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The Effect of Government Expenditure on Fiscal Deficits in Kenya

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Abstract:
In many economies world over, accountability and transparency as well as fiscal discipline in public expenditures take priority as the main catalysts to economic growth. However, large fiscal deficits have been reported in most developing countries which lead to inflation and currency devaluations. In this case, Kenyan government is no exception as its expenditures are consistently way above its revenues. This study therefore attempted to assess the relationship between government expenditure and fiscal deficit in Kenya. This study used a causal research design. Secondary data was obtained from the financial records of National Bureau of Statistics, The Economic Surveys, Kenya Institute of Policy Analysis and Research (KIPRA) and the Institute of Policy Analysis and Research (IPAR) ranging from year 2004/05 to 2010/11. Regression model was used to estimate the effect of government expenditure on fiscal deficits. The study established that a unit increase in government expenditure, increases fiscal deficit of GDP. The study recommends that the government of Kenya should come up with strong working policy to regulate the expenditure of its resources.

Keywords: *Government expenditure, fiscal deficits, recurrent expenditures, development expenditures, budget deficits*

1. Introduction

Fiscal deficit has become a big problem of the public sector financing in many countries. The widespread use of fiscal deficit as a financing tool is partly influenced by the desire of various governments to respond positively to the ever-increasing demands of the population and for enhancement of economic growth and development (Ariyo, 1993). Confronted with a cute resource gaps which have over time impeded economic growth, developing countries have to play an important role in promoting economic development particularly by mobilizing their own internal resources(Cinar, Ilhan& Baki, 2014). The implication is that effective spending policies have to be implemented which should be well designed if adequate resources have to be mobilized(Mohanty, 2012). Many developing countries are rarely able to raise revenues and finance all their undertakings. This implies that most of these countries find themselves with huge budget deficits (Navaratnam& Kesavarajah, 2016). Buchanan and Wagner (1977) posits that the rapid increase in government spending is caused by large deficits the argument being that the deficits are there anyway.

A weak capacity for credible fiscal policy would undermine the credibility of other macroeconomic policies especially if they are as sensitive to fiscal policy as monetary policies. Garba (1997) observe that federal government expenditure in Nigeria is not autonomous implying that if a part of federal government expenditure is endogenous, the relevance of conventional multiplier analysis to fiscal policy analysis and design becomes doubtful (Humera, 2015). Additionally, the capacity of the federal government to conduct credible fiscal policy is constrained by the inherent variability of endogenous expenditure(Pollin, 2012). The ramifications imply that a precise conceptualization and specification of federal expenditure reaction functions is indispensable to a potentially effective macroeconomic policy analysis and hence, to the attainment of the basic objectives of macroeconomic policy. Osoro (1997) finds that in Tanzania, public spending causes or drives public revenue which suggests that one of the causes of the deficits in Tanzania is the rapid growth in public spending. Arguably, measures to curtail deficits must consist mainly of policies to reduce spending. Policies meant to enhance revenue collection through broadening the tax base may be useful since empirical results indicate that more tax revenues do not lead to increased spending(Krugman, 2012).

Since independence recurrent expenditure has continued to be a major component of Kenya's budgetary process. Expenditures have persistently exceeded the revenues and both have maintained consistent growth patterns. Prior to the 1973/74 oil crisis, total revenue matched total expenditure. The country started to experience serious budget deficits thereafter calling for external sources of finance. Osei (1998) observes that the total expenditure as a percentage of GDP has declined steadily since 1985 when the Government started the implementation of the budget rationalization program
In Kenya the budget is an important tool that is used to control Government expenditures. The Kenya Government uses the Medium Term Expenditure Framework (MTEF) for budgeting which focuses on forward budgets(Odhiambo, Momanyi, Othuon & Fredrick, 2013). The MTEF is a three-year rolling planning exercise that establishes clear priorities for the allocation of recurrent and development resources (GOK, 2013). In the Policy Framework Paper of 1996, the government stressed on the need to maintain macroeconomic stability and continue with tightened fiscal policy that aims at lowering

domestic debt thereby allowing more credit to the private sector and reduction in real interest rates. Studies by Nyoni (1997), Killick (1991) and Corden (1984) observe that foreign aid increases government spending.

2. Fiscal Deficits

The high growth and the persistence of Government deficits have been observed in a number of countries. The economic effects of fiscal deficits are an important item on the macroeconomics agenda(Krugman, 2012). Khan (1988) argues that high deficits and the rapid growth in spending have been an issue of persistent debate among US economists and politicians. Osoro (1997) observes that low tax collection causes high and persistent deficits and maintains that such high deficits would be eliminated or substantially reduced by designing policies that would raise more tax revenues or improve tax collection(Humera, 2015). Other authors observe that rapid increase in public spending, rather than poor performance of tax revenue, is the major cause of high growth and the persistence of deficits in many developing countries(Nemanja, 2015). The author observed that government efforts to raise taxes will fail to reduce deficits if they do not go hand in hand with measures to reduce public spending (Tanzi, 1991).

The existence of a budget deficit, particularly chronic budget deficits, could have serious implications on the economy. When Governments find themselves running huge budget deficits, they might be forced to embark on one or more of the following approaches. Government could opt for discretionary tax measures (DTMS). This option tends to raise tax burden and is usually politically unpopular. Borrowing from the Central Bank fuels inflationary tendencies, whereas borrowing from the public especially through high yielding treasury bills exerts an upward pressure on other interest rates hence impeding private sector borrowing(Navaratnam & Kesavarajah, 2016). Where governments resort to international lending agencies, they should carefully analyze the debt servicing problems and stiff conditionalities imposed on foreign loans. This option for managing fiscal deficits is not only expensive but unsustainable and unpredictable (Siegel, 1979; Saede, 1990)

In many economies world over, accountability and transparency and fiscal discipline in public expenditures takes priority as the main catalysts to economic growth. Several projects and programs in many countries were externally financed and were initially started but with little or no accountability and transparency in their implementation, and quite a number of these projects were either not completed at all or were behind schedule in completion(Cinar, Ilhan & Baki, 2014). Virtually all developing countries separate recurrent budget from capital budget and attempt to finance recurrent budget from taxes, with some surplus over this going to the capital budget. The remainder of the capital budget is financed through domestic and or foreign borrowing. With introduction of conditionalities by development partners including requirement for stringent fiscal discipline, donor financing dwindled which called for most developing countries, including Kenya, to embark on Public Expenditure Reform Programmes (Feyzioglu, Swaroop and Zhu, 1999). Several externally financed projects and programs were initiated but with little or no accountability and transparency in their implementation ended as white elephants (Osei,1998; Devarajan, et. al; 1998).

Large fiscal deficits are a common feature in most developing countries which lead to inflation and currency devaluations. The magnitude of government surplus or deficit is probably the single most important statistic measuring the impact of government fiscal policy on an economy (Siegel, 1979). It is widely accepted that public sector finances and related policies constitute a central aspect of economic management the quality of which in no small measure influences overall macroeconomic performance as well as the distribution of resources between the public and private sectors. Buchanan and Wagner (1977) argue that fiscal deficits are the cause of rising public spending because they reduce the perceived tax price of publicly provided goods and services, therefore taxpayers respond by increasing their demand for such goods and services. Among the modes of financing government spending include; taxation, borrowing from the public, borrowing from the banking system (credit creation), loans and grants(Pollin, 2012). The costs associated with each of the alternative modes of financing determine how much should be from taxation and how much should be from other sources. Whereas a government can run a deficit over a long period of time households can only run a deficit for a limited time (Osoro, 1997).

The Kenya government is no exception as its expenditures are consistently way above its revenues. To mitigate this, the government has either resorted to inflationary financing or additional external financing with the consequent adverse effects on interest rates, the balance of payments and the value of the Kenya shilling.It is argued that fiscal deficits are the root of macroeconomic crisis, inflation, and external indebtedness and trade disequilibrium.This study therefore assessed the relationship between government expenditure and fiscal deficit in Kenya.

3. Materials and Methods

This study uses a causal research designto determine the effect of government expenditure onfiscal deficits in Kenya. The dependent variable was the fiscal deficit while the independent variables was the government expenditures. Government expenditure was measured as government expenditure/gross domestic product. On the other hand, fiscal deficit was measured using Total budget deficit/Gross Domestic Product. Secondary data was obtained from the financial records of National Bureau of Statistics, The Economic Surveys, Kenya Institute of Policy Analysis and Research (KIPRA) and the Institute of Policy Analysis and Research (IPAR) ranging from year 2004/05 to 2010/11. This period was selected to enable the researcher capture the dynamics in tax revenues, government expenditure and fiscal deficits during the era of globalization. Regression model was used to estimate the effect of government expenditure on fiscal deficits.

The following regression equation wasestimated;

$Y = \alpha + \beta X + e$ ……………………………………………………………………..(1)

Where *Y* is fiscal deficits while *X* is government expenditure, α is the constant term, β is the coefficient and e is the error term. Coefficient of determination (*r*) and (r^2) were estimated to determine the strength of the relationship between the variables. Tests of significance (t-test) were estimated to determine whether the relationship is significant.

4. Research Findings

The objective of the study was to determine the effects of government expenditure on fiscal deficits. In this case government expenditure was used as a predictor of government fiscal deficit, the rationale being that fiscal deficit is more driven by government expenditure as opposed to government revenue. The regression results are as provided in the Table 1 below.

Model Summary						
Model	R	R Square		Adjusted R Square	Std. Error of the Estimate	
1	.949(a)	.901		.882	.01479	
ANOVA(b)						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	.010	1	.010	45.673	.001(a)
	Residual	.001	5	.000		
	Total	.011	6			
Coefficients(a)						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.279	.052		-5.397	.003
	Government Expenditure	1.021	.151	.949	6.758	.001

Table 1: The Effect of Government Expenditure on Fiscal Deficits
a. Predictors: (Constant), Government Expenditure
b. Predictors: (Constant), Government Expenditure
c .Dependent Variable: Fiscal Deficits
d. Dependent Variable: Fiscal Deficits

The findings indicate a correlation coefficient (r) of 94.9% implies that there is a positive relationship between fiscal deficit and government expenditure. The coefficient of determination (r^2)of 0.901% denotes that the relationship is significant. The result of (r^2) can further be interpreted to mean that government expenditure can explain 90.1% of the fiscal deficits. The *F* value of 45.673 denotes that relationship is significant. Given a *p* – value of 0.001, it can be reasoned that the study reject the null hypothesis that government expenditure does not influence fiscal deficits. This regression model reveals that when government of Kenya incurs no expenditure, then fiscal deficit will be -0.279% of GDP. The results further show that a unit increase in government expenditure has a significant increment on fiscal deficit of GDP by 1.021% (*t* - 6.758, *p* – value 0.001). Thus, an increase in government expenditure will automatically lead to a significant increase in government fiscal deficit.

5. Conclusions and Recommendations

The study established that government expenditure affect fiscal deficits. Expenditure management principles including prioritization of expenditures, streamlining the law on expenditure management and defining appropriate parameters and ratios for recurrent versus capital expenditure is important. While recognizing that recurrent expenditures are high, particularly in many developing countries, governments in developing countries should not compromise their development agenda. While appreciating the role of development partners in the financing of development projects government should also define their development expenditure component which they should set aside for supporting development activities. For government to reduce its fiscal deficit there is need to reduce government expenditure. Deficit cutting measures goes hand in hand with expenditure cutting measures which is in line with the theory that one of the causes of government deficits is the high levels of Government spending. Therefore, there is need for government of Kenya to come up with strong working policy to regulate the expenditure of its resources.

6. References

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