The Economics and Politics of Foreign Aid and Domestic Revenue Mobilization

Abrams Mbu Enow Tagem, UNU-WIDER

Research question and contribution to the literature

- Is there a significant long-run relationship between foreign aid and tax ratios?
- Are the political costs of aid higher/lower than the political costs of tax?

Context

- Raising taxes is unpopular so recipients may choose aid (especially grants) since it is politically cheaper.
- There are also attendant costs of aid: dependency and administrative costs.
- Political costs of aid and tax are measured according to accountability and bureaucratic costs and are representative for donors and recipients.

Data

- 84 countries, covering the period 1980 – 2013. Foreign aid (OECD DAC), tax revenue (UNU-WIDER GRD).

Empirical Strategy

- Common factor approach: cross-country heterogeneity, cross-section dependence, non-stationarity in data.

$$tax_{it} = \beta_i' aid_{it} + u_{it} \qquad u_{it} = \alpha_i + \lambda_i' f_t + \varepsilon_{it}$$

- Error correction model (ECM): difference between long-run and short-run, co-integration between aid and taxes.

Results

- Long-run positive and significant relationship between aid and taxes. There is palpable cross-country heterogeneity: a positive relationship in Mauritius/Ghana and a negative relationship in Tanzania/Malawi.

Table 1. Linear Dynamic Estimates

PANEL A: Baseline Estimates	
	CCEMG
Long-Run	
Aid/GDP	0.077***
	[0.027]
Short-Run	
Aid/GDP	0.014
	[0.012]
EC Coefficient	
y_{it-1}	-0.495***
	[0.031]
t-statistic	-16.14

Conclusion

Country-specific factors (economic and political, internal and external) are the influential factors determining how aid influences taxes.