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CENTER FOR LATIN AMERICAN MONETARY STUDIES

Balance of Payments Statistics Workshop

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Primary Income Account

Definitions

<u>Current Account (functional categories)</u>

- Goods and Services
  - ✓Goods
  - ✓Services
- **Primary Income**
- Secondary Income

Definitions

- Primary income represents the return that accrues to institutional units for their contribution to the production process through labor, the provision of financial assets (equity and debt instruments) and for renting natural resources to other institutional units.

- The primary income account shows primary income flows between resident and nonresident institutional units.

Definitions

- Primary income differs from secondary income in that it shows the return for the provision of labor, financial assets and natural resources, whereas secondary income shows the next phase of the distribution of such income by means of current transfers.

- Secondary income is a separate functional category of the current account.

Types of Primary Income

- Compensation of employees
  - ✓Wages and salaries
  - ✓Social contributions of employers

- Income investment
  - ✓ Dividends
  - ✓ Reinvested earnings
  - ✓ Interest

Compensation of Employees

- Return for the labor involved in the production process.
- Such return is the counterpart for the contribution of the worker to the production process that someone makes by being involved in a labor relationship with a firm.
- For BOP purposes the employer and the employee need to be residents of two different economies.

Compensation of Employees

- Contributions made by employers to social security programs on behalf of their employees are regarded as a part of their compensation.
- This is so, because these social security programs end up benefiting the workers. It is like a payment received in kind.
- In BOP they are recorded as primary income because there is a benefit granted by the economy of the employer to workers who are residents in another economy.

Compensation of Employees (type of labor relationship)

- For BOP purposes, it has to be determined if there exists an employer-employee relationship between a resident and a non-resident.

- The existence of such type of relationship is the key to establish whether the payment is to be recorded as primary income or as a services transaction.

Compensation of Employees (primary income vs. services)

- When a person is hired in order to deliver a specific result, it is reasonable to think that there is a contractual ***services*** relationship between the hiring entity and the autonomous worker, not of the kind of an employer-employee relationship ***(primary income)***.

- An autonomous worker is regarded as one who owns an enterprise and therefore sells or offers the good or service that it produces.

- An autonomous worker is normally responsible for the decisions related to the work to be performed (procedures, acquisition of inputs, equipment to be used, hiring other workers, etc.).

Compensation of Employees (primary income vs. services)

- Several factors need to be considered in order to determine the nature of the labor relationship:

  - ✓The employer retains the right to control what needs to be done and how the employee will do it.
  - ✓The worker is entitled to benefits similar to those generally received by other employees of the same firm.
  - ✓The payment of social contributions by the employer strongly suggests the possibility of an employer-employee relationship.

Compensation of Employees (primary vs. secondary income)

- Cross-border workers are temporary or short-term workers (less than a year), as well as any other individual who is a resident of one economy but works in another one ***(primary income)***.
- On the other hand, the income of workers who have become residents of their new economy (the one where they work) that is sent to the economy where they come from are transfers ***(secondary income)***.
- Workers of diplomatic representations and military bases located abroad are residents of the economy that they represent, therefore their income is ***not recorded in the BOP***.

Compensation of Employees (functional categories)

Payment related to:	Functional Category
Employer-Employee relationship (different residence)	Primary Income
Employer-Employee relationship (same residence)	Secondary Income-Remittances*
Independent parts in the transaction (different residence)	Services

** Conditioned upon the money being sent abroad.*

Compensation of Employees (exercise)

A bahamian national has been living in the UK for six years. During the recording period he earned a salary equivalent to 1,000 US dollars. He sends 300 USD to his relatives in Bahamas. His sister, also a bahamian national, travels every week to Miami where she has a job and earned 800 USD in the recording period. Also, this woman, when in Miami, makes freelance fashion design work for different companies and earns 600 USD. During tbe period she spends 500 USD in the USA.

	Credits	Debits	Net
Current Account	**1700**	**500**	**1200**
Goods and Services			
Goods			
Services			
Travel		500	
Other Business Services	600		
Primary Income			
Compensation of Employees	800		
Secondary Income			
Personal transfers	300		
	Assets	**Liabilities**	**Net**
Financial Account	**1200**		**-1200**
Reserve Assets	300+800+600-500=1200		

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Compensation of Employees (sources of information)

- ITRS: Reports are made on a net basis because local purchases of workers are not reported, compilers should try to estimate gross income. Misclassifications can occur because these systems cannot distinguish the residence of the remitter or if he/she is in an employer/employee relationship.

- Personal surveys: The main advantage of using this source is that it collects data directly from workers on a timely basis, and therefore the mistakes due to memory recall would be avoided.

- Official sources: They may provide useful information on compensation payable to the local staff of the compiling economy's embassies and so forth located abroad.

Compensation of Employees (sources of information)

- Surveys of foreign embassies and similar institutions, including international organizations, located in the domestic economy could be a good source of information on compensation payable to resident staff working for these institutions.

- Employer surveys: They could be useful on compensation payable by resident companies to nonresident employees. The main advantages of using surveys of employers are that amounts are recorded on a gross basis, and compensation paid in kind can often be reported. The main disadvantage is the amount of effort required to maintain adequate coverage.

Compensation of Employees (sources of information)

- Money transfer firms: Money can be sent to the country of origin of the worker by using this channel. However, these companies do not know if the remitter is a resident of the country from where he sends the money (secondary income) or of his country of origin (primary income).

- Normally, most of the money remitted comes from residents of the country where the money is being sent from and, therefore, the whole flow is classified as transfers.

Investment Income

- Returns earned by residents of one economy for making available their assets to residents of another economies.

- The classification of investment income is the same as the one of functional categories in the financial account and the IIP:
  - ✓Direct investment
  - ✓Portfolio investment
  - ✓Financial derivatives (no income)
  - ✓Other investment
  - ✓Reserve assets

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Investment Income

By instrument:

- Debt securities→ Interest
- Loans and deposits→ Interest
- Equity (FDI and portfolio)→ Earnings/Dividends
- Gold bullion → No income
- Financial Derivatives → No income

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Interest

- Investment income accrued by the owners of some kinds of financial assets (deposits, debt securities, loans and other receivables) for making them available to another institutional unit. For interest to be recorded in the BOP, the lender and the borrower have to be residents of different economies.

- Interest payments include two components; the capital return (pure interest) and the payment for a financial intermediation service (FISIM).

Interest

- Interest is recorded as it accrues, as if they were continuously paid to the creditor throughout time on the outstanding principal.

- Therefore, non-paid accrued interest increases the value of the asset/liability in the financial account. When the interest comes due and is paid, a reduction in the corresponding asset/liability is recorded.

Interest (exercise)

A resident firm receives a five year loan of 30 million USD. The annual interest rate is 10%. Interest is paid in the last year.

	Year 1			Year 2			Year 3			Year 4			Year 5		
	Credits	Debits	Net	Credits	Debits	Net	Credits	Debits	Net	Credits	Debits	Net	Credits	Debits	Net
Current Account	0	3	-3	0	3	-3	0	3	-3	0	3	-3	0	3	-3
Primary Income															
Investment Income															
Other Investment															
Interest		3			3			3			3			3	
	Assets	Liabilities		Assets	Liabilities		Assets	Liabilities		Assets	Liabilities		Assets	Liabilities	
Financial Account	30	33	3	0	3	3	0	3	3	0	3	3	-45	-42	3
Other Investment															
Loans															
Other Sectors															
Non-Financial Corporations		33			3			3			3			-42	
*Principal**		*30*												*-30*	
*Non-paid accrued interest**		*3*			*3*			*3*			*3*			*-12*	
Reserve Assets	30												-30-15=-45		

** Not a standard component.*

Dividends

- Earnings delivered to the equity owners as a retribution for making funds available to the corporations.

- Returns paid by corporations to their owners and stockholders.

- Primary income originated from the holding of equity securities (ownership titles).

Reinvested Earnings

- Portion of the earnings not delivered to the direct investors who decided that these earnings should be invested back in the company in order to increase equity.

- Not a cash flow.

- The reinvestment decision may occur in a different period after the earnings were created.

Reinvested Earnings

- Reinvested earnings are recorded as if delivered to the direct investors who then decided to reinvest them back.
- Primary income imputed to direct investors is shown under primary income as reinvested earnings with a counterpart in reinvestment of earnings in the financial account.

	Credits	Debits
Current Account		
Primary Income		
Investment Income		
Direct investment		
Equity		
Reinvested Earnings		X
	Assets	**Liabilities**
Financial Account		
Direct Investment		
Reinvestment of Earnings		X

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Reinvested Earnings

- The rationale that underlies this treatment derives from the fact that the FDI firm is subject to the control or influence of direct investors. So the decision of retiring or reinvesting a part of the profits is in fact a decision by the investors to keep a share in a resident firm and it is, therefore, an investment decision.

- In BPM4, where reinvested earnings were not recorded in the BOP, increases in the FDI stock did not have a counterpart entry so they were being reported as errors and omissions.

Reinvested Earnings

- Earnings, whether paid or reinvested, cover exclusively the return of the investment. Any gains or losses made through the mere holding of an asset that changes its price is recorded in the IIP under “Other Changes in Financial Assets and Liabilities”.

IIP Integrated Statement				
	Initial Position	Financial Account	Other Changes	Final Position
FDI	100	10	5	115

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Rent

- Rent covers income receivable for putting natural resources at the disposal of another institutional unit. The BOP is interested in cases where the entity using land or natural resources and the unit who owns them are resident of two different economies.

- Some examples of rent are:

✓Amounts payable for the use of land without building

✓Extraction of minerals and other subsoil assets

✓Fishing, forestry and grazing rights

Investment Income (sources of information)

- Enterprise surveys may be selective (e.g., concentrating only on financial corporations or companies in direct investment relationships) or broadly based (e.g., covering nearly all companies with external assets and liabilities).

- Data on investment income, such as income related to official debt and reserve assets, could be obtained from official sources.

- When there is private debt publicly guaranteed, the official areas covering foreign debt normally have information.

Investment Income (sources of information)

- Foreign exchange controls or foreign investment approval procedures require companies to submit applications to remit profits. These applications could be used to estimate some components of investment income.

- ITRS can be useful but it is important to bear in mind that virtual transactions such as accrued no yet paid interest and reinvested earnings are not covered.

Investment Income (extrapolation)

- In the absence of direct information on investment income receipts or payments a data model can be used in which income yields are applied to levels of financial assets or liabilities. This approach may be used to estimate interest and dividends on securities and to estimate income on other financial items, such as loans and deposits.

- Estimates at the most detailed levels are encouraged for precision. For example, separate estimates for income on debt and equity securities.

Investment Income (extrapolation)

- Optimally, individual estimates for each specific type of financial instrument is recommended.

- The election of an appropriate income yield is crucial:
  - ✓Average dividend yield in the compiling economy’s stock markets (dividend debits).
  - ✓The weighted average yield in the stock markets of partner economies (dividend credits).
  - ✓Interest rates by relevant market and currency (interest).