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FISCAL DEFICITS AND OUTPUT GROWTH IN NIGERIA

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ABSTRACT

Both static and dynamic simultaneous equation models were used in determining the impact of fiscal deficits and inflation on output growth, and their impulses responses in Nigerian economy. Using annual data for the period of 1971 to 2009 shows that inflation rate, output growth, and money supply have contraction impact on the fiscal deficits. The real money supply was found to be relatively more important in explaining fiscal deficits. Equation 2 shows that real money supply, output growth and fiscal deficits have insignificant expansionary effect on inflation. Equation 3 of the static structural model reports that Fiscal deficit and inflation have a significant expansionary effect on Real money supply while output growth has a contraction impact on inflation rate in Nigeria. The empirical evidence from the VEC model reports that fiscal deficits are negatively related to output growth. On the other hand, fiscal deficits have a positive relationship with inflation rate.

KEYWORDS
Nigerian economy, Fiscal Deficits, Finance.

INTRODUCTION

Fiscal deficits contribute to greater liquidity and inflation which has led to situations where expenditure could not be curtailed, resources could not be raised for fear of adverse effects. In most of the developing countries, inadequate attention was given to policies that have inflation-induced thereby creating distortions in the management of available resources. There is no doubt that Nigerian economy is still suffering under mild output growth, high inflation rate and weak fiscal condition in spite of the demand management policies being adopted in Nigeria. In 1971, Nigeria had fiscal surplus of 2.6 percent, inflation rate 15.6percent and output growth 21.4 percent. In 1972, fiscal deficit was 0.8 percent, while inflation and output growth decreased to 3.2 percent and 5.5 percent respectively. The average rate of deficit between 1975 and 1978 was 4.05 percent while that of inflation was 21.8 percent and output growth was 2.2 percent. Fiscal deficit became continuous from 1981 to 1994 with an average of 8.2 percent. In the same period, inflation and output growth averaged 26.3 percent and 0.8 percent respectively.

Fiscal deficit was reduced from 15.6 percent in 1993 to 7.7 percent in 1994 while inflation rate increased from 54.2 percent in 1993 to 57 percent in 1994. A similar case was obtained between 1982 and 1983, 1986 and 1987. The collapse of oil price, frequent high rate of inflation and relatively insignificant output growth in 1980s led to efforts at restructuring the economy and addressing the increasing level of poverty. (Soludo 1998, Trade policy of Nigeria 2000).

There is a confusing linkage between fiscal deficit and output growth among many researchers. Some of them believe that fiscal deficit has a positive relationship with output growth (Eisner and Pieper1984) while others state that deficits are negatively associated with capital accumulation and hence negatively with output growth. The previous studies have advanced in characterizing the implications of alternative sources and composition of deficits spending without tracing the transmission of structural shocks from one variable to another. In light of the above discussion, this work intends to address the following questions.

1. What are the impacts of fiscal deficits on output growth and inflation in Nigeria?
2. What is the nature of the relationship among fiscal deficit, output growth and inflation?

OBJECTIVES OF THE STUDY

The objectives of the study are:

1. To determine the impact of fiscal deficits on output growth and inflation.
2. To determine the impulse responses among fiscal deficits, output growth and inflation in Nigeria in order to trace the transmission of structural shocks from one variable to another.

HYPOTHESIS OF THE STUDY

The hypotheses of the study are:

1. Fiscal deficits have no impact on output growth and inflation in Nigeria
2. Fiscal deficits, output growth and inflation have no significant impulse response in Nigeria.

SIGNIFICANCE OF THE STUDY

Fiscal deficits and output growth appear to be the macroeconomic problems facing Nigeria. It is possible that either a wrong diagnosis has been made of the problem or that certain factors within the economy are preventing the variables from staying within target level. The impulse response used in this research will indicate the magnitude of the shocks transmitted from one variable to another. This will help policy analysts in their recommendation and governments in pursuing consistent fiscal policies.

SCOPE AND LIMITATION

This study carries out econometric analysis of fiscal deficits and output growth in Nigeria. It determines the impact of fiscal deficits and inflation on output growth; and identifies the relationship among these macroeconomic indicators. This research covers a period of thirty (39) years (1971-2009).

LITERATURE REVIEW

De Gregorio (1992:417-425, Fischer (1993: 485-512) and Agenor (1999:28) observe that the correlation between inflation and growth is nonlinear and negative. Agenor (1999) believes that at low levels of inflation, changes in inflation have only a negligible impact on growth rate.

Money supply and real output influence the price level directly and inversely respectively. Adejube (1982:65) they show the relationship between real output and inflation, he did not show the relationship between fiscal deficit and inflation or fiscal deficit and output growth. He also did not find out whether dependent variable and each independent variable are random walk stochastic processes.

Anand and Wijnbergen (1989:31) state that government can expect 2.7 percent of GNP from the inflation tax if inflation remains at 25 percent a year. They conclude that "to maintain consistency between fiscal policy and even a moderate inflation target at 25 percent, a substantial further reduction in fiscal deficits of one percentage point of GNP is required.

The empirical work done by Chibber and Shafik (1990), Sowa and Kwakye (1991) and Sowa (1994) show that output and money supply are significant explanatory variables of the inflation spiral in Ghana. Sowa (1994) indicates that the inflation elasticity with respect to output is almost unity (0.967). He shows that inflation in Ghana, either in the long run or short run, is influenced more by output volatility than monetary factors. These studies did not determine the level of fiscal deficit that is sustainable with a given level of output growth and inflation rate.

Romer (1993:872) points out that unexpected monetary shock affect both prices and real output from its natural or equilibrium value is positively related to departure of actual inflation from expected inflation. Agenor (1991:28) states that high inflation and large fiscal deficits are often seen as key symptoms of macroeconomic instability. He observes that such instability is, in general, more pronounced in developing countries relative to industrial countries because the former tends to be more diversified and less able to absorb external shocks.

Oyijide (1972) observed that budget deficits in Nigeria (between 1957 to 1972) were used for capital formation, economic growth and development. He points out that deficit financing goes with increases in the domestic price level during the period of study. He did not specify the relationship between fiscal deficit and increase in aggregate demand. Ochimeze (1991) notes that changes in deficit financing do not have significant influence on changes in gross national income, gross capital formation and consumer price index.

THE MODEL

The model for the study is the Structural Vector Autoregressive (SVAR) transformed into a Vector error correction (VEC). Cooley and Leroy (1985) and Sarte (1997) state that if reduced VAR models are interpreted as structural VARs, the restrictions on error distribution adopted in atheoretical macroeconometrics are not arbitrary renormalizations but prior identifying restrictions. The structural equations of the model are written as:

$$INF_t = \alpha_0 + \Sigma\beta\ INF_{t-1} + \Sigma y_i\ (FD/GDP)_{t-l} + \Sigma b_i\ YG_{t-1} + \Sigma d_i\ RMS_{t-1} + e_{ti} \quad \text{---------- (1)}$$

$$(FD/GDP)_t = \alpha_1 + \Sigma\phi\ INF_{t-1} + \Sigma a_i\ (FD/GDP)_{t-1} + \Sigma\lambda\ YG_{t-1} + \Sigma p_i\ RMS_{t-1} + e_{t2} \quad \text{---------- (2)}$$

$$YG_t = \alpha_2 + \Sigma w_i\ INF_{t-1} + \Sigma k_i\ (FD/GDP)_{t-1} + \Sigma h_i\ YG_{t-1} + \Sigma g_i\ RMS_{t-1} + e_{t3} \quad \text{---------- (3)}$$

where: INF = Inflation rate

FD = Fiscal deficit = overall balance

GDP = Gross Domestic Product

YG = Output growth

RMS = Real money supply

α_0, α_1 and α_2 are the intercepts of inflation function, Fiscal deficit function and output growth function respectively.

β, y, b, d, ϕ, a, λ, p, w, k, h, and g are the coefficients of the macroeconomic variables in the model.

U's are the impulse or innovations (stochastic terms).

The Vector error correction (VEC) model is specified as:

$$\Delta INF_t = \alpha_0 + \beta\Sigma\Delta\ INF_{t-1} + y_i\Sigma\Delta\ (FD/GDP)_{t-l} + b_i\Sigma\Delta\ YG_{t-1} + d_i\Sigma\Delta\ RMS_{t-1} + \gamma_1\ (EC)_{t-1} + E_t \quad \text{---------- (4)}$$

$$\Delta\ (FD/GDP)_t = \alpha_1 + \phi\ \Sigma\Delta\ INF_{t-1} + a_i\Sigma\Delta\ (FD/GDP)_{t-1} + \lambda\ \Sigma\Delta YG_{t-1} + p_i\Sigma\Delta\ RMS_{t-1} + \gamma_2\ (EC)_{t-1} + E_{2t} \quad \text{---------- (5)}$$

$$\Delta YG_t = \alpha_2 + w_i\Sigma\Delta\ INF_{t-1} + k_i\Sigma\Delta\ (FD/GDP)_{t-1} + h_i\Sigma\Delta YG_{t-1} + g_i\ \Sigma\Delta\ RMS_{t-1} + \gamma_3\ (EC)_{t-1} + E_{3t} \quad \text{---------- (6)}$$

where: E's are the error terms
EC = The error correction term which is obtained from the co-integration relation.
Δ = change in

PRESENTATION OF RESULTS AND ANALYSIS

The results of the unit root tests show that all the variables are integrated of order one I(1). These results are presented in table 4.1.

TABLE 1: UNIT ROOT TEST

Variables	ADF		Longest lag	Standard error	t-value (level)	t-value (1st dif)	HCSE
	Levels	1st dif					
FD/GDP	0.66370	-0.3363	1	0.24541	2.704	-1.370	0.59969
INF	0.54761	-0.4524	1	0.16007	3.421	-2.826	0.21122
YG	0.04646	-0.9535	1	0.17343	0.268	-5.498	0.09204
RMS	0.83065	-0.1694	1	0.08898	9.335	-1.903	0.06564

The Engle-Granger (EG) and Co integrating Regression Durbin-Watson (CRDW) tests are now supplemented by the more powerful tests developed by Johansen. The results of the Johansen cointegration tests are summarized in Table 4.2.

TABLE 2: JOHANSEN COINTEGRATION TEST RESULTS

Eigenvalue	Likelihood ratio	5% critical value
0.904976	-155.601	27.1
0488318	-149.906	21.0
0.347634	-146.275	14.1
0.223756	-144.122	3.8

The Eigenvalues with corresponding likelihood shows rejection of the null hypothesis at 5 percent significance level.

RESULTS OF THE SHORT-RUN STRUCTURAL MODEL

The results for the short-run static unrestricted model are reported in table 4.4.

TABLE 4: RESULT OF THE SHORT-RUN STATIC REDUCED FORM EQUATIONS

Independent variables	**Dependent Variables**			
	FD/GDP Equation 1	INF Equation 2	RMS Equation 3	YG Equation 4
FD/GDP_{t-1}	0.82620 (-3.077)**	0.45309 (0.683)	1.3265 (0.740)	-0.61898 (-1.657)
INF_{t-1}	-0.078067 (-0.574)	-0.95747 (-2.852)**	0.12859 (-0.142)	0.20452 (1.082)
YG_{t-1}	-0.11106 (-0.668)	0.00776 (0.165)	-0.8923 (-0.809)	-1.1748 (-5.078)**
RMS_{t-1}	-0.046604 (-2.332)**	0.063131 (1.279)	0.21715 (-1628)	-0.10723 (-3.857)**

$R^2 = 0.975378$
Note: The figures in the parenthesis indicate the t-statistics.
** indicates that the statistic is significant at 5% level of significance.

The above result shows that inflation, output growth, Real exchange rate, and Real money supply affect Fiscal deficits by 0.078, 0.111, and 0.047 percents respectively. In equation 2, Fiscal Deficit (FD/GDP) affects Inflation rate by 0.45309 which is significantly different from zero. The most prominent effect on the inflation rate is that of the Real money supply as is evident from the total effect of 0.063131 and t-value of 1.279 which are significantly different from zero. This is in accordance with Chibber and Shafik (1990) and contrary to Sowa (1994:1114). In equation 4, RMS has a significant contraction impact on output growth with total effect of –0.10723 and t-value –3.857. Inflation has an expansionary effect on output but not significant. This is in order with the work of Fischer (1993) and Easterly and Rebelo (1993). In equation 3, Fiscal Deficits affects Real money supply rate by 1.3265. Inflation affects Real money supply by 0.12859 while output growth affects Real Money Supply (RMS) by -0.89823. The R^2 value of 0.98 indicates that about 98 per cent of the variations in the dependent variables can be explained by the exogenous variables. The F-tests on retained regressors indicate that money supply, fiscal deficits and output growth are significant.

THE RESULTS OF VECTOR ERROR CORRECTION MODEL

The results of the estimated preferred parsimonious VEC model are presented in table 5.

TABLE 4.5: THE RESULTS OF VEC MODEL

Independent Variables	**Dependent Variables**			
	FD/GDP Equation 1	YG Equation 2	INF Equation 4	RMS Equation 3
FD/GDP_{-1}	-0.22414 (-1.005)	-0.092984 (-0.374)	0.35736 (0.646)	0.04132 (0.028)
YG_{-1}	-0.118801 (0.655)	-0.15550 (0.768)	0.55797 (1.239)	0.9876 (0.606)
INF_{-1}	0.038190 (0.571)	0.063533 (0.852)	0.53669** (3.235)	-0.79112 (-2.174)
RMS_{-1}	0.024100 (1.163)	-0.074069** (-3.203)	0.11704** (2.275)	0.72581 (6.431)

Note: The figures in parenthesis indicate the t-tests
*indicates that the statistics is significant at 5 per cent level of significance

In equation 1, fiscal deficits are influenced by one year lagged value of itself. Other variables such as inflation, real exchange rate output growth and real money supply affect fiscal deficits and their parameters are significantly different from zero.
In equation 2, output depends on fiscal deficits, inflation and the lag of itself, but the most prominent effect on it is that of real money supply. Fiscal deficits and output growth influence inflation rate by 0.35736 and 0.55979 respectively. The coefficients of the variables in equation 2 are correctly signed.
Equation 3 in table 4.5 shows that inflation rate is significantly affected by the lag of itself and money supply. Fiscal deficits and output growth also affect inflation rate but not significant.
The above results indicate that if Nigeria wants to achieve a sustained high rate of growth of output in the long run, it must concentrate on the development of appropriate policies. The R2 = 0.933 implies that the repressors explain 93 percent of the variations in the system. The F-tests on the retained regressors also indicate that inflation, real money supply, output growth, rate and fiscal deficits are significant in the model.

THE IMPULSE RESPONSE

The result of the impulse response functions are shown in table 6.

TABLE 6: IMPULSE RESPONSE

Independent Variables	Dependent Variance			
	FD/GDP	YG	RMS	INF
FD/GDP	-0.8262	-0.1111	-0.04660	-0.07807
YP	-0.6.90	-1.175	-0.1092	0.2045
RMS	1.326	-0.8982	-0.2172	-0.1286
INF	0.4531	0.06777	0.06313	-0.9575

\+ = Expansionary impact
\- = Contraction impact
The impulse response functions indicate that any unanticipated increase in fiscal deficits will have a contraction impact on itself and output growth. The impact of this is expansionary on inflation rate and real money supply.
The effect of any unanticipated increase in output growth on its lag, fiscal deficits, and real money supply is contraction and expansionary on inflation. Any unanticipated increase in inflation rate will have contraction impact on its lag, as well as real money supply. On the other hand, an unanticipated increase in inflation rate will have expansionary impact on fiscal deficit and output growth.
The results of the impulse responses further indicates that any unanticipated increase in money supply will have contraction impact on itself, as well as output growth and fiscal deficits. It has an expansionary impact on inflation.

EVALUATION OF HYPOTHESES

In this section, we shall test the two hypotheses of the study base on our analysis of the model.
Test of hypothesis one
H_o: Fiscal deficits have no impact on output growth and inflation rate in Nigeria.
H_o: Fiscal deficits have impact on output growth and inflation rate in Nigeria.
The results of the parsimonious Vector Error Correction (VEC) model show that fiscal deficits have impact on output growth and inflation in Nigeria as show in table 4.5. The implication of negative coefficients of fiscal deficits is to emphasize a contractionary impact of fiscal deficit on output growth. On the other hand, fiscal deficits have positive impact on inflation rate. The $R^2 = 0.93$ shows the goodness of fit of the model.

TEST OF HYPOTHESIS TWO

H_o: Fiscal deficits, output growth and inflation have no significant impulse response in Nigeria. H_1: Fiscal deficits, output growth and inflation have significant impulse response in Nigeria.
The results of the impulse response functions show that there is a significant transmission of structural shocks from one variable to another. The summary of these results are shown in table 4.6.

SUMMARY

The study employed static and dynamic simultaneous equation models to determine the impact of fiscal deficits on output growth and inflation, and to specify their impulses responses in Nigeria using annual data for the period of 1971 to 2009.
The empirical evidence from static structural model indicates that inflation rate, output growth, and money supply have contraction impact on the fiscal deficits. The real money supply was found to be relatively more important in explaining fiscal deficits. Equation 2 shows that real money supply, output growth and fiscal deficits have insignificant expansionary effect on inflation. Equation 3 of the static structural model reports that Fiscal deficit and inflation have a significant expansionary effect on Real money supply while output growth has a contraction impact on inflation rate in Nigeria.
The empirical evidence from the VEC model reports that fiscal deficits are negatively related to output growth. On the other hand, fiscal deficits have a positive relationship with inflation rate. It affects inflation rate by a total effect of 0.35736. There is evidence that inflation in Nigeria is engineered more by real money supply and shortage in output.

RECOMMENDATION

The following recommendations are made based on our findings.
1. There is need to check the growth of money supply because of its likely contraction impact on output growth.
2. Government should check the level of deficits for effective control of inflation rate in Nigeria. The need arises because increase in fiscal deficit increases money supply which negatively affects output growth.

AREA FOR IMPROVEMENT

The researcher suggests the following for further studies.
A study of the optimal deficit that is consistent with output growth and inflation rate in Nigeria.

CONCLUSION

In conclusion, the impact of fiscal deficits on output growth is negative. A unit increase in fiscal deficits brings a total effect of –0.092984 on output growth. This shows that the impact of fiscal deficits on output growth is not in accordance with the way some economists such as Eisner and Pieper (1994) regard it.
Our study also reports that the impact of fiscal deficits on inflation is expansionary. A unit change in fiscal deficits cause about 0.35736 increase in inflation rate.
The impulse response among fiscal deficits, output growth and inflation show that there are transmissions of structural shocks from one variable to another. We found out that fiscal deficits have contraction impact on output growth but an expansionary effect on inflation rate. Our study also reports that unanticipated

increase in inflation rate will have expansionary impact on fiscal deficits and output growth. An unanticipated increase in inflation rate will have expansionary impact on fiscal deficits and output growth.

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