

# Impact of Public Debt on Economic Growth in Nigeria

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**ABSTRACT:** The study used Gross Domestic Product as the dependent variable and also used Public Debt, External Debt, Domestic Debt, External Debt Stock Ratio, Exchange Rate and Interest Rate as independent variables. The study used the Auto Regressive Distributed Lag modelling technique coupled with the Engle Granger causality test to reveal the direction of causality. Hence, it was revealed that External debt stock ratio has significant effect on Gross Domestic Product in the long run. However, External Debt, Domestic Debt and Exchange Rate were found to be positively related to Gross Domestic Product while Public Debt, External debt stock ratio and Interest Rate were found to be negatively related to Gross Domestic Product. Also, Gross Domestic Product causes Public Debt while Domestic Debt causes Gross Domestic Product, Exchange Rate and Interest Rate. Hence, it was recommended that Debt Management Office (DMO) should fix limits on the debt to be incurred by state and local governments in every fiscal year to ensure that the rate of debt is effectively minimized while a viable and active committee should be set up by the senate (legislative arm of government in conjunction with the Debt Management Office to monitor the use of the funds borrowed by the government and the funds channeled out of the economy to settle debt servicing dues.

**KEYWORDS:** Public Debt, Debt Servicing, External Debt, Domestic Debt

## I. INTRODUCTION

The sustained growth of the economy is the major desire of every nation including the less developed nations of the world which are facing the challenges of low capital formation, domestic savings and investment (Adepoju, Salau&Obayelu, 2007). Ordinarily, when countries face the problem of paucity of capital, in most cases, they tend to resort to borrowing to supplement the domestic savings within the economy (Aluko &Arowolo, 2010). According to Soludo (2003) as cited by

Utomi (2014), the majority of countries existing in the world at this contemporary time borrow in a bid to finance the increasing level of consumption an investment as well as financing or bridging the gap created by budget deficit in the economy. Government debt may be sourced from within or beyond the country where the government is domiciled, this led to the classification of debt as domestic or external debt whereby debt obtained within the country is known as domestic debt while external debt refers to debt obtained from outside the country sources.

In Literature, it has been considered that public debt has a substantial effect on economic growth especially after the 2008 global financial crisis that rocked the world (Canbek, 2014). Reinhart and Rogoff (2010) assumed that the rate of economic growth all over the world moves at a slow pace because of the increasing public debt to Gross domestic Product ratio which is exceeding 90% sparking various contributions in literature on the subject matter such as that of Kumar and Woo (2010) and Panizza and Pressbitero (2013). In theory, it is assumed that despite the assistance that public debt can provide to the economy, high level of public debt will definitely reduce the rate of economic growth through its crowding out effect, distortionary taxation, inflation and uncertainty within the economy. the need for external financing has been seen to be inevitable in Nigeria and according to literature, it will continue to exert substantial effect on the rate of economic growth.

Public borrowing has substantial effect on the domestic economy considering various countries in the world and Nigeria is not an exception. Hence, there exists a preponderance of contributions in literature as regards the subject matter (Muhammad, 2017; Amilcar, 2016; Ogawa, Sterken&Tokustu, 2016; Mousa & Abdullah, 2017; Saifuddin, 2016; Ewubare, Nteegah&Okpoi, 2017; Mbah, Umunna &Agu, 2016). Hence, this study is set to contribute to existing body of knowledge in this regards taking into cognizance the Nigerian

standpoint. Moreso, considering the contributions in literature as regards the subject matter from the Nigerian perspective (Ezeabasili, Isu&Mojekwu, 2011; Egbetunde, 2012; Al-Zeaud, 2014), it can be discovered that these studies were limited to the use of just the long run regression technique. However, this study will further improve on existing contributions by utilizing the Engle Granger Causality Test to determine the direction of causality vis-à-vis public debt indices and economic growth in Nigeria. Furthermore, considering the presence of mixed result in literature where Muhammad (2017) discovered a positive relationship between public debt and economic growth while Amilcar (2016) discovered otherwise, it is necessary to carry out a study to ascertain the real fact.

## II LITERATURE REVIEW

Public debt refers to government IOUs issued by the government to individuals, organizations and other governments. Ordinarily, governments borrow from entities within the economy just like private individuals do in a bid to finance their long term and short term financing needs which cannot be financed from other sources (Shaibu, 2003 in Okewale, 2012). The government of a country becomes indebted when it borrows to meet up with the deficit as a result of short fall in revenue to carry out necessary pre-planned expenditure. However, Okewale (2012) opined that government borrows to finance wars, handle economic crises and finance economic development. Specifically, public debt can majorly be classified as domestic or external debt; domestic debt refers to borrowings by the government from sources within the country while external debt refers to borrowings sourced from sources outside the country. These sources refer to the Paris and London clubs of creditors, Multinational agencies like the International Monetary Fund, World Bank and other agencies.

However, despite the obvious need for debt in financing the activities of the government, it has been argued in literature that debt has positive and negative effect on the development of the debtor country. Asley (2002) as cited by Okewale (2012) averred that a very high level of external debt in a developing country will definitely exert a negative influence on their trade capacities and performance. This debt overhang resulting from debt financing will lead to reduction in investment and stability. In same manner, it will reduce the ability of the government to invest in production and marketing exports, build infrastructure and coordinate a good labour force. Correspondingly,

Muhtar (2004) as relayed by Okewale (2012) assumed that the servicing of public debt has a negative influence on the economy as a whole, in that the resources /that could have been used to spur socio-economic development and reduce poverty are used to service debts resulting to a negative net resources flow. However, Eaton (1993) as cited by Okewale (2012) was of a different opinion that the effect of debt on economic development is a function of the kind of debt in question, debt was then classified as reproductive debt and dead weight debt, reproductive debt was considered as debt obtained to enable the state or the government to purchase assets like electricity while dead weight debt refers to debt obtained to finance war and expenses. As a result, the effect of debt on economic growth relates to context of the debt and the use of it as its effect diffuses into the economy.

The theory as propounded by Baran (1957) and popularized by Frank (1971) and Rodney (1974) assumed that the development of some countries greatly depend on the development of other countries. Hence, the dependent countries are merely a reflection of the dominant countries. Samir (1978) as cited by Okewale (2012) in substantiation of the theory that resources flow from the periphery of the poor and underdeveloped countries to the core of the wealthy states leading to the enriching of the wealthy countries at the expense of the poor countries. Ikejiaku (2010) as relayed by Okewale (2012) assumed that poor states are impoverished and the rich ones are enriched by the way the poor ones are integrated into the world system.

As a result of the above postulation, these dependent countries then go for loans to improve the situation, yet, they have to pay back the loans with higher interest rates, as a result rendering the countries more dependent on the dominant and rich countries, this is referred to as the debt trap. As a result, dependent countries remain dependent. The dependency theory assumes that poor nations provide the natural resources and labour at cheap prices whereas they end up as destination for obsolete technology as the dominant nations try to exert more influence on the dependent nations. In summary, dependent nations are not as wealthy as their dominant counterparts and as such still borrow from the wealthy ones making them more dependent and at the mercy of the wealthy nations.

The hypothesis as propounded by Krugman (1988) and substantiated by Fosu (1996) considers debt overhang as an economic circumstance whereby investments are reduced because the private sector assumes that the return

accruing to them from their investment will be used to pay back public creditors. This implies that the servicing of the public debt of a country directly relates to the output level of a country (Chongo, 2013). As a result, increasing the debt stock of a country will lead to behaviour of uncertainty as regards investment among investors in the country in relation to the policies of the government. Consequently, Krugman (1988) posited that most prospective investors in a country will first try to pause and forecast or see the policies of government as regards the servicing of debt before investing as it is assumed that discretionary tax measures will be used to finance debt servicing obligations. However, this waiting will definitely affect the rate of private investment in the country and the economy at large. Krugman (1988) in a more specific way explicated the debt overhang as a case whereby the anticipated present value of any future potential resource transfer is less than its debt in that the choice between additional financing and debt payment is irreconcilable.

Correspondingly, Alberto and Tabellini (1989) and Cerra, Meenakshi and Saxena (2008) argued that a high rate of public debt will definitely exert a negative effect on the economy as it discourages capital inflows and encouraging capital flight as funds are moved enmasse from the country in the name of settling debts. Effendi (2001) considers debt overhang as a situation whereby the external debt burden discourages domestic investment in slowing down the rate of economic growth in as much as foreign exchange earnings would have been turned over to foreign creditors.

The Harrod-Domar model displays a direct relationship between savings and economic growth and an indirect relationship between capital and economic growth. Hence, economic growth is considered to be a direct result of capital accumulation in the way of savings in the economy (Abuzaid, 2011). Furthermore, the model assumes that growth in the economy is proportional to the rate of investment, hence, it is imperative to note that growth can be achieved by multiplying the target growth rate with the incremental capital output ratio; as a result, the financing gap refers to the difference between available and required investment (Abuzaid, 2011). However, Tiruneh (2004) posited that this gap is filled in by the presence of foreign capital.

Specifically, the Harrod Domar model emphasizes the need for foreign borrowing or debt to close the gap between the targeted investment needs and the available national savings. This gap known as the investment savings gap can be filled

by foreign borrowing. However, the model has been criticized for being unstable in that it requires the equalization of warranted and natural growth rates coupled with the use of production function which does suitability between inputs rendering it unstable.

Muhammad (2017) studied the effect of public debt on economic growth in South East Asian countries between 2006 and 2015. The study used gross domestic product as the dependent variable and also used public debt as the independent variable coupled with the use of the Vector Auto Regressive technique, it was revealed that public debt has positive effect on economic growth. Hence, it was recommended that every country should establish proper public debt management to improve the rate of public debt.

Amilcar (2016) studied the impact of public debt on economic growth in developed countries between 1946 and 2009. The study used Gross Domestic Product as the dependent variable and also used public debt as independent variable coupled with the use of regression technique; it was revealed that public debt has a negative effect on economic growth. As a result, it was recommended that governments should develop strategies for management of public debt.

Ogawa, Sterken and Tokutsu (2016) studied the relationship between public debt and economic growth in industrialized countries between 1995 and 2013. The study used Gross Domestic Product as the dependent variable and also used public debt and interest rate as independent variable coupled with the use of regression technique, it was revealed that public debt has a negative effect on economic growth. Hence, it was recommended that countries should design a platform to stabilize economy despite mounting public debt.

Bilan (2015) studied the effect of public debt on economic growth in Europe between 1994 and 2013. The study used gross domestic product as the dependent variable and also used population, public debt, trade openness, exchange rate, inflation and interest rate as explanatory variables coupled with the use of descriptive and regression techniques, it was revealed that public debt has positive effect on economic growth but the effects becomes reversed after a particular threshold. Hence, it was recommended that countries with high debts should target fiscal sustainability.

Mousa and Abdullah (2017) studied the impact of public debt on economic growth of Jordan between 2000 and 2015. The study used Gross domestic product as dependent variable and also used domestic debt, external debt, debt

servicing and total public debt as independent variables coupled with the use of regression technique, it was revealed that public debt has negative impact on economic growth. Hence, it was recommended that government should rely on internal resources than resort to external borrowing.

Saifuddin (2016) studied the impact of public debt on economic growth in Bangladesh between 1974 and 2014. The study used gross domestic product as dependent variable and also used total public debt, investment, trade openness, remittance flow, human capital as independent variables coupled with the use of regression techniques, it was divulged that public debt is positively related to economic growth. Hence, it was recommended that resources generated through debt should be used for productive investment.

Jilenga, Xu and Igor-Mathieu (2016) studied the impact of external debt and foreign direct investment on economic growth in Tanzania between 1971 and 2011. The study used Gross Domestic Product as the dependent variable and also used external debt, foreign direct investment inflows, exchange rate, repayments on external debt and net official development assistance as independent variables coupled with the use of regression techniques; it was revealed that public debt has a positive effect on economic growth. Hence, it was recommended that proper management of external debt should be established to monitor debt servicing payments.

Khemais, Mohamed and Nesrine (2016) studied the effect of external debt on economic growth in Tunisia between 1961 and 2011. The study used Gross domestic product as the dependent variable and also used external debt, investment, trade openness, rate of schooling, rule of law and broad money supply as independent variable coupled with the use of Vector Auto Regressive technique, it was revealed that external debt service has negative effect on economic growth. Hence, it was recommended that debt should be used properly and efficiently.

Ewubare, Nteegah and Okpoi (2017) studied the effect of public borrowing on economic growth in Nigeria between 1980 and 2015. The study used Gross Domestic Product as the dependent variable and also used external debt, domestic debt, debt service, foreign direct investment and foreign exchange reserve as independent variable coupled with the use of the Auto Regressive Distributed Lag model revealing that external debt has positive effect on economic growth while domestic debt has negative effect on economic growth. The study recommended that funds borrowed should be effectively utilized.

Mbah, Umunna and Agu (2016) studied the impact of external debt on economic growth in Nigeria between 1970 between 2013. The study used Gross Domestic Product as the dependent variable and also used ratio of external debt to GDP, debt service stock to GDP, national expenditure to GDP, real exchange rate and trade openness as independent variables coupled with the use of the Auto Regressive Distributed Lag method, it was revealed that external debt has negative effect on economic growth. Hence, it was recommended that government should promote savings and attract foreign capital rather than borrowing.

Igbodika, Jessie and Andabai (2016) studied the effect of domestic debt on economic growth in Nigeria between 1987 and 2014. The study used gross domestic product as the dependent variable and also used domestic debt, inflation rate and lending rate as independent variables coupled with the use of regression techniques, it was revealed that domestic debt has a positive effect on economic growth. Hence, it was recommended that government should finance projects through the use of tax revenue than debts.

Abula and Mordecai (2016) studied the impact of public debt on economic development in Nigeria between 1986 and 2014. The study used Gross Domestic Product as the dependent variable and also used External debt, Domestic debt, external debt service payment and domestic debt service payment as independent variables coupled with the use of the Error Correction Mechanism, it was revealed that while external debt stock has a negative effect on economic growth, domestic debt has positive effect on economic growth. Hence, it was recommended that government should reduce the level of external debt as it accumulates over time.

Onogbosele and Mordecai (2016) studied the impact of domestic debt on economic growth in Nigeria between 1985 and 2014. The study used Gross Domestic Product as the dependent variable and also used treasury bonds, development stock, federal government bonds and interest rate as independent variable coupled with the use of descriptive analysis and Vector Auto Regression technique; it was revealed that domestic debt has significant impact on economic growth in Nigeria. Hence, it was recommended that government should acquire funds through the use of bonds as it exerts positive impact on economic growth.

### III METHODOLOGY

The study will adopt an economic approach in the analysis of impact of public debt on

economic growth. An econometric approach of the Auto Regressive Distributed Lag (ARDL) Modeling and Engle Granger Causality technique will be adopted to test for the relationship between the variables. The study will makes use of time series data spanning from 1986 through 2015. The Auto Regressive Distributed Lag (ARDL) bounds testing methodology as developed by Pesaran and Shin (1999) has been favoured above the co-integration analysis developed by Engle and Granger (1987) and Johansen and Juselius (1990) due to the low power problems associated with the co-integration analysis. It is used in cases of mixed integration (Shrestha & Chowdhury, 2007). The methodology as developed by Granger (1969) shows whether a change in a variable will cause a change in another variable. Causality can be

unidirectional, bidirectional or no relation at all based on the probability value of the F-statistics.

The objective of the study is to investigate the impact of public debt on economic growth in Nigeria. Hence, the model formulated for the study as adapted from the study of Abula and Modercai (2016) is stated hereunder:

$$GDP = f(PD, EXTD, DOMD, EDSR, EXGR, INTR)$$

#### IV ANALYSIS AND DISCUSSION OF RESULT

This segment of the study discusses the analysis and result of the study. Hence, the model formulated for the study as adopted from the study of Abula and Modercai (2016) is stated hereunder:

#### Bounds Test Result

F-Statistics	I(0)	I(1)
6.688011	2.45	3.61

Source: Analysis Output using E-Views 9 by author

The Bounds test result revealed that there exists a long run relationship between the variables as the F-statistics is greater than upper bound at 5%.

#### ARDL Short Run

Dependent Variable: GDP

Variable	Co-Efficient	Std. Error	T-Statistics	Prob.
GDP(-1)	0.710597	0.070295	10.10883	0.0000
PD	-0.008158	0.198745	-0.041047	0.9676
EXTD	0.067341	0.083019	0.811154	0.4264
DOMD	0.154077	0.105159	1.465181	0.1577
EDSR	-0.095280	0.042623	-2.235406	0.0364
EXGR	0.086925	0.062410	1.392807	0.1782
INTR	-0.047080	0.108896	-0.432336	0.6699
C	1.053799	0.381562	2.761803	0.0117

Source: Output of data analysis by author (2019) using E-Views 9

The ARDL short run result revealed that the lagged value of economic growth, external debt, domestic debt and exchange rate exert a positive effect on economic growth while public debt, external debt stock ratio and interest rate has

a negative effect on economic growth in the short run. However, lagged value of economic growth and external debt stock ratio has significant effect on economic growth.

**ARDL Long Run Result**  
**Dependent Variable: GDP**

Variable	Co-Efficient	Std. Error	T-Statistics	Prob.
PD	-0.028189	0.688846	-0.040921	0.9677
EXTD	0.232691	0.302053	0.770364	0.4497
DOMD	0.532394	0.357775	1.488070	0.1516
EDSR	0.329231	0.129351	2.545261	0.0188
EXGR	0.300358	0.219593	1.367798	0.1858
INTR	0.162679	0.364533	0.446268	0.6600
C	3.641284	1.205521	3.020506	0.0065

Source: Output of data analysis by author (2019) using E-Views 9

The relationship between the dependent variable and the independent variables can be expressed mathematically as: The relationship between the dependent variable and the independent variables can be expressed mathematically as:  $GDP = f(PD, EXTD, DOMD, EDSR, EXGR, INTR)$

$$GDP = 3.641284 - 0.028189PD + 0.232691EXTD + 0.532394DOMD - 0.329231EDSR + 0.300358EXGR - 0.162679INTR + \mu$$

**Engle Granger Causality Result**

PD does not Granger Cause GDP 1.6972 28 7 0.2053  
GDP does not Granger Cause PD 3.0900 2 **0.0648**

EXTD does not Granger Cause GDP 1.0692 28 2 0.3597  
GDP does not Granger Cause EXTD 1.3409 0 0.2813

DOMD does not Granger Cause GDP 3.5457 28 2 **0.0455**  
GDP does not Granger Cause DOMD 0.8861 7 0.4258

EDSR does not Granger Cause GDP 1.5753 28 7 0.2285  
GDP does not Granger Cause EDSR 3.2658 8 **0.0564**

EXGR does not Granger Cause GDP 3.1714 28 2 **0.0608**  
GDP does not Granger Cause EXGR 1.6045 1 0.2227

A proper scrutinization of the regression result shows that external debt, domestic debt and exchange rate has a positive effect on economic growth while public debt, external debt stock ratio and interest rate has negative effect on economic growth. However, external debt stock ratio which is the ratio of external debt to exports has significant effect on economic growth. This implies that an improvement in the ratio of external debt to exports leads to an increase in the rate of economic growth.

Source: Analysis Output using E-views 9 by author

The result revealed that Economic Growth causes Public Debt and External Debt Stock Ratio while each of Domestic Debt, Exchange Rate and Interest Rate causes Economic Growth.

Interestingly, the model was found to be highly significant and devoid of auto correlation, non-functionality, heteroskedasticity, instability and abnormal distribution as a result of the values of the LM Serial Correlation test, Heteroskedasticity test, Ramsey Reset Test, CUSUM test and Normality Test showed that the findings of the study can be relied upon for policy recommendation.

**V. CONCLUSION AND RECOMMENDATION**

The study examined the impact of public debt on economic growth in Nigeria. The study used Gross Domestic Product as the dependent variable and also used Public Debt, External Debt, Domestic Debt, External Debt Stock Ratio, Exchange Rate and Interest Rate as independent variables. The study used the Auto Regressive Distributed Lag modelling technique coupled with the Engle Granger causality test to reveal the direction of causality. Hence, it was revealed that External debt stock ratio has significant effect on Gross Domestic Product in the long run. However,

External Debt, Domestic Debt and Exchange Rate were found to be positively related to Gross Domestic Product while Public Debt, External debt stock ratio and Interest Rate were found to be negatively related to Gross Domestic Product. Also, Gross Domestic Product causes Public Debt while Domestic Debt causes Gross Domestic Product, Exchange Rate and Interest Rate. Hence, it was recommended that Debt Management Office (DMO) should fix limits on the debt to be incurred by state and local governments in every fiscal year to ensure that the rate of debt is effectively minimized while a viable and active committee should be set up by the senate (legislative arm of government in conjunction with the Debt Management Office to monitor the use of the funds borrowed by the government and the funds channelled out of the economy to settle debt servicing dues.

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