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Revenue Substitution? How Foreign Aid Inflows Moderate the Effect of Bilateral Trade Pressures on Labor Rights

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Summary. — This paper investigates how foreign aid inflows moderate bilateral trade-based pressures on the exporting countries' labor rights. Because aid provides additional resources to recipient governments, it reduces the importance aid-recipient governments attach to the preferences of their export partners. Consequently, aid inadvertently moderates the leverage exercised by importing countries on the governments of exporting, developing countries. Our analysis of a panel of 91 aid recipient countries for the period 1985–2002 lends support to the "revenue substitution" hypothesis. When aid levels are low, bilateral trade-based pressures are associated with improved labor rights. As aid levels rise, however, the effect loses significance.

Key words — trade, foreign aid, race-to-the-bottom, labor rights, revenue substitution

1. INTRODUCTION

Developing countries are linked to the global economy in numerous ways, including participating in trade and receiving foreign aid. While such linkages present developing countries with a range of opportunities, they also expose them to a variety of external pressure and influences. In many instances, the external pressures generated by these linkages all push domestic actors in the same direction; for instance, they encourage improvements in the rule of law or increased investment in human capital. In other situations, however, different external linkages create conflicting incentives for government leaders, simultaneously exposing them to and insulating them from pressures for reform. This article explores one such instance: while bilateral trade relationships serve to transmit higher labor standards across national borders, foreign aid inflows dull, or even blunt, this transmission effect. By establishing the opposing effects of these external influences, we point to the need for development policy scholars to consider both direct and conditional (and sometimes unanticipated) effects of external influences on domestic policy outcomes.

Both trade and foreign aid lead to resource transfers from developed countries to developing countries. Often, developing countries export significant volumes to, and receive important aid flows from, the same nations. During the last decade, exports accounted for 44% of developing countries' GDPs, on average. [1] As of 2008, more than half of exports originating from the developing world – amounting to $15.78 trillion in value – were absorbed by the developed world. [2] During the same time, foreign aid provided by developed countries, either bilaterally or through multilateral institutions, also increased steadily. Net official development assistance (ODA) increased by 63% during 2000–10, reaching $128.5 billion in 2010. [3] While foreign aid (specifically, official development assistance, or ODA) transfers resources directly from donor governments to recipient governments, trade serves as an indirect, usually via the private sector, transfer of resources. By providing markets for exports, developed countries influence the current account balance and, ultimately, public revenues and economic growth of developing countries.

Because both trade and aid can influence domestic policy outcomes in recipient/exporting nations, theories linking external economic flows with internal policy choices must address the multiplicity of external pressures (Lim, Menaldo, & Prakash, 2014). We do so by asking how, in the context of workers' rights, foreign aid and trade shape governments' incentives to enact laws vis-à-vis their labor force. [4] We suggest that, while bilateral trade serves as an important mechanism for the diffusion of laws influencing labor rights (Greenhill, Mosley, & Prakash, 2009; Cao, Greenhill, & Prakash, 2013), foreign aid can intervene, unexpectedly, in the workings of such trade-based diffusion mechanisms. Because aid serves as an alternative source of external funds for governments, our intuition is that it might render recipient governments less likely to accede to the demands of actors based in their key export markets.

We test our argument about the conditioning effect of aid on the bilateral trade-based diffusion mechanism in a panel of 91 developing countries for the period 1985–2002. First, we replicate prior research suggesting that bilateral trade serves to diffuse labor rights from importing to exporting countries. Next, to test our claim that aid conditions the operation of trade-based pressures, we assess the interactive effects of bilateral trade and aid. We find that when foreign aid levels are low, the diffusion effects of bilateral trade-based mechanisms persist (Greenhill *et al.*, 2009; Prakash & Potoski, 2006; Vogel, 2005). However, as foreign aid levels rise, this trade-based diffusion effect loses significance. Thus, countries that receive moderate to high levels of foreign aid tend not to experience changes in labor rights, even when their trading partners have very different – better *or* worse – labor standards. Importantly, our findings are robust to alternate specifications of foreign aid such as measuring bilateral aid and multilateral aid separately, controlling for bilateral aid extended by the United States, and including aid provided by non-traditional donors.

In the first section of the paper, we review the existing literature on the effect of foreign aid, as well as trade, on labor

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rights in the developing world. Building on this literature, Section 2 describes our theoretical framework and hypotheses. Section 3 presents the data and methods for empirical analyses, and Section 4 presents and discusses our findings. The last section concludes.

2. AID, TRADE AND LABOR RIGHTS: WHAT DO WE KNOW?

For several decades, U.S. government officials have argued that engagement with the global economy offers the best hope for social and economic development in low and middle-income countries. A key pillar for promoting such engagement has been the push for trade liberalization, via the multilateral trade system, as well as via various regional, bilateral, and unilateral trade preference arrangements. The 1968 "Enabling Clause" of the General Agreement on Tariffs and Trade (GATT) allowed wealthy countries to offer developing nations preferential market access for a range of exports, going beyond the most favored nation (MFN) status extended to all GATT members (Blanchard & Hakobyan, 2012; Tsogas, 2000). The 1970s and 1980s witnessed continued efforts at trade liberalization, especially in the context of the structural adjustment policies of the mid-to-late 1980s; the period also is characterized by a further expansion of foreign aid, albeit often driven by Cold War politics (Bearce & Tirone, 2010). While the 1990s saw a greater policy focus on trade than on aid, the emergence of the Millennium Development Goals brought a renewed attention to aid during the last decade. The OECD identifies foreign aid as "a necessary and complementary source of finance" for achieving the goals of pro-poor, pro-rights growth. [5]

The implicit premise behind this dual focus on trade liberalization and foreign aid is that both can serve as means to promote economic growth and to improve citizens' material wellbeing. The "aid for trade" discourse, which conceives aid as a "valuable complement" to the trade negotiations, also appears to reflect the assumption that aid and trade are complementary tools at developed nations' disposal (United Nations Economic Commission for Africa, 2013). [6] Thus far, there has been little empirical investigation into whether this is necessarily the case, especially when the end goal is beyond trade liberalization. How might the simultaneous inflows of export receipts and foreign aid affect domestic policy outcomes? Would each enhance the effect of the other; would they sometimes work at cross-purposes to one another; or would they work in a more compartmentalized fashion, so that the effect of trade is independent of that of aid? To answer this question, we examine the interactive effect of trade and aid on labor rights in developing nations.

The category of labor rights is multi-dimensional, including both the capacity of workers to act collectively (to associate freely, bargain collectively and strike) as well as the individual conditions they experience (hours of work, protection of health and safety, non-discrimination in hiring and compensation). The diversity among "labor rights" is reflected in the International Labour Organization (ILO)'s 189 conventions. The most important of these labor rights are those four types specified in the ILO's 1998 Declaration on Fundamental Principles and Rights at Work: the elimination of all forms of compulsory and forced labor; the prohibition of discrimination in employment and pay based on race, gender, ethnicity, or religion; the elimination of child labor (or, at least, the worst forms of child labor); and freedom of association and the right to collective bargaining. Our theoretical claims concern these core rights. Empirically, we focus on a subset of these core rights, namely the right of workers to associate freely, form unions, bargain collectively and strike. This represents procedural, rather than substantive labor right. Rather than imposing specific outcomes (wages or working conditions, for example), the right to collective bargaining offers workers the opportunity to achieve such outcomes.

Let us first consider the unconditional effects of aid and trade on labor rights outcomes. The evidence on the effect of foreign aid on labor rights is mixed. Most studies have focused on human rights generally, rather than on labor rights specifically, but the lessons likely hold for the latter. On the one hand, the potentially pernicious (although unintentional) effects of foreign aid can be inferred from a range of studies. Aid – the amounts of which are often small by global or donor country standards, but substantial relative to recipient-nation budgets and economies – is likely to be seen as a replacement for tax-based revenues. The increased aid flows thus allow governments to be less accountable to its own citizens and ignore broad public demands (Djankov, Montalvo, & Reynal-Querol, 2008; Gibson, Andersson, Ostrom, & Shivakumar, 2005; Remmer, 2004; Ross, 2012), enable rent-seeking behavior among political elites (Ahmed, 2012; Svensson, 2000), and undermine local civil society (Chahim & Prakash, 2014), all of which would hinder labor rights progress. These pernicious effects are linked to the process by which donor governments disburse aid: donor governments often are motivated by political and strategic, rather than by socioeconomic development, goals. If donor governments curry favor with recipient regimes, and if recipient regimes have substantial *de facto* discretion over how to spend aid, then recipient governments will have few incentives to spend aid in ways that provide broad public benefits or that might upset the political status quo.

Yet, donors have also increasingly sought to incorporate conditionality in foreign aid; requirements often include human and labor rights outcomes as well as broader "good governance" behaviors. Of course, the effect of such conditionality on actual outcomes is contingent on their implementation and, therefore, far from automatic (Demirel-Pegg & Moskowitz, 2009; Nielsen, 2013; Lebovic & Voeten, 2009). If the conditions and the associated aid cutoffs are effectively enforced, we might expect a positive association between more recent forms of foreign aid and labor rights. One also might expect that foreign aid could facilitate the enactment of rights-related policies by enhancing governments' capacity. Indeed, over the last two decades, ODA to social sector programs, including government and civil society promotion, has increased relative to foreign aid directed at economic and production sectors. [7] Such programs can assist governments in revising their labor laws to meet ILO core conventions, hiring additional labor inspectors, and educating private employers on basic standards for the treatment of workers (Schrank, 2009). Consistent with this logic, in a global study of the effects of various economic flows on personal integrity rights during the 1990s, Apodaca (2001) finds that aid positively affects human rights. Similarly, Dunning (2004)'s analysis of aid flows to African nations suggests that, from the late 1980s, aid is significantly and positively associated with human rights outcomes. As the competing insights from the existing literature indicate, our understanding about the unconditional (direct) influence of foreign aid on labor rights is far from conclusive.

The literature on the effect of trade on developing countries' labor rights also displays mixed findings. The "race to the bottom" narrative reminds us that market competition, which is enhanced by economic globalization, requires firms to lower production costs. It creates incentives for firms to establish