



30/04/2018

SUBMISSION

## **ISSUES, ANALYSIS AND RECOMMENDATIONS RELATED TO THE THIRD FORMULA FOR REVENUE SHARING AMONG COUNTIES IN KENYA**

*The International Budget Partnership would like to make a submission to the CRA concerning the revisions to the second formula and proposal for the third formula. This memorandum constitutes our submission.*

*It is divided into two parts. In **Part 1**, we summarize some of our key recommendations. In **Part 2**, we provide extensive analysis, supported by data, for those recommendations and go deeper into several issues. We have also attached data to support our arguments where possible.*

*We are available to discuss this submission at any time and welcome feedback. For further information, please contact Dr. Abraham Rugo at [arugo@internationalbudget.org](mailto:arugo@internationalbudget.org)*

### **Introduction**

In making this submission we are guided by three main observations over the first five years of devolved system of government in Kenya. First, during that period, we applied the first and second-generation formula which laid some good ground for revenue sharing among counties. These formulas have played a role in ensuring that counties are equitably allocated funds to run basic services and redistribute resources to deal with historical marginalization. While this has served the purpose, it is also easy to appreciate that the formulas do not use parameters that directly measure services that are related to the functions that counties run. This is the opportunity that the Commission on Revenue Allocation (CRA) has in the 3<sup>rd</sup> generation formula. There is more data now to push the discussion to a level that the needs in counties can be measured in better ways and funds allocated based on them.

Secondly, the period saw the settling of county governments. This has meant that some of the assumptions of the drivers of county costs have been clarified. The obvious case is that of the wage bill which over the period has ballooned and become complicated due to inherited costs from former local authorities. Further the expectation that counties could raise sufficient own source revenues to cover their annual budgets has not been met. While some counties have shown effort, others have struggled to meet their revenue targets and thus leading to carry over deficits.

Thirdly, public engagement with the division of revenue process has generally been poor. Regardless of the mechanism that one can come up with, the legitimacy and ownership of the formula should be deliberated with the public in an open manner. There is need to think of ways that the public is involved in a manner that they can influence decisions. This also includes engagement in the Division of Revenue discussion at the Senate where some of the key decisions on how much each county gets

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are made. IBPK's engagement through the Equity Week forums show that the public has the capacity to engage as long if they are provided with the right information and given sufficient time to engage on the decision to be made. In addition, when well guided, the public can prioritize issues in ways that the justification given is well thought through.

Thus, the revision of the second-generation formula provides an opportunity to improve the distribution of revenue among counties.

## Part 1: Key Recommendations

1. **We recommend that CRA consider replacing its single equitable share transfer with a set of transfers that achieve multiple objectives.** CRA's current formula has multiple objectives and trying to meet them all through one transfer formula creates confusion. In other countries, such as South Africa, India and Ethiopia, multiple transfers are used.
2. **The two main things that the formula currently tries to do are (1) to provide counties with funds to ensure that they can deliver their constitutional functions according to objective criteria, and (2) at the same time, to achieve substantial redistribution to address historical marginalization.** The formula has managed to achieve both to a certain level, but they are fundamentally divergent purposes and might be better handled through different distribution instruments. Doing so would increase the transparency and legitimacy of the formula(s) by ensuring that Kenyans understand its purposes and the rationale for the factors included.
3. **We recommend that the Equitable Share be distributed through a Service Delivery Transfer (the core transfer) and that this be complemented by a smaller Infrastructure Transfer, as well as some additional smaller transfers.** The first transfer will primarily cater for the ongoing costs of delivering services in counties. The second transfer will be more redistributive, to address historical marginalization and bridge infrastructure deficits across the country. This transfer will be a more robust version of the Equalization Fund in the constitution. Additional transfers will be used to deal with specific issues, discussed below.
4. **To achieve this, we recommend the reduction of weights in "Population", "Basic equal share" and "Poverty" in the Service Delivery Transfer to more direct measures of services.** A focus on more direct measures of need will be a better approach to achieve the objectives of providing an agreed standard of services in each county. For example, take two hypothetical counties with equal population numbers but one county has a sicker population than the other. The number of people who visit health facilities in both counties is a better measure of the expenditure need in health in both counties. Under the current formula, both counties would receive similar allocations just based on the size of their population.
5. **However, population remains a good proxy measure of need and should be retained, but at a lower weight.** High population may be an indication for higher cost of delivering services and the parameter also covers for services whose data may still not be available or is

not very reliable. Basic equal share and poverty parameters should also be maintained but with reduced weights as well.

6. **Improved availability of data on access to services run by counties provide an opportunity that was not available when working on the first two formulas.** Lack of disaggregated data on key services related to functions run by counties was a key challenge to using direct measures of needs in previous formulas. However, the situation is changing, and new data is now available that measure the needs of population at the county level. This should provide an opportunity to measure on-going services and service gaps in some sectors. Some updated data released after 2014 include:
  - i. Immunization data (KIHBS 2015/16)
  - ii. Registered births (Statistical Abstract 2017)
  - iii. Health facility attendance (Statistical Abstract 2017)
  - iv. Early childhood education data (MoE 2015)
  - v. Household water and sanitation access (KIHBS 2015/16)
  - vi. Health facilities (DHIS 2018)
  - vii. Access to electricity (KIHBS 2015/16)
  - viii. Poverty headcount (KIHBS 2015/16)
7. **The Service Delivery measures of need can start by focusing on the most expensive functions that are handled by counties.** Based on expenditure trends in the first four years, the sectors with the highest costs include Health, Agriculture and Early Childhood Development Education (ECDE).
8. **Health facility visits are a good measure of the need for health services but are also partially indicative of availability of health facilities and therefore should be looked at together with data on disease prevalence.** This provides information on risk of diseases across counties and should be combined with data on current health facility attendance. Data may be a challenge for most diseases but data on some of the main causes of morbidity and death are available. The Statistical Abstracts over the last few years has included data on, tuberculosis, respiratory diseases, malnutrition, and malaria among others.
9. **We recommend the use of other measures of need related to extension services in agriculture and early childhood development education among others.** The number of farmers both crop and livestock farmers, is a good metric for the need of extension services across counties. In addition, the number of children enrolled in ECDE centers is a good measure of the need in on-going costs for early childhood education. However, just like in health this is indicative of areas with ECDE centers. To give a full picture of need, data on the number of children of ECDE going age, which the government indicates in 3- 5 years should be used. That data is available from the last census and will be updated in 2019.

10. **We recommend that an Infrastructure Transfer be introduced.** This will build on the current development factor, with some revision. The parameter currently has a weight of 1 percent and is distributed based on three factors: water, electricity and roads. However, the commission should consider including sanitation, health infrastructure and ECD centers as well in the parameter. The objective will be to invest more in counties with infrastructure gaps in these key sectors to bring them closer the level of access in other counties. For example, 57.6 percent of the households in Laikipia take more than 30 minutes to get to water points and back home, this compares to only 0.4 percent in Nairobi. Therefore, this transfer would aim to bring Laikipia closer to Nairobi or the average enjoyed across the 47 counties. This is in line with the objective of the Equalization Fund to bring the quality of services in marginalized to those enjoyed in the rest of the country. For the fund to be effective and have a wider reach than the Equalization Fund, the weight of the development factor should be increased. However, the data on these gaps should be updated often and the parameter should be time bound based on a set standard of access across all counties.
11. **We recommend reduction of the weight to the “Basic Equal Share” to between 15-20 percent.** The parameter is supposed to provide a minimum funding to all counties to cater for certain basic functions, mostly administrative, that do not have significantly different costs across counties. Our study on the administrative costs of running counties in 2015/16 showed that these costs would range between 15 to 20 percent. The recurrent ceilings released each year by CRA and approved by the Senate capture some of the cross cutting administrative costs that can also provide some metric on the size of the Basic Equal Share. However, in these ceilings, administrative costs take up less than 20 percent of the equitable share.
12. **Some of the items under the recurrent ceilings approved by the Senate each year, are variable across counties and may form part of the factors related to needs.** Some cost centers in the ceilings are not constant across counties such as the number of sub-county and ward administrators, county assembly ward staff that vary based on the number of wards. Based on this factor, the current weight would be lower than the 20 percent estimate if these variable cost items are deducted.
13. **We also recommend a transfer that will focus on fiscal effort and capacity, and not be based on fiscal needs alone.** The capacity of counties to raise revenue means that there are counties that can raise more of their own revenue and other have smaller capacities. Capacity just like need is beyond the control of counties. Fiscal effort is currently measured through the fiscal responsibility index that is focused on the per capita growth in own source revenue in each county. Whether this transfer will be part of the equitable share transfers or a separate conditional grant is really a matter of preference.

#### **Additional recommendations**

14. **A large proportion of the current wage bill is related to inherited local authority staff, devolved staff and wages related to mandatory costs of new structures in the counties.** Our analysis shows that between 94 and 97 percent of the wage bill in 2015/16 was related to

these three categories of staff.<sup>1</sup> Available information in the Budget Implementation Reports from the Office of the Controller gives an indication of the high proportion of inherited wage bill and that limits counties' abilities to allocate funds to other priorities. In counties such as Nyamira, Nakuru, Kirinyaga and Nandi's devolved wages made up over 90 percent of the wage bill in the first year of devolution (2013/14). This was before considering new wage costs that counties had to deal with such as wages for MCAs and the executive leadership.

15. **We recommend that CRA brings back the mechanism to address high inherited staff costs in counties.** However, this should not be part of the equitable share as had been proposed in 2014 but a conditional grant to ensure there are tighter controls on eligibility. That will be one way to ensure the mechanism does not incentivize bloated wage bills in counties in a bid to get more money from the grant.
16. **The personnel factor should also be framed in a way that it interrogates efficiency of the existing wage bill.** This would require an analysis of wage bill based on administrative and service delivery staff. For example, counties whose proportion of health workers or extension workers is growing compared to the share of administrative staff can get a larger share of such an allocation. Counties with a growing wage bill that is higher on service delivery should be "rewarded" under the parameter to discourage employment of non-essential staff.

## Part 2: Analysis, full recommendations and justifications

### Moving beyond one transfer

1. **The first two formulas made reasonable attempts to measure the expenditure needs in counties.** These formulas made use of proxies of need across counties to estimate the funding needed for various functions. Population, poverty, basic equal share and land area were parameters that mainly looked at potential needs, but they do not directly measure any services that are offered by county governments.
2. **We recommend that CRA uses a core mechanism or a "Service Delivery Transfer" to distribute revenue for basic services across counties that will deal ensure counties are able to fund on-going services.**
3. **Secondly, we recommend an "Infrastructure Transfer" aimed at addressing historical marginalization, especially infrastructure deficits.** The current Equalization Fund is very small and the allocations to the fund cannot deal with marginalization effectively across the country. Let us use access to water as an example. This is a capital heavy sector and one of the four services that are to be funded by the fund. According to the KIHBS 2015/16, there are 3.1 million household in Kenya without access to improved sources of water. The budget estimates for 2017/18 state that access to improved water sources stood at 57 percent in 2015/16. This is projected to grow to 61 percent by 2019/20. In the period between 2016-2020, the government projects it will spend Ksh.129.5 billion for water and sewerage

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<sup>1</sup> <https://www.internationalbudget.org/wp-content/uploads/kenya-county-budget-implementation-in-2015-16-ibp-2017.pdf> Page 6

infrastructure development. This is significant expenditure to increase water access by about 4 percentage points. The Equalization Fund had an allocation of Ksh. 7.73 billion. Based on the scenario above, the Equalization Fund cannot be that effective across the four sectors it has to address. This means that all regions in the country are trying to qualify for the fund, but it's very small and already stretched too thin already.

4. **Thirdly, while proxy measures are important, a formula is more legitimate and accurate if it uses measures that are more directly related to the services it is meant to fund.** We believe that a good formula should be seen to be legitimate (or “fair”) and that it must also ensure that counties have sufficient funds to provide basic services. A formula that uses variables that people widely associate with what government should provide could be perceived to be more legitimate
5. **The second formula made an important improvement by introducing some direct measures of need in infrastructure through the development factor.** This saw the introduction of three factors: roads, water access at household level and household access to electricity. This was laudable and laid a foundation on measuring direct needs and a mechanism to deal with infrastructure deficits.
6. **Generally whatever mechanism is used, revenue sharing in Kenya should ensure counties have adequate resources to both fund ongoing basic services and to redistribute resources to deal with historical marginalization.** The current formula as well as the first one tries to achieve both objectives through one instrument. To ensure the mechanisms of distribution are more transparent, CRA should consider separating the two objectives and dealing with them through two different instruments.
7. **While population offers a good measure of potential demand for services we recommend that CRA makes use of more direct measures of need and demand for service like what the South African division of revenue adopts.** Data was a challenge when coming up with the first two formulas. However, the situation has improved over the last few years. There is more data available from counties over their five years of operations. In addition, updated data is available on aspects such as poverty and access to key services provided by counties such as water, sanitation, immunization, nutrition among others.
8. **It is more legitimate to measure the actual cost of delivering services compared to using parameters such as population.** It's also the case that direct measures of services such as the number of people who visit health facilities is highly correlated to population. Such measures also ensure that the mechanism is more transparent as people can connect the variable to the services that they expect across the counties.

### *The Service Delivery Transfer*

9. **In both South Africa and Ethiopia, the relationship between formula outcomes and population is very strong.** The correlations in both countries are high despite the actual weight assigned to the population parameter being quite low. Instead, these countries use population-related measures to measure the relative expenditure needs to the sub-national level. In South Africa, health and education measures take up 75 percent of the budget and the correlation between their allocations and population is 0.96. (See Table 2). Ethiopia's

Federal Grant Distribution formula also makes use of service access measures in education, health, agriculture, water and others to distribute funds among its' 10 regions. The correlation between the allocations and the population in the regions is 0.99. (See Table 3) The example from these two countries means that shifting to direct measures of need still captures the differences in population across sub-national levels but targets the regional needs in a more legitimate way. The correlation between Kenya's county allocations and the population is 0.84 which is much lower than the other two countries. However, the Kenyan case is affected by the large equal share which would give a correlation of one and therefore distorts the measure in a bigger way than in South Africa.

10. **To understand the relationship between Kenya's current formula and population, it is useful to look at two other measures besides correlation.** We call the first of these a *dispersion ratio*: what is the ratio of the per capita transfer between the county receiving the most and the county receiving the least? A formula that is highly population driven will have lower dispersion because the highest and lowest allocations will be closer to an equal per capita allocation.
11. **The second measure we call a deviation share, and it is a measure of the share of the total allocation that deviates from a perfectly equal per capita allocation.** Essentially, we sum up the absolute difference between what each unit would receive if it were to get an equal per capita allocation, and what it receives from the formula. The larger these differences are, the less population-driven the formula is. We look at the sum of these differences as a share of the total allocation.
12. **In both measures Kenya has results that are less strongly related to population than the other countries.** Kenya's dispersion ratio, the difference between the lowest and highest per capita allocation, stands at 7.04 which is actually much higher than it was in the first-generation formula which was at 5.3. This compared to a dispersion of 1.54 in South Africa and 3.76 in Ethiopia. The high dispersion in Kenya shows a weaker relationship to population needs compared to the kind of direct measures employed in other countries. Kenya's deviation is 26 percent compared to 12 percent in South Africa and 16 percent in Ethiopia. However, if direct measures of basic services are used as shown in Table 12, the dispersion drops to 3.4 and deviation reduces from 26 percent to 17 percent. This is the result even with some data challenges for some of the services like the need drivers in agriculture.
13. **Taken together, this suggests that Kenya's formula underweights population compared to other countries with population related expenditure needs formulas.** Based on this assessment CRA should consider increasing the weight of population and reducing the basic equal share. In addition, the use of direct measures of need would improve the population components response to populations needs across the counties.

## Drawing on the South African, India and Ethiopian examples

*In this section, we give recommendations modeled on South Africa, India and Ethiopia that would allow CRA to reduce the size of the “population” weight while maintaining the importance of population in the formula through measures more directly related to county service delivery.*

- 14. South Africa uses measures of need for health but also current access to health services.** The formula looks at the number of insured and their risk of getting ill. They also use the number of visits to health facilities. In this way the formula can combine measures of current demand for services and the need beyond current access.
- 15. South Africa’s health needs/demand component is weighted 25% toward assessment of the risk of illness (need) and 75% toward case load (demand).** The key innovation in the formula is the use of a risk adjusted funding model, which is frequently used to determine how much private insurers should receive to take care of a given population. Risk is related to standard factors like age, gender, pregnancy and prevalence of certain types of diseases (e.g., HIV) in the population.
- 16. Ethiopia uses infant mortality and maternal mortality, poverty and inverse population density to gauge its recurrent health needs.** Regions with higher number of children under 5 and women of child bearing age, 15-49 years, have higher needs to reduce infant and maternal deaths. In addition, Ethiopia uses inverse population density to adjust for economies of scale in access to health care in highly populated areas. This means that the government should invest more in low populated areas to deliver the same level of health services due to the additional costs of delivery to dispersed populations. Poor households have more challenges getting the level of nutrition needed to prevent health challenges in future. The grant formula in Ethiopia uses household poverty level to measure access to nutritious food as a preventive step to avoid future health costs.
- 17. To do something similar in Kenya would require an assessment of the key drivers of health facility visits and data on the number of visits by county.** The Statistical Abstract by the Kenya National Bureau of Statistics now has data on hospital visits for children under 5 as well as a separate set on visits by the population of age 5 and above. The data is broken down by reasons of visits and by county. In addition, the Kenya Integrated Household Survey 2015/16 has data on the proportion of county population with health insurance. The correlation between health facility visits and the county population is 0.87. (See Table 6)
- 18. The data suggests that facility attendance is a good indicator of availability of facilities as well as the demand for health services.** The correlation between county level facility visits and the spread of health facilities across the counties show a high relationship of 0.90. In addition, facility visits and the population have high correlation of 0.87. However, per capita attendance has a lower correlation with population per facility at -0.65. This means that as the population per facility increases, the visits per person decrease, but the relationship is not as strong. This could also mean that in some areas the visit to facilities is mostly by a limited number of people and the demand in the county is not fully met by available facilities.
- 19. Agriculture is another important service provided by counties, but we lack information on need or demand for agriculture services.** The number of farmers in the country should

provide a good measure of demand for services such as extension services. The number of crop farmers (or size of arable land) and livestock farmers could also capture the unique needs that are served by government services. However, in a largely agricultural country, the size of rural population per county also provide a good measure of the need for agricultural spending by government.

- 20. Ethiopia's agriculture component measures size of arable land, pastoral population and the population density.** The component constitutes 11 percent of the formula and makes use of two direct cost drivers in agriculture: the size of land under cultivation and the number of pastoralists. In both cases the regional governments have to support the farmers through extension services. Therefore, the need for extension services across Kenyan counties could also be a key measure of expenditure they will incur in agriculture.
- 21. The Indian formula compensates its states for arable land that is covered by forests due to lost opportunity for economic productivity.** In Kenya an argument can be made that land that is covered by forests and other protected areas such as national parks are useful for national heritage but reduce the size of available arable land that would be used for agricultural activities. For example, 62 percent of Taita Taveta county is occupied by Tsavo East and West. A county the same size as Taita Taveta could have full utilization of its land and have more productive economy and population.
- 22. However, lack of information on the economic potential at county level makes it hard to measure such opportunities.** Lack of county GDP numbers means that it might not be possible at this time to have clear estimates to even make the argument for "compensating" counties whose productive land is taken up by strategic national assets such as forests and parks. However, KNBS and county statistics offices should start gathering information that can put this into perspective.
- 23. South African provinces have a larger responsibility in education compared to Kenyan counties.** In South Africa the provinces are also in-charge of primary and secondary school education. The component makes up the largest proportion of grants to provinces at 48 percent. The component is measured based on the number of enrolled students in schools. However, just like in health this could be an indication of numbers where schools are easily accessible. To counter that, the education factor also takes into account the need which is the number of school going children who are aged 5-17 years. Each part makes up 50 percent of the component for education.
- 24. In Kenya, data on enrolment in ECD centers is now available as well as data on ECD age going children.** The Ministry of Education released data in 2015 that show the enrolment in ECD centers. In addition, Census data from 2009 can provide the number of children aged 3-5 years in each county as one way to measure the need for early childhood education across counties.

## Infrastructure Transfer

- 25. We propose an infrastructure-related, formula-based grant (Infrastructure Transfer) that is based in part on infrastructure backlogs (deficits) across counties, allocating more to those counties with bigger deficits.** This will help build the capital stock in counties that were historically marginalized. We believe this transfer should have some form of timeline to it and should be adjusted based on data on improvement every 3-5 years. These grants can include capital intensive services such as electricity, water, sanitation, roads and in some cases ECD infrastructure.
- 26. We are not aware of any measure of capital stock per county in Kenya, and therefore have no easy way to calculate capital deficits.** However, one could approximate the historical imbalance in capital stock in several ways. One is to look at measures of infrastructure per capita in specific sectors. For example, one could look at paved roads per capita across counties. This is not a perfect measure, because road needs also reflect other considerations (population densities and land area), but it is a reasonable starting point.
- 27. Access to electricity captures the potential for economic activity in a county but also the access to lighting power.** The allocations should be based on backlog of households without electricity in counties. (See Table 14) The distribution should be based on the share of households without access to electricity. However, the county land area should also be considered if the population without power connection is sparsely distributed. In South Africa, a capital grant is provided to municipalities to provide subsidies to connect poor households to the grid. However, the distribution is not channeled through a formula, but it is done at the national level through implementation of projects that can be scaled to cover the largest number of households.
- 28. Water is a capital-intensive service and access goes beyond connection but also the amount of time it takes to get the water.** The KIHBS report for 2015/16 has data on the number of households in each county with access to improved sources of water as well as the time it takes to access the water. Good access also means that a household takes 30 minutes or less for a return trip to a water point. The first measure looks at household that do not have access to improved sources of water. The second measure looks at the amount of time taken to get water even for households with access to improved sources. An index that combines both measures provides an index on access across counties. (See Table 15). In Ethiopia, the granting formula uses an inverse of population density to cater for cases where infrastructure must be built across large areas to provide water to smaller sizes of population. In South Africa, the Water Services Infrastructure Grant allocates the funds based on the number of households with water and sanitation backlogs, prioritizing the 27 priority district municipalities identified by government.
- 29. Roads also constitute a significant expenditure item in counties and should also be considered from at least three angles.** However, the data available on roads remains scanty and unclear. To still use this data, we group counties into 5 categories based on level of access across the three measures. Counties in the highest access class get a score of 1 and those in the lowest get a score of 5. (We think this is better than using the exact figures, because we are mindful of data quality issues. We then sum these points and calculate an average index based on the performance in the three categories. (See Table 17)

- 30. Based on the available data, counties with more per capita access to paved roads have had more investments in roads historically.** Therefore, counties with lower stocks of paved roads per capita should get higher allocations. Therefore, in our five categories counties with the lowest access have a score of 5. The other two measures look at the population with access to unpaved roads and the size of land area per km of paved roads.
- 31. Ideally, unpaved roads are an indication of need for investment in paved roads.** Therefore, counties where more people are connected by unpaved roads should get a higher allocation and get a score of five. In addition, counties with a small number of roads relative to their land area means they have low access to roads to cover the long distances within the counties.
- 32. Ethiopia's regions are responsible for the construction and maintenance and rural roads.** The criteria of distribution takes into account the weather condition, slope conditions in the regions as well as the soil types. Areas that have higher level of rainfall have higher costs of construction and in some cases requires some special materials that can stand high levels of rain. Regions that are hilly or sloping require more support structures such as bridges and culvers and make construction of roads more expensive compared to regions with more flat areas. Different soil types mean different construction requirements especially when the top soil must be moved, and new layers added.
- 33. The data used in the Ethiopian roads parameters is not taken into account when allocating funds to roads in Kenya.** However, some of the data is available and KNBS together with CRA should consider collating the data to clearly show the different costs of infrastructure beyond just the length of roads to be constructed. The Kenya Meteorological Department has details of the levels of rainfall across the country that can determine the level of surface run-off and that can be used to determine the right material across regions. In 2014, Kenya carried out a comprehensive study on the types of soils in Kenya and that is publicly available. We recommend that CRA start making use of some of these measures to ensure that counties whose cost of construction of roads is significantly affected by these factors get the right levels of funding.
- 34. The Division of Revenue already allocates money for rehabilitation of existing roads.** The funds for roads maintenance should also be considered together with the infrastructure transfer. This will provide a joint platform where capital spending in roads is done together with maintenance costs.
- 35. South Africa's roads maintenance formula is based on provincial road networks, road traffic and weather conditions.** The provincial roads maintenance grants are based on the different factors that affect the cost of maintaining roads. We recommend that CRA considers this type of approach in the distribution of the conditional grants under the Road Maintenance Fuel Levy Fund. The current use of the equitable revenue sharing revenue does not in any way measure the direct needs of maintenance of existing roads.
- 36. However, the use of the current data should be time bound based on the condition that better data on infrastructure stock is available.** Development of infrastructure should not happen in an endless process. Estimates should be made on the length of time it might take to get all counties to a reasonable level across counties. From that point then some

standard of access can be set, and the allocations could give each county an equal per capita allocation without the risk of negatively affecting some counties.

**37. It is important for CRA to consider regional issues that are shared across counties.**

There are regional coordination and financing issues related to water, sanitation, roads and health. Expenditure around issues such as Level 5 hospitals and water services by regional bodies affect services in more than one county and CRA should explore mechanism to ensure such services are adequately funded. Conditional grants are now accepted as mechanisms that can be used to address issues that cannot be adequately addressed through the equitable revenue sharing formula and CRA should explore this option. In addition, matching grants have also been applied in other jurisdictions and that is a second option to ensure regional issues are adequately funded.

### Fiscal Capacity and Effort

**38. The third-generation formula should give more weight to fiscal capacity and effort.**

While more data is now available on how much counties have been raising each year, the size of county GDP is still not available. Such data would help establish the potential for raising own revenue among the counties. In this case the higher the potential then the lower the allocation a county would receive because it is able to fund a large part of its budget. The World Bank generated some data on county GDP based on the number of lights across the counties.<sup>2</sup> Energy consumption can be an indicator of economic activity, the higher the economic activity the higher the revenue that could be raised in an area. While the data is it comprehensive, it makes the first attempt to estimate the size of county GDPs in Kenya. Therefore, CRA should consider using the data to understand potential across counties but we do not believe it can be used in the formula at this time.

**39. In the absence of credible data on the size and tax base of the county economy, we could look at measures related to actual collections.** Clearly, there is a relationship between the amount of resources a county raises through tax collection and the size of the economy. It should therefore be possible to examine data on key revenue sources, such as Single Business Permits and property rates, as a measure of economic activity in counties. The higher the collections from sources such as Single Business Licenses could be indicative of higher economic activity and potential for revenue.

**40. However, the erratic nature of own source revenue collection at the county level means that this data should be used cautiously.** Data going back to 2007/08 when local authorities were still in operation show that there are very steep drops and growth in the revenue raised on the sources that counties have now. (See Table 20). This cuts across all counties and even looking at the sources level the case remains the same. Even after counties started operating in 2013/14 the same trend remains which could be an indication of some systemic problems with the revenue sources that counties collect their revenue. In such a scenario, using the same

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<sup>2</sup> <http://documents.worldbank.org/curated/en/912151468188369841/pdf/WPS7461.pdf>

data to measure the fiscal effort across counties may be unfair to counties if the challenges in collection are beyond what they can control.

41. **Nevertheless, one challenge in using data on own revenue raised in counties is that it is difficult to know whether it is a measure of capacity or effort, since low collections can reflect either.** This is important because fairness dictates that we *reduce* allocations based on capacity, but we *increase* them based on effort. Collections data are also challenging to use because they may fluctuate from year to year for reasons that are hard to predict or for which it is hard to assign responsibility.
42. **In the absence of good data on either the taxable base or the size of the economy, however, the question arises as to what would constitute a fair approach to measuring capacity.** While data on actual collections could be used, these might introduce disincentives to collection where counties keep their collections low because they get more from the formula for low capacity. One way of mitigating this problem is to introduce an effort measure that would reduce the incentives to game the system. Counties that grow their revenue by higher margins between years should get more. The effort measure should be modelled in a way that counties are rewarded for the relative increment in their collections over time, regardless of the base.
43. **Counties could be rewarded for the increment in their collections relative to each other.** Counties could be ranked by their percentage increases in collections each year. The increases could then be divided into quintiles, and each county assigned a score based on its quintile. Those in the highest quintile would receive a larger share of the funds set aside for effort. (See “Option 2” in Table 21)
44. **The fiscal responsibility parameter in the second-generation formula introduced a measure of fiscal effort.** The parameter measures the own revenues growth per capita. Counties that have any growth in their revenue qualify to receive part of the allocation under this parameter. However, due to the fluctuations discussed earlier, only 19 counties would receive the fund based on the growth between 2015/16 and 2016/17 and only 26 in the year before. However, between 2013/14 and 2014/15 almost all (42 counties) would receive allocations based on their collections. Therefore, even with the current focus on per capita increments, the erratic nature of growth since the start of devolution and even before that could be a signal that county efforts to collect more is not the only factor affecting growth.
45. **Fiscal responsibility is really about effort, not capacity, and should reward counties that are doing more for themselves.** Therefore, the variable used should be a measure of effort, and rich and poor counties alike should be able to score well on that measure if they are exhibiting effort. What we mean is that each county should be assessed against its own potential and not compared to other counties.

## Fiscal Responsibility

46. **Fiscal effort should also be measured based on fiscal stability, transparency, public engagement and other good practices beyond tax effort.** A Fiscal Responsibility Index would include these measures that would also help disincentive a push by counties to just try to collect higher taxes at the expense of fairness in the mechanisms applied in the collection and growth of own revenue sources. Therefore, counties that are transparent in their budgeting, inclusive in decision making and adhering to the principals of fiscal discipline should be considered for a bigger allocation from this parameter.
47. **The current fiscal responsibility parameter does not include any factors in how prudent counties are using public resources.** The main reason why the formula did not consider other FR parameters in the first two formulas was due to lack or scanty data. However, with five years of operations there is sufficient data to start rewarding counties on a variety of measurements.
48. **There are other aspects of the PFMA that counties have not been meeting that could be incentivized through the formula.** For example, there are strict deadlines given to counties in the PFMA on production and publication of key budget documents. These documents should be in publicly accessible platforms and websites are the most obvious examples. Independent studies such as the bi-annual survey by the International Budget Partnership provide a good starting point to measure this.<sup>3</sup>
49. **The Kenya Devolution Support Program by the World Bank already has a conditional grant based on counties adherence to PFM Act and its regulations.** Counties are awarded points based on their performance across a wide range of variables such as adherence to the key steps of the budget process, opinion issues by the Auditor General, publication of budget documents on county websites, public engagement and feedback among other.
50. **CRA can build on this conditional grant and create a matching grant that could increase the incentives for counties to be more responsible.** It does not make sense to create a separate mechanism that will utilize the same criterion to distribute revenue to the same set of sub-national units. Therefore, CRA should consider increasing the allocation and take this as an opportunity to ensure the grant is sustainable even after the funding from the World Bank ends.

## Basic Equal Share

51. **The weight given for the equal allocation across counties should be reduced to a range between 10-15 percent.** Based on data from the recurrent ceilings for the executive and assemblies, the current allocation of 26 percent to the equal share is too high and should be lowered and the difference moved to cost lines that vary among counties. (See Table 22) We recommend that the difference be moved to the direct measures of need.

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<sup>3</sup> <https://www.internationalbudget.org/budget-work-by-country/ibps-work-in-countries/kenya/understanding-county-budgets/tracking-county-budget-information-kenya/>

- 52. The county recurrent ceilings approved by the Senate over the past four years place the proportion at an average of 17 percent.** The basic equal share is supposed to address administrative aspects that must be carried out in each county and there is no significant difference in their delivery. Many of the costs in the ceilings have similar costs across counties. However, there are some that vary and should not be part of equal share discussion e.g. the county assembly ward administrative officers whose numbers are dependent on the number of wards per county.
- 53. A more objective basis for the equal share could be constructed using actual data on fixed costs across counties (such as the administrative costs of running county government).** IBPK's analysis in 2015/16 on the cost of running counties found the total cost was 19 percent of the equitable share in that years. The analysis was mainly based on circulars from the Salaries and Remuneration Commission giving counties guidance on administrative costs.<sup>4</sup> However, the basic amount that all counties need, regardless of their size, is equal to what the county with the lowest running costs receives times 47. Any allocation above what is received by the lowest recipient is driven by difference in factors such as population and land area. For example, there were differences in the number of wards and therefore the number of ward administrators and county assembly ward staff. Therefore, using the lowest county allocation as the base, the cost comes to approximately 13% of the equitable share taking out the variable aspects that grow with the size of county executive and county assembly sizes.
- 54. South Africa has an institutional component which distributes a portion of its grant to provinces equally and has a weight of 5 percent.** Ethiopia and India do not have any parameters that distribute funds equally among their sub-national units. The high weight to the basic share in Kenya might have been practical in the first years of devolution as counties were setting up many of their administrative systems. For example, in our 2015/16 analysis there was an allocation of Ksh. 6.5 billion to help counties set up their public finance management systems. However, such costs are one off costs and therefore, the basic equal share should reduce after some time.

## Personnel Emoluments

- 55. Counties are still facing huge wage bills mostly occasioned by inherited staff.** The first two formulas are redistributive, and this did affect many counties that also had a large number of staff devolved to them. A mechanism for holding harmless counties to manage the shocks of the wage bill should be considered in the 3<sup>rd</sup> formula.
- 56. However, a parameter on the wage bill should not be part of the equitable share and should be a time-bound conditional grant.** There is an inherent risk that counties could start bloating their wages bills to get a larger share of such a fund. To control for that risk, we recommend that CRA uses proportions of the inherited wage bill in 2013/14. The county's

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<sup>4</sup> <http://www.src.go.ke/resource-centre/advisory/circulars>

share of that wage bill could provide an index to guide how much each county should get from the grant.

57. **This conditional grant should have two parts, the second part of the grant should be used to reward counties that are improving the efficiency of its workforce.** Counties that have a growing proportion of service delivery employees compared to administrative staff should get a higher proportion of the fund. Data on the mix of staff at the county level is not publicly available. However, CRA should explore the use of such data based on the staff coding that should be available on the Integrated Payroll and Personnel Database.