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Intergovernmental Fiscal Transfers and Decentralization Initiatives in Sub-Saharan Africa: A Case Study of SNGs in Kenya

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Abstract

Intergovernmental fiscal transfer is a pillar of fiscal decentralization initiatives in developing and transition economies. These transfers serve several functions that include: correcting the vertical and the horizontal fiscal balances, compensating or offsetting for the spill-overs or externalities between different jurisdictions, funding national priorities and administrative priorities and capacities of the national. However, SNGs in developing countries particularly in Sub-saharan Africa is struggling with fiscal decentralization initiatives due to the lowered potential of local revenue generation. Due to these gaps in studies on Intergovernmental Fiscal Transfers (IGFT) in devolved government structures, the study evaluated how IGFT is organized and structured in Kenya. The study adopted a descriptive design and undertook a review of publicly available data which was supported by interviews of selected directors from the budget, finance and planning departments in three county governments of Baringo, Kiambu and Vihiga. The study established that intergovernmental fiscal transfers make up 87 per cent of SNG revenues, equalization fund is about 2 per cent while own source revenues make up 10 per cent. Other revenue sources are conditional transfers in form of ad hoc and cost-reimbursement approaches from both the national government and development partners. Regarding intergovernmental fiscal transfers, the national government should disburse funds in a timely and efficient manner to enable county governments to fulfil their mandates. The study makes the following conclusions; there is an overreliance on intergovernmental fiscal transfers by SNGs and this might constrain their capacity to provide services and impede devolution initiatives; the formula-based unconditional grant in Kenya offers great prospects for devolution and the rise in unconditional transfers portends well for SNGs. The study recommends that SNGs speed up the legal mechanism for identifying and classifying and assigning local revenues, the national government should consider introducing or substituting fiscal transfers with the tax-sharing arrangement to incentivize revenue diversification among SNGs and lastly, SNGs should consider pooling of resources to incorporate special purpose vehicles for sub-national government borrowing. The study contributes to the existing knowledge by delving more into the elements of fiscal decentralization and in particular intergovernmental fiscal transfers. Recommendations for further studies include studies on how other elements of decentralization impact the performance of the counties, how decentralization is improving governance at the local level and how the East African Community may affect governance and service delivery at the sub-national levels.

Keywords: County Governments, Decentralization, Local Governments, Local Revenue Decisions, Subnational Government (SNGs)

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1. Introduction

Intergovernmental fiscal transfers are part of the comprehensive fiscal decentralization efforts in many developing and transitioning economies where they form the cornerstone of subnational government financing (Smoke, 2017, Bahl *et al.,* 2001). In most instances, the transfers fund the long-term development investments for the subnational governments in less-developed countries (Smoke, 2019) and are therefore crucial for the successful implementation of fiscal decentralisation in these countries (Durham & Verwey, 2012). Many SNGs in the developing and transition economies have fewer and appropriate revenue bases (Bahl *et al.,* 2001).

Fiscal transfers arise because of the development stages of the nation. At the development stage, the primary public sector responsibilities supporting fiscal centralization include infrastructure development, the provision of basic necessities, and the promotion of economic stability. But as the economy expands, coupled with urbanization, the public sector priorities shift towards the provision of local services such as social services, water supply among others, and this results in the inability of the local government to provide adequate levels of local public services. The gap must be filled in one of two ways, by either allowing more revenue-raising powers to the SNGs or by encouraging fiscal transfers from the central government to the sub-national governments (Bahl *et al.,* 2001).

The need for intergovernmental fiscal transfers is dictated by the amount of SNG's revenues. According to Smoke (2019), SNGs in low-income countries generate about 7.5% of public revenue, 20.3% in lower-middle-income countries, 25.1% in upper-middle-income countries and 29.7% in high-income counties. In many cases, SNGs in developing and transition economies have limited taxing autonomy (Mikayilov, 2007) but have a range of varying needs and capacities that would require differing financing policies and mechanisms (Smoke, 2019). Therefore, intergovernmental fiscal transfers take several forms that include shared taxes, grants, subsidies and subventions (Mikayilov, 2007; Veiga & Veiga, 2013). Intergovernmental fiscal transfers are used to achieve various objectives of central and local governments, such as filling the fiscal gap between national and SNGs, regional fiscal capacity and equalization from the viewpoint of the principle of horizontal equity (Miyazaki, 2016; Durham & Verwey, 2012).

The intergovernmental fiscal relations varies according to the number and structure of the SNGs. Some are fairly autonomous while others are hierarchical with many variations across countries in terms of the constitutional and/or legal foundations of the system, the nature and strength of empowerment and intergovernmental relations, and other factors (Smoke, 2017). For instance, fiscal transfers are an important source of finance for SNGs in Spain, Belgium, Austria, and Australia, and least important in Canada and Germany, while SNGs in the United States and Switzerland lie in between (Bird & Tarasov, 2004). In developed economies like the US, the intergovernmental fiscal transfers comprise a quarter of federal state and local government revenues while in Asia, most SNGs heavily rely on intergovernmental transfers with a few countries such as Indonesia, Pakistan and the Philippines opting for a tax-sharing arrangement (Smoke, 2017).

Intergovernmental fiscal transfers have several functions that include: correcting the vertical and the horizontal fiscal balances, compensating or offsetting for the spill-overs or externalities between different jurisdictions, funding national priorities and administrative priorities and capacities of the nation (Bahl *et al.,* 2001). Because of expenditure levels and the specific features of the inter-jurisdictional financial arrangements, sub-national governments in the federal systems exclusively rely on fiscal transfers as their main revenues (Freille & Capello, 2014). In developed countries, governments use conditional transfers to ensure that certain standards of service delivery by the subnational government are met. However, in developing counties such instruments based on standards and behaviour are uncommon (Smoke, 2019).

Generally, intergovernmental transfers are categorised into unconditional and conditional transfers (Shah,

2016; Searle & Ahmad, 2005; Miyazaki, 2016). Unconditional transfers are provided as budgetary support and are allocated without any conditionality and are designed to reduce vertical fiscal gaps between SNGs (Shah 2016) and preserve local government autonomy while boosting inter-jurisdictional equity (Broadway & Shah, 2009). Conditional transfers are allocated to specific projects to encourage expenditures in identified areas. Kitchen (2007) notes that unconditional transfers provide efficiency, fairness, flexibility, predictability, and give room for local leaders to meet the preferences of the local citizens. Usually, conditional transfers limit local public policy options resulting in undesired public investments (Boadway & Shah, 2007).

Whether conditional or unconditional transfers, the design of intergovernmental transfers depends on the objectives sought and the legal foundation; whether it is enshrined in a national Constitution or by a presidential decree or even annual legislation (Fumey & Egwaikhide, 2018). The design of these transfers should take cognizance of structure for the management of the transfers. Some countries including Australia, India and Nigeria use semi-autonomous agencies or statutory commissions to manage these transfers (Bahl *et al.,* 2001). All in all, well-designed and structured decentralization initiatives tend to transfer governance closer to people and realign the policies and programs to reflect local preferences and thereby generate welfare gain (Llanto, 2012).

There are three main ways of determining fiscal transfers to the SNGs; the use of a fixed proportion of national government revenues, the use of an ad hoc basis that is similar to any budgetary expenditure and lastly, a formula-driven basis where a proportion of specific SNG expenditures are reimbursed by the national government (Bird & Smart, 2002). These designs take many forms that include tax sharing arrangements, ad hoc transfers, or cost disbursements. The tax sharing involves the national governments allocating a share of the national collection of some tax to the SNGs while the ad hoc transfers involve the discretionary arrangement by the parliament or the government to transfer any amount to the subnational government. The cost reimbursement approach involves the national government defining the services for which it will guarantee to cover the cost incurred by the SNGs to deliver the service. These transfers are conditional and may be open-ended or closed-ended depending on the cost covered by the transfers (Bahl *et al.,* 2001).

A formula grant is a common approach to fiscal transfers as it uses some objective, quantitative criteria to allocate the pool of revenues among the eligible local government units (Bahl *et al.,* 2001). Several countries use formula-based allocation systems and they include Tanzania, Nigeria, Sweden and Senegal (Fumey & Egwaikhide, 2018), India (Smoke, 2017), while the Philipines use several forms that include the formula–backed unconditional grant, a specified share of taxes; and an ad hoc conditional grants (Llanto, 2012) while In Indonesia it consists of four main types: shared tax revenues, shared non-tax revenues (from natural resources), general-purpose grant and special-purpose grant (Lewis & Smoke, 2017; Lewis, 2013). In Spain, the regional government is mandated by law to transfer to its lower SNGs, 20% of the provincial sales tax, 20% of the housing tax and 20% of the fiscal transfers from the national government (Freille & Capello, 2014).

Empirical evidence indicates that fiscal transfers are contrasting and it is argued that the transfers dampen local revenue generation efforts while improving local expenditure patterns (Lewis & Smoke, 2017). Whereas transfers portend much for SNGs, there are several limitations and shortcomings. The first shortfall is that generous or poorly designed fiscal transfers may create disincentives for local revenue generation efforts, inflate or distort local spending, and generate higher local deficits (or surpluses) and debt burdens, and discourage local cost recovery. Further, the transfers may also not meet the stated goals of enhancing the quantity, mix, quality and impact of local government spending, and may even distort expenditure behaviour (Lewis & Smoke, 2017). According to Smoke (2019), these transfers may create disincentives for subnational revenue generation, limited information and capacity create administrative challenges, and

local political dynamics can weaken revenue policy and administration.

Intergovernmental fiscal arrangements are in the long – run unsustainable due to the following reasons; the heavy burden on central governments and the exaggerated poverty alleviation effects (Schroeder & Smoke, 2003) while discouraging local government autonomy, maintaining or enforcing uniformity, encouraging wasteful spending and probably offload the national government's budget deficit to SNGs (Bahl *et al.,* 2001). Its distribution among local jurisdictions is influenced by several factors including the achievement of electoral objectives and the satisfaction of powerful interest groups (Veiga & Veiga, 2013). However, greater dependence on fiscal transfers creates opportunities for control by the national government (Llanto, 2012).

2. Statement of the Problem

The system of intergovernmental fiscal transfers between different government levels has gained interest in research on how to improve SNGs fiscal operations and outcomes (Lewis & Smoke, 2017). The developmental states in Africa are faced with rapid population growth which has outstripped the capacity of SNGs to provide public services in terms of management, infrastructure, and financing (Fjeldstad & Heggstad, 2012). The lack of capacity by SNGs has been recognized as an important constraint in advancing intergovernmental fiscal relations (Smoke, 2017). Studies have attributed the failure of decentralisation initiatives in Africa to several challenges that include; limited legislative and regulatory changes, centralization of resources, limited fiscal transfers, weak local revenue bases and lack of local planning capacity (Robinson, 2007).

It is becoming increasingly important to know the effect of fiscal decentralisation on the economy, society and politics (Martinez-Vazquez *et al.,* 2017) because the subnational governments are particularly important actors in the provision and delivery of public goods and services (Veiga & Kurian, 2015). Many fiscal transfer mechanisms and systems in low-income countries are deficient and may require updating to reflect changing conditions and new challenges (Smoke, 2019). The mismatch in the revenue and expenditures decision between the different levels of government confers a balancing role to be assigned to the intergovernmental fiscal transfers (Bird & Smart, 2002). Thus, any fiscal transfer from the higher level to the lowest level government helps close the gap, however, fiscal gaps will of course remain for the poorer SNGs. It is against this background that this study examined the nature of intergovernmental fiscal relationships among the subnational governments in Kenya.

3. Theoretical Review

The study is premised on fiscal federalism which argues that SNGs cannot effectively execute redistributive policies based on locally generated revenues (Marton & Wildasin, 2007). This is based on the first-generation theory on fiscal federalism by Oates (1999) which supported the notion that intergovernmental fiscal transfers are normatively justified by two objectives of enhancing efficiency and more equitable resource allocation among local jurisdictions (Veiga & Veiga, 2013). This leads to a scenario where the bulk of the revenue-raising powers are centralized at the national government levels with the concurrent grants subsidies to SNGs in the form of fiscal transfers (Bahl *et al.,* 2001).

The fiscal decentralization theory indicates that intergovernmental fiscal transfers can provide fiscal equalization and thus combat disparities across different sub-national units, and internalize spill over effects to other local governments (Smart & Bird 2010). Globally, fiscal decentralization programmes are confronted with the best strategy for allocating resources, however, the principles of equity and efficiency are expected to drive the process rather than political considerations (Fumey & Egwaikhide, 2018). However, the mismatch arising from the revenue-raising capabilities and knowledge of local preferences results in the vertical imbalances which necessitate a dominant role for the intergovernmental transfers (Smoke, 2019; Bahl, *et al.,* 2001). Intergovernmental fiscal transfers also serve to solve the horizontal fiscal imbalances or the equalization (Bird & Smart, 2002)

While vertical fiscal gaps may be eliminated by; transferring revenue-raising power to SNGs, transferring expenditure responsibilities to the national government, or by reducing local expenditures or raising local revenues (Bird & Smart, 2002). Decentralization of responsibility for financing and providing services is believed to improve local-level revenue generation, spending and service delivery. These expected benefits in theory derive from the physical nearness of local governments to their constituents. Proximity is argued to allow local governments (relative to a central government) to discern demand for services more accurately and to tax and spend more effectively and efficiently (Lewis & Smoke, 2017).

The theory of fiscal decentralization assigns intergovernmental transfers the role of an important policy instrument for the central government (Oates 1972; Oates 1999; Tiebout, 1956). National governments often shape the intergovernmental fiscal policy by following the basic logic of the core fiscal decentralization principles (Smoke, 2017).On the other hand, it is premised that proximity allows SNGs to discern demand for services more accurately and to tax and spend more effectively and efficiently (Lewis & Smoke, 2017). Thus, the national government have inherent advantages for raising revenues based on the productive revenue bases and administrative considerations, but the SNGs are better placed in providing many public goods and services given their local knowledge and preferences (Smoke, 2019).

Fan *et al.,* (2018) notes that careful design of intergovernmental fiscal transfers fundamentally ensures that government funding facilitates local service delivery efficiently and equitably. Given that fiscal transfers are necessary, then the major issue of the design of the transfer system. One way is by estimating the revenue available to SNGs as a whole and the expenditure needs of each level of government. Another is the application of the minimum service level that must be filled by the transfers, however, this is constrained by the available revenues and lastly, historical expenditure levels of the SNGs are used to determine the fiscal needs of the SNGs (Bahl *et al.,* 2001).

While solving the vertical and horizontal fiscal gaps, almost every nation has raised the question of equalization as a part of their grand design. Thus, inter-regional equalization is an important consideration in designing any grant system (Bahl *et al.,* 2001). Equalization is aimed at providing the SNG with sufficient finances to enable it to provide a pre-determined level of public goods and services (Bird & Smart, 2002). However, the design of the equalization fund takes into consideration of the fiscal capacity, need and effort (Bahl *et al.,* 2001).

At times, the intergovernmental fiscal transfer system can be designed to accommodate the alignment of local public services and their spill-over effects, thereby correcting possible resource misallocation, inappropriate spending for some services, and free-ridership that would otherwise emerge from uncontrolled negative externalities (Wongpredee & Sudhipongpracha, 2014). Sometimes, the structure of intergovernmental transfers should have incentive effects on the behaviour of national and SNG (Miyazaki, 2016). However, ethnic parochialism, regionalism, and a long history of administrative centralization typically influence the design of the intergovernmental fiscal systems and structures of developing countries (Wongpredee & Sudhipongpracha, 2014).

Considering that the degree of fiscal empowerment of subnational governments and their role in public spending varies greatly (Smoke, 2017), fiscal transfers can be allocated based on an objective criterion that allows the central government to advance specific development goals through the enhancement of subnational government resources through equalization, increasing autonomy through unconditional transfers and prioritizing development objectives through conditional transfers (Smoke, 2019). However, fiscal decentralization may also cause distortions and concerns, like intergovernmental externalities, tax system inefficiency, tax wars, problems related to redistributive programs (Mikayilov, 2007). However, the national governments in the transitioning and developing economies have limited choices for the delegation of the taxing autonomy to their SNG (Bahl *et al.,* 2001).

4. Literature Review

Empirical studies have been reported in a different context. For instance, empirical evidence shows that intergovernmental transfers in developing and transition countries comprise about 60 per cent of the sub-national government's total expenditure and about 30 per cent in OECD countries (Veiga & Kurian, 2015). Alam (2014) reports that the transfers represent about 70 per cent of sub-national expenditures in developing countries and 38 per cent in developed economies. On average, fiscal transfers make up 52.6% of revenues and is as higher as 63.1% in lower-income countries, 52.2% in upper-middle-income countries and 49.8% in high-income countries (Smoke, 2019).

In France, Garello (2016) reported that the fiscal transfers on average make up approximately 40 per cent of the total sub-national government's revenue. In Japan, the intergovernmental fiscal transfers make up 31% of the government budget (Miyazaki, 2016) which comprise the tax sharing arrangements where the SNG received about 32% of income and alcohol taxes (Bird & Smart, 2002). In Austria, SNG receives a proportion of the taxes, that is, 12% of income and value-added taxes within their jurisdiction (Bird & Smart, 2002). In Switzerland, SNG received a share of federal tax amounting to 17% personal income tax and firm profit and 10% withholding tax (Soguel, 2019). In Germany, a tax share arrangement sees, 49.75% VAT going to the regional states and another 2.2% going to the municipalities (Bird & Tarasov, 2004).

In Spain, the transfers are split into 80.5% unconditionally to municipal governments; 3% unconditionally to local townships and other local communities; 12% conditional to the funding of the public health services of the local governments, 1.5 % equalization fund, and 3% discretionary spending in general and infrastructure investment in selected municipalities and townships (Freille & Capello, 2014). In the Philippines, intergovernmental fiscal transfers account for over 95% of the local government revenues (Llanto, 2012). In Indonesia, the SNG received are split into 90 % for the local governments and 10 % for the intermediate governments (Lewis & Smoke, 2017).

The structure of the intergovernmental fiscal systems influences the activities of the SNG (Lewis & Smoke, 2017). For instance, the expenditures of the SNG account for 10% or less of public expenditure in many low-income and even middle-income countries, but the figure is considerably higher in the Asian countries, that include Indonesia, India, the Philippines, and is significantly higher in China where subnational governments dominate public expenditures (Smoke, 2019). In the Asian continent, the SNG expenditure constitutes 20%–35% of the total government expenditure but this varies among levels. For instance, in Sri Lanka and Bangladesh, subnational government spend respectively less than 1% and 3% at the lowest levels while Viet Nam spends around 56% while in India spend around 66% (Smoke, 2017). The SNG in the Philippines consumes 24% of the government expenditures (Llanto, 2012) and 26% of government expenditures in Indonesia (Lewis & Smoke, 2017).

The practice of intergovernmental transfers is highly diverse with many countries increasingly defining the basis for allocating the annual pool. These bases include; a share of certain national revenue sources (e.g., in Kenya, Ghana, Indonesia, Mexico and the Philippines), regular and annualized determination of the pool during the budgeting process as in South Africa and Uganda and the use of a specific time as is the case of India and Pakistan based in recommendation of statutory government bodies and/or agencies (Smoke, 2019). But still, variations also exist with regards to the tiers of government (Smoke, 2019), where for instance, one level of SNG as in Kenya or cascaded into the various levels of SNG as in the federal systems such as those in India, Nigeria, Pakistan and Mexico where transfers go the intermediate tier and to the lowest SNG level based on the allocation decisions of the state or province (Smoke, 2019).

The formula-based conditional grant in Indonesia is shared based on population (50%), land area (25%) and equal share (25%) (Llanto, 2012). In Spain, the national government has tax revenue arrangements with the autonomous communities get 33% of the personal income tax of the tax derived, 35% of the VAT, 40% of the major excise taxes, and all taxes and distributed as

half conditional transfers (Bird & Tarasov, 2004). In Germany, the formula–backed arrangement in Germany sees 75% of the fiscal transfers being distributed based on the population statistics, while the cost-based conditional transfers see the federal government cover 50% cost of higher education and regional economic structure, 60% support for agriculture, and 70% for shoreline preservation (Bird & Tarasov, 2004).

In Spain, the conditional transfers are distributed based on several factors that include population, area, relative wealth, and fiscal effort (Bird & Tarasov, 2004) and other redistributive policies (Freille & Capello, 2014). In Ghana, there are four main factors including needs, equity, service pressure and responsiveness have remained constant but their composition and weights have changed many times (Fumey & Egwaikhide, 2018). In the Philippines, fiscal transfers to the SNG are allocated based on the following criteria; 70% population, 20% land area and 10% equitable share (Bird & Smart, 2002). Further, several countries have developed and adopted a unified transfer system that is made of a dominant unconditional formula–based transfer as in Kenya, Indonesia, the Philippines and such South Africa or multiple transfer programs such as those used by Uganda, Ghana and Brazil (Smoke, 2019).

5. Fiscal Decentralization in Kenya

At independence, Kenya inherited a system of Local Authorities (LAs), based on Local Government Act Chapter 265 which conferred them with four main legal instruments for raising OSR: the Local Government Act that empowered LAs to establish and maintain a General Rate Fund; the Valuation for Rating Act (Cap 266) and the Rating Act (Cap 267) which provided for the establishment of valuation roll by the local authorities, the imposition and collection of property rates; the Trade Licensing Act (Cap 497) which empowered LAs to impose business license fees; and, d) the Local Government Act (section 222) which empowered LAs to borrow, including through the issuance of stocks or bonds (GoK, 2016).

The creation of local authorities then did not portent much for decentralisation because the central government took much authority and legal framework and created a supervisory government ministry to run the affairs of the local authorities (Mitullah *et al.,* 2005). Between 1969 and 1989, a series of political reforms and Constitutional amendments transferred the powers of the LAs to Central Government ministries and departments. Take, for instance, the Transfer of Functions Act (1969) moved functions such as primary health and health services to the central government except for seven major municipalities (GoK, 2016). Further, the Act took away the power of municipalities to levy the Graduated Personal Tax (GPT) and was replaced with a grants system covering certain services. In 1989, the specific grants were replaced with a service charge levied on business premises and employees in formal and informal sectors. Later on, in 1998, the service charge was abolished and replaced with the Local Authorities Transfer Fund (LATF). By and large, this permitted the LAs a narrow range of local taxes, charges (GoK, 2016).

These initiatives which created local authorities took the form of de-concentration, a weaker form of decentralization that merely shift responsibilities from national government officials to individuals working in the subnational structures while creating strong field administration or local administrative capacity under the supervision of national government ministries. To remedy this, the national government came up with new regulatory and administrative frameworks for the decentralisation of funds that included Local Authority Transfer Fund (LATF) and Road Maintenance Fuel Levy (RMLF) and in 2003, the legislation created the Constituency Development Fund (Mitullah, 2012). Other important decentralised funds include the Free Primary Education Fund, the HIV/AIDS funds created in 1999 and the Water Services Trust Fund, which was meant to finance capital investment outlay of supplying water and sanitation services (KIPPRA, 2006).

To remedy this, the national government came up with new regulatory and administrative frameworks for decentralisation of funds that include Local Authority Transfer Fund (LATF) and Road Maintenance Fuel Levy (RMLF) and in 2003, the legislation was created the Constituency Development Fund (Mitullah,

2012). Other important decentralised funds include the Free Primary Education Fund, the HIV/AIDS funds created in 1999 and the Water Services Trust Fund, which was meant to finance capital investment outlay of supplying water and sanitation services. The main proxy for decentralising funds to local authorities was the Local Authorities Transfer Fund (LATF). LATF was established in 1999 to improve service delivery, improve financial management, local revenue mobilization and enhance accountability in local authorities (Mogeni, 2017; Otieno *et al.,* 2014). The study has used LATF as a proxy for fiscal decentralisation before the establishment of county governments in Kenya since it was specific to local authorities, were unconditional transfers and bestowed the local government the autonomy and discretion to come up with policies, procedures and rules that are in line with their needs and preferences of the local population.

LATF steadily increased in fund amounts and contributed to the improvement in services offered by the local authorities (Mitullah, 2012). In 2003, the decentralisation initiatives in Kenya were boosted by the introduction of the Constituency Development Fund (CDF) which comprised an annual budgetary allocation of 2.5% of the total national revenue (Bagaka, 2008). In essence, LATF was a form of intergovernmental transfers to the local authorities with no political decentralisation initiatives, while the CDF lacked both the fiscal and administrative decentralisation initiatives. These initiatives took the form of delegation where national governments transferred responsibility for decision-making and administration of public functions to semi-autonomous organizations not wholly controlled by the central government, but ultimately accountable to it.

With the promulgation of the Constitution of Kenya 2010, the country adopted devolution which split the territorial state of Kenya into two – tiers of governments; national and county. The lowest tier is the sub-national (county) government with subjugated urban (town and municipal) councils. The Constitution of Kenya, 2010 provides for at least 15 per cent of national revenues of the total government expenditure to be allocated to the SNGs, while the national government spend 84.5 per cent with 0.5 per cent allocated to an equalization fund year (The Constitution of Kenya, 2010)

The Constitution of Kenya 2010 justifies the devolution by providing reasons that include self-governance, equitable sharing of resources and promoting social and economic development (Wagana & Iravo, 2017). Accordingly, the subnational governments in Kenya has both the administrative structure made up of the appointed county executive committee headed by a directly elected governor and supported by a secretary and the political structures consisting of legislative arms which consist of a majority elected and smaller appointed Members of the County Assembly (MCAs), led by a speaker, who is elected from other persons. Thus, fiscal decentralisation is seen in both the administrative and political structures when the county executives draft the county fiscal budgets and submitted them for approval by the county assembly (Constitution of Kenya, 2010).

The devolved services include Agricultural development, health services, pollution control local transport and road infrastructure, animal control and welfare, trade development and regulation, County planning and development, county public works and services, pre-primary education, village polytechnics and craft centres, fire fighting services and disaster management, and promotion of governance and local levels (The Constitution of Kenya, 2010). Further, the parliamentary legislation supporting the Commission on Revenue Allocation Act indicated that the CRA has a constitutional duty to advise County Governments on ways to enhance OSR collection. Thus, the CRA should seek, when appropriate, to define and enhance the revenue sources of both levels of Government (CRA Reports, 2020).

In the Kenyan scenario, the intergovernmental fiscal transfers are supported by several constitutional bodies; the Commission on Revenue Allocation (CRA) under Article 215 and the Office of the Controller of Budget under Article 228 of the Constitution of Kenya 2010. The CRA is mainly tasked with making recommendations concerning the basis for the equitable

sharing of revenue raised by the national government between the national and county governments; and among the county governments. The Commission is also tasked with the determination, publishing and regularly reviewing of the criteria for the identification of the marginalized areas, consult and recommending the appropriation for the Equalization Fund. The Office of the Controller of Budget (OCoB) is tasked with overseeing the budget implementation at both the National and County Governments by authorizing a withdrawal from public funds. The Office is also expected to prepare, publish and publicize statutory reports, conduct investigations based on their initiative or a complaint made by a member of the public, and conduct alternative dispute resolution mechanisms to resolve disputes (GoK, 2010).

6. Methodology

The study adopted a descriptive design as the most appropriate in this instance because the study sought to describe the features of phenomena and also produce an accurate profile of factors, events and situations. The use of the design was accompanied by a survey approach that allowed for the collection of sets of qualitative data from the given population.

7. Sampling Procedure

The study drew subjects from the three purposely selected counties of Kiambu, Baringo and Vihiga. The counties were selected based on the distinct overall absorption rate of funds assigned in the financial year 2017/2018 as this was indicative of the efficiency of the county government in delivering public services. Kiambu and Vihiga Counties are extreme outliers with Kiambu having the highest overall absorption rate of 85.5% while Vihiga had the lowest overall absorption rate of 48.5%. Baringo, on the other hand, had a median absorption rate of 74.8% (Controller of Budget, 2019).

The target population comprised purposively selected nine (9) directors from the finance, budget and planning departments (or equivalent) because of their in-depth knowledge of the state of fiscal decentralisation in their respective counties. The study used interviews and documentary reviews as the main tools for data collection. First, secondary data on decentralisation was collected from the Constitutional offices and commissions such as the Auditor General, Controller of Budget (COB) and Commission on Revenue Allocation (CRA). Secondly, the study interviewed directors in the three-county governments of Vihiga, Baringo and Kiambu to ascertain their perceptions on the local revenue decisions.

8. Data Analysis

The secondary data were entered into an excel sheet and analysed by descriptive statistics while the output was presented in a tabular and graphical format, while the quantitative data were entered into Microsoft Excel and analysed by descriptive statistics and presented in a tabular format. The qualitative data were analysed through a combination of deductive and inductive approaches which include transcription, summarizing, categorizing and structuring summarized, categorization and structuring

9. Results

In Kenya, the unconditional transfers are subjected to a formula in its distribution between the national government and county governments and between the county governments. The introductory basis for the fiscal years 2013/2014 to 2016/2017 emphasized population parameters and was based on five parameters: population (45%), poverty gap (20%), land area (8%), equitable share (25%) and fiscal responsibility (2%). For instance, in 2013/2014, Lamu County was considered poorer and received the highest per capita transfer of Kshs 15,741 while in counties with the lowest per capita transfers were Nairobi City County at Kshs. 5,350, Kakamega county at Kshs. 4,054 and Mandera at Kshs. 2,731(CRA reports, 2016).

The second basis for a revenue-sharing formula for the fiscal years 2017/2018 to 2019/2020 focused on fiscal decentralization efforts, rectifying economic disparities and incentivizing local revenue generation efforts and was based on six parameters namely: equitable share (26%), population(45%), land area(8%), poverty gap

(18%), fiscal effort (2%) and development factor (1%). In 2016/2017, Isiolo County received the highest per capita transfer of Kshs. 22,146, followed by Lamu County at Kshs. 20,581 while Nairobi City County fared much worse than in 2013/2014 at Kshs 4,447, Kakamega County maintained a similar amount at KShs. 5,267, while Mandera fared much better at Kshs. 8,074 (CRA reports, 2016).

The Third Basis for revenue sharing formula which will run from 2020/21 to 2024/25 relies on a total of eight factors which are grouped into three objectives of enhancing service delivery, promoting development and incentivization of local revenue collection and fiscal prudence efforts. The five measures of service delivery are; health index (17%); an agriculture index (10%); population index, as an indicator of the need for other county services (18%); equal shares (20%); and an urban index as an indicator of the need for urban services as per the ratio of urban households (5%). The measures for the objective of promoting development are the land area index (8%) which takes cognizance of the proportion of land area occupied by the SNG, the rural access index (8%), an indicator of the need for rural services as per the ratio of the rural households and the poverty level (14%) as measured by the poverty headcount index. The third objective of incentivizing local revenue efforts includes the fiscal effort (2%) as measured by the fiscal effort index and lastly, incentivizing fiscal prudence (2%) as measured by the fiscal prudence index. The objective of enhancing service delivery take 70% weight, promotion of development takes 26% weight while incentivization takes 4% (CRA reports, 2020).

The information presented in Figure 1 illustrates the trends in intergovernmental fiscal transfers made by the national government and development partners to the county governments (SNGs) in Kenya. In the figure, the reference is the total intergovernmental transfers (unconditional, conditional, ad hoc transfers and equalization fund), while the transfers from development partners, the national government – constituency development fund (NG-CDF) are calculated as a ratio of the total fiscal transfers. The figure shows that the total revenues available to SNGs are increasing largely due to the increase in the fiscal transfers from the national government. Close examination shows that a direct proportionality between the fiscal transfers and SNGs revenues which illustrates the overall dependence by SNGs on intergovernmental fiscal transfers. The lowest amounts of the intergovernmental transfers are about 85.53% of total SNGs budgets in the 2014/2015 financial year and increased to 89.04% in the 2017/2018 financial year. The total local revenues average 10% and fluctuate between 9.05% in 2017/2018 and 12.67% in 2014/2015. The real increase in the local revenues for SNGs, when adjusted for inflation, is probably a decline considering that the 12 – month inflation rate ranged between 3.73% and 9.71% or an average of 6%. This would indicate a subpar performance in revenue collection which portends serious ramifications in service delivery among SNGs in Kenya.

There is a rise in conditional grants from the national government from 0.7% in 2013/2014 to more than 6.06% in 2020/2021 with an average of about 4 per cent of the total fiscal transfers. These grants comprise two elements; ad hoc transfers and cost-reimbursement transfers. For instance, the transfers for the construction of level 5 hospitals and vocations training institutes take the ad hoc transfers which are discretionary in nature while the user foregone fees, maternal healthcare take the full cost- reimbursement approach. It can therefore be inferred that they are not related to any transfer of functions as envisioned by the constitution of Kenya 2010 but can be a form of coercion to force SNGs to implement the desired goals of the public sector. Further, the rise in conditional grants has also seen the reduction in the unconditional fund which is stipulated at 15% of the total government revenue.

Third, there is a rise in conditional grants from the bilateral and multilateral donors from 0.27% in 2014/215 to 10.84% in 2019/2020 and 7.91% in 2020/2021. This represents about three per cent of the sub-national governments' revenues. At the onset of devolved governments, these transfers were geared toward the health sector reforms but its mandate has largely progressed to other significant sectors such as infrastructure and development support in water,

sanitation and roads devolution support in form of capacity building for the SNG and agricultural and climate-related initiatives. These transfers provide support to specific programmes such as capacity building for SNGs and promote devolution as well as support specific functions which are under the mandate of the county governments.

Fourth, the lack of utilization capacity in the transfers sees an average of 11 per cent of the conditional transfers being utilized and thus remain unabsorbed due to several reasons that include irregular disbursements by the national government, lack of planning by some SNGs, learning curve effects where devolution is still an experiment, bureaucratic processes during fund approvals and political effects. Lastly, the equalisation fund comprising 0.5 per cent of the total government revenues in a financial year has not been operationalized as of the year 2021 because of the lack of an existing legal framework. The fund comprises an average of two per cent of the total fiscal transfers and is geared towards the horizontal fiscal gaps among the SNGs in Kenya.

A closer examination of the reports shows that in the nascent years of the devolved governments in 2013/2014 and 2014/2015 financial years, the conditional transfers were marginal when compared to the unconditional transfers and was targeted towards capacity building for the provision of healthcare services through the construction of hospitals and other ongoing projects. In the 2015/2016 and 2016/2017 financial years, the conditional transfers from the national government and bilateral donors were geared towards healthcare provision on a full cost – reimbursement (user foregone fees, maternal healthcare), and ad hoc transfers on infrastructural projects (Road Levy Maintenance Fund), capacity building (medical equipment leasing scheme and level 5 hospital buildings) and education sector (construction of village polytechnics). The important initiatives that funded by the development partners include provisions of devolution support mechanisms, capacity building and infrastructure development for urban and peri-urban areas (water, roads and sanitation projects).

During 2018/2019, 2019/2020 and 2020/2021financial years, the conditional transfers were geared towards healthcare provision on a full cost – reimbursement (user foregone fees, maternal healthcare), and ad hoc transfers on infrastructure projects (Road Levy Maintenance Fund), capacity building in healthcare (level 5 hospital buildings) and education sector (construction of village polytechnics). The important initiatives funded by the development partners include provisions of devolution support mechanisms, capacity building and infrastructural development for urban and peri-urban areas (water, roads and sanitation projects) and agricultural development projects and climate change initiatives in counties in rural areas.

The study further examined how fiscal transfers are perceived by the senior public officers at the county government levels. The study interviewed six directors from the finance and economic planning and their replies are presented as per thematic areas of policy framework, budgetary allocations, and stringent conditions for the transfers governing intergovernmental transfers

According to the majority of interviewees, there is a great and elevated dependency on the transfers from the national government for county governments' budgetary allocations. As indicated by respondent, KIA002, "the county government cannot move from its reliance on transfers and grants from the national government, however, enhancement of collection of own revenue can supplement these transfers". The disbursements of the transfers are not timely as expected and thus affects the ability of the county government to discharge its duties and at the same time affect fiscal decentralisation. Because of the reliance on the transfers from the national government, the key informants suggested the following actions that could be implemented to improve their own-source revenues. These include; improvement in the collection of own-source revenues and expanding/diversification of the local revenue sources and collection.

The second major concern is the conditions attached to the intergovernmental transfers. These conditions

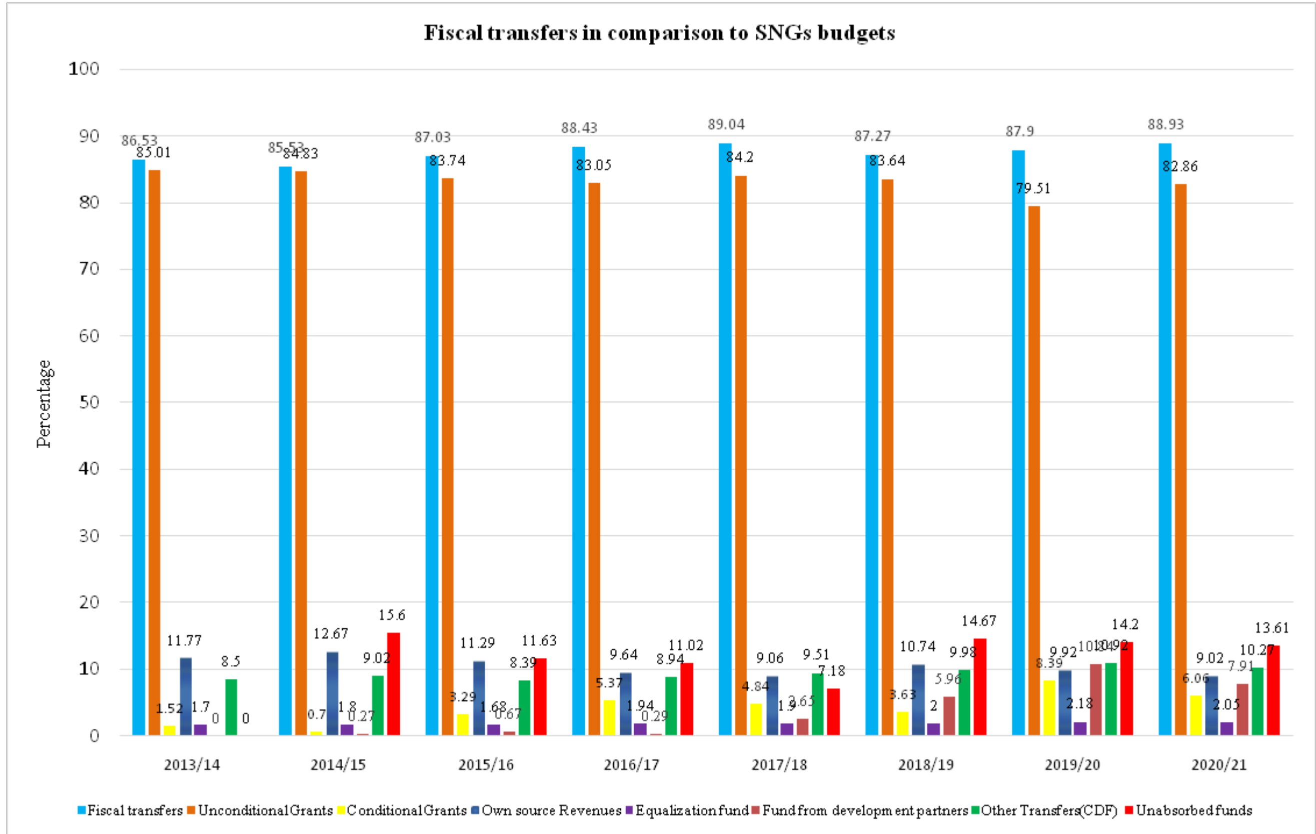

Figure 1. Decentralised Funds 2013/14 -2020/2021.

Data Sources: Controller of Budget (various reports).

have hindered the efficiency of the fiscal transfers and as indicated by the key informants, the main conditions include; the legal framework governing the use of funds as prescribed in the PFMA of 2012, the policy framework as provided by the office of the Controller of the Budget and the national treasury and other circumstantial issues that have arisen, for instance, payment of pending bills. "The legal framework restricts the use of funds for a specified purpose such as projects which are targeted by the national government or development partners, the fiscal capacity and efficiency of the county to use the allocated funds" as observed by informant KIA002. Other legal issues regarding the transfers are the provision for sufficient budgetary allocation which allows for the transfers to be provided for in the county budgets. The policy framework for these transfers is provided by the office of the Controller of the Budget, which stipulates how these counties can access, and use these funds. "The real challenge facing the counties is the procedures for the requisition and use of funds which include the following; the preparation of the budgets by the department, the approvals of budgets and the documentary requisitioning through the information systems before the funds are released", said respondent KIA001. The other issue raised by the key informants is the conditionalities made by the national government in the payment of the pending bills. The national government insists on counties paying all pending bills due to suppliers and service providers which may affect the cash flows of the county governments.

10. Discussion

Discussion of intergovernmental fiscal transfers starts with the legal framework supporting the transfers and its starts with the promulgation of the constitution of Kenya 2010 which stipulates that government revenues are divided as follows; 84.5% for national government programs, 15% for county governments

and 0.5% as equalization fund (Gok, 2021). Before the promulgation of the Constitution of Kenya 2010, the central government used several initiatives that include, the Local Authorities Transfer Fund (LATF), the Contribution in – lieu of rates (CILOR) and Road Maintenance Fuel Levy (RMLF) to support the operations of the local operations as a matching grant designed to match the local revenue decision as well as improve on local expenditure decision (Bird & Smart, 2002).

As deduced from Figure 1, the transfers form the principal source of revenue for the SNGs in Kenya and constitute an average of 87 per cent of the SNGs' total revenues, while own source revenue comprises 10 per cent and other funds constitute the remaining three per cent. As elicited by Smoke (2019) the intergovernmental fiscal transfers are the main financing sources for the SNGs in many developing and transitioning economies. The SNG dependence on these transfers arises because of their inability to draw and curve out appropriate revenue bases. This fact could be due to their levels of economic development which constraints SNGs from developing new revenue bases. Bahl *et al.,* (2001) noted that SNGs in developing economies tend to support infrastructural development and provide necessities to its constituents and thus they cannot draw out any significant revenues bases. Due to this fact, SNGs are limited in the tax assignments when compared to their compatriots in developed nations which generate a minimum of 25 per cent in local revenues (Mikayilov, 2007). Further, there are no tax–sharing arrangements between the different levels of governments in Kenya.

Whereas conditional transfers are the principal source of financing for SNGs, unconditional transfers in form of full cost – reimbursement and ad hoc transfers are slowly being adopted and used by the national government to support the national priorities in education, health and infrastructure needs of the counties. For instance, the user foregone fees and maternal healthcare is a form of full cost – reimbursement approach used by the national government to promote the maternal wellbeing of the mothers visiting the health facilities under the SNGs. The other conditional transfers take the form of ad hoc transfers that include, the financing of the construction of specific levels of hospitals, vocational training institutes and the specific class of roads as supported by the Road Maintenance Levy Fund (RMLF). These transfers are more aligned to the development needs of the SNGs as opposed to stimulating economic growth within the SNG. In most cases, conditional grants are believed to stimulate actual spending on specific public sector objectives (Bahl *et al.,* 2001).

The utilization and absorption of the equalization fund in Kenya is still nascent and has not yet been exclusively handled by the necessary agencies in Kenya. The equalization fund accounts for an average of two per cent of the total fiscal transfers in Kenya but its operationalization is still impeded by the lack of critical legal framework underpinning its use. In theory, the equalization fund is supposed to correct the horizontal imbalances among the different SNGs in Kenya, but according to Bird and Smart (2002), its function is to even out the differences in the capacity of SNGs to provide a specified level of public services. It may also be used to equalize the actual revenues of SNGs in per capita terms. In Spain, the equalization fund is about 1.5 % and is discretionarily spent by selected municipalities and townships (Freille & Capello, 2014).

In Kenya, unconditional transfers are subjected to a formula in its distribution between the national government and county governments and between the county governments. The introductory basis emphasized population parameters with different weights: population (45%), poverty gap (20%), land area (8%), equitable share (25%) and fiscal responsibility (2%). The second basis emphasized on fiscal decentralization efforts, correct economic disparities and incentivize local revenue generation efforts: equitable share (26%), population (45%), land area (8%), poverty gap (18%), fiscal effort (2%) and development factor (1%). The third basis is geared towards enhancing service delivery, promoting development and incentivizing local revenue collection and fiscal prudence efforts. The objective of enhancing service delivery take 70% weight, promotion of development takes 26% weight while incentivization takes 4% (CRA, 2020).

This formula-based unconditional grant is progressive as it redirects the government finances towards prudent use and even out development challenges between the SNGs in Kenya. The disparities in the economic development are large as some counties are located in arid – and semi-arid zones and thus the formula has transformed decentralization initiatives. For instance, Bahl *et al.,* (2001) cite the economic disparities between SNGs in developing and transition economies. These disparities could be as high as higher as 20 times greater in poorer places and therefore the formula–based unconditional grants like the one used in Kenya are primarily intended to reduce both fiscal and horizontal fiscal gaps. In other cases of formula-based grants used in Sub-Saharan Africa, Fumey & Egwaikhide (2018) cite the need factor as the most important parameter in Ghana. The need factor comprises the health facility per population ratio, health professional per population ratio, education facility per population ratio, trained teacher per population ratio, mileage of tarred roads and water coverage among others.

11. Conclusion

Drawing from the findings, the study concludes that SNGs in Kenya are heavily dependent on intergovernmental fiscal transfers with the transfers contributing over 85 per cent of SNGs finances. The overall dependence on fiscal transfers will likely constrain the ability of the SNGs to provide adequate public services to their constituents and impede fiscal decentralization initiatives in the long – run while undermining devolution initiatives.

The design of the formula–based unconditional transfers holds huge implications for devolution and the regional economic development between SNGs. The formula-based grant will even out the fiscal and horizontal fiscal gaps and incentivize all SNGs to promote devolution. According to Bahl *et al.,* (2001), formula-based grants or transfers have favourable economic outcomes as they ensure objectivity in disbursements and transparency in procedures.

The rise in conditional transfers from both the government and development partners portends well for devolution as it provides more financing arrangements and alternatives to the SNGs. When conditional transfers are considered, the conditions are more likely to improve on transparency and accountability at the local level. This is desired for the achievement of devolution as enshrined in the Constitution of Kenya 2010.

12. Recommendation

The recommendation includes:

First, SNGs should speed up the legal mechanism that would identify and classify the revenue sources and bases to reduce the reliance on intergovernmental fiscal transfers. Many SNGs are still struggling in the development of the critical legal framework and policy for local tax assignments and incentivize revenue generation.

Second, the national government should introduce several measures that would reward the SNGs which are optimizing their local revenue collections. Since there is a lacuna in law on the issue of tax–sharing arrangements, the national government should incentivize the performing SNGs with tax-sharing arrangements.

Third, individual subnational governments in Kenya can form a coalition of subnational governments and set – up a pool of funds that can be built over time to service any outstanding borrowing by the subnational governments as exemplified by the subnational governments in the Philippines which created a Municipal Development Fund (MDF). The MDF offers local government units or subnational units access to capital finance for social and economic development projects (Smoke, 2019).

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