IMF, Democracy and Economic Development: Review and Critique

Psofogiorgos, Nikolaos - Alexandros and Metaxas, Theodore

Department of Economics, University of Thessaly, Volos, Greece

2017

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Nikolaos Alexandros Psofogiorgos,
Economist, PhD Candidate **,** Department of Economics, University of Thessaly, Volos, Greece, Email: psofogio@uth.gr

Theodore Metaxas,
Assistant Professor**,** Department of Economics, University of Thessaly, Volos, Greece, Email: metaxas@econ.uth.gr

Abstract

IMF was established as a financial institution for the promotion of world trade and international financial stability of members. However, IMF focused on assistance to developing countries and transition economies and as a result seems to have political implications.

Many studies suggest that IMF lending programs undermine the quality of democracy in the countries which make use of the institution's resources. This conventional idea is rooted in two basic assumptions: First, when negotiations are made, the doors are closed. Secondly, the IMF programs impose strict limits on political power of borrowers that may result in power distribution consequences.

Other studies result in a positive relationship between IMF programs and democracy. Maybe the presence of an IMF loan itself doesn't affect the democracy, but high loan reforms required have negative impact on democratic practices. This effect depends on the type of reforms that are required by the loan.

Key words: IMF, democracy, reforms, political implications

Jel Codes: E02, G01, F33, O43

Introduction

IMF was established as a financial institution for the promotion of world trade, international financial stability, macroeconomic stability and the development of member countries. However, after the collapse of the Bretton Woods system, especially after the crisis of the 1980s, IMF focused on assistance to developing countries and transition economies. Among the many roles played by the Fund, an important role is the one that affects the global outlook in political democracy.

Many thoughtful observers, such as Stiglitz (2002), believe that the IMF lending programs undermines the quality of democracy in the countries which make use of the institution's resources. Since 2002, IMF has spent over $ 550 billion in funds for the Member States which needed its help. So, to safeguard these funds, IMF asks conditions and commitments for the policies pursued by the country which borrows. Thus, bounced on the lifeline offered by the IMF on governments to address the financial problems, imposes serious limits on the discretion of the government policy and restrictions on accountability to the public. The various changes in policy by governments to keep pace with the IMF required, such as various devaluations, rising taxes, cuts in public spending and other, sometimes cause violent social protest. A typical example is that of Bolivia, where when President Gonzalo Sanchez de Lozada announced a series of strict IMF austerity measures in 2003, the popular reaction was immediate, widespread and unequivocal as demonstrations were started and political demonstrations leading even to clash with army (Babb and Carruthers 2008). The result was Sanchez de Lozada leave the presidential palace and the country under conditions of severe social and political turmoil (Dreher and Gassebner 2008). The idea that the IMF austerity programs increase the risk of social instability is not new.

The stable high-level democracies are less prone to experience civil war and brutal output power. According to Kapur and Naim (2005), all agree that these statements exceed the economic sphere and have huge political and social consequences in the processes and institutions that make up the nerves of democracy. Several studies have shown the harmful political consequences of borrowing from IMF. Barro and Lee (2005) analyze that as the involvement of the Fund becomes deeper, the democracy becomes weaker in countries that borrow. Abouharb and Cingranelli (2009) find that human rights conditions deteriorate in the presence of IMF programs. Brown (2009), working on a sample of Latin American countries the period 1998-2003, concludes that most loans exert downward pressure on the republic level. Dreher and Gassebner (2008) find that the IMF programs dramatically increase the likelihood of governmental crises which in turn could exert undue pressure on fragile regimes. The conventional idea that democracy slows with the participation in IMF programs is rooted in two basic assumptions regarding the negotiation and implementation of IMF programs. First, when the negotiations are made, the doors are closed so that the voices of citizens are less likely to be heard. As supported by Kapur and Naim (2005), by their nature, the conditions of the IMF do not arise from the discussion in society, but come from unelected foreign experts. Thus, under such conditions that reduce transparency, it is no surprise opponents to see violence as the only reaction. Second, the actual implementation of IMF programs imposes strict limits on discretionary political power of borrowers and therefore can bring power distribution consequences. Governments have to choose which social groups will distribute more cost cuts. As supported by Hartzell, Hoddie and Bauer (2010) membership in IMF programs reduces the ability of state institutions to address or compensate losers raised by economic liberalization through cost cuts and the loss of any other form of control in the economy. As a result, increases the likelihood of violence by losers who are opposed to changing conditions.

Some other studies suggest the opposite. For example, studies of Limpach and Michaelowa (2010) and Nelson and Wallace (2005), looking to find the factors influencing the level of democracy, conclude that there is strong evidence that there is a positive relationship between IMF programs and measures of democracy. Also Keohane, Macedo and Moravcsik (2009) argue that participation in multilateral organizations often helps domestic democratic institutions to limit the validity of the specific factions' interest, to protect individual rights and improve the quality of democratic consultation while also increase capacity to achieve public purposes.

A more diversified view of policy implications of IMF lending arrangements, comes from Nooruddin and Simmons (2006), investigating how different regimes choose to bear the pain of IMF austerity. According to Noorudin and Simmons (2006), is not sufficiently accurate to agree with critics that the IMF programs are imposed on countries with economic turmoil and therefore the IMF is absolutely guilty for any negative consequences that have programs for the poor.

Rather, it suggests that the diversity of national polar institutions determines how spending cuts will be distributed to the various classes of the country. While the analysis shows that public expenditure on health and education are generally higher in the republic, under the IMF regime, authoritarian regimes tend to increase spending in these areas as opposed to democratic regimes in which cutting of these areas is made for achieving these objectives. As Vreeland (2003) argued, recourse to IMF includes the payment of a “sovereignty cost”, since it entails delivery of financial management to an external authority. Perhaps an explanation for the behavior of authoritarian regimes would be the fact that as an offset to this cost, leaders become more populist, seeking to expand its support base through selective expenditure increases aimed at a wider section of the population.

The "ownership"

IMF among many roles it plays in the global economy, appears to play an important and controversial role, at the same time, in influencing global perspective of political democracy. The added complexity of the issues to be faced by the institution has caused various controversies as politicians on the one blame the Fund for mismanagement and top economists from the other vehemently argue both for and against the IMF.

It is commonly accepted that the consequences of painful and politically sensitive austerity measures in borrowing countries transcend the economic sphere and are becoming larger social and political dimensions, at least as regards the procedures and institutions that make up the nerves of democracy. The IMF's primary purpose to promote and maintain high levels of employment and real income has an indirect relationship with democracy. According to Devesh Kapur and Moisés Naím (2005) countries with higher incomes tend to be easier to implement on consensus methods of solving political issues. A lending stance favoring democracy or not, may have a more direct effect on the democratic institutions of the country. The economic reforms that the Fund obliges borrowing countries to take, inevitably creates winners and losers who can opt for political action to preserve their profits or to compose their losses. Moreover, as some events may threaten the democratic order largely as an economic crisis, the actions of the Fund could be of great help for the preservation of the democratic state.

Most analyzes of the IMF's impact on democratic governance focus on the conditions imposed by the Fund to borrowers. The terms, historically the most central and controversial aspect of the Fund's programs have a direct impact on democracy. In the guidelines given again to the IMF in 2002, it was emphasized that the terms must be applied "sparingly" and should be sensitive to the administrative capacity of the borrowers. The guidelines because the Fund to focus on macroeconomic issues, point out that the Fund's programs as well, in which borrowers feel a sense of ownership, they are more likely to succeed. In a country where the democratic checks and balances are weak, the "ownership" may be more of a stranglehold sign that have the vested interests in national policy. Then, the difference between the induction of a government to "hold" an IMF program and to do so throughout a whole country may leave the Fund with hard choices. Regarding the "property" at the country level, the author wonders if this means that the IMF will have to leave the government to use public funds to save private banks looted from the political influence of the shares. The property, according to Devesh Kapur and Moisés Naím (2005), will not guarantee better policies. The borrowing governments can find ways to observe the terms of the loan and avoid or handle some of them. As shown by the example of Argentina, when the IMF gave large loans in a country, the need to protect its capital leads in a mitigation of the passion with which the conditions are imposed.

The negative effect of IMF on Democracy

In the research of Robert J.Barro and Jong Wha Lee (2005), it is found that IMF loans react to the financial statements and are also sensitive to political and economic variables. Estimates show that a higher percentage of contribution to IMF loans reduces economic growth. Moreover, borrowing from IMF, according to the findings of the investigation, has no significant impact on investment, inflation and international opening, but nevertheless has little negative impact on democracy and the rule of law. Reducing the rule of law implies an additional indirect channel through which borrowing from IMF reduces economic growth.

Thus, the analysis extends to other economic variables and polar measurements as IMF loan determinants. These variables include financial results, inflation, balances and democracy and rule of law indicators. The estimated results show that these additional variables are statistically insignificant in most cases, while the political and economic variables remain significant when additional political and economic variables are included. According to Staiger and Stock (1997), the instruments made by all the political and economic variables will not be weak.

In the results, Robert J. Barro and Jong-Wha Lee (2005) conclude that the effect of democracy is not linear, as the estimated coefficient of the linear term is statistically significant and the estimated rate of squared democracy is negative and marginally significant. Thus, the impact of the IMF loan is marginally significant negative variable to democracy. However, given the non-linearity of how democracy affects economic growth, this effect does not translate into significant indirect effects of IMF lending growth. The only statistically significant indirect effect on economic growth which has been isolated is that of the rule of law, as important localized negative effect of IMF is found in the state of law. The findings for the rule of law are consistent with those reported for external assistance and studies of Svensson (2000) and Alesina and Weder (2002), which according to them an increase in foreign aid leads to an increase in official corruption. The rationale was that foreign aid promotes speculative lobbying and of rulers. Similar opportunities may also arise from the IMF loan.

The problem of non-randomness and the mapping technique

Every investigation on the relationship between IMF programs and democracy should be treated with caution as there are huge endemic obstacles. The determination of the direction and magnitude of the effect of consistent debt to democracy is complicated by the way in which the IMF programs are distributed. If IMF distributed its loans randomly in different countries, it would be a certainty that the difference in levels of democracy between countries within and outside the program is due to IMF intervention. This is not done by the time the programs are not randomly distributed, while there are some factors that enhance the chances of a country to receive assistance from IMF and are related with the result, which in our case is the quality of democracy.

In the research of Stephen Nelson and Geoffrey PR Wallace (2011), in order to solve the problem of non-randomness, they use the technique of mapping which allows the assignment of a case that accepted the help of the IMF and of a near case that did not had the assistance of the Fund. As supported by Gilligan and Sergenti (2008), in the technique of mapping the conclusions are based entirely on data and no result is arising from hidden assumptions or unfounded arguments. The pairing is perhaps the most reliable way to address selection problems compared to alternative strategies used in studies dealing with the Fund and democracy.

This study uses data from a large sample of developing countries for thirty years, and concludes that IMF programs have moderate to quite a positive impact on levels of democracy. At the beginning of the investigation, is established that the estimates from data that have not been matched, are unreliable due to the difference in the distribution of important covariates between cases that are in the program and those that are not. Then the mapping technique is used to improve the balance in the data and then it turns out that the units are in active IMF program for year, are little more democratic than the units that are not in the IMF program.

Since then, the question arises whether countries are exposed repeatedly to IMF programs have a cumulative effect on the level of democracy. At this point, the study considers that the total number of years spent in IMF programs has a positive effect on the rating of democracy in various specifications.

Empirical perspective

The sample consists of 110 developing countries observed from 1970 to 2000. The survey is based on two widely used continuous measures of democracy: the Polity 2 and the Freedom House.

Polity 2 ranges from -10 (least democratic) to 10 (most democratic). Polity combines information on the competitiveness of the polar participation, the scope of restrictions regarding the power of the leader of the regime and the opening of the competitiveness of the process by which leaders are selected.

The Freedom House is a composite of two indices, one that measures the respect for civil liberties and another that measures political rights. The Freedom House ranges from 0 (least democratic) to 12 (most democratic).

The Freedom House and the Polity are highly correlated (0.85). The key variable is the presence of an active IMF lending program in country i in the year t. Selecting a set of variables that are likely to correlate positively or negatively with the likelihood that the country is in the context of the IMF program and affects the level of democracy. It is strange according to Geddes (1999) that while political scientists have dealt with the distinction between the various forms of democratic regimes (parliamentary, presidential, for example), do not pay attention to the differences between the types of dictatorships. According to Cheibub, Gandhi, Vreeland (2009), they are not all the same and there are three types of authoritarian regime: the monarchy, the military and the political. Since totalitarian regimes are very oppressive, with getting an IMF loan have more to lose than to win. The conclusions of the survey on the IMF's impact on Democracy could be biased if the majority of authoritarian regimes that were in the IMF program, were less repressive governments headed by civilians.

In addition, is used a variable that records all previous transitions used in autocracy from 1946 to year t (Cheibub, Gandhi, Vreeland, 2009). Countries that are rich in oil are prone to cycles of boom and less likely to obtain loans from the IMF over those with small oil exports. Ross (2001) noted that oil dependence is detrimental to democracy. The reserves of a country are an indicator of its economic health and the fewer are the greater chance there is for the IMF. Also, the health of the economy is likely to have an impact on democracy, particularly in fragile regimes. The average income per person and the size and direction of the annual variation in per capita wealth are factors that affect the likelihood of recourse to the IMF and the prospects for democracy. They should be considered the economic crises too, that brought a country to the IMF.

Consequently, an exchange market pressure meter is used that following the widespread definition of Frankel and Rose (1996) is set to number 1 for the years in which there was a nominal depreciation of the exchange rate of at least 30% which is also at least a 10% increase in the decay rate compared with the previous year.

Other factors that cause confusion and are taken into account, are the size of a country's population and the level of political violence. Larger developing countries could be difficult to govern themselves and thus have lower democracy scores. Moreover, larger countries are able to mobilize more resources and therefore there is less need for IMF funds. The countries affected by serious domestic violence or engage in cross-border conflicts are less likely to be able to pool resources to form a credible reform program in consultation with the IMF.

A new political violence index is included, which ranges from 0-13, which records the intensity of annual episodes of intra-interstate conflict (Marshall, 2010). And finally, it is assumed that the participation of a country A to the IMF program will increase the chance to participate in an IMF program the neighboring country B too, as the banking crisis extend beyond the borders of a country. There is convincing evidence for regional dynamics in the spread of democracy (Bunce and Wolchik, 2009). Countries are classified into one of six regions: Middle East and North Africa, Latin America and the Caribbean, East Asia and the Asia-Pacific region, post-communist, sub-Saharan Africa and South Asia.

Results

The technique of genetic mapping of Jasjeet Sekhon is used to produce balanced samples for two variables (Polity 2 and Freedom House). In the collected data, the cases displayed are less likely to be a military or authoritarian monarchy or dependent on revenue from oil exports, tend to have a history of reversions to autocracy, are poorer and less economically viable, they are likely to face monetary crises and political violence and have lower levels of the test cases.

According to the results, therefore, 1.252 cases of countries that are in IMF program, are slightly more democratic (Polity = -0.42) than 1.252 cases that are not in a program (Polity = -1.59). The estimate from the sample in which mapping was made, reveals that the difference in IMF program countries and those that are not, is a point which represents a modest but statistically significant effect. Similar results occur when the Freedom House is the dependent variable. The average of Freedom House in 1.208 cases is 5,31 compared to 4,78 for the 1.208 test cases. Comparing the results of the regressions in the paired and not paired data, it is observed that if omitted the check option, the analysts will lead to the fact that IMF programs do not have a significant effect on democracy, when in reality countries receiving conditional lending programs, experience little but noticeable improvement in the rating of Freedom House.

According to the survey, IMF regardless of the harm that may cause in the internal policy, actually promotes democracy through the terms of lending. Using the mapping, were minimized the differences between countries within and outside the program and found that part of the sample that was in the IMF program, had consistently higher scores in both measures of democracy. Moreover, the study concludes that the IMF is not a single impact in the new country that enters the program, but the benefits of democracy accumulate as many countries are turning to the Fund.

Finally, it is stated that it is widely accepted that the Fund offers more harm than good for borrowers (Vreeland, 2003). Despite the general harmful effects in individual sectors, in this survey weight is given to the differences identified between countries within the IMF program and those that are outside and leads to the fact that these differences have a blame for joining the IMF program but also for the future prospects for democracy in them. Finally, a positive impact of IMF programs on measures of democracy is identified.

The "democratic deficit"

In the investigation of Irfan Nooruddin and Joel W.Simmons (2006), it's established that internal political factors can influence the results of IMF programs. The IMF's critics often accuse the Fund for the promotion of "democratic deficit", namely the transfer of national sovereignty to the IMF, limiting the autonomy of the domestic government. The conditions set by the Fund require governments to take measures that might otherwise avoid, but the argument of democratic deficit is so quick to blame the IMF for imposing its will on helpless governments, and thus fails to recognize that domestic policies can also shape the way of implementation of the

Fund programs in recipient countries.

At this point, it is recalled that the IMF can only create a program at the request and consent of the recipient country. This is an important point because it means that no austerity conditions are imposed on countries exogenously but instead the observed content of the program is the result of arduous negotiations between governments and IMF. Therefore, the content of austerity is inherent in the characteristics of the IMF and the beneficiary country. Conway, Patrik (2003) stresses that the IMF austerity is an agreement between the IMF and the participating countries and therefore should be considered inherently fixed.

The conditions instead of being an independent list of political reforms to achieve economic growth and internal balance, is the result of negotiations between IMF and a partner country. The fact that this negotiation determines the content of these programs means that politicians in borrowing countries retain some leverage over spending cuts and the extent of these reductions.

Political leaders in borrowing countries expect that austerity will require structural reforms with significant redistributive effects. The fact that they maintain leverage over the nature of the austerity package is very important as it enables incumbents to influence the reform package in ways that minimize the expected cost of the budget cuts. The identification of policies that can achieve this objective remains an open question.

Studies of Kahler Miles (1993) for Jamaica and Somalia show that the negotiations between IMF and the beneficiary country is quite extensive and allows governments even in relatively small countries economically exclude programs from cuts and structural reforms.

The program content is usually quite vague and this implies more freedom in domestic policy during the program implementation process and on how budget cuts are distributed. Initially, the IMF programs had set targets for reducing costs but were less willing to dictate which programs should be cut and which to protect. The study of Bienen and Gersovitz (1985) shows that in a sample of IMF agreements taken from 1969 to 1978, only 3 out of 105 of them were told specific measures spending. Similarly, Dreher and Jensen (2007) write that on average the number of structural conditions in the agreements is fairly low. In 1987, according to them, the average number of cases included in IMF programs was about 3-9 by the end of 1990. Even when agreements clarified where to be the cutting, they did sometimes in vague terms. Based on the analysis of 15 IMF programs, the independent assessment body concluded that IMF programs are often vague in defining the categories of expenditure to be affected by the program.

According to this study, but as they say many critics too, the IMF programs simply apply to countries facing financial troubles and therefore IMF is completely guilty in any negative impact that have these programs in economically inferior groups if the results are actually negative.

Instead, the result of this short survey is that the available theoretical and empirical observations show convincingly that the negotiation process allows governments borrowers to maintain some influence on the IMF program content and therefore on the redistributive impact of these programs. If the results of IMF policies regarding the economically weaker groups, are actually negative as critics argue, then governments will have to bear some responsibility.

Democracy and conditions

Lake and Baum (2001) support a close theoretical framework, and argue that democracies are more likely to provide public services than non-democracies. They show that Democratic leaders, because of the fact that they face greater levels of competition, they will spend more on public services than non-democratic. Thus, Member States can be compared with companies that maximize their revenues. Furthermore, revenues of Member States depend on the public services provided to citizens.

When there are low levels of competition, as in authoritarian regimes, political leaders have an incentive to use their monopoly power and the deficient in public services, whereas in democracies, where there is competition in politics, leaders operate as regulated monopolies, providing most public services in an effort to maintain the edge over their opponents.

Democracies, ceteris paribus, characterized by more competition and bigger winning coalitions than in authoritarian regimes, would spend most of their budget to public services such as education and health. In this conclusion end many recent surveys, and particularly Bueno de Mesquita and others (2003) and Lake and Baum (2001).

Nooruddin and Joel W. Simmons (2006) lead to the fact that even under the austerity conditions that dominate in IMF program countries, where governments are invited to make spending cuts, democratic governments devote a larger share of their budget to public services by undemocratic governments.

Given the above thinking framework, the weakest groups in a country, that usually not organized interest groups, are those who will bear the biggest spending cuts in terms of social protection and economic aid.

Empirically, the research concludes that the effect of IMF programs on social spending may well depend on the type of the country's regime. While critics say that the IMF programs hurt the poor, it seems that in democratic countries and the politicians have the institutional incentives, but also the opportunity to protect services that regard on economically disadvantaged, adopting a policy that hurts less.

Instead, Vreeland says it needs political will to protect the economically weaker during austerity, and usually leaders have this desire in democratic regimes as when asked to make cuts, they choose to be pro-poor because the groups that would benefit otherwise are weaker politically.

In conclusion, one of the important research findings, is the fact that in democracies, the weight of the burden seems to be placed on the shoulders of those that are less able to have access to private sources of services such as health and education. Unlike the logic of the democratic deficit, it does not necessarily come from the IMF's intention to impose the will of the respective governments. Instead, governments retain some influence in the Application content of IMF programs.

Conclusion

After the collapse of the Bretton Woods system, IMF focused on assistance to developing countries and transition economies while simultaneously acquired other multifaceted roles too. As a result of this fact, the contribution of IMF seems to have political implications.

The main issue of the most surveys is the identified harm of IMF in political and economic sector. The difference here is that this survey focuses on the question if IMF and Democracy are two opposite meanings, that the existence of the one means the loss of the other. All this content can be used, as a basis for a future, more extended research.

In the results of most surveys, IMF and Democracy seem to have a negative relation where it’s concluded that the effect of democracy is not linear, as the estimated coefficient of the linear term is statistically significant and the estimated rate of squared democracy is negative and marginally significant. Thus, the impact of the IMF loan is marginally significant negative to democracy variable. The findings for the rule of law are consistent show that an increase in foreign aid leads to an increase in official corruption. The rationale is that foreign aid promotes speculative lobbying and of rulers. Similar opportunities may also arise from the IMF loan.

As many economists support, the IMF programs simply apply to countries facing financial troubles and therefore IMF is completely guilty in any negative impact that have these programs in economically inferior groups if the results are actually negative.

According to some other surveys, IMF regardless of the harm that may cause in the internal policy, actually promotes democracy through the terms of lending. The estimate from the sample in which mapping was made, reveals that the difference in IMF program countries and those that are not, is a point which represents a modest but statistically significant effect. Using the mapping, the differences between countries within and outside the program were minimized and found that part of the sample that was in the IMF program, had consistently higher scores in both measures of democracy. Moreover, IMF is not a single impact in the new country that enters the program, but the benefits of democracy accumulate as many countries are turning to the Fund. In this case, a positive impact of IMF programs on measures of democracy is identified.

Another important research finding of the survey is the fact that in democracies, the weight of the burden seems to be placed on the shoulders of those that are less able to have access to private sources of services such as health and education. Unlike the logic of the democratic deficit, it does not necessarily come from the IMF's intention to impose the will of the respective governments. Instead, governments retain some influence in the application content of IMF programs.

Finally, it is stated that it is widely accepted that the Fund offers more harm than good for borrowers. Despite the general harmful effects in individual sectors, in this survey weight is given to the differences identified between countries within the IMF program and those that are outside and leads to the fact that these differences have a blame for joining the IMF program but also for the future prospects for democracy in them. After all, a positive impact of IMF programs on measures of democracy is identified. The available theoretical and empirical observations show convincingly that the negotiation process allows governments borrowers to maintain some influence on the IMF program content and therefore on the redistributive impact of these programs. If the results of IMF policies regarding the economically weaker groups are actually negative as critics argue, then governments will have to bear some responsibility.

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