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Economic Determinants of Deficit Financing in Nigeria

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Abstract

Over the years fiscal operations in Nigeria have been characterized by massive deficits alongside massive infrastructural deficiency and weak economic fundamentals. This has not only weakened the conventional argument that governments engage expansionary fiscal policy to enhance economic growth and development but has extended the debate on whether deficit financing is the cause or result of weak economic fundamentals. In this study, the impact of selected economic indicators on fiscal deficits is examined. The study covers the period 1981-2016 and model estimation is based on the method of fully modified ordinary least squares (FMOLS). The result shows strong negative impact of external debt and money supply on fiscal deficits. It also shows that exchange rate depreciation and inflation exert strong positive influence on fiscal deficits in Nigeria. However, there is no evidence from the study that lending rate and output (GDP) growth rate significantly determine deficit financing in Nigeria. The study recommends that inflation and exchange rate targeting should be a major concern to the monetary authorities in the formulation and implementation of monetary policy. We suggest that future research in the area should incorporate institutional and political factors to ascertain whether or not they significantly determine the use of deficit financing in Nigeria.

Keywords: Government expenditure, Fiscal operations, Economic growth.

Introduction

Deficit financing as a strategy for promotion of rapid economic growth and development has been a subject of considerable debate over the years. The strategy entails the use of credit, by the government, to finance economic and social activities. It is the result of an expansionary fiscal policy whereby the government spends more than it collects in revenue through borrowings from internal and external sources as well as through taxation. Early advocates of fiscal deficits include Keynes (1936) and Musgrave (1959) who contend that government can impact the performance of the economy through its fiscal operations. This position was reinforced by Kustepelli (2005) who argue that large governments correlate positively with economic performance. Government expenditure relative to national income (GDP) is the most common measure of government size (Hage, 2003). To proponents of the Keynesian school, increased government expenditure or reduced taxation stimulates demand thereby raising the level of economic activity, creating more jobs and increasing national output.

Economists like Smith (1776), Pigou (1912) and Phillips (1958) argue that fiscal deficits distort economic performance. Gali, Lopez and Vall'es (2006) and Phillips (1958) contend that the use of fiscal deficits to stimulate economic activities fuels inflationary pressure with attendant adverse macroeconomic implications for the economy. According to the Central Bank of Nigeria (2002), liquidity surfeit associated with deficit financing creates undue demand pressure on prices with attendant negative implication for interest rate, exchange rate and ultimately the cost of production. Also, Stevan (2010) and Onoh (2007) argue that financing of fiscal deficits through the banking sector crowds out private sector participation in economic activities. Eyiuche (2000) contends that though developing nations adopt deficit financing as a conventional method of promoting rapid economic development, it actually worsened performance in Nigeria due to inherent structural imbalance in the economy

In view of the critical role of deficit financing in economic performance, discussions on what compels its use have also received great attention and what is common among discussants is that fiscal deficits emanate from multiple sources. For instance, propensity to engage deficit financing is often hinged on the increasing role of government in modern economies. Most developing nations are characterized by low capital formation arising from low income and high consumption propensity. Also, low level of technological development and low level of private sector investment in developing economies compel government to augment the rate of investment. Owing to resource constraints, the deficit financing option is engaged. In developing economies, it is quite common to see government dominance in the provision of socio-economic facilities in the areas of transportation (roads, airways and waterways), education, health, power, etc. In these economies, deficit financing is used by governments as a deliberate strategy for rapid economic growth and development.

Following the emergence of fiscal deficits in Nigeria's fiscal operations in response to the funding needs of the 3rd National Development Plan (1975-1980), fiscal deficits have become a recurring irritant in the nation's budgetary operations. Also, the collapse of the international oil price in the late 1970s and early 1980s led to severe decline in foreign exchange earnings which led to resort to massive external borrowings by the government to support its fiscal operations (Okoye, Evbuomwan, Ezeji and Erin, 2018). Over the period of this study (1981-2016), deficit financing was an integral part of the budgetary process in Nigeria except in 1995 and 1996 (CBN, 2016). However, the Nigerian situation presents a paradox of sorts because against the conventional assumption that deficit financing catalyzes the process of economic growth and development, there is glaring evidence of weak economic fundamentals, massive infrastructural deficiency, security challenges, etc. in Nigeria. Studies by Stevan (2010), Ezeabasili, Tsegba and Ezi-Herbert (2012), Ishaq and Moshin (2015), Okoye, Olokoyo, Ezeji, Okoh and Evbuomwan (2019) among numerous others which highlight the economic implications of deficit financing abound in economic literature. However, paucity of empirical evidence on what actually compels the use of deficit financing, particularly in developing economies, presents a compelling need to explore this area of study.

It is against this background, this study seeks to investigate the economic determinants of deficit financing in Nigeria. The study analyses the relationship between deficit financing in Nigeria (dependent variable) and key indicators of economic performance like exchange rate, inflation rate, external debt, money supply, lending rate and GDP growth rate (independent variables). Historical data between 1981 and 2016 was analyzed based on technique of fully modified ordinary least squares (FMOLS).

Review of Related Literature

Keynesian economists argue that budget deficits enhance economic growth by transferring liquidity or purchasing power to economic agents. The Keynesian argument has been criticized on the ground that deficits hurt the economy because they lead to higher interest rates and thereby lower investment and ultimately growth. Critics of budget deficits, who according to Mitchell (2005) are referred to as deficit hawks, further posit that deficits should not be a major fiscal policy instrument but when inevitable, they should be financed by taxes instead of borrowing. Over time, scholars have examined economic and non-economic factors that affect fiscal deficits. The diversity of results from the studies seems to suggest that determinants of fiscal deficits differ across countries. Some of the studies are reviewed in this section.

The work of Javid, Arif and Arif (2012) estimated the economic, political and institutional causes of fiscal deficits for South Asia and ASEAN countries over the 1984 to 2010 period. The study covered Pakistan, Bangladesh, India and Sri Lanka (for South Asia) and Thailand, China and Philippines (for ASEAN countries). Sample selection was

based on evidence of persistent, large and unstable budget deficits. Data analysis was based on dynamic panel model and generalized method of moments (GMM) of Blundell and Bond (1998). The result provides support for significant positive impact of income, inflation and budget size (relative to GDP) on budget deficit volatility which implies that higher values of these variables correlate with increased instability of budget deficits. It also shows negative impact of population growth on volatility of fiscal deficits. Further evidence from the study indicates strong positive impact of lagged fiscal deficits on budget deficit volatility, an indication of persistent effect of budget deficit volatility. High level of corruption, weak institutions and conflicts were also observed to cause budget deficit volatility in the study sample while sound democratic governance lead to lower deficits in fiscal performance.

Ekeocha and Ikenna-Ononugbo (2017) used data on state government fiscal operations to study the effect of cost of governance on fiscal deficits for the period 2008-2015. Model estimation was based on the dynamic panel of Arellano and Bond (1991) GMM Estimators in the Keynesian framework. The study shows cost of governance, inflation, population, and economic growth as major determinants of fiscal deficits across states in Nigeria. Democratic governance, based on presidential system, as practiced in Nigeria has often been criticized as the most expensive democracy. The finding of this study therefore suggests that high cost of governance may be inimical to economic growth in Nigeria.

The work of Eyiuche (2000) investigated the nexus between selected economic indicators and fiscal deficits in Nigeria based on data obtained between 1980 and 1994. The selected explanatory variables are interest and exchange rates, inflation, domestic savings, balance of payment, domestic debt, unemployment and gross domestic product. The study presents evidence of significant negative effect of balance of payment on fiscal deficits. This indicates that adverse balance of payment which characterized the study period significantly explains the prevalence of budget deficits in the country. It also shows strong positive effect of interest rate and domestic debt on fiscal deficits. There is also evidence of negative effect of exchange rate on fiscal deficits over the study period.

In a related study Okoye, Evbuomwan, Modebe and Ezeji (2016) examined the extent to which major economic fundamentals like exchange rate, inflation rate, unemployment and gross fixed capital formation explain fiscal deficits in Nigeria over the period 1981-2013. Estimation technique of vector error correction mechanism (VECM) was used for the study. The result shows that high rate of unemployment lowers fiscal deficits. This implies that policies that target employment generation through higher levels of productive investment raise fiscal deficits. The study further shows that high expenditure on infrastructural development (proxied as gross fixed capital formation) raises the level of deficits in Nigeria. With regard to inflation, the result indicates strong negative impact on fiscal deficits.

Torayeh (2015) analysed budgetary performance in Egypt over 1985-2013 to determine whether recurring deficits in fiscal operations are better explained by macroeconomic performance or political and institutional factors. Evidence from the study shows that high interest payment, huge public sector wage bill and subsidy payments arising from weak political and institutional systems significantly explain fiscal deficits Egypt's budgetary operations. The work of Safdar and Padda (2017) also established that economic and institutional factors strongly affect fiscal operations in Pakistan. With regard to economic factors, the study shows that high rate of inflation and trade liberalization or openness raise the level of deficits in Pakistan's budgetary operations. On the other hand, it produced evidence that high incidence of corruption, weak institutions and break-down of law and order increase budget deficit.

The research conducted by Hossain (1987) used quarterly data from 1974(Q2) to 1983(Q2) to estimate the impact of inflation on fiscal deficits in Bangladesh. Evidence from the study shows increase in fiscal deficits during periods of rising inflation. In Bleaney and Francisco (2016), the authors also report high and persistent inflation rate *vis-à-vis* large fiscal deficits in Sub-Saharan African countries.

Roubini and Sachs (1989) examined the role of economic and political factors in the large fiscal deficits among OECD countries. The result indicates that low growth rate and high level of unemployment account for increase in fiscal deficits. It further shows negative impact of tenure of government on fiscal deficits as well as positive impact on number of political parties in a ruling coalition on fiscal deficits. In another study Roubini (1991) identified political instability as a major determinant of fiscal deficits in developing countries, a reflection of huge expenditure on security and maintenance of law and order.

The work of Umoh, Onye and Atan (2018) examined political and economic determinants of fiscal policy persistence in West Africa. Fiscal persistence was measured as the extent to which government present fiscal

(income and expenditure) behaviour relates to its past behaviour. Evidence from the study shows government expenditure, corruption, government effectiveness and rule of law as significant determinants of fiscal persistence in 14 West African countries. The impact of political factors on fiscal deficits was also examined in Anwar and Ahmad (2012) for Pakistan. The authors find strong positive impact of government size on budget deficits which suggests that large government size leads to large fiscal deficits. Also, there is evidence that weak democratic institutions and low output level drive fiscal deficits.

Murwirapachena, Maredza and Choga (2013) investigated the economic causes of persistent massive budget deficits in South Africa over the 1980-2010 period using the VECM estimation method. The result indicates strong negative effect of unemployment, foreign reserve and government investment on fiscal deficits. It also shows significant positive effect of GDP and foreign debt on fiscal deficits.

Ammama, Mughal and Khan (2011) conducted a study to determine the direction of causality between fiscal deficits and inflation in Pakistan. The study covered the period 1960-2010. The result indicates both variables cause changes in each other (bi-directional causality). The work of Ozurumba (2012) established causal impact of fiscal deficits on inflation for Nigeria but not the other way.

Shahateet, Habashneh, Majali and Al-Majali (2014) conducted a causality study on the nexus between budget deficit and external debt in Jordan. The result of the study did not show any identifiable link (no causality) between fiscal deficits and external borrowings in Jordan. The nexus between external debt and budget deficit was also evaluated in Cukurcayir (2016). Though there was no evidence that external debt compels the use of deficit financing, the study showed ineffective tax system and low public sector revenue as major determinants of budget deficits in Turkey and Spain.

The above review shows that there are economic and non-economic factors that influence the use of fiscal deficits. Economic determinants of fiscal deficits, highlighted by the review, include national income, government expenditure, inflation, balance of payment, interest rate, public debt, unemployment, infrastructure, government wage bill, subsidy payments, and trade openness. Non-economic factors include corruption, institutional and security challenges, political and governance systems as well as country demographics. The review also reveals that against the background of persistent budget deficits in Nigeria, very few studies have been conducted to ascertain factors that sustain its continued dominance of the nation's fiscal operations. That is the essence of this study.

Scope and Methodology

The study covers the period 1981-2016 with data sourced from the Central Bank of Nigeria statistical bulletin. Fiscal deficits became a recurring irritant in Nigeria's fiscal operations from 1981, hence its adoption as the base period for the study. Being of a time series nature, data on the variables were tested for stationarity using the method of Augmented Dickey-Fuller (ADF). Having established stationary trend for the series, estimation of the model parameters was based on the technique of the fully modified ordinary least squares (FMOLS).

Model Estimation

The model employed in this study estimates the nature and magnitude of impact of the independent variables (external debt, exchange rate, money supply, lending rate, inflation rate and GDP growth rate) on the dependent variable (fiscal deficit). Implicitly the model is stated as follows:

$$FD = f(EXD, EXR, M2, LR, INF, GDPGR) \dots\dots\dots (i)$$

- Where: FD = Fiscal Deficit (Total budget deficit/GDP)
 EXD = External Debt (Total external debt/GDP)
 EXR = Exchange Rate
 M2 = Money Supply (Broad money supply/GDP)
 LR = Lending Rate
 INF = Inflation Rate
 GDP = GDP Growth Rate (Rate of output increase over successive periods)

The explicit form of the model is presented as:

$$FD = \beta_0 + \beta_1 EXD + \beta_2 EXR + \beta_3 M2 + \beta_4 LR + \beta_5 INF + \beta_6 GDPR + \varepsilon_{it} \dots\dots\dots (ii)$$

Where: β_0 = Intercept

$\beta_1 \dots \beta_6$ = Parameters to be estimated

ε_{it} = Error term (to capture explanatory variables not captured in the model)

Presentation and Analysis of Result

The result of Augmented Dickey-Fuller (ADF) and fully modified ordinary least squares (FMOLS) are presented and discussed below.

Unit Root Test

The result of the unit root test, presented in table 1, shows that only fiscal deficit is stationary at level. This is shown by ADF test statistic (-3.200487) being greater than level critical value at 5 per cent (-2.948404). However, all the variables achieved stationary trend at first difference.

Table 1: Unit Root Test using the ADF Test Statistics

Variables	ADF Test Stat @ Level	Critical Value (Level) @ 5%	ADF Test Stat @ 1 st Diff.	Critical Value (1 st Diff) @ 5%	Order of Integration
INF	-2.939813	-2.948404	-5.941402	-2.951125	Stationary at 1 st Diff.
EXD	-1.423367	-2.948404	-4.390913	-2.951125	Stationary at 1 st Diff.
EXR	-1.357722	-2.954021	-3.197646	-2.960411	Stationary at 1 st Diff.
FD	-3.200487	-2.948404	-7.206587	-2.951125	Stationary at Level
IR	-2.926116	-2.948404	-6.600553	-2.954021	Stationary at 1 st Diff.
M2	-0.605802	-2.948404	-5.258884	-2.951125	Stationary at 1 st Diff.
GDPR	-2.821629	-2.954021	-7.206587	-2.960411	Stationary at 1 st Diff.

Source: Researchers' compilation from E-Views 10

Fully Modified Ordinary Least Squares (FMOLS) Result

To establish the statistical relationship between fiscal deficit and the explanatory variables, the fully modified ordinary least squares (FMOLS) method of estimation was adopted. The result is presented in table 2 below.

Table 2: Fully Modified Ordinary Least Squares (FMOLS)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
EXD	-0.029823	0.012353	-2.414177	0.0234
EXR	0.027432	0.004917	5.579133	0.0000
M2	-0.230130	0.073382	-3.136080	0.0043
LR	-0.044684	0.049586	-0.901137	0.3761
INF	0.027666	0.011825	2.339652	0.0276
GDPR	-0.020517	0.047989	-0.427538	0.6726
C	-0.640806	1.179948	-0.543080	0.5919
R-squared	0.605083	Mean dependent var		-2.733438
Adjusted R-squared	0.510303	S.D. dependent var		2.107652
S.E. of regression	1.474901	Sum squared resid		54.38330
Long-run variance	0.977892			

Source: Researchers' compilation from E-Views 10

The regression result shown in table 2 indicates that external debt (EXD), exchange rate (EXR), money supply (M2) and inflation rate (INF) significantly explain the persistence of fiscal deficits in budgetary operations in Nigeria. Evidence from the study indicates that increase in the use of external debt lowers the level fiscal deficit. The result does not conform to *a priori* expectation as higher commitment to external creditors is expected lead to increased outflows of domestic resources in debt service obligations. Nigeria has a large stock of external debt outstanding which must be serviced and it is not known for prudence in resource management as to be able to productively engage external borrowings. The negative impact of external debt on fiscal deficits produced in the study contradicts the finding in Murwirapachena *et al* (2013) which established positive effect. Studies by Shahateet *et al* (2014) and Cukurkayir (2016) did not produce evidence that external debt affects fiscal deficits.

The result also shows strong positive impact of exchange rate on fiscal deficits, an indication that exchange rate depreciation raises the level of fiscal deficits. For an import dependent nation like Nigeria, this result derives from huge expenditure on sundry imports. Nigeria is a net importer of goods and services. The massive outflows of foreign exchange lead to exchange rate depreciation thereby making imports more expensive, leading to balance of payment problems. The ultimate result is resort to deficit finance. The negative result obtained from this study did not align with Eyiuche (2000) which produced strong negative effect of exchange rate on fiscal deficits.

There is also evidence of strong negative impact of money supply on fiscal deficits. This result implies that as money is injected into the economy, less of deficit finance is engaged. Reviewed literature did not show that relationship between money supply and fiscal deficits have been examined in prior research. Evidence presented in the study further indicates significant positive impact of inflation on fiscal deficits. This implies that high rates of inflation lead to high level of fiscal deficits. High inflation is associated with increase in the general price level which translates to a rapid increase in government expenditure. Though the result does not support the finding in Okoye, Egbuomwan, Modebe and Ezeji (2016), it is consistent with the outcome in Hossain (1987), Javid *et al* (2012), Bleaney and Francisco (2016) and Safdar and Padda (2017).

With regard to lending rate and GDP growth, the study shows non-significant negative impact on fiscal deficits. From reviewed literature, Eyiuche (2000) and Torayeh report strong positive impact of interest rate on fiscal deficits while Roubini and Sachs (1989), Murwirapachena *et al* (2013), Javid *et al* (2012), and Ekeocha and Ikenna-Ononugbo show strong positive effect of GDP growth on fiscal deficits.

The R² and Adjusted R² of 60.51 and 51.03 per cent respectively indicate moderate explanatory power of the joint influence of the independent variables. The statistics indicate the extent to which the independent variables jointly explain the dominance of fiscal deficits in fiscal operations in Nigeria.

Conclusion and Recommendation

This study provides empirical evidence on the nexus between fiscal deficits and key economic indicators in Nigeria based on data from the Central Bank of Nigeria. The study covers the period 1981-2016 and model estimation is based on the method of fully modified ordinary least squares (FMOLS). The study produced evidence of strong negative impact of external debt and money supply on fiscal deficits. It also shows that exchange rate depreciation and inflation exert strong positive influence on fiscal deficits in Nigeria.

However, the R² and adjusted R² of about 60.5 and 51 per cent respectively suggest that there may be other factors that equally impinge fiscal operations not captured in the study. The study recommends that inflation and exchange rate targeting should be a major concern to the monetary authorities in the formulation and implementation of monetary policy. We suggest that future research in the area should incorporate institutional and political factors to ascertain whether or not they significantly determine the use of deficit financing in Nigeria.

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