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BRIEFING PAPER

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Mitigating the Structural Imperfections and Negative Impacts of Remittances

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1. Remittances as a Form of Self-Help Development Finance

The World Bank reports that in 2005 remittances to developing countries sent through formal financial channels was about US$167 billion. A consensus has now emerged that remittances are an important form of international development finance. We argue that remittances are particularly important for sustainable development because the process involves self-help by people who originated from developing countries. The special significance of remittances is illustrated *inter alia* by the following:

- **Comparative Size of Remittances:** Firstly, the relative size of remittance inflows shows that migrants and the Diaspora are the foremost financial contributors to development. In many developing countries, the volume of remittances is several times that of Official Development Assistance (ODA) and Foreign Direct Investments (FDI). For countries such as Senegal and Ghana, remittances represent 10-15% of national income.

- **Enduring Self-Help Financing:** Secondly, unlike ODA and FDI, remittances are a form of continuous and enduring self-help finance generated and distributed by migrants and the Diaspora – not disbursements by foreign benefactors. ODA to developing countries tends to increase in times of natural or politico-economic catastrophes, whilst in contrast, FDI tends to increase in times of politico-economic stability. The World Bank reports that remittance inflows are on a steady and growing pattern, with the tendency to increase further in times of crises in the developing countries.

- **Absence of Financial Counter-Flows:** Thirdly, remittance inflows to developing countries are not countered by outflows characteristic of typical ODA and FDI financing schemes. ODA and FDI related outflows from developing countries include: interest, debt and dividend payments; retention and repatriation of funds to pay for donor country expatriates and professionals as well as product and service suppliers. Unlike ODA and FDI, financial counter-flows are not an inherent part of remittance financing.

- **Direct Financial Empowerment:** Fourthly, remittances are payments made directly to the beneficiaries in developing countries without the undue need for governments, corporate and other bodies to act as intermediaries. The directness of the financial relationship is an effective form of increasing financial and civil society empowerment. The beneficiaries of remittances are generally ordinary private citizens, families and local community groups.

- **Relevance to Millennium Development Goals:** Fifthly, remittances generally contribute to the relief of poverty and amelioration of human welfare in developing countries. The inflows are generally spent on food, shelter, education, health services, business start-up, community projects, land and property development etc. These activities funded by remittances are in line with Millennium Development Goals (MDGs) as well as charitable objectives.

2. The Economic and Development Benefits of Remittances

Remittances have a number of economic and socio-political benefits relevant to development. We have analysed the range of direct and indirect micro and macro-economic benefits, but have also identified the negative impacts and structural imperfections inherent in Diaspora and migrant remittances. Consequently, we have designed a scheme (i.e. RemitAid™), which mitigates the structural imperfections and optimises the effectiveness of remittances as a form of development finance.

2.1 Direct Impact on Poverty Reduction and Job Creation

Remittances contribute towards poverty reduction and job creation, and the direct economic impacts include the following:

- **Financing of Essential Human Needs:** The bulk of remittances are spent on subsistence and food; education; shelter; clothing; and medical services and products for the extended family and friends of the remitters. Absence, lack or inadequacy of these basic human necessities is what constitutes poverty. Thus remittances have a fundamental role in reducing poverty.

- **Increase in Household Income:** Remittances are sent to private households, often on a regular basis. In some countries, these inflows represent over 50% of the household income of a significant percentage of the population. Households that receive remittances have seen their incomes increase as a direct result of the inflows.

- **Investment in Micro-Enterprise and SME:** As responses to requests, as well as proactive attempts to reduce dependency of remittances, a significant number of remitters make ‘extraordinary’ remittances as seed capital funding for micro and SME businesses. Although the failure rate of business start ups are high, the relatively few successes do create jobs and have a positive effect in local economic activities and supply chains. For some recipients of such investment remittances, even the venture failure has the positive effect of increasing their enterprise and business awareness and skills.

- **Acquisition and Development of Real Estate:** The biggest sums remitted by Diasporans relate to the purchase or construction of houses for themselves and their families. This personal investment in property in the countries of origin, help create skilled and unskilled jobs, and generally stimulate and vitalise the construction sector. From architects, to builders, apprentices, building materials suppliers, interior decorators, furniture makers etc – all benefit from property investments by Diasporans.

- **Investment in Larger and Technological Enterprises:** A small number of Diasporans with high disposable incomes or those who access capital through their networks and connections in countries of residence, make major corporate investments in developing countries. These include investments in large scale business operations which create lots of employment as well as create business opportunities for smaller suppliers and service providers. Larger corporations are also more likely to invest in technology as well as staff training and development.

2.2 Indirect Impact on Economic Development

Remittances contribute to general economic development, and the indirect impacts include the following:

- **Foreign Currency Availability:** Remittances have become a significant source of foreign currency for many developing countries. This hard foreign currency is purchased by businesses and other organisations to be used to pay for importation of production inputs, machinery and other products and services. Increase in the supply of foreign currency through remittances lead to reduction in exchange rates. This in turn increases the buying power of importers. Remittances as a source of foreign currency is so important that some entrepreneurs set up money transfer operations offering very competitive rates, for the principal purpose of accumulating foreign currency rather than making a profit of the money transfer deals.

- **General Economic Multiplier Effect:** Irrespective of what the remittances are spent on, as far as they are spent in the local, regional and national economy, they contribute in creating a multiplier effect. Whether remittances are spent on essential subsistence, luxury goods, recreational services or productive ventures, the mere act of expenditure means that people who work in the businesses that provide the wide range of services earn incomes, and in turn spend their earnings by buying goods and services provided by other workers – thus a virtuous circle of income earning and expenditure is created in the local economy.

- **Circulation of Moneys in Deprived Areas:** In many developing countries, previously impoverished areas and localities have in recent years been regenerated and transformed due to intense inflows of remittances inflows. This arises from a phenomenon reported by the New Economic Foundation (NEF), observing that the more times money circulates within a given geographical area, the greater the level of economic prosperity in that area. Thus, deprived communities can be regenerated by encouraging recycling of moneys within those areas. This economic development model is relevant to remittances because there is a pattern to geographical origin of migrants and Diaspora. It is very common to have very high levels of migration from a particular village, region or country. Apart from migrants influencing and helping friends and family to migrate through a steady long term pattern, socio-political factors such as civil unrest, may also cause one-off mass migrations from specific geographical areas. These migrants then remit moneys to their areas of origin thereby creating intense financial inflows.

- **New Business Opportunities:** The increase and regularity in remittances have created new business opportunities in the finance sector in developing countries. In many countries, a new money transfer sector, outside of the mainstream banking and financial institutions have arisen. This new sector is increasing competition and service quality in the entire financial sector and is also creating new jobs and transferable business skills. In addition to the primary money transfer service, collateral products and services are being developed to meet the needs of Diasporan remitters. For example, instead of cash being handed to the family of remittance recipients, the diversified money transfer businesses would deliver groceries, school materials or other specified goods and services. Furthermore, entrepreneurs are constantly looking at the needs and wants of Diasporan remitters and then designing packaged services to respond to these emerging business opportunities.

3. Structural Imperfections of Remittances

Despite the numerous direct and indirect economic and poverty alleviation effects, Diaspora and migrant remittances as a form of international development finance currently suffer from a number of structural and inherent imperfections. These imperfections include the following:

3.1 New Indicator of Poverty

Paradoxically, the substantial body of evidence that demonstrates the far reaching direct impact remittances have in poverty reduction also highlights one of the fundamental structural problems of remittances as a form of development finance. Those in developing countries who do not have family and friends in the Diaspora to remit to them do not enjoy the direct benefits of remittances. Amongst the poor, access to remittances may mean escape from the grips of poverty, and lack of access to remittances starkly highlights the ongoing poverty. We even propose that amongst the unemployed and low income people of developing countries, lack of access to remittances has become a new economic indicator of poverty - defining the 'new poor' in developing countries. This is particularly so because many employed people earn meagre incomes that merely maintain them below the poverty line. As such, for the low income section of the population, employment has ceased to be an adequate indicator of poverty. Remittances need structural reform, so as to avoid reinforcing the gap between the poor and the well off. Already, many poor families fully accept that access to remittances is the new indicator of poverty and have changed their behaviour accordingly. Instead of effort concentrated on finding employment in home countries, poor individuals and families are concentrating on sending family to Europe or North America, so that these migrants would in turn remit to them. This pattern is so well established that it has in many countries become an organised sector - better structured that even the job search or business start-up sector. Financial patterns and sociological protocols are even emerging amongst the poorest households, to govern the practice of economic migration. Families borrow, save, mortgage and dispose of assets to fund the legal or illegal migration attempts of young family members. Those who successfully migrate are then bound by family, social and informal contractual obligations to remit moneys to the families and others who were involved in facilitating their migration. In other cases, desperate young people embark upon hazardous trips across, deserts, seas, oceans and border posts, often resulting in failure, horrendous suffering in foreign lands and loss of young lives. It is imperative that the Diaspora is engaged in a public-private collaboration like RemitAid™, to tackle the structural factors that have now made remittances the new indicator of poverty.

3.2 Dependency on Remittances

Families and households that receive regular remittances from the Diaspora come to expect such inflows. The moneys become part of the household income, and budgets, expenditure and lifestyles are based on the remittance inflows. Not surprisingly, there is a tendency for receiving households to become dependent on these remittances. Dependency on remittances puts pressure on diasporan remitters to the extent that it may even negatively affect the development of their own financial and economic resources. Remitters who have to send moneys to dependent families tend to have less means of building savings or undertaking financially rewarding investments in the countries of residence. On the other hand, dependence on regular remittances may reduce the motivation of recipients to be more industrious, venturesome and enterprising. Dependence on remittances may indeed have a negative effect on the productive and developmental drive of remittance recipients in developing countries.

3.3 Limited Investment in Economic Production

The bulk of remittances are spent on consumption rather than economic production. This means that upon spending the moneys, there is limited or no financial return to the remitter or recipient. It is arguable that expenditure on education (and to a degree health), should be seen as social investments that would in future yield financial results - however, they too do not yield short term financial returns. This consumptive nature of remittances is one of the reasons why they tend to create dependency. Recipients receive just enough to spend on short term needs rather than to invest into ventures that produce income for them. It is not likely that Diaspora remitters would suddenly have more funds to allow them to remit sums for investment in productive ventures. As such, a scheme like RemitAid™ is needed to ensure that there are more opportunities and mechanisms through which remittances can fund more productive ventures through private and social enterprises. Even when Diaspora remitters send capital funds for investment in micro and small businesses, the failure rate of such businesses is very high. The failures undermine the motivation of remitters to take part in productive and business ventures. It also reinforces the view that the Diaspora cannot take part in business in the home countries, whilst resident overseas. However, it is worth noting that the failure rate of new SME start-ups is very high generally in many countries. This is even true in industrialised countries where there are well developed and sophisticated public, private and independent business advice and support services. In developing countries, such business support is generally absent. Worst still, in many productive venture start ups, some of the core factors of production are absent. Diaspora remitters send capital, with which labour and other resources are paid for. The recipients of the remittance and promoters of the venture are supposed to be the entrepreneurs who drive and run the business. However, in far too many cases, the promoter does not possess the skills or disposition to provide that very core factor of production – entrepreneurship. This inherent weakness in the usage of remittances to fund productive ventures arises from the fact that very often when decisions are made to start a new business, it is due to desperation rather than vocation. The business is started not because the remittance recipient is an entrepreneur, but because there are no employment opportunities and self-employment is the only option. As such, even the limited level of remittances spent on SME start-ups suffer from an inherent imperfection, i.e. the absence of entrepreneurship, which in turn leads to higher levels of business failures.

3.4 Misapplication of Funds

Remittances are often sent to the head of a household for him or her to distribute and spend on a range of specified and unspecified goods and services. Remitters report incidences when remitted moneys are not spent on specified items, resulting in remitters being dissatisfied and having to re-sent moneys. As long as certain individuals in the households continue to be channels through which remittances are disbursed, the risk of misapplication and diversion of funds will remain. Such diversions may have a negative impact on development as funds may be diverted from social investment activities such as education of young girls and are spent of non-productive consumption such as entertainment and recreation.

3.5 Retention of Hard Currencies in Host Countries

In seeking to reduce misapplication of funds and whist improving services to remitters, packages are being developed whereby remitters pay agents in countries of residence, and the agents deliver goods and services to families in countries of origin. Although innovative and useful, if this sector grows, the macroeconomic risk is that hard foreign currencies will not flow into developing countries as they would have remained in countries of residence, thus having a negative effect on the local foreign exchange market. This retention of hard currency in industrialised countries is already a problem observed in ODA and FDI schemes.

4. RemitAid™: Framework for Mitigating the Imperfections and Improving the Impacts of Remittances

RemitAid™ is a scheme about remittance tax relief for international development. It seeks to mitigate the structural imperfections and negative impacts of remittances and to reform and improve the structure of the remittances sector through the financial instrument of tax incentives. This shall *inter alia*, result in the creation of a RemitAid™ Development Fund to finance the types of productive, equalitarian and poverty reduction schemes which private remittances do not normally fund. The key characteristics of RemitAid™ are as follows:

- **Practical Diaspora Partnership Initiative:** RemitAid™ is a Diaspora initiative which focuses on practical ways of harnessing and optimising the impact of the financial resources of the Diasporans and migrants from developing countries. It is also a mechanism that strengthens remittances as a form of self-help development finance, through a three way Diaspora-Public-Private partnership and collaboration.

- **Use of Standard Tax Incentive Tools:** RemitAid™ is a scheme through which Remittance Tax Relief (RTR) is claimed for remittances spent on international development – similar to existing tax relief schemes. In the United Kingdom, where the RemitAid™ idea originates, tax relief schemes such as Gift Aid, Venture Capital Trust (VCT] and Enterprise Investment Scheme (EIS) are used as financial incentives to stimulate and support charitable giving, investment in high risk ventures and economic regeneration respectively. Remittance Tax Relief (RTR) is a feasible mechanism for stimulating remittance expenditure on productive and regenerative ventures and other activities that contribute significantly to the attainment of the Millennium Development Goals (MDGs). The remittances that shall qualify for tax relief shall be those sent to developing countries (as defined by OECD), through formal regulated money transfer channels, for expenditure on activities that contribute towards MDGs and charitable objectives.

- **Simple Operational Framework:** The operational framework (see attached diagram) shall facilitate simple, transparent and low cost collection of remittance tax rebates from national tax authorities. Organisations and schemes that contribute to MDG and charitable objectives in developing countries (e.g. health centres, health insurance schemes, schools and enterprise support agencies) shall be designated as 'Recognised RemitAid™ Receivers (RRRs)', using accreditation frameworks which already exist in the receiving countries. (This would be in line with ODA FDI schemes which operate within in-country regulatory frameworks). Remittances sent and received by RRRs shall trigger a rebate claim. The RemitAid™ Agency shall collect verifiable and auditable documentary evidence from participating Money Transfer Agencies (MTAs). The cost of collecting the evidence shall be minimal as MTAs already generate, file and maintain such evidence for anti-money laundering (AML) and other regulatory purposes. The RemitAid™ Agency shall collate and present the evidence to tax authorities to validate RTR rebate claims.

- **Innovative Pooling of Tax Rebate:** One of the innovative aspects of RemitAid™ is that, unlike other tax incentive schemes, the tax rebate collected is pooled together in a common fund – instead of being paid directly to individual remitters or charities. The absence of direct financial gain for the individual remitters eliminates almost completely, motive, means and opportunity for fraudulent scams such as 'round tripping' and multiple rebate claims. The pooling of the rebates also creates substantial sums of moneys usable to fund a variety of major development programmes.

- **New Independent Development Fund:** The pooled moneys, i.e. the RemitAid™ Development Fund (RDF) shall be invested so as to create an enduring financial asset as well as a substantial annual income. The income shall be disbursed in the form of loans, grants and investment capital to fund productive, poverty reduction, enterprise, community and Diaspora projects and schemes. Remittances as a form of development finance is independent of both FDI and ODA. As such, the RemitAid™ Development Fund which arises from it shall be recognised as an independent capacity-building fund that supplements and complements remittance inflows, ODA and FDI by funding schemes not normally covered by everyday remittances. As with Gift Aid in the UK, the introduction of RemitAid™ shall be a political choice made by governments as a way of reforming and strengthening the remittance sector, for the purpose of supporting sustainable development and the Millennium Development Goals.

- **Management and Corporate Governance:** The RemitAid™ Development Fund shall be managed on a professional basis similar to charitable trust funds, but governance and control shall remain with the primary stakeholders, including representatives of Diaspora and migrant workers (i.e. the remitters), national tax authorities in host countries, regional and international development agencies etc.

5. Conclusion: Diaspora Engagement in Public-Private Collaboration

For RemitAid™ to become a reality, the diaspora would have to take part in a genuine intra and trans-national public-private collaboration. Each of the partners and stakeholders in RemitAid™ would need to undertake and discharge specific roles. It is the sum of the different efforts that would lead to the reform and improvement of the current remittance structure and sector. The partnership tasks include the following:

Diaspora:

- Organise and consult amongst itself in order to develop a shared understanding of the benefits and imperfections of remittances, and raise awareness about the need for structural reform of the sector. (AFFORD & RemitAid™ have undertaken initial consultations with 100s of Diaspora remitters and several Home Town Associations in the UK).

- Participate in further research and consultation exercises to express their views, needs, wants and expectations about RemitAid™ and the RemitAid™ Development Fund.

- Undertake effective policy lobbying and advocacy for the purpose to securing the required statutory and regulatory amendments needed for the actualisation of the RemitAid™ idea.

Private Sector:

- Private and social enterprises to create appropriate business, legal and corporate structures that facilitate investment in MDG related ventures and develop capacity to receive loan or equity investments from RemitAid™ or other development and enterprise Funds.

- Schools, health insurance schemes and other relevant organisations working in MDG related fields to register as 'Recognised RemitAid™ Receivers' (RRRs) such that direct remittances to them would trigger a remittance tax rebate claim.

- Money transfer agencies to support, adopt and be accredited as RemitAid™ agents and to set up systems so as to become aware of remittances to 'Recognised RemitAid™ Receivers' (RRRs), and to provide RemitAid™ with documentary evidence of remittances, usable for rebate claims.

Public Sector:

- Government, tax and other statutory bodies in host countries should review and amend regulatory and statutory frameworks, and undertake reform of the remittance structure through introducing the RemitAid™ tax relief scheme.

- Governments in developing countries to simplify investment and enterprise regulatory frameworks, and to participate in PPP co-financing schemes with RemitAid™ and other development Funds as investment partners.

- Governments to acknowledge and raise public awareness about the mutual benefits of managed migration and to formally recognise that remittances are a significant, reliable and growing form of self-help development finance that deserves structural support similar to those given for FDIs and charitable donations.

Further Information:

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Gibril Faal is a multidisciplinary practitioner with an eclectic professional background. He has been a management consultant, business adviser and University lecturer for over 15 years – working on private, public and charitable sector development. In the past 5 years, whilst on a Department of Trade and Industry (DTI)-funded project, he was one of the pioneers of social enterprise business support delivery in the UK. Gibril was previously a lecturer with The Open University, teaching on the MSc course in Global Development Management. In June 2006, he was appointed to undertake the independent impact evaluation of University of Oxford's Centre for Migration, Policy and Society (COMPAS). He is a Director at GK Partners – a UK-based consultancy specialising on: multiple bottom line business planning & development; corporate responsibility & governance; and implementing social enterprise & ethical business models. Gibril works on establishing conceptual and practical links between ethical and Islamic finance and well as social enterprise and international development. He is the founder of RemitAid™ - the programme for 'Remittance Tax Relief for International Development'. He is also the Chairman of the African Foundation for Development (AFFORD), a UK-based charity which works to extend and enhance the role Diasporans play in African development. He advises many other businesses and charities and sits part-time as a magistrate. His qualifications include: Combined Honours degree in Law, Finance & Management and postgraduate degrees in both Environmental Sciences and Development Studies. He is a member of several professional and academic bodies including the Chartered Institute of Arbitration, Chartered Management Institute, Institute of Islamic Banking & Insurance and the Royal Society of Arts. He has led projects and written papers on a wide range of political economy, business management and international development themes.

MINISTERIAL DECLARATION

"We, Ministers and Heads of delegations of the Least Developed Countries (LDCs), having met on 9 and 10 February 2006 in Cotonou, at the Ministerial Conference of the Least Developed Countries on Migrants' Remittances;

> *Urge Governments of host countries to consider introducing tax relief for remittances similar to tax incentives provided for investment funds and charitable donations"*
>
> ***[Conference organised jointly by UN-OHRLLS and the International Organisation for Migration (IOM)]***

COMMON FRAMEWORK RESULTING FROM THE WORKSHOP ON INTERNATIONAL MIGRATION, DEVELOPMENT AND POVERTY REDUCTION

" The participants wish to:

> *Recognize the importance of migrants' remittances and their potential impact on development of their countries of origin while being aware that they are private funds, these transfers must not be taken as a replacement of Official Development Assistance (ODA).*
>
> *Recognize that remittances, are a form of funding which contribute to development and should attract tax incentives similar to those available for aid and foreign direct investments, and therefore call on host countries to introduce remittance tax relief for development."*
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> ***[Workshop organised jointly by the African Capacity Building Foundation (ACBF) and the International Organisation for Migration (IOM) for West and Central African Sates; 8 – 10 August, Dakar, 2006]***