
Good Governance as a Transmission Channel for Fiscal Policy Effectiveness

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Abstract

This paper explores the issues and circumstances that come to play when good governance plays a role in determining the success of the fiscal policy. It shows that, despite its ability to improve the capacity of a given country to make counter cyclical fiscal policies, good governance does not directly increase the chances that a recession will occur. This is due to the absence of a systematic connection between the quality of governance and the risk of recession, which suggests that governance is a necessary, but not sufficient, factor in the successful fiscal intervention. Empirical findings also indicate that good governance principles are one of the limited factors that are always coupled with successful counter cyclical fiscal capacity. The connection between the quality of governance and the effectiveness of fiscal policy is demonstrated to be two way and it is dependent on the economic cycle. The presence of strong institutions, which are typified by transparency, accountability and procedural capacity enhances the transmission mechanisms of fiscal policies. However, fiscal effectiveness can be limited even in well-managed nations when recessions are taking place and the fiscal spending has a low demand-creating power. There is another set of complexity in implementing the fiscal policy, which is political-economic constraints. These nations that have poor governance are characterised by higher shadow economy and poor fiscal performance. A quality of governance is determined as a crucial factor of the foreign direct investment inflows and the growth implications. Though the developed economies have increasingly become more fiscal responsive, they have not been the same in the low-governance situations. Transparency and accountability are inalienable in boosting fiscal credibility and performance, access to information on income and assets of the public

officials strengthens public checks. In this paper highlights governance reform as the foundations of sustainability and effectiveness of the fiscal policy.

Keywords: Good governance, Fiscal policy, Political economy, Transparency accountability and Economic cycles

1. Introduction

In the majority of countries, fiscal policy is a key tool towards macroeconomic stability as well as in the boosting of economic growth, especially at times of downturn. State spending creates multiplier effects on the production and fosters economic growth, which eventually leads to better living conditions of the people [1]. In contrast, direct fiscal stimulus is widely believed to be less effective in the presence of high public debt than it is when the debt level is low, which compromises the effectiveness of fiscal policy in many countries. Moreover, high public debt counteracts recovery from a sharp decline and continues exerting a drag during the subsequent recovery phase [2]. Budget deficits widen either on account of large expansionary measures or a substantial decline in revenue, owing to worsened economic conditions. Some nations lack adequate fiscal space for countercyclical fiscal policy, which compromises the economic recovery from a major downturn. Other countries with similar debt and deficit situations yet with superior governance frameworks are able to effectively conduct counter-cyclical fiscal policy at the height of the financial crisis [3]. New public management initiatives are widely adopted to improve service quality as the figure 1.

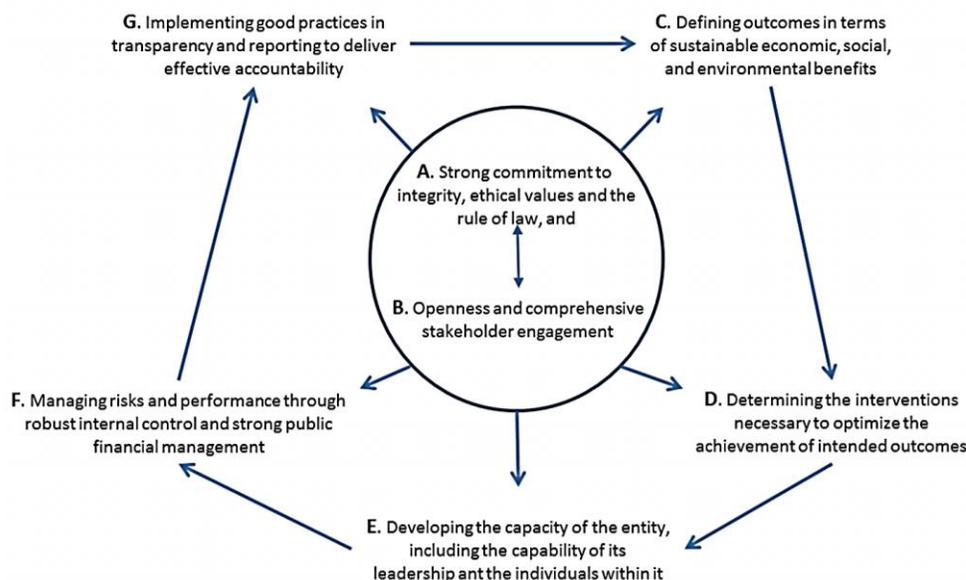


Figure 1. Key principles of good governance in the public sector (own elaboration from consultation draft [2]).

Good governance is crucial for attaining socio-economic progress and addresses distributional issues that arise from stagnant growth. Newly Industrialised Economies (NIEs) are believed to have secured substantial socio-economic gains as a result of adopting active industrial policies coupled with the provision of sufficient public goods, underpinned by a certain degree of good governance. In an environment with substantial public debt and accelerated deficit accumulation, the expenditure multiplier remains positive but diminished in comparison to the low public-debt situation. Public service, public administration, public management, and direct conduct of public affairs ultimately hinge on governance itself [13].

2. Conceptual Foundations

Good governance denotes the design, establishment, and operation of processes and arrangements that secure the accountability of the public sector. This conceptualization aims to answer the question of whether, when, and how actions

taken by agents in the public sector the elite de facto (managers, political decision-makers, senior bureaucrats) rather than the elite de jure (those holding formal offices) are conducive to public sector performance [14]. Accordingly, good governance is not merely a question of political economy or the “right” political principles; rather, it relates specifically to the design and implementation of mechanisms that control agents in the public sector [15].

2.1. Fiscal Policy: Objectives and Channels:

The fiscal policy will be instrumental in stabilizing the economy and directing resources to some critical development goals. When the economy is in a downturn, the fiscal policy alleviates the contractionary impacts of the external shocks, boosts the recovery process, and recovers the income and employment levels in the economy before the crisis. The structure of the public spending comes out as a determinant that is important to the course and speed of the recovery. The fact that timely changes in the priority sectors can have a significant impact on the recovery direction and result on cross-country analysis of expenditure composition supports the suggestion. The stabilization of the economy and re-allocation of resources to fulfil vital development needs, therefore, form the fiscal policy goals. Fiscal interventions in downturns reverse contractionary effects caused by external shocks and promote recovery, returning output, employment, and poverty reduction to - levels before the crisis [8]. The public expenditure structure is one of the main factors that define the recovery path. Comparative country analysis of the composition of expenditure can show the prudent, time-sensitive changes to priority areas have the ability to influence the course and the final result of recovery actions [16].

2.2. Good Governance: Dimensions and Measurement:

Governance has many different dimensions: Many aspects (economic, Political, administrative), all of which contribute to how governments make decisions, write

policy, and implement Public Policy. Proper Governance by the State requires to use Government power and authority in an appropriate manner to manage the Government's affairs and develop/create an environment of social unity, promote the welfare of society, Protect the Legal Rights of its PEOPLE to ensure their freedoms and opportunity.

Governments must implement mechanisms that promote participation (from the General Public) that are Inclusive (to everyone within their Jurisdictions) and create an atmosphere of Transparency and Accountability [6]. Four (4) Elements that are the most fundamental and central to Governance Architecture; (1) Political Stability, (2) Government Effectiveness, (3) Quality of Regulation, and (4) Rule of Law (e.g., enforcement of Laws). [20]. Several Indexes have been created using these Six Dimensions. The Ibrahim Index, The Bertelsmann Index , and the Worldwide Governance Indicator series are the best Known & Widely-used Worldwide, as they cover MULTIPLE DIMENSIONS and INDICATORS relating to "Good Governance". [21]

3. The Transmission Mechanism: How Governance Shapes Fiscal Outcomes

The effectiveness of fiscal policy varies widely among countries and in periods of low growth, additional fiscal measures are often considered, particularly in view of the current health pandemics and geopolitics. Theory and empirical evidence affirm that expenditure and revenue policy actions significantly affect output and growth. Some studies conclude that fiscal policy is more effective in countries with strong forms of governance [7]. Discretionary public expenditure does increase output and growth; higher revenue collection improves the public balance and speeds up recovery to contractionary shocks; better public-debt management shortens the length of the next recession after a positive output shock. In a two-gap model, it is

shown that countries with larger fiscal space achieve higher growth than those with little [19].

3.1. Efficiency of Public Expenditure:

In fiscally constrained environments, the composition and efficiency of public expenditure play an important role in determining the impact of fiscal policy on growth. Governance standards influence public investment decisions and “wasteful” transfers, which crowd out public projects that could stimulate growth. In contrast, well-managed and focused public outlays can enhance growth, especially during fiscal expansion [11]. Countries with low governance experience inefficient public expenditure, where the marginal product of public capital is significantly lower than the private contribution to output. Higher governance standards widen the fiscal space and improve efficiency, allowing a greater increase in total public spending during expansion from an already higher base [8].

3.2 Revenue Administration and Compliance:

Governance affects income and net worth taxation and, indirectly, the overall collection of revenue. Higher governance standards strengthen the technical-moral appeal of tax policies and the quality of enforcement [4]. The actual impact of tax changes on the public balance depends on existing constraints, where well-governed countries can adjust to what is optimal under their structural circumstances. High governance promotes compliance with fiscal rules that limit the financing of public deficits through bank credit, non-conventional instruments, or other forms, which tend to be used excessively or are even practised without explicit rules in countries with weak governance. Credit financing still contributes to unsustainable debt accumulation, and an ungoverned central bank tends to formalise deficit financing in monetary form [8].

3.3 Efficiency of Public Expenditure:

For several decades, it has become evident that the role of government is central in influencing economic growth. Several studies have argued that the efficiency of government expenditure is the most important factor in determining the effectiveness of public spending. Indeed, the consensus is that many governments, even in developed OECD countries, tend to waste around one-third of their total spending. High levels of public spending are not generally associated with high economic performance if the efficiency of government expenditure is low [9].

3.4 Public Debt Management and Credibility:

Inadequate public financing of public debt management causes an increase in a country's total public debt burden, resulting in adverse fiscal impacts or consequences. Fiscal stress increases the likelihood that a country will apply ill-advised economic stimulus to the country and decrease access to financial markets [9]. The credibility of a country's fiscal policies directly relates to the availability and enforcement of fiscal rules that establish limits on budgetary performance, including regulation of net borrowing and total amount of outstanding public debt, the establishment of a balanced budget, and the establishment of policies that govern the use of surplus or deficits in the public budget [21]. If a country's fiscal rules are perceived by market participants to be credible and to establish fiscal objectives that can reasonably be expected to be achieved, then market participants will have greater confidence that the actual performance of the country will correlate closely with the fiscal policy objectives. Therefore, the good governance of a country will improve the credibility of that country's fiscal framework and enhance a country's ability to access both the domestic and international capital markets at lower costs. In particular, the establishment of credibility will result in lower interest rates and reduced risk premiums and will also facilitate a more advantageous refinancing of

current debt. Countries with a history of short-term and long-term debt financing will rely primarily on public debt to finance their operations, and therefore, the connection between a country's credibility and its successful use of public debt financing will be a strong correlation for the majority of low-income countries.

3.5 Allocation of Resources and Economic Growth:

Good governance is an important way for the public financial management system to have an impact on the economy's performance.

The way that government funds are spent and how well the funds are utilized has a significant effect on economic growth rates. This section demonstrates that good governance results in improved economic development through increased effectiveness in converting public expenditures into public benefits (goods or services to the public). In particular, this section examines two components of this conversion, the approval process for public projects and the allocation of capital (e.g., public investments) into different categories and sectors, which are related to economic growth.

4. Methodological Considerations and Limitations

The effectiveness of fiscal policy is determined by several factors through good governance. Good Governance can improve how quickly a country can respond to the need for countercyclical measures; however, it does not increase a country's likelihood of suffering economic downturns. The lack of a systematic relationship between governance quality and the risk of recessions suggests that, while good governance may not be sufficient for countries to meet the objective of a countercyclical fiscal policy without the risk of subsequent fiscal slippage, it appears necessary. Indeed, the principles of good governance are among the few factors consistently associated with such a capacity [12]. The relationship between the quality of governance and the effectiveness of fiscal policy is bidirectional and

depends on the economic cycle. By enhancing the quality of institutions and governance—transparent, accountable, and capable of carrying out systemic procedures, processes, and organizations—countries are likely to strengthen the transmission mechanism through which fiscal policy achieves desired outcomes. Nevertheless, even countries with good governance may find fiscal policies ineffective in accelerating demand stimulation during a recession if the demand-creating capacity of government expenditure is low and the quality of economic or political governance fails to guarantee sustainable implementation of such expenditure.

4.1 Political Economy Constraints:

Governance of economies and firms continues to highlight its importance even with advances in and recognition of the benefits from the economics of micro foundations. Economies with lower governance scores grapple with significantly larger shadow economies, and the quality of governance is arguably the single most important determinant of both foreign direct investment (FDI) inflows and their impact on economic growth and export performance. Such observations are consistent with a sizeable knowledge base on the subject. Although wealthier economies and, in particular, the OECD improve fiscal policy responses and high-frequency output volatility continues to decrease, these post-1980 patterns do not hold for the lowest quartile of countries as categorised by the Kaufmann-Kraay-Mastrorillo (KKM) Governance Indicators. The fiscal policy regime of this group deteriorated sharply after the mid-1970s, following an earlier period of world-record-low output volatility and an accompanying steady build-up of macroeconomic imbalances (Kaufmann, 2003). To address issues related to transparency and accountability, the pertinent data sets and information should reflect the compliance of government officials with rules and ethical values, inform beneficiaries and potential relevant stakeholders and contribute to the design of effective evidence-based policies. The existence of

information on income and assets of government officials and the possibility for citizens to have access to that information can help address issues related to transparency and accountability as showing in figure 2.

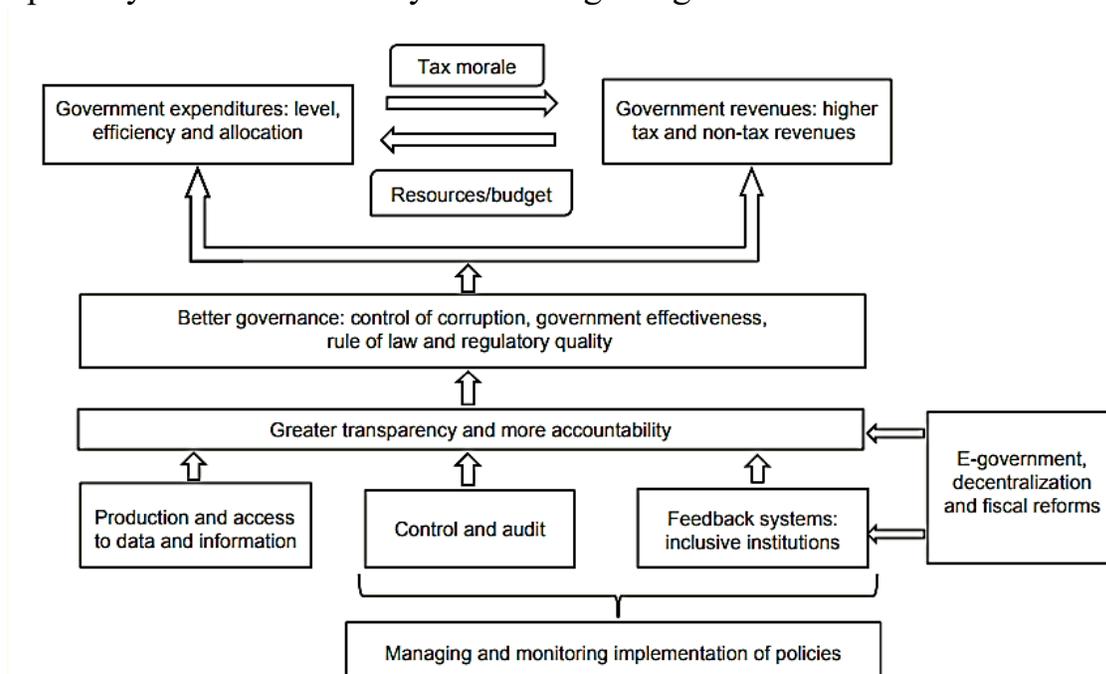


Figure 2. Framework of improving governance for better fiscal management

4.2 Case Study: Governance Quality and Fiscal Policy Effectiveness in Iraq (2015–2025):

Between 2015 and 2025, Iraq experienced repeated economic shocks, including the oil price collapse (2014–2016), the war against ISIS, the COVID-19 pandemic (2020), oil price volatility (2021–2023), and ongoing political instability. These shocks tested Iraq’s fiscal policy capacity and highlighted the central role of governance quality in determining fiscal effectiveness. Between 2015 and 2017, declining revenues from oil led to large reductions in the public sector investments, while on the other hand current expenditures—namely wages and pensions—

remained stable. Governance difficulties and a lack of fiscal space, along with poor public financial management, resulted in a 'pro-cyclical' fiscal contraction rather than any type of stimulus, which further exacerbated the downturn. During the COVID-19 crisis in 2020, العراق faced two shocks, namely collapsing oil prices and reduced economic activity. The government had no choice but to resort to borrowing and deferring payments, which resulted in significant reductions in capital expenditure. Although there were some emergency fiscal measures taken, the lack of institutional coordination and the limited scope for implementation meant that their potential impact on demand was reduced. As of 2024–2025, several reform initiatives (such as digital payroll systems, improved transparency of budgets, and the re-tooling of Public Financial Management) were beginning to show signs of progress, however the weakness of governance mechanisms continue to limit the potential for counter-cyclical policy.

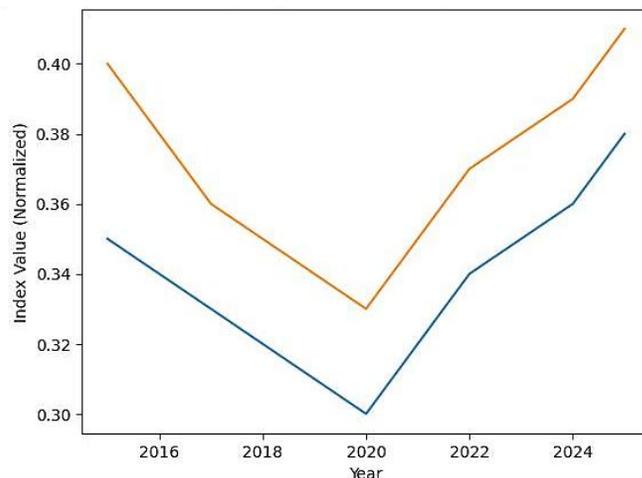


Figure 3. Comparison of Government Quality and Fiscal Policy Effectiveness in Iraq (2015-2025)

During 2015 through 2025, in Iraq governance quality and fiscal policy effectiveness are observed to have a negative correlation in the chart of figure 3. During this timeframe both items decrease at about the same time due to negative external factors such as oil price decreases, conflict-related expenditures, weak institutional capacity,

and the COVID-19 virus crisis during the years of 2015-2020.

The minimum value for both items occurred in 2020, when both governance constraints and fiscal-related stresses resulted in extreme reductions in expansionary fiscal policy effectiveness. Between 2021 and today, both items experienced a slow increase in value as oil revenue began to increase and small-scale reforms on public financial management and transparency began to take place.

Even though there has been some improvement, the lag between the Degree of Improvement on Fiscal Policy Effectiveness and the Increase on Governance Quality shows that the improvements on Fiscal Policy Effectiveness cannot occur without Improvement on Governance Quality. The figure illustrates that Improved Governance Quality is a necessary component to Improved Fiscal Policy Effectiveness through how better governance strengthens the transmission mechanism of fiscal policy. However, Iraq still has many institutional weaknesses that will inhibit their ability to implement and operate on effective counter-cyclical fiscal policies.

5. Conclusion

A well-developed system of good governance plays an important role in the efficiency of fiscal policy. Through effective legislation and the establishment of institutional frameworks, good governance (1) creates an economical tax base by facilitating the collection of taxes through the use of available resources; (2) establishes a manageable debt profile by making available resources usable to fund, maintain, and pay down public debts; and (3) provides the means to allocate available resources in an efficient and equitable manner. Through this means, a good system of governance increases the positive effects of fiscal policy on @@. Therefore, a good system of governance is an important prerequisite for effective fiscal expansion in the long run.

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