

# Good Governance, Development Expenditure and Economic Growth: Theoretical Review

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**Abstract:** Inefficiencies in development expenditure have led to increased calls for more governance in Kenya. The quality of governance, more so good governance, has been fronted as a prerequisite for economic growth, hence its inclusion as a key influencing factor in the efficient management of development expenditures. This paper offers a background on good governance, public expenditure and economic performance. It also provides a theoretical and empirical overview on the relationship between good governance on development expenditures in Kenya by reviewing other literature on the topic. This paper concludes that promoting good governance in Kenya is significant in improving efficiency in development expenditures leading to economic growth. Also, the paper creates a platform where further insight can be provided through empirical research.

**Keywords:** Governance, development, growth-enhancing, expenditure, economic growth, good governance.

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## I. INTRODUCTION

It is the government's duty to provide quality services to its citizens, and that provide a conducive environment for productive activities and hence economic growth. This is done through efficient management of development expenditure. Without delving into the intricacies of public finance, public expenditure can be divided into two main parts; recurrent expenditure and development expenditure. Development expenditures such as health, education and infrastructure are also called growth-enhancing expenditures as they are crucial in growing an economy. Efficiency in development expenditure can be regarded as when expected outcomes are matched against allocated spending. It is also when maximum social welfare is achieved and the needs and interests of the citizens are fulfilled. Efficiency increases performance and this is experienced with positive economic growth.

However, more often than not, expected outcomes do not match the expenditures creating inefficiencies. One of the main reasons attributed to this inefficiency is the quality of good governance. Good governance is a concept that has attracted a lot of attention recently, in an environment where transparency and accountability are increasingly being demanded in the management of public finance. Good governance, a very elastic and multi-dimensional term, is generally defined as the process through which power is exercised in the management of public funds (Gisselquist, 2012; Keefer, 2004). There are numerous studies which explain the growth and importance of these expenditures to economic development and performance and lately, many scholars are incorporating good governance as a factor to analyse its impact on improving efficiency in growth-enhancing expenditures and enhancing economic performance.

This relationship has led development partners such as the World Bank, IMF and the UN to assist in formulating governance reforms in developing countries. Funding from such institutions has become conditional depending on the efforts and progress made in successfully implementing the reforms. The reforms are aimed at allowing for more public participation, civil liberties (where civil societies become agents of the development partners), accountability and transparency in the public sector and political rights. However, despite the steps and measures undertaken by both governments and development partners to improve good governance through accountability and transparency, developing countries like Kenya are still inundated with poor economic performance. This is because of the unwillingness of the

government and its actors to align their actions and decisions with public interests and needs (Gisselquist, 2012; Republic of Kenya, 2011). As Waheduzzaman (2008) notes, the World Bank for instance, has over 600 initiatives aimed at promoting good governance with the main objective of enhancing efficiency in public spending systems. These initiatives produce marginal returns in most cases due to the unwillingness to cooperate.

Studies on the relationship between good governance, public expenditure and economic growth have shown that the higher the quality of governance, the higher the efficiency levels in public expenditure, and the more likely a country will encounter significant growth. Poor or bad governance contributes to poor economic performance. As Ndulu and O’Connell’s (1999) study showed, trends in the growth rates of GDP and per capita incomes for developing countries in Sub-Saharan Africa show a discernible pattern that they attributed to authoritarian rule during periods of reduced economic growth and enhanced democracy during periods of increased economic growth post-independence era. Kenya’s economic growth trends is similar to the trends of the region studied; growth during the 1960s, decline in the following two decades and marginal improvements in the decade beginning 1990 (World Bank, 2017).

In 1989, the World Bank established the concept of good governance to improved observed inefficiencies of the previous two decades. Therefore, the improvements observed in economic growth are partially the result of efficient public finance systems which were in turn a product of enhanced democracy, one of the underlying principles of good governance. Thus, the link between poor performance and quality of institutions in Kenya, economic and political, is visible when trends in both economic and political events are observed. In the last 15 years, good governance reforms and policies instituted to improve efficiency are not reflective of the growth in public expenditures, more significantly, development expenditures given the marginal good governance performance that Kenya has witnessed. According to the World Bank’s (2017) latest World Governance Indicators index, Kenya’s performance has increased from -0.75 to -0.59 a growth rate of 4% annually. With a scale range of -2.5 to 2.5, this shows that the country’s performance is still below the mid-line and more needs to be done to improve the situation. In the same period, development expenditures have grown at an annual rate of 25% (CBK, 2017).

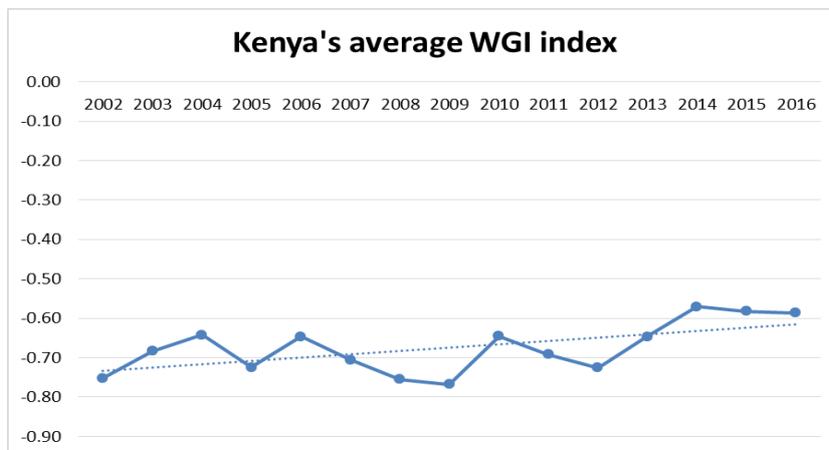


Fig 1. Average WGI Index (2002-2016)

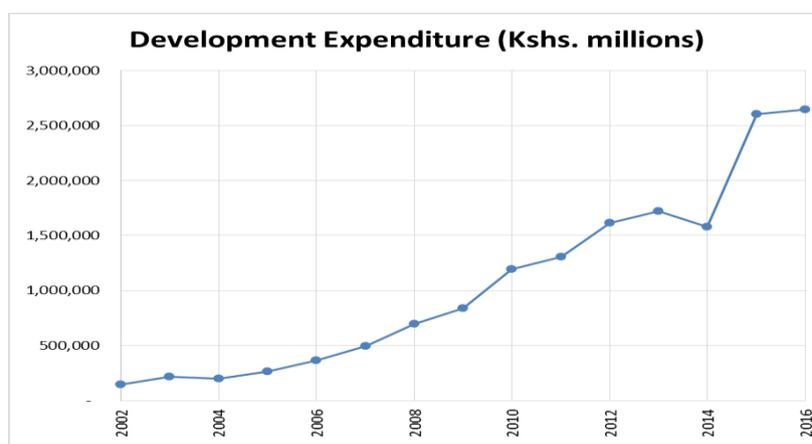


Fig 2. Development Expenditure Trend (2002-2016)

Bad governance is one of the key reasons for public expenditure inefficiency and poor economic performance. Key among the indicators is corruption which has contributed to the misappropriation of funds and diversion from growth-enhancing functions by actors in the public sector. Corruption has been generally defined as abuse of public office for private gain (Leruth and Paul, 2006). In Kenya, lack of commitment towards fighting graft in the public sector has resulted in poor governance performance records. In the last decade, corruption was the second poorest performing governance indicator (-0.97) after political stability (-1.25) in Kenya. Data on these indicators concur with previous studies in other countries such as Leruth and Paul (2006) and Ndulu and O'Connell (1999), that the level of corruption and type or stage of democracy that a country is in are very significant factors that determine their economic performance.

Though steps have been taken to counter corruption in Kenya, it is perceived that the existence of reform agencies (such as anti-corruption agencies) are just a clever move that the country has made to 'trick' stakeholders that the country is committed to improving good governance. Coupled with the fact that appointment of top positions in these institutions are politically motivated, very little progress can actually be experienced. Obedience to the rule of law and political stability promote good governance by providing a conducive environment for efficient management of public resources and economic development (Microfinance Development Centre, 2002).

A public reforms report by the Kenya National Audit Office indicated that performance of public expenditure is still below expectations due to challenges in good governance (Republic of Kenya, 2011). These challenges cause inefficiencies in public expenditure, despite its continual growth, and thus hinder progressive economic growth. Good governance has been termed as a prerequisite for economic growth and poverty reduction in least developing countries (UN, 1999). This indicates the need for further research into this relationship in Kenya.

## **II. STATEMENT OF THE PROBLEM**

One of the main reasons why developing countries such as Kenya record poor economic performance is the failure of public institutions hence the insistence of good governance on public finance (World Bank, 1989). Despite the continual increase in development expenditure in Kenya, the efficiency levels are still very wanting indicating low quality of governance. Even with the reforms and policies meant to enhance good governance, Kenya's governance index scores are discouraging; -0.59 as of 2016 (World Bank, 2017). This shows that a lot still needs to be done to improve good governance through strengthening of appropriate institutions (judiciary, anti-corruption, law enforcement), policies, the legal and regulatory reforms and a democratic environment that encourages public participation (Waheduzzaman, 2008). The quality of governance is important in improving development expenditures which are critical to economic growth (Easterly and Levine, 1997).

The Kenya National Audit Office attributed poor performance in government expenditures to challenges in good governance (Republic of Kenya, 2011). This in turn inhibits attaining the state's objective of maximising social welfare, reducing poverty, raising living standards and economic growth. These challenges include rampant corruption, lack of transparency and accountability, legitimacy issues in authority, poor or lack of adherence to rule of law and enforcement and poorly drafted policies among others. These challenges cause inefficiency in the performance of development expenditures. Hauner (2008) showed empirically that good governance is positively significantly related to high per capita income and enhanced policies that improve democracy and encourage economic growth.

The concept of good governance as a prerequisite for economic development and growth has elicited a lot of interest from different stakeholders in Kenya; government officials, civil societies (those who act independently in the interests of the public and those who act as agents of development partners), researchers and members of the public. However, very little literature, if any, exists linking it to public finance management, more so development expenditure in the Kenyan context. Most of the existing literature only explains the growth of public expenditure in general and in some cases, specific growth-enhancing expenditures and their relationship with economic growth. They ignore the significance of good governance as an influencing factor to improving efficiency in expenditures.

Most studies such as Cooray (2009), Gupta et. al. (2002), Kagundu (2006), Ndulu and O'Connell (1999) and Rajkumar and Swaroop (2008) discussing the role and importance of good governance in developing countries have been on a regional scale (Sub-Saharan Africa or developing countries across continents) rather than singly, such as Wardhani et. al (2017) recent study on Indonesia. Yet, there is need to understand this relationship and the significance of good governance and its impact on growth-enhancing expenditures on a local context. This would be greatly beneficial as it would be known where to put more efforts and increase expenditure efficiency through good governance measures to ensure socio-economic growth.

Therefore, this review opens up the stage and allows for further research on the relationship between good governance, development expenditure and economic growth in the Kenyan context. This subsequent research will fill both a knowledge and locational gap which will be crucial to researchers and policy makers, especially in the public-sector finance.

### **III. THEORETICAL REVIEW**

There exists a number of theories that explain growth of public expenditure and its role and link to economic growth, and also theories on the concept of good governance. For public expenditure theories, this paper will review Wagner's Law of rising public expenditure, Peacock and Wiseman's theory and the Keynesian theory of government expenditure. The good governance theories explored are the systems theory and the most recent, social network theory.

#### ***A. Public expenditure theories:***

##### **Wagner's Law of rising expenditure:**

Adolph Wagner, a German economist, came up with the law of rising government expenditure. By studying and analysing trends on public expenditure growth in relation to the size of the public sector (GNP), he found out that as per capita grows, the public sector will also grow in size. A country will experience an increase in spending as need for public services and expanding administrative and policing services and institutions rises (Maingi, 2010). Therefore, this expenditure growth reflects the socio-economic changes made to benefit the public and as a result of the growing public sector, the economy also grows with it (Brown et. al, 1996).

This theory is important to this paper as it explains the continuous growth in public expenditure and the public sector as explained earlier. Though one of the most applicable theories of public expenditure through its focus on the demand of public sector services, Wagner's law ignores public participation and assumes an organic state theory. Maingi (2006) contends that the state assumes the role of an individual in its decision-making and acts independently of its people and this could be problematic.

##### **Peacock and Wiseman's theory of public expenditure:**

Peacock and Wiseman (1967) theory incorporates a political perspective to explain public expenditure growth. They propose the views that people prefer lower to higher taxes, they will always vote to increase public services, and that their governments like using public funds. Maingi (2010), notes that with the people's affinity for lower taxes, there is a tolerable level of tax tolerable that limits the government's behaviour. This theory dictates that when the economy grows, the government's revenues increase and therefore, an increased public expenditure.

Peacock and Wiseman (1961) also brought forth the displacement and inspection effects that explain the government and citizens' behaviours during periods of economic downturn and movement of taxes. These effects cause periodic short-term bursts in public expenditure. During economic crises, a country will experience increased spending leading to higher taxes. This is the displacement effect and the people are contented with this change in taxation policies. After the economic crisis is over, expenditure levels return back to normal and the tax policies may or may not be reviewed downwards depending on the government's growth strategy (Maingi, 2010). The inspection effect is experienced when, during economic downturns, the people become more aware of socio-economic problems. The government responds to this by enhancing social services to counter the downturn's effects rather than raising taxes. The public's perception of tolerable taxes does not revert to its former state and thus, the government can cater for the increased expenditure.

This theory is applicable to this paper's context in that it explains growth and behaviour of public expenditure during economic crises when economic growth is slowed down or absent.

##### **Keynesian theory:**

Developed by Keynes (1936), this theory suggests a mixed economy where both the public and private sectors are crucial for economic growth. It is supposedly a solution to the failed notion of 'laissez-faire' economic liberalism which proposed that the private sector and financial markets operate optimally when the state does not intervene (Trotman, 1997). The Keynesian theory makes a few assumptions; prices and wages are fixed, planned consumption and savings are both related to income, the money market is irrelevant, the economy operates is short-term based only, and taxes are collected in lump-sum forms only. Keynes also emphasized that the collective demand for goods is the key driving force of the economy during recessions.

Government policies are used to manipulate the demand for goods at the macro level as well as counter deflation and high unemployment rates (Branson, 1989). During economic recession, the government's responsibility is to help with recovery efforts by increasing public expenditure. This encourages citizens to spend and invest more since there is more money in circulation, thereby helping the economy recover to pre-recession growth rates.

The applicability of the Keynesian theory to this study is that it recognizes the private sector's relevance and contribution to economic growth. In Kenya, the private sector, both on its own and with support from the government, has been very instrumental in the country's economic growth.

### ***B. Good governance theories:***

#### **Systems theory:**

This theory of governance looks at order patterns that arise from the interaction of symbiotic elements such as symbolic and cognitive structures which create a system (Bevir, 2013). Through the interaction of elements and actors, information is transferred leading to self-organization of the system even in the absence of a higher authority. It is also important to note that this theory evolved from the notion that society is centreless and that no particular authority is solely independent, but rather they are all connected and interdependent. This interaction ensures maximization of social welfare through monitoring and competition.

The systems theory is applicable in governance as it involves the analysis of how society reacts to different structural changes (Gibson, 2007). According to proposers of this theory, governance is assumed to be resultant of systemic governing interactions that create a self-organizing system with established activities, processes and exchanges between individuals and institutions (Gibson, 2007; Bevir, 2013). The government's duty is not to create order, but rather enhance socio-political interactions between different actors using problem-solving models while distributing services to both individuals and institutions.

In the real-world scenario, the systems theory of good governance explains how nations, institutions, civil societies, individuals, processes and activities interact to form a single functional system with each actor playing a specific role to ensure smooth running of the system. Therefore, the quality of governance among actors determines the system's efficiency.

This theory is applicable to this paper since good governance in Kenya involves many actors who play different roles in ensuring efficiency in public expenditure and economic growth.

#### **Social network theory:**

This is arguably one of the most recent theories of good governance proposed where structural changes in new forms of governance and capitalism led to its inclusion into the field of good governance. It states that individual actions and shared outcomes are explained by social relations (Schmidt, 2007). The social network theory looks at how formal and informal networks or institutions interact with each other at different levels and how they are linked by particular relationships (Leavitt, 2015; Schmidt, 2007). This theory rebuffs other theories which support the notion that only specific elements of a particular actor that can influence its outcomes. Rather, the social network theory suggests that these individual elements make sense only if they're linked with others. Therefore, it is a type of structural breakdown of the involved actors' structure, organization and behaviour patterns to provide outcomes and limits for action (Schmidt, 2007).

Due to its recent nature, the social network theory places a lot of emphasis on recent developments in governance such as decentralized governance, multi-level governance and the rapidly expanding communication capabilities. In developing countries such as Kenya, social networks accomplish important social and economic functions that are otherwise performed by governments, public institutions and financial markets in the developed nations (Leavitt, 2015). In these networks, there are multiple actors involved who all interdependent; the national government, formal and informal institutions, civil societies, private sector, and the general public. The roles that all these actors play are geared towards success in the design, implementing and evaluating processes, policies and service delivery.

## **IV. EMPIRICAL LITERATURE**

One of the first studies on the relationship between quality of governance and economic growth in developing countries in Sub-Saharan Africa was done by Ndulu and O'Connell (1999). Their results showed that the type of democratic freedom and political processes determined economic performance. Political environments that encouraged public

participation in public affairs experienced growth. This was because citizens felt empowered, which in turn increased their productivity. Similar to this study, was Dethier (1999) whose study concluded that good governance increases expenditure efficiency by improving human capital and driving socio-economic development.

Gupta et. al. (2002) studied efficiency in health and education spending in 50 developing countries. Their study found out that public spending had a positive effect on education (increased school participation) and health (increased mortality for children under 5 years) sectors. In their study, they concluded that increased allocation and efficiency through good governance in these two functions improves economic growth and helps achieve the government's object of maximising social welfare.

Kagundu (2006) performed a study on Sub-Saharan Africa to determine the relevance of quality of governance on economic growth. Using panel estimation, he found that governance has a positive significant effect on economic growth, that, the higher the quality, the better the economic performance. Relying on regression models he also found that governance was positively related to the share size of certain public expenditure functions; health, education and defence. Good governance increased the share of health and education expenditures, while decreasing the defence function's share in total expenditure. Changes in these functions had the most significant effects on economic growth.

Similarly, empirical evidence by Rajkumar and Swaroop (2008) who were studying the relationship between government expenditure and outcomes attributed observed inefficiencies to low quality of governance. Their study of 91 countries indicated that countries with good governance had a significant effect in their health and education expenditures, while those with bad governance did not experience any effect. Efficiency in health expenditures was observed as an increase in the mortality rate of children under 5 years, while in education expenditures, it as observed with increases in basic education levels.

Cooray (2009) researched the effects of size of government and quality of governance on economic growth. He measured the size effect using public expenditure and quality effect using good governance indicators in a study that involved 71 countries. According to his results, public expenditure and the quality of governance are significant factors for economic growth. He concluded his study by suggesting that investing in capacity for improved governance should be the main focus point for the countries in the study to improve on their economic performance.

Wardhani et. al. (2017) studied whether governance improves efficiency in government expenditure and indicators of performance of local government expenditures in Indonesia. Their research found out that efficiency in local government expenditures has decreased over time and that imposition of good governance would greatly improve this efficiency. They also found out that increased spending in health, and education significantly improved economic performance of Indonesian local governments. They concluded their study by stating that good governance is significant in improving public expenditure efficiency. This efficiency in turn results in better economic performance.

There is also literature which study the relationship between one or more indicators of good governance and economic growth. Hellman et. al. (2000) and Murphy et. al. (1991) studied effects of corruption on growth and found a negative relationship. They both note that rampant corruption hindered economic growth. Hellman et. al. (2000) stated that where corruption exists, a country is unable to protect its citizens, institutions and their property, enforce the rule of law and citizens are unable to exercise their rights and freedoms fully. Others like Barro (1997) and Rivera-Batiz (2002) studied the relationship between democracy and growth effects and observed a positive relationship. Countries with enhanced democracies will experience more economic growth compared to those with depressed democracies. Rivera-Batiz's (2002) study of countries during the period 1960-1990, concluded that democracy is important in increasing productivity and thus economic growth.

## **V. FINDINGS**

Studies identified in this paper show that there is a significant positive relationship between good governance in improving efficiency in public expenditure and promoting economic growth. Whether it is on only one indicator or a collective group of indicators of good governance, there is no doubt that it is significant. Gupta et. al. (2002), Kagundu (2006), Rajkumar and Swaroop (2008) and Wardhani et. al. (2017) observed that the main development expenditure functions on which good governance had the most significant effect were health and education. This leads us to the suggestion that these two components are the most important for economic growth as they contribute most to the factors of productivity. Contrary to previous studies, Wardhani et. al. (2017) found that the quality of governance did not have a significant effect on infrastructure expenditure.

Therefore, though good governance is important for improving the efficiency of development expenditure, it does not affect the outcomes of all its components, but its significance in contributing towards economic growth is undeniable. As noted, studies on the influence of good governance on improving public expenditure efficiency have been performed in different countries and regions, but none has been performed in Kenya. Therefore, this study provides a platform to fill this locational gap in light of existing evidence from studies in this review.

## VI. CONCLUSION

Empirical studies in this paper show that good governance is significant in increasing efficiency in development expenditures and ensuring economic growth. It improves accountability, transparency and achieving progressive economic growth (Easterly and Levine, 1997; Wardhani, 2017). However, though are numerous studies performed in other countries, there is very little or no empirical literature on the nature of this relationship in Kenya. Such a study would be important not only to key stakeholders such development partners and the government, but also to citizens whose interests and needs are the underlying subject of discussion, and policy makers to understand the impact of policies they formulate. Therefore, this review provides a platform to fill this locational gap and provide an understanding as to whether good governance is key in determining efficiency of public expenditure management in Kenya and promoting economic growth.

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