I

The Politics of International Capital

Attracting financial capital is essential for economic growth in developing countries, but tragically can often foster nondemocratic politics. Consider, for example, the impact of foreign aid. Since 2008 Ethiopia has been one of the largest recipients of US aid in Africa, averaging around $80 million per year. While the aid is intended to foster economic development, practitioners are growing increasingly wary of its political ramifications. Before the Ethiopian national election in 2010, foreign donors were charged with “subsidizing a regime that is rapidly becoming one of the most repressive and dictatorial on the continent.” Western aid officials “seem reluctant to admit that there are two Prime Minister Meles Zenawis. One is a clubbable, charming African who gives moving speeches at Davos and other elite forums about fighting poverty and terrorism. The other is a dictator whose totalitarianism dates back to Cold War days.”

Ethiopia is hardly the exception in terms of aid being “misused” by governments for nefarious political purposes. During the Cold War, foreign aid funded General Siad Barre’s highly repressive dictatorship in Somalia. “Foreign aid,” observed one Somali scholar, “provided the glue that held the system together in spite of internal waste and corruption.” The emergence of “new” donors after the Cold War has seemingly not changed the politically pernicious effects of aid. One recent study, for example, finds that African leaders disproportionately channel Chinese aid to finance “white elephant” projects.

1 In Development with Freedom, Human Rights Watch, for example, provides extensive documentation about how the Ethiopian government uses aid to repress. Based on interviews with 200 people in 53 villages and cities throughout the country, the report concludes that the Ethiopian government uses aid as a political weapon to discriminate against nonparty members and punish dissenters, sending the population the draconian message that “survival depends on political loyalty to the state and the ruling party.” For example, more than fifty farmers in three different regions said that village leaders withheld government-provided seeds and fertilizers (and even microloans) because the farmers did not belong to the ruling party; moreover, some were asked to renounce their views and join the ruling party in order to receive assistance.


4 For example, see Bermeo (2017) on the landscape of aid after the Cold War.
projects, especially in the leaders’ birthplaces. This fits a broader narrative that aid is misused, leading many experts and practitioners to conclude that despite more than fifty years of development assistance, foreign aid has been ineffective and “dead.”

The misuse of foreign aid by recipient governments has led to a championing of other types of external development finance that seemingly bypass these governments altogether. One such flow is migrant remittances, which flow to households and have been heralded as a “new development mantra.” With regard to their political ramifications, remittances – as a source of household income – have the potential to shape individual political behavior and may be a conduit for political liberalization. This view has percolated to the upper echelons of public policy. In a speech promoting human rights in Cuba, for example, President Obama declared that “increasing the flow of remittances and information to the Cuban people” constitutes “measures that decrease the dependency of the Cuban people on the Castro regime” and that efforts to promote “contacts between Cuban-Americans and their relatives in Cuba are means to encourage positive change in Cuba.” For example, by decreasing the population’s dependency on the regime (e.g., through its provision of lower quality public education), remittances can help free government resources to “reward” its supporters through state patronage. Yet, despite President Obama’s positive disposition to remittances as a source of democratization (i.e., “positive change”), Cuba has successfully transitioned from the dictatorial rule of Fidel Castro to that of his brother, Raul. In this instance, an individual’s detachment from the ruling authoritarian regime may have actually and tragically empowered it.

Of course, migrant remittances are not the only type of external capital that bypasses a government’s coffers. Another is foreign direct investment (FDI), capital that accrues to firms in host countries. Unlike other types of foreign capital that can enhance the productivity and profits of firms (e.g., portfolio investment), FDI is unique in its longer-term investment horizon. By definition, FDI entails an ownership stake in an enterprise abroad, frequently with investments in immobile factors of production, such as factories, oil wells, and the training of workers in the host country.

The “stickiness” of FDI can be a double-edged sword. On the one hand, in an effort to attract FDI, governments often undertake reforms that increase transparency, reduce the state’s powers to expropriate property, and raise the government’s commitment to the rule of law. On the other hand, the stickiness

7 An exception is Dietrich (2016), who documents the recent trends of aid “bypassing” governments. Bypassed aid, however, remains a very small share of total foreign aid.
11 Ahlquist (2006) provides an excellent account for the longer-term investment horizon of FDI and its political implications.
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of FDI may advance a government’s development goals and political strategies, especially in nondemocracies. For example, on coming to power in Brazil in 1965, the military actively courted FDI as a means of raising economic growth and gaining the support of the country’s business elite. The resulting “Triple Alliance” among the military, domestic business elites, and foreign investors sustained the military’s dictatorial rule in Brazil for nearly two decades. Such a governing strategy is not unique to Brazil: dictators in Indonesia and Egypt have also successfully leveraged FDI to sustain their dictatorships.

These anecdotes – foreign aid in Ethiopia, remittances in Cuba, and FDI in Brazil – suggest that foreign capital can prop up dictators. But how widespread is this phenomenon? What are the channels through which governments can harness these different “types” of capital flows to enhance their survival prospects? After all, these flows accrue to different actors in a receiving country (i.e., the government, migrant households, and firms), which can require different government strategies. And from an empirical perspective, given that a country’s socioeconomic and political characteristics affect its inflows of foreign aid, remittances, and FDI – thus introducing issues of endogeneity – is it possible to gauge the causal impact of international capital on authoritarian politics? This book addresses these questions.

From the perspective of economic welfare, answering these questions is important because financial capital – which can also augment technological and human capital – is essential to economic growth and progress, especially in most capital-scarce developing countries. For these countries, foreign capital can help fill shortfalls in domestic saving (e.g., through foreign aid), technology (e.g., through FDI), and investments in human capital (e.g., through remittances). These capital flows have grown tremendously for developing countries in the past forty years.

Figure 1.1 plots the aggregate amount of foreign aid, remittances, and FDI to 130 developing countries since 1970. In the 1970s, developing countries received about $31.5, $11.5, and $11 billion in foreign aid, remittances, and FDI.

12 As described by Evans (1979), foreigners tended to invest in firms and sectors controlled by large and powerful business leaders/families in Brazil.
13 For Indonesia, see Robison (1986). For Egypt, see Marshall and Stacher (2012).
14 Among development economists, a “gap” in investment due to insufficient national savings is a leading reason why developing countries are poor. Foreign aid is a means to fill this savings/investment gap (Chenery and Strout 1966). In contrast, FDI injects financial capital to firms and is frequently accompanied by the transfer of new technologies and firm-specific assets (e.g., managerial expertise, patents) that enhances the productivity and profits of domestic firms in receiving countries. Remittance income can be spent by migrant households in numerous ways, including on investments in education and/or better health care, both of which enhance an individual’s human capital (Acosta et al. 2007).
15 Appendix Table A1 lists the sample of developing countries that receive nonnegative amounts of aid, remittances, and FDI. These countries span Central and South America; the Caribbean; Africa; the Middle East; Central Europe; and Central, South, and East Asia.
FDI, respectively. All three capital inflows grew modestly in the 1980s, with especially dramatic increases in remittance and FDI since the 1990s. By 2010, aggregate inflows of aid, remittances, and FDI to developing countries amounted to $84, $312, and $711 billion, respectively. Since 2010, FDI inflows have exceeded aid and remittances, but tend to be more volatile. In contrast, foreign aid and remittances are sometimes more stable forms of external finance.

Foreign capital varies across countries. Figure 1.2 shows the average “intensity” of international capital for several developing countries. For each country in the figure, the corresponding numerical value is the average amount of aid, remittances, and FDI (as a share of GDP) a country received between 2000 and 2015. For a few countries, international capital comprises a significant share of their national economies. For example, foreign capital comprises about 40 percent of Afghanistan and Tajikistan’s national income. At the extreme, only 7 percent of Liberia’s income is produced domestically. Although Liberia is an outlier, international capital is nonetheless an important source of national income in many other countries. For instance, about one out of every five dollars of national income in Honduras, Jamaica,

16 All figures are in 2010 US dollars.
Figure 1.2. Cumulative inflows of international capital, 2000–2015.

Notes: The figure depicts the cumulative inflows of foreign aid, remittances, and FDI as a share of gross domestic product (GDP) for an arbitrary selection of developing countries across regions of the world (South America, Africa, the Middle East, and Asia). Each number reports the average share between 2000 and 2015. Calculations use data from the World Development Indicators.
Nepal, and Uganda comes from overseas. For “larger” developing country economies, international capital unsurprisingly comprises a smaller share of economic income (e.g., Brazil, China, Russia). These low shares, however, mask each country’s extremely large aggregate (nominal) capital inflows. Since 2000, China and Brazil have been the beneficiaries of more than $2.7 trillion and $1 trillion, respectively, in cumulative inflows of foreign capital.\(^1\)

The composition of international capital also varies across countries. For example, East Asian countries (e.g., China, Vietnam, Indonesia) tend to receive higher amounts of FDI compared to aid and remittances.\(^2\) These countries tend to be middle-income countries. In contrast, foreign aid and remittances tend to be a more important source of external finance in lower-income countries. Migrant remittances are important sources of foreign capital in many countries in Central America and the Caribbean (e.g., Honduras, the Dominican Republic, Jamaica), as well in South Asia (e.g., Nepal, Bangladesh). In many African countries, foreign aid constitutes a significant share of each country’s aggregate income. Since 2000, aid has accounted for more than 10 percent of Somalia and Uganda’s national income.

Together, Figures 1.1 and 1.2 demonstrate that foreign aid, remittances, and FDI are important sources of capital for developing countries. I will now discuss how these different flows – aid to governments, remittances to households, and FDI to firms – may be exploited by governments to their political advantage.

1.1 Argument

This book argues that international capital can foster authoritarian rule: international capital offers opportunities to strengthen autocratic institutions and governance, with the aim of helping prolong the political tenure of dictators.\(^3\) Building on revenue-based theories of political survival, I argue that autocrats can use international capital to finance strategies that bolster their political survival.\(^4\) For all governments, these strategies broadly entail

\(^1\) Inflows are measured in constant 2010 US dollars. Per annum, China and Brazil have received around $182 billion and $69 billion respectively since 2000. India, with annual inflows of about $75 billion since 2000 (equal to 5 percent of GDP per annum, or $1.1 trillion in cumulative foreign capital inflows), represents another recipient of large amounts of international capital.

\(^2\) The Philippines is an exception, as it receives significant amounts of remitted income from the Persian Gulf and North America.

\(^3\) Thus, measures of political institutions, governance, and political survival are important “dependent variables” investigated in this project.

\(^4\) If political actors are rational and “optimizing” their decision-making in equilibrium (a common assumption in positive political economy), then additional inflows of capital should _not_ threaten the political survival of dictators (as argued in this book). Empirically, this implies that additional amounts of international capital should _not increase_ the dictator’s probability of losing political office. This is equivalent to observing either a statistically significant decrease in the likelihood of losing office _or_ no discernible impact from an additional amount of international capital received in autocracies.
1.1 Argument

funding political “repression” and “loyalty,” which in turn can affect the quality of governance (e.g., lead to corruption) and features of political institutions (e.g., constraints on executive authority). However, the importance of each strategy is greatly influenced by the country’s underlying quality of democratic political institutions. In particular, relative to democrats, autocrats will allocate a greater share of their revenues to financing repression and accumulating loyalty.

Whereas foreign aid is given from one government to another, the transfer of funds is different for remittances and FDI. A government can siphon foreign aid directly into its revenue base, constituting an income effect. On the other hand, largely untaxed remittance income – which accrues to households – can allow a government to diminish its provision of welfare goods (e.g., health care, pensions) and divert those expenditures to policies that fund repression and accumulate loyalty, representing a substitution effect. By contrast, FDI can increase a government’s revenue in two ways – by creating opportunities for government rent extraction (rentier effect), and through higher wages that a government can tax. Moreover, the institutional features in nondemocracies, which incentivize autocrats to finance repression and patronage, magnify the utility of implementing these strategies in countries with authoritarian institutions.

As a consequence, this generates a conditional theory of international capital and government finances across regime types: relative to democrats, international capital can allow autocrats to fund various strategies that strengthen their prospects for political survival. As the empirical chapters demonstrate, some of these strategies include the deterioration of political rights (funded by foreign aid), the diminution of an autocrat’s constraints on power (induced by remittance income), and an augmentation in military spending (associated with inward FDI). Thus, international capital can affect both the quality of governance (e.g., corruption, political rights) and political institutions (e.g., executive constraints) in dictatorships, both of which affect a leader’s political survival.

The unified approach of this project reveals a broader detrimental impact of international capital than the study of any one capital flow, as developing countries are the recipients of varying amounts and compositions of foreign aid, remittances, and FDI. Scholars of foreign aid rightfully debate whether autocrats siphon aid directly to pay off loyal supporters, but this debate ignores

The ability of dictators to harness capital inflows to their political benefit parallels arguments that outflows can constrain dictators and foster democratic reforms (Boix 2003; Freeman and Quinn 2012). For instance, Freeman and Quinn argue that mobile capital can generate pro-democratic effects in autocracies with greater capital account openness and inequality. However, the greater “stickiness” (i.e., lower prospect of “exit”) of foreign aid, remittances, and particularly FDI weakens the potentially countervailing effects of mobile capital. Chapter 3 discusses other potential countervailing effects and the strategies employed in this book to address these concerns.
the substitution effect that remittances can provide to autocrats, and also ignores the ways in which FDI can generate rents for autocrats. A unified approach is theoretically and methodologically important because countries receive varying levels and compositions of these capital flows.  

1.2 EXISTING RESEARCH

Understanding how distinct types of international capital can affect authoritarian politics in a unified framework is largely absent in the extant literature. Rather, scholars tend to theorize on and analyze the political consequences associated with each capital flow in isolation.

Foreign Aid

While a large literature exists on the political economy of foreign aid, two strands are particularly pertinent for evaluating the effect of foreign aid on political survival and institutions. The first examines the conditions under which aid can be “effective” in fostering economic development. The workhorse models posit that aid can raise economic growth by filling the “investment gap” in recipient countries. An extensive empirical literature examines whether “aid causes growth” but a consensus on this issue remains elusive. However, as these studies have progressed over time, scholars have increasingly recognized that democratic governance in recipient countries can mediate the effect of aid on growth. In particular, aid is more likely to engender positive development outcomes in democratic settings. Democratic governments have stronger incentives to spend aid on public goods. In many instances, democratic governments are also more likely to undertake economic and political reforms “tied” to aid disbursements. Consequently, the effect of aid on beneficial economic outcomes may be “conditional” on the recipient’s underlying polity type.

Of course, the relevance of politics in the aid–growth nexus may be more direct. The second strand posits that aid can directly impact political survival and institutions; these, in turn, can affect a recipient’s economy. For instance,

22 From a methodological perspective, many studies looking at international capital flows in isolation suffer from omitted variable bias. For instance, if poorer countries tend to receive higher amounts of aid and remittances, omitting remittances from an econometric model that regresses foreign aid on political survival may overstate (“upward bias”) the effect of foreign aid.

23 For example, many studies examine the rationale and determinants of aid disbursements (e.g., Morgenthau 1962; Alesina and Dollar 2000; Werker 2012), while others gauge the impact of aid on “politics” (e.g., Bueno de Mesquita and Smith 2010a; Bermeo 2011; Ahmed and Werker 2015).

24 Roodman (2007) analyzes several studies to highlight the “fragility” in empirically evaluating the effect of aid on growth.

1.2 Existing Research

Morrison (2015) posits that foreign aid represents a source of nontax revenue that a government can spend on policies that lower the prospect of government termination and ward off institutional change. Moreover, foreign aid can diminish a government's tax effort, and concomitantly, its willingness to be politically accountable to its population. Viewed in this light, foreign aid as a source of nontax revenue is akin to government revenue generated from the exploitation of natural resources. In a panel of 108 countries from 1960 to 1999, Djankov et al. (2008) found that foreign aid deteriorates democratic institutions and that the "political curse" associated with aid may be larger than that related to oil.

Some scholars, however, remain skeptical regarding whether aid is like oil. One such area of differentiation is a donor's "intent." For instance, during the Cold War, donors often disbursed aid to "buy" allegiance from their recipients while ignoring the political ramifications of that aid. After the Cold War, the strategic interests of Western donors changed: they now increasingly "tie" aid disbursements to democracy-enhancing projects and reforms in recipient countries. A donor's preferences are not necessarily at odds with the "aid as nontax revenue" argument. For example, foreign aid from donors that have a pro-democracy intent could help a government finance its repressive capacity while still being tied to political reforms in other areas. Assessing the net effect of aid on democratic governance therefore remains an important empirical question, but one that is fraught with challenges, such as endogeneity. Existing studies frequently fail to mitigate concerns with endogeneity bias and do not provide robust causal effects of the aid on democracy. In this book, I tackle this challenge head on.

Migrant Remittances

Scholarly skepticism about the impact of foreign aid on governance has led to an academic championing of workers' remittances as a means to improve democratic participation. For many scholars, remittances constitute money that does not directly accrue to a government and is deemed "value neutral." As such, conventional scholarly wisdom portends that remittance income can improve the quality of democracy and facilitate the conditions (e.g., by contributing to higher levels of education and civic engagement) that can spur democratization. President Obama's speech on remittances in Cuba reflects this perspective.

26 Some examples of these spending decisions include increasing government outlays in the lead up to an election (in democracies), co-opting political rivals with financial inducements (in non-democracies), and expanding a state's repressive capacity to fend off revolutionary threats.
28 Bueno de Mesquita and Smith (2010a); Ross (2013).
29 Bermeo (2016).
30 Finkel et al. (2007); Bermeo (2011).
31 Some examples include Finkel et al. (2007) and Bermeo (2011, 2016).
In democracies, findings about the link between remittances and political participation are mixed. Survey data from Mexico, for instance, suggest that remittance recipients are less likely to vote and seek out political information but are more likely to engage in local nonelectoral organizations. Some organizations help migrant households pool their resources to finance various local public goods. This self-provision of public goods can further erode a remittance recipient’s desire to participate in politics.

While survey evidence about the effects of remittances on political participation in autocracies remains scant, some scholars argue that remittances may influence political outcomes in electoral autocracies. Escriba-Folch et al. (2015), for instance, posit that remittance recipients are frequently less financially dependent on patronage networks that underlie the durability of many party-based dictatorships. As a consequence, remittance recipients are less likely to vote for the incumbent, increasing the prospect of democratization. Escriba-Folch et al. corroborate this conjecture cross-nationally. Their findings suggest that remittances can potentially undermine authoritarian stability, at least in party-based dictatorships. Of course, not all autocracies are party based or permit elections that can remove an incumbent. Thus, these authors’ findings may not be generalizable to autocracies with different institutional features.

Moreover, the study of Escriba-Folch et al. – like those of others in this nascent literature – faces additional challenges. First, they tend to study the impact of remittances on politics in isolation from other capital flows. Doing so can be problematic. For example, countries that receive substantial amounts of remittance income are also some of the top foreign aid recipients. This omission can undermine both the empirical and theoretical relationships between remittances and “politics.” Second, many studies tend to discount the potential for governments to respond strategically to remittance income. One such response could be through the composition and/or level of government spending. For instance, if migrant households spend some of their remittance income on health care (which many do), a government could respond by decreasing its own expenditure on health care and reallocating its spending.

32 For example, Goodman and Hiskey (2008); Perez-Armendariz and Crow (2010).
33 Adida and Girod (2011).
34 Other studies posit that for those who do participate in the political process, remittance income can influence an individual’s voting calculus, especially in clientelistic electoral environments that characterize politics in Mexico and other Latin American countries (Pfurtsch 2012; Ahmed 2017a).
35 Electoral manipulation features prominently in many “hybrid autocracies” as a means to safeguard the incumbent autocrat from losing power.
36 An exception is Ahmed (2012), which advances a theory that foreign aid and remittance constitute “unearned foreign income” that an autocrat can leverage to fund strategies of political survival. This book builds on that framework by accounting for and modeling inflows of FDI (to firms).