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Aid and Taxation: Exploring the Relationship Using New Data

Summary of Working Paper 21 by Oliver Morrissey, Wilson Prichard and Samantha Torrance

This paper examines cross country evidence concerning the relationship between aid and taxation using a new dataset complied by the International Centre for Tax and Development (ICTD). It finds no support for the claim that aid reduces tax effort.

Previous studies are open to challenge

Most studies over the past decade explaining the impact of aid on taxation claim that aid discourages tax effort. Some find that the composition of aid matters, maintaining that loans that need to be repaid encourage tax collection, while grants discourage tax effort. However the robustness of these findings has been challenged by other scholars. In particular there are concerns about the quality of government revenue data employed, and its ability to capture key aspects of the relationship between aid and tax effort. More specifically:

- Previous studies base their analysis on total government revenue, ie including revenue from natural resources, rather than on tax revenue excluding natural resource income, thus failing to capture the key relationship between aid and tax that has to be "earned" from citizens.
- They fail to take account of the impact of aid on imports (aid provides foreign currency that can pay for imports, which in turn affect tariff revenue).
- They look for contemporaneous relationships between aid and reduced tax collection, overlooking the fact that the effect of aid on tax effort is behavioural, and therefore likely to be observable only over a longer period of time.
- They have been criticised for failing to take account of endogeneity: high levels of aid may affect tax collection, but levels of tax collection may also affect aid flows, with lower tax collection increasing the perceived need for aid funding.
- Earlier studies fail to take account of the tax effects of policy reforms associated with aid (for example reforms to tax policy and administration, or the more indirect impact on tax/GDP ratios of aid projects that promote economic growth or stronger institutions). These are potentially significant but difficult to identify with any confidence.

The ICTD dataset and approach

The ICTD research reported in this paper seeks to address the weaknesses of earlier studies in the following ways:

- It uses the ICTD Government Revenue Dataset (GRD) to improve the quality and coverage of revenue data. Critically, it systematically distinguishes between

> "Aid carries its own political costs, including dependency and conditionality."

resource and non-resource sources of taxation, thus making it possible to construct a tax revenue variable exclusive of natural resource revenue.

- It takes account of the impact of aid on imports by estimating the value of imports not financed by aid.
- To address the potential endogeneity between aid and revenue, the ICTD study introduces time lags of four and eight years between receipt of aid and impact on tax effort.

Results, and implications for research and policy

The ICTD study was unable to replicate the findings of earlier studies of a negative effect of aid or aid grants on tax effort. It found no consistent robust relationship between aid, in total or separated into grants and loans, and tax performance. Where it did find significant effects, these were positive for aggregated aid and grants, whereas for loans they were generally negative. Unlike many previous studies, the ICTD research accounts explicitly for non-tax revenue (mainly from natural resources), and finds a clear and negative relationship between non-tax revenue and tax revenue.

In short, the analysis shows either no relationship between aid and government revenue, or a positive one. The safest inference is that there is no consistent cross relationship between aid and tax effort, and in particular no evidence to justify claims that grants reduce tax effort whereas aid loans encourage tax effort (if anything, the findings suggest that the reverse is more likely the case). The lack of general cross country patterns suggests that heterogeneity (differences between country contexts) is more important than any underlying common tendency.

This lack of significant findings is unsurprising. Aid may affect tax collection through many channels, some of them conflicting: while aid may reduce the urgent need for revenue, it may have positive effects through technical assistance, conditionality and public spending. More broadly, the assumption that aid acts as a substitute for domestic taxation may be mistaken: from the perspective of the recipient government, aid carries its own political costs including dependency and conditionality. Moreover the aggregate category of foreign aid disguises huge diversity: while some particular types of aid may in some circumstances discourage tax effort, it is unsurprising to find no overarching effect. This points to the need for researchers and policymakers to direct analysis at the individual country level, while taking account of the diversity of aid and its impact in different contexts.

Further reading

Morrissey, Oliver; Prichard, Wilson & Torrance, Samantha (2014), *Aid and Taxation: Exploring the Relationship Using New Data*, ICTD Working Paper 21, Brighton: September

Credits

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