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The impact of intergovernmental transfers on local revenue generation in Sub-Saharan Africa: Evidence from Tanzania

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A B S T R A C T

Do intergovernmental transfers reduce revenues collected by local government authorities (LGAs)? There is already a well-established body of literature in public finance, which argues that intergovernmental grants "crowd out" local revenues. Most existing studies, however, explore the fiscal implications of intergovernmental transfers in high-income countries where sound fiscal systems are taken for granted. In this paper, I explore the impact of intergovernmental transfers on local revenues in sub-Saharan Africa, a region where local fiscal capacity is limited and endogenously determined by financial support from international donors and the central government. I argue that in places where the existing capacity of LGAs to administer tax collection is weak and political costs of enforcing taxation are low—which are perennial features of many rural districts in Africa—intergovernmental transfers *facilitate* local revenue generation instead of undermining it. Analyzing newly available quarterly fiscal data on local revenues in Tanzania, I show that intergovernmental grants improve the mobilization of local revenues, and also that the positive effect of fiscal transfers on local revenue collection seems to be more pronounced in rural districts.

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1. Introduction

> *The power to tax lies at the heart of state development. A moment's reflection on the history of today's developed countries and the current situation of today's developing nations suggests that the acquisition of that power cannot be taken for granted.*
>
> [Besley and Persson, 2013, p. 51]

Since the early 1990s, many African countries have experimented with decentralization, or the devolution of fiscal and administrative duties to local government authorities (LGAs) (Dafflon & Madies, 2013). As part of this decentralization process, LGAs have increasingly assumed the role of raising own revenues to finance their budgets and providing basic public services to their citizens. Most subnational governments in Africa, however, lack institutional capacity to collect local taxes and instead rely heavily on grants from the central government to keep themselves afloat (Shah, 2006). Critics argue that while financial transfers from the central government help finance the provision of public service delivery, they can also obviate the need for local revenue generation, which in turn undermines the fiscal autonomy of subnational governments. There is a well-established body of literature in public finance suggesting that intergovernmental transfers crowd out local revenues, whereby the inflow of external transfers can sap the incentive for LGAs to collect their own dues (Buettner & Wildasin, 2006; Bradford & Oates, 1971a, 1971b; Zhuravskaya, 2000).

Empirical evidence for the hypothesized negative linkage between intergovernmental grants and local revenues mainly derives from studies in countries *where sound fiscal institutions are already in place*. In most African countries, the administrative and institutional capacity of local governments to collect taxes and provide public goods is very limited, particularly in rural areas where geographical vastness, poverty, and low population density all make it extremely difficult for LGAs to collect taxes (Fjeldstad et al., 2014). The generation of local revenues requires robust monitoring and enforcement systems and qualified staff, who are costly to employ and maintain (Besley & Persson, 2013). Furthermore, fiscal policy is highly centralized and politicized such that political interference with local revenue collection is prevalent in the African context (Fjeldstad, 2001; Kasara, 2007; Lambright, 2014; PMORALG, 2013).

A central argument of this paper is that when the existing fiscal capacity of local governments is weak and the political costs of enforcing revenue collection are low—which are perennial features

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of rural districts in Africa—intergovernmental transfers *facilitate* local revenue generation. I posit that not only can fiscal transfers help rural LGAs to finance revenue collection efforts and broaden the tax base, they can also facilitate the provision of public goods, which in turn improves voluntary tax compliance. In urban areas, on the other hand, the marginal positive effect of central government grants on local revenue generation is lower due to the existence of (relatively) robust fiscal institutions and higher political costs associated with increasing a tax burden on urban taxpayers who already feel overly taxed compared to rural residents (Resnick, 2012).

Tanzania is an ideal country to study the link between intergovernmental grants and local revenues in the African context for a number of reasons. First, intergovernmental transfers make up a large proportion of local government budgets in Tanzania like many other countries in the region. In FY2012/2013, for instance, 91% of the local budget was financed through transfers from the central government. This number lies on a par with corresponding numbers from other African countries, such as Lesotho (90%), Uganda (88%), and Ghana (69%), which makes Tanzania more or less a representative case in the region (Fjeldstad & Heggstad, 2012, p. 5). Furthermore, as reported by the International Monetary Fund (IMF), "Tanzania is now considered to have one of the best PFM [public financial management] systems in sub-Saharan Africa" (Nord et al., 2009, p. 5). Most district councils in Tanzania now have computerized budget and accounting systems, and the Prime Minister's Office Regional Administration and Local Government (PMORALG) has published quarterly fiscal data on district-level expenditure and revenues online, which allows researchers to empirically test the linkage between intergovernmental transfers and local revenues.

One of the issues that complicates the identification of causal impact of intergovernmental transfers on local revenues is that the amount of central government grants that a given district receives is likely to be endogenous to the district's fiscal capacity. To alleviate this concern, I employ the instrumental variable (IV) estimation, utilizing exogenous variation in precipitation as instruments for intergovernmental transfers. Precipitation serves as a valid instrument for intergovernmental transfers because the allocation of transfers is determined partly based on agricultural productivity, which is exogenously determined by precipitation. Although rainfall is likely to directly affect local revenues by changing the amount of agricultural taxes being collected at the local level, it should have no such direct effect once those agricultural revenues are excluded from my analysis. PMORALG's new fiscal data—which are highly granular and can be disaggregated by type of revenues—allow me to actually remove agricultural taxes from total revenues, which can then be used as the dependent variable in my IV estimation.

My empirical analysis shows strong evidence that intergovernmental transfers help expand local revenues, and that this positive effect of transfers on local revenues is more pronounced in rural areas. These findings are important on their own right and have broader implications for state building and fiscal capacity in Africa. State-building entails efforts on the part of the state to generate its own revenues from its citizens. Governmental accountability derives from a social contract between the state and taxpayers, whereby the former is held accountable by the latter for its performance.[1] The same story can be told for local governments, which have become the key provider of public services in Africa. The conventional wisdom in public finance suggests that reliance on external grants may undermine the fiscal autonomy of local governments. This study shows that the relationship between transfers and local revenues defies this prediction in the context where the existing fiscal capacity is low or almost non-existent, like in many rural areas in Africa.

This paper is organized in the following manner. In the next section (Section 2), I review the existing literature on the fiscal implications of intergovernmental transfers. In particular, I highlight how the existing models in public finance fail to capture the issues of fiscal capacity, an essential asset that local governments need to mobilize local revenues. Section 3 describes the data used in my empirical evaluation of the causal link between transfers and local revenue generation in Tanzania. Section 4 presents the main findings of my econometric analysis. Section 5 concludes by discussing the policy implications of this study's core findings.

2. Theory

2.1. Intergovernmental transfers and local revenue generation

For the past two decades, African governments and international donors alike have encouraged decentralization as a means to promote development.[2] Many of the key responsibilities previously vested in the central government have been discharged to local governments, which now play the leading role in public service delivery. These decentralization efforts have been motivated partly by the idea that LGAs are more responsive to local needs than the central government because they stay in close touch with their own constituencies, although empirical support for this line of logic has been mixed at best (e.g., Brollo, Nannicini, Perotti, & Tabellini, 2013; Olken, 2007; Reinikka & Svensson, 2005; Crook, 2003; Tendler, 1997).

Critics argue that intergovernmental transfers erode local fiscal autonomy because they can serve as substitutes for local tax revenues (e.g., Bradford & Oates, 1971a, 1971b; Buettner & Wildasin, 2006; Mogues & Benin, 2012; Zhuravskaya, 2000). Bradford and Oates (1971a, 1971b) offer a formal theory of how grants may affect fiscal performance at the local level. Under the assumption that public and private incomes are fungible, they claim that unconditional intergovernmental grants free up extra resources for local governments to benefit individual citizens in the form of a lump-sum tax reduction, thus crowding out efforts to mobilize local revenues.

Empirical evidence for the crowding-out effects of central government grants has been far from conclusive. Analyzing fiscal data of individual municipalities across the U.S. for the period between 1972 and 1997, Buettner and Wildasin (2006) find that increases in central government grants do indeed lead to reductions in locally raised revenues. Zhuravskaya (2000, p. 338) finds a similar pattern in Russia, showing that "any change in a local government's own revenues is almost entirely offset by an opposite change in shared revenues," indicating that intergovernmental transfers serve as almost perfect substitutes for local revenues. In contrast, a number of other studies demonstrate that intergovernmental transfers tend to be used for public spending instead of tax reliefs—a phenomenon known as "flypaper effects" (see Rosen, 2005; Hines & Thaler, 1995). For instance, Dahlberg, Mork, Rattso, and Agren (2008) study fiscal data in Sweden and find that transfers from the central government do not reduce local tax revenues, but instead increase local spending. Furthermore, recent studies (e.g., Brun & Khdari, 2016; Caldeira & Rota-Graziosi, 2014; Zhang, 2013; Skidmore, 1999) find "crowding-in" effects of intergovernmental transfers, whereby grants *expand* local tax revenues. In

[1] See, for instance, Tripp (2013); Atunbas and Thornton (2012), Gadenne (2012), Fjeldstad et al. (2010), Lund (2007), Iversen, Fjeldstad, Bahiigwa, Ellis, and James (2006), Moss and van de Walle (2006), and Hoffman and Gibson (2005).

[2] The World Bank, for instance, has embraced decentralization as a key element of its developmental strategy since the late 1990s and funded projects that promote various aspects of the decentralization process (IEG, 2008).

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