Policy brief

Fiscal decentralisation and redistributive politics

Evidence from Kenya

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Series
Public finance and service delivery

Key messages

Fiscal decentralisation has the potential to improve spending on public services if local governments compete for performance. Equally, it may *reduce* spending if local governments seek to free ride on the spending of their neighbours.

In Kenya, there is evidence of free riding by local governments, which has led to a decline in public services spending in some counties and a decline in the quality of these services. The lack of electoral accountability seems to generate incentives for local governments to free ride.

National and local governments should promote ***budget credibility*** by ensuring that local spending is anchored on development objectives, plans and priorities. This could reduce free riding and discretionary spending that is associated with targeted goods.

Independent entities, such as audit institutions, and local governments should also promote ***budget accountability*** by ensuring that they provide local government audits and budgetary information to citizens in a timely and accessible way. This can form the basis for citizens to hold politicians accountable through the electoral process and enable the central government to sanction non-performing politicians or design better systems of fiscal transfer.

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Introduction

The decentralisation of fiscal responsibilities and budgets from national to subnational level is often expected to improve the quality of public spending for two reasons. First, local governments can allocate their expenditures according to local needs and preferences. Second, the hope is that residents will compare the policies and performance of their own locally elected politicians across local governments (Capuno et al., 2015), leading to spending in one jurisdiction encouraging spending in another – known as yardstick competition.

Against this, however, is a different school of thought, which argues that if one jurisdiction increases its spending on public services then neighbouring jurisdictions may 'free ride' – reducing their own spending on the basis that residents can use improved services elsewhere.

This theoretical debate matters for public policy. National governments may take a fairly hands-off approach in supporting improvements in local government spending where yardstick competition is expected to prevail. On the other hand, widespread free riding would justify greater national government involvement in determining the level and composition of local expenditures. At present, however, there is limited evidence on either side in terms of how and why spending decisions across neighbouring local governments might affect each other and their implications on the composition of budgets and the quality of public services.

This policy brief provides highlights from recent research that contributes to this policy and academic debate by looking at how counties in Kenya have reacted to an increase in spending on public goods and services by their neighbours, and how this affects service delivery outcomes.

Fiscal decentralisation in Kenya

Kenya's devolved system of governance, introduced in 2013, allocates significant expenditure responsibilities to 47 subnational county governments. Intergovernmental transfers provide significant resources to counties to finance public service delivery, with at least 15% of national revenues being allocated to counties in each year. This is allocated across countries using a pre-determined formula. Approximately 90% of a county's annual revenues consists of central government transfers.

Kenya's constitution (2010) grants counties significant autonomy in terms of budgetary decisions and delineates powers and functions between the central government and local government. According to the constitution's Fourth Schedule, counties are primarily responsible for providing agricultural, health, cultural, urban planning, transport and infrastructure, and trade development services.

A locally elected governor heads each county and is the most influential person in terms of budgetary decision-making. Governors are elected for a maximum period of two 5-year terms, which incentivises them to maximise the use of public resources for political gain. Governors run for public office under a specific political party.

To encourage economies of scale in public service provision, Article 189(2) of the Constitution allows counties to:

> Co-operate in the performance of functions and exercise of powers, as well as set up joint committees and joint authorities to coordinate policies and pool resources together for common investments. (GoK, 2010: 115)

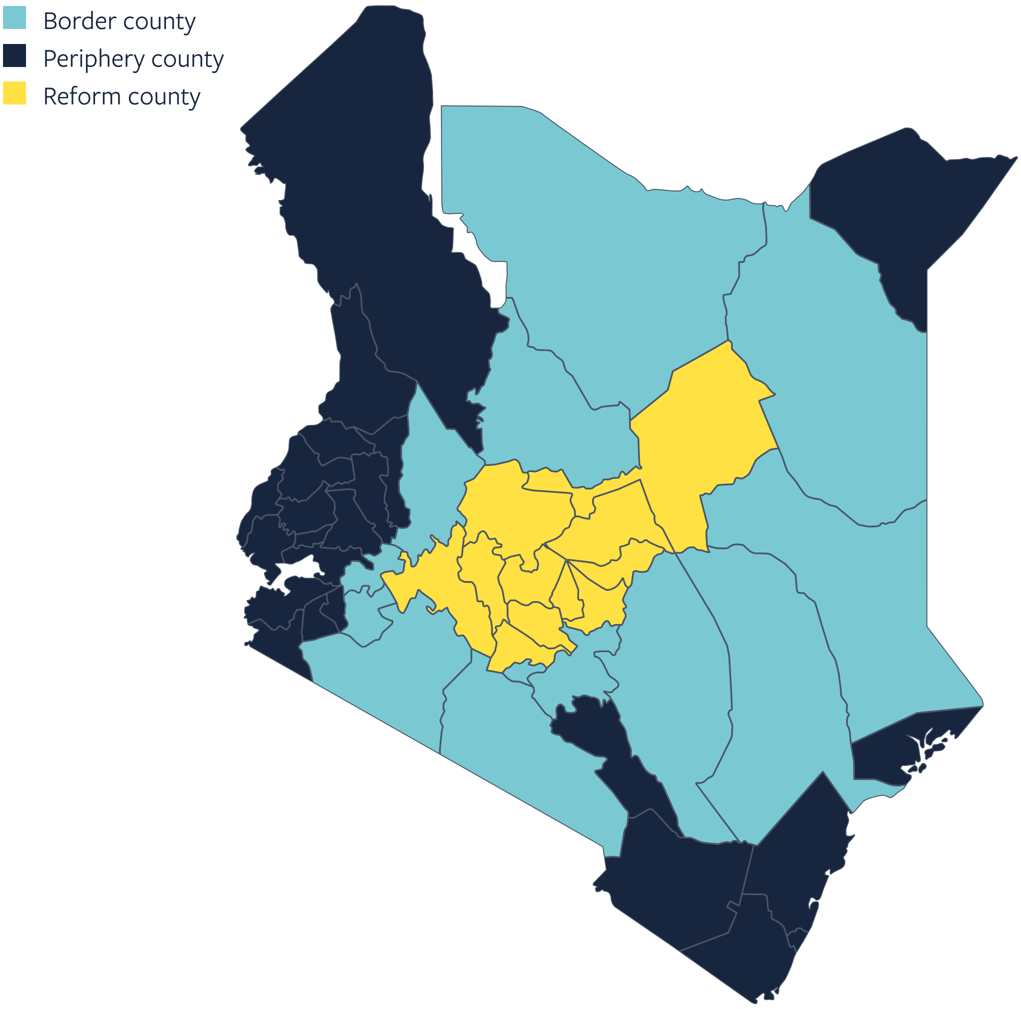
This clause forms the basis for the creation of the Mount Kenya and Aberdares Economic Bloc (MKAEB), a group of 10 neighbouring counties[1] that in 2015 jointly agreed to promote economic and social investment by harmonising public spending policies (GoK, n.d; GoK, 2019). The MKAEB reform, which was formalised in February 2016, aligned laws and regulations to facilitate trade and investments, leverage competitive and comparative advantages, and exploit economies of scale. To achieve this, it aimed to mobilise 100 billion Kenyan shilling (KSh) ($1 billion) (Ndung'u, 2018).

The reform focused on increasing spending: (1) productive sectors such as agriculture, agribusiness, tourism and industrialisation; (2) social sectors such as healthcare and education; and (3) enablers such as infrastructure, water and resource management, financial services and information and communication technology. In each financial year, governors are required to harmonise and increase spending in these categories, although there are no explicit targets (Council of Governors, 2016).

1 Embu, Kiambu, Kirinyaga, Laikipia, Meru, Murang'a, Nakuru, Nyandarua, Nyeri and Tharaka Nithi.

County governors established the MKAEB largely based on party alliance. All had run for office under the Jubilee Party of Kenya, who had in their party manifesto and 2013 election campaign pledged to pool resources across counties to enhance the large-scale provision of public goods and services. Before the reform, in 2014, expenditure on public goods and services in the 10 reform counties was 6.9 billion KSh ($69 million). After the MKAEB was established, this spending increased to 18.2 billion KSh ($182 million) in 2016 and to 67.3 billion KSh ($673 million) in 2017.[2]

Figure 1 Map of Kenya's counties, classified according to involvement in or proximity to the MKAEB reform



Source: Author's own elaboration.

2 The exchange rate used is $1 = 100 Ksh, the average rate for the year 2014.

Yardstick competition, party politics and public spending

In traditional models of fiscal decentralisation, voters who lack information about the quality of services or the performance of politicians in their own localities can overcome this by observing policies in neighbouring areas (Tiebout, 1956; Besley and Case, 1995). Voters can then use these observations to hold their elected officials accountable through the electoral process. Several studies show that politicians who underperform compared to their neighbours are more likely to be voted out (Allers and Elhorst, 2005; Kayser and Peress, 2012), which would seem to support the yardstick competition hypothesis.

However, this type of electoral accountability may depend upon the nature of political competition between neighbouring jurisdictions. Strong political parties at local level can weaken interparty competition, creating 'political markets' wherein particular parties can only effectively contest or win in particular jurisdictions. Electoral accountability is then restricted to these separate political markets, as politicians face greater competition from within their own political bloc and are therefore likely to benchmark their performance against only those neighbours that share the same political affiliation.

In the context of public spending, increased spending on public goods in certain localities within a single political market might not necessarily lead to an increase among the neighbouring localities. In fact, given that public goods are non-excludable (that is, individuals cannot be prevented from accessing or using them), and residents are mobile, neighbouring localities with different political affiliations to those spending more on public goods provision could 'free ride' with little fear of electoral repercussions. Free riding counties could then reduce their own spending, particularly in jurisdictions where the costs of accessing neighbouring services (including time and distance) are lower.

As the MKAEB reform was based on partisanship, this provides a unique setting in which to investigate whether neighbouring counties ('border counties') reacted to the increase in spending in reform counties. We do this by testing for 'expenditure spillovers' using disaggregated spending data and georeferenced household-level surveys, comparing any spending changes in border counties with spending changes in counties located further away ('periphery counties'). We also assess whether there is a relationship between changes in spending and proxies for household welfare.

Any reduction that free riding counties make to their spending on public services increases the availability of resources for more discretionary and targeted spending. There may be strong incentives for politicians to pursue such a change in spending composition, diverting resources towards targeted goods in exchange for votes – known as clientelism. The literature on electoral politics has long documented clientelism as crucial for political survival in developing countries (Diaz-Cayeros, 2008; Golden and Min, 2013) and in Kenya especially (Kiai, 2008; Githinji and Holmquist, 2012).

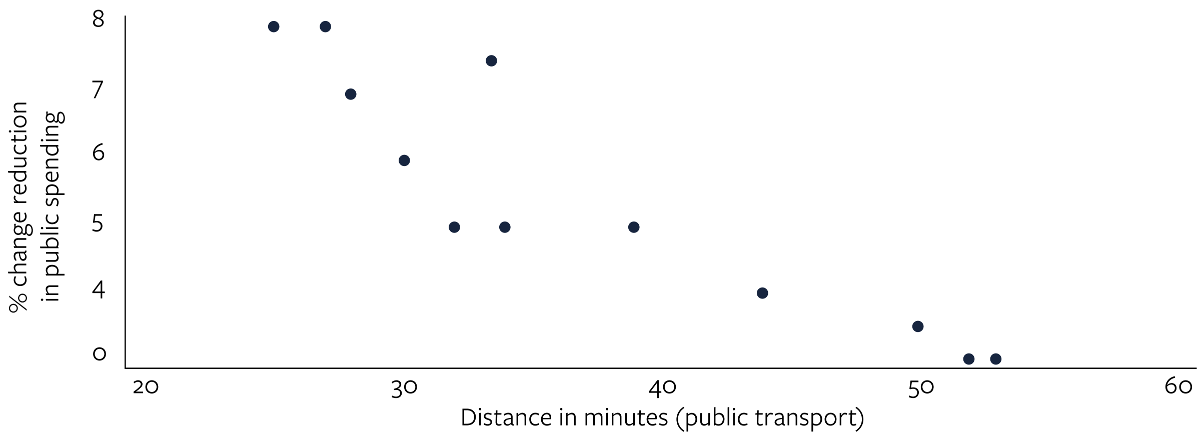
Findings – from public services to politically targeted: spending changes in MKAEB border counties

All else being equal, **the MKAEB reform led to a substantial decline (of between 37% and 40%) in total spending on public services in border counties** relative to counties located further way. This would seem to provide evidence of neighbouring counties free riding on reform counties' spending increases, and not of yardstick competition.

The magnitude of this reduction in spending is not only statistically significant but also economically substantial; given that each border county spends approximately 1.75 KSh per year ($16 million) on public goods provision, an illustrative calculation[3] suggests that free riding reduced spending on public services by between 651 million KSh ($5.9 million) to 704 million KSh ($6.4 million) per year between 2016 and 2017. The analysis also found a **substantial decline in the quality of and household access to important public services in border counties** after these governments reduced their spending.

The reduction in local government spending on public goods and services was **greater in counties where residents faced shorter distances and travelling time to reach services in the reform counties** (Figure 2). This is further support for the idea that neighbouring counties were free riding on increases in spending on public services in reform counties. As the cost of accessing services affects the ability to free ride, then this may be an important determinant of public spending.

Figure 2 Relationship between spending and accessibility



3 The exchange rate used is $1 = 110 KSh, the average over the years 2016 and 2017.

Border counties changed the composition of their expenditure, decreasing spending on public goods and increasing their spending on categories of expenditure that are likely to be associated with patronage and clientelism. High-frequency quarterly data shows that these increases were greater before elections – suggesting a strategic motive to influence electoral outcomes. This is consistent with theories of political budget cycles, signalling an incumbent's commitment to rewarding political supporters if re-elected (Rogoff, 1990; Capuno et al., 2015).

Increases were also higher for incumbents who had been in power for a long time and therefore may have already established clientelistic networks. This is to be expected as these politicians have had repeated interactions with voters, which means it may be clearer who to target and the types of benefits required (Dube et al., 2013). Over time, this enhances trust, which is crucial for maintaining clientelistic contracts and consolidating the payoffs from targeted spending (Keefer and Khemani, 2005).

Policy implications

The evidence suggests that Kenyan counties strategically benchmark their spending patterns against neighbouring counties governed by the *same* political party, and not against neighbouring counties ruled by different parties. This finding suggests that the spatial distribution of support for political parties, a proxy for political competition, can *reduce* the effectiveness of yardstick competition and affect budgetary outcomes. It appears to be consistent with the idea that the spatial distribution of parties creates multiple clusters of political markets, which in turn generates collective action problems – including some counties free riding on the efforts (and resources) of others. Further analysis reveals evidence of resource *mis*allocation, as counties that engage in free riding shift their spending from public to targeted goods. The cost is a reduction in welfare, demonstrated by a decline in both the quality of and access to public goods encountered by residents in these border counties.

Overall, these findings underline that while politicians and bureaucrats often take into account economic and social factors while formulating spending policies, these allocative decisions are complex, and political factors also play an important role. This has the potential to reduce the quality of public services and highlights the importance of understanding the incentives the broader political system creates for the decisions political leaders take on public spending. This can assist in ensuring that public financial management tools are tailored to better respond to the politics of the budget making process.

These findings have implications for policy. First, in contexts where fiscal decentralisation might increase clientelistc spending, the national and local governments may need to combine top-down and bottom-up approaches of accountability to help promote budget credibility and enable politicians to better align their spending policies with the objective of providing public goods and services. This could be achieved by using robust public management systems, especially well-designed development processes and plans that establish spending priorities. Central government could also play a key role, for instance by designing better fiscal transfer systems, such as those which incorporate conditionalities or spending rules, so as to guarantee a minimum level of spending on public goods. The national government will have to consider these sorts of measures, however, as they can limit the autonomy of local governments and reverse the gains associated with decentralisation (Fedelino and Smoke, 2013).

Second, the finding that free riding may reduce the quality of public spending through patronage further emphasises the importance of enhancing budget transparency. This could be through oversight mechanisms, like supreme audit institutions that produce audits or promote the publication of timely information about budgets and policy processes. Such information could play an important role, enabling central government to sanction poor performing politicians and helping citizens to local representatives accountable through the electoral process. There is evidence that independent audits can reduce the misappropriation of public resources (Avis et al., 2018) and greater political accountability can improve the quality of public services (Deininger and Mpuga, 2005).

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