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Differences in the Treatment in Macroeconomic Statistical Standards of Retained Earnings/Saving of Entities in Various Economic Relationships

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DIFFERENCES IN THE TREATMENT IN MACROECONOMIC STATISTICAL STANDARDS OF RETAINED EARNINGS/SAVING OF ENTITIES IN VARIOUS ECONOMIC RELATIONSHIPS

I. INTRODUCTION

This paper discusses how retained earnings/saving of various entities in various economic relationships might be treated in macroeconomic statistics[1]. This paper follows up on BOPCOM-02/42, presented to the IMF Committee on Balance of Payments Statistics at its meeting in Canberra, in 2002. The arguments presented in that paper have been more fully developed in this version. The issues raised in this paper are still under discussion in the Statistics Department (STA) of the IMF and so the views expressed should not be taken to represent an official STA position. The Committee's input is sought to help guide STA's deliberations and as part of the updating of the fifth edition of the *Balance of Payments Manual (BPM5)*.

The paper describes the way retained earnings are treated for direct investment enterprises (DIEs), vis-á-vis, their direct investors (DIs); reviews the treatment of property income on the technical reserves of life insurance enterprises and pension funds, and how the income is channeled to the policyholders/beneficiaries; considers whether retained earnings of mutual funds should be deemed to be distributed to their shareholders; and, in light of these instances, examines whether the ways that retained earnings/saving are treated in all other equity ownership relationships are consistent. The paper proposes that there is a need to standardize the treatment. The paper concludes with four options on how consistency might be improved.

II. TREATMENT OF RETAINED EARNINGS IN FOUR DIFFERENT CASES

A. Reinvested Earnings and Undistributed Branch Profits of Direct Investment Enterprises

In *BPM5*, all retained earnings[2] of a DIE are deemed to be distributed to the DIs, in proportion to their holdings of the DIE's equity (or equivalent), as *reinvested earnings*. *BPM5* describes reinvested earnings as follows:

> *"Reinvested earnings comprise direct investors' shares —in proportion to equity held — of (i) earnings that foreign subsidiaries and associated enterprises do not distribute as dividends and (ii) earnings that branches and other unincorporated*

[1] That is, the *1993 System of National Accounts (1993 SNA),* the *Balance of Payments*, fifth edition *(BPM5*), and the *European System of Accounts, 1995* (*ESA95).*

[2] In this discussion, the terms *retained earnings* and *reinvested earnings* of a DIE should be taken to include undistributed branch profits.

> *enterprises do not remit to direct investors.... Thus, reinvested earnings may be calculated as the entrepreneurial income (net operating surplus) of the direct investment enterprise, plus any* [investment] *income or current transfers receivable, minus any income or current transfers payable."* (*BPM5*, para. 278)

Accordingly, if a DIE is 100 percent owned by direct investor(s), it will have no saving. *BPM5* offers the following explanation for this treatment:

> *"Reinvested (undistributed) earnings of branches and other unincorporated direct investment enterprises and direct investors' shares of earnings, which are not formally distributed, of incorporated direct investment enterprises are deemed to provide additional capital to the enterprises and to increase the value of an economy's stock of foreign assets and liabilities. When such earnings are recorded in the balance of payments, therefore, entries should be made both for direct investment income and for direct investment capital."* (*BPM5*, para. 288)

In the *1993 System of National Accounts (1993 SNA)*, the treatment is the same (see paras. 7.119–122). The rationale for this treatment is somewhat different from *BPM5*.

> *"The rationale behind this treatment is that, since a direct foreign investment enterprise is, by definition, subject to control, or influence, by a foreign direct investor or investors, the decision to retain some of its earnings within the enterprise must represent a* ***conscious deliberate investment decision*** *on the part of the foreign direct investors(s)." (1993 SNA, para. 7.121)* Emphasis added.

The *European System of Accounts, 1995 (ESA 95)* adopts the same approach as the *1993 SNA*, but offers no rationale.

It should be noted that where a resident investor owns 10 percent or more in another resident entity, there is no such imputation in either the *1993 SNA* or *ESA 95.*

B. Life Insurance[3] and Pension Funds

In the *1993 SNA*, life insurance enterprises and pension funds are deemed to have no saving (other than that attributable to shareholders' funds in life insurance companies): all the excess of property income receivable[4] over costs of production and, if applicable, property income payable, are channeled to policy holders or beneficiaries (households and nonresidents)

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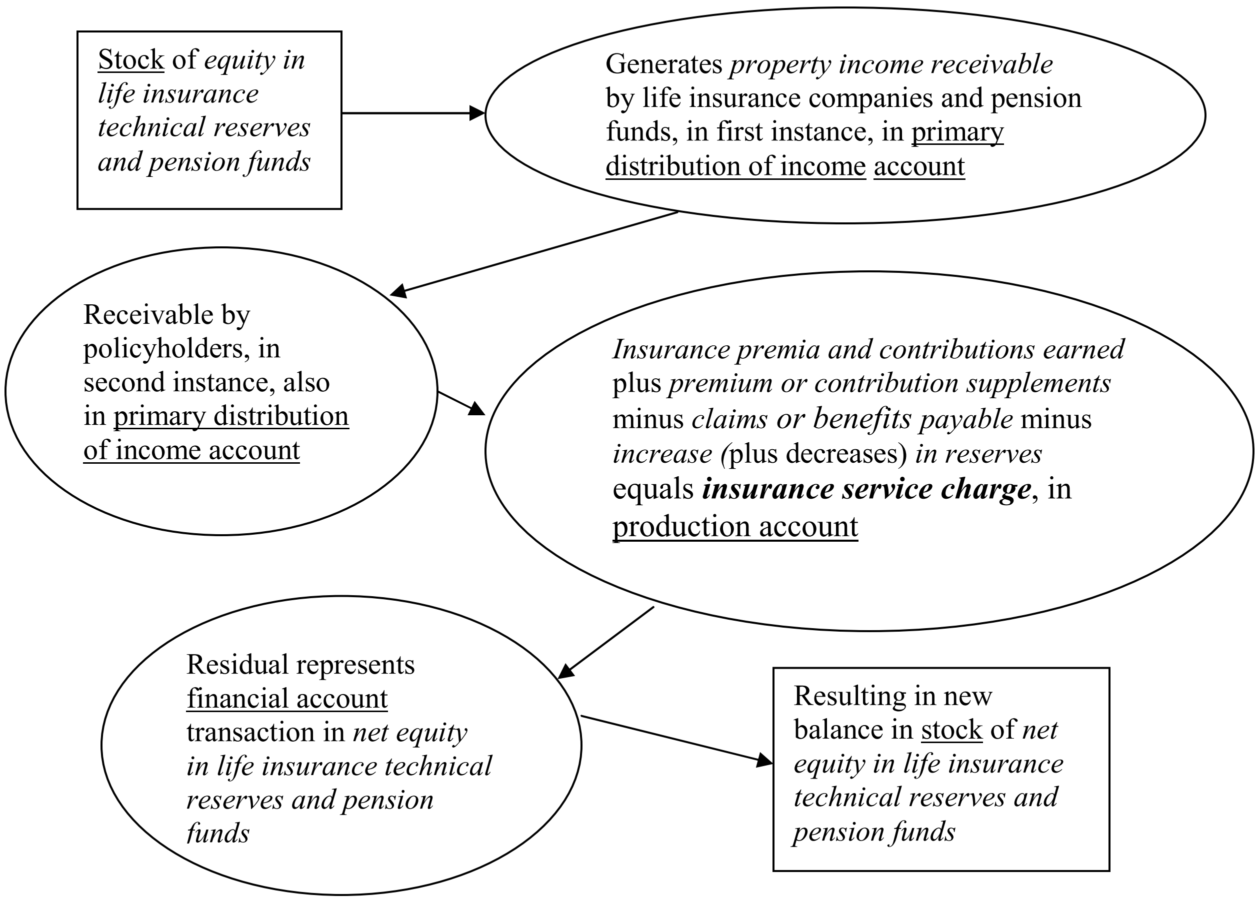
[3] Life insurance that is part of a social security scheme is not included in this discussion.

[4] The property income receivable by policyholders is not the full investment income receivable by insurance enterprises as not all the assets of an insurance enterprise have been funded by technical reserves. Some assets may have been funded by shareholders' funds. In this case, the amount of property income receivable by the policyholders should be prorated, on the basis of the ratio of the technical reserves to shareholders' funds.

through the primary distribution of income account. In the *1993 SNA* and *ESA95,* these funds are deemed to be reinvested, through the financial account, by the policyholders in these institutional units through *net equity on life insurance reserves and pension funds*[5]. Figure 1 may help to explain the treatment.

Figure 1. Routing of Property Income of Life Insurance Companies and Pension Funds in *1993 SNA*[6]



The *1993 SNA* provides the following rationale for routing the saving of insurance to policyholders:

[5] See *1993 SNA* 7.123 -127, *BPM5*, footnote to para. 257, and *ESA95*, para. 5.98.

[6] Drawn from *1993 SNA*, Annex IV, *The treatment of insurance, social insurance and pensions,* paras. 18 and 19.

> *"... as the technical reserves are assets of the insurance policyholders, the investment income receivable by insurance enterprises must be shown in the accounts as being paid by the insurance enterprises to the policyholders."* (*1993 SNA,* para. 7.124)

ESA 95 offers a very similar explanation (see *ESA 95,* para. 4.69).

In *BPM5*, the treatment, in principle, appears to be the same as in the *1993 SNA*, but it is not fully explored. It receives a single sentence entry:

> *"This category* [other investment income] *also includes, in principle, imputed income to households from net equity in life insurance reserves and in pension funds."* (*BPM5*, para. 281).

Table 1 (Table 7, in *BPM5*), indicates the entries in the balance of payments are as follows:[7]

Table 1

1. B. Income Account *Cr.* *Dr.*

2.3 Other investment
*2.3.3 Imputed income of households from net equity in life insurance and in pension funds**

2. B. Financial Account

3.1 Assets
3.1.4 Other assets
3.1.4.4 Other sectors
3.1.4.4.1 Long-term
*3.1.4.4.1.1 Net equity of households in life insurance reserves and in pension funds**
3.2 Liabilities
3.2.4 Other liabilities
3.2.4.4 Other sectors
3.2.4.4.1 Long-term
*3.2.4.4.1 Net equity of households in life insurance reserves and in pension funds**

** Details necessary for reconciliation with classifications used in the SNA Rest of the World Account.*[8]

[7] Table 7, in *BPM5*, lists Balance of Payments Standard Components and Additional Detail. The entries marked * are not standard components but are "details necessary for reconciliation with classifications used in the *1993 SNA* Rest of the World Account" (*BPM5*, Table 7, footnote).

C. Mutual Funds (and similar investment vehicles, such as unit trusts)

The three international standards appear to be in agreement that investments in mutual funds (and equivalent investment vehicles) are regarded as being in *shares and other equity* in the financial account and balance sheet in the national accounts' framework (see *1993 SNA*, para. 11.86–97, and *ESA95*, para. 5.96–97) and as *equity securities* in the balance of payments (*BPM5*, para. 388[9]), irrespective of what assets the mutual fund has acquired.[10] Therefore, even if a mutual fund invests solely in debt instruments, the shares in the fund are still regarded as equity instruments. However, the treatment of retained earnings of the funds differs between *ESA95,* on the one hand, and the *1993 SNA* and *BPM5*, on the other hand.

In *1993 SNA* and *BPM5*, it would appear that any income of mutual funds that is not distributed as dividends is regarded as being retained by the funds, and is treated as saving of mutual funds. This is not explicitly stated in either document but can be inferred from the discussion regarding the income of portfolio investment versus that for direct investment, as discussed in Section II. A above ("Reinvested earnings of direct investment enterprises"). As portfolio investment (equity) assets[11] are regarded as being passive, portfolio investors can have no "influence or voice in management". It would appear to follow, therefore, that portfolio investors are in no position to make a "conscious deliberate decision" as to how internally generated funds should be used. Consequently, *BPM5* argues that the proportion of retained earnings that is attributable to portfolio investors should not be deemed to have been distributed.

> *"Portfolio investors' shares in earnings, which are not formally distributed, of incorporated direct investment enterprises should not be entered in the balance of payments.'* (*BPM5*, para. 288)

Given that investment in mutual funds is treated as equity portfolio investment[12], it follows that any earnings that are not distributed to shareholders and are retained by mutual funds are deemed to be the saving of the mutual funds, and not the mutual fund's shareholders.

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[8] Footnote in *BPM5.*

[9] *BPM5*, para. 388, appears to describe investment in mutual funds as a portfolio equity investment, although the wording is less than clear.

[10] In the *Monetary and Financial Statistics Manual, 2000,* however , shares/units in money market mutual funds are treated as deposits, rather than as shares, because of their approximation to "money".

[11] That is, those with an equity claim that are not part of direct investment and which are not evidenced through claims on the technical reserves of insurance or pension funds.

[12] It is possible that some mutual funds may have direct investors. This issue is still to be resolved by the IMF Committee on Balance of Payments Statistics. However, even were the Committee to decide that the "10 percent rule" were to apply to mutual funds, the argument for not distributing income to the non-direct investors in these funds would remain the same.

In *ESA95,* on the other hand, all income of mutual funds is deemed payable to the share holders, regardless of whether or not it is distributed. In other words, mutual funds are deemed to have no independent income of their own. There are, however, apparent inconsistencies in the manner in which this treatment is applied. Para. 4.49 of *ESA95* states that any interest "received" by mutual funds is deemed to pass, as interest, directly to the shareholders: it is to be "assigned to shareholders, *even if it is capitalised*" (emphasis added). Para. 4.54 (b) of *ESA95*, using the same words, states that dividends received by mutual funds are also to be passed, as dividends, to shareholders, even if capitalized. These inconsistencies are considered further below.

D. All other Types of Equity Investment

For all other types of equity investment, the only income deemed by the three systems to be receivable by the owners of equity (or equivalent) is dividends receivable (or distributed profits receivable of unincorporated entities). This applies to *portfolio investment* in the balance of payments and ownership of *shares and other equity* in *1993 SNA* and *ESA 95*, even where the ownership by one resident unit in another resident unit is 10 percent or greater.[13]

None of the three documents offers an explicit explanation for the difference between this treatment and those above. In the case of *BPM5*, it might be inferred from the nature of *portfolio investment* (that it represents a passive investment, so that the investor has no "influence" or "voice in management") so that there would appear to be no basis for arguing that portfolio investors have any role in the decision making of the entity. *1993 SNA* and *ESA 95* describe the nature of dividends, using identical wording:

> *"Dividends are a form of property income to which shareholders become entitled as a result of placing funds at the disposal of corporations." (1993 SNA,* para. 7.113, *ESA 95*, para. 4.53)

They also describe withdrawals of income from quasi-corporations[14] in much the same manner.

> *"... the owner, or owners, of a quasi-corporation may choose to withdraw some or all of the entrepreneurial income of the enterprise. Conceptually, the withdrawal of such income is equivalent to the distribution of corporate income through dividends"* (*1993 SNA* (para. 7.115)

[13] Dividends are also receivable by direct investors their DIEs.

[14] Quasi-corporations should be taken to include overseas branches of direct investors.

> *"Withdrawals from the income of quasi-corporations consist of the amounts which entrepreneurs actually withdraw for their own use from the profits earned by the quasi-corporations which belong to them." ESA 95* (para. 4.56)

> *".. This income left in the business appears as saving by the quasi-corporations and only the profits actually withdrawn by the owner units are recorded [as] withdrawals from the income of quasi-corporations." ESA 95* (para. 4.58).

However, the *1993 SNA* also indicates that some withdrawals from quasi-corporations are withdrawals of equity:

> *"Withdrawal of income from a quasi-corporation do not, of course, include withdrawals of funds realized by the sale or disposal of the quasi-corporation's assets: for example, the sale of inventories, fixed assets or land or other non-produced assets. Such funds would be recorded as disposals in the capital account of the quasi-corporation and the transfer of the resulting funds would be recorded as a withdrawal from the equity of the quasi-corporation in the financial account of the quasi-corporation and its owner(s). Similarly, funds withdrawn by liquidating large amounts of accumulated retained saving or other reserves of the quasi-corporations, including those built up out of provisions for consumption of fixed capital, are treated as withdrawals from equity."* (*1993 SNA*, para. 7.118)

ESA 95, para. 4.61, uses the same arguments.

Para. 7.118 of the *1993 SNA* and para.4.61 of the *ESA 95* leave open the question as to where the line might be drawn between a "withdrawal" by a quasi-corporation as *income* and a "withdrawal" as equity. Moreover, an important point to note is that there is no comparable distinction between the distribution of "income" and the "withdrawal of equity" for an *incorporated* entity in either the *1993 SNA* or the *ESA 95.*

III. NATURE OF *SAVING*

In light of the different ways saving and retained earnings are treated for various entities in macroeconomic statistics, it may be useful, at this point, to examine the analytical meaning of the concept of "saving" in the national accounts and the balance of payments.

As an economic variable, saving has considerable importance in the balance of payments' and national accounts' frameworks. Saving is the means through which an institutional unit/sector/economy provides the internal resources from which to finance accumulation — be it financial or nonfinancial assets — or to repay debt. In that regard, it can be said to represent a major factor in an economy's growth. Saving should be seen to represent a deliberate decision on the part of an institutional unit to forgo consumption (or distribute (part of) its income), in order to undertake accumulation (or reduce debt).[15] Therefore, it would appear to follow that investment decisions should be made by the same entity that makes the saving decisions, because of the close relationship between saving and investment. For the most part, in the system, the assumption is that an institutional unit is making its own management decisions (for example, how to undertake production, employ staff, raise funds, consume, etc.), even when there is a "control or influence" from outside, in the form of a major shareholder (or equivalent). These decision-making powers are what makes them separate institutional units. There seem to be no *a priori* reason to treat saving differently.

On the other hand, it has been argued that any investor (though not a usually a life insurance policyholder or pension fund beneficiary) is actively endorsing, or otherwise, an entity's behavior (which implicitly includes its saving and investment decisions) merely by dint of choosing to continue to hold, or, conversely, to divest, shares in that entity. In that manner, all shareholders of an entity could be said to be "reinvesting" in that entity the proportion of the entity's retained earnings that would accrue to the investor, on a proportionate basis. This is considered further below.

IV. Can these differences in the treatment of retained earnings/saving in the different situations be explained?

This paper has identified several differences in the way that retained earnings/saving of entities in various economic relationships are treated in macroeconomic statistics. Table 2 summarizes those differences. This section will compare those differences, to see whether or not they are compatible. The section will also assess whether the current treatment is consistent with the concept of saving, as discussed above, that is, whether it represents an institutional unit's conscious decision not to consume or distribute (part of) its income, in order to undertake accumulation or repay debt.

In the case of the first two instances shown in the table—reinvested earnings of *direct investment enterprises*, and entities where a *resident has a 10 percent (or greater) ownership share on another resident unit*—there would appear to be a direct contradiction. On the one hand, the *1993 SNA* states that retained earnings of DIEs should be deemed to be distributed to the direct investors (in proportion to their ownership share) as *reinvested earnings* (and then deemed to be returned to the DIE in the financial account), because, as noted, of a "conscious deliberate investment decision". Moreover, *BPM5* argues that this treatment for reinvested earnings of DIEs is appropriate because they:

> *"provide additional capital to the enterprises and to increase the value of an economy's stock of foreign assets and liabilities."* (*BPM5*, para. 288)

[15] The *1993 SNA* does not appear to discuss any decision making element regarding saving. Saving is only discussed in the *1993 SNA* as being the residual of income and uses of income, representing the means through which accumulation is financed internally. See *1993 SNA*, paras. 9.17 through 9.20.

Table 2. Differences in Treatment in Macroeconomic Statistics of Retained Earnings of Various Economic Types of Investment

Type of investment	*1993 SNA*	*BPM5*	*ESA 95*	"Active" or "passive" investment
1. DIE, where cross-border ownership 10 percent (or more) of equity (or equivalent)	Deemed distributed	Deemed distributed	Deemed distributed	Active
2. One resident has 10 percent (or more) ownership of equity (or equivalent) in another resident entity	Not deemed distributed	Not applicable	Not deemed distributed	Active
3. Property income on net equity in technical reserves of life insurance enterprises and pension funds	Deemed distributed	Deemed distributed	Deemed distributed	Passive
4. Mutual funds	Not deemed distributed	Not deemed distributed	Deemed distributed	Passive
5. Portfolio investment, where ownership of equity (or equivalent) <10 percent	Not deemed distributed	Not deemed distributed	Not deemed distributed	Passive

However, similar arguments could be applied equally to those situations where a resident investor holds 10 percent or more of the equity (or equivalent) in another resident entity. Why do saving or investment decisions by, for example, a government business enterprise not result in the deemed distribution of retained earnings (losses) to the (resident) parent government, when the entity is "subject to control or influence" of the owner in the same way? Why is it that such a cross-sectoral investment does not "provide additional capital to the enterprise"? Indeed, it could well be that an entity is 50 percent owned by a nonresident DI and 50 percent by another investor (in a different sector). The present treatment of reinvested earnings would mean that 50 percent of the entity's retained earnings would be deemed to be distributed to a nonresident, but 50 percent would be considered the entity's saving, even though the DI and the resident investor are likely to have a comparable "voice" in the decision making.

Moreover, as shown above, *ESA 95* (para. 4.58, quoted above) explicitly notes that, for a quasi-corporation, any undistributed earnings are to be regarded as saving of the quasi-corporation. Implicitly, para. 7.115 of the *1993 SNA* (also quoted above) has the same reasoning. If a quasi-corporation is deemed to have separate decision making powers to decide on what to save and what to disperse, what makes the cross-border relationship of direct investment so different that DIEs' saving should be treated so differently? If any entity could be said to have a "control or influence" from outside, where the investor is "active", it would be a quasi-corporation, as it has no separate legal identity from that of its owners. No argument is offered by the manuals to justify this inconsistency, other than to state that DIEs have cross-border relationships, which, implicitly, seems to make them qualitatively different.

Regarding the treatment of the rerouting of investment income of *life insurance technical and pension funds reserves* to policyholders and beneficiaries, the *1993 SNA* justifies this treatment because the technical reserves are assets of the policholders and so must be rerouted to them (*1993 SNA,* para. 7.124, see above). This argument would seem to imply that life insurance enterprises and pension funds are not institutional units in their own right, and are merely extensions of the policyholders and beneficiaries. Moreover, if the nature of saving as discussed above is correct — that saving should be a conscious decision taken by the entity that undertakes the investment — life insurance policyholders and pension fund beneficiaries would not appear to meet that definition as they have little or no discretion in how investment decisions are made on their behalf by life insurance enterprises and pension funds. In addition, such rerouting runs contrary to the rationale, in *1993 SNA*, for the treatment of reinvested earnings, that as being "a conscious deliberate investment decision".

It could be argued that the treatment to reroute the property income on the technical reserves of life insurance enterprises and pension funds to policyholders and beneficiaries is justified on the grounds that it is necessary for the calculation of the output of life insurance companies and pension funds.[16] However, the formula to derive this output measure (premia receivable *plus* premium/contribution supplements[17] *less* claims/benefits payable *less* increases (*plus* decreases) in reserves), while necessary to calculate a more reasonable measure of output than would the case without the inclusion of premium/contribution supplements, does not, in and of itself, require this routing of investment income to be shown explicitly in the system. It is a calculation that can be done outside the system.

With regard to the treatment of the undistributed earnings of *mutual funds*, the arguments presented by the *1993 SNA* in support of the routing of investment income to policyholders and beneficiaries (that *the technical reserves are assets of the insurance policyholders,* [so that] *the investment income receivable by insurance enterprises must be shown in the accounts as being paid by the insurance enterprises to the policyholders*) could equally apply

[16] While the *1993 SNA* indicates in Annex IV how to calculate the output of pension funds, given that pension funds are merely asset holders, managed by separate institutional units, it is not clear they have any output. On the other hand, pension funds have intermediate consumption – the output of the fund's managers -- and the system must have some means for the pension fund to consume that output.

[17] Premium/contribution supplements represent investment income receivable by policyholders and beneficiaries on life insurance technical and pension funds reserves.

to mutual funds. It is not clear that the assets held by life insurance enterprises and pension funds are any more "the assets of the policyholders" than the assets of mutual funds are the assets of the shareholders in the mutual funds. It is, presumably, for this reason that *ESA 95* states that all undistributed earnings of mutual funds should be deemed to be distributed. This approach has the merit of consistency, even if there is an inconsistency in other aspects of the *ESA 95* treatment of the manner in which income is receivable by the shareholders in the mutual funds. Firstly, interest "received", as described in *ESA95,* para. 4.49, is inconsistent with the accrual principle: interest accrues over time, and so increases the financial asset that is earning the interest. Para.4.49 in *ESA 95* states that interest is "received", not "receivable", which implies a reversion to some sort of cash accounting, such as coupon payments. Secondly, and more importantly, it is difficult to see how the "pass through" of interest received/receivable by mutual funds to their shareholders can be treated as interest when the instrument on which the income received/receivable is based is regarded as being equity.

On the other hand, in view of the classification of shareholdings in mutual funds as *portfolio investment* or *shares and other equity*, and that for the most part they do not involve any direct investment relationships, it would appear reasonable that their retained earnings/saving be treated in like fashion to other *portfolio investment*, that is, that undistributed earnings are regarded as saving of the mutual funds. As noted above, it can be inferred that the *1993 SNA* and *BPM5* adopt this approach, though there is no explicit statement to that effect. Even so, there is a contradiction one way or the other between the way that the property income of other collective investment schemes[18] (i.e., life insurance and pension funds) is treated and the treatment of the property income of mutual funds. If mutual funds are collective investment schemes, in much the same fashion as life insurance or pension funds, and they would appear to meet the definition, it would seem appropriate that their property income should be treated in the same way, that is, be rerouted to the shareholders. This approach has, in principle, been adopted by *ESA 95*. However, as mutual funds have been treated in both the *1993 SNA* and *BPM5* as being no different from other types of portfolio investment, it is appropriate that their property income be treated in the same manner as other portfolio investment, that is, if it is not distributed, it represents saving of the entity concerned. But it seems that mutual funds cannot be both collective investment schemes and "normal" portfolio investment, at the same time.

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[18] BOPCOM/02-42 offered the following definition of collective investment schemes as representing *a pooling of assets to meet some definite or possible future event and/or to reduce transaction costs and research and analytical costs and/or to spread risk collectively. The schemes are usually managed by professionals, on behalf of the investors. The schemes may acquire a variety of assets (financial and nonfinancial) which are designed to provide investment income and/or holding gains or protection against an insured event. The investors will (usually) have a claim on the assets, in proportion to the contributions made or earned.*

V. Proposed Options for Reducing the Inconsistent Treatment of Returns on Equity[19]

There would appear to be four possible options for reducing the inconsistencies in the treatment of "income" on equity in the *1993 SNA* and *BPM5*:

1. treat dividends payable as the only distribution of the earnings of corporations and quasi-corporations; as a consequence, there would be no imputed transactions for DIEs' reinvested earnings, or for the property (investment) income on the technical reserves of life insurance enterprises and pension funds

2. in addition to the present treatment[20], prorate and distribute the retained earnings (on a proportionate ownership basis) to investors with an ownership stake of 10 percent or more in any entity, **regardless of the residence of the investors, vis-á-vis, the entity,** in the same manner as for the reinvested earnings of DIEs, and deem that these funds are reinvested through the financial account

3. reroute **all** saving by **all** corporations and quasi-corporations to their owners, **regardless of the size of the equity holding**, and retain the rerouting of the property income of technical reserves of life insurance enterprises and pension funds to policyholders and beneficiaries.

4. treat all dividends (and distributed profits of quasi-corporations) as withdrawal of owners' equity, discontinue reinvested earnings and the rerouting of property income on equity in technical reserves of life insurance enterprises and pension funds, thereby eliminating altogether any property income payable/receivable on equity.

1. *Treat dividends payable as the only distribution of the earnings of corporations and quasi-corporations*; *as a consequence, there would be no imputed transactions for DIEs' reinvested earnings or for the property (investment) income on the technical reserves of life insurance enterprises and pension funds.*

This option would include in the income account for returns on equity only dividends payable/receivable, i.e., reinvested earnings would not be regarded as a transaction, the income on the technical reserves of life insurance enterprises and pension funds would not be deemed payable to policyholders and beneficiaries. This would serve to reduce imputations

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[19] Including net equity of policyholders on technical reserves of life insurance enterprises and net equity on the reserves of beneficiaries of pension funds.

[20] That is, all dividends continue to be treated as "income", the retained earnings of DIEs continue to be deemed distributed to the DIs (in proportion to their ownership share of equity, or equivalent) and then be reinvested in the financial account, and the property income of the technical reserves of insurance corporations and pension funds continue to be deemed distributed to the policyholders and beneficiaries, and then be reinvested.

in the system. It would also ensure consistency between resident:resident relationships where an entity has at least one shareholder/owner with 10 percent or more of the equity outstanding (or equivalent) and those between DIs and DIEs, while, at the same time, avoid inconsistency between some passive investors (portfolio investors) and other passive investors (policyholders' and beneficiaries' equity on the technical reserves of insurance companies and pension funds). This option would also be in line with the view of saving to represent a "conscious, deliberate decision" by the institutional unit making investment decisions. This option would also be the simplest, and most transparent, means of addressing some of the inconsistencies.

On the other hand, there would be loss of information on reinvested earnings. Reinvested earnings are important for analysis of direct investment, and should not be ignored. To address this need, it would be necessary for information on reinvested earnings to be available elsewhere in the balance of payments framework. It could be included as a separate item (under *direct investment, equity*) in the "Other Changes in Assets Account", but in jurisdictions where that account is not prepared, it would be required as a memorandum item to the balance of payments statement.

2. *In addition to the present treatment, prorate and distribute the retained earnings (on a proportionate ownership basis) to investors with an ownership stake of 10 percent or more in any entity, **regardless of the residence of the investors, vis-á-vis, the entity,** in the same manner as for the reinvested earnings of DIEs, and deem that these funds are reinvested through the financial account.*

Under this option, the obverse of option #2, consistency across the national accounts framework would be further enhanced. For an entity with a resident:resident ownership relationship, where one or more investors hold 10 percent (or more) of the equity (or equivalent), its retained earnings would be treated (and prorated) in the same manner as in direct investment relationships. Thus, the role of an investor with sufficient holding of an entity's equity (or equivalent) to have a "voice" or "influence" would be treated comparably, regardless of whether the ownership relationship is cross-border or domestic.

The main disadvantage of this option is it would not be in line with the view of saving as representing a "conscious, deliberate decision" by the institutional unit making investment decisions. In addition, it would result in substantial changes to sectoral saving, (especially for general government and either (or both) the financial and nonfinancial sectors that have important government business enterprises). It would also involve a major change in the way in which most countries collect their data.

3. *Reroute all saving by **all** corporations and quasi-corporations to their owners, **regardless of the size of the equity holding**, and retain the rerouting of the property income of technical reserves of life insurance enterprises and pension funds to policyholders and beneficiaries*. This option amounts to option #1 *plus* all retained earnings of all corporations and quasi-

corporations that are in a direct investment relationship[21], **regardless of the ownership level of the investors and the residence of the owners**, would be deemed distributed to the ultimate owners. These "reinvested earnings" would then be reinvested through the financial account (in the same manner that the reinvested earnings of direct investors and the policyholders and beneficiaries of technical reserve holdings of insurance companies and pension funds are at present). This would have the virtue of treating the income on all equity instruments in the same manner but would the following disadvantages:

- it would involve more imputed transactions;

- it would mean that the saving of the nonfinancial and financial sectors of any economy would be zero;

- it would involve a major change in government accounting so that all the retained earnings/losses of government business enterprises would be included in the saving of general government;

- it would be very difficult for balance of payments compilers to measure the income receivable on portfolio investment assets; and, perhaps most importantly,

- it would appear to separate the saving and investment decision making process.

This option would be inconsistent with the view of saving as representing a "conscious, deliberate decision" by the institutional unit making investment decisions. It would, however, be consistent with the argument that all shareholders, whether portfolio investors or direct investors, cross-border or in a resident:resident relationship, are "active" investors, as they have the choice of continuing to hold their investment or to sell it (assuming a liquid market). Continuing to hold, and to receive the prorated retained earnings, accordingly, could be taken to represent a "conscious, deliberate decision" to save.

4. *Treat all dividends (and distributed profits of quasi-corporations) as withdrawal of owners' equity, discontinue reinvested earnings and the rerouting of property income on equity in technical reserves of life insurance enterprises and pension funds, thereby eliminating altogether any property income payable/receivable on equity.* The principal arguments for this approach are:

[21] The treatment of retained earnings of direct investment entities would not be changed, as that is part of the status quo.

(a) for *all corporations and quasi-corporations, their net earnings*[22] become part of shareholders'/owners' funds before the disbursement of dividends/remittance of earnings of quasi-corporations. Shareholders'/owners' funds also include realized holding gains (or losses), revaluations, or other (non-transaction) flows. Given that shareholders'/owners' funds are fungible, all these elements become indistinguishable and can be applied to a variety of purposes, such as, acquisition of nonfinancial or financial assets, repayment of debt, distribution to shareholders/owners of "special" dividends,[23] "liquidating dividends", and all other dividends[24]. Consequently, dividends may be payable out of sources of funds other than current operating income,[25] and may be declared payable even when an entity is losing money. Accordingly, any payment out of shareholders'/owners' funds to the shareholders/owners might better be represented as a disbursement of capital.

Not treating dividends as income, and regarding them as distributions out of shareholders'/owners' funds, would mean, in effect, that all returns to equity would be treated in a comparable fashion. Not only do many companies not distribute dividends (especially in the high technology industry), making cross-industry/cross-country analysis more difficult, but, as most investment in equities is undertaken with a view to making holdings gains, treating dividends as disbursement of capital would tie in better with the way that returns on equity are achieved.

Indirectly, the logic of this approach to the treatment of the returns to equity is recognized in the *1993 SNA* and *ESA95*, in the manner in which payments from the reserves of pension funds are treated. While, in the first instance, these payments are regarded as "income" (current transfers) because, as the *1993 SNA* states, "households ... tend to regard the pensions they receive as income in the form of current transfers" (*1993 SNA*, 9.14), the *1993 SNA* and *ESA 95* recognize that this approach is inconsistent with the structure of the system (such payments "constitute .. disposal of financial assts" (*1993 SNA,* para. 9.14). Consequently, the *1993 SNA* and *ESA 95* reverse this treatment in the Use of Income

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[22] That is, the sum of its receipts from production, investment income receivable (excluding dividends receivable), and current transfers receivable *minus* the sum of consumption expenses, investment income payable (excluding dividends payable), and current transfers payable.

[23] Or equivalent for quasi-corporations.

[24] "Special" dividends result from a de-merger or the sale of a substantial part of a business's activities. "Liquidating" dividends are paid to shareholders'/owners' funds, following the winding up of an entity. Both would be better considered to be disbursements from shareholders' funds, and consequently, be treated as a financial account transaction, than as "normal" dividends in the income account. Neither of these is discussed in *BPM5* but the *1993 SNA* (para. 7.118) and *ESA 95* (para. 4.61), as noted above, indicate that withdrawals from *quasi-corporations* (but not for incorporated entities) that result from the sale of capital assets are not to be considered part of income.

[25] One of the principal sources of income for a central bank is holding gains on securities or gains on foreign currency transactions. Dividends to their owners (the central government) are often sourced in this manner.

Account (through "Adjustment for the change in the net equity if households in pension funds") and then recognizes in the financial account that an asset holding ("net equity of households on life insurance reserves and pension funds") has been reduced[26]. Treating dividends/undistributed earnings of corporation and quasi-corporations as a reduction of shareholders'/owners' funds would represent a comparable recognition that they are not income.

(b) for the *technical reserves of life insurance enterprises and pension funds*, there would be no deemed distribution of property income to the policyholders and beneficiaries. The reason for this approach is that the saving and investment decisions of these entities are not made by the policyholders and beneficiaries, but by these entities on the policyholders'/beneficiaries' behalf. Although imputing this income payable to policyholders and beneficiaries is undertaken as part of the calculation of the output of these entities, it is not necessary, as noted above, to make this imputation within the system to derive this measure of output: it can be done separately. Therefore, there is no need to impute a saving decision to households/nonresidents where they have little effective input.

For corporations, quasi-corporations, and the technical reserves of life insurance enterprises and pension funds, such an approach would be consistent with the notion of saving, as set out in Section III, that is, the saving decision is a "conscious deliberate" act on the part of the institutional unit making the investment decisions, and the declaration of dividends is made as part of those investment decisions (i.e., what proportion of internally generated funds should be distributed to shareholders/owners and what proportion use for acquisition of assets or repayment of debt).

On the other hand, under this option, there would be loss of the information on reinvested earnings. Therefore, as with option #1, it would be necessary for information on reinvested earnings to be available elsewhere in the balance of payments framework. It could be included as a separate item (under *direct investment, equity*) in the "Other Changes in Assets Account", but in jurisdictions where that account is not prepared, it would be required as a memorandum item to the balance of payments statement.

The main disadvantage of this approach is that it would represent a significant change from the present manner in which returns on equity are measured, or, perhaps, understood.

Table 3 summarizes the impact of the various options.

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[26] It would have been simpler had the *1993 SNA* (and *ESA 95*) not imputed the pension payments as current transfers in the first place. But the outcome is the same.

VI. A FURTHER CONSIDERATION ON HOW REINVESTED EARNINGS AND THE PROPERTY INCOME OF TECHNICAL RESERVES OF LIFE INSURANCE ENTERPRISES AND PENSION FUNDS ARE TREATED IN THE PRESENT FRAMEWORK.

The analytical importance of reinvested earnings (policyholders'/ beneficiaries' claims on the technical reserves of life insurance enterprises and pension funds) lies in the identifying the means through which a DIE (life insurance enterprise/ pension fund) provides internally generated funds for accumulation of assets (repayment of debt). Reinvested earnings are deemed to be distributed and then reinvested as a deliberate act on the part of the DIs, and the property (investment) income of the technical reserves of life insurance enterprises and pension funds were deemed payable to the policyholders/beneficiaries because the system deems them to be the assets of the policyholders/beneficiaries. However, with the full array of accounts set out in the *1993 SNA*—integrating production of/transactions in goods and services, income, consumption, current transfers, capital accumulation (financial and nonfinancial), Other Changes in Assets Account, and the opening and closing balance sheets —changes in position that result from transactions or from other changes are identifiable separately[27]. They do not need to be commingled. The Other Changes Assets Account has an analytical meaning in its own right, and using it to explain non-transaction changes in balance sheet levels is an essential part of the system. A change in assets and/or liabilities between the opening and closing balances that retained earnings may finance may as easily, and more legitimately, be shown through the Other Changes Assets Account than through the imputation of a transaction (such as reinvested earnings of DIEs or attributing income of the technical reserves of life insurance or pension funds to policyholders and beneficiaries). Consequently, there is now no need to show reinvested earnings (or the rerouting of property income of the technical reserves of life insurance enterprise and pension funds) as a transaction.

VII. CONCLUSION

In summary, this paper has reviewed the manner in which retained earnings/saving are treated in macroeconomic statistics in certain situations. There are several different, and apparently inconsistent, treatments of retained earnings/saving in the *1993 SNA* and *BPM5*. The paper has highlighted these differences, and questioned whether the rationales offered by these documents are sufficiently robust to continue with the present treatment. The paper offered four alternatives through which inconsistency could be reduced:

(i) treat dividends payable as the **only** distribution of the earnings of corporations and quasi-corporations, and show data on reinvested earnings, either as a memorandum item to the balance of payments, or as an explicitly identifiable separate item in the

[27] The framework in *BPM5* is not as fully articulated but the Other Changes in Assets Account is implicit in its system.

Table 3. Comparison of the Options on how Saving/Retained Earnings of Different Investment Relationships would be Treated in the National Accounts and the Balance of Payments

Type of investment	Status quo	Option #1	Option #2	Option #3	Option #4
1. DIE, where cross-border ownership 10 percent (or more) of equity (or equivalent)	D + R	D	D + R	D + R	F
2. One resident has 10 percent (or more) ownership of equity (or equivalent) in another resident entity	D	D	D + R	D + R	F
3. Property income on net equity in technical reserves of life insurance enterprises and pension funds	R	N	R	R	N
4. Mutual funds	D[(1), (2)]	D	D	D + R	F
5. Portfolio investment, where ownership of equity (or equivalent) <10 percent	D	D	D	D + R	F
6. Consistent with nature of saving as a "conscious, deliberate decision" by saver	No	Yes	No	No	Yes

(1) In *ESA 95*, all retained earnings are deemed distributed.
(2) At present, no direct investment relationships are assumed to exist for mutual funds, and comparable investment vehicles. However, it is possible that, in the revised balance of payments manual, there may be instances where direct investment relationships may be deemed to exist between mutual funds and their investors, or between mutual funds and the entities in which they invest.

Legend:
R = Retained earnings deemed distributed, prorated on basis of ownership share, or property income on the technical reserves of life insurance enterprises and pension funds, as appropriate
D = Dividends only
F = Financial account only for dividends (distribution of dividends deemed to represent a withdrawal of shareholders'/owner's funds)
N = No transaction

Other Changes in Assets Account. The rerouting of property (investment) income of the technical reserves of life insurance enterprises and pension funds would also be discontinued. This option would be consistent with the notion that saving is a conscious, deliberate decision by the investing entity. This option would also be the simplest, and most transparent, means of addressing some of the inconsistencies;

(ii) in addition to the present treatment, prorate, on a proportionate basis to the ownership share, the retained earnings of any entity where there is an ownership stake of 10 percent or more by one or more investors, regardless of the residence of the investors, vis-á-vis, the entity, in the same manner as for the reinvested earnings of DIEs, and deem that these funds be reinvested through the financial account; and retain the present treatment on the rerouting of property (investment) income of the technical reserves of life insurance enterprises and pension funds. This option would reduce the most obvious inconsistency between cross-border ownership relationships and resident:resident ownership relationships, where the investor holds 10 percent or more of the equity (or equivalent). It would, however, be inconsistent with the notion that saving is a conscious, deliberate decision by the investing entity.

(iii) reroute **all** saving by **all** corporations and quasi-corporations to their owners, **regardless of the size of the equity holding**, and retain the rerouting of the property income of technical reserves of life insurance enterprises and pension funds to policyholders and beneficiaries. It would be inconsistent with the notion that saving is a conscious, deliberate decision by the investing entity, and would have the effect of reducing all saving by the corporate sectors to zero; and

(iv) treat all dividends (and distributed profits of quasi-corporations) as withdrawal of owners' equity, discontinue reinvested earnings and the rerouting of property income on equity in technical reserves of life insurance enterprises and pension funds to the policyholders and beneficiaries, thereby eliminating altogether any property income payable/receivable on equity. This option would be consistent with the notion that saving is a conscious, deliberate decision by the investing entity. Under this option, data on reinvested earnings would be required either as a memorandum item to the balance of payments, or as an explicitly identifiable separate item in the Other Changes in Assets Account

Questions for the Committee

1. Does the Committee have any views on the various options for the treatment of income on equity?

2. Does the Committee have a view as to whether that saving decisions should be regarded as conscious and deliberate acts?

3. Does the Committee think that the issues raised in this paper should be pursued in other fora, as part of the updating of BPM5, *before being brought back to the Committee?*