Why should we care about workers' remittances? And what should we do?

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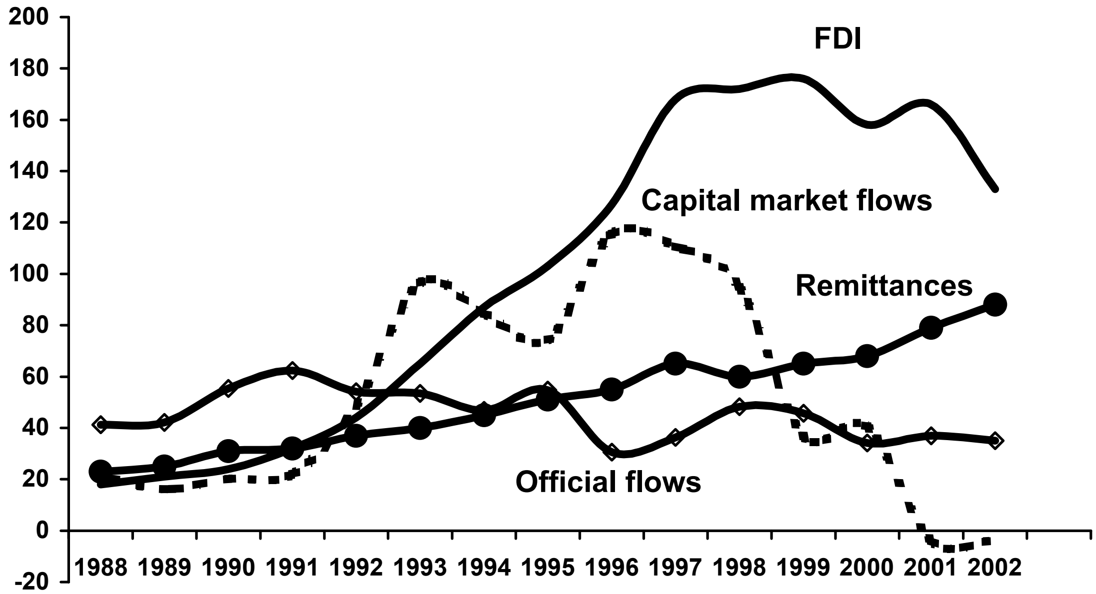
Workers' remittances have become a major source of external development finance. They can play an effective role in our efforts to reduce poverty. And remittances may provide a convenient angle for us to approach the complex migration agenda.

Officially recorded remittances received by developing countries exceeded $93 billion in 2003. The actual size of remittances, including both officially recorded and unrecorded transfers through informal channels, were even larger. *Remittances are now more than double the size of net official flows (under $30 billion), and are second only to foreign direct investment (around $133 billion) as a source of external finance for developing countries.* In 36 out of 153 developing countries, remittances are larger than all capital flows, public and private. Also remittances are stable, and may even be counter-cyclical in times of economic hardship (figure 1). Moreover, remittances are person-to-person flows, well targeted to the needs of the recipients who are often poor. And they are altruistic transfers that do not have to be paid back.

Figure 1: Resource flows to developing countries ($ billion)



I think the development community should address the following five issues:

1. How to strengthen the financial infrastructure supporting remittances?
2. How to balance policy between anti-money laundering and facilitating remittances?
3. What is the development impact of remittances, and how can this be enhanced?
4. How to improve data on remittances and migration?
5. Should governments use fiscal incentives to attract remittances?

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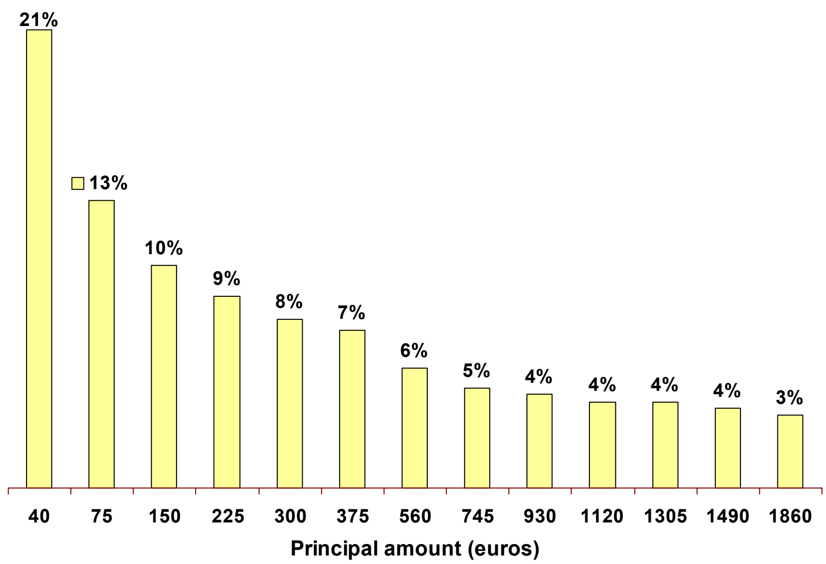
1. How to strengthen the financial infrastructure supporting remittances?

Exorbitant fees - 13 percent on average and frequently as high as 20 percent - charged by money transfer agents are a drain on hard-earned remittances (figure 2). And these fees especially affect the poor. *Reducing remittance fees would significantly increase annual remittance flows to developing countries.*

It is difficult to see why remittance fees should be so high, and why they should increase - rather than stay fixed - when the amount of transfer increases. It appears that the regulatory framework is flawed. There appear to be barriers to competition, and perhaps duplication of efforts in the payments system (e.g., each transfer agency investing in own proprietary transfer system). Fixing this problem would involve policy coordination – especially harmonizing regulatory and compliance requirements - in both source and destination countries.

Figure 2: Remittance costs are high, and regressive



(Cost of sending money from Brussels using a major money transfer operator)

Even with the existing cost structure, there may be scope to reduce average remittance costs by “bundling”, i.e., by enabling senders to remit more money but less frequently. In the above cost schedule, for example, if a person sends 150 euros per month for a period of six months, the total remittance cost would be 10 percent or 90 euros. If on the other hand, this person were able to send the entire 900 euros in one transaction, the remittance cost would fall to just over 4 percent or under 40 euros. The difficulty, of course, is that many poor remittance senders typically do not have sufficient funds to be able to “bundle” remittances. Banks and microfinance institutions could play a role in alleviating such liquidity constraints and reduce the effective cost of remittances.

Unfortunately, a large number of migrants, especially those who are poor or undocumented, do not have bank accounts. Improving migrant workers' access to banking in the remittance-source countries (typically developed countries) would not only reduce costs of remittances, it would also lead to financial deepening in many receiving countries. Remittance flows could be facilitated by using existing retail financial infrastructure, such as postal savings banks, commercial banks, or microfinance institutions in rural areas.

2. How should we balance our efforts to fight money laundering with those for facilitating remittance flows?

The regulatory regime governing remittances has to strike a balance between curbing money laundering, terrorist financing and general financial abuse, and facilitating the flow of funds between hard working migrants and their families back home through the formal channel. It is not entirely clear that personal remittances (which are typically small in size) are an efficient way of laundering or illegally transferring sizeable amounts of funds. More importantly, informal channels owe their existence to the inefficiencies in the formal system: informal channels are cheaper; they operate in remote areas where formal channels do not operate; and they often have staff who speak the language spoken by the migrant customers. Informal channels, however, can be subject to abuse. Strengthening the formal remittance infrastructure by offering the advantages of low cost, flexible hours, expanded reach, and language can induce a shift in flows from informal to the formal sector. Both sender and recipient countries should support migrants' access to banking by providing them with identification tools.

3. What is the development impact of remittances?

Impact on poverty and growth: On the positive side, *remittances are believed to reduce poverty, as it is the poor who migrate* and *send back remittances.* But this view has critics. It is sometimes argued that remittances may increase inequality, because it is the rich who *can* migrate and send back remittances, to make the recipients even richer. These questions should be studied at macro level using cross-country data and at micro level using household surveys. *The impact of remittances depends on their use, especially on schooling of children, deserves special attention.* A recent study (by Cox-Edwards and Ureta in the Journal of Development Economics) shows that in El Salvador, the school drop-out ratio is lower, and the enrollment ratio higher, in households that receive remittances.

Impact on creditworthiness: Like all external hard currency flows, too much remittance inflows could cause currency appreciation and affect a country's exports performance. On the other hand, remittance receipts enable a country to pay for imports and repay foreign debt. The effect of remittances on country creditworthiness is easily evident in some countries: For example, for several years it was feared that Lebanon was vulnerable to a balance of payments crisis because its foreign debt stood at nearly five times the size of its exports. Yet, such a crisis did not materialize, most likely because of remittances sent by its Diaspora are about as big as Lebanon's exports (about $2.4 billion in 2002). The ratio of Lebanon's debt to exports is halved when remittances are included in the denominator. (Brazil and some other countries have been able to borrow from the international capital markets at lower interest rates and longer maturity by using remittances as collateral.)

Offsetting the effect of brain drain: Remittances can offset the effects of brain drain on economic growth and on fiscal revenue of the remittance receiving country. The size of this offset factor, a grossly under-researched topic, may well hold a key to the success of the global migration agenda. (The other key is the question of job competition from in-migration in labor-receiving countries.)

4. How to improve data on remittances and migration?

Reliable data on remittances are key to our understanding of their development impact, yet available data leave much to be desired. Informal remittances are large and indeterminate. Even recorded data are incomplete. Rich countries such as Canada and Denmark, for example, do not report any remittance data, not to mention several poor countries that either do not report or report inaccurate data.

Improving remittance data would require not only gathering information, but also studying the relationship between migration stock and remittance flows, a study of remittance behavior of migrant workers in major remittance-source countries, and how remittances respond to changes in the source and destination economies. One way forward, and perhaps the only way forward, would be to conduct surveys of households in both sending and receiving countries, to find out the size of remittance flows, their sources and destinations, the channels used, and their uses.

5. Should governments use fiscal incentives to attract remittances?

Fiscal incentives: The majority of developing countries offer tax incentives to attract remittances. The side effect of such incentives, of course, is that remittances may then be used for tax evasion and money laundering. Also, some governments provide matching funds for remittance-backed projects (as in Mexico's 3-for-1 program). Again the side effect may be diversion of scarce budgetary resources to projects favored by nonresident nationals. These questions have not been examined seriously yet.

Role of HTAs: Many aid agencies are looking into using hometown associations (HTAs) to channel aid. I think there is limited potential for channeling any significant volume of official funds this way. However, there may be potential for using HTAs for promoting community financing of infrastructure or other collective funding for community priorities..

Tax collection: Related to the brain drain question is the issue of how governments in labor-sending countries may recover lost taxes resulting from migration of skilled workers. The literature has suggested changing the tax policy from one based on geography (i.e., taxing income generated within the country) to one based on nationality (i.e., taxing nationals even when they are residents abroad, similar to the U.S. tax policy).