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The Effect of Public Debt Composition and Government Expenditure on Economic Growth of Kenyan Government

Angela Mucece Kithinji

Abstract:
Many developing countries have high levels of public debt many of which do not have sufficient resources to meet the public debt obligations. The Kenya government has reported high debt levels the debt levels of which do not assume a downward trend but instead continue escalating from one year to another while not downplaying the role of the its huge expenditure. The major concern is whether some developing countries such as the Kenya government should raise more of foreign debt which is cheaper in terms of interest costs while adhering to the conditionality of lending countries or whether the country should borrow domestically despite the higher interest costs. It was thus feasible to establish the influence of the composition of the Kenya public debt and government expenditure on the country's economic growth. The study employed a causal research design. The period under study ranged from 2002 to 2017. The study used secondary data which was extracted from the National Bureau of Statistics, and National Economic Surveys which were available at the Government of Kenya website. Descriptive statistics was used to test the magnitude of the study variables. Regression analysis was used to establish the effect of public debt composition and government expenditure on economic growth in Kenya. The study established that both public debt composition and government expenditure had significant effect on economic growth of the country when tested individually. However, the findings further revealed that on the combined effect of the two independent variables, only government expenditure was found to influence economic growth unlike domestic public debt. The study therefore recommended that the government of Kenya should take precautions when engaging borrowing domestically and by extension in any form of borrowing.

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Introduction

Many developing countries are faced with high levels of spending, while their incomes are relatively low. Usually, weak revenue-generating systems are to blame for the debts. The Government has to adopt measures aimed at the reduction of the revenue, and excessive spending of the funds which in turn will usually have consequences on the level of the debt to be raised. That is why the Government is forced to pay back the debt for the financing of the activities that the Government may not be able to afford to be funded by the revenues that are generated with the help of the economic resources (IMF & World Bank, 2001). The public debt, is usually the main responsibility of a country, in particular in developing countries, where a large proportion of the national income that is spent on paying off the debt, which means there is very little in the financing of your business. The fiscal policy of the government, in order to ensure a safe, secure funding, including from participation in the medium-term objectives, combined with the flexibility to respond to changes in the economic conditions on the short term, the Bank for International settlements (Basel, 1999).

The measurement takes into account the cyclical changes in the economy, such as the increase of the government debt as a percentage of GDP, to give you some insight into the cyclical patterns in the world economy. In order to respond more to monetary policy than fiscal policy, and monetary policy, and the measures to be able to work faster than that of the tax policy the GDP of a given country is supposed to be steady. However, some researchers claim to be the opposite of that (Melecky, 2012). For instance, in developing countries such as Kenya, where the government uses government securities, such as treasury bills, as one of the instruments of monetary and fiscal policy decision-makers need to go into the level of detail in order to be able to have an intelligent, to say that the conduct of monetary or fiscal policy, it is more sensitive to the effects of the public debt. Treasury bonds, while being produced by the government for the long-term loans and advances shall not be a criterion for the determination of the interest rates, and the impact of macro-economic variables, the fact is that Treasury bills are quoted in the stock market, it is possible to indirectly affect not only the macro-economic variables, but also on economic fundamentals (Rainer, 2016).

The assessment of the impact of the issuance of the certificates to the key macro-economic variables that are of interest to policy makers, so that they will be able to formulate an appropriate policy in the reduction of the national debt (Onifade, et. al., 2020). In the Philippines, as the national government, with the co-ordinates of the conduct of monetary policy and its management of the public debt, through the chair of the Monetary Board and the government participates in the coordination of macroeconomic policies by the Board of directors of the National Economic and Development Authority (NEDA Board) (Redoblado; 2011). A country's public debt has an impact on the state budget, and in addition to the impact of macro-economic variables, as the government is lending are necessary in order to overcome the state's budget deficit. Thus, the public-sector borrowing and the need to be anchored in the budget process, in order to ensure that the debt increase is matched to the estimated amount (Guinigundo, 2015). It is also of fundamental importance in order to ensure that the budget of the levels of debt (whether domestic or foreign debt) are kept within acceptable limits relative to the increase in the budget and the budget.

The governments have to decide whether or not the collection of domestic or foreign debt and, in addition, a number of commercial and non-commercial debt. In which the development of the capital markets, it is one component of fiscal policy, the government should have a significant debt to finance the debt. The growth rate of your home loan will contribute to the development of national capital markets (Onifade, et. al., 2020). It will also

encourage more private companies to issue debt securities in the domestic financial markets. The public sector is often one of the few trusted issuers of long-term obligations, which is used for the provision of benchmarks, the rate of interest, and to create the conditions necessary for the private issuance of debt securities with long maturities. These long-term domestic debts could be used to finance long gestation projects, such as infrastructure, and could encourage greater private participation in infrastructure development (Alesina, et. al. 1992).

The problem of unsustainable public debt has brought many countries into deep economic crisis leading to regional and global crises. A government's debt portfolio often contains complex and risky financial structures which can generate substantial risk to the government's balance sheet and to the country's financial stability (Rahman, Shafinar & Ridzuan, 2019). Excessive levels of debt that result in higher interest rates can have adverse effects on real output. Governments should seek to ensure that both the level and rate of growth in their public debt is sustainable, and can be serviced under a wide range of circumstances while meeting cost and risk objectives. At the policy level debt managers should ensure that the fiscal authorities are aware of the impact of government financing requirements and debt levels on borrowing costs. It then becomes necessary to correlate public borrowing levels and financing of government projects that contribute to not only economic growth but to economic development in the long-term (Calderón and Fuentes, 2013).

Additionally, high debt servicing has thrown developing countries into a "debt trap" depriving them of the resources needed to secure long-term economic development and build up strong social and physical infrastructure. Essentially, good debt management will not by itself guarantee against future debt crises which are beyond government control, because governments have to borrow anyway, but it can however reduce a country's vulnerability to external and internal shocks. Debt market crises sometimes occur even where there are sound macroeconomic policy settings with risky debt management practices increasing the vulnerability of the economy to economic and financial shocks (GoK, 2011/2012). Policy makers on debt levels therefore need to not only monitor the levels of debt but also how the debt raised is used including monitoring the implementation of the projects that are financed using borrowed money (Maingi, 2017).

Sovereign debt management is the process of establishing and executing a strategy for managing the government debt in order to raise the required amount of funding, achieve its risk and cost objectives and to meet any other sovereign debt management goals the government may have set, such as developing and maintaining an efficient market for government securities. If macroeconomic policy settings are poor, sound sovereign debt management may not by itself prevent any crisis (Davide, 2016). Sound debt management policies reduce susceptibility to contagion and financial risk by playing a catalystic role for broader financial market development and financial deepening. Measures such as lengthening the maturities of borrowings and paying the associated higher debt servicing costs by adjusting the amount, the composition of foreign exchange reserves, and by reviewing criteria and government arrangements in respect of contingent liabilities are used to address debt market crises. From the point of the central bank, additional resident sourced sovereign debt would also reduce the incentive of the government to inflate its debt (Rahman, Shafinar & Ridzuan, 2019).

Poorly structured debt in terms of maturity and currency or interest rate composition and large and unfunded contingent liabilities have been important factors in propagating economic crises in many countries. The challenges of managing public debt differ from country to country and in some cases access to concessional borrowing – low interest loans with long payback periods – and debt restructuring take priority while in other countries access to the capital market is more important but in all cases governments have the ability to manage public debt effectively (Onifade, et. al., 2020). Many countries particularly in Africa borrow more from the financial market using tradeable and non-tradeable debt instruments and borrow very little from financial institutions directly. Essentially, there is need to decide whether these governments are going to raise debt from domestic sources or from external sources. One of the determinants of the source of debt is the maturity structure as well as the servicing cost of the debt. Many poor countries particularly in Africa resort to external borrowing to finance their public development programmes as domestic savings alone are not sufficient (Harding & Pagan, 2002). However, these countries are not able to raise sufficient foreign debt due to conditionalities imposed by the lender countries. They thus result to borrowing domestically despite the high cost of domestic debt and its high servicing costs (Rainer, 2016).

The institutional framework should encompass a legal framework which clarifies the authority to borrow, to issue, invest and undertake transactions by government from borrowed funds while organizational framework should be well specified including roles and mandates (Maingi, 2017). Linking the appropriate Government institutions with the institutions charged with the responsibility of managing public debt is important to ensure proper management of public debt whether domestic or external debt. To ensure accountability and transparency debt management activities should be audited annually by the auditor of government finances or by an external auditor. UNCTAD has assisted countries to come up with a debt management software; the Debt Management Financial and Analysis System (DMFAS) which can be used to manage external and domestic public debt as well as private debt and grants. It can also be integrated into other financial management systems used by government. In managing public debt countries should ensure that the government needs and payment obligations are met at the lowest possible cost over the medium to long-term, and that debt is assumed with a prudent degree of risk. Countries sometimes struggle to access concessional borrowing majorly at low-interest loans with long payback periods and debt restructuring take priority while others focus on debt that can be traded in in the capital market (Rodrigo, 2015).

RESEARCH PROBLEM

Many developing Countries have high levels of Public Debt many of which do not have sufficient resources to meet the public debt obligations. Governments should therefore seek to ensure that both the level and rate of growth in their public debt is sustainable and can be serviced under a wide range of circumstances while meeting cost and risk objectives. Debt managers should ensure that the fiscal authorities are aware of the impact of government financing requirements and debt levels on borrowing costs. For some countries public debt alone is not sufficient because the level of public domestic and public external debt and there cost implications is also necessary for informing policy (Maingi, 2017).

IMF and World Bank (2016) posits that the important ratios to measure debt sustainability are public debt to GDP ratio, public debt to government expenditure and public debt to tax revenues. The debt structure of borrowing by government which also an important parameter is measured by dividing domestic public debt by total public debt to get an

indication of public debt composition in terms of domestic versus external public debt which are the main types of public borrowings by government. Many governments seek to support debt structures by establishing where feasible, portfolio benchmarks related to the desired currency composition, duration, and maturity structure of the debt to guide the future composition of the debt portfolio (Rahman, Shafinar & Ridzuan, 2019). With respect to external debt management, domestic issuance would also reduce the currency risks faced by national government. Greater domestic issuance in domestic currency is said to reduce financial stability concerns. The shift from international debt to domestic debt means increasing the cost of servicing the debt since domestic debt is more costly than external debt in terms of interest costs (Onifade, et. al., 2020). To ensure financial stability, the attractiveness of public debt to foreign investors should not be underscored while realizing that most public debt has historically been held by residents. The need for liquidity calls for issue of short-term treasury bills which have negative implications for capital market development and long-term financial and macroeconomic stability (MartinezVazquez & McNab, 2001). The Kenya Government has reported high debt levels the debt levels of which do not assume a downward trend but instead continue escalating from one year to another. The major concern is whether some developing countries such as the Kenya Government should raise more of foreign debt which is cheaper in terms of interest costs while adhering to the conditionalities of lending Countries or whether the country should borrow domestically despite the higher interest costs. It is thus feasible to establish the relationship between the composition of the Kenya public debt and the country's economic growth while not downplaying the role of the huge government expenditure of the Kenya government (Maingi, 2017).

Empirical Literature review

Various studies have been carried out in relation to the concepts and context of under investigation. For instance, Calderón and Fuentes (2013) sought to establish how government debt influences economic growth of Latin America and the Caribbean region, South America. Their study revealed that public debt had a negative effect towards growth of countries' economy. Rahman, Shafinar and Ridzuan (2019). Research on the effect of public debt on economic growth? This was a systematic review of literature based on thirty-three journal articles. They realized that the scholars lacked mutual consensus in relating public debt with economic growth. In that, some found the relationship to be positive while some found a negative relationship and at the same time some results were even non-linear.

Based on statistics of the years ranging from 1963 – 2008, Maingi (2017) did a study testing the impact of government expenditure on economic growth in Kenya. The study established that GDP growth rate was statistically being associated with government expenditure. Furthermore, there was a bi-directional causality between growth rate of GDP and public expenditure. The impulse response functions result on variance decomposition disclosed that the components of government expenditure such as economic affairs, health care, physical infrastructure, investment, education, public debt servicing, national security defense, general administration and services, public order as well as government consumption were statistically affecting the economic growth of a country in terms of GDP growth.

A research done by Rainer (2016), sought to establish the effect of government debt on growth of GDP across three country clusters namely; Scandinavian (Nordic), Anglo Saxon (Liberal), and Core EU members (Continental). The results showed that more growth rate experienced in continental countries tend to reduce effects of public debt as compared to Liberal countries. The study further indicated that public debt seems to exert moderate

positive growth, and at the same time, a non-linear relationship was established in Nordic countries, producing a negative debt effects with a public debt value of about 60% of GDP. Onifade, et. al. (2020) carried out an empirical investigation on public expenditures and economic growth in Nigeria. They established that recurrent expenditures of government were found to be significantly impacting on economic growth in a negative way while the positive impacts of public capital expenditures were not significant to economic growth over the period of the study.

CONCEPTUAL FRAMEWORK

Based on literature reviewed, the study formulated its variables as displayed the conceptual model in Figure 1. It can be construed that public debt composition and government expenditure are the independent variables of the study. On the other hand, economic growth proxied by GDP is the dependent variable. The composition of the public debt has an effect on economic growth. The higher the domestic debt the higher the country's economic growth. Borrowing locally instills confidence on the citizens who are able to invest in government borrowing instruments which means that the citizens participate directly in financing government activities as lenders because they lend to government. Essentially the higher the level of domestic borrowing the higher the country's economic growth. Additionally, government need to control its expenditure for high economic growth to be realized through domestic borrowing. On the contrary high spending levels leads to increased economic activity and by extension increased economic growth. Therefore, even when governments borrow government needs to spend the borrowed money on productive activities and value adding government projects to realize the anticipated economic growth.

The conceptual model is as follows

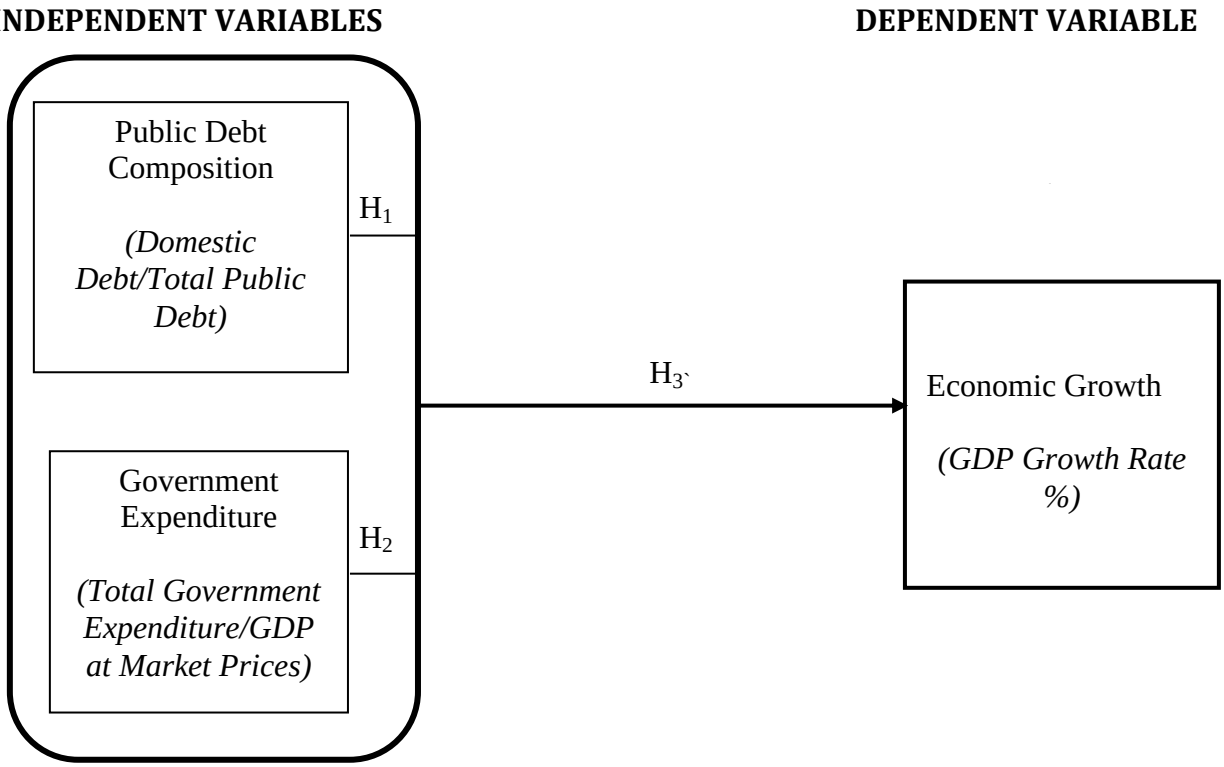

Figure 1: Conceptual Model

METHODOLOGY

The study employed a causal research design to establish the effect of public debt composition and government expenditure on economic growth in Kenya. The period under study ranged from 2002 to 2017 which was considered long enough to enable the researcher to derive conclusions and recommendations based on the study findings. Public debt composition was measured using a ratio of domestic debt/total public debt. The variable of government expenditure was measured as a ratio of total government expenditure/GDP. On the other hand, economic growth which was in this case dependent variable was measured in terms of GDP growth rate. The GDP at market prices was used in this study. The study used secondary data which was extracted from the National Bureau of Statistics, and National Economic Surveys which were available at the Government of Kenya website. Descriptive statistics was used to test the magnitude of the study variables. Regression analysis was used to establish the effect of public debt composition and government expenditure on economic growth in Kenya. The regression model was stated as below;

$Y = \alpha + \beta_1 X_1 + \beta_2 X_2$

Where Y is economic growth, X_1 is public debt composition, X_2 is Government expenditure, α is the constant term, and β_1 and β_2 are the regression coefficients of predictor variables.

Research Findings

The research findings were analyzed using descriptive statistics and inferential analysis where the study employed use of regression model to estimate the effect of the causal variables on independent variable.

Descriptive Analysis

Descriptive tests were estimated to establish various measures of central tendencies. Table 1 contains results on this estimates.

Table 1: Descriptive Analysis

Variables	N	Minimum	Maximum	Mean	Std. Deviation
Economic Growth (GDP)	20	1.50	7.00	3.7550	2.53553
Public Debt Composition	20	.37	.51	.3525	.18499
Public Expenditure	20	.22	.41	.2640	.14136

Research Data, 2021

The findings have shown that the minimum GDP growth was 1.5% and the maximum being 7%. On overall, the government of Kenya recorded 3.7% average GDP within a span of fifteen years that ranged from 2002 to 2017. The results as well revealed that the Kenyan government registered minimum debt ratio of 0.37 and the maximum debt ratio of 0.51. The results have further indicated that on average, the government had a debt ratio of 0.35. The minimum ratio of government expenditure 0.22 with maximum being 0.41. On average, the ratio of government expenditure within the study period was 26.4%

Regression Analysis

The regression statistics was done to help in determination of the relationships between variables. The estimation of goodness fit of the model was based on the R squared provided in the model summary results. Analysis of Variance (ANOVA) output was interpreted based on *F* and *p*– values where the study relied on a confidence interval of 95% and thus any hypothesis could be rejected if the error margin goes beyond 5% (0.05). The coefficient of variable estimation was done focusing on *t* – tests and *p* – values used in measuring the significance level of coefficients of each independent variable on dependent variable. Firstly, the study resolved to test the relationship between public debt composition and economic growth. This

was followed by a model testing the effect of public expenditure on economic growth and thereafter, estimated a combined effect of all the predictor variables (public debt composition and public expenditure) on dependent variable which in this case was economic growth measured base on GDP.

Effect of Public Debt Composition on Economic Growth

In estimation of the effect of public debt composition on economic growth, the summary results given in Table 2 indicate that the regression model provided a correlation *R*-value of 0.761 and an *R* squared value of 0.579. This has an indication that the public debt composition was found to have the ability of explaining about 57.9 percent of change in economic growth.

Table 2: Public Debt Composition and Economic Growth

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.761[a]	.579	.556	1.68986
a. Predictors: (Constant), Public Debt Composition				

ANOVA[a]						
Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	70.749	1	70.749	24.775	.000[b]
	Residual	51.401	18	2.856		
	Total	122.149	19			
a. Dependent Variable: Economic Growth (GDP)						
b. Predictors: (Constant), Public Debt Composition						

Coefficients[a]								
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval for B	
		B	Std. Error	Beta			Lower Bound	Upper Bound
1	(Constant)	.078	.830		.094	.926	-1.665	1.821
	Public Debt Composition	10.431	2.096	.761	4.977	.000	6.028	14.834
a. Dependent Variable: Economic Growth (GDP)								

The output of ANOVA shown in Table 2 provided a value of 70.749 being the sum square of a regression with the same mean value. The model gave a sum square for residual as 51.401 with mean square value of 2.856. The model further gave an *F* – value of 24.775 and a strong *p* – value of 0.000. This revelation therefore guides the study to reject the null hypothesis that public debt composition does not have significant influence on economic growth since the *p* – value is below the recommended 0.05. The coefficient results have shown that the composition of public debt has a strong relationship towards economic growth of the country. This relationship provided a coefficient value of 10.431 (t = 4.977) and a *p* value of 0.000).

Effect of Government Expenditure on Economic Growth

Another predictor variable under investigation was government expenditure and thus the study tested its effect on economic growth. The summary of model results produced an *R* value of .833 and an *R* squared of .693 as shown in Table 3. This has indication that public expenditure is likely to explain change in economic growth by a margin of 69.3% the remaining percentage can be explained by different variables not included in the model.

Table 3: Government Expenditure and Economic Growth

Model Summary				
Model	**R**	**R Square**	**Adjusted R Square**	**Std. Error of the Estimate**
1	.833[a]	.693	.676	1.44314
a. Predictors: (Constant), Public Expenditure				

ANOVA[a]						
Model		**Sum of Squares**	**Df**	**Mean Square**	**F**	**Sig.**
1	Regression	84.662	1	84.662	40.651	.000[b]
	Residual	37.488	18	2.083		
	Total	122.149	19			
a. Dependent Variable: Economic Growth (GDP)						
b. Predictors: (Constant), Public Expenditure						

Coefficients[a]								
Model		**Unstandardized Coefficients**		**Standardized Coefficients**	**t**	**Sig.**	**95.0% Confidence Interval for B**	
		B	**Std. Error**	**Beta**			**Lower Bound**	**Upper Bound**
1	(Constant)	-.187	.697		-.268	.791	-1.652	1.278
	Public Expenditure	14.933	2.342	.833	6.376	.000	10.012	19.853
a. Dependent Variable: Economic Growth (GDP)								

The analysis of variance findings indicated in Table 3 show a regression sum square value of 84.662 (Mean square = 84.662) and a residual sum square of 37.488 (Mean square = 2.083). The government expenditure and GDP model provided an *F* – value of 40.651 with a significance value (*p* = 0.000). This could imply that we should reject the null hypothesis that public expenditure does not affect economic growth within the Kenyan government significantly since the error we make by doing so is <0.05. The coefficient results for expenditure and GDP shows that economic growth is significantly affected by public expenditure as it gave a coefficient value of 14.933 (*t* = 6.376) supported with a significant *p* value of .0000. In other words, an increase in the economic growth is likely to increase the rate of public expenditure in Kenya.

Joint Effect of Public Debt Composition and Government Expenditure on Economic Growth

After estimating the effect of individual predictor variables on independent variable, the study resolved to test the combine effect of both public debt composition and government expenditure on economic growth of the country in terms of GDP. The summary results given in Table 4 indicate that the regression model provided a combined correlation *R*-value of 0.841 and an *R* squared value of 0.708. This has indication that the two independent variables under study (public debt composition and government expenditure) were found to explain approximately 70.8 percent of variation in GDP of the country. An indication that there exist other predictor variables not in the model which could be included to improve the model's goodness of fit.

The output of ANOVA gave a regression sum square of 86.462 and a residual sum square of 35.687 with mean square value of 43.231 for regression and 2.099 for residual. The model provided an *F* – value of 20.594 and a significant value of 0.000. The model therefore informs us that the public debt composition and government expenditure as independent variables were acceptable and fit to determine the GDP of the country. This could be an indication that the joint effect of all the predictor variables used in the study is significant in influencing economic growth. Thus, the study rejects the null hypothesis that public debt composition and government expenditure together do not significantly influence economic growth of the country.

Table 4: Effect of Public Debt Composition and Government Expenditure on Economic Growth

Model Summary				
Model	**R**	**R Square**	**Adjusted R Square**	**Std. Error of the Estimate**
1	.841[a]	.708	.673	1.44887
a. Predictors: (Constant), Public Expenditure, Public Debt Composition				

ANOVA[a]						
Model		**Sum of Squares**	**Df**	**Mean Square**	**F**	**Sig.**
1	Regression	86.462	2	43.231	20.594	.000[b]
	Residual	35.687	17	2.099		
	Total	122.149	19			
a. Dependent Variable: Economic Growth (GDP)						
b. Predictors: (Constant), Public Expenditure, Public Debt Composition						

Coefficients[a]								
Model		**Unstandardized Coefficients**		**Standardized Coefficients**	**t**	**Sig.**	**95.0% Confidence Interval for B**	
		B	**Std. Error**	**Beta**			**Lower Bound**	**Upper Bound**
1	(Constant)	-.061	.713		-.086	.932	-1.566	1.443
	Public Debt Composition	-5.713	6.168	-.417	-.926	.367	-18.727	7.301
	Public Expenditure	22.084	8.072	1.231	2.736	.014	5.054	39.114
a. Dependent Variable: Economic Growth (GDP)								

Based on the results on coefficients, it can be construed that despite predictor variables showing some significant relationship towards economic growth in the individual tests, only government expenditure was found to predict GDP significantly when they are grouped together. Public expenditure gave a coefficient value of 22.084 (t = 2.736, p = .014). On the other hand, public debt composition was found to have a weak relationship towards economic growth as it reported a coefficient value of -5.713 accompanied with a t value of .926 and an insignificant p value of .367.

Conclusion and Recommendations

The study concludes that public debt composition and government expenditure can influence economic growth of the country when tested individually. On the other hand, the study can conclude that public debt reduces its power when put together with government expenditure on their effect towards economic growth. This shows that government with well-structured public debt management strategy should reduce the borrowing cost, contain financial risks and develop their domestic markets. As the economy of any given country grows, it gives the government ability of planning its expenditure. Where countries have weak systems for debt management technical assistance for external debt management and debt tracking can play an important role and should be strengthened.

The results have shown that in absence of public debt, economic growth can improve based on how the government spending. Both the public debt and government expenditure can lead to change in economic growth because money that is borrowed from internal sources is spent on financing government activities. The major concern is whether some developing countries such as the Kenya government should raise more of public debt that is cheaper in terms of interest costs while adhering to the conditionality of lending organs. Countries make choices between raising public debt since lenders are sometimes hesitant to lend as the impose conditionalities which dictate how much these developing countries can borrow. The almost inevitable result is when a country experiences an increase in foreign borrowings in times of reduction in taxation. The ability to pay back the debts would be far-reaching without stead

income gotten through taxation. This study therefore recommends that the government should plan to spend based on its available means of getting funds

The study recommends that the government of Kenya should take precautions when engaging in any form of borrowing. Effective public expenditure remains an intrinsic part of sound public financial management and overall good governance it is therefore advisable to spent best on the available resources. Additionally, the government should balance public debt financing and consolidated financial position of government and be keen on how the composition of public debt fits into the government consolidated financial position while adhering to government disclosure requirements in line with the required transparency and accountability in government.

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