# INTERNAL DETERMINANTS IN COUNTY GOVERNMENT FISCAL SUSTAINABILITY IN KENYA: THE CASE OF NAROK AND NAIROBI CITY COUNTIES (2013-2016)

**BY**

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## DECLARATION

This research project is my original work and has not been submitted for any award in any university

Signature
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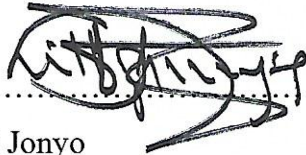
This research project has been submitted for examination with my approval as University Supervisor.

Signature……………….. Date 11/11/2020………………………………

Prof. Fred Jonyo

Supervisor

# DEDICATION

To my family Mercy, Justin, Olivia and Ruby, Parents Joel and Christina, brothers and sisters. It has been a while and worth it.

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## ACRONYMS

CADP: County Annual Development Plan

CBIRR: County Budget Implementation Review Report

CBROP: County Budget Review and Outlook Paper

CFSP: County Fiscal Strategy Paper

CIDP: County Integrated Development Plan

CILOR: Contribution in Lieu of Rates

CIPD: County Integrated Development Plan

CoK: Constitution of Kenya

CRA: Commission on Revenue Allocation

CRF: County Revenue Fund

FY: Fiscal Year

IBEC: Intergovernmental Budget and Economic Council

ICPAK: Institute of Certified Public Accountants of Kenya

IFMIS: Integrated Financial Management Information System

KIHBS: Kenya Integrated Household Budget Survey

LATF: Local Authority Transfer Fund

OCOB: Office of the Controller of Budget

PFM Act 2012: Public Financial Management Act of Kenya, 2012

RMLF: Roads Maintenance Levy Fund

# ABSTRACT

This study was concerned with internal determinants in county government fiscal sustainability in Kenya between 2013 and 2016. The first three fiscal years since the inception of devolved governance in March 2013 witnessed county governments struggle to meet their financial obligation and this catapulted them from one crisis to another leading to calls for more resources while at the same time calls for prudent fiscal management. The study's objectives included investigating the influence of county fiscal strategy on fiscal sustainability, determining the effect of non-adherence to fiscal responsibility laws on county fiscal sustainability, and ascertaining the influence of revenue capacity on county fiscal sustainability in Kenya.

The study found that majority of respondents concur that Nairobi City and Narok county governments face challenges including weak fiscal strategies, revenue inadequacy, inherent narrow revenue bases, unpredictable revenue allocation, lack of diversification of its revenue sources, and inflation of its recurrent expenditures all affecting their fiscal strategy. Secondly, the two county governments neither do not observe tax and expenditure limits from the Controller of Budget, do not adhere to balanced budget rules/requirement, lack fiscal discipline incentives in their revenue allocation, and a proper debt management plans. Lastly, the two county governments utilize antiquated local revenue collection measures, face higher vertical revenue gaps, do not promote accountability and transparency in fiscal management, and thus haplessly weak in revenue capacity. A few respondents believed the nascent devolved units require time to strengthen their fiscal capacities/strategies and compliance as all devolved functions were transferred to them with a bang by the Transition Authority.

Based on the findings, the study recommends that fiscal strategies be entrenched in all departments and with all the stakeholders. There is need for county government to totally adhere to fiscal responsibility laws as dictated by PFM Act 2012 and finally, Finally, county governments are urged to enhance revenue capacity by enhancing revenue collection measures, prudently managing intergovernmental transfers in service provision, embrace transparency and accountability, embracing IT in tax collection, properly prioritize spending needs, and enhance fiscal wealth to help cover government fiscal imbalances, and supplement the lowly performing local own source revenues.

# Chapter One
# Introduction

## 1.1 Background of the study

Fiscal sustainability, defined as the long-run capability of a government to consistently meet its financial responsibilities, reflects the adequacy of available revenues to ensure the continued provision of the service and capital levels that the public demands (Chapman 2008). It's a type of fiscal condition that allows a government to continue service provision now and in the future without introducing disruptive revenue and expenditure patterns (Gorina, 2013). It incorporates four magnitudes namely; liquidity, own-source revenue reliance, revenue flexibility and indebtedness. Liquidity measures a local government's ability to pay short-term obligations while relying on locally mobilized revenue or under reliance on intergovernmental transfers or other external sources. Revenue flexibility on the other hand encompasses capability to raise additional revenue in the vent of unanticipated fiscal shocks and indebtedness relates to the level of financial commitments i.e. maintain sufficient assets to cover its liabilities (Ryan, Robinson and Grigg, 2000).

Whilst examining challenges of managing local government finance in Nigeria, Coker and Adams (2012) found that local governments have dwindling revenue base, lacked autonomy in financial management, and bedeviled by corruption among others. They accredited poor financial status to over-dependence on intergovernmental transfers and tax evasion leading to lower revenue collection to meet both development and recurrent expenditures. Furthermore, local governments in Nigeria were found to lack qualified staff, had deficient account keeping, had poor account management and are not held accountable for its funding, suffered from political interference, and finally lacked transparency and accountability.

The 2010 Constitution of Kenya (COK, 2010) divided the territory into 47 counties and the subsequent general elections held in March 2013 established the 47 new County Governments as envisioned in Article 6 (1) and Schedule 1 of the Constitution. This was in line with the concept of devolution which was firmly anchored in the new Constitution. Devolution is one among several forms of decentralization namely; deconcentration and delegation. According to Rondinelli, Nellis and Cheema (1983), Deconcentration transfers execution of policy hierarchically to other points within the enterprise, such as a department, or to external branches of the same enterprise, such as regional branches. Delegation offers a

slightly stronger model of decentralization than deconcentration, such as in the government delegating responsibility to state corporations.

According to Martinez-Vazquez, McLure, and Vaillancourt (2006), devolution transfers duties and resources from the central to the subnational governments. In Kenya, devolution involves the division of political, administrative and fiscal functions and powers between the national government and each 47 county governments with the aim of enhancing service delivery. This was a departure from the centralist past as devolution is expected to promote efficient resource allocation, improving governance, accelerating economic growth, lead to poverty reduction, achieving greater gender equity, and empower weaker sections of society among many others. The fourth schedule of the Constitution of Kenya (CoK 2010) clearly demarcates the roles of the national and county governments. It empowers the county governments to choose on the use of resources allocated to them on health, education, sewerage, transport and infrastructure, access road construction and maintenance among others. On the same vein, it assigns specific revenue streams. The variance in resource endowment and the subsequent income streams has meant that county governments have different capability to finance the vast array of decentralized functions. Most county governments have narrow revenue base and chiefly rely on transfers from the central government.

Munyao (2018) found that the county government of Nakuru, Kenya did not pay creditors and suppliers on time besides delaying paying salaries and wages to its employees, relied on supplementary budgets to fund year-on-year expenditures, heavily depended on intergovernmental transfers for its operations, and earned value management analysis was concluded to be conducted to address the difference between the amount in the initial approved budget and what was approved for disbursement by the Controller of Budget.

During the period of study and even up to date, the Office of the Controller of Budget (OCOB) has reported rampant budget deficits and underperformance in local revenue collection resulting in county government's failure to adequately fund both recurrent and development expenditures. The Controller of Budget has noted in its annual report that all the 47 counties have performed dismally in revenue collection as evident in actual local revenue of Kshs.26.3 billion for the Fiscal Year (FY) 2013/2014, Kshs.33.85 billion for FY 2014/2015, and Kshs.35.02 billion for FY 2015/16 representing a performance of 48.5 per cent against the target of Kshs.54.2 billion, 67.2 per cent against a target of Kshs.50.38 billion, and 69.3 per cent respectively. Specifically, Nairobi City County, as the richest urban county, should ideally be collecting and meeting its local revenue targets but to the contrary, with a budget-

ary approval of Kshs.29.09 billion in FY 2015/16 it spent Kshs.23.95 billion broken down as Kshs.19.78 billion on recurrent expenditure (82.59 per cent) and Kshs.4.17 (17.41 per cent) on development expenditure contrary to the PFM act (2012) which stipulates around 30% be spent on capital projects. The county received Kshs.15.52 billion from the Exchequer and local revenue amounted to Kshs.11.71 billion all of which were spent at source also contrary to the PFM act. This is tantamount to fiscal indiscipline.

In terms of budget solvency, Narok County with an official budget of Kshs.8.31 billion in FY 2015/16 received Kshs.7.24 billion from the Exchequer broken down to Kshs.5.13 billion and Kshs.2.11 billion for the recurrent and development expenditures respectively. The budget deficits affect service delivery and lead to debt and fiscal discipline challenges. The scope of budgetary commitments has expanded significantly due to ambitious spending plans as exhibited in the County Integrated Development Plans. At the same time, revenue collected locally and also transferred from the central government does not match the need. This has created problems of fiscal imbalance and controlling government finances at county level leading to heavy indebtedness.

In terms of service level solvency, the rising need for basic services as stipulated in the COK 2010 and the lower growth of county government revenues to pay for those services contributed to high budget shortfalls, which in turn threatens the attainment of developmental goals. Their development expenditures have notably been lower than recurrent expenses composed of personal emoluments, operations and maintenance and other expenses. This is against the public finance principle which stipulates a certain percentage of county revenue should be allocated to development expenditure. Some have attributed this to devolution teething problems and external factors beyond their immediate control. However, some evidence points to a myriad of possible explanatory factors, including high levels of service needs versus inadequate funding, poor long-term planning, budget incrementalism, budget inefficiencies, inadequately funded national policies (i.e. wages), fiscal indiscipline, and weak budgetary controls.

## 1.2 Statement of the Problem

The issue of fiscal sustainability of decentralized government is not unique to Kenya. At the federal and state level in the United States, two supporting concepts of sustainability are important at the national level; the ability of government to service its debt responsibility

and to maintain current policies without running into bankruptcy (Gorina, 2013). This is influenced heavily by several factors both internal and external to the government.

In the Kenyan context, county governments became operational after the general election in March 2013 with FY 2013/2014 being the first full year of their financing. The county governments were envisioned in the new constitution to lead service provision in the immediate term, medium term and in the future. However, the first three fiscal years witnessed county governments struggle to meet their financial obligations and this catapulted them from one crisis to another leading to calls for more resources while at the same time calls for prudent fiscal management. As a testament of cash and budget difficulties, nurses and other county staff constantly went on strike/industrial actions to protest poor working conditions, delayed payments and promotions, unstocked pharmacies, inadequate personnel among other grievances as reported by the daily newspapers in Kenya. Furthermore, from 2013, county governments reported massive budget shortfalls thus unable to fund their expenditures leading to challenges to budgetary solvency; an element that hinder the quest of their financial sustainability.

The county government should improvise a fiscal strategy to remain sustainable while chiefly relying on national government equitable transfers amidst the high expectations and increasing demand from the population, suppliers and its employees as more and more functions were devolved as envisioned. County Fiscal Strategy Papers (CFSP) developed by county governments should adequately address the cash, budget and service level challenges that bedevil them. CFSP for the three fiscal years 2013/14, 2014/15 and 2015/16 did not help in addressing the long term fiscal sustainability challenge. This is evident from the Controller of Budget's in its annual CBIRR that all the 47 counties have performed dismally in revenue collection as evident in actual local revenue of Kshs.26.3 billion for the Fiscal Year (FY) 2013/2014, Kshs.33.85 billion for FY 2014/2015, and Kshs.35.02 billion for FY 2015/16 representing a performance of 48.5 per cent against the target of Kshs.54.2 billion, 67.2 per cent against a target of Kshs.50.38 billion, and 69.3 per cent respectively. This underperformance in local revenue collection does not board well in their endeavor to be fiscally sustainable.

The county government should adhere to its fiscal responsibilities of ensuring recurrent expenditure doesn't exceed the county governments' total revenue and allocating at least thirty per cent of the county budget to development over the medium term. County governments should adhere to the fiscal responsibilities principles as set out in Article 201 of the Constitution of Kenya of 2010 and in section 107 (2) of the Public Financial Management

(PFM) Act of 2012. However, this has not been the case. For instance, Nairobi City County received Kshs.15.52 billion from the Exchequer during FY 2015/16 and local revenue amounted to Kshs.11.71 billion all of which were spent at source contrary to the PFM Act 2012 which requires all locally collected revenue be deposited in the county revenue fund account and spending authorized by the OCOB. Furthermore, Narok county government had a budget deficit to a tune of Kshs.1.27 billion in FY 2015/2016 attributed to a supplementary budget of Kshs.8.31 billion funded through Kshs.5.29 billion as transfer from the National government and Kshs.1.75 billion as local revenue collection. This budget imbalance definitely affect sustainability and service provision.

In a bid to boost their fiscal capacity, county governments are required to maximize revenue collection by strengthening and reforming the revenue collection systems in a bid to meet their local spending needs. However, the Controller of Budget noted that local own source revenue collected were below what was collected from the defunct local governments. County governments struggled to grow their revenue at the same rate as expenditure if not faster. In FY 2014/15, Narok County performed relatively well in local revenue collection though one revenue stream contributes more than 80% of its total local revenue i.e. Maasai Mara game reserve by collecting Kshs.1.75 billion locally (74.8 per cent of its target). The OCOB reported a local revenue collection of Kshs.1.64 billion in the previous fiscal year (48.7 per cent of its target) and Kshs.1.54 billion in FY 2013/14 (41.6 per cent of annual target). This attests the low local revenue performance posted by the nascent Narok county government. As a fiscal capacity measure, both county governments ought to shift more resources from recurrent to development expenditure to promote sustainable and inclusive growth.

In addition, Nyanumba (2018), argued that little or no studies have been conducted specific to determinants of financial sustainability in a devolved set up like in Kenya. He further argued that the current county government's financial targets, as laid down in County Integrated Development Plans (CIPD), have proven over ambitious to be adequately sustained through county finances and allocations from the national government. From the foregoing, coupled with shortage of empirical proof on the new county governments fiscal sustainability, necessitated conducting this study. The central problem in this study was identifying the role and influence of fiscal strategy, adherence to fiscal responsibility laws and fiscal/revenue capacity in fiscal sustainability of the county governments in both Narok and Nairobi City county governments.

## 1.3 Research Questions

The study was steered by the general question: What are the internal determinants in county government fiscal sustainability in in Narok and Nairobi City counties between 2013 and 2016? The specific questions of the study were:

1. What was influence of county fiscal strategy on fiscal sustainability in Narok and Nairobi City counties between 2013 and 2016?
2. What was the effect of non-adherence to fiscal responsibility laws on county fiscal sustainability in Narok and Nairobi City counties between 2013 and 2016?
3. What was the influence of revenue capacity on county fiscal sustainability in Narok and Nairobi City counties between 2013 and 2016?

## 1.4 Objectives of the Study

The study broadly sought to analyze the relationship between internal determinants in county government fiscal sustainability in Narok and Nairobi City counties between 2013 and 2016. Specifically, it sought

1. To investigate the relationship between county fiscal strategy and the fiscal sustainability in Narok and Nairobi City counties,
2. To determine the relationship between non-adherence to fiscal responsibility laws and county fiscal sustainability in Narok and Nairobi City counties,
3. To ascertain the relationship between revenue capacity and county fiscal sustainability in Narok and Nairobi City counties.

## 1.5 Significance/Justification of the Study

This study is merited on both the academic and policy fronts. The successful fiscal performance of the county governments depends on proper, well instituted fiscal strategy, adherence to fiscal responsibility laws and enhancement of fiscal capacity relative to spending needs. This study, first, seeks to indulge us on the challenges to fiscal sustainability in the newly established county government of Narok and Nairobi City since 2013. A study on the internal determinants on the fiscal sustainability is timely since several counties across Kenya are struggling to meet employees, contractors, and supplier expenses with the little resources at their disposal. The study further aims at contributing to the existing body of knowledge for the sake of future researchers' reference in this area of research.

Secondly, this subject should be of great interest to all Kenyans and more so the policymakers. County governments are a key part of new governance and are tasked with providing key social services. Poor service delivery due to poor financial condition goes against the spirit of devolution in bringing services nearer to the citizens. This study may inform county government's officials and even independent commissions' staff in addressing the challenges faced in the implementation of county fiscal strategy, non-adherence to fiscal responsibility laws and fostering fiscal capacity. This will help the two levels of government to come up with better policies to ensure sustainability and avoid the overreliance of the county governments on the national governments transfers. Further, this will aid in proper planning of strategies that will enhance the mobilization of revenue in the counties.

## 1.6 Scope and limitations of the Study

The study examined the internal determinants in county government fiscal sustainability of County Governments in Kenya with attention drawn to Narok and Nairobi City counties between 2013 and 2016. It specifically studied the role of fiscal strategy, non-adherence to fiscal responsibility laws, and fiscal capacity in fiscal sustainability in the two budding counties of Nairobi City and Narok since their inception in 2013 and limited itself to three fiscal years since the advent of devolved governments in Kenya as the 2010 Constitution of Kenya in Article 190 granted parliament three years to enact all enabling legislations for counties to perform their devolved functions i.e. passed legislation for a phased transfer of all devolved functions over the three year period. The three fiscal years under this period are FY 2013/2014, 2014/2015 and FY 2015/2016.

Further, the study limited itself to two counties namely: Nairobi (industrial, urban, and most populous county), and Narok (marginalized, semi-arid area and strong own source revenue). The poverty index in both counties is below the national average of 46.6% with Nairobi at 22%, and Narok at 33.7%. (2005/06 KIHBS survey). The two counties mirror the remaining 45 county governments as established in Kenya since 2013 in terms of fiscal sustainability challenges.

In the two counties, the study targeted senior county executive, finance directors, constitutional bodies at the national level like CRA, OCOB and Treasury, citizens targeting 105 respondents. One major limitation was failure of some key staff from CRA, the National Treasury and OCOB to answer questions more so deeply into the subject matter while some respondents at the grass root level didn't respond satisfactorily in time maybe due to the sub-

ject and time constraint. To counter this, such situations warranted more than a single visit to their offices/residences and also use of a Maasai translator when interviewing respondents in Narok county.

Narok County is geographically vast, covering over 17,900 square kilometers and traversing the four sub-counties sometimes proved hard. Nairobi City on the other hand while covering 696.1 square kilometers, is quite populous and some areas were inaccessible due to insecurity and some respondents wanted to know the direct benefit they would garner from such academic exercise. The researcher cooperated with the locals and adjusted the schedule appropriately aside from reassuring all respondents that the study was for academic pursuit.

### 1.7 Definition of Concepts

The study operationalized the concepts used as follows;

**Fiscal sustainability:** This is borrowed from Chapman's definition as he examined the fiscal sustainability challenges in states and local finances in the United States. According to him, fiscal sustainability is the ability of a government to steadily encounter its financial obligations in the provision of public services as demanded by the citizens in the long term (Chapman, 2008). The study operationalized it by examining the growing imbalance between revenues and expenditures over the three fiscal years.

**Internal determinants:** The study defines these factors as those features of county government which is within its sphere of control. These are fiscal strategy, fiscal responsibility laws and fiscal capacity.

**Fiscal Strategy:** Plan for managing county finances which include spending, revenue and both assets and liabilities spelt out in the County Fiscal Strategy Paper prepared by the county treasury as contemplated in section 117 of PFM Act 2012. The Act requires all counties to table it before the County Assembly by February 28 each year.

**Fiscal responsibility laws:** These are seven principles of fiscal responsibility outlined in section 107 sub section 2 of the PFM Act of 2012 which county governments must adhere to. This study adopted the definition operationalized in the PFM Act of 2012.

**Fiscal capacity:** The study adopts the definition of fiscal capacity given by Chitiga-Mabugu and Monkam as they assessed local government's fiscal capacity in South Africa. They defined it as the degree of local government's capacity to raise revenues comparative to its spending needs (Chitiga-Mabugu and Monkam, 2013). This study operationalized this term as the capability of the county government to raise sufficient local revenue from property tax,

entertainment tax and other local sources as permitted in law relative to decentralized functions.

**Solvency:** This study adopts the definition of solvency given by Honadle, Costa and Cigler (2004) while examining local government fiscal health. They identified **cash solvency** which is the ability to pay immediate obligations as to generate sufficient financial resources to pay for current liabilities usually within 30 to 60 days, **budgetary solvency** which they viewed as the ability to generate sufficient incomes within a fiscal period to fulfil expenditures without sustaining debts, s**ervice level solvency** which they viewed as the ability to provide a level of services anticipated by its residents and **long-term solvency** which is the ability to continue paying obligations in future fiscal periods.

## 1.8 Literature Review

This section reviews the literature related to the study on the topic of fiscal sustainability in the decentralized governments. This review of literature examines literature relevant to internal determinants in fiscal sustainability. This section looks at empirical review on internal determinants including fiscal strategy, fiscal responsibility laws, and fiscal capacity and their influence on county fiscal sustainability in decentralized governments. The section also deals with identifying and discussing the research gaps.

### 1.8.1 County Fiscal Strategy

Fiscal strategy is a strong factor driving attainment of county objectives as set out in county integrated development plans (CIDP). County governments in Kenya set out to develop ambitious plans immediately upon assuming power beginning with 2013 to 2017 CIDPs even with the limited resources both financially and personnel. Globally, state and local governments face cyclical, structural and intergovernmental pressures affecting their revenue and expenditure trends therefore affect sustainability (Chapman, 2008). With population changes, urbanization, migration either rural-urban or urban-urban and e-commerce affect tax bases and demands for certain goods and services from the government. This study considered the internal determinants to county fiscal sustainability in Kenya specifically the role and effect of fiscal strategy, adherence to fiscal responsibility laws and fiscal capacity.

PricewaterhouseCoopers (PwC, 2006) concluded that local councils facing financial sustainability constraints in Australia were characterized by minimal revenue growth, costs growing at a higher rate than revenue centers, increasing interest in non-core service provi-

sion to meet the rising public burden, operating deficits necessitating deferment or under-spending on capital spending, limited access to financial and human capital skills, and limited access to rate revenue. They then recommended a raft of measures ranging from internal reforms to changes in intergovernmental funding.

In his PhD dissertation, Ntoiti (2013) while investigating the determinants of financial stress facing local governments in delivery of services noted that Local Authorities were cash insolvent and took commercial loans in order to meet their short term financial obligations. He studied 175 Local Authorities in Kenya before the onset of county governance and found that inefficiencies associated with financial management practices (internal controls, audited accounts, and financial reports), human resource management practices (employee selection, training and development, and performance appraisal and compensation), and corporate governance practices (accountability, transparency and corruption) were found to exacerbate financial distress (budget outrun ratio, salary to total operating revenue, net debt to total operating revenue among others). The study also found out that ineffective government regulation vis a vis Transfer of Functions Act of 1969, Abolition of G.P Tax in 1974, and the Constituency Development Fund Act of 2003 led to high levels of financial distress.

A well-executed fiscal strategy has a potential to influence rapid growth at all levels of governments. Local governments in Kenya however fail to adopt e-governments strategies aimed at boosting revenue collection and managing exponential expenditures. A study by Mugenda and Belle (2009) focusing on adoption of e-government by the local authorities in Kenya found that the main impediments faced by these institutions included weak revenue base and unskilled staff. This study stressed on financial distress in local government institutions as a major reason for their dysfunctional nature.

CoK (2010) allocates different sources of revenue for the two levels of governments in article 209 thus assigning property rates, entertainment taxes, and other taxes authorized for imposition by an Act of parliament to the county governments for instance trade permits, Cess fee, charges subject to the limits in subsection 209 (5). While the two tax bases are immobile, stable, and predictable, notable problems relates the outdated nature of valuation rolls and lack of enough manpower to collect them. Dollery and Robotti (2008) thus argued that small jurisdictions find it difficult and costly to administer them.

The County Fiscal Strategy Paper (CFSP) must aim to identify the sources of local revenue to be collected by the county governments. This is achieved by the enactment of the finance act in the respective counties to accompany the approved budget proposal. Local rev-

enue is affected by economic, technological, and demographic changes. Tax sources available to county governments vary in how well they meet the taxation principles of equity as to offer fair treatment for taxpayers and promoting social cohesion, effective in delivering the anticipated policy objectives without exorbitant administrative and compliance costs, and economic efficiency as to ensure optimum revenues with minimal cost and effort. In most cases, local government tax bases in developing countries are narrow and its administration ineffective and coercive.

### 1.8.2 Fiscal Responsibility Laws

According to the International Monetary Fund (2009), Fiscal responsibility laws are institutional instruments adopted by countries to nurture fiscal integrity and discipline by requiring governments to commit to fiscal policy objectives consistent with macroeconomic solidity and continual economic progress. They include balanced budget rules specified as overall balance or adjusted in real terms, debt rules setting a clear limit or goal of public debt as a percentage of GDP, expenditure rules setting limits on recurrent and development spending, and revenue rules setting upper and lower limits of revenues to enhance revenue collection and/or preventing unnecessary tariffs on residents and citizen to void unwarranted borrowing and debt buildup. According to Rose (2010), fiscal and political institutions exist to promote fiscal sustainability. Universal suffrage, term limits, and the independence of the legislature and judiciary from the executive are some of the political institutions which drive policy decisions making. On the other hand, tax and expenditure limits, balanced budget rules, debt limits, and rainy-day funds are fiscal institutions which constrain the policies that can be adopted.

Fiscal responsibility laws seek to guide taxing and spending decisions by imposing an ongoing restraint on fiscal policy decisions through numerical and non-numerical restrictions on total budgetary estimates. Fiscal rules namely balanced budget, debt, expenditure, and revenue rules aim at correcting inaccurate incentives and containing pressures to engage in expansionary practices/spending so as to ensure fiscal responsibility (World Bank, 2017). This will balance off during hard economic times as local governments will have slack resources to sustain the rainy periods.

The design of any decentralized system in regard to revenue assignment should provide incentive for comprehensive fiscal administration and dampen wasteful practices apart from ensuring subnational governments have sufficient revenues to discharge designated re-

sponsibilities and promote equity and predictability in subnational revenue shares. Shah (1997) argues that governments at all levels must be seized responsible for their decisions to guarantee fiscal discipline. However, subnational governments facing a soft budget constraint can overshoot spending limits imposed by various government Acts and in approved budgets, follow expensive market involvement, provide inflated assistance to interest groups, infinitely subsidize poorly performing enterprises, and participate in sleaze. The anticipation of bailouts and debt write offs depresses the financial costs to the subnational governments of these engagements thus knowledge and existence of soft budget constraints work against financial discretion.

Section 107 sub section (2) of PFM Act 2012 requires that counties to adhere to seven principles of fiscal responsibility. The Act further requires county governments to deposit into a CRF account all locally collected revenue. OCOB is the only authorized entity which authorizes withdrawals from CRF. Even with the presence of such budgetary controls, the controller of budget has reported county government's inability to adhere to PFM Act (2012). Are the fiscal responsibility laws sufficient to maintain the financial sustainability? The study sought answers from the Controller of Budget and Auditor General's office in regard to Nairobi and Narok counties between 2013 and 2016.

Proper budgeting in form of more accurate revenue forecasts and stricter spending supports long term planning and sustainability. This need concerted fiscal discipline at all levels of government. This can be enforced by hard budget constraints which involve clear expenditure assignment, local revenues, formula-based transfer system, limiting subnational borrowing and good financial reporting. In order to maintain fiscally sustainable governments, these counties need to safeguard their fiscal condition (Hou, 2003).

According to Corbacho and Schwartz (2007), Fiscal rules makes fiscal policies more credible and predictable as opposed to policy discretion which may be misused. The key characteristics of fiscal rules includes their jurisdictional scope, identifies coverage either handling procedural or numerical rules, enforcement process, independent body setting budget expectations with cyclical considerations, extent of sanctions, independent body monitors implementation and application of definite exit clauses.

According to Dollery (2009), while studying financial distress in the local governments in Australia, noted that there were various policies that had been recommended for dealing with financial unsustainability in Australian Local governments. These policy recommendations were: structural reforms in form of forced amalgamation of councils and in-

ternal reforms, increased fiscal transfers from central government to Local government, increased borrowings by Local councils inform of fixed interest bond issues, and relaxing rate capping regulations and the introduction of additional revenues sources such as environmental taxes.

### 1.8.3 Revenue/Fiscal Capacity

The decentralization theorem encourages policy makers, as part of building institutions in developing countries, to institute tax regimes capable of raising revenues from different diverse sources. In the United States, Fiscal capacity is a concept first introduced to the public domain by the United States Advisory Commission on Intergovernmental Relations (ACIR) to evaluate the relative capabilities of states, counties and municipal governments to raise revenue. ACIR defines fiscal capacity as the relative amount of revenue states would raise if they used a "representative" tax and revenue system, consisting of national average tax rates and charges applied to 30 commonly used tax and revenue bases (ACIR, 1962). Therefore, state capacities vary because of differing tax base characteristics, such as property values, sales tax receipts, and mineral production.

According to Watts (2008), Canada, Colombia and the United States assign the right to exploit the fiscal dividend of natural resources to its provinces and states with the aim of promoting their financial sustainability. Watts further observes that other countries are engaged in sharing arrangements between the central and regional governments to secure the future of the counties and the country as a whole.

The International Public Sector Accounting Standards Board (IPSASB) broadly identifies fiscal capacity alongside service capacity and revenue vulnerability as the main tenets of fiscal sustainability. The board viewed fiscal capacity as the capability of the entity (read county government) to meet its financial obligations on a continuing basis over time without levying more taxes. This is affected by the level of net debt as resources for the present provision of services to the citizens is reduced by debt repayments. Service capacity on the other hand is the degree to which the county governments can uphold service delivery to the current population and also meet future commitments. Finally, revenue vulnerability denotes the level at which county governments rely on vertical transfers from the national government and its attendant ability to adjust prevailing tax rates and adjust tax sources or ingeniously craft new tax sources (IPSASB, 2011). The study sought to investigate revenue collec-

tion measures, county government dependence on transfers vis its spending needs in the case of Nairobi City and Narok county governments.

In looking at revenue collection, proponents of decentralization argue for considerations of administrative costs, the need to increase tax compliance, and avoiding distortions and the creation of internal barriers. Local governments should be able to collect taxes efficiently and effectively therefore lower costs, incentivize locals to willingly pay, be reasonably fair, promote accountability, and should burden non-residents among others. (Bird and Vaillancourt, 2006). Unfortunately, the potential yields from such local sources invariably fall short on meeting the expenditure demands. This is worsened by the central governments interference on the local government revenue decisions by influencing subsidisation of user charges for instance maternity fee charged by county governments. This is despite the argument that local governments can expand the tax base (e.g. by setting lower thresholds, based on local knowledge), and the belief that local taxation may increase willingness to pay. The study sought to juxtapose the revenue collection measures in the case of Nairobi City and Narok in the midst of incessant national government interference between 2013 and 2016.

In many developing economies with devolved governments, subnational governments have some degree of access to their own tax bases majorly attributed to vast geographical and demographic challenges and chiefly depend on intergovernmental transfers. Vertical imbalances ought to be addressed through design of non-matching transfers, changes in taxing and spending responsibilities, changing tax base, and adopting revenue sharing mechanisms (Shah, 1994). County governments should enhance their revenue raising capacity by deploying trained personnel, use of technology, mapping all properties and even revising their property valuation rolls.

Revenue capacity is affected by narrow revenue bases coupled with weak revenue administration and forecasting measures. It could thus be enhanced by focussing on enlarging local revenue base, simplifying tax collection measures, reduce revenue seepages, improving administration efficiency though informed revenue forecasting based on realistic expectations.  Enlarging local revenue base involve identifying new taxpayers, conducting periodic updates on the property valuation rolls, and evaluating the revenue capacity of individual taxes. Simplifying tax collection measures involves optimizing rate structure, enacting appropriate rules and regulations, and empowering human resource through continuous training. In order to seal revenue seepages through proper controls, local governments should conduct surprise audits, improve control process, enforce heavy and strict penalty for non-compliance,

proper receipting of tax revenues and chastising staff contributing to leakage of revenue. Improving administrative efficiency with the aim of reducing collection costs on the other hand involves administrative simplification, calculating collection efficiency for each revenue type, and identifying factors contributing to sub optimal revenue.

There have been numerous debates revolving around the sufficiency of funds available to county governments from local tax sources. The constitution of Kenya stipulates that county governments will get an equitable share not less than 15 per cent of revenue raised nationally during each financial year. During the period of study, the criteria for distribution of finances as recommended by the Commission on Revenue Allocation (CRA) was 45 per cent on the basis of population, 20 per cent on poverty factor, 25 per cent on equal sharing basis, 8 per cent on the basis of land area and 2 per cent on fiscal discipline basis. It should be noted that this formula changes every fiscal year or as recommended by CRA subject to approval by the Senate. This has always prompted harsh debates on the adequacy of such allocation from county government leadership and members of the senate. County governments need to generate sufficient own source revenue for their sustainability.

CoK (2010) grants the County Governments the power to levy property rates, entertainment taxes and any other tax that it is sanctioned to levy by an act of parliament. These tax bases have not been sufficient to support county operations hence over reliance on the transfers. County governments have also failed to meet the local revenue targets while some over rely on one if not few revenue sources. The revenue bases assigned to county governments ought to enhance vertical balance whereby areas with greater revenue raising capacity are areas where more services can be provided. However, all county governments in Kenya were assigned the same revenue bases and Nairobi City county being the most populous should collect more revenue per capita than Narok or any other county in that case.

According to Devas et al (2008), most countries' local revenue sources meet only part – sometimes quite a small part – of local expenditure needs. There are two reasons for this. Firstly, the most significant taxes (such as income tax, corporate profits tax, VAT, customs duties, excises) are usually assigned to central government since central government is much better placed to raise such monies uniformly, efficiently and equitably, particularly where tax revenues are collected in only certain locations (e.g. ports, in the case of customs duties). The nature and extent of taxes assigned to counties in Kenya are such that counties will remain dependent upon national government transfers.

> It has been suggested that this assignment of taxes (property taxes, entertainment taxes, fees associated with licensing businesses and charges from the services) 'leaves county governments with a narrow local source tax base from which to make autonomous fiscal decisions' (Boex and Kelly 2011: 5, quoted in Munawwar Alam (2014).

Ultimately, enhancing and maintaining fiscally sound county governments is a function of entrepreneurial governments. According to Hijal-Moghrabi (2013), local governments should assume novel strategies to realize high performance while upholding sustainability by efficiently using available resources, inventing and generate more resources without saddling the citizens with more tax burdens. Local governments have to adopt new practices and strategies like promoting public participation, collaborative governance, fiscal and human resources' capacity building, developing measurement systems, expanding tax bases, developing creative measures and rewarding innovation, and effective leadership.

According to Ntoiti (2013), fiscal distress in the defunct Local Authorities in Kenya, characterized by the inability to pay its creditors, was chiefly caused by poor financial management practices like poor internal controls, poor budgeting and procurement practices and financial reporting. Furthermore, he noted lack of transparency, corruption, and lack of good leadership structure contributed to poor corporate governance practices thus contributing to fiscal distress. Finally, he noted that local authorities neither conducted comprehensive interviews during recruitment nor merit for promotions leading to poor human resource management practices. However, this study focused on the defunct local governments (city councils, municipal, town and county councils) under the old constitutional dispensation. This early study by Ntoiti utilized descriptive research design targeting all the 175 Local Authorities with a final sample of 20 selected using stratified random sampling and analyzed the role of financial management, corporate governance, human resources among others on financial distress before the advent of the new constitution in Kenya. This study focused on the new county governments of Nairobi City and Narok between 2013 and 2016.

A recent study by Nyanumba (2018) focused on influence of certain strategies on financial performance (read financial health) of the new county governments. He noted that effective county budget planning in terms strict adherence to procedures as laid out in PFM Act 2012 was bound to boost the county government sustainability. In addition, he argued that revenue diversification and expanded public private partnerships programs would bolster the sustainability efforts. The study utilized survey research design targeting all the 47 county

governments and used a blend of both probabilistic and non-probabilistic sampling procedures and differed with this current study as it utilized descriptive research design with non-probabilistic purposive sampling technique.

In another study conducted by Munyao (2018) focusing on the influence of financial management practices on fiscal sustainability in Nakuru County, it was found that enhancing financial controls in terms of internal audits, revenue targets, accountable finance managers and distinguishing revenues from various revenue streams, enhancing value management practices like proper budget implementation would strongly improve the financial sustainability stance of Nakuru county. This later study used descriptive research design just like this study but differs on the county government under focus and the independent variables. Based on the discussion above, this study sought to fill the knowledge gap and dig on the role of fiscal strategy, fiscal responsibility laws, and fiscal capacity in fiscal sustainability in the two budding counties of Nairobi City and Narok from 2013-2016.

## 1.9 Theoretical Framework

The study is anchored on fiscal federalism theory in order to understand how assignment of revenue and expenditure, intergovernmental transfers, tax administration, subnational borrowing, and budgeting and fiscal management affect fiscal sustainability through the lenses of fiscal capacity, fiscal strategy and non-adherence to fiscal responsibility laws. Fiscal federalism theory prescribes the allocation of functions between the national and county governments and the attendant assignment of revenues and expenditure. Early proponents of fiscal federalism identify three public functions namely stabilization, redistribution, and allocation whereby the first two are suited to the national government while the latter is best suited to subnational governments (Musgrave, 1959). These scholars argued that the central government perform the stabilization function to address market failure and the redistribution function to maintain macroeconomic stability. Furthermore, the allocation function was to redress income inequality therefore intergovernmental transfers sought to address the vertical and horizontal imbalances. The stabilization and distribution functions were left to the central government while the allocation function was decentralized in Kenya.

The main tenet of the first-generation theory of fiscal federalism was that the decision makers are benevolent out to maximize social welfare (Musgrave, 1959 and Oates, 1972). In fact, Oates (1972) identified four criteria to allocate explicit functions to specific levels of government based on economies of scale, heterogeneity of preferences, the presence of exter-

nalities, and emulation/competition. Musgrave (1959), on the other hand, argues that fiscal federalism promotes economic efficiency as it assumes communities possess taste and preference patterns that are homogenous and therefore their subnational government policies should be permitted to reflect these preferences. This is useful in explaining how county governments promotes service-level solvency at the local level through participatory and people-centred initiatives.

The economic efficiency as the main benefit of first-generation fiscal federalism is based on two assumptions. First, it assumes that there exist homogenous tastes and preferences for all individuals who reside in a community and second, it assumes existence of perfect knowledge among the residents of a region. However, second generation theory of fiscal federalism assumes that decision makers are driven by existing institutions, mainly political, that do not maximize citizen welfare (Oates, 2005). This second-generation fiscal federalism addresses itself to the principle-agent problem as government officials seek re-election and information asymmetry problems as citizens prefer more expenditure than taxation in the supply/demand for public goods. It therefore emphasizes on incentives driving both the principle and agent for driving economic prosperity and argues for local government competition, common market and hard budget constraints to guide against market failures. However, it fails to acknowledge the effect of asymmetrical information leading to fiscal illusion as county governments choose higher spending sometimes through grants and borrowing/overdrafts without full disclosure of the costs to the citizens.

Furthermore, the second assumption of the fiscal decentralization theorem addresses expenditure assignment, revenue assignment, vertical imbalance (imbalances between revenue and expenditures of subnational government), horizontal imbalance (equalization), and subnational borrowing. The theory further addresses assignment of taxation power and the design of intergovernmental grants and transfers by arguing that subnational governments should control their local sources of revenue to avoid machinations from the national government by taking into consideration adequate budgetary provisions, and autonomy in regulatory and taxation powers to carry out the assigned responsibilities (Bird and Vaillancourt, 2006). Devolution of taxing autonomy gives meaning and identity to the devolution of expenditure responsibility i.e. funding should follow functions. However, undertaking drastic fiscal decentralization, even before institutions have the requisite capacity might involve substantial economic cost, resource wastage and fiscal discipline breaches. As such, capacity

constraints manifests. Fiscal federalism sheds light on the influence of transfers on fiscal discipline in the counties through the soft budget constraint.

A critical element of fiscal federalism is intergovernmental transfers to address vertical fiscal imbalances as the national government is assigned major revenue sources thus narrow revenue base left for the subnational government, horizontal fiscal imbalance caused by different fiscal capacities as a result of unequal resource endowment, income levels and access to better tax bases among subnational government, higher expenditure needs due to poverty and other socioeconomic conditions, and finally to address inter-jurisdictional externalities. Intergovernmental transfers in form of conditional and unconditional transfers ought to convey to all citizens the cost of different baskets of public goods (Oates, 1999) though their over reliance to finance local expenditures fashions an incentive to bloat expenditures and engross in protracted dialogues for more resources (Ahmad, Hewitt and Ruggiero, 1997) and encourages subnational governments to disregard the cost related to revenue mobilization (Oates, 1999) to finance their spending leading to revenue collection lags leading to the problem of the commons. However, residents may not fully absorb the cost of service provision or benefit directly due to externalities.

Fiscal federalism offers conception on the role of intergovernmental transfers and their attendant glitches. Consequently, designing a system of intergovernmental transfers devoid of macroeconomic risks, and safeguards fiscal sustainability must promote marching of expenditure responsibilities with revenue sources, revenue capacity should be matched with political accountability, devolving functions consistent with efficient sense in mind, enforce hard budget constraints on subnational government, control of subnational borrowing, creation of appropriate supporting institutional mechanisms, and pegging decentralized functions on capacity. In assigning revenue, the richest subnational governments should fund from their own resources all locally provided services benefiting the local residents, and subnational revenues should be levied only on local residents and be matched to the benefit so derived (Bird and Vaillancourt, 2006).

Fiscal federalism literature also prescribes solutions to fiscal responsibility challenges attendant to devolved governments. A main tenet of fiscal responsibility involves borrowing to run government operations and requirements. Fiscal federalism scholars here argue that borrowing should be used to finance capital outlays. Bird (2004) argues that long-lived investment projects ought to be financed through borrowing as opposed to relying on either intergovernmental transfers or local revenues to achieve allocative efficiency and inter-

generational equity. Regulating borrowing requires subnational governments to be fiscally disciplined through adherence to imposed limits. Further, local citizens, in the presence of perfect information, reprimand fiscally- indiscipline subnational governments during elections. However, a problem of soft budget constraint facing most subnational governments in the developing countries imply that fiscal responsibility in the subnational governments in difficult to upkeep. Further, free-riding and exacerbation of the common pool resources in rampart under fiscal federalism, Ter-Minassian and Craig (1997) recommended numerical debt ceilings, debt restrictions, ban on borrowing, limits on non-local debts, and enforcing the necessity of balanced budget to discourage the vice. Fiscal federalism sheds light on the influence of transfers on fiscal discipline in the counties through the soft budget constraint. It predicts that county government will try to exploit the common pool and transfer expenses to the national government through predatory borrowing practices.

Finally, a complete fiscal federalism which includes revenue allocation, expenditure assignment, borrowing and efficient intergovernmental relations can boost citizens' welfare as argued by fiscal federalism theorem which dictates/prescribe that resource allocation efficiencies is maximized when public expenditure responsibilities are assigned based on the benefit principle. Subnational governments are mandated to provide services and governance closer to the people. Through fiscal federalism, subnational governments ought to be receptive, accountable and competitive in meeting local citizen's demands and preferences. Fiscal federalism and decentralization theories may be useful in explaining the challenges to financial sustainability in the county government s of Narok and Nairobi City. For example,

#### 1.9.1.1 **Relevance of the theory to the study**

The relevance of this classical fiscal federalism theory in this study is to aid in understanding the factors impeding fiscal sustainability in decentralized governments and how the constraints can be eliminated through experimentation and innovative measures in order to foster fiscal sustainability. Fiscal decentralization is beleaguered by challenges related to expenditure assignment and management, local revenue generation and autonomy, local government borrowing, and intergovernmental transfers. The theory is relevant in giving insight into how county governments perform empirically on resource allocation efficiency grounds in light of internal challenges on revenue capacity, fiscal strategy and adherence to fiscal responsibility laws.

## 1.10 Research Hypotheses

The study is guided by the following hypotheses;

1. There is a statistically significant relationship between county fiscal strategy and county government fiscal sustainability in Narok and Nairobi City governments.
2. There is a statistically significant relationship between fiscal responsibility laws and county fiscal sustainability in Narok and Nairobi City governments.
3. There is a statistically significant relationship between revenue/fiscal capacity and county fiscal sustainability in Narok and Nairobi City governments.

## 1.11 Research Methodology

In this sub-section, the study describes the research design adopted, population, sampling frame, research sites, study sample, data sources, collection and analysis, pilot, interpretation and finally on the presentation.

### 1.11.1 Research Design

Kothari (2004) define research design as the conceptual arrangement within which research is steered. It specifies the sources and types of information relevant to the research problem and thus specify the approach to gather data and analyze data. The study utilized descriptive research design. Descriptive research design aims to describe realities and features concerning an individual, groups or situations (Kothari, 2004). This is because the study aimed to analyze, examine, compare, and assess internal determinants affecting fiscal sustainability in the first three years of devolution to understand the future challenges which might lead to suspension, dissolution and bankruptcy of devolved governments in Kenya.

### 1.11.2 Population

Population is the researcher's universe (Kothari, 2011). A target population is the "complete group of specific population elements relevant to the research project. A study population is the sub-set of the target population" (Cooper and Schildler, 2013). The target population was all the 47 counties in Kenya whereas the study population was Narok and Nairobi city counties.

### 1.11.3 Sampling Frame and Technique

The sampling technique utilized was the non-probabilistic purposive sampling technique. The study was conducted in Narok and Nairobi City counties. The sampling frame consisted of two counties drawn from five (5) urban and five (5) strong own-revenue sources counties. Commission on Revenue Allocation identifies five counties as urban (more than 50%) namely; Nairobi, Mombasa, Kiambu, Kisumu, and Machakos while on the continuum of own revenue sources, five counties are identified as the strongest on own revenue sources thereby relying more less on transfers namely; Narok, Isiolo, Samburu, Nairobi, Laikipia and Kiambu. The same commission identifies Narok among 14 marginalized counties in Kenya namely West Pokot, Wajir, Turkana, Tana River, Taita Taveta, Samburu, Marsabit, Garissa, Isiolo, Kilifi, Kwale, and Lamu. The study therefore used Nairobi as the industrial, urban, most populous county and Narok as the marginalized, semi-arid area and strong own source revenue county. The poverty index in both counties is below the national average of 46.6% with Nairobi at 22%, and Narok at 33.7%. (2005/06 KIHBS survey).

Once the two counties were selected, the respondents were selected purposefully to ensure individuals with an official capacity to respond on behalf of the organization were considered. Stratified random sampling technique was used to select samples within the two counties owing to the need of ensuring that both counties are independently sampled and represented.

### 1.11.4 Research sites

#### 1.11.4.1 **Nairobi City County**

Nairobi City County is also the capital city of Kenya and part of the metropolitan region comprised of Machakos, Kajiado, Kiambu, and Muranga per the State Corporations Act of 2017. It lies between longitudes 36°45'East and latitudes 1°8' South and is administratively divided into nine subcounties of Westlands, Langata, Starehe, Dagoretti, Kamukunji, Njiru, Makadara, Kasarani and Embakasi, and politically divided into 17 constituencies. (IEBC 2012, Nairobi CIPD 2014). The key features are summarized on table 1.1 below.

#### 1.11.4.2 **Narok County**

The County Government of Narok occupies a mostly arid and semi area of about 18000 square kilometers lies between latitudes 0° 50´ and 1° 50´ South and longitude 35° 28´

and 36° 25´ East. It is one of the marginalized counties with poverty rates below the national average (33.7 per cent compared to 46.6). The county is administratively divided into four sub-counties of Transmara West, Narok North, Narok South and Transmara East and politically comprises of six constituencies. (IEBC 2012, (Narok CIDP 2013-2017). The key features are summarized on table 1.1 below

**Table 1.1: County Characteristics**

| **County** | **Population** | **Area (sq. km)** | **Population Density** | **Poverty Index** | **Marginal-ized?** | **Local Revenue 2015/16 (KES)** | **Expenditure 2015/16 (KES)** |
|---|---|---|---|---|---|---|---|
| Nairobi | 3,138,369 | 695.1 | 4,515 | 22% | No | 11.71 bil | 23.95 bil |
| Narok | 850,920 | 17,944 | 47 | 33.70% | Yes | 1.75 bil | 7.24 bil |
| Kenya | | | | 46.60% | - | - | - |

**Source: KNBS, KIHBS 2009**

### 1.11.5 Study sample

The study used a total of 105 respondents for the sample population broken down as follows; two from the Commission of Revenue Allocation, each County Executive Committee in charge of finances for Narok and Nairobi City, three from the Directorate of Budget, Fiscal and Economic Affairs at the National Treasury, two from the Controller of Budget, three from the Auditor General Office, nine sub-county administrators for Nairobi, four sub-county administrators for Narok County, 20 employees each from the two counties and 20 residents each from the two counties. The sub-county administrators were conveniently sampled because of their management and command role of the organizational functions in their respective units; they develop policies and plans and ensure service delivery. The employees provided a perspective on fiscal challenges from insider viewpoint while the residents provided the external one.

**Table 1.2: Sample size**

| Category | Size | Percentage |
|---|---|---|
| Commission of Revenue Allocation | 2 | 2 |

| | | |
|---|---|---|
| County Executive Committee in charge of finances for Narok and Nairobi City | 2 | 2 |
| Directorate of Budget, Fiscal and Economic Affairs at the National Treasury | 3 | 3 |
| Controller of Budget | 2 | 2 |
| Auditor General Office | 3 | 3 |
| Sub-County Administrators for Nairobi City | 9 | 9 |
| Sub-County Administrators for Narok | 4 | 4 |
| Employees and | 40 | 38 |
| Residents | 40 | 38 |
| **Grand Total** | **105** | **100** |

### 1.11.6 Sources of Data

The study utilized both qualitative and quantitative approach in data collection by utilizing both primary and secondary sources of data. Questionnaires, interviews, group discussions and observations were used in gathering primary data. Questionnaires consisting of both closed and open-ended questions were administered to all the interviewees based on rational reasons. Above and beyond, the study relied on well informed respondents especially officials knowledgeable on county governments operation and devolution. Information was also collected from the Commission of Revenue Allocation, County Executive Committee in charge of finances, Directorate of Budget, Fiscal and Economic Affairs at the National Treasury, Controller of Budget, Auditor General Office, and Treasury.

Secondary sources consisted a review of CBIRR reports from the OCOB to gather the secondary data which basically included revenue and expenditure breakdown, budget absorption, current assets and current liabilities among others. Secondary data also be obtained from relevant literature such as the Constitution of Kenya, County Government Act, books, articles, internet, newspapers and local publications have been used to gather background information to the study. In addition, these sources continued to act as reference materials

throughout the study. The choice of secondary data is informed by the availability of academic literature and policy documents on fiscal sustainability and as guided by the study's research question. Reports and handbooks on issues regarding fiscal capacity, fiscal strategy and fiscal discipline/adherence to fiscal responsibility laws and challenges to financial sustainability were utilized as sources of data.

### 1.11.7 Pilot

After designing the research tools, a pre-test was conducted involving representatives of the study samples identified above. This helped identify deficiencies in the design and enhanced its validity and reliability. This pilot was conducted before the actual data collection exercise in Nairobi to test the appropriateness of research instruments and thereafter fine-tuning if needed.

### 1.11.8 Data Collection and Classification of Respondents

The overall aim of the study was to establish internal determinants in county government fiscal sustainability in Kenya. The study analyzed primary data obtained through questionnaires which were administered via email and on face-to-face basis. This involved scheduling a mutually convenient time. Interview also helped probe deeply to obtain information that may not have be revealed and responses were recorded in a field-note book. Secondary data were analyzed from reports and handbooks on issues regarding fiscal capacity, fiscal strategy and fiscal discipline/adherence to fiscal responsibility laws and challenges to financial sustainability. The study operationalized the variables as follows:

**Table 1.3: Type of Variable, Measurement, and Data Collection methods**

| Type of Variable | Operationalisation of Variables | Data collection method |
|---|---|---|
| Independent: Fiscal Strategy | Quality of available fiscal strategies, revenue adequacy, revenue bases, revenue allocation, diversification of available revenue, revenue gaps, actual expenditures | Questionnaire and CBIRR reports |
| Independent: Fiscal capacity | Revenue collection measures, | Questionnaire and CBIRR |

| | transfers, transparency, IT, spending needs, fiscal wealth | reports |
|---|---|---|
| Independent: Fiscal Responsibility Rules | Expenditure limits, balanced budget rules, fiscal discipline incentives, debt management, budgetary controls, emergency fund, accountability, and laws in place | Questionnaire and CBIRR reports |
| Dependent: Fiscal sustainability | Budget, Service Level, Cash and Long-Term Solvencies | Questionnaire and CBIRR reports |

The study takes cognizance of the fluidity and changing circumstances on the ground. However, the study focused on the period 2013 to 2016 as this period marks the birth of new counties and transition to the devolved governance structure. In the interest of academic rigor, this study tried to update information by corroborating primary and secondary sourced data on the issues of concern.

#### 1.11.9 Data Analysis, Presentation and Discussion

Data analysis refers to calculation of certain measures along with searching for patterns of relationship that exist among data groups (Kothari, 2004). Data collected were coded and uploaded into Statistical Package for the Social Sciences (SPSS) and MS Excel to generate statistics such as frequency tables, percentages, mean, and standard deviation.

# Chapter Two

# Background/Historical Perspective

## 2.1 Introduction

The sustainability of public finances is a moderately new idea. It remarkably gained a lot of ground in Europe through the international publications funded by the Bretton Woods institutions and was founded on earlier concepts such as fiscal health and fiscal stress. The

study of fiscal sustainability has been a major concern for policy makers, scholars, and government institutions in the United States. At the national level, the global financial crisis reiterated the need to understand fiscal capacity, service capacity and vulnerabilities associated with fiscally unsustainable practices including early mapping and detection. This chapter commences with an appraisal of historical perspective of fiscal sustainability at the global and regional levels. The second segment explore the implications of internal determinant on county government fiscal sustainability in Kenya.

## 2.2 Global and Regional Perspectives on Internal Determinants on Fiscal Sustainability

As noted earlier, fiscal sustainability, as a type of fiscal condition, grew from the concepts of fiscal health and fiscal stress. Fiscal health also referred to as financial condition by scholars (for instance Wang et al 2007 and Hendrick 2004) to explain the general fiscal circumstances of a business, governments or individual. It can be strong, weak or in-between. For local governments, a strong financial condition thus denotes its higher ability to raise revenues, responsible borrowing, prudent spending behavior and efficient service provision to its residents. Fiscal stress, on the other hand, refers to weak financial condition as opposed to other closer concept as fiscal crisis denoting extremely weak financial condition. Again, for local government, fiscal stress would manifest in form of persistent budgetary disparity, over-reliance on debt for recurrent spending, and the inability to provide essential services.

According to Groves, Valente and Nollenberger (2003), there are four generally agreed upon measures of fiscal health namely cash solvency (a government's liquidity and capability to pay immediate obligations), budget solvency (ability to pay financial commitments within the current fiscal year and without incurring a deficit), long-run solvency (ability to continue paying commitments in future fiscal periods) and finally service-level solvency (ability to pay and continue providing the level and eminence of services anticipated by residents). As a result, fiscal stress measurement systems have been developed across the U.S focusing on different levels of government ranging from counties, municipal, state and federal governments. These measures vary in complexity and types of variables at each level of government.

In the United States' national context, fiscal sustainability is assessed through debt to GDP ratio holding macroeconomic and demographic environment constant. In order to long term fiscal sustainability, governments should constantly engage in strategic forecasting of

future revenues, future expenditures, socio-economic trends and related environmental factors in order to foster prudent financial plans. High and increasing debts are detrimental to government's fiscal condition as cash availability, budget level, long-run and service-level solvencies are negatively impacted. Furthermore, the U.S Government Accountability Office (GAO, 2007) predicted that state and local governments would experience persistent fiscal challenges in the next decade, including annual difficulty balancing revenues and expenditures, partly emerging as a result of current unsustainable policies coupled with state mandated services like healthcare costs and funding state and local pension schemes. To the contrary, American cities benefit from fiscal federalism as they exert significant powers over revenue collections, use varying revenue sources, issue debt instruments, and service delivery (Gorina, 2013).

The analysis of Australian public finance sustainability reveals an interesting twist. A review of six studies of fiscal sustainability in Australian councils by Dollery and Grant (2011) conclude that they all exhibit an accounting bias by narrowly focusing on accounting and financial ratios. In their analysis of the Australian local fiscal sustainability, Price Waterhouse Coopers (PWC, 2006) developed five financial ratios as key performance indicators and uses them to assess fiscal sustainability of a sample of 100 councils as follows; Operating surplus or deficit (net of revenue operating over expenditure where a deficit of over 10% of total revenue indicates a high level financial risk), Interest coverage (earning over borrowing costs where the ratio of three or more being the lowest threshold of sustainability), Sustainability ratio (capital expenditure over depreciation where ration of one indicates that assets are increasing ceteris paribus), current ratio (current assets over current liabilities where a sustainable government should strive for a ratio of unity), and rates coverage (total rates revenue over total cost where a ratio of 40 per cent is considered sustainable).

In assessing and measuring the financial condition and fiscal health of municipal government in the U.S, a framework based on an ecological/systems view of government was developed by Hendrick in 2004 summarized below. Based on a systems view of an organization, local/municipal government is viewed as an open system discrete from its county, state, and federal environment.

**Table 2.1: Dimensions of Fiscal Health in Municipal Governments**

**TABLE 1: Dimensions of Fiscal Health in Municipal Governments**

I) Properties of government's environment: conditions that are immutable, less controllable by government, and often due to regional trends
   A) Revenue wealth: value of tax bases and other revenue sources that governments are permitted to collect by state statutes, for example, property value or sales receipts
   B) Spending needs: conditions that determine the level of services governments must provide to ensure the health and safety of its residents and visitors, for example, miles of road. Spending needs are also a function of the range of services governments provide and the costs of service delivery, for example, salaries and wages.
   C) Socioeconomic, political, and demographic features: features of the municipal population, economy, and other underlying conditions that determine A and B above. Also represent state, national, or regional economic conditions.
   D) Changes in IA, IB, or IC
II) Balance of fiscal structure with environment: direct comparison of features in dimensions I and III to determine the balance or level of adaptation of a government's fiscal structure to environmental conditions, for example, property taxes collected relative to property wealth or public safety spending relative to need. Changes in I and III encompass change in II.
III) Properties of the government's fiscal structure: outcomes of officials' and other direct participants' financial choices (cumulative and current). Participants have more direct control over features in III than in I. This dimension includes revenue and spending levels and the subdimensions below. Reflects government's adaptation to environment and other structural features.
   A) Fiscal slack: level of flexibility, discretion, or surplus in the fiscal structure that allows governments to moderate or buffer the effects of environmental changes and uncertainty over several years, for example, fund balance and discretionary spending. Adaptation: for example, dependence on sales tax fosters high levels of slack (which reduces risk).
   B) Relativity of components within major structural areas: relative levels of revenue sources, spending functions, debt instruments, or other areas of financial activity, for example, percentage state aid or general obligation debt (of total debt). Adaptation: for example, high sales receipts foster dependence on sales taxes (which increases risk).
   C) Current operating conditions: reflects the government's ability to meet short-term obligations during the fiscal year, for example, liquidity, fund deficits, fund borrowing, or short-term borrowing.
   D) Future financial obligations: reflects the degree to which current financial choices and conditions have obligated future resources, for example, debt, pensions, deferred maintenance, long-term contracts, and unfunded liabilities.
   E) Changes in IIIA, IIIB, or IIIC

Adapted from Hendrick 2004, Pg .82

In a bid to advance the fiscal capacity of municipal/local government, efforts at diversifying revenues must be increased leading to revenue progression attributed to improved financial performance. Diversifying revenue stabilizes revenue streams, reduces financial threats associated with overreliance on limited revenue bases, and increases financial managers' flexibility for managing change and determinants of fiscal stress (Hendrick, 2002). Diversifying revenue sources is further used as an intentional approach to expand the revenue base, provide more permanence and elasticity in financial management therefore accomplish enhanced financial performance (Bartle, Ebdon, and Krane, 2003). Efforts to diversity reve-

nues must be balanced to counter inefficient outcomes and inflating expenditures while increasing the costs of revenue collection.

At the state level, economic advancement necessitates a capability to mobilize fiscal resources to finance essential service provision of which it's mostly lacking in the developing countries (Tanzi and Zee, 2000). At a decentralized government level, tax enforcement becomes an expensive exercise that necessitates collecting information from a vast geographical area, and from either densely populated or sparsely populated areas. According to Ali, Shifa, Shimeles and Woldoyes (2015), the advance in information technology (IT) offers a cheaper way to gather and analyze large amounts of data on taxpayers in a bid to improve their fiscal capacity. Fosu and Ashiagbor (2012), while analyzing the use of GIS technology for revenue mobilization in Ghana, posit that many of the weak devolved units rely on financial transfers and assistance from the central government. A fiscal structure chiefly financed by intergovernmental transfers incentivizes lower level governments to disregard the associated relatively high cost of revenue collection for financing their expenditures leading to growth in size of government. According to Bird and Vaillancourt (2006), a well-designed system of transfers should consider the amount of resources subjected to equitable share, basis for allocating the vertical transfers and the conditions attached therein.

According to Hou (2003), fiscal discipline, measured whether low or high, is the capability of a government to uphold seamless financial processes and strong fiscal condition in the long-term. He argued that fiscal discipline encompasses multi-year outlook on budgeting and includes mechanisms to sustain strong fiscal condition and steadiness over varying economic cycles. He further argued that fiscal discipline pertains to all measures of fiscal performance in total revenue, public debt, and financial balance. Other public scholars have argued about fiscal discipline based on deficit financing of current operations (Musgrave, 1959) while others like Mikesell (1999) have pointed its part on budgetary control.

According to Musgrave (1959), fiscal discipline encompasses government avoiding borrowing to finance current operations. To him, deficit finance burdens future generations with high taxes thus generational equity is affected by presenting a higher tax burden to future generations for current benefits. Thus therefore implies lack of or poor fiscal discipline if any, whether on government officials or citizenry and can be corrected by government officials deliberately desist from the lure of borrowing for current operations. Fiscal Rules, as a reflection of fiscal governance in conjunction with fiscal transparency and enforceability, involves setting rules on both expenditures and revenues, limiting debt, and setting targets for

budget deficit. High and increasing debt levels are harmful to county government fiscal condition and has a potential to create a vicious cycle of pending bills/debts therefore hinder service provision to the citizens.

According to Mikesell (1999), while agreeing with Musgrave on deficit financing i.e. government's expenditure must be limited to available finances, goes ahead to support fiscal discipline for budgetary control to ensure approved budgets are executed in intent and amount. He further argued that all elected and appointed officials must abide to popular will expressed through the legislature. Therefore, fiscal discipline is exercised when ministries execute their appropriations by spending on legislatively intended purposes only. In fact, debt stock, especially when not linked to proper midterm strategies, becomes a matter of unease to fiscal sustainability. When loans mature, public service delivery is affected as resources available are limited.

Ensuring fiscal sustainability calls for management of fiscal risks at the county government level and can be done in concert with the national government through fiscal rules and ex post insolvency mechanisms working in a complimentary manner. Fiscal rules regulate borrowing and monitor local government fiscal position to avert fiscal crises. Ex ante regulations can fall under market discipline, rule-based controls, administrative controls, and cooperation between different levels of government (Ter-Minassian and Craig, 1997). In the Kenya's case, borrowing is allowed for capital projects. It does not specify penalties for excessive borrowing, county government accountability via a political process, access to own-source revenues, and separation of fiscal from monetary policies.

## 2.3 Kenya's Perspective on Internal Determinants and Fiscal Sustainability

### 2.3.1 Fiscal strategy

County Fiscal Strategy Paper (CFSP) as prepared by the County Treasury plays a key role in setting or re-affirming the county government's medium-tern and long term objectives of their fiscal policy in terms of supporting transparency and prudency in public resources management. As an annual requirement stipulated in the PFM Act 2012, the County Treasury must conduct public participation sessions/inputs factoring in input from the Commission on Revenue Allocation bearing in mind the national objectives in the Budget Policy Statement (BPS), broad strategic goals and policy goals contained in its CIDP and the its financial projections with respect to county obligations in an attempt to present a balanced budget proposal.

A number of independent commissions exist in Kenya with a say in the internal decisions taken by county government officials in revenue, expenditure, and subnational borrowing matters, hence affecting their fiscal strategies. First, the Commission on Revenue Allocation (CRA) makes recommendations concerning the basis for the equitable sharing of nationally collected revenue and on financing of and financial management by county governments. Secondly, the Controller of Budget (OCOB) administers the implementation of the county budgets by sanctioning drawings from public coffers. Third, the Auditor-General audits reports to Parliament or the relevant County Assembly on the accounts of all county governments and lastly, the Salaries and Remuneration Commission (SRC) advises the county government on the remuneration and benefits of all other public officers apart from regularly reviewing and setting the same of all state officers.

CFSP have to provide a snapshot of the actual county performance in the previous period, then set priorities across sectors in terms of expenditure outlays while forecasting on revenues and expenditures expectations in the coming fiscal year and indicating the expenditure limits. Unfortunately, many county governments failed to provide comprehensive evidence on budget execution, actual expenditures data against their targets while others failed on estimates for economic growth, inflation or other factors that would have affected the upcoming budget year due to lack of human capacity and data (ICPAK 2014). The absence or late establishment of their county public service board together with the non-existence of incentives to attract and retain highly qualified personnel meant county governments could not produce quality CFSP even with the secondment of staff from the national government.

Local revenue forecasting has proven to be the Achilles' heels in bridging the gap between the overall expenditures and expected national shareable revenue. Counties are expected to invent state-of-the-art means of collecting local revenue to forestall budgetary deficits because of underperformance in revenue collections. A number of county governments have deployed modern revenue collection measures like embracing automation while others have entered into sub-contracting agreements with private sector players. According to Osborne and Hutchinson (2004), a budgeting process aimed at obtaining better results for all citizens in the age of a perpetual fiscal deficit crisis should involve overcoming five challenges including understanding the real problem whether long or short term and establishing whether the problem is either revenue or expenditure driven. They observed that many governments are shortsighted in planning and rely on more expensive short-term solutions which turn out to be expensive in the long run.

According to Nyongesa (2014), the county government of Mombasa adopted strategies in order to improve revenue collection including outsourcing cleaning, solid waste, and sewage management services to external providers; diversified its tax strategies including development of new licenses for all business groups and establishment of fully functional county offices; recruitment and training of new labor force; decentralizing local revenue collection systems and outreach centers at the sub-county level; tax awareness in the form of increased education and monitoring of county revenue collection staff; and performance management measures geared towards managing the output quality of its services at the least cost with maximum satisfaction.

Public availability of the CFSP will help provide the much-needed transparency of public resource management. However, county governments have delayed release of such information and wither input from the beneficiaries of sectoral allocation leading to wrong priorities and inflated recurrent expenditures. The strict timelines stipulated in the PFM Act 2012 on the submission of CFSP also affect the quality of the final paper as county governments must prepare it between October and February for adoption by the county assembly by mid-March of the current fiscal year and implementation in four months.

### 2.3.2 Fiscal Responsibility Rules

Adherence to fiscal rules, fiscal transparency and enforcing fiscal governance are major components of fiscal discipline. The 2010 constitution and the resultant act of parliament, PFM Act of 2012 set the tempo for fiscal discipline at all levels of government in Kenya. Article 201 of the constitution outlines the principles of public finance which includes openness and accountability in financial matters, and responsible fiscal management, among others. Further, the National Government Loans Guarantee Act of 2011 empowers parliament to set a limit on national government guarantees for capital projects considering borrower's paying capability, need to ensure stability of domestic financial markets, intergenerational equity, borrowing rights thresholds, objectivity, and prudence.

The 2010 constitution bestows CRA and OCOB roles in promoting fiscal responsibility. CRA, in formulating recommendations relating to the financing of the county governments, is required to consider fiscal responsibility as specified in subsection 3c of article 216. The first-generation revenue sharing formula by CRA did not objectively take into account fiscal discipline in allocating transferred resources among the forty-seven (47) counties as it granted all the 47 counties a constant 2% of the equitable share over a period of three years.

The CRA recently factored in fiscal discipline as a factor in horizontal revenue allocation between counties. This contrasts with the first revenue allocation formula approved in FY 2013/14.

OCOB is required by law to authorize withdrawals from the Exchequer by the county government as a means of ex-ante budget control. However, county governments have circumvented this function by spending locally collected revenue without first depositing them into the County Revenue Fund account as required by PFM Act 2012. In exercising this budgetary control measure, OCOB should be well staffed with qualified personnel therefore adequate funding should be in place to ensure it delivers on its mandate including establishment of its affiliate offices across all the county governments and also recruitment of competent staff. The constitution further assigns ex-post audit function to the Auditor-General.

Following the transfer of all devolved functions by the Transition Authority with a big bang without considering the capacities of each county to collect enough revenue to finance the massive expenditures related to the devolved functions, county government need to strictly adhere to fiscal responsibility laws to safeguard bad debt growth and accumulating huge pending bills. According to the International Monetary Fund (IMF, 2009), unless a hard budget limit can be successfully imposed in sub-national governments from developing countries, more funding to match decentralized functions does not guarantee adequate preservation of fiscal restraint.

### 2.3.3 Fiscal capacity

County governments are very important vehicle of service delivery in the new devolved units. They are the new centres of growth and development as provided in the fourth schedule of the constitution. As vehicles of service delivery, fiscal capacity of subnational governments ought to be measured by how they mobilize resources, how they provide services cost-effectively, and how they perform in providing minimum standards of service (Parker, 1995). Strong fiscal capacity reflects on adequate funding to exceed minimum standards of service, ability to fully mobilize all resources available from all or most tax sources, effective delivery of goods and services, and appropriate mix of services to match local liking. Article 203(e) of the CoK (2010) identifies fiscal capacity and efficiency of county governments as a criterion for determining the equitable share. In Kenya, weak fiscal capacity of the county governments manifests in their inability to attract and retain well skilled staff to device entrepreneurial measures.

According to the Institute of Certified Public Accountants in Kenya (ICPAK, 2014), a number of counties could not collect as much local revenue as the local governments within their jurisdiction collectively collected thus bringing forth on their fiscal capacity. ICPAK's devolution baseline report also identified technical incapacity leading to delayed preparation of vital documents such as the budget, CFSP, CIDP among others leading to late enactment of crucial budget and the attendant finance bill by the County Assemblies. The report further identified the lack of robust and autonomous internal audit department, fragile local revenue bases composed of antiquated tax systems, unstandardized remuneration, stressed relationship at the county level as governors and member of county assemblies clashed, inflated expectations from residents as some of the key barriers to growth and development of devolved governments (ICPAK, 2014).

To fund the new counties, CoK (2010) further provided new sources of funds namely unconditional transfers from the national government (Article 203 and 204), local revenues, and permitted sources being listed in Article 209 (3). Counties may also borrow over the medium term for capital expenditures only and not recurrent expenditures though cash flow management can be done through bank overdrafts. The nascent county government must have sufficient resources to effectively deliver. To the contrary, the national government allocated much less resources than as anticipated in the constitution of a minimum of 15 per cent of the nationally collected revenue. This in turn affected service delivery as the revenue collection targets were also not met.

The OCOB (2014) identified a number of challenges facing counties in its first ever report on county budget implementation to include but limited to low uptake of development funds and overrun in recurrent expenditures, low local revenue mobilization, poor technical capability to bear counties in budget preparation and legislation, connectivity and user challenges in IFMIS, and increasing wage bill. Nairobi was the only city council in the defunct local authorities and had a perfect foundation to take off under the new dispensation in terms of meeting revenue collection targets. However, a report of the Auditor General for FY 2014/2015 indicates the county had a revenue budget of Kshs.25.59 billion but indeed collected Kshs.22.76 billion thereby missing the target by over 11%. Furthermore, it was not using IFMIS instead using the defunct LAIFOMS and Jambo Pay for own source revenue collection.

Narok County, on the other hand, was under a town council and is currently among the marginalized counties and therefore will benefit from the Equalization Fund. The county

had a budgeted income of Kshs.8 billion in FY 2014/2015 but indeed received Kshs.6.27 billion which translates to a deficit of Kshs.1.73 in funding. The Auditor General noted that this revenue shortfall of about 22% affected most of the commitment therefore affecting timely payment to creditors resulting in pending bills at the end of the year. Higher local/own source revenue autonomy would have mitigated the problem as it implies better fiscal capacity.

# Chapter Three

# Data Analysis, Presentation and Discussion

## 3.1 Introduction

This chapter presents the findings, data analysis and discussion of the field data for the study areas; fiscal strategy, fiscal capacity and fiscal responsibility laws. The descriptive and inferential statistics are then presented, interpreted and discussed in line with the study objectives. In the next sub-section, we present demographic characteristics of the sampled population and summary descriptive statistics, regression analyses and analysis of variance (ANOVA) are presented for each study variable together with the fitting of a model.

## 3.2 Demographic Characteristics

This section presents findings of key preliminary results and the various tests conducted during the research.

### 3.2.1 Response Rate

The study targeted 105 individuals out of which 87 questionnaires were returned duly filled resulting in a response rate of 82.9 per cent. The study further found that the questionnaires that were half filled and returned were 10 with those that were not returned were 8.

**Table 3.2: Response Rate**

| Category | Frequency | Percentage |
|---|---|---|
| Returned Duly filled | 87 | 82.9 |
| Returned Half filled | 10 | 9.5 |
| Not returned | 8 | 7.6 |
| **Total** | **105** | **100** |

The responses were broken down as follows

**Table 3.3: Response Rate breakdown**

| Category | Expected Sample Size | Actual Response(s) |
|---|---|---|
| Commission of Revenue Allocation | 2 | 2 |
| County Executive Committee in | 2 | 2 |

| | | |
|---|---|---|
| charge of finances for Narok and Nairobi City | | |
| Directorate of Budget, Fiscal and Economic Affairs at the National Treasury | 3 | 2 |
| Controller of Budget | 2 | 1 |
| Auditor General Office | 3 | 1 |
| Sub-County Administrators for Nai-robi City | 9 | 7 |
| Sub-County Administrators for Narok | 4 | 3 |
| Employees and | 40 | 37 |
| Residents | 40 | 32 |
| **Grand Total** | **105** | **87** |

### 3.2.2 Gender Distribution

80% of the respondents were male and the rest were female. The study therefore sampled both genders with men being vocal on the subject at hand. The findings are presented in Table 3.3

**Table 3.4: Gender Distribution**

| Category | Frequency | Percentage |
|---|---|---|
| Male | 70 | 80% |
| Female | 17 | 20% |
| **Total** | **87** | **100%** |

### 3.2.3 Age Distribution

The majority of the respondents (41.4%) were between 41 to 50 years old as shown in Table 3.4 below

**Table 3.5: Age Distribution**

| Age Ranges | Frequency | Percentage |
|---|---|---|

| | | |
|---|---|---|
| 21-30 years | 10 | 11.5 |
| 31-40 years | 34 | 39.1 |
| 41-50 years | 36 | 41.4 |
| 51 years and above | 7 | 8 |
| **Total** | **87** | **100** |

### 3.2.4 Education Level Distribution

Graduate and postgraduate degree holders constituted 40% of the study respondents indicating that majority participants could understand the questions presented forth. The study had 10% of the respondents at other level i.e. doctorate and primary level as presented in Table 3.5 below

**Table 3.6: Education level**

| Level | Frequency | Percentage |
|---|---|---|
| Secondary | 20 | 23 |
| Diploma | 23 | 27 |
| Degree | 22 | 25 |
| Masters | 13 | 15 |
| Other | 9 | 10 |
| **Total** | **87** | **100** |

## 3.3 Descriptive Statistics for County Fiscal Strategy

The county fiscal strategy was examined using seven indicators. These indicators included county having weak fiscal strategies, county having inadequate revenues available, county inherently having narrow revenue base, county experiencing unpredictable revenue allocation, county not having diversified its revenue sources, county having insurmountable vertical revenue gaps, and county having inflated its recurrent expenditures using the five-point Likert scale.

**Table 3.7: Descriptive Statistics for County Fiscal Strategy**

| Statement | SD Freq % | D Freq % | N Freq % | A Freq % | SA Freq % | Mean | SD |
|---|---|---|---|---|---|---|---|
| County had a weak fiscal strategy | 0 0.0% | 5 6.2% | 11 12.5% | 60 68.8% | 11 12.5% | 3.88 | .703 |
| County had inadequate revenues available at its disposal | 5 6.2% | 4 4.2% | 2 2.1% | 63 72.9% | 13 14.6% | 3.86 | .945 |
| County inherently had a narrow revenue base | 7 8.3% | 7 8.3% | 4 4.2% | 62 70.8% | 7 8.3% | 3.62 | 1.044 |
| County experienced unpredictable revenue allocation | 2 2.1% | 9 10.4% | 0 0.0% | 65 75.0% | 11 12.5% | 3.85 | .850 |
| County did not diversify its revenue sources | 5 6.2% | 4 4.2% | 4 4.2% | 53 60.4% | 22 25.0% | 3.94 | 1.019 |
| County had insurmountable vertical revenue gaps | 0 0.0% | 9 10.4% | 7 8.3% | 65 75.0% | 5 6.2% | 3.77 | .722 |
| County inflated its recurrent expenditures | 4 4.2% | 5 6.2% | 2 2.1% | 69 79.2% | 7 8.3% | 3.81 | .842 |

The study found out that 81.3% agreed that the two county governments had weak fiscal strategies while 12.5% strongly agreed on the statement. There was a moderate consensus in respect to the counties having weak fiscal strategies given the standard deviation of 0.703. The study also found that majority of the respondents on being asked whether counties had inadequate revenues available concurred with the assertion (total of 72.9% and 14.6% agreed and strongly agreed respectively for a total of 87.5%) though 10.4% disagreed with the view. There was a moderate spread of the responses across the five response options on the metric therefore moderate consensus that the counties had inadequate revenues available. 79.1% of the respondents agreed that the two county governments inherently had a nar-

row revenue base with the factor achieving a mean of 3.62 reflecting the respondents' opinion being on average in agreement with the county having a narrow revenue base. The standard deviation of 1.044 indicated a huge spread of the responses from the mean that was indicative of a lack of consensus on the county having a narrow revenue base. This is reinforced by the assertion that Nairobi City county does not exploit its broad revenue bases in property and rates to its maximum and instead target mobile bases of car parking permits, health certificate fees among others therefore contributing to a significant percentage of 16.6% who disagreed with the view that county governments had narrow revenue bases.

The study further found that a cumulative 87.5% of the respondents concurred on whether the two county governments experienced unpredictable revenue allocation. This finding is not surprising given the constant bickering between the Senate and the National Assembly on before passage of the county allocation of revenue acts, delay in disbursements by the Controller of Budget, and slow uptake of IFMIS system by the counties in the formative years. 25% of the respondents strongly agreed that the two county governments had not diversified its revenue sources with a cumulative 14.6% on the opposite end of the spectrum. This is confirmed by the Controller of Budget indicating that Narok County heavily relied on proceeds from Maasai Mara Game Reserve (OCOB, 2015). The indicator on whether the two county governments had not diversified their revenue sources had a mean of 3.94 indicating that on average the respondents agreed with the assertion.

The respondents were also asked whether the two county governments experienced insurmountable vertical revenue gaps i.e. expenditure growth far outpaced revenue growth and the study found out that 75% concurred with the statement with 8.3% neutral on the matter thus a mean response of 3.77 and a standard deviation of 0.722 indicating a moderate spread of the responses relative to the mean and therefore a moderate consensus levels. 87.5% of the respondents concurred that the two county governments inflated their recurrent expenditures and this finding concurred with the Controller of Budget's report that 73.2% of Nairobi city's supplementary budget for FY 2014/2015 went to recurrent expenditure while the remaining 26.8% was for development expenditure of which the county experienced low absorption and slow implementation of the same development projects.

### 3.4 Descriptive Statistics for Fiscal Responsibility Laws

The fiscal responsibility laws were examined using eight indicators. These indicators included county not observing tax and expenditure limits from the controller of budget,

County not observing balanced budget rules (budget deficits witnessed and soft budget constraints), county lacking fiscal discipline incentives in its revenue allocation, county government having a debt management plan, county facing inefficient budgetary controls, and county not having operational contingency/emergency fund account. The other indicators included the current fiscal responsibility laws not being sufficient and county not being accountable to its people.

**Table 3.8; Descriptive Statistics for Fiscal Responsibility Laws**

| Statement | SD Freq % | D Freq % | N Freq % | A Freq % | SA Freq % | Mean | SD |
|---|---|---|---|---|---|---|---|
| County did not observe expenditure limits from the Controller of Budget | 2<br>2.1% | 11<br>12.5% | 4<br>4.2% | 58<br>66.7% | 13<br>14.6% | 3.79 | .922 |
| County did not observe balanced budget rules (budget deficits witnessed and soft budget constraints) | 5<br>6.2% | 9<br>10.4% | 7<br>8.3% | 49<br>56.2% | 16<br>18.8% | 3.71 | 1.091 |
| County lacked fiscal discipline incentives in its revenue allocation | 7<br>8.3% | 7<br>8.3% | 5<br>6.2% | 58<br>66.7% | 9<br>10.4% | 3.63 | 1.064 |
| County government had a debt management plan | 2<br>2.1% | 7<br>8.3% | 5<br>6.2% | 69<br>79.2% | 4<br>4.2% | 3.75 | .758 |
| County faced inefficient budgetary controls | 5<br>6.2% | 4<br>4.2% | 0<br>0.0% | 71<br>81.2% | 7<br>8.3% | 3.81 | .891 |
| County did not have an operational contingen- | 4<br>4.2% | 9<br>10.4% | 2<br>2.1% | 54<br>62.5% | 18<br>20.8% | 3.85 | 1.010 |

| cy/emergency fund account | | | | | | | |
|---|---|---|---|---|---|---|---|
| Current fiscal responsibility laws were not sufficient | 2 2.1% | 13 14.6% | 7 8.3% | 51 58.3% | 15 16.7% | 3.73 | .984 |
| County not accountable to its people | 9 10.4 % | 11 12.5% | 2 2.1% | 58 66.7% | 7 8.3% | 3.50 | 1.149 |

The study found out that a cumulative 81.3% of the respondents concurred with the indicator that the two county governments do not observe expenditure limits from the Controller of Budget. The blatant use of local revenue at source contrary to the provision of the PFM Act 2012 by Nairobi City county government should concern all stakeholders. The Controller of Budget further recommended that Nairobi City county should utilize approved exchequer issues on the expenditure items as per the requisition schedule to improve on its budget execution (OCOB, 2015). OCOB also noted that most county entities noticeably the Office of the Governor, and the departments of Health, Transport, Education and Finance and Planning in Narok County exceeded their budgetary allocations. The mean of 3.79 implied that the respondents on average agreed that the two county governments do not observe expenditure limits. The study found that there was a moderate spread amongst the respondents on their opinion on the county not adhering to the expenditure limits.

79.2% of the respondents agreed that the two county governments had a debt management plan with the indicator achieving a mean of 3.75 and a standard deviation of 0.758. 6.2% of the respondents had no idea on the indicator implying lack of information sharing and openness on the sensitive financial management matter. On the contrary though, COB noted, in its annual CBIRR for FY 2014/15, that Nairobi City county lacked a debt management strategy leading to huge pending bills.

89.5% of the respondents concurred that the two county governments had inefficient budgetary controls and this indicator is empirically supported by the OCOB who called out County Treasuries over inappropriate GFS expenditure classification structure and sometimes lack of Vote books to appropriately control exchequer issues to departments. The county government staff should embrace IFMIS to process financial transactions (OCOB, 2015).

75% of the respondents cumulatively agreed that the current fiscal responsibility laws were not sufficient while a cumulative 16.7% did not concur with the indicator. Fiscal discipline encompasses all stakeholders' right from the citizens though the Legislature to the Executive therefore more laws do not mean more compliance. 8.3% of the respondents were neutral in their responses. OCOB (2014) noted the lack of internal audit committee in Narok county in FY 2013/14 to provide advice and oversee operations of the internal audit department does not mean lack of laws rather lag in its implementation.

## 3.5 Descriptive Statistics for Fiscal Capacity

The revenue capacity was measured using five indicators of the study. These indicators included local revenue collection measures, intergovernmental transfers, accountability and transparency, use of technology, and enhancing revenue capacity at the county level.

**Table 3.9: Descriptive Statistics for Fiscal Capacity**

| Statement | SD Freq % | D Freq % | N Freq % | A Freq % | SA Freq % | Mean | SD |
|---|---|---|---|---|---|---|---|
| Counties should have enhanced local revenue collection measures | 7 8.3% | 2 2.1% | 5 6.2% | 60 68.8% | 13 14.6% | 3.79 | 1.010 |
| Counties should get more intergovernmental transfers from the central government | 5 6.2% | 11 12.5% | 4 4.2% | 56 64.6% | 11 12.5% | 3.65 | 1.062 |
| Counties should improve accountability and transparency | 4 4.2% | 9 10.4% | 2 2.1% | 67 77.1% | 5 6.2% | 3.71 | .898 |
| Counties should deploy technology | 5 6.2% | 4 4.2% | 9 10.4% | 60 68.8% | 9 10.4% | 3.73 | .939 |
| County is helplessly weak in revenue capac- | 5 6.2% | 11 12.5% | 7 8.3% | 51 58.3% | 13 14.6% | 3.63 | 1.084 |

| ity | | | | | | | |
|---|---|---|---|---|---|---|---|

The respondents were asked on whether the counties should enhance local revenue collection measures. 83.4% of the respondents concurred that the two county governments have not met their local revenue collection targets and that they should therefore work on enhancing their tax collection measures. While OCOB believes that county governments are over-ambitious on their local revenue collection targets, Ward administrators and other county employees felt that citizens evade their tax payment requirement. There was a moderate agreement that County government's share of revenue should be increased while at the same time county should enhance their collection measures. Some respondents attributed corruption to county's inability to meet their tax collection targets as 83.3% of the respondents concurred with the statement that the two county governments ought to improve their accountability and transparency. Narok county identified sealing all the loopholes on revenue collection at the Maasai Mara Game Reserve together with mapping out all urban areas and market centres, enhancing accountability, building capacity of revenue collectors, and rationalizing the hitherto existing revenue collection measures adopted by the then Narok town, Narok county and Trans Mara county councils. Three indicators had standard deviation greater than or equal to 1 implying high dispersion from the mean thus lack of consensus in respect to their effect on fiscal capacity.

A cumulative 79.2% of the respondents concurred that the two county governments ought to adopt technology to enhance their local revenues while 10.4% were neutral and another cumulative 10.4% didn't concur on the use of IT to enhance revenues. Nairobi City County emphasized adoption of e-payment solution to enhance their revenue collection measures on top of increasing surveillance to curb corruption and criminal activities of rogue staff, and enhancing capacity of their staff to improve service delivery. In fact, the county recognized that continuous reforms that affect the tax base, revenue collection mechanism and accountability modalities will play an important role.

### 3.6 County Fiscal Sustainability

The county fiscal sustainability was examined using the four solvencies namely; cash, budget, service-level, and long-run i.e. their ability to provide services to the citizen's preference and also suppliers' on time including paying their dues within the current fiscal year and even in future. The results of the frequency distribution are presented in Table 3.9.

**Table 3.10: Descriptive Statistics for County Fiscal Sustainability**

| Statement | SD Freq % | D Freq % | N Freq % | A Freq % | SA Freq % | Mean | SD |
|---|---|---|---|---|---|---|---|
| My county did not pay its obligations immediately/as they fall due (cash solvency). | 4 4.2% | 5 6.2% | 2 2.1% | 65 75.0% | 11 12.5% | 3.85 | .875 |
| My county did not pay financial obligations within the current fiscal period (budget solvency) | 2 2.1% | 7 8.3% | 9 10.4% | 63 72.9% | 5 6.2% | 3.73 | .792 |
| My county might not be able to continue paying obligations in future fiscal periods (long-run solvency) | 5 6.2% | 9 10.4% | 5 6.2% | 58 66.7% | 9 10.4% | 3.65 | 1.021 |
| My county might not be able to continue providing the level of services we expect (service-level solvency). | 4 4.2% | 2 2.1% | 4 4.2% | 65 75.0% | 13 14.6% | 3.94 | .810 |
| My county could not meet its obligations (both service and financial) | 9 10.4 % | 9 10.4% | 7 8.3% | 54 62.5% | 7 8.3% | 3.54 | 1.071 |

The study findings on the table above indicates that 75% of the respondents agree that the two county governments didn't pay their suppliers on time leading to massive pending bills and county governments resorting to bank overdrafts and short term loans to pay its debts. Similar to the previous finding, a cumulative 79% also concur that county governments did not pay all their expenditures within the current fiscal year a fact attributed to constant wrangling between the county government executive and its legislature, senate and the national assembly on the revenue allocation formula, and transfer of functions within the first two fiscal years.

On service delivery level, a cumulative 89.6% of the respondents concurred that the quality of service does not meet their expectations given a mean of 3.94. This can be attributed to the big-bang transfer of functions from the central government to the counties without sufficient funding levels. This study also cast a doubt on county government's ability to continue paying obligations in future fiscal periods given the current fiscal practices as a cumulative 77.1% of the respondents concurred with this indicator therefore affecting the sustainability of the county governments.

### 3.7 Regression Analysis

This study undertook regression analysis to establish the relative significance of each of these variables on fiscal sustainability at the county level from 2013 to 2016. Kothari (2004) notes that regression analysis seeks to observe the cause and effect relationship between one variable on dependent variable and two or more independent variables. As a result, regression analysis was used to observe the extent of change in county government financial sustainability is because of the changes in fiscal capacity, fiscal responsibility laws, and fiscal strategy. This analysis also looked at the predictive influence of fiscal strategy and adherence to fiscal responsibility laws and fiscal capacity on the county fiscal sustainability between 2013 and 2016. The results for the regression analysis are presented in three tables namely; model summary (Table 3.10), ANOVA (Table 3.11) and coefficients (Table 3.12).

**Table 3.10;Model Summary**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .886[a] | .784 | .770 | .12754 |

a. Predictors: (Constant), Revenue Capacity, Fiscal Responsibility Laws, and Fiscal Strategy

In this study, regression model presents the multiple linear correlation coefficient (R) and coefficient of determination (R Square). According to Chatterjee and Hadi, 2006, the multiple linear correlation coefficient examines the correlation (joint variation) between the independent variables cumulatively and the dependent variable. As shown above, R figure of .866 indicates a robust correlation between the independent variables (Revenue Capacity, Fiscal Responsibility Laws, and Fiscal Strategy) and the dependent variable (Fiscal Sustainability). In this study, the coefficient of determination of 0.784 shows that 78.4% of the changes in the county financial sustainability is a result of the three independent variables (revenue capacity, fiscal responsibility laws, and fiscal strategy) and the difference of 21.6% of the change in the financial sustainability would be due to factors beyond this study.

**Table 3.11;ANOVA[a]**

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | 2.602 | 3 | .867 | 53.309 | .000[b] |
| | Residual | .716 | 83 | .016 | | |
| | Total | 3.317 | 86 | | | |

a. Dependent Variable: Fiscal Sustainability

b. Predictors: (Constant), Revenue Capacity, Fiscal Responsibility Laws, and Fiscal Strategy

To assess the statistical significance of the result, the Analysis of Variance (ANOVA) was used to whether the model is good fit for data by testing the null hypothesis that multiple R in the population equals 0. According to Gathii, Wamukuru, Karanja, Muriithi, and Maina (2019), ANOVA is used to check whether the model has predictive capacity over the dependent variable by testing the following hypothesis;

$$H0: \beta 1=\beta 2=\beta 3=0$$

$$H1: \beta i \neq 0 \text{ where } i=1, 2, 3$$

This stated hypothesis was tested using F statistics with 5% level of significance. The achieved results were F (3, 44) = 53.309 with the p (Fc (3, 44) > Fobs (3, 44)) =0.000. Since the p value < 0.05, the study concluded that the null hypothesis was to be precluded and the alternative hypothesis established. The study therefore concluded that the regression model had predictive capacity (was good fit for data) over the dependent variable (Financial Sustainability) and therefore the coefficients of the regression model could be examined.

**Table 3.12: Coefficients[a]**

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|
| | B | Std. Error | Beta | | |
| (Constant) | .776 | .120 | | 6.479 | .000 |
| Fiscal Strategy | .226 | .058 | .340 | 3.886 | .000 |
| Fiscal Responsibility laws | .191 | .051 | .321 | 3.750 | .001 |
| Revenue Capacity | .233 | .042 | .443 | 5.512 | .000 |

a. Dependent Variable: fiscal Sustainability

The study examined the regression coefficients of the models with a view of constructing the regression model. The study revealed that fiscal strategy, fiscal responsibility laws and revenue capacity had coefficients of 0.226, 0.191 and 0.233 respectively leading to the following regression model;

$Y=0.776 + 0.226X1+0.191X2+0.233X3$ where X1, X2, and X3 are Fiscal Strategy, Fiscal Responsibility Laws, and Revenue Capacity respectively.

In the examination of the influence of fiscal strategy on fiscal sustainability, the study found a regression coefficient of 0.226 that implied that a 100 per cent change in the Fiscal Strategy would lead to a 22.6 per cent change in Fiscal Sustainability ceteris paribus. The study further noted that p (tc > tobs) stood at 0.000 therefore the results had statistical significance. The study also found, while looking at the influence of Fiscal Responsibility Laws on the Fiscal Sustainability, that a regression coefficient of 0.191 was achieved. This implied

that a 100 per cent change in Fiscal Responsibility Laws would lead to 19.1 per cent change in Financial Sustainability ceteris paribus. The study further found that p (tc > tobs) stood at 0.001 thus Fiscal Responsibility demonstrated a statistically important effect on the Fiscal Sustainability. Finally, the study found that a 100 per cent change in Revenue Capacity would lead to a 23.3 per cent change in Fiscal Sustainability without taking into consideration the influence of other variables. The study further revealed that p (tc>tobs) stood at 0.000 this indicating statistical significance.

# Chapter Four

# Summary, Conclusions and Recommendations

## 4.1 Introduction

This chapter discussed the summary of findings analyzed in the previous chapter in four ways. The first summarized the major findings. The study then evaluated the extent the core objectives of the study were met vis-à-vis the findings from literature review. The third one anchored the conclusion of the study on the major arguments presented and lastly, the study drew recommendations deduced from the study.

## 4.2 Summary of findings

The summary of the findings were summarized and examined per objective of the study.

### 4.2.1 County Fiscal Strategy

The study investigated the effect of county fiscal strategy on fiscal sustainability in Kenya. The county fiscal strategy was examined using seven indicators which included county having weak fiscal strategies, county having inadequate revenues available, county inherently having narrow revenue base, county experiencing unpredictable revenue allocation, county not having diversified its revenue sources, county having insurmountable vertical revenue gaps, and county having inflated its recurrent expenditures herein becoming the assumption underlying this objective.

The study found that all the indicators of county fiscal strategy had means of above 3.5 that ranged from 3.62 to 3.94 indicating that the respondents on average agreed with those indicators (Table 3.6). The study further noted that two indicators i.e. narrow revenue base (1.044) and diversified revenue (1.019) had standard deviations of above 1.000 leading to a conclusion that the respondents lacked consensus in respect to those indicators.

### 4.2.2 Fiscal Responsibility Laws

The study determined the effect of non-adherence to fiscal responsibility laws on county fiscal sustainability in Kenya. The fiscal responsibility laws were examined using eight indicators which included county not observing tax and expenditure limits from the controller of budget, county not observing balanced budget rules (budget deficits witnessed and soft budget constraints), county lacking fiscal discipline incentives in its revenue allocation, county government having a debt management plan, county facing inefficient budgetary

controls, and county not having operational contingency/emergency fund account herein becoming the assumption underlying this objective. The other indicators included the current fiscal responsibility laws not being sufficient and county not being accountable to its people.

The study found that all the indicators of the fiscal responsibility laws had means of above 3.5 indicating that there was agreement amongst the respondents on each of those indicators on average (Table 3.7). However, the study noted a general lack of consensus with respect to the county not observing balanced budget rules (1.091), county lacking fiscal discipline incentives in its revenue allocation (1.064), county not having operational contingency/emergency fund account (1.01), and county not being accountable to its people (1.149) had standard deviation above 1.000.

### 4.2.3 Fiscal Capacity

The study finally ascertained the influence of revenue capacity on county fiscal sustainability in Kenya. The revenue capacity was measured using five indicators of the study which included counties embracing sophisticated and better local revenue collection measures, counties getting more intergovernmental transfers from the central government, counties improving on the accountability and transparency, counties deploying modern technology, and county being helplessly weak in revenue capacity aspects herein becoming the assumption underlying this objective.

The study indicators had a mean of 3.5 and above indicating on average the respondents were in agreement with the metrics of the variable (Table 3.8). Only two variables i.e. improvement of accountability and transparency (0.898), and deployment of IT (0.969) had standard deviation of less than 1.000 indicating a modest consensus amongst the respondents on the items at hand. However, the respondents generally lacked consensus on the three other indicators i.e. enhancing revenue collection measures (1.01), increasing allocation from the central government (1.062) and lack in revenue capacity (1.084).

### 4.2.4 County Fiscal Sustainability

The study sought to explore whether county governments in Kenya were fiscally sustainable between 2013 through 2016. The county fiscal sustainability was examined using five indicators of the variable which included enquiring on cash solvency, budget solvency, long-run solvency, and service-level solvency. The study found that all the indicators of the county fiscal sustainability had means of above 3.5 indicating that the respondents on average

agreed that county governments were struggling to pay all its obligations as they fall due even within the fiscal year thus casting aspersions on their ability to pay in future periods. Majority of the respondents (89.6%) also agreed that services provided by county governments did not meet their expectations as the standard deviation was 0.81 (Table 3.9). However, two indicators i.e. service-level and long run solvency had a standard deviation greater than 1.000 indicating lack of general consensus on the role of county government in future.

### 4.3 Recapitulation of the study objectives

The broad objective of this study was to analyze the internal determinants in county government fiscal sustainability in Kenya between 2013 and 2016 utilizing the fiscal federalism and decentralization theories in a bid to understand how assignments of revenues and expenditures, intergovernmental transfers, tax administration, subnational borrowing, and budgeting and fiscal management affect fiscal sustainability. The study had three specific objectives namely, to first investigate the influence of county fiscal strategy on fiscal sustainability in Kenya; second, determined the effect of non-adherence to fiscal responsibility laws on county fiscal sustainability in Kenya, and finally, ascertained the influence of revenue capacity on county fiscal sustainability in Kenya. The results were discussed in relation to existing literature.

#### 4.3.1 Fiscal Strategy and Fiscal Sustainability

The study investigated the influence of county fiscal strategy on fiscal sustainability in Kenya. The study found that fiscal strategy had a statistical influence on the fiscal sustainability in that a 100 per cent change in fiscal strategy was associated with 22.6 per cent change in fiscal sustainability at 5% level of significance. These views agrees with Nyongesa (2014), who found that the county government of Mombasa had adopted strategies in order to improve revenue collection including outsourcing cleaning, solid waste, and sewage management services to external providers; diversified its tax strategies including development of new licenses for all business groups and establishment of fully functional county offices; recruitment and training of new labor force; development of geographically decentralized ICT-based tax collection systems and outreach offices at the sub county level; tax awareness in the form of increased education and monitoring of county revenue collection staff; and performance management measures geared towards managing the output quality of its services at the least cost with maximum satisfaction.

The study further agrees with Commission of Revenue Allocation's FY 2013/14 report that counties lacked the requisite capacity to adequately prepare the CIDP, CADP, CBROP and CFSP prior to budgeting. The counties neither met the timelines nor embark on public participation as stipulated in PFM Act of 2012 and thus the commission therefore provided technical assistance on planning and budgeting.

### 4.3.2 Fiscal Responsibility Rules and Fiscal Sustainability

The study determined the effect of non-adherence to fiscal responsibility laws on county fiscal sustainability in Kenya. The study found that adherence to the fiscal responsibility rules had a statistical significance on fiscal sustainability in that a 100% change in adherence to fiscal responsibility was associated with 19.1 per cent increase in fiscal sustainability. These results were found to be statistically significant at 5% level of significance.

These findings are congruent with the findings of the Auditor General who found that 40 counties had huge pending bills during FY 2014/15 therefore increasing the fiduciary risk. The Auditor General attributed this to fiscal indiscipline where the budget doesn't inform commitments during the year. Nairobi City County in fact reported KES. 58 billion for FY 2013/14. It was found that adhering to fiscal responsibility rules like expenditure limits (avoiding unsupported and unbudgeted expenditures), balanced budget, debt management, adherence to budgetary controls was bound to improve county government fiscal sustainability.

The study further agreed with CRA's findings in FY 2013/14 that the county governments witnessed unprecedented operations and maintenance costs which threatened development activities therefore against the fiscal responsibility laws in the PFM Act 2012. CRA had to introduce expenditure ceilings to counties which capped recurrent expenditures for the county executive and county assembly even though they were not adhered to as reported in subsequent FY 2014/15 and FY 2015/16 reports. Just like in India, the study agrees that most county government borrowing in form of bank overdrafts appears to finance recurrent expenditure therefore exhibiting inappropriate borrowing (Lewis and Searle, 2010).

### 4.3.3 Fiscal Capacity and Fiscal Sustainability

The study ascertained the influence of revenue capacity on county fiscal sustainability in Kenya. The study found that revenue capacity had a statistical influence on fiscal sustainability in that a unit increase in revenue capacity was associated with 0.233 increase in fiscal

sustainability at 5% level of significance. These findings supported with Pricewaterhouse-Coopers (PwC, 2006) which concluded that local councils facing financial sustainability constraints in Australia were characterized by minimal revenue growth, costs growing at a higher rate than revenue centers, increasing interest in non-core service provision to meet the rising public burden, operating deficits necessitating deferment or underspending on capital spending, limited access to financial and human capital skills, and limited access to rate revenue.

The study also agreed with the CRA in its 2013/14 annual report that marginalized counties including Narok County will benefit from the equalization fund as a conditional grant to be appropriated as a single budget line for each year. This will boost the revenue capacity and therefore fiscal sustainability. However, the equalization fund has not been operationalized by the National Treasury in the period of study.

## 4.4 Recommendations

The study realized important findings on internal determinants on county government fiscal sustainability in Kenya in line with the three specific objectives and results of the study.

### 4.4.1 Fiscal Strategy

The two county governments should strengthen their fiscal strategies by fostering public participation so that medium-term and long-term objectives of their fiscal policies is known to all residents. The two county governments should enhance their local revenue collection measures apart from lobbying for more transfers through the Council of Governors (CoG) and the Intergovernmental Budget and Economic Council (IBEC) from the national government in line with principle of funding following functions. In order to control the ballooning recurrent expenditure majorly wage bill at the two counties, both governments ought to work with the established commissions to rationalize their revenue and expenditure plans. Both county governments should broaden their revenue bases by diversifying revenue to provide more firmness and elasticity in financial management. Specifically, Nairobi City County should exploit its broad revenue bases in property and rates to its maximum and instead target mobile bases of car parking permits, health certificate fees among others while Narok County should look further than Maasai Mara Game Reserve to expand its local revenue base.

On unpredictable revenue allocation, the two counties through CoG and IBEC should work hand-in-hand with CRA and the Senate to ensure timely passage of revenue allocation formulas and the annual division of revenue bills, conform to OCOB requirement to ensure

no delays in disbursements, and train their staff on IFMIS in collaboration with the National Treasury. On the same vein, more transfers from the national government would help bridge the insurmountable vertical revenue gaps i.e. expenditure growth far outpaced revenue growth. Finally, the two county governments should rationalize their recurrent expenditures and adhere to statutory requirement of 30% of expenditure devoted to development expenditures. The two government should employ better revenue forecasting models in their CFSP in order to capture actual county performance in the previous period, set expenditure while forecasting expected revenue and expenditure for the next fiscal year. Both county governments should continue in their revenue automation efforts aside from engaging private sector players or even national government bodies like the Kenya Revenue Authority (KRA).

#### 4.4.2 Adherence to Fiscal Responsibility Laws

There is need for county government to totally adhere to fiscal responsibility laws as dictated by PFM Act 2012. The two county governments should observe expenditure limits from the Controller of Budget as passed by each vote in regard to personnel emoluments, operations and maintenance, and development activities. Nairobi City county government ought to desist from using its local revenue at source contrary to the provision of section 109 of the PFM Act 2012. This is revealed when total expenditure is considered as a percentage of the funds authorized for withdrawal against total expenditure. Further, the Controller of Budget further recommended that Nairobi City county should utilize approved exchequer issues on the expenditure items as per the requisition schedule in order to improve on its budget execution. As for Narok County, the Office of the Governor, and the departments of Health, Transport, Education and Finance and Planning among others should not exceed their budgetary allocations.

The two county governments should have a robust debt management plan and be willing to divulge information to their clients and suppliers for the sake of transparency. Specifically, Nairobi City County government should strive to pay their suppliers promptly and avoid huge pending bills. Both county government's Treasuries use appropriate GFS expenditure classification structures and adhere to vote books to appropriately control exchequer issues to departments. Both county government staff should embrace IFMIS to process financial transactions. Finally, adherence to all fiscal responsibility principles as espoused in PFM Act 2012 should be of paramount endeavour. Fiscal discipline encompasses all stakeholders' right from the citizens though the legislature to the executive therefore more laws

don't mean more compliance. In addition, Narok county government should embrace an internal audit committee to provide advice and oversee operations of the internal audit department.

### 4.4.3 Fiscal capacity

Finally, county governments are urged to enhance revenue capacity by enhancing revenue collection measures, prudently managing intergovernmental transfers in service provision, embrace transparency and accountability, embracing IT in tax collection, properly prioritize spending needs, and enhance fiscal wealth to help cover government fiscal imbalances, and supplement the lowly performing local own source revenues. The two county governments should enhance local revenue collection measures in a bid to meet their local revenue collection targets aside from being realistic in their local revenue forecast.

On the other hand, residents should pay taxes as required including depositing funds to official county accounts/channels instead of paying corrupt county officials as several Ward Administrators and other county employees felt that citizens evade their tax payment requirement. Both governments should improve on their accountability and transparency. Specifically, Narok county should endeavour to seal all the loopholes on revenue collection at the Maasai Mara Game Reserve together with mapping out all urban areas and market centres, enhancing accountability, building capacity of revenue collectors, and rationalizing the hitherto existing revenue collection measures adopted by the then Narok town, Narok county and Transmara county councils. Furthermore, the two county governments ought to adopt technology to enhance their local revenues. Nairobi City County should strengthen the adoption of e-payment solution to enhance their revenue collection measures on top of increasing surveillance to curb corruption and criminal activities of rogue staff, and enhancing capacity of their staff to improve service delivery.

### 4.4.4 Fiscal sustainability

The study recommends that the two county governments should endeavour to pay their suppliers promptly to avoid massive pending bills leading to resorting to bank overdrafts and short-term loans to pay its debts. In a bid to settle all current year expenditures as planned, both governments should work harmoniously and avoid constant wrangles between their county government executive and its legislature. This will ensure that the county budget implementation is not delayed for instance when the annual finance bill is out rightly rejected

by the County Governor at times due to political persuasions. On service delivery level, both governments should embrace public participation to contain the high level of expectation among its residents. Whereas devolution promises services delivery closer to the people, the situation is exacerbated by insufficient information on what are really contained in the short-term, mid\-term and long-term plans of the county. Both governments must appreciate that the big-bang transfer of functions from the central government without sufficient funding levels will not cut it as a reason for not-delivering on their mandates during elections.

## 4.5 Suggestions for further research

This study has contributed to the body of knowledge on effects/role of fiscal strategy, fiscal capacity and adherence to fiscal responsibility laws on fiscal sustainability in Kenya. The study recommends scholars and policy makers to research on other internal determinants like revenue diversification and budgeting practices on fiscal sustainability perhaps on other counties not sampled in this study.

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## APPENDICES AND ANNEXES

APPENDIX 1: Research Questionnaire

**Instructions**

1. Tick appropriately in the box ( ☐ ) or fill in the space provided.
2. Feel free to give further relevant information to the research and not in the questionnaire.

**PART A: Respondent information**

1) Name of respondent (optional)…………………………………………………
2) Title of the respondent………………………………………………………….
3) County (If applicable) ………………………………………………………….
4) Institution (If applicable) ……………………………………………………….
5) Sex Male [_____]
   Female [_____]
6) Age
   a. 21-30 [______]
   b. 31-40 [______]
   c. 41-50 [______]
   d. 51-above [______]
7) Level of formal education attained
   a. Secondary
   b. Diploma
   c. Degree
   d. Masters
   e. Other

**PART B: Describing the influence of county fiscal strategy on fiscal sustainability between 2013 and 2016.**

1. What is the experience the counties have had in its financial management between 2013 and 2016?

2. What strategies have you put in place to enhance fiscal sustainability?

3. What were the main challenges faced in preparing your fiscal strategies?
   Explain

4. Please indicate you level of agreement as in the following statements on influence of county fiscal strategy on fiscal sustainability
   **1). SA – Strongly Agree, 2) A – Agree 3) N – Neutral 4) D – Disagree 5) SD – Strongly Disagree**

| Statement | SA | A | N | D | SD |
|---|---|---|---|---|---|
| 1. County had a weak fiscal strategy | | | | | |
| 2. County had inadequate revenues available at its disposal | | | | | |
| 3. County inherently has narrow revenue base | | | | | |
| 4. County experience unpredictable revenue allocation | | | | | |
| 5. County has not diversified its revenue sources | | | | | |
| 6. County has insurmountable vertical revenue gaps | | | | | |
| 7. County has inflated its recurrent expenditures | | | | | |

5. What other reasons do you have?

**<u>PART C:</u> Describing the effect of fiscal responsibility laws on county fiscal sustainability between 2013 and 2016**

6. To what extent do you agree or disagree with the following statements on the effect of fiscal responsibility laws on county fiscal sustainability

   **1). SA – Strongly Agree, 2) A – Agree 3) N – Neutral 4) D – Disagree 5) SD – Strongly Disagree**

| Statement | SA | A | N | D | SD |
|---|---|---|---|---|---|
| 1. County don't observe tax and expenditure limits from the Controller of Budget | | | | | |
| 2. County don't observe balanced budget rules (budget deficits witnessed and soft budget constraints) | | | | | |
| 3. County lack fiscal discipline incentives in its revenue allocation | | | | | |
| 4. County government has a debt management plan | | | | | |
| 5. County face inefficient budgetary controls | | | | | |
| 6. County don't have operational contingency/emergency fund account | | | | | |
| 7. Current fiscal responsibility laws are not sufficient | | | | | |
| 8. County not accountable to its people | | | | | |

7. What other measures should counties undertake to ensure they succeed?

   ……………………………………………………………………………………………

…………………………………………………………………………………………………

……………………………………………………………………………………………..

…

**<u>PART D:</u> Describing the influence of revenue capacity on county fiscal sustainability between 2013 and 2016?**

8. To what extent do you agree or disagree with the following statements on the influence of revenue capacity on county fiscal sustainability

   **1). SA – Strongly Agree, 2) A – Agree 3) N – Neutral 4) D – Disagree 5) SD – Strongly Disagree**

| Statement | SA | A | N | D | SD |
|---|---|---|---|---|---|
| 9. Counties should enhance local revenue collection measures | | | | | |
| 10. Counties should get more inter-governmental transfers from the central government | | | | | |
| 11. Counties should improve accountability and transparency | | | | | |
| 12. Counties should deploy technology | | | | | |
| 13. Counties are generally not fiscally wealthy | | | | | |
| 14. County is helplessly weak in revenue capacity | | | | | |

9. What other measures should counties undertake to ensure higher fiscal capacity

   ……………………………………………………………………………………

   ………………………………………………………………………………………

   ………………………………………………………………………………………

**<u>PART E:</u> Describing county fiscal sustainability between 2013 and 2016?**

10. To what extent do you agree or disagree with the following statements on your county fiscal sustainability

**1). SA – Strongly Agree, 2) A – Agree 3) N – Neutral 4) D – Disagree 5) SD – Strongly Disagree**

| Statement | SA | A | N | D | SD |
|---|---|---|---|---|---|
| 15. My County is able to pay its obligations immediately/as they fall due (cash solvency). | | | | | |
| 16. My county is able to pay financial obligations within the current fiscal period (budget solvency) | | | | | |
| 17. My County is able to continue paying obligations in future fiscal periods (long-run solvency) | | | | | |
| 18. My county is able to continue providing the level of services expected by its constituents (service-level solvency). | | | | | |
| 19. My county is able to meet its obligations (both service and financial) | | | | | |