Impact of Institutional Quality on Economic Growth in Nigeria

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Abstract

This study investigates the impact of institutional quality on economic growth in Nigeria. The study employs the Ordinary Least Squares (OLS) approach to analyze annual time series data from 1986 to 2023. The objective of this study is to examine the relationship between institutional quality and economic growth in Nigeria. The results indicate that institutional quality has a positive and statistically significant impact on economic growth. However, the governance index shows a positive but insignificant influence. The study also finds that gross capital formation, population, and trade openness have mixed effects on economic growth, with significant positive and negative impacts, respectively. The study recommends that policymakers should strengthen institutional quality by enhancing governance structures, legal frameworks, and financial systems. Comprehensive reforms that address institutional weaknesses are essential for achieving long-term economic growth

Keywords: *Corruption, Governance index, Institutional Quality, OLS*

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Background to the Study

Growth and development require a framework of institutions that allows transactions to smoothen and by which investors know that their decisions and their contracts will be protected by law and enforced, thereby leading the economies toward growth and maturity (Sule, 2020). There is no sustainable economic development without a functioning rule of law. Besides sustainable economic policies like low interest rates, low inflation, low budget deficit, reasonable taxes, and economic freedom for business development, the necessary ones for a country's economic growth are the functioning of state institutions (Ogu et al 2023). This leads us to the question of how growth arises and what policies can be used to promote economic growth. New growth theory, spearheaded by Romer, emphasizes the importance of investment in human capital and technology, as well as real capital, for the continued growth of the economy. But what accounts for differences in the amount and kind of investments that are made in different countries and at different periods? The answer lies in the institutional framework under which the economy operates.

Institutions are dependent on social, political, and economic growth. Neoclassicals assumed that the growth would occur where benefits were available. One of the hindering factors of growth and development is violence, which is found in developing countries as people want to acquire wealth and prosperity. Institutions contribute to resolving the social and economic disputes (Shah, Zubair & Hussain, 2020). Recent studies provide evidence of a positive relationship between governance and growth in developing and emerging economies. For five BRICS countries, Misi Lopes et al. (2023) used principal component analysis to build an aggregate index of good governance based on the six World Governance Indicators to estimate the impact of institutional quality on real gross domestic product (GDP) growth. A review of the linkages between institutional quality and growth is done by Ivanyna and Salerno (2021). The spatial regression model is used by Mahran (2023) to estimate the impact of governance on growth for 116 countries in 2017. Other studies are focused on the long-run relationship between governance and growth, such as Yahyaoui and Bouchoucha (2021) for African countries, and Lustrilanang et al. (2023) and Shah (2023) for Asian countries. This study builds on previous research and contributes to the literature by examining the long-run relationship between institutional quality and economic growth in Nigeria. In this work, we rely on the control of corruption and good governance index from the World Governance Indicators to estimate the impact of institution quality on economic growth. To consider the effect of labour market institutions on growth, we use the unemployment rate. Labour market institutions should promote quality employment and reduce the unemployment rate. The rest of the paper is organized as follows: in section 2, theoretical and empirical studies on the relationship between institutional quality and economic growth are reviewed. Section 3 describes the methodology that is used to investigate the impact of institutional quality on economic growth. In section 4, the results and discussions of the study are presented. Finally, section 5 is the study's conclusion and recommendations.

Literature Review

This study conceptualized institutional quality as those basic tenets that guide the operations of public and other private institutions in other to maximise wealth. The enforcement of these

tenets is based on the act that establishes the institution, which most times conforms to global best practices. The pioneer of the theory in institutional economics North (1981) describes institutions as a set of rules compliance procedures, and moral and ethical behavioral norms designed to constrain the behavior of individuals in the interests of maximizing the wealth or utility of principals. To North (1990) institutions should promote and incentivize productive and wealth-increasing actions such as innovation, capital, and education acquisition, ensure property rights, and prevent predatory, wealth-destructive behavior (e.g. corruption, theft, and rent-seeking). Yildirim, (2015) defines institutions as habits that bring limitations to our actions through rules and organizations settled in social life, direct us on how we should behave, and lead a social life. Economic growth is the growth in both social and economic activities. The Nigerian economy has been growing at an average of 6.7% from 2000 to 2015 although, the fall in the price of crude in 2015, led to a contraction of the growth of the economy by --1.6 % in 2016 on account that the economy predicated on crude oil sales. In 2017, it started appreciating leading to a growth rate of 0.7% and this has remained on a positive trajectory at 2.0% in 2018. One of the major bottlenecks to actualizing its growth potential is due to the challenging business environment owing to the slow pace of reforms, and the lack of a market-driven exchange rate policy puts a lid on investment (PWC, 2017).

The impact of institutional quality on growth is empirically analyzed by many authors who have determined institutional quality as a key factor for economic development (Kebede & Takyi, 2017; Boța-Avram et al., 2018; Shchegolev & Hayat, 2018; Yinusa et al., 2020; Tran et al., 2021). The authors have provided evidence that political stability, government effectiveness, control of corruption, and property rights are important determinant factors for economic growth. Improving governance is considered a potential factor for economic development (Zhuang et al., 2010). Evidence that institutions have improved economic development at all stages of economic development is found by Abu-Ismail and Ishak (2021), based on annual data from 1996 to 2017 for developed and developing countries. The causality patterns between institutions and economic performance vary at different stages of income level according to Recuero and González (2019) and Law et al. (2013).

Furthermore, Dharmarathna (2020) employed a modified least-squares method to investigate the impact of public sector corruption on economic growth in the Asian region from 2008 to 2018. The results reveal that corruption has no significant impact on economic growth in the Asian region. Sule (2020) employed the OLS method to examine the effect of institutional quality on Nigeria's economic growth from 1979 to 2018. The results show that institutional quality has a positive and significant impact on economic growth. Radzeviča and Bulderberga (2018) examined the role of institutional quality in economic growth: implications for the Baltic States. The study used a Generalized Method of Moments on a panel of 113 countries during 2006 -2016. Government effectiveness, regulatory quality, tax burden, monetary freedom, financial freedom, trade freedom, the strength of auditing and reporting standards, the efficacy of corporate boards, and the strength of investor protection have positive effects on economic growth. Carraro and Karfakis (2018) examined the impact of institutions, economic freedom, and structural transformation in 11 sub-Saharan African countries. The study used the Panel Tool. The result reveals a positive and statistically significant effect of the quality of

institutions and economic freedom measures on structural transformation between sectors. Epaphra and Kombe, (2018) investigate the effect of institutions on economic growth in Africa. The study uses Generalized Methods of Moment (GMM), Fixed Effects (FE), and Random Effects (RE) models. 1996-2016. Institutional quality indicators and political stability appear to be the most significant factor in explaining real GDP per capita growth in Africa.

Nguyen, Su, and Nguyen (2018) analyzed institutional quality and economic growth: in the case of emerging economies. The study used the System Generalized Method of Moments (SGMM) 2002-2015. The finding shows significant positive impacts of institutional quality on economic growth. The institutional quality has negative effects on foreign direct investments (FDIs) and trade openness on economic growth. Iheonu, Ihedimma, and Onwuanaku, (2017) the study examined the effect of institutional quality on economic performance in West Africa. The study uses a Panel data set from 1996 to 2015. Findings reveal that control of corruption, government effectiveness, regulatory quality, and rule of law have positive and significant impacts on economic performance in West Africa.

In addition, Yildirim and Gokalp (2016) analyzed the impact of institutions on the economic performance of Turkey for the period of 2000-2011 employing OLS. The finding shows that institutional indicators such as the integrity of the law system, regulations on trade barriers, restriction of foreign investments, and share of the private sector in the banking system have a positive effect on the macro-economic performance. Judiciary independence, government expenditures, transfers and subsidies, civil freedoms, the black-market exchange rate, collective bargaining, and political stability have negative impacts on the macro-economic performances. More so, Nabila, Shazia, and Muhammad (2015) examined the impact of institutional quality on economic growth in developing economies of Asia for the period 1990-2013. The study employed Panel ARDL and the finding reveals that institutional quality exerts a positive influence on economic growth in addition to causality running between institutional quality and economic growth. Alege et al. (2014) provided an overview of the effect of corruption on the economic development of Nigeria. The authors noted that there has been a significant corruption reduction in Nigeria as a result of the anti-corruption policies put in place, though, no empirical or statistical justification for the statement. They further noted that corruption demeans the image of a country and loss of revenue.

Methodology
The data for the study is annual time series data covering the period 1986-2023 and were sourced from World Bank World Development Indicators. The methodology for this study took a cue from that of Sule (2020) who studied Institutional Quality and Economic Growth: Evidence from Nigeria for the period of 1979 to 2018. This study employs the Johansen Cointegration and Ordinary Least Square approach in the estimation of the model. This study also obtains the residual and incorporates it into the model to ascertain the speed of adjustment it will take to equilibrate in the long run.

The model of this study followed Solow (1956) model of economic growth used in the works of Udah and Ayara (2014) with modification who examined institutions, governance

structure, and economic performance nexus in Nigeria. According to the Solow model, the output is a function of labour (L) and capital (K), with constant returns to scale. The rate of capital accumulation in the long run is higher than that of the short run, the marginal efficiency of capital approaches zero and the growth rate is subsequently determined by technical progress and growth in the labour force.

$$GDP = AK_i^{\alpha} L_i^{1-\alpha} \qquad\qquad 1$$

Where
GDP = real GDP A = total factor productivity K = Capital Stock L = Labour α = elasticity of capital concerning output. The model assumes that each productive unit will use the same level of capital and labour with the following aggregate production function:

$$GDP = AK^{\alpha} L^{\beta} \qquad\qquad 2$$

In the study of Udah and Ayara (2014), they incorporate governance structure and institutions into equation two through their effects on total factor productivity (TFP) or technical efficiency on the premise of the role of institutions in increasing technical efficiency (David (1997), which in turn affects the efficiency of investment. Thus, their study assumes that TFP is a function of the quality of institutions and governance structure (corruption, government effectiveness, and rule of law).

Thus
$$A = Y_t = \alpha_o + \alpha_1 X_t + \alpha_2 CIM + \epsilon_t \qquad\qquad 3$$

Combining equations 2 and 3, we get
$$GDP = C_t K_t^{\alpha}, L^{\beta}, X_t^{d}, CIM^{\varphi} \qquad\qquad 4$$

Where α, β, d, and φ are elasticity coefficients. From equation 4 an explicit estimation function is specified, ignoring labour and capital and taking the natural logs of both sides as follows.

$$LogGDP_t = \alpha_o + \alpha_1 X_t + \alpha_2 CIM + \epsilon_t \qquad\qquad 5$$

Where, X_t = is a vector of explanatory variables including; voice and accountability (VACCOUNTR), Political stability and absence of violence (PSVIOLENCTR), governance effectiveness (GEFFECTR), regulatory quality (REGULATR), control of corruption (CORRUPTR), CIM = contract intensive money (CONTRINTR), E_t = stochastic error term with the usual normality assumptions. In other to achieve the objective of this study, which is to investigate the impact of institutional quality on economic growth in Nigeria for the period of 1986 to 2023, the model by Udah and Ayara (2014) in equation (5), will be adopted and modified. Thus, the implicit functional model of this study is stated below:

$$LNGDP_t = \beta_0 + \beta_1 COR_t + \beta_2 GF_t + \beta_3 LNGCF_t + \beta_4 LNPOP_t + \beta_5 TROP_t + \mu_t \qquad 6$$

Where $LNGDP_{it}$ is the natural logarithm of Gross Domestic Product (GDP), Cor is the control of corruption, GF is the government effectiveness proxy for good governance, $LNGCF_{it}$ is the natural logarithm of Gross Capital Formation, $LNPOP_{it}$ is the natural logarithm of Total Population proxy for labour inputs, TROP is the trade openness which measures the extent at which a country relate with other nations of the world, β_0, β_1, β_2, β_3, β_4, β_5, and μ_{it} are coefficients and error terms while t is period.

Date Source

This study examined the relationship between institutional quality and economic growth of Nigeria for the period 1986 to 2023 following the descriptive statistics, inferential statistics, and regression results of annual time series data. The data on GDP, GCF, POP, and TROP were sourced from World Bank Indicators (The World Bank, 2024). The data of COR and GF were collected from Economic Freedom of the World prepared by (Fraser Institute, 2024). The data so collected were analyzed using E-Views 10.

Results and Discussion

Table 1: Descriptive Statistics

	LNGDP	COR	GF	LNGCF	LNPOP	TROP
Mean	26.30580	-1.166067	-1.031165	24.16339	18.74956	0.411813
Median	26.30510	-1.130000	-1.010000	23.84766	18.74718	0.403449
Maximum	27.03436	-0.900000	-0.900000	25.12169	19.22628	0.536989
Minimum	25.52225	-1.500000	-1.210000	23.39397	18.26758	0.262436
Std. Dev.	0.522941	0.119521	0.090620	0.688293	0.291364	0.054755
Skewness	0.032993	-0.690952	-0.479936	0.238338	0.002248	-0.021229
Kurtosis	1.398428	3.656213	2.034636	1.220803	1.765753	3.222608
Jarque-Bera	4.068197	3.705435	2.934362	5.371876	2.412028	0.081315
Probability	0.130798	0.156810	0.230575	0.068157	0.299388	0.960158
Sum	999.6206	-44.31054	-39.18429	918.2088	712.4831	15.64888
Sum Sq. Dev.	10.11830	0.528556	0.303846	17.52864	3.141038	0.110930
Observations	38	38	38	38	38	38

Source: E-Views results (2023)

Table 1 shows the statistical characteristics of the variables used in this study. The results reveal an average growth of 26.31%, -1.16%, and -1.03% for the log of GDP, COR, and log of GF respectively. Similarly, it is evident from the results that the log of GCF, log POP and TROP had an average growth of 24.16%, 18.75% and 0.41% throughout the study. The values of the standard deviations indicate low volatility for variables for the variables of the study. As for the distribution of the skewness, the series is roughly equal given the closeness to zero for all the series. Importantly the variables of GDP, GF, GCF, and POP exhibit platykurtic distribution given their kurtosis values of less than three. However, COR and TROP exhibit leptokurtic distribution. Finally, the Jarque-Bera statistic implies that the series is not normally distributed given the validity of the significant values except TROP.

Table 2: Augmented Dickey-Fuller Unit Root Test

Variables	At Level	First Difference	Order of Cointegration
LnGross Domestic Product	-0.672629	-3.896745**	I(1)
Control of Corruption	-2.432398	-5.875998***	I(1)
Effective Governance Index	-3.445587	-9.360392***	I(0)
LnGross Capital Formation	-0.819136	-12.70366***	I(1)
LnPopulation	-1.037807	-4.352672***	I(1)
Trade Openness	-4.028901	-8.246554***	I(0)

Source: E-Views results (2023).

Notes: ***, **, and * denote 1%, 5%, and 10% significance levels at which the null hypothesis of non-stationarity is rejected for all tests.

The intercept and trend and intercept are included in the levels and the first difference equations. The optimal lag order is selected based on the Schwarz Information Criterion (SIC).

The econometrics procedure for the data analysis is to check for stationarity of the variables to avoid producing spurious results. The ADF test was employed and Table 2 shows the results of the test becoming stationary at level (that is I(0) and first difference (that is I(1). Hence, the next stage is to proceed to the cointegration testing amongst the variables. Engle and Granger (1987) pointed out that a linear combination of two or more non-stationary time series may be stationary. If such a stationary linear combination exists, the non-stationary time series is said to be cointegrated. The stationary linear combination may be interpreted as a long-run equilibrium relationship between the variables. The Johansen system framework was employed to test for the presence of cointegrating relationships among the non-stationary variables. The result is reported in Table 3.

Table 3: Cointegration Test

Null Hypothesis	Trace Statistic	0.05 Critical Value	Null Hypothesis	Max-Eigen	0.05 Critical Value
r=0*	121.1389	83.93712	r=0*	49.55711	36.63019
r≤1*	71.58176	60.06141	r≤1*	31.01261	30.43961
r≤2	40.56915	42.17493	r≤2	16.63960	24.15921
r≤3	23.92955	24.27596	r≤3	14.08478	17.79730
r≤4	9.844772	12.32090	r≤4	9.002406	11.22480
r≤5	0.842366	4.129906	r≤5	0.842366	4.129906

Source: E-Views results (2023)

Note: r represents several co-integrating vectors. Both Trace statistic and Max-Eigen statistic indicate 2 co-integrating equations each. * denotes rejection of the hypothesis at the 0.05 level

The Trace and Max-Eigen value test in Table 2 reveals a long-run relationship among the variables since their statistical value is greater than their respective critical values for the co-integrating equations at a 5% significance level. This implies a stationary linear combination,

as such the non-stationary time series are co-integrated. The application of the OLS approach will therefore yield informative, non-spurious, and dependable results. Based on the stationary linear combination, the effect of institutional quality on economic growth is examined through the Ordinary Least Squares method. The result is reported in Table 4.

Table 4: Regression result

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1.668658	0.902116	-1.849716	0.0742
COR	0.139362	0.080573	1.729629	0.0940
GF	-0.083403	0.110302	-0.756133	0.4555
LNGCF	0.244841	0.031598	7.748730	0.0000
LNPOP	1.181962	0.078386	15.07865	0.0000
TROP	-0.063884	0.164427	-0.388525	0.7004
ECM(-1)	-0.702996	0.156806	4.483235	0.0001

R-Square = 0.993420; Adj. R-squared = 0.992104; F-stat =754.8329; Prob(F-stat) =0.000000 and DW = 2.188160

Source: E-Views Output (2023)

The speed of adjustment (ECM) to equilibrium is negatively sign as required – estimated at 70% and statistically significant. The adjusted R^2 implies that 99% of the variations in economic growth are accounted for by institutional quality variables (corruption and effective governance index), gross capital formation, population, and trade openness. The F-statistics reveal the combined goodness of fit of the model. The F calculated (754.83) is greater than the F tabulated (2.62) – therefore, we deduce that the explanatory variables (COR, GF, GCF, POP, and trade openness) have a joint influence on economic growth. Thus, the overall predictive power of the econometric model is statistically significant.

In Table 4, the estimated linear OLS model reveals that control of corruption has a positive and insignificant impact on economic growth in Nigeria within the period of the study. This implies that a one percent change in the control of corruption will lead to a 13 percent increase in economic growth. This finding is supported by extensive coverage in the literature review section (Abubakar, 2020; Agyey and Idan, 2022; Da Viega, 2022; Dada and Abanikanda, 2022; Emara and Rebolledo, 2021; Hartmann and Spurk, 2020; Iheanou *et al.,* 2021; Islam and Shindaini, 2021; Matallah and Benlahcene, 2021; and Utile *et, al.*, 2021). Similarly, the result further demonstrates that the effective governance index exerts a negative and insignificant relationship with economic growth. This is against expectations and in line with the findings of Nguyen, Su, and Nguyen (2018). Gross capital formation and population are positive and significant with the capacity to engender the growth of economic growth, however, has a moderating effect. Surprisingly, trade openness reveals a negative and insignificant impact on economic growth, which goes to say that Nigeria as a nation might depend on imported goods at the expense of local production which might be inadequate to stimulate growth which can be attributed to weak institutional settings.

Conclusion

The objective of the study is to examine the impact of institutional quality on economic growth in Nigeria. The choice of the country-specific analysis of Nigeria is on account of highly corrupt cases, not adhering to rules and regulations, littered uncompleted projects, and the demand for the provision of basic social and economic goods. To ascertain the direction of these dynamics, the study investigates the potential of institutional quality through contract-intensive money and effective governance index to economic growth in Nigeria from 1986 to 2023, using both the Johansen Cointegration and Ordinary Least Square approach.

The estimated cointegration test reveals a joint relationship among the variables. The findings of the estimated linear OLS model show the existence of a significant and positive relationship between the control of corruption and economic growth. Improving institutional quality will further sustain the long-run economic growth. In addition, the results reveal that economic growth is engendered by the variables of gross capital formation and population (labor). The study found that it takes about 70% for institutional quality changes to equilibrate its effects on economic growth in the long-run horizon. The paper also found that trade openness has a negative and statistically insignificant effect on economic growth. Based on the findings, the study recommends amongst others that given the insignificant impact of control of corruption on economic growth in Nigeria, the government strengthen and empower anti-corruption agencies to carry out the fight against the endemic corrupt practices in Nigeria. For instance, the Independent Corrupt Practices Commission (ICPC) should properly investigate corrupt practices and apportion appropriate sanctions. This could positively influence the cultural reorientation and moral character thereby providing redemption for national consciousness, patriotism, and manifestation of civilized acts by the citizens. This would help curtail the negative effect of corruption on economic growth in the country. The study recommends that further research should include more institutional variables, such as the economic freedom index of the Heritage Foundation, or ease of doing business, which could offer more insight into the relationship between institutions and growth.

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