Financing Sustainable Urban Development

CASE STUDY 1

Enhancing the financial position of cities: evidence from Kisumu County Government
Supporting the urban dimension of development cooperation: *Enhancing the financial positions of cities in developing countries to achieve sustainable urban development*

This initiative has been requested by the European Parliament. It is implemented by European Commission and UN-Habitat, supported by the International Growth Centre. These partners are working to identify relevant measures to help mobilise financing for urban development at all levels of government. The work has been undertaken through case studies conducted in Dakar (Senegal), Hargeisa (Somaliland, Somalia), Kampala (Uganda), Kisumu (Kenya), Mzuzu (Malawi), meetings with experts and practitioners, and empirical literature. The initiative works with an Advisory Group, chaired by Professor Sir Paul Collier from the University of Oxford, and consisting of representatives from the European Investment Bank, African Development Bank, UN Capital Development Fund, UN Economic Commission for Africa, and United Cities and Local Governments.
Enhancing the financial position of cities: evidence from Kisumu County Government

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Acknowledgements

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The content is based on both interviews and online research conducted between April 2019 and July 2020. For their contributions, we would like to thank the representatives and departments of the Kisumu County Government, the World Bank, the Ministry of Transport, Infrastructure, Housing, Urban Development and Public Works, Strathmore University, Collection Africa Limited, and UNCDF.
Summary

The Kisumu County Government (KCG) provides an interesting case study of the common pitfalls of Municipal Finance reforms. Over the past few years, the KCG undertook reforms, which on paper looked promising. It digitalised its tax collection processes, carried out capacity building initiatives, updated its valuation roll, outsourced property tax arrears collection, and acquired its first credit rating. However, the clear benefits of these seemingly promising initiatives are yet to materialise. Own-source revenue (OSR) per capita, access to credit and private investment in infrastructure have remained low. The KCG’s tax base has not changed, the efficiency of its collection and compliance mechanisms leave room for improvement, its property arrears remain high, and its revenue strategy continues to be focused on regressive/low-potential revenue streams. Yet, it is the very challenges of the KCG in successfully bringing reform to fruition, which offer important lessons on why promising technical Municipal Finance interventions often do not achieve the desired outcomes.

In implementing these reforms, the KCG faced a host of challenges from technical implementation problems, to capacity bottlenecks and budget constraints. One particularly complex challenge appeared to be vested interest in the status-quo of the OSR system of various stakeholders, including landowning elites and tax collection personnel. These interest groups were firmly entrenched, benefiting from tax collection loopholes, porous public financial management (PFM) processes and weak overall rule of law. Overcoming these interest groups required considerable political capital and political will.

Addressing Municipal Finance issues in Kisumu and other similar contexts thus requires placing greater emphasis on political realities and incentive mechanisms when designing reform initiatives. The more defective a Municipal Finance system appears to be, the greater the rents it allocates in unintended ways and the more resistant to change it may become. Overcoming such flawed but stable equilibria requires more than isolated technical tweaks.

Key messages:

- Building the capacity of local officials and providing technical support may be futile where there is insufficient political capital to sustain reforms.

- There is a need for more transparency in accounting and budgeting systems to reveal and increase the stakes of malpractice.

- The international community as well as national governments need to think more carefully about how their interaction with local governments as well as existing regulation incentivises Municipal Finance reform. This includes:

  ➔ Conditioning larger shares of national transfer on compliance with national financial regulation in contexts of sub-optimal usage of existing OSR authority.

  ➔ Conditioning access to capital markets, donor grants and Public Private Partnerships (PPPs) on compliance and progress in regard to key OSR indicators.
Urbanisation trends, challenges and financial needs

Over the past decade, Kenya has been touted as one of Africa’s potential success stories. Significant political and economic reforms have led to steady economic growth of around 5.6 per cent since the global recession in 2008. A relatively stable political and macroeconomic environment and an investor-friendly climate have turned the country into one of the largest recipients of FDI in Africa and supported the emergence of Nairobi as one of Africa’s start-up hubs. Kenya has also made progress in regard to key HDIs, including life expectancy, years of schooling, and access to health care. Despite this progress, at a GDP per capita of around US$2,000, it remains a low-income and largely agrarian country with 73 per cent of the population living in rural areas. Fully leveraging its potential will require Kenya to address poverty, growing inequality, low private sector productivity and public sector inefficiency, among other things. This will require optimising the devolved system of governance.

Since the new 2010 Constitution, Kenya has been governed by a decentralised system of 47 county governments. At an average population of over a million, these are over six times the average size of other local governments on the continent. One of the economically most significant of these units is Kisumu, located in the far west of the country on the banks of Lake Victoria, home to 1.2 million inhabitants and Kenya’s third largest city – Kisumu City. Kisumu is also one of the most urbanised Kenyan counties with around 50 per cent of the population living in urban areas. Its favourable ecological and climatic conditions contribute to the production of cotton, sugarcane, rice, and horticulture. Its lakeside location and international airport also have the potential to make Kisumu a tourism and trading hotspot.

Despite these favourable overall conditions, Kisumu faces several significant challenges on its path to greater socio-economic development. Its economic growth has slowed down over the past few years to around 3.4 per cent, placing it well below the national average of almost 6 per cent. Rapid population growth and urbanisation have created large informal settlements, which house nearly 40 per cent of the urban population. These informal settlements provide inadequate housing conditions and lack access to basic services, including basic sanitation, waste management, and security. Access to basic services is also an issue in the more rural areas of the county. Only around 58 per cent of the county has access to water and 46 per cent to electricity. With only 15 per cent paved roads, Kisumu also requires significant investment in infrastructure to decrease transportation costs of agricultural produce and attract private investment in the county’s underutilised rural areas. Investment is also needed in education, vocational training and the creation of job opportunities for its young and rapidly growing workforce (around 40 per cent of the population is between the ages of 15-35). Of this young population, 60 per cent are formally unemployed, surviving on low informal sector jobs that by now employ 60 per cent of the total workforce.

Overcoming these challenges requires significant public and private investments. Yet, up until now, the KCG’s revenues are not sufficient to cover its significant developmental needs. With a total budget of US$72 million in FY18/19, the KCG could spend US$60 per person, of which less than US$20 per person was available for developmental expenditures. To overcome the overall revenue shortfall, the KCG will need to increase its own revenues and build financial management capacity to attract grants/loans and enable private investment.
Municipal finance and urban governance structure

Urban governance structure and mandate

Following the post-election violence in 2007/8, Kenya embarked on a process of reconciliation, culminating in a unity government and an unambiguous vote for a new constitution on the 4 August, 2010. The new constitution envisioned far-reaching changes and more fair, efficient and accountable governance. An essential part of these changes was the creation of 47 new county governments, which were to replace the fragmented nature of the previous 175 Local Authorities and over 280 district administrations. The reform thus sought to streamline local service delivery and facilitate the accountability of local government to its citizens with clearly delineated and simplified functional responsibilities. In addition to merging existing subnational structures, it also sought to expand the functional responsibilities of the new county governments and concurrently reform national institutions to align them with the new service delivery framework. The devolution process in Kenya was labelled as one of the most ambitious in the world. Consequentially, seven years after the official start of the implementation of devolution in March 2013, the promises of that process are yet to fully materialise.

One area of devolution that still requires fine-tuning is the functional mandate of the counties. Kisumu and the other counties have been given responsibilities in 14 general government areas, the main devolved sectors being public health, agriculture and livestock. With the exception of education, for which only early childhood development was devolved, Kenya followed international best practices with regard to the intergovernmental division of responsibilities. It assigned policy, standard setting, and public good provision (for example national security) to the national level, while devolving service delivery to the county governments. While there has been a lot of discussion around the areas of functional overlap and previously unassigned functions, the real challenge lies not with the theoretical allocation of roles but with the implementation of responsibilities at the county level. The transition to county governments has been marred by inconsistency, management issues and lack of coordination between the two levels of government. As a result, public health has increasingly become a candidate for recentralisation.

An unforeseen challenge of the new devolved system is managing the intensity of political competition among elected officials, which can distract counties from carrying out their mandates. KCG, as the other 46 county governments, is run by a County Governor and an Executive Committee or cabinet, nominated by the governor. Governors are elected democratically by simple majority voting at the time of national presidential elections and take the lead in budget and development planning. Although the decisions of the executive are vetted and approved by the local legislative arm, the County Assembly, the executive has priority access to the distribution of county resources, and thus, control over patronage networks. This position of power is contested by the County Senator, sitting in the Upper House of National Parliament, debating and approving National Bills concerning counties, but equipped with little own source of patronage. Rather than supporting county governments at the national level, the structure has lent itself to competition and in-fighting, undermining governance and detracting efforts from developmental agendas.

A third important dimension of the devolved governance structure, which is yet to be fully fine-tuned, is the management of urban areas. Given the importance of urban agglomerations for economic development, there is concern that in a largely rural country, urban areas will be under-resourced. The 2010 constitution, in a sense, recentralised urban management, from the smaller local authorities to the county governments, which are vested with full control over urban functions and resources. Whilst the constitution does state that "every county government shall decentralise its functions and the provision of its services to the extent that it is efficient and practicable to do so", for some time, there was no clear process or framework for such delegation. The 2019 Urban Areas and Cities (Amendment) Act partially filled this void by outlining a process for putting in place urban boards appointed by county governments with responsibilities for urban management as delegated by the counties.

Kisumu City was thus created within the KCG under the leadership of the City Manager who is answerable to the City Board, which reports directly to the gov-
The City of Kisumu covers 14 of the 35 wards of the county and is provided with partial own revenue authority as well as own funds based on ‘objective criteria’ (for example, population, poverty, physical area) as defined by the KCG. In a sense, Kisumu City is like a department of the KCG, with the difference that it is managed by a board that must approve budget requests before they go to the County Treasury. While in theory, the creation of this separate entity makes sense for urban management, in many cases, it has led to the fragmentation of administrative processes between the county and the city.

Municipal finance overview

The revenue of the KCG has grown by around 77 per cent since the start of devolution to a total of US$96 million in FY18/19. While this appears to be a relatively significant increase in revenue, it is almost entirely due to increases in national transfers (See Figure 1). As a result, Kisumu by FY18/19 was 78 per cent reliant on national transfers. Own-source revenue (OSR) of Kisumu slightly increased in the first year of devolution but has stagnated since. The National Treasury initially estimated that Kisumu and the other counties would be able to cover around 50 per cent of their budgetary needs via OSR. Since this has not been achieved (for reasons outlined in this report), Kisumu has come under increasing budgetary pressure. Consequently, it retains only approximately US$20 per capita for development expenditure, and is thus struggling to fulfil its ambitious development agenda outlined in its County Integrated Development Plan 2018-2022.

A large portion of what Kisumu receives from central government transfers comes from the ‘Equitable Fund’, which gets filled every year by a minimum of 15 per cent of the national tax revenue. The ‘Equitable Fund’ then allocates each county government with an ‘Equitable Share’ based on a formula that includes population, poverty, land area, fiscal/OSR performance, and development. Since national tax revenue has been growing year on year, with healthy GDP growth rates, transfers have too.

This growth in transfers was also a result of the politics around devolution, which prompted the national government to allocate well above the mandated 15 per cent of national revenue to the counties. From FY14/15 to 19/20, it averaged 20.8 per cent.

While central funding is necessary to meet developmental needs, Kisumu’s considerable dependence on governmental transfers can undermine the accountability of local governance and effective, citizen-focused spending. The dependence is also likely to pose a challenge in the near future since the national government is under increasing pressure to implement fiscal austerity. Kenya’s debt has more than tripled since 2013, reaching 59.9 per cent of GDP in 2019 and a debt-servicing-to-revenue ratio of 50 per cent. While the exact effects of the recent COVID-19 pandemic are still unclear, it is likely to move the country towards an even more curtailed fiscal space. In fact, The National Treasury has already frozen the county government revenue allocation from the Equitable Fund for 2020/21.

The second, significantly smaller part of the national transfers, constituting 8.2 per cent of total national transfers in FY18/19, is made up of conditional grants. The purpose of these grants is

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**Figure 1: KCG revenue from 2013-2019**

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Own Source Revenue (OSR)</th>
<th>National Conditional Grants</th>
<th>Official Development Assistance</th>
<th>National Equitable Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 13/14</td>
<td>$40</td>
<td>$60</td>
<td>$20</td>
<td>$20</td>
</tr>
<tr>
<td>FY 14/15</td>
<td>$50</td>
<td>$60</td>
<td>$20</td>
<td>$20</td>
</tr>
<tr>
<td>FY 15/16</td>
<td>$60</td>
<td>$60</td>
<td>$20</td>
<td>$20</td>
</tr>
<tr>
<td>FY 16/17</td>
<td>$70</td>
<td>$60</td>
<td>$20</td>
<td>$20</td>
</tr>
<tr>
<td>FY 17/18</td>
<td>$80</td>
<td>$60</td>
<td>$20</td>
<td>$20</td>
</tr>
<tr>
<td>FY 18/19</td>
<td>$90</td>
<td>$60</td>
<td>$20</td>
<td>$20</td>
</tr>
</tbody>
</table>

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i Budget figures were converted from KSh using the exchange rate from July of each year and drawn from yearly budget documents. Since the CBROP was not available for every year, for some years earlier budget versions are used that may not include all supplementary budget modifications.

ii For more detail on this see Commission on Revenue Allocation (2017) Recommendation On The Basis For Equitable Sharing Of Revenue Between National And County Governments For The Financial Year 2018/2019, Commission on Revenue Allocation

iii National tax revenue as a % of GDP has decreased from 18% in FY 2013/14 to 14% in FY 2018/19. This decrease is more than compensated for by the annual growth in GDP. See Commission on Revenue Allocation (2019) Recommendation On The Basis For Equitable Sharing Of Revenue Between National And County Governments For The Financial Year 2018/2019, Commission on Revenue Allocation
to compensate counties for services that they provide beyond the standard devolved functions. Kisumu receives conditional grants for health-related services, the development of youth polytechnics and the maintenance of national roads.

**Own-source revenue** (OSR) in Kisumu since devolution has not managed to reach government targets and expectations as most other Kenyan counties have. After collecting a fraction of the targeted amount in the first year of devolution (initially defined by the National Ministry of Finance), the county adjusted its methodology of estimating OSR targets, decreasing the gap between targeted and actual amounts (See Figure 2). Nonetheless, the actual performance has remained stable at a low annual OSR of around US$10 million, or US$9 per capita, despite rapid population and economic growth. OSR in FY19/20 actually dropped to US$7.4 million primarily due to a drop in revenue in Q4 following the onset of the global COVID-19 pandemic (See Figure 3). Irrespective of the latest drop in revenue, estimates of Adam Smith International/World Bank, the Ministry of Finance and UN-Habitat, suggest that the KCG has generally leveraged only 15 per cent of its potential OSR (See Figure 4).

Of its existing revenue streams, the single largest source for the county is user fees from hospitals. These are administered by hospitals directly as well as the local Public Health Department. All other major revenue streams (outlined in Figure 5) fall under the control of the Revenue Department and typically constitute around 60-70 per cent of annual OSR. The most important of these streams and second most important stream overall for the KCG is trade licenses, also referred to as Single Business Permits (SBP).
The third most important source of OSR are land rates (property taxes) at 12.7 per cent of total OSR. This is a relatively low percentage. Property taxes are commonly the most significant revenue stream of local governments, representing 2 per cent of GDP in OECD countries and between 0.3 per cent and 0.7 per cent of GDP in developing countries. In Kisumu, they make up only 0.0004 per cent of the Kisumu County Domestic Product. In total, the county has 30 separate revenue categories, of which 18 generate less than 1 per cent of total OSR, subsumed in Figure 5 under “Other Revenues”.

A third source of financing in Kisumu that has gained importance over the years is Official Development Assistance (ODA). This ODA comes in the form of primarily conditional grants from the World Bank, the Danish International Development Agency (DANIDA), and the EU, that are largely tied to facilitating institutional reform (e.g. devolution, health system reform) or specific projects such as climate-smart agriculture. The most important of these is the Kenya Urban Support Program (KUSP) of the World Bank, providing around $7 million in FY2018/19 or the equivalent of around 70 per cent of the KCG’s total OSR.

In terms of expenditure, total budgeted county expenditure has stagnated somewhat since devolution at around US$90-100 million or around US$83 per capita. Figure 6 provides the exact budget figures in US$. It should be noted that due to a slight depreciation in the Kenyan Shilling (KSh) in the past few years, one would observe slightly stronger revenue growth in KSh terms.

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### Figure 5: KCG breakdown of OSR in FY18/19 by revenue stream

<table>
<thead>
<tr>
<th>Revenue Stream</th>
<th>Annual Revenue (US$)</th>
<th>% of Total Annual Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health</td>
<td>1,762,350</td>
<td>17.5%</td>
</tr>
<tr>
<td>Trade license fees</td>
<td>1,702,144</td>
<td>16.9%</td>
</tr>
<tr>
<td>Land Rates (Property Tax)</td>
<td>1,282,888</td>
<td>12.7%</td>
</tr>
<tr>
<td>Paybillvii</td>
<td>1,229,662</td>
<td>12.2%</td>
</tr>
<tr>
<td>Bus park</td>
<td>895,504</td>
<td>8.9%</td>
</tr>
<tr>
<td>Sign board promotion etc.</td>
<td>779,191</td>
<td>7.7%</td>
</tr>
<tr>
<td>Market Fees</td>
<td>600,419</td>
<td>6.0%</td>
</tr>
<tr>
<td>Parking Fees</td>
<td>418,252</td>
<td>4.2%</td>
</tr>
<tr>
<td>Monthly Stickers</td>
<td>286,882</td>
<td>2.8%</td>
</tr>
<tr>
<td>Liquor licence</td>
<td>203,279</td>
<td>2.0%</td>
</tr>
<tr>
<td>Rents</td>
<td>172,768</td>
<td>1.7%</td>
</tr>
<tr>
<td>Building Plans (Building Permits)</td>
<td>161,995</td>
<td>1.6%</td>
</tr>
<tr>
<td>Other Revenues</td>
<td>580,450</td>
<td>5.7%</td>
</tr>
</tbody>
</table>

vii Paybill is a generic account that is used by the Revenue Department for all kinds of revenues that are received without being clearly linked to a specific revenue stream. This has happened due to mistakes with receipting and a failure of the IT system which removed existing receipts making it difficult to accurately account for existing payments.

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### Figure 6: KCG current vs capital expenditure from 2013 to 2019 (in US$millions)viii

<table>
<thead>
<tr>
<th>FY 13/14</th>
<th>FY 14/15</th>
<th>FY 15/16</th>
<th>FY 16/17</th>
<th>FY 17/18</th>
<th>FY 18/19</th>
</tr>
</thead>
<tbody>
<tr>
<td>$29</td>
<td>$32</td>
<td>$26</td>
<td>$28</td>
<td>$30</td>
<td>$36</td>
</tr>
<tr>
<td>$38</td>
<td>$32</td>
<td>$26</td>
<td>$28</td>
<td>$25</td>
<td>$30</td>
</tr>
<tr>
<td>$28</td>
<td>$32</td>
<td>$26</td>
<td>$32</td>
<td>$36</td>
<td>$39</td>
</tr>
<tr>
<td>$27</td>
<td>$30</td>
<td>$33</td>
<td>$36</td>
<td>$39</td>
<td>$46</td>
</tr>
</tbody>
</table>

viii Here we combine Use of Goods and Services, “Current transfers and Grants”, “Transfers to other Government Units” and “Security Benefits” under Operations and Maintenance. Where possible these figures were taken from the County Budget Review and Outlook Paper of the respective years. For some years these documents were not accessible so other budgetary documents were taken that may not include all budget revisions. The figures are converted to US$ amounts using exchange rates from the July of the respective year.

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vi Kisumu’s share of Kenya’s national GDP of US$78.76 billion (2017) is 2.9%, thus Kisumu has a GCP of US$2.28 billion with land rate collections of only US$1 million per year = 0.0004% of GCP

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A minimum of 30 per cent of this total expenditure was budgeted year on year for capital or development expenditure, as per the Public Financial Management Act of 2012. Similarly, planned expenditure in Kisumu also did not surpass expected revenues, and allocated less than 35 per cent of the overall budget to personal emoluments.

On the whole, expenditure in Kisumu is not fully in line with prudent Public Financial Management (PFM) principles. Budget execution levels reveal that actual expenditure tends to be below budgeted expenditure, with an average absorption rate (share of actual expenditure out of budgeted expenditure) of 70 per cent. Par-
particularly challenging in this respect is development expenditure, where there is an average absorption rate of 40 per cent, compared with 76 per cent for operational expenditures and 97 per cent for personal emoluments (see Figure 7). The county government attributes the low absorption rates to overly ambitious budgeting processes, late disbursement of national transfers and lengthy procurement procedures. As a consequence, the county spends more than it should on wages/personal emoluments (repeatedly exceeding the 35 per cent wage threshold) while spending too little on development. The Control of Audit reveals that in FY16/17 and FY17/18, allowances made up 66 per cent and 55 per cent of the wage bill respectively – exceeding the cost of the basic salary. This has also contributed to a high unit cost of labour in Kisumu as well as in other counties, surpassing that of national-level agencies.

In terms of spending by department, KCG’s budget reveals that the majority of available resources are allocated towards the health department (see Figure 8). The City of Kisumu, which essentially functions as an additional department of the government tasked with providing services to the county’s urban population, received 10 per cent of the total budget in FY18/19. 15 per cent of the budget also went towards the county legislative and executive branches. Meanwhile, the revenue department, the budget of which is officially a part of the overall finance budget, received around 2 per cent of the overall budget – or US$2.1 million. Given that it collected around 65 per

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**Figure 7: KCG budget execution, planned vs actual expenditure from 2013 to 2019**

<table>
<thead>
<tr>
<th></th>
<th>Planned</th>
<th>Actual FY 13/14</th>
<th>Planned FY 14/15</th>
<th>Actual FY 15/16</th>
<th>Planned FY 16/17</th>
<th>Actual FY 17/18</th>
<th>Planned FY 18/19</th>
<th>Actual FY 18/19</th>
</tr>
</thead>
<tbody>
<tr>
<td>Millions</td>
<td>$120</td>
<td>$80</td>
<td>$60</td>
<td>$40</td>
<td>$20</td>
<td>$10</td>
<td>$30</td>
<td>$20</td>
</tr>
</tbody>
</table>

**Figure 8: KCG expenditure breakdown by department for FY 2018/19 (in US$millions)**

- Health Services: $33.3M (34%)
- Roads, Transport and Public Works: $7.8M (8%)
- Office of the Governor and County Administration: $6.4M (7%)
- Economic Planning: $1.4M (2%)
- The County Assembly of Kisumu: $7.3M (8%)
- Business, Energy and Industry: $5.1M (5%)
- Revenue Department: $2.4M (3%)
- City of Kisumu: $9.6M (10%)
- Education, Gender, Youth, Human Resource Development, ICT and Social Services: $5.1M (6%)

**Figure 9: KCG recurrent expenditure comparison with OSR**

- FY 13/14 Development: $9M
- FY 14/15 Operational maintenance: $17M
- FY 15/16 Personnel Emoluments: $11M
- FY 16/17 OSR: $12M
- FY 17/18 Development: $24M
- FY 18/19 Operational maintenance: $16M

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ix Figures are derived from County budgets converted to US$ based on currency exchange rates of July of each financial year.

x Budget figures were converted from KSh using the exchange rate from July of each year and drawn from yearly budget documents. Since the CBROP was not available for every year, for some years earlier budget versions are used that may not include all supplementary budget modifications.
cent of total OSR for that year (US$6.4 million), over a third of the revenue generated by the department was spent on collecting that revenue.

The consequence of KCG’s spending patterns is an underinvestment in development, as well as a significant reliance on national transfers to cover current expenditure. While OSR could ideally cover all of the KCG’s current expenditures, it currently only covers an average of 15 per cent (Figure 9). This exposes the county to financial risk in the event of a stagnation in future national transfers. Going forward, the KCG will either have to use its available resources more effectively, or significantly increase its OSR, with the latter holding more potential to increase government accountability.

Indeed, when local governments increase reliance on OSR they are commonly forced to strengthen the reciprocal arrangements with their citizens and provide improved services and/or representation in exchange for tax contributions. A study of local budgets in several East African countries found that as the share of local budgets financed from local revenues increased, the share of expenditures on service delivery did as well. In contrast, greater dependence on intergovernmental transfers and development aid was found to be associated with a higher budget share for administrative costs and employee benefits. Thus, increasing OSR can be critically important for the KCG. In the following sections, we examine the steps it has taken to enhance its OSR.

xi The remaining OSR is collected by departments directly. For example, the Kisumu Health Department collects user fees from hospitals.
Reforms undertaken to enhance the city’s financial position

Enhancing the capacity of city financial management

Digitalising Tax Collection

The digitalisation of tax collection processes has gained popularity in recent years and has been posited as a key reform to enhance taxation efforts. It is used to reduce compliance costs for taxpayers, and thereby enhance voluntary compliance. More importantly, it is said to decrease administrative costs, increase transparency and efficiency within tax administrations, as well as reduce opportunities for pilferage by tax collectors. Consequently, it is not surprising that digitalisation is a key component of OSR-related reform in Kenyan counties. In fact, the extent of tax collection digitalisation is often held as an indicator of success and modernisation in the country as a whole.27

Kisumu, in particular, has attracted significant attention for its swift and comprehensive OSR automation. However, as explored below, automation alone has been unable to eliminate pre-existing tax collector malpractice, and consequentially has not yielded increases in OSR. This highlights the importance of complimenting digital reforms with institutional and management reforms.

In Kisumu, the main thrust of the digitalisation reform was around the digitalisation or ‘automation’ of tax payments. A tender was launched in 2017 for automation of market, bus park and parking fees (other revenue streams were to be digitalised later). These streams are called unstructured revenue streams since they are collected on a daily basis, compared with the licenses and property taxes (‘land rates’), which are paid annually. Together, these revenue streams make up around a quarter of Kisumu’s total OSR, and thus represented a reasonable proportion of revenue for an initial automation pilot. Bus parks were officially included but ultimately left out – ostensibly due to their ties with politically backed gangs.28

The tender for automation was won by Strathmore Research & Consultancy Center Limited (Strathmore), a firm with significant experience of automation in other Kenyan counties. The plan was to provide the KCG with Point of Sale (POS) devices, which tax collectors would use instead of a manual receipt system. These POS devices would be able to track the time of the payment, the payment recipient and payer details. Taxpayers would receive unique payment receipts, which could prevent fraud and recycling of tax receipts among taxpayers. The data would then be stored on a Strathmore software, which would allow the tax administration to oversee the process, evaluate tax collector performance and uncover potential abuse.

The original assessment carried out by Strathmore indicated that around 300 POS devices would be needed to fully automate the collection of unstructured revenues, with each device costing US$500.29 Due to budget constraints, the KCG proceeded with 100 devices and the Strathmore system was launched in Q1 of FY18/19. To compensate for the lack of devices, the county Revenue Department also launched a mobile money payment system via the countries’ mobile payment provider, M-Pesa. Given the very high penetration rates of mobile money in Kenya (with an estimated 60 per cent of the national population actively using mobile money), this appeared to be a promising complementary digital option to POS devices.

However, as of July 2020, automation has not yet yielded intended results. By the time the Strathmore system was operational in Q1 of FY18/19, total revenues for the automated streams was already declining (see Figure 10) and automation has not been able to reverse this trend. Market fees and bus parks declined for the two consecutive years after automation. Parking fees dipped in the first year of automation and recovered slightly in FY19/20, but only to pre-automation levels.

Challenges with payment automation

Several factors may have contributed to the challenges of automation in Kisumu, including the impact of COVID-19, an insufficient number of POS devices, and lack of complimentary changes in the management of tax collectors.30

COVID-19 reached Kenya at the end of March 2020 and the government responded by introducing a nation-
wide nightly curfew (on March 27, 2020), restricting public movement in the country’s largest urban agglomerations (Nairobi and Mombasa) and imposing other social distancing regulations. The government also introduced tax cuts as part of a larger economic stimulus package, although these did not include county OSR.31

The pandemic and the government response also impacted daily life in Kisumu, reducing overall economic activity. Consequently, automated OSR streams experienced drastic revenue decreases (see Figure 11). The drop in revenue in Q4 of 2020 caused at least in part by COVID-19 thus might partially explains the overall drop in revenue in FY19/20 (see Figure 10). However, it does not explain the drop between July 2018 and March 2020.

The sharp drop in the revenue collected from the automated revenue streams in the months right after automation (see July, August in FY18/19 in Figure 12, 13) can be attributed to the lack of an adequate number of POS devices. Prior to automation, around 300 tax collectors (or 75 per cent of all KCG tax collectors) were engaged in collecting unstructured revenues. With automation, only 100 collectors received POS devices and were allowed to carry on collecting taxes while nearly two-thirds of existing collectors were rendered temporarily unable to carry out their collection duties. Some collectors started sharing devices, which was not an effective practice given the distance of locations they covered.

Realising that the lack of POS devices was a bottleneck, the Revenue Department eventually re-introduced manual receipts that enabled all tax collectors to resume work essentially meaning that the collection process went on as before automation, but with 100 collectors using an additional automated process. A few months after automation, the number of tax collectors in the unstructured revenue streams thus returned to pre-automation levels. However, these explanations still do not explain the apparent stagnation in revenues between October 2018 and March 2020.

The ongoing challenges with automation appear to arise from the manner in which automation was instituted ‘on top of’ a defective collection system. The OSR system in Kisumu, as in many other local governments around the world,32 lacked control, incentive and performance mechanisms to prevent tax-collector malpractice. Large annual and monthly revenue fluctuations (see Figures 12,13) called for deeper analysis to understand variances. However, there were no regular audits of tax collectors and no control mechanisms in place to probe for irregularities in daily collections (for example, by comparing daily collections to historic or potential revenue figures). There were also no processes in place for the revenue department to verify where POS devices were being used, what their daily collection should have been or whether tax collectors used them at all. There were also no salary-based performance mechanisms or sanction in response to tax collector malpractice, leaving

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**Figure 10: KCG ‘unstructured revenues’ from 2013 to 2019**

<table>
<thead>
<tr>
<th>Year</th>
<th>Parking Fees</th>
<th>Market Fees</th>
<th>Bus Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 13/14</td>
<td>$1,200,000</td>
<td>$1,000,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>FY 14/15</td>
<td>$1,000,000</td>
<td>$800,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>FY 15/16</td>
<td>$800,000</td>
<td>$600,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>FY 16/17</td>
<td>$600,000</td>
<td>$400,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>FY 17/18</td>
<td>$400,000</td>
<td>$200,000</td>
<td>$0</td>
</tr>
<tr>
<td>FY 18/19</td>
<td>$200,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>FY 19/20</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

**Figure 11: KCG ‘unstructured revenues’ at the beginning of the COVID-19 pandemic**

<table>
<thead>
<tr>
<th>Month</th>
<th>Bus Park Fees</th>
<th>Parking Fees</th>
<th>Market Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2020</td>
<td>$140,000</td>
<td>$100,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>February 2020</td>
<td>$120,000</td>
<td>$80,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>March 2020</td>
<td>$100,000</td>
<td>$60,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>April 2020</td>
<td>$80,000</td>
<td>$40,000</td>
<td>$0</td>
</tr>
<tr>
<td>May 2020</td>
<td>$60,000</td>
<td>$20,000</td>
<td>$0</td>
</tr>
<tr>
<td>June 2020</td>
<td>$40,000</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>
The OSR system thus created the possibility for tax collector pilferage. Random respondents in UN-Habitat interviews reported having to regularly bribe tax collectors, while collectors attributed bribe seeking to delayed or irregular payments and to further corruption at senior levels.33 This highlights the challenges of instituting automation to reduce opportunities for pilferage without changing the underlying control mechanisms. The failure of the mobile money system, which was introduced alongside the POS devices, is indicative of how implementation challenges arose from insufficient incentives mechanisms rather than deficient technical solutions. The M-Pesa system only lasted for a few months before it was found to be prone to abuse and abandoned.34 Tax collectors were unable to differentiate between the original M-Pesa receipts which taxpayers received upon payment from the mobile operator and those that had been forwarded and edited by taxpayers. This type of M-Pesa receipt fraud is common in Kenya and can be exposed by looking at the sender address. M-Pesa’s failure was therefore likely not as a result of taxpayer fraud, but rather insufficient incentives for tax collectors to make it work.

Increasing the likelihood of automation success

Properly phasing in a new digital system is key to introducing automation, and new systems must be tested and processes adjusted before a total digitalisation can be carried out. This will also reveal possible drawbacks and allow for careful development of contingency plans. Furthermore, when introducing changes to a complex tax collection environment, it is important to be mindful of the different interest groups and the various potential leakages. A tax collection system is only as strong as its weakest link. Changes in collection need to be accompanied by improvements in audit, sanction and tax collector management mechanisms, especially when these are not well developed to begin with.35 The fewer control mechanisms in place incipiently, the greater the likely extent of ‘capture’, and the more challenging the implementation of reforms can be. Overcoming these challenges requires acknowledging the political realities around the collection process, adopting comprehensive reforms, or careful negotiation and cooperation with effected stakeholders.36 Where the political dynamics of reform are not considered and the focus remains on technical solutions, reform is unlikely to succeed.xiii

Capacity building and strategising

There are numerous examples of local governments in low-income countries

xii This table does not include Q4 to exclude the effects of Covid-19 analysed in the previous figure

xiii See McCluskey, Franzsen, Kabinga and Kasese, 2018, for an example of technical reform getting derailed by politics in Kenya’s Kiambu County
that lack the capacity to optimally leverage their own tax authority. Local governments, being smaller administrative units, often do not have access to the same capacity building programmes and/or qualified staff as their national-level counterparts. Given that fiscal decentralisation is relatively recent in many parts of the developing world, these local governments also often lack the institutional knowledge and processes to optimally tax their citizens for services provided.

County governments in Kenya are no different. A majority of its revenue officers were retained from the Local Authorities and received minimal training. A study found that only 40 per cent of revenue staff was reported as ‘qualified’ and only 50 per cent of counties had OSR procedures and/or a training manual in place. The Strathmore Gap Analysis carried out in 2017 (prior to automation) found similar conditions in Kisumu. Revenue officials lacked formal education, and more importantly, the technological equipment and processes to properly collect and analyse revenue data. Despite this apparent need for capacity building, external support to the KCG did not bring about a change in the overall OSR approach and thus was insufficient to overcome political interests in the status-quo.

In April 2019, UN-Habitat worked with KCG to facilitate the optimisation of OSR via capacity building. The idea behind this intervention was to carry out an analysis of the key issues around OSR optimisation in Kisumu alongside the Revenue Department and determine the most strategic areas of improvement. Strategic prioritisation was deemed as essential to ensure the optimal usage of the Revenue Department’s limited time and resources. The intervention adopted UN-Habitat’s ROSRA (Rapid Own Source Revenue Analysis) methodology, which consolidated international ‘best practices’ on OSR systems and linked these to a problem diagnosis. The first part of this intervention consisted of a revenue gap analysis per revenue stream. The gap analysis was complemented by a profitability analysis and a more granular problem deconstruction. Lastly, it explored the dependencies between root causes to determine useful reform entry points.

Based on this analysis, UN-Habitat recommended that the KCG build up its own analytical and management capacity and streamline the analysis of the ROSRA into its internal accounting and reporting systems. These changes were needed to create a more transparent and evidence-based OSR policy. It also recommended the simplification of the overall revenue system and a shift of its strategic focus from unstructured revenue streams towards land rates (and other high-potential revenue sources). The need to shift tax collection efforts away from ‘unstructured revenue’ was based on the findings that:

- The KCG only collected around 19 per cent of its total OSR potential in FY18/19 (confirming earlier estimates carried out by the National Treasury and Adam Smith International)
- Land rates constituted nearly 40 per cent of the overall revenue gap (See Figure 14)
- Land rates received a fraction of the overall tax collection resources

Despite being applauded by the city for its level of detail and accuracy, the UN-Habitat’s recommendations proved difficult to implement, with the system defaulting to business as usual. Rather than shifting resources towards the collection and enforcement of land rates and other structured revenue streams, the focus remained on unstructured revenues. In 2020, the Revenue Department acquired 300 more POS devices for unstructured revenue streams as well as hired around 300 new tax collectors and enforcers, the vast majority of which (270) were intended for unstructured revenue streams. Similarly, rather than focusing collection efforts on fewer, more high potential revenue streams that are easy to collect from and have strong policy rationales, the Revenue Department introduced a new license fee on Boda Bodas (motorcycle taxis) which was regressive, prone to pilferage and economically distortionary. There also were very few reforms, if any, that sought to build and improve the analytical, accounting and reporting practices within the Revenue Department. As such, it continues to be difficult for senior managers in the KCG to accu-
Financing Sustainable Urban Development

The challenges of reforming OSR strategy

Along with any potential technical Public Finance reservations, the proposed reform also struggled to gather large-scale interest. Due to the funds they have the potential to generate, OSR systems are often the object of considerable political controversy.42 Any proposed change to such a system is thus politically delicate and will create new winners and losers. A shift away from unstructured revenues will likely be opposed by tax collectors who may fear losing their jobs as a result of more automated, structured tax collection processes. A shift towards property taxes in Kisumu as in the rest of the world would also face resistance from large landowning elites.43 Simplifying the tax system and imposing regulations on revenue streams may also face opposition by parties that benefit from complicating the system to hinder transparency and maintain pilferage opportunities.44 Different interest groups thus may hold onto the status quo and decelerate the ambitions of the most avid political visionaries. The fire that broke out in the Finance Department in February 2020 with the alleged aim of wiping out existing records is a solemn reminder of these vested interests.45 The OSR system in Kisumu has therefore been known as being “too messy” to change.46

Accelerating OSR reform

As discussed above, meaningful OSR strategy pivots require serious political capital and/or fortuitous political windows of opportunity.47 Escaping
from such ‘dysfunctional’ but ‘stable equilibria’ requires first and foremost a greater appreciation for the importance of political realities in sustaining the status-quo. Technical solutions provided by external experts and/or development partners are typically hardly new or unknown to technical staff in Revenue Departments. The challenge instead is ensuring that technical insights, which commonly exist at lower technical levels, are communicated to senior management – and ultimately implemented.

Lower-level staff may sometimes withhold information to strengthen their own value within the organisation and prevent senior staff from effectively monitoring individual and departmental performance. Therefore, a fundamental first step for senior officials thus is to establish control over necessary information processes and key metrics such as revenue potential per revenue stream, profitability per revenue stream, tax incidence, and tax collector performance without over-burdening the relevant Revenue Departments. While implementing these types of information processes may face political resistance, it is less directly threatening to established interest groups than actual reforms to the OSR systems.

Increasing accessibility of information will also help strengthen incentives for responsible political officials to align OSR strategy with technical realities. It may also clarify to senior managers the extent of the system’s problems and motivate change. Further, the more publicly this information is available, the greater the public pressure that officials will face to address existing weaknesses. Once the political leadership is well informed about the OSR system, it needs to charter a realistic reform path that balances the appetite for technical change with a realistic understanding of the existing political constraints and legitimacy requirements. Mastering this journey requires leadership that is willing to take advantage of crises to construct narratives around the need for reform, as well as build reform alliances and secure quick wins to maintain reform legitimacy.
Capturing land value and unlocking dead capital

Optimising property taxes

Property taxation – or ‘land rates’ as it is called in Kenya and Kisumu – has for some time been considered as the most under-used revenue stream for county governments.52 Land rates are worthy of focus as they are generally also more progressive than most other user fees and license-based charges. They are also largely non-distortionary and thus better suited to funding the provision of public goods and recurrent expenditure more broadly – unlike user fees, the revenues of which should generally be linked to the recovery of distinct services.53

Since land value is not a function of the actions of landowners themselves, but rather the developments/investments in surrounding areas, it is fair to capture some of the increases in land values for public good. The traditional and most common way of doing so is, of course, via land rates.

Kisumu, as many of its peers, has not managed to fully leverage its revenue potential from land (see Figure 18). In fact, revenue from land rates has largely stagnated since devolution (see Figure 18), only increasing by 20 per cent in six years. The lack of progress is partially explained by the inability of the county to enforce compliance of land rates of landowners54. Nearly 70 per cent of landowners have outstanding arrears.55 Another important reason for the low revenue from land rates is the outdated nature of the valuation roll. The current valuation roll from 2008 does not cover all existing land parcels and also does not value them at their current market value, given the rapid population growth in Kisumu and the overall increase in serviced land, among other things. To overcome the coverage/assessment gap, in 2016, the KCG decided to update the valuation roll. This initiative has stalled to some extent and has not yet succeeded in updating property values. The analysis detailed below suggests that political interests may have, once again, stood in the way of a seemingly sensible reform initiative.

Updating the valuation roll

In February 2016, the KCG launched a tender process and by March 2017, awarded Syalar Consortium US$1.2 million to come up with a new valuation roll. The process took around three years and by April 2019, the new roll was completed. As per the new roll, the value of the land in Kisumu jumped from US$127 million (based on the 2008 roll) to just over US$1 billion – an eightfold increase in land value. It also increased the number of registered parcels from 25,284 to 55,000. This meant that in an ideal scenario with 100 per cent compliance, the county would be able to increase its annual land rate revenue almost 15-fold (see Figure 19). This would, however, be unlikely given the low compliance and the significant increase in the average tax liability per landowner (increasing from US$75 to US$278 per year). Nonetheless, even if the compliance rate were to decrease to only 18 per cent (such that all current landowners would pay US$51 per annum as before) the overall revenue would still more than double. With these figures, the investment in updating the valuation roll was likely pay for itself in less than a year. However, despite the immense potential of the valuation roll to increase land rate revenue, by July 2020, it had still not been officially approved/enacted by the County Assembly.

Figure 18: Actual KCG land rate revenue from 2013 to 2019 vs potential revenue\textsuperscript{xvi}

\textsuperscript{xvi} The overall revenue potential is based on changes in land values alone, as per the new valuation roll, which is awaiting final approval
Difficulties in getting the new valuation roll approved

There are several reasons for the delay in approving the valuation roll: financial, legal and political. On the financial side, the valuation roll could not be approved since the KCG has not been able to fully pay Syalar for its services. Following repeated delays in instalment payments to Syalar, the third party decided to withhold the GIS components of the valuation roll until it received the final outstanding payment of around 30 per cent of the overall contractual fee. Without this GIS data of the mapped-out land parcels, the valuation roll remains incomplete and thus cannot be approved. However, this payment has not been prioritised: the KCG paid around 50 per cent of its nearly US$2 million accounts payable in April/May 2020, in which the payment to Syalar was not included.56

The delays in these payment obligations and the passing of the new valuation roll are also due to concerns over its overall legality. Indeed, creating a legal basis for a new valuation roll requires the KCG to pass a Local Rating Act, which spells out the valuation methodology and implementation process. However, a Local Rating Act has been ready for approval since October 2014 without being passed (see section on Rating Act below). Further, since the valuation roll was launched prior to the passing of a Local Rating Act, the valuation roll can only be retroactively validated. This type of retroactive validation was undertaken by Kiambu County, which passed a new valuation roll in 2014 but only passed the corresponding regulation in 2017.57 While retroactive validation of the valuation roll may be legally contestable, it would nonetheless strengthen the legal enforceability of land rates. The current valuation roll was carried out in 2008 and has close to no legal validity since it is required by law to be updated every ten years.

From a political perspective, large landowners in Kisumu may be opposed to the valuation roll as it would significantly increase their tax obligations. Naturally, these landowners will seek a reduction in the land rate, as well as the cancellation of existing land arrears when moving from the old to the new valuation roll. Decision makers might have been disincentivised to push the valuation roll forward because of the political ties of much of the land-owning elite. As has been exemplified the world over, political survival and success can often hinge on courting elite favour.

Overcoming the challenges of passing new valuation rolls

Financial shortcomings can derail valuation rolls as these tend to be costly exercises. Local governments are well advised to finalise valuation rolls within one administrative term and avoid passing payment responsibilities over to new administrations. Even with a carefully crafted and executed procurement practice, powerful interest groups can find ways to influence the process. One potentially useful way of curtailing outside influence is by addressing information asymmetries.58 Lawmakers and lower-level bureaucrats may often withhold necessary information from top officials, obscuring causes and over-complicating potential solutions. At a minimum, high-level decision makers need to develop accurate and distilled understandings of the actual bottle-

Figure 19: Kisumu Land Rate Revenue Estimations based on New Valuation Roll (in US$)\textsuperscript{xvii}

<table>
<thead>
<tr>
<th></th>
<th>Status-quo</th>
<th>New Valuation Roll</th>
<th>Likely Scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registered Parcels</td>
<td>25284</td>
<td>55000</td>
<td>55000</td>
</tr>
<tr>
<td>Total Land Value</td>
<td>$127M</td>
<td>$1.020M</td>
<td>$1‘020M</td>
</tr>
<tr>
<td>Average Parcel Value</td>
<td>$5K</td>
<td>$18K</td>
<td>$18K</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>1.5%</td>
<td>1.5%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Average Tax Liability per Landowner</td>
<td>$75</td>
<td>$278</td>
<td>$278</td>
</tr>
<tr>
<td>Compliance Rate</td>
<td>68%</td>
<td>100%</td>
<td>18%</td>
</tr>
<tr>
<td>Tax Paid Per Landowner</td>
<td>$51</td>
<td>$278</td>
<td>$51</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>$1.2M</td>
<td>$15.3M</td>
<td>$2.8M</td>
</tr>
</tbody>
</table>

\textsuperscript{xvii} The compliance rate of the status-quo was estimated based on the data provided by CAL, the other two scenarios provide hypothetical compliance rates (scenarios). Average parcel value was calculated by dividing the total land value by the number of registered parcels; Tax liability was calculated by multiplying the tax rate by the average parcel value; tax paid per landowner was calculated by multiplying the tax liability by the compliance rate. The Likely Scenario was calculated by assuming that landowners would on average continue to pay the same tax liability that they had paid prior to the new valuation roll ($51). This assumption is based on the lack of enforcement mechanisms and already low compliance in the status-quo. In the new scenario, new landowners who previously paid nothing, would too start paying land rates. This is a hypothetical scenario used to underscore the point that it is unlikely that the new valuation roll will solicit taxpayers to pay tax liabilities that are three times as high as before (US$78 to US$278)
necks. In the case of Kisumu, financial and legal complications may distract from the real challenge of building the necessary political momentum for reform. Where incentives at high-levels are insufficiently strong to push through new valuation rolls, national and external actors are advised to rethink incentive mechanisms before advocating for complex technical reform. This may also entail removing potential obstacles in the process, for example, passing national legislation to replace the need for a ‘Local Rating Act’ – a process which has actually already been launched in Kenya.

Collecting property tax arrears

Another important aspect in enhancing property tax (land rate) revenue is compliance. As much as a new valuation roll will help to increase tax liabilities, if it is not supported by improved enforcement and compliance, it may merely further increase arrears.

In Kisumu, land rate arrears in FY18/19 already amounted to over US$100 million.xxi In other words, the KCG was owed over 10 times its total annual OSR in land rate arrears. Over the years, it has attempted different measures to collect this accrued revenue, including temporary tax arrears waivers on accrued interests for citizens who paid their overdue tax obligations. The KCG also tried brief campaigns utilising social pressure, publishing names of individuals with large arrears in the local press. After this resulted in a significant political backlash, the Revenue Department abandoned the approach and instead hired a private debt collection firm. Collection Africa Limited (CAL) won the tendering process and launched efforts to collect tax arrears in March 2019. CAL was experienced in helping banks recover debt. It was well-equipped and quickly ramped up operations in Kisumu. Within the space of a few weeks, it had around 100 staff on the ground as well as call-centre support. CAL’s approach was to retrieve tax arrears data in the form of demand notices from the KCG’s Local Authority Integrated Financial Operations and Management System (LAIFOMS) system, and to then physically locate individuals, ascertain contact details of debtors, generate payment plans, as well as Promissory to Pay (PTP) documents with corresponding dates of payment. This information would then be logged into a CAL database and used by the CAL call-centre to carry out targeted follow-up calls.

In its first month of operation, CAL was able to deliver close to 1,440 demand notices.58 This constituted nearly a 15-fold increase in taxpayer sensitisation from KCG’s own approach. After the first few months, nearly 40 per cent of the taxpayers who had been contacted ended up paying a part of their arrears. This constituted a near 4,000 per cent increase in payment from the KCG’s past arrear collection efforts. Within the first month (March 2019), land rate revenues increased to US$948,810 or nearly three times the land rate revenue that the KCG had earned in the March of preceding years.59 However, this initial success was not sustained. Over time, CAL’s monthly collections decreased and by October 2019, CAL stepped down operations. Collections picked up again somewhat in 2020, but remained at a low overall level, collecting under 0.02 per cent of overall debt per month. At this rate, CAL would take around 50 years to collect all the arrears, assuming these would not keep growing.

Challenges with outsourcing arrear collection

CAL faced several operational bottlenecks that limited its ability to collect arrears. One of these had to do with the receipt of demand notices. The KCG, as well as responsible officials within the City of Kisumu, were not printing demand notices as quickly...
as CAL was processing them. By July 2020, CAL had received around 10,000 demand notices of a total of 17,000. While the act of printing demand notices required little more than a mouse click in the system, the reluctance to provide CAL with the notices could perhaps have been in an effort to protect specific debtors/landowners from having to pay arrears. It has been said that some debtors provided payments to government officials instead of making formal payments in return for not being issued with official demand notices.

Another challenge encountered by CAL was that the demand notices frequently did not accurately reflect real property ownership or the debt data in the system. Land-related payment data had not been maintained properly over the past years; there was also no log or record of changes made to the LAIFOMS portal, and no way to trace instances where data on arrears and defaulters was fraudulently changed within the system.

Thirdly, CAL encountered problems around the legal enforcement of arrear payments. Some taxpayers refused to pay on the premise that the KCG would not be able to take legal action against them — a line of argument particularly prominent among wealthy landowners. CAL found a strong correlation between size of arrears, parcel value and the likelihood of payment. CAL found that landowners who had connections among county officials did not make payments. These findings are corroborated by the overall make-up of arrears by income group. Indeed, UN-Habitat estimated that nearly 90 per cent of the arrears or US$90 million was owed by the top 10 per cent of the largest landowners in the county (see Figure 21).

A fourth and final reason for the inability of CAL to maintain its initial revenue collection rate was due to non-payment by the KCG. By June 2020, it had only received around 20 per cent of the contractual payments that they were due. After not receiving payment for some time, CAL scaled down its operations from around 100 collectors to around 30 and also reduced call-centre activity. Rather than being paid on a monthly basis as stipulated by the contract and providing CAL with a commission on the revenue it collected, the KCG paid it in sporadic lumpsum payments, the last of which was paid in January 2020.

This violation of the CAL contract can be partially attributed to problematic accounting processes. The KCG has struggled with accounting for arrears collected, which do not feature clearly in its monthly revenue statements. Since, the CAL is contractually entitled to a percentage of the overall arrears collected, the KCG has not been able to determine its own payment obligations to CAL. Additionally, a failure in the KCG revenue accounting system in April-May 2019 led to a loss of payment receipts and further complicated the payment situation. Payment delays also occurred due to faulty processes and a lack of communication between county departments and the City of Kisumu who hold different parts of the data. There have also been claims that the payment delay could be a means to extort bribes from a service provider in return for processing payment.

Supporting third-party arrears collection

This reform initiative suggests that even where the legal context does not optimally facilitate the sanctioning of non-compliance, proactive sensitisation and follow-up can significantly increase taxpayer compliance. This may be a cost-effective and quick way to increase compliance rates while waiting for required supporting legislation. Ultimately, however, when the legal system is weak around the issue of non-compliance, arrear collection will falter, especially among parties with stronger incentives not to pay such as large landowners, who have larger tax liabilities and easier access to political networks and legal expertise. Additional measures may therefore be needed to enforce compliance and reduce the regressive potential of such an intervention.

**Figure 21: KCG land arrears by income group (UN-Habitat estimates)**

![Figure 21: KCG land arrears by income group (UN-Habitat estimates)](image)

**Figure 21: KCG land arrears by income group (UN-Habitat estimates)**

- Owed by poorest 90%
- Owed by richest 10% (excluding top 10 individuals)
- Owed by top 10 individuals

**Figure 21: KCG land arrears by income group (UN-Habitat estimates)**

- Owed by poorest 90%
- Owed by richest 10% (excluding top 10 individuals)
- Owed by top 10 individuals

**Figure 21: KCG land arrears by income group (UN-Habitat estimates)**

- Owed by poorest 90%
- Owed by richest 10% (excluding top 10 individuals)
- Owed by top 10 individuals

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**xxiii** The contract between CAL and the KCG stipulated that CAL was to receive a percentage of the overall land rates collected.
Ensuring compliance and optimising the usage of third-party arrear collectors will ultimately require that the Revenue Department is fully aligned with the reform goals. In these instances, decision makers will need to invest more time and resources into ensuring that the interests of their own staff align with the reform vision. This may take the form of negotiations, salary incentives, performance incentives, and/or contractual decisions. When these underlying issues are overlooked, reforms are built onto unstable ground and doomed to eventually peter out with little lasting change. Ensuring the success of suitable technical solutions, as in the case of digitalisation, requires creating the right enabling context first before building onto it.

**Improving the regulatory OSR environment**

So far, this report has covered the steps the KCG has taken to improve its financial position by digitalising its tax collection, updating valuation rolls and outsourcing arrear collection. It is also important to assess the broader regulatory environment and how it affects the KCG’s ability to leverage OSR. It appears that the regulatory challenge for the KCG is not expanding the existing revenue authority but rather facilitating its usage. The KCG has not however, been able to overcome existing challenges and pass necessary local legislation.

As already mentioned, the Kenyan counties do not have access to a large range of important revenue streams. Kisumu and the other counties were, as per Article 209(3) of the CoK, granted the right to levy a) Property rates; b) Entertainment taxes; c) Charges for services they provide; and, d) Any other tax or licensing fee authorised by an Act of Parliament. However, under the constitution, there is no provision for counties to charge taxes such as excise taxes, payroll taxes, or other general consumption taxes. They also do not receive revenues from local public utility companies where significant funds are generated via electricity and water provision. This limited tax authority has been criticised by various actors, including the World Bank in its initial assessment of devolution in 2012.

While the devolved revenue authority certainly does not facilitate the counties’ revenue self-sufficiency, it does provide enough authority to cover a sizable proportion of the budget. As per the National Treasury and Adam Smith International findings, the Kenyan counties, similarly to Kisumu, only leverage around 20 per cent of their overall OSR potential. Devolving more tax authority would possibly therefore decrease overall national revenues more than it would increase local revenue. Thus, it may make sense to ensure appropriate usage of existing tax authority before introducing regulatory changes to expand it.

Having said that, new county legislation is required to improve the accountability of the counties’ existing OSR systems. Accountability is a cornerstone of effective local governance, but also directly impacts the voluntary compliance of taxpayers. Under section 120 of the County Governments Act, 2012, a Tariffs and Pricing Policy should articulate the rationale for application of tariffs, fees, levies or charges by a county government and how these are linked with service provision. Yet most counties, including Kisumu have not developed such local legislation. Instead, Kisumu uses the annual County Finance Act as omnibus laws to impose all fees and charges. This is not sufficient to provide adequate regulatory functions and collection procedures. Finance Acts should be reserved for annual amendments to fiscal provisions, arising from the county annual budget while county legislation that creates a regulatory duty/obligation or imposes a licensing fee should be set out in separate county legislation.

**The Local Rating Act**

New legislation is also necessary to support county governments in fully leveraging their existing tax authority. The 2010 constitution was not accompanied by a comprehensive legal revision of existing OSR laws. This meant that the former legislation, which regulated how subnational government structures (preceding the counties) handle OSR, was re-framed as being valid for transitional purposes until the new county governments passed their own legislation. One of the revenue streams for which this transitional authority of counties is most questionable is land rates.

In fact, there is no overarching law at the national level that guides counties in their imposition of land rates. The existing law used by the former local authorities (Rating Act Cap.267) was passed in 1963 and is supported by the Rating for Valuation Act Cap.266 of 1956. The counties have continued to use these Acts on the basis of the provisions set out in the interim/transitional legislative protections pro-

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**Footnotes:**

1. In Kenya, the services of water and electricity are offered by incorporated companies and not the County Governments.

2. The most legally contentious revenue streams besides land rates are agricultural produce cess, outdoor advertising fees, liquor licensing, entertainment taxes, and tourist taxes.
Enacting a Local Rating Act of its own thus appears to be the only real option for Kisumu while waiting on the potential national revision of existing laws, to create legal enforceability for their land rates and land rate arrears. Given the extensive potential of land rates and the huge land rate arrears, the KCG should feel some urgency to pass corresponding local rating legislation. To facilitate the development of this local legislation at the county level, the Commission on Revenue Allocation (CRA) in conjunction with the Kenya Law Reform Commission (KLRC) and the Council of Governors (CoG) developed a County Model Revenue Legislation Handbook containing model laws on land rates and other local taxes. With this support, a Local Rating Act was prepared and forwarded to the KCG County Assembly for approval in October 2014. The Act was not accepted, which led to further iterations and another submission to the County Assembly in 2017. To this day, the Act has not been passed.

Challenges with passing the Local Rating Act

The lack of customisation to the context of Kisumu has been cited as one of the barriers to the passing of the Act. However, Kisumu is not alone in struggling to produce necessary local legislation. Indeed, by February 2019, less than 10 of the 47 counties in Kenya had passed a Local Rating Act. This gap has prompted the national government to plan national legislation to overcome the challenges that counties are facing in passing land rate-related legislation. However, while this is a sensible decision, it may also result in weakening the counties’ incentive to close this legislative gap in the interim. Pressure from landowning elites may have further acted to disincentive the passing of this Act in Kisumu as in other counties. Since a new Ratings Act can strengthen the legal enforceability of sanctions for non-compliance with land rates and arrears, such landowners have a strong financial interest in opposing the Act’s passing.

Realising the potential of investment in improving infrastructure

To improve its financial position, the KCG has not restricted itself to working on OSR and has also attempted to increase its access to credit, and attract private investment. Meeting the county’s development targets as outlined in its 2018-2020 County Integrated Development Plan II, will require capital expenditures and upfront investment that cannot be met by OSR alone. Accessing capital markets can make particular sense when the returns on investment surpass its financing costs. It could also help address issues of inter-generational equity. Despite the benefits of accessing external funding, the KCG’s success in this endeavour have been limited largely due to the challenges it faces in enhancing OSR and implementing solid PFM processes.

Access to credit

The Kenyan fiscal decentralisation framework is generally supportive of subnational borrowing. The Kenyan constitution allows county governments to take on long-term debt for capital expenditure with the approval of their respective County Assemblies, a recommendation from the Intergovernmental Budget and Economic Council (a body consisting of all the County Executive Committee members for Finance) and a guarantee from the National Cabinet Secretary. Overall, counties may borrow an amount of long-term debt equivalent to 20 per cent of total county budgets (with no more than 15 per cent of budget going towards debt servicing). Counties may also take up short-term debt to overcome cash flow issues. Although, borrowing for this purpose is not allowed for longer than one year and may not exceed 5 per cent of the county’s last audited financial accounts.

Despite these legal options, Kisumu and other counties have struggled to access capital markets. This has less to do with regulatory restrictions and more with foreign exchange risk, competition from the national government for credit and low creditworthiness. In fact, most counties have never had an official credit rating. This might also deter private investors who rely on credit ratings to gauge the riskiness of lending to local governments. Some of these impediments to accessing capital markets are difficult to resolve and are outside the control of the county governments. Creditworthiness, on the other hand, is largely within their control.

Consequently, Kisumu county eagerly participated in the Kenya County Creditworthiness Initiative (CCI) in early 2019, which included Kisumu as one of the 10 participating pilot counties. This could potentially help shore up investor confidence and allow counties to better gauge opportunities that
capital markets had to offer, as well as help diagnose areas of improvement to enhance future credit ratings. Kisumu County worked to facilitate the creation of its first credit rating alongside the National Treasury, the Commission on Revenue Allocation (CRA), and the Capital Markets Authority (CMA), the World Bank (WB), and the Global Credit Rating Agency (GCR).

The credit ratings from this initiative were revealed to the public in March 2020. Kisumu was ranked third among pilot counties after Makueni County and Bungoma County, with a score of BB for its long-term debt (“Low credit quality levels of obligor/obligation creditworthiness”) and B for its short-term debt (“Low to vulnerable certainty of timely payment of Short term obligations relative to other issuers or obligations in the same country”). According to GCR’s national rating scale, this meant that Kisumu was below average in regard to other issuers in the same country, for both long- and short-term debt.

As per the GCR final report, Kisumu’s rating was positively influenced by relatively stable government transfers, its diverse economy, its low reliance on agriculture, and its above country average Gross County Product (GCP) per capita. Less favourable was the fact that the county’s economic growth had fallen behind the national average. The report made particular mention of its inability to maintain industrial infrastructure, revive agro-processing industries and/or exploit the potential of Lake Victoria. More concerning still was GCR’s assessment of the county’s overall financial position and its operating performance. It pointed to the county’s deterioration in OSR in FY17/18, its sizable unpaid trade creditors (33 per cent of FY17/18 revenue), its challenges in executing the development budget, its large recurrent expenditure and rising staff costs. GCR also pointed out concerns over the KCG’s audit outcomes, which highlighted extensive misuse of public funds and flouting of PFM regulations.

Whether the credit rating will facilitate KCG’s access to credit markets remains to be seen. For now, its key value addition has been providing data to the KCG to better prioritise further Municipal Finance reforms. Given the Municipal Finance difficulties highlighted by the GCR report, Kisumu might continue to struggle to issue debt at favourable interest rates. The overall macro-economic context and the COVID-19 pandemic might add to these challenges. Eventually, the KCG must address the core underlying Municipal Finance issues highlighted by the GCR report to access credit markets under favourable conditions.

Private investment and PPPs

Another significant potential means of attracting external funding for larger capital expenditures are Public Private
Partnerships (PPPs). PPPs bear the potential for KCG to limit investor risk, attract funding, and possibly circumvent existing Municipal Finance bottlenecks by ring-fencing cash flows within specific projects. As per Kisumu’s 2018-2020 County Integrated Development Plan II, around US$75 million to finance the County’s ambitious development is to come from PPPs. While this may seem like a relatively small amount, it is equivalent to around 75 per cent of the KCG’s annual budget. It is also a considerable amount given that the KCG has historically not managed to share the financial burden of infrastructure provision via PPPs.73

There have been several PPPs in Kisumu, but these do not feature the KCG as the contracting authority. For instance, the Kisumu Sea Port worth US$80 million that was completed in 2019 was managed via the Kenya Ports Authority, the Magwagwa Multipurpose Dam Development amounting to US$835.6 million is managed by the Lake Basin Development Authority, and the Transmission Grid Expansion programme worth US$434 million is similarly managed by the Kenya Electricity Transmission Co. Ltd. (KETRACO).74

Pursuant to the powers, functions and responsibilities delegated to the county governments under the County Governments Act, 2012, they can enter into partnerships with any private organisation in accordance with the Kenyan Public Private Partnerships Act 2013. According to the 2013 PPP Act, however, counties are required to involve the national PPP Unit under the National Treasury. This PPP Unit has extensive information requests that counties can struggle to comply with. In most instances, the PPP preparation period tends to extend beyond a single administrative cycle, thus undermining the desire of newly elected officials to show results. Thus, the KCG and other Kenyan County government officials have reported the complexity of the PPP process as one of the bottlenecks to creating these partnerships, and KCG officials have joined critics in calling for a simpler PPP process. While the PPP process is indeed comprehensive, a World Bank report found that it was not overly complex.xxvi A certain level of complexity is necessary due to the far-reaching consequences of badly designed PPPs, particularly the risk of placing perilous contingent liabilities on subnational balance sheets that eventually require national bailouts. In fact, it could be argued that the PPP Act of 2013 was not explicit enough in regard to the development of PPPs at the county level. As a consequence, counties spent resources in launching PPP processes that ultimately never materialised, including a US$560 million Agricity in Homa Bay or a Blue Sea Energy Project in Meru County. For this reason, the national PPP Amendment Bill of 2018, awaiting parliamentary approval, aims to entrench the need for all PPP projects valued above US$500,000 to pass through even more direct oversight of the Public Private Partnership Unit (PPPU) within the National Treasury of the Kenya government before being presented to the national PPP Committee for approval.

Given the Kisumu county’s struggles with abiding by overall PFM regulations and managing expenditure and normal procurement, it could potentially be risky to ease regulatory requirements for enacting PPPs. The Auditor General Reports of KCG Financial Operations provide some insight into the extent of malpractice in the county, which covers the range of financial accounting malpractices, including excess expenditure, un-surrendered impres, unsupported expenditure, unexplained bank balances, unexplained variance in bank

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**Figure 22: Propriety issues of KCG expenditure; Auditor General Reports (in US$) (2013-2018)**xxvii

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Expenditure with Propriety Issues</th>
<th>Total KCG Revenue</th>
<th>% of Total KCG Expenditure with Propriety Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 2013/14</td>
<td>$22,066,943</td>
<td>$54,946,286</td>
<td>40%</td>
</tr>
<tr>
<td>FY 2014/15</td>
<td>$34,157,274</td>
<td>$70,507,973</td>
<td>48%</td>
</tr>
<tr>
<td>FY 2015/16</td>
<td>$5,471,933</td>
<td>$70,541,504</td>
<td>8%</td>
</tr>
<tr>
<td>FY 2016/17</td>
<td>$45,102,654</td>
<td>$76,136,282</td>
<td>59%</td>
</tr>
<tr>
<td>FY 2017/18</td>
<td>$5,037,513</td>
<td>$78,260,577</td>
<td>6%</td>
</tr>
</tbody>
</table>

xxvii Note that for the year 2018 the figure is lower as the Audit Report for the County Executive is not available, only that of the County Assembly. Propriety issues in regard to expenditure here take note of all amounts in the Auditor General Reports whose propriety cannot be verified as per the respective reports.

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Figure 23: Kenyan County revenue breakdown from 2013 to 2019

100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0
Equitable Share
Conditional Grants
OSR
FY 13/14 FY 14/15 FY 15/16 FY 16/17 FY 17/18 FY 18/19 FY 19/20

statement, missing assets and liabilities from the county’s financial statements, among other things. The Auditor General concludes that year on year, public money has not been applied lawfully or in an effective manner, and that the Financial Statements do not accurately reflect the Financial Position, or cash flow of the county (see Figure 22 for a summary).

The challenge with putting in place PPPs can therefore not be addressed by easing PPP regulations alone. While there is certainly room for improvement in the PPP regulation, the key bottleneck is arguably elsewhere. The current lack of county-level PPPs needs to be tackled by addressing the inability of county governments to create conducive investment environments, adhere with existing PFM regulations, and increase OSR. By developing these foundations of Municipal Finance, the KCG can create a more appealing environment for investment and build up sufficient internal capacity to prepare bankable projects and PPPs more quickly.

Facilitating access to external funding

The analysis above suggests that both in regard to access to credit markets as well as PPPs, the KCG must strengthen its OSR performance as well as its overall PFM. However, ensuring the proper functioning of the Municipal Finance foundations can be less politically appealing as it requires long-term dedication and substantial political capital, without offering many quick wins. Thus, strengthening incentives for KCG and other local governments to build Municipal Foundations should be a priority for national governments and development partners. OSR performance can also function as a useful indicator of how prepared local governments are for accessing other high-potential external revenue sources.

National transfers in particular offer a promising means of strengthening these Municipal Finance foundations. Kenya’s intergovernmental transfer formula allocates 2 per cent of the overall funds to counties based on their OSR performance. Given the overall importance of enhancing OSR for the overall financial position of the KCG and other counties, transfers should be more heavily contingent on OSR performance. The third and latest transfer formula revealed by CRA in June 2020 does not provision a change to the OSR variable (also referred to as “fiscal effort”). It does, however, introduce an additional 2 per cent variable for compliance with PFM standards (“fiscal prudence”). This new formula does not prioritise the unsustainable dependence of counties on national transfers (see Figure 23), access to external finance or the efficiency of county expenditure, as issues that require urgent attention.

Lake side fish market in Dunga Beach, Kisumu, Kenya © Shutterstock
Lessons, success factors and priorities for future reform

On paper, it looks as though the KCG did many of the ‘right’ things to optimise its financial position, especially in regard to OSR. It digitalised tax payments for the key user charges (‘unstructured revenue streams’), engaged in capacity building to revise its OSR strategy, and hired firms to update the valuation role, and drive in property tax arrears. It also worked on improving local legislation and acquired the county’s first credit rating. In fact, nearly all of these reforms are commonly found among the best practices for enhancing the financial position of local governments, and yet, none of them really worked.

Several factors contributed to the dilution and deceleration of these reforms. Arguably, the most important of these was political resistance to reform. Ultimately, the KCG struggled with overcoming vested interests in the status quo ranging from lower-level government officials, tax collectors and/or powerful landowning elites. Decision makers have been unable or unwilling to confront and overcome these vested interests without the support of powerful information and control mechanisms or strong reform incentives. Consequently, OSR reforms lost momentum, which in turn made it difficult for the KCG to use other revenue sources more optimally, particularly credit and private investment.

Lessons and success factors
Overcoming reform hurdles

This case study analysis offers some lessons on chartering a successful reform path. For this, a decision maker needs to balance their desire to change the functionality of the system with the political legitimacy requirements of the local context. Ultimately, the exact form and sequence of reform steps must be determined through a process of problem-solving: attempting reform initiatives, closely monitoring progress and flexibly adjusting course to match outcomes.

Some of the lessons summarised below may also apply to other local governments. While there is always some degree of vested interest in the status-quo, it is particularly pronounced in contexts with weak adherence to the rule of law. For instance, weak compliance with PFM standards have exacerbated opportunities for public officials to benefit from dysfunctional municipal finance systems. Where tax collectors can openly accept bribes and make little effort to conceal pilferage, technical collection reforms are likely to meet steep internal resistance. In such a context, a local government ability to leverage its OSR can indicate the extent of vested interests. The lower the ratio of actual-to-potential OSR, the greater this resistance is likely to be.

A failure to overcome vested interests is likely to promote reforms that look promising on paper and provide short-term legitimacy gains to the government, but ultimately do not significantly alter the functionality...
of the Municipal Finance system. Most of the KCG’s OSR reforms fall into this category of isomorphic mimicry. Sustaining reform initiatives and bringing about real change in these contexts, as in Kisumu, thus requires overcoming vested interests. Doing so will also require the strengthening of reform incentives to nourish a sense of urgency and foster political will.

**Strengthening information and control systems**

Adequate data management, reporting and control systems are critical for overcoming vested interests. Inadequate information systems make it difficult for government decision makers as well as the public to hold government officials accountable. Lack of information also makes it difficult to understand the status-quo, identify culprits, and uncover financial malpractice. In such an environment, decision makers will find it difficult to defend the need for reform initiatives as they lack the evidence to describe the gravity of the need for reform. They also lack the tools to understand why reforms are not meeting their intended targets and to adjust the course of reform. In such an environment, decision makers will struggle to identify the key reform entry points to quickly elicit results and support reform initiatives with needed legitimacy.

To overcome these challenges, Revenue Departments should avoid functioning as black boxes of information, but rather be as transparent and conducive to analysis as possible. Analysis of leakages should not be carried out as a one-off strategic capacity building initiative, but rather streamlined into monthly reporting systems to expose malpractice and strategic weaknesses continuously. Data should be made as publicly accessible as possible and records must be cleaned to facilitate analysis. To better understand patterns of tax evasion, taxpayer information that is usually stored in separate records should be integrated on digital platforms. Reforms aimed at increasing compliance by sanctioning non-payment can particularly benefit from such integrated taxpayer records.

In a similar vein, internal information systems must be strengthened. Technical reforms will be insufficient if not accompanied by management reform among tax collectors. As evidenced by this case study, irrespective of the quality of the digital system or the number of devices used for revenue collection, additional management reform is needed to ensure successful implementation. Introducing POS devices without changing the method of monitoring collectors leaves them free to choose when to use POS devices and when to ‘pocket’ revenue. Payment automation also needs to be embedded in management systems that estimate daily revenue targets based on realistic potential of revenue stream and hold collectors accountable to achieving pre-defined targets. For this, historic revenue figures should not be used to define revenue targets, as these are unlikely to provide trustworthy baselines. Instead, Revenue Departments should use proven methodologies, such as top-down approaches (see UN-Habitat ROSRA), bottom-up revenue mapping (literal counting/surveying of the tax base) or manual testing. Manual testing would entail engaging new and reliable tax collectors for a short period to define targets based on the amounts they collect.

Unlike other reform initiatives that directly challenge vested interest groups, creating information systems is an indirect or a more covert way of limiting the power of vested interest groups. It is thus less likely to face the same level of political resistance, also because it might be more difficult for vested interest groups to conjure up legitimate reasons for resisting such reforms. Where this type of reform is not possible, the national government and outside actors can help to create the right incentives. The national government, in particular, can put in place standardised data management and reporting systems for local governments without increasing their control over subnational authorities.

**Facilitating organisational change**

When such reform options do not bear fruit, decision makers may have to opt for more drastic approaches. The Municipal Finance literature is replete with examples of how organisational reform and human resource reshuffling has been successfully used to overcome internal opposition to reform and create new functional OSR systems. Undertaking such measures requires significant political capital in the presence of strong reform incentives, which are often only possible once the right management and control mechanisms have been installed, or when there is a change in senior leadership. Newly appointed decision makers usually have less interest in defending past approaches and find it easier to expose past malpractice. Significant strategic pivots, as the one recommended by UN-Habitat may only be possible following a change in senior leadership as well as additional organisational change within the Revenue Department.
Introducing change in small and well-defined spurts

When political opposition is steep, decision-makers are well advised to advance the reform agenda in small and self-contained steps. When larger leaps of long duration are needed, the decision points should be predefined as much as possible and contained within one administrative cycle. The valuation roll in Kisumu lost momentum as it dragged on for years, and extended to a new administration. It also struggled from a lack of clear and predefined processes for carrying over arrears. When change is introduced in small increments, realities change on the ground and slowly start to erode the basis of resistance of vested interest groups – before they can notice it.

Strengthening OSR incentives of governmental transfer formulas

The external environment can also play an important role in strengthening OSR reform incentives. One effective way of doing so simultaneously without restricting the autonomy of local governments is to refine intergovernmental transfer formulas. When local governments violate PFM
Financing Sustainable Urban Development

regulations, fail to provide crucial OSR related data, and – more broadly – underperform on OSR objectives, they should experience transfer reductions. Given the importance of OSR in enhancing counties’ financial position, it would be a loss not to use this powerful resource lever to incentivise more serious optimisation of OSR reform and concomitant solidification of the rule of law, the social contract and government accountability.

**Focusing on OSR as a precondition to accessing other sources of finance**

This case study underscores the foundational importance of OSR for the financial position of local governments. Enhancing investments by skipping OSR is difficult and will greatly increase the costs associated with gaining access to external finance. Credit ratings can be a useful means of better understanding key OSR challenges, but are unlikely to facilitate access to credit when the OSR system is not functional. As much as local governments and their national/development partners attempt to circumvent OSR-related problems and scale up government investment by accelerating access to other sources of finance, it is unlikely to facilitate the building of a solid finance foundation. In fact, it might lead local governments into a development trap and diverge attention away from an OSR system that needs to be fixed to meaningfully attract other funding. Thus, there is a need to consider framing OSR as a prerequisite to unlocking other financing options, as opposed to just being a stepping stone.

**Priorities for current and future reform**

According to the KCG, OSR reform continues to be a key priority. However, its plans for overcoming existing bottlenecks are still unclear. Given that OSR reform has been slow and that it only is a small percentage of the overall budget, the KCG is particularly keen to find ways of attracting private investment. In this, the successes of Mombasa and Meru County in creating Special Purpose Vehicles (SPVs) and Joint Ventures have served as an inspiration. The Lakefront Development of Kisumu, which is still in its preliminary stages, is the first project in Kisumu to be realised via an SPV. While there are currently very few investment opportunities that can offer sufficient revenue from user payments, the KCG can offer its public land to attract private investment. However, whether significant investments will materialise in this way in the near future remains to be seen. This case study suggests that if left unaddressed, the very roadblocks the KCG faces in addressing its Municipal Finance and OSR challenges might potentially also undermine its ability to attract other private investment.
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