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Committee of the Regions

ESA 2010 accounting rules

Impact of new ESA 2010 on Local and Regional Authorities

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1. Executive summary

The European Commission has recently updated its accounting standards used for the production of national and regional accounts data - the European System of Accounts (ESA) - to better reflect the changes occurring in world economies and production processes globally. The update was implemented through a Regulation in May 2013 and the ESA 2010 rules have been fully in force since September 2014. The primary motivation for the new standards is to capture more accurately the performance of an economy and also to ensure that the European standards are internationally compatible, making it possible to describe the total economy of a region, country or group of countries in the EU in a way that is reliably comparable with other economies in the world.

A number of methodological changes, which have an impact on macro-economic indicators such as GDP, public debt, etc., have been incorporated in the revised ESA 2010 standards; and most Member States are using the opportunity to also incorporate statistical changes (new data sources, improvement of sources, etc.). The key changes involve capitalisation of research and development (R&D) expenditure, and also military expenditure; modification of methodology for goods sent abroad for processing (recorded only as an export processing service and not as goods exported); a more detailed analysis of pension schemes; and an improvement in measuring the contribution of non-life insurance to GDP by reducing the volatility caused by the varying nature of claims. Another important change, also pertinent to local and regional authorities (LRAs) is the change in sectoral classification wherein the definitions for assessing whether an entity is government, public corporation or private sector are modified and include also qualitative criteria. In terms of transmission of data, a faster deadline has been envisaged (also for the main regional accounts indicators) for more timely, improved monitoring.

With specific regard to the impact of these changes on LRAs, a number of potential issues emerge, verified also through a series of interviews/ case studies carried out for the purposes of this study. The methodological changes which have a regional variation, e.g. R&D which varies widely across the regions, shall cause some restructuring in the budgets and allocations of LRAs, thereby affecting their investment capacity. The impact on structural fund allocations, though not immediate, shall be felt after 2016 when the allocations data shall be reviewed based on updated regional GDP data for the years 2012-2014.

Two key issues, as evidenced by the case study of Belgium, may hamper the performance of LRAs. Firstly, the fact that all expenditure (including investments) is recorded as debt and thus the capital aspect of investments is

completely ignored by the ESA 2010 standards. This implies a risk of inflating the amount of public debt, a key parameter used in economic monitoring, and thereby a reduction in the spending capacities of LRAs. Secondly, since the capital nature of government expenditure is not considered, all expenditure is accounted for in a single year and cannot be written down / amortised over a period of years. This seriously affects the regional accounts balance, for example, in the case of Walloon regional accounts wherein a surplus of €560 million becomes a deficit of €330 million, simply because expenditure cannot be amortised over a period of time. A third important matter in this regard is the reclassification of the public sector, implying that the debt of sectors which were previously not part of the public sector is now to be absorbed by the governments and be classified as public debt.

The technical impacts of the changes on LRAs are quite limited, as evidenced by the case studies in Italy, Romania and Sweden. Even the change in transmission deadline for key indicators of regional accounts, revised from 24 months after reference year to 12 months after, have no real implications on LRAs or even regional statistical offices, as the compilation of regional data occurs centrally. However, one point of concern here is the fact that since the technical impacts on LRAs are minimal, no specifically targeted communications/ training activities have been organised for the LRAs, even if in practice these changes might affect their spending capacities. Also, very limited involvement of LRAs through consultations in the preparatory phases of the regulation and in the implementation phases has been observed so far, even if the new standards will affect the spending capacity of several sub-national administrations, raising questions on the credibility of these new rules.

As regards recommendations, the primary solution is to relax the ESA 2010 rules to allow certain degree of flexibility in the calculation of public debt: especially strategically important structural fund investments (e.g. for sustainable development) could be excluded from strict debt categorisations. Additionally, if changing the rules proves too difficult, LRAs need to explore alternative paths such as channelling investments through non public sector entities. Lastly, even if the technical impacts are weak at local/ regional levels, LRAs must be properly trained of the changes in order to facilitate successful, inclusive transition to ESA 2010.

2. ESA 2010 analysis of new rules

2.1 Overview of ESA 2010 and rationale for update

The European System of Accounts (ESA) is the framework for the measurement of the economical and financial activities of an economic system, its components and the relations between them in a given period of time. It sets down the harmonised methodology that must be used for the production of national accounts data in the European Union (EU). It is used both for national-level and regional-level accounts.

In 2009, the United Nations Statistical Commission endorsed a revised set of international standards for the compilation of national accounts: the System of National Accounts (SNA) 2008. The European System of National and Regional Accounts 2010 (ESA 2010) is the adaptation of 2008 SNA to the European context. ESA 2010 is consistent with the 2008 SNA with regard to definitions, accounting rules and classifications. This compatibility means that European national and regional accounts data is fully compliant with international standards and can be used for meaningfully comparing performance with other economies. It nevertheless incorporates certain differences, particularly in its presentation, which is more in line with its specific use in the EU. The specific situation refers to the fact that macroeconomic figures in Europe, besides the 'traditional' roles of preparation and evaluation of policy, also play a major role in various 'administrative' procedures, e.g. the excessive deficit procedure, the macroeconomic imbalances procedure, the EU budget own resources and the structural funds allocation. By way of example, the monitoring of government finance and, in particular, the excessive deficit procedure (EDP) requires high-quality data that should be fully comparable across EU Member States. The same is true for determining Member States' respective contributions to the EU budget, as the calculation is based on gross national income (GNI). ESA 2010 was adopted as a legally binding regulation 549/2013[1], and Member States are expected to have started transmitting national account according to the new standards from September 2014 onwards.

The rationale for changing the ESA framework from the erstwhile ESA 95 to the current ESA 2010 has been to better reflect the performance of the economy in line with changes occurring in world economies. It will adapt the national accounts to the current economic environment, advances in methodologies and changing user needs. It is important to note that the ESA 95, the former

[1] European Commission (2013), *Regulation (EU) No 549/2013 of the European Parliament and the Council, of 21 May 2013, on the European system of national and regional accounts in the European Union,* (OJ L 174 of 26.06.2013).

methodological framework, for producing national accounts data has been developed in the 1990s. In the meantime, substantial changes have impacted economies, in particular the increasing role of information and communication technologies in production processes, the growing importance of intangible assets, intellectual property products and services, and the globalisation of economic systems. A shift of manufacturing production by multinational corporations to emerging countries has resulted in the international fragmentation of production processes, facilitated by rapid advances in communication and information technology, and financial innovation. The way in which macroeconomic statistics are compiled needs to be adjusted accordingly, to reflect these changes.

The changes concern important economic indicators such as GDP, external trade and the net international investment position, as well as government deficit and debt. The changes will also have an impact on the recording of debt of non-financial corporations and the saving ratio of households. As regards GDP, the weighted average impact of methodological changes is an increase of 2.3% as at 2010, of which +1.9 (around 80% of the total impact) is due to the capitalisation of research and development (see below). Another related point worth noting here is that the Member States also took the opportunity to re−benchmark their national accounts, review their data sources and introduce new or improved ones. These statistical improvements increased GDP by 1.4 %, creating an upward revision to total GDP for the EU−28 of 3.7 % in 2010. In addition, also the harmonised inclusion of illegal activities into the GDP, these numbers may further escalate. The introduction of ESA 2010 did not affect much the EU−28 government deficit ratio, but at national level there were some significant changes. Nine countries improved their deficit ratios and eleven worsened them. Revisions to the government debt ratio were quite substantial in a number of countries and at the EU level, were revised from 79.9% to 78.2%, a -1.7% change for the EU−28.

2.2 Analysis of key changes in ESA 2010

Several changes have been introduced in the new ESA 2010 framework as compared to the erstwhile ESA 95, and a detailed manual has been prepared by Eurostat[2] delineating the exhaustive list of changes, consequences of these changes in terms of national estimates and numerical examples illustrating these

[2] Eurostat (2014), *Manual on the changes between ESA 95 and ESA 2010*, Publications office of the European Commission, Luxembourg.

changes. The current section highlights the key methodological changes[3] in the new standards, focusing specifically on those which are significant in terms of their impact on economy/ potential for additional burden, and presents the rationale for introducing these changes. Changes pertinent to regional accounts are analysed in the following section.

Capitalisation of research & development expenditure

Research and development (R&D) has long been recognised by economists as having the characteristics of fixed assets: defined ownership rights, long-lasting and repeated uses and benefits in production process. However, ESA 95 (even if it considered mineral exploration; computer software; entertainment, literary & artistic originals as intangible assets) did not recognise R&D as capital formation, despite the fact that it is thought to be a major contribution to future economic growth. Instead, R&D expenditure, whether conducted on own account or purchased, was recorded as intermediate consumption, meaning that it was recorded as "completely used in the production process" at the end of the period. As a result, the balance sheet of the economy was understated, as well as GDP and operating profits. In ESA 2010, outputs of R&D are now capitalised, meaning they are recognised as assets and the acquisition, disposal and depreciation of R&D fixed assets will be treated in the same way as other fixed assets. This is the major improvement introduced by 2008 SNA and ESA 2010 and the expansion of the asset boundary also to include R&D expenditure is only logical and especially relevant in a modern, increasingly digitised economy like the EU. In the conservative world of accounting, it is quite a bold change, coming way ahead of business accounting practices.

The most immediate and visible impact for users will be that the level of GDP will be increased for all countries, by an amount depending on their investment in R&D. It will lead to macroeconomic balance sheet data that have better analytical capacity. According to preliminary estimates the level of GDP will be boosted by 1.9% in Europe (weighted average of Member States). The impact of this change has been estimated at 2.5% in the United States, due to, relatively, more R&D expenditure in the US. However, the European figure is an average that masks diversity among Member States due to variability in their respective R&D expenditure. The change will also influence other indicators that are contingent on the level of GDP, such as debt and deficit ratios. Potential difficulties in measuring R&D involve setting the absolute value of these

[3] This section draws heavily and expands upon papers / guidelines prepared by Eurostat, the European Central Bank and the work of specialised experts through papers presented in conferences. See for example, the highly pertinent paper by Eurostat experts, Gueye, Gallo and Jens Gruetz (2014), *Issues Related to the Introduction of ESA 2010 in Europe*, Paper Prepared for the IARIW 33rd General Conference, Rotterdam, the Netherlands, August 24-30, 2014.

investments and especially the measurement of price and volume split. As there hardly is any information on market prices of R&D-expenditures, a substantial part of which is produced on own account, most countries have to rely on some kind of input method to measure volume and price changes.

Capitalisation of military expenditure

In ESA 95, military acquisitions of weapon systems and their means of delivery such as military aircrafts or vessels were treated as intermediate consumption regardless of their life length and only the acquisition of those military structures and equipment which were considered to have a civilian equivalent were to be recorded as capital formation. Examples given were airfields, docks, roads and hospitals. This treatment does not correspond to the economic reality as weapons and their means of delivery are used for a long period and can even be exported after several years. In ESA 2010, the boundary of military capital assets is extended to include military weapons and supporting systems, even if they have no equivalent civilian purpose as long as they are items of value and last longer than a year. ESA 2010 treats as gross fixed capital formation all expenditure by the military which meets the definition of being used in production over a period in excess of one year, regardless of the nature of the expenditure or the purpose intended for it, in particular regardless of its destructive potential. Military weapons systems, comprising vehicles and other equipment such as warships, submarines, military aircrafts, tanks, missile carriers and launchers are fixed assets, used continuously for more than one year in the production of defence services.

The impact of this change for the accounting of destructive weapons and their means of delivery on GDP (equal to consumption of fixed capital of these weapons and means of delivery) obviously differs among countries depending on their military budget; a rough estimate is a weighted average increase of around 0.1% of GDP for the EU as a whole. An issue under this particular heading may be the sometimes confidential nature of the relevant expenditures.

Goods sent abroad for processing

The ESA 95 treated goods that are sent abroad for processing and then returned to the country from which they were dispatched as exports for their full value when they leave the first country and in imports when they return to it. Because of the growing international fragmentation of production processes, it is more logical to look at the value added content of trade flows, by subtracting the import content from the exports and, by doing so, removing the double counting implicitly included in gross trade flows. The ESA 2010 and the new Balance of Payment Manual (BPM6) use a change of ownership recording which is no

more based on physical movement. In fact, the new treatment recognises that the recipient country does not export goods but exports its processing services.

Under ESA 2010, the value of goods sent abroad for processing will no longer impact both gross imports and gross exports figures. Also, the value of the processing will be re-classified as export/import of services. Thus, in the national accounts and the balance of payments, the level of exports and imports of goods will be reduced while the level of exports and imports of services will increase. This is important for international trade analysis. For example, for countries that significantly undertake processing, their goods trade balance will be negatively impacted, while their service trade balance will be positively impacted. It is important to note that, as the new recording affects symmetrically exports and imports, there is practically no impact on the overall balance of external trade of goods and services. So there is no significant impact on GDP.

A more detailed analysis of pension schemes

ESA 95 recognised pension obligations on the balance sheet only for funded schemes; unfunded employer schemes did not lead to recognition of liabilities for the employer. Also no pension entitlement was recognised for households (employees & retirees) in the case of unfunded schemes. ESA 2010 recognises in its core accounts employment-related pension entitlements, irrespectively of whether the schemes are funded or not. In addition, a supplementary table presents all accrued-to-date pension entitlements in social insurance; including unfunded government pension schemes and social security pensions, besides also allowing for reporting on household retirement resources, to enable countries to report all pension schemes including those which are not part of social insurance. Hence the supplementary table shall provide a powerful tool for economic analysis of households' pension wealth across countries.

ESA 2010 also changes the recording of lump sum payments that are sometimes received by governments from public corporations in exchange of the taking over of the pension liabilities of these employers. Previously, under ESA 95, such a lump sum was considered revenue of the government, and thus positively impacted its deficit in the year of the transaction. ESA 2010 does not recognise it as revenue, as, in fact, it is compensated by an increase in the pension obligations of the government. This may lead to some correction of the deficit figure for the few Member States that have recently undertaken such transactions.

Non-life insurance

ESA 2010 will in particular improve significantly the measure of the contribution of insurance services to GDP. Under the previous system, this contribution was based on the difference between premiums and claims. As the level of claims may be quite volatile (catastrophes are more and more frequent), the result was itself volatile. In ESA 2010, the formula of calculation of the non-life insurance output has been amended and an "adjusted claims" methodology is used in order to smooth the level of this output.

The consequence of the change is that the non-life insurance service charge (output) is less volatile, and value added less likely to be negative under ESA 2010. Using the ESA 95 approach, in times of unusually large claims, the payments for the service charge by customers may be negative reflecting the large amount of money transferred as claims are made. In ESA 2010, the service charge calculated using adjusted claims ensures that the service charge remains representative of the activity of nonlife insurance over an extended period of time.

Other changes - sectoral classification etc.

There will be a number of other changes that could affect GDP or some other important variables, such as general government deficit and debt, due, for example, to some reclassification of units notably following the refinement of the 50% sales to costs criterion for the distinction between market and non-market. Given the important policy requirement for accurate figures on government deficit and debt in Europe, and the experience of applying ESA 95 in determining reliable estimates, there is a significant increase in material on these issues in ESA 2010 over ESA 95. The changes include expanded guidance on the **sector boundaries between government, public corporations, and private corporations**. Under ESA 95, an entity is classified to the general government sector if it is either a non-separate institutional unit from the government, or when separate but controlled by the government, it satisfies the non-market criterion of having 50% or less of its production costs covered by sales. In ESA 2010, besides this 50% quantitative criterion, a number of qualitative criteria are also applied - such as the entity's economic motivation, independence in respect of undertaking a profit-making activity and the ability to pay its debts without government support, in order to ensure that only independent entities that are motivated by market competition fall outside the general government sector. The ESA 2010 also provides for a clearer separation between non-financial corporations and corporations that are not directly engaged in non-financial activities, such as holding companies of non-financial corporations and other so called captive financial institutions. These changes

allow a better analysis of the financing and investment of non-financial and financial corporations.

Based on first preliminary data, the impact of these changes on the overall EU economy aggregates appears limited. The change in the criteria for determining whether an entity is part of the general government sector is likely to increase the number of units classified in the sector and thereby increase government debt and also to have a small impact effect (increase or decrease) on government deficit levels. Further, differing on a country to country basis, these changes might cause some serious adjustments in public debt and deficits in some Member States. For example, in Croatia, the application of ESA 2010 has led to a remarkable rise in public debt from 60% to 80% of GDP[4], not because of new debt creation but because of the change of the methodology, the debts of the shipyards were included in the public debt and as of next year the budget will have to swallow also the debts of the Croatian motorways (estimated at around €30 billion of guarantees and debt).

Transmission programme

Alongside the methodological rules for the compilation of the national accounts figures, also the transmission programme has been changed in order to allow for more detailed and timely data, e.g. on sector accounts and financial accounts. Under the ESA 2010, the release deadlines will be brought forward to two months (60 days) after the reference quarter, from the current deadline of 70 days after the reference quarter. Specific changes in the transmission programme of regional accounts have been explained in the following section.

The new ESA 2010 transmission programme supposedly will allow an improved monitoring of economic changes in the next 15 years. More complete balance sheet data shall be made available, also more quarterly variables, with improved timeliness and seasonal adjustment, and a complete new set of data on potential obligations of government.

The overview of the impact of the above methodological changes (and other key ones) on the main economic indicators in the EU has been presented in the table below.

[4] Marini, Adelina (2014), *Croatia Supports More Flexibility of Fiscal Rules*, euinside <http://www.euinside.eu/en/news/croatia-again-in-recession-autumn-economic-forecast-gjurkovic> [accessed 14 May 2015].

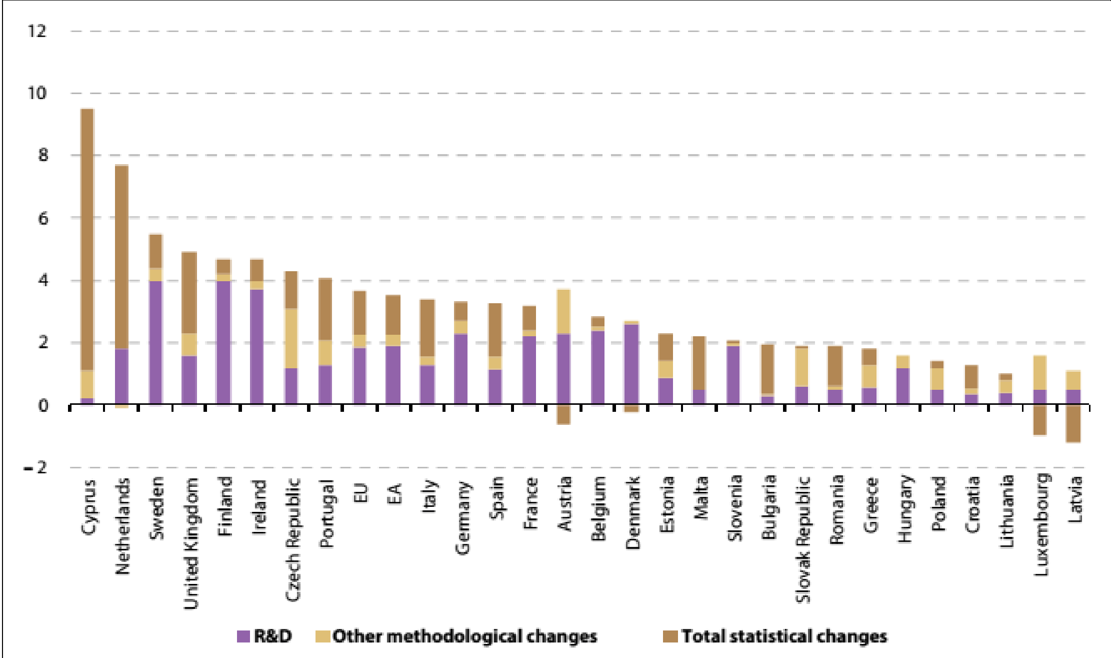
Table 1: Expected impact of main methodological changes on important macro-economic variables

Variables	Change in level	Explanation
GDP and investment	Increase	• The ESA 2010 records expenditure on research and development and on military weapon systems as investment, rather than intermediate consumption. • Many Member States carry out a statistical benchmark revision (usually every five to ten years) to introduce new data sources and compilation methods. This generally has an upward effect on GDP and gross national income (GNI).
Net trade in goods and services	Increase or decrease	• Goods sent abroad for processing are no longer considered as exports/ imports of goods as no change of ownership occurs. The valued added in processing is instead recorded as a manufacturing service. • Merchanting of goods is reclassified from services to exports of goods (in net terms) by the country of the merchant, although the goods do not physically cross the border. • Financial intermediation services indirectly measured (FISIM) are classified as financial services, rather than other investment income.
Net international investment position (i.i.p.) External debt	Increase or decrease Increase	• It is clarified that entities (such as special purpose entities) registered or incorporated in a country are deemed to be resident in that country, even if they have little or no physical presence there. • The treatment of the allocation by the IMF of special drawing rights as a liability of the central bank (or general government) will increase the external debt and decrease the net i.i.p. • The foreign direct investment relationship is extended to better cover complex, multi-economy corporate structures. Positions will be reclassified from other types of investment (portfolio or other investment) with, in principle, no effect on the total net i.i.p.
Government debt	Increase	• Stricter criteria will shift publicly controlled "borderline" entities into the government sector.
Government deficit	Increase or decrease	• The impact of the higher number of government entities on the government deficit may vary. • Settlements under swaps are no longer treated as interest (payable or receivable). The deficit may increase or decrease as a result. • Lump-sum payments to government to cover a transfer of pension liabilities will no longer reduce the deficit. If the lump sum is less than the pension liabilities transferred, the deficit will increase.
Household saving and pension claims	Increase	• Employer contributions to pension schemes record the increase in accrued pension rights of households. In the case of underfunded defined benefit pension funds, this will lead to increased income and saving of households as employer pension contributions are recorded as a part of compensation of employees, i.e. income, which is saved.

Source: ECB Monthly Bulletin, August 2014, p. 85.

As regards GDP in particular, the impact of the methodological changes (split between R&D related versus other), as well as the statistical changes, spread across the Member States is presented in the figure below.

Figure 1: Impact of methodological and statistical changes on the level of GDP, 2010 (in % terms)



Source: Eurostat.

3. Potential impact on LRAs

On an overall level, it may be stated that the idea of updating the European accounting rules in line with international standards is a commendable one. It is worth noting that the revised 2008 SNA has already been implemented in the USA, Australia and Canada as early as 2009-13 (Australia in 2009, Canada in 2012, the USA in 2013) and therefore the updates in the European standards to increase comparability of data across economies is indeed praiseworthy. However, since changes in the accounting standards necessarily imply a change also in the budgets/ spending capacities of LRAs, the impact of these changes at the local/ regional level needs to be carefully studied.

3.1 Key implications of the changes for LRAs

At the regional level, *two types of effects* can be distinguished.

Firstly, the impact of changes at national level which do not have a specific regional variation. This is the case for instance for weapon systems expenditure, which is not allocated across regions in a different way than before. These changes will affect the GDP of all regions equally, and will therefore not affect the spread of GDP between regions. Secondly, the impact of changes which do have a regional variation. The most important change of this type is the treatment of research and development expenditure as investment. Since R&D tends to have a higher incidence in Member States and regions with a relatively high GDP per inhabitant, an increase in the spread of GDP per inhabitant among regions is expected.

In specific regards to the *allocation of structural funds*, a key item in the budgets of LRAs, the impact is not immediate but shall be felt after 2016. The allocation of structural funds for the current multi-annual financial framework (2014-2020) was decided in 2012 on the basis of regional GDP data for the reference years 2007 - 2009. The allocation will be reviewed in 2016, most probably on the basis of regional GDP data for the reference years 2012-2014. This data set will be compiled in accordance with ESA 2010. Due to the potential increase of the spread in regional GDP per inhabitant that will result from the implementation of ESA 2010 there should in theory be an impact on regions whose values of GDP per inhabitant were very close to the eligibility thresholds for structural funds assistance in 2012. This is especially relevant for instance in the case of a region receiving structural funds assistance while at the same time investing a considerable amount of resources in R&D, the main factor in the upward increase of GDP per inhabitant.

The European Commission, however, claims that since R&D activities tend to be concentrated in regions of relatively high GDP per inhabitant, including in comparatively less prosperous Member States, such effects would be very small compared to other changes resulting from the developments of economic activity at the regional level that have taken place since 2009. The validity of this argument shall only be verified when the allocation shall be reviewed in 2016.

3.2 Impact on performance of LRAs

In addition to the key implications of the methodological changes to ESA 2010 highlighted in the previous sub-section, there are certain provisions in the new standards that have the potential of impairing the performance of governments in general and LRAs in particular. They deal specifically with the potential of increase in government debt and thereby a reduction of the budgets and spending capacities of LRAs. For the sake of clarity, the consultants would like to repeat the fact that this potential increase in debt is not because of new debt creation in the regional/ local economies but because of changes in the accounting methodology, and hence a matter of concern for LRAs. In this regard, two major issues indicated below have been repeatedly stressed as pertinent for LRAs by relevant regional stakeholders, such as the Committee of the Regions (CoR) and the Council of European Municipalities and Regions, amongst others.

Categorisation of all government expenditure as debt

The first major issue with ESA 2010, as with the ESA 95 standard, which emanated from the application of the Maastricht Treaty, is that it continues to record public investment only as debt without taking into account the capital assets relating to it. In other words, as the CEMR[5] notes, the ESA 2010 does not distinguish between expenses made by the LRAs towards operational costs and those towards investments. So, all investments of the government are counted as debt and add to the debt-to-GDP ratio which has a ceiling of 60% of GDP in order to stay out of the corrective mechanism of EU's budgetary control, the Excess Deficit Procedure (EDP). Under the Stability and Growth Pact, the EDP operationalises the limits on the budget deficit and public debt given by the thresholds of 3% of deficit to GDP and 60% of debt to GDP (failing to meet which fines/ sanctions may eventually be imposed on Member States) and since the regional budgets are integrated into the national budgets, the LRAs are

[5] Council of European Municipalities and Regions (2014), *EU accounting rules must not jeopardise public investment*, CCRE < http://www.ccre.org/en/actualites/view/2962> [accessed 20 May 2015].

forced to reduce their investment considerably. The same point was clearly stressed by CoR in its "Opinion of the European Committee of the Regions — Guidelines on the application of the measures linking the effectiveness of the European Structural and Investment Funds (ESIF) to sound economic governance" (2015/C 140/06): *"(CoR) therefore reiterates its concerns regarding Eurostat's new ESA 2010 accounting framework, implemented as from September 2014, which makes no distinction between expenditure and investment and which obliges local and regional authorities to apply maximum investment ceilings per year and per inhabitant. These ceilings could prevent local and regional authorities in certain Member States from providing the co-financing needed for ESIF projects. The Committee therefore urges the Commission to present a report on the implementation of ESA 2010"*.

The CEMR, in its declaration in Rome, on 17th December 2014, at the occasion of its Policy Committee meeting, calls for *"the review of the accounting rules (ESA 2010) to treat expenses for investments different than expenses for operational costs, allowing public authorities to invest in the maintenance and improvement of their infrastructure and services to the benefit of the citizens and businesses and a sustainable and competitive future. It also underlines the need to exclude public expenditure related to the implementation of the Structural and Investment Funds programmes from the budgetary surveillance rules"*.

Budgeting of expenditure (investment) in a single year

A related point to the one mentioned above is the fact that since government expenditure is not considered as capital investment but merely debt or expenditure, the whole sum is accounted for in the year in which it is made. According to general accounting rules, investments can be depreciated. However, since ESA 2010 does not recognize the capital nature of government investments (i.e. makes no distinction between operational expenses and investment), there is no room for depreciation/ amortisation of these investments. As Hugues Bayet of the European Parliament notes[6], *"It is like asking a citizen to pay for their house in just one year. It is all the more unwelcome as the extremely low interest rates cost the authorities less and therefore become more profitable. But, for the many authorities who repay their investment on a multiannual basis, it is a real brake on investment"*.

This particular provision has potential repercussions for regional accounts. For example, in a speech at the same declaration of the CEMR mentioned above, Jacques Gobert, the President of the Union of Cities and Municipalities of

[6] Bayet, Hugues (2014), €300bn European investment plan will be hampered by ESA, The Parliament Magazine <https://www.theparliamentmagazine.eu/articles/opinion/%E2%82%AC300bn-european-investment-plan-will-be-hampered-esa> [accessed 20 May 2015].

Wallonia (Belgium), indicated the impacts of the ESA 2010 which does not allow for amortisation of government expenses. Taking the example of the accounts of Walloon region's cities and municipalities, he noted that under their own accounting rules, which allow (and even require) the amortisation of investment, the accounts show a surplus of €560 million, a figure which becomes a deficit of €330 million in ESA accounting, because the investment cannot be amortised and must enter into the accounts in the year as a current expense.

3.3 Transmission changes and information gap

Of the three tables[7] related to regional accounts, a change in transmission deadline occurs only in the case of table 10[8]: 'Tables by industry and by region (NUTS level 2)'. The general transmission deadline for regional statistics remain unchanged at t+24[9] months, however some important indicators are required to be reported under the revised deadline of t+12 months. Specifically, an important data set in the EU policy context is the information on gross value added and employment at regional level (table 10), which provides input for the allocation of the most important structural development budget of the EU, the Structural Funds. Currently, this information is only available 24 months after the end of the reference year. This deadline will now be advanced to 12 months, providing more timely information for policy decisions.

Another related aspect to consider here, besides the change in transmission deadline, is the short transposition timeline. From the regulation in June 2013 to the required submission of updated accounts in September 2014, a quick understanding of the changes from ESA 95 to ESA 2010 is required and regional stakeholders may not yet be ready to accept/ implement these changes. It is worth noting that regional stakeholders have not been involved in consultation processes either during the preparation of the regulation or thereafter, and naturally, there is not enough clarity regarding the proposed changes at the local/ regional levels. In addition, no consideration has been placed on the potential added burden of these rules on LRAs/ statistical offices and this raises questions on the credibility of the new standards.

[7] Table 10 - Tables by industry and by region (NUTS level 2); Table 12 - Tables by industry and by region (NUTS level 3); and Table 13 - Households accounts by region (NUTS level 2).
[8] These commonly employed "table numbers" are well-established references across Europe among data-providers and compilers.
[9] Indicates the time-lag after which data becomes available: for e.g. t+24 implies that regional accounts for the year 2013 become available only 24 months (or 2 years) after 2013 - i.e. in 2015.

3.4 Note on statistical changes in regional accounts

For the specific purpose of regional accounts, apart from the faster transmission timelines, the following changes[10] can be observed between ESA 95 and ESA 2010 in recording of the data. This sections aims to assist the *statistical offices and other relevant stakeholders* by highlighting the key differences in preparing the accounts based on the new standards. The sections indicated below (e.g. ESA 13.21, 13.40, 13.44 etc.) refer to Eurostat's manual on ESA 2010 standards[11].

1. Local Kind of Activity Units (KAUs): ESA 13.21, sections b) and c) provide new texts about respectively 'production units without significant labour input' and 'production activity without a fixed location'.

2. ESA 13.40 provides another concept for the allocation of Financial Intermediation Services Indirectly Measured (FISIM) to user industries[12].

3. ESA 13.44 is a new item about per inhabitant data and the fact that these data are not calculated for the extra-regio territory.

4. ESA 13.46-13.48 regard a new item for regional accounts: the compilation of volume growth rates of regional GVA.

5. ESA 13.55 regards an extension of the regional household accounts with the use of income accounts.

6. ESA 13.55 regards a new item for the regional accounts: social transfers in kind.

7. Though not mentioned explicitly in chapter 13 of ESA 2010, attention should be drawn to conceptual changes for GFCF (see ESA 2010, par. 3.124 - 3.129):

    a. Weapons systems.
    b. Research and development.
    c. Databases.

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[10] See Annex 4 of Eurostat (2013), *Manual on regional accounts methods*, Publications Office of the European Union.

[11] Eurostat (2013), European System of Accounts ESA 2010, Publications Office of the European Union (refer specifically to Chapter 13, pp. 321-326) <http://ec.europa.eu/eurostat/en/web/products-manuals-and-guidelines/-/KS-02-13-269> [accessed 14 May 2015].

[12] The concept to allocate FISIM to user industries has been applied by the Member States from 2005 on.

4. Narratives from case studies

For the purpose of this study, the consultants interviewed a number of relevant authorities/ experts, spread across the EU (Belgium, Romania, Sweden and Italy) in order to gain a balanced viewpoint and build narratives on the regional/ local impact of ESA 2010. A series of interviews were conducted from 21st to 29th May 2015 and the following respondents were involved: Hugues Bayet (Mayor of Farciennes and Member of the European Parliament) representing *Belgium (focused on impacts in the Walloon region)*; Mrs. Mondilu (National Institute of Statistics, Romania) representing *Romania*; Linda Kollberg (Statistics Sweden) representing *Sweden*; and finally information was also collected from the *Marche and Puglia regional statistical offices of the Italian National Institute of Statistics* (ISTAT). On an overall level, a great level of information could not be extracted from these case studies (except in the case of Belgium) as the general awareness of ESA 2010 was not very high (because of its new-ness) and the potential impacts, especially at regional/ local levels, have not yet been assessed.

Of the several interviews, only in the case of Belgium, it emerged that ESA 2010 accounting rules are debated with a strong reference to the impacts on local and regional levels. This is the reason why a peculiar attention has been dedicated to the Belgian case (with a separate case study presented); whereas for the Romanian, Swedish and Italian cases, which highlight merely technical aspects related to the ESA 2010 rules implementation, the key insights generated have been summarised and presented jointly.

4.1 Belgian case[13]: impact on LRAs' performance

In Belgium, a public debate was started in spring 2015 on the impact of the European budgetary coordination on LRAs investment capacity, with specific regard to the changes in ESA 2010 accounting rules. This debate, which includes both political and highly technical components, is summarised, expanded through one targeted interview and presented in the following paragraphs.

[13]This case study on Belgium is based on technical, political and mass media sources. The main source is a study, published by Belfius Research in May 2015, entitled 'Les pouvoirs locaux dans le cadre du pact de stabilité budgétaire et des normes SEC – Analyse thematique Finances Locales'. On the political level, the position of the Mayor of Farciennes (and Member of the European Parliament) Hugues Bayet has been considered, taking into account an article published on 'The Parliament Magazine' in December 2014, an interview conducted on 26 May by our researchers, and a technical note sent directly by the team of Mr Bayet. Also two articles published on the Belgian business newspaper L'Echo, respectively on 10 April and 27 May 2015, were taken into account

The economic context of Belgium is characterised by a public debt of over 60% of the GDP. This forces the country to adopt a restrictive and corrective budgetary plan under the New Stability Pact for the period 2015-2018. These new financial constraints are of key importance for the Belgian LRAs' investment capacity. Since 13 December 2013 - as a consequence of the Cooperation agreement between the Federal State, the Communities, the Regions and the Community Commissions on the implementation of Article 3(1) of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union - the Belgian LRAs are integrated in the process of public budget coordination and programming. In other words, Belgian LRAs are directly committed to the achievement of the national annual budget objectives, without having the possibility to take part in the negotiations. Furthermore, it is worth noting that over the last 20 years, LRAs in Belgium have demonstrated the capacity to generate a significant share of public investments in a country featured by a general low capacity of public investment (1.6% of GDP, being one of the lowest registered in Europe). A more direct participation of LRAs could offer the occasion to emphasise that public debt incurred by these authorities represents only 5% of the national public debt, whereas LRAs' weight in terms of public investments amounts, since 1995, to ~40% of the public investment at national level.

In such a context, the debate in Belgium has highlighted a number of direct negative impacts of the ESA 2010 accounting system on the performance of LRAs by reducing their spending capacities.

The first major issue is that no distinction is made between financial needs linked to the exploitation cycle (operational costs), and investments (gross fixed capital formation according to ESA 2010). The impact on Belgium's LRAs is especially important because the financial needs accounted for according to ESA 2010 at regional/ local level are almost entirely related to investments. Another highly relevant issue here is the lack, in the ESA 2010 accounting system, of the financial asset management perspective. The investments costs are accounted as debts in the local authorities' accounts, but the assets are not considered. The implication is that even if LRAs focus their spending on necessary, financially viable investments, they will still face accounting problems as the expenditure shall add to the public debt. As a natural consequence, it was noted that LRAs in Belgium are forced to under-invest, which represents a sort of hidden debt, because it will generate future (and probably higher) costs.

The second issue refers to the necessity, for the local authorities, to account the budgeting expenditure in a single year. In the previous section, it was highlighted that the whole sum of the investment enters into account in the year in which the investment is made. Therefore, there is no amortisation or

depreciation possible for the investment. This negatively affects the balance of regional accounts (as for example in Walloon region, where the surplus of €560 million is converted to a deficit of €330 million in ESA accounting) and it becomes increasingly difficult for LRAs to obtain loans, even if favourable rates would encourage opting for this solution. The new ESA 2010 standards are expected to have a serious impact on a number of Belgian municipalities, especially those which repay on multi-annual basis.

The last ESA 2010 issue which is considered to have a negative impact on the Belgian LRAs is the reclassification of public entities. In detail, entities like alternative financial entities, Public Private Partnerships (PPP), or social housing societies at regional level are considered now to be part of the public sector. A total of 700 entities were reclassified in Belgium and participate now to the deficit and the public debt, as illustrated in the table below (see Table 2). This new element is expected to have an important impact on the Walloon region, for example, where a social housing company invested in an affordable housing project before the ESA 2010 implementation. This organisation is now registered as a public sector entity under ESA 2010, and the project is accounted as a debt of approximately €11 billion at the regional level.

Table 2: Impact of the transition to ESA 2010 on the financial balance and public debt (2013) in Belgium

	Financial balance		Public debt	
	€ Millions	%	€ Millions	%
Federated entities: Communities/ Regions (S1312)	-640.5	0.16%	+18,030	4.6%
Local governments (S1313)	-92.4	0.02%	+2,804	0.7%

Source: Belgian High Council of Finance (November 2014).

All these factors are considered as serious threats to the Belgian LRAs' capacity for investment. Another example of a negative impact based on ESA 2010 is in Liège, a city of Walloon region, which had to stop its tramway line project. The new accounting standards therefore affect the quality of life of citizens and the services provided to them. The risk of the ESA 2010 standards for LRAs and indirectly for the citizens could be to increase taxes or bring to the decision to sell public assets.

The debate in Belgium is of particular interest not only because of the problems identified, but also because some feasible transferrable solutions have been identified to minimise the impact on LRAs. Some very specific technical solutions appear as ESA 2010 neutral, and could be therefore immediately adopted by LRAs across Europe. The first solution implies that a third party

supports the investment risk through operational leasing, concession contracts or some form of Public Private Partnership (PPP). Another possibility is to identify bodies, which do not belong to the group of public entities affected by the budget constraints and channel investments through such bodies, without increasing the public debt. It is clear that both solutions imply the transfer of the risk, from the public sector to outside of it.

It is worth noting that in Belgium also more 'political' solutions, implying a new interpretation of the ESA 2010 accounting rules, are under discussion, with particular regard to the possibility to consider differently the investments which are feasible, clearly defined in terms of management costs and financially sustainable. For instance, in the CEMR declaration (see footnote 5 above), Mr. Jacques Gobert, President of the Union of Cities and Municipalities of Wallonia, calls for excluding some categories of structural funds investments from the budgetary surveillance procedures, which should be possible through exploring further the flexibility offered by the Stability Pact.

4.2 Other case studies- Sweden, Italy and Romania: key narratives

Limited technical impacts for regions

In terms of the potential technical impacts, especially in reporting according to the new standards and respecting the new transmission deadlines, it seems that local/ regional stakeholders are not seriously affected. For instance, even if Statistics Sweden admitted that ESA 2010 is more complicated than ESA 95 owing to its methodological changes, there seemed to be no major issues in collecting and transmitting data according to the new standards and transmission deadlines. The required indicators of preliminary regional accounts could easily be made available in t+12 months (instead of the earlier t+24 months). In Italy as well, both in the case of Marche and Puglia regions, it emerged that the regional levels were not involved in calculating the indicators or the regional accounts. The regional offices collected data, verified its accuracy and passed it on to the national office where indicators were calculated and the regional accounts produced. Romania, similarly, concurred that the change in accounting standards concerned only the national level as the compilation of regional accounts data was performed at a central level while and that the transmission from ESA 95 to ESA 2010 was not difficult to manage. Therefore, all potential technical impacts related to the change in methodology/ transmission etc. affected only the national office and not the sub-national levels.

Lack of regional involvement

The awareness on the ground at the local/ regional levels of the new ESA 2010 standards is limited. In Italy, the comprehension of the ESA 2010 accounting system by the regional offices mainly depends on the access to the web platform developed by the national office of statistics. The necessity of a more structured process of learning did not arise, as the new commitments for the regional offices appear as very limited. Likewise, in Romania, the national statistical office highlighted that they did not consider the change in ESA standards as a relevant issue for regional statistical offices and hence much efforts were not spent on informing/ training stakeholders at sub-national levels (a press release detailing the key changes was issued, as in the case of other Member States). Again, in the case of Sweden as well, awareness of the ESA 2010 seemed to be at a national level. This indicates a general lack of involvement of LRAs and the regional perspectives both during the preparation of the legislation (through consultations) or thereafter (through trainings/ targeted communications). Hence, it would be a reasonable assumption to extrapolate that, since ESA 2010 is treated largely as a matter of national concern (and not sub-national), many local/ regional authorities across Europe, whose budgets may potentially be impacted by the change in ESA, are not properly informed (and in some cases, not even aware, especially in the case of smaller local authorities) about these new accounting standards. Further although it is true that the technical impacts at the regional/ local levels are minimal, the potential reduction of budgets/ investment capacity of LRAs is a matter of serious concern.

5. Conclusions / recommendations

As conclusion, taking into account the information gathered from literature review and the case studies organised as well as the consultants' understanding of the impacts of the new ESA 2010 on LRAs, the following sets of recommendations are prescribed.

Recommendation 1: change in items affecting public debt

This two-fold recommendation calls for additional flexibility, and if possible, slight modifications in the ESA 2010 rules to account for the perspective of LRAs. Since it may not be feasible to allow all public investment at the local/ regional levels to be excluded from adding to the public debt, *certain strategically important categories of structural funds investments*[14] (esp. those focused on sustainable economic development, mobility infrastructure, public housing, and health and social inclusion facilities) *could be excluded from the strict definitions of public debt and the triggering of Excessive Deficit Procedures*.

The second natural consequence of categorising these structural expenditures as 'investment' would imply that these *can be amortised over a period of years under general accounting standards*. This would allow LRAs greater control in planning their budgets over a long period.

Recommendation 2 (alternative to 1): adjustment by LRAs

As a substitute to the recommendation 1 above, if it proves difficult to alter the ESA 2010 rules, *LRAs need to be flexible enough to explore alternative paths* (even if it implies additional complexity) and the Commission must strongly support such paths. For instance, the learning from the case of Belgium, where *strategies to channel investments either through the private sector* (e.g. public-private partnerships) *or through an entity not categorised as a public body* might be a possible solution to circumvent the strict 'public debt' calculation and restrictions thereof.

[14] These categories are highlighted by Mr. Gobert in the CEMR declaration above (see footnote 5).

Recommendation 3: better training/ involvement of LRAs

Lastly, for a smoother transition, even if the rules do not cause a technical impact on LRAs, they have to be properly trained/ informed of the changes in ESA. *A more structured approach to reach out to LRAs and regional statistical offices in order to communicate/ coach them* is essential for grassroots level acceptance/ implementation of ESA 2