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Fiscal Decentralization and Macroeconomics Stability in Kenya

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About Article

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ABSTRACT

This study investigated effects of the fiscal decentralization on macroeconomic stability in Kenya using time series data for the period 1991 – 2023. Specifically, analyzed the effects of fiscal decentralization on inflation and unemployment in Kenya. Literature on fiscal decentralization show that the association between fiscal decentralization and macroeconomic stability has been scantily analyzed and controversial. This study complements this subject by looking at other dimension of macroeconomic stability and examining other factors that might moderate the effects of fiscal decentralization on macroeconomic stability. Within the framework of a monetary phenomenon, the ordinary least square technique is used to estimate the effect of fiscal decentralization on macroeconomic stability in Kenya. The paper employed two indicators of fiscal decentralization, expenditure decentralization and revenue decentralization to measure the degree of fiscal decentralization in Kenya. The empirical results revealed while revenue decentralization appears to improve macroeconomic stability, expenditure decentralization had no significant effect on macroeconomic stability in Kenya. The policy implication of this findings is that national government needs to give fiscal autonomy to county governments while putting in place a mechanism to engender budget constraints and make county governments accountable for their expenditure.

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1. INTRODUCTION

Fiscal decentralization involves transferring authority over public finances and service delivery from the central government to regional or local governments (Tanzi, 1996; Litvack, 1999). This process encompasses four key fiscal relationships between different levels of government: (i) the allocation of spending responsibilities, (ii) authority to generate revenue through taxation, (iii) the ability of subnational entities to borrow, and (iv) mechanisms for intergovernmental fiscal transfers. In recent years, fiscal decentralization has become a significant policy consideration for many developing countries and is strongly supported by international organizations such as the World Bank and the Organization for Economic Cooperation and Development (World Bank, 2003).

In the 1980s, economic reforms in developing nations primarily emphasized enhancing market efficiency through liberalization and creating a more supportive environment for market operations. For a time, this focus heavily leaned toward strengthening the private sector, often overlooking the potential contributions of the public sector to development. However, in more recent decades, there has been a growing effort to reassess and revamp the role of the public sector in these countries, with an emphasis on improving its effectiveness. A key aspect of these efforts has been the adoption of decentralization policies, aimed at redistributing governmental responsibilities. Since the early 1990s, fiscal decentralization and local governance reforms have emerged as major elements in development strategies (World Bank, 2000).

In many developing nations, local governments were initially established through colonial rule and international development aid. However, these structures often failed to fulfill their intended roles or gain legitimacy among local populations. After gaining independence, many countries inherited governance systems that did not align with their cultural values or developmental priorities. As a result, local governments were primarily used for administrative control rather than fostering local autonomy, democratic participation, or economic progress. Additionally, early development theorists often advised centralizing economic control as a means of accelerating growth, discouraging the formation of robust local governance. Consequently, national development strategies emphasized central planning, industrialization, and technology transfer, often favoring spatial concentration to achieve economies of scale. This led to the marginalization of local authorities, who were largely relegated to executing decisions made by central governments.

One of the main reasons local governments have often been overlooked in developing nations is the resistance from powerful central governments to decentralize authority (Smoke, 2001). While some of this resistance is justifiable—such as the need to maintain national unity in ethnically diverse societies or to preserve macroeconomic stability in vulnerable economies—other factors are more self-interested. Political elites, frequently from dominant ethnic groups, may resist decentralization due to concerns over losing control and access to resources. Additionally, central government ministries and political parties that manage significant budgets are generally reluctant to relinquish authority or share financial power with independent local institutions.

Davoodi and Zou (1998) highlight a widely accepted theoretical assumption that delegating political and administrative responsibilities to local governments enhances economic efficiency in delivering public services. This is largely attributed to local authorities' closer proximity both institutionally and geographically to citizens, which gives them better access to information. As a result, decentralization is believed to contribute positively to economic growth at both national and regional levels. Similarly, scholars such as Oates (1993), Bird (1993), and Gramlich (1993) argue that decentralizing revenue and expenditure responsibilities can enhance the public sector's efficiency, help reduce fiscal deficits, and promote overall economic development.

Despite these potential benefits, some researchers warn that fiscal decentralization can negatively impact macroeconomic stability (Tanzi, 1996; Prud'homme, 1995; Phillips, 1997; Ter-Minassian, 2000). Critics often raise several recurring concerns. First, they point out that local governments frequently operate at a deficit and rely on the central government for financial support. Second, rigid systems of resource allocation from the central to local levels may weaken the central authority's ability to manage national finances effectively. Third, there are concerns that local authorities often default on loans provided by the central government, which may lead the latter to assume the repayment burden sometimes involving international creditors like the World Bank. Fourth, it is argued that local governments may exert political pressure on the central government to obtain more resources. Fifth, the perception that local administrations are more prone to corruption raises concerns about inefficient and improper use of public funds. Lastly, critics warn that competition between local governments and between local and central governments over tax bases or business-friendly policies can disrupt domestic trade and raise operational costs for businesses. Altogether, these issues are seen as significant threats to maintaining macroeconomic stability.

1.1. Fiscal Decentralization and Macroeconomic Stability in Kenya

Like other developing countries, various Kenyan administrations have pursued fiscal decentralization as a strategy to promote balanced development across the country's diverse regions. Since gaining independence in 1963, the government has introduced several fiscal decentralization initiatives. These include the District Development Grant Program launched in 1966, the Special Rural Development Program initiated in 1969/1970, District Development Planning introduced in 1971, the District Focus for Rural Development strategy of 1983/84, and the Rural Trade and Production Center program rolled out in 1988/89, the Local Government Transfer Fund (LATF) (1999), the Constituency Development Fund (CDF) and the Constitution of Kenya 2010 further entrenches decentralization through equitable sharing of revenue between the national and county governments. Despite the introduction of a multiplicity of decentralized funds over the years, there is little improvement in the living standards and circumstances of the poor. This study seeks to investigate the effects of fiscal decentralization on macroeconomic stability in Kenya. The figure 1 represents the dynamics of fiscal decentralization and Macroeconomic stability indicators for Kenya in the period 1991-2023.

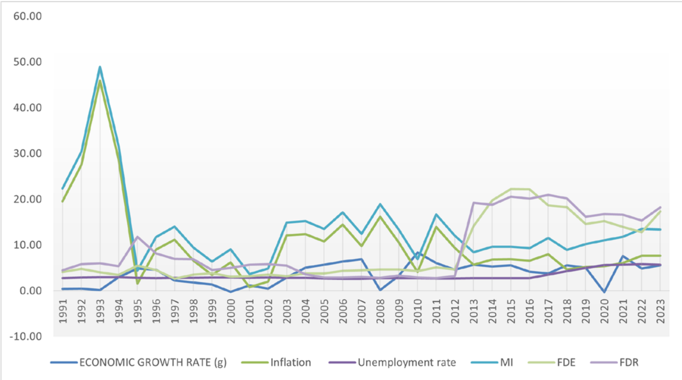

Figure 1. Dynamics of fiscal decentralization and Macroeconomic stability indicators for Kenya in the period 1991-2023.

The most widely used indicators of fiscal decentralization are the share of subnational governments in total government expenditure (FDE) and the revenue autonomy indicator, which reflects the proportion of subnational revenue in total government revenue (FDR). As illustrated in Figure 1, both the subnational spending share (FDE) and the ratio of local government revenue to total government revenue (FDR) remained low, suggesting a high level of centralization up to 2013. After that year, there was a noticeable improvement, which was ascribed to the devolution measures that created counties as independent subnational organisations with more fiscal power. Kenya's macroeconomic stability has seen significant swings over time, as evidenced by changes in the Misery Index (MI) and inflation trends. Due in large part to an excess of money, a lack of foreign exchange after exchange rate liberalization, and increased government spending related to the 1992 elections, inflation reached a peak of 46% in 1993. Following this time, the nation went through periods of more stable conditions, punctuated by periods of volatility caused by both internal and external influences. Early in the new millennium, inflation decreased, but when food and energy prices rose and political unrest occurred, inflation eventually rose. Notably, the worldwide food crisis, the post-election unrest in 2007 and 2008, and the global financial downturn caused inflation to spike in 2008 and 2011. All things considered; Kenya seems to have preserved more macroeconomic stability throughout the devolution era.

One important question that still has to be answered is whether county governments' increased spending leads to national fiscal deficits and jeopardizes macroeconomic stability. In general, there can be a great deal of volatility in macroeconomic indices including inflation, money supply, interest rates, unemployment, and exchange rates. This can impede the growth of the national economy and create an unstable macroeconomic environment. Given that the central government's duty covers the entire nation, this issue is especially pertinent to the stabilization function that it normally plays, particularly in regulating the national currency and containing inflation. Consequently, it is clear that fiscal decentralization has important effects on macroeconomic stability as well as national growth. Using time series data spanning the years 1991–2023, this study seeks to examine how Kenya's fiscal decentralization has affected macroeconomic stability.

Although fiscal decentralization is well recognized for its benefits in enhancing resource allocation (Tanzi, 1996), it also poses serious obstacles to preserving macroeconomic stability at the national level. The central government's control over a sizable amount of taxes and public spending is diminished as government duties are divided across several levels. Its ability to successfully guide macroeconomic outcomes may be limited by this deterioration of fiscal control. Furthermore, national attempts to preserve economic stability may be jeopardized if local governments are allowed unfettered access to capital markets or if they neglect to properly manage their budgets.

The precise nature of this relationship is yet unknown, despite the claims of some academics that fiscal decentralization improves macroeconomic stability (Prudhomme, 1995; Martinez-Vazquez & McNab, 2006; Treisman, 2000; Rodden & Wibbels, 2002; Martinez-Vazquez & McNab, 2003). Some empirical studies have found a negative or insignificant effect, especially in terms of price stability (Feltenstein & Iwata, 2005; Shah, 2006; Thornton, 2007), while others have found a positive and significant impact on stability (King & Ma, 2001; Neyapti, 2004; Martinez-Vazquez & McNab, 2006). Several researchers also contend that there is no consistent link between fiscal decentralization and inflation levels (Treisman, 2000; Rodden & Wibbels, 2002; Blessings, 2020).

Existing research offers no clear consensus on the nature or significance of the relationship between fiscal decentralization and macroeconomic stability. The issue of whether fiscal decentralization significantly affects macroeconomic stability is still up for debate. The majority of earlier research has mostly examined its direct impact on economic expansion. The purpose of this study is to evaluate fiscal decentralization's direct and possible indirect effects on growth, with a focus on how it affects macroeconomic stability. The study specifically aims to assess how fiscal decentralization affects Kenya's macroeconomic stability.

2. LITERATURE REVIEW

Tiebout (1956), Musgrave (1959), and Oates (1972) developed the first theoretical framework of fiscal federalism, which served as the foundation for a thorough examination of fiscal decentralization. Olson (1969) made a substantial contribution as well with his notion of fiscal equivalency. The fundamental, first-generation literature on fiscal decentralization includes these publications as well as Brennan and Buchanan's (1980) introduction of the public choice theory of multi-level governance in The Power to Tax: Analytical Foundations of a Fiscal Constitution.

According to Musgrave (1959), the three main purposes of public finance are resource allocation, income distribution, and economic stabilization. Especially outside the public choice framework, these functions have been important points of reference for traditional public finance experts in their initial assessments of fiscal decentralization. Although each function may be studied separately using a consistent theoretical framework, integrating them presents difficulties because of varying opinions regarding the relative significance of stability, equity, and efficiency. Musgrave's approach has been crucial in bringing attention to the limitations of fiscal decentralization, specifically stabilization and redistribution, as well as its potential benefit in enhancing allocative efficiency within the framework of federalism.

Spending decentralization tends to promote macroeconomic stability, especially in rich countries where its stabilizing benefits are more noticeable than in emerging ones, according to Treisman (2000). King and Ma (2001) found a negative correlation between revenue decentralization and macroeconomic stability in their examination of emerging economies, indicating that it reduces macroeconomic volatility. In a similar vein, Feltenstein and Iwata (2002) came to the conclusion that fiscal decentralization improves macroeconomic stability by reducing inflation. According to Neyapti (2004), macroeconomic stability was negatively impacted by revenue decentralization as indicated by the percentage of tax revenues allotted to subnational governments.

On the other hand, Thornton (2007) concluded that there is no statistically significant effect of revenue decentralization on macroeconomic stability. However, decentralization of spending had little influence on macroeconomic stability, whereas decentralization of revenue had a substantial negative association, according to Iqbal and Nawaz (2010). Additionally, their research showed that while population size has no discernible impact on inflation, investment has a detrimental impact on macroeconomic stability. In a similar vein, Jalil *et al.* (2012) discovered a substantial negative correlation between decentralization of revenue and spending and macroeconomic instability, indicating that decentralization enhances macroeconomic stability.

Ali and Batool (2017) came to the conclusion that decentralization of both revenue and expenditures supports Pakistan's economic stability. Additionally, they found that macroeconomic stability is negatively impacted by GDP growth, higher unemployment, and increased investment. Similarly, Melnyk *et al.* (2018) found that decentralization of revenue and spending had a stabilizing effect and a substantial negative association with macroeconomic instability. Decentralization of revenue reduces inflation, whereas decentralization of spending may increase it, according to Bojanic (2018). Furthermore, it has been demonstrated that foreign direct investment (FDI) and GDP per capita promote macroeconomic stability. Dadgar and Nazari (2018) used the misery index to analyse the relationship between macroeconomic stability and economic growth in Iran. They discovered that GDP growth had a negative correlation with the index, indicating increased stability. Using the general government primary balance as a percentage of GDP to gauge stability, Lago-Peñas *et al.* (2019) discovered that spending decentralisation greatly enhances macroeconomic stability across OECD nations.

In contrast, Ahmad, Shah, Mazhar, Khan, and Javaid (2022) found that both revenue and expenditure decentralization enhance economic stability, improve resource allocation, and contribute positively to overall economic performance in Pakistan. Similarly, Rauf *et al.* (2021), using fiscal transfers as a proxy for fiscal decentralization, concluded that fiscal dependency and rapid population growth negatively impact Pakistan's economic stability. Additionally, Osmani and Tahiri (2022) discovered that revenue decentralization, educational attainment (measured in years of schooling), and population growth increase the unemployment rate in Kosovo, thereby contributing to greater macroeconomic instability. Additionally, Mariani *et al.* (2022) found that fiscal decentralization measured using indicators such as Regional Original Revenue, Special Allocation Fund, General Allocation Fund, and Capital Expenditure has a significant effect in reducing the unemployment rate in Indonesia.

3. METHODOLOGY

Macroeconomic stability can be interpreted in multiple ways. In decentralization research, it is commonly represented by price stability, with inflation serving as the primary indicator (Treisman, 2000; King & Ma, 2001; Neyapti, 2004; Martinez-Vazquez & McNab, 2006; Shah, 2006; Thornton, 2007). Nonetheless, Martinez-Vazquez and McNab (2006) argue that a more comprehensive measure of macroeconomic stability is the Misery Index, which combines both inflation and unemployment rates. Originally developed by Arthur Okun, the Misery Index provides a broader snapshot of the economic climate by summing the unemployment and inflation rates for a specific time period.

$$MI = UR + INF \quad (1)$$

According to the Monetarist School of thought, inflation (INF) is a monetary phenomenon (Romer, 2006).

$$M/P = L(i,Y) \quad (2)$$

$$P = M/L(i,Y) \quad (3)$$

Where M – money stock, P – Price (Inflation), Y – Real income, i- Nominal interest rate and L(i,Y)- demand for real balances. Thus INF = f(Money Supply). Equation 3 suggests there are many potential sources of inflation (Romer, 2006). Macroeconomic stability of the country is determined by various economic factors. This study hypothesized that macroeconomic stability is determined by the level of fiscal decentralization.

$$MI = f(FD) \quad (4)$$

$$MI = f(M2_t, GDP_t, GFCF_t, FDE_t, FDR_t, FDI_t, Open_t, Pop_t, Election_t, Devln_t) \quad (5)$$

Where MI is Misery Index, summation of inflation rate and unemployment rate; M2 is money supply proxied by M2 as a percentage of GDP; GDP is growth rate of GDP; GFCF is Gross Fixed Capital Formation as a percentage of FDP; FDI is Foreign Direct Investment as % of GDP; Open is openness i.e Total trade as % of GDP; Pop is the population; Election is the dummy variable taking 1 for election year and o otherwise; Devln is a dummy variable for Devolution period taking 1 for period 2013 to 2023 and 0 otherwise; FDE and FDR are the expenditure decentralization and revenue decentralization respectively. FDE is measured as the percentage of total county governments expenditure of the total national government expenditures i.e FDE = County Governments total expenditures/National government expenditures. While FDR was proxied as the share of revenues of county budgets in the revenues of the consolidated budget of Kenya, (%).

This study estimated three models. The first model assumes that the government is only intended to decentralize expenditure.

$$MI = \propto_0 + \alpha_1 M2_t + \alpha_2 GDP_t + \alpha_3 GFCF_t + \alpha_4 FDE_t + \alpha_5 FDI_t + \alpha_6 Open_t + \alpha_7 Pop_t + \alpha_8 Election_t + \propto_9 Devln_t + \varepsilon \quad (6)$$

The second model assumes that the government is only intended to decentralize revenue

$$MI = \propto_0 + \alpha_1 M2_t + \alpha_2 GDP_t + \alpha_3 GFCF_t + \alpha_4 FDR_t + \alpha_5 FDI_t + \alpha_6 Open_t + \alpha_7 Pop_t + \alpha_8 Election_t + \propto_9 Devln_t + \varepsilon \quad (7)$$

And modal 3, assumed that government performs revenue as well as expenditure decentralization simultaneously, so the following regression model was estimated.

$$MI = \propto_0 + \alpha_1 M2_t + \alpha_2 GDP_t + \alpha_3 GFCF_t + \alpha_4 FDE_t + \alpha_5 FDR_t + \alpha_6 FD_t + \alpha_7 Open_t + \alpha_8 Pop_t + \alpha_9 Election_t + \propto_{10} Devln_t + \varepsilon \quad (8)$$

4.RESULTS AND DISCUSSIONS

A unit root test was conducted, and all the study variables were found to be stationary at level; thus, the OLS method was deemed applicable. The study employed robust standard errors to control for potential heteroskedasticity. In addition, pairwise zero-order correlations were estimated to examine the degree of multicollinearity. The results showed no evidence of multicollinearity. The OLS results for the three models are presented in Table 1.

Table 1. OLS Regression Results of the three Models

	Model 1 (Equation 6)		Model 2 (Equation 7)		Model 3 (Equation 8)	
	Coefficient	**Prob.**	**Coefficient**	**Prob.**	**Coefficient**	**Prob.**
M2	-0.0000203	0.147	-0.0000248**	0.035	-0.00002*	0.105
GDP	6.5400*	0.111	8.2500**	0.016	7.78**	0.031
GFCF	0.9400	0225	0.8738	0.269	0.6420	0.396
FDE	-0.3938	0.497	-		1.1861**	0.053
FDR	-	-	-2.5561***	0.004	-3.2159***	0.002
FDI	5.4439	0.201	5.1318	0.132	4.6216	0.181
Open	-0.5343	0.181	-0.2653	0.507	-0.1191	0.767
Pop	-0.8500	0.227	-1.7078**	0.021	-2.1368***	0.012
Election	-4.5922	0.323	-4.3869	0.240	-2.3364	0.547
Devln	-0.1772	0.988	44.9180**	0.016	39.3693**	0.025
Constant	51.1271*	0.070	78.3372***	0.014	85.9426***	0.008
R-squared	0.3763		0.5429		0.5733	
Prob >F	0.0090		0.0119		0.00796	
No. of obs	33		33		33	

Source: Author's computation, 2025

****, **, * Implies statistically significant at 1%, 5% and 10% respectively*

Every variable, including the spending decentralization indicator, was statistically insignificant, as seen in Model 1. Revenue decentralization, on the other hand, exhibited a substantial negative coefficient, according to Model 2, indicating that a rise in county own-source revenue improves macroeconomic stability in Kenya. Given that both types of decentralization are now in use in the Kenyan context, similar results were shown in Model 3, which implemented both revenue and spending decentralization concurrently. This scenario is more realistic. Nonetheless, in this instance, decentralization of revenue and expenditure was statistically significant at the 1% and 5% levels, respectively. Expenditure decentralization appears to exacerbate macroeconomic instability, whereas revenue decentralization contributes to its reduction in the Kenyan context.

These results contradict the theory of federalism, which posits that fiscal decentralization particularly revenue or tax decentralization—is not well-suited for the stabilization function. It is crucial to remember that Kenya's revenue decentralization is still in its infancy and has limited scope. Therefore, to find out if there is a point at which revenue decentralization may have a detrimental effect on macroeconomic stability, more research may revisit the topic. According to earlier research by King and Ma (2001), Neyapti (2004), Iqbal and Nawaz (2010), Jalil *et al.* (2012), Ali and Batool (2017), Ahmad *et al.* (2022), and Mariani *et al.* (2022), revenue decentralisation has a detrimental effect on macroeconomic stability, which is consistent with these empirical findings. However, our findings differ from those of Okonkwo and Godslove (2015), Makreshanska and Petrevski (2015), Palienko *et al.* (2017), and Osmani and Tahiri (2022), who found a positive effect of revenue decentralization on macroeconomic stability, as well as from the results presented by Palienko *et al.* (2017), Shah (2006), and Thornton (2007), which indicate that revenue decentralization does not significantly affect macroeconomic stability. In contrast, the current finding supports the findings of Okonkwo and Godslove

(2015) and Rauf *et al.* (2021) that expenditure decentralization positively influences macroeconomic stability.

5. CONCLUSIONS

Using the most recent time series data from 1991 to 2023, this study investigated how Kenya's macroeconomic stability was affected by fiscal decentralization. According to the empirical data, decentralization of revenue improves macroeconomic stability while decentralization of spending exacerbates macroeconomic instability.

These findings have important policy consequences. Regarding revenue decentralization, the findings indicate that a sizable amount of county governments' income comes from the federal government. Therefore, rather than relying mostly on handouts from the federal government, counties must adopt measures to increase locally generated (own-source) revenue.

Additionally, the federal government ought to think about giving county governments more financial autonomy while simultaneously putting in place systems to maintain responsibility in spending management and enforce budgetary restraint.

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