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DEMOCRACY, FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH IN NIGERIA

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ABSTRACT

A well-operated democracy and efficient financial sector will deliver on the well-being of the citizenry through enhanced economic performance as may be reflected on the quantum increase on the Gross Domestic Product (GDP). Prior to 1999 the Nigeria political space was characterized by an interchange between democracy and military dictatorship. But the events of recent years show that the nation seems to have finally towed the path of sustained democratic governance notwithstanding several obstacles. Several policies have also been put in place in an attempt to overhaul and reposition the financial services industry. Some of these measures include the banking sector consolidation, capital market reform and measures aimed at addressing corporate governance issues. It is within this context that this work is situated. Hence, its objective is to investigate the extent democracy and financial developments have impacted on economic growth in Nigeria. The dynamic OLS (DOLS) estimator has been employed to estimate the long-run equilibrium relationship among the variables. In line with existing studies in the literature such as Alvarez & López (2013) and Ayadi, Arbak, Naceur, & De Groen (2015), the three measures of financial development are Credit (as a % of GDP), broad money (as a % of GDP), and market capitalization (as a % of GDP). Using factor analysis, this study develops a composite index of financial development (FINDEV). A binary variable has been used to capture Democracy. The results show that Democracy and Financial Development have very high and significant impacts on Economic growth of Nigeria. This therefore, calls for invigorated efforts to strengthen democratic rule in Nigeria while at the same time ensuring that good policies targeting the financial sector are sustained.

Keywords: Democracy, Financial Development, Economic Growth, Nigeria JEL Classification: E31, F13, G28, G38, H11, H50

1. INTRODUCTION

The Nigerian economy is characterized by unpredictability of growth actualization. This is usually associated with political instability and macroeconomic shocks occasioned by either regime change (from military to military or from civilian to civilian) or regime transition (from military to civilian or civilian to military). Suffice it to say that between 1st October 1960 when and 2018 the nation has had three eras of democratic governance (1960-1967, 1979-1983 and 1999-2018) and two eras of military administration (1967-1979, 1984-1999). That is, thirty years of democracy and twenty eight years of military rule. For the data coverage period of thirty four years (1981-2014) the nation experienced democratic governance for eighteen years (1981-1983 and 1999-2014) and military rule for fourteen years (1984-1999). While economic growth varied during these periods amidst (sometimes) turbulent macroeconomic environment the governments (military and civilian) also experimented with different policies that were targeted at improving the financial development indicators. Some of these measures include the banking sector and capital market reforms.

Nevertheless, economic growth and development are generally spurred by economic and non-economic factors the behaviour of which is predicated on different sets of some 'generic' variables which include; infrastructure, governance institutions, culture, tradition and the system of government. The drivers of these growth fundamentals are the monetary-financial factors (which are designed by the monetary policy) and the fiscal variables (which are predetermined by the fiscal policy). Flowing from the above, it could be deduced that growth and development could be unleashed (or otherwise) by a combination of various factors such as socio-economic infrastructure, law and order, security, corruption, fiscal operations (through revenue, government spending, public debt, fiscal deficit policies), interest rate, money supply, market capitalization, credit availability and the regime of government. This way an attempt towards investigating the determinants of economic growth could approach the subject from any perspective of interest. The focus of this work is therefore, an attempt to examine how democracy and financial development have fuelled economic growth in Nigeria.

The remaining part of the paper is structured as follows; section two examines some conceptual issues while section three is dedicated to theoretical framework. Empirical Literature review has been treated in section four, methodology applied is presented in section five while empirical results are discussed in section six. Conclusions of the paper are presented in section seven.

2. CONCEPTUAL ISSUES

2.1. Democracy

According to (Huntington,1991), the central procedure for a democratic government is the selection of leaders though elections that are competitive by the general public where every qualified person is allowed to exercise his/her franchise. Siegle et al (2005) also corroborates this line of reasoning. (Schumpeter, 1942) sees democracy as a system of arriving at societal decisions in which individual acquire the power to participate or decide through the means of a competitive struggle for the people's vote. According to (Ntalaja, 2005) democracy is a universal form of rule with specific manifestations in time and space. Abraham Lincoln, a former president of America, in his address of 19th November, 1863, described democracy as 'government of the people, for the people and by the people. His claim on the meaning of democracy underscores the notion that democracy is both representative and participatory. His emphasis is actually on the general welfare of the people. Under a good democratic system, the policies of government should be the product of the collective decisions of the general populace. In order words, the people are either directly or indirectly involved in taking decisions that affect their well- being. With reference to the Abraham Lincoln definition of democracy, it is safe to say that democracy justifies the social contract which exists between the citizens and their elected representatives. In the opinion of (Diamond,1999) democracy implies accountability of office the office holders to one another with a view to constraining power, protecting the constitution and following a deliberative process. According to (Wolterstorff and Cuneo, 2012), the liberal notion of democracy requires that there are equal rights among the citizens to full political voice to be exercise within the limit of the framework of the constitution in the country.

2.2. Financial Development

Financial sector development is the wholesale, retail, the formal and the informal institutions in the economy which offer financial services to consumers, business as well as other financial institutions. Financial sector comprises banks, stock exchanges, credit unions, money lenders and micro finance institutions etc. (Financial Sector Team of Department for International Development, 2004). (Liang and Reichert, 2007) proclaimed that endogenous financial development results directly from economic growth; the aggregate demand for goods and services increases as the economy grows. For the producers to expand output, they must look for a more efficient way to raise capital while consumers on the other hand will seek a means more efficient in other to raise their returns on their savings as this implies a more functional financial market is needed. Hence financial development could be measured by individual monetary policy, capital, or money market indicators such as money supply, market capitalization and credit disbursement or a composite indicator that combines some of the individual variable.

3. THEORETICAL FRAMEWORK

3.1. The Standard Modernization Hypothesis

The standard modernization hypothesis has it that economic development leads to and it is a necessary pre-condition for democracy. In (Lipsey, 1959) it has been argued that economic development generated a greater likelihood of democracy development. Th author also argued that an increase in wealth will reduce the level of inequality, weaken status distinction and increase the size of the middle class. Similarly (Diamond, 1992) argued that when development is inclusive in so far that it reshapes class structure, political culture and state society relations, it facilities and improve on democracy. However, (Przeworski, 2000) argued that modernization theory has little if any explanatory power on the issue of democracy. He argued that productive factors can grow under a dictatorship, but using resources may be more efficient under a democracy.

Studies by (Glaeser et al., 2004) and (Hawkes and Ugur, 2012) suggested that income levels, educational attainment and economic growth all lead to stronger institutions as this view of theirs pointed to a different causal path as regard the claim of the modernization theory. In contrary to the argument of the modernization theory, there is also a claim that democratic good governance is not an outcome of economic development but a necessary condition for an improved well-being of the citizens (Chalker, 1991, Acemoglu et al, 2005). In a similar view (Siegle, Weinstein, and Halperin 2004, 2005) are of the view that democracy have the institutional advantage to outperform non-democracies; they found out that countries that have embraced democracy have outperformed countries with authoritarian system of government comparing the full range of indicators such as life expectancy, life expectancy, access to clean drinking water, agricultural productivity, infant mortality among many others indicators. They have put forward the core representative governance (shared power, openness and adaptability and wide participation of people directly or indirectly in decision making).

The most important factor for achieving economic growth or development according to (Leftwich, 1996) is neither the system of government nor the regime type of the state but the politics which both generate and sustain the state regardless of whether the state practice democracy or not.

3.2. Economic Growth Theory

The pioneering work of (Schumpeter, 1912) on the finance led growth nexus has it that financial development will promote economic growth via an efficient allocation of financial resources to the sectors of the economy that are highly productive. This view was however challenged by (Robinson, 1952) on the premise that it is the necessity from high economic growth that leads to the need and demand for financial sector. In the view of (Robinson, 1952), it is the improvements in the economy that triggers higher demand for the use of money which in turns promotes financial development. In other words, financial market development is as a result of the aftermath of an increased demand for their services from the growing real sector. The two views above were later formalized by Patrick (1966) who put forward two possible relationships between economic growth and financial development viz; the "supply –leading" which means the finance led growth hypothesis and the "demand –following" which is growth led-finance hypothesis. The former is captured in the view of (Schumpeter, 1912) as the latter is captured in the view of (Robinson, 1952). The Keynesian monetary growth models and the Mackinnon and Shaw models both support the supply leading hypothesis. The line of difference in their views is in the role of government and interest rates in the financial markets. While Keynes claimed that there is a historical and natural tendency of an increase in interest rates above the full employment equilibrium level and he that there is a need for the government to intervene in order to reduce it as this will in turn stimulate growth following an increase in the demand for loanable funds given the inverse relationship between interest rates and the demand for loanable funds. In his model of money and economic growth (Tobin, 1965) advocated for the growth-enhancing implication of low and regulated level of interest. He observed that house will hold more capital relative to money the higher the return on capital relative to money given that households have two assets which are money and productive capital. This leads to a higher capital/ Labour ratio, a higher labour productivity as this in turn leads to a higher economic growth. It therefore follows that a reduction in interest rate which is the return on money, will improve on the economic growth rate.

4. EMPIRICAL REVIEW

4.2. Democracy and Economic Growth Nexus

In their studies (Bardhan, 2002); (Przeworski and Lamongi, 2007) found out that a negative relationship exists between democracy and development. They further claimed that regime type does not have different impacts on the growth of per capita income. In contrary to this view, barrow as cited in Pel (1999) explained that the relationship between democracy and growth is likely to be low in the most politically repressed societies. An improvement in the political rights and civil liberties in such society tend to produce a higher economic growth. In a study by (Pel, 1999), the question on whether the democracy promotes development is premised on the central idea that political institutions are vital for achieving economic development and are more likely to exists and function effectively under democratic rule. These institutions include among others the rule of law which is for the protection of the property rights, the individual liberty which promote creativity, the freedom of expression which ensures the production and unimpeded flow of information as well as the institutions checks and balances that minimize a massive theft of the public wealth which often observed in these days' democracies.

4.2. Empirical Review on the impact of financial development on economic growth in Nigeria

The existing literatures show mixed results on the relationship between financial development and the economic growth. For instance, (Akinlo and Egbetunde, 2010) investigated the long run causal relationship between financial development and economic growth in ten Sub-saharan African countries. The results of their findings show that financial development causes economic growth in four countries while growth on the other hand granger causes financial development in just one country. Also, the results of the rest of the five countries however support bidirectional causality.

The work of (Osuji and Chigbu,2012) adopted Granger causality test and Error Correction Model (ECM) in examining the impact of financial development on economic growth in Nigeria, the granger test indicates a bi-causality between Money Supply (MS) and Economic growth (GDP). In a similar endevour (Odeniran and Udeaja, 2012) investigated the impact of financial sector development on economic growth in Nigeria. The study tests the impact of the financial sector development on the economic growth using granger causality tests in a VAR framework over the period ranging from 1960 to 2009. The results found out that there is a bidirectional causality between some of the proxy of financial developments and the variables used to proxy an economic growth. Again, (Salami et al, 2013) also carried out a study on the impact of financial sector development and economic growth in Nigeria, adopting OLS of the regression analysis. The study found out that the interest rate is negatively related to economic growth while other independent variables such as while other variables such as liquidity liabilities to GDP and ratio of credit to private sector to GDP have a positive relationship with the economic growth in Nigeria.

The focus of the study (Nzotta and Okereke, 2009) was on impact of financial deepening on the economic growth in Nigeria between 1986 and 2007. The results of the two-stage least squares analytical framework that financial deepening index is low in Nigeria over the periods of the study. The study from its findings concluded that financial system has not sustained an effective financial intermediation in the economy.

5. METHODOLOGY

5.1. Model specification and data

Consistent with studies such as (Hasan, Wachtel and Zhou, 2009), (Miletkov and Wintoki, 2009), (Boudriga and Ghardallou, 2012), and (Abida, Sghaier and Zghidi, 2015) in the democracy, financial development and economic growth literature, the model for this study is specified as

$$GGDP_t = \gamma_0 + \gamma_1 FINDEV_t + \gamma_2 DEM_t + \gamma_3 X_t + \mu_t \qquad (1)$$

Where t = 1; . . . ; t refers to the time period. FINDEV is the measure of Financial Development; DEM is a measure of democracy in Nigeria. It is a binary variable that equals 1 if it is a democratic system and 0 if it is a military system, X is a vector of control variables such as openness, interest rate and inflation. μ_t denotes the estimated residuals. The data are sourced from the Central Bank of Nigeria Statistical Bulletin and the World Bank Development Indicators. The data covers the period 1981 to 2014.

5.2. Estimating Technique

The first stage in the analysis is to determine the unit root properties of the variables. Most economic time series are not stationary. A stochastic process is said to be stationary if its mean and variance are constant overtime (Gujarati, 2003). Hence, unit root test is carried out to verify whether the time series is stationary so as to avoid a spurious regression. Therefore, the augmented Dickey Fuller (ADF) test is adopted for this study.

Following the tests for unit roots is the test for co-integration. Economically, two (or more) variables are cointegrated if they have a long run equilibrium relationship among them (Gujarati, 2003). The Johansen cointegration test is used in this study to test for co-integration.

In a situation whereby the variables are cointegrated, the next stage is to estimate the long-run relationship. The dynamic OLS (DOLS) estimator is used to estimate the long-run equilibrium relationship among the variables (Harris & Sollis, 2003). The DOLS is well justified because the DOLS estimator is asymptotically unbiased and normally distributed even in the presence of endogenous regressors.

6. EMPIRICAL ANALYSIS

In line with existing studies in the literature such as Alvarez & López (2013) and Ayadi, Arbak, Naceur, & De Groen (2015), the three measures of financial development are Credit (as a % of GDP), broad money (as a % of GDP), and market capitalization (as a % of GDP). Using factor analysis, this study develops a composite index of financial development (FINDEV), as depicted in Table 1).

TABLE 1. FACTOR ANALYSIS

Factor Method: Maximum Likelihood					
	Loadings				
	F1	Communality	Uniqueness		
MKCGDP	0.717	0.514	0.486		
M2GDP	0.993	0.985	0.015		
CRTGDP	0.936	0.876	0.124		
Factor	Variance	Cumulative	Difference	Proportion	Cumulative
F1	2.375	2.375	---	1.000	1.000
Total	2.375	2.375		1.000	

Notes: M2GDP =broad money (as a % of GDP), CRTGDP = Credit (as a % of GDP) and MKCGDP = market capitalization (as a % of GDP)

Multiplying each individual score with their respective factor loading scores and then adding up all products together to get a weighted average score yields the composite index (Hair, Black, Babin & Anderson, 2010).

The composite index is therefore computed as:

$$FINDEV = \frac{0.717 * MKCGDP + 0.993 * M2GDP + 0.936 * CRTGDP}{0.717 + 0.993 + 0.936} \tag{2}$$

The unit root properties of the variables established using Augmented Dickey-Fuller (ADF) and unit root test. The results are presented in Table 2. There is a mix of I(1) and I(0) of underlying regressors and none of the variables is I(2). Thus, the DOLS procedure can proceed.

TABLE 2. ADF UNIT ROOT TEST

Variable	**Without trend**		**With trend**		**Decision**
	Level	*First Difference*	*Level*	*First Difference*	
FINDEV	-1.526	-5.135*	-2.182	-5.050*	I(1)
GGDP	-3.715*	-8.569*	-5.324*	-8.437*	I(0)

GEXP	-2.040	-2.797***	-2.797***	-4.349**	I(1)
INFL	-2.741***	-5.349*	-3.773**	-4.523*	I(0)
OPEN	-1.769	-7.394*	-1.656`	-7.581*	I(1)

Note: *** significant at 10% leve; ** significant at 5% level; * significant at 1% level. FINDEV = financial development; GGDP = GDP growth; GEXP = government expenditure; INFL = inflation; OPEN = trade openness

The next stage is to conduct a cointegration test to determine if there is a long-run equilibrium relationship among the variables. The Johansen cointegration test is thus used, as shown in Table 3. The trace test and max Eigen statistic shows the presence of three cointegrating vectors. Consequently, the Johansen cointegration test strongly suggests that a long-run cointegrating relationship exists between the variables.

TABLE 3. JOHANSEN COINTEGRATION TEST

Hypothesized	**Trace**	**0.05**		**Hypothesized**	**Max-Eigen**	**0.05**	
No. of CE(s)	Statistic	Critical Value	Prob.**	No. of CE(s)	Statistic	Critical Value	Prob.**
None *	195.259	69.818	0.000	None *	94.262	33.876	0.000
At most 1 *	100.996	47.856	0.000	At most 1 *	66.040	27.584	0.000
At most 2 *	34.955	29.797	0.011	At most 2 *	26.370	21.131	0.008
At most 3	8.585	15.494	0.405	At most 3	5.793	14.264	0.639
At most 4	2.791	3.841	0.094	At most 4	2.791	3.841	0.094

Trace test indicates 1 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

**MacKinnon-Haug-Michelis (1999) p-values

The DOLS estimates are as shown in Table 4. It is observed that the estimated sign of the variable financial development variable (FINDEV) is positive and significant at 1% level. As well, the democracy variable (DEMOC) is positive and significant at 1% level. The estimated size of government expenditure (GEXP) effect on economic growth is small and not significant. Inflation, though negative, has significant effects on economic growth at 5% level. On the contrary, trade openness has insignificant positive effects on economic growth.

TABLE 4. THE DOLS ESTIMATES

Dependent Variable: GGDP				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	Prob.
C	0.433	0.221	1.955	0.066
FINDEV	0.457	0.411	2.650*	0.004
DEMOC	0.585	0.166	3.505*	0.002
GEXP	0.190	0.103	1.843	0.081
INFL	-0.143	0.056	-2.513**	0.021
OPEN	0.116	0.081	1.427	0.170

R-squared	0.845	Mean dependent var	0.246
Adjusted R-squared	0.838	S.D. dependent var	0.185
S.E. of regression	0.147	Sum squared resid	0.390
Lon-run variance	1.917		

Notes: *, **, indicate significance at the 1 per cent and 5 per cent per cent level respectively. Fixed leads and lags specification (lead=1, lag=1); Long-run variance estimate (Bartlett kernel, Newey-West fixed bandwidth = 4.0000)

5. CONCLUSION

This paper is an attempt to investigate the impact of Democracy and Financial Development on Economic Growth in Nigeria. The rationale of this inquiry derives from the seeming penetration of democracy (as may be indicated by the number of years of democratic governance especially the uninterrupted democratic regime since 1999) and the overwhelming efforts of the state towards repositioning the financial sector. The analysis shows that there exist a long run relationship between Democracy, Financial Development and Economic Growth n Nigeria. In addition to this, the empirical results have also revealed that the two variables, Democracy and Financial Development exert significant influence on Economic Growth at a critical level of 1%. This is an indication that entrenchment of democracy reflect in better economic decisions which are subservient to economic growth. Similarly, consolidation of the gains from various reform programmes of the financial sector may have ensured that investment decisions translate to widened production base and increased output. Thus democratic governance has the potential to unleash growth and development in every economy particularly when the financial services sector is developed and robust. This will be the case because democracy frees the economy from unfettered regulations and controls of factor inputs while an efficient financial system ensures a highly reduced impediments financial flow to cater for both short term and long term needs of producers and consumers. The state should therefore, endeavour to further strengthen democratic institutions and values while at the same time ensuring enhanced performance of the financial sector through invigorated monetary and financial policies.

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