

CIES POLICY BRIEF 3

THE PERILS OF DEVELOPMENT AID IN RESOURCE-RICH COUNTRIES

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The emergence of China and other new donors offering foreign assistance to mineral- and land-rich African countries has spurred a renewed interest in the relationship between international aid and natural resources (Dreher and Fuchs, 2015; Dreher et al., 2018). Many low-income countries with valuable natural resources have historically received large amounts of aid from OECD donors (Fig. 1).

Poor countries endowed with abundant fossil fuels or mineral reserves can have difficulties in converting their resource wealth into other forms of physical or human capital, because these subsoil assets take time to be managed, extracted and traded. Foreign aid can thus provide a complementary source of immediate liquidity for development. On the other hand, the provision of external finances has the potential to hinder political accountability, and ultimately economic development especially in countries with weak institutions.

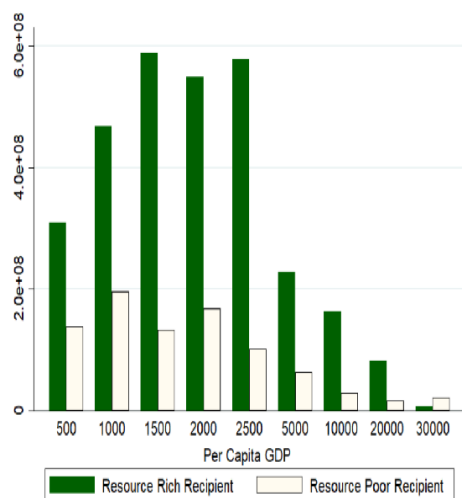


Figure 1 – Average aid flows (1970-2010) from OECD donors (Ravetti, Sarr and Swanson 2018)

Aid and Natural Resources: two potential curses?

Both natural resources and foreign aid constitute a form of government revenues that can be problematic for two reasons: first, they both make politicians less accountable to their domestic tax base, since the government's budget is independent from the country's general economic productivity. Second, they expose public finances to international volatility, such as fluctuations in global commodity prices, or decisions in the donors' community (Morrison, 2009). Aid and oil differ in several dimensions, and empirical studies find various forms of the «resource curse» (Venables 2016) and the «aid curse». Djankov et al. (2008) find that aid is even worse than oil for its adverse effects on democratization, but recent evidence shows that aid alone is not necessarily detrimental for democracy or political institutions (Kersting and Kilby 2014, Jones and Tarp 2016).

Weak institutions and distorted incentives

The political economy risks deriving from foreign aid and resource wealth are more salient in countries with weak governance, such as non-democratic states that own oil or other resources. These countries receive substantial amounts of aid, despite their poor institutional environments (Fig. 2). For example, Angola, ranked 125 of 167 in the Economist Democracy Index, receives aid from multiple donors while remaining the second largest oil exporter in Sub-Saharan Africa (Economist, 2017). 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. Dictators face uncertainty in the duration of their tenure, always fearing

a *coup d'état*. Thus, they often adopt corrupt political behaviours, such as patronage, while plundering as rapidly as possible the resources of their country, without investing in long term development. This behaviour can have detrimental effects on political stability and ultimately on development. Aid windfalls have been found to reduce outbreaks of political discontent against dictators and regime collapse (Ahmed 2012). In the case of natural resources, instead, new discoveries seem to lead to revolutions and enhanced political instability in weak institutional settings (Cabral and Hauk 2011).

Looting and political instability

One of the main risks of providing aid liquidity to non-democratic resource-rich countries is that their unchecked elites can easily embezzle these funds. Some estimates show that, in Sub Saharan Africa, a one percentage point increase in natural resource rents raises the illicit capital flight-to-GDP ratio by more than 10% (Ngondjeb and Nlom, 2017). There are numerous historical cases of autocrats who looted their countries' resources and aid, and lost power in coups, revolutions or exile: for example, Mohammed Reza Pahlavi, Shah of Iran, received continuous American foreign aid and military support, and looted an estimated \$35bn before fleeing the country after the 1979 Islamic Revolution (Dulin and Merckaert, 2009). Mohamed Suharto, President of oil-rich Indonesia, received around \$4bn a year by the US while presiding over a brutal and corrupt regime, and was forced out of power after plundering an estimated \$15–35bn (Transparency International, 2004).

Natural resources, aid loans and odious debt

Another crucial aspect of this problem is that, even when dictatorial regimes end, countries are bound to repay the debts accumulated by their previous governments. The literature defines 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 hydrocarbons and minerals can act as collateral for repayment. Financial flows from private institutions have already been linked to this problem: lending from international credit markets to resource-rich countries reduces the incentives for autocrats to invest in development, increasing political instability and worsening the economic outlook of the nation (Sarr et al. 2011).

Structure of aid and fungibility

A recent article by Ravetti et al. (2018) suggests that even foreign aid loans go hand in hand with political turmoil and poor development prospects in resource-rich autocracies. The structure of aid has a pivotal role: aid donations in the form of grants or for humani-

tarian purposes do not relate to political instability or lower growth, in conjunction with resource revenues. However, aid loans and other types of aid, such as infrastructure or multiple sectors' aid, are associated with significantly worse political and economic outcomes. Other studies similarly argued that the purpose and fungibility of aid flows matter, as they capture donors' intentions (Bermeo 2011, 2016). After the Cold War, the strategic aim of aid has changed, and the donor's community should

carefully consider these political economy forces (incentives to loot funds in weak institutional environments, debt accumulation from aid loans that treat resources as collateral, the effect on political instability, etc.) to improve the effectiveness of aid assistance and better understand the role of new donors like China.

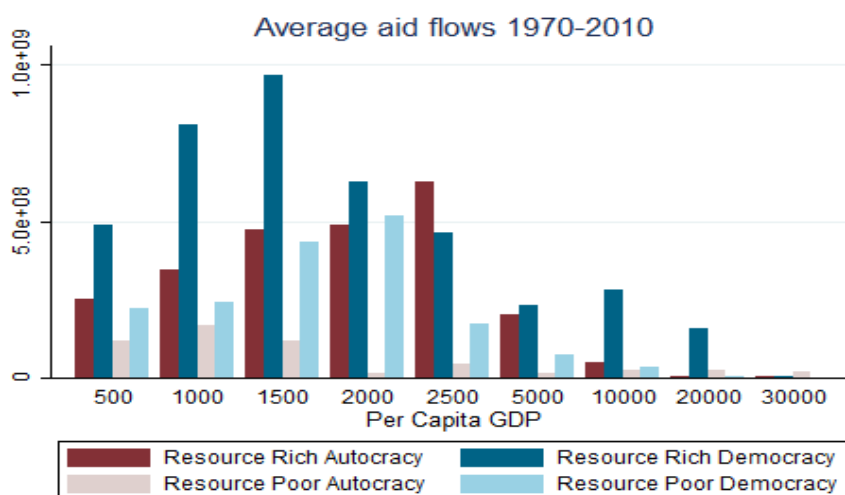


Figure 2 – Aid flows (1970-2010) by resource wealth and political regime of recipient (Ravetti, Sarr and Swanson 2018)

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