

**THE IMPORTANCE OF WORKERS' REMITTANCES AS A SOURCE OF  
DEVELOPMENT FINANCE**

by

**Ramkishen S. Rajan\***

January 2006

-----

\* School of Public Policy, George Mason University. E-mail: [r.raj@gmu.edu](mailto:r.raj@gmu.edu)

## THE IMPORTANCE OF WORKERS' REMITTANCES AS A SOURCE OF DEVELOPMENT FINANCE

### 1. Introduction

A notable and much discussed trend in external finance to developing countries is the declining share of Overseas Development Assistance (ODA), as the OECD countries have consciously cut back their concessional grants since the early 1990s. Indeed, most developed countries have failed to meet the United Nation's (UN's) suggested aid target of 0.7 per cent of GNP in 1970 (Table 1).<sup>1</sup> The reasons for the so-called "foreign aid crisis" are almost certainly attributable to a combination of factors. These include the global political environment, in particular the end of the Cold War which blurred ideological differences and removed much of the political motivation for aid; the desire on the part of donors to reduce their own fiscal deficits; and a general perception that aid has been ineffective at encouraging economic growth and reducing poverty (due to, for instance, the possibility that aid substitutes for, rather than supplements domestic resources).

While there still remains a great deal of "aid pessimism", there is, however, a growing body of evidence that finds foreign aid has been effective in many poor countries, and can be particularly effective at reducing poverty when combined with good domestic economic policy and institutions.<sup>2</sup> Accordingly, it is important to focus on increasing both the magnitude but also the effectiveness of ODA. The need to encourage creditor countries in the Asia-Pacific to raise their regional aid commitments is particularly acute as there are concerns that aid from the US and other donors may increasingly be

---

<sup>1</sup> Exceptions have been Denmark, Norway, Netherlands and Sweden. While the US has been the largest donor in absolute level, it spends just about 0.12 percent of its GDP on foreign aid (*The Economist*, May 3, 2003, p.66).

<sup>2</sup> The debate on the links between aid and growth has given rise to a voluminous literature in the area. Notable recent papers include C. Burnside and D. Dollar (2000). "Aid, Policies, and Growth", *American Economic Review*, 90, pp.847-868; World Bank (1998). *Assessing Aid: What Works, What Doesn't, and Why?*, New York: Oxford University Press; S. Radelet, M. Clements and R. Bhavani (2004). "Counting Chickens When they Hatch: The Short-Term Effect of Aid on Growth", *Working Paper No.44*, Center for Global Development (Washington, DC); and R.G. Rajan and A. Subramaniam (2005). "What Undermines Aid's Impact on Growth?", *Working Paper No.11657*, NBER. Without entering that debate here, it may be useful to keep in mind two caveats. One, it might be argued that aid benefits the poor in recipient countries even if it does not contribute directly to growth, by raising expenditures on health, education, water and sanitation. Two, aid effectiveness issues may vary by categories, and in particular, whether it is tied versus untied. Three, there may exist a macro-micro paradox; while questions remain about the general effectiveness of *program-aid*, evidence suggests that *project-aid* has had beneficial impact when carefully targeted and administered.

influenced by strategic and political considerations (the war on terrorism, financing the reconstruction in Afghanistan and Iraq, etc) rather than pure development/economic considerations. This may result (in fact, has been resulting) in a significant reallocation of aid among potential recipient countries. For instance, aid to Afghanistan and its bordering countries, Pakistan, Tajikistan, Turkmenistan and Uzbekistan increased threefold from US\$ 1.1. billion in 2000 to US\$ 3.7 billion in 2002<sup>3</sup>

The United Nations Millennium Development Goal (MDG) is to reduce income poverty worldwide by about one half between 1990 and 2015.<sup>4</sup> But at a time of severely curtailed overseas development assistance (ODA) and other official flows, where will the *external* resources to alleviate constraints for financing development come from?<sup>5</sup> This is the key concern of the Monterrey Consensus of the International Conference on Financing for Development (Ffd) (adopted at Monterrey Mexico, on 22 March 2002).<sup>6</sup> As highlighted by the Monterrey Consensus, in an era of falling aid flows, international trade (export revenues), private capital flows, particularly foreign direct investment (FDI), and worker remittances, are crucial sources of financing for development.<sup>7</sup>

---

<sup>3</sup> World Bank (2004). *Global Development Finance 2004*, Washington, DC: The World Bank, Chapter 4. This source also offers a succinct overview of the dynamics of foreign aid to developing countries, prospects of increasing such flows and their development impact in the future.

<sup>4</sup> Income poverty reduction is not the only objective that constitutes the MDG to be realized by 2015. Other goals are: (a) attainment of universal primary education; (b) promotion of gender equality and empowerment of women; (c) reduction of the infant (under five) mortality rate by two-thirds; (d) improvement of maternal health by reducing by three-quarters the maternal mortality ratio; (e) halting the spread of HIV/Aids, malaria and other major diseases; (f) ensuring environmental sustainability including halving the proportion of people without sustainable access to safe drinking water; and (g) development of an open, rule-based, predictable and non-discriminatory trading and financial system. See <http://www.developmentgoals.org>.

<sup>5</sup> We recognize, but do not discuss, the importance of internally raised resources for development (domestic resources finance most of the investment expenditures in developing countries). For a more specific discussion on budgetary resource mobilization in Asia see M. Asher (2004). "Budgetary Resource Mobilisation in Asia: Growing Complexity", *Economic and Political Weekly*, 38, pp.3639-3646.

<sup>6</sup> For details of Monterrey Consensus, see United Nations (UN) Secretariat (2002). "Final Outcome of the International Conference on Financing for Development", Note by the Secretariat, February 15. Some have used the term the "Monterrey development deficit" to highlight the insufficiency of financial resources to meet and surpass the MDG.

<sup>7</sup> Reducing the external debt burdens of many developing countries is a further element of the Monterrey Consensus. Indeed, debt relief initiative for the heavily indebted poor countries (HIPC) (launched in 1999) remains a key component of the Monterrey Consensus. However, agreement was not reached on debt relief for middle-income countries. There are valid concerns that debt relief could lead to a reduction in the grant component of foreign aid.

## 2. Significance of Worker's Remittances

There is already an extensive literature on all aspects of FDI. In sharp contrast, workers' remittances -- which are the financial counterpart of the outflow of migration flows -- have generally been paid much less attention to by mainstream academics and policy-makers.<sup>8</sup> This is, however, gradually changing with the growing recognition that workers' remittances have been and will continue to be an important and stable source of financing.

Specifically, workers' remittances have maintained a steady and marked upward trend between 1995 and 2003, peaking to over US\$ 90 billion in 2003 compared to just over US\$ 50 billion in 1995. Workers' remittances have in fact become the second most important type of private external finance to developing countries after FDI (Tables 2 and 3). The data in Table 2 pertains only to the narrowest definition of remittances, viz. "unrequited transfers". Broader data coverage of remittances would include "migrant transfers" and the "compensation of employees" as recorded in the balance of payments statistics. Thus, the magnitude of remittances noted above is clearly understated. Indeed, insofar as migrants make payments in kind such as payments directly to schools (tuition fees) or international airlines (airfares) on behalf of relatives or friends in their home country, or channel remittances via other means (e.g. non-resident rupee deposits in India), the true magnitude of remittance transfers is probably much larger than captured by available statistics.<sup>9</sup>

Asia's share of workers' remittances to developing countries averaged almost 40 percent in 2002 and 2003, half of which was destined to India and the Philippines.<sup>10</sup> The three main source countries of remittances have been the US, Saudi Arabia and Germany.<sup>11</sup> While India clearly dominates as a destination for workers' remittances

---

<sup>8</sup> Two caveats should be noted. One, while out-migration of unskilled labour is acknowledged as offering significant economic benefits for both the sources and host countries, there is an active debate on the economic consequences of out-migration of skilled workers (i.e. "brain drain" or "brain gain"?). Two, there is some evidence that skilled migration is associated with lower remittances than migration of unskilled labour. It is, however, unclear whether these differences are robust and if they are whether they are due to different occupations of the two sets of migrants or because of differences in migration status, i.e. unskilled tend to be temporary and skilled tend more likely to be permanent migrants. Some of these issues are explored in R. Faini (2003). "Is the Brain Drain and Unmitigated Blessing?", Discussion Paper No.2003/64, United Nations-WIDER.

<sup>9</sup> Work is being done by the World Bank, individual countries and international agencies and others to enhance the quality of remittance data. See [http://devdata.worldbank.org/wdi2005/Section6\\_1.htm#fc](http://devdata.worldbank.org/wdi2005/Section6_1.htm#fc) and World Bank (2003). *Global Development Finance 2003*, New York: Oxford University Press, Chapter 7.

<sup>10</sup> As a share of GDP, remittances are particularly important to Tonga, the Philippines and Sri Lanka in the Asian and Pacific region.

<sup>11</sup> World Bank (2003), *op. cit.*.

(Figure 1),<sup>12</sup> these financial flows are more evenly spread out than private capital flows. For instance, in 2001 the top ten remittance recipients received 60 per cent of total remittances to developing countries. This was below the share of the top ten recipient countries for FDI (almost 75 percent), dominated by China (Figure 2).

As important as the relative magnitudes is the relative stability (or lack thereof) of the various sources of finance. The well known story is that during the crisis of 1997-98, FDI in Asia remained relatively stable while debt and portfolio equity flows collapsed. This is clearly borne out by the data. Specifically, FDI, workers' remittances and export revenue flows have the lowest variability, while debt flows -- specifically short-term debt -- are the most variable, followed by portfolio equity flows. This conclusion holds true when we limit the analysis to the crisis-hit economies in Southeast Asia (Malaysia, Thailand, Indonesia, and the Philippines) or to just China and India.<sup>13</sup> In addition, while FDI as well as other private capital flows tend to be procyclical (rising as the host country is doing well and there is general bullishness about the country's prospects), the same may not be true remittances. This is so as remittances could be viewed as a self-insurance mechanism for developing countries, or there may be an element of philanthropy (i.e. altruistic motive) in the sense that the overseas diaspora increases remittances at times when most needed (e.g. during periods of economic crises or natural disasters).<sup>14</sup> This relatively low positive correlation between remittances and other private capital flows and its well-targeted nature (i.e. person-to-person flows), makes it a particularly important source of finance to developing countries. Such a stabilizing role was historically played by ODA.

### 3. FDI versus Workers' Remittances: China and India Compared

A comparison is often made between FDI inflows to the two Asian giants of (Mainland) China and India, both of which have among the world's largest overseas migrants in absolute terms. Even if one discounts round-tripping from Hong Kong

---

<sup>12</sup> Remittances to India have kept its current account deficits at low levels, even registering surpluses in recent times despite large merchandise trade deficits.

<sup>13</sup> R. Rajan (2005). "Financing Development in the Asia-Pacific Region: Trends and Linkages", *The Role of Trade and Investment Policies in the Implementation of the Monterrey Consensus: Regional Perspectives*, Studies in Trade and Investment No.55, pp.21-65.

<sup>14</sup> Admittedly, however, we cannot say whether remittances are actually *counter-cyclical* as market considerations and signals clearly also play some role in remittance inflows. C. Buch and A. Kukulenz (2004). "Worker Remittances and Capital Flows to Developing Countries", *Discussion Paper No. 04-31*, ZEW Centre for European Economic Research and A. Solimano (2003). "Remittances by Emigrants: Issues and Evidence", mimeo (August).

(China)<sup>15</sup> and makes adjustments to differences in FDI data in both countries (Indian sources severely understated inward FDI though adjustments have been made to it recently),<sup>16</sup> China still shows up as having attracted far more FDI than India.

Part of the difference in FDI flows to the two countries could be attributed to the relatively more aggressive rechanneling of resources by overseas Chinese to China compared to Non-resident Indian (NRIs). Overseas Chinese are said to invest ten to twenty times more in China as NRIs do in India. On the other hand, China has received relatively low remittances -- about US\$ 1.5 billion dollars annually in the last decade (1995-2003) (compared to US\$45 billion dollars in FDI inflows), which was about one-eighth of India's receipts (\$8.8 billion annually over the same period) (compared to US\$ 3 billion dollars in FDI inflows). Thus, when one combines FDI and remittances (and makes the data on FDI comparable across both countries), the total financial contribution by the Chinese diaspora to China may not be significantly higher than that of NRIs to India.<sup>17</sup>

It is commonly suggested that the difference in manner and types of capital inflows by the countries' respective diasporas is a function of the economic opportunities in both countries and economic characteristics between the two diasporas. While there may be some merit in this, when one considers the fact that a large fraction of FDI in China (about one quarter) has been invested in real estate,<sup>18</sup> while a significant share of remittances tend to be devoted to land and housing purchases as well (for instance, see Brown, 1994), "it reinforces the suspicion that there is a not inconsiderable statistical overlap between remittances and FDI".<sup>19</sup> More to the point, the foregoing suggests the existence of a degree of substitutability between remittances and FDI.

#### 4. Conclusion

Overall, remittances have been growing in absolute terms as well as in comparison to other sources of external finance and they are a relatively stable form of finance.

---

<sup>15</sup> For a detailed discussion of round-tripping phenomenon, see G. Xiao (2004). "Patterns of PRC's FDI and their Relations to Round Tripping", *Discussion Paper No.7*, Asian Development Bank Institute.

<sup>16</sup> See R. Sen and S. Srivastava (2003). "Competing for Global FDI: Opportunities and Challenges for the Indian Economy", paper presented at the New Zealand Association of Economists (NZAE) Annual Conference, Auckland. India has recently altered its FDI statistics methodology to make it more internationally comparable by including reinvested earnings and intercompany loans.

<sup>17</sup> D. Kapur (2003). "Remittance: The New Development Mantra", mimeo (August).

<sup>18</sup> W. Tseng and H. Zebregs (2002). "Foreign Direct Investment in China: Some Lessons for Other Countries", *Policy Discussion Paper No.02/3*, IMF.

<sup>19</sup> Kapur, *op. cit.*

Admittedly, there needs to be much more empirical work on the links between remittances and private capital flows (substitutes or complements?) and remittances and growth. With regard to the latter, while most of the literature is generally holds a benign view on the growth and development impact of remittance inflows, it has been suggested that remittances may actually hinder growth for two reasons.<sup>20</sup> At a micro-level there is a moral hazard problem in that remittance inflows provide less incentive for the remitter to enter the labour force. At a macro-level, large-scale remittances could lead to a “Dutch Disease” phenomenon of overvalued real exchange rates, loss of export competitiveness, over-consumption, under-investment and delay much-needed policy reforms.<sup>21</sup> However, more recent work suggests that, at least at a macro level, remittances are less likely than foreign aid to have perverse macroeconomic effects (i.e. loss of competitiveness, etc).

These caveats notwithstanding, workers’ remittances have been and will continue to be an important and stable source of external finance for developing countries, and it is incumbent of policy makers to facilitate such flows. It is generally recognized that the remittances business is extremely segmented and inefficient; transactions costs are high as a few players dominate the market and charge “excessive fees”. Specifically, remittances have hitherto largely been channelled via Money Transfer Operators (MTOs), post offices, ethnic stores, couriers, and such (some of these go unrecorded). Reduction of the intermediation costs by encouraging more players to enter the remittance business (particularly by establishing partnerships between retail banks with extensive branches and government post office network) can provide a significant fillip to this source of financing for development.

---

<sup>20</sup> R. Chami, C. Fullenkamp and S. Jahjah (2004). “Are Immigrant Remittance Flows a Source of Capital for Development?”, *IMF Staff Papers*, 52, pp.55-81.

<sup>21</sup> This suggests the need for the government to work in concert with financial institutions not only to promote more efficient financial intermediation, but also to offer remittance recipients new and innovative financial services that would be useful to them, as well as proactively encourage a “savings culture”.

**Table 1**  
**Overseas Development Assistance (ODA) by industrial countries, 1990-2002**  
**(billions of US dollars)**

	1990	1997	1998	1999	2000	2001	2002	ODA/GNI in 2002 (per cent) <sup>1</sup>	Percentage change in real terms in 2002 <sup>2</sup>
Total ODA	54.5	48.5	52.1	56.4	53.7	52.3	58.3	0.23	7.2
G-7 countries	42.5	35.1	38.6	39.4	40.2	38.2	42.6	0.20	9.2
United States	11.4	6.9	8.8	9.1	10.0	11.4	13.3	0.13	15.0
Japan	9.1	9.4	10.6	12.2	13.5	9.8	9.3	0.23	-1.2
Germany	6.3	5.9	5.6	5.5	5.0	5.0	5.3	0.27	-0.2
France	7.2	6.3	5.7	5.6	4.1	4.2	5.5	0.38	22.1
Non-G-7 countries	12.0	13.4	13.5	17.0	13.5	14.1	15.7	0.47	1.8
<i>Memo item:</i> EU countries	28.3	26.8	27.6	26.7	25.3	26.3	29.9	0.35	5.8

Source: OECD Development Assistance Committee.

Note: 1) GNI = Gross National income (GNI).

2) Takes into account inflation and exchange rate movements.

**Table 2**  
**Workers' Remittances Received by Developing Countries, 1995-2003**  
**(billions of US dollars) <sup>†</sup>**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
All developing countries	51.1	56	66.1	62.9	67.6	68.4	77	88.1	93
Asia <sup>2</sup>	19.9 (38.9)	23.7 (42.3)	30.5 (46.1)	23.1 (36.7)	27.2 (40.2)	25 (36.5)	26.8 (34.8)	33.9 (38.5)	35.8 (38.5)
China	0.4 (0.8)	1.7 (3.0)	4.6 (7.0)	0.3 (0.5)	0.5 (0.7)	0.8 (1.2)	1.2 (1.6)	2.4 (2.7)	2.4 (2.6)
India	6.2 (12.1)	8.8 (15.7)	10.3 (15.6)	9.5 (15.1)	11.1 (16.4)	8.5 (12.4)	8.2 (10.6)	8.4 (9.5)	8.4 (9.0)
Indonesia	0.4 (0.8)	0.8 (1.4)	0.7 (1.1)	1 (1.6)	1.1 (1.6)	1.2 (1.8)	1 (1.3)	1.3 (1.5)	1.3 (1.4)
Malaysia	0.1 (0.2)	0.2 (0.4)	0.2 (0.3)	0.2 (0.3)	0.3 (0.4)	0.3 (0.4)	0.4 (0.5)	0.4 (0.5)	0.4 (0.4)
Philippines	5.4 (10.6)	4.9 (8.8)	6.8 (10.3)	5.1 (8.1)	6.9 (10.2)	6.2 (9.1)	6.2 (8.1)	7.4 (8.4)	8 (8.6)
Thailand	3.4 (6.7)	3.6 (6.4)	3.3 (5.0)	2.8 (4.5)	2.9 (4.3)	3.4 (5.0)	2.5 (3.2)	2.8 (3.2)	2.8 (3.0)
Pakistan	1.7 (3.3)	1.3 (2.3)	1.7 (2.6)	1.2 (1.9)	1 (1.5)	1.1 (1.6)	1.5 (1.9)	3.6 (4.1)	4.2 (4.5)
Sri Lanka	0.8 (1.6)	0.8 (1.4)	0.9 (1.4)	1 (1.6)	1.1 (1.6)	1.2 (1.8)	1.2 (1.6)	1.3 (1.5)	1.5 (1.6)
Bangladesh	1.2 (2.3)	1.3 (2.3)	1.5 (2.3)	1.6 (2.5)	1.8 (2.7)	2 (2.9)	2.1 (2.7)	2.9 (3.3)	3.2 (3.4)

Source: World Bank (2004). *Global Development Finance 2004*, New York: Oxford University Press.

Notes: 1) Figures in brackets denote individual countries percentage share of all developing countries flows.

2) Asia constitutes of South Asia and East Asia and Pacific as defined by the World Bank.

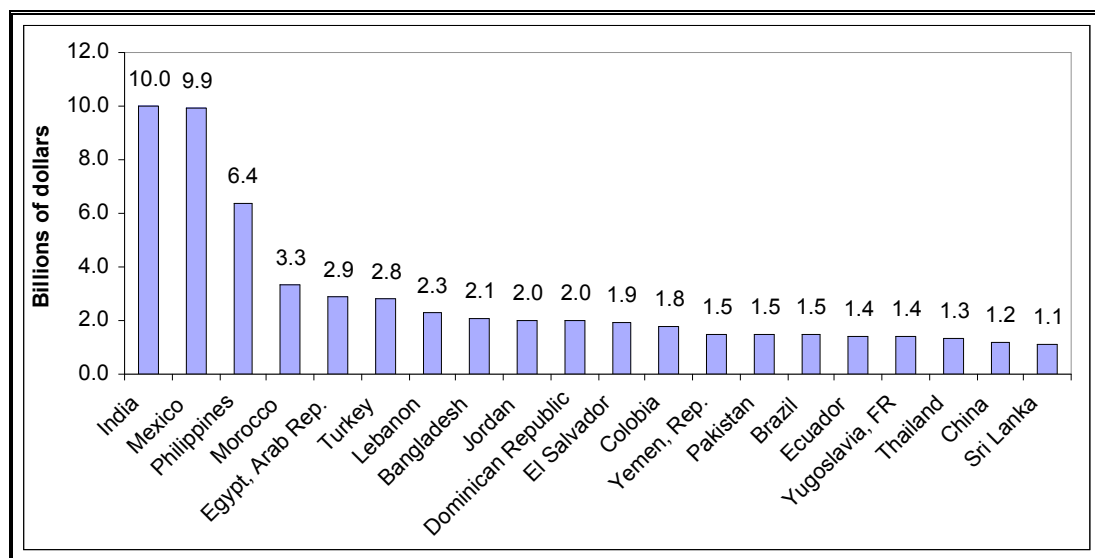
**Table 3**  
**Significance of Remittance Receipts to Developing Countries, 2002**  
**(billions of US dollars)**

	<b>All developing</b>	<b>Low-income</b>	<b>Lower-middle-income</b>	<b>Upper-middle-income</b>	<b>High-income</b>
Total remittance receipts	88.1	25.7	44.5	17.9	44.4
As percentage of GDP	1.5	2.9	1.3	1.0	0.2
As percentage of imports	5.1	12.1	4.9	3.2	1.2
As percentage of domestic investment	8.0	14.6	5.9	14.0	35.7
As percentage of FDI inflows	66.2	388.9	49.2	51.3	8.4
As percentage of net official finance	250.0	-	-	-	-
Other current transfers <sup>1</sup>	38.0	9.0	22.0	7.0	83.0
Remittance receipts and other current transfers	126.1	40.2	66.6	24.6	127.4
Total remittance payments	28.0	1.5	3.1	23.4	77.2
Excluding Saudi Arabia	12.1	1.5	3.1	7.5	77.2

Source: World Bank (2003). *Global Development Finance 2003*, New York: Oxford University Press.

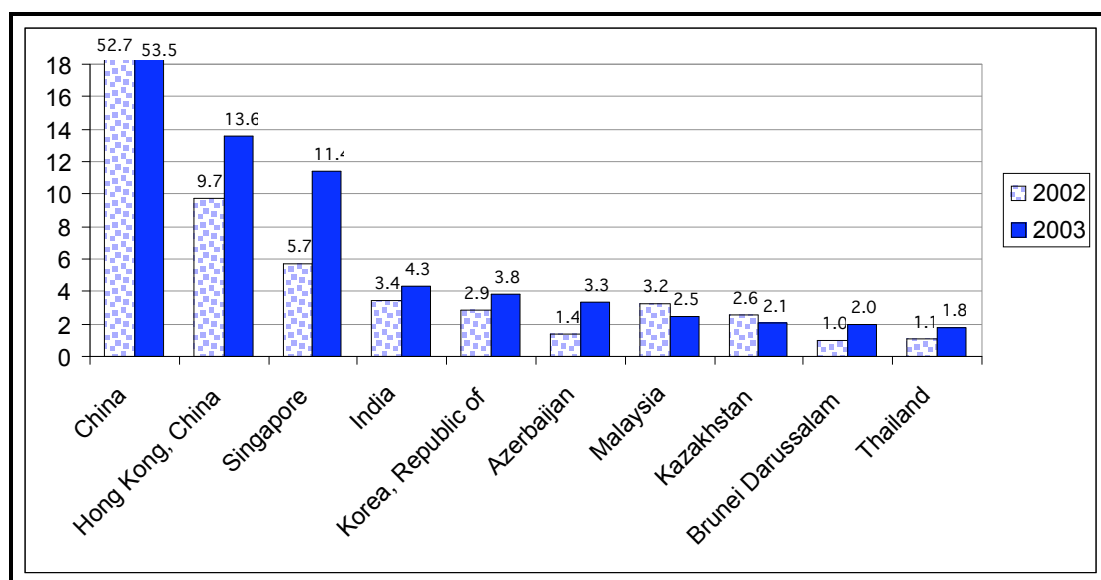
Note: 1) Other current transfers include gifts, donations to charities, pensions received by currently retired expatriate workers, etc. They may also include personal transfers by migrant workers to families back home.

**Figure 1**  
**Top 20 Developing Country Recipients of Workers' Remittances, 2001**  
**(billions of US dollars)**



Source: World Bank (2003). *Global Development Finance 2003*, New York: Oxford University Press.

**Figure 2**  
**Top 10 Recipients of FDI Inflows in the Asian and Pacific Region, 2002- 2003<sup>1</sup>**  
**(billions of US dollars)**



Source: UNCTAD (2004). *World Investment Report 2004*, New York and Geneva: Oxford University Press.

Note: 1) Ranked on the basis of the magnitude of 2003 FDI inflows.