation of NPIs

The 1993 SNA assigns non-market NPIs to the general government sector if the NPIs are "controlled and mainly financed by government" (SNA 4.62). In this context, control is to be understood as the ability to determine the general policy or program of the NPI. In reality, due to the difficulty in applying the "controlled by" portion of this guideline, it appears that many statistical agencies have, in practice, tended to allocate at least a few NPIs to the general government sector on the basis of whether a government unit is their principal source of financing, irrespective of whether they are actually controlled by government or not.

In the *Handbook on Non-Profit Institutions in the System of National Accounts,* published by the United Nations in 2003, an explicit decision was made to disregard the source of income in determining the boundaries of the broadly-defined non-profit sector, based on the premise that financing (whether by governments or private donors) does not necessarily translate into "control".

The Task Force on Harmonisation of Public Sector Accounting (TFHPSA) also explicitly acknowledged that financing does not necessarily translate into control. They proposed reformulating the definition of a government-controlled NPI by dropping the phrase "and mainly financed by government". Instead they proposed that one of the five criteria that were developed to determine if an NPI is controlled by government should be "an NPI that is mainly financed by government may be controlled by that government. Generally, if the NPI remains able to determine its policy or programme to a significant extent along the lines mentioned in the previous indicator, then it would not be considered controlled by government." The full set of five criteria is given in Appendix 2.

The TFHPSA has therefore made good progress toward resolving some of the issues in the treatment of NPIs in the existing SNA guidelines, specifically by excluding from the general government sector NPIs which are mainly financed but not controlled by government. Any remaining differences in the allocation of NPIs to the general government between the core system (based on TFHPSA guidelines) and a satellite account implementing the UN NPI *Handbook* would be largely due to differences remaining between the definition of "control by government" in a new SNA and the "self-governing" criterion of the *Handbook*

The TFHPSA also recommended that "all remaining NPIs allocated to the general government sector should retain their identity as NPIs in statistical records, to facilitate analysis of the complete set of NPIs." This classification of NPIs should be maintained for all sectors so that all NPIs NPISH, NPIs serving Business and Market NPIs as well as Government sector NPIs can be pulled together to get a picture of the total NPI function in the economy.

Should there be an NPI sector?

While a number of characteristics distinguish NPIs from other types of institutional units, as a group they do not appear to share a distinctive set of common principal functions, behaviour, and objectives. They are not only diverse, they form a very disparate group. They include foundations acting only or mainly as funding channels as well as some institutions in receipt of their funds who carry out a wide range of activities. Some of these may provide support to the community at large (through advocacy groups for example) or to individual households (for example those with a member suffering from a particular sort of disability). Other units classed as NPIs may clearly serve purely commercial interests.

Given that in the SNA institutional units are grouped together to form institutional sectors, on the basis of their principal functions, behaviour, and objectives, it would not seem appropriate to envisage a completely new sector which brought together all NPIs and removed them from the sectors where they presently appear as a standard part of the SNA. However it would clearly be advantageous to be able to do this as a supplementary exercise and for this some principles need to be established.

The principles for determining control of a government funded NPI as presented in the draft chapter on Government and Public Sector will be part of the sectoring principles in the updated SNA as will the extra clarity on the meaning of economically significant prices to separate market producers from non-market producers.

Appendix 1

MAIN PARAGRAPHS ON NPIs IN THE 1993 SNA

4.54. Non-profit institutions are legal or social entities created for the purpose of producing goods and services whose status does not permit them to be a source of income, profit or other financial gain for the units that establish, control or finance them. In practice, their productive activities are bound to generate either surpluses or deficits but any surpluses they happen to make cannot be appropriated by other institutional units. The articles of association by which they are established are drawn up in such a way that the institutional units which control or manage them are not entitled to a share in any profits or other income which they receive. For this reason, they are frequently exempted from various kinds of taxes.

4.55. The motives leading other institutional units - whether persons, corporations, or government - to create NPIs are varied. For example, NPIs may be created to provide services for the benefit of the persons or corporations who control or finance them; or they may be created for charitable, philanthropic or welfare reasons to provide goods or services to other persons in need; or they may be intended to provide health or education services for a fee, but not for profit; or they may be intended to promote the interests of pressure groups in business or politics; etc. Although they may provide services to groups of persons or institutional units, by convention they are deemed to produce only individual services and not collective services.

The characteristics of NPIs

4.56. The main features of NPIs may be summarized as follows:

(a) Most NPIs are legal entities created by process of law whose existence is recognized independently of the persons, corporations or government units that establish, finance, control or manage them. The purpose of the NPI is usually stated in the articles of association or similar document drawn up at the time of its establishment. In some countries, especially developing countries, an NPI may be an informal entity whose existence is recognized by the society but which does not have any formal legal status; such NPI may be created for the purpose of producing non-market goods or services for the benefit of individual households or groups of households;

(b) Many NPIs are controlled by associations whose members have equal rights, including equal votes on all major decisions affecting the affairs of the NPI. Members enjoy limited liability with respect to the NPIs operations;

(c) There are no shareholders with a claim on the profits or equity of the NPI. The members are not entitled to a share in any profits, or surplus, generated by the productive activities of the NPI, such profits being retained within the NPI;

(d) The direction of an NPI is usually vested in a group of officers, executive committee or similar body elected by a simple majority vote of all the members. These officers are the counterpart of the board of directors of a corporation and are responsible for appointing any paid managers;

(e) The term “non-profit institution” derives from the fact that the members of the association controlling the NPI are not permitted to gain financially from its operations and cannot appropriate any surplus which it may make. It does not imply that an NPI cannot make an operating surplus on its production.

NPIs as market and non-market producers

4.57. As in the case of producer units owned by government units, it is important to distinguish between NPIs engaged in market and non-market production as this affects the sector of the economy to which NPI is allocated. NPIs do not necessarily engage in non-market production.

NPIs engaged in market production

<u>Market producers NPIs</u>

4.58. Market producers are producers that sell most or all of their output at prices that are economically significant - i.e., at prices which have a significant influence on the amounts the producers are willing to supply and on the amounts purchasers wish to buy. Schools, colleges, universities, clinics, hospitals, etc. constituted as NPIs are market producers when they charge fees which are based on their production costs and which are sufficiently high to have a significant influence on the demand for their services. Their production activities must generate an operating surplus or loss. Any surpluses they make must be retained within the institutions as their status prevents them from distributing them to others. On the other hand, because of their status as "non-profit institutions" they are also able to raise additional funds by appealing for donations from persons, corporations or government. In this way, they may be able to acquire assets which generate significant property income in addition to their revenues from fees, thereby enabling them to charge fees below average costs. However, they must continue to be treated as market producers so long as their fees are determined mainly by their costs of production and are high enough to have a significant impact on demand. Such NPIs are not charities, their real objective often being to provide educational, health or other services of a very high quality using their incomes from endowments merely to keep down somewhat the high fees they have to charge.

<u>Market NPIs serving businesses</u>

4.59. Most market NPIs serving businesses are created by associations of the businesses whose interests they are designed to promote. They consist of chambers of commerce, agricultural, manufacturing or trade associations, employers' organizations, research or testing laboratories or other organizations or institutes which engage in activities which are of mutual interest or benefit to the group of businesses that control and finance them. The NPIs often engage in publicity on behalf of the group, lobby politicians or provide advice or assistance to individual members in difficulty for one reason or another. The NPIs are usually financed by contributions or subscriptions from the group of businesses concerned. The subscriptions are treated not as transfers but as payments for services rendered and these NPIs are, therefore, classed as market producers. However, as explained below, when chambers of commerce or similar organizations for the benefit of businesses are controlled and mainly financed by government units, they are classified as non-market NPIs and allocated to the general government sector.

NPIs engaged in non-market production

4.60. The majority of NPIs in most countries are non-market rather than market producers. Non-market producers are producers that provide most of their output to others free or at prices which are not economically significant: that is, at prices which do not have a significant influence on the amounts the producers are willing to supply or on the amounts purchasers wish to buy. Thus, NPIs engaged mainly in non-market production may be distinguished not only by the fact that they are incapable of providing financial gain to the units which control or manage them, but also by the fact that they must rely principally on funds other than receipts from sales to cover their costs of production or other activities. Their principal source of finance may be regular subscriptions paid by the members of the association that controls them or transfers or donations from third parties, including government.

4.61. NPIs engaged mainly in non-market production may be divided into two main groups: those NPIs controlled and mainly financed by government and those NPIs providing non-market goods and services to households financed mainly by transfers from non-governmental sources - households, corporations or non-residents. The second group are described as "NPIs serving households" (NPISHs) and constitute a separate sector in the System.

NPIs controlled and mainly financed by government

4.62. NPIs controlled and mainly financed by government must be properly constituted legal entities which exist separately from government. In this context, control is to be understood as the ability to determine the general policy or programme of the NPI by having the right to appoint the officers managing the NPI. Such NPIs may be engaged in research or development, for example, for the benefit of certain groups of producers, such as farmers. They may also be concerned with the setting or maintenance of standards in fields such as health, safety, the environment, accounting, finance, education, etc., for the benefit of both enterprises and households. Governments find it appropriate to create NPIs for this purpose, rather than using agencies of government to carry out the same functions, because NPIs concerned with public standards may need to be seen as detached and objective, and not subject to political pressures. NPIs controlled and financed by government are allocated to the general government sector, irrespectively of the types of institutional units that mainly benefit from their activities.

4.63. In some countries, certain legal entities created by government units may have the characteristics of, and behave like, NPIs controlled and mainly financed by government units and yet be formally described as "corporations". Such entities must be treated as NPIs whatever their names. In general, the status of a legal entity cannot be automatically ascertained from its name and it is necessary to take account of its functions and purpose.

NPIs serving households (NPISHs)

4.64. Non-profit institutions serving households (NPISHs) consist of NPIs which provide goods or services to households free or at prices that are not economically significant. Two main types of NPISHs may be distinguished.

4.65. The first type consists of NPISHs which are created by associations of persons to provide goods or, more often, services primarily for the benefit of the members themselves. The services are usually provided free, being financed by regular membership subscriptions or dues. They include NPISHs such as professional or learned societies, political parties, trade unions, consumers' associations, churches or religious societies, and social, cultural, recreational or sports clubs. They do not include bodies serving similar functions that are controlled and mainly financed by government units, except that churches are always treated as serving households even when mainly financed by government units. Political parties in countries with one-party political systems that are controlled and financed by government units are always included in the general government sector.

4.66. In some communities, NPISHs may be found which do not possess any legal status or formal articles of association. They should be treated as NPISHs when they perform the same kinds of functions as the societies, parties, unions, etc., described above, even if they are not legally constituted as NPISHs. However, when groups of households collaborate on communal construction projects (such as construction of buildings, roads, bridges, ditches, dykes, etc.), they should be treated as informal partnerships engaged on own-account construction rather than

NPISHs. NPISHs should normally have a continuing role to play and not be deemed to be created for single projects of limited duration.

4.67. The second type of NPISH consists of charities, relief or aid agencies that are created for philanthropic purposes and not to serve the interests of the members of the association controlling the NPISH. Such NPISHs provide goods or services on a non-market basis to households in need, including households affected by natural disasters or war. The resources of such NPISHs are provided mainly by donations in cash or in kind from the general public, corporations or governments. They may also be provided by transfers from non- residents, including similar kinds of NPISHs resident in other countries.

Appendix 2

Excerpts from the TFHPSA Draft chapter on Government and Public Sector

Government control of non-profit institutions[1]

1. Control of a NPI is defined as the ability to determine the general policy or programme of the NPI. All NPIs allocated to the general government sector should retain their identity as NPIs in statistical records, to facilitate analysis of the complete set of NPIs. To determine if a NPI is controlled by the government, the following five indicators of control should be considered:

- The appointment of officers. The government may have the right to appoint the officers managing the NPI either by the NPI's constitution, its articles of association or other enabling instrument.

- Other provisions of enabling instrument. The enabling instrument may contain provisions other than the appointment of officers that effectively allow the government to determine significant aspects of the general policy or programme of the NPI. For example, the enabling instrument may specify and/or limit the functions, objectives and other operating aspects of the NPI, thus making the issue of managerial appointments less critical or even irrelevant, give the government the right to remove key personnel or veto proposed appointments, require prior approval of budgets or financial arrangements by the government, or prevent the NPI from changing its constitution, dissolving itself, or terminating its relationship with government without government approval.

- Contractual agreements. The existence of a contractual agreement between a government and an NPI may allow the government to determine key aspects of the NPI's general policy or programme. As long as the NPI is ultimately able to determine its policy or programme to a significant extent, such as by being able to renege on the contractual agreement and accepting the consequences, by being able to change its constitution or dissolving itself without requiring government approval other than that required under the general regulations, then it would not be considered controlled by government.

- Degree of financing. An NPI that is mainly financed by government may be controlled by that government. Generally, if the NPI remains able to determine its policy or programme to a significant extent along the lines mentioned in the previous indicator, then it would not be considered controlled by government.

- Risk exposure. If a government openly allows itself to be exposed to all or a large proportion of the financial risks associated with a NPI's activities, then the arrangement constitutes control. The criteria are the same as in the previous two indicators.

2. Totality of all indicators. A single indicator could be sufficient to establish control in some cases, but in other cases, a number of separate indicators may collectively indicate control. A decision based on the totality of all indicators will necessarily be judgmental in nature.

[1] Criteria developed for non-profit institutions (NPIs) apply also to other kinds of non-profit units like extra-budgetary agencies.

Market/non-market delineation: the notion of economically significant prices

3. Government units are public units whose output is mostly non-market. Non-market producers provide all or most of their output to others free of charges or at prices that are not economically significant. Economically significant prices are prices which have a significant influence on the amounts the producers are willing to supply and on the amounts which purchasers wish to buy. It is the criterion that is used to classify output and producers as market or non-market, thus deciding whether an institutional unit set up by government, or in which government has controlling interest, is to be designated as non-market—therefore classified in the general government sector—or as market—therefore considered a public corporation.

4. It can be presumed that prices are economically significant when the producers are private corporations. When there is public control, however, the unit's prices may be modified for public policy purposes, which may cause difficulties in determining whether the prices are economically significant. Public corporations are often established to provide goods that the market would not produce in the desired quantities or prices. The sales of such corporations may cover a large portion of their costs, but one can expect that they respond to market forces quite differently than would private corporations.

5. It is likely that corporations receiving substantial government financial support or that enjoy other risk reducing factors such as government guarantees will act differently than corporations without such advantages because their budget constraints are softer. A non-market producer is a producer that faces a very soft budget constraint so that the producer is not likely to respond to changes in the economic conditions in the same way as real market producers.

6. The difference between a market and non-market producer that sells its output for a price, then, relates largely to the ways in which the producer responds to changes in market conditions. To decide this inherently difficult question, it is useful to consider a taxonomy that specifies which units are the consumers of the goods and services in question and whether the producer is the only supplier.

The output is sold primarily to corporations and households

7. Prices are economically significant if they cover the majority of the producer's costs (including consumption of fixed capital and a return to capital) and consumers are free to choose on the basis of the prices charged. Although there is no prescriptive numerical relationship between the value of output (excluding both taxes and subsidies on products) and the production costs, one would normally expect the value of goods and services sold (the sales) to average at least half of the production costs over a sustained multi-year period.[2]

8. Because economic circumstances vary considerably, it may be desirable to accept a different threshold to achieve consistent economic measurement over time, between branches and across countries. For the same reason, the distinction between market and non-market may be made for a group of entities undertaking similar activities rather than on a case-by-case basis. Examples may be higher educational institutions or transport systems. However, when compiling the general government sector accounts, this should never result in combining the accounts of market institutional units with those of non-market institutional units

The output is sold only to government

[2] No specific threshold carries full agreement as a rule at the international level.

9. Some services are typically required by all units as ancillary services. These include activities such as transportation, purchasing, sales, marketing, computer services, communications, cleaning, and maintenance. A unit that provides this type of services exclusively to its parent unit or to other units in the same group of units may be described as an ancillary unit. Ancillary units provide all of their output to their owners for use as intermediate consumption.

10. If a public producer is the only supplier of its services, it is treated as a non-market unit unless it competes with a private producer in tendering for a contract with government on normally accepted commercial terms.

11. If a public producer is one of several producers, it is considered a market producer if there is evidence that it competes with other producers in the market and its prices satisfy the general criteria of economically significant prices.

The output is sold to government and others

12. If a unit is the only supplier of its services, it is a market producer if its sales to non-government units are more than half of its total output or its sales to government satisfies the tender condition above.

13. If there are several suppliers, a public producer is a market producer if it competes with the other producers.

Definition of sales and of costs

14. In order to compare the output of a public unit selling goods and services with its production costs, as an assessment of economically significant prices and of market output, the output at basic prices of this unit is measured as equal to the total amount of goods and services sold (the "sales"), plus if necessary the change in inventories, excluding taxes on products and subsidies on products, except those subsidies that are also granted to all private producers for this type of activity. In all cases, subsidies or transfers to cover an overall deficit are excluded. Own-account production is not considered part of sales in this context.

15. Production costs are the sum of intermediate consumption, compensation of employees, capital services, and other taxes on production. Other subsidies on production are not deducted.

16. The case of units engaged in financial activities needs special consideration. Financial intermediation is usually considered a market activity, and financial intermediaries are classified in the financial corporations sector. However, an important characteristic is that a financial intermediary does not simply act as an agent for other institutional units but places itself at risk by incurring liabilities on its own account. In this context, if a public financial unit does not place itself at risk by incurring liabilities on its own account, it will not be considered a financial intermediary and the unit is to be classified in the general government sector rather than in the financial corporations sector.