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Are debt repayment incentives undermined by foreign aid?

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ABSTRACT

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This paper investigates the effects of inflows of foreign aid on the debt repayment behavior of developing countries. The paper first delineates the overall incentives to committing to timely debt repayment in a war of attrition-type model. A set of panel estimates including 93 developing countries shows that foreign aid is strongly negatively associated with repayment incentives. The findings pertain to both total debt service and service on publically guaranteed debt. A set of conditional estimates suggest that the main findings generalize to the majority of developing countries. *Journal of Comparative Economics* **41** (4) (2013) 1073–1091. Department of Economics and Business, Aarhus University, Denmark.
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1. Introduction

A large share of the world's poor countries suffers from disproportionate external debt burdens. A long line of celebrities, including Bono, Muhammad Ali, Sir Bob Geldoff and the Pope, have therefore joined in campaigns such as the Jubilee 2000 campaign to call for a cancellation of developing countries' debts, as well as for an increase in foreign aid to these countries. Since the inception of the Jubilee campaign and other similar initiatives about a decade ago, and the launch of the Highly Indebted Poor Countries (HIPC) initiative – as well as even earlier initiatives in the Baker and Brady Plans – developing countries have received debt relief worth more than 50 billion dollars (Freytag and Pehnelt, 2009). The underlying idea of these initiatives is that developing countries have ended up with an excessive debt burden and are now unable to finance growth-promoting and pro-poor policies (Feeny and McGillivray, 2003; Johansson, 2010).

Yet, campaigns, celebrities and many social scientists have acted as if governments and politicians in developing countries are always benevolent and trustworthy partners, i.e. that they would almost always engage in pro-poor, growth-promoting policies if they only had the chance. Feeny and McGillivray (2003), for example, attribute the massive debt problems of HIPCs to benevolent politicians having misconceptions of the social benefits of investments financed by foreign loans, and thus that slow debt repayment or sovereign debt default in poor countries is simply bad luck, i.e. a materialisation of the risk associated with any type of government-conducted investments.

One can nevertheless question the implicit assumptions underlying explanations resting on honest errors or bad luck (i.e. risk) on four central grounds. First, half a century of research in public choice and political economy has suggested that the actions of democratically controlled governments in Western Europe and North America are often best explained by self-interest and that those of developing countries lacking solid checks and balances are even more often so (cf. Mueller, 2003; Imbeau, 2009). Moyo (2009), for example, claims that the large inflows of foreign aid to Africa since the 1960s have

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contributed to worsening the economic situation and human development of the continent by empowering self-interested elites. Results in Boone (1996) and Bjørnskov (2010) likewise seem to indicate that foreign aid in some countries is primarily captured by political elites that may have little incentive to adopt a long-term horizon necessary to repay foreign loans. The same seems to pertain to funds attained in the international financial markets. As Bulow and Rogoff (1990, 40) find, the loans of the 1970s and 1980s were generally misspent and "a very large percentage went to finance conspicuously unpromising government investment projects and capital flight".

Second, if indebtedness was simply the result of a row of unlucky blows and failed government investments, it should not exhibit such systematic patterns. In particular, one should not find that a relatively small group of countries such as Haiti and Nicaragua are *persistent* bad payees, accounting for a large share of the accumulated world sovereign debt and bad loans. Third, given systematic patterns of risk and the absence of any significant collateral on offer, one has to ask why market-oriented financial institutions in the western world actually lend money to poor countries? Rational market agents in economies and banks in particular, are not generally perceived as entities that can be repeatedly fooled. Accordingly, possible distortions such as ulterior lending motives might be at play (see Eaton and Fernandez (1995) for a review on literature dealing with points 2 and 3 and Geginat and Kraay (2012) on defensive lending). Fourth, what if, as some aid critics have suggested, the mounting debt problems and shaky loan repayment are partially caused by foreign aid (Kanbur, 2000; Easterly, 2002; Bjerg et al., 2011)?

Against this background, we ask why poor countries are able to build up such excessive debt while at the same time displaying a highly unstable repayment track record and if foreign aid can in any way exacerbate or alleviate this problem. Our starting point is the observation that loan agreements are, at least in principle, voluntary and based on market conditions, and thereby subject to negotiations between the sovereign government of a poor country and some financial institutions abroad. Developing countries in general seem to have incentives to repay their foreign debts, for the reason that they desire future access to financial services, i.e. that they fear exclusion from future lending, and also in other areas need to defend their international reputation.

On the one hand, Amador (2008) shows theoretically that even in the presence of tragedy-of-the-commons-like problems such as Tornell and Lane's (1999) 'voracity effect', the existence of potential future economic gains can ensure that developing countries repay their debt. The reason is that the same countries value the option of borrowing again in the future, which provides enough incentive to overcome coordination problems. On the other hand, inflows of foreign aid may dramatically change incentives. Mayr (2010) formalizes such concerns in a model in which aid inflows in part depend on countries' indebtedness. Given that donors try to alleviate problems associated with debt burdens, she shows the existence of a moral hazard problem, as politicians that are otherwise benevolent on behalf of their own population have an incentive to rationally run budget deficits. Even without voracity effects or problems of high discount rates due to, e.g., political instability, it is therefore rational to under-service international debt so long as donors are sensitive to the problems this may create; i.e. debtors partially or fully default because it generates aid inflows. Such problems are further exacerbated when politicians cannot be assumed to be entirely benevolent.

In the present paper, we explore a different causal link between aid and debt repayment, namely, we model the loan agreement between the developing country government and the international financial sector as a negotiation of self-interested agents, where the presence of foreign aid may affect the negotiation outcome. In particular, we capture the situation as a *war of attrition* type game where both players, the developing country government and an international bank, are potentially benefiting from large scale finance of projects in the developing country, but have to agree on the terms of the financial transaction and in particular on the speed and level of repayment. While both players benefit from an agreement materializing, they are opposed as to what the preferred variety of such agreement looks like. The developing country government prefers large-scale loans with lenient repayment requirements, while the foreign creditor prefers a credible commitment to a speedy repayment schedule at market rates. Of course, different creditors may have different lending motives, affecting their willingness to accept lenient loan conditions (see e.g. Alesina and Dollar, 2000, for a detailed study on the patterns of foreign aid allocation). For example, loans given by the IMF to a country in distress may command a slower repayment schedule than a loan given by a commercial bank. In any case, by not acting (no commitment and no loan) both players can delay the negotiations, and the winner is that agent who is the most patient to wait for his favorite outcome. Adding into this an outside financing event – the inflow of foreign aid – which alleviates the current status quo for the developing country, the balance in the *war of attrition* is changed in favor of the developing country government winning; i.e. obtaining a foreign loan at a slow repayment schedule. The reason is not necessarily that aid agencies react to payment problems, as in Mayr (2010), but that previously agreed-upon inflows of foreign aid cause a change in the negotiation balance, forcing the international financial institutions to accept a more lenient loan agreement.

The application of the *war of attrition* is by no means new. This type of game is, in particular, well-known from analyses of bargaining situations over economic reforms.[1] In the current paper, we use the modeling framework to organize our thinking on the interaction between aid and debt service and to derive testable hypotheses. A number of disclaimers are in place. We do not build our theoretical argument based on any of the traditional sovereign debt models, as those outlined in, e.g., Eaton and

[1] A number of papers have employed similar war of attrition settings. Most prominent among these papers is Alesina and Drazen (1991), who in their seminal paper examine delays in fiscal stabilization. Further examples are Perotti (1998), who studies financial sector reform in transition economies, Heinemann (2000), who discusses the strategic effects of creating the EMU, and Brücker et al. (2004) who are concerned with the eastward enlargement of the European Union.

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