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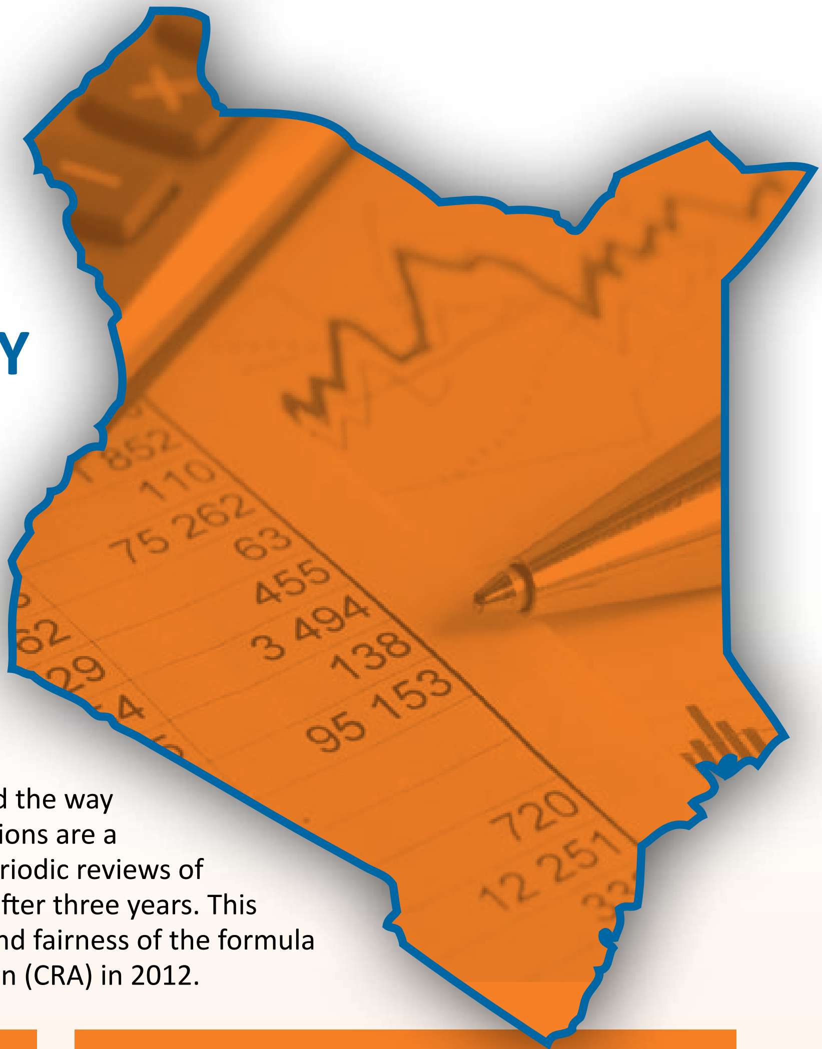
EFFECTIVE, FAIR AND TRANSPARENT SHARING OF COUNTY REVENUES

SEPTEMBER 2014



A SUMMARY OF IBP'S SUBMISSION TO THE COMMISSION ON REVENUE ALLOCATION PREPARED BY JASON LAKIN AND JOHN KINUTHIA

By the end of 2014, Kenya is meant to have revised the way it shares money among the 47 counties. The revisions are a requirement of the constitution, which calls for periodic reviews of the formula every five years and an initial review after three years. This first review will focus on improving the accuracy and fairness of the formula designed by the Commission on Revenue Allocation (CRA) in 2012.

THREE PRINCIPLES OF REVENUE SHARING

We normally think of three key principles for what is fair in revenue sharing: Need, capacity, and effort.

NEED

A county that needs more resources should receive more resources. For example, this principle says that a county with more sick people needs more money for healthcare than a healthier county.

CAPACITY

Counties with more of their own resources should finance more of their own development and receive less from the overall pot. This is equivalent to saying that a rich family should pay more out of its own pockets for services, while a poor family should receive more help from the state.

EFFORT

Counties that make more of an effort to finance themselves should not be punished for doing so. Instead, counties should be rewarded when they make an effort to raise money on their own and spend it wisely. This means we should not reduce the amount of funds they receive from the overall pot when they are successful in their efforts to raise more funds on their own.

THE CURRENT FORMULA

Parameter	*Weight*
Population	45%
Basic Equal Share	25%
Poverty	20%
Land Area	8%
Fiscal Responsibility	2%
Total	100%

The current formula uses **Population**, **Poverty**, and **Land Area** to estimate the cost of delivering services in a given county. Likewise, **Basic Equal Share** aims to ensure that all counties have a basic level of expenditure (for common costs such as public administration) regardless of other variables. Thus, 98 percent of the original formula is based on expenditure need.

Fiscal Responsibility accounts for the final 2 percent of the transfer. This was intended to measure how well a county manages public finances and to provide an incentive for improvements. In practice, however, up to now each county has received an equal share and it has been indistinguishable from Basic Equal Share.

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PROBLEMS WITH THE CURRENT FORMULA

The current formula suffers from several weaknesses:

- The formula is crude. It could use variables that more closely measure service delivery needs than Population and Poverty.
- The formula focuses almost exclusively on need, ignoring important principles of fairness like the capacity of counties to collect their own revenues and the effort they make to do so.
- The formula tries to do too much. Within the same transfer, it combines an emphasis on meeting ongoing county service costs with a desire to redistribute resources. This makes it difficult to understand how much is being dedicated to maintaining services and how much is dedicated to compensating for historical marginalization.

We propose a number of ways of dealing with these weaknesses, starting with shifting toward measures that more closely correspond to service delivery needs.

RECOMMENDATION 1: A BETTER PICTURE OF POPULATION NEEDS

Looking at a county's population is a reasonable way to begin to estimate the demand for county services. However, relying solely on a basic headcount to assess the demand for county services is too simplistic. Information is available that can be used to give a better picture of the needs of a county's population and the demand for services in individual counties.

To move beyond reliance on a basic headcount, and more accurately calculate the needs of each county's population, we can make use of data related to county services such as health, agriculture, and education. The next section explores how information on each of these services can be used to help us construct a better picture of the need for services in a given county.

MEASURING DEMAND FOR SERVICES: FROM POPULATION TO POPULATION NEEDS

HEALTH NEEDS INDEX

The single most expensive service delivered by counties is healthcare. There are a number of measures we can use to get a better picture of needs for healthcare at the county level.

- Health facility visits: Counting the number of visits to health facilities in a given county in a given year will give a more accurate picture of the demand for healthcare.
- Risk of disease: The incidences of diseases such as tuberculosis, malaria, and HIV (the key drivers of illness in Kenya) will give a better picture of the risk of falling sick in each county.

These two measures can be combined to formulate a **Health Needs Index** that will more accurately measure the costs of providing healthcare in each county. This is similar to what other countries, such as South Africa, have done to measure health needs.

AGRICULTURE

For agriculture, looking at the numbers of crop farming households can be used to estimate the demand for agriculture services. While not perfect (the measure excludes livestock farmers), it gets us closer to a measure of need in agriculture.

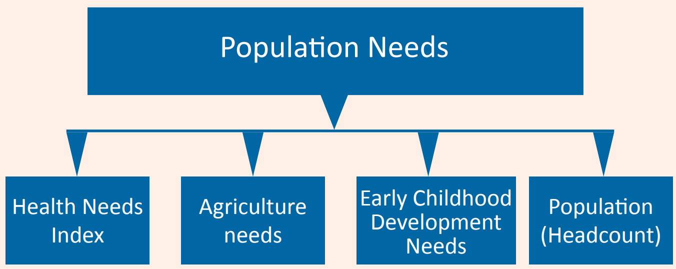
EDUCATION INDEX

Most education services are delivered at the national level, so education represents a much smaller share of what counties need to spend money on. Nonetheless, early childhood development education is an important county function. A county's population of under one-year olds offers an indication of the potential demand for early childhood development education in each county.

DETERMINING POPULATION NEEDS

These indicators can be used to derive a more accurate measure of **Population Needs** than using a population headcount alone. However, we lack good measures for a number of county functions, such as livestock extension services, library services, and even preventive health services (such as immunization, provided to everyone). Given these limitations, headcount population should be retained at a smaller weight as a proxy for these costs, but subsumed under the new Population Needs measure (see Figure 1 below).

FIGURE 1: DETERMINING POPULATION NEEDS



As more and better data becomes available, future iterations of the formula could take these into account and further reduce the weight given to population headcount.

RECOMMENDATION 2: FILLING GAPS IN INFRASTRUCTURE NEEDS

Along with the need to deliver services, there is also the need to invest in less-developed counties and expand the quantity and quality of services delivered in areas that have faced historical marginalization. To do so, we recommend using a set of indicators to assess **Infrastructure Needs** for each county. These indicators should be related to access to roads, piped water, and electricity (and possibly health infrastructure) to calculate an allocation of funds for infrastructure needs.

Investing in Infrastructure Needs should be deliberately redistributive to ensure that counties with infrastructure deficits can catch up to other counties. This is consistent with the objective and structure of the Equalization Fund in the constitution. It could be time bound like the Equalization Fund. However, it should be larger than the Equalization Fund, which is too small to close the gaps.

As we explain below, the **Infrastructure Needs Transfer** should probably be introduced as a separate funding stream to keep a clear and transparent division between the funding to support ongoing service needs, and the funding to fill historical gaps.

RECOMMENDATION 3: RECOGNIZING CAPACITY AND EFFORT

The measures recommended above are all related to service delivery needs. But the objectives of county revenue sharing, particularly the need for fairness, also require part of the division of revenue to be based on capacity of counties to raise their own revenue and effort they make to do so. This is because there are large differences in the size of county economies and their tax bases.

CAPACITY

A county like Nairobi can certainly raise more revenues than a county like Wajir. This should be recognized in how revenues are distributed. Many countries look at capacity by estimating what all counties could collect if they applied a similar tax to their tax bases. This approach avoids a situation where counties are punished for collecting more taxes, since it is based on their potential to raise revenues rather than actual collections.

EFFORT

Effort expresses the idea that two counties with similar economies and tax bases might collect different amounts because one county might make more of an effort to enforce the tax laws, or might use more creative taxes and charges to access the base. One way of looking at effort is to see how much counties increase their tax collections over time and to reward those counties that have higher increases. Effort can also be about how well counties manage their funds, and whether they follow the law in raising and spending money.

CRA has proposed using a **Fiscal Responsibility Index** for this purpose and invited debate about how to craft it. At this point, rather than measure fiscal responsibility directly, counties should be assessed on their systems. For example, those that are more transparent and facilitate greater scrutiny of their budgets could be rewarded.

RECOMMENDATION 4: MULTIPLE TRANSFERS RATHER THAN A SINGLE FORMULA

We recommend that Kenya move beyond a single formula for calculating how revenues are shared and use different transfers to achieve the differing objectives for which the money is intended. Using different transfers to achieve different objectives is more transparent: The purpose of each discreet transfer is more readily understandable and can be more readily assessed on how effective it is at achieving its objective.

SERVICE DELIVERY TRANSFER

The service delivery transfer should be made up of the following elements:

- **Population Needs** measure outlined above should account for 67% of the service delivery transfer.
- **Basic Equal Share** should be reduced from 25 percent to 11 percent.
- **Poverty** measure should be reduced from 20 percent to 13 percent.
- **Land Area** should increase from 8 percent to 9 percent.

This transfer is similar to the current formula, but it focuses exclusively on need, moving the Fiscal Responsibility parameter to a separate transfer (see below). It also partially replaces **Population** with **Population Needs** as we defined it above.

INFRASTRUCTURE TRANSFER

A separate transfer should be established for investing in infrastructure. As outlined above, this would be a deliberately redistributive transfer that allows counties that are lacking in infrastructure to catch up with more developed counties. It would consist of the following:

- **Roads Access** measure accounts for 50 percent of the transfer.
- **Water and Electricity Access** measure accounts for 30 percent of the transfer.
- **Equal Share** for maintenance of existing infrastructure accounts for 20 percent of the transfer.

It would also be possible to consider reducing the Roads Access measure to add a measure of health infrastructure access.

CAPACITY AND EFFORT TRANSFER

We propose a small transfer targeting both capacity and effort (50 percent for each). For now, the measure of capacity we recommend is an index of the share of property rates and business license fees collected by each county prior to devolution. This measure is based on older data, therefore it will not reduce incentives for counties to collect taxes. However, we believe that this measure should eventually be replaced with an estimate of county tax potential (rather than actual collections).

Effort can be measured using a combination of **Tax Effort** (the percentage increase in per capita tax collections over time) and **Fiscal Responsibility**. Fiscal Responsibility can be measured through an index composed of at least some of the elements in the table below.

Indicator	Possible response	Score
Budget estimates available online within 3 days of tabling?	Yes No	1 0
Is the budget program based? (According to basic criteria, as required by PFM Act.)	Yes No	.5 0
Does the budget use standard chart of accounts?	Yes No	.5 0
Are quarterly reports available to public within 30 days? (As required by PFM Act.)	Last 4 Quarters Last 3 Quarters Last 2 Quarters Otherwise	1 .75 .5 0
Formation and meetings of county budget and economic forums	Formed and meeting regularly to discuss CFSP, etc. Formed but irregular meetings Not formed	1 .5 0
County funds follow PFM Act Section 116 on the rules for management of funds?	Yes (or no funds) No	1 0
Total Possible Points		**5**

ADDITIONAL TRANSFERS

We recommend a number of conditional transfers to address particular concerns in particular counties.

A LEGACY COST TRANSFER

Some counties have inherited staff and debt from the previous Local Authorities. These legacy costs must be paid for, but may not belong in any general revenue fund. It is important to consider temporary conditional grants or other arrangements for relieving pressure on counties to find resources to cover these legacy costs. This problem may eventually be relieved by the government's ongoing rationalization exercise. But until it is these costs must be catered for.

A SHARED RESOURCE TRANSFER

Shared resources and facilities tend to be located in a single county but benefit multiple counties. It is only fair that counties that benefit from shared resources also contribute to these in some way. One way of dealing with these resources is through targeted conditional grants that require counties to use funds in particular ways. These could be coupled with requirements for consultation with other counties, either through formal inter-county boards or other mechanisms. This approach could be used to manage regional hospitals, water resources, energy, and so on.

A WITHIN-COUNTY INEQUALITY TRANSFER

Inequality within the wards of different counties in Kenya is severe and devolution runs the risk of exacerbating this marginalization. We recommend devising a conditional transfer that targets the most marginalized wards within counties. For example, infrastructure grants to counties could carry a requirement that a certain percentage is set aside for use in those wards that are below the median in access to basic infrastructure (such as roads, electricity, or water). The distribution of such funds should also be based not only on county level indicators of access, but also on ward level measures that can capture marginalization within counties that may be less marginalized at county level.

CONCLUSION

Given that resources are always limited, how revenues are shared among the counties will always involve trade-offs: Should maintaining services at existing levels be prioritized? Or should investing in less-developed counties to help them to catch up be the priority?

We do not try to answer this question here. Rather our recommendations are geared toward improving the precision, transparency and equity of the revenue sharing formula.

To achieve these objectives, we recommend four important changes:

1. Construct a better picture of Population Needs.
2. Fill the gaps in Infrastructure Needs.
3. Recognize Capacity and Effort.
4. Use multiple transfers rather than a single formula.