COMMISSION ON REVENUE ALLOCATION

Promoting an Equitable Society

RECOMMENDATION ON THE THIRD BASIS FOR REVENUE SHARING AMONG COUNTY GOVERNMENTS

FOR FINANCIAL YEARS 2020/21 - 2024/25

(THE POPULAR VERSION)

FOREWORD

The third basis recommendation for equitable sharing of revenue among county governments has been prepared in accordance with the provision of Article 216 (1) (b) of the Constitution of Kenya, which mandates the Commission on Revenue Allocation to make recommendations concerning the basis for the equitable sharing of revenue raised nationally among the county governments. Further, Article 217 (2) (b) stipulates that in determining the basis of revenue sharing, the Senate shall request and consider recommendations from the Commission. In accordance with Article 217(1), this basis will be used to share revenue among county governments for the next five financial years, 2020/21 to 2024/25.

This recommendation is anchored in a revenue sharing framework which seeks to closely align funding to functions assigned to county governments to enhance service delivery. The framework also takes into account the need to address developmental gaps and economic disparities among counties. In addition, the framework seeks to create incentives for county governments to adhere to principles of fiscal responsibility and to optimize their capacity to raise own revenue.

This popular version of the third basis is to be read together with the detailed third basis recommendation.

Dr. Jane Kiringai
CHAIRPERSON

1. INTRODUCTION

The third basis recommendation for equitable sharing of revenue among county governments has been prepared in accordance with the provision of Article 216 (1) (b) of the Constitution. The constitution requires the Commission on Revenue Allocation (CRA) to make recommendations concerning the basis for the equitable sharing of revenue raised nationally among the county governments. In addition, Article 217(1) requires the Senate once every five years, by resolution to determine the basis for allocating among the counties the share of revenue raised nationally. In doing so, the Senate takes into account the commission's recommendations.

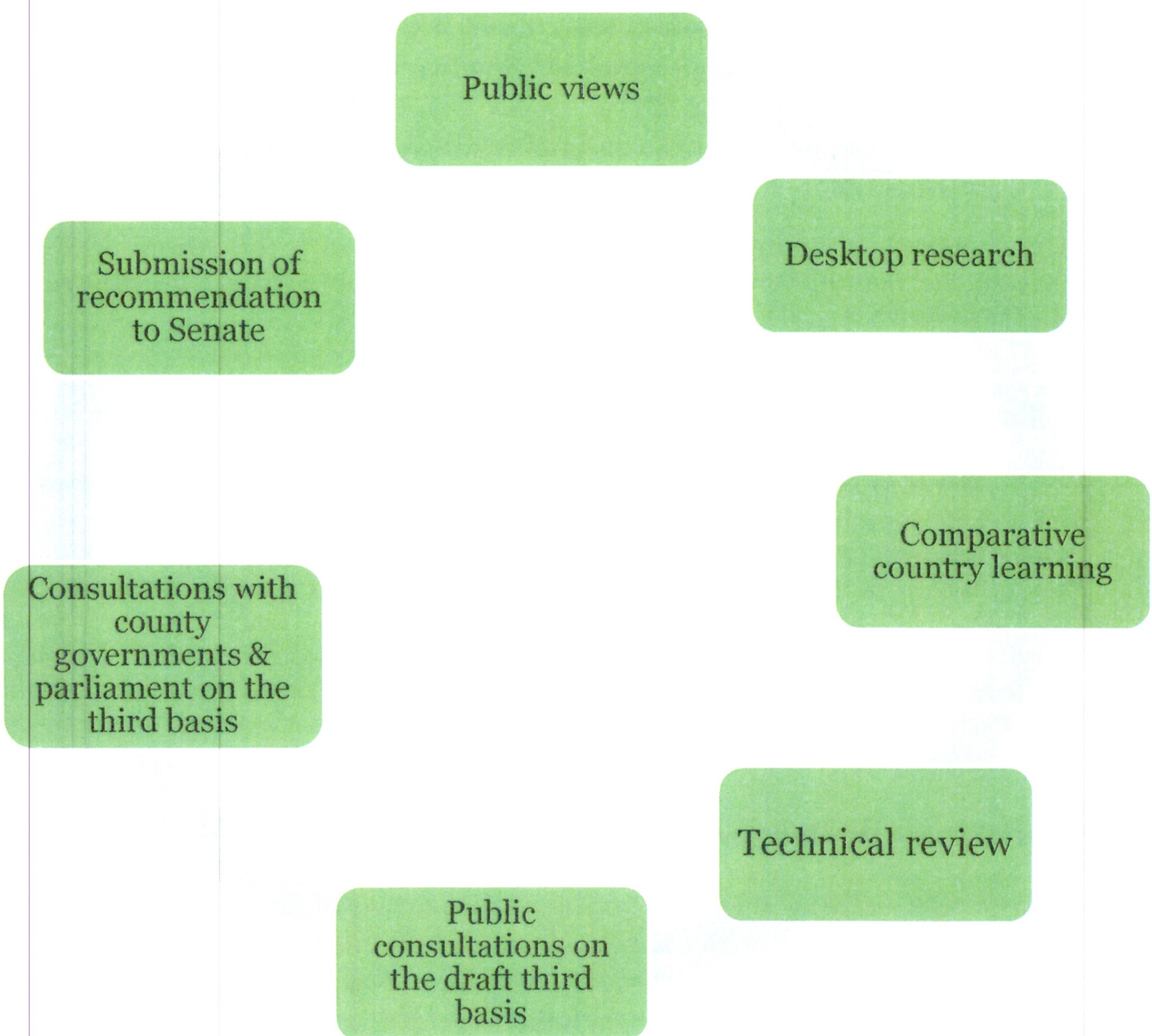
The first and second bases were transitionary and shared revenue for seven years. The first basis was used for four years (2013/14; 2014/15; 2015/16; and 2016/17) instead of three years due to delays in approval of the second basis in parliament. The second basis has been used to share revenue for three years (2017/18 to 2019/20). The third basis once approved by parliament will be used to share revenue among county governments for the next five financial years, from 2020/21 to 2024/25.

In a departure from the first and second basis, this third basis is predicated on constitutional provision in Article 187(2)(a) of the constitution that "*finance should follow functions*". In this regard the basis has four objectives which seek to closely align funding to functions assigned to county governments. These objectives are:

i. Enhance equitable service delivery;
ii. Address developmental gaps and economic disparities among counties;
iii. Enhance counties capacity to raise own revenue and;
iv. Create incentives for county governments to adhere to principles of fiscal responsibility.

2. RECOMMENDATION PROCESS

In formulating the 3rd basis recommendation, the Commission engaged a consultative process involving local and international experts, and the public. The recommendation was also informed by a comprehensive review of the second basis and lessons from experiences of other countries that have a devolved system similar to Kenya such as: South Africa; India, Philippines and Ethiopia among others. This process is depicted in Figure 1 below.



3. THIRD BASIS RECOMMENDATION FRAMEWORK

The third basis recommendation takes into account the functions assigned to county governments in the Fourth Schedule and the criteria provided in Article 203 of the constitution

The major shift from the second to the third basis is that while the second basis focussed on expenditure proxies the third basis focusses on functional assignment to the counties. The third basis seeks to address four objectives derived from the provisions in the 2010 Constitution. The objectives are:

- Enhance equitable service delivery; Article 187, 203(d)
- Promote balanced development; Article 203(f)(g)(h)
- Incentivize counties to optimise capacity to raise revenue; Article 209(3) 203(i)
- Incentivize prudent use of public resources by counties Article; 216(3) (c),201(d)(e)

The functions of county governments are mapped into the above objectives to determine expenditure needs and appropriate measures for the parameters used to share revenues.

In formulating the third basis, the Commission followed a four stage process as follows:

i. Mapping of the devolved county functions into the four objectives above
ii. Determination of the expenditure need for each devolved function
iii. Determination of the appropriate measure for the expenditure need
iv. Setting of the weights for measures of expenditure for each parameter.

To determine the parameter weights, the Commission has been guided by; existing policies on devolved functions, binding conventions on some of the devolved functions, actual expenditures by county governments and transfer shares from nationally raised revenues for key devolved functions.

Objective 1: Enhance equitable service delivery

The service delivery objective considers the devolved functions carried out by counties as provided in the fourth schedule of the constitution namely: county health; agriculture, livestock and fisheries; pre-primary education, village polytechnics, homecraft centres and childcare facilities; cultural activities, public entertainment, public amenities and urban services. Implementation of specific national government policies on natural resources and environmental conservation is also considered. A basic minimum allocation to each county for public administration for both the county executive and the assembly has also been taken into account within the service delivery component.

Objective 2: Promote balanced development

To promote balanced development, the third basis has taken into account the need for county governments to address poverty, provide infrastructure and additional costs in service delivery emanating from land size. The framework uses number of poor people, access to roads and land area as the revenue sharing parameters.

Objective 3: To incentivise Counties to Optimise Capacity to Raise Revenue

Article 209(3) requires that county governments raise revenues by imposing property and entertainment taxes, charges and fees for services rendered. Article 203(i) further provides that the basis for equitable sharing of revenue takes into account the need for economic optimisation and the need to provide incentives for counties to optimise their capacity to raise revenue. To cater for this constitutional requirement, a fiscal effort measure has been incorporated in the formula.

The fiscal effort measure is defined as a ratio of a county's actual Own Source Revenue (OSR) to the Gross County Product-GCP/county GDP, (OSR/GCP).

Objective 4: To Incentivise Prudent Use of Public Resources

The Constitution requires county governments to exercise prudence in the use of public resources. Article 216(3)(c) requires that the Commission's recommendations encourage fiscal responsibility. Further, the Public Finance Management Act (PFMA) 2012 holds county governments to a number of fiscal responsibility measures.

The fiscal responsibility measures include:

i) Allocating a minimum of thirty per cent of their budget to development expenditure;
ii) Establishment of internal audit committees for both the executive and the assembly;
iii) Establishment of County Budget and Economic Forum (CBEF) and
iv) An independent audit of the accounts of both the executive and assembly by the Auditor General.

To mainstream PFMA requirements, the third basis recommendation incorporates a fiscal prudence measure which is a composite index that considers the above four measures of fiscal responsibility.

Table 1 below gives a summary of the third basis recommendation framework.

Table 1: Summary of objectives, functions & indicators for the third basis

Public Sector Function	Constitutional Functions & Powers	Indicator of Expenditure	Weight
Objective 1. Enhance services delivery			
1.1 Health	• County health services	Health index	17%
1.2 Agriculture, livestock & fisheries	• Agriculture, livestock and fisheries • Animal control and welfare	Agricultural index	10 %
1.3 Other county services	• Pre-primary education, village polytechnics, homecraft centres and childcare facilities. • Cultural activities, public entertainment and public amenities	County population	18 %
1.4 Public Administration	• County planning and development • Implementation of specific national government policies on natural resources and environmental conservation • Ensuring and coordinating the participation of communities in governance at the local level	Basic share index	20%
1.5 Urban Services	• Urban services and environment ✓ Control of air pollution, noise pollution, other public nuisances and outdoor advertising. ✓ Fire-fighting services and disaster management. ✓ Control of drugs and pornography. • County public works and services for storm water management, water and sanitation services	Urban households	5 %
Objective 2. Promote balanced development			
2.1 Infrastructure	• County transport • Trade development and regulation	Land area Rural access index Poverty	8 % 4 % 14%
Objective 3. Incentivize capacity to raise revenue			
3.1 Revenue collection	• County revenue collection	Fiscal effort index	2 %
Objective 4. Incentivize prudent use of public resources			
4.1 Prudent use of public resources	• Establishment of Internal audit committee • Establishment of the County Budget and Economic Forum • Expenditure on development • Opinion of the External Auditor	Prudence index	2 %

4. EXPENDITURE NEEDS FOR THE THIRD BASIS RECOMMENDATION

This section expounds on the expenditure needs and parameters used to achieve each objective and weights assigned to each parameter as provided in Table 1.

Objective 1: Enhance equitable service delivery-Allocated weight: 70%

This will be achieved through four (4) parameters namely:

1. Health-Allocated weight: 17%
2. Agriculture, Livestock & Fisheries-Allocated weight: 10%
3. Urban services-Allocated weight:5%
4. Other County services-Allocated weight:18%
5. Basic equal share-Allocated weight:20%

1. Health-allocated weight: 17%

Expenditure needs considered under the health parameter are:

i) Health facility gap-Allocated sub-weight: 10.2%
ii) In-patient days equivalent-Allocated sub-weight:3.4%
iii) Outpatient visits-Allocated sub-weight:3.4%

Total 17%

The sub-weights are arrived at through a statistical procedure. The next section describes these measures in more details.

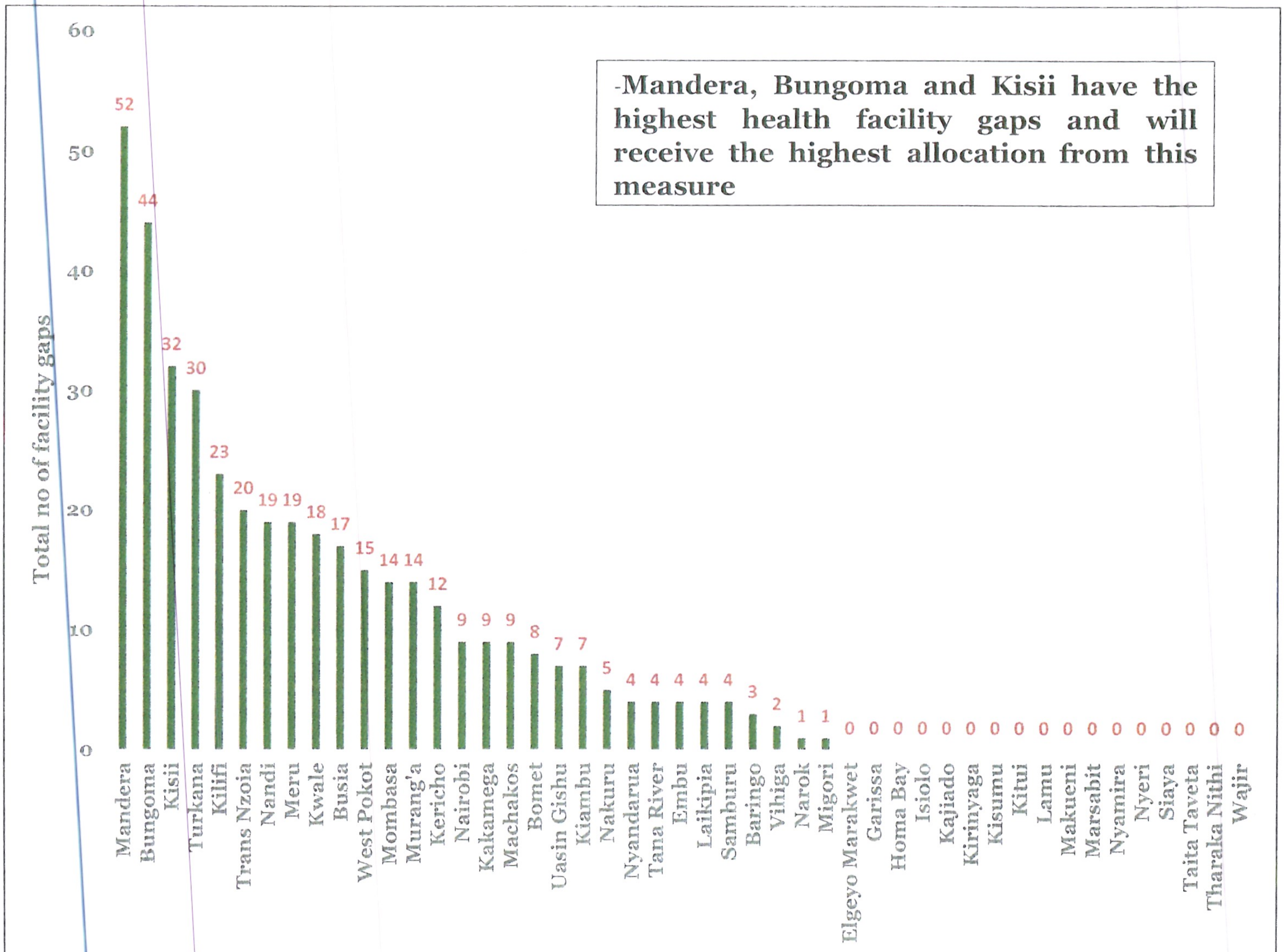
i) Health Facility Gap

To determine the health facility shortfalls in each county, the third basis recommendation uses the infrastructure gap for each level of health care based on health facility norms and standards provided by the ministry of health as follows:

- Community unit/level I –required for a population of 5,000 people
- Dispensary/level II-required for a population of 10,000 people
- Health center/level III-required for a population of 30,000
- Primary referral facilities/level IV-required for a population of 100,000
- Secondary referral facilities, Level V-required for a population of 1 million persons
- Tertiary referral facilities/Level VI-5 million persons (*These are national government level facilities)*

The third basis determines the health financing gap using the above norms and standards which is monetized to inform revenue sharing. Figure 2 below shows total facility gaps in level II to Level IV based on data from the ministry of health. 30 counties have facility gaps while 17 counties have achieved the norms recommended by the ministry of health.

Figure 2: Total health facility gap per County- (Level II, III and IV)

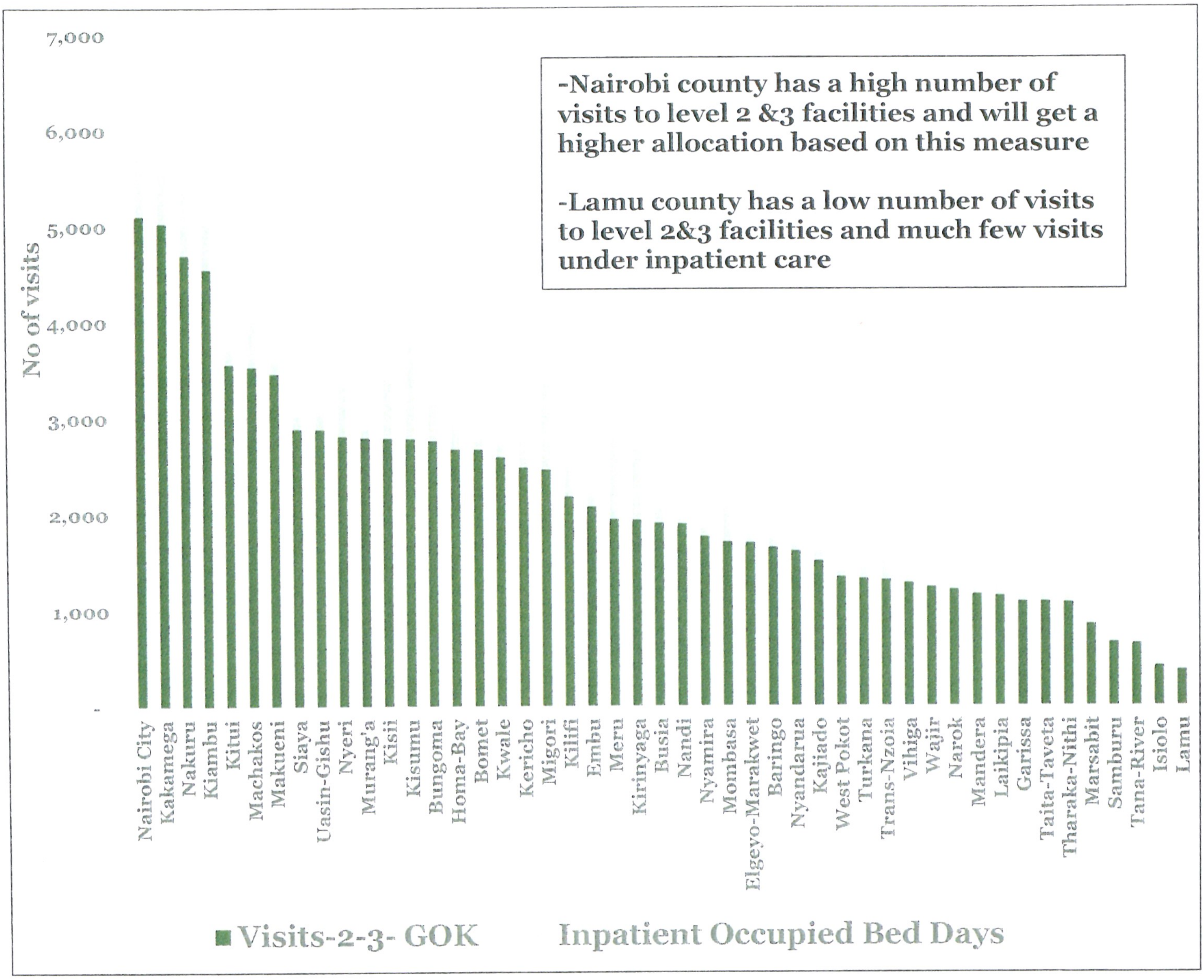


ii) In-Patient days in Level IV and V (3 -year average – 2015/16 to 2017/18)

iii) Health workload/outpatient visits -Clinic visits to Level II & III

Variation in disease burdens across counties result in different heath service demands as measured by in-patient and out-patient attendances. For inpatient days level IV and V health facilities are considered while for outpatient level II and III facilities are considered. Figure 3 below shows the number of people by county visiting inpatient and outpatient facilities.

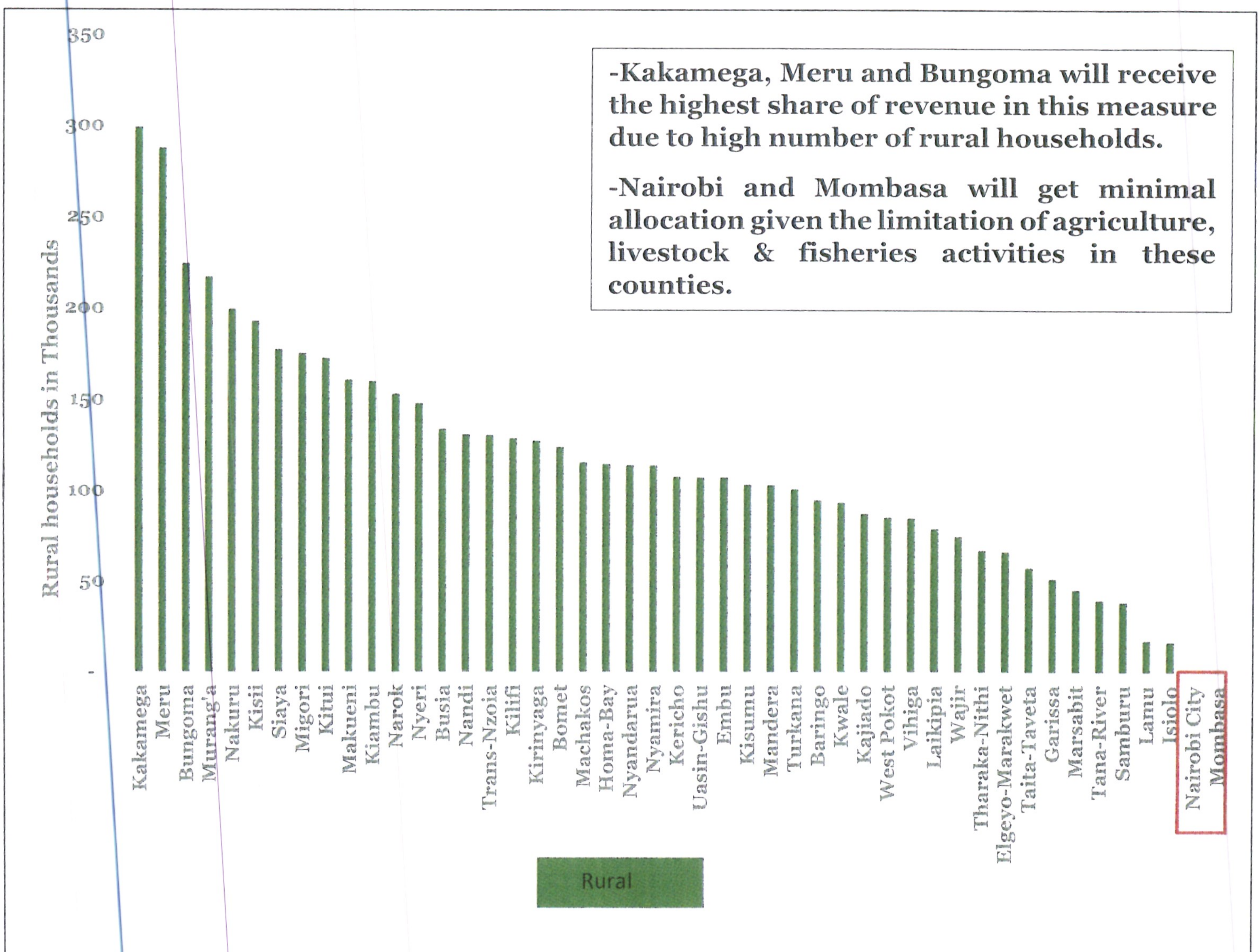
Figure 3: Number of outpatient visits to level II&III and in patient days in level IV and V



2: Agriculture, Livestock and Fisheries-Allocated weight: 10%

Agriculture, livestock and fisheries services provided by county governments include: crop and animal husbandry; livestock sale yards; county abattoirs; plant and animal disease control; and fisheries. County governments provide agriculture extension services to farmers in each sub-sector of agriculture. The agriculture, livestock and fisheries services measure is based on a county's proportion of rural households as provided in the Kenya Population and Housing Census (KPHC) of 2009. Figure 4 below shows the number of rural households per county.

Figure 4: Rural households in each county (KPHC 2009)

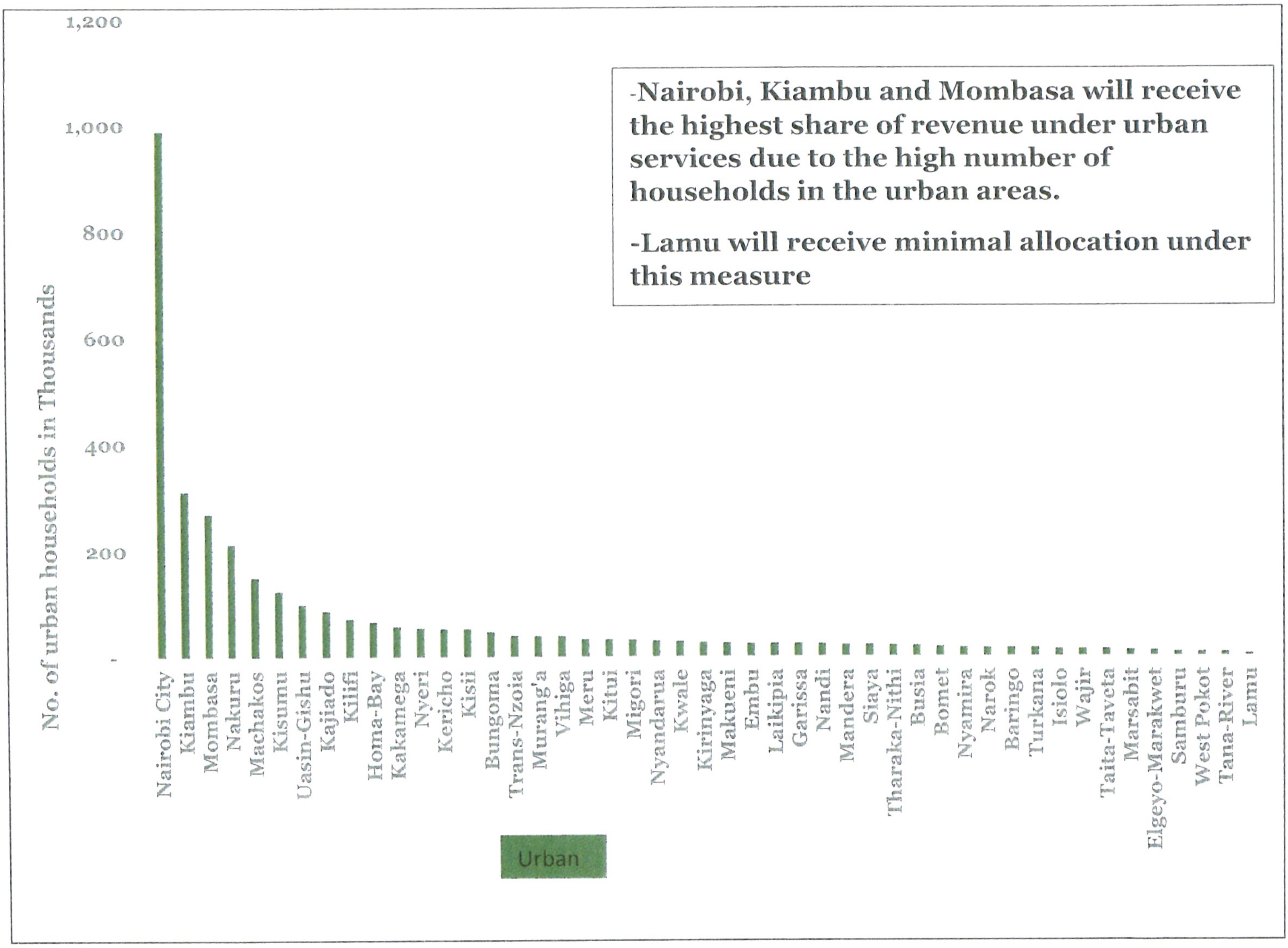


3: Urban Services-Allocated weight: 5%

Counties are responsible for provision of urban-based services including: solid waste management; control of air pollution, noise pollution, other public nuisances and outdoor advertising. County governments are also responsible for county public works and services such as storm water management.

The number of urban households has been considered to provide service needs in the urban areas as provided in the Kenya Population and Housing Census data (KPHC) of 2009. Figure 5 gives the number of urban households per county.

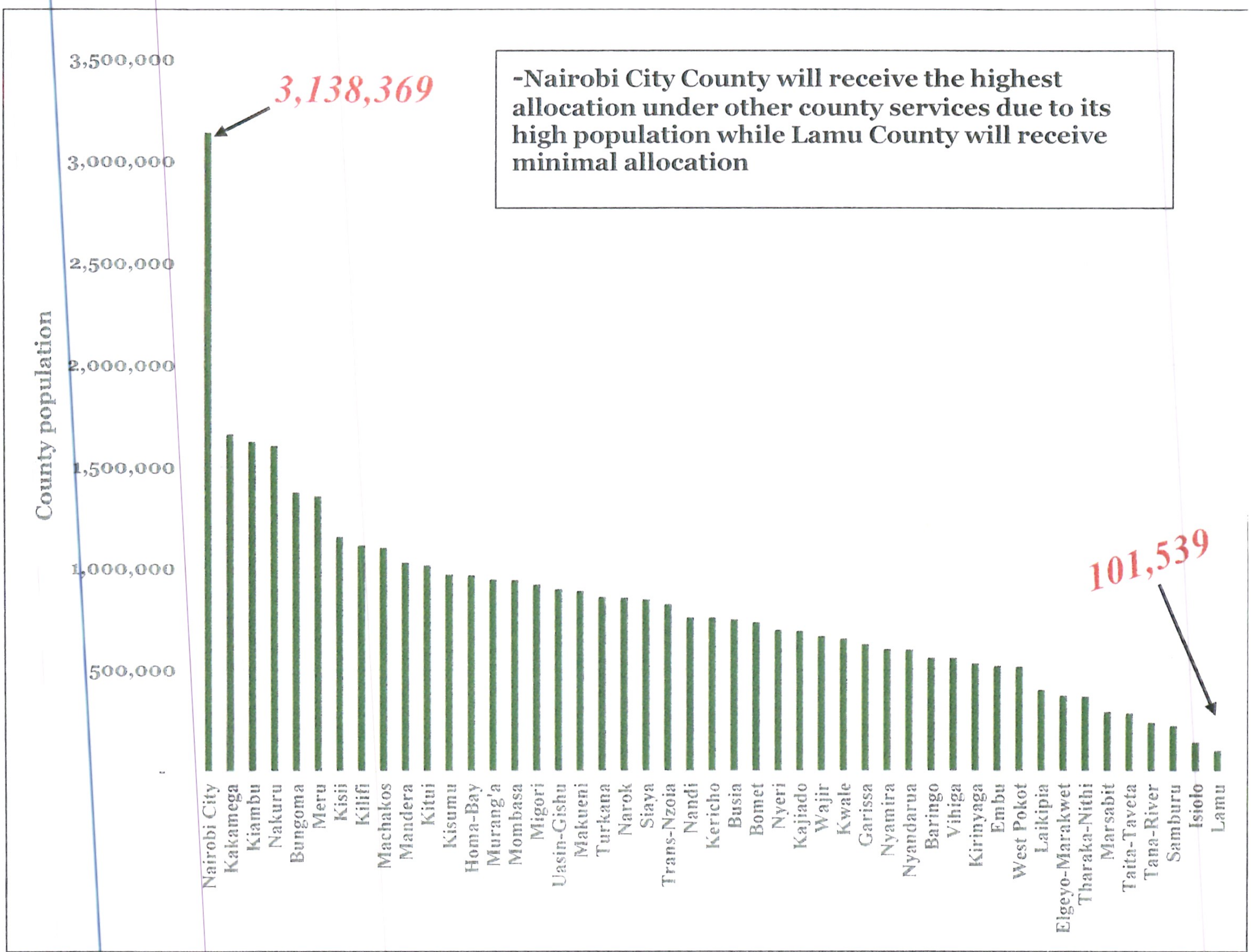
Figure 5: Urban households: 2009 Census



4. Other county Services-Allocated weight: 18%

Other county services include: pre-primary education; village polytechnics; homecraft centres and childcare facilities; cultural activities, public entertainment and public amenities; animal control and welfare; fire-fighting services and disaster management; control of drugs and pornography and implementation of specific national government policies on natural resources and environmental conservation. Given that these services are largely population-based, total county population is considered an appropriate measure of expenditure needs based on the 2009, Kenya Population and Housing Census. Figure 6 gives the county population

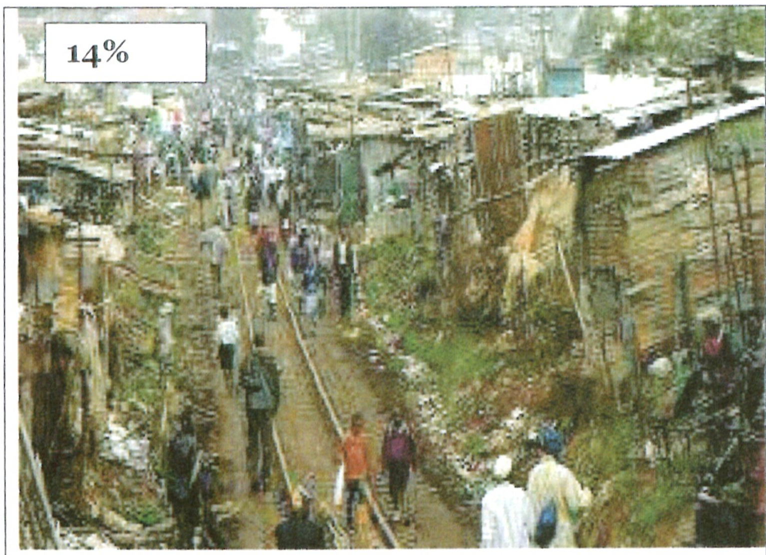
Figure 6: County Population: Census 2009

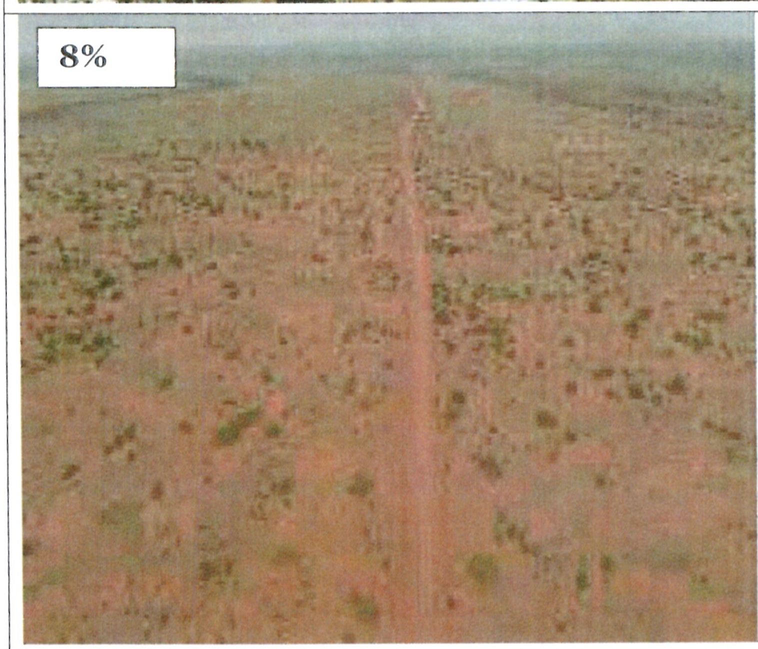


Objective 2: To promote balanced development-Allocated weight: 26%

This will be achieved through three (3) parameters namely:

1. Poverty-Allocated weight: 14%
2. Land area-Allocated weight: 8%
3. Roads-Allocated weight-4%

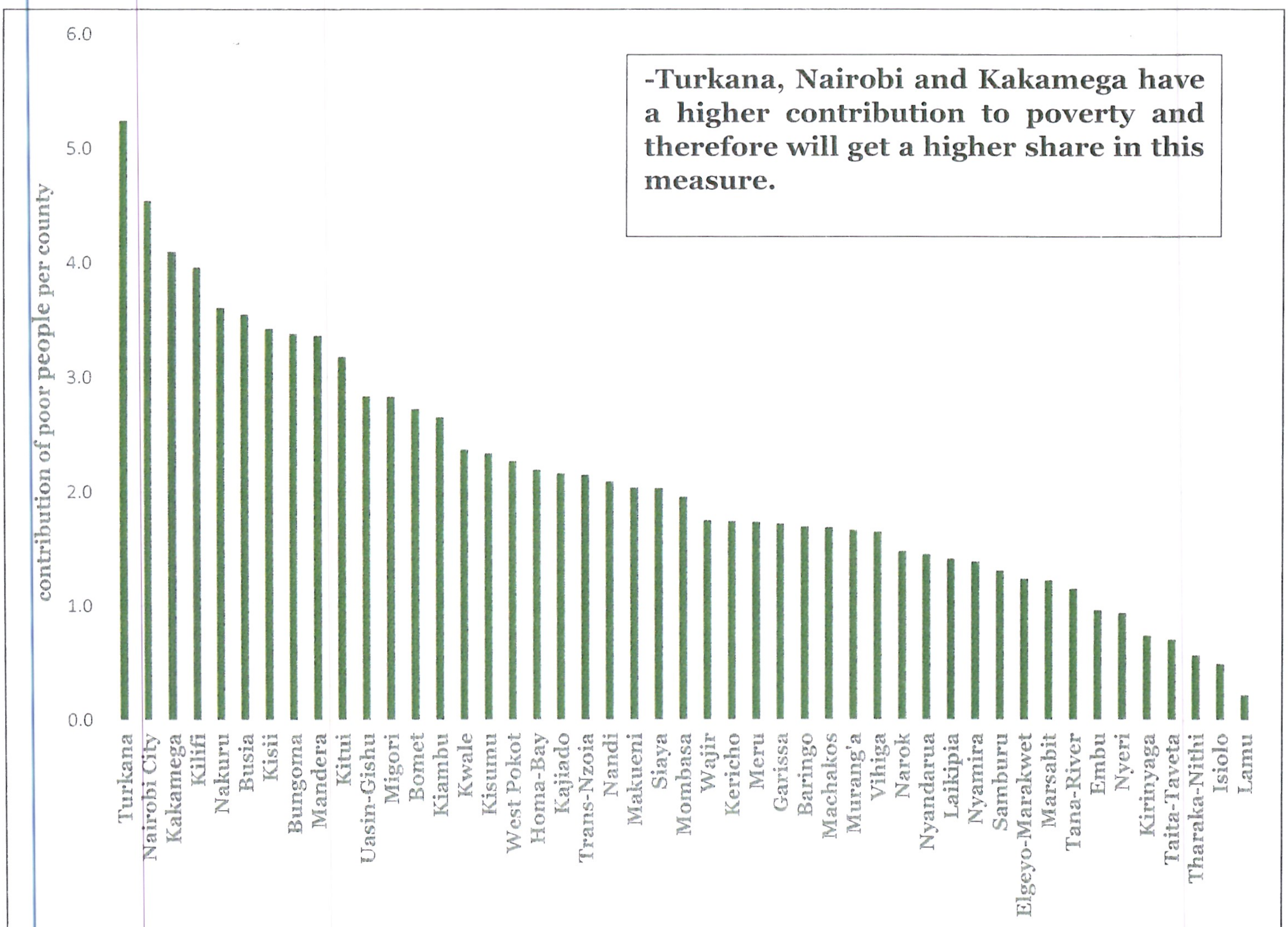




1. Poverty-Allocated weight: 14%

The poverty parameter uses poverty head count which is defined as a county's proportion of poor people as provided in Kenya Integrated Household Budget Survey (KIHBS) 2015/16. Under-development and poverty have a close relationship, therefore poverty is used as a substitute for developmental needs and economic differences among counties. Figure 7 gives the contribution of poor people per county.

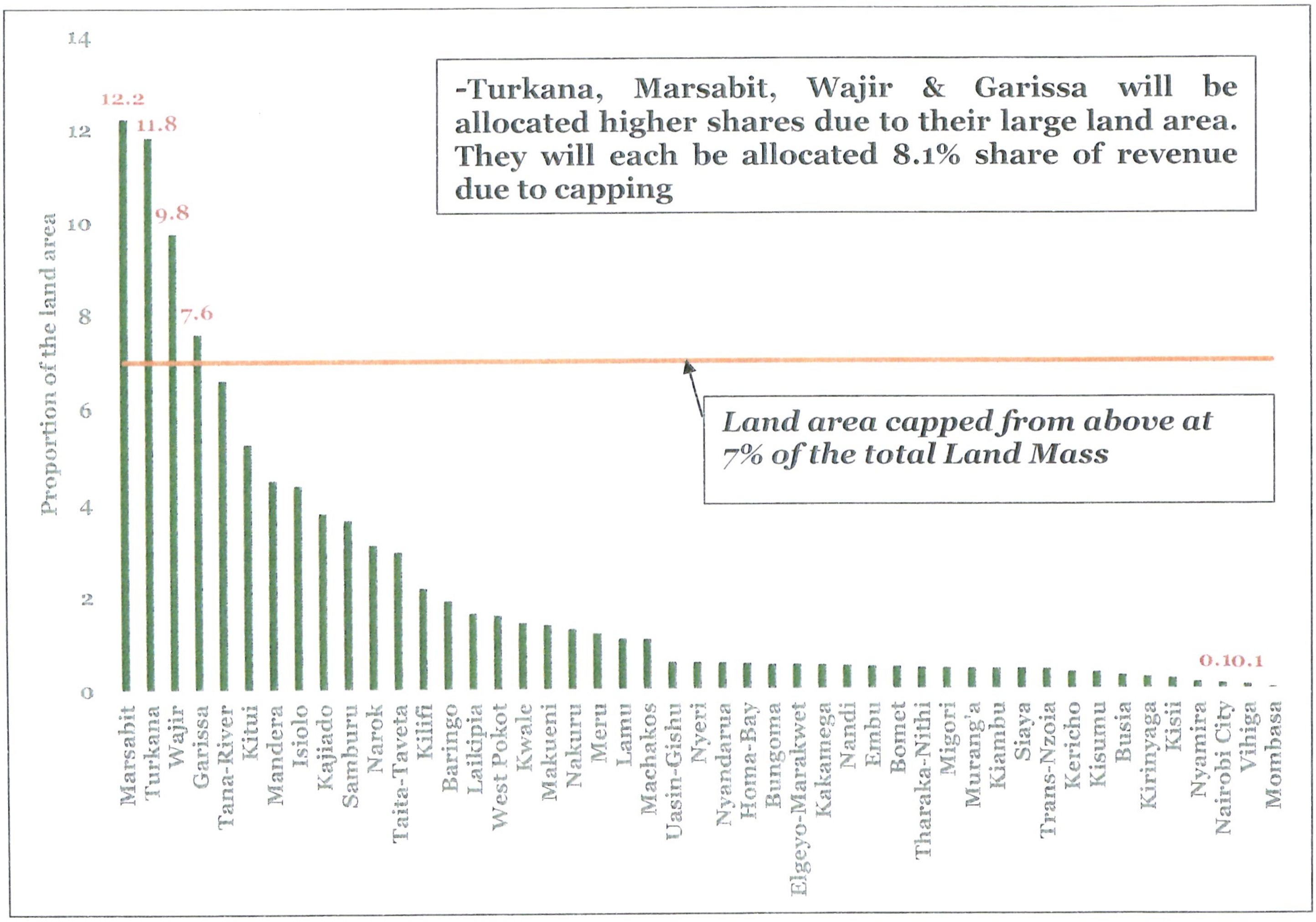
Figure 7: County contribution to poverty-KIHBS 2015/16



2. Land Area-Allocated weight: 8%

The allocation of revenues based on land parameter is meant to provide counties with adequate resources to cater for additional costs in service delivery-land disadvantages since it more expensive to provide services in counties with large land area and low population density. The measure used for this parameter is the county's proportion of the land area. Land area been capped at a maximum proportion of seven per cent. Figure 8 gives each county's proportion of land area.

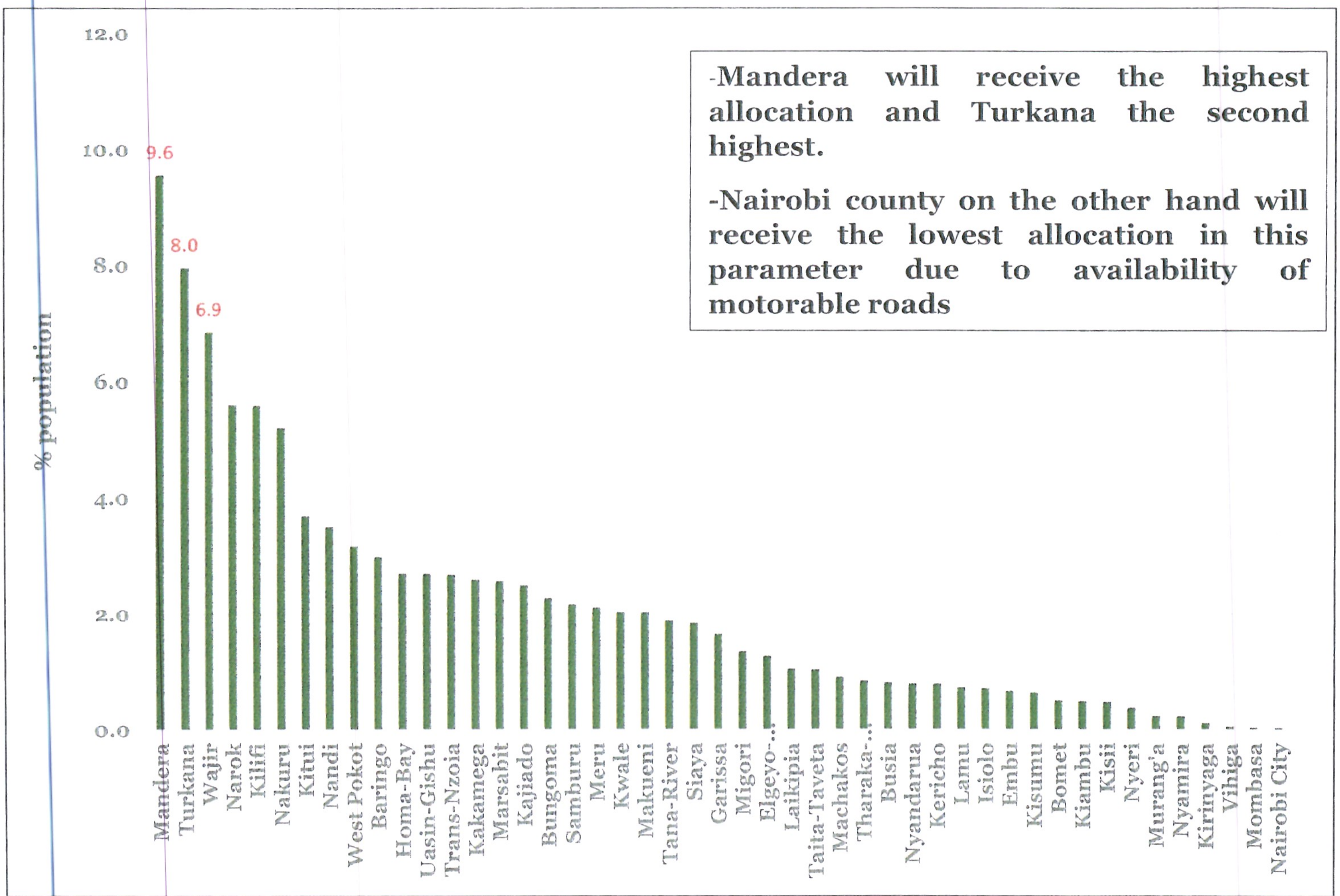
Figure 8: County Land Area (sq. Km)



3. Roads-Allocated weight: 4%

County governments are responsible for construction and maintenance of county roads-class D roads and below. The roads measure is defined by the county's rural access index (RAI) which is the proportion of a county's population without access to a motorable road within two kilometers based on data from the Kenya Roads Board for 2017. Figure 9 gives the % of population in each county without access to a motorable road.

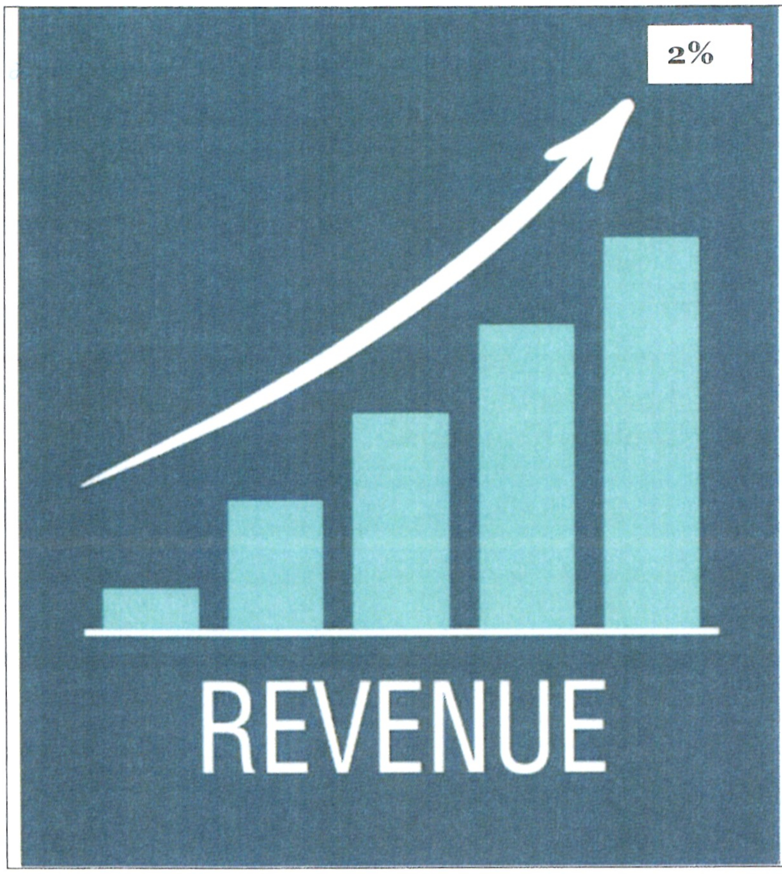
Figure 9: % Population without access to a motorable road within 2 km distance)



Objective 3 & 4: Incentivize counties capacity to raise revenue and prudent use of resources-Total allocated weight 4%

This will be achieved through the following parameters:

1. Fiscal effort-Allocated weight: 2%
2. Fiscal prudence-Allocated weight: 2%




2%

County operated 17 illegal bank accounts, audit report shows

Counties

Weak budget controls highlighted in report

BUSINESS DAILY

Spending billions on trips unnecessary, unacceptable

Counties lost millions in fishy deals—auditor

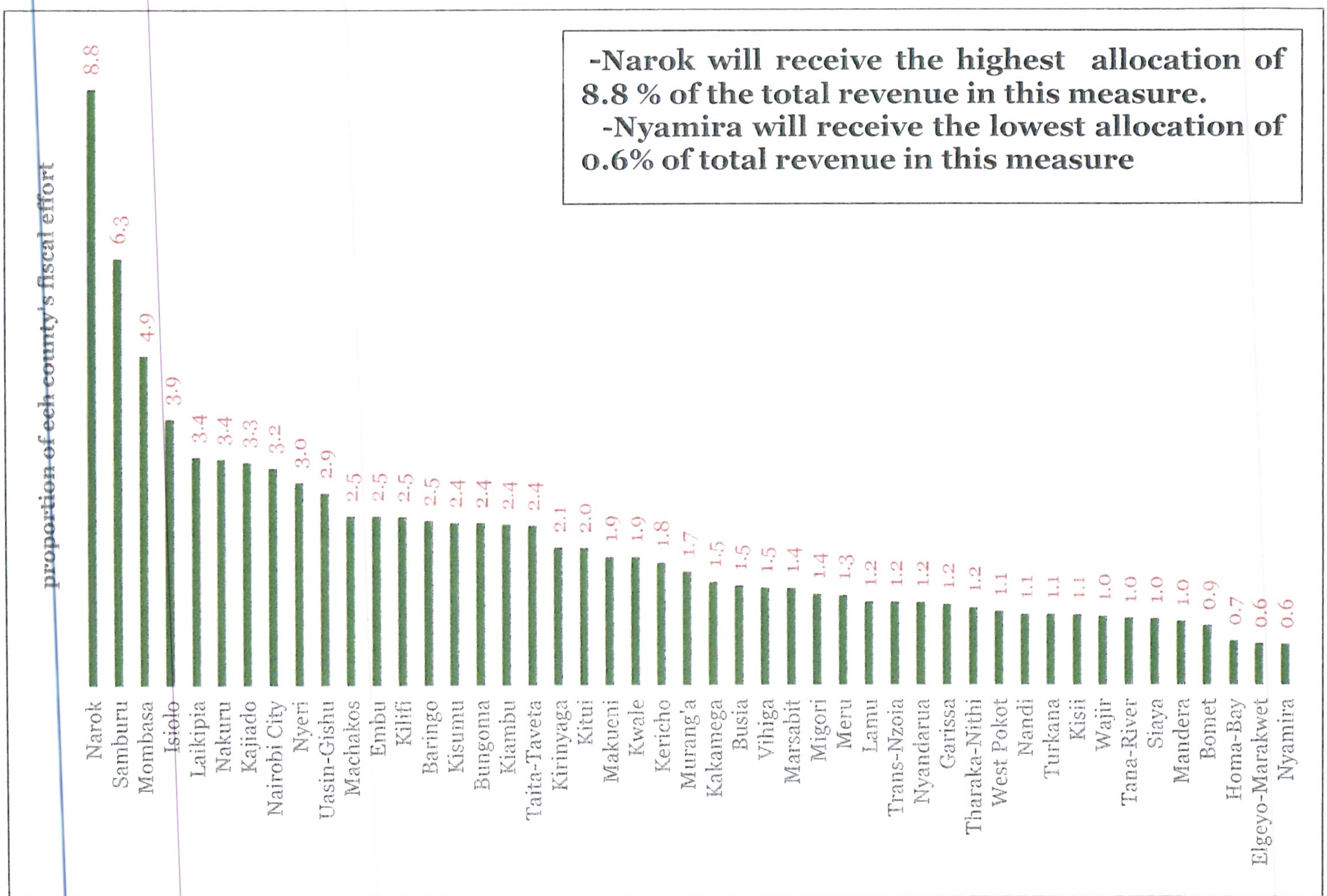
Counties

Audit cites cash misuse by county assemblies

Fiscal Effort-Allocated weight: 2%

The fiscal effort measure is defined as a ratio of a county's actual Own Source Revenue (OSR) to the Gross County Product (GCP) based on data from the Controller of Budget and KNBS, respectively. The fiscal effort parameter is weighted at two per cent and will change every year based on performance of county governments' OSR collections. Figure 10 gives the proportion of each county's fiscal effort measure based on FY 2017/18 data.

Figure 10: County own source revenue 2017/18 as ratio of GCP 2017 (OSR/GCP)



Fiscal Prudence-Allocated weight: 2%

The fiscal prudence measure is a composite index that considers; the external auditor's opinion of a county's expenditures, use of funds for development and establishments of internal audit committee and the County Budget and Economic Forum (CBEF) across all the counties. Each of these indices has a weight of 0.5%. The prudence parameter is weighted at two per cent and will change annually based on a county's performance in the above areas. These measures are presented in table 2 below.

Table 2: Fiscal Prudence Measures

No.	Variable	Indicator	Score	Responsible	Weighting
1	Audit Opinion	Non-Qualified	4	County Executive & Assembly	CE=90% CA=10%
		Qualified	2		
		Adverse	0		
		Disclaimer	0		
2	Development Expenditure	At least 30%	1	County Government	100%
		Below 30%	0		
3	Internal Audit Committee	In place	1	County Executive & Assembly	CE=90% CA=10%
		Not In Place	0		
4	County Budget and Economic Forum(CBEF)	In place	1	County Government	100%
		Not In place	0		

5. SUMMARY

The third basis recommendation is a framework for revenue sharing and not a budgeting tool for counties. Effectively, this framework is used to make a general-purpose transfer to all county governments. The basis creates a link between the devolved functions and the county shareable revenue and uses better measures of poverty and fiscal effort. The basis also provides for peculiar service needs of urban areas and will encourage counties to be more careful in the use of public resources.

This recommendation has also taken into account Article 203(d) and (j) which requires that the criteria for revenue sharing ensures that county governments are able to perform the functions assigned to them and that the allocations are stable and predictable.

The impact of the third basis on the allocation for each county will depend on the equitable share allocation to counties for the FY 2020/21. In this regard, the Commission recommends that if there is significant variation on the shareable resources to the counties, the third basis be implemented in a phased-in manner over a period of one year to cushion counties whose allocations for the FY 2020/21 will be significantly reduced. For this reason, the Commission recommends the setting aside of 15% of the annual equitable share increment to cushion counties with a reduction exceeding Kshs. 400 million emanating from adoption of the third basis.