LOCAL REVENUE MOBILISATION SERIES

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1

GENERAL PRINCIPLES OF REVENUE ENHANCEMENT

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TABLE OF CONTENTS

EXECUTIVE SUMMARY

Governments, whether national or devolved, exist to provide services to their constituents. To achieve this, they need revenue to properly execute their mandate. This revenue is derived mainly from the equitable share, conditional and unconditional grants, Own Source Revenues (OSR) and borrowing. This handbook looks specifically at OSR (also known as Local Revenues) and outlines the general principles to abide by to maximise them.

In the Kenyan context, the Kenyan Constitution, 2010, ushered in devolved units of governments in the form of counties in addition to the National Government. Though broad frameworks around revenue generation have been set, there are a lot of grey areas in between.

This handbook has been developed by Expertise Global Consulting Limited, an advisory services firm focused on improving public service delivery. Our mission is to improve operations in public finance management for National and Subnational Governments, and the organisations that work for and with them.

Expertise Global Consulting Limited typically (but not exclusively) works with Subnational Governments, National Treasuries/Ministries of Finance, Departments of Devolution or Local Government, Development Partners, Non-Governmental Organisations and the Private Sector.

We undertake entity-specific analysis by working side-by-side with our clients on the ground, identifying the issues and providing context specific recommendations. We also create and disseminate knowledge, based on our own internal research and analyses, that we feel will enhance the ability of our clients and the public to actively engage in the enhanced provision of public services.

EQUATION OF REVENUE ENHANCEMENT

1. A good way for a County Government to think about revenue enhancement is by using a simple equation.

Figure 2.1: The Revenue Equation

BASE X RATE X COVERAGE RATIO X VALUATION RATIO X COLLECTION RATIO = TAX REVENUE

- The base is the item or activity that is subject to taxation according to county policy, and is reflected in county legislation.
- The rate is the percentage paid based on the value of the item or activity. It can also be thought of as the fixed value based on prescribed categories of items or activities. This is determined annually in the budget process.
- The coverage ratio is the proportion of items or activities captured by the county governments out of the total base.
- The valuation ratio is the proportion of the actual value of the base that is captured by the County Government.
- The collection ratio is the proportion of actual revenues collected out of all items or activities billed. (Kelly 1999a 1999b)

Using these factors, one can draw out practical principles that counties can use to evaluate the extent to which OSR can be enhanced.

ECONOMIC PRINCIPLES

Principle 1

Understand the potential of any tax or charge to distort taxpayer behaviour, and minimise unwelcome distortions.

2. Taxes and charges, whether major or minor, can have a disproportionate effect on the behaviour of citizens. For example, introducing a small fee for access to a public library can completely deflate demand, while increasing parking fee charges in urban areas might not make a significant difference. Influencing behaviour, however, can be a desirable outcome. A good example is the use of congestion charges to reduce traffic in high traffic areas.

3. Regulatory charges should focus on the public policy objective. Charges that are focused on achieving a certain policy objective should be priced and administered accordingly. For example, for fire safety inspections, the main objective may be to minimise fire risk. Making the inspections free but random, and charging full cost recovery for attending to fires might then be an appropriate structure to consider.

Principle 2

Clearly link goods and services provided, to the fees and charges needed to finance them.

4. Integrate policy objectives in pricing decisions for public services: The pricing decision needs to weigh equity and efficiency. A service does not have to be priced to recover full cost because cost is only one factor in the pricing decision - a range of non-financial factors come to play such as the ability to pay, overall general benefit to society or encouraging consumption through marginal cost pricing (think of public libraries). Pricing can also help manage scarce resources like the use of a water supply system. Services with mainly private good characteristics should be funded by user fees while those with user and non-user benefit can be financed using tax revenues.

5. User fees and charges can be successfully linked to the services that mimic private good characteristics – for example, water, parking, renting out a county-owned venue. On the other hand, services such as garbage collection, street cleaning, public parks and other public goods should be financed by taxes (Slack 2009). Services sometimes exhibit both private and public good characteristics and do not have clear links. If considered private, the beneficiary should pay a fee or charge; if considered public, it may justify being funded through tax revenues.

Principle 3

Consider equity across economic regions within a county.

6. When harmonising rates of taxes and charges within and out of the areas of former local authorities, be aware that taxpayers in smaller urban and rural centres have less capacity to pay, and probably receive fewer services than those in larger towns. Where possible, provide for exemptions based on hardship - these can be temporary, and granted on application.

Principle 4

Ensure the base remains buoyant (maintains both the coverage ratio and valuation ratio).

7. When the tax base increases, the coverage ratio, and eventually the valuation ratio, should also increase. The Single Business Permit (SBP) can be naturally buoyant if County Governments can ensure that business registries are kept up to date with new businesses and new business categories. Property, on the other hand, is not naturally buoyant because it relies on re-evaluation of property values which, over the years, has proven difficult to undertake without reform.

FISCAL PRINCIPLES

Principle 5

Ensure revenue-producing assets are allocated sufficient maintenance funding.

8. Oftentimes, county assets generate significant profits from their use. However, these revenues are redirected to fund other county priorities, essentially killing the goose that lays the golden egg. Funds generated by a particular asset should at least be partially ring-fenced to ensure that the asset continues to be maintained and improved.

LEGAL PRINCIPLES

Principle 6

Ensure a clear and unambiguous legal authority for collecting any tax or charge.

9. Create specific, detailed county legislation for the specified taxes to enable a clear, well-defined methodology for all processes - from the definition of the base, to collection, to enforcement, to reporting. Many counties are relying on outdated, pre-devolution legislation that does not address context-specific issues at the county level. The Constitution says, in Article 210 (1), that no tax or licensing fee shall be imposed, waived or varied except as provided by legislation. A handbook on model county revenue legislation by the Commission on Revenue Allocation (CRA), the Kenya Law Reform Commission (KLRC) and the Council of County Governors (CoG) provides model laws that can be adapted by the counties to this effect. It is good practice to put the most important information in the laws, and put less important matters, or matters that are likely to change regularly over time, into subsidiary instruments like regulations and rules.

Principle 7

Respect constitutional provisions and national policy.

10. In order for the country to function as a unit, county legislation must be guided by national policy. Article 209 (5) notes:

> *5) The taxation and other revenue-raising powers of a county shall not be exercised in a way that prejudices national economic policies, economic activities across county boundaries or the national mobility of goods, services, capital or labour.*

Principle 8

Link county tax legislation with the county finance law for ease of administration.

11. County tax revenue legislation provides legal authority to impose taxes and sets the initial rate. The finance law sets out the framework for the actual tax payable each year. Any increases to the taxes for a particular year will be set out in the finance act for that year while the county tax revenue legislation remains unchanged (unless substantially amended).

Principle 9

Be clear on the purpose of the classified revenue category.

12. A fee or charge that is charged by a county that exceeds the realistic cost of its provision might be considered a *de facto* tax irrespective of what it is labelled. A charge that has the behaviour of a tax could be considered unconstitutional. This is especially tricky to administer with regard to regulation of ‘bads’. For example, parking fees - Nairobi City County recently doubled parking fees in the Central Business District. Has the parking fee, therefore, become a tax? This can be subject to discussion by Kenyan regulators.

ADMINISTRATION PRINCIPLES

Principle 10

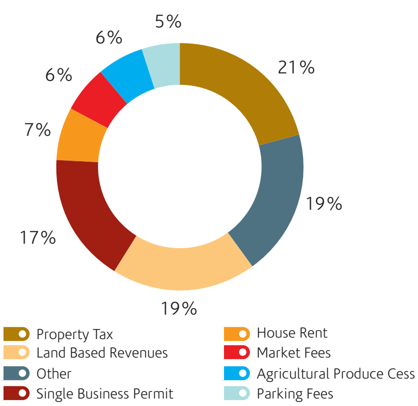
Focus revenue enhancement efforts on the measures that will bring the greatest revenue gains.

13. As illustrated in Figure 2.1 below, different counties earn the most OSR from different revenue categories. County Governments should understand their individual pattern of revenue collection and concentrate their efforts on maximising areas with the most revenue potential. This is done by identifying and estimating the size of the base, and then measuring the coverage, valuation and collection ratios. Applying the cost-benefit principle (see Box 2.1 below) will put collection and reform energy where it will bring the greatest return.

14. The charts below highlights the 5-10 singular source top revenue streams for the county, that as a total amount to 70% or over of the total OSR. All other smaller revenues streams that in total constitute 30% or less of county revenues, have been put into a catchall category, "Other". It is important to note that the "Other" category includes a multitude of revenues that may or may not be generating a net positive revenue stream for the county i.e. some revenues cost more to collect than they generate. They include agricultural training facilities, application fees, building plans, county health facilities, fire section fees, game park fees, hire of county properties, house rent/stall rent, impounding fees and fines, income from county estates, meat inspection and veterinary services, outdoor adverts and signboards, plot rent, refuse collection fees, sale of tender documents, slaughter house fees, solid waste, survey cash bond, toilets fee, transfer and subdivision fees, and water and sewerage amongst a variety of others. An analysis of these revenues will undertaken in another book of the Local Revenue Mobilisation Series.

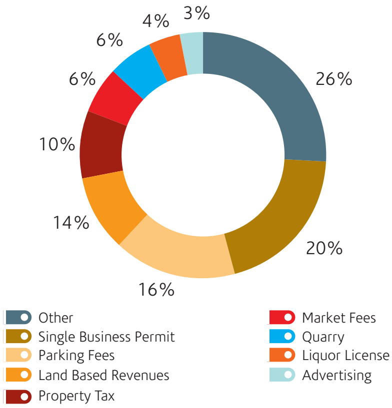
Figure 2.1: Own Source Revenue collections for selected counties

Nakuru County OSR, actual 2014/2015



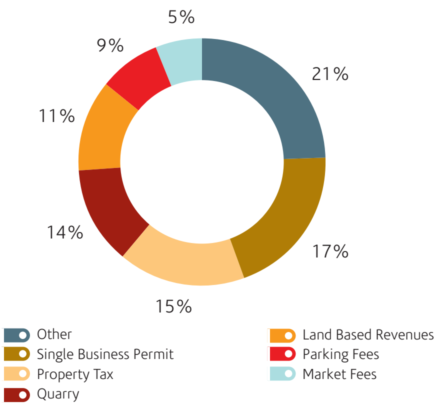
Revenue Source	Amount (KES)
Property Tax	327,139,634.00
Land Based Revenues	304,749,406.00
Single Business Permit	271,556,391.00
House Rent	115,814,409.00
Market Fees	94,028,156.00
Agricultural Produce Cess	90,982,257.00
Parking Fees	77,759,357.00
Other*	291,636,146.00
Total	1,573,665,756.00

Kiambu County OSR, actual 2014/2015



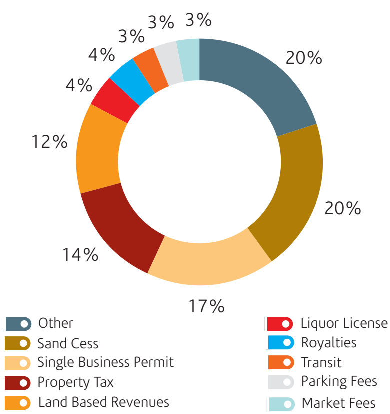
Revenue Source	Amount (KES)
Single Business Permit	295,408,933.00
Parking Fees	239,276,420.00
Property Tax	128,314,012.00
Land Based Revenues	143,025,695.00
Market Fees	93,335,104.00
Quarry	84,286,080.00
Liquor License	55,470,318.00
Advertising	41,121,774.00
Other*	387,718,241.00
Total	1,467,956,577.00

Machakos County OSR, actual 2014/2015



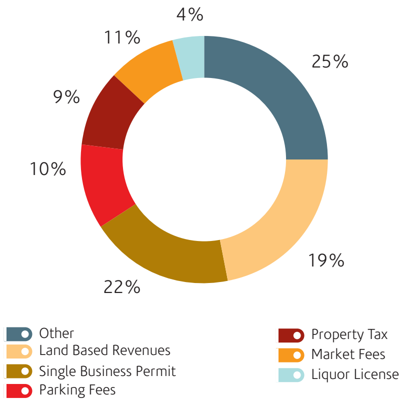
Revenue Source	Amount (KES)
Single Business Permit	198,978,358.00
Property Tax	183,794,859.99
Quarry	160,154,847.50
Land Based Revenues	129,153,300.00
Sand Cess	124,221,208.00
Parking Fees	83,812,307.00
Market Fees	56,724,663.00
Other*	249,761,206.21
Total	1,186,600,749.70

Kajiado County OSR, actual 2014/2015



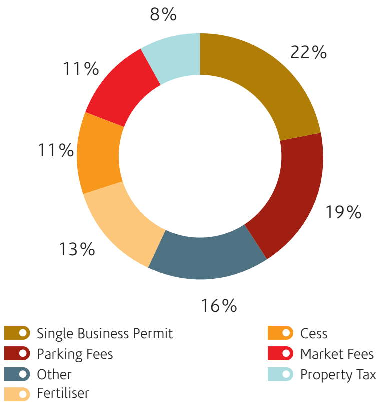
Revenue Source	Amount (KES)
Sand Cess	152,165,185.00
Single Business Permit	133,625,978.00
Property Tax	107,987,727.00
Land Based Revenues	90,043,887.00
Liquor License	31,332,675.00
Royalties	27,988,434.00
Transit	24,563,050.00
Parking Fees	23,857,780.00
Market Fees	21,818,770.00
Other*	151,435,353.00
Total	764,818,839.00

Muranga County OSR, actual 2014/2015



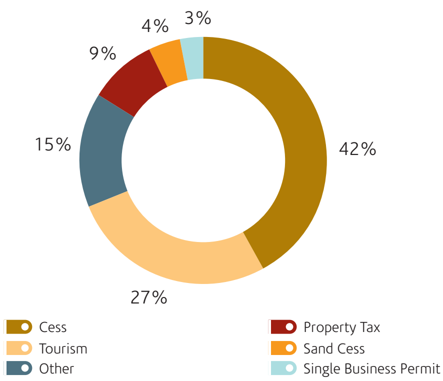
Revenue Source	Amount (KES)
Land Based Revenues	107,811,353.00
Single Business Permit	91,352,399.00
Parking Fees	51,297,375.00
Property Tax	47,657,932.00
Market Fees	44,983,309.00
Liquor License	18,401,900.00
Other*	120,474,576.00
Total	481,978,844.00

Bungoma County OSR, actual 2014/2015



Revenue Source	Amount (KES)
Single Business Permit	68,822,090.00
Parking Fees	58,907,936.00
Fertiliser	40,444,000.00
Cess	34,677,127.00
Market Fees	33,246,465.00
Property Rates	24,542,595.00
Other*	48,046,069.00
Total	308,686,282.00

Isiolo County OSR, actual 2014/2015



Revenue Source	Amount (KES)
Cess	87,634,030.00
Tourism	56,804,052.00
Property Tax	19,740,491.00
Sand Cess	7,466,630.00
Single Business Permit	5,636,920.00
Other*	32,467,905.00
Total	209,750,028.00

*Other: Agricultural training facilities, application fees, building plans, county health facilities, fire section fees, game park fees, hire of county properties, house rent/stall rent, impounding fees and fines, income from county estates, meat inspection and veterinary services, outdoor adverts and signboards, plot rent, refuse collection fees, sale of tender documents, slaughter house fees, solid waste, survey cash bond, toilets fee, transfer and subdivision fees, and water and sewerage are amongst a variety of other small revenue streams. Other has been omitted in the chart because it is a combined category of various revenues as indicated above, and therefore, would be misleading and distortionary as a single revenue stream.

Summary of OSR collections for selected counties, 2014/2015

	Kajiado	Kiambu	Machakos	Muranga	Isiolo	Bungoma	Nakuru
Advertising	-	41,121,774.00	-	-	-	-	-
Agricultural Produce Cess	-	-	-	-	-	-	90,982,257.00
Cess	-	-	-	-	87,634,030.00	34,677,127.00	-
Fertiliser	-	-	-	-	-	40,444,000.00	-
House Rent	-	-	-	-	-	-	115,814,409.00
Land Based Revenues	90,043,887.00	143,025,695.00	129,153,300.00	107,811,353.00	-	-	304,749,406.00
Liquor License	31,332,675.00	55,470,318.00	-	18,401,900.00	-	-	-
Market Fees	21,818,770.00	93,335,104.00	56,724,663.00	44,983,309.00	-	33,246,465.00	94,028,156.00
Parking Fees	23,857,780.00	239,276,420.00	83,812,307.00	51,297,375.00	-	58,907,936.00	77,759,357.00
Property Tax	107,987,727.00	128,314,012.00	183,794,859.99	47,657,932.00	19,740,491.00	24,542,595.00	327,139,634.00
Quarry	-	84,286,080.00	160,154,847.50	-	-	-	-
Royalties	27,988,434.00	-	-	-	-	-	-
Sand Cess	152,165,185.00	-	124,221,208.00	-	7,466,630.00	-	-
SBP	133,625,978.00	295,408,933.00	198,978,358.00	91,352,399.00	5,636,920.00	68,822,090.00	271,556,391.00
Tourism	-	-	-	-	56,804,052.00	-	-
Transit	24,563,050.00	-	-	-	-	-	-
Other	151,435,353.00	387,718,241.00	249,761,206.21	120,474,576.00	32,467,905.00	48,046,069.00	291,636,146.00
Total	**764,818,839.00**	**1,467,956,577.00**	**1,186,600,749.70**	**481,978,844.00**	**209,750,028.00**	**308,686,282.00**	**1,573,665,756.00**

15. Urban and semi-urban counties like Kiambu and Nakuru collect a significant amount of OSR from property tax and SBP. A rural county like Bungoma also collects most of its OSR from SBP fees generated in Bungoma Town, a highly concentrated commercial area by the Uganda-Kenya border, but it also benefits greatly from its rural economy where fertiliser is used for farming.

16. Rural counties like Isiolo and Kajiado collect most of their OSR from cess. Most cess is agricultural, sand or quarry and is harvested to support the large construction boom in the neighbouring urban counties and in fledgling urban areas within the counties themselves. Markets also feature prominently in the top revenue streams stemming from small scale farming operations.

17. With big game parks and conservancies, Isiolo also makes a large proportion of its OSR from tourism activities. The case is similar in Narok[1], which makes almost all its revenues from game park fees, and almost none from property tax and single business permits. The problem with reliance on revenue from tourism activities is that they are highly volatile. Travel advisories due to insecurity in the region is a prime example that has caused a huge downtrend in revenues from tourism, and has hurt service delivery in these counties.

Principle 11

Assess the cost of collection before introducing new charges.

18. Avoid what is known as ‘rats and mice’ charges – charges that generate insignificant revenues and may also cost more to collect. The benefits of regulating the activity must outweigh the costs. Note that the cost also includes the opportunity cost of deploying staff and resources to collect revenues, and the time spent on these activities as opposed to others. By the same token, the social benefit of engaging in revenue collection against a particular revenue stream should also be taken into account.

[1] Figures not shown here

Cost Benefit Analysis (CBA) is normally undertaken as one aspect of a more comprehensive assessment of appropriateness, efficiency and effectiveness.

A CBA is primarily designed to answer the question 'does the expenditure of public money on the collection of this particular tax provide a net benefit to the county economy and the public, bearing in mind that these resources could be applied in an alternative use?'

In principle, CBAs enable governments to compare the relative merit of different (or alternative) taxes and charges in terms of their returns on the use of public resources.

In practice, it is often difficult to provide a clear ranking of alternative demands on public funds. Another important stumbling block is that the assessment depends on what would have happened without the project or programme, which has to be forecast. What is foregone when we undertake a project is known as the 'opportunity cost'.

Source: Introduction to Cost-Benefit Analysis and Alternative Evaluation Methodologies – Commonwealth of Australia

Principle 12

Minimise the transaction cost of collecting revenue.

19. The use of annual or monthly billing services for fees and charges can save costs for both the County Government and the citizen. This can include user accounts for payments like market fees, parking fees and game park permits, instead of collecting on individual use. Use of Information and Communication Technology (IT) can also save costs. Typically, advance payments are incentivised by discounted rates. Costs can also be saved on:

(i) property valuation for taxation by using mass valuation methods that maximise on computer technology;
(ii) business registration, by automating payments and follow-up enforcement where possible;
(iii) tax, license payments and charges being harmonised where appropriate across the areas of former local authorities within the county.

Principle 13

Integrate processes and information systems that underpin revenue collection.

20. Tax collection systems should not be separate from other revenue collection systems in the county. Ensure that any systems created or purchased work seamlessly together. This minimises disruption and improves reporting and forecasting. IT systems enable governments to be faster, more efficient, more accurate and to harmonise processes. Moreover, information can be made available across departments to ensure actions are harmonised. Policy/legislative processes can be streamlined through IT – for example, if a bill is overdue, a system will provide notification to the County Governments, and with the use of mobile technology, to the taxpayer. Payments by phone can also be integrated to reduce transaction costs.

SOCIAL ACCOUNTABILITY PRINCIPLES

Principle 14

Respect the social contract - taxpayer motivation is crucial for maximising the collection ratios and the coverage ratio.

21. Many counties underestimate the need for a communications and public relations function. When constituents are involved in the decision-making process of imposing taxes and setting fee rates, there is less resistance to paying them. Communications should not be one-off or only brought in from time to time. The Communications Department should be able to fully understand the context of tax strategy and be embedded in the process so that they can generate effective and realistic materials that have a higher probability of effectiveness. This will improve the collection ratio in the short term and the coverage ratio in the medium to long term.

Principle 15

Engage citizens on decisions on adjustments in taxes or charges.

22. Any adjustments should be negotiated with taxpayers to ensure that they understand the changes and to maintain or increase the collection ratio. In addition, citizens can provide valuable information on how best to administer collection including phasing them in gradually.

23. County officials in the executive and assembly must themselves understand the taxes and rates in place for full buy-in and support. This calls for adequate communication, dialogue and consensus building on any proposed tax or rate, between the county executive and county assembly. In the recent past many counties have seen county assemblies reject taxes and rates proposed by county executives citing lack of consultation. Citizen participation, civic awareness and adequate service delivery can all raise public support or toleration of taxes. This bolsters the willingness of elected leaders to continue supporting the taxes or rates.

24. The fight against corruption in county revenue collection should also be part of wider anti-corruption efforts in the county. If the culture in a county is generally permissive and tolerant of corruption then this is likely to be found in all departments including those charged with revenue collection. At a minimum, a county should have in place, (i) a code of conduct in line with the provisions of Chapter 6 of the Constitution on leadership and integrity, (ii) mechanisms to encourage and protect whistle-blowers, (iii) robust internal controls e.g. separate people to receive, record, reconcile payments; and, (iv) sufficient incentives and sanctions to discourage corruption.

Principle 16

Formalise a monitoring and evaluation framework to track revenue performance.

25. Counties should encourage performance based management, both of revenue collecting departments as well as of staff. The top county management should clearly communicate revenue objectives and missions, share these with staff and constantly review them until this becomes the county culture. Recruitment of staff involved in revenue collection needs to be merit based and promotion based on performance.

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