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EUROSTAT

Directorate D: Government Finance Statistics (GFS) and quality

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Subject: **Sector classification of *Tiesu namu aģentūra* (TNA)**

Dear Ms Aija Žīgure,

Following the EDP visit to Latvia from 7-9 June 2017, Eurostat would like to provide you with its opinion regarding the Sector classification of *Tiesu namu aģentūra* (TNA).

Thank you for providing the additional information on TNA, including the Court documentation on the decisions on the case of both Administrative District and Regional courts and the additional written explanations to the court from TNA and from the Ministry of Economics of Latvia.

1. THE ACCOUNTING ISSUE FOR WHICH A CLARIFICATION IS REQUESTED

1.1. Description of the case

The State joint-stock company "*Tiesu namu aģentūra"* (TNA) is a public real estate company in Latvia,100% owned by the State (by the Ministry of Justice) that owns selected State's real estate and rents them back to government.

In 2014, the Central Statistical Office (CSB), in compliance with the ESA 2010 rules, reclassified TNA to the list of general government sector units. TNA regarded its inclusion in the government sector list as unfounded and non-conforming to the legal provisions of ESA 2010 and accordingly contested the decision in court in July 2014. In April 2015, the Administrative District Court ruled in favour of CSB. TNA appealed against this decision and won in the second instance at the Administrative Regional Court in March 2016.

The Administrative Regional Court considered that *"there is no dispute between the participants of the case on the fact that the applicant is an institutional unit and that it*

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belongs to the public sector. The participants of the case have differing opinions on whether the applicant may be considered a non-market institutional unit."[1]

The Administrative Regional Court considered that the reasoning indicated in the appealed decision was not providing enough justification to regard TNA as a non-market public sector institutional unit, arguing that the market/non-market activity analysis had been incompletely

carried out. *"The appealed decision includes only a list of legal norms, but there is no reasoning behind the eligibility of the respective norms to the specific case. (…) It is not indicated in the appealed decision to which specific Paragraph of the Regulation the applicant corresponds, in order for it to be reasonable to consider it a non-market public sector institutional unit."*[2]

As explained in part 4, Eurostat broadly supports CSB analysis and fully agrees with the entity classification in the general government sector in national accounts. Similar cases have been observed in a number of EU countries, for instance in Slovenia (see Eurostat's advice letter from May 2017[3]).

In the EDP April 2017 notification and following notifications, CSB continued to include the company in the government accounts, although they removed it from the published list of entities included in S.13. Eurostat supported this pragmatic provisional solution.

Eurostat also discussed the issue of the statistical classification of units challenged (by units) in Courts, also occurring in other Member States, in the EDPS WG (July and December 2017 meetings).

The classification of TNA was discussed during the EDP visit to Latvia on 7-9 June 2017 and Eurostat agreed to provide to CSB an advice letter with a detailed analysis on the TNA sector classification, including the rationale for the reclassification and the applicable ESA paragraphs.

1.2. Background information on TNA

TNA originates from the non-profit organisation State joint-stock company "TNA",[4] which was then transformed into a State joint-stock company according to Cabinet Regulation No. 766 from 14 October 2004.

According to TNA web site[5], TNA provides legal institutions with premises necessary for the fulfilment of their functions and delivers necessary services for their maintenance. TNA effectively manages and rents out real estate for the maximum comfort of both premise users and clients. The highest governing body of TNA is the shareholders meeting, which represents the holder of shares, i.e. the Ministry of Justice. The main lines of TNA business include:
- management and maintenance of real estate being in the possession of the Ministry of Justice;

[1] Judgement of the Administrative Regional Court from 08.03.2016 on the case nº A420351114.
[2] Judgement of the Administrative Regional Court from 08.03.2016 on the case nº A420351114.
[3] http://ec.europa.eu/eurostat/documents/1015035/7878213/Advice-2017-SI-Sector-classification-of-DSU-company.pdf
[4] Established by the Cabinet Order No. 70 from 12 February 1997.
[5] http://www.tna.lv/en/about-us/, accessed on 18.05.2018.

- ensuring the operation of IT infrastructure of Republic of Latvia courts, Ministry of Justice, its subordinate institutions and other clients: maintenance and administration of workstations, servers, and computer networks;
- publication of legal educational books, legal acts and their collections, as well as summaries of court rulings.

TNA manages 54 units of real estate that are fixed assets of the company, including 51 units taken over from the Ministry (of Justice) and 3 newly built properties.

According to the 2015 audit report of the State Audit Office, the Ministry of Justice and its affiliates is the owner of the capital company TNA, as well as the main purchaser of the service provided by this capital company.
The revenue of TNA can be split, by business lines and by sector of its clients, as follows:

(% of output)

<table>
<tr><th>Clients / Business Line</th><th>Min. Justice</th><th>Other State institutions</th><th>Other General Government</th><th>Other public</th><th>Other private</th><th>TOTAL</th></tr>
<tr><td>Management of real estate</td><td colspan="3" rowspan="4">90%</td><td rowspan="4">-</td><td rowspan="4">10%</td><td>80.9%</td></tr>
<tr><td>Renting out real estate</td><td></td></tr>
<tr><td>Management of real estate</td><td></td></tr>
<tr><td>Other</td><td></td></tr>
<tr><td>Maintenance of IT infrastructure</td><td colspan="3">100%</td><td>-</td><td>-</td><td>2.3%</td></tr>
<tr><td>Publishing</td><td colspan="3">100%</td><td>-</td><td>-</td><td>16.7%</td></tr>
</table>

The decision making power for the construction, renovation and reconstruction of buildings takes place in accordance with the annual work plan prepared by the company, which is approved by the representative of the holder of capital shares: the Ministry of Justice.

The company may terminate rental agreements without coordinating its actions with the structure overseeing the company (Ministry of Justice), but only if this is explicitly foreseen by the terms of the rental agreement. The company carries out renovation works with the aim of providing the tenants with the premises required for the fulfilment of their functions. The rental fee is in principle set at an amount that completely covers the expenses of the lessor, which are related to the management of the building being rented out during the rental period.

1.3. Documentation provided

As a follow-up to the EDP visit of 7-9 June 2017, the CSB provided to Eurostat (by e-mail of 31 August 2017) the translations of the following court documents:

- Judgement of the Administrative District court Riga courthouse of 14 April 2015;
- Appellate complaint regarding the judgement of 14 April 2015 of the Administrative district court in the case nº A420351114, of 12.05.2015;
- Acceptance and beginning of the appellate proceedings by the Administrative Regional Court regarding the case, of 22.05.2015;
- Additional written explanations from *Tiesu namu aģentūra* to the Administrative Regional Court in the case nº A420351114, of 01.02.2016;
- Additional written information from the Ministry of Economics to the Administrative Regional Court in the case nº A420351114 of 10.02.2016, provided in the following written explanations of TNA to the Court, of 01.02.2016;
- Judgement of the Administrative Regional Court of 08.03.2016 on the case nº A420351114.

In addition, the CSB provided some information on the TNA case to Eurostat by an e-mail of 14.07.2016 and answered to Eurostat's questions by e-mails of 14.12.2017, 08.05.2018 and 16.05.2018.

2. COURT'S RULINGS

2.1. Judgement of the Administrative District Court - Riga courthouse

On 14.04.2015, after assessing the evidence included in the case and the explanations provided by the parties during the hearing, the Court didn't identify any significant procedural irregularities and acknowledged TNA's conformity to the criterion to be included in the list of non-market public sector institutional units. The Court thus dismissed TNA's application to refuse to accept the inclusion in the list and, as a result, requested the submission by TNA of the quarterly statistical report 2-FAP "Financial Assets and Liabilities".

Following the paragraphs 2.68–2.71 and 20.24–20.29 of Regulation No. 549/2013, the District Court concluded that the merchant is a non-market public sector institutional unit, as *"more than a half of the net turnover of the applicant is formed by payments of other units of the general government sector for the services provided to them. Namely, Paragraph 20.25 of Regulation No. 549/2013 foresees that 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.*
(...) the aims of activity foreseen in the regulations of "Tiesu namu aģentūra" are the management of real estate corresponding with the requirements of the justice sector, ensuring the Ministry of Justice, the institutions subordinate to it, as well as courts with premises required for the implementation of the functions thereof.(...) the applicant has been formed and operates with the aim to provide services to the Ministry of Justice, as well as the institutions subordinate to it and courts." [6]

During the procedure, the Ministry of Finance indeed noted: *"The statutes do not stipulate that SJSC "Tiesu namu aģentūra" aims at providing other tenants who wish to rent premises with real estate. The fact that SJSC "Tiesu namu aģentūra" also provides its services to others and that part of the institutions of the Ministry of Justice are not able to lease premises from the SJSC "Tiesu namu aģentūra" due to the high prices has no major significance in the present situation, as it only indicates a deformed market situation and, possibly, use of real estate not meeting the main aim of the particular economic activity. By its very nature, SJSC "Tiesu namu aģentūra" was established to provide solely the Ministry of Justice, institutions subordinate to it and courts with real estate meeting the requirements of the justice sector."*[7]

The Court judged that *"The Agency has been formed exclusively to provide services to the government (Ministry of Justice), and such a market cannot be considered as a classic market of free competition, in which merchants compete with one another by offering the best price possible for services or goods. The fact that the applicant has been registered according to the procedures prescribed by the Commercial Law is legally insignificant in the context of the specific objection.*

[6] Judgement of the Administrative District Court Riga courthouse from 14 April 2015.

[7] Additional written information from the Ministry of Economics to the Administrative Regional Court in the case nº A420351114 from 10.02.2016, provided in the sequence of the written explanations of TNA to the Court from 01.02.2016.

(…) It is not significant that the defendant has included only the Ministry of Justice in the explanation of the term "government", as it is clear to everyone that the respective term does not refer to only one institution, but it is the body of all public administration institutions."[8]

2.2. Appellate complaint from TNA to the Administrative Regional court

TNA contested the judgement from the Administrative District Court and on 12 May 2015 presented an appellate complaint to the Administrative Regional Court. TNA believes that the assessment to be included in the general government list of entities was not done according to the conditions and objectives of the Regulation.

The appellate complaint regarding the judgement of 14 April 2015 of the Administrative District Court includes the following: *"(...)[6.4] Conclusions on the turnover of the applicant were made on the basis of annual reports that are not included in the case. During the hearing, the applicant was asked only about the funds transferred by the Ministry of Justice, not by other institutions."*[9] TNA considered that, given the fact that there is no reference to net turnover as a non-market feature in any of the respective paragraphs of Regulation No. 549/2013, the Administrative District Court had unjustifiably established that (according to paragraphs 2.68-2.71 and 20.24-20.29) TNA was a non-market public sector institutional unit, on the basis that it had more than half of the net turnover formed by payments of units of the general government sector for the services provided to them.

TNA declined being a non-market public sector institutional unit, selling only to government or being the only supplier of its services. TNA claims that *"it operates in open market conditions by performing open economic activity and gains profit. Ever since the founding of the Applicant in 1997, it has gained profit every year."* TNA "*provides services in the real estate industry, including the provision of services to 36 subjects of private law, thus competing within the open market of real estate rent.* (…) *At the same time,* [TNA argues] *it is not the only service provider. Neither the Decision, nor the Judgement contain any references to evidence that would confirm the opposite*." [10]

TNA did not agree with the definition of the word "government" provided in the Judgement of the court of first instance, and to the underlined reference to the Ministry of Justice, as including as well as the institutions subordinate to it and courts.

TNA explained that "*premises are rented from private renters by all of the following: the Civil Registry Office of the Ministry of Justice, Data State Inspectorate, PLC "Latvijas vēstnesis", Patent Office, State Language Centre and the Legal Aid Administration. In fact, TNA does not only compete with the private sector, but also other institutions of the public sector, for example, the Investment and Development Agency of Latvia, which rents out premises to the Enterprise Register.*

[TNA] *sells its services freely to whoever is prepared to pay the asking price. For example, TNA used to rent out premises to the Ministry of Justice, however, the Ministry of Justice opted out of the services of TNA due to the high rental costs and found a more suitable*

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[8] Judgement of the Administrative District Court Riga courthouse from 14 April 2015.

[9] In "Judgement of the Administrative Regional Court from 08.03.2016 on the case nº A420351114".

[10] Appellate complaint regarding the judgement of 14 April 2015 of the Administrative District Court in the case nº A420351114, from 12.05.2015.

option on the market. TNA is currently renting out premises to two merchants, which carry out catering services and are able to pay higher rental costs than any other public authority."[11]

2.3. Judgement of the Administrative Regional Court

On 22 May 2015, the complaint of "*Tiesu namu aģentūra*" regarding the judgement of 14 April 2015 of the Administrative District Court has been accepted.

On 8 March 2016, the Administrative District Court ruled in favour of TNA, revoking the decision of the Administrative District Court. It considered that *"The court of first instance has not applied the correct legal norms in the judgement, and has also not checked essential actual circumstances of the case."*

It ruled that *"the reasoning indicated in the appealed decision is not sufficient enough in order for the applicant to be recognised as a non-market public sector institutional unit. The appealed decision includes only a list of legal norms, but there is no reasoning behind the eligibility of the respective norms to the specific case. Moreover, it may be observed from the information mentioned in the appealed decision, explanations at the hearing of the court of first instance and the additional explanations at the court of appellate instance that during the decision-making process and the proceedings the institution has not had a single opinion regarding which of the norms of the Regulation No. 549/2013 were applied in the specific case. Considering this, there is no room for the conclusion regarding the sufficiency of reasoning behind the appealed decision.*
(...)There is no dispute between the participants of the case on the fact that the applicant is an institutional unit and that it belongs to the public sector. The participants of the case have differing opinions on whether the applicant may be considered a non-market institutional unit.
(...) Since the applicant is not the only supplier of services to the Ministry of Justice, as well as the institutions subordinate to it and courts, there is no reason to conclude that the criteria mentioned in Paragraph 20.27 of Regulation No. 549/2013 have been met in order for the applicant to be presumed to be a non-market producer.
(...) According to Paragraph 20.25 of Regulation No. 549/2013, 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. A typical case is tendering for a contract with government on commercial terms and therefore government payments are only for services delivered.

It is not indicated in the appealed decision, whether the applicant corresponds to this specific paragraph of the regulation, it is not assessed in the decision, whether the applicant sells only to the government and whether it is the only supplier of its services. According to the information provided by the applicant and the publicly available information, the most notable recipient of the applicant's services is the Ministry of Justice, as well as institutions subordinate to it and courts, but they are not the only recipients of the applicant's services. Moreover, as mentioned previously in the present judgement, the applicant is also not the only supplier of services. Therefore, it may be concluded that the applicant does not correspond to Paragraph 20.25 of Regulation No. 549/2013.

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[11] Additional written explanations from Tiesu namu aģentūra to the Administrative Regional Court in the case nº A420351114 from 01.02.2016.

In the appealed decision, the institution has not mentioned or assessed, whether the applicant is offering an economically significant price. The institution has not carried out a non-market test in the appealed decision in order to conclude that the applicant is a non-market producer."[12]

3. ANALYSIS OF COURT'S RULINGS

On the one hand, the Administrative District Court dismissed the application of TNA "a*fter assessing the evidence included in the case in conjunction with the explanations provided by the participants of the proceedings during the hearing"*[13], concluding that TNA corresponded with the criteria to be included in the list of general government units.

On the other hand, the Administrative Regional Court, having reviewed the materials of the case, considered that "*the court of first instance has not applied the correct legal norms in the judgement, and has also not checked essential actual circumstances of the case*"[14], on the basis of which it revoked its decision to include TNA in the list of the General Government units.

The Administrative Regional Court argues that the lower Court merely listed legal norms with no reasoning behind the eligibility of the respective norm to the specific case. It also argues that the defendant, during the procedure, unclearly referred to ESA 20.27 or ESA 20.25 as the ESA paragraphs deemed relevant to the case.

Although the Administrative Regional Court is formalistically founded to identify weaknesses in the presentation of the case, in substance the analysis of the CSB and the judgement of the Administrative District Court correctly captured the essence of this section of the ESA 2010 covering paragraphs 20.24 to 20.28 (see section 4 below). In addition these paragraphs cannot be understood in isolation without reference to ESA 20.29 or to ESA 20.19 to 20.22. The section 4.3.5 below discusses this in more detail.

The disparity in the conclusions of the two courts may be explained by the comments sent by the Ministry of Economics to the Administrative Regional Court on 10.02.2016: *"Regulation No. 549/2013 cannot be applied literally; many paragraphs are mutually exclusive or applicable in parallel but having conflicting results."*

Along this line, although the three concepts of autonomy of decision, control and market/non-market are clearly defined and distinguished, there are a number of interrelations between them, as a result of their nature and of specific paragraphs of ESA 2010.

In particular, the qualitative criteria can lead to the conclusion that the entity, in fact, is not an institutional unit, if deemed to have the characteristics of an ancillary unit or of an artificial subsidiary (ESA 20.24 and ESA 2.24-2.26). TNA can broadly be judged having those characteristics. Sections 4.3.2, 4.3.3 and 4.3.4 below discuss this in more detail.

Sometimes the spirit of the regulation cannot be correctly captured if read literally or formalistically. The assessment of the genuine nature of the activity of the unit needs to be

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[12] Judgement of the Administrative Regional Court from 08.03.2016 on the case nº A420351114.
[13] Judgement of the Administrative District Court Riga courthouse from 14 April 2015.
[14] Ibid.

analysed. In this context, there are borderline cases that manifest themselves. The most appropriate opinion to the circumstance does not always flow from a literal reading of the text. ESA 2010 applies the principle of substance over form when classifying units, events or transactions (ESA 20.164). To secure methodological soundness, the application of the regulation No. 549/2013 has often to consider the analysis of concurrent paragraphs that lead to different conclusions. In borderline cases, the genuine substance of the case should prevail. ESA 2010 generally cannot be applied literally.

This is the reason why, the conceptual framework and rules set out in ESA 2010 are supplemented by guidelines (advice and guidance notes), which are the result of in-depth discussions between Eurostat and the Member State concerned and its ESS partners. Supplementing guidelines on the appropriate treatment of statistical issues concerning EDP/GFS for the government sector, thus complementing or clarifying ESA 2010, are primarily provided in the Manual on Government Deficit and Debt (MGDD), which has been approved by the DMES by written procedure. All this interpretative material is published by Eurostat on its website.[15]

4. METHODOLOGICAL ANALYSIS AND CLARIFICATION BY EUROSTAT

4.1. Applicable accounting rules

- ESA 2010, Chapter 1 *General features and basic principles*, § 1.31 *Characteristics of the ESA 2010 concepts* and ESA 2010 §1.90 regarding legal and economic ownership.
- ESA 2010, Chapter 2 *Units and grouping of units*, in particular §2.24 to §2.26 *Artificial subsidiaries.*
- ESA 2010, Chapter 3, § 3.12 to §3.13, dealing with *ancillary activity.*
- ESA 2010 §9.24 *Local KAUs within one industry.*
- ESA 2010, Chapter 20 *the government accounts*, notably the section *Market/non-market delineation* § 20.19 to § 20.28.
- In addition to ESA 2010, the Manual on Government Deficit and Debt (MGDD) provides a section dedicated to *delimitation of the general government sector* (Part I), in particular Part I.2 *Criteria for classifying units to the general government sector*, chapter I.2.4 *Concept of a market or non-market institutional unit*. Also Part VI *Leases, licences and concessions.*

4.2. Availability of national accounting analysis

CSB reclassified the State joint-stock company "*Tiesu nama aģentūra*" in the government sector in 2014, alongside with 6 other similar public capital companies that manage real estate of ministries or other State real estate, on the basis that they carry out functions delegated by government, in the form of government real estate management. The reclassification had effect from 2006 onwards.

The practice followed by the CSB and supported by ESTAT foresees that if a company is an institutional unit, which is controlled by government, and the company is carrying out a function delegated to it on behalf of the government (e.g. management of real estate), then it

[15] EDP: Excessive Deficit Procedure; GFS: government Finance Statistics; ESS: European Statistical System; DMES: Director of Macro-Economic Statistics.

is enough to assume that a qualitative criterion is present and an institutional unit is classified in S13.

According to the latest information provided by TNA to CSB, its income from budgetary institutions amounts to 90 % of income. The share has remained unchanged over the past three years (2014–2016).

Resulting from the EDP visit to Latvia on 7-9 June 2017, CSB was to examine and to provide its feedback on the Eurostat advice to Slovenia dated 17 May 2017 on a similar case published on Eurostat's website. On 31.08.2017, the CSB informed Eurostat that the Eurostat advice to Slovenia seemed applicable to TNA. Both companies (DSU[16] and TNA) were established by the government and are mostly holding leases on buildings with government units.

4.3. Methodological analysis and clarification by Eurostat

4.3.1. Sector classification general procedure

In national accounts, the classification of units mainly consists in analysing the entity according to three criteria, being 1) an institutional unit[17]; 2) a government-controlled institutional unit; 3) a non-market institutional unit. One must first establish if an entity meets the criteria of being an 'institutional unit', by testing if it has 'autonomy of decision'. Second, one must determine if the entity belongs to the public sector or not. Third, the activity of the entity has to be clarified, i.e. one identifies if the activity of the entity is market or non-market. The market/non-market test comprises both quantitative and qualitative criteria. As a result, the government sector comprises all institutional units that are public and non-market.

For the analysis of the market character of the unit, according to ESA 20.29: "*For other producers that operate under the control of government, an assessment of their activity and resources is necessary. In order to decide if they are market units, and charge economically significant prices, the criteria as set out in paragraphs 20.19 to 20.28 are to be checked. In summary the conditions are as follows:*

> *(a) the producer is an institutional unit (a necessary condition; see also the decision tree in paragraph 20.17);*
> *(b) the producer is not a dedicated provider of ancillary services;*
> *(c) the producer is not the only supplier of goods and services to government, or, where that producer is, it has competitors; and*
> *(d) the producer has an incentive to adjust supply to undertake a viable profit-making activity, to be able to operate in market conditions and to meet its financial obligations.*

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[16] *Property Management and Consultancy - družba za svetovanje in upravljanje.*

[17] ESA 2010 § 2.12: The Institutional Units – *"Definition: an institutional unit is an economic entity characterised 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 up 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."

The ability to undertake a market activity will be checked notably through the usual quantitative criterion (the 50 % criterion), using the ratio of sales to production costs (as defined in paragraphs 20.30 and 20.31). To be a market producer, the public unit shall cover at least 50 % of its costs by its sales over a sustained multi-year period."

To help on the allocation of units to sectors, ESA 2010 provides a so-called "decision tree diagram" (diagrams 2.1 and 20.1), with a summary of the main questions to be answered, presented in a hierarchical order. However, sometimes, to allocate a unit to a sector based on the tree is not so simple. There are borderline cases that manifest themselves, notably related to the concept of artificial subsidiary or ancillary unit, and to the qualitative criteria (who is the client?). To decide whether the unit is an institutional unit, the interpretation of the autonomy of decision can vary. TNA is a borderline case that is not adapted to the cascade tree. In particular, it is debatable that TNA actually meets in substance the criteria of an institutional unit despite, *a priori*, formalistically meeting the criteria set in ESA 2.12 (see footnote 17).

Indeed, as a borderline case, TNA can in fact be analysed in three ways: being either an artificial subsidiary or an ancillary unit (meaning, TNA is not an institutional unit), or an institutional unit falling within the qualitative criteria – each of them calling for a classification inside government. Aside from that, the activities of TNA can also be judged nonmarket, which also would imply a classification inside government.

4.3.2. Artificial subsidiary

Concept of artificial subsidiary

According to ESA 2.24 and 2.25, artificial subsidiaries are entities created to artificially host either the assets, or the employees, or the liabilities, or a combination thereof, in legally separated structures, whereas these various parts of the enterprise in fact constitute a unique whole, from an economic point of view, and should be recognised as one unique institutional unit. In a sense, each legal entity cannot meaningfully or effectively operate without the others: each entity can be seen as sole (or predominant) client or supplier to the others.

The system thus explicitly recognizes that analysing each producer as if it was by definition or convention operating on a market, independently from its creator and main client, would be a fiction that would not do justice of the economic reality.

TNA as an artificial subsidiary

It can easily be defended that TNA is not genuinely engaged in the activity of renting assets on the market but is a dedicated provider of services to the Ministry of Justice and its affiliated units. According to ESA 2.24 to 2.25, this leads to consider the unit as an artificial subsidiary to be recorded in the general government sector.

Under this view, the establishment of TNA was merely a way for government to organise itself with respect the management of real estate (and renting them out mostly to State's institutions). TNA is not an institutional unit genuinely engaged in the activity of renting assets on the market, on a commercial basis. The major piece of evidence for this is the fact that the government units are responsible for at least 90% of the sale of TNA. It should be noted that the reference to turnover as a proxy of sales appears appropriate to Eurostat. The fact that the term 'turnover' is not referred to in the ESA 2010 itself is without consequence: the term turnover is a reference to source data that are to be used to proxy the sale or output concept referred to in the ESA 2010.

Furthermore, existing lease and auction procedures are not unbiased (see below) and there are indications that applied prices for a large part of turnover cannot be considered as economically significant (i.e. they are not determined by an actual demand and supply mechanism). Only the premises that are unoccupied and are not needed by the Ministry of Justice or its subordinated institutions and courts are subject to auction procedures. Moreover, in the auction procedure a public entity will always be prioritised over the private sector entity, and will be charged only a minimum rent.

Eurostat is of the opinion that TNA meets in substance the criteria for an 'artificial subsidiary', as described in ESA 2.24 to 2.26. In particular, ESA 2.25 says, regarding artificial subsidiaries, that *"their level of output and the price they receive for it are determined by the parent that (possibly with other corporations in the same group) is their sole client. They are, thus, not treated as separate institutional units, but are treated as an integral part of the parent, and their accounts are consolidated with those of the parent, unless they are resident in an economic territory different from that where the parent is resident."*

It seems this view was shared by the Administrative District Court (although the court did not explicitly identify the possibility of artificial subsidiary case).

SNA reference of real estate units as artificial subsidiaries

It is worth noting that international manuals have long recognised that such artificial subsidiaries could be created to host the buildings of a unit for subsequent lease back. SNA 2008 4.63 refers to such case of real estate artificial subsidiaries as the first case in its list of examples: "*For example, the parent may create a subsidiary to which ownership of its land, buildings or equipment is transferred and whose sole function is to lease them back again to the parent corporation; the subsidiary may be the nominal employer of all the staff who are then contracted to other corporations in the group, the subsidiary may keep the accounts and records of the parent on a separate computer installation; the role of the subsidiary may be established to take advantage of favourable funding or regulatory treatments and so on. In some cases, corporations may create "dormant" subsidiaries that are not actually engaged in any production but which may be activated at the convenience of the parent corporation."* The SNA 1993 4.42 had already this reference.

The ESA 2010 is the European version of the SNA 2008, and is, in principle, fully compatible. While the ESA 2010 sometimes deviates from the SNA 2008 in the letter, it often merely copies literally the SNA 2008, although in an abbreviated way, often dropping long lists of examples as well as detailed explanations. As the result, SNA 2008 paragraphs are generally directly applicable as a source of interpretation of ESA 2010 – unless some ESA 2010 paragraphs not existing in SNA 2008 are seen as conflicting with them. In case of conflict, ESA 2010 obviously prevails.

Artificial subsidiaries and ancillary subsidiaries

It should be noted that the notion of artificial subsidiary is introduced in ESA 2010 and SNA 2008 and explicitly distinguished from a sister notion, that of ancillary unit. In comparison, SNA 1993 4.44 tended to assimilate them. Although ESA 2010 2.26 and SNA 2008 4.66 explicitly point to the fact that the two notions do not coincide, they remain relatively close with significant overlap. One can surmise that a distinction between the artificial subsidiary and the ancillary unit relates to the fact that the latter exclusively

concerns activities that are common to all producers following ESA 2.26 and SNA 4.66. Another distinction may be that ancillary activities may be recognised as local KAU[18] following the additional explanation of SNA 4.66, while artificial subsidiaries may not (in particular, when such entities have no employees).

4.3.3. Ancillary producer

Concept of ancillary unit and proximity to the qualitative criteria

ESA 3.12 states: "*An ancillary activity is an activity whose output is intended for use within an enterprise. An ancillary activity is a supporting activity undertaken within an enterprise in order to enable the principal or secondary activities of local KAUs to be carried out. All inputs consumed by an ancillary activity — materials, labour, consumption of fixed capital, etc. — are treated as inputs into the principal or secondary activity which it supports."* and ESA 2.26: "*Ancillary activities are limited in scope to the type of service functions that virtually all enterprises need to some extent or another such as cleaning premises, running the staff payroll or providing the information technology infrastructure for the enterprise."*

Considering chapter 20 of ESA 2010, in the part regarding the *Market/non-market delineation* sub-part *Criteria of the purchaser of the output of a public producer, The output is sold only to government*, TNA could also be considered as a unit carrying out 'ancillary activities' as described in ESA 20.24.

The fact that this reference to ancillary units is included within the ESA 2010 section *the output is sold only to government* (ESA 20.24 to 20.26) is not by accident. It aims at emphasising the proximity of the case of units created to sell to government only, or mostly, and the ancillary unit case. These paragraphs indicate that when sales are exclusively delivered to government, it is considered that the entity is non-market, unless the contracts have been attributed through public tender. ESA 20.27 and 20.28 indicate that when sales are partly delivered to government, a public producer can be considered as a market producer if more than the majority of sale is to non-government entities or fulfils the tendering condition (see section 4.3.5).

Regarding TNA, even if there are some minor revenues from non-government entities, on the one hand, there is a very high dependence from government as crucial customer and, on the other hand, there is the government ownership of TNA, which means that government *de facto* acts on both sides of the transaction.

As a secondary activity TNA also provides to Government IT services which are explicitly mentioned in ESA 2.26 and 3.12 as ancillary activity.

Renting back buildings as a case of ancillary activity

Although renting buildings is not explicitly mentioned in the ancillary activity examples in ESA 2.26 and in the list in ESA 3.12, renting equipment is explicitly cited in ESA 9.24. In addition, taking into account that the list provided in ESA 3.12 is not exhaustive but is open, it is worth noting that renting of offices can be considered to be meeting the ancillary activity general definition from ESA 3.12 and ESA 2.26 seen above. Also in support of this view, as mentioned above, the SNA 1993 explicitly referred to leasing of buildings as a first example of ancillary unit.

[18] Local kind-of-activity units.

Moreover, according to the MGDD, section VI.2.2.1 *(Sale and leaseback) - The unit is created on purpose by government*, point 6. "(…) *As long as the main activity of the involved unit is to provide rental facilities to the government which created it, it is classified in the general government sector.*
7. If its only activity is to provide services to a single government unit which created it, it is considered to be engaged in an ancillary activity (see ESA 2010 2.26. It is thus not considered a separate unit from its government parent. No transaction in national accounts has to be considered: neither a transaction on assets when created, nor later any transactions in goods and services – output and intermediate consumption."

Recognising ancillary activities in the production account

Similarly to the case of artificial subsidiary, the entity providing ancillary services is not considered as an institutional unit. This is mostly based on the fact that the monopolistic or quasi-monopolistic arrangement prevents genuine autonomy of decision (here: TNA largely holds buildings and rents them mostly to government units), aside from preventing pricing at economically significant prices.

Under ESA 2010, ancillary activities are in fact transparent. ESA 1.31 states that *"the outputs of ancillary activities shall not be recorded (within the production boundary). All inputs consumed by an ancillary activity shall be treated as inputs to the activity it supports."* As a result, the ancillary activities do not show in the input/output tables, in general.

Nonetheless, ESA 2010 and SNA 2008 recognize that ancillary activities may in some circumstances be recognised as a specific local KAU (i.e. establishment): when this is analytically useful to do so and source data are available, or when the activities take place in a separate location. In this case, the output of those activities are shown separately as additional P.1 with additional P.2 and some value added reported in the predominant NACE.

Interestingly, SNA 5.44 also prescribes: "*It is appropriate to treat specialized agencies serving central government as a whole, for example, computer or communications agencies, which tend to be large, as separate establishments.*" TNA has also such IT activities. Eurostat considers that this statement of the SNA is a clear invitation to recognise dedicated unit supplying services as a local KAU, but not as an institutional unit.

4.3.4. Treatment of part of output sold to outsiders

It should be noted that SNA 5.44 explicitly foresees the case where the ancillary unit starts selling some of its output outside its parent or sister subsidiaries. "*When an activity starts to provide a proportion of its services to outsiders, the part of the output that is sold has to be treated as secondary rather than ancillary output.*" The SNA 2008 guidance is therefore not to conclude that the unit is not an ancillary unit anymore, but that the part sold outside should be recognised as a secondary output. This guidance is important to the extent that it explicitly articulates what statisticians do in practice: minor flows are not to be taken into account when interpreting ESA/SNA and deciding on classification.

For this reason, the fact that a small fraction of TNA sales are not to Government units does not mean that neither ESA 20.24 nor ESA 20.25 – 20.26 are applicable. It is thus Eurostat's view that the concerns of the Administrative Regional Court while comprehensible, are however unfounded based on the economic approach followed by ESA 2010. It would

require that the extra sales are sufficiently meaningful, as the Administrative District Court recognised.

The notion that the fact that a fraction or part of the output is sold to outsiders does not change the statistical treatment of the ancillary activity is also applicable to artificial subsidiaries. The existence of output sold to outsiders is consistent with the sole function of TNA to leaseback to the parent. A sole function can be fulfilled while having primary and secondary products, some of the latter possibly sold to outsiders.

In addition, only when Government is not interested in renting, the properties are leased to outsiders. This further underlines the fact that TNA has for sole function the leaseback to the parent.

4.3.5. Qualitative criteria – ESA 20.24-20.28

Qualitative criteria, an innovation of ESA 2010

As indicated above, ESA 2010 innovated by expressly inserting, for the determination of the sector classification, criteria – often called qualitative criteria – concerning cases where the client of the entity is government itself, only or mostly. These considerations are grouped under ESA 20.25 to 20.28.

In addition, this approach and its motivation are explicitly spelt out in ESA 20.22 as well as ESA 20.21. ESA 20.24 also provides implicitly a line of argumentation.

Indeed, ESA 20.21 explains that judging if prices meet the economically significant prices can be difficult for public units. ESA 20.21 ends up stating that even if sales constitute a large share of costs (i.e. meet the 50% test), this would not necessarily mean that the unit is market. "*Public corporations are often established by government to provide goods and services that the market would not produce in the quantities or at the prices to meet government policy. For such public units enjoying government support, the* ***sales may cover a large part of their costs, but they will respond to market forces differently from private corporations***."(bold added)

ESA 20.22 goes on to explicitly indicate that knowing who is the client and whether there is competition is important to sort out whether the activity is market: *"…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.*" This paves the way to the subsequent ESA 2010 paragraphs (20.23 to 20.28).

As already noted above, in section 4.3.3, the ESA 2010 section "the output is sold to government" formed by ESA 20.24 to 20.26 starts with considerations on ancillary units. This ESA 20.24 paragraph is thus deliberately inserted in this section, in order to emphasize the parallel with cases where an entity apparently meets the institutional unit but sells its output to its creator.

The writer of ESA 2010 then foresees 4 cases, establishing a sort of matrix, depending on whether the company created sells all or only most of its product to the parent (monopsony or quasi-monopsony) and the parent buys the type of product only from that entity or not (monopoly).

Paragraphs that lead to a classification of institutinal units inside Government, depending on the monopoly situation and the part of sales to Government

		Sole supplier	
		Yes	No
Part of sales to S.13	All	ESA 20.25	ESA 20.26
	more than 50%	ESA 20.27	ESA 20.28
	less than 50%	*	**

* Derived by general criteria: prices not economically significant and 50% test.

** Supposed not covered by ESA 20.28, derived by the general criteria: prices not economically significant and 50 % test.

Differentiation of the 4 cases

Although the paragraphs 20.25-20.28 contain differences in drafting, in reality, their reasoned interpretation leads to the conclusion that there is a dominant factor: the absence or presence of competition.

A first point to clarify is that ESA 20.25-20.28 are not meant to provide some derogation to the 50% test foreseen in ESA 20.29 and 20.30 for units that are providers of goods and services to government as their sole business or to a significant extent. These paragraphs are meant to provide additional criteria for deciding that a unit should be classified inside general government. This derives from mere logic, otherwise one would have the anomaly that while a public producer would need to pass the 50% test, it would be relieved from this only based on the fact that a part of its sales would be with government. Aside from mere logic, this is also proved by the drafting of ESA 20.29 which provides for a sequence of tests to apply, with ending with the 50% test that all units must pass: "*To be a market producer, the public unit shall cover at least 50 % of its costs by its sales over a sustained multi-year period.*"

A second point to clarify is that while ESA 20.25 sets criteria for the unit to be non-market, ESA 20.26-20.28 sets criteria for the unit to be market. Taking into account the first point above, to obtain a comparable basis, one needs to 'invert' ESA 20.26-20.28. This is done in the table below.

Finally, ESA 20.28 seems drafted so to encompass also cases when the share of sales to government is below 50%. This seems not realistic. It is presumed that ESA 20.28 places itself in a situation where the majority of sales are outside government to be a market producer, as a variation to ESA 20.27.

The combination of those points leads to populate the matrix the following way based on ESA 20.25-20.28, having in mind the general criteria for classifying nonmarket units:

		Sole supplier	
		Yes	No
Part of sales to S.13	All	S.13 unit, unless competition with private and meeting the 50% test	S.13, if no competition or if prices not economically significant or if 50% test fails
	more than 50%	S.13, if no competition with private or if prices not economically significant or if 50% test fails	S.13, if no competition or if prices not economically significant or if 50% test fails
	less than 50%	S.13, if prices not economically significant or if 50% test fails	S.13, if prices not economically significant or if 50% test fails

As can be observed, the unit is reclassified inside government if not passing the 50% test or the prices are not considered to be economically significant, or not meeting a certain competition test through tendering contracts: with at least one private competitor if the entity is the sole supplier; with competitors (presumably private or public) if the unit is not the sole supplier.

Upon this reading, it thus appears that the criteria are thus essentially the same across ESA 20.25 – 20.28: whether competition exists and manifests itself through tendering – irrespective of whether TNA is considered sole supplier or solely supplying government.

In which cell of the matrix TNA falls into?

Given that not all TNA sales concern government and that government rents buildings from other entities, one may consider that ESA 20.28 is applicable. However, the qualitative criteria can't be assessed so formalistically. Instead, the assessment of the genuine nature of the activity of the TNA should be analysed.

TNA is carrying out functions delegated by government and it is a dedicated provider of ancillary services to the Ministry of Justice and other government entities (leasing of buildings and IT services), whereas it is also the only supplier of judicial publications. The remaining part of its leasing activity (output sold to private sector) is not significant in size. In addition, the sale of judiciary publications is merely a secondary activity of this unit. TNA sales to non-government entities are thus sufficiently marginal such that in practice its output can be considered to be received only from Government. TNA could thus resort to 20.25 or 20.26.

Even if the entity is not the sole supplier of assets to a local KAU / department, this may not be relevant for the classification, for instance when the assets are dedicated. It will be enough that the entity is the sole supplier of some specific or dedicated assets. The sole supplier concept can't be taken in the wide sense: to be the sole supplier of specific assets will be enough. Thus, TNA could resort to ESA 20.25 (or potentially to 20.27).

Given the fact that some of the assets are specific (i.e., court's rooms), the company has *de facto* a monopoly which leads to the fact that the specific criteria applicable for the qualitative test is less credible. Even if there is an auction procedure, it applies only when renting to private entities, thus only for a small part of the leasing. For the largest part of the leases, the applied prices are not determined by an actual demand and supply mechanism. This would imply a classification inside government under ESA 20.25 (or potentially 20.27).

In national accounts, the classification of units is based on the economic substance of the organizational arrangements/structures or transactions and not on the legal design (see ESA 1.90 and 20.164) (substance over form). The Ministry of Justice created an entity which is the legal successor of the rights, liabilities, functions, property and financial resources of the non-profit organization SJC "*Tiesu namu aģentūra*" and which can only be a market unit if some criteria apply. TNA rather resembles an artificial subsidiary or an entity providing ancillary services to the Ministry of Justice, as section 4.3.2 and 4.3.3 have developed.

4.3.6. Economically significant prices

In case TNA would be judged neither an artificial subsidiary nor an ancillary unit, and would not be considered to be classified inside government according to the qualitative criteria (i.e. because of the specific relation it has with its main client), an analysis would then be required regarding whether the price of the rentals can be judged to be market, that is: to meet the economically significant price criteria, or not.

As explained in ESA 20.19 and following paragraphs, as well as in the MGDD section I.2.4.1 - *the concept of "economically significant prices"*, the capacity of producers and consumers to react to economic "signals" is fundamental when assessing market behaviour.

A price is said to be economically significant according to ESA 20.19 when it has *"a substantial influence on the amounts of products producers are willing to supply and on the amounts of products that the purchasers wish to acquire."* The MGDD adds: *"The capacity of producers and consumers to react to economic "signals" is fundamental as to assess market behaviour. A price is said to be not economically significant when it has little or no influence at all on how much the producer is prepared to supply and have only a minor influence on the quantities demanded. It is thus a price that does not determine the observed levels of supply or demand."*

Eurostat understands[19] that the renting prices of the real estate units owned by TNA are set according to the internal regulations regarding real estate rental procedures prepared by the company and approved by the representative of the holder of capital shares (Ministry of Justice). According to the regulations, the rental fee for the real estate units managed by TNA is set at an amount that completely covers the expenses of the lessor, which are related to the management of the building being rented out during the rental period, according to Cabinet Regulation No 515 (08.06.2010) "Regulations on the Procedure of Leasing Property of a Public Person, Methods for Setting the Rental Fee and Standard Terms of Rental Agreements". The auctions for renting real estate (applicable only for selected private entities) are also carried out according to the internal regulations regarding real estate rental procedures prepared by the company and approved by the representative of the holder of the capital (Ministry of Justice).

Eurostat thus observes that the settlement prices, the procurements and the auction procedures are based on internal regulations of TNA, a company owned by the Ministry of Justice. The Ministry of Justice is then the rule setter as well as both the owner (thus, accordingly, the supplier) and the major customer of the business of the company.

Furthermore, according to the audit report from the State Audit Office from February 2016[20], *"in certain cases the lease payments determined under the agreements concluded by*

[19] e-mail from CSB of 14.12.2017.

[20] http://www.lrvk.gov.lv/en/no-long-term-development-planned-legal-sector-property-discovers-state-audit-office/

Courthouse Agency [TNA] are not justified with specific calculations, as stipulated in the applicable regulatory enactment. Also, the payments are not examined on the basis of the actual real estate maintenance costs.

As a result, two thirds or 67% of the leased property are practically unprofitable and in some cases the maintenance costs exceed the income from the lease payments by up to 60%. The losses are compensated by charging unreasonably high lease payments for the remaining one third of the objects. Since the objects managed by Courthouse Agency are usually public bodies and 95% of the income of Courthouse Agency are obtained from the State budget, thus, to some extent, creating the principle of communicating vessels: losses of the State from very high lease payments for some objects are compensated by unreasonably low lease payments for other objects. The State Audit Office believes that such cross subsidization is not acceptable, because such practices are not oriented towards long-term profits from managing of buildings."

In addition, according to the CSB answers by e-mail to Eurostat, "*if the Government has a need for that real estate, even if a private party offers a better price in an auction, it will not win since the operational objective determined in the regulations of TNA foresees the management of real estate corresponding to the requirements of the justice sector, as well as providing the Ministry of Justice, the institutions subordinate to it, and courts with premises required for the implementation of the functions thereof."*

Based on these elements, it can also be concluded that the prices set out by TNA do not follow market based calculations and are not economically significant in the sense of ESA 20.19 to 20.22.

The auctions are carried out for a small part of the turnover This is consistent with the fact that "*67% of the leased property are practically unprofitable and in some cases the maintenance costs exceed the income from the lease payments by up to 60%"* (according to the State Audit Office). Economic significant prices require at a minimum that capital costs and other costs are covered (ESA 3.19(a)).

5. CONCLUSION

Eurostat supports the statistical treatment decided by CSB. It is of the opinion that TNA should be classified into the general government sector S.13. TNA has real estate assets and rents offices, at least 90% of which to the Ministry of Justice or other entities of general government. Moreover, TNA statutes in practice creates an obligation to keep servicing the needs of the Ministry of Justice and its affiliates, and, as a result, although there are auctions for marginal part of the rental assignments, government is in fact prioritised over other market bidders.

The establishment of TNA is merely a way for government to organise the management of real estate (and renting them mostly back to State institutions). TNA is not an institutional unit genuinely engaged in renting assets on the market, on a commercial basis. Its activity is to provide services to the government unit which created it.

In the face of these elements, Eurostat is of the view that TNA should be classified in the government sector on the basis of four main ESA 2010 references:

1. TNA is not genuinely engaged in the activity of renting assets on the market but is a dedicated provider of services to the Ministry of Justice. According to ESA 2.24 and 2.25, TNA can be seen as an artificial subsidiary (also in the light of SNA 4.63);
2. TNA can be considered as a unit carrying out 'ancillary activities', taking into account that its sales to non-government are indeed sufficiently marginal such that

its output can be considered to be received only from Government, so that the provisions set in ESA 20.24 and ESA 1.31 and 3.12 would prevail.

3. The spirit of the qualitative criteria should be genuine and can't be taken formalistically. The genuine nature of the activity of the TNA is to hold buildings to be rent mostly to government units with monopolistic/monopsonic or monopolistic/quasi-monopsonic arrangements that prevent genuine autonomy of decision, as well as pricing at economically significant prices. Accordingly ESA 20.25 would apply (or potentially 20.26 to 20.28 – all leading to the same conclusions).
4. Because of the obligation of TNA to service the needs of its creator, the Ministry of Justice, and its affiliates, and given the practice observed by the Court of Auditors, the prices charged do not seem to meet the economically significant price, such that TNA is a unit essentially providing non-market services.

Each of these arguments in itself suffices to classify TNA inside general government.

6. PROCEDURE

This preliminary view of Eurostat is based on the information provided by the statistical authorities of Latvia. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its view.

We would like to remind you that Eurostat is committed to adopting a fully transparent framework for its decisions on debt and deficit matters in line with Council Regulation 479/2009 and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat therefore publishes all official methodological advice (ex-ante and ex-post) given to Member States, on the Eurostat web site.

Yours sincerely,

(e-Signed)
Luca Ascoli

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