

# INTERNATIONAL TRANSFERS AND ECONOMIC PERFORMANCE ANALYSIS

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This paper examines the appropriate treatment of international transfers in the national accounts. It argues that the appropriate treatment differs, depending upon the use to be made of the accounts. The treatment recommended in the SNA is appropriate for expenditure behavior analysis, with its emphasis on total disposable income on the one hand, and its allocation between consumption and saving on the other. For economic performance analysis, however, the primary focus of interest is the excess, if any, of aggregate resource use over the GNP, i.e., the extent to which the combined level of consumption and investment is sustained out of own production or is dependent on unrequited capital inflow. It is essential for this purpose that the measure of capital inflow include all international transfers regardless of their economic destination.

The object of this paper is to examine the treatment of international transfers in the United Nations system of national accounts, and to assess the impact of this treatment on the adequacy of the derived estimates of national saving and external current account surplus for country performance analysis.<sup>1</sup> Although these estimates are key inputs for virtually all types of country economic analysis, their conceptual basis in the UN accounting system is not explicitly defined, with the result that their adaptability to particular analytical purposes may not always be evident. This is attributable, at least in part, to the fact that both national saving and the current surplus are obtained as residuals or balancing items in the sector and summary national accounts, so that their definition is implicit in the treatment of other items in the accounts:

“Saving is the balancing item on the income and outlay account of resident institutional units, after all current receipts and disbursements have been accounted for. Saving is thus defined in terms of the flows which have been discussed in the preceding sections of this chapter.”<sup>2</sup>

Since differing treatments of transfer flows can give rise to significantly different pictures of savings performance and foreign capital inflow, any uncertainty concerning the conceptual basis of the estimates can have serious implications for analysis at both the country and cross country levels. A construction which is designed for expenditure behavior analysis, for example, may yield estimates which are misleading or erroneous for purposes of economic performance analysis, and *vice versa*. The danger of this occurring is especially great in the case of transfers received from and paid to abroad by households, non-profit institutions and general government, which in some countries are large in comparison with national saving and the external current surplus.

The specific question for discussion is the distinction made in the UN system of accounts between transfers on current and capital account. Transfers classified

<sup>1</sup>It may be important to emphasize that the present discussion relates to the treatment of transfers and not of factor payments to and from abroad. Although it may be difficult at times to decide whether a particular flow should be recorded as one or the other, this is a problem of classification and not of principle.

<sup>2</sup>“A System of National Accounts”, Studies in Methods, Series F, No. 2, Rev. 3, United Nations, New York, 1968, p. 130, para. 7.70.

as current are recorded in the sector accounts and the external transactions account of the donor country as current expenditure, and are thereby excluded from (i.e. reduce) the residual estimates of national saving and external current surplus. In the recipient country they are recorded as current revenue, thereby increasing national saving and the external current surplus—or, perhaps more typically, reducing the current deficit.<sup>3</sup> Whether the estimates emerging can be deemed acceptable must depend, of course, on the analytical purpose for which they are to be employed.

As presently structured, and particularly with reference to the treatment of transfers, the UN accounting system would appear to be geared primarily to *expenditure behaviour analysis*, with its emphasis on total disposable income on the one hand and its allocation between consumption and saving on the other:

“... The net receipts of residents of a country of incomes from employment, entrepreneurship and property and from re-distributive transfers, make up their national disposable income. Finally, the income and outlay accounts show how residents apportion their disposable income between final consumption expenditure and saving.”<sup>4</sup>

This is also evident from the nature of the criteria postulated for distinguishing between current and capital transfers, which focus exclusively on the subjective reactions of donors and recipients and the impact of the transfers on their expenditure decisions:

“Unrequited current transfers are distinguished from capital transfers in light of the purpose for which the transfer is to be utilized and the basis, source and frequency of the payments. Transfers on current account should be utilized to finance production or consumption, but not investment in tangible or financial assets, during a period of account; and should be made out of current income, and not wealth at very infrequent intervals. In order to be classed as a current transfer, a transaction should be on current account from the point of view of both the recipient and the donor.”<sup>5</sup>

“Capital transfers, as understood here, refer to those unrequited transfers which are not, in general, considered by the recipient as adding to his current income or by the payer as reducing his current income. Such transfers, in principle, influence the level of consumption only indirectly through their effects on the amount and composition of the the assets of the recipient or the payer. Instead, they influence directly the level of capital investment or wealth of the recipient or the payer. In practice, however, intersectoral transfers of a mixed character may take place, particularly between general government and other sectors, in which one party regards the transfer to be of a current nature while the other regards it as of a capital nature. The rule followed here is that all mixed transfers of this kind should be treated as capital transfers.”<sup>6</sup>

<sup>3</sup>Most countries receiving sizeable transfer payments from abroad would appear to be in deficit rather than surplus on external current account.

<sup>4</sup>“A System of National Accounts”, United Nations, 1968, p. 120, para. 7.5.

<sup>5</sup>*Op. cit.* p. 127, para. 7.60.

<sup>6</sup>*Op. cit.* p. 131, para. 7.75.

Against this background, the question arises as to whether the saving and current surplus estimates derived from a system adapted to expenditure behavior analysis are also appropriate for economic performance analysis. In what follows, it will be argued that this is not in fact the case, and that the estimates now obtained give an erroneous picture of the relative savings performance of the donor and recipient countries and understate the degree of dependence of the recipient country on foreign capital inflow. For performance analysis, the requisite picture is obtained only when all international transfers, other than those which are not in the nature of gifts,<sup>7</sup> are recorded as capital account transactions.

Before proceeding further, it will be useful to clarify briefly the difference between the definitional requirements of expenditure behavior analysis and economic performance analysis. For this purpose, a hypothetical model of the income and expenditure accounts of two individuals, "A" and "B", will be employed.

In period I, A is assumed to earn a net income (i.e. has a net product) of 40,000 of which 39,800 is spent on consumption and 200 saved; B is assumed to earn a net income (net product) of 10,000 which is spent entirely on consumption. Their income, consumption and saving accounts would thus look as follows:

PERIOD I (No transfer)			
	Earned Income (Product)	Consumption	Saving
A	40,000	39,800	200
B	10,000	10,000	—
Consolidated Total	50,000	49,800	200

Now let it be assumed that in Period II the earned income of A and B remains unchanged but that A sends a gift check of 1,000 to B. Assume also that in order to do this, A cuts down his consumption expenditure by a further 800, while B increases his consumption expenditure by 900 and retains a surplus of 100. The question arises as to how these data are to be interpreted. If the conventional approach is adopted (i.e. A's gift to B is recorded as a current transfer), the following picture is obtained:

PERIOD II (Gift recorded as current transfer)					
	Earned Income (Product)	Current Transfer Receipts	Total Disposable Income	Consumption	Saving
A	40,000	-1,000	39,000	39,000	—
B	10,000	1,000	11,000	10,900	100
Consolidated Total	50,000	—	50,000	49,900	100

<sup>7</sup>These are usually relatively minor flows such as membership contributions to international or private organizations, etc.

Thus out of a combined income (product) of 50,000, 49,900 was consumed and 100 saved. The source of this saving was B's abstention from consumption. A saved nothing.

These results, which reflect A's and B's consumption and saving decisions from the standpoint of their total disposable income, are consistent with the requirements of expenditure behavior analysis. For this type of analysis, it is generally a matter of indifference whether the income disposed of was earned or unearned.<sup>8</sup> From the standpoint of A's and B's individual and relative *performance*, however, i.e. their production and disposition of real resources, this picture of saving is entirely misleading. If A's gift to B continues to be treated as a current transfer, the following results will emerge:

A produced 40,000, consumed 39,000 and saved nothing  
 B produced 10,000, consumed 10,900 and saved 100  
 A and B together produced 50,000, consumed 49,900 and saved 100

Thus, although B consumed 900 more than he contributed to the combined product, he is credited with having saved 100. On the other hand A, who consumed 1,000 less than he contributed to the combined product, appears as having saved nothing. Furthermore, this appears to have occurred despite the fact that A had actually saved 200 in Period I and had further cut down his consumption by 800 in Period II. These results are clearly implausible.

If A's gift to B is now excluded from current revenue and expenditure and is recorded as a capital transfer, the following picture is obtained:

PERIOD II  
 (Gift recorded as capital transfer)

	Earned Income (Product)	Consumption	Saving	Capital Transfer Receipts
A	40,000	39,000	1,000	-1,000
B	10,000	10,900	-900	1,000
Consolidated Total	50,000	49,900	100	—

These results, which are consistent with the requirements of economic performance analysis, state that the primary source of saving in the system was A. B on the other hand, who contributed 10,000 to the combined product and consumed 10,900, consequently dissaved to the extent of 900. This was made possible by A's saving of 1,000—which was transferred to B as a gift and of which 900 was spent on increased consumption and 100 was retained as a surplus. In contrast to expenditure behavior analysis, therefore, it emerges that saving in the context of performance analysis can be considered to take place only out of *earned income (product)*.

<sup>8</sup>This need not be entirely true. To the extent that unearned receipts are regarded by the recipient as a distinct category, their expenditure pattern could be different from that of earned income. This point is not taken up, however, since the present paper is concerned primarily with the requirements of economic performance analysis and not with those of expenditure behavior analysis.

With appropriate modifications, this same argument can now be applied to transfers between countries. For purposes of illustration, a highly simplified two-country model is employed, with each economy consisting of an enterprise sector, household sector and rest-of-world sector. Consumer goods only are produced and there is no fixed investment. Household saving is thus reflected in the accounts of the enterprise sector as an increase in stocks of unsold consumer goods. Prior to effecting the transfer, there is no foreign trade between the two countries. Using the same basic data as previously, the accounts for Period I will appear as follows:

PERIOD I (No transfer)							
COUNTRY A				COUNTRY B			
Enterprises				Enterprises			
Value Added (=GNP)	40,000	Sales to households	39,800	Value Added (=GNP)	10,000	Sales to households	10,000
		Increase in stocks	200				
	40,000		40,000		10,000		10,000
Households				Households			
Domestic consumer goods	39,800	Earned income	40,000	Domestic consumer goods	10,000	Earned income	10,000
Saving	200						
	40,000		40,000		10,000		10,000
Rest-of-World				Rest-of-World			
Exports	—	Imports	—	Exports	—	Imports	—

Assume now that in Period II, households in Country A cut back their consumption by a further 800 and make a transfer (gift) of 1,000 to households in Country B.<sup>9</sup> Assume also that households in B increase their consumption expenditure by 900 and retain a surplus of 100. It would be possible to construct almost any number of hypothetical *ex post* results, depending on the assumptions made regarding the impact of the transfer on the two economies. At one extreme, one could assume the existence of unused capacity in B, so that B's production of consumer goods rises in order to meet the new demand. At the other, the increased demand in B could be met by importing consumer goods from A. Other possibilities include part of the new demand being met out of increased produc-

<sup>9</sup>The same argument will apply in equal measure to transfers between governments, non-profit institutions, etc.

tion and part out of imports or previously accumulated stocks. For the sake of simplicity, it will be assumed that the increased demand in B is met by importing consumer goods from A, although it will be clear that this assumption in no way affects the generality of the argument.

Recording A's gift to B as a current transfer, the results for Period II will appear as follows:

PERIOD II  
(Transfer recorded as a current transaction)

COUNTRY A				COUNTRY B			
Enterprises				Enterprises			
Value added (=GNP)	40,000	Sales to households	39,000	Value added (=GNP)	10,000	Sales to households	10,000
		Exports	900				
		Increase in stocks	100				
	40,000		40,000		10,000		10,000
Households				Households			
Consumer goods domestic	39,000	Earned income	40,000	Consumer goods domestic	10,000	Earned income	10,000
Transfer to B	1,000			imported	900	Transfer from A	1,000
					10,900		
				Saving	100		
	40,000		40,000		11,000		11,000
Rest-of-World				Rest-of-World			
<i>Current Account</i>				<i>Current Account</i>			
Exports	900	Imports	—	Exports	—	Imports	900
Current deficit	100	Transfer to B	1,000	Transfer from A	1,000	Current surplus	100
	1,000		1,000		1,000		1,000
<i>Capital Account</i>				<i>Capital Account</i>			
Net borrowing (or decrease in international reserves)	100	Current deficit	100	Current surplus	100	Net lending (or increase in international reserves)	100
	100		100		100		100

The following equations may now be derived:

COUNTRY A							
Consumption		Domestic Investment		Exports		Imports	GNP
39,000	+	100	+	900	-	0	= 40,000
Domestic Investment		Current Surplus		National Saving			
100	+	-100	=	0			
GNP		Current Transfer Receipts		Consumption		National Saving	
40,000	+	-1,000	-	39,000	=	0	

COUNTRY B							
Consumption		Domestic Investment		Exports		Imports	GNP
10,900	+	0	+	0	-	900	= 10,000
Domestic Investment		Current Surplus		National Saving			
0	+	100	=	100			
GNP		Current Transfer Receipts		Consumption		National Saving	
10,000	+	1,000	-	10,900	=	100	

Let us now examine what these results imply. They state that while Country B produced 10,000 and consumed 10,900, it nevertheless saved 100 which was lent abroad to Country A (or, alternatively, was retained as an increase in international reserves). Country A on the other hand produced 40,000, consumed 39,000 but saved nothing; at the same time it invested 100 in an increase in stocks which would appear to have been financed by an equal capital inflow (borrowing) from Country B or, alternatively, by drawing on international reserves.

From the point of view of A's and B's *performance*, this interpretation is clearly unacceptable. A's investment in stocks was in no wise conditional on financing from B or on drawing down international reserves; and neither was B the ultimate source of saving and investment financing for the two economies. On the contrary, the primary source of financing, whether for A's investment in stocks or for B's rise in consumption and foreign lending, was the abstention from consumption (i.e. saving) of households in A. This picture is obtained when A's gift to B is recorded as a capital transfer:

PERIOD II  
(Transfer recorded as a capital transaction)

COUNTRY A				COUNTRY B			
<i>Enterprises</i>				<i>Enterprises</i>			
Value added (=GNP)	40,000	Sales to households	39,000	Value added (=GNP)	10,000	Sales to households	10,000
		Exports	900				
		Increase in stocks	100				
	40,000		40,000		10,000		10,000
<i>Households</i>				<i>Households</i>			
<i>Current Account</i>				<i>Current Account</i>			
Consumer goods domestic	39,000	Earned income	40,000	Consumer goods domestic imported	10,000	Earned income	10,000
Saving	1,000				900		
					10,900		
				Saving	-900		
	40,000		40,000		10,000		10,000
<i>Capital Account</i>				<i>Capital Account</i>			
Transfer to B	1,000	Saving	1,000	Net lending	100	Saving Transfer from A	-900
							1,000
	1,000		1,000		100		100
<i>Rest-of-World</i>				<i>Rest-of-World</i>			
<i>Current Account</i>				<i>Current Account</i>			
Exports	900	Imports	—	Exports	—	Imports	900
		Current surplus	900			Current surplus	-900
	900		900		—		—
<i>Capital Account</i>				<i>Capital Account</i>			
Current surplus	900	Transfer to B	1,000	Current surplus	-900	Net lending (or increase in international reserves)	100
Net borrowing (or decrease) in international reserves)	100			Transfer from A	1,000		
	1,000		1,000		100		100



The relevant equations are now the following:

COUNTRY A

Consumption		Domestic Investment		Exports		Imports		GNP
39,000	+	100	+	900	-	0	=	40,000
Domestic Investment		Current Surplus		National Saving				
100	+	900	=	1,000				
GNP		Consumption		National Saving				
40,000	-	39,000	=	1,000				

COUNTRY B

Consumption		Domestic Investment		Exports		Imports		GNP
10,900	+	0	+	0	-	900	=	10,000
Domestic Investment		Current Surplus		National Saving				
0	+	-900	=	-900				
GNP		Consumption		National Saving				
10,000	-	10,900	=	-900				

These results state that A produced 40,000, consumed 39,000 and therefore saved 1,000. This saving was transferred to B as a gift, of which 900 was subsequently spent by B on imports from A and 100 retained as a surplus. This unspent balance was reflected in a corresponding increase in B's international reserves (or net lending to abroad). In Country A, 900 of the transfer funds were recouped as export earnings and gave rise to an external current surplus. The unrecouped balance (100) was financed by drawing down international reserves (or by net borrowing from abroad) and was offset in the enterprise account of A by an increase in stocks of unsold goods. Country B produced 10,000, consumed 10,900 and thereby dissaved to the extent of 900.

The results obtained by the two methods are summarized in the following:

	GNP	Consumption	Saving	Current Surplus	Investment
I. Transfer treated as current transaction					
Country A	40,000	39,000	—	-100	100
Country B	10,000	10,900	100	100	—
Consolidated Total	50,000	49,900	100	—	100
II. Transfer treated as capital transaction					
Country A	40,000	39,000	1,000	900	100
Country B	10,000	10,900	-900	-900	—
Consolidated Total	50,000	49,900	100	—	100

Construction I attributes savings of 100 to B and implies that these were the ultimate source of investment financing in A. Construction II states that, from the performance point of view, the primary source of saving in the system was A, and that the decline in A's international reserves (net borrowing from abroad) was not a source of investment financing but was simply the net cash outflow necessary to finance its gift to B. The increase in B's international reserves (net lending to abroad) was not attributable to its own savings effort but was merely the unspent part of A's saving which had been received as a gift.

In the UN system, the construction whereby one country is considered to place part or all of its saving at the disposal of another country is recognised only with respect to transfers earmarked for investment:

“... In an open economy, net capital transfers received from the rest of the world constitute an independent source of finance for accumulation, and together with net borrowing from abroad, represent that part of the saving of the rest of the world placed at the disposal of the economy.”<sup>10</sup>

or again:

“The adoption of this principle may be explained by considering what the situation would be if the accounts of the payer and recipient of an unrequited transfer were consolidated. Where the recipient utilizes the grant to finance accumulation, the funds would appear as part of saving on the consolidated account. Thus, the payer may be considered to be placing part of his saving at the disposal of the recipient. If the recipient utilizes the grant to finance his consumption expenditure, the saving on the consolidated account would be correspondingly reduced.”<sup>11</sup>

<sup>10</sup>“A System of National Accounts”, United Nations, 1968, p. 130, para. 7.74.

<sup>11</sup>*Op. cit.*, p. 131, para. 7.76.

What remains unclear<sup>12</sup> is why only transfers destined for capital formation should be regarded as “that part of the saving of the rest of the world placed at the disposal of the (recipient) economy”, whereas transfers used to finance consumption expenditure are implicitly taken to represent saving by the recipient country and dissaving by the donor country.<sup>13</sup> Furthermore, in the final sentence of the above passage it is stated that:

“If the recipient utilizes the grant to finance his consumption expenditure, the saving on the consolidated account would be correspondingly reduced.”

The intent of this statement, however, is likewise not entirely clear, since the use of transfer funds for consumption purposes rather than for capital formation will always result in a lower figure of saving on consolidated account, regardless of whether they are classified as current or capital flows. For performance analysis, the crucial question is how this net saving figure on consolidated account is reflected in the gross accounts of the donor and recipient countries. Depending on the classification employed, two radically different solutions are possible:

	GNP	Transfer Receipts	Consumption	Saving
<b>I. Transfer treated as current transaction</b>				
Country A	40,000	-1,000	39,000	—
Country B	10,000	1,000	10,900	100
Consolidated Total	50,000	—	49,900	100
<b>II. Transfer treated as capital transaction</b>				
Country A	40,000	-1,000	39,000	1,000
Country B	10,000	1,000	10,900	-900
Consolidated Total	50,000	—	49,900	100

The net saving figure of 100 can thus appear as being attributable exclusively to Country B, with Country A saving nothing (Construction I); or to be the outcome of a savings effort of 1,000 on the part of A and a dissaving of 900 on the part of B (Construction II). The former solution is adapted to the needs of expenditure behavior analysis and defines national saving as being equal to GNP less consumption expenditure plus current transfers received. The latter solution is consistent with the needs of economic performance analysis and defines national saving as being equal to GNP less consumption expenditure.

In this same context, it is sometimes urged that it would be incorrect to record transfers used for consumption expenditure as capital transactions, because were

<sup>12</sup>i.e. from the performance point of view.

<sup>13</sup>In the sense that transfers recorded as current revenue of the recipient country increase its current surplus and saving (or reduce its current deficit and dissaving), while the opposite is true of the donor country.

it not for the transfers received there would have been no increase in consumption. The recipient country should not, therefore, be shown as being dependent on capital inflow for maintaining its current consumption level. It is evident, however, that the same causal relationship exists between capital grants received from abroad and the level of domestic investment; i.e. in the absence of such grants the level of investment in many countries would be considerably lower than it actually is. Even so, this hardly leads to the conclusion that such countries should not therefore be shown as dependent on foreign capital inflow for investment.

For economic performance analysis, the primary focus of interest is the excess, if any, of *aggregate* resource use over the GNP<sup>14</sup> i.e. the extent to which the combined level of consumption and investment is sustained out of own production or is dependent on unrequited capital inflow. Since the measure of capital inflow is provided by the external current deficit, it is essential that it also include all international transfers regardless of their economic destination.<sup>15</sup> This treatment likewise ensures that the derived estimates of national saving reflect abstention from consumption only i.e. GNP *less* consumption expenditure, and not abstention from consumption *plus* current transfers received.

<sup>14</sup>This is not to detract, of course, from the analytical importance of the allocation of aggregate resources between consumption expenditure and capital formation.

<sup>15</sup>For minor exceptions see Note 3, p. 3.