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The Effects of Fiscal Policy on the Performance of Commercial Banks in Kenya

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Abstract:
Fiscal policy refers to the use of government spending and tax policies to influence economic conditions. Fiscal policies have existed for a long time, with major debates between proponents of the Keynesian model and the monetary approach. Fiscal policy can either be contractionary, expansionary, or neutral. This study analyses the literature on the effect of the national budget on banks performance; effect of Taxation on bank performance; and the effect of public expenditure on performance of Banks in Kenya. The literature shows that government expenditure is a good fiscal policy measure in terms of the positive performance of commercial banks however, there is a need to consider the issue of corruption that negatively affects the expenditure controls that are crucial in an effective government approach in terms of the way the authorities ensure effective expenditure programs. Budget surplus and the positive impact on banks' lending, no direct or clear argument shows the role of budgeting on commercial banks' performance. Taxes also play an important role in developing infrastructures that are crucial for the improved performance of firms. However, gaps exist in literature that needs to explored by further studies.

Keywords: Financial Performance, Fiscal Policy, National Budget, Taxation, Public Expenditure

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1. Introduction

Fiscal policy can either be contractionary, expansionary, or neutral. The fiscal policy concept emerges from John Maynard Keynes. He argues that decreasing or increasing expenditure (spending) and revenue (taxes) levels affect the flow of money through the economic system as well as employment and inflation (Kipkemoi, Atambo, & Mogwambo, 2016). Numerous studies consider fiscal policy, and the effectiveness of the concept is observed based on its impact on long-term sustainable development and economic growth, with the concept existing in the Keynesian Theory. Blinder (2008) argues that Keynesian asserts that aggregate demand is influenced by several economic decisions (private and public) and at times behaves erratically. The author adds that public decisions include fiscal and monetary policies. For several decades,

economists have debated the strengths of fiscal and monetary policy, with both sides arguing that the other side's approach is powerless. However, monetarists and Keynesians currently believe that monetary and fiscal policy affect aggregate demand (Blinder, 2008).

The influence of fiscal policy on economic growth is influenced by numerous factors, some of which include employment in the economy, the composition of government expenditures, the transparency of government, or even the government size. Constâncio (2020) points out that the debate between the monetarists and the Keynesian during the 1960s and 1970s resulted in three arguments that were directed toward the effectiveness of the fiscal policy. The first argument was linked to the slow implementation of fiscal policy.

According to Baldacci, Gupta & Mulas-Granados (2009), the 2008 financial crisis began in the United States mortgage industry in 2007, which turned into a global credit crunch and consequently led to the global recession observed in 2009. Hence, the researchers state that access to credit markets was hindered by the crisis leading to the decline of consumption because of wealth and income effects. New investment was restricted by the negative forecasts, forcing the authorities to enact various measures to bring back growth and reinstate government confidence. Baldacci et al. (2009) further show that the government's policy interventions were centered on fixing the banking system so that there was a flow of credit to the economy and adopting monetary and fiscal stimulus packages to bring aggregate demand and prevent the decline of the output. As interventions involving monetary easing significantly eased because of the restricted space for additional interest rate cuts and poor monetary policy transmission channels, the main tool that could be used for economic recovery was fiscal recovery.

Kipkemoi et al. (2016) identify that the National Treasury and the Fiscal Policy Division (FIPOD) are responsible for the short-and medium-term projection of deficit financing, expenditures, and revenues. The scholar adds that the National Treasury is also involved in the tax policy and monitoring of the government. On the other hand, the Central Bank of Kenya (CBK) comes up with and conducts monetary policy to maintain inflation at the government target of 5%. Kulundu et al. (2020) state that in Kenya, since independence, the authorities have focused on economic growth as the main strategy for reducing inequality and poverty through fiscal policy. According to the researchers, even though there has been a robust use of fiscal policy tools and high growth rates, as well as other initiatives such as decentralization of fiscal funds, inequality and poverty have remained relatively high. Besides, the degree to which growth in Kenya has generated the decline of poverty has been lower than in other African economies. For instance, in 2015, Kenya's growth elasticity of poverty reduction was 0.57, which is lower than Uganda, Tanzania, or Ghana. The global crisis also affected how Kenya addressed the economic challenges using fiscal policy tools. The World Bank (2010) points out two major challenges the Kenyan Government faced in integrating a sound fiscal policy. The first challenge is that even though the authorities implemented the debt to Gross Domestic Product (GDP) ratio as the fiscal anchor, the indicator does not consider the GDP's cyclicality. Such an occurrence means that a cyclically adjusted deficit was a useful instrument for the authorities and would benefit Kenya in appropriately managing its national debt. The other complication entails the potency of fiscal expansion to reinforce economic growth and the basis of a fiscal stimulus. Even though the issue has been debated in Kenya since early 2009, there is no formal analysis.

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2. Problem Statement

Understanding the effect of fiscal policy on the performance of commercial banks in Kenya is crucial because of the mutual relationship between fiscal policy, monetary policy, and banks' profitability. According to Kithandi (2022), commercial banks play an important role in risk sharing and capital resources of future flows in any country or economy. The researcher also argues that effective and efficient banking industry in any nation facilitates the business cycle by bringing increased growth and welfare. Therefore, commercial banks' financial performance, is of great importance. However, for commercial banks to be profitable, there need to be policy changes that facilitate their operation. The use of fiscal policy is usually combined with monetary policy to meet economic goals and influence the economy's direction (Larch & Martins, 2009). Hence, the way monetary policy is used has a direct impact on the financial sector. Kithandi (2022) states that the financial performance of Kenya's commercial banks is decreasing, resulting in concerns in all areas of the financial sector. For instance, the scholar states that in Kenya, from 2012 to 2016, there has been a decreasing trend in the profitability of commercial banks

The interest rate controls are key reasons for the decline in profitability. Alper et al. (2019) state that interest rate controls were passed to decrease borrowing costs, increase returns on saving, and expand credit access. However, the authors claim that the law resulted in the opposite outcome, where there has been a credit collapse to micro, small, and medium enterprises; reduced financial intermediation; and a decrease in loan books of the small banks. After lifting the interest rate controls by the CBK, commercial banks have been cautioned against punitive interest rates above 20%, and there is a need for justification of margins the lender puts in its formula (Guguyu, 2022). Interest rates have a direct association with fiscal policy. Weil states that fiscal expansion leads to increased interest rates and crowding out of some private investment, which lowers the fraction of output constituting private investment. In addition, in a liberal economy, the fiscal policy directly impacts the trade balance and exchange rates, with expansion increasing the interest rates because government borrowing entices foreign capital. Such attributes of expansionary fiscal policies have a positive effect on commercial banks. Maigua and Mouni (2016) also states that exchange rates, inflation rates, and discount rates have positive outcomes on the performance of commercial banks.

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As mentioned earlier, Kenya has used the expansionary approach in fiscal policy over the years since the 2008 financial crisis and the 2007 violence that affected the country's economy (World Bank, 2010). The study can help answer how such initiatives have impacted the performances of commercial banks in Kenya. Besides, other crises have emerged since then, with the emergence of the COVID-19 pandemic that required intervention through government policies. According to a recent study by Mathias (2021), where the effect of the pandemic was examined when it comes to the performance of commercial banks, the researcher identified that the banks' profitability was negatively affected. During the period, there were responses by the government. Owino (2021) reports that the initial financial and policy measures during COVID-19 included the Economic Stimulus Package intended to boost the economy's recovery and cushion vulnerable businesses and persons from the impact of the pandemic. Other policy responses included a waiver of income taxes for people earning below KES 24,000, turnover taxes by 2% for all micro, small and medium enterprises, and reduced value-added tax to 14% from 16%. Since the end of the pandemic, some of the initiatives have been reversed. Such actions also warrant research to examine how commercial banks have recovered and the degree of recovery in financial performance.

3. Methodology

This study's main methodology was a critical analysis of the prior work on the variables of fiscal policy influencing bank performance in the post-consolidated banking sector. This article provides a review of the research in order to reach conclusions about how the literature perceives the impact of fiscal policy on the performance of Kenyan banks.

4. Literature Review

This section explores the various aspects of fiscal policy and performance in the light of the other research studies conducted in this area.

Government Expenditure and Bank Performance

Kipkemoi et al. (2016) conducted a study to examine the effect of fiscal policy and Kenyan commercial banks' profitability using a regression model against government expenditure between 2006 and 2015 using Kenya Commercial Bank (KCB) as a case study. In the research, the investigators concluded that the profitability of Kenyan commercial banks is significantly affected by the fiscal policies intended to stabilize other macroeconomic factors. Therefore, Kipkemoi et al. (2016) concluded that the stability of macroeconomic factors should be the top policy for the regime to guarantee the bank sector's profitability and ensure the economy's sustainability. Another study by Du (2015) that used information on the expenditure of the United States government on national defense, as well as information on the interest rates from 1959 to 2002, identified a positive association between government expenditure and real interest rate. Interest rates are also associated with the increased performance of commercial banks.

The study by Maigua and Mouni (2016), in line with the above statement where the researchers concluded that the interest rates determinants of the study, namely: exchange rates, inflation rates, and discount rates had a positive association with the performance of commercial banks. The study aimed to examine the influence of interest rate determinants on commercial banks using 26 Kenyan banks and multiple regression analysis methods. Even though government expenditure is considered to have a positive relationship with banks' profitability, several challenges have been highlighted with the approach. For instance, Pattanayak (2016) states that the absence of effective expenditure controls can harm fiscal discipline and macroeconomic stability. The researcher further concludes in over 60% of the low- and middle-income countries, such as Kenya, there are relatively weak mechanisms of expenditure control, which can negatively impact the effectiveness of the fiscal policy approach. Aonothe study established that COVID-19 and Inflation rate significantly affect the Foreign Exchange rate in Kenya, hence requiring a close monitoring, proper policy formulation and mitigation measures (Kenga, Kamau, & Amayo, 2022). In a study by Eboso (2018) to examine the connection between Kenya's government expenditure and public sector corruption, the scholar concludes that corruption has a bearing on general public expenditure in the country. Therefore, even though there is a positive relationship between government expenditure and the profitability of commercial banks, corruption can negatively affect the relationship because it leads to poor expenditure control.

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Budget and Bank Performance

The World Bank (2010) highlights that based on international encounters and empirical studies, fiscal policy tends to be expansionary during a boom and contractionary during recessions, particularly in third world nations, where the approach tends to "lean with the wind."

However, in the study by the bank, the fiscal policies in Kenya do not lean with the wing. Besides, even though some revenue elements adjust automatically over the business cycle (falling in recessions and increasing in booms), the association of the discretionary budget component with the cyclical component of GDP is small. Hence, one can argue that the fiscal policy in Kenya has been a growth-enhancing factor. The World Bank (2010) further argues that, as shown in several studies, cyclicity is often linked to volatility, which is observed in low economic growth. However, the acyclical nature of Kenya's fiscal policy shows that the interventions did not increase extraneous shocks and could have led to growth between 1996 and 2007 when the World Bank conducted the study, which would have led to growth. It is also important to note that fiscal shocks usually lead to macroeconomic instabilities, and a major fiscal shock can result in macroeconomic instability in Kenya.

The argument regarding the area of the national budget and the impact on financial performance is not easy to discuss since most studies do not directly touch on the relationship. However, Dinç (2005) investigated the political influences on government-owned banks and identified that the budget surplus has a significant and positive effect on lending loans where there is no deficit to finance. Even though there is a positive relationship between budget deficit and lending, the Kenyan economy has not had a surplus for a long time. O'Neill (2022) highlights that from 2017 to 2020, Kenya's budget balance concerning GDP has had a negative value that is expected to go until 2027. Therefore, the argument by Dinç (2005) does not apply to the Kenyan financial sector. However, a study by Thiongo (2018) identified that the increase in bank loan portfolios negatively impacted banks' financial performance in the ensuing years. The researcher also identified that the increase in a bank's portfolio leads to a rise in non-performing loans in the ensuing years. A study established that loanable fund levels and board of directors" skills positively influence the financial performance of financial institutions (Wanyonyi, Kamau, & Sasaka, 2019). Similarly, Muhindi and Ngaba (2018) affirm that the increase in loans for a bank increases the losses experienced by the bank in the ensuing years. The researchers argue that diversification has been identified as the needed approach to mitigate loss exposure. However, there are no findings in the study that prove that portfolio diversification decreases the issue of bad loans as banks increase their loan portfolios.

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Taxation and Bank Performance

Baldacci et al. (2009) examined the impact of fiscal policy response in over 100 events of the systemic banking crisis. The researchers identified that the fiscal expansion interventions that depend significantly on the initiatives to support government consumption had more positive outcomes than those based on income tax cuts or public investment. Thus, the study concludes that income taxes are not as effective as consumption taxes in quickly addressing the banking crisis. Therefore, consumption taxes are the preferred approach to expanding the economy after a crisis, increasing firm performance. In another research by Albertazzi and Gambacorta (2010), the investigators examined how corporate income tax (CIT) affects bank profitability. The direct effect of CIT on the bank's profitability can be observed in the impact of the tax on equity, which can make lending expensive or less costly based on the tax.

The indirect impact emerges because CIT is not explicit to the banking sector, which can indirectly affect the bank's corporate demand for loans and fee-generating services. Therefore, the study by Albertazzi and Gambacorta (2010) identified significant uncertainties in how taxation can affect banks' profitability. However, a study by Chauvet and Ferry (2021) that examined the relationship between firm performance and taxation in developing nations identified a positive association because taxation is key in developing public infrastructure, which is crucial for the

firms operating in these nations. However, Chauvet and Ferry (2021) caution that the positive effect is not observed when corruption is too pervasive and the source of tax revenue decreases government accountability. The researchers conducted the study by combining tax information from the Government Revenue Dataset and the World Bank Enterprise Surveys at the firm level. Even though corruption is observed as a barrier to firm performance, Bolarinwa, and Soetan (2019), while assessing the link between bank profitability and corruption, point out that banks can use corruption to increase profitability both in developed and developing nations. Tax avoidance and evasion is also another factor that influences of the major practice of creative accounting among companies in private sector in Kenya, hence interfering with financial reports (Kamau, Mutiso, & Ngui, 2012). Therefore, there are conflicting findings regarding taxation, firm performance, and the role of corruption.

The high bureaucracy for tax changes and implementing expenditure is experienced particularly in public investment. The issue is genuine regarding fiscal policy and can only be intervened by having a permanent collection of adequate projects. The second argument is associated with crowding out of private investment and consumer durables because of their deficits, and the increasing debt will also increase rates. Constâncio (2020) states numerous historical episodes where a higher deficit did not increase interest rates. One of the examples shared is the liquidity traps that occurred during the 2008 financial crisis. The third group of arguments were associated with consumer behavior and the response to fiscal stimulus. According to the Permanent Income theory of consumption, whenever there are temporary fiscal expansionary initiatives cannot affect consumer behavior because they react only to their view on their permanent income (Constâncio, 2020). According to Constâncio (2020), after World War II, the Keynesian claim prevailed, leading to the use of fiscal policy as the main approach in targeting output stabilization, with the monetary policy being used passively because it was believed to have lower effectiveness. Eventually, monetary policy had some sort of fiscal dominance where central banks were not independent and had to partner with Treasuries.

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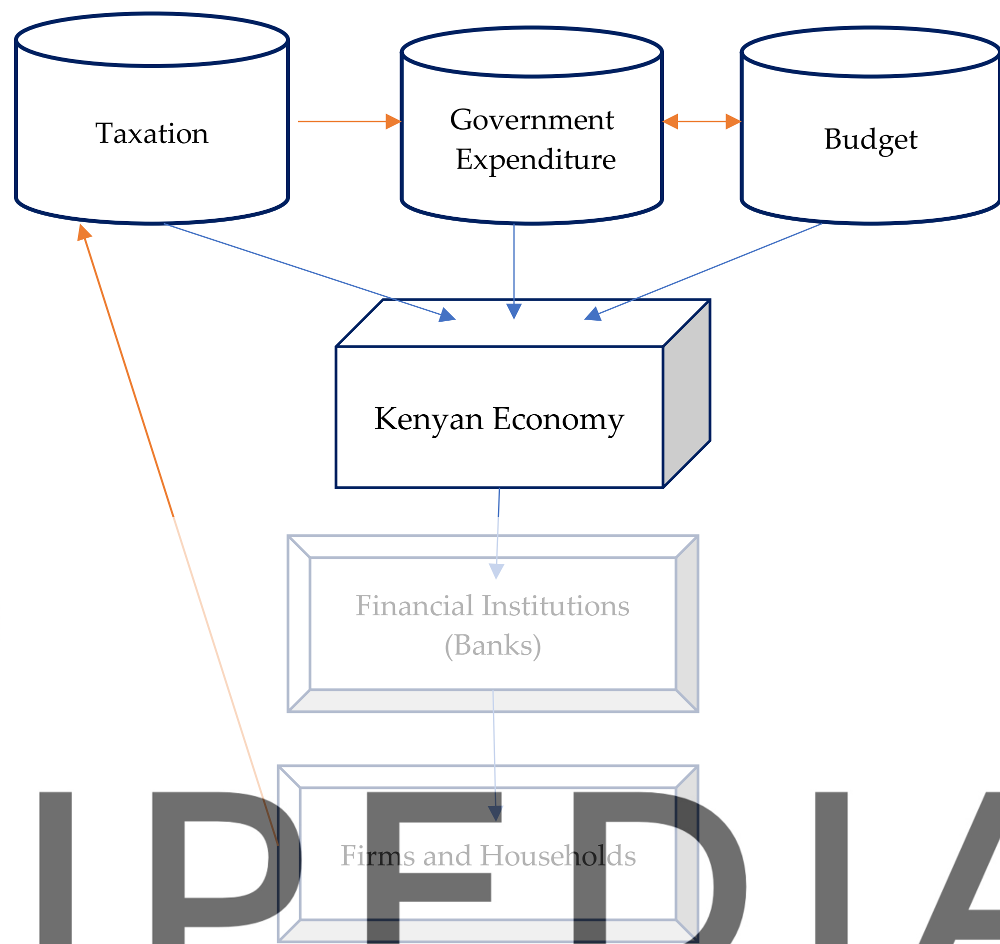

Figure 1: Flow of funds

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5. Conclusion

Concerning government expenditure and commercial banks' performance, the studies by Kipkemoi et al. (2016) and Du (2015) show a positive relationship. However, the major challenge is that the studies do not consider the expenditure controls that affect the positive outcomes of government expenditure. Corruption in Kenya has been identified as a key factor in how the government allocates its expenditure (Eboso, 2018). The argument by Dinç (2005) regarding the increase in lending and budget surplus does not reflect the Kenyan budget, which has not had a surplus budget for more than ten years. Hence, it is not plausible in the current discussion. Besides, none of the studies could directly link government expenditure and its impact on bank performance. Lastly, even though Baldacci et al. (2009) identify consumption taxes as the best fiscal policy for expanding the economy after a banking crisis, which can increase the performance of banks, Albertazzi & Gambacorta (2010) provide inconclusive outcomes regarding the effect of CIT in firm performance. However, Chauvet and Ferry (2021) show that taxes positively impact firm performance, but corruption can negatively affect progress. However, the research is contradicted by Bolarinwa and Soetan (2019), who conclude that corruption can be used to increase profitability.

In sum, even though government expenditure is an excellent fiscal policy in terms of the positive performance of commercial banks, there is a need to consider the issue of corruption that negatively affects the expenditure controls that are crucial in an effective government

approach in terms of the way the authorities ensure effective expenditure programs. Besides the argument of budget surplus and the positive impact on banks lending, no direct or clear argument shows the role of budgeting on commercial banks' performance. Besides, the Kenyan financial budget has always had a deficit in the past decade. In addition, literature shows that increased lending leads to a negative performance of the banks. On the other hand, taxation has conflicting findings, but consumption taxes have been identified as crucial in the expansion of an economy after a crisis. Taxes also play an important role in developing infrastructures that are crucial for the improved performance of firms. However, the role of corruption has had conflicting contributions, with part of the literature saying it is damaging to firm performance and other literature showing that it can be used for profitability.

Several gaps exist in the literature. The first observed gap is that not many studies have examined the effect of fiscal policies on the performance of commercial banks. The only study that has been conducted such as study is that by Kipkemoi et al. (2016), but it is centered on KC, which the government partly owns. Hence, it is important to focus on a privately owned bank such as Standard Chartered Bank to identify whether the findings align with the study. Corruption is also a recurring theme in the literature, and most studies have not integrated the vice's impact on how fiscal policies can impact the performance of commercial banks. The studies do not touch on the role the national budget has on the performance of commercial banks. The study that touches on the topic does not address the conditions in the Kenyan budget allocations. Hence, the current study needs to examine the role of the budget as a fiscal policy instrument on the performance of commercial banks.

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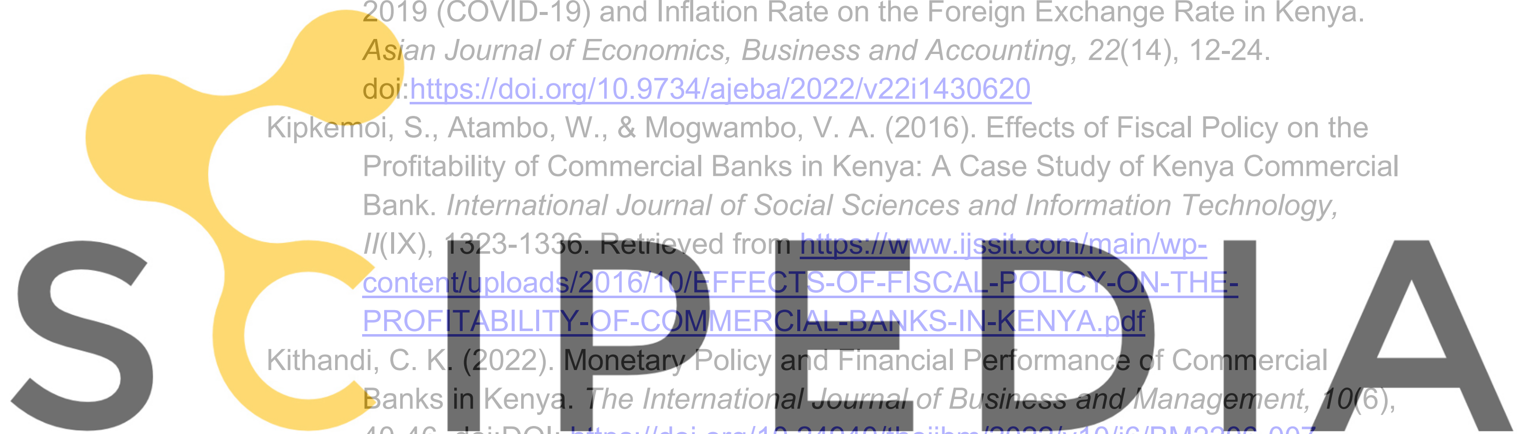

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