ICPAK 07-A/2014
POSITION PAPER ON PARAMETERS FOR MEASURING FISCAL DISCIPLINE IN KENYA

The Institute of Certified Public Accountants of Kenya – July 2014

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1.0 INTRODUCTION

Fiscal discipline is a key value in public finance management at national and sub national levels. It is defined as the capacity of a government to maintain smooth financial operation and long-term fiscal health[1]. It branches into multi-year perspective on budgeting and mechanisms to maintain fiscal health and stability over business cycles. The measure is a scale ranging from low to high. Strong fiscal discipline builds up financial management capacity which contributes to sound governance at the county levels. Given limited resources, expenditure claims would result in chronically high deficits and increasing debt and tax burdens if governments at both the national and county levels are not fiscally restrained. Fiscal discipline pertains to all key measures of fiscal performance: the total revenue, the financial balance, and the public debt.

At the national level, fiscal discipline has been interpreted as maintaining budgeted and actual spending, revenue, and borrowing at levels that are financially sustainable and compatible with short- and long-term macroeconomic objectives, given likely risks. In Kenya, fiscal discipline was identified by the Commission on Revenue Allocation (CRA) as one of the parameters for allocating revenue horizontally to County Governments

The objective of this paper therefore, is to review the existing literature and frameworks on fiscal discipline and make proposals on measuring fiscal discipline at the county level for efficient and effective delivery of services. These proposals will help in determining the level of fiscal discipline among the County Governments as a criterion for horizontal revenue allocation.

1.1 THE FISCAL DISCIPLINE CONCEPT

The term "fiscal discipline" in public finance management has three related meanings. The first is by public finance theorist Richard Musgrave defines fiscal discipline to mean mainly deficit financing of current operations, that is, a government should cover its current expenditures only with current revenues. Musgrave argues that:

(i) such deficit financing indicates low or even absence of fiscal discipline;

(ii) fiscal discipline involves not only elected officials but also voters/tax payers, both of whom pay more attention to immediately current needs than the future;

(iii) it is up to professional finance managers (elected or appointed) to correct this erroneous inclination so as to maintain proper fiscal discipline.

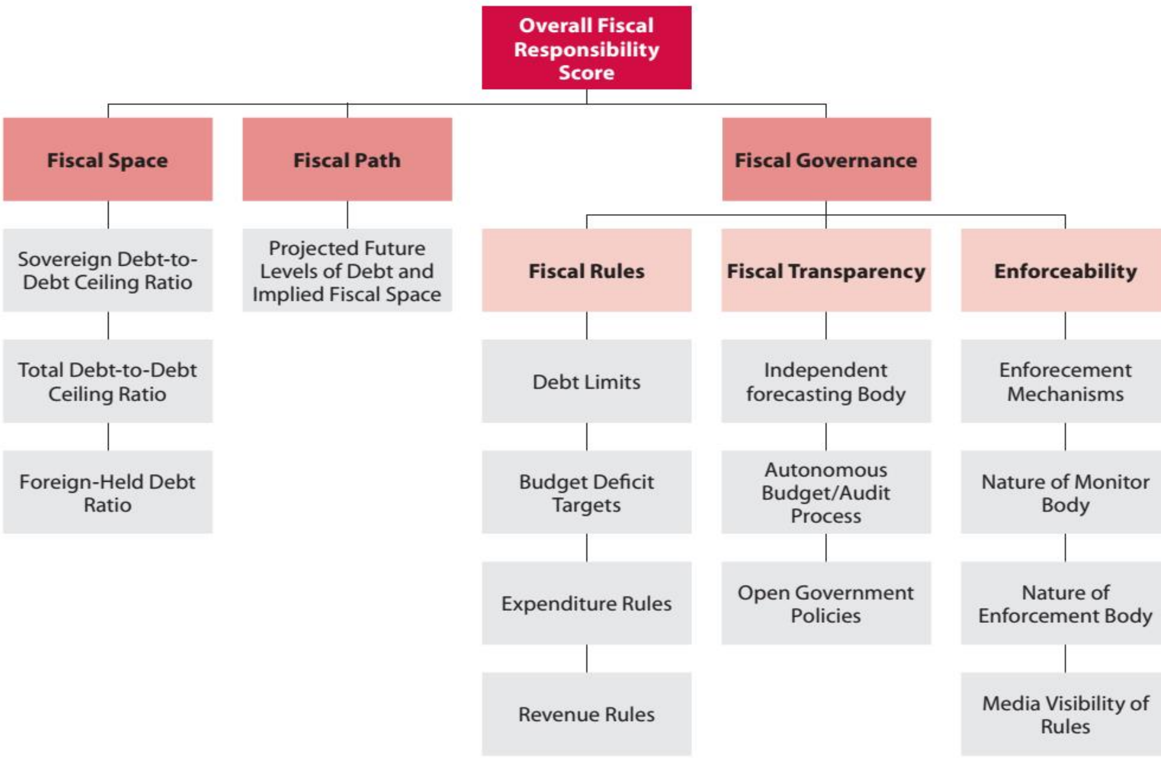
[1] See Yilin Hou 2003: Fiscal Discipline as a Capacity Measure of Financial Management by Sub national Governments - http://unpan1.un.org/intradoc/groups/public/documents/iias/unpan011246.pdf

The second usage, by John Mikesell, upholds Musgraveǿs point against deficit financing, *restraining expenditures to the limits of available finance*,ô and elaborates on fiscal discipline as part of the budgetary control process, óinsuring that enacted budgets are executed, and preserving the legality of agency expendituresô in intent and amount.

The third definition extends the coverage of fiscal discipline to legislators: The legislature should act to ómeet its own deadlines, that is, on resolutions, budget and appropriation bills.
These three interpretations of fiscal discipline are complimentary. Together they form a more complete picture: *Fiscal discipline is meant for all players in governmental finance—legislators, elected officials, civil servants, and citizens as well.*

It is important to underscore that fiscal discipline is more to the three schools of thought postulated above. It is more than managing annual deficits. To a greater extent, it involves creating sound institutions, rules and procedures to regulate the budget process. In addition, the existence of sound enforcement mechanisms is also important to ensure compliance, i.e. fiscal governance.

FIGURE 1: Aspects of Fiscal Discipline



Source: International Monetary Fund (2009), Fiscal Rulesð Anchoring Expectations for Sustainable Public Finances, Working paper SM/09/274, Washington, D.C., IMF

The above diagram outlines three aspects of fiscal discipline: fiscal space which represents the additional amount of debt that a country can raise before it is virtually certain to be in a fiscal crisis; fiscal path which outlines the projected future levels of debt and implied fiscal space and; fiscal governance which outlines rules, transparency and enforceability of budgets.

Of the three, fiscal governance is the most crucial for these simple reasons:

i) Fiscal rules are the most effective methods of maintaining fiscal responsibility. By the force of law, they limit the government ability to spend irresponsibly. For example, New Zealand and Australia that have implemented strong fiscal rules have registered declining debt levels and reasonable government spending.
ii) Fiscal transparency implies governments revealing its spending patterns. This translates into better economic performance and lower sovereign debts. Fiscal transparency is further defined by open government, autonomous budgeting and auditing and independent forecasting.
iii) Fiscal enforceability implies assessment of the degree to which rules and processes are followed and enforced.

1.2 WHY SHOULD GOVERNMENTS PURSUE FISCAL DISCIPLINE?

The main factors underlying fiscal profligacy by county governments include limited revenue authority and dependence on national government transfers.

Fiscal decentralization aims to improve public services but also creates new challenges for the institutions through which governments manage macroeconomic stability and growth. Lack of fiscal discipline at the local level and perverse fiscal behavior by county governments in the case of Kenya could lead to macroeconomic risks.

It is worth-noting that unsustainable fiscal policies can jeopardize the countryҫs international creditworthiness and macroeconomic stability. This proposes the danger of increasing the cost of future borrowing with the ultimate affect of deepening the investor confidence. Therefore, failure to maintain fiscal discipline during implementation of county government budgets could lead to imposition of in-year expenditure cuts and disruption of the county government services.

Similarly, avoidance of difficult recurrent expenditure adjustments could lead to postponement or termination of discretionary types of expenditure, perhaps decreasing the quality and quantity of services. Fiscal discipline not only helps governments avoid the negative consequences of extreme fiscal stress, but also makes a positive contribution to fiscal outcomes.

2.0 FISCAL DISCIPLINE IN KENYAN CONTEXT

In Kenya, Fiscal discipline is clearly stipulated both in the Constitution (2010) and the Public Finance Management Act, 2012. Article 201 of the Constitution, outlines Principles of Public Finance in Kenya, as shown in box 1 below. Subsections *c)* and *d)* are particularly clear on fiscal discipline and performance:

Furthermore, Article 203(e) of the Constitution identifies fiscal capacity and efficiency of County Governments as a criterion for determining the equitable share. Equally, in formulating recommendations relating to the financing of the County Governments, the Commission on Revenue Allocation (CRA) shall consider *fiscal responsibility* (Article 216(3 c).

The Public Finance Management Act, 2012 introduces *fiscal responsibility* principles meaning the principles of public finance specified in Article 201 of the Constitution, together with the principles of fiscal responsibility referred to in section 15, in relation to national government;

a) Over the medium term a minimum of thirty percent of the national and county governments budget shall be allocated to the development expenditure;
b) The national government's expenditure on wages and benefits for its public officers shall not exceed a percentage of the national government revenue as prescribed by regulations;
c) Over the medium term, the national government's borrowings shall be used only for the purpose of financing development expenditure and not for recurrent expenditure;
d) Public debt and obligations shall be maintained at a sustainable level as approved by Parliament for the national government and the county assembly for county government;
e) Fiscal risks shall be managed prudently; and
f) A reasonable degree of predictability with respect to the level of tax rates and tax bases shall be maintained, taking into account any tax reforms that may be made in the future.

Section 107 outlines the principles of fiscal responsibility in relation to a county government as:

a) The county government's recurrent expenditure shall not exceed the county government's total revenue;
b) Over the medium term a minimum of thirty percent of the county government's budget shall be allocated to the development expenditure;
c) The county government's expenditure on wages and benefits for its public officers shall not exceed a percentage of the county government's total revenue as prescribed by the County Executive member for finance in regulations and approved by the County Assembly;
d) Over the medium term, the government's borrowings shall be used only for the purpose of financing development expenditure and not for recurrent expenditure;
e) the county debt shall be maintained at a sustainable level as approved by county assembly;
f) the fiscal risks shall be managed prudently; and

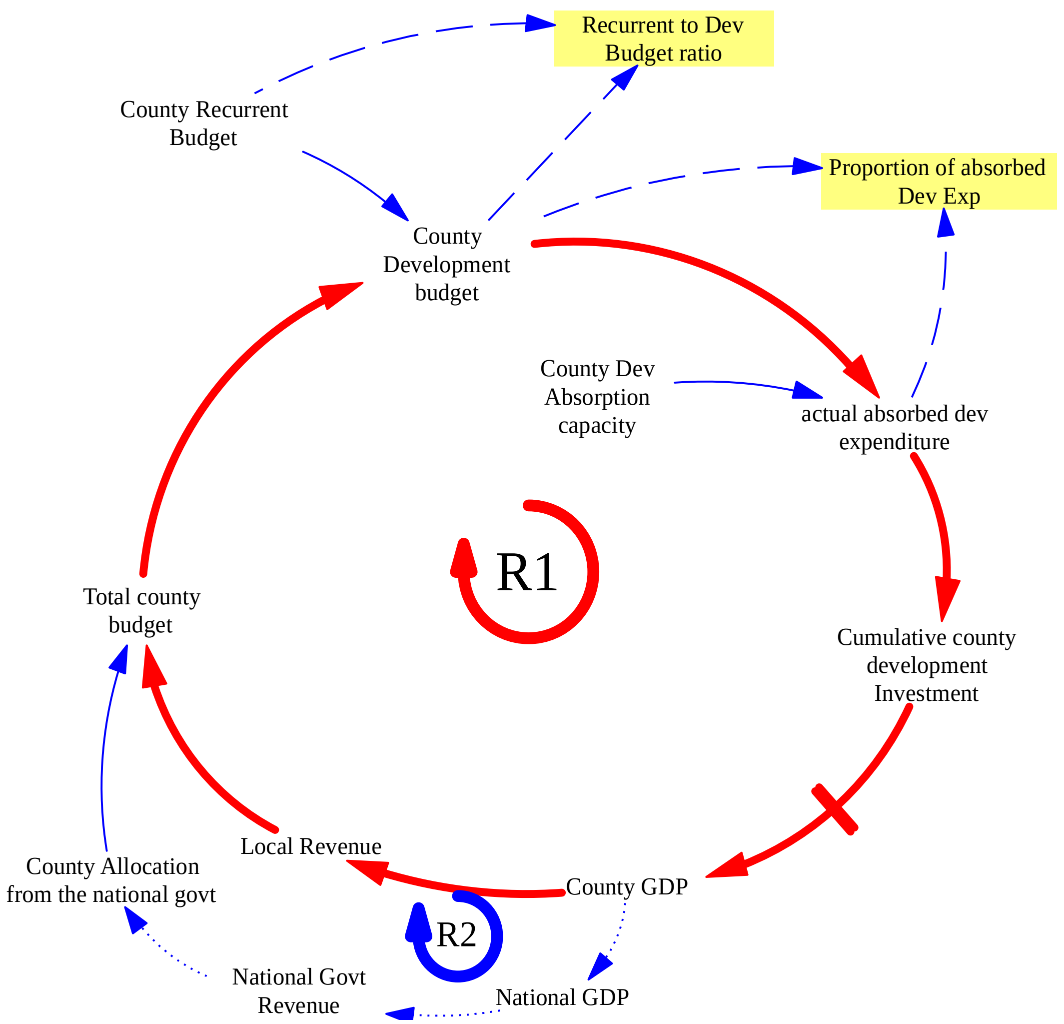
g) a reasonable degree of predictability with respect to the level of tax rates and tax bases shall be maintained, taking into account any tax reforms that may be made in the future.

The revenue sharing formula by the CRA considers population, land area, poverty levels and a countyҫs fiscal discipline. Among the parameters, fiscal discipline is one variable that is likely to remain dynamic and potentially contentious. The First Generation Revenue Sharing Formula by CRA did not objectively take into account fiscal discipline in allocating transferred resources among the forty seven (47) counties; it granted all the 47 counties a constant 2% of the equitable share over a period of three years. It was given that the different counties would adopt themselves to different fiscal behaviors and hence the need for a responsibility measure. Looking at the performance by the County Governments with regard to budget prudence, it is becoming of necessity to define and make this criterion an effective basis for allocating revenues.

Most literature available defines fiscal responsibility as merely a consideration of debt and its potential on sustainability of public finances. Given the uniqueness of the Kenyan case where in the short-run debt has not taken centre-stage in the financing of county government budget, it may be critical to propose a guiding definition that aims to take into account all the causalities of what would be deemed fiscal irresponsibility.

To achieve fiscal responsibility, county governments should employ sound economic and budgetary practices that yield value for the public. The following diagram helps us underscore the implication of fiscal responsibility both on the short-term and long term county financial health including enabling counties to generate own revenue and improve delivery of services to the county populations: The R1 loop shows how countries grow and increase their GDP and own revenue and R2 loop indicate how they, in the long-run contribute to the national growth and GDP.

FIGURE 2:The Generic process through which a county grows and contributes to the National GDP



SOURCE: ICPAK Causal Loop Analysis 2014

The total county budget consists of the equal share allocated from the national government and the amount generated locally referred to as the local revenue. It is from the total revenue basket that counties would henceforth allocate funds for county development. However, an allocation by itself cannot produce results; the results would come from the amounts absorbed in the different allocations. This would further determine the level and quality of investments in the county. It would be from the investments in a given county that the countyӗs GDP would be determined. This would also form a basis for counties to collect revenues. Hence, an increase in a countyӗs GDP would mean an increase in the own revenue basket holding all factors constant and in the long-run increasing the national GDP.

Fiscal discipline in this regard, is the only performance based parameter that acts as an incentive for improved management of devolved resources.

3.0 PROPOSED PARAMETERS FOR MEASURING FISCAL DISCIPLINE

There are varied ways of measuring fiscal performance and discipline of any given economy. As mentioned above, debt management is one of the key parameters for measuring fiscal discipline. However, this paper restricts itself to the Kenyan Constitutional provisions on public financial management and the fiscal responsibility principles as stipulated by the PFM Act 2012 and listed above and that specifically relate to the county governments. Consequently, the Act requires the development of a Fiscal Responsibility Index to measure fiscal discipline. The following parameters are proposed as good measures of determining the level and weighting of fiscal discipline for the counties;

1. Structural balance between recurrent and capital expenditure;
2. The degree of budget absorption in a holistic sense and also the degree by which counties absorb their development budget.
3. The proportion of the direct personnel costs (wages and benefits) against total recurrent expenditures
4. How productive is the tax administration systems employed by the counties to rope maximum own revenue to fund their approved budgets so as to limit instances of dependence on national government transfers and debt.
5. The extent to which county government develop and approve balanced budgets whose funding is envisaged to be wholly by local revenues.
6. Compliance to PFM Systems as measured by the report from both internal audit and the Auditor General.

These would construe the variables in the Fiscal Responsibility Index. Given that fiscal discipline is a measure of different variables, each of the variables proposed to constitute the Fiscal Responsibility Index above would be allocated a ratio. This means that a variable for instance like Structural Balance would receive a certain ratio in the fiscal responsibility index.

3.1 STRUCTURAL BALANCE BETWEEN RECURRENT AND CAPITAL EXPENDITURE

The Fiscal responsibility principles as provided by the PFM Act 2012 point out two critical elements in regard to county public expenditure management:

(i) The county government's recurrent expenditure shall not exceed the county government's total revenue in a given financial year; and

(ii) Over the medium term a minimum of **thirty percent** of the county government's budget shall be allocated to the development expenditure.

In developing a fiscal responsibility index from the above PFM requirement, we assess fiscal discipline as a measure of the structural balances between recurrent and capital expenditure. We propose to quantify the structural balance in the following four ways:

(i) Assess budgets in which capital expenditure are envisaged to be under the threshold of thirty percent and provide no allocation on the basis of this parameter in the index

(ii) For budgets whose capital expenditure is at the thirty percent, provide an allocation of fifty percent of the accessible funds;

(iii) For budget whose allocation to capital expenditure is above thirty percent but below forty, provide an allocation of up to seventy percent of the available funds;

(iv) For capital budget above forty percent of total budget, provide for hundred percent access to the fund;

Denoting the structural balance parameter in the fiscal index as (SB), the horizontal allocation to counties would be computed using the following simple model:

$$\mathbf{SB_i = kA_i}$$

$$\mathbf{SB = kA_1 + kA_2 + \ldots\ldots\ldots + kA_{47}}$$

Where:

$\mathbf{SB_i}$ = Measure of structural balance in the Fiscal Responsibility index of a given County $_i$

i = 1,,2é é é 47

k = 0 for counties whose budgetary allocation to capital expenditure under the thirty percent threshold

= 0.5 for counties whose budgetary allocation to capital expenditure is at the thirty percent

= 0.7 for counties whose budgetary allocation to capital expenditure is above thirty percent but below forty

= 1 for counties whose budgetary allocation to capital expenditure is above forty percent.

A = total available funds allocable under this parameter in the ratio proposed

For example from the FY 2014/15 equitable share of Ksh. 221,175,000,000 that is to be shared among the 47 counties, a percentage is sharable under the fiscal responsibility (FR) parameter. Assuming the Fiscal Responsibility parameter is allocated a 20% share in the horizontal sharing formula, Ksh. 44, 235,000,000 would be available for sharing under this parameter. This would further be shared among counties in the ratios proposed under the Fiscal Responsibility Index / formula.

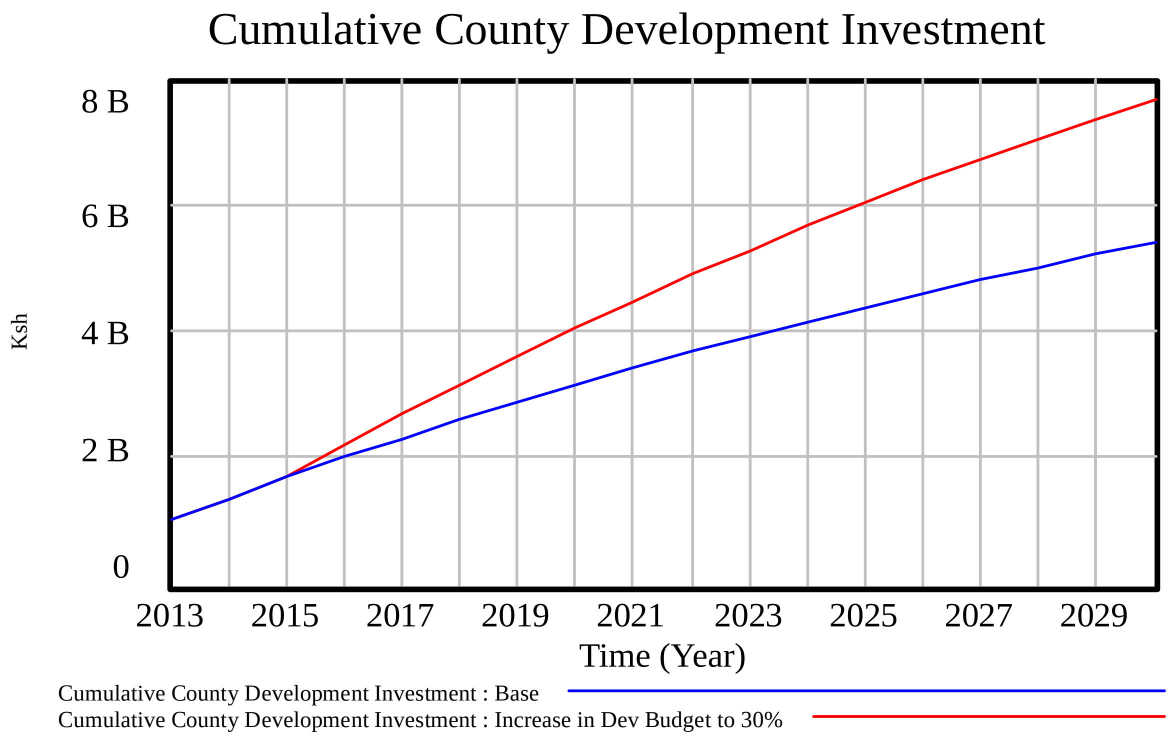
As illustrated by the table below, if this scenario is maintained throughout the fiscal year, it will mean that only Bomet, Machakos and Kakamega would have satisfied the fiscal responsibility principle on a minimum 30% allocation to the development expenditure. Equally, in the same vein, some counties namely Mombasa, Lamu and Mandera did not have any expenditure on development despite them having funds released for development expenditure:

County	TOTAL EXPENDITURE ANALYSIS(PERCENTAGE)			
	Personal Emoluments	**Operation and Maintenance**	**Development Expenditure**	**Debt repayment and Pending Bills**
Baringo	52.4	41.3	6.3	0
Bomet	30.5	26.8	42.7	0
Bungoma	44.6	45.5	9.8	0
Busia	44.2	48.2	7.6	0
Elgeyo/Marakwet	77	16.8	6.2	0
Embu	62	36.8	1.2	0
Garissa	34.1	52.3	13.6	0
Homabay	50.1	36.4	13.5	0
Isiolo	41	51	8	0
Kajiado	56	37	7	0
Kakamega	45	21	33	1
Kericho	60	24	15	1
Kiambu	70	22	8	0
Kilifi	52.5	31.8	15.5	0
Kirinyaga	52	39	9	0
Kisii	57	19	24	0.5
Kisumu	73	23	1	3
Kitui	63	30	7	0
Kwale	39	49	11	1
Laikipia	52	37	10	1
Lamu	60	40	0	0
Machakos	34	25	41	0
Makueni	44	47	9	0
Mandera	36.8	63.2	0	0
Marsabit	40	44	16	0.3
Meru	52.6	39.1	8	0.3
Migori	44	47	9	0
Mombasa	58	42	0	0
Murangĝa	46	27	27	0
Nairobi City	55	17	9	
Nakuru	58	38	3	1
Nandi	40	53	7	0
Narok	44	52	4	0
Nyamira	27	51	20.8	0
Nyandarua	51	35	14	0
Nyeri	54	25	21	0
Samburu	42	41	17	0
Siaya	43.1	47.5	9.4	0
Taita/Taveta	61	26	13	0
Tana River	34.9	59.6	5.4	0
Tharaka Nithi	42	37	21	0
Trans Nzoia	47	41	12	0
Turkana	60		40	0
Uasin Gishu	69	26	5	0
Vihiga	42	48	10	0
Wajir	27	42	31	0

West Pokot	48.47	32.92	18.6	0

Source: Controller of Budget: County Budget Implementation Review Report, Quarter 3 FY 2013-14

We assumed a case of a county that allocated twenty percent (20%) of its total revenue in the FY 2014/15 and simulated the same in a model. Assuming its cumulative development investment in the year 2015 is worth one billion Kenyan shillings, the county would by the year 2030, maintaining the same allocation of 20% would have increased its cumulative county development to slightly above KSh. 5b. If the same county increased the allocation to development to 30% in the year 2015 its cumulative development investment would be to the tune of Ksh. 8billion. This is illustrated in the table below:



3.2 Absorption capacity

Absorption capacity of funds allocated is an important yardstick in determining fiscal discipline to the County Governments. While we have stated above that striking the structural balance between recurrent and capital expenditure would earn a higher allocation to the county, this should be assessed relative to the degree of absorption of the development budget relative to the actual budgetary allocation.

The proposal will mean that counties with low percentages of absorption get a lower share. Increasing ratios of absorption would attract a higher allocation as illustrated below:

- Below fifty percent absorption would lead to no allocation under this parameter

- Fifty to seventy percent absorption rate would lead to fifty percent allocation under this parameter
- Over seventy percent absorption rate would lead to full allocation (100%) under this parameter.

Denoting the absorption capacity parameter in the fiscal index as (AC), the horizontal allocation to counties would be computed using the following simple model:

$$\mathbf{AC_i = kA_i}$$

$$\mathbf{AC = kA_1 + kA_2 + \ldots\ldots\ldots + kA_{47}}$$

Where:

AC_i = Measure of absorption capacity in the Fiscal Responsibility index of a given County $_i$
i = 1,,2é é é 47
k = 0 for counties whose absorption capacity is below 50% i.e 0ÓACÒ50
= 0.5 for counties whose absorption capacity is fifty to seventy percent i.e 50ÓACÒ70
= 1 for counties whose absorption capacity is over70% i.e 70ÓACÒ100
A = total available funds allocable under this parameter in the proposed ratio
This would prompt counties to work towards 100% absorption by ensuring they have in place effective project implementation and monitoring teams. We make an assumption that there will be no externalities involved and that the relevant organs including the National Treasury, the National Assembly, the Senate, the Auditor General, the Controller of Budgets and the County Assemblies will work on the prescribed timelines to allow for timely disbursal of funds.

In the FY 2013/14 County Government recorded low absorption of development budgets. The recurrent expenditure during the period represented an absorption rate of **45 per cent** of the total recurrent budget for the county governments while development expenditure translated to an absorption rate of **11.7 per cent** of the total development budget for FY2013/14 as illustrated below:

FIGURE 3: ABSORPTION RATES JULY 2013 - MARCH 2014

County	Total Budget	Budget of the two arms of County Governments		Expenditure by the two arms of County Governments		Absorption Rates	
		County Assembly Budget	County Executive Budget	County Assembly Expenditure	County Executive Expenditure	County Assembly	County Executive
MANDERA	6,987,632,929	880,721,416	6,106,911,513	175,604,728	942,087,672	19.9%	15.4%
MARSABIT	3,840,008,898	415,043,304	3,424,965,594	95,697,528	840,872,499	23.1%	24.6%
MERU	5,681,680,382	810,477,204	4,871,203,178	359,768,752	2,008,216,558	44.4%	41.2%
MIGORI	5,530,654,457	848,935,737	4,681,718,720	215,973,202	1,578,940,315	25.4%	33.7%
MOMBASA	11,686,014,896	855,841,396	10,830,173,500	271,313,611	2,397,981,011	31.7%	22.1%
MURANGA	5,621,869,067	497,556,000	5,124,313,067	164,398,453	1,778,956,285	33.0%	34.7%
NAIROBI	25,225,181,329	1,620,201,208	23,604,980,184	598,336,042	12,424,665,713	36.9%	52.6%
NAKURU	10,038,042,113	979,547,831	9,058,494,282	490,746,634	2,812,425,435	50.1%	31.0%
NANDI	3,899,794,019	704,040,331	3,195,753,688	296,216,795	994,547,737	42.1%	31.1%
NAROK	8,083,853,311	701,915,629	7,381,937,682	229,101,730	2,295,547,636	32.6%	31.1%
NYAMIRA	3,415,715,932	658,734,200	2,756,981,732	189,748,990	1,131,200,182	28.8%	41.0%
NYANDARUA	3,639,860,739	546,860,002	3,093,000,737	201,267,574	1,103,824,544	36.8%	35.7%
NYERI	4,550,415,709	598,654,331	3,951,761,378	258,876,272	1,508,976,468	43.2%	38.2%
SAMBURU	2,906,460,855	447,767,621	2,458,693,234	104,875,393	776,876,406	23.4%	31.6%
SIAYA	4,264,097,958	664,608,056	3,599,489,902	184,976,070	831,844,031	27.8%	23.1%
TAITA TAVETA	2,858,870,449	417,474,217	2,441,396,232	90,086,874	809,058,078	21.6%	33.1%
TANARIVER	3,206,097,123	511,164,000	2,694,933,123	128,377,670	633,943,908	25.1%	23.5%
THARAKA NITHI	2,518,590,070	260,281,769	2,258,308,301	162,711,552	786,344,137	62.5%	34.8%
TRANS-NZOIA	4,424,512,783	641,699,379	3,782,813,404	185,880,468	1,468,893,963	29.0%	38.8%
TURKANA	8,145,087,939	1,196,834,342	6,948,253,597	342,025,655	1,947,478,086	28.6%	28.0%
UASIN GISHU	5,727,883,679	573,391,967	5,154,491,712	250,477,949	1,217,922,308	43.7%	23.6%
VIHIGA	3,263,931,119	696,718,231	2,567,212,888	227,997,648	726,836,175	32.7%	28.3%
WAJIR	5,413,561,682	400,428,626	5,013,133,056	228,461,075	1,388,866,671	57.1%	27.7%
WEST POKOT	3,631,252,476	404,846,804	3,226,405,672	176,564,446	824,264,848	43.6%	25.5%
Total	**269,134,214,016**	**31,396,437,854**	**237,737,776,222**	**11,274,607,483**	**75,432,873,254**	**35.9%**	**31.7%**

Source: *Controller of Budget Quarter III Report - June 2014*

3.3 PROPORTION OF THE DIRECT PERSONNEL COSTS AGAINST TOTAL RECURRENT EXPENDITURES

The PFM Act states that the county government's expenditure on wages and benefits for its public officers shall not exceed a percentage of the county government's total revenue as prescribed by the County Executive Member for Finance in regulations and approved by the County Assembly. While this principle is important in capping the public service wage bill and freeing-up resources for development and service delivery there is no uniform ceiling across the forty seven county governments to ensure consistency of assessment.

The Controller of Budget Report (Feb 2014) indicated that the Counties wage bill for the first six months of the Financial Year 2013/14 was 47.8 percent of the total counties expenditures. With this trend, the wage bill is bound to increase beyond control in the long run. There is therefore an urgent need to conduct a staff rationalization and harmonization exercise at both levels of government to check on the wage bill.

Between July 2013 to March 2014, counties spent a total of 42.9 billion on personal emoluments to the staff. This translates to 49.5% of the total expenditure. This comes at a time when the controller of budget noted non compliance with circulars from Salaries and Remuneration Commission (SRC) and Transition Authority (TA) regarding remuneration and allowances, managing the wage bill and employment of ward staff by the county assemblies.

The 42.9 billion spent on emoluments represents 56% of the recurrent expenditure for the period. This begs the question as to whether the proportion is appropriate at a time when the national government is struggling to bring down its wage bill and to what extent can wage bill as a factor could be used to determine the level of discipline in the counties.

If this parameter was to be applied, counties with more than 50% of their recurrent expenditure going to personal emoluments can be regarded as undisciplined. This would make counties recruit when there is need and maintain a lean workforce as opposed to a scenario whereby both the County Assembly Public Service Board and the County Public Service Boards are recruiting, leading to a bloated and unsustainable wage bill.

Table: **County recurrent expenditure wage bill proportion**

County	**Personal emoluments**	**recurrent expenditure**	% of Recurrent	**Total expenditure**	**% to expenditure**
Baringo	667.403	1194.5	56%	1274.404	52%
Bomet	595.544	1120.2	53%	1955.669	30%
Bungoma	824.29	1665	50%	1846.707	45%
Busia	705.251	1474.1	48%	1596.715	44%
Elgeyo/Marakwet	614.446	748.2	82%	797.731	77%
Embu	572.983	912.7	63%	923.516	62%
Garissa	315.533	800	39%	926.01	34%
Homabay	826.911	1490.5	55%	1722.333	48%
Isiolo	253.941	572.4	44%	619.407	41%
Kajiado	802.774	1324.4	61%	1425.117	56%
Kakamega	1256.972	1858.1	68%	2775.831	45%
Kericho	1031.885	1461.8	71%	1722.645	60%
Kiambu	2299.329	3010.4	76%	3291.073	70%

County	Personal emoluments	recurrent expenditure	% of Recurrent	Total expenditure	% to expenditure
Kilifi	1239.937	1991.5	62%	2358.142	53%
Kirinyaga	549.755	970.8	57%	1064.881	52%
Kisii	1265.501	1696.2	75%	2232.362	57%
Kisumu	1450.294	1970.2	74%	1992.213	73%
Kitui	1037.646	1529.6	68%	1637.294	63%
Kwale	484.028	1102	44%	1244.227	39%
Laikipia	669.894	1153.2	58%	1275.617	53%
Lamu	260.706	436.7	60%	436.654	60%
Machakos	1196.298	2103.6	57%	3542.804	34%
Makueni	519.792	1077.2	48%	1186.06	44%
Mandera	410.882	1117.7	37%	1117.692	37%
Marsabit	374.443	789.4	47%	936.57	40%
Meru	1246.486	2179.3	57%	2367.985	53%
Migori	779.998	1625.6	48%	1794.913	43%
Mombasa	1546.641	2669.3	58%	2669.294	58%
Murang'a	945.464	1419.5	67%	1943.354	49%
Nairobi City	7102.169	11831.9	60%	13023.001	55%
Nakuru	1922.045	3221.5	60%	3303.172	58%
Nandi	524.384	1204.6	44%	1290.764	41%
Narok	1096.545	2408.8	46%	2524.649	43%
Nyamira	364.556	1046.3	35%	1320.949	28%
Nyandarua	668.528	1117.6	60%	1305.092	51%
Nyeri	958.84	1392.1	69%	1767.852	54%
Samburu	367.084	731.2	50%	881.751	42%
Siaya	437.81	921	48%	1016.82	43%
Taita/Taveta	547.33	782.2	70%	899.144	61%
Tana River	266.348	720.9	37%	762.321	35%
Tharaka Nithi	394.366	748.9	53%	949.055	42%
Trans Nzoia	771.951	1458.7	53%	1654.774	47%
Turkana	391.294	1378.3	28%	2289.503	17%
Uasin Gishu	1009.091	1398.3	72%	1468.4	69%
Vihiga	403.223	859.4	47%	954.833	42%
Wajir	435.128	1116.4	39%	1617.327	27%
West Pokot	485.139	814.7	60%	1000.829	48%
	42890.858	74616.9			
AVERAGE			**56%**		**48%**

Source: Controller of budget report third quarter FY 2013/2014

According to the Salaries and Remuneration Commission, the internationally acceptable ratio of wage bill to total recurrent expenditure of any government ought not to exceed forty percent (40%). It is proper that we adopt this benchmark as a threshold for assessing fiscal responsibility with regard to personnel costs.

We propose that County Governments seek to curb their direct personnel costs to the internationally acceptable benchmark of 40%. The proposal will mean that Counties whose personnel costs are:

- Below the 40% threshold should be allocated 100% of the funds available under this parameter.
- At 40% threshold should be allocated 75% of the funds available under this parameter
- Above 40% but not more than 50% should be allocated 50% of available funds under this parameter
- Above 50% should not be considered for allocation of available funds under this parameter.

Denoting the Proportion of the direct personnel costs against total recurrent expenditures parameter in the fiscal index as (PC), the horizontal allocation to counties would be computed using the following simple model:

$$\mathbf{PC_i = kA_i}$$

$$\mathbf{PC = kA_1 + kA_2 + ... + kA_{47}}$$

Where:
$\mathbf{PC_i}$ = Measure of PC in the Fiscal Responsibility index of a given County $_i$
$\mathbf{i}$ = 1,,2é é é 47
k = 0 for counties whose direct personnel costs are way above the internationally acceptable benchmark of 40%. i.e >50%
= 0.5 for counties whose direct personnel costs are between 40- 50%
= 0.75 for counties whose direct personal costs are capped at 40%
= 1 for counties whose direct costs are below the 40% mark.
A = total available funds allocable under this parameter in the ratio proposed

3.4 OWN REVENUE GENERATION

Own-revenue capacity is a cornerstone of local fiscal discipline, particularly in a decentralized environment. Without access to their own revenue, County Governments have fewer options when faced with fiscal pressure (or even with year-to-year infrastructure development needs).

Since their inception, counties have relied heavily on the equitable share transfers from the National Government with most not going an extra mile to achieve their revenue targets.

In the FY 2013/14, nine months down the line with only a quarter remaining to year end, as illustrated below, most counties did not attain half their annual revenue targets. Only Bomet, Homabay, Kericho, Marsabit, Nairobi, Nyeri, Samburu, Tharaka Nithi and West Pokot attained above 50% of their annual revenue targets. In period under review, counties cumulatively generated 19.1 billion against an annual target of 61 billion translating to 31.3% of the total revenue targets as illustrated below:

Table: **Analysis of County Government Local Revenue Versus Targets Up To The Third Quarter FY 2013/14**

County	**Annual Local Revenue Estimates**	**Realized revenue by March 2014**	**Realized Revenue as a % of the Annual Local Target Revenue**
Baringo	360	129.603	36%
Bomet	245	136.639	56%
Bungoma	2,753.78	139.476	5%
Busia	632.4	199.247	32%
Elgeyo/Marakwet	85	38.267	45%
Embu	659.165	87.111	13%
Garissa	150.53	27.451	18%
Homabay	140.68	98.868	70%
Isiolo	360	100.941	28%
Kajiado	517	209.544	41%
Kakamega	3,500.00	150.548	4%
Kericho	338.692	209.308	62%
Kiambu	3,058.57	869.541	28%
Kilifi	2,064.09	330.772	16%
Kirinyaga	437.99	146.072	33%
Kisii	1,229.19	171.819	14%
Kisumu	3,417.12	466.653	14%
Kitui	713.85	178.56	25%
Kwale	642.36	127.765	20%
Laikipia	557.17	178.825	32%
Lamu	86.124	18.75	22%
Machakos	2,541.87	866.245	34%
Makueni	350	116.576	33%
Mandera	437.4	62.986	14%
Marsabit	44	28.716	65%

Meru	658	208.049	32%
Migori	795.37	164.61	21%
Mombasa	5,074.62	1380.538	27%
Murangôa	1,300.04	319.849	25%
Nairobi City	15,448.05	7783.94	50%
Nakuru	3,076.74	1191.426	39%
Nandi	422.472	82.673	20%
Narok	4,216.26	1251.077	30%
Nyamira	100	33.249	33%
Nyandarua	204.7	82.864	40%
Nyeri	479.05	285.749	60%
Samburu	223.55	156.598	70%
Siaya	153.47	71.754	47%
Taita/Taveta	241.19	86.589	36%
Tana River	87.29	24.334	28%
Tharaka Nithi	84.16	52.72	63%
Trans Nzoia	501.5	131.004	26%
Turkana	250	99.204	40%
Uasin Gishu	1,946.18	417.101	21%
Vihiga	204.27	77.455	38%
Wajir	119.03	36.546	31%
West Pokot	38	29.36	77%
Total	**60,945.92**	**19,056.97**	
Average percentage		**31%**	

Source: Controller of budget report third quarter FY 2013/2014

Assuming we are using the percentage revenue collected to measure the level of fiscal discipline, only the counties listed above would be ranked as disciplined and hence attracting more allocations. That would probably motivate the underperforming counties mainly because most of them have not fully exploited their potential as they are collecting less than what the defunct local authorities collected.

It is prudent that county Governments seek to maximize own revenues to check against overreliance on national transfers. We therefore propose the following criteria to be adopted in assessing this aspect of fiscal responsibility:

- Counties that realize 80% or above of their projected revenue targets out of own sources should be allocated 100% of the funds available under this parameter.

- Counties that realize between 50% and 80% of their projected revenue targets out of own sources should be allocated 50% of the funds available under this parameter
- Counties that realize below 50% of their projected revenue targets out of own sources should get nil allocation under this parameter.

Denoting own revenue generation parameter in the fiscal index as (R), the horizontal allocation to counties would be computed using the following simple model:

$$\mathbf{R_i = kA_i}$$

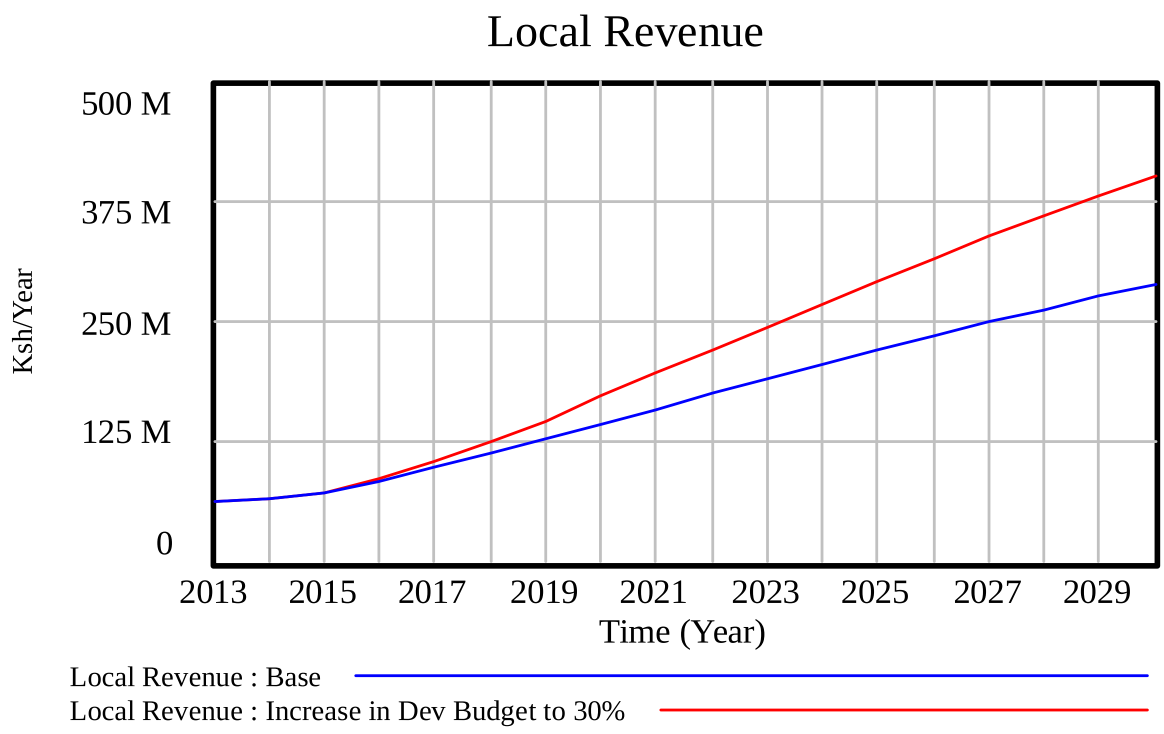
$$\mathbf{R = kA_1 + kA_2 + \ldots\ldots\ldots + kA_{47}}$$

Where:
R_i = The rate of change of own Revenue in the Fiscal Responsibility index of a given County $_i$
i = 1,,2é é é 47
k = 0 for counties that realize below 0.5% of their projected revenue targets
= 0.5 for counties that realize below 50-80% of their projected revenue targets
= 1 for counties that realize below 80% and above of their projected revenue targets
A = total available funds allocable under this parameter in the ratio proposed

In considering the above criteria in this parameter, the CRA would need to further assess the revenue projections alongside the revenue potential of the individual counties. In this regard, there must be an effort to check against fiscal profligacy by County Governments which include limited own revenue and dependence on National Government transfers. Further, there is need to institute mechanisms to curb against counties setting easily achievable revenue targets.

k could also be a measure of the rate of increase in the amount of revenues collected when compared to previous periods or years. Revenue growth and or improvement will encourage counties to keep thinking how to improve efficiency in collection in order to increase local revenues.

A simulation was conducted of the impact of a slight increase in the development allocation on the local revenue in the long run and the results was a corresponding increase in the local revenue as illustrated below; a county that collects KSh. 100million would by 2030collect to a tune of KSh. 400million as a result of one digit increase in the development allocation.



3.5 Compliance with Public Finance Management Systems

Prudence in the utilization of public finances and compliance to the set PFM systems are the cornerstones of our public finance system in Kenya. In regard to fiscal discipline, compliance can be measured at various levels:

(i) Compliance to the public finance principles set by article 201 of the Constitution and sections 35 and 105 the PFM Act;

(ii) Fidelity to the timelines in the budgeting process such as development of County Integrated Development Plans, County Fiscal Strategy Papers, Debt Management Strategy Papers, County Budget and Outlook Paper among others as outlined by the law. This will also contribute to fiscal efficiency at the County level.

(iii) An effective internal audit system;

(iv) Compliance to internal and public procurement and assets disposal law and regulations;

(v) Fiscal reporting should simple and clear: The County Governments should adopt templates as prescribed by the Public Sector Accounting Standards Board;

(vi) Fiscal transparency: Availability of fiscal data to the public through the website or hard copies, Braille or other accessible channels.

There are notable examples of non-compliance such as disregard of the budgetary allocations. For instance, in the just completed FY 2013/14, reports on implementation of county budgets showed that some Counties failed to spend on what was budgeted for and such reallocations directed to the lesser priority areas. Absence of limits and ceilings made the budget implementers lack the incentive to suspend lower priority areas.

A number of counties in the past nine months also seemed to have ignored the directive by the Transition Authority not to commit or settle any liabilities and outstanding bills awaiting verification. A total of 2.96 Billion was utilized in payment of debts and outstanding bills in disregard to the directive.

According to the report by controller of budget, Busia and Laikipia counties exceeded their allocation on local and international travel by 31% and 4 % respectively with Nyeri, Tana River, Kericho and Vihiga motor vehicle purchases absorption at 169.4%, 158.6%, 109.2% and 107.9% respectively.

It is prudent that county Governments seek to comply with laid down public financial management systems as a measure of fiscal accountability. We therefore propose the following criteria on the audit opinions by the Auditor General to be adopted in assessing this aspect of fiscal responsibility:

- Unqualified opinion by the Auditor General should guarantee a county 100% of the available funds under this parameter.
- Qualified opinion by the Auditor General should guarantee a county 75% of the available funds under this parameter.
- Adverse opinion by the Auditor General would lead to a 50% of the available funds under this parameter to the County.
- Disclaimer of opinion by the Auditor General should lead to NIL allocation under this parameter.

Denoting compliance with the Public Finance Management Systems in the fiscal index as (CF), the horizontal allocation to counties would be computed using the following simple model:

$$\mathbf{CF_i = kA_i}$$

$$\mathbf{CF = kA_1 + kA_2 + \ldots\ldots\ldots + kA_{47}}$$

Where:
CF_i = Measure of compliance with PFM systems in the Fiscal Responsibility index of a given County $_i$
i = 1,,2é é é 47

k = 0 for counties whose Auditorôs opinion would be a Disclaimer of opinion
= 0.5 for counties whose Auditorôs opinion is Adverse
= 0.75 for counties with a Qualified opinion from the Auditor General
= 1 for counties with an unqualified opinion from the Auditor General
A = total available funds allocable under this parameter in the ratio proposed

3.6 GENERAL CRITIQUE OF THE FIRST GENERATION FORMULA

The constitution provides guidelines for a review of the formula based allocation criteria. It provides that the process of review should be guided by the following generally accepted principles:

- Provide adequate resources to the county governments to perform their mandated functions
- Enhance equity and fairness and support a fair allocation of resources.
- Ensure stability by providing transfers in a predictable manner
- The formula should be simple and transparent,
- The formula should not create negative incentives for local revenue mobilization, and should not induce inefficient expenditure choices.
- Focus should be on service delivery
- As a principle the equal shares should not be a major allocation factor since this assumes that all Counties are at the same level yet this is not the case.
- While the allocation mechanism would favour marginalised areas and communities in the effort to bring them closer to the other communities, care should be taken to avoid making these other communities worse off.

The golden rule of devolution is that funding follows functions hence, the funds allocation to counties should be based on the functions currently being undertaken by the county governments. To this end we submit that the first generation formula that includes the population, poverty, equal share and land area variables does not relate directly to the functionality of the counties. The equitable share formula should incorporate the need for financing constitutionally mandated basic services under schedule 4 of the constitution. A revision of the formula to capture direct aspects of the functions is necessary.

From the above submissions however, we strongly submit that fiscal responsibility is a critical parameter in the determination of the horizontal revenue share. It will be prudent to rein in on counties in light of the thrift spending that characterized budget implementation in the last fiscal year.

Further, we are of the opinion that an allocation of twenty percent to equal share is no longer policy-wise given the objective which informed the weight may have been achieved by the more prudent counties. This allocation was initially weighted at twenty five per cent was intended to allow for counties to set the necessary infrastructure in readiness for effective implementation of devolution.

Effectively, the weight should now be re-balanced to given prominence to fiscal responsibility which has now become a more sensible measure of prudence and the behavior of the county government has demonstrated dire need for focus on this area. In light of this argument, we propose adjustment to the weights of the First Generation Formula as follows:

Parameter	**Population**	**Equal Share**	**Poverty**	**Land Area**	**Fiscal Responsibility**	**Total**
Current Weight (%)	45	25	20	8	2	100
Proposed weight	40	12	20	8	**20**	100

3.7 WEIGHING FISCAL RESPONSIBILITY

From the above parameters, fiscal responsibility measure is a weighty measure that requires serious consideration in the horizontal revenue share formula. To gauge the level of responsibility, fiscal discipline is computed through assigning weights to the above discussed parameters. In the following formula, we propose weights to the above parameters to enable an objective measure of fiscal responsibility:

$$\mathbf{FR_i = SB_i + AC_i + R_i + PC_i + CF_i}$$

Where:

FR_i = Measure of Fiscal Responsibility of a given County *i*

i = 1,,2é é é 47.

SB_i = Revenue allocated to a county on the basis of Structural Balance between Recurrent and Capital Expenditure parameter.

AC_i = Revenue allocated to a county on the basis of Absorption Capacity parameter.

R_i= Revenue allocated to a county on the basis of Own Revenue generated.

PC_i = Revenue allocated to a county on the basis of Proportion of Direct Personnel Costs against total recurrent expenditure parameter.

CF_i= Revenue allocated to a given county on the basis of a countyĝs compliance with PFM requirements and structures

An objective scale of measuring Fiscal Responsibility (FR_i) can be formulated within the range of either 0 ï 1 or 0-10. A mean of the individual scores for instance if SB = 0.75; AC=0.5; PC=1; R=0.5 & CF=1, the FR_i index would be (SB+AC+R+PC+CF)/5= 0.75 (which is between 0 and 1. We suggest FR_i to be of a significant weighted measure of about twenty percent of the total allocation of the revenue to be shared to all counties. The parameters weights should henceforth be a ratio of this in the following manner:

$\mathbf{FR_i = SB_i:AC_i:R_i:PC_i : CF_i}$ where $\mathbf{FR_i = 2:3:5:3:7}$ respectively.

This would give compliance with PFM requirements a weightier measure among the parameters.

3.8 COMPARATIVE JURISPUDENCE

Internationally, most countries do not consider fiscal discipline as a parameter for revenue share however, they have formulated fiscal responsibility laws institutions of governments in the same economyð national and sub-national can commit to help avoid irresponsible fiscal behavior that could have short-term advantages to one of them but that would be collectively damaging.

Coordination failures with sub-national governments in the 1990s contributed to macroeconomic instability and led several countries to adopt fiscal responsibility laws as part of the remedy. The fiscal responsibility laws in Argentina, Australia, Brazil, Canada, Colombia, India, and Peru are designed to address the short time horizons of policymakers, free riders among government units, and principal agent problems between the national and sub-national governments.

We explore some of the methodologies in the different countries:

Chile

Chileøs structural balance methodology is based on the criteria used by the International Monetary Fund (IMF) and the OECD, with some adjustments to take account of the specific characteristics of the countryøs public sector finances. Conceptually, the central government structural balance isolates the impact of the economic cycle on public finances, providing a long-term picture of the fiscal situation in contrast to the effective balance which reflects the situation prevailing at a particular moment.

In other words, the structural balance estimates the fiscal income that would be obtained independently on the phase of the cycle, whether it is positive or negative. This involves estimating the fiscal income that would be received if the economy were growing at its trend rate and, in practice, means adjusting income in line with a parameter that captures the gap between effective GDP and its trend level.

The cyclical impact of GDP on fiscal income is evident, as there a strong correlation between total fiscal income ï and particularly tax revenue ï and economic activity as measured by GDP.

Canada, in the 1990s both the federal and provincial governments needed serious fiscal corrections to reverse chronic fiscal deficits and growing debt burden after years of lax fiscal policy. The drive for restoring fiscal health was viewed as means to help accelerate economic growth. The deteriorating sovereign ratings increased the cost of borrowing, and private saving was not sufficient to finance both private investments and chronic fiscal deficits (Traclet 2004). The federal government undertook legislative reforms during the 1999s: enacting the Federal Spending Control Act (1991) setting limits on spending, and adopting a new framework to meet the medium-term fiscal balance and decrease debt ratio with rolling short-term deficit targets. Such measures succeeded in significantly reducing the national debt (IMF, 2

The **Indian** Constitution forbids states from borrowing abroad and requires them to obtain central permission for domestic borrowing. The central government places limits on statesô borrowing through the annual discussions with states on financing state development plans. While limiting explosive growth of state debt, the system has not prevented deterioration of fiscal trends as indicated by high levels of debt over GSDP in many states in the late 1990s. Factors contributing to the deteriorating fiscal accounts across Indian states in the 1990s include: rapid increase in expenditures on salaries, retirement benefits, and pensions and subsidies, increased borrowing to support the growing revenue deficit, and growth in contingent liabilities associated with fiscal support to the public sector units, cooperatives, and the statutory boards.

Since the early 2000s, the fiscal reform has focused on moving towards a more flexible, market -linked borrowing regime within sustainable overall borrowing caps imposed by the central government and self-imposed state-level deficit caps. The federal government enacted Fiscal Responsibility and Budget Management Act in 2003 which applies to the national government only, but some states had also adopted their own FRLs before the enactment of the federal FRL (e.g., Karnataka and Punjab in 2002) and many states have since 2003 adopted FRLs in line with the national law. FRL has become mandatory after the Twelfth Finance Commission (2005) and the federal government has offered a sizeable incentive to states for passing FRL.

Australia:

The idea of legislating for fiscal responsibility gained considerable attention in the 1990s in Australia. At the federal level, the Business Council of Australia called for legislation requiring a surplus budget on average over the business cycle. It reiterated this theme during the 1996 federal election campaign. The adoption of the Charter of Budget Honesty Act in 1998 at the federal level followed years of improvement in fiscal outcomes. In fact, in the mid-1980s, Australia adopted its first set of explicit fiscal rules limiting the growth of expenditure, taxation and budget deficit. Although the recession in the 1990s saw the net debt of the country increased, never went beyond 20 percent of GDP. The combined state and Commonwealth general government net debt had not exceeded 30 percent of GDP in the 1990s

4.0 CONCLUSION

Fiscal discipline is one of the key parameters in the formula approved by Parliament for determining the revenue share between the counties. The CRA and National Treasury have consistently given mentions to this parameter without elaborating the extent of adherence by counties. Article 217 (1) of the Constitution further requires the Senate to, once in every five years, determine the basis for allocating among the counties, the share of national revenue that is annually allocated to the county level of government. This requires an objective analysis of the current parameters; fiscal discipline included in order to advice the next review of the allocation criterion. The preliminary factors proposed in this paper could be used by the relevant institutions to set the discussion rolling as to what constitutes fiscal discipline in Kenya and how fiscal discipline as a parameter could be determined and measured.

Finally, we wish to implore the CRA to issue a policy definition to demystify the concept of Fiscal Responsibility and develop manuals and guidelines on the same. The submissions of the Institute can be a useful guide in this regard.

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