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THE NEXUS BETWEEN DEFICIT FINANCING AND ECONOMIC GROWTH IN NIGERIA: EVIDENCE FROM THE ECM APPROACH

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Abstract
The study investigated the relationship between deficit financing and economic development in Nigeria from 1980 - 2024. The estimated from the co-integration test indicated that all the variables are integrated of order 1(0) fostering the need to conduct or apply the error correction mechanism to found if there is a short run relationship among then variables under investigation. The variables used are economic development proxy like human development index (HDI), broad money supply (BMS), deficit budget (BGD), domestic debt (DMD and external debt (EXD). Results showed that there is a long equilibrium among the variables with a speed of adjustment from its long run equilibrium to its short run equilibrium within the review period. The study concludes that running a budget deficit to a large extent controls the excesses of government spending due to the negative relations with human development index and finally the study recommends a comprehensive approach towards its fiscal spending in areas such as her domestic and external debts as it affects the economic wellbeing of Nigeria..

Keywords: Deficits, debts, development, financing, Nigeria

Background to the study

Deficit financing, where a government spends more than it collects in revenue, can have both positive and negative impacts on Nigeria's economic development. While it can boost growth through increased spending and investment, it can also lead to inflation, increased debt, and economic instability if not managed properly (Ogwueleka, Uju, Amaka, Obisike and Uzoma, 2022; Ishaka and Likita, 2021). The key is to ensure that deficit financing is used strategically, focusing on productive sectors and avoiding excessive levels of borrowing. Deficit financing is when government has a budget deficit, it is as result of government total revenue less total expenditure in a year. According to Kasasbeh and Alzoub, 2019; Pesaran, Shin and Smith, 2001; Dickson, 2020; Eze and Nwambeke, 2015), when government rather than using tax borrows to finance her public investments. In the same vein deficit financing arises due to budgetary deficit. This occurs when total revenue is less than total expenditure (Tosan and Olubomi, 2020; Ughulu, Edogiawerie and Billyaminu, 2023). In 1970, there were much economic crises: over-indebtedness and the debt burden in Nigeria, high inflation rate and poor investment performance due to exchange rate fluctuation and high-interest rate. According to Okoro (2013), this crisis where due to deficit financing in Nigeria. Deficit financing started in 1961. The policy was justified during the post-independence era,

largely because of the need to expand the economy then. From 1970, the country adopted the budgetary deficit policy because of huge public sector spending war reconstructions, wasteful spending, and mismanagement of the oil boom in the 1970's till the 1980's and from 1982, there was a decline in crude oil export earnings, this reduced the national reserves and resulted to heavy borrowing to finance public investments (Adesuyi and Falowo, 2013; Akanbi, Uwaleke and Ibrahim 2022). The fiscal deficit increased public spending, while revenue declined. Thus, leading to deficit financing as a practice in which government spends more money than it receives. According to Umaru, Aliero and Abubakar, 2021; Ezenwobi and Anisiobi, 2021; Eche, Pam, Akeem and Salawu, 2022), the government planned to put more money into the economy than it takes out by taxation, with the expectation that increased business activity will bring enough additional revenue to cover the shortfall, it is also called deficit spending. In other words, it is the government spending in excess of revenues that a budget deficit is incurred which is financed by borrowing. In recent times, it is known that the current public debt growth is larger than the growth of the economy for most of the developing countries (Ughulu, Edogiawerie and Billyaminu, 2023). It is expected that the growing public debt will cause problems in relation to its services (Nwikina, Meekor, Cookey & Gbarato, 2021; Aladejare, 2022; Elhendawy, 2022).

Objective of the study

The broad objective of the study is to investigate the association between deficit financing and economic development in Nigeria**.** The specific objective is to**;**

i. examine the link between broad money supply and human development index in Nigeria,
ii. investigate the relationship between budget deficit and human development index in Nigeria,
iii. study the association domestic debt and human development index in Nigeria,
iv. consider the bond between external debt and human development index in Nigeria,

Study hypotheses

i. there is no relationship between broad money supply and human development index in Nigeria,
ii. there is no relationship between budget deficit and human development index in Nigeria,
iii. there is no relationship between domestic debt and human development index in Nigeria,
iv. there no relationship between external deficit and human development index in Nigeria.

Statement of the Problem

At the moment, the Nigeria's debt profile has reached a level of serious concern to many scholars. Despite the fiscal policies introduced by the government, the current deficit financing growth has not brought any increase in the growth of the economy. It is expected that the growing deficit financing will cause problems in relation to its economic development. There are more economic crises related to deficit financing like:

inflation, unemployment, inequality levels still remain high, income per capital very low and massive infrastructure deficit**.** The policy of deficit budgeting or deficit budget financing has grown enormously in Nigeria over the years. It appears it was meant to help hasten the growth of critical infrastructures in Nigeria, nevertheless, the genuineness staring on Nigerians instead of the good intentions of deficit budget financing, is rather contemptible. Nigeria, have been lurched in to unimaginable debt profiles both locally and internationally. The imagined infrastructural development through this government fiscal instrument is either nonexistent (Okoro and Oksakei, 2020). Numerous efforts have been made by government to mitigate the effect of deficit budget with little or no result as the status quo still remained unchanged. Countless scholars have puttered into this area of study with dissimilar investigation concern. Nevertheless, the emphasis is to find out the impact of deficit budget financing on economic development in Nigeria. Billions of naira spent has no significant impact on the living standard of the citizens. However, in the need to secure better economic conditions, often the government is forced to implement expensive fiscal policies whose aim is to stimulate economic activities in the market and accomplish a higher level of economic development. Therefore, the central problem of this research is to empirically verify the existence of a causal relationship between deficit financing and economic development in Nigeria.

i. Theoretical Literature Reviewed

Ricardian Equivalence

The Ricardian school of thought, similarly known as the Ricardian Equivalence was postulated by David Ricardo, but was later completed by Barro (1989). The theory postulates that budget deficit has neither positive nor negative effect on the economy. They emphasize that an upsurge in budget deficits will be repaid either now or in future because a cut in taxes today must be matched by future increase in taxes thereby leaving real rate of interest, private investment, exchange rate and domestic production unaffected. This theory is established on two assumptions which are the assumption of rational expectations and household taxation which states that as budget deficit increases through borrowing, and as taxes reduce, the government will not increase future taxes to repay the interests and debts. Furthermore, they believe that people found out by experience that increase in government bond as a result of decrease in taxes offers temporary revenue for the individual at the present time, and as the debt of government continues to rise, people will save more so as to provide higher tax revenue in the future.

ii. 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 (Eze and Nwambeke, 2015). Functional finance has influenced many heterodox economists who advocate expansionary macroeconomic policies. Public borrowing tends to generate adverse effects on the markets, including labor and financial markets. Similarly, 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 (Eze and Nwambeke, 2015).

Empirical Literature Reviewed

This study by Muinga, Gathiaka and Osoro (2024) analyzed the relationship between fiscal deficit and economic growth in the East African Community (EAC) at both regional and country level. The Pooled Mean Group (PMG) estimation technique was employed and panel data for the period between 2000 and 2021 to meet objectives of the study. PMG estimator gave both long run and short run regional outcomes and country-specific short run results. The findings indicate that there is a positive relationship between fiscal deficit and economic growth, with significance level of 1% observed in the long term. The country specific short run results reveal a negative link between fiscal deficit and economic growth in Burundi, Kenya and Rwanda while for Tanzania and Uganda the link is positive and significant. Real interest rate and inflation rate deteriorate economic growth in the EAC. Broad money supply growth and foreign direct investment boost economic activity in the EAC region. Fiscal restraint and discipline are required to promote economic growth in the region. There is need for governments to ensure price and interest rate stability through inflation targeting and limiting money supply. Adebayo and Bolukale (2024) study examined the relationship between deficit financing and economic growth in Nigeria over the period 1996 – 2022 and the role of corruption in moderating the relationship. The study made use of annual time series data compiled from the Central Bank of Nigeria (CBN) Statistical Bulletin and World Bank's World Development Indicators. The data were analyzed using descriptive statistics and Autoregressive Distributed Lag (ARDL) regression technique. It was found that deficit financing and the interaction between deficit financing and corruption affect economic growth after a 2-year lag, while corruption also has a significant direct negative effect on growth. It was thus concluded that corruption not only directly affects the Nigerian economy negatively, it also has a significant delayed moderating effect on the relationship between deficit financing and economic growth. It was therefore recommended that efforts be made to improve both the spending and revenue sides of the budget while intensifying efforts at better prevention of corruption in government. Nwani and Adukwu (2024) study studied the effects of deficit financing on economic development in Nigeria from 2003-2021. The specific objectives were; to ascertain the effect of budget deficit on economic development in Nigeria, to determine the effect of domestic borrowing on economic development in Nigeria and lastly to evaluate the effect of external borrowing on economic development in Nigeria. The study adopted Ex-post facto research design with yearly time series

data obtained from publications of the United Nations Development Programme (UNDP) and the Central Bank of Nigeria Statistical Bulletin. A computer based multiple regression equation using autoregressive distributed lag (ARDL) method of estimation and other descriptive statistics techniques were employed to determine the relationship between the variables in the study. The findings from the study revealed that budget deficit and domestic borrowing had significant positive effect on economic development in Nigeria whereas external borrowing had weak effect on economic development in Nigeria. Consequently, the study recommended among others that there must be genuine commitment in executing budgets and also the need for adequate monitoring so that budgetary allocations can result in actual development across all the targeted sectors. The study therefore concludes that deficit financing is a major driver of economic development in Nigeria and that financing the deficit through domestic borrowing is also an important contributor to development in Nigeria. Ojonago and Onoja (2023) examined the relationship between deficit financing and economic development in Nigeria from 1991-2023. Adopting the autoregressive distributed lag model, the study analyzed time series data on variables including GDP growth rate which was the proxy for economic development in the study, deficit financing, inflation and interest rate. These variables were found to be stationary in mixed order making the use of ARDL relevant in the study. The study found that there was no co-integration among the variable and so, the short run form of the ARDL model was estimated and all the variables in the model were seen to be negatively related to GDP growth rate indicating that, deficit financing, interest rate and inflation rate had a negative impact on the growth rate of GDP in Nigeria. The study concluded that excessive deficit spending could affect development in Nigeria if the expenditure were not adequately invested in productive sectors. Therefore, the study recommended that Nigeria should invest more of the deficit spending on the productive sector so as to create a situation where the country would offset such debts with its return on investment rather than borrowing to pay debt; a situation that may cripple the economy of Nigeria. Ughulu et al. (2023) studied the impact of deficit financing on economic growth in Nigeria. The study employed annual times series data for the period 1981 to 2019. The study employed real gross domestic product as the dependent variable while federal government domestic debt, federal government external debt, federal government budget deficit, foreign exchange reserves and broad money supply served as the independent variables. The study employed Fully Modified Ordinary Least Square (OLS) estimation technique and found that domestic debt, budget deficit and the broad money supply had positive and significant impact on economic growth in Nigeria while external debt had negative and significant impact on economic growth in Nigeria. The impact of foreign exchange reserves on economic growth in Nigeria was positive but not statistically significant. Frances, Ezenekwe, Metu, Ezindu and Promise (2022) investigated the effect of deficit financing on the productive sectors in Nigeria. The study employed the use of the ARDL method and sourced data on the variables of interest from 1984 to 2019. The study added that the use of deficit budget was not to be discouraged but the use of disaggregated measures in handling the budget deficit should be encouraged. The study added that, the deficit financing should be targeted towards fixing the economy rather than

consumption purposes. Sylvanus and Ndu (2022) who investigated the impact of budget deficit financing on economic development in Nigeria using secondary data on variables such as inflation, deficit financing, estimated budget value and economic growth from 2011 to 2020. The study employed the use of Ordinary Least Square and also adopted descriptive research design and found that budget deficit financing, had a positive impact on economic development whose proxy was economic growth. Umaru, Aliero, and Abubakar (2021) also investigated the impact of budget financing on economic growth Nigeria. The study examined relevant variables such as GDP, Interest rate, and budget deficit. The study considered 1981 to 2019 and ARDL was used to conduct the study. Budget deficit was also seen to have a positive impact on economic growth. The study however cushioned that the using of budget financing must be done to the point where it would not become a burden. Okolie and Anidiobu (2020) study focused on effect of deficit financing on economic growth and development in Nigeria. We therefore studied deficit financing dynamics in Nigeria using twofold indices (real GDP and per capita income); as one index approach could compromise complementarity. To achieve this, two specific objectives were assessed: (i) effect of deficit financing [(measured by external source of deficit financing (EXSDF) and non-bank source of deficit financing (NBSDF)] on real gross domestic product (RGDP); and (ii) impact of EXSDF and NBSDF on per capita income. Annual time series data for 32 years (1986-2018) were obtained from World Development Indicators (WDI), Debt Management Office (DMO) and Central Bank of Nigeria (CBN) Statistical Bulletin. Data stationarity and normal data distribution were achieved using Augmented Dickey-Fuller and descriptive statistics respectively. Ordinary least square estimation was applied. A 5% error tolerance level was permitted. Findings showed (i) EXSDF had a negative and significant impact on real GDP, but NBSDF had a positive and significant impact on real GDP; (b) EXSDF exerted a negative and significant influence on per capita income, but NBSDF exerted a positive and significant influence on per capita income. Economic implication of result was neither that deficit financing improved macroeconomic performance in Nigeria nor stabilized it within review period. This outcome was ascribed to inept fiscal policies that negated budget discipline. In conclusion, deficit financing remained a veritable mechanism for boosting public revenues and accomplishing desired economic objectives. Study recommended that government should commit deficit financing solely to productive sectors of the economy and adopt fiscal adjustment mechanism that enhances income generation through improved taxes rather than borrowing to finance deficits, among others Keywords: Deficit financing, external source of deficit financing, non-bank source of deficit financing, real GDP, per capita income and ordinary least square. Awolaja and Esefo (2020) studied the relationship between budget deficit and economic growth in 20 Sub-Saharan Africa countries from 1991 to 2018.Pooled Mean Group (PMG) estimated the variables. Results revealed budget deficit related negatively and significantly with economic growth in the long-run, while budget deficit related positively and significantly with economic growth in the short-run.

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Model Specifications

Our empirical model is based on the empirical model of Ughulu et al. (2023)). The functional variables are real gross domestic product as the dependent variable while federal government domestic debt, federal government external debt, federal government budget deficit, foreign exchange reserves and broad money supply. The functional form of the model is specified as RGDP = f (*BDMS*,*FGDB*,*FGXD*,*FGBD*,*FECR*).....(1)

Where

RGDP = real gross domestic product

BDMS = broad money supply

FGDB = federal government domestic debt

FGBD = federal government budget deficit,

FEXR = foreign exchange reserves

The model was adopted here in this study with modifications. The functional form of the model is specified as

HDI = f (*BMS*,*BGD*,*DMD*,*EXD*).....(2)

HDI = human development index

BMS = broad money supply

BGD = deficit

DMD = domestic debt

EXD = External debt

F = functional notation

ε_t = Error term

β_0 =Intercept

β_1,, β_2, & β_3 are parameter estimates

Analytical Techniques

The data using Augmented Dickey-Fuller (ADF) unit root test for co-integration was conducted to ascertain the order of integration of the variables employed. Subsequently, the Error correction mechanism test was carried out to ascertain if the variables have long-run association.

Presentation and discussions of Results Unit Root Test on deficit financing and economic development in Nigeria

Table 1. The Augmented Dickey Fuller (ADF) unit root test is use to establish the stationarity of the time series data used in the study.

Variables	Levels	First Difference	Order of	P-value

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	ADF Statistics	**5% Critical Value**	**ADF Statistics**	**5% Critical Value**	**Integration**	
HDI	-2.342547	-1.434562	2.7791159	-1.946072	1(0)	0.0062
BMS	-5.564323	-2.686573	-3.169343	-2.908420	1(0)	0.0266
BGD	-3.543253	2.674353	-3.169343	-2.908420	1(0)	0.0330
DMB	-4.932343	-2.865487	-3.892570	-2.915522	1(0)	0.0034
EXD	-5.765498	-4.905647	-3.892570	-2.908420	1(0)	0.0029

Source: Author Computation from EViews 2025* Level of significance at 5%

This study employs the Augmented Dickey-Fuller (ADF) unit root test to check the order of integration of the variables and the results are presented above in a table. The results of Augmented Dickey-Fuller (ADF) showed that the variables are integrated of order zero series. The ADF result discovered that all variables are stationary at levels 1(0). This condition makes the Error Correction Mechanism (ECM) test approach to co-integration possible to appropriate for investigating the long-run relationship among these variables.

Table 2. ECM Short-run Result (HDI)

Variable	Coefficient	Std. Error	t-Statistics	Prob
C	-0.327505	0.095939	-3.413683	0.0015
D(HDI)	0.456373	0019862	3.151124	0.0006
D(HDI(-1)	-0.006107	0.024465	-0.249625	0.8042
D(BMS(-2)	-0.034944	0.020209	-1.729130	0.0915
D(BMS)	-0.117079	0.041731	-2.805586	0.0052
D(BGD(-1)	-0.000260	0.050393	-0.005151	0.9959
D(DMDR)	-0.024159	0.040919	-0.590400	0.5582
D(DMDR)	-0.222959	0.102217	-2.181227	0.0351

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D(DBD(-1)	0.383830	0.125570	3.056702	0.0001
D(EXD(-2)	-0.090421	0.099960	-0.904570	0.3711
D(EXD)	-0.132177	0.170749	-0.774100	0.4434
Ecm (-1)*	-0.209532	0.006325	-3.312732	0.0020
Adj R^2 = 0.230173	F-statistics = 2.139910	DW1.=804049		

Source: Author Computation from E-Views 2025. Level of significance at 5%

The coefficient estimate for the Error Correction term, ECM (-1) has a negative value and is significant at the 0.05 level suggesting that the model will reach long-run equilibrium at a rate of -0.02% every year. This means that a yearly adjustment speed of -0.02% may fix the mistake from the previous year. The independent variables HDI, explain 20% of the total variation in all the dependent variables according to the corrected R-Square (R^2) value of = 0.230173 or 23 percent. In nutshell, the model is noteworthy since the F-statistic is significant at the 5% level of significance. Without serial correlation, the model would not work, according to the DurbinWatson statistics of 1.804049, which is close to 2.

Discussion of Findings

Broad money and human development index in Nigeria.

Inference drawn from the ECM result revealed that, broad money supply (BMS) have a negative relationship with human development index (HDI) in the first and second year period of the shortrun in Nigeria. The negative relationship between broad money supply and human development index does not conform to economic theory. It is expected that increase broad money supply will escalate human development index. The p-value of the result also indicate that BMS is statistically significant to influence HDI. The study therefore rejects the null hypotheses that there is no significant relationship between BMS and HDI. This implies that there is a statistical significant relationship between deficit financing and HDI.

Budget deficit and human development index in Nigeria

Insinuation drawn from the long-run using the ECM result revealed that, budget deficit have a negative relationship with human development index in Nigeria. The negative relationship between budget deficit and human development index does not conform to economic theory. It is expected that increase in budget deficit will slow-down human development index in the country. The p-value of the result also indicate that Budget deficit is statistically significant to impact on human development index. The study consequently reject the null hypotheses that there is no significant relationship between budget deficit and

human development index. This implies that there is a statistical significant association between budget deficit and human development index.

Domestic debt and human development index in Nigeria

Suggestion drawn from the long-run and short-run using the Error correction mechanism result revealed that, budget deficit have a negative relationship with human development index. The negative relationship between deficit financing and human development index do not conform to economic theory. It is expected that increase in deficit financing will promote HDI. The p-value of the result also indicate that domestic debt is statistically significant to influence human development index. The study therefore rejects the null hypotheses that there is no significant relationship between domestic debt and human development index. This implies that there is a statistical significant relationship between domestic debt and human development index

External debt and human development index in Nigeria.

Submission drawn from the long-run and short-run using the Error correction mechanism result revealed that, external debt have a negative relationship with human development index. The negative relationship between external debt and human development index conform to economic theory. It is expected that increase in external debt will slow-down human development index. The p-value of the result also indicate that external debt is statistically significant to influence human development index. The study therefore rejects the null hypotheses that there is no significant relationship between external debt and human development index. This implies that there is a statistical significant relationship between external debt and human development index. This result agree with previous studies by Akpansumg and Babalola (2009).

Conclusions / Recommendations from the findings

This study fixated on the relationship between deficit financing and human development index in Nigeria. The study covered a period covers from 1980-2024. The study's proxy for economic development is human development index as dependent variable while the independent variables are budget deficit, broad money supply, domestic debt and external debt. The study made use of time series data sourced mainly from World Development Indicators (WDI) of the World Bank. The model was estimated using error correction mechanism technique. Specifically, the data analysis carried out in the study include: unit root test using Augmented Dickey-Fuller (ADF), cointegration test as well as long run and short dynamics of ECM model. The findings obtained are summarized as follows:

i. Broad money supply in the current and lagged (1) value period had a negative but significant relationship with human development index of the short-run but positive.
ii. Similarly, domestic debt is shown to have a negative and significant relationship with deficit financing with HDI short-run.
iii. Additionally, budget deficit revealed a negative relationship with HDI in the short-run but significantly.

iv. Equally, external debt is reported to have a negative but significant relationship with HDI both in the current lagged (1) period.

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