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ANALYZING THE NEXUS BETWEEN INSTITUTIONAL QUALITY AND EXTERNAL DEBT IN WEST AFRICA

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Abstract

This study examines the impact of institutions on external debt in ECOWAS countries for a period of 10 years (2008-2018) covering 16 West African countries. The study adopts the System Generalized Method of Moments as a technique of data analysis. The study measured institutions by six proxies namely; Government effectiveness, Rule of Law, Control of corruption, Political stability, Regulatory quality and Voice and accountability. The results revealed that rule of law and regulatory quality have no significant positive influence in the management of external debts in the ECOWAS sub region, while political stability and government effectiveness has significant positive impact on external debts; control of corruption has negative impact on external debt. To improve the performance of external debts in ECOWAS sub-region, while voice and accountability have a significant negative impact on external debts management in the period under review. The paper recommends better government control of corruption, reduction in administrative bottlenecks and multiplicity of government agencies which have led to unnecessary delays in implementation of government policies. Equally, the respect for the rule of law should be supreme. This implies that the constitution among various countries remain absolute and the rule of law is respected and observed

Keywords: Institutional Quality, External Debts, ECOWAS, System GMM.

1. Introduction

Getting the right types of external source of financing is critical, particularly for developing economies to achieve their macroeconomic objectives. The route to these ends, however, is entirely dependent on sound institutions, good economic policy and natural resources, capable of attracting the essential flow of external capital and investment (Acemoglu, Gallego & Robinson, 2014). The desirability of optimum capital and investment are necessary for capital accumulation and production, hence, countries continue to contend amongst themselves in getting more investments. Given its abundant advantages of providing such large funds and inflow of foreign managerial and technical know-how, countries are adopting policies which encourage inflows of external capital to boost their productivity (Mostafa, 2019). External debt is a type external finances that have strong effects on the growth of developing economies (Alhassan, 2019). External debt is a component of total amount of debt in a country that is payable to recipient economy. It is believed that external debt is beneficial to the recipient nations only if utilized carefully in capital investment and development projects (Chaudry, Iffat & Farooq, 2018) that is self-sustaining over a long period and profitable enough to pay back the debt.

The impact of this source of external finance can never be overemphasized, providing the much needed funds to stimulate economic prosperity in emerging economies. However, the dynamism of external debts can be seen explicitly in two situations; first, the condition in which a country's expected repayment on external debt falls below the contractual value of the debt. Under this

scenario, the expected debt service is likely to be an increasing function of the country's fiscal statement. The presence of this debt overhang may be counterproductive on the country's long term investment and factor productivity and hence economic growth (Krugman, 1998; Wamboye, 2012).

Again, is the crowding out effect, a situation where a country's debt repayment obligation overtakes private investments through hike in interest rate causing scarcity of local finances to boost local production and investment (Wamboye, 2012). External debts may be affected, however, by the quality of institutions which may destabilize the multiplier effect of their infusion in the economy. For instance, in a country where rule of law is weak and public officials are also corrupt, state resources, including borrowed funds, may be diverted into wrong pockets and inefficient investments. Therefore, good governance and well-functioning institutions can help safeguard the acquisition and usage of external debts. Dellis, Sondermann and Vansteenkiste, (2017) argue that institutions have more causal effects on economic outcomes, and therefore, countries with good governance tend to grow faster.

The relevance of institutions on long-run development cannot be underrated even at the micro level, Blanas, Seric and Viegelahn, (2017) note that firms' pay higher wages to workers in countries with less institutional quality and the host country tend to benefit more from them**.** Cherchye and Verriest (2016) believe that the firm's profitability strongly depends on its characteristics (based on the eclectic paradigm theory) and on host country-specific institutions, and therefore, institutions have an absolute negative influence on profit, because they promote competition among firms. Ordinarily, external debts are contracted to encourage economic progress; therefore, the quality of institutions could ensure that the funds are used for their intended purposes. Ultimately, sound institutional environment has been found to affect the volume and efficiency of investment; hence in the presence of good institutions, external debt and FDI may account for cross-country growth differences.

This study has become necessary because earlier studies largely ignore the role of the host nation's institutional quality in the external debt nexus relying more on growth related outcomes see (Qayyum & Haider, 2012; Chaudry et al 2018: Jilenga, Hu & Gondje-Dacka, 2016).We strongly argue that given the right institutions, West African countries can benefit from the proceeds of external debt.

The main purpose of this study is to investigate the relationship between institutions and external debt. Specifically, the paper examines the impact of institutional quality on foreign debt and how it has affected the efficient management and utilization of public external debts. The work is divided into five (5) sections; the next section gives a review of previous related studies, section three outlines the data and methodology while section four presents the empirical results and section five concludes the study.

1.1Recent Trends in External Debts in Africa

There has been interesting development in the flow of external debts over the last few decades, this is primarily attributed to increase in globalization and going by the recent trajectory by scholars and researchers, this situation is bound to be more intriguing as time goes. External debt (% of GDP) for Sub-Saharan African countries over recent the decades was estimated to be in 1994 and 1995 at 80%, 73% respectively, however, gradually between 1996 and 1997 it is observed to have been expanding at a declining trend of 69% and 65%, respectively (World Development Indicators, 2016). Meanwhile, within the same period the combined effect of FDI and FEPI (Foreign Equity Portfolio Investment) as a percentage of SSA's GDP was only 1%, 2%, 2% and 4% respectively (World Development Indicators, 2016). Meanwhile, global External debt stock stood at $8 trillion for 2018, with low-and middle income countries having a share of $529 billion. Africa, indeed Sub-Saharan African countries' share of external debt for the year 2008 stood at$236 billion dollars rising steadily to $441 billion in 2014 and $484 billion in 2016, rising from $555 billion in 2017 to a record high of $583 billion in 2018 (Figure 1).

Bulk of these loans are mostly government, public guaranteed, long-term debts with repayment plans even more financially draining and usually taking a huge chunk of the annual budgetary plans of most African government with millions of dollars paid annually as debt service commission (Ostadi and Ashja (2014). A combination of consistent FDI inflow and an efficiently managed external debt can facilitate and stimulate economic prosperity if the institutional arrangement permits such (Jilenga et al, 2016).

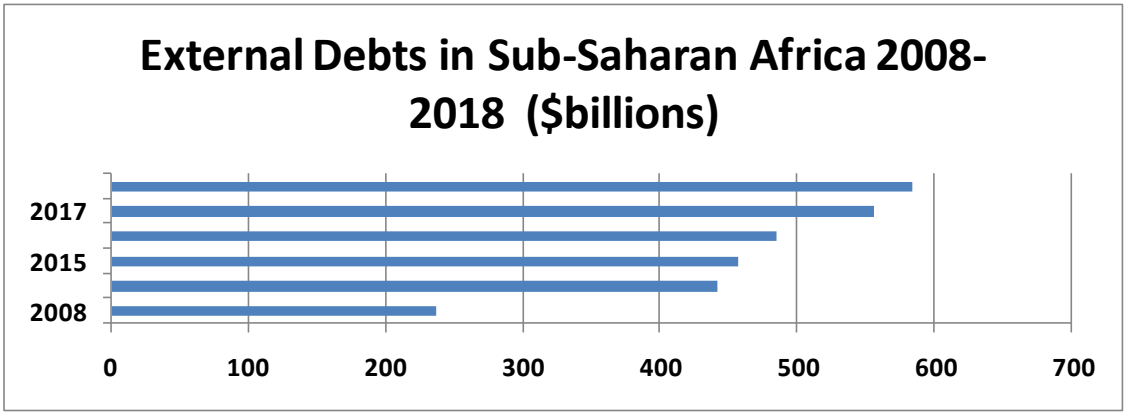

Figure 1: External Debts Profile in Africa 2008-2018
Source: Author's computation from the International Debt Statistics 2019.

Meanwhile, within the same period the accumulated external debts for the top 5 West African countries show that Nigeria leads with $46 billion followed by Ghana with an estimated $23.1 million with Cote de I voire trailing behind at $15 billion loosely is Senegal with a foreign debt profile of $12 billion, while Mauritania and Mali with $4 billion (figure 2). The lowest being the Gambia and Guinea-Bissau with a debt profile of $681 million and $420 respectively behind Liberia, Guinea and Cape Verde at $1 billion dollars respectively (International Debt Statistics, 20190. These huge capital inflows has placed the West African region at advantage position to be in the forefront of economic stability, better placed than its Eastern and Southern African neighbors combined. However, according to World Bank (2021) the increasing rate of this influx of exogenous capital has not been strongly felt, largely due to the decaying institutional environment observable in these countries within the region, for instance the institutional quality of these countries measured by the quality of its civil service in implementing government policies shows that for the period (2008-2018); Liberia, Cote di voire and Nigeria scored very low in the level of institutional quality with an average of 2.4, 2.5 and 2.7 respectively, while Ghana and Senegal on the average scored 3.5 each and Mauritania 3.0 on the CPIA Quality of Administration index which has the highest institutional quality measurement score at 7 (World Development Indicators, 2021); this low institutional quality even in the presence of these huge capital inflows is the motivation for this empirical investigation.

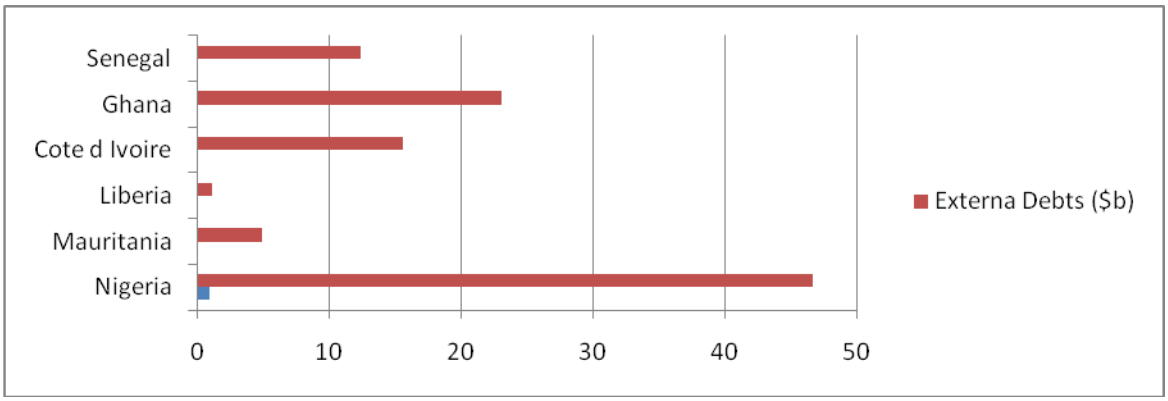

Figure 2: External Debts destination in West Africa, 2018.
Source: Author's computation using data from International Debts Statistics, 2019.

2. Literature Review

2.1 Conceptual Review

The understanding of institutional quality has received numerous attentions from scholars over the years drawing from variant definitions, Effiom (2013) defines institution as a process which emanates from the totality of a people's history, what its values, cherishes and transmits as traditions and culture from one generation to another. Therefore, an institution basically is transcendental, moral and spiritual structure that forms the subjective basis of the socio-economic existences of a people. They cannot be decreed by fiat into existence and the formal mechanisms somehow proceed from it. Similarly, North (2003) refers to institution as the formal and informal constraints on political, economic and social interactions. They are the rules, enforcement mechanisms and organization. Institutions are the incentive systems that structure people to behave in certain ways; and if effective, they structure and provide incentives for economic, political and social activities which in the short or long run may stimulate employment generation Institutions are the rules of the game of a society or more formally are the humanly devised constraints that structure human interaction. It consist of formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behavior, and self-imposed rules of behavior); and the enforcement characteristics. Therefore, institutions are the outcome of societies combined experiences arising from sustained co-existence, shared beliefs and idiosyncrasy, these shared beliefs defines what is generally accepted by society and guides the effective use of public resources, both natural and non-natural. Non- natural resources can be financial resources either internally or externally generated. A good external source of financial resources is foreign debt.

According to Nwachukwu (2017) external debt is the borrowed fund from foreign countries with specific percentage of interest rate attached to the money borrowed. Also, Were (2001)described this economic variable as that part of a country's debt that is borrowed from foreign lenders including commercial banks, governments or international financial institutions like IMF, Asian Development Bank, World Bank or any other private corporation.

There are numerous theories explaining this subject matter, however this paper is anchored on dependency theory developed by Baran (1957). This theory describes the nature of international relations among countries of the world, stating clearly that developed countries influence less developed countries through their economic power. The theory adherents prescribe foreign assistance in form of loan, aid, investment, as well as unhindered operations of the Multinational Corporations (MNCs) as remedial measures. The state of dependency on technologically advanced countries by Africans is attributed to bad leadership, mismanagement, poor institutional framework, corruption, low level of technology, and lack of close integration (Gabriel *et al.*,

2020). Empirical results from previous studies related to the subject matter are discussed below.

Empirical Review on the Relationship between Institutions and Debts

Mensah, Bokpin and Boachie-Yiadom (2018) investigates institutional quality and the external debt-growth nexus for (36) SSA countries for the year 1996-2013 using the system GMM method of data analysis. Results from this study suggest that institutional quality has robust effects on the external debt–growth nexus. Thus, the impact of external debt on growth is through host nation's institutional quality. However, the mediating effect of institutional quality on this nexus is up to a point. Similarly, Masuch, Moshammer and Perluigi (2017) provides empirical evidence that sound institutions has strongly cushioned the effects of high debts volatility in European countries, also indicating that those countries with institutions below the EU average are associated with poor long-term real growth. In an earlier work, Van-Rijckeghen and Weber (2006) examines the role institutions play in domestic and external debts default payments in democratic and dictatorship countries, it was found out that for democracies, governments are more likely to pay up debts obligations due to the presence of checks and balances, than in dictatorship where their institutions are less influenced by public opinion. In a recent study, Daud (2020) finds empirical evidence in support of the notion that high level of external debts weakens the impact of strong institutions and vice versa, however, another related study, Butkus and Saputiene (2018) investigates the influence of institutions on debt level threshold for 152 countries for a period of 20 years, their results shows that government effectiveness does not have any positive significant relationship with external debt threshold.

Alvaras-Botas and Gonzalez (2009) analyses the effects of institutions and banking structure on debts for a sample of 37 countries, their results reveals the cost of debts decreases due to presence of sound institutional variables; like rule of law, legal protection of creditor's rights and the weight of the bank structure. Qayyum, Din and Haider (2012) extending the Ramsey-Cass-Koopman model by incorporating governance, examines the relationship between good governance, foreign aid and external debt. The results indicate no relationship between governance and external debt, similarly Guscina (2008) analyses the role of institutional quality in development and management of domestic debt market in 19 emerging economies for a period of 25 years, empirical results shows that weak institutions hinder the development of the domestic markets.

3. Methodology

This is set to examine the impact of institutions on external debts for a sample of 16 West African countries (ECOWAS) covering the period ten (10) years. The data used in this study is secondary in nature and were collected from various secondary sources. For the purpose of this study, the data is sourced from the Worldwide Governance indicators (WGI) database, developed for the World Bank by Kaufman, Kraay and Mastuzzi (2016). While data for External debt was sourced from the development indicators of World Development Indicators (2020), while external debts is proxied by total net public debt stock. Institutional quality has been proxied by different indicators namely; voice and accountability, government effectiveness, regulatory quality, control of corruption, political stability and absence of terrorism.

The model specified is modified from the works of Nwachukwu and Ugwuanyi, (2019) and Kida (2017). To estimate the impact of institutions on External debts, the following model was set up.

EXDbt=f (VOIACC, POLSTA, GOVEFF, REGQUA, CONCOR, HUMCAP, PROPRIT,c)... ……(1)

Mathematically expressed from equation (1) as

$(EXDbt_{it}) = \alpha_0 + \alpha_1 voiacc_{it} + \alpha_2 polsta_{it} + \alpha_3 goveff_{it} + \alpha_4 regqua_{it} + \alpha_5 concorit + \alpha_6 humcap_{it} + \alpha_7 proprit_{it} + C_I + \mu_{IT}$……..……...…….…(2)

Where;

α_0 is the intercept, (voiacc), represents Voice and accountability, (polsta) represents Political stability, (goveff) represents of Government effectiveness, (regqua) measures Regulatory quality, while (concor) is the measure of Control of corruption, and (humcap), measures Human capital, while (proprit) is the measure of Property rights, C_i= is a unit- specific error component while μis the remaining error components, $_i$ represent country and $_t$ is the country dummy.

The study used System Generalized Method of Moments (GMM) developed by Arellano and Bond (1990). They have been widely used in the literature particularly because of its potential for obtaining consistent parameter estimate even in the presence of measurement errors and endogenous right-hand side variables (Asuquo, 2015). The system GMM approach is used because it allows analyses with longer N and shorter time period (T). Use of panel data in estimating common relationships across countries is particularly appropriate because it allows the identification of country specific effects that control for missing or unobserved variables (Judson & Owen 1996).The system GMM approach is preferred for controlling endogeneity bias, omitted variable bias, reverse causality, unobserved heterogeneity, the weak instruments problem and unit root effects in the choice of instruments (Blundell & Bond, 1998). Moreover, the use of system GMM approach will take care of flaws and statistical problems that are associated with OLS, fixed and random effects models and that of the first-difference GMM by producing consistent and efficient parameter estimates (Bond, 2002).

4. Findings and Discussion.

The findings of the two step system GMM are presented in table 1. The total numbers of the observation used for the study are 176. This shows the period covered by the study as a result of the existence of seasonable variation across countries and time (cross-section). Hence, the heterogeneities exhibited across countries and time therefore, makes the choice of panel data model more appropriate for the study. The implication is that the disparity displayed among the series is usually taken care of by the GMM model (Blundell & Bond, 1998).

Table 1: GMM Model of External Debt and Institutions in ECOWAS Countries

Independent Variables	Model Two EXDBT Coefficients	T-ratio	
VOIC	-2.400	-3.21***	
REGQUA	1.240	0.28	
POLSTA	5.630	2.33***	
RULAW	0.992	0.01	
CONCOR	-2.740	-0.46	
GOVEFF	1.100	2.27**	
L_1.	1.207	16.49***	
F-Value	105.27***		
Diagnostic Tests			
AR(1)	-1.14	(0.254)	

AR(2)	1.10	(0.273)		
Sargan test of overid. chi^2	1.15	(0.283)		
Hansen test of overid. chi^2	1.15	(0.283)		

*Source: Author's computation using STATA version 14 software. ***, ** and * indicates the level of significance at 1%, 5% and 10% respectively. Values in the parentheses are the p-values, 2020.*

Preliminary diagnostic tests indicate that the insignificant probability test statistics for the model of AR (1) and (2) indicates 0.254; indicates that error term of the differenced equation is not serially correlated at the second order; we therefore, reject the null hypothesis. Also the Sargan/Hassin tests of over-identifying restrictions with an insignificant probability value of about 0.283, we thus reject the null hypothesis of all instruments as a group is exogenous, showing that our instruments are valid and our model is appropriate for prediction.

The performance of external debt among ECOWAS countries shows specifically that voice and accountability (VOIC) has a significant negative impact on external debt. This is consistent with studies undertaken by (Mensah et al, 2018; Van-Rijckeghem & Weber, 2006) this could be attributed to efforts towards transparency among member countries and the strong effects of pressure groups, social media campaigns and political parties' activities. The coefficient of regulatory quality (REGQUA) shows a positive and no significant effect on external debt in ECOWAS countries. Political stability (POLSTA) coefficient shows a positive and significant effect on external debt on ECOWAS member's countries at 1% level this confirms the results obtained by (Weber, 2006) and Colombo & Longoni, (2009). This is an indication that political stability in this region has been considerable stable and beneficial as observed in literature. The weak regulatory quality continued with advent of democratic rule which has ensured stable polity over some years explaining the increasing public debt figure of ECOWAS countries. Every regime wants to deliver dividends of democracy beyond the available resources; hence most often they resorted to loan without recourse to existing regulatory framework

The coefficient of rule of law (RULAW) revealed a not significant positive impact on external debt in ECOWAS member's countries, consistent with the results obtained by Alvara-Botas and Gonzalez, (2009) and Butkus and Saputiene, (2018). On the other hand, control of corruption (CONCOR) shows a negative but no significant impact on external debt (EXDBT) among ECOWAS countries. Finally, the coefficient of government effectiveness (GOVEFF) shows a positive and a significant impact on external debt, in conformity with the hypothesis that good governance in general promotes the efficient utilization of public debts. This could be attributed to improvement in policy performance such as establishment of anti-graft agencies, checks and balances, separation of powers and lack of incessant interference in the market mechanism by the state in member's countries for the period under review (see Said & Morai, 2020; Guscina 2008; Qayyum et al 2012).

5. Conclusion and Policy Recommendations

This approach investigates the relationship among external debts and institutions in ECOWAS member countries from 2008-2018. However, to achieve this major objective, the study adopted the System Generalized Method of Moments developed by Arellano and Bond (1990) to analyze the impact of institutional development of ECOWAS countries on the attractiveness and utilization of these forms of external modes of capital financing. Different diagnostic tests were carried out on the estimated GMM model, the results show that the model passes through all the tests. Confirming the instruments validity of the model, Sargan/Hassin test provides evidence in support of the validity of instruments in the model. On the other hand, a unit change in voice &accountability brought about decrease in external debts among ECOWAS sub region, while political stability and government effectiveness have

significant positive impact in attracting more external debts among ECOWAS sub region.

Efforts should still be made by West African countries to make optimal utilization of its external debts to achieve economic prosperity as theorized in the literature. The region as a matter of urgency should provide framework to control corrupt practices which reduces the financial impact of these funds, reduce administrative bottlenecks observable in government agencies thereby ensuring that the constitution among various countries remain supreme and the rule of law is respected and observed to properly manage these modes of external capital financing for economic growth and development.

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