Resources Policy xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Resources Policy

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

Foreign aid and political instability in resource-rich countries

Chiara Ravetti[a,*], Mare Sarr[b], Tim Swanson[c]

[a] Polytechnic of Torino and OxCarre, University of Oxford, Manor Road, Oxford OX1 3UQ, UK
[b] Pennsylvania State University and University of Cape Town, Lewis Katz Building, University Park, PA 16802, USA
[c] Department of Economics, Graduate Institute of Geneva (IHEID). Maison de la Paix, Ch. Eugène-Rigot 2, CH-1211 Geneva, Switzerland

A R T I C L E I N F O

JEL classification:
O11
O13
F35

Keywords:
Political instability
Foreign aid
Resource curse
Economic growth
Autocracy
Loans

A B S T R A C T

In this article we examine whether foreign aid and natural resources can act as a double curse on developing countries with poor governance. We hypothesize that affording external liquidity to dictators based on their resource wealth reduces the political incentives for long term investment and enhances the looting of the country and more frequent irregular exit of leaders from their office. We then examine the empirical evidence for such a link between international aid flows and government irregular turnover in resource-rich countries. We find that the interaction between natural resources and most forms of international aid combines with political instability in the case of non-democratic regimes. In turn, this combination of foreign aid, natural resources and political instability is associated with lower growth performance. Some types of less fungible aid (notably humanitarian) and aid grants that do not build indebtedness do not seem to have this effect.

1. Introduction

International aid to developing countries shares some of the characteristics and challenges of natural resource rents. Both constitute a form of non-tax revenue, with the potential of engendering a ‘curse’, as the government's budget depends less on the country's general economic productivity (Djankov et al., 2008; Morrison, 2009). The availability of substantial amounts of external liquidity can distort political incentives, since they require fewer investments in the general economy, they make the government less accountable to its domestic tax base, and they expose the public budget to volatility from international factors outside of domestic control (such as global commodity prices and decisions in the international donors' community). These problems might be particularly acute when aid and natural resource wealth are both present in abundance, as the developing country must manage simultaneously these two interlinked sources of liquidity, loosely tied to the rest of its economy.

Interest in the relationship between aid and natural resources has grown dramatically in recent years because of the role of China and other ‘new’ donors offering foreign assistance to mineral- and land-rich African countries (Fuchs and Vadlamannati, 2013; Dreher and Fuchs, 2015; Dreher et al., 2018).[1] However, the flow of foreign aid to resource-rich economies is a long-standing phenomenon and several resource-rich, low-income countries have historically received amounts of foreign aid that are even larger than their revenues from natural resources from standard OECD donors (Dobronogov and Keutiben, 2014). Yet, to date, the research looking at the interplay between these two potential ‘curses’ and the political economy of recipient countries over the past decades remains scant.

This article aims at filling this gap, examining some of the implications of resource wealth in combination with foreign aid. We focus particularly on developing nations that are ruled by non-democratic regimes and could experience the strongest distortions in the political decision-making process. We develop a theoretical model to demonstrate that providing foreign liquidity to autocratic leaders can encourage a political behaviour akin to moral hazard, resulting in systematic looting of the resources of the country, indebtedness and political instability. We then examine the empirical evidence for such political economy dynamics with bilateral aid data from the Development Assistance Committee (DAC). Our findings suggest that in several cases foreign aid inflows go hand in hand with political instability in resource-rich autocracies, where political leaders have more discretionary power in making economic decisions for the whole country.

* Corresponding author.
E-mail addresses: chiara.ravetti@polito.it (C. Ravetti), mxs2566@psu.edu (M. Sarr), tim.swanson@graduateinstitute.ch (T. Swanson).

[1] This recent literature does not actually find evidence that Chinese or Indian official development assistance is particularly targeted at natural resources or other economic indicators, but rather is based on political motives analogous to those of standard aid donors.

https://doi.org/10.1016/j.resourpol.2018.05.017
Received 22 October 2017; Received in revised form 31 March 2018; Accepted 30 May 2018
0301-4207/ © 2018 Elsevier Ltd. All rights reserved.

Our argument is rooted in the literature that draws a parallel between foreign aid and the resource curse. Aid can be analysed as any other form of non-tax revenue for developing countries (Morrison, 2009), and poses economic problems similar to those associated with the so called 'resource curse'[2]: increased indebtedness (Manzano and Rigobon, 2003), volatile revenues (Humphreys and Sandbu, 2007), and possibly the so-called 'Dutch disease', an appreciation of the exchange rate due to the export of the resource, which penalizes domestic industries by inflows of cheap imports and unfavourable conditions for exports (Sachs, 2007). Doucouliagos and Paldam (2009) argue that a similar Dutch disease effect on exchange rates provides a plausible explanation for the ineffectiveness of aid in the past 40 years of development assistance. Similarly, Rajan and Subramanian (2005); Rajan and Subramanian (2011) find that prices may be rendered uncompetitive externally due to the impact of aid flows on real exchange rate appreciation, in a sort of Dutch disease for aid on manufacturing growth.

On the other hand, the curse is also linked to multiple governance issues: regarding natural resources, some common potential culprits are higher rent-seeking and corruption (Leite and Weidmann, 2002), domestic conflict and political instability (Collier and Hoeffler, 2004), the development of autocratic regimes and poor institutions (Ross, 2001; Isham et al., 2005) and in general with weaker accountability of the political leadership (Ross, 2001). One of the studies in this literature closest to ours is the work of Cabrales and Hauk (2011), who focus specifically on leadership turnover and find that resource discoveries can lead to revolutions in countries with weak institutions. They argue that politicians tend to over-extract resources immediately because they only care about the future resources if they remain in power. Our work extends this argument, considering the implications of having external liquidity (aid) available in the context of resource extraction and weak institutions.

The aid literature has also been concerned with governance for a long time. In the 1990s major donors and development institutions established a 'good governance agenda' (Neumayer, 2003; Diarra and Plane, 2014). The aid effectiveness literature has repeatedly examined the link between official development assistance (ODA) and governance in the recipient countries. Following the seminal work of Burnside and Dollar (2000), who argue that aid has different impacts depending on the policies and governance of the recipient country, a rich literature has flourished on the allocation, effectiveness and consequences of aid under conditions of weak institutions and poor governance. Findings, however, are heterogeneous.[3]

Our paper departs from this literature by developing a specific political economy mechanism to motivate the potentially detrimental interaction of aid and natural resources in autocratic regimes. The argument rests on two key features of international financial aid flows, namely the agency problem that can lead to moral hazard in politically unstable aid recipients, and the persistence of indebtedness through the infamous 'odious debt' phenomenon. Firstly, political leaders who are not subject to the checks and balances of democratic institutions have an incentive to misuse the liquidity afforded to their country. Amegashie et al. (2013) find some evidence that unrestricted financial transfers can induce moral hazard in the recipient governments, as also hypothesized by Svensson (2000) and Azam and Laffont (2003). As autocratic dictators face high uncertainty in the duration of their tenure, always fearing being overthrown in a coup d'état, they might engage in reckless political behaviour, plundering as rapidly as possible the resources of a country without investing in long term development. This problem of systematic looting in autocratic regimes is well documented, despite difficulties in its precise measurement. We provide a number of anecdotal examples of this phenomenon in Section 4.

The second crucial aspect of this problem is that, even when a dictatorial regime terminates, the country is bound to repay the debts accumulated by the previous government. The literature has defined this phenomenon as 'odious debt' (Jayachandran and Kremer, 2006). Failure to repay these debts can hurt a country's reputation and its future access to credit. In the case of resource-rich countries, the accumulation of debt can be particularly fast, since fossil fuels and mineral resources can act as collateral for repayment. In describing the building of Africa's odious debt, Ndikumana and Boyce (2011) provide numerous accounts demonstrating that resource-rich countries attract aid-based lending, which is then often looted by unscrupulous autocrats. Bulow (2002) provides a clear description of the manner in which lenders take their returns, when sovereign borrowers are in trouble.[4] Even in recent debt renegotiation processes (such as in the Iraqi case), the concept of 'odious' debt accumulated by previous tyrants did not supply a meaningful mechanism for debt repudiation (Massari, 2007). A plethora of historical examples describe countries that inherited huge debts from their previous unelected and kleptocratic governments and were bound to repay them (Ndikumana and Boyce, 1998; Jayachandran and Kremer, 2006).

We argue that the combination of these two elements (moral hazard in autocrats' use of aid liquidity and the building of a stock of 'odious debt') constitute the fundamental mechanism that underlies the problem of giving aid to resource-rich autocrats. We first model these concepts theoretically, then provide anecdotal examples where such mechanisms could be at play, and finally test this mechanism empirically with different types of aid flows. We find that aid structured as grants or for humanitarian purposes does not relate to political instability in conjunction with resource revenues. However, other types of economic aid, such as assistance for economic infrastructure or for multiple economic sectors, are associated with significantly worse political and economic outcomes. In line with our theoretical hypotheses, aid in the form of loans is observed to vary substantially in conjuncture with political turmoil: with no resource assets, countries receive less foreign aid lending, but the greater their resource stocks, the more they can borrow in concessional aid loans.

The paper proceeds as follows: in Section 2, we present a model of the distorted incentives created by foreign aid in a resource-rich autocracy. In Section 3 we set out our hypotheses, considering some anecdotal examples where this mechanism seems to be at play. In Section 4 we develop our empirical analysis of these claims, examining the evidence regarding the relationship between aid, instability, and growth. In Section 5 we discuss some of the possible determinants of aid inflows and their implications for political instability. Finally, in Section 6, we perform some robustness checks, using a different dataset, which includes alternative measures of political instability and oil wealth and oil discoveries as a measure of the resource stock. Section 7 Discusses further implications of our results, and Section 8 concludes.

[2] The first definition of this 'curse' dates back to Sachs and Warner (1995).

[3] For a comprehensive review on the allocation of aid flows to poorly governed countries, see Winters and Martinez (2015). For the literature on the effects of aid on governance, instead, contributions date back at least to the so called Samaritan's dilemma (Buchanan, 1975), whereby recipients are at risk of becoming heavily dependent of the foreign support. Some important studies on this issue include Knack (2001), who finds evidence of a possible deterioration of the risk profile of a country with increasing aid flows; Brautigam and Knack (2004), who find that aid transfers may distort domestic governance regimes, engendering aid dependence, structural problems and poor growth; Svensson (2000) and Bhattacharyya and Hodler (2010), who find that (unstructured) transfers may induce rent-seeking and corruption. Wright (2009) instead finds that aid can foster democratization, if leaders expect to remain in office afterwards, while Kalyvitis and Vlachaki (2012) find that aid reduces the chances of democratization. Furthermore, there is a significant body of political science literature looking at the impact of aid on the longevity of leaders (Licht, 2010; De Mesquita and Smith, 2007, 2009; Lai and Morey, 2006).

[4] Lenders can seize any sovereign assets existing overseas (claiming rights to assets in lieu of rights to interest), and the rescheduling of loans (Bulow, 2002).

Download English Version:

https://daneshyari.com/en/article/10153812

Download Persian Version:

https://daneshyari.com/article/10153812

Daneshyari.com