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Aid and democracy redux ☆

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A B S T R A C T

This paper uses Freedom House ratings to assess the impact of foreign aid on democracy. We employ an interval regression to account for Freedom House's method of rating countries. A cross-sectional analysis examining the long run effect of aid on democracy in 122 countries between 1972 and 2011 finds a significant positive relationship that survives various tests for endogeneity. A short run annual panel analysis of 156 countries between 1985 and 2011 explores whether aid operates through leverage and conditionality. We present evidence that (i) donors allocate aid in response to democratization and (ii) recipient countries respond to this incentive for democratic reform. Our identification strategy relies on the reduced importance of democratization in the allocation of aid to geopolitically important countries.

1. Introduction

Does foreign aid promote democracy? A growing literature examining the impact of aid on democracy has reached divergent conclusions. In the most widely cited article on the topic, Knack (2004) finds no evidence that aid promotes democracy in a long run cross-sectional analysis and several studies report that aid undermines democracy in short run panel analyses. Yet many researchers do find evidence of a significant positive impact, both in the long run (Heckelman, 2010) and the short run (Bermeo, 2011).

In this paper, we revisit the aid and democracy question, looking more carefully at issues of timing, utilizing an estimator that reflects the process generating democracy ratings and taking advantage of an expanded data set. Timing is critical since aid's role as either input or incentive depends on whether aid flows precede or follow changes in democracy. The process employed by Freedom House to generate the democracy ratings used by Knack and others starts with a finer grain scale; an interval regression that reflects this data generating process is more efficient and avoids the attenuation bias of least squares. Finally compared with early work in the field, we take advantage of much more substantial post-Cold War data.

The impact of aid on democracy is largely an empirical matter as theory suggests both positive and negative effects. By promoting economic and social development, aid may plant the seeds for democracy (Lipset, 1959). Educated voters are an important prerequisite for a well-functioning democracy and also more likely to demand self-determination. Assuming civil liberties and political rights are normal goods, greater demand for democracy goes hand-in-hand with economic growth. Aid can also promote democracy directly when it funds institutional development within the government and civil society, growth in news or social media, empowerment of oppressed groups, or election administration (so-called democratic aid). Finally,

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donors committed to democratic reforms may be able to use aid as leverage, making the continued flow of funds conditional on political reform.

However, aid may also stymie moves toward democracy. By providing an alternative to tax collection, aid can make recipient governments less accountable to their citizens. Aid flows may also be viewed as rents, competition for which results in corruption that weakens the fundamental institutions of government and promotes clientelism, thereby narrowing the selectorate. This is particularly likely when donors cannot credibly commit to enforcing aid conditions due to other overriding priorities, be they geopolitical (*e.g.*, the U.S. during the Cold War) or commercial (*e.g.*, China today). In sum, whether the net impact of aid on democracy, like the net impact of aid on growth, is positive or negative remains fundamentally an empirical issue.

This paper explores links between aid and democracy both in the long run using cross-sectional data and in the short run using annual panel data. A cross-sectional analysis similar to Knack (2004) but applying interval regression and covering 122 countries between 1972 and 2011 finds a significant positive relationship that survives various robustness checks and endogeneity tests. The panel analysis finds a small positive link between aid and democracy but only for aid from OECD Development Assistance Committee (DAC) members. The panel analysis also uncovers evidence of a more substantial incentive effect. When recipients can expect donors to condition future aid on democratization (*i.e.*, when democracy conditionality is credible), more democratic reform is observed. In order to identify when conditionality is credible, we examine how aid allocation decisions by the G7 as well as autocratic and multilateral donors depend on recipient country democracy. While all non-autocratic donors respond to varying levels of democracy, for some donors that response depends on the recipient country's strategic importance. For these donors, democracy conditionality is not credible from the point of view of a strategically important recipient. When countries that typically receive a large share of their aid from these donors are strategically important, they are less likely to democratize.

Section 2 reviews recent empirical research on aid and democracy, placing it in a framework that links the timing of aid to its potential role in democratization. Section 3 details the empirical model and estimation method as well as key variables. Section 4 describes cross-sectional data and results for the long run impact of aid from DAC donors on democracy. Section 5 turns to panel data and short run analysis, capitalizing on the role of democracy in aid allocation decisions in order to explore possible incentive effects. Section 6 concludes.

2. Previous research

Aid potentially can play any of three roles in the promotion of democracy. Over the long run, aid may promote economic and social developments that are preconditions for democratization. Over a short time horizon, aid may provide key immediate inputs to successful elections and a transition to democracy. Finally, if conditioned on democratic reform, aid acts as an incentive to induce the government or elements of civil society to undertake or advocate for democratization. A key question in empirical analysis is how to identify aid's impact under each of these scenarios.

Over the course of decades, aid may promote growth (Minoiu and Reddy, 2010; Clemens et al., 2012), education (Michaelowa and Weber, 2006; Dreher et al., 2008; Christensen et al., 2011; Birchler and Michaelowa, 2013), and the expansion of civil society (Keck and Sikkink, 1998; Brown et al., 2008). If democracy is a normal good (demand increases with income) that depends on an educated selectorate and active civic associations, aid may act as a general input for democratization by laying the necessary foundation. This argument suggests a link between aid over several decades and democratization over that or subsequent periods.

Just prior to an election, certain types of aid may act as a specific input to democratization. Aid targeted to opposition parties or non-governmental organizations (NGOs), poll observers or polling stations, election media, or technical assistance for drafting legislative reforms may have a direct and immediate effect on civil liberties and political rights (Finkel et al., 2007; Kalyvitis and Vlachaki, 2010; Nielsen and Nielson, 2010; Scott and Steele, 2011; Carothers and de Gramont, 2013). This pathway might explain a link between certain categories of foreign aid and improvements in democracy over a short period of time (*e.g.*, 1–3 years). Alternatively, in the short run aid may promote stability and thus allow for democratic reform in some circumstances (Dutta et al., 2013).

Finally, aid may act as an incentive for democratic reform if key players in the recipient country expect that democratization will lead to sufficiently large increases in aid flows. Whether this takes the form of traditional conditionality (conditions stated *ex ante*) or selectivity (conditionality only applied *ex post*), it provides an incentive for political reform as long as donor conditionality is credible.

The literature on aid and democracy is active—with studies falling into each of the three categories in terms of their treatment of aid—but little consensus has emerged on methodology or findings (Wright, 2009). One approach is long run cross-sectional analysis that examines the change in measures of democracy over decades. Knack (2004) finds aid as a share of GDP robustly insignificant in a global sample. In contrast, Goldsmith (2001a) and Heckelman (2010) find positive effects of aid per capita for Africa and the transition economies.

Panel studies focus on the short run impact of aid, examining either annual data or 5 year averages. Looking at Africa from 1975 to 1997, Goldsmith (2001b) uncovers a positive effect which Dunning (2004) demonstrates is driven entirely by the post-Cold War period. Using a range of measures and estimation methods with a global (though with a somewhat limited) sample of countries, Djankov et al. (2008) uncover a robust negative contemporaneous relationship between aid