The Quarterly Review of Economics and Finance 60 (2016) 207–223

Contents lists available at ScienceDirect

The Quarterly Review of Economics and Finance

journal homepage: www.elsevier.com/locate/qref

Out of inequality and poverty: Evidence for the effectiveness of remittances in Sub-Saharan Africa

Eric Akobeng*

University of Leicester, Department of Economics, University Road, Leicester LE1 7RH, United Kingdom

ARTICLE INFO

Article history:
Received 9 December 2014
Received in revised form 3 October 2015
Accepted 23 October 2015
Available online 31 October 2015

JEL classification:
C13
J61
O11

Keywords:
Inequality
Poverty
Finance
Remittances

ABSTRACT

This paper takes a new look, from a macro perspective, at the issue of remittances effectiveness. An important point of departure for this study is the adoption of poverty reduction, as contrasted with economic growth, as the metric for measuring remittances effectiveness. By controlling for time-invariant country-specific effects and endogeneity, I find that remittances reduce poverty, but the size of the poverty reduction depends on how poverty is being measured. Additionally, remittances have income-equalizing effects. A well-functioning financial sector enhances remittances effectiveness in Sub-Saharan Africa.

1. Introduction

Sub-Saharan Africa lags behind other developing nations in several human development indicators (UNDP, 2010). These factors among others have resulted in consistent migration of both skilled and unskilled labour in search of better working conditions.

Remittance flows are one of the upshots of migration, which has emerged as a key link between human mobility and development. The inflow of international remittances in developing countries has increased dramatically since the 1990s, increasing from US$33 billion in 1990, $70 billion in 2004, $125 billion in 2005, $325 billion in 2010 to US$372 billion in 2011, has emerged as the most important source of private capital flows after foreign direct investment, and exceeds total foreign aid by 50% for dozens of these countries (WDI, 2012).

Besides this huge amount and increasing trend, remittances ensure stability and even distribution, hence they are considered as one of the major stable and promising external financial resources for developing countries. Despite the increasing importance of remittances in total international capital flows, the relationship between remittances, poverty and inequality has not been adequately studied. In particular, studies on Sub-Saharan Africa are scarce. This is due to inadequate poverty data and the poor nature of data on international remittances. As a result of these data problems, many pertinent questions remain unanswered. This paper intends to investigate how remittances affect poverty and inequality and how finance enhances the effectiveness of remittances using a dataset of 41 Sub-Saharan African (SSA) countries.

The objective of this article is to test the hypothesis that there is a negative relationship between remittances and poverty/inequality and to verify whether finance reinforces the poverty- and inequality-reducing effects of remittances. This paper contributes to the existing literature in the following ways. First, I use the most current data and chart a different path: the paper provides macro-level evidence of the effects of remittances on poverty and inequality using the two-stage least squares instrumental variable (2SLS-IV) and the two-step dynamic system generalized method of moments (SGMM) estimators. Second, the paper provides empirical evidence about the enhancing effect of the financial sector on the poverty and inequality-reducing effect of remittances. Finally, this is the first paper to attempt a comprehensive study of remittances, finance and inequality/poverty in Sub-Saharan Africa.

Though it is an empirical challenge to ensure that all biases linked to measurement error, reverse causality, and omitted variable problem are effectively addressed, an attempt is made to address these econometric concerns using the internal instruments

* Tel.: +44 7338113473.
E-mail addresses: ea211@leicester.ac.uk, eakobeng@yahoo.co.uk

http://dx.doi.org/10.1016/j.qref.2015.10.008
1062-9769/

of the 2-step dynamic SGMM and the standard 2SLS-IV estimators. The paper finds that, although the continent receives only a small portion of the total recorded remittances to developing countries, international remittances defined as the share of remittances to GDP reduce poverty and inequality in Sub-Saharan Africa and financial development reinforces the link between remittances and poverty/inequality in Sub-Saharan Africa.

The paper is organized as follows. Section 2 deliberates the characteristics of remittances to Sub-Saharan Africa. Section 3 reviews the findings of studies on the relationship between international remittances, inequality and poverty. Section 4 presents the dataset. Section 5 uses econometric methods to estimate the effect of remittances on poverty and inequality and verifies the facilitating role of finance in the remittances–poverty/inequality links. Section 6 discusses the results. Section 7 summarizes the findings and presents policy implications.

2. Remittances to Sub-Saharan Africa

Fig. 1 shows the flow of different types of financial capital to developing countries in billions of US dollars. The degree of volatilities of some types of flows – particularly the portfolio inflows – are a major concern for the macroeconomic stability of the recipient countries. Foreign aid or official development assistance (ODA) flow was least volatile among all types of flows from 1990 to 2014, as depicted in Fig. 1a.[1] Remittances flow to developing countries has recovered after the global financial crisis, but is forecast to grow at a slower pace in 2012–2014 (see Fig. 1b).[2]

Fig. 2 shows the percentage share of flows to developing countries compared to Sub-Saharan Africa from 1970 to 2006 and the flow to Sub-Saharan Africa from 1981 to 2010.[3] One of the striking observations shown by the breakdown is the marked difference between Sub-Saharan Africa and developing countries in general. Aid on average represents 63% of the net flows to the region and remittances are not a large source of finance (see Fig. 2b). At the developing countries level, the shares of foreign aid and foreign direct investment (FDI) are almost similar (see Fig. 2a), but this again hides large regional differences: Europe and East Asia depend a lot on FDI, while other regions essentially receive external finance from foreign aid and international remittances (Frot & Santiso, 2008). Fig. 2c demonstrates the share of remittances, foreign aid and foreign direct investment in millions of US dollars as share of GDP from 1981 to 2010 for the 41 Sub-Saharan African countries under study with foreign aid, remittances and foreign direct investment contributing 67%, 13% and 20% respectively.

3. Literature review

The earliest literature on remittances establishes that the reasons for remittances are pure altruistic ones. Lucas and Stark (1985) introduce an altruistic utility function where the migrant's utility supports the consumption of the other household members. Agarwal and Horowitz (2002) and Gubert (2002) claim that the family can act as an insurance company that protects its members against income shocks by verifying the sources of income. On the other hand, Poirine (1997) and Ilahi and Jafarey (1999) describe the household as a bank that finances migration for its members.

There is little consensus in the literature concerning the impact of international remittances on poverty. Cattaneo (2005), using a dataset of 149 countries, finds that remittances do not have any impact on poverty. Other scholars, however, conclude that the poor do benefit from remittances (Anyanwu & Erhijakpor, 2010; Ghosh, 2006; Ratha, 2011; Skeldon, 2008). The evidence on the direct effect of remittances on poverty and inequality seems to vary according to the sample (Barham & Boucher, 1998). The migration patterns in East European and former Soviet Union countries are such that richer households receive greater remittances than do poorer households and this is likely to heighten inequality (Mansoor & Quillin, 2007). However, Leon and Koechlin (2006) find that, as migrant communities form close networks in a foreign country, the cost of migration falls, and remittances no longer reinforce inequalities in the recipient country. Also, Stark, Taylor, and Yitzhaki (1986) and Chami, Fullenkamp, and Jahjah (2005) provide that remittances reduce inequality.

McKenzie and Rapoport (2007) argue that the overall impact of migration and remittances on income inequality at origin is a priori unclear, as it depends upon the initial income distribution and the position of potential migrants in that distribution. The authors also state that the first migrants will be those positioned on the higher steps of the income distribution, because they have both the means and the incentives to migrate. Barham and Boucher (1998) and Adams (2006) point out that remittances increase inequality but reduce poverty.

A growing number of papers are addressing the effectiveness of remittances in a growth context using a broad range of developing countries. Fajnzylber and López (2008), Giuliano and Ruiz-Arranz (2009) and Singh, Haacker, Lee, and Le Goff (2011) look at the effectiveness of remittances by interacting remittances with institutional variables to see how such variables enhance the remittances–growth relationship. The scholars find that a well-developed financial sector or a more stable political environment enhances the remittances–growth relationship. Adams and Page (2005) finds that remittances reduce poverty in developing countries and Acosta, Calderon, Fajnzylber, and Lopez (2008) use a household survey for 10 Latin American countries and find that remittances have negative and relatively small inequality and poverty-reducing effects. Gupta, Pattillo, and Wagh (2009) extend this by looking at the direct effect of remittances on poverty and financial development in Sub-Saharan Africa with the inclusion of 24 Sub-Saharan African countries and conclude that remittances reduce poverty and promote financial development. Aggarwal, Demirgüç-Kunt, and Perí a (2011) complements this by looking at the direct relationship between remittances and financial sector development in 109 developing countries. Giuliano and Ruiz-Arranz (2009) and Ketkar and Ratha (2001) supply evidence that remittances boost growth in countries with less developed financial systems. Entrepreneurs in developing countries face much less efficient credit markets, and access to credit is among their biggest concerns (Paulson & Townsend, 2004). Banerjee and Newman (1993) and Aghion, Caroli, and Garcia-Penalosa (1999) assert that credit constraint is important factor in determining growth prospects in countries with a high level of income inequality.

The existing literature provides evidence on the direct relationship between remittances and financial development and also how finance facilitates the remittances and growth relationship, but literature on the role of finance in enhancing the remittances and poverty/inequality relationship is lacking. An important point of departure for this current study is the documentation of the role played by finance in strengthening the link between remittances and poverty/inequality in Sub-Saharan Africa. This article also updates the investigation of the remittances–poverty relationship in Sub-Saharan Africa by Gupta et al. (2009) with 41 Sub-Saharan

[1] Volatility is a measure of the coefficient of variation of the flow to GDP series.

[2] There are several sources of vulnerability in the forecasts for remittances to developing countries. The debt crisis in Europe and high unemployment rates in high-income OECD countries are affecting the economic and employment prospects of migrants. e and f in Fig. 1 represent estimate and forecast.

[3] Sub-Saharan Africa in this paper is used to describe the area of the African continent which lies south of the Sahara desert.