THE ECONOMICS AND POLITICS OF FOREIGN AID AND DOMESTIC RESOURCE MOBILIZATION

ABRAMS MBU ENOW TAGEM

Preliminary and incomplete – please do not cite

Abstract

The main argument of this paper is that there is considerable heterogeneity in the way aid can shape tax performance in developing countries: through behavioural effects, donor conditionality, recipient policy reform and through technical assistance and these effects are country-specific. Focus is on disentangling these effects using econometric techniques that account for time series properties of fiscal data, cross-country heterogeneity (created by domestic political and economic factors) and the distorting impact of cross-country correlation (induced by global shocks and/or spatial spill-overs). We investigate these effects by applying the dynamic Common Correlated Effects Mean Group (CCEMG) estimator (Chudik and Pesaran, 2015) to two datasets; one provided by Combes, Ouedraogo and Tapsoba (COT, 2016) comprising 47 low- and middle-income countries covering the period 1980-2010, and a compiled dataset comprising 84 developing countries from 1980 to 2013. First, we show that aid (and its compoenents) and taxes comprise an equilibrium (cointegrated) relation. Our results provide robust evidence of a positive, long-run association between aid and taxes. Second, in modelling the donor-conditionality and recipient policy effects of aid on taxes, we find that countries with *met* conditionality in donor-supported programs have a positive relationship between aid and taxes, while technical assistance is essential for policy effects of aid to increase taxes. Third, we address simultaneity and endogeneity using recently developed tests for the direction of long-run causality in panel time series econometrics. We find that long-run causality runs from aid to taxes, suggesting that on average, changes in aid induce permanent changes in taxes.

Keywords: aid, taxation, tax reform, cointegration, common factor models

JEL classification: C23, E62, F35, O23

The Author

Abrams Mbu Enow Tagem is a PhD candidate in the School of Economics, University of Nottingham, United Kingdom. Tel: +447470216716. Email: lexam17@nottingham.ac.uk

Acknowledgements

The author is grateful to Oliver Morrissey, Giulia Mascagni, Simon Appleton, Patrick Marsh, Markus Eberhardt and Roel Dom for useful comments. I am also indebted to Jean-Louis Combes and co-authors for willingly sharing their data. This work was supported by the Commonwealth Scholarship Commission [grant number 2015111]. The usual disclaimer applies.

1. INTRODUCTION

Domestic revenue mobilization (DRM hereafter), in particular increasing tax revenues, is essential for developing countries, given the increased financial need to meet sustainable development targets. This is particularly salient for aid recipients, as traditional donor assistance is unlikely to increase sufficiently to meet future development finance requirements. Increasing revenue is a challenge for most developing countries (given the relatively small tax bases which reflect their large informal and agricultural sectors), reason why aid has direct effects on DRM, not least because aid and taxes are alternative sources of revenue, with the choice between them depending on political economy factors (Morrissey, 2015). This paper contributes to the literature by examining, empirically, the long-run equilibrium relationship between foreign aid (and its components) and tax ratios in developing countries.

To address the fundamental research question, this paper builds on insights from multi-factor models in nonstationary panels (Kapetanios, Pesaran and Yamagata, 2011; Pesaran, 2006). We employ common factor models developed by Pesaran (2006) and modified by Chudik and Pesaran (2015) to estimate the average long-run effect of aid on taxes across two datasets: one comprising 47 developing countries covering the period 1980 to 2010 and the other comprising 84 developing countries from 1980 to 2013. The common factor approach allows for cross-section correlations in the data, *created* by global shocks that affect countries to varying degrees, and *represented* by unobserved common factors. Our focus in the empirical part of this paper is on obtaining average estimates of the impact of aid on taxes using these common factor models that allow for variable dynamics, heterogeneous fiscal impact across countries and cross-section dependence. Another advantage of the panel time-series techniques is they allow agnosticism about the endogeneity of variables; and simultaneity and endogeneity is addressed using recently developed tests for the direction of long-run causality.

There are at least four ways in which aid may affect taxes (and DRM in general). First, aid can have behavioural effects on taxation: because aid provides revenue, it can substitute for efforts to raise tax revenue (governments will decide whether or not to expend effort in collecting taxes). The choice between tax and aid will depend on the political costs of taxes (increasing taxes is unpopular) and aid (increased dependency and lack of autonomy), and how these costs offset each other (Morrissey, 2015). Second, donor conditions (for example, trade liberalization and revenue conditionality in donor-supported programs) and recipient policies associated with aid (for example, creating autonomous revenue authorities), as distinct from the amount of aid, affect tax revenue. Third, technical assistance (transfer of knowledge and capacity building) associated with aid also influence taxes. Fourth, the nature of donor-recipient relationships, reflected by the stability and predictability of aid flows, would impact on tax revenues. If the level of aid has high year-on-year variability, any impact aid has on tax revenues may be eroded. Basically, aid is likely to influence tax revenue mobilization through multiple mechanisms, with the effects being country-specific and potentially in different directions.

Extant empirical literature addressing the effect of aid (usually disaggregated into grants and loans) on tax has been dominated by cross-country regressions (including aid among the determinants of the tax/GDP ratio). Some studies find that aid grants crowd out tax revenue

and loans encourage tax effort (see *inter alia*, Gupta, Clemens, Pivovarsky and Tiongson, 2004; Benedek, Crivelli, Gupta and Muthoora, 2014) while others find a positive (sometimes meagre) impact of aid on tax revenues (Clist and Morrissey, 2011; Carter, 2013; Clist, 2016 among others). Generally, these panel estimates provide no consensus as results are sensitive to specification, empirical strategy, sample and data. We propose four reasons for dissension in the literature; persistence in fiscal data, measuring aid and revenue, cross-country heterogeneity and endogeneity.

First, the studies apply standard panel approaches (fixed effects and GMM) which typically ignore the time-series properties of the data, thus ignoring potential long-run (levels) relationships between aid and tax ratios. Fiscal variables are usually trending (nonstationary) in the long-run, hence in a levels specification a mixture of stationary and nonstationary variables, or a mixture of nonstationary variables of different order may lead to unreliable results (Herzer and Morrissey, 2013). Carter (2013) uses more flexible empirical methods (allowing for variable nonstationarity) and finds a marginal, positive impact of aid on taxes. Our approach, similar to Carter (2013)'s, considers the time series properties and dynamics of the data, permitting us to make credible claims about long-run (equilibrium) and short-run relationships between the aid/GDP and tax/GDP ratios. Specifically, we test for the existence of a long-run equilibrium (cointegrating) relationship between aid and taxes.

Second, measuring aid and revenue in a way that best describes behavioural effects. Regarding aid, the analyst is interested in getting a measure that has behavioural effects on taxes; that is aid going through recipient governments' budgets. Only in the recent past has aid data specifically for domestic revenue mobilization been available, with most studies in the tax performance literature using net aid (as a proportion of GDP) instead. Such a measure of aid is likely to be problematic for two reasons. First, not all aid is expected to influence recipients' tax/GDP ratios. Some aid finances human and physical capital development, and it is uncertain how much of the aid is meant for domestic revenue mobilization. Additionally, such a broad measure of aid likely includes technical assistance, and as argued in section 2; technical assistance, independent of the amount of aid, plays an important role in influencing DRM. Second, more aid tends to go to countries experiencing growth-retarding factors independent of their ability to raise tax revenue (or lack thereof), creating endogeneity concerns.

As regards tax revenue, most studies use total revenue; tax and non-tax revenue (which includes revenue from natural resources) but interest should be on non-resource tax revenue as that is the revenue category expected to respond to changes in aid. Gupta *et al.,* (2004), Clist and Morrissey (2011), Benedek *et al.,* (2014), and Carter (2013) use total government revenue while Crivelli and Gupta (2017) and Combes *et al.,* (2016) use tax revenue data; the studies obtaining data from the International Monetary Fund (IMF) databases. Morrissey, Prichard and Torrance (2014), Morrissey and Torrance (2015) use tax revenue data (excluding natural resource revenue) from the Government Revenue Dataset (GRD) compiled by the International Centre for Tax and Development (ICTD) and the United Nations University World Institute for Development Economics Research (UNU-WIDER). In this paper, we use a measure of net aid void of technical assistance, and a measure of tax revenue (void of natural resource components) similar to the measure used by Morrissey and Torrance (2015).

Third, recipient heterogeneity is important but the cross-country estimates are based on the homogeneity assumption; that the effects of aid on taxes are the same for all countries in the respective samples. Countries may be in the same region, and even be at the same stage of economic development but have fundamental institutional differences that influence the fiscal impact aid would have on taxation. Incorporating such heterogeneity is fundamental in estimating any potential effects aid might have on taxes. Recently, there have been country-specific studies estimating the fiscal effects of aid and the general conclusion from those studies is that aid is associated with increased domestic revenue (see *inter alia* Osei, Morrissey and Lloyd, 2005 for Ghana; Mascagni and Timmis, 2017 for Ethiopia; Bwire, Morrissey and Lloyd, 2017 for Uganda). In this paper, we build on the country-specific, time series analysis by estimating the effect of aid (and its components) on taxes, over time on average, in two panels: one comprising 47 developing countries and the other comprising 84 developing countries, allowing for those effects to differ across countries; and disentangling the different ways through which aid influences taxes.

Fourth, cross-country approaches suffer from the potential endogeneity of aid. Poor countries that attract aid typically have low tax/GDP ratios (because of weak tax bases); and aid flows are higher to countries facing difficulties in raising revenue. This creates a reverse causality problem which standard instrumental variable methods can address. Nonetheless, Temple (1999) documents the difficulty in finding variables that qualify as instruments, alongside the spuriousness of estimates when the instruments are weak or invalid. Closely related to the issue of endogeneity is unobserved heterogeneity and the ensuing cross-section dependence that characterises macro panel datasets.

Internal and external factors that influence recipients' taxation capacities, and potentially the amount of aid they receive, create interdependencies across countries. This means in standard panel data approaches the country variable series, as well as residuals from country-specific regressions, will be correlated. Such correlations are palpable in macro panel data, and ignoring those results in inconsistent and biased estimates (Chudik and Pesaran, 2015). Hence in this study we employ nonstationary panel methods that allow for cross-section correlation and test for the existence of a long-run (equilibrium) relationship between aid and taxes. We then test for exogeneity (direction of long-run causality) in taxes and aid, providing evidence on how recipients and donors react to deviations from the budgetary equilibrium.

Specifically, our findings are five-fold. First, the results provide evidence of a long-run equilibrium (cointegrating) relationship between aid and taxes which represents a behavioural relationship between aid and taxes. The average long-run effect of aid on taxes is positive, and robust to variable and residual correlation, outliers and omitted variables. Second, the composition of aid matters as grants are associated with increases in tax/GDP ratios in developing countries. This contrasts Gupta *et al.*, (2004) and Benedek *et al.*, (2014) but is consistent with Clist and Morrissey (2011) and Mascagni and Timmis (2017). We argue that the political costs of accountability for grants outweigh the political costs of tax, such that recipients will prefer tax increases to aid-dependence. Third, for countries with *met* revenue conditionality in IMF-supported programs aid has a positive long-run relationship on tax revenues. Fourth, technical assistance is vital in improving revenue performance (and fiscal policy in general) in developing countries; especially through its impact in improving tax administration, assisting in implementing policy reforms and establishing revenue authorities. Fifth, long-run causality runs from aid to taxes, suggesting that on average (or in general),

changes in aid induce permanent changes in taxes. Aid, on the other hand, is weakly exogenous; emphasising our claims of a behavioural representation in which taxes adjust positively to changes in aid.

The rest of the paper is organised as follows: Section 2 provides a conceptual framework from which hypotheses will be tested; emphasising how aid can shape tax performance, as well as the econometric issues faced in estimating the effects of aid on taxes. Section 3 presents a brief discussion of the data used in the analysis while section 4 sets out the empirical model specification. Section 5 presents results for tests for cross-section dependence and unit roots, estimates for the impact of aid on taxes, as well as results from exploratory analysis and the analysis of weak exogeneity. Section 6 concludes.

2. CONCEPTUAL FRAMEWORK AND RELATED LITERATURE

2.1 Conceptualizing the Dynamics between Aid and Taxation.

In least developed countries (LDCs) domestic revenue is too low to finance the provision of public goods and services required for growth and development; reason why they receive aid and that aid is more likely to be in the form of grants. Low domestic revenue does not imply that tax effort is weak, nor does it signify fiscal nonchalance on the part of recipient governments' policy-makers. Given the relatively small tax bases in these countries, which reflect their large informal and agricultural sectors, revenue mobilization may be as high as feasible but is still not enough to generate economic gains (Keen and Simone, 2004; Morrissey, 2015). Due to these revenue constraints, aid provides a direct alternative source of revenue. This makes the choice between tax and aid a complex task, and there are legitimate concerns as to whether aid is a complement to or a substitute for domestically raised revenue. In exploring the relationship between aid and taxes, the alternative ways through which aid can influence tax revenue mobilisation must be considered.

First, most studies on tax performance assume that in recipient countries there is a behavioural impact of aid on tax revenue: because aid provides revenue, governments are less inclined to expend political and administrative effort on tax collection. This is plausible because increasing taxes is unpopular, and recipients may see aid as a politically less costly source of revenue to cover government expenditure; reducing the urgency of tax revenue collection. However, there are also political costs associated with aid: increased dependency (lack of autonomy), costs of accountability, as well as bureaucratic costs of administration. The choice between aid and tax is dependent on the respective costs, and how they offset each other (Morrissey, 2015; Morrissey and Torrance, 2015). These costs are evaluated according to autonomy, accountability and bureaucratic costs.

The costs of accountability refer to whom and the extent to which a government must account for its uses of revenue, and the costs are likely to be higher for aid than taxes (Morrissey, 2015). Donor agencies have to account to their governments on how their aid is used so they implement strong monitoring mechanisms to minimise fungibility. They also attach conditions; and recipients have to expend effort in trying to circumvent the conditions. The costs of autonomy are reflected in a country's ability to make independent policy choices since aid-dependent governments cede some policy influence to donors, and lose leverage in negotiating on policy conditionality (Morrissey and Torrance, 2015). In addition, there are bureaucratic costs of tax and aid. The former relates to the costs of tax administration (with

fiscal reform implemented in many developing countries tax administration has improved, reducing the bureaucratic costs of tax) while the latter, which is a function of the number of donors refers to the costs of organising, and attending meetings with different donor agencies. The bureaucratic costs of aid are still high, and this is exacerbated by donor proliferation, disbursement heterogeneity, and the changing requirements on monitoring aid. In general, the political calculus between taxes and aid is heterogeneous across countries.

This line of argument suggests that if the political costs of taxation are higher than those of aid (which is an implicit assumption from the Gupta *et al.*, 2004 findings), recipients will choose to expend less effort on tax collection; and this will be reflected empirically by the negative relationship between aid and taxes. Conversely, if the political costs of aid are higher, then recipients expend more effort in tax collection while systematically reducing the aid they receive. Empirically, this will be reflected by a positive relationship between aid and taxes.

Second, Morrissey and Torrance (2015) state that transfer of knowledge and capacity building from donors through technical assistance, as distinct from the amount of aid *per se*, is what potentially influences revenue mobilization through strengthening of weak tax institutions and improving the formulation of tax policy. Technical assistance also has the potential to relax capacity constraints in implementing institutional policy reforms; thereby improving revenue performance in developing countries. Third, donor-instigated policies and institutional reforms, such as trade liberalization, currency devaluation, creation of revenue administration and enforcement agencies, might also be associated with changes in tax revenues (Clist and Morrissey, 2011), with the country-specific effects potentially moving in opposite directions. The net tax effects of such policy reforms are thus uncertain (Carter, 2013); and it is difficult to distinguish between the direct causal, effects of aid on taxes, and effects that can be associated with changes in policy reforms. This is exacerbated by donor and aid proliferation; with many recipients having multiple donor-instigated initiatives implemented over time (Carter, 2013). Fiscal reforms supported by donors may improve tax administration and collection efficiency, but this may not necessarily translate into an observable increase in tax revenue (Morrissey, Prichard and Torrance, 2014).

Fourth, donor conditionality associated with aid also has effects on tax revenue through its effect on tax rates, tax collection and the tax base (Morrissey *et al.*, 2014). Conditionality takes different forms, including prior actions (measures a country agrees to take before donor financing is approved or a review is completed), quantitative performance criteria (specific and quantifiable conditions that have to be met to complete a review, relating to macroeconomic variables under the control of the recipient), indicative targets (established to supplement quantitative performance targets) and structural benchmarks (typically non-quantifiable reform measures intended to assess program implementation during a review). Crivelli and Gupta (2016) find that revenue conditionality in IMF-supported programs has a positive impact on tax revenue performance in 126 developing countries from 1993-2013, while Brun, Chambas and Laporte (2010) find evidence of a positive impact of donor-supported conditionality on total revenues in Sub-Saharan Africa from 1984-2007. Crivelli and Gupta (2017) state that other donors tend to rely on the IMF to implement macroeconomic conditionality, such that focusing on revenue conditionality from the IMF is enough to capture broader donor conditionality accompanying aid.

Fifth, the impact of aid on tax revenues may be influenced by donor policies; particularly the stability of donor-recipient relationships and how they relate to the stability of aid flows to developing countries (Lensink and Morrissey, 2000). There is a degree of continuity in donor-recipient relations such that recipients expect to receive aid every year. These recipient governments also have some form of expectations of the exact amount of aid to be received, as aid commitments are known some time in advance (Lensink and Morrissey, 2000). Additionally, knowing past values of aid flows; recipients expect some variability in aid so they plan fiscal policy accordingly. Thus if disbursement (donor) difficulties in countries create relatively high year-on-year variation in the level of aid, there may be no discernible impact of aid on tax ratios as aid is too unpredictable to be useful for planning; with a net effect of zero. Plausibly, increased aid instability may result in fiscal vulnerability in developing countries, resulting in reduced tax/GDP ratios. Aid receipts may also vary due to macroeconomic uncertainty; causing donors to deviate from recipients' expectations, creating some unanticipated instability in aid which may also determine the way aid impacts on tax revenues.

2.2 Econometrics

In this sub-section we motivate the empirical issues faced with estimating cross-country effects of aid on taxes: the heterogeneous nature of the aid-tax relationship, time series properties and dynamics in the data, as well as endogeneity and ensuing cross-section dependence in the aid-tax relationship. We begin by discussing time-series properties of the data, and then proceed to motivate cross-country heterogeneity, endogeneity and cross-section properties of the data.

Aid/GDP and tax/GDP ratios are typically approximated by stochastic (through the presence of a unit root), rather than deterministic (through the presence of higher order time trends) processes (Herzer, 2014). That implies for most developing countries both aid/GDP and tax/GDP ratios are non-stationary in the long-run, albeit with positive and/or negative trends. Thus a linear combination of these non-stationary variables is stationary if aid/GDP and tax/GDP ratios are cointegrated (Engle and Granger, 1987; Granger and Newbold, 1974); that is if there is a long-run equilibrium relationship between the aid/GDP and tax/GDP ratios and permanent changes in the aid/GDP ratio are associated with permanent changes in the tax/GDP ratio. If both variables are not cointegrated then any linear combination between them is spurious (Granger and Newbold, 1974); a situation where even if aid/GDP and tax/GDP ratios are unrelated, the regression results indicate a highly significant relationship since standard tests for significance and goodness of fit are now invalid. A salient characteristic of heterogeneity in fiscal effects is the presence of heterogeneous cointegration; that is the long-run relationship between aid/GDP and tax/GDP ratios differs for all countries in the sample.

There is pervasive heterogeneity in government fiscal behaviour across developing countries; with domestic political and economic, internal and external, factors interacting in different ways across recipient countries. Foreign aid (and its components) interacts with these factors in different ways across different countries, resulting in heterogeneous tax/GDP ratios across countries over time.[1] Furthermore, the standard revenue (tax) performance equation is a

[1] A clear example will be two countries with similar import/GDP ratios but collect different amounts of revenue from imports because of differences in tariff rates, policies (one country may have more trade agreements will

contemporaneous relationship whereby current tax/GDP ratio are determined by current values of the economic structure variables (Clist and Morrissey, 2011; Carter, 2013) which represent the determinants of taxable capacity. These country level determinants of tax/GDP ratios are not captured by available data (Morrissey, 2015), resulting in the use of (often poor) proxy variables for the tax base; such as *per capita* income, sectoral output shares of agriculture, manufacturing and trade. In addition, these data do not account for policy changes in tax rates and tax administration.

Nonetheless changes in the proxy variables will be associated with contemporaneous changes in tax/GDP ratios but the relationship between the aid/GDP and tax/GDP ratios (the relationship of primary theoretical interest in this study), is most likely dynamic since taxation policy and tax systems are statutory; making tax/GDP ratios highly persistent over time (at least in the short-run). Changing tax structures, tax rates and improving the efficiency of tax collection are all time-consuming processes, delaying the potential impact of aid. Furthermore, faced with the uncertainties of changes (increases/decreases) in the level of aid, recipient governments may delay in altering fiscal policy (O'Connell and Buffie, 2008); underscoring the importance of dynamics in the relationship between aid and taxes.

Introducing dynamics in the relationship between aid and taxes allows for the possibility of feedback between both variables, with revenue performance in recipient countries potentially influencing donor aid allocation; creating a reverse causality problem. It is also conceivable that there is a bi-directional (simultaneous) relationship; with recipients' structural characteristics determining both high (low) aid and low (high) revenue. Clist and Morrissey (2011) and Morrissey and Torrance (2015) argue that lagging aid by one or two years as is done in previous studies (see *inter alia* Gupta *et al.,* 2004; Benedek *et al.,* 2014) is insufficient to curb the simultaneity. Due to the persistence of tax/GDP ratios, uncertainties of the timeline for which aid is likely to influence revenue performance, and because the structural characteristics change slowly, longer lags of aid are needed to deal with simultaneity. Morrissey and Torrance (2015) attempt to deal with endogeneity by using longer lags of aid.

In a (panel) time series context, however, endogeneity is dealt with differently. If aid and taxes are both nonstationary and co-integrated, then tests for weak exogeneity (i.e. the direction of long-run causality) are applicable. If donors, in their aid allocation decisions respond to changes in revenue performance in receiving countries, this implies aid is endogenous for the long-run equilibrium; suggesting some kind of behavioural impact of aid on taxes for the donors. If donors do not respond to such changes in their allocation decisions but aid/GDP influences tax/GDP ratios, aid is weakly exogenous or *long-run forcing* (Lloyd *et al.,* 2009).

Tax ratios may be determined by unobserved country-specific factors (Morrissey and Torrance, 2015). The unobserved factors may be influenced by shocks that affect all countries to varying degrees (for example the recent financial crisis or the 1970s oil crises) or by multiple economic, social and cultural ties between countries; representing mere spill-over effects. In addition, the individual evolution paths of the unobservables are unrestricted to simple linear trends, allowing for non-linearity and nonstationary in evolution (Eberhardt and

lower tariff rates than the other), exemptions (one country may have more tax exemptions than the other depending on the investment climate in said country), as different magnitudes of tax evasion.

Teal, 2017). Interest is in the cross-country average effect of aid/GDP ratios on tax/GDP ratios, making the use of annual time-series data appropriate (Clist and Morrissey, 2011). However, use of annual data raises concerns about the distorting influence of business cycles on empirical inference (Eberhardt and Teal, 2013; Temple, 1999), such that analysis is usually carried out with time-averaged data (Morrissey and Torrance, 2015; Morrissey *et al.*, 2014). In this paper, we argue that adopting a common factor approach deals with any business cycle effects, whether they represent spill-over effects (idiosyncratic to a small number of countries) or global shocks with more profound, albeit heterogeneous impacts.

In summary, the effect of foreign aid on taxation depends on several factors, the most important of which are the dynamic political and economic factors. These factors, themselves influenced by policy changes, are not captured by available data hence not adequately incorporated into econometric specifications. In addition to the data concerns, donor-supported reforms and conditionality, and technical assistance, independent of the level of aid, also influence revenue performance. Furthermore, institutions are country-specific, and tax systems and policy display strong persistence over time; such that the dynamic relationship between aid and taxation is specific to each country. These issues will be addressed in the empirical analysis.

3. DATA

Combes *et al.*, (2016) use an annual dataset of 59 developing countries covering the period 1974 to 2010. Their analysis explores the determinants and effects of shifts in aid dependency on fiscal policy in developing countries: thus they compile a dataset of many macroeconomic and institutional variables, details of which can be found in their paper. For our purposes, focus is on aid and taxes. They use aid disbursement data, obtainable from the OECD's Query Wizard for International Development Statistics (QWIDS) data base. Data on tax/GDP ratios are obtained from various international and internal IMF datasets.

To analyse the robustness of results to alternative data sources, we collect data on 84 developing countries covering the period 1980 to 2013. Data on net aid disbursements, gross aid disbursements, gross aid loans, gross aid grants and technical assistance are sourced from the OECD's Development Assistance Committee (2016) database. One of the objectives of this study is to estimate, independently, the impact of technical assistance on tax/GDP ratios in developing countries. Thus, aid should be measured in a way that influences taxes; typically, a measure of aid 'close' to one that goes through the budget. We deduct technical assistance from grants to obtain a new measure of grants which we add to net loans to get net ODA figures for the econometric analysis; and scale it with real GDP data (constant $US 2010) sourced from the IMF's *World Economic Outlook*. We also estimate variants of the main model with, grants, loans and technical assistance (all as percentages of GDP) as regressors of primary interest.

For data on domestic revenue mobilization we rely on the Global Revenue Dataset (GRD 2016) from the International Centre for Tax and Development (ICTD) and the United Nations University World Institute for Development Economics Research (UNU-WIDER). This includes non-resource tax revenue, total tax revenue and total government revenue; all excluding grants and social contributions so we get measures of domestic revenue suitable for econometric analysis (Prichard *et al.*, 2014). The data are then scaled by GDP series (sourced from the *World Economic Outlook*) in local currency units. Non-resource tax revenue

excludes royalties and natural resource taxes (Prichard *et al.*, 2014). Total tax revenue comprises all direct and indirect tax revenues while total government revenue is a composite of all tax and non-tax revenues (for instance, central bank receipts). The GRD (2016) dataset has two major advantages over other tax datasets. First, it combines fiscal revenue data from major international databases (for example the *World Development Indicators* and *Government Finance Statistics* databases which suffer from missing values), as well as IMF Article IV reports and national budgets. This significantly improves data coverage, particularly in the more recent past (from the 1990s onwards). Second, it meticulously distinguishes between resource and non-resource components of tax revenue, allowing for consistency in the treatment of natural resource revenue in econometric analyses, while also permitting the construction of a tax variable exclusive of natural resources. This is very important as fiscal theory posits that aid should affect only non-resource taxation (Morrissey *et al.*, 2014).

Although the original COT (2016) dataset covers 59 countries over the period 1974 to 2010, some countries have missing observations so they are dropped from the analysis (these countries include Afghanistan, Bangladesh, Congo, Algeria, Cambodia, Laos, Liberia, Mongolia, Mauritania, El Salvador and the Democratic Republic of Congo), with effectively 47 countries used in the regression analysis. Furthermore, to ensure relatively 'direct' comparability between the COT (2016) and GRD (2016) datasets, we restrict our analysis to the period from 1980 onwards. This implies some countries from the original COT (2016) dataset lose few observations.[2]

COT (2016) use two measures of aid in their analysis; the aid to GDP ratio and aid *per capita*. We use only the aid to GDP in our analysis for two reasons. First, *per capita* measures of aid are preferable when the objective is determining the effectiveness of aid on specific social sector measures like health (for example the impact of *per capita* health aid on the infant mortality rate and/or the maternal mortality ratio) and education (for example the impact *per capita* education aid on secondary and primary school completion rates), gauging the impact of aid in reducing hardship. *Aid per capita* can be used if the aim of the study is to estimate the impact of foreign assistance on specific components of tax. As our measure of taxation is the total tax to GDP ratio, this makes aid *per capita* less intuitive. Second, it is standard practice in cross-country regressions to use the aid/GDP ratio as it captures the relative importance of aid.

[2] It would be reasonable to use the COT (2016) dataset as it is. However, of the 47 countries included 25 countries have a sample starting from 1980, with the other 22 having sample start dates varying from 1974 to 1980. Based on our econometric methods we posit that the few observations that drop out would not influence our analysis.

Table I: Average aid/GDP and tax/GDP ratios over the sample period(s)

	Combes *et al.,* (2016)		GRD (2016)			GRD (2016)	
Country	Aid/GDP	Tax/GDP	Aid/GDP	Tax/GDP	*Country*	Aid/GDP	Tax/GDP
Belize	4.59	20.30	2.75	20.05	**Algeria**	0.26	11.73
Benin	10.16	12.54	0.32	12.87	**Angola**	1.90	6.67
Bhutan	14.34	7.17	10.34	8.23	**Argentina**	0.04	15.07
Bolivia	7.23	14.32	-	-	**Bangladesh**	2.11	5.91
Botswana	3.86	27.13	2.02	15.02	**Chile**	0.08	16.11
Burkina Faso	13.61	10.14	9.31	10.31	**China**	0.14	15.03
Burundi	21.12	15.02	16.44	12.23	**Colombia**	0.21	9.49
Cameroon	4.21	13.04	2.95	10.28	**DRC**	6.17	5.69
Cape Verde	25.43	16.19	15.45	15.36	**Congo Rep.**	4.17	10.25
CAR	12.48	8.72	8.57	9.24	**Dominica**	5.53	20.27
Chad	11.58	5.48	6.70	5.03	**Dominican Republic**	0.44	10.30
Comoros	19.58	11.22	11.59	11.23	**Ecuador**	0.50	8.46
Costa Rica	1.54	13.02	0.87	1.11	**El Salvador**	2.85	11.11
Cote D'Ivoire	4.50	17.29	3.50	16.13	**Equatorial Guinea**	8.76	10.86
Djibouti	19.36	22.63	-	-	**Fiji**	1.77	21.12
Egypt	4.01	16.30	1.81	12.18	**Gabon**	0.83	10.89
Ethiopia	10.28	9.27	7.42	9.45	**Guatemala**	1.06	9.51
Gambia	17.22	16.02	10.38	12.62	**India**	0.29	9.51
Ghana	8.39	12.94	3.90	10.64	**Indonesia**	0.45	8.45
Guinea	9.00	11.00	5.94	7.88	**Iran**	0.04	5.57
Guinea-Bissau	38.18	6.72	16.18	5.05	**Jamaica**	1.49	23.33
Guyana	14.54	23.15	-	-	**Kiribati**	21.93	16.36
Haiti	12.70	9.43	-	-	**Laos**	8.10	7.30
Honduras	7.25	14.34	4.05	13.06	**Maldives**	4.40	10.74
Jordan	10.39	15.57	5.95	17.32	**Mauritania**	11.40	12.61
Kenya	6.62	15.52	3.61	13.98	**Mauritius**	1.04	17.57
Lesotho	16.79	40.30	9.88	42.07	**Mexico**	0.03	9.26
Madagascar	10.92	10.25	7.55	9.69	**Morocco**	1.43	20.34
Malawi	20.89	15.06	10.40	14.56	**Panama**	0.33	11.24
Mali	16.69	12.05	9.23	10.89	**Paraguay**	0.70	10.16
Mozambique	26.64	11.18	16.41	10.54	**Peru**	0.54	13.37
Nepal	8.44	8.24	5.29	8.49	**Philippines**	0.67	13.03
Nicaragua	14.27	17.93	8.90	14.24			
Niger	14.24	9.26	10.16	9.13	**Sao Tome & Principe**	27.03	10.13
Oman	0.84	2.10	-	-	**Seychelles**	3.35	30.46
Pakistan	2.23	11.80	1.20	9.85			
Papua New Guinea	8.48	22.53	3.61	18.00	**Solomon Islands**	18.34	17.19
Rwanda	20.01	9.89	14.02	9.96	**St. Vincent**	3.20	20.82
Senegal	10.56	15.51	7.15	15.86	**Sudan**	4.79	6.81
Sierra Leone	17.09	8.89	10.84	6.99	**Thailand**	0.25	15.21
Sri Lanka	5.23	16.00	2.89	15.35	**Tonga**	10.46	15.61
Swaziland	3.71	23.89	1.74	23.62	**Turkey**	0.17	13.61
Syria	3.40	14.35	-	-	**Uruguay**	0.13	16.17
Tanzania	15.93	11.86	9.53	8.71	**Vanuatu**	11.84	16.46
Togo	9.72	16.53	6.54	14.71	**Venezuela**	0.03	8.69
Tunisia	1.70	20.94	-	-	**Zambia**	9.95	15.72
Uganda	11.99	8.59	7.73	7.29			

Notes: *Aid/GDP = Aid to GDP ratio, Tax/GDP = Tax to GDP ratio. The countries in bold are those not included in the COT (2016) dataset, but included in our own dataset. CAR – Central African Republic, DRC – Democratic Republic of Congo, Congo Rep – Republic of Congo, St. Vincent – St. Vincent and the Grenadines.*

Sources: *OECD DAC (2016), UNU-WIDER/ICTD GRD (2016).*

Table I lists the countries along with the average values of the aid/GDP and tax/GDP ratios over the period 1980 to 2010 for the COT (2016) dataset and 1980 to 2013 for the GRD (2016) dataset. What is immediately apparent is the cross-country heterogeneity in the average values of the series across datasets. Aid data is sourced from the OECD database but the average aid to GDP ratio differs across both datasets. This difference is due to: (i) differences in the sample period (our sample is slightly longer than the COT, 2016 sample), (ii) whether technical assistance is included in the measure of aid, (iii) whether gross or net aid (net of repayments) is used, and (iv) the difference in GDP series used to scale the aid data. As COT (2016) use gross aid disbursements (which comprises technical assistance) their aid/GDP ratios are typically higher than those from our dataset; and are also much larger than tax/GDP ratios. For example, Belize has an average aid/GDP ratio of 4.59% in the COT (2016) dataset but 2.75% in our dataset. Benin has 10.16% in COT (2016) but 0.32% in ours, Bhutan 14.34% against 10.34%, Cape Verde 25.43% against 15.45%, and Central African Republic 12.48% against 8.57%. Although taxes are scaled by GDP from different sources, they are more consistent across both datasets. Belize has an average tax/GDP ratio of 20.30% in the COT (2016) dataset against 20.05% in our dataset, Benin 12.54% against 12.87%, Chad 5.48% against 5.03%, Comoros 11.22% against 11.26%, and Ethiopia 9.27% against 9.45%.

Given the importance of technical assistance in our econometric analysis, as well as the need to measure aid that goes through the budget we focus on summary statistics with the measure of aid from our compiled dataset; making comparisons to COT (2016). First, Sao Tome and Principe and Kiribati are the most aid-dependent economies with aid amounting to over 21 percent of GDP. Some other least developed countries are still very aid-dependent with an average ratio of aid to GDP more than 15% (Burundi, Cape Verde, Guinea-Bissau, Mozambique, and Solomon Islands). Second, even in some least developed countries that are supposedly more aid-dependent, the aid/GDP ratio is fairly similar to the tax/GDP ratio; underscoring the burgeoning importance of domestic resource mobilization in developing countries. For example, for the most aid-dependent countries Cape Verde has an average aid/GDP ratio of 15.45% with a tax/GDP ratio of 15.36% and 18.34% versus 17.19% in Solomon Islands. For other least developed countries, Comoros has an average aid/GDP of 11.59% with an average tax/GDP ratio of 11.23%, Mali 9.23% against 10.89%, Niger 10.16% against 9.13%, and Tanzania 9.53% against 8.71%. Third, middle income countries with the highest tax/GDP ratios tend to have the lowest aid/GDP ratios. Belize, Fiji, Argentina, Botswana, Jamaica, and Mauritius, for example, are among the countries with the highest tax/GDP and lowest aid/GDP ratios in our sample.

4. EMPIRICAL MODEL SPECIFICATION

4.1 Linear Dynamic Model

To estimate the relationship between the aid/GDP and tax/GDP ratios in country i at time t we employ a multifactor error framework of the form:

$$tax_{it} = \beta_i' aid_{it} + u_{it} \qquad u_{it} = \alpha_i + \lambda_i' f_t + \varepsilon_{it} \tag{1}$$

Where tax_{it} is the log of the tax/GDP ratio over time periods t=1, 2,…, T and countries i=1, 2,…, N. aid_{it} is the percentage of net Official Development Assistance (excluding technical assistance) to GDP. The vector of parameter coefficients (β_i) differs across countries, but is

constant over time. Equation (1) also includes country-specific intercepts (α_i) and a vector of unobserved common factors f_t with country-specific factor loadings λ_i to account for the levels and evolution of unobservables, respectively. We allow for the possibility that the growth of unobservables not only differs across countries, but within countries over time (Eberhardt and Vollrath, 2016); with the main concern now being how to separate the country-time specific shock, λ_{it}, from the random error term, ε_{it}. However, we can model such country-specific unobservable evolution by adopting a multi-error factor structure for the error term, u_{it}. Let

$$u_{it} = \alpha_i + \lambda_i' f_t + \varepsilon_{it} = \alpha_i + \lambda_{S,i}^{S} f_t^{S} + \lambda_{W,i}^{W} f_t^{W} + \varepsilon_{it} \quad (2)$$

where the common factors, which are orthogonal to each other, can be a combination of a limited number of 'strong' factors (f^S) (following Stock and Watson, 2002) and an infinite number of 'weak' factors (f^W) (Chudik *et al.*, 2011). Strong shocks like the global recession of the 1980s and the recent financial crisis are assumed to affect all countries, albeit to varying degrees. Weak shocks, (for example, the devaluation of the CFA franc in 1994) on the other hand, affect only a sub-sample of countries so they represent localized (spill-over) effects. In addition, the unobservable factors not only drive tax/GDP ratios, but also aid/GDP ratios: creating an endogeneity problem (Kapetanios *et al.*, 2011) whereby the parameter β_i^{aid} is not identified unless we can account for the unobservable factors in the error term u, or provide a *valid* and *informative* set of instruments for potentially endogenous aid. Nonetheless, Bazzi and Clemens (2012) state that satisfactory instruments are unavailable. Furthermore, standard instrumental variables techniques are inappropriate in this set up due to the heterogeneous equilibrium relationships across countries (Eberhardt and Presbitero, 2015) and the omnipresence of unobserved common factors (Eberhardt and Presbitero, 2015; Temple and Van de Sijpe, 2015). The unobserved common factors can also be nonstationary, with implications for estimation and inference since both observable and unobservable processes in the model are now integrated (Kao, 1999; Eberhardt and Presbitero, 2015).

Given the importance of dynamics and time series properties of aid/GDP and tax/GDP ratios, we employ an unconditional error correction model (ECM)[3] of the form:

$$\Delta tax_{it} = \alpha_i + \rho_i\left(tax_{it-1} - \beta_i^{aid} aid_{it-1} - \lambda_i' f_{t-1}\right) + \gamma_i^{aid}\Delta aid_{it} + \gamma_i^{F}\Delta f_t + \varepsilon_{it} \quad (3)$$

where the expression in brackets represents the potential cointegrating relationship we seek to identify, β_i^{aid} represents the long-run equilibrium (cointegrating) relationship between the tax/GDP and aid/GDP ratios, the γ_i^{j} represent the short-run adjustment dynamics and ρ_i indicates the speed of convergence of the economy to its long-run equilibrium. Unobserved common factors f are included in the long-run relation, which implies we will investigate an equilibrium relationship between taxes, aid and the unobservables. We can test for cointegration in the ECM based on the statistical significance of the error correction term in the ECM, with a negative and significant error correction coefficient representing cointegration; indicating that the economy returns to its long-run equilibrium following a deviation.

[3] See Tagem (2017) and Eberhardt and Presbitero (2015) for advantages of a heterogeneous ECM specification over static and/or more restrictive dynamic specifications.

Finding cointegration between tax/GDP and aid/GDP ratios is important as it would imply no potentially important nonstationary variables have been omitted from estimation: any omitted nonstationary variable that is part of the cointegrating relationship will now be part of the error, producing nonstationary residuals and failure to detect cointegration (Herzer, 2014; Herzer and Morrissey, 2013). Lutkepohl (2007) states that if there is cointegration between a set of variables, then this property extends into the variable space. There are many determinants of tax revenue performance, most of which are nonstationary (for example, export- and import-to-GDP ratios), which if included in our model may result in further cointegrating relations. The original cointegrating relation, however, is unaffected by these recently included nonstationary variables.

To estimate the heterogeneous ECM in equation (1) given the common factor framework we focus on novel panel time series estimators that allow for heterogeneity in the aid-tax relationship and cross-section dependence. Following Pesaran (2006), the Common Correlated Effects Mean Group (CCEMG) estimator uses (weighted) cross-section averages of the dependent ($\overline{tax_t}$) and independent variables ($\overline{aid_t}$) constructed to filter out the unobserved common factors f and omitted elements of the cointegrating relationship. Kapetanios *et al.,* (2011) and Coakley *et al.,* (2006) show that the estimator is consistent in the presence of cointegration and noncointegration of the model variables, structural breaks, nonstationary common factors, regressor-specific common factors, factor loading dependence and the presence of multiple common factors. Augmenting equation (3) with cross-section averages of the dependent and independent variables we get:

$$\Delta tax_{it} = \pi_{0i} + \pi_i^{EC} tax_{it-1} + \pi_i^{aid} aid_{it-1} + \Phi_i^{aid} \Delta aid_{it} + \pi_{1i}^{CA} \overline{\Delta tax}_t + \pi_{2i}^{CA} \overline{tax}_{t-1} + \pi_{3i}^{CA} \overline{aid}_{t-1} + \pi_{4i}^{CA} \overline{\Delta aid}_t + \varepsilon_{it} \quad (4)$$

Chudik and Pesaran (2015) extend the standard Pesaran (2006) approach to accommodate dynamics (feedback) from weakly exogenous regressors (a result of the inclusion of a lagged dependent variable); and find that the standard CCEMG is subject to small sample bias, especially in samples of moderate time series (30 to 50 years of annual time-series data). Chudik and Pesaran (2015) provide an empirical strategy to deal with the bias: in addition to the cross-section averages from the standard CCEMG, they suggest including lags of cross-section averages in the ECM, in our setup

$$\Delta tax_{it} = \pi_{0i} + \pi_i^{EC} tax_{it-1} + \pi_i^{aid} aid_{it-1} + \Phi_i^{aid} \Delta aid_{it} + \pi_{1i}^{CA} \overline{\Delta tax}_t + \pi_{2i}^{CA} \overline{tax}_{t-1} + \pi_{3i}^{CA} \overline{aid}_{t-1} + \pi_{4i}^{CA} \overline{\Delta aid}_t + \sum_{l=1}^{p} \pi_{5i}^{CA} \overline{\Delta tax}_{t-p} + \sum_{l=1}^{p} \pi_{6i}^{CA} \overline{\Delta aid}_{t-p} + \varepsilon_{it} \quad (5)$$

and/or the inclusion of cross-section averages of one or more further covariates (other than aid) which may help identify the multiple unobserved factors. In our setup,

$$\sum_{l=0}^{p} \pi_{7i}^{CA} \overline{\Delta \Upsilon}_{t-p}$$

where the π_s and Φ_s represent the long-run and short-run coefficients respectively, the $\pi^{CA}{}_s$ represent the coefficients on the cross-section averages of the dependent and independent variables (all coefficients yielding the standard CCEMG estimator), and Υ represents further covariates included in the model. The $\sum_{l=1}^{p} \pi^{CA}{}_s$ represent the coefficients on the additional lags of cross-section averages which Chudik and Pesaran (2015) suggest be added to the

standard CCEMG estimator (yielding the dynamic CCEMG estimator). As a rule of thumb, the lags of the cross-section averages to be added to the standard model are chosen by $p = T^{\frac{1}{3}}$ (Chudik and Pesaran, 2015). The country-series for additional covariates *do not* enter the model as regressors; just their cross-section averages and lags of cross-section averages enter the model. The objective here is to help identify the unobserved common factors f_t so including variables that may be directly linked to the tax/GDP ratio is reasonable. Therefore we include any of the robust determinants of tax revenue performance fit for purpose (*per capita* income, the share of agricultural value added in GDP, and/or exports – all in logs), following Gupta (2007).

Chudik and Pesaran (2015) show that once the CCEMG estimator has been augmented with the sufficient number of lags and/or lags of other covariates, the estimator is unbiased in the presence of dynamics (the lagged dependent variable), and also in the presence of weakly exogenous regressors. We estimate equation (5) by relaxing the common factor restriction between the parameters ρ_i and β_i implicit in equation (3) and reparametrize the model following Eberhardt and Presbitero (2015). From the levels terms (π_i^{aid}) we obtain the long-run coefficient on aid in the form:

$$\beta_i^{Aid} = -\frac{\pi_i^{aid}}{\pi_i^{EC}} \qquad (5^*)$$

whereas the regression coefficients on the terms in first differences capture the short-run (transitory) effects, and can be read off directly from estimation. Inference on π_i^{EC}, the speed of convergence to equilibrium, provides insights into the presence of a long-run (cointegrating) relationship between aid and taxes. If $\pi_i^{EC} = 0$ then there is no cointegraion, and the model reduces to one with variables in first differences. If $\pi_i^{EC} \neq 0$ then there is 'error correction' in the model. That is, following a shock the economy returns to its long-run equilibrium path, and therefore there exists a cointegrating relationship between aid and taxes.

4.2 Endogeneity and Causality

So far we have discussed one type of endogeneity; whereby the unobserved common factors drive both the dependent variable and the independent variables. In studying the relationship between aid and taxes (and other macroeconomic variables in general), one must consider the fact that aid is allocated in a non-random manner (Carter, 2013). Structural characteristics may determine both low (high) revenue and high (low) aid; with poor countries that have weak tax bases and low tax ratios attracting more aid and vice versa. Thus, interest is in investigating if donors respond to recipients' fiscal imbalances when disbursing aid, or if disbursement is independent of the fiscal situation in recipient countries. To test for causality, we follow the procedure in Canning and Pedroni (2008) and Eberhardt and Teal (2013).

Provided there exists a cointegrating relationship between the aid/GDP and tax/GDP ratios the Granger Representation Theorem (Engle and Granger, 1987) states that at least one variable must adjust to maintain an equilibrium relation; and the variables can be represented in the form of a dynamic ECM. For a pair of cointegrated variables, we can then test for weak exogeneity in the following models:

$$\Delta tax_{it} = \rho_{1i} + \theta_{1i}\hat{e}_{it-1} + \sum_{j=1}^{K} \lambda_{11ij}\Delta \text{tax}_{it-j} + \sum_{j=1}^{K} \lambda_{12ij}\Delta aid_{it-j} + \epsilon_{it}^{tax} \qquad (6)$$

$$\Delta aid_{it} = \rho_{2i} + \theta_{2i}\hat{e}_{it-1} + \sum_{j=1}^{K} \lambda_{21ij}\Delta aid_{it-j} + \sum_{j=1}^{K} \lambda_{22ij}\Delta tax_{it-j} + \epsilon_{it}^{aid} \quad (7)$$

where ρ_i are constant terms and $\hat{e}_{it-1}$ is the disequilibrium term $\hat{e} = y - \hat{\beta}_i x - \hat{d}$ constructed using the cointegrating relationship between the variables (d represents deterministic terms like a constant and a country-specific trend). Each variable may react to its lagged differences, as well as lagged differences of other variables in the cointegrating relationship. The Granger representation theorem implies that at least one of the adjustment coefficients θ_{1i}, θ_{2i} must be non-zero if a cointegrating (long-run) relationship between the variables is to hold (Canning and Pedroni, 2008 p. 512). If $\theta_{1i} \neq 0$ then aid_{it} has a long-run causal impact on tax_{it} and if $\theta_{2i} \neq 0$ then tax_{it} has a long-run causal impact on aid_{it}. If both θ_{1i} and θ_{2i} are non-zero then aid_{it} and tax_{it} determine each other jointly.

One of the advantages of using the disequilibrium term from a cointegrating relationship is that all the variables in equations (6) and (7) are stationary. This means once ECMs are estimated for each country, estimates for θ_i can be investigated using standard t-ratios (Canning and Pedroni, 2008; Eberhatrdt and Teal, 2015). Following Canning and Pedroni (2008) we use two separate statistics to test for weak exogeneity. The first is the group-mean statistic (GM hereafter) which averages the θ_i from individual country estimations of equations (6) and (7) and the GM test for the null of 'no long-run causal impact' is computed from the averaged t-ratio from country regressions ($\bar{t}_{\theta_2} = N^{-1}\sum_{i=1}^{N} t_{\theta_2}$). The GM statistic follows a standard normal distribution under the null hypothesis of 'no causal impact'. The second statistic is a Fisher-type (*Lambda*-Pearson) statistic which is constructed from the p-values of the t-tests from the country regressions to get the overall marginal significance associated with those p-values. The Fisher statistic follows a χ^2 distribution with $2N$ degrees of freedom under the null hypothesis of 'no causal impact'.

The null and alternative hypotheses for both tests are the same when the θ_i coefficients are the same for all members of the panel. This translates into a null that $\theta_i = 0$ for all members in the panel against an alternative $\theta_i \neq 0$ for some non-negligible members of the panel (Canning and Pedroni, 2008). The interpretation of the tests, however, differs when θ_i differs across countries. The GM test is a two-tailed test so can take on positive or negative values under the null and alternative hypothesis depending on whether $\hat{\theta}_i$ is positive or negative whereas the Fisher statistic is a one-tailed test that only takes positive values in both the null and alternative hypotheses. If these two tests fail to agree on the direction of causality between variables, this can be interpreted as θ_i being on average zero (allowing for large negative and positive values to cancel each other), but not pervasively zero in the panel (Canning and Pedroni, 2008; Eberhardt and Presbitero, 2015). If that is the case, it provides evidence of the heterogeneity of θ_i across countries.

5. EMPIRICAL RESULTS

5.1 Preliminary Analysis

We investigate the cross-section correlation properties in the data using the CD test following Pesaran (2004), and report the cross-country correlation coefficients and the CD test statistic (appendix tables A1 and A3). The results point to pervasive cross-section dependence across datasets and different variable specifications (levels versus first differences). The correlation coefficients and CD statistics are considerably lower for variables in first differences. Cross-

section dependence results in over-rejection of the null hypothesis of nonstationarity in standard panel unit roots tests (Pesaran, 2007). Thus we employ a panel unit root test, the CIPS test, which allows for cross-section correlation. Appendix tables A2 and A4 provide the results from conducting the 'CIPS' test. We report the Ztbar statistic (and its corresponding p-value) for H_0 = nonstationarity in all countries' variable series versus H_1 = stationarity in some countries' variable series. The panel statistic is obtained by normalising the individual country t-statistics using simulated values of the mean and variance (Söderbom *et al.*, 2014). Normalization makes the Ztbar statistic distributed $N(0,1)$. For both variables in levels, nonstationarity cannot be rejected once the equation is augmented with lags and/or a linear trend. Nonstationarity is rejected for both variables in first differences.

5.2 Heterogeneous Baseline Estimates

Having confirmed the prevalence of cross-section dependence, and established that all the variables are nonstationary in levels we proceed to estimate the heterogeneous ECM using a dynamic CCEMG estimator; results of which are reported in Table III. We report results for the standard CCEMG (Pesaran, 2006), as well as variants augmented with one and two lags of cross-section averages respectively (Chudik and Pesaran, 2015). Long-run averages and short-run coefficients of the variables are reported. The coefficient on the lagged dependent variable is reported as well.

The long-run average coefficient is obtained by averaging ECM coefficients, then computing the long-run coefficient with standard errors computed through the Delta method. We employ the robust regression (see Hamilton, 1992) – which weighs down outliers in computing the averages – in all estimations. Relevant diagnostics (RMSE, CD test statistic, the CIPS test statistic) are reported at the bottom of the table. Given the small sample bias the standard CCEMG faces, in addition to the *favourable* results and diagnostics from the variant with two additional lags of cross-section averages, we only discuss results based on the CCEMG augmented with two lags of cross-section averages; in the main model and for the exploratory analysis.

Both aid/GDP and tax/GDP ratios are I(1) so we can test for cointegration by investigating the statistical significance of the lagged dependent variable as shown in table III. Across all specifications and datasets the coefficient on the lagged dependent variable is negative, statistically significant and different from zero, indicating that the system reverts to its equilibrium path following a shock. The results indicate that on average there is a long-run equilibrium relationship between the tax/GDP and aid/GDP ratios, with increases in the tax/GDP ratio sustained by movements in the aid/GDP ratio. Additionally, as residual testing for stationarity also provides an *ad hoc* test for cointegration, we confirmed cointegration across the three specifications for each dataset.[4]

The long-run average coefficient on the aid/GDP ratio is positive and statistically significant across models and datasets. This average effect is robust to outliers, omitted variables and structural breaks. We treat this long-run as a behavioural relationship between aid and taxes, based on political costs associated with aid and taxes, for two reasons. First, our measure of

[4] Panel cointegration tests have been proposed in the econometric literature, each with their strengths and weaknesses. The tests can be classified into 'first-generation' and 'second-generation' tests, the latter incorporating cross-sectional dependence which the former ignores. See, *inter alia*, Eberhardt (2011) for a detailed review.

aid is close to that which goes through the budget, such that it will have a direct impact on taxation. Second, the ECM distinguishes between short-run and long-run effects; such that for the long-run effect it is not essential to specify the variable lags (as *per* Clist and Morrissey, 2011 and Morrissey and Torrance, 2015) through which aid will impact taxes (Herzer and Grimm, 2012). On average, the evidence across datasets suggests that the political costs of aid are higher than those of taxes.

The costs of accountability of aid are likely higher than those of tax. Some donor agencies may operate in domestic environments where there are opponents to aid (usually political parties or vocal politicians), especially in cases where some aid projects financed by said donor agencies failed; thereby increasing the accountability costs of aid. The accountability costs of tax are much lower, especially developing in countries with weak political and tax systems. Political systems in most developing countries do not place any constraints (checks and balances) on the power of the executive, and non-state actors, by virtue of the fact that they do not pay much in taxes (huge informal sectors may suggest that they pay no taxes at all) are unable to control and limit elites' access to resources. Such political systems are less transparent and political elites easily evade taxes and bend tax rules in their favour (Riccuiti *et al.*, 2016; Besley and Persson, 2014). Regarding the costs of autonomy; to the extent that recipients meet the policy reform conditions stipulated to them by donors when disbursing aid; and there is evidence to suggest that *met* revenue in donor-supported programs either increases tax/GDP ratios (Crivelli and Gupta, 2016) or mitigates the negative effects of aid on taxes (Crivelli and Gupta, 2017), recipients cede less policy influence to donors. This suggests the costs of autonomy for recipients, relating to aid dependence, have reduced.

The bureaucratic costs of aid are also higher than those of tax. Moore (2014) and Fossat and Bua (2013) document fiscal reforms in Anglophone and Francophone Africa, respectively, with many other developing countries implementing reforms and improving tax administration in the last decade. These reforms reduce the bureaucratic costs of taxation, while also increasing the efficiency of tax collection. Contrarily, the bureaucratic costs of aid are still high. This is exacerbated by donor fragmentation, and the emergence of novel donors with changing requirements for aid allocation and monitoring. The evidence suggests that the political calculus has shifted in favour of taxation.

Table III: CCEMG Estimates

	Combes *et al.*, (2016)			GRD (2016)		
	CCEMG	**One-lag CCEMG**	**Two-lag CCEMG**	**CCEMG**	**One-lag CCEMG**	**Two-lag CCEMG**
Country trends ϱ	x	x	x			
Long-Run						
Aid/GDP	0.084**	0.091**	0.084**	0.080***	0.086***	0.077***
	[0.033]	[0.037]	[0.039]	[0.027]	[0.028]	[0.027]
Short-Run						
Aid/GDP	-0.007	-0.004	0.004	0.011	0.009	0.014
	[0.017]	[0.017]	[0.017]	[0.010]	[0.011]	[0.012]
EC Coefficient						
y_{it-1}	-0.615***	-0.603***	-0.606***	-0.444***	-0.472***	-0.495***
	[0.049]	[0.051]	[0.052]	[0.027]	[0.028]	[0.031]
t-statistic	-12.63	-11.83	-11.61	-16.57	-16.61	-16.09
Diagnostics						
RMSE	0.100	0.087	0.081	0.107	0.098	0.092
Stationarity ϟ	I(0)	I(0)	I(0)	I(0)	I(0)	I(0)
CD test	-0.91	-1.21	-0.93	-0.79	-1.02	-1.45
(p-value)	(0.365)	(0.228)	(0.353)	(0.430)	(0.308)	(0.148)
Observations (N)	1245 (47)	1212 (47)	1166 (46)	2473 (84)	2423 (84)	2371 (84)

***Notes**: The second to fourth columns are based on data provided by Combes et al., (2016); with results based on an error correction model for all 47 countries in the sample with the first difference of log (tax/GDP) as dependent variable. The fifth to seventh columns are based on collected data (aid and tax data from the OECD DAC, 2016 and UNU-WIDER/ICTD GRD, 2016 databases respectively); with results based on an error correction model for all 84 countries in the sample with the first difference of log (tax/GDP) as dependent variable. The aid/GDP ratio used is net disbursements (excluding technical assistance) as a share of recipient's GDP. 'CCEMG' represents the Pesaran (2006) common correlated effects mean group (CCEMG) estimator while 'one-lag' and 'two-lag CCEMG' represent the standard CCEMG augmented with one and two lags of the cross-section averages respectively. The long-run averages are computed from the robust mean estimates of the CCEMG models with standard errors (reported below the averages) computed through the Delta method. The short-run coefficients are read off directly from estimation. ϱ The models are augmented with country-specific linear trend terms. The t-statistic on the lagged dependent variable is a non-parametric statistic derived from the country-specific coefficients following Pesaran and Smith (1995). RMSE is the root mean square error, ϟ Pesaran (2007) test results for ADF tests on the residuals: I(0) – stationary, I(1) – nonstationary. CD test is the Pesaran (2004) test distributed $N(0,1)$ under the null of cross-section independence (p-value in parantheses below).*, ** and *** indicate significance at 10% ,5% and 1% respectively.*

5.3 EXPLORATORY ANALYSIS

We investigate, further, the relationship between aid and taxes. We rely on dummy variables to group countries with similar characteristics, and explore heterogeneity using proxy variables typically used in the tax performance literature.

5.3.1 Heterogeneity in Aid Flows

We estimate the heterogeneous effects of grants, loans and technical assistance on the tax/GDP ratio. Accordingly, we re-estimate equation (3) with respectively, grants (column 2), loans (column 3) and technical assistance (column 4) as the measure of aid and report the results in table IV. Combes *et al.,* (2016) do not provide disaggregated aid data so results are based solely on our compiled dataset.

Table IV: Heterogeneity in Aid Flows

	Grants	**Loans**	**Technical Co-operation**
Additional covariate(s) ϱ			*gdppc*
Long-Run			
Aid/GDP	0.058***	0.010	0.077**
	[0.018]	[0.018]	[0.039]
Short-Run			
Aid/GDP	0.013	0.0007	0.015
	[0.008]	[0.007]	[0.018]
EC Coefficient			
y_{it-1}	-0.521***	-0.517***	-0.503***
	[0.029]	[0.026]	[0.034]
t-statistic	-17.81	-19.66	-14.98
Diagnostics			
RMSE	0.092	0.089	0.085
Stationarity ϯ	I(0)	I(0)	I(0)
CD test	-0.07	-1.60	-1.64
(p-value)	(0.940)	(0.110)	(0.102)
Observations (N)	2414 (84)	2328 (84)	2412 (84)

***Notes**: Error correction models are estimated for all 84 countries in the sample; first with grants/GDP as the aid variable of interest (column 2), then loans/GDP (column 3), and finally technical co-operation/GDP (column 4).* ϱ *The CCEMG estimator is implemented with two lags of cross-section averages and cross-section averages of other variables (gdppc – GDP per capita in constant $2010 values, in logs) as indicated – see main text for details. For all other details see Table III.*

From table IV, grants have a long-run positive association with tax/GDP ratios in recipient countries, while loans have no effect on tax/GDP ratios. A plausible explanation for this is the costs of accountability, for both the donors and recipients, are likely to be higher for grants than for loans. For donors, it is easier to justify to their governments and parliaments, the disbursement of a loan than a grant; the straightforward reason being that loans come with obligations of repayment and servicing while grants are seen as 'free' money. Thus donors place more stringent policies to monitor their aid grants and minimise fungible use. For recipients, they will have to account to the donors how the grants they disbursed are being spent. These accountability costs also lead to increases in costs of autonomy for the recipient,

as they will have to expend effort to circumvent those donor-installed monitoring policies, as well as cede some policy influence to donors.

Technical assistance also has a long-run positive association with tax/GDP ratios. Such technical assistance has the potential to relax capacity constraints in tax administration and policy, as well as increase tax collection efficiency without necessarily increasing tax rates; thereby reducing the bureaucratic costs of taxation. Due to the persistence of tax/GDP ratios such improvements are mostly medium to long-term; corresponding to the long-run positive association between the technical assistance-to-GDP and tax/GDP ratios.

5.3.2 Domestic Revenue

Royalties, taxes and other revenue from natural resources are important in countries endowed with natural resources. Thus we re-estimate equation (5) with two new measures of revenue; total tax revenue and total government revenue. The former comprises revenue from non-resource and resource taxes (both direct and indirect tax components), while the latter is a composite of tax and non-tax revenues.[5] Results are reported in table V. Regarding total tax revenue (column 2), the results do not differ much from those with non-resource taxes as the measure of domestic revenue.

Table V: Heterogeneity in Domestic Revenue

	Total Tax Revenue	**Total Domestic Revenue**
Additional covariates ד	*gdppc, agriculture*	
Long-Run		
Aid/GDP	0.080***	0.052**
	[0.026]	[0.021]
Short-Run		
Aid/GDP	0.012	-0.003
	[0.012]	[0.010]
EC Coefficient		
y_{it-1}	-0.548***	-0.539***
	[0.036]	[0.032]
t-statistic	-15.16	-16.64
Diagnostics		
RMSE	0.083	0.091
Stationarity ד	I(0)	I(0)
CD test	-1.47	-1.40
(p-value)	(0.143)	(0.162)
Observations	2374 (84)	2343 (83)

Notes: *'Total Tax Revenue' and 'Total Domestic Revenue' refer to error correction models for all 84 countries first with total tax revenue (including natural resource taxes) as the measure of domestic revenue (column 2), then total government revenue as the measure of domestic revenue (column 3). For all other details see Table III.*

There is a positive long-run relationship between the aid/GDP and the (total) tax/GDP ratios. Regarding total government revenue (column 3), the coefficient on the aid/GDP ratio is relatively smaller. This is to be expected as total domestic revenue comprises non-tax revenue

[5] The Combes *et al.,* (2016) data on total government and total tax revenues has many missing observations; and more observations are lost once we apply the dynamic CCEMG. Hence, we present results on our dataset.

(of which natural resources form the bulk), and theory is not predictive on how aid can affect such non-tax revenue. It is possible that the smaller effect shows aid having a positive association with the non-resource tax revenue component of total government revenue.

5.3.3 Donor Conditionality

In line with the argument in section 2 we test if there is a role for revenue conditionality in improving tax/GDP ratios. Data on revenue conditionality in IMF-supported programs is obtainable from the IMF's Monitoring of Fund Arrangements (MONA) database; following Crivelli and Gupta (2016, 2017). Results are presented in table VI. There is evidence of a positive long-run association between aid/GDP and tax/GP ratios in countries with *met* revenue conditionality, across both datasets. This long-run effect reflects the all-encompassing nature of revenue conditionality, including quantitative (for example, observable targets like increasing the VAT rate) as well as structural (for example, statutory aspects of tax reform like submitting legislations to parliament) conditionality. For the GRD dataset, there is also evidence of a positive short-run relationship between aid/GDP and tax/GDP ratios, most likely reflected through quantitative revenue conditionality in which the effects plausibly take less time to be observed. This would also suggest that the political calculus, based on costs of autonomy, is in favour of taxes. Countries that meet revenue conditions in IMF and other donor-supported programs will have the ability to make independent policy choices, thereby reducing the political costs of autonomy.

Table VI: Revenue Conditionality

	Combes *et al.,* (2016)		GRD (2016)	
	Revenue Conditionality	**No Revenue Conditionality**	**Revenue Conditionality**	**No Revenue Conditionality**
Additional Covariates ǂ	*exports*			
Long-Run				
Aid/GDP	0.108**	0.011	0.119***	-0.006
	[0.052]	[0.059]	[0.039]	[0.032]
Short-Run				
Aid/GDP	0.003	-0.005	0.032**	-0.020
	[0.021]	[0.031]	[0.016]	[0.015]
EC Coefficient				
y_{it-1}	-0.540***	-0.856***	-0.483***	-0.519***
	[0.049]	[0.158]	[0.042]	[0.043]
t-statistic	-11.03	-5.40	-11.50	-12.02
Diagnostics				
RMSE	0.077	0.071	0.089	0.097
Stationarity ד	I(0)	I(0)	I(0)	I(0)
CD test	-1.54	-1.90	0.34	-0.69
(p-value)	(0.125)	(0.058)	(0.731)	(0.493)
Observations (N)	912 (35)	254 (11)	1539 (54)	830 (30)

Notes: *'Revenue Conditionality' refers to countries with met revenue conditionality (either quantitative or structural) in IMF-supported programs while 'No Revenue Conditionality' refers to the rest of the countries in the sample.* ǂ *The CCEMG estimator is implemented with two lags of cross-*

section averages and cross-section averages of other variables (exports – values of exports in current $US values, in logs) as indicated – see main text for details. For all other details see Table III.

5.3.4 Recipient Policy Reform

To capture the policy effects of aid on tax/GDP ratios we focus on the creation and operation of Semi-Autonomous Revenue Authorities (SARAs hereafter). Evidence on the effectiveness of such authorities is mixed. The benefit of having such authorities is that tax collection is handled by an independent agency (which receives performance incentives). Ideally, the effectiveness of SARAs in improving revenue performance should reduce the accountability costs of taxes in recipient countries. Indeed Ahlerup *et al.*, (2015), using data for 47 countries from 1980-2010, provide evidence that SARAs in Sub-Saharan Africa have been associated with at least short term increases in tax revenue (the effects usually subside after about 5 years). A weakness of SARAs is that governments (politicians) still retain control over tax policy design and can still favour select groups by granting tax exemptions. In addition, the effectiveness of SARAs depends on domestic political and economic events; with political instability and adverse economic developments undermining the positive aspects of reform. Furthermore, as politicians retain control over tax policy in developing countries, the countries are still subject to political budget cycles (Brender and Drazen, 2005; Shi and Svensson, 2006); which is exacerbated by the weak nature of tax institutions (lack of transparency and accountability). Dom (2017), using data for 46 SSA countries from 1980-2012, suggests that there is no observable effect of SARAs on revenue collection.

Table VII: Recipient Policy Reform

	Combes *et al.*, (2016)		GRD (2016)	
	Revenue Authority	**No Revenue Authority**	**Revenue Authority**	**No Revenue Authority**
Long-Run				
Aid/GDP	0.117	0.071	0.044	0.090***
	[0.087]	[0.046]	[0.049]	[0.033]
Short-Run				
Aid/GDP	-0.0009	0.003	0.015	0.011
	[0.037]	[0.020]	[0.031]	[0.013]
EC Coefficient				
y_{it-1}	-0.493***	-0.619***	-0.502***	-0.494***
	[0.029]	[0.071]	[0.048]	[0.040]
t-statistic	-16.99	-8.70	-10.36	-12.50
Diagnostics				
RMSE	0.093	0.074	0.083	0.095
Stationarity ך	I(0)	I(0)	I(0)	I(0)
CD test	-1.18	0.64	0.42	-1.49
(p-value)	(0.239)	(0.519)	(0.673)	(0.135)
Observations (N)	415 (16)	751 (30)	715 (25)	1656 (59)

Notes: *'Revenue Authority' comprises countries with operational semi-autonomous revenue authorities, while 'No Revenue Authority' refers to the rest of the countries in the sample. For all other details see Table III.*

Following the tax performance literature we disaggregate countries based on the presence of an operational semi-autonomous revenue authority in the country, and re-estimate equation (5) for both groups of countries across datasets. The COT (2016) dataset provide no evidence of a relationship between the aid/GDP and tax/GDP ratios whether or not the country has an operational SARA. Using the GRD (2016) dataset, we find that for countries with SARAs there is no observable long-run (or even short-run) relationship between the aid/GDP and tax/GDP ratios. For countries without SARAs, we find a strong positive long-run relationship between the ratios. As already mentioned the effectiveness of these authorities depends a lot on dynamic political and economic factors, which are typically country-specific. Tax administration and policy has improved over the years (Moore, 2014; Fossat and Bua, 2013) and tax ratios have also increased gradually, but most developed countries are still subject to political and economic instability, thereby undermining the efforts of reform (see Ahlerup *et al.*, 2015 for country-specific evidence on the effectiveness of SARAs). It is also possible that technical assistance subsumes the effect of reform, such that any positive effects of SARA reform are being captured by the positive long-run impact of technical assistance. This last argument is tested by re-estimating equation (5) for the SARA and non-SARA groups using technical assistance as the measure of aid.[6] We find evidence of a positive long-run relationship between technical assistance and tax/GDP ratios for countries with revenue authorities. This is to be expected since technical assistance is given to countries to help implement fiscal reforms involving tax administration and establishing independent revenue authorities.

Table VII(b): Recipient Policy Reform

	GRD (2016)	
	Revenue Authority	**No Revenue Authority**
Long-Run	0.104**	0.065
	[0.052]	[0.054]
Aid/GDP		
Short-Run	0.034	0.007
	[0.034]	[0.021]
Aid/GDP		
EC Coefficient	-0.518***	-0.496***
	[0.052]	[0.043]
y_{it-1}	-9.86	-11.62
t-statistic		
Diagnostics		
RMSE	0.078	0.088
Stationarity ד	I(0)	I(0)
CD test	1.04	0.01
(p-value)	(0.300)	(0.993)
Observations (N)	726 (25)	1689 (59)

Notes: *'Revenue Authority' comprises countries with operational semi-autonomous revenue authorities, while 'No Revenue Authority' refers to the rest of the countries in the sample. The aid/GDP ratio used here is 'technical assistance-to-GDP ratio'. For all other details see Table III.*

[6] This is carried out using only the UNU-WIDER/ICTD GRD (2016) dataset since the COT (2016) does not include technical assistance.

5.3.5 Level of Development

The sample is split into two income groups- least developed countries (LDCs) and other low income incomes (LICs) - to further explore the heterogeneous effects of aid on tax/GDP ratios across different levels of development. Results are reported in table VIII. Across both datasets, there is a long run positive association between aid/GDP and tax/GDP ratios, as well as a short run positive relationship between the variables in the GRD dataset. Teera and Hudson (2004) state that LDCs have lower tax/GDP ratios and tax effort (typically less than one), with most of them exploiting their taxation potential less than average. However, countries with lower tax effort are those with higher potential for increases in tax/GDP ratios, and they are the countries in which increases in the aid/GDP ratio will plausibly be associated with long-term increases in the tax/GDP ratio; as confirmed in table VIII. Additionally, the evidence from table VIII suggests that the political calculus may have shifted in favour taxes, with a tendency for governments to increase domestic revenue than accept aid as the political costs of aid are higher. Developing countries are still aid dependent because they are constrained in their abilities to raise taxes (Keen and Simone, 2004), but would prefer increasing domestic revenue to aid.

Table VIII: Heterogeneity in Levels of Development

	Combes *et al.*, (2016)		GRD (2016)	
	LDCs	**LICs**	**LDCs**	**LICs**
Long-Run				
Aid/GDP	0.164***	0.006	0.125**	0.048
	[0.055]	[0.051]	[0.051]	[0.031]
Short-Run				
Aid/GDP	0.015	-0.011	0.046**	-0.003
	[0.029]	[0.017]	[0.023]	[0.013]
EC Coefficient				
y_{it-1}	-0.561***	-0.674***	-0.505***	-0.487***
	[0.056]	[0.100]	[0.047]	[0.041]
t-statistic	-10.00	-6.70	-10.74	-11.75
Diagnostics				
RMSE	0.090	0.069	0.113	0.069
CD test	-0.68	-0.67	-0.76	-0.65
(p-value)	(0.500)	(0.500)	(0.447)	(0.515)
Observations (N)	658 (25)	508 (21)	1078 (38)	1293 (46)

***Notes**: LDCs refer to least developed countries and LICs refer to other low-income countries. Error correction models are estimated for each income group; with the first difference of log (tax/GDP) as dependent variable. For all other details see Table III.*

5.3.6 Region

The sample is split into four regions: Sub-Saharan Africa (SSA), Latin America and the Caribbean's (LAC), Asia and the Pacific (AsiaPAC) and the Middle East and North Africa (MENA). Results are presented in table IX. For both datasets, there is a long-run positive association between aid/GDP and tax/GDP ratios in the SSA region; again, with a short-run relationship for the GRD dataset. For the COT (2016) dataset 16 of the 23 LDCs are SSA countries while in the GRD dataset, 31 of the 37 LDCS are SSA countries. Again, these are countries with low tax effort and huge potential for increases in tax/GDP ratios, hence countries in which increases in the aid/GDP ratio will be associated with increases in the tax/GDP ratio. The only other long-run positive effect is for the Asia and Pacific region using the COT (2016) dataset. It is worth noting that the AsiaPAC sample is quite small, and the positive effect is driven by the positive impact of aid/GDP on tax/GDP in Sri Lanka.

Table IX: Heterogeneity across regions

	Combes *et al.*, (2016)				GRD (2016)			
	SSA	**LAC**	**MENA**	**AsiaPAC**	**SSA**	**LAC**	**MENA**	**AsiaPAC**
Long-Run								
Aid/GDP	0.122***	-0.136	0.123	0.105***	0.119***	0.040	-0.0211	0.051
	[0.051]	[0.112]	[0.101]	[0.047]	[0.043]	[0.053]	[0.092]	[0.059]
Short-Run								
Aid/GDP	0.005	-0.012	0.011	-0.002	0.040*	0.004	0.002	-0.022
	[0.026]	[0.027]	[0.056]	[0.007]	[0.022]	[0.025]	[0.020]	[0.016]
EC Coefficient								
y_{it-1}	-0.578***	-0.527***	-0.766***	-0.826***	-0.531***	-0.484***	-0.378**	-0.452***
	[0.051]	[0.144]	[0.252]	[0.243]	[0.042]	[0.067]	[0.188]	[0.066]
t-statistic	-11.42	-3.67	-3.04	-3.40	-12.71	-7.27	-2.01	-6.84
Diagnostics								
RMSE	0.093	0.050	0.055	0.046	0.106	0.060	0.074	0.091
CD test	-0.93	0.56	0.43	0.21	-1.45	1.82	-0.25	0.72
(p-value)	(0.353)	(0.575)	(0.668)	(0.831)	(0.148)	(0.069)	(0.805)	(0.472)
Observations (N)	778 (29)	123 (6)	138 (6)	127 (5)	1161 (40)	512 (19)	174 (6)	501 (18)

Notes: *The sample is disaggregated into four regions. SSA stands for Sub-Saharan Africa, MENA for Middle East and North Africa, AsiaPAC for Asia and the Pacific, and LAC for Latin America and the Caribbean's. Error correction models are estimated for each region; with the first difference of log (tax/GDP) as dependent variable. For all other details see Table III.*

5.3.7 Heterogeneity by Natural Resource wealth

The availability of natural resources may reduce the need for aid such that recipients are more likely to raise domestic resource revenues if they want control over how funds are being used (Morrissey, 2015). This is because resource revenues are more fungible than aid: resource revenues are obtained independently of the government's effort and a huge chunk of the proceeds from natural resource extraction goes to the state (von Haldenwang and Ivanyna, 2017). In addition, aid is subject to conditionality; hence monitored by donors. Thus, the accountability costs of taxation will be lower than the accountability costs of aid such that governments do not necessarily prefer aid to tax; or that they would substitute aid for tax (with the net effect of aid on taxes unchanged). The latter are the effects we uncover when we distinguish resource-rich from non-resource-rich countries in our sample (see table X). Countries are classified as resource-rich based on the IMF (2012) categorization. For countries with natural resource wealth, aid has no effect on tax/GDP ratios while for those without natural resources the aid/GDP ratio has a long-run positive impact on the tax/GDP ratio across both datasets.

Table X: Countries with/without natural resources

	Combes *et al.,* (2016)		GRD (2016)	
	Natural Resources	**No Natural Resources**	**Natural Resources**	**No Natural Resources**
Long-Run				
Aid/GDP	0.079	0.083**	0.073	0.079**
	[0.105]	[0.041]	[0.056]	[0.032]
Short-Run				
Aid/GDP	0.003	0.007	0.026	0.011
	[0.043]	[0.019]	[0.028]	[0.013]
EC Coefficient				
y_{it-1}	-0.615***	-0.601***	-0.540***	-0.473***
	[0.137]	[0.056]	[0.062]	[0.035]
t-statistic	-4.50	-10.67	-8.77	-13.62
Diagnostics				
RMSE	0.088	0.079	0.104	0.086
CD test	-0.66	-1.12	-0.86	-0.82
(p-value)	(0.511)	(0.263)	(0.391)	(0.415)
Observations (N)	327 (13)	839 (33)	719 (26)	1652 (58)

***Notes**: 'Natural Resources' includes resource-rich countries with active extractive industries; oil, gas and mining as classified in IMF (2012) while 'No Natural Resources' includes non-resource-rich countries. For all other details see Table III.*

5.3.8 Stability of Donor-Recipient Relationships

Here we classify countries according to the volatility of the aid they receive. If the level of aid is highly unpredictable from one year to the next, aid may be too unpredictable for fiscal planning, worsening revenue performance in developing countries. Alternatively, such unpredictability may offset any possible impact aid would have on the tax/GDP ratio, with the net effect being zero. We estimate two measures of aid volatility; one intended to capture uncertainty (following Lensink and Morrissey, 2000) while the other is a measure of instability. Aid uncertainty can be defined as the unanticipated variability in the aid/GDP as a

result of macroeconomic uncertainty. It is measured by the standard deviation of the residuals of a forecasting regression (a $AR\ (2)$ process) of the aid/GDP ratio to determine the expected component of the aid/GDP ratio. We classify countries with high aid uncertainty as those with a standard deviation greater than 0.3, with the rest of the sample representing countries with low aid uncertainty.

The second measure of volatility is the coefficient of variation (CoV) of the logged aid/GDP ratio; measured as a ratio of the standard deviation of the aid/GDP series to the mean value of the series over time. Morrissey and Osei (2004) state that this is a measure of general instability of aid (a result of donor difficulties) over the period. We classify countries with high aid instability as those with the coefficient of variation greater than 0.6, with the rest of the sample representing countries with low aid instability. Results for both measures of aid volatility are reported in tables XI (a) and (b).

Table XIa: Heterogeneity by Aid Uncertainty

	Combes *et al.*, (2016)		GRD (2016)	
	High Aid Uncertainty	**Low Aid Uncertainty**	**High Aid Uncertainty**	**Low Aid Uncertainty**
Long-Run				
Aid/GDP	0.069	0.099*	0.032	0.155***
	[0.052]	[0.056]	[0.028]	[0.053]
Short-Run				
Aid/GDP	0.019	-0.005	0.014	0.026
	[0.020]	[0.025]	[0.013]	[0.022]
EC Coefficient				
y_{it-1}	-0.624***	-0.585***	-0.479***	-0.502***
	[0.093]	[0.065]	[0.046]	[0.040]
t-statistic	-6.75	-9.07	-10.71	-12.39
Diagnostics				
RMSE	0.089	0.077	0.097	0.085
CD test	-0.52	-0.80	-1.04	0.78
(p-value)	(0.606)	(0.423)	(0.299)	(0.436)
Observations (N)	428 (17)	738 (29)	1302 (47)	1069 (37)

***Notes**: 'Aid Uncertainty' is defined as the unexpected variability in aid as a result of macroeconomic shocks. It is measured as the standard deviation of the residuals from a forecasting equation (an AR (2) process) to determine the expected component of aid/GDP. In our classification, countries with high aid uncertainty are those for which said standard deviation is greater than 0.3, and low aid uncertainty countries represent the rest of the countries in the sample. For all other details see table III.*

For countries with high aid uncertainty, there is no discernible effect of the aid/GDP ratio on the tax/GDP ratio across both datasets. This confirms the assertion that high year-on-year variability in aid may offset any potential effects aid has on tax revenue. In countries with low aid uncertainty there is a positive long-run relationship between aid/GDP and tax/GDP ratios. The less donors deviate from their aid commitments, the more predictable aid flows will be and in such countries, aid has a positive long-run association with taxes. For countries with high aid instability, there is no observable relationship between the aid/GDP and tax/GDP ratios. For countries with low aid instability, there is a positive long-run relationship between the aid/GDP.

Table XIb: Heterogeneity by Aid Instability

	Combes *et al.*, (2016)		GRD (2016)	
	High Aid Instability	**Low Aid Instability**	**High Aid Instability**	**Low Aid Instability**
Long-Run				
Aid/GDP	0.076	0.087	0.033	0.119***
	[0.056]	[0.056]	[0.031]	[0.043]
Short-Run				
Aid/GDP	0.005	0.009	0.011	0.019
	[0.017]	[0.028]	[0.014]	[0.018]
EC Coefficient				
y_{it-1}	-0.567***	-0.620***	-0.513***	-0.475***
	[0.056]	[0.074]	[0.053]	[0.037]
t-statistic	-10.10	-8.37	-9.74	-13.00
Diagnostics				
RMSE	0.073	0.087	0.096	0.088
CD test	-1.38	-0.88	0.01	0.80
(p-value)	(0.167)	(0.380)	(0.989)	(0.422)
Observations (N)	480 (19)	686 (27)	1042(38)	1329 (46)

***Notes**: 'Aid Instability' is defined as the year-on-year variation in the aid/GDP ratio in developing countries; with the coefficient of variation (the standard deviation of the variable series as a percentage of the mean value for the series) used as a measure of instability. In our classification, countries with high aid instability are those with a coefficient of variation greater than 0.6 and the rest of the sample make up those with low aid instability. For all other details see Table III.*

5.3.9 Share of Exports and Imports in GDP

Heterogeneity is explored here based on trade; the shares of exports and imports in GDP. We follow Clist and Morrissey (2011) and Morrissey and Torrance (2015) in including exports and imports separately as they potentially have distinct effects. In the sample period, most developing countries eliminated export taxes so exports are not inherently a source of revenue. Insofar as the export sector supports economic activities that generate revenue, we would observe a positive relationship between aid/GDP and tax/GDP ratios for countries with the highest share of exports in GDP. Imports typically proxy for tariff revenue and although most countries reduced tariffs over the years, higher imports would still be associated with higher revenue.

Countries with the highest share of exports and imports in GDP are those with mean export/GDP and import/GDP greater than 30%, respectively. For the COT (2016) dataset, exports are expressed in current $US so we consider the top 25 exporters as 'highest exporters'. Results are reported in table XII. The results are in line with *a priori* expectations across datasets. The COT (2016) dataset shows a positive long-run relationship between the aid/GDP and tax/GDP ratios for the highest exporters, while for the GRD (2016) dataset the disaggregation is irrelevant; for both the highest and lowest exporters there is a positive long-run association between the aid/GDP and tax/GDP ratios. For importers, the results show the importance of tariff revenue in developing countries (a positive long-run relationship between the aid/GDP and the tax/GDP ratio). This positive relationship for highest importers may also

proxy for economic activity, economic growth associated with increased imports (Morrissey and Torrance, 2015).

Table XII: Heterogeneity by percentage of Exports and Imports in GDP

	Combes *et al.*, (2016)		GRD (2016)			
	Exports ($US)		Exports (% GDP)		Imports (% GDP)	
	Highest	Rest	Highest	Rest	Highest	Rest
Long-Run						
Aid/GDP	0.096**	0.066	0.074*	0.096**	0.095***	0.065
	[0.049]	[0.071]	[0.039]	[0.042]	[0.036]	[0.045]
Short-Run						
Aid/GDP	-0.006	0.014	0.016	0.022	0.018	0.013
	[0.018]	[0.035]	[0.015]	[0.020]	[0.016]	[0.021]
EC						
Coefficient						
y_{it-1}	-0.608***	-0.565***	-0.476***	-0.537***	-0.509***	-0.505***
	[0.062]	[0.091]	[0.043]	[0.046]	[0.036]	[0.065]
t-statistic	-9.87	-6.22	-11.01	-11.79	-14.29	-7.74
Diagnostics						
RMSE	0.076	0.087	0.088	0.089	0.096	0.076
CD test	-0.12	0.31	1.45	1.06	-0.44	0.80
(p-value)	(0.902)	(0.754)	(0.147)	(0.287)	(0.662)	(0.427)
Observations (N)	642 (25)	524 (21)	901 (33)	1470 (51)	1528 (54)	843 (30)

***Notes**: 'Exports (% GDP)' and 'Imports (% GDP)' are the value of total exports and imports, respectively, as a percentage of GDP. The highest exporters and importers are those with mean export/GDP and import/GDP ratios greater than 30% respectively. For all other details, see table III.*

5.3.10 Share of Industry and Agriculture in GDP

Here we explore heterogeneity based on the shares of agricultural and manufacturing (value added) in GDP, results of which are reported in table XIII. Countries with the highest agricultural and industrial shares in GDP are those with mean agriculture/GDP and industry/GDP greater than 30%, respectively. Across both datasets, for countries with the highest mean share of agricultural value added there is a positive long-run association between the aid/GDP and tax/GDP ratios. Investigation of the data shows that for the COT (2016) dataset, 21 of the 25 countries with the highest share of agricultural value added are LDCs while for the GRD (2016) dataset, 26 of the 28 countries are LDCs. As established earlier, LDCs are the countries with the highest potential to increase tax/GDP ratios so there is a positive association aid/GDP and tax/GDP ratios.

For the industrial value added, focus is on the GRD dataset as COT (2016) do not collect the data. For countries with a huge industrial sector there is no discernible effect of the aid/GDP ratio on the tax/GDP ratio. Morrissey and Torrance (2015) state that this may be because large multinationals have very sophisticate tax management schemes, making it difficult to tax them. For less industrialized countries, the majority of whom are highly agrarian, there is a positive long-run association between the aid/GDP and tax/GDP ratios.

Table XIII: Heterogeneity by Agricultural and Industrial Value Added as per cent of GDP

	Combes *et al.*, (2016)		GRD (2016)			
	Agriculture (% GDP)		Agriculture (% GDP)		Industry (% GDP)	
	Highest	Rest	Highest	Rest	Highest	Rest
Long-Run						
Aid/GDP	0.157**	0.028	0.146**	0.054	0.008	0.111***
	[0.065]	[0.048]	[0.060]	[0.034]	[0.031]	[0.039]
Short-Run						
Aid/GDP	0.011	-0.007	0.069**	0.004	-0.010	0.027*
	[0.034]	[0.017]	[0.034]	[0.014]	[0.016]	[0.016]
EC						
Coefficient						
y_{it-1}	-0.565***	-0.601***	-0.621***	-0.474***	-0.500***	-0.492***
	[0.069]	[0.077]	[0.057]	[0.037]	[0.051]	[0.039]
t-statistic	-8.22	-8.41	-10.88	-12.91	-9.77	-12.58
Diagnostics						
RMSE	0.092	0.067	0.107	0.073	0.093	0.091
CD test	0.63	0.82	1.46	-0.79	-0.13	-0.15
(p-value)	(0.529)	(0.414)	(0.145)	(0.432)	(0.893)	(0.880)
Observations (N)	624 (24)	542 (22)	819 (28)	1552 (56)	825 (31)	1546 (53)

***Notes**: 'Agriculture (% GDP)' and 'Industry (% GDP)' are the shares of agriculture (value added) and industry (value added), respectively, as a percentage of GDP. Countries with the highest agricultural and industrial shares in GDP are those with mean agriculture/GDP and industry/GDP greater than 30%, respectively.*

5.4 Endogeneity and Long-Run Causality

In tables XIV (a) and (b) we present results for weak exogeneity tests; using specifications of equations (6) and (7) with two lags. The results are based on the dynamic CCEMG model augmented with two lags of cross-section averages (this is the long-run relationship from which the disequilibrium term is constructed). In each row with 'equation', the specified variable is used as dependent variable in the ECM regression. We also report the panel robust $\hat{\theta}_i$ estimate, which exists only for the group-mean tests (Canning and Pedroni, 2008), and its associated t-statistic. We would expect a typically high t-statistic on the average $\hat{\theta}_i$ coefficients in the tax equations (which can be interpreted as evidence of a long-run causal relationship from aid to taxes) and a low t-statistic (below 1.96) in the aid equations (Eberhardt and Presbitero, 2015). In the last column we report the share of countries in the sample ($^{N_i}/_{N}$) that fail to reject the null of 'no causal' impact.

In examining the details of tables XIV (a) and (b), the first clear pattern is that both the GM and Fisher statistics consistently fail to reject the null of 'no causal impact' from the aid/GDP ratio to the tax/GDP ratio. In addition, the share of countries that fail to reject the null of 'no causal impact' from aid to tax is uniformly low across datasets and alternative specifications, typically below 40% in both datasets. This provides strong evidence in favour of a long-run causal relationship from aid/GDP to tax/GDP ratios, across datasets, as well different measures of aid and varying degrees of heterogeneity. The results conform to the statutory nature of tax systems such that tax policy, once implemented, is not easily reversed in the

short-run. Hence changes in the level of aid induce permanent (long-run) changes in the level of taxation.

With regard to the ECM specifications with aid as dependent variable, the results across both datasets have five characteristic features. First, we cannot reject the null that tax/GDP ratios have a zero average long-run impact on aid/GDP ratios; for the baseline estimates (the main behavioural representation from table III) and across various degrees of heterogeneity. However, for the baseline estimates, we can conclude that the long-run impact of taxes on aid is not pervasively zero; such that changes in tax/GDP ratios may induce changes in the aid/GDP ratio in some, but not all countries. Furthermore 77% of countries fail to reject the null of 'no causal impact' in the COT (2016) dataset and 79% in the GRD dataset, suggesting that aid is potentially weakly exogenous. While aid is important for long-run taxation behaviour in developing countries (fiscal planners have expectations for aid as commitments are known in advance), the level of aid is independent of revenue performance in recipient countries. Second, grants are strongly weakly exogenous but *long-run forcing*; as they have a significant long-run impact on tax/GDP ratios. Accounting for the contemporaneous correlation between high grants and low tax-to-GDP ratios, we find that in the long-run the level of grants is independent of revenue performance in recipient countries.

Third, technical assistance is weakly exogenous, which is intuitive. As this is a measure of off-budget aid it is determined irrespective of the recipients' revenue and/or growth characteristics but it has a long-term beneficial impact on tax/GDP ratios through relaxing capacity constraints. We also test for weak exogeneity of technical assistance for countries with revenue authorities (as technical support is given for tax administration and policy design, typical activities carried out by revenue authorities). Again, technical assistance is found to be weakly exogenous; such that tax/GDP ratios have a zero average long-run impact on technical assistance in countries with revenue authorities, and changes in technical assistance induce permanent changes in taxes in those countries. Fourth, reverse causality may be associated with revenue conditionality; such that countries with macroeconomic and structural weaknesses – reflected by low tax/GDP ratios- may request for IMF (and other donor-) support to improve their fiscal situation. As seen from table XI (a), we are confident that our results for donor conditionality are not driven by reverse causality. Long-run causation is uni-directional, from aid/GDP to tax/GDP and not vice-versa. Fifth, for countries with low aid volatility (low aid uncertainty and instability), long-run causation runs from the aid/GDP to the tax/GDP ratio.

Ultimately, given the data dimensions and characteristics, and given the all the problems and caveats of individual country and panel exogeneity tests, we suggest most conservatively that long-run causation runs mainly from aid/GDP to tax/GDP ratios; with aid (and its components) being weakly exogenous. There is no 'donor disbursement rule' in which recipients' revenue performance influences the level of aid received.

Table XIV (a): Weak Exogeneity Tests (Combes *et al.*, 2016)

	GM	(p)	Fisher	(p)	Mean $\hat{\theta}_i$	t-stat	N_i/N
Baseline Estimates							
Tax Equation	-1.797	0.072	306.40	0.000	-0.550	-8.339	34%
Aid Equation	-0.172	0.864	119.13	0.030	-0.176	-0.931	77%
Donor Conditionality							
Tax Equation	-1.793	0.073	226.02	0.000	-0.512	-8.480	37%
Aid Equation	-0.341	0.733	83.484	0.129	-0.305	-1.738	80%
LDCs							
Tax Equation	-1.950	0.051	169.70	0.000	-0.561	-7.756	32%
Aid Equation	-0.226	0.821	50.710	0.445	-0.243	-2.100	85%
Sub-Saharan Africa							
Tax Equation	-2.065	0.039	212.067	0.000	-0.582	-9.055	28%
Aid Equation	-0.177	0.860	64.680	0.255	-0.187	-1.148	83%
Asia and the Pacific							
Tax Equation	-1.265	0.206	31.651	0.001	-0.540	-1.493	40%
Aid Equation	-0.401	0.688	10.353	0.410	-0.861	-0.772	100%
No Natural Resources							
Tax Equation	-1.712	0.087	218.288	0.000	-0.534	-6.504	33%
Aid Equation	-0.206	0.837	78.295	0.143	-0.318	-2.072	79%
Low Aid Uncertainty							
Tax Equation	-1.750	0.080	184.479	0.000	-0.525	-6.801	35%
Aid Equation	-0.219	0.827	63.627	0.285	-0.077	-0.370	86%

Notes: *We report results only for significant long-run impacts from tables III to XIII. We report both statistics developed by Canning and Pedroni (2008). GM denotes the group-mean statistic which is the average of country-specific t-ratios on the disequilibrium term which is distributed $N(0,1)$. Fisher is $-2\sum_{i=1}^{N} ln\Pi$, where Π is the p-value of the country-specific t-value on the disequilibrium term. The Fisher statistic is distributed $\chi^2(2N)$. Both test statistics are for the null of 'no causal impact' which in our case can be interpreted as the variable not adjusting to maintain fiscal equilibrium. We also report the robust $\hat{\theta}_i$ estimate, and its associated t-statistic. In the last column we report the percentage of countries in the sample that fail to reject the null of 'no causal' impact.*

Table XIV (b): Weak Exogeneity Tests (UNU-WIDER/ICTD GRD 2016)

	GM	(p)	Fisher	(p)	Mean $\hat{\theta}_i$	t-stat	N_i/N
Baseline Estimates							
Tax Equation	-1.974	0.048	639.52	0.000	-0.493	-12.766	38%
Aid Equation	-0.124	0.901	212.12	0.012	-0.109	-1.044	79%
Heterogeneous Aid (1)							
Tax Equation	-2.114	0.034	668.827	0.000	-0.556	-15.044	33%
Grants Equation	-0.040	0.968	172.633	0.387	-0.080	-0.564	86%
Heterogeneous Aid (2)							
Tax Equation	-2.085	0.037	686.019	0.000	-0.586	-14.293	33%
Technical Assistance Equation	-0.089	0.929	189.240	0.125	-0.094	-1.214	87%
Donor Conditionality							
Tax Equation	-1.827	0.068	373.22	0.000	-0.448	-9.192	40%
Aid Equation	-0.288	0.774	135.26	0.040	-0.227	-2.059	80%
No Recipient Reform							
Tax Equation (1)	-1.971	0.049	449.058	0.000	-0.467	-9.802	39%
Aid Equation	-0.275	0.783	147.025	0.036	-0.190	-1.503	76%
Tax Equation (2)	-2.160	0.031	220.733	0.000	-0.676	-12.144	16%
TC Equation	-0.409	0.683	53.073	0.357	-0.280	-1.690	88%
LDCs							
Tax Equation	-2.057	0.040	307.660	0.000	-0.495	-8.312	37%
Aid Equation	-0.293	0.770	103.093	0.021	-0.204	-1.830	79%
Sub-Saharan Africa							
Tax Equation	-2.050	0.040	311.46	0.000	-0.535	-9.826	33%
Aid Equation	-0.278	0.781	91.361	0.181	-0.238	-2.149	85%
No Natural Resources							
Tax Equation	-2.024	0.043	477.460	0.000	-0.466	-9.878	40%
Aid Equation	-0.198	0.843	143.265	0.044	-0.206	-1.721	78%
Low Aid Uncertainty							
Tax Equation	-1.882	0.060	472.62	0.000	-0.464	-10.526	46%
Aid Equation	-0.022	0.983	148.42	0.105	-0.095	-0.737	84%
Low Aid Instability							
Tax Equation	-2.061	0.039	366.948	0.000	-0.465	-10.706	37%
Aid Equation	-0.133	0.894	90.496	0.525	-0.134	-1.328	83%

Notes*: See table XIV (a) for details.*

6. CONCLUSION AND DISCUSSION

This paper first examined the relationship between aid and taxes using heterogeneous (panel) time-series techniques to deal with problems creating dissension in cross-country aid-tax research: neglecting long-run levels relationships between aid and tax ratios (a result of persistence in fiscal data), measurement of aid and revenue in a way that captures behavioural effects, heterogeneity, endogeneity, cross-country correlation and causality between aid and taxes. Using data for 84 (47) developing countries over the period 1980 to 2013 (1980 to 2010), we find that aid and taxes comprise a long-run (equilibrium) cointegrated relation. Estimates show that on average, aid has a positive long run association with taxes and the effect is robust to outliers and empirical specification. The positive long-run relationship is also robust to sample selection, with an observed effect in least developed countries and countries in Sub-Saharan Africa. The effect of aid on tax reflects a revenue choice that differs across countries based on political economy factors, which donors may influence through technical support and conditionality, over which source of revenue best meets government objectives (Morrissey, 2015). Thus, our findings are consistent with the argument in section 2 that the political calculus may have shifted in favour of taxes, such that recipients prefer increasing taxes instead of depending on aid since the political costs of aid are higher.

Correlations between aid and taxes have been mistaken for causation in the fiscal effects literature, and empirical evidence may suggest that aid (especially in the form of grants) discourages tax effort. Given the structure of the economy (low tax bases reflecting high informal and agricultural sectors), aid goes to countries with *ex ante* lower income levels (hence lower tax/GDP ratios and higher need), independent of their tax effort (or implied lack thereof). Sceptics, backed by cross-country empirical evidence, erroneously point to this contemporaneous correlation as aid having a behavioural effect on tax effort (with this perceived effect stronger for lower income countries based on the argument above). As countries experience growth, one typically observes a corresponding increase in the tax base (increases in income levels with increases in tax revenues) and a decline in the level of aid (as the need for aid decreases). Using methods that account for this correlation, we find that increases in aid are associated with increases in taxes.

The importance of aid heterogeneity, with different effects for grants, loans, and technical assistance is confirmed in this study. The argument that aid grants tend to reduce effort while aid loans encourage tax effort is tenuous: there are associations between aid and tax in the data, largely due to structural characteristics of the economy whereby high aid receipts (especially in the form of grants) are associated with determinants of tax revenue. In this paper, we find that grants are associated with increased tax/GDP ratios while loans have no impact on taxes. We argue that grants are associated with higher costs of accountability than taxes, for both recipients and donors, since they are disbursed with more stringent monitoring mechanisms and policy conditionality. Increased accountability costs translate to increased costs of autonomy for the recipient as they have to expend effort in circumventing donors' monitoring mechanisms and conditionality. Technical assistance is particularly important in improving revenue performance in developing countries, especially in countries engaged in revenue reform; through improving the design and implementation of tax policy reforms, and improving processes to increase tax collection efficiency. Such technical support from donors will help to reduce the bureaucratic costs of taxation, thereby assisting a transition to increase domestic revenue.

The revenue choice between aid and taxes depends on domestic political economy factors which may also be influenced by donors through aid conditionality, and there are two innate limitations with modelling revenue conditionality in aid programs. First, the measure of conditionality is too narrow since it considers only IMF conditionality (although Crivelli and Gupta, 2017 argue that other donors rely on the IMF for macro-related conditionality); and donor proliferation ensures that they have different motivations for providing aid. Second, revenue conditionality changes over the years (countries move across conditionality spectra) and empirical specifications cannot easily account for these transitions. The importance of aid conditionality in improving revenue performance, however, is confirmed in this study.

Understanding the characteristics of aid and taxation data, as well as the relationship between aid, donors and taxation informs the appropriate analytical method. Given that cross-country heterogeneity is pervasive, aid and tax data are characterised by persistence, and the need to distinguish long-run (equilibrium) from short-run dynamics an error correction model representation is appropriate. Once these salient features are incorporated into econometric specifications, results are robust across datasets. Average estimates differ across both datasets, but the common result is a positive association between aid and taxes.

Rather than just asking if there is a strong positive relationship between foreign aid (its components, as well as conditions and technical support associated with it) and taxes we can isolate the presence of an effect of aid on taxes while simultaneously controlling for the reverse effect that taxes are likely to have on aid. Across different specifications and datasets, we find that causality between aid and taxes is uni-directional; with pervasive evidence for long-run causality from aid to taxes. This underscores the argument that previous research in the area tends to treat correlation as causation, which is misguided. To explore in more detail, the interaction of dynamic political and economic factors permeating the impact of aid on taxes, rigorous country specific analysis (in the spirit of Bwire *et al.,* 2017; Mascagni and Timmis, 2017) is warranted. That is beyond the scope of this paper.

REFERENCES

Ahlerup, P., Baskaran, T., & Bigsten, A. (2015). Tax innovations and public revenues in sub-Saharan Africa. *The Journal of Development Studies*, *51*(6), 689-706.

Benedek, D., Crivelli, E., Gupta, S., & Muthoora, P. (2014). Foreign aid and revenue: Still a crowding-out effect? *FinanzArchiv: Public Finance Analysis*, *70*(1), 67-96.

Besley, T., & Persson, T. (2014). Why do developing countries tax so little? *The Journal of Economic Perspectives*, *28*(4), 99-120.

Bwire, T., Lloyd, T., & Morrissey, O. (2017). Fiscal reforms and the fiscal effects of aid in Uganda. *The Journal of Development Studies*, *53*(7), 1019-1036.

Canning, D., & Pedroni, P. (2008). Infrastructure, long-run economic growth and causality tests for cointegrated panels. *The Manchester School*, *76*(5), 504-527.

Carter, P. (2010). Foreign aid and taxation, revisited. *Bristol: University of Bristol (Working Paper 10/614)*.

Carter, P. (2013). Does foreign aid displace domestic taxation? *Journal of Globalization and Development*, *4*(1), 1-47.

Chudik, A., & Pesaran, M. H. (2015). Common correlated effects estimation of heterogeneous dynamic panel data models with weakly exogenous regressors. *Journal of Econometrics*, *188*(2), 393-420.

Chudik, A., Pesaran, M. H., & Tosetti, E. (2011). Weak and strong cross-section dependence and estimation of large panels. *The Econometrics Journal*, *14*(1).

Clist, P. (2016). Foreign aid and domestic taxation: Multiple sources, one conclusion. *Development Policy Review*, *34*(3), 365-383.

Clist, P., & Morrissey, O. (2011). Aid and tax revenue: signs of a positive effect since the 1980s. *Journal of International Development*, *23*(2), 165-180.

Coakley, J., Fuertes, A. M., & Smith, R. (2006). Unobserved heterogeneity in panel time series models. *Computational Statistics & Data Analysis*, *50*(9), 2361-2380.

Combes, J. L., Ouedraogo, R., & Tapsoba, S. J. A. (2016). Structural shifts in aid dependency and fiscal policy in developing countries. *Applied Economics*, *48*(46), 4426-4446.

Crivelli, E., & Gupta, S. (2017). Does Conditionality Mitigate the Potential Negative Effect of Aid on Revenues? *The Journal of Development Studies*, 1-18.

Crivelli, E., & Gupta, S. (2016). Does conditionality in IMF-supported programs promote revenue reform? *International Tax and Public Finance*, *23*(3), 550-579.

Dom, R. (2017). *Semi-Autonomous Revenue Authorities in Sub-Saharan Africa: Silver Bullet or White Elephant* (No. 2017-01).

Eberhardt, M., and Teal, F. (2017). *The magnitude of the task ahead: productivity analysis with heterogeneous technology*. Working Paper.

Eberhardt, M., & Vollrath, D. (2016). *The Role of Crop Type in Cross-Country Income Differences* (No. 11248). CEPR Discussion Papers.

Eberhardt, M., & Presbitero, A. F. (2015). Public debt and growth: Heterogeneity and non-linearity. *Journal of International Economics*, *97*(1), 45-58.

Eberhardt, M., & Teal, F. (2013). No mangoes in the tundra: spatial heterogeneity in agricultural productivity analysis. *Oxford Bulletin of Economics and Statistics*, *75*(6), 914-939.

Eberhardt, M. (2011, September). Panel time-series modeling: New tools for analyzing xt data. In *2011 UK Stata Users Group meeting*.

Engle, R. F., & Granger, C. W. (1987). Co-integration and error correction: representation, estimation, and testing. *Econometrica: journal of the Econometric Society*, 251-276.

Fossat, P., & Bua, M. (2013). *Tax Administration Reform in the Francophone Countries of Sub-Saharan Africa* (No. 13/173). International Monetary Fund.

Granger, C. W., & Newbold, P. (1974). Spurious regressions in econometrics. *Journal of econometrics*, *2*(2), 111-120.

Gupta, A. S. (2007). *Determinants of Tax Revenue Efforts in Developing Countries* (No. 07/184). International Monetary Fund.

Herzer, D. (2014). *The long-run relationship between trade and population health: evidence from five decades*. Verein für Socialpolitik/German Economic Association.

Herzer, D., & Morrissey, O. (2013). Foreign aid and domestic output in the long run. *Review of World Economics*, *149*(4), 723-748.

Herzer, D., & Grimm, M. (2012). Does foreign aid increase private investment? Evidence from panel cointegration. *Applied Economics*, *44*(20), 2537-2550.

Kapetanios, G., Pesaran, M. H., & Yamagata, T. (2011). Panels with non-stationary multifactor error structures. *Journal of Econometrics*, *160*(2), 326-348.

Keen, M., & Simone, A. (2004). Tax policy in developing countries: some lessons from the 1990s and some challenges ahead. *Helping countries develop: The role of fiscal policy*, 302-52.

Lensink, R., & Morrissey, O. (2000). Aid instability as a measure of uncertainty and the positive impact of aid on growth. *The Journal of Development Studies*, *36*(3), 31-49.

Lloyd, T., McGillivray, M., Morrissey, O., & Opoku-Afari, M. (2009). The fiscal effects of aid in developing countries: A comparative dynamic analysis. *Development Aid: A Fresh Look, Basingstoke: Palgrave Macmillan UNU-WIDER Studies in Development Economics and Policy*, 158-179.

Lütkepohl, H. (2007). General-to-specific or specific-to-general modelling? An opinion on current econometric terminology. *Journal of Econometrics*, *136*(1), 319-324.

Mascagni, G., & Timmis, E. (2017). The Fiscal Effects of Aid in Ethiopia: Evidence from CVAR Applications. *The Journal of Development Studies*, 1-20.

Moore, M. (2014). Revenue reform and statebuilding in Anglophone Africa. *World Development*, *60*, 99-112.

Morrissey, O. (2015). Aid and domestic resource mobilization with a focus on Sub-Saharan Africa. *Oxford Review of Economic Policy*, *31*(3-4), 447-461.

Morrissey, O., and Torrance, S. (2015), 'Aid and Taxation', ch. 31 in B. M. Avin and B. Lew (eds), Handbook on the Economics of Foreign Aid, Cheltenham, Edward Elgar.

Morrissey, O., Prichard, W., & Torrance, S. (2014). *Aid and Taxation: Exploring the Relationship Using New Data* (No. 12790). Institute of Development Studies, International Centre for Tax and Development.

Morrissey, O., & Osei, R. (2004). Capital flows to developing countries: Trends, volatility and policy implications. *IDS Bulletin*, *35*(1), 40-49.

Osei, R., Morrissey, O., & Lloyd, T. (2005). The fiscal effects of aid in Ghana. *Journal of International Development*, *17*(8), 1037-1053.

Pesaran, M. H. (2007). A simple panel unit root test in the presence of cross-section dependence. *Journal of Applied Econometrics*, *22*(2), 265-312.

Pesaran, M. H. (2006). Estimation and inference in large heterogeneous panels with a multifactor error structure. *Econometrica*, *74*(4), 967-1012.

Pesaran, M. H. (2004). *General diagnostic tests for cross section dependence in panels* (No. 1229). CESifo Working Paper.

Pivovarsky, M. A., Clements, M. B. J., Gupta, M. S., & Tiongson, M. E. (2003). *Foreign aid and revenue response: does the composition of aid matter?* (No. 3-176). International Monetary Fund.

Prichard, W., Cobham, A., & Goodall, A. (2014). *The ICTD Government Revenue Dataset* (No. 10250).

Ricciuti, R., Savoia, A., & Sen, K. (2016). How do political institutions affect fiscal capacity? Explaining taxation in developing economies.

Söderbom, M., Teal, F., Eberhardt, M., Quinn, S., & Zeitlin, A. (2014). *Empirical development economics* (Vol. 24). Routledge.

Stock, J. H., & Watson, M. W. (2002). Forecasting using principal components from a large number of predictors. *Journal of the American statistical association*, *97*(460), 1167-1179.

Tagem, A. M. (2017). *Aid, Taxes and Government Spending: A Heterogeneous Cointegrated Panel Analysis* (No. 2017-02). University of Nottingham, CREDIT.

Teera, J. M., & Hudson, J. (2004). Tax performance: a comparative study. *Journal of International Development*, *16*(6), 785-802.

von Haldenwang, C., & Ivanyna, M. (2017). *Does the political resource curse affect public finance? The vulnerability of tax revenue in resource-rich countries* (No. 2017/7). WIDER Working Paper.

Appendix

Appendix Table A1: Cross-Section Dependence

Panel A	Variables in Levels				
	Tax_{it}	Aid_{it}	$Grants_{it}$	$Loans_{it}$	TC_{it}
avg $\hat{\rho}_{ij}$	0.121	0.133	0.139	0.268	0.522
avg $\lvert\hat{\rho}_{ij}\rvert$	0.401	0.335	0.354	0.359	0.602
CD	37.71	40.35	43.83	82.15	160.69
p-value	0.000	0.000	0.000	0.000	0.000
Panel B	Variables in First Differences				
	ΔTax_{it}	ΔAid_{it}	$\Delta Grants_{it}$	$\Delta Loans_{it}$	ΔTC_{it}
avg $\hat{\rho}_{ij}$	0.003	0.042	0.036	0.016	0.152
avg $\lvert\hat{\rho}_{ij}\rvert$	0.181	0.178	0.193	0.183	0.223
CD	0.88	13.02	10.95	4.61	45.36
p-value	0.381	0.000	0.000	0.000	0.000

Notes: *We use the stata routine 'xtcd' developed by Markus Eberhardt. We report the average correlation (avg $\hat{\rho}_{ij}$) and average absolute correlation (avg $|\hat{\rho}_{ij}|$) coefficients of the $N(N-1)$ sets of correlations. CD is the Pesaran (2004) test for cross-section dependence distributed $N(0,1)$ under the null of cross-section independence. Panels A and B test for cross-section dependence in the variable series for levels and first differences respectively. Tax revenue (Tax), Net ODA (Aid), Grants, Loans and Technical Assistance (TC); all as percentages of GDP.*

Appendix Table A2: Pesaran (2007) Unit Root Test

Levels: CIPS with intercept only										
Variable	Tax		Aid		Grants		Loans		TC	
Lags	Z*t*bar	*p*	Z*t*bar	*p*	Z*t*bar	*p*	Z*t*bar	*p*	Z*t*bar	*p*
0	-4.80	0.00	-8.32	0.00	-11.35	0.00	-12.55	0.00	-4.10	0.00
1	-3.30	0.00	-3.88	0.00	-6.13	0.00	-6.52	0.00	-0.41	0.34
2	-0.90	0.18	-0.74	0.23	-2.71	0.00	-5.34	0.00	-0.08	0.47
3	-0.86	0.20	-0.94	0.17	-1.79	0.04	-4.17	0.00	-0.32	0.38
4	-1.03	0.15	2.00	0.98	2.55	1.00	-2.03	0.02	1.65	0.95
Levels: CIPS with intercept & trend										
Variable	Tax		Aid		Grants		Loans		TC	
Lags	Z*t*bar	*p*	Z*t*bar	*p*	Z*t*bar	*p*	Z*t*bar	*p*	Z*t*bar	*p*
0	-6.46	0.00	-8.22	0.00	-10.73	0.00	-11.81	0.00	-6.18	0.00
1	-4.79	0.00	-3.70	0.00	-4.72	0.00	-3.56	0.00	-1.66	0.05
2	-1.51	0.07	-0.47	0.32	-1.24	0.11	-1.28	0.10	0.10	0.54
3	0.16	0.56	0.59	0.72	-0.64	0.26	0.40	0.65	0.75	0.77
4	2.19	0.99	4.88	1.00	4.68	1.00	2.10	0.98	3.18	1.00
Differences: CIPS test with drift										
Variable	Tax		Aid		Grants		Loans		TC	
Lags	Z*t*bar	*p*	Z*t*bar	*p*	Z*t*bar	*p*	Z*t*bar	*p*	Z*t*bar	*p*
0	-34.41	0.00	-37.85	0.00	-40.27	0.00	-39.82	0.00	-39.44	0.00
1	-23.15	0.00	-25.74	0.00	-28.69	0.00	-25.70	0.00	-23.61	0.00
2	-14.45	0.00	-15.57	0.00	-17.11	0.00	-15.08	0.00	-13.54	0.00
3	-8.59	0.00	-11.86	0.00	-14.33	0.00	-10.16	0.00	-11.29	0.00
4	-3.90	0.00	-7.23	0.00	-10.61	0.00	-7.05	0.00	-4.65	0.00

Notes: *Net ODA (Aid), technical cooperation (TC), tax revenue (Rev) and government expenditure (Exp) all in logs. 'Lags' denote the number of lags of the differenced dependent variable included to wipe out serial correlation. Tax revenue (Tax), Net ODA (Aid), Grants, Loans and Technical Assistance (TC); all as percentages of GDP.*

Appendix Table A3: Cross-Section Dependence

Panel A	Variables in Levels	
	Tax_{it}	Aid_{it}
avg $\hat{\rho}_{ij}$	0.077	0.247
avg $\lvert\hat{\rho}_{ij}\rvert$	0.405	0.418
CD	12.29	40.29
p-value	0.000	0.000

Panel B	Variables in First Differences	
	ΔTax_{it}	ΔAid_{it}
avg $\hat{\rho}_{ij}$	0.003	0.055
avg $\lvert\hat{\rho}_{ij}\rvert$	0.178	0.179
CD	0.27	9.22
p-value	0.784	0.000

Notes: *We use the stata routine 'xtcd' developed by Markus Eberhardt. We report the average correlation (avg $\hat{\rho}_{ij}$) and average absolute correlation (avg $\lvert\hat{\rho}_{ij}\rvert$) coefficients of the $N(N-1)$ sets of correlations. CD is the Pesaran (2004) test for cross-section dependence distributed $N(0,1)$ under the null of cross-section independence. Panels A and B test for cross-section dependence in the variable series for levels and first differences respectively. Tax revenue (Tax), Net ODA (Aid): all as percentages of GDP.*

Appendix Table A4: Pesaran (2007) Unit Root Test

	Levels: CIPS with intercept only			
Variable	Tax_{it}		Aid_{it}	
Lags	Z*t*bar	*p*	Z*t*bar	*p*
0	-4.58	0.00	-3.89	0.00
1	-3.22	0.00	-1.19	0.12
2	-0.97	0.17	1.03	0.85
3	1.30	0.90	-0.10	0.46
4	2.47	0.99	1.96	0.98
	Levels: CIPS with intercept & trend			
Variable	Tax_{it}		Aid_{it}	
Lags	Z*t*bar	*p*	Z*t*bar	*p*
0	-5.27	0.00	-4.561	0.00
1	-3.97	0.00	-1.84	0.03
2	-2.29	0.01	1.22	0.89
3	1.00	0.84	-0.03	0.49
4	2.46	0.99	1.19	0.88
	Differences: CIPS test with drift			
Variable	ΔTax_{it}		ΔAid_{it}	
Lags	Z*t*bar	*p*	Z*t*bar	*p*
0	-24.63	0.00	-26.48	0.00
1	-15.76	0.00	-16.29	0.00
2	-10.75	0.00	-7.89	0.00
3	-4.99	0.00	-5.95	0.00
4	-2.91	0.00	-4.14	0.00

Notes: *Lags' denote the number of lags of the differenced dependent variable included to wipe out serial correlation. Tax revenue (Tax), Net ODA (Aid): all as percentages of GDP. The COT (2016) dataset does not gather data on grants, loans and technical assistance.*