Deficit Financing, Debt Servicing and Economic Development in Nigeria

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Abstract:

The study empirically investigated the relationship between deficit financing, debt servicing and economic development in Nigeria over the time period from 1981 - 2022. Government External Debt (GED), Government Domestic Debt (GDD), Cost of Serving Debt (CSD), Inflation rate (INFL) and Interest rate (INTR) were used as dimensions of independent variables, while Human Development Index (HDI) was used as the dependent variable. Annual time series data on the targeted variables were obtained from secondary sources, including the Central Bank of Nigeria annual statistical bulletin, World Bank development indicators. The Unit root test shows that cost of debt servicing, government domestic debt, government external debt, interest rate and human development index are all stationary after first difference (I(1)), while inflation rate was stationary at level I(0). The data were analyzed using the Autoregressive Distributed Lag (ARDL). The empirical results show that human development index has a negative relationship with the variables of CSD, GED, INF and INTR both in the long run and short run, while GDD is positively signed and statistically significant only in the long run. The study recommends amongst others that the Federal government should reduce the rate at which it results to loans, especially foreign loans as a means of financing budget deficits.

Keywords: *Budget deficit, Debt servicing, Economic Development, Nigeria, ARDL*

1. Introduction

Government borrowing is the total amount of money borrowed by the federal government to pay for public services and benefits. The government announces an annual borrowing program in the Budget because tax and non-tax revenue is insufficient to fund the government's spending program. Government borrowing becomes necessary, according to, when government revenue sources are insufficient to finance growing government expenditures (Abdulkarim & Saidatulakmal, 2021). One of the keys to accelerating economic growth and development is government’s borrowing at a reasonable rate to fund public and infrastructure development. Joy and Panda (2020) asserted that excessive borrowing without proper investment planning can result in a high debt burden and interest payments, which can have a number of negative consequences for the

economy. Most governments have massive outstanding debts as a result of this process over the years. Nigeria has struggled with a higher debt service to revenue ratio since the recession in 2016, as revenues have fallen in direct correlation with the drop in oil prices. In 2019, Nigeria's government spent 2.45 trillion Nigerian Naira on debt service, out of total revenue of N4.1 trillion, for debt service to revenue ratio of 59.6 percent. The rising cost of Nigeria's debt profile breached a new milestone with the country's debt service as a percentage of revenue rising to 83 percent in 2020. This suggests that 83 percent of the revenue generated in 2020 was used to meet debt service obligations and this is worrisome. In 2020, the government spent N1.76 trillion to service domestic debt, compared to a budget of N1.87 trillion. A total of N553 billion was spent on foreign debts, compared to a target budget of N805.47 billion. Lower interest rates on foreign borrowing, as well as very limited borrowing from the foreign debt market during the year, are likely to have contributed to the decrease. Instead of the budgeted N272.9 billion, the government only contributed N4.58 billion to the sinking fund. The sinking fund is required to set aside funds that will be used to pay down other loans in the future, such as bonds. The government's constant borrowing from the domestic market was preventing private businesses in need of credit from obtaining financing for expansion and growth (Ogunjimi, 2019).

A government is deemed to run a budget deficit when its aggregate expenditure exceeds its revenue in the national budget of the fiscal year (Adam, 2019 & Kimberly, 2019). One sagacity drawn from the words of Adam (2019) and Kimberly (2019) is that, deficit incurred in the budget is as a result of excess spending relative to income. In order to remedy budget deficit, government primarily resorts to numerous means. Such means include; cutting down government expenditures, borrowing and/or resorting to financial aids from donor agencies. Amongst these strategies in recent years, borrowing seems to be the easiest and more accessible option to most governments globally. Furthermore, budget deficit can be financed through foreign or domestic borrowing and/or the both. Irrespective of the source, borrowing is at a cost, which may exert positive or negative implication (s) on the economy as a whole. It is on this premise that Keynes (1936) argues that government spending is a stimulant to investment, which triggers rise in income, output and employment. This implies that if properly used, budget deficit has the tendency of improving the level of economic growth and development of any economy. However, it may as well push the economy into inflationary pressure, which may eventually lead to recession, hence, retarding

economic activity (Adam, 2019). This experience is applicable to both developed and developing economies particularly Nigeria.

Therefore, the study examines the relationship between budget deficit, debt servicing and economic development in Nigeria. This article is organized as follows; the introductory part in section one, section two contains the literature reviewed, which includes conceptual clarifications, theoretical framework and empirical review. The methodology, which contains the model design, model specification is in section three and section four presents the empirical results and discussions. The work is concluded with the conclusion and recommendations in section five.

2. Literature Review

2.2 Conceptual Clarification

2.2.1 Government Borrowing

Government Borrowing refers to the government sector's demand for loans obtained through financial markets to fund purchases not covered by taxes. In terms of the circular flow, this is one of two family saving demands that are channeled into financial markets, the other being investment borrowing. Government borrowing is a loan obtained by the government that is recorded as capital receipts in the Budget document. It's the total amount of money borrowed by the federal government to provide government services and benefits. Because tax and non-tax revenue is insufficient to fund the government's spending program, the government announces an annual borrowing program in the Budget (Economic times, 2020). The most common way for government to borrow is to issue securities, such as government bonds and bills. Countries with poor credit ratings may borrow directly from supranational entities (US legal, 2021). The key to accelerating economic growth and development is borrowing at a reasonable rate to support public and infrastructural improvements. Excessive borrowing without sufficient investment planning, on the other hand, can lead to a significant debt burden and interest payments, which can have a number of negative economic implications (Joy & Panda, 2020). The government's capacity to invest more productively in infrastructure, education, and public health may be hampered by rising debt levels (Soludo, 2003).

2.2.2 Economic Development

Todaro and Smith (2015) conceptualized development as "the sustained elevation of an entire society and social system toward a "better" or "more humane" life. Economic development strategies used to focus on industrialization and infrastructure, but since the 1960s, they've become more concerned with poverty alleviation. Improvements in a range of sectors or indicators, such as literacy rates, life expectancy, and poverty rates, are often associated with economic development (Pritchett, Woolcock, & Andrews 2013). Economic development is the transformation of simple, low-income national economies into modern industrial economies (Myint & Krueger, 2000). The human development index (HDI), which is published on a regular basis by the United Nations Development Programme (UNDP) in its Human Development Report, is the most well-known indicator of development. The HDI is a composite indicator that ranks countries based on how well they perform across three categories. Specifically, life expectancy, education, and GDP per capita in PPP dollars (UNDP, 2011)

2.3 Theoretical Literature

2.3.1 Keynesian Theory of Budget Deficit

The theory of budget deficit was introduced by Keynes (1936). The theory is based on two major assumptions. First, this theory assumed the possibility that some economic resources are unemployed. Secondly, it presupposes the existence of a large number of myopic liquidity constrained individuals. This second assumption guarantees that aggregate consumption is very sensitive to changes in disposable income.

According to Keynes (1936) large public debt is considered as a national asset rather than a liability and that steady deficit spending is necessary to foster rapid growth and development of the economy. This is contrary to the classical view which opposed the intervention of the government in the economy. In other words, Keynesian doctrine conflicts with the liberal assumptions and principles of the classical theory. In response to the challenges of those times, especially the great depression, the Keynesian doctrine attaches great importance to government whose interventions in the economy is considered helpful in complementing the activities

of the free market system. Therefore, the Keynesian economists propose a positive relationship between deficits financing and economic development.

2.3.2 Functional Finance Theory

This theory was propounded by Lerner in 1943. The theory is based on three major assumptions: First, it is the role of government to stave off inflation and unemployment by controlling consumer spending through the raising and lowering of taxes. Secondly, the purpose of government borrowing and lending is to control interest rate, investment levels, and inflation. Lastly, government should print, hoard, or destroy money as it sees fit to achieve these goals. Lerner formulated two principles of functional finance: government should spend more if there is unemployment, and government should supply more money if interest rates are too high. Generally, the theory is based on the idea that in a monetary economy of production the government has no financial impediments to engage in macroeconomic policies in order to adjust effective demand to the level of potential output. Functional finance has influenced many heterodox economists who advocate expansionary macroeconomic policies.

The opponents of the functional finance theory include Greenspan (2009) and Aspromourgos (2015). For Greenspan (2009), public borrowing tends to generate adverse effects on the markets, including labor and financial markets. Similarly, Aspromourgos (2015) posit that debt liabilities raise additional difficulties and constraints, primarily because they involve additional assets that government cannot freely create. However, this study is in accordance with the functional finance theory as it deepens the understanding of the implications of external debt on economic growth and development.

2.3.3 Human Development Theory

Human development theory incorporates concepts from a variety of disciplines, including ecology, sustainable development, feminism, and welfare economics. It avoids normative politics in favor of focusing on how social and instructional capital might be leveraged to maximize the overall value of human capital in an economy. The most well-known human development theorists are Amartya Sen and Mahbub ul Haq. Democracy and the protection of human rights, according to Sen, are beneficial to development. Freedom of the press, expression, assembly, and other such liberties boost the chance of honest, clean, and good government.

The process of human development entails the expansion of human freedom. It is "the expansion of freedoms that enable people to live lives that are meaningful to them." Political freedom, economic opportunity, social opportunities, transparency, and security, according to Sen, are five forms of interconnected freedoms. By providing public education, health care, social safety nets, strong macroeconomic policies, productivity, and environmental protection, the state may help to foster liberties. Freedom entails not just the ability to do something, but also the ability to make it happen. "Economic possibilities, political liberties, social powers, and the enabling condition of good health, basic education, and the support and growth of initiatives" all influence what people can achieve (their potential). Sen has influenced UNDP thinking on human development, including the creation of the human development index (HDI), a composite index that measures a country's average achievement in three basic dimensions of human development: a long and healthy life, as measured by life expectancy at birth; knowledge, as measured by the adult literacy rate and the combined gross enrolment ratio for primary, secondary, and higher education (Sen, 2001).

2.4 Empirical Literature

Abdulkarim and Saidatulakmal (2021) evaluated the influence of government debt on Nigeria's economic growth. Using annual data from 1980 to 2018 and the Autoregressive Distributed Lag approach, Real GDP, domestic debt, external debt, debt service payment, foreign reserve position, interest rate, gross fixed capital creation, and foreign direct investment were the variables of research. External debt was found to be an obstacle to long-term growth, while having a growth-enhancing effect in the short run. Domestic debt had a large favorable long-term influence on growth, while having a negative short-term impact. Debt service payments slowed growth both long and short term, proving the debt overhang effect. According to the conclusions, the government should invest the borrowed monies in diversifying the economy's productive base. Igudia (2021) examined the impact of external debt servicing on human capital development in Nigeria for the period of 1960 to 2019 using OLS regression technique for the empirical data analysis. The results of the study revealed that external debt servicing has an inverse relationship with HCD, whereas external debt stock has a significantly positive impact on HCD. The study concluded that though expenditure in education and health services (HCD) may have improved because of external borrowing, such an increase may have been as a result of its contribution to the payment of salaries of workers in both the

education and health sectors rather than in real terms. The study recommended that non-politicised feasibility studies should precede every request for funds that would require external or internal financing at both levels of government with non-partisan project monitoring units that will involve the communities where the projects are sited to supervise the execution of such projects.

Okoro and Oksakei (2020) studied the impact of fiscal deficits on macroeconomic variables in Nigeria from 2000 to 2015 using the Autoregressive Distributed Lag (ARDL) as the estimation model. The results of the study revealed that federal government deficits have significant impact on external debt and inflation in Nigeria. The study concluded that fiscal deficits play important role in shaping macroeconomic performance in Nigeria. The study recommended that, the fact an upward trend of inflation is expected in a period of expansionary fiscal policy, borrowing by government, therefore, which may be the starting point of increasing fiscal deficit, should be anchored on infrastructure or other projects that may likely increase economic growth and development of the country.

Emefiele, *et al* (2019) studied the deficit budget and its effect on the growth of Nigeria economy from 1990 to 2016, using multiple regression analysis to analyze the sourced data. The results of the study revealed that budget deficit has negative impact economic growth in Nigeria. The study concluded that the negative impact of the budget deficit on the economic growth is because governments are short of resources to meet their expenses in the long run. Their savings as well as revenues are not enough to meet their expenses. The study recommended that the Government should strive to finance budget deficit by improving on the present revenue base rather than resulting to domestic borrowing. This can be achieved by improving its revenue sources and efficient pursuit of tax reforms

Aero and Ogundipe (2018) carried a study on fiscal deficit and economic growth in Nigeria for the period of 1981 to 2014, using Threshold Autoregressive Model to analyze the sourced data. The empirical analysis of the study revealed that fiscal deficit has significant negative impact on economic growth in Nigeria. The study concluded that the Nigerian economy has been characterized by continuous fiscal deficits, which has not positively contributed to economic growth. The study therefore, recommended that the government should increase capital spending and ensure that an optimal fiscal deficit bracket level of 5% is maintained.

Drawing support from Okun's law and Phillips curve theoretical frameworks, Onwe (2014) carried out a study on the impact of deficit financing on economic growth in Nigeria for the period of 1970 to 2013, using the regression analysis technique. The study applied econometrics method in the analysis of the secondary data. The results of the study revealed that deficit financing has a negative implication on economic growth in Nigeria. The study concluded that deficit financing through Banking System Source of Deficit Financing (BSF) and Ways and Means Source of Deficit Financing (WM) will reduce economic growth thereby causing instability in the economy. The study, therefore, recommended that deficit financing in Nigeria should be focused on the productive sectors of the economy. This is because deficit financing has merely resulted in economic instability indicating that sound policies are needed to achieve economic stability in Nigeria.

3. Methodology

Model Design

The research design adopted is the quasi-experimental design called correlational research design which according to Hassan (1995), aims at establishing relationships between variables and to know if the relationship that exist is significant. Another justification for the use of quasi-experimental research design is that the study is descriptive and analytical.

Model Specification

Human development index (HDI)

The mathematical form of the model is expressed as

$$HDI = F(GDD,GED, CSD, INTR, INFR)\ldots\ldots\ldots\ldots\ldots\ldots\ 1$$

Where HDI = Human development index

HDI is the dependent variable

The linear regression models based on the above functional relation is expressed as:

$$HDI = \beta_0 + \beta_1 GDD + \beta_2 GED + \beta_3 CSD + \beta_{4I} INTR + \beta_5 INFR + U\ldots\ldots\ldots\ldots\ldots\ldots\ 2$$

$$\Delta HDI_t = \alpha_{0i} + \beta_{1i} HDI_{t-1} + \beta_{2i} GDD_{t-1} + \beta_{3i} GED_{t-1} + \beta_{4i} CSD_{t-1} + \beta_{5i} INTR_{t-1} + \beta_{6i} INFR_{t-1} + \sum^{q}_{i=1} \alpha_1 \Delta HDI_{t-1} + \sum^{p1}_{i=1}\alpha_2 \Delta GDD_{t-1} + \sum^{p2}_{i=1}\alpha_3 \Delta GED_{t-1} + \sum^{p3}_{i=1}\alpha_4 \Delta CSD_{t-1} + \sum^{p4}_{i=1}\alpha_5 \Delta INTR_{t-1} + \sum^{p5}_{i=1}\alpha_6 \Delta INFL_{t-1} + et \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots 3$$

ECM model is also specified as:

$$\Delta HDI_t = \alpha_{0i} + \sum^{q}_{i=1} \alpha_{1i} \Delta HDI_{t-1} + \sum^{p1}_{i=1} \alpha_{2i} \Delta GDD_{t-1} + \sum^{p2}_{i=1} \alpha_{3i} \Delta GED_{t-1} + \sum^{p3}_{i=1} \alpha_{4i} \Delta CSD_{t-1} + \sum^{p4}_{i=1} \alpha_{5i} \Delta INTR_{t-1} + \sum^{p5}_{i=1} \alpha_{6i} \Delta INFR_{t-1} + \lambda ECT_{t-1} + et \quad \ldots\ldots\ldots\ldots\ldots\ldots 4$$

$$B_1 \geq 0, \beta_2 \geq 0, \beta_3 \geq 0, \beta_4 \geq 0, \beta_5 \geq 0, \beta_6 \geq 0$$

All other variables and parameters are previously interpreted.

4. Empirical Results and Discussions

Table 1: Augmented Dickey Fuller and Philips Perron Unit Root Test for HDI Model

Variable	ADF					PP				
	Level Coeff.	5% CV	1st Diff Coeff.	5% CV	I(.)	Level Coeff.	5% CV	1st Diff Coeff.	5% CV	I(.)
CSD	-3.113	-3.524	-4.922	-3.563	I(1)	-3.058	-3.524	-12.841	-3.527	I(1)
GDD	-1.171	-1.952	-3.269	-1.951	I(1)	-2.863	-1.950	-1.976	-1.950	I(1)
HDI	-1.488	-3.524	-5.560	-3.526	I(1)	-1.643	-3.524	-5.560	-3.527	I(0)
GED	-1.550	-3.527	-3.778	-3.527	I(1)	-1.046	-3.524	-3.638	-3.527	I(1)
INTR	-1.950	--1.538	-2.676	-1.950	I(1)	-2.070	-3.524	-7.318	-3.527	(1)
INFL	-3.506	-2.946	--	--	I(0)	-3.099	-2.941	--	--	(0)

Table 1, shows the result of unit root test conducted using both Augmented Dickey Fuller Test (ADF) and Philips Perron Test (PP). To get a robust result for this empirical study, we adopted the outcome of Philip Perron statistics, due to the robustness of the result in point of structural breaks. In line with the preposition of Jenkins and Box (1970). Variable that are not stationary at levels would be made stationary after first difference. The following variables in the model were made stationary after first difference, CSD, GDD, HDI, GED, and INTR, while INFL was stationary at level.

ARDL model Result

The ARDL Bound Test, Short-run and Long-run Results for **HDI** Model

Table 2: Bound Test for HDI Model

F-Statistics	7.522385	
K	5	
Significant levels	Critical Bound I0	Critical Bound II
10%	2.26	3.35
5%	2.62	3.79
2.5%	2.96	4.18
1%	3.41	4.68

Source: Computed from E-views 10

The result presented in table 2 shows that the calculated F-statistics of 7.522385 is higher than the upper bound critical value of 3.79 at 5% significant level. Based on this result, it is concluded that a long run relationship exists among the variables of **HDI** model. So, there is a long run co-integration amongst the variables in the model.

Table 3: ARDL-ECM Short-run Results for HDI model

Cointegrating Form

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLOG(CSD)	0.005593	0.002711	2.062915	0.0539
DLOG(CSD(-1))	-0.004951	0.002335	-2.120873	0.0481
DLOG(GDD)	0.005954	0.009221	0.645623	0.5267
DLOG(GED)	-0.001791	0.001443	-1.240980	0.2305
D(INFL)	0.000211	0.000129	1.635630	0.1193
D(INFL(-1))	-0.000054	0.000145	-0.368504	0.7168
D(INFL(-2))	0.000253	0.000107	2.358936	0.0298
D(INTR)	-0.000570	0.000484	-1.178098	0.2541
D(INTR(-1))	-0.000984	0.000534	-1.843428	0.0818
D(INTR(-2))	0.001355	0.000418	3.240655	0.0045
CointEq(-1)	-0.261618	0.072624	-3.602392	0.0020

Cointeq = HDI - (0.0468*LOG(CSD) -0.0269*LOG(GDD) -0.0068 *LOG(GED) -0.0010*INFL -0.0045*INTR + 0.5774)

Source: Computed from E-views 10

The result of the short run dynamic regression for Human development index model is presented in table 3, the result indicates that in the short run, the variables of cost of servicing debt coefficient in lag 1 and interest rate coefficient lag 2 have negative relationship with the coefficient of human development index and are all statistically significant in the short run. It thus means that CDS and INTR coefficients impact negatively on HDI in Nigeria. Government domestic debt coefficient and inflation rate coefficient positively and insignificantly impact on human development index in Nigeria in the short run.

The ECM coefficient has a negative value of -0.261618 which suggests 26% speed of adjustment. This means that correction towards the long run equilibrium will be restored at approximately 26% speed of adjustment.

Table 4: Estimated long run ARDL result

Variables	Coefficient	Std. Error	t-statistics	Prob.
C	0.577365	0.053120	10.869027	0.0000
Log (CSD)	-0.046819	0.010409	-4.497753	0.0003
Log (GDD)	0.026889	0.011093	2.423914	0.0261
Log (GED)	-0.006844	0.005416	-1.263599	0.2225
INFL	-0.001021	0.000728	-1.403701	0.1774
INTR	-0.004540	0.001825	-2.488173	0.0229

Source: Computed from E-views 10

The result of the long run regression estimates for human development model is presented in table 4. The regression estimates indicate that cost of servicing debt coefficient is negatively signed and it is also significant in the long run. Government domestic debt coefficient is positively signed and statistically significant in the long run. While all other variables are negatively signed, however, coefficient of interest rate is statistically significant in the long run.

The finding showed that domestic debt is positively signed and has a statistically significant effect on economic development), external debt has a negative and non-significant effect on economic development of the nation. The poor performance of

the external debt could be attributed partly to payment of principal and interest that is usually repatriated outside the country, whenever payment is made and partly to poor management of the loan obtained. On the other hand, cost of servicing debts has been rising, thereby leading to budget deficits and more borrowing to finance the budget. These findings are in line with previous findings by Abdulkarim and Saidatulakmal (2021) and Igudia (2021).

Residual Diagnostics Test for HDI

TESTs	F-Statistics (Prob)	R-Square (Prob)
Heteroskedasticity test: Breusch-Pagan-Godfrey	1.225 (0.3374)	17.172 (0.3087)
Serial Corr. LM test: Breusch-Godfrey	3.033 (0.0764)	9.3474(0.0993)

Source: Computed from E-views 10

The null hypothesis states that there is no heteroskedasticity. Since each of the F-statistics probability value is greater than 5%, we cannot reject the null hypothesis of no heteroskedasticity. It thus means that the result of the model can be taken seriously, that is the set of explanatory variables included in the model do not suffer the problem of heteroskedasticity.

On the other hand, the null hypothesis of LM test for serial correlation stated that there is no serial correlation. Since each of the F-statistics probability value is greater than 5%, we cannot reject the null hypothesis of no serial correlation.

Stability Tests for HDI

The test is meant to test the appropriateness and stability of the estimated model. This is to check if the coefficient of the model are stable and can be used for prediction. The stability test was conducted using the cumulative sum (CUSUM) and cumulative sum of square (CUSUMSQ) tests. If the plot of the CUSUM and CUSUMSQ for the model lies within the 5 percent critical bound, it is suggestive that the model is stable. From figure 1 and 2 below, the model is stable.

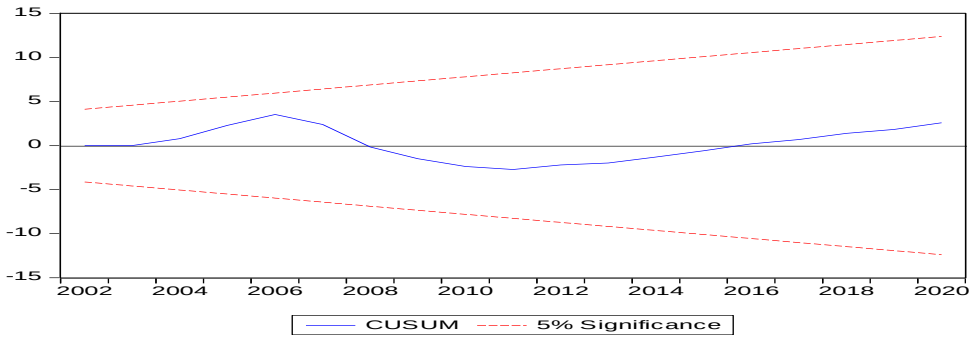

Figure 1. Cumulative sum for HDI Model

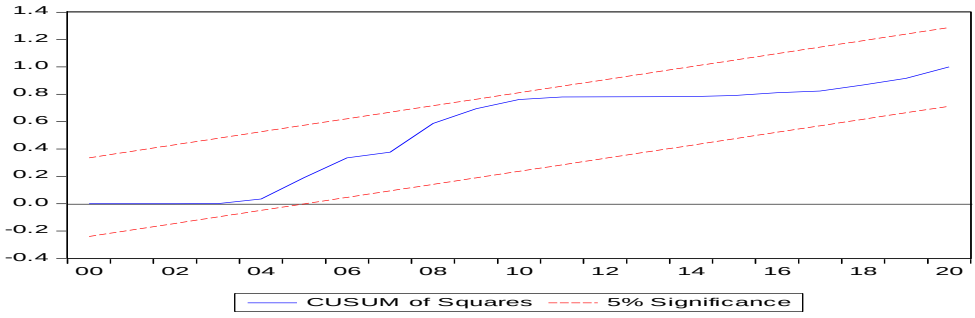

Figure 2. Cumulative sum of Square for HDI Model

5. Conclusion and Recommendations

This study examined the impact of budget deficit, debt servicing on economic development in Nigeria from the period 1981 – 2022. The study investigated the long run and short run relationship between the variables using Autoregressive Distributed Lag (ARDL). The empirical results show that human development index has a negative relationship with the variables of CSD, GED, INF and INTR both in the long run and short run, while GDD is positively signed and statistically significant only in the long run. Based on the findings, the study makes the following recommendations: Since government domestic borrowings are positively and statistically significant to Nigeria's development, the government should direct borrowed monies to sectors/areas of the economy that will spur growth and development, such as education, health, industry, and transportation. The education and health sectors can be enhanced with enough funding and equipment. To stimulate investment, the interest rate should be modest. At the very least, interest

rates should not exceed single digits, borrowers should be able to obtain loans, and the repayment period should be extended, so that consumers do not feel trapped each time they obtain a loan. The Federal government of Nigeria should reduce the rate at which it results to loans, especially foreign or external loans as a means of financing budget deficits.

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