

98/2003 - 21 August 2003

New decision of Eurostat on deficit and debt

Capital injections by government units into public corporations

Eurostat, the Statistical Office of the European Communities in Luxembourg, has taken a decision on the accounting treatment of capital injections undertaken by government units into public corporations, as defined in the European System of Accounts (ESA95). Eurostat has specified conditions according to which the transfer of funds to a public corporation has to be recorded either as a financial transaction with no effect on government deficit/surplus or as a government expenditure (capital transfer) with an impact on government deficit/surplus.

The decision is in line with the European System of Accounts (ESA95) and consistent with the opinion taken by a majority of members of the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB).

Background

It has been observed that in some circumstances Member States' governments provide cash to public corporations under their control. Usually the government considers such funding as a form of aid and, therefore, records it as public expenditure. In national accounts this transaction is generally treated as a capital transfer that impacts on government deficit/surplus. Such transactions are normally carried out for government policy purposes.

However, in some cases, governments claim that as a counterpart of this funding, it has acquired a financial asset. Generally, this asset takes the form of shares (an increase in the equity capital of the corporations) but it might also take the form of a loan. Under these conditions, the transaction is not recorded as public expenditure and has no effect on government deficit/surplus.

Eurostat has already examined past transactions of this kind undertaken in some Member States. In some cases, Eurostat has decided that, under national accounts rules, there was no evidence that government effectively received a financial asset, notably when there were strong doubts about the market value of such a claim. As a consequence, some of the capital injections classified as financial transactions were reclassified by Eurostat as capital transfers.

In this respect, the main point is to assess whether government may effectively be considered as a "normal" shareholder or investor, defined as expecting a return in the form of a future flow of dividends and/or a future increase in the value of the financial instrument representing its claim on the corporation.

However, in some cases, either the funding is provided to cover accumulated losses - and, therefore, is just intending to restore an adequate level of own funds of the corporation - or there are strong reasons for believing that the public corporation would not be profitable in the near future.

Eurostat had already fixed a first set of rules with the cooperation of Member States. This material is included in the current ESA95 Manual on government deficit and debt published in 2002 (Second edition, chapter II.3).

However, experience showed that some Member States encountered practical difficulties in applying the existing rules and that there was a need to provide further guidelines on this issue, with the aim to cover a greater number of concrete cases without any change in the spirit of the existing rules.

Eurostat decision

General case

Government injects capital into an existing corporation (that does not, as a consequence, radically change its main activity) that has accumulated net losses as recorded according to Generally Accepted Accounting Principles. Government is acting alone (possible other shareholders do not participate in the injection).

As a general rule, the capital injection is in this case treated as a non-financial transaction for its full amount.

However, there are two exceptions to be considered:

- when both the capital injection exceeds the amount of accumulated losses and it may be shown that the part in excess is exclusively used for investment in already profitable operational areas of the corporation activity. The capital injection is treated as a non-financial transaction up to the level of the accumulated losses and as a financial transaction beyond this amount;
- when a "fundamental restructuring" of the corporation has been designed and decided in order to restore profitability; in this case:
- the capital injection is treated as a financial transaction for its full amount if there is a large consensus on the high likelihood that the corporation will become profitable in the near future due to the restructuring,
- but if there is some uncertainty as to the future effects of the restructuring, the capital injection is treated as a non-financial transaction up to the level of the accumulated losses and as a financial transaction beyond this amount.

Other cases

A first possible additional case relates to a public corporation bearing losses but with the substantial participation of private shareholders (including newcomers) in the capital injection.

Provided some conditions relating to the private investors are fulfilled (notably concerning rights and risks similar to those incurred by government) the capital injection is treated as a financial transaction for its full amount.

A second case might involve a public corporation that has accumulated no losses in recent fiscal years.

The capital injection is then recorded as a financial transaction in "shares and other equity" (or possibly as a loan) for its full amount, except in the event of a change in the conditions of the corporation's activity imposed by government which could raise strong doubts about the future profitability of the corporation. In this case, the capital injection should be treated as non-financial transaction for its full amount.

A last case involves a new public corporation, set up at the time of the injection, or an existing public corporation starting a complete new activity or acquiring new kinds of productive assets, where it is obvious that government does not intend to use this corporation for public policy purposes.

If various analytical elements may show that, after a normal period of losses (as usually observed for similar investment) the corporation should be structurally profitable, the capital injection is treated as a financial transaction for its full amount. If this is not the case, the capital injection is treated as a non-financial transaction for its full amount.

Consequences of the decision

Any capital injection that, totally or partially, is considered as a non-financial transaction is treated as government expenditure and, therefore, has a negative impact on government deficit/surplus.

The treatment in national accounts, for the purpose of the Excessive Deficit Procedure, does not take into account the classification that may be implemented in public accounts. Thus, even where government's

transfers of funds have legally taken the form of shares (or other equity), an impact on deficit/surplus may be recorded if the precise conditions set above are not fulfilled.

As a result, it is important that government authorities consult Eurostat on borderline cases before making a final classification decision. This is in line with the Code of Best Practice endorsed by the Ecofin Council on 18 February 2003.

This news release focuses on the main aspects of the new set of guidelines. For further details, please refer to the new version of the chapter of the Debt and Deficit Manual that will be made available soon.

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CMFB opinion on the treatment in national accounts of capital injections by government units in public corporations

(as proposed in the new draft part II.3.1 Capital Injections into public corporations - revised version 10/06/03 - of the ESA95 Manual on government deficit and debt)

On Eurostat's request the CMFB Chairman, with the assistance of the CMFB Executive Body, invited the CMFB Members on 15 July 2003 to give opinions on the above-mentioned subject. The deadline for returning the questionnaire was Tuesday 29 July 2003. Thirteen (13) national statistical institutes and eleven (11) national central banks from the Member States returned the questionnaire. A total of twenty-four (24) national institutions, from all (15) Member States, thus participated in the consultation. The ECB also provided a reply.

The result of the consultation was as follows:

On question 1:

Do you agree to the new draft part "II.3.1 Capital Injections into public corporations (revised version 10/06/03)" of the ESA95 Manual on Government deficit and debt?

Twenty-three (23) national institutions responded **Yes**, among which seven (7) expressed **reservations** that mainly referred to a lack of clarity of some parts. One (1) national institution answered **No**.

On question 2:

Have you specific remarks on the structure and text of the new version of the chapter?

Twenty-one (21) national institutions had no specific remarks. Three (3) expressed specific observations mainly related to drafting aspects.

Accordingly, the CMFB endorses the content of the new draft part "II.3.1 Capital Injections into public corporations (revised version 10/06/03)" of the ESA95 Manual on Government deficit and debt. It also recommends that this part incorporates the clarifications and drafting improvements advised by CMFB Members, in so far as they do not change the substance.

In addition to this opinion, the following has been transmitted to Eurostat and will be kept in the records of the CMFB secretariat: a document putting together the summary of the votes and all the original answers from the CMFB Members.

(Signed)

Jean CORDIER

CMFB Chairman

Paris, 11 August 2003