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Does The Composition of Public Expenditure matter to Economic Growth for Kenya?

John Mudaki * Warren Masaviru

School of Business and Economics, Moi University
P.O Box 39-30100, Eldoret, Kenya
Tel: +254 0722 426 863
*E-mail: mudakijohn@gmail.com

Abstract

There is often controversy and debate on the most appropriate way of allocating public funds in Kenya, necessitating the need to investigate the effect of the composition of public expenditure on economic growth. This study investigated the impact of public spending on education, health, economic affairs, defense, agriculture, transport and communication on economic growth with data spanning from 1972 to 2008. The data was differenced to make it stationary then linearized for estimation using ordinary least squares. The findings showed that expenditure on education was a highly significant determinant of economic growth while expenditure on economic affairs, transport and communication were also significant albeit weakly. In contrast, expenditure on agriculture was found to have a significant though negative impact on economic growth. Outlays on health and defence were all found to be insignificant determinants of economic growth. The findings did not conform to apriori expectations.

Keywords: Economic Growth, Public Expenditure,

1.0 Introduction

In recent times Kenya has experienced numerous strikes from public servants agitating for more pay alongside higher revenue allocations. The Doctor's strike of December 2011 is a remarkable example. The doctors were among other things demanding that the government increases the budgetary allocation to the heath sector from the current 7 per cent to 15 per cent of the national budget besides upgrading health facilities and investing in hospital infrastructure to the tune of Kes 10 billion over a two year period and hiring more doctors. The education sector has also been characterized by striking teachers demanding for more pay and a bigger share of the national budget for investment in education related activities. Inaddition, The Kenya Defence Forces engaged in a military pursuit of the Al-Shabaab militia in the year 2011 and consequently demanded an even larger share of the national budget. Nearly all sectors of the Kenyan economy demanded more budgetary allocations in 2011.This brought about the need to examine and determine the effect of sectoral budgetary allocations on the national economy to generate the much needed information critical in decision making and prioritizing expenditure.

In this quest to get further insights into the linkages between fiscal policies and economic growth, more research should be done to identifying the elements of public expenditure that have significant association with economic growth (Bose, Haque & Osborn, 2003). Furthermore, existing studies on the linkages between public expenditure and economic growth showed conflicting results. For instance, according to Ram (1986) and Romer (1989, 1990a, 1990b), there was a significant and positive relationship between public expenditure

and economic growth. In contrast, Landau (1983, 1985, 1986), Grier & Tullock (1989), Alexander (1990), Barro (1990, 1991) found a significant but negative relationship. Kormendi & Meguire (1985), Levine & Renelt (1992) found the association between public expenditure and economic growth to be insignificant. These conflicting findings highlighted the importance of more research to identify the linkage between the composition of public expenditure and economic growth for developping countries.

The very popular and widely acceptable theories of public expenditure are the Wagner's law of increasing state activities, Keynesian, Wiseman and Peacock's theories. According to Wagner (1883), causality runs from economic growth to public expenditure. The thrust of Wagner's Law is that as a country's output increases, public expenditure increases as well but at a much faster rate. Bağdigen & Çetintaş (2003) reaffirmed Wagner's suggestions that had shown that there was a relationship between the growth of a country's output and public expenditure and this relationship was in one direction; from the growth of country's output to public expenditure. According to Wagner (1883), public expenditure rises constantly for most countries. It shows an upward sloping trend. In contrast, Keynes (1964) assumes that causality runs from public expenditure to economic growth in times of recessions. The Keynesian theory postulates that expansion of government spending accelerates economic growth. The Wiseman and Peacock's hypothesis says that there is usually considerable increase in revenue to governments due to the economic developments over the years, thereby leading to an increase in public expenditure. Wiseman & Peacock (1961) argue that spending increases when governments spend to meet demands made by the population regarding various services. Further during wars, tax rates are increased by the government to generate more funds to meet the increase in defense expenditure; such an increase in revenue therefore gives rise to government expenditure (Peacock & Wiseman, 1961).

The objective of this paper was to examine the impact of sectoral public expenditure on economic growth for Kenya with an intention of establishing which specific components of government expenditure had a significant impact on economic growth for the period of the study. The study focused on establishing the linkages between public expenditure on education, health, agriculture, transport and communication, economic affairs, defense, manufacturing and economic growth. This disaggregated analysis was important from the policy perspective. The results for the economic impact of sectoral public expenditures gave rise to information that is critical for developing countries which are resource constrained and therefore need to allocate the limited resources optimally. The paper was organized as follows. In section the introduction is presented followed by a review of literature in section 2. In section 3 the econometric models to be estimated were specified and a presentation and interpretation of the results made in section 4. Finally, recommendations and conclusions are made in section 5.

2.0 Literature review

Keynes (1964) advocated for government spending to create jobs and employ capital that has been unemployed or underutilized when an economy is in a downturn with high unemployment of labor and capital. Keynes's theory postulates that government spending is needed to increase economic output and promote growth.

However, Stratmann & Okolski (2010) argued that there are many spending options for governments who might not know where goods and services can be most productively employed and therefore spending might not stimulate desired growth when it does not accurately target the projects where it would be most productive. This information problem

confounded by a non-progressive political process can stunt economic growth (Stratmann & Okolski, 2010). Tullock (2010) was in agreement with Stratmann & Okolski (2010) and suggested that incumbent politicians and bureaucrats seeking re-election try to gain control of as much of the economy as possible and so preferentially allocate money arbitrarily to favored groups rather than spend it where it would be most productive in an attempt to maximize votes. Similarly, Wright (1974) found in his research to account for the differences in per capita federal spending to the states during the Great Depression that instead of allocating spending based purely on economic need during a crisis, the party in power may distribute funding based on the prospect of political returns. Moreover, lobbying the government for resources by interest groups and the private sector leads to misallocation of resources. These political processes do not favor economic growth. Stratmann & Okolski (2010) also argued that an increase in government spending crowds out private spending and interest sensitive investment by increasing the tax burden on citizens either now or in the future which leads to a reduction in private spending and investment. They further argued that government spending reduces savings in the economy, thus increasing interest rates and this could lead to less investment in productive sectors of the economy. Conversely, when governments cut spending, there is a surge in private investment.

The fiscal multiplier is seen as a way that government spending can fuel growth. However, Barro & Redlick (2009), Ramey (2009) found that in practice, unproductive government spending is likely to have a smaller multiplier effect and that government spending may actually decrease economic growth, possibly due to inefficient use of money. In fact, a large pool of studies found no positive correlation between government spending and economic growth. For instance, Mueller & Stratmann (2002) in a study of 76 countries, Akpan (2005) and Laudau (1983), Wadal and Kamel (2009), Tomori and Adebiyi (2002), Fosu (2001) and Adebiyi (2003) found a statistically significant but negative relationship between government spending and economic growth.

However, Easterly & Rebelo (1993) in an examination of empirical data from approximately 100 countries from 1970-1988, Korman & Brahmasrene (2007) in their co-integration analysis for Thailand, Donald & Shuaglin (1993), Gregorious & Ghosh (2007) and Gupta *et al*.,(2002) found a positive correlation between general government investment and GDP growth. Further, Donald and Shuanglin (1993) found that government expenditure on education and defense had positive impact on economic growth. However, the effect of welfare expenditure was insignificant and negative for the 58 sampled countries. Although Wadad and Kamel (2009) found a short-run negative correlation between education and economic growth, they found that in the long-run educational spending was a statistically significant determinant of economic growth but found spending on defense was to be insignificant both in the short–run and the long-run. Deger & Smith (1983), Knight *et al*., (1996) found similar results for defense.

In contrast, Devarajan *et al*. (1993), in their study of 140 OECD countries, found that spending on education and defense did not have a positive impact on economic growth. It was rather expenditure on health, transport and communication that was significantly and positively related to economic growth. Similarly, Diamond (1989), Barro (1991), Easterly & Rebelo (1993), Romer (1990), Folster & Henrekson (1999) found that government spending was not a significant determinant of economic growth. In light of these findings, Barro and Sala-i-Martin (1992) cautioned that government expenditure may be productive or unproductive.

Loto (2011) specified the growth model in equation 2.0 below to study the link between government spending on Education (E), Health (H), Security (SEC), Agriculture (Ag) and Transport & Communication (TC) on and economic growth for Nigeria:

$g = \alpha_0 + \alpha_1 E + \alpha_2 H + \alpha_3 SEC + \alpha_4 Ag + \alpha_5 TC + \mu$ 2.0

His findings unlike those by Korman & Brahmasrene (2007), Donald & Shuaglin (1993), Gregorious & Ghosh (2007) and Gupta *et al*.,(2002) showed that spending on education had a negative and insignificant relationship with economic growth (attributed to brain drain) while on the other hand health expenditure was found to be positively and significantly related to economic growth. Further, Loto (2011) found government spending on security, transport and communication was found to have a positive but insignificant impact on economic growth. Spending on agriculture though found to be significant was negatively related to economic growth.

Similarly, Bağdigen & Çetintaş (2003) examined the Wagner's Law of long-run relationship between public expenditure and GDP for the Turkish case over the period of 1965-2000 where public expenditure was supposed to be an outcome, but not a cause of growth in GDP. Using the co-integration test and the granger causality test they found no causality in both directions prompting them to conclude that neither Wagner's Law nor Keynes hypothesis was valid for the Turkish case. Yamak & Küçükkale's (1997) found empirical evidence to support the Wagner's law of causality from economic growth to public expenditure for Turkey. However, Demirbas's (1999) found no evidence to support both the Wagner's law and Keynesian hypothesis for the Turkish case and therefore concluded that there was no causation from economic growth to public expenditure or from public expenditure to economic growth for Turkey.

Bose, Haque & Osborn (2003) examined the impact of public expenditure by sector on economic growth for a panel of thirty developing countries paying attention to the "sensitivity" issue arising from initial conditions and conditioning variables while also avoiding the omission bias that may result from ignoring the full implications of the government budget constraint. They found that education was the key sector to which public expenditure should be directed in order to promote economic growth. This was contrary to previous findings of negative or insignificant effects of education expenditure on economic growth for developing countries by Landau (1986), Miller & Russek (1997) and Devarajan *et al.* (1996). Secondly, they found that the share of government capital expenditure in GDP to be positively and significantly correlated with economic growth, while the impact of recurrent expenditure on economic growth was insignificant for their group of countries. They also found that public expenditures in the defense, transport and communication sectors had a significant impact on economic growth but became insignificant when they incorporated the government budget constraint and other sectoral expenditures into their analysis. The private investment share of GDP was significantly and positively related to economic growth. There was strong evidence that a government budget deficit gave rise to adverse growth effects.

3.0 Specification and Estimation of Econometric Models

The model used by Loto (2011) to estimate the impact of public expenditure on economic growth for Nigeria was adopted for the Kenyan case. Loto (2011) designed a model similar to the one used by Tsoukas & Miller (2003) and Manh & Terukazu (2006) who specified public capital expenditure, public current expenditure, tax rate and technology as the determinant factors of economic growth in a CES production function.

The model that was estimated in this study is specified below:

RGDP = F (EXPEA, EXPED, EXPH, EXPDEF, EXPAGRI, EXPTRSPT, EXPMAN)… (3.1)

In log-linear form the model is specified as:

$$\ln RGDP_t = Ln\beta_0 + \beta_1 \ln EXPEA_t + \beta_2 \ln EXPED_t + \beta_3 \ln EXPH_t + \beta_4 \ln EXPDEF_t$$

$$+ \beta_5 \ln EXPAGRI + \beta_6 \ln EXPTRPT + \beta_6 \ln EXPMAN_t + \varepsilon_t \ldots\ldots\ldots\ldots\ldots\ldots (2)$$

Where:

RGDP- Real Gross Domestic Product

EXPDEF-Expenditure on Defense

EXPEA-Expenditure on Economic Affairs

EXPH- Expenditure on Health

EXPE- Expenditure on Education

EXPTRPT-Expenditure on Transport & Communication

EXPAGRI-Expenditure on Agriculture

EXPMAN-Expenditure on manufacturing

3.1 Types and Sources of Data

The data set on public expenditures was obtained from the Kenyan Statistical Abstracts and Economic Surveys published annually by the Central Bureau of Statistics and the Central Government. These annual publications have established themselves as reliable sources of data for the Kenyan Economy.

4.0 Presentation and Interpretation of Results

An empirical analysis of the relationship between economic growth, components of government expenditure and other macroeconomic variables requires appropriate estimation techniques for both the long run and short run analysis. However, this study takes the first step to examine the properties of the time series and estimate the regression using ordinary least squares. An analysis of the extent of cointegration between the variables and investigating the long run and short run relationships between the variables will be taken up in another study.

Using the Augmented Dickey Fuller (ADF) test, it was found that all the variables were non-stationary at levels, thus leading us to test for stationarity at first differences, which showed that all the variables were stationary at first difference at 1 per cent level of significance as seen in table 1 below.

Table 1: Testing the Order of Integration by Applying Unit Root Test

	Test Applied	
Variable	Augmented Dickey Fuller (ADF)	Phillip Peron (PP)

LNRGDP	I(1)*	I(1)*
LNEXPEA	I(1)*	I(1)*
LNEXPED	I(1)*	I(1)*
LNEXPH	I(1)*	I(1)*
LNEXPDEF	I(1)*	I(1)*
LNAGRI	I(1)*	I(1)*
LNEXPTRPT	I(1)*	I(1)*
LNEXPMAN	I(1)*	I(1)*

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Source: Authors' Workings

Notes: i) * denotes the significance at 1% level; ii) LN stands for Natural Logarithms.

Both tests led to the conclusion that all the variables were integrated of order one I(1), which means that the data are non-stationary at levels but stationary at first difference.

4.1 Regression Results

Ordinary least square was used to estimate the log-difference of RGDP on the independent variables appearing in equation (1) above. The regression results are shown in the table 3 below:

Table 3:

Ordinary Least Squares Estimation

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Dependent variable is LNRGDP

36 observations used for estimation from 1973 to 2008

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Regressor	Coefficient	Standard Error	T-Ratio [Prob]
CONSTANT	3.1737	.13169	24.1004[.000]
LNEXPEA	.082283	.070095	1.1739[.250]
LNEXPED	.94529	.045534	20.7601[.000]
LNEXPH	.1937E-3	.032216	.0060124[.995]
LNEXPDEF	-.0061434	.030429	-.20189[.841]
LNEXPAGRI	-.084368	.039314	-2.1460[.041]
LNEXPTRPT	.018818	.023145	0.81306[.423]
LNEXPMAN	-.014871	.012304	-1.2086[.237]

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R-Squared	.99838	R-Bar-Squared	.99798
S.E. of Regression	.065109	F-stat. F (7, 28)	2469.0[.000]
Mean of Dependent Variable	12.1443	S.D. of Dependent Variable	1.4480
Residual Sum of Squares	.11870	Equation Log-likelihood	51.7826
Akaike Info. Criterion	43.7826	Schwarz Bayesian Criterion	37.4485
DW-statistic	1.4849		

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Source: Authors' Workings

4.2 Interpretation of Results

The findings showed that public expenditure on education was a highly significant and positive determinant of economic growth with a very high t-ratio. A unit percentage increase in expenditure on education will, loosely speaking, increase real gross domestic product by about 0.95%. Expenditure on agriculture on the other hand was also found to be a significant albeit negative determinant of economic growth which did not conform to the apriori expectation of a positive linkage between agriculture and economic growth. The findings showed that a unit percentage increase in expenditure on agriculture would reduce real gross domestic product by about 0.08%.

Interestingly and unexpectedly expenditure on economic affairs, health, transport and communication was found to positively but weakly matter to economic activity. Further, outlays on defence and manufacturing were found to be not only negative but also insignificant determinants of economic growth.

The value of R-Squared was extremely high (0.99838) suggesting that the variables included in the model collectively explained 99.83% of all the determinants of economic growth. This finding pointed towards the need to subject the data to even more robust statistical checks to avoid spurious correlations. The Durbin Watson statistic was below the usually recommended value of 2.0 which again pointed towards the probability of serial correlation among the variables.

5 Conclusions and Recommendations

Before allocating resources governments should use the best peer-reviewed literature to assess whether spending in that particular area is likely to stimulate growth. Unfortunately, researchers investigating the link between sectoral public expenditure and economic growth have found divergent results. This has confounded the problem.

Our findings showed that public expenditure on education is critical in enhancing economic growth. This finding corresponded to findings by Donald and Shuanglin (1993), Wadad and Kamel (2009), Deger & Smith (1983), Loto (2011) and Knight *et al*., (1996) but contrasted those by Devarajan *et al*. (1993) for 140 OECD countries. From the findings, the authors hasten to recommend increased expenditure on education as one of the key pillar/determinant of economic growth for Kenya.

On the other hand the authors hesitate to recommend reduced government spending on economic affairs, health, transport and communication which were found to be near insignificant determinants of economic growth. Though expenditure on defence and manufacturing were also found to be insignificantly related to economic growth, the authors suspect that inadequate investments and inefficiencies, slow adoption of technology, corruption & embezzlements in these areas led to this adverse finding. However, the authors resort to economic theory to recommend increased spending in these sectors which remain important pillars of the economy.

Increased outlays on agriculture though found to be significant but negatively related to economic growth should guarantee national food security. This finding could have been caused by an inefficient agricultural sector majorly focused on crop farming and not

extensively mechanized. Despite this finding and on the basis of economic rationale more resources should be channeled to the agricultural sector to make it more productive.

Expenditure on manufacturing was also found to be statistically insignificant, however, manufacturing is arguably one of the most sang engine of economic growth and so we exercise prudence and recommend more outlays to this sector. It is probable that this variable was found to be insignificant because quality research and adequate resources are not channeled to this sector not only in Kenya but also in other developing nations.

In summary and from the findings of this paper it becomes increasingly important to explore further what portfolio of government outlays are ideal for growth to support resource constrained governments on optimal resource allocation and prioritization of expenditure.

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EXTRACT OF DATA

Kshs Million

YEAR	RGDP	EXPEA	EXPED	EXPH	EXPDEF	EXPAGRI	EXPTRPT	EXPMAN
2008	2099798	154203.38	151676.86	36121.90	41209.46	28331.83	45677.67	535.89
2007	1825960	99037.84	124908.59	302282.54	36741.86	20460.30	31105.67	153.89
2006	1622434	71420.75	109238.90	27517.68	25122.90	14141.61	44478.40	568.90
2005	1415724	49488.64	96027.43	22963.79	31161.04	10610.70	18550.40	475.30
2004	1274311	47307.50	84726.31	16308.89	20979.25	10266.20	13507.30	879.40
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1972	15052	731.96	807.56	255.46	238.92	250.62	639.42	51.56
Average	**478824.03**	**24760.92**	**32379.51**	**15283.54**	**9405.94**	**6173.35**	**8397.72**	**1005.28**

Source: Central Bureau of Statistics & Central Government