THE RELATIONSHIP BETWEEN LOCAL GOVERNMENT EXPENDITURE AND INTER-GOVERNMENTAL FISCAL TRANSFER

BY

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DECLARATION

This project report is my original work and has not been submitted for examination in any other university.

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This project is submitted for examination with my approval as university Supervisor.

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DR. SIFUNJO KISAKA

DEDICATION

I am proud to dedicate this study to my two great loving kids Sayali,Sahil, and my lovely wife Manisha.

For their endless love, encouragement and understanding.

Without their love, support and encouragement my studies would have been an impossible task to undertake.

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I acknowledge the power of God, the maker, and the provider of knowledge for enabling me to complete my two years of studies in the right spirit.

I owe a great deal of gratitude to my mother, my wife and my two children for their unfailing moral support throughout my period of study. For their understanding and appreciating the demand of the course in terms of time and resources. I salute the dedication of Dr. Sifunjo Kisaka for his persistence guidance throughout the project without giving up on me.

I cannot forget my classmates who influenced positively in my life and were a source of inspiration throughout my study and for assisting me in sourcing for information and materials for this project.

To all my friends, thank you for your understanding and encouragement in my many, many moments of crisis. Your friendship make my life a wonderful experience. I can not list all the names here, but you are always on my mind.

To all my lecturers who contributed in one way or another in quenching my thirst for knowledge I owe you my gratitude.

To you all, God bless.

ABSTRACT

The introduction of centrally independent municipal budget laws is a major step towards sorting out local financing and providing a basis for distinct municipal self-government. The discrepancy between legal provisions for fiscal autonomy and actual conditions for its practical application is deepened by the fact that many central governments still prefer to maintain control over major local taxes and other local revenue sources. This has contributed to huge contradiction as the public expects service delivery from their local government yet the finances for provision of such services are bestowed at the central government and its agencies at the provinces and districts level. The study sought to analyze the relationship between local government expenditure and inter-governmental fiscal transfer.

In methodology a survey research to explore the existing status of two or more variables at a given point in time. In this study, the researcher preferred to carry out survey on impact of intergovernmental transfer using a relationship model. The population of this research consisted of 40 local authorities in Kenya. The researcher utilized secondary sources to collect the data. The sources were obtained from the treasury and the ministry of local government. Qualitative data was analyzed using content analysis techniques. For quantitative, descriptive statistics, percentages and frequencies were derived and used.

From the findings each of the predictor, variables (Grants, Tax price and Private income) explain variation in the dependent variable (local government expenditure). In addition grants, tax price and private income significantly influences Local government expenditure. Meanwhile, the results of this study suggest that the local fiscal capacity, which is reflected from the local own revenues have not distributed evenly across the local authorities. Local own revenue, and grants and transfer, each individually, have a significant effect on the local government expenditure. Finally, it can be concluded that the experience of regional autonomy with fiscal decentralization policy has encouraged local governments to increase regions fiscal capacity. The local government expenditure is thus positive and significantly influence the inter-government fiscal transfer

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ABBREVIATIONS /ACRONYMS

CEE: Central and Eastern Europe

GDP: Growth Domestic Product

LAs: Local Authorities

LATF: Local Authority Transfer Fund

SBP: Single Business Permit

RMLF: Road Maintenance Levy Fund

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Recent years have witnessed a worldwide movement towards administrative and fiscal decentralization in an effort to enhance democracy and governance. The institutional separation of local government structures and finances from those of the central state is considered among the more important prerequisites for the success of the political and administrative reforms in the former socialist countries (Bird. 1995).

The evolution of independent local government structures has clearly begun in the early 1990s in almost all ex-socialist countries of Central and Eastern Europe (CEE), but has not yet ended anywhere (Bird, Wallich, 1995). In Poland and Hungary, for example, local governments were established in their present form in 1990, in Romania, Bulgaria, and in the Russian Federation in 1991, in Albania in 1992, in Latvia, Lithuania and Estonia - in 1993. In most of these countries, the process continues and efforts are directed towards handling the new responsibilities by incorporating accountability, expenditure responsibility, and revenue raising authority (Zsamboki and Bell, 1997).

The introduction of centrally independent municipal budget laws in recent years in many CEE countries is considered a major step towards sorting out local financing and providing a basis for distinct municipal self-government. Recent research (Bird. 1995; Zsamboki and Bell. 1997) shows that fiscal problems of local governments have become a central concern of policymakers in many CEE countries. Despite the considerable

degree of fiscal autonomy provided to local governments by newly designed financial laws, many of them face substantial difficulties in dealing with the new responsibilities. Statistical data provide evidence that under the new economic and legal conditions, local governments tend to cause even stronger pressure on central governments for meeting local expenditure needs. In many countries the inertia of the socialist intergovernmental relations is not yet overcome. Due to their unique, although often also precarious financial position during the socialist regime, central governments were able to either ignore or compensate local budget deficits through extended central debt or external borrowing. In many of the CEE countries this type of policy lead to large central government deficits financed by expended domestic credits, external borrowing, or both. Under the new economic and financial conditions of the transition to a market economy, the opportunities for further extension of both the internal and external debts have become extremely limited in most of the CEE countries.

1.1.1 Intergovernmental Fiscal Transfers and Determinants

While fiscal decentralization has been adopted by a large part of the developing world, there is a wide consensus in the literature that the benefits expected from decentralization will fail to materialize if the system of intergovernmental fiscal transfers does not rely on an equitable and efficient horizontal allocation mechanism. Although a huge literature on the determinants of allocation of intergovernmental fiscal transfers in developed countries exists, this kind of study is still limited for developing countries, especially Subsaharan countries.

The traditional view on intergovernmental transfers is that they should be motivated by equity and efficiency considerations (Buchanan, 1950, Oates, 1972, Gramlich, 1977), a

wel-fare maximizing government might want to transfer money from richer to poorer jurisdictions and to correct for externalities. Actually, a number of empirical studies have pointed out that political factors are as important or even more relevant in explaining the allocation of inter- governmental transfers. Beginning with Wright (1974), economic historians have examined the question of how transfers were allocated amongst American states during the New Deal in the 1930s. They find that political variables explained this allocation considerably better than economic factors.

Atypical empirical model estimating the spending impact of various types of grants on local expenditure postulates the level of local government expenditure as a function of determinants of the demand for public goods (local government expenditure serves as a proxy for such demand). In a typical case, the set of determinants include grants, private income, tax price, and other relevant independent variables. The size of the coefficient of the grant variable (expected to be positive) measures the responsiveness of local expenditures to the intergovernmental grant. Comparison of this coefficient with the income coefficient is used to draw inferences, such as the flypaper effect.

A number of studies adopt the median voter model of public good demand; in these cases the private income and tax price variables are defined for the median voter. The median voter is typically considered to be the household with the median value of income. However, where the median voter is not relevant or is not easy to identify the average income and mean values of the tax price variable are considered. Another formulation examines the effects of grants on local own-source revenue along with other determinants of such revenue. In this case the relationship between own-source revenue and the grant variable is expected to the negative.

The own-source revenue and expenditure equations described above are basically two sides of the budget identity, given a balanced-budget constraint. The two variables are therefore simultaneously determined; estimation procedures should account for this simultaneity. Two additional critical econometric issues arise in estimating the public expenditure model used for measuring the expenditure impact of grants-the endogeneity of the grant variables and the econometric problems created by piecewise linear budget constraints, in the case of specific-purpose closed-ended grants.

In the case of matching grants, where the level of grants from a federal or state government is determined simultaneously with the level of local expenditure, the grant is clearly endogenous. This simultaneity in the determination of the grant and local expenditure biases the coefficient of the grant variable upward. Researchers who correct for this by adopting two-stage least squares estimation methods come up with lower estimated coefficients of the grant variable (Gramlich 1977).

1.1.2 Fiscal Decentralization in Local Government in Kenya

The Kenyan system of the government since independence in 1963 has been a two tier system consisting of local government and central government which is represented by the provincial administration and in most cases the delegated authority goes to lower district and division levels of central government administration. The number of Local Government authorities was much fewer than currently and they were then relatively powerful and well functioning institutions, delivering a wide range of services including primary education, health, road maintenance, water and sanitation, public housing and land administration. Lack of national policy and recognition of local government system in the Kenyan constitution compromised greatly the development of local government as

the national politics favoured the provincial administration in which they had full control from government headquarters in Nairobi. Local government system was established through the Act of parliament "Local Government Act Chapter 265" and therefore the system did not have strong foundation as the Act could be amended to suit the interest of the ruling government by the minority vote in the parliament.

While these dual structures remain, there has been a gradual weakening of LAs; for instance, the Transfer of Functions Act of 1969, led to the transfer of major services such as primary education, health services, roads maintenance and major local revenue sources, to central government agencies. The situation in LAs has further been complicated by the creation of many more LAs, which now total 175, some of which are observed to be unviable entities. There are currently 175 LAs in Kenya Authorities made up of 1 City Council, 45 Municipal Councils, 62 Town Councils and 67 County Councils Each local government is divided into wards and each ward elects one councillor. The councillors elect from amongst themselves a mayor (in cities and municipalities) or a chairman (in towns and counties).

The councillors elected have 5 years term in the local council. Additional councillors are nominated by the political parties pro rata to their representation in the council. The mayor or the chairman position of the local authority is not an executive position but more of a ceremonial position. The local government chief officers which includes the Town Clerks (Chief executive Officer), Treasurer, Engineers etc are public services appointed by the central government LAs have been further weakened by the loss of local revenue sources, combined with increased demand for services, resulting in a situation where financial resources are no longer commensurate with services currently expected

of Local Authorities residents. The institutional, operational and technical capacities of LAs to deliver services are also weak.

1.2 Statement of the Problem

While new national budget laws in most of the countries envisage decentralization of fiscal policy including shift of service provision and spending responsibilities to the local level, few of them provide the necessary financial autonomy and revenue authority to local governments to fulfill those central mandates (Gibson 2003). This discrepancy between legal provisions for fiscal autonomy and actual conditions for its practical application is further deepened by the fact that many central governments still prefer to maintain control over major local taxes and other local revenue sources. So, while the breadth of spending responsibilities assigned to local governments is notable and includes many spending areas that have not been local responsibilities before (such as public education, health care, and other public services), the necessary revenue raising authority for financing those services is still missing (Bryon 2005).

In Kenya, service provision in Local Authorities includes maintenance of local roads, public markets, bus parks, slaughterhouses, municipal housing, solid waste management and social welfare programmes. A few local governments also provide services in respect of health and education. All these services provision are not mandatory required service provision by the local authorities as they are expected to be provided by the central government. This has contributed to huge contradiction as the public expects service delivery from their local government yet the finances for provision of such services are bestowed at the central government and its agencies at the provinces and districts level (LATF Report 2005).

Thus, with the local governments kept on a tight fiscal leash, the autonomy provided for in the new laws seems to be more symbolic rather than real (Bird, Wallich, 1995). Statistical data and research studies carried in several countries indicate that despite legislative changes, central grants to local governments and respective transfer systems also remain *ad hoc* and often, instead of providing for fiscal equalization, they are counter-equalizing (Marshall, 2009). Lack of local fiscal discretion, imprecisely defined spending responsibility, vague accountability requirements, as well as a general absence of revenue autonomy and authority to set local tax rates were and still are characteristics of local governments in the ex-socialist countries (Surazska, Blazek, 1997). Based on this review, the study sought to analyze the impact of intergovernmental fiscal transfer in Kenya and guided by the following research question: what is the impact of intergovernmental fiscal transfer in Kenya?

1.3 Objective of the Study

To determine the impact of intergovernmental fiscal transfer in Kenya

1.4 Value of the Study

This study explores some specific approaches in dealing with local finances based on the respective Kenya's fiscal legislation and municipal budget laws. It is also an attempt to link available statistical data to the legal bases of local government revenue systems in Kenya. Without adequate revenues and resources, local governments will neither be able to justify the expectations of the drafters of the reform nor of the wider public for an improvement of services, better living conditions, poverty alleviation, good governance and a more dynamic process of development. The study will thus enhance local governments in Kenya in planning process including budget preparation and authority to

generate their resources through levying various fees and charges as approved by the ministry of local government.

The importance fiscal decentralization in any economy cannot be downplayed. The study hopes to show a great improvement in services delivery to the public by devolving the funds to the lowest level of government system. This will enhance appropriate legal, administrative and institutional framework and as well relevant policies to be put in place to ensure the objectives set for decentralization are met.

CHAPTER TWO:

LITERATURE REVIEW

2.1 Introduction

This chapter presents literature review including theoretical and empirical review. Section 2.2 provides the theoretical review, section 2.3, the empirical literature, section 2.4; intergovernmental fiscal transfers in Kenya and section 2.5 the summary.

2.2 Theoretical Literature

2.2.1 Theory of Fiscal Federalism

The traditional theory of fiscal federalism lays out a general normative framework for the assignment of functions to different levels of government and the appropriate fiscal instruments for carrying out these functions (Richard Musgrave 1959; Oates 1972). At the most general level, this theory contends that the central government should have the basic responsibility for the macroeconomic stabilization function and for income redistribution in the form of assistance to the poor. In both cases, the basic argument stems from some fundamental constraints on lower level governments. In the absence of monetary and exchange-rate prerogatives and with highly open economies that cannot contain much of the expansionary impact of fiscal stimuli, provincial, state, and local governments simply have very limited means for traditional macroeconomic control of their economies.

Similarly, the mobility of economic units can seriously constrain attempts to redistribute income. An aggressive local program for the support of low-income households, for example, is likely to induce an influx of the poor and encourage an exodus of those with

higher income who must bear the tax burden. In addition to these functions, the central government must provide certain "national" public goods (like national defense) that provide services to the entire population of the country (Qian, 1997).

Decentralized levels of government have their raison in the provision of goods and services whose consumption is limited to their own jurisdictions. By tailoring outputs of such goods and services to the particular preferences and circumstances of their constituencies, decentralized provision increases economic welfare above that which results from the more uniform levels of such services that are likely under national provision. The basic point here is simply that the efficient level of output of a "local" public good (i.e., that for which the sum of residents' marginal benefits equals marginal cost) is likely to vary across jurisdictions as a result of both differences in preferences and cost differentials. To maximize overall social welfare thus requires that local outputs vary accordingly (Strumpf, 1997).

These precepts, however, should be regarded more as general "guidelines" than firm "principles." As has been pointed out in the literature, there is certainly some limited scope for decentralized macroeconomic efforts (Edward Gramlich 1987) and for assistance to the poor. In particular, there is a theoretical case for some poor relief at local levels (Mark Pauly 1973), and the fact is that state and local governments undertake a significant amount of redistributive activity. Intergovernmental grants constitute a distinctive and important policy instrument in fiscal federalism that can serve a number of different functions. The literature emphasizes three potential roles for such grants: the internalization of spillover benefits to other jurisdictions, fiscal equalization across jurisdictions, and an improved overall tax system. Intergovernmental grants constitute a

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2.2.2 The Rationale of Inter-Government Transfer

Sufficient revenue is indispensable for governments to fulfill their responsibilities. Broadly speaking, the revenues for sub-central authorities can be recruited from four sources: loans, charges, taxes and grants. David King analyzed the four resources as follows (Jackson, 1993, p168): The implication of loan finance and tax finance is identical if people were fully rational. The problem may occur when people migrate from one area to another area. The emigrants will benefit from the public spending without paying costs of loans. In addition, the loans are usually confined by the capital available. When providing the public services, both efficiency and equity factors need to be considered. Equity arguments generally favor charges. For it seems equitable for road costs to fall chiefly on the heaviest road users. On the other hand, efficiency requires zero-price tax-financed services. Due to public goods characteristics, excessive charges are not suitable. Local demands for public services vary from area to area. In order to meet the preferences, local governments should have their own expenditures.

From this point, it is important for sub-governments to determine their own policies of levying taxes. If they depend largely on the central government grants, they will lose control over local affairs. The effort-related grants can solve this dilemma. Under such a system, grants are transferred to any area according to how much the area raises its taxes. But, the system may encourage excessive or super-optimal spending. In addition, the

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central government is answerable to its voters nation-wide for how revenue and grants are spent. So, it is entitled to set up regulations concerning local authority services, and consequently limits the strength of local governments to make decisions by their wishes (Jackson, 1993).

2.3 Intergovernmental Fiscal Transfer in Kenya

While there exist several definition and interpretation of decentralization depending on practical applications, for the purpose of this report, decentralization will be defined in the context of devolution which is the most comprehensive form of decentralization in regard to fiscal decentralization. Devolution, in its purest form, entails the lower levels of Government having autonomous powers for the raising of resources and the identification of priorities for the use of those resources. The lower level of Government plans for the use of the resources and is responsible for the implementation of the plans. It also has autonomous powers over the hiring and firing of staff (LATF 2005).

The local governments in Kenya have a planning process including budget preparation and authority to generate their resources through levying various fees and charges as approved by the ministry of local government. The budget after being approved by the local assembly has to be subjected to final scrutiny by the ministry in charge of local government. This process has hampered autonomy of the local government in the context of devolution and in some cases delaying decision making at the local government. After enactment of Transfer of Functions Act of 1969 that led to the transfer of major services such as primary education, health services, roads maintenance and major local revenue sources, to central government agencies, most of the major revenue sources such as resident tax and individual taxes were transferred to central government while some were abolished thinning the revenue base of local government to uneconomically unviable

levels. This is huge contrast between Japan tax allocation system which allows local government to collect taxes such as Income tax, corporate tax, consumption, liquor and tobacco tax. The total local government expenditure in Kenya is less than 4% of the total government expenditure compared to 60% in Japan, indicating a highly centralized fiscal management system (LATF 2006).

Low local government expenditure can be attributed to non clear allocation of responsibilities between local government and central government. The Local Government Act Cap 265 sets out the mandates of Local governments giving different responsibilities to different classes of councils. The bulk of these are permissive rather than mandatory. The only mandatory responsibility of County Councils for example is "to provide for the burial of all destitute persons" and to ensure that "there are adequate a suitable arrangements for the burial or cremation of the dead."(S167). Many of the permissive powers have been eroded as they have been taken over by central ministries (education, health) or government agencies and authorities (water, roads), leading to confusion as to the responsibilities of the Local governments. Municipal authorities continue to operate schools and clinic for example under their permissive authority, alongside Government service outlet operated by the sector ministry. Classrooms are built by Municipalities in Ministry of Education schools and teachers are provided by the Ministry for Council schools (LATF 2008).

2.3.1 Local Government Source of Financing

Municipal Revenues: The revenue base of municipal authorities consists of locally generated revenues and transfers from the central government. The basic revenue sources for municipalities are defined in several statutes. These laws give local authorities the

right to raise revenue from a wide variety of sources upon receiving the approval of the Minister for Local Government (Smoke 1994). The municipal revenue base, therefore, is influenced a great deal by the central government through the granting or withholding of fiscal authority over potential sources. The main sources include: Property taxes collected in the form of land rates; Business tax referred to as the Single Business Permit (SBP); Motor vehicle parking fees; Market fees (for stalls and use of space in council markets); Rents from council buildings, housing estates and community facilities; Fees for various municipal services.

Intergovernmental transfers: The main transfers from the central government, already noted, are the RMLF, school bursaries from the universal free education fund, national HIV AIDS control fund, and the LATF. The main transfers that are reliable in terms of timing and amount are LATF and RMLF. These transfers have become an important part of local government finance in Kenya since the late 1990s. LATF is a direct block grant that is not earmarked for any specific local expenditure (LAR 2007:4) unlike RMLF which is earmarked for roads development, rehabilitation and routine maintenance. The annual budget process allows the LA to rationalize the actual deployment of the funds and enables MLG to review the work plans pertaining to the proposed expenditure priorities for each financial year. LATF allocations are based on an objective formula. It includes the overall population size of the LA (weighted at 60 percent), the urban population of the LA (weighted at 31 percent) and a basic minimum guaranteed lump sum allocation of Ksh.1.5 million roughly equal to 9 percent. Criteria for allocating RMLF resources include the length of classified roads and existing road conditions.

Both LATF and RMLF are generally predictable. While RMLF is earmarked for specific use, LATF comes with conditionalities, and therefore constrain LAs' autonomy in setting

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Both LATF and RMLF are generally predictable. While RMLF is earmarked for specific use, LATF comes with conditionalities, and therefore constrain LAs' autonomy in setting

local budget priorities (Smoke, 1994). Moreover, city authorities have argued that their share of income tax through LATF is fairly small, amounting to only five percent of national tax revenue during 2008/09. In nominal terms, the total amount of LATF funds allocated to LAs has risen from Ksh.1.0 billion in 1999/00, to Ksh.5.0 billion in 2005/06, and to Ksh.8.0 billion in 2007/08.

Yet another source of revenue is CILOR (Contribution In Lieu of Rates)—the tax that central government pays to LAs in respect of properties located within its tax jurisdiction. A key issue is that CILOR funds are inadequate and unpredictable, making it difficult for cities to plan for their utilization. Because of their poor financial health, cities are also not in a position to access funds from the market directly through either direct borrowing or through intermediaries.

2.3.2 Local Authority Transfer Fund (LATF)

The Local Authority Transfer Fund (LATF) derives its mandate from the Local Authority Transfer Fund Act. The Act was passed in 1998 and came into effect in 1999 when the first disbursement of Ksh 1.00 billion was distributed by the central government to the then 174 local authorities. The purpose of LATF is to supplement local government revenue so as to enhance their service delivery capacity. LATF is expected to do this through a three-prong approach viz: manifested improved local services delivery; streamlined financial management and debt reduction. LATF is a block grant which accounts to 5% of total income from both the individual and corporate tax. This is equivalent to approximately 2% of the total GDP. The LATF allocation criteria are basically population size of local government and the disbursement is based on the general and performance criteria. Each local government is allocated a minimum of

Ksh.1.5 million which was basically an equalization factor to cushion local government whose populations were too small especially in small town council. This factor is no longer meaningful since the total LATF amounts have increased over the years and therefore insignificant (LATF 2009).

2.4 Empirical Literature

In most countries, there are clear divisions between local and central governments. The local government usually provides services based on local interests, such as local roads, water supply, parks, and recreation facilities. As for the central government, it is mainly in charge of defense, diplomatic relations, motorways, etc. In some cases, where benefits extend beyond local boundaries, like education and health care, the responsibilities are often in the hands of both levels of governments.

The rational division of services is determined by economic and political factors, and also related to the historical relationship between different levels of governments. The four main economic roles of a government are the allocation, distributive, regulative and stabilization roles (Bailey 1995). Among these roles, resource allocation is mainly the concern of local governments, while income distribution and stabilization are undertaken by the central government. Regulatory function is done primarily by the central government (Oates 1972; King 1984).

The effects of grants on grant recipient spending range from no effect/ statistically insignificant effects (full displacement) to a \$0.60 effect of a \$1 increase in grants (flypaper effect). As expected, the effect of an increase in income on local public expenditure is much lower (\$0.03—\$0.10). Most of the estimates of the effects of general-purpose non matching grants do not account for the endogenity of the grant

variables in their estimation procedure. These estimates may therefore not be consistent and could be upward biased, given the rationale provided by Knight (2002) regarding the endogeneity of the non matching aid. The studies of the effects of general-purpose non matching grants for us on a variety of relevant fiscal issues. A commonly neglected issue in estimating the effects of intergovernmental grants is the distinction between the long-term and short-term effects of grants. Gramlich and Galper (1973) introduce the dynamic adjustment of state and local spending to changes in grants. They estimate the long-term impact of all state exogenous resources, including federal lump-sum transfers on state and local spending, at $0.43 (the corresponding impact of private income is $0.10). This effect is substantial larger than the short-term effect, which is not statistically significant.

Including political and institutional variables in the grant recipient's expenditure equation and disaggregating grant recipient's spending categories suggests that the flypaper effect comes from various sources (Craig and Inman 1986). A $1 increase in federal lump-sum grants leads to a $0.09 (not statistically significant) increase in state revenue; the private income impact on state government revenue is $0.03. A $1 increase in general-purpose non matching grants increases state welfare expenditure by $0.09. It has a statistically insignificant effect on state education expenditure and increases other state expenditure by $1.21 (a large flypaper effect). Grossman (1989) estimates the effect of state grants to local governments on state own-source expenditure (—$0.17, or an elasticity of —0.08 at the mean). The results are the estimated effects of federal general-purpose non matching grants on state own-source (direct) expenditure of $1.14. Gamkhar and Oates (1996) estimate the effects of increases and decreases in federal grants to state and local governments in the United states, considering federal non welfare grants and using a two-step least squares estimation technique. They find a grant effect of $0.60—much higher

than the effect of private income of $0.27 (all grant types other than open-ended matching grants are treated as non welfare grants). They find no asymmetry in the response to increases and decreases in these grants.

Baretti, Huber, and Lichtblau (2002) estimate the effects of equalizing transfers from federal to state governments in Germany (not statistically significant) and the accompanying (statistically significant) effect of an implicit tax on state revenues (-$0.007). The effect of the implicit tax on state revenues suggests a strong displacement effect of the equalizing transfer program in richer versus poorer jurisdictions. Bergstrom, Dahlberg, and Mork (2004) examine federal grants to municipalities in Sweden and the effects on municipal employment of converting from specific-purpose to general-purpose non matching grants in 1993. They examine whether here is a differential in the effect on municipal employment of grants relative to private income. The estimated effect of grants ($0.63 before 1993, $0.33 after 1993) and private income ($0.17) suggest that the conversion from specific- to general-purpose grants has reduced the effects of general-purpose non matching grants on municipal employment generation in the local economy, but it is still larger than the marginal effect of private income. However, the stimulus to municipal employment by an increase in grants, measured by the elasticity's, is relatively small, both before (0.06) and after (0.03) the reforms.

Craig and Inman (1982) find that resources displaced in education by the receipt of education grants are transferred to other public service needs, such as welfare and other local services, as well as tax reduction. Their estimates suggest a $0.43 marginal impact of lump-sum federal education aid to states, with the remaining portion of $1.00 of federal aid going to welfare ($0.09), other expenditure ($0.09), and tax reduction ($0.39).

Gordon (2004) finds that federal education grants for income-disadvantaged students initially increase total school district revenue and instructional spending (grant coefficient of $1.41) but that the initial effects are completely displaced by the third year (the grant coefficient is not statistically significant). The fungibility of resources causes a decline in local revenue (in the third year) and other changes in the intergovernmental grant structure at the state level. Gordon points out that despite the insignificant changes in instructional spending as a result of the grant, federal mandates regarding maintenance of effort restrictions are followed to the letter by the jurisdictions receiving federal grants, essentially because the federal maintenance of effort restrictions is relatively broadly defined and consequently not binding at the local level.

Soft budget constraints that allowed regions to spend more than their revenues without any credible punishment from the federal government are being restricted in a number of countries with stricter financial policy requirements and, in a number of cases, reductions in the amount of the federal grants. Levaggi and Zanola (2003) estimate the response of regional health care expenditures in Italy to different sources of funding (in particular non matching health care grants). They test whether there is asymmetry in the response to increases and decreases in these grants and examine whether the soft budget constraint is affecting the expenditure response of the grant recipient. They find that in the presence of a soft budget constraint, the estimated marginal effect is $0.84 for grants and $0.01 for private income—a large flypaper effect. These effects are higher than the effects of grants in a specification without a soft budget constraint.

Levaggi and Zanola (2003) find that the asymmetry in response to grants results in a strong retrenchment-type asymmetry when grants are decreased—referred to as a "super

flypaper effect"—when the soft budget constraint is ignored. A super flypaper effect" is observed when a decrease in grants causes the grant recipient's expenditure to decrease by more than the decrease in grants.6 However, controlling for the soft budget constraint, Levaggi and Zanola observe a milder form of retrenchment: grant recipient's expenditure decreases by more than the symmetric effect but by less than the decrease in the grants. Several papers address the specific-purpose open-ended matching grants issue (Moffitt 1990; Shrodcr 1995; Ribar and Wilhelm 1996, 1999; Baker, Payne, and Smart 1999). In all of them, increases in welfare spending are attributable to an increase in recipients or an increase in benefit levels. The price of welfare for the state is determined by the federal share in state spending s and the recipiency ratio (the ratio of recipients (R) to taxpayer population (N), or R/N); the price is measured by (1 — s) 1< RIN. States are also sensitive to the benefit levels provided by their neighbors and often use non income restrictions on recipients to adjust to price changes (Baicker 2005).

One of Moffitt's contributions to this literature is his estimation strategy for measuring income and price elasticity with respect to benefit levels per recipient. He proposes an estimation technique that accounts for the nonlinear budget constraints created by the AFDC program's matching rate policy (Moffitt 1984). Unlike in his 1990 paper, where he considers cross- sectional data for 1960, here he simplifies the matching rate variable by considering the value of the 1960 matching rate as the rate applicable at the mean value of benefits. Using data from 1960, he comes up with an income elasticity of 0.98 and a price elasticity of 0.17

Baicker (2005) decomposes the price and income elasticities with respect to benefit per recipient and recipients per capita by estimating two separate equations. She estimates the

cross-price elasticity between benefits and recipients, correcting for the endogeneity of the federal matching rate variable using simulated state AFDC shares and federal contributions—A strategy that overcomes some of the problems of endogeneity and weak instruments used in earlier studies. Baicker finds that the price elasticity with respect to benefits is —0.38 and the price elasticity with respect to the number of recipients are —0.28. While the price elasticities from separate equations for benefits and number of recipients are slightly higher in absolute terms than the estimates obtained from previous studies, she finds that the cross-price elasticities between the level of benefits and the number of recipients are also positive and statistically significant.

The price elasticity estimates reported in previous studies do not account for the cross-price elasticities between benefits and recipients and are therefore misleading (Baicker 2005). For total AFDC spending, the income and price elasticities of benefits are 1.33 and -0.3 1; the elasticity of total spending with respect to recipients is not statistically significant. The conversion from open-ended matching AFDC grants to TANF block grants effectively raised the price of both benefits and recipients by about 120 percent. Based on the estimated elasticities, Baicker predicts a 40 percent decrease in welfare cash assistance expenditure.

The Canadian experience with conversion of federal welfare grants from open-ended matching grants to a closed-ended block grant is useful because the conversion was undertaken in just 3 of Canada's 10 provinces. Baker, Payne, and Smart (1999) studies the three provinces that were affected by the conversion, using the unaffected provinces as a control group for other changes in the environment that coincided with the imposition of the cap. They predict that over the medium term, the "cap on CAP" policy

in Canada will reduce the growth rate of welfare expenditure by 8—9 percent below the (predicted) levels had the program not been capped. They find that the downward adjustments in total welfare spending by the affected provinces to meet the caps were made by reducing the growth in beneficiaries, changing the eligibility requirements, monitoring, providing supplementary benefits, and changing the classification of beneficiaries, not by adjusting benefit rates.

The key features of specific-purpose closed-ended matching grants are the conditions these grants impose with respect to the programs on which the money has to be spent, the matching rate, and the upper limit on the grants. The conditions attached to the grants create a piecewise linear budget constraint that requires a special two-step estimation technique (Moffitt 1984). In the United States, own spending on the program by the grant recipient is greater than the upper limit on the grant in most cases (Bezdek and Tones 1988). Therefore, the grant has a marginal effect similar to a non matching grant (Gamkhar 2000, 2003; Knight 2002).

Other researchers contend that the price and income effects of closed- ended matching grants are endogenously determined. They have developed and implemented empirical tests for this phenomenon, referred to as the fungibility hypothesis. The studies taking this approach treat the price and income changes caused by specific-purpose closed-ended matching grants as unknown parameters (McGuire 1973; Shah 1989; Zampelli 1986). Knight (2002) considers a symmetric response model but corrects for the potential endogeneity of federal highway expenditures(essentially reimbursements of state and local spending). He finds that the impact of $1 of federal highway expenditures on state highway spending (including grant funded spending) varies from $0.33 to $0.12.

Considering grant conditions as endogenous and fringible, McGuire (1973) explains local government response to federal grants in the United States, finding strong evidence of flingibility. About 64—69 percent of U.S. education grants and 76 percent of non education grants are fungible. McGuire also observes a positive trend in fungibility over the 1 964—7 1 period, confirming that bureaucracies are becoming increasingly proficient at circumventing nominal restrictions on grant use. Applying a similar model to explain city governments' response to provincial transportation assistance in Alberta, Canada, Shah (1989) finds no statistically significant evidence of fungibility. Zampelli (1986) finds that the fungibiity parameter on U.S. state aid is statistically insignificant. McGuire (l973, Shah (1989), and Zampelli (1986) examine the impact of aid from different levels of government. McGuire's study considers federal aid to local governments; Shah and Zampelli consider provincial/state aid to localities. The results of these studies could be interpreted to suggest that fungibility varies directly with the degree of separation between the grantor and the recipient. Federal assistance to local governments is more fungible than state assistance as the federal government has less ability to monitor local fiscal behavior.

These studies produce very different findings on the flypaper effect. McGuire's results support the phenomenon, Zampelli's do not. In Shah's study, the phenomenon has no relevance, since the upper limits on matching grants cannot be reached due to their closed-ended nature. Shah finds that $1 of closed-ended matching grants induces about $3 in local self- financed expenditure in the case of transportation. His results show that while both categories of grants (transportation and non transportation) have positive effects on local self-financed expenditure on transportation, they have a negative effect

on self-financed non transportation expenditure; the combined effect of grants on total expenditure is not statistically significant.

2.5 Summary

This chapter synthesizes the theoretical and empirical literature to explain the divergence between actual results and theoretical predictions. It shows that the actual results obtained depend on the specific design of the grant and implementation mechanisms; the nature of political and fiscal institutions that guide public spending including fiscal rules; and the nature of political and fiscal competition within and across jurisdictions, horizontally and vertically. The empirical work on the impact of grants does not always substantiate the predictions of the theory. Several studies suggest that the portion of general-purpose grants retained for greater local spending tends to exceed local government's own revenues relative to residents' income. Grant money tends to stick where it lands. Thus even general-purpose transfers can stimulate local expenditures more than predicted by the theory.

Estimation of the effects of grants on grant recipient's spending behavior has been riddled with problems. These include the endogeneity of the grant variable in the expenditure equation; the complexity of grant mechanisms, such as closed-ended matching grants, which create nonlinear budget constraints that make linear estimation techniques inappropriate; omitted variables, particularly the variables and model specifications that take into account the intricate grantor conditions on grant programs and the omitted non purchased inputs in the demand for public goods (these are not directly observed in government budgets, but their omission from the estimated equations can bias the grant effects); and questions about the symmetry of the response of grant

recipient's spending to increases and decreases in grants. Lack of local fiscal discretion, imprecisely defined spending responsibility, vague accountability requirements, as well as a general absence of revenue autonomy and authority to set local tax rates were and still are characteristics of local governments in the ex-socialist countries (Surazska, Blazek, 1997). Based on this review, the study seeks to analyze the impact of intergovernmental fiscal transfer in Kenya.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter highlights the methods and procedures used in carrying out the study. It includes the following; section 3.2 presents survey research design; section 3.3 presents the population; section 3.4 presents sampling frame and technique used; section 3.5 entails data collection methods (instruments and procedures); while section 3.6 presents data analysis, Conceptual and analytical model as well as data presentation methods.

3.2 Research Design

The study used survey research design. Phil (1996) says that descriptive research studies are designed to obtain information concerning the current situation and other phenomena and wherever possible to draw valid conclusion from the facts discussed. This was a survey research to explore the existing status of two or more variables at a given point in time. In this study, the researcher preferred to carry out survey on impact of intergovernmental transfer using a relationship model. This design is suitable for this study since through data collection and analysis draw conclusions based on the findings.

3.3 Population and Sample

Borg and Gall (1999) define population as all the members of a real or hypothetical set of people, event or objects to which a researcher wishes to generalize the results of the study. The population of this research consisted of 40 local authorities in Kenya.

3.4 Data and Data Collection Techniques

The researcher utilized secondary sources to collect the data. The sources were obtained from the treasury and the ministry of local government. Secondary sources included, financial statements including the operational budgets of the council for a period of 5 years (2005-2010) and including internet resources, and publications.

3.5 Data Analysis

Data analysis is the process of bringing order, structure and meaning to the mass of information collected. It involves examining what has been collected and making deductions and inferences Kombo and Tromp (2006). Qualitative data was analyzed using content analysis techniques. For quantitative, descriptive statistics, percentages and frequencies were derived and used. Presentations were done by use of tables, graphs as well as charts. Items from the open-ended questions were analyzed and organized into themes and then presented in narrative form.

3.5.1 Conceptual model

The relationship among the variables is estimated using a function:

LGE = f (GR, PI, TP) .... (1)

GR = grant

TP= Tax price, Median or mean income

PI =Private income

LGE =Local government expenditure

The size of the coefficient of the grant variable (expected to be positive) measures the responsiveness of local expenditures to the intergovernmental grant. Comparison of this coefficient with the income coefficient is used to draw inferences, such as the flypaper effect.

3.5.2 Empirical model

local expenditure postulates the level of local government expenditure as a function of determinants of the demand for public goods (local government expenditure serves as a proxy for such demand). In a typical case, the set of determinants include grants, private income, tax price, and other relevant independent variables. The size of the coefficient of the grant variable (expected to be positive) measures the responsiveness of local expenditures to the intergovernmental grant. Comparison of this coefficient with the income coefficient is used to draw inferences (Levaggi, etal 2003.). Based on this, t;he study used a regression model to predict the extent to which the identified independent variables affect the dependent variable. In this case, SPSS version 18 was used in regression analysis and computation of coefficients. The regression line is represented by the following equation:

$$LGE = \alpha_0 + \beta_1 GR + \beta_2 PI + \beta_3 TP + e_t \quad \text{...(2)}$$

Where;

LGE =Local government expenditure

GR = grants

Alpha $_0$ = this is the Y-intercept which is a constant (β_1............ β_3 coefficients)

e_t = Error term

TP= Tax price, Median or mean income

PI =Private income

3.6 Data validity and reliability

The study applied construct validity. It determines the degree to which a measure relates to other variables as expected within a system of theoretical relationships. Reliability is a measure of degree to which a particular measuring procedure provides consistent results or data after a repeated trial (Gay 1992).

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents data analysis and interpretation. The objective of the study was to determine the impact of intergovernmental fiscal transfer in Kenya. Data was collected from a sample of 40 local authorities in Kenya- from the treasury and the ministry of local government.

The data sources included financial statements, operational budgets of the councils for a period of 5 years (2005-2010) as well as internet resources, and publications. Section 4.2 presents the summary statistics; section 4.3 the estimated or empirical model; 4.4 is the discussion of the findings while 4.5 presents the summary.

4.2 Summary Statistics

Table 4.1: Descriptive Statistic of the Data

Items	2007	2008	2009	2010
Grants				
N	40	40	40	40
Minimum	604.4	788	2,636.78	4,044.00
Maximum	329,073.61	269,730.84	353,367.49	449,676.00
Mean	24,509.52	28,258.73	32,228.52	38,285.43
Std. Deviation	33,508.58	37,401.74	40,198.55	47,555.05
tax price				
N	40	40	40	40
Minimum	66,050.00	181,586.52	222,399.52	154,566.00
Maximum	749,874.04	975,556.54	1,280,997.43	1,303,941.00
Mean	262,546.80	414,699.75	493,368.91	549,040.26
Std. Deviation	113,942.08	153,640.54	186,950.28	205,872.41
Private income				
N	40	40	40	40
Minimum	88,759.57	88,759.57	199,503.32	200,471.70
Maximum	1,125,045.23	1,271,641.07	1,624,534.56	1,866,522.13
Mean	355,107.45	455,792.05	513,691.59	610,786.32
Std. Deviation	173,305.50	186,217.11	211,541.39	264,907.33

The relationship between grants, tax price and private income on the Local government expenditure, theoretically explained that government spending could affect the regional economy through the growth of the sector-sector and regional revenues. Further increase in the local economy will have an influence on local income especially local revenues.

A descriptive of the variables are presented in Table 4.1. It shows the data description of the grants, tax price, and private income. Grants have uneven distribution that can be seen from the comparison between the mean and standard deviation. In 2005, an average of grants is 24,509.52 and the standard deviation is 33,508.58. This comparison showed that there still exists a great variation among local authorities. The large variation exists because the value of standard deviation is greater than the mean. In 2008, the mean was 38,285.43, the standard deviation is 47,555.05, and this still shows a great variation.

Therefore, it can be said that the changes that led to the improvement of distribution has not occurred, and a very large variation between regions is still happening. The results also show that there is no great variation in the distribution. Private income is expected to ensure regional economic growth, which also experienced a similar distribution with tax price. During 2005 to 2008, the average value of private income of the budget is always greater than the value of standard deviation. This illustrates that the variation between local authorities is not too big.

4.3 Estimated or Empirical Model

4.3.1 Correlation analysis

The Pearson product-moment correlation coefficient is a measure of the strength of a linear association between two variables and is denoted by *r*.

Table 4.2: Correlation Results

		grant	Tax price	Private income
grant	Pearson Correlation	1		
	Sig. (2-tailed)			
	N	40		
Tax price	Pearson Correlation	.874**	1	
	Sig. (2-tailed)	.000		
	N	40	40	
Private income	Pearson Correlation	.727**	.579**	1
	Sig. (2-tailed)	.000	.000	
	N	40	40	40

**. Correlation is significant at the 0.01 level (2-tailed).

The researcher used the Karl Pearson's coefficient of correlation (r) to study the correlation between the study variables. From the findings, it was clear that there was a high positive correlation between the variables i.e. tax price and grant (.874), between Private income and grant (.727), and between Private income and Tax price (.579).

The researcher conducted a simple regressions analysis to determine the influence of each of the three variables (grant, Tax price and Private income) on Local government expenditure (LGE). The following are the findings

Table 4.3: Model of fitness results

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
Grants	0.713	0.509	0.499	0.156
Tax price	0.735	0.540	0.48	0.166
Private income	0.91	0.82	0.72	0.147

Table 4.3 above shows the model of fitness results. From the findings, grants had an R^2 of 0.51; tax price had an $R^2 = 0.54$; while private income had an $R^2 = 0.82$. Thus the independent variables are positive and significantly affect budget Local government expenditure. where private income explain the highest variance in local government expenditure.

Table 4.4: Analysis of Variance

Model		Sum of Squares	df	Mean Square	F	Sig.
Grants	Regression	0.04	1	0.047	14.761	.000a
	Residual	1.46	39	0.003		
.	Total	1.50	40			
Tax price	Regression	0.03	1	0.033	10.155	.001a
	Residual	1.47	39	0.003		
	Total	1.50	40			
Private income	Regression	0.01	1	0.014	4.268	.038a
	Residual	1.49	39	0.003		
	Total	1.50	40			

From the table the F statistics for the three variables are small (less than 0.05). From these findings each of the predictor, variables (Grants, Tax price and Private income) explain variation in the dependent variable (local government expenditure). Therefore, we accept the Hypothesis that all the population values for the regression coefficients are not 0.

Table 4.5 Regression Analysis Results

Model	Unstandardized Coefficients	t	Sig.
	B		
1 (Constant)	10.43	56.3372	0.00
Grants	0.276	14.0284	0.00
Tax price	0.328	14.921	0.00
Private income	0.772	29.815	0.00

Table 4.5 above shows the results of regression tests:

From the results the equation becomes;

LGE = 10.43+ 0.276 GR+ 0.328PI + 0.772TP

From the equation, grants is positive significantly influence the Local government expenditure with, B = 0.276; tax price is positive and significantly affect local government expenditure with B = 0.328 while private income is positive and significantly affect Local government expenditure with B = 0.772. Thus grants, tax price and private income significantly influences Local government expenditure

4.4 Discussion

Empirical test results indicate that the local government expenditure is positive and significantly influence the inter-government fiscal transfer. These results are in accordance with the recommended and stipulated by the national regulation (Sidik & Kajatmiko, 2004), and the results of empirical studies by Lewis (2005). However, some researchers (Brojonegoro, 2004; Bayhaqi, 2004; Firdausy, 2004) argued that the local governments are still shrouded in various capacity constraints. Brodjonegoro and Mahi (2003) argued that local governments have no significant capacity. While Firdausy (2004) argued that fiscal decentralization, have implications for the emergence of local taxes that have proliferated, levy a burdensome and restrictions on business and trade. Similarly, Pambudi (2008) points out that inter-governmental fiscal transfer brings about interference to the business, taxes and levies ignore the creation of a conducive of business climate.

Meanwhile, the results of this study suggest that the local fiscal capacity, which is reflected from the local own revenues have not distributed evenly across the local authorities. Inequality of the capacity was still pushing the local governments to impose tax efforts. These efforts are impeded the local economic growth.

Local own revenue, and grants and transfer, each individually, have a significant effect on the local government expenditure. This finding is also supported by previous researches (Lewis, 2005; Sidik & Kajatmiko, 2004; Brodjonegoro, 2004). Local own revenue is a representation of the capacity of local financial resources. As a regional resource, this includes natural resources, human, and technology. The results of local resource management, whether for business purposes or for the purposes of infrastructure development, have an effect to the fiscal capacity for both locally, and nationally.

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Local fiscal resources are relatively more limited (Bayhaqi, 2004) and is very critical to developed, as it relates to economic activity (World Bank, 2007). The higher local taxes imposed on society, certainly can reduce the ability to expand their businesses (Pambudi, 2008).

Implications of fiscal resources held by the government are the existence of a very high level of local dependence on the transfer (Lewis, 2005; Sidik & Kajatmiko, 2004). Although Lewis (2005) suggests that there is no empirical evidence that reliance on transfers cause local governments to develop new tax sources. However, the results of several studies (Firdausy, 2004; Pambudi, 2008) show different things. Recent observations (Pambudi, 2008) still shows there are still many regions levies in the form of user charges that are not clear designation.

Simultaneously both the independent variable local own revenue, and grants and transfer has a positive and significant impact on budget performance. This finding is supported by previous researches (Lewis, 2005; World Bank, 2007; Asian Development Bank, 2004). Under the law, that local own revenue is used to finance the needs for public services, while grants and transfer is used to help the fiscal capacity of improving public services and regional development (Sidik & Kajatmiko, 2004). However, in fact, the regions relies heavily on financial transfers (Lewis, 2005), and significant sources of income in the hands of central government (Firdausy, 2004; Bayhaqi; 2004). Therefore, it is unavoidable to make the transfer of local government as the main financial sources. This means that the effort of the national government to encourage the local own revenues have not been achieved.

Finally, it can be concluded that the experience of regional autonomy with fiscal decentralization policy has encouraged local governments to increase regions fiscal capacity. However, the unavoidable dependence of local governments to transfer from national government is still very high. The situation is still carrying the potential conflict of interest between the two levels of government, particularly in setting priorities for programs into the budget.

The local own revenue is a potential source that is effective in promoting the performance of the budget. The mediator's role of grants and transfer, in fact, weaken the significant of local own revenue to the budget performance. This is because regions fiscal capacity is concentrated merely on the grants and subsidy, but effective financial management is on the local own revenue.

4.5 Summary

This chapter offered the analysis of data. From the findings. sources of revenues for the local authorities include European Union (EU) Poverty Reduction Fund Grant. charges. fines and interests, advertising fees and planning. Most Local Authorities are showing significant levels of capital expenditure and debt resolution payments.

Empirical test results indicate that the local government expenditure is positive and significantly influence the inter-government fiscal transfer. Meanwhile. the results of this study suggest that the local fiscal capacity, which is reflected from the local own revenues have not distributed evenly across the local authorities. Inequality of the capacity was still pushing the local governments to impose tax efforts. These efforts are impeded the local economic growth.

CHAPTER FIVE

SUMMARY AND CONCLUSION

5.1 Introduction

This chapter presents summary of findings, conclusion and recommendations. The aim of the study was to examine the relationship between local government expenditure and inter-governmental fiscal transfer.

Thus, this section involves a summary of findings conclusion and recommendations based on the main objective of the study as follows; section 5.2 presents summary of the study, 5.3 conclusions; 5.4 limitations of the study, while 5.5 recommendations for further research.

5.2 Summary of the study

Although fiscal decentralization is not a new phenomenon, the practices of expenditure and revenue assignment across the levels of governments are varied from local authority to the other.

In order to resolve the vertical fiscal gap and imbalance, policies related to reassign the functions, decentralize tax power to the sub-national governments, tax-base sharing (give autonomy to sub-national governments to levy complementary rates on a national tax-base) etc need to be revised and changed time to time. Moreover, the government should adopt revenue sharing policy and provide formula based unconditional grant to the lower level of governments. The tax and revenue sharing are normally used to tackle the fiscal gap between national and sub-national levels.

Revenue sharing from the government to regional and local governments is necessary for minimizing the vertical imbalances and horizontal inequities. Vertical imbalances arise when regional and local governments have more expenditure responsibilities than the revenues assignments. Horizontal inequities happen due to the different fiscal capacities of regions and local governments. Both of these issues must be dealt at the central government level; although regional governments could play a mediating role with local governments. In order to address the vertical imbalances and promote the fiscal decentralization, revenues collected from VAT, certain natural resources, and Personal Income Tax and certain minor taxes by the government should have been shared to the sub-national levels by designing an effective tax sharing system. The "piggybacking" approach would be appropriate for the tax sharing to sub-national levels.

From the findings, the pattern of local government expenditure is, to some extent, not oriented towards poverty alleviation in terms of coverage, scale, design, spending method and transparency. Therefore, in order to engage local bodies in alleviating poverty, it should be reoriented in future. As a result, local bodies can be helpful in poverty reduction. All the functions relating to poverty reduction should be devolved to local bodies and the expenditures should be designed considering the poverty status in the lower level.

5.3 Conclusion

The concept of fiscal decentralization is being adopted and implemented globally after 1990's whether the political system of governance is federal or unitary. Necessarily, expenditure decentralization is given more priority rather than revenue decentralization in many countries of the world. For effective implementation of fiscal decentralization, authorities on fixing the bases and rates of taxes should be devolved to sub-national

governments. The financial independency of local government bodies in Kenya on central government has increased year by year. For stabilization and fiscal equalization/redistribution purposes, general practice is that the central government should collect 50% or more of total taxes, and those taxes should be from a broad-based elastic tax bases (such as income or value added).

For horizontal equity (among local governments) and vertical balance (matching revenues and expenditures), the government should have at least one tax that is shared with sub-national governments on a formula basis which takes into account fiscal capacity and tax effort. Although the degree of fiscal equalization is a political question, it is not probably desirable and possible to attempt for 100% equalization. It is better to provide certain incentive for regional and local governments to develop their own-source revenues because it simply results in less revenue sharing from the national government. The lack of any equalization program often regards as one of the defects in the central system. Some combination of tax sharing and rate sharing (or piggybacking) could deal with the equity issues while not crippling national stabilization functions.

Regional or state governments could play a positive intermediately role by allowing the national government to deal with national disparities and inequalities whereas the regional governments will deal with local disparities and individual allocation needs. Regional oversight over local taxes may be important to ensure integrity and uniformity, especially if the local tax base is used in a formula determining fiscal capacity (e.g., assessed real property values). It can be said that the VAT might be a good-shared tax that could be collected at either the national or the regional level. The VAT is more stable than the income tax and thus provides a more assured revenue stream for regions and/or

local governments. Sharing natural resource taxes is appropriate because natural reserves are a national resource; yet, in another sense, the exploitation of those resources imposes costs on local governments. The property tax is a good local tax in. Business taxes, charges and fees are often closely related to specific services provided by state or local government and thus are good from a standpoint of allocation efficiency. Regional governments might rely on a piggybacked source of revenue, such as on a national income tax or VAT, or on excise taxes.

5.4 Limitations of the Study

The study had a few limitations. First, the study was conducted on 40 local authorities. This number is not fully satisfactory to generalize the findings on the relationship between local government expenditure and inter-governmental fiscal transfer in Kenya.

Secondly, the actual information gathered from the treasury was not sufficient. Thus other sources such as journal articles, books, news briefs, reports, were used. Thus, the exercise was rather time-consuming for data verification.

5.5 Recommendations for Further Research

Based on review of literature and data analysis, the following recommendations have been made for the further enhancement of the fiscal decentralization effort in Kenya.

The major four pillars of fiscal decentralization viz. expenditure responsibility, revenue assignment, inter-governmental fiscal transfer and borrowing need to be clearly defined and provisioned in the constitution so that local governance system would be ensured and promoted. In order to increase the self-reliant rate of sub-national governments and enhance the service delivery mechanisms, fiscal decentralization needs to be ensured by devolving more fiscal autonomy to sub-national governments.

The share of revenue by the local government bodies are found much less as compared to their expenditure responsibilities. Therefore, to address this problem, the theory of ***'finance follows functions'*** should be followed strongly. The Government has to increase the volume of local development expenditure for positive impact on local government expenditure. The participatory planning and inclusive decision-making processes should be followed while preparing annual and periodic plan of local government bodies. In addition, more autonomy to fix tax base and rate at local level needs to be devolved to local governments for effective mobilization of resources. The local government is the vehicle to implement the activities relating to poverty reduction at local level. Therefore, the expenditure assignment should be designed accordingly.

The performance based grant system has promoted the participatory planning process and encouraged local government bodies to perform works more effectively and transparently. It has also supported them to make more responsible and accountable for service delivering. So, this system is highly recommended to be continued and promoted. The role of Local government needs to be clearly defined and directed towards the facilitation and monitoring of the activities to be carried out by the local bodies. Moreover, urgent need is that the information system including financial database of needs to be updated timely. Likewise, their role should be focused on capacity development, infrastructure development, and coordination to the local government' activities.

The placement of elected representatives in the local government bodies is the very important precondition in promoting and strengthening the governance system including

fiscal decentralization for effective, transparent and accountable service deliver at the local level. To end, the strong political commitment in principle (policy) and encouraging environment to implement the policies at both central and sub-national level are the preconditions to effectively execute the fiscal decentralization. People's representation through periodic election is extremely important to translate the policies into real practice for enhancing the fiscal decentralization. Moreover, the expenditure assignments among the levels of governments should be based on the principle of subsidiary so that inclusive participation and ownership of local people in decision-making process can be ensured.

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Appendix 1: Expenditures and Approved Budgets

ANNEX	III	EXPENDITURES	AND	APPROVED	BUDGETS	FOR
	LOCAL AUTHORITIES					
	FY 2005-06		FY 2007-08	FY2009-010		FY2011-12
	Local	Authority	Name	Budget	Actuals	actual
1	Nairobi	City	5,977,525,562	3,224,208,882	4,981,810,866	6,083,296,563
2	Awendo	TC	23,957,709	21,454,108	30,361,315	48,439,350
3	Baringo	CC	43,488,913	28,064,837	44,004,834	62,266,275
4	Bomet	CC	36,397,592	36,544,076	48,168,015	63,258,237
5	Bomet	MC	26,749,489	17,487,732	20,660,830	25,169,976
6.	Bondo	CC	35,577,979	26,241,228	40,521,098	59,308,458
7.	Bondo	TC	12,245,735	13,507,298	17,030,240	20,488,786
8	Bungoma	CC	76,653,387	43,198,883	88,775,900	132,369,998
9	Bureti	CC	34,419,035	41,173,467	40,942,849	56,293,121
10	Busia	CC	38,540,693	34,999,521	45,862,867	57,856,202
11	Busia	MC	38,841,618	26,646,482	50,255,902	56,616,989
12.	Butere-Mumias	CC	68,309,949	68,828,782	75,844,086	99,839,730
13	Chepareria	TC	3,736,242	2,816,185	5,561,445	4,962,028
14	Chogoria	TC	12,469,513	7,079,278	11,657,057	12,300,752
15	Chuka	MC	16,211,143	12,599,756	20,917,624	21,667,844
16	Eldoret	MC	226,830,714	254,441,783	348,949,235	369,697,027
17.	Embu	CC	25,338,834	23,605,591	31,720,815	41,514,891
18	Embu	MC	80,069,113	35,901,048	60,957,595	99,358,436
19.	Funyula	TC	6,675,831	4,360,561	4,976,071	6,319,529
20.	Garissa	CC	35,516,291	37,280,135	45,442,531	68,142,264
21	Garissa	MC	41,936,154	35,009,979	45,359,870	65,783,894
22.	Gucha	CC	27,223,856	37,508,967	42,407,180	62,546,463
23	Gusii	CC	32,921,800	36,573,562	46,062,036	69,246,210
24	Homabay	MC	40,607,744	30,568,404	42,906,835	58,321,813
25	Ijara	CC	9,114,541	10,394,766	11,780,803	13,922,533
26	Isiolo	CC	88,897,584	19,893,750	169,987,075	131,904,055
27	Iten-Tambach	TC	9,147,105	7,797,222	13,119,119	13,223,275
28	Kabarnet	MC	17,709,562	13,972,905	18,853,396	25,107,851
29	Kajiado	TC	15,790,747	9,362,104	15,326,117	18,612,002
30.	Kakamega	MC	62,643,089	59,686,503	78,950,446	92,601,710
31	Kandara	TC	4,933,991	5,070,919	6,381,331	7,731,488
32	Kangema	TC	10,278,735	8,347,604	11,108,408	12,288,648
33	Kangundo	TC	37,989,969	26,725,094	39,789,747	63,458,484
34	Kapenguria	MC	15,318,669	15,736,619	22,417,825	28,663,078
35	Kapsabet	MC	29,515,887	22,214,208	33,534,346	43,395,964
36	Karatina	MC	52,113,306	35,309,087	41,882,325	40,197,273