MEMORANDUM

ISSUES AND RECOMMENDATIONS ON DIVISION OF REVENUE 2014

This memo summarizes our concerns and recommendations regarding the Division of Revenue Bill 2014 as approved by the National Assembly, and now before the Senate.

This memorandum will also be made available on our website at www.internationalbudget.org/kenya. For further information, please contact us at +254729937158.

The first part of the memo lists our key concerns and recommendations. The second part provides some additional background information and details.

In addition to the substantive issues mentioned below, we note that the process of tabling and approving the DORB this year has been substantially delayed, non-transparent, and in violation of the PFM Act and prudent financial management.

Part I: Key Concerns and Recommendations

1. We believe that the conditional grant for Level 5 Hospitals should be restored. The initial draft legislation from Treasury eliminated this grant. The parliamentary report on the Budget Policy Statement 2014 restored it. In the Bill tabled in the National Assembly on March 26, money was set aside for this purpose, though it was no longer called a “conditional grant.” In an amendment from the floor, the Assembly appears to have removed the set-aside and returned these funds to the equitable share.

Aside from the fact that no explanation has been given for why this was done, we are of the view that it represents a serious threat to the viability of these institutions. A conditional grant is intended to allow for the fact that these are regional facilities servicing multiple counties, and putting the burden to support them on a single host county may result in under-funding. There are various ways of dealing with a situation like this, and a longer-term solution may be to create regional boards to manage these hospitals that also collect
mandatory payments from the various counties on the board. However, in the absence of such legislation, and given the need to ensure continued service provision now, we believe there is no alternative to a conditional grant. The structure of that grant could be refined to ensure that counties also contribute something to the hospitals within the range of what would be feasible, given their budgets.

2. **The Division of Revenue Bill 2014 has introduced considerable confusion into the revenue sharing process, undermining transparency and informed public debate. The Senate should rectify this by revising the language in the Bill entirely.** We give several examples of this problem.

   a. For reasons that are unknown, the National Assembly opted to eliminate the use of the terms “conditional” and “unconditional” allocations from the Bill. In the original Bill tabled on 26th March, they left set-asides for hospitals, rural electrification, youth polytechnics. By eliminating the use of the term “conditional grants” to describe these funds, however, the National Assembly reduced clarity about the status of these funds. If they are not conditional allocations, they should go through the Equitable Share. If they are conditional allocations, they should be referred to as such and there should be further policy guidance as to how they are to be used. Both in the Bill and in the Hansard from 22 and 23 April, 2014, it remains entirely unclear what the intention of these set-asides was or is meant to be. We are told that the conditional allocations were dropped so as to “consolidate the total allocation to counties as a block figure.” Then we are told that the “initial spirit of…providing specific resources for priority services…is echoed in the Bill.” This is vague and ambiguous language that obfuscates rather than enlightening.

   b. The Bill uses 2009/10 as the basis for calculating the share of revenues for counties. The Bill states that these are the most recent audited and approved accounts. This may or may not be correct, but is at odds with the Division of Revenue Act 2013, which used 2010/11 as the basis. Either the DORA 2013 had the wrong basis, or the DORB 2014 has the wrong basis. Either way, this issue needs to be clarified. Moreover, the use of the 2009/10 audited accounts as the basis contradicts CRA, Treasury and even the National Assembly Budget Committee’s own prior recommendations for 2014, all of which used 2011/12 as the basis. The constantly shifting bases for calculating revenue shares undermines transparency and makes it difficult to assess trends over time.

   c. The Bill compares the Equitable Share in 2013 with the total allocation in 2014 (Equitable Share plus set asides for hospitals, etc.). This is inappropriate and creates a misleading impression that the county share has increased more than it actually has.

   d. This version of the Bill still contains a provision for “Other National Services” which is unclear. This has replaced the previous version of the Bill which contained a set aside under National Interest called “National Strategic Interventions.” Other National Services requires over Ksh 76 billion per year, but no explanation is provided for what this line is, or why it should be considered part of the national interest as per the constitution. This undermines serious debate about revenue sharing.

3. **The Division of Revenue Bill 2014 still fails to engage with the central issue in revenue sharing: priority setting.** The Senate should consider the core issue of

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priorities in revising the Bill, with a focus on the relative importance of security, education, agriculture, health and other services. The basis for revenue sharing across the two levels of government is not only the “cost” of functions, as derived from current and historical spending, but the desired expenditure on different priorities. The baseline for determining the share of revenues going to national and county governments is still the cost of all functions that national government managed in 2012/13. In 2012/13, nearly 60 percent of the budget went to education, infrastructure and security, while less than 20 percent went to health and agriculture. Are those still the right priorities today? (See Annexures).

To supplement this review of priorities, of course, better information is needed on the current costs of government to perform its various functions, and a better understanding of which functions of government are to be performed at each level. In our view, Parliament has complained severally about the lack of costing information, but has not called the heads of line ministries to task for these failures. Going forward, we recommend that the accounting officers of all ministries be summoned to Parliament to explain the status of the functional assignment and costing process.

4. **The Senate should clarify the costs of running county governments further before approving these figures.** The current version of the Bill provides no information about the actual costs of running county government. Instead, it attacks the CRA figures without providing an alternative basis. This reflects the general hodge-podge nature of the Bill, which has completely altered from the original draft prepared by Treasury, while retaining some of the original language and justifications. While we believe the CRA figures cannot be defended, there is no justification for throwing them out without due consideration and replacing them with other equally indefensible figures.

5. **The Senate should ensure that the approach to conditional grants in the Division of Revenue is comprehensive and guided by policy frameworks.** The discussion of set-asides or conditional grants is incomplete in the current Division of Revenue. Certain grants, such as the grant for free maternity care, are not included in the Bill, while others are discussed. There is no logical reason for this. All grants touching on county functions should be considered together. Moreover, this year, funds for polytechnics and rural electrification are being discussed, yet there is no framework for their implementation. Aside from the fact that the Bill says nothing about how these will be distributed (leading us to conclude that they will follow the formula), it is hard to justify taking away half the budget for the Rural Electrification Authority and giving it to counties without any framework for how counties and REA are going to coordinate ongoing projects, or new projects, to avoid duplication. Arbitrary reallocations of this type do not serve the public interest and should be preceded by policy reforms. Otherwise, we may undermine a functional state corporation and encourage waste of resources at the same time.

6. **Related to the previous point, there is no justification for specifically targeting REA and leaving aside other state corporations.** The Senate should comprehensively review the position of all state corporations providing services that now fall under county functions. There are many other state corporations providing county functions, such as the Water Service Boards, road boards, and various agriculture-related state corporations. These have remained untouched. The ad hoc approach to dealing with these
issues is likely to undermine services and lead to an irrational mix of state corporations that remain untouched with no justification, and others that have been gutted without properly building county systems to take up their roles. This issue should have been addressed by the Transition Authority, but now falls properly to the Senate.

7. **Still on the matter of conditional grants, the Bill continues to discuss the Equalization Fund but to our knowledge, there is still no policy guidance on how this Fund is to be shared and utilized.** Our understanding is that no county has actually received funds from the EF, and no county will, until a framework is put into place for its use. The CRA proposed a Marginalization Policy over a year ago that has never been debated, amended or approved. The Senate should push for the EF to be operationalized through legislation in Parliament.

8. **The Bill exceeds its mandate in several ways, and this should be rectified by the Senate.** The Division of Revenue Bill should be used to determine the share of resources going to the two levels of government. In our view, the only relevant issues to be discussed in this Bill are the share of funds going through the Equitable Share, and any other conditional or unconditional allocations to counties. Yet this Bill seeks to impose allocations on national government by introducing a set-aside for Economic Stimulus Package funds to be distributed to constituencies. In our view, this issue must be debated as part of the Budget Estimates, and not as part of the Division of Revenue. The same is true for the county set-asides: unless these are given as conditional grants, they are being used to allocate county funds in a way that is unconstitutional. Funds given to counties through the Equitable Share are to be budgeted for as counties see fit. It does not make sense to pull out only certain functions, such as youth polytechnics, and tell counties that they must use their funds on these, but not to mention any other functions. The purpose of conditional allocations is to achieve what cannot be achieved through the Equitable Share. This should be restricted to issues where the formula for the Equitable Share would lead to undesirable results (e.g., distributing money for L5 hospitals to counties without such facilities) or where national government wishes to add funds to a function of county government to achieve national policy goals (e.g., maternal health grants).

**Part II: Further Notes on Hospitals, Costing, Priorities, and Debt**

The International Budget Partnership-Kenya wishes to raise the following issues with regard to the Division of Revenue Bill (DORB) 2014 for the attention of Parliament:

1. **The 2014 Division of Revenue Bill eliminates the conditional grant contained in the Division of Revenue Act 2013 for regional hospitals without any explanation.** In 2013, it was recognized that the transfer of provincial hospitals to counties could lead to under-financing of these facilities. The logic was that regional hospitals serve people from many counties, but by transferring them to a single county (where they are located), that county would then be bearing the cost of services for users from many counties. This can lead to under-financing. Moreover, the distribution of funds through the equitable share formula does not favor counties with regional hospitals, so they would tend to receive inadequate funding to maintain services at these facilities.
It was thought that these counties should therefore receive dedicated funding for regional hospitals through a conditional grant. In addition to the 7 provincial hospitals, 4 additional “high volume” Level 5 facilities were included in the list to be subsidized. The initial proposed grant in FY 2013/14 was Ksh 10 billion, which was reduced by Parliament to Ksh 3.4 billion. It was argued that those counties that host such facilities get disproportionate advantage from them and should be forced to use some of their own funding, while this would be topped up through the conditional grant. No research has been done to assess the impact on regional hospitals of this decision, but we are aware that a number of counties, such as Nyeri, did not in fact top up the funding for the health sector in their county budgets for 2013/14.

We urge Parliament to interrogate this issue further and ensure that adequate funds are to be made available for regional hospitals in this year’s budgets. Although the issue remains unresolved, we note with concern that there is no conditional allocation for these facilities in this year’s Division of Revenue. The assumption would seem to be that host counties will bear the full cost of these facilities. Without further analysis, this seems an extremely risky decision which could negatively impact service delivery at regional/high volume hospitals.

2. The proposed allocation for counties is based on the incomplete and opaque functional assignment process that informed the 2013 Division of Revenue Act, rather than an updated and improved assessment of what each level of government should be doing. The basis for the allocation of revenue is still the exercise conducted by Treasury in the 2012/13 budget estimates. This is implicit in Treasury’s choice to use the 2013 Division of Revenue as the “baseline” for allocations. This exercise, which led to the coding of certain functions that were then performed by national government as “devolved functions (98),” has never been fully validated. It was the responsibility of the Transition Authority to complete this exercise in a more comprehensive fashion, by fully unbundling all government services and determining, consistent with the Fourth Schedule of the Constitution, which level of government was responsible for which services.

The failure to update this functional assignment process means that we cannot be sure that funds have been properly divided between the two levels, and that both national and county governments have an adequate share of funding. The use of the 2012/13 budget to assign functions is inadequate, because that budget was based on a set of inputs, rather than functions. There is not a clear alignment between the use of funds in 2012/13 and the functions assigned by the Constitution. This makes it very difficult to know if budget figures for the two levels accurately reflect what each level of government is supposed to do.

For example, consider the provision of HIV services in the 2012/13 budget. The National Aids Control Programme was allocated Ksh 932 million in 2012/13. Of that, the 2012/13 budget coded Ksh 903 million as “devolved functions” for “specialized materials and supplies.” Without knowing what those “specialized materials and supplies” are, we cannot know whether it was proper to devolve this amount to counties and to leave Ksh 29 million at national level or not.
In 2013/14, moreover, the national government allocated 288 million for National Aids Control Programme, a massive increase from the 29 million that was supposed to remain at national level. Most of those funds (about 250 million) were again for “specialized materials and supplies.” Because specialized materials and supplies is not a function of government, it is impossible to know why these funds were retained at national level. It is possible that this reflects the fact that certain medicines must continue to be procured nationally or through donor arrangements of some kind. But there is no explanatory information available. This is one example of a problem that is rampant in the budget.

Parliament should demand more comprehensive information and a proper functional assignment to ensure that the estimation of county and national government financial needs is properly done. There is no good reason why no further work has been done since last year to improve upon the existing functional assignment process. This represents the failure of national institutions like the Commission on Revenue Allocation, the National Treasury, the Transition Authority and the national line ministries to perform their functions adequately to inform Parliament.

3. The continued use of the 2012/13 budget allocations as a baseline is problematic, because it assumes that Kenya’s priorities do not change from year to year; yet the Division of Revenue is the time to question whether the country should shift its priorities in the coming year. Even if the functional assignment process in 2012/13 was perfect, using it now would mean that we continue to have the same priorities as a country as we did in 2012/13. But the annual budget process is designed explicitly to allow us to debate that every year and to change our priorities over time. That discussion should happen now, when we debate the DORB, and not only later, during the debate over the full Budget Estimates.

In 2012/13, nearly 60 percent of the budget went to education, infrastructure and security, while less than 20 percent went to health and agriculture. For further details of the budget, please see attachments to this memo. The key question Parliament must ask is if we want to continue to distribute the budget in these ways. If, rather, we decide to spend more on health or agriculture, then this would necessitate giving more shareable revenues to counties and less to national. On the other hand, if we believe security and infrastructure deserve more funding, the reverse would be true.

4. In the original bill from Treasury, the total cost of administration at county level had risen from 13.6 billion last year to Ksh 30.2 billion, in addition to pension payments at 4.2 billion for staff transferred from national to county government, but there is inadequate justification for these numbers. These numbers are no longer in the Bill, but we assume that they still form the basis for the recommendations. At a time when government is discussing the need to control the wage bill, it is important that every increase in staff/administration costs be discussed rigorously. It is therefore important to have additional information on the exact calculations behind the increase in administrative costs.

Parliament should demand more detailed information on the staff numbers and remuneration that are driving the increase in administrative costs at county level.
This is also important because Treasury’s figures are lower than the comparable estimates from CRA, which puts the cost of staff remuneration at 38 billion, plus another 10 billion in administrative costs, for a total of 48 billion. Parliament should satisfy itself as to the reasons for the difference between Treasury’s 34.4 billion for staff, pensions, and administration, and CRA’s figure of 48 billion covering the same.

5. **The rising allocations for debt repayment should be debated by Parliament in order to ensure that the country has the proper balance between debt and current services.** According to the figures in this year’s DORB, debt payment has risen by about 22 billion from last year, which is an increase of roughly 7 percent in the funds which national government needs to meet its obligations. This will take the total size of the budget going to debt payment to over Ksh 350 billion. This is a considerable increase since 2011/12, when it was only Ksh 210 billion. Since the share of the budget that must be set aside for debt payment and other national obligations must be catered for in the national share, this reduces the funding available for other services.

6. **Parliament should interrogate further the reasons for the basic disagreement between Treasury and CRA over the source of the baseline figures to be used for estimating the cost of all functions, leading to a difference of Ksh 40 billion.** Treasury states that CRA uses the forward estimates from the 2012/13 budget for 2014/15 as the baseline in calculating the allocation for functions. (In other words, the 2012/13 budget contains projections for 2013/14 and 2014/15. CRA has used the figures projected for 2014/15 that were contained in the 2012/13 budget.) Treasury argues that this is not appropriate, because the baseline should really be the political agreement reached in the 2013/14 budget, which deviates, as budgets usually do, from the projections the prior year.

For Parliament, the relevant point is to understand the source of the differences in the figures generated by Treasury and CRA for the cost of functions. Neither has given adequate explanation for the source of their figures. For Parliament to adjudicate a difference of nearly Ksh 40 billion in estimated costs of delivering services, they must have more information about the source of the differences. Moreover, there is also a figure from the Intergovernment Budget and Economic Council (IBEC) mentioned of 238 billion total, which is in between the total figure from Treasury and total figure from CRA (279 billion) but with no explanation. It is problematic for figures to be discussed without reference to their basis in estimates of cost or other considerations.

ANNEXURES/ATTACHMENTS

The Right Priorities?
The Right Priorities Revisited
Sharing Revenue: How Much Is Already Committed?