



# Foreign Aid Responses to Political Liberalization

BERNHARD REINSBERG\*

*University of Zurich, Switzerland*

**Summary.** — This paper analyzes the impact of political liberalization on receipt of foreign aid. It distinguishes different types of donors facing different constraints in rewarding democratization with foreign aid, notably bilateral donors, the World Bank, and the European Commission. Based on a sample of 174 recipient countries from 1995 to 2009, the paper jointly examines short-term dynamics and long-term effects of sustained liberalization. Except for the World Bank, donors react to regime change. Bilateral donors are found to reward political liberalization in the second year after transition.  
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**Key words** — foreign aid, democratization, bilateral donors, multilateral donors, World Bank, European Union

## 1. INTRODUCTION

Do donors reward political liberalization?<sup>1</sup> Given the recent wave of democratic revolutions and the overall trend towards democracy across the globe, this question has continued relevance for developing countries. Countries that underwent democratization have higher economic growth (Persson & Tabellini, 2007). Similarly, and more important for this paper, foreign aid seems to be more effective if given to democracies or if disbursed under good policies (Kosack, 2003; Svensson, 1999).

In this paper, I revisit the issue of ex-ante conditionality in the provision of foreign aid more specifically for transitions toward democracy.<sup>2</sup> In particular, I ask whether donors reward political reforms with foreign aid, and if so, how (and when)? Using a sample of countries receiving aid from OECD/DAC donors from 1995 to 2009, which includes 27 spells of sustained liberalization, I conduct non-linear multivariate analysis to study the responses of official donors in terms of aid flows. The results are robust to alternative indicators, additional control variables, linear panel regression methods, and a matching approach. My study goes beyond previous work in several ways.

In particular, I distinguish among different donors facing different constraints in their use of political conditionality, notably bilateral donors, the World Bank, and the European Commission. After the Cold War, most donors have committed to support democratization with higher flows of aid (i.e., UNGA, 1993), and some donors vigorously embraced political conditionality in their aid allocation (e.g., Wright, 2009, p. 552). Among all donors, donor governments arguably are closest to domestic publics and therefore should have the strongest incitation to respond to political reforms within recipient countries. Direct accountability to voters equally implies that donor governments should respond to political liberalization within a short time horizon. In contrast, multilateral donors such as the World Bank are remote from electoral pressure and should thus not be responsive to political liberalization. Moreover, the World Bank is legally constrained from explicitly endorsing regime change with higher aid flows. The Commission as a mixed type donor combines features from those two types of donors.

I also seek to disentangle the short-term impact of liberalization from the long-term effect of sustained liberalization, developing two distinct measures capturing these effects. To

the best of my knowledge, both effects have not been studied together in a single econometric framework. To increase measurement precision, my results are not based on total aid, which might capture flows of aid that are inherently unpredictable or that cover expenditure in donor countries unrelated to recipient-country events. I rather use “country-programmable aid,” which more appropriately reflects the aid flows that are subject to aid agreements with the recipient government (OECD, 2013a).

These refinements are important because existing empirical assessments of aid conditionality are inconclusive. Aid allocation does not seem to be primarily affected by good governance, although governance has become a more important criterion for some donors since the Cold War (e.g., Clist, 2011; Dollar & Levin, 2006; Wright, 2009). However, these studies typically analyze selectivity using levels of democracy; fewer studies examine liberalization episodes within recipient countries (Alesina & Dollar, 2000). Using more precise measures derived from theoretical considerations and advanced empirical methods, I am able to draw more refined conclusions on the characteristics of the aid response. Particularly, my study sheds light on the reasons why some donors may not be able to embrace political conditionality. While much work exists on the difficulties to impose aid sanctions (e.g., Crawford, 2001; Hakenesch, this issue; Molenaers, Gagliano, Smets, & Dellepiane, this issue), I am not aware of studies focusing on similar constraints with respect to aid rewards.

In addition to its scientific contribution, this paper bears practical relevance. The recent wave of political reforms in many recipient countries begs the question what kind of response these countries can expect from various donors. To which donors would these countries appeal to leverage foreign aid for their own political development? In which year would the bulk of the additional aid be expected? My paper may inform questions along these lines.

I proceed as follows. Section 2 summarizes the main debates in the democratization literature as well as the primarily empirical literature on aid allocation based on political conditions. Section 3 presents the theoretical argument on the

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impact of political liberalization on aid flows across distinct types of donors. Section 4 entails the empirical analysis, including a discussion of key variables, data issues, main results, and robustness tests. Section 5 discusses the findings, and Section 6 concludes.

## 2. LITERATURE

I proceed with a review of two relevant strands of literature. The first strand clarifies the conceptual underpinnings of democratization. The second strand summarizes literature on aid allocation based on recipient-country progress toward explicitly political objectives.

### (a) Democratization

There are many definitions of democratization, as there are many definitions of democracy (Dahl, 2000). As commonly used, democratization additionally requires that the ensuing regime has institutionalized the essential traits of democracy, such as constitutionally guaranteed human rights and civil liberties, regular elections for assigning executive offices, and a working principal-agent relationship with the citizens (e.g., Dahl, 1971; Diamond, 2008; Murtin & Wacziarg, 2014; Sartori, 2001).<sup>3</sup>

In contrast, a minimalist definition of democratization would require only a relative improvement of the institutional patterns of authority over a specified period of time (e.g., Mansfield & Snyder, 2002, p. 535). This minimal concept of democratization seems to be widely used among foreign aid donors. For example, the European Commission (EC) contends that “[f]ostering good governance requires a pragmatic approach based on the specific context of each country” (EC, 2006, p. 13). This suggests that donors may even reward relative improvements toward democracy. For the sake of clarity, however, relative improvements of political institutions should be called “political liberalization,” while the subset of political reforms leading to “coherent democracies” should be called “democratization.” Democratizations are complex processes that unfold their own dynamics. For analytical purposes, the process of democratization can be divided into three phases, notably liberalization, transition, and consolidation (Schneider & Schmitter, 2004).

First, the phase of liberalization can be violent (e.g., Cederman, Hug, & Wenger, 2008). Liberalization increases political instability (Bremmer, 2007), because the lower opportunity costs for political offices increase the number of elites in the political contest. If institutions are weakly developed, elites mobilize along ethnic lines (Snyder, 2000), and sometimes ignite external war to rally their supporters (Mansfield & Snyder, 2002).

Second, the phase of transition establishes a more democratic regime—sometimes the old leader becomes ousted, sometimes it enters into a power-sharing agreement with an oppositional leader. New regimes are typically installed by elections, oftentimes interpreted as a sign of democratization among donors (Collier, 2010; Crawford, 2001). However, the new political equilibrium remains fragile, and even though some fundamental rights may be formally guaranteed by a constitution, human rights violations may be commonplace. In some cases, especially post-conflict transitions, the state is too weak to protect its citizens, notably minorities. It turns out that many transitions become stuck in this phase, or even fall back to autocracy.

Third, democratic consolidation occurs when the new regime stabilizes. The elites refrain from violence as the stakes from losing elections are lower (Przeworski, 1991), understandings of democratic principles become widespread (Schmitter, 1992, p. 424), and hence, democracy becomes the “only game in town” (Stepan & Linz, 1996). Institutional features conducive to consolidation are regularly held competitive elections, the alternation of political power, checks and balances, the rule of law, fundamental human rights, as well as participatory governance and a vibrant civil society (Collier, 2010; Deng, 2008; Diamond, 1994; Dahl, 1971; Przeworski, 1991; Putnam, 1993; Reynolds, 2010). Donors particularly consider elections to be a cornerstone of any consolidated democratic regime (e.g., Crawford, 2001; Diamond, 2008). Sustained democratization may have a positive impact on pro-poor development and economic growth (e.g., Haggard & Kaufman, 1995; Persson & Tabellini, 2007), mainly due to increased public accountability and enhanced checks and balances on executive power (Gibson & Boone, 2011). Democracies are more likely to deliver pro-poor policies and public goods since enfranchisement empowers poorer people (e.g., Meltzer & Richard, 1981; Plümper & Martin, 2003).

### (b) Political conditions in aid allocation

Conditionality can be ex ante, implying a selection of recipient countries; conditionality can also be ex post, responding to specific events in a given recipient country (see Koch, this issue). Empirical studies have addressed both types of conditionality related to the political governance of recipient countries.

Most studies focus on the punitive side of conditionality, assessing whether donors punish human rights violations with aid withdrawal (Boulding & Hyde, 2008; Carey, 2007; Demirel-Pegg & Moskowitz, 2009; Doucouliagos & Paldam, 2011; Lebovic & Voeten, 2009; Molenaers *et al.*, this issue). Conversely, some studies examine positive ex-ante conditionality, for example whether or not donors favor democracies in their aid allocation (Gates & Hoeffler, 2004; Hoeffler & Outram, 2011; Isopi & Mattesini, 2010; Svensson, 1999). Economic governance has similarly been made a condition for aid disbursement. Some studies establish that donors have increasingly favored well-governed countries (Dollar & Levin, 2006, p. 2044), especially after the end of the Cold War (Berthélemy & Tichit, 2004, p. 267; Scott & Steele, 2011, p. 53; Wright, 2009, p. 552), when bilateral donors have de-emphasized other motives of aid allocation (e.g., Bearce & Tirone, 2010; Claessens, Cassimon, & Van Campenhout, 2009). However, more corrupt countries seem to have received more aid (Alesina & Weder, 2002; Easterly & Pfutze, 2008, p. 42). Overall, donor selectivity in favor of democratic polities and good governance remains low, without any significant improvement over the last two decades (Clist, 2011). Most ex-ante studies exploit cross-sectional variation among recipient countries, thereby establishing the general effect of democracy on the allocation of aid.

Only a few studies examine ex-post political conditionality, notably whether donors reward democratization with more aid. Based on a sample of 77 countries from 1970 to 1994, a seminal study by two economists finds that political liberalization increases subsequent total aid flows by 50% over a three-year period (Alesina & Dollar, 2000, p.34). A more recent study independently tests for the impact of improvements of two components of democracy; it finds that donors reward

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