Preface

It took years to have a new Constitution in place in Kenya. But in 2010, Kenya ushered in a new Constitution. This in turn, ushered in a new era in the manner in which the country would henceforth be governed. Central to the new Constitution is the devolved system of government. The notion of a devolved system presupposes better and improved service delivery to the people.

Central to devolution is the manner in which national resources and revenue are to be shared between the two levels of government; the national and the county levels. This paper specifically looks at the modalities laid out in the new constitution for the effective fiscal transfer of revenue between the two levels of government. It examines the criteria for best practices, types of transfers and grants and how the Constitution mandates the sharing of nationally collected revenue and the types of transfers of grants available to county governments.

Finally, it examines the challenges that lie ahead and what needs to be done to ensure a smooth and fair transfer of the revenue collected, and places heavy responsibility on the citizens as the ultimate beneficiary of the devolved system of government who must, therefore, choose their leaders responsibly.
POLICY PAPER ON FISCAL TRANSFERS IN KENYA
Unconditional and Conditional Transfers: Prepare by Njeru Kirira

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1.0 Introduction

Fiscal transfers form one of the critical pillars of inter-governmental fiscal relations that drive devolution. In many countries, both developed and developing, transfers constitute the major source of funding for sub-national governments. In the case of Kenya (based on the role of Local Government Transfer Fund (LATF) which currently accounts for about 40% of local authority expenditures), transfers are expected to fund over 90% of county operations.

1.1 Objectives of fiscal transfer, both conditional and unconditional

Cross Country experience as outlined in table 1 shows that fiscal transfers are targeted to meet several objectives, among them to;

i. Correct vertical imbalances or inequities;
ii. Address horizontal inequities or imbalances (in revenue raising);

iii. Ensure sub-national governments deliver on their functions;

iv. Correct negative externalities or spill over;

v. Facilitate the national government to implement national policies;

vi. Promote flexibility for national government to carry out targeted functions.

These objectives are met through two main types of transfers, namely;

a. Unconditional transfers also referred to as block transfers.

b. Conditional transfers which are targeted to specific purposes, sectors or beneficiaries.

**1.2 Principles of Intergovernmental Fiscal Relations**

For Intergovernmental Fiscal Transfers to succeed, they should be based on clear principles that have:

i. Have clear policy goals and objectives;

ii. Ensure there is enough funding for the programs or projects; with due regard to vertical and horizontal equity, based on devolved functions (own resources and transfers, i.e. Close the fiscal gap between expenditure responsibilities and capacity to finance);

iii. Address disparities of fiscal capacities, expenditure needs and inequities, i.e. Transfers to compensate for county ability to raise revenue;

iv. Maintain budget autonomy consistent with national priorities, i.e. Sub-national government, e.g. County governments be free to manage;

v. Maintain sustainable range of transfers;

vi. Sustained transparency and accountability, not too many to cause fragmentation;

**2.0 Best Practices**

International best practices advocate that devolution should form part of a comprehensive whole. This considers a number of assumptions:

a. That fiscal transfers or grants be part of a comprehensive system of devolution that encompasses political, administrative and fiscal aspects.

b. That fiscal transfer be guided by clear policy objectives and goals.

c. That financing follows functions, not the other way round, i.e. to ensure revenue adequacy, it is necessary to start from expenditure responsibilities to move to funding.

d. That there exists a strong well capacitated coordinating unit capable of proposing sharing criteria, monitor, evaluate and report i.e. an effective central leadership is essential to collect data, analyze, evaluate, and prepare reports to guide fiscal decision making.

e. That decentralization and transfers remain flexible and fit into local operating environment, one size fit all is unlikely to work; therefore it is necessary to ensure flexibility between rural and urban units.

### Table 1: Vertical Imbalances in Argentina, Brazil, Peru (1993)

<table>
<thead>
<tr>
<th></th>
<th>Argentina</th>
<th>Brazil</th>
<th>Peru</th>
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<tbody>
<tr>
<td></td>
<td>Central</td>
<td>Regional</td>
<td>Local</td>
</tr>
<tr>
<td>Revenue Share</td>
<td>77.30</td>
<td>18.90</td>
<td>3.80</td>
</tr>
<tr>
<td>Expenditure Share</td>
<td>57.13</td>
<td>35.12</td>
<td>7.75</td>
</tr>
</tbody>
</table>

3.0 Varieties and types of transfers

3.1 Varieties of transfers

There are three common varieties of transfers, namely:

i. De-concentration
ii. Devolution
iii. Decentralization

**De-concentration** involves the transfer of fiscal responsibilities to cover same level agents of the National Government. These are geographical relocations carried out in accordance with the restructured management. For example, some undevolved functions and services such as Judiciary and the Teachers Service Commission (TSC) are already restructuring to fit into the new social-political and economic management system. They will each have officers in charge of counties but who will be answerable to their national CEOs.

**Devolution** is the most extensive form of decentralization. It involves granting sub-national governments the constitutional and legal authority to;

i. Levy taxes (sharing of tax base) without reference to the National Government
ii. Receive financial transfers or grants from the National Treasury which may be;
   a. Non-conditional; meaning they will be free to spend as their legislature decides
   b. Conditional; which means funds are tied to specified goods, services or beneficiaries.

**Decentralization** involves the transfer of functions or responsibilities belonging to one level of government to another level or agency. Normally, this should be based on mutual agreement, allowed by Constitution or by law. Such transfer needs to be matched by adequate resources needed to deliver the
function or responsibility. This arrangement is provided for in Article 187 of the Constitution.

It is important for persons interested in understanding or monitoring fiscal transfers to have a good understanding of the above categories. This will give them the knowledge and appreciation of what information they need and who is responsible. Once they have the information, they will be empowered to direct their concerns to the right people or office. For example, a delayed transfer of funds to schools does not necessarily involve counties in which the schools are located. This is a matter for the Ministry of Education and the National Treasury. The same should apply to issues affecting delivery of services by the Judiciary.

3.2 Types of transfers

Transfers fall into two main categories; they can be either conditional or unconditional.

a. **Unconditional grants or transfers** are also referred to as block transfers and are normally allocated;
   - On the basis of a predetermined objective criteria or formula;
   - Without specified requirements or target use leaving the sub-national unit (County) free to decide on how to use the funds.

This means that under this category, budgeting is done at sub-national level, a situation which allows better match between budget allocations and identified needs or priorities. It also allows the sub-national government to exercise its autonomy.

The only requirement on such transfers is that their management complies with the Public Finance Management law, regulations and procedures as happens at National Government.

b. **Conditional grants or transfers**

These are grants or transfers allocated for a targeted use, project, or beneficiary. Decisions on this category of grants may be made with or without consultations with the target unit or county. In some cases, such grants may require joint funding by two units of government. For example, county governments may be required to contribute, based on a set ratio, part of the funding as a condition by the National Government.

When conditional grants are given without adequate consultations the transfers can;
   - Interfere with the autonomy of the receiving unit or county;
   - Impose additional costs, when funding is not adequate;
   - Interfere with operations, especially where human resources and equipments are needed and have to move from their normal duties.

Conditional grants or transfers may be subject to a variety of requirements including;
   - Requirement to undertake specified policy changes, e.g. Budget support, reduce debt ratios or restructure expenditures in a given direction;
   - Meeting specified targets, outputs periodically or at year end;
   - Submission of performance data or information on regular basis;
   - Being subjected to special audits, etc.

4.0 Fiscal transfers or grants in Kenya

The Constitution mandates sharing of nationally collected revenues and provides for both conditional and unconditional grants and transfers.

4.1 Revenue sharing is divided into two levels: the county and the national

i. Sharing between National Government and counties as a group, is subject to principles in Article 201, and;

ii. Sharing amount set aside for counties among the 47 counties is based on
the use of objective criteria set out in Article 203 of the constitution;

iii. Sharing between the two levels is subject to a minimum of 15% going to counties (based on latest audited revenue receipts). However, the actual amount to be set aside will depend on actual costs of devolved functions;

iv. 15% is set aside for counties, whether the cost of county functions as detailed in the Second Schedule of the Constitution is less or not;

v. If the cost of devolved functions is more than 15% of national revenue, the amount for counties shall be increased as appropriate (the Commission on Revenue Allocation (CRA) will advise on this);

vi. The share of revenue set aside for the National Government is to be determined on the basis of objective criteria that takes into account:

• National interest, provision for national debt and other national obligations;
• Determination of national need and obligations based on objective criteria.

Therefore the determination of the amount of funds set aside for the National Government is not based on discretion or gut feeling but on set criteria. However, Counties may get additional grants whether conditional or non-conditional. One such possible transfer cited in the Constitution is that from the Equalization Fund which targets marginalized areas and groups. This money if transferred will be used for provision of basic services such as water, roads, health facilities, electricity, etc.

4.3 Best practices

Consistent with best practices, the Constitution has done the following:

a. Established the Commission on Revenue Allocation (CRA). This is an independent commission whose principle functions are:

• To consider, analyze, and make recommendations on revenue sharing between the two levels of government and allocation among the 47 counties based on set criteria;
• To finance and manage county government finances;

4.2 Sharing among the counties

It is provided for in the Constitution that the portion of revenue set aside for counties will be shared unconditionally among the 47 counties taking into account the following criteria;
• To define and enhance revenue sources for both levels of government;
• To encourage fiscal responsibility.

b. Provided for regular review (every 5 years) by the Senate of revenue allocation among counties. The review culminates in a resolution approved by both Houses (National Assembly and Senate). This means that though the major portion of revenues for counties will be unconditional, allocations will be based on very strict constitutional and legal requirements. However, once the national budget is approved and funds allocated, the counties will have full autonomy to manage them.

c. Provided for unconditional grants which may include, grants to county budgets, either for a specified period, say a year or longer. These grants or transfers give discretion to recipients to decide their target use and to manage the revenue as part of their own revenue receipts.

4.3.1 Conditional grants

The Constitution opens the way for counties to receive conditional grants or transfers which are subject to specific conditions that may include:

i. Target use by sector or purpose, e.g. Capital investment, pre-school facilities, to fund marginalized groups or areas etc;

ii. Requirement for matching (i.e. Matching grants) which require recipients to contribute part of the costs: one shilling to one, or any other ratio;

iii. Requirement to meet specified targets, outputs or results, e.g. Access to health facilities, school enrolment etc;

iv. One off-funding or over a period, e.g. Revenue enhancement study;

v. Open ended grants or transfers, e.g. the LATF but with requirements to achieve specified performance ratios such as debt, revenue etc.

4.3.2 Challenges of conditional grants

These types of grants or transfers carry many risks which include the following:

• They may undermine autonomy of counties to make budget decisions;
• They may lead to additional costs, if funding is not enough;
• They may lead to unfunded operating costs.

When these transfers originate from consultations between the two levels, they have the potential to spur change. They provide positive incentives especially when they finance critical county priorities. However, they can be a source of fiscal instability when inappropriately designed and applied.

5.0 Preconditions for success

For transfers or grants to succeed in meeting their objectives, they need to;

i. Be guided by clear policy goals and objectives;

ii. Respect autonomy of the recipient county to manage;

iii. Ensure adequacy and affordability to both levels on initial costs and operations so that the grant is enough to fund the target commitments, while recipients have capacity to operate the investment alone or jointly;

iv. Be transparent and predictable; the fund arrangements should be clear, open and predictable especially when a project covers several years;

v. Be efficiently implemented; the recipient county should have capacity to implement the programs or projects efficiently;
vi. Have in-build incentives; grants need to be based on clear incentives for effective implementation;

vii. Ensure responsiveness and to be needs based. The target funding should be based on expressed needs and clear outputs or outcomes in order to generate local support;

viii. Ensure flexibility; this is critical to coping with the ever changing environment and needs;

ix. Be based on clearly understood and jointly owned channels of accountability;

x. Have clear coordination and collaboration mechanism between the key players, especially between the two levels of government. This is critical to avoiding policy conflicts.

6.0 Possible risks and challenges of fiscal transfers

Management of transfers or grants face several risks and challenges which include the following: the approach taken, the determination of national interests and obligations, failure to follow the Constitution, resistance to change developing objective criteria, lack of infrastructure and capacity at county level, lack of institutional arrangements for coordination, effective links between development plans, County and National Government and other imperatives.

6.1 The approach taken

Best practices require that allocations follow the sharing of expenditure responsibilities, i.e. “finance follows functions”. Unfortunately, in Kenya this has not been the case, the common approach being ‘how much do we get’, which is like putting the cart before the horse. The recent proposal by CRA regarding the sharing of money has already generated controversy.

However, based on devolved functions in the Second Schedule of the Constitution, the basis of the revenue allocation process should be the cost of devolved functions. This should be the starting point from which adjustments can then be made as necessary on the basis of available information.

6.2 Determination of national interests and obligations

Article 203(1) a), b), and c), of the Constitution lays out the process for revenue sharing. It specifies out three stages to follow:

i. Identify national interests;

ii. Provide for national or public debt and other national obligations;

iii. Use objective criteria to determine value or estimated portion.

This order has not been followed even though a proposal to allocate a specified amount of money for counties has already been set aside. The process, however, raises a number of questions:

i. How did the proponents of the current allocations determine national interests, public debt and other obligations?

ii. Has the proposal allocated too much or too little?

iii. Are Kenyans simply taking a short cut?

6.3 Failure to follow the Constitution

Assessments of county specific details are laid out in Article 203 (1) (d) to (k) with specific requirements which include the following:

a. The need to ensure county governments are able to perform functions allocated to them;

b. The need to take into account the development needs of counties;

c. The need to consider the fiscal capacity and efficiency of each county government;

d. The need to take into account economic disparities within and among counties and need to remedy them;
e. The need to take into account the affirmative action in respect of disadvantaged areas and groups;

f. The need to take into account the economic optimization of each county; providing incentives for each to optimize capacity to raise revenue;

g. The desire for stable and predictable allocation of revenue, and;

h. The need for flexibility to respond to emergencies and other temporary needs, based on objective criteria.

There has been no attempt to comply with the above criteria, a situation which not only exposes any decision made on allocations to objections and challenges through a constitutional court, but which could also delay the planned take off of fiscal devolution.

The government has already made several constitutional errors some of which have resulted in successful court appeals and thereby to reversals of executive decisions. Such embarrassments can be avoided by adhering to the Constitution and the criteria set out. The law should be followed in order to successfully manage fiscal transfers in the implementation of a devolved system of government.

6.4 Resistance to change

Experience shows that people tend to resist change; hence, resistance to a devolved system is no exception. This resistance may be political, institutional, constitutional or simply bureaucratic. In some cases, politicians resist change just as much as bureaucrats. As Kenya moves to implement devolution, it is necessary to expect some resistance.

6.5 Developing objective criteria

Objective criteria to determine national interest and obligation may present challenges and controversies. It is however necessary to develop and get such criteria approved in order to ensure compliance and the fair sharing of revenues between the two levels. Criteria for flexible response to emergencies and other temporary needs for both national and county governments should be developed too. CRA should consult and come up with the necessary criteria in order to avoid legal challenges.

6.6 Lack of infrastructure and capacity at county level

There is urgent need to embark on capacity building at county level for the smooth take off of the county fiscal management. This should go hand-in-hand with the creation of necessary infrastructure to link operations between various government actors, especially those dealing with finance. County governments should embark on early preparations after the March 2013 General Elections to avoid disrupting service delivery and thereby speed up the devolution process.

6.7 Lack of institutional arrangements for coordination

There is need to establish an effective mechanism for coordination between the two levels of government and between counties and also between agencies of the two levels of government. This is especially necessary so as to avoid duplication and wastage. For example, there are many facilities that have been built such as schools and health centres using CDF money but which remain under-utilized or idle due to lack of coordination or simply resistance from public actors.

6.8 Effective links between development plans, County and National Government

The Constitution requires counties to prepare their plans in consultation with the National Government. This exercise is urgent and needs to be given priority as the basis of preparing and driving budgets at the county level. These plans will be the basis of identifying and ranking community needs and priorities in the budgets. This calls for capacity
building among the local communities and civil societies in order to ensure that the public understands its role and how to play it.

6.9 Other Imperatives

Besides the above concerns, to ensure fiscal transfers, both conditional and non-conditional grants will need the following imperatives in order to succeed;

i. Development and operationalization of an effective fiscal reporting system, preferably electronic, with capacity and outreach in all counties;

ii. Effective capacity in the central agency. CRA will be expected to collect, analyze, and disseminate fiscal and economic information and present it to the legislature and executive arms of the two levels of government. This is as urgent as it is important;

iii. Preparation of objective criteria to assess marginalized or disadvantaged areas and groups within and among counties, which is critical to ensuring a common assessment of such areas and groups for funding purposes;

iv. Development of objective criteria to assess economic disparities and the best system to remedy them.
Conclusion

The most urgent concern regarding fiscal transfers is the quality of leadership in county governments. Kenya has witnessed perpetual controversies and fights among councillors, especially on matters of finance, a situation which the devolved system cannot afford to condone. The critical functions devolved to counties, together with the transfer of large amounts of money to fund such functions makes counties critical centres of public service delivery. How they receive and manage the funds, the quality of services they deliver, and how they will account for the funds they receive will determine whether a county shall receive more, less or nothing especially with regard to conditional grants. Ultimately, their efficiencies will affect the success or failure of the devolved system.

Unless the quality of leadership improves, there is a real risk that delivery of public services may deteriorate and hurt the very people the devolution was expected to benefit. It is therefore in the best interest of the people and the counties that the calibre of county leaders be as good as those at the national level. Counties need representatives who can match the calibre of national leaders. After all, they are the representatives of the public who are the taxpayers and true owners of power. This is because the Constitution vests power in the people.

For these reasons, the public needs urgent empowerment by way of civic education in order to understand their role in electing quality and effective leaders. In this regard, civil society organizations have a very important and urgent role to play. It should be understood by the public that the county governments will only be as good and as effective as the leaders who manage them. The public must therefore, take responsibility to elect good leaders and must thereafter hold them to account so as to ensure effective delivery of services.
## Summary of selected Decentralization sequencing Issues in Five Case Countries

<table>
<thead>
<tr>
<th>Rationale for Fiscal Decentralization</th>
<th>Finance Follows Function</th>
<th>Subnational Government Taxing Powers</th>
<th>Rationality in the design of the transfer system</th>
<th>Policy Paper or White Paper</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>Revenue assignment and transfers, and expenditure assignment were developed simultaneously by two different ministries; Secession threats; demand for local political autonomy</td>
<td>Minimal local government taxing power</td>
<td>Core grant is unconditional and vertical sharing rule is transparent. Natural resource revenue sharing has less clear objectives and exacerbates disparities.</td>
<td>There was no policy framework.</td>
</tr>
<tr>
<td>Russia</td>
<td>Murky expenditure assignments that have changed over time</td>
<td>Minimal regional and local government taxing power</td>
<td>A formula-based equalization grant has been established. Revenue sharing is not equalizing and conditional grants not well developed.</td>
<td>A White Paper was developed after the decentralization program was underway.</td>
</tr>
<tr>
<td>India</td>
<td>Revenue assignment and transfers change over time by Finance and Planning Commission recommendations. Expenditure assignments, with a long “concurrent” list are based on the 1950 Constitution.</td>
<td>States have some significant taxing powers. Local governments have access to property tax and little else.</td>
<td>Transfers are distributed by three different bodies with what often appear to be contradictory objectives.</td>
<td>The Federal Finance Commission reports every five years. The State Finance Commissions report</td>
</tr>
<tr>
<td>Tanzania</td>
<td>Followed the “finance follows function” rule but with some murkiness in expenditure assignment.</td>
<td>Minimal local taxing power</td>
<td>All grants are earmarked and both vertical and horizontal shares are distributed in an ad hoc way. There is no equalisation grant.</td>
<td>A White Paper guides decentralization policy development.</td>
</tr>
<tr>
<td>Mexico</td>
<td>Expenditure assignments are defined by sectoral laws.</td>
<td>States raise about 5 percent of revenues from own taxes. Municipalities raise about one-third of revenues from own sources.</td>
<td>Transfers are distributed by formula but the overall results are not equalizing.</td>
<td>Source: World Bank Policy Research Working Paper 3914, May 2006, Roy Bahl and Jorge Martinez-Vazquez</td>
</tr>
</tbody>
</table>
Annexe 2

Indicators of Decentralization, the Soufflé’ Theory

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