March 22, 2016

MEMORANDUM

The first part of this memorandum is a summary of the key questions that we encourage Parliament to ask when considering the Division of Revenue Bill (DORB) 2016. The second part is an in depth analysis of the issues and concerns related to the DORB 2016.

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

PART I: Summary of Key Questions

1. **Why is there a disparity in the rate of growth of the equitable share in comparison to that of sharable revenue?** In the DORB 2016, the equitable share is set to increase by 8% while the sharable revenue will grow by 11%. The DORB, however, offers no explanation for this difference. Nor does it adequately explain why Treasury's growth rate is lower than that proposed by the Commission on Revenue Allocation. To avoid suspicions that allocations are arbitrarily arrived at or distorted to favour one level of government, the DORB should provide an explanation for the disparity.

2. **Why are allocations for laptops or the National Youth Service considered part of the "national interest," while Treasury suggests that there is not enough funding to support polytechnics?** As was the case last year, the Treasury proposes an arbitrary definition of national interest which is not properly defended in the documentation.

3. **Why is the grant to Level 5 facilities distributed in a way that favours smaller facilities at the expense of larger one?** Our analysis finds that the way this grant is distributed rewards facilities with similar bed occupancy rates, even if one facility is much larger than another. This has the effect of giving Nakuru and Meru similar amounts, yet Nakuru has nearly twice as many inpatient beds. This is not equitable, as it punishes larger facilities for no justifiable reason.

4. **More generally, what are the justifications for the number, type and distribution criteria of the conditional grants and are these consistent with principles of equity and transparency?** The number of conditional grants in the DORB has increased each year since

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2013/14, but there has been inadequate debate over the basis for establishing these grants and the criteria for distributing them. This lack of attention to distributional criteria is leading to inequities and may undermine the purposes for which they were created.

5. **Why, four years into devolution, have we still not reformed state corporations to release funds and functions in the roads, water and regional development sectors?** While state corporations in these areas perform some regional functions and may need to be preserved in some form, there is no question that they need to be reformed and some of their functions released to counties. Why hasn't this happened and what can be done to speed up the process?

PART II: Detailed Analysis of Key Issues and Concerns in the DORB 2016

The International Budget Partnership-Kenya wishes to raise the following issues with regard to the Division of Revenue Bill (DORB) 2016 for the attention of Parliament:

1. **The Division of Revenue Bill 2016 provides no explanation for the difference in the rate of growth of the equitable share for counties and overall sharable revenue.** In the Division of Revenue Bill 2016, the National Treasury has recommended Kshs. 302 billion be devolved to the counties, an increase from Kshs. 287 billion in 2015/16. Most of these funds are for the equitable share, which will increase by 8% (from Kshs. 260 billion last year to Kshs. 280 billion this year). At the same time, sharable revenue will increase by 11% (to Kshs. 1,380 billion from Kshs. 1,243 billion in 2015/16). This means national government will take an increasing share of total revenue. Why should this be?

   The rate of growth of the national and county shares need not be exactly the same, but any differences require explanation. It is possible to argue that the share for either level should increase because the country needs to prioritize functions carried out by that level in a given year (such as security or health). Or it is possible to argue that the cost of a set of functions performed by one level or the other are growing faster and that level therefore needs a larger share.

   No such arguments are made in the DORB, which fuels suspicion that allocations are arbitrarily arrived at or are skewed to favor one level of government. Treasury justifies the share for counties on the basis of an "agreed growth factor" that lacks a clear basis and upon which no one seems to have agreed. The National Treasury has applied a revenue growth factor of 7.8 percent, which they claim is based on revenue performance in the recent past. This differs by a huge margin from the growth factor applied by the Commission on Revenue Allocation (CRA) of 15.1% in its recommendations for 2016/17. CRA uses the annual revenue growth in revenue over the last three years based on audited revenue accounts. The table below shows how CRA arrives at its figure.

	2011/12	2012/13	2013/14	2014/15	Average 3 Year Growth
Audited Revenue Accounts	682	777	936	1,038	
Growth in Shareable Revenue		13.9%	20.5%	10.9%	15.1%*

National Treasury indicates that it has also relied on prior year figures and justifies the difference with CRA based on the fact that it took actual revenue "performance" into account. It is unclear what this means since CRA used audited accounts, which already factor in actual collections (rather than targets).

Parliament should demand a clear explanation for this difference in growth factors. It is worth noting that National Treasury gave a growth factor of 9.85 percent in the draft Budget Policy Statement (BPS) released in late January, and has also provided no explanation for its shift to a lower number a few weeks later.

2. **The debate over the meaning of the "national interest" continues this year with no significant improvements.** Last year, CRA indicated that the national interest should not be equated to national government programs. Instead, it should be a collective reflection on the country's priorities, regardless of which level of government carries them out. Civil society organizations, including IBP Kenya, agreed. Nothing has been done to revisit the issue of how to define the national interest, and Treasury continues to define it in terms of the current government's flagship programs. This is an inadequate justification for the major trade-offs that must be made in any budget. Parliament should ask hard questions about how we define the national interest each year.

3 & 4. There is a need to improve on the justifications for conditional grants (including the Level 5 grant) and how they are distributed.

a. **There is no clear basis for the size of conditional grants. It is not clear why the grant to Level 5 hospitals is pegged at 4 billion or the free maternity grant at 4.1 billion.** The free maternity grant has declined from 4.3 billion last year without explanation. Even the road grant, which both Treasury and CRA agree should be 15% of last year's Road Levy Fund, turns out to be valued differently by the two institutions. The National Treasury claims that 15% of the fund is equivalent to 4.3 billion whereas CRA claims that 15% is equivalent to 4.8 billion. Since there are no publicly available financial statements from the Kenya Roads Board to verify the actual returns in 2014/15, Parliament should interrogate further the reasons for the disagreement between Treasury and CRA over the Fund's returns.

b. **There is also no clear basis for the distributional criteria used to allocate these grants, which is particularly egregious in the case of the Level 5 facilities**. The table below shows how the grant is distributed based on bed occupancy rates. But using rates is never a good approach to distributing service-related grants unless the objective is extreme redistribution. In this case, a better approach is to look not at occupancy rates but at the share of all bed occupancy in the country that occurs in a particular facility (compare column 2 and column 5 in the table below). This is a better measure of relative costs, because a county like Nakuru with twice as many beds as Meru is going to be serving nearly twice as many people with the same occupancy rate (77%). The current formula redistributes heavily from Nakuru to Meru for no obvious reason.

1	2	3	4	5	6	7	8
Facility	Occupancy (%)	Bed capacity	Occupied Bed	Share of Occupied Bed to the total	CARB County Allocation	Allocation Based on Number of Occupied Bed as a share of the Total	Difference
Machakos	79	375	296	8%	365,317,919	339,446,400	25,871,519
Embu	62	618	383	11%	286,705,202	439,028,802	(152,323,600)
Garissa	71	224	159	5%	328,323,699	182,229,723	146,093,976
Kakamega	88	449	395	11%	406,936,416	452,732,697	(45,796,281)
Meru	77	306	236	7%	356,069,364	269,975,901	86,093,463
Mombasa	80	499	399	11%	369,942,197	457,407,604	(87,465,407)
Nakuru	77	588	453	13%	356,069,364	518,777,222	(162,707,858)
Nyeri	84	323	271	8%	388,439,306	310,881,341	77,557,965
Kisumu	76	457	347	10%	351,445,087	397,962,949	(46,517,862)
Thika	85	265	225	6%	393,065,584	258,093,845	134,971,739
Kisii	86	379	326	9%	397,687,861	373,465,517	24,222,344
Total		**4,483**	**3,491**	**100%**	**4,000,001,999**	**4,000,001,999**	-

c. **Other grants also lack justifications.** The road fund is distributed according to the CRA formula for the equitable share. Using this formula to distribute the road maintenance grant sees counties with fewer roads receive more money for road maintenance. Since the Fund was created to help maintain already existing roads across the country, this is not the most logical way to distribute it. The National Treasury has also recommended the addition of one conditional grant in 2016/17. This special conditional grant is meant for two health facilities in Tana River and Lamu Counties to help them meet demand for emergency services. This decision is informed by their proximity to Somalia which has made them vulnerable to terror attacks. Parliament should interrogate why only these two counties were selected given that there are other border counties prone to cross border insecurity.

d. **The conditional grants proposed by National Treasury have limited conditions attached to them in the documents proposing their creation**. It is important that the conditions be clearly laid out, followed by clearly defined enforcement measures should the facilities benefiting from the grant not meet the conditions. While there are some conditions mentioned in the County Allocation of Revenue Bill, it is not clear how they are enforced. For example, the user fee grant requires facilities to have a "functional Health Management Committee." Who checks to ensure that this is the case and what happens if it is not? There is no evidence that such conditions are enforced or that those facilities that fall short are sanctioned (e.g., do not receive their allocations).

5. **The failure to reform state corporations is no longer excusable four years into devolution.** It has been clear since 2010 that water service boards, regional development authorities, roads boards and other state corporations in agriculture, etc. would have to be reformed as they perform at least some devolved functions. Very little has happened in this regard, however. The issue of roads has been litigated in court and it is likely that other sectors will end up in court as well. While the courts have a role to play, legal processes are not a substitute for properly planned reforms of government agencies with an eye on how best to separate functions and sequence transfers. It is unfortunate that the executive has failed to act on these reforms, but Parliament should force the executive to prepare detailed plans for state corporation restructuring.