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COMMISSION ON REVENUE ALLOCATION

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RECOMMENDATION ON THE SHARING OF REVENUE RAISED NATIONALLY BETWEEN THE NATIONAL GOVERNMENT AND THE COUNTY GOVERNMENTS FOR THE FINANCIAL YEAR 2014/15

TRANSMITTAL LETTER

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COMMISSION ON REVENUE ALLOCATION

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- **Clerk of the Senate**
- **Clerk of the National Assembly**
- **Cabinet Secretary, National Treasury**
- **Clerks of the County Assemblies**
- **Excellencies Governors**

Dear Sir/Madam

**REF: RECOMMENDATION ON SHARING OF REVENUE RAISED
NATIONALLY BETWEEN THE NATIONAL AND COUNTY
GOVERNMENTS FOR THE FINANCIAL YEAR 2014/2015**

Pursuant to Article 216 (1) (a) of the Constitution, the Commission on Revenue Allocation is mandated to make recommendations concerning the basis for equitable sharing of revenue raised by the national government between the national and county governments.

Article 216 (5) requires the Commission to submit its recommendations to the Senate, National Assembly, the National Executive, County Assemblies and County Executives. Accordingly, the Commission hereby recommends that out of the shareable revenue of Shs.682 billion for the financial year 2014/2015, the National Government is allocated Shs.400 billion, the county governments is allocated Shs.279 billion and the balance of Shs.3.4 billion, being 0.5% of the shareable revenue is allocated to the Equalization Fund.

Yours Sincerely,

Micah Cheserem
CHAIRMAN

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EXECUTIVE SUMMARY

In accordance with Article 216 (1) (a) of the Constitution of Kenya 2010, the Commission on Revenue Allocation hereby submits its recommendation concerning the basis for equitable sharing of revenue raised by the national government between the national and county governments for the financial year 2014/2015.

Based on the analysis of historical allocations and the additional costs of new county structures, the total cost for running all the 47 counties in 2014/15 is Kshs.279,162 million, or 40 per cent of the total shareable revenue for the fiscal year 2011/12 audited and approved accounts.

Table ES1: Vertical Share for National and County Governments for Financial Year 2014/15 in Kshs. Millions

Budget Item	Kshs. Million	Percentage
Exchequer Accounts for 2011/12	913,342	
Less Non-Shareable Revenue*	231,201	
Shareable Revenue 2011/12	682,141	100
Share to National Government	399,568	58.58
Share to County Governments	279,162	40.92
Equalisation Fund	3,411	0.50

* This amount constitutes largely Grants and Loans and is therefore set aside for the national government

The allocation to the county governments as a percentage of shareable revenue for the various financial years is as follows:

Table ES2: Vertical Share for County Governments based on Various Financial Year in Kshs. Millions

Fiscal Year	2011/12 Actual	2012/13 Actual	2013/14 Estimate	2014/15 Estimate
Total Shareable Revenue	682,141	776,856	863,000	998,400
Allocation to Counties (2014/15)	279,162	279,162	279,162	279,162
Percentage Allocation to Counties	41%	36%	32%	28%

1.0. INTRODUCTION

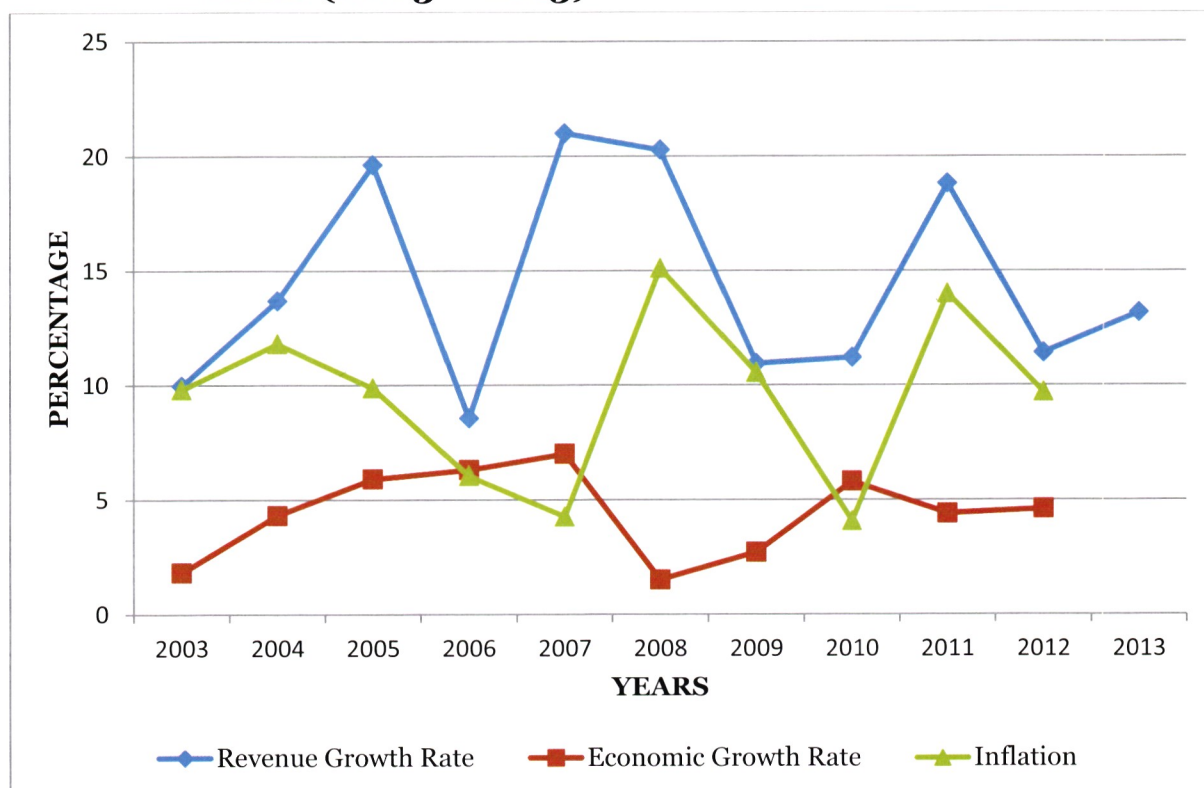
- 1.1 The Constitution of Kenya 2010 provides for a devolved system of government in which, the sovereign power of the people is exercised at the national and county levels. The Constitution requires that revenue raised by the national government is shared equitably between the national government and the county governments.
- 1.2 The Kenyan fiscal decentralisation structure is such that counties are funded from nationally raised revenues through not less than fifteen per cent equitable share, conditional and unconditional grants under Article 202 of the Constitution, and from their own internal revenue sources.
- 1.3 This report provides a recommendation on the vertical sharing of revenue for the financial year 2014/2015. This is the third report on vertical revenue sharing and as such, the report has benefited from reviews of previous recommendations by various stakeholders.
- 1.4 In formulating this recommendation, the Commission has taken into account: the universal fiscal decentralisation principles; the criteria for revenue sharing as set out in the Constitution under Article 203; and the assignment of devolved functions as per Legal Notice Number 16 of 2013 and Gazette Supplement No. 116 of August 2013.

2.0 OVERVIEW OF RECENT ECONOMIC PERFORMANCE

- 2.1. The economy is on a recovery path, registering a growth of 4.6 per cent in 2012, and is projected to grow at a rate of 5.6 per cent in 2013. This growth is way below the Vision 2030 target of 10 per cent required to ensure Kenyans enjoy a high standard of living.
- 2.2. Pursuant to tight fiscal and monetary policies put in place in 2012 by the government, inflation rate has declined from a high of 19.7 per cent recorded in November 2011 to below 10 per cent in recent months. Short term interest rates have also eased in line with the drop in inflation, while the shilling exchange rate has stabilized against all major world currencies.
- 2.3. As a result of slow recovery of the economy, the country's public debt has steadily increased to a high of Sh1,894 billion as of June 30, 2013, comprising of 44.5 per cent external and 55.5 per cent domestic. This is equivalent to 55.1% of Kenya's Gross Domestic Product for 2012. A huge public debt has a consequential effect of sinking the country into higher debt as the country raise its borrowing, especially from the domestic market, to cover for the increased repayment of debt. Besides, this could erode Kenya's sovereign rating in addition to crowding out the private sector. To maintain the debt within a sustainable level, there is need to urgently establish the Grants and Loans Council.
- 2.5. Total revenue yield has been rising over the years. However, due to the slow recovery of the economy, revenue growth has mostly fallen short of projected targets, though substantially higher than the economic growth rate. As a proportion of the Gross Domestic Product, total revenue was 24.7 per cent in 2010/11, 23.5 per cent

in 2011/12, and 23.7 per cent in 2012/2013. This percentage is projected to be 25.5 per cent in 2013/2014. Figure 2.1 is a graphical presentation of the volatility of economic growth, revenue growth and inflation rate over a ten year period.

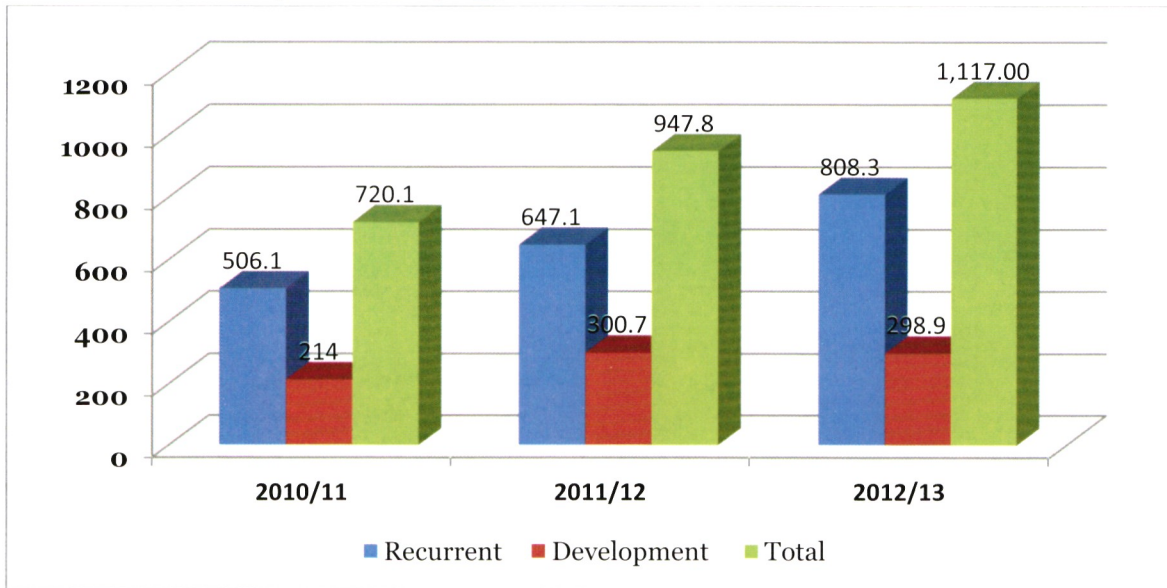
Figure: 2.1: Gross Domestic Product, Revenue and Inflation Rates (2003 – 2013)



2.6. Total government spending has not been in tandem with the slow recovery of the economy. It has continued to increase over the years in both recurrent and development expenditures. Nonetheless, recurrent expenditures have been rising much faster than development expenditures. Trends show that budget allocations to development expenditures were 29.7 per cent in 2010/11, 31.7 per cent in 2011/12, and 26.8 per cent in 2012/2013 of the total expenditure, (Figure 2.2). The PFM Act 2012 Sec.15 (2) (a) requires that in the medium term, a minimum of thirty per cent

of national and county governments budget be allocated to development expenditure.

Figure 2.2: Recurrent and Development Expenditure in Kshs. Billions (2010/11-2012/13)



2.7. Overall, total running costs of the public sector, especially recurrent, are bound to increase even more with the operationalization of the county governments. This is because of the creation of new structures, namely: the county assembly and the county executive. Fiscal discipline calls for the restructuring of both governments to ensure macroeconomic stability. Resources should strictly follow functions by ensuring that as county governments expand, the national government should contract in the medium term.

3.0. LEGAL FRAMEWORK FOR REVENUE SHARING

- 3.1. The Constitution of Kenya 2010 provides for a devolved system of government in which the sovereign power of the people is exercised at the national and county levels. Article 202 (1) of the Constitution requires that the national and county governments share revenues raised national equitably.
- 3.2. Article 203(2) requires that for every financial year, the equitable share of revenue raised nationally that is allocated to county governments be at least fifteen per cent of all revenue collected by the national government.
- 3.3. Article 202 (2) provides that county governments may be given additional funding from the national government share through either conditional or unconditional grants.
- 3.4. Section 15 (2) (a) and Section 107 (2) (b) of the PFM Act, 2012 requires that over the medium term, a minimum of 30 per cent of the national and the county government budgets be allocated to the development expenditures.
- 3.5. The Commission, under Article 216 (1) (a) of the Constitution is mandated to make recommendations concerning the basis for equitable sharing of revenue raised by the National Government between the national and county governments based on a criteria set out in Article 203 (1).
- 3.6 Article 219 provides that a county share of revenue be transferred to the county without undue delay and without deduction.

4.0. FUNCTIONAL ASSIGNMENT FOR NATIONAL AND COUNTY GOVERNMENTS

- 4.1. The Constitution establishes two levels of government that are distinct and interdependent to each other. Schedule 4 of the Constitution assigns functions and powers of the national and the county governments.
- 4.2 Article 186 (2) provides that a function that is conferred on both levels of government is a concurrent function whereas, Article 186 (3) provides that where a function is not assigned by the Constitution or legislation to a county it is deemed to be a function of the national government.
- 4.3 The Transition Authority is mandated under Section 7 of the Transition to Devolved Government Act, 2013 to facilitate and coordinate the transfer of functions to county governments pursuant to section 15 of the Sixth Schedule to the Constitution. Functional assignment is based on Article 174 of the Constitution on the objects of devolution of government. These include:
- a) To recognize the right of communities to manage their own affairs and to further their development;
 - b) To protect and promote the interest and rights of minorities and marginalised communities;
 - c) To promote social and economic development and the provision of proximate, easily accessible services;
 - d) To ensure equitable sharing of national and local resources throughout the country; and
 - e) To facilitate the decentralization of the state organs, their

functions and services, from the capital of Kenya.

- 4.4. In line with the objects of devolution, Schedule 4 of the Constitution assigns policy-related functions to the national government and service-related functions to county governments.
- 4.5. In February 2013, the Transition Authority transferred the first batch of functions from the national government to county governments through Legal Notice No. 16. The Transition Authority has subsequently transferred additional functions to county governments as of August 2013 under Special Gazette Supplement No. 116. The outstanding functions will be transferred to county governments in line with Article 262 (15) of the Constitution.

5.0. METHODOLOGY FOR REVENUE SHARING

5.1 In developing the recommendation, the Commission adopted a combination of approaches to ensure that the resultant recommendation is credible and, achieves equity, fairness and transparency. The Commission identified four practical approaches that are generally available to determine the pool of funds to allocate to each level of government. These are discussed below.

5.1.1. **Zero-based costing** of functions assigned to county governments involves activity analysis and the costing of activities as if programs were being proposed for the first time. This approach has the conceptual advantage of ensuring efficient use of limited resources by allocating them according to the relative importance of programs to achieve designated objectives most successfully. However, this is a costly and time-consuming process that requires unbundling of functions and development of unit costs and standards as prerequisites. The current services delivery system in the country is neither fully unit cost nor standard based and, therefore, this approach cannot be used in the short term.

5.1.2. The **need-resources gap** approach involves financing the expenditure gap between the amounts a county can raise from own revenue sources if it exerts ‘normal’ revenue effort, and the amount it must spend to provide a minimum acceptable level of services. While this approach can be easily conceptualized, measuring needs

can be highly subjective. In addition, the cost of providing the minimum levels of service is also highly subjective and, therefore, difficult to measure in the absence of minimum standards.

5.1.3. **Historical allocations approach** involves determination of costs of assigned functions based on historical allocations. Budgeted allocations by entities that used to perform the devolved functions are extracted from their budgets and the amounts used as a basis for determining the vertical share. This approach takes advantage of readily available data on past allocations to devolved functions and is easily understood. However, it propagates the status quo, ignores costs of new structures introduced by county governments and is not based on county specific needs and priorities.

5.1.4. **Aggregation of county budgets** approach involves analysis of county budgets for financial year, 2013/2014 and budget projections for financial year 2014/15. Aggregated amounts constitute the estimated cost of all the county governments and form the basis for vertical revenue share. This approach is easy to understand and benefits from readily available data on county budgets. It assumes that the various county governments are fully aware of their respective priorities and financial needs. In practice, the lack of underpinning county integrated plans, and uniformity in the preparation of the 2013/2014 county budgets and

questions about accuracy and completeness of the budgets pose a challenge in the use of this approach.

5.2. From the foregoing analysis of possible approaches on determination of vertical share, for financial year 2014/15, the Commission elected to use the historical allocations to devolved functions as the primary approach. This is supplemented by the 2013/2014 county government budgets on costs relating to the running of the new county structures. To correct for historical inequalities in resource allocation, the Commission will pool resource together and use an objective formula to re-distribute the resource among the forty seven counties.

6.0. THE COST OF DEVOLVED FUNCTIONS

- 6.1. The Commission adopted the historical expenditure approach in order to arrive at the amount required to meet the cost of devolved functions for financial year 2014/15. This exercise involved detailed analysis of ministry budgets for the financial years 2012/13 to 2014/15. In order to ensure sufficient funds are allocated for devolved functions, the cost of new devolution structures was computed and included in the total budgetary allocation.
- 6.2. The Commission is of the view that cost savings from rationalisation of national government structures and the increase in shareable revenues by 12 per cent (from Kshs.610 Billion in 20012/13 to Kshs.682 Billion in 2013/14) will be sufficient to cover the cost increase associated with the functions assigned to county governments.
- 6.3. The Commission's computation of the cost of devolved functions based on the budget estimates for financial year 2014/15 is Kshs.230.9 billion. This is summarised in Table 6.1.

Table 6.1: Cost of Devolved Functions based on 2014/15 Budget Estimates between National and County Governments in Kshs. Millions

Ministry	Total Budget	Allocation to national	%	Allocation to Counties	%
1. Health	92,495	20,700	22	71,796	78
2. Devolution and Planning	99,103	34,780	35	64,323	65
3. Agriculture Livestock & Fisheries	32,930	11,730	36	21,201	64
4. Lands , Housing & Urban Development	32,918	15,697	48	17,221	52
5. Sports, Culture & the Arts	15,945	8,042	50	7,903	50
6. Industrialization and Enterprise Development	7,024	4,902	70	2,121	30
7. Transport and Infrastructure	138,830	108,487	78	30,342	22
8. EAC Affairs, Commerce and Tourism	7,964	6,285	79	1,679	21
9. Information, Communication & Technology	8,628	6,883	80	1,745	20
10. Labour Soc. Securities & Serv.	2,944	2,403	82	541	18
11. Environment, Water & Nat. Resources	67,449	58,279	86	9,170	14
12. Education, Science & Technology	126,989	124,806	98	2,183	2
13. Energy and Petroleum	58,529	58,114	99	415	1
14. Interior & Co-ordination	100,967	100,722	100	245	0
TOTAL	792,714	561,831	71	230,884	29

Source: Budget Estimate for Financial Year 2012/13

6.4. The Constitution provides for establishment of the County Assembly and the County Executive. The cost for the running of the new county structures based on Gazette Notice No. 2885 of March 2013 is Kshs.48,269 million as shown in Table 6.2.

Table 6.2: Remuneration and Administrative Costs for the County Assembly and Executive in Kshs. Millions

Budget Item	Cost
Remuneration for New County Staff	38,143
Administrative Cost of New County Structures	10,126
Total Allocation to Counties	48,269

Source: Gazette Notice No. 2885, March 2013

7.0. SHAREABLE REVENUE

7.1. The revenue to be shared between the national government and county governments is defined in the Constitution and Section 2 of the Commission on Revenue Allocation Act, 2011 as follows:

“all taxes imposed by the national government under Article 209 of the Constitution and any other revenue (including investment income) that may be authorised by an Act of Parliament, but excludes revenues referred to under Articles 209 (4) and 206 (1) (a) (b) of the Constitution.”

7.2. The basic principles that guided the Commission in developing the vertical revenue share recommendation are those stipulated in Article 201 of the Constitution, namely:

- a) Openness and accountability;
- b) Promotion of an equitable society;
- c) Sharing of burdens and benefits resulting from the use of resources and public borrowing equitably between present and future generations;
- d) Prudent use of public money; and
- e) Responsible and clear financial management.

7.3. In addition, the Commission took account of the following fiscal decentralization principles and experiences, including:

- a) Aiming to keep the vertical share predictable;
- b) Following the principle of “funds follow functions.”

7.4. The Commission has also taken into account the provisions of Article 203 (1) of the Constitution regarding the criteria to be taken

into account in determining the equitable sharing of revenue as detailed below.

- a) The fourth schedule assigns functions and powers of national interest such as foreign affairs, immigration, defence, Judiciary, monetary policy, national elections, as well as other services rendered by independent commission exclusively to the national government. Resource meant to provide these functions have been left with the national government;
- b) Provision in respect of the public debt and other national obligations have been made by delimiting non-shareable revenue amounting to Kshs.231,201 million for financial year 2011/12 to the national government;
- c) The national government performs other functions such as policy and planning, public investment, disaster management, infrastructure development and provision of education either exclusively or concurrently with county governments. These functions have been adequately provided for both governments. The national government has been allocated an equivalent of 59 per cent of the shareable revenue for the financial year 2011/12;
- d) The need to ensure county governments are able to perform the functions assigned to them by ensuring that resources associated with the delivery of services are transferred in line with the principle of *'funds follow functions'*. Table 6.1 estimates the cost of the devolved functions at Kshs.230,884 million. This comprises resources for both recurrent and development expenditures. In addition, resources amounting to Kshs.48,269 million have been allocated for the running of the County Assembly and Executive structures;

- e) The county governments have been in office for less than one year. Therefore, the process of restructuring the hitherto local government structures is on-going. In this regard, it is impractical to assess the county governments' fiscal capacity and efficiency. To support the county governments put in place the requisite structures to maximize revenue collection and utilization, adequate financing has been provided in their vertical share for financial year 2014/15;
- f) Development and other needs of counties also been adequately provided for through allocation of both development and recurrent budgets for the devolved functions;
- g) Economic disparities within and among counties and the need to remedy them have been addressed by pooling resources together. These resource will be redistributed using an objective criteria to various counties;
- h) The need for economic optimization of each county and to provide incentives for each county to optimize its capacity to raise revenue by allocating adequate resources to county governments to ensure that on-going projects and programs are not disrupted. With the increase in shareable revenue by 12 percent, no county will receive less than what they received for financial year 2013/14;
- i) The desirability of stable and predictable allocations of revenue by ensuring that counties will receive in financial year 2014/15 no less than what they received for financial year 2013/14;
- j) The need for flexibility in responding to emergencies and other temporary needs by ensuring that the national government remains with adequate resources to provide for the contingency

fund. County governments may also establish, from the resources allocated to them, a County Emergency Fund.

- 7.5. Article 203 (3) of the Constitution stipulates that revenue to be shared be calculated on the basis of the most recent audited accounts of revenue received, as approved by the National Assembly. The most recent audited and approved accounts are for the fiscal year 2011/2012. These are presented in Table 7.1.
- 7.6. The line items in the Statement of Exchequer Account have been segregated into “shareable” and “non-shareable” revenue. Out of the total Exchequer receipts of Kshs.913,342 million for 2011/2012, the shareable revenue is Kshs.682,141 million, which is 74.6 per cent of total revenue. Most of non-shareable receipts comprise of government borrowings and foreign grants.

Table 7.1: Exchequer Account for the Years 2010/11 and 2011/12- Sharable and Non-shareable Revenue

	PARTICULARS	FY 2011/12	FY 2012/13
		(Audited & Approved)	(Being Audited)
		Kshs. Millions	Kshs. Millions
1	Opening Balance	64	1,159
2	Income Tax from Individuals (P.A.Y.E)	166,036	199,790
3	Income Tax from Corporations	146,427	173,296
4	Withholding Tax	-	-
5	Immovable Property	-	-
6	Second Hand Motor Vehicle Purchase Tax	-	-
7	V.A.T. on Domestic Goods & Services	81,496	92,772
8	V.A.T. on Imported Goods & Services	94,891	92,144
9	Excise Taxes	78,884	85,660
10	Licenses under Traffic Act	2,277	2,431
11	Royalties	-	-
12	Customs Duties	51,712	57,650
13	Other Taxes from International Trade & Transactions	24,762	24,163
14	Stamp Duty	7,857	8,538
15	Interest Received	1,236	1,356
16	Profit & Dividends from CBK	-	1,500
17	Other Profits and Dividends	14,132	13,764
18	Rent of Land	1,627	1,789
19	Fees under Traffic Act	-	-
20	Motor Driver's Licenses	-	-

	PARTICULARS	FY 2011/12	FY 2012/13
		(Audited & Approved)	(Being Audited)
		Kshs. Millions	Kshs. Millions
21	Land Adjudication and Case Fee	-	-
22	Sale of Freehold Interest in Agricultural Land	-	-
23	Fines, Penalties & Forfeitures & Other Charges	1,079	1,465
24	Miscellaneous Revenue ¹	9,662	19,379
	SUB TOTAL-SHAREABLE REVENUE	682,141	776,856
25	Recurrent Recovery Over Issues 2008/09 & 2009/10	5,185	-
26	Development Recovery Over Issues 2008/09 & 2009/10	11,312	-
27	Grants from Foreign Govt. through Exchequer	7,765	11,014
28	Contribution from Govt. Emp. To S.&W.S within Govt.	46	-
29	Loans from Foreign Govt. through Exchequer	19,343	23,569
30	Loans to Non-financial Public Enterprises	1,584	2,035
31	Loans to Financial Institutions	26	66
32	Domestic lending-T/Bills	-	99,400
33	Domestic lending-T/Bonds	134,682	232,430
34	Civic Contingencies Fund Recoveries	-	-
35	Appropriations in AID	-	-
36	Commercial Loans	51,258	-
37	Net Domestic Borrowing(CBK)	-	-
	SUB TOTAL -NON SHAREABLE	231,201	368,514
	GRAND TOTAL	913,342	1,145,370

Source: Exchequer Accounts

¹ Includes miscellaneous and sundry revenue, immigration visas and other consular fees, work permit fees, passport fees, fishing rights, betting control, registration services, and other revenues.

- 7.7. The vertical share is bound below by Article 203 (2) of the Constitution which provides that not less than fifteen per cent of all revenue raised nationally be allocated to the county governments.
- 7.8. Based on the results of our analysis of historical allocations and the additional costs of new county structures, the total cost for running all the 47 counties in 2014/15 is estimated to be approximately Kshs.279,162 million, or 41 per cent of the total shareable revenue for the fiscal year 2011/12 audited and approved accounts.

Table 7.2: Vertical share for National and County Governments for Financial Year 2014/15 in Kshs. Millions

Budget Item	Kshs. Million	Percentage
Exchequer Accounts for 2011/12	913,342	
Less Non-Shareable Revenue*	231,201	
Shareable Revenue 2011/12	682,141	100
Share to National Government	399,568	58.58
Share to County Governments	279,162	40.92
Equalisation Fund	3,411	0.50

* This amount constitutes largely Grants and Loans and is therefore set aside for the national government

- 7.9. It is important to note that due to the delay in the auditing and approval of the exchequer accounts, the Commission is required by the Constitution to make recommendations based on the latest available audited and approved exchequer accounts. These are for financial year 2011/12. At the time of preparing this recommendation in November 2013, the Exchequer accounts for the financial year 2012/13 were being audited. Article 229 (4)

requires that auditing be completed within six months after the end of each financial year. Use of these outer years to allocate resources to county governments substantially changes the percentage as shown in Table 7.3.

Table 7.3: Vertical Share for County Governments based on Various Financial Year in Kshs. Millions

Fiscal Year	2011/12 Actual	2012/13 Actual	2013/14 Estimate	2014/15 Estimate
Total Shareable Revenue	682,141	776,856	863,000	998,400
Revenue Allocation to Counties	279,162	279,162	279,162	279,162
Percentage Allocation to Counties	41%	36%	32%	28%

7.10. Article 204 (1) provides that one half per cent of revenue collected by the national government each year calculated on the basis of the most recent audited accounts of revenue received, as approved by the National Assembly be paid to the Equalization Fund. Based on the 2011/12 Exchequer accounts, the Commission recommends Kshs.3,411 million be allocated to the Equalization Fund.

7.11. The comparable cost of running 47 county governments for financial year 2013/14 was Kshs.190 billion, amounting to 31 per cent of shareable revenue for financial year 2010/11. This allocation has proved to be inadequate to provide the requisite infrastructure needed by the county governments for effective service delivery. In line with Article 203 (1) (d) and following the transfer of more functions to the county governments (Gazette Notice 116 of August 2013), more resources need to be allocated to county governments to ensure county governments are able to perform the functions allocated to them.

RECOMMENDATION

8.1 The Commission, under Article 216 (1) (a) of the Constitution is mandated to make recommendations concerning the basis for equitable sharing of revenue raised by the National Government between the national and county governments.

8.2 As required under Article 216(5), the Commission hereby submits its recommendation that the division of revenue raised nationally as per the audited and approved accounts for financial year 2011/12 be shared out for the financial year 2014/15 between the national and county governments as follows:

Table 8.1: Vertical Share for National and County Governments for Financial Year 2014/15 in Kshs. Millions

Item	Kshs. Million	Percentage
Share to National Government	399,568	58.58
Share to County Governments	279,162	40.92
Equalisation Fund	3,411	0.50
Total Shareable Revenue	682,141	100

