

Foreign Aid and Political Stability

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Concerns about international terrorism have moved stability of failing states to the center of western foreign aid policies. This paper explores how recipient governments can exploit this preference for stability through increased rent extraction. Donors will pick up the bill for preserving stability, and are left with a situation that is inherently more instable. The paper presents a formal model to illustrate this new form of moral-hazard. A test of comparative static predictions uses data on 125 recipient countries and 22 donors from 1979 to 2006. The results show that aid by stability oriented donors increases rent extraction rates. Stability orientation leads to an increased *ex-ante* risk of civil conflict, but aid itself exhibits a pacifying effect.

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