
Innsbruck Student Papers in Economic and Social History

Papers by Students and Papers for Students

ISPESH 4

Conception of Aid and Why Remittances Dominate

by Fabian Karg

submitted June 2011, reviewed June 2012, published August 2012

*A series of the research field “Economic and Social History” (at the same time working area “History of Globalization” in the Research Centre Empirical Economics and Econometrics **EmpEc**) at the School of Economics and Statistics of Innsbruck University (Austria).*

Contact: Andreas Exenberger, Department of Economic Theory, Policy and History, University of Innsbruck, Universitaetsstrasse 15, A-6020 Innsbruck, e-mail: andreas.exenberger@uibk.ac.at

*Eine Reihe des Forschungsfeldes „Wirtschafts- und Sozialgeschichte“ (zugleich Arbeitsbereich „Geschichte der Globalisierung“ im Forschungszentrum für Empirische Wirtschaftsforschung und Ökonometrie **EmpEc**) an der Fakultät für Volkswirtschaft und Statistik der Universität Innsbruck (Österreich).*

Kontakt: Andreas Exenberger, Institut für Wirtschaftstheorie, -politik und -geschichte, Universität Innsbruck, Universitätsstraße 15, A-6020 Innsbruck, e-mail: andreas.exenberger@uibk.ac.at

URL: <http://www.uibk.ac.at/empec/ispesh>

Conception of Aid and Why Remittances Dominate

By Fabian Karg^{*}

There are a variety of reasons to provide foreign aid to developing countries but the most important one is to alleviate its population out of poverty. However, research clearly suggests that foreign aid has only a marginal effect on poverty due to its inefficiencies. Therefore, globalizing the world gives the bottom billion the chance to get out of their poverty by migrating to developed countries and generating remittances. By reviewing literature on this topic, I find that this fairly new phenomenon outweighs foreign aid by far. Furthermore, these financial flows are more stable and significantly more effective because they go straight to the poor.

Introduction

A few years ago, William Easterly wrote in “The White Man’s Burden” that there are two tragedies afflicting the world’s extremely poor; the first is that they are forced to live in poverty and they have little prospect of improving their circumstances. The second is that over the last five decades, while the West has spent \$2.3 trillion on foreign aid, they have still not managed to get enough medicine, food or bed nets to poor families.¹ To escape these tragedies, these families vote with their feet and migrate to developed parts of the world such as Europe, Canada or the US. International migration is not a new development in the aftermath of globalization but has been present for the last few centuries. What moved into the spotlight of recent economic scholarly literature about migration is that employed immigrants getting remunerated generate remittances, which are sent back to the sending country and significantly outweigh foreign aid provided by receiving countries.

Foreign Aid is provided for a variety of reasons, including economic, political and cultural. However, the most important one is to alleviate poverty in developing countries. Typically, these countries have low income and a high unemployment rate with high population growth; this results in low savings and investment. In order to sustain such large populations, they need rapid economic development, which is simply not possible due to low levels of saving and investment. The purpose of Official Development Aid (ODA) is to supplement domestic savings to encourage economic growth in less developed countries. By using the financial aid, living standards and wages are supposed to equalize to standards of developed countries. Due to inefficiencies in the ODA transferring system, these financial means never make it to the right place. Furthermore, ODA is only a short-term increase in financial means to improve basic requirements for growth like health care and infrastructure but the follow-up costs of maintaining are not taken into account. Hence, governments of developed countries increase ODA every year and institutions like the World Bank distribute ODA according to the need in developing countries but unfortunately there is evidence that ODA has only a marginal effect.

^{*} Fabian Karg (e-mail: fabian.karg@student.uibk.ac.at) is advanced student at the School of Economics and Statistics, University of Innsbruck, Austria, recently finishing his diploma thesis in development economics.

¹ See Easterly, *A White Man’s Burden*.

In this paper, I want to provide supporting evidence that these remittances, in combination with controlled migration to developed countries, is more effective than transferring billions of dollars as foreign aid. I divide this paper in two sections. In the first one, I provide a definition of foreign aid and narrow it down to ODA, followed by an historical overview of the development of foreign aid over the last 50 years. Next, I illustrate research and data that show that ODA has no significant impact on economic development and expand these findings with its inefficiencies. The second part consists of the definition and the historical overview of remittances, rounded up by illustrating significant findings and data as well as the benefits of remittances.

Defining foreign aid

Clearly strategic, political and welfare interests are all motivations to transfer foreign aid to developing countries but instead of differentiating between these motivations I rather look at foreign aid as to assist the poor. Global assistance and aid programs to mitigate poverty involves multilateral and bilateral assistance from rich to poorer countries in form of grants at below market rates, technical assistance, commodities or aid from international organizations to only name a few. But in this context, I limit foreign aid to the pure flow of financials as development assistance to ensure comparability of foreign aid and remittances. Therefore, ODA is defined as flow of capital to developing countries with non-commercial purpose. These ODA contracts include all official grants and concessional loans to a certain degree, which means softer interest rates and repayment periods.² ODA therefore includes capital transfers from governmental sources or publicly donated money aimed at increasing human and economic welfare in Less Developed Countries, (LDCs), left out military assistance.³

As highlighted, issues already occur when separating ODA from the umbrella term “foreign aid”, but also calculating its value poses problems due to the differing valuation of one dollar in various countries. Therefore respectively, for comparison I do not distinguish between different valuations of transferred dollars.

Furthermore, aid contracts involve conditions that have to be fulfilled when receiving aid. ODA can be tied to a source by limiting usage of these grants only for donor-country products or tied to its projects. These financial means then cannot be used or split up for several points of investment where financial support is required and possibly has more impact. Levy, in his research, shows that aid is in fact transferred only with certain conditions or is used for the benefit of political intentions by providing data about destinations of money flows. The data shows that in developing countries, governments receive major parts of the provided aid and private consumption remains unchanged.⁴ Therefore, LDCs apply the money to public and not to the private consumption.

Development of ODA

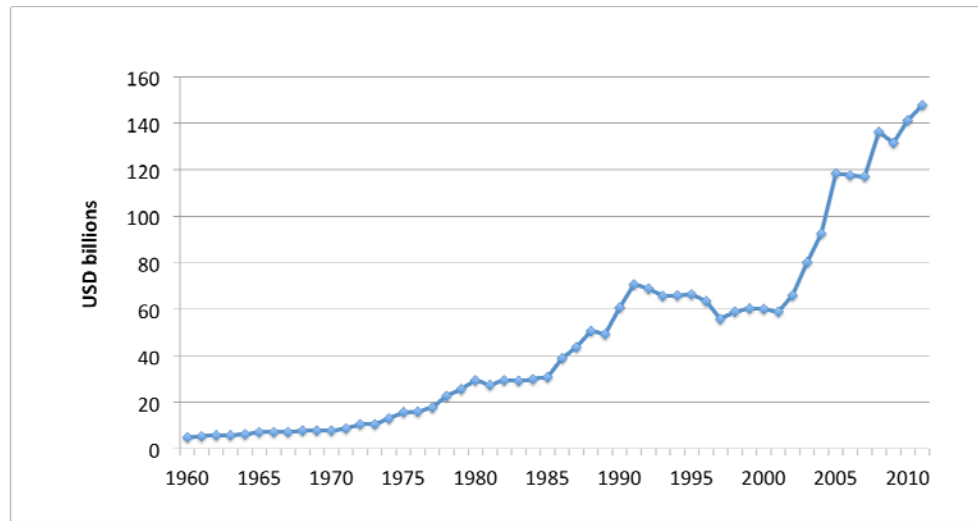
One can see when looking at the development of money provision that over the last five decades, the amount of money provided for aid has increased significantly. Figure 1 gives an impression of the development of ODA since 1960. In comparison, Figure 2 shows the development of money stock for aid from 1960 to 2010 provided by the G7 countries.

² Todaro et al., *Economic Development*, p. 729.

³ Boone, “Politics and the effectiveness of foreign aid,” p. 304.

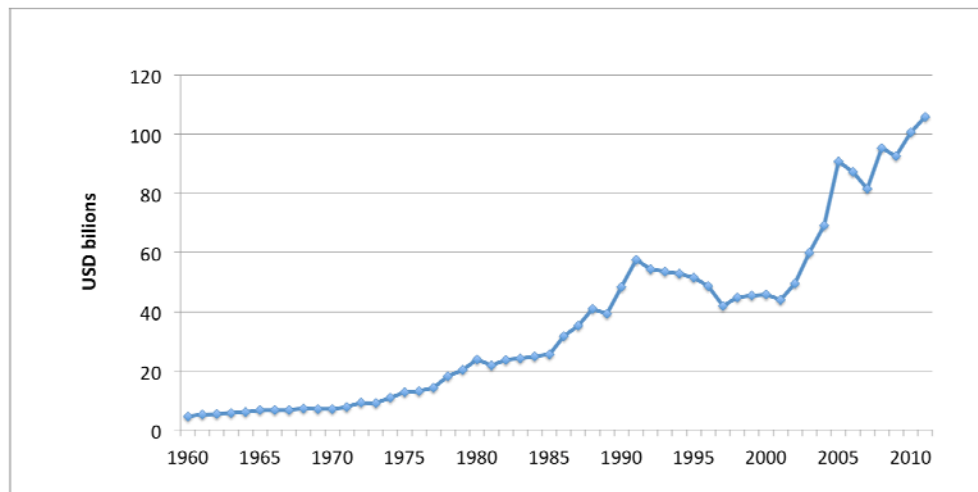
⁴ See Levy, “Anticipated Development Assistance”.

FIGURE 1
DEVELOPMENT OF ODA, 1960–2010 (current US\$ billions)



Source: OECD (<http://stats.oecd.org/>)

FIGURE 2
DEVELOPMENT OF AID IN G7 COUNTRIES, 1960–2011 (current US\$ billions)



Source: OECD (<http://stats.oecd.org/>)

As can be seen in Figure 1 and 2, massive aid programs were established after World War II and took off at the beginning of the 1960s. Economists believed that transferring capital to developing countries, combined with government interference encourages economic growth by reference to the rapid industrialization of the Soviet Union caused by central state planning. Donors have already transferred approximately \$20 billion of non-military concessional aid in 1978 but no development resulted. The collapse of fixed exchange rate systems, a huge fluctuation in commodity prices and two oil shocks in the 1970s posed big problems for developing countries and increased the degree of dependence. ODA was further increased, and during the debt crisis in the 1980s, G7 countries continued to increase their provision of financial means. But the proof that dependence and government intervention do not work came with the collapse of the Soviet Union.⁵ Jean-Paul Azam,

⁵ Kanbur et al., “The Future of Development Assistance,” pp. 10-12.

Shantayanan Devarajan and Stephen O'Connell argue in support of these experiences that country dependency due to ODA is especially enhanced when initial institutional capacity is weak, which is the case in LDCs, and both sender and recipient are locked in their aid relationship. The recipient is not willing to take steps to bring institutional development on the way of graduation to reduce dependency.⁶ Most LDCs found themselves stuck in this position because they were substituting the lack of domestic savings with inflows of capital from aid donors.⁷ Michael Todaro and Stephen Smith even argue that most bilateral ODA appears to be largely unrelated to economic development, and rather is mainly based on political or military deliberation, the multilateral one seems to be slightly less deliberated and not focused on alleviating poverty at all.⁸

As the Figure 2 shows, in 1991, development assistance peaked at \$75 billion. According to Peter Boone, in the period from 1970 – 91, huge amounts of ODA were steadily transferred to LDCs almost without conditionality. This originated in the implementation of the 0.7 per cent target, which was first mentioned in paragraph 43 of the UN's 1970 General Assembly Resolution on October 24th, 1970.⁹ The target has been complementary to the Millennium Development Goals initiated in 2000. The committed countries were to establish a timetable to achieve a 0.7 per cent share of their GNIs being directed to poor countries as ODA.

However, it seems like capital shortage and poverty may not be related with each other because aid increased consumption in LDCs but this increase did not benefit the poor. Furthermore, he also found that these transfers did not have any significant effect on enhancing human development regarding infant mortality and primary schooling ratios. This alludes to the fact that long-term development assistance in form of capital flows had little effect on human development or investment.¹⁰

After 1991, the cold war was over and the Berlin Wall fell. Therefore the US decreased its aid money stock that was made available for foreign aid due to the fact that they did not have to support friendly regimes anymore. The Marshall Plan, the Mutual Security Act of 1951 and the Foreign Assistance Act of 1961, to only name a few, gathered a huge group of allies. Regarding this purpose, all three foreign aid contracts had a certain degree of dependency and even more importantly, major political intentions to gain allies during the cold war.¹¹ Figure 3 shows the development of provision of ODA of the US compared to three other major OECD countries: Canada, Germany, and the UK.

As can be seen in Figure 3, three out of the four countries reduced their ODA in the 1990s; only the UK had a steady increase of capital stock for aid. Even though financial development assistance was reduced, the sub-Saharan region experienced growth while also coming to the conclusion that economic growth may only be achieved through peace and security. Their average growth was 2.4 per cent during the 1990s and elevated to 4 per cent at the beginning of the 2000s.¹² While major contributors of foreign aid reduced their share of foreign aid, sub-Saharan Africa started to grow.

Finally in 2000, all the above-mentioned countries stopped reducing foreign aid and significantly increased their shares in a fast pace. Accompanied by the Millennium Development Goals by the United Nations, the rapid increase signalled hope for new uses of ODA to the rest of the OECD countries and they started to

⁶ Azam et al., "Aid Dependence Reconsidered," p. 12.

⁷ Boone, "Politics and the Effectiveness of Foreign Aid," p. 292.

⁸ Todaro et al., *Economic Development*, p. 731.

⁹ See UN, "1970 General Assembly Resolution".

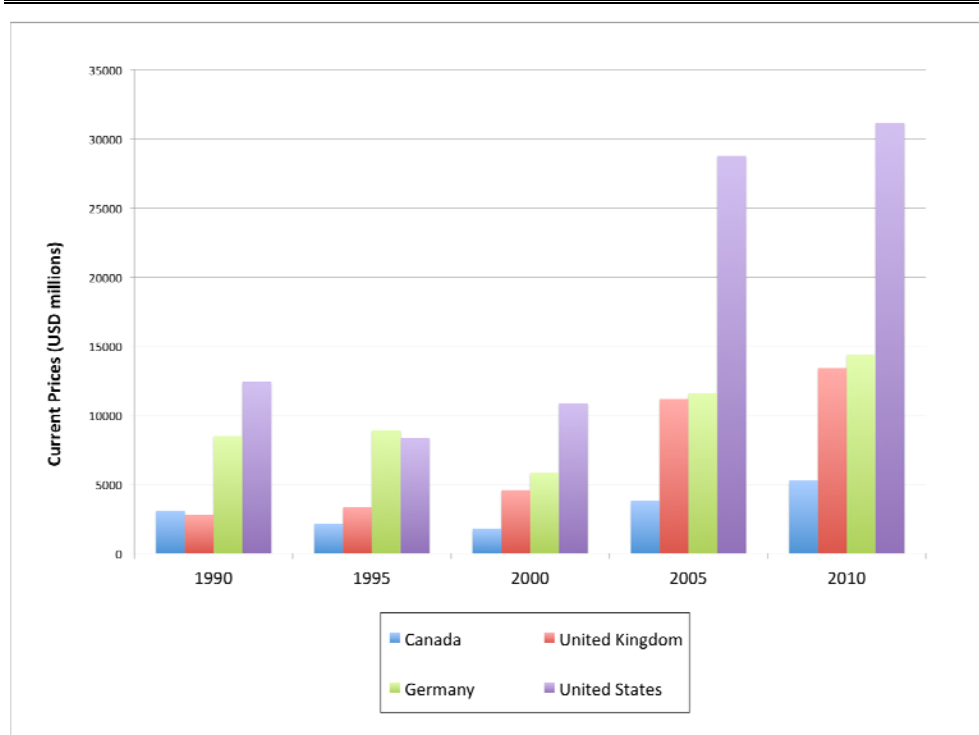
¹⁰ Boone, "Politics and the Effectiveness of Foreign Aid," p. 322.

¹¹ Bräutigam et al., "Foreign Aid, Institutions and Governance in the Sub-Saharan Africa," p. 256.

¹² Adem, "Official Development Assistance," p. 1.

increase their share of aid as well. While in 2001, the total flow of capital accounted for \$60 billion, the provided capital doubled within five years and continued to increase steadily only with a short slump during the 2008 financial crisis. In the 2010 analysis conducted by OECD statistics, total ODA has passed the \$140 billion mark.¹³

FIGURE 3
ODA BY SELECTED OECD-MEMBERS, 1990–2010



Source: OECD (<http://stats.oecd.org/>)

But what is vision without implementation? It seems to be hallucination because the \$ 140 billion are approximately only half of the required funds to achieve the MDGs.¹⁴ Looking back at the above-mentioned 0.7 per cent target shows that this goal has not been met. The current value of funds flowing to developing countries is still insufficient as major industrialized countries hardly follow through with their commitment. Denmark, Luxembourg, the Netherlands, Norway and Sweden are the exceptions in transferring the 0.7 per cent share within the group of developed countries. Especially the major players such as Britain, Canada, France, Germany and the U.S. have lacked of strong commitment throughout the whole period.

Unfavorable light for ODA

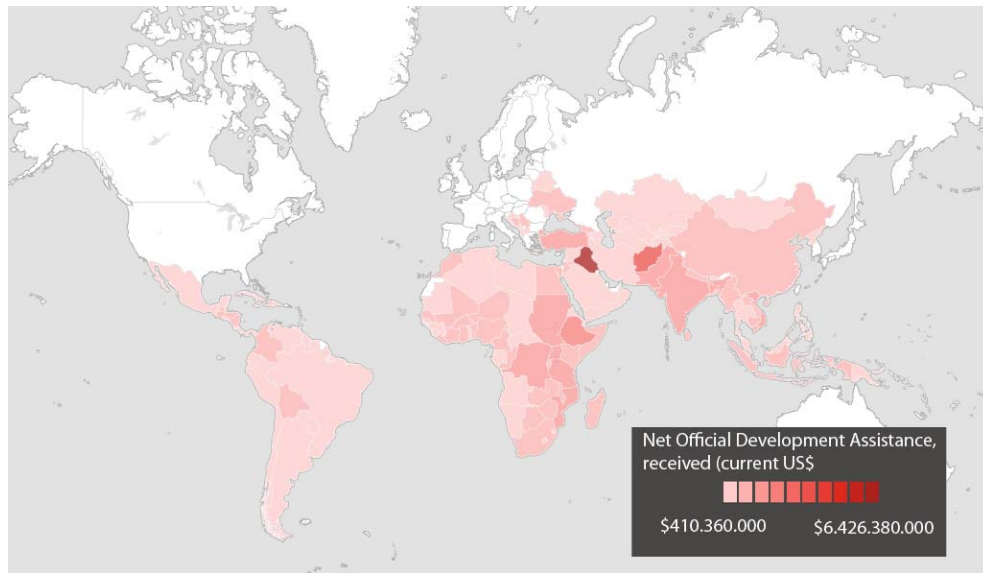
After this rough look at the development of ODA from the 1960s, one could argue that these huge amounts of money must have had an impact on LDCs but many economists concluded in their research that ODA only has impact on the government in developing countries but not on reducing poverty. They found that monetary financial aid requires good policies and institutions in place to have a

¹³ OECD Statistics 2010, <http://stats.oecd.org/Index.aspx> (accessed 24 May 2011).

¹⁴ Sachs, "Institutions Matter," p. 41.

measurable impact, which is not the case in most LDCs.¹⁵ Figure 4 shows all countries, which have received ODA over the last four years. Comparing the red coloured countries with the World Bank ranking of countries by GNI per capita, one can notice that almost all indicated countries on this map, except some of the Americas, have a GNI per capita less than \$4035, which according to the World Bank classifies a country as lower middle income country.¹⁶

FIGURE 4
WORLD MAP OF ODA RECIPIENTS, 2008–11



Source: World Bank (<http://data.worldbank.org>)

Therefore, according to Boone, in all cases of transferred ODA he surveyed, he only found insignificant and wrong signals in general. ODA's only impact is recorded by an increase in public consumption, which consequently causes expansion of government. Even though consumption rises as already pointed out earlier, Boone concludes that he cannot find any evidence that any of the poor gain from aid due to a lack of change in infant mortality rates or primary schooling. The data he used forecasts that infant mortality is reduced by 2 per cent over a ten-year period when receiving annual ODA of ten per cent of GNP. This shortcoming of ODA on human development indicates strong evidence for government and institution failure. Only Chile and Costa Rica already had direct programs in place to improve human living standards through aid. But the missing correlation between ODA and improving the health system does not encourage developing countries to put necessary policies or institutions in place.¹⁷

Additionally, John Hudson and Paul Mosley claim that in theory ODA is used to stimulate economic development by supplementing domestic saving, and therefore investment especially in human development. But they point out that increasing exchange rates or higher wages due to the need to pull workers out of other sectors may be two threats when receiving aid with investing purpose. Furthermore, in common with Boone, they only found slight impacts on infant mortality over time and they, supported by Hansen and Tarp, cannot find any evidence of enhancing ODA's effectiveness through good policies even though Hudson and

¹⁵ See Hudson et al., "Aid Policies and Growth,"; and Boone, "Politics and the effectiveness of foreign aid".

¹⁶ World Bank 2011, <http://data.worldbank.org> (accessed 24 May 2011).

¹⁷ Boone, "Politics and the Effectiveness of Foreign Aid," pp. 314-319.

Mosley believe that aid promotes incentives to put good policies in place.¹⁸ Adding to these findings, Carl-Johan Dalgaard, Henrik Hansen and Finn Tarp conclude that ODA might be conducive for growth but is not the magic cure for poverty reduction because the only significant effect of ODA they found is on productivity and not on development indicators. Therefore, ODA cannot guarantee convergence.¹⁹

Finally, Todaro and Smith present strong arguments against aid by pointing out that ODA may even slow growth because domestic savings are substituted, instead of supplemented, by inflows of capital in the form of development assistance as well as worsens the balance of payments by increasing debt repay obligations and tying aid to exports of the sending country.²⁰ By substituting domestic savings with aid, there is no need to establish a domestic financial market from which to borrow money for investments. This fosters even more the allegation that aid retards growth.

Inefficiencies and Costs

These research findings are accompanied and strengthened by inefficiencies and high transaction costs of foreign aid. As Easterly concluded in his 2008 published research, many agents participate on both sides of the business of foreign aid. The number of sending and receiving countries is huge and a lot of governmental institutions and NGOs serve as intermediates between both sides. Additionally, distribution of foreign aid is still poorly managed because corrupt and autocratic countries receive major portions and countries with the largest populations of poor people get relatively low per-capita aid.²¹ This mismanagement originates in the high number of projects by donors and huge body of bureaucracy. In 1989, the number of donors' aid programs was as high as 800 and even though studies recommended to reduce the number of projects by half to increase manageability the number further augmented to 2000 within three years.²² These high numbers generate significant transaction costs because government institutions and intermediates have to monitor every project and measure their efficiency accompanied by the costs of contract negotiations. Furthermore, not only does setting up institutions to manage aid distribution create significant costs, but also the bureaucratic process to grant a loan within these intermediates consumes huge amounts of money.²³ Also on behalf of LDCs, the allocation of financial aid is deteriorated by the "tragedy of the common"-dilemma, supporting Todaro's and Smith's claim that foreign aid retards growth, because local government officials perceive the pool of aid as publicly accessible capital for investment for future projects without consideration of the consequences of future governments. They might lack of the ability to pay back their debts because of low tax and project revenues or other issues, which influence generating governmental revenue.²⁴

In addition to transaction costs, there is more inefficiency in transferring ODA to developing countries due to corruption with its many different forms including fraud, bribery, misuse of assets and diversion of aid resources. Especially corruption and red tape are closely related in the principal-bureaucrat-agent hierarchy due to lack of information, which creates opportunity for ex ante and ex post

¹⁸ Hudson et al., "Aid Policies and Growth," pp. 1024, 1034-1036.

¹⁹ Dalgaard et al., "On the Empirics of Foreign Aid and Growth," p. F211.

²⁰ Todaro et al., *Economic Development*, pp. 737-738.

²¹ Easterly et al., "Where Does the Money Go?," p. 51 and Todaro et al., *Economic Development*, p. 730-731.

²² Bräutigam et al., "Foreign Aid, Institutions, and Governance in Sub-Saharan Africa," p. 261

²³ Easterly, "The Cartel of Good Intentions," pp. 2-5.

²⁴ Bräutigam et al., "Foreign Aid, Institutions, and Governance in Sub-Saharan Africa," pp. 264-265.

corruption.²⁵ Through the additional pressure of secrecy, some scholars suggest taxation to be the less cost intense.²⁶ Unfortunately, ODA is, as we defined earlier, transferred in form of capital flow and therefore vulnerable to corrupt regimes. These are especially present in developing countries because of unstable or authoritarian governments. The transferring system of ODA with its huge number of agents and intermediates also facilitates corrupting aid, even if financial assistance is tied to specific terms.²⁷ Hence, one could think that intermediates discriminate corrupt governments exactly for that reason. But Alberto Alesina and Beatrice Weder show in their regression analysis of aid and corrupt governments that the opposite may be true. Indeed, only two results are significant in terms of statistics but all regressions are negatively correlated meaning that donors do not discriminate against corrupt regimes. That implies there is no evidence that intermediates or foreign donors treat corrupt governments less favourably and Alesina and Weder even further their results by showing that more corrupt governments receive more aid by using ODA as a percentage of government spending. By conducting a second study on two different periods of time, they also present evidence with significance only in two cases that countries with an increasing level of corruption also receive more aid over time. That means there is no evidence that the amount of aid is reduced for corrupt governments with the same level of corruption or even raising levels in the following period.²⁸ Aaron Tornell and Philip Lane further Alesina's and Weder's study by showing that ODA even encourages corruption due to augmenting the capital stock of the government through financial aid, which results in rent seeking.²⁹ Easterly supports these results of research in his working paper published in 2002. In the case of Kenya, he finds that the International Monetary Fund (IMF) and the World Bank grant new adjustment loans to the corrupt government even though Kenya already received 19 adjustment loans and shows 22 years of economic mismanagement. Additionally to Kenya, Transparency International lists Cameroon as the most corrupt country and the Freedom House as the most undemocratic country, however it is one of the first countries to be eligible to get debt relief.³⁰

It is important to mention that corruption has two faces. The above outlined cases anticipate the negative form of corruption. But Nathaniel H. Leff in 1964 and Samuel P. Huntington in 1968 suggested that corruption also has two positive effects. One could be called speed money that refers to creating the ability to avoid bureaucratic delays and the second is that bureaucrats tend to work harder when bribes act as a piece rate.³¹ Paolo Mauro points out that corruption therefore relates to increased investment because he found that bureaucracies working with higher efficiency attract more investment, which is positively related to GDP growth.³² But the challenge and difficulty is to limit corruption to specific areas where corruption might be economically desirable.³³

Finally, aid inflows cause significant problems for the LDC's economy by impeding impact of macroeconomic policies. The so-called "Dutch" disease refers to the phenomenon that increasing revenues in the natural resource sector and therefore increasing inflows of foreign exchange make the national currency stronger compared to any other currency. This mechanism results in higher prices

²⁵ Guriev, "Red Tape and Corruption," pp. 502-503.

²⁶ Bardhan, "Corruption and Development," p. 1326; Shleifer et al., "Corruption," pp. 16-20.

²⁷ Transparency International, "Corruption in Humanitarian Aid," pp. 1-3.

²⁸ Alesina et al., "Do Corrupt Governments Receive Less Aid," pp. 13-19.

²⁹ Tornell et al., "The Voracity Effect," pp. 40-43.

³⁰ Easterly, "The Cartel of Good Intentions," pp. 36-37.

³¹ Leff, "Economic Development through Bureaucratic Corruption," pp. 10-1; and Huntington, *Political Order in Changing Societies*, pp. 68-70.

³² Mauro, "Corruption and Growth," p. 705.

³³ Rose-Ackerman, "The Political Economy of Corruption," pp. 34-41.

in the manufacturing sector and causes its exports to be more expensive for trading partners. The consequences are a less competitive manufacturing sector, which harms the overall economy and jeopardize LDC's economic situation especially in the medium term horizon as Christopher Adam and David Bevan pointed out.³⁴ Stephen Younger shows this phenomenon by analyzing Ghana's economy and effects of major aid inflows. The country is facing economic problems because of high public expenditures due to the abundance of foreign exchange in the form of aid inflows, which cause increased aggregate demand, and a slowing manufacturing sector. Several attempts to fight the increased aggregate demand through strict monetary policy, and to maintain the real exchange rate made credit scarce and have kept inflation high.³⁵ Hence, taking the history of ODA and the results of recent research into account, there is little evidence that foreign aid has any measurable impact on economic development of LDCs and shows ODA in a very unfavourable light.

The new phenomenon: remittances

Let us now take a look at a financial flow to LDCs that significantly outweighs ODA. Remittances have a long history but did not always have the same direction. In 19th century historical Britain, the word "remittances" was used in context of sending money to someone who lives in a British colony far away. The purpose of remittances has not changed over time. Already at this time, they were to send money to persons for support and assisting payments, but from their home country Britain to the colony. Over the last decades, the direction of remittance flow has turned around and now goes into the opposite direction. Migrants move to developed countries to find employment and remit a percentage of their compensation back to their families who remain in the sending country. The UN narrowly defines remittances as "the sum of selected balance of payments flows" and states that "remittances aim at measuring the economic impact of migration mostly on the home economy. The unit under consideration is the migrant (including also short-term migrant), independently of whether his or her status (e.g. employed or not, legal or illegal, etc.). The aim is to capture the net receipt of transactions between the migrant and the related household in the home country, independently from the source of income (be it wages and salaries, social benefits or any other current transfer) and the use this money is put to in the home country."³⁶ Today, remittances are included in the framework of the Balance of Payments (BoP), which includes all monetary transactions and serves as an accounting record. Because of their recent importance, the IMF established annual records to keep detailed record of remittances to labour-exporting countries. The World Bank records go back until 1970. The recorded figures only illustrate the official channels but there is a significant unrecorded figure of money channelled to labour-exporting countries through mail and private tourism.³⁷ To see where remittances are located within financial flows with the purpose of encouraging development in developing countries, we take a look at Figure 5. It outlines three important capital flows: Foreign Direct Investment (FDI), remittances and ODA. To better compare FDI and remittances and to get a more accurate impression, I also calculated FDI as well as Remittances by omitting all OECD members, adjusted accordingly to their admittance to the OECD.

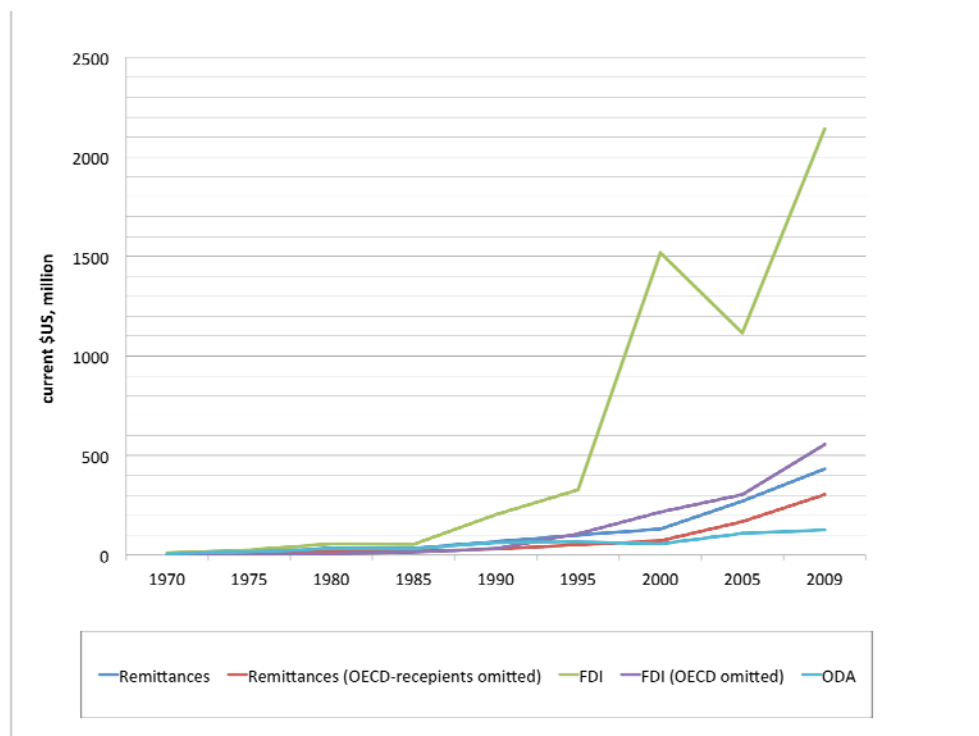
³⁴ Adam et al., "Aid, Public Expenditure and Dutch Disease," pp. 4, 21.

³⁵ Younger, "Aid and the Dutch Disease: Macroeconomic Management When Everybody Loves You," pp. 1587-1588, 1595.

³⁶ Alfieri et al., "Definition of Remittances And Relevant BPM5 Flows," p. 3.

³⁷ Adams et al., "International Migration and Remittances," p. 1647.

FIGURE 5
OVERVIEW ON INTERNATIONAL FLOWS 1970–2009 (current US\$ million)



Source: World Bank (<http://data.worldbank.org>)

As can be seen, remittances have outbalanced ODA since the 1980s and were already double the amount of foreign aid in 2000. Only FDI is significantly higher than remittances. Taking a look at the non-OECD FDI, which is significantly lower because most FDI goes to OECD countries, compared to Remittances, both have an upward trend and Remittances almost equalled non-OECD FDI in 2005. But as mentioned above, FDI is indeed privately generated and transferred to other countries and cannot be ignored, but due to its commercialized purpose it is not relevant to this paper. Figure 6 shows that remittances have steadily increased from 1970 onwards, when they were first recorded by the World Bank. As the graph further shows, remittances took off in the 1990s when already 154 million were migrated out of their home countries, rising to 175 million in 2000, according to UN estimates, and is, next to relaxed exchange controls by the International Monetary Fund for foreign currencies, used as obvious explanation for the significant growth of remittances circulating.³⁸

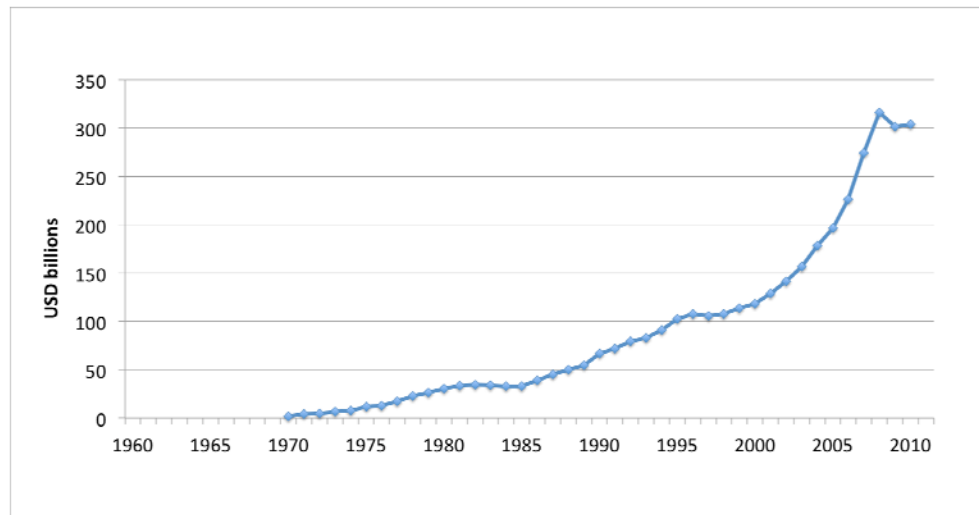
Over the last four decades, the world has experienced several financial crises but with no impact on remittances. Dilip Ratha even states in his paper that remittances tend to be a more stable, important and especially reliable source of foreign exchange than capital flows like international bank credit and portfolio investment, even in economic downturns.³⁹ In addition to their stability, no transaction costs and no contract negotiations or intermediaries are required because the flow of remittances does not underlie the fads of government officials and NGOs. Therefore, they go straight from migrants to their families as free lunch because no further fees or services of intermediaries apply. That implies that on both sides remittance

³⁸ UN Data 2010, <http://data.un.org> and Kapur et al., "Migration's New Payoff," p. 51.

³⁹ Ratha, "Workers' Remittances: An Important and Stable Source of External Development Finance," pp. 157-158.

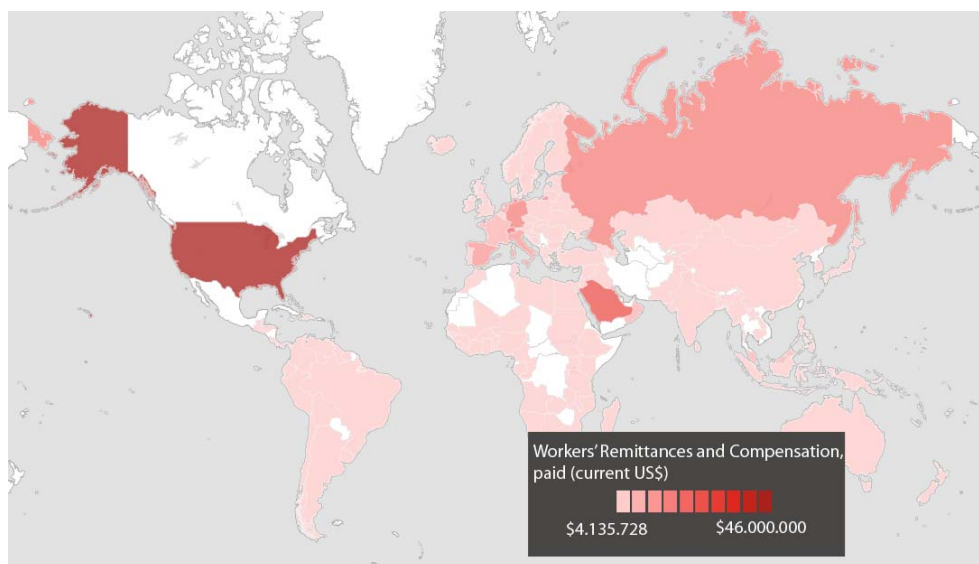
transactions do not require any costly bureaucracy provided by the government and the chance of money drain due to corruption is reduced to zero.⁴⁰ If no intermediates like governments participate in transferring remittances, the money goes straight to the poor people who lack sufficient financial means, implying with high probability that there is no better way to reallocate and improve welfare of the poor populations of LDCs.⁴¹

FIGURE 6
REMITTANCES 1970-2010 (current US\$)



Source: World Bank (<http://data.worldbank.org>)

FIGURE 7
REMITTANCES: MAP OF SENDING COUNTRIES



Source: World Bank (<http://data.worldbank.org>)

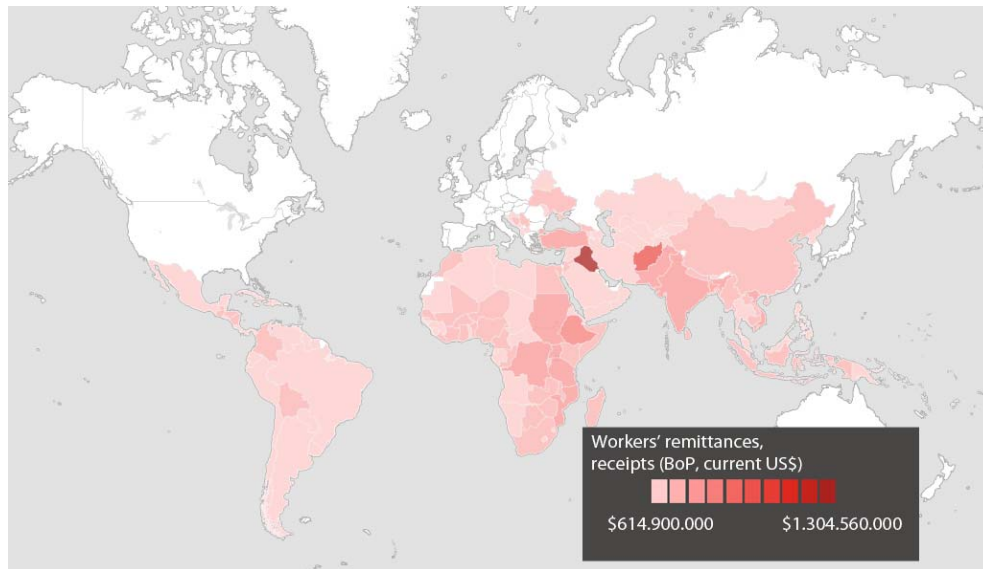
But what countries generate remittances and which receive them? In the following two maps, one can see that sending countries simultaneously receive remittances except the U.S. and certain industrialized European countries. The majority

⁴⁰ Kapur et al., "Migration's New Payoff," p. 50.

⁴¹ De Haar, "International Migration, Remittances and Development: Myths and Facts," p. 1277.

of countries therefore are sending and receiving remittances but only a small number maintains balance in in- and outflows. In the same breath sending countries receive major migration flows. Figure 7 shows the sending countries and Figure 8, in contrast, indicates all receiving countries. Both maps show remittances recorded by the World Bank, but informal money transfers sent home by mail or brought home by travel lead to an underestimation of remittances flows.

FIGURE 8
REMITTANCES: MAP OF RECEIVING COUNTRIES



Source: World Bank (<http://data.worldbank.org>)

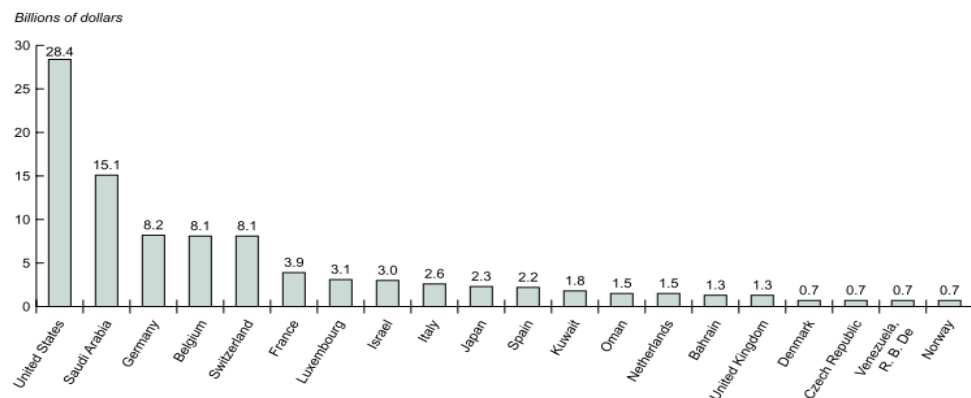
Effects with benefit

Formal remittances have important side effects that encourage further growth in developing countries. The first one is the establishment of banking systems and capital markets in LDCs because transferring remittances requires basic infrastructure of banking systems in receiving countries so that money can move across borders. One decade ago, service fees were as high as ten per cent to transfer money to developing countries, or it was merely impossible due to the lack of a banking system. Several banks recognized a well paying business, which consequently attracted more players to enter the market of international remittance banking. The new competition on this market brought along major benefits due to causing transaction fees to decrease and competing banks further opened a huge number of branches in developing countries, even in relatively backward, rural regions. Through remittances, developing countries develop a flourishing banking infrastructure. The development of banking systems as well as the creation of a capital market in LDCs moreover constitutes new chances for local microbusinesses to finance themselves by providing the chance to borrow money. Therefore, these microbusinesses are not dependent on developing countries' governments or development assistance anymore and can benefit from self-help.⁴² To demonstrate this impact, Kapur refers to the US located bank Western Union and its development in the business of transferring remittances. In 1996, Western Union had 35,000 branches worldwide with only 10,000 outside the US but already in 2002, money could be transferred to 95,000 branches overseas. The newly emerged bank busi-

⁴² Kapur, "Remittances," pp. 16-19.

ness drove 40,000 credit unions to launch the International Remittance Network to enable migrants to remit at no charge and more favourable exchange rates.⁴³ This development ensures the beneficial trend of shifting from informal money transfers to formal ones and enables institutions to measure remittances more accurately. This directly improves poor families' situations because they are able to save money due to using remittances as disposable income at reasonable interest rates for future investments in health care and education.

FIGURE 9
TOP 20 SOURCE COUNTRIES OF REMITTANCE PAYMENTS, 2001 (US\$ billions)



Source: IMF, Balance of Payments Yearbook, Graph taken from Ratha (2003), "Workers' Remittances," p. 160

The second benefit of remittances is the impact on politics. In most developing countries we find unstable and authoritarian governments flagged by corrupt leaders and government officials. These regimes benefit from their poor and uneducated population. But as the population gets richer, they can afford education and therefore are not willing to involuntarily accept the government's policies. As Luin Goldring pointed out in his paper, individual remittances within the family network probably do not improve political conditions but if remittances are seen in a collective environment, they definitely have a major impact on voters' opinions and hence political decisions.⁴⁴ In the Dominican Republic, where remittances account for ten per cent of the GDP, president candidates have triggered their campaigns on expatriate communities in the US as well to increase their votes. Other South American emigrants may have also influenced their countries' elections due to the fact that they have partly financed campaigns of moderate politicians by remitting money. In the case of the Philippines, a new bill was passed by legislation that permits naturalized citizens immigrated to developed countries from the Philippines to vote in upcoming national elections.⁴⁵ As can be seen, remittances effect power distribution and legislation in LDCs and might lead to a more democratic regime. This new movement reduces the chance of corruption and offers new tools for political amendments since voters in sending countries cannot be bought or intimidated by LDC's government. On the other side, one can argue that remittances finance hard-line regimes in developing countries and worsen the conditions even more. But there is weak evidence that these consequences may be true. Rather, remittances may be seen as casualties of war on terrorism due to unofficial flow of capital to exactly the countries where the world community locates the origins of

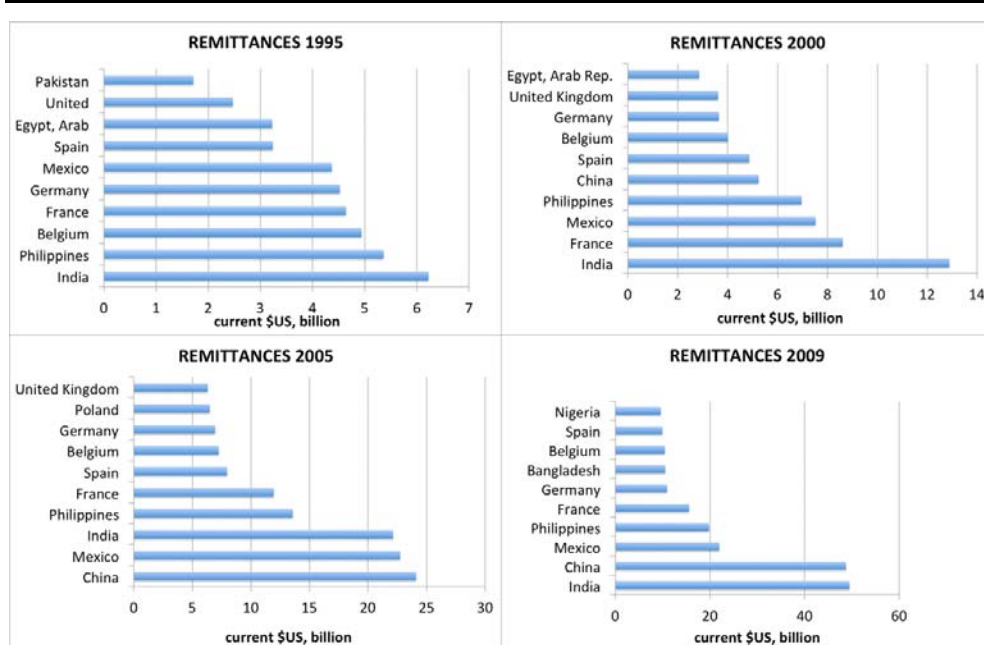
⁴³ Kapur et al., "Migration's New Payoff," pp. 51-52.

⁴⁴ Goldring, "Re-thinking Remittances," pp. 9-10.

⁴⁵ Kapur et al., "Migration's New Payoff," pp. 54-55.

terrorism. After 9/11, the US imposed blanket sanctions against countries and their governments where the US presumed terror cells but where remittances are also most needed.⁴⁶ This development may cause issues to the flow of remittances and their amount because as can be seen in Figure 9, the US is by far the major sending country of remittances with almost double the amount of the second sending country, Saudi Arabia, and ahead of most OECD members.

FIGURE 10
TOP 10 REMITTANCES COUNTRIES 1995–2009 (current US\$ billions)



Source: World Bank (<http://data.worldbank.org>); graph generated by the author

When we take a look at countries receiving remittances we may notice that India is the number one country since 1995. According to US Census 2000, Indians represent 3.3 per cent of 32.5 million foreign born citizens in the United States, only surpassed by the Mexican population in the US, which accounts for 9.8 million people or 30 per cent of the foreign born population. Todaro and Smith state that following 2000, India took off with its economic development and experienced rapid growth until today.⁴⁷ Figure 10 and 11 support these claims. As can be seen in Figure 10, except in 2005, when China is number one, India receives the most remittances.

Figure 11 shows that India had the most net migration out of the country before 2000 followed by Mexico and the Philippines. In 2009, India is on the third position behind Mexico, where the major part of net migration accounts for the flow from Mexico to the US and Pakistan. In connection with Todaro's and Smith's findings, India's take-off in 2000 might be the reason for decreased migration from 1.43 million to about a million within ten years.

Even though economic growth may be slightly slowed down due to output losses by emigration of highly skilled labour, according to Ratha, these losses are almost offset by remittances.⁴⁸ Irma Adelman and Edward Taylor support this claim with their survey, which was conducted on the basis of the case of Mexico,

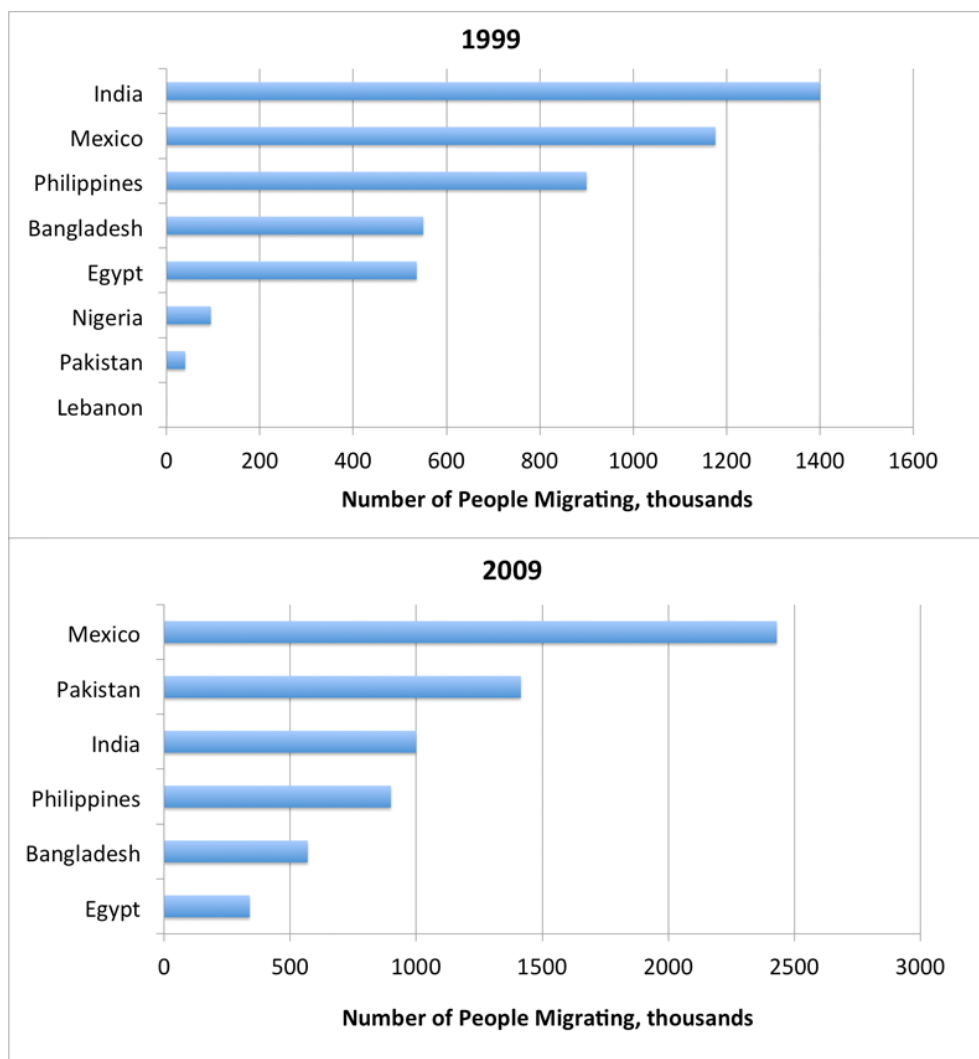
⁴⁶ Amoores et al., "Governance, Risk and Dataveillance in The War On Terror," pp. 153-157.

⁴⁷ Todaro et al., *Economic Development*, p. 727.

⁴⁸ Ratha, "Workers' Remittances: An Important and Stable Source of External Development Finance," p. 164.

by showing that every dollar that is generated by migrants and remitted to Mexico, increases Mexico's GDP by \$2.69 to \$3.17, depending on the location of the recipient.⁴⁹ Overall, there is strong evidence that remittances clearly favour economic development in the receiving countries as well as do not pose severe threats to the sending countries' economies except the loss of sales tax revenue due to reduced ability to consume.

FIGURE 11
NET-MIGRATION FLOWS FROM TOP 8 REMITTANCE-RECEIVING COUNTRIES, 1999 AND 2009



Source: World Bank (<http://data.worldbank.org>); graph generated by the author; OECD members (France and Spain) omitted

Finally, Richard H. Adams and John Page found in their econometric analysis that international remittances in relation with international migration have a strong, statistically significant correlation with poverty reduction.⁵⁰ They found that a 10 per cent increase in international migration achieves a 2.1 per cent reduction of the share of population living in poverty. The same increase in official interna-

⁴⁹ Adelman et al., "Is Structure Adjustment With a Human Face Possible? The Case of Mexico," pp. 390-395.

⁵⁰ Adams et al., "International Migration and Remittances," p. 1660.

tional remittances further adds a 3.5 per cent decline of the share of population living in poverty. Adams in his World Bank publication on Guatemala found that remittances significantly reduce the level, depth and severity of poverty in developing countries.⁵¹ Important to remark is that the size of impact depends on the method of measuring poverty. He further found that households supported by remittances only use about 50 per cent for consumption goods. A significant portion of the rest goes into education and savings.

Bringing ODA and remittances together

Developed countries provided the less developed world with billions of dollars in the form of ODA over the last six decades as the World Bank has recorded since, and they have not been successful in alleviating poverty in any part. But a new capital flow occurred. In the 1970s, remittances from developed countries to LDCs were first measured; they grew slowly over two decades and then took off, bypassing ODA and are now far outweighing ODA. Remittances in comparison to ODA show clear advantages. First, remittances emerged through private effort without governmental intervention, and therefore maximize private utility. Aid on the other hand is provided by governments and already consumes high costs to set up the transfer. Furthermore, remittances do not have inefficiencies due to transaction costs or corruption. In addition, they go directly to the poor families without any detour through intermediates where a clear distribution issue occurs due to the hundreds of applications for aid and long-lasting contract negotiation procedures. The lack of infrastructure to guarantee capital mobility only slows the impact of remittances down because transferring networks already exist through mail and travels, but also as outlined above remittances are part of development of a local banking system and capital markets.

Furthermore, no intermediates and bureaucracy are required, which benefits transferring money because the amount transferred cannot siphon through them to finally reach developing countries. Even though banks charged fees for money transfers at the beginning, which may be comparable to the loss due to transaction costs or corruption, these charges were competed away over time and the emergence of transferring networks promoted by credit unions in the US enable migrants to get better exchange rates for their remittances. Next to financial benefits, immigrants are given the chance to experience democracy in developed countries, which they may transfer back to their countries of origin, as well as education due to sound school systems.

Compared to the fifty-year long research in the field of ODA, surveys about remittances are able to measure impacts already within one decade, as can be seen in the cases of India, Mexico and the Philippines. Evidence of negative impacts like output losses due to emigration of highly skilled labour has no significant effect because these are compensated by the amount of remittances sent back to home countries.

Conclusion

As this paper outlines, the amount of remittances available, and the benefits of remittances, outbalance ODA by far in monetary terms. The impact of ODA provided by developed countries only seems to be a small drop in a huge bucket and only small portions get to the projects they were intended for. As Adams and Page point out, even though remittances have a positive impact on poverty reduction, the availability of data on remittances and migration compared to ODA data is

⁵¹ Adams, "Remittances," p. 77.

unfortunately small. But in recent years, the IMF in cooperation with the World Bank has started to collect and publish recent data on a country-specific basis.

Certainly, remittances need migration to developed or richer neighbouring countries where migrants can find employment, but most developed nations have immigration policies in place to limit migration into their country. Due to these rather unfortunate migration opportunities, the flow of remittances is perceived as rather volatile.⁵² The direct flow of remittances into households' pockets increases these households' ability to invest in education but also requires saving a portion for the future. These developments bring an important social and political dimension with them, which cannot be discounted.⁵³

These concluding points imply two important advancements in the international policy framework. First, countries known as recipients of migrants increase the flow of remittances by promoting savings accounts in foreign currency as well as facilitate cross-national banking to further reduce transaction costs. Second, to increase the opportunities to generate remittances the international development community requires an organ for managing migration through a globally integrated migration policy. Arguments of developed countries for anti-migration policies are that immigration poses a threat to their social infrastructure due to a lack of funding and to their labour market due to an increase in labour supply and a decrease in wages.⁵⁴ But as Ronald Jones put it, "if immigrant labor differs in certain qualities from the local relatively unskilled labor force, perhaps by a different willingness to work in particular occupations, the two groups may prove to be complements in production in that a greater inflow of immigrants could raise the marginal productivity of locals."⁵⁵ Therefore, switching to controlled immigration may increase the amount and benefits of remittances as well as their impact, and foreign aid could be fully substituted, which results in availability of funding for further immigration to developed countries. As the final note, I am following the statement by Jorge Durand and his co-authors, who wrote: "As they elevate a family's standard of living, contribute to business formation, and lead to community improvements, [remittances] represent a tangible accomplishment [...]."⁵⁶

References

- Adam, C. (2003) "Aid, Public Expenditure and Dutch Disease." The Centre for the Study of African Economies.
- Adams, R. H. (2006) "Remittances, Poverty, and Investment in Guatemala." In Özden, C. & Schiff, M. (Eds). *International Migration, Remittances & The Brain Drain*. (p. 292). Washington, DC: World Bank; Palgrave Macmillan, 2006.
- Adams, R. H. & Page, J. (2005) "Do International Migration and Remittances Reduce Poverty in Developing Countries?" *World Development*, 33(10), 1645-1669.
- Adelman, I. & Taylor, J. Edward. (1990) "Is structural adjustment with a human face possible? The case of Mexico." *Journal of Development Studies*, 26(3), 387-407.
- Adem, G. (2002) "Official Development Assistance." *se1.isn.ch*, 2006. OECD Publishing.
- Alesina, A. (2000) "Who gives foreign aid to whom and why?" *Journal of Economic Growth*, 63(March), 33-63.
- Alesina, A. & Weder, B. (2002) "Do Corrupt Governments Receive Less Foreign Aid?" *American Economic Review*, 92(4), 1126-1137.
- Alfieri, A., Havinga, I. & Hvidsten, V. (2005) "Definition of Remittances and Relevant BPM5 Flows." UN Department of Economic and Social Affairs Statistics, Meeting of the Technical Subgroup on Movement of Natural Persons–Mode (Vol. 4, pp. 1-9).

⁵² Ibid., p. 78.

⁵³ Goldring, "Rethinking Remittances," p. 18.

⁵⁴ Hatton, "The Cliometrics of International Migration," p. 952-954.

⁵⁵ Jones, "Immigration vs. Outsourcing," p. 15.

⁵⁶ Durand et al., "International Migration," p. 261.

- Amoore, L. & Goede, M. (2005) "Governance, Risk and Dataveillance in The War on Terror." *Crime, Law and Social Change*, 43(2-3), 149-173.
- Azam, J. P., Devarajan, S. & O'Connell, S. A. (1999) "Aid dependence reconsidered." *The Centre for the Study of African Economies Working Paper Series*, 13, 189.
- Bardhan, P. (1997) "Corruption and Development: A Review of Issues." *Journal of Economic Literature*, 35(3), 1320-1346.
- Boone, P. (1996) "Politics and the effectiveness of foreign aid." *European Economic Review*, 40(2), 289-329.
- Bräutigam, D. A. & Knack, S. (2004) "Foreign Aid, Institutions, and Governance in Sub-Saharan Africa." *Economic Development and Cultural Change*, 52(2), 255-285.
- Dalgaard, C.-J., Hansen, H. & Tarp, F. (2004) "On The Empirics of Foreign Aid and Growth*." *The Economic Journal*, 114(496), F191-F216.
- De Haas, H. (2005) "International Migration, Remittances and Development: Myths and Facts." *Third World Quarterly*, 26(8), 1269-1284.
- Durand, J., Kandel, W., Parrado, E. A. & Massey, D. S. (1996) "International Migration and Development in Mexican Communities." *Demography*, 33(2), 249-64.
- Easterly, W. (2006) "The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good." Penguin Press HC, The. (1st Edition).
- Easterly, W. (2002) "The Cartel of Good Intentions: Bureaucracy Versus Markets in Foreign Aid." *Center for Global Development Working Paper*, 4.
- Easterly, W. & Pfutze, T. (2008) "Where Does the Money Go? Best and Worst Practices in Foreign Aid." *Journal of Economic Perspectives*, 22(2), 29-52.
- Goldring, L. (2003) "Re-thinking remittances: Social and political dimensions of individual and collective remittances." *York University. CERLAC Working Paper Series*.
- Guriev, S. (2004) "Red tape and corruption." *Journal of Development Economics*, 73(2), 489-504.
- Hatton, T. J. (2010) "The Cliometrics of International Migration: A Survey." *Journal of Economic Surveys*, 24(5), 941-969.
- Hudson, J. & Mosley, P. (2001) "Aid Policies and Growth: In Search of The Holy Grail." *Journal of International Development*, 13(7), 1023-1038.
- Huntington, S. P. (1968) *Political Order in Changing Societies*. (p. 488). New Haven, CT: Yale University Press.
- Jones, R. (2005) "Immigration vs. Outsourcing: Effects on Labor Markets." *International Review of Economics & Finance*, 14(2), 105-114.
- Kanbur, R. & Sadler, T. (1999) "The Future of Development Assistance: Common Pools and International Public Goods." Washington, DC: Overseas Development Council, (25).
- Kapur, D. & McHale, J. (2003) "Migration's New Payoff." *Foreign Policy*, 139(139), 49-57. JSTOR.
- Kapur, D. (2004) "Remittances: The New Development Mantra." G-24, 1-38. Retrieved May 9, 2011, from <http://www.g24.org/dkapugva.pdf>.
- Leff, N. H. (1964) "Economic Development Through Bureaucratic Corruption." *American Behavioral Scientist*, 8(3), 8-14.
- Levy, V. (1987) "Anticipated Development Assistance, Temporary Relief Aid, and Consumption Behaviour of Low-Income Countries." *The Economic Journal*, 97(386), 446-458.
- Mauro, P. (1995) "Corruption and Growth." *The Quarterly Journal of Economics*, 110(3), 681-712.
- OECD Statistics (2010), <http://stats.oecd.org/Index.aspx>
- Ratha, D. (2003) "Workers' Remittances: An Important and Stable Source of External Development Finance." *Global Development Finance*, 1, 157-75. Banco Mundial.
- Rose-Ackerman, S. (1997) "The Political Economy of Corruption." In Elliot, K. A. (Ed). *Corruption and the Global Economy*. (p. 244). Washington, DC: Peterson Institute, 1997.
- Sachs, J. (2003) "Institutions Matter, But Not For Everything." *Finance and Development*, June, 38-41.
- Shleifer, A. & Vishny, R. W. (1993) "Corruption." NBER Working Paper Series, No. 4372. Cambridge, MA.
- Todaro, M. & Smith, S. (2002) "Economic Development." Addison Wesley (8th Edition).

- Tornell, A. & Lane, P. R. (1999) "The Voracity Effect." *The American Economic Review*, 89(1), 22–46. JSTOR.
- Transparency International. (2006) "Corruption in Humanitarian Aid." Transparency International Working Paper, 7.
- UN (1970) "General Assembly Resolution." UN Publications, October 24th, 1970. New York City, NY.
- UN Data (2010), <http://unstats.un.org/unsd/databases.htm>
- World Bank Statistics (2010), <http://data.worldbank.org/>
- Younger, S. D. (1992) "Aid and The Dutch Disease: Macroeconomic Management When Everybody Loves You." *World Development*, 20(11), 1587-1597.