AMERICAN UNIVERSITY OF BEIRUT

ON THE PERSISTENCE OF THE DEMOCRACY DEFICIT IN
THE MENA REGION: THE ROLE OF DEVELOPMENT AID

by
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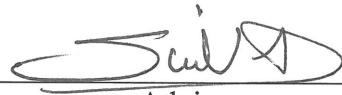
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ON THE PERSISTENCE OF THE DEMOCRACY DEFICIT IN THE
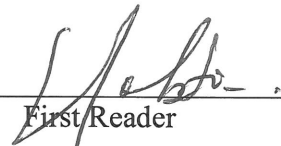MENA REGION: THE ROLE OF DEVELOPMENT AID

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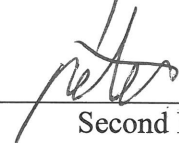Economics

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AN ABSTRACT OF THE THESIS

Rima Radwan Al Mokdad   for   Master of Arts
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Title: On the persistence of the democracy deficit in the MENA region: the role of
         development aid

        The literature on the impact of foreign aid flows on the quality of political institutions and the democratization process has increased in the last decade. In this paper, we attempt to measure the effect of aid directed towards developmental objectives on the democratization process in the MENA region. Using a panel data of 22 MENA countries between 1970 and 2014 we utilize a Two-Stage Least Squares method to estimate this effect. We find that aid flows are associated with a small but significant deterioration in institutional quality and hence in the democratization process.

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INTRODUCTION

During the last decade, or perhaps more precisely since the independence of all states in the Middle East and North Africa (MENA), "autocratic "is considered to be the characterization that most reflects the quality of governance or political institutions in these states. Conflict has been the striking trait of this region while the abundance of its natural resources has been the primary element in drawing in in interest and interventions of the world's leading empires and the stage for their in the region. Not until 2010, did any waves of democratization sweep through the region. Yet, with the unfolding of the seventh year since the beginning of major uprisings in the region, the prospects democratic transitions in the region are still precarious and perhaps what has been excitingly proclaimed as the "Arab Spring" will not necessarily result in democracies but a return to or at best some form of partial democracies (Elbadawi & Makdisi, 2017)

On the other hand, in the last four decades, massive amounts of foreign aid have been channeled to the developing regions of the world (historically the MENA regions has been receiving the second highest ratio of development aid (as a percent of GDP)after Sub-Saharan Africa. Recent literature on the relationship between development aid and changes in the quality of political institutions (democratic versus autocratic) does not point to a clear-cut picture; it has been rather polemical. The study of this relationship is attractive for two main reasons. First, there has been an increase in the prevalence of democracy as a world phenomenon which has prompted empirical studies on the determinants of democratization(Acemoglu & Johnson, 2005; Barro,

1999; Vani K. Borooaha, 2007). Second, although aid is intended to help towards developmental projects in many instances its implicit goal has been to influence political developments.

The literature on the correlation between development aid and democratization has only recently captured the attention of scholars, yet findings differed. In his paper, Knack (2004) finds that foreign aid has no significant effect on the quality of political institutions (democratization) in the long run while other papers conclude that aid undermines the democratization process. other empirical work finds evidence that aid promotes democratization or democratic transition (Bermeo, 2011; Heckelman, 2010).

In this thesis, the impact of development aid on the democratization process is revisited, however, with reference to the MENA region only (Mauritania, Djibouti, Jordan, Yemen, Syria, Egypt, Sudan, Iraq, Tunisia, Morocco, Lebanon, Oman, Bahrain, Cyprus, Algeria, Turkey, Libya, Iran, United Arab Emirates, Kuwait, Qatar, and Saudi Arabia). We assess the impact of foreign aid on the quality of their political institutions using a panel of these countries for the period 1970 -2014. A large number of institutional quality measures are used to assess the nature of political institutions including Polity IV, political rights and civil liberties from Freedom House, CHECKS from Keefer and Stasavage (2003)and the Dichotomous DD dummy from Przeworski, Alvarez, Cheibub, and Limongi (2000). The thesis makes two distinct contributions: the first is its assessment of the impact of development aid on the democratization process in the MENA region, which we believe, has not been carried out before. The second is the use of new instrumentation technique to deal with the potential endogeneity of foreign aid through a Two-Stage Least Squares estimation .

We find that the allocation of development aid to the MENA region has undermined the quality of governance and hindered the democratization process; aid flows are associated with a decrease in of political institutions.

This thesis is organized as follows. First, we define Political institutions and explain their relative importance. Second, we discuss the status of political institutions in the MENA region and the main reasons behind its democracy deficit. Third, we discuss the basic theoretical and empirical literature on the effect of foreign aid in the democratization process. Fourth, we present relevant information on the allocation of development aid across MENA countries. Fifth, we specify our econometric model and the employed set of variables. Finally, our results, robustness checks, and conclusions follow.

A. Defining political institutions and their importance

As Douglas North (1990)formulates it: "Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction… In consequence they structure incentives in human exchange…" Breaking North's definition down, several points can be inferred. First, Institutions are "humanly devised" i.e. the result of human choices and decisions irrespective of any other causes that are exogenous of human control. Second, institutions determine the constraints on human behavior, in other words, they determine how the political game is played. These constraints are both formal and informal; informal constraints pertaining to sanctions, codes of conduct, and customs and formal constraints dictating laws, property rights, and constitutions. Third, institutions structure incentives whether political, social, or

economic. Where institutions determine the rules of the game, the end objective of those who set the rules is winning the game.

Building on the above definition, political institutions are the steering wheel that direct the pathway through which the state operates. In other words, they form the political structure of the country, primarily the form of governance that can fluctuate between democracy, dictatorship, and anything within these two boundaries and thus determining the extent of constraints on politicians and political groups (political power). Laws, political rights, civil liberties, electoral systems, veto power, and constraints on the level of political competition are assigned according to the structure of political institutions.

Logically, political institutions, which determine the distribution of political power, will affect the structure of the corresponding economic institutions in the country, which will consequently determine economic performance. Economic laws and property rights are determined by the consensus of political elites in such a way to maximize political power, which will in turn determine transaction and production costs and the feasibility and productivity of engaging in any economic activity.

Previous literature conveys that there appears to be a level of consensus among economists that effective political institutions will produce effective social and economic development. In a recent paper, Acemoglu and Johnson (2005)conclude that good economic institutions, which depend on the nature of political institutions and the distribution of political power in society, are the fundamental cause of economic growth and differences in development across countries. Levine and Roodman (2003) and Rodrik, Subramanian, and Trebbi (2004)show that institutional quality has a large effect on economic performance even when controlling for measures of trade openness and

geography. Similarly, Easterly, Levine, and Roodman (2004) found that macroeconomic variables do not have a significant impact on economic development after institutions are introduced into the analysis. Earlier, Aron (2000) had regressed development on different institutional measures and found a positive relationship between political stability, property rights, and democracy with development, and a negative correlation between development and political instability.

B. Classifying institutions

The popular classification of political institutions consists in dividing these institutions between democracies and autocracies though more recently this classification has been widened to include as well anocracy or partial democracy. Before discussing the democracy deficit in the MENA region, it would be useful to define both democratic and autocratic political institutions.

1. Defining democracies

Democratic theory is one of the most researched topics in economic, political, and social fields, yet there is no consensus on a unique definition of democracy. Perhaps the most widely known definition of democracy is the one offered by Schumpeter (1975) where he defines democracy as an institutional arrangement for arriving at political decisions in which individuals acquire the power to decide by means of a competitive struggle for the people's vote." According to this definition, a democracy is achieved through an institutional mechanism that is elections. More recently, Przeworski et al. (2000) proposes a minimalist definition of democracy being "a system in which parties lose elections". This definition has two aspects the first being that

government positions should be filled and the second that they should be filled through contested elections.

These two well-known definitions have been critiqued. First, what what is known as the "fallacy of electoralism" considers that elections alone are not sufficient for securing a democratic regime, other institutional guarantees should be given (Diamond, 1999). These "institutional guarantees" are highlighted in Robert Dahl's Polyarchy (1971) and they include basic rights such as the freedom of expression and the right of access to information. Second, the "institutional" representation of democracy is a source of disagreement. Beetham (1999) claims that democracy cannot be merely defined by institutional factors such as rights and liberties. He recommends the distinction between the concept of democracy and the actual theories on democracy. He argues that "the core idea of democracy is that of popular rule or popular control over collective decision making". In other words, Beetham considers institutions as the mechanism through which democracies are sustained by allowing the public to realize their control over politics and to achieve political equality. Accordingly, elections are not in themselves important, rather the extent to which these particular institutional procedures help the population to recognize two basic concepts which are "political control" and "political equality".

Based on the above definitions, one can cautiously define democracy as a system of governance where actual political power is vested in the hands of the people and whereby government decisions and the direction of all policies are based on the direct or indirect approval of the majority of adults in a given country. Practically, democracy is achieved by allowing the transfer of power through free and transparent

elections. This process is contingent on institutions that manifest the laws and regulations that govern the electoral process.

2. Defining autocracies

Unlike democratic regimes, autocracies not as well discussed in the literature. Regimes are classified as autocratic where there exists no real transfer of power (no electoral challenges), whereby one ruling party dominates the political system. As such, competitive political participation is restricted to power-holders who, without the electoral consent of people, determine the amount of freedoms and rights that the people are permitted to enjoy. In practice, however, people might enjoy a limited degree of civil liberties such as economic freedoms[1].

It is worth noting here that dividing political institutions strictly between democracies or autocracies is not useful for two main reasons. To begin with, this categorization reduces the variance between different regime types, as it does not allow the identification of hybrid regimes or regimes that include a mix of institutional qualities. Second, the path from autocracy towards democracy or vice versa is not necessarily a direct one between autocracy and democracy in that the shift between regime types could be a gradual process or one that spirals after short and sudden events (military take-over, revolutions…).

C. Institutions in the MENA

In recent decades, specifically after the fall of the Soviet Union, democratic institutions have gained growing worldwide acceptance. All developed countries and a

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[1] In reference to T Gurr, K Jaggers and WH Moore 1993

considerable portion of developing countries have been successful at maintaining and achieving democratic political regimes. After the 1990s, a World Bank report by Keefer and Khemani (2004) indicates that the number of countries that selected their leaders through competitive elections has risen significantly; between 1989 and 2000, the number of democracies rose from 60 to 100. Also, among poorer countries, the transition has been more striking since the number countries where the people elected their governments increased from 11 in 1989 to 32 in 2000 (a three time increase). The world has therefore witnessed striking transitions towards adopting some democratic institutional changes mainly through implementing competitive elections.

Unfortunately, the Middle East and North Africa have remained resistant to democracy. According to the Arab Human Development Report (Farjani, 2002), "There is a substantial lag between Arab countries [the bulk of the MENA region] and other regions in terms of participatory governance". The democratic wave was not evident in Middle Eastern and North African countries; this is what became famously known as the "democracy deficit or democracy gap" in the MENA region (Makdisi & ElBadawi, 2011). In order to understand more comprehensively the historical status of political institutions in the MENA region two global measures of democracy, namely the Polity IV index of democracy and the political rights and civil liberties index produced by Freedom House, are utilized.

D. Polity IV measures

The Polity IV dataset is a composite index that captures the regime authority spectrum with an index ranging from-10 (hereditary monarchy) to +10 (consolidated democracy). Different regime categories have a range in the Polity score: -10 to -6

represent autocracies, -5 to +5 represent anocracies, and +6 to +10 represent democracies.

The Polity IV index reveals that, over the last 40 years or so, the MENA region has been consistently lagging behind the rest of the world suggesting the persistence of the democracy deficit. According to the Polity IV, the MENA region has been and remained authoritarian over the last 40 years with negative values for the Polity index. On the other hand, other developing countries have remained not very democratic until 1990. Afterwards, the trend for developing countries steps up from the negative to the positive zone suggesting a transition towards more democratic governance according to the index. On the other hand, Countries under the Economic Co-operation and Development (OECD) have been consistently democratic over the last 40 years.

In the period ranging between 1960 and 2016, the democracy gap between MENA countries and the developed regions of the world has generally remained relatively unchanged. What is noticeably striking is the gap between MENA countries and other developing countries. Between 1960 and 1990, the gap has remained consistently stable, however from 1990 and onwards the gap has significantly widened with MENA countries showing a minor increase in the Polity trend while other developing countries showed on average a considerable leap in their Polity IV score towards a more democratic form of governance.
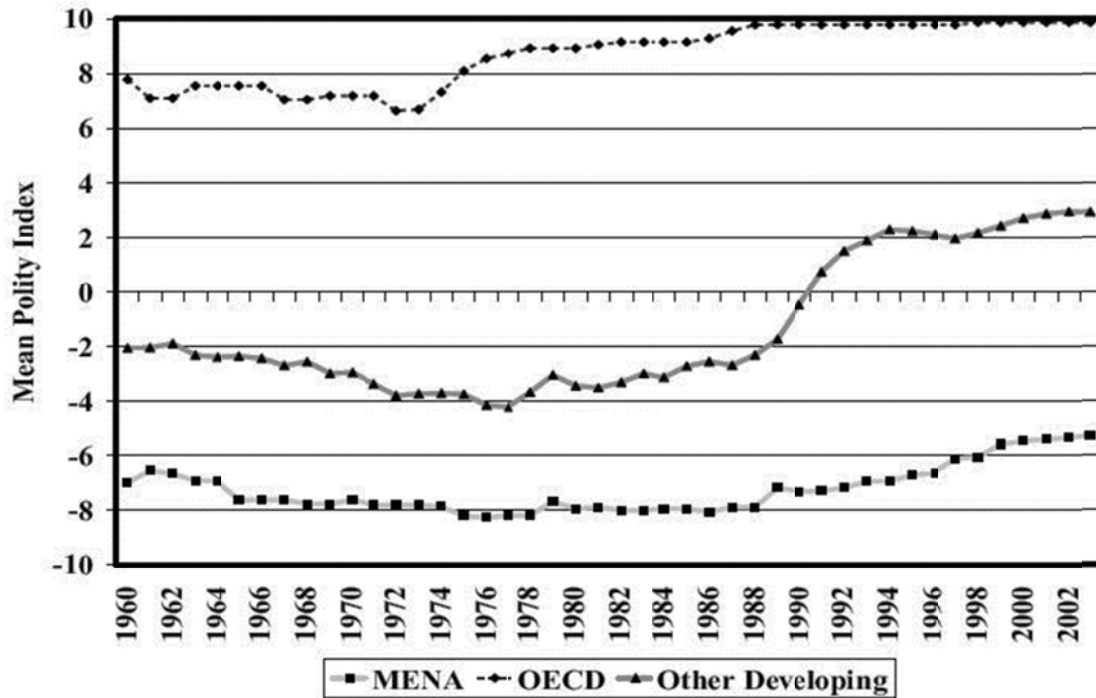
Figure 1.1. Polity IV score across MENA, OECD, and other developing regions (1960-2004)
Source: Nabli, Silva-Jáuregui, and Aysan (2008)

E. Freedom House score

The annual Freedom House score measures freedom as a combination of political rights and civil liberties across countries. By definition, political rights are the rights that allow people to participate in the political process by competing for public office, joining political organizations and parties, engaging in competitive elections to elect representatives who have a decisive impact on public policies, and competing for public office. Similarly, civil liberties allow people to maintain personal autonomy away from governmental intervention, freedom of expression and belief, and enjoy the rule of law. These two indexes are averaged into one "Freedom" score which classifies countries into three main categories: "free" with the highest level of political rights and civil liberties (score 1-2), "partly free" (score 3-5), or "not free" where political rights and civil liberties are virtually absent (6-7).

Of the countries in our sample and over the period of nearly forty years (1970 onwards), only Cyprus has been considered as "free" (over most of the period 81%). All other countries are classified either as being "not free" for the majority of the period (like Saudi Arabia, Sudan, Qatar, Mauritania, Syria, Iraq, United Arab Emirates, and Oman), "partially free" for the majority of the period (like Turkey, Lebanon, Morocco, Kuwait, and Bahrain), or present in these two categories at similar ratios during the last forty years (like Jordan, Djibouti, Tunisia, Yemen and Egypt).

Table 1.1. Country years of freedom in the MENA region (1972–2014)

	% of Country Years		
Country Name	"Not Free"	"Partly Free"	"Free"
Algeria	93	7	0
Bahrain	40	60	0
Cyprus	0	19	81
Djibouti	48	52	0
Egypt	52	48	0
Iran	83	17	0
Iraq	100	0	0
Jordan	43	57	0
Kuwait	7	93	0
Lebanon	31	62	7
Libya	95	5	0
Mauritania	88	12	0
Morocco	0	100	0
Oman	98	2	0
Qatar	71	29	0
Saudi Arabia	100	0	0
Sudan	86	14	0
Syria	93	7	0
Tunisia	55	43	2
Turkey	0	86	14
United Arab Emirates	69	31	0
Yemen	57	43	0

Source: Freedom House

1. Some clarifications: on the diversity in the MENA region

The MENA scores presented above do not necessarily represent accurately the prevailing situation in the region, the overall picture only reveals the anomalous prevalence of authoritarianism but a proper assessment requires the recognition of existing diversities within. A closer look at specific countries reveals that democratic or semi-democratic forms of governance is prevalent in Lebanon, Turkey, and Cyprus and more recently Tunisia.

It is also important to recognize that the process of liberalization and democratization has been initiated by many countries. According to Elbadawi and Makdisi (2006) "there was evidence of a "hesitant" democratization spell in the diversified Arab (therefore MENA) world since the late 1980s, but was not deep enough to lift the regimes above autocracy to positive scores associated with "net democracy"". Although some autocratic countries like Bahrain, Yemen, UAE, Qatar, Libya, and Saudi Arabia have not instituted any democratization, not all countries have avoided this process. Major reforms have been announced in many MENA countries to strengthen public participation in the political process. These countries include Egypt, Algeria, Kuwait, Morocco, and Tunisia. In 1973, Egypt announced its commitment to reform, the establishment and activity of political parties is allowed and elections are periodically held. Likewise, Morocco, in the mid-1970s, allowed the rehabilitation of political parties and elections were held. Similarly, in all the above-mentioned countries, political parties have been revitalized and parliamentary, presidential, or municipal elections have since been held periodically.

The true problem that exists, reflected in the so-called MENA exceptionalism, is that these institutional reforms have caused little is no change in the quality of the

governance in these countries. Despite the opening of parliaments, the initiation of elections, and the signing of agreements guaranteeing basic freedoms and rights, these countries have failed to progress significantly towards more democratic governance (as measured by both the Polity IV score and the Freedom of the World Survey).

2. Behind this deficit

In an attempt to unravel the persistence of the democracy deficit in the MENA region, various economic, social, and historical variables have been postulated. The following section draws on the findings of recent scholars on the MENA region and specifically on the Arab region to shed light on the variables that might have significantly affected the persistence of the democracy deficit.

According to Lipset's (1959) modernization hypothesis economic developments is the main factor that drives towards democracy. More recently, lending support to this hypothesis Barro (1999) asserts that empirical evidence shows that real per capita GDP along with educational attainment and increased life expectancy lead to the emergence of democratic Polity. What is peculiar about the MENA region is that the six oil-rich countries that rank amongst the top, with the highest per capita GDP in the world (more than $10,000 since early 1970s) are amongst the most autocratic countries in the world. On the other hand, mid income countries in the region (Tunisia, Lebanon, Morocco, and Egypt) are doing much better in terms of democratic Polity. The modernization hypothesis thus fails to explain the persistence of autocratic governance in the MENA region. Theories behind the democracy deficit are presented below:

<u>a. Oil-a natural resource curse</u>

Perhaps one of the most reliable arguments in the literature explaining the democracy deficit in the MENA region is that oil renders the emergence of democracies less likely. Earlier studies (Beblawi, 1987) pointed out the negative impact of oil revenues on democracy. This was later empirically verified when Ross (2001) found evidence of a negative and significant relationship between oil wealth and democracy. This relationship did not hold only for MENA countries but to other regions of the world as well.

The logic behind these results was that oil producing countries specifically Gulf countries are allocation states where most of their income is derived from outside (oil selling) and government spending is therefore not reliant on the collection of taxes. With no taxation, citizens are less demanding in terms of political participation. This might present a plausible explanation of the democracy deficit in Gulf countries but it is not enough to explain this deficit in the entire region the main reason being that a considerable number of countries in the MENA are oil-poor countries with no reliance on oil wealth.

<u>b. Islam</u>

Samuel Huntington (1984) argued that Islam was "not hospitable" to democracy. In his main argument, he proposes that in Islam there is no separation between religion and politics or between spirituality and secularity. He continues that political participation is an "alien" concept in Islamic culture. However, Makdisi and ElBadawi (2011) find that religion has no significant impact on democratic Polity and no empirical evidence exists to support the claim that Islam impedes any democratic

transition. More interestingly, Polity IV scores reveals that the biggest Islamic countries like turkey and Indonesia are long standing democracies. At the same time religion can be instrumentalized ,i.e, used for political purposes (Platteau, 2008) as has been happening in recent years especially on the part of fundamentalist groups.

c. Conflict

Perhaps one of the most compelling arguments in the literature explaining the persistence of a democracy deficit is MENA's conflictual environment: home wars, interstate   wars and the ever-continuing Arab/Israeli conflict. Along with oil, they appear to be major determinants of the democracy deficit in the region,

The basic argument is that time persisting conflicts have provided authoritarian leaders with the excuse to tighten their autocratic grip on their countries by imposing emergency rule and strengthening military power. Empirical work of Elbadawi and Makdisi (2017) show that while ~~in~~ most regions in the world experienced more democratization following conflicts, the MENA region (specifically Arab states) has continued to experience less or no democratization.

Another possible argument is that the combination of oil and conflict in the region has made it more profitable for the United States and other western powers to maintain autocratic governance in the region because they are better able to serve their interests in the region. The Gulf war of 1991 demonstrated how the U.S. was willing to go to war to defend its strategic interests in the region. Equally, the U.S. along with other western countries have been willing to forge alliances with-non-democratic countries in the region such as Saudi Arabia, Qatar, and Jordan…etc. To preserve their both their oil interests and in support of Israel.

In recent years, specifically after 2010 a new picture has emerged in the region with the rising of new fundamentalist movements accompanying the uprisings in many countries that turned to armed civil conflicts which have put the region through a turmoil that does not seem to be ending anytime soon.

d. Other variables

- Previous works by O'Donnell and Schmitter (1986) and Linz and Stepan (1996) argued that splits in the ruling coalition serves a prerequisite for any political transition. More recent literature focuses on the relationship between radical and moderate opposition (Hamladj, 2002).
- Past colonial rule has been found to negatively impact the transition towards a democracy but alone it is not sufficient evidence to the entrenchment of autocratic rule in the MENA region.

To summarize, the entrenchment of MENA autocracies and the persistence of the democracy deficit has been best explained by the presence of conflict and the abundance of oil as a natural resource. However, here another variable, hardly visited, stands out, namely, foreign development aid, and its impact of development on the quality of political institutions in the MENA. Did aid play a role in the gradual move towards the 2010 uprisings or did it facilitate the strengthening or already existing autocratic regimes? Could aid have had little or no impact on the quality of political institutions in the MENA?

Before attempting to study the impact of development aid on the institutional quality and governance in the MENA region, a brief review of the literature on aid and

democratization would be useful (section below). First, the basic theoretical

mechanisms through which development aid can influence institutions is addressed and

secondly, empirical results are presented.

CHAPTER 2

LITERATURE REVIEW

A. Mechanism: the theoretical framework on the effect of aid

A fair amount of literature exists that tries to explain the mechanism through which foreign aid effects political institutions. Here we begin with the common assertion that the decision on quality of political institutions (governance) is dependent on the way political elites optimize their expected utility, subject to relevant constraints. Accordingly, foreign aid flowing to a country has the potential of altering political calculus and inducing a shift in the existing political institutions (this shift *takes place because existing political elites find it more utility optimizing to do so). Two basic mechanism are presented on the way aid influences institutions.*

First, following Moore (2004), higher quality institutions are characterized by cost-efficient processes of domestic revenue collection. An increase in the amount of aid flowing to the country, if significant enough, would constitute a substitute for domestic revenue collection which would lead to a decline in the quality of political institutions. In other words, governments that rely on foreign aid as an important part of their inflows are less reliant of the collection of tax revenues and therefore, are less responsive to their citizens' pressures for reform and accountability. Therefore, what follows is the impediment of the democratization process due to citizens' hampering control over the ruling political parties (through the payment of taxes). This provides a theory on aid with similar characteristics and institutional effects as natural resources with the potential consequence of developing, what is commonly known in the literature

as rent-seeking states or rentier states (the natural resource curse) (Djankov, Hart, McLiesh, & Shleifer, 2008; Mesquita & Smith, 2013; Morrison, 2007).

The basic critique of this mechanism is in its simplicity. To begin with, proponents of this mechanism suggest that this often applies on non-democratic regimes and doesn't apply where democratic institutions are already in place suggesting that initial conditions of existing institutions matter.

 Further considerations of this mechanism led some researchers to reject the whole theory of the foreign aid curse. Altincekic and Bearce (2014) claim that the classification of the effects of aid as similar to the effects of natural resources requires a certain degree of *fungibility* of aid- or the ability of aid to unconditionally (completely) replace governmental tax revenues. According to the authors, this characteristic is not present in aid (except to a certain degree) since the expenditure financed from aid are more constrained than those collected from tax revenues are. This is because donor countries often impose certain restrictions and conditions on the allocation of aid and on the potential uses of aid.

A third critique of this theory suggests that utility achieved for political leaders from achieving better institutional quality provide a higher revenue stream. Where foreign aid constitutes a considerable amount of the government's budget and where the amount of foreign aid is dependent of institutional quality, political actors are therefore motivated to enhance the quality of deteriorating institutions or sustain the quality of already higher quality institutions.

The second mechanism through which foreign aid can affect the quality of existing institutions relies on the concept of political survival. This theory attributes the effects of foreign aid to the amount of aid political elites can actually utilize and the

degree of discretion on the use of aid. In this context, Licht (2010) found that aid helps strengthen the position of newly elected leaders. Others point out that aid is dependent on the alliances donor countries have with domestic political leaders in recipient countries with leaders with strong alliances receiving on average more aid (Faye & Niehaus, 2012). Freidman (1958) argued that foreign aid impedes democratic transition because most of it goes to governments thus undermining the role of the private sector and a comparative strengthening of the government sector. Other scholars, have pointed out to different channels through which foreign aid has facilitated democratic transitions where donor countries explicitly deploy aid to foster popular demand or institutional change towards a more democratic governance, therefore, pressing leaders to implement these changes for the sake of staying in power (Scott & Steel, 2011).

The above brief review clarifies some very important aspects when considering the impact of aid on political institutions. First, the relationship between aid and political institutions is not as simple or uni-directional as it may first seem. There are country specific structural components (complex), primarily related to the calculus and status of the political elite class that might affect the direction of foreign aid. Second, aid cannot be considered as a homogenous good since the type of aid and the existing preconditions on the disposal of aid result in a variation of the institutional effects. Third, institutional effects of aid depend on the continuity of aid (known as the volatility of aid flows). Short-term aid driven by short-term donor strategic interests promising long-term institutional changes is not likely to be credible or efficient. Celasun and Walliser (2008) claim that aid volatility leads to the allocation of aid on recurrent expenditures rather than long-term investments. Also, Kangoye (2013) finds out that higher aid volatility is associated with higher levels of corruption.

B. Empirical findings

The impact of foreign aid on economic growth has spawned a huge amount of literature since early 1970s. In an attempt to present the major results on the effects of foreign aid on economic growth outcomes, we reference Rajan (2005) :"the debate about aid effectiveness is one where little is settled". In a similar perspective, a large amount of literature tried to study the impact of institutions on growth. Here, there was a sort of agreement amount scholars that high quality political institutions, specifically strong private property rights, are associated with higher per capita income and therefore positively related to growth (Acemoglu & Johnson, 2005; Barro, 1996; Rodrik et al., 2004).

Recently, however, the question of the effect of aid on recipient country's institutions drew the attention of researchers. While the basic aim of foreign aid is to achieve economic growth, many researchers have argued that success of aid in achieving its purpose is a function of the quality of institutions (Burnside & Dollar, 2000, 2004) though there is yet no widely-accepted conclusions. However, as discussed above it would be incorrect to state that the literature so far did not succeed in providing a clear-cut picture on the effect of aid on the democratization process. The following section presents the basic empirical finding on the effects of foreign aid on the quality of political institutions (governance).

Optimists view aid as a powerful tool that has the ability of leading autocratic countries to implement democratic governance. Knack (2004) tries to put a theoretical framework to explain the mechanism through which aid promotes democracy before testing testing the effect empirically. He explains that foreign aid can provide technical assistance to recipient countries that in turn strengthens their legislative and judicial

authorities. Technical assistance through "democratic aid" primarily seeks to support the achievement of democratic election by providing the appropriate infrastructure for elections, providing security at voting locations, and monitoring the transparency and legitimacy of the election process through the presence of independent professional observers. Second, with proper targeting, foreign aid can help strengthen the democracy-supporting institutions; specifically making the criminal justice system more efficient and transparent or even strengthen opposing parties which will in turn weaken autocratic rule. Other researchers focused on the ability of aid in improving education and income and thus enhance democratic rule. Lipset (1959) suggest that foreign aid has the ability of modernizing societies by increasing literacy and income that are key components to the modernization hypothesis.

On the other hand, other scholars noted some adverse effects of aid. First, and most worryingly, the excessive aid can weaken local demands of the mass population for institutional reform and accountability. Second, foreign may cause a moral hazard problems for both the recipient and the donor by relieving to some extent budget constraints (Bräutigam & Knack, 2004).

Third, in countries where ethnic fractionalization is high, foreign aid, it is suggested, may escalate the competition between interest groups to control and benefit from a greater amount of resources which in turn increase rent-seeking activities and hence weaken political institutions   (Grossman & Helpman, 1992; Svensson, 2000).

Empirically, Goldsmith (2001) finds that more aid is related with increasing political and economic freedoms and civil liberties, where he finds a positive and statistically significant relationship between aid (specifically ODA) received from western countries and the level of democracy in forty-eight recipient countries in Sub-

Saharan Africa. In addition, using a sample of countries in the post-Cold War period, Dunning (2004) reports a small positive effect of aid on democracy which shed light on the importance of the geopolitical context when looking at the effects of aid.

Yet in contrast with this positive view, the bulk of recent empirical evidence has been generally pessimistic about the effectiveness of aid. Contrast to his theoretical framework, Knack (2004) uses a long-run cross sectional analysis covering a 25-year span and finds that there is no evidence that foreign aid promotes democratization but he did not estimate the effect to be negative.

Boone (1996) was amongst the first who reflected on the effect of different regime types on aid effectiveness. He found that aid's effect on the growth in checks and balances does not differ between regime types. Svensson (2000) applies a game theoretic model that focused on foreign aid flows to study rent seeking activity. In his model, aid can either be allocated towards the investment of private goods or to private consumption. Svensson reports that due to high rent-seeking activity, foreign aid is mainly associated with higher corruption levels. More recently Rajan and Subramanian (2007) reported that among developing countries, foreign aid was associated with deterioration in the quality of institutions and governance.

Djankov et al. (2008) find some support that higher levels of foreign aid can harm the recipient county's political institutions. On the same page, Heckelman and Knack (2009) studied the impact of foreign aid on economic institutions of recipient countries and found evidence to the hindrance of market oriented reform. In a later paper, however, Heckelman (2010) found that foreign aid has no significant impact on economic institutions.

A number of studies focus on the effect of foreign aid on democratic transition-sizable shifts towards democracies. Wright (2009) finds the effect of aid depends on the initial governance conditions, and aid has a democratizing effect across all countries. Except where military regimes are present, the effect is reversed. Furthermore, Bermeo (2011) examines the different effects of foreign aid conditional on the nature of the political institutions of donor countries. He finds that there exists a positive relationship between aid from democratic countries (DAC donors) and transitions but no such link was found in the case of autocratic donors (rich oil countries for example).

Other studies focus on the impact of development aid and other rents (for example oil) on democratic transition. Morrison (2007) finds that all rents (foreign aid included) have a negative impact on the probability of democratic transition. In contrast, Wright (2009) finds that in the times of economic crises, foreign aid increases the likelihood of a democratic transition while oil rents decrease this likelihood. Bermeo (2011) reports results that the impact of aid on the political governance of countries changed as a result of the change in donor motives after the Cold War while the impact of oil rents didn't change.

Of interest as well is recent the empirical finding related to the theory of the amplification effect of foreign aid. Accordingly, Dutta, Leeson, and Williamson (2013) suggest that foreign aid plays the role of consolidating and strengthening already existing political institutions; in other words, autocracies become more autocratic while democracies become more democratic. This view was also adopted by Mesquita and Smith (2013) where they explain that aid tends to be captured by the political authorities and where the rule is already autocratic it will tend to survive longer. Dutta et al. (2013) use panel data and reports an amplification effect of aid on political institutions.

However, this theory of the effect of foreign aid has only little empirical support in the literature for the time being.

CHAPTER 3

AID IN MENA COUNTRIES

A. Allocation across countries

In order to assess the impact of aid on political institutions on the MENA region, a better understanding to the amount of development aid allocated towards MENA countries must be established first. Accordingly, the below section begins by representing the amount of development aid received by the 22 MENA countries under study from 1970 to 2014, followed by a comparison between the development aid allocated to the MENA regions in comparison to other regions of the world.

As mentioned in the previous section, the literature utilizes official development assistance (ODA) to measure the effect of foreign aid on institutional quality and on growth. Looking at the MENA region in the period between 1970 and 2014 (table 2) one can notice the large range of discrepancies in the distribution of foreign aid across MENA countries. On one hand, Mauritania and Djibouti receive the highest ratios of aid to GDP between all the countries in the region on average (17.31% and 17.13% respectively). Jordan ranks third with an average ratio of development aid to GDP of 13.96%. Yemen, Syria, and Sudan received foreign aid close to 7% of their GPD. On the other hand, oil-rich countries including Saudi Arabia, Kuwait, United Arab Emirates, and Qatar receive practically no foreign aid assistance (close to 0.01% of their GDP).

Discrepancies hold even when considering every country individually across different periods. It is worthy to know that the path of foreign aid distribution was not consistent through the years. For example, Iraq has an average ratio of aid to GDP of

4.26% between 1970 and 2014, between 1990 and 1999 foreign aid averaged 1.92% of

GDP this increased substantially between 2000 and 2009 to average 15.25% (almost an

8 times increase). This substantial increase was witnessed after the invasion of Iraq in

2003. These discrepancies in the allocation of ODA by donor countries could be

attributed to a variety of developmental or political factors.

Table 3.1. ODA as percent of GDP across MENA countries

| | Year Category | | | | | |
Country	*1970-1979*	*1980-1989*	*1990-1999*	*2000-2009*	*2010-2014*	*Total average*
Mauritania	19.67	21.48	17.88	14.15	9.42	*17.31*
Djibouti	15.43	20.71	22.27	12.88	11.61	*17.13*
Jordan	27.39	17.54	8.52	6.09	6.59	*13.96*
Yemen	15.19	11.87	3.69	1.82	3.31	*7.6*
Syria	16.28	8.99	2.65	0.45	7.84	*7.17*
Egypt	18.16	5.87	5.99	1.41	1.46	*7.15*
Sudan	4.3	8.87	2.9	3.38	3.29	*4.69*
Iraq	0.57	0.23	1.92	15.25	2.4	*4.26*
Tunisia	5.61	2.17	1.34	1.11	1.69	*2.46*
Morocco	2.72	2.79	2.14	1.26	1.56	*2.15*
Lebanon	1.26	1.9	1.64	2.19	1.59	*1.73*
Oman	4.27	1.15	0.57	0.25	-0.01	*1.38*
Bahrain	1.57	2.14	1.35	0.34	0	*1.2*
Cyprus	1.49	0.66	0.23	0	0	*0.53*
Algeria	1.08	0.34	0.48	0.29	0.12	*0.5*
Turkey	0.36	0.28	0.18	0.11	0.36	*0.25*
Libya	0.07	0.07	0.02	0.03	0.76	*0.13*
Iran	0.05	0.04	0.12	0.06	0.04	*0.06*
United Arab Emirates	0.05	0.03	0	0	0	*0.02*
Kuwait	0	0.02	0.02	0	0	*0.01*
Qatar	0.01	0.02	0.01	0	0	*0.01*
Saudi Arabia	0.01	0.02	0.01	0	0	*0.01*

B. MENA versus other regions

Between 1970 and 1979, the MENA region received the highest percentage of

official development assistance to GDP across all other developing regions in the world

(the regions are Sub-Saharan Africa, Latin America and Caribbean, East Asia and Pacific, and South Asia). After the 1970s until this day, the MENA region has received the second highest official development assistance to GDP ratios after Sub-Saharan Africa.

Official development assistance to GDP allocated to the MENA region decreased while that allocated to Sub-Saharan Africa increased considerably. From the 1970s and onwards, the trend of official development assistance to GDP has been in a decline (from 3.5% to close to 1%). This figure is perhaps confusing since the MENA region includes high-income countries that do not receive development assistance. In the 1990, however, there was a small increase in the allocation of development assistance in the MENA region (close to 3.5%). A similar increase could be noted for Latin America and the Caribbean (see figure 1 below).
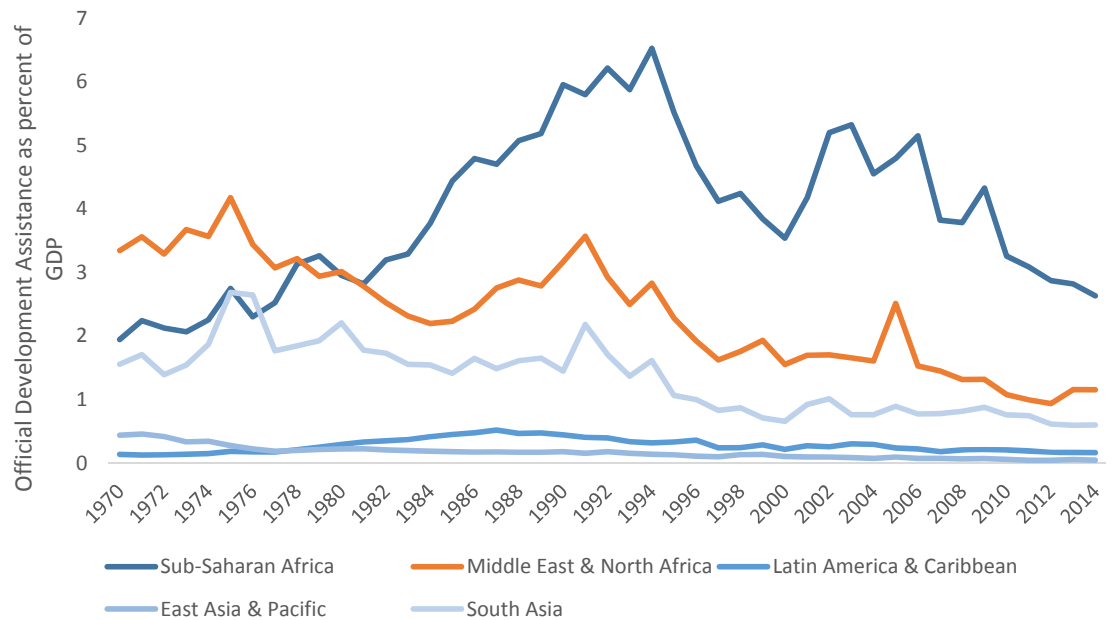
Figure 3.1. ODA as percent of GDP across the different regions of the world

CHAPTER 4

DATA AND EMPIRICAL METHODOLOGY DATA

In an attempt to measure the effect of foreign aid on political institutions in the MENA region, we employ random effects panel data from 22 MENA countries between the years 1970 until 2014.

A. The dependent variable: measuring institutions

In order to investigate the effect of ODA on our dependent variable of interest (political institutions) we need to find a proxy that accurately measures governance quality in countries. Previous literature uses different proxies of institutional quality with each comprising different mechanism and capturing different aspects of institutions to measure governance. This paper tries to reduce measurement error associated with individual institutional measures by compiling five different institutional measures into one compounded indicator. The belief is that this indicator will more efficiently capture institutional quality by making advantage of the different aspects measured by the different indicators. The five institutional indicators are (1) the Polity IV democracy score; (2) the checks and balances measure by Keefer and Stasavage (2003); (3) the Democracy Dictatorship dichotomous measure by Przeworski et al. (2000) and later developed by Cheibub, Gandhi, and Vreelan (2010); (4) civil liberties and (5) political freedoms provided by Freedom House. The five different indicators are described below.

The Polity IV project (Marshall & Jaggers, 2010) measures the level of democracy (DEMOC). The measure focuses primarily on executive recruitment,

constraints on the level of political competition, and the guarantee of civil liberties to all citizens. The Polity utilizes a scale between 0 and 10, with 10 representing full democracies.

The checks and balances (CHECKS) measures utilizes different indicators from the Database of Political institutions (DPI). CHECKS score approximates the number of "veto" players that are part of the country's political system, and whose agreement is necessary before policies are changed. A higher CHECKS measure is indicative to higher constraints on the government and greater protection of individuals against arbitrary government actions and therefore, more democratic governance.

The dichotomous Democracy Dictatorship (DD) indicator measures institutions by defining democracy as a regime where "key government office", including both executive and legislative offices, is filled by "contested elections" (Przeworski et al., 2000). Accordingly, the reversed "DD" dummy codes 1 for democracies and 0 for dictatorships while transition years are coded according to the later emergent regime.

The political rights (POL_RIGHTS) and civil liberties (CIV_LIBERTIES) indicators are provided by the Freedom House. They represent more comprehensive measures of democracy than the previous indicators. POL_RIGHTS measures political institutions based on the nature of the electoral system, the functioning of the government, and the extent of political heterogeneity. CIV_LIBERTIES, on the other hand, evaluates the conditions of freedom of belief, personal autonomy, and the rule of law. It represents a comprehensive measure of governmental constraints.

These five institutional measures are normalized and averaged into one institutional measure, which will represent the dependent variable under study in this thesis.

Table 4.1. Indicators to construct the dependent variable

Data	Source and creation	Description
DEMOC	Polity IV by Marshall & Jaggers, 2010	Measures the level of democracy. Focuses primarily on executive recruitment, constraints on the level of political competition, and the guarantee of civil liberties to all citizen
CHECKS	Keefer and Stasavage (2003)	Approximates the number of "veto" players that are part of the country's political system, and whose agreement is necessary before policies are changed. Higher CHECKS measure is indicative to more democratic governance
Dichotomous Democracy Dictatorship (DD)	Przeworski et al. (2000) & Cheibub, Gandhi, and Vreelan (2010)	Measures institutions by defining democracy as a regime where both executive and legislative offices, is filled by "contested elections"
Political Rights	Freedom House	Measures political institutions based on the nature of the electoral system, the functioning of the government, and the extent of political heterogeneity
Civil Liberties	Freedom House	Evaluates the conditions of freedom of belief, personal autonomy, and the rule of law

B. Measuring the key independent variable: foreign aid

To obtain our primary independent variable of interest, we use official development assistance (ODA) data to measure the amount of foreign aid each country in the MENA region receives. ODA consists of official funding provided by 23 OECD (members of the Organization for Economic Co-operation and Development) countries that are members in the Development Assistance Committee (DAC) plus the European Commission. ODA consists of official grants and loans dispersed to a recipient country during a year with the primary objective of achieving economic development. Following the work of Burnside and Dollar (2000), ODA is converted to 2005 dollars using the World Import Unit Value Index[2] provided from the International Monetary

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[2] import unit value indices measure the overall change in the prices of transactions in goods and services between the residents of an economic territory and residents of the rest of the world (IMF; 2010). In order to have data in constant 2005-dollar prices and in purchasing power parity we multiply the Unit Value Import Index of 2005 and then divide by the UVI for the world of the current year.

Fund (IMF). Afterwards, ODA is divided by real GDP data gathered from the Penn

World Table version 8.0 (Feenstra, Inklaar, & Timmer, 2013).

Table 4.2. Independent variables: source and description

Data	Source and creation	Description
Official Development Assistance (ODA)	Development Assistance Committee (DAC) from the Organization for Economic Co-operation and Development	Consists of official grants and loans dispersed to a recipient country during a year with the primary objective of achieving economic development. It is converted to 2005 dollars using the World Import Unit Value Index provided from the International Monetary Fund (IMF). ODA is divided by real GDP data gathered from the Penn World Table version 8.0
Trade openness	World Development Indications	Sum of exports and imports divided by GDP. It converted to 2005 dollars and then divided by GDP values
Oil production	British Petroleum Statistical Review of World Energy, Historical Data	We compute oil share by multiplying number of barrels by oil prices and dividing by 2005 GDP values
Military expenditure	World Development Indicators	Military expenditures converted to 2005 dollars and divided by GDP (2005 dollars).
Religious Fractionalization	MacroDataGuide	Time Invariant
Ethnic Fractionalization	MacroDataGuide	Time Invariant
Initial values of political institutions	Compiled indicator	Initial values of political institutions (from the compiled indicator) are used in every period

C. Other independent variables

A number of control variables are used to control for political, economic, social,

religious determinants of institutional change. The choice behind these variables is

based on existing empirical and theoretical literature and is modified according to the availability of data and the specificity of the studied region.

External factors, namely the degree of trade openness is likely to influence the prospects of changing institutional quality by spreading and popularizing liberal and more democratic political systems (Gleditsch, 2002). This paper employs a measure of trade openness (sum of exports and imports divided by GDP) to capture this influence (source: World Development Indications). The sum of exports and imports is converted to 2005 dollars and then divided by GDP values (similar calculations done on ODA).

Following the argument known as the "oil curse", which states that oil rich countries are less likely to adopt democratic forms of governance; states have the ability to raise revenues without resorting to tax revenues from the population and thus reducing the degree of accountability towards its citizens and disregarding reform pressures (Ross, 2001). Data on oil production are gathered from the British Petroleum Statistical Review of World Energy, Historical Data. We use data on oil production (in thousands barrels) and oil prices (converted to 2005 dollars). We compute oil share by multiplying number of barrels by oil prices and dividing by 2005 GDP values.

The power of the military regime in the country has been also regarded in the literature as a determinant of the political regime (Ross, 2001). Historically, the main reasons behind overthrowing governments are military (military coup or conquest). Strong military has the capability of both preventing or deterring and arising or increasing the threat of military coups, and therefore the power of consolidating or changing political regimes. Military expenditure, from World Development Indicators Dataset, is converted to 2005 dollars and divided by GDP (2005 dollars).

In accordance with previous literature, the degree of ethnic and religious fractionalization is also likely to affect the democratization process. Democracies are less likely to prevail in socially divided countries (Horowitz, 2003). Two proxies for ethnic and religious fractionalization from the MacroDataGuide are employed as an index to measure the depth of social division in every country.

One of the primary characteristics of political institutions is its persistence and self-sustainability (Acemoglu & Johnson, 2005; Barro, 1999). The initial conditions of the political system are thought to limit the capacity of countries to increase their rating. Initial values of political institutions (from the compiled indicator) are used in every period. This enables regime rating to be conditional on their initial institutional values and would help dealing with serial correlation associated with the dynamic modeling of political regimes.

D. Model

Our dataset is comprised of a panel data of 3-year periods from 1970 till 2014: 1970-1973, 1973-1976, 1976-1979, 1979-1982, 1982-1985, 1985-1988, 1988-1991, 1991-1994, 1994-1997, 1997,2000, 2000-2003, 2003-2006, 2006-2009, 2009-2012, 2012-2014. The data is divided over 3-year periods because we expect that any change in policy or institutional quality is not likely to take place directly upon the delivery of aid.

Our expectations are that during the 3-year period of observed aid flows there will be an effect on institutional quality. 3-year periods, and not longer, are enough to capture institutional change in the MENA region mainly because unlike all other regions in the world, the frequency of political instability and turmoil in the MENA is

very high (Cordesman & Wilner, 2012). Theoretically, there no preference for a specific interval of time. Some previous studies used time series panel approach with 5 year intervals (Burnside & Dollar, 2000; Djankov et al., 2008), others used 3 year intervals (Busse & Gröning, 2009), and some used annual data (Wright, 2009). We should keep in mind that institutions tend to be persistent over time and it is reasonable to expect lag periods between the deliveries of aid the implementation of any institutional reforms.

E. OLS Estimation

To analyze the relationship between foreign aid and institutional quality, our starting point is with the following OLS specification model:

$$\Delta INST_{(it-1;t)} = B_0 + B_1 AID_{t-1;t} + B_2 INST_{it-1} + BZ_{(t-1;t)} + e_{it}$$

(1)

Where $\Delta INST_{(it-1;t)}$ is a measure of the change in the compiled proxy for political institutions between the third year and the first year (described in the data section above). $AID_{t-1;t}$ is the measure of average aid as a percent of GDP received between (t-1) and t.

$INST_{it-1}$ is a proxy for the initial level of institutions; this is sensible specifically while keeping in mind that institutions are persistent and that the level of institutions is likely to be a function of the quality of initial institutions (the dependency is logical given the bounded nature between the 2 measures). Also, reporting for the initial level of institutions is standard in the literature (Djankov et al., 2008; Heckelman, 2010).

$Z_{(t-1;t)}$ is a vector of control variables described in the data section to account for country specific characteristics, it includes the 3-year average levels of oil, military expenditure, and trade openness, and ethnic and religious fractionalization. In addition, e_{it} is the residual error.

Finally, period fixed effects are included in the above model because the level of institutions may change over time not in a monotonic or linear fashion. Certain periods may be associated with an overall increase or decrease in the amount of aid given by many countries at the same time. For example, the introduction of the Millennium Development Goals in 2000 was associated with increased aid flows, while major economic crisis are supposed to be associated with a decrease in aid flows.

F. The endogeneity of aid

The basic problem with the above model is that OLS regression is that it probably does not succeed in showing the causal impact of aid because aid is endogenous (OLS regression gives biased results. The basic justification behind this is that the allocation of aid is likely to be affected by simultaneity bias, as it is subject to donor's interest of recipient countries political regime. In other words, decisions on whether or not to give aid are affected by institutional quality of the recipient country. To provide evidence on this, Alesina and Dollar (2000) report that "countries that have democratized have received a surge in foreign aid, immediately afterwards [...] the democratizing country receives 50% increase in aid". They also provide evidence that donors are heavily influenced by the recipient countries' records of human rights and the quality or governance, with specific emphasis on the impact of democracy on the allocation decision. On the other hand, humanitarian needs of recipient countries seem

less important than political indicators in determining aid flows. Brück and Xu (2012) report similar results. In addition, the influential paper by (Burnside & Dollar, 2000, 2004) recommends that donor countries should consider institutional quality before making any allocation decisions.

To correct for this endogeniety, we adopt Two-Stage Least Square (2SLS) random effects estimation with instrumental variables. This technique is suitable for controlling for the potential endogeniety of aid (the appendix provides information on the theoretical framework of 2SLS estimations).

G. Two-stage least squares estimation

A 2SLS regression model with instrumental variables is supposed to confront issues related to the potential endogeniety of aid. This theoretical argument yields a first stage regression and a second stage regression with the following specifications:

First stage regression:

$$AID_{it} = \alpha_0 + \alpha_1 population_{it-1} + \alpha_2 GDP_{it-1} + \alpha_3 distance1_{it} + \alpha_4 distance2_{it} + \alpha_5 INST_{it-1} + \alpha Z_{t-1;t} + \varepsilon_{it}$$

(2)

Second stage regression:

$$\Delta INST_{(it-1;t)} = \beta_0 + \beta_1 AID_{t-1;t} + \beta_2 INST_{it-1} + \beta Z_{(t-1;t)} + e_{it} \qquad (1)$$

In order to address the endogeneity of aid we start with a first stage regression where we regress foreign aid on a variety of instruments that have been pointed out in the literature to assess aid allocation criteria. Aid is also regressed on a set of control variables (from equation 1). The basic idea behind the first stage regression is to regress

aid on a set of instruments that are correlated with aid but not correlated with e_{it}. The predicted values of aid are then used in the second stage regression (shown above).

H. Instrumenting aid

The choice of instruments used in the first stage regression follows the literature. Boone (1996), Burnside and Dollar (2000), and Alesina and Dollar (2000) showed that there are a variety of instruments that are suitable to deal with the endogeneity of aid; Aid/GDP is a function of a group of instruments that are not correlated with institutional quality namely population size, income size, and donor strategic interests. These instruments are supposed to cleanse out the correlation between aid and the error term in the second stage regression (equation 1) and ensure to capture a portion of aid that is not captured by the other control variables in equation 1. The instruments are utilized in the first stage regression. The following explain each instrument and the likelihood of its correlation with aid:

- GDP_{it-1} is the log of initial GDP. There is generous evidence in the literature that foreign aid is directed to low income countries. The primary goal of development aid is to increase GDP per capita of recipient countries.

- $population_{it-1}$ is the log of initial population. Evidence shows that countries with small population size in general receive more aid (country size bias). This could be true for several reasons. First, countries with a large population size requires large nominal amounts of foreign aid transfers which put international institutions and foreign donor under greater public scrutiny. Second, small countries are more likely to sell their influence by joining a coalition of countries instead of acting independently as large countries are more likely to do. Third, small countries are

more likely to have a higher voting influence in some international organizations like the United Nations.

- $distance1_{it}$ and $distance2_{it}$are respectively the distance from the capital of every country to the first and second closest foreign military base. These two variables are supposed to capture donor strategic interest in the MENA region.

In contrast to the altruistic belief that foreign aid is primarily allocated a relief poverty, a body of literature provides evidence that it is allocated according to political and geopolitical interest as well. Maizels and Nissanke (1984), Trumbull and Wall (1994) point out that strategic alliance of donor countries play a significant role in determining the distribution of aid. To control for these strategic interests previous literature (Boone, 1996; Burnside & Dollar, 2000, 2004; Knack, 2004) adopted standard political dummies (regional dummies: Sub-Saharan Africa, the Franc Zone countries, Egypt, Central American Countries). Taking into consideration the specificity and compactness of the region under study, regional dummies would not capture precisely the geopolitical interests of donor countries.

This paper adopts new variables not used before in the literature to capture geopolitical interests in the high-conflict MENA region- the distance between the capital city in the country and the two closest foreign military bases. The importance of foreign military bases in local and global politics has only recently captured the attention of political scientists (what is today known as the study of base politics). The establishment of foreign military bases is not limited to achieving military objectives; they are utilized to achieve political as well as economic interests of the establishing country and its global allies and partners. In the MENA region, there is an abundance of foreign military presence;

the United States, the United Kingdom, Russia, France, Turkey, and China hold military

bases on the MENA ground or very close to it. DAC members and donors are strong allies

of the US, the United Kingdom and France with intertwining political and strategic

interests. Thus, the study of the distribution of different foreign military bases depict to

some extent political interest of donor countries in the region.

Distance1 and *distance2* are generated by calculating the distance (in kilometers)

from the capital city of every country to the geographically closest foreign military base

(coordinates of latitude and longitude are converted to distance in kilometers). Theoretically

speaking, the higher the geopolitical and economic interests of major countries in a specific

country or group of countries, the higher willingness of these countries to control and

preserve these interests, and the more likely they are to establishing a military presence (for

example military bases). This might be more evident in the MENA region than all other

regions in the world considering the abundance of natural resources and the overarching

continuous turmoil with conflicting interests of major countries.

CHAPTER 5

RESULTS

The previous section describes the econometric model to infer the impact of the change in the stock of foreign aid (ODA in our case) on political institutions. The results of the previous estimation are reported in table 5.

We first estimate the effect of ODA of political institutions by constructing OLS estimation. Changes in institutional quality are regressed on ODA and a number of other independent variables that are addressed by previous literature as determinants of the quality of political institutions (Ethnic fractionalization, religious fractionalization, initial institutional quality, oil production, military expenditure, trade openness, and an interaction variable between trade and oil). Column (1) in table 5 represents the results of the OLS estimation. ODA has a negative (-0.00562) but insignificant effect on the changes in the quality of political institutions.

Following our explanation in the previous section, OLS estimation is likely to be biased primarily due to the endogeneity of ODA. A two-stage least squares with instrumental variables estimation is applied in attempt to solve the endogeneity of aid. The Columns (2) and (3) in table 5 represent the results of the first stage and second stage regressions.

The first stage regresses aid on a variety of instruments that have been explained in the previous section (logarithm of initial GDP, logarithm of initial population, and the distance to the first and second closest foreign military base) as well as a series of independent variables that effect changes in institutional quality. These instruments

used are likely to be correlated with the level of institutions, but they do not consider them as being determinants of the change in institutional quality.

As expected, foreign aid is directed towards low development countries or poorer countries (logarithm of initial GDP is negative and highly significant with a relatively high coefficient -3.917). Moreover, the larger the population of the country the more likely aid is allocated towards it, this follows from the idea that the more populous the country is, the more likely it is to be poor (logarithms of initial population is significant at 1% level and higher). Results show that the closer you are to the closest foreign military bases the more likely you are to receive foreign aid assistance (distance to the closest foreign military base is negative and highly significant -0.00653). This could be possibly explained as a clear indication that foreign aid is directed in accordance with the geopolitical interests of donor countries.

The results of column (3) table 5 correspond to the 2SLS estimations. The coefficient of ODA is negative and significant at a 10% level thus the more aid a country receives the worse its political institutions get after 3-years. Results show that a standard deviation increase in aid is associated with a 0.06387 decrease in institutional quality. Although the coefficient is relatively small but it is still significant.

Concerning all other independent variables, results of the 2SLS regressions shows that ethnic fractionalization, initial institutional quality, oil production, trade openness, and military expenditure have a negative and significant effect of the quality of institutions (significance is either at a 1%, 5%, or 10% level). Religious fractionalization had a positive but insignificant effect on the quality of political institutions.

Table 2.1. The effect of development aid on institutions in MENA region

Variables	(1) OLS	(2) First Stage Regression	Two-Stage Least Squares (2SLS)
	Dependent Variables		
	Change in Institutional Quality (Political Regime)	ODA	Change in Institutional Quality (Political Regime)
ODA	-0.00562		-0.0258*
	(0.007)		(0.01)
Ethnic Fractionalization	-0.653**	0.1814	-0.659**
	(0.22)	(1.23)	(0.32)
Religious Fractionalization	0.057	-4.0678**	-0.0158
	(0.19)	(1.18)	(0.20)
Initial Institutional Quality (Political Regime)	-0.223***	-0.398*	-0.246***
	(0.03)	(0.17)	(0.03)
Oil Production	-0.00533*	-0.0037	-0.00716**
	(0.002)	(0.012)	(0.002)
Trade Openness	-0.00271**	0.0112*	-0.00243*
	(0.002)	(0.005)	(0.001)
Oil Production*Trade Openness	0.000144**	0.00111***	0.000165**
	(0.02)	(0.001)	(0.001)
Military Expenditure	-0.0275	-0.0989	-0.0317*
	(0.014)	(0.082)	(0.015)
Distance to Closest Foreign Military Base		-0.00653***	
		(0.0017)	
Distance to Second Closest Foreign Military Base		0.003272**	
		(0.001)	
Logarithm of Initial GDP		-3.5858***	
		(0.23)	
Logarithm of Initial Population		1.4135***	
		(0.23)	
Constant	1.114***	69.44***	1.305***
	(0.201)	(4.55)	(0.21)
R-squared (within)	0.3362	0.5852	0.3166
N	330	330	330

Notes: *, **, and *** denote statistical significance at the 10, 5, and 1% levels, respectively. Standard errors are clustered by country and are reported in parentheses.

A. Validity checks

1. The plausibility of the instrumentation strategy

The validity of the instrumentation approach is considered by first testing the explanatory power of the instruments selected using an F-test to test their joint significance. The null hypothesis of this test is Ho: the instruments are weak. According to Staiger and Stock (1997) , who formalized the definition of a weak instrument, if the F-statistics of excluded instruments is higher than 10, then the selected set of instruments are not weak. The F-statistics of excluded instruments is large (F (4, 319) = 79.73) and it is above the usual thresholds implying that our instruments are relevant and not weak. The partial R2 for the first stage regression is 0.5852 which is relatively high (table 6).

Table 5.2. F-test for excluded instruments

F-test of Excluded Instruments	
Ho: equation is weakly identified	
F(4, 319) =	79.73
Prob > F =	0

Second, the instruments should not be correlated with the error term of the second stage regression to be valid. A Sargan-Hansen-type test of over-identifying restriction is performed. The null hypothesis is that the instruments are validly excluded from the second stage regression. The reported J-statistics leads to the non-rejection of the null hypothesis, indicating that the instruments are exogenous or uncorrelated to the error term of the second stage regression (table 7).

Table 5.3. Sargan statistics for over-identifying instruments

Sargan statistic (over-identification test of all instruments):

Ho: over-identifying restrictions are valid

Sargan-Hansen J-stat: 6.171 Chi-sq(3)

 P-value =   0.1036

2.On the endogeneity of aid

Concerning endogeneity, Davidson and MacKinnon (1993) suggest an augmented regression test Durbin–Wu–Hausman test where the null hypothesis of this test is that there is no correlation between the predictor variable and the error term and thus OLS is consistent. The interpretation of the test is rather simple; a p-value<0.05 leads to the rejection of the null hypothesis. Table 8 shows the steps of the DWH test where the residuals of the suspected endogenous variable (ODA) enter from the first regression the main regression alongside with all other exogenous variables. The significance of the residual is then tested in the model where the p-value= 0.0186< 0.05. This leads to the rejection of the null hypothesis, indicating the foreign aid is endogenous and OLS is not consistent.

Thus after running these validity checks, we can safely infer that the above instrumentation technique is valid and endogeneity has been properly addressed.

Table 5.4. Steps of the Durbin–Wu–Hausman test of endogeneity of aid

	ODA	Change in Institutional Quality (Political Regime)
Ethnic Fractionalization	-0.616	-0.657**
	(2.92)	(0.22)
Religious Fractionalization	-4.925	0.00481
	(2.77)	(0.199)
Initial Institutional Quality (Political Regime)	-0.665**	-0.239***
	(0.23)	(0.03)
Oil Production	0.0072	-0.00665**
	(0.018)	(0.002)
Trade Openness	0.00574	-0.00251*
	(0.005)	(0.000)
Military Expenditure	-0.131	-0.0305*
	(0.085)	(0.015)
Distance to Closest Foreign Military Base	-0.00523	
	(0.004)	
Distance to Second Closest Foreign Military Base	0.00253	
	(0.002)	
Logarithm of Initial GDP	-3.917***	
	(0.43)	
Logarithm of Initial Population	1.212*	
	(0.49)	
ODA		-0.0201*
		(0.01)
Residual		0.0372*
		(0.016)
_cons	81.97***	1.251***
	(7.84)	
R-squared		
N	330	330

Notes: *, **, and *** denote statistical significance at the 10, 5, and 1% levels, respectively. Standard errors are clustered by country and are reported in parentheses.

Other robustness checks have been applied on the instrumentation strategy. We try to change our instrumentation strategy by using the traditional dummies for donor strategic interests that are applicable in the MENA region (using regional dummies: Former French Colonies, Former British Colonies). We find that aid still has a negative and significant impact on the changes in institutional quality.

Table 5.5. Durbin–Wu–Hausman test results

Testing for Endogeniety of Aid

Ho: Residual = 0

chi2(1)=	5.54
Prob > chi2=	0.0186

CHAPTER 6

CONCLUSION

This paper reassesses the relationship between development aid and democratization in aid recipient countries in the MENA region. This thesis builds on a body of recent and polemical literature on the relationship between aid and institutional quality and development. The basic theoretical relationship between aid and the quality of political institutions suggests that the relationship between these two is not likely to be a simple monotonic relationship. There is a significant amount of political calculus that is likely to interfere in the allocation of aid. Theoretically, these considerations are applicable when deciding on the allocation of aid to all recipient countries in general. We believe that political calculus is specificity of the MENA region with the entrenching history and present of conflict and the countless volumes of intervening domestic and foreign actors.

In an attempt to figure the causal relationship between development aid and political institutions, we try to resolve the potential endogeneity of aid by utilizing Two-Stage Least Squares estimation with instrumental variables. The instrumentation technique has been drawn in reference to previous literature in addition to a new attempt of choosing better instrumentation methods to capture geopolitical interests of donor countries. Moreover, this paper creates a new proxy of institutional quality that reduces measurement errors and the discrepancies between individual measures of institutional quality. We use five different institutional measures which are normalized and averaged to create on institutional measures which we believe is more efficient.

We find that foreign aid aimed to promote development in MENA countries has been detrimental to institutional quality and to the democratization process in any case. Foreign aid has been found to have a relatively small but negative and significant impact on changes in institutional quality of MENA countries. Our instrumentation technique proves to be valid and yielding strong instruments.

The main results appear to be robust to endogeneity concerns. Rerunning the model with the traditional instrumentation strategies utilized gives a negative and significant impact of development aid on institutional quality.

There are many possible interpretations for these results. We will try to interpret these results with a special consideration to the specificity of the region under study. The MENA region is characterized as the most autocratic region among all other regions. On the other hand, the MENA region receives the second highest ration of development aid to GDP after Sub-Saharan Africa. The allocation of aid to this part of the world may have assisted already existing autocratic regimes in maintaining or establishing a stronger grip on their powers. Another explanation could be that the revenue created by the flow of development aid has a similar impact to the revenues created by oil rents; they create corruption, rent seeking behavior, and a reduction in the reliability of the government towards its people.

This paper uncovers yet another factor that has negatively effects the prospects of democratic transition and the persistence of autocratic governance in the MENA region (although the impact is relatively small). Being an external intervening factor, results show that is has so far failed to assist in the transition towards better governance. Here, the MENA region doesn't stand out between other developing countries; recent literature has found evidence of the undermining effect of aid on political institutions.

There ought to be reconsideration from the side of donor countries calling on democratic governance in all countries in the world on the criteria through which aid is allocated in the MENA region: who should get aid? Moreover, how should aid be given? If development aid is supposed to assist in the reduction of poverty and the establishment of better governance, then in the MENA region it has failed to do so.

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