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Paper Summary

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

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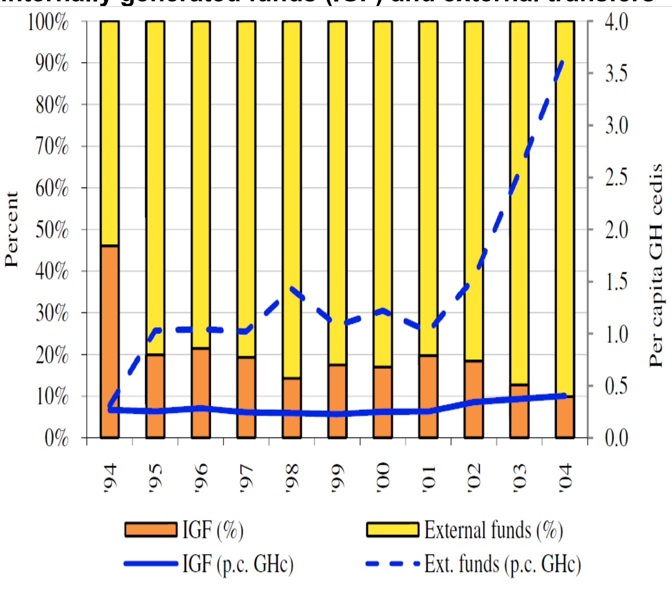
A major argument for decentralization holds that subnational governments are better placed to allocate public resources more efficiently and effectively, because they have better information about the needs for and requirements of public services in their jurisdictions. This argument rests on the assumption that local governments have a substantial degree of fiscal autonomy, and are able to use discretion in allocating their resources. The fiscal responsibilities of district governments in Ghana, however, remain quite circumscribed, because their budgets are largely dominated by external (i.e. central government or donor) transfers. The share of Internally Generated Funds (IGF), that is, the funds that the districts themselves are able to raise from local fees and taxes, has declined in recent years, both because the IGF has been nearly stagnant, and because the funds received from the central government and donors has increased rapidly (Figure 1). Intergovernmental and donor transfers to district governments are usually tied to specific investments and rules for allocation that may or may not match the priorities of local governments. Therefore, local governments' fiscal autonomy is intimately tied to their IGF.

Figure 1. Component of districts' revenue: internally generated funds (IGF) and external transfers



The policy debate about fiscal autonomy

An important aspect of the current policy debate around decentralization in Ghana concerns the question of how local governments can increase their internally generated funds so that they can expand their fiscal autonomy and, thus, better realize the potential of decentralization to achieve more equity and efficiency in the local provision of public services. In Ghana, there are a range of potential constraints affecting the ability of the local governments, that is the district assemblies, to expand their IGF. These include incentives such as a component in the formula for intergovernmental transfers which increases transfers when local revenues are higher. Also, the scope of district assemblies' revenue assignments may be narrow. IGF can further be delimited by districts' revenue collection capacity, and possible limitations on their discretion in setting rates on their tax and fee bases. Finally, challenges with enforcement of honest revenue-collection practices would also affect the size of districts' IGF.

Objectives and approach of the study

One strategy research brief presents the findings of a study that focused on one of the major potential constraints to expanding IGF: the role that external transfers play in influencing the level of IGF. The study investigated what impact the flow and the size of grants (i.e., central government and donor funds) have had on the incentives of district assemblies to generate own revenues, thus aiming to answer the question whether increasing external transfers “crowd out” IGF by reducing the incentives of the district assemblies to collect their own revenues.

With grants comprising the bulk of district assemblies’ total revenues (Figure 1), the incentive effect that grants have on district assemblies’ own revenues is indeed 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 mobilisation. 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 (Ghana 2007).

This study corresponds to this policy concern by analyzing the impact of the flow and size of externally generated revenues (from central government and donors) on the district assemblies’ own-generated revenues, or IGF. The study used 1994–2004 panel data on 110 district assemblies’ public finances (revenues from different sources and different types of public expenditures) and other district-level data. The study used different regression techniques to test the relationship between external transfers and IGFs. All calculations were performed both for the data of single years, and for three-year averages. The Hausman-Taylor estimation gives the primary results. Since fixed-effects estimation results do not identify time-fixed variables, the variables used in this model that are treated as time-invariant are not estimated in regressions [7] and [8]. The results are estimated (in the case of random effects and ordinary least squares) both with and without the control variables, to examine the robustness of the core results to the exclusion of these controls.

Main findings from the study

The study found that greater external transfers in the previous year are significantly and negatively associated with district assemblies’ levels of IGF (Table 1). This indicates that district governments with higher externally generated revenues tend to have significantly lower levels of internally generated revenues. Moreover, they also experience a slower subsequent *growth* in IGF. The negative sign in the relationship between external transfers and the growth if IGF is consistently present across different estimation methods and model specifications. However, the effect of external transfers on the growth of IGF is statistically not as strong as the effect that external transfers have on the level of IGFs.

Therefore, district assemblies’ external sources of revenue appear to discourage rather than encourage their internal revenue generation. The analysis suggests that this result is strongly driven by the model of intergovernmental transfer patterns, especially in the latter years (from 2001 onward) of the time period under study.

The results also show that larger public expenditures of district assemblies are significantly associated with more local revenue generation in subsequent years, but this effect differs strongly between different types of district government expenditure type. Past spending on capital expenditures has a very low effect on IGF. The effect is substantially larger for personnel spending, and is by far the largest for nonpersonnel recurrent spending. This strong differentiation between spending categories is consistent with the way that revenue sources are linked to expenditure types: District assemblies undertake capital investments primarily using external transfers, while internally generated revenues are mostly used for maintenance, operational, and, to a lesser extent, personnel expenditures. Thus, higher expenditures in these categories are more likely to invoke greater local revenue mobilization in subsequent years than are increases in capital expenditures.

Table 1. External transfers and level of internally generated funds

Dependent variable:	Single-year	3-year average	Single-year		3-year average	
	Hausman-Taylor		Random effects			
	[1]	[2]	[3]	[4]	[5]	[6]
External transfers in previous year (ipy)	-0.025*	-0.011	-0.026**	-0.029**	-0.012	-0.014
Personnel expenditure ipy	0.112***	0.032**	0.114***	0.127***	0.033**	0.039**
Recurrent expenditure ipy	0.473***	0.479***	0.476***	0.518***	0.480***	0.510***
Capital expenditure ipy	0.029**	0.034***	0.031**	0.025*	0.035***	0.030***
Control variables	Yes	Yes	Yes	No	Yes	No
Region dummy variables	Yes	Yes	Yes	Yes	Yes	Yes
	Fixed effects		Pooled ordinary least squares			
	[7]	[8]	[9]	[10]	[11]	[12]
External transfers in previous year (ipy)	-0.024*	-0.011	-0.027**	-0.035***	-0.015	-0.026**
Recurrent expenditure ipy	0.119***	0.034**	0.108***	0.131***	0.0308*	0.05***
External transfers in previous year (ipy)	0.413***	0.4478***	0.534***	0.618***	0.561***	0.658***
Recurrent expenditure ipy	0.027**	0.033***	0.0349***	0.0224*	0.0411***	0.019
Control variables	No	No	Yes	No	Yes	No
Region dummy variables	No	No	Yes	Yes	Yes	Yes
Number of observations	1,028	951	1,028	1,028	951	951

Notes: Levels of statistical significance: *** 1%, ** 5%, * 10%; all local public finance variables are measured as the natural log of real per capita GHC (10,000s).

Policy implications

Decentralization is based on the premise that local governments are better placed to allocate public resources more efficiently and effectively than the central government. This study indicates that district assemblies in Ghana lack sufficient fiscal autonomy to realize this potential. This may reduce the effectiveness of public expenditures for promoting growth and achieving equitable development outcomes. The following strategies may be considered to address this challenge: One way of increasing the fiscal autonomy of district assemblies is increasing the discretionary component of the external transfers that they receive. However, this strategy has to be handled with care, since the the accountability of local governments to their constituents may be lower for external grants than it is for internal revenues. Provisions that limit the discretion in spending external grants, for example, by specifying targeting rules, can serve as a strategy to avoid problems--such as politically motivated targeting--that may be associated with limited accountability.

Involving district assemblies in all stages of program and project design, implementation, and monitoring and evaluation will help match the priorities of external funders with local priorities.

There is a relative absence of accountability associated with grants compared to IGF. Thus, making district assemblies accountable to their jurisdictions for all sources of revenue will be important, as decentralization is fundamentally about making governance at the local level more responsive to the needs of the large majority of the population.

This could be achieved through the implementation of the District Development Facility, an approach which has also been discussed in the Decentralisation Review in 2007 but has not yet been implemented. There are other promising approaches, such as the institution of matching grants provided by donors and matched to IGF.

The Ghana Strategy Support Program (GSSP) is a research, communication, and capacity-strengthening program to build the capabilities of researchers, administrators, policymakers, and members of civil society in Ghana to develop and implement agricultural and rural development strategies. With core funding from the U.S. Agency for International Development (USAID)/Ghana and a mandate to develop a multi-donor-funded program, IFPRI launched GSSP as a partnership between Ghana and its development partners. Any opinions stated in this note are those of the author(s) and do not necessarily reflect the policies or opinions of IFPRI.

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