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AN OVERVIEW OF INTERGOVERNMENTAL FISCAL RELATIONS AND SUBNATIONAL PUBLIC FINANCE IN NIGERIA

James Alm and Jameson Boex *

1. INTRODUCTION

Fiscal decentralization reform, the reform of fiscal relations between different levels of government, is an important fiscal policy issue in many African countries. While for many African nations the decentralized delivery of government goods and services is a relatively new concept, the issue of intergovernmental fiscal relations has been a constant and important fiscal policy consideration in Nigeria since the country's independence in 1960.

Despite the fact that Nigeria has had a federal government structure since before independence, until recently it would have been difficult to seriously consider Nigeria as a fiscally decentralized country. For much of the country's history, military regimes dismissed elected officials and legislative bodies at all levels of government at regular intervals and replaced them with military appointees. Since under military rule subnational governments in Nigeria were accountable to the country's military authorities rather than to state or local electorates, we cannot properly speak of political and fiscal decentralization during this period. Nonetheless, Nigeria's decentralized administrative structure was maintained by successive military regimes: under military rule, state and local governments continued to operate as distinct government units, provided important government services, collected own source revenues and received intergovernmental transfers, albeit at the discretion of military governors and appointed local executives rather than at the direction of the local electorate. With the return of civilian rule to Nigeria in 1999, which entailed the adoption of a new constitution and the election of government officials and legislative assemblies at all levels of government, it can be argued that Nigeria instantaneously became one of the most decentralized countries in Africa.

Nigeria's long –albeit often nominal- tradition of fiscally decentralized government and its thoroughly decentralized administrative structure are often overlooked in discussions of fiscal decentralization reform in Africa. More often than not, comparative studies point to countries such as Uganda or Ghana as models what a decentralized system of government in

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Africa could or should look like, despite the much more limited nature of fiscal decentralization in either of these countries when compared to the current situation in Nigeria. While it is true that Nigeria's "brand" of fiscal federalism is fraught with numerous imperfections, we believe that much can be learned from Nigeria's system of intergovernmental fiscal relations and subnational public finance, and should serve as an important case study (for better or worse) for other African countries currently contemplating or implementing fiscal decentralization reforms. To this effect, this paper presents a broad overview of intergovernmental fiscal relations and subnational public finance in Nigeria.

The remainder of this paper follows the main conceptual building blocks or pillars of fiscal decentralization and subnational government finance. After a brief overview of Nigeria's federal system, Section 2 discusses the assignment of functional responsibilities in Nigeria's federal system. Section 3 presents an analysis of revenue assignments, considering what revenue sources are available to each level of government. Section 4 looks at the design and implementation of Nigeria's system of intergovernmental transfers. Finally, Section 5 through 7 consider state and local fiscal management issues, including the importance of capital development budgets and the associated problems with subnational government borrowing (Section 5), subnational budget formulation issues (Section 6) and subnational budget implementation issues (Section 7).

Overview of the Nigeria's federal system. The Nigerian fiscal system and the country's system of fiscal federalism are defined to a large extent in the Nigerian constitution of 1999 (*Constitution of the Federal Republic of Nigeria 1999*). The constitution prescribes three levels of government: a federal government, state governments, and county-like local governments. Thirty-six states are defined in the constitution (plus the Federal Capital Territory, Abuja), and there are at present 774 local government areas.

The constitution defines the expenditure responsibilities of each level of government. While the federal government provides public services that are of national scope or importance, such as national defense, important expenditure responsibilities are assigned to the subnational levels of governments. Key local expenditure responsibilities include primary education and a host of traditional local government functions (such as operating local markets), while state governments play a key role in providing health care, secondary and tertiary education, and physical infrastructure.

The Nigerian constitution also defines the manner in which resources are shared among the different levels of government. Revenues are highly centralized. With the exception of the VAT and some minor federal revenues, all federally collected revenues are paid into the "Federation Account," which (less specific first charges) is then shared by formula among governments at the federal, state, and local levels. The value-added tax (VAT) itself is also shared by formula among government units at all three levels of government. The main source of revenues for the Federation Account are petroleum taxes. Several major non-oil revenue sources also contribute to the Federation Account, notably the companies income tax as well as customs and excise duties. The state and local government shares of the

Federation Account are distributed using allocation formulas, thus assuming the character of intergovernmental transfers. Jointly, the Federation Account disbursements plus the VAT apportionment are referred to as the “Federal Allocations”.

While most significant revenue sources accrue to the Federation Account at the federal level, a number of smaller taxes are also assigned to each level of government. State governments collect most personal income taxes, as well as some minor taxes, levies and fees. Local governments are assigned a number of minor rates, license fees, and market fees.

Oil revenues play a dominant role in intergovernmental fiscal relations in Nigeria. Oil production is concentrated in eight states, mainly in the Niger River delta. While oil revenues are federally collected, they are shared between the Federation Account and oil-producing states on a derivation basis: 13 percent of oil revenues is shared with the oil-producing states, while the remaining oil revenues are paid into the Federation Account and distributed among all levels of government.

The Federation Allocations are administered by the *National Revenue Mobilization Allocation and Fiscal Commission*. The make-up of the Commission is constitutionally-defined, comprising the Federal Minister of Finance and representatives from each of the states, typically the State Finance Commissioners and State Accountants-General. The Commission meets in Abuja on a monthly basis to allocate the previous month’s tax receipts among the recipient governments. Local governments are not directly represented in the Commission, although local governments receive their allocations directly from the Federation Account. Since the local government allocations do not pass through state accounts, state governments have no financial control over the disbursements to local governments. While a few other intergovernmental transfer arrangements exist, these are less substantial and are of discretionary and non-statutory nature (Mered 1997).

2. THE ASSIGNMENT OF EXPENDITURE RESPONSIBILITIES

Commonly accepted objectives of fiscal decentralization include promoting an efficient allocation of resources via a responsive and accountable government sector, assuring an equitable provision of services to citizens in different jurisdictions, and stimulating economic growth while preserving macroeconomic stability. These objectives provide guidance for the sound assignment of expenditure responsibilities among different levels of government.

It is useful at the start the discussion of expenditure assignments in Nigeria (the decision which level of government should have which functional responsibilities) to discuss some general principles of public finance which could guide the expenditure assignment decision. Much of the literature on this topic presents what might be termed the “Western” approach to fiscal decentralization. The many insights of this broad approach might need to be modified on a case-by-case basis in application to developing or transitional countries such as Nigeria.

General principles of assigning expenditure responsibilities. The issue of the appropriate assignment of fiscal functions among the levels of government - or the optimal amount of centralization or decentralization - has long been debated by economists. If the broad economic functions of government are divided into the stabilization, distribution, and allocation roles, and if the economic criteria for assignment are revenue adequacy, economic efficiency, and equity, then it is typically concluded that the stabilization function should largely be performed by the national government because the mobility of resources makes it unlikely that an effective stabilization policy can be pursued by a lower level of government.

For a similar reason, redistribution properly belongs to the national government; the unequal and possibly inadequate fiscal capacities of state and local governments also make centralization desirable on equity grounds. These guidelines should not be taken too rigidly.

State and local governments can sometimes contribute to an effective countercyclical policy by addressing specific features of their economies, and it is clear that they can also often have a significant effect on the distribution of income. Nevertheless, the dominant government player in the stabilization and distribution games must be the central government.

However, the allocation function, or the decision to provide government services, should often be performed by lower levels of government. The efficient provision of government services requires that the public sector satisfy the needs and preferences of taxpayers as well as possible. This is best achieved by the *subsidiarity principle*: responsibility for the provision of government services should take place at the lowest level of government that can efficiently provide this service. Government services should therefore be provided at the level of government for which a correspondence can be achieved with the “benefit area” associated with those services. The benefit area for sanitation services is clearly the local community; for national defense the benefit area is the entire national territory. The rationale for this principle is simple: elected government officials operating closer to their citizenry are better able to adapt service levels more closely to the preferences of their citizens, thereby making available to individuals a wider range of fiscal choices than could be provided by uniform national government provision. The argument for decentralization is weakened if the costs of state or local provision are higher due to the smaller scale of government operations, or if there are substantial spillovers from government expenditures. Importantly, the subsidiarity principle requires that government officials be accountable to their citizens. The absence of effective electoral systems considerably weakens the case for decentralization.

Leaving the supply of public services with wider benefit areas to smaller units of government is likely to result in the inefficient under-provision of services. For example, if the responsibility of national defense would be left to the state level, each state would seek to spend as little as possible on defense, as each state would hope to rely on the national defense contributions of all other states. Because all states would minimize national defense expenditures, clearly a sub-optimal level of spending would result for national defense. Efficiency in the provision of public services is further enhanced if there is a link between

the benefits of government services and the costs of providing these services, via fees, service charges, or state and local taxes.

Allocative functions that properly belong with state governments are those for which there are significant benefit spillovers from one jurisdiction to another, such as with health or welfare services. Some specific allocative functions that are typically performed by local governments in all countries are water supply, sewerage, power, telephones, public transportation, traffic control, police and fire protection, refuse collection, parks and recreation, and general city administration. These services primarily benefit the citizens of the specific town or city, even though it may not always be possible to identify individual beneficiaries. As discussed later, the assignment of expenditure responsibilities in Nigeria is largely consistent with these principles.

An area where the assignment of functions has received considerable attention is the construction and maintenance of capital projects. Typically, the central government is responsible for the construction of large projects, often by the issuance of long-term debt; the state (or local) government is then put in charge of the completed project, and must generate from its own sources the recurrent revenues needed to operate and maintain the services. However, this practice has sometimes created severe problems if the state government must raise revenues for projects that it may not have wanted in the first place.

The assignment of expenditure responsibilities in Nigeria. The assignment of expenditure responsibilities in Nigeria, as provided for in the constitution, is summarized in Table 2.1. To a large extent, these expenditure assignments have changed little over time and are broadly accepted by all levels of government. Corresponding to the subsidiarity principle, public services that benefit the nation as a whole (such as national defense, national transportation network, and so on) are assigned to the federal government, while assigning the responsibility for important expenditure responsibilities to the state and local government levels. Expenditure responsibilities assigned to the local government level include primary education and a variety of traditional local government functions (such as operating slaughter houses, local markets, and local infrastructure). State governments are assigned a major role in providing health care, secondary and higher education, and provide most physical infrastructure.

The assignment of expenditure responsibilities can be quantified in the relative expenditures made by each level of government. As reflected in Table 2.2, between two-thirds and three-quarters of public sector spending has historically been done by the federal government. State governments account for approximately 20-25 percent of public sector spending, while local governments account for roughly 5 percent of public sector spending. Overall public sector spending by all levels of government accounts for about 20 percent of GDP.

Assessment of Nigeria's expenditure assignments. The overall assignment of expenditure responsibilities in Nigeria coincides to a large extent with the principles of sound expenditure assignment; government services with a smaller benefits area are left to lower

levels of government, while the federal government focuses on policy areas of national significance. However, some concerns should be raised regarding the current assignment of expenditure responsibilities in Nigeria:

Social policies. One area in which the expenditure assignment causes reason for concern is the realm of social policies. In Nigeria, subnational governments are assigned a large number of responsibilities for social policies, including social welfare and poverty alleviation activities, health care policies, and primary and secondary education. Since these social activities are partially of a redistributive nature, subnational government may not be in a position to provide adequate levels of these services, unless funding is provided specifically for these activities by the federal government. For example, a poor region might not have the resources to engage in poverty alleviation, one reason why redistributive social policies are best conducted (or at least funded) at the national level. In some cases the federal government provides specific transfers in areas that it deems of national importance (e.g., universal primary education). Whether revenue sharing through the federal allocations provides an adequate funding mechanism for social development activities is discussed in detail later.

Joint expenditure responsibilities. In several cases, the Nigerian constitution assigns responsibilities for certain sectors to more than one level of government. For instance, higher education is a responsibility of both the federal government as well as state-level governments. Another example is that while the Nigerian Police Force is a federal agency, states are (nominally) assigned responsibility for state public order. Such joint assignment can lead to one of two extremes if the two levels of government fail to coordinate their efforts, namely either inadequate provision of certain government services or duplication of effort.

Division between public and private sector activities. A final area of concern with regard to the assignment of expenditure responsibilities in Nigeria is the separation of the public and private sector, especially at the subnational level. In some cases the division between the roles of the public and private sector needs to be drawn more clearly. There is consensus among economic experts that the role of government should be limited to a specified set of functions, as summarized in the “Washington Consensus”. In open market economies, the main economic role of the government sector is to regulate the productive sector and not to engage in productive activities. This appears not to be a well-understood principle among state and local government officials in Nigeria, as subnational governments habitually own and operate productive enterprises. Instead, state and local government should be encouraged to follow the principle that “the business of business is business” and that “the business of government is governing.”

3. THE ASSIGNMENT OF REVENUE SOURCES

General principles of revenue assignment. As with the assignment of expenditure responsibilities, tax instruments must be assigned among the different levels of government. Although there is much diversity in the fiscal structures of national, state, and local governments, several general principles have emerged that provide a useful point of departure.

- First, only the national (i.e., central or federal) government should impose progressive income taxes. Due to the potential mobility of households and firms, economist would argue that state and local government attempts to redistribute income by progressive income taxes will lead to the out-migration of mobile, higher-income individuals, thereby leaving immobile, lower-income households to bear the burden of the taxes. Progressive income taxes are also thought to be effective countercyclical instruments, and such macroeconomic goals are best pursued by national government policies. However, proportional income taxes or “piggy-back” income taxes are considered a promising revenue source for subnational governments in many countries.
- Second, only the national government should impose and collect taxes for which the tax bases are distributed unequally across jurisdictions, in order to prevent excessive fiscal disparities between regional and local governments. The national government may use the revenues from these taxes to equalize fiscal capacities across these areas. As a result, taxes on natural resources an major corporate income taxes often flow to the national government.
- Third, state and local governments should rely predominately upon user charges, taxes on immobile tax bases, and revenue sources that follow the benefits principle. In particular, user charges should be used to finance goods that provide measurable benefits to identifiable individuals within a single jurisdiction, and taxes should be used to finance local services for which it is difficult to identify individual beneficiaries and to measure individual costs and benefits. For instance, property taxes offer an excellent source of local revenue since the tax base is not mobile and the tax follows the “benefits principle:” there is a broad correspondence between the amount the taxpayer has to pay and the benefits from local government services received, as households and firms with larger properties arguably benefit more from local government services such as police and fire protection, or infrastructure improvements.
- Fourth, state and local governments should be assigned adequate sources of revenues consistent with their expenditure responsibilities. These governments should have discretion over the rate of some taxes to promote accountability of elected officials and to establish a link between services demanded and the cost of service provision. Assigned taxes should exhibit adequate revenue elasticity so that collections can

grow with the demand of services over time.

- Fifth, intergovernmental transfers should be used to finance those services that generate spillovers to nearby jurisdictions because relying strictly on state and local revenue sources will lead to an inefficient provision of these government services. Transfers should also be used to equalize fiscal capacities across jurisdictions. Transfers are discussed in more detail later.

In practice, few countries rigidly follow these guidelines, although the broad pattern of tax assignment is often largely consistent with these prescriptions. As discussed later, the assignment of taxes in Nigeria does not closely follow these rules, mainly because state and local governments have not been assigned significant real own-source revenues.

Around the world there are essentially two basic models of revenue assignment that attempt to satisfy these principles. In what might be called the Western model of fiscally “strong” subnational governments (e.g., the United States, Canada, and others), state and local governments independently legislate and administer their own taxes, an approach that obviously gives these governments significant fiscal autonomy and adequacy. However, this model is not appropriate given the wide range of fiscal capacities of and the severe administrative limitations on subnational governments in Nigeria. Instead, in many other decentralized countries the model is one of fiscally weak subnational governments that do not generate much revenues from their own sources, that do not independently legislate and administer their own taxes, that receive the bulk of their revenues from intergovernmental transfers, and that often are allowed to add a local tax onto the back of some existing central government tax. This approach is being increasingly used as part of decentralization reforms in developing and transitional countries around the world.

State and Local Internal Generated Revenues (IGR). As discussed in Section 1, most key revenue sources in Nigeria (including petroleum revenues, corporate income taxes, and the VAT) are collected by the federal government and disbursed by formula to government units at all levels of government as part of the Federal Allocations. The VAT was introduced in Nigeria in 1994, replacing a state-level sales tax. Similar to the Federation Account, the VAT is shared between the three levels of government on a formula basis. Some of the VAT collections are allocated on a derivation basis.

In addition, state and local governments have a number of own revenue sources or “Internal Generated Revenues” (IGR) as they are known in Nigeria (Table 3.1). The current assignment of revenue sources was set forth in Decree 21 issued in 1998 under military rule (Taxes and Levies, Approved List for Collection, September 30, 1998). State level taxes include a variety of personal income taxes (e.g., the pay-as-you-earn tax, the self-assessment tax, the withholding tax, and the capital gains tax on individuals), development levies (akin to property taxes), a number of minor business taxes, and several miscellaneous fees and levies. Local governments are given the right to collect a myriad of minor rates, levies and fees, although state governments have the power to regulate local taxes within the state.

Table 3.2 shows the composition of revenue sources at the state level in Nigeria. Preliminary data for 1999 suggest that an average state received approximately 80 percent of recurrent revenues from federal allocations, while, on average, states collected about 15 percent of recurrent revenues from internally generated revenue sources. The remaining state revenues came from other sources, including grants and transfers from the Stabilization Account. In addition, Table 3.2 presents data on the per capita level of state revenues by state in 1999. An average state collected and received N 1,791 per person in revenues and transfers, of which N 1,444 came from federal allocations. Significant variations in the availability of state resources are reported, with a coefficient of variation (CoV) of 0.95 for federal allocations, and a CoV of 1.09 for state own source revenues. Table 3.3 shows the trend in state revenue composition for the period 1993-99.

Fiscal capacity, fiscal effort and fiscal need. What determines the variation in own source revenue collections at the state level in Nigeria? Two explanations come to mind. First, it could be that a state is simply not as wealthy as other states, so that its tax bases are smaller: a state may have a lower level of “fiscal capacity” than other states. Second, it could be that a state does not try to collect revenues as hard as other states: a state may have a lower level of “fiscal effort” than other states. Of course, one of the reasons why a state may exert greater fiscal effort is when its demands or needs are greater than other states; one would logically expect a subnational government with greater fiscal needs to exert a higher level of fiscal effort.

A measure of a government’s ability to raise revenues is referred to as “fiscal capacity.” While there is a need for a reliable measure of fiscal capacity, the fiscal capacity of a state cannot be easily quantified. One obvious and intuitive measure of fiscal capacity is the level of revenue collection in a region. However, the amount of revenues collected is not a good measure of fiscal capacity, since revenue collections are not only a function of fiscal capacity, but also of a state’s fiscal effort. It is typically hard to come up with a single number that represents the potential ability or capacity of a state to raise revenues. The data that are necessary to compute measures of fiscal capacity are often of low quality or may not be available at all in Nigeria.

A variety of methods are used around the world to measure a state or region’s fiscal capacity. (Martinez-Vazquez and Boex 1997). First, an often-used measure of fiscal capacity is the state’s level of own source revenue collections, despite the conceptual shortcomings of this indicator. Second, per capita personal income has been extensively used around the world as a proxy for fiscal capacity, including in the United States. Third, a measure of the level of economic activity in a state such as Gross State Product (the state-level equivalent of Gross Domestic Product) or State Value Added can also be used as measure of fiscal capacity. Fourth, a category of more complex measures of fiscal capacity exists that find their roots in the Representative Tax System.

In general, there is very little reliable state-level data in Nigeria. There is no good

information on economic production at the state level, thus precluding us from estimating Gross State Product for Nigerian states or using other sophisticated measures of fiscal capacity. Consequently, we considered two available measures of fiscal capacity, both of which are fraught with problems. First, the Federal Office of Statistics in Abuja reports household income levels by state; these data are somewhat dated, as reported in the 1997 edition of the Annual Abstract of Statistics, and the data should be deemed unreliable because they are plagued by easily detectable errors. Nonetheless, household income data provide a comparative measure of the relative fiscal capacity of state governments, thereby providing some comparative measure of each state's ability to collect revenues. A second data source that might be used to arrive at a measure of fiscal capacity is state-level Value-added tax (VAT) collections data, which are more recent and may be more reliable. Table 3.4 compares the two measures of state fiscal capacity. The correlation between these two measures of fiscal capacity is 0.41, suggesting that there are substantial differences in the variation between the two measures.¹ Although we have strong reservations about using either measure, given the apparent sampling and reporting problems for household income, we give more credence to VAT collections as a measure of fiscal capacity.

Variations in economic conditions do not only affect a state's ability to collect revenues, but variations in regional economic conditions also cause different states to have different "fiscal needs." For instance, states with a higher number of children will have to spend more on education, and states with greater poverty will have to spend more on poverty alleviation measures. When all else is held equal, states with higher fiscal needs will have fewer resources to funnel towards discretionary projects such as capital development. Of course, an important issue is the measurement of fiscal needs. It should be noted that many of the variables used to measure fiscal need have the same statistical problems as the measures of fiscal capacity. Table 3.5 reports a number of measures of regional variations in fiscal need: population, population density, poverty, unemployment, and primary and secondary school enrollment (expressed per 1000 residents).

Own source revenue potential. We noted earlier that there are substantial variations in IGR collection between states. In order to further analyze these variations, we use a technique known as regression analysis. Regression analysis is a statistical technique used to analyze how variations in certain variables (or explanatory variables) relate to variations in another variable (or the dependent variable).

Table 3.6 contains regression equations for a number of fiscal variables, based on fiscal data for all 36 states (excluding the FCT Abuja). The regressions in the Table 3.6 seek to explain the variation in per capita IGR between states, as well as variations in fiscal effort between states. Fiscal effort can be defined as the degree to which a government utilizes the revenue

¹ A similar comparison between several different fiscal capacity measures for the Russian Federation resulted in significantly higher correlation coefficients, between 0.64 and 0.92 (Boex and Martinez-Vazquez 1997).

bases available to it to collect internally generated revenues. As such, the level of fiscal effort is affected by the level of the tax rates applied (if subnational governments have discretion over rates), by the level of exemptions granted (again if subnational governments have discretion over the structure of the tax), and by the tax enforcement effort exerted by the tax administration authorities. The level of fiscal effort is typically measured as the ratio of the actual amount of revenues collected to some measure of fiscal capacity.² The explanatory variables that are used in the regressions include fiscal capacity (as measured by per capita VAT collections in each state), and a number of measures of fiscal need, including the poverty rate, secondary school enrollment (SEE; per 1000 residents), and population density.

The first regression presented in Table 3.6 examines the factors that cause variations in per capita IGR collections between states. We expect that states with higher fiscal capacity collect more internal revenue. In addition, we expect that states with a higher fiscal need or a higher demand for state government services would also collect more own source revenue.

These expectations generally are confirmed. The regression results for per capita IGR collections suggest that every 1 Naira increase in fiscal capacity (as proxied by VAT collections in a state) increases internal revenue collections per person by N 0.82. Whether IGR collections increase in response to higher fiscal needs is more ambiguous. A state's poverty rate can function both as a measure of fiscal capacity (e.g., the poorer a state's population the less able it is to generate revenues) or a measure of fiscal need (e.g., the poorer a state's population the greater are the demands on the state for poverty alleviation and other government services). The regression results suggest that states in Nigeria with higher poverty levels collect fewer own source revenues. Additionally, states with higher demand for public education (as measured by secondary school enrollment) have statistically significant higher own source revenues. Rural states, or states with a lower population density, typically also have higher internally generated revenues.

This regression does an adequate job in explaining the variation in per capita IGR, with 76 percent of the variation in the dependent variable explained by the explanatory variables. All parameter estimates are statistically significant at the five percent level or better.

The second regression equation in Table 3.6 examines the determinants of fiscal effort. A priori, it is impossible to determine the effect of fiscal capacity on fiscal effort: wealthier states could either exert lower fiscal effort because it is easier for them to collect a certain level of revenue, or they could exert higher fiscal effort because wealthier residents might have disproportionately higher demands for government services. The regression results indicate that the former effect dominates because fiscal effort falls with greater per capita

² Throughout our study, we define fiscal effort as the ratio of a state's internally generated revenues to the level of VAT collections in a state. All concerns that relate to using VAT collections as a measure of fiscal capacity also apply to this measure of fiscal effort.

income. Although we expect that fiscally needier states would exert a higher level of fiscal effort, there is no statistically significant impact of fiscal needs measures on fiscal effort, other than that more densely populated states appear to exert a higher level of fiscal effort.

Local government revenues. Fiscal data on local government areas (LGAs) in Nigeria is dated, incomplete, and inconsistent. These problems make it difficult for us to conduct the same kind of analysis at the local government level as we did for the state governments. Nevertheless, some information is available that is helpful in our analysis.

Table 3.7 presents some information on the aggregate revenues and expenditures of all LGAs in Nigeria. In the aggregate, LGAs depend almost entirely on central government transfers, especially the Federation Account and the VAT pool, for their revenues. These statutory federal transfers generally account for roughly 90 percent of total current revenue. Internal revenue of LGAs averages only 7 percent of current revenue, and local government borrowing is virtually nonexistent.³

What are the reasons for poor local government revenue performance? Evidence suggests that the most important reason for the low level of local revenue collections is that the revenue potential of the revenues sources assigned to local governments is quite limited. The minor fees and levies assigned to the local level are simply sources that do not raise a lot of revenue, while local governments lack a major tax such as a local sales tax, income tax, or property tax with significant revenue-raising potential. In addition, it is apparent that the administrative capabilities of local government officials are extremely limited. The skills of local tax personnel are quite limited, their numbers are insufficient, computerization is seldom used, and corruption is likely to play some role. Given these administrative weaknesses, and in combination with the limited potential of the revenue sources, the likelihood that existing revenue sources can be quickly turned into more productive sources is virtually nonexistent.

Some general principles of revenue assignment to local governments. In order to provide some basis for policy recommendations that stem from our analysis, it is useful to discuss in some detail the major types of taxes that are used by local governments around the world. Although there is much diversity in country experiences, the property tax is a common and important tax for local governments in many countries, a practice that is not followed in Nigeria.

Of course, we are cognizant that many property-tax-like revenues currently flow to the state

³ These data, as well as those in Table 3.7, come a survey of LGAs conducted annually by the Central Bank of Nigeria. It should be noted that this information is often quite different than information on LGAs reported in official statistics compiled by the Federal Office of Statistics and published in its *Annual Abstract of Statistics*.

level in Nigeria, and that from a political point of view it is understandable that the state would prefer to maintain control over these resources. However, from an economic point of view, there are a number of reasons why it might be preferable to assign the responsibility for, and revenue from, the property tax (or similar sources such as development levies, and so on) to the local government level. The same is true for some other revenue sources that in Nigeria are assigned to the state level but which are typically assigned to the local government level in other countries.

The property tax is in many ways an attractive local revenue source. If measured properly, its base should increase with urban growth. Because property can be assessed by physical inspection by local governments, the tax is difficult to evade. (The physical proximity of local government also makes the property tax a more logical choice for local governments as opposed to state government). There is much evidence that the tax has at least a proportional and often a progressive effect upon the distribution of income. The tax is unlikely to create serious distortions in land markets, and may in some circumstances actually improve the efficiency of resource use. Finally, it is sometimes argued that the property tax is most appropriately administered at the local government level because officials there have a better motivation to collect the tax and because the tax can be viewed in part as payment for local services.

However, there are also major difficulties with the property tax. The revenue potential of the property tax is seldom realized, due largely to significant administrative problems in identifying properties, valuing them, adjusting valuation over time, collecting revenues, and enforcing penalties. A particular problem is valuation. Property transactions do not occur at regular intervals, which makes it necessary to impose the tax on some estimate of each property's value, and also makes it necessary to use some method to adjust this value over time for changes in prices. Unfortunately, there are few good procedures for such valuation. Experience also demonstrates that it is especially difficult to generate major amounts of additional new revenues from the property tax via short term reforms. The property tax is also often rated by individuals in polls as among the least popular of all taxes. It is a highly visible tax to taxpayers, since the tax is typically paid directly by taxpayers rather than by the employer (as with source-withholding of individual income taxes) or by the firm (as with firm payment of sales and excise taxes). Administration of the tax in many developing countries is highly arbitrary and idiosyncratic, especially in the procedures used to determine the value of properties; when the procedures used to generate this assessed value are performed incompetently, even corruptly, individuals rightly perceive the tax as unfair.

The tax base of the property tax is typically distributed across local governments in uneven ways, thereby sometimes contributing to extreme fiscal disparities across jurisdictions. Perhaps as a result, the property tax is often seen by individuals as a regressive tax, one in which greater burdens are imposed on lower-income households compared to higher-income households. All of these issues are well-known, but this recognition has done little to improve the administration of the tax, even in wealthy countries. As noted by Netzer (1966) in the context of the United States, “[n]o major fiscal institution has been criticized so much

and with such vigor; yet no major fiscal institution has changed so little.”

Many local governments impose taxes on automobile ownership and use, such as an annual license tax, a registration fee, a transfer tax, a fuel tax, a parking fee, and tolls. Automotive taxes are a useful source of revenues for local governments. Because car ownership is concentrated in upper income classes, automotive taxes are likely to increase the progressivity of local government finances. Revenues are likely to grow steadily with urban growth. The taxes can be administered at relatively low cost. They can be used to finance road construction and maintenance and to decrease congestion and pollution in urban areas. However, with a few exceptions, these taxes are an underused source of revenue.

There are several indirect taxes that are potential revenue sources for local governments (McLure, 1996). Local governments often impose a range of specific excise taxes, sometimes called sumptuary taxes, on commodities like beer, liquor, and tobacco. These taxes generate substantial revenues, they are easy to collect, and they may well discourage consumption of harmful or "immoral" commodities (or "sin taxes"). However, such taxes are also unlikely to grow much over time, they are highly regressive, they may not discourage consumption if consumers are unresponsive to price changes, and their use is clouded by the possibility of individuals buying commodities (or smuggling them from) outside the boundaries of the taxing jurisdiction. It is possible that local governments could obtain some revenues from, say, a piggy-back on the state income tax, or a purely local broad-based tax. However, these arrangements require that the central government should be willing to share the tax base and be willing to allow local governments (some) discretion over tax rates.

Some other indirect taxes are not suitable candidates for local government use. These include import duties, manufacturing sales taxes, value-added taxes, and other broad-based sales taxes. These taxes are typically reserved for use by higher levels of government. The administration of a value-added tax by local governments is particularly complicated and should not be seriously considered, given the usual methods of calculation.

Local governments use numerous miscellaneous taxes and fees, which in some cases may be quite important in their finances. For example, many governments impose taxes on various forms of entertainment (e. g., restaurants, hotels, movies, and gambling). Local governments also employ a wide variety of "nuisance" taxes. These include stamp duties, license fees, and various minor taxes on advertisements, construction activities, nonmotorized vehicles, and the like. These taxes do not rate highly in revenue performance, administrative ease, and efficiency and distributional effects. They also are seldom an important source of revenues. However, they are likely to continue to be used.

Few local governments around the world impose an income tax, at least one administered entirely by the local government itself. An income tax is difficult to administer at the local level, and the national government is seldom willing to share the income tax base with local governments. Given the potential mobility of individuals and firms, the imposition of a local

income tax would likely generate significant distortions in resource use. Also, given the predominant use of income taxes for stabilization ends, these taxes should be reserved primarily for central government use. However, it is not uncommon for local governments to impose a surtax, or an additional local government tax, on a national government income tax. There are a number of reasons for caution in the use of a local government income surtax, sometimes called a "piggyback tax." A local income surtax could generate distortions in resource use, as individuals move to avoid paying the tax and as cities "compete" with one another by changing the tax rate. A local piggyback income tax could also complicate the use of income taxes for stabilization purposes. The fiscal capacity of a local income surtax will differ greatly across localities. In Nigeria, the state governments may be unwilling to share an income tax base with local governments, especially if (as should happen) the higher level government has to lower its tax rates to allow local governments to piggyback without an overall increase in the tax burden.

Still, there are some clear advantages to local surtaxes. The central government administers the tax, thereby avoiding unnecessary duplication of administrative efforts. The central government also retains the authority to define the tax base, which reduces locational distortions from mobile factors and which also reduces interferences of local governments in national stabilization policies, even if these coordination problems are not eliminated. Importantly, local governments are given some discretion in choosing tax rates, within some lower and upper bounds, and this choice enhances their ability to make effective fiscal decisions. Some of these same goals can also be achieved by tax sharing among governments, although tax sharing does not typically give local governments any real authority in the selection of local tax rates. Surcharges have been increasingly recommended as part of decentralization efforts elsewhere, especially in transition countries where it is necessary to find some quick way to give cities a significant fiscal capacity.

In any event, few of these revenue sources are actually assigned to local governments in Nigeria (see Table 2.3). The revenue sources that are assigned to local governments are almost entirely unproductive ones, with little potential for significant increases in collections. In addition, local government discretion on bases and rates of these sources is quite limited. These considerations suggest that new and additional revenue sources for local governments need to be considered.

At the same time, states should be mindful that increases in taxing authority for local governments will raise the tax burden of the state's residents and would only be viable if residents would receive a corresponding increase in benefits from local governments services. Allowing local governments to tax too much could hinder business enterprise, result in a disincentive for business to locate in a state, and reduce tax compliance with both local and state taxes.

Assessment of Nigeria's revenue assignments. The assignment of revenue sources between the different levels of government only partially conforms with the principles of sound

revenue assignment. The overall assessment is a mix of positive features, as well as a number of negative points:

- The assignment to the federal level of a number of important tax revenue sources such as the corporate income tax is appropriate, as states would be unable to efficiently administer these taxes.
- Revenue sharing of part of the petroleum revenues with the states has resulted in large fiscal disparities between the few oil-producing states and the remainder of the country.
- It is administratively difficult to share part of the VAT on a derivation basis with the states. As Nigeria's economy develops and the number of multi-state firms increases, this arrangement will become increasingly distortionary and harder to enforce.
- The assignment of personal income taxes (pay-as-you-earn and self-assessment taxes) to the state level provides states with a potentially significant revenue source. Personal income taxes further provide a good revenue source for state governments because there exists a correspondence between household incomes, income tax collections and the demand for public services by households at the state level. However, the absence of state control over the marginal income tax rates (within federally determined boundaries) greatly limits the fiscal discretion of state governments. In addition, the assignment of personal income taxes on military and police personnel to the federal level is an unnecessary complication of the tax system and muddles the overall tax assignment.
- Road taxes and vehicles registration fees provide a potentially buoyant revenue source to the subnational level.
- Overall, the amount of own source revenue potential of state governments is typically only about 10-20 percent of a state's budget expenditures. This lack of revenue autonomy is further aggravated by the absence of state discretion over the rates of subnational taxes.
- The own source revenues assigned to the local level offer local governments little or no revenue-raising capability. The local government areas are not assigned any revenue source with revenue-raising potential, such as a local sales tax or a local property tax. Instead, property taxes (development levies, business premises registration fees and right of occupancy fees) are oddly assigned to the state level.
- While the constitution gives state governments the power to legislate local government taxes, the constitution gives the federal government the power to regulate state taxes. Under current federal legislation, states are not given discretion to determine either the tax base or the tax rate for any own revenue sources. This provision means that state governments have no control over the size of their own revenues, and thus no control over the size of their own budgets (other than through tax enforcement). Thus, even if voters in a state would prefer a higher level of public service and are willing to pay for this through higher taxes, the state would be unable to generate additional revenues. This lack of revenue autonomy unnecessarily limits the fiscal policy options of state governments. It should be noted that, while the constitution gives the federal government the power to regulate taxation, it does not prohibit the federal government from giving states a certain level of discretion over

fiscal policies. For instance, the federal government could allow (within some limits) each state to determine its own personal income tax rates. Such a minor change in federal fiscal regulation could substantially increase revenue autonomy at the state level.

Tax administration issues. Since states lack any discretion over state tax rates, the effectiveness of state tax policy is determined exclusive by the manner in which states administer their taxes, thereby making tax administration an important topic in intergovernmental fiscal relations in Nigeria. Our experiences and meetings with tax officials from one of Nigeria's states, Anambra State, may be illustrative in discussing the tax administration challenges faced at the state-level in Nigeria:

- State revenue collections data appear not to be publicly available. We had difficulty obtaining recent data for actual revenue collections, putting into doubt the public availability of this data. During the military era the reporting apparatus was aimed upwards, or toward the federal regime. However, in a democratic society fiscal data such as tax collections should be made publicly available as soon as possible to the public at large and their elected representatives in state legislatures. Increased transparency, in part through systematic reporting of IGR collections, is an important part of effective and transparent state government.
- There is some concern that collection of state revenues may be too fragmented. Most of Anambra State's internally generated revenue sources are collected by the State Board of Internal Revenue, which contracts out part of the collection activities to private tax collection firms. Other ministries and state agencies also collect miscellaneous revenues such as user fees. While user fees may be collected by the government agency that provides the service, all other taxes, levies, and rates should be collected by a single tax administration office. This procedure would improve the efficiency and effectiveness of collection, allow for the cross-referencing of tax databases, reduce the opportunity for evasion, and reduce the cost for taxpayers in complying with their fiscal responsibilities. Lowering compliance costs, through streamlining of the tax system and administrative requirements, would likely lead to increased compliance.
- Anambra State's tax administration apparatus seems to be poorly equipped for the task of collecting IGR. For instance, there is no computerized information system to track collections. It also appears that the primary source for the master list of taxpayers in Anambra State is the federal VAT office. The absence of a state taxpayer data base and the lack of a significant state enforcement mechanism make it virtually impossible for Anambra State to collect revenues from individuals or firms who evade federal taxes.
- Anambra State's Board of Internal Revenue appears to be improperly staffed for the purpose at hand. While the Board has 600 employees, it was reported that this number only includes 21 certified tax inspectors. International experience indicates that the number of tax inspectors appears grossly insufficient for a state with 3.5 million

residents. It was felt that the Board's inability to attract qualified personnel was the main cause of the low number of inspectors, both in absolute amount and relative to the Board's total staff. Reorganization of the structure and staffing of the Board appears to be an important first step to improve IGR collections.

- Improvements in tax administration and enforcement are expected to result in significant revenue gains, especially in the improved collection of the self-assessment tax. While increasing spending on tax enforcement is typically political unpopular, the measure should be seen as an investment: if implemented properly, improvements in tax administration and enforcement will increase revenue collections by more than the cost of collection.
- The level of voluntary tax compliance at the state level appears quite low. Tax compliance could be improved by the standard policies of increasing penalties and audit rates. Compliance could also be improved by advertising and promoting the need to pay taxes and by informing the public about the good works that are being funded with taxpayer monies. Also, increasing the visibility of tax compliance may increase compliance with applicable tax laws and reduce corruption. For instance, requirements to post a business license in a clearly visible public place will facilitate collections and enforcement, as well as exert social pressure on individuals and business to comply.
- While firms in Anambra State can be identified by their federal VAT registration number, individuals in Nigeria lack a federal taxpayer identification number. The federal government has little incentive to introduce such a system, since personal income tax collections flow to the state level. However, such an identification system, implemented either at the federal level or by individual states, could substantially facilitate the collection of personal income taxes, especially if the administration of the personal income tax is computerized.

3. INTERGOVERNMENTAL FISCAL TRANSFERS

The transfer of resources between different levels of government is an important issue in intergovernmental relations, and represents a major source of finance for many state and local governments in developed and developing countries. As highlighted in the previous section, this is especially true in Nigeria where 80-90 percent of all subnational revenues is derived from intergovernmental transfers.

There are a number of economic justifications for intergovernmental transfers. Transfers can be used to encourage or stimulate specific local government activities, to equalize the fiscal conditions of state and local jurisdictions, and to finance activities that generate spillovers to nearby jurisdictions. Of course, the proper design of intergovernmental transfers depends upon whose perspective is taken and upon what criterion is selected. The state or local

government wishes to maintain control over its own finances, to be able to plan its budget in a timely way with a minimum of uncertainty, and to be assured of an elastic revenue source. The central government generally wishes to achieve such goals as maintaining control over state and local government finances, stimulating specific expenditures, equalizing service levels or fiscal capacities across jurisdictions, and increasing the fiscal effort exerted by state and local government.

Unfortunately, no single grant can achieve all these goals, and different grant types each have advantages and disadvantages. The provision of an adequate level of revenue is best achieved by determining the grant pool on the basis of an income-elastic revenue source. State and local fiscal planning is best ensured by the use of pure shared taxes or shared taxes with a formula distribution because these grants give the most certainty to governments in their budgeting process. State and local fiscal autonomy is affected least by a pure shared tax; general purpose grants also provide significant government discretion, while cost reimbursement grants limit governmental choices more than other forms of grants. Partial cost reimbursement grants appear best able to promote government accountability.

Federal allocations: the Federation Account and VAT. The Federation Account and revenue sharing from the VAT are the dominant methods of resource sharing in Nigeria's public sector. As mentioned in the previous section, essentially all federal revenue sources (with some minor exceptions) accrue to the Federation Account at the Central Bank of Nigeria, which is then shared among all levels of government using a formula-based approach. Since states have no control over either the tax base or the tax rate of the federal allocations, these revenues should properly be considered intergovernmental transfers as opposed to own source revenues for subnational governments.

Distribution of the Federation Account among the different governments is based on a vertical allocation formula that assigns a specific share of the account to each level of government as well as horizontal allocation formulas that distribute both the state share of the Federation Account among the states and the local government share among the local governments. Both the horizontal and vertical allocation formulas are discussed in greater detail later. Although the formulas have periodically changed over the years, this conceptual approach to revenue sharing has changed little since its inception in colonial times.

Vertical fiscal balance. The historical and current distributions of the Federation Account and the VAT pool are shown in Table 4.1. Currently, states receive 24 percent of the Federation Account and 50 percent of VAT revenues. However, many state governors and politicians claim that insufficient revenues from the Federation Account flow to the state level, and have openly advocated increasing the states' share in the distribution of fiscal resources between the different levels of government.

The distribution of public resources between different levels of government is referred to by economists as "vertical fiscal balance." While vertical fiscal balance is a thorny political issue that is widely debated based largely on anecdotal evidence, the guiding principle used

by economists is whether “financing follows function”; that is, does the distribution of resources reflect the expenditure responsibilities of each level of government? This question is very difficult to resolve. However, there are several ways to detect the presence of vertical fiscal imbalances:

- Revenue Trends. First, we can examine the distribution of fiscal resources between the different levels of government over time. Table 4.2 shows trends in revenues, expenditures, and budgetary deficits (surpluses) expressed as a percent of GDP for the federal government, consolidated state governments, and consolidated local governments for the period 1995 to 1999. When we look at the revenue trend for state and local governments, the resources available to state and local governments as a group have been steadily increasing since 1996. In 1996 states generated 3.3 percent of GDP in state revenue (or federal allocations plus IGR); by 1999 this had increased to 5.7 percent. Similarly, local government resources have increased from 0.9 percent of GDP in 1996 to 1.9 percent in 1999. Federal revenues reflect a much more unstable picture. Federally retained revenues have generally fluctuated between 13 and 15 percent of GDP, but spiked in 1999 at 22.3 percent. These numbers provide little direct evidence that there exists a large vertical fiscal imbalance in Nigeria. This conclusion is reinforced by the expenditure patterns in Table 4.2 (as well as in Table 2.2, which provides a longer term view of expenditure trends). With the exception of the period 1981 to 1984, federal expenditures have fluctuated around 70 percent of total government sector expenditures.⁴
- Fiscal Balance. A second indicator of vertical fiscal balance is the budget balance of each level of government. The relative budgetary position of each level of government would be a reflection of vertical fiscal imbalances if each government is equally efficient in allocating its resources to achieve its responsibilities and there are no institutional constraints on governments at each level to incur budget deficits. If these assumptions hold, as they seem likely to at least at the federal level, then we would have to conclude that Nigeria’s federal government has disproportionately few resources because it systematically incurs budget deficits. However, the absence of fiscal deficits at the subnational level is not a reflection of the fiscal affluence of subnational governments. Instead, the absence of subnational budget deficits is mainly a reflection of the requirement that subnational governments in Nigeria need to balance their budgets. Therefore, comparing the fiscal surplus or deficit of each level of government in Nigeria does not provide us with a valid measure of vertical fiscal balance.
- Proportion of Capital Expenditures. Along the same vein, a third approach to assess

⁴ We note that federal expenditures spiked in 1999 (especially due to a large increase in recurrent expenditures), causing federal expenditures to account for 81.2 percent of public sector spending in 1999.

the presence of vertical fiscal imbalances would be to look at the relative spending on capital expenditures at each level of government. Due to the structure of the budget and the budget process in Nigeria (discussed in greater detail later in this overview), governments at all levels of government in Nigeria first allocate resources towards recurrent expenditures items, and then use any recurrent budget surplus for the purpose of funding capital expenditures. The share of the budget spent on capital expenditures could thus be a measure of fiscal pressure.⁵ By this measure, the fiscal structure would indeed be biased in favor of the federal government: the federal government spends between half and two-thirds of its resources on capital expenditures, compared to only roughly one-third of expenditures for state and local governments.

In summary, there is no consistent economic evidence to support the political argument that there exist major vertical fiscal imbalances in Nigeria. Still, it would be appropriate to explore at a political level whether the expenditure of almost half of the federal budget on capital projects is an efficient allocation of public resources. An additional point that states may wish to raise is their lack of revenue autonomy. For instance, instead of asking for an increased share of the Federation Account and VAT revenues, we believe that subnational governments might fruitfully seek increased revenue autonomy by demanding increasing discretion over the tax rates of certain federally regulated taxes. For instance, states could be allowed to increase income tax rates within certain limits, instead of relying mainly on hand-outs from the federal government. This would force state governments to make the difficult trade-offs between increasing public spending and increasing the tax burden.

Stability of vertical allocation. It should be noted that the use of Federal Allocations (i.e., the Federation Account and the VAT sharing) as the dominant funding mechanism for subnational governments does not provide a very stable source of funding for subnational governments over time. The federal allocations fluctuate greatly over time depending on the price of oil on international markets. Yet, state and local governments have a need for a stable revenue stream because they provide many of the most basic public services, such as primary education and primary health care. For this purpose, a “Stabilization Account” exists in order to stabilize revenue streams over time. However, this Stabilization Account does not appear to be achieving its objective. Payments into, and withdrawals from, the Stabilization Account are ad hoc and politically motivated. For instance, whereas payments should be made into the Stabilization Account during times of high oil prices, the *National Revenue Mobilization Allocation and Fiscal Commission* was discussing making withdrawals from the Stabilization Account in October 2000 during record oil prices on the international markets.

⁵ Of course, the proportion of the budget spent of capital items might also vary between levels of government due to differences in the expenditure responsibilities of each level of government.

In order to achieve a system of revenue sharing that provides a more stable stream of resources for subnational governments, the funding scheme for the Federation Account could be altered in several ways. For instance, one possibility to ensure increased stability would be to determine the subnational share from the Federation Account as a nominal amount or as a percent of GDP, as opposed to a specifying the state and local shares as percent of revenue collections. However, this arrangement would mean that any decline in Federation Account revenues would have to be fully absorbed by the federal government, while completely shielding state and local government from fluctuations in resources; that is, the tradeoff for assuring increased fiscal stability at the subnational level would be increased fiscal instability at the federal level.

Other arrangements to increase fiscal stability for state and local governments might be more acceptable. For instance, the mechanism of federal allocations could be modified so that subnational governments would rely less on oil revenues, which presumably are more variable than other revenue sources. Subnational governments could be assigned a higher share of VAT revenues (presumably a more stable revenue source) but a smaller share of oil proceeds. Alternatively, the revenue sharing formulas for subnational governments could be legislatively fixed for a multi-year period, thus providing greater fiscal stability for state and local governments.

Horizontal fiscal balance. While the vertical allocation of public sector resources has drawn most of the political attention in Nigeria, there are many problems with the horizontal distribution of the funds, or the distribution of federal allocation between states and between local governments. This issue relates to the “horizontal fiscal balance” in Nigeria.

We once again turn to regression analysis to better understand how resources are allocated using the Federation Account and the VAT sharing mechanism. The first regression in Table 4.3 examines the causes of variations in per capita federal allocations to state governments. Based on the factors that are included in the distribution formula (discussed below and contained in Table 4.4), the allocation mechanism in Nigeria seems to be designed to do four things: allocate a portion of revenues on a derivation basis, particularly for oil revenues and VAT collections; provide general purpose funding; provide additional funding for needier regions; and stimulate fiscal effort. It is noteworthy, and surprising, that a common objective in many grant formulas is missing here, namely equalizing fiscal capacity.

Initially, we sought to explain variation in federal allocations between states using the same explanatory variables as in the first set of equations in Table 3.6, notably measures of fiscal capacity and fiscal need. However, these measures of fiscal capacity and fiscal need only explained 4 percent of variations in per capita federal allocations, and none of the variables had a statistically significant impact. Consequently, we modified the regression equation in one important way: since a large share of the Federation Account and VAT collections are shared based on “equality” (i.e., each state gets an equal share, or 1/36 of the pool), it is likely that when we consider per capita allocations smaller states will receive higher per capita federal allocations. Accordingly, in the second regression we added population as an

explanatory variable.

We should note three things about this second equation (see Table 4.3). First, the inclusion of population in the regression equation improves the ability of the regression to explain per capita federal allocations, from 4 percent in the first equation to 63 percent in this equation. Second, as expected, population has a strong negative impact on per capita federal allocations. For every one million increase in population, the per capita transfer decreases by almost N 300. Third, the regression results indicate that higher income states actually receive greater federal allocations. Put differently, federal allocations appear to be counter-equalizing, and as a whole they favor wealthier states. This result largely reflects the fact that a portion of the Federation Account and VAT collections are allocated on a derivation basis.

We also added fiscal effort as an explanatory variable to the equation explaining federal allocations. This equation is not reported, but it indicates that fiscal effort does not have a statistically significant impact on federal allocations. In fact, the parameter estimate on fiscal effort was negative (although not statistically significant), suggesting that states with greater fiscal effort receive fewer federal allocations.⁶

Issues with the state distribution formula. There are a number of serious policy concerns related to each of the five components of the state distribution formula for the Federation Account. While not explicitly highlighted here, many of the same issues also impair the VAT distribution formula and the distribution formula for local governments.

Equality. The largest share (40 percent) of the Federation Account fund is distributed among the states based on “equality,” meaning that each of the states receives an equal share (1/36) of this portion of the Federation Account regardless of the state’s population size. The implicit rationale for using equality as an allocation factor is that both large and small states alike need to support a Governor, a set of state ministries, and a state bureaucracy. The logical implication is that states with a smaller population receive a larger amount of federal funding when considered on a per capita basis.

Using equality in the distribution formula raises great concerns about incentives, efficiency, and fairness of the allocation. These concerns are magnified by the fact that nearly half (40 percent) of the Federation Account is allocated according to this factor. The importance of the equality factor was confirmed in the regression in Table 4.3. This regression showed that a state’s population explains the major share of the variation in per capita federal allocations, confirming the hypothesis that less populated states receive higher per capita federal

⁶ This result would not be surprising in light of the results of the second equation in Table 3.6, which suggests that wealthy states exert lower fiscal effort. This simply reinforces the result that poorer states and those with higher fiscal effort receive lower federal allocations.

allocations than more populated states.

The use of equality as a dominant factor in the allocation formula raises a question of basic fairness. Other things equal, it is often argued that equity is generally served best by distributing resources more or less equally in per capita terms. After all, the citizen, through his or her state government, is the ultimate recipient of the federal transfers. Is it fair that 40 percent of federal allocation are split equally between the states, despite vast difference in population size? Consider, for example, Lagos State and Yobe State. Lagos State has a population of over 7 million, while Yobe State has a population of less than 2 million. Based on the current allocation approach using the equality factor, Yobe State receives an amount per resident that is four times larger than Lagos State. Also, while scale economies are likely to be present in the delivery of public services, there is a complete absence of proportionality between the possible scale economies and the equalization; that is, it is highly unlikely that it costs four times as much, or even twice as much, to provide public services in Yobe than in Lagos.

The use of equality in the allocation formula also gives states a major fiscal incentive to split into two (or more) states, and thereby doubling the grant allocation from the federal allocation. In this light, it is hardly surprising that the number of states in Nigeria has increased from 4 in 1960 to 36 in 2000. This fragmentation of the federal structure causes substantial duplication at the state level. Each new state is forced to allocate a substantial level of resources towards duplicating a full-fledged state government apparatus.

The heavy reliance on the equality principle in the distribution formula causes substantial efficiency losses by holding states harmless from the effect of scale economies. For instance, recent and ongoing expenditures of new states include not only the construction and operation of new state government administrative facilities, but also state-funded television stations and other arguably non-essential facilities. In the absence of the equality-based funds, smaller states would likely pursue cost-saving measures to deal with these scale economies, such as inter-state cooperation in the delivery of certain services. From an economic point of view, the fragmentation and duplication that is promoted by the use of the equality principle drain resources away from higher-priority public needs, such as education, health care, transport, and poverty alleviation. If the ongoing trend of fragmentation continues, the use of the equality principle would continue to allow a single state (with federal government blessing) to substantially increase the fiscal allocations to its populace by splitting up, at the expense of all other states.

It is also important to recognize that we are only addressing the economic issues raised by the formula, and we are ignoring any possible political motives for the prominent inclusion of the equality principle in the distribution formula. For instance, by reducing the likelihood of large and politically strong state governors, fragmentation of state governments might be important to the overall (political) stability of the Nigerian federal system. Fragmentation might also be beneficial to federal dominance over the states. Further, the appeasement of less populated, rural states, or particular ethnic or religious regions of the country might play

an important political role in the rationale for using the equality principle in Nigeria's federal system. Fragmentation may also allow a state that has a highly heterogeneous population to split into more homogeneous states, thereby reducing the threat of civil disorder. Federal allocations distributed based on equality may simply provide a fiscal incentive to achieve such political objectives.

Population. Population is both an appropriate and a commonly used factor in general allocation funding formulas around the world. However, it is important to assure that accurate and timely data are available for the variables used in the allocation formula.

We believe that there are significant problems with the statistical techniques used to produce population estimates, problems that could result in considerable bias. The most recent census in Nigeria was held in 1991, providing a count of the country's population by state and local government area. Population estimates for subsequent years are computed by multiplying each state and local government's 1991 population count by the national average population growth rate of 2.83 percent per annum. This estimation approach is mandated by federal statistical authorities, and state and local officials are constitutionally prohibited from modifying these estimates.

However, it is highly unlikely that all state and local governments grow at the national average growth rate. Migration from rural to urban areas causes urban growth rates to be higher than rural population growth. Similarly, there are likely to be differences in population growth rates due to differences in demographic, ethnic, religious, social, and economic characteristics. Failure to account for differences in growth rates will introduce significant biases in the allocation of public resources. For instance, urban regions are likely underfunded via intergovernmental transfers as a result of the poor estimation approach, and estimates of other variables specified in per capita terms are biased by inadequate population estimates. The biases introduced due to this inadequate estimation approach possibly take on significant proportions because the estimated growth rate is compounded.

Land Mass and Terrain. The reliance on land mass and terrain is common in transfer formulas in many countries. Geographically larger states could successfully argue that large states typically have higher expenditure need, as it is more costly to deliver government services across a larger land area. While it might be true at face value, it is not altogether clear whether this approach is valid in Nigeria, as land area and terrain may not be good proxy measures of variations in the cost or need of public services. For example, representatives from urbanized states and localities might similarly argue that the cost of delivering public services could also be higher in highly densely populated areas such as major urban areas. Rather than using land area and terrain as proxies, differences in price levels across states could easily be directly included in the horizontal distribution formula, either as a separate factor in the formula or by multiplying each state's revenue share by a cost index. This is a common practice in other countries.

Social development factors. There are a number of concerns with the way in which funds are

distributed based on social development factors in the horizontal allocation formulas. These concerns are mitigated somewhat by the fact that each sub-factor only contributes in a minor way to the overall distribution of resources.

First, there is a major concern about the use of physical infrastructure measures, such as hospital beds, in the allocation formula. The number of hospital beds in a state is arguably a very poor measure of the health needs of a state. Wealthier states, with more money to spend on health care, would likely have more hospital beds and thus receive more generous transfers, in spite of the fact that wealthier states typically have healthier populations. In addition, the use of hospital beds as a measure of health care needs provides a poor incentive to states. Instead of focusing on the quality of health care, the mechanism gives the State Minister of Finance a reason to press the State Ministry of Health to provide a larger number of hospital beds simply in order to increase transfers. In general, it is desirable to avoid using measures of physical capacity (e.g., the number of hospital beds, the number of schools) in a grant formula and instead to focus on measures of the number of clients or citizens with a certain need. A better measure of health care needs as distribution factors would be the reported incidence of medical conditions. For example, the incidence across states of HIV/AIDS and infant mortality are more suitable measures of state health care needs that are free from this incentive problem.⁷

Second, the use in the formula of the relative number of elementary and secondary school children as a measure of the state's need for educational services is also flawed. This variable is clearly an attempt to measure the need for education for school-aged children. However, the distribution formula implicitly recognizes its own limitation: while the presence of school children is a measure for the need of social development expenditures, the presence of school dropouts is also a social development concern. In an attempt to correct for this problem, the distribution formula also includes allocations based on the inverse of secondary and commercial school enrollments.⁸ Rather than including both enrollment and its own inverse, the allocation could be improved by using the potential client base for

⁷ In order to prevent similar equity problems, it is necessary to ensure that the reporting of such medical factors is done as evenly across states as possible; that is, one wants to prevent a situation in which poor states under-report infant mortality or HIV/AIDS because they lack the funds to detect or register these diseases.

⁸ It is not exactly clear to us how this inverse is computed, and we are concerned that the manner in which this inverse is calculated simply does not have the intended result of providing funding for states with higher dropout rates. The data suggest the possibility that the computation of inverse enrollment simply benefits states with small absolute numbers of students, thus failing to properly capture the number of non-enrolled students. It is also possible that the direct and inverse measures simply cancel each other out. However, without specific knowledge on how the inverse enrollment is computed, we cannot be certain about its impact.

schooling, which is the school-aged population. Using the school-aged population to distribute state funding would avoid the complications brought about by the use of enrollment.

Fiscal effort. One objective of Nigeria's distribution formula is the stimulation of fiscal effort. We earlier defined fiscal effort as the degree to which a state utilizes the revenue bases available to it, and is generally measured as the state's collection expressed relative to some measure of fiscal capacity. The idea here is that regions that try harder to raise revenues but are still unable to finance a certain level of public services may be more worthy of receiving grant money. On the other hand, simply rewarding regions that exert higher levels of fiscal effort could result in the use of federal resources on regional projects that lack any merit. Higher levels of fiscal effort in some regions may simply be the result of higher levels of demand for government goods and services in those regions. Even though a case can be made for encouragement of fiscal effort, the case is theoretically quite weak; there is no economic reason to give more federal moneys to regions that prefer to spend more of their gross incomes in the public sector rather than in the private sector. This being said, in countries where there is no tradition of revenue autonomy at the subnational level, as is the case of Nigeria, it may be justified to have temporary policies that encourage tax effort. However, in the long run, the best policy is to neither discourage nor encourage tax effort, and federal policies should be largely neutral with respect to the tax effort of subnational governments.

Even aside from any reservations about stimulating fiscal effort through the transfer mechanism, two problems exist with the manner in which internal revenue effort is stimulated in Nigeria.

First, three-quarters of the funds allocated under this heading are not at all designed to stimulate effort, but are simply allocated on an "equal shares" principle.

Second, the remaining funds are distributed based on the increase in internal revenue collections relative to the previous year. Thus, increases in fiscal effort are rewarded, rather than the overall level of fiscal effort. One disadvantage of this approach is that poor states need to consistently exert a higher level of fiscal effort to provide a standard set of government services, leaving them little to room to reap the benefit of this incentive by further increasing their fiscal effort. This mechanism also stimulates and rewards wealthier states that had previously low levels of fiscal effort for achieving an average level of fiscal effort. Further, by rewarding increases in fiscal effort, there is little incentive for maintaining a consistently high level of effort in the collection of internally generated revenues.

Equalization? One final concern about the workings of the distribution of federal allocation among states is that the mechanism does not include any avenue for the equalization of fiscal capacity between states. In fact, the federal allocations may be counter-equalizing by allocating oil-producing states 13 percent of oil revenues prior to applying the horizontal

allocation formula to the remainder of the funds;⁹ similarly, part of the VAT sharing takes place on a derivation basis. Consequently, wealthier states actually receive larger transfers through the federal allocations than poorer states. This finding should be of considerable concern to those who believe that it is the responsibility of the federal government to encourage poverty alleviation by redistributing fiscal resources across the national territory.

Ultimately, any funding scheme needs to be judged by a simple standard: does the allocation achieve its objective of funding state governments in an effective and equitable manner? We believe that a strong case can be made that the answer to this question is currently “no.” Most obviously, when considered on a per capita basis the distribution formula is clearly and overwhelmingly biased in favor of small states due to the heavy reliance on the “equal shares” principle. This problem is so overwhelming that the population size of a state is the most important determinant of per capita federal allocations in Nigeria, and not other potentially important factors like fiscal capacity, social development, fiscal need, or fiscal effort.

5. SUBNATIONAL BUDGETS, CAPITAL DEVELOPMENT AND BORROWING

This section –along with the two next sections- addresses the ability of state and local governments in Nigeria to effectively formulate and implement their own budgets, and how their budget practices and fiscal management systems help or hinder the optimal allocation of resources. As we argue here, the current techniques used by subnational governments significantly limit their ability to engage in sound fiscal policy. In particular, these techniques create a significant impediment to the proper use of resources for capital expenditures.

We say this for two main reasons. First, there are significant problems in the way in which (subnational) government budgets are formulated in Nigeria, preventing linkages to be established between the recurrent budget and the capital budget. Second, there are problems with the manner in which budget decisions, especially capital budget decisions, are implemented, leading to an inefficient use of resources. In combination, we believe that these problems result in an inefficient allocation of subnational government resources, and make it difficult for state and local governments to undertake any large capital infrastructure project. In light of the lack of discretion over state revenues, improvement of the budget process and fiscal management techniques becomes crucial to assure the best use of the state’s limited resources.

The structure of subnational government budgets in Nigeria. Public sector budgets in

⁹ It could be argued that the monies allocated on a derivation basis are in proportion to the additional infrastructure demands and pollution concerns caused by oil extraction.

Nigeria follow a highly structured format that is the same at all levels of government. The detailed budget plan in each budget document is preceded by a summary of both the recurrent budget (revenues and expenditures) and the capital budget. The recurrent budget is broken down by organizational classification and line item. The staff of each government organization is presented by job function and salary scale. The capital budget is broken down by functional classification and project. This structure offers a very transparent method of budget reporting. A typical budget summary statement is presented as Table 5.1.

A characteristic feature of the budget structure in Nigeria is the structural and persistent separation of the recurrent budget and the capital (or "development") budget. This separation appears to be founded in the wide-spread perception in Nigeria that an important role of the budget process is to stimulate capital expenditures. As a result, state governments systematically seek to minimize expenditures on recurrent items. Any surplus from the recurrent budget can then be transferred to the capital budget, thereby allowing any available resources to be fully allocated towards capital expenditures. In some cases, the separation of the recurrent and capital budgets extends to the planning and implementation of the budget. For instance, in Anambra State, the recurrent budget falls under the responsibilities of the Commissioner of Finance, while the development budget is prepared by the Commissioner of Planning and Economic Development.

Capital expenditures are broadly classified in four categories: Economic Sector, which includes capital spending on agriculture, fisheries, forestry, rural electrification, land transport, manufacturing, crafts, and other commercial activities; Social Development (or education, health, youth and sports, and other social development); Area Development (or water supply, sewer and drainage, housing and urban planning, and urban roads); and General Administration, which includes investment in government administrative buildings.

Table 5.2 compares the expenditure pattern of state governments in Nigeria. The average state in Nigeria spent N 1,722 per person in 1999, of which N 1,080 per person (or 62 percent of the state budget) was for recurrent expenditures while N 642 per person (38 percent) was spent on capital expenditures. We found earlier that the federal government spends about half (53 percent) of its resources on development expenditures (Table 4.2).

Some international comparisons. In order to determine whether Nigeria's spending on capital development projects is adequate, we compared capital spending in Nigeria to other countries in the region. Table 5.3.5 shows capital expenditures in some selected African countries, giving the percentage of central and subnational budgets spent on capital expenditures. Table 5.3 indicates that capital expenditures in the selected African nations range from about 5 percent of the total budget (e.g., local governments in South Africa and the Congo) to almost 31 percent (e.g., Zambia); the unweighted average level of capital expenditures of the selected countries equals 16.9 percent. Compared to these levels, the current proportion of national and state-level capital expenditures in Nigeria (at 53 and 38 percent, respectively) should clearly be considered extremely high.

This comparison raises two questions. First, why are capital expenditures in Nigeria considerably higher than in other African countries? Second, are these high levels of capital expenditures justified? It is of course impossible to answer these questions with absolute certainty. Nevertheless, we can still shed some light on these questions.

Consider the first question: why are (state-level) capital expenditures in Nigeria higher than in other African countries? Economic theory suggests that capital expenditures tend to be higher under a certain set of circumstances:

- When the absolute need for capital expenditures is relatively high (e.g., when virtually no infrastructure exists to begin with or after a natural disaster has destroyed existing capital);
- When capital development deteriorates quickly and needs to be systematically replaced (e.g., when roads consistently wash away);
- When the demand for capital expenditure goods is higher relative to recurrent expenditures, which might occur due to differences in preferences for the type of public goods consumed;
- When resources are disproportionately available for capital goods (e.g., when real interest rates are low);
- When significant amounts of development grants are funneled to capital projects by donor agencies or international financial institutions;
- When the demand for capital expenditures is artificially inflated, for example, due to biases in the budget process or to political considerations.

While recognizing that differences in resource constraints and in demand for public services across Africa are likely to exist, anecdotal evidence suggests that conditions in Nigeria are not sufficiently different from the surrounding countries that they would warrant the much higher relative levels of capital expenditures in Nigeria.¹⁰ Thus, the second question becomes relevant: are these high levels of capital expenditures justified? Put differently, are

¹⁰ The availability of substantial external revenue sources in Nigeria (such as oil revenues distributed through the Federation Account) might enable the Nigerian public sector to increase spending on capital projects. This availability might give Nigerian governments additional resources that are disproportionately used for capital investment projects. The external nature of the revenues, especially the fact that the burden of generating these revenues is not felt by local taxpayers and voters, might also reduce the accountability of public officials and politicians, who could allocate the funds toward capital projects for political or financial gain.

the high levels of capital expenditures optimal, or are state governments in Nigeria spending an inefficiently high share of their resources on capital expenditure items?

The answer to this question is that it depends on citizen attitudes toward the capital expenditures that are being funded. If capital funding is targeted on highly useful capital expenditure projects that are widely believed to be an efficient and effective use of public resources when compared to other (recurrent and capital) expenditure programs, then Nigeria's high level of capital expenditures may be justified. On the other hand, if it is widely felt that the capital projects funded are not a high priority and the money could be better spent on other expenditure items, then the high level of capital expenditure would be inefficiently high. Foremost, this is an issue that must be answered by the taxpayers, citizens, and voters.

However, there are certainly reasons why inefficiently high levels of capital expenditures might be sustained in spite of the inefficiencies in resource allocation that are created. There might be a mistaken belief that capital projects are more important to the economic development of the state than investment in human capital like education or other types of recurrent activities. Alternatively, capital expenditures might be too high because capital projects are highly visible, and it is politically expedient to promote these highly visible projects. A less benign but no doubt relevant view might be that capital projects allow a better opportunity for bureaucrats, politicians, or influential individuals to siphon off public resources for private gain, since large-scale capital projects allow greater opportunities for corruption.

The role of borrowing and on-lending in the subnational budget process. Recall that the major share of resources for subnational capital projects comes from the surplus of the recurrent budget. As discussed in greater detail later, it is essential to recognize that the recurrent budget surplus is directly spent to pay for capital projects as they are being constructed. This is a highly unusual - and undesirable - fiscal management practice. In principle, borrowing is a more appropriate way to finance capital expenditures.

Reality is different in Nigeria: there exist few if any avenues for borrowing for state and local governments. Banks, financial institutions, and individuals appear to be generally unwilling to lend money to state and local governments. There is no organized market for subnational bonds; the federal government does not have a mechanism for borrowing to subnational governments; and donor agencies or international financial institutions do not actively provide loans to the state government level in Nigeria (or, indeed, to subnational governments in most other countries). Another impediment to borrowing for capital investment purposes that was frequently mentioned was the high nominal interest rate of 15 to 20 percent.¹¹

¹¹ Nominal interest rates are high, but this should not necessarily discourage borrowing for capital investment purposes. It is the real interest rate, or the nominal interest rate less the inflation rate, that reflects the true cost of borrowing. However, the unstable

Historically, some loans from international agencies were passed on from the federal government level to the state government level in a process known as “on-lending”. Here, the federal government would “lend on” loans from international financial institutions and donors. Repayment of these loans was among the “first charges” from the Federation Account; that is, these loans would be repaid out of the Federation Account before the account would be distributed, so that in effect all states would bear the burden of one state’s capital project.

Under the previous military regime this practice was discontinued, and the repayment of existing loans was frozen. Further, a ban was imposed on external subnational borrowing by state and local governments, largely inhibiting states from engaging in effective infrastructure development using borrowed funds from external sources. However, the new civilian-led federal government is moving to lift this restriction. Once this policy is realized, state governments would have a potentially important fiscal tool to fund capital infrastructure development.

In the framework for renewed on-lending by the federal government (and the repayment of previously frozen loans), the Government of Nigeria is expected to move to a system where each state would be held accountable for its own portion of money lent on to the subnational level. In other words, instead of treating repayment of on-lent funds as a first charge, the cost of servicing debt would be broken down by state and subtracted from each individual state’s gross allocation of the Federation Account. This change would represent a major improvement in the fiscal management structure, and would potentially allow for substantial subnational borrowing. However, even this new mechanism would be unable to function properly unless the federal government makes loans available or unless donors and international financial institutions provide funds targeted for on-lending to the state level. Most states are probably not credit-worthy, and most also are unlikely to have the institutional knowledge to borrow substantially on international or domestic financial markets.

Shortcomings and improvements in the budget formulation process. The practice in Nigeria of separating the recurrent and capital budgets does not conform to best practices in budgeting and fiscal management. While this separation was considered an appropriate budgetary practices several decades ago, there is currently a wide-spread consensus among budget experts that there should not be such a separation between the recurrent and capital budgets, for several reasons:

- There is no reason to believe that capital expenditures are a priori more beneficial

economic environment, poor business climate and the mistrust of government to repay loans will undoubtedly continue to contribute to relatively high real interest rates in the foreseeable future for subnational governments in Nigeria.

than recurrent expenditures; that is, any premise that governments should attempt to maximize capital expenditures is false. The resulting reduction of the recurrent budget might result in too few resources being spent on recurrent budget items, such as combating HIV/AIDS through public awareness programs or educating secondary and university students. From a practical budgetary point of view, the current separation of the recurrent budget and the capital budget does not allow sectoral policy makers to make a direct trade-off between the benefit of spending one Naira on a recurrent budget item or spending one Naira on a capital investment project. As a result, policy makers are not able to properly prioritize expenditures.

- The structure of the budget makes it difficult to recognize and to internalize the implications of decisions in the capital budget for the recurrent budget. For instance, the building of a new university will result in the one-time capital expense of building the physical facilities for the university, but a new university will also require the outlay of resources for recurrent items on an annual basis, such as faculty, staff, maintenance, and other annual expenditures. If a capital investment project is conceived and approved based only on its capital costs without duly considering the implications for the recurrent budget, then it is likely that future budget problems will be created. In addition, pressure to minimize recurrent expenditures makes it likely that the legitimate maintenance needs of existing capital infrastructure (which form part of the recurrent budget) will be overlooked at the expense of creation of new capital infrastructure. The result is that existing infrastructure deteriorates rapidly in the absence of proper maintenance, even though allocation of resources on maintenance (instead of additional capital construction) might result in more and better buildings and infrastructure.
- The annual budget plans of state and local governments, especially the capital budgets, are often completely unrealistic. These capital budget plans seem largely a political wish-list or even a notional budget, but the plans do not provide the basis for budget execution. This gives the state executive excessive discretion in determining the capital development budget, and this also makes the executive vulnerable to political attacks and political pandering.
- The entire budget process ignores the intertemporal dimension of capital infrastructure. Unlike recurrent expenditures, it is appropriate for governments to engage in borrowing for capital expenditures because capital investments by definition generate a stream of benefits in future years. This is not institutionalized in any way in the Nigerian budget process.
- Concerns with the effectiveness, efficiency, and transparency of the budget process will make potential lenders (banks and private investors), international financial institutions, and donor agencies hesitant to provide funds to state and local governments. Consider the lender's perspective. Would an institution wish to loan funds to an entity that has poor control over its budget process? Would the institution

not like to know how the loan is being used (e.g., for a revenue-generating activity that will generate user fees or other revenues that could potentially guarantee the loan)? If not, how would the loan be secured? The current nature of the budget formulation process obscures the answers to these questions.

6. IMPROVING THE SUBNATIONAL BUDGET FORMULATION PROCESS

Over the last decade, a large number of both developing and developed countries have introduced significant reforms in the budgeting process. Three general trends can be discerned in these reforms. First, many countries have started to devolve budgetary responsibilities from the central budget authority to individual spending departments, thus giving these departments the freedom to allocate funds within centrally determined departmental spending limits. Second, a large number of countries have introduced result-oriented budgeting techniques into the budget process. These techniques are known under a variety of names, such as “strategic budgeting” or “performance-based budgeting.” They require as part of the budget process and as a measure of departmental performance that the government unit clearly states its mission, the objective it wishes to achieve, and the progress it makes toward achieving the mission and objective. These two sets of reforms are aimed at enhancing the efficiency with which public resources are allocated. A third general trend is that in recent years many countries have moved to frame their annual budget process in a strategic multi-year framework.

Based on the shortcomings of the subnational budget processes in Nigeria, these trends are clearly relevant in Nigeria. While the fiscal management capacity of many local governments is likely to be insufficient to support effective reforms, a number of steps could be taken that would significantly improve the budget process at the state government level.

1. End the current separation of recurrent and capital budgets. As discussed in the previous section, Nigeria’s current budget structure fails to give state agencies effective ownership over their capital budget projects. Typically, the State Ministry of Planning and Economic Development or the State Ministry of Finance prepares the capital budget, either jointly or on behalf of the state line ministries, but no agency currently owns the capital budget in the same way that recurrent budgets are attached to individual ministries. While this practice gives a measure of political and fiscal control to the Governor, it also fails to give line ministries an incentive to prioritize expenditures and to respect the overall budget constraint. Line ministries are not expected to give up resources from their recurrent budget to finance capital expenditures in order to obtain a larger capital budget, or vice versa. As a result, the capital budget has become a wish-list budget for capital expenditures,¹² and the budget

¹² In addition to the over-budgeting of resources for capital expenditures, many line items carry a mark that reflects a notional entry (e.g., 10e) , allowing the executive branch flexibility to increase expenditures for items even if they are not contained in the budget

process fails to prioritize expenditure programs within a realistic budget constraint. Further, the state legislature's role in the budget process is diminished, and too much discretion over the capital budget has come to reside with the Governor's office. As far as possible, state and local governments should end the artificial separation of the recurrent and capital budgets and should instead integrate the capital budget in the regular budget process.

A sound budget process determines resource envelopes for sectoral policies and then lets line ministries develop and plan capital development projects within the sector.¹³ The first step of a sound budget process is to start with the determination of a realistic estimate of overall resource availability for the coming budget year, based largely on revenue estimates for internally generated revenues and projected transfers from the federal allocations. The second step in determining budget allocations is to set priorities for different sectoral objectives that the government is trying to achieve. These sectoral priorities should be determined before considering the separation between recurrent and capital expenditures. Once an overall fiscal strategy is plotted, the government should divide all its available resources along these sectoral objectives.

2. Establish clear sectoral strategies and give line ministries policy discretion. In order to achieve a level of transparency and accountability, each ministry and state agency should have a clearly defined mission, a clearly defined objective, and a well-defined policy goal. Also, sectoral priorities should be determined by those policy experts best informed about what the sector needs, namely the line ministries themselves. Each line ministry should specify and budget for the programs and projects that it seeks to pursue in order to achieve these missions, objectives, and goals. As part of the budget exercise, each sectoral ministry should be allowed to decide the preferred allocation of resources between recurrent and capital expenditures. Thus, sectoral ministries should determine the level of spending on capital items, and do so in consideration of their recurrent budget. This set-up forces line ministries to plan their sectoral budgets programs realistically and to consider direct trade-offs between the benefits between capital investments and recurrent expenditures.

The proposed reforms do not necessarily require that the entire structure of the budget document be abandoned. Many of the changes are of a procedural nature, and can be accommodated within the current budget structure. However, these recommendations require that the decision-making structure for recurrent and capital expenditures be fully integrated with the line ministries. For increased transparency, each ministry should be required to publish its mission, strategy, and unified budget proposal (including both

plan.

¹³ Of course, the Ministry of Planning or another central state agency may be tasked to provide technical assistance to the line ministries, or to supervise procurements and procedures. Nevertheless, control over sectoral funds should be firmly placed with the line ministries.

recurrent and capital budgets) as part of the annual budget process.

3. Improve accountability and reporting requirements. A sound budget approach would abandon the current emphasis on capital expenditures, and would instead place the focus on sectoral policy objectives. Of course, the fear in pursuing this approach is that the line ministries will not make decisions to achieve their policy objectives, but instead will seek to maximize political power, will seek to increase the number of civil servants within their ministry, or will neglect to fund capital expenditures. To some extent, these concerns may be based on past experience. However, three mechanisms should place some restraints on line ministries at the state level. First, line ministries should be required to follow the annual sectoral budget, which is approved by the state legislature; regular expenditure reports should be produced by the line ministries and the Ministry of Finance, and any deviations from the budget plan should be either approved or should be penalized if not approved. Second, the Governor should monitor on a day-to-day basis the implementation of sectoral policies and hold individual ministers accountable. Third, political pressure from the legislature, civil society groups, and individual voters should provide an additional level of control on the line ministers when sufficient reporting requirements are imposed on line ministries.

4. Reform the financing of capital projects by introducing borrowing for capital expenditures. In order to ensure increased efficiency in the allocation of public resources, the method of financing capital projects should also be reformed. As emphasized earlier, the budget formulation process creates an artificial bias in favor of capital expenditures. In contrast, the current budget structure provides ministries with very little political incentive to invest in capital projects, since the benefits from a capital project are spread out over many years while the cost has to be borne up-front. The appropriate solution is to move away from mandating high levels of capital expenditure as is done in the current system, in part by reforming the ways in which governments may borrow for capital purposes.

It is apparent that one problem that limits capital development at the state level in Nigeria is the inability of the state to borrow for capital development purposes. This inability is caused by a number of factors, including the lack of donor resources for subnational development, the poor relationship between the Government of Nigeria and international financial institutions, the lack of creditworthiness of Nigeria on international credit markets, and the absence of a well-developed domestic capital market. Despite these constraints, state and local governments should work to come up with an alternative method of capital financing as part of a renewed focus on the efficient use of public resources.

As discussed earlier, Nigeria's federal government appears to be moving toward a system of on-lending for state governments, using the Federation Account as a guaranteeing/withholding mechanism. If resources are indeed made available through this mechanism, on-lending is likely to play an important role in improving the ability of

subnational governments to implement capital projects.¹⁴ In [on-lending], the federal government plays an intermediary role between the Nigerian states and the international financial institutions.¹⁵ In this set-up, the federal government would get a loan from an international financial institution for capital development, and the federal government would then on-lend the money to the states based on some predetermined mechanism. Repayment for each state's loans would automatically occur through withholdings from the Federation Account, thus providing both a guarantee of repayment for the donor and the federal government and appropriate incentives for the state government.

Subnational borrowing for capital investment purposes would substantially change the role of the capital component of the state budget. Instead of budgeting actual outlays for capital development and construction, the capital budget would comprise the cost of servicing loans (interest payments and repayment of loan sum) of monies borrowed by the state for capital investment purposes.

Within the state budget process, a line ministry would have to propose capital development projects in line with the state's stated policy objectives. If loan funds were available for the purpose at hand and when approved as part of the annual budget process, the line ministry would commit to the repayment of the loan as part of its entire sectoral budget, including the recurrent and capital components. The line ministry would subsequently include repayment of the loan in its annual capital budget for the term of the loan. Instead of disbursing these funds to the line ministry, the Ministry of Finance would simply certify that the loan payment has been made as part of the state's withholdings from the Federation Account.

This approach is desirable for several reasons:

- It would resolve the intertemporal dimension of capital projects, assuring that payments for the project would coincide with the period over which benefits flow from the capital

¹⁴ On-lending is not the only manner in which Anambra State could resolve the intertemporal problem surrounding funding capital projects. One way around this dilemma is to let the private sector engage in the development and financing of capital projects, based on a contractual arrangement with the state. In this set-up, the state would rent or lease buildings and other infrastructure based on long-term contracts. This arrangement could substantially reduce the problems associated with financing, implementing, and monitoring capital projects. However, it would also require multi-year commitments of public resources in the budget process, and trust on behalf of the partners that the contractual commitments will be honored in the long term. Federal guarantees through the Federation Account could substantially reduce the risk of state-level defaults.

¹⁵ As a rule, international financial institutions such as the International Monetary Fund and the World Bank only provide loans to national governments, not directly to subnational governments.

projects;

- It would allow a substantial increase in capital expenditures over the current practice because the capital budget would only be applied towards servicing long-term loans, thereby allowing a multitude of capital projects to be financed and implemented simultaneously; alternatively, it would allow for a reduction in overall capital expenditures and a corresponding increase in recurrent expenditures, if such a reallocation was desired;
- It would allow for the full-funding of a capital infrastructure project all at once as opposed to the incremental, piece-meal funding that is necessitated by the many ongoing capital development projects and the limited resources available for a number of competing capital projects.

7. IMPROVEMENTS IN SUBNATIONAL BUDGET IMPLEMENTATION

The ability of state and local governments to engage in capital infrastructure development is not only limited to the problems that they encounter in the budget formulation process. Additionally, the effectiveness with which state and local governments are able to engage in capital development is limited by shortcomings in the implementation of the capital expenditure budgets. Transparent and systematic budget implementation, including budget controls, tender procedures, and audits of capital projects, is needed.

1. Reducing Discrepancies between the Budget Plan and Actual Expenditures. For many state and local governments, huge discrepancies arise between the proposed budget plan and the actual allocation of government resources.¹⁶ Table 3.6 compares budget plans and actual expenditures by expenditure category, and finds only a very weak correlation between the plans and actual expenditures.

The deviations between state and local budget plans and the amounts actually spent are in part due to the inadequate ability of subnational governments to forecast the resources available to them. As a result, the budget process becomes mainly a political exercise, often a notional wish-list of projects, rather than the formulation of a “real” budget plan that the government intends to implement. The failure of the budget formulation process to come up with a realistic budget was addressed earlier. However, differences between budget plans and actual expenditures are also due to systematic policy deviations during budget execution. In the absence of clearly stated strategic expenditure priorities, expenditure plans simply get

¹⁶ At the state level, the budget plan is presented by the Governor and, after debate and modification, approved by the state legislature. Of course, under the previous military regime, there was no accountability through any elected body.

changed throughout the budget year. These changes may be due to policy priorities that change over time, to politically motivated changes in spending, or to transactions of a corrupt nature.

The budget execution process may also fail in its goals by allowing actual expenditures to deviate from the budgeted amounts. This deviation is likely due to a lack of transparency in the budget process, as well as due to poor budget control and audit mechanisms. Correspondence between budget plans and actual expenditures is increasingly important in the new democratic setting. In a democratic environment where the legislature holds the power of the purse, democracy is diminished if the executive branch is able to substantially modify spending priorities without being held accountable by the elected representatives in the legislature.

The development of an efficient, consistent, and transparent budget process finds its roots in a well-formulated budget. In the absence of realistic sectoral strategies and ministerial budget plans, it is not possible to assess the budget performance of any government agency. Once a ministry has clearly stated objectives and goals, and once ministries have laid out in detail the capital development activities that they will pursue within the resources available to them, a much greater understanding can be achieved by the stakeholders and the public about the capital expenditure process. At the end of the budget year, a public budget document should report and publicize how actual ministerial spending coincided with the budget plan. The efficiency of public spending can be improved by giving individual line ministries increased discretion over sectoral priorities (such as allowing line ministries to prioritize between recurrent and capital spending), while also holding line ministries accountable for poor budgetary decisions.

Additionally, the ex post reporting of actual budget expenditures for subnational government budgets is often inadequate. It is virtually impossible to find accurate and timely published reports of actual expenditures of state or local governments in Nigeria. Accordingly, stronger budgetary reporting requirements and controls should be put in place in order to increase the transparency of the budget process.

This recommendation has clear political implications. First, in order for individual ministers to be held accountable, they will have to operate in a more transparent manner. It is quite likely that ministers will resist any move to subject their activities to greater scrutiny. Second, allowing line ministries greater discretion over the budget process requires a reduction in the role of the governor over the budget because the executive would have to allow individual line ministries increased authority over their own budget. Currently, the governor holds substantial discretion in approving capital projects and related expenditures irrespective of whether these projects were prioritized in the state's budget. As such, we also recommend that the governor use his position in the budget process to assure that the implementation of the budget coincides with the budget plan, and as a rule to deny requests for budgetary spending that is inconsistent with individual ministry's budget plans.

2. Monitoring capital projects via fiscal controls, audits, and computerization. The fiscal management process at the subnational level limits the state or local government's capacity to implement and to monitor capital projects efficiently and effectively. The need to monitor capital projects is accentuated both by the high levels of capital expenditures and by the reality that capital projects are particularly prone to manipulation, fraud, and abuse.

The absence of a computerized financial management and reporting system increases the chance of errors in the budget process, and also increases the ability of budget officials to manipulate the budget process. The introduction of a computerized financial management system would improve the efficiency, the effectiveness, and the transparency of the budget process, and would further facilitate systematic reporting of budget data. Since computerization increases the transparency and accuracy of the budget process, it would increase efficiency in budget administration, increase the level of accountability in the budget process, and reduce the ability of budget officials to manipulate budget resources.

3. Improving capital project implementation. Another concern regarding the current approach to implementing capital projects is that it ignores the cost of capital. Casual observation suggests that a relatively large number of capital projects were started in the past few years and that the number of ongoing projects quite possibly exceeds the ability of state and local governments and their contractors to effectively implement these projects. It is quite possible that this is the result of a political desire to engage in highly visible projects, or this may simply be due to the budget process's inability to adequately prioritize projects. We are concerned that available resources are used inefficiently because it appears that many capital projects are started that are not finished in a timely manner, thereby tying up resources in unfinished capital projects. This is a problem for a number of reasons. First, these resources could have been invested or saved, in which case they would have provided a significant financial return, especially since interest rates in Nigeria are high and also since it takes several years to finish a capital project. Second, unfinished capital projects have a tendency to deteriorate over time after construction begins, and there is a higher chance of theft of construction materials if the construction period is extended. Thirdly, as the development period of capital infrastructure projects drags on, there is some chance that the project is simply never finished, thereby wasting all the resources put into the project over time.

To the extent possible and practical, the implementation of capital projects should take into account these concerns. State and local governments should make every effort to prioritize the capital projects that they wish to execute within the budget constraints. The cost-benefit analysis and capital budget plans should include realistic construction schedules, and contractors should be penalized for not completing projects in a timely fashion

4. Providing loan guarantees? A final concern with the budget execution process at the subnational government level is somewhat preemptive, and regards a practice known to economists as "contingent liabilities." With the recent democratic reforms, there have been suggestions that resources may be forthcoming from donors, non-governmental

organizations (NGOs), and expatriated Nigerians, resources that could be put to use for poverty alleviation activities, the construction of housing, and so on. It has also been suggested that these resources could play a major role in the state's economic development efforts. Some subnational policy makers hope that subnational government might be able to harness these resources in order to improve the well-being of the people. For instance, NGOs or private firms could implement housing projects and engage in the development of markets and other public amenities, while the government would simply guarantee the loans necessary to accomplish such projects. Of course, it is envisioned that the loan would be repaid from rents and market fees generated by the project.

We would warn against the unbridled use of government loan guarantees for a number of reasons:

- Loan guarantees are really a form of off-budget financing, and constitute what is known as a “contingent liability: contingent upon the borrower defaulting on the loan, the loan amount becomes an actual budget liability. As such, such guarantees should be accounted for in some manner in the budget in order to prevent a budget deficit in the event that the state becomes liable for paying these guarantees upon borrower defaults.
- It is very hard to perform accurate financial projections in an unstable economic environment such as Nigeria. Unanticipated inflation, unexpected economic downturns, or unforeseen economic and political events may disrupt the flow of revenues that are anticipated in future years to pay for the project, likely triggering a default. In addition, the introduction of a loan guarantee actually increases the likelihood of default, since both the bank and the borrower are comforted by the knowledge that the loan will be repaid in case of default. Experience elsewhere shows clearly that defaults are common on loans guaranteed by government, a result that would leave the government with a significant real cost in paying off the loans or being forced to default on the loan itself. Loan guarantees are also often used for political patronage and other corrupt practices and as such should be considered very carefully.
- Government loan guarantees raise fundamental questions regarding the role of government, the role of the private sector, and the separation of the public and private sectors. In some cases there might well be a role for government to be a broker of sorts, especially when various kinds of imperfections, especially information imperfections, prevent the emergence of financial markets. However, the provision and construction of, say, housing are predominantly private sector functions.
- Even in the case of poverty alleviation, many objectives can be achieved by regulatory or supervisory activities, without the risks brought by loan guarantees. In fact, most poverty alleviation activities cannot rely on loan guarantees because many poverty alleviation activities do not pay for themselves. For instance, if the state underwrites a loan to fund housing for poor households, these households are unlikely to be able to afford rent payments sufficient to make the project profitable; with default, the

government would simply bear the burden of the original project. This type of loan can only be repaid if the housing is occupied by non-poor, rent-paying households, and in this setting the project would do little to alleviate poverty.

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Table 2.1
Assignment of Expenditure Responsibilities in Nigeria, 1999

Assignment	Federal	State	Local
Defense	National defense		
Foreign Affairs	Diplomatic and consular missions; international treaties; foreign policy		
Public Order	National police, security services, prisons	State public order	
Trade and commerce	Commercial policy, banking, insurance, bankruptcy, international trade, interstate trade	Intra-state trade and commerce	Local markets; slaughter houses; local economic development
Natural Resources	Mines and mineral, including oil and gas surveying and mining		Natural resource development other than minerals
Agriculture and Fisheries	Promotion of agricultural research and production; fishing rights	Development of state agricultural	Local agriculture development
Health	Federal health policy	State health policy	Local health services
Education and Science	University and professional education; scientific and technological research; national statistics	Regulation of primary education; provision of post-primary education; University and professional education; scientific and technological research	Provision and maintenance of primary school and vocational training
Transportation networks and public transportation	Aviation policy and airports; railways; federal highways	State highways; public transit	Local roads and highways; local public transit

Source: 1999 Constitution of the Republic of Nigeria (Second and Fourth Schedules)

Table 2.2
Government Sector Expenditures by Level of Government, 1980-98
(as percent of total)

Year	Federal Expenditures	State Expenditures	Local Expenditures
1980	67.6	32.4	-
1981	50.9	49.1	-
1982	51.4	48.6	-
1983	47.9	52.1	-
1984	58.2	41.8	-
1985	68.8	31.2	-
1986	73.6	26.4	-
1987	72.6	27.4	-
1988	71.9	28.1	-
1989	75.9	24.1	-
1990	75.0	25.0	-
1991	68.4	27.7	3.9
1992	68.0	26.9	5.1
1993	75.0	17.3	7.7
1994	68.2	23.7	8.1
1995	71.3	22.3	6.4
1996	72.7	21.2	6.1
1997	74.5	19.3	6.2
1998	71.0	22.2	6.8
1999	81.2	14.0	4.8

Note: “-“ indicates that data are not applicable or available.

Source: Computed by authors based on data supplied by the Central Bank of Nigeria.

Table 3.1
Tax Administration and Collections: Federal, State and Local Responsibilities

Federal Government	State Government	Local Government
1. Companies income tax	1. Personal income tax (Pay-As-You-Earn and Self-Assessment)	1. Shops and kiosks rates
2. Withholding tax on companies for non-residents and FCT Abuja	2. Withholding tax on individuals	2. Tenement rates
3. Petroleum profits tax	3. Capital gains tax on individuals	3. Liquor License fees
4. Value added tax	4. Stamp duties on individuals	4. Slaughter slab fees
5. Education tax	5. Gambling taxes	5. Marriage, birth, death registration fees
6. Capital gains tax for non-residents, corporate bodies and FCT Abuja	6. Road taxes	6. Street naming fees (excl. State Capital)
7. Stamp duties for non-residents, corporate bodies and FCT Abuja	7. Business premises registration fee	7. Right of occupancy fees
8. Personal income tax for military and police personnel, non-residents, and FCT Abuja	8. Development levy on individuals	8. Market taxes and levies
	9. Street naming registration fee for State Capital	9. Motor park levies
	10. Right of occupancy fees	10. Domestic animal license fees
	11. Market taxes and levies	11. Bicycle, truck, canoe, cart fees
		12. Cattle tax
		13. Merriment and road closure levy
		14. Radio and television licence fees
		15. Vehicle radio licence fees
		16. Wrong parking charges
		17. Public convenience, sewage and refuse disposal fees
		18. Customary burial ground permit fees
		19. Religious places establishment permit fees
		20. Signboard / advertising fees

Source: Decree 21, Taxes and Levies (Approved List for Collection), 30 September 1998.

Table 3.2
Federal Allocations to the States and State Internal Generated Revenue, 1999

State	In Naira per capita				As a percent of total		
	Federal Allocations	Internal Generated Revenue	Other Revenues	Total Revenues	Federal Allocations	Internal Generated Revenue	Other Revenues
Abia	978.1	179.2	25.7	1,183.0	82.7	15.1	2.2
Adamawa	1,221.6	140.9	94.2	1,456.7	83.9	9.7	6.5
Akwa Ibom	1,226.6	395.4	167.1	1,789.2	68.6	22.1	9.3
Anambra	926.8	233.5	39.1	1,199.4	77.3	19.5	3.3
Bavelsa	2,677.4	633.9	0.0	3,311.2	80.9	19.1	0.0
Bauchi	822.9	31.2	80.1	934.2	88.1	3.3	8.6
Benue	1,061.6	206.2	58.5	1,326.4	80.0	15.5	4.4
Borno	1,072.8	86.5	0.0	1,159.4	92.5	7.5	0.0
Cross River	1,380.4	196.1	24.2	1,600.8	86.2	12.3	1.5
Delta	1,265.1	746.7	54.0	2,065.8	61.2	36.1	2.6
Ebonvi	1,966.6	79.8	0.0	2,046.4	96.1	3.9	0.0
Edo	1,175.5	587.6	125.1	1,888.3	62.3	31.1	6.6
Ekiti	1,160.7	131.0	0.0	1,291.7	89.9	10.1	0.0
Enugu	1,068.0	254.8	0.0	1,322.7	80.7	19.3	0.0
Gombe	2,025.2	154.9	0.0	2,180.1	92.9	7.1	0.0
Imo	988.5	150.9	0.0	1,139.4	86.8	13.2	0.0
Jigawa	938.2	60.2	83.5	1,081.8	86.7	5.6	7.7
Kaduna	865.2	242.9	0.0	1,108.2	78.1	21.9	0.0
Kano	630.3	143.3	201.3	975.0	64.7	14.7	20.6
Katsina	852.4	86.3	0.0	938.7	90.8	9.2	0.0
Kebbi	1,177.3	141.4	0.0	1,318.7	89.3	10.7	0.0
Kogi	1,138.5	161.1	24.5	1,324.1	86.0	12.2	1.9
Kwara	1,536.2	270.1	183.0	1,989.3	77.2	13.6	9.2
Lagos	1,015.5	1,174.6	172.7	2,362.9	43.0	49.7	7.3
Nassarawa	1,728.5	76.0	75.9	1,880.4	91.9	4.0	4.0
Niger	1,203.4	120.1	0.0	1,323.5	90.9	9.1	0.0
Ogun	1,165.5	410.1	77.3	1,652.9	70.5	24.8	4.7
Ondo	1,270.7	359.6	0.0	1,630.3	77.9	22.1	0.0
Osun	1,027.7	357.6	143.3	1,528.6	67.2	23.4	9.4
Ovo	910.5	215.1	227.3	1,352.8	67.3	15.9	16.8
Plateau	1,161.2	166.3	0.0	1,327.5	87.5	12.5	0.0
Rivers	978.0	1,018.1	0.0	1,996.0	49.0	51.0	0.0
Sokoto	1,059.3	77.1	0.0	1,136.4	93.2	6.8	0.0
Taraba	1,611.2	122.1	86.0	1,819.2	88.6	6.7	4.7
Yobe	1,762.4	59.8	31.1	1,853.4	95.1	3.2	1.7
Zamfara	1,159.9	30.6	0.0	1,190.5	97.4	2.6	0.0
FCT Abuja	9,214.1	1,377.4	0.0	10,591.5	87.0	13.0	0.0
Average	1,443.9	294.0	53.3	1,791.3	80.8	15.6	3.6
CV	0.949	1.085	1.274	0.872	0.161	0.736	1.370
Minimum	630.3	30.6	0.0	934.2	43.0	2.6	0.0
Maximum	9,214.1	1,377.4	227.3	10,591.5	97.4	51.0	20.6

Note: Preliminary data.

Source: Computed by authors based on data from the State Governments' Accountants-General's Reports as reported by the Central Bank of Nigeria.

Table 3.3
Nigeria: Consolidated State Government Recurrent Revenues, 1995-1999

	Per capita (in Naira)					<i>As percent of total</i>				
	Federation Account	VAT Sharing	State Revenue	Other Revenue	Total Current Revenue	Federation Account	VAT Sharing	State Revenue	Other Revenue	Total Current Revenue
1995	388.7	63.7	173.7	57.2	683.4	56.9	9.3	25.4	8.4	100.0
1996	405.5	110.3	190.3	168.9	875.0	46.3	12.6	21.7	19.3	100.0
1997	483.8	132.2	260.1	45.5	921.6	52.5	14.3	28.2	4.9	100.0
1998	610.7	149.8	270.0	293.1	1,323.6	46.1	11.3	20.4	22.1	100.0
1999(p)	931.7	213.5	306.6	67.2	1,519.0	61.3	14.1	20.2	4.4	100.0

Note: (p) Preliminary data.

Source: Computed by authors based on data from the State Governments' Accountants-General's Reports as reported by the Central Bank of Nigeria.

Table 3.4
Measures of State Fiscal Capacity

State	Mean Household Income Per Capita	VAT Collections
Abia	7,377.3	252.2
Adamawa	4,847.1	51.7
Akwa Ibom	3,967.5	47.3
Anambra	1,008.5	114.3
Bayelsa	8,705.2	183.1
Bauchi	3,873.8	47.4
Benue	7,686.8	34.9
Borno	4,519.1	45.9
Cross River	4,264.1	75.9
Delta	5,033.0	485.3
Ebonyi	6,102.5	65.5
Edo	5,539.8	119.5
Ekiti	3,639.7	33.6
Enugu	6,102.5	102.7
Gombe	3,873.8	165.3
Imo	5,852.6	56.5
Jigawa	2,831.3	11.0
Kaduna	5,847.5	285.6
Kano	4,706.5	101.4
Katsina	4,380.6	28.3
Kebbi	2,324.6	57.1
Kogi	3,425.3	44.5
Kwara	3,876.1	81.0
Lagos	7,524.3	1,708.6
Nassarawa	6,434.2	73.9
Niger	5,824.4	58.4
Ogun	3,327.9	211.8
Ondo	3,639.7	54.8
Osun	3,158.5	32.8
Oyo	9,250.5	176.5
Plateau	6,434.2	109.3
Rivers	8,705.2	702.2
Sokoto	2,587.3	62.2
Taraba	4,294.6	62.6
Yobe	3,210.2	50.0
Zamfara	2,587.3	35.1
Unweighted mean	4,910.1	161.9
Weighted mean	5,058.5	173.6
Coefficient of Variation	0.400	1.841
Minimum	1,008.5	11.0
Maximum	9,250.5	1,708.6

Note: VAT collections are an annualized estimate based on VAT collections from January-September 2000.

Sources: Annual Abstract of Statistics (1997) and computed by authors based on data provided by the Revenue Allocation Commission.

Table 3.5
Measures of State Fiscal Need

	Estimated Population in 1999 (million)	Population Density (per square kilometer)	Poverty Rate (percent)	Extreme Poverty Rate (percent)	Unemployment Rate (percent)	Primary School Enrolment (per 1000)	Secondary School Enrolment. (per 1000)
Abia	2.92	462.6	42.8	20.5	6.4	184.5	54.2
Adamawa	2.63	71.2	44.6	10.4	9.4	211.1	24.8
Akwa Ibom	3.01	425.4	49.4	12.9	6.6	241.2	60.4
Anambra	3.50	721.7	23.9	3.8	8.3	130.8	49.7
Bayelsa (**)	1.19	246.6	27.5	7.7	6.4	12.3	44.4
Bauchi (**)	3.58	84.2	72.6	33.8	0.1	95.0	20.1
Benue	3.44	101.1	45.8	14.7	0.3	220.9	49.8
Borno	3.17	44.7	30.7	5.0	0.1	212.1	26.4
Cross River	2.39	118.5	45.4	11.4	4.4	110.1	42.7
Delta	3.24	183.0	49.6	20.5	2.0	155.6	84.4
Ebonyi (**)	1.29	307.3	38.0	8.3	8.3	178.3	37.3
Edo	2.72	152.5	39.4	9.1	2.0	208.8	87.3
Ekiti (**)	2.25	225.8	54.0	16.3	2.8	137.7	41.1
Enugu (**)	2.66	307.3	38.0	8.3	8.3	178.3	37.3
Gombe (**)	1.86	84.2	72.6	33.8	0.1	95.0	20.1
Imo	3.11	561.9	46.5	15.4	6.4	201.9	67.0
Jigawa	3.59	155.3	50.7	9.3	4.6	111.9	7.5
Kaduna	4.92	106.8	38.5	8.1	5.1	7.0	30.9
Kano	7.26	360.8	36.7	8.9	4.6	12.6	16.2
Katsina	4.69	193.9	52.2	10.8	0.7	151.7	14.1
Kebbi	2.59	70.3	65.8	24.8	0.2	88.9	11.6
Kogi	2.68	90.0	79.2	46.8	1.6	199.3	46.2
Kwara	1.94	52.6	60.0	24.2	1.6	182.3	67.4
Lagos	7.16	2,139.7	55.8	39.5	9.6	134.2	91.9
Nassarawa (**)	1.51	71.4	48.6	12.6	0.1	194.2	45.0
Niger	3.03	39.6	36.2	6.7	1.4	151.1	43.4
Ogun	2.92	174.1	49.5	17.5	1.4	175.7	74.5
Ondo (**)	2.48	225.8	54.0	16.3	2.8	137.7	41.1
Osun	2.70	291.6	48.0	12.8	0.1	253.1	8.7
Oyo	4.32	151.7	28.7	8.3	0.1	191.9	84.1
Plateau (**)	2.63	71.4	48.6	12.6	0.1	194.2	45.0
Rivers (**)	4.20	246.6	27.5	7.7	6.4	12.3	44.4
Sokoto (**)	3.02	85.0	70.5	33.0	0.2	61.5	13.1
Taraba	1.89	34.7	46.2	22.3	9.4	247.2	29.4
Yobe	1.75	38.5	68.5	30.5	0.1	283.3	8.1
Zamfara (**)	2.56	85.0	70.5	33.0	0.2	61.5	13.1
FCT Abuja	0.46	63.5	30.0	5.3	9.3	91.9	103.3
Average	3.0	239.1	48.3	16.8	3.6	149.1	42.9
Coefficient of Variation	0.460	1.495	0.296	0.644	0.965	0.484	0.604
Minimum	0.5	34.7	23.9	3.8	0.1	7.0	7.5
Maximum	7.3	2,139.7	79.2	46.8	9.6	283.3	103.3

Sources: Annual Abstract of Statistics (1997). (**) Based on old state

Table 3.6
Regression Analysis of State-Level Revenue Sources

Dependent Variable	Explanatory Variable					R ²
	Intercept	Fiscal Capacity	Poverty	SSE	Population Density	
Per Capita IGR Collections						
Coefficient Estimate	222.95	0.82	-2.94	2.43	-0.20	0.76
t-statistic	2.06	5.77	-1.70	2.13	-1.75	
Fiscal Effort						
Coefficient Estimate	255.53	-0.56	-0.04	0.81	0.32	0.16
t-statistic	1.45	-2.42	-0.01	0.44	1.73	

Note: Bold indicates statistical significance at the 5 percent level.

Table 3.7
Aggregate Local Government Finances, 1995-1999
(in Naira millions)

	1995	1996	1997	1998	1999
Current Revenue:	24,412.7	23,942.1	31,183.3	44,968.2	56,012.0
Federation Account	17,875.5	16,569.7	20,443.3	30,620.9	36,746.9
State Allocation	625.4	691.1	578.9	750.4	719.2
Vat	3,558.1	4,581.7	7,515.0	10,170.8	13,903.9
Internal Revenue	2,110.8	2,027.1	2,506.9	3,331.6	4,047.8
Grants And Others	242.9	72.5	139.2	94.5	594.2
Recurrent Expenditure	16,317.2	17,292.5	21,856.5	29,135.2	37,265.6
Current Surplus (+)/Deficit (-)	8,095.5	6,649.6	9,326.8	15,833.0	18,746.4
Capital Expenditure	6,126.1	6,969.2	8,083.4	14,864.7	18,530.8
Total Expenditure	22,443.3	24,261.7	29,939.9	43,999.9	55,796.4
Overall Surplus(+)/Deficit(-)	1,969.4	-319.6	1,243.4	968.3	215.6
Financing:					
Loans	50.5	24.0	79.4	39.9	74.4
Other Funds	-2,019.9	295.6	-1,322.8	-1,008.2	-290.0

Source: Central Bank of Nigeria, Annual Report and Statement of Account for the Year Ended 31st December, 1999.

Table 4.1 A
Federation Account: Vertical Allocation Formula

	1960	1963-67	1980	1982	1987	1990	1993	1995- 2000
Federal Government	70	65	55	55	55	50	48.5	48.5
Regional/State Government	30	35	34.5	34.5	32.5	30	24	24
Local Governments	0	0	8	10	10	15	20	20
Special Funds	0	0	2.5	0.5	2.5	5	7.5	7.5
Total	100	100	100	100	100	100	100	100

Note 1: Between 1960 and 1976 local governments were funded through the regional/state governments.

Note 2: Oil states also receive a portion of mineral resources on a derivation basis.

Source: Approved Budgets of the Government of the Federal Republic of Nigeria; CBN Changing Structure

Table 4.1 B
VAT Allocation: Vertical Allocation Formula

	1994	1995	1996	1997	1998	1999	2000
Federal Government	20	50	35	35	25	15	15
State Government & FCT	50	30	40	40	45	50	50
Local Government	30	20	25	25	30	35	35
Total	100	100	100	100	100	100	100

Note: VAT sharing started in 1994

Source: Approved Budgets of the Government of the Federal Republic of Nigeria

Table 4.2
Vertical Fiscal Balance:
Fiscal Balance at Each Level of Government (as percent of GDP)

	1995	1996	1997	1998	1999
Federal Government					
Current Revenue (*)	15.7	13.5	14.9	13.0	22.3
Recurrent Expenditures	6.8	4.5	5.6	6.6	15.1
Capital Expenditures	8.9	7.8	9.5	11.4	16.7
Recurrent Fiscal Balance	8.9	8.9	9.3	6.5	7.2
Overall Fiscal Balance	0.1	1.2	-0.2	-4.9	-9.6
Consolidated State Governments					
Current Revenue	3.5	3.3	3.4	5.3	5.7
Recurrent Expenditures	2.8	2.0	2.1	2.8	3.5
Capital Expenditures	1.3	1.1	1.2	2.3	2.0
Recurrent Fiscal Balance	0.7	1.3	1.3	2.5	2.2
Overall Fiscal Balance	-0.6	0.2	0.2	0.2	0.2
Consolidated Local Governments					
Current Revenue	1.2	0.9	1.1	1.7	1.9
Recurrent Expenditures	0.8	0.6	0.8	1.1	1.3
Capital Expenditures	0.3	0.3	0.3	0.5	0.6
Recurrent Fiscal Balance	0.4	0.2	0.3	0.6	0.6
Overall Fiscal Balance	0.1	0.0	0.0	0.0	0.0
Memo: GDP (billions of Naira) (**)	1,961	2,740	2,835	2,717	2,974

Note 1: (*) Federally retained revenue excluding state and local share of Federation Account and VAT.

Note 2: (**) 1999 estimate based upon 6.6% inflation rate and 2.7% real growth rate.

Source: 1999 Central Bank of Nigeria Report 1999, International Monetary Fund.

Table 4.3
Regression Analysis of State-Level Revenue Sources

Dependent Variable	Explanatory Variable						R ²
	Intercept	Fiscal Capacity	Poverty	SSE	Population Density	Population	
Per Capita							
Federal Allocations							
Coefficient Estimate	1,176.15	0.15	1.21	1.13	-0.32		0.04
t-statistic	3.58	0.36	0.23	0.33	-0.94		
Federal Allocations (including Population)							
Coefficient Estimate	2,326.29	0.69	-3.86	-2.80	0.00	-295.01	0.63
t-statistic	8.78	2.45	-1.14	-1.24	0.02	-6.94	

Note: inclusion of effort into the fed alloc regression did not change R2 or significance
 Bold indicates statistical significance at the 5 percent level.

Table 4.4
Horizontal Distribution Formula, 2000

Basis	Percentage of Total Fund
Derivation:	
Oil Revenues	13
Equality:	40
Equality	40
Population:	30
Population	30
Land Mass and Terrain:	10
Land mass	5
Terrain	5
Social Development Factors:	10
Primary school enrollment	2.4
Secondary/commercial school enrollment	0.8
Inverse secondary/commercial school enrollment	0.8
Hospital beds	3
Water supply spread	1.5
Rainfall proportion	1.5
Internal Revenue Effort:	10
Ratio	2.5
Equality	7.5

Source: Federation Account Allocation Committee

Table 5.1
Nigerian Budget Process:
A Typical Budget Summary Statement

RECURRENT REVENUE	7,930,900,000
Internal Generated Revenue	861,000,000
State Share of Federation Account	6,419,910,000
VAT	649,990,000
RECURRENT EXPENDITURE	4,480,447,780
Consolidated Revenue Fund Charges	940,387,230
Personnel Cost	2,516,706,690
Overhead Cost	1,023,353,860
RECURRENT SURPLUS	3,450,452,220
Transfer to Capital Development Fund	3,450,452,220
CAPITAL RECEIPTS	13,911,407,000
a. Transfer from Consolidated Revenue Fund	3,450,452,220
b. Internal Loans	0
c. External Loans	7,679,952,000
d. Internal and External Grants	1,561,030,000
e. Government Fund Raising Activities	419,972,780
f. Other Receipts	0
g. Ecology	800,000,000
TOTAL BUDGET SIZE	18,391,854,780

Table 5.2
Comparison of Anambra State versus Other States:
Relative Importance of Recurrent and Capital Expenditures, 1999

State	Per Capita Expenditures			As Percent of Total		
	Recurrent	Capital	Total Expenditure	Recurrent	Capital	Total Expenditure
Abia	768.0	444.6	1,212.6	63.3	36.7	100.0
Adamawa	939.2	514.0	1,453.1	64.6	35.4	100.0
Akwa Ibon	1,121.1	627.2	1,748.3	64.1	35.9	100.0
Anambra	744.3	323.1	1,067.4	69.7	30.3	100.0
Bayelsa	2,276.9	1,021.5	3,298.4	69.0	31.0	100.0
Bauchi	596.7	362.8	959.5	62.2	37.8	100.0
Benue	823.9	496.3	1,320.2	62.4	37.6	100.0
Borno	697.1	460.8	1,157.9	60.2	39.8	100.0
Cross River	963.6	647.1	1,610.7	59.8	40.2	100.0
Delta	1,368.3	838.1	2,206.4	62.0	38.0	100.0
Ebonyi	1,056.9	972.7	2,029.6	52.1	47.9	100.0
Edo	1,171.1	680.5	1,851.6	63.2	36.8	100.0
Ekiti	671.9	539.9	1,211.8	55.4	44.6	100.0
Enugu	816.9	467.0	1,283.9	63.6	36.4	100.0
Gombe	1,230.2	826.8	2,057.0	59.8	40.2	100.0
Imo	666.8	451.3	1,118.0	59.6	40.4	100.0
Jigawa	590.5	445.6	1,036.2	57.0	43.0	100.0
Kaduna	666.0	409.6	1,075.6	61.9	38.1	100.0
Kano	516.5	435.6	952.1	54.2	45.8	100.0
Katsina	578.0	318.2	896.2	64.5	35.5	100.0
Kebbi	778.3	467.2	1,245.5	62.5	37.5	100.0
Kogi	784.4	507.8	1,292.2	60.7	39.3	100.0
Kwara	1,158.0	777.4	1,935.4	59.8	40.2	100.0
Lagos	1,611.9	624.4	2,236.4	72.1	27.9	100.0
Nassarawa	937.5	790.5	1,728.0	54.3	45.7	100.0
Niger	8□6.5	387.2	1,273.6	69.6	30.4	100.0
Ogun	1,138.1	446.7	1,584.7	71.8	28.2	100.0
Ondo	1,081.3	508.3	1,589.7	68.0	32.0	100.0
Osun	1,065.8	431.5	1,497.3	71.2	28.8	100.0
Oyo	800.6	506.0	1,306.6	61.3	38.7	100.0
Plateau	716.5	502.0	1,218.6	58.8	41.2	100.0
Rivers	953.4	852.0	1,805.4	52.8	47.2	100.0
Sokoto	676.4	394.8	1,071.2	63.1	36.9	100.0
Taraba	1,155.0	596.1	1,751.0	66.0	34.0	100.0
Yobe	954.4	780.9	1,735.3	55.0	45.0	100.0
Zamfara	743.5	390.5	1,133.9	65.6	34□4	100.0
FCT Abuja	6,248.4	3,525.7	9,774.1	63.9	36.1	100.0
Average	1,079.8	642.5	1,722.3	62.3	37.7	
Coefficient of Variation	0.9	0.8	0.8	0.1	0.1	
Minimum	516.5	318.2	896.2	52.1	27.9	
Maximum	6,248.4	3,525	9,774.1	72.1	47.9	

Table 5.3
Capital Expenditures in Selected African Countries
(as percentage of total expenditure)

Country	Government Level	Capital Expenditures
Algeria	Central	26.49
Dem. Republic Congo	Central	4.90
Cote d'Ivoire	Central	26.45
Egypt	Central	24.04
Ethiopia	Central	29.78
Kenya	Central	11.73
Kenya	Local	10.27
Lesotho	Central	19.30
Morocco	Central	21.63
South Africa	Central	4.05
South Africa	Local	4.85
Tunisia	Central	20.58
Yemen	Central	17.10
Zambia	Central	30.89
Zimbabwe	Central	5.85
Zimbabwe	Local	12.76
Average		16.92
Coefficient of Variation		0.55
Minimum		4.05
Maximum		30.89

Source: Government Finance Statistic Yearbook 1999. International Monetary Fund.