The Economics and Politics of Foreign Aid and Domestic Resource Mobilization (DRM)

Abrams Mbu Enow Tagem – University of Nottingham

Motivation

-The advent of the SDGs underpins the importance of DRM.
-The tax/GDP is determined by structural factors (determinants of the tax base, to which the tax rate is applied).
-Revenue performance is low in most developing countries.

Motivation (2)

-Due to the constraints on DRM aid is pivotal.
-The impact of aid on taxes is a revenue choice depending on political economy factors, based on the political costs of aid and tax (accountability, autonomy and bureaucratic costs of administration).
-Donors influence the choice through:

(i) Technical support (transfer of knowledge)
(ii) Conditionality (e.g. revenue conditionality in IMF programs).
(iii) Supporting reform to improve efficiency and administration.

Motivation (3)

-Aid/GDP and tax/GDP ratios are typically nonstationary
-Pervasive heterogeneity in fiscal effects across developing countries
-Long run and short-run dynamics between aid and taxes.
-Business cycle influences (1970s oil price shocks, recent financial crisis).
-Simultaneity and endogeneity.

Research Questions

-Does a long-run equilibrium relationship between the aid/GDP and tax/GDP ratios exist?
-Does aid's composition matter for tax performance?
-Does revenue conditionality in donor programs improve revenue performance?
-Do countries with autonomous revenue authorities have higher tax/GDP ratios?

Data

-Annual time series data on 84 developing countries from 1980 to 2013.
-Net aid disbursements (OECD DAC dataset).
-Tax/GDP data from the ICTD GRD (2016) dataset.

Methods

-Common factor models.
-Dynamic Error Correction Model (ECM) estimated using the CCEMG estimator.
-Cross section averages and lags of cross-section averages.

Results

-Co-integrationg (equilibrium) relationship between the aid/GDP and tax/GDP ratios.
-Long-run positive relationship between aid and taxes.
-Political costs of aid are larger than those of taxes.

Results (con'd)

-Revenue conditionality in IMF-supported programs is very important (LR and SR positive effects).
-Quantitative (SR effect) and structural (LR and SR effects) conditionality

Weak Exogeneity

-Tests by Canning and Pedroni (2008).
-GM statistic (from t-ratios of country ECMs).
-H_0: No LR impact for all in the panel.
-H_1: LR impact for a huge proportion of the panel.

Weak Exogeneity Results

-Aid is weakly exogenous. There is no 'donor disbursement rule'.
-When conditionality is incorporated, aid is still weakly exogenous (this allays worries about endogeneity of donor-supported conditionality).
-Taxes are endogenous for the equilibrium so long-run causality is uni-directional (from aid to taxes).

Conclusion

-Tax/GDP ratios are sustained by foreign aid.
-Political costs of aid are greater than those of taxes.
-Aid and its components are weakly exogenous.