The Political Economy of Unearned Foreign Income

An Application for Non-oil Producing Muslim States

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Abstract

This entry argues that foreign aid and remittances constitute a form of "unearned foreign income" that has affected the public finances and shaped political outcomes in the non-oil producing Muslim countries in North Africa, the Middle East, and South Asia. Aid and remittance flows have stabilized authoritarian rule in this "broader" Middle East and North Africa (MENA) region by reducing the likelihood of conflict, fostering corruption, and extending the duration of non-democratic governments.

Keywords

Foreign aid; Remittances; Unearned income; Governance; Non-democracy

JEL

F3; P16; F24; F35

Introduction

Unearned foreign income comprised of foreign aid and workers' remittances is an important source of income for many developing countries. Increasingly, scholars are evaluating the macro-*political* consequences of these capital inflows. One strand of this nascent scholarship conceptualizes aid and remittances inflows as a form of "unearned income" with non-tax like properties for government finances. In doing so, this strand of research links the political economy ramifications of aid and remittances to the politically pernicious effects associated with rentier states (e.g., authoritarianism, corruption, political violence). Building on this conceptualization, this entry argues that aid and remittance inflows have entrenched authoritarian governance and rule in many non-oil producing Muslim countries in North Africa, the Middle East, and South Asia (a region, I will call "broader MENA.")

Unearned Foreign Income and Authoritarian Governance

Aid and Remittances as Unearned Foreign Income

Unearned Income Unearned income is a concept in economics that has different meanings and implications depending on the theoretical framework used. Political economists broadly view unearned income as non-tax government revenue

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(e.g., Madhavy 1970; Besley and Persson 2010). For them, the distinction between non-tax and tax revenue has implications for political development: governments that derive a greater share of their revenues from taxation tend to be more democratic and more accountable to their populations (e.g., Tilly 1992).

Foreign Aid as Unearned Foreign Income Foreign aid is the international transfer of capital, goods, or service from a country or international organization ("donor") for the benefit of the recipient country (i.e., its government, its population). These transfers can involve financial resources, technical advice and training, or commodities (e.g., food or military equipment). In many instances, the resources can take the form of grants or concessional credits (e.g., export credits). In practice, the most common type of foreign aid is official development assistance (ODA), which aims to promote development and combat poverty. The primary source of ODA is bilateral grants from one country's government to another, and while a small fraction of aid may "bypass" a recipient government to a non-government organization, the vast majority of aid directly enters a recipient government's revenue. Since this revenue is foreign and not derived from domestic taxation, it fits the definition of unearned income.

Remittances as Unearned Foreign Income Whereas foreign aid is a transfer of resources between governments, remittances do not directly enter a government's revenue base. A remittance is a transfer of money by a foreign worker to an individual in his or her home country. Frequently, this transfer occurs between family members. Measuring remittance flows can be arduous since they may flow through unofficial channels and many recipient (developing) countries often lack the capacity to accurately track, record, and tax these capital inflows (Chami et al. 2008). However, remittances may enter a government's revenue base indirectly. For instance, via an expenditure-switching mechanism, a government may reduce its provision of certain welfare goods (e.g., health care or education), forcing migrant households to purchase them instead. This mechanism frees resources for governments to spend elsewhere, such as on the military and government salaries (Abdih et al. 2012; Ahmed 2012).

Unearned Income and Authoritarian Governance

Unearned Income and Governance The ability to "collect" revenue is central to the viability of any state (Levi 1988); without it, the state cannot carry out its basic functions such as providing security. States can collect their revenue from taxation (e.g., from individuals, firms, land, capital, consumption, international trade) and non-tax sources (e.g., revenues from the state's production of natural resources, foreign aid). On the latter, the availability of unearned income as a viable and important source of government revenue (especially since the nationalization of oil production in many countries during the 1970s) has sparked an active research agenda that theorizes and empirically evaluates the effects of unearned income on politics, such as democracy, institutions, and civil war (Ross 2013).

Scholars of the Middle East were the first to articulate the relationship between unearned income and democracy, while investigating whether the prevalence of "rents" contributed to authoritarian governance in that region (Mahdavy 1970). The central argument in the rentier state literature is that governments funded by external rents are freed from the need to raise taxes, which makes them less accountable to their citizens and to less committed to democratic governance. Many qualitative and quantitative studies have empirically substantiated this relationship (see Ross 2013 for an overview).

This negative relationship between unearned income and democratic governance may depend on the quality of preexisting institutions. For instance, Tornell and Lane (1999) advance a model showing how, upon receiving a positive shock to fiscal capacity (e.g., a resource boom, foreign aid), a state with weak institutions may suffer from a "voracity effect" in which powerful groups compete for and squander the windfall, in addition to diminishing any pro-growth effects. Focusing on the political ramifications, Robinson et al. (2006) formulate a parallel model demonstrating that when institutions are weak ex-ante, increases in unearned income lead to excessive public employment and patronage (e.g., corruption). In these weak institutional settings, unearned income can finance additional forms of patronage goods such as the co-option of political rivals, religious leaders, business elites, and the military. The latter can strengthen a government's repressive capacity to fend off revolutionary threats (Bueno de Mesquita et al. 2010).

Unearned Foreign Income and Patronage in Non-democracies Patronage politics is particularly salient for political survival and stability in non-democracies (Bueno de Mesquita et al. 2003). As a consequence, when compared to governments in democracies, governments in autocracies will place greater weight on expenditures for patronage in their spending decisions. Building on this framework, Ahmed (2012) develops a game theoretical model in which foreign aid and remittances expand a government's revenue base (akin to traditional forms of unearned income) and finances patronage in non-democratic regimes. Unearned foreign income does so via two distinct channels: an income effect and a substitution effect.

As a transfer of resources between governments, aid directly increases government revenue. And since governments in autocracies tend to allocate a greater share of their revenues towards patronage, a higher share of their aid is spent towards patronage goods. This process constitutes an "income effect."

In contrast, remittances do not directly enter a government's revenue base. Rather, the model identifies a substitution effect. Households will spend a portion of their remittance income on certain substitutable welfare goods (e.g., better quality health care and/or education for their children). The government "observes" these expenditures and marginally decreases its own provision of that welfare good, diverting those unused funds towards patronage. In the model's equilibrium, autocratic governments have a greater incentive (i.e., higher utility) to divert resources towards patronage from higher levels of remittance income. Thus, the substitution effect is magnified in non-democratic regimes. In combination, Ahmed shows that higher levels of aid and remittances finance more patronage in non-democracies. Thus, aid and remittances should stabilize governments in non-democracies, for example, by lowering the likelihood of institutional change and government turnover.

Unearned Foreign Income in the Broader MENA Region

Within this theoretical framework, the next two sections present empirical evidence linking unearned foreign income to non-democratic governance in the non-oil producing Muslim countries in North Africa, the Middle East, and South Asia; a region I will call "broader" Middle East and North Africa (MENA).

Unearned Foreign Income in Broader MENA

Since the 1970s, countries in the broader MENA region have received large sums of unearned foreign income; a substantial portion of which originates from oil producing countries in the Persian Gulf (e.g., Saudi Arabia, Kuwait, the United Arab Emirates). And, oil price booms and busts explain a large share of the temporal variation in these capital flows.

Gulf oil producers ramped up their aid disbursements following the first oil price shock in 1973. Between 1974 and 1994, Gulf donors doled out 1.5% of their GDP, which amounted to 13.5% of all aid given out over this period – overwhelmingly, this aid favoured non-oil producing Muslim countries (Neumayer 2003). Certainly, some of the motivation for this assistance was political, as the Gulf countries were at the same time trying to subdue unrest stemming from the huge inequality among their co-religionists (between the oil haves and have-notes), and seeking to "assure them[selves] a clear position of dominance within the Muslim world" (Kepel 2002, 69–70). Much of this Gulf aid looked like unearned income (e.g., oil rents) flowing to the state, as it came primarily in the form of block grants to recipient governments with comparatively few strings attached (Hunter 1984).

The oil boom in the 1970s also affected remittance inflows into the broader MENA region. In the aftermath of the 1973 oil crisis, labour from different countries in North Africa, South Asia, and Middle East migrated in great numbers to the oil-exporting countries in the Middle East. The first wave of workers (totaling about 500,000) migrated from non-oil producing Gulf States, such as Jordan, Palestine, and Yemen. In the latter part of the decade, Gulf States began to recruit a large number of South Asian workers from India, Pakistan, and Bangladesh. For example, it is estimated that the number of Pakistani workers jumped from roughly 500,000 in 1975 to over 1.25 million in 1979. By the early 1980s, there may have been some 3.5–4.65 million migrants, in a combined labour force of 9–10.2 million workers (Choucri 1986). This large movement of labour generated large capital flows in the form of workers' remittances from Gulf oil producers to a variety of non-oil producing labour exporting countries in the Middle East (e.g., Jordan), Africa (e.g., Mali), and South Asia (e.g., Pakistan).

Temporal Variation

Inflows of aid and remittances into the broader MENA region have varied over time and tracked the world price of oil. Figures 1 and 2 depict movements in the price of oil (right axis) and superimpose the *aggregate* annual amount of aid (Fig. 1) and remittances (Fig. 2) into the broader MENA region (measured as a share of the region's GDP). In the early 1970s, aggregate aid and remittance inflows were quite low but then increased sharply following the first oil shock in 1973. These inflows remained high through about 1984 and then declined after 1985 as oil prices tanked. As oil prices recovered in the 1990s, aid and remittance flows began to rise again. In the 2000s, the correlation (positive) between oil prices and these capital flows (in particular aid) tends to weaken. On balance, Figs. 1 and 2 suggest a strong correlation between oil price and aggregate flows of unearned foreign income into the broader MENA region.

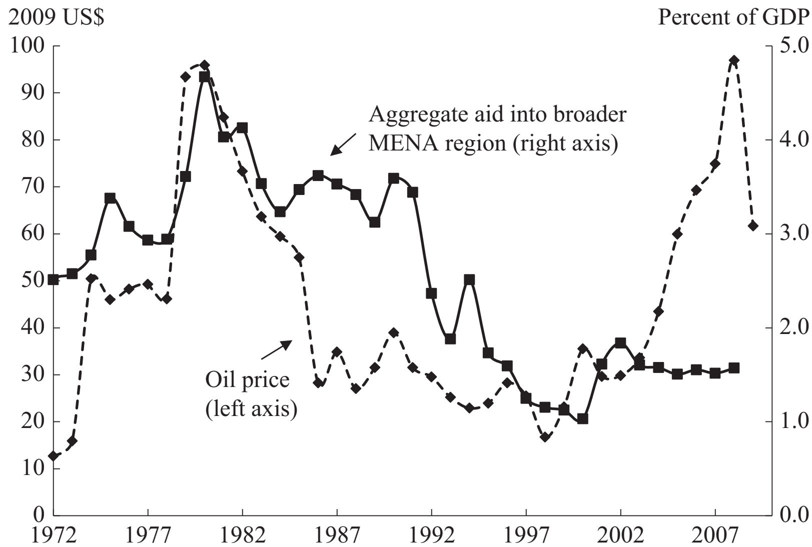
Interestingly, the recipients of oil price-induced aid and remittance flows were primarily non-oil producing Muslim countries. Conversely, similar "shocks" resulting from variation in oil prices did not affect aid and remittances to non-oil producing *non*-Muslim nations. Figure 3 provides such evidence. It plots movements in oil prices (left axis) and superimposes the difference in average of foreign aid and remittance inflows between non-oil producing Muslim and non-oil producing non-Muslim countries (right axis). A positive differential implies the "typical" Muslim countries received higher amounts of aid and remittances (as a share of GDP) relative to the typical non-oil producing non-Muslim recipient.

Figure 3 shows that between 1970 and 2000, this "differential" in aid and remittances tracks the price of oil. As oil prices rose in the 1970s, so did the differential. Moreover, it remained large and positive during the decade of high oil prices (1974–1984). Countries in the broader MENA region tended to receive substantial inflows of aid and remittances (i.e., between 6% and 10% of additional GDP per annum) than non-Muslim recipients. As oil prices plummeted after 1986, so did the differential. On average, Muslim and non-Muslim countries tended to receive similar amounts of aid and remittances (as a share of their respective country GDPs).

Evidence

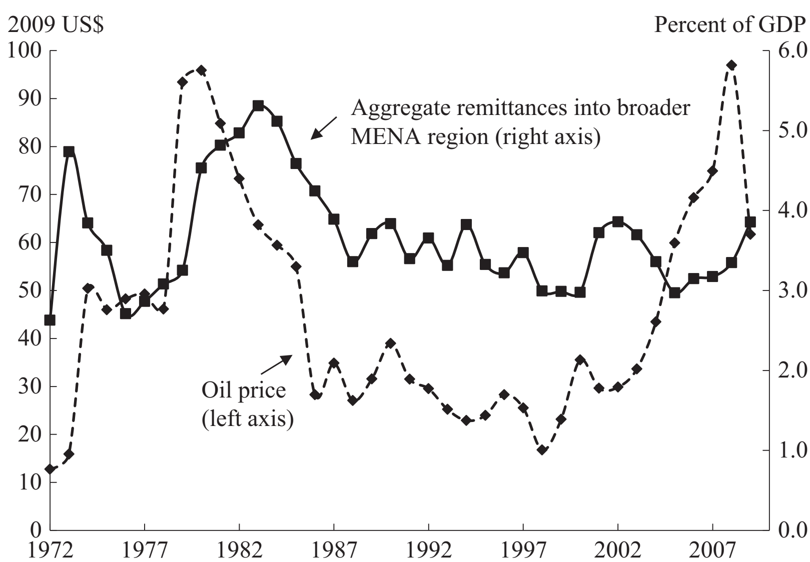
Establishing Causality

Evaluating the causal effect of unearned foreign income on political outcomes is problematic as these income flows are plausibly endogenous with the "politics" in the receiving states. Gauging a causal effect therefore requires some plausibly exogenous source of variation in these income flows that is uncorrelated with underlying political and economic conditions in the receiving states. Figures 1 and 2 show that foreign aid and remittances inflows into the broader MENA region are correlated with world oil prices, and these prices are plausibly exogenous to political and economic conditions in poor, non-oil producing Muslim countries (e.g., Jordan, Bangladesh). Thus, variation in oil prices can serve as a plausibly exogenous source of variation in aid and remittance flows to the broader MENA region. Moreover, Fig. 3 shows that in comparison to



Notes: Foreign aid includes disbursements from all donors (as reported by the OECD) into the broader MENA region. This includes disbursements from both OPEC and non-OPEC (e.g., the United States, the UK) donors. Data from the World Bank World Development Indicators and the author's calculations

The Political Economy of Unearned Foreign Income, Fig. 1 Aggregate foreign aid in the "broader MENA" region



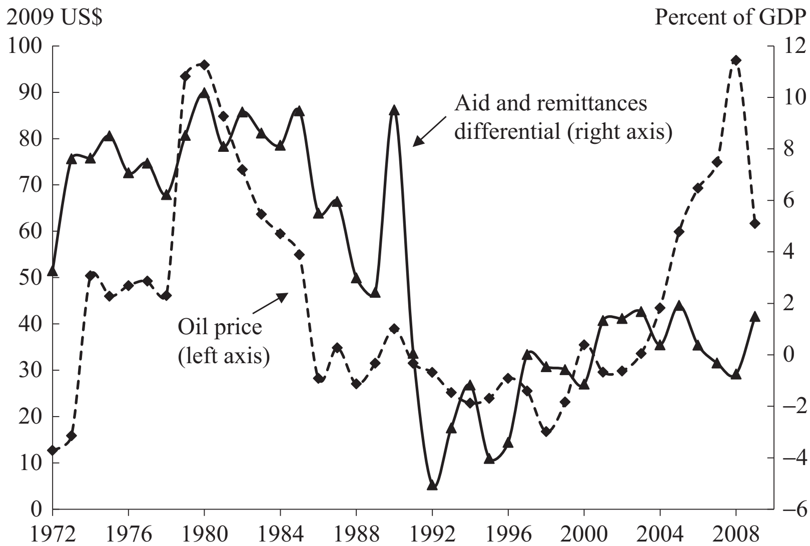
The Political Economy of Unearned Foreign Income, Fig. 2 Aggregate remittances in the "broader MENA" region (*Notes*: Remittances include flows from all countries (as reported by the World Bank) into the broader MENA region. This includes remittances from the Persian Gulf and elsewhere (e.g., Western Europe and North America). Data from the World Bank World Development Indicators and the author's calculations)

non-Muslim countries, Muslim countries were the main beneficiaries of the oil-price induced aid and remittance "shocks." Indeed, several studies leverage these facts to evaluate the causal effect of aid and remittances on various political outcomes in the broader MENA region.

Foreign Aid and Civil War

Ahmed and Werker (2015) evaluate whether foreign aid affects political stability. They argue that aid can "buy" political stability (often by strengthening a state's repressive capacity and autocratic institutions), while declines in aid foster

The Political Economy of Unearned Foreign Income, Fig. 3 Difference in unearned foreign income between non-oil producing Muslim and non-Muslim recipients (*Notes*: Data from the World Bank World Development Indicators and the author's calculations)



instability. They measure instability using the incidence of civil war. To identify the causal impact of aid on conflict, they leverage a difference-in-differences (DID) strategy to show that periods of higher aid receipts (due to higher oil prices) are associated with a lower probability of conflict in the broader MENA region.

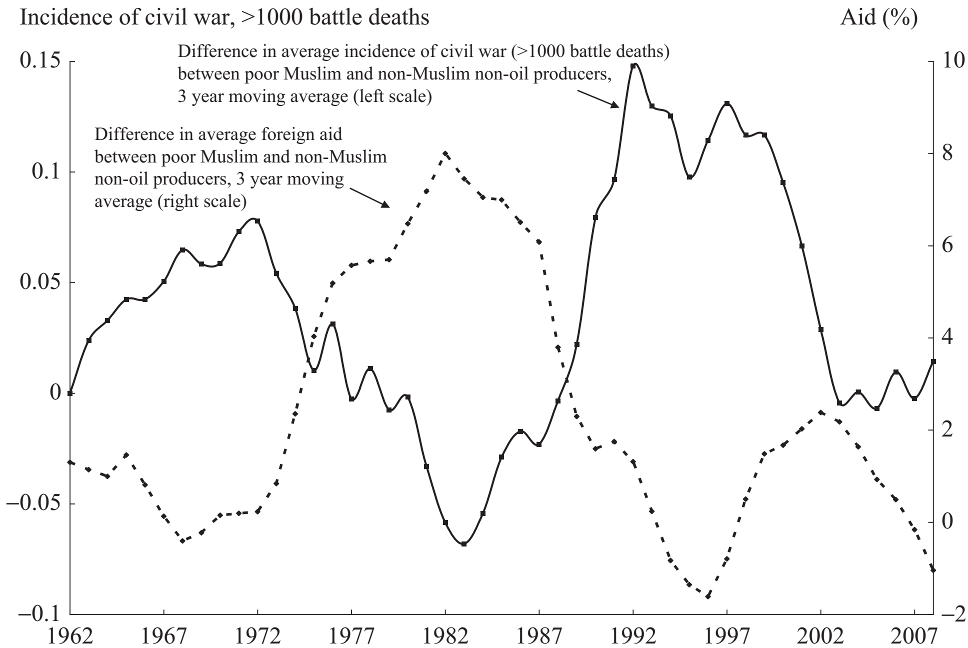
Figure 4 captures their core findings. The figure examines the relationship between the aid differential and the conflict differential across Muslim and non-Muslim countries. Muslim countries in the broader MENA region experienced less conflict than non-Muslim countries when they received comparatively more aid. As the aid differential reversed due to lower oil prices from the mid-1980s until the early 2000s, Muslim countries were substantially more likely to experience civil war.

The differential effects of aid on political violence are large and statistically significant. Ahmed and Werker (2015, Table 1) present DID estimates in which the aid windfall between 1973 and1985 made countries in the broader MENA region 7 percentage points more stable (i.e., less conflict prone) compared to non-Muslim aid recipients. The end of the windfall fostered a relative rise in political violence as Muslim countries became 11 percentage points more likely to be engaged in civil war, while non-Muslim countries became slightly more stable (around 1 percentage point).

Remittances and Corruption

Autocrats frequently permit corruption as a strategy of political survival. It can be a means to reward loyal supporters and erode the provision of public goods in favour of private government goods, such as patronage (Bueno de Mesquita et al. 2003). Thus, given the viability of corruption as a strategy to maintain political stability in autocracies, Ahmed (2013) investigates whether or not remittances may be a conduit for corruption. To that effect, Ahmed interacts oil prices with a Muslim country's distance to Mecca to construct a cross-national and time-varying instrumental variable for remittances received by countries in the broader MENA region. To hone in on patronage-based government corruption, Ahmed uses the ICRG corruption index, which measures "actual or potential corruption in the form of excessive patronage, nepotism, job reservations, 'favor-for-favors', secret party funding, and suspiciously close ties between politics and business."

Leveraging this research design, the paper establishes two key results. First, remittances foster corruption, particularly in countries with pre-existing authoritarian politics. Second, remittances do so by allowing governments to divert spending from welfare goods to patronage. Table 1 reports a snapshot of the econometric analysis from Ahmed (2013), highlighting these main findings. The



The Political Economy of Unearned Foreign Income, Fig. 4 Foreign aid and civil war (Source: Fig. 5 in Ahmed and Werker (2015))

coefficient estimate in column 1 implies that a 3-percentage point increase in aggregate remittances raises the corruption index by about 1 index point. Column 2 evaluates whether a country's preexisting quality of authoritarian politics magnifies the effect of remittances on corruption. The positive coefficient on the interaction effect (Remit. x Autocracy) implies that remittances received in countries with more autocratic politics has a *greater* causal impact on corruption.

The remaining columns in Table 1 show that a substitution effect is a plausible channel through which remittances foster corruption. Columns 3 and 4 show that remittances cause governments in the MENA region to decrease their expenditures on welfare goods (column 3) and shift those to patronage in the form of greater compensation for government employees (column 4). The latter is a common measure of patronage in developing countries, as it frequently reflects the government's incentives to channel spending to targeted constituencies (Keefer 2007). Remittances are also negatively associated with government expenditures on health care and education (Ahmed 2013, Table 11).

Unearned Income and Political Stability

Finally, in combination, foreign aid and remittances have stabilized governments in the broader MENA region. Table 2 below reports the core results from Ahmed (2012). That paper employs an instrumental variables strategy to show that greater inflows of unearned foreign income in the broader MENA region caused governments to experience a lower likelihood of losing office between 1973 and 2004. The coefficient estimate in column 1 implies that a 1 percentage increase in unearned foreign income (relative to GDP) lowers the likelihood that a government will fall out of power by about 5 percentage points (in that calendar year). Moreover, this stabilizing effect is larger for governments in countries with stronger authoritarian political institutions (column 2). Since many of the governments in the MENA region were authoritarian over the sample period, the results in columns 1 and 2 imply that unearned foreign income increased the duration of autocrats in non-oil producing Muslim countries. King Hussein in Jordan, as well as the military dictatorships in Bangladesh and Pakistan during the 1970s and 1980s, illustrates this claim.

The Political Economy of Unearned Foreign Income, Table 1 The impact of remittances on authoritarian governance

Dependent variable	Corruption		Transfers	Salaries
			(% Gov. expenditures)	
Method of estimation	2SLS	2SLS	2SLS	2SLS
	(1)	(2)	(3)	(4)
Remittances (% GDP)	0.323	−0.143	−3.248	3.39
	(0.151)**	(0.066)**	(1.258)**	(0.876)***
Autocracy		−11.798		
		(0.178)*		
Remit. × Autocracy		1.361		
		(0.618)**		
No. obs	863	863	305	315

Notes: Results from Ahmed (2013), Tables 6, 8, and 11. Estimation via 2SLS. Robust standard errors clustered by government are reported in parentheses. *, **, *** = Significant at 10, 5, 1%, respectively. All specifications control for GDP per capita (% annual), log GDP per capita (1995 US$), log population, POLITY autocracy score, year trend, and country fixed effects. Remittances are instrumented with p(oil)*distance to Mecca. In columns 1 and 2, the dependent variable is ICRG corruption index (range: 1–6) where a higher value implies greater corruption. In column 3, the dependent variable is government transfers and subsidies (% government expenditures). In column 4, the dependent variable is government compensation of employees (% government expenditures)

The Political Economy of Unearned Foreign Income, Table 2 Unearned foreign income and authoritarian stability

Dependent variable	Government turnover		Transfers (% gov exp.)
Method of estimation	2SLS	2SLS	2SLS
	(1)	(2)	(3)
Aid and remit. (% GDP)	−0.046		−1.509
	(0.022)**		(0.785)*
Aid and remit. × Autocracy		−0.294	
		(0.135)**	
Aid (% GDP)			1.363
			(0.777)*
No. obs	1639	1639	315

Notes: Results from Ahmed (2012), Tables 4 and 6. Estimation via 2SLS. Robust standard errors clustered by government in parentheses. *, **, *** = Significant at 10, 5, 1%, respectively. In columns 1 and 2, the dependent variable is equal to 1 if the government loses office in that year, and zero otherwise. In columns 1 and 2, the specifications control for log GDP per capita (1995 US$), GDP per capita growth (% annual), duration splines, and indicator variables for finite-term, incidence of low and high internal discontent, country and year fixed effects. Splines are duration time, duration time squared, and duration time cubed. Column 3 controls for log GDP per capita (1995$). These coefficients and a constant are not reported. Aid and remittances are instrumented with the p(oil) × Muslim country dummy

Column 3 presents evidence of both an income effect and a substitution effect associated with unearned foreign income inflows. In this specification, the dependent variable is a government's expenditures on transfers and subsidies as a share of total government expenditures. A negative regression coefficient implies that the variable shifts the allocation of government spending away from the provision of welfare goods to another type of government spending. Given this interpretation, the negative coefficient on aid and remittances implies that increases in unearned foreign income reduce a government's share of expenditures on welfare goods. This observation is consistent with a substitution effect. Of course, as Ahmed (2012) explicitly models, an autocrat may want to spend some fraction of its aid on welfare goods. The positive coefficient on aid is consistent with this income effect.

Conclusion

How governments derive their revenues can have important political ramifications. The availability of unearned income or non-tax revenue, in particular, can make governments less accountable to their populations and fund various strategies of political survival (e.g., patronage, repression). Governments in these states tend to be non-democratic. Building on this framework, this entry argues and presents evidence that foreign aid and remittances have constituted a form of unearned foreign income that has fostered authoritarian politics in countries in the broader MENA region.

These findings offer broader insights on the political economy of unearned income. First, since a large share of the aid and remittances emanated from oil producing countries in the Persian Gulf (and was driven primarily by movements in oil prices), it stands to reason that the pernicious political and economic effects of the "resource curse" can be exported abroad via capital outflows (Ahmed et al. 2016). Second, since non-oil producing Muslim countries comprised the unique recipients of a shock in unearned foreign income in the 1970s (relative to non-oil non-Muslim countries), the processes described in this entry offer a plausible explanation for the "democratic deficit" that has emerged in Islamic states (Huntington 1993). Finally, while this entry has focused on the political ramifications of aid and remittances in the broader MENA region, there is no reason to assume that these effects manifest themselves only in this region (e.g., Ahmed (2017); Doyle 2015). Thus, a fruitful area of future research will assess whether or not unearned foreign income generates similar effects in other regions with different underlying political structures.

See Also

- ▶ Development Economics
- ▶ Dutch Disease and Foreign Aid
- ▶ Foreign Aid

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