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How can developing countries use their diaspora capital?

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INTRODUCTION

Migration is a very old phenomenon; much older than trade and capital flows. Scientists believe that the first massive migration of modern humans happened between 60,000 and 80,000 years ago from Africa to Asia. In modern history, migration has typically been the subject of heated policy and political debates, even becoming the raison d'etre for hundreds of organizations worldwide.

The number of international migrants increased from 75 million in 1960 to close to 250 million today. This has created important diasporas for many countries in the world, both large and small. This trend has been accentuated by the recent refugee crisis, adding about 15 million people to overall migrant figures.

Clearly, this irreversible trend begs the question: Can the growing diasporas represent an opportunity for developing countries in nurturing their home economies? Migrants and diasporas are, to some extent, "unexploited capital," and the purpose of this document is to explore this growing opportunity.

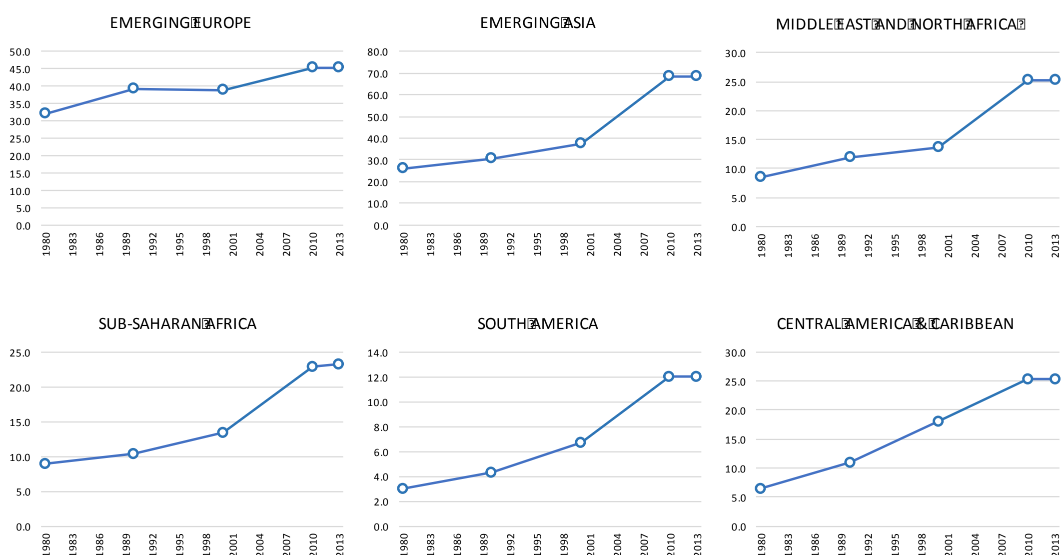
We start by describing the most recent data on migration and diasporas. Then we review different ways through which diasporas can be an asset for the economic development of their home countries. Finally, we suggest guidelines on policies that can be used to utilize these assets.

WHERE AND HOW LARGE ARE DIASPORAS?

Many countries have very large and significant diasporas, which tend to be quite spread out around different areas of the world. We focus on seven groups of countries containing developing nations. These groups are emerging Europe (which we define as all Eastern European countries plus Turkey), emerging Asia, Middle East and North Africa, sub-Saharan Africa, South America, and Central America and the Caribbean (including Mexico).

Figure 1 shows the sizes of diasporas by region of origin, in millions of people. There are about 45 million migrants around the world from emerging Europe. The homologous number is 70 million for emerging Asia, 25 million for the Middle East and North Africa, close to 25 million from sub-Saharan Africa, 12 million for South America, and 25 million for Central America and the Caribbean. Migrants from developing countries account for about 200 million of migrants out of a total of 250 million migrants in the world.

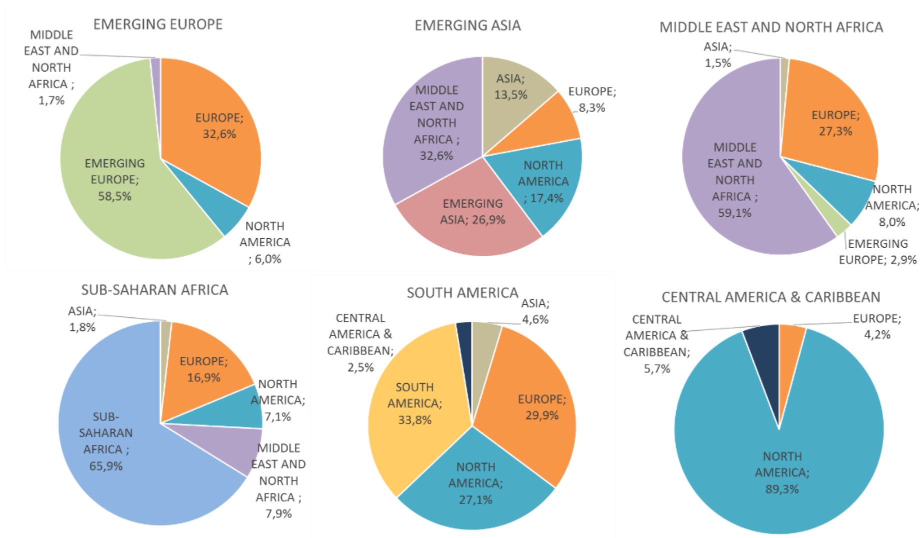
Figure 1. Number of migrants by region of origin (millions)



Source: The World Bank's Global Migration Database and authors' calculations.

These migrants are, in fact, also quite geographically spread around the globe, as shown in Figure 2, which visualizes the distribution of destination regions for these seven groups. Migrants whose countries of origin are in emerging Europe are spread around other countries in emerging Europe (58.5 percent) and in Western Europe (32.6 percent), as well as a few of them in North America and the Middle East and North Africa. Besides from migrants originally from Central America and the Caribbean countries—who are overwhelmingly residing in North America—migrants originating from countries in all the other regions are characterized by having a large share of their migrants in other countries within the same region, but also another sizable share spread around other developed and developing countries.

Figure 2. Share of migrants by region of destination (2013)



Source: The World Bank's Global Migration Database and authors' calculations. Figures exclude values below 1 percent.

Figure 2 also visualizes that North America (namely the United States and Canada) and (Western) Europe are important destinations for migrants from all over the world. Thus, an important share of these diasporas is located in developed countries.

HOW CAN DIASPORAS FOSTER ECONOMIC DEVELOPMENT OF THEIR COUNTRIES OF ORIGIN?

We focus on three main ways through which diasporas can support the development of their home countries: remittances, business networks, and the diffusion of knowledge. We summarize evidence behind each one of those.[2]

Remittances

The role of remittances can be highly beneficial for countries that have a relative large diaspora. Remittances can significantly increase income, consumption and investment, thus increasing welfare among, particularly, lower income households, and in turn complement through taxation resources that

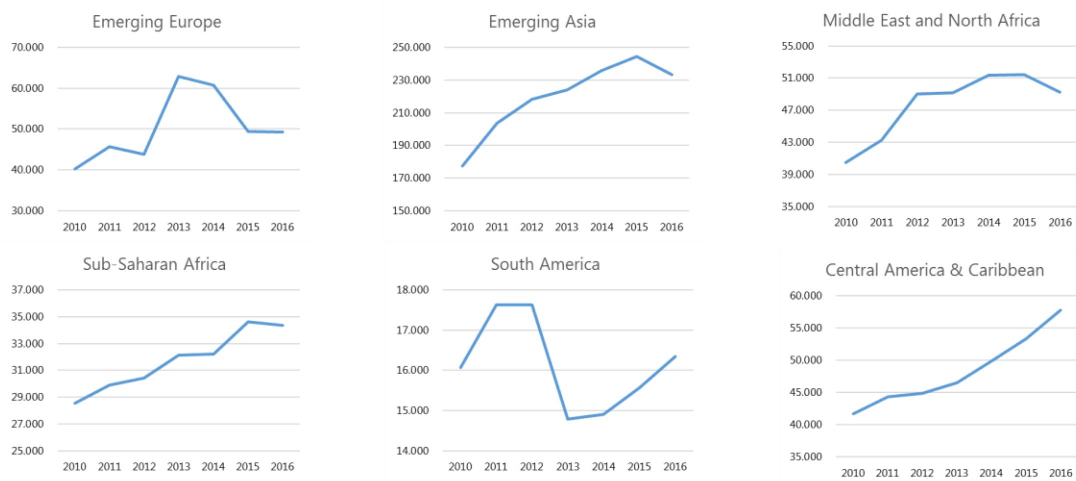
[2] We summarize the most relevant channels for this note. For a complete understanding of the benefits of migration according to the economic literature see Docquier and Rapoport (2012), Kerr et al. (2016), and Clemens (2015).

can be used toward the provision of public goods such as education, health, and infrastructure, among others.[3]

Overall, remittances have become an increasingly important flow: from year 2000 until 2015 they more than doubled as a share of global production. Today they add up to almost $440 billion per year worldwide (more than three times the size of official development aid flows). For particular countries, such as Mexico, remittances are a crucial source of income. Only in 2016, remittances to Mexico reached almost $29 million—about 2.7 percent of its GDP—mostly coming from Mexicans living and working in the United States.[4] Countries like India and the Philippines, together with Mexico, are the largest recipients of remittances. For smaller countries, such as Armenia, Moldova and El Salvador, remittances make at least one sixth of national income.[5]

Figure 3 visualizes the size of remittances received by different regions containing a majority of developing countries. They amount to significant sizes and trend upward over time. Countries in emerging Europe, for instance, received $50 billion of remittances in 2016; a similar figure for countries in the Middle East and North Africa as well as Central America and the Caribbean. Countries in emerging Asia received about $250 billion of remittances in 2016, while countries in sub-Saharan Africa and South America received about $35 billion and $16 billion, respectively.

Figure 3. Remittances received (in USD millions) by region (2010-2016)



Source: The World Bank Migration and Remittances Data and authors' calculations

Translating these figures to relative terms reveals how significant remittances are for emerging regions. For example, in Central America and the Caribbean, remittances received in 2016 account for about 4 percent of the accumulated regional GDP, whereas it represents between 2 and 2.5 percent of the GDP of the Middle East and North Africa region and sub-Saharan Africa, respectively. For countries in emerging Europe and emerging Asia, remittances received in 2016 represent about 1.5 percent of GDP on average, while for South America they represent about 0.5 percent of GDP.

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[3] The debate on whether taxation of remittances is a good or bad policy is a very long one, and out of the scope of this note. Yet, we offer a couple of thoughts on the taxation of remittances as a policy. In many countries remittances are directly taxed the moment they enter the borders. Given that remittances usually flow toward poor families, this direct tax is, in essence, a regressive tax, and therefore it is far from ideal. Moreover, precisely because these funds go mostly to the hands of the families in the lower end of the income scale, they are typically spent in consumption. Therefore, even if there were no direct taxes, remittances funds would be indirectly taxed through value added tax or other consumption-related taxes. Thus, regardless of whether there are policies in place to directly tax remittances or not, there benefits to the government from allowing remittances in.

[4] https://www.wsj.com/articles/remittances-to-mexico-hit-record-27-billion-in-2016-1485978810

[5] https://www.project-syndicate.org/commentary/remittances-not-only-benefit-to-homeland-economies-by-ricardo-hausmann-2015-06

Thus, remittances are a key component of how countries benefit from their diaspora, and often a very important source of foreign currency for developing countries.

Business networks

Migrants residing abroad can play a crucial role in lowering the costs of doing business in between their home and current countries.

Evidence shows that migrants play an important role in fostering trade through the creation of networks. A great example can be found in the bilateral trade patterns between Vietnam and the U.S. In 1975, the U.S. military evacuated over 100,000 refugees from South Vietnam and brought them over to the U.S. Once in the U.S., it was the government—not the refugees themselves—who decided their resettlement destination. Throughout this period, and until the mid-1990s, the U.S. followed an embargo on Vietnam eliminating the possibility of trade between the two countries. Parsons and Vezina (2018) use this episode to show how the Vietnamese diaspora in the U.S., who were spread around different states in different proportions, played a role in restarting bilateral trade with Vietnam following the lifting of the trade embargo. Ultimately, U.S. states that received more Vietnamese refugees traded more with Vietnam.[6]

This is an example of how migrants play a role in assisting businesses navigating informal trade barriers, particularly when one of the countries is a developing one. But, what in particular can migrants do that others cannot? Many things: For instance, migrants are able to overcome communication and language barriers typical of two natives from two different countries. Migrants are also more likely to have knowledge on the regulatory environment in both countries, which are crucial for establishing bilateral business transactions.

A similar argument is made for cross-borders investment, which is often hindered by risks associated with the uncertainty on formal and informal rules in the "other" country known by the migrant. Migration has proved to help mitigate those risks by liaising between potential investors and partners, both private and public.[7]

These type of barriers to trade and investment are what economists typically refer to as transaction costs, and migrants have been proved to be able to reduce them significantly.

The diffusion of knowledge

One fact that has fascinated economists for the past decades is that the diffusion of knowledge is a localized phenomenon. An example is that scientists and inventors tend to cite more often the work of other scientists and inventors (e.g., academic papers, patents, etc.) located nearby. Another example is that local firms tend to become more productive following the establishment in their neighborhood of a new larger firm, often a multinational one, from which they can learn or copy best practices.

Why is the geographical component so important in the diffusion of knowledge? A widely accepted answer is that human interaction is a key component for such diffusion to occur, and as people are typically not as mobile (at least as compared to other flows such as goods and capital), then knowledge is not as mobile either. After all, even in the era of internet, students learn from their teachers by congregating in the same space and businesspeople still travel to meet face-to-face in order to conduct their businesses.

In this sense, if human interaction is critical for the transmission of knowledge and technologies, then migrants can play a crucial role as carriers of knowledge across borders. In fact, there is both anecdotal and empirical evidence supporting this idea. Take for example the wine industry in South Africa, one of the country's best known exports. Many of the most renowned wineries in South Africa are located in Franschoek Valley, a town located about 30 miles from Cape Town, and founded in the late 17th century by French Huguenot refugees who were expelled from France by King Louis XIV. These migrants brought with

[6] http://voxeu.org/article/long-run-trade-effect-vietnamese-boat-people
[7] e.g., Kugler, Rapoport and Levinthal (2017 WBER)

them production and merchandising know-how and developed highly sought after varieties of South African wines.

The importance of migrants as drivers of new knowledge that reflects in higher productivity has been well documented. The role of migrants in diffusing knowledge goes in both directions: Large firms that hire return migrants, for example, perform better in terms of patenting.[8] More generally, evidence shows that migration plays a role in improving industry-level productivity for both the sending and the receiving countries of the migrants.[9]

Overall, evidence suggests that diasporas play a role in facilitating the diffusion of knowledge and of technologies back home, contributing to economic growth. In all these cases, the role of skilled migration is the largest.

PUTTING DIASPORA CAPITAL TO WORK: WHAT POLICIES CAN PUT IN PLACE?

The first question to ask is: Why should there be policies in place for this matter? The answer is straightforward: Migrants play a role in many important aspects of economic development by lowering existing frictions in imperfect markets. For example, remittances could alleviate credit constraints for small or family businesses. Similarly, diasporas can alleviate frictions in the form of informal institutions and non-tariffs trade barriers, or lower the cost of diffusion of tacit knowledge by reducing the uncertainty in the process of knowledge transmission.

As discussed, migrants have proved to be a good vehicle in overcoming these frictions, but there are certainly cases in which frictions are too costly for migrants to deal with alone. Thus, public policy might play a role in encouraging diasporas to overcome frictions in particular instances where the stakes, and costs, are higher.

In next section, we explore a number of policy options available to governments, particular in emerging markets, that could counteract frictions by putting in place a structure of incentives for diasporas.

Encouraging remittances for consumption and investment purposes

Remittances can play a crucial role in capital inflows of developing countries, and thus, countries would want to encourage such flow.[10] Remittances from private individuals abroad to their home countries tend to be used by the receiving households for consumption purposes and perhaps as investment in small businesses, which adds to local economic development. Yet, there are circumstances in which remittances have been used to finance public goods by creating public-private partnerships between the diaspora and institutions back home. The provision of public goods at the local level, such as infrastructure or security, could be fueled by remittances in the presence of a public policy vehicle such as a matching scheme of donations sent by emigrants of those cities, towns or villages. One example of this is *Tres Por Uno (*"three for one") program in Zacatecas, Mexico. The program is designed so that for every $1 contributed by diaspora associations the federal and state governments would match another $1 each. This money is gathered in a fund that is then used to invest in local development, through a vehicle where decisions are made by local residents and contributing emigrants.[11] From the government perspective, this allows them to provide public goods with partial funding from privates residing abroad, and the local communities play an active role in the investment decisions.

These remittances could also be channeled as private investment from investors in the diaspora to fuel productivity in their hometowns or, more broadly, the country. Seed capital, for the purpose of the creation

[8] https://www.hbs.edu/faculty/Pages/item.aspx?num=49266
[9] Bahar and Rapaport (2018) show that countries are more likely to become exporter of goods typical of the sending countries of their immigrants and receiving countries of their emigrants.
[10] Encouraging remittances could also have cons, such as putting pressure on the exchange rate to appreciate and thus affecting export demand. We refrain from this discussion in this paper, though it should be taken into account when designing the policies.
[11] See Chapter 5 in World Bank Diaspora book.

of new businesses, is often lacking in developing countries given the coordination failures associated with it (no capital without projects to invest in, and no projects without the existence of capital). Migrants residing abroad could play an important role in bridging this gap. These migrants know the business environment of their home countries and, perhaps, could better deal with the information asymmetries involved in the process of selecting entrepreneurs, since they know the local culture. Thus, investors in the diaspora could play an important role in partnering with local entrepreneurs by contributing with capital, and more importantly, mentoring. Governments could support this effort, as they often do when it comes to risk capital, by using their own innovation and entrepreneurship agencies to match investment in new ventures, thus reducing the risk for the investor from abroad.[12]

Strengthening international business networks

The existence of strong business networks in between countries is an important stepping stone to overcome non-tariff trade barriers or other market failures hindering cross-border trade and investment. In that sense, we sketch a basis for policy recommendations to help bridge business gaps between countries that aim to strengthen the role of diasporas in the political process of countries. One way to accomplish this is by creating a public-private partnership that involves the existence of organized diasporas abroad, which could contribute to the ongoing discussions between the local business community and the government.

There are plenty of examples of these organizations. Given the important role they could play in partnering with local communities, it is in the interest of governments to encourage and support their creation. In fact, in many countries there are also counterparts, often at the ministerial level. Countries such as Albania, Brazil, Chile, Mexico, Peru, Philippines, and Romania have ministries of diaspora affairs, each with different goals but with the general common purpose of engaging with the country's emigrants.

These institutional arrangements could play an important role in assisting in the policymaking aimed at improving the flow of goods and of capital into the country. Given that migrants per se alleviate frictions created by non-tariff barriers when it comes to trade or uncertainty when it comes to foreign investment, they could play a role in the formulation and negotiation of bilateral economic treaties between their home and destination countries. One model through which this can be accomplished is by providing political representation of some sort. For instance, the Institute for Democracy and Electoral Assistance mention 11 countries that in 2007 had parliaments with political representation for members of the diaspora.[13] Either through direct political representation of joint governmental commissions that include diaspora members of the private sector, migrants could assist bilateral negotiations on trade and foreign investment (as well as on migration) with their knowledge of informal institutions and existing bottlenecks in economic activity across countries.

Fostering the diffusion of knowledge through migration policies

Since the diffusion of knowledge requires human interaction, involving the diaspora in programs to improve competitiveness and productivity can be crucial. For instance, a firm could benefit from having their workers temporarily train abroad to learn new technologies or gain specific knowledge that could result in higher productivity upon their return. Multinational firms often have these programs for their employees, allowing them to relocate to a foreign branch for a period. Yet, for small and medium firms this is problematic. First, they simply do not have foreign branches where they can host their workers. But, more importantly, they cannot afford it. This represents a clear externality: If small and medium-sized firms would pay for their worker's training abroad, they risk losing them to other firms upon their return. Therefore, there is an underinvestment in workers training, in particular when the cost is high (e.g., training a worker abroad).

[12] See Chapter 7 in Developing a Road Map for Engaging Diasporas in Development book
[13] Voting from Abroad. The International IDEA Handbook. http://www.idea.int/publications/catalogue/voting-abroad-international-idea-handbook

Public policy could address these difficulties for small and medium-sized firms. First, after coordinating with diaspora organizations, foreign firms in similar industries owned by members of the diaspora could host employees for temporary training abroad. This, naturally, should come accompanied by a bilateral agreement that deals with permits and visas for these workers. Second, given that the binding constraint is the underinvestment, and training abroad workers represents a social gain, it would be justifiable for the government to partially or fully subsidize those experiences. In this sense, the government would be overtaking part or all of the risk linked to the worker not coming back to his or her original workplace; but even if that happens, the society as a whole would benefit from the investment. The "right" amount of the subsidy, thus, is to be defined within each circumstance, but it would have to be such that is enough to diminish or eliminate the private risk but at the same time not to use public funds to crowd out private investment. In practice, this might require some initial conditions and adjustments over time. Another option to promote temporary migration of this form is to provide the funds directly to the worker in the form of a conditional loan (and the firm, of course, would have to commit). This loan would only need to be repaid if the worker does not return to the country after the training period (similarly to the format used in many scholarships to study abroad).

Another way for the government to assist in acquiring knowledge is by encouraging members of its diaspora to return home. Particularly regarding migrants from developing countries in developed nations (and even more so skilled migrants), their stay abroad typically involves the acquisition of human capital and—perhaps more importantly—experience and tacit knowledge that could translate into productivity growth upon their return. This productivity growth can be reflected in several ways. First, migrants are disproportionally more likely to become entrepreneurs. Thus, return migration can result in an increase in business dynamism, which is explanatory of productivity growth. Second, even beyond the creation of new businesses, migrants can bring knowledge to already existing firms (e.g., technologies, management styles, understanding of other markets), which could boost innovation and productivity at the firm level. Third, linked to the topics discussed above, returning migrants can further create and foster business opportunities with firms in the countries where they lived.

Thus, an important policy instrument could be for the country to incentivize return migration of their citizens abroad by providing fiscal or other incentives. For example, the reduction of the marginal income tax rate for a number of years upon return, which could be conditioned on employment and/or investment.[14] The structure of incentives could be constructed in a way that is horizontal: Equally to all migrants working in all sectors, or on the contrary, it could encourage investment and/or entrepreneurship in particular occupations. Another possibility (not necessarily a substitute) is exemption of (some or all) customs taxes on repatriation of property.

WHO SHOULD PAY FOR THE POLICIES?

A question that remains is whether these policies are fiscally responsible. Naturally, this is a context-specific question, highly depend on many factors (fiscal and others). These factors are critical not only on the decision on whether or not to pursue such policy, but also on defining the size of the fiscal resources used for this policy. Yet, it is important to keep in mind that this requires a medium- to long-term analysis: The fiscal resources used to attract talent that can translate into productivity, and thus, economic growth. Thus, they are likely to be recovered through fiscal contributions later on (as any other investment).[15]

A common characteristic of these policies is that they are, indirectly, targeted toward working-age skilled migrants. Why? Because the exemption of income or customs taxes is a more attractive proposition for those with more properties or potential of larger income, causing self-selection among skilled migrants.

[14] Investment does not necessarily have to come from the migrant him or herself, but also from other sources linked to the migrant's economic activity upon return.

[15] A recent report by the National Academies of Sciences, Engineering and Medicine (2016) discuss this at length for the U.S. case. They find that while there is a fiscal burden of about $1,000 per immigrant, this is offset by fiscal contributions of second and third generation migrants. However, it is safe to assume that if looking at skilled working-age migrants only, the fiscal burden is much lower or non-existent at all.

Naturally, the “optimal” duration of a migrant’s foreign experience in order to have impact upon their return has not been determined. On one hand, too little time abroad might not be sufficient to have acquired enough of the experience that could be translated into a meaningful economic impact, while on the other hand too much time could weaken the links to the home country, making adaptation very costly and thus somewhat impractical. More research is required in this subject in order to be able to identify a detailed time frame.

CONCLUSION

The role of diasporas in fostering economic development in their home countries has been studied widely for years. However, despite the potential, policies that aim to boost the benefits from nationals residing abroad seem not to be always prioritized in the national agendas of developing countries with large diasporas.

However, the question remains: should these policies be pursued as a top priority by policymakers? Is the potential benefit larger than the cost? These are all questions that can only be answered with further rigorous research. Yet, we know that the policies described above vary quite significantly in terms of their financial costs. For example, matching remittances is quite costly but providing political representation to diasporas is not. Thus, if there are financial constraints—as it is often the case—some policies at very low costs are still feasible.

As opposed to international trade and investment, migration is a flow that still can, and probably will, keep growing at fast rates. If the theory holds, further migration flows will result in larger aggregate welfare increments as it did with trade and investment, but it could also bring winners and losers. However, under proper redistribution and strong enough safety nets (as opposed to how it was done with the opening of markets to trade and investment) the losers due to increased migration flows can also become winners.

As it is known, the productivity slowdown in the current decade is the most important challenge faced by both advanced and emerging markets. Migrants could play an important role in reversing this trend, and this document, while not comprehensive, aims to provide direction on a set of policies that could be useful for these purposes.

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