Irish Fiscal
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Analytical Note No. 6: Adoption of New International Standards for National Accounts and Balance of Payments

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Analytical Note 6: Adoption of New International Standards for National Accounts and Balance of Payments

New international standards for economic statistics are being adopted this year. The change concerns a number of definitions, methods and measures underpinning the National Accounts and Balance of Payments statistics. The introduction of these new guidelines has led to a number of changes to how Irish economic activity is measured which – among other things – boosted the overall level of Irish GDP. This has significant implications for various fiscal measures as well, given that annual budget deficits and debt levels are typically scaled against nominal GDP levels when assessing national and European fiscal targets. This note examines the main changes to the Irish National Accounts and Balance of Payments under the revised framework as well as the associated fiscal implications.

Moving from ESA 95 to ESA 2010

EU National Accounts are compiled according to guidelines set out by the European System of National and Regional Accounts (ESA). In 2014, the new ESA 2010 framework replaced the previous rules dating back to 1995 (the ESA 95) and all EU Member States were legally required to adopt ESA 2010 by September 2014.[1] At the time of the release of the annual NIE results for 2013 last July, Ireland was among the first countries to have published results under the revised framework.

The move to ESA 2010 has brought European economies broadly in line with international standards for measuring economic activity such as those outlined in the UN Systems of National Accounts 2008. The US, Canada and Australia had already conformed to the revised global standards.

Key Changes To Macroeconomic Activity

The new guidelines have implications for a vast number of areas.[2]

A reclassification of Research and Development (R&D) spending is by far the biggest change to how Irish output is calculated. Having previously been recorded as a part of intermediate consumption (i.e. a further cost in the course of production), the new rules now treat R&D as investment expenditure in

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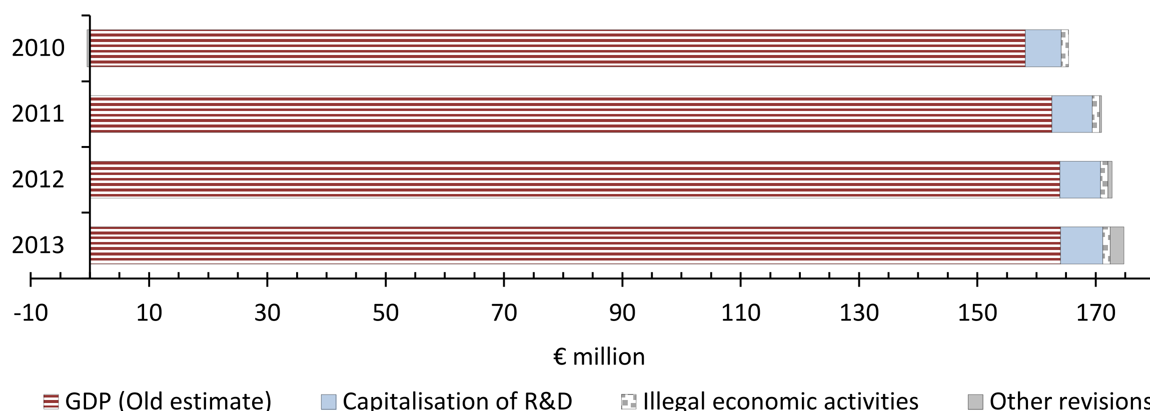
[1] ESA 95 – the predecessor to ESA 2010 – was published in 1996 (Council Regulation (EC) No 2223/96 of 25 June 1996 on the European System of national and regional Accounts in the Community). The legally binding implementation schedule for the ESA 2010 was published in Council Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European System of national and regional Accounts in the European Union.

[2] The new framework is outlined in detail in the European system of accounts (2010), with changes from the ESA 95 guidelines outlined here.

R&D assets. This has two impacts: it adds to overall GDP levels[3]; and it adds to the total stock of fixed assets measured in the economy in the form of an additional stock of intangible R&D assets (i.e. intellectual property). The updated NIE 2013 estimates saw R&D activities contribute just over 4 per cent to overall GDP levels in 2013 and similar amounts in earlier years.

In addition to the ESA 2010 changes, more formal methods for including estimates of illegal activities such as prostitution and drug trafficking in the National Accounts are introduced. These components represent a relatively small part of the Irish economy, however (see Figure N.1). To put them in context, at just 0.7 per cent of total GDP, they equate to roughly one-third the size of the agricultural, forestry and fishing sectors in Ireland.

FIGURE N.1: COMPOSITION OF NOMINAL GDP REVISIONS, 2010-2013



Source: CSO.
Note: Other revisions also incorporate revisions that form part of the normal course of estimates being updated as additional information becomes available between releases.

In total, the official estimates of nominal GDP for 2013 saw an upward revision of €10.7 billion – a dramatic increase and one larger than had been expected on the basis of early CSO indications for the ESA 2010 impact alone (IFAC 2014a).[4] While the level of activity has shifted upwards due to the new rules, it is important to note that this does not have a major bearing on underlying growth dynamics provided that the scale of the newly recognised areas remains relatively unchanged over time.

ECONOMIC OWNERSHIP

Another important change to the National Accounts under ESA 2010 has important implications given the increasing globalisation of modern manufacturing activities. The changes have consequences for

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[3] It takes the form of investment spending in the expenditure approach and value added in the income approach.

[4] The latter had excluded revisions that form part of the course of normal updates, albeit the combined effect of including illegal economic activities and R&D spending was estimated. Early indications were for an upward revision to nominal GDP of €4 billion - €5 billion.

how trade in manufactured goods is recorded. ESA 2010 follows a stricter “change of economic ownership” principle for goods transactions compared to ESA 95. Changes of ownership between residents and non-residents are now the foremost consideration rather than the actual physical movement of goods across borders. As a result, transactions follow their financial counterparts more closely. The new approach more accurately reflects the globally integrated production processes used by multinationals and the actual monetary flows associated with their activities.

The revised standards have a sizeable impact on the scale of gross goods exports in some cases. In particular, recording of goods for processing, deliveries between affiliated enterprises, production abroad and merchanting activities are all impacted. For cross-border deliveries between affiliated enterprises (mother and daughter companies), ESA1995 assumed by definition a change of economic ownership. The new guidelines require a judgement on whether or not the resident unit is the economic owner of the goods.

An example of the statistical treatment arising under contract manufacturing might be an Irish resident firm that owns design patents for a certain product and/or underlying raw materials. This firm will often own any final products that result from the manufacturing contracted out to a third party. Although the physical production may be carried out abroad, any resulting final products are considered as domestic output and the raw materials as intermediate use. In cases where the raw materials are bought and sold abroad, the eventual sale of the final products are still to be recorded as goods exports. These transactions are not observed in foreign trade statistics which are simply based on goods crossing borders.[5] To comply with ESA2010, these transactions are therefore added to the foreign trade data (CBS, 2014).[6]

Changes to the Balance of Payments

As well as the revised approach to National Accounts estimates, the CSO has also implemented a series of changes to the Balance of Payments figures dating back to 1998. This is again intended to bring it in line with international rules corresponding to the IMF’s sixth Balance of Payments and International Investment Position Manual (BPM6).

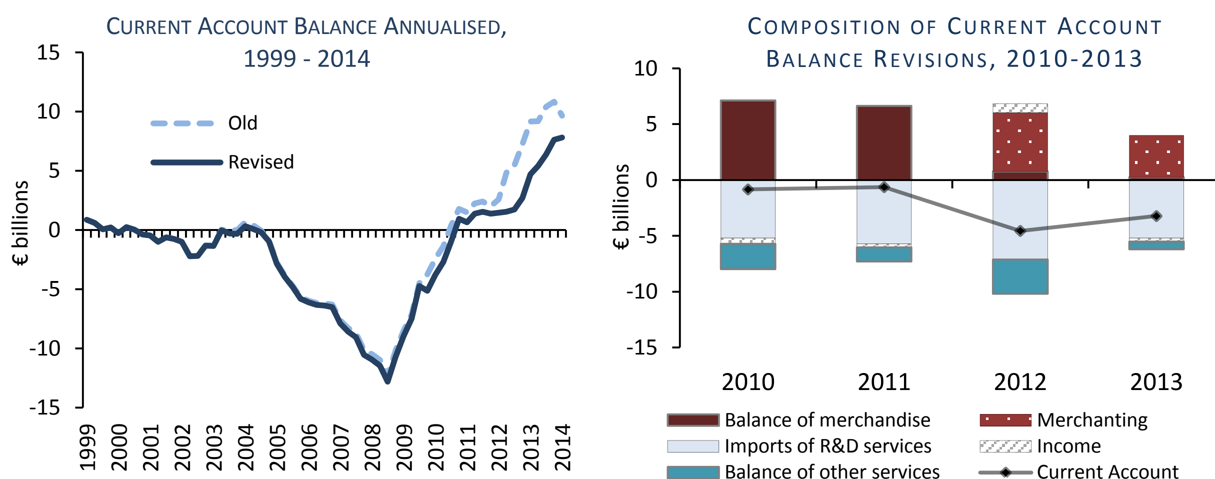
The key change under BPM6 for the Irish figures relates to the classification of non-produced, non-financial assets: mainly patents and copyrights. Sales and purchases of patents and copyrights are no

[5] For example, the merchandise trade data produced by the CSO, as in the monthly publication ‘Goods Exports and Imports’, record trade on the basis of border crossing.

[6] Note that the CBS (2014) provide a very clear description of these and other associated treatments under ESA 2010.

longer included in the capital account, but instead now form part of Ireland's current account balance, appearing under services exports and imports of R&D. As the CSO note, large net purchases of patents and copyrights by Ireland's multinational sector mean that the new treatment typically reduces the current account surplus by increasing services imports. Figure N.2 shows the net effect since 1998. The newly revised current account surplus for 2013 was revised down to €7.6 billion from €10.9 billion as a result of the change.

FIGURE N.2: CURRENT ACCOUNT BALANCE



Source: CSO.

Note: Merchanting data only available for 2012 and 2013

As the second panel in Figure N.2 shows, some €5.2 billion of the reduction in the 2013 current account surplus was due to the inclusion of R&D imports. Offsetting the fall in the current account surplus is an increase in merchandise exports. This is due in large part to merchanting activities now being included under goods instead of services. Other smaller changes of note – which largely balance out – include Financial Intermediation Services Indirectly Measured (FISIM) becoming part of financial services, rather than income, in line with the treatment of FISIM in the National Accounts.

FISCAL IMPLICATIONS OF STATISTICAL REVISIONS

There are two sources of changes to commonly used fiscal measures, including those used for surveillance as part of the Excessive Deficit Procedure, arising from the ESA 2010 revisions. These correspond to changes to the numerator (i.e. changes related specifically to fiscal measures such as expenditure, revenue, deficits and debt levels) and to increases in the denominator (i.e. nominal GDP levels). The impact of both of these is discussed here.

First, looking at the denominator developments, revisions to GDP levels under ESA 2010 have lowered the relative size of revenues and primary expenditures when scaled against GDP. This results in a net

improvement in the primary balance amounting to a net 0.1 percentage points of GDP. Lower interest spending as a percentage of GDP reduces the overall balance (GGB) by a further 0.3 percentage points. The Gross Government Debt (GGD) ratio and net debt ratio – due to their large scale – fell even more as a result of the upwardly revised level of nominal GDP (falling by roughly 8 and 6 percentage points, respectively).

TABLE N.1: DECOMPOSITION OF REVISIONS TO SELECTED FISCAL MEASURES, 2013 (% OF GDP)

Contributions, % of GDP	**(1) Due to Revised Nominal GDP**	**(2) Due to Revised Fiscal Measure**	***- of which related to IBRC***	***- of which related to swaps***	**(1+2) Combined Impact**
Revenue (a)	-2.3	1.2	-	-	-1.1
Primary Expenditure (b)	-2.4	0.1	-	-	-2.3
Total PB Revision (a-b)	**0.1**	**1.2**	0.7	-	**1.3**
Interest (c)	-0.3	0.2	-	0.2	-0.1
Total GGB Revision (a-b-c)	**0.4**	**1.1**	**0.7**	**0.2**	**1.5**
GGD Ratio	-8.1	7.7	7.2	-	-0.4
Net Debt Ratio	-6.0	-0.3	-0.4	-	-6.3

Sources: CSO; internal calculations.

The new upward revisions to nominal GDP levels mean that a number of typical measures of fiscal capacity now look less onerous than they previously did.[7] However, this improvement does not necessarily reflect any change in the capacity to finance high deficits and high debts in the absence of specific moves to raise revenues from the newly measured areas. Indeed, the fiscal position continues to appear challenging when scaled against GDP, GNP or the Council's own Hybrid measure.

Second, a number of changes to accounting treatments also alter the picture for various fiscal measures. The key changes to the debt and deficit in particular can be broken into three categories[8]:

Sector classification changes: these primarily relate to the reclassification of the government-owned Irish Bank Resolution Corporation (IBRC) as part of the Government sector.

- The new ESA 2010 international statistical standards interpret IBRC as essentially a bank in wind-down largely controlled by Government with limited autonomy to carry out banking business. This is now classified for statistical purposes as belonging to the General Government sector (even if its liabilities are not fully guaranteed by the Government). Previously, licensed banks were automatically excluded by definition from the General Government sector under ESA 95.

[7] The larger denominator (with a negligible increase in fiscal capacity) is also likely to give a false sense of security in light of the historical understanding of relative dangers of high debt burdens.

[8] Taken from CSO (2014): 'Government Finance Statistics Quarterly Results'

- The retrospective reclassification from mid-2011 results in a steeper rise in gross General Government debt in the period 2011 to 2013 which is expected to unwind upon completion of the IBRC liquidation.[9] *Budget 2015* estimated that the repayment of some IBRC liabilities in 2014 using accumulated resources from the sale of its assets by the special liquidator would result in a fall in the GGD of 6.2 percentage points in 2014. The remaining IBRC liabilities were expected to add 0.8 percentage points to the end-year GGD.[10]
- Since payments under the Government's Eligible Liabilities Guarantee (ELG) Scheme arising from the IBRC liquidation in 2013 are now treated as intra-government transfers rather than government expenditure, the reclassification also lowers the 2013 deficit compared to that under ESA 95.

Removal of swaps and Forward Rate Agreements from interest expenditure:

- ESA 2010 aligns the treatment of swaps and FRAs with the measure of the deficit previously used for countries outside of the Excessive Deficit Procedure (EDP). Swap transactions had raised Irish interest payments over 2010-2013 as it was under the EDP, but are now excluded under ESA 2010 – even for countries with excessive deficits. This means that the deficit is lowered by the amounts of associated interest flows. For 2013, swap contract flows previously added some €273 million to the deficit (0.2 percentage points of GDP).

Pension obligations transferred to government:

- The pension obligations of universities and semi-state bodies were transferred to government in 2009 and 2010. ESA 95 recorded these as deficit reducing at the time due to additional revenues generated by the associated assets. Under ESA 2010, however, these transfers are treated as deficit-neutral financial transactions in cases where pension scheme assets and liabilities are equal and as deficit-increasing when liabilities exceed scheme assets. Since liabilities exceeded scheme assets at the time, the GG deficit is raised by 1 percentage point in 2009 and by 1.5 percentage points in 2010 compared to the ESA 95 estimates. The inclusion of imputed revenues in later years offset any expenditures incurred.

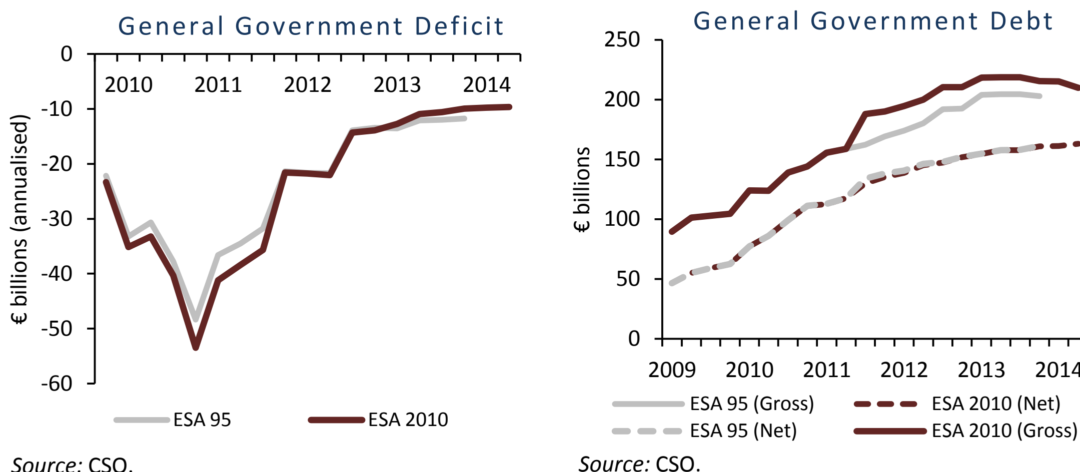
Summarising these changes, the overall net deficit and debt impact is shown in Figure N3 for the period 2010 to 2013. The nominal deficit for earlier years is larger than previously measured

[9] The reclassification applies from the date of the creation of IBRC following the merger of Anglo Irish Bank and Irish Nationwide Building Society (INBS) on 1 July 2011 after which IBRC sold its deposit book and has been in a wind-down phase ever since. This followed approval by the EU Commission of a joint restructuring plan for Anglo Irish Bank and INBS. It required the merger of the banks, the sale of their deposit books, and the orderly work-out of the merged loan book over a period not to exceed 10 years. The nature of the wind-down – involving a rescue; the creation of an entity dedicated to the management of problematic assets; the assumption of government control or risk; and closure of new business – qualifies it as a "defeasance structure" under the rules outlined in Section IV.5 of the Manual on Government Deficit and Debt and its implementation of ESA 2010 (see http://europa.eu/rapid/press-release_IP-11-801_en.htm).

[10] The NTMA (2014) in late-October indicated that a surplus may result following the results of the liquidation.

reflecting the removal of revenues associated with pension liabilities assumed by the state. For 2013, however, the deficit is noticeably improved as a result of the reclassification of payments made under the ELG scheme. While the level of nominal gross debt has been revised upwards for recent years owing to the transfer of IBRC borrowings to the Government's balance sheet, this impact is expected to be temporary as the former bank is being wound down. Nominal net debt is relatively unaffected for earlier years by the transfer, however, as IBRC assets are also included.

FIGURE N.3: DEFICIT AND DEBT CHANGES ASSOCIATED WITH ESA 2010, 2010-13 (€ BILLIONS)



Source: CSO.

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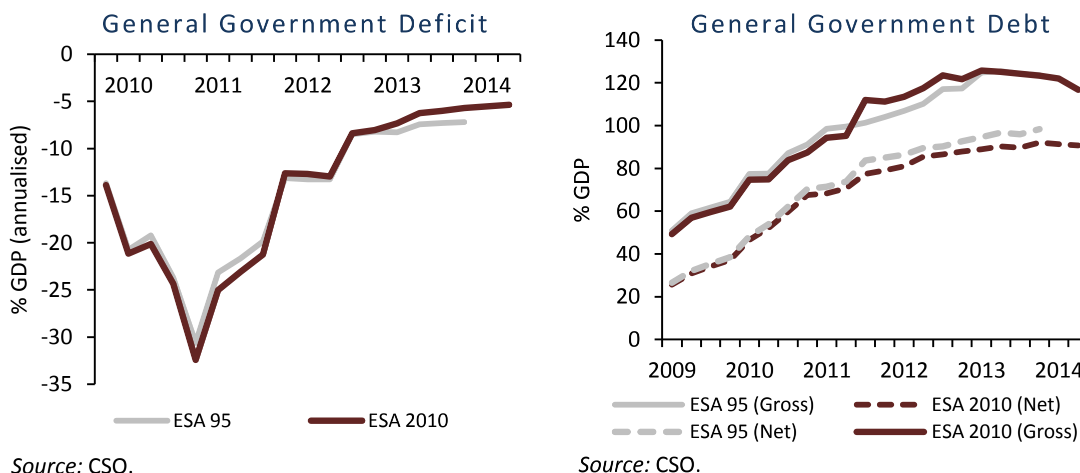
Figure N.4 shows the impact on the deficit and debt levels expressed as a share of GDP that arises following the impact of the combined ESA 2010 changes to both the numerator and the denominator. As this highlights, the deficit is further improved by higher nominal GDP levels when expressed as a ratio. Similarly, gross debt levels – while higher in nominal terms – benefit when scaled against the higher GDP levels. Virtually all of the improvement in the net debt ratio is due to GDP revisions.

FIGURE N.4: DEFICIT AND DEBT RATIO CHANGES ASSOCIATED WITH ESA 2010, 2010-13 (% OF GDP)



Source: CSO.

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