Fiscal Decentralization for Sustainable and Inclusive Development in Emerging African Economies: A Comparative Study of Ethiopia and Kenya

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1. Introduction

Fiscal decentralization is a mechanism by which central governments devolve responsibilities for revenues and expenditures to sub-national governments[1], including county and urban governments. Transferring adequate revenue and authorizing local authorities to allocate expenditures empowers them to provide services to all citizens in an efficient and equitable manner. It also encourages sub-national governments to assume additional responsibilities; and be more accountable and transparent in service delivery and public policy making (De Mello, 2000; Kee,2003).

For an effective system of fiscal decentralization, there should be a clear assignment of responsibilities and fiscal authority between the central government and sub-national governments. In many systems, these are spelt out in the law or the national constitution of the country. Most often, the apportionment stipulates functions and responsibilities; determines shared and independent sources of revenue; and also lays down the basis for fiscal transfers from the central to sub-national governments. The law also provides mechanisms for resolving differences or disputes regarding any of these respective powers and functions (Bird, 2002; Rao, et.al., 2007).

Fiscal decentralization makes it possible to provide services in a fair and all-inclusive manner. Simply put, fiscal decentralization helps to insure that all citizens have equitable access to publicly funded services regardless of where they live. This has the advantage of creating a harmonious society and reducing public discontent; and also enhances the popularity of national governments. From an efficiency perspective, fiscal decentralization helps sub-national governments to be more responsive and accountable than central governments in providing services and infrastructure because of their proximity to the people (De Mello, 2000;Shah, 2006).

One of the important goals to be attained through fiscal decentralization is to avoid inequities in the provision of public services. Many countries have mandated this imperative in national constitutions. To make this practical, central governments design a formula by which all sub-national governments acquire a fair share of national revenues through different forms of grants. They are also given corresponding powers to allocate expenditures among different needs. In general, the mechanism by which national revenues are distributed to sub-national governments takes into account relative fiscal need; revenue raising capacity of sub-national governments; disparities in development among regions, such as, for example, poverty indices; and other important factors, such as spatial differences in the cost of providing services (Shah, 2006; Smart, 2005).

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[1] In this paper, the term 'sub-national government' is used to encompass all levels of government below the central/national level.

From a technical perspective, fiscal decentralization aims at addressing concerns related to fiscal inequality among sub-national governments, which in turn can lead to citizens receiving different benefits from public spending because of differences in places of residence. Therefore, to eliminate differences in net benefits among citizens, grants or fiscal transfers from the central government to sub-national governments are required. As has been explained earlier, these grants or fiscal transfers must be allocated to sub-national governments through a formula that needs to address problems of vertical and horizontal imbalance as well as factor in spillover effects and efficiency considerations in tax collection (Smart, 2006).

Vertical fiscal imbalance in fiscal decentralization refers to differences in fiscal capacity between central and sub-national governments. It arises due to the possibility that most buoyant and elastic revenue and income taxes may have been allocated to the central government. This has the effect of leaving sub-national governments with inadequate resources to meet expenditure needs. Since this fiscal gap is beyond the control of sub-national governments, there is a clear justification for fiscal transfers from the central government to compensate for the gap. The share of sub-national government expenditures that is financed with sources of revenue under its control can be used as a good measure of vertical fiscal imbalance.

The term ‘horizontal fiscal imbalance’, which is another justification for fiscal transfers from central to sub-national governments, indicates the extent of fiscal disparity among sub-national governments. This fiscal gap needs to be corrected through transfers from central to sub-national governments because it will work against inclusive and equitable provision of services among citizens living in different places. Often, horizontal fiscal imbalances are caused by a number of reasons the most important being that some jurisdictions have better fiscal capacity than others because of better resource base; higher taxes; higher incomes, etc. It may also arise because some jurisdictions, i.e. urban and county governments, may also have higher expenditure needs due to spatial price differences that can be mostly caused by remoteness, population density, level of infrastructure development, etc.

In dealing with horizontal fiscal imbalance, care must be taken not to adopt a simplistic approach that equalizes actual revenues and expenditures of each sub-national government (Rao & Chelliah, 1991). This approach is problematic because equalizing actual expenditures in terms of per capita can discourage both local revenue-raising efforts and local expenditure restraints. In addition, as Bird and Smart (2002) put it, equalizing actual outlays of local government in per capita terms, i.e., raising all to the level of, for example, the richest local government, ignores differences in local preferences, needs in cost, and own revenue-raising capacity. Simply put, horizontal equalization objective of fiscal transfer may create poor incentives for local government to raise their own resources.

Fiscal transfers from central to sub-national governments are also justified because of the need to address inter-jurisdictional spillover effects or externalities. Spillover effects refer to a situation where services provided by one sub-national government extend benefits to communities in other or adjacent authorities and vice versa. Examples can be pollution control (water or air), inter-regional highway, higher education (graduates may leave for other regions to work), fire departments (may be used by neighboring areas), etc. A local government, be it either county or urban, tends to under invest in such projects because it continues to reap all the benefits of these projects at little or no cost. Therefore, the central government needs to provide incentives or financial resources in the form of transfers to address such problems of under-provision in the affected jurisdiction.

Finally, yet another justification for fiscal transfers from central to sub-national governments is the efficiency consideration in tax collection. In many systems, the lion's share of the national revenue is collected by the central/federal government because it has a greater capacity than sub-national governments to assess and collect taxes. It is less costly, therefore, for the central government to collect the taxes and then to allocate the revenues to sub-national governments in the form of transfers. This can ease up the financial difficulties of sub-national governments and enable them to provide services and infrastructure to citizens.

In summary, the primary goal of fiscal decentralization is to transfer resources to sub-national governments for service delivery and infrastructure provision. This is attained through equalization of resources among sub-national governments, which can be done by instituting an equitable and fair fiscal transfer system. Equally important, the theory of fiscal decentralisation suggests that those receiving transfers must have a clear mandate, adequate resources, and sufficient flexibility to make decisions (Bird and Smart, 2002). Local governments receiving transfers must be accountable for the results as well. Hence to satisfy these conditions, transfer systems must be designed properly and with care. The following section discusses how fiscal transfer systems must be designed and what factors need to be considered in the process.

2. Design of a Fiscal Decentralization System

There are many approaches to design effective fiscal transfer systems from central to sub-national governments. An important litmus test of such a system is that it ensures equalization of resources among sub-national governments. To bring about equitable and fair distribution of resources, the two dimensions of fiscal transfer must be considered: (i) equalization of expenditure needs, and (ii) equalization of fiscal capacity (Martinez-Vazquez, George and Boex & Jameson, 1997). An assessment of expenditure need and fiscal capacity makes it possible to bring about equitable distribution of resources and fill the gap that can exist among sub-national governments. Avoiding disparities ensures equitable and efficient provision of services and infrastructure by sub-national governments.

2.1. Measuring Fiscal Capacity

As indicated earlier, measuring fiscal capacity is key to attain the goal of equalization of resources among sub-national governments through fiscal transfers. As reiterated earlier, this is necessary to provide services equitably and efficiently. The fiscal capacity of a sub-national government is its potential ability to raise revenues from own sources in order to pay for a standardized basket of public goods and services. Several factors are taken into account to measure the fiscal capacity of sub-national governments. These include actual revenue collection, per capita personal income, gross regional product (GRP), total taxable resources, and representative tax system (RTS). As the following discussion reveals, care must be taken in the use of these factors to measure fiscal capacity.

(i) Actual Revenue as Proxy for Fiscal Capacity

Many fiscal decentralization systems use actual revenue as proxy for potential fiscal capacity of sub-national governments. But, such an approach has been found to be problematic because actual revenue will differ from that of the potential capacity because the former can be influenced by the amount of tax rate applied, the enforcement effort and taxpayer compliance. In other words, applying actual revenue to represent potential revenue will assume that all sub-national governments will apply a uniform tax rate; exert equal enforcement effort; and demand uniform taxpayer compliance regime, all of which may not be true for all sub-national governments. Because of these important differences, it is not advisable to use actual revenue representing potential fiscal capacity.

(ii) Per Capital Income as Representing Potential Fiscal Capacity

Per capita personal income is often used as a variable to measure potential fiscal capacity of sub-national governments. This is based on the assumption that the most important source of a revenue for a regional government is the income of its tax-paying residents (Martinez-Vazquez, George, Boex & Jameson, 1997). However, although the use of per capita income introduces simplicity, it has its own disadvantages. First, measuring per capita income is not easy as data pertaining to income is not always easy to collect. Second, residents' per capita income does not allow sub-national governments to tax economic resources or economic rents owned by residents outside the particular sub-national government's jurisdiction. Hence, using per capita income to measure potential fiscal capacity must be used with caution; or preferably with other factors.

(iii)Gross regional product (GRP)

Gross regional product (GRP) is often used to measure fiscal capacity of sub-national governments. GRP can be taken as representing the total value of goods and services produced by the sub-region's economy over a given period of time. GRP is more comprehensive than per capita income because it includes income within a region irrespective of the location of the residence of the worker or producer. In this regard, GRP has several features. First, it is possible to generate substantial revenue because most of the taxable residents are easily accessible as they work and own business in the region. Second, it includes the income of non-residents that a regional government may tax. These two features add to its strength as approximating the region's potential fiscal capacity to a significant degree.

Despite its strengths, however, the GRP approach has certain weaknesses. First and foremost is the fact that the GRP approach to measuring potential fiscal capacity of sub-national governments is data intensive; and not all sub-regional governments may have such data.

(iv)The Representative Tax System to Measuring Potential Fiscal Capacity

The most common and widely applied approach to measure the potential fiscal capacity of sub-national governments is the Representative Tax System (RTS). The basic principle in RTS is to estimate the amount of revenue a region would collect if it were to exert average fiscal effort. It measures the fiscal capacity of a sub-national government, be it county or urban, by the revenue that could be raised if all of the standard sources are employed at the nationwide average intensity of use.

Estimating potential revenue that can be collected by the sub-national government requires information on the designated tax bases and tax revenues for each sub-national government. This is often spelt out in the law of the country. In the event that there are under-performing sub-national governments, these will have to be brought up to the median, mean, or some other norm to provide for consistency and uniformity. Although theoretically popular, the RTS approach is quite data intensive with regard to tax sources, tax base and rates; and also requires a complex econometric model, all of which reduce its attractiveness.

2.2. Measuring Fiscal Need

Measuring the fiscal need of sub-national governments is an important component of an effective fiscal decentralization mechanism because it is key to bring about resource equalization among these governments. In other words, it helps to reduce the 'horizontal fiscal imbalance' among sub-national governments by encouraging fair and equitable share of resources.

There are several approaches to measure the fiscal need of sub-national governments. Two of these: (i) Ad hoc determination of expenditure needs; and (ii) Representative Expenditure System (RES). The latter is widely used in many countries (Shah, 2006).

(i)..Ad hoc determination of expenditure needs uses simple measures of expenditure needs in general-purpose transfers. The factors used and their relative weights are arbitrarily determined. The experiences of many countries suggest that some of these factors may be population size and density; number of public employees; measures of backwardness; remoteness and location factors; or equitable share of resources among all sub-national governments.

***(ii)* The Representative Expenditure System (RES)**

As the Representative Tax System (RTS) was used to measure the potential fiscal capacity of sub-national governments, the Representative Expenditure System (RES) can be considered its counterpart in measuring the fiscal or expenditure needs of sub-national governments. In theory, RES can require rigorous econometric analysis and regression techniques; but, in practice, a simple and non-technical application is preferred.

The practical application of RES call for dividing sub-national expenditures into various functional categories, such as education, health, rural development, roads, agriculture, etc; determining total expenditures by jurisdiction for each function; identifying relative need/cost factors; assigning relative weights for the factors considered; and allocating total expenditures of all jurisdictions on each function across jurisdictions on the basis of their relative costs and needs for each function. RES' main advantage lies in the fact that it avoids the need for very elaborate calculations and assumptions needed to determine the cost of provision of services and infrastructure. It determines allocation of expenditures to various functions based on the sum of actual expenditures as the point of departure for measuring specific expenditure needs among sub-national governments on the basis of selected indicators of need, including using proxies for determining expenditures if the need arises.

The preceding general introduction is intended to set the stage for the discussion of the Ethiopian and Kenyan experiences in fiscal decentralization for equitable and inclusive development. These two countries represent emerging African economies; and have put in place a fledging fiscal decentralization system that can provide lessons and also suggest means to address challenges. A review of the political and socio-economic profiles of these two nations is in order to provide a proper context for assessing how the fiscal decentralization system has fared in achieving its goal of inclusive and sustainable development.

3..The Ethiopian Experience in Fiscal Decentralization

3.1. Country Background

With an estimated population of nearly 90 million inhabitants (2013), Ethiopia is Africa's second populous nation after Nigeria. It is one of the most diverse nations with more than 85 ethno-linguistic groups. Since ancient times, most Ethiopians are followers of the two great religions-----Christianity and Islam[2]. A significant majority are Christians accounting for nearly 63percent of the total population. Among these, Orthodox Christians constitute 43.5percent; Protestants 18.6percent; Catholics 0.7percent, and about 3percent belong to different religions. Moslem Ethiopians constitute about 33.9percent (Population Research Institute (PRI) & US Census on World Population, 2011; CSA, 2007).

Ethiopia is a unique African country in many respects. It is Africa's oldest independent nation that has enjoyed an uninterrupted tradition of statehood. It has never been colonized by Europeans except for the brief 5-year occupation by Fascist Italy during World War II. The country has a distinctly indigenous alphabet and calendar system that set it apart from other nations. The rich heritage and diversified value systems and traditions of Christians and Moslems point to the possibility that Ethiopia might have for centuries been a meeting center of African, Arab and Asiatic cultures.

Ethnicity is an important feature shaping national politics in Ethiopia; and in recent years has been a decisive factor in restructuring the state and political representation at national and regional levels. Upon assuming power in 1991, the current Government reorganized the country along ethnic and linguistic lines by establishing a federal state that consisted of 9 autonomous ethnic regions and two administrative areas. These regional states manifest enormous differences in population, territory and level of infrastructural development, etc. and this has produced important implications on the functioning of the federal arrangement.

[2] The number of Ethiopian Jews otherwise known as 'Bete Israel' has diminished since their exodus to Israel beginning in the mid-1980s.

The economy is predominantly agricultural and rural based. Agriculture is the pillar of the national economy accounting for about forty-five percent of the Gross Domestic Product (GDP), 63 percent of total exports and 85 percent of employment. In recent years, the country has registered fast economic growth averaging 11.2percent per annum between 2002/2003-2008/09. Despite the successes, however, the economy continues to be fragile because of persistently runaway inflation, its dependence on primary commodities and rain-fed agriculture; and widespread poverty (ADB, 2010;

Over the past 5 decades or more, Ethiopia's political history has been marked by recurring regime changes and absence of continuity in leadership. Since WW II, the country has been ruled by three radically different regimes---(i) the Haile Selassie I imperial era (1931-1974)…..a period of semi-feudal absolute monarchy; (ii) the Derg period (1974-1990)----rule by a leftist military dictatorship characterized by incessant civil war, atrocious repression and political turmoil; and (iii) the current government led by the Ethiopian Peoples' Revolutionary Democratic Front (EPRDF). The latter is a coalition of ethnic-based organizations that has been running the country since 1991 following the overthrow of the Derg (Dessalegn & Meheret; Bahru, ----). .

Currently, Ethiopia is ruled by a government led by the Ethiopian Revolutionary Democratic Front (EPRDF), which came to power in 1990 after overthrowing the Derg regime. Following the drafting of a constitution, it has been declared a federal state comprising 9 semi-autonomous regional states and two administrative areas. These regional states have considerable self-rule authority, and are empowered to deliver public services and development benefits to advance the social and economic rights of citizens.

According to the 1995 constitution, the federal/central government has an obligation to transfer resources to sub-national governments or regional governments to enable them provide services and infrastructure to citizens. The transfers must be done in accordance with the principles of the constitution, which provides for 'equitable, fair and truly just' distribution of the country's resources. It is also provided that the House of Federation (HoF) has the power to design a federal budget distribution formula according to which the federal/central government will allocate budget transfers to regional states.

3.2. The Beginning of Fiscal Decentralization

Ethiopia first initiated a fiscal decentralization system starting in 1995/96. For nearly two decades now, the federal/central government has been transferring grants to regional states according to a formula approved by parliament. Federal/central government fiscal transfers to regional governments are made to ensure equitable distribution of the national budget. These transfers have been very important in the structure of public finances representing 80-85 per cent of regional states' fiscal needs. Most of these are unconditional, general-purpose grants giving sub-national governments considerable autonomy on how to allocate among different expenditure categories. Sub-national governments use these grants to finance public services and expand infrastructure so that citizens get the same basket of services regardless of where they live.

The main objective of fiscal decentralization is to distribute the federal budget to regional states in accordance with the provisions of the Constitution of the Federal Democratic Republic of Ethiopia (FDRE). The constitution provides for 'equitable, fair and truly just' distribution of the country's resources with sub-national governments through a federal budget allocation formula. According to article 62, sub-article 7 of the Constitution, the House of Federation (HoF), which is the upper house, has the power to design a federal budget subsidy distribution formula according to which the Federal Government will allocate budgets to regional states. It is also stipulated that parliament approves the national budget and determines how much of this national budget will be earmarked to sub-national governments.

3.3. Main Features of the Ethiopian Approach to Fiscal Decentralization

The Representative Tax System (RTS) and Representative Expenditure System (RES) are the principal approaches used in fiscal decentralization in Ethiopia. As indicated earlier, the main goal to be attained by using these models is to bring about horizontal equalization of resources among sub-national governments. Equalization of resources can guarantee equitable and fair provision of services and infrastructure to citizens regardless of where they live.

Federal/central fiscal transfers are made after careful assessment of the potential revenue capacity and expenditure needs of each sub-national government. The gap that exists between the expenditure needs and potential revenue that a sub-national government can collect with average tax effort is made up for by a block grant that the federal/central government transfers to the regions.

- **Estimating Potential Revenue using RTS**

This approach focuses on major revenue sources of sub-national governments and application of appropriate tax rates to arrive at potential revenue. It is characterized as 'Representative' because it picks up the most lucrative revenue sources of the sub-national governments that account for a highly significant share of the total revenue collected by sub-national governments. The approach identifies an appropriate tax base and uses the applicable tax rate to arrive at potential revenue that can be derived by a sub-national government from an identified source.

Within the framework of the preceding discussion, using revenue assignments given to sub-national governments, major tax types which constituted 85-90per cent of the sub-national government's total revenue in the past 5 years , i.e. 1998-2002, have been selected. For the purpose of determining the potential revenue that a sub-national government can collect, the following major tax sources have been used:

- ✓ Payroll tax
- ✓ Agricultural income tax
- ✓ Land use fee
- ✓ Livestock tax
- ✓ Business profit tax
- ✓ Turnover tax
- ✓ Value added tax (VAT)

Data for estimating tax bases have been mainly obtained from the Central Statistical Agency (CSA). For some revenue (tax) sources, the applicable tax rate that has been used. These tax/revenue sources and rates are determined by law. The applicable tax rate is the actual tax rate that is currently in use. The use of applicable tax rate reflects the reality better than the representative tax rate which is computed on the basis of the actual revenue collected and the estimated tax base. In some instances, however, where it is found out to be difficult to use the applicable tax rate, a representative tax rate is computed, which is the average tax rate for all sub-national governments.

- **Estimating Fiscal Needs Using RES**

As was done in estimating revenue, important expenditure sectors have been identified to estimate fiscal or expenditure needs of sub-regional governments. These sectors have been determined by taking the most important expenditure categories that account for more than 90percent of the sub-national government's total public expenditure. Since they cover the lion's share of the expenditures of sub-regional governments, they can be considered as 'representative tax categories'. Data provided by the Ministry of Finance and Economic Development and the Office of the Auditor General served as a basis to make this estimation. Accordingly, the following expenditure categories or budget items, which, as was indicated earlier, were found to cover more than 90 percent of the total fiscal needs of all sub-national governments, have been considered in the design of the fiscal decentralization formula:

- General administration;
- Elementary and secondary education (including TVET);
- Public health ;
- Agriculture and rural development
- Environmental protection;
- Drinking water development;
- Rural road construction and maintenance;
- Urban development; and
- Micro and small scale enterprise (MSE) development.

To provide for an accurate assessment of the fiscal needs and revenue potential of sub-national governments, it was found necessary to follow certain working principles that can add to the transparency and integrity of the fiscal transfer system. Some of these are indicated below:

- ✓ Estimation of fiscal needs of sub-national governments must be based on national plans, indicators and policies; e.g. growth targets

- ✓ Fiscal need assessment is done based on the expenditure responsibilities assigned to sub-national governments by law.

- ✓ Expenditure categories to be considered in the fiscal need assessment should at least account for more than 90percent of the total annual budget of the sub-regional government.

- ✓ By the same token, the number of revenue items to be considered in estimating potential revenue should at least account for more than 85percent of the total annual revenue of the sub-national government.

- ✓ The major tax sources used to estimate fiscal capacity are those that have been assigned to sub-national governments by law.

- ✓ The federal/central government transfers should guard against the possibility of sub-regional governments manipulating data to influence future fiscal transfer policies.

- ✓ Estimates of both fiscal need and potential fiscal capacity should not be based on specific policies at the sub-national level.

- ✓ The fiscal potential assessment process should not discourage sub-national government efforts in revenue collection, i.e. it has to be effort-neutral.

- ✓ Data used for assessments should be availed from neutral and independent sources, such as Central Statistical Agency, Ministry of Finance and Economic Development and Office of the Auditor General.

- ✓ Fiscal transfers must uphold the right of every citizen to equal and fair access to publicly funded social services.

3.4. Determining Fiscal Transfers to Sub-national Governments

Once revenue estimates and expenditure needs are assessed, it is necessary to determine the fiscal gap that needs to be made up for by federal/central government transfers. This is determined by subtracting the total fiscal or expenditure needs from the potential revenue that can be collected at the sub-regional level. Simply put, it is determined as follows:

> Fiscal Gap (size of fiscal transfers) = Fiscal/Expenditure Need minus Revenue Potential/Capacity

- **The Allocation Formula**

In Ethiopia, fiscal transfers to sub-national governments are officially made in the form of federal grant subsidies. These subsidies are transferred to sub-national governments on the basis of an allocation formula that has been approved by parliament. The allocation formula has been originally developed by professional experts/consultants and has been implemented after approval by the House of Federation (HoF), which is the upper house of parliament.

As a matter of principle, the process of allocating transfers must insure fair and just distribution of the country’s resources among sub-national governments. Simply put, the aim is to ensure complete equalization and equitable distribution of the national budget among sub-national governments. This affirms the right of every citizen equal access to publicly funded social and economic services.

As in many other systems, the following variables were considered in designing the federal subsidy allocation formula to sub-national governments:

- Population and including pastoral and non-pastoral population, urban and rural population, etc.
- Geography--territorial size, remoteness, weather condition, level of environmental degradation, etc.
- Level of infrastructure and services, such as kms. Of roads, school enrollment, access to modern health services, rate of unemployment, etc.

Regression analysis was used to estimate costs of the different expenditure categories. In addition, other key factors, such as spatial price differences for providing services and infrastructure, fixed costs and variable costs for different expenditure categories, etc. were also considered.

3.5. Special Consideration to Emerging/Marginalized Regions

Within the Ethiopian context, the grant allocation formula has special provision for marginalized regions. At present, there are 4 such regions which receive special consideration in the transfer of federal subsidies to sub-national governments. These are remote from the center and are historically disadvantaged with deficiencies in terms of service provision and the level of socio-economic infrastructure. The aim of the special grant is to address historical inequities and at the same time bring about political and inter-ethnic harmony by diffusing sentiments for separatism. According to the 2008/09 grant formula approved by parliament, 1 per cent of the total grant to regions is set aside for such regions to bring them to a comparable level attained by other relatively well developed sub-national governments.

In brief, the Ethiopian system of fiscal transfers ensures a truly just, fair and equitable distribution of national resources among sub-national governments. This has the advantage of ensuring inclusive and sustainable development and also promoting political harmony. But, the use of sophisticated regression analysis in the design of the allocation formula may somehow make the approach a bit complicated. In addition, the intensive demand for data also reduces its attraction and limits its wide applicability in many countries.

4. **The Kenyan Experience in Fiscal Decentralization**

4.1. Brief Country Profile

Kenya, officially known as the Republic of Kenya, is a state in the Horn of Africa bordering on the Indian Ocean to the south-east, and Ethiopia, South Sudan, Uganda and Tanzania, to the north, north west, west and south respectively. The country covers 581,309 km^2 (224,445 sq. miles) and has a population of about 44 million in July 2012. Because of fast population growth, the country has a high young population with nearly 73percent of the residents below 30 years of age (UNDP, 2013). Compared with other African countries, Kenya has until recently enjoyed relatively high political and social stability[3].

In terms of religion, Kenyans are predominantly Christian (83percent), with 47.7percent belonging to the Protestant faith; 23.5percent are Catholic; and the rest belong to the smaller reformed churches, including Presbyterian Church of East Africa (10percent), Africa Evangelical Presbyterian Church, the Independent Presbyterian Church in Kenya, and the Reformed Church of East Africa. About 621,200 are Orthodox Christians. Notably, the country has the highest number of Quakers in the world, with around 133,000 members. Sizeable minorities of other faiths do exist (Muslims (11.2percent); irreligious (2.4percent); indigenous beliefs (1.7percent) (Population & Housing Census Results, 2009 & 2010).

Like many other African countries, Kenya is a multi-lingual and multi-ethnic nation. The major ethnic groups are: (i) Kikuyu (22percent); (ii) Luhya (14percent); (iii) Luo (13percent) (iv) Kalenjin (12percent); (v) Kamba (11percent); (vi) Kisii (6percent); (vii) Meru (6percent); (viii) Other Africans (15percent); (ix) Non-African, i.e. Arab, Asian, European, etc.(1percent). Nationally, English and Swahili are the official languages. However, English is widely spoken in commerce, schooling and government (Brown, Asher & Simpson, 2006).

Politically, Kenya is a presidential representative democratic republic. The president is head of state and head of government elected for a 5-year term. Executive power is exercised by the government. Legislative power is in the hands of the National Assembly, which is the lower house. The judiciary is credited with being independent of the executive and the legislature. In addition, Kenya is home to a very vibrant and active civil society culture often challenging unpopular public policies and deepening the democratization process.

The economy is the largest by GDP in east and central Africa. Traditionally, the government has followed a liberal market model with little state regulation and involvement in the economy and price controls. Agriculture is an important sector and a major employer absorbing about 75percent of the workforce. The country is a recognized exporter of coffee and tea, and more recently has also become a major exporter of cut flowers. Over the past decades, there has developed a booming service sector boosted by a rapid expansion of tourism, telecommunication and financial activity. In recent years, there has also been a burgeoning of a more efficient and lucrative technology-knowledge-and-skill-based service; and fast-growing industry and manufacturing sectors, which employ only employ 25 percent of the labour force but contributes the remaining 75 percent of the GDP (World Bank, 2013).

Despite the economic success, however, it is still a poor developing country with a Human Development Index (HDI) of 0.519, putting the country at position 145 out of 186 – one of the lowest in the world. About 38 percent of the people live in absolute poverty (UNDP, HDI 2013).

Administratively, Kenya has a highly devolved system of governance and administration. It has a two-tier state structure: National Government and County Governments. There are 47 county governments. Its capital Nairobi is the largest city with well over 3 million residents.

[3] The exceptions being the 2007 and 2013 national elections, which were followed by ethnic-based violence.

The National Assembly, which is popularly elected, is the most sovereign body. The independence of the judiciary is the envy of many countries. Under the national government are the President, the cabinet and the national civil service. The county Government constitutes a county assembly, governor, county executives and county civil services.

4.2. Fiscal Decentralization in Kenya

Kenya is committed to a genuinely decentralized fiscal system for sustainable and inclusive development. To this end, the Commission on Revenue Allocation (CRA) has been established with a core mandate to recommend the basis for insuring equitable and fair distribution of revenues raised nationally between the national government and 47 county governments; and sharing of revenue among county governments. As per the Articles 215 and 216 of the Constitution, the CRA is an independent and impartial body that has been assigned the following important functions:

- Recommend the basis of equitable sharing of revenue raised nationally between national and county governments (Art. 216) (1)(B).
- Recommend the basis of equitable sharing of revenue raised by national government among county governments (Art. 216)(1)(B).
- Recommend on matters concerning the financing of county government (Art. 216)(2).
- Recommend on matters concerning financial management of county government (Art.216) (2).
- Define and enhance revenue sources of national and county governments (Art. 216)(3)©.
- Recommend on appropriating of money out of the equalization fund.

In broad terms, functions and responsibilities between counties and the national government are by law divided. Apart from detailed mandates as provided below, the principal responsibilities of the county assembly are mainly making laws and endorsing economic plans while also serving as an oversight instrument over the county executive. According to Kenyan law, the county executive has been given wide ranging powers and functions—both urban and rural. These cover diverse socio-economic, agricultural, environmental, trade and commerce, etc. activities and functions. The details are provided below.

As per schedule 4 of the Constitution, state functions are divided between the national government and county governments. These serve as the basis for revenue sharing between the national government and county governments, both rural and urban. Accordingly, the following functions are assigned to the National Government:

- ✓ Foreign affairs
- ✓ Immigration
- ✓ National Defence
- ✓ Monetary policy
- ✓ Primary schools, secondary schools and tertiary education and universities
- ✓ National referral health facilities
- ✓ National elections
- ✓ Health policy

- ✓ Agricultural policy
- ✓ Capacity building and technical assistance to the counties
- ✓ Public investment

County governments have been assigned the following important functions:

- ✓ Agriculture
- ✓ County health services
- ✓ Control of pollution
- ✓ Cultural activities
- ✓ County transport
- ✓ Animal control
- ✓ Trade development and regulation
- ✓ County planning and development
- ✓ Pre-primary education
- ✓ Implement specific national government policies
- ✓ County public works
- ✓ Fire fighting services and disaster management
- ✓ Control of drugs and pornography
- ✓ Ensuring and coordination communities participation in governance

4.3. The Basis and Goal of Revenue Sharing in Kenya

Revenue sharing between the national government and county governments and among county governments is done on the basis of the formula approved by the National Assembly. The shared revenue will empower the national and county governments to provide services and infrastructure in a fair and equitable manner to all citizens regardless of where they live. The current formula in use has been approved by the National Assembly on 27th November 2012.

Revenue raised nationally will be shared between National and County governments and among county governments as follows;

Total revenue raised = 100percent

- National Government <84.5 percent
- 47 County Governments >15 percent
- Equalization fund =0.5 percent

The >15percent revenue sharable among the 47 county governments will be shared using the formula approved by parliament.

By a resolution passed on 22nd November 2012, the National Assembly resolved in pursuant of Article 217 of the Constitution, the basis of revenue sharing shall be as follows:

Parameters	Percentage Weights
1. Population	45percent
2. Poverty Index	20percent

3. Land Area 8percent
4. Basic Equal Share 25percent
5. Fiscal Responsibility 2percent

4.4. Revenue Allocation Formula

Based on the parameters, the following is the formula used in allocating revenues to county governments:

$Ca_i = P_i+PV_i+A_i+BS_i + FR_i$
Where:
Ca=Revenue allocated to county
i =1,,2………47.
P_i =Revenue allocated to a county on the basis of population parameter.
PV_i = Revenue allocated to a county on the basis of poverty gap parameter.
A_i= Revenue allocated to a county on the basis of land area.
BS_i= Revenue allocated to a county on the basis of basic equal share parameter.This is shared equally among the 47 counties.
FR_i= Revenue allocated to a given county on the basis of fiscal responsibility. this is shared equally among the 47 counties.

4.5. Special Provision for Marginalized Areas

As is the case in Ethiopia, Kenya too has a special provision for marginalized areas in the national revenue transfer system. According to the 2010 Constitution, Article 216 {4}, the Commission on Revenue Allocation shall determine, publish and regularly review a policy in which it sets out the criteria by which to identify the marginalized areas. According to Article 204 {2}, an Equalisation Fund is established into which shall be paid one half per cent of all the revenue collected by the national government each year calculated on the basis of the most recent audited accounts of revenue received, as approved by the National Assembly. This will be used to provide basic services, including water, roads, health facilities and electricity to marginalised areas to the extent necessary to bring the quality of those services in those areas to the level generally enjoyed by the rest of the nation, so far as possible. For the period 2011/12-2013/14, CRA's criteria for identifying marginalized areas that can benefit from the equalization grant are: widespread poverty and illiteracy; poverty levels above the national average; high poverty levels; food insecurity; water scarcity for human and livestock use; illiteracy levels above the national average; etc.

5..**Conclusion: Summary and Lessons**

The Ethiopian and Kenyan experiences on revenue sharing are based on clear and legal assignment of functions between the national/central government and sub-national governments---county governments in the case of Kenya and regional governments in the
case of Ethiopia. The basic rationale of fiscal transfers is equalization of resources among sub-national governments. These transfers are made on a regular basis so that sub-national

governments can provide access to publicly funded basket of services and infrastructure by all citizens irrespective of the place of residence.

Parliament determines the criteria and amount of revenue allocation between different levels of government. This is often done by a formula that is developed either by an independent body or appointed experts/professionals. In the case of Kenya, it is the Commission on Revenue Collection (CRA), which is assigned this responsibility; while in Ethiopia the task is undertaken by a group of experts commissioned for the work.

Both countries have equalization grants for marginalized areas; and this can be a good lesson for other African countries facing similar challenges. This is key to promote inclusive development and bring about political harmony. The two countries use a set of criteria for designating marginalized areas; and on the basis of those variables design formulas for equalization grants so that a comparable level of services and infrastructure is provided to all citizens. The variables used are fairly common: poverty levels; illiteracy levels; levels of food insecurity; deficiencies in services and infrastructure, etc.

The Ethiopian and Kenyan experiences suggest that quite a significant amount of data is required in designing fiscal transfer formulas. The source of such data is the national government; and this helps to provide integrity and objectivity to the system and avoid sub-national bias as well. The two countries have fairly strong and independent statistical agencies that can generate data for designing fiscal transfer systems. Other African countries aiming to institute fiscal decentralization for inclusive and sustainable development will be well advised to set up strong statistical organizations to design fiscal transfer formulas appropriate to their needs.

The revenue allocation practice in Ethiopia requires quite extensive data and employs rigorous statistical and econometric models that can reduce its simplicity. The Kenyan approach is relatively straightforward and replicable; and the variables selected for national resource sharing are easily identifiable and measurable. The two systems can provide useful comparative lessons. In the final analysis, however, it is suggested that any African country should opt for the alternative that suits its needs and particular circumstances.

The Ethiopian system of fiscal transfers is based on assessment of expenditure needs and potential revenue raising capacity of sub-national governments. The purpose of expenditure need assessment is to address problems of horizontal imbalance among sub-national governments by guaranteeing equalization of resources through a grant system. The amount of revenue that sub-national governments can potentially generate from own sources is estimated through a revenue assessment exercise. The gap between own revenue and expenditure needs is met through central/federal government fiscal transfers to regional governments. As has been indicated earlier, this is done according to a formula approved by parliament.

Kenya is a unitary state but highly devolved whereby counties are assigned a significant set of functions. As per the Constitution, the government has put in place a revenue sharing scheme between the national government and county governments to provide all citizens access to public services and infrastructure. The sharing of revenue is done according to a set of parameters, which serve as a basis for developing a formula for revenue allocation. Recommendations on how to share revenue between the national government and the 47 county governments are provided by the Commission on Revenue Allocation (CRA), which is an independent and impartial body set up by parliament. The fact that the country has such an institution integrity and that is accountable to parliament can be a good lesson which other African states can consider to embrace.

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