

Institutional Quality and Economic Growth Nexus: An Empirical Evidence from Nigeria

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ABSTRACT

Economic literature has shown the importance of institutional quality framework in facilitating growth in many economies. This study examines the nexus between institutional quality and economic growth in Nigeria over the period 1981 – 2023. The study tried to ascertain the effect of institutional quality on economic growth in Nigeria. Time series data from the World Development Indicator on the following variables: Real GDP (proxy for economic growth), real interest rate, gross fixed capital formation, labour force size and institutional quality index (generated) were used. The Augmented Dickey-Fuller test and the Bounds Testing for cointegration were conducted. The ARDL estimation technique was employed to determine the impact of institutional quality on economic growth in Nigeria. The findings of this study indicate that institutional quality negatively and significantly impacts economic growth in Nigeria; it also showed that a long-run relationship exists between institutional quality and economic growth. This study suggests that the government should formulate and execute a technology-centric strategy designed to elevate the standard of institutions in diverse sectors and to cultivate synergistic partnerships between the public and private sectors to propel endeavours focused on institutional advancement.

Keywords: Institutional Quality, Economic Growth, Nigeria, Empirical Evidence, Institutions, and ARDL Technique

JEL Classification: F43, C10

Introduction

Economic literature has shown the importance of institutional quality framework in facilitating growth in many economies. Strong institutional quality frameworks attract economic growth, while weak ones lead to poor economic performance [1]. The significance of economic growth in economic literature has been acknowledged for several decades [2]. Traditionally, economic growth is measured in terms of real GDP inflation-adjusted and standard annualized growth figures, which provide insight into a nation's output [3]. It has also been observed that Nigeria is among the African nations that, by the year 2025, will be able to propel economic growth [4]. The economic growth of countries is important to international bodies because of the significance it has on global development and the fight against poverty. These institutions realize that even if the growth is long established, it

will still be important for improving living conditions and socio-economic development.

Moreover, the ability of some countries in the Sub-Saharan Africa region to grow their economies has been a challenge. Political influence, inadequate governance, high levels of corruption, poor infrastructure, underdeveloped financial markets, and commodity dependency are some of the constraints that have limited their economic growth [5]. The challenges of attaining higher economic growth rates in these and many other countries point to the complex nature of economic development and the wide range of constraints that can inhibit it. It emphasizes the need to deal with structural problems, adopt appropriate economic strategies, and create the right conditions for businesses to thrive to solve these problems and achieve steady economic growth.

Nigeria has encountered numerous obstacles that have impeded its ability to attain higher economic growth. The country heavily relies on revenue from oil exports, rendering it vulnerable to fluctuations in global oil prices. These price fluctuations not only

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disrupt revenue stability but also impact government spending on critical sectors, obstructing economic diversification and sustainable growth [6]. Furthermore, Nigeria's inadequate infrastructure, epileptic power supply, poor transportation networks, and archaic telecommunications systems pose a significant hindrance to economic expansion. Insufficient infrastructure not only limits productivity and business operations but also escalates production costs, making it arduous to attract investments and stimulate economic activities [7].

Governance challenges, corruption, and weak institutions have also plagued Nigeria. Corruption erodes public trust, distorts economic activities, and diverts resources away from productive sectors [8]. Weak governance structures and ineffective policies impede the implementation of necessary reforms for economic growth [9]. In addition, inconsistent or inadequate economic policies and regulations have adversely affected Nigeria's business environment and investor confidence. Uncertainty surrounding policies, lack of transparency, and delays in policy implementation have hindered private sector development and foreign direct investment inflows [7]. Moreover, Nigeria has grappled with security challenges, particularly in the northeastern region due to insurgency and conflicts. As a result, these security threats have negatively impacted economic activities, interrupting agricultural operations, causing forced migrations, and putting stress on the development funds available at the public level [10]. These factors, among others, have all combined to plague the Nigerian economy with a long-standing challenge of economic growth and diversification.

Nigeria has existed for a long time, and since its independence till date, it has been able to implement different policies that are geared towards promoting the growth of the economy. In the earlier years, specifically the 1960s-1970s, the country was involved in policies such as Import Substitution Industrialization (ISI), which meant placing taxes on imported goods, giving incentives to local industries, and controlling the volumes of imports entering the country to increase production of local goods and reduce reliance on the imports. Between the 1980s and 1990s, Nigeria adopted the Structural Adjustment Program (SAP) under the guidance of international lending/advancing entities (Danladi & Peter, 2016). This program was quite broad in its aims and tried to achieve macroeconomic stability, exchange rate liberalization, fiscal discipline, trade liberalization, and privatization.

In the early 2000s, Nigeria expanded its strategies on economic management by adopting NEEDS aimed primarily at reducing poverty, enhancing economic development, and promoting the growth of the private sector. (Ja, 2011). The strategy wanted to broaden the sectoral base of the economy, improve the necessary social overhead capital, stimulate governance systems, and expand the stock of human capital in this case applied to agriculture, manufacturing, and services. In 2009, a long-term development plan, Vision 20:2020 was introduced. The purpose of this plan is to make Nigeria one of the top twenty biggest economies by 2020. The plan prioritized economic diversification, investment in critical sectors, infrastructure development, human capital development, and institutional reforms.

In order to try and attain economic growth and resolve structural issues, Nigeria embarked on an Economic Recovery and Growth

Plan (ERGP), which was in operation between 2017 and 2020. Hoping for a stable environment, the plan included among others improving infrastructure, human capital, agriculture and manufacturing, broadening the economy and even reducing the country's heavy reliance on oil. Nonetheless, blame was apportioned to a wide range of variables including the execution of these policies, governance, political environments, and even international altercations as the reason why only some policies were successful (Solomon and Fidelis, 2018). That is to say, the success of the enacted policies and the contribution they were able to make to economic development largely depended on the above factors. Economists and policymakers have begun to believe more and more that the performance of institutions can play a major role in economic growth. Institutions are the rules, norms, and organizations that frame the economic and social workings within a society. The evidence supporting the positive relationship between economic growth and the quality of institutions has increased in numbers. For instance, Acemoglu, Johnson, and Robinson conducted a deep research that encompassed the scrutiny of the role of institutions in the economic well-being of various countries. Their findings suggested that countries with better property rights protection, rule of law, and control of corruption tend to experience higher levels of long-term economic growth.

Similarly, Rodrik, Subramanian, and Trebbi established the importance of institutions, including governance structures such as checks and balances and the absence of corruption as aspects enhancing economic growth rates. Mauro sought to investigate the effect of corruption in economics and showed that higher levels of corruption were associated with decreased economic growth. North pointed out that the idea of property rights and their protection is the fundamental institutional framework for the prosperity of the economy. In the recent available data for Nigeria, the country's scores in various dimensions of institutional performance were relatively low. For Nigeria, percentiles for voice and accountability, government effectiveness, regulatory quality, the rule of law, and control of corruption were 26.1, 19.8, 21.4, 28.1, and 24.7, respectively World Bank, Worldwide Governance Indicators [11].

Moreover, a study conducted by Ajide, Olabisi, and Osode established a clear relationship between increases in institutional quality and economic growth. Additionally, the World Economic Forum's "Global Competitiveness Report" provided a thorough evaluation of the business environment, institutional framework, and performance of countries. Consequently, Nigeria was ranked 116th out of 141 countries overall, a ranking that highlights the scope of the challenges facing the nation's business promotion organizations [12]. These findings emphasize the increasing significance of institutional quality in influencing economic growth in Nigeria. Various studies have shown that the institutional quality of a nation has much to do with its ability to achieve long-run growth and highlights a country's potential to thrive economically [14,15]. Corruption represents a deeply rooted issue with the institutional quality of Nigeria as evidenced by the country's 149th ranking out of 180 countries in the Transparency International Corruption Perception Index, 2021 [9]. Widespread corruption in the country has eroded public trust, scared away investments, and diverted funds from sectors that could have been productively deployed in the economy.

In the same vein, Nigeria is beset by numerous challenges due to a weak rule of law, which translates into inefficiencies, delays, and poor compliance by contract participants within its legal system, all of which negatively affect business activity and investor confidence (Omoke, 2021). The country is unable to provide the key infrastructure, for example, reliable power supply, effective transportation networks, or reliable communications systems, because of a shortage of investment. This limits Nigerian industries' ability to compete and impedes economic growth due to lower productivity, and higher production costs [11].

The Nigerian government has been initiating reforms to deal with issues like weak institutional quality, which is affecting economic growth. Initially, the policymakers created an anti-corruption organization, the Independent Corrupt Practices Commission (ICPC), in 2000 to prevent and prosecute corruption cases [16]. Also, the Treasury Single Account (TSA) Policy, launched in 2015, aimed at aiding better financial management so that there would be lower corruption (Office of the Accountant General of the Federation, 2015). The policy required government agencies and parastatals to maintain a single account with the Central Bank of Nigeria to enhance transparency and accountability [17].

Despite these efforts, the quality of institutions in Nigeria has failed to improve, and this is one major factor hampering economic growth in Nigeria. According to data from World Bank, as revealed in figure 1 below, the institutional quality index (IQ index) has, on average, shown an upward trend. In the early 1980s, as seen in figure 1.1 also, the IQ Index starts at a low value of 0.00 and gradually increases, indicating a positive trend in institutional quality. This upward trend continues until the early 1990s, with the IQ Index peaking at 5.00 in 1998. This period reflects efforts to improve institutional quality in Nigeria. From the late 1990s to the early 2000s, there is a noticeable decline in the IQ Index, suggesting a potential setback in institutional quality. This period coincides with economic challenges and political instability faced by Nigeria. However, the IQ Index starts to recover from 2004 onwards, indicating renewed efforts to improve institutional quality.



Figure 1: Institutional Quality Index in Nigeria (0-5 scale, 1980-2021)

Source: World Bank Development Indicators, 2022

To further demonstrate Nigeria's underperformance in terms of economic growth, figure 2 below shows fluctuations in the trend of GDP growth rate in Nigeria over the years.

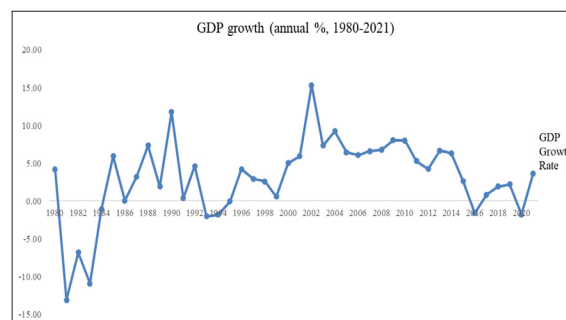


Figure 2: GDP growth rate in Nigeria (1980-2021)

Source: World Bank Development Indicators, 2022

In the early 1980s, as revealed in figure 1.2 above, Nigeria experienced significant economic downturns with negative growth rates, reaching a low of -13.13% in 1981. These negative growth rates were influenced by various factors, including a global recession and domestic economic challenges. Starting from the mid-1980s, Nigeria's GDP growth rates gradually improved, with positive growth observed in most years. The country witnessed a period of robust growth in the 1990s, particularly in 1990 with a growth rate of 11.78%. The early 2000s marked another period of relatively high economic growth, with growth rates above 5% and reaching a peak of 15.33% in 2002. This growth was fueled by various factors, including increased oil prices and economic reforms. From the mid-2000s to the early 2010s, Nigeria experienced relatively stable growth rates in the range of 4% to 8%. However, there was a significant decline in 2016 with a negative growth rate of -1.62%, reflecting the impact of falling oil prices and other economic challenges. In recent years, Nigeria's GDP growth rates have shown some recovery and stabilization. The growth rate was 3.65% in 2021, indicating a positive growth trajectory after the decline observed in 2020 due to the COVID-19 pandemic and related disruptions. Table 1. below presents a snapshot of Nigeria's economic performance and institutional quality over different decades, along with a specific year. The data reveals a mixed picture of economic growth and institutional quality.

Table 1.: Institutional quality index and GDP growth rate in Nigeria (1981-2021)

Decade	1981-1990	1991-2000	2001-2010	2011-2020	2021-2023
Institutional Quality Index	-1.29	-1.15	-1.17	-1.09	-1.05
Average GDP Growth Rate	-0.18%	1.64%	7.97%	2.67%	3.65%

Source: World Bank Development Indicators, 2023

From table 1 above, the 1980s saw a decline in average GDP growth rate, possibly due to low institutional quality as indicated by the negative institutional quality index. The 1990s marked a recovery in economic growth, albeit with still relatively low institutional quality.

The 2000s showed significant improvement in both GDP growth and institutional quality, suggesting positive reforms and policies. However, the following decade witnessed a slowdown in GDP

growth, although institutional quality showed slight progress. In 2021, despite challenging global conditions, Nigeria exhibited positive GDP growth and a marginally improved institutional quality index. The data highlights the importance of continuous efforts to enhance institutional quality for sustained and robust economic growth in Nigeria.

Furthermore, divergent outcomes have emerged when examining the relationship between institutional quality and economic growth. Investigations carried out by Dandume, Izilein and Mohammed, and Utile et al. suggested an adverse influence of institutional quality on economic growth. However, on the contrary, it has been argued by Udah and Ayara, Yusuf and Malarvizhi, Abubakar and Nadabo and Salisu that institutional quality does indeed have a positive effect on economic growth in Nigeria. Therefore, it is necessary to present new empirical knowledge to converge these polarised views. For this reason, this work aims at conducting an additional empirical analysis that would reveal how institutions are affecting the economic growth of Nigeria, so it may help to give insight into the structured reforms needed by the policymakers to anchor their economic transformations in the light of these findings.

Methodology

The endogenous growth model was used to provide theoretical underpinning for this study. This model is chosen based on the plausibility and relevance of its assumptions, its flexibility and its accommodation for the randomness that characterizes real-world events. The Cobb–Douglas production framework is presented in the form:

$$Y = AX_1^\alpha X_2^\beta \quad (*)$$

where Y is economy-wide output, X_1 and X_2 are inputs, α and β are the output elasticities of respective inputs. A represents

technological progress or total factor productivity. The Cobb–Douglas production framework is flexible and permits the amplification of A by incorporating other factors that directly affect economic growth. By incorporating the endogenous growth perspective into the Cobb–Douglas production framework, additional variables that contribute to sustained growth can be introduced. Hence, the appropriate frameworks are expressed as follows:

$$LRGDP_t = \lambda_0 + \lambda_1 INSQ_t + \lambda_2 LGCF_t + \lambda_3 INTRT_t + \lambda_4 LSLF_t + \varepsilon_t \quad (3.3)$$

Where RGDP = Real Gross Domestic Product
INSQ = Institutional Quality Index
GCF = Gross Capital Formation
RINT = Real Interest Rate

SLF = Labour Force Size

L = Logarithmic transformation of the variables performed to reflect a linearization of the Cobb–Douglas model. Also, to interpret the regression coefficients in terms of percentages.

$\lambda_0, \lambda_1, \lambda_2, \lambda_3, \lambda_4$, and λ_5 = Regression Parameters

t = this is used to denote time

μ = Stochastic Disturbance Term

The Generalized ARDL(p,q) model is represented in (*) below as:

$$Y_t = \alpha_{oj} + \sum_{i=1}^p \delta_{1i} Y_{t-i} + \sum_{i=0}^q \delta_{2i} X_{t-i} + \varepsilon_t \quad (*)$$

Where: provided that p and q do not necessarily suggest symmetry of lag-lengths, p = optimum lag length for the predicted parameter.

q = optimum lag length for the predictors. $\alpha, \delta_1, \delta_2$ = model parameters

ε_t = disturbance term

Presentation and analysis of results

Table 2: Descriptive Statistics of Variables

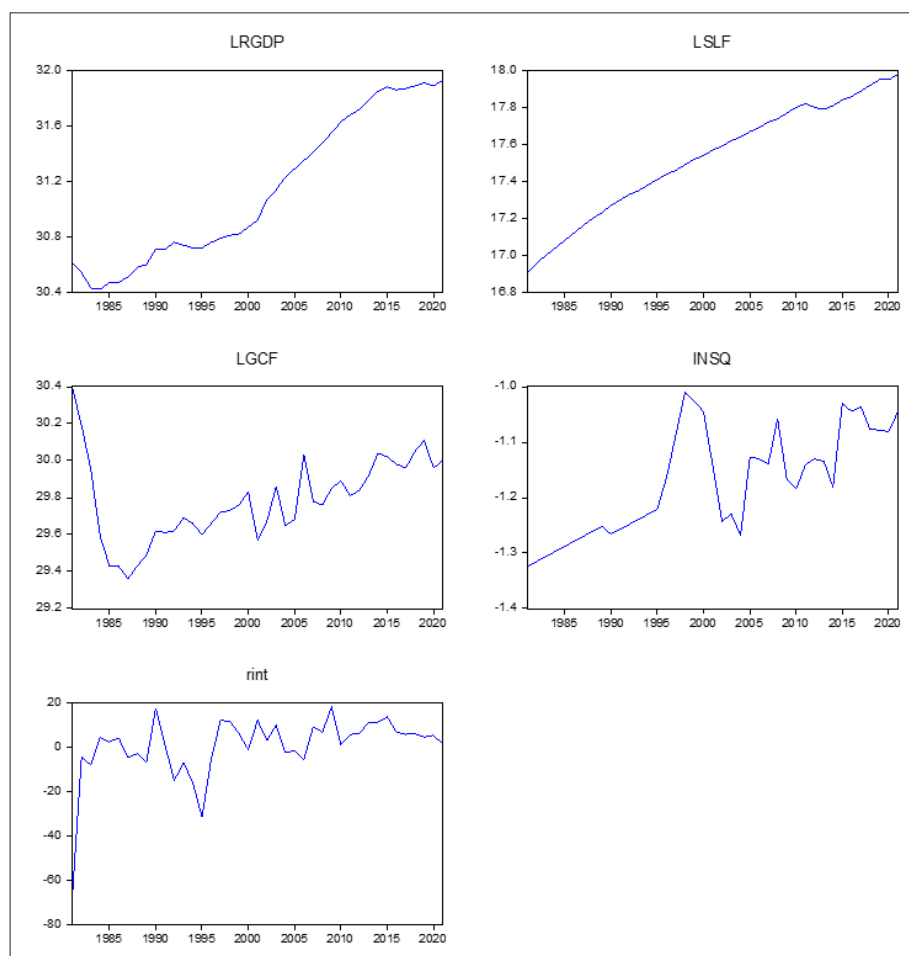
	Real GDP (₦'bn)	Institutional Quality_Index	GCF (₦'bn)	Labour Force Size	Real Interest Rate
Mean	38,100	-1.172056	8,850	42772476	0.453578
Median	26,900	-1.167736	8,420	42586341	4.310292
Maximum	73,400	-1.010065	15,800	64479317	18.18000
Minimum	16,200	-1.324048	5,660	22150378	-65.85715
Std. Dev.	20,500	0.095759	2,080	12374169	14.25917
Skewness	0.580279	0.121334	0.956930	0.007828	-2.717477
Kurtosis	1.717425	1.672562	4.344462	1.808946	12.91104
Jarque-Bera	5.111157	3.110840	9.345334	2.423879	218.2694
Probability	0.077647	0.211101	0.009347	0.297620	0.000000
Observations	43	43	43	43	43

Source: Author's Construct using EViews

Table 2 above gives face-value information about the measures of cluster, dispersion, and variability of the variables under consideration. The mean values of ₦38,100 billion and -1.172 show the respective average values or expected observations of the Real Gross Domestic Product and institutional quality index in Nigeria over the time span of the study. This interpretation is akin to that of other variables in line with their respective mean values. The difference between the maximum values and minimum across the data set will yield the range. By arithmetic intuition, the table does not suggest the presence of an outlier in the data set. The

standard deviations also indicate that the variables exhibit some variations and also, all the variables in the data set are positively skewed. Furthermore, the table reveals that all the variables, except gross capital formation, are normally distributed. With 43 as the number of observations for all variables suggests that there are no missing entries.

Descriptive Graphs of the Variables



Source: Author's construct using EViews

In the panel above, Real GDP shows on average, an upward continuous growth. Although on the negative, institutional quality shows, on average, an upward trending pattern during the period under study. While other variables exhibit similar upward trend, interest rate exhibits a downward trend.

Table 3: Unit Root Test Result

Variable	ADF at level		ADF at first difference		Order of Integration
	ADF T-Stat	5% critical Value	ADF T-Stat	5% critical Value	
LRGDP	-1.887216	-3.544284	-3.888381	-3.529758	I(1)
INSQ	-2.853320	-3.526609	-6.280740	-3.529758	I(1)
LGCF	-5.804111	-3.529758			I(0)
RINT	-7.588137	-3.525509			I(0)
LSLF	-2.411548	-3.526609	-4.176417	-3.529758	I(1)

Source: Author's Computation from EViews

From the results presented in table 3, and based on the initially stated decision rule, the variables, except gross capital formation (LGCF) and real interest rate (RINT), in the model are nonstationary in their level form. That is, while LGCF and RINT is integrated of order zero, I(0), others are integrated of order one I(1), implying that they became stationary after first differencing.

Estimation Results

Table 4: Long Run Regression Result (DV: LRGDP)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LRGDP(-1)	0.900485	0.035461	25.39374	0.0000
INSQ	-0.307780	0.078280	-3.931805	0.0004
LGCF	0.013665	0.044607	0.306336	0.7613
LGCF(-1)	-0.090210	0.035872	-2.514779	0.0170
LSLF	0.290039	0.061985	4.679207	0.0000
RINT	0.001800	0.000504	3.572948	0.0011
C	-0.042721	1.009044	-0.042338	0.9665
R² = 0.997800	F-statistics = 2494.929		Durbin-Watson = 2.694626	
Adj. R² = 0.997400	Prob(F-Stat) = 0.000000			

Source: Researcher's Computation from EViews

ECM Regression Result

Table 5: Short Run and ECM Regression Result [DV: D(LRGDP)]

Variable	Coefficient	Std. Error	t-Statistic	Prob.*
D(LRGDP(-1))	1.146127	0.134687	8.509586	0.0000
D(INSQ)	-0.301115	0.073388	-4.103074	0.0003
D(RINT)	0.002159	0.000418	5.160297	0.0000
D(LGCF)	0.008337	0.032456	0.256866	0.7990
D(LGCF(-1))	-0.161299	0.033622	-4.797370	0.0000
D(LSLF)	0.413444	0.312239	1.324129	0.1951
ECM(-1)	-1.667908	0.218304	-7.640289	0.0000
C	-0.013202	0.010857	-1.216063	0.2331

Source: Researcher's Computation from EViews

ARDL Bounds Test for Co-Integration

The ARDL bounds test developed by Pesaran Shin, and Smith (2001) was used to examine the existence of a long run relationship among the variables.

H_0 = No Co-integration,

H_1 = Co-integration.

Decision Rule: Reject H_0 if f-statistics > upper critical boundary at 5% level of significance. Otherwise, do not reject and conclude that long run relationship does not exist. The results of the bounds test is presented below.

Table 6: ARDL Bounds Test for Co-integration

F-Statistic	Critical Value					
	1%	5%	10%			
	I(0)	I(1)	I(0)	I(1)	I(0)	I(1)
14.57080	3.29	4.37	2.56	3.49	2.2	3.09

Source: Author's estimation using e-views

From the table above, the F-statistic of the Wald test (14.57080) is greater than the lower and upper critical boundaries at the 5%

level of significance. We therefore reject the null hypothesis and conclude that there is co-integration among the variables used in this study.

Findings

Institutional quality was found to have a negative relationship with real gross domestic product. This coefficient, as evident from the result, is statistically significant. Therefore, holding other variables constant, an increase in INSQ leads to about 32 percent decrease in real gross domestic product in the long run, and reduces economic growth by the same amount. This result does not conform to a priori expectations but reflects the dominance of corruption and bad governance in Nigeria. Corruption and bad governance deter foreign direct investment and affect the competence of public investment instead of attracting it [18]. This finding is in line with that of Dandume, Izilein and Mohammed, Utile et al. and also Alika. Studies by Zouhair and Murphy et al., indicate that the quality of institutions is pertinent for investment and long-term sustainable growth [19-25].

The study found Gross capital formation to have a positive relationship with real gross domestic product but not statistically significant though an increase in GCF will likely lead to about 3 percent increase in real gross domestic product in the long run. This result conforms to a priori expectation. Other studies by Shuaib and Dania, Ncanywa and Makhenyane in Nigeria and Bal, Dash, and Subhasish in India all affirm that capital formation exerts a positive impact on economic growth. Capital expenditure through interest rate was found to have a positive relationship with GDP and is statistically significant signifying that increases in real interest rate will have a positive impact on GDP at about 2%. This result does not conform to a priori expectation [26-30].

Labour force was found to have a positive relationship with real gross domestic product and is statistically significant. Therefore, a percentage increase in SLF leads to about a 40 per cent increase in real gross domestic product in the long- run, and increases economic growth by the same amount [31-35]. The coefficient of determination was 0.998, suggesting that the independent variables explain the variations in the explained variable by 99.8%. In other words, 99.8% of the total variations in real gross domestic product are explained by institutional quality index, gross capital formation, interest rate and labour force size; whereas the remaining 0.2% of the variations were explained by the error term [36-40]. All the variables in the model were individually and jointly significant. The result also showed that there is no causal relationship between institutional quality, as measured by the institutional quality index, and economic growth [41-45].

Summary of Research Findings

This empirical study undertakes a comprehensive exploration of the intricate interplay between institutional quality and economic growth within the context of Nigeria. The study employs a sophisticated analytical approach, combining the Autoregressive Distributed Lag (ARDL) methodology with the bounds test co-integration technique [46-50]. This research innovatively utilized an institutional quality index, which amalgamates all six key

indicators of good governance into one and this differentiates it from earlier investigations. The empirical result showed that institutional quality negatively impacts economic growth in Nigeria. This implies that as institutional quality improves, the rate of economic growth tends to decrease. This unexpected connection reflects the weak state of institutional quality in Nigeria, and the role of institutions is largely muted in driving economic growth [51-55].

Furthermore, this study found that there is a short- and long-run relationship between economic growth and institutional quality in Nigeria [56-60]. This temporal dimension emphasizes the significance of considering the duration of the impact of institutional quality improvements on economic growth. This insight is important in the formulation of strategies for driving sustainable economic development [61-65]. Using the Granger causality test to check for a causal link showed that a zero-causal relationship exists between institutional quality and economic growth in Nigeria [66-71].

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