

The Development Impact of Remittances in Latin America

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Remittances are extremely important in the Latin American context. In 2006, remittances to Latin America amounted to about US\$52 billion, making them comparable to foreign direct investment (FDI) and much larger than official development assistance (ODA) flows to the region. Today, Latin America is the top recipient region of remittances both by volume and in per-capita terms. Yet some important questions remain. What is the impact of these flows on the poverty levels of the different countries? Are there costs associated with remittances—and more significantly—to the migration that logically precedes remittances flows? What are the main challenges that policy makers face in countries experiencing a surge in remittances flows? In short, what is the development impact of remittances in Latin America, and how can it be enhanced?

Introduction

According to the World Bank's *Global Economic Prospects 2006*, remittances to middle- and low-income countries in 1990 amounted to about US\$31 billion. Fifteen years later, they were estimated to have reached about US\$200 billion, of which about one-fourth was directed toward the Latin America and the Caribbean region (Latin America henceforth). While this dramatic increase may to some extent reflect improvements in data collection, together with growing migration flows, the magnitude of remittances flows during recent years has attracted a great deal

of attention among academics and development practitioners, who have grown increasingly interested in understanding their potential development impact and corresponding policy implications.

Existing evidence on these issues, however, is mostly restricted to a small number of countries, notably Mexico and El Salvador in the case of Latin America. To the extent that patterns of migration and remittances vary considerably across countries and regions—for instance in terms of the social and economic background of migrants and their families—the impact of growing remittances flows is also likely to differ in ways that at present are still largely unknown. This provides the main motivation for undertaking the research summarized in this book, which is aimed at uncovering possible cross-country differences in the development impact of remittances, while at the same time providing evidence that could help policy makers in taking advantage of those flows. To that end, we combine microeconomic country case studies based on household surveys with the analysis of aggregate data on remittances flows for a large sample of countries.

There are four main messages that emerge from this book. First, no matter how we look at the issue, remittances are extremely important in the Latin American context. With remittances estimated to have topped more than US\$50 billion in 2006, Latin America is now the main destination of these flows. Today, remittances are comparable to foreign direct investment (FDI) flows and more than six times larger than official development assistance (ODA). The importance of remittances for some countries in the region can be best illustrated by expressing them as a ratio to GDP, while in others the percentage of recipients in the population or the absolute total of per-capita value of remittances flows are more revealing. In Guyana, for example, remittances represent about 25 percent of GDP. In the Dominican Republic, more than 20 percent of the households report receiving remittances on a regular basis. In Jamaica, remittances are close to US\$700 per person per year, whereas in Mexico, they add up to more than US\$20 billion per year. Policy makers and development practitioners should therefore pay due attention to the issue.

Second, remittances generate a number of important positive contributions to economic development. In particular, they tend to reduce poverty and inequality in recipient countries, as well as increase aggregate investment and growth. Moreover, thanks to their countercyclical behavior, remittances significantly reduce growth volatility and help countries adjust to external and macroeconomic policy shocks. At the microeconomic level, remittances allow poor recipient households to increase their savings, spend more on consumer durables and human capital, and improve children's health and educational outcomes. Remittances should thus be welcomed, encouraged, and facilitated.

Third, even though remittances have a positive impact on the development indicators of the recipient economies, the magnitude of the estimated

changes tends to be modest. There are two main explanations for this finding. One is related to the fact that in the Latin American context, remittances are not necessarily targeted to the poorest segments of the population. Instead, in a number of cases, they seem to flow to better-off households. This distributional profile will clearly lower the potential poverty-reducing impact of remittances. The other explanation is related to the costs associated with remittances flows and the migration that logically precedes them. In particular, in addition to the emotional hardships endured by migrants and the family members that are left behind, the departure of migrants who were active in the labor market should lead to reductions in other sources of household income. In the case of some small Caribbean islands, this may be aggravated by the fact that many migrants come from among the most educated segments of the population. The impact of this phenomenon, which has often been termed “brain drain,” is such that countries like Haiti, Jamaica, Grenada, and Guyana have lost more than 80 percent of their college graduates. Remittances, therefore, should not be considered a panacea or an alternative to sound economic policies.

Fourth, policy makers may take actions to enhance the development impact of remittances. For example, the empirical evidence in this book indicates that remittances increase the reservation wage of recipient households. Similarly, countries experiencing a surge in remittances tend to also experience a real exchange rate appreciation. In the absence of any policy action, these elements will have a negative impact on the international competitiveness of the tradable sector, and therefore somewhat offset the positive effect of remittances. Another area where policy interventions can make a difference is the financial sector. There is now ample evidence of the positive impact that a well-developed financial sector has on growth (Beck, Levine, and Loayza 2000) and poverty (Beck, Demirgüç-Kunt, and Levine 2007) so that to the extent that policy makers can enhance the impact of remittances on the financial sector of the recipient country, they will also be enhancing their development impact. This issue is particularly relevant to the region because as discussed in this book, remittances appear to have a modest impact on the development of the Latin American financial sector. One important message of this book is that the way countries benefit from remittances appears to be positively related to the countries’ own institutional and macroeconomic environments.

We next summarize in more detail the main findings of the studies included in this book, starting with a description of aggregate remittances trends and the position of recipients in the income distribution of their home countries (chapter 2), and with an analysis of the profile of Latin American migrants and its relationship with the volume of remittances that they send home (chapter 3). We then summarize the main findings of the book on the impact of remittances on poverty, inequality, growth, and output volatility (chapter 4), and their effect on household expenditures,

educational attainment, and labor supply (chapter 5). This is followed by a review of the links between remittances and the deepening of financial markets (chapter 6), the issues associated with possible real exchange rate overvaluations (chapter 7), and the possibility that remittances are crowded out by conditional cash transfer programs (chapter 8). Finally, we review the main regulatory issues involved in reducing transaction costs (chapter 9), and we report on our findings regarding complementarities between remittances flows and development policies (chapter 10).

Remittances Trends and Their Distribution

Over the past two decades, workers' remittances to Latin America and the Caribbean have increased 10-fold in real terms. As described by Acosta, Fajnzylber, and López in chapter 2, Latin America is at the top of the ranking of remittances-receiving regions both by volume (US\$48 billion in 2005) and on a per-capita basis (an average of about US\$90 per person in 2005). Within the region, remittances are particularly important for countries in Central America and the Caribbean. For example, remittances in 2005 represented about 25 percent of Guyana's and Haiti's GDP, whereas in Honduras, Jamaica, and El Salvador, they were 22 percent, 19 percent, and 17 percent of GDP, respectively. In terms of volume, the country with the highest absolute remittances flows is Mexico, which is estimated to have received US\$21.8 billion in 2005. This would represent 45 percent of total flows to Latin America in that year and would make Mexico the third-largest world recipient (after China and India). In the region, Mexico is followed by Brazil and Colombia, which were ranked 19th and 20th, respectively, among the top remittances-receiving countries in the world, with flows of US\$3.5 billion and US\$3.3 billion, respectively, in 2005.

To gain insights about the characteristics of those at the receiving end of those flows, chapter 2 also uses national representative household surveys that contain specific questions on remittances. That information is available for 11 Latin American countries, which together represent more than two-thirds of remittances to the Latin America region: Haiti, El Salvador, Honduras, Nicaragua, Guatemala, the Dominican Republic, Ecuador, Paraguay, Mexico, Bolivia, and Peru. These surveys suggest that the fraction of households receiving remittances varies significantly across Latin American countries. For example, in Haiti, more than 25 percent of the households reported having received remittances in 2001. At the other extreme, only 3 percent of Peruvian households benefited from these flows. In between, remittances reached between 10 percent and 25 percent of the households in the Dominican Republic, El Salvador, Nicaragua, and Honduras; between 5 percent and 10 percent in Mexico and Guatemala; and between 3 percent and 5 percent in Bolivia, Ecuador, and Paraguay. Thus, remittances are a common element of household income in these countries.

There is also considerable heterogeneity in terms of the position along the income distribution of households that receive remittances. For instance, in Mexico, the recipients of remittances are predominantly poor: 61 percent of the households that report receiving remittances fall in the first quintile of nonremittances income, whereas only 4 percent of them are in the top quintile. Similarly, in Paraguay, 42 percent of recipients are in the lowest quintile of the distribution, and only 8 percent are in the top quintile. The other countries where at least 30 percent of the recipients of remittances are in the first quintile are Ecuador, El Salvador, and Guatemala.

By contrast, in Peru and Nicaragua, the distribution of remittances across households is completely different. For example, in Peru, fewer than 6 percent of the households that receive remittances belong to the lowest quintile, while 40 percent belong to the top quintile. In the case of Nicaragua, where only 12 percent of the recipients are in the first quintile, 33 percent belong to the fifth quintile. Thus in these two countries, remittances seem to be flowing toward the richest. In between the group of Mexico, Paraguay, Ecuador, El Salvador, and Guatemala, and the group of Peru and Nicaragua, there are four countries (Bolivia, Honduras, the Dominican Republic, and Haiti) where remittances recipients are found at similar rates among households in the bottom and top income quintiles, exhibiting a U-shaped distribution—that is, remittances flow at a higher proportion toward the poorest 20 percent and the richest 20 percent of the population, and to a lesser extent toward the three middle quintiles.

Overall, we find that the distribution of remittances income is quite unequal. In the cases of Mexico, El Salvador, Guatemala, and Paraguay, however, remittances are less unequally distributed than total income, with the poorest 60 percent receiving 41 percent of remittances, compared to 29 percent of income. By contrast, in the other seven countries, the first three quintiles receive only 16 percent of total remittances, compared to 26 percent of total income. These statistics suggest that remittances should have quite different impacts on inequality and poverty across the various countries of the region.

Migration Patterns and Remittances

To understand the volume of remittances that a given country may receive, it is critical to have some knowledge about its migrant population. Niimi and Özden explore this issue in chapter 3 by analyzing the profile of Latin American migrants living in developed countries. Due to data limitations, we are not able to cover the “South-to-South” migrants. We find, first, that while most Mexican and Latin American migrants go to the United States, for many South Americans, Europe continues to be a major destination. In some cases, migrants to the United States from South America represent less than 50 percent of those countries’ migrants. That is the

case for migrants to the United States from Brazil, Chile, Paraguay, and Uruguay. Among Latin Americans who migrate to European countries, language seems to play an important role; the Caribbean migrants prefer the United Kingdom as a destination, and the South American migrants choose Spain.

The total number of Latin American migrants in the United States increased from 8.6 million in 1990 to about 16 million in 2000 (an 86 percent increase). Among the countries in the region, Honduras experienced the most rapid growth in migrants in the United States—from 112,000 in 1990 to 281,000 (a 150 percent increase) 10 years later. The second-largest relative increase is found for Brazil, whose migrants in the United States increased from around 95,000 to about 210,000 in the same period, and Mexico, which also more than doubled its migrant population in the United States. Mexico is also the country with the largest number of migrants in the United States (close to 10 million in 2000), followed by Cuba (870,000), El Salvador (820,000), the Dominican Republic (680,000), Jamaica (550,000), and Colombia (510,000). When comparing numbers of migrants in the United States with the corresponding population of their home countries, the small islands of the Caribbean stand out, with an average of 30 percent of their labor force living abroad. In comparison, for non-Caribbean countries, the ratio of migrants in the United States to home country population averages about 10 percent (6 percent for South America).

The schooling levels of Latin American migrants in the United States are relatively low, especially in the case of those from Mexico and Central America. Yet there are significant differences in the education distribution when comparing different countries. Thus, while only 4 percent of Mexican migrants have tertiary education, the figures are 7 percent for Central America, 12 percent for the Caribbean, 24 percent for the Andean region, and around 30 percent for other South American countries. Even larger cross-country differences are found with regard to the share of migrants occupied in high- and medium-skilled jobs. That ratio is about 10 percent for Mexicans and Central Americans, and between 40 percent and 50 percent for Caribbean and South American migrants.

Most Mexican and Central American migrants are drawn from the lower end of the education spectrum of their home countries. By contrast, migrants from the Caribbean and South America tend to be proportionally more educated than those who remain behind. For example, even though education levels in Brazil and Mexico are similar, their migrants are starkly different in their education profiles. One possible explanation of this finding is that it is relatively easy for Mexicans and Central Americans to migrate to the United States, either through legal channels using family preferences, or without proper documentation.

So-called brain drain appears as a problem for many small Caribbean countries. More than 80 percent of people born in Haiti, Jamaica, Grenada,

and Guyana who have college degrees live abroad, mostly in the United States. However, fewer than 10 percent of college graduates from South American countries have migrated, even though they form a large portion of the migrant population. This is mainly owing to the low levels of overall migration from South America. For Mexico and Central America, the migration level of college graduates is about 15 percent to 20 percent, which is relatively high in comparison to that of South America, but not as alarming as the situation found in the Caribbean.

The econometric analysis in this chapter relating remittances to the stock of migrants living abroad indicates that the ratio of remittances to GDP of a given country increases with its stock of migrants. However, larger migrant stocks are associated with lower remittances sent per migrant, which renders the impact on remittances received per capita ambiguous. In addition, increases in the overall education levels of migrants tend to reduce remittances sent, but remittances sent by migrants increase with the level of financial development and the rates of economic growth of their home countries.

The Impact of Remittances on Poverty, Inequality, and Growth

Since the position of migrants and remittances recipients in the income and educational distribution varies considerably across countries, the social and economic impact of remittances flows is also likely to vary across countries. To assess whether there is indeed heterogeneity in the effect of remittances on inequality and poverty, Acosta, Calderón, Fajnzylber, and López use both micro- and macroeconomic data and techniques in chapter 4. Those analyses are based on household survey data for 11 Latin American countries, and on the estimation of cross-country regressions for a large sample of countries, using balance of payments statistics on aggregate remittances flows.

In the first approach, we first compare Gini coefficients and poverty head count estimates obtained using observed total household income and nonremittances income. This simple analysis indicates that 9 out of 11 countries—the exceptions being Nicaragua and Peru—exhibit higher Gini coefficients for nonremittances income, suggesting that if remittances were exogenously eliminated, inequality would increase.¹ Quantitatively, however, the estimated potential changes in the Gini coefficient are small, which can be attributed to the generally very unequal distribution of remittances income, and to remittances reaching relatively well-off households in most countries. On the other hand, this simple methodology suggests large reductions in poverty head counts derived from remittances, especially in those countries where migrants tend to come from the lower quintiles of the income distribution.

In a second methodological approach, we take into account the potential losses of income associated with the migrants' absence from their families and communities. In particular, for remittances-recipient households, we impute the value of household income in a counterfactual scenario where migration hypothetically does not take place. Using this imputed income we find that the Gini coefficients that prevailed before remittances *and* migration were indeed larger than those currently observed, with the largest differences obtained for Haiti (7.7 percent), followed by Guatemala (2.9 percent), El Salvador (2.1 percent), Nicaragua (1.8 percent), and Honduras (1.1 percent). We also find that on average, migration and remittances reduce moderate and extreme poverty by 0.37 percent and 0.29 percent, respectively, for each 1 percentage point increase in the remittances to GDP ratio.

Similar results are obtained using cross-country regression analysis, building on the work of Adams and Page (2005) and the IMF's *World Economic Outlook* (2005). But this analysis considers the fact that remittances vary by region, and attempts to capture the impact that remittances have on poverty due to the increases in per-capita income, as well as the changes they trigger in income inequality. The results suggest that remittances tend to reduce poverty to a larger extent in Latin America than elsewhere in the developing world, partly because they lead to less income inequality, while the opposite is observed for other regions.

We also use a cross-country approach to look at the growth-remittances link. We do so while correcting for reverse causality and other sources of endogeneity in remittances flows, for which we employ external and time-varying instrumental variables. Our results suggest that remittances have a positive and significant impact on growth, even after controlling for per-capita income, education, financial depth, openness to trade, the quality of institutions, government expenditures, inflation, and real exchange rate overvaluation. As mentioned above, we find that for the average Latin American country in the sample, the increase in remittances from 0.7 percent of GDP in 1991–95 to 2.3 percent of GDP in 2001–05 led to an increase of only 0.27 percent per year in per-capita GDP growth, as well as to a 2 percent increase in the share of domestic investment to GDP—which would correspond to about one-half of the estimated total impact of remittances on growth during that period.

Chapter 4 also presents robust evidence suggesting that remittances exhibit countercyclical behavior, thus helping to maintain macroeconomic stability. This suggests that remittances behave quite differently from other procyclical private capital flows, and appear to be dominated by compensatory transfers sent by migrants to their families in order to offset or prevent income shortfalls due to negative external shocks. Remittances also appear to increase significantly after financial crises and natural disasters.

Remittances and Household Behavior

In chapter 5, Acosta, Fajnzylber, and López address the links between remittances and three aspects of household behavior—namely the pattern of household expenditures exhibited by recipients in comparison with nonrecipients, the extent to which the former keep their children in school for longer periods of time, and the different labor supply behavior of individuals living in recipient households. To that end, we use household survey data for seven Latin American countries. In particular, we test whether the share of different expenditure categories varies across recipient and nonrecipient households that share similar demographic characteristics and are in the same quintile of the household income distribution (prior to migration). We find that remittances' recipients direct a smaller share of their total expenditures toward food, thus suggesting that Adams' (2005) findings for Guatemala also apply to other Latin American countries with considerable remittances receipts. The reduction in food expenditures among remittances recipients is complemented by an increase in expenses for other nondurable goods, durable goods, housing, education, and health.

There is, however, considerable heterogeneity in the relative importance of these various increases across countries, as well as in the patterns observed for recipient households with different levels of income. In the case of Mexico, for instance, recipients in the lower income quintiles exhibit the same pattern observed for the overall recipient population, but their richer counterparts increase expenditures for nondurable goods and lower the share of expenditures for housing improvements and education. On the other hand, in the remaining countries under analysis, remittances only have the beneficial effect of changing consumption patterns toward higher educational and health expenditures among middle- and upper-class households. For those in the lower quintiles of the income distribution, the results tend to confirm the popular perception that remittances tend to tilt household expenditures mainly toward nondurable goods, with some effects on durable consumption, but with limited impacts on housing and human capital investments.

The above results indicate that, at least for some segments of the income distribution, remittances can help overcome borrowing constraints that limit human capital investments. However, a priori, this effect could be compensated for by the fact that migration can have disruptive effects on family life, with potentially negative consequences on the schooling of children. Moreover, to the extent that most migrants tend to work in occupations that require limited human capital in destination countries, the returns from investments in education may be lower for those who are envisaging international migration. We complement previous evidence on the impact of remittances on education by taking an approach similar

to that employed by Hanson and Woodruff (2003) for Mexico. We find that remittances are positively and significantly associated with higher educational attainment among children ages 10 to 15, with larger effects obtained for children whose parents have low levels of schooling. While there are large differences in the magnitude of the effects across countries, and by gender and urban status (for example, in some countries the effects are stronger for girls or for rural areas, while in others they also affect boys and urban areas), it appears that remittances tend to relax budget constraints that otherwise would force children to leave school, especially in households with low levels of adult schooling.

Complementing the evidence on changes in household expenditure and children's school attendance, we explore whether remittances also affect labor force participation and the number of hours worked by individuals in recipient households. Simple comparisons with nonrecipient households suggest that remittances may also have a large effect on this dimension of household behavior. This is confirmed by more detailed analyses that control for individual and household characteristics associated both with access to remittances and with labor supply decisions. Thus, in all the 10 countries for which data are available, remittances have the effect of reducing both the number of hours worked per week and, with some exceptions, the probability of participating in the labor force. Moreover, we find that in most cases the reductions in labor supply caused by remittances are larger among individuals with lower levels of schooling.

Remittances and Financial Sector Development

It is a priori not clear whether remittances should be linked to higher or lower levels of financial development. Indeed, to the extent that a fraction of the money received from abroad is saved, remittances may increase the demand for savings and other financial products and services. Moreover, even if higher bank lending to remittances recipients does not materialize, overall credit in the economy might increase if banks' loanable funds surge as a result of deposits linked to remittances flows. On the other hand, remittances might not increase bank deposits if they are immediately consumed or if remittances recipients distrust financial institutions and prefer other ways to save these flows. In addition, because remittances can help relax individuals' financing constraints, they might lead to a lower demand for credit and have a dampening effect on credit market development. In this context, Maria Soledad Martínez Pería, Yira Mascaró, and Florencia Moizeszowicz investigate in chapter 6 the association between remittances and financial development in the specific case of Latin America, using both macro- and microlevel data and techniques.

In the first approach, the chapter shows that remittances have a positive and significant impact on both bank deposits and bank credit, but this

effect is smaller in Latin America than in the rest of the world. Moreover, within Latin America, we find that in five countries—Belize, Dominica, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines—remittances appear to have no statistically significant impact on financial development. For the remaining countries, a 1 percentage point increase in remittances results in an approximately 2 percentage point to 3 percentage point rise in bank deposits and credit. We do not have definitive explanations for the smaller impact on financial development for Latin American countries relative to other developing economies.

Possible explanations include the fact that financial crises have been more recurrent and severe in Latin America, which could make remittances recipients in that region more distrustful of financial institutions. Second, as suggested by surveys of remittances senders performed by the Inter-American Development Bank, in 2004 only 7 percent of remittances were sent through banks. Third, access to physical banking outlets is more limited in this region than in other countries, and the costs of banking are higher in the region, as suggested, for instance, by data collected by Beck, Demirgüç-Kunt, and Martínez Pería (2005). Finally, even if the supply of loanable funds increases with remittances, credit might not rise in Latin America because of weak creditor protection and poor contract enforcement.

The chapter also presents microeconomic evidence on the topic using household-level survey data to investigate the association between remittances and the use of financial services. All in all, simple comparisons of the use of financial services among remittances-recipient and nonrecipient households provide some evidence consistent with the hypothesis that the former have a higher degree of access to those services. This is particularly the case for deposit holdings, and less so for credit. However, this evidence needs to be taken with a grain of salt for at least two important reasons. First, the tests conducted do not control for other household characteristics that might account for differences in the use of financial services. Second, these simple statistics suggest a correlation between remittances and the use of financial services, but are in no way proof of causality.

To mitigate the first problem, we use household survey data from three countries that have been analyzed elsewhere in the study—Guatemala, the Dominican Republic, and Haiti—and find that households with access to remittances are significantly more likely to report deposit accounts. However, at least in Haiti and the Dominican Republic, recipients are also less likely to have bank and nonbank outstanding credit. An additional, more detailed analysis is performed using data from El Salvador and Mexico, which also allows for controlling for the possibility that remittances might be endogenous. For El Salvador, the results consistently indicate that households that receive remittances have a higher likelihood (between 0.12 percentage point and 0.16 percentage point higher) of owning a deposit account, but the likelihood of having outstanding bank debt

does not seem to be affected by whether households receive remittances. We also find that the likelihood that remittances recipients have bank accounts is twice as large if remittances are channeled through the banking sector. On the other hand, no such effect is present on the credit side.

A second detailed case study is performed for Mexico, which is Latin America's largest recipient of remittances in dollar terms. To that end, chapter 6 combines information from the 2000 Mexican Census on the share of households across Mexican municipalities that receive remittances, with municipal-level information from the Comisión Nacional Bancaria y de Valores (National Banking and Securities Commission) on the size of the commercial banking sector and the use of its services across municipalities. We find that municipalities where a larger percentage of the population receives remittances also tend to have higher ratios of deposit accounts per capita, larger deposit amounts to GDP, and a higher number of branches per capita. However, contrary to the findings on deposits and branches, there does not appear to be a significant association between remittances and credit across municipalities.

Remittances and the Real Exchange Rate

In Chapter 7, López, Molina, and Bussolo discuss the possibility that when remittances flows are very large relative to the size of the receiving economies, they may also bring the undesired consequence of a loss of external competitiveness derived from an appreciation of the real exchange rate. The mechanism would operate through the increased consumption levels of recipients, which would raise the relative prices of nontradable goods and services (for which competition is likely to be somewhat limited) relative to those of their tradable counterparts. In turn, a number of additional macroeconomic effects can result from a real exchange rate appreciation associated with remittances flows. They include: (i) adverse effects on the tradable sector of the economy; (ii) widening of the current account deficit; and (iii) weaker monetary control, inflationary pressures, and sectoral misallocation of investment.

Both descriptive and econometric evidence presented in chapter 7 indicate that, at least in the Latin American context, remittances may indeed lead to real exchange rate appreciations. Depending on the specification of the model and the estimation method, a doubling of remittances would lead, on average, to a real exchange rate appreciation of between 3 percent and 24 percent. Of this impact, it is estimated that about one-half of the estimated appreciation would be consistent with the evolution of economic fundamentals, while the rest would be related to transitory factors or temporary overvaluations.

The chapter also discusses possible policy responses. The first is the use of *fiscal restraint*. However, our estimates also indicate that the adjustment

needed to stabilize the real exchange rate may be quite large and therefore be constrained by political economy considerations. The chapter also argues against relying on the *sterilization* of remittances inflows, as the corresponding quasi-fiscal costs may be too large, and because sterilization could put pressure on domestic interest rates, a development that might put even more pressure on the exchange rate. Other alternatives include *microeconomic interventions*, including, for instance, actions aimed at making the economy more competitive and domestic markets more efficient and flexible. However, recognizing the extent to which fiscal adjustment and microeconomic interventions may not be sufficient to correct the upward pressures in the real exchange rate, it is possible that Latin American policy makers will have to accept some real appreciation, especially in those countries with substantial inflows.

We also note that since additional microeconomic interventions aimed at increasing the competitiveness of the economy may require increased public spending, they may not necessarily be consistent with the recommended tightening of fiscal policies. Several considerations have to be taken into account in this context. First, for a given taxation structure, the increase in national income associated with a surge in remittances would *ceteris paribus* result in higher tax revenues. Second, countries should try to avoid taxes on incoming remittances² for two main reasons: (i) this type of action likely would discourage the formalization of remittances flows; and (ii) directly taxing remittances would conflict with one of the general recommendations of this book, namely, making efforts to reduce the costs of sending remittances. Third, even in those cases where policy makers facing a surge in remittances do not consider it a priority to raise fiscal revenue, it is possible that they could experience some competitiveness gains by shifting from payroll taxes to value added taxes (VAT) or sales taxes. In fact, the evidence presented by López, Molina and Bussolo in chapter 7 for Jamaica indicates that such a policy, accompanied by a compensatory increase in VAT rates, can maintain the government balance unchanged and sterilize most of the negative labor supply effect of rising remittances.

Do Public Transfers Crowd Out Remittances?

Conditional cash transfer (CCT) programs have become an important antipoverty tool in many Latin American countries. CCTs currently reach 60 million people, representing approximately 60 percent of the extremely poor in Latin America (Lindert, Skoufias, and Shapiro 2006). As argued by Lindert, Skoufias, and Shapiro (2006), cash transfer programs tend to be well targeted and have strong performance in terms of their marginal contribution to social welfare, outranking not only social insurance schemes but also social assistance programs. Moreover, Olinto (2006) reports that impact evaluations of conditional cash transfers in Mexico,

Brazil, Honduras, and Colombia indicate that these programs have had large impacts on transition rates and secondary school enrollment (especially for girls), and in delaying student dropout.

One concern, however, is that CCTs could crowd out private transfers, particularly remittances. In fact, there is evidence that in the United States, private assistance in the form of both cash and time help were crowded out by Aid to Families with Dependent Children (AFDC) benefits, and unemployment insurance crowds out interfamilial transfers (Schoeni 1996, 2002). Moreover, Cox, Eser, and Jimenez (1998) have found that social security benefits crowd out the incidence of private transfers in Peru. With regard to CCT programs, however, studies utilizing experimental data provide more mixed results. Thus, while Attanasio and Rios-Rull (2001) find some weak evidence supporting the crowding out hypothesis for Programa de Educación, Salud y Alimentación (PROGRESA), Teruel and Davis (2000) reject that hypothesis on the basis of additional rounds of survey data.

In chapter 8, Pedro Olinto adds to this literature by exploiting experimental data from the evaluations of two CCTs in Central America—the *Red de Protección Social*³ in Nicaragua and the second Programa de Asignación Familiar⁴ (PRAF-II) in Honduras—to assess the link between the access to conditional cash transfers and the incidence and volume of private transfers. The author's findings are in line with those of Teruel and Davis (2000) for PROGRESA, as the chapter finds no evidence that CCTs crowd out remittances transfers in either Nicaragua or Honduras. These results should help dispel concerns that CCTs could be displacing private networks and informal insurance schemes and therefore add little to the utility of the recipient parties. In particular, it appears that as long as transferred amounts continue to be small, and programs are targeted to those who are more likely to be poor (and therefore less likely to receive remittances), CCTs are not likely to crowd out remittances and other forms of private insurance.

The Regulatory Framework: How to Facilitate Remittances Flows

For migrants who send money home, remittances services are still expensive, with fees of up to 20 percent of the principal sent, depending on the size and type of the transfer, as well as on its origin and destination. Fee structures themselves have been opaque (with hidden charges and poor exchange rates), and have penalized transfers of small amounts of the type commonly made by migrants. Not surprisingly, reducing the price of remittances services has been a major target for many multilateral initiatives and regulatory efforts. However, authorities have generally shied away from imposing direct price controls, favoring instead mechanisms aimed at

enhancing competition in the system, increasing transparency, and reducing barriers for users to access a wider range of service providers.

While the incentives for incumbent remittances services providers (RSPs) to realize cost savings and reduce prices may be naturally limited in smaller corridors where the limited volume of operations represents a natural barrier to entry for new operators, many of the benefits of competition can be realized through increased market contestability. In this respect, the role of the authorities encompasses: (i) eliminating unnecessary regulatory entry requirements to new operators; and (ii) ensuring appropriate access to domestic payment infrastructures under fair conditions.

A complementary, crucial set of actions is related to the improvement of payment and settlement systems. The degree of development of those systems, and the extent to which new RSPs can access them, largely determines the potential for competition in the market. In this respect, technological barriers for the access of new RSPs to existing payment systems are less important than formal restrictions. Indeed, direct access to national payment systems is normally granted only to well-capitalized and established banking institutions. In this context, regulation of payment and settlement systems should ensure that indirect access to RSPs—for example, through banks—is provided under fair conditions.

An additional challenge is that of building cross-border payment systems, with appropriate coordination and adoption across borders of, for example, communications standards and payment message formats that facilitate greater interoperability, as well as rules, procedures, and operating hours that support straight-through processing. Cross-border initiatives may require a high level of bilateral (or possibly multilateral) cooperation on technical, regulatory, and oversight matters.

In parallel, it is also important to take measures directed at guaranteeing transparency and accessibility in the remittances market, so that users can make informed decisions and have the ability to choose their best service option. In particular, remittances senders are often unaware of the different direct and indirect costs and fees charged by RSPs, and therefore ignore the total price of their remittances transaction until the money is delivered to their relatives. In this respect, regulators can actively facilitate transparency through the collection and publication of comparative prices and conditions of service among different RSPs. These efforts can be complemented by the provision of basic financial literacy to users.

The recent entry of financial institutions into the remittances market has made available more cost-efficient transactions, such as account-to-cash and account-to-account remittances. These are slowly gaining market share but are constrained by the fact that a large percentage of migrants do not have access to banking facilities, partly because of their irregular status. Indeed, at least in the case of the United States, federal regulation does not expressly forbid the provision of financial services to undocumented applicants, but the issue is far from being clear,

creating concerns among both financial institutions and a large segment of prospective clients.

Accessibility issues and the quality of the financial services infrastructure in recipient countries are also critical to ensure security and efficiency of remittances services. Accessibility can be improved by enabling more financial institutions to participate in the remittances market. In particular, savings and loans, credit unions, and microfinance companies may be well positioned to act as disbursing agents, as their networks may be closer to the usual recipients of remittances than those of large commercial banks. In this sense, authorities in recipient countries should ensure that there are no unduly burdensome regulatory constraints to the participation of these entities.

Finally, since remittances channels can potentially be used for illicit purposes, including money laundering, fraud, and financing of terrorist activities, it is important to encourage and enable the use of formal systems (such as banks). Indeed, the risk of misuse of remittances channels is highest among informal providers that are completely unknown to the regulatory or supervisory bodies. Moreover, countries should ensure that oversight of formal providers is commensurate with the risk of misuse to avoid unnecessary costs, thus balancing the benefits of increased safety of the system with the possible inefficiencies that increased oversight might also create.

Policy Complementarities: What Can Policy Makers Do to Enhance the Development Impact of Remittances?

Since remittances are transfers between private parties, it is difficult to imagine which type of policies governments should follow to enhance their development impact. For example, if recipients and senders jointly decide that, given the country's existing economic environment and their personal situations, remittances should be directed toward consumption rather than toward savings or investment (a typical concern of policy makers in recipient countries), then it is difficult to imagine which type of *direct* policy interventions may induce these individuals to do otherwise, other than forcing recipients to save, as a number of African countries (such as Lesotho and Mozambique) and Latin American countries (Mexico in the 1940s) have done in the past. In fact, the latter is probably the type of policy recommendation to avoid. As argued by Maimbo and Ratha (2005), forcing remittances recipients to save more and consume less tends to reduce, rather than increase, consumer welfare.

Yet this is not to say that governments cannot do anything to increase the development impact of remittances, especially if we consider *indirect* policy interventions, that is, policies that try to change the remittances

recipients' incentives to use their resources in one way or another. For example, as noted by Burnside and Dollar (2000, 2004), the impact of aid flows on the growth rate of recipient economies depends on whether the policy environment is favorable to private investment. Good policy environments will increase the return on investment (or reduce the risk associated with a given return), and thus will raise the opportunity cost of consumption. Chapter 10 explores whether a similar case can be made for the possibility that the development effectiveness of remittances depends, as that of official aid does, on the policy environment prevailing in recipient countries.

Our evidence suggests that indeed, remittances are more effective in both raising investment and enhancing growth in countries with higher levels of human capital, strong institutions, and good policy environments. Somewhat surprisingly, we also find that increases in remittances apparently have more of an investment and growth impact in countries with less developed financial sectors. One possible reason is that, as noted by Giuliano and Ruiz-Arranz (2005), remittances can be seen as relaxing liquidity constraints faced by the poor, and that those constraints would be more relevant in countries with less developed financial sectors.

The finding that remittances have more positive effects on growth in better policy contexts—encompassing more stable macroeconomic regimes, better institutional quality, and higher levels of human capital—is particularly important for Latin America. Indeed, in the three areas that seem to complement the impact of remittances on growth, the region has significant progress to make. Thus, during the first half of the 2000s, Latin America, together with the Middle East and Sub-Saharan Africa, were the regions with the worst combined indicators of inflation, trade openness, and excessive government burden.

Similarly, on the institutional front, Perry et al. (2006) note that a majority of Latin American countries (the exceptions being Brazil, Chile, Costa Rica, Mexico, Nicaragua, Panama, Trinidad and Tobago, and Uruguay) score below what would be expected in a combined index of the six institutional measures of the Kaufmann, Kraay, and Mastruzzi (2005) database. Finally, as noted in De Ferranti et al. (2003) even if the Latin American picture regarding net primary enrollment rates is quite encouraging, most Latin American countries have massive deficits in net enrollments in secondary education, even after controlling for income levels.

Overall, these results strengthen the basic conclusion of this study, namely that remittances have positive implications for growth and poverty reduction, but they are not a substitute for sound development policies. In particular, countries that have experienced sizable migration flows and now receive large volumes of remittances from their migrants have even stronger reasons to improve their policy environments, so as to enhance the positive impact of those flows and create better incentives for foreign and domestic investment.

Notes

1. Note that household surveys include remittances received from abroad and do not differentiate between those coming from developed or developing nations. Thus, these results encompass cases where South-South and South-North migration are predominant.

2. Today, most remittances-receiving countries do not impose explicit taxes on incoming remittances, although there are some cases of implicit taxation in the form of financial services taxes.

3. Social Protection Network.

4. Family Allowance Program.

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