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**REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND
THE COUNCIL**

**on the implementation of Regulation (EC) No 1445/2007 of the European Parliament
and of the Council of 11 December 2007 establishing common rules for the provision of
basic information on Purchasing Power Parities and for their calculation and
dissemination**

(Text with EEA relevance)

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1. INTRODUCTION

This report reviews the provisions of Regulation (EC) No 1445/2007 of the European Parliament and of the Council of 11 December 2007 establishing common rules for the provision of basic information on Purchasing Power Parities and for their calculation and dissemination (hereinafter referred to as 'the Regulation') as required in its Article 14.

The report summarises the state of implementation of the Regulation and various developments since its adoption. It proposes a revision of the regulatory framework for Purchasing Power Parities to reflect those developments, as well as to align it with the Lisbon treaty.

2. BACKGROUND

Purchasing Power Parities (PPPs) are indicators of price level differences across countries. They indicate how many currency units a particular quantity of goods and services costs in different countries. PPPs can be used as currency conversion rates to convert expenditures expressed in national currencies into an artificial common currency (the Purchasing Power Standard, PPS), thus eliminating the effect of price level differences across countries.

Their main uses are:

- to convert national accounts aggregates into comparable volume aggregates. In particular, PPPs can be used to compare the Gross Domestic Product (GDP) of different countries without the figures being affected by differing price levels in those countries.
- to analyse relative price levels across countries. For this purpose, the PPPs are divided by the current nominal exchange rate to obtain a price level index (PLI) that expresses the price level of a given country relative to others.

PPPs also have important administrative purposes. They play a role in defining the eligibility criteria of the Structural Funds and Cohesion Fund. The principal indicator determining eligibility for the Structural Funds is PPP-deflated regional GDP per capita, whereas for the Cohesion Fund it is PPP-deflated Gross National Income (GNI).

The International Monetary Fund (IMF) uses PPPs when deciding the quota subscriptions of its members. A country's quota subscription determines the financial

resources it is obliged to provide to the IMF, among other things. The weight of PPP-deflated GDP in the quota formula is 20 per cent.

Eurostat produces annual PPPs for 37 countries: the 27 EU Member States, three member states of the European Free Trade Association (EFTA), one acceding country, four candidate countries, and two potential candidate countries¹. The production of PPPs is a multilateral exercise involving the National Statistical Institutes of the participating countries, Eurostat and the Organisation for Economic Cooperation and Development (OECD). The exercise is referred to as the ‘PPP programme’.

Eurostat has been producing PPPs since the 1970s, but only in 2007 was the PPP programme put on a firm legal basis with a Regulation. This mainly encoded practices at that time, ensuring sustained collection of the basic data and calculation, as well as dissemination of PPPs. Its main new feature was the set-up of a formalised system of quality control.

Since 2007, the PPP programme has evolved. New methodology has been introduced or is imminent in a number of important areas such as education, health, energy and construction (see section 4.2).

The PPP programme is closely related to Eurostat’s national accounts programme as it is based on the European System of Accounts (ESA). The adoption of the 2010 version of the ESA and its implementation in 2014 will also be reflected in the PPP programme.

Article 14 of the Regulation requires its provisions to be reviewed five years after its entry into force. The Article also states: *‘It shall be revised, if appropriate, on the basis of a Commission report and proposal, submitted to the European Parliament and the Council’*. This report proposes the Regulation be revised and offers a number of suggestions to this effect.

3. IMPLEMENTATION OF THE REGULATION

3.1. Transmission of basic data

All EU Member States and EFTA countries comply fully with the requirements regarding data transmission stipulated in the Regulation. This includes their completeness, frequency, timeliness and adherence to the minimum quality standards defined in Annex I of the Regulation.

All acceding and candidate countries (except Montenegro) are also already fully compliant. Montenegro and the two Western Balkan countries that are potential candidate countries are medium to highly compliant with the requirements. The main weaknesses identified for these countries lie in the provision of detailed national accounts data.

3.2. Calculation and dissemination of PPPs

Eurostat calculates and disseminates PPPs on an annual basis, going beyond the minimum requirements of the Regulation. First estimates of PPPs for year t are published in June $t+1$, with subsequent revisions in December $t+1$, December $t+2$

¹ The Regulation of course only applies to the Member States and the EFTA countries. The remaining countries participate in the context of their accession or potential accession preparations.

and December t+3 (final estimates). No further revisions are made to these final PPPs, in accordance with the Regulation.

Eurostat publishes PPPs, price level indices, per capita volume indices and a number of other indicators for 60 categories.

3.3. Methodological manual

The Regulation requires Eurostat to produce and maintain a methodological manual. The first version of the ‘Eurostat-OECD Methodological Manual on Purchasing Power Parities’ was published at the end of 2006. In 2012, it was completely revised and fully updated to reflect the most recent methodology. It is available on Eurostat’s website².

3.4. Quality control

The Regulation (Article 7) introduced a formal process of quality control into the PPP programme. All countries provided a structured set of documentation on their sources and methods for the collection and provision of basic data. The set consists of a survey report for each consumer goods price survey (cf. Section 5 of Annex I of the Regulation), as well as an ‘Inventory’ of sources and methods, giving a full description of the manner in which the Regulation has been implemented (cf. paragraph 5.3.1 of Annex I of the Regulation). For both types of information, the structure is laid down in Commission Regulation (EU) No 193/2011 of 28 February 2011 implementing Regulation (EC) No 1445/2007 of the European Parliament and of the Council as regards the system of quality control used for Purchasing Power Parities. This Commission Regulation was required by Article 7(4) of the Regulation.

Eurostat started formal assessments of Member States’ practices in 2011 (cf. paragraph 5.3.2 of Annex I of the Regulation), after a period in which countries drafted their Inventories. By the end of 2012, 10 countries had been visited and assessed. The assessment reports are available on Eurostat’s website. These assessments include an in-depth analysis of the sources and methods used by each country and a verification of their compliance with the Regulation and the methodological manual.

3.5. Financing

PPPs are fundamentally *international* statistics and have limited national purposes. That is why Article 13 of the Regulation stipulates that Member States shall receive a financial contribution from the Commission. This contribution amounts to a maximum of 70% of the costs eligible under the Commission’s grant rules.

The Commission proposes to maintain this financial support, which is necessary to ensure the sustainability of the PPP programme.

4. DEVELOPMENTS SINCE THE ADOPTION OF THE REGULATION

4.1. Rolling Review

A Rolling Review on the PPP programme was carried out in 2010 in the context of Eurostat’s Quality Assurance Framework. The Rolling Review consisted of a survey among users, a survey among partners (mainly the National Statistical Institutes) and

² See http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-RA-12-023/EN/KS-RA-12-023-EN.PDF.

a self-assessment by Eurostat. The executive summary of the final report is available on Eurostat's website³.

The Review concluded that users and partners rated the quality of the published PPP highly. It says:

'The production of European PPPs is based on the PPP Regulation and this ensures a high level of harmonisation of PPP data. In addition, the data collection is based on a strong methodological basis and has adopted well established European and international definitions and nomenclatures. The work in the PPP programme is efficiently organised, coordinated and guided by Eurostat and the OECD. There is very low response burden for individuals or business enterprises. The use of common software tools for item list management, data entry and validation and of data transmission standards greatly facilitates the work of Eurostat and its partners.'

The Review report formulated a set of recommendations that Eurostat is following up.

4.2. New methodology in special areas

The methodology for comparing prices and volumes of different goods and services across countries is evolving continuously.

- In the area of *education*, Eurostat introduced a new methodology in 2008. This measures the volume of output directly, rather than basing the PPPs on prices of inputs (such as teacher's salaries). This method is applied for the PPPs of reference years 2005 onwards.
- For *health*, a new methodology, developed in conjunction with OECD, is to be introduced in 2013, for reference years 2010 and onwards. This new method is based on evaluating quasi-prices for a set of standard medical treatments.
- For construction, the implementation of the survey was changed in 2010 by spreading the data collection over a period of two years and simultaneously reducing the number of construction projects to be priced.
- Finally, in the area of *energy* (more specifically, the consumption of gas and electricity) Eurostat is exploiting synergies with Energy Price Statistics⁴.

The improvement in methodology is on-going and will continue. However, whenever a new method is introduced, there is a break in the time series of PPPs, as data preceding the innovation are no longer strictly comparable to data compiled after it⁵. The Regulation, in Article 9(4), states that published final PPPs are generally not revised. This article effectively prevents Eurostat from providing users with a better service, which would be possible if the new method were to be applied as far back in the series as possible. That is why this report proposes investigating whether the Regulation's policy on revision could be relaxed.

Adopting the new methodology in each of the areas requires adaptation of the basic heading classification in annex II of the Regulation.

³ See http://epp.eurostat.ec.europa.eu/portal/page/portal/quality/documents/PPP%20Final%20Report_Executive%20Summary_0.pdf.

⁴ The details of the new methodologies can be found in the revised PPP manual.

⁵ For this reason, a 'b' flag for 'break in series' is added to the 2005 data in Eurostat's dissemination database for all variables that are affected by the introduction of the new method for education.

4.3. Classification of Individual Consumption according to Purpose (COICOP)

For the purpose of PPP calculations, household consumption expenditure is broken down into categories derived from the Classification of Individual Consumption according to Purpose (COICOP).

The internationally-agreed version of COICOP stops at the four-digit or class level. This is not sufficiently detailed for some statistical applications, and as a result, there are different versions of COICOP at the five-digit or subclass level.

Within the European Union, three five-digit versions of COICOP were developed: one for Household Budget Surveys (HBS), one for the Harmonised Index of Consumer Prices (HICP) and one for PPPs. The three versions are not the same and this compromises comparability across the three statistical domains. Harmonising COICOP-PPP and COICOP-HICP has particular relevance for the PPP Programme: it will improve the quality of extrapolations of PPPs from survey years to non-survey years carried out with HICP indices.

In 2010, Eurostat started the process of developing a 5-digit version of COICOP to be used by all Eurostat statistics. The process was limited to the five-digit level. Changes at the four-digit level would have to be discussed in the context of a broader revision involving the United Nations Statistics Division, the guardian of COICOP. The objective at five-digit level is to draw up a master classification with subclasses defined to meet the needs of the PPP Programme, the HICP Programme and the HBS. The process was concluded in 2012. The classification is to be introduced in HICP, PPP and HBS by 2014/2015.

The harmonisation of COICOP-PPP and COICOP-HICP should lead to greater alignment between basic heading PPPs and their HICP extrapolators. It should also result in greater coherence in the presentation of PPP and HICP results and, possibly, in the results themselves. Finally, it will no longer be necessary to collect CPI information in the COICOP-PPP classification separately, as is currently the case, thus reducing the survey burden on countries.

The introduction of the harmonised five-digit COICOP in the PPP exercise requires an adaptation of the basic heading classification in annex II of the Regulation.

4.4. European System of Accounts 2010

The Regulation ensures in Article 2(2) that the definitions used in the PPP programme are fully in line with those of the European System of Accounts 1995 (ESA 95)⁶. The ESA 95 is currently being updated and a new ESA Regulation ('ESA 2010') will be applied by the Member States from September 2014.

The ESA 2010 keeps the theoretical framework of the system it will replace. There are no radical departures from its predecessor. Even so, changes will occur under gross fixed capital formation as a result of changes that have been introduced in the classification of fixed assets.

The most important changes in this respect are the reclassification of expenditures on research and development (R&D) and on military weapons systems as expenditures on fixed assets to be included under capital formation. Previously, these expenditures were treated as intermediate consumption. Extending the assets boundary to include expenditure on R&D will raise both the levels of gross fixed capital formation and

⁶ Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community.

GDP. The inclusion of expenditure on military weapons systems will increase the level of gross fixed capital formation and, to a lesser extent, the level of GDP, but it will also reduce the level of collective services as these are estimated as the sum of their costs of production, of which intermediate consumption is one.

Including R&D and military weapons systems in gross fixed capital formation requires an adaptation of the basic heading classification in annex II of the Regulation.

4.5. Classification of Products by Activity (CPA)

CPA 2008 is the latest version of the Classification of Products by Activity. It is a revision of CPA 2002, which itself is a revision of CPA 96. CPA 96 is the version that was used in Annex II of the Regulation to define the expenditure classes under gross fixed capital formation. CPA 2008 was introduced in the national accounts of Member States in 2011. A revision of annex II of the Regulation is thus required to align the PPP classification with the new CPA 2008.

4.6. Lisbon treaty

The Regulation also needs to be adapted to take into account the entry into force of the Lisbon treaty in 2009. In particular, the ‘comitology’ articles (Articles 11 and 12) need to be reviewed to bring them into line with new procedures.

5. CONCLUSION

The PPP Regulation has ensured the reliability and quality of the PPPs as published by Eurostat. However, the above summary of developments since the adoption of the Regulation in 2007 shows the need for a general update to reflect current practices and legal requirements.

In 2013, the Commission therefore plans to propose a revision to the regulatory framework for PPPs, to bring it into line with the provisions of the Lisbon treaty and to reflect developments over the last five years, including a revision of the classification in Annex II.