Paper Laid on
11th February, 2015
by Sen. Billow
Kerrow

REPUBLIC OF KENYA

PARLIAMENT

THE SENATE

REPORT OF THE SENATE STANDING COMMITTEE ON FINANCE, COMMERCE & BUDGET ON THE CONSIDERATION OF THE SECOND GENERATION CRITERIA FOR RESOURCE ALLOCATION, 2015/16, 2016/17 AND 2017/18

Approved
11/2/15

Hon. Speaker
You may approve
for tabling.
11/02/15

CLERK'S CHAMBERS
THE SENATE
PARLIAMENT OF KENYA
NAIROBI

FEBRUARY, 2015

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1.0 PREFACE

Mr. Speaker,

The Standing Committee on Finance, Commerce and Budget is established pursuant to Standing Order No. 208 and is mandated, *to investigate, inquire into and report on all matters relating to coordination, control and monitoring of the county budgets and to:*

i. Discuss and review the estimates of County governments and make recommendations to the Senate;
ii. Examine the Budget Policy Statement presented to the Senate;
iii. Examine and report on the Budget allocated to constitutional commissions and independent offices;
iv. Examine bills related to the Counties;
v. Examine the Budget, including the Division of Revenue Bill; and
vi. Examine and consider all matters related to resolutions and Bills for appropriations, share of national revenue amongst the counties and all matters concerning the National Budget, including public finance, monetary policies and public debt, trading activities and commerce, tourism, investment and divestitures policies, planning and development policy.

Mr. Speaker, Sir

The Committee on Finance, Commerce and Budget was constituted by the House on Thursday 13th March 2014 during the Second Session of the Eleventh (11th) Parliament and comprises of the following members:

1. The Hon. Sen. Billow Kerrow, MP -Chairperson
2. The Hon. Sen. Peter Ole Mositet, MP.-Vice-Chairperson
3. The Hon. Sen. G.G Kariuki, MP
4. The Hon. Sen. Moses Wetang'ula, EGH, MP.
5. The Hon. Sen. Beatrice Elachi, MP.
6. The Hon. Sen. MutahiKagwe, EGH, MP.
7. The Hon. Sen. BoniKhalwale, MP.
8. The Hon. Sen. (Prof.) Peter Anyang' Nyong'o, EGH, MP.
9. The Hon. Sen. (Dr.) Zipporah Kittony, MP.
10. The Hon. Sen. James Mungai, MP.
11. The Hon. Sen. Catherine MukiteNabwala, MP.
12. The Hon. Sen. Mutula Kilonzo Junior, MP.
13. The Hon. Sen. (Prof.) John Lonyangapuo, MP.
14. The Hon. Sen. Paul Njoroge Ben, MP.
15. The Hon. Sen. (Dr.) Wilfred Machage, MGH, MP.

Mr. Speaker, Sir,

Pursuant to the provisions of Article 118 of the Constitution and Standing Order 130 (4), the Committee received and considered representations from the Commission on Revenue Allocation, the general public and other stakeholders on Second Generation Revenue Sharing formula between the National and County Governments. During the public hearing, members of the public and stakeholder such as International Budget Partnership made presentations through oral and written memoranda (**see list of participants**).

Mr. Speaker

In accordance with Article 216(5), the CRA submitted to the Senate the recommended basis for sharing revenue among county governments for the three financial years commencing 2015/2016. Subsequently recommendations were tabled in the House and committed to the Standing Committee on Finance, Commerce and Budget for consideration pursuant to Standing Order 130.

RECOMMENDATIONS

Mr. Speaker

From the deliberations and consideration of recommendations by the Commission on Revenue Allocation and representations from the other members of the public, the Committee recommends that the House approves the following Parameters and the Formula.

	Parameter	**(Current Weights First Revenue Sharing Formula** %	**(Recommended Weights) Second Generation Revenue Sharing Formula) %**
1	Population	45	45
2	Basic Share	25	25
3	Poverty	20	18
4	Land Area	8	8
5	Fiscal Responsibility	2	1
6	Development Factor	-	1
7	Personnel Emolument	-	2
	TOTAL	**100**	**100**

Recommended basis for sharing revenue among counties for the three financial years commencing 2015/2016

$$CA_i = 0.45PN_i+0.25ES_i+0.18PI_i+0.08LA_i+ 0.01FR_i + 0.02\ PE_i+ 0.01DF_i$$

Where:

CA_i=Revenue allocated of the i^{th} county,

PN_i is the population factor,

ES_i is equal share factor,

PI_i is poverty index,

LA_i land area factor,

FR_i Fiscal responsibility factor and,

DF_i is development Factor

ACKNOWLEDGEMENTS

The Committee wishes to sincerely thank the Offices of the Speaker and the Clerk of the Senate for the necessary support and services extended to the Committee to execute its work.

As Chairperson, I must thank Members of the Committee for their patience, sacrifice, endurance and hard work despite their other commitments and tight schedules, in their endeavor to deliberate on this Formula.

I wish to thank the staff of the Senate for their steadfast support without whose dedication, the work of the Committee would not have been facilitated and completed.

Mr. Speaker, Sir,

On behalf of the Committee, I now have the honour and pleasure to present the Report and Recommendations to the House.

Thank You,

Signed ....

CHAIRPERSON

(SEN. BILLOW KERROW)

Date: 11th February 2015

2.0 BACKGROUND ON THE REVENUE SHARING FORMULA

Mr. Speaker, Sir

The Constitution of Kenya 2010 establishes that Counties will receive an allocation from total revenues raised for the execution of their functions necessitated the development of a formula for revenue sharing between National and County Governments as well as among county governments;

Article 203 (2) stipulates that for every financial year, the equitable share of the revenue raised nationally that is allocated to county governments shall be not less than fifteen per cent of all revenue collected by the national government;

Articles 201 to 204 stipulate that revenue raised nationally shall be shared equitably among National and County governments and expenditure shall promote the equitable development of the country, including making special provision for marginalized groups and areas;

Article 217 requires Parliament to determine the basis of revenue sharing for the county governments.

Mr. Speaker, Sir

Article 217 of the Constitution states that the Senate shall by resolution every five years determine the basis for allocating among the counties from the share of national revenue that is annually allocated to the County level of Government.

Article 203 (1) (d) to (k) provides for the criteria to be take n into account in determining the equitable shares among the national and county governments and in all national legislation concerning county government. The basis for the revenue sharing formula shall take into account the following:

i. Ability of the county governments to perform the functions allocated to them;
ii. The fiscal capacity and efficiency of county governments;
iii. The developmental and other needs of counties;
iv. The economic disparities within and among counties and the need to remedy them;
v. The need for affirmative action in respect of disadvantaged areas and groups;
vi. The need for economic optimization of each county and to provide incentives for each county to optimize its capacity to raise revenue;
vii. The desirability of stable and predictable allocations of revenue; and,
viii. The need for flexibility in responding to emergencies and other temporary needs, based on similar objective criteria.

The Constitution in its transition clauses also provides that the first and second determination of the basis of division of revenue among the counties would be made at three year intervals rather than five years.

2.1 The First Revenue Sharing Formula

Further, and in accordance with the provisions of Art.216 (10 9(a)(b) the CRA prepared the first revenue sharing formula which was approved by the National Assembly in November 2012. The formula was as presented below;

$$\mathbf{Ca_i = P_i + PV_i + A_i + BS_i + FR_i}$$

Where:

Ca=Revenue allocated to county

i=1, 2,3.........47.

$\mathbf{P_i}$ =Revenue allocated to a county on the basis of population parameter.

$\mathbf{PV_i}$ = Revenue allocated to a county on the basis of poverty index parameter.

$\mathbf{A_i}$= Revenue allocated to a county on the basis of land area.

$\mathbf{BS_i}$= Revenue allocated to a county on the basis of basic equal share parameter. This is share equally among the 47 counties.

FR_i= Revenue allocated to a given county on the basis of fiscal responsibility.This is shared equally among the 47 counties.

The formula was based on the following five (Parameters) namely;

	Parameter	Assigned Weight (%)
1	Population:	45
2	Basic equal share	25
3	Poverty	20
4	Land Area	8
5	Fiscal Responsibility	2
	Total	**100**

The initial formula sought to achieve two objectives; service delivery and redistribution of resources.

Consequently, the Commission of Revenue Allocation drafted recommendations for the basis of revenue sharing for the next three years in accordance with Article 216 (1) (b) and Schedule 6(16).

2.2 PRESENTATIONS ON THE SECOND REVENUE SHARING FORMULA BY THE COMMISSION ON REVENUE ALLOCATION

Cognizant of the role of the Senate and its Committees, the CRA invited the Sessional Committee on Devolved Government and the Standing Committee on Finance Commerce and Budget to a Consultative Forum. The workshop was held at the Enashipai Resort and Spa between Monday 27th and Tuesday 28th October, 2014. On 4th December, 2014, a breakfast meeting was held between the Committee and the CRA at the Laicco Regency Hotel in Nairobi.

During the workshop presentation were made by the Commission of Revenue Allocation (CRA) on proposal for the Second Generation Sharing Formula. It was stated that:-

a) In accordance with the legislative provisions in Articles 216(1) and 217 (1) together with the Sixth Schedule section 16, the second determination of the basis of the division of revenue among counties (known as the Second Revenue Sharing Formula) need to be in place for the sharing of revenues among counties for the financial year 2015/16; 2016/17 an 2017/18;

b) In exercise of the principle of openness and public participation in financial matters, the commission had used a participatory approach in the preparation of the new formula;
c) The CRA also held discussions with County Government stakeholders such as the county executive, County Assembly Budget and Appropriations Committee members, academia, public, civil society organizations, and trade unions in 45 of the47 counties;
d) The County Governments and other stakeholders had recommended the retention of the previous 5 parameters used in the first sharing formula but recommended a review of the weights assigned to each of the parameters;
e) They also recommended the addition of new parameters such as infrastructure, terrain, population density, urbanization, absorption capacity of counties, dependency ratio, county contribution to GDP, land productivity, fiscal gap, level of marginalization ,sector based approach, among others;
f) That the new formula had taken into account best practices and lessons from countries such as India, Ethiopia, South Africa, and Philippines, which have implemented intergovernmental transfers over a long time and;
g) the ideal formula for sharing of revenue among counties should be: simple; based on available official data; contain incentives for efficient fiscal management; minimizes inequalities among counties; and should be in line with the provisions of the Constitution of Kenya.

The CRA recommended the use of seven parameters and whose weights are stated as follows;

	Parameter	**Assigned Weight (%)**
1	Population	45
2	Poverty index	18
3	Land area	8
4	Equal Share	25
5	Fiscal Responsibility	1
6	Development Factor	1
7	Personnel Emolument	2

i. In justifying the role and impact of each of the parameters, the CRA argued that the cost of services should be based on population of a county, which translated into counties with higher population ratios getting a higher share.

ii. On the poverty index, it is argued that the assumption is that poor people will be treated equally across the country.

iii. To back the "equal share index", CRA argued that each county has fixed costs, which will be met by this fixed amount despite population, poverty, and land size.

iv. With regard to land size, the justification for using this index was that cost of service delivery would depend on the size of a county, and thus to ensure equity the land size would be considered.

v. The fiscal discipline index takes into account fiscal management in the county and the extent to which the county exploits its revenue potential. This parameter had been suspended for the 2012/13 and 2013/14 years due to lack of reliable measures of local revenue bases.

vi. The formula or the county equitable share formula was expressed mathematically and diagrammatically and Members were taken through simulations on the impact of the parameters on the revenue allocations for each of the 47 counties.

2.3 DELIBERATIONS BY THE COMMITTEE ON CRA PRESENTATIONS

From the deliberations that ensued, the Committee noted the following:

i. the Commission of Revenue Allocation incorporates issues raised and submit its final proposal to the Senate for approval in order to be used in the allocations;
ii. the Committee of Finance, Commerce and Budget and the Committee on Devolved Government conduct a benchmarking visit to the countries with best practice and experience on intergovernmental transfers in order to enrich the formula;
iii. The Senate holds more consultative meetings and collect more views from Kenyans through public hearing and other forms of consensus building on the parameters and their weights ;
iv. The prevailing (1st generation) formula is not applicable for use in the allocation of resources to Counties through the County Allocation of Revenue Bill, 2015.

2.4 Deliberations by the Committee on the Recommendations by the CRA

From the recommendations of the Second Generation Revenue sharing formula by CRA, the Committee considered comparatives scenarios, simulations and implications of each of the parameters as follows:

	Parameter	(Current Weights First Revenue Sharing Formula %	(Recommended Weights) Second Generation Revenue Sharing Formula) %
1	Population	45	45
2	Basic Share	25	25
3	Poverty	20	18
4	Land Area	8	8
5	Fiscal Responsibility	2	1
6	Development Factor	-	1
7	Personnel Emolument	-	2
	TOTAL	**100**	**100**

From the table above, population, Equal Share and Land area were retained at 45, 25 and 8 percent respectively in the second sharing formula. The argument was that no substantial change on the basis of economic disparities among counties had been noted over the past formula.

However, to cushion counties with huge personnel emolument costs, the weight on poverty and fiscal responsibility were reduced and two new parameters namely development factor and personnel emolument factor with weights of 1 and 2 percent respectively were added. The development factor addresses economic disparities among counties while the personnel emolument factor was introduced to cushion counties with huge personnel emoluments obligation.

It was also observed that there was need to ensure that Members on the Standing Committee on Finance, Commerce and Budget and the Sessional Committee on Devolved Government of the Senate engage in in-depth deliberations to enable them comprehensively understand and own the new formula, including the basis upon which the formula has been developed.

3.0 REPRESENTATIONS FROM THE PUBLIC HEARING

Mr. Speaker, Sir,

The Committee held public hearings on 29th January, 2015 to receive input from the public on the Second Generation criteria for resource allocation. Two groups were present namely a delegation from Nyeri County and representation of the civil society by the International Budget Partnership (IBP). The submissions received were as follows;

a) That the weight given to fiscal responsibility should be enhanced rather than contracted and should be calculated on incremental revenue collection rather than on absolute revenue figures since these depended on a county's historical advantage in revenue collection;

b) That the weight attached to the basic equal share continues to be too large, and a quarter of county budgets as a result go to basic administrative costs that are equal across counties while most costs vary from county to county according to needs;

c) That while population is a critical weight in a formula, it should gradually be replaced with a more direct measure of population needs which would focus on trying to measure the actual need/demand for health, agriculture, ECD services, etc which would be consistent with the attempts to introduce direct measures through the development parameter to gradually replace poverty;

d) That the support to personnel emolument should instead be provided through a conditional grant so that eligibility requirements can be tightened to ensure it does not become an entitlement or incentive towards a bloated payroll;

e) That the final criterion should also encompass 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

4.0 CASE STUDIES

4.1 Ethiopia

I. The grant formula and the methodology used to design the formula have been reviewed four times in order to improve the methodology of determining the size and character of transfers to Regional Governments.

II. The new formula considers four aspects as follows;

i) Population.
ii) Differences in relative revenue raising capacity.
iii) Differences in relative expenditure needs.
iv) The question of performance incentives.

G = P (APCG+ADF1+ADF2+ADF3 etc.)

Where –

- G is the grant to each Region
- P is the population of each Region
- APCG stands for "Average Per Capita Grant" and is simply the average per capita subsidy for all Regions combined (i.e. total allocation divided by total population)
- ADF stands for "Assessed Difference Factor" and is, for Factor 1 for example, the assessed need or capacity of each Region in per capita terms relative to the average for that factor for all Regions (and similarly for ADF2 etc.); these amounts may be positive or negative.

III. An assessments of revenue capacity and expenditure needs have been made by comparing each region`s situation with an average for all regions combined. For each revenue or expenditure item examined, the result would be positive or negative.

- A positive result means that the region has a higher than average capacity to raise taxation and that other things being equal, it should receive less than the average share of the grants.
- A negative result means that the region has a lower than average capacity to raise taxation and that other things being equal, it should receive more than the average share of the grants.

The way ADF`s are calculated will vary from case to case depending on the logic involved in each revenue or expenditure category and what data are available.

4.2 Nigeria

I. Nigerian revenue allocation formula is based on horizontal (inter-state and inter-local) distribution. The formula is based on two major principles equity principles including even development, national interest, continuity in government services, minimum responsibility of government financial comparability, primary school enrolment and social factors including national minimum standard landmass and terrain.

II. Under the current sharing arrangement, Nigeria's central government gets 52.7 percent of the revenue, the states receive 26.7 percent and local councils have 20.6 percent. The amount to be received by each states and council is further determined by population that account for 30%, equality 50% and derivation 20% that is each state's contribution to total revenue.

4.2.1 Challenges faced in revenue sharing:

- No revenue formula has been acceptable to all levels of government at any point in time.
- Static formula with no annual changes.

4.3 South Africa

The formula for allocation of funds is reviewed and updated with new data annually and is mainly population driven and the amount allocated per state depends on the weighted average assigned to each of the major sectors such as health and education.

Revenue distribution	Education	Health	Basic share	Institutional component	Poverty component	Economic output
Percentage share	51	26	14	5	3	1

I. The education share is based on the size of the school-age population (Ages 5-17) and the number of learners enrolled in public ordinary schools. The health share is based on the proportion of the population with and without access to medical aid.

II. Poverty component considers the poor population determined by the earnings on income and expenditure survey. Economic activity is a proxy for provincial tax capacity. Institutional component recognizes that some costs associated with running a provincial government, and are not directly related to the size of a province's funds are therefore distributed equally between

...SSONS LEARNED FROM THE CASE STUDIES

...countries were reviewed; one with a dynamic formula, one with a ...ic formula and one which is a mix of both and the following lessons can be drawn from the study with respect to designing a formula;

i. It should be structured in such a way that the methodology clearly brings out the assessment of differences between counties in their underlying financial needs and capacities;

ii. It should be well documented, so that the nature of the calculations, the sources of data etc. are clear and can be checked out by interested persons;

iii. It should be such that, if policy makers wish to insert new or amended elements into the assessments, that can be readily accommodated;

iv. The methodology should be such that, as improved data became available or other refinements or improvements are identified and become feasible, they can be readily accommodated;

v. It should not produce undue fluctuations in grant levels to individual county governments from year to year;

6.0 THE COMMITTEE RECOMMENDATIONS

From the deliberations and consideration of recomm[illegible] Commission on Revenue Allocation and representations [illegible] members of the public the Committee recommends that the House app[illegible] the following Parameters and the Formula.

	Parameter	(Current Weights First Revenue Sharing Formula %	(Recommended We[illegible] Second Generatio[illegible] Revenue Sharing Formula) %
1	Population	45	45
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Where:

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