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KENYA ECONOMIC UPDATE

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Navigating the storm, Delivering the promise

with a special focus on Kenya's momentous devolution

Australian AID

THE WORLD BANK

Poverty Reduction and Economic Management Unit Africa Region

Navigating the storm, Delivering the promise

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ABBREVIATIONS AND ACRONYMS

CBK	Central Bank of Kenya
CBR	Central Bank Rate
CCK	Communication Commission of Kenya
CDD	Community-Driven Development
CDF	Constituency Development Fund
CIC	Commission on Implementation of the Constitution
CRA	Commission on Revenue Allocation
CRR	Cash Reserve Ratio
GDP	Gross Domestic Product
EAC	East African Community
ERS	Economic Recovery Strategy
ICT	Information and Communication Technology
KANU	Kenya African National Union
KES	Kenya Shillings
KEU	Kenya Economic Update
KNBS	Kenya National Bureau of Statistics
KRA	Kenya Revenue Authority
KTB	Kenya Trourism Board
LASDAP	Local Authority Service Delivery Action Plan
LATF	Local Authority Transfer Fund
MIC	Middle Income Country
NARC	National Rainbow Coalition
NEER	Nominal Effective Exchange Rate
ODA	Official Development Assistance
RCA	Revealed Comparative Advantage
REER	Real Effective Exchange Rate
RMLF	Road Maintenance Levy Fund
SME	Small & Medium Enterprise
SSA	Sub-Saharan Africa
TFDG	Task Force on Devolved Government
UACA	Urban Areas and Cities Act
VAT	Value Added Tax
WB	World Bank

FOREWORD

It is my pleasure to present the fifth Kenya Economic Update, which we launch as Kenya enters a defining year in its history. While 2011 has already been challenging, managing Kenya's economy will become even more difficult in 2012. Kenya will need to weather the impact of the unfolding Euro crisis, conduct national elections, and continue to implement its new Constitution, including its far-reaching devolution. This is why we called this report ***"Navigating the storm, Delivering the promise"***. In the past, Kenya has managed economic shocks well. If Kenya succeeds in overcoming its ongoing economic challenges, implementing devolution effectively, and conducting national elections peacefully, the government will be in a position to begin delivering the promise of a more prosperous future.

This report has three main messages. First, Kenya has been navigating through rough economic waters in 2011. A combination of external shocks and domestic policy challenges raised inflation to around 20 percent, and widened the current account deficit to above 10 percent of GDP. As a result, growth for 2011 is estimated to be slightly below expectations, at 4.3 percent. Second, for 2012, the World Bank projects a growth rate of 5 percent if Kenya is successful in managing risks; if not, growth could drop to 3.1 percent. Third, Kenya's momentous devolution holds the promise of more equity and prosperity, if government policies strike an appropriate balance between redistribution and growth-enhancing policies, and existing service-delivery arrangements are safeguarded in the short run. For decentralization to be successful, Kenya will need a simple and transparent fiscal transfer architecture, which can be monitored and understood by all citizens, so that they can hold their representatives accountable.

The World Bank remains committed to helping Kenya to navigate through the economic storm and deliver on the promise of devolution. The Kenya Economic Updates, which the Bank is publishing every six months, have become our leading vehicle for analyzing development trends in Kenya, and thus contributing to the implementation of the World Bank's Africa Development Strategy, which puts a special emphasis on knowledge and partnerships. With these reports, we want to support all those who want to improve the economic management of Kenya, and we are proud to have worked with many Kenyan stakeholders during the preparation of this report. In particular, we intend to help inform and stimulate debate on topical policy issues, and to make a contribution to unleashing Kenya's growth potential.

Johannes Zutt
World Bank
Country Director for Kenya

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Partnership with key Kenyan policy makers was instrumental in the production of this report. On November 8, 2011, a draft of the report was presented at the *Quarterly Economic Roundtable.* The meeting was chaired by Professor Njuguna Ndung'u, Governor of the Central Bank of Kenya, and attended by senior officials from the Ministry of Finance, the Central Bank of Kenya, the Kenya National Bureau of Statistics, the Kenya Institute of Public Policy and Research Analysis, the Kenya Revenue Authority, the International Monetary Fund, Ministry of Local Government, the National Executive and Social Council, the Commission on Implementation of the Constitution, and the Australian High Commission.

Special appreciation goes to AusAid for supporting the World Bank's Fiscal Decentralization Knowledge Program.

Main Messages and Key Recommendations

Main Messages

- **2012 will be a defining year for Kenya.** National elections, the establishment of a new system of devolved government, and the possibility of a deterioration in global economic conditions will make the next twelve months extremely challenging. At the same time, if Kenya manages these challenges well–peaceful elections and transition to a new government, successful introduction of a new system of devolved government and continued growth during a global financial crisis–2012 will set the foundation for a more prosperous future.
- **Kenya is navigating rough economic waters, which will lower growth prospects for 2011 and possibly 2012 as well.** High food and fuel prices, the drought in the Horn of Africa, and the Euro crisis have weakened Kenya's external position, which was already fragile given the large current account deficit. These economic challenges will lower growth to an estimated 4.3 percent in 2011. For 2012, the World Bank projects growth to recover slightly and reach 5.0 percent, if Kenya succeeds in managing the risks.
- **Kenya's constitutionally-mandated devolution is one of the most ambitious programs of its type in the world.** The bulk of decentralization reforms will be implemented in 2012 and will impact Kenya's social stability, service delivery, and fiscal health for years to come. In responding to the economic crisis, Kenya's policy makers will need to find the fiscal space required to deliver on the promise of devolution, while protecting public investment.

Key Recommendations to respond to the economic turbulence

- **Remain steadfast in containing macroeconomic pressures, by reigning in inflation expectations while containing the debt-to-GDP ratio.** This will require maintaining tight monetary policies and fiscal prudence to manage the economy over the short term.
- **Guarantee a level playing field for all market participants and avoid regressive economic policies.** Price and currency controls distort economic activity and typically result in worse outcomes, namely higher prices and a weaker currency, while increasing opportunities for corruption.
- **Enhance export competitiveness.** Kenya will succeed economically and be less vulnerable to shocks only if it balances its economy through stronger exports. It now needs to move beyond tea, tourism and horticulture, where it is already performing strongly. Kenya is well positioned to make new products (such as textiles, chemicals and automotive parts) and enter new markets (such as Asia) if it continues to improve its infrastructure and investment climate. Increased domestic energy production, especially geo-thermal, would play a critical role, as it will also reduce dependence on expensive fossil-based thermal energy.

Key Recommendations to manage Kenya's decentralization successfully

- **Ensure a fair distribution of national resources commensurate with county needs and capacity and balancing national interests.** This will involve clarifying the responsibilities of county governments and the process for transfering of functions will be phased over time.
- **Devise a simple and transparent transfer architecture that promotes spatial redistribution without compromising growth and efficiency objectives.** While tackling geographic inequities is a central promise of devolution, this will need to happen over time, so as not to jeopardize future growth and existing service delivery. The objective should be to equalize opportunities for all Kenyans, while recognizing that economic growth will be concentrated in certain areas.
- **Build capacity in Kenya's counties, particularly the weaker ones.** Paradoxically, those counties that stand to benefit the most from devolution in theory (the more remote, least developed counties) could lose out in practice, if their capacity to manage devolved funds effectively and transparently is not sufficiently developed.
- **Get accountability right from the start.** Accountability should focus on both funds and performance, and systems should emphasize both central monitoring and reporting, but also maximize the involvement of citizens so they can hold their representatives accountable.
- **Ensure transition does not interrupt service delivery.** Effective coordination of the transition at both national and county levels will be crucial. Urban services will be particularly vulnerable since the existing institutions in charge of urban services will be abolished. This will require a clear and inclusive decision on who is in charge of coordination and agreement on a high-level strategy for implementation.

EXECUTIVE SUMMARY

Kenya is entering a decisive year. Three main developments will make 2012 extraordinary. First, Kenya will hold national elections for the first time since the traumatic post-election violence of 2007-08, which ended Kenya's high growth momentum abruptly. Second, Kenya's economy will need to navigate through a severe economic storm, which could well become a hurricane, especially if Europe enters into a recession. Third, the country will implement its most ambitious governance reforms ever, namely the devolution of responsibility to forty-seven new counties. Kenya's policy makers will need to display tremendous skill and steadfast leadership in order to balance the need for fiscal prudence, with ensuring that resource flows to new local governments are sufficient to meet their needs. High expectations of the promise of devolution need to be met by equally high quality planning and execution of its delivery.

Flying on one engine through the economic storm

Kenya will enter 2012 from a weaker-than-expected economic position. Kenya's economy is navigating rough economic waters, where existing structural weaknesses have been compounded by short-term shocks. The most visible sign of Kenya's economic challenge is the depreciating Shilling, which reached an all time low against the US Dollar in October 2011. The elements behind this situation are high international food and fuel prices, the drought compounded by conflict in the Horn of Africa, the Euro crisis, widening fiscal and current account deficits, and major inefficiencies in Kenya's agriculture sector. The recent developments are also undermining one of Kenya's main strengths over the last decade: the credibility and predictability of its macroeconomic policies.

Kenya has been caught in a vicious inflationary cycle. Higher import prices–initially for food and fuel–have sparked inflation, which in turn weakened the Shilling and put further pressure on prices. Because of the sharp depreciation of the Shilling, import prices continued to rise even after global food and fuel prices had started to retreat. Like in many other African countries, inflation increased substantially as global food and fuel prices rose sharply in the first half of 2011. But in Kenya, food prices have been well above high global prices due to the National Cereal and Produce Board's policy of maintaining high maize producer prices, and its inefficient marketing systems. As a result, overall inflation is expected to reach an estimated average of 13 percent for the whole year–with Kenya's poor bearing the brunt of the cost. The Central Bank's recent move to increase the benchmark policy rate from 7 to 16.5 percent has calmed the markets, improved prospects for 2012, and proven that decisive action could shape expectations.

Despite challenges, Kenya is still projected to grow at 4.3 percent in 2011. This is lower than in 2010 (5.6 percent) but substantially higher than during the recent crisis of 2008-09, and also above Kenya's long-term average performance (3.7 percent). The services sector remains buoyant and tourism is also expected to have a record year, in spite of the recent security concerns. Agriculture was also performing better than expected in the first half of 2011, after a good year in 2010. The short rains are promising a strong harvest for end 2011 and early 2012.

In the absence of further shocks, inflation will slow down in the first half of 2012. Global food and fuel prices have already been declining, and there is a possibility that global commodity prices will fall further, if Europe's economic situation deteriorates further. Kenya's good harvest prospects should lower the demand for food imports. Finally, the

Central Bank's tighter monetary policies will slow credit supply and start to reduce core inflation.

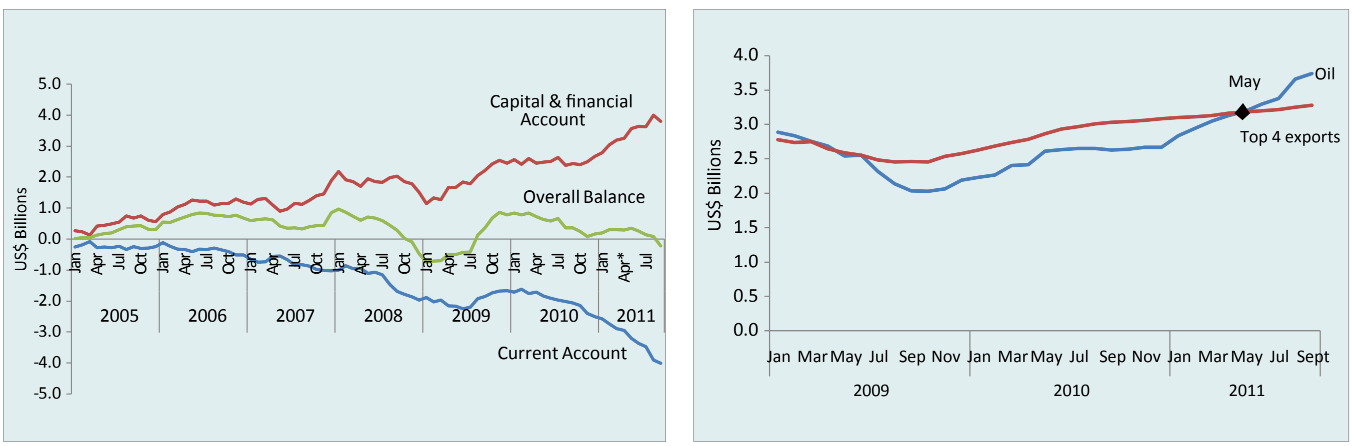
But exchange rate and inflation woes are just the tip of the iceberg: underneath the surface is a deep structural problem. Kenya's economy is increasingly imbalanced, with a growing gap between exports and imports. This makes the economy particularly vulnerable to external shocks. In 2011, imports soared (mainly due to higher oil and food costs), while exports remained stagnant. The gap between imports and exports of goods and services, known as the *current account deficit*, now stands at above 10 percent of GDP, which is even higher than in Greece. Today, Kenya's four main exports do not even earn enough to pay for its oil imports, not to mention other imports beyond oil (see figure 1)! For too long Kenya's economy has been like an airplane flying on one engine: its strong domestic demand and a vibrant service sector keep it up in the air, but to get to its destination, the second engine (exports) will have to pick up.

> "The current account deficit now stands at above 10 percent of GDP, which is even higher than in Greece

Kenya's economic imbalance is driven by a combination of weak exports and high dependence on oil imports. Its export performance is poor due to a number of factors, including inefficiencies at the port of Mombasa, and an inadequate and expensive supply of energy. This makes Kenya too expensive for international investors, especially in manufacturing, despite low labor costs than in emerging Asia. Kenya is globally competitive in a number of sectors–especially tea, tourism and horticulture–but it has not ventured sufficiently into new products, especially light manufacturing, where opportunities could materialize as Asia's emerging economies start to graduate from these sectors. At the same time, oil currently accounts for over a third of the import bill, which reinforces the need for accelerating non-fossil based domestic energy generation. The scaling-up of Kenya's geothermal energy production provides an unmatched opportunity to create reliable clean energy and at the same time reduce the import bill.

If macroeconomic stability is restored, Kenya can reach 5 percent growth in 2012. This is a slight downgrade from the World Bank's last projection of 5.3 percent, reflecting domestic economic challenges and a weaker global environment. Kenya's economic vitality will depend crucially on the restoration of macroeconomic stability, prospects for stabilization in Somalia, and a smooth

Figure 1: Kenya's current account deficit has hit 10% and top exports can no longer cover oil imports



Source: World Bank computations based on CBK data

run up to the next elections, followed by a peaceful transition of power from one administration to the next. Services will continue to drive growth in this election year as the country gets into campaign mode. Investment growth will be moderate, as players will hold off on major decisions until a new government is in place.

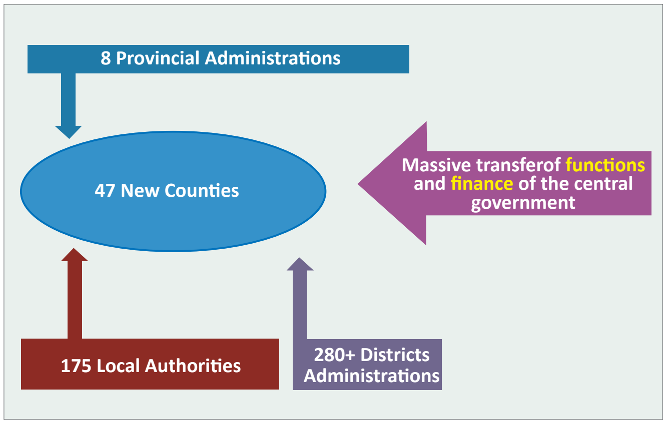
However, there are substantial risks going forward, especially if the economic crisis in the Euro zone deepens and if the national elections usher a period of economic uncertainty. If one or both risks fully materialize, growth could be as low as 3.1 percent. The ongoing crisis in Europe will have a negative impact on some of Kenya's main exports which are still dependent on European markets (horticulture and tourism). On the domestic scene, election years in the past have been problematic for Kenya's growth as investors have held back, waiting to see the outcome and whether there would be a peaceful transition. Over the last 30 years, election years have been associated with a one percentage point lower growth rate than the long-term average. If government does not take pro-active steps to set the stage for a peaceful run-up to voting and a smooth transition thereafter, this unfortunate pattern could be repeated in 2012.

Delivering the promise of devolution

Economic turbulence has hit Kenya at the very moment when it is preparing for the most far-reaching institutional reforms in its history. In the long run, successful implementation of the Constitution is likely to be the single most critical factor in determining Kenya's development prospects. The establishment of a new leadership team in the justice sectors has created great hopes for lasting change. The next wave of reform, of even greater scale and importance, is the transfer of functions and finance to forty-seven entirely new county governments.

Kenya's devolution program is one of the most ambitious in the world, because it is transferring a substantial amount of power and resources to an entirely new level of government. In one go, Kenya's eight provinces and over 280 districts will be replaced by forty-seven brand new counties. In many countries, devolution is a process of giving political autonomy to administrative units that are already in place. By contrast, in Kenya, devolution will entail creating new political and administrative units at once.

Figure 2: A massive challenge of administrative and fiscal re-engineering



Source: World Bank

For many Kenyans, devolution carries the promise of a more equitable model of development. The prevailing feeling is that investments and services have been spread unequally across the country, often following political and tribal affiliations, thus fuelling resentment. To a large extent, this is in fact correct: not only is economic activity concentrated spatially (which is not inherently problematic), but access to services (which determines future opportunities), also remains highly unequal. The hope is that devolution will address these historical and spatial inequities, by shifting significant resources and responsibilities to semi-autonomous and locally accountable county governments. But there are important challenges to be managed along the way, if the theoretical promise of devolution is to be made a reality.

In a tight fiscal environment, matching resources to needs will be extremely challenging. In order to avoid major resource allocation mismatches, which could leave either the county or the national

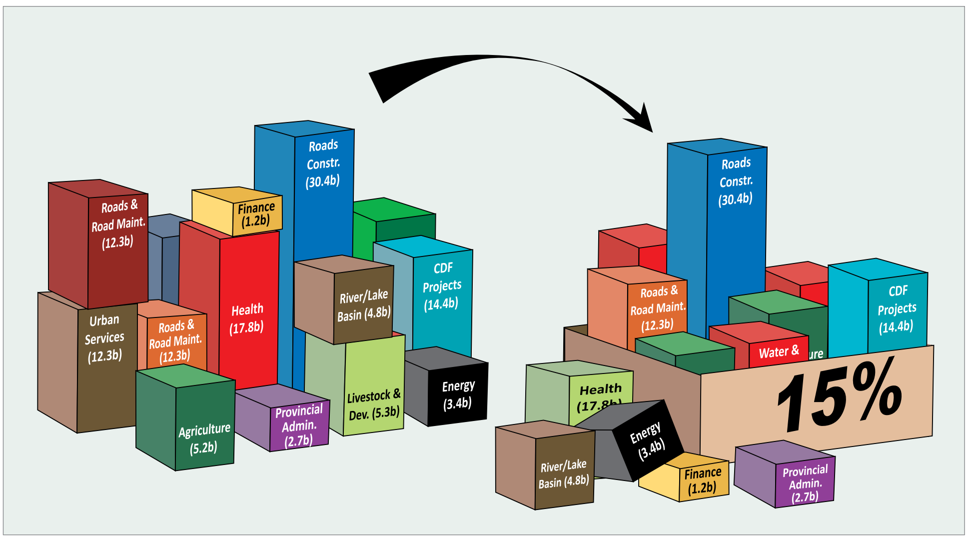
governments strapped for cash, a detailed process of function assignment will have to be worked-out. In turn, this process should guide the division of revenues between the two levels of government. Moreover, equitably sharing the county share of national revenue across the forty-seven new counties will be immensely challenging as the fiscal space is simply not there to expand public spending. Any attempt to drastically rebalance expenditures spatially, would undermine existing service delivery and compromise future growth.

The Constitution mandates that a minimum of 15 percent of national revenue is to be transferred unconditionally to counties, but this would not be enough to finance the full set of devolved functions. Therefore, determining how many of these functions will effectively be devolved and when, and designing the transfer architecture around this, will constitute the main challenge and potentially determine whether additional fiscal stress is created or whether service delivery is likely to decline in the short run. Preliminary estimates suggest that current spending on functions that could be devolved is well in excess of the minimum 15 percent. (See figure 3)

A central paradox of Kenya's devolution is that counties which stand to gain the most in theory could well be the biggest losers in practice. The capacity of the new county governments to manage funds efficiently and transparently, and to retain skilled staff to deliver devolved services will vary tremendously. Regions of the country which have been historically left out are precisely the ones for which capacity constraints are likely to be most binding, with the potential for weak financial management, major disruptions in service delivery, and unmet expectations. Therefore, the success of devolution will depend critically on capacity building and preparation at the local level. The national government will also have a crucial supporting role to play, in setting and monitoring minimum standards of financial management and service delivery.

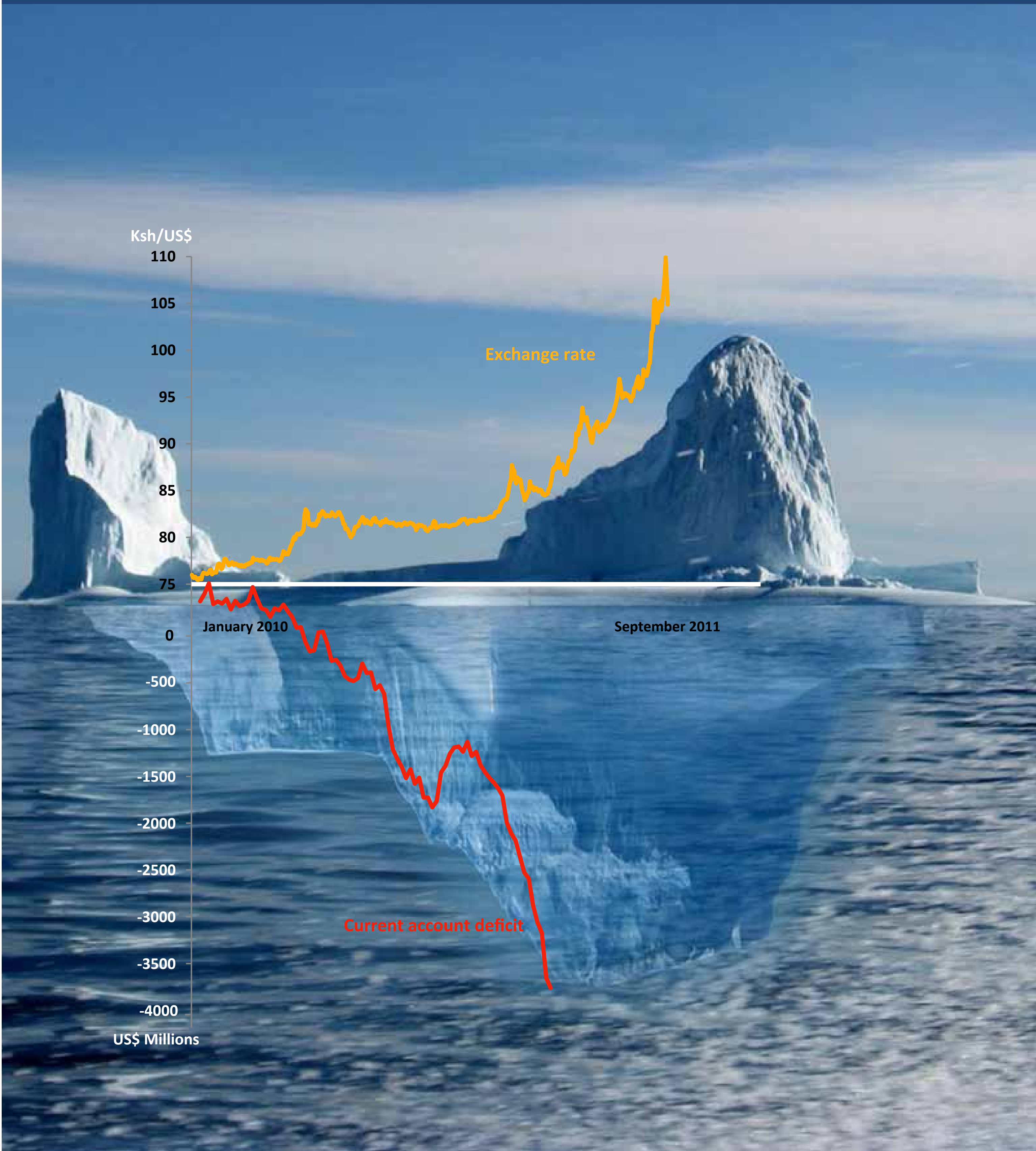
Establishing strong systems and institutions for accountability of county governments will determine whether devolution is successful. Devolution requires renewed emphasis on enhancing accountability of local government to citizens. In many countries, accountability failures have undermined devolution, leading to more corruption and weaker public services. With Kenya's pioneering "Open Data" initiative and a world-class ICT sector, the tools are there to be used to ensure that there is accountability between county governments and citizens.

Figure 3: Current funding for functions likely to be devolved is well in excess of 15%



Source: World Bank

The State of Kenya's Economy



Kenya's economy has been navigating through an economic storm in 2011. Economic growth is still robust, although below potential and initial expectations. At an estimated 4.3 percent, Kenya's growth rate will fall short of its 2010 performance, when the economy rebounded strongly at 5.6 percent but will be higher than Kenya's long-term average rate of 3.7 percent. The ongoing economic crisis underscores Kenya's structural challenges, especially weak exports, which are the primary cause of Kenya's recent macroeconomic instability, and contributor to the sharp decline in the Kenyan shilling. For 2012, the Word Bank projects a 5.0 percent growth rate, if the government is able to effectively manage the current crisis, maintain political stability in the run-up to the elections, and address the security challenges arising from the conflict with Somalia.

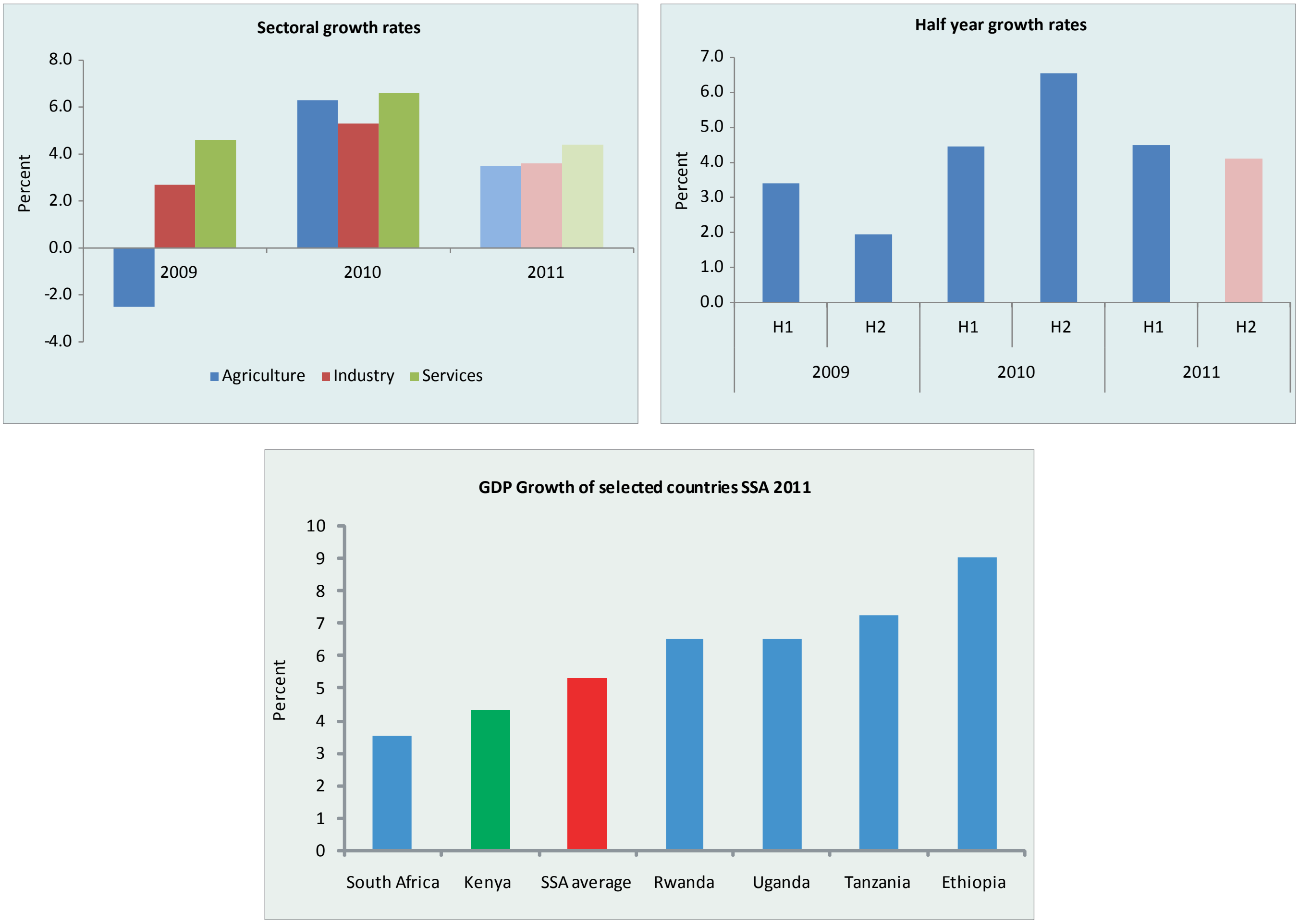
1. Kenya's economic performance in 2011

1.1 An Economy under Pressure

Despite a number of economic challenges, Kenya will still experience a satisfactory growth rate of 4.3 percent in 2011. This will be higher than Kenya's long-term growth rate of 3.7 percent but still a full percentage point below the average projected for Sub-Sahara Africa. In the first half of 2011, the Kenyan economy grew by 4.5 percent, driven by a strong performance in the financial sector (8.2 percent), construction (8.1 percent), as well as hotels and restaurants (6.4 percent). Moderate growth was recorded in the agricultural and industrial sectors. Overall growth for 2011 is expected to be balanced across all key sectors, with the services sector maintaining its position as the growth engine over the last decade (see figure 1.1 and table 1):

- **Agriculture has performed average despite the moderate drought.** Agriculture production grew by 3.5 percent in the second first half of the year as rains normalized, especially in Kenya's "bread basket", the Rift Valley, and production held up again. The drought mostly affected Kenya's livestock production in Northern and Eastern regions. It is estimated that the drought shaved off 0.2 percentage points from GDP growth, mainly as a result of livestock mortality. Beyond these arid regions, low rainfall and high temperatures affected tea production. In addition, the crises in North Africa and Europe adversely affected the demand for Kenya's cash crops, mainly horticulture, coffee and tea.
- **Industrial sector growth remains driven by construction while manufacturing is lagging.** The construction sub-sector recorded an impressive 8.1 percent growth in the first half compared to a 2.2 percent growth in the same period in 2010. Manufacturing grew at a modest 3.2 percent, compared to 5.5 percent in the same period last year. The drought impacted hydro power generation and the resulting high cost of energy has adversely affected the industrial sector. The share of hydro power in Kenya's energy supply declined from 57 percent in July 2010, to 43 percent in July 2011. This in turn increased dependence on back-up thermal power generation, which uses expensive imported fuel as its feedstock. Industries that depend on imported raw materials, saw their production costs increase significantly due to high import costs (oil and steel), along with the depreciation of the shilling. The costs of imported machinery and equipment also increased substantially. The combined effect of these factors has negatively impacted the competitiveness of industry, resulting in a sluggish performance in 2011.
- **The services sector is holding up, fueled by continued growth in ICT and a strong performance in tourism.** Services grew by 4.3 percent in the first half of 2011, mainly driven by financial intermediation (8.2 percent); hotels and restaurants (6.4 percent), and transport and

Figure 1.1: Kenya's growth is projected at 4.3 percent in 2011, balanced across sectors but below the average for SSA

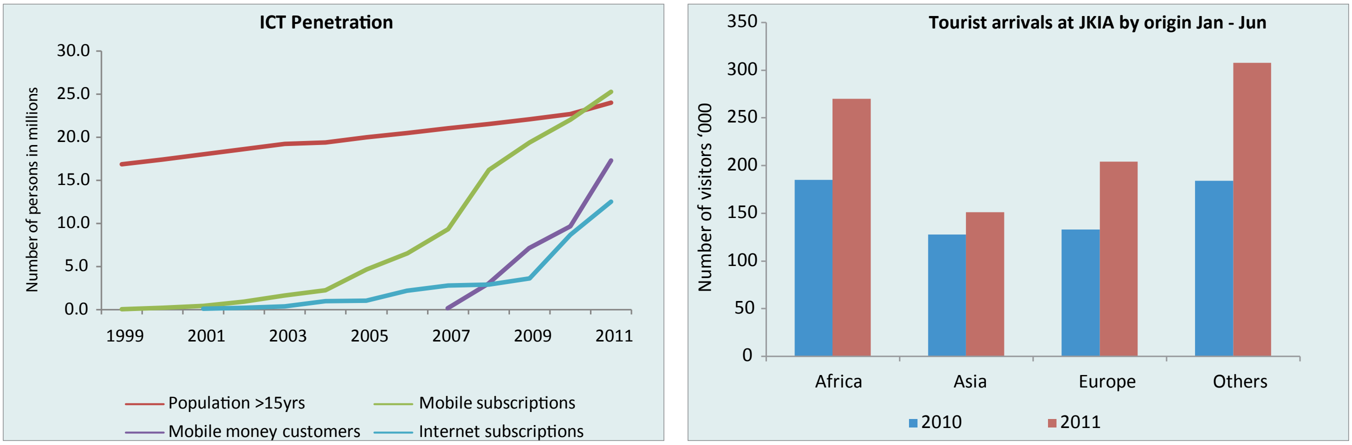


Source: World Bank computations based on KNBS data

communication (5.2 percent). Tourist arrivals increased by 13.6 percent in the first half of 2011, compared to 2010 levels. Despite Europe's economic slowdown, 46 percent of arrivals were still from Europe, 25 percent from the rest of Africa, 12 percent from the Americas, and 10 percent from Asia. However, the emerging security concerns stemming from Kenya's incursion in Somalia will dampen tourist arrivals for the remainder of the year, though the high season is over.

The ICT revolution is reaching new milestones and is stimulating growth in other services. The mobile phone revolution has continued, with subscriptions peaking at 25.3 Million at the end of June 2011, which is more than the number of adults in Kenya. Since June 2010, subscriptions increased by more than 25 percent. In the same period, internet users increased by 60 percent, climbing to 12.5 Million. This indicates that the data revolution is now also in full swing. A key factor in the growth of internet usage is the new affordable tools, including smart phones and social networking applications with both internet and mobile interface that are proving increasingly popular, especially among the urban youth. The sector has also generated additional innovations, including M-banking, linking mobile money with personal bank accounts, M-credit, and M-insurance, which are expanding the reach of financial services to previously unbanked segments of the population (see figure 1.2).

Figure 1.2: The first half of 2011 has seen strong growth in tourist arrivals and ICT penetration



Source: World Bank based on CBK and KTB

However, Kenya's economy has come under pressure in 2011. Four mutually reinforcing shocks have curtailed Kenya's high growth momentum:

- **Higher global fuel prices, which were triggered by the crisis in the Arab world.** In the first nine months of 2011, international crude oil prices increased by 37.4 percent[1]. This resulted in a 42.2% increase in Kenya's oil import bill. Oil now represents 26% of Kenya's imports.

> "Food inflation remains the driver of overall inflation and the situation is particularly severe for maize and sugar, where Kenya's policies have contributed to rising prices

- **Higher food prices, notably maize, of which Kenya imports substantial quantities.** Kenya's food deficit had to be met through highly priced imports of maize, with global prices increasing from a 9 -month average of US$ 167 per metric ton in 2010 to US$ 299 in 2011. Moreover, Kenyans ended up paying up to US$ 530 per metric ton of maize, due to additional policy distortions that disrupted the domestic food market.

- **Drought in the Horn of Africa, which led to a massive influx of refugees and significant loss of livestock.** The drought only marginally affected Kenya's agricultural production, but severely affected communities owning livestock, who live in drought-afflicted areas. Below normal rainfalls resulted in higher power costs as hydropower production declined, adversely affecting the competitiveness of the industrial sector.

- **The Euro crisis, which created uncertainty in the global markets and increased currency volatility.** Europe is the main market for Kenya's horticulture, and the third destination for Kenya's tea. The economic slowdown in Europe, along with the crisis in the Arab world, a significant destination for Kenya's tea, negatively impacted the growth of Kenya's key exports.

Escalating food and fuel prices, in turn, drove up inflation, which increased by 18.9 percent from the beginning of 2011, through to the third quarter. This is the highest rate of inflation Kenya has seen since the introduction of a new methodology for measuring inflation in 2009. Transport inflation has doubled – from 13 to 26 percent in the first ten months of the year. Likewise food inflation has more than doubled from 10 to 26 percent, between January and October 2011 (see figure 1.3). Second round effects are now emerging as core inflation, which excludes food and energy prices, increased from 1.4 to just over 10 percent in the same period. Food inflation remains

[1]*Crude oil price increased from an average of US$ 79.7 per barrel in 2010 to US$ 109.4 in the first 9 months of 2011.*

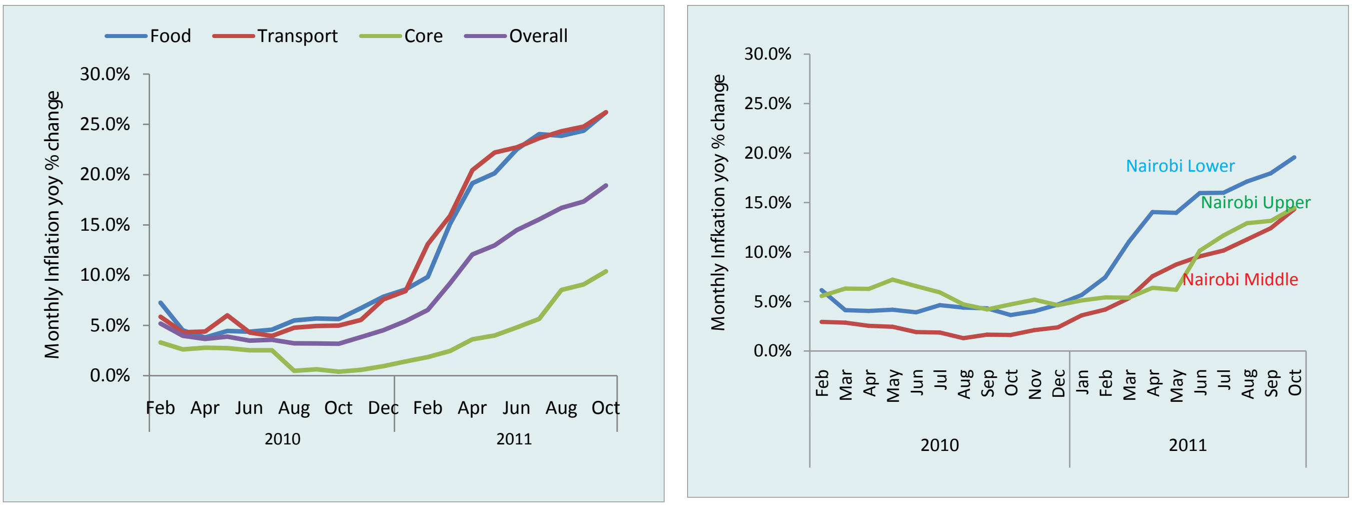
the driver of overall inflation, and the situation is particularly severe for maize and sugar, where Kenya's policies have actually contributed to rising prices:

- **Maize.** Kenyans paid a record US$ 45 per bag of maize in July 2011 which was more than double the price at the beginning of the year and about 70 percent above the already high world market prices (see figure 1.4).

- **Sugar.** Kenya's record high inflation in the second half of 2011, is strongly influenced by rising sugar prices. Today, Kenyans pay about twice as much for sugar as Europeans, even though the drought did not affect sugar-producing areas. As in the case of maize, a number of well connected businessmen benefit from disproportionately high prices, which they manipulate through their control of import licenses, to the detriment of Kenyan public.

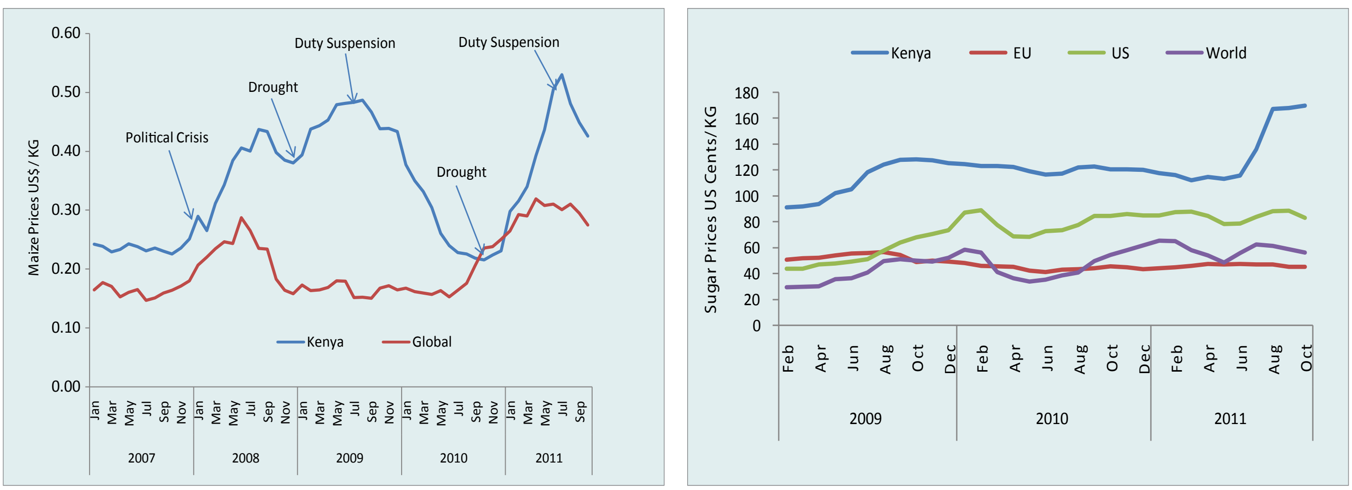
High inflation tends to hurt the poor disproportionately. This is especially so when inflation is driven by high food and fuel prices, as the poor spend a significant proportion of their income precisely on food and transport. A breakdown of Kenya's inflation by urban income groups shows that low income households have been hit hardest by inflation in 2011. For instance, in October 2011, the inflation experienced by low income households was 19.6 percent, compared to the previous year, by

Figure 1.3: Overall inflation has been driven by food and transport … hurting the poor most



Source: World Bank computations based on KNBS data

Figure 1.4: Kenyans pay too much for maize and sugar



Source: World Bank computations based on KNBS data

contrast to 14.5 percent for high income households (see figure 1.3).

These shocks hit the economy at a time when fiscal policy buffers had been depleted and monetary policy was still expansionary. The fiscal stimulus of 2009 and 2010 was largely financed through domestic borrowing, which increased public debt as a share of GDP, by three percentage points (up to 48.8 percent against a policy target of 45 (see figure 1.5).

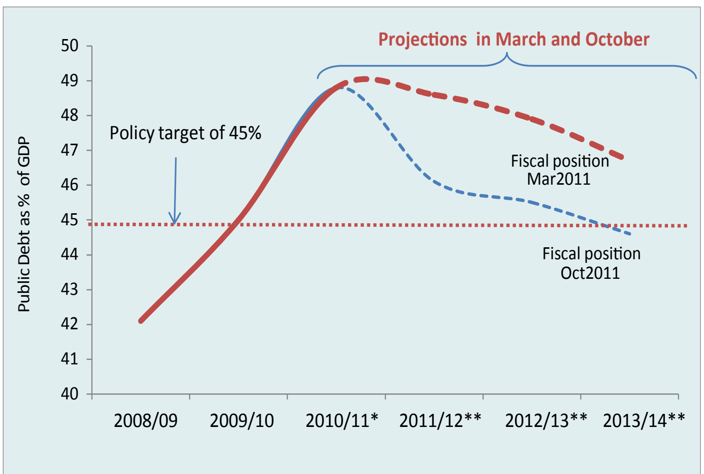
The Central Bank was still pursuing a broadly accommodative monetary policy in response to the 2009 economic crisis when the 2011 shocks hit. Domestic interest rates both in the short and long end of the market were at historic lows until they started to rise in the second half of 2011 (see figure 1.5). Furthermore, the Central Bank had run down foreign exchange reserves during the 2009 crisis, so that foreign exchange reserves were below the statutory 4 months of import cover at the beginning of 2011.

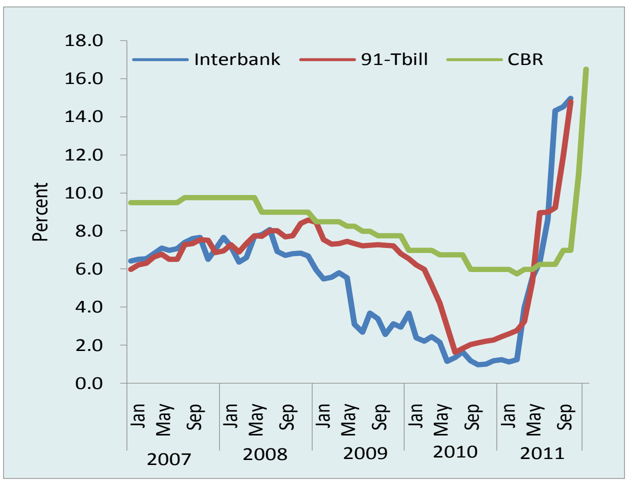
1.2. An economy out of balance

Kenya's economy has been out of balance for a long time but in 2011 a number of external shocks exposed Kenya's unsustainable external position. The rapid rise of oil prices in the first half of 2011, and the Euro crisis in the second half of the year, as well as the drought in the Horn of Africa, triggered the depreciation of the Kenyan shilling to an all time low (see figure 1.6). At the same time, Kenya's current account deficit reached a record high: between December 2010 and September 2011, it grew by almost 4 percentage points, from 6.7 to 10.5 percent of GDP. In the first three quarters of 2011, imports expanded by 22.7 percent, compared to 15.0 percent for exports, increasing the current account deficit by US$ 1.9 Billion. By May 2011, earnings from Kenya's top exports (tea, horticulture, and manufactured goods), along with international travel, were not sufficient to pay for oil imports alone (See figure 1 in the executive summary).

The prevailing expansionary policies accentuated internal and external macroeconomic imbalances. Growth in credit to private sector, reflecting robust domestic demand, put pressure on domestic prices. By September 2011, private sector credit had grown by 36 percent since the beginning of the year. Rising aggregate demand could not be met by domestic production, and spilled into high demand for imports. Export growth proved to be lackluster as Kenya's main European and Middle Eastern markets experienced their own economic pressures. Finally, increasing international prices for fuel and food created inflationary pressures domestically while also increasing the cost of the import bill. The resulting imbalances were reflected in a widening current account deficit, and a depreciating shilling.

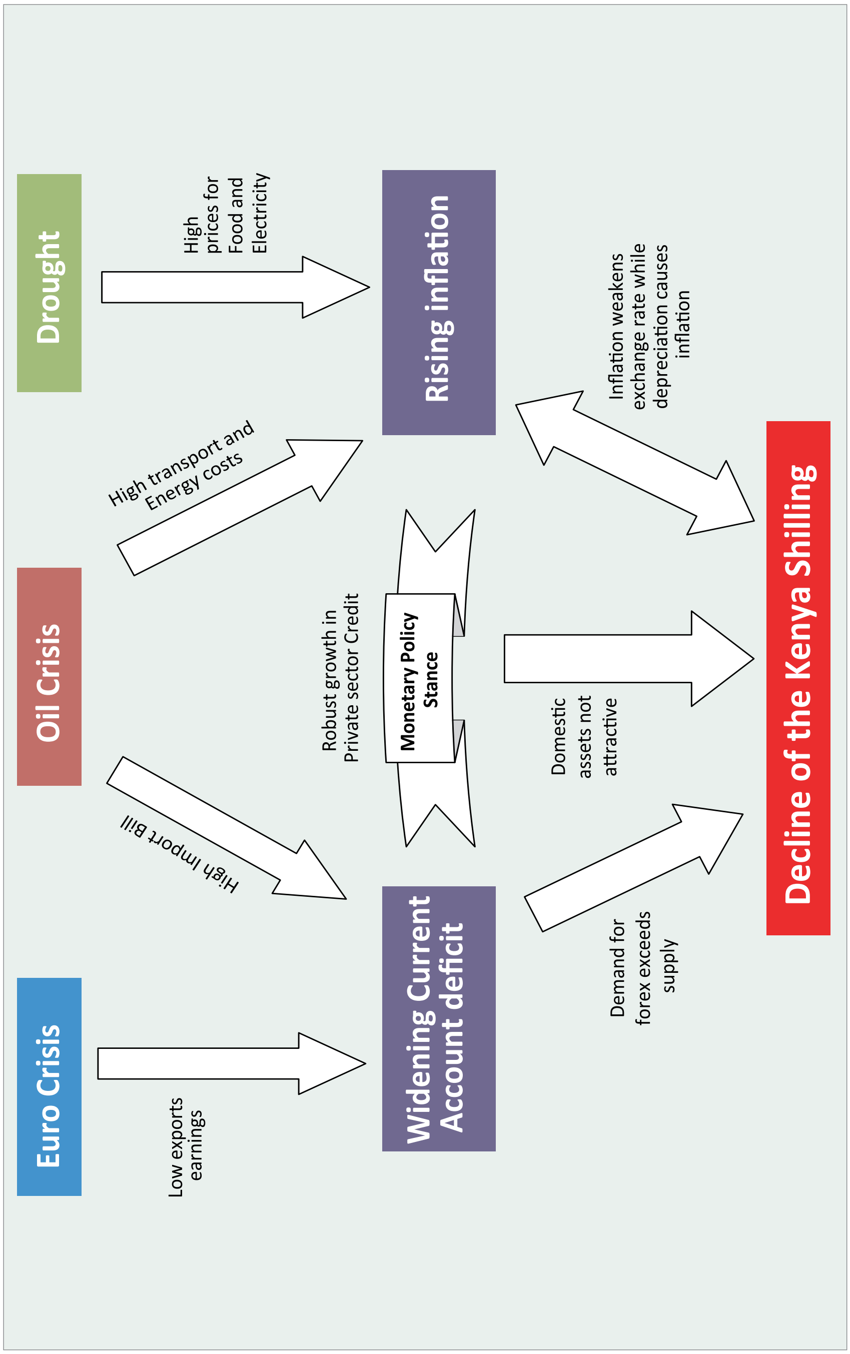
Figure 1.5: Debt has increased to 48.8 percent of GDP and interest rates rose sharply





Source: World Bank computations based on MOF & CBK data

Figure 1.6: How the genie came out of the bottle – Explaining the decline of the Kenya shilling

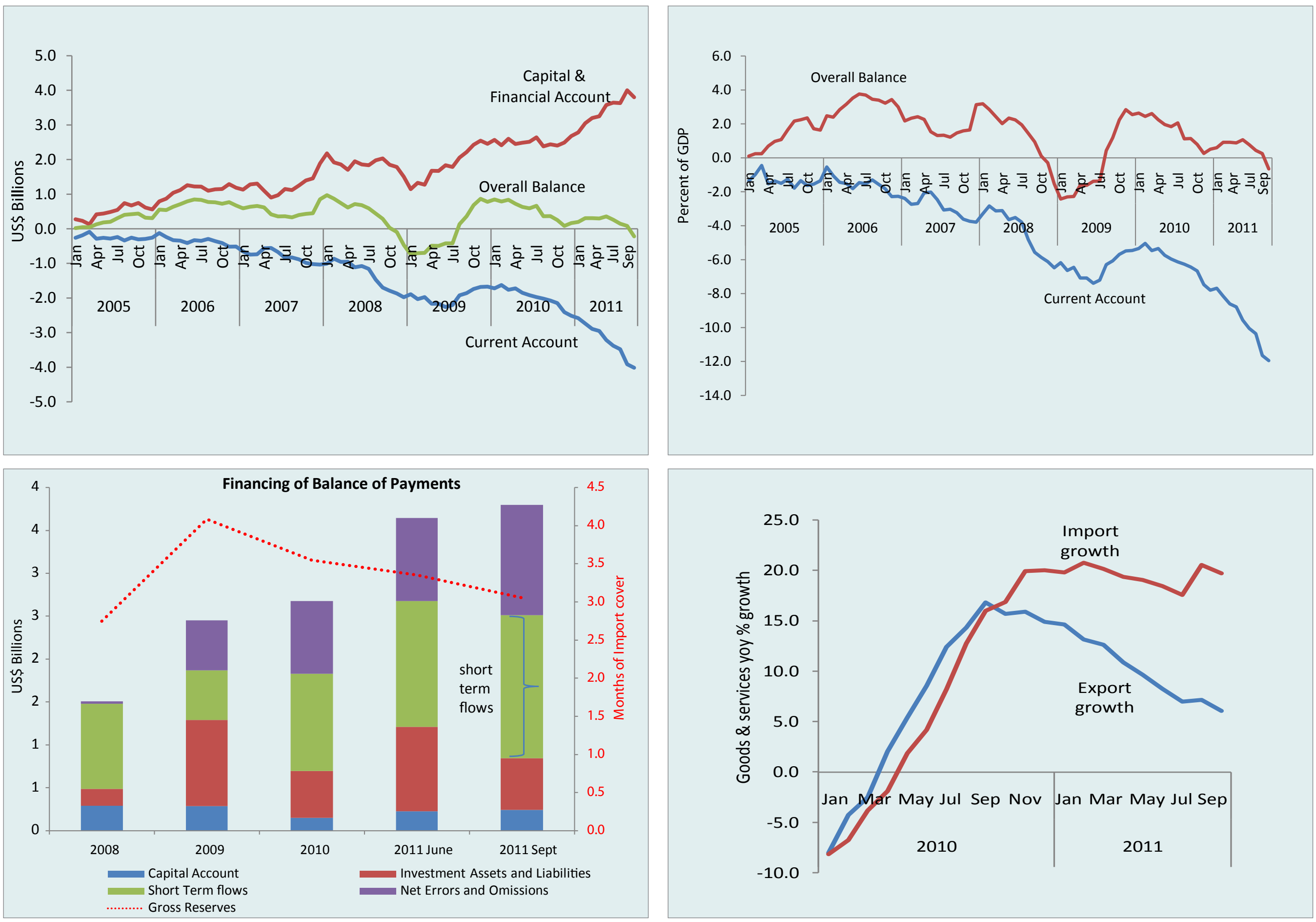


Source: World Bank

Short term flows help to finance the current account deficit, but constitute a source of volatility. The deficit in the current account is largely financed via short term financial flows, which consist of money invested in the equity and money markets, often referred to as footloose capital. These inflows can quickly reverse into net outflows (see figure 1.7). Yet Kenya's imports consist mainly of oil, capital machinery and intermediate inputs, which are all essential for growth, and are difficult to scale back. Although Kenya's balance of payments has previously been in surplus (the tip of the iceberg), it remains vulnerable to external shocks and outflows of footloose capital.

The global downturn, particularly in Kenya's export markets, has curtailed the growth in exports, following a strong performance in 2010. The moderate growth of horticulture exports (2-2.5 percent for the first three quarters of 2011) broadly reflects Europe's economic growth, while tea exports were also affected by disruptions in North African markets. Exports of coffee grew by 9.2 percent as at September 2011, despite a decline in production as a result of a 128.7 percent increase in coffee prices since 2010. Tea exports contracted by 1.8 percent in the same period, despite a 25.3 percent increase in prices. The political crisis in Egypt and marked decrease in demand from Pakistan, the major destinations for Kenyan tea, resulted in a slowdown in exports, while drought conditions contributed to below normal levels of production (see figure 1.7).

Figure 1.7: The current account deficit is at record levels putting pressure on the overall balance of payment

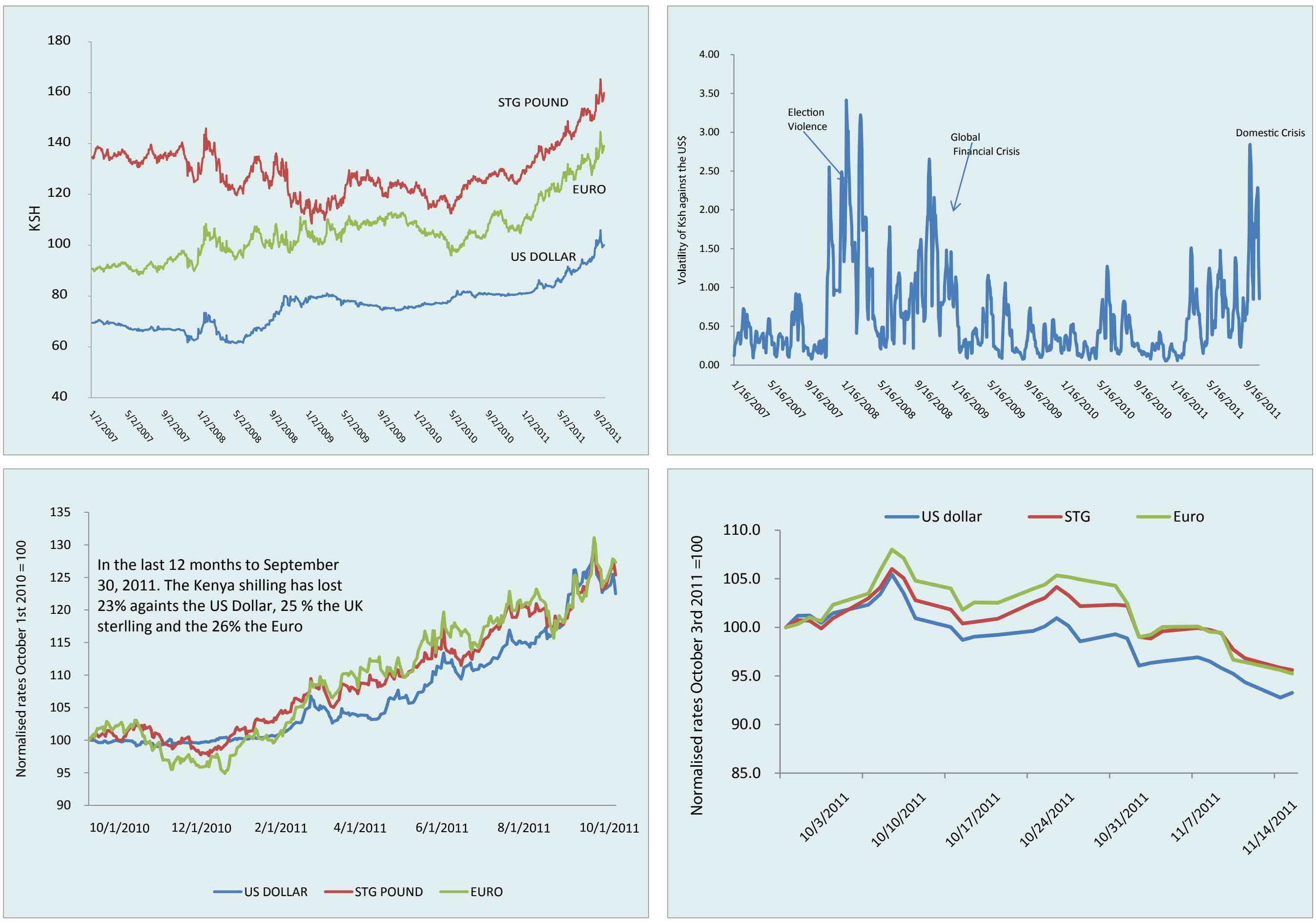


Source: World Bank computations based on CBK data

Remittances increased significantly in 2011, but the growth in service exports was disappointing. The growth of services exports was flat in 2011, which is in contrast to the 23.4 percent increase registered in 2010. This is explained by current transfers which declined by 3.0 percent from US$ 2.3 billion in 2010, to US$ 2.2 billion in 2011, mainly as a result of declining public current transfers (money sent to NGOs and civil society organizations declined from US$ 0.2 billion in 2010, to US$ 0.06 billion in 2011).[2] Remittances grew by 33.2 percent increasing from US$ 0.6 Billion in 2010, to US$ 0.8 Billion in 2011.

The Kenya shilling exchange rate had to yield to the pressure on the external account, and experienced a significant depreciation in the third quarter of 2011. In the last twelve months, the shilling lost approximately a quarter of its value against the US dollar, the UK sterling pound and the Euro. The shilling depreciated from KSHS 81 to the US dollar in January 2011, to a high of Kshs 104 in September 2011, before settling back to under Kshs 100 to the US dollar in November 2011. There are two main underlying reasons for these developments: investors' uncertainty with the Kenyan economy in the year ahead, and negative terms of trade shock which resulted in a deterioration of the trade balance. In turn, uncertainty induced depreciation may have further contributed to a higher trade deficit over the short run, while the trade deficit may have further increased investors uncertainty (see figure 1.8).

Figure 1.8. Exchange rate volatility accelerated in 2011

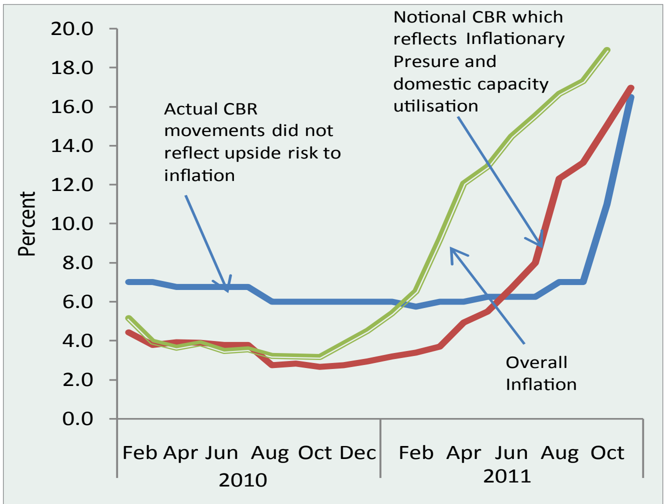


Source: World Bank computations based on CBK data

[2]Current transfers are those transactions in which an economy provides real and financial resources that are immediately or shortly consumed by other economies without receiving equivalent values in return. Examples are workers' remittances sent or received by residents to or from non-residents, and donations or gifts given or received by the government to or from other government or non-residents.

The initial adjustments made by the Central Bank of Kenya in the policy rate were not sufficient to contain inflation. When inflation started to rise at the end of 2010, the initial policy stance was appropriate as inflation was still below the Central Bank's five percent target. But when that target was exceeded at the end of the first quarter of 2011, the Central Bank could have considered raising the Central Bank Rate (CBR). Negative real lending rates in the first three quarters of 2011 and robust growth in credit to the private sector, indicate that CBR increases did not achieve the intended objective. Real lending rates turned negative in June 2011, and credit to private sector remained robust, growing at 36 percent in the year to September 2011.The market also began reacting to inflationary concerns in April 2011, as reflected in the steep rise in interbank and 91-day T-Bill rates, but the CBR remained unchanged. CBK finally raised the CBR dramatically in October 2011, in an effort to contain spiraling inflation. In figure 1.9, a simulated CBR, adjusted for domestic capacity utilization, shows a hypothetical path, if the CBR had been adjusted periodically as inflation picked up, compared with the actual CBR.[4]

Figure 1.9. Kenya's monetary response: First too little – then a strong catch-up



Source: World Bank computations based on CBK data

Credit to the private sector crowded out lending to government, impacting budget implementation. Interest rate on government paper (91 day T-Bills) turned negative in January 2011 and the subscription to government paper (both T bills and bond auctions) declined. In the first quarter of FY 2011/12 only 44 percent of government bonds were subscribed compared to 121 percent in a similar period in FY 2010/11. Consequently, domestic borrowing was 0.4 percent of GDP against a target of 1.5 percent. This forced the government to trim down expenditures and net lending to 5.9 percent of GDP, compared to the initial plan of 7.3 percent. Development and recurrent expenditures were scaled back by 0.7 and 0.6 percentage points of GDP, compared to initial targets.

1.3. Restoring macroeconomic stability

Since October 2011, CBK has taken decisive action to restore macroeconomic stability. The CBK's Monetary Policy Committee raised the CBR by 400 basis points in October 2011, and by a further 550 basis points in November 2011. These recent hikes in interest rates along with additional measures announced by Ministry of Finance, have begun to stabilize the exchange rate and curtail the flight from the shilling(see figure 1.10).[5]

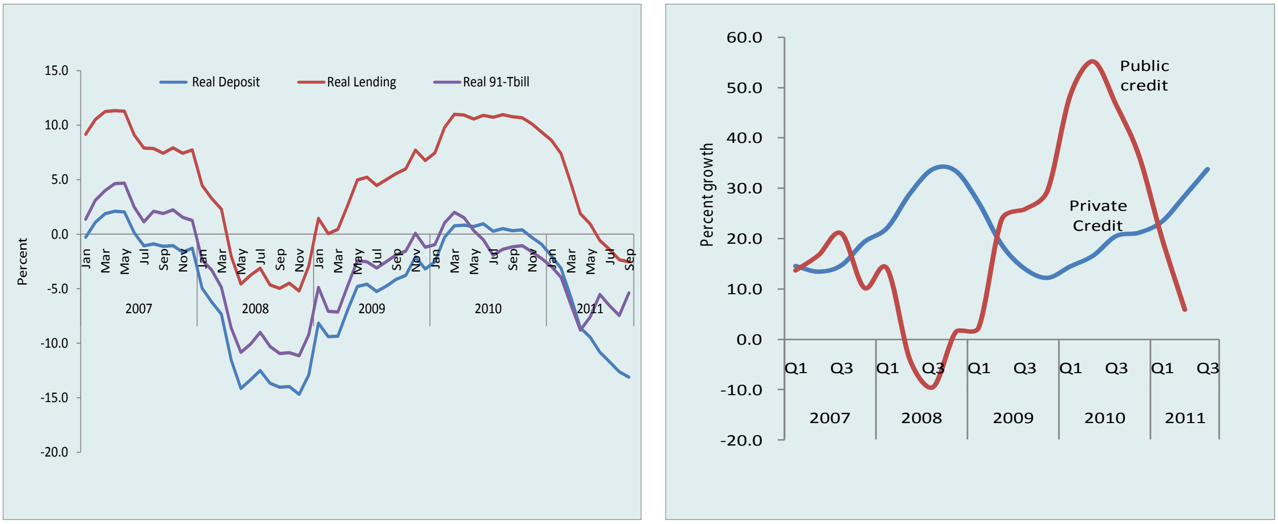
Adjustments to the CBR have resulted in substantially higher short term interest rates. Domestic interest rates both in the short and long maturity instruments have risen sharply, while capital markets activities have diminished. The recent tightening of monetary policy through significant increases in the CBR, and open market operations to reduce liquidity led to an increase in short term rates. By October, 2011, the repo, interbank and the 91 Day Treasury bills rates had increased by 16, 14 and 12 percent respectively, as growth in money supply declined.[6]

[4]Note (i) The simulated CBR is a hypothetical CBR which is adjusted to take into account domestic Inflationary Pressure and domestic capacity utilization (ii) It can be calculated as simulated $CBR = \pi + r + 0.5(\pi - \pi^*) + 0.5(y - y^*)$ where CBR is the Central Bank Rate, π is the inflation rate that excludes food and energy prices, r is the equilibrium interest rate (assumed to be 2 percent), y is the log of quarterly GDP and y is the log of trend quarterly GDP. We assume that when formulating monetary policy, the CBK put equal weight in fighting inflation deviation from target and GDP growth from target.*

[5]The Shilling has reversed its path appreciating from 107 in October to 93 in November.

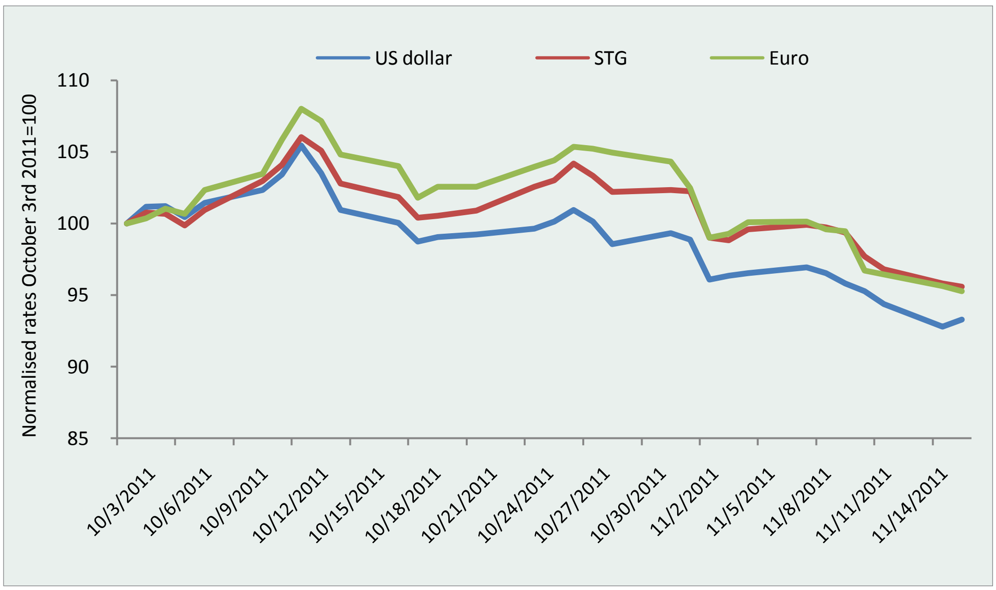
[6]Money supply growth (M1, M2 and M3) has been declining significantly since February 2011. The growth in M3 has declined from 20.8 percent in February to 16.7 in August while M2 and M1 have declined from 21.4 and 27.6 percent respectively to 15.0 and 20.7 percent in August 2011.

Figure 1.10: Real interest rates turned negative while lending to private sector remained robust



Source: World Bank computations based on CBK data

Figure 1.11 The Kenya Shilling strengthened against the major currencies since October 2011



Source: World Bank computations based on CBK data

Long term interest rates have remained relatively steady but increased steeply in November, in response to the tighter monetary policy stance. However, the transmission mechanism, between short term and long term rates in the market, is still weak. Tighter monetary policy has led to sharp increases in interbank and 91 day Treasury bill rates, but long term rates have not responded in a similar fashion. However, after the CBR increased to 16.5 percent in November, lending rates have increased to 20-25 percent, while deposit rates have increased to 10 percent. The interest rate spread (lending minus deposit rates) remains steady at around 10 percent.

The additional credit from the International Monetary Fund (IMF) will rebuild foreign exchange reserves and support the Kenya Shilling. The government has approached the IMF for additional financing through the Exogenous Shock Facility. If the credit is approved it will provide an additional US$

250 Million to the existing US$ 500 Million facility. Front loading disbursements in FY 2011/12 will help rebuild foreign exchange reserves and stabilize the shilling.

Recent shocks have provided fresh impetus to fiscal consolidation. Fiscal consolidation started in FY 2011/12. Initially the Government planned to reduce debt to GDP ratio from 48.8 percent in FY 2010/11 to 46.7 percent by 2013/14. However, the recent shocks and the need to reduce domestic demand have called for a more aggressive consolidation, which would reduce debt by an additional 2 percentage points, to 44.6 percent by 2013/14. The consolidation is to be achieved through spending cuts in the medium term, to improve the primary deficit from -2.7 percent to -2.2 percent of GDP and by a further 0.1 percentage point in FY 2012/13 (see figure 1.12).

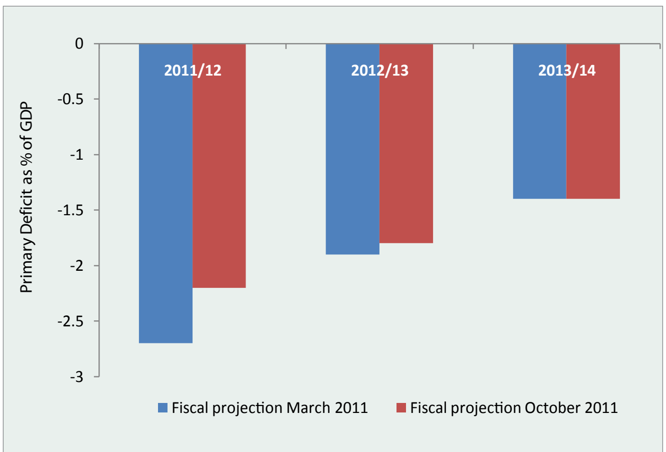
If the envisaged consolidation takes place, it will rebuild fiscal policy buffers back to pre crisis levels. However, fiscal consolidation will be more difficult in light of emerging pressures. The implementation of the new Constitution and the elections in FY 2012/13 will build additional spending pressures (see the outlook for FY 2012-13 and special focus of this report).

1.4 Rebalancing the economy

The current shocks have revealed Kenya's declining international competitiveness as a major structural weakness in the economy. While the recent policy measures will constrain demand and restore exchange rate stability in the short term, problems will remain in the long run if supply side weaknesses in Kenya's exports are not tackled urgently.

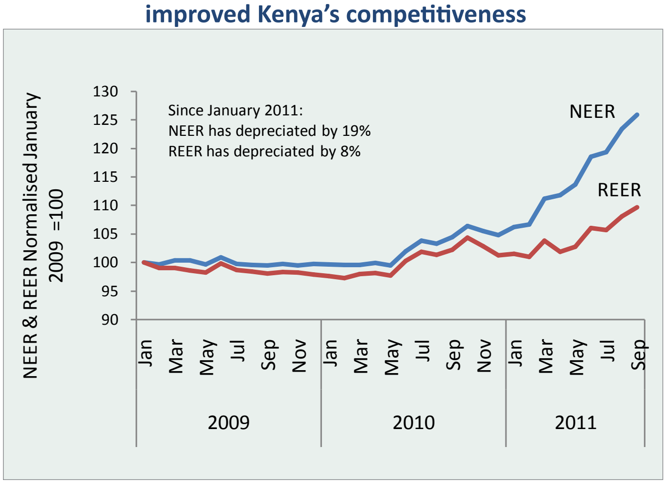
The weakening of the shilling has translated into only marginal benefits for exporters. A look at the trade weighted nominal effective exchange rate (NEER), which is a measure of how the shilling performs against the currencies of Kenya's trading partners, indicates that the shilling had lost 20 percent of its value against them from January 2011 to September 2011. However, export competiveness measured by the real effective exchange rate (REER) improved by about 7 percent (see figure 1.13). There are three possible explanations for this: (i) the benefits of a weaker exchange rate are being eroded to some extent by high domestic inflation (the real exchange rate has depreciated much less than the nominal exchange rate); (ii) Kenya's export products have a high import content (for instance chemicals and fertilizer), and the benefits of a weaker currency are

Figure 1.12: The government is taking a tighter fiscal position



Source: World Bank computations based on MOF

Figure 1.13: The depreciation in the Ksh has marginally improved Kenya's competitiveness

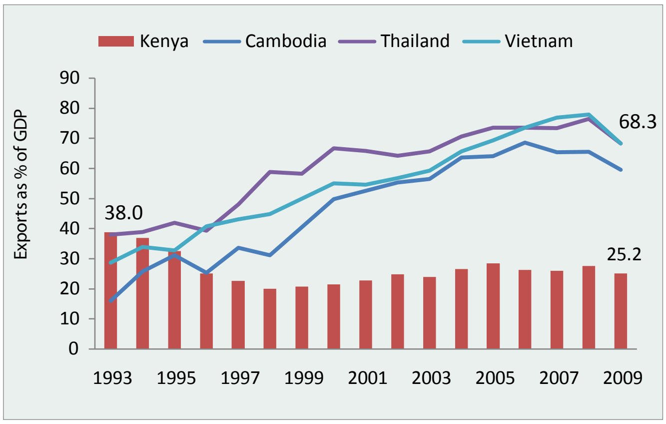


Source: World Bank computations based on CBK data

significantly offset when the currency depreciates; and, (iii) the depreciation seen since January 2011 is being driven mainly by fundamentals, and reinforced by speculative activity.

The current shocks have increased Kenya's vulnerability and highlighted structural problems in the economy that require long-term solutions. In the second economic update of June 2010, it was argued that the 'Kenyan economy is running on one engine', that economic growth is largely driven by domestic demand, and export growth is fragile. The extent of Kenya's economic fragility is reflected in the recent volatility of the shilling. Kenya's trade performance is below its potential. Three structural weaknesses in Kenya's export performance were identified, that have contributed to the current external vulnerability: (i) Kenya's openness to trade has improved only marginally in the last decade compared to comparator countries (see figure 1.14); (ii) the gap between potential and actual exports to current markets has widened; and, (iii) export diversification has progressed slowly and the export basket remains concentrated. In addition, the state of infrastructure, particularly energy, rail, and the port of Mombasa undermine export competitiveness. These challenges need to be addressed and resolved for Kenya to increase its export competitiveness.

Figure 1.14: Kenya's openness to trade has stagnated while Asian economies have taken off



Source: WDI

2. Outlook for 2012

2.1. Achieving moderate growth: the World Bank's projections

The World Bank projects a growth rate of 5.0 percent in 2012, increasing to 5.5 percent in 2013. Ongoing public investment in roads and energy will drive growth, while private investment is anticipated to grow moderately for two main reasons: first the tighter monetary policy stance adopted in the last quarter of 2011 is expected to continue in 2012; and second, investors are likely to remain cautious until a new government is elected and peacefully installed. Private consumption will increase from 2011 levels once inflation is contained, and the harvest from the current short rains produces an increase in the food supply. But fiscal consolidation will constrain growth in public consumption, as discussed in the previous section (see table 2).

Table 2: Macro Economic indicators 2007-2013

Variable	2007	2008	2009	2010	2011*	2012**	2013**
GDP	7.0	1.6	2.6	5.6	4.3	5.0	5.5
Private Consumption	7.3	-1.3	3.8	2.8	3.0	3.9	4.1
Government Consumption	4.4	2.3	5.5	4.8	4.5	4.3	4.6
Gross Fixed Investment	13.6	9.5	0.6	7.4	10.2	9.5	11.0
Exports, GNFS	7.3	7.5	-7.0	6.1	8.9	6.7	6.7
Imports, GNFS	11.1	6.6	-0.2	3.0	8.6	6.7	6.7

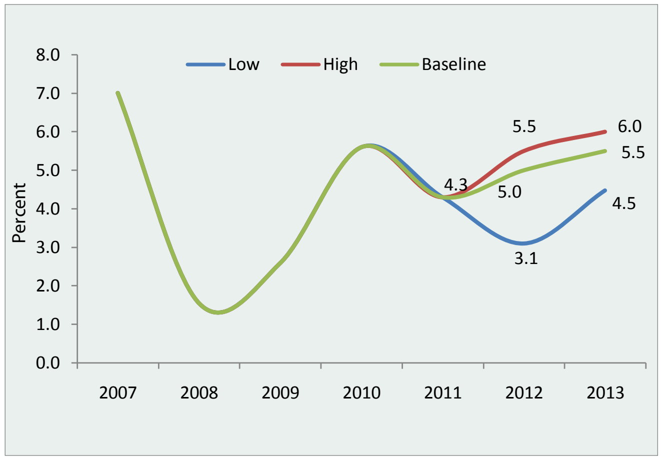
Source: World Bank

The pressure on the external account will ease as the current account deficit narrows. Tighter monetary policies and the depreciated currency will act as a brake on aggregate domestic demand. Also, the drop in international oil prices from an average of US$ 105 per barrel to a forecast price of US$ 97 per barrel in 2012, will reduce the costs of oil imports. Imports of intermediate goods used for production such as capital equipment and machinery, will decrease as private investment slows down. Production of tea and coffee should increase following good rains in late 2011. With improving conditions in Middle Eastern markets, exports of these crops will most likely increase. The flower industry is looking at markets in Asia, which could become competitive as these economies continue to grow. A similar situation applies to tourism and the Kenya Tourist Board has in fact begun an aggressive campaign to attract tourists from Central Europe and Asia. Kenya is already seeing the dividends from this strategy, as tourist from China increased by 50 percent between 2010 and 2011. Another bright spot for Kenya's exports are the ECA countries, whose economies are growing rapidly. Finally, strong growth in EAC countries should translate into higher regional exports of manufactured goods. This combined with a depreciated shilling should allow Kenya to expand its exports of manufactures within the region.

Growth could even approach 5.5 percent in 2012, if a number of favorable factors materialize. Kenya's economic and political situation would need to stabilize, and world markets would need to grow more rapidly, than what is currently forecasted. With moderate inflation, an improved current account, and a small decline in interest rates, private investment would pick up. However, a smooth run up to the elections will be essential for this scenario to materialize.

But growth could fall to around 3.1 percent if the environment worsened instead of improving. This scenario could develop if a number of adverse developments materialize, either from external shocks or from any of the numerous domestic challenges facing the Government (see section 2.2 below). Figure 2.1 shows the various economic growth scenarios for 2012 and 2013.

Figure 2.1: Starting 2012, growth should again reach 5 percent – if no shocks occur



Source: World Bank

2.2 Risks to economic growth in 2012: Euro crisis and elections

On the external front, the most challenging development would be full blown recession in the Euro zone[7]. Europe remains Kenya's main market for horticultural exports and tourism. Any crisis in the euro area would affect the demand for these products, and further weaken Kenya's foreign exchange position. The current slow-down in Europe has led to anemic growth in Kenya's horticultural exports, and this sector would be hit hard by a Euro crisis, unless the industry is able to diversify its markets.

Internal challenges in 2012 constitute another set of risks to economic growth. There are two major challenges which the government will need to address with great skill, in order to avoid economic disruption:

- Successfully managing the economic transition from a high inflation environment with a deteriorating fiscal position, to a moderately growing economy with restored macroeconomic fundamentals; and,

[7]*Annex Table A1.17 (Economic Shocks: Comparing 2009 vs. 2012 Outlook) compares the situation Kenya faced in 2009 at the time of the last global downturn with the situation it is likely to face in 2012.*

- Successfully managing the fiscal pressure associated with the run-up to the 2012 elections, and the current military incursion in Somalia.

Growth will suffer if Kenya is not be able to reduce inflation or restore its fiscal balance. Inflation should moderate in coming months as higher interest rates curb consumption and investment. Furthermore, expected reductions in the international price for oil, and increased domestic production of food should reduce the pressure on prices. Finally, the government is committed to restoring the fiscal balance, and has already demonstrated this by reducing borrowing and spending in 2011. It remains to be seen if the government can hold the line on spending in 2012. In particular, it may need to intervene to keep growth on track if the private sector holds back significantly because of the political uncertainty.

The second major risk is the uncertainty associated with the run-up to the 2012 elections[8] and the political transition to a new government. In the past, Kenya's growth performance has suffered during election years (both before and after the election). Over the past three decades, Kenya has had its lowest growth periods - on average about one percentage point below the long-term average - in or just following election years (see table 3).

Table 3: Kenya's growth is lower in election and post-election years

	Average Growth rate
All years 1980-2010	3.4
Election years	2.4
Post election years	2.7
Non election years	3.9

Source: World Bank based on KNBS

Kenya has experienced low growth in two thirds of the election years over the last thirty years. In these cases, pre-election violence and political uncertainty deterred domestic and international investors. The year 2007 was an exception, when Kenya benefited from stable macroeconomic policies and the Economic Recovery Strategy (ERS), and achieved its highest growth rate (7 percent) in recent history. The management of post-election dynamics is equally challenging. Over the last six elections, three were followed by low-growth, especially in 2008, when the post-election violence put an abrupt end to the achievements of previous years (see figure 2.2).

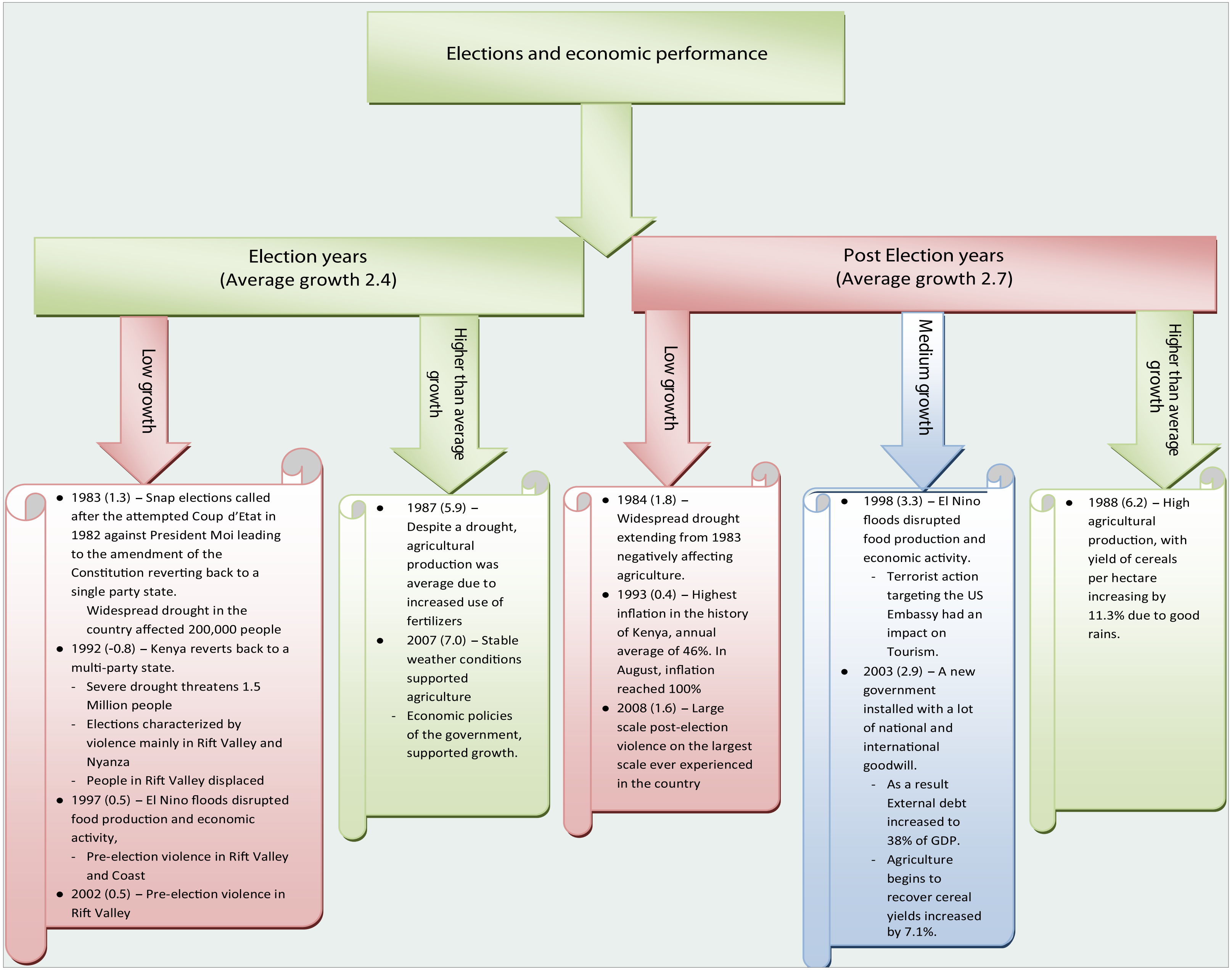
Elections have impacted activity via a number of channels. Most election years have had several common factors. They were characterized by negative growth in investment and household consumption, which typically decline in periods of uncertainty. Elections in Kenya are prone to uncertainty because they have often resulted in violence and new policy regimes.

Looking forward into 2012, the economic circumstances are more challenging than in 2007. The government will need to control public spending in light of inflation pressures and public debt burden. Although the government has committed to reducing expenditures, it will face spending pressures related to the devolution process, and to organizing and financing the 2012 elections.

The 2012 elections will not only usher in a new national government, but also a new system of devolved government. Businesses and investors will need to adjust to new institutional arrangements at the local level, that are yet to be fully developed, and to the possibility that a new government may come in with new policies. The result is likely to be a wait-and-see attitude from the private sector. But there is also an upside dividend if the election is handled well. The election period presents an opportunity for the government to restore public confidence in the legitimacy and power of institutions, and its ability to ensure justice, equity, and an enabling environment for development. The new government will need to manage these expectations, and the outgoing government will have to ensure a peaceful, flawless transition. Presently, there is every indication that the current government is aware of these challenges, and is proceeding with a program to keep the economy and the country on an even keel.

[8]One of the uncertainties surrounding the 2012 elections is the ongoing investigations by the International Criminal Court (ICC) on the violence that followed the 2007 elections. The ICC is investigating six politically influential Kenyans (including several potential candidates for the Presidency in 2012) and will decide in January 2012 whether to confirm charges against these individuals for a full trial. It is unclear what impact the ICC decision will have on the run-up to the 2012 elections, but a decision to go for full trial could result in some domestic political turmoil.

Figure 2.2: Kenya has experienced slow growth in many election and post-election years



Source: World Bank

Special Focus: Kenya's Momentous Devolution

The turbulence in Kenya's economy coincides with implementing the constitutional blueprint for a new political and administrative architecture; arguably the most momentous and far-reaching reforms in Kenya's post independence history. At the heart of this transformation is the devolution of power to county governments and the design of arrangements that will turn the constitutional vision into a reality. Kenyans bring to this process a tremendous enthusiasm and energy, but the devil lies in the detail. The design of fiscal, accountability, public service and transition arrangements will determine whether Kenya can weather the economic storm in a way that enhances social equity, service delivery, citizen engagement, and so deliver on Kenyans' expectations of constitutional transformation.

Devolution is a central promise of Kenya's new Constitution. But the ambition and magnitude of the administrative and political changes, and the formidable expectations about what it will deliver, mean that making it work will pose substantial challenges. The hope is that Kenya will become a more equal and economically balanced country, but making that hope a reality will take time, particularly given the current economic uncertainty. The downside risks—of service delivery failure and political backlash—are very realif devolution is not skilfully managed and seen to deliver tangible results. Successful implementation will require careful coordination and planning, clear communication, as well as visionary and committed leadership.

This Special Focus reviews the promise of devolution and the steps needed to deliver on it. Section three briefly covers the history of devolution in Kenya, because history and context are key to understanding the passion that Kenyans have invested in the devolution process. Then, by analysing gaps in access to services and growth variations across Kenya's counties, the importance of equity is stressed as a central promise of devolution. In section four, consideration of the main steps and challenges in designing fiscal arrangements that can deliver on the promise are discussed. Fiscal arrangements are core to the design, but so are mechanisms for ensuring good accountability by county governments to their citizens, covered in section five. Section six looks at ways of managing the risks when funds are not well spent. Finally, the outcomes of devolution will be profoundly shaped by how effectively the transition process is managed, covered in section seven.

If too much is expected of devolution, outcomes will inevitably disappoint some. In order to manage expectations, it is useful to focus on what devolution can and cannot realistically achieve. In particular, four popular myths that strongly influence common understandings of how devolution works need to be dispelled:

- **Myth #1: With devolution, central coordination is no longer needed.** Some Kenyans express the sentiment that the central government should largely stay out of devolution and leave it to the counties to manage their own affairs. The paradox is that, in fact, devolution requires sustained central coordination to be effective.
- **Myth #2: Devolution will result in additional resources and services at the local level.** There is a perception that the new counties will receive major new funding, and enjoy wide latitude to spend funds differently. Indeed, devolution involves shifting responsibilities and resources to the sub-national level, but the starting point is the existing levels of public spending. Counties will receive significant public funding but also the responsibility for funding existing services: if they decide to shift resources to new uses, they will need to make cuts in other services that are currently provided.
- **Myth #3: Devolution will immediately address entrenched inequity across and within counties.** Some counties will start at a relative disadvantage

and it will take time to build up their capacity and ability to use resources well. The paradox is that counties that stand to benefit the most from devolution in theory, because they were neglected under the old constitution, will be the least equipped in practice to make efficient and transparent use of their resources, and retain the skilled staff that are essential to making services work. This means that dramatic redistribution will not occur overnight: it will need to be phased in gradually.

- **Myth #4: Devolution will automatically result in increased accountability.** Countries around the world implementing decentralization reforms have repeatedly found themselves struggling with increased corruption, elite capture, and deterioration in service delivery. Kenya's own experience with decentralized service delivery has repeatedly highlighted the challenges when transparency and accountability systems are weak. Building a culture of accountability into the fabric of the new devolved county governments, will require early and sustained effort.

3. The promise of devolution: power for the people and equity

3.1 Kenya's long journey to constitutional transformation

Kenya's new Constitution marks a critical turning point for the nation. On August 27th 2010, Kenyans witnessed President Mwai Kibaki sign the new Constitution into law. This historic event was one of Kenya's greatest moments. In response to the people's expectations of greater democracy, human rights and accountability of the government to its citizens, the Constitution ushered in a new republic with expanded, transparent political and economic structures, including devolution to forty-seven counties. The new system builds on over sixty years' experience with local government, a brief flirtation with federalism at independence, and a decade of failed attempts at constitutional reform. The design of the system of devolved government must be understood against the backdrop of this complicated history (see box 3.1), which will also fundamentally shape the way it is implemented.

The new Constitution marks the end of a highly centralized state and attempts to resolve the critical issues of state power versus citizens' rights and control over the development process. Previous endeavors had failed. A powerful centralized state was ushered into place at independence, influencing key decisions including the formation of the judiciary and the parliament. The Kenya African National Union (KANU) finally lost power in the December 2002 general election, to a united National Rainbow Coalition (NARC), which promised a new constitution soon after it was installed in power. In 2003, NARC established the Constitution of Kenya Review Commission, which embarked on an all-inclusive process to overhaul the Constitution. The first draft was tested, but defeated, during a 2005 referendum, leading to a political crisis that continued to the December 2007 general election in which the results of the presidential vote were disputed.

The new Constitution establishes a powerful framework for democratic reforms, devolution of state power, land reforms, gender equality and human rights. Progress to date on implementing constitutional reforms has seen the appointment of independent office holders, including the Chief Justice, Attorney General, Auditor-General and Budget Controller, and three important constitutional bodies, the Commission on Implementation of the Constitution (CIC), the Commission on Revenue Allocation (CRA), and the Independent Electrol and Boundaries Commision.

Devolution of political and economic power to the new counties will take effect after the next elections. The new county governments feature full separation of powers between the Governor and County Assembly members, and a non-elected executive appointed by the Governor with the approval of the Assembly. They will enjoy a guaranteed share of national revenues, comprehensive law-making powers, a limited range of exclusive taxing powers,

>> Box 3.1: Decentralization in Kenya: overcoming post-independence concentration of power

Embryonic decentralization under the colonial state (1950s). Like in many other African countries, Kenya's system of local government was established during colonial rule. The colonial government had two separate systems; one for settlers and another for indigenous Kenyans. The system was restructured in the 1950s with the creation of African District Councils and a system of County Councils in white settler areas. These authorities had a majority of elected councilors, power to employ staff, formal legal status, and a system for collecting their own revenues (mainly the graduated personal tax). They also benefited from limited intergovernmental transfers. This two-tiered system was combined under the 1963 Local Government Act, which gave the new councils significant responsibilities and revenue-raising powers.

Aborted devolution post-Independence (1960s). The 1963 Constitution provided for a system of devolution now popularly referred to in Kenya as 'majimbo'. It established regions with elected assemblies and executive authority over roughly a third of government functions including health, education, agriculture, part of the police forces and local government. However, the newly independent government sought to weaken devolution in three ways: by exercising much closer control over regional civil servants than the Constitution envisaged, by delaying implementation of provisions allowing regions to assume full responsibility for their own finances, and by delaying the transfer of functions to the regions. The system was abolished in 1964 and replaced by provincial and district administrations. While local authorities continued to exist, their powers were assigned administratively rather than under constitutional authority.

Centralization of political and economic power (1960s - 1980s). Over the following two decades, the powers of local governments were gradually eroded. Although Sessional Paper 12 of 1967 included proposals to strengthen local government, the government reversed course with the Transfer of Functions Act in 1969, transferring many of local governments' functions back to the center along with their main sources of local revenue, leaving local governments considerably weaker than before. Following constitutional amendments in 1982 that concentrated power in the central government and president still further, the District Focus for Rural Development Program was introduced, as a means of involving local people in development and sharing resources more equitably. Ultimately, the program became a vehicle for presidential political patronage, undermined the role of local governments, and resulted in little meaningful redistribution of economic development.

Piecemeal decentralization (1999-2010). This decade saw the introduction of devolved (geographically earmarked) funds in an attempt to address spatial inequality. The most notable were the Local Authority Transfer Fund, (LATF)-created through the LATF Act No 8 of 1998, the Road Maintenance Levy Fund, (RMLF)created through the Kenya Roads Act, 2007, the Rural Electrification Fund, created through the Energy Act of 2006 and the Constituency Development Fund, created through the CDF Act of 2003. Despite these piecemeal efforts to address inequality in resource distribution, political tensions remained high spilling over into the 2007 election crises and subsequent unrest, which proved to be the tipping point leading to demands for a new Constitution.

Source: World Bank, adapted from Cherry Gertzel, 'The Politics of Independent Kenya', 1970 and Paul Smoke, 'Local Government Finance in Developing Countries, the Case of Kenya.' 1994

and control over their own public servants. These dimensions of devolution offer the potential for real and meaningful control by local citizens over service delivery and local economic development.

As of December 2011, Kenya is halfway through the preparatory phase of the devolution process. The first constitutional deadlines were met in August 2011, with the enactment of the Urban Areas and Cities Act, and a law on national guarantees for county borrowing. A further seven bills are currently pending, covering the framework for administration of county government, intergovernmental relations, public financial management, and the transition process. These bills are, or soon will be, before the CIC.

This report covers important policy issues that are rapidly evolving. Within the next six months, Kenya will enact the remaining bills into law and make some crucial decisions about how the transition process should proceed. By early 2013, the first county governments will have been elected. By that time, many of the questions raised in the following pages

will have been decided, one way or another, and new issues will be emerging. Indeed, devolution is a constantly evolving process with no fixed end point. Although the constitutional referendum in many senses marked the end of a journey, in another sense, Kenya is at the beginning of a new and hopeful road, which offers the opportunity to turn the constitutional promise of devolution into a reality.

3.2 Devolution and people's expectations: the hope for a more balanced model of development

The 2010 Constitution ushered in a sense of national renewal. After four decades in which power was perceived to have been removed from the people and concentrated in the hands of a small elite, the new Constitution provided renewed optimism that power and resources would be shared more equitably. The Constitution is predicated on five basic principles; (i) equity and inclusiveness; (ii) equity of opportunities; (iii) delinking politics and policy; (iv) better access to national resources; and, (v) bringing government closer to the people.[1] These aspirations resonate with the views of the top leadership of the country, as well as of ordinary Kenyans (see boxes 3.2 and 3.3).

3.3 A challenging starting point: enduring inequality and a highly ambitious devolution project

Two factors suggest the need for realism about how soon devolution can deliver on people's high expectations. First, Kenya is starting from a base of enduring inequalities in service delivery – inequalities that may even be exacerbated in the initial transition phase of devolution. Second, Kenya's devolution is among the most ambitious in the world, in terms of its scope and proposed speed. Resolving these inequalities will take time, and a learning by doing approach to devolution, especially given that county administrations will be new and inexperienced when they start out. Paradoxically, a more gradual transition is more likely to result in the full delivery of the promise of devolution embedded in the Constitution.

A history of spatial inequalities

Spatial inequalities help to explain the passion Kenyans display for constitutional issues and the hopes that they have pinned to devolution. Economic development has been concentrated along a narrow corridor between Mombasa and Kisumu,

>> Box 3.2: The promise of devolution as seen by Kenya's leaders

"The new institutions that will come with the national and county governments need the support of all Kenyans. More importantly, let us use the opportunities being offered by the county governments to develop all corners of the country. The devolved governments must be adequately anchored in readiness to make their contribution to the attainment of Vision Twenty-Thirty."

President Mwai Kibaki (Speech on August 27, 2010 - Presidential Press Service)

"By devolving power and resources to the 47 new counties, we shall be investing in local solutions for local problems, and facilitating local ownership of improvements to infrastructure, such as roads, irrigation, schools and hospitals."

Prime Minister Raila Odinga (Speech to Strathmore University August 24, 2010 - Prime Minister Press Service)

[1] *Final Report of the Task Force on Devolved Government (2011)*

>> Box 3.3: What Kenyans hope devolved government will do for them

Alice Vutage – Housekeeper in Nairobi. Born in Western Kenya 32 years ago, Alice Vutage migrated to Nairobi in 2000 in search of employment. With little education and determination to support her family back home, she found a job as house-help. Alice is not conversant with the new Constitution. All she knows is that it will improve the livelihood of Kenyans, a fact gathered from her daily interaction with friends and relatives. "People say that the new Constitution will bring a lot of development in the country, and this makes me happy, because I would like to see people in my village leading a better life," she said. Alice who is a single mother of a two year old daughter, hopes that the new Constitution will help to create job opportunities in her rural area, so that people can engage in economic activities, and become less dependent on financial support from relatives who work in big cities. "I am really eager to see how life will improve for my daughter and I when the new Constitution is implemented," she said, with a hint of apprehension in her voice.

Yvonne Chigiri – 21 year old student from Kilifi. Yvonne is currently pursuing a diploma in human resource management. "What I like most about the new Constitution is the way it addresses women's issues, compared to the old Constitution," she said. Yvonne believes that the new Constitution will eliminate inequality in the job market, which in turn will improve welfare outcomes of many households.

In addition, she believes that the shift of public service delivery through counties will be a more effective way of addressing people's problems. This is because the selected governors will have direct contact with the people they represent and hence, be in a better position to address their problems more effectively. Although Yvonne prefers to work in Nairobi once she completes her studies, she is hopeful for the youth in rural parts of the country, because urban areas will soon develop in the new counties and create job opportunities there. "Even though people will still be living in the rural hinterlands of the counties, the new urban areas will soon have the necessary infrastructure for job creation for many youth who are currently jobless," she said.

Kenyans hope the new devolved government system will...

1. Improve livelihoods for all;
2. Bring development, infrastructure and jobs to remote parts of the country;
3. Create new opportunities for future generations;
4. Promote more gender equality;
5. Ensure more effective service delivery at the local level.

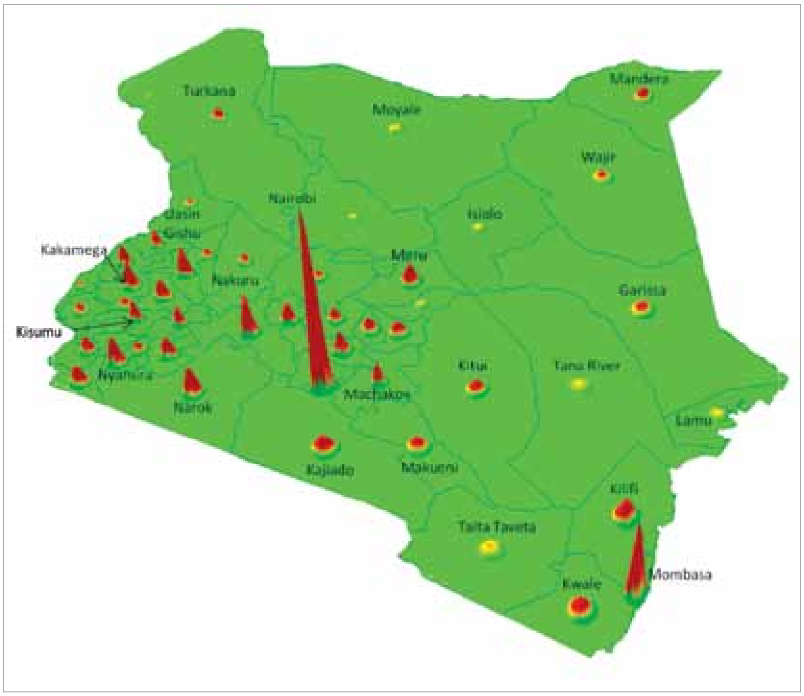
Source: World Bank

leaving wide swathes of the country behind in terms of economic activity and employment. Moreover, the wealth created by Kenyans has not been adequately redeployed through public service delivery, to promote equal opportunities for all.

Economic activity has been and remains concentrated in specific geographic areas. Nairobi and Mombasa, the leading urban centers, account for the bulk of Kenya's total production (see figure 3.1). Eighty percent of Kenya's economic activity is generated by only one half of Kenya's counties (23 out of 47). Outside of the two biggest urban centres, activity is highly concentrated in a few leading areas. Annex 2.1 contains a detailed methodology for estimating counties levels of economic activity.

Kenya's experience with spatially unbalanced growth is by no means unique. Heavy spatial concentration of economic activity is the norm in most developed and developing countries. Initial natural endowments (like fertile soils) and location factors (like proximity to ports) are reinforced by migration of people to areas where they can make a living more easily—a process known as agglomeration. Firms tend to cluster where there are other businesses that supply inputs or buy their products or services. These agglomeration and clustering effects explain

Figure 3.1: Economic activity is concentrated in Nairobi, Mombasa and Kenya's South West



Source: World Bank

to a large extent why some regions have developed faster than others and remain more dynamic; why cities, as opposed to rural areas will increasingly be driving growth, and why only a few among them have the potential to become major industrial and service hubs. In China, three coastal provinces accounted for over 50 percent of the country's GDP in 2005.[2]

Make growth more inclusive

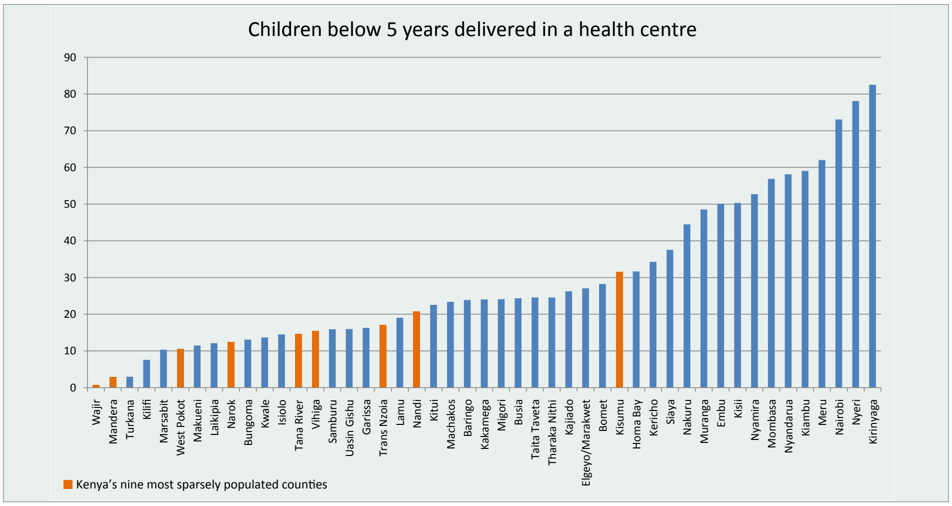
Although economic activity will be spatially concentrated, development can be inclusive if the state redistributes national income through investments and services. In other words, while all areas may not have the potential to become centers of economic development, all Kenyans should be entitled to the same level of basic services and to equal opportunities, in order to lead a healthy productive life. How well has Kenya delivered on this front until now?

One measure of this is the extent to which Kenyans have equal access to education, health care, and adequate water and sanitation. Access to these services neatly captures opportunities because it plays a large role in determining individuals' welfare over the course of their lives. In this section, coverage rates for these services are presented. In the graphs below, counties have been ranked from left to right in terms of access (from lowest to highest) and colour-coded to tag Kenya's nine most sparsely populated counties, so as to check for correlation between access to services and population density (used as a proxy for remoteness).

Inequality of opportunity is pervasive in Kenya, indicating partial failure of the Kenyan state over the years to redistribute the national income through services. The index of access to health services (measuring the share of newborns delivered at a health facility) displays the highest levels of inequality between counties. For example, while over 8 in 10 children are delivered at a health facility in Kirinyaga, just 1 in 20 have that chance in Wajir, which is located in the arid northern part of Kenya. This is closely mirrored by the index for access to safe water. While over the years, primary education

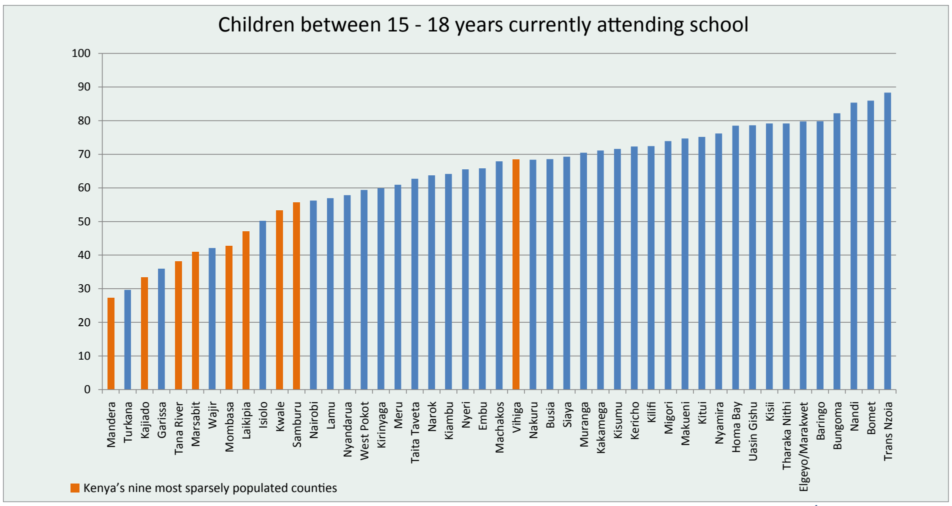
[2] *Source: World Bank World Development Report 2009*

Figure 3.2: There are significant differences in access to health care between counties



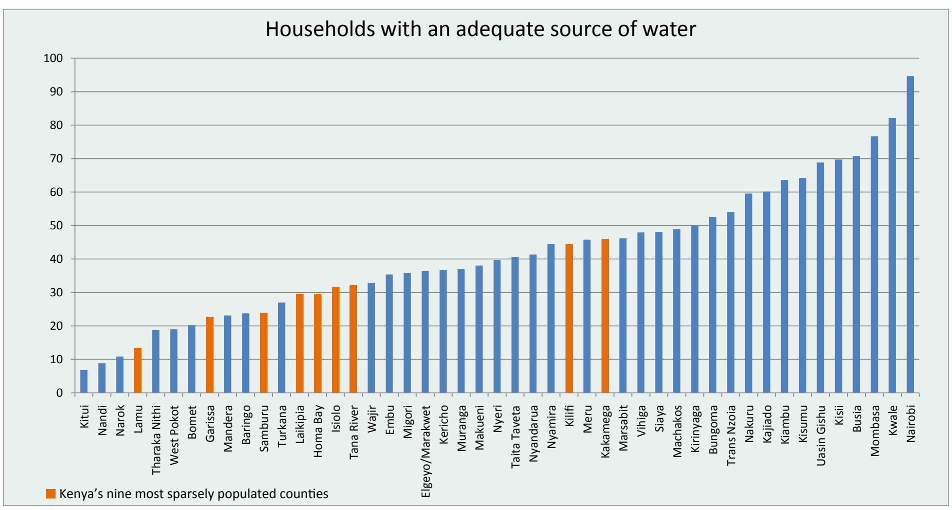
Source: World Bank computations based on Kenya Integrated Household Budget Survey, 2005/06

Figure 3.3: Primary education is relatively evenly spread but not secondary education



Source: World Bank computations based on Kenya Integrated Household Budget Survey, 2005/06

Figure 3.4: Access to water and sanitation, which is highly unequal, affects health, development and livelihoods



Source: World Bank computations based on Kenya Integrated Household Budget Survey, 2005/06

outcome gaps have narrowed (thanks to the free primary education policy) there are still significant differences at the secondary level.

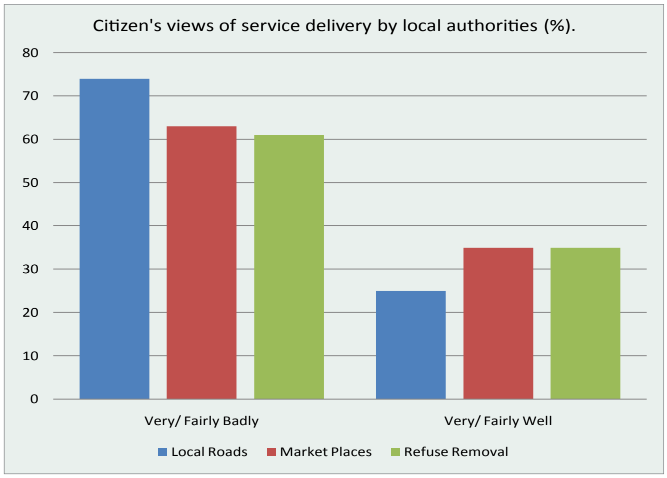
Variations in access to services mirror, to a large extent, historical patterns of marginalization. Kenya's North-Eastern areas—which are the least developed economically—have failed to receive the level of central government attention and support required to equalize access to services (arguably the cost of delivering services there, and the needs will also have been significantly higher). For instance, while malnutrition is relatively low in Mombasa, where 84 percent of children are of adequate height for their age, in Wajir county only 21 percent of children are of adequate height for their age, implying very high levels of chronic malnutrition. Overall, there is close correspondence between low population density and low social outcomes and as figure 3.1 shows, economic activity as well. Therefore, the only way that these inequities can be addressed is through redistribution and the design of adequate fiscal arrangements.

Is devolution the solution?

Some counties will require particular assistance to catch-up, but devolution alone is no guarantee that this will happen. While devolution is explicitly seen by many as a direct response to historical patterns of neglect, it is by no means certain that it can radically alter these imbalances by itself. In fact, it could even result in entrenching disparities, if the right policies are not implemented. Except for education, most public services will be delivered by county governments. A recent survey of the performance of Kenya's local authorities recorded very high rates of dissatisfaction with the services that local authorities are delivering (see figure 3.5). There are many explanations about why local governments have failed, but results to date demonstrate that it will be quite challenging to get devolution right, and there will be many opportunities to get it wrong.

Is devolution the "magic bullet" that will allow Kenya to turn the page on marginalization and inequitable distribution of wealth and opportunities? This

Figure 3.5: Kenyans think Local Authorities have performed poorly at basic service delivery



Source: Afrobarometer Kenya Survey, 2008. (difference from 100% total on account of 'don't know' answers)

will depend critically on the design of devolved government—much of which remains to be determined—as well as on the management of the massive transition from the current to the new government structure. Flawed design, poor planning, weak coordination and fragmented leadership, could compromise the ability of county governments to operate effectively and affect the incentives of leaders to respond to their citizens' demands for key services. A rushed transition might set counties up to fail, by giving them responsibilities before they have the capacity to carry them out. If the practical and detailed steps involved in Kenya's radical reforms are not thought through, the immediate risk is a breakdown in service delivery. The greater long-term risk is of a political backlash if the Kenyan people feel that their hopes and aspirations for devolution have been deceived.

What needs to happen if devolution is to help redress Kenya's entrenched inequalities of opportunity? Whether the devolution process can deliver on the promise of the Constitution will depend on design and implementation: (i) giving counties adequate resources to carry out their assigned functions; (ii) ensuring that accountability systems give them the right incentives to use resources effectively; (iii) adequately addressing risks that resources—both financial and human—will be badly managed; and, (iv) making sure there is orderly coordination and

management of the transition from the current centralised system to the newly devolved one. In the following chapters, challenges of successful design and implementation across these four dimensions will be considered.

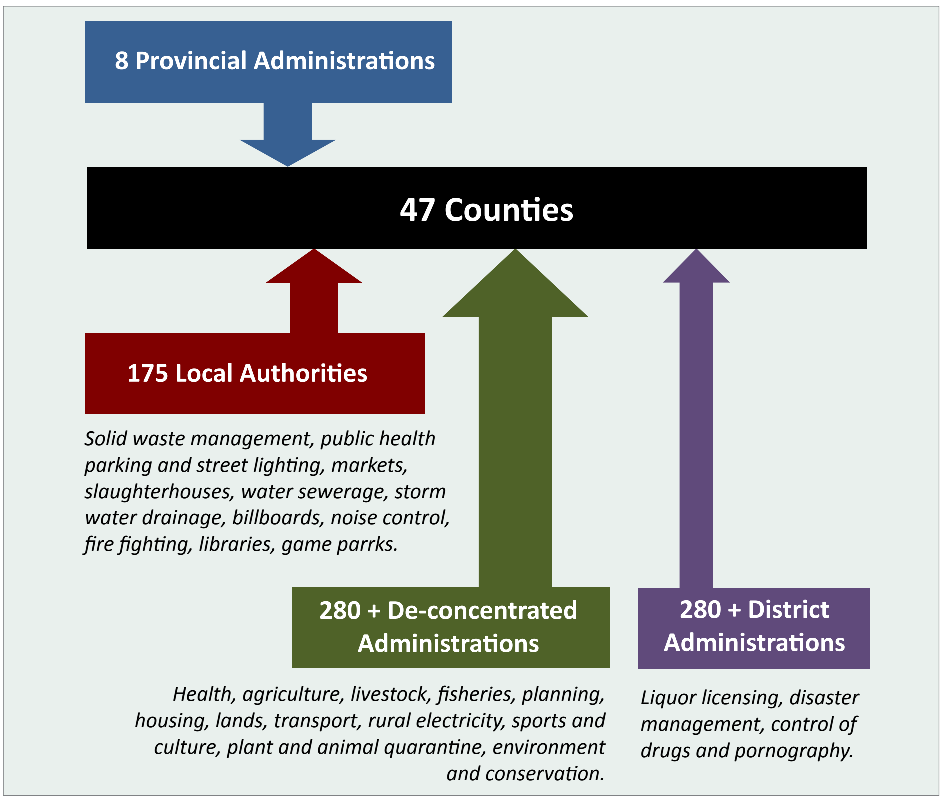
4. Financing the promise of devolution

More equitable distribution of resources lies at the heart of the constitutional objectives of devolution. Achieving this goal is more complicated than it might seem at first. It involves both dividing resources vertically (between national and county governments), and sharing them horizontally between the counties. Equity needs to be balanced with efficiency to make sure that existing services are not compromised, especially in urban areas, that are critical for future economic growth. Conditional grants may be an important instrument for realising key national goals, but they should not crowd out the space for county governments to exercise real autonomy over resources—or else the potential benefits of decentralization will be lost. It will not be possible to strike an appropriate balance between these competing considerations overnight; it will take time, and devolution should be seen as a constantly evolving process, rather than a short-term journey towards a fixed end point.

Kenya's devolution is also particularly ambitious by global standards. Not only does it involve the creation of forty-seven new elected governments, but the administrations that support them will be forged out of around 280 existing de-concentrated and district administrations, and 175 local authorities. Managing change on this scale would be a major undertaking for even the most capable and cohesive government.

Reaching the goal of improved equity will take time. County administrations will need to develop the capacity to use resources in ways that reduce

Figure 4.1: Kenya's devolution involves a major restructuring of public administration



Source: World Bank

>> Box 4.1: Key elements of Kenya's devolution arrangements

Political structures. Kenya's new Constitution establishes forty seven new county governments, each with an elected Assembly, a Governor and an Executive Committee. Both the Executive Committee and the Governor are from outside the Assembly, meaning that there will be full separation between the legislature and executive at county level, just as there is at national level. Counties (although not county governments) will also have a voice in the national Parliament through the new upper house, the Senate, which mainly comprises forty seven directly elected county representatives.

Functions and powers. County governments are responsible for a range of service delivery functions, including health, agriculture, transport and water. In many of these areas, the national government also has responsibilities. In general, the national government is responsible for policy and oversight, while counties are responsible for implementation, but the national government retains some important service delivery functions, including the provision of education and social welfare services. The Constitution also provides for counties to take over urban functions that were previously the responsibility of local authorities established under the Local Government Act.

Local government. The Constitution envisages changes to the way urban areas are governed, but does not specify them. The recently enacted Urban Areas and Cities Act provides for urban areas with over 250,000 inhabitants to have corporate bodies to manage urban services. Today, five urban areas in Kenya meet this threshold. In other urban areas with a population under 250,000, the executive responsibilities of local authorities will pass to county governments, although a town committee will advise the county government. In both cases county governments will be responsible for financing urban service delivery.

Financing. County governments' resources will come from four main sources: a) own source revenues, b) equitable share transfers, c) equalisation fund transfers and d) other conditional or unconditional grants from the national government.

Staffing. Each county government will have its own public service and will be able to appoint its own public servants, within a "framework of uniform national standards" prescribed by an act of Parliament (Article 235 of the Constitution). Significant numbers of staff that are currently performing devolved functions, in sectors like health, agriculture and urban service delivery, are expected to move across from national to county governments.

Changes to local governance and service delivery. The forty seven county governments will take over both functions and revenue raising powers from the one hundred and seventy five local authorities that are currently responsible for urban service delivery and a limited range of other functions. It is expected that the staff of local authorities will be absorbed into the county governments. County Governments will also take over the service delivery responsibilities currently performed by the staff of many deconcentrated line ministries in the counties (including health, agriculture, livestock and others) and also some of the functions of provincial and district administrations (including liquor licensing and control of drugs).

Source: World Bank

inequality. While systems of strong accountability can be put in place at the start, it will take time for citizens to learn how they can influence their elected representatives to make decisions that benefit the majority. Implementing devolution is like flying a plane: too much speed heightens the risk of mechanical failure, but too little speed runs the risk of stalling, both with the same ultimate outcome. Thus balancing is required across two dimensions; firstly between the competing policy considerations, and secondly in terms of the time within which it is planned to achieve them.

4.1 How much will counties need?

Much attention has been paid to how much county governments should receive, because this is seen as a measure of whether government is serious about devolution. While this focus is understandable, the real question, to start with, is how much county governments will need. The fundamental principle of financing devolution is that *funding should follow functions*. Counties need sufficient funding to carry out the functions that are devolved to them, and to begin to address the most noticeable service gaps. In practice, costing the counties' needs presupposes: (i) clarity over

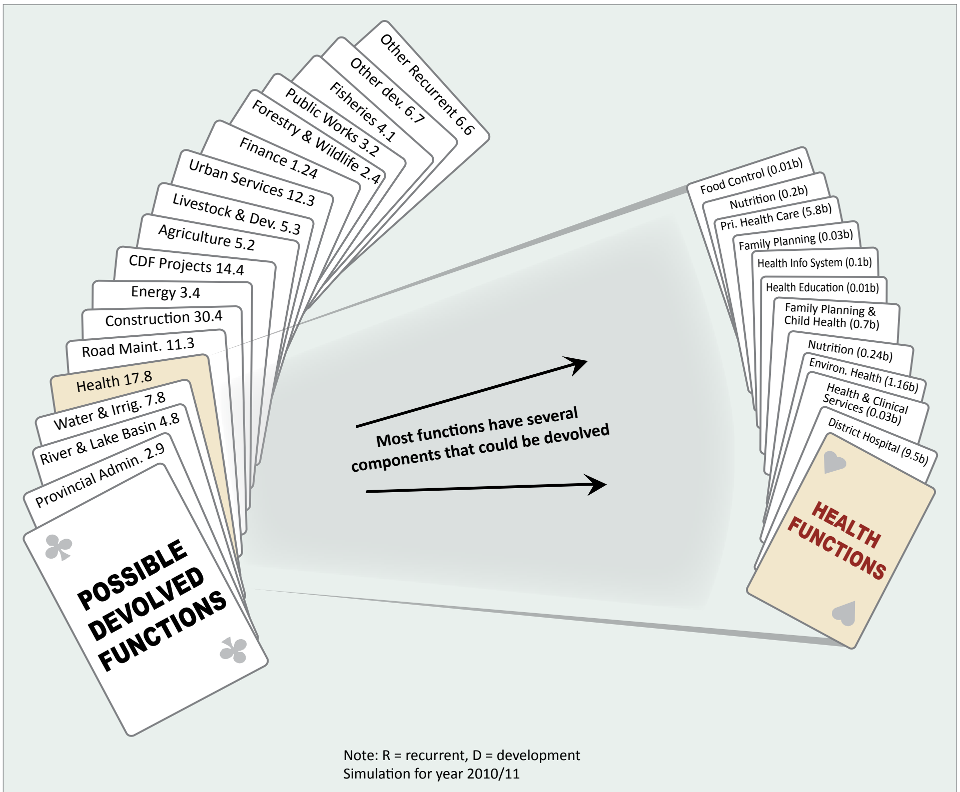
the assignment of functions between national and county levels; as well as, (ii) a roadmap for phasing in these functions (and the funding associated with them) over time.

While the Constitution provides a broad framework for assignment of functions between national and county levels of government, some major decisions still need to be made. The Fourth Schedule of the Constitution sets out the respective functions of county and national governments, and Article 186 provides for the national government to retain functions that are not explicitly assigned in the Fourth Schedule (i.e. 'unspecified' functions). Crucially, the unspecified functions will have to be defined before what is defined as a county function becomes clearer. For example, in areas of shared responsibility, like health, some important activities like training, HIV and provincial hospitals are not mentioned in the Fourth Schedule. A clear decision is needed as to whether these are unspecified functions that belong to the national government, or are considered part of the county functions that have been listed in the Fourth Schedule. Other sectors face similar assignment issues.

Specify functions

Even when major functions are all specified, it will be essential to 'unbundle' the many specific functions within each sector. The Fourth Schedule refers to very high-level aggregated functions and additional decisions are required at a much more detailed intra-sectoral level. These decisions cannot be made on the basis of the Constitution alone, and require careful consideration. They will often have significant cost implications. For example, in agriculture the 2011/12 budget disaggregates agricultural extension into three: Headquarters, Provincial and District extension services. Should these all pass to county level, or only some? Figure 4.2 shows a graphic representation of different components of the health services, some or all of which might be devolved.

Figure 4.2: Once major functions are all specified, unbundling them is the next step



Source: World Bank based on Estimates of Recurrent and Development Expenditures 2010/11

Most counties are unlikely to be ready to take over many of these functions right away. Some will be ready earlier than others. The Constitution provides for a transition period during which functions should not be transferred to a county government unless it is ready. A roadmap will be required to guide how the phased transfer happens. Phasing could be approached in two ways. One approach is to transfer functions sector-by-sector, for example, by first focusing on health functions, then agriculture and so on. Another way is to transfer across several sectors at once, but to transfer only some activities, in each sector initially. Clear communication will also be required to ensure that the counties realise that a gradual approach to the transfer of functions is absolutely necessary for the success of devolution, rather than simply an excuse to delay or halt it altogether.

Funding should then follow function, with resources available to counties to be matched with estimated county costs. There are four main sources of county revenues (see box 4.2) which will need to be considered jointly. The objective of the revenue sharing arrangements should be to ensure that counties have sufficient resources to meet the costs of delivering the assigned functions from all sources of revenue, and that the resources continue to be sufficient, as county needs change over time.

Work out the cost

How much counties need will vary depending on how the transfer of functions is sequenced. Clearly defining, unbundling and assigning functions is the first step; the second step is ensuring that counties receive enough collectively to fund those functions. This is sometimes referred to as 'vertical sharing'. It is an intensely political process in all countries, and this is no less true in Kenya. Because there is never enough to meet all competing demands for expenditure, the process of vertical sharing should be focused on reaching a fair split, taking into account both national and county needs.[3]

Vertical sharing starts with an understanding of the aggregate needs of county governments. Existing spending by the national government on future county functions provides a good starting point. In the 2010/11 fiscal year, the national government budgeted KES 140 billion for a range of functions that could conceivably be transferred to county governments over time in line with the

>> Box 4.2: How will counties be funded?

Counties will receive revenue to fund their functions from four different sources:

- ***Own source revenues.*** The Constitution grants counties the exclusive right to collect property taxes and entertainment taxes, as well as fees associated with licensing businesses and charges from other services. Since revenues from these taxes and fees are relatively modest, most counties will be heavily dependent on transfers.

There are three kinds of transfers provided for in the Constitution:

- ***Equitable share.*** First, national revenues are divided equitably between the two levels of government, with counties guaranteed to receive a share of not less than 15 percent of national revenue. This is a lower limit: the National Assembly will decide the percentage annually as part of the budget process, after considering advice from the Commission on Revenue Allocation (CRA). The horizontal allocation of the county equitable share across each of the fourty seven counties will be decided according to a resolution of the Senate made every five years, after receiving advice of the CRA.
- ***Equalisation Fund.*** An additional amount of 0.5 percent of national revenue is channelled into an Equalisation Fund, to be used to provide basic services to marginalized areas. The allocation of the fund will be decided through the budget process.
- ***Unconditional or conditional grants from the national government.*** The national government may pay additional conditional or unconditional grants to counties from its share of national revenue. The allocation of these grants will be determined through the budget process.

Source: World Bank

[3] *The Constitution of Kenya has provided guidance, both through the criteria listed in Article 203, and in the form of independent advice from the Commission on Revenue Allocation. In this respect, Kenya is already ahead of many countries with much more developed systems of decentralization.*

Fourth Schedule of the Constitution. This analysis is shown in table 4.1, and uses the 2010/11 fiscal year to simulate the process of determining the vertical division of resources. It shows the key functions that might be transferred to counties (including the CDF), and what assumptions about the percentage split between county and national governments underpin the costing. These assumptions are further detailed in annex 2.2. The amounts attached to each function are converted into a percentage of the total pool of

Table 4.1: Current funding for devolved functions likely to be delivered

Vote	% of vote budget devolved	Type R= Recurrent D=Development	Budget 2010/11 (KES billions)	As % of sharable revenues in 2010/11	Budget 2012/13 as extrapolated from 2010/11 shares (KES billions)
Provincial Administration	6.6%	R	2.7	0.6%	3.7
		D	0.2	0.0%	0.3
River and Lake Basin Authorities	77.9%	R	0.8	0.2%	1.1
		D	4	0.9%	5.4
Water and Irrigation	32.8%	R	2.1	0.5%	2.8
		D	5.7	1.3%	7.7
Health	42.7%	R	14.2	3.1%	19.2
		D	3.6	0.8%	4.9
Road Maintenance (recurrent only)	25.2%	R	11.3	2.5%	15.3
		D	n/a	n/a	n/a
Construction of Roads (development)	67.7%	R	n/a	n/a	n/a
		D	30.4	6.7%	41.1
Energy	17.1%	R	0.7	0.2%	0.9
		D	2.7	0.6%	3.7
Constituency Development Projects funded through CDF	3.6%	R	n/a	n/a	n/a
		D	14.4	3.2%	19.5
Agriculture	31.7%	R	3.3	0.7%	4.5
		D	1.9	0.4%	2.6
Livestock and Development	81.4%	R	3	0.7%	4.1
		D	2.3	0.5%	3.1
Urban Services	66.0%	R	12.3	2.7%	16.6
		D	n/a	n/a	n/a
Finance	2.3%	R	1.2	0.3%	1.6
		D	0.04	0.0%	0.1
Forestry and Wildlife	40.7%	R	1.7	0.4%	2.3
		D	0.7	0.2%	0.9
Public Works	49.8%	R	0.7	0.2%	0.9
		D	2.5	0.6%	3.4
Fisheries	99.9%	R	0.9	0.2%	1.2
		D	3.2	0.7%	4.3
Other functions	3.9%	R	6.7	1.5%	9.1
		D	6.6	1.5%	8.9
Total			**139.8**	**31%**	**189.2**

Source: World Bank Staff based on Estimates of Recurrent and Development Expenditures 2010/11

Functions which cost more to deliver compared to others.

national revenue available for sharing. This allows the results to be applied to fiscal year 2012/13. For that year, the extrapolated cost of devolved functions would total KES 190 billion. Depending on what functions are actually transferred on "day one," the amount that counties need in the early years of devolution might be much less, with a gradual progression towards this.

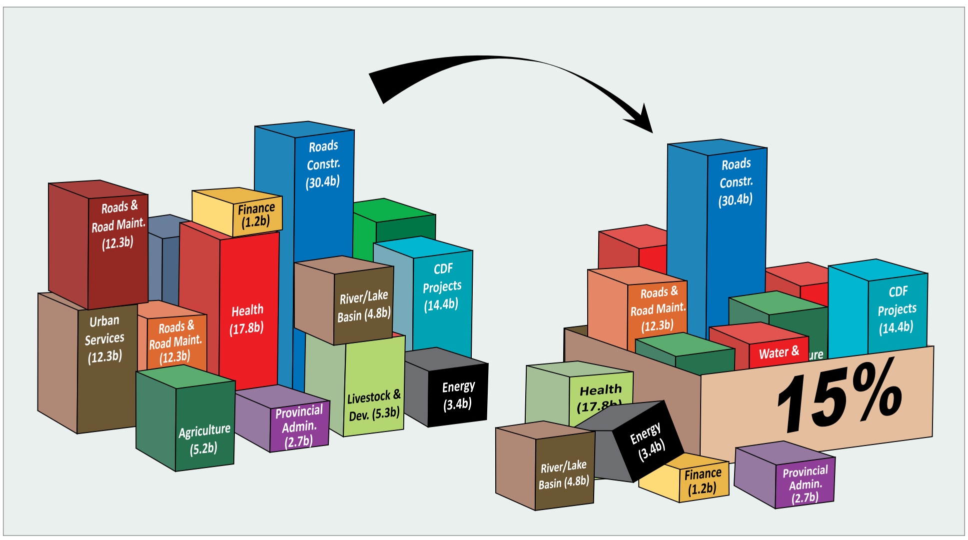
In thinking about function assignment, it makes sense to concentrate on defining the more costly functions first. Some functions cost a lot more to deliver than others (see highlighted rows in table 4.1). This is why it is so important to make function assignment decisions soon, so that the assessment of total county needs is based on an accurate understanding of which costs counties will be expected to bear.

As more functions are transferred to county governments, the counties' share of national revenues will need to increase. International experience suggests that a good deal of discipline is needed to ensure that changes in the functional assignments always result in corresponding reviews of the funding arrangements, so that funding continues to follow function. Since the national government raises most of the revenue, and the national parliament decides on the respective shares of revenue, it will be up to the national government to ensure that counties have enough funding to do what they are responsible for. If this does not happen, and their resources fall short (as shown in figure 4.3), the inevitable result will be that services deteriorate. Because defining functions will remain a central ongoing dynamic in the system of devolution, it is crucial that these decisions are managed through an orderly and transparent process, in which fiscal implications are at the forefront.

Coordinate function assignment

The process for defining county functions, and the timing of their transfer, should be coordinated centrally. Line ministries know the most about how functions are best delivered, but they often seek to retain as many functions as possible. Because the Constitution requires that a minimum percentage of national revenues is shared with counties, devolving too few functions could leave the government with too little funding to finance its own responsibilities. This would potentially create pressure for more borrowing, and threaten the macro-economic stability Kenya has successfully maintained for a number of years.

Figure 4.3: Current funding for functions likely to be devolved is well in excess of 15%



Source: World Bank

>> Box 4.3: How functions might be transferred

The Task Force on Devolved Government has included a proposed mechanism for the transfer of functions to counties in the draft Transition to Devolved Government Bill. The mechanism has four elements:

(a) criteria for assessing whether a county is ready to receive a function

(b) applications by individual counties for specific functions to be transferred to them

(c) a determination on the application by the Transition Authority, also to be established under the same Bill

(d) publication of the determination in the gazette.

This approach has several advantages. It establishes a natural filtering mechanism: to be able to apply, counties must have some capacity first. It provides a transparent process that is relatively free from discretion (as far as this is possible), and it puts an independent and neutral body in charge.

However, there are also some disadvantages. It is likely to generate a large volume of applications, with perhaps between 500 and 2,500 individual applications being generated. The Transition Authority will have to rely on line ministries to help it evaluate applications, because it is unlikely to have the technical expertise to assess whether a county is ready to carry out a function. Finally, the resulting 'patchwork quilt' of different counties with different functions (each presumably receiving funding on a different basis), would make the intergovernmental financing and performance management arrangements very complicated.

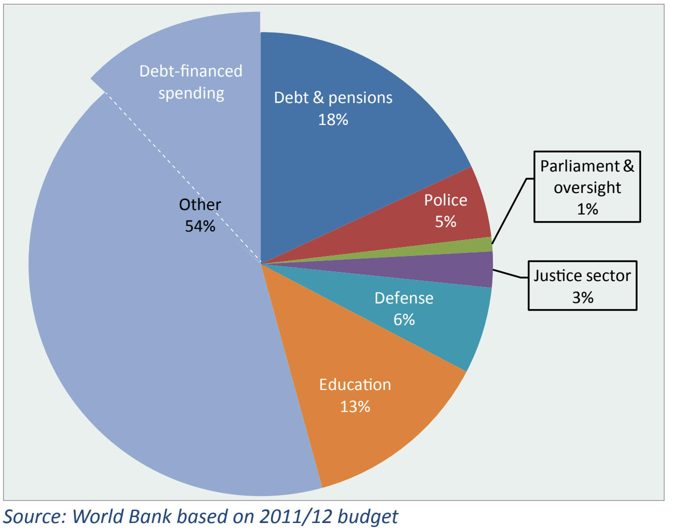
Source: World Bank adapted from the August draft of the Transition to Devolved Government Bill, downloaded from www.cickenya.org

Clarity of functions is not just important for financing, it is also key for accountability. Unless citizens know which level of government is responsible for what, they cannot hold them accountable. Even within a constitutional framework of function assignment, the distribution of functions is usually dynamic. Changes are likely as both levels of government determine what works best for service delivery. To ensure there is always clarity there should be: a framework for negotiating reallocation of functions between levels of government (preferably on a whole-of-government basis rather than ministry by ministry); and, a mechanism through which ordinary Kenyans can easily find out which level of government is responsible for a particular service.

Balance national interests

National needs also have to be considered. The national government retains important and costly functions, like education and police. The Constitution directs that national interests are also relevant in deciding the respective shares of national revenue. Figure 4.4 shows what the national government is currently spending on different functions, including debt servicing, and how much of that spending is financed by borrowing. The amount of 'room to move' within the national priorities is relatively small, in comparison to the large spending items. Many of the big items in the national budget are sticky. Spending on debt servicing, and on paying the salaries of teachers, soldiers, police and provincial administration, cannot be reduced overnight, or easily.

Figure 4.4: The 'room to move' in the national budget is limited



Source: World Bank based on 2011/12 budget

At a time of fiscal hardship, Kenya simply cannot afford to give revenues to counties unless the corresponding costs are also shifted there. Moreover, transferring functions is never neat and tidy: some residual costs are inevitably left behind, at the national level, and costs of delivery at the local level cannot be assumed to remain the same. In particular, the proposal for national staff to be seconded to counties during the transition period[4] creates a risk of blowing out the wage bill, if large numbers of the seconded public servants are not absorbed into county administrations and return to the national level, once the transition phase is over. All these issues need to be considered as part of the function assignment process.

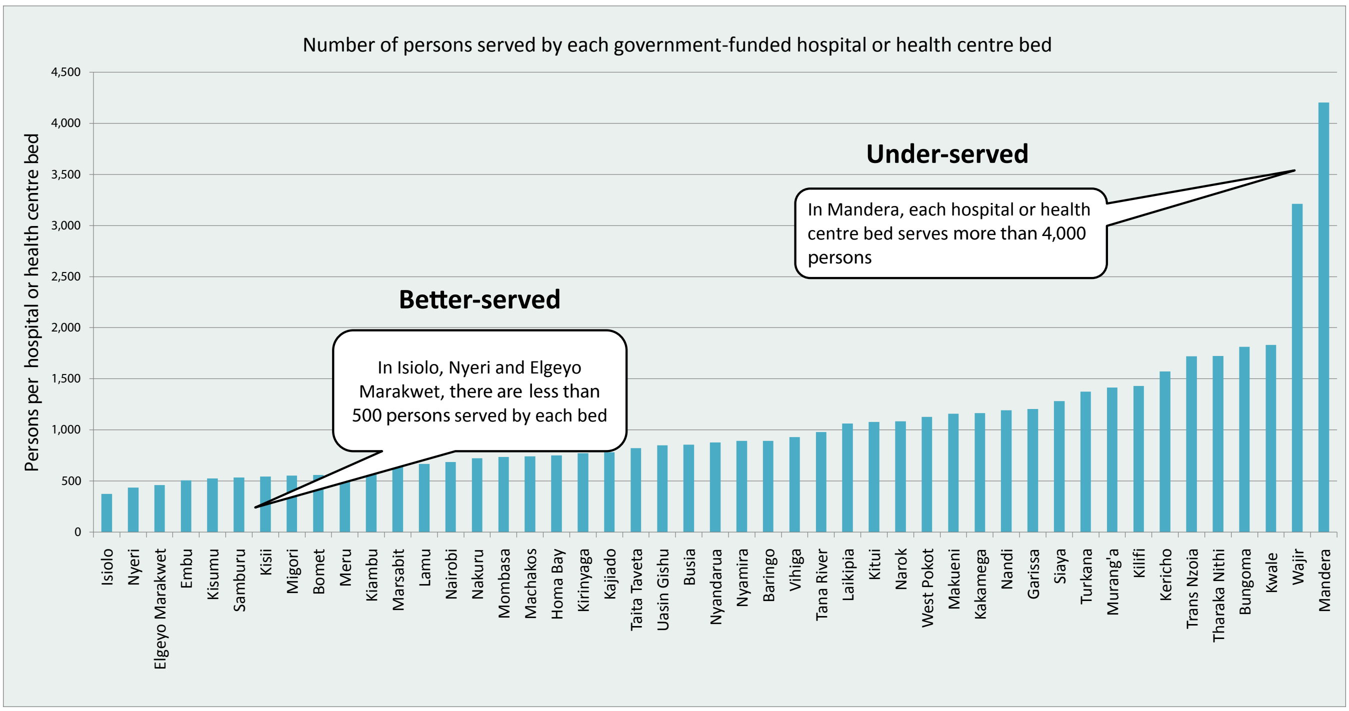
Refine the costing over time

Current spending by the national government is a good starting place, but it does not tell the full story of county needs. These will also include: (i) the total cost of urban service delivery (which is partly funded out of own revenues); (ii) some service delivery costs that are currently being financed by donors; and, (iii) the costs involved in running the new county institutions created under the devolved government arrangements. Moreover, there are a number of reasons why the cost of delivering services at central versus local level cannot be assumed to be identical (these reasons include scale diseconomies, efficiency differentials etc.).

Current spending from the national budget also reflects the inequitable treatment of some parts of the country. In the more remote and marginalized counties, the national government currently does not allocate sufficient resources to assure a basic level of service delivery to their citizens. These counties will need additional resources if service and infrastructure gaps are to be closed. Figure 4.5 shows the number of people for each publicly funded hospital bed in each county. The county with the poorest access, Mandera, has more than ten times as many people per bed, than do the counties that are best served—Isiolo, Nyeri, and Elgeyo Marakwet.

If access to services must increase in underserved counties while maintaining existing levels elsewhere, the overall cost of service delivery will rise. Over

Figure 4.5 : Existing service levels reflect entrenched spatial inequities



Source: World Bank based on Health management information systems (www.hiskenya.org)

[4] *Section 28 Transition to Devolved Government Bill and Section 157 Devolved Government Bill, versions available on the Commission on Implementation of the Constitution website.*

time, the annual calculation of the vertical share should take into account this expansion, reflecting increases in the population and more equitable access to services.

4.2 How much should each county get?

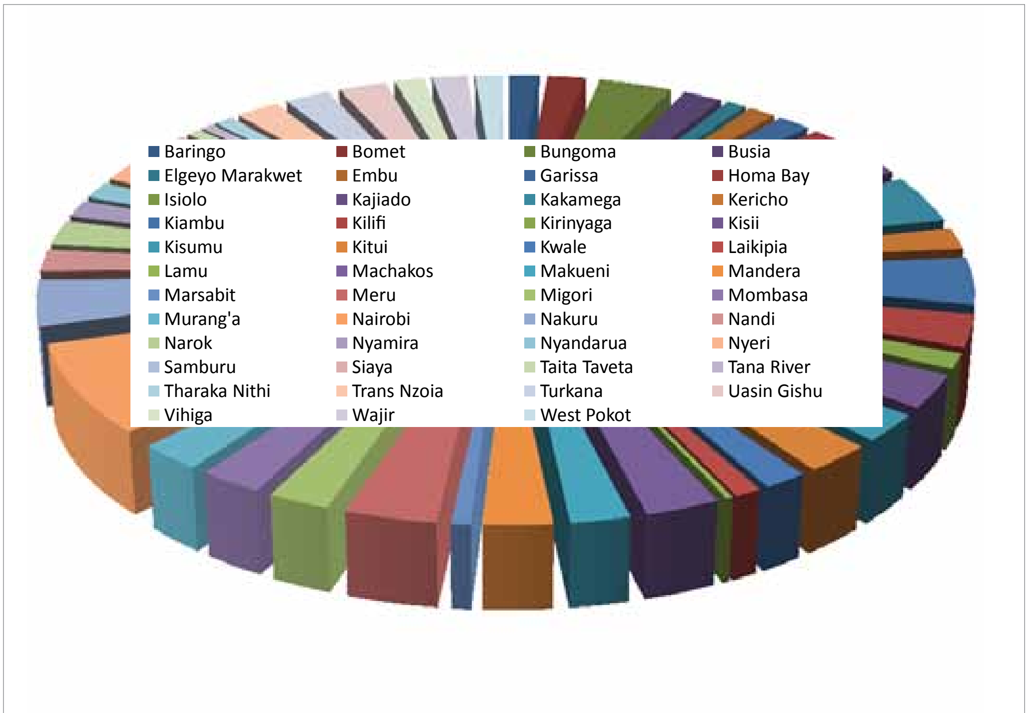
Working out total needs for all the counties is only a first step; the next challenge is to distribute this total across the forty-seven counties. This process of horizontal sharing will be particularly complex because the goal of equalization will need to be pursued without disrupting services or undermining growth and efficiency. This has two major implications: (i) existing imbalances may only be tackled over time; and, (ii) equalization policies should target people who will benefit from improved services, rather than trying to achieve equality between different geographic locations.

Equalize access to services

Equity is a central value in Kenya's Constitution, but how to achieve it in practice through redistribution is very complex. The difficulty derives from the fact that people have various understandings of what is equitable, and because broad principles eventually need to be translated into a workable transfer formula. While formulas can capture many different variables, there is always a trade-off involved. The more finely tuned a formula is, the more complicated it becomes. This is particularly important for Kenya, because the Senate will decide the formula for horizontal sharing. Members of the Senate are likely to want a simple formula they and their voters can readily understand.

Equity does not mean each county should get an equal share. At the very minimum, a formula should seek to balance the costs different counties will face in delivering their mandated functions. The crudest measure of cost differences is population: all other factors being equal, population is the most significant driver of cost differences between counties (figure 4.6 illustrates the outcome of a purely population based formula). But in addition, counties also experience other cost disabilities. For example, delivering services to people in remote areas that are sparsely populated costs more per person. Some populations also have

Figure 4.6: Cutting the cake: illustrating a population-based formula



Source: World Bank based on 2009 census, KNBS

>> Box 4.4: Equalization as an explicit goal of the Constitution

Article 203 of the Constitution (Equitable share and other financial flows) explicitly underscores the redistribution objective of the proposed transfers architecture.

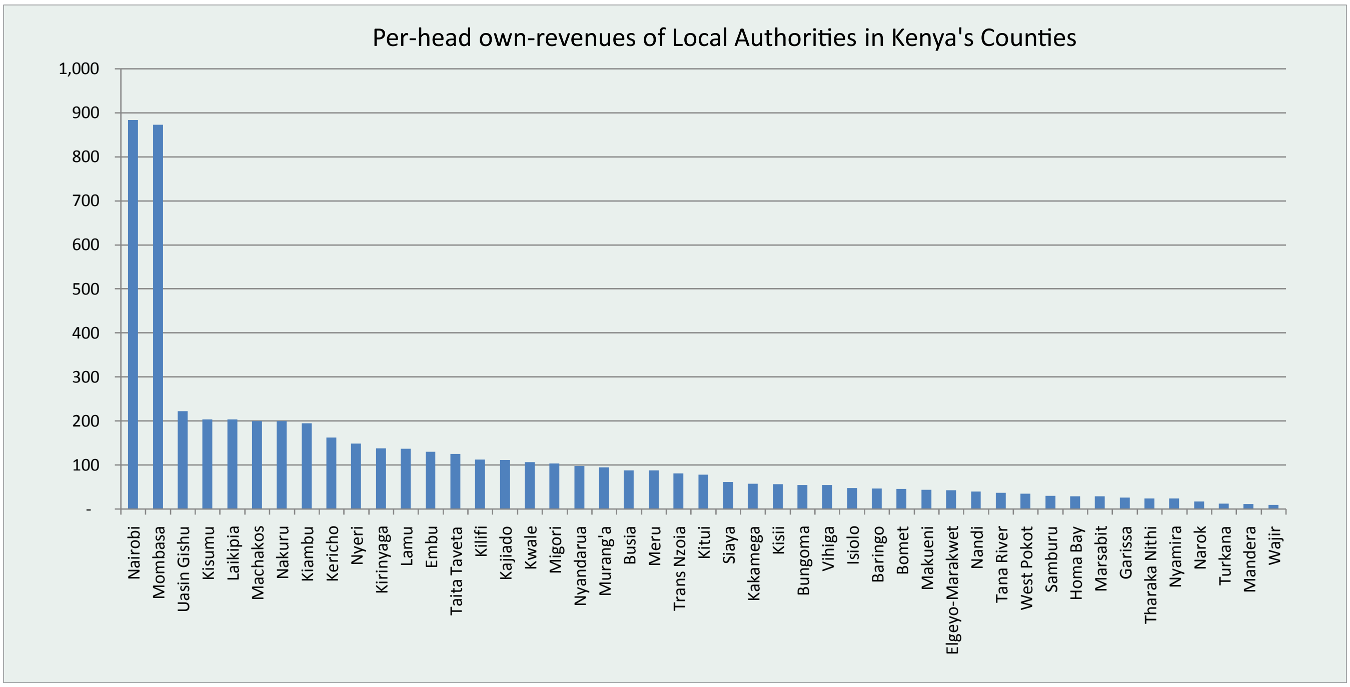
Among the criteria to be taken into account in "determining the equitable share":
- developmental and other needs of counties
- economic disparities within and among counties and the need to remedy them
- the need for affirmative action in respect of disadvantaged areas and groups

Source: World Bank staff based on the Constitution of Kenya

higher service needs (for example if the population suffers more illness and disease). A simple formula can add measures such as land area (to account for the much higher unit costs of delivering services to sparsely distributed populations), or poverty prevalence (to capture higher needs associated with poor communities). Both of these measures are readily available for Kenya.

Transfers may need to account for own revenue potential. Counties are not only unequal in terms of needs, they will also have widely different abilities to raise revenues to meet them. Figure 4.7 shows the per capita revenues raised by local authorities in each of the 47 counties in 2008/09. Local authorities currently have similar revenue raising powers to those the counties will have, so these figures provide some indication of the revenues counties will be able to mobilise from their own sources. On this basis, the per capita local revenue of Nairobi county would be more than ten times that of Garissa county. This raises an important question about whether the transfers will take into account both the highly diverse set of needs as well as available resources. Formulas that take into account both needs, and resources are often described as fiscal gap formulas (see annex 2.3).

Figure 4.7: Own-revenue potential will vary widely across counties



Source: World Bank staff calculations based on LATF annual report 2008/09

Transfers should address equality of opportunity by equalising access to services—not gaps in levels of economic development. Article 203 of the Constitution requires that the formula should take into account *"economic disparities within and among counties, and the need to remedy them."* [5] But does this mean that each county can expect to eventually have a capital city the size of Nairobi, or an international airport?

It is not realistic to expect all counties to reach the same level of economic development. As nations develop, population and production concentrate around urban areas. In Kenya, few probably think that Turkana or Garissa will ever catch up with Machakos or Narok; likewise it is unlikely that Kitale can be tomorrow's Nairobi. The process of development almost universally implies an initial increase in inter-area disparities in living standards, before the gap begins to narrow when countries reach a high level of income. The reason why these gaps in living standards narrow as a country's income grows is because the benefits of economic development are increasingly shared with the whole population as a country becomes more wealthy. The main avenue for sharing wealth—achieving inclusive growth—is to improve social services that benefit all citizens.

Policies seeking to reduce internal disparities in production and living standards are likely to be inefficient and costly. Not all counties, even with adequate infrastructure and public services, have the same potential to develop. In these cases, it is much less costly to move factors of production (workers and capital) from lagging to leading regions—where their full productive potential can be realized—than to develop remote areas. While large transfers to lagging regions would possibly generate equity and efficiency benefits for that region, the country as a whole would be losing.

The goal should be that all Kenyans have the same opportunities through universal access to services and deeper integration of the economies of different regions. While not all regions of Kenya will grow at the same rate, redistributive policies—including intergovernmental transfers—should seek to ensure that all Kenyans, regardless of where they live, have access to a basic bundle of quality services such as basic education and health, drinking water and sanitation, and security. This means adequately resourcing counties, to the extent that they are able to use these resources efficiently and transparently. Moreover, the distance between lagging and leading areas should be narrowed through integrated

>> Box 4.5: People versus places ... re-inventing the wheel?

The World Bank's 2009 World Development Report must have seemed extremely familiar to Kenya's policy-makers. Its flagship recommendation, to target equalization policies at "people versus places" is strikingly similar to the directions of Sessional paper 10/1965. In paragraph 134 of the section entitled Provincial Balance and Social Inertia the paper states:

The purpose of development is not to develop an area, but to develop and make better off the people of the area. If an area is deficient in resources, this can be best done by-

(i) Investing in education and training of the people whether in the area or elsewhere;
(ii) Investing in the health of the people; and
(iii) Encouraging some of the people to move to areas richer in resources; and of course
(iv) Developing those limited resources that are economic.

Good intentions don't always result in good outcomes. Enduring inequalities in Kenya reflect the failure of the central government over the years to roll out the policies outlined in the 1965 Sessional paper.

The transfer system under devolution should empower and resource county authorities to do precisely that. However it does not and should not force them to do so. The challenge on going forward will be to design the proper democratic and financial incentives to realise these outcomes.

Source: World Bank

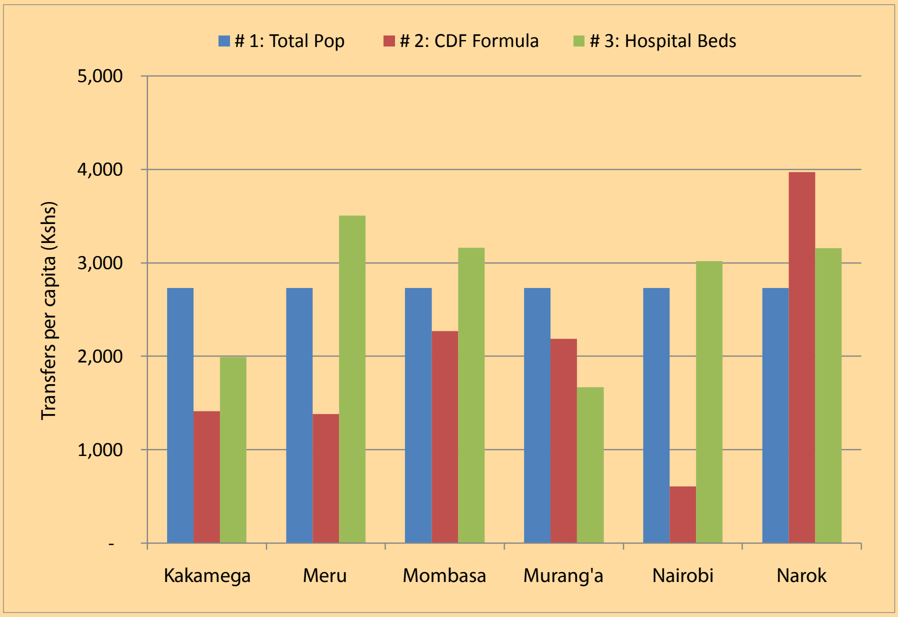
[5] *Constitution of Kenya, Article 203(1)(g).*

>> Box 4.6: Simulating the complexity of sharing revenue across counties

For the purpose of illustration, 15 percent of Kenya's revenue raised nationally in respect of FY 2010/11 is divided among the fourty seven counties on the basis of three different hypothetical allocation formulas:

- Formula # 1: Purely per capita allocation
- Formula # 2: Current CDF formula [equal shares (75 percent) and poverty rate (25 percent)]
- Formula # 3: Simulated inherited needs [county share of hospital beds]

The resulting allocations to six selected counties are as follows:



Main take-aways:

- The choice of formula will generate widely different outcomes for each individual county and therefore creating and winners losers.
- Formulas with equal share components will disproportionately benefit small counties.
- Accounting for inequalities will need to be traded-off against the risks of:
  - o Leaving richer counties with significant unfunded liabilities; and
  - o Exposing poorer' counties to absorptive bottlenecks.

Source: World Bank

infrastructure development, which will connect marginalized areas to the country's growth poles.

What are the implications for the transfers system?

- Unconditional intergovernmental transfers should first and foremost seek to equalize the capacity of counties to deliver a basic package of essential services;
- Additional policy goals could be financed through conditional instruments;
- Central government may retain the responsibility for developing integrative infrastructural policies that facilitate the movement of goods, services and people.

Safeguard economic efficiency and growth

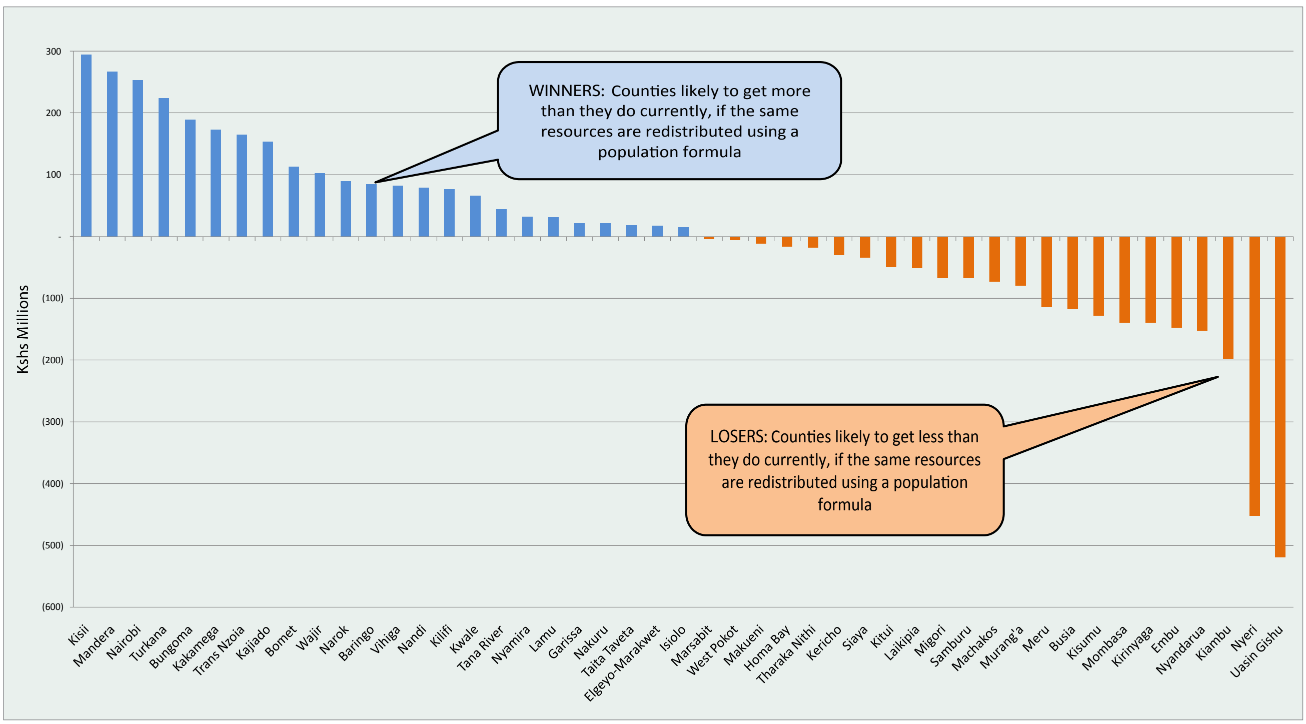
Large-scale redistribution across counties may not be possible or desirable immediately, given budget constraints and efficiency considerations. All other things being equal, any formula that would channel

significant additional resources to marginalized or lagging counties would result in reduced funding for all other counties. There are two major risks: firstly, even wealthy counties may not have the flexibility to rapidly reduce outlays, particularly if they are currently allocated to sticky uses (such as personnel or multi-year projects). Secondly, these counties are also among Kenya's most dynamic regions, which are driving economic growth and generating the bulk of the national income out of which redistribution efforts will eventually be financed.

The immediate priority is to preserve existing service delivery. Kenya's counties start from very different positions. This also means that they will inherit vastly different obligations in terms of existing sticky expenditure liabilities. Any drastic move to redistribute resources away from affluent towards destitute counties could result at best in severe fiscal stress, and at worse in the collapse of essential service delivery. For instance, figure 4.8 presents a very crude simulation of "winners and losers" if existing resources for district health[6] were reallocated purely on a population basis. Counties like Kisii or Mandera would benefit, but Uasin Gishu or Nyeri would see a dramatic decline in the resources available to fund existing services. That is because these areas currently have good access to health services compared to the rest of the country, and redistribution of resources will mean they will get substantially less. In some cases, they may get so much less that they cannot afford to maintain services at existing levels.

Equalize over time. While the short run priority is to maintain existing service delivery, this does not mean business as usual forever. Equalization should be pursued over time. Box 4.7 provides an illustration of how redistribution can be phased in gradually, and this should be clearly communicated to the public, so that it is widely understood.

Figure 4.8: Winners and losers of radical equalization



Source: World Bank calculations based on 2010/11 budget estimates and health facility data - Health Management Information Systems, Min. of Health

[6] *To estimate current allocation we have used distribution of nurses as a proxy.*

>> Box 4.7: How Papua New Guinea introduced equalization gradually

Papua New Guinea introduced a new intergovernmental financing system in 2008. The political negotiations involved in getting sufficient number of MPs to pass the required constitutional amendments meant striking a deal to ensure no province would lose out as a result of the changes. Mechanisms of this kind are often called 'hold harmless' provisions.

The new arrangements provide for provinces to share a percentage of national revenue called the Equalisation Amount. Over a five-year transition period, the provincial percentage share has gradually increased each year, starting from a base which gave provinces a slight increase over the previous year. The distribution of the Equalisation Share is based on a two-step process. First, an amount equal to the nominal value of the amount each province had received in the year before the new system began was distributed. Second, the remaining balance is distributed on an equalisation basis. As the amount of the Equalisation Share increases each year, there is more available to equalise.

At the end of the transition period, these 'hold harmless' arrangements stop, and the whole pool is distributed on an equalisation basis. Initially, it was feared that this would result in some provinces' funding suddenly reducing, but it was decided to deal with this closer to the event. As it happens, these fears have not been realised. Because of strong national revenue growth, the equalisation pool has grown, and the amount available for all provinces is sufficient to ensure any decrease is very small compared with overall levels of funding.

Source: World Bank

There is a second compelling reason for avoiding radical redistribution. Areas that currently receive the lion's share of national revenues not only provide services that reach beyond county boundaries (such as referral hospitals and international airports), but also generate the bulk of these revenues to start with. Maintaining services in these areas is essential to continued wealth creation for the whole country. Specifically, there is an acute risk that the ability of Kenya's cities to remain the country's main engines of growth will be significantly undermined.

4.3 Protect the urban growth engine

Urban areas are increasingly important for economic growth in Kenya. Currently the bulk of Kenya's economic output comes from its urban centers and as the economy becomes more service oriented, and less dominated by agricultural production, economic growth will be more dependent on good urban management. Urban areas provide proximity benefits to businesses. But firms need more than just proximity: they need an enabling environment that provides well-managed transport networks, good security, consistent power supply, and management of solid waste. In other words, stable and reliable delivery of basic urban services.

As cities grow in size, delivering these functions becomes more complex and expensive. This is why international practice is for cities to be managed by democratically elected, fiscally autonomous urban local governments that can collect taxes from urban residents and use them to provide urban services. City governments are amongst the most complex public sector organizations, with large programs of capital investment, extensive asset management, and sophisticated accrual accounting systems.

Mitigate recentralization of urban service delivery

The recently enacted Urban Areas and Cities Act 2011 recentralizes urban service delivery for most urban areas from local authorities to county governments (see box 4.8). It remains to be seen what impact this bold and globally unprecedented experiment in urban management will have over time, but there is a clear risk that urban service delivery may be interrupted in the short to medium term. There are two aspects of the new arrangements that give rise to this risk: (i) the abolition of corporately managed bodies for most urban areas in Kenya; and, (ii) the recentralization of management responsibility under county governments, most of which will likely have a strong rural bias.

>> Box 4.8: Recentralization of urban service delivery?

Under the Urban Areas and Cities Act:

- County governments can establish corporate municipal boards for urban areas over 250,000. All other areas have town committees that are unincorporated and operate through the county administration
- Cities can be established for urban areas over 500,000. A special purpose city can be created if there is good reason, but this is unlikely to apply to urban areas that are too small to be municipalities
- Members of the municipal and city boards will be appointed (in part by the county government, and in part by local associations representing professional, business, informal sector and residents)
- Municipal and city council functions include planning, control of land use, regulating public transport, and service provision functions delegated by county governments
- Funding for municipal and city county functions will come from grants from the county government, or revenue raising powers delegated by the county government
- Citizen fora will provide an opportunity for citizens to air their views
- Nairobi is the capital city awill be governed as a county. Kisumu and Mombasa are deemed to be cities

Source: World Bank

Only three of the existing local authorities qualify to become city or municipal boards under the Urban Areas and Cities Act. The Act provides for cities and municipal areas to have corporate bodies to manage them, but it sets a minimum population threshold of 250,000. Urban areas between 10,000 and 250,000 are classified as towns and entitled only to an unincorporated town committee to advise the county government on management issues. Assuming Nairobi and Mombasa are governed as counties, only three urban areas will qualify for municipal boards—Eldoret, Nakuru and Kisumu. Kisumu is deemed a city.

Even if they do not have direct electoral representation, having corporate entities to manage urban services would provide greater continuity with existing local authority arrangements. A larger number of urban areas would have had corporate management under the proposals of the Task Force on Devolved Government, which recommended the minimum threshold for municipal boards should be 75,000 inhabitants. The threshold was lifted when the Bill was debated in Parliament. Table 4.1 shows the impact of this different threshold on the number of corporate entities. The table in Annex 2.4 shows which urban areas would have corporate management under different population thresholds.

Maintain urban services to generate county revenues and nurture private sector growth

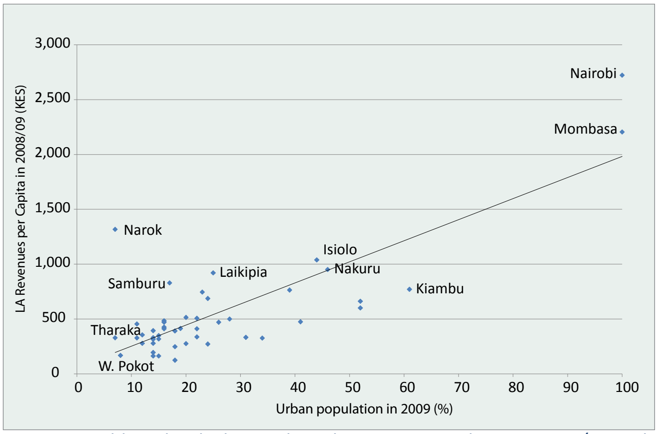
Urban residents will contribute a disproportionately large share of county revenues, but they could be the biggest losers under Kenya's devolution. Only five counties (Nairobi, Mombasa, Kiambu, Kisumu and Machakos) have a majority of urban residents (see figure 4.10). In these counties, there is less reason to fear the deterioration of urban services because the majority of residents will be very concerned to ensure

Table 4.2: Impact of different population thresholds on the number of municipal and city boards

Cities under Urban Areas and Cities Act (UACA) (threshold 500,000 + Kisumu)	3
Municipalities under UACA (threshold 250,000)	2
Number of urban areas over 75,000 (TFDG recommendation for municipal threshold)	33
Number of counties that would have at least one municipal board, if threshold is lowered to 75,000	22
Number of counties with no urban area having a municipal board, if threshold lowered to 75,000	25

Source: World Bank

Figure 4.9: County own revenues will be derived mostly from cities…

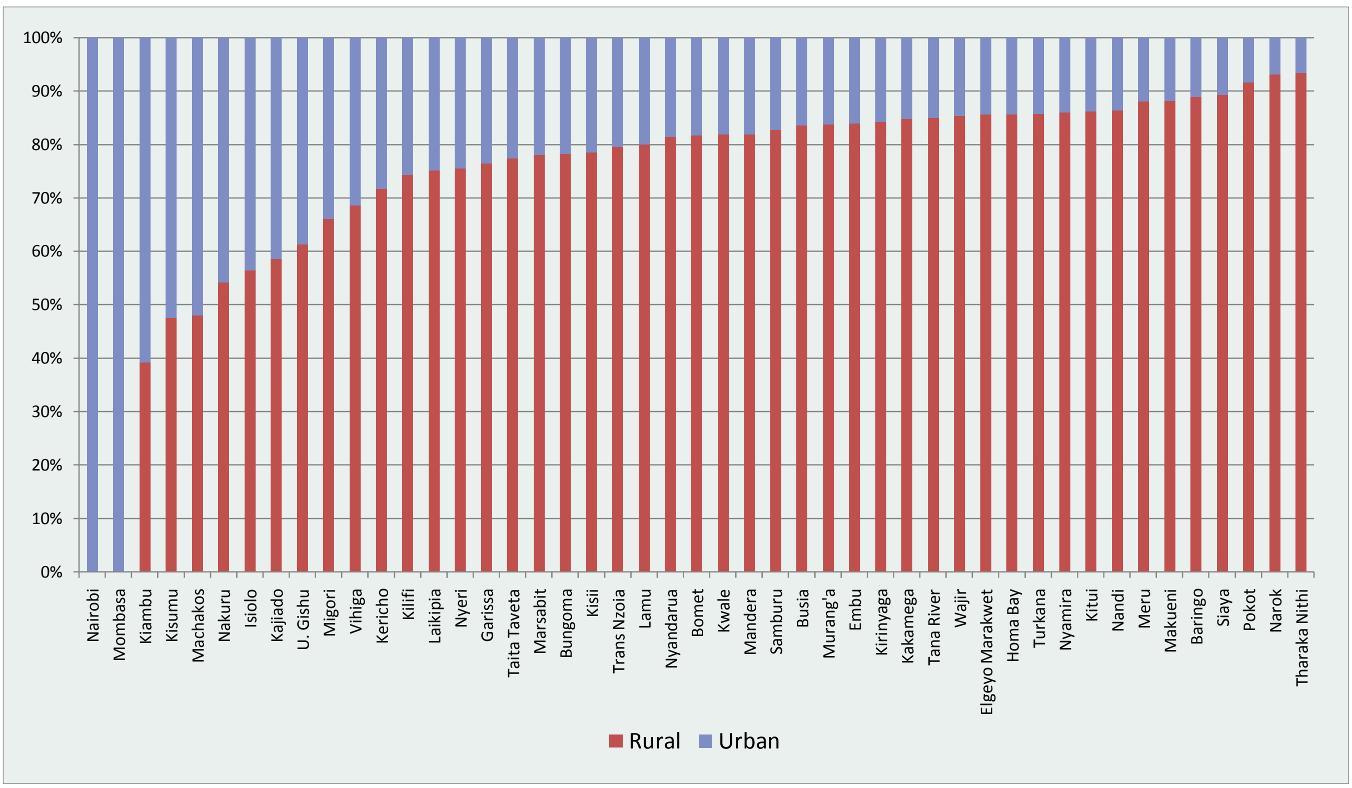


Source: World Bank calculations based on LATF annual report 2008/09 and 2009 Population Census

their county governments look after these services. In the other forty-two counties, rural residents will be in the majority. There is a real risk that they will use their majority in the Assembly to direct resources away from urban services.

The risks of under-funding urban services could be managed by having earmarked funding for urban services, and by setting standards and benchmarks for urban service delivery and monitoring them. Earmarked funding would involve financing urban service delivery (outside Nairobi and Mombasa) through conditional grants. Counties could be required to contribute to funding of urban services as well, since they benefit from the revenues generated by urban residents. As a complement to this, the national government could set standards for urban service delivery, including benchmarks for the resourcing required to finance effective service delivery. Benchmarking would provide citizens with a basis to assess whether their county governments are giving sufficient priority to urban services. Standards and benchmarks are likely to be important for other sectors too, as there are broad risks of poor prioritization in resource allocation by the counties that need to be managed.

Figure 4.10: …but County Assembly members will be mostly from rural areas



Source: World Bank calculations based on 2009 Population Census

4.4 Desing an integrated financing architecture

Conditional grants could play a fundamental role in the new intergovernmental transfers architecture for three reasons: (i) to safeguard priority expenditures at the local level such as primary health care; (ii) to elicit and reward county performance; and, (iii) to ensure that the equitable share formula (governing the distribution of unconditional grants) can remain as transparent and simple as possible.

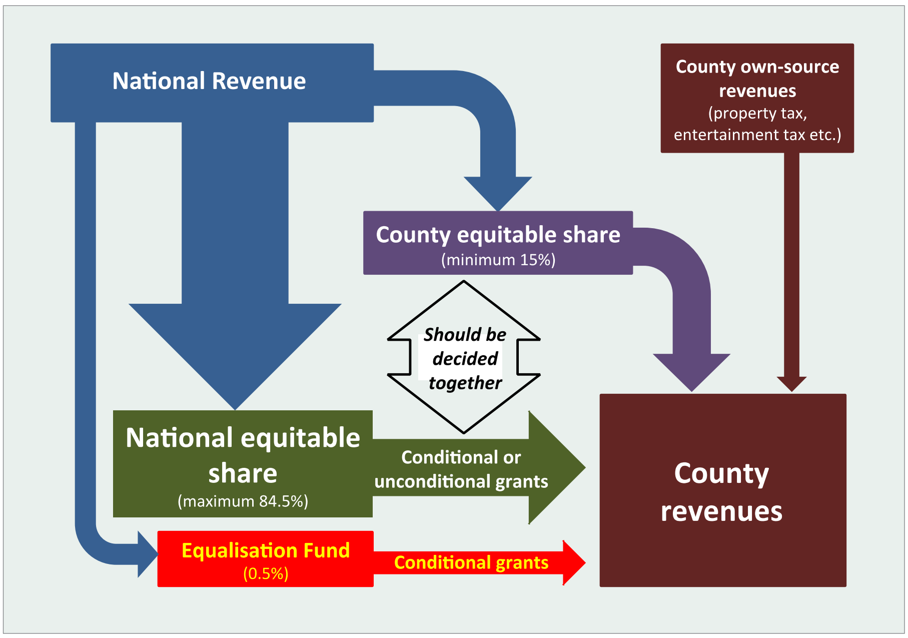
But making space for conditional grants implies adjusting the unconditional equitable share. To maintain fiscal flexibility and sustainability, all the different kinds of transfers need to be considered as a whole in terms of how adequately they meet the total needs of counties.

Consider all the transfers together

The (minimum 15 percent) equitable share is not the only source of revenue to meet county needs. Counties have their own source revenues and the government may also finance them through other conditional and unconditional grants and via the equalization fund. However, the scope for the government to target and leverage expenditure at the county level via conditional instruments will depend on the fiscal space left after the government has accounted for the (unconditional) equitable share and other priority expenditures.

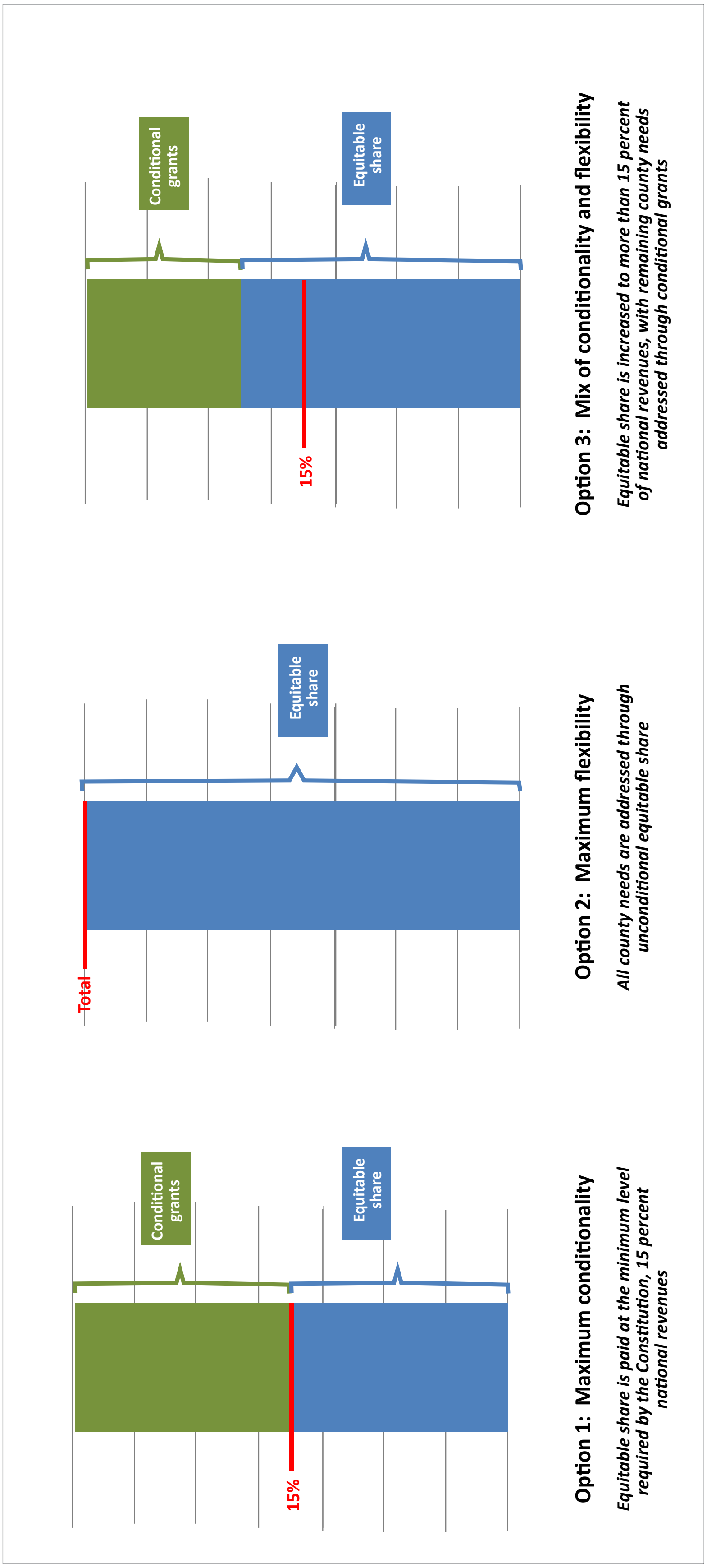
The higher the proportion of county need that is met through the equitable share, the lesser the scope for targeted conditional transfers (and vice versa). Figure 4.12 shows three different financing models for how those needs could be met. In option 1, the equitable share is paid at the minimum level of 15 percent, and the remaining need is met from conditional grants. In option 2, all county needs are addressed through the equitable share. There is a large range of options in between. Option 3 shows one of those, under which the equitable share is increased, but not to the full extent of needs, thereby requiring some conditional funding.

Figure 4.11: Flows of revenue from different sources for county governments



Source: World Bank

Figure 4.12: Three basic options for financing counties



Source: World Bank

Keep in mind the cost of conditional grants to the center

There are strong arguments in favour of some conditional funding to counties if only to continue existing programs. But conditional funding will need to be considered and prioritized carefully as it will be additional to the minimum 15 percent allocation.

Government may already be considering the use of conditional grants to fund counties. A number of existing programs tie funding to spending on particular purposes (see box 4.9). If continued, these mechanisms would effectively constitute conditional grants to counties. Additional conditional grants may also be appropriate for financing cross-border services—where one county is responsible for delivering a service that several other counties depend on (for example, provincial hospitals).

A key implication of this analysis is that decisions about the vertical share and decisions about conditional grants need to be made together. If these decisions are made separately, there is a risk that counties will be given too much, or too little, relative to the functions they will have to pay for. The county equitable share will be determined through the Division of Revenue Bill, enacted by Parliament. Treasury, Parliament, the CRA and counties will be involved in consultations through which the vertical shares are decided. What the foregoing discussion highlights is that these discussions must also involve consideration of conditional grants, which will be the other main source of revenue for counties. This consultation will need to start early in the budget process in order to be effective.

Fiscal space must be preserved for conditional transfers. For devolution to have any meaning as the Ugandan example suggests (see box 7.1) counties must be able to freely determine their own spending priorities. The Kenyan Constitution does justice to this by imposing a minimum untied transfer. But to the extent that the sharing formula will need to be simple and transparent (and therefore relatively crude), conditional transfers may also be needed to cater for: (i) counties with special needs; (ii) programs of strategic significance; and, (iii) projects that are asymmetric in space or time.

>> Box 4.9: Existing funding arrangements that would be conditional grants if continued

To the extent that they remained earmarked to specific uses, these programs would have to be financed through conditional grants and their costs would not be included in the calculation of the county equitable share:

Road maintenance—county share KES 11.3 billion. Road maintenance is currently funded through the Road Maintenance Levy Fund, financed by a fuel excise. If this funding is to continue to be tied to road maintenance, it would need to be an earmarked grant.

Constituencies Development Fund (CDF)—KES 14.4 billion. Some commentators have suggested that CDF will be maintained as a dedicated fund, but devolved to counties to manage. If CDF continues to be an earmarked program for spending only on specific projects, and allocations calculated using a specific formula, then it will effectively constitute an earmarked grant.

Local Authorities Transfer Fund (LATF)—KES 12.3 billion. Urban services are partly funded from the national government's LATF. If the national government wishes to earmark funding for urban service delivery, this would not be factored into the calculation of the county equitable share.

Staff costs—Not known. The draft Transition to Devolved Government Bill recommends that during the transition period, staff performing devolved functions should be seconded to county governments, and their salaries should continue to be paid by the national government. Around KES 10 billion is currently being spent on the costs of district-level staff in health and agriculture sectors alone. If these remain national costs, they would not be factored into the calculation of the county equitable share.

Source: World Bank

5. Get accountability right from the start

The Constitution seeks to reshape the way citizens relate with government, and places a strong emphasis on principles of participation, transparency, and accountability. The spirit of devolution is to bring government closer to the people, so that they can better communicate their needs to the government, and ensure that the government responds to their needs. In particular, the Constitution seeks to "enhance the participation of people in the exercise of the powers of the State and in making decisions affecting them."[8]

Nonetheless, devolution by itself will not necessarily produce such responsiveness or accountability. Global experience and empirical research provide many examples of accountability failures in decentralization reforms, leading to substandard service delivery and corruption. Factors that prevent traditional top-down accountability systems from functioning well in a decentralized setting include: (i) geographic distance from central government; (ii) diffused reporting lines; (iii) the multiplicity of programs; (iv) projects and funds that are dispersed at the local level; (v) low capacity levels.

Kenya's own experience with decentralized funds—such as CDF, LATF and community-driven development (CDD) projects—highlight some of these challenges. Kenya's audits, expenditure reviews, and civil society monitoring initiatives regularly document white elephant projects and significant levels of waste and leakage in government programs. According to these reviews, factors that often limit accountability to local communities and citizens include: (i) overlapping roles and responsibilities across decentralized programs; (ii) limited systems to reliably account for funds or track performance; (iii) limited availability of information on project activities; (iv) finances and performance; and, (v) limited systems to enable communities and citizens to obtain recourse.

A mixture of both top-down and bottom-up accountability systems are crucial for managing the risk that county governments will use their resources poorly: by favoring only some parts of the county, by spending on low-priority unproductive expenditures, or by spending too much on salaries. Traditionally, accountability has been about having strong systems of reporting to a central authority that can take action if resources are managed poorly (i.e. 'top-down' accountability). This approach is less effective in decentralized settings. When resource management is decentralized, it is difficult to exercise top-down oversight, because decision-making is more diffused (so it is hard to track who is responsible) and because these decisions are made a long way from the capital, and are far from centres of oversight. This means it is even more important for effective devolution to strengthen the 'bottom-up' systems of accountability that empower citizens to hold their elected local representatives accountable. But these mechanisms also rely on strong central systems. The two approaches—top-down and bottom-up—complement each other.

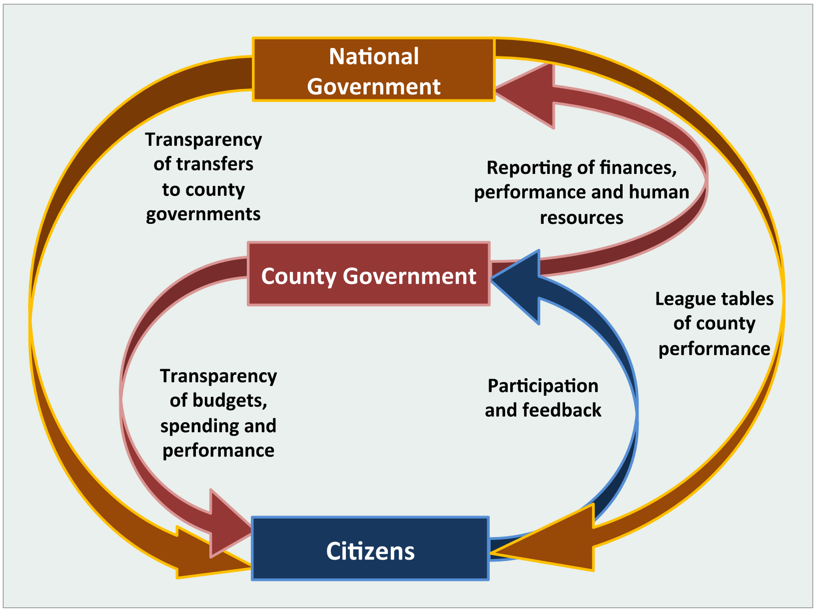
5.1 Build strong public financial management systems

The new Constitution raises big challenges for public financial management institutions at both national and local level. At local level, the significant increase of funding flows to local government, combined with the massive administrative reorganization involved in building a new tier of county governments, will make managing public money in the newly decentralized system a key challenge. Although many civil servants are in place, most of them will have had little experience at making major resource management decisions. The skills of staff across a range of devolved sectors (health, agriculture and so on) in planning, budgeting, budget implementation and managing human resources, are likely to be weak or non-existent.

A large, rapid, well-planned and carefully implemented program of capacity building is required to prepare civil servants and politicians for this new challenge. Staff in many local governments lack sufficient experience in planning, budgeting,

[8] *Article 174 (c), Constitution of Kenya*

Figure 5.1: Getting information flows right: top-down and bottom-up accountability



Source: World Bank

spending, reporting and accounting for such large funding flows. New structures, reporting relationships and accountabilities will be established at county level to manage these funding flows, with county governments responsible for meeting legal public financial management standards set in national legislation, and horizontally accountable to County assemblies. county governments will be required to submit their annual financial statements to the Auditor General. If counties make serious or repeated material breaches of the public financial management legal framework, they are liable to have their transfers curtailed by the Cabinet Secretary for Finance.

However, before capacity can be built, systems need to be put in place. Regardless of how many laws provide for public financial management, it is essential that there should be a single, country-wide public financial management system, covering both national and county governments. Elements of this system would include:

- a budgeting format that highlights expenditure on services (particularly transfer of funds to facilities) and projects, with planned outputs specified
- a common classification system for budgeting and accounting
- a single channel for flow of funds to county governments that eliminates the fragmentation of the current system
- a sound framework for managing disbursement of grants to community projects, facility-level service delivery, and small projects

There is also scope to avoid disconnection between planning and budgeting systems by integrating both functions under a single department at the county level. This would require integration of what are currently separate provisions proposed in the draft Public Finance Management Bill, and the draft Devolved Government Bill.

County assemblies will play an active role in financial management and will also need considerable support to develop their capacity. County assemblies will be empowered to safeguard the fiscal health of the County governments through setting and tracking levels of borrowing, scrutinising deviations from fiscal responsibility principles, reviewing fiscal strategy papers, considering budget review and outlook papers, and County government debt management strategies, considering and approving budget estimates, and enactment of associated County appropriation Acts. This will in turn involve building,

more or less from scratch, specialised committee structures with additional analytical support in the forty-seven new County assemblies. Learning from early good performers and sharing experience of what works and what does not among County assemblies will be important in ensuring all assemblies are able to guarantee a basic level of financial oversight. However, the capacity of county assemblies to hold the county executive accountable will only be truly effective if the accountability 'loop' is complete, and county citizens are empowered to hold their elected representatives accountable as well.

> "Effective participation requires feedback systems, such as complaint mechanisms and customer satisfaction surveys

5.2 Promote accountability to citizens

Preventing accountability failures in devolution requires a sustained effort to enable citizens to participate in and hold local government to account. Bottom-up participation and accountability systems can complement traditional top-down accounting, auditing, and performance management systems. Effective citizen participation and bottom-up accountability requires several key mechanisms to be put in place:

- **Transparency of government programs, rules, finances, and performance.** To participate effectively, citizens need to access financial management and performance information on public service delivery in formats that are *readily available, clearly presented, timely and relevant*. Online access to information is the easiest means of making this information accessible to a national audience, but paper documents should also be available in public offices upon request. Transparency of fiscal information at the facility and project level, including for schools, health centers and Community Driven Development projects, best ensures that this information is relevant for citizens. Transparency can be safeguarded through legal provisions that mandate the publication of information on programs, finances, and performance.

- **Participation mechanisms that enable citizens to express their views on development priorities and to monitor the performance of government programs.** To be effective and fair, these mechanisms must be open to the public, and especially to marginalized groups, well designed to allow substantive input, and relevant to citizens so that their participation is meaningful. Effective participation also requires feedback systems, such as complaint mechanisms, customer satisfaction surveys, etc., that enable citizens to directly provide feedback on service delivery performance and funds.

Effective citizen participation requires both information sharing and participatory feedback mechanisms—a piecemeal approach is unlikely to be successful. Uninformed citizens cannot participate effectively, meaning that key fiscal and performance reports, especially the budget, must be made public in a timely and accessible manner. Citizens who participate substantially in the identification and design of a project are much more likely to provide feedback on it, such that participation promotes accountability. These elements of social accountability can reinforce one another.

Transparency of national government disbursements to county governments is also important. It is common in devolved systems for lower-level governments to blame service delivery stagnation on the national government's failure or delay in release of funds. The Controller of Budget is already constitutionally mandated to oversee the implementation of the budgets of the national and county governments. In addition to this oversight role, he/she could be required in legislation to publish a simple monthly report on intergovernmental transfers, to show the

public the volume and frequency of transfers. This approach was utilized in Nigeria's decentralized system, and helped to diffuse public mistrust of central government, focusing public scrutiny and pressure on the use of funds. Of course, information alone is not a sufficient condition to improve service delivery, but it is an important ingredient in a broader set of institutional reforms.

Kenya can draw on its experience using performance-based funding, to reinforce both upward and downward accountability by local authorities. The Local Authority Transfer Fund system seeks to reinforce both citizen participation and timely submission of plans and financial reports, by linking a proportion of funding to compliance with these requirements. A Local Authority Service Delivery Action Plan (LASDAP) must be prepared annually with input from citizens.

However, while the LATF system was largely successful in ensuring reporting by local authorities, the information they produced is not usually made public. The LATF Regulations specify in detail the penalties for late submission of required information, but there is no requirement in the Act for the reports to be made public, so the information has typically not been made available to citizens. The Public Expenditure Review of 2010 also observed that the quality of reports was quite substandard, reinforcing the need for enhanced capacity and transparency. The LASDAP process is intended to include citizens in the local authority planning process through public meetings, but several reports suggest that attendance is often limited, and budgets are not well aligned with the priorities identified in the LASDAP plans.

Several actions can strengthen participation, transparency and accountability in public financial management and performance of county governments. A first key action would be to establish a clear legal framework that supports participation, transparency and accountability. The public financial management legal framework, and the devolution bills, are the most appropriate place to require transparency of financial and performance information, and to detail the mechanism, timing and which office or official is responsible for compliance. Legislation can also provide strong legal mandates, as well as sufficient space (time) in the budget cycle to ensure meaningful participation in budget prioritization and monitoring.

Drawing on the LATF system, production of financial and performance reports could be tied to transfers, and these documents should be publicized, especially on the internet. The production of these documents could be among the performance conditions attached to performance grants discussed earlier. A more robust system of performance funding would build on the LATF by also requiring publication of the reports on the internet, and providing a system of independent verification, to confirm their accuracy. Transparency of this information will better inform citizens, and will also aid in creating pressure to improve the quality of the reports.

Building on the LASDAP system, devolution laws could require county governments to involve citizens in the budget and planning process, give the county administration responsibility for facilitating this, and integrate planning and budgeting more closely. Responsibility for designing opportunities for participation is better vested in the county administration so that it remains political. The Governor and assembly members should be invited to participate but should not control who attends.

The county administration should also be responsible for upholding certain good practices of participation, such as openness, inclusion of minorities and marginalized groups, and clear communication of events to the general public. Planning and budgeting units should be under a single county department to help make sure that planning actually feeds into budget development (and vice versa).

Kenya has the opportunity to be a leader in Africa with respect to transparency and local government accountability, but getting accountability relationships right will require sustained effort to build the capacity of both county governments and citizens to use them effectively. A strong legal

framework is important, but building effective participation and accountability mechanisms will also require substantial capacity at both levels of government. Capacity will be needed at the national level to develop systems (including for soliciting citizen feedback and registering complaints), and at the local level to implement them (including transforming complex financial information into formats that are accessible by citizens). This is an important component of a long-term project of capacity building to support the effectiveness of devolved government. It is important that these long-term goals should not be overlooked in the preoccupation with immediate and urgent concerns that will inevitably accompany the early transition period.

6. Manage risks

Kenyans have embraced devolution with the hope that it would solve three enduring governance bottlenecks: a monopolistic use of state power to the benefit of certain groups and regions, widespread corruption, and inefficient administration, and a desire by the majority of the population for a more equitable distribution of resources.

> "If not well prepared and implemented, devolution could result in exacerbated inequalities, decentralized corruption and disrupted services

Economic theory would say devolution is precisely the right answer to these problems; but the experience of many other countries suggests a less clear-cut picture. If it is not well prepared and implemented, devolution could result in exacerbated inequalities, decentralized corruption and disrupted services. In particular, even if the transfers are fair, and adequately balance competing considerations of equity and efficiency, this alone will not be sufficient to ensure that the promise of more equitable service delivery is fulfilled.

While resources are important, counties' abilities to use them well will be equally key and equally challenging. Ironically, counties that need additional resources are least likely to be equipped to use them well. There is a risk that implementation failure may provoke a backlash against devolution that leads ultimately to recentralisation.

6.1 Risks of poor spending

The impact of transfers to counties on overall inequality critically hinges on the way they are managed at the county level. Empowering and resourcing county governments is not a guarantee for equity within counties. Devolution will transfer discretion over the use of significant public resources from the national to the county level. To the extent that specific regions may have been penalized by central neglect or discretion in the past, this is a major protection. But global experience indicates that local governments will not necessarily be more virtuous. They may face perverse incentives and pursue misguided policies. If unchecked, county leaders could use their offices to benefit powerful subgroups or interests. From a political economy point of view, county governments may be more prone to elite capture and less willing to trade-off narrow local interests for national greater good. Kenya's own experience with decentralized funds has highlighted some of these challenges.

Increased control over resources by county governments will not automatically translate into expenditure that prioritizes service delivery. Many countries' sub-national governments have trouble spending money well. Common problems include over-spending on salaries and administrative overheads, at the expense of service delivery and infrastructure investment. If county governments spend poorly, service delivery standards could actually worsen, instead of improving. The role of central government in setting and monitoring standards will be critical in managing this risk. The elements of a strong system of performance management for county governments will include standards for expected service delivery, indicators for measuring them, a system of regular reporting, and incentives for county governments to report accurately. Funding that is linked to meeting performance

>> Box 6.1: Performance criteria under the Local Authorities Transfer Fund: A possible model

Local authorities can receive a full payment from the performance account if they submit seven documents: financial statements (revenues, expenditures, cash and bank balances), statement of debtors and creditors and debt management proposals, abstract of accounts, revenue enhancement plan, and a Service Delivery Action Plan.

Criteria for accessing the higher performance account are:

- executing the local authority budget as planned
- keeping expenditure on personnel emoluments within 5 percent of the budgeted amount
- increasing revenue collection by more than 10 percent
- implementation of the strategic plan
- having an unqualified audit report for the previous financial year

Source: World Bank based on LATF Regulation

indicators related to the establishment and operation of these systems—rather than to the service delivery outcomes themselves—can play an important role in reinforcing performance management systems.

6.2 Human resource risks

The importance of human resources in decentralization is often under-estimated. Capable personnel are crucial to achieve the promises of devolution, but human resources also present substantial risks to the effectiveness of decentralization. Governments with lower capacity find that employing more staff is the easiest way of all to spend money. This tendency is compounded by local pressures to employ staff as a way of shoring up political support. Managing human resources well relies on three key elements: (i) containing the risk of overspending on salaries; (ii) getting incentives right to encourage counties to acquire and retain skilled staff; and, (iii) increasing the focus on, and incentives for, good performance.

Overspending on salaries is a particular risk in the Kenyan context, because the Constitution gives county governments full control over engagement of staff. Article 235 of the Constitution empowers county governments to hire and fire staff, within a framework of uniform norms and standards. In order to manage the risk of overspending on unproductive consumption expenditure, this framework should include benchmarks for expenditure on personnel costs, and a standard remuneration framework. Absence of a standard remuneration framework may have another unintended consequence, in that it may lead to a widening capacity gap between rich and poor counties.

Kenya already experiences an inequitable distribution of staff and skills across counties. An unintended consequence of having forty seven individual county public services may be to further entrench or exacerbate this inequity, particularly if wealthier counties have the power to attract the most skilled public servants. There are a number of ways this risk can be addressed, but all of them require a national framework—for remuneration, entitlements to staff development, and other benefits—that give skilled staff an incentive to work for the county public services that need their skills the most, but are least likely to be able to attract them.

6.3 Structure funding to improve capacity

In seeking ways to improve county government performance, carrots may work better than sticks. Linking some proportion of funding to nationally-set performance benchmarks provides an incentive for county governments to meet those benchmarks. In developed countries (and some developing ones), the performance benchmarks are related to service delivery outcomes, or outcome improvements. In weaker capacity environments local governments may lack the basic systems of public administration that allows them sufficient control over resources to set and meet performance targets. In these contexts, improvement of systems is an essential precursor to improvement of services.

Performance-based grants can reinforce the development of essential public financial management and performance monitoring systems. Funding is calculated on the basis of compliance with a set of indicators relating to both functioning and improvement of basic elements of these systems. This is similar to two components of the current Local Authorities Transfer Fund (see box 6.1). Performance grants systems supported with donor financing have operated in over twenty countries, some of them for more than a decade. Kenya can draw on this experience to improve the approach to performance-based financing for counties. A key lesson is that the design of a robust monitoring system, involving self-reporting, desk auditing, and field review teams with independent personnel is crucial. Given the political context of devolved government, it may be appropriate for the highest level intergovernmental coordinating body to play a role in overseeing the monitoring of county government performance. This approach can be useful in establishing transparency about county governments' performance among their peers, giving an even greater incentive for improvement.

Conditional grants, in which some funding is tied to specific kinds of spending, may also play a limited role. In general, experience shows that conditional grants with complex conditions are relatively ineffective because they are very difficult to monitor. However, a simpler form of earmarking referred to as function block grants, or sector block grants, can serve to signal the county government about the amount that should be allocated to a particular sector or program. Conditional grants can also be a useful way to tailor the allocation formula to a particular purpose, rather than complicating the general equalization formula with several different elements. Urban services may be a good candidate for this kind of conditional grant in the Kenyan context for both these reasons. Ultimately, the effectiveness of any kind of tied funding—whether tied to capacity benchmarks or to spending purposes—will depend on strong systems of public financial management.

7. Navigate a major public sector transition

Implementing devolution will involve a radical transformation of Kenya's public sector. Such a transformation presents enormous opportunities for improvement, but also carries correspondingly high risks that—at least for a period—outcomes worsen while the new systems are rolled out. Public sector transition is also the area of greatest risk for increased fiscal instability. If transition is managed in a way that increases total public sector employment in an uncontrolled way, this will be to the detriment of both fiscal discipline and devolution outcomes.

Kenya's devolution is one of the most ambitious to be implemented globally. In many countries, decentralization is a process of giving political autonomy to administrative units that are already in place. In Kenya, devolution will entail not only creating new political units, but also creating entirely new systems of administration that will absorb some or all of three existing systems of administration.

The golden rule of implementing decentralization is 'do not disrupt service delivery'. Deterioration of services can rapidly erode popular support for decentralization. The dissipation of support in turn provides ammunition for recentralization. Therefore, ensuring that county governments do not over-reach themselves too early is important to protect the widespread support they enjoy at the moment. The risk of service deterioration in the Kenyan situation is greater because the changes to systems of public administration are on such a large scale.

Three specific aspects of the transition process warrant close attention. The first question is how such a complex transition will be managed and coordinated. Second, the single biggest transition issue will be managing the movement of public servants from national ministries and local authorities to county administrations, in line with the staff-intensive service delivery functions that are being transferred. A third overlapping issue is the sudden transition from local authorities to new

county governments, which raises serious risks of interrupting important urban services.

Someone needs to be in charge. Decentralization is one of the most substantial reforms any government can undertake. Because Kenya's devolution is so ambitious, coordinating its implementation is a major undertaking. The Task Force on Devolved Government has proposed the establishment of a Transition Authority. International experience suggests decentralization is likely to be more successful if it is independently coordinated, but time is a major factor. Further empowering the Commission on Implementation of the Constitution may be a more realistic option given the short time left to get the new arrangements in place.

> Around 32,000 local authority employees and upto 50,000 national public servants are likely to move to county governments

There should be a plan. The main function of the independent body supporting implementation should be to steer, not row. It can do this most effectively by developing and getting agreement on a high level strategy for implementing devolution that will guide line ministries. The detailed leg-work of implementation needs to be done by line ministries, because they understand the detail and technical dimensions of their functions. Above all, decentralization is a change management process for national ministries whose roles will change from actual service delivery, to setting standards and overseeing them. But oversight will be needed to make sure they stay on track. This should be the job of an independent body.

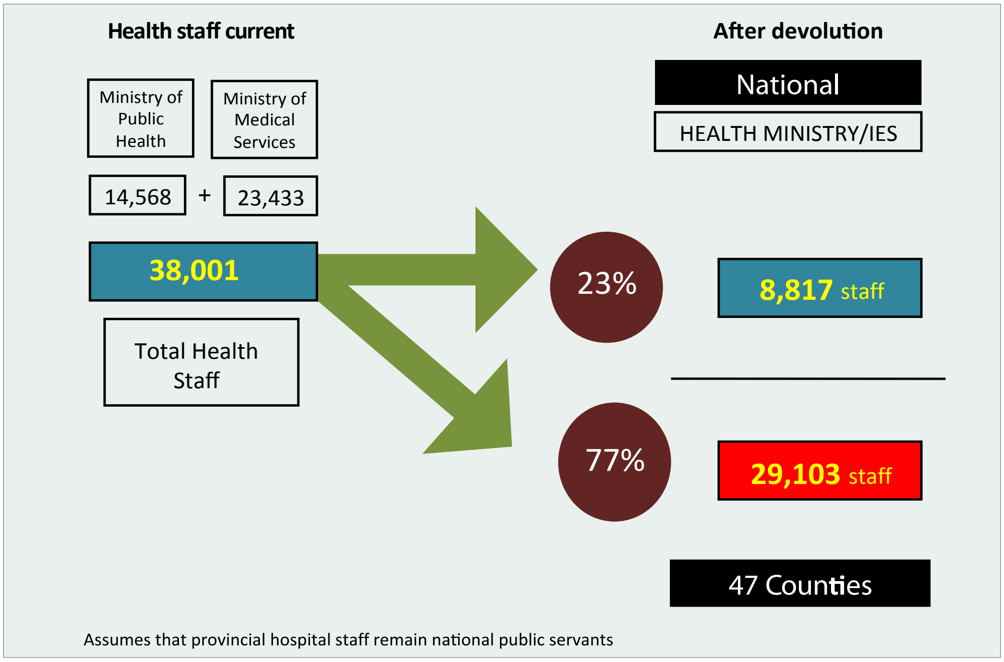
The plan should aim to devolve incrementally. Rapid decentralization comes with high risks. In other countries like Uganda, the impact of rapid decentralization was disruption and deterioration of important services (see box 7.1). This provided ammunition for line ministries to argue successfully for increased controls over funding and staff that effectively led to a recentralisation of control over key resource decisions. Uganda's district governments now seems more like de-concentrated administration than a genuinely autonomous system of local government.

A clear policy on what will happen to public servants is needed soon. Around 32,000 local authority employees and as many as 50,000 national public servants are likely to move to county governments. More than 70 percent of the staff of the two health ministries alone will move (see figure 7.1). The Task Force on Devolved Government has recommended that these staff should initially be seconded, while county governments undertake their own recruitment of staff, including from the ranks of seconded staff. The bills the Task Force has prepared included provision for this approach. However, it is not clear what entitlements public servants will have—will they be entitled to refuse secondment, and if not recruited to a county government, will they be entitled to return to their original job (even though it may not longer exist)? This decision has major fiscal implications if the national government is left to continue paying staff whose jobs have been devolved even though occupants have not.

A basic rule for managing the risks of service delivery disruption is to leave people doing the jobs they do now. As far as possible public employees based in counties—working both for local authorities and de-concentrated administrations—should keep on doing the same jobs, even though they may report to a set of elected representatives.

Transition may be particularly dramatic in the case of urban services. The draft legislation to implement devolution provides for the Local Government Act to be repealed at the completion of county elections. If this proposal is adopted then, regardless of what other functions they assume, counties will be responsible for urban service delivery from day one. If county governments are unlikely to have any meaningful capacity immediately, it may be better to

Figure 7.1: Projection of health staff positions likely to be devolved



Source: World Bank staff based on 2010/11 budget data

leave the local authorities in place for a period after the election, to minimize the disruption to urban services.

A framework of uniform national standards for county public services is mandated by the Constitution. Important choices are being made about how extensive that framework should be. Key considerations are: (i) whether there should be a national remuneration framework that applies to all counties; (ii) which ministry should regulate public service matters (Local Government or Public Service); and, (iii) how extensive the national framework should be—over what matters will county governments have discretion.

All these policy considerations are informed by one key choice: how much of the administrative architecture of county governments should be put in place before they are elected? Most countries put in place transition arrangements to establish the basic machinery of administration before first elections are held. In Kenya the level of suspicion with which some policy actors regard central government leads them to propose that the establishment of administrative machinery should not begin until the county assembly and county government are elected. While the sentiments that underpin this approach are understandable, this is a high-risk strategy.

Kenya's devolution has the potential to transform government, by giving citizens more equitable access to resources, a greater say in how they are spent, and an increased sense of control over their own lives. But these objectives do not flow automatically from devolution, and enthusiasm alone will not guarantee their achievement. Careful design of fiscal, public service and accountability components is required, focusing on devolution as a system, to ensure the different elements function together. In public policy, however, today's solutions are inevitably tomorrow's problems. Implementation will almost certainly not proceed as planned, and problems will emerge that were never foreseen. Whether these problems are merely bumps along the road, or fatal impediments to the success of devolution, is likely to depend on how carefully implementation is planned and managed.

>> Box 7.1: The risks from trying too much too soon ... lessons from Uganda

Uganda undertook a radical decentralization following the introduction of a new Constitution in the mid-1990s. The reforms were homegrown and there was an unusual degree of commitment to them by the government of the time. By the late 1990s Ugandan local governments were among the most empowered and best financed in Africa.

Local governments were given block grants and had substantial autonomy over budgeting and staff. However, over time it became apparent that many local governments were performing poorly in delivering services. A public expenditure tracking study revealed that very little funding was reaching schools. Central agencies that had initially supported decentralization began to realize the impact on their power and resources and argued for stronger central controls in the form of conditionalities on grants. These demands were supported by donors who were financing a substantial proportion of the delivery of basic services. The multiplication of conditional grants coupled with increased fragmentation of local governments removed much of the fiscal autonomy of local governments, and rendered them increasingly impotent in terms of making genuine decisions about local priorities. There has been little impetus to reverse these trends, with the result that Ugandan local governments are now relatively weak.

Despite much initial enthusiasm, the pace and trajectory of Uganda's reform proved too ambitious, and in addition there was too much emphasis on formal development of the system and too little on developing local accountability. This experience illustrates why 'hastening slowly' might be the fastest way for devolved governments to achieve real and lasting autonomy.

Source: Adapted from USAID, Comparative Assessment of Decentralization in Africa, Uganda Desk Study

ANNEXES

Annex 1: A new macroeconomic environment in 2011

	2007	2008	2009	2010	2011**
GDP Growth rates (%)	7	1.6	2.6	5.6	4.3
Agriculture	2.3	-4.3	-2.5	6.3	3.5
Industry	7.1	4.7	2.7	5.3	3.6
Services	8.1	2.7	4.6	5.8	4.4
Fiscal Framework (FY) % of GDP					
Total Revenue	22	21.8	22.3	24.0	24.5
Total expenditure	27.3	26.6	29.5	29.2	30.6
Grants	1.3	0.8	0.8	0.7	1.3
Budget Deficit (incl grants)	4.0	4.0	6.4	4.5	4.8
Total debt	34.6	41.7	45.0	48.8	46.1
External Account % of GDP					
Current account Balance	-3.8	-6.4	-5.6	-7.5	-10
Memo items					
Inflation (average)	4.3	16.2	10.5	4.1	13.0
Exchage rate (Ksh/$) *	67.3	69.2	77.4	79.2	88.5

Source: World Bank / Ministry of Finance

Annex 1.1: Key macroeconomic indicators

External Account	10-Sep	10-Dec	11-Sep	Change 11-Sept - 10-Dec
Current Account (US$ Billions)	-2.1	-2.5	-4.0	-1.5
Oil (US$ Billions)	2.6	2.7	3.7	1.1
Capital account (US$ Billions)	0.15	0.15	0.24	0.09
Financial Account (US$ Billions)	2.3	2.5	3.5	1.0
Overall balance (US$ Billions)	0.4	0.2	-0.2	-0.4
Import Cover (months of cover)	4.0	3.9	3.6	0
Interest Rates (%)				
Real CBR	2.8	1.5	-10.3	-11.8
Real Interbank	-2.0	-3.3	-9.9	-6.5
Real 91 day Treasury bills	-1.2	-2.2	-5.4	-3.2
Growth in Monetary Aggregates (%)				
M3	26.0	21.6	19.3	-2.3
M2	23.9	30.5	16.9	-13.6
Private Sector Credit	22.9	20.3	36.3	16.0
Inflation (%)	**10 Sep**	**10 Dec**	**11 Oct**	**Change 11-Oct - 10-Dec**
(Overall)	3.2	4.5	18.9	14.4
Food Inflation	5.7	2.8	26.2	23.4
Transport Inflation	4.9	7.6	26.2	18.6
Core Inflation	0.6	0.9	10.4	9.5

Source: World Bank / Central Bank

Annex 1.2: GDP Growth rates, Kenya and Sub Saharan Africa

Percent

	2007	2008	2009	2010	2011f*	2012f*
GDP growth rate Kenya	7.0	1.6	2.6	5.6	4.3	5.0
GDP growth rate SSA	6.5	5.2	2.0	4.8	5.1	5.7
GDP growth rate World	3.7	1.5	-2.2	3.8	3.2	3.6
GDP Per capita growth rate Kenya	4.4	-1.0	-0.1	3.0	1.9	2.4
GDP per Capita growth rate SSA	4.1	3.1	-0.3	2.7	3.3	3.5

Source: Global Economic Prospectus January 2011, KNBS
f - forecast*

Annex 1.3: Kenya's GDP per capita

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011f*
GDP/Capita (US$)	402	397	438	461	523	611	719	774	738	760	772
GDP growth rate	4.5	0.5	2.9	5.1	5.9	6.3	7.0	1.6	2.6	5.6	4.3

Source: WDI & KNBS

Annex 1.4: Sectoral Growth rates

Percent

Sector/ Year	Contribution to GDP Growth	2007	2008	2009	2010	2011f*
Agriculture	(24.7)	2.3	-4.3	-2.5	6.3	3.5
Industry	(15.3)	7.1	4.7	2.7	5.3	3.6
Service	(60.0)	8.1	2.7	4.6	5.8	4.4
GDP		7.0	1.6	2.6	5.6	4.3

Source: KNBS

Annex 1.5: Quarterly GDP Growth rates

Percent

Year	Quarter	GDP growth rate
2009	H1	2.0
	H2	3.4
2010	H1	4.5
	H2	6.6
2011	H1	4.5
	H2f*	4.1

Source: KNBS
f - forecast*

Annex 1.6: GDP growth rate of other African countries

Percent

	2009	2010	2011f*
Ethiopia	8.7	9.0	9.0
Tanzania	6.0	7.0	7.2
Ghana	4.7	6.6	13.4
Rwanda	4.1	6.5	6.5
Uganda	7.1	6.3	6.5
Kenya	**2.6**	**5.6**	**4.3**
SSA average	1.7	4.7	5.3
South Africa	-1.8	2.7	3.5

Source: Global Economic Prospectus 2011

Annex 1.7: Kenya's Inflation

Percent

Year	Month	Overall Inflation	Food Inflation	Transport Inflation
2010	January	4.7	4.1	5.2
	February	5.2	7.2	5.9
	March	4.5	4.5	4.3
	April	3.7	3.8	4.4
	May	3.9	4.4	6
	June	3.5	4.6	3.9
	July	3.6	4.6	3.9
	August	3.2	5.5	4.8
	September	3.2	5.7	4.9
	October	3.1	5.6	5.0
	November	3.8	6.7	5.5
	December	4.5	7.8	7.6
2011	January	5.4	8.6	8.4
	February	6.5	9.8	13.1
	March	9.2	15.1	15.9
	April	12.1	19.1	20.4
	May	12.9	20.1	22.2
	June	14.5	22.5	22.7
	July	15.5	24.0	23.6
	August	16.7	23.9	24.3
	September	17.3	24.4	24.8
	October	18.9	26.2	26.2

Source: KNBS

Annex 1.8: Kenya's foreign exchange rates

Year	Month	KSH/US$	KSH/Euro
2010	January	75.8	108.3
	February	76.7	105.1
	March	77.0	104.5
	April	77.3	103.7
	May	78.5	98.8
	June	81.0	99.0
	July	81.4	103.9
	August	80.4	103.8
	September	80.9	105.6
	October	80.7	112.2
	November	80.5	110.1
	December	80.6	106.5
2011	January	81.0	108.2
	February	81.5	111.3
	March	84.3	117.9
	April	83.9	121.1
	May	85.4	122.4
	June	89.1	128.1
	July	89.9	128.5
	August	92.8	133.0
	September	96.4	132.7
	October	101.4	138.7
	November (1st - 15th)	96.2	131.9

Source: CBK

Annex 1.9: Capital markets indices

Year	Month	Dow Jones Industrial Average Index	Nairobi Stock Exchange Index
2010	January	10,067	3,565
	February	10,325	3,629
	March	10,850	4,073
	April	11,009	4,233
	May	10,137	4,242
	June	10,144	4,339
	July	10,466	4,439
	August	10,151	4,455
	September	10,860	4,630
	October	11,118	4,640
	November	11,092	4,528
	December	11,578	4,396
2011	January	11,823	4,527
	February	12,130	4,265
	March	12,221	3,873
	April	12,811	4,006
	May	12,442	4,078
	June	11,935	3,968
	July	12,143	3,733
	August	11,285	3,444
	September	10,913	3,292
	October	12,231	3,382

Source: CBK & Dow Jones Industrial Average

Annex 1.10: Interest rates

Year	Month	Lending Rates	Central Bank Rate
2010	January	14.98	7.00
	February	14.98	7.00
	March	14.96	7.00
	April	14.58	6.75
	May	14.44	6.75
	June	14.39	6.75
	July	14.29	6.75
	August	14.18	6.00
	September	13.98	6.00
	October	13.85	6.00
	November	13.95	6.00
	December	13.87	6.00
2011	January	14.03	6.00
	February	13.92	5.75
	March	13.92	6.00
	April	13.92	6.00
	May	13.92	6.25
	June	13.92	6.25
	July	14.14	6.25
	August	14.32	7.00
	September	14.8	7.00
	October		11.00
	November		16.50

Source: CBK

Annex 1.11: Credit distribution to the private sector

	Mar 2009	Jun 2009	Sep 2009	Dec 2009	Mar 2010	Jun 2010	Sep 2010	Dec 2010	Mar 2011	Jun 2011	Sep 2011
Total Private Credit	15.4	20.2	1.8	52.4	21.1	39.9	43.7	45.5	66	90.2	114.9
Agriculture	3	-1.4	5.6	0.4	-1.1	2.4	1.9	1.2	2	5.6	5.6
Manufacturing	-0.8	-3.1	1.8	-0.3	4.7	6.2	10.9	2.6	4.9	11.8	15.2
Trade	-0.7	2.2	8.9	26.6	-12.2	7.5	9.5	13.7	4.7	12	19.6
Building & construction	-0.9	3.4	-2.1	7.9	-9.9	-4.8	0.6	0.9	3.6	3.3	4.9
Transport & communication	-1	-1.5	4.2	5.1	1.9	0.6	-6.4	0.1	3.7	11.6	7.7
Finance and insurance	-0.6	2.8	-1.3	5.3	4.3	-4.4	-2.4	1.5	-1.1	2.6	2.6
Real estate	5.2	4.3	3.1	6.5	0.9	27.9	11.3	5.9	6.1	13	10.5
Mining & quarrying	3	8.1	-15.9	2.7	5.8	2.3	-0.2	-1.5	7.8	3.1	2.4
Private households	-4.8	-1.4	18.4	-12.1	24.6	2.8	-0.9	6.5	15.3	13.7	16.4
Consumer durables	2.3	4.2	2.2	6.5	3.2	-4.2	2.1	5.4	5.9	1.7	7.3
Business services	-3.5	12.2	-7.1	-9	4.2	8.8	8.6	4.2	-4.8	2.2	11.1
Other activities	14.1	-9.5	-16.1	13	-5.5	-5.2	8.7	5.2	17.8	9.5	11.6
Percentage Growth yoy	**28.6**	**22.5**	**10.6**	**13.9**	**14.4**	**16.8**	**22.9**	**20.3**	**25.7**	**30.7**	**36.3**

Source: CBK

Annex 1.12: Oil price movements 2010

Year	Month	Pump Prices Petrol (Ksh/Lt)	Murban oil price ($/barrel)
2010	January	86.24	77.50
	February	86.78	74.20
	March	88.52	78.30
	April	90.64	84.80
	May	92.40	77.90
	June	92.17	74.80
	July	92.23	73.0 0
	August	92.86	74.60
	September	96.16	75.90
	October	96.73	81.50
	November	98.79	85.65
	December	94.05	91.85
2011	January	95.67	94.8
	February	98.08	101.27
	March	102.44	111.63
	April	111.17	116.62
	May	115.35	113.60
	June	114.93	112.15
	July	115.39	113.95
	August	117.22	109.05
	September	117.75	110.09
	October	120.50	

Source: KNBS, World Bank

Annex 1.13: Kenya's Fiscal position

% of GDP	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Revenue and Grants	23.3	22.6	23.4	24.7	25.8	26.0	26.3
Revenues	22.0	21.8	22.3	24.0	24.5	24.7	24.9
Tax Revenues	20.2	20.4	20.6	21.9	22.2	22.5	22.7
Income tax	8.0	8.2	8.5	9.3	9.3	9.4	9.4
Value-added tax	5.7	5.7	5.8	6.2	6.2	6.4	6.5
Import duty (net)	1.7	1.7	1.7	1.7	1.8	1.8	1.8
Excise duty	3.2	3.1	3.0	2.9	2.8	2.9	2.9
Nontax Revenue	3.5	3.2	2.9	3.6	4.0	3.9	3.9
Grants	1.3	0.8	0.8	0.7	1.3	1.3	1.4
Expenditure and Net Lending	27.3	26.6	29.5	29.2	30.6	31.0	30.3
Recurrent expenditure	20.6	19.5	20.5	21.1	20.3	20.5	19.8
Interest Payments (4+5)	2.4	2.3	2.6	2.7	2.6	3.2	2.6
Wages and Benefits (civil service)	7.4	6.9	7.0	7.1	6.8	6.6	6.6
Development and Net Lending	6.7	7.2	8.7	8.0	10.1	10.2	10.2
Budget Deficit (commitment basis)	-3.9	-4.0	-6.4	-4.5	-4.8	-5.0	-4.0
Public Debt to GDP (Net)	39.3	42.1	44.8	48.8	46.1	45.5	44.6

Source: Ministry of Finance

Annex 1.14: Balance of Payment (September)

	US$ Millions			Percentage growth		
	2009	2010	2011	2009	2010	2011
Exports (fob)	4522	5010	5760	-8.2	10.8	15.0
Coffee	199	199	218	23.6	0.3	9.2
Tea	858	1152	1131	1.5	34.3	-1.8
Horticulture	674	713	719	-11.3	5.7	0.9
Manufactured Goods	513	598	718	-17.6	16.6	20.0
Raw Materials	219	216	311	-33.0	-1.5	44.2
Chemicals and Related Products	421	408	547	-7.6	-3.0	33.9
Other	796	927	1145	-12.4	16.4	23.5
Imports (cif)	10202	11803	14483	-7.4	15.7	22.7
Oil	2040	2631	3742	-33.6	29.0	42.2
Chemicals	1314	1528	1893	-6.8	16.2	23.9
Manufactured Goods	1420	1719	2177	-7.2	21.0	26.7
Machinery & Transport Equipment	3061	3430	3958	5.0	12.1	15.4
Other	2245	2376	2525	11.3	5.8	6.2
SERVICES	3824	4720	4706	-12.0	23.4	-0.3
Non-factor services	1750	2512	2479	-17.2	43.5	-1.3
Income account	-66	-82	4	-6.0	-25.1	104.8
Current Transfers account	2139	2291	2222	-6.9	7.1	-3.0
Remittances	597	619	824	-2.1	3.7	33.2
CURRENT ACCOUNT	-1856	-2073	-4017	-6.4	-11.7	-93.7
CAPITAL & FINANCIAL ACCOUNT	2217	2439	3796	9.1	10.0	55.7
OVERALL BALANCE	360	365	-220	25.4	1.4	-160.4
% of GDP						
Exports (fob)	14.8	15.6	17.1			
Imports (cif)	33.4	36.7	43.1			
SERVICES	5.7	14.7	14.0			
CURRENT ACCOUNT	-6.1	-6.4	-12.0			
OVERALL BALANCE	1.2	1.1	-0.7			

Source: CBK

Annex 1.15: Maize production 2009 and 2010

Province	2009			2010			% Increase in Maize
	HA '000	Bags (90 Kg) Millions	Yield	HA '000	Bags (90 Kg) Millions	Yield	
Central	123	1.2	9.4	176	1.4	8.0	21
Coast	118	1.4	12.0	137	1.96	15.5	38
Eastern	465	6.0	13.0	455	3.8	8.3	-38
NEP	2	0.001	0.5	4	0.009	2.1	812
Nairobi	0.3	0.003	12.0	0.7	0.014	19.0	349
Rift Valley	618	14.2	23.1	675	21.1	36.5	48
Western	227	4.5	20.0	233	5.1	22.0	14
Nyanza	296	5.05	17.0	327	5.1	17.3	0
Total	**1,850**	**32.4**	**17.5**	**2,008**	**38.5**	**19.2**	**19**

Source: Ministry of Agriculture

Annex 1.16: Key Macro-economic indicators low case, baseline and high case scenario

Variable	2007	2008	2009	2010	2011*	2012**	2013**
Baseline							
GDP	7.0	1.6	2.6	5.6	4.3	5.0	5.5
Private Consumption	7.3	-1.3	3.8	2.8	3.0	3.9	4.1
Government Consumption	4.4	2.3	5.5	4.8	4.5	4.3	4.6
Gross Fixed Investment	13.6	9.5	0.6	7.4	10.2	9.5	11.0
Exports, GNFS	7.3	7.5	-7.0	6.1	8.9	6.7	6.7
Imports, GNFS	11.1	6.6	-0.2	3.0	8.6	6.7	6.7
Low case Scenario							
GDP	7.0	1.6	2.6	5.6	4.3	3.1	4.5
Private Consumption	7.3	-1.3	3.8	2.8	3.0	3.9	4.1
Government Consumption	4.4	2.3	5.5	4.8	4.5	4.3	4.6
Gross Fixed Investment	13.6	9.5	0.6	7.4	10.2	6.8	7.9
Exports, GNFS	7.3	7.5	-7.0	6.1	8.9	2.0	6.0
Imports, GNFS	11.1	6.6	-0.2	3.0	8.6	6.7	6.7
High case scenario							
GDP	7.0	1.6	2.6	5.6	5.2	5.5	6.0
Private Consumption	7.3	-1.3	3.8	2.8	3.0	3.9	4.1
Government Consumption	4.4	2.3	5.5	4.8	4.5	4.4	4.6
Gross Fixed Investment	13.6	9.5	0.6	7.4	13.9	11.0	12.1
Exports, GNFS	7.3	7.5	-7.0	6.1	9.0	7.0	7.2
Imports, GNFS	11.1	6.6	-0.2	3.0	8.6	6.7	6.7

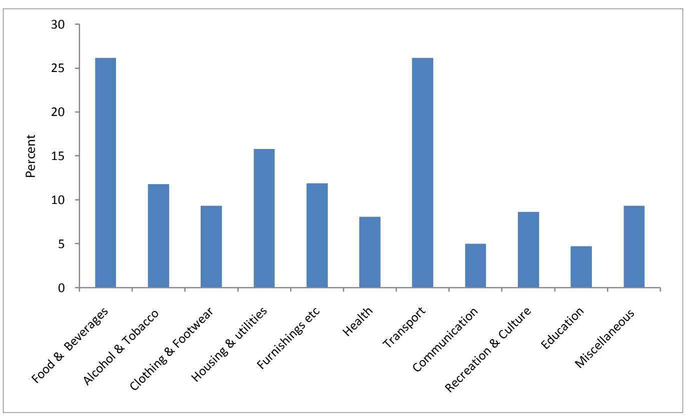
Source: CBK; KNBS; World Bank estimates
**Projection*
***forecast*

Annex 1.17: Shocks: Comparing 2009 with the 2012 outlook

Transmission mechanism	Impact 2009	Outlook 2012
External Sector	Current account deficit at 6.7 percent of GDP.	Current account already high at 10 percent of GDP in 2011 from 7.8percent in 2010 could increase due to weak export performance.
Monetary and Financial Sector	No contagion. NPLs stand at 9 percent (September 2009). Capital Adequacy: 19.8 percent against a statutory requirement of 12 percent. CBK stimulated credit growth through injecting liquidity in the system and lowing CRR, CBR. Banks lowered lending rates.	No contagion. Local banks are not dependent to significant funding from foreign banks abroad. Capital Adequacy: 20 percent against a statutory requirement of 12 percent. Higher interest rate may increase NPLs CBK reducing liquidity through increase in CRR, repos, and signaling liquidity through CBR.
Foreign exchange	The nominal exchange rate – as the automatic stabilizer depreciated by 26percent in between June 2008 and march 2009. Trade weighted NEER depreciated by 16percent while REER depreciated by 7percent,	Banks increasing lending rates. The exchange rate has depreciated by 23 percent between December 2010 and September 2011. Trade weighted NEER has depreciated by 18.6 percent between December 2010 and August 2011 while REER depreciated by 6.8 percent.
Financial flows (remittances, FDI, other flows)	Remittances projected to grow by 3 percent (higher than expected but below pre-crisis growth rates). Net FDI expected to drop by US$500 million (but "other financial flows" have increased). Remittances down 9 percent.	Short term interest rates have risen from 2percent in Jan 2011 to over 14percent September, short term inflows have risen by US$ 940 million in the first 7 months of 2011. FDI which are generally low in Kenya have almost dried up since January 2011. Remittances are up by 24 Percent year to July 2011.
Official Flows	Nairobi Stock exchange index mirrors Dow Jones and remains more than 50 percent below mid 2008 levels.	Nairobi Stock exchange index lost 968 points (27 percent) since January 2011.
	No significant reduction in bilateral flows.	No significant reduction in bilateral flows.

Source: KEU team

Annex A1.18: Break down of overall inflation: October 2011



Source: KNBS

Annex 2.1: A frame work for estimating County Levels of Economic Activity

Methodology

(i) We use the production approach and identify 18 economic activities as detailed in the table below (Economic activities)
(ii) At the county level we use gross output as a proxy for economic activity, since it is much harder to get data on value added. For instance, in the case of agriculture, we were able to obtain data on total volume of production for most crops by geographical region. But is much harder to obtain data on wage employment and profits (value added) by agricultural activity.
(iii) We develop a simple framework to estimate levels of economic activity (Y) for each county (k) :

$$Y_k = \sum_{i=1}^{22} \theta_i * \frac{\alpha_{ki}}{A_i}$$

Where;

Y_k is economic activity for county k

θ_i activity i contribution to GDP

A_i is gross output of activity i

α_{ki} is county k's share in output of activity i

Using this framework we develop a 47 (county) X 18 (economic activity) matrix where the row total aggregates a county's level of economic activity (Y_k) and the column total gives gross output of each economic activity as follows (A_i):

Matrix of economic activity by county

	Sector / Activity	
County	Crops Livestock … … … Manufacturing … … … … … .18	Y_k
1 2 47	$Y_k = \sum_{i=1}^{22} \theta_i * \frac{\alpha_{ki}}{A_i}$	Total County economic activity
	A_i Total sector activity	National output $\sum_{i=1}^{22} A_i = \sum_{k=1}^{45} Y_k$

This simple framework assumes that the technology of production for each activity is the same across geographic regions. However, we differentiate the technology of production for livestock which differs significantly between pastoralist and other forms of livestock farming.

Economic Activities

Sector	Subsector	Activity
Agriculture	Growing of crops Keeping of animals Fishing Forestry	Cereals Tea Coffee Horticulture other crops
Industry	Manufacturing Mining & Quarrying Electricity & Water Construction	
Services	Wholesale & Retail trade Hotels and Restaurants Transport & Communication Financial Intermediation Real Estate Public Administration Education Heath and Social Work Other social & personal services Private Households with employed persons	Repair of Motor Vehicles Transport – Land, Water, Air, Pipeline Posts & telecoms Renting & business services private public private public

Source: World Bank

Annex 2.2: Methodology and assumptions underpinning estimate of spending on county functions

The functions assigned to the national and county governments in the Constitution of Kenya 2010 are generally broad and non-specific. Using 2010/11 as simulation year, the following methodology was used for the purposes of identifying and beginning to cost county functions (using current allocations as a proxy).

Step 1: Unbundle the sector functions, consistent with the Constitution of Kenya, down to specific activities and assign these to the two levels of government. Main assumptions are listed in the table below. Basic criteria underlying these assumption decisions were (1) whether the function had spillovers or services that benefited more than one county, (2) the technical complexity of the function, and (3) whether there were economies of scale in the provision of the function.

Step 2: Map the expenditure items listed by Vote or Head to the functions and competencies identified in Step 1.

Vote	Assumptions on functions to be transferred to counties	Corresponding share of the budgeted amounts
Provincial Administration (01)	District Administration devolved by half of the budget to cater for restructuring, taking into account the national officers who will be coordinating functions in counties such as education or security functions.	6.6%
Public Service (03)	Counties assumed to have their own public services, Matunga District Development which already exists can be devolved directly	6.8%
OVP and Home Affairs (05)	Field Services of Betting and Control though headquarter services of Betting and Control retained at the national level as a policy setting function.	0.4%
Planning and V2030 (06)	Rural planning, district development services and smallholders and community services devolved as part of county planning activities.	3.6%
Constituency Development Projects as part of Planning, National Development and Vision 2030 (06)	Constituency Development Projects assuming CDF is devolved.	3.6%
Finance (07)	District Treasuries and District Internal Audit to cater for the county financial management activities and infrastructure.	2.3%
Regional Development Authorities (09)	River and lake basin authorities - Kerio, Tanathi, Lake Basin, Ewaso Nyiro South/North, and Coast Development Authorities devolved under county water services – though water service boards are retained at the national level.	77.9%
Agriculture (10)	Provincial and District Agricultural and Livestock Extension Services as well as Farmers Training Stations devolved. Horticultural Crop Development Services part of devolved functions in county crop and animal husbandry.	31.7%

ODPM and Local Government (12)	Provincial Local Government Offices and infrastructure to be converted into facilities and services for the management of urban services as a county function according to the Urban Areas and Cities Act of 2011.	12.5%
Urban Services based on LATF directed to the Ministry of Local Government (12)	For the provision of urban services that LATF typically funds at the county level – the financing of urban service provision has been transferred to the county governments by the Urban Areas and Cities Act of 2011.	66%
Labour (15)	Micro and small scale enterprise development devolved as a function of county trade development.	13%
Livestock and Development (19)	Provincial and district livestock services and veterinary services devolved as county animal husbandry functions	81.4%
Forestry and Wildlife (55)	The portion of forestry and conservation going to the county-level implementation of national government forestry and wildlife policies.	40.7%
Fisheries Development (56)	All functions except for Deep Sea Fisheries Development because deep sea areas are managed nationally and do not belong to a specific county.	99.9%
Medical Services (11)	District and sub-district hospitals, primary facilities and primary health care programs devolved as county health services.	39.7%
Public Health and Sanitation (49)	Primary health care including family planning and health education, rural health and training centers devolved as county health services.	46.9%
Roads (13)	The portion that goes to the Kenya Rural Roads Authority and the Kenyan Urban Roads Authority is devolved as part of county roads functions.	70%
Road Maintenance based on RMLF directed to Roads (13)		25.2%
Transport (14)	Kenya Ferry Services fully devolved as a county transport function.	7.7%
Trade (16)	Provincial and field trade development services devolved as county trade development functions.	12%
Water and Irrigation (20)	Rural, Urban and Special Water Programmes, as well as Irrigation and Land Reclamation, Flood Control Management devolved to counties. Water Conservation and Dam Construction devolved at half the budget to cater for its concurrent delivery with the national government	32.8%
Cooperative Development and Marketing (22)	Co-operative Management and training programs devolved as county cooperative management, trade functions.	90%

Energy (30)	Rural Electrification Programme devolved to support county electricity and gas reticulation, and energy regulation function.	17.1%
Education (31)	Early Childhood Development Education (ECDE) devolved under pre-primary education county function.	0.3%
Information and Communications (32)	Provincial and district information management and rural press devolved to cater for county information and communications.	2.3%
Lands (36)	District survey and physical planning offices and district lands offices devolved as part of county planning and development functions in land survey and mapping.	9.2%
National Heritage and Culture (41)	Managing museums and cultural activities at the county level including records management, languages and oral tradition, development of performing arts and library services fully devolved. Records kept at provincial level that are considered county are devolved while the rest retained at the national level as a concurrent function.	55.7%
Youth Affairs and Sports (42)	Youth development and training field services especially those dealing with sports as a county function, devolved.	27.9%
Housing (44)	County planning functions in housing including district government estates and provincial Housing management fully devolved. Slum Upgrading and Housing Development mostly devolved apart from a portion left to manage policy for slum areas as a national concern.	49.4%
Tourism (46)	Local (domestic) tourism devolved as a function of county trade development	2.7%
Nairobi Metropolitan Development (57)	Half of the budget going to serve Nairobi's status as a county is devolved while the other half is retained national for Nairobi's function as the capital city and the house of national government.	50%
Development of Northern Kenya and Other Arid Lands (58)	Northern Kenya and Other Arid Lands functions as county specific devolved at half the budget while the functions that deal with aspects of national agricultural, veterinary and environmental protection retained national.	50%
Public Works (59)	Provincial and district public works at half the budget to cater for concurrent functions with national public works.	49.8%
Industrialization (60)	Small Scale Industries Field Services fully devolved as county trade and development functions.	1.8%

Annex 2.3: Fiscal gap approach to horizontal sharing and options for Kenya

The textbook objective of an equitable sharing formula is to fill the 'fiscal gap' between expenditure needs and revenues for each sub-national government. Below is a simple depiction of how a fiscal gap formula works.

1) The first step is to define sub-national expenditure needs (this is the first element in the first equation) given the service delivery functions assigned to them and the cost of delivering these functions
2) The second step is to asses extent to which sub-national governments could meet (part of) these needs out of their own revenues (this is the second component of the first equation)
3) The job of a formula is to share the available resources fairly between individual counties, based on their relative needs: rresources available to sub-national government units (the county equitable share) are allocated among them according to the relative size of each county's fiscal gap. (this is the second equation)

How a Fiscal Gap formula works

Equation 1: the fiscal gap

EXPENDITURE NEEDS	**minus**	***FISCAL CAPACITY***	**equals**	***FISCAL GAP***
Amount a county needs to deliver their mandated functions		*Revenue a county can raise using its own taxing powers, to meet those costs*		*Shortfall (gap)*

Equation 2: the county share

$$\frac{\textit{Fiscal gap of County X}}{\textit{Fiscal gap of all Counties in Kenya}} \; X \; \textit{County equitable share} = \textit{Allocation to County X}$$

A complex 'fiscal gap' formula may not be possible or desirable for Kenya in the near future. Firstly there are inherent methodological and practical obstacles to adequately captured revenue capacity. Secondly, complex formulae can undermine the transparency of the allocation and therefore the extent to which all citizens can understand the public finance architecture and have faith in its objectivity. This is particularly important when geographic distributional decisions overlap with political divisions.

A workable formula for Kenya

In the short term the CRA should concentrate its efforts on getting the expenditure side right first. In practice, the formula could focus on equalizing the ability of counties to provide a standard basket of services in a few critical devolved service areas. This would include factors that proxy demand for services (from the crudest –population, poverty prevalence- to sector specific indicators –such as kilometers of roads or the number of elderly) as well as factors influencing the cost of provision (such as geography). An equal share component could be added, whose purpose would be to reflect the fixed costs associated with running county administrations.

Tackling the revenue side would be more difficult and perhaps less urgent. Given (i) data limitations and (ii) the moderate extent to which counties' own revenues are likely to contribute to overall financing of decentralized functions, seeking to equalize fiscal capacity would be needlessly complex and compromise the objective of transparency. Over time, estimates of fiscal capacity could be built into the formula, possibly relying on a single macro measure of capacity (such as county level GDP). If the CRA wishes to design a formula that accounts for own-revenues the best option in the short term would perhaps be to include actual revenue collection data in the formula but with a discount to minimize perverse incentives on revenue collection effort.

Annex 2.4: The impact of various thresholds on corporate management of urban areas

Previously, urban centers were arbitrarily assigned corporate management status. The new Cities and Urban areas Act, sets a minimum population threshold of 250,000 residents for cities and municipal areas to have corporate bodies to manage them. In the table below.

- Blue highlights show those cities that would have a corporate body under the current Act (with threshold at 250,000
- Yellow highlights show those cities that would have a corporate body if the threshold were lowered to 150,000
- All other cities would have a corporate body if the threshold were lowered to 75,000

	County	Urban Centre	Population (2009)
1	Bomet	Bomet	83,729
2	Garissa	Garissa	116,317
3	Kajiado	Ngong	107,188
4	Kakamega	Mumias	99,987
5		Kakamega	91,768
6	Kericho	Kericho	101,808
7	Kiambu	Ruiru	238,858
8		Kikuyu	233,231
9		Thika	136,917
10		Karuri	107,716
11		Kiambu	84,155
12		Limuru	79,531
13	Kilifi	Malindi	118,265
14	Kisii	Kisii	81,801
15	Kisumu	Kisumu	388,311
16		Awasi	93,369
17	Kitui	Kitui	109,568
18	Machakos	Kangundo-Tala	218,557
19		Machakos	150,041
20		Mavoko	137,211
21	Mandera	Mandera	87,692
22	Migori	Rongo	82,066
23	Mombasa	Mombasa	938,131
24	Nairobi	Nairobi	3,133,518
25	Nakuru	Nakuru	307,990
26		Naivasha	169,142
27	Nandi	Kapsabet	86,803
28	Nyeri	Nyeri	119,353
29	Trans Nzoia	Kitale	106,187
30	Uasin Gishu	Eldoret	289,380
31	Vihiga	Vihiga	118,696
32	Wajir	Wajir	82,800

Source: KNBS; 2009 Population Census

Navigating the storm, Delivering the promise

with a special focus on Kenya's momentous devolution

Kenya is entering a defining year in its history. While 2011 has already been challenging, managing Kenya's economy will become even more difficult in 2012. National elections, the establishment of a new system of devolved government and a looming global economic crisis will make the next twelve months extremely challenging. At the same time, if Kenya manages these challenges well – peaceful elections and transition to a new government, successful introduction of a new system of devolved government and continued growth during a global economic crisis – 2012 will be remembered as the year in which Kenya was ***Navigating the Storm*** *and* ***Delivering the Promise*** *of a more prosperous future.*

Kenya's economy has already been weathering rough economic conditions in 2011. High food and fuel prices, the drought in the Horn of Africa, and the Euro crisis have weakened Kenya's external position, which was already fragile given the large current account deficit. These economic challenges will lower growth to an estimated 4.3 percent in 2011. For 2012, the World Bank projects growth to recover slightly and reach 5.0 percent, if Kenya succeeds in managing the risks. The ongoing economic crisis underscores Kenya's structural challenges, especially its weak export performance, which has been a primary cause of Kenya's recent macroeconomic instability and a contributor to the sharp decline in the Shilling in 2011.

The turbulence in Kenya's economy coincides with implementing the Constitutional blueprint for a new political and administrative architecture; arguably the most momentous and far-reaching reforms in Kenya's almost fifty year history. At the heart of this transformation is the devolution of power to county governments, and the design of arrangements that will turn the constitutional vision into a reality. Kenyans bring to this process tremendous enthusiasm and energy, but the devil lies in the detail. The specific design of fiscal architecture, accountability systems and the management of this massive transition will determine whether Kenya can weather the economic storm in a way that enhances social equity, service delivery, citizen engagement, and so deliver the promise of institutional transformation.

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