27 November 2014

Memorandum

Analysis of CRA Proposal for Second Generation Formula Released in November 2014

Key Messages

- The Commission on Revenue Allocation (CRA) has proposed a formula that is close to the first generation while introducing small but substantive adjustments.

- **A New Development Parameter**. The most significant decision taken by CRA is the introduction of a development parameter, partially substituting for the poverty parameter. The development parameter more directly measures access to services, including measures related to education, health, sanitation, electricity, water, and roads.

- We applaud the CRA for introducing some of these direct measures of service access, but note that: 1) the weight attached to this measure is too small, 2) the parameter does not focus on the main drivers of costs in these sectors, and 3) it is not properly constructed to reward the most marginalized counties.

- We are concerned that the CRA continues to refuse to consider conditional grants, even though there are existing grants — such as the Equalisation Fund and the free maternity grant — that serve similar purposes to what the development parameter is meant to do and that require careful consideration to avoid duplication and ensure effective use of funds.

- **Fiscal Responsibility Parameter.** The decision to reduce the weight attached to fiscal responsibility from two to one percent is a surprise, for which inadequate justification is provided.

- We do not agree with CRA's approach to measuring fiscal responsibility, which gives all counties an equal share on the one hand, and appears to reward counties with higher fiscal capacity on the other hand.

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- Fiscal responsibility should focus not on county fiscal capacity, but on rewarding county fiscal effort, which should be measured through increases in revenue collection over time.

- **Fiscal Capacity.** If fiscal capacity is considered in the formula separately from fiscal responsibility, then counties with higher fiscal capacity (higher capacity to raise own revenues) should receive less, not more from the national transfer.

- **Basic Equal Share.** Counties already receive a basic equal share for administrative costs, which should include setup of PFM systems, and there is no need for an additional equal share.

- The weight attached to the basic equal share continues to be too large, as we do not believe that a quarter of county budgets should go to basic administrative costs that are equal across counties (most costs vary from county to county according to needs, etc.)

- **Population Parameter.** While we agree with the CRA that population is a critical weight in a formula, we believe it should gradually be replaced with a more direct measure of population needs, as we proposed in our submission.

- Population needs would focus on trying to measure the actual need/demand for health, agriculture, ECD services, and so on, and is consistent with the attempts to introduce direct measures through the development parameter to gradually replace poverty.

- **Personal Emoluments Parameter.** We agree with the decision by the CRA to introduce a mechanism to cushion counties with high inherited staff costs. However, we would prefer to see this support provided through a conditional grant so that eligibility requirements can be tightened to ensure it does not become an entitlement to a bloated payroll.

- **Other Conditional Grants.** Finally, the CRA has not considered other important areas for conditional grants, such as debt relief to counties that inherited high debts, or a grant to deal with inequalities within counties, which are more severe than those across the counties.

Detailed Analysis and Recommendations

1. **The Commission on Revenue Allocation has managed to maintain a formula that is close to the first generation while introducing small but substantive adjustments.** The main adjustments are:

    - A reduction in poverty from 20 to 18 percent.

- The introduction of a “development” parameter to take up 1 percent of the two points liberated from this reduction in poverty.
- A reduction in fiscal responsibility (FR) from 2 to 1 percent.
- The introduction of a “personal emoluments” parameter to take the other one percent liberated from poverty and the one percentage point liberated by reducing FR.

2. **As we look at the adjustments, we should also look at what did not change. The following things did not change.**

    - Population remains at 45 percent.
    - Basic equal share remains at 25 percent.
    - Land area remains at 8 percent.
    - There is only a single formula for a single transfer, with no consideration of conditional grants (including the Equalisation Fund) or other approaches to channeling funds.
    - There is no attempt to resolve outstanding debts inherited by some counties.
    - There is no attempt to deal with inequalities within counties.

IBP Kenya had previously recommended changes to all of these in our submission to the CRA, which is available on our website, and which has been shared with the Chairs of the Senate Committees on Finance and Devolution. See http://internationalbudget.org/revenue-sharing-formula/.

This memo proceeds to analyze in further detail the proposed changes, review what has remained the same, and make suggestions for improvement.

Development Parameter

3. **Perhaps the most significant decision taken by CRA in this proposal is the introduction of a development parameter that more directly measures access to services.** By reducing the weight attached to poverty and replacing it with more direct service measures, CRA has partially followed our advice that the formula is more legitimate when it measures service needs more directly. Poverty is a general measure that does not relate to any specific county function or service. The development parameter measures service access more directly.

4. **According to the CRA report, the development parameter has a number of components, including measures related to education, health, sanitation, electricity, water, and roads.** Under education, there is a measure of illiteracy and of children 3-5 years old not attending pre-primary. Under health, there is a measure of access to immunization and the share of babies born at home. The other measures are single measures of household access to sanitation, electricity, and water. For roads, it is a bit more complex, using two different approaches. One is the share of unpaved roads in the county as a share of national unpaved roads. The other looks at the county’s total share of all type of roads per square kilometer of

county land area. Both of these measures properly focus on county roads only (Class D and below). They also measure two different issues in the sector: the degree to which there are roads given a certain geographical area, and the degree to which a county's roads are paved or unpaved. Overall, the focus of the development parameter is reasonably consistent with county functions and national priorities.

5. **The development parameter, as it is explained on page 30 of the CRA report, has a number of problems, starting with the way the variables are entered into the formula.** First, the parameter appears to be intended to reward marginalized counties. That is also why it is replacing the poverty measure. In our language, it serves a redistributive role of ensuring that counties that need more (in the sense that they have been marginalized from enjoying services) should get more. That is fine, but the math of the formula is not consistent with this. Let us start with an example that is consistent. The education variable consists of illiteracy and children out of school. The way the variable is constructed, a county with high illiteracy and high numbers of children out of school will get more from the formula. That is consistent with rewarding marginalized counties (although there is an error in the formula, where SE, which stands for children out of school, is dropped in favor of an undefined parameter called PE). However, if we look at other variables, such as immunization, there is a problem. Here it appears that a county with a higher rate of immunization will get more funds, which is actually not benefiting marginalized counties, but is more consistent with a service delivery rationale. If that is the intention, it should not be part of the development parameter. Otherwise, it should be inverted so that counties with lower immunization rates receive more. Since this variable is combined in a single factor with sanitation and home deliveries, both of which are measured to favor those with LESS access, we assume this is an error. The same error is there for electricity: those counties with greater access to electricity will get more from the formula.

6. **Another problem with the development parameter is that the variables chosen are not the most relevant when thinking about funding decisions, for a couple of reasons.** First, in the case of illiteracy, this is probably most related to primary school attendance, which is not a county function. It may relate to ECD, but there is already an ECD measure in the formula and it isn't clear what this measure adds. One would need further detail than the report provides to justify including two measures for ECD. Second, for health, the focus on immunization and home deliveries is important, but represents a very small share of spending in the health sector. The question is whether it would not be more appropriate to look at issues such as lack of health infrastructure or lack of health personnel more broadly rather than to focus on these niche issues. The Commission has questioned whether data is available for this purpose, but payroll data on staff should be available, and the Health Management Information System has data on facilities and facility visits.

7. **The final problem with the development measure is its small size.** We would prefer to see the formula introduce these measures more aggressively, reducing poverty to 10-12 percent and replacing it with a larger weight for this parameter

(with some changes to the parameter). It is currently too small to have a major impact. It is also not entirely transparent because, given the large number of variables and small total weight, it is very hard to know which variables within it are actually driving a county's score on the parameter. No real explanation is provided for the data sources used. No reasons are provided for why certain weights were chosen for certain variables, such as why health was weighted at 50 percent but infrastructure at 25 percent.

8. **It is also an open question whether or not this development parameter should be in the formula at all, or should be the core of a second transfer focused on marginalization, or "catch-up."** We had proposed that we restrict the main formula to service delivery objectives and separate out the redistributive transfer. This is more transparent: the first transfer tries to give counties an amount per capita that allows them to provide services at a reasonably similar level. The second transfer recognizes that some counties lack infrastructure or minimum service levels and need more to catch-up.

9. **Our approach of separating these two objectives is actually more consistent with the constitution, which envisions a separate "Equalisation Fund" specifically for catch-up purposes.** Given that this is fashioned as a conditional grant, it is worth considering something similar for the second transfer.

10. **In a sense, what is needed is a more robust Equalisation Fund that can tackle infrastructure deficits in water, electricity, roads and health (as required by the constitution).** The size of the EF is too small to do this, but it can be complemented, and this is something the Senate should consider, rather than the use of a small development parameter within a single formula for the equitable share.

11. **The Commission's approach, exemplified by the development parameter, continues to keep our heads in the sand when it comes to the role of conditional grants.** This is particularly obvious in the case of the home delivery variable. Given that the national government has a conditional grant to promote in-facility deliveries, in what ways does this parameter not simply duplicate what is being done to incentivize facility births? While both are intended to reduce home deliveries, CRA's approach actually rewards counties with more home deliveries, while the conditional grant rewards counties that have more in-facility births. The Senate should be asking if these two policy tools, which have similar ends but contradictory means, make sense when considered together. We can only ask such questions if we do not consider the formula in isolation from conditional grants.

12. **Our view is that we should look at the underlying causes of development challenges, such as low proportion of in-facility births**. If this is due to lack of infrastructure, let us measure and resolve that with the development parameter. If it is due to lack of staff, let us measure that and resolve it. Focusing on home

deliveries *per se* is not the best approach and we should leave this to the conditional grant for free maternity.

Fiscal Responsibility

13. **The decision to reduce the weight attached to fiscal responsibility is a surprise**. In our view, this factor should remain small, but we would not advocate a reduction. In our visits around the country, most Kenyans think this parameter is critical and would want to see it increased. In our view, it must remain small because it does not directly measure anything associated with service delivery, and the main formula should continue to focus on factors related to the costs of delivering services.

14. **Once again, we should consider whether this should be used in the formula, or form the basis for a separate conditional grant.** It may be more transparent to have it as a separate grant, which is focused on county efforts to raise and use funds well.

15. **We do not support CRA's approach to measuring fiscal responsibility.** CRA's proposal is to split this measure in half. The first half is to be given to all counties equally to set up financial management systems. It is assumed from this that the cost of setting up such systems (e.g., IFMIS) is the same across counties. To the extent that is true, this should be covered by the basic equal share parameter, and not by fiscal responsibility. We return to the basic equal share below, but it is essentially intended to compensate counties for costs which are equal across the counties, such as the salaries of governors, and basic administration that is needed in counties of all sizes. That is the appropriate place for the financial management system startup costs to be. In our view, these are already covered by the large basic equal share transfer, so there is no need for them to be included again in fiscal responsibility, and there is also no reason to further increase the basic equal share.

16. **The second half of the parameter is more in line with the concept of fiscal responsibility, but we do not agree with the approach taken**. This half of the parameter seeks to measure the own revenues collected by a county as a share of the county's total budget. The thinking seems to be that counties that fund a higher share of their budget from local sources are more fiscally responsible and should be rewarded with a higher transfer from national government.

17. **The problem with this approach is that it confuses two ideas in revenue sharing: fiscal capacity and fiscal effort.** Normally, when thinking about how to share resources fairly, we think that those places with more fiscal capacity (meaning they can raise more of their own revenues) should get less from the transfer than those who cannot raise as much. On the other hand, we also think it is fair to reward those that make more of an effort to raise more of their own revenue than those who do not make such an effort. So in summary, we normally give more to those with low capacity, but also to those with high effort.

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18. **The challenge is to distinguish these two factors using available data.** A county that has high own revenue collection might have both high capacity and high effort, or it might only have high capacity. A rich county may not make much effort but still generate a lot. A county with low collection might have low capacity and low effort, but it might have only low capacity. A poor county may make an effort, but still generate little. We have to be careful to choose measures that allow us to discriminate between these things. One way to do so is to focus on changes in collections over time that allows us to distinguish effort from capacity to a certain degree.

19. **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.

20. **However, the approach taken by CRA seems geared to reward capacity rather than effort.** The CRA approach looks at own revenue collected in a single year as a share of budget. Since this variable is likely to be high in counties with high fiscal capacity and low in counties with low capacity, it is better thought of as a measure of capacity than effort. There is no way for a poor county that is making an effort to increase its revenues to do well on this parameter. And from the outputs, it is clear that the parameter favors wealthy counties like Nairobi, Nakuru, and Kiambu.

21. **The parameter also has a curious property introduced mathematically, which is that it weights each county's share of own revenues in budget by its population.** This seems likely to exacerbate the problem, since it rewards the higher population counties, which also happen to have larger economies and more revenue generating capacity. We are not sure why CRA opted to do this, but it may have been trying to avoid a situation where a county with a very small population and a good ratio of own revenue to budget received the same amount as a large population county with the same ratio. In effect, the idea would be that the two counties should receive the same amount on a per capita basis, rather than a total basis. While that has a certain logic, it still tends to reward those with higher capacity, which goes against general notions of fairness. We believe that given the small size of the weight attached to this parameter, we should not worry as much about the problem of small counties being rewarded disproportionately.

22. **A better approach to measuring effort is to look at the percentage change in revenues, using either total own revenues or per capita own revenues.** This approach allows poor counties with small absolute changes in collection, but high percentage changes to benefit. For example, a county collecting 10 Ksh per person that increases this to 20 Ksh, will have only increased by 10 Ksh per person, but a 100% increase from their original base. This requires more effort than a county that increases from 1000 KSh per person to 1010 Ksh per person.

23. **In order to make use of this data, one would group counties by the percentage increase into a number of categories, say 5, and then award them points depending on their category.** For example, counties with a decrease in collections would get zero points. Counties with an increase of up to 20 percent would get 1 point; counties from 21-40 percent would get 2 points and so on. These points would then be converted into shares to calculate the county's index. If a county had 2 points out of a total of 30 points across all counties, they would receive 7 percent of the funds available.

24. **CRA has claimed that this is not possible to do this because counties have not been around long enough to have two years of comparable revenue data.** While this is indeed a challenge, it is not insurmountable. First, that problem only exists this year, but for all future years, there will be such data. Second, we already have data by quarter on revenue collections from the Controller and it is possible to compare the first quarter of 2013/14 and the first quarter of 2014/15. By the time the first division of revenue under the proposed formula has to be done, we will have at least data from Q2, and (assuming we don't actually have to do the final figures until June) for Q3 as well. It is possible to use quarter to quarter comparisons, or to use as much data is available (half year or three quarters). It is also possible to use data from local authority collections in the period immediately before devolution as a base for the first year, and then shift to county figures in the second year. We used PBO figures from 2010/11 as the base in our submission to CRA and compared those to COB half year results (available at the time), multiplied by two to project for the year. The results of that simulation are available here.

25. **This approach makes it far easier for a small, poor county to benefit from its efforts.** For example, using this approach, Turkana and Baringo would do much better than Nairobi or Nakuru because they have had a higher percentage increase in own revenue even though they bring in much less revenue than those counties. See Fiscal Effort chart available here.

26. **We proposed in our submission to CRA a different approach which is far more focused on effort than the CRA approach, but still takes into account the absolute size of what the counties bring in.** We combined all the per capita increases and discarded all decreases (if own revenues decreased, a county does not get anything from this parameter). We then summed the per capita increases and awarded counties based on their share of the increase. This is mathematically a bit unorthodox, but focuses us on what we think effort is, which is a county's ability to increase its per capita own revenues. Because the per capita increases are not calculated in percentage terms, it still tends to favor larger counties with more own revenue capacity, but not as much as the CRA approach. As can be seen in the attachment, the counties that do best under that approach are Narok, Samburu, Machakos, and Baringo.

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Personal Emoluments

27. **We agree with the decision by CRA to introduce a mechanism to cushion counties with high inherited staff costs.** This has been a factor making it difficult for certain counties, particularly larger population counties and former provincial headquarters, to meet their wage bills and still pay for other devolved services. The CRA has wisely introduced this as a temporary measure which can be eliminated once a national policy for rationalization is in place to help all counties (and national government) manage excess staff costs.

28. **Nevertheless, we would prefer to see this support provided through a conditional grant.** Giving counties money to support high staff costs is never an ideal option because it can reward behavior we actually want to prevent: a bloated payroll. When a variable like this enters the formula, it becomes a sort of entitlement, and it results in counties receiving unconditional funding that they can use to hire additional workers. If this funding was given as a conditional grant, this would make it easier to tighten eligibility or scrap the grant on short notice, it would force counties to use the money in particular ways, and it could be tied to conditions, such as preventing the payroll from increasing further, or above a certain rate, that would avoid the perverse incentives of paying for high staff costs.

Parameters That Did Not Change

29. **While we agree with CRA that population is a critical factor in revenue sharing, we had proposed a shift from population to population needs.** Our approach to this (as laid out in the attached brochure) was to replace population with a parameter that would directly measure health, agriculture, and ECD needs and use a smaller population headcount to capture other population services for which we have no data.

30. **Our health measure borrows from the South African approach and focuses on health facility visits and disease incidence.** While this is a more direct measure of need, facility visits are still highly correlated with population. For agriculture, we used share of crop-farming households in a county, and for ECD, the population under 1 as a proxy for the potential population needing ECD over time.

31. **Now that CRA has introduced related measures into its "development" parameter, the question arises as to why we should not also slowly reduce the population parameter and replace it with more direct measures of service need in the major devolved sectors, such as health and agriculture.** In our view, CRA has not provided a compelling reason for avoiding this approach.

32. **The decision to keep the basic equal share at 25 percent is also mystifying.** As we move from an approach that uses general proxies to one that is more specific, we should specify exactly what is covered by this basic equal share. If indeed it is intended to cover those administrative expenditures that are exactly equal across

counties, such as the salary for governors or the basic operational costs of running the county assembly, let those be specified and measured more carefully. In our view, if the common administrative costs of running counties amount to 25 percent of budget, we should be worried. Many things are not equal across counties. For example, all counties have assemblies, but their size is related to population and can be better proxied by that. We therefore believe that the basic equal share should drop to no more than 15% and probably less.

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