ELSEVIER
www.elsevier.com/locate/worlddev

World Development Vol. 40, No. 5, pp. 1054–1067, 2012

0305-750X/$ - see front matter

doi:10.1016/j.worlddev.2011.12.001

Do External Grants to District Governments Discourage Own Revenue Generation? A Look at Local Public Finance Dynamics in Ghana

TEWODAJ MOGUES
International Food Policy Research Institute, Washington, USA

and

SAMUEL BENIN *
International Food Policy Research Institute, Davis, USA

Summary. — Using rich panel data on all of Ghana's districts' local public finances over 11 years, this paper investigates the way that intergovernmental and other transfers to local governments affect local governments' incentives to collect internally generated revenues and funds (IGF). We find that despite an incentive scheme built into one of the major intergovernmental grants, the flow of all grants taken together discourages, rather than encourages, IGF. This is reflected both in the depressing effect of transfers on IGF levels, as well as on IGF growth.

Key words — decentralization, local public finance, internally generated revenues, intergovernmental transfers, Africa, Ghana

1. INTRODUCTION

Since the late 1980s, many developing countries have started the process of devolving political, administrative, and fiscal responsibilities from central to provincial and local jurisdictions. The motivations of countries for undergoing such a governance change are varied and include a range of political as well as social and economic factors. Even where political factors have been the main drivers in implementing decentralization, strong financial backing from the donor community has usually been founded on economic arguments, many of which have been laid down in the canonical literature on decentralization. Subnational governments may have better information (or can obtain information more cheaply) about the local needs for and requirements of public services, and thus a decentralized system would generate greater allocative efficiency in public service provision (Hayek, 1945). Improved public service provision would also emerge in a politically and fiscally decentralized system through greater political competition at the local level, leading to more accountable local governments (Crook & Manor, 1998), and through greater jurisdictional competition arising from citizens choosing their location on the basis of the quality of services (Tiebout, 1956).[1]

These and other arguments for decentralization rest strongly on the assumption that the fiscal aspect of decentralization in fact results in local governments gaining substantial discretion in allocating public resources to competing economic uses in their jurisdictions. This assumption is germane to the realization of the benefits from decentralization mentioned above, since achieving these benefits are predicated on the notion of local governments as capable decisionmakers, able to act upon information and upon the pressures of political and jurisdictional competition. In practice, in many developing countries—as in the case of Ghana, which this paper focuses on—local fiscal discretion is highly restricted in the sense that local authorities may have relatively little control even over their own budgets. In Ghana, a substantial share of local authorities' revenues is made up of transfers from upper tiers of government or from donors, and these funds tend to be tied to particular activities, projects, or sectors.[2] Revenues that local governments generate themselves, through the tax and fee bases assigned to them, can, in contrast, be used in a completely flexible manner. In this sense, local governments' fiscal autonomy is intimately tied to their ability to generate own resources.

Therefore, an important part of the policy debate around decentralization concerns the question of how local governments can expand their fiscal autonomy by increasing their internally generated revenues and funds (IGF) and realize the hypothesized efficiency gains in the local provision of public services. In Ghana, there are a range of potential constraints affecting the ability of district assemblies—the term for Ghana's district-level governing bodies—to expand their

* The authors are grateful for financial support from the Ghana Strategy Support Programme (GSSP) of IFPRI. We thank Godsway Cudjoe for his research assistance and contribution to an early version of this work. Helpful comments were received from five referees, and also remarks on an earlier working paper version from an anonymous reviewer, the late Leah Horowitz, and Nethra Palaniswamy. Thanks also goes to comments provided by participants at the University of Oxford's Centre for the Study of African Economies (CSAE) conference, participants at a local government workshop at IFPRI, discussant Ian Coxhead and participants at the Allied Social Science Association (ASSA) meetings in Denver, CO, and discussant Guy Grossman and participants at the Midwest International Economic Development Conference at the University of Wisconsin-Madison—all conferences at which this work was presented. Final revision accepted: September 16, 2011.

IGF. These include the scope of local governments' revenue assignments, revenue collection capacity, discretion in setting rates on their tax and fee bases, and enforcement of honest revenue-collection practices. This paper focuses on a specific potential driver of IGF, by investigating what impact the flow and size of external grants (i.e., central government and donor funds) have had on the incentives of local governments to generate their own revenues. While this question has received research attention in the developed country context, there is hardly any literature in developing regions that empirically examines the effect of intergovernmental and other external fiscal transfers on local governments' internal revenue effort.

With grants comprising the bulk of local governments' total revenues, the incentive effect that grants have on local governments' own revenues is a critical policy concern in Ghana. The recent Decentralization Policy Review, conducted jointly by the government and donors in Ghana to inform the development of a new decentralization policy by the cabinet, states that

> although the DACF [District Assemblies Common Fund] formulae contains [sic] a small incentive to improve on IGF (very small criteria weight for the so-called "responsiveness" factor), this is not perceived sufficient to promote improvements in the MMDA [Metropolitan, Municipal, and District Assembly] revenue mobilization. As indicated in a report from 2000, the incentives to collect revenues may be impacted negatively by the increase in grants. Further studies of this and of the real MMDA revenue potential within the existing legal framework is urgently required. (GoG (Government of Ghana), 2007, p. 52).

This paper sets out to investigate this very question: How does the flow of intergovernmental grants to local governments affect their incentives to raise their own revenues? In the next section, we present our framework and a review of the empirical literature on how external grants, as well as other factors, may affect local revenues. [3] This is followed in Section 3 by an outline of the policy and empirical context for this study, a discussion of district governments' revenue structure and degree of fiscal autonomy, and the criteria used in determining how one major grant facility is allocated across districts, particularly the own revenue incentivization criterion. Section 4 describes the empirical model for determining the effect that intergovernmental and external transfers have on districts' incentives for generating own revenues. In so doing, we describe the potential confounding factors which may introduce bias in the estimation of this effect, and outline an estimation and instrumentation strategy to address these factors. The results are discussed in Section 5, and the final section offers concluding thoughts.

2. DETERMINANTS OF LOCAL GOVERNMENT REVENUE GENERATION

The interest in the question of how local tax-generation efforts and revenues respond to intergovernmental transfers is variably motivated by policy concerns with regard to how local government fiscal behavior contributes to evolving decentralization, by the question of the efficiency of local tax rates, by that of the benefit incidence of local taxes, or by other factors. [4] Nearly all quantitative empirical research on this topic, however, involves developed economies, likely due in large part to the scarcity of data on local public finances of developing countries. This paper contributes useful empirical findings particularly in light of this lacuna of research in the developing country context.

A frequently used conceptual foundation for the pathway through which external grants affect local revenues is the median-voter model. Applied in this context, the hypothesis is, simply put, that grants from upper-tier governments crowd out revenues from local taxes. Assuming an initial optimal balance between local public consumption and private consumption, additional intergovernmental grants would be passed on by local governments to local residents as reductions in local taxes and fees, other factors remaining unchanged (Bradford & Oates, 1971). Wildasin (1984) theoretically sketches out in a general equilibrium framework the pathway of impact that different types of intergovernmental transfers (matching grants versus lump-sum grants) have on welfare, via their effect on local taxes, finding that matching grants are superior to lump-sum grants when transfers can be optimally tailored to each local government.

Other studies theoretically examine the efficiency and equity effects of intergovernmental transfers that are designed for particular policy purposes. For example, Bucovetsky and Smart (2006) and Smart (1998) examine the effect of transfers specifically designed to increase equity in revenues across local jurisdictions, and draw different conclusions based on their different assumptions about the mobility of tax bases: when tax bases are immobile, equalization grants can induce excessive local tax rates and thus increase the dead-weight loss from distortionary taxation; this effect is mitigated when tax bases are mobile. The literature on the relevance of taxation for political accountability (recent studies on developing countries include Moore, 2008 and Ross, 2004) may suggest yet another type of welfare effect of intergovernmental transfers, through their impact on local tax effort. The potential fiscal effort disincentives of higher tier grants may be detrimental in light of the argument that local governments are, all else equal, more likely to spend efficiently resources they have to raise themselves from the populace than resources they do not (Bird & Smart, 2002).

Several studies have empirically tested the effect that higher-tier grants have on locally raised revenues. Zhuravskaya (2000) establishes a crowding-out effect in a transitional country (Russia), where each monetary unit raised in own revenues by a local government is offset by a reduction by 0.9 units in revenue sources from the higher-tier government, which strongly implies that local governments will have nearly no incentive to exert any tax-generating effort when transfers increase. Similar findings of reductions of locally raised revenue being greater than the grants that induce them emerge in one of the few studies of a developing country context, Rajaraman and Vasishtha (2000) in their analysis of data from Kerala, India. Buettner and Wildasin (2006) take an integrated approach in which all interrelationships between various local public finance variables—general expenditure, debt service expenditure, intergovernmental grants, and own revenues—are assessed, with minimal imposition of structure on the empirical model. They find that the adjustment of local governments to an increase in external grants results in reduced subsequent own revenue generation—a finding broadly consistent with the above hypothesis. In a similarly empirically oriented study, Dahlberg, Mörk, Rattsø, and Ågren (2007), who focus on econometrically addressing the potential endogeneity of grants, do not find a crowding-out effect of intergovernmental transfers on local tax rates, nor on local tax revenues. Only a few studies empirically refute the above hypothesis and identify a positive (crowding-in) effect of higher-tier government aid to local governments on locally generated revenues (an example is Skidmore, 1999).

Local revenues can also be affected by several factors other than intergovernmental grants. These include other fiscal variables, such as tax limitation measures imposed by