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A Background Brief on Kenya's Devolution[1]

World Bank

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1. Overview and key points

Kenya's first county assemblies, governors and senators were elected on March 4 2013. In the eight months that have followed, most county governments have appointed executive committees, passed their first budgets and adopted their first plans, and have begun recruiting their own staff. The first full year revenue sharing process was completed and the second post-devolution budget cycle is just beginning.

The early months of Kenya's devolution were characterized by intense bargaining between organs of the county and the national governments. The most significant outcome of this process was acceleration of the transfer of functional responsibilities to counties, and growing calls for counties to be given more resources.

The significance of the administrative changes brought about by devolution should not be underestimated. There are very large institutional capacity challenges, which counties are requesting help to address, mainly in the areas of planning, budgeting, Human Resources (HR), revenue enhancement, and citizen outreach. Led by the Ministry of Devolution and Planning (MODP), an integrated capacity development framework is being developed. Implementing it will be a major and expensive undertaking, but it is hoped that the framework will avoid fragmentation of development partner support to counties.

2. Function assignment

The first transfer of functions to county governments was made in early February 2013. As required by the Transition to Devolved Government Act, the Transition Authority transferred a suite of functions closely aligned with the roles of the former Local Authorities, which the county governments have now replaced.

Most of the remaining devolved functions were formally transferred to all county governments in August 2013. The Constitution envisaged that functions would be transferred gradually over a three-year period, as county governments developed the capacity to assume them. However, following a period of lobbying by county governors, on 9th August the Transition Authority (TA) gazetted the transfer of almost all remaining functions. The TA's formal legal role in assessing and gazetting function transfer should now be focused on a few 'big ticket' function areas that have yet to be fully transferred.

Resolution of function assignment issues may now have to focus more in sectors than was previously the case. This is good, from the perspective that staff of sector ministries understands the policy concerns of their sectors, but it is apparent that national staff of ministries affected by devolution is still grappling with what devolution means for their functions.

The most important risks to manage are those that threaten service delivery in key sectors like water, health, and roads. Inadequate resourcing, particularly for key recurrent inputs; mishandling of the transfer of staff to county governments; ad hoc and short-sighted county interventions in service delivery; and, stalling of project implementation are the most likely underlying causes of service delivery failure.

It is not clear what role the TA will continue to play in function assignment. The Ministry of Devolution and Planning has foreshadowed amendments that would see the Transition Authority replaced by the technical secretariat to the National and County Government Coordinating Summit (The Summit). The TA argues it still has an important role to play, and that it will remain in existence until its life comes to an end (4th March 2016) or its parent legislation is repealed.

Function assignment and sector capacity building are very likely to be closely integrated. However, the initial major focus of capacity building is likely to be around core administrative systems—PFM, HR and associated systems. The TA may have its hands full just supporting these core systems. It is important that sector-specific capacity building is not overlooked, and that where this overlaps with core systems (for example on PFM), there is strong coordination between government and development partner actors.

3. Intergovernmental coordination

Intergovernmental bodies will play an increasingly important role in negotiating detailed assignment of functions, but also potentially in capacity building. One such body is the Intergovernmental Budget and Economic Council. IBEC, which has a specific focus on funding, consists of 47 county finance "ministers" plus the Cabinet Secretary for Treasury, and representatives of the other two arms of government and some key independent commissions.

Eight sector forums have now been convened for the sectors where functions have been devolved and met for the first time in the week of 1st September and since then three subcommittees have been formed. These three committees are chaired by the Deputy President, the Cabinet Secretary for Devolution and Planning, and the Cabinet Secretary responsible for Treasury (or their nominees) and have had several meetings. The National Treasury acts as the secretariat for the Council in place of the Intergovernmental Relations Technical Committee which is in the process of being put in place.

Staffing will be key to making the new intergovernmental bodies effective. Experience with the establishment of the constitutional oversight commissions before the election was that it takes much time for new bodies to establish themselves, and even longer to become effective. The delayed establishment of the TA severely hampered its capacity to respond to the enormous challenges of

midwifing the implementation of devolution. Currently, the IBEC is using officers from the Treasury and has not officially allocated them duties through perhaps more formal arrangement such as secondments.

4. Financing arrangements

County governments came into operation four months before the end of the 2012/13 fiscal year. Because their functions matched those of the former Local Authorities, it was expected that the traditional revenue sources—locally collected taxes and the Local Authorities Transfer Fund (LATF)—would continue to fund those functions. The new costs associated with county governments were covered by an allocation made by Parliament in a transitional appropriation law passed in January 2013. A further transitional law called the County Governments Public Finance Management Transition Act that expired on 30 September 2013 provided county governments with the basic PFM legal infrastructure including an accounting officer and carryover of legal authority to collect local government taxes and charges.

2013/14 is the first full year of financing for county governments. County governments are receiving funding from two sources: transfers, and own source revenues. Transfers are of three kinds:

- Unconditional equitable share transfers, which allocate the county share of revenue (determined by the Division of Revenue Act) according to a formula agreed by Parliament and set out in the County Allocation of Revenue Act. **Total KES 190 billion**
- Allocations of the equalization fund (which is to address backlogs in key infrastructure). **Total KES 3.4 billion**
- Conditional transfers which are of two types:[2]
    - Conditional grants included in the County Allocation of Revenue Act, which cover devolved donor projects (16.6 billion)[3] and funding for level 5 hospitals (3.4 billion). **Total KES 20 billion**
    - Conditional grants embedded in the national budget, which include grants for the operation and maintenance of health facilities, and funding to compensate them for loss of revenue from the free maternity and free primary health care policies of the national government. This is estimated at **KES 7 billion**

[2] It is anticipated that the budgeting arrangements for conditional grants may be made more uniform once the supplementary budget is passed**.**

[3] It should be noted however, that it is unlikely that most of this 16.6 billion will actually be transferred to counties, for two reasons. First, the distribution of the project funds among counties is in some cases at odds with the project agreements that govern the use of the funds (both in terms of how the funds will actually be managed and in terms of how they are allocated between counties). Second, some project funds are actually managed off budget (for example, GAVI: Global Alliance for Vaccines & Immunization) and therefore not available to be distributed by the national government.

5. Vertical sharing

Kenya's first revenue sharing process was highly politicized, as could be expected. Negotiation in the National Assembly changed the outcome substantially from what Treasury had originally proposed. The major change involved removing proposed 'hold harmless grants' that would have cushioned some of the 'cash-poor' counties against the fiscal shocks consequent on receiving less funding than had been spent on devolved functions when they were managed by national government.[4] As part of a deal brokered by the Deputy President, hold harmless grants were converted to increase the equitable share.

Even after the equitable share was increased, the Senate—comprised of 47 county delegations with one vote each—still considered counties should get more money. The equitable share of KES 190 billion approved by the national assembly equates to almost 22% of revenue for 2013/14, or 34% of 2010/11 revenues (the base stipulated by the Constitution is the most recent audited revenues) compared with the legally mandated minimum of 15%. On the recommendation of the Commission on Revenue Allocation (CRA), the Senate proposed to increase the equitable share to KES 238 billion plus the KES 20 billion in conditional grants, making a total of KES 258 billion. The National Assembly did not agree, and when the Division of Revenue Bill was returned to it from the Senate, it passed the Act on the basis of the original agreement of KES 210 billion.

A Senate challenge to the constitutional validity of the Division of Revenue Act in the Supreme Court was upheld. The case was heard in the last week of August and a decision was reached in late September 2013. The Supreme Court declared that is *was unconstitutional for the Speaker of the National Assembly to by-pass the Senatorial process, by not going through the mediation arrangement provided in the Constitution*. The constitutional implication of this is that *both* the National Assembly and the Senate should participate in the debates on, and the passage of the Division of Revenue Bill[5]. In general, the issues that were argued in court throw up difficult questions of interpretation around the respective law-making powers of the National Assembly and the Senate.

No local organization (inside or outside government) has undertaken a quantitative analysis of the revenue sharing outcomes. A comparative assessment of how much the devolved functions received before devolution, and compared with what has been allocated through the equitable share is needed.

[4] Treasury initially proposed an equitable share of KES 154 billion together with KES 40 billion in conditional grants that included a special grant to "hold harmless" counties that would receive less as a result of the formula than had been estimated to be spent on devolved functions in those counties before devolution. Conditional funding of KES 10 billion for level 5 hospitals was proposed. Following negotiations in the National Assembly, the hold harmless grants were abolished, funding for level 5 hospitals was decreased to KES 3.4 billion and the savings were used to increase the equitable share.

[5] In its ruling, the Supreme Court emphasized the principle of co-operation, checks-and-balances, and accountability in governance. Specifically, the Court advised that the current Constitution has made a striking departure from previous ones, by establishing State organs that must consistently operate in harmony and with transparency and accountability, for the purpose of effective service delivery in the public interest.

There has been no public debate about how much funding should go to national functions. National government remains responsible for four of the "big five" functions. In order of typical cost these are: education, police, prisons, defence, and health; of these only health has been devolved. Education involves an especially high cost in Kenya; more than 25% of annual revenue is allocated to education. This cost is rising. Soon after the 2013/14 budget was passed teachers in Kenya went on strike, claiming implementation of a KES 57 billion wage agreement from the 1990s.

Many stakeholders consider that "costing devolved functions" is the answer to intense debates about vertical sharing. In some quarters it is agreed that national functions need to be "costed" too, but the majority of stakeholders may not yet recognise that costing functions like police and defence will be a political process involving crucial choices about service levels, not a scientific process that can deliver a certain result. Reference to historic costs (even as a baseline) is generally rejected by Kenyan stakeholders on the basis that it enshrines historical injustices that marginalized some counties, and there is a widespread belief that padding and systematic diversion of the national budget means national functions can be significantly cut without fear of undermining service delivery.

Although a few high-cost functions have been held back, funding for these functions has already been devolved. Analysis of the 2012/13 budget alongside the 2013/14 budget shows how much was allocated to these functions in 2012/13 that has now been cut from the 2013/14 national budget. The calculation of the equitable share included not only these functions, but one large function that was not transferred—the Constituency Development Fund—valued at around KES 22 billion.

The transfer of funding without transferring corresponding programs may leave national government carrying some costs for which it has no budget. Programs where functions have been held back but funds have already been devolved include the following, which together amount to almost half the amount transferred in the equitable share of 190 billion:

- Salaries of national public servants working in counties on devolved functions – estimated cost 47 billion. National government has agreed to fund these costs for 6 months, although on a reimbursement basis, that is that counties will refund what national government has spent.
- Recurrent funding for maintenance of rural and urban roads – 8.5 billion was allocated to this function in 2012/13.
- Capital funding for projects managed by the Kenya Urban Roads Authority and Kenya Rural Roads Authority (virtually all county roads of any significance) – KES 27 billion was allocated to this function in 2012/13 although some of this funding may have come from donors.
- Some funding for rural electrification – estimated at KES 5-8 billion in 2012/13.

It is not clear how the national government will manage the fiscal disconnect between the functions it has retained and the funding it has devolved. It is not clear that county governments have even budgeted for all functions that have been devolved. In some cases, county governments have fully budgeted the transfers they anticipated receiving in 2013/14 on other things. It seems very unlikely that the national government will be able to hold back funds from the equitable share, unless governors individually agree to this. The Constitution in article 219 stipulates that the equitable share shall be transferred "without undue delay and without deduction", which further complicates the issue.

6. Impact of fiscal equalisation

Parliament adopted a highly equalizing formula for sharing the equitable share on the recommendation of the CRA. The CRA's objective has been to advance the equalization agenda as far and as fast as possible, possibly on the basis that the political window of opportunity to redress historical injustices may be short lived. The elements of the formula are population (45%), poverty (20%), equal shares (25%), land area (8%), and a 'fiscal discipline' component (2%) that is currently shared on an equal basis.

The formula does not take account of own revenues, but it also does not take account of inherited (including urban) costs. The effect of the formula is to redistribute in favour of the counties, predominantly in north-eastern Kenya, which have large land area, small population densities, and high levels of poverty. These counties have inherited relatively low historical costs because their service networks were not extensive, and many civil service positions remained vacant. In contrast, counties in central and south-western Kenya have inherited large service networks and staffing. In some counties, inherited salary costs from national civil servants performing devolved functions could equate to more than their equitable share transfer. These more urbanized counties have also inherited significant wage costs to pay for former Local Authority staff.

Some counties that have inherited high historical costs may have very little fiscal room for development spending, at least until they raise more revenues, or downsize inherited costs through staff rationalization. The PFM Act places great emphasis on fiscal room for development spending, by providing that spending on recurrent cannot exceed 70% of the budget. Many of the counties with high inherited costs may not yet fully understand how limited is their fiscal room for development spending.

The actual fiscal room available to counties is an important determinant of the county planning process. Under the County Government Act, counties are legally prohibited from spending money unless they have a plan. It is expected that all counties have now finalized and re-submitted their (revised) budgets for 2014/15, together with their integrated plans. Yet it is likely that some counties lacked

information to correctly estimate the amount they may have available for development. Because they did not understand they were required to meet the full cost of devolved functions—even those that had not been transferred—many counties did not include these costs in their initial budgets.

7. County budgets 2013/14

There was significant preoccupation with the requirement for passing the 2013/14 budgets by the required deadline of 30 July. A focus on timing instead of content has meant a number of county budgets were inadequate in a number of respects:

- **No provision for essential costs of core functions**. In particular, counties did not budget for the salaries of civil servants in counties that are performing devolved functions that were not covered by the national budget. Other key areas where budgets are likely to fall short are Operations & Maintenance (O&M) costs, and key inputs like pharmaceutical drugs.
- **No common chart of accounts**. Some counties did not separate sector programs and lumped together salaries and recurrent budgets into a single budget program. This makes it impossible to assess whether county governments have made adequate provision for O&M, as compared with what national government previously allocated.
- **Too much development expenditure, too little recurrent expenditure.** Most counties admirably adopted consultative processes in the lead up to finalizing their budgets. Citizens understandably focused on development projects. This emphasis, combined with the absence of accurate information about the historical allocations to recurrent service delivery in each county, may have led some counties to budget too little for recurrent.
- **Large unfunded deficits.** Over half the counties budgeted for more expenditure than they did revenue, with no indication of where how the deficit would be financed. Since county governments require a guarantee from the national government to borrow, it seems unlikely these deficits will be funded.
- **Unrealistic revenue projections constitute a second hidden deficit in some counties.** In total, counties budgeted to raise KES 95 billion in revenue. Local Authorities raised an estimated KES 25 billion from similar sources in 2012/13. Based on CRA published data,[6] 26 counties budgeted to double their revenue collection from the previous year. In nine counties the budget plans for a five-fold increase. Four of these have budgeted to increase revenue collection by more than ten times their previous level (Kisii for example has budgeted for an increase of more than 7,000%).

[6] Commission on Revenue Allocation, 2013, *County Budgets 2013-2014*

In sum, a number of the original 2013-14 county budgets lacked credibility. The Office of the Controller of Budget announced that it would not authorize the release of funds to county governments that had budgeted for expenditure that was not authorized (such as allowances for county assembly members beyond those authorized by the Salaries and Remuneration Commission) or which had unfunded deficits. In response, counties undertook to revise their budgets, the full outcome of which is yet to be analyzed.

Political bargaining around the county budget process may hamper credible and timely budgeting. Because Governors are not members of the county assembly, county assemblies are crucial actors in the budget process. In some cases county assemblies used their political power to alter budgets to either demand direct control over a portion of resources, insert spending that had not been proposed by the executive, or to inflate spending contrary to the fiscal responsibility rules in the PFM Act. In addition, as at November 2013, county assembly members have been on strike in protest over their level of remuneration for a number of weeks. This has prevented some counties from enacting revised budgets and passing Finance Acts to authorize the collection of revenue.

8. Looking forward to 2014/15

The most important lesson from the above sequence of events is that the negotiations over revenue sharing must begin very early in the budget process—perhaps even earlier than is provided for in the law. The PFM Act requires the CRA to present its recommendations on vertical sharing for 2014/15 to Parliament in December 2013. CRA has already initiated consultations with key stakeholders on the vertical sharing process for 2014/15. The IBEC should play an important role in the consultations. It is also apparent that more quantitative data on historic spending needs to be available to stakeholders as they bargain around the budget process. The CRA has begun a process of collecting more accurate information for the 2014/15 revenue sharing process.

9. Establishment of county PFM systems

County governments are in the process of establishing treasuries and preparing for the 2014/15 budget. Most counties have adopted county integrated development plans, but few have met the next budgetary deadline, the development of a county budget review and outlook paper.

Several aspects of financial management pose immediate challenges. These include: full adoption of Integrated Financial Management Information System (IFMIS), adoption of a common chart of accounts, and establishment of county payroll systems.

The Constitution places great emphasis on citizen participation in government as the basis for stronger accountability and inclusiveness. In general, county

governments appeared to embrace the need for citizen engagement in developing budgets. There has been far less compliance with PFM Act requirements for budget transparency, both at national and county level, with almost no county budgets available online almost 6 months into the fiscal year.

10. Local revenue generation

Own revenue sources for county governments are limited but important. The Constitution assigns two tax bases to county governments, property rates and entertainment tax. In addition, the function of trade licensing (previously a function of Local Authorities) is assigned to county governments under the Fourth Schedule of the Constitution. County governments can also collect fees and charges for services they provide.

The legal basis for county governments to continue raising revenues inherited from Local Authorities continues to be shaky. Local Authorities raised revenues under a variety of national laws and regulations including the Rating Act and the Local Government Act. None of these laws were amended in anticipation of county governments replacing Local Authorities, and in the case of the Local Government Act, the law was repealed by the introduction of county governments. The County Governments Public Finance Management Transition Act included a bridging provision that authorized county governments to continue collecting local government revenue sources, but the Act has since lapsed.

Property rates are a source of considerable fiscal space potential at county level but only for some counties. Many Local Authorities underperformed badly in collecting property rates, for two main reasons. First, the base for property rates is poorly defined. Valuation rolls are incomplete and many years out of date. Second, collection is inefficient and ineffective. Computerisation is likely to be an important component of any modernization approach that improves the efficiency of collection. However, property rates may not hold much scope for enhancing revenue generation in more rural counties were land is not titled, values are low, and citizens have a limited capacity to pay.

Much of the recent focus on county own revenues has been on fees and charges set out in county Finance Acts. However, while Finance Acts set the level of fees or charges, the legal power to impose them is generally found in other legislation dealing with various regulatory processes administered by county governments, such as public health, building control and development planning laws. Many of these laws still refer to Local Authorities, and need to be amended to empower county governments to administer them.

County governments are still heavily reliant on old local authority systems for revenue generation. In some counties, more than 10 former Local Authorities

managed revenue collection in parallel. Integrating these will be a crucial component of any county revenue system initiative.

11. Establishment of county public services

The County Government Act provides for county governments to establish their own public services under the guidance of a county public service board. County assemblies have their own county assembly service board. In recent months, most (if not all) counties have established county public service boards and commenced hiring staff, beginning with the appointment of chief officers, who will head the county departments. In the interim, staff of line ministries performing devolved functions has been seconded to county governments under the provisions of the County Government Act.

Appointment of permanent county public services will involve absorbing—or shedding—around 100,000 existing civil servants. Of these, around 33,000 are inherited from former Local Authorities, and around 67,000 are national civil servants attached to line ministries that were performing what are now devolved functions. It is not clear who is responsible for meeting the retrenchment costs for civil servants that do not win positions in a county civil service. The County Government Act allows these staff to be returned to the national government, which may however lack budgetary resources to sustain any higher staff levels.

Fiscal sustainability of wage bills is a key issue for some counties, especially the larger urban counties.

12. Capacity building

The national government is constitutionally responsible for supporting county governments to develop the capacity to assume their functions. In practice, responsibility for coordination of capacity development rests with the Ministry of Devolution and Planning. Conveniently, the Ministry of Devolution and Planning has responsibility for several key agencies that play important roles in capacity building, including the Transition Authority, the Kenya School of Government, and the former Special Ministry of State for Public Service.

While the mandate of the Ministry of Devolution and Planning is to provide and coordinate capacity building and technical assistance to counties, a national capacity needs assessment framework (that details how this will be carried out), will be required. This will clarify to stakeholders, including development partners keen to provide support, the priorities for capacity building. Generally capacity building should be well sequenced, regular and with necessary quality control measures.