

Effect of Governance on the Relationship between External Debt Financing and Economic Growth among East Africa Community Member Countries

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Abstract

Governments borrow to finance budget deficits. Public debt and growth relationships can be both positive and negative. The main proponents of public borrowing to bridge the domestic financial resources gap confirm that debt contributes to economic growth through capital accumulation. In the last two decades, the EAC member countries have witnessed unexplained disparities between rise in public debt levels and economic growth levels. Research studies conducted on the relationships between debt and economic growth have however remained inconclusive as some studies allude to positive, negative, U-shaped and dual causality relationships respectively. This study used a lagged multiple linear regression model to establish the effect of governance on the relationship between external debt financing and economic growth in the EAC member countries using the Baron and Kenny moderation testing approach. Premised on the Keynesian, balanced growth and institutional corruption theories, the study embraced a panel longitudinal research design to examine the relationships. The study finds that 80.70% of variations in sustainable economic growth are explained by variations in external debt, governance index and the interaction term between external debt and governance index. The relationship between external debt and sustainable economic growth is positive but not statistically significant implying that a unit increase in external debt necessitates increase in sustainable economic growth by up to 0.043 units. The relationship between governance and sustainable economic growth is positive and statistically significant inferring that a unit increase in governance raises sustainable economic growth by up to 11 units. The interaction term between governance and external debt exhibits a statistically significant relationship with sustainable economic growth which is however negative due to the negative governance indices in the region. The finding implies that a unit increase in external debt and governance decreases sustainable economic growth by up to 0.509 units. To benefit from the envisaged positive debt and growth nexus, Government policy makers should put in place efforts to improve the domestic debt market infrastructure and encourage domestic investor participation so as to benefit from the long term effects of debt finance. This should be reinforced with sound Country governance framework. Policy makers and external development partners should relook at the terms of the specific external borrowings channeled for development in the region. As a contribution to further research, a study should be modelled on the optimal mix of debt and the turning point (threshold) at which the positive effects of public debt reverts to negative effects. Also, since governance indicators in the region are negative though the EAC member countries continue to attract external financing for development. A study should be designed to undertake a review on the effectiveness of the external debt covenants especially on clauses on governance and the consequences thereon on flouting the covenants. The study should review the types of covenants and the compliance by the governments.

Key Words: *External Debt Financing, Economic Growth, Sustainable Economic Growth, Governance*

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1.1 Introduction

Governments continually require financial resources to support public expenditure. The documented main proponents of public borrowing as early as Keynes (1935) advance that government can borrow to bridge the financial resources gap in the event domestic revenues are inadequate. According to Poirson, *et al.* (2014) and Schclarek (2004), the link between debt financing and economic growth is mainly through capital accumulation. Alesina and Tabellini (1989), Anoruo and Braha (2005), Benfratello, Del Monte and Pennacchio (2018) and Kim, Ha and Kim (2017) illustrate that governance, in particular corruption and political instability can lead to capital flight, erosion of capital formation, high government consumption, thereby slowing down economic growth.

The Keynesian theory of public debt, proposes that debt adds value than risk to a country's economic prosperity (Keynes, 1935). The theory affirms that debt contributes to capital formation, which leads to economic growth. Public debt and growth relationships can be both positive and negative. As explained in Pattillo, *et al.* (2002), the positive debt-growth relationship exists where debt is below certain levels of Debt-GDP ratio, while the negative debt-growth relationship takes effect above these thresholds. The positive relationship according to Poirson, *et al.* (2014) is through gross capital formation. The adverse effects of debt that leads to the negative relationships as acknowledged in Arize, *et al.* (2014) include factors such as high interest payments, increased taxation to raise funds to repay the loans, diminishing national savings, spending cuts and high inflations rates.

Globally, as noted by the World Bank (2018), the economic growth is anticipated to slowdown, largely because of global slack dissipates and the removal of policy accommodations by majority nations. In the last decade, World Bank (2019) estimates that long-term debt from developed countries to poor countries increased by over 50% to \$309 billion in 2017 due to increase in bond issuance. In the EAC member countries, World Bank (2019) notes that average public debt as a percentage of GDP has risen from 22% in 2010 to 34% in 2017. The International Monetary Fund (2018) observes that public debt increase has raised concerns over debt sustainability among local policy makers and international lenders. Annually, the East African Community (2017) and World Bank (2015) note that the EAC member countries have recorded an average of

4.2% GDP growth. Fole (2003) cite expansions of government expenditure, inflation and rise in global interest rates as some of the causes of debt increase in the EAC member countries and Africa at large.

1.2 Research Problem

Over the years, Countries require financial resources in order to provide public services and goods. As countries operate as budgetary deficit units, the governments borrow from surplus units to fill the respective budgetary deficits especially where domestic revenue is inadequate. As noted in Alzoubi, Khasawneh and Zoubi (2020), the debt problem is one of the most prominent obstacles facing developing countries, because of its negative effects on both the social and economic development. Krugman (1988), Musgrave (1959) and Myers (1977) document that high levels of debt can lead to debt overhang problem, trigger high interest rate and inflation rate which can crowd out private investment and also slow down economic growth.

Developing countries have experienced decreases in their local savings, high consumption rates and the lack of local investments. The scenario as noted by Alzoubi, Khasawneh and Zoubi (2020) has led to resorting to debt as one of the means of providing the necessary financing to achieve the desired growth and advancing economic development. As noted by the East African Community (2017) and World Bank (2019) documents, in the last two decades, the EAC member countries have witnessed unexplained disparities between economic growth and rise in debt levels. On average, annual economic growth remained at 4.2%, against a rise in debt levels from an average of 22% in 2010 to 34% in 2017. World Bank (2015) note on country governance, that the EAC region has experienced loss of control over corruption, political stability and government effectiveness in the last two decades.

Empirical studies on the relationships between public debt and economic growth have remained inconclusive mostly because of diverse country study contexts as well as variations in research methodologies. Positive relationships are established by Babu *et al.* (2014) in EAC, Putunoi and Mutuku (2013) in Kenya while negative relationships are established by Panizza and Presbitero (2014) among 17 OECD countries, Lee and Ng (2015) in Malaysia and Were (2001) in Kenya. Isibor, *et al.* (2018) in Nigeria however notes that external debt negatively affects the economy

while internal debt positively affects the economy. A U-shaped debt-economic growth relationship is established among EU member countries by Mencinger, *et al.* (2014) while dual causality relationships are established by Egbetunde (2012) in Nigeria.

On governance, Alesina and Tabellini (1989) established that political instability causes capital flight, leads to reduced domestic investment and provides an incentive for the government to acquire more debt leading to slow economic growth. Jalles (2011) established that countries that are highly corrupt were unable to take the opportunity of borrowing. Kim, Ha and Kim (2017) findings endorses the hypothesis that public debt and economic progression bond is affected by the level of corruption in that economy. Chen, Yao, Hu and Lin (2017) researched on the peak levels of public debt and economic growth. At a particular levels of borrowing, the effect on economic growth changes from positive to negative. Benfratello, Del Monte and Pennacchio (2018) established that corruption in the public sector increases public debt, increases government spending and indirectly limits economic growth. The foregoing findings lead to the question; what is the exact effect of governance on the relationship between external debt financing and economic growth among the EAC member countries?

1.3 Research Objectives

The study sought to establish the effect of governance on the relationship between external debt financing and economic growth in the EAC member countries.

2.1 Literature Review

The governance, debt and economic growth relationship is explained in the Keynesian theory and balanced growth theory as well as several empirical studies discussed herein that arrive at conflicting conclusions and recommendations.

2.1.1 Keynesian Theory

Keynesian theory of public debt was established by Keynes (1935) and recommended that debt adds value instead of a risk for economic development of a country. In like manner, Keynes (1935) expound that acquiring debt for capital development is basic, like foundation of an organization, which will add to a profitable yield henceforth and positive financial development.

The Keynes theory therefore encourages developing nations to borrow for purposes of economic development. The consequence of this theory is that nations that borrow but do not channel the funds towards capital buildup, may not realize the economic gain anticipated.

According to the Keynes theory, debt contributes to the economic growth, mainly through capital accumulation. As explained in Habib and Zurawicki (2002) capital formation can also be created through use of domestic revenue, foreign direct investments, international trade, foreign aid and external remittances for purpose of economic progress. It is also noted that economic development is not generally proportionate with huge borrowing in view of factors including political agitation and monetary flimsiness. Keynesian theory of public debt contributes to this study by elucidating the link between debt financing, capital formation and economic growth.

2.1.2 Balanced Growth Theory

The balanced growth theory as advanced by Nurkse (1952) states that in order to achieve balanced growth in any underdeveloped nation, the government needs to make large and simultaneous investment in several industries. Premised on the principle of demand and supply which is adversely affected by poverty levels in a nation, Nurkse (1952) underscore that because of the adverse poverty, there is minimal saving and investment affecting both supply and demand. In essence, Nurkse (1952) links low income and poverty with under development and therefore encourages government to invest heavily across several sectors of the economy.

The balanced growth theory considers breaking the poverty cycle as key to growth of developing nations. From this background, Nurkse (1952) vouch for investment in multiple sectors to enlarge the market size, boost productivity and incentivize the private sector to invest. In essence, the theory advocates for internally driven growth, favoring internally generated revenue for the investment (capital creation).

2.1.3 Institutional Corruption Theory

The theory as elucidated by Thompson (1995) refers to the use of public office in a manner that negates the principle foundation and purpose of the institution, which can then have negative effects on economic growth. As explained by English (2013), the political and economic

institutions through which a nation provides public goods, become vulnerable to influences that causes them to serve illegitimate and socially disastrous objectives.

As observed by Anoruo and Braha (2005), corruption impedes economic growth by limiting productivity, investment and pushing up government consumption. Contrarily, Cooray, Dzhumashev and Schneider (2017) established that corruption pushes up public debt, government expenditure and thus consequently positively affect the growth of the shadow economy. This theory explains the relationship between debt financing, governance and economic growth. According to Cooray, Dzhumashev and Schneider (2017), corruption pushes up public debt , government expenditure, thereby affecting the economic growth.

2.2 Empirical Review

Using the regression model, Alesina and Tabellini (1989) investigated on the debt, capital flight and political risk relationships in South America countries between 1968 and 1986. The study established that political instability causes capital flight, leads to reduced domestic investment and provides an incentive for the government to acquire more debt leading to slow economic growth.

Using OLS analysis model, Jalles (2011) examined the influence of governance on debt-economic growth relationship in 72 developing countries between 1970 and 2005. The study established a positive relationship in the medim term and a lasting negative debt impact on economic development. The study established that countries that are highly corrupt were unable to take the opportunity of borrowing and therefore corruption had undesirable consequence on economic progression.

In a regression analysis framework, Benfratello, Del Monte and Pennacchio (2018) examined the corruption and debt relationship in 166 countries between 1995 and 2015. The study established that corruption in the public sector increases public debt, increases government spending and indirectly limits economic growth.

Kim, Ha and Kim (2017) adopted the OLS, fixed effects and GMM models to research on 77 countries between 1990 and 2014 with an objective understanding corruption, public debt and economic growth association. The corruption-economic growth relationship was found to be statically significant. The findings of the research endorses the hypothesis that public debt and economic progression bond is affected by the level of corruption in that economy. Highly transparent countries are likely to register positive economic growth with use of increase in public debt.

Chen, Yao, Hu and Lin (2017) researched on the peak levels of investment, public debt and economic growth. The study applied panel regression analytical model to establish the optimal government investment levels on economic growth. Data was collected from 65 countries between 1991 and 2014. The findings showed a decreasing trend in economic growth as the government investment levels increases. At a particular levels of investment, the effect on economic growth changes from positive to negative. This is the similar trend on the impact of borrowing on economic growth.

3.1 Methodology

The study embraced a panel longitudinal research design. The longitudinal research design was adopted because the study variables namely the external debt financing, governance and sustainable economic growth change over time. This design, therefore, allowed the collection of data on the same study variables repeatedly over a long period in order to establish the trend and relationships. Since data was collected across EAC member countries, panel longitudinal research design enables the researcher to analyze and establish trends among the study variables in individual countries. Panel longitudinal design was also chosen because it gave the researcher more data points which reduces collinearity and increases the degree of freedom among the explanatory variables (Hsiao, 2007).

4.1 Findings, Conclusions and Recommendations

The study sought to establish the trend movement of external debt amount among the EAC member countries. The time series trend movement for natural log for the five countries is presented in figure 4.1 below.

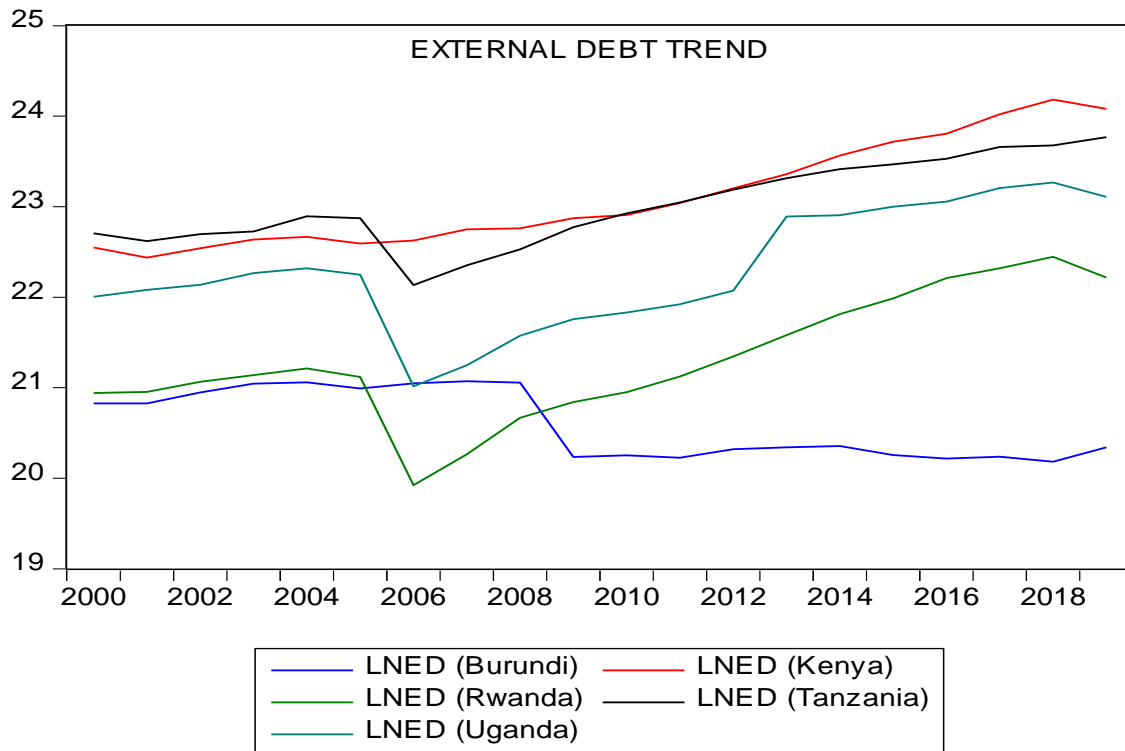


Figure 4.1: Movement of External Debt

As presented in Figure 4.1 above, the external debt for Kenya has been on an increasing trend from year 2000 to 2018 when it declined slightly. Tanzania, Uganda and Rwanda external debt levels declined between the years 2006 and 2007 mostly due to the global financial crisis after which its levels have exhibited an increasing trend. External debt trend for Burundi has declined since year 2008.

Generally, regional countries’ sustainable economic growth has been on an increasing trend save for Burundi where the sustainable economic growth levels exhibit a near stagnation trend over the period. Kenya sustainable economic growth index leads the regional pack followed by Tanzania, Uganda, Rwanda and Burundi respectively. In figure 4.2 below, the sustainable economic growth for Kenya, Tanzania, Uganda and Rwanda declined in year 2009 when compared to the general increasing trend exhibited in earlier years.

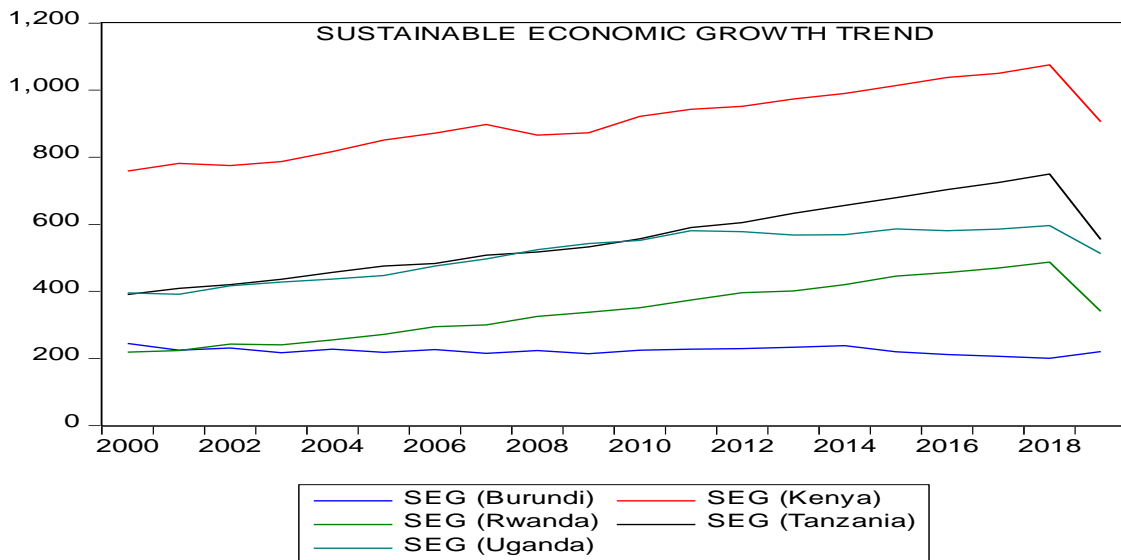


Figure 4.2: Movement of Sustainable Economic Growth

As presented in table 4.3 blow, prior to 2008, Tanzania had higher governance indicators in the region as compared to the other member countries. Since 2008, Rwanda that has had an increasing Governance indicator since 2000 has led the region in Good governance. Over the years, the levels of Governance indicators for Kenya and Uganda have been improving though at relatively lower rates. For Burundi, over the years, the governance indicator has fluctuated over the years but has not improved over time as compared to the other EAC member countries.

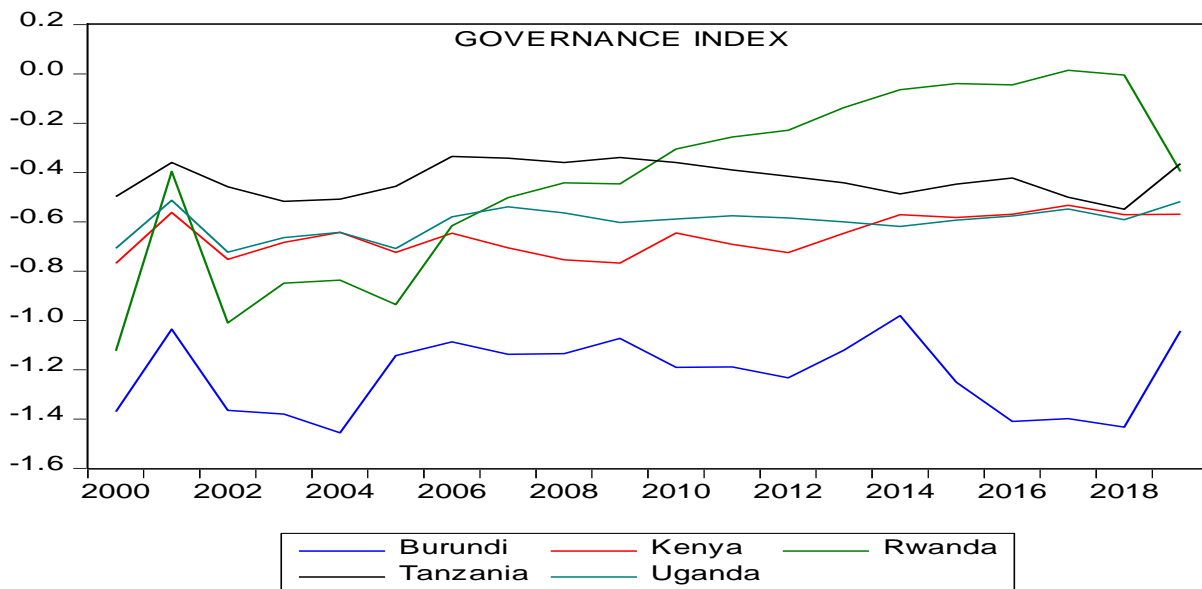


Figure 4.3: Governance Index Trend

As presented in table 4.1 below, there are statistically significant strong positive relationships between external debt and sustainable economic growth ($r=0.834$, $P<0.05$), governance and external debt ($r=0.544$, $P<0.05$). Governance has a statistically significant weak positive relationship with sustainable economic growth ($r=0.397$, $P<0.05$).

Table 4.1: Correlation Analysis

	SEG	LNED	GOV
SEG	1		
LNED	.834**	1	
GOV	.397**	.544**	1

** . Correlation is significant at the 0.01 level (2-tailed).

* . Correlation is significant at the 0.05 level (2-tailed).

The Baron and Kenny (1986) approach was useful to test the moderation effects of governance on the relationships between external debt financing components and sustainable economic growth. In the first step, sustainable economic growth was regressed against the debt financing attributes.

Table 4.2: Debt Financing and Sustainable Economic Growth

Dependent Variable: LNSEG				
Method: Panel Least Squares				
Periods included: 18				
Cross-sections included: 5				
Total panel (balanced) observations: 90				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
LNED	0.015817	0.036153	0.437500	0.6628
LNDD	0.064943	0.019696	3.297253	0.0014
LNTD	0.293019	0.030639	9.563583	0.0000
C	-2.061933	0.356290	-5.787228	0.0000
R-squared	0.900284	Mean dependent var		6.132769
Adjusted R-squared	0.896805	S.D. dependent var		0.503761
S.E. of regression	0.161828	Akaike info criterion		-0.761137
Sum squared resid	2.252198	Schwarz criterion		-0.650035
Log likelihood	38.25118	Hannan-Quinn criter.		-0.716334
F-statistic	258.8153	Durbin-Watson stat		0.453360
Prob(F-statistic)	0.000000			

The regression model in Table 4.2 above presents Adjusted $R^2 = 0.8968$, $F = 258.815$, $p < 0.05$. The regression outcome therefore shows that 89.68% of variation in sustainable economic growth may be attributed to changes in debt financing choices amongst the EAC member countries and the relationship is statistically significant ($p < 0.05$). As presented in Table 4.2 above, the positive relationship between external debt financing and sustainable economic growth is not statistically significant ($\beta = 0.015$, $t = 0.437$, $p > 0.05$).

As a second step in testing the moderating effect of governance on the relationship, governance and external debt finance together with the interaction term of governance and external debt were regressed against sustainable economic growth. As presented in Table 4.3 below, 80.70% of movement in sustainable economic growth are attributed to movement in levels of external debt and governance index and the relationship model is statistically significant (Adjusted $R^2 = 0.8070$, $F = 125.054$, $P < 0.05$). As presented in Table 4.3 below, the relationship between external debt and sustainable economic growth is positive but not statistically significant ($\beta = -0.043$, $t = 0.635$, $P > 0.05$) thus implying that a unit increase in external debt necessitates increase in sustainable economic growth by up to 0.043 units.

The relationship between governance and sustainable economic growth is positive and statistically significant ($\beta = 11.000$, $t = 5.146$, $P < 0.05$). The presented finding in Table 4.3 below therefore infers that a unit increase in governance raises sustainable economic growth by up to 11 units. Also, the interaction term between governance and external debt exhibits a statistically significant relationship with sustainable economic growth which is however negative due to the negative governance indices in the region. The coefficients ($\beta = -0.509$, $t = -5.030$, $P < 0.05$) imply that a unit surge in external debt and governance decreases sustainable economic growth by up to 0.509 units. The significant relationship in the model leads the study to reject the sub hypothesis:
H_{03c}: The influence of Governance on the relationship between external debt financing and economic growth among EAC member countries is not significant.

Table 4.3: External Debt, Governance and Sustainable Economic Growth

Dependent_Variable LNSEG				
Method_Panel_Least_Squares				
Periods_included_18				
Cross-sections included: 5				
Total panel (balanced) observations: 90				
Variable	Coefficient	Std_Error	t_Statistic	Prob.
LNED	0.043259	0.068039	0.635789	0.5266
GOV	11.00004	2.137246	5.146829	0.0000
LNED_GOV_	-0.509520	0.101283	-5.030635	0.0000
C	5.138344	1.467946	3.500363	0.0007
R_squared	0.813515	Mean_dependent var		6.132769
Adjusted_R-squared	0.807009	S.D_dependent var		0.503761
S.E_of_regression	0.221306	Akaike_info_criterion		-0.135114
Sum_squared resid	4.211966	Schwarz_criterion		-0.024011
Log_likelihood	10.08014	Hannan_Quinn_criter.		-0.090311
F_statistic	125.0540	Durbin_Watson_stat		0.340434
Prob(F-statistic)	0.000000			

In summary, the study establishes that the influence of governance on the relationship between sustainable economic growth and external debt finance is statistically significant. The study finds statistically significant relationships between interaction terms of governance with external debt which confirms the arguments presented in institutional corruption theory by Anoruo and Braha (2005) who asserts that corruption impedes economic growth by limiting productivity, investment and pushing up government consumption. In Cooray, Dzhumashev and Schneider (2017), it is observed that corruption which is one of the indicators of governance pushes up public debt, government expenditure, thereby affecting the growth of the economy. The findings are consistent with propositions of Alesina and Tabellini (1989), Jalles (2011) and Kim, Ha and Kim (2017). Specifically, the effect of corruption on productivity of external debt is elucidated in Isibor, Babajide, Akinjare, Oladeji and Osuma (2018).

The study also finds statistically significant negative relationship between sustainable economic growth and interaction of governance and External debt which implies that governance

diminishes the relationship especially in EAC where governance indices are negative. Thus, it is incumbent upon the EAC members states to address the negative governance trends in the region in order realize the benefits debt in financing economic development programs.

Bivariate study models have alluded to positive or negative debt growth relationships without considering the country governance practices as an extraneous variable. The current study opens up the possibility of governance environment influencing the relationships. Specifically, governance strengthens the link among domestic debt and sustainable economic growth as it diminishes the bond among external debt and sustainable economic growth.

Given that governance indicators in the region are negative though the EAC member countries continue to attract external financing for development. A study should be designed to undertake a review on the effectiveness of the external debt covenants especially on clauses on governance and the consequences thereon on flouting the covenants. The study should review the types of covenants and the compliance by the governments.

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