Research Paper

Effect of External Debt on Poverty Rate In Nigeria

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ABSTRACT
This paper explores the relationship between external debt and poverty. A number of observers haveargued thathighexternal indebtedness isamajor causeof poverty. Using the first-differencedgeneral methodof moments (GMM) estimator, this project models theimpact ofexternaldebtonpoverty in Nigeria,measured bylifeexpectancy, infantmortality,andgrossprimary enrollment rates, while duly taking intoaccount theimpact of external debton income. The project thus endeavors tobring together theliterature that links external debt withincome growth and poverty in Nigeria. The main conclusion is thatoncetheeffect of income on poverty has beentakenintoaccount,externalindebtedness indicatorshavealimited butimportantimpact on poverty.

1.1 Background to the Study

Severalobservers,notablyinternationalnongovernmentalorganizations (NGOs),havelongargued that alargeexternal debtburden isamajor causeof povertythroughits effects oneconomic growthandhuman development in Nigeria. Somehaveevenadvanced thehypothesis thatexternal debtis*the* causeof poverty. While thereisasubstantive literature onthe relationship between growth and poverty,andonthatbetweenexternaldebtandgrowth,InDollarandKraay(2001) and Moser and Ichida (2001), they are of the view thata systematic study of thelinkages between external debtandpoverty are relevant for studies. Links between external debt and poverty arecomplex, because there are several social, economic and cultural factors reflecting, among other things these have contributed to the multidimensional aspects of poverty.

There isincreasing empirical evidence that economic growth plays akeyrole inpoverty reduction. Dollar andKraay (2001) summed it of best with the title of theirpaper, "Growth IS Good for the Poor."However, thereisstill anongoing debateon tl1eextent towhich growth actually affects poverty. Forexample, Ghura andothers (2002) question theextent to which theincome of the poorestone-fifthofthepopulation grows indirectproportion toaverageincome.Using fairlyrobust statistical methods, theyidentify what theycall "super pro-poor" conditions ontopof growth itself. Thus, contrarytoDollar and Kraay, they find that theaverage growth ofincome does not lead to a one-to-one increase in the income of the poorest quintiles.

Thelinksbetween growthandpoverty havebeen longdebated byeconomists andsocial scientists. One view isrepresentedby"trickle-down"growth optimists who believe that growth eventually benefits thepoor.Theotherviewfocusesonreducing incomeinequality tocombat poverty(Barro, 2000; Galor andMoav, 2000). For example, usingaheadcount ratioofpoverty, based onthe US$Iadaycutoff,RavallionandChen(1997)findthatpovertyfallssystematicallywithhigher

GDPpercapita, withanaverage elasticity of-3.1. Anumber ofstudies havefound income to be a keydeterminant ofnon-income povertyindicators, suchas theinfant mortalityrateandeducation levels (Deaton, 1999). Atthesame time,several studies havealsofound thatbetterhealth and education increase growth(Ranis andothers,2000),suggesting atwo-wayrelationship between economicgrowthandpoverty.Therefore,itwouldseemthatgrowthnormallyreducespoverty,but that itseffects varysignificantly across countriesinagiven period and across periods in agiven country (Ravallion, 2001).

Thereisalsoevidencethatexternaldebtmayaffect growth.Moststudiessuggest thattheimpactof externaldebtongrowthoccursmostlythroughtheinvestmentchannel.First,theservicing ofheavy debt

maydirectly divert budgetaryresources from investments necessary tostimulate economic growth(Krugman, 1988; Sachs, 1989). Second,highindebtedness discourages private sector-led investmentandemployment (andtherefore growth)owingtouncertaintyaboutgovernmentactions inservicing thelarge external debt (Serven, 1997). Third, high indebtedness mayleadto capital flight (Ajayi and Khan,2000). Finally, acountry withhigh indebtedness isoften perceived by internationalfinancial marketsanddonorsasexhibitingproblemsofeconomicmismanagement and badgovernance, and therefore toberiskyfor investment.New flows ofexternal resources to countries faced with largeexternal debtscould bethus becurtailed.

Theavailable empirical evidencethusindicates thatthe level ofexternal debt has animpact on economic growth, which, intum, isfound in many studies to beakeydeterminant of poverty. Hence,external debtislikelytoaffectpovertythroughitsimpactoneconomicgrowth. However, theexplicit linkamongindebtedness,growth, and poverty hasgenerally been lackingin the empirical literature. This paperisan attemptto partially fill this void.

This paperempirically explores thelinks through which external indebtedness hasan effect upon poverty, measured bylifeexpectancy, theinfant mortality rate, and theprimary gross enrollment rate.Highdebtservice candirectlyreducegovernment resources thatareavailableforthepoor,for example, health andeducation expenditures andexpenditures onsocial safety nets. Even iftwo countries consistently have thesame growth rate, thecountry with ahigh debt service islikelyto spend lessonprovision ofsocialservices, thereby havinganegative effect onnon-income poverty indicators (Gupta,Verhoeven, and Tiongson, 2001).

1.2 Research Objectives
The aim of this project is to model the effect of external debt on poverty rate in Nigeria with the following objectives
i.   To analyze the poverty rate in Nigeria from 2007 to date
ii.   To analyze the external debt in Nigeria
iii. To use the first-differencedgeneral methodof moments (GMM) estimator to models theimpact ofexternaldebtonpoverty in Nigeria as in (i) and (ii)
iv.   Analysis of Result

1.3 Model Specification
This project models theimpact ofexternaldebtonpoverty in Nigeria,measured bylifeexpectancy, infantmortality,andgrossprimary enrollment rates, while duly taking intoaccount theimpact of external debton income

2.1Previous Work
Studiesinvestigating thelinkbetweenexternal debtandgrowthplaceastrongemphasisontherole of investment. Largedebtstocks aretypically expected to lower growth through thechannel of reduced investment which isusually described bythedebtoverhang hypothesis (Krugman, 1988; Sachs, 1989). Outstanding debtultimately becomes solarge thatinvestment will beinefficiently lowwithoutsizabledebtordebtservicereduction (Claessens and Diwan, 1989;andClaessensand others,1989 and 2000). Theburden of large debt sooner orlater can lead to extreme scarcityin liquidity, negatively impactingupon capital formation, growth, and consumption. Theincentive effectofthishypothesis referstothe lowpublicandprivate investment becausealarger andlarger shareofresources istransferredabroadfordebtservicing.Inotherwords,someofthereturnsfrom investing in thedomestic economy are effectively taxed away.

Another strand of thedebt overhang theoryemphasizes the point that large debtstocks increase expectationsthatdebtservicetends tobefinanced bydistortionarymeasures(inflation tax orcutsin publicinvestment) asin Agenor andMontiel (1996). Under suchuncertainty,privateinvestorswill prefer to exercisetheiroption of waiting (Serven, 1997) and maychoose to invest less, ordivert theirresources towards quick, financial returns with high risk, orresort totransfer their money abroad (capital flight).

TheoriginalLafferdebtcurve(Cline,1995)graphstheexpectedrepayment againstthefacevalue ofdebtservice.Itshows that asoutstanding debt increases beyondathreshold level,the expected repayment begins to falldue totheadverse effects mentioned above. Pattillo and others (2002) discuss the possible nonlinear relationship between debt and growth.

2.2 Overview of the Project

In this project the first-differencedgeneral methodof moments (GMM) estimator will be used to models theimpact ofexternaldebtonpoverty in Nigeria,measured bylifeexpectancy, infantmortality,andgrossprimary enrollment rates, while duly taking intoaccount theimpact of external debton income. The project thus endeavors tobring together theliterature that links external debt withincome growth and poverty

2.3 Theoretical Framework

Most of theempirical studies find one ormore debt variables to be significantly andnegatively correlated withinvestment or growth,forexample,Borensztein (1990) forthe Philippines,Iyoha (2000)for sub-SaharanAfricancountries,Elbadawi andothers (1997)forsub-Saharan African countries,Were(2001)forKenya.SimilarresultswerefoundbyDegefe(1992),Osei(1995),Mbire andAtingi(1997),andAjayi and Khan (2000).The debt-to-long-rungrowthrelationshipwas analyzed byCohen(1993,1997),andCohenandSachs(1986).

Notwithstandingtheattractivenessofthedebtoverhanghypothesisasanexplanation for highdebt lowgrowth nexus, empirical evidence oftheeffects ofa debt overhang has been mixed. Claessens (1990) found that fiveof the 29middle-income countries in his sample wereon thewrongsideof theLafferdebtcurve,suggestingthatpartialdebtreduction wouldincreasetheexpectedrepayment to thecreditors. Formiddle-income countries, Warner(1992)concludes thatthedebtcrisis didnot depress investment, whileCohen (1993) found that itwasthe crowding-out effect ofcurrent debt servicing thatwassignificant. Oks and van Wijnbergen (1995)concluded thatoverhang did not exist for Mexico.

Several other studies concluded that it isdifficult todisentangle the impact of debt variables on growth and theroleof debt overhang from other factorson growth and that debt burden can negativelyimpactotherfactors(forexample,debtcanaffectdomesticrealinterestrates whichcan impact on investment and growth).

3.1   ModelSpecificationandEstimationMethodology
Theguidancefromthetheoretical literatureisnotveryclearastotheexactnature,intensity,and transmission mechanisms throughwhich externalindebtedness affectsgrowthandpoverty. Nonetheless,thereseemtobedirectandindirectlinkagesbetweendebtandgrowth,andbetween growth and poverty. Therelationship between debt and povertyis likelyto bebothdirect and indirect, and nonlinear. Intheabsence ofasolid theoretical framework, we hope toshed some empirical light on thisissue,whileguarding against what Sala-i-Martin (1997)calls"creative theorizing". Inordertoinvestigate theimpactofexternal debt onpoverty, weuseamodel ofthe form.

$$Plc,t::::;al \qquad +a2Yc,I+a3Dc,t+a4xc,/+\mu c+v,+ec,I \qquad\qquad (1)$$

Where:
- $Plc.$,representsthemeasureofpovertyinconntryc attimet
- $Y,..$percapitaincomeincountrycattimet
- $D,,$themeasureofexternalindebtednessincountrycattimet
- $X,,,$asetofcontrolvariablesincountrycattimet.
- Thedisturbance termrepresents acountry-specificeffect ($\mu,$), atime-specific effect (u,) and a common error term (e,,,).

Ourempirical specification allowsustoidentify therelationshipbetweenexternal debtandpoverty. First, weestimateequation (1)withoutcontrol variables (a.,=O) using thesimpleordinaryleast squares(OLS), withthedifferent measures ofpoverty(lifeexpectancyatbirth,infantmortalityrate, primarygross enrollment rate) and indebtedness. Real percapita GDP might beendogenous, and failing tocontrol this would lead to inconsistent estimates. As wehavealready indicated, real per capita GDP islikely tobeacauseaswell astheresult of poverty. Itispossible to estimateequation
(I)usinginstrumental variables(IV)tocorrectforendogeneity. However, thisestimatorcorrects onlyfor endogeneity,but not theomitted variable bias, which couldalso lead toinconsistent estimates. Thefirst-differencedgeneralized methodofmoments(GMM) estimator (Blundell and Bond,1998) isusuallyused toaddresssimultaneouslybothomittedvariablebiasandissuesofendogeneity.This method consists oftakingthefirst-differencesoftheequation toremoveunobserved time-invariant countryspecific effects, and then instrument theright-hand-sidevariables with thelevels ofthe variables lagged rwoperiodsormore.Nonetheless, Blundell andBond (1998)haveshown that the first-differencedGMM estimators arebiased when theinstruments used areweak.Moreover, the previous methods do notaccount for thepresence ofcountry-specific effects, while it is likely that poverty may becorrelated with theunobservedcountry-specific effects.
Toaddresssimultaneouslyomittedvariablebias,issuesofendogeneity, whilenotentirelyremoving thecountry-

specificeffects (Bond, Hoeffler, andTemple, 2001), Blundell and Bond (1998) have suggested tousethesystem GMM method thatjointly estimates theequation inlevels (I)and in first difference (2),imposing therestriction that thecoefficients inthelevel anddifferenced equation are equal:

*MIC,/=***a***l+azYc,t+a3wc,I+a4Mc,t+.6.ec,I*………………………..(2)
L(/1Plc,H,.6.Yc,t-!,/j,]Jc.1-l),D(Pfc,I'''Pfc,1-2,Yc,l'''Yc,1-2,Dc,i···Dc,1-2)

Theinstruments used inthelevel equation (L) are thelagged first differences ofthevariables. The GMM-type instruments for thedifferenced equation (D)are thelagged levels ofthevariables. The equationin levelsallowsonetoexploit thelargecross-country variation inthevariables, whereasin thedifferenced equation, time-invariant,country-specific,sources ofheterogeneity areremoved. In addition, theuseof appropriate Jags ofright-hand sidevariables asinstruments allows one to address thethree problems of measurement error, omitted variables, and endogeneity (Dollar and Kraay, 200I).In what follows,weestimate equation (**1**)using also thesystem GMM method. To ensure that ourresults arenot driven bytimespecific effects, weestimate all regressions with time
dummies. ThevalidityoftheGMMinstruments aretested usingSargantestsofover-identifying restrictions.

Thebasicspecification allowsustocapture throughtheincome variable theimpactofa number of macroeconomic policies. Wenonetheless expand thebasic model byintroducing twocontrol variables: openness, andacountry-risk indicator. Tradeopenness isexpected toaffect positively humandevelopment. WeiandWu (2002),report several piecesofevidencesuggesting thathigher tradeopenness is associated with alonger life expectancy and alower infant mortality rate.An improvementinthecountry riskindicator, measured bytheoverall International CountryRiskGuide(ICRG) index,isexpected tohaveapositive impact on human development. Thelatter allowstoassessthepossibilitythatbadinstitutions, corruption, andeconomicmismanagement and badgovernancemayleadtolowerflowofforeignresources,lowlevelandefficiencyofinvestment in social sectors.

4.1 Data Analysis
One measure ofpovertyhas been generally in terms ofconsumption or income. Themostwidely nsed incomepoverty indicators aretheheadcount index, per capita GNP, and percapita GDP corrected forpurchasing power parity(PPP). However, new perspectives onthecauses and manifestationsofpovertyhaveshown thatpovertyisamultidimensionalphenomenon,andcanbe expressedin termsofincome,andbasicneedssuchasaccesstohealthservices and education. We usethreestandard hnman developmentindicators tomeasurepoverty:thelifeexpectancy atbirth, infant mortality rateandprimary grossenrollment rate. Several studies have shown that these indicators conld beused to measurethevariations in thephysical well-being of people*(World Development Report,*2000/2001), and thatinmanycountrieshealth and education indicators are worsefortheincome-poorthanfortheincome-nonpoor.InSouthAfrica,forexample,theunder-5
mortalityrateistwiceashighastheratefortherichest20percent, andin Northeast andSoutheast Brazil, it is three times as high.
Thetheoretical literature israther vagueon thepreferred definition of external debtindicators. In linewith empirical practice, weare ratheragnostic onwhat isthebestindicator. Admittedly, each indicator isamenable to adifferent interpretation.We therefore use threedifferent external debt indicators. First, weuse theratio ofnominal debt toGDP, which isauseful indicator toassessthe overallresource basisavailable tothecountry. However, thefacevalueoftheexternaldebtstockis generally not a good measure ofacountry's debt burden when asignificant partof thedebt is concessional,i.e.,containsagrantelement,asisusuallythecasefordebtcontracted bylow-income countries. We thus also use the ratio the ratio of NPV of debt to exports to assess the country's capacity to repay(solvency). Thisratioisa key variable in debt sustainabilityanalyses,especially withintheHIPC(HighlyIndebted PoorCountries) Initiative framework. Thesetworatioswillhelp to isolate anydebt overhang effect. Totakeinto account thepotential liquidity effect or crowding out effect, we used the ratio of debt service to exports.
The analysis uses annual data for67low-income countries[8](ofwhich 41 are HIPCs[9]),overthe period 1985-99.Themain datasetcomprisesthe threenon-income povertyindicators (life expectancy,infantmortalityrate,andgrossprimaryschoolenrollment rate),GDPpercapitaPPP, andthreeexternaldebtindicators(nominaldebttoGDP,NPVofdebttoexports,anddebtservice to exports).
Various sources areused togather thedata. Lifeexpectancy atbirth (years), infant mortalityrate (numberofdeathsper1,000livebirth)andprimarygrossenrollmentrate(grosspercent) arefrom the*WorldDevelopmentIndicators*(WorldBank).Thesedataareavailablefor I985,1987,1990, 1992,1995,1997.Nominalstockofdebt,totaldebtservice,GDPandexportsarefrom the*Global Development Finance*(WorldBank).Netpresent valueofdebtdataarefromEasterly(2000).Real purchasingpowerparityGDP,termsoftrade,openness((import+export)/GDP)arefromtheWEO database of the IMF.

Table 1shows theevolution of averagepercapitaincome, external debt andpovertyindicatorsfor theentiresample ofcountries fortheperiod 1985to 1997.First,during the period 1985-92(and prior tothe bilateral andmultilateral debtrelief), asaverage per capita income increased, the external debtindicatorsalsoincreased rapidly, which indicatesthatnew external borrowingsmay havebeen akeyfactorineconomic growthand development. Second,since 1992,as debtrelief undertheaegisofParisClubandotherinitiativeswasaccelerated,theexternal debtindicatorshave decreased. Third,perhaps due to averagingof indicators across thesample size,nosystematic pattern is observed over timein thepoverty indicators ofinfant mortality, primaryeducation and lifeexpectancy. Moreover, thereappears to be a neither positive noranegative relationship between percapitaincome andthepovertyindicators.Thesearethe"original" HIPCs. Thecurrent listof HIPCs thathaveobtained orare expected torequiredebt relief under the HIPC Initiative is somewhat shorter (about 36).

TableI.EvolutionofAveragePerCapitaIncome,Debt,andPovertyIndicators

Year	Percapitaincome (U.S.dollar,PPP)	Life expectancy (years)	fnfantmortalityrate (per1000)	PrimaryGross enrollmentrate (percent)	Nominal debt (percentofGDP)	NPVofdebt (percentof exports)	Debtservice (percentof exnorts)
1985	1,160.2	54.6	106.3	83.1	85.8	330.5	23.6
1987	1,610.4	53.9	105.2	81.3	104.4	426.2	25.6
1990	1,721.3	54.3	120.5	83.6	134.6	408.9	21.0
1992	1,545.91	53.6	101.7	80.4	119.9	445.5	18.4
1995	1,471.8	54.4	92.9	80.8	121.0	267.2	19.6
1997	1,512.5	54.1	125.7	80.8	105.0	232.6	14.6

Twomainfindingscould bedrawnwhenanalyzingthebivariaterelationship betweenper capitaGDP,non-income pove1iy indicators anddebt indicators:

• First, there seems to bea relationship between real GDP per capita and health indicators.TableI showsthatlifeexpectancyincreases withrealpercapitaGDP. Infant mortality ratedecreases with real per capita GDP (Figure 2). In contrast,
Table2doesnotshowauniformlinkbetween primarygrossenrollment rateandreal per capita GDP. Table 2, which reportsnon-income indicators byincome groups, confirms these findings. Itshows that higher real GDP per capita isassociated with better lifeexpectancy andinfant mortality rate. These results are similar to those

confirmed byTable2,whichcompares povertyindicators for countries withNPVof debt lessthan 150percent ofexportsandNPV ofdebt higher than 150percent of exports,andforcountrieswithnominaldebttoGDPlessandhigherthan 40percent. Povertyindicators appear tobeworseincountries with NPVofdebttoexport higher than 150percent andincountries withnominal debttoGDP higherthan 40 percent.

Table2.PovertyIndicators,byExternalIndebtednessGroups (averages)

	NPV/X<150%	NPV/X>150%	Nominaldebt to GDP<40%	Nominaldebtto GDP<40%
Income(US$)	1,591	1,492	1,578.2	1,498.2
Lifeexpectancy(years)	57.0	53.5	56.1	53.8
Infantmortalityrate(per1000 birth)	86.3	113.5	85.0	113.1
Primaryrossenrollmentrate(%)	90.0	79.9	77.7	82.5

5.1 Discussion of Result

Thekeyobjective ofthis projectwas toestablishwhether external debt plays acrucial rolein influencing povertylevels.Anumberofinternational NGOs havecategoricallystated thatdebt causespoverty.Thiswork seeksto contribute tothisdebateas well as to the literatureon growth andexternaldebt.Thereisanextensive andgrowingliteratureontheimpactofgrowthonpoverty, and on therelationship between external debtand growth.However, there is apaucityof studies directlylinkingexternaldebtandpoverty.Thisprojectthusendeavorstobringtogetherthetwoareas of study, while emphasizing the complex relationships.

Externaldebtaffectspovertynot onlythroughitsnegativeimpactonpublicinvestment andincome growth but also through highdebt service's crowding out of governments'social spending. High debtservicedirectly reduces government budgetary allocations on health, education,social safety nets,andwaterandsanitation, in partbecause governments find itpolitically easier tocut backspendinginsuchsectorsbecausethepoorarenotusuallyorganizedtohaveavoiceinsuch decisions.

Inordertoadequatelyexaminethecomplexinterlockingrelationshipsintheexternaldebt-growth- povertynexus, this work has used the GMM methodology, which allowsus to simultaneously address both the problems of endogeneity andomitted-variablebias.

Themain findings of thework confirm thatonce theeffect of income onpovertyhas been taken intoconsideration,highdebtservice andrelated external indebtedness indicators have an adverse, butlimited impact onnon-income povertyindicators, such aslifeexpectancy, theinfant mortality rate,andtheeducationenrollment rate.Themoststatisticallysignificantrelationshipisthatbetween thedebtservice-to-exportsratioandlifeexpectancy, where wefindthata20 percentincrease inthe debt- service ratio leads to a I percent declinein lifeexpectancy at birth.

Themainfinding,whilenotcontradictingotherstudies in theliterature,suchasPattillo andothers (2002)and Dollar andKraay(2001),is that the impact of external debton poverty is a relatively muted, albeit important, variable in the poverty-growth nexus.

Fromtheseresults,inlinewiththe findingsofAbregoandRoss(2001), inordertoreducepoverty, the keypolicyoption isto focus on factors that impede growth, of whichdebt isbut one.Focusing exclusivelyon external debtrelief is probablynot a veryeffective way to reduce poverty. In this context, anewconsensus (asin the Monterrey Consensus andthe Johannesburg Conference) is emergingamongthemembers ofthe international community; the longer-term goalbeingfocused onisaccelerated povertyreduction,whichneedstobesupported byadditionalaidflows,whichare increasingly being provided in the formof grants,combined withdebt relief forcountries thatcan demonstrate effective utilization of theseresources and maximize the benefits to thepoor.

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